UHERO
THE ECONOMIC RESEARCH ORGANIZATION AT THE UNIVERSITY OF HAWAI'I

UHERO STATE FORECAST UPDATE, PUBLIC EDITION

# Growing in a Riskier World

FEBRUARY 26, 2016

## Hawaii's expansion remains on track, but could the global economy derail it?

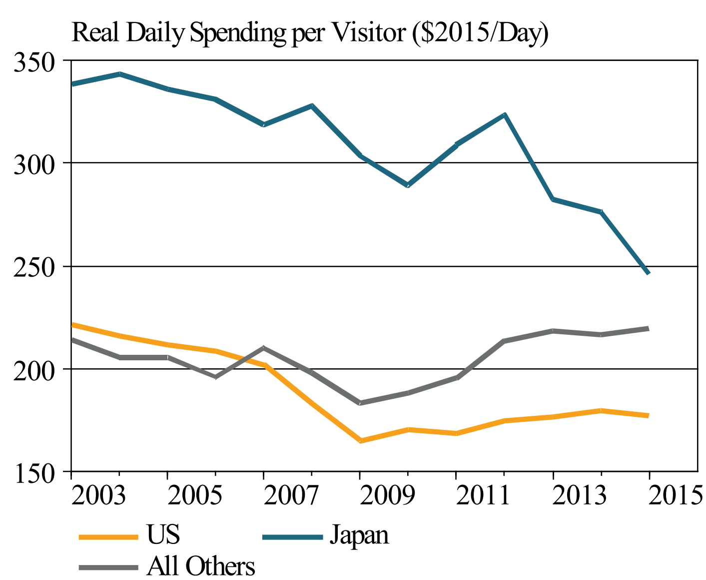
Like the U.S. economy overall, Hawaii continues on a moderate growth path despite financial market volatility, a surging dollar, and global slowing. To be sure, record-setting levels of visitor activity are beginning to feel the adverse effects, but construction strength and a pause in federal sequestration have arrived at just the right time. While risks have clearly heightened in recent months, our outlook is for fairly decent growth over the next several years.

### ARRIVALS WILL REMAIN STRONG, BUT THE DOLLAR WEIGHS ON SPENDING

Last year proved to be yet another record breaking one for Hawaii tourism. In total we hosted more than 8.5 million visitors, about 4% more than in 2014. Each county saw an increase in visitor days. Occupancy rates on Oahu have remained in the lofty 85% range they have inhabited since 2012, an unprecedented period of very high capacity utilization. (Data is from Hospitality Advisors LLC.) And still, arrivals have grown, with additional visitors apparently being absorbed by alternative accommodations.

The strong arrivals figures mask a substantial deceleration of visitor spending, related in part to the strengthening US dollar. Since 2011 the Australian, Canadian, and Japanese currencies have all fallen by roughly 30% against the US dollar. Trade and commodity related weakness in several overseas markets is also a concern, but the biggest spending dropoff has been among Japanese travelers, whose daily spending has declined by almost 25% over the past three years. This has had the biggest impact on Oahu, where international tourists make up nearly half of all visitors, compared with less than a quarter on the Neighbor Islands. But even among US visitors, inflation adjusted daily spending is flat, posing risks for the industry statewide. We will have much more to say about the outlook for the four counties in our County Forecast report, due out in the second quarter.

The airline seat outlook reflects anticipated slowing of the North American markets and continuing challenges in Japan, with more upbeat expectations for other international markets. For the US, after first quarter gains from expanded Delta, Alaska, and Virgin America offerings, the annual number of scheduled seats is expected to be flat. A similar story holds for the Canadian market, where new Westjet routes lift scheduled seats in the first quarter, but leave anticipated annual figures more or less unchanged. Airlift is

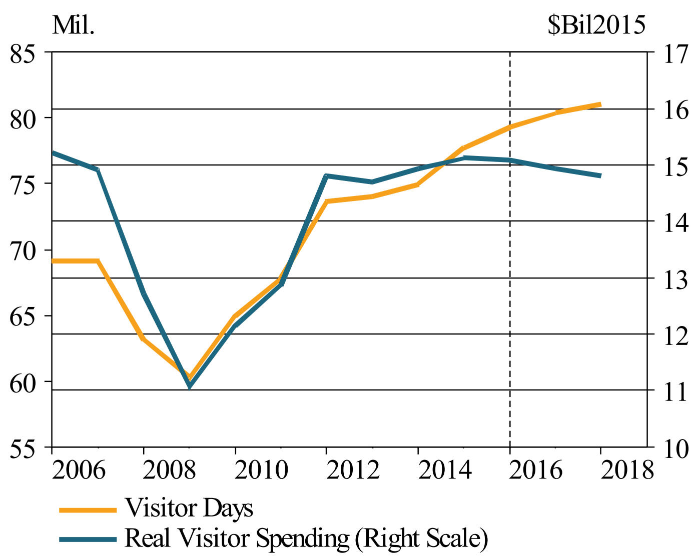



JAPANESE DAILY VISITOR SPENDING HAS FALLEN BY ALMOST 25% OVER THE PAST THREE YEARS.

expected to be higher for Australia and China, although this will be offset by further declines in Japanese flights.

Some lift to the industry may come from lower travel costs. So far the massive decline in oil prices has been slow to translate into lower airfares. In the first half of 2015 (the latest data available), the average roundtrip airfare on flights from the US mainland to Honolulu declined by roughly 5% year over year; during that same period the price of oil fell by nearly half. Japanese carriers have, however, been removing fuel surcharges. Of course, as we have seen nationally, the positive effects of lower energy costs can be offset by their adverse effects on investment in affected countries and regions.

The overall visitor outlook remains favorable, but gains will fall short of recent years. Restored capacity will provide more space on Oahu, and the Neighbor Isles still have spare capacity, but global economic conditions and the cautious stance by airlines are sobering. We expect arrivals to rise by 1.3% this year and just 1% in 2017. The dollar will continue to weigh on spending, which will be essentially flat in real terms this year. Sharper currency movements could take a bit more off our already cautious forecast for international arrivals, as well.




THE STRONG ARRIVALS FIGURES MASK A SUBSTANTIAL DECELERATION OF VISITOR SPENDING.

## EMPLOYMENT GAINS WILL LIFT WAGES

Labor market conditions continue their trend improvement. Employment growth is outpacing expansion of the labor force, driving the unemployment rate down to a seasonally adjusted 3.2% in December, its lowest rate since early 2008. At the same time, the pace of growth in payroll jobs has eased as we have moved from the business cycle recovery period onto a more typical long-run path. Job growth averaged more than 2% in 2012-2013; last year payrolls increased by 1.4%, fewer than 9,000 jobs.

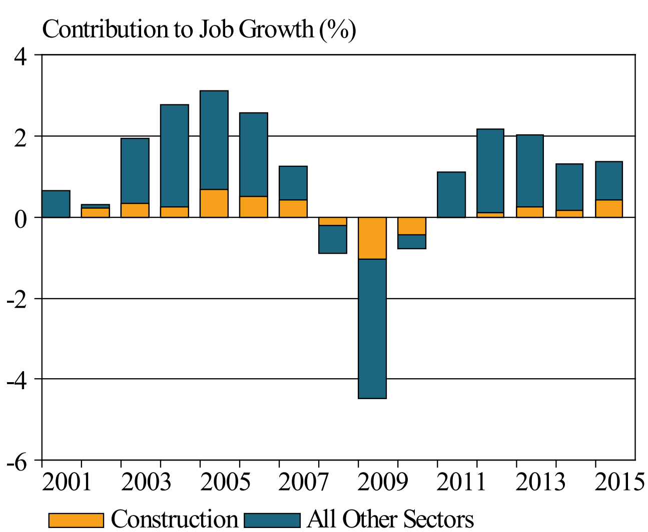
As we have discussed in past reports, the impetus for growth has increasingly shifted away from travel and tourism, which led the state's emergence from recession. Now it is construction that is generating the greatest job gains. The sector really kicked into high gear in 2015, accounting for nearly one-third of all jobs created. Recent months have come in particularly strong. According to our in-house estimates of the upcoming government benchmark revision, we now estimate an 8% gain in construction jobs last year. All other sectors combined increased by about 1%.

The principal drag on growth continues to be the public sector, which shed more than 900 jobs last year. While recent legislation has deferred the next round of federal budget battles until after the presidential election, the medium-term prospects for federal employment remain bleak. Things look a bit better at the state and local levels, where budget constraints are likely to be less severe.

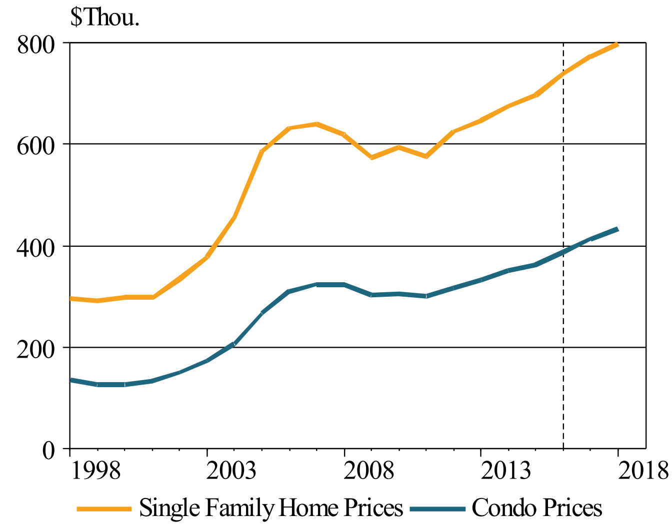
There are several areas of ongoing strength outside the construction sector. Healthcare had a very strong year, expanding nearly 3% and accounting for about a fifth of all jobs created. This may reflect increased Medicaid transfers under the Affordable Care Act. Transportation and utilities surged 3%. Despite the stronger than expected arrivals gains, jobs in the accommodations and food services sector managed only 1.4% growth last year, in part because of temporary closure of several resorts for renovation. Retail trade employment rose less than 1%, and the broad "other services" category by only 0.7%. Business services saw limited growth that was partially offset by softness in the information industry and private sector education services.

Tightening of the labor market is now prompting significant gains in personal income. Real income per employed person last year posted its strongest growth since 2012, according to UHERO estimates. Still, the data suggest that pockets of labor market weakness remain. For example, temporary service employment continues to play a disproportionate role in job gains. Further improvement in employment conditions will drive a broad based increase in wages, as unemployment rates edge further downward and pockets of worker shortage emerge in some industries.

Employment in several important sectors will be significantly affected by downsizing, business closures,




THE CONSTRUCTION SECTOR ACCOUNTED FOR NEARLY A THIRD OF ALL JOB GAINS IN 2015.



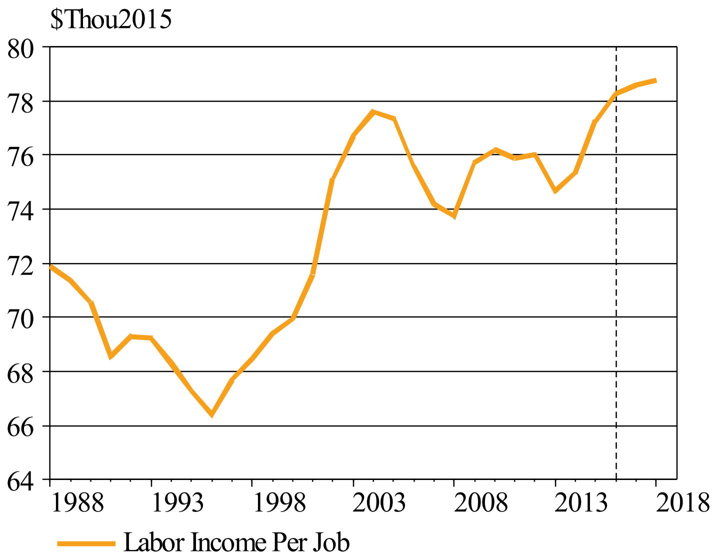

OAHU HOME PRICES CONTINUE TO MOUNT, BUT AT A RESTRAINED PACE.

and ownership change. Alexander & Baldwin's recently-announced closure of Hawaii Commercial & Sugar, the state's last remaining sugar plantation, will lead to the layoff of roughly 650 employees by 2017, about 1% of the Maui labor force. Kaiser Permanente has agreed to take control of the state-run hospitals on Maui and Lanai by mid-year, reducing uncertainty over jobs at three Hawaii Health Systems Corporation facilities.

The Army will be cutting by 8% the number of active duty army troops stationed at Schofield Barracks by the end of fiscal 2017; this will result in a loss of roughly 1,200 troops. The Army will cut roughly 17,000 civilian workers nationwide during the same period, although the details of where those layoffs will occur are yet to be determined. Over the longer run, the anticipated relocation of Marines from Okinawa to Hawaii will be a stabilizing factor.

Overall, we expect the payroll job count in the islands to expand by 1.3% this year, in line with last year's growth. As the construction upswing matures, growth will drop below 1% by 2018.




LABOR INCOME GAINS ARE NOW THE DRIVING FACTOR IN OVERALL INCOME GROWTH.

## CONSTRUCTION CYCLE IS THE CLEAR GROWTH IMPETUS

The construction sector is bustling. Last year, the real (cost-adjusted) value of private permits rose nearly 14%, the second year of double-digit gains. The main driving force remains the residential sector on Oahu, but the Neighbor Islands have also picked up steam, with an 11% surge in construction jobs last year.

Prospects for residential construction continue to look favorable statewide. Notable recent developments include a Supreme Court ruling that clears the way for D.R. Horton's Hoopili project on the Ewa Plain, planned 2016 groundbreaking on several more Kakaako condo towers, and progress on residential developments on the Big Island. On the flip side, we have seen our first cancellation of a planned Kakaako residential tower, the luxury Vida project, because of weak sales. Other luxury projects, such as Park Lane, have had very successful pre-sales, so it is unclear whether this reflects a topping out of the high end market or merely characteristics and timing of this particular project.

Home prices continue to mount, but at a fairly restrained pace. The median price of a single family home on Oahu increased to $700,000 in 2015, or about 3%. The median price for a condo rose to $360,000. Homes and condos continue to sell at a very rapid clip, with median time on market of about 20 days. Home prices across the Neighbor Islands have continued their recovery as well. Kauai saw the most substantial growth last year, with the median price for a single family home jumping more than 15%; the Big Island and Maui saw more modest gains of 4% and 2%, respectively.

Activity on the nonresidential side has been more moderate, with some falloff of permitting in the second half of the year. While new retail and resort-related projects are in the works or ongoing, others are now winding down. The half-billion-dollar development of Ala Moana Center's Ewa Wing was completed last fall. We expect an uptick in non-residential permits this year and next, falling off thereafter.

Public construction surged last year, in part due to a second quarter spike in contracts awarded for roadway and car rental improvements at Kahului airport and the appearance of Honolulu rail stations in the statistics. Looking forward, rail has lept another hurdle with the recent approval by the Honolulu City Council of the GET surcharge through 2027, and there are ongoing upgrades to Hilo Harbor, and new road work on the Big Island. As we noted in our last report, the future of the Thirty Meter Telescope is uncertain, as the entire permitting process has to be restarted, which is likely to take years rather than months. In the meantime, TMT management is actively searching for alternative sites.

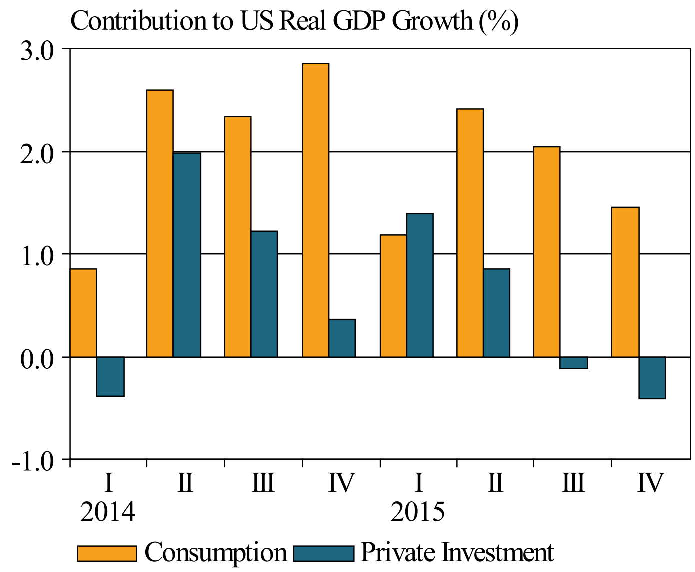
## INFLATION RESPITE WILL END, AND INCOME GAINS WILL TAPER OFF

Inflation remained muted in the second half of 2015, largely thanks to falling energy prices. For 2015 as a whole, Honolulu consumer prices increased 1%, the lowest rate since 2009. The energy component of the Honolulu CPI declined by 25% as the price of oil dropped from an average of $100/bbl in 2014 to $37/bbl by the end of 2015.

While headline inflation has remained low, it is clear that prices for many goods and services are beginning to increase. Core inflation, which excludes the volatile food and energy components, ticked up to 2.7%, the fastest pace since 2007. The shelter component of the CPI increased by 3%, also the highest inflation since 2007. As the dampening effect of energy price decline fades, these factors will push inflation above 2-½% by 2017 and to nearly 3% in 2018.

Moderating inflation has helped to boost income. Through the first three-quarters of last year, real personal income increased 4%, the fastest income growth since 2004. Labor income is now the driving factor, led by double-digit gains in the construction sector. But income growth will taper off across nearly all sectors over the next several years, with particular weakness expected in the public sector. Real income growth will slow to 2.3% this year and drop to 1.4% late in the decade.

Since the beginning of the recovery we have seen relatively limited gains in real gross domestic product for Hawaii. In 2014, the latest data available, per-capita real GDP remained more than 8% lower than the pre-recession peak. However, based on currently available data we estimate that real GDP increased 4% in 2015, and we expect 3.2% growth this year. As with income, GDP growth will slow in coming years, falling to 1.6% late in the decade.




THE OIL PRICE COLLAPSE HAS HAD A NEGATIVE EFFECT ON CAPITAL INVESTMENT.

## WORRIED ABOUT THE REST OF THE WORLD

So, Hawaii seems more or less on track. The problem is a rising risk that global economic conditions could derail us. Marked slowing in China and the adverse effects on developing countries of plunging commodity prices have prompted concerns about the resiliency of global demand going forward. This has come right when the Federal Reserve has begun its move away from ultra-low interest rates. The result has been growing financial market volatility and weakness, and depreciation of many currencies against the dollar. To keep their economies afloat, policymakers abroad have scrambled to come up with new monetary stimulus.

This does not yet mean we are in for a global recession, or that global conditions will deteriorate enough to badly hurt Hawaii. The US economy has held up well so far. Yes, exports have suffered from poor demand and the strong dollar, and the oil price collapse has had a marked negative effect on capital investment. But US consumer spending remains steady and confidence high, and the drag from government cuts has eased for now. With the US still by far our largest visitor market, this is certainly good news. And while foreign economies have weakened, there remains considerable upside potential for these markets over the medium term.

Still, the situation remains precarious. With the US only managing 2+% growth, and with little room for monetary easing and zero appetite for fiscal stimulus, prolonged financial market turmoil, additional dollar appreciation, or excessive Fed tightening could tip things downward. Since the US is the sole growth engine at present, that would swing the global economy toward recession. If that were to happen, all bets would be off for Hawaii growth.

HAWAII ECONOMIC INDICATORS
YEAR-OVER-YEAR PERCENT CHANGE

| | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|
| Visitor Arrivals | 1.7 | 2.3 | 4.3 | 1.3 | 1.0 | 1.2 |
| U.S. Visitor Arrivals | 0.7 | 2.2 | 5.7 | 1.5 | 1.2 | 1.1 |
| Japan Visitor Arrivals | 3.6 | -0.4 | -0.8 | -0.5 | 0.1 | 1.2 |
| Other Visitor Arrivals | 3.2 | 5.0 | 4.7 | 2.1 | 1.1 | 1.5 |
| Non-farm Payrolls | 2.0 | 1.3 | 1.4 | 1.3 | 1.1 | 0.9 |
| Unemployment Rate (%) | 4.9 | 4.4 | 3.7 | 3.0 | 2.8 | 2.9 |
| Inflation Rate, Honolulu MSA (%) | 1.8 | 1.4 | 1.0 | 1.7 | 2.6 | 2.8 |
| Real Personal Income | -1.0 | 3.2 | 3.9 | 2.3 | 1.7 | 1.4 |
| Real GDP | 0.8 | 1.3 | 4.0 | 3.2 | 2.1 | 1.6 |

Note: Source is UHERO. Figures for income and GDP for 2015 are UHERO estimates. Figures for 2016-2018 are forecasts.

Non-farm Payrolls for 2014 and 2015 are UHERO estimates of the forthcoming benchmark revision.

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