UHERO STATE FORECAST UPDATE - PUBLIC SUMMARY

EXCEPT FOR WEATHER, OUTLOOK SHINES

SEPTEMBER 25, 2015

Record tourism and stronger construction are driving Hawaii's healthy expansion. Let's hope that's enough in a riskier global environment.

Hawaii's economic outlook continues to look bright. Tourism is pushing toward new records, and the construction upswing is building in strength. The overall expansion remains solidly on track, delivering better labor market conditions and the prospect of further household income gains. Still, in the midst of this hot and soggy summer we are pondering some ominous clouds forming out on the horizon.

Despite high levels of capacity use on Oahu, the visitor industry continues to exceed last year's performance and our expectations. Through the first seven months of the year, visitor arrivals, days, and real spending are all up 3-4%, and visitor numbers will almost certainly end the year in record territory. This reflects a surge in activity on the Neighbor Islands, which has pushed hotel occupancy above 70%, even if this still lags pre-recession levels. (Data is from Hospitality Advisors LLC.) While tighter conditions were expected to limit gains on Oahu, the county has kept pace with the Neighbor Islands, although weakness in the Japanese market has restrained spending.

US mainland visitors have contributed the most to continuing growth. Arrivals from the US mainland are up 6% year-to-date, while visitor days and real spending are up more than 4% and 3% respectively. Strong gains in US visitor volume on the Neighbor Islands, particularly on Maui and the Big Island, have been facilitated by increased direct airlift to Kahului and Kona. While reliable data is hard to come by, another likely support is the availability of alternative vacation accommodations, which have seen a surge in popularity nationally thanks to online booking services like Airbnb and VRBO.

The Japanese market has continued to post visitor declines, with arrivals off more than 1% in the year to

UHERO REPORT SCHEDULE WILL CHANGE

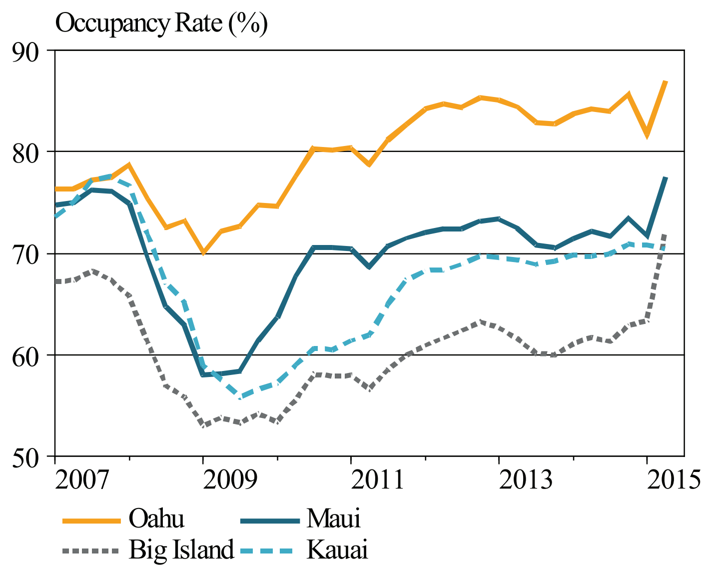
Our annual schedule of UHERO forecast reports will change beginning next quarter in order to rebalance workload over the course of the year and to place our flagship Annual Hawaii Forecast report in the fourth quarter. Remember that all reports include the full set of updated state forecast tables. Thanks for your understanding as we implement these changes.

First quarter: Hawaii state forecast update

Second quarter: County forecast with state update

Third quarter: Construction forecast with state update

Fourth quarter: Annual Hawaii forecast, including global outlook



STRONG VISITOR GROWTH BOOSTED HOTEL OCCUPANCY RATES ON MAUI AND THE BIG ISLAND. (SOURCE: HOSPITALITY ADVISORS LLC)

date and real expenditures down nearly 11%. Depreciation of the currency above the 120 yen/dollar mark has eroded purchasing power and made it more costly for Japanese tourists to visit the state, and faltering Japanese economic growth is also a drag. The decline in purchasing power is having an impact on expenditure patterns, with visitors spending less at local retailers and for accommodations.

Visitors from nontraditional markets have been major drivers of industry growth in recent years, and they made a strong showing in the first half of 2015. Third quarter data are much weaker, and for the year gains in these markets will lag the US market. Still, these visitors have an outsized impact on visitor spending. In the year so far, visitors from these markets have accounted for roughly 30% of the gain in visitors days but nearly 80% of the increase in visitor expenditures, despite generally weaker currency values relative to the dollar.

The number of visitors to Hawaii will top 8.4 million for the first time this year, a greater than 3% rise over 2014. With statewide occupancy pushing toward 80%, gains will be smaller in 2016, falling to roughly 1% for the next several years. Spending will slow as well, rising at a rate below local inflation in 2016. This is a picture of continuing health for the industry, but we are past the point where significant additional expansion will be seen.

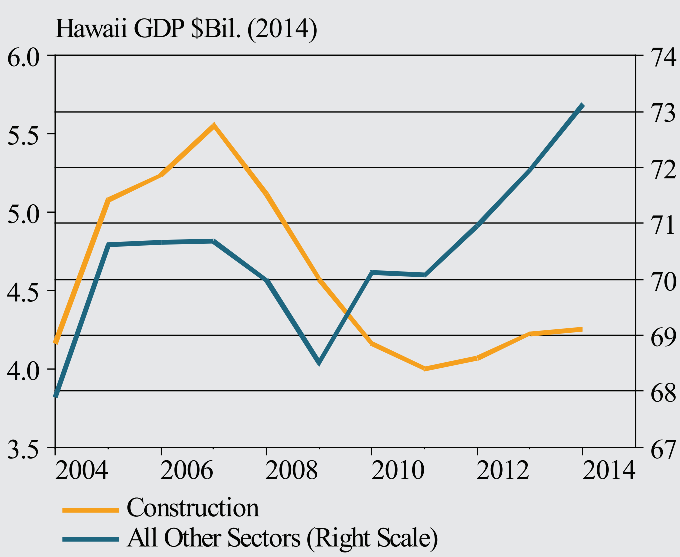
Conditions in the broader economy show measured rates of job growth and firming personal income, while much cheaper energy is keeping a lid on prices for now. The payroll job count has risen a fairly modest 1.3%, according to UHERO's in-house estimates of upcoming government data revisions. Public sector weakness is weighing on overall employment, even as the private sector continues to add jobs at a moderate pace. Most industries, with the exception of construction, are seeing job growth in the 1-2% range, which is to be expected at this point in the business cycle.

The weakness in public sector hiring is not a new story. It reflects budget challenges, but also excessive conservatism by policymakers that has been an unnecessary drag on the economy. In the year to date, government payrolls are down 1%, a loss of 1,300 jobs. Federal employment continues to fall, albeit at a slightly slower pace than during the past two

CONSTRUCTION UPTURN NOW WELL ESTABLISHED

Construction activity is ramping up, although high variability and long delays in permit issuance continue to make it difficult to assess how far along we are in the current upswing. Through the first half of the year, the real (cost-adjusted) value of issued private construction permits was up more than 27% from the same period in 2014. Job growth has accelerated after a rather weak showing in 2014.

The main driver of permitting growth this year has been the residential sector, especially on Oahu, where a large number of high-rise towers are passing through the permitting pipeline. These projects tend to cause big swings in the data when a single large permit is issued for an entire residential tower. And because permits for high-rise projects are issued with long delays (in fact, most projects are well under way before permits are approved), they do not serve as a useful leading indicator of building activity. UHERO has identified $650 million in high-rise permit applications awaiting approval, but it is not clear when these permits will actually be issued.



SLOW IMPROVEMENT IN CONSTRUCTION HAS WEIGHED ON THE ECONOMY

We are starting to see some acceleration in single-family home construction. The number of new homes permitted statewide is up almost 25% through the first half of the year. The strongest gains have occurred on Maui, but even Kauai and the Big Island—where conditions have been extremely weak—are seeing a pickup in homebuilding. That being said, the pace of new home construction is still very close to historic lows. The state's two largest single-family home projects, Hoopili and Koa Ridge on Oahu, are still awaiting rulings on constitutional challenges pending before the Hawaii Supreme Court.

On the nonresidential side, gains this year have been more moderate, with real permit values up 4% through the first half of the year. Last year was an especially strong one for nonresidential permits, due to renovations to Ala Moana Center and a number of condo towers in the Kakaako area receiving approval for podium construction (which is classified as nonresidential). There remain a number of large projects awaiting approval, including the International Marketplace redevelopment and the two towers of Ritz-Carlton Residences in Waikiki. Earlier this year, the Park Lane superstructure in Ala Moana added about $75 million to nonresidential permits on Oahu, and the nearly $300 million Westin Kaanapali Resort Villas added a significant bump to numbers for Maui. Permitting for residential photovoltaic (PV) systems has picked up in recent months, following changes to interconnection rules earlier this year.

New contracts for public construction have been growing at a rapid clip, nearly surpassing last year's total in the first six months of 2015. This year's figures are pushed up by an apparent change in the treatment of contracting for Honolulu Rail system components. Previously, work on the system had been excluded from the official statistics, but this year the rail stations along Farrington Highway were included in figures for government contracts awarded. Even without these, total government contracts are running more than 80% higher than at this time last year. Significant public projects include $290 million for runway improvements and construction of a new rental car facility at Kahului Airport, more than $60 million for construction at Marine Corps Base Hawaii, and about $25 million of contracts for work at Kapiolani Community College.

Contrary to official government statistics, hiring in the construction trades appears to have picked up strongly since the beginning of the year. According to UHERO estimates, when revised data are released in early 2016 they will show that the construction sector job count rose 6.5% in the first half of this year, compared with the same period in 2014. (The official stats show only a 2.8% gain.) Average hourly wages advanced nearly 11% in the first half of the year, although weekly hours dipped nearly 3%. If our estimates of revised job counts are any indication, these preliminary figures on wages and hours are likely to be revised upward.

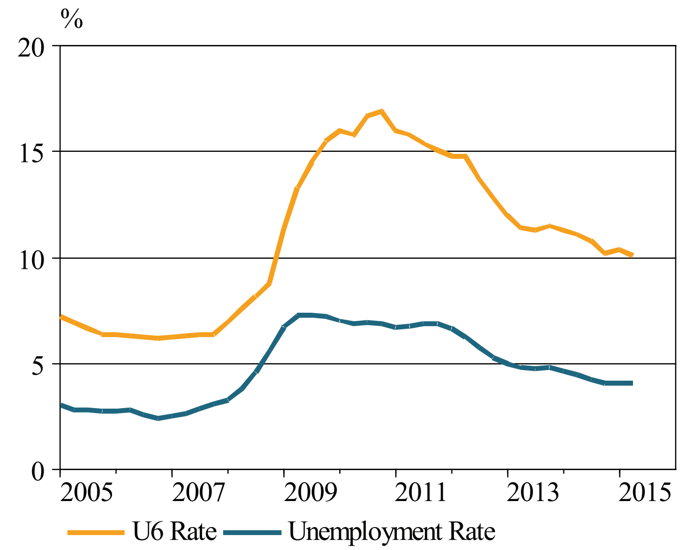
We expect the construction sector to continue on its current pace of healthy expansion for the next several years. There is now a large volume of ongoing high-rise activity. Even as interest rates begin to rise, healthy labor markets and household income growth will remain favorable for increased single-family building activity, which has been limited so far. Additional industry growth will add several thousand more jobs before the expansion tops out late in the decade, and income in the sector will grow accordingly.

years. In contrast to earlier years, when civilian department of defense (DoD) positions bore the brunt of losses, this year the job losses have been concentrated on the nondefense side. State government payrolls are also down 1.2% so far this year. Local government hiring has been limited, up less than 1% (150 jobs) due to still-tight county budgets.

Private sector payrolls rose nearly 2% in the first half of 2015. Hiring in the construction industry is finally occurring at a robust pace, surging 6.5% so far this year based on UHERO estimates. (See the box, *Construction Upturn Now Well Established*.) The service areas—which as a group represent roughly half of all jobs in the state—continue to expand at a moderate pace. Among these, the healthcare industry has seen the strongest growth this year, with payrolls up nearly 2.5%. Note that the highly publicized job losses at state-run hospitals are showing up in the decline in state government workers, not in private healthcare jobs. Despite strong tourism performance, the accommodation and food services industry has seen limited hiring, after several years of rapid growth.

Gains in employment from the survey of households continue to outpace labor force growth, pushing down unemployment. In July 2015, the statewide unemployment rate dropped to a seasonally adjusted 3.7%, the lowest since early 2008. The headline unemployment rate only counts jobless individuals who are actively searching for work, so it may overstate labor market health. But even here, the signs of progress are encouraging. The broad “U6” unemployment measure, which includes discouraged and involuntarily part-time workers, dropped to just above 10% in the year’s second quarter. While higher than the sub-9% rate of 2008, this represents a substantial improvement over the recession peak of nearly 17%. Still, it is an indication that labor markets are not as tight as the narrow unemployment rate might suggest.

Going forward, the employment outlook remains positive. Incremental gains will be smaller, with job growth easing from 1.5% this year to 1% by 2018. But this reflects a labor market that by now has largely completed the long and painful recovery from the 2008-2009 recession. Unemployment has settled near its long-run average, and job growth will converge to a level consistent with trend growth of Hawaii's population and labor force.



THE U6 RATE STILL REMAINS SOMEWHAT ELEVATED, INDICATING THAT THE LABOR MARKET IS NOT AS TIGHT AS THE LOW UNEMPLOYMENT RATE SUGGESTS.

The latest data on Honolulu consumer prices indicates headline inflation below 1% in the first half of 2015. Slowing inflation this year is largely the result of falling energy prices—the energy component of the CPI fell more than 20% from a year earlier. Regular gasoline on Oahu averaged $3.05 per gallon in August, 29% lower than in August 2014. Residential electricity prices were down more than 20% in the second quarter. Food costs continued to see moderate increases (+4.4%), but this was largely driven by higher restaurant prices, as grocery prices rose just 2.6%. It is possible that the 50 cent increase in the state's minimum wage that took effect January 1 could explain part of the lift in restaurant prices.

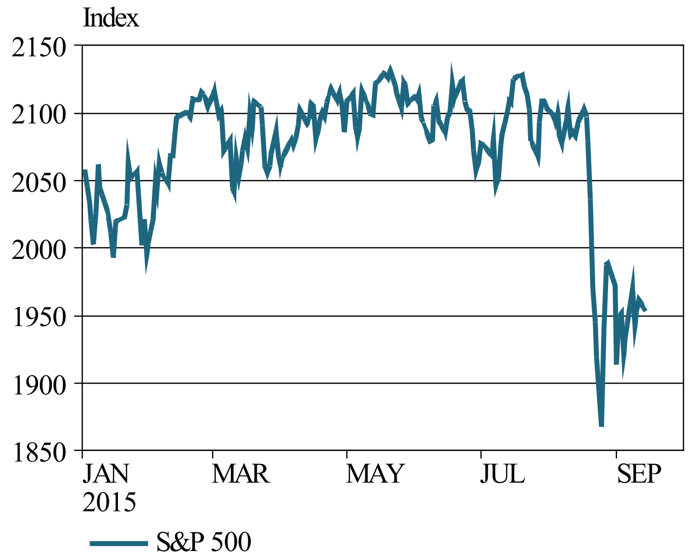
Core inflation, which excludes food and energy prices, was up 2.3% in the year's first half, the highest rate since 2009. Shelter costs increased 3%, reflecting higher home prices and rising rents. Medical care prices increased almost 5%, which may reflect higher out-of-pocket costs for medical care, higher insurance premiums, or both. The firming of core inflation has been expected now that the business cycle is maturing and the labor market is become tighter. As we have seen in past cycles, higher housing costs will be particularly important going forward, helping to push headline inflation to 3% by 2017.

This year's stable prices are helping to support a healthy rise in inflation-adjusted real income, which advanced nearly 3% statewide in the first quarter, the fastest growth since 2009. Real labor income was up 2.8%, led by strong growth in the construction sector, where firming wages and surging jobs propelled total income in the sector up more than 7%. Due in part to increased Medicaid enrollment, government transfer payments to Hawaii residents have grown more than 4% in real terms. Real income growth for 2015 as a whole will match the nearly 3% pace set in the first quarter, easing to the roughly 2% range in 2016-2017.

Looking back on the past half-decade, the recovery in statewide economic output has certainly been long and gradual. New figures reveal that since the recovery began in 2009, real gross state product has averaged only about 1% annual growth. Real output increased 1.6% last year, on par with the fastest growth in this recovery, but still lackluster by historical standards. In large part, the recovery's slow pace can be attributed to the severe drop and limited rebound we have seen so far in the construction sector, whose output remains nearly 25% below its 2007 peak. Excluding the construction sector, real output statewide returned to pre-recession levels in 2012; as of 2014 it was 3.5% above the previous peak.

All told, the Hawaii economy is delivering a solid performance this year. The persistent strength of tourism and new-found construction buoyancy should bode well for a continuation of the current expansion, and this is reflected in our numerical forecasts. And yet we find ourselves a bit less comfortable about the outlook than in recent quarters.

The external climate has become less hospitable. Recent tremors in the financial markets have highlighted concerns



FINANCIAL MARKETS IN THE US AND GLOBALLY HAVE BEEN VOLATILE THIS YEAR

about pockets of weakness globally, particularly in China, and of risks when the Federal Reserve begins to raise interest rates in coming months. The fallout from such developments may have adverse impacts in Hawaii. Already, we have witnessed a sharp drop in US consumer sentiment in the wake of the recent stock market gyrations. The dollar, already strong, could push higher as US rates rise and fears over global weakness mount. And the one-time boost from dropping energy prices is not likely to be repeated.

These are precisely the sort of conditions that could threaten Hawaii's leading industry, if they cause a sustained decline in traveler confidence or travel affordability. So we see indications of rougher weather ahead—or maybe that's just the humidity talking.

HAWAII ECONOMIC INDICATORS
YEAR-OVER-YEAR PERCENT CHANGE

	2013	2014	2015	2016	2017	2018
Visitor Arrivals	1.7	2.3	3.4	1.2	0.9	0.9
U.S. Visitor Arrivals	0.7	2.2	5.1	2.0	0.9	0.8
Japan Visitor Arrivals	3.6	-0.4	-0.7	0.5	0.2	0.7
Other Visitor Arrivals	3.2	5.0	2.3	-0.5	1.8	1.6
Non-farm Payrolls	2.0	1.3	1.5	1.4	1.2	0.9
Unemployment Rate (%)	4.9	4.4	3.9	3.3	3.1	3.0
Inflation Rate, Honolulu MSA (%)	1.8	1.4	0.6	2.0	3.0	3.1
Real Personal Income	0.6	2.3	2.9	2.1	1.8	1.6
Real GDP	1.6	1.6	2.8	2.2	1.9	2.0

Note: Source is UHERO. Figures for 2015 are UHERO estimates. Figures for 2016-2018 are forecasts. Non-farm Payrolls for 2014 and 2015 are UHERO estimates of the benchmark revision.

HAWAII STATE FORECAST UPDATE

CARL S. BONHAM, PH.D.
Executive Director

BYRON GANGNES, PH.D.
Senior Research Fellow

PETER FULEKY, PH.D.
Economist

ASHLEY HIRASHIMA
Graduate Research Assistant

JAMES JONES
Graduate Research Assistant

RESEARCH ASSISTANCE BY:
Adele Balderston

UHERO
THE ECONOMIC RESEARCH ORGANIZATION
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