HIGHMARK® CAPITAL MANAGEMENT

INVESTMENT HIGHLIGHTS **JANUARY 2011**

Hidden Value in Plain Sight

Throughout 2010, we have encouraged investors to embrace the value we perceived in global equities. Our preference favored Emerging Market and U.S. equities, particularly small-cap stocks. These tilts have played out well for our clients last year, even as the U.S. dollar firmed relative to European currencies. Valuations have only improved as strong S&P 500 earnings growth outpaced even our expectations and the index return. We believe equities will outperform other asset classes in 2011, including bonds and alternative assets, as well as providing the best hedge against increasing inflation concerns and rising interest rates. Commodities, particularly gold, may not have much room for further appreciation as financial speculative exposures have increased from $10 billion to more than $250 billion over the last decade. A wider range of investors chased new financial products with an expectation far exceeding the 2.5% return observed for commodities since 1900. Bonds are also significantly overvalued, in our opinion. Given the excessive risk aversion of investors toward equities, measured any number of ways, it is not surprising that there remains *Hidden Value in Plain Sight*, despite an S&P 500 return of over 96% since March 6, 2008 and reaching the highest level since Lehman's bankruptcy.

The key to unlocking the *Hidden Value* in equities is a visible transition from recovery to a broader expansion. Only then are fund flows likely to swing in favor of equities, benefiting from a rotation out of bonds and alternative investments, including commodities and hedge funds. Real-estate and other distressed investments may still have upside, as confidence improves and write-offs are reversed, even as skeptics remain fearful of another shoe-to-drop. U.S. real GDP has matched our 2.6% beginning-of-year forecast, while global growth expectations of 4.9% are near the upper end of our stronger-than-concensus global growth range of 4.5-5.0%, in spite of a second quarter stall and double-dip expectations. It seemed logical to us that the recovery would transition to expansion this year, in spite of various regulatory and legislative inhibitors to growth.

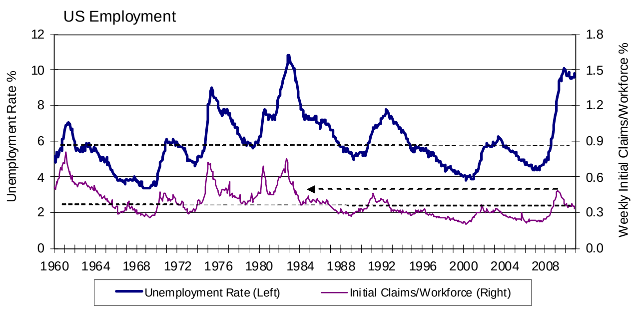
Many investors remain skeptical of the stock market after back-to-back bear markets during the "naughts" decade, but such divergence from normal averages typically leads to an inflection point in equity sentiment and mean reversion of long-term asset class returns. Corporate earnings growth and balance sheets haven't been this compelling in many decades. If there is any faith left in equity valuations based on earnings, book value, or dividends there is tremendous *Hidden Value in Plain Sight* for further equity outperformance. We have observed increased interest in dollar cost averaging into equities and higher dividend seeking portfolios, used as transitional strategies into higher equity exposures.

Economic Outlook

With another upward revision of U.S. economic growth to 2.6% in the third quarter, rolling annual real GDP of 3.3% exceeded old fashioned normal potential real growth of 2.7-3.0%. Now 18 months into an economic expansion, GDP has nominally exceeded the previous peak in 2007. The resilience of consumer spending has surprised most economists, with retail sales growing 7.7%, well above its 20-year average of 5.0%. Similarly, 5.4% growth in industrial production has rebounded from the -12.7% trough in June 2009. Exports increased 15.5% over the last year, while the ISM survey index has been above 50% for 16 months, suggesting purchasing managers believe economic conditions are improving. Profits in the national accounts data (i.e., broader economy) increased 45% over the last year through Q3, outpacing S&P 500 operating earnings growth. Furthermore, estimates for real global growth have been revised higher with consensus expectations of 4.9% now within our range set earlier this year of 4.5-5.0%.

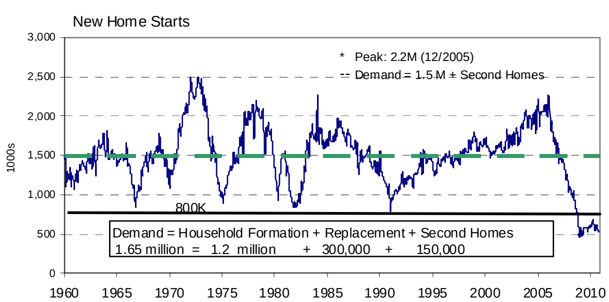
The strength of economic indicators since June 2009 suggests the U.S. recovery has been stronger than expected in many dimensions, except for unemployment and housing. We address both of these critical issues, as well as inflation expectations below. In spite of the various policy mistakes we perceived throughout 2010 that undermined business and consumer confidence, the economy grew fast enough to produce strong earnings and cash flow growth that has improved balance sheets. Refinancing of corporate and household debt has reduced leverage, as well as interest expense. In contrast, the U.S. Treasury has significantly increased its debt burden, such that its interest expense will increase significantly if interest rates rise.

The unemployment rate should decline in 2011, in spite of another extension of unemployment benefits. In *Expansion by Natural Causes (Q4/2010)*, we outlined our theory about why a recovery in employment has failed to match the strength of the broader economy. We believe that extending unemployment benefits, as with many other misguided stimulus programs, probably caused more harm than good. Extending unemployment benefits seemed like a compassionate thing to do, but are benefits of up to 99 weeks, double the previous maximum rate of 49 weeks, undermining employment growth at great cost to taxpayers? Employers are struggling to fill rapidly increasing job vacancies, up 33.5% according to the Department of Labor, while the unemployment rate among college graduates is 5.1%. There appears to be a mismatch between skills and job vacancies. We also think incentives to not search for a job are too high. Initial claims for unemployment insurance have been trending lower (-12.3%), which is encouraging since this indicator has led unemployment rate changes historically. In the chart below, we normalized initial claims to the size of the workforce—we anticipate initial claims falling further, leading to a decline in the unemployment rate to 8.7% in 2011.



Source: HighMark Capital Management and Thomson Datastream

Unemployment of 9.8% is below the 1982 recession peak of 10.8%, but still uncomfortably high, even if it does tend to lag the economic cycle. Hiring managers need confidence that demand is sustainable, even as rising employment costs remain an impediment. High unemployment continues within construction, so an improvement in housing starts is critical to job growth.



Source: HighMark Capital estimates and Thomson Datastream

Household formation is the driver of housing starts, but during March 2009-March 2010, U.S. Census reported that just 347,000 households were created. This is well below the historical average of 1.2 million households formed per year. The chart above illustrates the cyclical mean-reverting behavior of housing starts, which is empirically consistent with intuitive sustainable demand estimates of 1.5 million housing units. Low household formation bolsters the case that deferred activity could increase even more sharply once housing confidence improves. Note that there was no analogous decline in birth rates 25 years ago, but rather just the opposite, as an increasing birthrate defined the Echo Boomers, also known as Gen-Y or the Millennials (born 1985-1995).

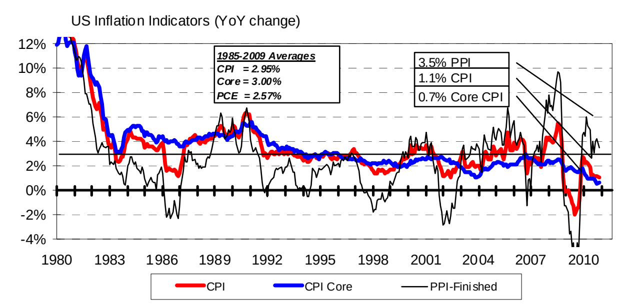
We believe that the recovery has failed to meet expectations because the fiscal stimulus was only transitory and failed to offer sustainable incentives. Tax rebates, unemployment benefit extensions, useless research grants, unnecessary infrastructure spending, cash-for-clunkers, and home buyer tax credits increased our national debt, but failed to promote a sustainable expansion. Demand was pulled forward by a few months, but the stimulus retreated just as quickly when individual programs eventually expired. We are now left waiting for the economy to work through an expansion derived from the natural process of recovery. Below we summarize our outlook for 2011-2012.

Economic Forecasts	**2006**	**2007**	**2008**	**2009**	**2010e**	**2011e**	**2012e**
U.S. GDP (Y/Y Real)	2.5	2.6	-1.9	0.1	**2.6**	**3.0**	**3.0**
Earnings Growth	15.3	-1.6	-27.9	-2.0	**38.8**	**13.1**	**9.5**
CPI Inflation (Y/Y)	2.5	4.2	-0.1	2.8	**1.8**	**2.0**	**2.5**
Unemployment	4.4	5.0	7.4	10.0	**9.5**	**8.7**	**8.0**
Fed Funds Target	5.25	4.25	0.25	0.25	**0.25**	**1.25**	**2.50**
Treasury Notes-10y	4.71	4.03	2.25	3.84	**3.32**	**3.75**	**4.50**
S&P 500 Target	1418.	1468.	903.	1115.	**1258.**	**1375.**	**1520.**

Source: HighMark Capital estimates and Thomson Datastream

Inflationary Forces Building

The third critical economic issue being actively debated, beyond jobless growth and housing, is inflation expectations, which is so important to setting monetary policy. We have disagreed with the current policy to restart quantitative easing, as announced on November 3rd, and keep the Fed Funds target at the credit crisis level of 0 - ¼%. U.S. economic growth has been exceeding its long-term average, bolstered by economic demand from emerging markets, while early indicators that suggest higher future inflation are already visible.



Source: HighMark Capital Management and Thomson Datastream

Many academics contend that inflation should not be a concern given the output gap argument attributable to slack in employment and manufacturing utilization. The recent decline in inflation toward 1% supports this view. Yet, the Consumer Price Index (CPI) inflation has swung dramatically peaking at 5.5% in July 2008, as commodity prices surged during 2002–2007, then falling precipitously by September 2009 to -2.0%. When there is excess supply of something, prices should decline until the market finds a clearing price, assuming that market is free and competitive. Under normal circumstances, this theoretical argument is reasonable, but unemployment and housing have decoupled from the economic cycle. So the debate rages on between the “Output Gap-ers” and the “Pragmatic Vigilantes”.

For the Pragmatic Vigilantes, inflation expectations should be a function of commodity prices and other input costs, which are rising and evident in higher producer prices. Food costs have increased materially with rising wheat to meat prices and higher transportation costs that will only accelerate inflation. Other constituents of consumer prices that have been deflationary now have the potential of reversing quickly. Rent equivalent shelter (32% of CPI) was declining with housing weakness, but home prices troughed in January 2009, so rising rental rates and declining vacancies reinforce the inflection point in shelter costs already observed. Energy prices, which are about 10% of the CPI index, are likely to rebound after the weakness observed in natural gas prices seems to have troughed. A weaker dollar and increasing wages in emerging markets, coupled with higher commodity input costs, are pushing up import prices, even as the U.S. seeks to encourage China to appreciate its currency further. US wages also increased 4.0% over the last 12 months--so much for employment slack capping inflation. Thus, the drivers of inflation are numerous, while the causes of disinflation have faded.

A hike in interest rates to 1.0-1.5% in 2011 would still be highly stimulative, but keep inflation expectations in check. The economy will be resilient if the Fed can communicate the need to unwind overly stimulative monetary policy, including negative real interest rates. Inflationary forces are building and becoming widespread, so it will grow increasingly difficult to tamp down if the Fed doesn’t reposition its stance soon. That will include reversing itself on *Quantitative Easing* (QE) or the purchase of Treasuries to drive bond yields lower.

Failure of Quantitative Easing Evident

Introducing QE-1 was a bold and creative move during the Financial Crisis of 2008, but as with most successful interventions, it was predicated on shock-and-awe. Credit markets had seized up, but Fed purchases of mortgage securities was so far outside the scope of what had ever been contemplated, that credit markets responded positively. In fact, it was so successful that in November 2009, the Fed announced it would wind down QE-1 by April 2010, as it had already done with other liquidity programs. Credit spreads tightened, as hoped, and record new debt issuance in 2010 was absorbed well in all sectors. The economic stall in the second quarter was not sufficient to derail economic recovery.

On August 27th, at a Federal Reserve sponsored Annual Economic Symposium in Jackson Hole, Chairman Bernanke laid out three policy options for increasing output and employment. They included: (1) re-starting quantitative easing for Treasuries only, (2) enhancing the Fed’s communication, or (3) reducing the interest rate paid on excess reserves. Since June, bank credit availability has loosened, but is still tight as higher capital requirement rules and their impact in financial reform legislation and Basel III are still uncertain. Financial conditions couldn’t be more different than in 2008 when credit spreads were tight and Treasury yields plunged to historic lows. We preferred the Fed eliminate interest paid on reserves to encourage greater lending, but the Fed has opted for re-starting quantitative easing. Their objective was to drive long-term interest rates lower, stimulating growth, but Treasury bond yields must actually fall for there to be any hope that quantitative easing will work. There was no shock-and-awe in QE-2 by simply purchasing Treasuries and offering a well choreographed program too small and spread out over time to have much effect. Unless mortgage rates fall, we do not think that quantitative easing can help accelerate housing starts or increase investment.

It is our belief that QE-2 has failed, because it didn’t surprise markets---worse than that, it apparently caused investors to increase their inflation expectations instead, driving up Treasury yields. When the Fed announced its intent to purchase Treasuries on November 2nd, 10-year Treasury yields were hovering at 2.6%, but yields climbed to over 3.5% during December. Mortgage rates have risen almost as much. Now the Fed must find a way to unwind an even larger balance sheet of assets it has purchased. In our opinion, QE-2 is more likely to increase future economic volatility.

An advantage of the Fed’s monetary mandate is that it isn’t a rigid rules-based policy. During mid-2007, the Fed began cutting rates, despite rising commodity prices, and increasing inflation risk that eventually drove CPI inflation over 5.5% in August 2008. The economic risk of tightening credit conditions was too great. Other central banks that were unable to deviate from their inflation target disciplines either kept rates steady or, in the case of the European Central Bank, mistakenly hiked interest rates in July 2008. The Fed’s creative efforts to restore liquidity to credit markets worked well, including the first attempt at quantitative easing unleashed on July 24, 2009. While flexibility provides room for more adaptive and effective monetary policy, we believe recent efforts to keep interest rates at emergency levels of 0 - ¼% and implementation QE-2 are misguided, exacerbating gathering inflation concerns.

We think QE-2 should be suspended as it clearly has failed to accomplish its goal. Furthermore, with the economy growing in excess of potential growth and inflationary forces increasing, the Fed should begin to raise interest rates slowly, so as to keep inflation expectations contained. Interest rates of up to 2% would remain stimulative, even as we expect inflation indicators to continue gathering steam. Meanwhile, the year-end rotation of regional bank presidents will result in a notably more hawkish Federal Open Market Committee (FOMC) of the Federal Reserve in 2011, including Dallas Fed President Fisher and Philadelphia Fed President Plosser as voting members. The new San Francisco Fed President has yet to be nominated since Janet Yellen was confirmed as FOMC Vice Chairman.

Conclusion

Security in an increasingly volatile world is elusive. Correlations change by the week, but persistent patterns, illogical as they may be, have trumped fundamental intuition. Provocateurs seem to get more attention these days. Falling Treasury yields coincided inconceivably with higher gold prices over the last two years. Commodities and hedge funds have supplanted equity exposure, even as the U.S. dollar weakened against the Japanese yen, despite Japan's burden of the highest debt/GDP ratio worldwide, supported by less than half the economic growth rate of the U.S.

Investment return expectations have shifted dramatically since the credit crisis of 2008, but popular forecasts bear little resemblance to either capital market theory or long-term empirical observations. We expect the returns of the next 10 years will bear little resemblance to the last 10 years. Investors must be paid to take risk, so an equity risk premium must be observed. We expect investors to adjust their risk preferences, recognizing compelling global equity valuations and rich bond yields, resulting in a dramatic rotation of asset allocation exposures. Cash flows have favored absolute return, commodity and bond funds, but skepticism of these strategies, which we expect will increase over time, should re-direct flows into equity and target risk strategies, much like we observed in 2003-2007 and 1982-1999. The popularity of absolute return strategies surged in recent years, but was likely the result of a poor decade for equities, and new financial products that increased the liquidity and acceptance of commodities. New funds just a few years old realized voracious, but unsustainable inflows. We believe that as equities reassert their rightful place in the asset class pecking order and interest rates begin to rise, increasing holding costs, enthusiasm for commodities will fade. 2011 will be a transition year for Emerging Market equities and bonds due to higher inflation, increasing interest rates and slowing growth. Brazil and Mexico could disappoint investors, in our opinion, while India faces similar challenges, but without the political uncertainty and better growth prospects.

U.S. growth that was better than consensus expected benefited from five key growth drivers we introduced in 2010. We expect inventory contributions observed will fade by mid-year, but increased housing activity has upside potential in 2011 after expanding only modestly last year. Deflation concerns caused by rapid innovation and creative destruction in goods and services have undoubtedly provided strong productivity improvements that over the long-run are more beneficial than problematic. Investors remain bullish on emerging market growth prospects, but higher inflation rates are likely to result in near-term interest rate increases that will hamper growth. We remain overweight U.S. equities, particularly small-cap stocks, as we observe *Hidden Value In Plain Sight*. We are most concerned that the level of global bond yields, particularly U.S. Treasuries, are too low given global inflation pressures, and are likely to lead to disappointing bond returns in 2011.

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