

# Economic Forecast

**OAHU EDITION 2014 - 2015**

## Continued Progress Expected for Hawaii into 2015

**A** year ago I had the following prognosis for Hawaii's economy: "I expect 2014 will be a continuation of what we have seen since 2010. That is to say, continued overall growth with strength in most sectors. However, there will be a shift in the sources of growth: tourism's torrid pace will taper, but construction will pick up. I believe that 2014 will be a good year for Hawaii's economy."

History has shown that forecast was not far off the mark. What does the next year look like?

### 2015 Outlook: Growth, But Slow (Chart 1)

I am cautiously optimistic about the outlook for the rest of 2014 and 2015: Despite erratic tourism patterns and slow, but promising, construction spending, the Hawaii state economy has built some internal momentum so that output, jobs and incomes are expected to expand overall next year with continued strength in most sectors. Tourism will contribute to growth, but construction will finally fulfill its anticipated role as the leading growth engine in 2015.

■ **VISITOR ARRIVALS, SPENDING:** I see visitor arrivals growing by 1% for all of 2014 and 2% for 2015. At over 8 million annual visitors, we are approaching capacity constraints. In addition, high airfares and room rates plus a continued strong dollar relative to the yen, and Canadian and Aussie dollars all suggest that tourism will continue to contribute to growth but at a moderated pace. Visitor expenditures will remain positive

(up about 3% next year), but not robust.

- **CONSTRUCTION COMPLETED:** As tourism maintains muted growth rates, construction will accelerate into 2015. The construction permit data described below plus continued pent-up demand for housing will result in greater completed activity — double-digit (12%) growth in 2015 is my forecast. In addition, healthier fiscal positions for local governments means that deferred maintenance and infrastructure renewal spending will continue to contribute to construction's growth. All of this should help bring back some of the 8,000 construction jobs that we have yet to recover from the Great Recession.
- **JOB MARKET:** The return of more construction jobs will contribute to improvements in the overall Hawaii labor market. I expect that total job growth will pick up slightly and the state's unemployment rate will continue to improve, dropping to 3.9% in 2015.

**CHART 1 • GROWTH FORECASTS FOR 2015**

	2013 (Actual)	2014 (Forecast)	2015 (Forecast)
<b>Visitor Arrivals by Air</b>	+1.8%	<b>+1.0%</b>	<b>+2.0%</b>
<b>Nominal Visitor Spending</b>	+1.1%	<b>+2.2%</b>	<b>+2.9%</b>
<b>Construction Completed (Tax Base)</b>	+4.6%	<b>+9.0%</b>	<b>+12.0%</b>
<b>Total Jobs</b>	+1.9%	<b>+1.4%</b>	<b>+1.6%</b>
<b>Unemployment Rate (level)</b>	4.7%	<b>4.2%</b>	<b>3.9%</b>
<b>Real Personal Income</b>	+1.1%	<b>+2.6%</b>	<b>+2.5%</b>
<b>Inflation</b>	+1.8%	<b>+1.5%</b>	<b>+2.0%</b>

Source: Dr. Jack Suyderhoud

- **PERSONAL INCOME:** As the labor market improves, inflation-adjusted personal income will continue to expand at a rate of about 2.5% next year.
- **INFLATION:** Lastly, as the economy rebounds, concerns arise about resurgent inflation. Hawaii inflation is most affected by national price patterns, and there seems little fear of U.S. inflation through 2015. However, I expect that higher housing and rental prices, along with

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### ON THE INSIDE

**6** Gradual, uneven global recovery

### ISLAND FORECASTS

For our detailed economic forecasts of Hawaii Island, Maui, Kauai, Guam and CNMI (Saipan), please go to: <https://www.fhb.com/economicforecasts>

**State Outlook** (continued from page 1)

higher wages in tighter labor markets, will be reflected in the Hawaii price data. I am thus expecting an up-tick in inflation to 2% in 2015.

**Statewide Economic Data Trends:**

Let's take a look at recent trends in various economic measures in the Islands.

2014 marks the fifth year of Hawaii's economic expansion in the years since the Great Recession. State GDP in 2009-dollar values is expected to be a record \$72 billion in 2014 with growth continuing into 2015. (Chart 2.) This growth has occurred in spite of sputtering tourism patterns and a frustratingly slow pick up in the construction cycle.

Because the recovery has been gradual and there remains excess capacity in the national and Hawaii economies, inflation has not reared its ugly head as might be expected this far into an expansion. Price pressures remain subdued in Hawaii as is the case nationally. (Chart 3.) On average, inflation is running about equal to the nation as a whole, with differences largely due to housing prices.

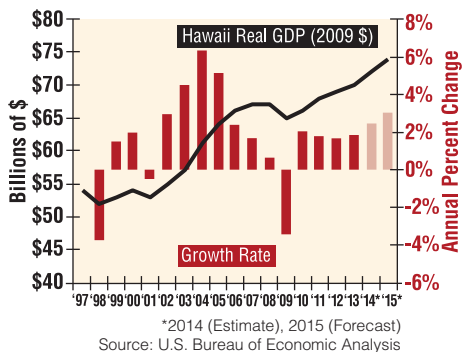
Chart 4 shows how Hawaii's labor market has steadily improved along with the overall economy. Total state jobs are up by over 41,000 since their low in 2010, and the unemployment rate has decreased to nearly 4%.

Likewise, personal incomes (Chart 5) continue to grow as reflected by inflation-adjusted state personal income that has expanded somewhat steadily since the lows of 2009. Let's look at what's behind these patterns.

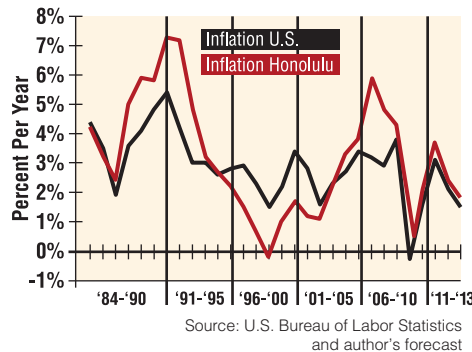
**Tourism Sputters**

Tourism remains the prime driver of Hawaii's economy. Visitor arrivals (Chart 6) bottomed out in mid-2009 and experienced a strong comeback until late 2013. 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.

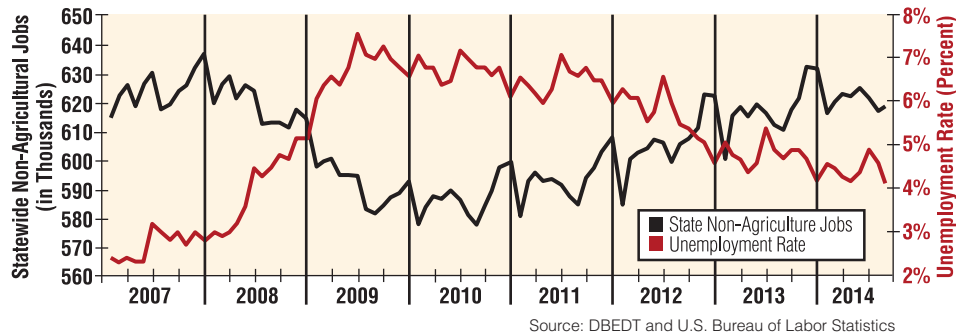
**CHART 2 • HAWAII REAL GDP & GDP GROWTH**



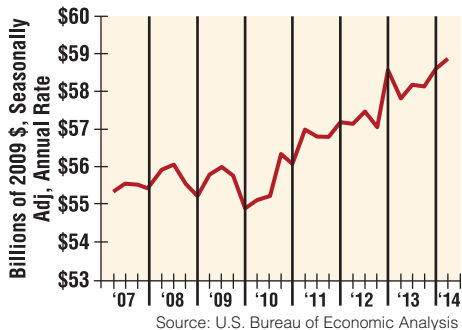
**CHART 3 • CONSUMER PRICE INFLATION, U.S. AND HONOLULU**



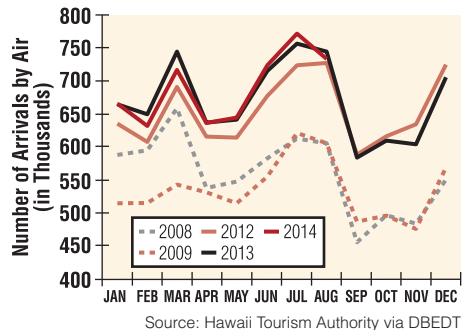
**CHART 4 • HAWAII JOB COUNT, UNEMPLOYMENT RATE**



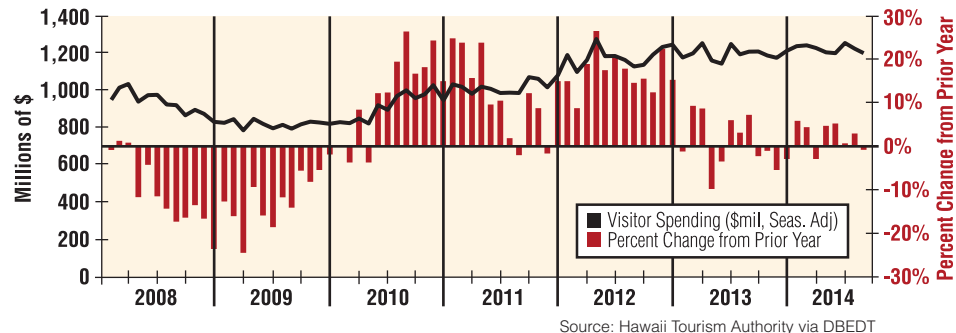
**CHART 5 • HAWAII REAL PERSONAL INCOME**



**CHART 6 • VISITOR ARRIVALS BY AIR, 2008-2014**



**CHART 7 • HAWAII VISITOR EXPENDITURES, 2008-2014**



Meanwhile, inflation-adjusted visitor spending after several very good years started slowing in 2012 and has remained flat since. (Chart 7, on previous page.)

Tourism expansion has not been uniform across the Neighbor Islands. Maui has fully recovered from the 2008-09 slump, but Kauai and Hawaii Island are still 5% below their prior peaks in visitor arrivals. (Chart 8.)

Airline seat capacity is critical to tourism success and Hawaii has benefited from carrier commitments of seats. Year-to-date seats are up for all destinations except Hilo. (Chart 9.) The picture looks good through the fall as well for flights from domestic origins, though the outlook for international capacity is less optimistic. (Chart 10.)

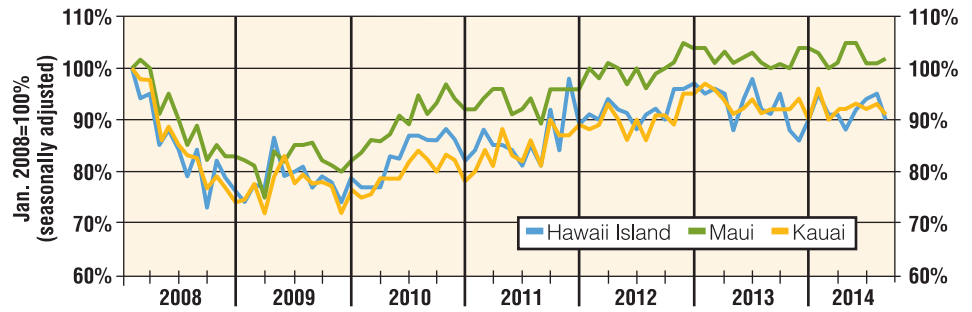
### Construction: Waiting to Explode

It was hoped that the construction industry would make up for much of the tourism lull, but this has only partially materialized so far this year. Construction job growth stalled in 2013-14. (Chart 11.) Of the 12,500 jobs lost in this sector due to the recession, only 3,900 have returned.

The state construction tax base (Chart 12) showed negative growth in the second half of 2013 and into 2014, but this is due in part to tax laws changes that exempt certain construction activity as well as the drop-off in photovoltaic installation activities.

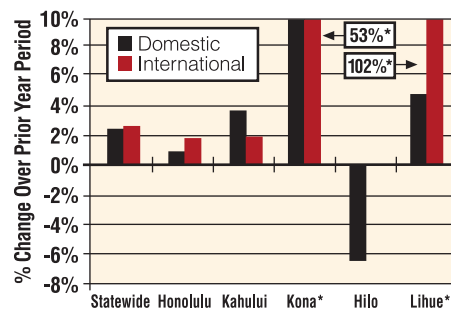
The media have documented the planned construction activities: rail on Oahu and infrastructure on all islands, development of Kakaako, new single-family housing projects, and renovations of hotel properties on all islands. All this will add to construction in the state. Both private and government permit growth remain positive, confirming the greater prospective construction activity in the second half of 2014 and into 2015. (Chart 13.)

**CHART 8 • NEIGHBOR ISLAND ARRIVAL TRENDS**



Source: Hawaii Tourism Authority via DBEDT

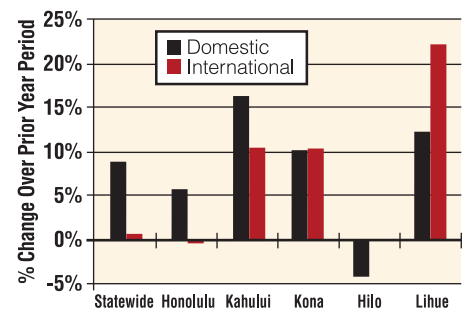
**CHART 9 • DOMESTIC AIRLINE SEATS, YTD AUGUST 2014 VS SAME PERIOD 2013**



\*Kona International 53% (Actual)  
\*Hilo International 102% (Actual)

Source: Hawaii Tourism Authority Monthly Visitor Statistics

**CHART 10 • AIRLINE SEAT OUTLOOK, OCTOBER - DECEMBER 2014**



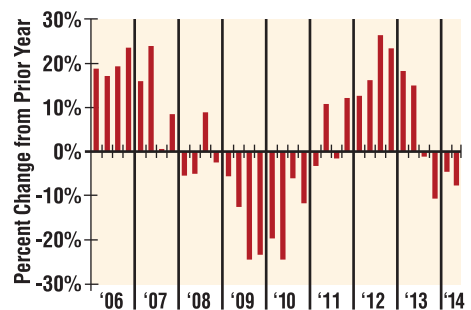
Source: Hawaii Tourism Authority Airline Seat Capacity Outlook

**CHART 11 • TOTAL CONSTRUCTION JOBS**



Source: DBEDT

**CHART 12 • CONTRACTING TAX BASE, % CHANGE FROM PRIOR YEAR**



Source: Hawaii State Department of Taxation

**CHART 13 • CONSTRUCTION IN THE PIPELINE**



Source: DBEDT

### Job Growth Has Been Uneven

The gains in jobs have been uneven both geographically and by economic sector. Most of the growth has been in the visitor-related sectors. (Chart 14.)

Likewise, the growth has not been uniform across the state's counties. Oahu was impacted the least by the contractions in the job market and has now returned within 3% of the peak employment at the end of 2007. (Chart 15). The Neighbor Islands had more serious fall-offs in employment ranging up to 12% of total jobs and their recovery has taken longer with Hawaii Island and Kauai still 5% below their peak.

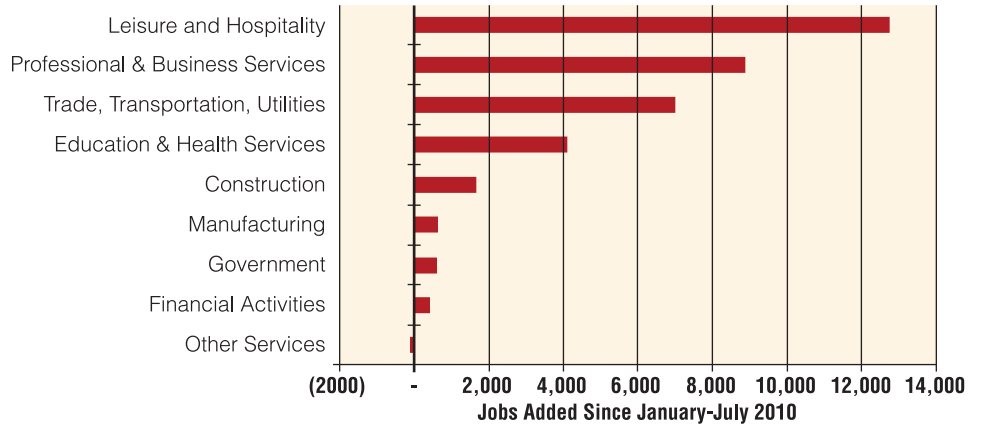
### Consumer Spending Strong

More jobs and higher incomes have led to improved consumer spending. The State's retail sales tax base has expanded significantly since 2009. (Chart 16.)

Likewise merchants' debit and credit card activity monitored by First Hawaiian Bank's Business Activities Report, published quarterly by the bank, has reaccelerated in 2014, after a fall-off in growth in late 2013 (Chart 17.) Leading the growth has been the hotel sector, but many spending categories that are more "local", rather than tourist-related, have also done well.

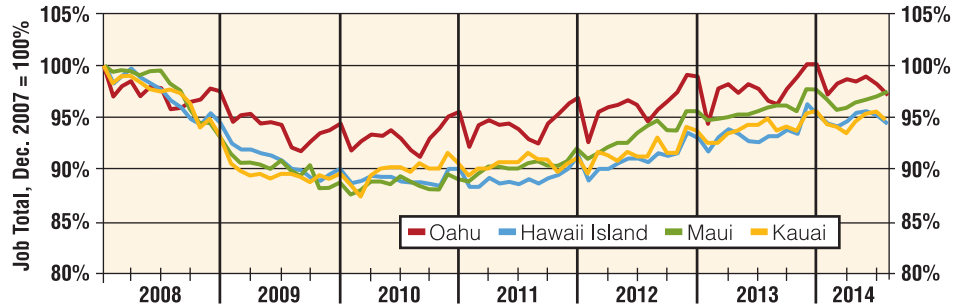
Car sales are always a good barometer of the economy's health. Data from the Hawaii Automobile Dealers Association (Chart 18) shows that retail car and light truck sales are expected to increase by nearly 10% in 2014, marking five consecutive years of growth.

**CHART 14 • JOB GROWTH BY SECTOR, 2010-2014**



Source: DBEDT

**CHART 15 • JOB TRENDS BY COUNTY**



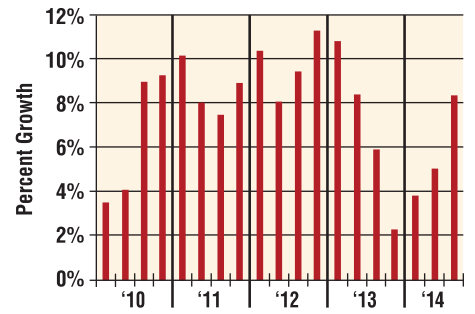
Source: DBEDT

**CHART 16 • GENERAL EXCISE TAX BASE, RETAIL SALES**



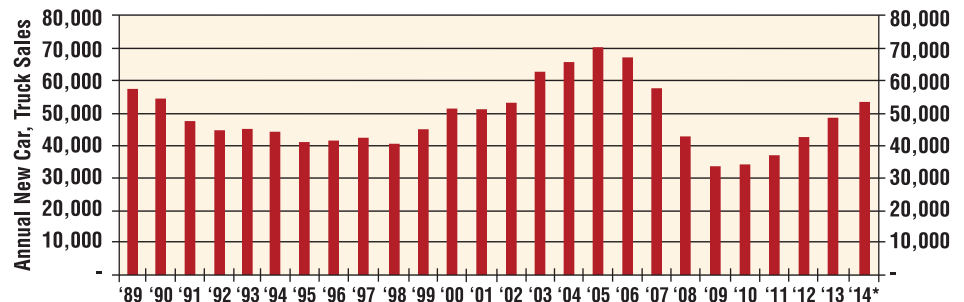
Source: Hawaii Department of Taxation

**CHART 17 • CARD SPENDING GROWTH RATE**



Source: First Hawaiian Bank Business Activity Report

**CHART 18 • HAWAII NEW VEHICLE SALES, 1989-2014**



\*2014 figure is HADA forecast. Source: Hawaii Automobile Dealers Association

## Real Estate: Deceleration of Strong Recovery

Supported by favorable macro-economic conditions and excess demand in many markets, Hawaii real estate has recovered smartly from the effects of the Great Recession. On Oahu, single-family and condominium units sold (Chart 19) climbed through 2013, but have since slowed their ascent. Prices likewise rebounded through 2013, but these increases have also tapered. (Chart 20.)

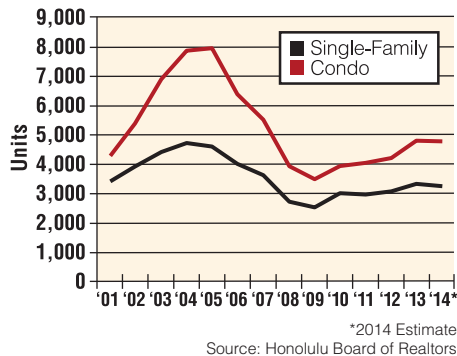
The improving real estate trends were also experienced on the Neighbor Islands. However, they went through more serious market contractions than Oahu. (Chart 21.) In spite of good comebacks, these markets are still more than 20% below their prior price peaks.

## Government Finances

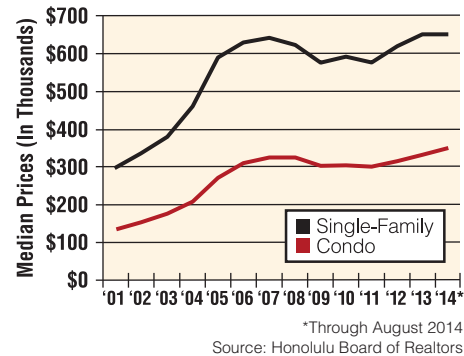
Among the many beneficiaries of the improving economy has been county government. My review of Neighbor Island finances shows that recovering assessed property values combined with enacted tax rate increases have put these governments on a better fiscal footing.

In spite of improving incomes and increased spending, Hawaii State government tax revenues hit the skids after some great years. Starting in 2013, General Fund revenue growth turned negative. (Chart 22.) Contributing to this pattern were slowing collections of the State's leading source of revenues, the General Excise Tax, as well as statutory transfers out of the General Fund. These trends will make financing ever-increasing demand for services more difficult, especially given negotiated public worker wage increases.

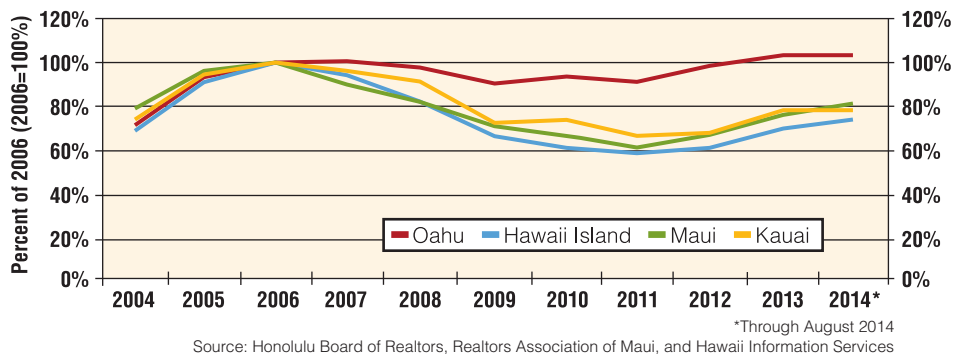
**CHART 19 • OAHU REAL ESTATE RESALES, 2001-2014**



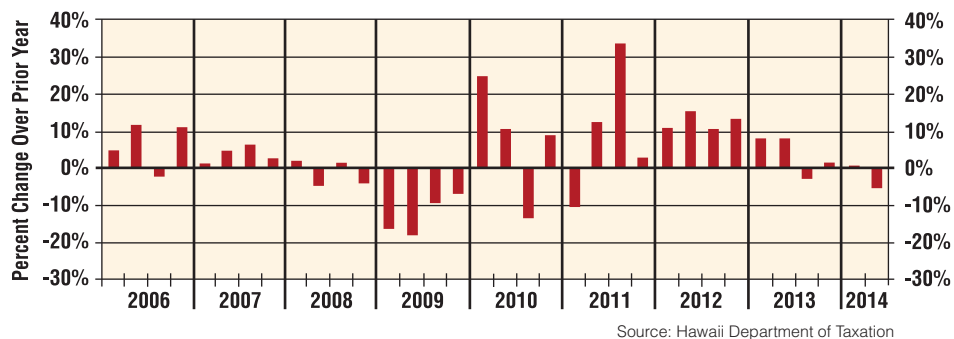
**CHART 20 • OAHU MEDIAN PRICES, 2001-2014**



**CHART 21 • SINGLE FAMILY MEDIANS, BY COUNTY**



**CHART 22 • STATE GENERAL FUND COLLECTIONS, QUARTERLY CHANGE**



## Some Caveats

My forecast could be considered optimistic, and there are those who would suggest more caution. After all, we are five years into an economic growth cycle, and the post-war average length of such expansions is 58 months. In addition, exogenous shocks can spell trouble, including:

- Japanese sluggishness and yen depreciation
- A hard landing in China

- Deepening European weakness
- Mideast madness
- Putin on the march in Russia
- Fed stumbles in its "exit"

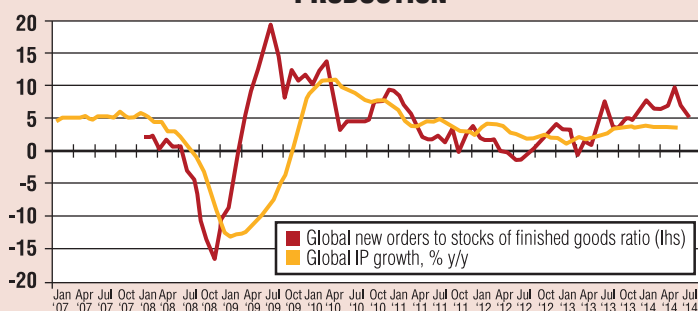
Assuming none of these becomes a serious issue, I believe that 2015 will be a good, but not great, year for Hawaii's economy.

# Gradual, uneven global recovery

By Dr. Larry Hatheway, Managing Director and Chief Economist, UBS Investment Bank

A gradual global recovery continues, though its defining characteristic may be how uneven it is. The US and the UK provide the sole examples of accelerating growth. After stagnating in Q2, Europe's leading indicators suggest only a marginal return to growth in Q3. Japan's economy contracted sharply in Q2 following the introduction of the higher consumption tax, and is set to resume growth of just over 1% in the coming year. China's economy has again weakened, sufficiently to prompt a further easing of credit conditions. And elsewhere in the emerging and commodity complex there are few, if any, signs of acceleration, and only then as a result of a modest upturn in (non-commodity) exports.

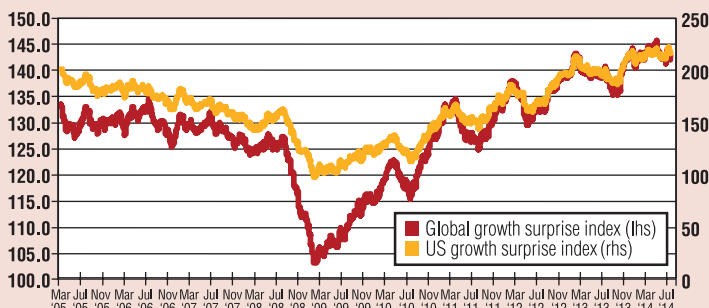
**CHART 1 • GLOBAL STOCKS TO ORDERS AND INDUSTRIAL PRODUCTION**



Source: Haver, OEF, UBS estimates

Put differently, matters can be described as American exceptionalism. That's not because the US is demonstrating superb growth. Rather, the US is the only large economic bloc experiencing an acceleration of growth, preparing for a tightening of monetary policy, and enjoying an appreciating currency. The US recovery is underpinned by lessening fiscal drag (compared to 2013), accommodative monetary and financial conditions, and lower energy prices. But its underlying momentum also stems from more flexible labour and product markets, a recapitalised and functioning financial sector, as well as innovations, particularly in energy and technology. Overall, we expect US growth to accelerate to a 3.2% annual rate in H2 2014, maintaining that pace for calendar year 2015.

**CHART 2 • US GROWTH SURPRISES DRIVE GLOBAL GROWTH SURPRISES**



Source: Bloomberg, UBS

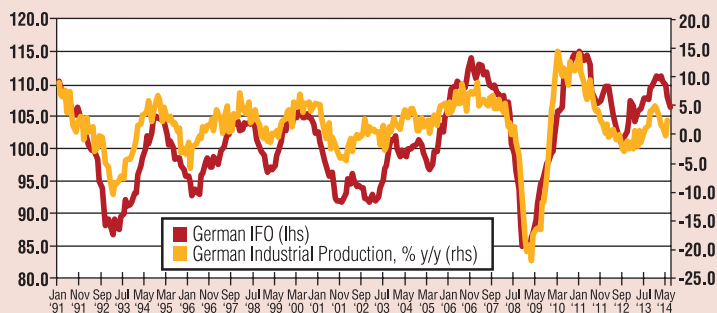
US inflation remains subdued, but we expect some modest upward drift in core consumer prices (targeting a 2.1% core PCE inflation rate by end 2015) as the output gap narrows and wage inflation picks up. Accordingly, we continue to anticipate that the Federal Reserve will initiate its first rate hike in June 2015, with the Fed funds rate rising to 1.25% by end 2015.

That all adds up to a stronger US dollar driven by:

1) the advanced cyclical position of the US; 2) a divergence of Fed and rest-of-world monetary policies; 3) higher returns capital in the US and; 4) a more innovative US economy. Dollar strength is likely to be broad based, with further gains against the euro, the yen, commodity and emerging currencies over the next fifteen months.

In the Eurozone, leading indicators such as the latest PMI data suggest the return to very slow growth in Q3, accompanied by a worrisome deceleration in Germany, the backbone of the region's economy. That's somewhat surprising given that factors supporting the US recovery, such as reduced fiscal drag or accommodative financial conditions, are present for Europe as well. Most probably, anxiety unleashed by the Russia-Ukraine conflict has eroded confidence and slowed growth more in Europe than elsewhere, an unsurprising outcome given the proximity of the conflict and Europe's heavy reliance on Russian energy supply.

**CHART 3 • GERMAN IFO AND INDUSTRIAL PRODUCTION**



Source: Haver, UBS estimates

ECB easing, largely in response to the dip in Eurozone HICP inflation to 0.3% in August, is focused on repairing the 'transmission mechanism' between its policy stance and economy-wide credit conditions. That policy is multi-faceted, and includes direct asset purchases (covered bonds and asset-backed securities), incentivising banks to lend (TLTRO and negative deposit rates) as well as shoring up confidence in the financial sector (asset quality review and stress tests). Still, we have a lingering doubts that no matter how bolstered the financial sector becomes the greater challenge will be boosting the demand for credit. Unfortunately, the factors determining credit demand—income insecurity, collateral values, overall levels of indebtedness and cultural inhibitions to debt—lie largely beyond the ECB's control. Hence, the primary transmission mechanism for ECB policy, at least for now, is a weak euro, which should lift import prices (and offset declines in the dollar price of oil).

But Japan offers reasons to doubt that currency weakness will do much more than lift import prices. Over the past two years Japanese export prices have barely budged despite the yen's significant depreciation. Indeed, export volumes are rising more sluggishly than expected, even as the yen has resumed its depreciation. That outcome mirrors outcomes elsewhere (e.g., the UK in the immediate post-crisis period), suggesting that changes in real exchange rates have relatively small impacts on export volumes and therefore on investment in the traded-goods sector. Instead, they provide a one-off boost to corporate profitability, but not much else.

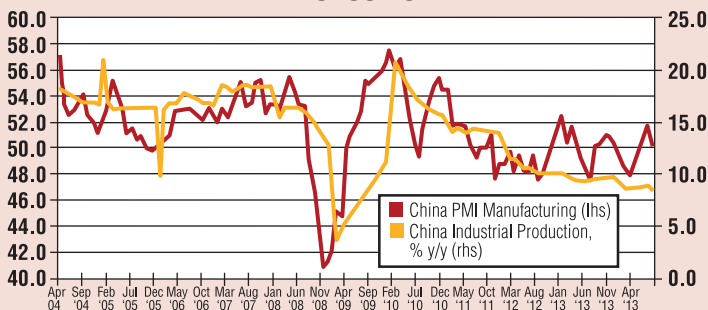
Apropos Japan, the hike in the consumption tax produced a larger-than-expected decline in Q2 domestic demand, prompting us to trim our full year growth number from 1.6% to 1.1%. Despite some indications of a re-think by the Abe government, we believe the second stage of the consumption tax hike (from 8% to 10%) will take place next April. Even with a weaker yen, some offsetting fiscal stimulus and, possibly, a further expansion of the Bank of Japan's (BoJ) QE purchases, we think the impact will be to restrain growth to a 1.2% rate next year. Barring an unexpected and broad-based surge in wages (which are currently rising less than the underlying rate of inflation), we remain sceptical that the BoJ will achieve its 2.0% inflation target by end 2015.

South Korea has initiated steps to support its economy. The government plans to raise spending 5.7% next year versus an estimated 4% increase this year, thereby expanding the fiscal deficit to -2.1% of GDP in 2015. Fiscal stimulus should help the economy grow just shy of 3.0% in 2015 (forecast 2.9%).

In August the Bank of Korea cut rates 25 basis points as further sign of policy support. Yet with private sector indebtedness high at about 200% of GDP, there is limited scope for a further acceleration of credit growth (which is already robust relative to nominal GDP). Indeed, rising levels of indebtedness pose downside risks to South Korea's growth in 2015-16.

The external sector also presents a mixed picture for South Korea. Signs of a further slowdown in China are troubling, as is a potential erosion of competitiveness given a weakening of the yen and euro. Still, exports to a firming US economy are up 14% year-on-year, which is a significant source of support.

**CHART 4 • CHINA MANUFACTURING PMI AND INDUSTRIAL PRODUCTION**



Source: Haver, UBS estimates

Turning to other emerging economies, the story remains one of weak or weakening growth. China's economic activity slowed more than expected in August, with industrial production dipping to a five-year low of 6.9% year-on-year. Our proprietary expenditure and physical activity indices also softened in August, as did China's purchasing manager indices. Fundamentally the property market recession remains the culprit, with no relief in sight. Still, real retail sales, which rose 10.6% year-on-year in August, remain resilient. Overall, weakness in property and industrial production has prompted us to trim our full-year GDP forecast to 7.2% in 2014.

China's policymakers have signalled their willingness to provide support to the economy, courtesy of liquidity injections into the larger banks and a cut in the repurchase rate. Reports indicate that the big banks may be asked to ease mortgage lending conditions. Our China economist, Tao Wang, expects further policy support, including a possible reduction in interest rates over the next two quarters.

In China, and in some other emerging economies, exports have picked up with base effects and the global recovery largely responsible. Commodity intensive economies, including in the emerging complex, are not likely to be beneficiaries, however, given weak basic materials demand (owing to China's property recession) and soft prices for many other commodities (e.g., energy).

In sum, the global recovery continues and we forecast global real GDP growth of 2.8% this year (versus 2.5% last year), rising to 3.3% in 2015. But the recovery is remarkably uneven, resting to an uncomfortable degree on the US as the sole domestic demand growth pole. Unsurprisingly, growth and interest rate expectations are pushing the dollar broadly higher in foreign exchange markets. That trend is likely to continue (e.g., we forecast EUR/USD 1.20 by end 2015).

### Risk factors

The chief risks to our outlook are as follows:

- **Fed anxiety.** A sharp acceleration of US growth (possibly underpinned by stronger consumer spending given solid job formation, rising asset prices and falling energy prices) could lead markets to rapidly re-calibrate their expectations for the first Fed rate hikes. Akin to 'taper tantrum' last year, markets could become prone to 'rate rage' at some point in the next few quarters.
- **China slowdown.** Although Chinese growth has already weakened, the downturn in the property sector is likely to be prolonged. Should falling property prices increase financial risk or lead prospective buyers to pull back, China's slowdown could intensify, putting particular pressure on commodity and basic materials prices, as well as on the currencies of commodity-producing countries

—continued on page 8

### **Gradual, uneven global recovery** (continued from page 7)

- **Geopolitical conflict.** Thus far, conflict in Russia/Ukraine and the Middle East has coincided with falling crude oil prices. But should the conflicts intensify and raise concerns about energy supplies, global activity could be significantly impaired. Europe remains most at risk, given the proximity of the tensions in Ukraine.
- **Populism and political unrest.** The ‘no’ vote in the Scottish referendum may not deter calls for greater regional autonomy elsewhere in Europe. Moreover, the scale of the economic fallout in the Eurozone periphery could still lead to questions about the sustainability of orthodox policies in at-risk countries, potentially leading again to rising sovereign risk premiums

### **Contours of the world economy**

We have recently launched an initiative to examine the ‘contours’ of the world economy. Our twelve contours are as follows:

- (1) **Gradual, uneven global recovery**  
*-The world economy continues to gradually heal, but the recovery is uneven, with only the US (and the UK) able to ‘bootstrap’ their recoveries via domestic demand.*
- (2) **Minimal inflation pressures**  
*-Or why, despite the extraordinarily expansive monetary policies of recent years, inflation is likely to remain subdued in most parts of the world economy for the foreseeable future.*
- (3) **A strong US dollar**  
*-US dollar appreciation is not yet complete—what that portends for economic, policy and market outcomes.*
- (4) **Prolonged period of above-average returns on capital, particularly in the US**  
*-Another example of why simplistic mean reversion does not apply in the post-crisis world, and what it means for valuations and asset prices.*
- (5) **Below-average real interest rates**  
*-Well-anchored inflation expectations, downward pressure on interest rates owing to expansionary monetary policies in the Eurozone and Japan, and the return of a global savings glut are likely to result in low real interest rates, with potentially significant implications for asset prices and the conduct of monetary policy.*
- (6) **Emerging economy indebtedness**  
*-As noted by our emerging Asia economics team (‘Debtopia’) many emerging economies will struggle to revive growth as they labour under the burden of high levels of indebtedness. Slower growth and a reversion to exports as a growth driver are key implications.*
- (7) **Unresolved global imbalances**  
*-Uneven global growth and a strong dollar imply a return to global imbalances. History rhymes.*
- (8) **Weak world trade growth**  
*-World trade is no longer growing as fast relative to world GDP, for various reasons. As noted by Bhanu Baweja and Andy Cates, this is likely to have adverse impacts on emerging economy growth and trend earnings, and also lowers fair value estimates of emerging currencies.*
- (9) **Promising yet disruptive new technologies**  
*-Innovations in energy, robotics, additive manufacturing, cloud computing and the internet of things—among others—may potentially lift trend world growth in the coming decade by as much as the advent of the PC and internet did in the 1990s. Yet these technologies also pose challenges to conventional industries and structures (e.g., global supply chains).*
- (10) **Unequal and plutocratic outcomes**  
*-Economic outcomes in many countries are becoming more unequal, with significant implications for growth, social stability and political outcomes.*
- (11) **No successor to the ‘Washington consensus’**  
*-The financial crisis and great recession have sown doubts about the post-war ‘Washington consensus’, namely that liberalisation (of trade and finance) and orthodox policies (inflation targeting, sound fiscal policies) promote growth and macroeconomic stability. In their wake, no successor ideology has emerged, leaving policy more adrift than at any time since the 1930s.*
- (12) **The return of history (resurgent nationalism/populism)**  
*-The great ideological debates of the twentieth century were ostensibly resolved with the fall of communism in 1989. But that was not the end of history. Territory, religion, ethnicity and, yes, history matter a great deal, possibly even more than ideology. Future conflicts, unfortunately, are unlikely be limited to Russia/Ukraine or the ongoing realignments in the Middle East. Latent sources of conflict are found in nearly every time zone. How can investors factor geo-political risk into their decision-making?*