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CAPITAL MANAGEMENT

INVESTMENT INSIGHTS **May 12, 2010**

Bold Steps For European Periphery Countries

Greece and the other four little PIIGS[1] have been causing significant financial stress within the Eurozone for several weeks, periodically spilling over and having a broader global market impact. On Thursday, May 6th, Greece's parliament approved drastic austerity measures that were needed to secure loans from the European Central Bank (ECB) and International Monetary Fund (IMF) totaling more than $140 billion (€110 billion) to fully fund government debt maturities. Proposed deep spending cuts caused demonstrators to turn violent and also caused investors to raise new questions about whether needed reform was possible. The historic plunge in U.S. stock averages Thursday, May 6th, in barely the "blink of an eye" is still being investigated, but seems to us was driven more by emotion and fear than real economic substance.

On Sunday May 9th, the ECB announced a new Securities Market Program which will provide liquidity of €750 billion to support lending to holders of distressed sovereign debt and should have a similar effect to the Federal Reserve's purchases of mortgages in 2009. The immediate impact has been a significant contraction of risk premiums, measured as yield spreads to German debt and improving equity index levels.

Below are a few of our key conclusions, given events over the last week:

I. Greece's recent debt problems should be thought of as a catalyst for positive fiscal reforms and a more conservative policy approach globally.

II. The overall economic impact to U.S. and global growth of increased fiscal austerity should be minimal due to the limited economic significance of the PIIGS, and for Europe, adverse consequences of lower government outlays in the periphery may well be more than offset by improved competitiveness of EU exports due to the Euro's devaluation. The Global Economy is much stronger today and better able to withstand economic uncertainty than it was when the credit crunch was in full bloom and global growth was decelerating. With easy G-7 monetary policies, we expect global GDP growth can still exceed 5.0%.

III. The historic plunge in U.S. stock averages at 2:40 pm Thursday afternoon (May 6, 2010), in barely the "blink of an eye", was driven more by emotion and fear than real economic substance. One focus of inquiry was an unusually large sell order for S&P 500 e-mini futures contracts in a two minute period that apparently triggered an exceptional cascade of additional orders during a period markets were already skittish.

IV. Bold steps to shore up liquidity have bolstered investor confidence. This should avert the immediate debt funding concerns and offer time for governments to deal with longer-term fiscal imbalances.

V. We expect the ECB will keep interest rates low for longer now, while devaluation of the Euro and other EU currencies will tend to lift growth and inflation in Europe above current expectations for 2011.

VI. Misguided behavioral tendencies can cloud intuition and get in the way of market efficiency. The emotions of fear and regret can dictate how we respond to gain and loss and help explain why market volatility breeds investment opportunities. We believe investor behavior is being influenced more than usual by peripheral events, exposing an exceptional number of tactical opportunities. *Behavioral Realities* (Quarterly Outlook: Q2/2010) addresses the emotional challenges of investing in today's world of uncertainty.

Further Insights

While liquidity support of nearly $1 trillion has been well received by investors, the root causes of the European debt crisis, beyond Greece and even the periphery, have yet to be fully addressed. Significant permanent reductions in government spending are required to close budget gaps across Europe, but for Greece, the only material legislated changes so far include an increase in the retirement age, higher gasoline taxes, and a freeze on public salaries. Entitlement program liabilities have reached a tipping point for Greece, as the current public spending rate is unsustainable. Concern that other countries are also close to the tipping point has forced passage of additional liquidity support.

Greece lost credibility since the government had to restate national accounts data several times, boosting their fiscal deficit/GDP to over 13%. This explains Greece's sudden and significant divergence from the Maastricht fiscal deficit guidelines of just 3%. Money needed to fund public needs of other countries within the

[1] PIIGS includes Portugal, Ireland, Italy, Greece, Spain

European Monetary Union (EMU) will have to be redirected to support the irresponsible policies of Greece and possibly others. Investor concern evident in other regions suggests some uncertainty about whether the proposed "bailout package" can be approved by each country. Longer term, we have concerns about whether EMU is viable and sustainable as it exists today. Other strategists appear increasingly sympathetic to this view.

It is expected that many of the other Eurozone countries will share the potential consequences of higher interest rates and further Euro devaluation. Currency weakness in the Euro (-16.3%) since December 2009 now provides a more competitive exchange rate for exports and should boost growth. The British pound, which was also a concern, has fallen 28% since 2008. Accommodating monetary policy and low interest rates also should bolster growth. We believe this should more than offset expected fiscal austerity measures in the European periphery. In the meantime, policymakers have moved aggressively to restore liquidity in distressed sovereign debt, which is believed to be large enough to fend off the speculative "wolves". Liquidity can't resolve long-term liabilities unless complemented by reduced spending.

For some time, HighMark has been concerned about the relative valuation of the Euro. We have argued that the Euro was unlikely to challenge the U.S. dollar in the next five years as an alternative reserve currency due to certain basic flaws, including, but not limited to, lack of political union and the significant differences between European countries (i.e., dominant industries, sensitivity to interest rates, debt levels, taxes, demographics, etc.) that still exist. We expect the US$/Euro exchange rate will weaken further, with downside to 1.10-1.20.

Greece should be thought of as a catalyst for positive fiscal reforms and a more conservative policy approach globally. Think of it as a little short-term pain for now. Reduced government spending among the PIIGS will lower European real GDP marginally, but the greatest impact will be felt along the European periphery. Our global estimate for GDP growth remains at 5.0%. Recently increasing growth estimates for developed nations is far more significant than the knock-on effect to growth expected from these smaller countries.

Liquidity by itself won't fix the debt problems that Greece and the other four little PIIGS face, but it does buy them time, at a reasonable interest rate, to chart a new course. Yield spreads versus German bonds have finally collapsed for the PIIGS, and equity markets rallied, led by the European bank stocks, which will likely benefit most from the ECB's liquidity program. Policymakers have committed to defending the stability of the Euro and EMU, but structural weaknesses have been exposed. The PIIGS may avoid a second dip, assuming the Euro remains weak enough and interest rate spreads versus German bonds tightens even further than already observed to more sustainable and reasonable levels.

We don't expect a double dip recession in the U.S. or any other developed G-7 nation. Double dip recessions are typically two independent "V"s with a policy mistake in the middle. We are monitoring tax and regulatory policy changes for a possible "mistake" that could have a meaningful adverse economic impact. The remaining $500 billion of stimulus spending over the next 12 months will be an incremental 3.5%-of-GDP insurance policy. In our opinion, there may be too much monetary and fiscal stimulus still in the pipeline for an economy already growing in excess of potential growth.

The economy is accelerating, benefiting from each of our five defined excess growth drivers, namely business investment, inventory re-stocking, net export growth (ex-oil), increasing housing starts, and better than expected consumer spending. Overall economic confidence is improving and appears to be broadening globally. Global synchronized recovery, coupled with high profit margins and exceptional productivity, is a significant tail wind for improving earnings.

A strong global recovery with high profit margins gives us greater confidence in our 2011 operating earnings forecast of $95. Observing that 78% of companies have reported earnings above analyst expectations for this quarter (Q1/2010) is on track to be the second best earnings surprise rate ever recorded, exceeding forecasts by an unprecedented earnings surprise of 16% on average. The best recorded earnings surprise rate was in Q3-2009 which topped 79%. Furthermore, 66% of companies reported that revenues also beat expectations for the first quarter, and we have observed that companies also are guiding higher. We are more likely to revise up our operating earnings targets as consensus estimates have also increased. At 15X earnings, we see that the S&P 500 Index has upside to 1425 vs. the close of 1128 last Thursday on May 6th.

We have observed downside volatility in each of the last three quarters, as remarkable earnings results have been reported in July 2009, October 2009, January 2010, as well as in April-May 2010. This is particularly surprising to us, given that subsequently, the equity market eventually regained its footing and found a new higher level, bolstered by a resilient global recovery and remarkable upside surprises to earnings

The historic plunge in U.S. stock averages Thursday, May 6th, in barely the "blink of an eye" is still being investigated, but was driven more by emotion and fear than real economic substance. A very large SELL order for S&P 500 e-mini futures contracts that appears to have been 1000-times larger than intended, apparently triggered a cascade of stop-loss orders and algorithmic trading. Several large and well-respected stocks, including Accenture and Proctor & Gamble, fell precipitously by as much as 60-90% in a short period of time with no material news. Stock exchanges are still compiling trading details, but something technical may have exacerbated investor uncertainty. In our opinion, this correction was inconsistent with constructive valuations, particularly as companies report earnings and revenues exceeding expectations by a wide margin and offer positive guidance.

Political uncertainty also increased in the United Kingdom and Germany over the weekend, May 8-9. Conservative Tory party leader David Cameron has finally emerged as the next Prime Minister of the United Kingdom after a weekend of negotiation to form a coalition government. Meanwhile, German Chancellor Angela Merkel's party lost a critical regional election in North Rhine-Westphalia that undermined her coalition majorities in both chambers. In Germany, the election is being tied to support for the ECB and IMF European Monetary Union liquidity program.

Conclusion

We continue to recommend an overweight to equities, with a preference for small-cap and value stocks, while favoring U.S. companies over developed international markets. Other tactical exposures we favor include REITs, Emerging Market equities, and High-yield bonds. We expect the U.S. dollar to continue strengthening versus the Yen and European currencies, maintaining its position as the world's dominant reserve currency.

We also recommend shorter fixed income maturities, anticipating an increase in interest rates in 2010. Within fixed income, we continue to hunt for value in lower rated credits, including overweighting high-yield. We expect credit spreads will be stable, but as interest rates rise across the yield curve, shorter maturity securities should outperform. Bond flows continue to be strong, but we believe global government bonds are most likely to underperform over the next year. We expect central banks will begin tightening monetary policy, and the strongest economies will begin increasing interest rates this year, including the United States.

We believe that it is important to keep an eye on the global picture and what is truly significant enough to be a relevant concern. We have noted consistently that volatility of equities and other riskier securities will remain high for an extended period, just as it does after nearly every significant financial crisis (for example, Asian currency crisis, technology bubble, 1987, 9/11, Iraq War I, etc.). Global equity markets are relatively inexpensive, in our opinion, particularly considering the high profit margins and expectations for earnings growth.

The theme of our Quarterly Investment Outlook *Behavioral Realities*, published this month, addresses the emotional challenges of investing in today's world of uncertainty. Many investors remain wary of equities and are reluctant to rebalance their portfolios to their desired investment objective, concerned about whether this economic recovery is sustainable. We believe it is, and this opportunity can provide a chance to re-balance toward one's targeted equity allocation. In periods of turmoil, behavioral biases can cause market inefficiencies, which provide opportunities that active investors may exploit, while passive investors get nothing more than a chance at guaranteed underperformance versus an index.

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