PILLAR PACIFIC
CAPITAL MANAGEMENT, LLC

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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

The current economic recovery continues to progress slowly. In past US economic cycles, the consumer fueled a more robust recovery with consumption based on borrowing against the wealth effect of rising real estate prices. **In the current recovery, the consumer has been mostly absent.** By any measure, household debt attained unsustainable levels before the collapse of real estate prices in 2008. Coupled with high unemployment, consumers have reined in their propensity to spend borrowed money, resulting in the current economic malaise.

For a time, emerging market demand for capital equipment and raw materials, combined with a cheaper dollar, drove a moderate cyclical recovery in the U.S. The prime mover of this demand was the infrastructure build in China. However, such rapid growth also created domestic problems in China until it became necessary for authorities to impose monetary and fiscal restraint.

In Europe, the excesses of the past decade came to a halt when the flow of cheap money was cut off. Most of this information is not new; it's a wonder that details of this continuing saga and the apparent inability to resolve the issues can still rile the markets. With the passage of time, some progress is becoming apparent. **China is again beginning to stimulate, Europe is doing what is necessary to hold the parts together, and companies in the U.S. continue to earn money, albeit at a slower pace**.

Before the current crisis began, the conventional fix for slow economic growth was simple. Central banks would print money; consumers and companies would spend, invest, and borrow. The economy would begin to recover and central banks would step aside, until they needed to intervene to slow the pace.

In this monetary scenario there are two essential components. The first is simply the mechanism for making money available; it is a mechanical function and the responsibility of the central banks. **The second essential part of this system is dependent on behavior. People (and companies) need to have enough confidence in the future to be willing to spend and invest.** While there has been no shortage of liquidity provided by the central banks, it is confidence which has been missing in this recovery. Part of the reason for this lack of confidence stems from the residual fear arising from the recent financial crisis, part from the fear mongering of the media, part from the perceived lack of leadership of elected officials, and part from the weight of non productive regulatory burdens. Whatever the cause, the results are apparent. **Each time a central bank proposes a new stimulus package, the markets rally briefly in anticipation of finally breaking out of the malaise**. So far, it has not been sustainable, but if it ever sparks renewed confidence, it will be the dawn of a new era.

There are several potential catalysts to spark confidence. Our elected officials could work toward an early resolution to the "fiscal cliff." European politicians could come together to resolve their differences, building a foundation for a sustainable and stable economic union. China may have a relatively tranquil political transition and embark on a new round of infrastructure build. But, maybe the most likely catalyst is the possibility that residential real estate prices may have bottomed and start to improve. **Whatever event, or combination of events, which inspires money to begin circulating, will be most welcome.**

In the meantime, markets are caught in a trading range. **With slow economic growth, something as mundane as a seasonal adjustment can distort reported data.** Such a distortion had a significant impact during the first and second quarters of this year. When economic activity, stimulated by warmer than normal weather in the first quarter, was further amplified by a seasonal adjustment, it gave the appearance of acceleration in the recovery. When the data was adjusted during the second quarter, it appeared the economy was suddenly slowing, prompting the doomsayers to predict an inevitable slide into recession. Both distortions brought increased volatility to the markets.

Our view is that we will continue to be in this slow growth phase until confidence is restored. Since we are increasingly tied to the global economy, renewed confidence may take a little time. **On the positive side, even as stock prices mark time, companies continue to grow earnings, leading to ever more attractive valuations.** In the meantime, expect stock prices to continue to be volatile.

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Fixed Income Market

The Fed completed its monthly meeting on June 20th and **Chairman Bernanke announced the extension of Operation Twist until the end of the year with an additional $267 billion.** The effectiveness of the policy continues to be debated and interest rates already at historical lows moved little with the announcement from the Fed.

In last quarter's newsletter we discussed 10 year Treasuries reaching 2.10%, but **as of the writing of this newsletter the 10-year Treasury has declined to 1.60% and reached a new record low of 1.44% on June 1.** With rates at such low levels, we continue to avoid U.S. Treasuries in our fixed income portfolios.

On the municipal bond front, **GASB (Governmental Accounting Standards Board) recently adopted two new standards that will likely have widespread effect on the creditworthiness of many municipalities.** The new standards are an attempt to provide a clearer picture of the size and nature of pension financial obligations for state and local governments. One of the tenets of the change is in the projected investment rate of return assumptions that will be reduced in some cases to better reflect current market conditions. This could lead to an increased need for additional funding to retirement plans. Governments will also have to count their pension obligations as liabilities for the first time and post the net pension liability on financial statements. As a result of these changes, state and local governments may see an adverse effect on their credit ratings. We remain watchful of any municipal offerings we participate in.

After the market closed on June 21st, Moody's downgraded the credit ratings of almost all the major US banks. **On a overall basis, corporate bonds were minimally impacted as the downgrades were across the board and relatively consistent among all major lenders**. Bond interest rates for those financial institutions have reflected this much anticipated downgrade for some time. With their attractive spreads over other fixed income alternatives, we continue to sparingly use these bonds in our client accounts. It is a good reminder that the credit rating should not be the sole criteria when evaluating the credit worthiness of the investment.

International Market

The show appearing in the European "theater" this quarter is nothing short of a circus act. **Beyond Greece's problems, the European Union continues to face the challenges of bank and sovereign insolvency, lack of fiscal integration and consolidation, poor economic growth, structural reform, and politically driven events**. Spain, following Greece, Ireland, and Portugal, became the fourth nation requiring bailout funds and in June requested 100 billion euro from the European Union.

The inability of politicians to effectively address various economic issues has caused voters to lose confidence in their governments and has resulted in some shifts of power in Europe. French Socialist Party candidate, Francois Hollande, defeated the incumbent, Nicolas Sarkozy, in the French Presidential election. Hollande's party also won a majority in parliament in the subsequent legislative elections. **Although we do not anticipate dramatic policy changes from the election results in France, we cannot say the same for the Greek election results**. Failing to form a coalition government, following its first parliamentary election, prompted a second election and raised the specter of a disorderly exit of Greece from the Eurozone. This, in part, contributed to the recent global market selloff. Although the correction is not as bad as the one we experienced last year, it nonetheless shows investors' confidence level is still tenuous. The fact that the New Democracy Party won a narrow victory in the second election and has formed a government joined by PASOK Socialists and Democratic Left has only slightly alleviated the concerns on a disorderly Greek exit from the Euro.

To combat the negative developments, central banks from major economies as well as international agencies have either already taken steps or are prepared to provide liquidity in preventing a credit squeeze in financial markets. **Twelve emerging-market nations including China and Brazil have also recently formalized funding pledges to the International Monetary Fund, helping to almost double the agency's lending power to protect the world economy from Europe's debt turmoil.** The injection of funds through various mechanisms at least provides the Euro with adequate liquidity, which could help diminish the risk associated with refinancing European banks. However, the liquidity injection does not change the Eurozone's fundamental outlook and critical challenges remain. European Union leaders are moving in the right direction by discussing longer-term solutions for deeper fiscal and banking unity as well as measures to revive growth. However, investors should realize that the more ambitious reforms will require treaty changes that take time to approve and implement.

Aside from Europe, China, as the second largest economy, also warrants some attention. The Chinese government's focus on reining in rapidly rising property prices appears to have been successful but unfortunately those efforts have also slowed economic growth. As a result, **we are now seeing policymakers resume actions towards easing; the reserve requirement ratio has been lowered three times and the key interest rate was cut for the first time in more than three years.** In one of his recent speeches, President Hu Jintao said, "China has taken targeted measures to boost domestic demand."

In stark contrast to the previous hostile stance toward the real estate market, the People's Bank of China has newly issued guidelines permitting commercial banks to offer up to 30 percent discounts on loans to first-time home buyers. The resulting falling borrowing costs for home buyers has been gaining traction as property sales in some major Chinese cities including Hangzhou, Shenzhen, and Nanjing have picked up in recent months. **With increasingly accommodative monetary and fiscal policies, China's economy might be in the process of bottoming out.**

Despite all the turmoil that mainstream media continues to exploit, none of the credit crisis and volatility measurements are approaching the stress levels we saw in recent past years. In fact, global economic trends, although slow, are improving. Interbank lending costs, measured by three-month LIBOR, EURIBOR and EONIA, are all near record lows and VIX, at a 3-month average of roughly 20, is far below peak levels. **The global leading economic indicator (LEI) indices also show that a majority of the world's 37 largest economies have their LEIs increasing on a 6-month basis; this is the first time we have seen this positive trend in over a year**. Even though we remain cautiously optimistic on the economy, we continue to monitor the financial instability in Europe and are mindful of the recent downturn in global capital markets. There still remain major threats to disrupt the fragile state of the world economy.