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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

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~

When I first started in the investment business, I worked for a Chief Investment Officer, named Peter Vermilye. Peter had a mantra that **you should only buy straw hats in January, the point being that they weren't popular in the winter, hence cheap; by summer, prices and demand would have returned to normal and if you had missed out on the winter bargain, you would pay top dollar.**

I was reminded of Peter's mantra a few weeks ago when I came across a Wall Street Journal article by John D. Stoll titled, "Hug the Uncertainty Monster." Although the article describes the inertia which often clouds business decisions during turbulent times, the focus of the article was the availability of unique opportunities, often only available during these periods of uncertainty.

This principal applies, just as readily, to the financial markets. **Perhaps the best indicator of uncertainty in the stock market is directionless volatility, the most recent example being market turbulence in August. The volatility indicated there was no clear consensus among investors.** After second quarter earnings and guidance were pronounced in July, there was very little financial news to guide the market until after Labor Day. Analysts were on vacation, and there was a dearth of new financial information released by companies. Market trading volume declined and market reaction to headlines rather than fundamentals drove stock prices.

During August, the often cited culprit for both the rise and decline of stock prices was the ongoing trade negotiations between the U.S. and China. We have discussed the primary economic impact of tariffs often in this newsletter, and also during our presentations, these past few years; yet, here we are, with a market still exaggerating the economic impact of short term headline news.

In a very thorough white paper published by CitiBank, Catherine L. Mann, Global Chief Economist, makes the case that globalization actually peaked around 2008. She looks at **three factors comprising globalization: trade, financial flows, and human movement, with human movement and tourism the only area to continue to show growth.** While she cites the widely recognized advantages of globalization to aggregate growth, she also acknowledges, "rising disparities in outcomes including income and wealth, and across generations, firms, and regions." Her proposed solution to these inequalities is that, "globalization concerns should be reinterpreted as a domestic policy question – have we failed to deploy policies to address disparities, or are policies simply less effective…?" **In summary, like most economists, she argues for greater globalization to increase the aggregate global "pie," and reforms to address the distribution of wealth.**

One area which Dr. Mann touches on, but admits is beyond the scope of the paper, is data and its increasing presence in our global lives. In a second white paper, David Halpert, of Prince Street Capital, suggests that with "4 billion people – more than half the global population – using the internet," and connectivity largely originating from a single country, the U.S., what has emerged is a form of colonialism. **Halpert's argument is that as the world moves away from globalization to a form of mercantilism, countries will increasingly attempt what he calls digital decolonization or digital independence.** Without going into detail, Halpert sees this occurring as three broad trends: Protectionist, Localist, and Leapfrogging Technology. Aside from a catchy label, much of what he describes has been going on for the last decade or more. For example, we have been buying Chinese search engine companies protected from Google for years. **Still, if globalization has plateaued, there may be additional opportunities in emerging market mid and small capitalization companies.**

We want to remind our readers that stock prices are inherently volatile. We have been spoiled since 2008 by the Federal Reserve Bank's, and other central banks', managing the financial markets. We have now returned part way toward market forces setting stock prices, and as a consequence, a return to more normal market volatility. Even though the media, almost always, attributes cause and effect linkages to short term stock market price movement, this is rarely the case. **Indeed, short term volatility should be seen for what it is, a temporary disequilibrium between supply and demand which is quickly arbitraged away. Globalization is truly a long term dynamic, having little to do with the daily drama presented by the media as a reason for the market to rise or decline, because of progress, or lack of progress, in trade discussions.**

Fixed Income

The direction of monetary policy plays an important role during the later stages of the market cycle. Economic downturns are rarely caused by a single factor and most have had their roots in several different areas – e.g. credit bubble bursts, oil shocks and property collapses. **However, we do know that monetary policy tightening has been the single factor that has contributed to the majority of previous recessions.** In the current market cycle, recent data does not point to an economy in need of lower interest rates, yet the Federal Reserve has already begun loosening monetary policy without a deterioration in the gross domestic product (GDP) or employment data. The Fed cut rates by 25bps at the July FOMC meeting and by an additional 25bps in September to reduce its target for the Fed Funds rate to the 1.75 and 2.00% range. According to the accompanying statement, the cut was a response to "the implications of global developments for the economic outlook as well as muted inflation pressures." In Fed Chair Jerome Powell's press conference, he characterized the cuts as a "mid-cycle adjustment to policy" that provides some insurance to protect downside risks to the economy posed by trade uncertainty and weaker global growth, and the Fed will "act as appropriate to sustain the expansion." **At this time, the market expects the Fed to end the mid-cycle adjustment after a third 25bps cut in December, rather than pursue a policy which entails an extended loosening cycle.**

Investor concern regarding inversions of different sections of the U.S. yield curve has been ongoing for well over a year now. The inversion between the 10-year and 2-year Treasury spread in August was the latest part of the curve to turn briefly negative for the first time since 2007. Despite the strong track record, whether an inverted yield curve is still a reliable predictor of a U.S. downturn is up for debate after a decade of extraordinary central bank stimulus. **"I would really urge that on this occasion it may be a less good signal," said former Fed Chair Janet Yellen. "The reason for that is there are a number of factors other than market expectations about the future path of interest rates that are pushing down long-term yields."** Long-term yields are certainly falling; the rate on the 30-year bond, the U.S. Treasury's longest maturity, fell to a record low below 2%, or less than the Federal Reserve's annual target for inflation during the month of August.

Although the yield curve is the best single leading indicator of recessions two to three quarters ahead, yield curve inversions tell us little about the timing of future downturns. Inversions of the 10-year and 2-year Treasury sections of the yield curve have preceded downturns anywhere between three months and three years away. Further, as we've previously discussed in this newsletter, 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. **Given the Fed has already begun loosening policy prior to the inversion of the yield curve, in addition to the structural factors that continue to weigh on the long-term yields, we continue to place less emphasis on the inversion warning signal.**

International Market

On September 14th, more than two dozen missiles and drones attacked Saudi Arabia's Abqaiq oil processing plant and Khurais oil field. The price of crude futures spiked immediately; at the opening of commodity trading, benchmark Brent crude surged 20%. However, with Aramco, Saudi Arabian's state-owned petroleum and natural gas company, restoring production at the Abqaiq and Khurais facilities back to normal levels within two weeks' time, the price of crude has reverted, now trading at pre-September 14th levels. **These events remind us not only that geopolitical tension could easily bring fluctuation to the market, but more importantly, that making investment decisions based on reactions to news events can be costly.**

With the immediate spike of futures prices, it is apparent that there were people trading on the news before the initial assessment had even begun. It is understandably tempting to act quickly, especially while news networks all over the world broadcast massive flames seeming to engulf an entire plant. However, appearances can be deceiving, and what seem to be logical assumptions can later be proven false. **When the damage turned out to be less severe and the restoration much quicker than originally feared, the irrational price movement quickly returned to normal, and those trading on headlines paid a hefty price.**

The same principle applies to other news events, and this so-called "trade war" is currently one of the hottest headlines, causing the market to fluctuate in reaction to any tweet by President Trump. There isn't a shortage of commentary that a "trade war with China would devastate the U.S. economy." **Two of the most common arguments presented to justify the remark are 1) that U.S. exports to China will suffer, and 2) that the U.S. consumer will pay more because of the added tariffs.** Upon hearing these two logical assumptions in the media, investors can easily feel the urge to take action in their portfolio. **However, if we examine these two assumptions with actual data, they turn out to be less convincing.**

In reality, the U.S. economy is not heavily dependent on exports to China. In 2018, for example, U.S. exports to China were worth roughly $120 billion, while U.S. GDP in aggregate amounted to $20.6 trillion. Exports to China make up roughly 0.5% of the U.S. GDP. **Even assuming that the trade relationship with China is significant to the economy, there still has not been much change to monthly export figures since the beginning of last year, before the trade conflict started.** In addition, the decline in trade with China is easily made up with more trade with other nations. **The latest trade numbers released reveal that in July, U.S. exports rose by 0.6% month over month, and for the quarter, exports are expected to go up by 2.3%.**

The Consumer Price Index (CPI) is the index used to gauge inflation, and based on the readings, the U.S. consumer is not currently paying higher prices than before the escalation of trade tensions with China. Current headline inflation has actually been lower than that of the beginning of last year. Hence, the two seemingly logical assumptions about the "trade war" are much less convincing when fact-checked against data. The **bottom line is that the U.S. economy has not been meaningfully impacted by the trade conflict with China.** For those who cannot resist the urge to react with investment decisions every time they hear negative news from the media, the consequences can be costly. **So far, all the fluctuations caused by trade headlines have quickly recovered and the market continues to reach new highs. Those who reacted too quickly to the news and decided to sell are left behind.**

The real fundamental impact to the global economy of a bilateral trade conflict is the inefficiency resulting from the reshuffling of the global supply chain. In reality, when China's average wage started to surge years ago, companies had already begun searching for alternatives to relocate their manufacturing capacities; the trade conflict only speeds up the process. As tariffs start to add up on the bilateral trade between U.S. and China, both countries quickly turn to alternative sources. Countries such as Vietnam and Taiwan benefited from more exports to the U.S., and countries such as Brazil, Argentina, and Chile benefited from more exports to China. **Once this dislocation of supply chain is repositioned, the impact should be greatly diminished.**

Although we believe that the impact of this trade conflict will be further diminished, we also expect it to linger for a while. The terminology of "trade war" will undoubtedly continue to be repeated by the news media. **Therefore, we would like to remind our readers once again of the danger of reacting to headlines without considering the fundamentals. Doing so could have undesirable consequences to the long-term performance of the portfolio.**