

ARE THE NIGHTMARES BEHIND US?

Investors have had to contend with many upsetting concerns over the last year, including geopolitical uncertainty, social unrest, natural disasters, monetary tightening, new regulations, and a U.S. government downgrade. The European Sovereign Debt Crisis was underway for over a year when the worrying *Nightmares* began compounding in March 2011. These *Nightmares* undercut confidence and global growth expectations, which impeded equity returns, despite earnings growth exceeding 16% in 2011. Treasury yields plunged below 2.0%. Uncertainty fueled much higher volatility across equity, bond, currency, and commodity markets.

Most of these threats we expected to be transitory, as we've observed. We cautioned investors about the potential misleading assumption of relying on "soft data" or sentiment indicators given the contradictory economic data. Insights that seem so intuitive to investors can overlook key variables that aren't so obvious. Now, consumer confidence has rebounded sharply since October from 40.9 to 64.5, while expectations jumped from 50.0 to 76.4, with improving economic conditions. Uncertainty has been retreating with each positive economic surprise. Equity markets rebounded strongly too, reflecting improved investor confidence. An economic inflection point has emerged, reinforced by the constructive themes we discuss below. A few *Nightmares* remain, not the least of which is the Eurozone's struggle to manage their fiscal deficits and reduce high debt levels, necessary to reduce government yields to a reasonable level. Focusing on HighMark's five exceptional drivers of economic surprise continues to guide our thinking about growth.

Surprising strength in earnings, consumption and investment activity has persisted. Economic data, including retail sales, industrial production, business sales, capital investment, exports, productivity, and profit margins exceeded expectations. The "output gapers" have argued that there is too much slack in employment and manufacturing capacity to push up inflation, yet consumer prices have surged 3.9%, before easing recently. Inflation is showing up in wages, producer prices, and even shelter costs. Relative valuations across asset classes, countries, sectors, currencies and stocks now provide compelling opportunities for active management in 2012, as extreme relative valuations should normalize.

Investment Review

Global equities rose in the fourth quarter, to finish off a volatile year. The S&P 500 index rose or fell greater than +1% on 96 days or 36% of all trading days, with a nearly equivalent number of up and down days. Just 11 of the last 35 months have posted negative returns. The S&P 500 returned a noteworthy 11.8% versus a Barclays Capital Aggregate bond return of 1.1% during the fourth quarter, which marked a significant divergence between stocks and bond returns. For 2011, bonds (7.9%) outperformed stocks (2.1%), as the 10-year Treasury yield fell from 3.3% to 1.9%. Treasury bonds are now at the lowest level in more than 50 years despite inflation more than doubling to 3.9% by October, unemployment dipping to 8.5% from 10.5% in 2009, and lack of any signs of recession in the foreseeable future, as fourth quarter real GDP is expected to exceed 3.5%.

Small-cap outpaced large-cap stocks by 3.7%, while value trumped growth stocks by 2.5% during the fourth quarter, although large-cap and growth equity styles dominated in 2011. Preferences for higher dividend yield and defensive stable-earnings growth stocks extended valuations further of outperforming sectors in 2011, including Utilities (19.9%), Consumer Staples (14.0%), Health Care (12.7%) and Telecommunications (6.3%). Lagging Financial (-17.1%) and Material (-9.8%) sectors reflected growth and financial sector concerns due to the Eurozone Debt Crisis. Correlations increased between individual stocks and country indices, so the 37% return dispersion in 2011 across sectors was surprising.

In 2011, international equities underperformed U.S. equities, as we expected, with MSCI EAFE lagging the S&P 500 significantly by 13.8%, but the MSCI Emerging Market Index (-18.2%) underperformed MSCI EAFE by a lesser amount of -6.4%. Fears of a collapse in the U.S. dollar have failed to materialize, as it strengthened 0.9% in 2011, on a trade weighted basis. Since S&P cut the U.S. Government's credit rating to AA+ on August 5th, following the debt ceiling debate, the U.S. dollar actually rose 5.9% through year-end.

Given low interest rates, a 32% increase in the U.S. monetary base, failure to sufficiently address the budget deficit, and the Arab Spring conflict (higher oil prices), investors expected gold to appreciate above its \$1900/oz peak. The last time gold exceeded twice the CRB Index was in 1980, and it took 29 years before it attained that level again. In September, Gold exceeded

the CRB Index by 3X, but gold was off -18.2% from its high to \$1574 by year-end, after tumbling -9.8% in December. Gold rose 11.1% in 2011. Commodities fell for only the second time in 10 years by -10.6% in 2011, but still exceeds the average return of 2.6% = (Inflation – Holding Costs). Changes in input costs can't exceed output costs, thus commodity returns can exceed inflation over the long-run, with higher risk than bonds.

A new secular paradigm has hypothesized diminished capacity for economic growth and lagging equity returns since the Financial Crisis, but it has failed to materialize. Instead, equities returned 103%, far surpassing the total return to bonds of 21.6%, since the March 2009 trough.

Cyclical Themes

The recent economic slowdown appears to have been a mid-cycle transitory pause, similar to 2010, rather than a precursor to another recession. We expect capital investment, consumption, and export growth in 2012, with a pick-up in hiring and housing starts. Housing starts increased 25% to 657 in 2012, but that is only 57% of the historical average household formation rate of 1.2 million. About 300K homes are replaced annually due to fire, floods, hurricanes, earthquakes, and decay, suggesting natural demand for housing starts of 1.5 million, ignoring second homes. Household formation has been predictive of housing demand, so after falling to a low of 356K through 2009, the formation rate is rising fast and expected to exceed 700K in 2011. This fifth HighMark driver of exceptional economic surprise has the potential to surprise again in 2012.

Monitoring HighMark's five drivers of exceptional growth has helped us better understand the economic cycle. Four of the five drivers exceeded expectations in 2011, including consumption, exports, investment and housing starts. Only inventory re-stocking disappointed in 2011, but now inventories are even leaner because consumption exceeded expectations. Thus, re-stocking inventories should add to growth in 2012, with orders already increasing. Consumption may be the least likely to provide an upside surprise in 2012.

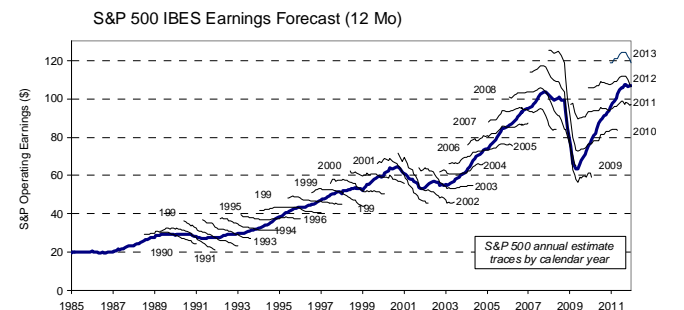
Economic Forecasts	2008	2009	2010	2011e	2012e	2013e
U.S. GDP (Y/Y Real)	-3.4	-0.6	3.2	1.8	2.3	2.8
Earnings Growth	-26.5	-5.6	43.4	15.2	5.7	5.4
CPI Inflation (Y/Y)	-0.0	2.8	1.4	3.0	2.5	2.5
Unemployment	7.3	9.9	9.4	8.5	8.3	8.0
Fed Funds Target	0.25	0.25	0.25	0.25	0.25	1.00
Treasury Notes-10y	2.25	3.84	3.31	1.88	3.00	3.50
S&P 500 Target	903.	1115.	1258.	1258.	1350.	1450.

Source: HighMark Capital estimates and Thomson Datastream

Earnings growth is expected to slow this year, but the consensus forecast still suggests growth approaching 10%. Our estimates are a little lower than the \$107 consensus expectation, but equity valuations are very compelling, in our opinion, so little if any growth seems to be discounted. Thus, we expect the equity return can exceed 9.5%, before much increase in the 12X forward price/earnings multiple. Earnings growth and high profit margins have benefited from above average productivity

and increasing revenues, but earnings growth is expected to slow this year to 10%, according to the consensus. Forward 12-month earnings will continue to increase over time, given 2012 and 2013 estimates.

There is no evidence that the positive trend in earnings surprise dissipated in the third quarter with 70% of S&P 500 companies beating June 30th estimates by 6.0%, despite economic concerns and geopolitical headwinds. It was the eighth sequential quarter in a row of significant positive earnings surprise. Analysts now expect earnings exceeding \$97, up 16% in 2011, surpassing the \$88 earnings record of 2006 and \$93 forecast two years ago.



Earnings	2013e	2012e	2011e	2010	2009	2008	2007
HighMark	6.1%	2.6%	15.2%	43.4%	-5.6%	-26.5%	-4.6%
Consensus	11.7%	9.7%	16.2%	43.4%	-5.6%	-26.5%	-4.6%
HighMark	\$ 105.00	\$ 99.00	\$ 96.50	\$ 84.15	\$ 58.40	\$ 61.48	\$ 85.12
Consensus	\$ 119.38	\$ 106.84	\$ 97.38	\$ 84.15	\$ 58.40	\$ 61.48	\$ 85.12
Financials	13.4%	22.0%	10.6%	288.2%	106.9%	-130.8%	-2.1%
Non-Financials	11.4%	7.6%	15.8%	28.1%	-18.6%	7.2%	3.2%

Source: HighMark Capital estimates and Thomson Datastream

Below we introduce three longer-term cyclical themes that have important implications for investors:

1. *Shift to Asynchronous Global Expansion*
2. *Era of Exceptional Productivity*
3. *Ignoring Cyclical Inflation Threat Could Be Perilous*

Shift to Asynchronous Global Expansion

In 2009, we began advocating a *Global Synchronized Recovery*. Global growth accelerated on the heels of massive coordinated monetary and fiscal stimulus, coupled with low interest rates, engineered to restore confidence and liquidity to the banking system. The global economic cycle became more synchronized as the recovery gained traction, but this is an unusual condition that hasn't been sustainable historically. Higher than normal correlations between asset classes, sectors, and securities observed amplified market volatility. Now, signs of global economic decoupling have emerged, which we expect leads to a more typical *Asynchronous Global Expansion* that should last 4-5 years, at least.

Our world is more interconnected than ever, so risk of contagion has increased. The effects of the Eurozone Debt Crisis are serious, but we think the influence on their trading partners has been exaggerated. Although European growth should remain positive in 2012, even a 1% decline in growth, affecting 14% of S&P 500

revenues, has an impact of just -14 basis points. Eurozone countries have many options to significantly reduce debt and interest expense. European banks were less aggressive about raising capital than U.S. banks, so any decline in sovereign debt, once risk-free regulatory capital, also reduces lending capacity and profits. Banking is a global industry, so the Eurozone governing paralysis, which has impeded resolution to the debt crisis for two years, has weakened capital ratios and profitability. New regulations and efforts to introduce a financial transaction tax likely will further undermine Eurozone bank competitiveness versus global peers.

In an *Asynchronous Global Expansion*, we expect factor correlations will decline and the risk of Eurozone contagion will diminish, particularly for North America and other self-sustaining economies. Concerns about the Eurozone Debt Crisis should be overwhelmed by fundamental forces that define real economic activity. Unique country and regional economic differences, as well as diverging monetary and fiscal policies, should further increase decoupling. High frequency trading has exceeded 60% of daily volume, and algorithmic trading programs take time to adapt, but the unique characteristics of individual countries still matter. Countries exhibit different sensitivities to economic variables, interest rate changes, and industrial themes. We expect that the resurgence of fundamental influences will drive a meaningful reversion to familiar intuitive dependencies that have persisted for decades.

Will Deleveraging Persist?

The extent of any further deleveraging across household and corporate sectors will influence potential growth over the next 3-5 years. Household net worth and corporate balance sheets have improved as asset values recovered and debt was reduced. Restructuring loans reduced interest burdens, while strong earnings bolstered cash balances. Investment spending remained strong, even if companies were reluctant to expand their workforce given regulatory, legislative, and labor cost uncertainty. Liabilities moderated with reduced credit card balances and lines of credit, but financial holdings increased. Mortgage liabilities were reduced by paying down principal, possibly to qualify for a conforming loan.

The most significant change resulted from restructuring debt as interest rates plunged. Lower financing costs increased purchasing power, but also improved the sustainability of existing leverage. Deleveraging is a transitory state for households, corporations, and banks that will most likely subside as confidence improves and investment opportunities offer sufficient returns. We believe corporate and household deleveraging is unlikely to continue at its recent pace. After all, deleveraging has always been an unlikely secular theme, rarely persisting for more than a year or two.

Commercial lending began expanding again, as recent surveys suggest increasing demand and easing lending standards. Bank leverage has plunged to a near record

low of 7X total assets-to-cash, from a peak of 40X in October 2008, as estimated by Deutsche Bank. Increased regulatory uncertainty and the capital ratio requirements of the Dodd-Frank Act and Basel III, plus the Federal Reserve paying 0.25% on reserves and deposits since October 2008, constrained bank lending.

Liquid assets have increased to over \$2.0 trillion for non-financial companies, equal to 7.4% of total assets, which is the highest ratio since 1959. Heightened economic uncertainty is among the reasons cited by management, but other purposes for holding cash include: (1) financing acquisitions, (2) investment needs, (3) share buybacks, and (4) accumulated foreign earnings. Strong cash flows, which increased considerably since 2009, have helped tremendously, in this regard. The household savings rate is much higher than the prevailing rate in 2007, but off 2009 highs during the Financial Crisis.

Government deleveraging has not been observed. Spending continued to increase as tax revenues declined, resulting in expanding state and federal fiscal deficits. Since the stimulus had little effect in boosting growth, winding down temporary programs shouldn't cause much drag either. The U.S. economy has been growing on its own for over two years, despite many headwinds. Households typically anticipate changes and temporary windfalls, so only permanent tax policy changes and incentives have much effect.

Era of Exceptional Productivity

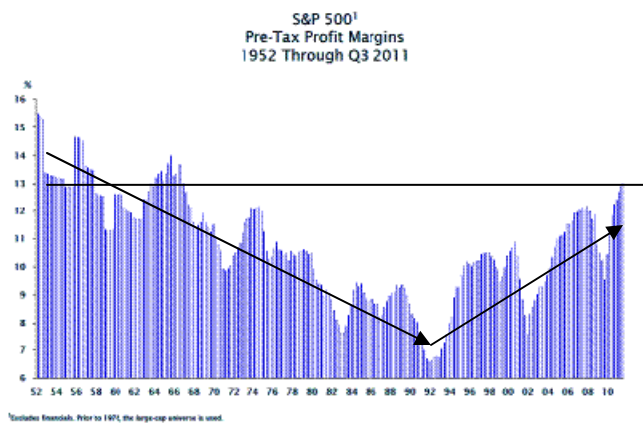
The best way to predict the future is to invent it. Really smart people with reasonable funding can do just about anything that doesn't violate too many of Newton's Laws!
— Alan Kay, inventor of Smalltalk at PARC in 1971

Population plus productivity growth are fundamental drivers of economic growth. Periods of exceptional productivity have sustained above average real growth and rising profit margins. Innovation is vital to competitiveness, and breakthroughs are redefining competition of entire industries in a fraction of the time for previous cycles. Silicon Valley has long been near the epicenter of innovation. Having grown up in Silicon Valley, I believe there is something different here that changes your point of view. Believing in "impossible things" is often looked upon with skepticism in most circles, except in Alice's *Wonderland* and Silicon Valley. Entrepreneurs have raced new products to market, in spite of the Financial Crisis, and continue to do so. The list is seemingly endless---how can this be?

Today's needs exist in developing new materials and power sources, as well as improving agriculture yields, machine learning, communications, security, information access, education, power, health care, natural resource exploration, resource substitution, process engineering, and robotics. There is always a market for producing something cheaper, faster, smarter, or more efficiently, but developing an innovation that defines new industries

or materially improves living standards exposes a need that can be filled by many companies.

Rapid innovation over the last two decades has lifted our living standards, yielding greater prosperity and periods of exceptional productivity. Such high and persistent productivity following the financial crisis was unexpected. Can this rate of innovation persist or even accelerate further, contrary to conventional wisdom today? Profit margins and productivity are presumed to be mean reverting as exceptional profits tend to be arbitrated away, but the pace of innovation is not governed by laws of physics, although we might be limited by our capacity to see the potential of new discoveries. Should they be any more constrained than Moore's Law?



Source: Empirical Partners

We identified nine key drivers to an emerging *Era of Exceptional Productivity*. This theme has the potential for significantly boosting long-term growth. Periods of exceptional productivity have sustained above average real growth and rising profit margins.

- (1) *Accelerating Innovation* tackling an ever-increasing *Abundance of Problems to Solve*
- (2) *Ubiquitous Computing*: Enabling broad-based and low-cost access to information and applications
- (3) *Revolutionizing Communication*: E-mail to social networks, facilitating collaboration and networking
- (4) *Expanding Universe of Inventors*: Emerging markets are contributing meaningful intellectual property
- (5) *Democratization of Education*: New teaching methods, growth in literacy, access in any language
- (6) *Research, Development and Process Engineering*: Shorter prototyping cycles, intellectual property protections, unlimited opportunities, revealed needs
- (7) *Investment Spending Displacing Labor*: Repetitive tasks, manufacturing, and quantitative disciplines impacted by systems improving efficiency or quality
- (8) *Financial Liberalization*: Free markets and a large pool of incentivized investment risk capital
- (9) *Forces of Secular Disinflation*: Globalization, outsourcing, hyper-competition, and increased price transparency leverage innovation and creativity

We believe that appropriate incentives with a low cost of capital (debt or equity) can unleash the entrepreneurial spirit to provide exciting investment opportunities, funding more innovation. We observe previous virtuous productivity cycles in 1960-1975, 1984-1990, and 1995-2005, lasting up to 15 years. Investing in basic research triggered prior cycles from the space race in the 1960s, strengthening national defense in the 1980s, and the technology boom of the 1990s. Falling cost of communication and information access are converging to bring about the next wave of heightened productivity. Where other countries exploited natural resources to promote periods of hyper-growth, the U.S. has leveraged investment capital to mine intellectual muscle. Periods of exceptional productivity have yielded a sustained period of above average real growth and rising profit margins.

Population and productivity are fundamental drivers of real economic growth. Has either shifted so dramatically that we should lower our growth expectations well below long-term averages? Why should this be, when instead we observe accelerating innovation, 4.8% annualized increase in household net worth since 2002, and improving living standards? The dismal forecasts of a secular *New Normal* seem to have exaggerated concerns about deleveraging and debt crisis contagion, aiding and abetting heightened volatility. Yet, economic growth, earnings, profit margins, and equity performance have far exceeded the theory's implied conclusions.

We assume U.S. potential real growth is currently 2.7%, adding population growth, which averaged 1.0% over 1990-2010, plus 1.7% productivity, which averaged 1.8% since 1990. If productivity exceeds 2%, then real growth could average over 3%, instead of 1.0-1.5% real growth, with productivity $\leq 0.5\%$, some suggest is our new secular equilibrium. Any release of higher than normal corporate and household cash levels should promote greater trade, inventory restocking, investment, and consumption. Somebody else's *New Normal* doesn't have to be our destiny. Instead, what if we have already embarked on an *Era of Heightened Productivity*, yielding higher sustained profit margins, as observed for the last decade, interrupted only by the 2008 Financial Crisis?

Ignoring Cyclical Inflation Threat Could Be Perilous

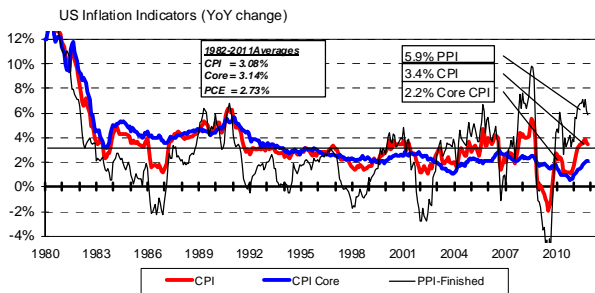
CPI inflation has increased from 1.3% to over 3.0% in just a year. Higher inflation has now become entrenched with rising prices for commodities, transportation, food, energy, imports, and shelter now working their way into cost of living increases and boosting wages. Weekly earnings have increased 2.2% and personal income is up 3.9%. We are concerned that the longer rising prices persist, the greater the likelihood that inflation will become more difficult to contain.

Quantitative easing (QE-1) and other creative monetary policies initiated at the depths of the crisis were effective during the financial crisis to stabilize credit markets and restore liquidity. Economic conditions have improved since 2009, yet interest rates are still at record low levels

and the Federal Reserve has sought to push bond yields even lower by reducing the supply of Treasuries.

Effective central bank interventions typically are massive in scale and surprise investors. Under QE-2, the Federal Reserve purchased Treasuries worth just \$600 billion, but that was insufficient to keep bond yields from rising. "Operation Twist" is expected to purchase \$400 billion of Treasuries maturing in 6-30 years, financed by selling securities maturing before 2015. Since the September 21st announcement, there hasn't been much change in 10-year Treasuries, then at 2.0% vs. 1.9% at year-end. It appears that both policy moves failed because they didn't surprise investors and weren't massive relative to total U.S. debt. And recent bond purchases have worked counter to Treasury's effort to extend maturities, given interest rates are so low. As the Federal Reserve seeks to provide transparency and increase communication, they will forego an ability to have greater effect with any change in monetary policy.

We believe U.S. interest rates are unsustainably low, but we have to balance an economically rational interest rate policy, as suggested by the Taylor Rule, versus the old adage: "Don't fight the Fed". The Taylor Rule suggests a U.S. interest rate of 3.35% is appropriate now, even if we drop inflation to 2.5%, in contrast to an implied April 2009 target of -3.6%. Of course, we can't have negative interest rates, but the Taylor Rule calculation illustrates how much conditions have changed. How can a similar interest rate policy be as appropriate today, as it was during the Financial Crisis? Current economic conditions do not justify such loose monetary policy, increasing the monetary base by 32% due to QE-2. As economic data continues to surprise positively, it would be prudent to raise interest rates sooner than expected in mid-2013.

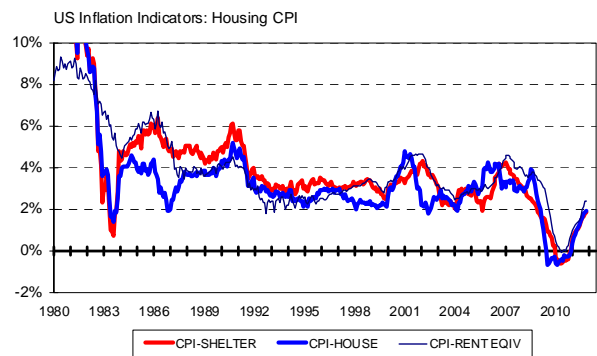


Source: HighMark Capital Management and Datastream

The Federal Reserve has justified keeping interest rates near 0%, since December 2008, based on perceived "slack" in the economy, including high unemployment and excess manufacturing capacity. They maintain that inflation risk is low, so interest rates can remain low through mid-2013. The expansion already extends into its third year, given NBER's recession endpoint of June 2009. Capacity utilization has increased from 67.3% to 77.8%, approaching the 30-year average rate of 80.4%, while unemployment has fallen from 10% to 8.5%. There is some skepticism about the decline with individuals leaving the workforce, but it is worth remembering that the Boomers are retiring now, and the next generation

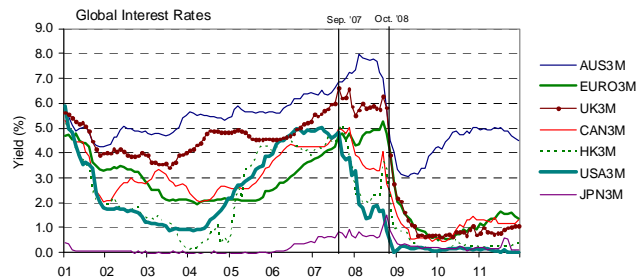
won't require as many new jobs to maintain the natural rate of unemployment, assumed to be 6%. We suggest monetary policy needs to normalize, including hiking interest rates, before inflation becomes more entrenched. Once artificially low interest rates begin to rise, we expect market forces will cause greater volatility than desirable as rates normalize.

High commodity prices continue to drive manufacturing input and food prices, while import prices are up 9.9%. An increase of 7.7% in wholesale producer prices has yet to work its way through prices of intermediate and finished goods. In 2008, plunging housing costs drove overall inflation lower. Housing rents are rising 2.4%, and accelerated to a rate of 3.8% over the last 3 months. Rents for apartments have been rising 4 to 6%. Shelter costs account for 32% of CPI inflation and show no signs of easing, but few have focused on its importance.



Source: HighMark Capital Management and Datastream

Normalizing global inflation has triggered interest rate increases from Norway to the Eurozone and Emerging Markets. U.S. interest rates will need to rise as economic growth and inflation normalizes sooner than expected.



Source: HighMark Capital Management and Datastream

Secular disinflationary forces, such as globalization, outsourcing, hyper-competition, increased Internet price transparency, innovation, and creativity helped to keep inflation contained. This business cycle could extend longer than normal, if inflation remains contained. Our forecasts suggest stable economic and earnings growth through 2013. Suggesting the business or investment cycle will be different this time can be a perilous supposition. Investors should be wary of provocative theories that grab attention in times of uncertainty, regardless of how unlikely their outcome might be.

Rotation in Investment Leadership

Investors should expect investment leadership will be different over the next 10 years, in contrast to the last decade. There has been a dramatic reversal in relative stock vs. bond valuations since 2001. The S&P 500 Price/Earnings exceeded 35X more than 10 years ago, so rolling off of 2001 returns has helped close the gap between equity and bond returns. Small-cap (5.6%) and Emerging Market equities (14.2%) outperformed the S&P 500 over this period. Trailing 10-year S&P 500 equity returns are finally positive again, and relative returns versus bonds should improve further in 2012.

HighMark's recently updated asset class expectations are summarized below. Our 6.5% equity risk premium suggests stocks will outperform bonds by a wider than normal margin, whereas bonds, cash and commodities will struggle to beat inflation until interest rates rise or prices correct. Within equities, we expect a value tilt to beat growth by 2.5%, and small-cap to outperform large-cap by 1.5% annually over the next investment cycle, assumed to be 5-7 years.

Asset Class Returns				HighMark E[Return] ¹	Risk
Annualized	10-years	1973-2011	1900-2010 ²		
Stocks	2.9%	9.6%	9.4%	8.5%	15.8%
Bonds	5.8%	8.1%	4.8%	2.0%	5.8%
Cash	1.8%	5.4%	3.9%	2.0%	1.0%
Commodities	11.4%	3.8%	2.6%	2.0%	13.8%
Inflation	2.5%	4.4%	3.1%	2.5%	1.2%
Risk Premium					
Stock-Bond	-2.9%	1.6%	4.6%	6.5%	
Bond-Cash	4.0%	2.6%	0.9%	0.0%	

(1) Expected return refers to long-term performance over an investment cycle of 5-7 years

(2) 1900-2010 data from Credit Suisse Global Investment Returns Yearbook 2011

(3) Data as of December 31, 2011

(4) **Stocks:** S&P 500, **Bonds:** Barday's Aggregate Bond, **Cash:** 3m T-Bill, **Commodity:** CRB

Source: HighMark Capital estimates and Thomson Datastream

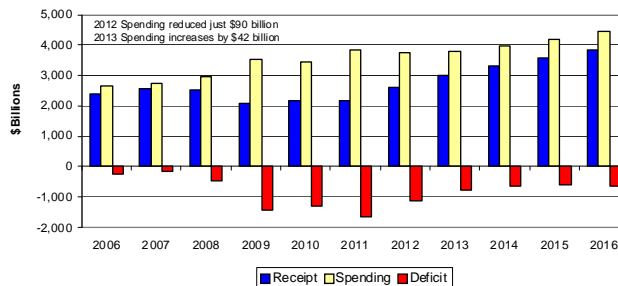
A 30-year bull market in bonds has driven 10-year Treasury yields from 15.3% in September 1981 to year-end below 1.9%. For bonds to provide a "normal" real return of 2.5% above inflation, as observed over the last 60 years, 10-year Treasury yields must exceed 5.5%. We suggest investors are too complacent about negative real bond yields versus historical average inflation of 3.0%. The low yield for bonds explains investor preference for dividend paying stocks. Dividends and long-term capital gains are more favorably taxed at 15%, while coupon payments are taxed at the highest marginal rate in taxable accounts.

Getting Back to Even (2Q/2011) observed that many variables that have already surpassed key economic and financial market milestones. U.S. GDP of \$15.2 trillion exceeds the previous peak in Q2/2008 of \$14.4 trillion, as do so many other growth variables. In August 2008, before Lehman declared bankruptcy, the S&P 500 stood at 1282 vs. 1258 at year-end. Since the S&P 500 low of "666" during the Financial Crisis on "03/06/09", the S&P 500 has returned 103%. Earnings in 2011 exceeded the prior peak in 2007 of \$88, but the S&P 500 is still 17.8% below the record high of 1565 on October 9, 2007.

Lower Gov't Spending, Not Recession Precursor

U.S. government spending growth is budgeted to slow in FY 2012, but shouldn't undermine economic growth much as Government agencies shift their efforts to increase efficiency, just as the private sector has improved productivity in recent years. The economic effectiveness of government stimulus is a complex question, but changes in tax policy have had greater observed impact on growth, than deficit spending (*Ref: Barro, Romer & Romer*). There is no free lunch, thus it is illogical to assume deficit spending can produce growth exceeding spending, or a multiplier greater than 1.0. Deficit spending must be repaid, most likely with tax increases that usually inhibit growth. Government spending tends to crowd out more productive private sector activities before it is additive to growth. Some economists have ventured a guess that recent stimulus spending produced a growth multiplier less than 0.5.

Much of the savings from reduced spending will come from eliminating the most unproductive work and redundancies, which will have minimal effect on growth. We think it is unlikely that the U.S. economy will tip into a recession by reducing spending by just -90 billion or failing to renew the payroll tax cut. However, bigger tax increases planned for 2013 do approach levels that could have consequences. New spending authorizations have increased the fiscal deficit from \$162 billion to \$1.25 trillion since the change in leadership of the House and Senate in 2007. If spending was frozen at FY2008 levels, the budget would be in surplus by 2014.



Source: HighMark Capital and Thomson Datastream

The U.S. recession ended in June 2009, according to NBER, after numerous creative monetary policies helped restore liquidity and stabilize capital markets. Driving down interest rates near 0% reduced the cost of capital and restored confidence in credit markets. The \$787 billion stimulus, known as the American Recovery and Reinvestment Act is now estimated to cost \$840 billion, but had very limited effect on the economy. Only \$36 billion was disbursed by September 2009, according to Recovery.gov. In our opinion, the inefficient allocation of stimulus funds, in the rush to get it done, was a critical reason for its ineffectiveness. In order to accelerate the dispersal of funds, targeted entitlements and tax benefits comprised over \$600 billion. Cash-for-Clunkers and the Homebuyers Tax Credit only managed to pull forward demand, without providing any sustainable benefit, thereby only increasing economic volatility.

Thus, we have witnessed significant deleveraging across the board in the corporate, banking, and household sectors. Sovereign governments, as well as U.S., state and local municipalities are under pressure to reduce spending and reverse large fiscal deficits that are unsustainable. For as much discussion about the need for fiscal austerity, we anticipate only the Eurozone will be noticeably affected. We believe the U.S. economy, in particular, is able to stand on its own now, particularly as deleveraging in both the corporate and household sectors slowed significantly. Why should deleveraging persist if consumption, business sales, and investment are growing faster than normal?

Many temporary tax cuts are legislated to expire over the next year, increasing concerns about the likely economic impact. Differentiating between economic effects of temporary and permanent changes to tax policy is well-documented. Individual households change their behaviors well before implementation of known adjustments. So if the payroll tax holiday is not renewed, thereby increasing social security withholding from 4.2% to 6.2%, there is likely to be less impact on growth than the full 2% difference, as some forecast. Since the tax break is highly progressive because it is capped, higher-income households benefited less and will not be as impacted by expiration. Many other variables are likely more important to the forecast of U.S. growth in 2012.

More Geopolitical Uncertainty, But Less Volatility

The number of countries that experienced a significant and unexpected change in government was the greatest surprise of 2011. The causes in each case varied by country, but generally can be grouped in two categories: (1) The Arab Awakening, aimed at improving political freedom and equality, resulted in the fall of authoritarian governments in Tunisia, Egypt, Libya, and Yemen (2) The European Debt Crisis, which directly or indirectly led to the ouster of five out of 17 Eurozone governments, including Ireland, Portugal, Spain, Greece and Italy.

A new uncertainty has emerged in the significant number of presidential elections slated for 2012, including the United States, France, Finland, Russia, Mexico, Venezuela, India, Taiwan (just held), Hong Kong (Chief Executive), South Korea, Turkey and Egypt. Unique sovereign interests characterize each election. While the stakes are high in the United States, in what many believe is the most pivotal election in modern time, Russia's alleged parliamentary election fraud, linked to Vladimir Putin's United Russia party, has already triggered protests in Russia.

The Eurozone Debt Crisis appears to be moderating, with efforts to stabilize fiscal deficits and lower interest rates to offset reduced government spending. Any fiscal or geopolitical crisis, as we are dealing with today, requires a different solution than a financial crisis, and takes longer to resolve. Lately, Spanish and Italian yields have eased after several successful bond auctions. We expect volatility may remain higher than normal, but

lower than observed in 2011. Less uncertainty will provide an opportunity for expanding equity valuation multiples that boost returns in excess of earnings growth, particularly in stable developed markets such as the United States, Canada, and Germany, as well as cheap developing countries with easing monetary policy such as Brazil, China, South Korea, and India.

Long Workout Ahead For Europe

The Euro was born out of a desire to bind nations through economic and monetary union, without political integration or enforceable fiscal discipline. It has taken 20 years to learn autonomous fiscal policies of sovereign countries can't coexist in a single monetary union. In our opinion, this flawed experiment has proven to be a significant economic policy mistake. The day of reckoning has arrived as compounding deficits finally reached a tipping point for investors. Sovereign financing costs have soared, exacerbated by inferior global competitiveness. The ability to manage any future crisis has been compromised. The Eurozone Fiscal Crisis is a stern warning to other indebted nations.

Europe has the capacity to significantly reduce its debt burden and implement fiscal deficit reduction measures to address investor concerns that have plagued the region since April 2010. Decades of misguided government policy can't be reversed quickly. Eurozone spending cuts have forced the European Central Bank to reverse two previous interest rate increases totaling 0.5% over a year ago. We expect them to cut rates once more to 0.75%, to offset slowing economic activity and Eurozone spending cuts. There can never be an optimal monetary policy for all members, with such diverse economies, without political union or surrendering sovereign freedom to fiscal compromises. Consequently, we expect Europe's trend growth will be lower. It took Germany many years to integrate East Germany, but to resolve this crisis requires even greater time.

We believe it is unlikely any member of EMU will leave the Eurozone, although Germany exiting is the most likely scenario, if the most heavily indebted fail to reduce their debt burdens, potentially forcing "mutualization" of debt by issuing Eurobonds. Governments have been reluctant to tighten their grip on tax evasion or sell assets, including land, buildings, and retained company securities, which could raise sufficient funds to retire significant debt. Spending reform also must address unsustainable budget deficits, and accept greater fiscal integration by imposing stricter Maastricht Treaty adherence and sacrificing budget control.

This fiscal crisis has highlighted the costs and constraints of Eurozone membership, as well as precipitating government turnover in five countries. Higher risk premiums, evident in increasing bond yields, have made it even harder for Eurozone weaklings to finance their debt, while unable to devalue their currencies to regain competitiveness. In stark contrast, the United Kingdom, Switzerland, Sweden and Denmark

have benefited from the flexibility of retaining sovereign independence and their own currency during this crisis. If the Eurozone has turned the corner, as falling bond yields suggest, it was achieved at a great cost to all.

Conclusion

Investor concerns are rightly focused on global growth, but it appears that most transitory *Nightmares* are now behind us. In our opinion, strong earnings growth, global equity market declines, and low interest rates have reinforced equity valuations at attractive levels. We favor U.S. and Emerging Market equities over exposures in Europe and Japan. Emerging Market growth has slowed with tighter monetary policy, but that seems to be reversing with moderating inflation. Emerging market growth is more cyclical now, but secular drivers of urbanization and insatiable consumption still persist. We don't dismiss any of our enumerated concerns, although they are trumped by many positive global economic trends, strong earnings growth, compelling valuations, and an anticipated *Era of Exceptional Productivity*.

Our tactical asset allocation models suggest this is a compelling opportunity for equities overall, as well as small-cap and value stocks, in particular. With earnings revisions pushing up 2011 S&P 500 forecasted earnings toward \$97, or 16% growth, equity valuations have continued to improve amidst flat to declining equity prices. We conclude that market risk premiums have already priced in a dire economic scenario, evident in credit spreads and equity valuations, so there isn't much to gain being defensive, even if economies weakened in 2012. We also believe cyclical industrial, technology, and basic material stocks are too cheap and neglected.

Equity valuations are particularly compelling relative to bond yields. The current S&P 500 price multiple on 2012

earnings has fallen to 12X, and the S&P 500 dividend yield of 2.1% exceeds a 10-year Treasury yield of 1.9%. From a bond perspective, the stock market P/E would need to soar to 52X just to reach parity with 10-year Treasury yields. Considering the tax advantage of dividend income relative to low yielding bonds, it is not surprising that demand for high dividend yielding stocks has pushed their relative valuations to extreme levels.

With no sign that inflation is relenting, advocacy that slack in employment and capacity utilization should contain inflation is less convincing. Indications of near potential growth and increasing inflation should eventually force hiking U.S interest rates. HighMark correctly anticipated increases in interest rates that surprised most others in 2004. Investors seem too complacent about Treasury valuations after a 30-year bull market in bonds drove 10-year yields from 15.3% in 1981 to 1.9% now. *Ignoring the Threat of Inflation Could Be Perilous* with above average inflation increasingly becoming entrenched. We think inflation is the most likely of our concerns that could derail the expansion and robust profit margins in the foreseeable future.

We remain overweight global equities, with a preference for U.S. and Emerging Market regions. If commodity prices moderate further, combined with slower wage growth and easing monetary policy, Emerging Market productivity and profit margins could improve materially. We have slightly reduced global equity exposure during the quarter, but increased exposure to high-yield bonds. We revised up our U.S. inflation forecast, adjusted down economic growth forecasts, and pushed out our first expected hike in U.S. interest rates.

David Goerz, SVP - Chief Investment Officer
<http://commentary.highmarkfunds.com>

Quarterly Investment Outlook is a publication of HighMark Capital Management, Inc. This publication is for general information only and is not intended to provide specific advice to any individual. Some information provided herein was obtained from third party sources deemed to be reliable. HighMark Capital Management, Inc. and its affiliates make no representations or warranties with respect to the timeliness, accuracy, or completeness of this publication and bear no liability for any loss arising from its use. All forward looking information and forecasts contained in this publication, unless otherwise noted, are the opinion of HighMark Capital Management, Inc. and future market movements may differ significantly from our expectations. HighMark Capital Management, Inc., a registered investment adviser and subsidiary of Union Bank, N.A., serves as the investment adviser for HighMark Funds. HighMark Funds are distributed by HighMark Funds Distributors, Inc., a wholly owned subsidiary of BNY Mellon Distributors Inc. Union Bank, N.A. provides certain services for the HighMark Funds for which it is compensated. Shares in the HighMark Funds and investments in HighMark Capital Management, Inc. strategies are not deposits, obligations of or guaranteed by the adviser, its parent, or any affiliates. Index performance or any index related data is given for illustrative purposes only and is not indicative of the performance of any portfolio. Note that an investment cannot be made directly in an index. Any performance data shown herein represents returns, and is no guarantee of future results. Investment return and principal value will fluctuate, so that investors' shares, when sold, may be worth more or less than their original cost. Current performance may be higher or lower than the performance quoted. Investments involve risk, including possible LOSS of PRINCIPAL, offer NO BANK GUARANTEE, and are NOT INSURED by the FDIC or any other agency. **Mutual fund investing involves risk, including possible loss of principal. Investors should consider the Funds' investment objectives, risks, charges and expenses carefully before investing. This and other information can be found in the Funds' prospectus, which may be obtained by calling 1.800.433.6884 or by visiting www.highmarkfunds.com. Please read the prospectus carefully before investing.** Entire publication © HighMark Capital Management, Inc. 2012. All rights reserved.