

Economic Forecast

HAWAII ISLAND EDITION 2011 - 2012

Visitor Industry Paces Slow Hawaii Island Recovery

Visitor arrivals to Hawaii Island are registering welcome percentage gains; visitor spending growth is even stronger. Still, the overall forecast for the county remains similar to a year ago — a measured recovery, led by tourism, but held back by a mixed picture in other sectors and a continued downbeat construction industry.

It's a theme that is repeated across all of the Neighbor Island counties. In good times and bad, however, one thing that always distinguishes Hawaii County from the other Neighbor Islands is its greater diversity. Astronomy and UH-Hilo contribute to that, and the Big Island has been able to hang on to a healthier and more diversified agricultural sector than any other county.

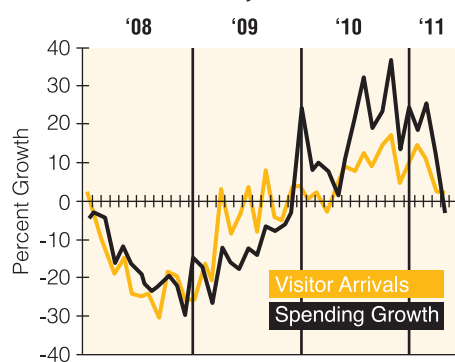
Arrivals Up Significantly; Spending Growth Strong

Hawaii County visitor industry performance recently has been quite good. Chart 1 shows arrivals growing in the double digits in some recent months, with visitor spending usually surpassing the arrival numbers.

A significant development is a re-branding of the island in terms of marketing. Apparently there are enough “geographically challenged” people around who confuse “the Big Island” with Oahu, where the bulk of the population resides. Thus, a new identity for Hawaii County is being sought: “Hawaii Island.” The Hawaii Island Visitors Bureau considers this an important change in image.

Loss of the direct JAL flight into Kona in October 2010 prompted a search for a replacement airlift. Continental/ United has begun direct daily 737-800 service from Los Angeles

CHART 1 • HAWAII ISLAND TOURISM GROWTH, 2008-11



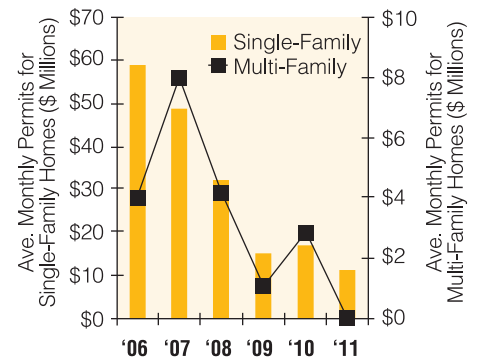
Source: State Department of Business, Economic Development & Tourism

into Hilo. A similar weekly flight comes from San Francisco. The last direct flight from the U.S. Mainland to Hilo was in 1983. The hope is that visitors will spend more time and money on the East side than just a rushed day trip from West Hawaii to see the volcano.

There remains a longstanding need for more updated visitor accommodations in Hilo. Since the state leasehold problems with Banyan Drive hotels make renovations there unprofitable, any addition would likely be located elsewhere. Bringing Hilo more into the action would serve to further diversify the island's visitor experience, and distinguish it more from the typical sun-and-surf tropical destination.

Japan's tsunami in March 2011 did more damage to West Hawaii than elsewhere in the state, although its impact was spotty and the visitor industry did a remarkable job of getting back into operation. Four Seasons Hualalai now shows no sign of damage, with a price tag of about \$15 million. Kona Village management says it intends to get the resort back into operation, though no time frame has been given.

CHART 2 • HAWAII COUNTY BUILDING PERMIT VALUES



Source: County of Hawaii and HPM Building Supply

Construction Industry Remains In Doldrums as 2011 Unfolds

In 2010, a slight uptick in building permits gave rise to optimism that the island's construction cycle was turning around. But that was unsustainable; Chart 2 shows a different story for 2011:

■ In 2010, single-family residential permits increased 17% over 2009. That growth was due to increased activity in West Hawaii, thanks to the ultra-high-end Kukio/Hualalai market. Also, the Department of Hawaiian Home Lands permitted and is currently building a 40- to 45-unit, single-family home project in Laiohua in Kona. But Waimea and East Hawaii saw their third year of permit declines in 2010.

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ON THE INSIDE

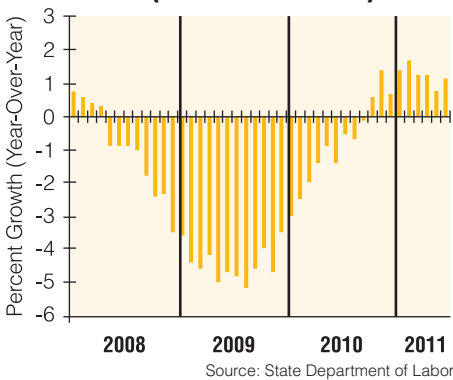
5 U.S. & Global Economic Outlook: Great Debt Debate

Sluggish Recovery Throughout the State

For the last couple of years our position has been that we could look forward to only a slow recovery from the serious recession. That has certainly proven to be the case — at the global, national, state, and individual county level here in Hawaii.

Job growth: One of the best concurrent indicators of the local economy is job growth; it is also what matters most to the great majority of people. Chart A shows that the State of Hawaii broke into positive territory in late 2010 after declines that began in 2008 and worsened in 2009. Those job gains have improved as 2011 has progressed. Barring unforeseen setbacks, this growth should improve as the recovery takes hold more. So far, state jobs are still about 5% below the pre-recession year of 2007. These overall job figures also mask some unevenness across various sectors of the economy.

CHART A • STATE JOB GROWTH (YEAR-OVER-YEAR)



Unemployment: The statewide unemployment rate (Chart B) is well below the national number though still higher than average for Hawaii. Part of this lower unemployment rate is likely due to discouraged workers who dropped out of the labor force during the recent recession.

Tourism: The leading edge of the recovery has been the visitor industry; Chart C shows how it snapped back more strongly than many expected when the recession hit. State visitor arrivals have shown spectacular growth after the declines of 2009, and visitor spending growth has been even more stunning. Unfortunately, tourism's strength has

CHART B • STATE UNEMPLOYMENT RATE, 2007-11

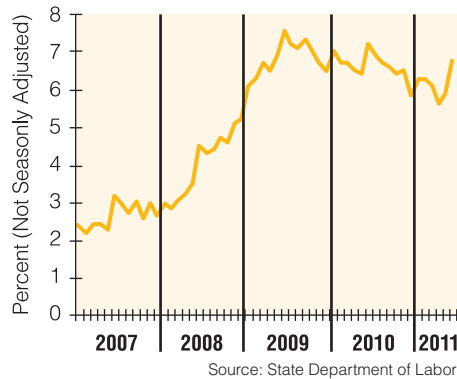
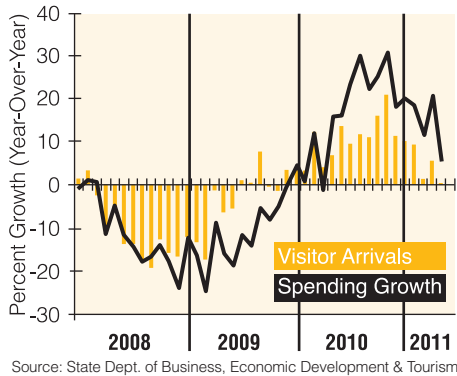


CHART C • STATE VISITOR INDUSTRY GROWTH, 2008-11



not yet spread to some other important sectors of the state economy.

Construction: One of those lagging sectors is construction. That continued weakness is shown in these figures on construction completed (Chart D), lower building permits (Chart E) and losses in the industry's job total (Chart F). As rail transit ramps up, there will be a big boost for the construction industry on Oahu, but that won't help Neighbor Island construction numbers.

CHART D • STATEWIDE CONSTRUCTION COMPLETED, 2006-11

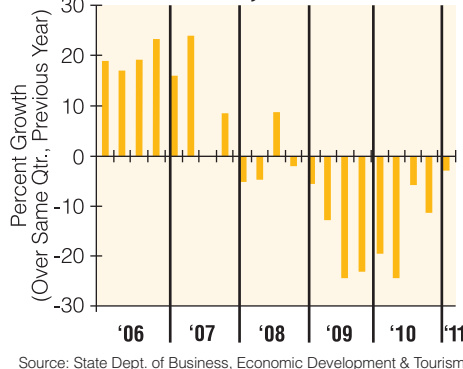


CHART E • GROWTH IN PRIVATE PERMITS STATEWIDE, 2006-11

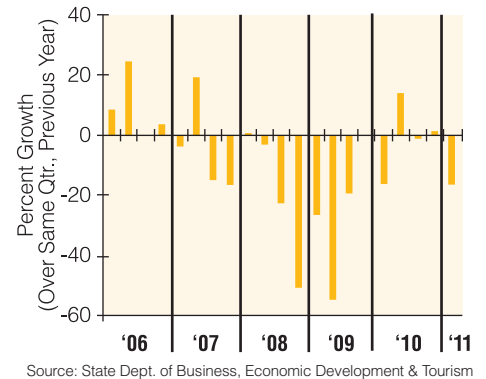
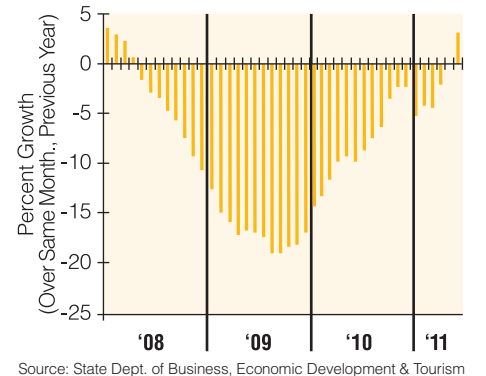
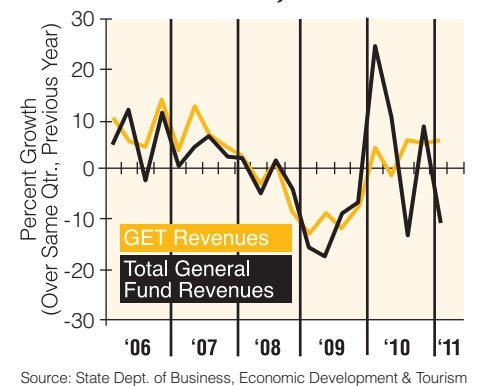


CHART F • CONSTRUCTION INDUSTRY JOB GROWTH, 2008-11



Tax revenues: The weaker economy has brought subpar growth in state tax revenues (Chart G), forcing unpopular budget cuts at just the wrong time. The general excise tax growth in recent quarters reflects some improvement in the economy, but the overall General Fund has not done as well.

CHART G • STATE TAX REVENUE GROWTH, 2006-11



Hawaii Island (continued from page 1)

- Multi-family residential permits in 2010 increased 164% over 2009. But nearly the entire total was issued for the Villages of Aina Lea housing project near the entrance to Mauna Lani resort, which has been plagued with financing and land classification issues. Unless these issues are resolved, local observers say the remainder may never be built.
- Permit values did not show a good beginning for 2011. West Hawaii saw a big drop in the first quarter, breaking a positive trend, and East and North Hawaii continued to gradually decrease.

Thus, local residential construction trends mirror what is happening elsewhere. Prices of existing homes have fallen so far that one can get a better deal on a resale than a new home, so developers aren't building new product. Foreclosures and short sales continue to put downward pressure on prices.

Island Real Estate Sales Rise, But Prices Still Falling

Hawaii County real estate sales are still rising and prices are falling, according to 2011 data from the Hawaii Information Service. But, as Chart 3 shows, the rate of price decline for single-family units is diminishing. The usual caveat on Neighbor Island real estate data applies here — small sample sizes can be distorted by the specific mix of transactions that occur in any given period.

It's interesting to observe what some local market analysts are currently saying about the local economy.

Chart 4, put together by Mike Griggs at Clark Realty, shows a 12-month moving average of homes for sale and a moving average of median prices for North Kona District, excluding sales over \$4 million. The orange line captures the run-up in prices over the last decade, as well as the subsequent decline. Over the last year, the leveling in price declines might lead one to assume a bottoming out.

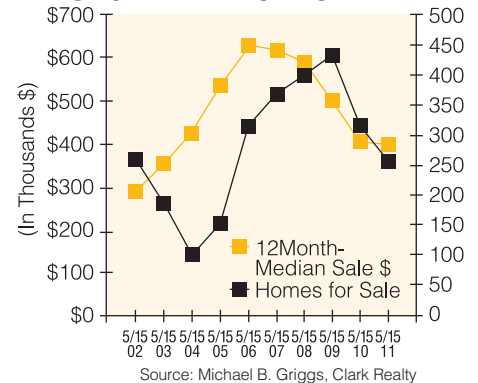
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CHART 3 • HAWAII COUNTY REAL ESTATE SALES AND PRICES (% GROWTH OVER PRIOR YEAR)

Sales	2010	YTD 2011
Single-Family	+21%	+5%
Condominiums	+58%	+19%
Median Price	2010	YTD 2011
Single-Family	-7%	-4%
Condominiums	-10%	-17%

Source: Hawaii Information Service
YTD 2011 through June

CHART 4 • NORTH KONA SINGLE-FAMILY SALES TREND



Source: Michael B. Griggs, Clark Realty

Job Total Moving Toward Positive Growth

Job growth during our recession and recovery has been distributed across counties, as Chart X shows. Job losses were less and jobs created were greater in Oahu's much more diversified and larger economy. While job growth on each of the Neighbor Islands has been lower than Oahu, there are some differences among them.

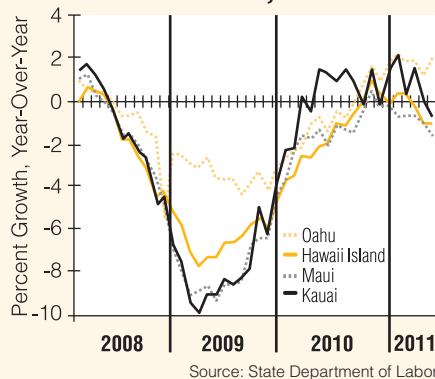
Kauai shows the strongest growth, but also had lost the most — percentage wise. Maui continues to lose jobs; its visitor industry is healthy, but weakness in other sectors overwhelms that strength.

Hawaii County recently broke into positive territory, though it's a mixed bag. There have been gains

in educational and health services, professional and business services, and information and technology. The new Target store and large Safeway in Hilo add to the job count. Other sectors are still losing jobs. And until job formation gains a wider base, overall growth will remain precarious.

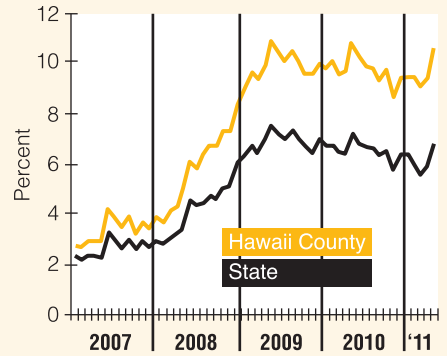
Hawaii County's jobless rate remains highest in the state. That often is true, partly because of the separation of jobs in West Hawaii from the higher population in East Hawaii. The rate has been coming down, but very slowly; it's still a far cry from the 2-3% range in 2007. Those slow declines will likely continue in the future.

CHART X • JOB GROWTH, BY COUNTY, 2008-11



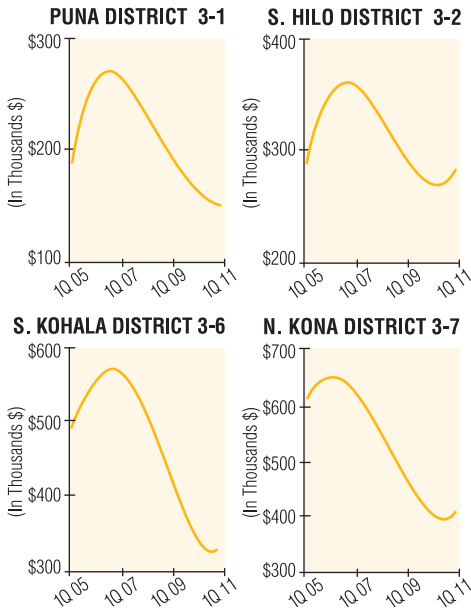
Source: State Department of Labor

CHART Y • UNEMPLOYMENT: STATE VS. HAWAII COUNTY



Source: State Department of Labor

**CHART 5 • HUSSEY APPRAISAL GROUP
MEDIAN PRICE ANALYSIS, 2005-11**



The graphs in Chart 5 from Hussey Appraisal Group also might suggest a bottom is approaching. They apply an econometric technique that obtains the best fit to the scatter of median price observations over time for the county's most populous districts.

Of course, historical data doesn't necessarily predict the future. Appraisers were quick to point out the many homeowners whose homes are now not worth the mortgage amount; these owners will continue to liquidate their losses through foreclosures and short sales. Only when this distressed selling slows can a bottom be reached.

Keahole Natural Energy Lab Contributes to Economy

The Natural Energy Lab at Keahole Point survived the recession without losing any of its 41 tenants and its contribution to the economy is important. There are about 400 employees, and combined tenant revenues total about \$50 million. Around half comes from five bottled water operations, and the other half from aquaculture. Bottled water sales still go mainly to Japan, and recession there has affected sales. But ironically, in the long run Japanese demand for pure water could actually rise.

Thirty Meter Telescope (TMT) Remains on Track for Mauna Kea

Development of the Thirty Meter Telescope (TMT) telescope atop Mauna Kea remains on track. The permit application was approved in February 2011 by the Board of Land and Natural Resources.

It is hard to overestimate the importance of this project for jobs, the construction industry, UH-Hilo base facilities and the image of the island generally. A payroll of 140 permanent employees, not including contractors, and an estimated annual budget of \$26 million are only the beginning. Because TMT is the first of an entirely new generation of telescopes, its Hawaii location ensures the primary role of the state and county in astronomy's future.

Based on requirements of current observatories and the creation of new positions with the TMT, it has been estimated that nearly 500 new observatory jobs will open up through 2023. In the past, about 40% of technical and administrative staff had to be recruited from outside the state. That percentage could decline with more developed local training programs.

This will be the world's largest and most advanced optical/infrared observatory. The project is a U.S./Canada/Japan/China/India partnership and will enable astronomers to study objects at the very edge of the observable universe. Construction will extend over most of a decade, with the first scientific applications scheduled for 2018.

As usual, some cultural and environmental opposition has surfaced, but much less than for some past proposals at the summit. TMT supporters have worked hard to minimize environmental and cultural opposition. The balance has shifted this time to the side of supporters, who are united and vocal behind the project.

Hilo: On Track to Become A 'University Town'

The growing presence of UH-Hilo puts Hilo on the road to becoming a "university town." One development in 2011 is graduation of the first class at the new Hilo College of Pharmacology. Also, the Western Association of

Schools and Colleges recently approved a Doctor of Pharmacy program.

Additions to the campus in recent years have been several, and more are in the pipeline, including: a new Office of Student Services Building; Hale Kanilehua Student Housing (\$8 million); and Kawili Street Student Housing Phase I (\$32 million), the initial phase of University Town Center.

Housing like this is critical for expansion. With an enrollment of 4,000 students, UH-Hilo now has only 600 beds on campus and estimates that it loses 350 admitted students each fall for lack of housing. Outside rents are generally higher than most of them can afford, and most such rentals are not near the campus.

Diversified Agriculture Helps Island Economy

The Big Island's agriculture sector brings valued diversification, even though trends are often mixed:

- Cattle prices have rebounded from 2010 lows, thanks to short supply of beef cattle on the Mainland. But drought has affected herd size and conception rates.
- The number of potted dracaena growers has shrunk due to low demand and strict quarantine issues in California. Foliage palms growers are seeing a recovery in their market for these high-value plants.
- The 2010-11 macadamia nut crop was depressed due to effects of prior drought. Another downward pressure on supply has been the exodus of many independent farmers due to low return on investment. Prices have been holding at 2010 levels due to the shortages. If blessed with good rain this year, the industry hopes production will increase significantly.
- The Kona coffee crop is expected to be significantly larger in 2011, closer to normal annual production. The coffee borer is expected to have some impact on the industry, however. The market for 100% Kona coffee is impacted by recent recession, but demand for blended product remains strong. Prices are expected to remain about the same as 2010.

U.S. & Global Outlook for 2012: The Great Debt Debate

By Dr. Jack P. Snyderhoud, Professor of Business Economics, Shidler College of Business, University of Hawaii at Manoa

In the wake of the Great Recession of 2007-09 both politicians and economists have been absorbed in a contentious debate about debt. The debt is the result of consumer borrowing as well as public sector deficits. The former was a contributing factor to the Great Recession while the latter has been a long-term problem exacerbated by the recession.

Economists can be placed into two camps regarding debt. In the first camp we have debt and deficit “hawks” who believe that debt is a drag on economic activity and, the sooner it is dealt with in a credible fashion, the faster the economy will return to adequate growth. In the other corner are the debt and deficit “doves” who recognize that something has to be done about debt but believe now is a bad time to do it because of the weak U.S. economy, European debt uncertainties, the effects of the Japan earthquake, unrest in the Arab world, and high commodity prices.

The Accumulation of Debt

Households, businesses, and government all face a fundamental choice: How much do we consume now and how do we save and invest for the future? In the United States, as Chart 1 shows, for the last 30 years we have opted to consume more and borrow more, mostly in the form of mortgages. (However, other forms of household debt also increased, for example by 65% between 2000 and 2008.) Chart 2 shows how household debt (black line) grew while mortgage interest rates (orange line) fell to historic lows.

Households have actually reduced their debt levels since the start of the Great Recession, in part by walking away from some mortgage debt and in part by saving more and consuming less. But this decline in consumption contributed to the recession.

Deficit spending to fight the recession causes government debt to explode and has pushed debt levels to uncomfortable levels (Chart 3). If we add to this the “hidden” debt of Social

CHART 1 • U.S. HOUSEHOLD DEBT (1980-2011)

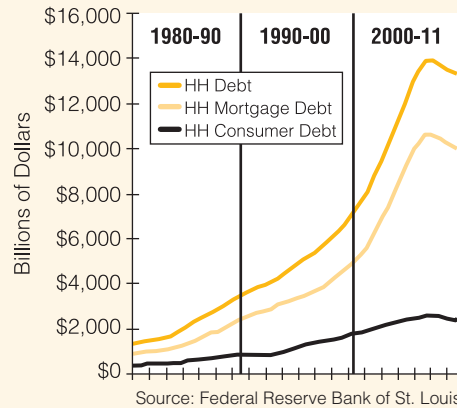


CHART 2 • HOUSEHOLD DEBT, MORTGAGE RATES (1980-2011)

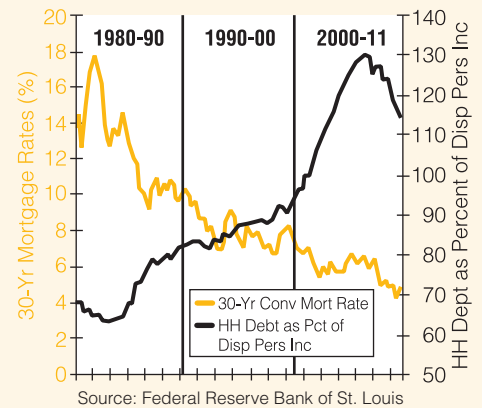
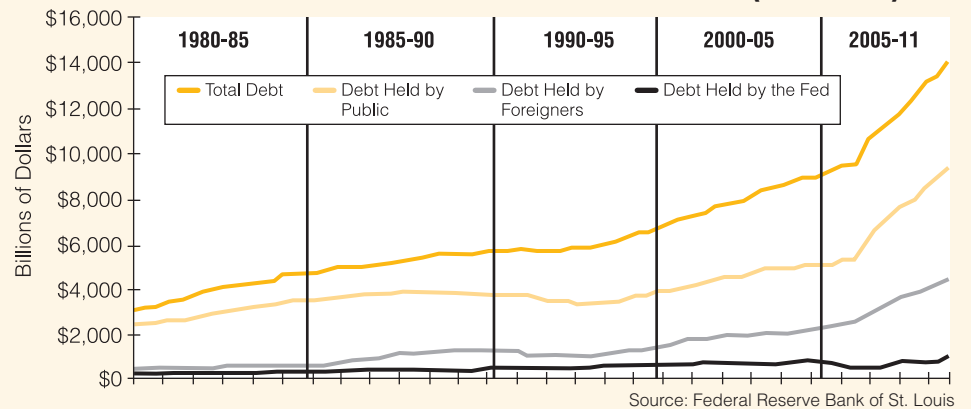


CHART 3 • U.S. FEDERAL GOVERNMENT DEBT (1990-2011)



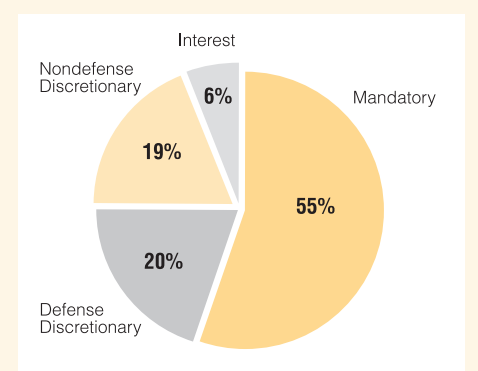
Security and state-local pension underfunding we can understand why ratings agencies have begun to express doubt about our future course.

Ways to Reduce Public Debt

There are several ways to reduce public debt. The most scary is default. However, defaulting on U.S. government debt would shake the foundations of the global financial system and would cause great pain both in the financial sector and the real economy. Less painful would be inflation, which reduces the real cost of debt, but risks other economic consequences.

Debt and deficit hawks have pushed for austerity — raising taxes and/or reducing spending. The hawks, especially the political versions of the hawks, have pushed for spending reductions. Since our deficits are so

CHART 4 • U.S. FEDERAL SPENDING 2010



high (10% of GDP) and the Federal budget is so constrained by “mandatory” spending (Chart 4), debt reduction through spending cuts will be painful.

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U.S. & Global Outlook for 2012

(continued from page 5)

The least painful solution is to increase the growth of the economy. If the economy grows faster than debt, the debt will become a smaller relative burden. But this still requires either increasing growth or reducing deficits.

2011: The Soft Patch

Meanwhile, the economy muddles along. 2011 has not been as strong as 2010 and has turned even softer than expected. The dreaded phrase “double dip” has been heard more often.

Job growth has finally returned, but it has been anemic and not sufficient to bring the national unemployment rate down significantly. The housing sector has remained in a state of depression. As a result, while consumer spending has rebounded, consumer confidence remains low.

At the same time, the fiscal stimulus that created the huge public debt increases has run its course. In fact, if austerity measures are implemented, fiscal policy may be a short-term drag on the economy. This leaves the Fed as the only potential stimulus through yet another round of quantitative easing.

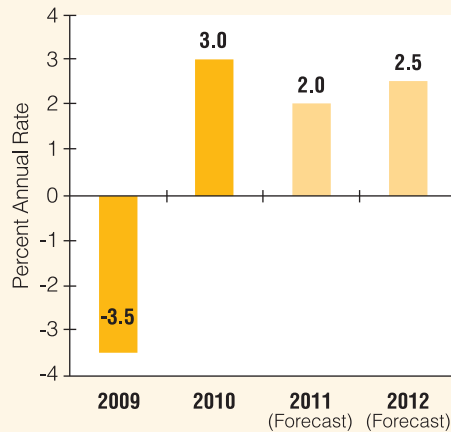
The only really good news is that our weak dollar and good economic growth in foreign markets has resulted in a strong rebound in U.S. exports.

The Outlook

The outlook for the rest of 2011 and 2012 will depend in part on the extent of fiscal austerity the politicians agree to and on external forces such as commodity prices. I am assuming that until the 2012 elections little progress will be made on resolving the U.S. structural deficit issues. Likewise, I assume European economies will continue to struggle with their debt issues. These uncertainties will be a drag on the economy.

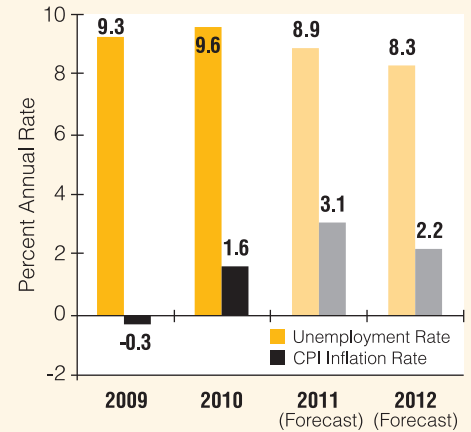
I am also assuming that oil prices will remain in the \$100-\$110 per barrel range through 2012. This sounds good, but remember oil averaged \$80 in 2010. Overall, energy prices will have a neutral impact on the economy for this outlook period.

CHART 5 • U.S. REAL GDP GROWTH FORECAST



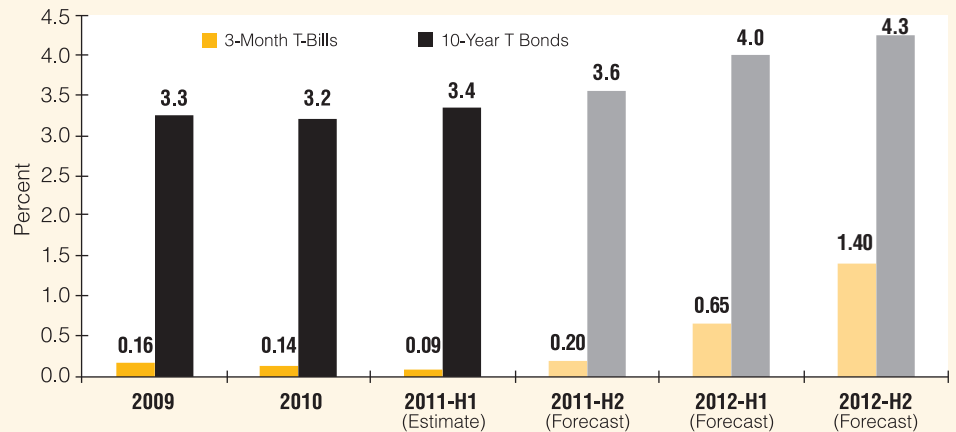
Source: Federal Reserve Bank of St. Louis

CHART 6 • FORECAST U.S. UNEMPLOYMENT, INFLATION



Source: Federal Reserve Bank of St. Louis

CHART 7 • FORECAST U.S. INTEREST RATES



Source: Federal Reserve Bank of St. Louis

Developed Economies: Growth returned to most developed economies in 2010 and '11. Only Japan is expected to have negative growth in 2011 due to the earthquake, tsunami, and nuclear problems. European growth is not expected to be robust (i.e., not above 3%).

Asian Economies: The picture looks much better in the Asia-Pacific region. China, Korea, India and Australia will all have growth rates above the global average. Starting in 2010 the central banks in these countries began to raise interest rates to try to avoid inflation and cool off torrid growth.

U.S. Forecast and Risks: In the first half of 2011 U.S. GDP growth was less than 2%. However, I expect it to pick up marginally in the second half of 2011 so that overall GDP growth will be about 2% this year (Chart 5). 2012 will also have positive growth, but

below the desired 3% rate that brings down unemployment significantly. As a result, the unemployment rate will remain near 9% through 2011 and only slightly better in 2012 (Chart 6). Inflation will see a bit of a bump in 2011, but remain in check through 2012.

The combination of slow growth and the absence of significant inflation will keep interest rates low (Chart 7). Both short-term Treasury bill rates and long-term 10-year Treasury yields will increase somewhat through 2012 but remain very low by historical standards.

Again, these forecasts assume relatively stable energy markets, short-term deficit fixes but no real progress in U.S. structural debt reduction. If things go awry in these scenarios, a loss of consumer confidence could push the economy into a second dip.