First Hawaiian Bank

Economic Forecast

HAWAII ISLAND EDITION 2014 - 2015

Weathering the Storm: Hawaii Island Growth Continues, Despite Tourism's Deceleration

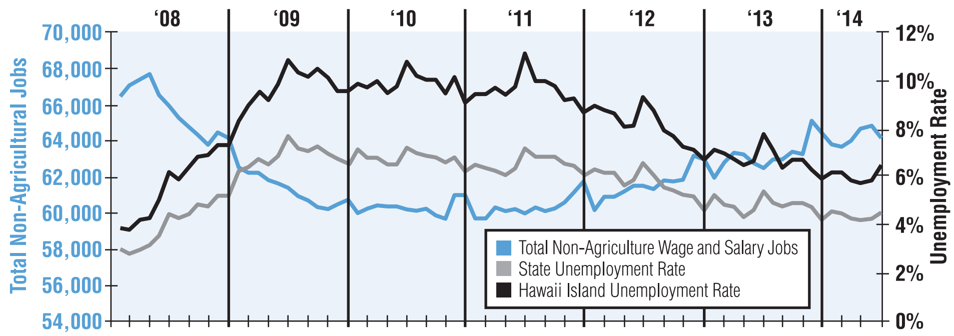
Overall, Hawaii Island's economy continues its expansion, coming back from the downturn of the Great Recession. The rest of 2014 and 2015 are expected to be good for most of the island's businesses and workers, in spite of Tropical Storm Iselle:

- Even though tourism overall has been sputtering, some parts of the island such as the Kohala coast are doing record business.
- Real estate has benefited from the island's economic strength and from interest from outside buyers.
- Construction is continuing to come back on the strength of residential and infrastructure projects.
- We are awaiting data to see how Tropical Storm Iselle will ultimately affect the island's economy. Although there was serious damage to Puna's homes, utilities, small businesses and papaya farms, the good news is that the damage was geographically limited and Hawaii Island's tourism infrastructure was not badly affected. Rebuilding will add to construction activity.

Jobs Picture is Bright

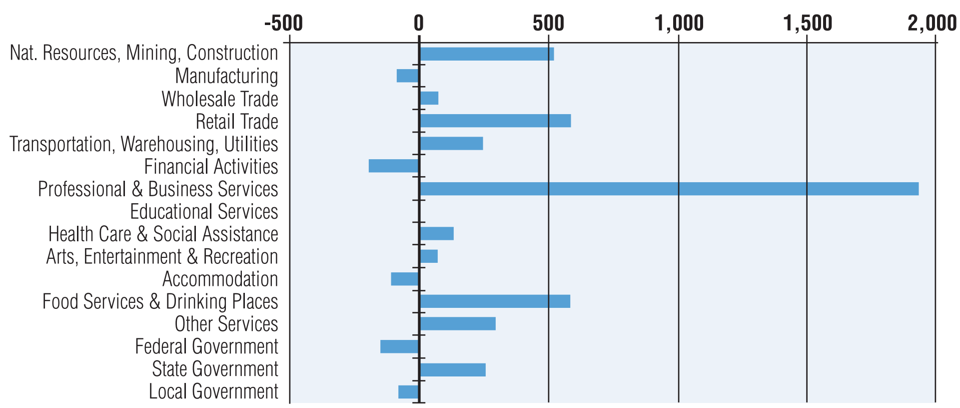
Job growth (Blue line, Chart 1) returned to Hawaii Island in late 2011 and continued through 2013. Job counts are now 4,300 above the low in 2010, and the county unemployment rate has steadily improved to around 6% — well off the peak above 11% in 2011. Yet the Hawaii Island labor market is not as robust as the state as a whole where unemployment is now approaching less than 5%.

CHART 1 • HAWAII ISLAND JOBS AND UNEMPLOYMENT



Source: Hawaii State Department of Labor via DBEDT

CHART 2 • HAWAII ISLAND JOB GROWTH, 2010-2014



Source: Hawaii State Department of Labor via DBEDT

Job growth has been uneven across the island as employers remain somewhat gun-shy about hiring. Much of the growth has come in tourism-related jobs, such as retail trade and food service. (Chart 2.) Construction has also seen increases. Yet, the largest growth has been in professional and business services — somewhat misleading because much of this category refers to jobs through employment agencies. These agencies are the official employer of record even though the actual jobs may be in any other part of the economy. Yet, some in this group are also high-value added workers in innovation, energy efficiency, and business services.

—continued on page 2

ON THE INSIDE

Analysis by Dr. Jack P. Suyderhoud, Professor of Business Economics, Shidler College of Business, University of Hawaii at Manoa and Economic Adviser to First Hawaiian Bank.

Hawaii County *(continued from page 1)*

Tourism: Unsteady in 2014

Visitor Arrivals: Hawaii Island is less dependent on tourism than other neighbor islands. Chart 3 shows the visitor arrivals per resident in each market. Since 1990 this relative dependence has been decreasing across the state, including Hawaii Island. Here, of course, the Hilo and Kona sides are at polar opposites in terms of tourism dependence: Kona has a high (and above average) dependency on tourism whereas the Hilo side does not. Hence, when we discuss Hawaii Island tourism, it is mostly a west-side story.

Visitor arrivals to Hawaii Island were 1.45 million in 2013, up slightly from the prior year, but not yet back to the pre-recession peak of 1.62 million in 2007.

> *"Hawaii Island tourism is mostly a west-side story."*

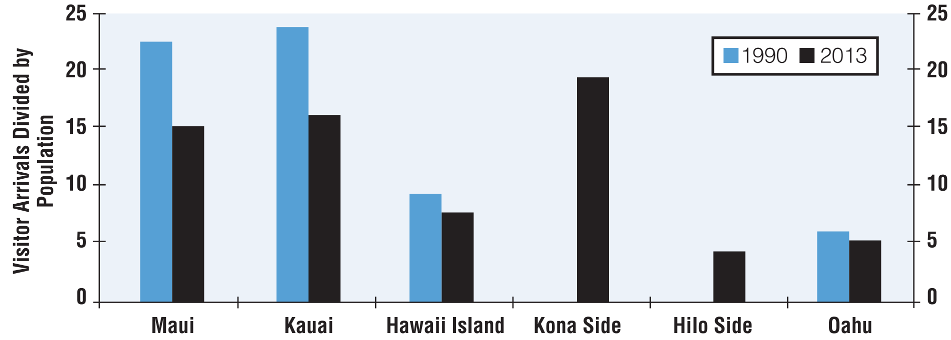
We had hoped 2013 would be better than it was, but starting in the last quarter of the year visitor arrival numbers turned negative. (Chart 4.) While we had expected a slowdown, the downturn in late 2013 caught many by surprise. Also troubling is that the downturn has persisted into the first few months of 2014.

Visitor Spending: The visitor arrival softness has been accompanied by weak visitor spending, as shown in Chart 5. Fortunately for Hawaii Island the decline in visitor expenditures has not been as drastic. In fact, there have been recent months when spending has been up, if only slightly, even as arrivals declined.

The makeup of the tourists coming to Hawaii Island remains unique among Neighbor Islands. Hawaii Island has the largest proportion of foreign visitors with Japan leading the way. (Chart 6.) Increasingly, more Chinese visitors come for day trips. This growth is important, but given the small base, even large growth of Chinese visitors will not add huge numbers to the counts.

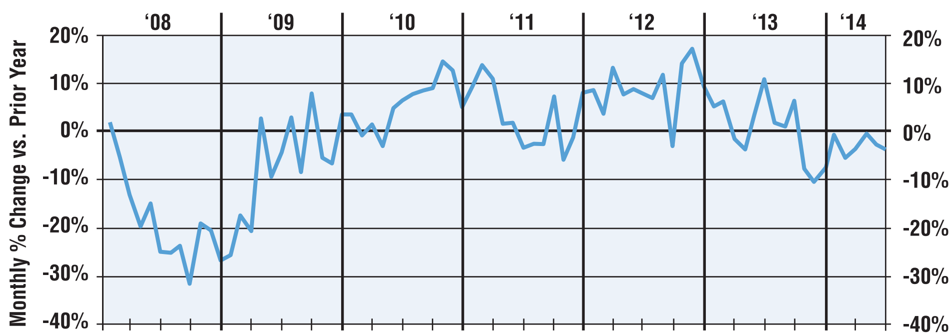
Visitors to Hawaii Island are not big spenders. In 2013 average daily spending was $177 compared to $205 for Oahu and $194 for Maui. Only Kauai at $171 was lower. Hawaii Island benefits somewhat from its lodging inventory, which is not as dominated by alternative vacation units such as timeshares and condo hotels. In addition, hotels have been less likely to increase room rates on Hawaii Island compared to other Hawaii locales.

CHART 3 • RELATIVE IMPORTANCE OF TOURISM SECTOR



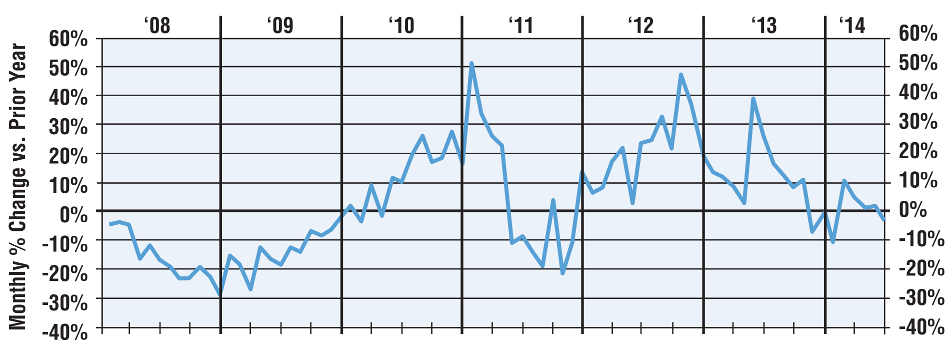
Source: Hawaii DBEDT

CHART 4 • HAWAII ISLAND VISITOR ARRIVAL GROWTH



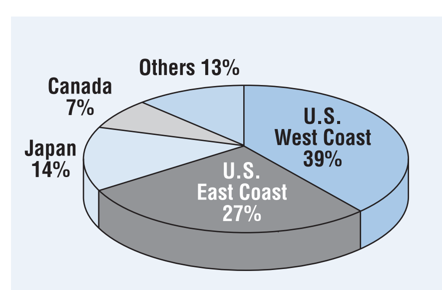
Source: Hawaii DBEDT

CHART 5 • HAWAII ISLAND VISITOR SPENDING GROWTH



Source: Hawaii DBEDT

CHART 6 • HAWAII ISLAND VISITOR ARRIVALS BY MARKET AREA, 2013



Source: Hawaii Tourism Authority via Hawaii DBEDT

Airline Seats: The business strategies of airlines matter a great deal to visitor counts. The slowdown in arrivals is perhaps caused by, and certainly associated with, declining seats. Hilo experienced declines in airline seat capacities in the first part of 2014, but Kona did well. (Chart 7.) It's good news that for Kona both domestic and international seats are expected to increase in late summer of 2014. Alas, Hilo is not destined for the same. Tourism officials note that airlift from Honolulu remains a concern though the expansion of routes by the state's smaller carriers may be helping.

Tourism marketers continue to focus on the Island's "bread and butter" markets: California and the Pacific Northwest. Meanwhile they are also working hard to bring more international travelers to Hawaii Island, though the lack of an acceptable customs facility and determining how to pay for immigration and customs enforcement personnel remain significant obstacles.

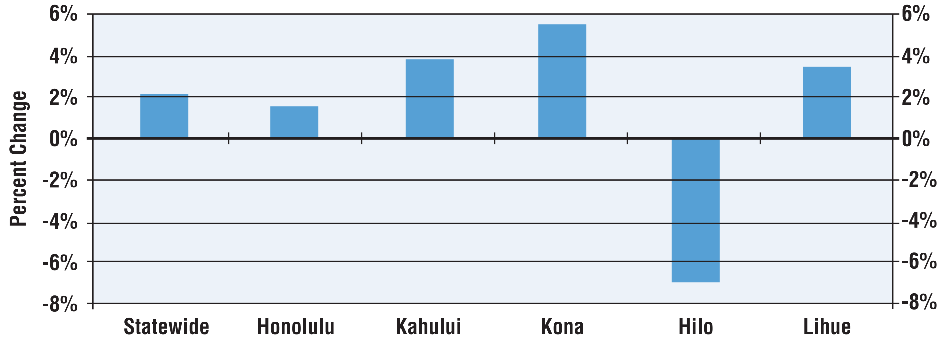
West Side Visitor Trends: Based on my conversations with industry insiders, Kohala coast resorts are doing great with high occupancy and bookings solid for 2015 and even into 2016. Vacation rentals also continue to do well and are expanding.

New capacity has been added through the Holiday Inn Express in Kailua and the completed renovations at the Hapuna Beach Prince. Progress is being made with the insurance and legal issues of the Kona Villages Resort. There is optimism that the $100-million renewal there can get underway later this year.

An interesting trend in the industry is that hotel and resort properties are increasingly under ownership of private equity funds more focused on short-term returns. This could cause some changes in operating behaviors.

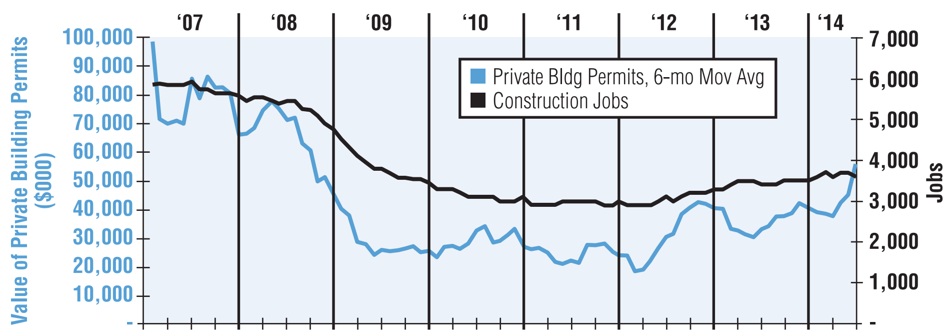
Hotel numbers are also translating into strong retail sales. For example, the Queens' MarketPlace at Waikoloa is reportedly doing well with rents increasing, more space being leased and new up-market restaurants opening.

CHART 7 • DOMESTIC AIRLINE SEATS, YTD JUNE 2014 OVER SAME PERIOD 2013



Source: Hawaii Tourism Authority

CHART 8 • HAWAII ISLAND CONSTRUCTION ACTIVITY



Source: DBEDT and County Building Department

East Side Visitor Trends: Hilo side tourism continues to be dominated by the uncertainties associated with Banyan Drive. The Hilo Hawaiian Hotel has completed its renovations. But the state's lease extension rules are proving difficult for many leaseholders and shoreline management permit rules add obstacles.

Some good news for East Side tourism is that cruise ship bookings are up for 2014 and into 2016, including Disney Cruises.

Construction Boom Coming

Even before Iselle, it was hoped that construction would make up for slowing tourism, and to an extent it has done so. The number of construction jobs continues its slow climb out of the hole created by the 2008 downturn when over 3,000 jobs were lost. Gradually, about 800 have been recovered. (Black line, Chart 8.)

There are several reasons to be optimistic about construction's near-term outlook. Since 2011, private building permits (blue line, Chart 8) have made a slow, if unsteady, improvement to about $90 million per month.

Single-family building permits have been growing since 2011 when quarterly permits were $10-$13 million per month. As of early 2014 this had increased to $20 million per month with the most recent data seeing huge increases. Kona permit values have spiked due to some high-value projects. Hilo has seen a doubling of permit values. This recent upswing in permits suggests the rest of 2014 and 2015 would have been good periods, even before Iselle's effects.

Hilo Construction: One of the most significant infrastructure projects is the Hilo harbor where construction of the new inter-island cargo facility at Pier 4 is underway. Phase II is the container yard, a $10-million project. The Phase III pier will involve another $37 million. Related to this is the $3.4-million Kumau Street widening, now underway. Another $5 million is budgeted for demolition of part of the Pier 1 shed so that larger ships with roll-on/roll-off capabilities can use the port.

—continued on page 4

Hawaii County *(continued from page 3)*

On the private side, Punahou Mauka residential development continues, and the Regency assisted living project proceeds with its build-out.

The Kea'au and Puna areas are experiencing significant activity. The Route 130 widening is a $150-million project. HMSA's 20,000-square-foot facility has begun at the Kea'au Town Center and Shipman has started construction on the other part of that space. The Bryson Community Center at Pahoa is another $20-million project.

Finally, the much anticipated UHH College of Pharmacy is expected to get underway later this year.

West Side Construction: Residential construction features prominently on the west side. The uncertainties at Hokulia have been resolved thanks in part to the $20-million infrastructure payment made by developers to the County. At Mauna Lani the KaMilo and Kulalani properties are building out and selling. Likewise, Kohanaiki is selling custom home sites and La'i Opua is selling lots and residences.

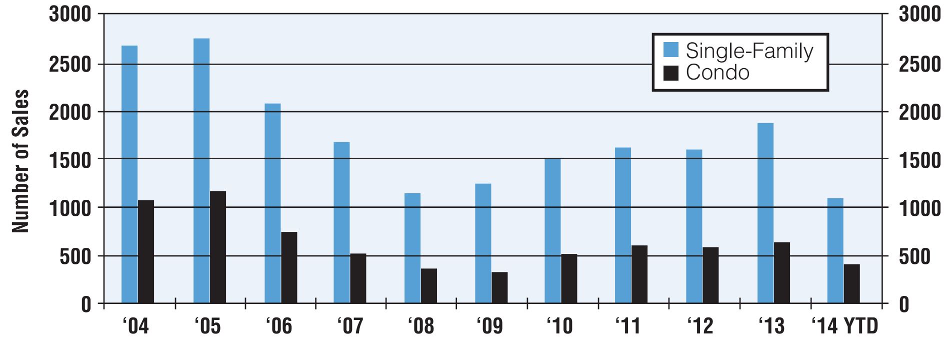
Several infrastructure projects are continuing to buoy the sector including HCC's $20-million Palama Nui campus build-out. Widening of Queen Kaahumanu Highway is expected to get underway with a $75-million increment. Improvements at Kawaihae harbor should be wrapped up. The Kona Airport terminal modernization budgeted at $60-70 million will likely start late 2015.

Completion of the $32-million Phase III of Saddle Road improvements has made the cross-island journey shorter and safer and will change how business is done in ways not now imagined.

Real Good in Real Estate

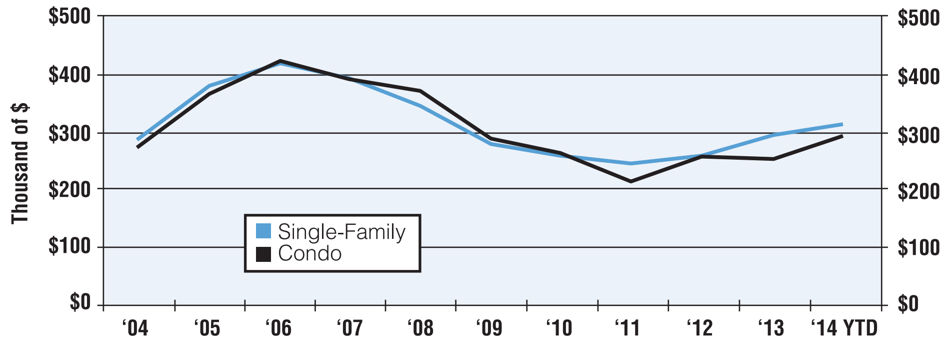
The improving strength of the economy is also being felt in the real estate market. Chart 9 shows units sold for both single-family and condos continue to recover from the depths plumbed in 2008. Likewise, median prices (Chart 10) continue a gradual rebound off the 2011 lows.

CHART 9 • HAWAII ISLAND REAL ESTATE SALES



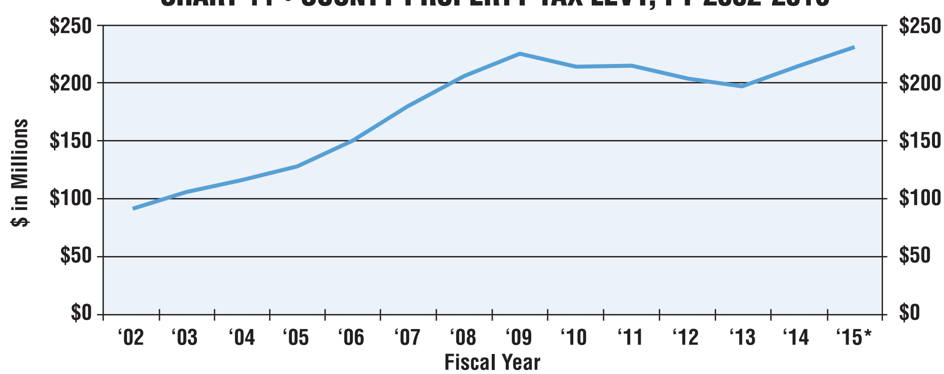
*2014 - YTD through June
Source: Hawaii Information Services & Paradise Appraisals

CHART 10 • HAWAII ISLAND MEDIAN PRICES



*2014 - YTD through June
Source: Hawaii Information Services & Paradise Appraisals

CHART 11 • COUNTY PROPERTY TAX LEVY, FY 2002-2015



*2015 Estimate
Source: County of Hawaii

Analyses by Mike Griggs and Putty Clark show that bank-owned and short sales are down from 30-40% in 2012 to 13-18% now. As such distressed sales continue to decline, the market will strengthen. This strength is already reflected the "pending sales to listings" ratio, which has been increasing.

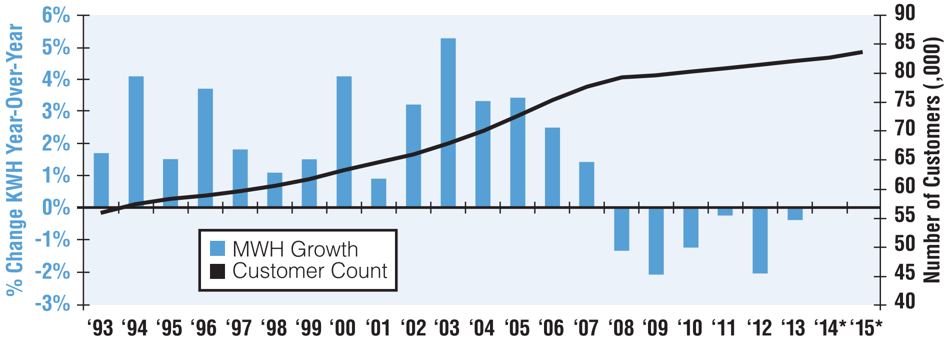
A more granular look at Hawaii Island provided by Stew Hussey shows that real estate on both the east and west sides are on the upswing. In fact, Realtors report greater recent interest from outside buyers in both markets.

However, good news in the residential market has not spread widely to commercial, light industrial, and office property. R.J. Kirchner reports that vacancy rates are still high: for example, 20-25% in office space in the Kona market. Hilo vacancy rates are better since there has been less new construction there.

County Finances: Good Shape

Hawaii County finances have benefited from the real estate rebound. Property valuations are expected to be an aggregate $25.1 billion for fiscal 2015,

CHART 12 • HELCO TRENDS, 1993-2015



*2014 & 2015 Estimates Source: HELCO

up 7%. (Chart 11.) County property tax collections in fiscal 2015 are expected to rise to $232 million without raising tax rates. There was also modest good news when the Legislature raised transient accommodation tax revenues to Hawaii County by $2 million. One wild card is the impact that Iselle may have on county tax collections and spending.

Electricity Sales Trends

Electricity billings by HELCO used to be a good indicator of the economy. With the growth of distributed generation, such as photovoltaic, billings have actually declined since 2007. (Chart 12.) In spite of this, the number of customers the utility serves has increased steadily, meaning fixed costs as a percent of revenue rises; these higher costs must be borne by ratepayers.

Specific Economic Drivers

Hawaii Island is fortunate to have significant economic drivers that contribute to economic diversification:

Agriculture: In 2012, Hawaii Island was home to 6,000 hired agricultural workers, with a payroll of $68 million, Census data showed. The total is likely larger because many workers are informally employed.

One of the most important crops is papaya. There are about 160 papaya farms on the island farming 1,700 acres, much of it located in the Puna area, hard-hit by Iselle. Wind felled the fragile trees and much of the crop has been lost, according to Robert Ikeno of the state Agriculture Department. Fortunately other crops and nurseries were not heavily damaged and should recover well.

"Iselle may have an impact on County tax collections and spending."

Coffee production is up despite the coffee berry borer. The growing reputation of Ka'u coffee is resulting in new orchards there. Macadamia nut prices have continued a three-year upward trend with prices in the 90-98 cents per pound, wet-in-shell.

Cattle ranchers have benefited from higher mainland prices and are shipping wean-offs to the mainland rather than grass-feeding them for the local market.

One big story in agriculture has been the GMO debate. Bill 113 passed by the County Council and signed by the Mayor is facing a legal challenge, but it has sent a chilling message through the ag sector. While the scientific basis for the anti-GMO movement is controversial, there can be no controversy that agriculture sales and jobs are important to a diversified Hawaii Island economy. If upheld, Bill 113 has the potential for creating obstacles and uncertainties that will reduce investment, production, sales, and employment in this sector.

Natural Energy Laboratory: The Natural Energy Laboratory of Hawaii Authority (NELHA) is estimated to have a $100-million direct economic impact supporting 600 statewide jobs. It has 44 tenants including two water bottlers, six aquaculture ventures, and Cyanotech food supplements. It lost Sopogy solar thermal when that firm went bankrupt.

The marine mammal center (monk seal hospital) is scheduled to open in September and Cyanotech expects to add 14 acres to its facilities. Destiny Deep Seawater has completed an investment in bottle manufacturing using imported PET granules.

In all, NELHA has $57 million of construction projects in 2013 and 2014. They are positioning themselves in the forefront of research on energy storage for renewable power.

However, the most visible development will be the plan to improve the land abutting Queen Kaahumanu Highway. A $9.7-million extension of the Kahilihili Street is now in the environmental assessment phase with construction expected to begin in 2015.

Mauna Kea Observatories: Mauna Kea observatories involve 11 facilities with an annual budget of $83 million supporting 497 county-based staff.

The big story is the Thirty Meter Telescope (TMT); permits have been issued with final lease approval by the Land Board. Construction and equipment cost will be $1.2 billion and once operational in 2021 the TMT will have a budget of $27 million per year in today's dollar values. The consortium will provide $1 million per year for local community organizations via the Hawaii Community Foundation plus $1 million per year in ground rents.

UH Hilo: Enrollment is over 4,000, down slightly, consistent with other UH campuses and national trends. New programs in aviation sciences and heritage management are in the works. Development of University Village Phase II focusing on 30 acres of mixed residential and commercial activity has gone out for proposals.

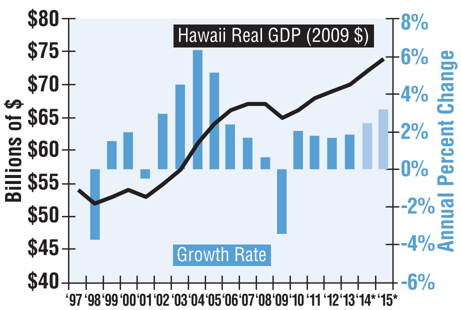
Some Island Challenges

Although the economic news is generally good, Hawaii Island does face challenges. The GMO debate has split the community and created uncertainty in an important segment of the economy. Uncertainties associated with Banyan Drive leases and commercial leases downtown will have adverse effects on other, mostly small, businesses. Likewise new Federal watershed regulation in West Hawaii has created uncertainties.

State Growth Continuing Despite Erratic Tourism, Lackluster Construction

2015 will mark the fifth year of Hawaii's economic expansion post-Great Recession. State GDP (Chart 1) in 2009-dollar values is expected to be a record $72 billion in 2014 with growth accelerating into 2015. This growth has occurred in spite of sputtering tourism patterns and a frustratingly slow pick up in the construction cycle.

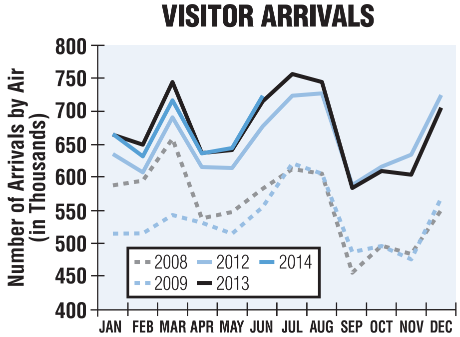
CHART 1• HAWAII GDP GROWTH



*2014, 2015 Estimates
Source: U.S. Bureau of Economic Analysis and author's forecast

Tourism remains the prime driver of Hawaii's economy. Visitor arrivals bottomed out in mid-2009 and experienced a strong comeback until late 2013. (Chart 2.) At that time arrivals slowed and turned negative for several months. Nevertheless, 2013 was a record year with over 8 million arrivals. So far, 2014 has struggled to keep up with that pace. Meanwhile, inflation-adjusted visitor spending after several very good years started slowing in 2012 and has remained flat since.

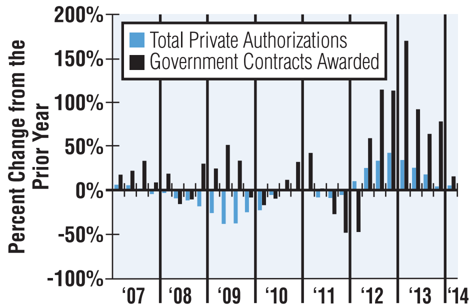
CHART 2 • STATEWIDE MONTHLY VISITOR ARRIVALS



Source: Hawaii Tourism Authority via DBEDT

It was hoped that the construction industry would make up for much of the tourism lull, but this has only partially materialized. Construction job growth stalled in 2013-14. Of the 12,000 jobs lost in this sector due to the recession, only 2,800 have returned. Nevertheless, both private and government permit growth remain positive pointing to greater construction activity in the second half of 2014 and into 2015. (Chart 3.)

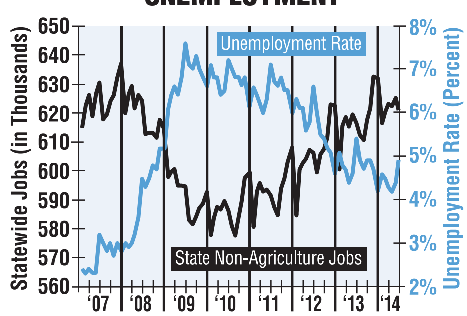
CHART 3 • STATEWIDE CONSTRUCTION PERMITS (4-QTR MOVING AVE.)



Source: DBEDT

The overall Hawaii labor market has benefited from the prior momentum of tourism and the underlying economic strength in other sectors. Total state jobs are up by over 43,000 since their nadir in 2010, and the unemployment rate has decreased to less than 5%. (Chart 4.)

CHART 4 • STATE JOBS AND UNEMPLOYMENT



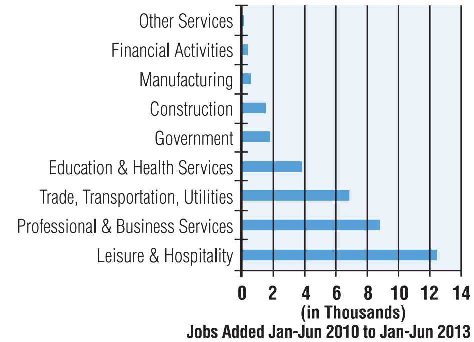
Source: DBEDT & U.S. Dept. of Labor Statistics

The gains in jobs have been uneven. Most of the growth has been in the visitor-related sectors. (Chart 5.) Likewise, the growth across the state's counties has not been uniform. Oahu was impacted the least by the contractions in the job market and has now returned within 2% of the peak employment at the end of 2007. (Chart 6.) The Neighbor Islands had more serious fall-offs in employment ranging up to 12% of total jobs and their recovery has taken longer.

In spite of improving incomes and increased spending, Hawaii State government tax revenues have hit the skids after some great years. Starting in 2013, general fund revenue growth turned negative. (Chart 7.) Declines in collections of the State's leading source of revenues, the General Excise Tax, is the primary reason for this. These trends will make balancing the state budget more difficult, especially given negotiated public worker wage increases.

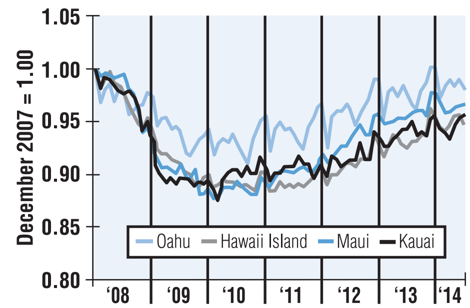
In sum, despite erratic tourism patterns and slow, but promising, construction spending, the Hawaii state's economy has built some internal momentum so that output, jobs and incomes are expected to expand into 2015.

CHART 5 • HAWAII JOB INCREASES BY SECTOR



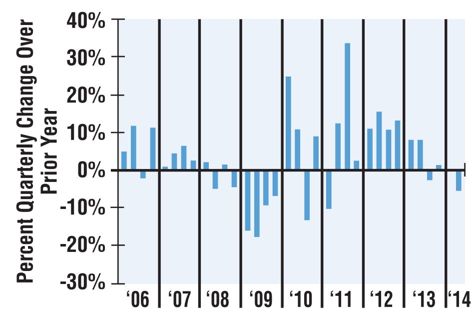
Source: DBEDT

CHART 6 • JOB PATTERNS SINCE 2008



Source: DBEDT

CHART 7 • STATE GENERAL FUND REVENUE GROWTH



Source: Hawaii State Department of Taxation

Getting Back in Sync: U.S., Global Outlook for 2014-15

By Dr. Ken Miller, CFA, *Chief Investment Strategist & Director of Investment Services, First Hawaiian Bank*

Global Growth Led By Developed Regions

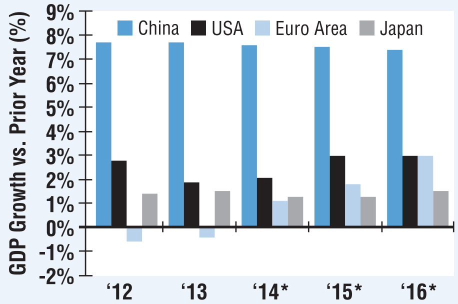
The global economy was buffeted in the first half of the year by harsh weather conditions in the U.S., financial market turbulence in emerging markets, and geopolitical instability in the Ukraine and elsewhere. As a result growth projections for 2014 as a whole have been downgraded, but accelerating growth in the second half of the year should carry over into 2015 and beyond.

The World Bank (Chart 1) forecasts 2.8% world growth in 2014, up from 2.4% last year, and 3.4% and 3.5% growth in 2015 and 2016, respectively. Most of the growth impulse is coming from developed markets, notably the U.S. and the Euro Area, which are benefiting from healing labor markets, release of pent-up demand, and diminished fiscal drag. The Euro Area is in the early stages of recovery and continues to exhibit great imbalances between the core (especially Germany) and the economies of its periphery, some of which remain nearly 10% below pre-crisis peaks. Encouragingly, unemployment rates in Europe are beginning to improve, albeit from very high levels.

Japan's economy is out of sync with the West, reflecting domestic economic policies. Growth in Japan was front loaded this year due to the April sales tax hike, which is now causing fiscal drag and will likely to contribute to softer growth over the near term. Over the medium term, growth will be influenced by the success of structural reforms, but Abenomics seemingly has already accomplished a great deal by reversing the deflationary mindset of Japanese consumers.

Emerging market economies, already growing at close to potential, are seeing a slower pick up in output. China has recently shown some acceleration of industrial output and exports, and is benefiting from a series of governmental growth-supporting measures. However, there remains concern that China's overextended property sector, a major growth driver, is due for a correction as credit conditions tighten.

CHART 1 • GROWTH ACCELERATION



*Forecast Source: World Bank

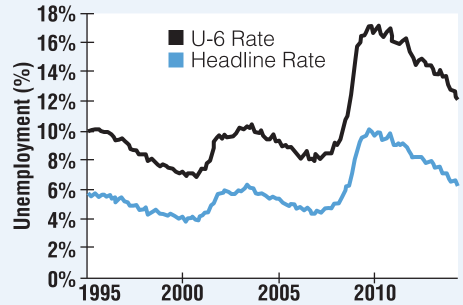
U.S Growth Rebounding

The U.S economic 2.1% (annualized) contraction in the 1st quarter was largely due to extreme weather conditions, diminished inventory growth, and weak demand for exports. Thankfully, growth bounced back to a 4% rate in the second quarter, but overall the economy was sluggish the first half of the year. Headwinds to the economy include diminishing wealth effect from higher asset prices, stabilization in the household savings rate, softening exports, and slower growth in consumer durables and home building. But higher capital expenditure spending and diminished fiscal drag should boost growth. All in all, above-trend growth of about 3% or higher seems quite likely in the second half 2014 and into next year.

The Employment Picture: Looks Can Be Deceiving

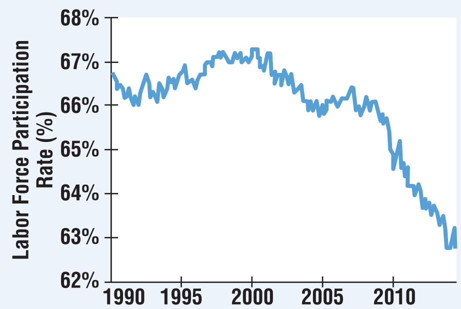
Although job growth has been reasonably steady for the past five years, and quite robust in the first half of 2014, the tremendous damage to the jobs market wrought by the Great Recession is still being felt. It seems that every piece of positive data carries with it some underlying negative counterpoint. For example, by mid-year the headline unemployment rate had fallen to 6.1%, down from a peak of 10%, but a wider measure including discouraged job-seekers and part-timers unable to find full-time work stood at over 12%, higher than the peak associated with the 2001 recession (Chart 2). And while all of the nearly 9 million jobs lost during the Great Recession have now been regained, the composition of the work force has changed, with more jobs in lower-paying sectors and more part-time workers.

CHART 2• UNEMPLOYMENT STILL HIGH



Source: Bureau of Labor Statistics

CHART 3 • FEWER WORKERS



Source: Bureau of Labor Statistics

It is a myth, however, that job growth since the trough has been entirely due to part-time jobs — the vast majority of added jobs have been full time.

Most concerning, we are still about 6 million jobs short of where we were in 2007, adjusted for population growth, reflecting still-elevated unemployment and a decline in the labor force participation rate (the proportion of the adult population available for work). That rate has generally been falling since 2000 due primarily to retirement of baby boomers, and has dipped sharply since the Great Recession (Chart 3).

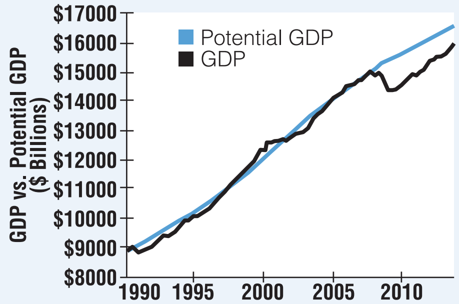
It is normal for participation to decline during recessions, but the recent drop has been greater than expected. Since the final quarter of 2007, the labor force participation rate has fallen from 65.9% to 62.8% in the second quarter of 2014, equating to about 7.7 million workers. According to the Congressional Budget Office and other studies, about half the decline is due to aging of the population. The rest reflects a combination of cyclical weakness and structural factors, such as mismatch between labor force skills and employers' needs, or lack of incentives to return to work.

—continued on page 8

U.S., Global Outlook for 2014-15

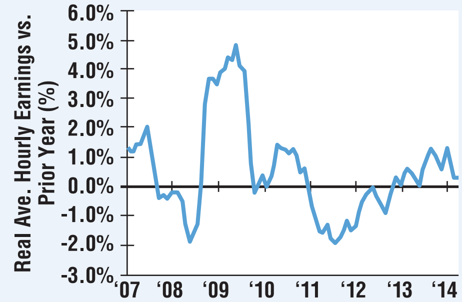
(continued from page 7)

CHART 4 • OUTPUT WELL BELOW POTENTIAL



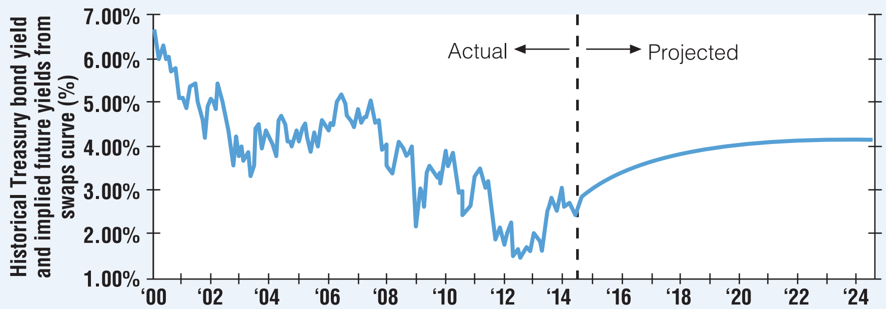
Source: Bureau of Economic Analysis, CBO

CHART 5 • LITTLE WAGE GROWTH



Source: Bureau of Labor Statistics, BEA

CHART 6 • THE NEW NORMAL: LOW INTEREST RATES PERSIST



Source: Bloomberg

Most policymakers seem to agree that the fate of the long-term unemployed is a key part of the story. Due to eroding skills and the stigma attached to long-term unemployment, such workers have difficulty in finding jobs and frequently stop looking altogether.

Is Inflation Around the Corner?

Headline inflation reached 2.1% in May and June, exceeding the Fed's 2% target for the first time in nearly two years, and raising questions about the Fed's continuing willingness to keep rates low. Yet Fed Chair Janet Yellen has been at pains to point out that the inflation data is "noisy," that the Fed's preferred measure of inflation, core PCE, was only 1.5% in May and June, and that inflation expectations remain well anchored. Moreover, Yellen argues that that there is still plentiful economic slack, precluding a sustained pickup in inflation. There is not universal agreement on this assessment, even within the Fed.

The Congressional Budget Office estimates that economic output is about 5% below potential output at full employment, defined as the highest level of employment achievable without causing inflation (Chart 4). Inflation hawks worry that we are actually quite close to full employment, arguing that many workers who have left the labor force over the past several years will not return. However, there is evidence that quite a bit of underemployment is simply due to a cyclically subdued economy. For example, if a structural mismatch between the skills of the labor force and the needs of employers was a major factor, you would expect to see unemployment rates vary quite a lot by industry. But in fact, unemployment has been remarkable uniform across industries, implying economy-wide cyclical pressures are having an effect. Most tellingly, wage growth has also been virtually absent, both in aggregate (Chart 5) and industry-by-industry. Recently there have been a few indications of nascent wage growth, which the market will be monitoring carefully.

Our view is that there is still considerable economic slack, and therefore that inflation and higher interest rates are still some way off. Further, as the natural course of the economy is to converge with (and frequently overshoot) potential output, we may see several years of above-trend economic growth until the output gap is closed.

Investment Outlook

Markets brushed off troubles at home and abroad to power U.S. stock indexes to new record highs in the first half of the year. At the same time, the wild market swings that were formerly so common largely disappeared, a further sign of investor complacency. It is as if investors were unaware that in the first quarter the U.S. economy had the worst growth performance since WWII outside of a recession, that inflation has accelerated, or that OPEC's second largest oil producer (Iraq) is sinking into chaos. Toward the end of July markets reversed, wiping out much of the year's gains, but stock prices were still quite elevated relative to earnings growth rates. It is likely that markets reflect a reasonable assessment that the domestic economic situation is not as dire as it appears, and that geopolitical concerns, though always unpredictable, remain manageable for a diverse global economy.

Despite higher valuations, geopolitical uncertainties, and disappointing economic growth in the first quarter, the conditions that produced such strong equity returns last year are generally still in place — easy monetary policy with a sluggish but broadening economic recovery. Market corrections are to be expected, but our base-case expectation is that equities will continue to outperform other asset classes over the long term. However, we do not perceive a "bond bubble." There is a disconnect between many market commentators who view sharply higher interest rates as nearly inevitable, and the futures and swap markets, which imply only a modest rise in rates even ten years from now (Chart 6). In our view, rates are not far from "fair value" given weak growth and lack of inflation pressure.

ECONOMIC FORECAST - 2014-2015 HAWAII ISLAND EDITION © FIRST HAWAIIAN BANK