PILLAR PACIFIC
CAPITAL MANAGEMENT, LLC

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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

As I write this newsletter, it is the start of the New Year and the tax portion of the fiscal cliff appears to be resolved. The media circus attending the last minute debates might have been darkly humorous, if the costs weren't so expensive and the potential consequences so dire. **The uncertainty created by the process will certainly temper growth in the first half of 2013.** With an even larger debate looming, over the debt ceiling and spending cuts, it is no wonder that economists are pessimistic about our economic future.

Besides the political mess, **economists cite a number of "headwinds," which will result in slower real growth in the US over the next decade or more. Among these are an aging population, global competition, and uncontrollable household and government debt.** Add to this list the perennial belief that technological innovation is doomed to falter. Another argument in the Wall Street Journal claims that annual economic growth of 2% since the Civil War has been the result of earlier breakthroughs such as railroads, electricity, communication, cars, computers and the Internet, all of which created much larger economic impact than future innovations could produce. Since these historic innovations were made possible by an unlimited supply of cheap energy, the lack of cheap abundant energy would be a constraint to future economic growth.

On the other hand, **recent developments in the technology for extracting natural gas from shale lead other analysts to a more optimistic view.** According to Dow Chemical, manufacturers in the US have announced more than $90 billion in new investments to take advantage of cheap natural gas, and there is more to come. **Because natural gas is both a source of energy and a feedstock to multiple and diverse industries, it is driving an industrial renaissance, providing an additional competitive advantage to US manufacturing.**

Whether the US economy is doomed to slow growth for decades to come or on the verge of a new era, is really not as important for investors as the price they pay to participate in this growth. **A tenet of contrarian or value investing is that the stock markets of countries whose economies are expected to grow at a faster pace tend to under perform the returns from the stock markets of countries with projections for slower growth.** In other words, investors tend to overpay for the hopes of a bright future and discount the potential for opportunity with slower growth.

Since 2009, the beginning of the current bull market, investors have reduced their allocation to stocks from 72.5% to 72%, in spite of an 85% rise in stock prices. Bloomberg estimates this has cost investors $200 billion. **Fresh cash has gone into bonds in spite of anemic returns, while valuation metrics for stocks are at a 12% discount to their sixty year average.** During this weak economic recovery, companies have weathered an uncertain regulatory and fiscal environment to produce profits. We expect the companies we own to continue to adapt to the environment of the coming years and continue to produce profits for shareholders.

In conclusion, **the grimmer the future, the more optimistically you should invest**.

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Fixed Income Market

On 12/12/12, the Federal Open Market Committee announced a policy shift which some call Quantitative Easing 4 (QE4). **With QE4, the Fed will embark on a round of Treasury purchases of $45 billion a month to replace the expiring Operation Twist program**. This is in addition to the QE3 or “Q infinity” program previously announced where the Fed committed to buying $40 billion a month in mortgage-backed securities with no end date established. That total of the two programs will be about $85 billion per month or about $1 trillion per year.

One difference in this recent announcement is the setting of tangible targets for 6.5% unemployment and 2.5% inflation which will serve as goals for changes to the current low rate policy. They also removed 2015 as the date for raising rates to provide more flexibility should inflation start to rise, sooner. Despite these new policies by the Fed, interest rates on Treasuries have remained relatively unchanged from prior periods with the U.S. 10-year Treasury bonds yield at 1.70%, slightly above last quarter’s figure of 1.67%. The 30-year rate is also relatively even at 2.87% versus last quarter at 2.85%.

As the year 2012 came to a close it appears there is, finally, agreement on dealing with the “Fiscal Cliff”. A major provision of the compromise will have taxes increase for higher income households (income over $450,000). **However it is still unclear how the markets’ reaction to the deal will impact interest rates and investors’ appetites toward income generating vehicles in the future.** We will undoubtedly keep an eye on the impact to the various types of bonds we hold and act accordingly.

We continue to favor high quality corporate bonds simply because it is one of the few areas to pick up some yield on the Treasuries. However interest rates for new issuance corporate bonds have also contracted primarily due to companies’ taking advantage of the low rate environment. According to Bloomberg, the 2012 issuance of corporate bonds totaled nearly $1.5 trillion.

As always, the focus at Pillar Pacific is to find the best yields for the type of bonds we are buying and ensuring your portfolios of fixed income instruments are properly laddered and diversified in the current environment.

International Market

During 2012, international markets experienced several positive events. The European Union (EU) has taken the first steps toward unified oversight of the diverse fiscal policies of its member nations. In China, the leadership transition went smoothly and economic indicators have improved. **These developments provide encouragement that the international markets may improve in the year ahead.**

The Euro zone has been a troubled economy for several years with a fundamentally flawed system of using a single monetary policy to service the needs of multiple fiscal policies. The only solution to address this flaw is to establish a central policy authority. **With European finance ministers finally agreeing to give the European Central Bank the power to supervise Euro zone banks starting from 2014, the region is embarking on a new order of closer integration to help support the euro.** It also lays the cornerstone for a stronger banking union in the future and a common approach to deal with failing banks. Ultimately this will lessen the risk of a few vulnerable countries dragging down the entire entity.

Negative news tends to dominate media headlines; as a result, the average investor may have the impression that all of Europe is struggling. This is not necessarily the case. Germany’s equity market has quietly turned in its largest annual gain since 2003. **The European Central Bank (ECB) has expanded asset purchases, keeping interest rates artificially low and creating a business-friendly environment for companies.** As investors’ confidence in Germany’s medium-term economic outlook continues to grow, confidence is also beginning to improve for second tier nations. For example, the ECB has started to accept Greek government bonds as collateral for loans and Standard & Poor’s has raised Greece’s credit rating from “default” to “B-”.

In China, the once-in-a-decade leadership transition created some uncertainty among developers and investors that resulted in projects being temporarily placed on hold, slowing the economy. As the ruling Communist Party’s new generation of leaders headed by Xi Jinping assumed power without major incident, **China’s economy has also started to rebound. After seven quarters of slowing economic growth, the government has increased spending on infrastructure, accelerated investment project approvals, and implemented pro-market initiatives**. One such initiative includes the removal of the Qualified Foreign Institutional Investor (QFII) limits on foreign investors. The Shanghai Composite Index has recovered from its lows for the year as a pledge by the nation’s new leaders to promote the development of rural areas has boosted expectations that corporate earnings will improve.

Recent economic data readings also suggest that China’s efforts may be gaining traction. The final release of China’s Purchasing Managers Index (PMI) was not only an upward revision from the preliminary estimates but also the highest indication of future economic activity since 2011. Other encouraging data includes strong numbers for industrial production and new orders. **More importantly, inflation has been abating with current CPI levels around 2%, allowing Beijing to implement pro-growth policies for the coming year. If infrastructure construction is carried out as planned and property market conditions continue to stabilize, the momentum of this recovery could accelerate.** Although the official GDP growth forecast for China still remains at 7.5%, average estimates by street analysts range as high as 8.6%.

A Global Market Sentiment Survey, conducted by the Chartered Financial Analysts Institute, reveals that its members, although cautious, are becoming more optimistic that the global economy will continue to expand. They also predict global equities to outperform all asset classes. **Even so, we must emphasize that we are in the early stages of addressing issues that have dogged the global markets for several years and new obstacles can still emerge along the way.**