PILLAR PACIFIC CAPITAL MANAGEMENT, LLC

Quarterly Newsletter

Volume XIII, Issue 3 October 2009

Mindy L. Ying, MBA
President & CEO

Arthur T. French, CFA, CIC
Chief Investment Officer

Craig A. MacLeod, MBA
Advisor

Sally E. Haff, CFA
Senior Portfolio Manager

Sonny C. Lin, CFA
Senior Portfolio Manager

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

Lily L. Ku, CFP®
Financial Planner

Hongmin Lu, CFA
Compliance Officer & Quantitative Analyst

Devon M. Chan
Operations Analyst

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 ~

About one year ago, on October 6, Jim Cramer, on the "Today Show," forecast a 20% decline in stock prices and advised anyone who needed stock money, in the next five years, to get completely out of the market. Actually, stocks fell more than 40%, but have recovered in less than a year, instead of five. Although we still have a way to go before attaining the pre-crisis market high, **we should not be surprised at the pace of the recovery.**

According to Michael Darda, chief economist of MKM Partners, "**The most important determinant of the strength of an economic recovery is the depth of the downturn that preceded it.** There are no exceptions to this rule, including the 1929-1939 period."

There are several reasons why this is true. The issue is precisely framed by the English economist Arthur Pigou, who stated, "The error of optimism dies in the crisis, but in dying gives birth to an error of pessimism. The new error is born not an infant, but a giant." While this description is more literate than one usually finds in economic discourse, it is really based on some very simple math. Large contractions leave an economy further below its full capacity potential, allowing for a quicker pace of growth to get back to equilibrium. **Among all the post world war recessions, output has returned to prior peak levels within one year or less**.

Another driver of economic recovery is, quite simply, bargain hunting. The current real estate market is an interesting example of this force. **The Case-Shiller Composite Index of house prices fell a slower than expected 5.5% for the first six months of 2009**. This is a deceleration from the pace of the past two years, and prices have actually appreciated each month from May through July. This puts into doubt the 14% decline in housing prices assumed by the Fed for all of 2009.

It is also important to consider the government's use of fiscal and monetary policy to attack the current recession. James Grant, in a Wall Street Journal essay, estimates fiscal stimulus at 10% of GDP and monetary stimulus at 9.5%, for a combined equivalent of 19.5% of GDP. **In an otherwise optimistic essay, Grant cautions that the Fed is putting the value of the dollar at risk**. **We agree**.

This unprecedented monetary and fiscal response to the current crisis has replaced market forces with policy, leaving plenty of room for error. It will be difficult to call the end to stimulus. We think they will err on the side of staying too long, which **will put upward pressure on both inflation and taxes to finance the resulting deficit.**

While we can do without increased taxes, a small increase in inflation and a slightly weaker dollar is not necessarily a doomsday scenario. **There are ways to protect your portfolio, and its future purchasing power, and we have already taken steps in that direction.** First is to take advantage of the steepening yield curve to move from money market fund rates to slightly more attractive intermediate maturity bonds, as we wait for rates to go even higher. Second is to build stock portfolios with a global exposure. We accomplish this by using ADRs and the stocks of US companies which derive much of their revenues outside the United States. Here we benefit both from increased sales due to price advantage, because of the weaker dollar, as well as from the conversion from stronger currencies back to the dollar. We also seek companies capable of growing their output due to the growth of demand for goods and services. This is called ***unit or organic growth***, and helps to offset the erosive effects of inflation on purchasing power.

While our forecast is positive, we have a few concerns. We mentioned, earlier, the issue of policy makers determining when to take away fiscal and monetary stimulus. Second, there is little to indicate that recent economic activity is driven by sustainable growth in end demand. Finally, economies have generally taken longer to recover after a financial crisis than from recessions that did not involve the breakdown of the financial system.

While the policy issues will continue to hang over the market, we think the other concerns will be alleviated by what George Soros calls "reflexivity." This is the term used to describe the dual effect of market/economic cycles. Not only does the rise and fall of market averages reflect economic reality, it also changes it. **A year ago, market liquidation brought global commerce to a halt. Today, the markets are helping to revive it.**

Fixed Income Update

Federal Reserve Chairman Ben Bernanke said in an interview last week that the recession was "very likely over." Indeed, the Chairman is referring to many different signs of economic recovery. The Leading Economic Index, which declined for twenty months, has been rising since April with widespread gains in the components. At the same time, the Coincident Economic Index stopped falling. **Taken together, it suggests the ending of the recession. But, what does this mean for the fixed income markets?**

In the wake of the financial crisis, investors became much more risk averse encouraging a mass movement of funds out of riskier asset classes into the relative safety of Treasuries causing corporate and municipal spreads to widen abnormally. After the Federal Reserve and the Government committed $11.6 trillion through programs and guarantees, the markets began to heal. By the end of the second quarter, the liquidity crisis eased, and the economic picture showed signs of stabilization. Investors became much less risk averse and returned to the more attractive yields of the riskier asset classes of the corporate and municipal bond markets. The spreads off treasuries of these two asset classes improved dramatically, allowing for strong returns over the period. **What has surprised many investors is that the Treasury bondholders have lost money year to date for the first time in ten years amid an unprecedented decline in the gap between the interest rate on the 30-Year mortgages and government notes.** It shows that investors no longer need the safety net of the US Government debt, and that they are beginning to price in inflation over the long term as more evidence points to an economic recovery.

As the fixed income asset class provides capital preservation, diversification, and income to your portfolio, we have been monitoring the impacts of the tremendous monetary and fiscal stimulus. **Although we continue to look for opportunities for high grade corporate and municipals with intermediate maturities as well as Treasury Inflation-Protected Securities or adjustable rate corporates as an alternative to money funds, we are still keeping the average maturity and duration of your portfolio relatively short.** As the economy continues to improve and the government asset purchase program begins to unwind, inflation risk premiums will rise. In longer maturity fixed rate debt, as the risk premium and required interest rate rise, the price of the debt instrument may fall. Capital preservation of your fixed income portfolio is a high priority. Therefore, the attraction of the higher yields found further out on the yield curve is countered by the possibility of further price instability. Today's ten year Treasury yield of 3.3% is one of the lowest yields we have witnessed over the past fifty years.

International Market Update

Emerging markets are having a remarkable year. Year-to-date, the MSCI Emerging Markets Index has returned 60% which surpasses returns from developed markets by a large margin. Although equity markets from many emerging countries are turning in great performance, the Chinese market, due to its size and influence, draws the most attention. A RMB 4 trillion ($586 billion) stimulus package, combined with credit easing, spurred Chinese economic growth to a 7.9% annual rate in the second quarter, while other nations were still contracting. **Perhaps, because asset prices have gone up so much and so quickly, investors worry that the Chinese economy may be overheating.**

What Premier Wen Jiabao did to address the Chinese economy is somewhat similar to the strategy employed by Alan Greenspan, some years ago, flooding the market with credit in order to keep the economy going. As a result, the Chinese real estate market, just like real estate in the United States, was driven to new highs by speculative investors. **Unless the employment rate and GDP growth rate are much stronger than expected, the Chinese real estate market will undergo a correction just like the U.S. experienced.** But, since China's real estate, unlike the U.S., is much less dependent on derivative financing instruments, the severity of any correction might not be as huge.

In order to entice domestic demand for consumer products, the Chinese government has "encouraged" its banks to increase lending. Local currency lending is on track to exceed RMB 10 trillion ($1.5 trillion) in 2009, well above the initial target of RMB 8 trillion ($1.2 trillion). This 34% increase in loans from last year helps the Chinese economy return to positive growth, but it also creates a concern for potential bad loans. According to the People's Bank of China's news release last quarter-end, credit card balances, at least 6-months past due, increased 131% compared with last year, signaling a build up of bad debt on the banks' balance sheets.

Although asset-price inflation and the health of the banks' balance sheets are two major concerns, investment in Chinese ADRs remains an important piece of our global asset allocation, due to its continued strong growth potential. According to Bloomberg, China's economy is expected to grow 9.5% next year, after rising 8.3% in 2009. Goldman Sachs even predicts it could grow at the sizzling rate of 11.9% next year! **Factoring in China's growth rate, Chinese equities are trading at a relatively reasonable level.** We do, however, avoid the financial companies. Instead, our strategy is to choose stocks of companies that participate in the overall economic growth and the rise of a consumer class.

In general, Asia continues to be our most favored region, followed by the resource rich Latin America. We remain less enthusiastic on Europe, but our confidence in a European economic recovery is beginning to encourage a closer look.