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CAPITAL MANAGEMENT

INVESTMENT HIGHLIGHTS **MAY 2009**

Assumed the Worst, Now Hope for the Best

Global equities have rebounded off the March 9th lows, with the S&P 500 jumping over 31% through the end of April. The equity rally and shift in risk aversion has been remarkably swift, as the latest economic data suggest a second half recovery has become increasingly probable. High-yield credit spreads collapsed from 21% to 13%, while Emerging Markets rocketed more than 40%. Short-term credit markets are also trading more efficiently, retracing to levels seen last summer. Even the Treasury-Eurodollar (TED) spread has dipped to 0.4%, near its historical average and well below the 4.6% peak. Tightening credit and equity risk premiums is good news for the global economy, which can't grow naturally without reasonable credit available to finance business activity and investment.

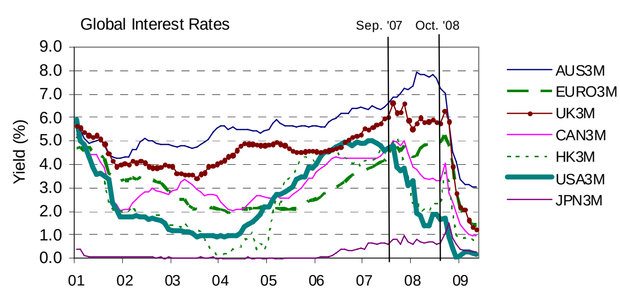
Seized-up credit markets undermined consumption, while businesses laid off workers, reduced inventories, and deferred investment activity to preserve their cash. Global economic activity stalled. We think the primary driver of the recent economic slowdown has been restricted access to credit. We have learned from past experiences (ref: Credit Control Act, "*The Upside of Down Markets*", Feb. 2009) that once the flow of credit resumes, activity can pick up rather quickly if pent-up activity has been deferred until confidence improves. When activity does accelerate, the cost of capital will be low and central banks will have provided more than enough liquidity.

Historically, the sharper an economic downturn, the faster and more powerful the rebound in equity prices. Visibility is improving, as emerging "*green shoots*" are becoming more numerous and persistent. Most economists now expect the U.S. economy to bottom-out in mid-2009. The economy will feel weak for a while longer, but 2010 growth expectations suggest improved earnings lie ahead. We *Assumed the Worst* during the credit crisis, but now is the time to *Hope for the Best.*

Let the Games Begin

We believe that all that needed to be done in order to reverse the deleterious effects of the global credit crisis was achieved by cutting interest rates and expanding the money supply, including supporting asset-backed securities. Globally, more than $10 trillion allocated to bolster credit markets and provide fiscal stimulus is a massive effort. Speed was of the essence to shore up confidence, but massive fiscal spending agreed on too hastily is not only dangerous, it can also be wasteful. By the time U.S. fiscal stimulus adds to GDP, interest rates may have to rise faster and higher to compensate for increasing inflation risks, thus it was probably a waste. Looking forward, eventually it will be essential to unwind government backing when possible.

History suggests that 6-9 months following interest rate cuts, the economy should begin recovering. Critics point out that U.S. interest rate cuts have been ineffective since September 2007, so conclude that more troubling imbalances must exist. Unfortunately, central banks concerned about inflation appear to have more than counteracted attempts by the Fed to improve liquidity through October 2008. Economic cycles between countries have rarely been as highly correlated as we have observed over the past few years. As a result, the Fed was unable to fight the liquidity squeeze-induced global slowdown alone. Delaying coordinated monetary efforts by more than a year became particularly serious, with such high interest rates maintained by the greatest contributors to economic activity. With coordinated cuts in October 2008, we can now see evidence of "green shoots" starting to take hold.



Source: HighMark Capital Management and Thomson Datastream

Well-regulated markets can improve capital market efficiency and bolster investor confidence. Misguided or over-reaching regulation can be as damaging as no regulation at all. Naturally, many assume that insufficient regulation exacerbated, if not caused, the credit crisis. However, greater consistency and enforcement of existing regulation actually may be what is needed most.

New complex financial product innovations can spread quickly and slip through the cracks, as regulators are often stretched to keep up. The market for unregulated Credit Default Swap (CDS) contracts grew very fast to over $15 trillion in just a few years. Yet no agency was prepared to accept oversight responsibility for these profitable, complex, and highly-customized transactions. The ability to hedge default risk can create perverse incentives to destroy otherwise viable companies when they become worth more dead than alive. CDSs may have facilitated insider trading and stock manipulation that went undetected. On May 5th, the SEC filed its first insider trading case tied to credit default swaps for a $1.2 million profit. We are surprised that it took so long.

CDSs provided a means of capitalizing on the odds of failure with significant leverage. Many companies struggled to defend themselves, but Sarbanes-Oxley limited what officers could say. Further exacerbating these challenges, stretched credit rating agency analysts became increasingly reliant on swap and stock prices to assign credit ratings. Since the Uptick Rule was suspended in July 2007, a combination of false rumors and aggressive short selling undermined primary dealers and investment banks, both of which are essential to providing liquidity to capital markets. SEC Chairwoman Mary Shapiro hopes to tighten rules on naked short selling and approve a modernized Uptick Rule. The SEC comment period ends next month on the Uptick Rule.

OTC derivatives had no central clearinghouse or register until the DTCC Deriv/SERV Trade Information Warehouse was created on October 31, 2008. As of May 8th, there was $15.2 trillion in CDS exposure and $9.2 trillion in CDX exposure for a total of $28.4 trillion, but less than half of the estimated exposure that existed in September 2008. This notional exposure quantifies counterparty risks, but overstates the economic risk of net swap positions.

We believe that suspending the Uptick Rule while implementing a significant accounting rule change (FAS #157) increased the pace and amount of naked short-selling, stock manipulation, and disseminating false rumors. In the past, rule changes are routinely assimilated (ex: option expensing), but this time multiple waves of a *perfect storm* collided simultaneously, and the result was improbable, but highly destructive, nonetheless.

Economic and Capital Market Outlook

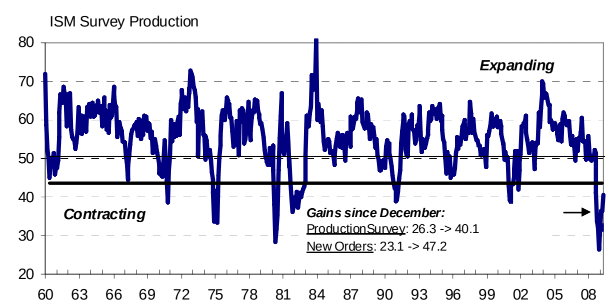
There remains a great deal of uncertainty about where the economy and markets are headed, but a few "green shoots" of economic data are looking more like plants and suggest recovery may be underway already. Below we summarize HighMark's 2011 economic outlook. We have increased our expected growth and inflation rates for 2010, suggesting a more constructive economic scenario than consensus expectations. Many risks remain, but there has been more good news than bad since March. Rallying equity markets and tightening credit spreads have helped reinforce sentiment overall.

Two real threats are developing on the horizon. We believe that inflation could become problematic before 2011, while rising deficits, requiring ever greater issuance of Treasuries, show no sign of moderating. Both risks could have an adverse impact on the cost of capital by pushing up Treasury yields. If budget deficits appear manageable and are contained below 5% of GDP, there probably won't be much of a risk premium. As issuance has increased to finance asset purchases and fiscal stimulus, we have grown concerned that we are reaching a tipping point where deficit levels do matter. They may also crowd out investment.

Economic Forecasts	**2007**	**2008**	**2009e**	**2010e**	**2011e**
U.S. GDP (Real)	2.0	1.1	**-1.5**	**2.0**	**3.0**
Earnings Growth	-1.6	-23.6	**-7.0**	**23.1**	**17.7**
CPI Inflation	2.9	-0.1	**0.3**	**1.5**	**2.5**
Unemployment	4.6	7.2	**9.0**	**8.3**	**8.0**
Fed Funds Target	4.25	0.25	**0.25**	**2.0**	**3.0**
Treasury Notes-10y	4.0	2.25	**3.5**	**4.5**	**5.0**

Source: HighMark Capital Estimates and Thomson Datastream

Business, investor, and consumer confidence have all risen significantly since March. We have noted that this would be a necessary condition for meaningful economic recovery. Consumer confidence will likely continue to struggle until the unemployment rate peaks, but the University of Michigan's Consumer Sentiment Index has risen from November lows. Investor confidence is measurable every day as the equity market rally becomes increasingly difficult to derail. Even business sentiment has improved, as the Institute of Supply Management (ISM) tends to lead changes in industrial production. The recent April ISM survey level of 40.1 compares to historical levels that suggest 42 equates to 0% real growth and 50 is consistent with 2.7% real growth. Among ISM sub-indices, changes in New Orders and the Production Index are compelling.



Source: HighMark Capital and Thomson Datastream

While the unemployment rate continued to rise, it was an increase in the labor force of 683K that drove the jump from 8.5% to 8.9%. Initial unemployment claims have moderated, while Challenger, Gray & Christmas, Inc. reported that outplacements tumbled from January's peak of 241K to 133K. Although nonfarm employment fell -539K, much less than the -629K expected, the household employment survey rose +120K, and was the first increase since April 2008. Unemployment will probably rise above 9%, but, just as quickly as businesses shed jobs, employment trends could reverse.

Construction unemployment has started to fall from its peak of 22.8%, accounting for 34% of all jobs lost since November 2007. Housing starts have fallen to 458K, well below annual household formation plus replacement which totals 1.5 million units. With home sales rising and prices improving sequentially January-April, more buyers are taking advantage of lower mortgage rates, tax incentives, and exceptional housing affordability.

A possible limitation to robust economic recovery is weak consumer confidence, which some believe could drive up the savings rate materially toward 10%. Wealth effects due to changes in asset prices tend to have a more muted effect on consumption than expected. The savings rate has increased to 5% since the crisis began. We believe the recent rise reflects a temporary increase in risk aversion, but not a permanent material adjustment in household behavior.

What we expect to glean from monitoring the savings rate is better understood from the Fed's Flow of Funds data summarizing household net worth. With $65.7 trillion in household assets versus $14 trillion in liabilities, net worth is a better measure for understanding wealth effects. About 2/3rds of household assets or $40.8 trillion are financial assets, including nearly $8 trillion parked in bank deposits. Higher FDIC insured deposit limits have probably driven deposits up further. Household net worth plunged -17.2% in 2008, but still increased 5.5% annually since 2002. Monitoring changes in the savings rate may be useful, but should not be literally interpreted for historical comparison. The savings rate might rise by 2-3%, but a jump to 10% seems unlikely.

The recession is showing signs of winding down and fears of an economic depression have receded. Most unusual, however, is that profit margins and productivity remain high. This is no typical recession given its complex origins in a credit crisis and the dismal failure of confidence, both of which can reverse quickly. Capacity utilization of 70% is the lowest in 50 years and there is slack in employment too. Inventory liquidation, underway for two years, accounted for -2.8% of the -5.7% drop in Q1 GDP. With lean inventories, any pent-up demand will unleash growth and encourage restocking. The word *unprecedented* is used a lot these days, but equity and credit valuations provide a rare investment opportunity, with potential upside for earnings and economic activity.

Oil Prices

After oil prices rose to $147 last year, many believed that prices could rise to $200 or more. It may take time for the triple threats to higher oil prices of *Conservation, Substitution* and *Innovation* (CSI) to have their collective impact, but demand destruction is visible. EIA reported U.S. crude oil inventory is up 8.2%, while gasoline demand has been falling 3-4% since 2008. We first introduced CSI in April 2008, as oil prices rose well beyond logical levels. We theorized that high prices alone can cause demand destruction. Subsidizing oil prices in Emerging Markets, static CAFE standards (unchanged for 18 years), and financial investors (ETF flows) allowed OPEC to gain the upper hand. Now there is worldwide excess inventory and production capacity.

The Energy Independence and Security Act of 2007 mandated an increase to 35 mpg by 2020, including light trucks. Congress accelerated this timetable to 2016 and raised the bar to 35.5 mpg in May 2009, mandating a 30% increase in fuel economy that will eventually reduce foreign oil demand. America's endeavors to increase transportation fuel economy through innovation (i.e.: improved engines and electric motors, lighter materials alternative fuels, and batteries) will have a global impact. Last April we highlighted electric car maker Tesla Motors. The company recently announced the Tesla Model S for 2011: A four door sedan with a range of 300 miles, 0-60 mph acceleration in 5.6 seconds, and 106 mpg equivalent. The base model, net of tax rebates, starts at $50K. Ford CEO Alan Mulally commented recently that "you are going to see a major portion of our portfolio move to electric vehicles." Oil prices may drift over $60 as hurricane season approaches, but U.S. regulatory changes and shifting global consumer preferences will likely undermine demand longer term.

Earnings Growth

For the Equity Market to continue its upward trend, earnings will need to accelerate. S&P 500 earnings declined -23.8% during 2008. The primary driver was the -117% decline in financial sector earnings, which was 28% of the S&P 500. Non-financial earnings actually increased 4.7% despite Q4 headwinds. Therefore, if asset-backed security write-offs are transitory and diminishing now, then an earnings rebound is probable for 2009. Expectations for a -24.2% decline in 2009 non-financial earnings seems unlikely given the resilience of higher than anticipated profit margins. First quarter S&P 500 earnings came in well ahead of expectations with 74% that met or beat consensus expectations by 6.7% in aggregate versus an average miss of -9.5% over the previous 8 quarters, according to Thomson Reuters.

Earnings	2011	2010	2009	2008	2007	2006
HighMark	17.3%	25.0%	-8.0%	-23.8%	-1.6%	15.6%
Consensus	23.5%	28.1%	-13.3%	-23.8%	-1.6%	15.6%
HighMark	$ 88.00	$ 75.00	$ 60.00	$ 65.23	$ 85.62	$ 87.04
Consensus	$ 89.48	$ 72.48	$ 56.58	$ 65.23	$ 85.62	$ 87.04
Financials	63.1%	91.6%	245.1%	-116.6%	-2.1%	21.8%
Non-Financials	19.9%	22.7%	-24.2%	4.7%	3.2%	12.4%

Source: HighMark Capital estimates & Thomson Datastream

Investment Conclusions

Consumers, businesses, and investors have suffered a significant blow to confidence due to the credit crisis. Out of necessity, businesses moved swiftly to preserve cash by slashing headcount and rationalizing every cost. The velocity of the global slowdown is without precedent, but with credit markets improving, the recovery taking shape has a lot of monetary and fiscal policy support. Recessions are typically periods of transition, but companies should realize higher profit margins over the next cycle. Weaker competitors are consolidated or marginalized, while those that survive should enjoy a greater share of available revenue.

Some observers are questioning conventional wisdom, doubting the validity of accepted beliefs and suggesting modern portfolio theory has "led a generation…down the road to ruin." Relative returns were quite normal until a -37% decline in the S&P 500 and plunging interest rates skewed the averages. Stocks have underperformed bonds by 7.6% over the last 10 years, but we should recognize 2008 for being the aberration it is. For wealth to grow in excess of inflation, we need to strike an appropriate balance between equity and fixed income. Strangely enough, while bonds handily beat stocks over 1999-2008, riskier small-cap stocks outperformed large-cap stocks by 4.4% annualized and Emerging Markets beat EAFE (international) stocks by 8.1% annualized.

Asset Class Returns

	2008	10-years	1973-2008	1973-2007	1900-2008	Expected Return (1)	Risk
Stocks	-37.0%	-1.4%	9.2%	11.1%	9.0%	9.5%	15.8%
Bonds	21.2%	6.2%	7.9%	7.8%	5.1%	6.1%	8.3%
Cash	3.1%	3.7%	6.0%	6.1%	4.0%	4.6%	0.8%
Inflation	-0.1%	2.6%	4.7%	4.5%	3.0%	3.1%	1.2%
Risk Premium							
Stock-Bond	-58.2%	-7.6%	1.3%	3.3%	3.9%	**3.5%**	
Bond-Cash	18.1%	2.5%	1.9%	1.6%	1.1%	**1.5%**	

(1) Expected return refers to long-term performance over an investment cycle

Source: HighMark Capital estimates & Thomson Datastream (A.R.)

The most recent 10-year return comparison should be considered in the context of a significantly overvalued stock market in 1999 and moderately high Treasury yields of about 6% vs. 3¼% today. Note the unlucky coincidence that exactly 10 years separate the most exuberant stock market valuation from the most compelling valuation in at least two generations.

Modern Portfolio Theory never promised that portfolio diversification could protect stock investors from losses. In a global crisis, correlations within asset classes often increase, and equity allocations to any style or country probably won't emerge unscathed. That shouldn't imply that being well-diversified is undesirable. During periods of great uncertainty, investors with well-diversified portfolios are rarely worse off, and over the long-term empirical analysis confirm they are generally better off.

Many believe it is necessary to wait for better economic visibility before equities can add to recent gains, notwithstanding discomfort with how quickly equity and credit markets have recovered. Our greater concern lies in increasing federal budget deficits, risk of higher inflation, and the difficulty in eventually unwinding monetary stimulus. Increased debt issuance, including issuance deferred from last year, will likely strain debt markets. Our forecast calls for much higher Treasury yields of 5% by 2011, although the Fed has strived to open a window of opportunity to refinance mortgages and keep interest rates as low as they can.

We expect a global economic recovery will be led by Emerging Market economies followed by North America. Most other non-U.S. central banks waited far too long to respond to the financial crisis, while developing economies weren't nearly as dependent on credit or leverage. With most policymakers now aligned toward accelerating growth, recovery is the path of least resistance. Exceptional risk premiums result in significant investment opportunities if we can get over our discomfort with recent volatility and murky visibility. We remain overweight global equities and cash (underweight bonds), with a preference for U.S. stocks, particularly small-cap, Emerging Market Equities and high-yield bonds. Bargains have emerged, creating more opportunities than usual for active investors who *Assumed The Worst, Now Hope For The Best.*

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