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CAPITAL MANAGEMENT

INVESTMENT HIGHLIGHTS SEPTEMBER 2009

Think Without Boundaries

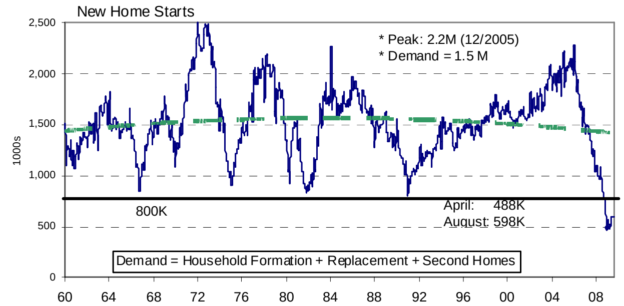
The recent downturn was fundamentally different from any other observed since 1980. The question now is whether a restructuring of the economic order lies ahead. Many have jumped on the foreboding *New Normal* bandwagon. There is concern about whether U.S. potential growth of 2.7% can be maintained as the stimulus unwinds, recognizing some consumers are still overextended. On the other hand, it has never paid to underestimate our resilience and assume America to be fragile, inflexible, and unable to adapt. There are many divergent views, but if we can *Think Without Boundaries*, we might be rewarded by anticipating a few unimagined, even unthinkable, consequences of what we believe could be the threshold of the most synchronized global economic recovery in modern history.

The first paper we read outlining *The New Normal* was written by Ian Davis, Managing Director of McKinsey & Company in March 2009. McKinsey expects less leverage and a greater government role, including the risk of increased protectionism and higher taxes. This economic restructuring could introduce new hurdles and inefficiencies, which may be costly to investors and businesses. McKinsey concludes that *The New Normal*, "while different from the past, is no less rich in possibilities for those who are prepared." We share this view that many things have changed since the Financial Crisis, but there are still many opportunities. We also hope that regulators address the need for greater consistency and enforcement of existing regulations.

Others have proposed alternative paradigms, including PIMCO (*A New Normal,* May 2009*)*. Their popularized conclusions suggest an era of weak consumption, undermined by a de-leveraged and re-regulated banking system, with low inflation driven by a wide output gap (i.e., actual growth less than potential growth). Persistent subpar real growth and deflation is expected to be a consequence of "excessive regulation, higher taxation and government intervention". They conclude that such a scenario will yield exceptional real asset returns, "subordination of the equity risk premium" (bonds outperforming stocks), and devaluation of the U.S. dollar. This is an unusual mix, particularly if frontier market economies, which depend on our exports, continue their de-coupling, as we expect.

Economic Outlook

The current recession has roots in housing weakness and faltering consumer confidence, so it is encouraging that housing appears to be improving. Existing home prices have been rising since January (+8.3%), as has sales volume, according to the National Association of Realtors. Housing starts are in deficit versus the household formation plus replacement rate of 1.5 million. A rebound in housing construction would bolster employment and sentiment.



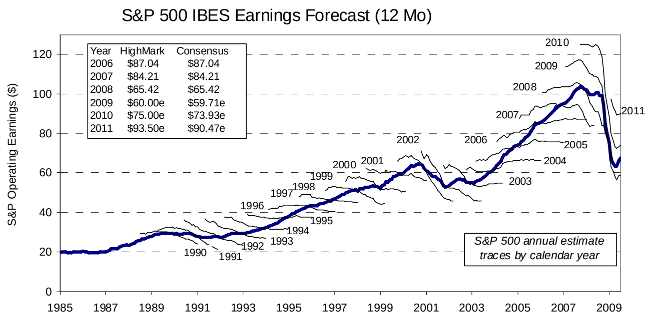
Source: HighMark Capital and Thomson Datastream

With increasing equity prices and tightening credit spreads, recent Federal Reserve data on household balance sheets reported an increase in net worth of $2 trillion or 3.9% during the second quarter. Household net worth, which has increased 4.3% annually since 2002, is a better indicator of consumer sentiment and the propensity to spend than the savings rate, currently at 4.2%. Since 2003, cash holdings increased 6.5% to $7.8 trillion. Cash holdings are significant and provide a buffer in hard times, but the $10.8 T (-16.8%) decline in household net worth since 2008 has adversely affected consumption, and it will take some time to recover.

Balance Sheet of Households ($ billions)	2006	2007	2008	2009-Q2	A.G.R.
Total Assets	**76,749**	**78,229**	**67,134**	**67,208**	**4.9%**
Real Estate	21,948	20,477	18,317	18,272	3.6%
Financial Assets (inc. retirement, securities)	**48,025**	**50,703**	**41,957**	**42,361**	**5.4%**
Deposits (Bank deposit + Money Funds)	6,779	7,381	7,827	7,760	**6.5%**
Change in Financial Assets (y/y) %	11.0%	5.6%	-17.2%	1.0%	
Liabilities	**13,414**	**14,318**	**14,217**	**14,068**	**7.4%**
Home Mortgages	9,833	10,485	10,431	10,402	8.7%
Household Net Worth	**63,335**	**63,911**	**52,917**	**53,140**	**4.3%**
Growth Rate (y/y)	7.7%	0.9%	-17.2%	0.4%	
Disposable personal income (NIPA)	**9,916**	**10,403**	**10,799**	**10,903**	**5.2%**
Growth Rate (y/y)	6.9%	4.9%	3.8%	1.0%	
Owners' equity in real estate	**12115.4**	**9992.2**	**7886.4**	**7870.4**	**-1.1%**
Change in Real Estate Equity %	-3.6%	-17.5%	-21.1%	-0.2%	

Source: Federal Reserve, Flow of Funds (Table B.100)

As corporate spreads have tightened and housing prices improved, losses caused by the dramatic divergence between intrinsic values and mark-to-market prices for so-called "toxic" investments should be reversing. Bank earnings improved last quarter, as the steep yield curve has increased their profitability given a significant spread on loans. Stock issuance dilution and sales of distressed securities will limit earnings per share gains of weaker banks. Financials will eventually benefit from *write-ups* of leveraged loans and asset-backed securities, re-rated with improving confidence.



Earnings	2011	2010	2009	2008	2007	2006
HighMark	$ 93.50	$ 75.00	$ 60.00	$ 65.42	$ 85.62	$ 87.04
Consensus	$ 90.90	$ 74.34	$ 59.56	$ 65.42	$ 85.62	$ 87.04
HighMark	24.7%	25.0%	-8.3%	-23.6%	-1.6%	15.6%
Consensus	22.3%	24.8%	-9.0%	-23.6%	-1.6%	15.6%
Financials	53.7%	79.4%	185.7%	-127.2%	-2.1%	21.8%
Non-Financials	19.6%	19.4%	-22.0%	7.4%	3.2%	12.4%

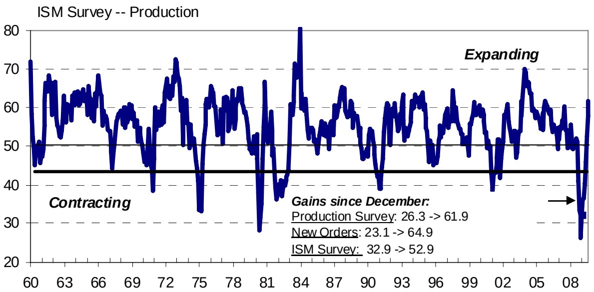
Source: HighMark Capital Estimates and Thomson Datastream

Financial sector losses drove the S&P 500 earnings decline of -23.6% in 2008. Non-Financial earnings actually rose +7.3% last year. A reversal is now evident in forecasted operating earnings, as analysts scramble to catch up with improving economic conditions. Surprisingly, non-financial earnings are still expected to plunge -22% in 2009, even as the economy seems to have troughed sooner than expected, and emerging market growth is accelerating. Sector-by-sector, the inconsistencies are palpable:

- Earnings for Materials are expected to plunge -63% this year, despite rising commodity prices
- Industrial earnings are expected to fall -30% this year, yet the U.S. ISM Production Survey has doubled to 62
- Technology earnings are expected to fall -8% this year, despite re-stocking for the release of Windows 7 in Q4-2009

Stocks in these three sectors powered the biggest upside surprises last quarter and outperformed the S&P 500 over the last six months. Technology has been the clear winner in 2009, soaring +39.8%, followed by Materials. Earnings reports topped estimates for 73% of S&P 500 companies, as estimates have risen every week since May. A 15X Price/Earnings ratio on $100 for the S&P 500 could lift the index to 1500 in a few years, providing upside potential from current levels.

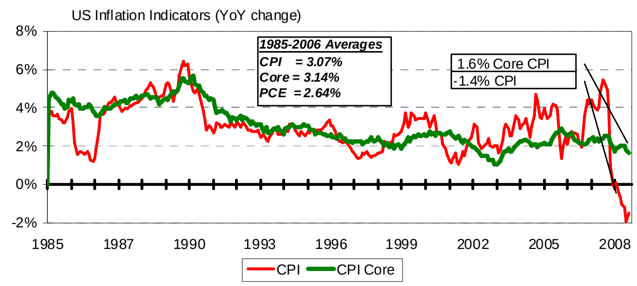
U.S. GDP has declined $403 billion or just -2.8% from its peak of $14.5 trillion since Q3-2008. This decline, following Lehman's default, was less than might be expected given the equity losses and restricted credit. The transient causes of the Financial Crisis, as we've written about, are now waning. Although household de-leveraging is expected to restrain future consumption, uncertainty has led to a tightly wound coiled spring of potential that has emerged in housing, inventories and business investment. Housing starts of 581K are well below the natural household formation plus replacement rate of 1.5 million units. Inventory liquidation has undermined GDP since 2006, subtracting $360 billion during the first half of 2009 alone. Meanwhile, ISM Survey readings over 50 historically correlate with real GDP growth exceeding 2.7%. This was the first and most critical green shoot. Economic statistics have been improving recently. GDP forecasts are decidedly positive now for the second half of 2009, coinciding with improving investor, business, and consumer sentiment and suggesting an end to the recession.



Source: HighMark Capital and Thomson Datastream

More Than a Whiff of Inflation Coming

Inflation will eventually return, having averaged 3% for consumer prices (CPI) and 2.6% for personal consumption (PCE) since the 1970s. Volatility in oil prices drove the inflation rate up, peaking last summer at 5.5%, only to plunge to the lowest annual change in 50 years of -1.9% by year-end. With the core inflation rate (ex-food and energy) tracking stubbornly above 1.6%, the annual change in inflation must rise, and should exceed 1.5% by year-end. Rising oil prices (+59%), a minimum wage increase, stimulative monetary policy, tax increases, tighter regulations and other commodity price appreciation tend to push up inflation. As trailing observations wash out, January-August already shows an annualized inflation increase of 2.7%.



Source: HighMark Capital Estimates and Thomson Datastream

The Federal Reserve may soon need to turn its attention to hiking interest rates. The Fed usually has waited until the unemployment rate declines. We forecast that the Fed will begin to hike rates as early as Q1-2010 as the economy firms and oil volatility washes out to reveal rising inflation. Interest rates this low are not sustainable for long given the potential for global re-synchronization, and criticism that the Fed waited too long to raise rates in 2004. Chairman Bernanke has been re-nominated for another term, which defuses a risk of politicization of the Fed's independence. Rising interest rates, first in the U.S., followed by emerging markets, should bolster the U.S. dollar, but undermine gold and oil.

Skepticism High, but Investor Optimism Improving

Embracing a *New Normal* scenario would suggest a preference for bonds over stocks. Many are also concerned that equities rose too far, too fast after a 54.5% S&P 500 return off the March 6, 2009 low. We don't share these views, because we believe the primary causes of the financial crisis were transitory, and the stimulus is unprecedented. Risk tolerance has improved to such an extent that the high-yield credit spreads collapsed from over 20% last November to 8% by August (historical average: 5.5%). Global corporate bond issuance has soared $1.1 trillion through August and has already surpassed the 2007 annual record of $898 billion (Dealogic). Volatility should remain high for an extended period, but the challenge for equity skeptics will be that consensus earnings forecasts are rising consistently.

HCM Forecasts	**2006**	**2007**	**2008**	**2009e**	**2010e**	**2011e**
U.S. GDP (Real)	2.8	2.0	1.1	**-1.0**	**2.5**	**3.0**
Earnings Growth	15.3	-1.6	-22.8	**-9.2**	**25.0**	**24.7**
CPI Inflation	2.1	4.4	-0.2	**0.5**	**2.0**	**2.5**
Unemployment	4.6	4.6	7.2	**9.5**	**9.0**	**8.0**
Fed Funds Target	5.25	4.25	0.25	**0.25**	**2.00**	**3.50**
10y Treasury Bond	4.71	4.03	2.25	**3.50**	**4.50**	**5.00**

Source: HighMark Capital Estimates and Thomson Datastream

Chairman Bernanke believes that economic activity "very likely" bottomed out over the summer and is showing signs of an upswing. Growth estimates for GDP have risen, but are still less than potential growth until 2011. Capital markets have embraced data indicating that the financial crisis has moderated and access to credit has improved, but we believe equities have yet to discount the likelihood of a global synchronized recovery ahead.

We have updated HighMark's long-term asset class return expectations for the next 5-7 years, as highlighted below. The most significant change to our outlook was to lower our bond and cash return forecasts, resulting in a higher equity risk premium. Bonds are unlikely to achieve a normal 5% annualized return, similar to the 1900-2008 average, given a Treasury yield of 3.4%.

	Asset Class Returns					HighMark Expected	
	2008	10-years	1973-2008	1973-2007	1900-2008	Return	Risk
Stocks	-37.0%	-1.4%	9.5%	11.1%	9.0%	8.2%	15.8%
Bonds	21.2%	6.2%	7.8%	7.8%	5.1%	3.8%	5.8%
Cash	3.1%	3.7%	5.8%	6.0%	4.0%	2.7%	0.8%
Inflation	-0.1%	2.6%	4.7%	4.5%	3.0%	2.5%	1.2%
Risk Premium							
Stock-Bond	-58.2%	-7.6%	1.7%	3.3%	3.9%	**4.4%**	
Bond-Cash	18.1%	2.5%	1.9%	1.8%	1.1%	**1.1%**	

Source: HighMark Capital Estimates and Thomson Datastream

The *New Normal* debate was triggered in part by observing that bonds outperformed stocks by 7.6% over the last decade, which is quite unusual, but also specific to the start date. In 1999, the stock market was overvalued (P/E: 29X) and Treasury yields had risen to 6.43%. A reason for outperformance of bonds over stocks over the last decade was a significant stock-bond valuation reversal. Last year's performance also was one of the worst years on record for equities. We expect that expanding P/E ratios with normalization of risk aversion, coinciding with rapid earnings growth of about 25% forecast in both 2010 and 2011 (see table above) should provide strong equity returns over this period. In contrast, disappointing bond and cash returns are expected, starting from such low yields. "Subordination of the equity risk premium", popularized by *New Normal* thinking, would be difficult to repeat, given current valuations of stocks and bonds.

Awakening Sleeping Giants

Innovation has driven business productivity to unexpected heights for decades, yet we still struggle to think beyond only what is possible today. Gordon Moore of Intel believed that exponential growth in the number of transistors was possible as far back as 1965, and later upped his forecast to doubling every two years. Such exponential growth must eventually hit atomic limitations of physics. Yet, considering our history of innovation, why do we impose such limits on our beliefs about productivity? The pace of innovation is accelerating, and new growth drivers are emerging with increased focus on energy, environment, health, materials, food and water. Technology has evolved from being the focus of innovation, to becoming a facilitator of innovation, thereby slashing product development cycles. Sustaining economic growth depends on developing new ideas and markets. Although some previous drivers of growth may be moderating, innovation has improved living standards for generations. In the months ahead, we will highlight various new growth drivers that can be a source of new jobs and offer hope of sustaining potential growth.

Liquidity and Interest Rate Stimulus Unwinding

There is the question of how much the economy is still dependent on government support. Pulling back stimulus too soon could undermine liquidity, but utilization has been waning, and unwinding these various liquidity measures is likely a precursor to raising interest rates. In 2004, we were well ahead of the curve in calling for rising interest rates. We believe rate hikes are coming sooner than anticipated by the market, as liquidity programs have been unwinding for months already.

Banks have repaid $70 billion of loans through the Troubled Asset Relief Program (TARP), and paid $14 billion in interest. Cashed-in warrants reaped another $4 billion. The Commercial Paper Funding Facility peaked at $350 billion, but is guaranteeing just $41 billion. The Term Auction Facility financed nearly $500 billion, but has shrunk to $212 billion. Treasury allowed the $2.5 trillion guarantee of money market funds to expire this month, while demand has fallen off for foreign currency swaps and the $200 billion Treasury Securities Lending Facility. Bank of America ($45B), Citibank ($50B), and Wells Fargo ($25B) would like to pay back their TARP loans, but have been denied. Restrictions on pay and governance controls, plus 5% interest, provide strong incentives to repay their TARP loans. We never expected liquidity programs would add much to the federal debt, but some losses are expected from AIG and the automakers.

Lingering Risks and Concerns

Expectation of a *new normal* requires some brave assumptions, but there continue to be various risks worth monitoring. There is concern that commercial mortgage-backed securities (CMBS: $700 billion) could be the next debacle, despite being just a fraction of the $10.4 trillion residential mortgage market and improving confidence supporting a rebound in CMBS prices. Total bank exposure to commercial real estate is just $1.7 trillion. September bank failures were less than 50% of July's peak rate, but 95 failures in 2009 is higher than the 26 recorded last year. If the U.S. economy is already accelerating, then risk in the commercial sector may be exaggerated with no subprime and higher loan-to-value. We will monitor these concerns, as well as:

- Continued uncertainty, anxiety, and skepticism of investors, households, and businesses
- Higher personal and corporate taxes, increased regulation, health care reform, and cap-and-trade
- Inflation pressures and weakening U.S. dollar
- Unwinding of global monetary liquidity, rising fiscal deficits, and timing of raising interest rates

Conclusion

What does it mean to *Think Without Boundaries*? Under normal conditions, we tend to constrain our thoughts to practical and probable outcomes, but lately, we live in a world of outliers, including two-headed black swans. Many have suggested dramatic scenarios to captivate their intended audience and although highly improbable, would have dire potential consequences. To *Think Without Boundaries* is an opportunity to form compelling, logical, and intuitive insights.

Many needs, from basics like sufficient energy, food and water to an increased sense of security (i.e., terrorism, identity theft, crime) provide opportunities for emerging new industries. We pursue ways to live healthier lives, be more productive, leverage information, and benefit from better access to education, while reducing energy consumption. New basic materials are needed that will be stronger, lighter and cheaper than available today. In a free market economy, these desires present opportunities that can awaken sleeping giants that help advance our desired standard of living and create new, jobs. We must not constrain Capitalism, but minimize government intervention, while improving its efficiency. Communism failed because forced equality and redistribution of wealth reduces a society to apathy and indifference, which historically has led to unfulfilled potential growth and depression. Hope withers and there is no incentive to take risk. When did we abdicate our ability to innovate and invent?

Someone else's "New Normal" does not have to be our destiny. Our wish is that we *Think Without Boundaries* and pursue seemingly impossible dreams to achieve our full growth potential.

David Goerz, SVP - Chief Investment Officer

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