

Hawaii's recovery pace has slowed to a standstill this year. Despite downside risks from the US and abroad, we expect modest gains for the state economy in 2012.

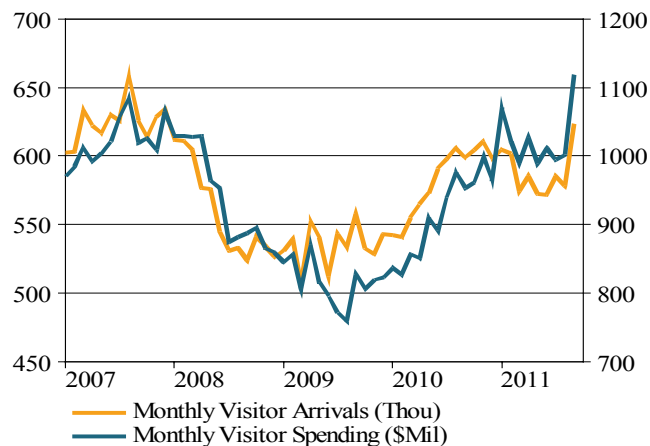
This year's Hawaii slowdown continues to play out, with external risks heightened. While in some respects the local economy remains healthier than the US as a whole, the same general problems are evident here, in particular stagnant labor markets, absent construction, and limited income growth. Hawaii's recovery process is tenuous and far from complete. Our forecast is for gains as we move into 2012, but not at a pace that will lead to rapid improvement in economic conditions.

US economic conditions have not changed substantially since the time of our last report. (For an in-depth discussion see the UHERO Annual Hawaii Forecast, September 2, 2011.) Consumer confidence and spending remains anemic and manufacturing activity continues to hover just barely above contraction. The European debt crisis has worsened, with sovereign debt pressures extending to more countries and funding pressures mounting for European banks. Domestic political impediments have caused governments to dither, rather than adopting decisive action to stave off a major crisis, and announcements from Europe last week raise more questions than answers. The Euro zone region has likely slipped into recession, and the downside risks are clearly enormous if difficult to quantify. Japan has made progress in addressing post-quake reconstruction, while developing Asia has slowed to some extent as demand in the rich world has softened.

In Hawaii, the visitor industry has suffered this year, from the Japanese quake, higher energy prices, and deteriorating US consumer confidence. While year-over-year growth rates were impressive early on, there has been considerable

weakening since January. By August, monthly arrivals had fallen 4.5% below their level in August 2010, although the year-to-date total remained 2.3% higher than the total for the first eight months of last year. Visitor spending growth decelerated from nearly 28% year-on-year growth in January to just 2.5% year-on-year in August. September numbers were much more encouraging, with arrivals up 4.1% and expenditure rebounding by more than 17%.

There have been positive developments in several areas recently. The post-quake Japanese visitor falloff has been reversed. In September, arrivals from Japan were nearly 1% higher than their year-earlier level. Oil prices have retreated somewhat from the peak level of \$110 in April to less than \$86 in September, although they remain \$10/bbl higher than in September 2010. Higher oil prices contributed to weak arrivals numbers mid-year, so even a partial retreat is good news. We have seen added capacity on international flights, and of course the opening of Disney's Aulani resort was welcome news.



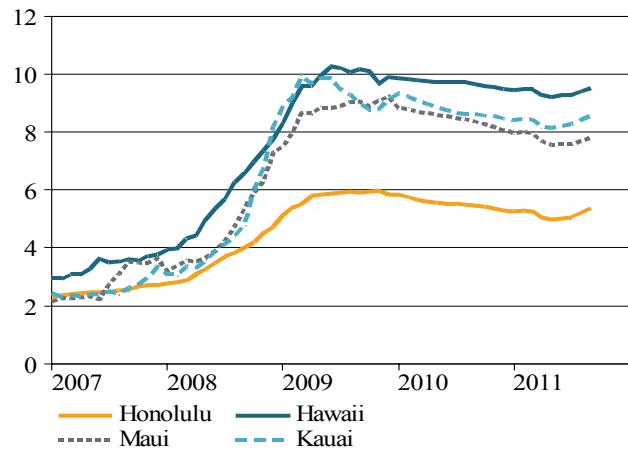
VISITOR ARRIVALS AND SPENDING

Most worrisome this year has been the steady decline in visitors from the US mainland. These arrivals began the year roughly 10% higher than at the start of 2010; they trended lower thereafter, and in August they were 10% lower than the year-earlier level. September brought tantalizing evidence that some firming in US travel could be occurring, with US arrivals up 2.3% compared with September 2010. Still it is hard to get too excited about future US visitor performance given the generally dismal economic outlook for the US mainland.

The strong point for tourism this year has been the stunning visitor numbers from countries other than the US and Japan. Visitor arrivals from these markets are up a combined 18% in the year through September. Canadian visitors are up 21%. Increases in airlift and the relatively weak dollar should make this a continued area of strength in the fourth quarter. Scheduled airline seats from Australia are up 28% from a year ago, and seats on Seoul-to-Honolulu flights are up 78%. Seats from Canada are up a more modest 6.6%. (Note that overall airlift is expected to be only 1% higher in the fourth quarter because of losses in flights from the US mainland.)

We anticipate relatively strong visitor numbers in the final quarter of the year. Japan's rebound will contribute to this, as will the APEC conference in early November. For the year as a whole, we expect arrivals to rise 2.1% compared with 2010. The recovering Japanese market and slower, but still strong, tourism from emerging markets will partially offset US market weakness in 2012, leading to 2.7% arrivals growth. Modest growth of about 2% will be seen in 2013-2014. Hotel occupancy, which drifted down below 71% on a seasonally adjusted basis in July, will average about 73% for this year as a whole, firming to nearly 75% by 2013.

The construction industry remains in the deep doldrums, although there is now clear evidence of stabilization on Oahu. Statewide contracting jobs have edged into positive territory,



UNEMPLOYMENT RATE BY COUNTY

rising about 2% year-on-year in September. This is all about Honolulu County; with the exception of Kauai, Neighbor Island construction jobs are still running considerably below last year's level. Permits for new construction are languishing at low levels. Adjusted for inflation, real building permits for both residential and nonresidential construction are at levels not seen since the early 1980s.

We have written in past reports about the prospects for public sector construction to pick up at least part of the slack. Indeed there is a substantial volume of government infrastructure work that should be coming down the pike, including the Governor's New Day Work Projects, massive sewer construction to address problems with the aging Honolulu sewer system and other projects. A number of these programs are already moving forward, particularly transportation projects, but so far this has not led to any increase in this year's official figures for government contracts awarded. Instead, the \$63 million dollars of public contracts in the second quarter was the lowest level of government contracting since the first quarter of 1984!

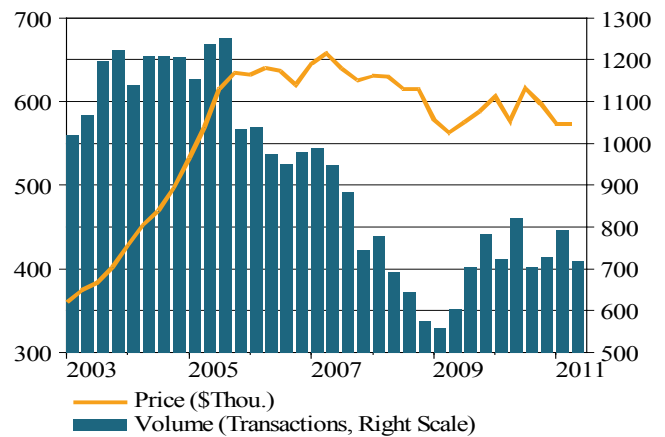
We continue to expect a marked upturn in public procurement in coming years, with the single biggest contribution coming from rail mass transit construction on Oahu. According to the County's *Financial Plan for Entry into Final Design*, issued in September, completion of the necessary full funding agreement with the Federal Transportation

Administration is not expected until September 2012. Because of this, as well as downward cost revisions, we have pushed back and lowered somewhat our estimate of the path of rail construction spending. An additional uncertainty is the pending legal challenge in Federal Court. Still, by late next year we expect rail to be making a substantial contribution to the state construction industry. Again, much of this will be on Oahu with a more tepid construction upturn expected for the Neighbor Islands.

Residential real estate in the Islands has lost some ground this year after rallying a bit in 2010. On Oahu, in the year to September, resale volume is off 2.2% and the median single-family home price is down more than 4%. Volumes are up on each of the Neighbor Islands, but median prices are down 6.0-8.6%. On Maui and to a lesser extent the Big Island there is still a clear downward trend with no sign of price stabilization. There continues to be a substantial foreclosure overhang, equal to at least two months of resale inventory. Figures for new foreclosure actions are down considerably from a year ago, but this is artificial, reflecting the effective moratorium that resulted from statutory changes during the past legislative session.

Employment gains began in the Islands at the beginning of 2010, and the number of payroll jobs reported in the separate establishment survey began to pick up about nine months later. Recovery by both measures has largely stalled out in recent months, although year-to-date averages remain in positive territory compared with the first nine months of 2010. The statewide unemployment rate has moved back up to 6.4% on a seasonally adjusted basis, from 6% in June. The statewide payroll job count in September was about equal to that of January 2011 and still 5% below the December 2007 peak. Clearly the jobs recovery has been disappointing.

Aggregate figures always hide substantial differences across sectors. In percentage terms, year-to-date gains have been largest in administrative services (+8.7%),

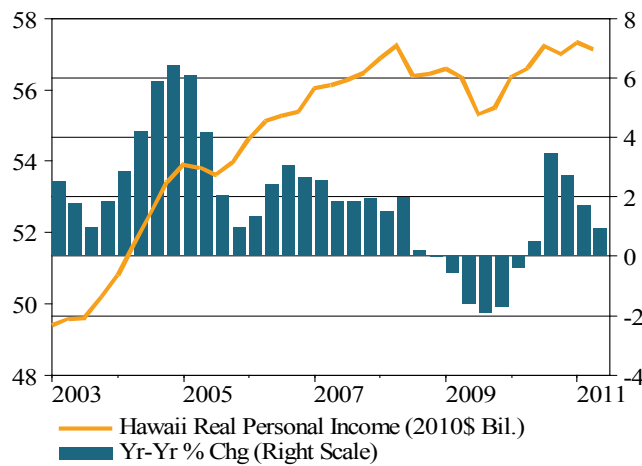


PRICE AND RESALE VOLUME OF SINGLE FAMILY HOMES - HONOLULU COUNTY

private education (+14.6%), and professional and business services (+4.6%). Accommodations and food service are each up about 3% through September. The biggest losers have been wholesale trade (-3.4%), finance (-2.4%) and transportation and warehousing (-1%). Presumably these reflect the continuing struggles of the construction sector and the financial service industry. With a stabilizing picture at least on Oahu, construction jobs are down only 1.1% so far this year. Most other sectors have seen small losses, with the exception of health care (+1.4%). Despite some large month-to-month fluctuations, state government payrolls are essentially flat for the year to date.

While the rather gloomy external environment will create headwinds, we do expect a resumption of limited job recovery in coming months. After 1.2% growth in 2011, non-farm payroll jobs will expand by 1.7% in 2012, with firming to 2.1% in 2013 as the US and global economies get more firmly back on track. Recent new claims for unemployment benefits have shown promising signs, and we do expect the downward drift in unemployment to resume; how much of a burden still-high unemployment will impose on local families will be importantly impacted by whether Congress decides on a further extension of long-term unemployment compensation.

Since the time of our last report, the federal government released personal income estimates for the second quarter



HAWAII REAL PERSONAL INCOME

as well as revised data for the 2008-2010 period. Estimates for the past three years were revised upward from previous estimates. However, real personal income has flattened out in recent months. Labor income growth had expanded at a nearly 3% rate in the third quarter of last year, but slowed thereafter and contracted by 0.7% in the second quarter of this year. In part, this reflects an uptick in inflation, which reduces the purchasing power of income. This year's cut in payroll taxes and strong growth in transfer payments like unemployment compensation and Medicaid have provided some cushion. There is considerable uncertainty regarding potential program extensions, but, consistent with existing law,

we assume an expiration of this year's payroll tax relief at the end of 2011. As a result, we project real income growth of 0.9% in 2012, down from 1.3% growth this year. Real income will expand by a healthier 2.1% in 2013.

Hawaii's slowing this year has been disappointing, but not particularly surprising. The dynamic snap-back of tourism last year raised hopes of a broader acceleration of activity here, but this was not to be. Instead, the underlying economic challenges reasserted themselves, including foreign and domestic public debt scares, intractable unemployment, languishing construction, and still-pricey oil. There has been a renewed awareness of just how delicate the global recovery is and how much drag may soon be coming from efforts to address fiscal imbalances. Against this backdrop, we have seen stock market selloffs and faltering consumer spending.

The biggest present risk is in Europe, where a euro zone that is probably already in recession could be crushed by the sovereign debt crisis if political will is not found to drive a comprehensive solution. The US economy and Hawaii can avoid falling into outright recession if Europe manages to get things right. We are counting on that.

HAWAII ECONOMIC INDICATORS
YEAR-OVER-YEAR PERCENT CHANGE

	2009	2010	2011	2012	2013	2014
Visitor Arrivals	-4.4	8.8	2.1	2.7	1.9	2.0
U.S. Visitor Arrivals	-3.9	7.3	0.8	1.3	1.3	1.4
Japan Visitor Arrivals	-0.6	6.1	-6.6	5.4	0.5	0.8
Other Visitor Arrivals	-10.5	18.3	17.0	5.1	4.8	4.6
Payroll Jobs	-4.5	-0.8	1.2	1.7	2.1	1.9
Employment	-4.1	-0.2	1.6	1.5	1.8	1.9
Unemployment Rate (%)	6.8	6.6	6.0	5.5	5.0	4.6
Inflation Rate, Honolulu MSA (%)	0.5	2.1	3.2	1.6	2.1	1.7
Real Personal Income	-1.4	1.6	1.3	0.9	2.1	2.3
Real GDP	-1.6	-0.1	1.7	2.1	3.0	3.4

Note: Source is UHERO. Figures for 2011-2014 are forecasts.

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