

## ***A Rising Tide***

We have used the analogy of a *Perfect Storm* to describe the events leading up to the Financial Crisis of 2008. It appears to us that the tide might finally be turning. During the months ahead, investors will likely debate the potential strength of the recovery. Given the prevailing economic conditions and massive global stimulus in play, the probability that the recovery accelerates faster than might be assumed may increase, despite many concerns about various imbalances, rising taxes and increased government regulation. Investors increasingly seem to be discounting *A Rising Tide*.

The events of the last 18 months have been traumatic. This recession has been devastating in terms of its breadth and depth, revealing risks we believed to be highly improbable. Some causal relationships are being revealed, but until the credit crisis runs its course, any certainty about its cause will remain illusive, although we have shared our hypothesis. There may be as many unexpected surprises in recovery as there were over the last year during the financial crisis. Most agree, however, that the severe global credit crisis meaningfully contributed to, if not caused, the economic slowdown and will have lasting consequences. The circumstances that drove the financial crisis and stalled economic activity dictate the prevailing forces driving the eventual recovery in investment, trade, and consumption.

Business and consumer confidence surveys have improved somewhat since March, but rebuilding trust and restoring confidence will take time. Volatility tends to persist long after a steep correction. Massive government intervention and stimulus worldwide sought to address certain symptoms of the financial crisis, as faltering business, consumer, and investor confidence drove equity volatility to unprecedented levels. If these efforts are successful, we should anticipate meaningful improvement in economic conditions and earnings growth, as well as higher equity prices and tighter credit spreads. Returns are often strongest when valuations are most favorable, even if uncertainty remains high.

Once sufficient evidence of a recovery emerges, it may ignite concerns about inflation and questions about the unwinding of global monetary stimulus. The collapse or consolidation of many weaker companies across just about every industry has put significant, previously defended market share up for grabs. Businesses moved quickly to rationalize costs when access to credit seized up, so their operating margins have remained resilient.

The recovery should be quite unique, given the current unusual economic conditions. Earnings for non-financial companies actually rose 5.6% last year versus a decline of -23% for S&P 500 earnings, during the most severe credit crisis since 1980. Just over 1/3<sup>rd</sup> of the way through earnings season, 77% of companies have exceeded analyst expectations. This is the highest positive surprise ratio observed since 2003, even as earnings estimates have been rising since mid-May. In other words, companies are beating *increasing* estimates for the first time since 2007. Consider that most of the decline in earnings is due to unprecedented non-operating losses from non-recurring write-offs concentrated in Financials. Eventually, when the inventory cycle reverses, housing demand improves, investment picks up and consumption resumes, then low interest rates and exceptional productivity, bolstered by considerable slack in labor markets and capacity utilization, could drive profit margins even higher, particularly in non-financial sectors.

Many share our view that we have never observed such a dramatic divergence in economic forecasts, earnings estimates and capital market expectations. Real growth forecasts for 2010 range from 0.5–3.5%, even as the consensus has risen about 1% recently. The average S&P 500 earnings estimate for 2011 has increased over 5% just last month. Recessions are typically times of transition and significant change, including upheaval in business practices, government policies, and labor (ex: 1974, 1981, 1990, 2001, and 2008). If we correctly anticipate just a few of the many vital, forward-looking themes and outcomes, the investment opportunities could be rewarding.

These are certainly interesting times, but it is also an exciting time for those able to exploit what we perceive to be an unusual number of tactical investment opportunities. There is a great deal of uncertainty about many critical variables, including global growth potential, emerging market decoupling, tax policy, increased regulation, government deficits, shifting savings rates and residual financial leverage. We discuss several key economic considerations and our outlook for the rest of 2009 below.

## **Investment Performance Review**

Looking back over the second quarter, asset class returns were remarkable in many respects. The S&P 500

rose 15.9% during the quarter and 25.8% between March–May. The only three month period since 1960 to appreciate more was the period of August-October 1982, when the S&P 500 rose 26.7%. From intraday lows on March 6<sup>th</sup>, the S&P 500 returned 39% through June. Yet, we believe equity valuations are still compelling with respect to book values, dividends and forecasted earnings, particularly given the low level of interest rates.

Value stocks outperformed growth by a modest 0.4% during the quarter, but growth stocks still have a 14.4% edge for 2009. HighMark recommends a neutral equity style weighting now after unwinding our growth overweight. Small-cap stocks outpaced large-cap stocks by 4.8% during the quarter. Among the most unlikely results, Financials were the best performing sector, increasing 35.7%. Information Technology (+19.7%) and Industrials (+18.9%) also performed well during the quarter. Emerging markets followed suit, rising an impressive 34.8%, while MSCI EAFE jumped 25.8%, outpacing the U.S. by 9.9%, largely attributed to a weaker U.S. dollar during May.

Bond yields have risen steadily on concerns of rising deficits and rapidly increasing issuance (crowding out), as well as growing concerns about future inflation and central bank exit strategies. Corporate and municipal debt issuance deferred from 2008, including failed auction rate securities, needs to be placed. With Treasury yields at 2% during December, they were hardly a safe haven, and have now backed up to 4% in mid-June. Treasuries (10-yr.) lost -6.1% during the quarter for a cumulative loss of -8.5% in 2009. The Barclays Capital Aggregate fared a little better, returning 1.6% during the quarter. High-yield bond investors were pleased with their 22.5% return (29.0% year-to-date) as high-yield spreads versus Treasuries collapsed from over 21% to 10.2%---another sign that investor risk tolerance is improving. With the Fed expecting to remain on hold for an extended period, real cash yields are not likely to be compelling. Capital markets can signal needed policy discipline and are not always as forgiving about deficit spending, as President Clinton learned soon after taking office.

Interest rate cuts, beginning in September 2007, failed to prevent a global liquidity squeeze. Financial speculation in energy and other commodities fueled an acceleration of ETF asset flows and derivative trading, which likely drove up inflation measures worldwide. Oil prices peaked at \$147 about a year ago, but subsequently collapsed since. Can markets really be this inefficient? While economic activity slowed and the Fed cut interest rates last year, many other central banks hiked interest rates during the same period to contain inflation concerns. Interest rate increases through July 2008 now appears to have been a colossal mistake by the European Central Bank.

Producers are laying down rigs, while oil tanker loadings have slowed due to excess supply of oil. Leaving oil supply in the ground is quite a different scenario than

envisioned in 2008 when China was stockpiling a strategic reserve and peak oil theorists were in great demand. Since early 2008, we have highlighted the long-term importance of conservation, substitution and innovation once oil prices rose too high. Bidding for development of northern Iraqi oil fields is expected to double or even triple production of 2.5 mb/d. Increased mileage standards passed in 2007 will raise fuel economy 27% from 27.5 mpg to 35 mpg. Recent energy legislation accelerated the timetable to 2016. Growing investment in alternative energy and efficiency solutions further reduce forecasted demand for gasoline. Clean emission nuclear energy production has gathered support, while efficiency gains and conservation can slow the overall demand for energy. Substitution of natural gas and electricity holds promise of even greater load-sharing within the transportation sector. Buses, taxis and truck fleets running on natural gas are becoming more common. We believe substantive change in energy production and demand destruction for transportation fuels in developed markets became inevitable once oil prices shot past \$100.

## **Economic Outlook**

The *Economist*, in an article published September 25<sup>th</sup>, 2008 following Lehman's bankruptcy and just weeks before the peak in the financial crisis, called de-leveraging a "Fate worse than Debt". The author's concern was that consumers and businesses would be forced to cut back on spending in order to repair the damage done to their balance sheets. There is concern about whether an increase in the household savings rate to 6.6% suggests a new paradigm or simply a sign of greater uncertainty and tightening credit access. There could be long-term implications affecting consumption, but forecasts of the death of the American consumer have been greatly exaggerated time and again.

Monitoring changes in household net worth may be more relevant than the savings rate to gauge consumers' propensity to spend. Rising unemployment and declining net worth have undermined household confidence. Such changes can drive behavioral reactions that may temporarily boost the savings rates and lower consumption, but permanent changes are very difficult to anticipate. Household net worth declined -17.4% in 2008, according the Fed's flow of funds data, which was one of the steepest declines on record. Yet, recent estimates of net worth exceed \$50 trillion, growing 3.9% on average since 2002. Of the \$14.2 trillion in household debt, \$10.4 trillion is mortgage debt, so leverage will be hard to reduce. Banks reducing credit lines and tightening standards have undermined credit growth, as well, while securitization has plunged from more than a \$1 trillion per year in 2006 and 2007, to just \$28 billion in 2008. The savings rate increase has been forced upon many borrowers, and may reflect more than simply an increase in risk aversion. Even if the savings rate settled at 5%, potential GDP growth of 3.0% would be little changed. The economic consequences of an increasing savings rate are obvious, but also tends to be cyclical.

The global economic slowdown has exposed our reliance on well-functioning credit markets. This economic linkage was first uncovered in 1980 when President Carter imposed credit controls by Executive Order No. 12201 (Credit Control Act) on March 14, 1980 to contain accelerating inflation. This decision taught us an important lesson as a slow-growing economy (+1.3%) was driven into a steep recession (-7.6%). In a matter of weeks, industrial output sputtered, unemployment rose, and retail sales plunged, causing stagflation. After rescinding the order July 3<sup>rd</sup>, the economy recovered quickly, with increases of 7.6% and 8.4% in GDP for the subsequent fourth and first quarters. Consider how much more the global economy depends on credit expansion today than it did 28 years ago. The circumstances restraining credit are different, but the effect is illustrative and suggests that the U.S. economy can recover rather quickly, if and when credit concerns ease.

Consumers and businesses have faced difficult challenges as the turmoil spread globally, but consensus forecasts for real GDP, inflation and even earnings are finally increasing. Monetary stimulus, including a dramatic decline in global interest rates, plus government guarantees, has helped improve liquidity. Even debt issuance has been recovering from January lows. Is this *A Rising Tide* we are observing?

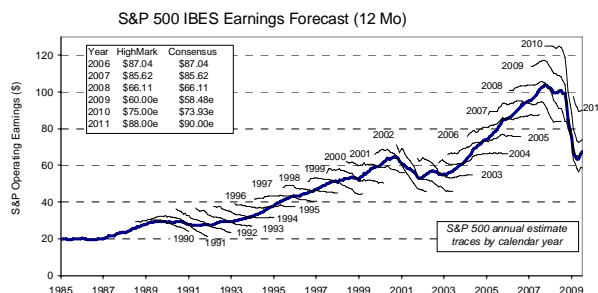
<u>HCM Forecasts</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009e</u>	<u>2010e</u>	<u>2011e</u>
U.S. GDP (Real)	2.8	2.0	1.1	-1.5	2.0	2.5
Earnings Growth	15.3	-1.6	-23.6	-7.0	23.1	14.7
CPI Inflation	3.2	2.9	-0.1	0.3	1.7	2.5
Unemployment	4.6	4.6	7.2	9.5	8.5	8.0
Fed Funds Target	5.25	4.25	0.25	0.25	2.00	3.25
10y Treasury Bond	4.71	4.03	2.25	3.50	4.50	5.00

Source: HighMark Capital Estimates and Thomson Datastream

Tumbling corporate profits took a significant toll on investor confidence, but more than ever, it is important to understand the reasons behind dramatic performance differentials in sector earnings. A meaningful reversal in earnings estimates has finally broken the vicious downward spiraling earnings revision trend, with financial sector earnings increasing the most, followed by other cyclical sectors such as industrials, technology and consumer discretionary. A steep yield curve is driving strong cash flow in the financial sector after earnings plunged -117% in 2008 due to accounting write-offs and loan loss provisions. Accounting for 28% exposure in the S&P 500, reported losses in Financials explain more than the S&P 500 earnings decline of -22% in 2008. Deposit growth has benefited from increased FDIC insurance levels. Commercial banks have expanded their lending volume, but it still isn't sufficient to meet the voracious need for credit. The government has filled this gap in the interim by buying asset-backed securities and guaranteeing commercial paper issuance, but capital markets must be able to resume their normal risk capital function. Credit issuance has been encouraging, but is still far from normal.

It is remarkable that during such a significant financial crisis, non-financial earnings actually grew by 5.6%.

Detail at the sector level reveals an inconsistency in non-financial forecasted earnings. Non-financial earnings are expected to decline -23.1% for 2009, which seems rather inconsistent given efficiency gains realized and an economy now expected to trough in 2009. Rising earnings estimates for 2009-2011 have coincided with constructive company guidance.

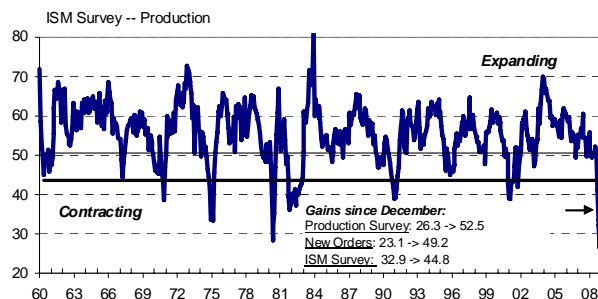


Earnings	2011	2010	2009	2008	2007	2006
HighMark	17.3%	25.0%	-9.2%	-22.8%	-1.6%	15.3%
Consensus	21.7%	26.5%	-11.5%	-22.8%	-1.6%	15.3%
HighMark	\$ 88.00	\$ 75.00	\$ 60.00	\$ 66.11	\$ 85.62	\$ 87.04
Consensus	\$ 90.00	\$ 73.95	\$ 58.48	\$ 66.11	\$ 85.62	\$ 87.04
Financials	51.2%	93.0%	244.8%	-116.9%	-2.1%	21.8%
Non-Financials	20.2%	20.1%	-23.1%	5.6%	3.2%	12.4%

Source: HighMark Capital Estimates and Thomson Datastream

Fewer companies are providing guidance so analysts' visibility is significantly impaired. Yet, the startling decline in earnings estimates since October has finally been arrested and we suspect overall earnings estimates have probably been marked too low. If earnings forecasts improve materially for non-financials, equity markets should discount improving overall earnings estimates. This could extend beyond the U.S.

A significant leading indicator is the Institute of Supply Management Survey. This timely gauge of changes in business sentiment has a long and consistent history. This survey tends to suggest convergence to potential growth of 2.7% when readings are close to 50 and negative real growth as readings drop below 42. If there were lingering structural problems, we might expect a drawn out recovery in the ISM survey. Instead, the unusually rapid rebound observed suggests growing confidence that the financial crisis flared and then is being extinguished surprisingly quickly. This may not preclude some other concern from arising, but improving economic momentum is consistent with *A Rising Tide*.

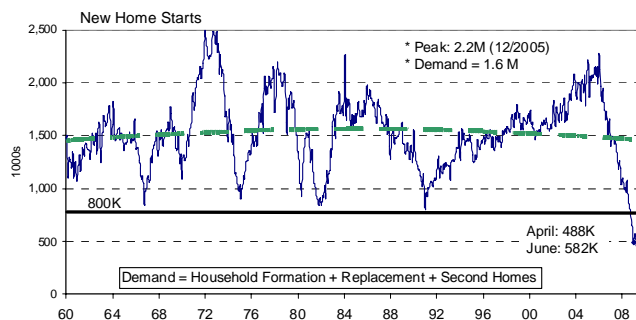


Source: HighMark Capital Estimates and Thomson Datastream

We believe that the current combination of very low mortgage rates and increased affordability will entice previously hesitant home buyers into the market. Recent surveys suggest that it costs more to rent than to own. Employment could expand once housing starts accelerate, given the concentration of job losses in residential construction.

Housing starts are running at a pace of 532K/year, but demand from household formation, plus replacement and second home demand, total 1.6 million/year. Thus, housing starts are just 33% of the number of new units needed. Housing inventories have declined -17% from the peak last July to a level that is about 15% above normal (3.7 million vs. 3.2 million). Housing markets tend to vary regionally, so particular regions may remain under pressure for several years. In the mid-1990s, Southern California's recovery lagged due to Defense spending cuts and in the 1980s, Texas suffered after oil prices collapsed. Given concentrations of unsold homes in a few particular markets, 500K of excess inventory may represent tighter inventory than assumed.

The National Association of Realtors reported through June that home prices rose about 10% sequentially since the January low of this year and that sales volumes have been increasing since last summer. Housing prices are -22% lower than the peak in 2005, yet foreclosures tend to fetch 10-20% below market, reflecting steep discounts and account for about 50% of sales. Current supply vs. demand conditions could now support a trough in home prices. Thus, home builder comments a few months ago citing increased activity seem to be reflected in recently rising housing starts.

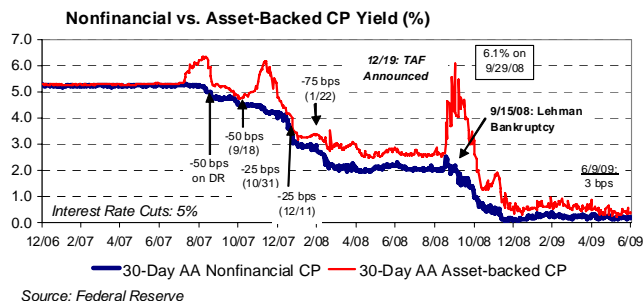


Source: HighMark Capital and Thomson Datastream

Inflation concerns are increasing now. Consumer price (CPI) inflation is -1.0%, which is largely a residual of the 50% decline in oil prices from last June. Core CPI (ex-food & energy) has increased 1.8% versus headline CPI, which is trending toward 1.6% annualized through June, and drives cost-of-living wage increases. With oil prices rising in 2009 and an increase in the minimum wage, it is mathematically unlikely that CPI inflation will decline -0.5%, as expected by consensus. If the inflation rate is more likely to be 1% than -0.5%, negative real interest rates will not be sustainable and the Fed will need to hike interest rates sooner than expected. We expect the Fed will begin raising interest rates no later than the first quarter of 2010.

Water rationing in the California Central Valley also may take a toll on food prices later this year. It is an extraordinary sight this time of year to see so many fields lying dormant. Water rationing was triggered for farmers when the two inch smelt fish, which is not indigenous to the California Delta, was added to the Federal endangered species list. More than \$1 billion in crops were produced in the Westlands Water District in prior years, but if this region doesn't have sufficient water to grow enough crops, food inflation may emerge.

Patience is difficult, particularly when politics and market volatility intersect, yet many companies are now exploiting an abundance of opportunities. The *Invisible Hand*, popularized by the philosopher Adam Smith in *The Wealth of Nations*, is believed to be a strong force that can bolster America's resilience during difficult times. It is always better to grow due to natural causes, with little or no intervention. Policy intervention can help accelerate the process, as long as it doesn't do more harm than good over the long run. Too much stimulus can increase inflationary pressures or boost fiscal deficits to costly levels. Worldwide efforts to stabilize capital markets and economic activity, as well as bolster confidence and liquidity seem to be working. We believe that all that needs to be done has been done to improve liquidity and access to credit, addressing the symptoms of the credit crisis.



The commercial paper market provided the first indication that a liquidity squeeze was emerging in the fall of 2007 and has been a good indicator that credit conditions have improved in 2009. The chart above also highlights the significant decline in financing costs. Many corporations have announced intentions to reduce their reliance on short-term commercial paper financing in favor of longer term debt. This implies they will be carrying more cash on their balance sheet. Any increase in issuance tends to push up long-term interest rates, but we also expect the Fed's balance sheet to contract as their liquidity programs are scaled back and demand eases for the Commercial Paper Funding Facility, Term Auction Facility, and foreign exchange credit swap lines. These programs exceed \$3 trillion in committed capital, but should eventually unwind with only limited residual taxpayer debt burden, if not a profit.

Broadly higher corporate taxes intuitively increase inflation and reduce potential productivity. Additional costs are passed along to consumers, so the cost of any

corporate tax increase reduces global competitiveness and is shared across American households. There is a strong correlation between heavily taxed states and countries with those having the greatest difficulty in balancing their budgets. More progressive tax regimes tend to experience greater volatility in their tax revenue, a consequence that California, as well as our nation, is finally recognizing. Reducing after-tax returns undermines incentives to invest and impedes entrepreneurial risk-taking. Promoting innovation and being a leader in many industries is how America has retained her edge.

Management of Social Security, Medicare and Medicaid programs provide little confidence that the massive overhaul of health care being debated in Congress, including subsidizing universal coverage, will fare any better. This and the urgency to rush through legislation have raised concerns with taxpayers. Declining quality of care and increasing costs seem to be overwhelming the system, yet there seems to be little concern about the primary drivers, particularly fraud, liability costs and the expense of malpractice insurance. The deficit this fiscal year is now forecast to exceed \$2 trillion vs. \$178 billion in 2007 and \$190 billion in 2008. Huge budget gaps at the state level and corporate bankruptcies have exposed overly generous benefits that accrue ballooning liabilities. Businesses have been offloading defined benefit liabilities for years and are now seeking ways to limit health care expenditures too, if not get out of the business altogether.

We believe that the economy will recover most efficiently of its own accord. However, the burden of many agendas being debated in Washington could have adverse long-term implications for America's potential growth rate from cap-and-trade taxes on businesses to mandated health care coverage or increasing personal income taxes. Increasing taxes and regulation have the potential to drive inflation higher, increase fiscal deficits by slowing potential long-term economic growth, and undermining our global competitiveness. Regulations fail to meet their objective when enforcement is unable to keep up with innovation and oversight redundancy produces gaps in responsibility, as recently observed. Encouraging innovation, supporting free-markets, enhancing our competitiveness, and promoting productivity has helped improve our American lifestyle for generations. These objectives should be engrained in our national agenda.

### **Will The U.S. Dollar Retain It's Reserve Status?**

A controversial debate is breaking out about whether the U.S. dollar can retain its position as the world's reserve currency. The U.S. enjoys many benefits from being the world's reserve currency, most importantly the ability to finance imports at a lower cost and the persistent demand for U.S. dollar denominated debt. Many countries have linked or pegged their exchange rate to the U.S. dollar, while most commodities, including oil and gold, are priced in U.S. dollars. China and Kuwait

recently switched from a U.S. currency peg to a peg indexed to a basket of currencies, but they remain predominately linked to the U.S. dollar. It is not surprising that other countries would like a greater share of worldwide foreign currency holdings and/or support the notion of a single global currency. However, monetary union, without harmonization of tax rates and political interests, is untenable, just as the European Monetary Union has exposed, particularly during times of crisis.

How long can the U.S. dollar last as the world's reserve currency? Our belief is a very long time. It would take decades to close the gap between the Euro and Dollar, assuming the Euro didn't have its own issues. Currency linkages to the U.S. dollar have been convenient, even necessary historically, but these linkages also imply that holding other currencies will increase the volatility of their other foreign currency holdings. Since 1994, the US dollar has ranged between 60-70% of total worldwide official foreign exchange reserves. U.S. dollar reserves are estimated to total 64.0% at the end of 2008, which is relatively unchanged versus 2007. Most fluctuations in reserve levels can be attributed to shifting relative exchange rates and which tend to accumulate in appreciating currencies.

The U.S. dollar appreciated from 1995-2000 with strong investment demand for technology from U.S. companies. Is it so surprising that U.S. dollar foreign reserves peaked at 70% in 2001 and has indeed declined since? Today, the Euro accounts for 26.5% of foreign reserves, which isn't much different than 2003. The European Monetary Union (EMU) in 1999 consolidated holdings in German marks, French francs, Dutch guilders, European Currency Units (ECU), and other smaller currencies within the EMU. Reserve holdings of U.S. dollars in 1996 of 62.1% were actually lower than today, while currencies among future members of the EMU comprised an estimated 23.5%. The notion that the Euro is gaining ground is rarely challenged, but isn't supported by historical data or the operating needs of central banks. We believe that a secular decline in the U.S. dollar is unlikely, and our tactical currency models suggest that modest U.S. dollar strengthening over the next year is more likely.

We have noted that currencies are a zero-sum game. Unlike stocks and bonds with a positive real risk premium that can be observed, there is no measurable return attributable to currencies over the long run, net of interest rate differentials. While the U.S. Treasury has issued an incredible amount of debt, other developed nations are in a similar fix. However, should Congress layer on significant additional liabilities, such as universal health care or additional tax increases that could stall economic recovery, advantages that we now enjoy vs. Japan (171% debt/GDP) or Europe (~2% potential real growth) might wane.

Currency devaluation resulting from faltering relative economic performance will tend to bolster a country's

competitive advantage. Strength in a country's currency will tend to slow export growth, as well as inflation. Floating currency exchange rates facilitate competitive rebalancing in a global economy with low barriers to free trade. When the US dollar is weak for a prolonged period of time, other countries often will vocalize concern about being disadvantaged. When the U.S. dollar is strong, there is no better currency for exchange. While China and Russia may call for a new global reserve currency, it really would make little difference. Furthermore, would the IMF or World Bank have sufficient resources, relative to the influence of the Federal Reserve, and provide an alternative to function as the world's reserve currency?

### What should investors do?

Over the long-run, stocks outperform bonds and bonds outperform cash, however over the last 10 years, that expectation proved unreliable. Stocks returned -1.4% annualized versus a 6.2% return for U.S. Treasuries over the last decade. Is this a new normal, as some seem to be suggesting? We don't think so, and would observe that below average periods of performance are usually followed by above average performance. Empirical observations, tabulated below, must satisfy an intuitive theory about risk premiums. Simply put, investors require a higher return to hold assets with greater risk or volatility.

It is generally accepted that stocks were significantly overvalued in January 1999, while bonds were cheap, with Treasury yields over 6%. Today, bonds are expensive, with a 3.5% Treasury yield, while stocks are undervalued, particular if we take into account low interest rates. Dividend yield and Price/Book reinforce the remarkable valuation reversal over the last decade, including the unusual relative performance observed. Sometimes our starting point or inclusion of extreme events (i.e., 2000-2002 & 2008) can dramatically skew the analysis of historical returns. The last decade was anything but normal, but eventually the powerful forces of mean reversion tend to sort it all out.

	Asset Class Returns					HighMark Expected Return (1) Risk	
	2008	10-years	1973-2008	1973-2007	1900-2008	Expected Return (1)	Risk
Stocks	-37.0%	-1.4%	9.3%	11.1%	9.0%	8.7%	15.8%
Bonds	21.2%	6.2%	7.8%	7.8%	5.1%	5.0%	8.3%
Cash	3.1%	3.7%	6.0%	6.1%	4.0%	3.7%	0.8%
Inflation	-0.1%	2.6%	4.7%	4.5%	3.0%	2.7%	1.2%
<b>Risk Premium</b>							
Stock-Bond	-58.2%	-7.6%	1.5%	3.3%	3.9%	3.7%	
Bond-Cash	18.1%	2.5%	1.8%	1.6%	1.1%	1.3%	

(1) Expected return refers to long-term performance over an investment cycle or 10 years

Source: HighMark Capital and Thomson Datastream

In order for bonds to return a secular average of 5.5%, Treasury yields must rise significantly from current levels, resulting in loss of principal. Rising budget deficits will make this even more challenging. Thus, a 4.9% or better average Treasury bond return over the next five years, when starting from a yield of 3.7%, is unlikely.

Consensus estimates for inflation of -0.5% or less are difficult to envision. If a rising inflation scenario is priced into yield curves, bond returns will likely disappoint investors further. We are concerned that inflation will re-

emerge sooner than expected, as debt issuance in every sector continues to increase. Except for high-yield bonds, it will be tough for fixed income investors to keep up with inflation over the next couple of years, as the economy recovers. For this reason, HighMark continues to recommend underweighting bonds, except for high-yield bonds. Low interest rates are observed around the world, so we shouldn't expect much return from bonds until interest rates rise above average inflation rates.

Disappointing fixed income returns could drive investors into other asset classes, particularly stocks, if earnings begin to improve materially. That leaves stocks or possibly real estate to provide capital appreciation. Equities have averaged 9.0% return since 1900, exceeding bond returns by 3.9%. If the earnings growth rate exceeds 20% through 2011, as consensus forecasts suggest, there could be significant upside to stock returns. Recent stock market losses and volatility are still unsettling for many investors, so a rapid appreciation off the March 6th lows might be viewed with great skepticism. Still depressed equity prices coupled with rising earnings estimates and low interest rates should be able to support much higher valuation multiples. A great deal of cash remains on the sidelines, as well.

### Conclusion

A confluence of bullish leading indicators on the global economy and signs of improving investor risk tolerance is encouraging. Economic commentary has shifted from debating various discouraging scenarios to talk of "green shoots" and economic recovery by the second half of this year. The inventory cycle of the last 18 months has clipped 1-2% annually from GDP, including -1.5% in the second quarter, but it must eventually reverse. Although June job losses caused some anxiety, we are growing more confident that the end of the recession may be just months away, if not upon us already. The number and significance of investment opportunities that we believe have emerged is remarkable. Even though volatility has retreated from its peak, it will likely remain elevated for an extended period of time, but that shouldn't preclude global equity gains from current levels.

Our outlook for the global economy is constructive, but there are lingering concerns worth monitoring. We have enumerated several of these concerns to keep in mind as the financial crisis begins to wind down, most of which are discussed in greater detail above. Concerns, from housing to de-leveraging, as well as a variety of economic issues, continue to persist and we think will tend to restrain risk tolerance. Deposit growth has provided some capacity for banks to grow lending portfolios and the Federal Reserve has increased its balance sheet, but capital markets will need to support credit expansion. The profit in loans for banks has rarely been so compelling, given the steep yield curve and still wide credit spreads. We look for economic leadership to benefit from a much broader globally-led recovery, hinging on Emerging Market decoupling.

Taxes are expected to increase for individuals and possibly businesses as well, which could be a drag on economic activity. Spiraling budget deficits have soared in the last six months and a plan needs to be put forward to manage existing spending, as well as any new initiatives the Administration seeks to pursue. Additional government regulation may also raise doubts about the sustainability of economic recovery, as well as the long-term impact on potential growth and productivity. In addition, we are concerned that once economic recovery takes hold that inflation may increase faster than expected, given higher oil prices and an increase in the minimum wage, which could pressure the Fed to hike interest rates sooner than expected.

Another concern is how much upside could there be from here, given the remarkable run for riskier assets recently. Investors seem to have grown more cautious, not more confident, about whether equity indices can rise further before additional concrete evidence of economic recovery emerges. With the June consolidation of exceptional gains, questions arose about whether markets, that had discounted the worst, may have exceeded reasonable levels.

Our tactical models, including various valuation measures, suggest the equity rally has further upside support from here. Should earnings surprise to the upside, the opportunity for equities could be sustained further. We recommend continuing to overweight global stocks, with tilts favoring U.S. equities, particularly small-cap stocks, as well as Emerging Markets. Within fixed income, we recommend tilting toward high yield bonds

and maintaining a short duration. If credit spreads tighten, as we expect, high yield still offers a compelling investment opportunity for yield starved investors. Municipals also remain cheap relative to comparable Treasuries, although issuer default risk is higher than normal in many states.

Several key leading indicators we rely on are encouraging, while many concerns that triggered credit crisis, including higher oil prices, housing weakness, and certain meaningful regulatory changes, have moderated or are being addressed. Even at current levels, still compelling credit spreads and equity valuations, plus low interest rates, provide for further upside for equity markets, despite the already remarkable rally since March. Our tactical models suggest equity valuations are still compelling and Treasuries are still unattractive, while credit spreads have only reached peak levels of prior recessions. Investor behavior will continue to flip-flop between emotions of fear, greed, and envy until greater clarity in economic indicators is observed, but that shouldn't preclude capital markets from continuing to climb an impressive Wall of Worry. Investors have grown increasingly skittish again that equities may be over-extended, but the S&P 500 Index is still 40% off 2008 highs. Volatility tends to persist well beyond market troughs, but generally contrarian investors have been rewarded for following a consistent discipline, as uncomfortable as it might seem right now.

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