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

UHERO STATE FORECAST UPDATE, PUBLIC EDITION

GROWTH CONTINUES, FOR NOW

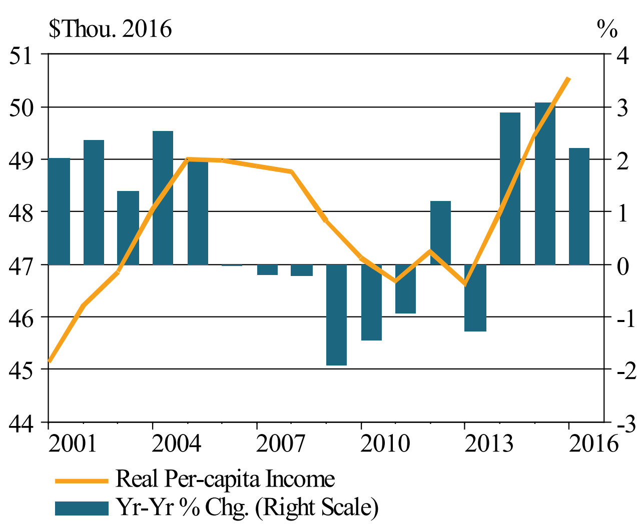
MAY 5, 2017

The economic outlook for Hawaii remains favorable, despite tremendous uncertainty about future US policy.

Hawaii's economy has started the year in fine form. Moderate job and income growth are continuing, and generally favorable global and national conditions are maintaining impressive tourism numbers. The construction buildup has eased, but the industry remains very active. While developments in Washington could hurt us, for now prospects look good for continued growth, if at a less rapid pace than we have seen in recent years.

EXPANSION GENERATING NICE INCOME GAINS

Seven years of expansion have largely eliminated spare capacity across much of the local economy. This has restored labor markets to health and improved household finances. The latest figures on personal income illustrate both the gains to date and point to continuing moderate expansion. Income lagged in the years following the Great Recession, but recent growth has been impressive. Between 2013 and 2016 per-capita real income in the state grew by 2.7% per year, the strongest three year period since the early 2000s. Now that recovery is complete and inflation is beginning to pick up, further gains will be smaller. Real personal income growth will slow to 1.6% this year and 1.3% by 2019.



INCOME LAGGED AFTER THE GREAT RECESSION, BUT RECENT GROWTH HAS BEEN IMPRESSIVE

Labor markets are now at or near what economists consider "full employment" conditions, that is, unemployment has receded to the normal level consistent with an economy growing along its long-term trend path. Nonfarm payrolls now surpass their 2007 peak by 25,000 jobs, and the unemployment rate is near its lows of the previous decade. The scope for further employment gains is therefore limited, but there are few signs of developing weakness. Aggregate job growth will ease to 1% this year and will decelerate to roughly half a percent by the end of the decade.

GLOBAL OUTLOOK BETTER, RISKS HUGE

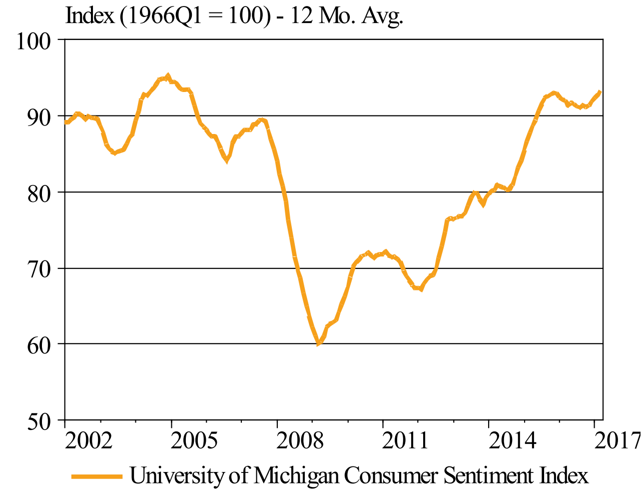
Global economic conditions are always important to Hawaii's outward-oriented economy, and rarely have the stakes been higher. The election of Donald Trump and the return to Republican control of both the executive and legislative branches have raised the possibility of significant changes to federal fiscal policy, both on the spending and tax sides. Already, the push for tighter immigration has disrupted travel and tourism, although to date the impact on Hawaii appears limited. That the temporary travel ban on visitors from majority Muslim countries has been halted (for now) in the courts shows the possible limits to the most aggressive policy changes, and the failure of the first stab at health care reform demonstrates the challenges Republicans face on important domestic issues. Still, there is the potential for disruptive change that could have both positive and adverse effects here.

One area where we have already seen direct effects is the President's temporary halt to federal hiring. Although the freeze expired in April, the latest administration guidance to federal agencies will continue to limit hiring. The administration's sketchy budget blueprint, released in March, includes a $54 billion expansion in defense spending, offset by deep cuts in many types of non-defense spending. The administration has instructed federal agencies to begin planning now for workforce reductions in coming years. It appears unlikely that Congress will go along with anything like the proposed sweeping changes, still there is a risk that big spending cuts in some areas are in the offing. On the flip side, there remains talk of a substantial infrastructure spending program, which could boost activity here. For now, our expectation is for relatively flat overall federal government payrolls in Hawaii.

Prospects for macroeconomic performance in the US and abroad have improved a bit since our last report. A pickup in world trade and apparent firming in China are leading to a bit more optimistic global outlook. In the US there is now a puzzling disconnect between measures of real economic activity, which with some exceptions have been only moderately strong, and measures of sentiment, which are the most positive since at least the pre-crisis period. The question is which of these will win out: will sentiment fuel a spending surge, or will reality bring confidence back down to earth? Certainly this will be influenced by any federal fiscal changes and the pace of interest rate hikes by the Federal Reserve.

NOT MUCH ROOM FOR TOURISM GROWTH

The positive, if unremarkable, outlook for US and global growth suggests ongoing strength in the demand for Hawaii tourism. And 2017 has started off strong for the industry. In the first two months of the year, there were 1.4 million visitor arrivals, 2.3% more than during the same period last year. Hotels are operating at very high levels of occupancy, and in

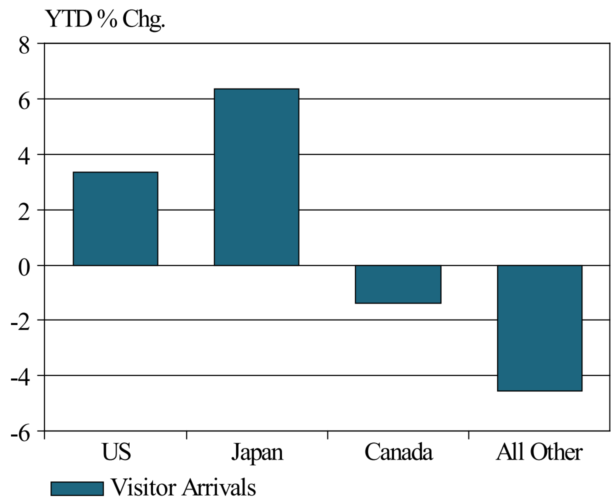


US CONSUMER SENTIMENT HAS RETURNED TO PRE-CRISIS LEVELS

recent months room rates have been rising rapidly (data from Hospitality Advisors LLC). Appreciating room prices have been the biggest factor behind a nearly 9% surge in overall visitor spending in the year so far.

Visitor growth this year has come largely from the traditional US mainland and Japanese markets, while other markets around the Asia-Pacific region have slumped. The Japanese market saw a substantial boost in direct airlift to the state when Hawaiian launched Tokyo-to-Kona service, and both Hawaiian and JAL have expanded service to Honolulu. As a result, arrivals from Japan surged more than 6%, the first signs of growth after several years of stagnation. Visits from the US mainland are continuing to grow at a modest rate. Arrivals have been flat or falling across most non-traditional markets, reflecting both the strong dollar and restrained growth within the Asia-Pacific region. Recent evidence of a pickup in China's economy and in regional trade is good news for a firming of these markets.

Nevertheless, the scope for additional arrivals growth is limited. Traditional hotel and timeshare properties are already operating at very high levels of occupancy. While individual vacation rentals have taken up some of the slack, prospects for further expansion may be limited by the number of available units and potential regulatory pushback. We



VISITOR GROWTH THIS YEAR HAS COME FROM THE US MAINLAND AND JAPAN

expect total arrivals to advance nearly 2% this year. Growth will slow below 1% by the end of the decade as capacity constraints bite. Still, despite slowing growth, the state's visitor industry will continue to operate at robust levels of activity, with visitor volumes at all time highs in all counties. (We will have more to say about prospects for each county in our annual *County Forecast* report, to be released in the coming weeks.)

CONSTRUCTION SETTLING ON HIGH PLATEAU

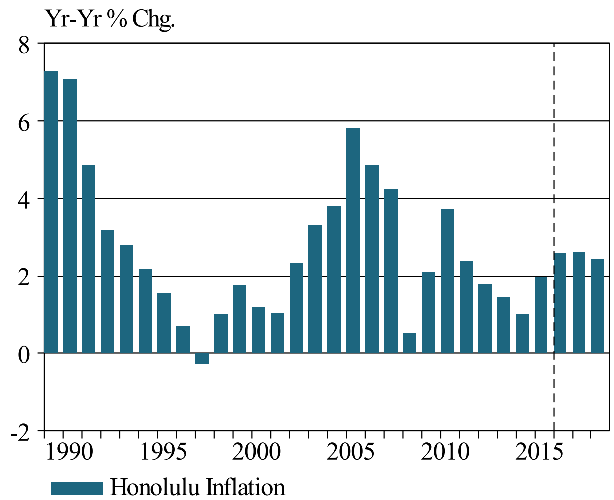
The multi-year ramp-up of construction has ended. Industry jobs topped out early last year and in March were actually running more than 2% lower than year-earlier levels. However, there is enough activity in the pipeline to maintain employment near the current level for the next several years. Recent announcements of new projects have been centered in resort and retail related construction, with indications that a slow buildup in residential home construction will continue. On Maui, the Makena Resort redevelopment, which will convert the 310-unit hotel into luxury apartments, could break ground next year and finish by 2023. On Oahu, a mainland developer has unveiled plans to redevelop the former Niketown building in Waikiki, which has been vacant since 2009, into a 230-room hotel. Construction on the second residential tower in Howard Hughes' Ward Village neighborhood is expected to finish this summer, and demolition is due to begin at Ward Warehouse by year end, in preparation for the next set of towers. Statewide construction employment will remain near 38,000 workers through 2018, before easing lower as the current cycle begins to wind down.

Home prices on Oahu continue to appreciate at a modest rate. In the first quarter of 2017, the median-priced single-family home sold for more than $745,000, up 3.6% from the same period last year. Energy prices, which have been keeping a lid on inflation, have also begun to pick up; regular gasoline prices on Oahu are now roughly fifty cents higher than in early 2016. Overall, we expect the inflation rate to rise to the 2.5% range for the next three years.

RAIL NOT ONLY PUBLIC SECTOR CHALLENGE

The Honolulu rail project continues to grapple with funding challenges. Faced with a projected budget shortfall of $3 billion, the Caldwell administration originally requested that the State extend to perpetuity the half-percent excise tax surcharge. When that went nowhere, the City reduced the request to a ten-year extension. At the time of this writing, state lawmakers are tussling over options, with one possibility just a two-year extension. Mayor Caldwell has indicated that without the excise tax extension the remaining shortfall would need to come from property tax increases. This would require City Council approval, as well as the repeal of an existing ordinance that explicitly blocks general fund revenues from being used to finance rail construction. The Feds have required that the City submit a revised funding plan by the end of April.

Budget pressures are also evident at the State level. Since the July 2016 start of the current fiscal year, revenue numbers have been very volatile month-to-month, and have generally been coming in lower than projected. This has worsened longer-running structural challenges to funding State



INFLATION WILL RISE TO THE 2.5% RANGE FOR THE NEXT THREE YEARS

obligations. The Hawaii State Teachers Association's proposal for a dedicated tax on investment properties and resorts to fund education, which would require a constitutional amendment, has been deferred, but could resurface next session. At the time of this writing, House and Senate leaders have agreed on a State budget that increases spending over last year's levels, but less than in the Governor's initial budget request, and they have tentatively approved a billion dollar construction budget. Negotiations with public sector unions are ongoing. In any event, tight fiscal conditions are expected to continue at both state and local levels, which will hold the line on public sector employment in coming years.

WHAT, US WORRY?

Once again, we have a fairly upbeat forecast for the state economy. Growth will trend lower now that recovery is complete and construction is topping out, but there are no signs of an imminent downturn. We are wary of potential disruptions at the federal level, which the first 100 days of the Trump presidency have demonstrated are impossible to anticipate. Tax cuts or an infrastructure plan could boost US growth prospects, although knock-on effects here would be limited by tight capacity. Risks to the downside continue to be a bigger concern, whether in trade and immigration policy, job cuts, or the longer-run drag from a blow-up in public debt.

HAWAII ECONOMIC INDICATORS
YEAR-OVER-YEAR PERCENT CHANGE

	2014	2015	2016	2017	2018	2019
Visitor Arrivals	2.4	4.5	3.1	1.9	1.1	0.8
U.S. Visitor Arrivals	1.1	6.9	4.1	2.6	1.4	0.6
Japan Visitor Arrivals	-0.4	-1.9	0.4	1.9	-1.0	1.1
Other Visitor Arrivals	9.2	3.1	2.6	-0.4	1.9	1.5
Non-farm Payrolls	1.4	1.8	1.4	1.0	0.8	0.6
Unemployment Rate (%)	4.4	3.6	3.0	2.8	2.9	3.2
Inflation Rate, Honolulu MSA (%)	1.4	1.0	2.0	2.6	2.6	2.4
Real Personal Income	3.6	3.7	2.4	1.6	1.5	1.3
Real GDP	1.1	3.9	2.3	1.4	1.3	1.4

Note: Source is UHERO. Figures for GDP for 2016 are UHERO estimates. Figures for 2017-2019 are forecasts.

[THIS PAGE INTENTIONALLY LEFT BLANK]

UHERO

THE ECONOMIC RESEARCH ORGANIZATION
AT THE UNIVERSITY OF HAWAIʻI

UHERO THANKS THE FOLLOWING SPONSORS:

KAWEKIʻU - THE TOPMOST SUMMIT

Hawaii Business Roundtable

KILOHANA - A LOOKOUT, HIGH POINT

American Savings Bank
First Hawaiian Bank
Hawaiian Airlines
Hawaiʻi Electric Light Company, Ltd.
Hawaiian Electric Company, Inc.
Matson Company
Maui Electric Company, Ltd.
The Nature Conservancy

KUAHIWI - A HIGH HILL, MOUNTAIN

Bank of Hawaiʻi
Better Homes and Gardens Real Estate Advantage Realty
Central Pacific Bank
First Insurance Company of Hawaii, Ltd.
Hauʻoli Mau Loa Foundation
HGEA
The Howard Hughes Corporation
Kaiser Permanente Hawaiʻi
Kamehameha Schools
The Natural Energy Laboratory of Hawaii Authority
The Pacific Resource Partnership
Servco Pacific, Inc.
Stanford Carr Development
Young Brothers, Limited

Kulia I Ka Nuʻu (literally "Strive for the summit") is the value of achievement, those who pursue personal excellence. This was the motto of Hawaiʻi's Queen Kapiʻolani. Sponsors help UHERO to continually reach for excellence as the premier organization dedicated to economic research relevant to Hawaiʻi and the Asia Pacific region.

The UHERO Forecast Project is a community-sponsored research program of the University of Hawaiʻi at Mānoa. The Forecast Project provides the Hawaiʻi community with analysis on economic, demographic, and business trends in the State and the Asia-Pacific region.

All sponsors receive the full schedule of UHERO reports, as well as other benefits that vary with the level of financial commitment.

For sponsorship information, browse to http://www.uhero.hawaii.edu.