Are The Nightmares Behind Us?

Economic and Capital Market Outlook

May 2012

David J. Goerz
SVP, Chief Investment Officer
HighMark Capital Management
www.HighMarkFunds.com
www.HighMarkCapital.com

Commentary: Commentary.HighMarkFunds.com

ECONOMIC OUTLOOK: Constructive Forces, Extraordinary Profit Margins

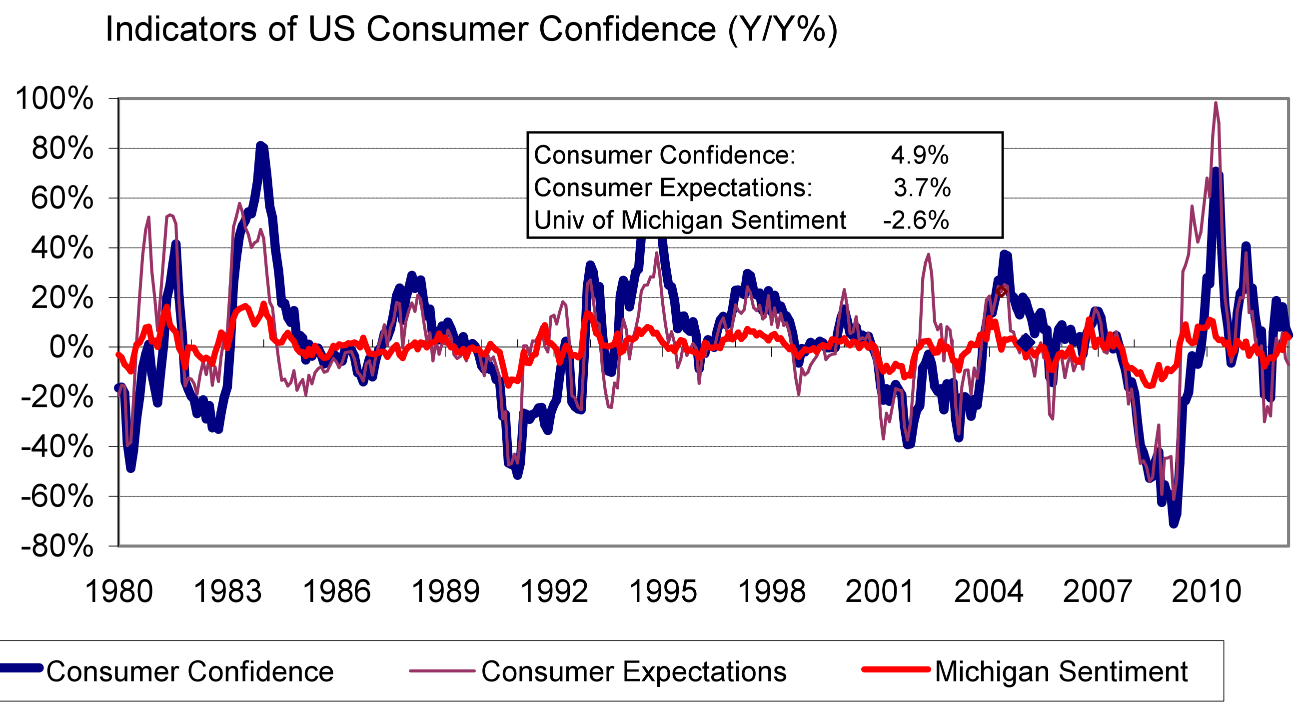
- Cyclically coiled spring of potential activity drives the expansion, reinforced by HighMark's five drivers: business investment, inventory re-stocking, export growth, housing starts, and consumption
- Sentiment diverged from "hard data" with heightened risk aversion, investor anxiety, skepticism Transitory exogenous factors: Fiscal & Geopolitical crises, Regulatory uncertainty, Natural disasters
- Emerging Market forces: Decoupling, urbanization, insatiable consumption, expanding credit, trade
- *Asynchronous Global Expansion* is evolving from *Global Synchronized Recovery* (2009-11): More typical/sustainable paradigm, decoupling, importance of fundamentals, and reduced correlations
- *Threat of cyclical inflation* becoming entrenched with rising commodities, transportation, imports, shelter, labor. Interest rates should rise as economic growth & inflation normalize (Taylor rule: 3.4%)
- *Era of Heightened Productivity*: Exceptional earnings growth, margins, revenues, balance sheets
- *Rotation in Investment Leadership*: Next decade expected to recognize relative valuation reversals. Significant shift in asset allocation preferences as equities favored over bonds & commodities.

Economic Forecasts	**2008**	**2009**	**2010**	**2011e**	**2012e**	**2013e**	**2014e**
U.S. GDP (Y/Y Real)	-3.4	-0.5	3.2	**1.7**	**2.5**	**2.5**	**2.8**
Earnings Growth	-23.1	-7.1	40.3	**13.2**	**8.8**	**6.7**	**7.1**
CPI Inflation (Y/Y)	-0.0	2.8	1.4	**3.0**	**2.3**	**2.5**	**2.8**
Unemployment	7.3	9.9	9.4	**8.5**	**8.0**	**7.5**	**7.2**
Fed Funds Target	0.25	0.25	0.25	**0.25**	**0.25**	**1.00**	**2.00**
Treasury Notes-10y	2.25	3.84	3.31	**1.88**	**2.75**	**3.50**	**4.0**
S&P 500 Target	903.	1115.	1258.	**1258.**	**1440.**	**1520.**	**1650.**

Source: HighMark Capital Management estimates & Thomson Datastream

CONSUMER CONFIDENCE

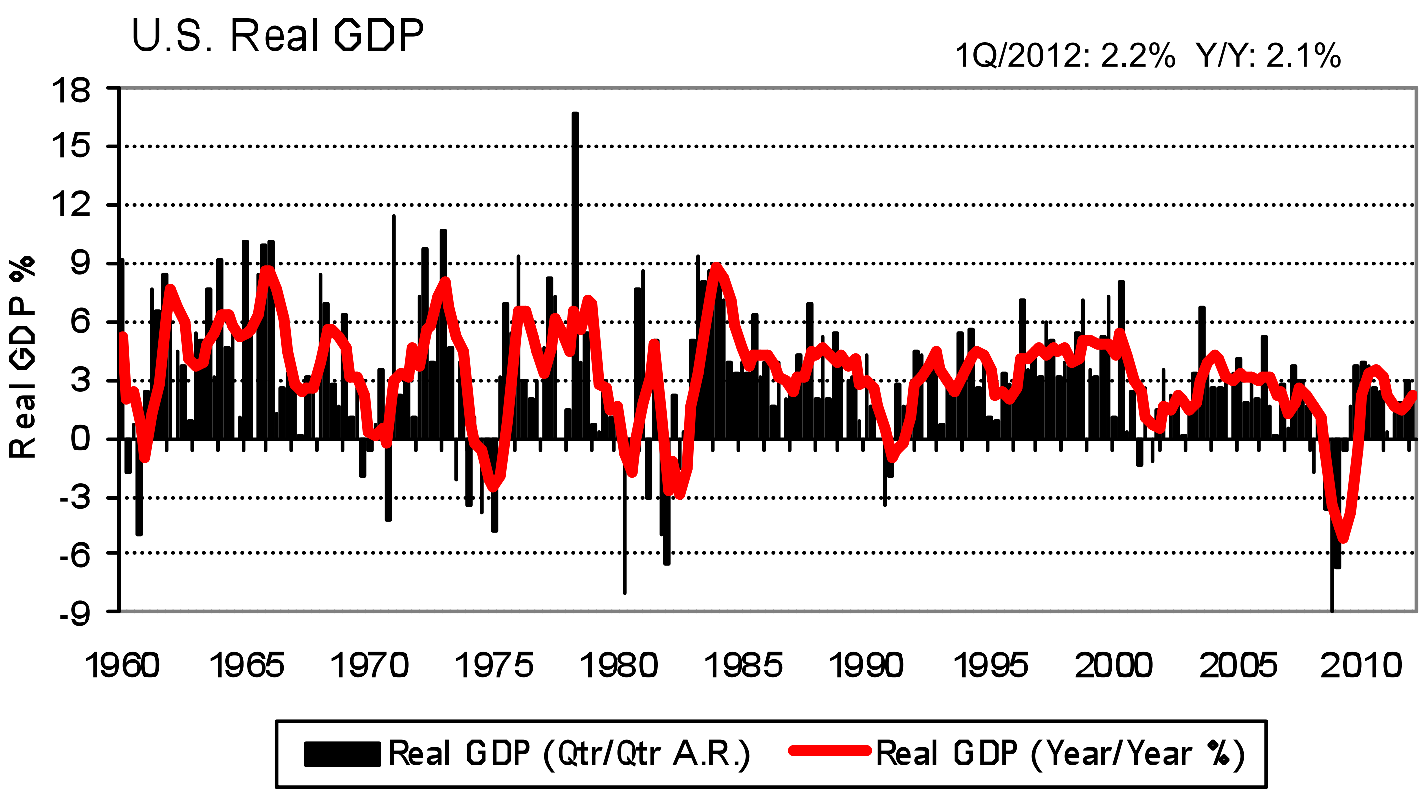
Confidence Declined Faster Than Consumption or Manufacturing Growth Rates



Source: HighMark Capital & Thomson Datastream

U.S. GROSS DOMESTIC PRODUCT

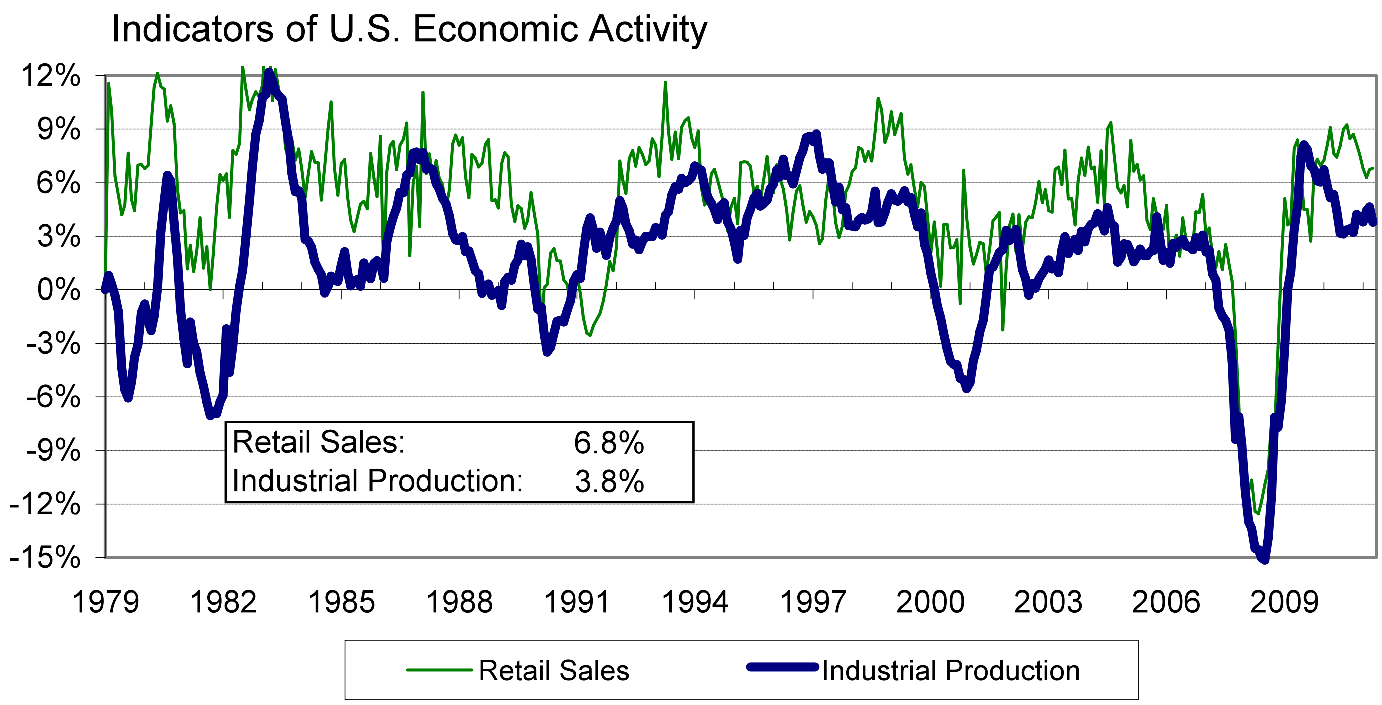
Contraction beginning September 2008, ended in June 2009, and since has surpassed previous peak
Expect more modest, but extended expansion thru 2012



Note: 2001 Recession now revised away
Source: HighMark Capital and Thomson Datastream

DRAMATIC RECOVERY FOLLOWED A STEEP U.S. RECESSION

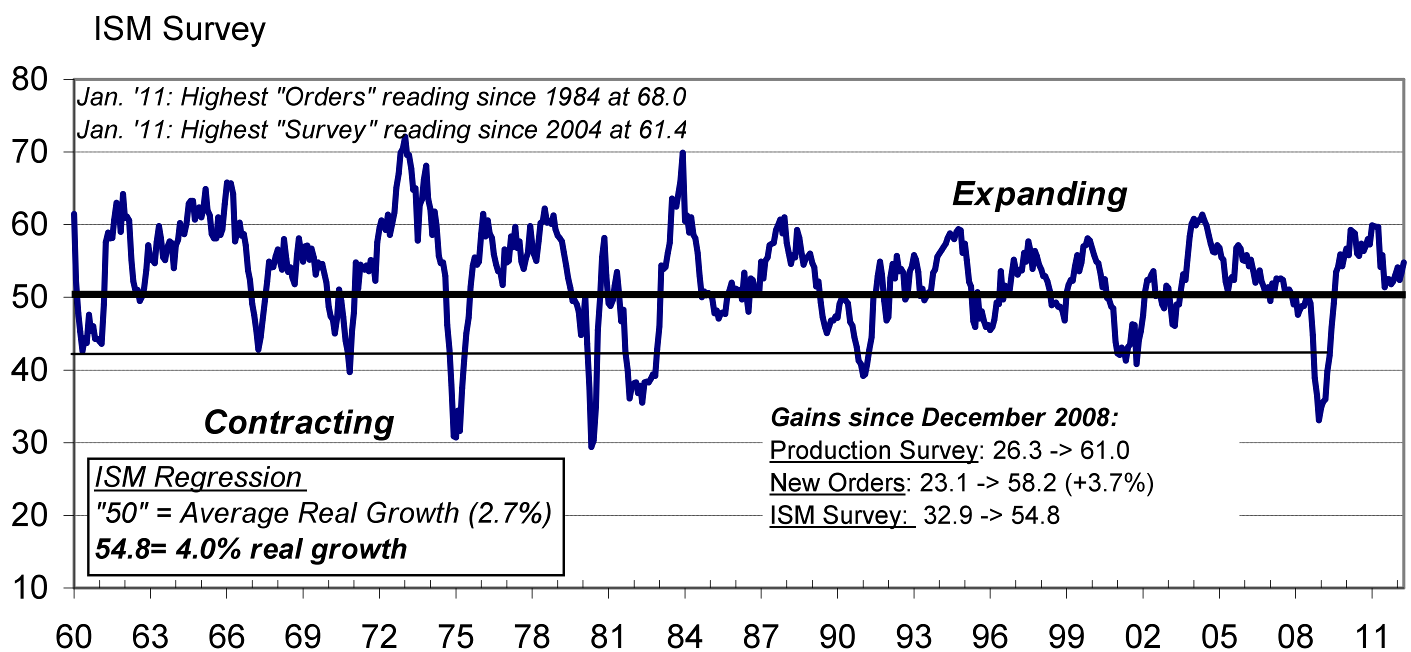
Can we continue to ignore this data? Consumption & industrial production remarkably resilient
Manufacturing slowdown appears transitory and decoupling from Eurozone



Source: HighMark Capital & Thomson Datastream

INDUSTRIAL AND MANUFACTURING SENTIMENT

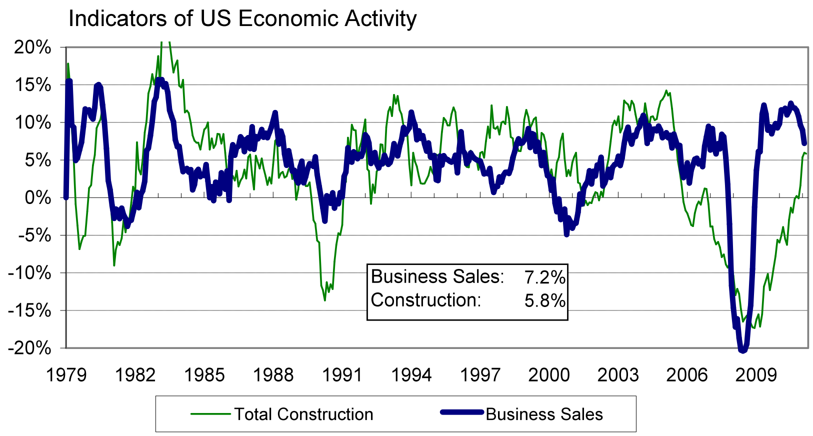
ISM Survey above 50 correlates with expansion greater than potential growth

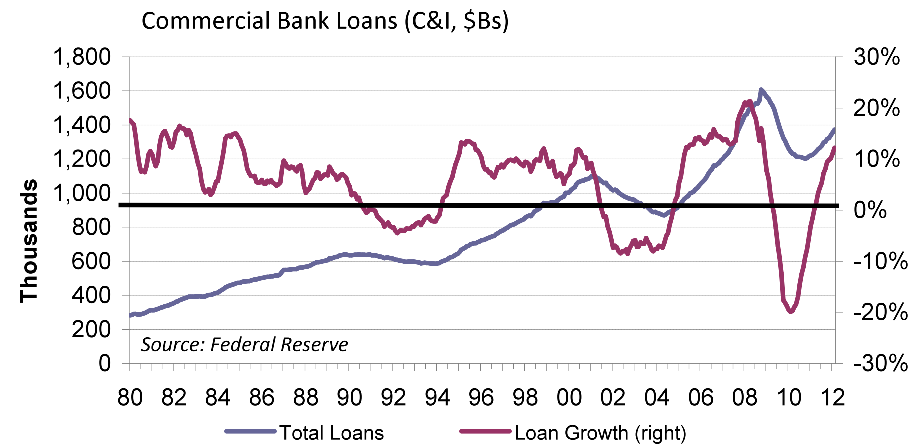


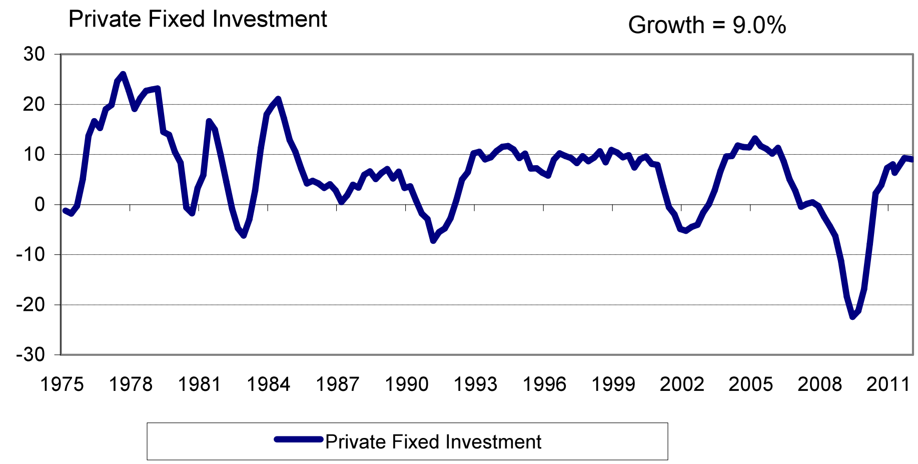
Source: HighMark Capital & Thomson Datastream

CORPORATE INVESTMENT

Key for employment: Construction expanding again, even housing starts picking up



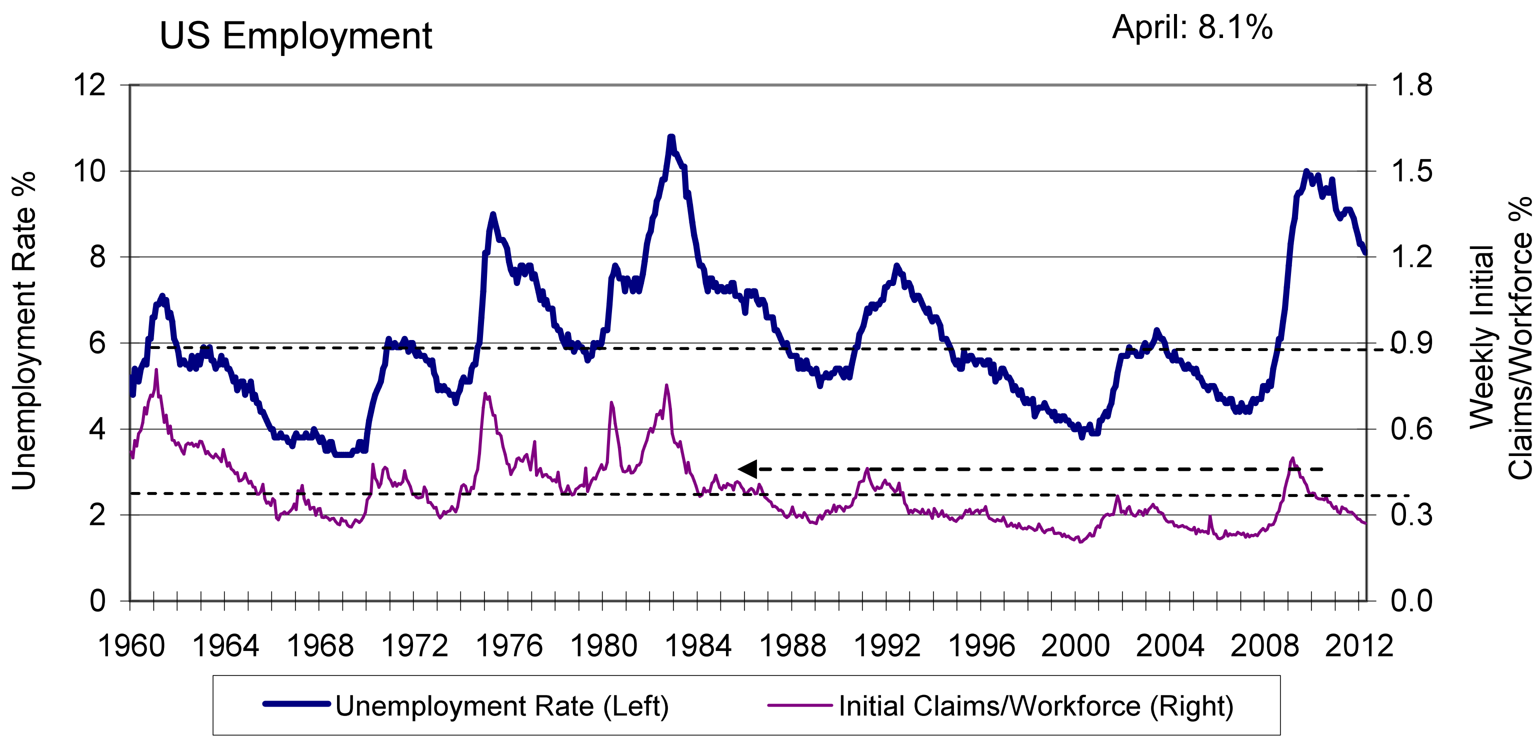




Source: HighMark Capital & Thomson Datastream

UNEMPLOYMENT DECOUPLED FROM BROADER RECOVERY

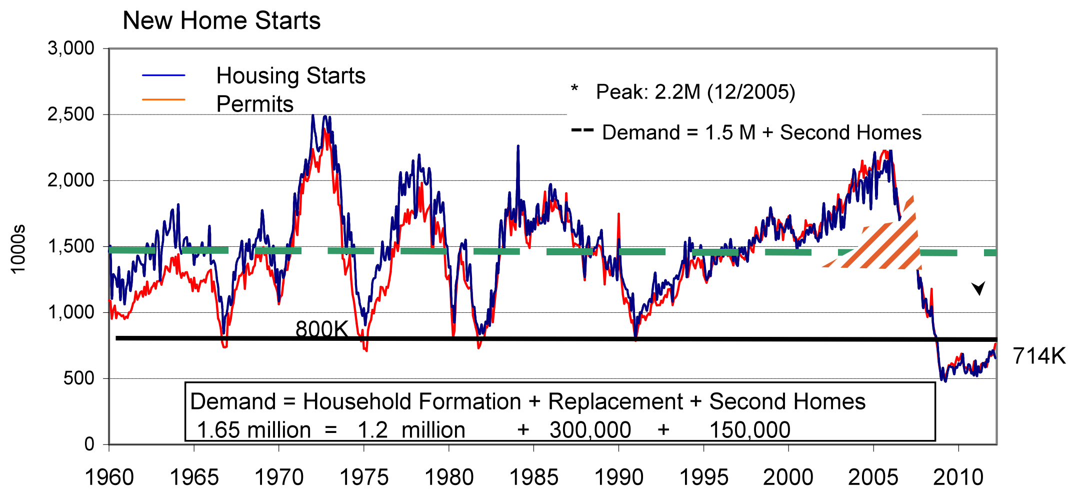
- Weekly Initial Claims and continuing claims peaked, historically have led -- now finally faster
- High productivity, mismatched job skills and business uncertainty hampering job recovery
- 2010 Nobel Prize: Extended benefits not incentivizing productive behaviors. Are other policies?



Source: HighMark Capital & Thomson Datastream

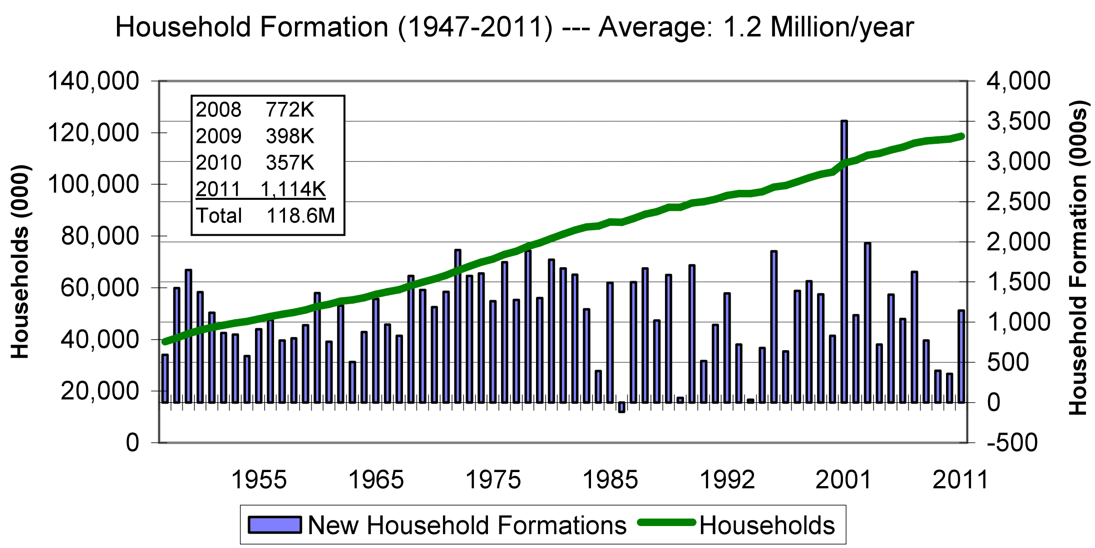
HIGHMARK® CAPITAL MANAGEMENT

HOUSING MARKET: Rebound In Housing Starts Coinciding With Formation



Housing starts rose 25% in 2011 and are at the highest level since November 2008.

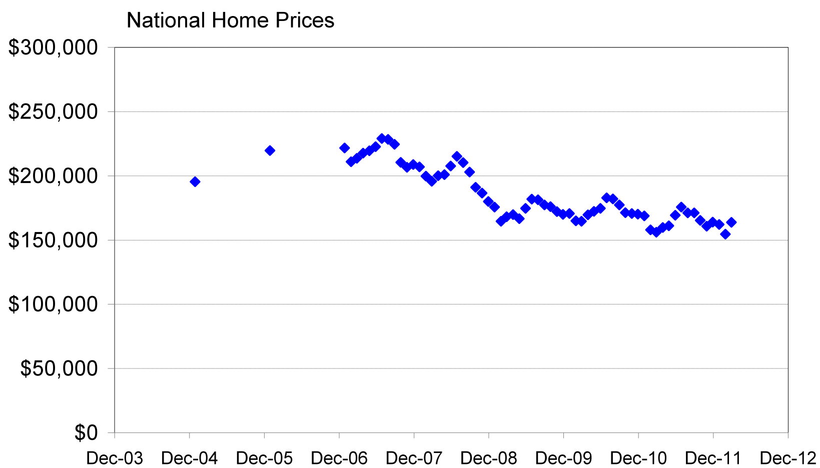
Source: HighMark Capital & Thomson Datastream

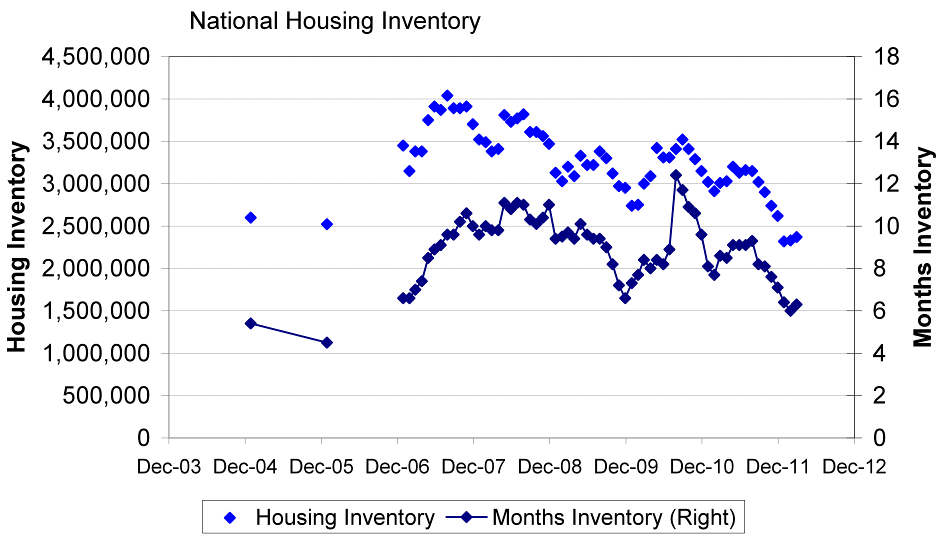


U.S. Census published its 2011 estimate of household formation, which ***jumped from 357K to 1.1 million.*** This explains a pick-up in demand, rent, and falling vacancies.

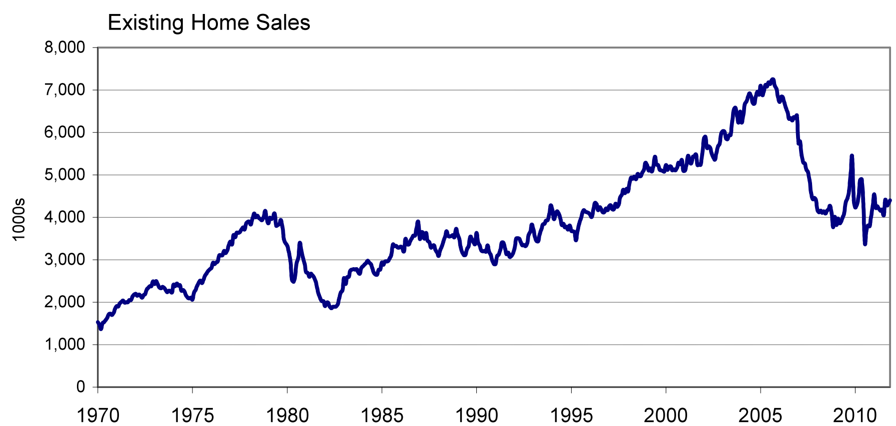
Source: U.S. Census

HOUSING MARKET DETAILS





Source: National Association of Realtors

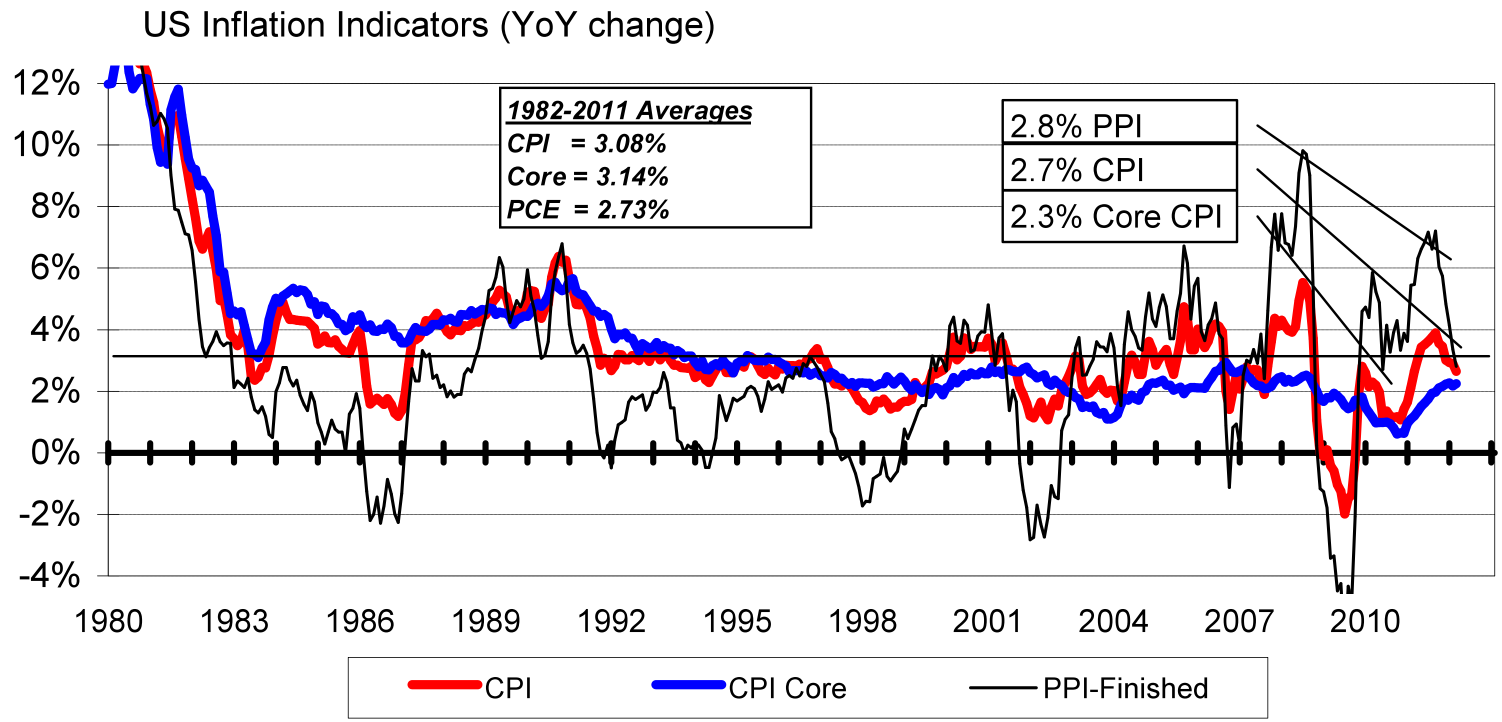


Source: HighMark Capital & Thomson Datastream

HIGHMARK®
CAPITAL MANAGEMENT

CONSUMER PRICE INFLATION NORMALIZING

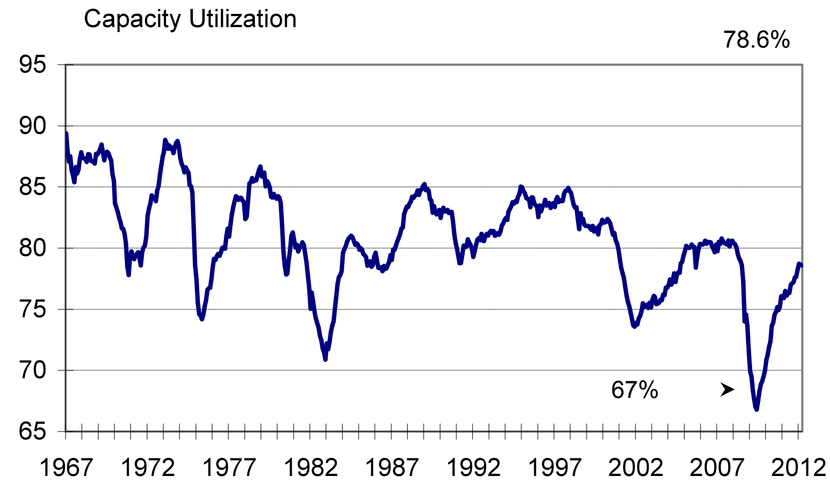
Nothing comforting about inflation, although the Fed is attempting to contain inflation expectations
Assumed slack in employment and manufacturing hasn't contained excessive monetary stimulus

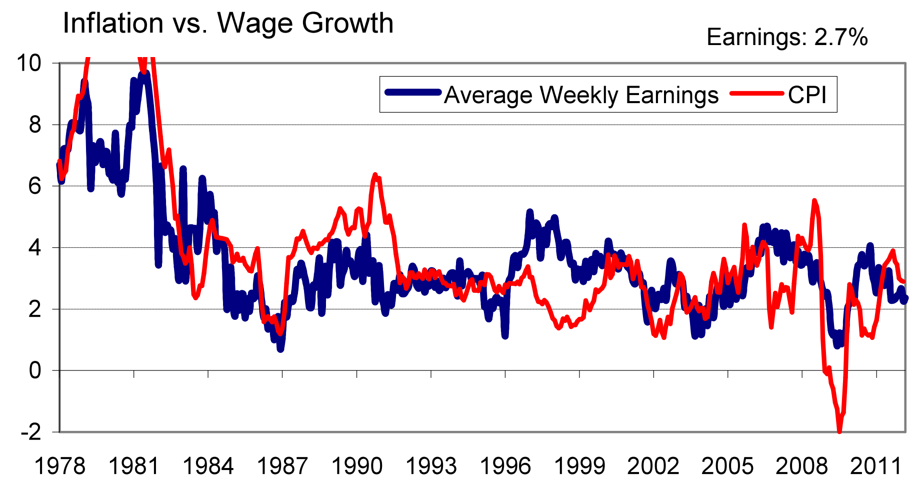


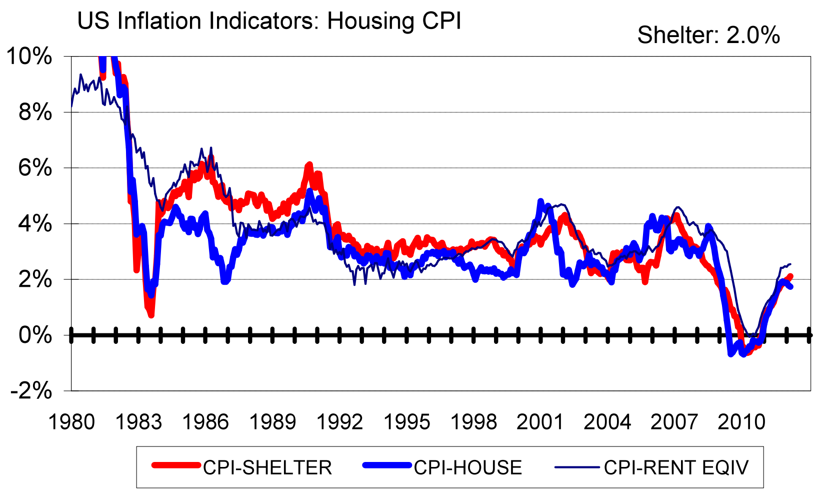
Source: HighMark Capital and Thomson Datastream

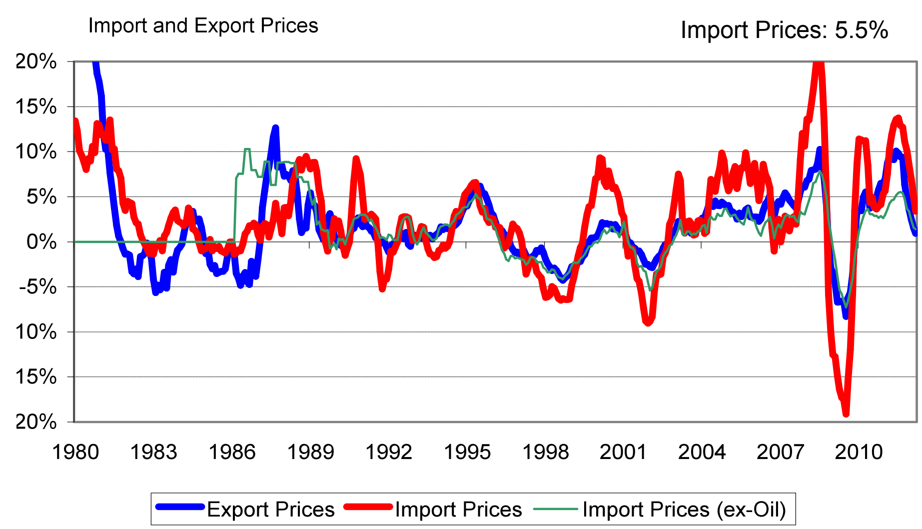
INFLATION PRESSURES AND EXPECTATIONS INCREASING

Slack in labor and production is a necessary, but not sufficient condition to contain inflation







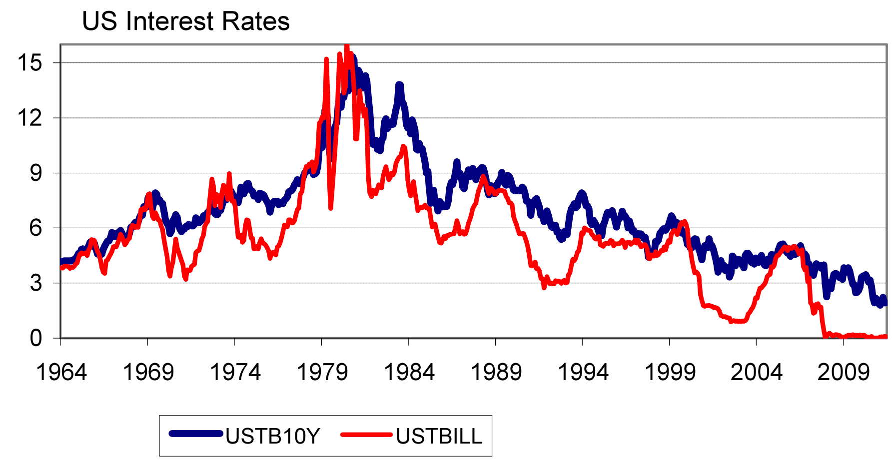


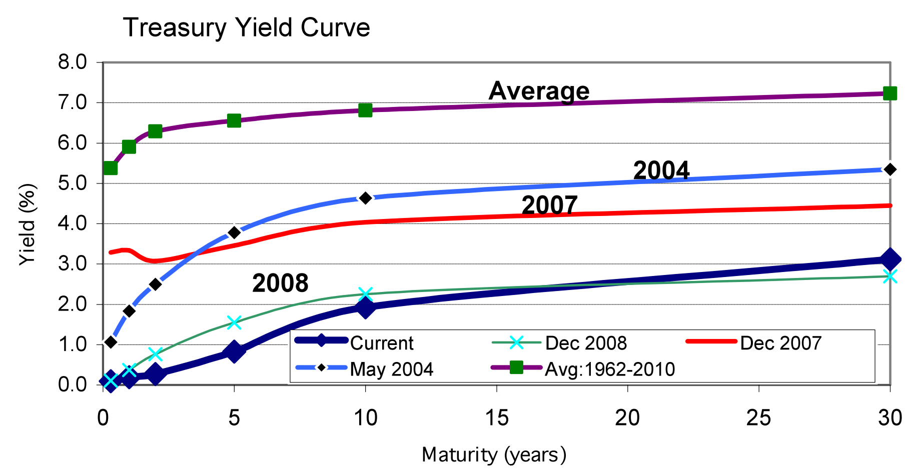
HIGHMARK®
CAPITAL MANAGEMENT

Source: HighMark Capital & Thomson Datastream

INTEREST RATES ARE EXCEPTIONALLY LOW

- Bull Market in Treasuries over 30 years coming to an end
- Yield curve similar to 2004 below would be more consistent with current conditions
- Treasury bonds should underperform other asset classes, particularly equities
- Low interest rates have undermined U.S. dollar, driven demand for alternatives, but unsustainable
- Favor credit exposure as spreads on high investment grade and agency mortgages near normal
- Taylor Rule suggests Fed Funds Rate should be 3.4% today vs. -3.6% in March 2009

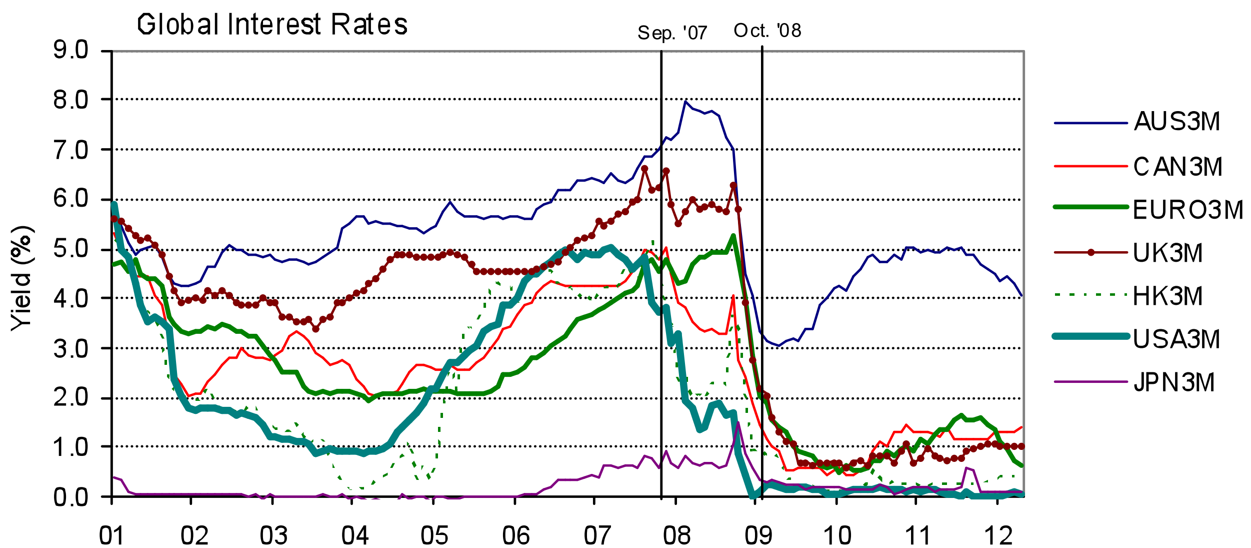




Source: HighMark Capital & Thomson Datastream

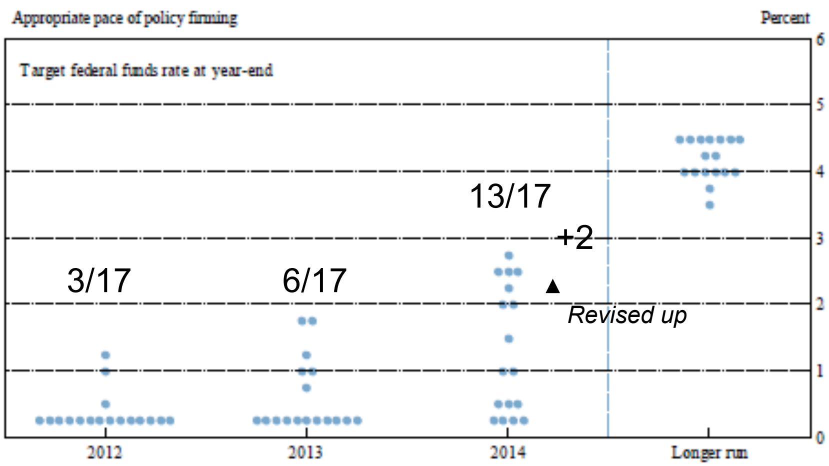
GLOBAL INTEREST RATES

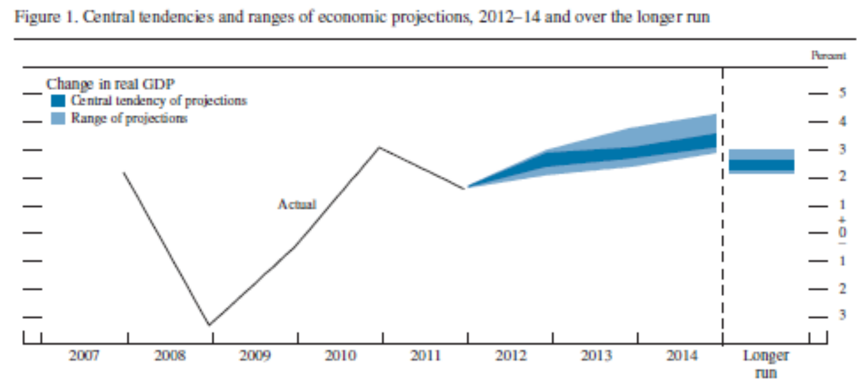
- Global interest rates are too low and unsustainable at current levels, risking higher
- Interest rates must eventually rise as economic conditions normalize
- U.S. interest rates should lead increases before Europe and Japan, bolstering the U.S. dollar, which should eventually drive gold and oil prices lower



Source: HighMark Capital & Thomson Datastream

FOMC ASSESSMENTS: Why is the Fed still easing?





Source: Federal Reserve, April 2012

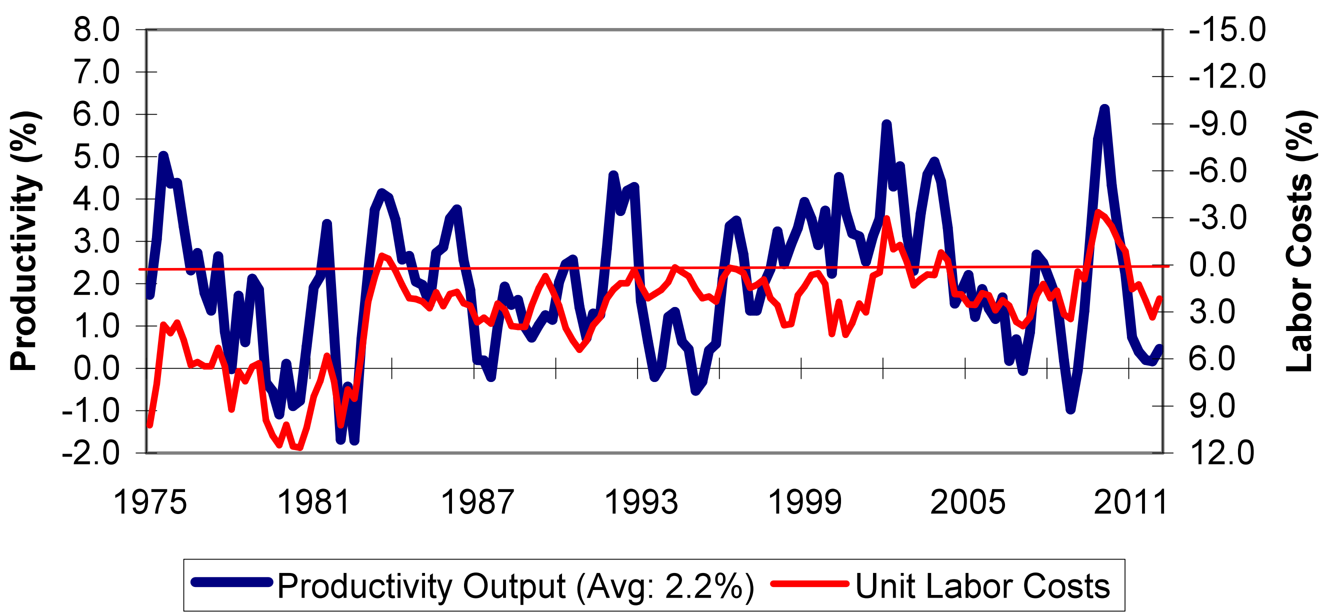
Federal Reserve	2008	2009	2010	2011	**2012 E**	**2013 E**	**2014 E**
U.S. GDP (Real)[1]	-0.3	-3.5	3.0	1.7	**2.7**	**2.9**	**3.4**
CPI Inflation	3.9	-0.4	1.6	3.2	**2.4**	**2.1**	**2.3**
Core PCE[1]	2.3	1.6	1.4	1.4	**1.9**	**1.9**	**1.9**
Unemployment[1]	5.8	9.30	9.60	9.0	**7.9**	**7.5**	**7.1**
Fed Funds[2]	0.25	0.25	0.25	0.25	**0.37**	**0.60**	**1.32**

Source: Bloomberg, HighMark Capital Management, Thomson Datastream, Federal Reserve
1. *Mid-point of central tendency range (excluding three highest and three lowest forecasts)*
2. *Fed Funds is average of all FOMC members in most recent Economic Projections – April 2012*

PRODUCTIVITY AND UNIT LABOR COSTS

Rising labor costs slowed productivity---How much “excess slack” exists when labor costs are rising?

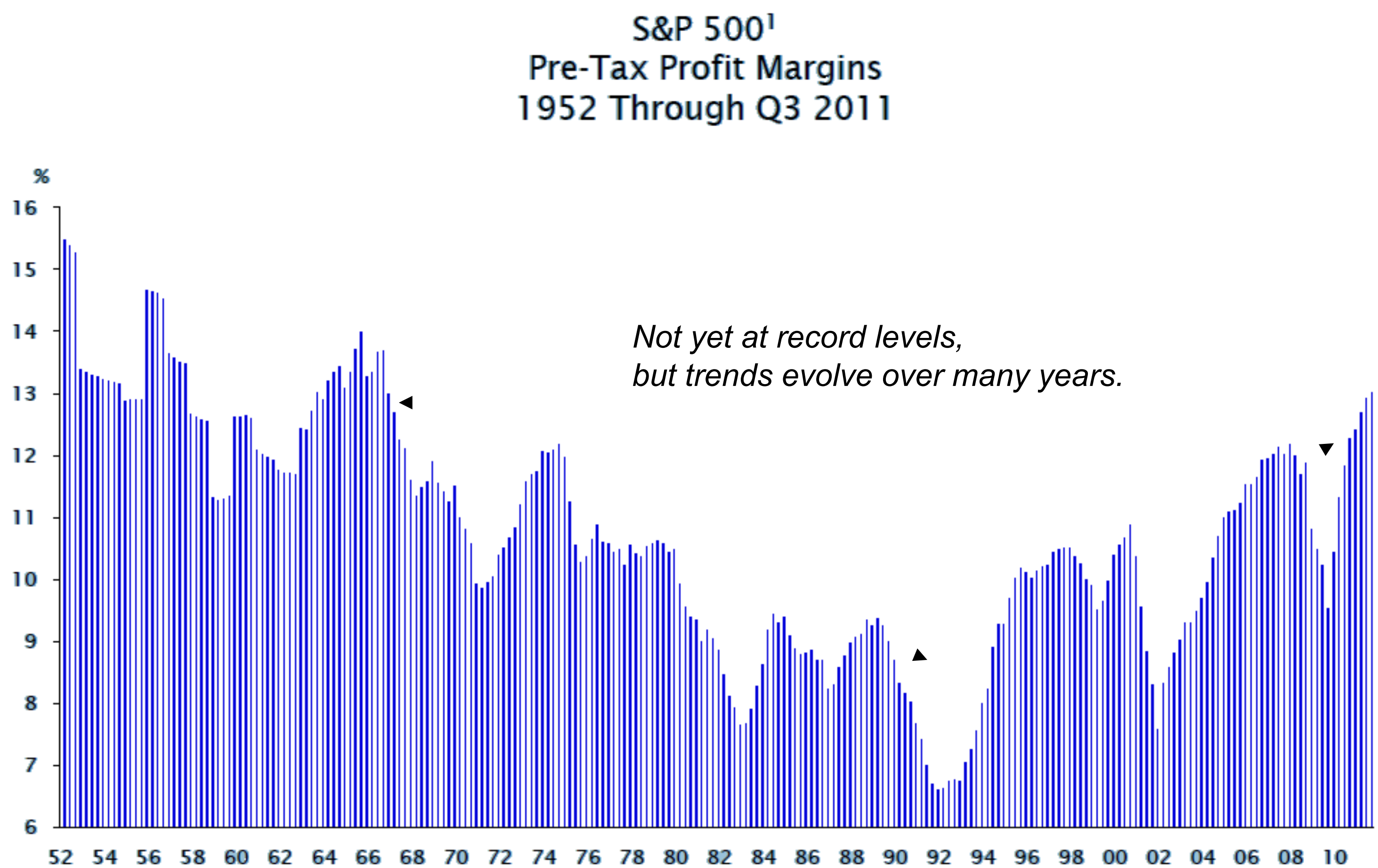
Real GDP (Growth) = G + C + I + T = Population Growth + Productivity



Source: HighMark Capital & Thomson Datastream

G = Gov’t Spending
C = Consumption
I = Investment
T = Net Exports (Trade)

CYCLICAL PEAK MARGIN OR PARADIGM OF EXCEPTIONAL PRODUCTIVITY?

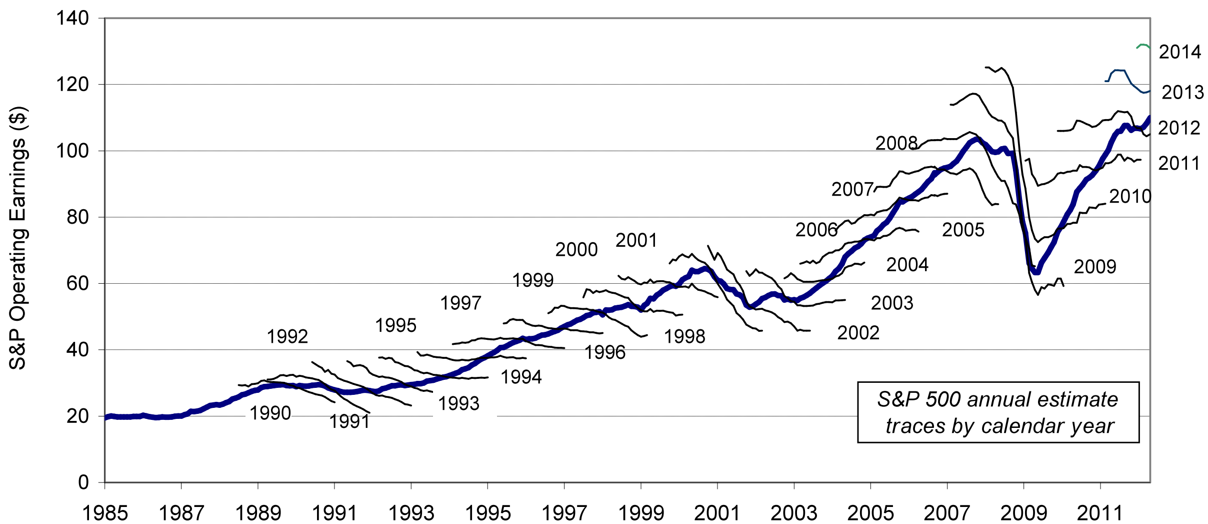


[1]Excludes financials. Prior to 1976, the large-cap universe is used.

Source: Empirical Research Partners

S&P 500 EARNINGS

S&P 500 IBES Earnings Forecast (12 Mo)



Earnings	2013e	2013e	2012e	2011e	2010	2009	2008	2007
HighMark		6.7%	7.3%	14.7%	40.3%	-7.1%	-23.1%	-3.5%
Consensus	11.9%	11.9%	8.8%	14.7%	40.3%	-7.1%	-23.1%	-3.5%
HighMark	$ 120.00	$ 112.00	$ 105.00	$ 97.82	$ 85.12	$ 60.80	$ 61.48	$ 85.12
Consensus	$ 132.69	$ 118.04	$ 104.98	$ 96.68	$ 85.12	$ 60.80	$ 61.48	$ 85.12
Financials	17.4%	15.1%	21.1%	5.6%	288.2%	106.9%	-130.8%	-2.1%
Non-Financials	10.7%	11.9%	6.5%	15.8%	28.1%	-18.6%	7.2%	3.2%

Source: HighMark Capital & Thomson (Through April 30, 2012)

Some Key Earnings Themes

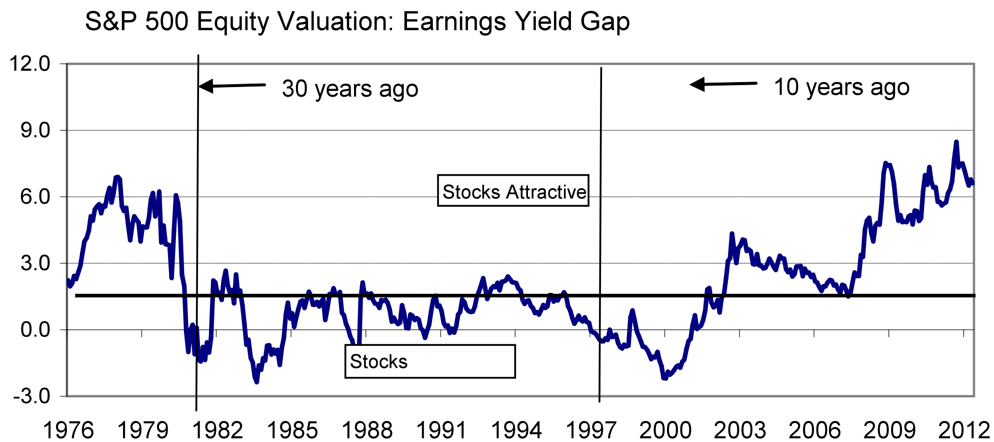
- *Valuation supportive vs. earnings, dividends & book value*
- *Earnings consistently revised higher*
- *Small-cap earnings growth strong*
  - ***2011: 24.1% growth,***
  - ***2012: 25.5%, 2013: 28%***
- *High profit margins and persistent positive earnings surprises*
  - 4Q/2010: 70% beat by 6.0%
  - 1Q/2011: 68% beat by 6.4%
  - 2Q/2011: 72% beat by 6.3%
  - 3Q/2011: 70% beat by 6.0%
  - 4Q/2011: 62% beat by 3.6%
  - 1Q/2012: 68% beat by 5%

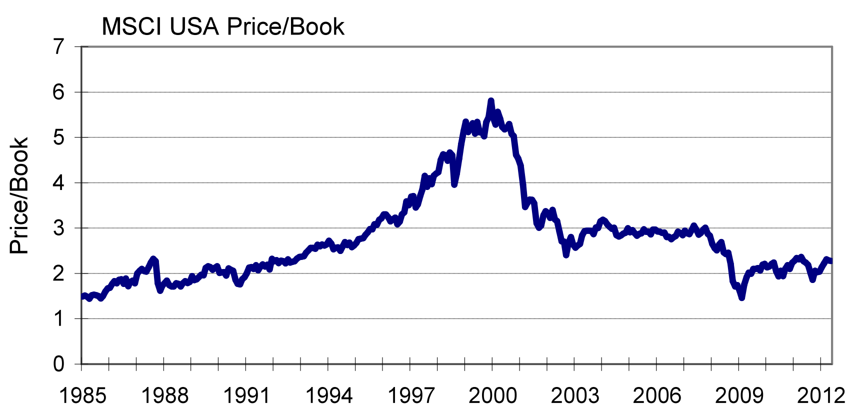
Too Far, Too Fast? *Not yet.*

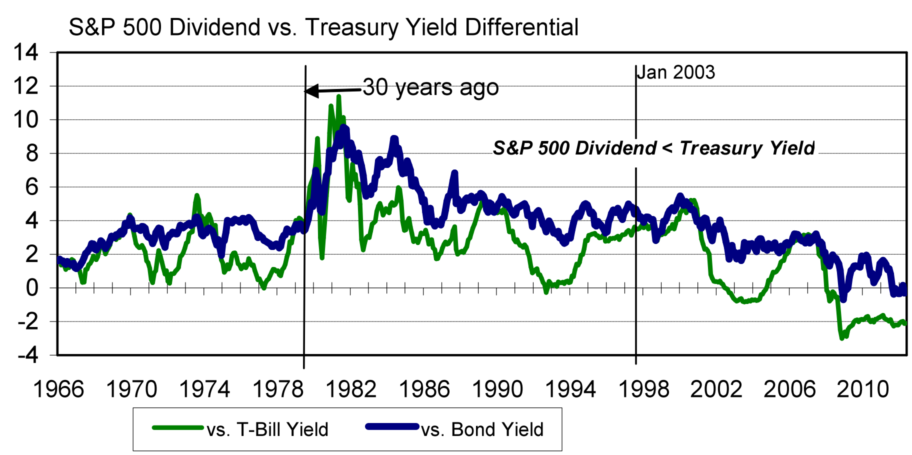
S&P 500 Index

15X @ $98 = 1470
15X @ $105 = 1575
15X @ $115 = 1725

EQUITY VALUATION – Room For Upside Even After Equity Rebound



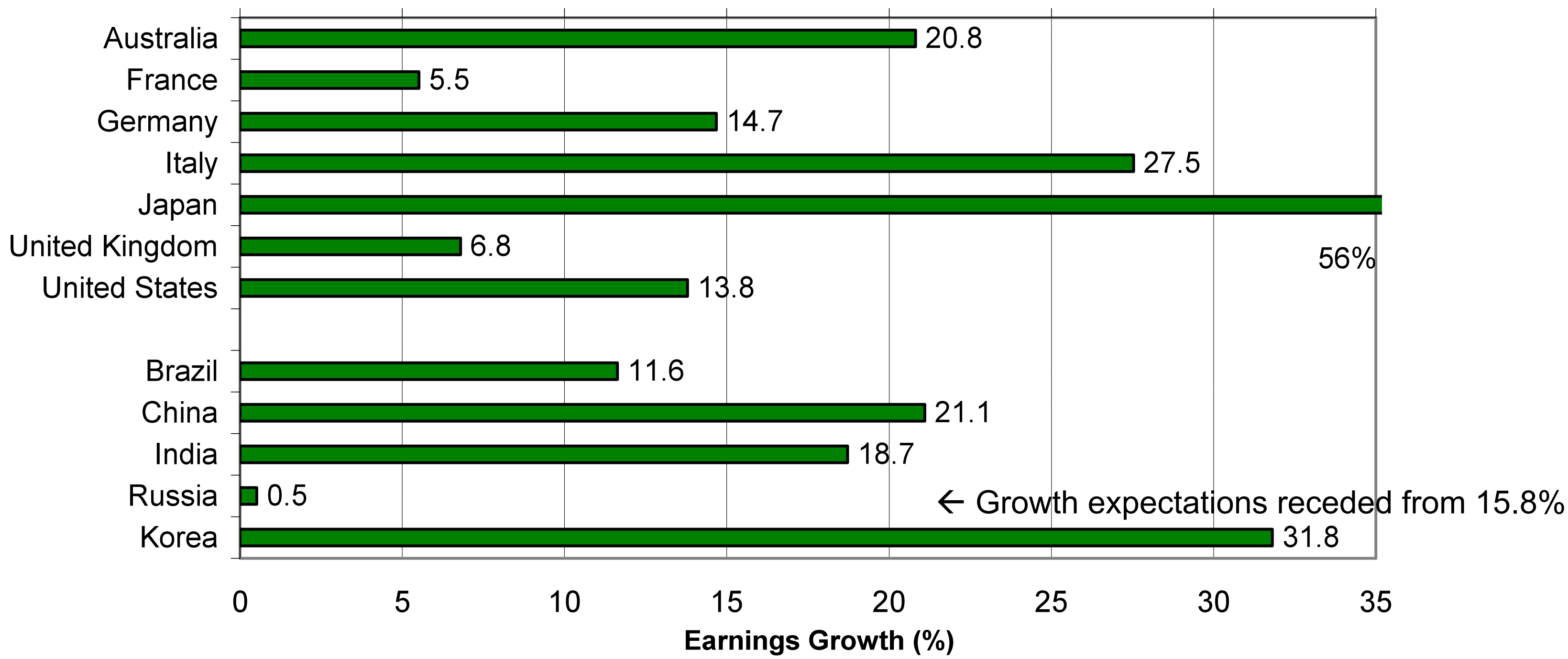




Source: Thompson Datastream & HighMark Capital

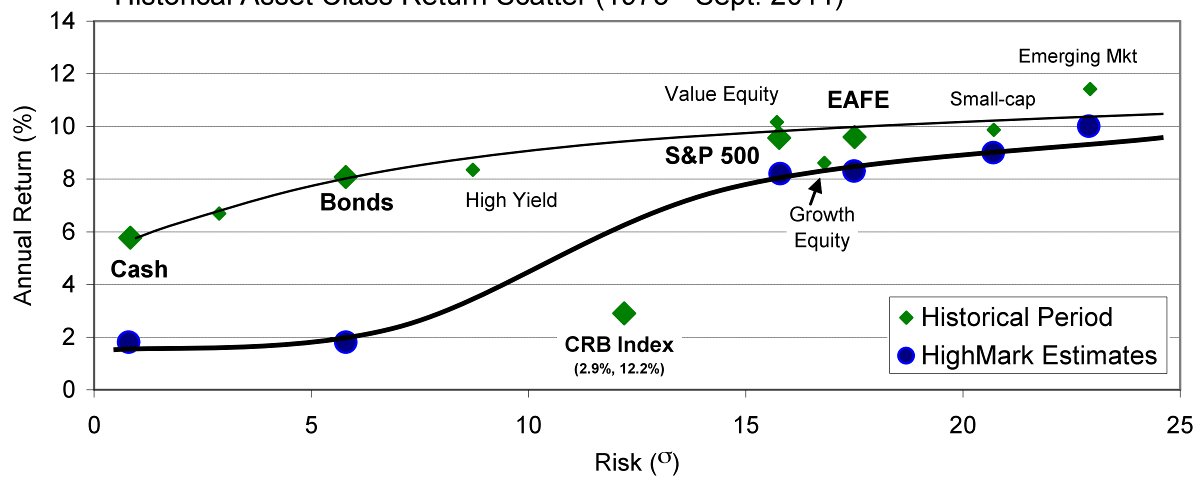
GLOBAL EARNINGS GROWTH EXPECTATIONS (12M Forward)

Difference between emerging and developed markets has been negligible recently



Source: Thompson Datastream & HighMark Capital

HIGHMARK ASSET CLASS RETURNS: Equity Risk Premium Sturdy to 1900



Commodity Expectations:
Input prices can't exceed output prices, thus commodity returns can't exceed inflation (-0.5% storage/holding costs).

Asset Class Returns				HighMark					
Annualized	10-years	1973-2011	1900-2010[2]	E[Return][1]	Risk	2011	2010	2009	2008
Stocks	2.9%	9.6%	9.4%	8.5%	15.8%	2.1%	15.1%	26.5%	-37.0%
Bonds	5.8%	8.1%	4.8%	2.0%	5.8%	8.7%	6.6%	4.5%	21.2%
Cash	1.8%	5.4%	3.9%	2.0%	1.0%	0.1%	0.1%	0.2%	3.1%
Commodities	11.4%	3.8%	2.6%	2.0%	13.8%	-10.6%	30.0%	33.4%	-23.7%
Inflation	2.5%	4.4%	3.1%	2.5%	1.2%	3.0%	1.4%	2.8%	-0.1%
Risk Premium									
Stock-Bond	-2.9%	1.6%	4.6%	**6.5%**		-6.6%	8.5%	21.9%	-58.2%
Bond-Cash	4.0%	2.6%	0.9%	**0.0%**		8.7%	6.5%	4.4%	18.1%

(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:** Barclay's Aggregate Bond, **Cash:** 3m T-Bill, **Commodity:** CRB

Source: HighMark Capital & Thomson Datastream

HOW WE ARE INVESTED TODAY

Upside for global equity markets from compelling valuations, and many tactical opportunities

Asset Class Model Targets

Equity	Overweight
Bonds	Underweight
Cash	Overweight

Note: Asset Allocation Committee recommendation compares to 60% Equity, 35% Bond strategic policy with a range of ±10%. Client allocations may vary depending on specific account investment guidelines and risk tolerance.

Asset Class Tilts:

1. Overweight U.S. vs. Developed International (EAFE) Equities
2. Neutral on equity style, but pro-cyclical sector exposure (i.e., Tech, Industrials, REITs)
3. Keep fixed income maturities short, avoiding Treasuries
4. Preference for high yield, credit exposure
5. Basic material companies more attractive than raw commodity holdings

- *Information Technology, Consumer Discretionary, Industrials*, and *Materials* tend to lead in the recovery phase of the investment cycle.

IT IS OFTEN EASIER TO DO THE COMFORTABLE THING

What is the difference between a bleak and bright future?

- Rapid innovation has fundamentally lifted our living standards
- Global financial liberalization provides freer capital flow, investment
- Investment in research & development, education are critical
- Abundance of new opportunities spark capital spending & trade
- High productivity, remarkable profit margins sustained & globalizing
- Strength lies in entrepreneurship, flexibility and incentives of free market
- Somebody else's *New Normal* doesn't have to be our destiny
- Natural state of economy is to grow–time to put lazy money to work

<u>Active Management</u>
Exceeding client investment expectations requires *discipline*, *conviction*, and a *willingness to be uncomfortable.*

We observe an abundance of opportunities we believe we can exploit to add value.

DISCLOSURES