UHERO STATE FORECAST UPDATE, PUBLIC SUMMARY

After Austerity, Road Ahead Will Be Smoother

FEBRUARY 28, 2014

Federal budget woes caused a softening of growth at year-end. With that behind us, we'll see better performance in 2014.

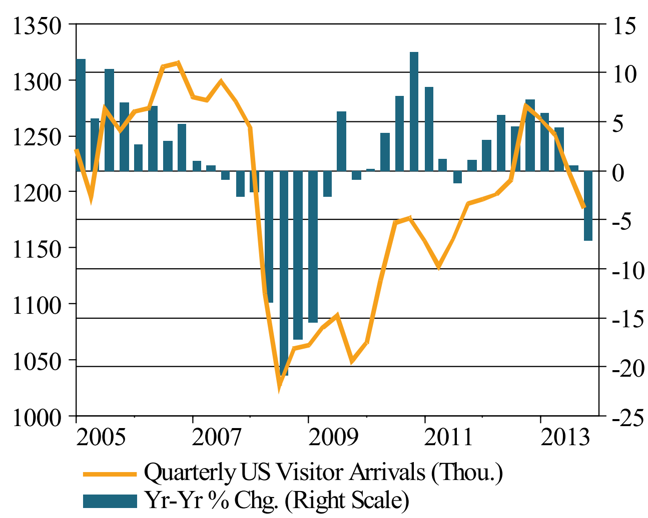
As feared, Hawaii took a hit last year from US fiscal austerity and the uncertainty surrounding Congressional inaction. This showed up in a very weak year-end for tourism, federal civilian job losses, and lower take-home pay for households as the payroll tax holiday ended. Nevertheless, underlying private sector strength remains. Labor markets will continue their gradual improvement, and elusive income gains will finally begin to appear in 2014.

2013 was another record-setting year for the visitor industry, but the year ended on a sour note. While both arrivals and spending were up about 5% through August, the fall shoulder season was especially weak, and December arrivals declined a surprising 2.9% below last year's level. Despite the weak finish to the year, nearly 8.1 million visitors (by air) came to Hawaii in 2013, up 2.5% from the record set only a year earlier. Statewide visitor spending totaled nearly $14.5 billion, up about 2% but essentially flat in real terms after taking into account the estimated increase in local consumer prices.

The lackluster ending to the year was largely the result of weakness in the US visitor market, where fiscal austerity and uncertainty, along with rising vacation costs, suppressed demand for Hawaii travel. According to US Bureau of Economic Analysis data, real spending on travel and tourism also softened nationally after mid-year. During the September to December period, US mainland arrivals were off 6.6%, a net loss of more than 100,000 visitors. US arrivals advanced by less than 1% for 2013 as a whole and remain almost 5% below their 2006 pre-recession peak.

After a strong post-quake bounce back in 2012, Japanese visitor arrivals decelerated sharply. Still, for the year as a whole more than 1.5 million Japanese tourists visited the state, up nearly 4% from 2012 and the highest level since 2001. As we have noted in past reports, the significant depreciation of the yen has had an adverse effect on Japanese visitor spending. Yen-denominated spending increased by 13% last year, but this was offset by a more than 25% decline in the value of the Japanese currency: dollar-denominated expenditures fell by 7.6%. Japanese spending has fallen particularly sharply at retail outlets, presumably reflecting both the weaker yen and soaring hotel room rates.

Once again, the main driver of arrivals expansion was growth in other Pacific Rim markets. Arrivals from China and Korea decelerated sharply from 30%-plus rates of growth in 2012, but still rose 12-13% last year. There were nearly 80,000 more visitors from Oceania (principally Australia and New Zealand), an increase of nearly 30%. Now that it has been added to the US Visa

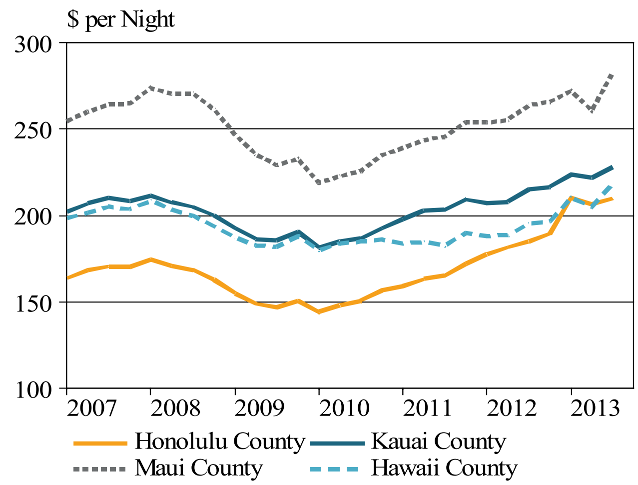


THE LACKLUSTER ENDING TO THE YEAR WAS LARGELY THE RESULT OF WEAKNESS IN THE US VISITOR MARKET

Waiver Program and has a new direct flight, Taiwan's arrivals more than doubled. Despite the strength of Asian visitor markets, the financial gyrations of recent weeks raise some concerns going forward. As prospects for stronger US growth and relative Fed tightening have developed, investors have begun to rebalance portfolios away from emerging markets, leading to capital outflows and exchange rate depreciation in some countries. This process could push a Hawaii vacation beyond reach for some potential visitors and slow arrivals gains from the region.

Even without the risk of adverse currency movements, Hawaii is becoming a more expensive travel destination. In the third quarter, the average room rate on Oahu was $216 per night, up more than 13% from the same quarter last year and nearly 31% higher than in 2011. A 5.1% increase in average airfare from the Mainland to the Islands in the third quarter also weighed on US visitors' budgets. The surge in hotel room rates is the direct consequence of high capacity use. Hotel occupancy rates on Oahu, as reported by Hospitality Advisors LLC, have edged down slightly from their highs last year, but hotels remain full by historical standards. In the third quarter of 2013, 87.2% of Oahu hotel rooms were filled, down just a bit from the 88.7% seen in the third quarter of 2012.

Hotel occupancy on Oahu is likely to tighten further this year as several hotels in Waikiki are scheduled to be taken out of service. The 357 room Miramar at Waikiki was closed at the end of 2013 as part of the International Marketplace redevelopment. Following its recent purchase by a consortium of local and mainland investors, the Ohana Waikiki West is scheduled to begin a renovation project that will upgrade all 659 of the hotel's rooms in several phases starting this spring. The largest shock will come in August when the Sheraton Princess Kaiulani is scheduled to close as part of a three-year $500 million redevelopment plan that will take roughly 1,100 hotel rooms out of the market.



SOARING HOTEL ROOM RATES CONTRIBUTED TO THE RISING COST OF A HAWAII VACATION

With capacity constraints on Oahu biting, it's no surprise that most of the gains in visitor volume have come on the Neighbor Islands, where the number of tourists measured by visitor days broke new records. Visitor days increased by about 4% in Kauai and Maui Counties, and by nearly 3% on the Big Island; visitor days were down by nearly 2% on Oahu. The Neighbor Island markets still have a ways to go to get back to rates of occupancy seen prior to the Great Recession, in part because there have been increases in the stock of accommodations since that time. So there is the potential for at least some additional outward push of visitors to the Neighbor Islands as the expansion continues, but we will need to see an increase in direct flights to Maui and Hawaii Island to facilitate this transition.

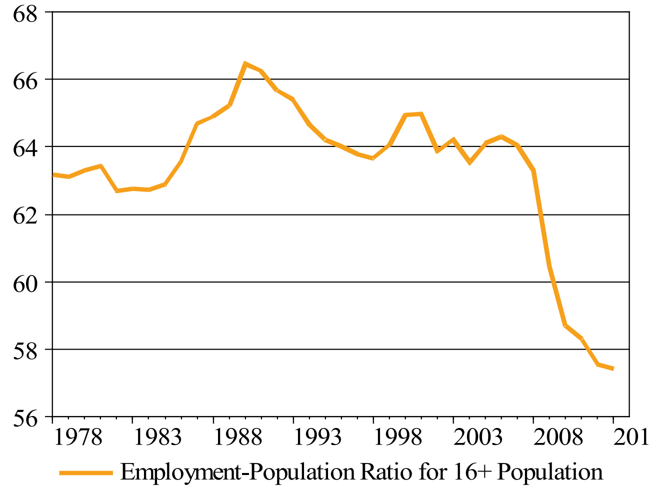
With a fourth quarter decline in visitor arrivals, the tourism industry boom is over. The extent of cost increases we have seen, the lackluster global growth environment, and high rates of capacity use, will all weigh on further growth in the industry. Total arrivals to the Islands will expand just seven-tenths of a percent this year and a bit more than 1% in 2015. While activity will remain at a high level, the days of rapid, recovery-driven visitor gains are behind us.

In the labor market, job creation has been running slower than the pace set in 2012. Not surprisingly, the public sector has been weak, and this has offset stronger job growth in the private sector. Overall, we estimate that 2013 total nonfarm payrolls rose 1.7%, a net gain of roughly 10,500 jobs.[1] After three consecutive years of moderate job gains, conditions in the local labor market have improved considerably, and the number of jobs has climbed back to within roughly 1% of its pre-recession peak.

The private sector job base rose 2.6% last year, and job growth was fairly widespread. Construction firms have ramped up hiring: jobs in the sector were up nearly 7% in 2013, a net gain of more than 2,000 jobs. Related industries also saw expansion, with jobs in the transportation and utilities industry increasing by 3.6%. Visitor industry health drove 3.4% growth in accommodation and food service jobs. Job growth also picked up in professional and business services and in the health-care industry. One notable laggard was wholesale and retail trade, which added fewer than 700 jobs.

State and local government jobs were down nearly 1% in 2013. Federal government jobs were off about 3%, with civilian Department of Defense positions bearing the brunt of the cuts. In preparation for the "sequestration" budget cuts at the beginning of the year, temporary workers were laid off, and a civilian hiring freeze was put into place, resulting in the net loss of roughly 500 DoD positions. Over the course of the year, contract workers were let go as their contracts expired and the civilian hiring freeze remained in place, resulting in the loss of another 500 positions. By the end of the year, there were 5.3% fewer civilian DoD jobs statewide compared to 12 months earlier.

1 *The preliminary payroll employment statistics have been erratic this year, and we expect substantial revisions when the annual benchmark is released in March. The job figures we report here are UHERO estimates that are based on methods and data similar to those used by the Bureau of Labor Statistics in their annual benchmark revisions.*



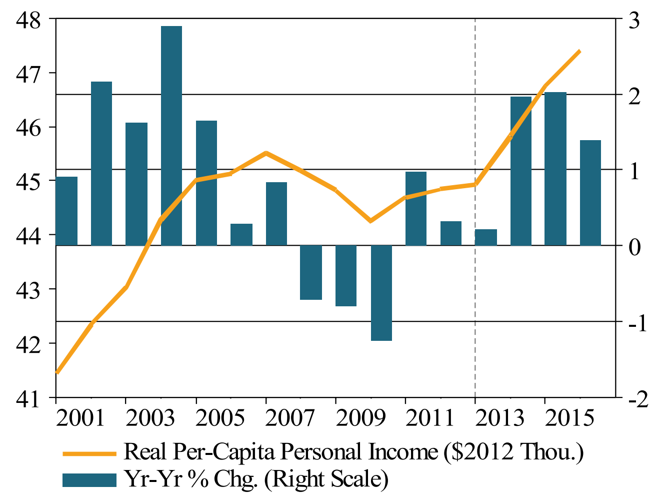
THE SHARE OF THE POPULATION THAT IS EMPLOYED REMAINS WELL BELOW PRE-RECESSION LEVELS

The statewide unemployment rate has fallen steadily since 2012. But this is mostly for the wrong reason: a large number of people have been exiting the labor force, while there have been only marginal gains in employment. (Employment and unemployment from the household survey can differ from the job counts reported by firms in the establishment survey.) The share of the population that is employed remains well below pre-recession levels, mirroring national trends. Preliminary estimates from the Bureau of Labor Statistics indicate that across the state, 57.4% of the civilian non-institutional population was employed in 2013, compare to the pre-recession peak of 64.3% in 2006. While some of the decline is the result of demographic change as the population ages, the declining employment rate is also seen in the working age population, suggesting that cyclical weakness remains a real problem. Hawaii's labor force did pick up at year-end, leading to what is likely a temporary uptick in the unemployment rate.

Prospects for job growth are a bit better for 2014 than they were in 2013, reflecting the fact that public sector job losses have hopefully now run their course. After a net decline of 1.4% in combined federal, state, and local government jobs last year, 2014 will see a modest gain. The private sector overall will see net job creation of just over 2%, down a half point from 2013. The total payroll job base will expand by just under 2%. Growth in most private sectors will be lower this year than last, reflecting slowing that has occurred in recent months and the tendency for rates of increase to flatten as the expansion matures. This will be particularly notable in tourism related sectors, now that growth has receded significantly.

The one important area that will see stronger job growth in 2014 is construction. Activity in the sector will continue to ramp up over the next several years. Building permit data has actually been somewhat mixed of late. Permitting for new residential structures, which include both single family homes and condominium towers, surged by more than 40% in 2013 on Oahu. At the same time, permits for additions and alterations, which were a significant driver of growth in 2012, declined by almost 6% on Oahu. A significant source of weakness in this category has been the substantial slowdown in permitting for photovoltaic systems associated with changes in tax policy and grid restrictions. Across the Neighbor Islands, permitting activity declined by 2.3%, with falling permit values on Maui more than offsetting small gains on Kauai and the Big Island.

While gains in private permitting activity have been uneven, government contracts awarded surged ahead by more than 50% last year. Total government contracts awarded--which do not include work on the Honolulu Rail Transit project--totaled almost $1.2 billion, the highest nominal level since 2004. The State is currently moving forward on a number of infrastructure projects, and military construction will pick up as work at Marine Corps Base Hawaii gets into full swing to prepare for a new squadron of Osprey MV-22 aircraft scheduled to arrive in 2015 or 2016. We'll have more information on the latest developments in the construction industry and a full analysis of industry prospects in our UHERO Construction Forecast, coming in March.



PER-CAPITA INCOMES WILL BEGIN TO RECOVER AS A TIGHTER LABOR MARKET PUTS UPWARD PRESSURE ON WAGES

Returning to broader indicators of economic activity, recent estimates from the Bureau of Economic Analysis indicate that statewide personal income growth picked up in the third quarter, increasing about 4% year-over-year. After adjusting for UHERO's estimate of annual inflation, real personal income increased by a more modest 2%. Real labor income edged up 1.7%, but most of these gains were offset by higher social security taxes as the payroll tax holiday expired. Net earnings, which take into account payroll taxes, were essentially flat. As on the mainland, the recovery has not really begun to raise personal incomes significantly: across the state real per-capita personal income remains roughly 1% below precession levels. That should begin to change now that the payroll hike is behind us and a tighter labor market puts upward pressure on wages. We expect about 3% growth in real personal income for the the next two years.

Finally, new population estimates from the US Census Bureau indicate that the state population surpassed 1.4 million for the first time in 2013. The state population increased by 1% from 2012 to 2013, outpacing the national population growth rate of 0.7%.

CONCLUSION

Our projections for 2014 growth have been marked down somewhat since our last forecast--by about half a percent for both jobs and income. Still, overall economic performance this year will be better than a disappointing 2013. The leading positive factors will be the public sector's turn from substantial drag to marginal contributor and the ongoing expansion in Oahu construction.

For a number of sectors we are now past the growth peak of the current business cycle expansion. That is not to say that growth is ending, but simply that the period of strongest recovery-related job gains has ended. Further increments to hiring will be more measured. The picture for income is different. While we have seen few gains so far, tighter labor markets and better business profitability should allow workers to begin to share more fully in the benefit of economic growth.

There are always storm clouds somewhere on the horizon. Today, they are a spate of recent economic news that could suggest US economic prospects are softening (although the mainland's brutal weather may explain all or most of this). The recent selloff in emerging market stocks and currencies also shows how tricky it will be for the Fed to unwind the extraordinary monetary expansion that it has engineered successfully over the past five years. In Asia, China's slowing growth is a concern, as is the looming consumption tax increases slated for Japan. Still, with Europe on the mend, the global picture remains an overall positive one, and should be sufficiently strong to support continuing growth here in the Islands.

HAWAII ECONOMIC INDICATORS
YEAR-OVER-YEAR PERCENT CHANGE

	2011	2012	2013	2014	2015	2016
Visitor Arrivals	3.7	9.7	2.5	0.7	1.1	1.6
U.S. Visitor Arrivals	2.3	5.2	0.8	0.0	0.4	1.8
Japan Visitor Arrivals	0.2	18.0	3.9	-0.1	0.8	1.0
Other Visitor Arrivals	13.4	17.6	6.6	3.4	3.3	1.3
Non-farm Payrolls	1.2	2.2	1.7	1.8	1.7	1.6
Unemployment Rate (%)	6.5	5.8	4.7	4.2	3.9	3.7
Inflation Rate, Honolulu MSA (%)	3.7	2.4	1.9	1.8	2.6	3.5
Real Personal Income	2.0	1.3	1.2	2.9	3.0	2.3
Real GDP	0.3	1.0	2.6	2.9	3.9	3.2

Note: Source is UHERO. Figures for 2014-2016 are forecasts.
Non-farm Payrolls for 2012 and 2013 are UHERO estimates of the benchmark revision.
Real Personal Income and Real GDP for 2013 are UHERO estimates.

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