Economic Forecast

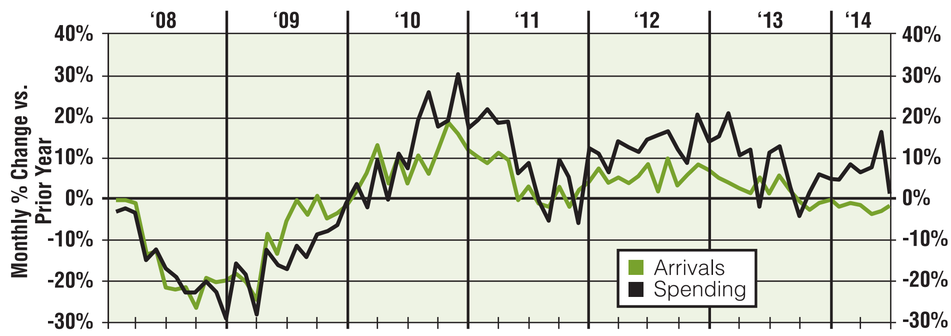
MAUI EDITION 2014 - 2015

Tourism Sputters, But Outlook Remains Positive

Maui's tourism boom began slowing in late 2013 and an anticipated construction rebound has yet to make up for it. Yet, there are reasons for hope on Maui as job creation continues and the real estate market remains firm.

Locally focused retailing remains positive and the apparent commitment of airlines to provide more seat capacity is encouraging. The recovery continues, but it has not been consistent over time and across sectors. "Choppy" may be the watchword on Maui for the next year.

CHART 2 • CHANGE IN MAUI ARRIVALS, SPENDING, 2008-2014



Source: Hawaii Tourism Authority via Hawaii DBEDT

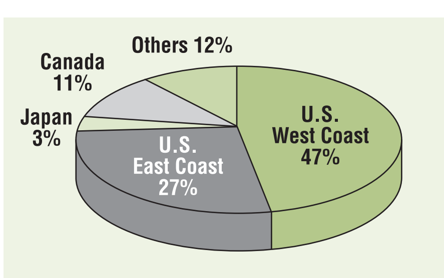
Tourism

The visitor industry continues to be the largest driver of Maui's economy, directly or indirectly accounting for about 40% of the county's GDP — higher than any other county of the state.

Visitor Arrivals: Maui County remains largely dependent on visitors from the U.S. West and East coasts as well as Canadian tourists. Together, they account for 85% of the visitor arrivals to Maui. (Chart 1)

Disclosure by the Hawaii Tourism Authority of possible errors in their data makes trend analysis problematic. However, we can say that 2013 started with strong arrivals, but the arrival count turned down in the last four months of the year. Despite that dip, full-year arrivals were 2.4 million, up 2% from 2012, and nearly equal to the pre-recession peaks of 2006 and 2007. (Chart 2.) 2014 arrivals have been choppy with the first three months showing negative growth followed by good April and May numbers. Through the first half of the year the 2014 arrivals are even with the prior year period.

CHART 1 • MAUI VISITOR ARRIVALS BY MARKET AREA, 2013



Source: Hawaii Tourism Authority via Hawaii DBEDT

Visitor Spending: Spending tends to follow arrival patterns. Maui benefited from double-digit spending growth for most of the 2010-2012 period, but this started to slow in 2013 and early 2014.

Maui Island's per-person daily spending ($196 as of 2013) is above the statewide average but somewhat lower than that on Oahu. This is due in part to lodging choices. Unlike Oahu, visitors to Maui are more likely to stay in alternatives to hotels such as time-shares.

Consistent with what many people suspect, the composition of spending has changed over time — more money for lodging and, to a lesser extent food and beverage, but less on other things, including activities.

Visitor Retailing: The slowdown in visitor spending has affected retailers. Whalers Village estimates 2014 sales to be up by 3% over 2013, but shoppers are very careful about their outlays. The Outlets of Maui are expanding space even if sales have not been as robust as hoped for. The Shops at Wailea seem to be doing modestly better. In all cases, higher labor costs created by a tightening labor market and the new minimum wage law will be a challenge to all retailers.

Visitor Outlook: In spite of the slowdown in recent months, industry insiders seem optimistic about the future despite strong competition from traditional sources such as Mexico and the Caribbean. In addition, international travelers, especially those from Asia, are finding alternatives such as Dubai and the Maldives. The Maui

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ON THE INSIDE

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)*

Visitors Bureau and Maui County government have launched initiatives to market Maui in Korea and Oceania.

New inventory has come on line with the opening of the Andaz at Wailea and the Montage at Kapalua and completion of the Westin's $60-million renovations at Kaanapali. Hyatt's 130 time-share units will be added at the end of 2014 or early 2015, with construction costs of about $100 million. The increased supply will perhaps create price competition.

Looking longer term, A&B's Piilani suites at Wailea, the recently approved Makena resort renovations, as well as the ongoing renovations and plans for Pulama Lanai are indicative of longer-term investor confidence in Maui tourism.

Key to short-term success is airlift, both from Honolulu and direct flights. Here the news has been relatively good. Kahului is the only airport in the state to see positive changes in both domestic and international seat growth in 2014. (Chart 3) The Hawaii Tourism Authority expects this trend to continue through the summer of 2014. For example, Hawaiian has added 2 daily flights between Los Angeles and Kahului. Likewise, Island Air's resurgence and Hawaiian's new Ohana service will add Honolulu/Maui capacity.

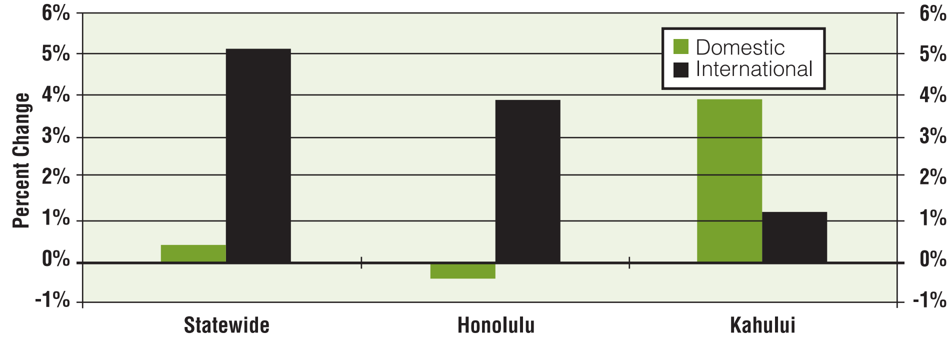
In the long run, Maui's desire to attract more international visitors will require physical and regulatory infrastructure. Right now the only international flights landing are from Canada, where passengers clear U.S immigration at the point of origin. Maui tourism and government leaders are working hard to establish immigration and customs capacity on Maui.

Overall, while the first half of 2014 has seen mixed visitor numbers, there are reasons to be hopeful for the rest of 2014 and 2015.

Jobs, Unemployment and Retailing

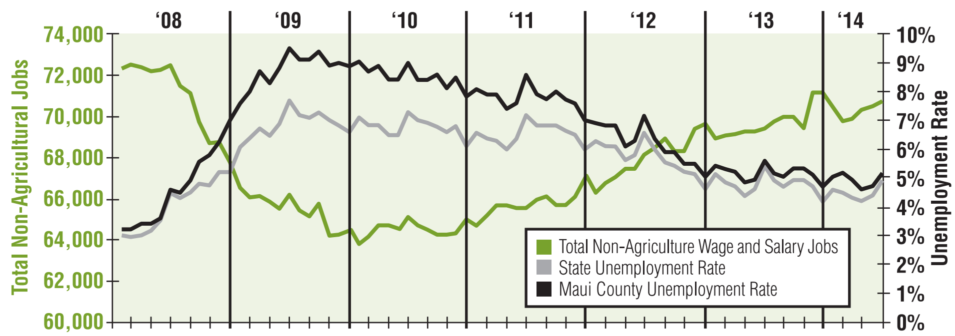
The strength of tourism up to late 2013 helped improve the Maui labor market. As seen in Chart 4, Maui lost about 10,000 jobs as a result of the Great Recession. About two-thirds of

CHART 3 • AIRLINE SEATS, YTD MAY 2014 OVER SAME PERIOD 2013



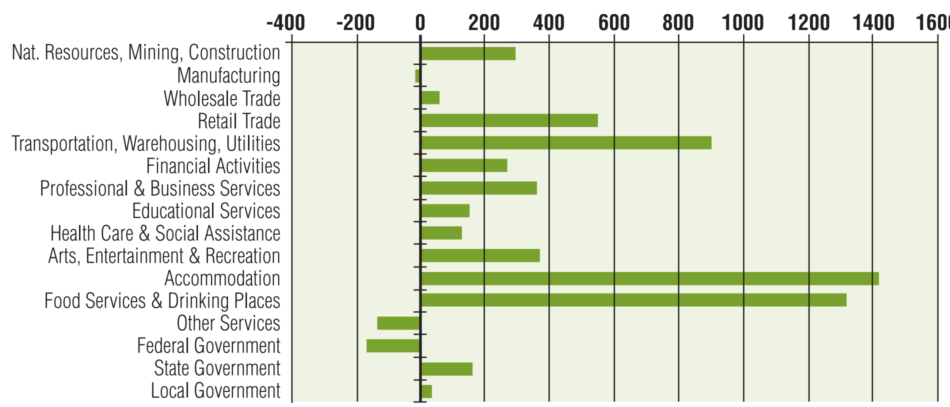
Source: Hawaii Tourism Authority Visitor Statistics

CHART 4 • MAUI COUNTY JOBS AND UNEMPLOYMENT, 2008-2014



Source: Hawaii State Department of Labor via DBEDT

CHART 5 • NUMBER OF NEW MAUI JOBS, 2010 TO 2014



Source: Hawaii State Department of Labor via DBEDT

those have returned. Maui's unemployment rate has followed the state's improving trend to 5%.

However, job creation (Chart 5) has been uneven across sectors of the economy. Tourism related jobs such as hotels and restaurants have seen the most growth in job counts. Federal government and some service jobs have actually declined.

Job growth has not been so strong as to cause businesses to worry about being able to hire and retain qualified staff. In my discussions with employers there are some concerns about worker's being able to get from where they can afford to live to where the jobs are.

As jobs grow, consumer confidence rebounds, translating into higher retail spending. For example, Queen Kaahumanu Center, with a predominantly local customer base, reports greater foot traffic and revenues up 3-4% this year. New retail capacity aimed at the local market includes a new Target store on A&B property and a new Foodland at

Kehalani. Along with the recently opened Safeway these will afford consumers more choices. Equally important is that they signal investor and developer confidence in the future of Maui retailing.

Electricity Sales

One important trend on Maui has been the changing nature of electrical energy generation and distribution. A significant amount of MECO'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 co-generation.

Encouraged by generous tax credits, solar installations (Chart 6, green line) increased dramatically in 2011 and 2012. This seems to have leveled off in 2013. The down side for MECO is that their sales (Chart 7) have declined and are expected to do so again in 2014 and 2015 in spite of higher customer counts.

The windmills on the ridge over Maalaea and on Ulapalakua Ranch lands, and the $30-million Smart Grid project by Hitachi and the Japanese government, are all tangible evidence that Maui is on the forefront of changing electricity generation and use.

Construction and Development

Last year we had hoped a construction rebound would help offset the deceleration in tourism. Unfortunately, this has yet to occur. As shown in Chart 8, construction permits (green line presented as a 6-month moving average), have shown some growth since the depth of 2010. However, growth has not been steady. Construction jobs (black line) were down by 2,700 from the peak of 2007 to the trough of 2010. We have recovered only 800 of those.

Part of the problem is the lack of residential construction. Some things are happening in this sector. The Parkways at Maui Lani have begun construction, and sales have been brisk. A&B has made it to the list to receive water meter permits for its Haliimaile project. A&B is also developing 600 single- and multiple-family units at

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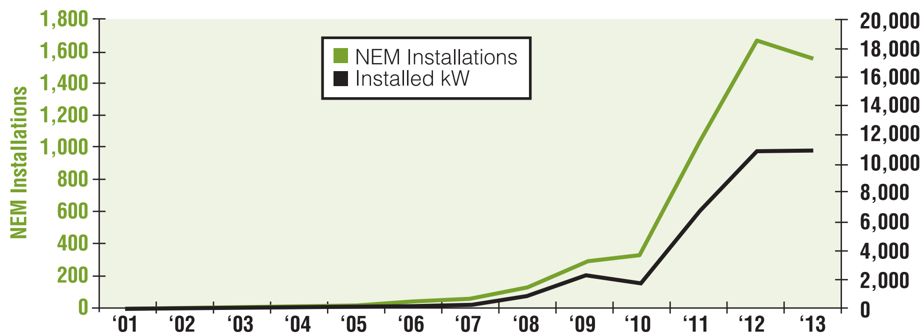
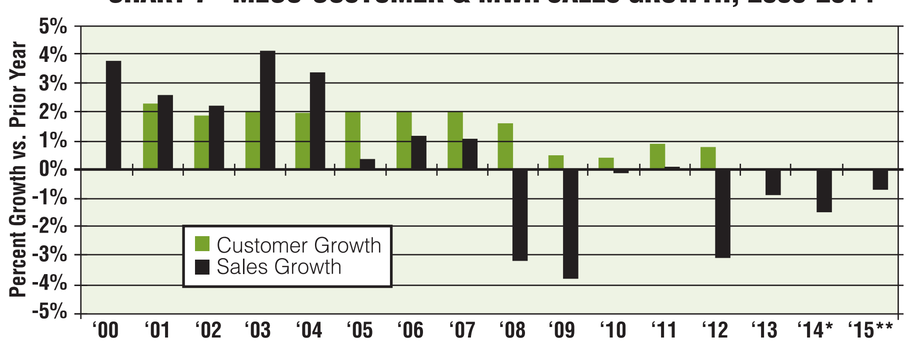
CHART 6 • GROWTH OF PHOTOVOLTAIC INSTALLATIONS, 2001-2013



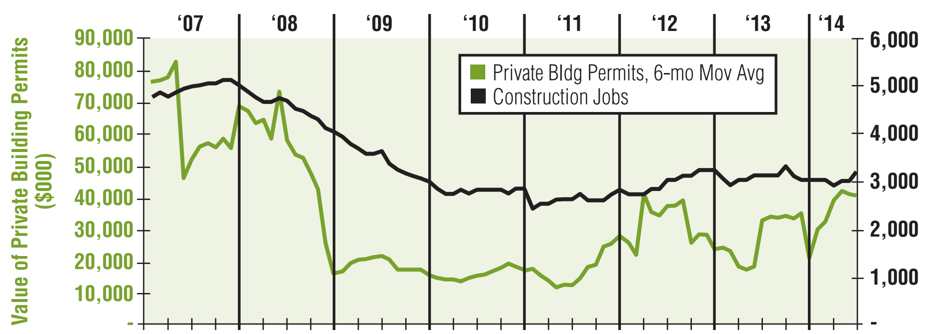
Source: PUC and Maui Electric Co.

CHART 7 • MECO CUSTOMER & MWH SALES GROWTH, 2000-2014



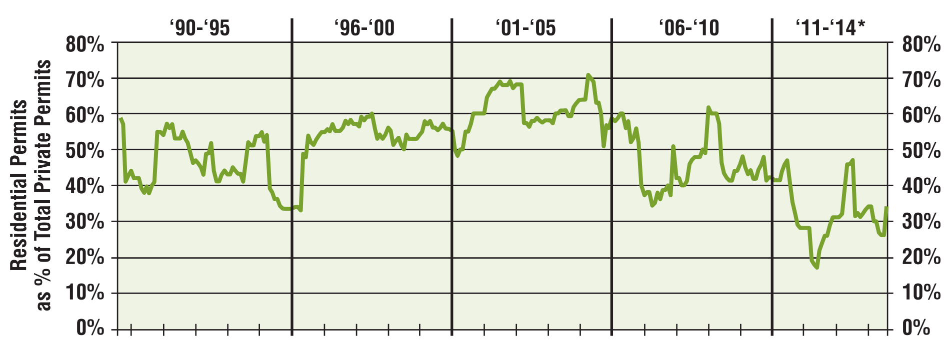
*Estimate **Forecast
Source: PUC and Maui Electric Co.

CHART 8 • MAUI CONSTRUCTION ACTIVITY, 2007-2014



Source: Maui County Building Department via DBEDT

CHART 9 • RESIDENTIAL PERMITS AS % OF TOTAL PRIVATE PERMITS



* 2014 YTD through June
Source: Maui County Building Department via DBEDT

Maui County *(continued from page 3)*

Kihei. Some additional units are being built at Kahoma, west Maui and Waikapu.

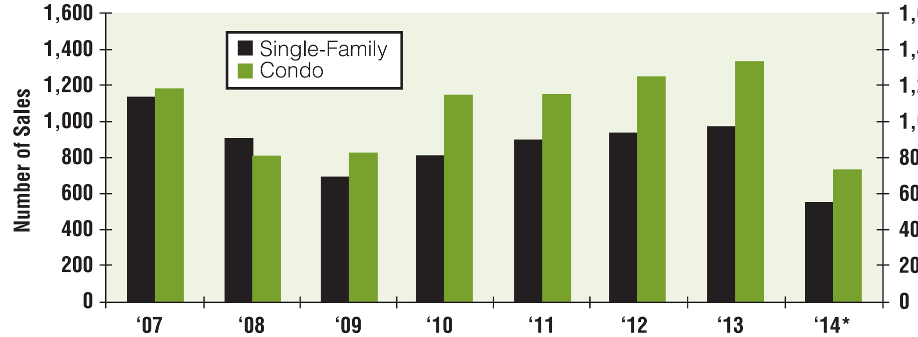
However, regulatory hurdles have, over time, prevented more housing from being built. Chart 9 (on previous page) shows that the value of residential permits as a percentage of all permits has declined from about 60% ten years ago to 30% today. When it takes 7-10 years for new projects to get entitlements, it can't help but slow housing construction.

Infrastructure: The strength in construction remains public infrastructure. The new airport access road has begun and is budgeted for $53 million. The airport's new centralized rental car facility, estimated to be a $250-million project, will be under way this fall. Long overdue restroom improvements at the airport are progressing in phases. Runway resurfacing at $3.2 million was planned to start in July. Other airport improvements, roofs, the PA system, and fire sprinklers will run $7 million and are getting under way late summer. All Maui County airports are also getting new, more efficient lighting to the tune of $60 million.

Phase 3 of the Lahaina by-pass road has begun design work and Kihei high school will involve more than $130 million in construction.

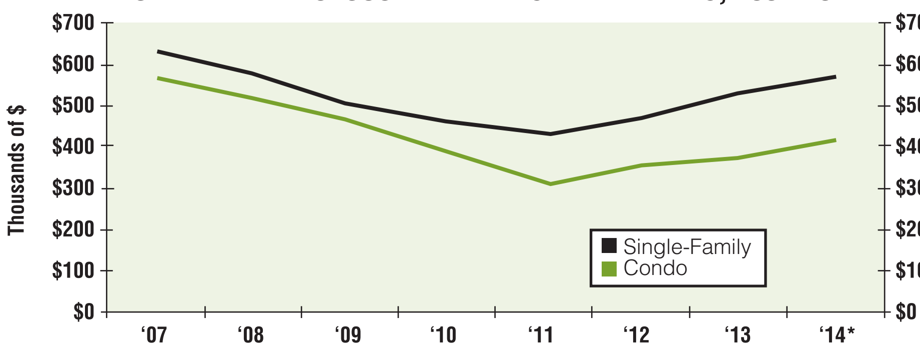
Commercial Development: Commercial development and construction has been good, but less robust than we had hoped for last year. A&B's Maui Business Park has benefited from the opening of Ho'okele Street and Costco's gas station. Their initial increment of 70 acres of fee-simple commercial lots is on the market. Likewise, Maui Lani is selling fee-simple commercial space and developing their Village Center. These spaces are meeting an important need for small businesses.

CHART 10 • MAUI COUNTY REAL ESTATE SALES, 2007-2014



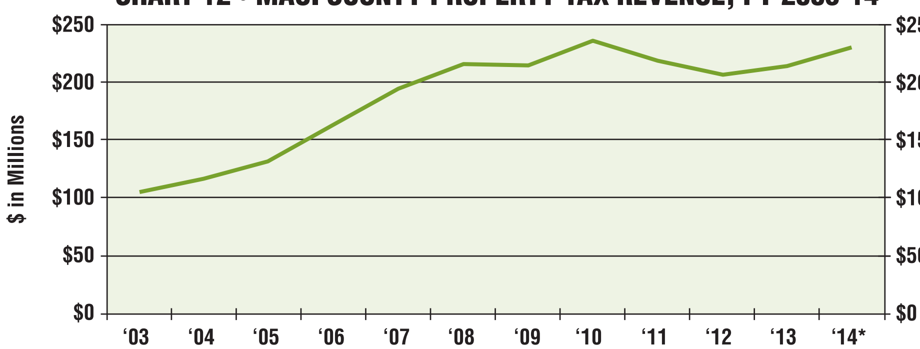
*2014 YTD through July
Source: Realtors Association of Maui

CHART 11 • MAUI COUNTY REAL ESTATE MEDIANS, 2007-2014



*2014 YTD through July
Source: Realtors Association of Maui

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



*2014 Estimate
Source: County of Maui

Real Estate

When combined with job growth and a still-favorable interest rate environment, the lack of residential construction creates a supply-demand imbalance in the housing market. As a result, Chart 10 shows sales activity for condominiums is now above the 2007 peak. Single-family units sold are not there yet, largely due to a lack of inventory.

Median prices are reflecting the economic realities as single-family prices are now basically back to their pre-recession levels (Chart 11.) Condominium prices still have a ways to go before recovering completely.

As reported by the Realtors Association of Maui, foreclosures and short sales accounted for 45% of all transactions in 2011 and have since declined to less than 15% in 2014. This cannot but help firm up an already robust market.

County of Maui

Improving property values and assessed valuations have helped County of Maui government finances. Property tax collections (Chart 12) were up in fiscal year 2013 and expected to be $16 million higher for fiscal 2014. Higher assessments have allowed the County to lower rates while maintaining revenue increases.

Road maintenance has been moved from a 50-year cycle to 20-25 years with outlays averaging $30 million per year. The Kihei Police Station was completed at a cost of $33 million and the South

Maui gym and multi-purpose center is expected to cost $16.6 million. Additional projects include $14 million for the flume at Waikamoi and $20 million for planned wastewater recycling. The County is also involved in affordable and senior housing at Kihei, Kula, and Lanai.

Some Specific Economic Drivers

Maui is fortunate to have some economic drivers other than tourism that contribute significantly to the island's economy:

HC&S: HC&S is an important component to the Maui economy with about 800 employees. The four-year trend of increasing HC&S production seems to have come to an end. (Chart 13.) According to General Manager Rick Volner, the decline was largely weather related as more rains caused the crop to mature later in the harvesting year. Recent rulings on water use mean HC&S can take less surface water and must rely more on pumped sources, increasing costs and leaving less electricity to sell to the grid.

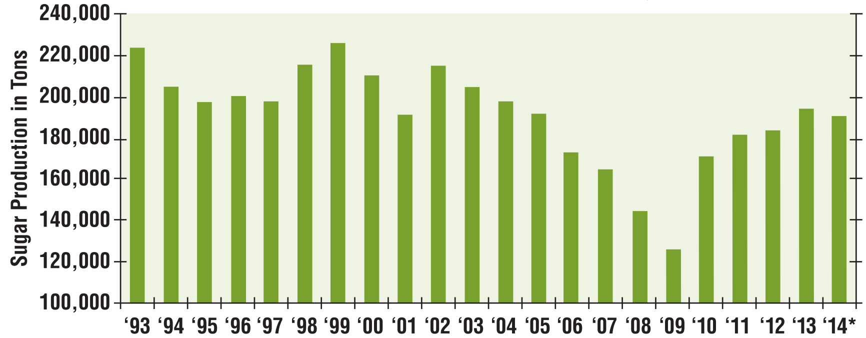
Sugar prices are up in 2014 due to rulings by the U.S. International Trade Commission that Mexico was dumping sugar in the U.S. market. However, most of the 2014 revenues are based on forward contracts that were inked in 2013 when prices were down.

The passage of the U.S. national farm bill has reduced some of the uncertainties faced by HC&S, yet it remains a vulnerable part of Maui's economy.

Other Agriculture: According to U.S. Department of Agriculture statistics, as of 2012, Maui County had 230,000 acres of farmland. Of that, about 35,000 is in sugar cane and 7,000 in other crops. In other words, there is no shortage of agricultural lands.

The seed corn industry has diversified Maui County's economy. Monsanto farms about 1,900 acres on Maui and Molokai. They have 540 employees with an annual payroll of $17.8 million. Cumulatively they have invested $100 million in Maui County. Dow Agro Sciences employs another 100 employees on Molokai. Seed companies have

CHART 13 • HC&S SUGAR PRODUCTION, 1993-2014



*Forecast Source: HC&S

other benefits. They purchase supplies and services from local vendors, maintaining a distribution channel that other farmers can tap into. Without the activity created by seed corn, those channels would either not be there or costs would be much higher.

The seed corn industry is in here because growing conditions allow the companies to bring products to market with shorter lags. Yet the industry faces strong resistance from parts of the community who fear their products and production techniques. The basis for the fears is controversial. What is not controversial is that if Maui loses this part of its economic base it will be impossible to replace in the near future, and there will be significant adverse economic impacts on both Maui and Molokai.

Haleakala Observatory and Maui Research and Technology Park: According to the UH Institute for Astronomy the annual operating budget of Haleakala's eight observatory facilities is $40.4 million, supporting 167 county-based staff. This number is down due to reductions in Federal spending and employment.

The new Advanced Technology Solar Telescope, renamed as the Daniel K. Inouye Solar Telescope (DKIST), is a $340-million project with a 2019 completion date. It is estimated that local contractors will be paid $29.5 million for local labor and materials during site preparation and basic building construction. Another $49 million will be spent on Maui for construction and/or assembly of the telescope enclosure. As many as 30 project employees will be working on Maui with a payroll of $30 million. 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. Uncertainties with the management contract for the super computer are being resolved and should allow the center to stay. Sequestration and budget cuts have slowed prospects for the Pacific Joint Information Technology Center that supports Defense Department medical readiness requirements and IT modernization.

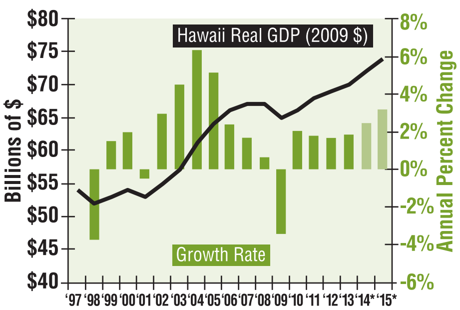
UH Maui College has grown and matured under Chancellor Clyde Sakamoto, who will retire this fall. More than 90% of the students come from Maui County. Enrollment remains at about 4,000, with 500-600 in bachelor's programs, and these numbers are not expected to increase significantly in the next few years.

The Daniel K. Inouye Allied Health Center will be completed by the end of 2014 with 18 operatories and at a cost of $4.5 million. It is likely that the $3.5 million for renovations of student housing and creating a teaching hotel will be underway this fall. A $4-million food innovation center is under design now. The Molokai Education Center has acquired an additional three acres and they are looking for additional monies to leverage $1.2 million already available for expansion. UHMC is also working with Pulama Lanai to provide workforce development in support of developments on that island.

State Growth Continuing Despite Erratic Tourism, Lackluster Construction

2015 will mark the fifth year of Hawaii's economic expansion post-Great Recession. State GDP (Chart 1) in 2009-dollar values is expected to be a record $72 billion in 2014 with growth accelerating into 2015. This growth has occurred in spite of sputtering tourism patterns and a frustratingly slow pick up in the construction cycle.

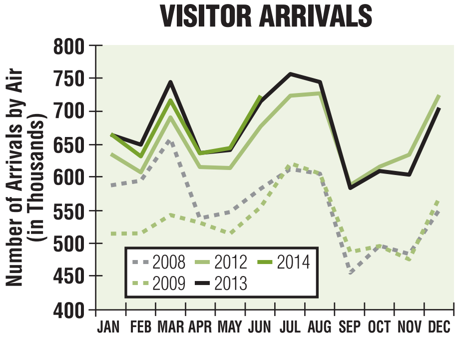
CHART 1• HAWAII GDP GROWTH



*2014, 2015 Estimates
Source: U.S. Bureau of Economic Analysis and author's forecast

Tourism remains the prime driver of Hawaii's economy. Visitor arrivals bottomed out in mid-2009 and experienced a strong comeback until late 2013. (Chart 2.) At that time arrivals slowed and turned negative for several months. Nevertheless, 2013 was a record year with over 8 million arrivals. So far, 2014 has struggled to keep up with that pace. Meanwhile, inflation-adjusted visitor spending after several very good years started slowing in 2012 and has remained flat since.

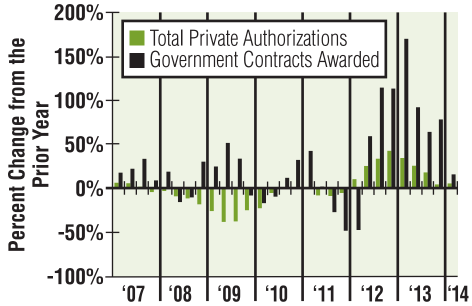
CHART 2 • STATEWIDE MONTHLY VISITOR ARRIVALS



Source: Hawaii Tourism Authority via DBEDT

It was hoped that the construction industry would make up for much of the tourism lull, but this has only partially materialized. Construction job growth stalled in 2013-14. Of the 12,000 jobs lost in this sector due to the recession,

CHART 3 • STATEWIDE CONSTRUCTION PERMITS (4-QTR MOVING AVE.)

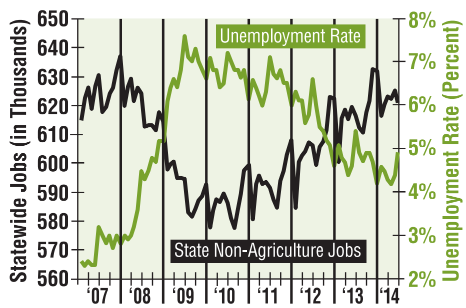


Source: DBEDT

only 2,800 have returned. Nevertheless, both private and government permit growth remain positive pointing to greater construction activity in the second half of 2014 and into 2015. (Chart 3.)

The overall Hawaii labor market has benefited from the prior momentum of tourism and the underlying economic strength in other sectors. Total state jobs are up by over 43,000 since their nadir in 2010, and the unemployment rate has decreased to less than 5%. (Chart 4.)

CHART 4 • STATE JOBS AND UNEMPLOYMENT

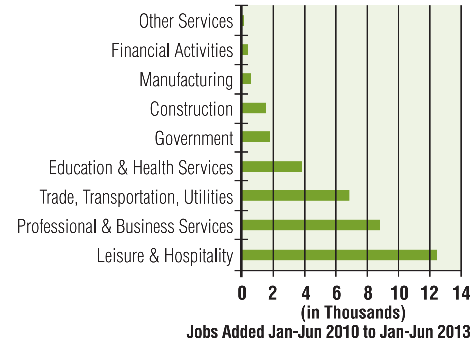


Source: DBEDT & U.S. Dept. of Labor Statistics

The gains in jobs have been uneven. Most of the growth has been in the visitor-related sectors. (Chart 5.) Likewise, the 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 2% of the peak employment at the end of 2007. (Chart 6.) The Neighbor Islands had more serious fall-offs in employment ranging up to 12% of total jobs and their recovery has taken longer.

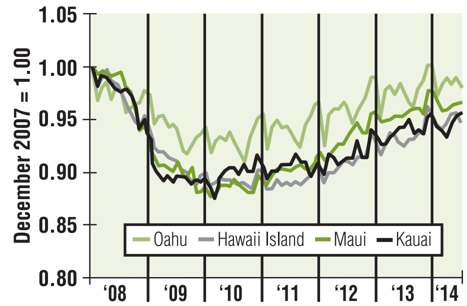
In spite of improving incomes and increased spending, Hawaii State government tax revenues have hit the skids after some great years. Starting in

CHART 5 • HAWAII JOB INCREASES BY SECTOR



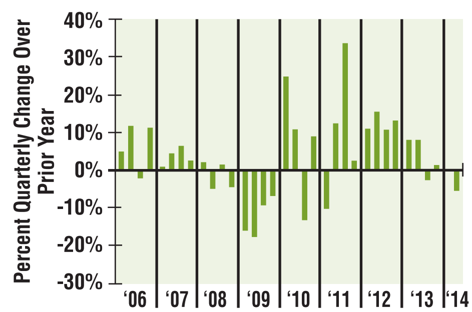
Source: DBEDT

CHART 6 • JOB PATTERNS SINCE 2008



Source: DBEDT

CHART 7 • STATE GENERAL FUND REVENUE GROWTH



Source: Hawaii State Department of Taxation

2013, general fund revenue growth turned negative. (Chart 7.) Declines in collections of the State's leading source of revenues, the General Excise Tax, is the primary reason for this. These trends will make balancing the state budget more difficult, especially given negotiated public worker wage increases.

In sum, despite erratic tourism patterns and slow, but promising, construction spending, the Hawaii state's economy has built some internal momentum so that output, jobs and incomes are expected to expand into 2015.

Getting Back in Sync: U.S., Global Outlook for 2014-15

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

Global Growth Led By Developed Regions

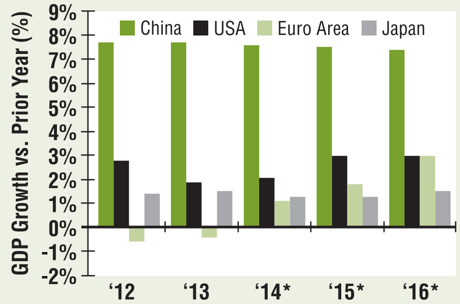
The global economy was buffeted in the first half of the year by harsh weather conditions in the U.S., financial market turbulence in emerging markets, and geopolitical instability in the Ukraine and elsewhere. As a result growth projections for 2014 as a whole have been downgraded, but accelerating growth in the second half of the year should carry over into 2015 and beyond.

The World Bank (Chart 1) forecasts 2.8% world growth in 2014, up from 2.4% last year, and 3.4% and 3.5% growth in 2015 and 2016, respectively. Most of the growth impulse is coming from developed markets, notably the U.S. and the Euro Area, which are benefiting from healing labor markets, release of pent-up demand, and diminished fiscal drag. The Euro Area is in the early stages of recovery and continues to exhibit great imbalances between the core (especially Germany) and the economies of its periphery, some of which remain nearly 10% below pre-crisis peaks. Encouragingly, unemployment rates in Europe are beginning to improve, albeit from very high levels.

Japan's economy is out of sync with the West, reflecting domestic economic policies. Growth in Japan was front loaded this year due to the April sales tax hike, which is now causing fiscal drag and will likely to contribute to softer growth over the near term. Over the medium term, growth will be influenced by the success of structural reforms, but Abenomics seemingly has already accomplished a great deal by reversing the deflationary mindset of Japanese consumers.

Emerging market economies, already growing at close to potential, are seeing a slower pick up in output. China has recently shown some acceleration of industrial output and exports, and is benefiting from a series of governmental growth-supporting measures. However, there remains concern that China's overextended property sector, a major growth driver, is due for a correction as credit conditions tighten.

CHART 1 • GROWTH ACCELERATION



*Forecast Source: World Bank

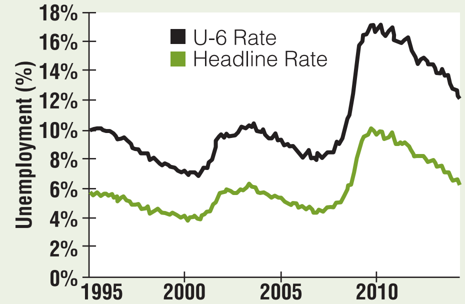
U.S Growth Rebounding

The U.S economic 2.1% (annualized) contraction in the 1st quarter was largely due to extreme weather conditions, diminished inventory growth, and weak demand for exports. Thankfully, growth bounced back to a 4% rate in the second quarter, but overall the economy was sluggish the first half of the year. Headwinds to the economy include diminishing wealth effect from higher asset prices, stabilization in the household savings rate, softening exports, and slower growth in consumer durables and home building. But higher capital expenditure spending and diminished fiscal drag should boost growth. All in all, above-trend growth of about 3% or higher seems quite likely in the second half 2014 and into next year.

The Employment Picture: Looks Can Be Deceiving

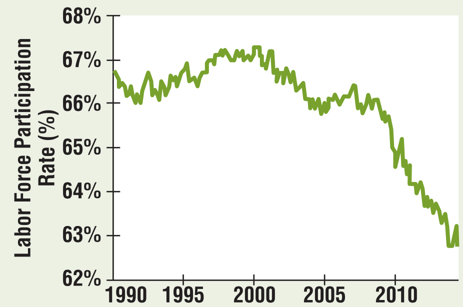
Although job growth has been reasonably steady for the past five years, and quite robust in the first half of 2014, the tremendous damage to the jobs market wrought by the Great Recession is still being felt. It seems that every piece of positive data carries with it some underlying negative counterpoint. For example, by mid-year the headline unemployment rate had fallen to 6.1%, down from a peak of 10%, but a wider measure including discouraged job-seekers and part-timers unable to find full-time work stood at over 12%, higher than the peak associated with the 2001 recession (Chart 2). And while all of the nearly 9 million jobs lost during the Great Recession have now been regained, the composition of the work force has changed, with more jobs in lower-paying sectors and more part-time workers.

CHART 2 • UNEMPLOYMENT STILL HIGH



Source: Bureau of Labor Statistics

CHART 3 • FEWER WORKERS



Source: Bureau of Labor Statistics

It is a myth, however, that job growth since the trough has been entirely due to part-time jobs — the vast majority of added jobs have been full time.

Most concerning, we are still about 6 million jobs short of where we were in 2007, adjusted for population growth, reflecting still-elevated unemployment and a decline in the labor force participation rate (the proportion of the adult population available for work). That rate has generally been falling since 2000 due primarily to retirement of baby boomers, and has dipped sharply since the Great Recession (Chart 3).

It is normal for participation to decline during recessions, but the recent drop has been greater than expected. Since the final quarter of 2007, the labor force participation rate has fallen from 65.9% to 62.8% in the second quarter of 2014, equating to about 7.7 million workers. According to the Congressional Budget Office and other studies, about half the decline is due to aging of the population. The rest reflects a combination of cyclical weakness and structural factors, such as mismatch between labor force skills and employers' needs, or lack of incentives to return to work.

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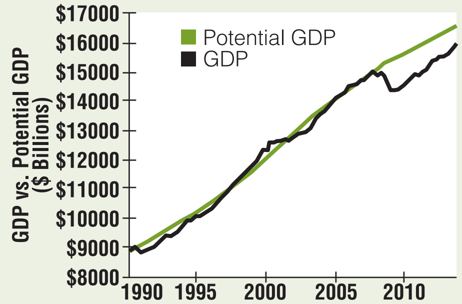
Most policymakers seem to agree that the fate of the long-term unemployed is a key part of the story. Due to eroding skills and the stigma attached to long-term unemployment, such workers have difficulty in finding jobs and frequently stop looking altogether.

Is Inflation Around the Corner?

Headline inflation reached 2.1% in May and June, exceeding the Fed's 2% target for the first time in nearly two years, and raising questions about the Fed's continuing willingness to keep rates low. Yet Fed Chair Janet Yellen has been at pains to point out that the inflation data is "noisy," that the Fed's preferred measure of inflation, core PCE, was only 1.5% in May and June, and that inflation expectations remain well anchored. Moreover, Yellen argues that that there is still plentiful economic slack, precluding a sustained pickup in inflation. There is not universal agreement on this assessment, even within the Fed.

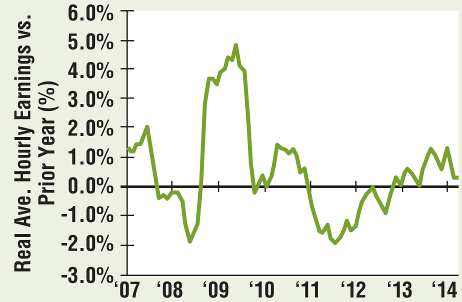
The Congressional Budget Office estimates that economic output is about 5% below potential output at full employment, defined as the highest level of employment achievable without causing inflation (Chart 4). Inflation hawks worry that we are actually quite close to full employment, arguing that many workers who have left the labor force over the past several years will not return. However, there is evidence that quite a bit of underemployment is simply due to a cyclically subdued economy. For example, if a structural mismatch between the skills of the labor force and the needs of employers was a major factor, you would expect to see unemployment rates vary quite a lot by industry. But in fact, unemployment has been remarkable uniform across industries, implying economy-wide cyclical pressures are having an effect. Most tellingly, wage growth has also been virtually absent, both in aggregate (Chart 5) and industry-by-industry. Recently there have been a few indications of nascent wage growth, which the market will be monitoring carefully.

CHART 4 • OUTPUT WELL BELOW POTENTIAL



Source: Bureau of Economic Analysis, CBO

CHART 5 • LITTLE WAGE GROWTH



Source: Bureau of Labor Statistics, BEA

CHART 6 • THE NEW NORMAL: LOW INTEREST RATES PERSIST

Source: Bloomberg

Our view is that there is still considerable economic slack, and therefore that inflation and higher interest rates are still some way off. Further, as the natural course of the economy is to converge with (and frequently overshoot) potential output, we may see several years of above-trend economic growth until the output gap is closed.

Investment Outlook

Markets brushed off troubles at home and abroad to power U.S. stock indexes to new record highs in the first half of the year. At the same time, the wild market swings that were formerly so common largely disappeared, a further sign of investor complacency. It is as if investors were unaware that in the first quarter the U.S. economy had the worst growth performance since WWII outside of a recession, that inflation has accelerated, or that OPEC's second largest oil producer (Iraq) is sinking into chaos. Toward the end of July markets reversed, wiping out much of the year's gains, but stock prices were still quite elevated relative to earnings growth rates. It is likely that markets reflect a reasonable assessment that the domestic economic situation is not as dire as it appears, and that geopolitical concerns, though always unpredictable, remain manageable for a diverse global economy.

Despite higher valuations, geopolitical uncertainties, and disappointing economic growth in the first quarter, the conditions that produced such strong equity returns last year are generally still in place — easy monetary policy with a sluggish but broadening economic recovery. Market corrections are to be expected, but our base-case expectation is that equities will continue to outperform other asset classes over the long term. However, we do not perceive a "bond bubble." There is a disconnect between many market commentators who view sharply higher interest rates as nearly inevitable, and the futures and swap markets, which imply only a modest rise in rates even ten years from now (Chart 6). In our view, rates are not far from "fair value" given weak growth and lack of inflation pressure.