

THAT UNCERTAIN FEELING AGAIN

Strategists and economists can't seem to agree on what the future holds, leaving investors disillusioned about prospects for "normal" returns. Of course, economic growth comparisons to a year ago will grow increasingly difficult to sustain mathematically. However, these are hardly the seeds of a double-dip recession, and we think there are reasons to be hopeful that the second half may be even stronger than the first half of 2010. Rattled investors seem to be anticipating slower growth and deflation due to European austerity measures meant to address soaring fiscal deficits, Chinese monetary tightening, tax increases, burdens of health care reform and financial regulation, high unemployment, and other concerns. On the other hand, the five key drivers¹ we've identified are reinforcing U.S. growth, while benefiting from an unusual global synchronized recovery. Our concerns include increasing inflation risks, attributable to often lagged demand-led price pressures.

Confidence remains critical to keeping economic growth on track, so fear of a slowdown or deflation is probably the greatest risk today. A gloomy outlook can become a self-fulfilling prophecy, justified or not. *That Uncertain Feeling Again*, coupled with increased volatility, can make it emotionally difficult to rebalance portfolios, even if doing so has improved performance. Expansions often encounter mid-cycle challenges, but rarely have much impact on growth unless confidence becomes an overriding factor. We think the second quarter correction was likely an over-reaction, as uncertainties are being moderated, deferred, or extinguished.

Most economists, including the Federal Reserve, believe that the economy has been accelerating since June 2009, resulting in positive real growth every quarter since 3Q/2009. In spite of many mistakes throughout history, America has always risen to face its challenges, adapting as needed to resolve issues that confront us. Investors have perceived bonds and alternative investments as "safer", shunning stocks just as they shunned bonds in 1999. *That Uncertain Feeling Again* is difficult to dismiss, but we have confidence in normalizing asset prices. We should expect volatility to persist a while longer, but continue to use these opportunities to our advantage by rebalancing.

¹ HighMark's five key pent-up demand drivers were introduced in *Rendezvous With Auld Lang Syne*, Q1-2010: (1) business investment, (2) inventory re-stocking, (3) increasing global trade, (4) normalizing housing starts, (5) rising consumption.

Investment Performance Review

Equity and credit markets rebounded so dramatically off March 2009 lows that most investors were sympathetic to the need for a correction. After four strong quarters, global equities retreated in the second quarter. The S&P 500 fell -11.4% as the Barclays Capital Aggregate Bond Index returned 3.5%. Equities (-6.7%) have lagged bonds (5.3%) in 2010, but remain well ahead for the trailing 12-month period with the S&P 500 returning 14.4%. Emerging market equities (-8.3%) outperformed developed international equities (EAFE: -13.7%), and the trade-weighted U.S. dollar gained 3.0%.

Value stocks continued to outperform growth stocks by 0.6%, and small-cap stocks increased their advantage over large-cap stocks another 1.5% during the quarter. Pro-cyclical sectors such as Industrials (-0.8%) and Consumer Discretionary (-1.0%) outpaced the S&P 500 in 2010, but defensive sectors beat the market in Q2, including Utilities (-3.7%), Telecommunications (-4.2%) and Consumer Staples (-8.1%). Our overweight to REITs benefited from a rebound in commercial real estate, as the NAREIT Index outperformed the S&P 500 in all periods, including the quarter (-4.1%), year-to-date (5.6%), and over the trailing 12-month period (53.9%).

With global markets in turmoil over soaring European fiscal deficits, it was surprising that investors bid up Eurobonds. German Bonds rallied 5.4% during the quarter, even as spreads to peripheral markets such as Spain and Greece widened. U.S. AAA Corporate Bonds underperformed Treasuries by 2.2% for the quarter, although commercial mortgages have returned 12.1% for the year, outperforming Treasuries by 7.1%. Spreads of distressed bonds are still benefitting from tightening.

Expansion May Just Be Getting Started

We suspect this expansion may just be getting started if fear itself doesn't impede the natural evolution of a business cycle. In *Behavioral Realities (Q2/2010)*, we observed that cognitive and emotional biases can dictate how investors respond to gain and loss. Capital markets may not always behave rationally and corporate decision makers may forego the most compelling opportunities. Economic growth in most countries, particularly the U.S., has surged above their long-term potential growth rates. Such high productivity and exceptional profit margins, as observed coming out of this recession, is extraordinary.

Over the last year, industrial production and retail sales have risen about 7.5%, new orders increased 14.4%, and exports soared 25.3%. These are enviable statistics. Although inflation remains contained, this kind of activity will tend to drive prices higher, as we are already observing. The likelihood of a double-dip recession is limited by considerable fiscal and monetary stimulus still coursing through the economy. There is still \$500 billion (3½% of GDP) yet to be spent over the next 12-18 months. With favorable economic momentum, we expect to sustain U.S. real growth of 3% through 2012, while global growth trends toward 4.5-5.0%. Our favorite leading indicators are predictive of strong global equity returns and supportive of expanding economic activity.

Higher than expected inflation could be a surprise over the next year. We expect inflation to normalize around 2.5%, but should remain contained as long as oil prices don't rise significantly above \$80. Real interest rates will likely remain negative for awhile, but that shouldn't preclude rate hikes. We believe there is no longer a need for 0-¼% emergency interest rates, and interest rates should be at least as high as the inflation rate now.

Economic Forecasts	2007	2008	2009	2010e	2011e	2012e
U.S. GDP (Y/Y Real)	2.6	-1.9	0.1	3.0	3.0	3.0
Earnings Growth	-1.6	-27.9	-2.0	32.2	18.8	14.2
CPI Inflation (Y/Y)	4.2	-0.1	2.8	2.0	2.0	2.5
Unemployment	5.0	7.4	10.0	9.2	8.5	8.0
Fed Funds Target	4.25	0.25	0.25	0.50	2.25	3.25
Treasury Notes-10y	4.03	2.25	3.84	4.00	4.50	5.00

Source: HighMark Capital estimates and Thomson Datastream

The most likely source of significant job growth should come from construction. Employment in residential and commercial construction suffered most during the recession and the sector has the highest unemployment rate. Retraining workers to do something else would be a significant challenge, but if the economy is turning the corner, construction starts should accelerate. Housing starts are well below demand from household formation.

“Double-dippers” re-emerged during the second quarter as economic confidence in a global recovery and stock market sentiment faltered. Historically, double-dip recessions have resulted from significant man-made policy mistakes, not natural causes of the business cycle. The only double-dip recession observed in the last 80 years was in 1982, so a double-dip is extremely rare, and we believe unlikely in 2010. Overcoming high inflation and unemployment were a far greater challenge in 1982, yet tax cuts proved effective at jump-starting economic activity. Imagine letting taxpayers retain more of what they earn, while boosting economic activity, instead of increasing the tax burden for future generations with more debt. Given tax cut incentives, growth accelerated, unemployment fell, inflation moderated, and tax revenues increased so dramatically that the fiscal deficit was cut from 5.5% in 1982 to 2.5% by 1990. “Double-dippers” will be disappointed that loss of confidence was not enough to derail the recovery.

Just over a year since passing the fiscal stimulus, we believe it is now apparent that ARRA (American Recovery and Reinvestment Act) failed in its objective to jump-start economic growth. The flaw of fiscal stimulus and tax rebates is their transitory effect that only tends to pull forward demand, resulting in disappointing pay-back later. We've seen this with the February 2008 tax rebate, cash-for-clunkers, and the home buyers' tax credit. Consumers and businesses respond well to permanent changes, such as tax cuts. Tax cuts cost taxpayers less than increasing spending and have typically generated higher revenue. Robert Barro of the Hoover Institute has studied the effects of tax cuts vs. fiscal spending and concludes that “The available empirical evidence does not support the idea that spending multipliers typically exceed one, and thus spending stimulus programs will likely raise GDP by less than the increase in government spending. However, there is empirical support for the proposition that tax rate reductions will increase real GDP.” Christina Romer also has concluded, prior to joining the Administration, that tax cut multipliers “have large and persistent effects.” Tax cuts leverage incentives, whereas fiscal spending is hampered by the disincentive of higher expected future taxes resulting from deficits and usual latency of spending. Congress is expected to take up this debate as 2003 tax cuts expire.

There seems to be little distinction made between the so-called bank bailout (i.e., TARP, TALF, TAF, TSLF, CPFF, and other liquidity programs) and the costly \$862 billion economic bailout (ARRA), but the impact to taxpayers couldn't be more different. A liquidity squeeze and credit crunch should require different remedies than a normal business cycle slowdown. The liquidity programs were structured to stabilize capital markets, while explicitly limiting the cost to taxpayers. Borrowing costs of 5%, plus warrant issuance, incentivized unwinding of liquidity support as soon as practical and offset losses. Liquidity programs stabilized the banking system by March 2009, setting up the economic rebound beginning in June 2009. The liquidity programs have unwound naturally and by design as demand waned, with the exception of mortgage and Treasury purchases.

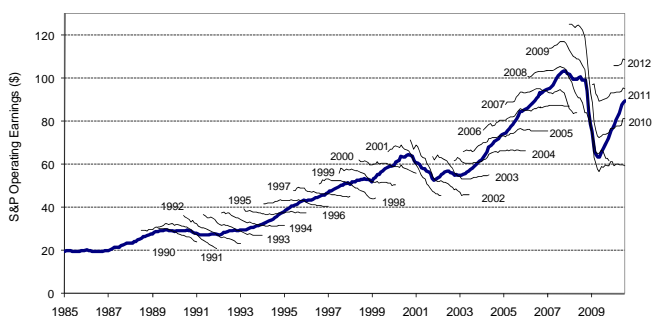
Monetary programs and lower interest rates designed to increase credit market liquidity gained traction faster than hoped. By the time ARRA passed, credit spreads were tightening, equity markets were rebounding, and the economic recession had nearly troughed. Fiscal stimulus has failed to bring down high unemployment or provide any evidence of a “Keynesian multiplier” effect. The Administration has embarked on a campaign to highlight the merits of ARRA, but with about \$500 billion still to be spent, the stimulus failed in being timely enough or appropriately targeted. Efforts to pass additional stimulus seem ill-advised, we believe.

Many imbalances have been corrected as consumers deleveraged and banks raised capital. We've highlighted the effect of how obscure regulatory changes

contributed to the Financial Crisis, including mark-to-market accounting (FAS #157) and suspending the uptick rule. What mark-to-market hath taken away, it can also return. Reversing loan loss reserves and re-valuing “toxic” asset-backed securities should bolster bank earnings over the next several quarters, as confirmed by the outperformance of REITs and recovery in mortgage-backed securities. We expect banks to defer taxes as long as possible, even if distressed debt investors, who snapped up bonds last spring, realize gains.

Earnings growth has far exceeded even our hopes and historically, such trends have been resilient. Thus, even without the expansion in the Price/Earnings ratio to a more normal 15-17X, simple growth in earnings through 2012 will support a much higher level of equity prices. If future earnings are not fully discounted, are analysts overly optimistic? We don't think so. Since Reg. FD (fair disclosure) and Sarbanes-Oxley were implemented in 2003, corporate guidance has been limited and earnings have exceeded analyst forecasts consistently, with the exception of 2008. Equity investors seem too skeptical.

S&P 500 IBES Earnings Forecast (12 Mo)



Forecast	Consensus Earnings	Growth	P/E @ 1031
2010	\$82.54	36.4%	12.5
2011	\$95.71	16.0%	10.8
2012	\$111.68	16.7%	9.2

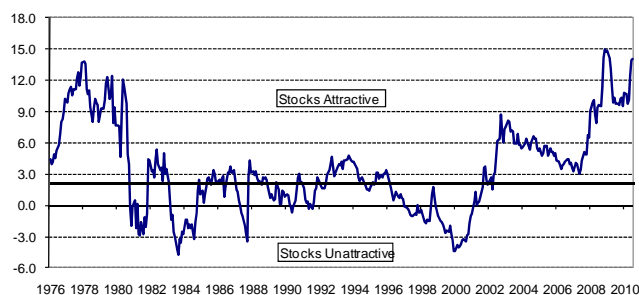
Source: Thomson Consensus Earnings Estimates

Notice the steep trend of expected earnings revisions, indicative of unprecedented levels of positive earnings surprise. 78% of companies beat earnings estimates by 16% in Q1/2010 versus the January 1st estimate. This was the second best quarter ever recorded, only surpassed by the 79% rate in Q3/2009. The Q2/2010 earnings surprise matched the first quarter rate of 78% through July 23rd, surpassing March 31st forecasts by 12%. Second quarter's earnings are expected to be 34% higher than last year. A 7% annual earnings increase is normal, but a surprise of this magnitude over and above extraordinary expectations for growth, when sentiment is so horrible, could be a catalyst for a strong rally.

Strong earnings growth has exceeded the recovery in stock indices. Cash levels approaching \$2 trillion are more than 25% higher than last year, and demand for new corporate debt issuance has been strong.

Companies are buying back stock, refunding debt (deleveraging), and increasing dividends. Price/Book has fallen below 2.0 vs. a 35-year average of 2.4. With low interest rates, the hurdle rate for equities is lower than normal. The difficult thing about the equity peak of October 2007 was that the equity market was never expensive before financial sector earnings collapsed in 2008 and liquidity seized up. Such compelling equity valuations don't usually persist for long, suggesting there is something more to our uneasiness. Risk intolerance and demand for liquidity can trump compelling opportunities. Our own earnings yield gap valuation factor (E/P – interest rate) is predictive of future stock returns and suggests significant upside for stocks.

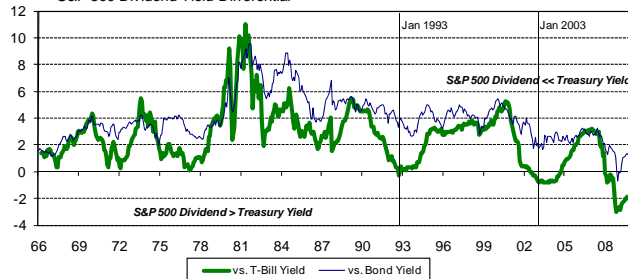
S&P 500 Equity Valuation: Earnings Yield Gap



Source: HighMark Capital Management and Thomson Datastream

Treasury yields versus S&P 500 dividend yields have narrowed to 0.75% versus an average of 3.9% over 45 years. Driven lower by heightened risk aversion, bond and cash yields are now so low that investors are not being adequately paid for interest rate risk and are losing purchasing power versus inflation.

S&P 500 Dividend Yield Differential



Source: HighMark Capital Management and Thomson Datastream

Some suggest that recent compression of valuation represents a new paradigm of higher risk aversion. However, it makes no sense to assume lower expected equity returns, unless earnings growth assumptions are lowered. Equity returns are driven by earnings growth, not risk aversion, but normal valuations can persist at lower-than-equilibrium levels for long periods of time.

Conclusion

Investors are wary of *That Uncertain Feeling Again*. Anxiety increased with various concerns, but their

impact appears to be limited and investors seem to be ignoring many offsetting positives. We suspect a behavioral phenomenon that economists call “herding” has emerged with heightened uncertainty. Studies in Behavioral Finance have shown that increased risk aversion causes alignment of investor beliefs. Such feedback can reinforce market inefficiencies. We believe identifying fundamental trends, as markets overshoot, should be more rewarding than usual. We’ve emphasized the significance of cognitive and emotional biases. Behavioral finance can’t predict market direction, but it does reinforce the need for investment discipline.

We believe equity markets are overlooking earnings growth and bond markets have over-reacted to deflation risks. Markets have diverged significantly from our estimates of fair value, so it is reasonable to ask whether we missed something. We don’t dismiss investor fears, but they must be considered in the context of many positive influences. Our tactical models rarely exhibit such conviction in so many asset classes. Such times can be uncomfortable, but tend to be the most profitable.

Recent complacency about inflation is concerning, given deflationary pressures are so narrowly and exceptionally concentrated in energy and shelter. Employment and manufacturing slack is a necessary, but not sufficient, condition for disinflation. Shipping costs are soaring, as supply chains are stretched. Rents are increasing, following housing prices higher by +7.7% in 2010. Shelter in the CPI index has been a significant deflationary drag for some time, but that is changing. Shelter could be the most important reason a stronger CPI will surprise investors over the next few quarters. With rising commodity prices and higher wages driving producer price increases (+8.4% wholesale prices, +6.1% intermediate goods), inflation is unlikely to remain

below 2.5-3.0% if growth is resilient. We believe interest rates should be at least as high as the inflation rate.

Manic pessimism and uncertainty can open the door for new and untested theories, justified by failures exposed during the last crisis. Just as we show faith in a new order, new paradigm or new normal, the markets seem to remind us that assuming “it is different this time” is often dangerous. The demise of the business cycle has been exaggerated, but no regulation without adequate enforcement can hope to protect us from the next crisis.

In 1999, I watched as well-respected value investors ditched their time-tested but failing investment disciplines. Cognitive and emotional biases challenged philosophical valuation theories. Similar suggestions of a new paradigm embrace below normal Treasury yields, subordination of equity risk premiums, foreign currency preference, commodity return expectations in excess of inflation, or decoupling of oil and gold from broader commodity index relationships. Investors should always be skeptical when they hear: *It is just different this time.*

We unwound our underweight to international equities (EAFE) vs. U.S. stocks and initiated an overweight to REITs and Industrials in our Asset Allocation Funds. We continue to overweight global equities vs. bonds, favoring small-cap and emerging market equities and a value tilt for large caps. While it was a bruising second quarter for our overweight to global equities, the last 15 months have been rewarding, benefiting from a variety of tactical tilts. Time will tell if the market’s response to *That Uncertain Feeling* was appropriate or misguided.

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