

Long-Term Economic Thesis and Investment Outlook

Investment Banking • Financial Advisory • Restructuring Advisory • Wealth Advisory

January 2011



Separating *Knowledge* from *Beliefs*

www.highbank.com

Private and Confidential

Table of Contents

I. Our Long-Term Economic Thesis

II. Key Economic Fundamentals: *Separating Knowledge From Beliefs*

III. Advising Our Clients Today

Long-Term Economic Thesis - Overview

- Three over-riding impacts on the United States (and likely also the global) economy over the next 10 years



Energy



Healthcare



Infrastructure

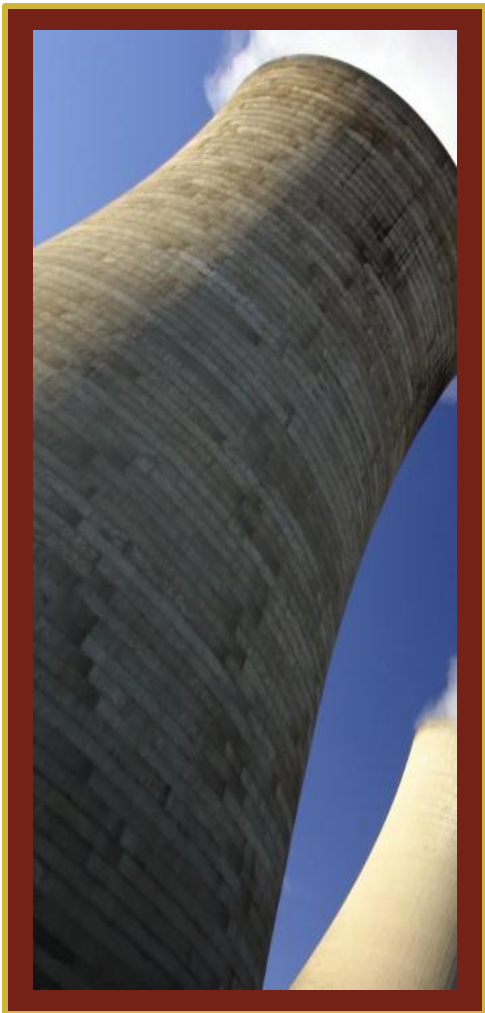
- Government deficits at the local, state, and federal level will weigh heavily on how these impacts are felt and managed

Long-Term Economic Thesis - Energy



- The price of energy will continue to increase, potentially significantly
 - Low and medium cost supply of oil has peaked
 - Costs associated with deep water off-shore drilling will keep a firm floor on oil prices. Public awareness surrounding the potential safety and environmental costs have increased significantly as a result of the Deep Water Horizon accident
 - An eventual, more robust U.S. economic recovery will increase energy demand
 - The significant growth in developing countries' (China, India, Brazil, etc.) middle class will increase energy demand annually for many years albeit at a moderating pace
 - The United States is ill prepared with alternatives (the United States for instance, spends a little more than half of what China spends on research and investment into "green tech")
 - Technologies to alter this course (e.g. carbon sequestration) are years away from even nascent commercialization
- Many current business models with high energy based cost structures will have to be significantly modified or face extinction
- A major acceleration in (or real acceptance of) the threat of global warming could quickly and radically exacerbate this trend

Long-Term Economic Thesis – Energy (continued)



- The increase in energy prices and the threat of global warming will drive significant investments in:
 - The electric grid
 - Alternative sources of energy
 - Nuclear and geothermal will be the biggest long-term winners (10+ years)
 - Wind and, to a lesser extent, water and solar will also be contributors but their ability to materially alter the price of energy is dubious
 - High speed rail (where the United States is woefully behind every major developed country despite having the largest geographic footprint)
- Natural gas is the only significant medium-term solution, but this assumes a long-term lack of acceptance of a real global warming threat
- In the United States a re-urbanization will occur (for reasons that include both the cost of energy and the demographic changes ahead) while we will see some de-globalization of the world's economy

Long-Term Economic Thesis – Healthcare



- The aging population (demand) in combination with:
 - Continued increases in healthcare costs
 - The critical supply shortage of healthcare professionals, and
 - Substantial and continuing government deficits which will require reductions in Medicare and Medicaid...
- ...will lead to a healthcare crisis (are we there yet?), with limited solutions
 - Efficiency (waste and fraud)
 - Remote care (technology/systems)
 - Low cost retail delivery
- The recently enacted healthcare bill exacerbates these challenges as coverage was increased (demand) but cost containment was largely ignored. Efforts by the house to overturn the legislation will only cast more doubt about our seriousness in containing healthcare costs

Long-Term Economic Thesis – Infrastructure



- The United States lags many developed countries in infrastructure investment among a wide range of asset classes. Per the ASCE Report Card:
 - Water and the Environment (e.g. dams, levees, drinking water, waste water, etc.) – Grade: D/D-
 - Transportation (e.g. roads, bridges, rail, etc.) – Grade: D
 - Public Facilities (e.g. schools, parks and recreation, etc.) – Grade: D+
 - Energy (e.g. the grid, alternative energy, nuclear) – Grade: D+
 - And ASCE neglects to mention
 - Communications (e.g. internet, broadband and cellular)
 - Public education, jobs, and skills training
- Many developing countries are investing in the “next generation” technologies in each of these critical infrastructure assets and are “leapfrogging” the United States
- Our long-term global competitiveness is at risk and with local, state and federal governments unable to finance the investment necessary, the private sector will be a big part of the solution (along with taxes!)

Long-Term Economic Thesis – Summary

- The impacts of energy, healthcare, and infrastructure will be dramatic on the United States financial position
 - It will be extremely difficult for the United States to reduce its budget deficit for many years which has ballooned due to the recent recession and historic financial crisis
 - Taxes will need to be increased significantly
 - As will fees for the service/use of what we have all grown accustomed to being “free” public assets
 - Corporations (the only economic participants with healthy balance sheets) and high net worth individuals will be expected to pick up a significant part of these costs
- Politics (as usual) will get in the way by creating inefficient allocation of resources aimed at addressing the challenges

Table of Contents

I. Our Long-Term Economic Thesis

II. Key Economic Fundamentals: *Separating Knowledge From Beliefs*

III. Advising Our Clients Today

Key Economic Fundamentals

- What may our thesis mean for key economic fundamentals (which drive asset values)?
- Must separate the thesis into what we **know** to be true versus what we **believe** to be true

Key Economic Fundamentals (continued)

➤ What we know to be true:

- ✓ There is a limited and declining supply of affordable oil and, either way, the trend toward the “greening” of the globe is irreversible (although the speed of the trend is in question)
- ✓ The population is aging with the percentage of the population 65 and over increasing from 13% to 16% from 2010 to 2020 (United States Census Data)
- ✓ The population make-up will begin to change significantly. Most prominently, the percentage of the United States population represented by Hispanics will increase from 16% in 2010 to almost 20% in 2020 (United States Census Data)
- ✓ A massive build in the middle class in developing countries is upon us which will drive up global consumption relative to the United States
- ✓ The percentage of United States GDP that needs to fund entitlement programs will grow substantially over the next 10 years and this growth is beginning at a time of record deficits
- ✓ There is a significant deferred investment in all areas of infrastructure which will require significant government spending and/or wide scale privatization

Key Economic Fundamentals (continued)

➤ What we don't ***know*** but do ***believe*** to be true:

✓ **We are still in a deflationary cycle, but inflation at the consumer level (e.g. food, energy, healthcare and clothing/apparel) is going to increase uncomfortably**

➤ Despite the dramatic swelling of the money supply (“Inflation is always a monetary phenomenon” – Milton Friedman), the velocity of money remains muted

- Credit supply and demand is still relatively weak and without credit increasing velocity will not increase
- Supply is and will continue to be constrained by bank's balance sheets which are still burdened by bad debts
- Demand is low – consumers in particular are still highly leveraged and have seen their retirement savings and equity in their homes erode substantially. As they age, a focus on saving versus spending will win out.
- By the time velocity (credit) begins to pick-up, the government will have pulled back significantly on the monetary base

Key Economic Fundamentals (continued)

- What we don't know but do believe to be true:

✓ Inflation (continued)

- Labor costs (still the largest single input in production) will remain well contained as the employment market has, at best, only recently stopped deteriorating and no one can demand higher wages
- Commodity costs (the second largest input in production) are becoming the single largest threat, but the threat should be contained as with few exceptions (see consumer inflation above) businesses are facing long odds at passing on input prices
- Inflation expectations can “self-fulfill” inflation (essentially built in to long-term treasury prices) and although there is inflationary sentiment (see the price of gold and other commodities as well as the recent increase in treasury yields), the headwinds of velocity/credit and the labor markets will mostly off-set this over the near term

Key Economic Fundamentals (continued)

- What we don't know but do believe to be true:

✓ Interest rates

- Interest rates are much more likely to head in only one direction – up
- But with inflation in check (see previous pages) what could cause a significant increase in rates? Only one thing – the supply/demand equation on United States government debt
 - Supply is assured due to the long-term deficits the United States will have to finance
 - Demand is not. Even China (which may eventually be dealing with the after effects of its own real estate bubble) will have an eventual limit on United States government debt purchases (even if not initiated by trade or territorial disputes, although that would make it worse)
 - Long-term Interest rates will be the equalizer, while short term rates will remain low resulting in a continued steepening of the yield curve

Key Economic Fundamentals (continued)

- What we don't know but do believe to be true:

✓ Interest rates (continued)

- Higher long-term interest rates will have two significant benefits and two big drawback

Benefits:

- ✓ Further dampen credit demand to keep a longer term cap on significant/hyper inflation
- ✓ Quicken the recovery of the banks (due to the steepening yield curve)

Drawbacks:

- ✗ Higher long-term rates will further exacerbate the government deficits (not to mention the consumer's efforts to repair its own "balance sheet") due to much higher carrying costs
- ✗ Higher long-term rates means higher mortgage rates which will slow the recovery of the United States housing market

Key Economic Fundamentals (continued)

- What we don't **know** but do **believe** to be true:

✓ The United States Dollar

- Multiple conflicting impacts make it very hard to predict. Best guess is that it will be volatile as these impacts hold sway with traders and foreign governments (who will adjust their own currency policies)
 - Generally printing money in large quantities (as the United States has done over the last 18 months) and running large deficits (which the United States has done for the entire decade) will put downward pressure on one's currency
 - But if interest rates rise relatively faster than in other major countries, the dollar should appreciate. This is likely, particularly relative to the Euro and the Yen.
 - Further, in the meantime, sovereign debt risk will create a continuing flight to safety which will benefit the dollar (until/unless the debt contagion spreads to the United States, which we see as, eventually, more likely than not)

Key Economic Fundamentals (continued)

- What we don't **know** but do **believe** to be true:

✓ The United States Dollar (continued)

- China over the longer-term may likely be the single biggest factor one way or another and their interests in the outcome (higher versus lower dollar) and their ability to influence it should not be underestimated
 - Lower dollar (which means lower renmiabi since it still does not float freely) creates low prices abroad for its products
 - Higher dollar will maintain the value of China's dollar reserves (well over \$1 trillion)
 - Longer-term as China develops its middle class (which historically means greater domestic demand which can replace export demand) and yields to international pressure to let their currency float (which it will be increasingly willing to do as their domestic demand increases) their desire for a strong dollar will win out
 - The emergence of a competing "reserve currency" could alter this view and, as such, the impacts on the value of the dollar will require close attention

Table of Contents

- I. Overview of Long-Term Economic Thesis
- II. Key Economic Fundamentals: *Separating Knowledge From Beliefs*
- III. Advising Our Clients Today**

Given our Long-Term Economic Thesis, how are we advising our clients today?

- Overall, equity investors should not plan on anything better than mid single digit returns on their investments over the next 5-10 years and should be prepared for potential negative real returns
- To do better (which most investors must do to save sufficiently for retirement), the equity portion of an investor's asset allocation should focus on:
 - Yield (dividends) – where we see as much as 50% of total returns being generated
 - Overweight exposure to certain segments within three sectors:
 - Energy
 - Healthcare
 - Infrastructure
 - Hedging inflation with some commodity exposure
 - Hedging the slower growth developed economies with emerging market exposure
 - Minimizing taxes and transaction/management fees
- On the fixed income side, layer maturities and don't assume credit worthiness of any issuer

We believe it's time for higher standards and results. Don't you?

What we know to be true will not change and will be the source of growth and value; what we believe to be true today will change tomorrow and will require constant and thorough analysis. Thankfully that is one of our greatest strengths...

For Specific Investment Recommendations or Consultation Please Contact:

**Stephen Gaines
sgaines@highbank.com
(443) 478 1970**