



Separating *Knowledge* from *Beliefs*

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HighBank 2011 Outlook and Update to our Long-Term Economic Thesis

To our current and future clients:

On behalf of my colleagues at HighBank, I am pleased to provide you our first annual economic and investment outlook as well as an update to our Long-Term Economic Thesis which we first published in May of 2010.

2010 has ended with a fair amount of confidence in an improving economic outlook for the coming year. At risk of you viewing us as being a pessimistic and dispirited bunch, the level of expected improvement strikes us as being overly optimistic. As you read our 2011 Outlook, remember that we will always honor the pillars of HighBank's foundation:

- You will always get the truth
- We will never self-deal
- We will never compromise confidentiality
- Only your interests will be served
- We will relentlessly focus on your objectives

We refuse to follow the herds of advisers and bankers who will sell unrealistic optimism to gain your business and fatten their wallets.

That said, we do think that the economic outlook is improving and that money can be made (and as importantly preserved). In the private markets, the continued credit challenges present significant opportunities to achieve outsized returns and we at HighBank are originating these opportunities on behalf of our clients on almost a daily basis. In the public markets, we continue to advise our clients to invest in quality and focus on yield. We believe as much as 50% or more of the total return for the coming year will be generated through yield and not capital appreciation. Finally, remember that the wealth accumulation "race" is a marathon and not a sprint and much like the long distance runner who does not stick to the race plan and starts out too fast (take it from an old washed-up marathon runner...), taking unnecessary risks in order to feel better about your annual return misses the point of wealth creation. Preservation of what you have is more important than chasing alpha (i.e. above market returns).

2011 Outlook

Beginning with the U.S. Economy, we believe we will see growth, albeit muted by the continuing overhang of structural impediments, specifically the elevated levels of unemployment which will take years and not months to reduce to more historical norms and federal, state and local debt burdens which will crimp spending and thus growth. Further, of the three sources of investment and spending (consumers, corporates and governments) only corporates are in a position to create economic growth and, even then, only the largest (often public) corporates fit this category.

Small businesses are still burdened by uncertainty and anemic pricing power leading to investment (and, unfortunately, hiring) paralysis. Large corporates will do their share of investment and spending in 2011 (in particular in areas like mergers and acquisitions), but many have gotten extremely comfortable (downright pleased) with the ability to drive earnings growth through (first) cost reductions and (now) cost controls and as such we should not expect any ground swell of hiring. Without the corporates hiring in a robust way and with the government in dire need to reduce bloated budgets, any meaningful (below 9%) reduction in the 9.5%+/- unemployment rate will wait at least another year.

Finally, consumers will continue to spend episodically (e.g. holidays, summer vacations, etc.) but will contain discretionary spending until; (i) they are more certain about not just the security of their job but (daresay) the potential for earnings growth; and (ii) they see the value of their homes not just stabilize but begin to show modest improvement. If the improvement in the jobs market is at least a year off, the improvement in the housing market is at least two years off and even then, any growth in home prices will be muted due to increasing financing costs. If that were not enough, the fast rise in “consumer” inflation (i.e. energy, food, and healthcare) will be a significant drag on discretionary spending in 2011.

On a global basis, the growth engine of the emerging economies will slow as monetary policies aimed at containing inflation will become more prevalent. In particular China, which is likely facing significant future cyclical headwinds (due to real estate and banking issues – sound familiar?) as well as their own share of secular challenges (aging population – sound familiar?), will grow at a materially reduced level over the coming years. Even without the above challenges, it is sensible that their outsized level of economic growth would slow naturally anyway. This slower growth, however, will be further reduced as monetary officials try to stay ahead of inflationary impacts emanating from their government policies of the recent past.

Global developed economies, in particular Europe and Japan, will show anemic growth at best. Europe will continue to be challenged by sovereign debt issues including one or more defaults (oops, I meant “restructurings”) which will bring the future of the common union and currency back into mainstream discussion. Absent better choices, we see these challenges being met (not without potential market dislocations in the meantime) but even once resolved the union (maybe then a federation?) will be facing an economic anchor of its aging population and social spending ways. In Japan we dare say things are largely beyond repair. Their economy is destined for slow to non-existent growth with almost no way to address their long-term secular nightmare and debt burden. Japan will need to innovate to grow so that it can significantly boost its exports globally to off-set otherwise inevitable domestic economic decline.

Now for a few specific things you will likely hear and read more about in 2011:

- Dollar and commodity strength squeezing corporate earnings
- Anemic job recovery
- Anemic (if not double dip) housing recovery



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- “Consumer” inflation (i.e. food, fuel, and healthcare, with clothing/apparel the next to be added to the list)
- Potential currency controls and trade disputes (we hope contained) – see rare earth minerals
- Increasing local or even state debt “restructurings”
- Questions about the banking industry’s reserve adequacy to cover mortgage re-purchases

I would sum up the above as follows. There are still significant structural and secular impediments that need to be dealt with before the U.S. Economy can return to robust growth. The economic situation is improving (albeit slowly and a bit unpredictably) and as such money can be made. But, this is not the time to take outsized risks because the pundits of Wall Street say so. If you earn a modest return on your investments with a focus on yield and capital preservation, you will avoid most (but never all) of the downsides that the current market may throw at us all in 2011.

Update to our Long-Term Economic Thesis

We first published our Long-Term Economic Thesis and Investment Outlook last May. For those familiar with our thesis or who understand the meaning of our tag line – *Separating Knowledge From Beliefs*, you are aware that separating what one knows from what one believes should be at the center of an investment approach. Unlike our 2011 Outlook above which is largely based on *beliefs*, our thesis is *knowledge* - focused with a truly long-term view (5-10+ years).

Given its long-term view, not much of our thesis has changed since last May, although we have refined some predictions and certain views as we will continue to do going forward. As you will see, based on a small sample size of eight months, we appear on target. The foundations of the thesis – Energy, Healthcare and Infrastructure - remain the same but we are keeping a close eye on how our views may be impacted by related matters such as the level of U.S. government debt and the pace of global warming (more on that in a future update).

Whether you are working with us today, will work with us tomorrow, or decide our “cup of tea” is not for you, we wish you the best for 2011.

Sincerely,

Stephen Gaines