

Economic Forecast

KAUAI EDITION 2014 - 2015

Construction, Jobs Looking Up Despite Weaker Tourism Growth on Garden Island

Kauai's labor market is slowly improving as construction begins to show signs of life. Like the rest of the state, the Garden Isle has seen strong tourism growth evolve into weakness in early 2014.

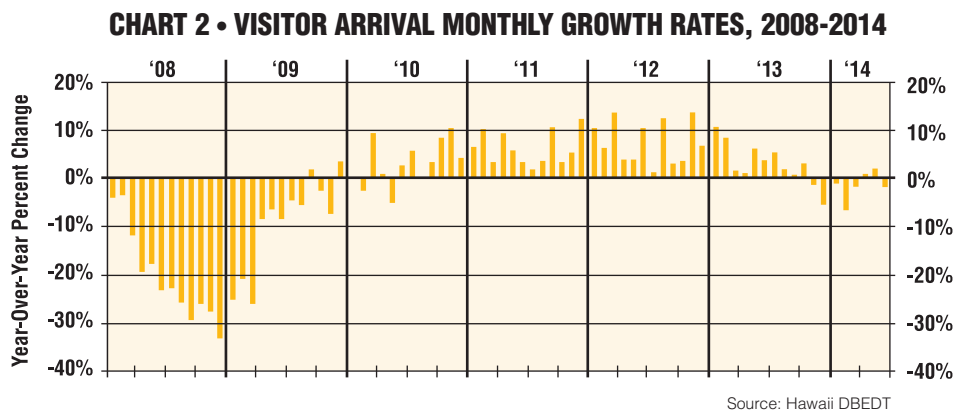
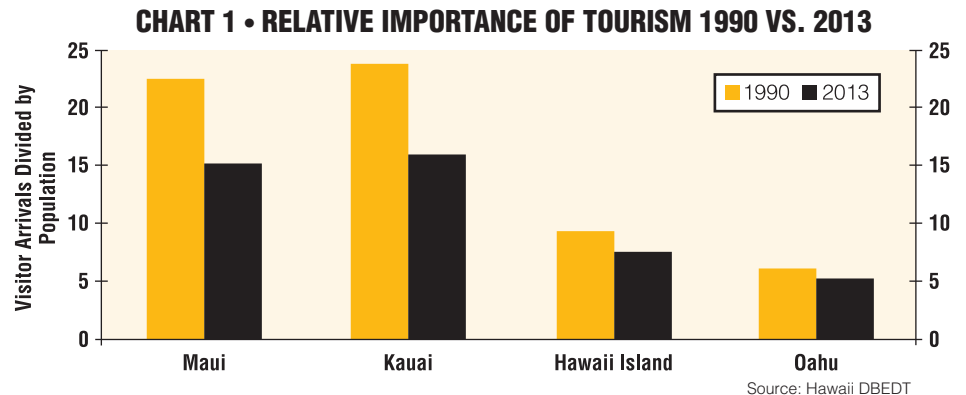
However, this has not yet hurt the overall economy as real estate sales and prices have remained on positive trajectories benefiting from jobs and income growth and low continued interest rates. The economy has also benefited from unique agriculture-based businesses that are developing brand identities.

Guarded optimism may be the best description for 2015, especially if construction breaks out.

Kauai Tourism

Kauai's economy still depends on visitors for much of its economic vitality (Chart 1), even though the industry is not as important as it was two decades ago.

There were 1.1 million visitor arrivals to Kauai in 2013, up by 2.7% over the prior year, but still below the 1.3-million peak in 2007. As shown in Chart 2, monthly growth rates were strong in early 2013, but weakened and then turned negative in the latter part of the year. This downturn lasted into the first part of 2014 so that arrivals through July were slightly below the numbers of the same period in 2013 in spite of a positive April and May numbers. Kauai is not alone in this pattern; the state overall and each neighbor island market have seen similar trends. Industry insiders point to competition from other markets, especially Mexico, the Caribbean and other foreign destinations.



There is concern that Kauai's costs for airfare and lodging have turned off some price-sensitive market segments. Thus Kauai needs to improve its value proposition to visitors. This seems to be happening. For example, close to \$30 million has been invested in east side hotel renovation and upgrades. The prospective sale of the Aloha Beach Resort should allow for renovation and possible rebranding. The Royal Coconut Coast Association continues to market and brand its offerings.

Such activities have resulted in positive publicity in various media outlets.

For example, "Kayaking the Na Pali Coast" was second in *USA Today's* "10 best bucket-list adventure trips", and *Forbes* named Kapaa as one of America's prettiest towns. *USA Today* also named Kauai to its top-10 island list, the only Hawaii island to be so recognized.

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Kauai County (continued from page 1)

The improved value of the Kauai experience helps visitors open their — wallets. However, the Hawaii Tourism Authority has admitted to problems in their expenditure estimates. Hence, inferences must be hedged. That being said, visitor spending seems to have been more robust than arrivals. In 2013, visitors spent about \$1.45 billion on Kauai compared to \$1.3 billion the prior year. Chart 3 shows this positive trend. Yet spending growth did slow and became erratic in the latter part of 2013 and into 2014.

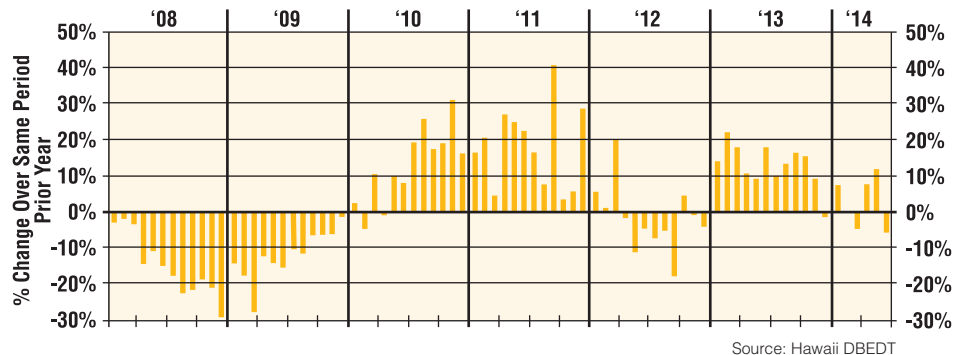
The composition of visitor spending has also changed since the 2008-09 Recession. Between 2007 and 2012 visitors spending declined on a daily basis on Kauai. However, lodging has taken up a larger percentage of total spending (Chart 4).

Kauai daily visitor spending per person trails the rest of the state. Through the early part of 2014 average daily spending per visitor was \$170, compared to \$206 on Maui and \$203 on Oahu. Part of this is explained by lodging inventory. Among all Hawaii's islands, Kauai has the greatest proportion of non-hotel accommodations. These tourists tend to spend less.

Airlines serving Kauai seem to remain optimistic, increasing airline seats to Lihue in the first half of the year (Chart 5). There is further good news as expectations are for increased lift later in the year. Hawaiian Airlines has, for the first time, commenced Lihue to mainland service with seasonal flights from Oakland and Los Angeles providing both a real and emotional boost to the island.

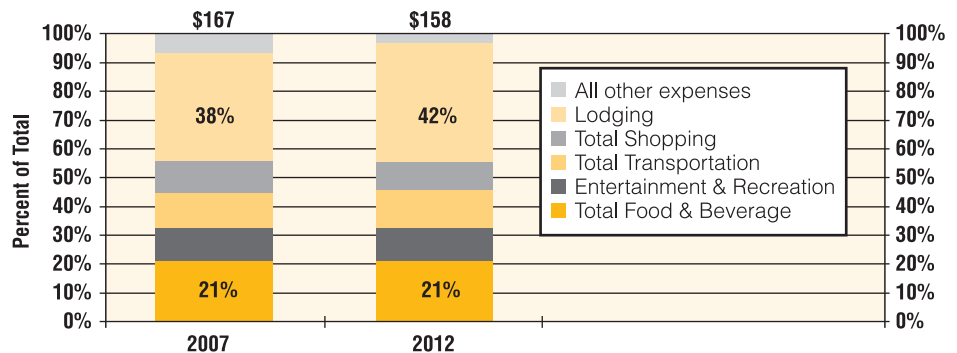
Overall, people in the visitor sector remain optimistic even given the swings in the arrival numbers.

CHART 3 • KAUAI VISITOR SPENDING GROWTH



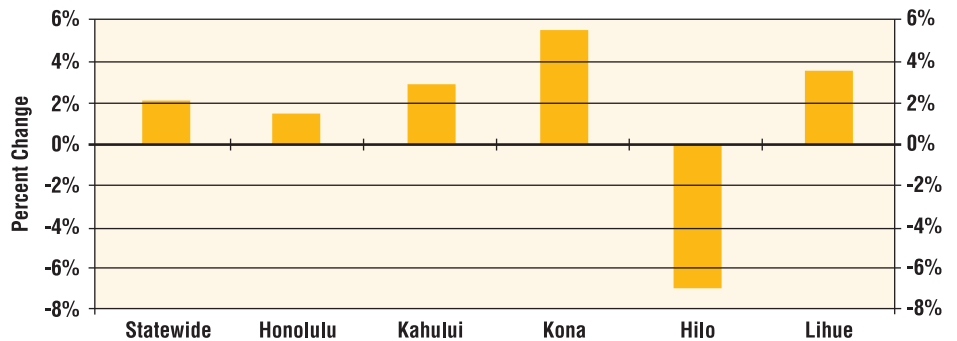
Source: Hawaii DBEDT

CHART 4 • KAUAI PERSONAL DAILY SPENDING



Source: Hawaii Tourism Authority, Annual Research Report, 2013

CHART 5 • DOMESTIC AIRLINE SEATS, YTD JUNE 2014 OVER SAME PERIOD 2013



Source: HTA Monthly Visitor Statistics

Construction Building Momentum, Gradually

The slow-down in the tourism sector is gradually being offset by a long-awaited rebound in construction. As shown in Chart 6 on page 3 (black line), construction jobs have barely budged and remain 600 jobs below the pre-recession peak.

But better things are on the horizon. Permits are a portent to construction activity but they are difficult to interpret. Permits are lumpy in value, especially for commercial activity, and permits do not

necessarily become actual jobs. Even so, activity is slowly picking up. Industry participants are encouraged by the recent upward trend in single-family permits that is shown in Chart 6 (yellow line) on a 6-month moving average basis.

Single-family construction remained the important and steady component of the construction sector even after the recession. Grove Farm's Pikake subdivision has sold 320 lots and has seen 150 houses built. They are also planning another 200 lots as part of the Puakea master plan development and

46 more up-market units at their Waihohonu project at old Koloa Camp.

In contrast to single-family construction, multi-family housing permits almost disappeared from the scene in the last few years before making a recovery in the second quarter of 2014. An example of this is the phase-one, 60-unit Rice Camp elderly housing project costing about \$8.6 million. Ground breaking at Princeville for the Kolopua workforce housing occurs in the fall after permits have been obtained. This will allow expansion of the Princeville shopping center.

Community and infrastructure projects also declined after 2008 and have started to come back. Government projects such as the Lihue Mill Bridge and bridge improvements will continue. The Water Department has re-bid their \$10 million administration building improvements. The community center projects at Anaina Hou in Kilauea are in the planning phase and seeking permits.

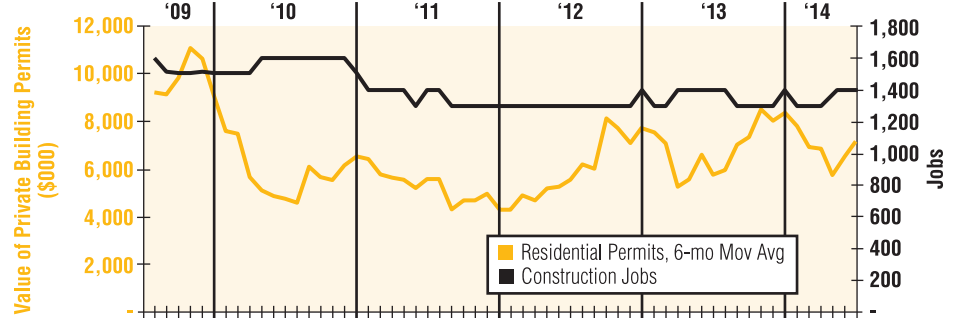
Significant commercial activity is underway at various places such as Longs in Kapaa. The Hokelei Village project is being led by Safeway's property development arm on 14.25 acres purchased from Grove Farm. The Safeway lifestyle store is expected to open in the first quarter of 2015 and will be joined by Walgreens, Petco, Jack-in-the-Box and Shell gasoline.

The purchase of Coconut Market Place by ABC Stores means that this retail center may get a makeover. Ohana Real Estate Investors plans for an 86-room hotel and 34 individual lots at the site of the former Hanalei Plantation Hotel in a \$450 million, 8-10 year project that will create jobs as well as shoreline access to the rehabilitated Kamo'omaika'i fish pond.

Improving Labor Market

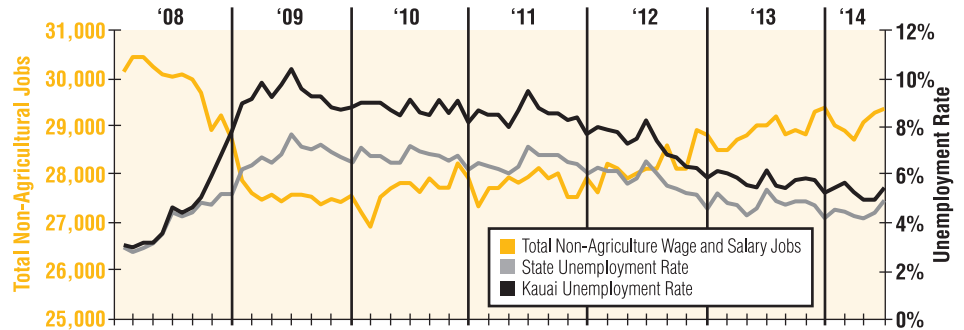
The gradual improvement in Kauai's economy can best be seen in the overall jobs numbers in Chart 7. Kauai jobs have grown on a time trend basis over the last four years. There are now 2,300 more jobs since the low point in 2010. At the same time, Kauai's unemployment rate declined to a post-

CHART 6 • CONSTRUCTION ACTIVITIES



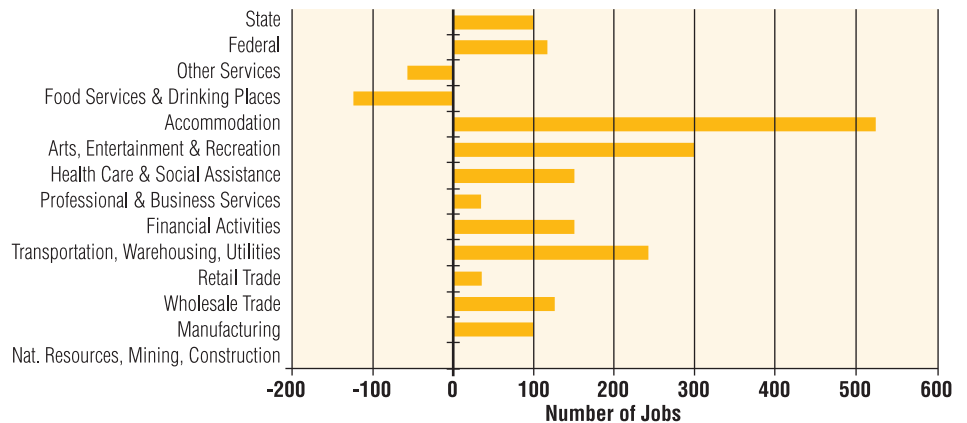
Source: County Building Department via DBEDT

CHART 7 • KAUAI JOBS AND UNEMPLOYMENT



Source: State Labor Department via DBEDT

CHART 8 • KAUAI JOB GROWTH BY SECTOR



Source: State Labor Department via DBEDT

recession low of 4.9%, only to regress to 5.2% as of July, somewhat above the statewide average.

Consistent with the tourism trends above, the job growth since 2010 has come mostly in tourism-related sectors, with accommodations leading the way (Chart 8.) Surprisingly, job counts in the restaurant sector have actually declined slightly.

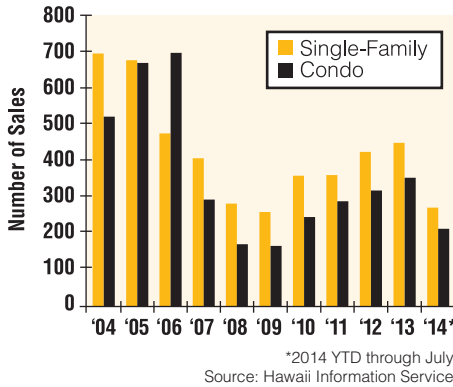
Real Estate Recovery Continues

Kauai real estate has benefited from the island's economic recovery and from the national trend of jobs and income growth combined with low interest rates. Though financing requirements remain tough in response to the excesses of a decade ago, real estate sales have been strong on the island. As seen in Chart 9 (top of page 4), both single-family and condo unit sales have experienced four years

—continued on page 4

Kauai County (continued from page 3)

CHART 9 • KAUAI REAL ESTATE SALES TRENDS



of growth, and 2014 is expected to continue that trend.

Median prices have recovered more for condos than for single-family units (Chart 10). These prices are still well off their prior peaks, which arguably were unrealistic. The Kauai Board of Realtors reports an increase of 20 members since the turn of the new-year, a sure sign that the market has improved.

Little office or commercial space has been added to inventories in the last few years. The costs of constructing new space are still higher than rents charged in existing buildings. There has been a small upward trend in office rents and occupancy in Lihue is about 90%. Industrial space is also tighter and will get more so as Safeway's suppliers need storage and operating space.

Electricity: New Opportunities

At one time Kauai Island Utility Cooperative's electricity sales were an indicator of economic activity on the islands. While this is no longer so, KIUC has lost none of its relevance and, in fact, has become even more important as a pillar of the Kauai economy.

Chart 11 shows that the number of KIUC customers (meters, the black line) continues to grow with the overall growth of the island's economy. Due to conservation by customers and distributed generation, such as rooftop photovoltaic, the utility's sales have actually declined significantly since 2007. This puts cost pressure on KIUC

CHART 10 • KAUAI MEDIAN PRICES

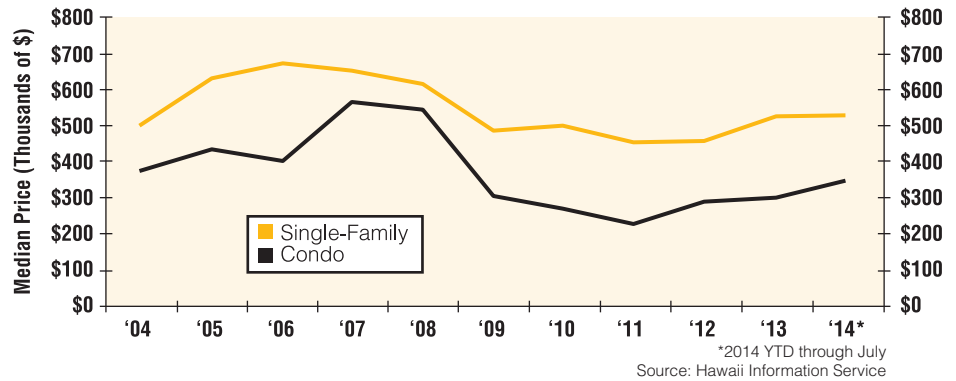
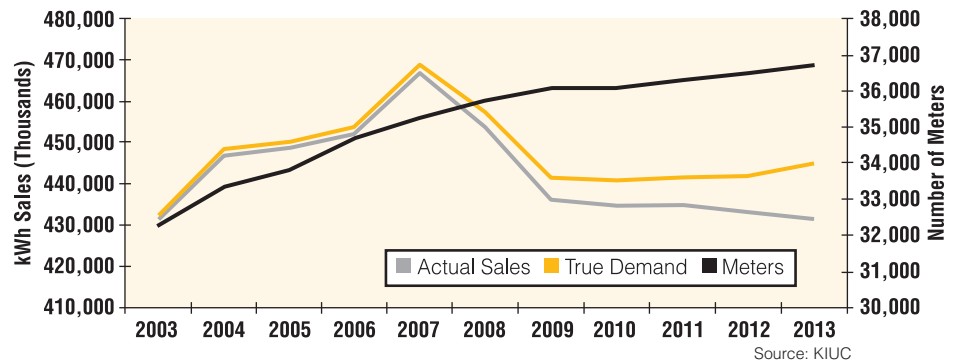


CHART 11 • KAUAI ELECTRICITY TRENDS



since more customers have to be served on a smaller revenue stream.

The utility has been aggressively pursuing lower cost, renewable sources of power. The solar farm at Eleele has been joined by the recently operational \$40-million Koloa solar facility providing 12 megawatt capacity. A \$90-million biomass plant will add another 7 megawatts of base power by late 2014, and 12 MW will be added in spring 2015 with the \$54-million Anahola solar farm. In 2010, 92% of the electricity used on Kauai was generated by burning oil. After the new facilities come on line, this will be down to 60%.

One challenge involves storage of variable power such as solar. The utility is investigating technologies from batteries to pumped hydro to store surplus daylight power for use at peak demand in the morning and evening. This would allow KIUC to be even less dependent on oil-fired generators.

Significantly, KIUC estimates that the new renewable power can be created at lower costs than oil-fired. Hence, KIUC actually hopes it can cut rates and certainly not increase them as much

as the price of oil. Lower relative energy prices will put disposable income in consumers' pockets and stimulate business opportunities. Hence, KIUC will be an important catalyst to economic development on the island.

Kauai County Finances

Thanks to improving property values and discretionary rate increases, Kauai County's finances are as good as any time since the Great Recession. Property tax revenues for fiscal 2014 are up by about \$8 million over the prior fiscal year (Chart 12).

Fiscal 2015 property tax revenues are forecast to be up \$12 million, or 13%. About half of that increase is coming from tax base growth and half from rate increases, mostly from higher rates on vacation rentals and hotels and resort property. Vacation rentals have also been hit with higher permit fees.

The County is also getting a small boost of \$1.45 million for at least two fiscal years in its share of the transient accommodation tax.

Agriculture: Important & Controversial

The demise of sugar and pineapple caused a significant fall-off in Kauai agriculture. As seen in Chart 13, total acres in cropland fell by more than 50% from 1982 to 2007. Harvested cropland fell even more.

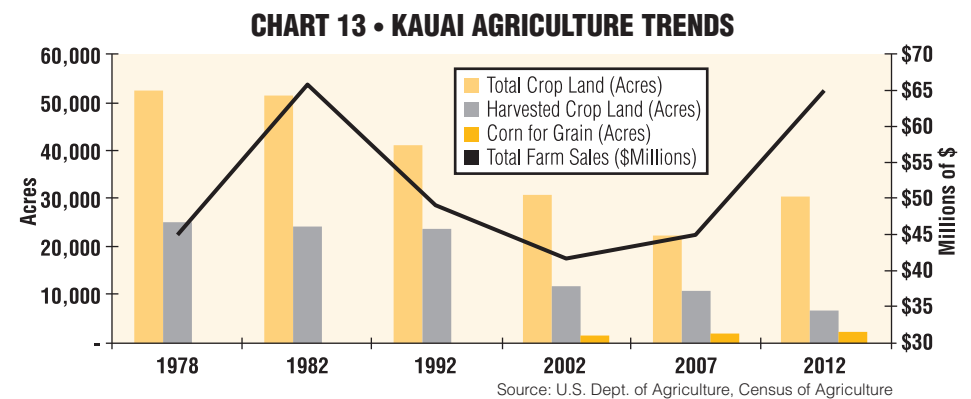
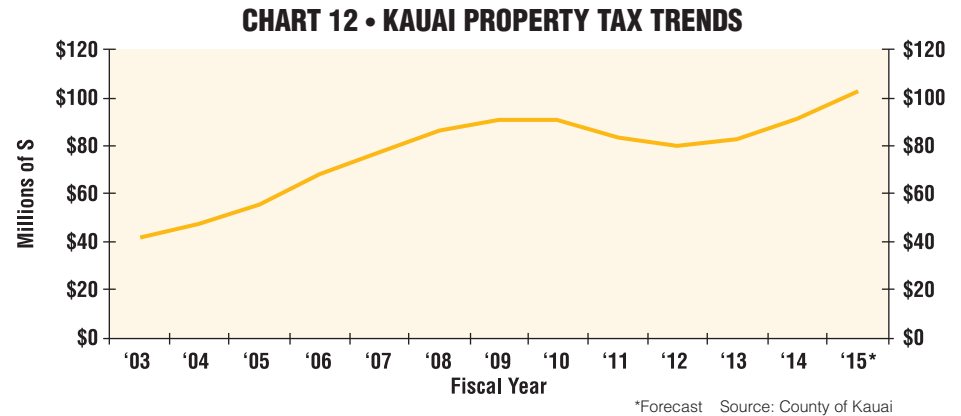
The seed corn companies stepped into this vacuum and now farm about 2,500 acres out of 30,000 acres of total cropland. These companies on Kauai employ 300-400 fulltime workers plus over 300 seasonal employees. Together they have about \$80 million per year in operating budgets on the island.

Kauai Coffee has been caught up in the regulatory net aimed at the seed corn companies. Through their European parent company, Kauai Coffee has focused on establishing a niche brand with some success, employing 90 full-time equivalent employees with over 100 seasonal harvest workers. They want to expand their acreage, but this is on hold until the regulatory uncertainties are settled.

Another bright spot is Sunrise Capital's Kauai Shrimp, which has been very successful in the highly technical and scientifically sophisticated business of growing breed stock shrimp for a global market. Last year they shipped over 200,000 of these high-value units and are ahead of that pace in 2014. They employ 54 full-time plus a dozen part-time workers with a \$5 million per year operating budget. They are expanding into gourmet shrimp for sale to retailers. Two Japanese companies have accepted their products as "sashimi grade". In the future look for Kauai Shrimp to expand processing facilities and move into new product lines such as clams.

Koloa Rum Company is yet another example of an agriculture-based product that spans into the retail space. They have over 20 employees and over \$5 million in annual sales. With their recently approved move to a new Koloa site, they will expand operations and more than double their employment.

Finally, the Hawaii Dairy Farm project that has been a vision of Grove



Farm and the Ulupono Initiative is an example of how any new project, no matter how seemingly benign, can create unexpected community resistance. In this case, the concern is that the operations will create negative impacts for Poipu tourism and for streams and ocean waters. Project managers and investors have proposed a smaller start-up. They estimate supplying enough milk for the entire island and an annual operational budget of \$6 million.

Other Economic Drivers

Pacific Missile Range Facility: PMRF at Barking Sands is another important and integral part of Kauai's economy. It employs about 1,000 workers including about 90 active duty military and 150 civil service employees, plus about 750 contractors. It injects \$137 million per year into the Kauai economy through local payrolls and contracted goods and services, plus another \$8-15 million annually for periodic testing events.

The Terminal High Altitude Area Defense (THAAD) and the sea-based Aegis systems have reached maturity

but will be back for periodic follow-on testing. The Aegis Ashore Missile Defense Test Complex conducted initial operating tests in March with follow-on tests scheduled at 2-3 per year. The Advanced Radar Detection Lab has begun hiring workers. Finally, Kauai has seen spending benefits from the biennial RIMPAC exercise conducted in the summer.

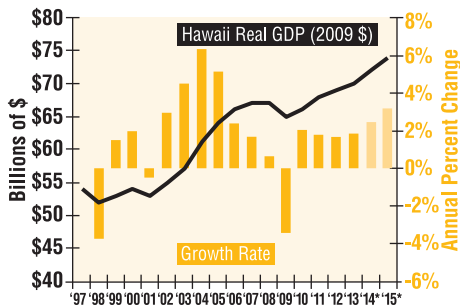
Film Industry: Kauai remains a desirable film location. According to the Kauai Film Commission, the casting call for Ebttide Production (*Jurassic World*) drew 1,600 people to Kauai Community College Performing Art Center in March. The production spent six weeks on Kauai setting up production office and base camps, and filming. Kauai continues to attract TV documentaries and reality-type shows. The HGTV-commissioned "Hawaii Life" returned for the fourth season of 26 episodes that will begin showing in December.

The synergies between the film industry and tourism are clear as visitors flock to sites used in popular movies such as *The Descendants*.

State Growth Continuing Despite Erratic Tourism, Lackluster Construction

2014 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.

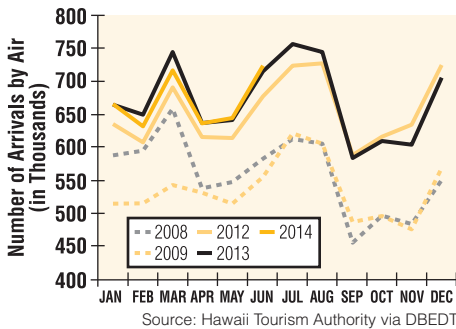
CHART 1 • HAWAII GDP GROWTH



Source: U.S. Bureau of Economic Analysis and author's forecast

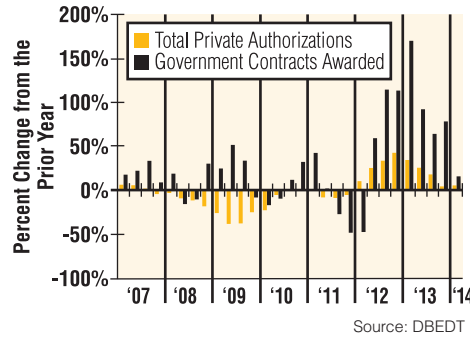
Tourism remains the prime driver of Hawaii's economy. Visitor arrivals bottomed out in mid-2009 and experienced a strong comeback until late 2013. (Chart 2.) At that time arrivals slowed and turned negative for several months. Nevertheless, 2013 was a record year with over 8 million arrivals. So far, 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



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,

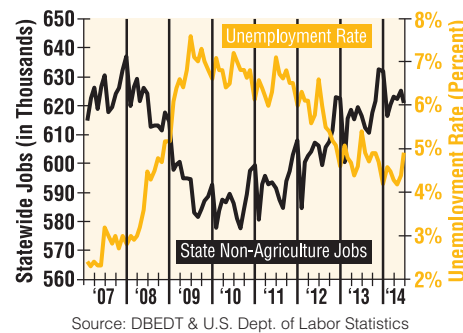
CHART 3 • STATEWIDE CONSTRUCTION PERMITS (4-QTR MOVING AVE.)



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.)

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



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

CHART 5 • HAWAII JOB INCREASES BY SECTOR

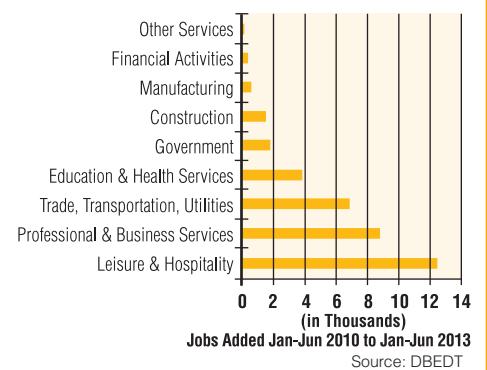


CHART 6 • JOB PATTERNS SINCE 2008

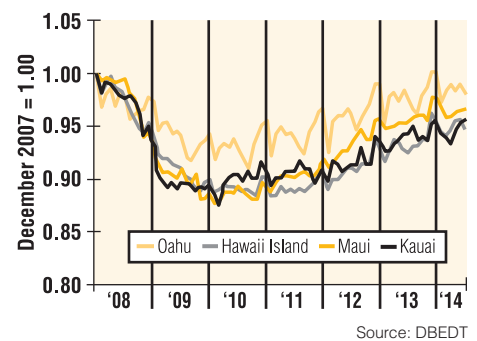
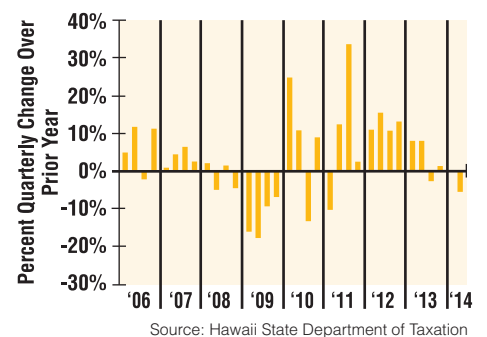


CHART 7 • STATE GENERAL FUND REVENUE GROWTH



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.

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

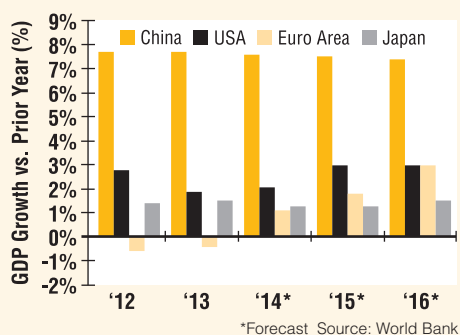
The global economy was buffeted in the first half of the year by harsh weather conditions in the U.S., financial market turbulence in emerging markets, and geopolitical instability in the Ukraine and elsewhere. As a result growth projections for 2014 as a whole have been downgraded, but accelerating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



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

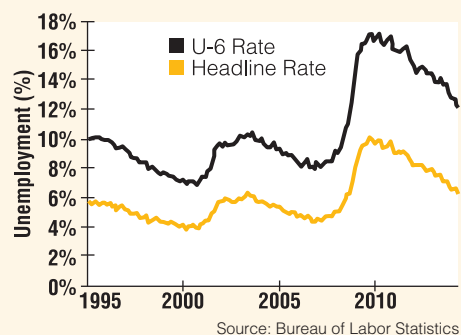
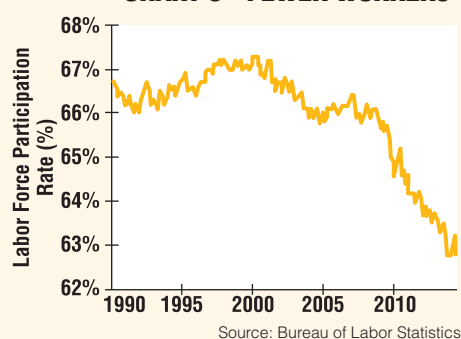


CHART 3 • FEWER WORKERS



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.

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U.S., Global Outlook for 2014-15

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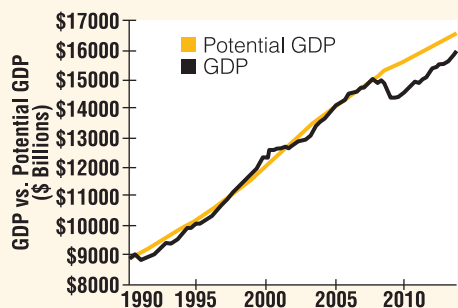
Most policymakers seem to agree that the fate of the long-term unemployed is a key part of the story. Due to eroding skills and the stigma attached to long-term unemployment, such workers have difficulty in finding jobs and frequently stop looking altogether.

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 there is still plentiful economic slack, precluding a sustained pickup in inflation. There is not universal agreement on this assessment, even within the Fed.

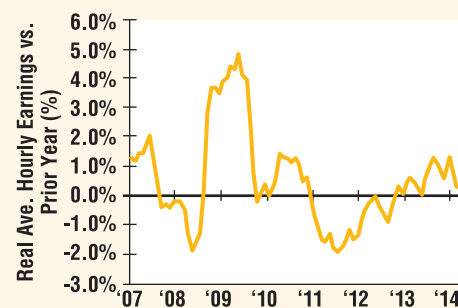
The Congressional Budget Office estimates that economic output is about 5% below potential output at full employment, defined as the highest level of employment achievable without causing inflation (Chart 4). Inflation hawks worry that we are actually quite close to full employment, arguing that many 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 indica-

CHART 4 • OUTPUT WELL BELOW POTENTIAL



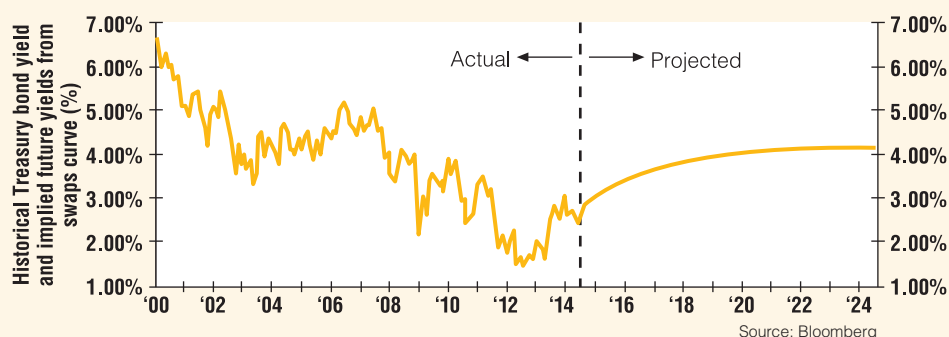
Source: Bureau of Economic Analysis, CBO

CHART 5 • LITTLE WAGE GROWTH



Source: Bureau of Labor Statistics, BEA

CHART 6 • THE NEW NORMAL: LOW INTEREST RATES PERSIST



Source: Bloomberg

tions 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.