PILLAR PACIFIC
CAPITAL MANAGEMENT, LLC

Quarterly Newsletter

Volume XVII, Issue 1 April 2013

Mindy L. Ying, MBA
President & CEO

Arthur T. French, CFA, CIC
Chief Investment Officer

Sonny C. Lin, CFA, CIC
Senior Portfolio Manager

Alan K. Chuang, CFA, CPA, CFP®, CIC
Portfolio Manager & Business Development Officer

Lily L. Ku, CFP®
Financial Planner

Joseph Fontamillas
Client Service Manager

Grace Hill
Operations Manager

Carmen Pon
Operations Manager

Jennifer S. Ying, CPA
Financial Consultant

Offices:

Southern California:
2540 Huntington Dr.
Suite 105
San Marino, CA 91108
Tel: (626) 286-4029
(888) 295-4419
Fax: (626) 286-0624

Northern California:
333 Gellert Blvd.
Suite 121
Daly City, CA 94015
Tel: (650) 758-0130
Fax: (650) 758-0131

www.PILLARPACIFIC.com

~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

It is official, if not entirely accurate: during March, the Dow Jones Industrial Average surpassed a level last reached in 2007. **Towards the end of the month, the Standard and Poor's 500, a much broader market benchmark, also attained its prior high water mark.** While these statements make for compelling headlines, they ignore the fact that, adjusted for inflation, these measures are still well below the levels reached nearly six years ago.

Still, stock markets in the United States have made significant gains from the lows reached in March of 2009, prompting many of our clients to be concerned about valuation. We will attempt to address these concerns in this month's newsletter.

First we would like to point out that stocks are financial assets which allow investors to participate in the future profitability of their companies, forever. The price of a stock reflects what the market determines this future stream of cash flow is worth. This is in stark contrast to real assets, such as gold, commodities, real estate, etc., whose price represents a speculation that a buyer will pay more for the asset in the future. Often, the price of a real asset includes a cost of ownership without the offsetting revenue stream provided by a financial asset.

In order to determine whether or not stocks are attractive, we need to look to the future. The current business cycle has been one of slow growth. Presently, there is no sign of imminent recession. **The purchasing managers index (PMI), a primary indicator of economic expansion and contraction, continues to indicate the economy is expanding. Corporate profits remain healthy and growing. In addition, most forward looking valuation metrics are either undervalued or fairly valued based on conservative estimates for the coming year.** This was due to concern about the "Fiscal Cliff" over the past year, which held back optimism for the first half of 2013. Indeed, if all the provisions comprising the "cliff" had been allowed to occur, we would be in recession now. Fortunately, the "cliff" was largely avoided. The year-end tax increases and $50 billion (fiscal year) spending cuts resulting from sequestration are estimated to result in a total fiscal year drag of about $200 billion or 1.3% of GDP. This will likely be enough to further slow the already-sluggish growth recovery, but not enough to cause a recession.

More than offsetting this fiscal drag, the Federal Reserve Bank continues with quantitative easing at a monthly rate of $85 billion, or more than $1 trillion per year. There was much discussion about programs which would suffer under sequestration, but its effect on the economy is eclipsed by the aggressive use of monetary policy.

With this stimulus in place for the foreseeable future, we expect to see growth in the economy begin to accelerate. So far, this economic cycle has been characterized by below average consumer spending. We think this could be changing. **Housing starts have been improving since 2010, resulting in an increase in construction related jobs. We expect this to continue due to a backlog of demand as a result of tighter credit restraints as well as deferred household formations due to slow job growth.** With the current shortage of housing, there is a growing expectation for higher housing prices. The expectation for higher home prices is highly correlated to improved consumer confidence and spending. In the past quarter, it is estimated that household worth increased by $1.7 trillion on a rise in housing prices.

In our last quarterly newsletter, we discussed the broad economic benefit of lower natural gas prices as a result of new drilling technology. This same technology is being employed in the production of shale oil. In the first ten months of last year, the United States was able to produce 84% of the energy it consumes, the highest level since 1991. **In the next five or six years, the U.S. will surpass both Saudi Arabia and Russia to become the largest producer of oil in the world**.

This renewed abundance of relatively inexpensive energy, along with the readily available monetary liquidity from the Federal Reserve Bank, could provide the competitive advantage for a continued renaissance in U.S. manufacturing and a longer, more persistent, cycle of economic expansion. Then, we can celebrate when the stock markets truly reach record levels.

Fixed Income Market

As of the writing of this newsletter, the 10-year Treasury rate stands slightly below 2% and the 30-year rate is at 3.10%. These are increases over the recent past, but still near historical lows. **With continuing concern over Euro-zone issues and the Fed's QE (Quantitative Easing) actions, interest rates have been pressured to remain at lower levels.**

With signs that the U.S. economy is improving, there have been more headlines describing a bond "bubble" bursting or a collapse in the fixed income market. We would like to address this concern among investors. **We agree that interest rates are likely to rise from these historically low levels along with inflation as the money supply builds velocity and the economy grows. However, in order for there to be the mass disruption in bond prices that some pundits are espousing, there would have to be a *rapid* rise in interest rates**. The rapid rise in rates would result in lower bond prices, leading to a flight out of the asset class and spiral downward from there.

We see several reasons that a rapid rise in rates will not occur. First, there would have to be a dramatic improvement in the global economy. The signs are good that the U.S. economy is improving, but with the unemployment rate at 7.7% and GDP still at muted levels along with the concerns in Europe, there is still a way to go.

Next, the Fed would have to stop supporting low rates. Last fall, the Fed implemented additional bond buying that amounts to more than a trillion dollars a year, with its target fund rate remaining near zero. **The Fed would have to reverse its current actions for rates to rise rapidly. No indications of such reversals are currently expressed by the Fed.**

Finally, demand for Treasuries would have to drop drastically, which would only happen if the U.S. were no longer the "safe haven" it has been. **Although many other countries are growing even as the U.S. faces problems with deficits and debt levels, it is difficult to imagine another country supplanting the U.S. as a major safe haven.** While we recognize the challenges in the fixed income market, we do not believe there will be a collapse in that market in the foreseeable future. **We continue to build diversified and laddered bond portfolios with a short duration as part of our clients' long term investment strategy. This will increase the yield without a significant increase in risk.**

International Market

Just when it seemed that Euro issues had settled down, Cyprus, an island republic in the eastern Mediterranean, reignited worries about a "European sovereign debt crisis" last week. Even though uninsured deposits in the nation's banks will be frozen and used to resolve debts, it was encouraging that a rescue plan was so quickly orchestrated to keep Cyprus from defaulting and possibly leaving the euro-zone. **These actions reaffirm the markets' belief that the "troika" (European Union, International Monetary Fund, and European Central Bank) has a working blueprint in place to deal with issues that have troubled the euro-zone for some time**.

Optimism is growing that issues which have plagued international markets for the past few years are improving. **There seems to be a working model capable of handling Europe's troubled banks and China's once slowing economic growth has begun to accelerate.** As a result, international markets, both emerging and developed, have rebounded from years of sub-par performance and quietly staged a decent comeback in 2012.

The central problem with the European sovereign debt crisis is a lack of confidence. Initially, as fear spread and counterparties' survival became questionable, market participants drastically reduced their economic activity. Therefore, an essential part of the solution is to establish the confidence that was lost. **The market has only gradually returned to normal after ECB President Mario Draghi's promise that, "the European Central Bank is ready to do whatever it takes to preserve the euro."** So far, the market reaction affirms the belief that Europe is on the right path; as Klaus Regling, head of the European Stability Mechanism, has said, "The euro-zone is on a difficult path, but relevant data shows that the strategy is working."

China's once-a-decade leadership transition seems to be a smooth one and inflation in China remains moderate. This has allowed Beijing to keep policy accommodative in a bid to sustain growth recovery and ease doubts that have clouded the market. Rising sentiment among purchasing managers suggests that manufacturing activity in China has resumed expansion. The Chinese Census Bureau also confirms that the country's housing starts have gained momentum as well. **Assuming that China's new leadership can continue to implement certain economic, financial, and regulatory reforms, the resumption of growth will likely be sustainable.** The Organization for Economic Cooperation and Development (OECD) supports this view with a very bullish prediction that China's economy will rebound to 8.5% growth this year and 8.9% the following year with domestic consumption the biggest driver.

Amid all the recent positive developments, one major concern that emerges is if the newly crafted Cyprus rescue package is to serve as a precedent for future bailouts. If so, depositors in troubled banks of weak countries would understandably worry about sudden raids on their savings. This would increase the chance of bank runs in countries such as Italy, Spain, and Greece. The head of the Eurogroup of euro-zone finance ministers, Jeroen Dijsselbloem, did initially say that Cyprus was a template for handling the region's other debt-strapped countries. He stated that when failing banks need rescuing, euro-zone officials would turn to the bank's shareholders, bondholders and uninsured depositors to contribute to their recapitalization. Though he quickly clarified his comments by citing Cyprus as an exceptionally challenging case that required the bail-in measures, this event is an example of the continuing problem of the lack of confidence in the euro-zone.

As we continue to "climb the wall of worry," we will closely monitor and judiciously deal with new developments, especially negative ones. Given our reading for potentially higher growth rates and valuations trading at discounts to their historical averages, we also see benefits to be weighed against risks. **We remain cautiously optimistic on international investment opportunities and continue to hold a healthy exposure to international markets.**