

Confounded Expectations

It has been an emotional rollercoaster for two years and many widely accepted financial relationships have broken down or simply disappointed. Investors have grappled with just about every emotion, including fear, uncertainty, anxiety, regret, misery, disgust, surprise, confusion, delight and euphoria. Many have questioned various investment theories and standard practices. The Efficient Market Hypothesis is an obvious casualty of the *Financial Crisis* and has seemed to break down during every crisis, precisely when needed most. If capital markets were efficient, then security prices would reflect new information correctly and in a timely manner. Assuming markets to be efficient has been a fatal mistake of those enacting recent policy and regulatory changes. Lack of market efficiency has *Confounded Expectations* during both the downturn and the recent resurgence of confidence. Behavioral finance and rational beliefs theories are gaining influence.

Economic recovery has been stronger than expected. Low interest rates and government facilitated liquidity seem to have had their desired effect on the real economy. The pace of job losses has slowed, housing appears to be bottoming, and credit issuance has already exceeded 2007's record global corporate issuance through September. Replenishment of inventories from low levels appears to be driving improving order demand, as evident in the ISM survey. Export growth is accelerating, as Emerging Market economies are also firming.

The global recovery will likely be unique in many respects. Investor, business, and consumer confidence are improving simultaneously, as equity prices rise, credit spreads tighten, and increasing debt issuance is absorbed without much difficulty. Given how quickly businesses responded by slashing costs when credit markets seized up a year ago, we should differentiate between recessions caused by structural economic problems, which take longer to fix, versus soaring economic and financial risk aversion caused by a liquidity-induced credit crisis and financial panic. The dramatic reversal in risk aversion has baffled many perplexed experts who expected that the October – March period would be just the beginning of the demise of Western Civilization, but we have suggested America is more resilient than that. *Financial Times* editorials on the *Future of Capitalism* and *Future of Investing* seemed to question basic American values and investing theory, including: free markets, capitalism, rule of law, respect

for property rights, globalization, free trade, deregulation, portfolio diversification, and the equity risk premium. These views might never have been printed, except for the opportunity that a crisis provides to question everything. Provocative hypotheses that had some appeal at the peak of the Financial Crisis now seem less alluring. We embrace these challenges as an opportunity to re-validate time-tested core beliefs.

The depth and breadth of the Financial Crisis caught us by surprise a year ago. Although we highlighted various concerns before the financial crisis, the likelihood of a near simultaneous collapse of confidence and liquidity seemed very low. An unlikely perfect storm brought global economic activity to an abrupt halt. Financial and economic conditions still aren't perfect, but many concerns have moderated enough to support normal capital market and economic activity. There has been a re-rating of asset prices, which has *Confounded Expectations*, and we believe that this has further to go.

When central bankers worldwide went "all-in" last fall, massive stimulus actually reinforced alignment of the global economic cycle and re-synchronized worldwide growth. Investors who failed to rebalance their portfolios or worse, disengaged from their investment policy, now face tough choices at less attractive levels about how to re-engage. As global re-synchronization takes hold and the worldwide outlook continues to improve, we believe this significant global re-alignment offers many tactical opportunities that have only partially played out.

Investment Performance Review

A remarkable second quarter for the S&P 500 (+15.9%) was followed by a nearly as spectacular 15.6% return during the third quarter. Since the intraday low on March 6th, the S&P 500 has rebounded 53.8%. Rebalancing through the downturn has proven its worth again. The Barclays Capital Aggregate Bond Index returned 3.7% during the quarter and appreciated 7.1% since March. Investors who fled to 10-year Treasuries lost -6.1%, while 30-year bonds lost -18.9% this year. Our overweight to high-yield bonds has benefited from credit spreads tightening from 21% to 7%. High-yield bonds added 14.5% for the quarter to returns of 47.7% for the year, but cash has returned just 0.2% so far this year.

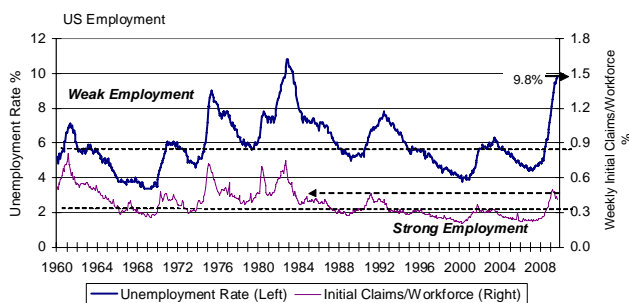
We were encouraged by the 4.3% outperformance of Value vs. Growth stocks and Small-cap stocks, which outperformed the S&P 500 by 3.7%. Emerging Markets

continued their strong rebound, tacking on 21.0% to the year-to-date total return of 64.9%. It is not surprising to observe large differences in sector returns at significant inflection points. The pro-cyclical sectors including Technology (17.0%), Consumer Discretionary (19.3%), Basic Materials (21.5%), Industrials (22.0%), and Financials (25.5%) all led the market higher during the quarter. Technology (46.1%), Basic Materials (38.4%) and Consumer Discretionary (29.5%) have exceeded the return of the S&P 500 by 10% or more in 2009.

Economic Outlook

Monetary stimulus and interest rate cuts have been effective and are getting traction now. With third quarter real GDP rising 3.5%, we believe the recession has passed. We expect that the recovery will accelerate, bolstered by stronger exports and investment, while lean inventories are rebuilt. These drivers should be of greater significance than consumer spending, although the savings rate has dropped to 3.3% after peaking at 5.9% in May, further *confounding expectations*.

Consumer confidence is improving, but employment is the key to consumption. Weekly earnings increased 2.8% annualized in Q3 (+0.7% y/y), benefiting from a minimum wage increase. Real income growth is even better with inflation falling, and hours worked has been steady at 39.8 hrs./week. Unemployment of 9.8% is high, even if leveling off. In past recessions, employment recovered once the economy turned, so we expect employment growth to resume in 2010. The ratio of claims versus the workforce tends to peak, as observed, a few months before unemployment starts to decline.



Source: HighMark Capital and Thomson Datastream

The housing market has rebounded earlier and stronger than we expected, although some local markets remain extremely weak. Home prices have increased 6.1% since January's low, according to the National Association of Realtors. Existing home sales increased 17.4% through September, while inventory has plunged to 7.8 months from a high of 11.3 in April 2008. We expected home prices to trough by spring 2010, but it appears a housing recovery began a year earlier than we expected. Low mortgage rates, sufficient inventory, falling home prices and tax credits have bolstered demand. Adjustable mortgage rates are resetting lower and strong refinancing activity has substantially reduced household interest expense, freeing up discretionary income. Fixed rate mortgages below 5% are the lowest

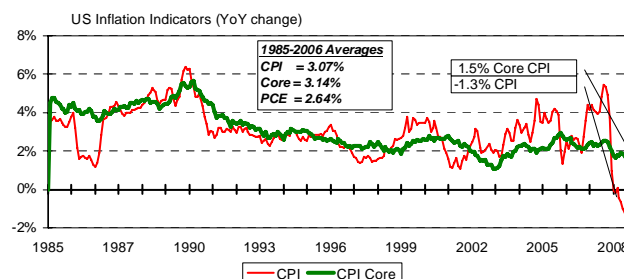
since the 1950s. Housing starts of 590,000/year are just 37% of the new homes needed to match household formation plus replacement, and could double from here.

<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	-1.0	2.5	3.0
Earnings Growth	15.3	-1.6	-23.6	-9.2	25.0	24.7
CPI Inflation	3.2	2.9	-0.1	0.8	2.0	2.5
Unemployment	4.6	4.6	7.2	9.9	9.0	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

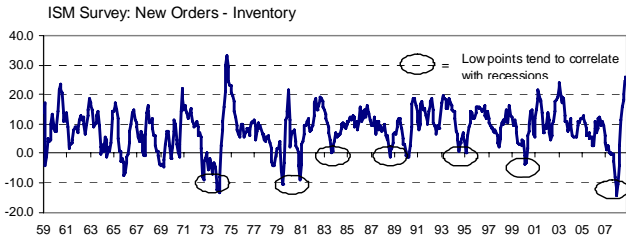
It appears to us that all that was needed to be done had been accomplished by December 2008, in slashing interest rates and restoring liquidity through government guarantees, loans, and asset purchases. Typically, six-to-nine months after injection of significant monetary stimulus, the real economy responds, just as we've observed. In an impressive turnaround, the U.S. economy expanded with positive growth in the third quarter of 3.5%. If growth exceeds 3% in the fourth quarter, as expected, 2009 real GDP could be -0.2% or better. We think there isn't any need for further fiscal stimulus, and unspent funds of the American Recovery and Reinvestment Act should be returned to taxpayers. There is a risk that stimulus will be wasted if the Fed has to hike interest rates more aggressively to offset spending. Increased deficits pass on significant debt, which can crowd out investment and push up yields.

There is sufficient slack evident in labor and production (capacity utilization: 70.4%) to keep inflation contained below 3% over the next 12-18 months, but we expect that inflation will be higher than current expectations of 1-2% indicate. This assumes the Fed restrains monetary policy in a timely manner. Productivity and profit margins are much higher than normal at this stage of the business cycle. This has *Confounded Expectations*, as well, yielding exceptional corporate profitability.



Source: HighMark Capital and Thomson Datastream

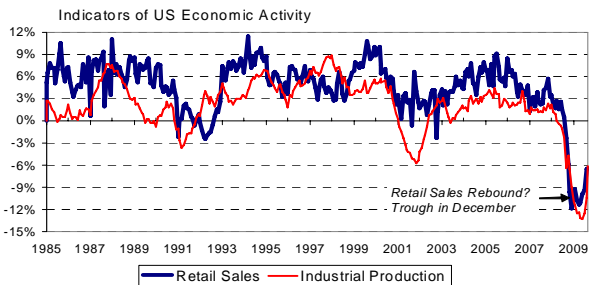
We suspect there is a false sense of security about inflation. Consumer prices have risen 2.7% annualized through September and the core rate (ex-food and energy) increased 2.0%. With oil prices and most other material costs increasing, a minimum wage increase and excessive monetary stimulus, inflation must be a threat. Realization of higher inflation than consensus could become problematic for bonds. Inflation won't remain subdued if accelerating growth improves. The New Orders – Inventory chart below suggests supply chain demand is picking up.



Source: HighMark Capital and Thomson Datastream

The real engine of America's growth has been small business, but owners are quite fearful of proposed new taxes, increased regulation, and continued difficulty tapping credit lines. There apparently wasn't much "stimulus" left over for them. Of \$700 Billion in TARP funds, \$318 billion remains unallocated. Many banks have repaid government loans they didn't want or need, particularly after new stipulations were imposed.

Pending legislative and regulatory reforms, including cap-and-trade and healthcare reforms, could significantly increase the cost of doing business and taxes on consumers. Increasing corporate taxes and regulation on business simply passes through to consumers. Increasing reliance on an ever more progressive income tax system increases cyclical volatility of tax revenue. According to the IRS, 40% of tax revenue was paid by the top 1% of households in 2007 and 71% of taxes were paid by the top 10%. On the other hand, 50% of households paid less than 3% of taxes. A combination of policy and economic uncertainty may be keeping businesses from expanding employment.

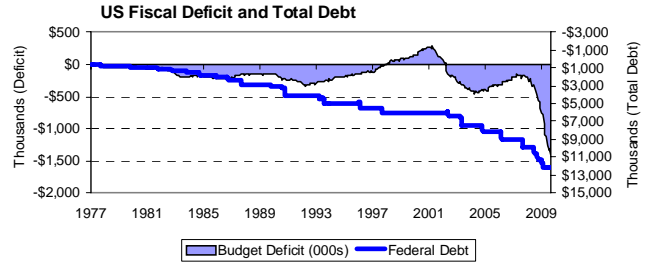


Source: HighMark Capital and Thomson Datastream

Economists recognize that The Recovery Act has failed to boost economic growth or job creation much yet, given that only a fraction of the funds have been distributed. As of October 10th, the Administration's data at Recovery.gov reported that just 30,383 jobs were created or saved by the fiscal stimulus. Grants, loans, and entitlements allocated total \$120 billion, but only a fraction has been put to work. This is disappointing, given the "imperative" rush to approve the \$787 billion.

Congress should heed Moody's recent warning that federal deficit spending is increasingly untenable. Congress will soon have to raise the federal debt ceiling above \$12 trillion after a \$1.4 trillion jump in the fiscal deficit this year. It is hard to believe the deficit was "only" \$162 billion in 2007. Once the economy is expanding, fiscal deficits will come down, but overall debt will be

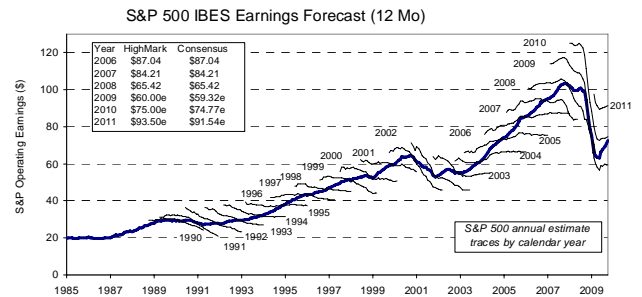
higher than necessary. If investors are losing confidence in America's fiscal discipline, it might partially explain the recent U.S. dollar weakness.



Source: HighMark Capital and Thomson Datastream

Bargain Hunting

It is hard to imagine anything could still be on sale after the S&P 500 jumped 54% from the March lows. Thus, it is reasonable to ask whether equities rose "too far, too fast." After the S&P 500 tumbled 57% from 1,562, the worst stock market decline since the 1930s, the index would need to rise 135% to reach the previous peak. Equity prices should rise to a reasonable multiple of future earnings, benefiting from weaker companies donating market share or dropping out of the index. Although the economy came to a grinding halt in 2008, non-financial earnings increased 7.4%. We expect non-financial earnings will be more resilient than the -22% earnings decline suggests.



Earnings	2011e	2010e	2009e	2008	2007
HighMark	24.7%	25.0%	-8.3%	-23.6%	-1.6%
Consensus	22.4%	26.0%	-9.3%	-23.6%	-1.6%
HighMark	\$ 93.50	\$ 75.00	\$ 60.00	\$ 65.42	\$ 85.62
Consensus	\$ 91.54	\$ 74.77	\$ 59.32	\$ 65.42	\$ 85.62
Financials	53.7%	79.4%	185.7%	-127.2%	-2.1%
Non-Financials	19.6%	19.4%	-22.0%	7.4%	3.2%

Source: HighMark Capital Estimates and Thomson Datastream

In 2009, earnings are expected to trough around \$60. Earnings have been undermined by financial sector mark-to-market write-downs of credit securities accounting for more than the -23.6% decline in earnings in 2008, but write-downs are reversing. If we assume a potential of \$100 earnings, then a 15X multiple suggests an upside to 1,500 on the S&P 500 Index, plus dividends. That would be a compelling return.

Dramatic cost cutting has driven stronger revenue guidance and positive earnings surprises exceeding 80% of estimates, compared to an average of 64% and 71% last quarter. Positive surprises have been most

evident in cyclical and investment-oriented sectors. Valuation multiples of trailing earnings, depressed by volatile accounting write-offs, may give comfort to the *New Normal* crowd, but some simple math suggests a powerful recovery of back-to-back 25% earnings growth through 2011. We believe this is a historic time to take advantage of many investment opportunities. Earnings are rising strongly now and the upside is significant, so it is not surprising that equities may have anticipated that.

Conclusion

Extraordinary monetary policy has reinforced global re-synchronization. Heightened uncertainty, coupled with low investor risk tolerance, drove asset risk premiums to unprecedented levels. With equity returns exceeding 53% since the March lows, it is tempting to believe markets have overshot. However, investor, business, and consumer confidence are all improving, coupled with a remarkable resurgence of earnings, which *Confounded Expectations*. This suggests to us that stocks have further upside if earnings rise, as we expect. Conditions favor stocks outperforming bonds, not the "subordination of the equity risk premium", as suggested by the well popularized hypothesis of a *New Normal*.

We expect Treasury returns will be disappointing until yields rise above 5%. The Fed's quantitative easing, including the purchase of \$300 billion of Treasuries, was completed this month. Low financing costs for bank purchases of Treasuries also have helped keep yields low. Foreign buyers are favoring shorter duration Treasuries, so there is a risk that they might let their bonds mature and re-allocate funds elsewhere. We are concerned that the Treasury might lengthen the average issuance maturity, given outstanding debt is at a 26-year low of four years. Increasing supply with potentially less demand for 10 and 30-year bonds as the Fed is hiking interest rates could drive longer maturity yields higher.

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We believe interest rate hikes should be expected sooner than anticipated, as government liquidity programs have been unwinding for months already. The timing and impact are key concerns for investors. Interest rates may stay low for an extended period, but that doesn't preclude the Fed from hiking rates 1% or more. We expect interest rates will begin to rise by spring 2010. The Fed has been criticized for waiting too long to hike rates in 2004. A recent Barron's cover story has supported raising interest rates soon, by as much as 2%. Failing to hike rates in a timely manner runs the risk of having to increase rates faster and further. Need for a pre-emptive move exceeding 0.5% could put some money funds with longer average maturities in a tough position. The Fed has usually waited for a decline in unemployment, but interest rates have never been this low before, nor has the economy responded so quickly.

As global re-synchronization takes hold, we will need to identify new growth engines of innovation that can carry us through the next cycle. Recent surveys suggest that trust in government has plunged to a 12-year low. We believe that expanding government control can't create wealth, only destroy, limit or redistribute it. However, free markets and access to capital markets can incentivize entrepreneurship, helping us discover the next generation of America's national champions. We should not accept that our future is hopeless. Somebody else's *New Normal* doesn't have to be our destiny. Many are proposing alternative ideologies, but only Democratic Capitalism has sustained a society for over 200 years and these values are being imitated by others around the world, *Confounding Expectations*.

David Goerz, SVP - Chief Investment Officer

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