

## Behavioral Realities

Certain *Behavioral Realities* can dictate how we respond to gain and loss, which is important in explaining why markets may not always appear rational. Fear and anxiety have persisted longer than is normal since the Financial Crisis erupted in 2008, suggesting there is something more to our national uneasiness. Misguided behavioral tendencies can cloud intuition and get in the way of market efficiency, since it is as human to want to avoid loss of wealth, as it is to breathe. Media hype can be persuasive and interfere with objectivity. We suggest that emotions of fear and regret can help explain why market volatility breeds investment opportunities.

Wealth effects are believed to be the result of certain relatively predictable behavioral tendencies that impact investor and consumer confidence. Heightened significance of wealth effects over the last cycle is likely a consequence of the growth in household financial assets. We have emphasized that consumption is highly correlated with changes in household net worth, just as profit margins influence business investment behavior.

It has been an emotional rollercoaster for over two years. Investors have grappled with fear, uncertainty, anxiety, regret, misery, disgust and confusion, as well as surprise, delight and euphoria. Investor skepticism and consumer confidence seem to be a reflection of changes in household net worth. During the Financial Crisis, wealth effects appear to have played a greater role than ever before. Wealth destruction was significant as net worth plunged about \$16 trillion (-24.8%) from January 2008 - March 2009 according to the Federal Reserve.

<u>Balance Sheet of Households (\$Bs)</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009-Q4</u>	<u>2002-09 A.G.R.</u>
<b>Total Assets</b>	<b>77,869</b>	<b>78,795</b>	<b>65,599</b>	<b>68,178</b>	<b>4.7%</b>
<b>Tangible Assets</b>	<b>29,735</b>	<b>28,037</b>	<b>23,891</b>	<b>23,063</b>	<b>2.6%</b>
Households: Real Estate	22,944	20,978	17,039	16,575	1.9%
<b>Financial Assets (inc. retirement)</b>	<b>48,134</b>	<b>50,759</b>	<b>41,707</b>	<b>45,115</b>	<b>6.0%</b>
Deposits (Bank deposit + Money Funds)	6,769	7,426	7,901	7,750	6.0%
Change in Financial Assets (y/y) %	11.0%	5.5%	6.4%	-1.9%	
<b>Liabilities</b>	<b>13,405</b>	<b>14,312</b>	<b>14,195</b>	<b>14,001</b>	<b>6.8%</b>
Home Mortgages	9,825	10,484	10,427	10,262	7.9%
Growth Rate (y/y)	11.0%	6.7%	-0.5%	-1.6%	
<b>Household Net Worth</b>	<b>64,464</b>	<b>64,484</b>	<b>51,404</b>	<b>54,176</b>	<b>4.2%</b>
Growth Rate (y/y)	8.2%	0.0%	-20.3%	5.4%	
<b>Disposable personal income (NIPA)</b>	<b>9,916</b>	<b>10,403</b>	<b>10,799</b>	<b>11,050</b>	<b>5.0%</b>
Growth Rate (y/y)	6.9%	4.9%	3.8%	2.3%	
<b>Owners' equity in real estate</b>	<b>13118.3</b>	<b>10493.8</b>	<b>6612.3</b>	<b>6312.7</b>	<b>-4.1%</b>
Change in Real Estate Equity %	-0.9%	-20.0%	-37.0%	-4.5%	

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

Strengthening household finances should result in better than anticipated consumer confidence and consumption. Since 2002, net worth has increased 4.2% annualized.

Appreciating capital markets over the last three quarters boosted household net worth by \$5.7 trillion to \$54.2 trillion through year-end (Q1 available June 2010). Strengthening household finances should result in better than anticipated consumer confidence and consumption as reflected in 8.2% retail sales growth over the last year. Increasing net worth has coincided with the “V”’s observed in other key growth variables.

Skepticism about the economic recovery and cynicism about capital markets have kept investors on the sideline. U.S. bank deposits, plus money market savings totaling \$7.75 trillion, according to the Federal Reserve, are still near a record level, even if real interest rates are negative. Households are losing purchasing power on their lazy money, as short-term interest rates remain pinned near 0% and inflation has ratcheted higher. High cash exposures aren’t surprising, given the painful memories of two recent equity bear markets. The *Behavioral Reality* is that it takes time to shake investor fear and skepticism. Consequently, we believe that an equity bull market can run longer in duration and drive indices higher than if there was greater confidence than evident today. The best stock returns of an investment cycle tend to follow significant corrections, just as economies tend to rebound strongly after recessions.

Our tactical recommendations have taken advantage of a number of investment opportunities during Q1/2010. We believe investor behavior is being influenced more than usual by peripheral events past, present and anticipated, thus exposing an exceptional number of tactical opportunities. It has opened up tactical opportunities that we expect to persist for several more quarters. Familiar and predictable patterns of our society, as well as certain accepted beliefs seem to be slipping away, as policy makers seek to experiment in ways that seem at odds with economic history and America’s founding principles. Re-regulation and higher taxes will eventually undermine potential growth. Overextended countries, such as Greece, finally recognizing their policy mistakes, will have to endure slashing government spending in order to embark on a path back to fiscal health.

## Investment Performance Review

The S&P 500 chalked up its fourth strong quarter in a row through March 2010, tacking on another 5.4%. The index has risen 80.5% from the March 6, 2009 intraday

low. Sector performance dispersion was dramatic in the first quarter. Industrials (+13.1%), Financials (+11.1%) and Consumer Discretionary (+10.4%) led stocks higher. Telecommunications (-4.3%), Utilities (-3.6%), and Energy (0.8%) continued to lag. Energy lagged even as oil prices rose 5.5%, but REITs rose 10%, despite a dire outlook for commercial real estate. Rotation into more cyclical stocks is evident as value indices beat growth by +2.1% and small-cap stocks surged ahead of large-caps by 3.5%. We pulled back modestly from Technology stocks at year-end in our Asset Allocation Funds to add new tactical tilts to REITs and Industrials. We also increased small-cap and value stock tilts. In early April, we boosted our equity overweight further by increasing exposure to Emerging Markets and reducing cash.

Bonds (+1.8%) lagged stocks, although credit spreads continue to tighten. High yield returned 4.8%, but 10-year U.S. Treasuries lost -0.2% after the worst post-war year for Treasuries in 2009 (10 year: -9.4%). Holders of previously "toxic" credit securities and loans that haven't defaulted have realized a significant windfall. However, liquidity can still be problematic. A fiscal crisis across Europe, including the U.K., is worrisome and has bolstered the U.S. dollar. Japan is unlikely to be immune for much longer. The Euro has depreciated -10.8%, while the Yen has fallen -8.3% since December.

**Economic Outlook**

The global synchronized recovery has strengthened with renewed confidence in capital markets. We continue to emphasize our five potential drivers of exceptional U.S. economic activity, noting that there are signs that similar economic forces are observed globally. We believe global economic recovery has become self-sustaining. Except for housing starts, positive surprises have been observed in the other potential excess growth drivers.

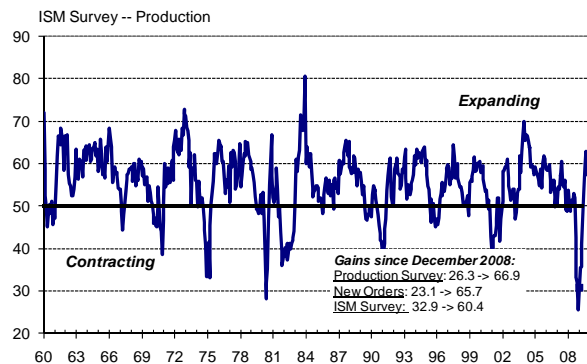
**Five Drivers of Potential U.S. Excess Growth**

1. *Deferred capital investment*
2. *Inventory destocking*
3. *Net export deficit (ex-oil)*
4. *New housing starts deficit*
5. *Pent-up consumption demand*

As the U.S. economic recovery continues to broaden out, global stock markets are climbing above levels last seen prior to Lehman Brother's failure. Consumer and business confidence have been improving steadily for a year now, although mutual fund equity flows are hesitant. Global equity and high yield credit returns have rallied dramatically following the strong rebound in corporate profits, which have benefited from unusually high profit margins and productivity. An unprecedented global monetary policy response, including lower interest rates, reversed the most adverse effects of the global credit crunch, which precipitated worldwide recessions.

The ISM survey reported in January 2009 provided the first strong evidence of U.S. recovery. This diffusion index is one of the best leading economic indicators that

we track, and its recent sustained high level remains encouraging. Monetary programs and low global interest rates were effective at restoring credit market liquidity needed to bolster business and consumer confidence. Fiscal stimulus came too late. The government spending remaining is about \$500 billion, or 3.5% of GDP, and will be spent through Q1/2011. With the economy already growing above its potential rate, this stimulus could push real growth well above 3% this year and may require the Fed to hike interest rates more aggressively. If so, most of the \$862 billion of the stimulus will be wasted, while further increasing the debt burden for future generations. We believe that tax cuts would have been a more effective way to stimulate investment and job growth.



Source: HighMark Capital and Thomson Datastream

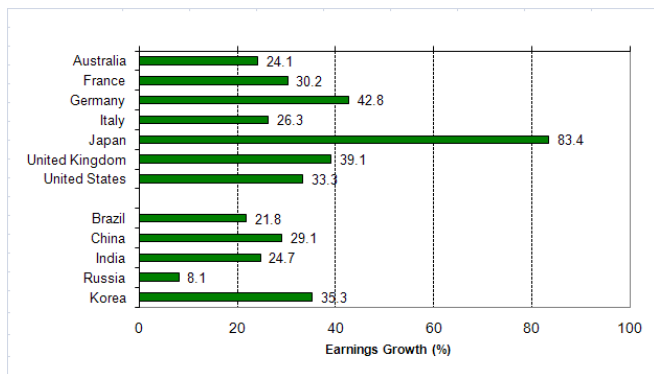
Business surveys suggest hiring should accelerate soon. The unemployment rate usually tumbles once the economic recovery begins to gain momentum. Declining continuing claims may flatten out after Congress extended unemployment benefits yet again, but we expect initial claims to continue trending lower. Certainly, the high unemployment rate is unacceptable for politicians before upcoming midterm elections.

<b><u>Economic Forecasts</u></b>	<b><u>2007</u></b>	<b><u>2008</u></b>	<b><u>2009</u></b>	<b><u>2010e</u></b>	<b><u>2011e</u></b>	<b><u>2012e</u></b>
U.S. GDP (Y/Y Real)	2.8	-1.9	0.1	3.0	3.0	3.4
Earnings Growth	-1.8	-27.9	-0.4	30.1	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	9.2	8.5	8.0
Fed Funds Target	4.25	0.25	0.25	1.25	3.00	3.25
Treasury Notes-10	4.03	2.25	3.84	4.50	5.00	5.00

Source: HighMark Capital estimates and Thomson Datastream

Housing starts should be a critical key to employment. Over the last year, prices stabilized (+1.8%), inventories fell (-1.8%) and sales volumes (+16.1%) increased. Commercial property prices appear to have troughed in 4Q/2009 following a precipitous decline since March 2008. Our clients have benefited from increased exposure to Commercial Mortgage-Backed Securities (CMBS) and increased REIT exposure as commercial property prices (Moody's/REAL) increased.

Strong global earnings growth has been aided by high productivity and exceptional profit margins, coinciding with improving economic activity and confidence. A few markets, such as Japan, still seem expensive although earnings growth rates are impressive. Japan's Topix Index earnings were negative in 2008.



Source: HighMark Capital and Thomson Datastream

## Other Concerns Affecting Investor Behavior

Greece and the other four little PIIGS<sup>1</sup> have become a daily reminder of how unsustainable a future of soaring public liabilities is, bringing our own fiscal problems into focus. Increasing tax and regulatory uncertainty, given legislative priorities, seems to be holding back business investment and hiring, according to surveys. Time is short with November mid-term elections approaching. We think recent legislation has not been well vetted in a rush to vote and various unintended consequences are already emerging, in our opinion.

Coal mine canaries in Europe should not be ignored. Greece and the other four little PIIGS remind us of the consequences of high fiscal deficits and the burden of excessive debt. It is not uncommon for recessions to increase fiscal deficits, but most of the Eurozone is well above Maastricht-imposed 3% fiscal deficit limits. European Monetary Union has allowed Greece, Portugal and others to enjoy lower interest rates, as well as a stable currency, while masking their significant structural problems and liabilities. The fiscal cost of failing to manage debt burdens and expanding entitlements must be shouldered by all Eurozone members, so it is not surprising that Euro confidence is faltering. The greater risk is that some of the PIIGS might need to re-incarnate their sovereign currencies and devalue 10-30% or restructure their debt. Either course could result in large losses for holders of Greek debt. The IMF and other lenders are requiring Greece to rein in spending and impose other austerity measures, which has already ignited social unrest and riots. If the Europeans bail out Greece, as expected, we believe the Euro will weaken further and reduced spending will limit growth, but the effect on the global economy should be modest.

There is little comfort in the fact that America is not as bad off as Europe, including the U.K., or Japan (200% of GDP) with the U.S. debt burden approaching 90% of GDP and a fiscal deficit of nearly 10%. With fewer safe places to hide, the greatest concern is that deficits finally do matter. Investors may soon demand higher yields for U.S. Treasuries and other G-7 sovereign bonds. As debt approaches 100% of GDP, the susceptibility to fluctuations in interest rates rises. It costs over twice as

much to pay off our debt if long-term yields rise from 4% to a historical average rate of 6%.

Rushing through legislation can create serious unintended consequences. Our fragmented financial regulatory system had significant gaps that may only be closed by reducing the number of overlapping regulatory agencies. In our opinion, simplifying oversight to one bank regulator (Federal Reserve) and one securities regulator (SEC) would improve enforcement efficiency, accountability and effectiveness, while likely lowering the cost burden for regulated firms. Credit default swaps fell through the cracks because neither the SEC nor CFTC took lead responsibility for over-the-counter derivatives. Congress has proposed increasing complexity by funding three new regulatory agencies from scratch. Berkshire Hathaway's Charlie Munger, commenting on Goldman Sachs, recently observed that circus trainers should consider reforming their practices first when escaping tigers regularly cause havoc, instead of blaming the tiger who is simply doing what comes naturally. There is broad agreement that derivatives need to be better regulated and transparency improved, but we believe the Senate bill needs much more work.

The banking bill addresses many issues, but the greatest impact will be felt with regard to restricting derivatives, hedge funds, private equity, and proprietary trading. However, does it address who was responsible for lowering credit standards? There is no attempt to change how government sponsored lenders, Freddie Mac and Fannie Mae, currently in conservatorship, securitize and guarantee loans that permitted unqualified borrowers to overextend. The Office of Thrift Supervision, the newest bank regulator, oversaw rapid expansion of subprime and Alt-A lending, which was concentrated among its regulated firms. Proposed government agencies won't be effective for some time. This bill also does little to change the behavior of credit rating agencies, such as S&P and Moody's. Credit ratings are required for an ever-expanding number of regulatory purposes, including quantifying collateral requirements, capital ratios and investment guidelines. Conflicts of interest exist when issuers pay for credit ratings they desire to be as high as possible. Diminishing reliability of credit ratings has undermined investor trust. Legislation has made barriers of entry artificially high for competition. Investors who bought AAA-rated bonds were misled to believe the risk of default was low, but rating agencies argue that First Amendment rights protect them from litigation for fraud.

Congress hopes financial reform will avoid a repeat of the recent crisis. In our opinion, the legislation tackles a few high profile issues for questionable benefit without regard to the consequences of global competitiveness and profitability. It provides little needed reform that would assure resilience in future crises. Limiting derivatives will likely raise hedging costs for business. Regulating proprietary trading may be the only idea that addresses a potential conflict of interest with clients.

<sup>1</sup> PIIGS: Portugal, Italy, Ireland, Greece, and Spain

Many of the capital adequacy issues arising from the credit crisis are addressed by the new Basel II Accord, which does provide more stringent capital requirements for banks. Such a harmonized international standard adopted by all countries has the benefit of rigorously managing many aspects of banking. It appears some very specific needs were exposed by the Financial Crisis, but few seem to be addressed by the current bill.

## Conclusion

The chance to just get back to even for many would be welcome after significant declines in the value of their homes, retirement accounts, and other financial assets. Global equity markets are relatively inexpensive, in our opinion, particularly considering the high profit margins and expectations for earnings growth. We expect Treasury (10-yr.) yields to rise above 5% by 2011, in which case bond returns will be disappointing.

Persistent skepticism has kept many investors on the sideline. Although it seems intuitive to wait for the next correction, January's correction became just another missed opportunity for some. Given our constructive outlook for global real growth approaching 5% this year, we continue to recommend an overweight to equities, with a preference for small-cap and value stocks, while favoring U.S. companies over developed international markets. Other tactical exposures we favor include REITs, Emerging Market equity, and high yield bonds. We expect the U.S. dollar to continue strengthening versus the Yen and European currencies, maintaining its position as the world's dominant reserve currency.

We continue to recommend shorter fixed income maturities, anticipating an increase in interest rates in 2010. Within fixed income, we continue to hunt for value in lower rated credits, including overweighting high yield. We expect credit yield spreads will be stable, but as

interest rates rise across the yield curve, shorter maturity securities should outperform. Bond flows continue to be strong, but we believe global government bonds are most likely to underperform over the next year.

We expect central banks will begin tightening monetary policy, and the strongest economies will begin increasing interest rates this year, including the United States and Canada. Our interest rate target of 1.25% suggests the Federal Reserve should hike rates at every meeting starting in June by  $\frac{1}{4}\%$  from levels attained during the most severe credit conditions over 18 months ago. When interest rates do rise, we expect equity markets to respond similarly to 2004 rate increases, not 1994.

While economic conditions continue to improve, there remain many threats on the horizon. Fiscal deficits have soared as tax revenues plunged and spending increased. Although strong growth in profits and incomes should help cut deficits meaningfully, increasing debt issuance risks driving up interest rates and crowding out investment. With regard to raising taxes and increasing regulation, it may take years for what is done today to have a measurable adverse economic impact, so we must be careful not to discount policy changes too soon. We are concerned about policy trends, but we also believe that the cyclical forces are very supportive of stronger than normal economic growth, high profits, and positive equity returns for at least a few more quarters. Support for a "New Normal" will continue to fade, along with skepticism and other behavioral biases. *Behavioral Realities* can cause inefficiencies and create opportunities that active investors may exploit, but passive investors never get a chance for anything more than guaranteed underperformance versus an index.

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 PFPC 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. **Read the prospectus and carefully consider the HighMark Funds' investment objectives, risk factors and charges and expenses before investing. This and other information, including fees and expenses as well as the most recent performance data, can be found in the HighMark Funds' prospectus, which may be obtained by calling 800.433.6884 or by visiting [www.highmarkfunds.com](http://www.highmarkfunds.com).** Entire publication © HighMark Capital Management, Inc. 2010. All rights reserved.