

The Upside of Down Markets

Investor and consumer confidence has been shattered since September 2008 following a significant increase in risk aversion and concerns about slowing economic growth. Looking back over the fourth quarter, the November 20th S&P 500 low of 752 has held for three months and now rivals October 2002 levels when headlines chronicled Enron and WorldCom bankruptcies, exposing accounting deficiencies. This period was as uncomfortable for value-oriented, tactical asset allocators, as it is today. Equity markets seem to have overshot fundamental equilibrium again, even if current earnings forecasts still prove too optimistic. GDP is 35% greater and operating earnings are 61% higher than in the fall of 2002. What does this say about current valuations? Each new plateau for equity valuations is ever more compelling. In 2003, the S&P 500 returned 28.7% from very distressed levels. While the S&P 500 Index has closed in on 2002 lows, total return including dividends, is actually 13.1% higher over the current period. Dividend yields over 3%, taxed at a lower rate than income, should not be overlooked. From a level similar to six years ago, the *Upside of Down Markets* from here could be meaningful.

Each new measure of fiscal and monetary support will take time to work, as history teaches. Concerns linger about housing weakness, rising savings (reducing consumption), and whether secular emerging market trends were an illusion. Yet, there are some hopeful signs: credit risk spreads have contracted, trading volume has increased, liquidity has improved, and new issuance has surged.

The shift from a normal investor risk tolerance to an emotional risk tolerance has often exposed exceptional return opportunities for contrarian investors. Capital markets regularly overshoot due to recurrent cognitive and emotional biases, including during periods of transition from one cycle to the next. Our natural human behavior seeks to avoid danger, including losing money. Many suggest this is the worst crisis since the Great Depression, but we've observed other U.S. recessions that were worse by a variety of measures. Our fears are heightened by extrapolating trends, uncertainty, and confusing interpretations of highly complex issues.

The current threatening economic state, triggered by the issues highlighted below, has exposed human instincts and together they have come together to form a *perfect storm*.

1. Housing weakness—beginning Dec. 2005
2. Timing of Fair Value Accounting rules—Nov. 2006
3. Super-spike in oil prices to \$147-- peaking July 2007
4. Suspending the *Uptick Rule*—July 2007
5. Central Banks constrained by inflation targets—2008

The order and timing of these events provided the perfect combination to cause a storm surge. Now that many of these have been defused or are mostly played out and massive stimulus has been initiated to turn the tide, we believe the remaining issues will be overcome.

U.S. policymakers have implemented creative solutions, in coordination with classic policy prescriptions, to address America's concerns. We expect this massive effort to be successful at restoring global credit flow and bolstering confidence. Given compelling equity valuations and low interest rates, it would seem a shame to waste such an opportunity. It may take time for policy stimulus to gain traction, but America has recovered from every previous crisis. Capital markets tend to anticipate recovery well before economic trends are visible, although premature false rallies are possible and have already been observed. As capital markets have seemingly priced in extreme emotional risk aversion, current valuations provide an *Upside to Down Markets*.

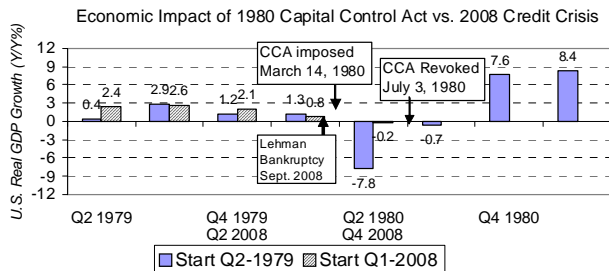
Economic and Capital Market Outlook

This has been a different kind of crisis for many reasons, beginning with its roots in capital markets/credit and commodity price volatility. Real GDP growth of almost 1% during the first year of this recession and 2-3% growth in earnings of non-financial companies during 2008 illustrates how resilient the U.S. economy was for most of last year. Other OECD economies in aggregate fared worse than the U.S., which has contributed to a stronger U.S. dollar and exacerbated the decline in weaker non-U.S. stock markets.

One of the remarkable themes that we have highlighted over the years has been the resilience of American productivity and profit margins. American businesses have become increasingly agile and responsive to their respective markets, adapting quickly to changes in demand, competition, and innovation. When economic activity slows, we intuitively expect productivity should suffer. Recessions don't typically start with such a high rate of productivity, but productivity increases exceeded 1.5% in each of the last four quarters, including 3.3% in

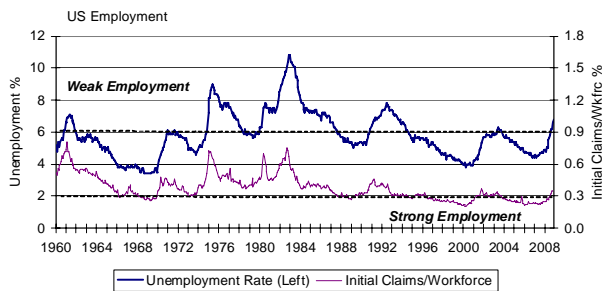
the fourth quarter. The 2.7% increase for 2008 compares favorably to an average increase of 2.2% over the last 20 years. This increase is surprising, given commodity price volatility and inflation peaking over 5.5% last July.

We have also highlighted the effect of another dramatic credit contraction. Shortly after the Credit Control Act was imposed in 1980, real GDP plunged -7.8%, but rebounded quickly after suspending President Carter's executive order. If credit availability was this important during 1980, imagine what role it played in 2008.



Source: HighMark Capital and Thomson Datastream

Recessions are times of transition, but the speed with which companies responded to this downturn has been unprecedented. It may explain why inventory and employment indicators are leading, not lagging indicators this cycle. Inventories began contracting in 2006 while unemployment began rising in April 2007. The inventory correction has subtracted up to 1% annually off GDP and the unemployment rate troughed at 4.4% versus the 6% historical average. Weekly unemployment claims, when normalized relative to the size of the workforce, are still lower than peak levels of prior recessions.



Source: HighMark Capital and Thomson Datastream

Construction has been a significant source of job loss, as housing starts plunged from 2.2 million units at the end of 2005 to 560K in January 2009. Since mid-2006, construction jobs have plunged by 2.1 million or 21.5% of all construction jobs making up a significant proportion of the 3.5 million jobs lost over the period. The concentration of construction jobs losses is noteworthy.

Housing inventory has now fallen to 9.3 months as starts plunged to a fraction of household formation plus replacement demand, estimated to be 1.5 million units annually. Current starts barely cover the replacement need of 300K units per year. Idled housing developments in overbuilt regions may take years to recover, from California's Central Valley to Florida, but

shouldn't preclude a rebound in housing throughout the rest of the country. Rising existing home sales, including significant foreclosures, plus mortgage restructurings are reducing the overhang of distressed loans. Falling interest rates are lowering mortgage payments through refinancing and mortgage rate resets.

Headlines regarding the economy appear grim, but there have been periods in the post-WWII period that were worse than current conditions. Timing of the Presidential election probably exacerbated the current crisis of confidence, but signs of some improvement are evident in January data (i.e., housing, retail sales, ISM surveys). Data persistence will be needed to restore confidence.

	Unemp.	IP	GDP	Low T-Bills	Bank Failures
1931	25.0	-47.0%	-30.0%	1.0%	12,000
1975	9.0	-12.4%	-2.5%	3.2%	79 (1970s)
1982	10.8	-9.8%	-2.9%	7.6%	747
1992	7.6	-3.6%	-3.2%	2.7%	925 (1990s)
2002	6.2	-5.4%	0.2%	0.9%	-
2008	7.6%	-8.6%	+1.3%	0.01%	32
Date	Jan '09	Jan '09	2008	Dec-08	Feb-08

Source: HighMark Capital and Thomson Datastream

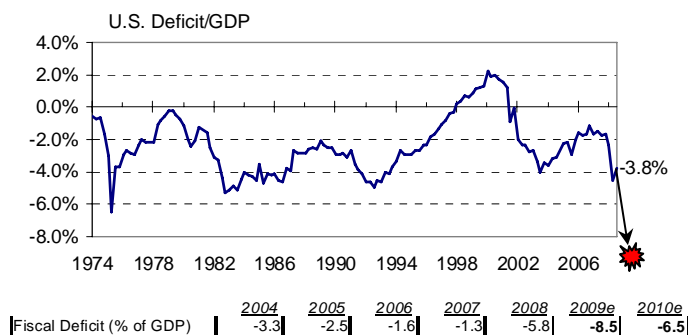
Many contributing factors have been blamed for the 2008 Credit Crisis. Lenders and borrowers bear frontline responsibility. However, little scrutiny has focused on quotas governing fair lending practices to lower income households and underserved geographic areas. Federal regulations set Freddie Mac and Fannie Mae origination quotas for low-to-moderate income households at 30% in 1992, rising to 50% by 2001 and 56% by 2005. HUD's 2006 Budget Summary included \$0 down payment loans through FHA and "payment incentives" for weak credit borrowers. Increasing homeownership is a worthy objective and efforts to assure fair lending practices are in our nation's best interest. However, subprime mortgages increased dramatically by 2006, as a consequence of this HUD guideline. Countrywide and others only qualified enough marginal borrowers to meet federal guidelines by lowering credit standards, minimizing down payments, and seeking favorable appraisals. To compete, many lenders relaxed borrowing standards, with unintended consequences. Yield-hungry investors rarely looked beyond yield and credit ratings to judge investments, fueling the untenable situation.

Recent changes in fair value accounting rules have exacerbated losses. Declining confidence in the rating agencies and rising credit default spreads have propagated a vicious cycle for illiquid credit securities. Write-offs on credit securities exceed current loan losses and trade at a discount to intrinsic value, reinforced by wide bid-ask spreads. Any further write-offs should have a diminishing impact, as the financial sector exposure has plunged to 10.6%. Only about \$1 trillion of subprime exposure remains of \$11 trillion in home mortgages.

The challenges we face today are not insurmountable, but bolstering confidence is critical. The World Economic Forum brings together leaders seeking insights into

trends and that new-new thing. Last year's dotting spotlight focused on hedge funds, private equity, and alternative investments. Davos attendees this year were greeted by an avalanche of economic pessimism and calls for nationalizing banks. To paraphrase *Business Week* Editor-in-Chief Stephen Alder, Davos identified villains and a few heroes, but he suspects that "we are oversimplifying the story line and assuming we know more than we do. There's still much more to be learned, and the explanation of something so complicated requires a good deal of skepticism and humility".

Next up is a healthy dose of fiscal stimulus. The American Recovery and Reinvestment Act will cost \$790 billion. Exceeding 5% of GDP, it is the most expensive package ever, but it is hoped to restore 3.5 million jobs. If targeted monetary measures and interest rate cuts do gain traction, then this stimulus will have to be offset by aggressive interest rate hikes. It is unknown how much the additional debt will affect long-term economic prosperity, but any related increase in financing costs or crowding-out of investment will impede growth.



Source: HighMark Capital and Thomson Datastream

The federal deficit has increased since 2007 as tax revenues declined and \$152 billion was spent on the Economic Recovery Act of 2008. The fiscal deficit is expected to rise to over -8.5% of GDP. Rising deficits can force up long-term interest rates. Treasury yields have jumped 1% since December.

The Administration promised 95% of Americans would receive a tax cut. For 12% of America's population living in California, this payroll tax cut only offsets the sting of increasing sales taxes, rising 1% to 8¼%, the near doubling of vehicle license fees, and the addition of a surcharge to income tax bills. For a family of four earning \$60,000/year with a car(s) worth \$20,000, the additional tax burden will cost more than the federal payroll tax benefit of \$800 (Sacramento Bee Calculator).

Deleveraging

"Deleveraging" has become a catch-phrase for various observed behaviors. Risk reduction and increased conservatism appear more descriptive of what we observe today. Investors have reduced their risk tolerance by swapping equity exposure for bonds or credit exposure for Treasuries. Peak leverage ratios for

investment banks approached 35 times in September, but have since plunged below 13 times for Goldman Sachs and 11 times for Morgan Stanley. Consumer leverage is highly concentrated in their mortgage loans, which is difficult to reduce. Household savings rates do appear to be increasing, but most of this anomaly was driven by rebate checks and tends to reverse rather quickly at the first sign of recovery. Interest rate cuts that lower payments on credit increase disposable income.

Businesses have trimmed costs and managed growth better through this cycle. Shuttering U.S. automotive plants for an extended period during January on top of the dislocation effects of the credit crisis in the fourth quarter will create significant short-term volatility in orders, jobs and various other demand-driven indicators. These swings will be confusing but we believe will eventually even out over the next couple months. Commercial real estate avoided most of the dodgy lending practices observed in the housing sector, but there is no immunity from economic contractions that may reduce needs for office space and store expansion. Leverage by itself is not a hindrance to economic growth, but rising interest costs may reduce flexibility. Deleveraging is occurring, but increased risk aversion and conservatism are dominating behaviors.

One of the interesting stories of "deleveraging" has been the unwinding of swap exposure. More than \$60 trillion of estimated exposure was assumed to be outstanding in June 2008. This number became one of the most exploited statistics used to heighten investor fears. Since many swap contracts are private agreements, data on total exposure could only be estimated prior to DTCC setting up their database last October. Nominal credit exposure tracked on DTCC Deriv/SERV in mid-February now totals just \$26 trillion. How could this reduction be possible without triggering massive losses? The money changing hands between Lehman swap sellers and buyers totaled just \$5.2 billion at final settlement.

Netting offsetting trades and matching gains with losses revealed very little market exposure. The explanation for this remarkable story lies in the fact that derivatives are a synthetic equivalent to holding cash securities. Every derivative contract yields equivalent gains and losses. In contrast, stock and bond price declines destroy wealth. Daily trading volume in derivative products typically exceeds cash trading several times over, but investment banks typically realize only modest variation margin in the value of trading portfolios.

Derivatives are recognized as a cost effective and liquid tool for portfolio management. If an investor buys a swap (ex: S&P 500 - Russell 2000 return differential) on January 30th to expire in one year, but chooses to unwind the position earlier, another swap must net out the trade until maturity. Although relatively indifferent to what happens after offsetting the position, derivative exposure has doubled. Offsetting contracts written with the same counterparty minimize settlement risk.

Investment Conclusions

Throughout history, America has confronted many challenges. Globally, more than \$8 trillion has been committed in coordination with unprecedented cuts in interest rates to improve liquidity and restore the flow of credit. Visibility for companies has diminished to such an extent that many companies will no longer provide earnings guidance. To protect their bottom line, they have sought to cut costs and preserve cash by delaying investments and hiring. We have entered this global slowdown at remarkable levels of productivity, so once recovery takes hold, profitability should accelerate faster than normal. There has been a remarkable infusion of stimulus targeted at easing credit, but the risks are serious that without credit expansion, economies worldwide could slow or contract further.

Studying asset class returns through history suggests a compelling case for equities. While these have been unnerving times for investors, stocks have outperformed bonds and cash over the long-run. From 1900 - 2008, the durability of the equity risk premium is evident in real returns of 6.0% (nominal return exceeding 9%) handily beating real bond returns of 2.1% and real Treasury bill returns of 1.0%. Any significant decline in equity prices below fundamental equilibrium should imply higher potential returns over a subsequent period of time. High equity risk premiums have been observed worldwide.

We have experimented with tax rates and spending over the last century, providing documented consequences of fiscal policy changes. Hiking tax rates for corporations and individuals tends result in higher inflation and has generally reduced the likelihood of balancing the budget. Is it so surprising that high tax rate countries also have the highest ratios of national debt to GDP? We have a few suggestions to improve America's competitiveness and confidence, as well as maximize sustainable growth.

- Regulation consistency - better enforcement and simplicity are preferred to increasing regulation.
- Ratify negotiated free-trade agreements, seek other bilateral agreements, and avoid protectionism.
- Eliminate tax on debt repurchases trading at a discount, narrowing stock repurchase equivalence.
- Reduce corporate tax on foreign earnings to 15%, encouraging repatriation and domestic reinvestment.
- Cut corporate taxes to median global levels to incentivize investment and reduce inflation.
- Simplify tax calculations at state and national levels.
- Make current income and capital gains tax rates permanent and pass line-item veto budget authority.
- Adopt IASB fair value accounting guidance and reinstate the SEC's *Uptick Rule* adopted in 1938.

Capital markets tend to anticipate economic recovery by six-to-nine months. We believe policymakers have implemented innovative solutions that should help resolve this credit crisis. The volatility of earnings surprise will probably increase in coming months, as fewer companies publish guidance and uncertainty has increased. The dispersion in valuations is as great as it has ever been by a variety of measures. We believe that exceptional bargains have emerged as a consequence of behavioral biases, which are known to cause overshoot and create opportunity for active investors. When markets are at extremes, valuation factors can become more predictive. Investment and business cycles will come and go, but the most likely path is often the least obvious at the turning points.

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