

## **SOVEREIGN SHOCK SYNDROME**

The Greek debt crisis has spread to envelope Europe, becoming just one of many concerns that have undermined investor confidence. Self-imposed spending cuts have settled markets, even as the European Central Bank (ECB) has committed to buying up excess debt to keep sovereign yields within a reasonable range. Europe's sovereign debt crisis is likely to be contained within the region. Fiscal drag from spending cuts or even tax hikes, can be offset by looser monetary and interest rate policy, as well as devaluation of the Euro. Equities have suffered the most, yet the sovereign debt crisis should be most concerning to debt holders.

*Sovereign Shock Syndrome* extends beyond the European debt crisis to include China's policy actions to limit growth and real estate appreciation, political transitions in Japan and the United Kingdom, policy responses to the Gulf oil spill, and U.S. legislative policy uncertainty, including financial reform. We recognize there are many concerns that have unsettled investors, but we believe they are simply not enough to derail U.S. or Emerging Market growth or justify the decline in global risk tolerance we've experienced since mid-April. Rather despite the recent events, the global synchronized recovery is being sustained by five key drivers of pent-up demand (*Rendezvous With Auld Lang Syne* Q1/2010), as we hoped would emerge and have.

Our current U.S. growth forecast of 3% and global growth trending toward 4.5-5.0% in 2010 should be encouraging, particularly as U.S. GDP has already surpassed its previous peak in Q3/2008 to \$14.6 trillion. Hope and "green shoots" have transitioned to global synchronized recovery. We believe this recovery can be more robust than previous cycles because the massive global policy response was synchronized and a credit crunch is usually transitory. Since U.S. growth was hovering near potential when credit markets seized up, the coiled spring of pent-up demand should re-coil faster. We are monitoring many concerns, but with considerable fiscal and monetary stimulus still coursing through the economy, it will be hard to derail recovery.

The financial crisis has provided new insights about fiscal deficits, tax cuts vs. government spending, as well as the dangers of unintended consequences and policy mistakes. The most comfortable way to extinguish fiscal deficits is to grow faster, but highly stimulative monetary and fiscal policies risk higher inflation. Spending cuts are needed since once interest rates rise, the financing

costs of high debt levels will crowd out discretionary needs. Protests and strikes in Europe are an urgent warning to all countries with high debt levels, including the U.S. and Japan. Fiscal deficits usually decline rapidly as growth accelerates and stimulus spending wind down, but governments shouldn't become complacent. European governments are accepting the new reality of self-imposed austerity by cutting public worker salaries, increasing retirement age, selling off national interests, and reducing entitlements. This will be a difficult adjustment given huge accumulated liabilities.

### **Economic Outlook**

Confidence of investors, businesses and consumers is critical right now, having improved over the last year. The psychology of markets is difficult to predict and tends to overshoot in both directions, but America's economy is rarely as fragile or inflexible during periods of crisis as is often assumed. Fears of a double-dip coupled with deflation at one extreme, contrast sharply with other experts expecting a strong recovery, but concerned that massive monetary and fiscal stimulus could lead to much higher inflation.

The outlook of certain institutions, such as the Fed and the National Bureau of Economic Research (NBER), can have an important impact on investor sentiment and politics, and thus must be objective. Unlike other countries whose central banks define recessions clearly and simply as beginning with two sequential quarters of negative real growth, the Fed has deferred to the Business Cycle Dating Committee of NBER, which is charged with determining the beginning and end of recessions. Statistical data indicate the precipitous economic decline during Q4/2008 was triggered by a global credit crunch that escalated through August 2008, followed by the bankruptcy of Lehman Brothers and shotgun acquisition of Merrill Lynch by Bank of America in September. The announcement dating the start of the recession as December 2007 is surprising since it was followed by two quarters of positive real GDP growth.

In April 2010, NBER said: "*Although most indicators have turned up, the committee decided that the determination of the trough date on the basis of current data would be premature.*" In contrast, Chairman Bernanke said September 15, 2009 that the Fed believed the economy had troughed in June 2009. He recently reaffirmed "the U.S. economy should continue to grow this year and next." Prof. Robert Gordon of

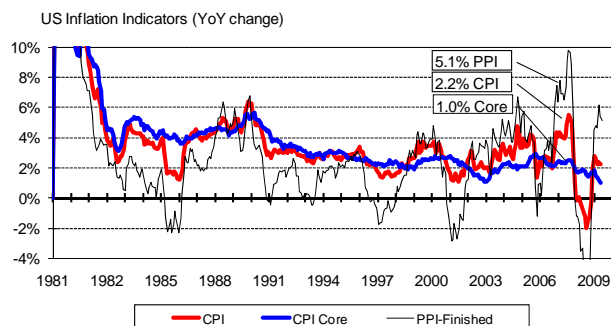
NBER also believes the recession ended during mid-2009. He observed that over 40 years, peaking initial unemployment claims coincided with the end of the last seven recessions. Real GDP has averaged greater than 3% for the last three quarters (2Q/2010 forecast: 3.3%) and initial claims peaked in June 2009. Yet, NBER believes it is premature to date the end of the recession to a year ago, before the ink was even dry on the \$864 billion stimulus provided by the American Recovery and Reinvestment Act. Would a decision to date the end of the recession jeopardize lingering justification for further stimulus? Most investors have already come to their own conclusions about when the recession ended, given the economy has been expanding for a year and growth of 2-4% every quarter is expected through 2011.

Although there is a lot of anxiety about the possibility of a double-dip, inflation could be the most significant surprise. We expect 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 shouldn't preclude rate hikes. We believe there is no longer a need for 0-¼% emergency interest rates.

Economic Forecasts	2006	2007	2008	2009	2010e	2011e	2012e
U.S. GDP (Y/Y Real)	2.5	2.6	-1.9	0.1	3.0	3.0	3.0
Earnings Growth	15.3	-1.6	-27.9	-2.0	32.2	18.8	14.2
CPI Inflation (Y/Y)	2.5	4.2	-0.1	2.8	2.0	2.0	2.5
Unemployment	4.4	5.0	7.4	10.0	9.2	8.5	8.0
Fed Funds Target	5.25	4.25	0.25	0.25	0.75	2.50	3.25
Treasury Notes-10y	4.71	4.03	2.25	3.84	4.00	4.50	5.00

Source: HighMark Capital estimates and Thomson Datastream

Given the rebound in the Consumer Price Index (CPI) a year ago, it should not be surprising that annual CPI inflation has moderated. However, there is nothing comforting about inflation, even as the Fed has managed to contain expectations. Inflection points in the Producer Price Index (PPI) tend to lead CPI inflation. Prices for wholesale, intermediate and finished goods have increased with demand.

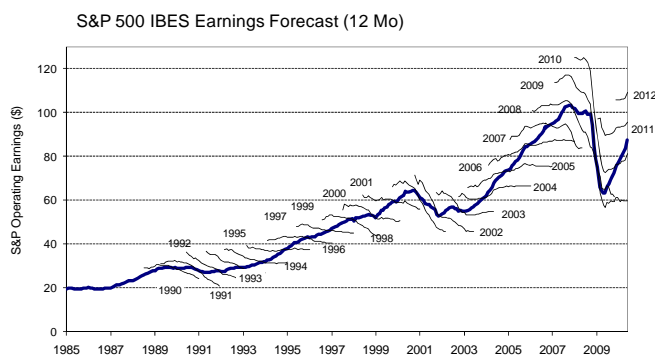


Source: HighMark Capital and Thomson Datastream

Housing, including utilities, dominates 42% of CPI. Home prices have declined since 2005, including a drop of -0.7% in shelter costs over the last year. Rents are now rising for both housing and commercial property. Rising shelter costs and wage increases are likely to increase inflation. Thus, it is unlikely that the Fed can

justify endangering price stability if the economy continues to expand above our 2.7% potential growth rate. Improving trends should necessitate interest rate tightening sooner than expected, but the European debt crisis has raised concerns at the Fed and caused us to drop our year-end target from 1.25% to 0.75%.

S&P 500 earnings are expected to increase 59% during 2010-2011. Even we have been surprised by the ability of companies to beat expectations by such wide margins, even as they guide analysts higher. During the first quarter, 78%<sup>1</sup> of companies beat January 1<sup>st</sup> estimates by 14.3%. This was the second best performance on record. Earnings revision trends are still positive and rarely reverse quickly. This inflection point in earnings is nothing like we've ever seen before and highlights the uniqueness of the recent recession.



Earnings	2012e	2011e	2010e	2009	2008	2007
HighMark	14.2%	18.8%	32.2%	-2.0%	-27.9%	-1.6%
Consensus	17.4%	17.5%	35.5%	-2.0%	-27.9%	-1.6%
HighMark	\$ 108.50	\$ 95.00	\$ 80.00	\$ 60.53	\$ 61.74	\$ 85.62
Consensus	\$ 113.18	\$ 96.41	\$ 82.02	\$ 60.53	\$ 61.74	\$ 85.62
Financials	23.6%	35.8%	237.2%	148.4%	-130.8%	-2.1%
Non-Financials	15.0%	14.4%	21.8%	-17.3%	7.2%	3.2%

Source: HighMark Capital estimates and Thomson Datastream

High earnings growth, low interest rates, and exceptional productivity bolster already compelling equity valuations, which should provide significant upside once confidence is restored. The Price/Earnings ratio on 2010 earnings dropped to 13X, but with interest rates so low, expansion to 15-17X typically can be expected. Earnings drive stock prices, so a 15X earnings multiple on our 2011 forecast of \$95 suggests significant return for the S&P 500 from current levels, plus dividends.

## China's Year of the Tiger

Could anything be more fitting than the Chinese lunar calendar celebrating the Year of the Tiger? The Tiger's traits of physical power, independence, and bravery will coincide with China's expected economic rebound in 2010. January's increase in bank reserve requirements, followed by recent attempts to slow property price appreciation and contain inflation pressures, were

<sup>1</sup> A record of 79% companies beat estimates in Q3/2009

unsettling for investors. Yet, we believe the real concern about China's housing market is that there are not enough lower cost apartments rather than an excess capacity issue. State-owned banks were created as government lending institutions, so they do not pose a systemic risk and China re-capitalized them already.

Urbanization and industrialization of China creates unprecedented demand for infrastructure investment from railroads to highways, seaports to airports, and water systems to electricity capacity. Global trade is normalizing, as both China and the U.S. have enjoyed a spectacular increase in exports. We should not be concerned about a "hard landing" in China, for now. While commodity prices are rising, China's labor cost advantages are still significant, but the gap is closing. We expect 8-10% real growth over the next year or two.

### **Greece and Other Concerns**

Greece has been one of the fastest growing countries in the Eurozone over the last decade, often exceeding 4%. Since joining the European Monetary Union, it has failed to ever meet Maastricht deficit guidelines limiting deficits to 3%. Greece reached a tipping point when its total debt exceeded 130% of GDP, which spiked bond yields. This crisis has highlighted the risk to many countries seeking to finance unsustainable indebtedness. Economies need not be dependent on deficit spending to achieve sustainable growth. Only a credible plan for reducing deficits will keep Bond Vigilantes at bay.

George Papandreou, elected in October 2009, revealed early this year that Greece's fiscal deficit was not 6%, but as high as 12.7%, and later revised to 13.6%. This revelation led to Greece being downgraded on April 27<sup>th</sup> to below investment grade. Greece has frozen public sector wages for three years, increased taxes, and raised the retirement age public workers. Privatization of state-owned companies and property also will help reduce debt. Other countries also have passed or are considering similar austerity measures. There have been protests and strikes across Europe, although violence in Greece was the most dramatic. Offsetting reduced spending, the devaluation of the Euro will bolster exports, while the ECB expects to keep interest rates low for longer than under normal conditions.

*Bold Steps for European Periphery Countries* (5/12/2010) discussed the impact of the ECB's Securities Market Program, which provided liquidity of €750 billion to bailout European banks and other holders of sovereign debt. The program has a similar objective to the Federal Reserve's 2009 quantitative easing, which purchased Treasuries and distressed mortgages held by U.S. Banks, resulting in tighter credit spreads.

We have argued that despite America's imbalances, there is no other currency that might rise to the currency reserve status of the U.S. dollar. The risk to U.S. dollar

devaluation through forfeiture of its status has been exaggerated as far back as 2005 (*Volatility and Opportunity Returns*, June 2006). In *A Rising Tide* (Q3/2009), we again posed the question: will the U.S. Dollar retain its reserve currency status? Confidence in the Euro has been shattered after its -20% decline. We have argued that the Euro was unlikely to be a formidable alternative reserve currency due to certain basic flaws. Without changes to the Maastricht Treaty and greater fiscal alignment among its members, it is unlikely the Euro could become a legitimate reserve currency, beyond its share of 20-25%.

### **Can These Concerns Derail Economic Growth?**

Uncertainty about the legislative and regulatory agenda in the U.S. has kept business from hiring more workers and investing more aggressively. The financial reform bill is expected to undermine the competitiveness and profitability of U.S. banks, including proposals to reform derivatives trading, proprietary trading, and managing hedge funds. Many of these activities were profitable during the crisis. In a recent AP poll, 64% say they think the new financial regulations Congress is debating won't do anything to prevent another crisis. Many believe the reform bill still fails to address various concerns that compounded the financial crisis, including failed credit underwriting standards of Freddie Mac and Fannie Mae or widespread use of ratings-based investment guidelines that relied on specific credit rating agencies.

On May 21<sup>st</sup>, the Senate passed its version of sweeping Financial Services reform, but just a month before, it was the rapidly shifting probability of passage that coincided with equity market highs since the crisis began. The key event that seemingly changed the debate and the likelihood of passage was the timing of a controversial Securities Exchange Commission vote to charge Goldman Sachs Group, Inc. on April 16<sup>th</sup> with fraud in structuring and marketing a collateralized debt obligation issued for sophisticated investors silenced many critics of the bill. Following public hearings, settlement discussions have dragged on for months, but no evidence has proven the firm violated any law.

Financials dragged the market lower, discounting the adverse impact of likely passage of reforms and the higher cost of hedging for businesses. Many provisions of the current bill could have an undesirable economic impact, but there may be little further downside risk. We believe reform should begin with consolidation into a single banking regulator and securities regulator, which should close regulatory gaps, increase consistency, help adapt to innovation, and improve enforcement.

Political transitions can also cause uncertainty, but the expedient resolution of the U.K. elections elevated Mr. David Cameron to Prime Minister. Mr. Cameron is the youngest leader of the conservative Tory Party in 200 years. Meanwhile, Japan's parliament elected Mr. Naoto

Kan of the majority Democratic Party as its new Prime Minister on June 4<sup>th</sup>. Mr. Kan was the previous Finance Minister and is seen as a fiscal conservative, likely to address Japan's mounting debt.

## Changing Sector Weights

Once a year, Russell rebalances its equity indices. Usually this is of primary interest to index funds, but this year the changes are significant due the addition of Berkshire Hathaway and the reclassification of Exxon as a growth stock. Changes are expected to be most significant in Energy and Consumer Staples, but Consumer Discretionary and Health Care adjustments are material too. Equity returns exceeded 70% over the last year, so turnover triggered by index rebalancing will likely result in higher capital gains for investors.

<u>GIC Sector Adjustment</u>	<u>Russell 1000</u>	<u>R1K Growth</u>	<u>R1K Value</u>
Consumer Discretionary	0.0%	3.3%	-3.2%
Consumer Staples	-0.6%	-6.0%	4.8%
Energy	-0.2%	6.4%	-6.9%
Financials	1.1%	-0.4%	2.5%
Health Care	0.0%	-4.7%	4.7%
Industrials	0.2%	2.0%	-1.6%
Information Technology	-0.2%	-0.9%	0.6%
Materials	-0.1%	0.9%	-1.0%
Telecommunication	-0.1%	0.2%	-0.4%
Utilities	<u>-0.1%</u>	<u>-0.7%</u>	<u>0.4%</u>
Turnover ( $ \Sigma /2$ ) %	1.3%	13.2%	12.7%

Source: HighMark Capital

## Conclusion

Concerns over Greece quickly enveloped other countries also burdened by high debt levels and unaffordable public commitments. The cost of running

persistently high fiscal deficits finally reached a tipping point. Whenever global growth stalls, deficits often surge, and the weakest countries suffer most. Sometimes flexibility of a floating currency is helpful to restore balance by improving relative competitiveness.

The global recovery, led by Emerging Markets and the U.S, will likely be unique in many respects. The recent equity correction is a buying opportunity caused by a rapid succession of unquantifiable concerns that undermined confidence. These are of relatively less economic significance than the adverse capital market impacts observed over the last few years. Markets seem to have discounted slower growth and a possibility of deflation. We think neither is likely. Rather, we believe the rewards appear significant from tactical opportunities available in security, sector, and asset class valuation divergences for those investors with greater conviction during this volatile and uncertain period.

We believe global cyclical forces are strong enough to overcome the many concerns and headwinds of new regulations and taxes, as well as increased skepticism of economic recovery. Maintaining confidence is critical, but we believe increasing inflation pressures are being ignored. Free markets can still incentivize entrepreneurship, nurturing the next generation of America's national champions. As the *Sovereign Shock Syndrome* fades and global synchronized recovery continues, HighMark, as active investors, will seek to identify new growth engines of innovation, future themes and tactical opportunities that can add value.

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