PILLAR PACIFIC
CAPITAL MANAGEMENT, LLC

Quarterly Newsletter

Volume XXIII, Issue II | July 2019

Mindy L. Ying, MBA
President & CEO

Arthur T. French, CFA, CIC
Chief Investment Officer

Sonny C. Lin, CFA, CIC
Senior Portfolio Manager

Lily L. Ku, CFP®
Financial Planner

Kendra D. Baranko, CFA, CFP®
Portfolio Manager

Corey H. Liu, CFA
Associate Portfolio Manager

Jennifer S. Ying, CFP®, CPA
Financial Consultant

Joseph Fontamillas
Client Service Manager

Carmen L. Pon
Operations Manager

George F. Huang, CIPM
Project Manager

Jeremy W. Chang, MBA
Financial Consultant

Offices:

Southern California:
2650 Mission Street,
Suite 205,
San Marino, CA 91108
Tel: (626) 286-4029
(888) 295-4419
Fax: (626) 286-0624

Northern California:
210 Eureka Square
Pacifica, CA 94044
Tel: (650) 758-0130
Fax: (650) 758-0131

Texas:
2100 West Loop South,
Suite 900
Houston, TX 77027

www.PILLARPACIFIC.com

~OUR CHIEF INVESTMENT OFFICER'S COMMENTARY~

As trade negotiations with China drag on, it is important to review and understand the issues. **On one hand, the easy part of the dialogue simply involves the reversal of concessions granted in 1999 to entice China to join the General Agreement on Tariffs and Trade (GATT).** At the time, China was a developing economy and these concessions enabled China to become the second largest economy in the world. From a global trade perspective, it is difficult to justify allowing China to continue to enjoy these advantages at the expense of trading partners and competitors. This is the most easily understood and, perhaps, most easily resolved aspect of the trade negotiations.

But, under the guise of global trade, China forced the exchange of technology, sometimes willingly provided in exchange for commercial opportunity, and sometimes simply purloined. China's spy apparatus has been very aggressive at grabbing technological innovation when needed to enable their engineers to become competitive.

A significant aspect of the trade negotiations, then, involves the protection of intellectual property, now and in the future. Perhaps more than any other single issue, the initiative to develop the 5th generation of wireless communication technology (5G) is at the crux of this debate. In prior generations of wireless technology, the goal has been to provide consumers with faster and broader bandwidth. The result has been the communication, internet access, and data processing capabilities we currently enjoy on our mobile devices. **Applications of 5G will be very different; think of it as the enabling technology for the internet of things (IoT), with an immediate impact on the development of autonomous transportation systems and factory automation, and with obvious military and defense implications.**

This is where the debate with China over the fate of Huawei becomes critical. For the remainder of this newsletter, reference will be made to an article published in the *S. Rajaratnam School of International Studies Commentary*, by Donald K. Emmerson, who heads the Southeast Asia Program in the Shorenstein Asia-Pacific Research Center at Stanford University. **In his article, Emerson concludes, "Nothing can fully protect a country from secret malfeasance involving the company it hires to provide and maintain its 5th generation wireless system."**

Huawei is an ostensibly private company, founded by a former People's Liberation Army engineer. Emmerson points out that even if Huawei were to agree to safeguards to prevent access to a country's data, **the company would still be obliged to comply with the "intrusive prerogatives of the state authorized in China's National Intelligence Law, Article 7."**

Emmerson notes that besides Huawei, there are two additional competitors in the race for share in the global market for the radio access equipment needed to enable 5G transmission, Nokia and Ericsson. Also, relevant to this discussion is the "devastating review of Huawei in the fifth annual report of the Huawei Cyber Security Evaluation Centre (HCSEC) Oversight Board, released in the UK on 28 March 2019." **Among the findings from the report were "serious and systematic defects in Huawei's software engineering and cyber security competence," resulting in "extensive vulnerability" and "significant increased risk" for users.**

According to Emmerson, "When choosing between 5G network providers, user states could benefit further by taking into account the trustworthiness not only of a given 5G firm, but of its home government as well." The 2019 *World Justice Project Rule of Law Index®* score of Constraints on Government Powers, "ranks 126 countries by **the extent to which the government in each one is held accountable within the effective framework of law that limits its power. Finland and Sweden, the countries of domicile of Nokia and Ericsson respectively, are ranked 3rd and 4th ... China is 119th."**

Since nothing less than the technological dominance of the future is at stake, it is difficult to imagine a speedy resolution to this keystone of the trade negotiations. **Furthermore, since everything else pales by comparison, it is unlikely that other aspects of the trade negotiations will be resolved without significant progress in this important conflict.**

Fixed Income

The Federal Reserve extended its dovish signal that interest rates are unlikely to be raised this year while market expectations have increasingly shifted towards the possibility of interest rate cuts by year-end. The target fed funds rate remained unchanged at 2.25-2.50% during the FOMC's June meeting. Despite the market's sentiment for lower rates in the near term, key indicators monitored by the Fed are not yet signaling for rates to be lowered. Economic growth of 3.1% for the first quarter continues to indicate that GDP is still growing at a healthy pace, while the 3.6% unemployment rate remains at historic lows. **Signs of a prolonged slowdown in economic growth, the catalyst compelling the Fed to cut rates in the past, have not been evident in the most recent data.**

(continued)

The Fed's monetary policy targets full employment and price stability while other factors such as trade policy and global growth trends are not key factors. These broader market considerations may, however, influence policy decisions. For a rate cut to occur, it would be a slowdown in U.S. growth which would drive the decision, not escalating trade tensions or political pressure. **In the event where it is perceived that continued trade restrictions may cause U.S. growth to slow, it may precipitate Fed action; but, so far, there hasn't been a sharp enough deterioration in growth to warrant Fed easing.**

The 10-year yield declined to 2.00% at the end of the quarter, a more than 69bps decline from the start of the year. For much of the year, we have discussed the slope of the yield curve and the structural factors driving long-term rates lower. Once again, it is important to note there is no direct causation between an inverted yield curve and a slowdown in the economy. **An inversion of the yield curve does not cause an economic recession.** When long-term yields are lower than short-term yields, it is a signal that the bond market is anticipating the Fed will need to loosen policy in the future to support a slowing economy. Although the yield curve has continued to flatten, the spread between the 2-year and 10-year Treasury yields has not yet inverted. **It is also important to note that the yield curve is not a good predictor of when a recession might occur.** The yield curve has inverted anywhere between 9 and 23 months prior to the past five U.S. recessions. In a repeatedly changing economic landscape, no two market cycles are the same. Therefore we must consider the current economic data at this time in order to determine how changes in broader financial conditions may affect the economy.

International Market

Early in the quarter, a tweet from President Trump reignited trade tensions between the U.S. and China. We could not have predicted this event, but it should not have been a surprise. As we have indicated before, "we foresee several rounds of difficult negotiations before a deal can be reached with China." **Despite its impact on the markets, our fundamental view of the renegotiation of any treaty has not changed: "rigid postures and harsh rhetoric are merely tactics used to obtain the best possible deal acceptable to all parties."** We would like to once again caution investors not to overreact to every twist and turn in the process, as amplified by the news media. An investment decision in reaction to headline news is based on emotion, and often results in unintended consequences to investors' long-term objectives.

Tariffs, both threatened and implemented, have a two-pronged impact on the economy and financial markets. One is fundamental and the other is psychological. A fundamental impact results from the loss of efficiency due to the disruption and relocation of global supply chains. A psychological impact occurs from reduced business confidence, resulting in deferred investment decisions. Although difficult to quantify, the psychological impact of trade rhetoric may result in a more significant immediate impact to the economy than supply chain disruption. But, it is worth noting that business investment ultimately depends on demand for a company's products and services. As long as demand is unaffected, deferred investment decisions will eventually be implemented, and any shortfall created from the deferred decision will be resolved in order to meet the demand. **As a result, the temporary dislocations resulting from a psychological reaction to negotiation rhetoric are transient and should be resolved in time.**

Unfortunately, there is never a shortage of investors who react to news and make investment decisions based on fear. The risk is for this reaction to bring about a permanent shift in demand. For this reason, the psychological impact from the escalation of trade tensions has had a greater impact on financial markets than on the real economy. In the latest round of trade tensions, the spot price of soybeans serves as a prime example of how costly it can be for investors to react emotionally to the news. As the tension between the U.S. and China intensified this quarter, commentary on how U.S. farmers will be hurt by the tariffs flooded the media. As a consequence, the spot price for soybeans started to trend lower from $9/bushel down to $8/bushel as panicked investors rushed to sell. It is not clear whether those commentators even knew that soybeans, in addition to other major U.S. agricultural products such as fresh pork and wheat, had not been included on the new $60 billion list of products with retaliatory tariffs announced by China. **As the reality of the situation slowly prevailed, the spot price of soybeans rebounded to trade above $9/bushel by end of June and those investors who made impulsive sell decisions handed over profits to those who relied on fundamentals.**

The underlying point is that bilateral trade between the U.S. and China is quite small. Total exports from the U.S. to China account for 0.6% of U.S. GDP, and exports from China to the U.S. account for 3.4% of China's GDP. Further, the U.S. economy is relatively closed and service-based, and despite the widely held view that China's economy is export-driven, it has continued to evolve into a domestically driven economy over the past decade. **As a result, the direct impact of the trade discussions should be relatively modest.**

Even with the insignificant portion of GDP that is directly tied to trade, it is still unrealistic to assume that all output will be lost. Economic theory suggests the real fundamental cost of tariffs to the overall economy is the efficiency lost due to the disruption and relocation of the global supply chains. China's average wage has been increasing for years and it is no longer the manufacturing epicenter it once was. The trend of relocating manufacturing capacity to other countries with lower labor costs started long before the trade conflict began, and trade tensions have undoubtedly accelerated the process. According to the DIGITIMES Research of Asia, the manufacturing capacity of semiconductors is currently being shifted to countries such as South Korea, Taiwan, and Japan, while cell phone manufacturing has moved to India. In addition, an increasing amount of computer notebooks are being manufactured in other Southeast Asian countries, and more electronic appliances' production lines have been moved to Mexico, Vietnam, and Thailand. **As additional capacity becomes available from countries not affected by the tariffs imposed, the likely impact from tariffs will eventually diminish.** This is perhaps why the market reaction to the latest round of trade tensions is more muted compared to last year. **We believe the trend is to expect the impact from future trade negotiations to shrink even further.**

Even if progress is made following the meeting between Trump and Xi at G20, investors should not expect smooth sailing going forward. As elaborated earlier, the dispute between Washington D.C. and Beijing is not solely focused on the trade imbalance. There is a much broader set of concerns surrounding industrial strategy and national security. Such concerns have a large constituency among U.S. businesses, and responding firmly and aggressively has received strong public approval. **Therefore, the protectionist agenda pursued by President Trump is not only politically popular with disenfranchised blue-collar Republican voters, but also with Democratic voters to some degree.** Senator Bernie Sanders has publicly stated "we need to fundamentally rethink our trade policies and move to fair trade rather than just unfettered free trade."

The use of tariffs as a negotiation tactic will likely continue regardless of which political party wins the White House in 2020. Investors should become accustomed to viewing the increased volatility caused by trade headlines as a normal market occurrence. **We want to caution investors to maintain the discipline of their investment approach and not misdirect their long-term perspective due to volatility. We also urge investors to embrace the opportunity afforded by irrational market movement as an opportunity to rebalance the portfolio in order to achieve their long-term investment objective.**