

## The Winter of Our Discontent

Investor concerns have shifted from weak growth, including housing, and tight credit conditions, to worrying about higher taxes, increasing regulation, soaring fiscal deficits, and various policy reforms being considered. Business leaders appear skeptical that these initiatives will be constructive. The uncertainty seems to have restrained hiring most of all. However, it was the Administration's hastily drawn banking reform proposals that put such significant pressure on large financial firms, even as the likelihood of tax-laden health care reform was withering in Congress. The timing of Chairman Bernanke's re-confirmation triggered a debate over the future of the Federal Reserve and their continued independence, as Congress sought greater oversight.

China increased reserve requirements to slow the rate of new lending after a doubling of bank loans in January, raising concerns as to whether global growth was sustainable. Greece's escalating debt crisis undermined confidence in Europe's ability to deal with its deficits. As a result, some economists suggested the global economic recovery had peaked before it was even a year old, while strategists have been calling for an equity correction after the equity market's stratospheric 70% rise. When the S&P 500 dropped from January's high of 1150 to as low as 1044 (-9%), investor sentiment dragged consumer and business sentiment lower.

This was "The Winter of Our Discontent", but like for Richard III, it is now "made glorious summer." The future looks increasingly brighter, not bleak. Global economic activity has picked up significantly and U.S. earnings reports beat company expectations by a wide margin again in the fourth quarter. There are signs of positive momentum in each of our five potential growth drivers to varying degrees.

Equity mutual fund flows were disappointing in 2009, but we expect them to turn positive in 2010. Although good news of another quarter of strong earnings seemed to be lost among many concerns, improving fundamentals have bolstered our global tactical equity return forecasts. High profit margins and productivity are driving a stronger recovery in earnings than expected. Meanwhile, Value and Small-cap equity forecasts are compelling, and U.S. equities are preferred over all other developed countries. Global bonds are expensive, notwithstanding the burden of stretched deficits and excessive supply expected. We expect the Euro and British pound to depreciate further.

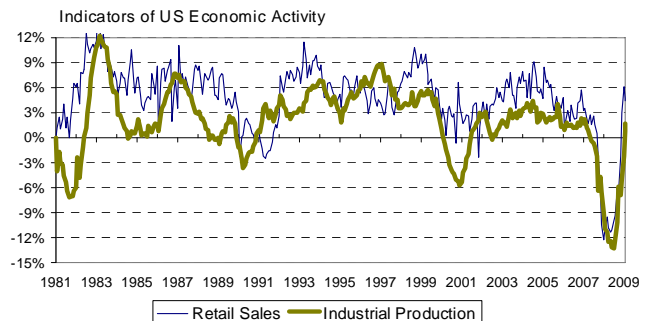
## Economic Outlook

We are constructive on global real growth, expecting an increase of 4.5% in 2010, and believe U.S. growth is more likely to exceed 3.0% than disappoint. Our long-term potential growth expectation remains at 2.7%, consistent with the Fed's published range of 2.4-3.0%. Thus, we believe there is no longer a need for 0-0.25% emergency interest rates, which, in fact, imperils the Fed's primary objectives to maximize sustainable output and promote stable prices. HighMark expects inflation to normalize around 2.5%, and should remain contained as long as oil prices don't rise significantly above \$80. Real interest rates are likely to remain negative for an extended period, but that doesn't preclude rate hikes.

<i>Economic Forecasts</i>	2007	2008	2009	2010e	2011e	2012e
U.S. GDP (Y/Y Real)	2.6	-1.9	0.1	3.0	3.0	3.0
Earnings Growth	-1.8	-27.9	-1.1	31.0	18.8	14.2
CPI Inflation (Y/Y)	4.2	-0.1	2.8	2.0	2.5	2.5
Unemployment	5.0	7.4	10.0	9.4	8.5	8.0
Fed Funds Target	4.25	0.25	0.25	1.25	3.00	3.25
Treasury Notes-10y	4.03	2.25	3.84	4.50	5.00	5.00
S&P 500 Target	1488.	903.	1115.	1213.	1375.	1520.

Source: HighMark Capital estimates and Thomson Datastream

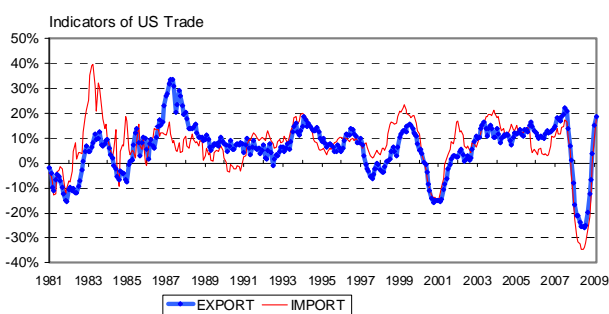
U.S. economic indicators, including industrial production and retail sales, have turned positive as the pace of recovery has exceeded even our expectations. We don't anticipate a double dip scenario, but are watching for policy mistakes that could trigger a second "V", which typically characterizes a so-called "W". Fourth quarter real GDP growth of 5.9% was stronger than third quarter growth of 2.2%, and the Fed now believes that the recession ended in June 2009. We highlighted five potential drivers in *Rendezvous With Auld Lang Syne* (January 2010) that we believe can yield higher cyclical growth over the next year or two. Below we observe strength in several of these key drivers, even after strong winter storms threatened to undermine consumption.



Source: HighMark Capital and Thomson Datastream

The global economy is expanding and even appears to be accelerating. In addition to a pick-up in inventory restocking and business investment, we also observe a normalization of consumption. A return to normal doesn't require conspicuous consumption, but simply an average 5-7% sales growth, consistent with what we have averaged historically over the last 50 years.

The other important sign of global economic activity is an improvement in trade. As our readers know, we tend to favor splitting growth in exports and imports versus simply tracking the trade balance. With an eye on oil prices, we can get a better sense of the underlying demand trends affecting U.S. export demand, another one of our critical drivers. Export growth is up 18.2% over the last year. Like growth in industrial production and retail sales, this chart will continue to improve with easy comparisons through at least July.

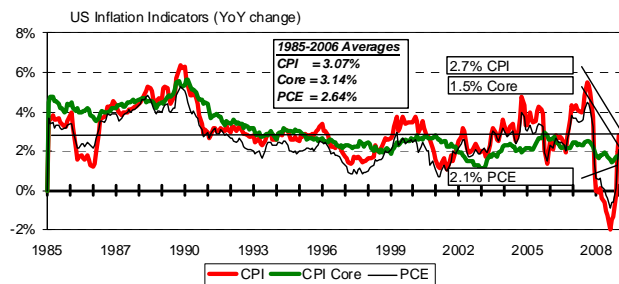


Source: HighMark Capital and Thomson Datastream

Consensus inflation expectations are low for now, but conditions are ripening with higher commodity prices, wages, and the beginning of inventory rebuilding. Housing prices appear to be a key reason that inflation isn't higher, but rents may begin to rise as housing firms. Producer prices increased about 5% over the last year and seem to be accelerating with industrial demand. CPI inflation has surged to 2.7%, although inflation may moderate somewhat over the next few months.

Slack in labor and production is being used to justify low inflation expectations, but capacity utilization has risen to 72.7% from a low of 68.3%. We suspect employment is going to start showing significant job gains by April in May's report. Normally the unemployment rate comes down fast once it rolls over. This was an atypical recession that should actually promote faster job growth. With such high productivity (7.2% A.R.), output can accelerate with less cost pressure, so companies can expand production quickly, if confidence improves.

Inflation forecasts are trending toward 2%, although there is risk consumer prices (CPI) could rise faster. The 42% of CPI tied to rent equivalent shelter prices has recovered, but is still hovering around 0%. If housing prices are firming, as they appear, below average inflation (3%) is not sustainable. Total housing inventory has fallen back to 2005 levels, although months-of-inventory is slightly higher with sales about 75% of 2005.

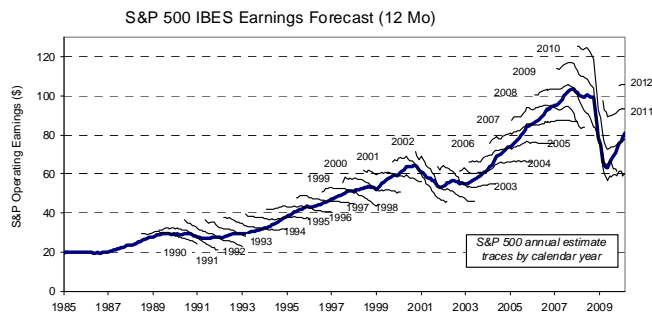


Source: HighMark Capital and Thomson Datastream

There is nothing particularly comforting about inflation, although the Fed seeks to contain expectations. We believe it is unlikely that the Fed can justify endangering price stability if the economy continues to expand faster than its potential rate of 2.7%. Short-term interest rates are starting to rise. The Fed has raised the Discount Rate by 25 basis points, and we should expect increases in the Fed Funds rate as early as midyear. Recent improving economic trends should necessitate monetary and interest rate tightening sooner than expected.

The Fed has been preparing for some time for the end to quantitative easing on March 31<sup>st</sup>, including purchases of both Treasuries and mortgages. Low interest rates and quantitative easing have undermined the U.S. dollar. Many expect mortgage rates to widen by as much as 1% when the Fed stops buying mortgages, which could push rates over 6%. Considering that the Fed has slowed its purchases, we believe the unwinding of monetary stimulus has already been discounted. Some leading economists have suggested the impact may be less than 0.3%. We are more sympathetic to their arguments.

Companies began to pre-announce upside earnings surprises in March 2009, triggering a reversal in stock indices. As the economy rebounds, S&P 500 earnings are expected to increase 63% over the next two years, according to consensus forecasts. We expect the 12-month forward expectation of earnings to continue its encouraging trend given targets for 2011 and 2012.



Earnings	2012e	2011e	2010e	2009	2008	2007	2006
HighMark	14.2%	18.8%	31.0%	-1.1%	-27.9%	-1.6%	15.6%
Consensus	13.2%	20.1%	27.7%	-1.1%	-27.9%	-1.6%	15.6%
HighMark	\$ 108.50	\$ 95.00	\$ 80.00	\$ 61.08	\$ 61.74	\$ 85.62	\$ 87.04
Consensus	\$ 106.05	\$ 93.68	\$ 77.97	\$ 61.08	\$ 61.74	\$ 85.62	\$ 87.04
Financials	24.1%	49.9%	151.0%	159.2%	-130.8%	-2.1%	21.8%
Non-Financials	16.3%	15.6%	19.7%	-18.7%	7.2%	3.2%	12.4%

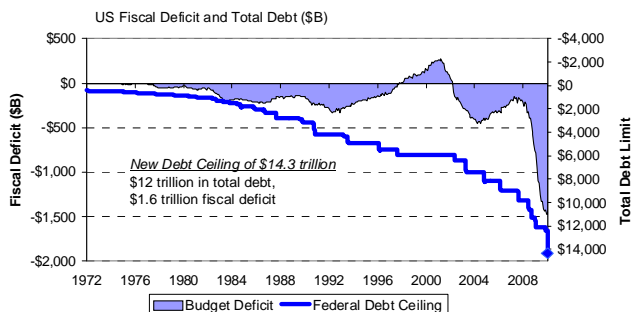
Source: HighMark Capital and Thomson Datastream

Thomson reported that 79% of companies beat earnings estimates in Q3 of 2009, the highest percentage to date. Q4 earnings reports were nearly as strong with 72% of companies exceeding expectations, compared to a historical average of 61%. Earnings drive stock prices, so putting a 15X earnings multiple on our 2011 forecast suggests an upside for the S&P 500 to 1425 or 30% return, including dividends from the end of February.

We have raised our earnings estimates for 2010 and published our first forecast for 2012. Technology earnings are expected to jump 24% in 2010, but that will appear modest versus increases in Materials (73%), Energy (47%), and Consumer Discretionary (28%). Financial earnings estimates increased 156% in 2009 and should rise another 162% in 2010. While much of this may be discounted, we believe the greatest potential for upside surprise is in the Industrial sector with its international exposure, as the global synchronized recovery and inventory re-stocking takes hold.

### Deficits and Taxes

Our public debt has soared in the last couple of years as Congress racked up new spending initiatives. Today's fiscal deficit exceeds any in history, and we are still adding additional burdens to the budget. Although bond yields remain relatively low, a soaring debt burden can eventually crowd out investment and potentially increase the risk premium that can result in higher interest rates, which might force fiscal restraint under difficult terms.

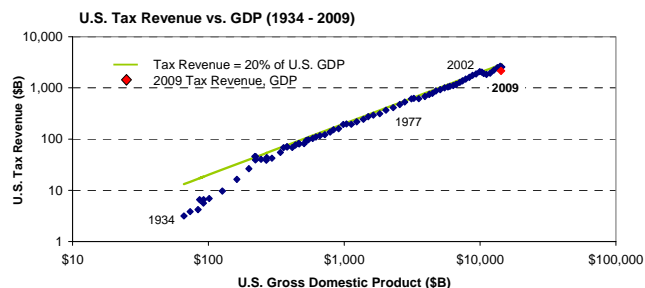


Source: HighMark Capital and Thomson Datastream

Greece and several other Eurozone countries are paying much higher interest rates than other members as a result of their soaring debt burdens. Greece's deficit has risen to 13% of GDP versus the Maastricht Accord which stipulates a limit of 3%. Portugal, Ireland, Italy, Greece and Spain have begun the difficult work of resolving their fiscal deficits through a combination of tax increases and spending cuts. Greece and the four other little "PIIGS", as well as the United Kingdom, highlight a broader concern that unchecked expansion of government programs is unsustainable, risking higher interest rates, worrisome social unrest, and difficult periods of fiscal austerity that limit growth. The Euro has depreciated about 11% since fiscal troubles emerged within the European Monetary Union. The inability to competitively devalue a weaker country's currency is costly to the rest of the members. The visual images of social unrest and general strikes against government austerity moves are

unsettling. We question whether the Euro can ever be a significant reserve currency alternative to the U.S. dollar.

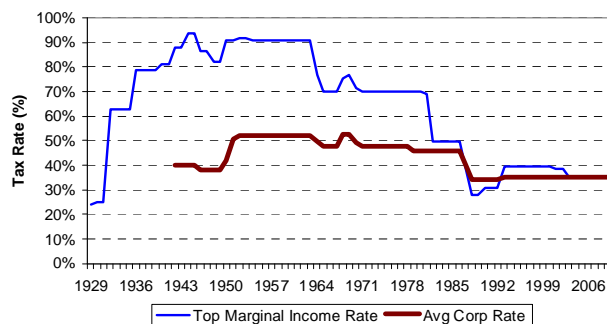
During the last two recessions, we cut taxes and the economy recovered more quickly. This time it is clear that deficit spending didn't work as well as tax cuts did in the past. Unemployment has increased from 8% to 10%, while our fiscal deficit soared. There is a great deal of "discontent" about how money was spent, and how little help it seemed to provide in stimulating job growth.



Note: Total U.S. Tax Revenue includes: Individual, Corporate, Social Security, Excise & Other Sources

Source: U.S. Government, Office of Management and Budget

Historically, raising taxes slowed growth in GDP, which is why the relationship of tax revenue being limited to 20% of GDP since 1934 has persisted, despite large variations in both individual and corporate tax rates. In a steep recession, a plunge in GDP can yield much less revenue than 20%, as it did in 2009. The damage caused by the Roosevelt Administration in raising corporate and individual taxes from 1934-1937 in order to pay for programs during the Great Depression is well chronicled. On the other hand, if imitation is the sincerest form of flattery, then supply-side policies replicated by other countries, including several former Soviet-bloc countries that adopted flat tax regimes, ignited incentive-based growth and capitalism. A government simply cannot tax and spend a country into prosperity. Businesses, disciplined by free markets, have always been the most efficient allocators of capital.



Source: U.S. Government, Office of Management and Budget

Between September 2008 - June 2009, the downturn significantly undermined both federal and state tax revenues. Government spending represented a high fixed cost relative to tax revenue that proved much more volatile during the Financial Crisis due to highly progressive income tax policies in Europe and the U.S. We believe that expanding government control can't create wealth, only destroy, limit or redistribute it.

When the American Recovery and Reinvestment Act passed, the Congressional Budget Office (CBO) and the Joint Committee on Taxation estimated that it would increase budget debt by \$787 billion during 2009-2019. Of that amount, about \$575 billion was attributable to additional spending and \$212 billion to tax cuts. CBO now believes that the stimulus has gotten more expensive and in February revised up the deficit impact to \$862 billion due to higher costs of unemployment insurance (\$21 billion), supplemental nutrition benefits (\$34 billion), and Build America Bonds. In 2009, most of the money spent went to individual payments. In 2010, a greater share of spending will bolster economic activity, but now the Fed will likely have to increase interest rates faster to offset activity that may overheat the economy.

State reported tax revenues have started to increase with higher bonuses, capital gains, and corporate profits. Bonuses are rising as sales are improving and economic uncertainty is moderating. Some companies who froze salaries last year to conserve cash have provided "catch-up" adjustments. It will be difficult to justify withholding bonuses two years in a row with visible improvement in the economy. Profit sharing and company matching retirement contributions also have been reinstated. Some financial service companies have raised base salaries in order to shrink bonuses. We should expect the fiscal deficit to moderate over the next few years with incomes of business and households rising, but even with an economic recovery, our concern is that spending is rising too fast.

## Conclusion

The global recovery will likely be unique in many respects as the recent recession's origins, and therefore the response, was indeed exceptional. Investor, business, and consumer confidence are improving, 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, we should differentiate between recessions caused by structural economic imbalances, and financial risk aversion caused by a liquidity-induced credit crisis and financial panic.

Global growth appears to be accelerating, and liquidity in capital markets has been restored. We believe global cyclical forces are strong enough to overcome the various headwinds of new regulations and taxes, as well as skepticism to yield better than average growth for the foreseeable future. Free markets can still incentivize entrepreneurship, helping us discover the next generation of America's national champions. As global re-synchronization takes hold, we will need to identify new growth engines of innovation and identify the opportunities that can add value as active investors.

Many widely accepted beliefs have been challenged as tough questions have been raised about basic American values, economic principles and commonly accepted investing theories. Risks of adverse policy changes that might undermine future economic growth have diminished somewhat, particularly within the Senate, while the Fed's independence has emerged intact after a brutal confirmation fight. There is a lot of anxiety about heavily debt-laden governments around the world, but fiscal deficits will moderate as global activity rebounds. Just as seasons come and go, the collective fears and skepticism present during "The Winter of Discontent" are finally fading. The "glorious summer" has become increasingly visible.

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