First Hawaiian Bank

Economic Forecast

MAUI EDITION 2013 - 2014

Growth Spreading to Construction, Real Estate, Jobs

Maui's economy is highly dependent on tourism and the county has benefited from the ongoing visitor boom. Slowly these benefits have spread from the tourism sector to other parts of the economy including commercial construction, real estate, and most importantly, jobs. While challenges remain, the outlook is positive.

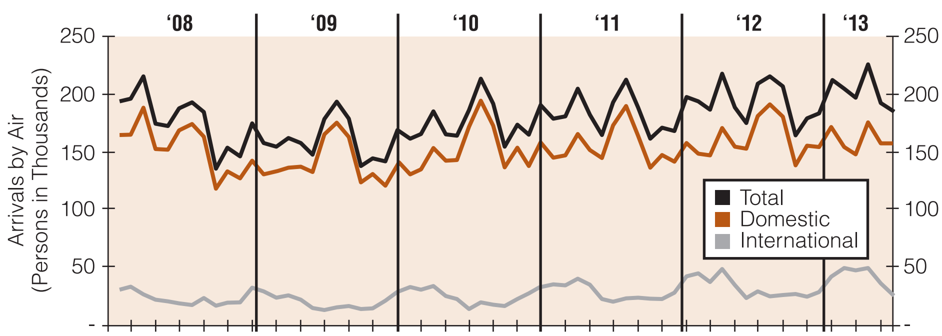
Maui is fortunate to have a number of unique economic drivers other than tourism that contribute significantly to the island's economy, including the HC&S sugar plantation, observatories atop Haleakala, Maui Research and Technology Park and the expanding UH Maui College campus.

Tourism: Exceptional Rebound Continuing into 2013

Consistent with other Hawaii markets, Maui visitor arrivals (Chart 1) are trending upward from the lows of 2008-09 with many months seeing more than 200,000 arrivals. While international arrivals are showing solid trend increases, Maui remains highly dependent on tourism from the U.S. west and east coasts. (See Chart 2.)

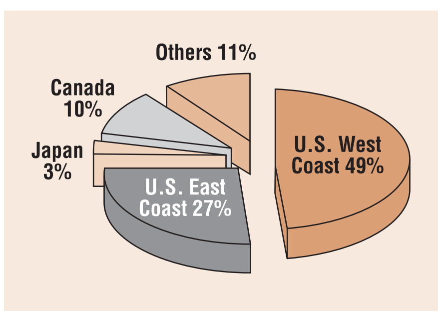
As visitor arrivals have rebounded, monthly visitor expenditures (Chart 3) have increased even faster. Beginning in 2010, visitors increased their spending, with some of the early recovery months showing over 20% growth on a year-over-year basis. This slowed to more modest, but also more sustainable, rates in 2012. The only exception was during the summer 2011 doldrums when the U.S. economy experienced a slowdown. This is a good reminder of how we are still very much linked to external economic forces.

CHART 1 • MONTHLY VISITOR ARRIVALS BY AIR, 2008-2013



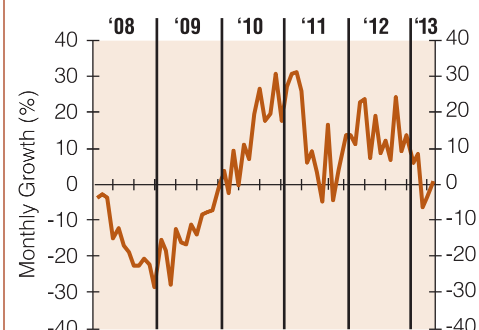
Source: State of Hawaii, DBEDT

CHART 2 • MAUI VISITOR ARRIVALS BY MARKET AREA 2012



Source: State of Hawaii, DBEDT

CHART 3 • MAUI VISITOR SPENDING GROWTH, 2008-13



Source: State of Hawaii, DBEDT

It is also good to be reminded of how important visitors are to Maui's economy. Chart 4 (at the top of page 2) shows annual visitor arrivals divided by the population of each island; the greater this ratio, the more "tourism dependent" the economy. Since 1990, this ratio has declined for all counties, but Maui is still three times more tourist-dependent than Oahu.

The rebound of the last two years has been exceptional, and we should not assume that it will last forever. In fact, the Maui Visitors Bureau is expecting growth of about 2-3% in arrivals for all of 2013. They are working hard to extend the Maui brand awareness to new markets, mostly focused on the U.S. Midwest and parts of Asia.

To accommodate the expected growth, new capacity has been and is being added through Marriott's just-completed time-share towers, the Andaz Hotel in Wailea, and the Hyatt

—continued on page 2

Hawaii analysis by Dr. Jack P. Suyderhoud, Professor of Business Economics, Shidler College of Business, University of Hawaii at Manoa and Economic Adviser to First Hawaiian Bank

Maui County *(continued from page 1)*

Regency time-share towers which by itself will add 140 rooms in Kaanapali in late 2014. Further on the horizon, the Royal Lahaina Resort has plans for a $300-million renovation pending financing and permitting. The Sheraton Kaanapali is likewise making renovation and expansion plans. Alexander & Baldwin has plans to build an all-suites hotel on its Wailea property.

To make sure the visitor experience remains the best, the Kaanapali Resort Association is planning a major, $7-million beach replenishment project for 2015-16.

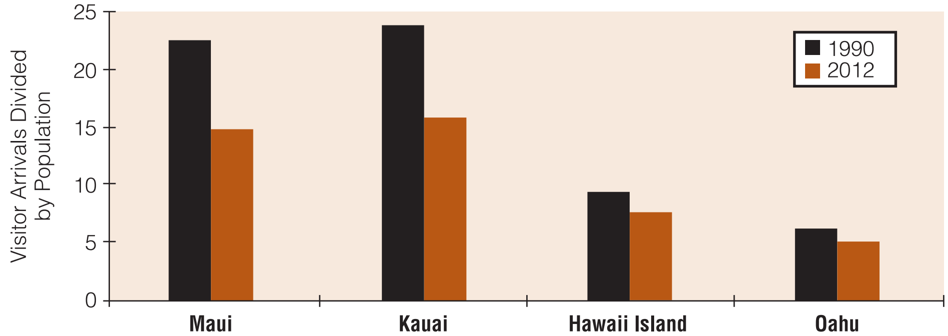
Air seat capacity continues to be a concern for the industry. Hawaiian added two daily Los Angeles flights for this year's June-August peak season. Offsetting this have been cutbacks by other airlines, especially merged carriers. For example, Northwest and Delta formerly accounted for six flights per day before they merged but now provide only two. Hope is that Southwest will enter the market, but they have not been heard from of late.

Visitor-focused retailers are benefiting from the positive trends. Whalers Village reports 2013 sales up by more than 4% compared to the same period in 2012. They anticipate renovations and adding 15,000 square feet of space in 2014.

Jobs Up, Unemployment Down

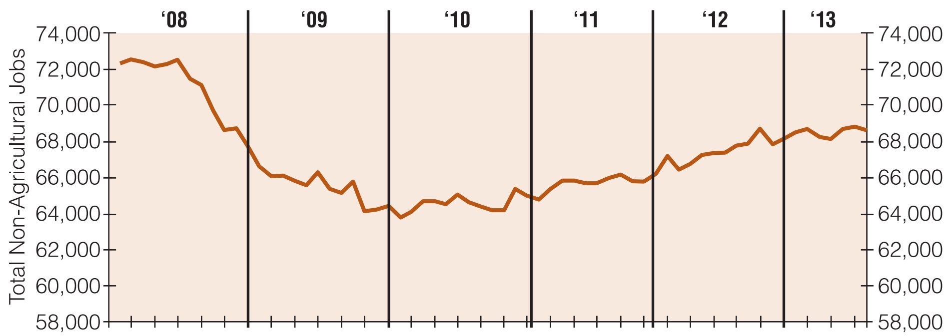
Maui jobs are starting to come back as the effects of the tourism rebound have spread. (See Chart 5.) Between the 2008 peak and the 2010-11 low point Maui lost almost 9,000 jobs. About 5,000 of them have returned. As a result, the Maui unemployment rate (Chart 6) has followed the statewide unemployment rate downward since mid-2011. Unlike the other neighbor islands where the job market has substantially lagged the statewide average, Maui's unemployment rate is only marginally higher than the state overall. While this is very good news, it is worth noting that Maui is still 4,000 jobs below the prior peak and the unemployment rate is still well above the 3% rate before the Great Recession.

CHART 4 • RELATIVE IMPORTANCE OF TOURISM SECTOR



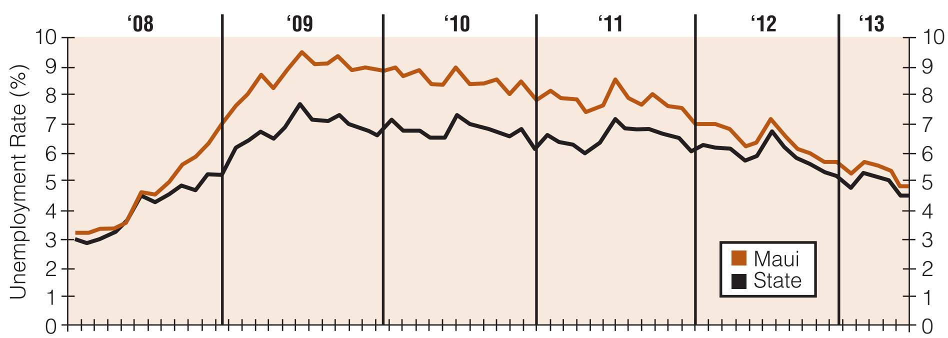
Source: State of Hawaii, DBEDT

CHART 5 • MAUI JOB COUNT, 2008-13



Source: Hawaii State Department of Labor & Industrial Relations

CHART 6 • MAUI VS. STATE UNEMPLOYMENT RATE, 2008-13



Source: Hawaii State Department of Labor & Industrial Relations

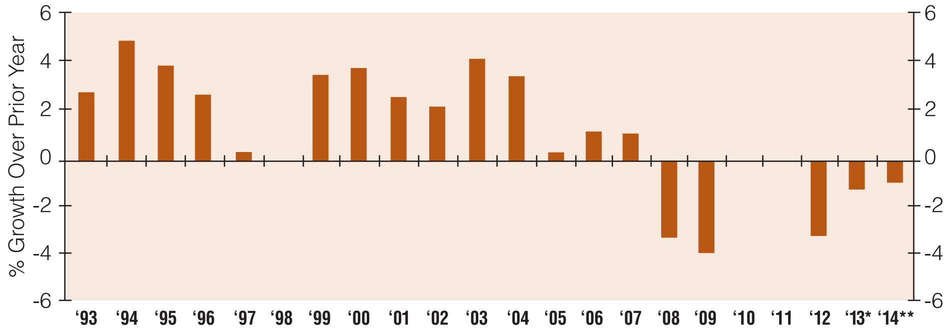
It appears that the job growth has been mostly in tourism and other service-related fields. Even construction jobs are up, but this is from a very low base.

As the job market improves, businesses are increasingly concerned about being able to hire and retain qualified staff. The Maui Economic Development Board is hard at work providing training programs, especially in the areas of sciences and technology, the so-called STEM disciplines.

Electricity Sales Dropping

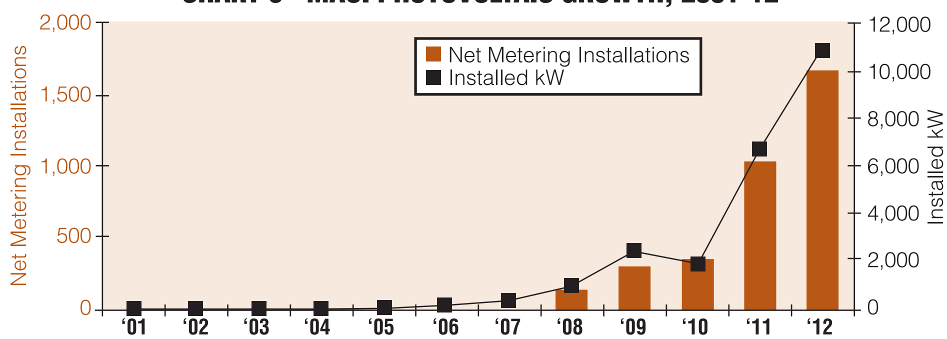
Traditionally, one way to gauge the strength of an economy has been the consumption of electricity. When the economy is strong, electricity usage is up, typically. However, due to the market penetration of residential and commercial photovoltaic (PV) systems as well as demand-side management, it is harder to infer economic activity from Maui Electric Co.'s sales. Chart 7 shows that electricity sales have been dropping since 2008 even though the number of customers has not declined. Chart 8 shows the market penetration of net energy metering associated with

CHART 7 • MAUI ELECTRIC MEGAWATT SALESGROWTH, 1993-2014



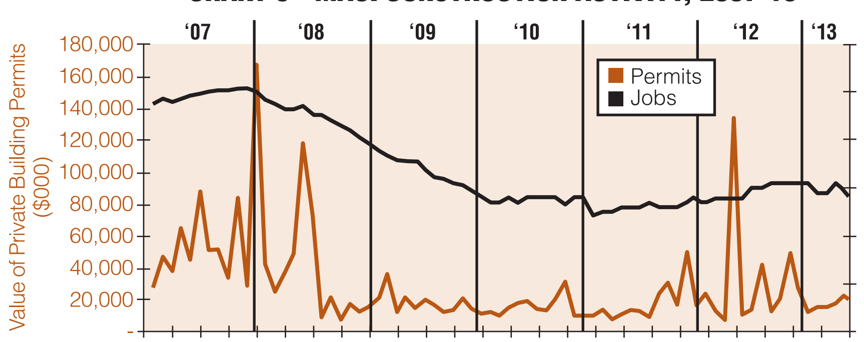
*2013 Estimate **2014 Forecast Source: Maui Electric Co.

CHART 8 • MAUI PHOTOVOLTAIC GROWTH, 2001-12



Source: Public Utilities Commission & Maui Electric Co.

CHART 9 • MAUI CONSTRUCTION ACTIVITY, 2007-13



Source: Hawaii DBEDT based on DLIR and county building department data

PV installations. In the last few years the use of these systems has expanded enormously.

A significant amount of Maui Electric's power is now coming from renewable sources that currently supply 20% of sales with a goal of 30%. About 5-6% of the existing renewable energy is from HC&S sugar plantation co-generation. Two so-called "smart grid" demonstration projects, one of them funded to the tune of $30 million from Japan's Hitachi, will help with demand management goals.

Construction: More Upbeat

Construction activity is trending up from the depths plumbed in the aftermath of the recession. Contractors and developers seem more upbeat, but not jubilant, as challenges persist.

As shown in Chart 9, construction jobs began picking up in early 2011 and are now about 700 jobs above their low point, but still 2,000 below the prior peak reached in 2008. Private building permits, which are very lumpy from month to month, are showing some signs of trend improvement, and this holds out hope that the industry will continue to expand into 2014. Insiders are saying that the mix of work has changed with more opportunities coming from infrastructure and commercial construction and less from residential and time-shares.

Infrastructure: Several infrastructure projects are helping buoy the sector. The new airport access road is budgeted for $52 million from a combination of state highways and airports money. Confirming the fact that construction is not out of the woods, it appears that all five bids for the airport side of the access road project came in under budget, in some cases significantly so.

Also at the airport the new centralized rental car facility is a $200-million project that will soon be under way. Rehabilitation of the main runway, a $3-million project, will begin in September. Other airport improvements, including restrooms, roofs, the PA system, and fire sprinklers will run $12 million.

Phase three of the Lahaina bypass road has begun archeological work, and the Kihei police station and Kihei high school will together involve more than $300 million in construction.

Commercial Development: As of now, commercial development appears to be leading the way on Maui. The new Safeway center and the planned Target store will help transform Maui retailing. Target construction is expected to start in 2014 with opening in 2015. Other tenants will be attracted to that location. Other parts of A&B's Maui Business Park are well under way with the completion of Ho'okele Street and the initial increment of 70 acres of fee-simple commercial lots being sold. Likewise, Maui Lani is providing fee-simple commercial space and developing their Village Center on the mauka side of their property. These spaces are meeting an important need for small businesses who want to own their property, and sales seem to confirm that desire.

Residential Development: On Maui, residential development is lagging commercial activity. The county's affordable housing and water access

—continued on page 4

Maui County *(continued from page 3)*

requirements appear to remain as obstacles to residential property development. These obstacles are more difficult to overcome for smaller developers, thus leaving the field to the larger players. For example, at Maui Lani sales of 150 lots at The Tradition by D.R. Horton have accelerated in 2013, and Towne Island Homes is developing 200 lots at The Parkway. A&B is planning single- and multi-family units at Wailea, the latter with Armstrong Development and for sale commencing 2013 and construction starting in 2014.

Real Estate Benefits from Positive News

As we have seen, the positive economic news eventually spreads through the economy via job creation and construction. Real estate is also benefitting, and the Maui residential market is in recovery mode.

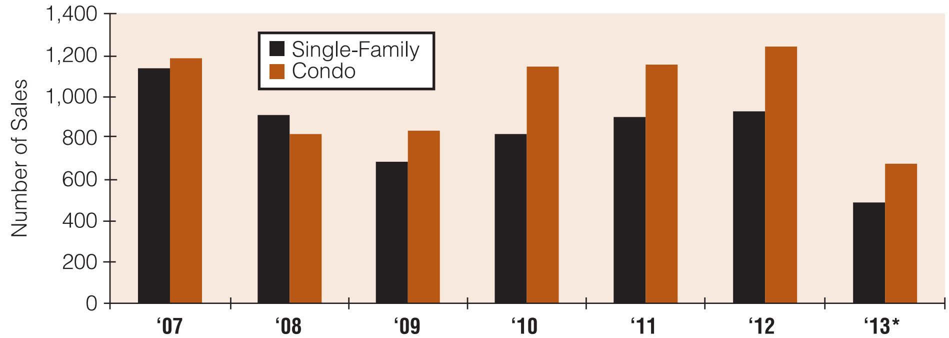
As seen in Chart 10, units sold have increased for the last four consecutive years and condo unit sales are past their 2007 peak. Chart 11 shows that, as the demand-supply equation has improved, islandwide prices have rebounded. While we are still below the prior price peaks, the news is relatively good.

One indicator of the market is the number of members of the Realtors Association of Maui. As a result of the recession this fell from a high of 1,750 to less than 1,200. It has now bounced back to about 1,350.

Analysis by Terry Tolman at the Realtors Association of Maui shows that bank-owned and short sales for single-family homes are down from 45% in 2011 to 34% in 2012 and about 25% in mid-2013. As the inventory of distressed sales continues to decline, the market will strengthen.

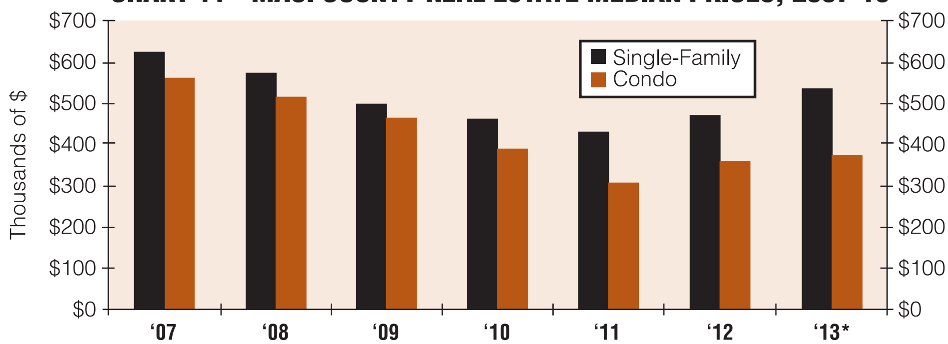
Interestingly, land sales have lagged finished houses. It appears that buyers want a finished house and are not anxious to bear the costs and risks of building on their own. It seems that completed home prices have yet to catch up with the costs of land and construction.

CHART 10 • MAUI COUNTY REAL ESTATE UNIT SALES, 2007-13



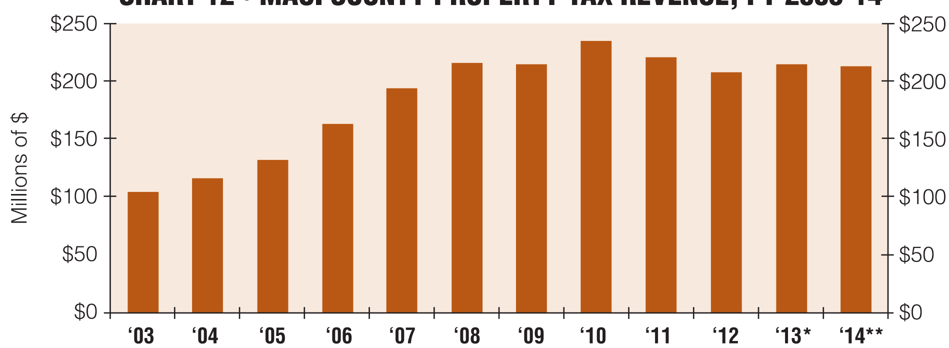
*2013 YTD through June
Source: Realtors Association of Maui

CHART 11 • MAUI COUNTY REAL ESTATE MEDIAN PRICES, 2007-13



*2013 YTD through June
Source: Realtors Association of Maui

CHART 12 • MAUI COUNTY PROPERTY TAX REVENUE, FY 2003-14



*2013 Estimate **2014 Forecast
Source: County of Maui

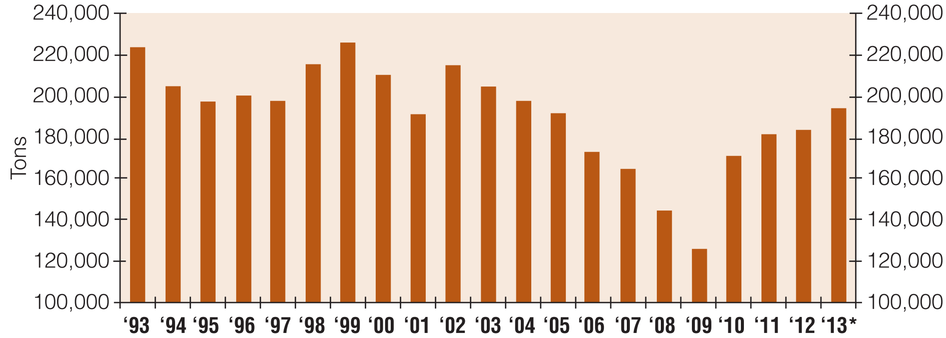
The County of Maui government is starting to see the effects of a rebounding property market. As shown on Chart 12, fiscal years 2011 and 2012 saw declines in property tax revenues in spite of some rate increases. Additional rate increases combined with less erosion of assessed values is helping to stabilize the trends for the fiscal years 2013 and 2014.

Retail Returns As Jobs Improve

Consumer spending depends on jobs and incomes. As job growth has returned, so has the retail sector. One good gauge of this is the Queen Kaahumanu Center where 85% of the customers are local. They expect sales to be up 5-10% in 2013 with the smart merchants who know and anticipate customer wants doing even better.

A&B's Maui Mall is adding TJ Maxx with construction expected to begin in 2014 and opening summer in 2015. Queen Kaahumanu is also adding new "name" brands shops.

CHART 13 • HC&S SUGAR PRODUCTION, 1993-2013



Source: HC&S

While overall sales are doing well, customer tastes are also shifting away from traditional gifts such as jewelry to tech-based gifts such as phones and tablets and related products.

Maui's Economic Drivers

Maui is fortunate to have some economic drivers other than tourism that contribute significantly to the island's economy. It is worth looking at these individually.

HC&S: Sugar still lives on Maui. HC&S production has continued to increase from the low year of 2009 and is approaching the 200,000-ton-per-year figure that makes them feel good (Chart 13.) According to General Manager Rick Volner, Jr., the recent increases have been due to a number of factors including more acres planted (as they took back some pineapple land) and better yield. Yield improvements have been due to better rain but also smarter practices, some of which are throwbacks to older days.

The price for much of the production is known in advance through the use of forward contracts. Thus robust 2013 revenues are actually also due to prices in 2012. However, since 2013 sugar prices are down, 2014 is not expected to be as good a revenue year for HC&S even if improving production trends continue.

In addition to these market risks, the U.S. sugar industry is also subject to political risks associated with the U.S. national farm bill and NAFTA. Apparently Mexico has increased sugar output, a challenge to domestic U.S. growers. This means that HC&S remains an important but vulnerable part of Maui's economy.

Haleakala Observatory and Maui Research and Technology Park: Haleakala observatories involve nine facilities. According to the UH Institute for Astronomy the annual budget of these facilities is $55 million, supporting 244 county-based staff.

The big news on the mountain is the Advanced Technology Solar Telescope (ATST). This is a $340-million project that started in late 2012 with completion forecast in 2019. By the end of 2013 the spending on Maui will be $16 million with a total of $94 million by 2019. Once completed the annual operating budget will be $18 million in today's dollar values with 35 local staff.

The Research and Technology Park at Kihei complements the activities on the mountain. One of the exciting endeavors there is the Pacific Joint Information Technology Center that supports U.S. Defense Department medical readiness requirements and IT modernization. It houses $60-million worth of projects employing more than 60 people and has incubated 25 start-ups.

The park is also home of the Maui Economic Development Board that, among its other activities, raises the technology profile of Maui through the Advanced Maui Optical Space Surveillance Technologies conference, better known as AMOS.

UH Maui College: Under the leadership of Chancellor Clyde Sakamoto, the College has expanded beyond traditional associate degree programs to also offering baccalaureate degrees. Student enrollment increased by 45% from 2006 and now stands at about 4,000, with 500-600 in bachelors' programs. The number of students is not expected to increase significantly in the next few years.

Construction of the $26 million science building has been completed. Starting this summer, the old science building is being renovated to the tune of $4.5 million and will house the Daniel K. Inouye Allied Health Center for the nursing, dental assistant, and dental hygiene programs. This will also serve as a community health center servicing 8,000 patients per year in cooperation with the Lutheran Medical Center.

A $3.5-million legislative appropriation has been made to renovate the old dorms and convert them into a teaching hotel for the hospitality program. This is expected to start during summer 2013 with completion in 2014. In addition, a $2.25-million Molokai Performing Arts Center is planned.

Other construction activities for Maui College include a $1-million photovoltaic project for panels over the parking lot. This will be with a third-party through a power purchase agreement.

In Sum

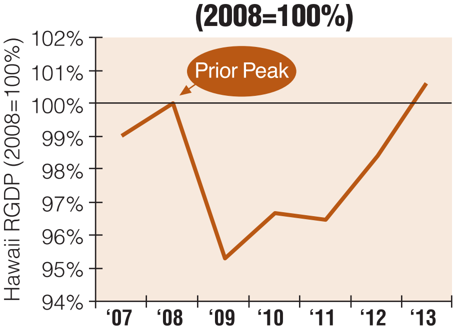
Maui's tourism boom will slow down, but its continued strength will support the rest of the economy. We are seeing improvements in the labor market as job creation has continued, benefiting retailing and real estate. Certainly challenges remain in the residential construction sector, but infrastructure and commercial construction are leading the way. The business outlook for Maui is positive in the next year.

Statewide Economy: Corner Turned, Moving Ahead

*By **Dr. Jack Suyderhoud**, Professor of Business Economics, University of Hawaii at Manoa and Economics Adviser to First Hawaiian Bank*

Thanks to a brightening national economic picture, Hawaii's economy is gathering a head of steam as it moves into 2014. The years of bouncing along the bottom appear to be over, at least for awhile. 2013 will mark the year that Hawaii entered a new growth phase of the latest business cycle. Until now, as Chart 1 shows, the prior peak had been 2008 when real GDP for the state reached $60 billion. We are expected to exceed this in 2013.

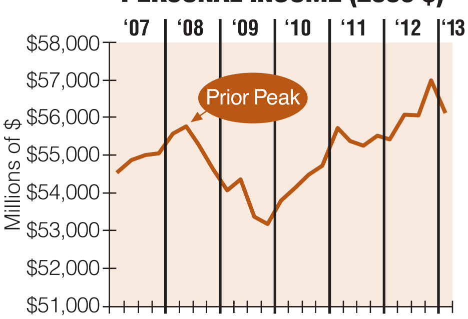
CHART 1 • HAWAII REAL GDP (2008=100%)



Source: Fed. Res. Bank St. Louis & Hawaii DBEDT

This pattern is confirmed by inflation-adjusted state personal income data (Chart 2) that also peaked in the first half of 2008. Since the second half of 2012 we have been above that prior maximum.

CHART 2 • HAWAII REAL PERSONAL INCOME (2008 $)

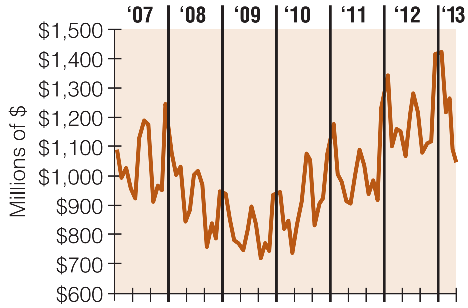


Source: U.S. Bureau of Economic Analysis

Not surprisingly, the visitor industry has been the engine of growth for Hawaii's economy. Visitor arrivals bottomed out in mid-2009 and have experienced a strong comeback since then except for a hiccup in 2011. Current arrival numbers put us on a pace to exceed 2012's record. Meanwhile, visitor spending (Chart 3) is also trending upward at even a stronger clip.

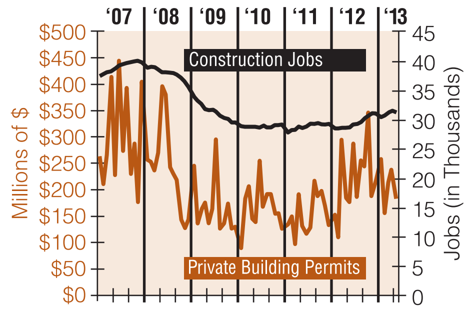
Historically, the construction industry has also been an important source of growth. However, in order to prosper, the construction industry requires a good underlying economy. Hence, it tends to lag the overall economy. But even here we see signs of strength. Building permits (Chart 4) are starting to trend upwards and construction jobs are up 4,000 from the trough. As a result, the state construction tax base (Chart 5) is once again showing growth after two years of shrinking.

CHART 3 • STATEWIDE VISITOR SPENDING (MILLIONS OF $)



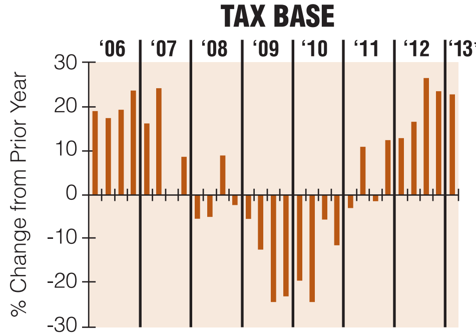
Source: State of Hawaii, DBEDT

CHART 4 • STATE CONSTRUCTION



Source: County building departments via state DBEDT

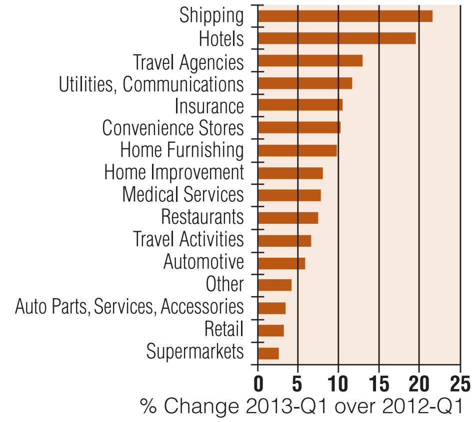
CHART 5 • STATE CONTRACTING TAX BASE



*1st Qtr. 2013 Source: Hawaii State Dept. of Taxation

The improving economy is reflected in merchants' credit card activity as monitored by First Hawaiian Bank's Business Activities Report (Chart 6), published quarterly. Leading the growth in the last year are hotels and shipping. Nearly all sectors are experiencing 5% or more growth.

CHART 6 • FIRST HAWAIIAN BANK BUSINESS ACTIVITY INDEX

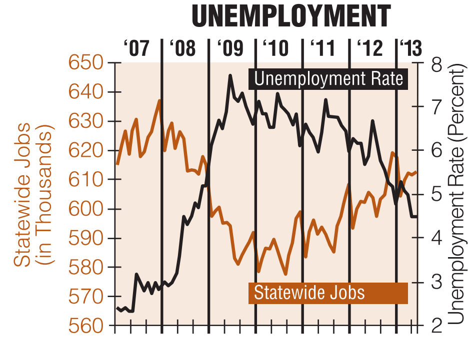


Source: First Hawaiian Bank

The labor market (Chart 7) has benefited from the economic strength. Labor is always a lagging statistic and so improvement in labor conditions usually starts only after the economy is on firm footing. Total state jobs are up by 35,000 since their nadir in 2010, and the unemployment rate has decreased to 4.5%, much better than the 7.7% peak but still above the pre-recession levels of less than 3%.

The improvements in the job market have been uneven. Most of the growth has been in the visitor-related sectors. Likewise, growth across the state's counties has not been uniform. Oahu was impacted the least by the contractions in the job market and has now returned within 4% of the peak employment at the end of 2007. All the neighbor islands had more serious fall-offs in employment ranging up to 12% of total jobs. Their recovery has been generally steady but also slower. Maui has done the best and has recovered to 95% of its peak employment. Hawaii Island still has a 7% gap and Kauai 8%.

CHART 7 • STATE JOBS & UNEMPLOYMENT



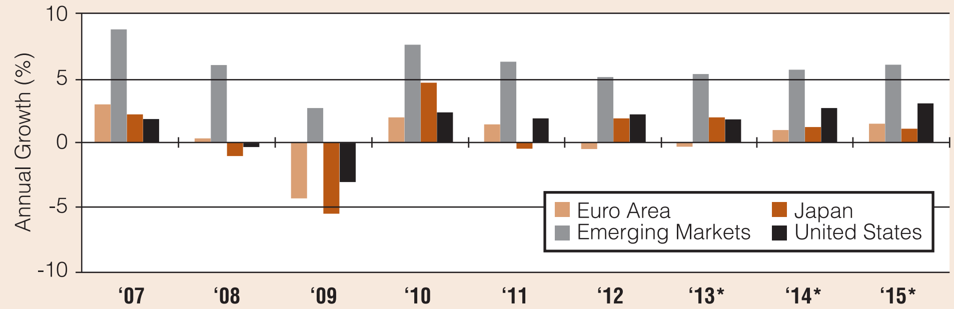
Source: Hawaii Department of Labor & Industrial Relations via state DBEDT

World Growth Trends Moderating: U.S., Global Outlook for 2013-14

By Dr. Ken Miller, CFA, *Chief Investment Strategist & Director of Investment Services, First Hawaiian Bank*

Global growth is forecast to be 3.1% in 2013, in line with 2012 but down from 3.9% in 2011 due to slower growth in key emerging market economies and a prolonged recession in the euro area. Emerging markets (Chart 1) are still growing considerably faster than advanced economies, but are experiencing lower domestic demand, capital outflows, and currency depreciation. There is considerable uncertainty about growth in Japan. World output should increase slightly in 2014 as the euro area exits recession, U.S. growth firms, and emerging markets stabilize. In the U.S., tax hikes and the sequester are producing a strong fiscal headwind which should ease in 2014.

CHART 1 • WORLD ECONOMIC GROWTH FORECAST



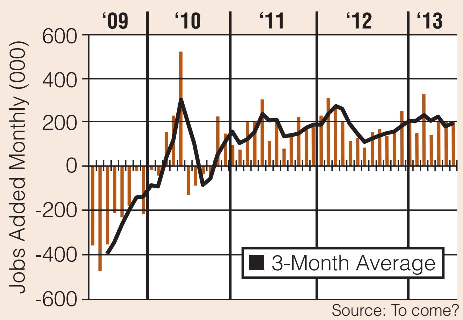
*2013 is an estimate; 2014 and 2015 are forecasts.
Source: International Monetary Fund, Dr. Jack Suyderhoud

Jobs: Slow, Steady Improvement

The jobs market (Chart 2) is improving slowly but steadily with about 200,000 jobs being added per month. An estimated 8.7 million jobs were lost as a result of the Great Recession. Over the past three years about 6.6 million jobs have been regained, leaving the U.S. with 2.1 million fewer jobs than at the prior peak despite the growth in population. In addition, a disproportionate share of the growth has been in relatively low-paying and part-time jobs.

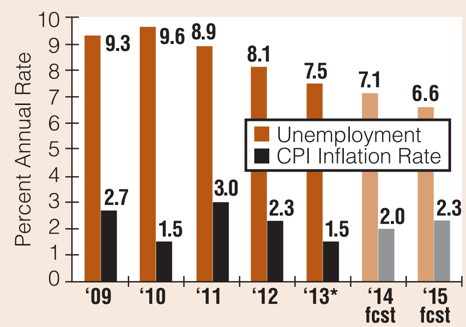
The headline unemployment rate (Chart 3) has fallen, but partly due to discouraged job-seekers leaving the labor force. A wider measure of unemployment including discouraged and involuntary part-time workers hovers at 14.3%. With improved labor market conditions, workers should reenter the labor force, which will temper the fall in the unemployment rate.

CHART 2 • MONTHLY CHANGE IN PAYROLLS, 2009-13



Source: To come?

CHART 3 • FORECAST UNEMPLOYMENT AND INFLATION

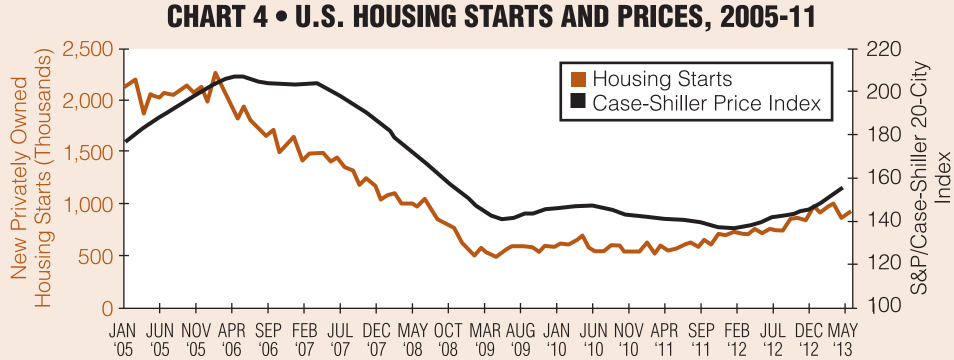


Source: Federal Reserve Bank of St. Louis and Dr. Suyderhoud's Forecasts

Inflation: Well Controlled

Inflation (also Chart 3) remains well below the Fed's target of 2%. However, there appear to be transient factors pushing down prices, and some mild reacceleration of inflation is expected. Longer term, expansion of the money supply raises the risk of inflation, but even 10-year inflation expectations remain low.

CHART 4 • U.S. HOUSING STARTS AND PRICES, 2005-11



Source: Federal Reserve Bank of St. Louis

Housing Market Recovering

A key positive going forward is the recovery in the housing market (Chart 4), an important cyclical economic sector and as well as a driver of household net worth and consumer confidence. Nationwide home prices troughed about 18 months ago. Rising home prices are gradually reducing the number of homeowners "underwater" on their mortgages. New construction is also up sharply although still well below peak levels.

The Reliable Consumer

U.S. consumers have for the most part maintained their buying behavior through thick and thin (Chart 5, black line, at the top of page 8). However, part of the growth in consumption has been fueled by a fall in the savings rate from over 6% in early 2009 to under 3% this year. Consumer confidence (Chart 5, red line) is as high as it has been since the financial crisis, which bodes well for consumption spending going forward.

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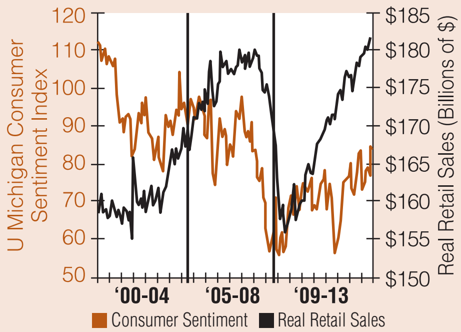
U.S., Global Outlook for 2013-14

(continued from page 7)

CHART 5 • CONSUMER SENTIMENT AND REAL RETAIL SALES (MONTHLY '09-'13)



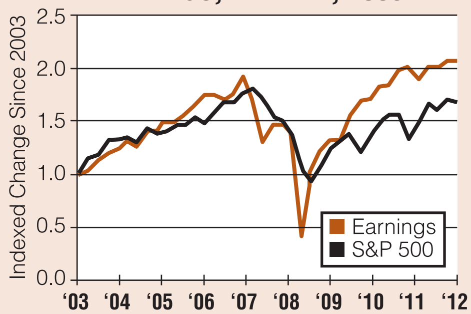
Source: Federal Reserve Bank of St. Louis and Bloomberg

Is the Recovery "Artificial"?

There is widespread agreement that excessive debt, the popping of the housing bubble, and the subsequent financial crisis were the causes of the Great Recession, but there is less agreement on why the recovery has been so painfully slow. Some pin the blame squarely on "supply side" factors such as excessive regulations, Obamacare, and uncertainty about future taxes, which, it is argued, hold back hiring and business investment. This view also argues that any recovery so far has been largely artificial, fueled by government borrowing and ultra-low interest rates. Others say the main problem faced by businesses is a lack of consumer demand. They note that real economic activity usually takes a long time to recover after a financial crisis, due to consumers paying down debt and tighter credit conditions. It certainly appears that the current recovery fits this pattern. The corollary of this more expansive view of the economy is that a real recovery is underway, which should accelerate as economic headwinds begin to fade.

Despite the sluggish recovery, the stock market has reached record highs. To some market observers the cause of this apparent disconnect is, once again, the Fed. In this view, the stock market is being fuelled by low interest rates and an expansion in the money supply. There are, however, other factors. First, some portion of the market recovery must owe to a failure of worst-case scenarios to materialize. Second, stock

CHART 6 • STOCK PRICES VS. EARNINGS, INDEXED, 2003-12



Source: Standard & Poors

prices are ultimately determined by profits, which grew spectacularly in the early years of the recovery and are still positive (see Chart 6). Third, stock prices also reflect a collective view of future economic growth.

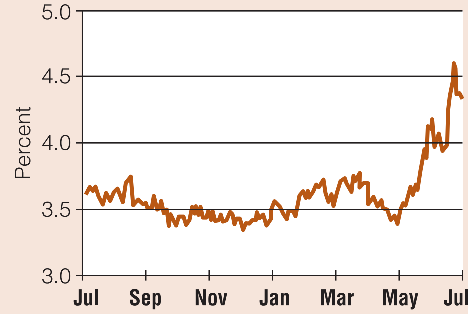
Monetary Policy: While there are other reasons for the recovery beyond government/Fed interventions, it is obvious that the eventual "tapering" of quantitative easing presents considerable risk to the market and the real economy. Stock and especially bond markets swooned in June when Fed Chairman Ben Bernanke laid out a potential time line for winding down Fed bond purchases, showing how sensitive markets are to the future course of monetary policy.

Although he stressed that "the taper" was dependent on continued improvement in the economy, and that higher short-term rates would only follow much later, the market has moved up expectations for a first rate hike to 2014. This may be an overreaction, as the Fed has clarified that reaching its 6.5% unemployment target will not automatically lead to a rate hike. For monetary policy, however, perception is everything, and the Fed has shown it is not completely in control of the message that investors receive.

The very sharp rise in interest rates in June could not have been the Fed's intention, and shows how market risks can spill over to impact the real economy. It does not appear that the recent increase in interest rates will be enough to derail the recovery but the jump in mortgage rates, for example, is worrisome (see Chart 7).

Market Outlook: The outlook for financial asset prices is, as always,

CHART 7 • MORTAGE RATES, JULY 2012-JULY 2013



Source: bankrate.com

subject to considerable uncertainty, particularly in the near term. At least we can confidently predict that market volatility will be elevated as investors try to gauge the timing and impact of the wind-down of monetary stimulus. Both the real economy and the stock market owe their resurgence to much more than Fed policy. Therefore both should be able to withstand the withdrawal of monetary accommodation, particularly as such a shift is likely to happen only when economic fundamentals strengthen. The investment implication is that tighter monetary conditions present a risk to the stock market but do not negate the positive long-term outlook.

It is hard to foresee any more than minimal returns for bonds, whose principal value will be eroded sooner or later by higher interest rates. However, notwithstanding the recent sharp rise in rates, bond price rationally reflect continuation of low short-term rates for the next several years, and thus are not, in our view, in a bubble.

Perhaps the surest prediction one can make regarding the markets is that returns generally will be lower than over the past 30 years. Total return from bonds is likely to be in line with current miniscule yields (or lower) — say 3% for the broad bond market. Meanwhile stocks, hit by two historic bear markets in a decade, are unlikely to see prices rise faster than earnings as they did in the 1980s/90s, which experienced a huge expansion in valuation ratios. A reasonable estimate for stocks is that prices will rise in line with earnings growth of approximately 5%, plus a 2% dividend yield for a total return of about 7%.