

## ~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

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The National Bureau of Economic Research (NBER) announced on September 20, that **the Great Recession ended in June 2009**. The recession lasted 18 months and was the most enduring recession since World War II.

**If the recession is over, why is it that so many of us don't feel like it is over?** In part, it is because a recession is a clearly defined economic state. It is measured from the peak of economic activity to the trough, considering such factors as real gross domestic product, real gross domestic income, etc. It takes time to process the numerous data revisions before the determination is finalized.

Even though the recession is over, the economy has not returned to the levels attained in 2007. Certainly the recovery has been disappointing. **In large measure, this is a function of inefficient resource utilization; whether it is capital, labor, or capacity.** This has caused many to worry that we will not recover or, worse, that we will slide into an even deeper recession. To paraphrase Neal Soss, a senior economist at Credit Suisse, the fear of recession is "bad enough" but recession is "much worse."

At Pillar Pacific, we think the double dip scenario is highly unlikely for a number of reasons. **Most importantly among them is the amount of liquidity (cash) that is currently being hoarded by banks, corporations and individuals. Eventually, these funds will need to seek better returns than they are earning in cash equivalents.** As these funds are deployed, they will tend to stimulate economic activity (and higher inflation). Also unlikely, yet possible, is that this large cash infusion will lead to high, unsustainable inflation.

**Instead, we expect to see slower economic growth with moderately higher inflation in this economic cycle.** In part we think slower growth will be due to the diminished capacity of the consumer as the primary driver of final

demand. The consumer currently represents as much as 70% of U.S. economic activity. But the consumer is aging, overleveraged, fearful of unemployment and worried about lifetime net worth, due to the decline in the value of their primary asset, the family home.

It is human nature that our judgment is shaped by the recent past. During the financial crisis of 2007-2008, liquidity disappeared and cash was scarce. Now, banks, corporations, and individuals are hoarding their cash reserves. Banks are holding more than one trillion dollars as excess reserves at the Federal Reserve. Corporations, too, have been holding their profits in low interest short term cash equivalents; finally, it is beginning to impact returns. Due to uncertainty, companies have been reluctant to build inventories and hire employees. Until now, they have spent only on the equipment and software necessary to enhance productivity. We think that is beginning to change. **Companies are starting to deploy cash to buy back their own stock or to make strategic acquisitions of other companies. Eventually, they will increase their capital expenditures.** Any of these strategies increase earnings growth over the returns from holding cash.

A third factor that will shape this economic cycle is the foreign exchange value of the dollar. We have written before about the advantage our manufacturing and export companies have derived from the decline of the dollar over the past several years. **We do not think the dollar will strengthen substantially in this cycle,** (indeed it could weaken further) due to the inflation potential of stimulus programs already in place.

The last recession was caused by a financial crisis. The current recovery is slowed by the veil of uncertainty. **Nevertheless, as the recovery gains traction, we think that investors will enjoy decent, if not stellar returns in the cycle ahead.**

## Fixed Income Market

In their last meeting, the Federal Open Market Committee (FOMC) decided to keep the Fed funds rate in the range of 0.00%-0.25% for an “extended period”. **This language has persisted for some time and this meeting marked the fourteenth “no-change” position for the committee.** This is evidence of the Fed’s desire to maintain stability and ensure the economy is well on its way to recovery before initiating new policy. The Fed has no easy task with economic data reinforcing both positive and negative trends from week to week. The end result continues to be a relatively steep Treasury yield curve with the spread between 2 and 10 year treasuries at 206 bp as of 9/28/10. The short term rates are anchored by the Fed funds rate target and longer term rates are higher on anticipation of an increasing interest rate environment.

We are facing one of the lowest interest rate environments since World War II. With intermediate Treasury bonds yielding around 2.4% or half the long-term historical average of 4.8%, it becomes important as ever to balance a reasonable yield with the type of bond being considered. Although corporate cash coffers have continued to increase in general and thereby benefit bondholders, credit defaults still occur as evidenced by the recent bankruptcy filing by Blockbuster. Fortunately, Blockbuster’s case is more related to industry changes specific to the video rental business than widespread credit problems. **It is important to carefully evaluate the financials of the corporate bonds being reviewed and select those with minimal default risks.**

On the Municipal front, the summer months have been relatively slow in new issuances, but the fall should bring renewed activity particularly if the November elections provide guidance for the direction of personal income tax rates. **For California residents facing a top tax rate of 9.55% and possible federal tax rates increasing to 39.6%, municipal bond offerings can still provide attractive after tax yield for higher income investors.** Again safety needs to be a priority as many have no doubt heard of the Bell city officials’ debacle and recent arrests. It is not surprising that Standard and Poor’s rating services downgraded Bell bonds five levels to “junk” status.

Despite a historical low interest rate environment, we continue to see opportunity for fixed income investments that are subjected to careful due diligence. **It is also important to be reminded that in any yield environment, fixed income instruments play a vital role in a well diversified portfolio.** They not only provide for current income needs, but also preserve capital and enhance the overall stability of the investment portfolio. In the long term, the addition of bonds to an equity portfolio can help minimize volatility while maintaining return potential.

## International Market

Concerns that China’s astonishing growth might be slowing have had a negative impact on global equity markets several times this past year. It is true, after many quarters of growth above 10%, the Chinese government is taking steps to prevent its economy

from overheating and to keep rising inflation under control. **According to its statistics bureau, Chinese CPI for August surged 3.5% when compared with the same period last year and increased 0.6% when compared with July, the worst results since October of 2008.** Whether China will continue to be the engine of growth for the world remains an important question for investors.

Even as Premier Wen Jiabao’s government trimmed credit growth from last year’s record 5.59 trillion Yuan (\$1.4 trillion) and discouraged multiple home purchases to restrain a surge in property prices, in the second quarter, China’s GDP still grew 10.3% from a year earlier. Although it was lower than the 11.9% recorded in the first quarter, a GDP growth rate of more than 10% is anything but “slow.” **Also, it is worth noting that the source of China’s economic growth has shifted from producer-focused to consumer-focused as labor cost, a major competitive advantage used by China’s export manufacturers, starts to rise.**

In the current year, strikes staged by workers demanding pay increases have already halted production at several manufacturing plants in the nation. Due to concern that these wage labor disputes may spur social unrest, the Chinese provinces and municipalities have been forced to raise minimum wages by as much as a third. **This increased wealth of China’s middle class not only boosts domestic consumption and reduces the economy’s reliance on exports but is also believed to be the source of China’s next wave of economic growth.** Thus, despite the fact that the major Chinese equity indices, heavily weighted in large-cap manufacturing companies, are having sub-par performance year to date, investors have found consumer focused industries and companies that have benefited from this trend and whose stock prices are continuing to break into new highs.

Europe, after the second quarter roller coaster ride, is beginning to emerge from the sovereign debt crisis that almost brought them down. **From the recent statements released by its key leaders and the relatively strong market demand for newly issued “PIIGS” bonds (troubled EU nations such as Portugal, Ireland, Italy, Greece, and Spain), it seems that in the aggregate, the European economies have weathered the storm much better than expected.** One byproduct of this recent crisis is a weakened euro, which may have helped European companies by making their goods and services more competitive in the international market. Led by a 4.4% jump in exports, the biggest in the euro’s history, the euro-area economy has expanded at a better than anticipated 1% in the second quarter, the fastest pace in 4 years.

We are beginning to see opportunities surface in Europe, mainly from industries and companies that would benefit directly from a weak euro. **We continue to be positive on both Asia and Latin America.** Although there were few significant news items in Latin America this past quarter, the region continued to be the best performing, year to date.