First Hawaiian Bank.

Economic Forecast

HAWAII ISLAND EDITION 2013 - 2014

Tourism Boom is Spreading to Other Economic Sectors

Overall, Hawaii Island's economy is enjoying a rebound after some unpleasant years. Thanks to the statewide tourism boom, the island's economic outlook is better than it has been in the last five years. Both sides of Hawaii Island are experiencing economic expansion, though not all sectors are benefiting uniformly.

The tourism boom will slow down, but its continued strength will spread through the rest of the economy. As economic activity increases there will be more self-sustaining growth and more opportunities for all of Hawaii Island's businesses and residents.

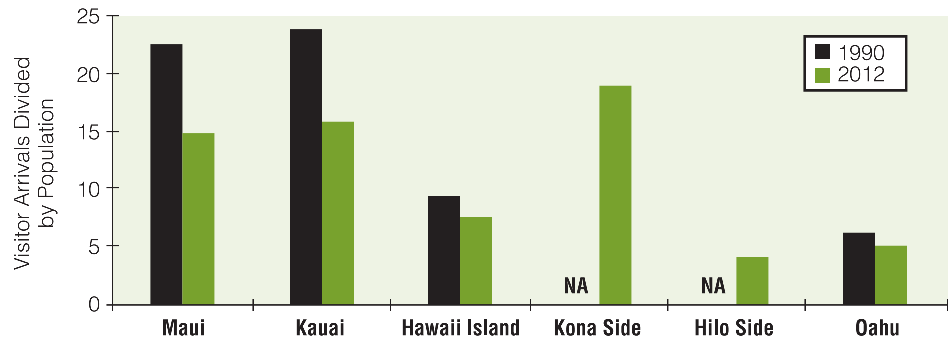
Tourism

Hawaii Island is not as dependent on tourism as Maui or Kauai. Chart 1 shows the annual visitor arrivals divided by the population; the greater this ratio, the more "tourism dependent" the economy. Since 1990, this ratio has been declining for all counties, and Hawaii is the lowest among the three Neighbor Island economies. Yet, this masks the distinct nature of the two sides of the island. As the chart shows, the Kona side is more reliant on tourism than other Neighbor Island markets, while the Hilo side is not at all so.

Hawaii Island is mostly dependent on mainland U.S. tourism. (See Chart 2.) However, among the neighbor islands, Hawaii has proportionately the most foreign tourists, led by Japanese visitors.

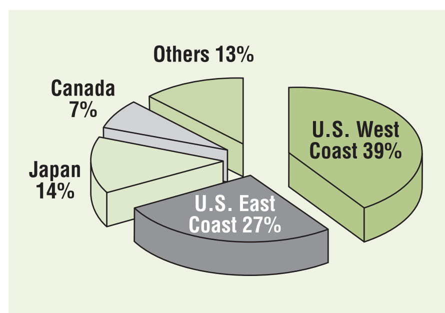
Consistent with other Hawaii markets, Hawaii Island visitor arrivals are trending upward and consistently above the 120,000 per month benchmark from the prior peak. (See Chart 3.) Even international arrivals are showing good increases.

CHART 1 • RELATIVE IMPORTANCE OF TOURISM SECTOR



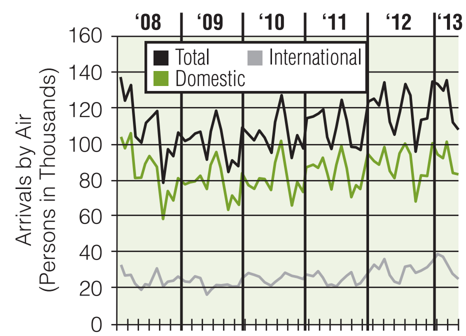
Source: State of Hawaii, DBEDT

CHART 2 • HAWAII ISLAND VISITOR ARRIVALS BY MARKET AREA 2012



Source: State of Hawaii, DBEDT

CHART 3 • MONTHLY VISITOR ARRIVALS BY AIR, 2008-13



Source: State of Hawaii, DBEDT

As arrivals have rebounded, monthly visitor expenditures have increased even faster. Since the beginning of 2010, visitors have increased their spending, sometimes at over 20% growth on a year-over-year basis (See Chart 4 at the top of page 2). The only exception was the summer 2011 doldrums when the U.S. economy experienced a slow-down. This is a good reminder of how we are still very much linked to external economic forces.

Kona Visitor Trends: The visitor rebound is especially important to the Kona side where tourism dependence is so much greater. Based on my conversations with industry insiders, hotel occupancy rates are up and required booking lead-times are increasing. Group and incentive travels bookings are now being made through 2014. Vacation rentals also seem to be doing well.

—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

Hawaii Island *(continued from page 1)*

New capacity is being added through the Holiday Inn Express in Kailua-Kona and the eventual re-opening of the Kona Village, where civil engineering work is underway. Refurbishment of the Four Seasons Hualalai has been completed and renovations are underway in other locations.

Air seat capacity continues to be a concern for the industry. The Hawaii Island Visitors Bureau is working hard to bring back Japanese airlift. Eight charter flights are scheduled for the second half of 2013, but there is concern about the weakness of the yen and the staffing of customs and immigration for flights from Asia.

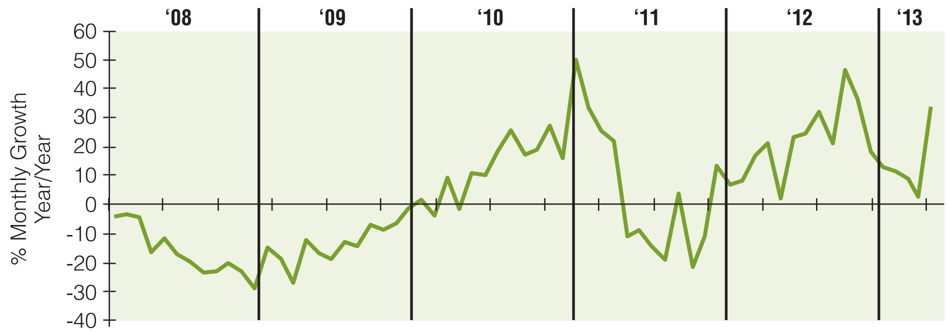
Hilo Visitor Trends: As has been the case in years past, the Hilo side tourism story is dominated by the uncertainties associated with Banyan Drive. The state's lease extension rules requiring renovations equal to at least 50% of the value of the improvements on the land is proving difficult for many leaseholders. Likewise, shoreline management area permitting rules add obstacles. The Naniloa is in Chapter 11 and has one wing shuttered.

The Hilo Hawaiian Hotel seems to be doing well, catering mostly to a local market (70%) with short stays (less than 2 days). Almost one-third of their inventory is in renovation. Japanese group travel to visit the volcano seems to be a good niche market for this property.

In addition to the Banyan Drive issues, there is concern about airlift for Hilo Airport. This is the typical "chicken or egg" problem and airlines will probably wait to see demand increase before adding capacity.

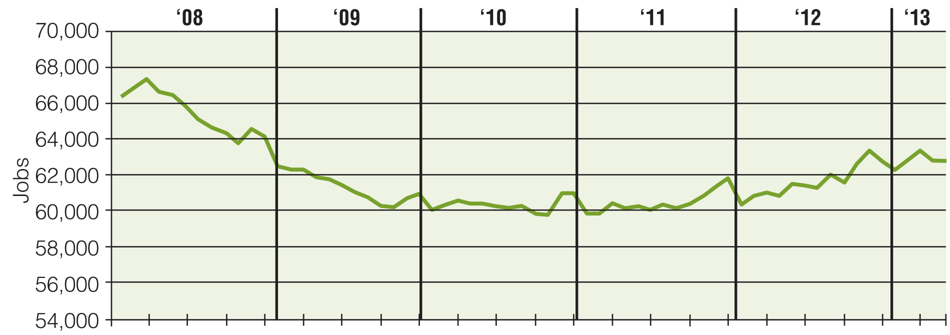
Finally, the harbor reports that cruise ship activity is on the upswing as new lines plan stops in 2014.

CHART 4 • HAWAII ISLAND VISITOR SPENDING GROWTH, 2008-13



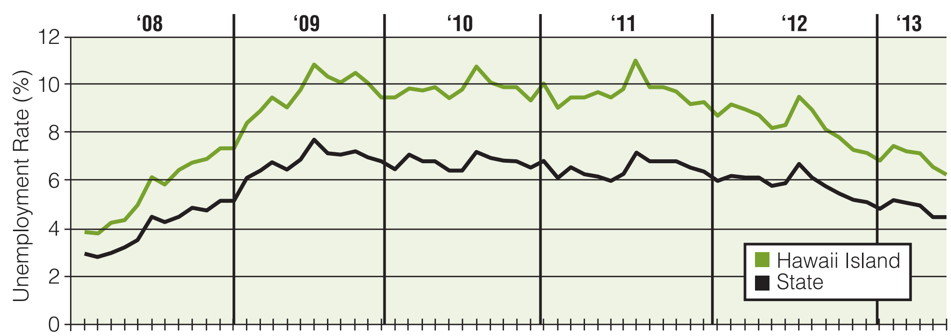
Source: State of Hawaii, DBEDT

CHART 5 • HAWAII ISLAND NON-AGRICULTURAL JOBS, 2008-13



Source: Hawaii State Department of Labor & Industrial Relations

CHART 6 • UNEMPLOYMENT, HAWAII ISLAND VS. STATE



Source: Hawaii State Department of Labor & Industrial Relations

Jobs and Unemployment

As the effects of the tourism rebound have spread, Hawaii Island jobs (Chart 5) are starting to come back. Between the 2008 peak and the 2010-11 trough, Hawaii Island lost nearly 8,000 jobs. About 3,000 of those jobs have returned. As a result, the unemployment rate (Chart 6) has followed the statewide unemployment rate downward since mid-2011. However, the island's rate is still 2% above the statewide average. In other words, Hawaii Island's job market is recovering more slowly that the rest of the state.

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

As the job market improves, businesses are increasingly concerned about being able to hire and retain qualified staff. The Hawaii Economic Development Board, the Workforce Development Division of the State Department of Labor, and the higher educations institutions on island are hard at work providing appropriate training programs, especially in health care, green energy, tourism support, and sustainable and diversified agriculture.

Electricity Sales

Traditionally, one way to gauge the strength of the economy has been the consumption of electricity. When the economy is strong, electricity usage is up. 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 HELCO's sales. Chart 7 shows electricity sales dropping from 2008 through the present, but the decline is expected to level off as the economy rebounds.

Most of the decline can be attributed to the market penetration of PV. Evening peak demand (when solar is not available) has recently reached a three-year high. Hence, HELCO still needs capacity to service the growing peak demand.

Much of HELCO's power is now coming from renewable sources that currently supply 40-45% of sales. Much of this is geothermal which is expected to increase capacity up to 38 megawatts. With the addition of more geothermal as well as the Hu Honua Biomass facility and Kona biodiesel, HELCO's renewable sources will account for more than 60% of sales in three years.

Construction

Construction activities as measured by building permits have bottomed out and are trending up. Contractors seem more upbeat, but hardly jubilant as challenges persist.

As shown in Chart 8, private building permits are up 25% in the first part of 2013 compared to the same period the year before. Improved activity is also reflected in construction jobs that began picking up in the spring of 2012. Construction jobs are up by 1,000, making a good dent in the 3,000-job decline created by the Great Recession.

According to industry insiders, single-family residential construction is leading the way. But rising costs of materials, workforce availability and payment delays are future concerns.

Kona: Several infrastructure projects are helping buoy the sector on the west side. Hawaii Community College has broken ground on the $20-million Palamanui campus build-out. The widening of Queen Kaahumanu Highway is expected to get underway this fall with a $75-million increment. Phase III of the Saddle Road improvements will cost $32 million.

The judiciary building, Kaiser Permanente's $22-million building, and renewal work at the old Kona airport will bring new activity to the west side.

Additional development and construction at the Pohakuloa Training Area will be required as the military ramps down training in the Makua Valley of Oahu.

Hilo: In the last several years, Hilo side construction activity has been dominated by UH Hilo's projects, but these are now winding down. The failure to approve the new pharmacy building has been a setback, but there is hope that this decision will be reversed.

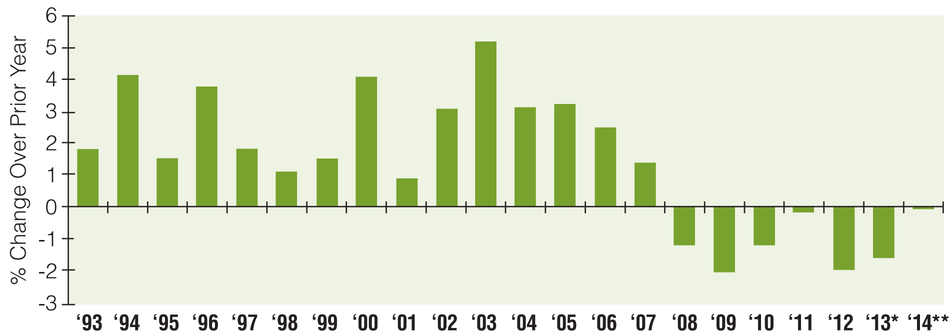
Other construction is focusing on elderly and low-income housing. The Mohouli Senior Housing project in Hilo is a $30-million investment. Lanakila low-income housing involves another $7 million and Kaloko transitional housing is another $2 million.

On the private side, Punahou Mauka residential development is underway, and the Regency assisted living project appears to be moving forward. Apparently the latter involves backing from Chinese money through the EB-5 visa program.

The Kea'au and Puna areas are experiencing significant activity. The Route 130 widening is expected to be a $150-million project. HMSA is building a 20,000-square-foot facility at the Kea'au Town Center. The Bryson Community Center at Pahoa is another $20-million project.

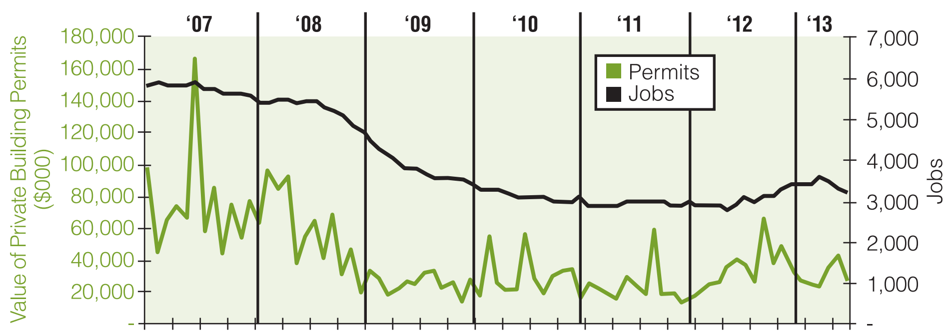
One of the potentially most significant infrastructure projects is Hilo harbor. Pier 4 improvements are still awaiting Department of Health approvals for remediation before activity can begin. The Pier 5 master plan has been in place for a long time. This has the potential for transforming the Hilo waterfront from the harbor to Banyan Drive and would be a great boost to tourism, both cruise-based and others.

CHART 7 • HELCO SALES GROWTH, 1993-2013



*2013 Estimate **2014 Forecast
Source: HELCO

CHART 8 • HAWAII ISLAND CONSTRUCTION ACTIVITY



Source: Hawaii DBEDT using DLIR and county building department data

Real Estate

As we have seen, the good economic news eventually spreads through the economy via job creation and construction. Real estate is also benefiting. For example, the Hokuli'a project has finished its infrastructure and sales have started.

The Hawaii Island residential real estate market is in recovery mode. As seen in Chart 9, units sold have increased for three consecutive years. Chart 10 shows that, as the demand/supply equation has changed, island-wide prices have rebounded. While we are nowhere near prior price peaks, the news is relatively good.

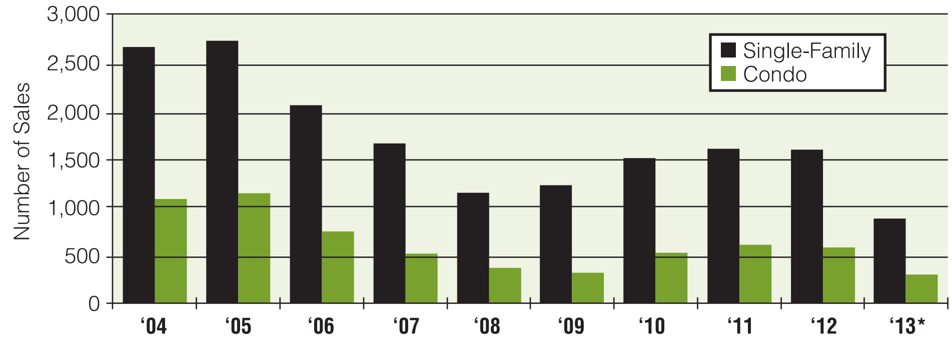
"Hawaii Island's residential real estate market is in recovery mode."

Analyses by Putty Clark and Mike Griggs show that bank-owned and short sales are down from 30-40% (depending on market area) to 15-28%. As the inventory of distressed sales continues to decline, the market will strengthen. This strength is already reflected in the ratio of "pending sales to listings." When times are good, this ratio is high and Clark and Griggs believe we are now in a seller's market in some market segments.

Appraisal analyses bear out the sales data. We talked with R.J. Kirschner and Stew Hussey who have seen residential prices turn up in starting in the latter half of 2011 in almost all of Hawaii Island's markets.

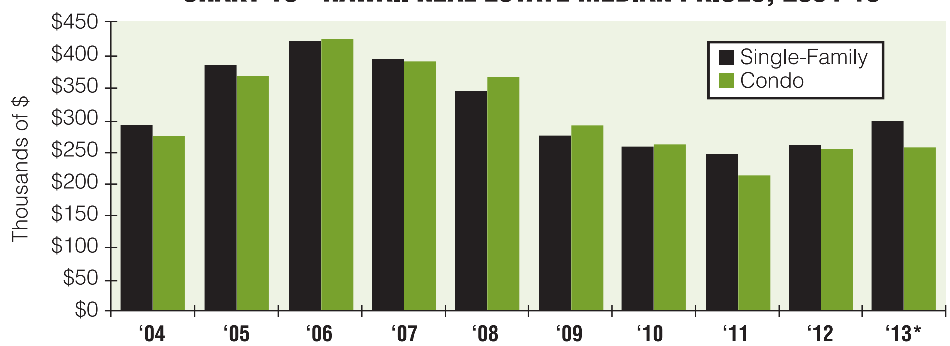
Interestingly, land sales have lagged finished houses. It appears that buyers want a finished property and are not anxious to bear the costs and risks of building on their own. It seems that completed home prices have yet to catch up with the costs of land and construction.

CHART 9 • HAWAII REAL ESTATE UNITS SOLD, 2004-13



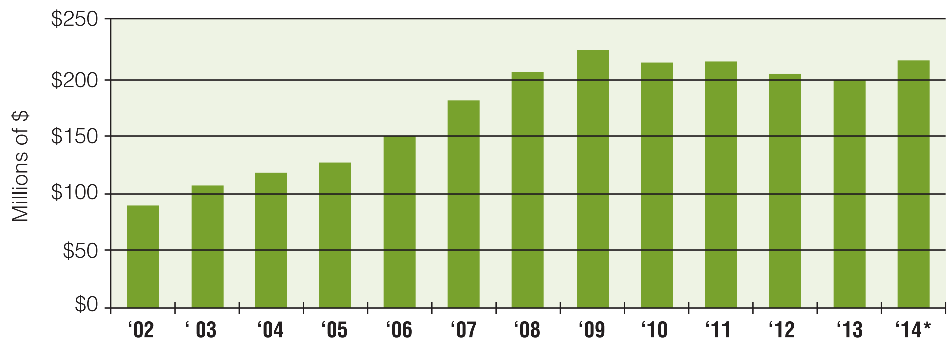
*2013 YTD through June
Source: Hawaii Information Service and Paradise Appraisals

CHART 10 • HAWAII REAL ESTATE MEDIAN PRICES, 2004-13



*2013 YTD through June
Source: Hawaii Information Service and Paradise Appraisals

CHART 11 • HAWAII COUNTY PROPERT TAX LEVY, FY-2002-14



*2014 Forecast
Source: County of Hawaii

However, the good news in the residential market has not spread widely to commercial, light industrial, and office property. Vacancy rates are still high: for example, 20-25% in office space. As HCC and the county move into their own buildings, office space will come on the market in large lumps.

One beneficiary of the real estate improvements is County government. Thanks to improving property values and property tax rate increases approved by the county council this spring, property tax revenues are expected to rebound in fiscal 2014. (See Chart 11.)

Agriculture

The agriculture sector accounts for about 3,000-4,000 jobs on Hawaii Island. This is probably a low number given that not all agriculture employment is formal.

One of the most important crops is papayas. In the Ka'u area alone there are 5,000 acres in papaya employing about 900 people. According to industry data gathered by Robert Ikeno of the State Agriculture Department, production has been stable while prices have risen slightly over the last year. Marketing efforts in Canada have been successful in increasing shipments from 4 million pounds in 2011 to 8 million in 2012. There is also hope that, with Japan's approval of GMO papaya sales as of December 2011, sales there will also grow.

Coffee production is up slightly and prices paid to farmers are in the $1.50 to $1.60 per pound range. Some farmers have been able to differentiate themselves and are gaining both reputation and pricing strength.

Macadamia nut production is down and prices are up; processors are looking beyond Hawaii to source.

Cattle ranchers are doing better as prices remain strong. However, herd sizes are down due to drought conditions.

Finally, floral products are struggling and have yet to recover from the 2008 recession. Lease costs as well as competition and changing market demand for specific products are posing challenges.

Specific Economic Drivers

Hawaii Island is fortunate to have some unique economic drivers that contribute significantly to the island's economy:

Mauna Kea Observatory: Mauna Kea observatories involve 11 facilities. According to the UH Institute for Astronomy the annual budget of these facilities is $75 million, supporting 527 county-based staff.

There are changes underway in the countries that participate in observatory activities. Due to austerity measures and changing priorities, European countries are pulling out of Mauna Kea projects and consolidating their activities in Chile. However, participation on the mountain by Asian countries, including China and India, is increasing.

Of course, the big story is the Thirty Meter Telescope (TMT), funded by a consortium of countries, universities, and organizations. Permits have been issued but a final appeal has been lodged in the courts. Once underway the project construction and equipment cost will be $1.2 billion and, once operational in 2021, the TMT will have a budget of $27 million per year in today's dollar values. The consortium will provide $1 million per year for local community organizations via the Hawaii Community Foundation.

Courtesy TMT Observatory Corporation

UH Hilo: In spite of the disappointment about the pharmacy school building, UH Hilo is moving forward on a number of fronts under the leadership of Chancellor Donald Straney. Plans are to grow enrollment from 4,100 now to 5,000 by 2020. New programs are envisioned in applied engineering and aviation sciences at the undergraduate level and a master's degree in heritage management.

UH Hilo's economic impact is measured at about $300 million per year, attracting $17 million in research funding annually; the college supports 500 employees beyond teaching and research faculty.

Development of University Village phase two focusing on mixed residential and commercial activity is in the plans. This is consistent with the recognition that UH Hilo will become less reliant on legislative appropriations and more on its own resources.

Natural Energy Laboratory: The Natural Energy Laboratory of Hawaii Authority (NELHA) is an important non-tourism driver of the west Hawaii economy. It is estimated to have a $100-million direct economic impact supporting 600 statewide jobs. It is operationally self-sufficient, relying on land rents and water revenues for its $5 million annual income. At present it has 45 tenants including two water bottlers, six aquaculture ventures, Cyanotech food supplements, and Sopogy solar thermal. Cyanotech is doing so well that the company is seeking an additional 14 acres.

New clients include the marine mammal center (monk seal hospital) and the West Hawaii Exploration Academy, a charter school that has $8 million funding for construction. The Abell Foundation is funding a 1-megawatt OTEC demonstration facility to the tune of $35 million.

Infrastructure improvements planned include a 28-inch warm water connector pipeline ($2 million) and repairs to an existing 40-inch pipeline ($5 million). A $4-million alternate energy and biotech incubator project is also planned.

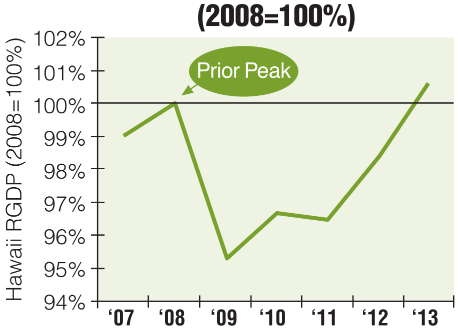
However, the most visible development will be the plan to improve the land abutting Queen Kaahumanu Highway. A $10-million extension of the Kahilihili Street is scheduled to go out for bid late this summer or fall with completion in 2014. This will open planned commercial space in a prime location near the airport.

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.

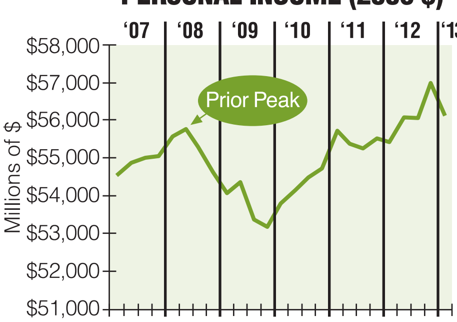
CHART 1 • HAWAII REAL GDP (2008=100%)



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 $)

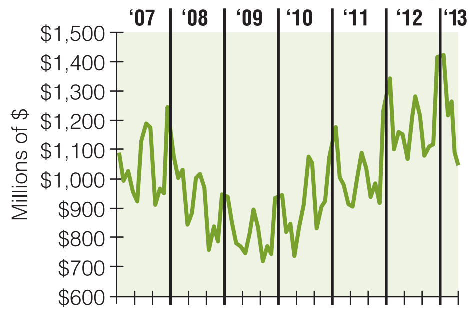


Source: U.S. Bureau of Economic Analysis

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.

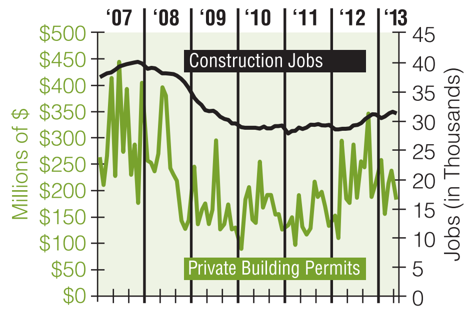
Historically, the construction industry has also been an important source of growth. However, in order to prosper, the construction industry requires a good underlying economy. Hence, it tends to lag the overall economy. But even here we see signs of strength. Building permits (Chart 4) are starting 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 $)



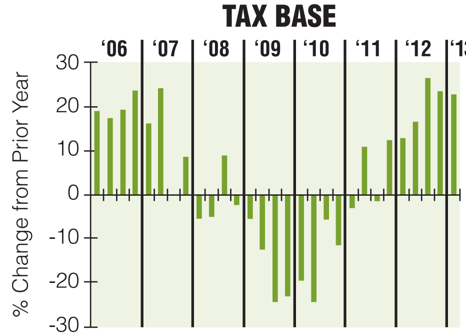
Source: State of Hawaii, DBEDT

CHART 4 • STATE CONSTRUCTION



Source: County building departments via state DBEDT

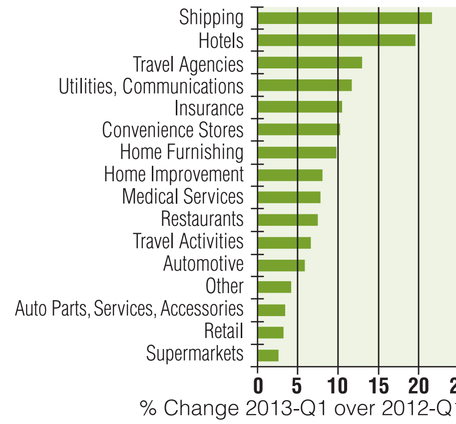
CHART 5 • STATE CONTRACTING TAX BASE



*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

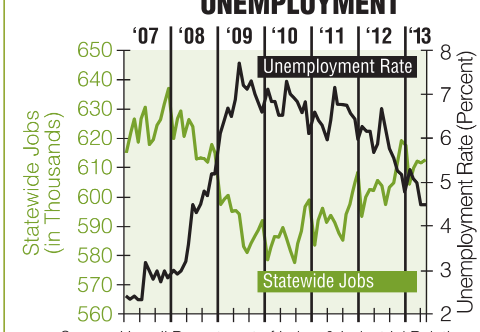


Source: First Hawaiian Bank

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.

Jobs: Slow, Steady Improvement

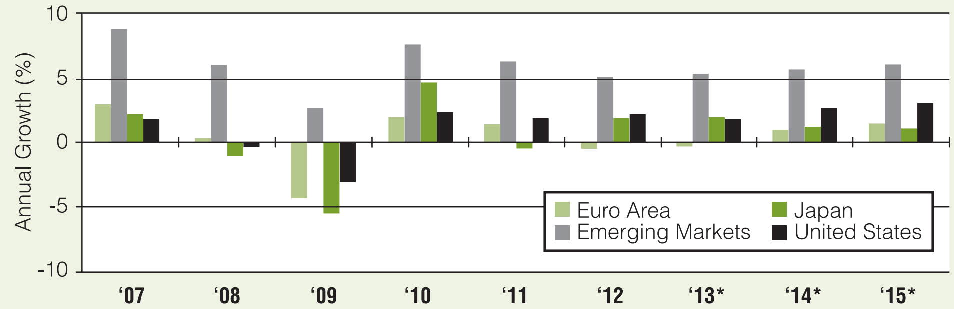
The jobs market (Chart 2) is improving slowly but steadily with about 200,000 jobs being added per month. An estimated 8.7 million jobs were lost as a result of the Great Recession. Over the past three years about 6.6 million jobs have been regained, leaving the U.S. with 2.1 million fewer jobs than 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.

Inflation: Well Controlled

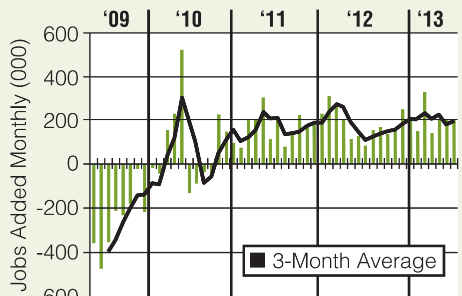
Inflation (also Chart 3) remains well below the Fed's target of 2%. However, there appear to be transient factors pushing down prices, and some mild reacceleration of inflation is expected. Longer term, expansion of the money supply raises the risk of inflation, but even 10-year inflation expectations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

CHART 1 • WORLD ECONOMIC GROWTH FORECAST



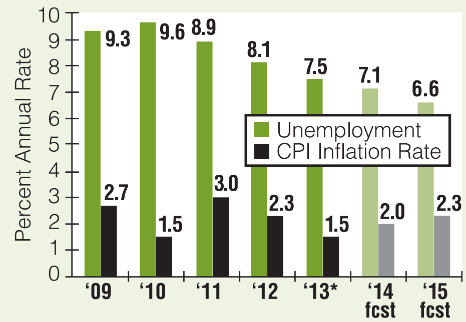
*2013 is an estimate; 2014 and 2015 are forecasts.
Source: International Monetary Fund, Dr. Jack Suyderhoud

CHART 2 • MONTHLY CHANGE IN PAYROLLS, 2009-13



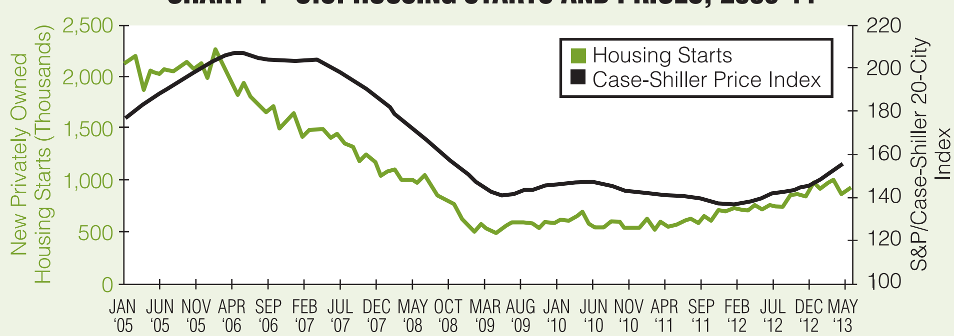
Source: Bureau of Labor Statistics

CHART 3 • FORECAST UNEMPLOYMENT AND INFLATION



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

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

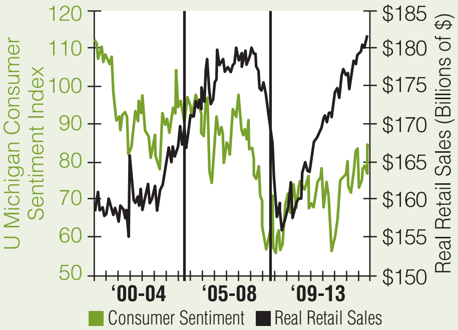
U.S. consumers have for the most part maintained their buying behavior through thick and thin (Chart 5, black line, at the top of page 8). However, part of the growth in consumption has been fueled by a fall in the savings rate from over 6% in early 2009 to under 3% this year. Consumer confidence (Chart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

—continued on page 8

U.S., Global Outlook for 2013-14

(continued from page 7)

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



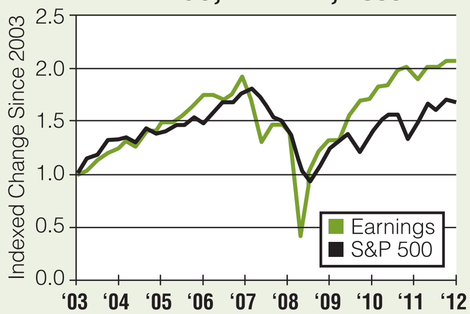
Source: Federal Reserve Bank of St. Louis and Bloomberg

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%.