PILLAR PACIFIC
CAPITAL MANAGEMENT, LLC

Quarterly Newsletter

Volume XVI, Issue 3 **October 2012**

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 ~

For the past few years, we have used a probability distribution to describe our five year economic forecast. **We attach the greatest probability (60%) to an economy which will grow at a slower than normal pace with gradually increasing inflation**. The slower growth is due to a number of factors, especially the diminished role of consumer spending in this cycle.

Two risks to this economic forecast are rapidly accelerating inflation due to the excess liquidity provided by the Federal Reserve Bank, and the vulnerability of this slow growth economy to external shock. In the past year and a half, we have weathered several of these shocks, mostly from abroad, as the U.S. economy continued to grow.

Lately, another potential shock has been recognized, the risk of a "Fiscal Cliff". **Most of us have heard about this event, a series of U.S. tax and spending policies scheduled to take effect on January 1, 2013, the magnitude of which would force the economy into recession**. With elections looming, it is difficult to predict whether and how a solution can be reached. With the guidance of economic analysis from Neal Soss, and his team at Credit Suisse, we will describe the situation.

If all the policies included in the Fiscal Cliff were to take effect, they would reduce the deficit by more than $800 billion, an amount equal to about 5% of current year Gross Domestic Product (GDP). These policies are comprised of two thirds tax increases and one third spending cuts. **Spending cuts have a greater immediate impact on short term GDP growth than tax increases.** If all the policies were to take effect on January 1st, it is estimated that it would reduce calendar year 2013 GDP growth by 3.8%. Since GDP is currently growing at a rate less than 2%, it is likely the U.S. economy would experience a recession early in 2013, if the entire Cliff were to take effect.

We do not think all of these policies will be allowed to take effect. The largest of the potential tax increases, the expiration of the current tax code, amounts to nearly $300 billion, including the $75 billion expiration of upper income tax provisions. With neither party seeking to raise taxes on middle or lower income earners, it is unlikely that these taxes will be allowed to increase (even though the fate of the upper income tax provisions may be determined by the outcome of the election). This, alone, would effectively reduce the Cliff by 30%.

The largest spending reduction is the first installment of a ten-year project called the Budget Control Act of 2011, commonly referred to as "budget sequestration', amounting to $86 billion. These cuts are equally weighted between defense and domestic spending. With defense contractors warning of layoffs, given the uncertainty of Pentagon contracts, Congress is already bickering over who was responsible for such an idea. Since neither party wants to shoulder the blame for higher unemployment during election season**, it is likely that a compromise will be reached to temporarily suspend sequestration until it can be replaced with a less abrupt form of deficit reduction.**

When we go through an analysis of each provision, in the Cliff, **we come to the conclusion that the most likely impact on GDP growth, for 2013, will approximate 1.5%**; enough to impact a slow growing economy, but not enough to guarantee a recession. Of course, this is our most likely scenario and assumes a rational approach to policy by our elected officials.

There are two points to make when talking about recession. The first is that by the time the economy slips into recession, the stock market is already beginning to rally in anticipation of the rapid growth typical of economic recovery. The second point is that fiscal policy does not occur in isolation. **It is probably more than a coincidence that the Federal Reserve Board's recent announcement of continued quantitative easing (QE3) is an almost dollar for dollar offset to the likely impact of a Fiscal Cliff.**

With the challenges facing us, we are still cautiously optimistic regarding the potential for gains in the stock market. **Companies are better positioned now than they were four years ago, valuation levels are better than we've seen since the 1970s, and for the first time since 2008, we are seeing significant positive cash flow from institutional investors into equities.**

Fixed Income Market

The Federal Open Market Committee instituted another quantitative easing (QE) program at their most recent meeting in September. **The Fed will purchase $40 billion in mortgage-backed securities per month until it deems the employment market has improved "substantially".** This last caveat differentiates this "QE" from earlier versions at it leaves open the amount and timing of asset purchases the Fed is willing to carry out. This newest action will operate in conjunction with the continuation of Operation Twist and again has the goal of lowering long term interest rates in the hopes of boosting economic growth. However, many critics claim that the Fed's most recent easing program will have little effect on the interest rate environment, already at historical lows, while also increasing the potential for inflation.

At Pillar Pacific Capital Management we use fixed income as a capital preservation tool, while still seeking the best yield for the bond instruments we're buying. Recently there has been an increase in corporate bond issuance, as companies try to cut borrowing costs. **Therefore, our bias has been to purchase bonds on the lower end of investment grade range, even venturing into the BBB arena where the average spread over Treasuries with the same maturity is about 2%.** We continue to apply our rigorous research process to ensure we buy bonds of companies with strong balance sheets and earnings growth with low default risk.

The municipal bond market has also seen increased supply of new issuance. **While we generally find value in holding municipal bonds for our higher income tax clients, it is an asset class that will need careful monitoring in the coming months.** With the potential "Fiscal Cliff" along with higher income tax rates approaching at year end, there will be increased demand for municipal bonds, driving up their prices and lowering yields. On the other hand, the current administration has proposed eliminating the tax-exempt benefit of municipals and such actions could adversely affect the municipal bond industry. We will keep a watchful eye on the situation and act accordingly in your portfolios.

International Market

It was once again an eventful quarter for the European "theater" but fortunately, most of the recent developments were positive and could help the troubled euro-region nations to attain monetary stability. **The European Union, European Central Bank, and International Monetary Fund are now cooperating to make sure that Europe's financial system remains stable**.

European leaders' desire to hold the currency union together reflects the recognition that the fallout from a breakup could be worse than the cost of getting the troubled PIIGS nations back on their feet. This now seemingly obvious conclusion actually took a tremendous amount of effort by all parties, as politicians have their own agendas and constituents to appease.

Only after larger nations such as Italy and Spain started to decline, did stronger countries realize the need for mutual cooperation to prevent further collapse.

Increasing capital flight is the likely inflection point forcing countries like Germany to capitulate. **Signs of individual and international corporations and even central banks moving assets away from the euro and into other currencies sounded the alarm**. In the first quarter of 2012, claims in euro only represented 24.9 percent of central banks' allocated reserves, down from 26.5 percent in the same period of 2011 and 27.3 percent in 2010. If capital flight continued unabated, institutions and consumers might have lost faith in the euro, leading to a massive exodus and economic collapse. Even Germany cannot afford for that to happen as more than half of its exports are to the euro-region countries.

Therefore, the euro's institutional structure is finally being addressed and a working blueprint is starting to take shape. **Through the use of temporary vehicles such as EFSF (European Financial Stability Facility) and later the permanent agency, ESM (European Stability Mechanism), euro nations are making sure their financial system is capable of handling adverse developments to their member nations' financial condition**. Additionally, the unlimited ECB purchases of sovereign bonds on the secondary market, the "Outright Monetary Transactions (OMTs)", serves as a quasi safety net underlying the pressured European sovereign bond markets.

It was agreed on June 29th, that the ECB would be the sole bank supervisor with power to grant banking licenses within the 17-nation euro area. **By giving the ECB full supervisory powers related to financial stability, European leaders aim to achieve a euro-area banking union.** This serves as a starting point in attempting to complement the monetary union by forming a fiscal union, which we believe would be the fundamental solution to the problem faced by the euro-region.

The crisis in Europe not only affects EU nations but also impacts China. **China's number one trading partner is Europe and the European sovereign debt crisis has crimped China's exports to the region.** Another reason why the Chinese economy has slowed considerably is the government's crackdown on property prices that has cooled its domestic demand. China also faces a once-in-a-decade leadership transition that has created uncertainty among developers and investors.

One benefit of the cooling economy is the easing of inflationary pressure that now allows the Chinese government more room for stimulus actions. Various signs indicate that Chinese leaders will follow policies of further easing after political power struggles are settled. **Infrastructure build-out projects, rate cuts, municipal debt forgiveness, and targeted easing in specific regions are examples of tools available to the Chinese government**.

Low valuations attract buyers and currently, the Shanghai Composite Index is trading at less than half of its 10-year average. Investors, especially foreign investors, have a renewed interest in the Chinese market as quotas requested and allotted to Qualified Foreign Institutional Investors (QFIIs) have almost tripled. Additionally, investors should never underestimate the power of the Chinese government which owns the world's largest foreign exchange reserve at $3.2 trillion.

Although developments on the international markets seem to be improving, they are by no means fully resolved. **It is almost certain that we will still encounter headwinds going forward as both euro-region countries and China implement various strategies to get their economies running.** Also, rising geo-political tensions across various regions need to be closely monitored.