

Economic Forecast

OAHU EDITION 2013 - 2014

State Outlook – Continued Growth Despite D.C. Flaws

The news is good. Thanks to four years of steady growth, the Great Recession has been left behind and Hawaii has entered an expansionary phase of our business cycle. We forecast 2014 to be a continuation of what we have seen since 2010 — 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, as the sector continues to grow but at a more moderate pace.
- Construction will pick up, adding jobs.
- State and local government will contribute to growth while federal spending will not.

Though much of the economic news for Hawaii is good and some of it is even great, many people remain skeptical about this recovery, with good reason. One need only look at the antics in Washington to be nervous. This report will try to explain the numbers behind these conflicting feelings.

The Forecast (Chart 1)

- **TOURISM:** We expect visitor arrivals to grow 4.8% for all of 2013 and 3% for 2014. At over 8 million annual visitors, we are approaching capacity constraints in hotel rooms and airline seats. In addition, high airfares and room rates plus a continued strong dollar relative to the yen, and Canadian and Australian dollars all suggest that tourism’s growth will moderate. Likewise, growth in visitor expenditures will taper as we move into 2014.

CHART 1 • FORECASTS FOR 2014

	2013 (Estimate)	2014 (Forecast)
Visitor arrivals by air	+4.8%	+3.0%
Visitor spending growth	+6.0%	+5.3%
Construction completed (tax base)	+10.0%	+15.0%
Total job growth	+2.0%	+2.5%
Unemployment	4.7%	4.3%
Real personal income growth	+2.8%	+3.0%
Inflation	+2.2%	+2.8%

Source: Dr. Jack Suyderhoud

- **CONSTRUCTION:** As tourism returns to less spectacular growth rates, construction will accelerate into 2014. Construction permit trends plus continued pent-up demand for housing will show up in robust double-digit percentage increases in construction completed. In addition, healthier fiscal positions for the state and county governments mean that deferred maintenance and infrastructure renewal spending will also contribute to construction’s growth. Finally, Honolulu’s rail construction will show up in the data. All this will help bring back some of the 6,000 construction jobs that we have yet to recover from the Great Recession.

- **LABOR MARKET:** The return of more construction jobs will contribute to improvements in the overall Hawaii labor market. Adjusting for seasonal patterns, statewide job growth has been consistently positive since 2010. That should continue and in fact accelerate to 2.5% as we move through 2014. As a result, the state’s

unemployment rate will continue to improve in 2014, but not to the point of over-full-employment that we saw prior to 2008.

- **PERSONAL INCOME:** As the labor market improves, inflation-adjusted personal income will continue to expand at a rate of about 3%. This is good news for retailers and home sellers as Hawaii consumers will continue to spend.

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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

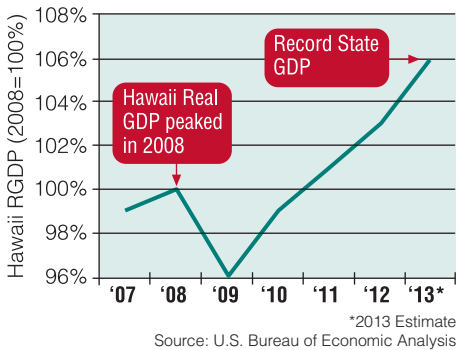
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■ **INFLATION:** Lastly, as the economy rebounds, concerns arise about resurgent inflation. Hawaii inflation is most affected by national price patterns, and there seems to be little fear of national inflation through 2014. However, higher housing and rental prices, along with higher wages in tighter labor markets, should be reflected in the Hawaii price data, causing an up-tick in inflation to 2.8% in 2014.

Broad Economic Measures Are Looking Good

Using the broadest measures of Hawaii's economic performance, 2013 marks a relative high point. Inflation-adjusted state gross domestic product (GDP) is at the highest point of our history, well above \$60 billion in 2008-dollar values. (See Chart 2.)

CHART 2 • HAWAII REAL GDP (2008=100%)



The Great Recession was indeed traumatic for our economy with a sharp and deep downturn. (See Chart 3.) However, when compared to the lengthy doldrums of the 1990's, the short and deep downturn may not have been as bad as that persistent malaise of a generation ago.

A more timely and sensitive indicator for the overall economic well being of the state is inflation-adjusted personal income. Here we also see the

CHART 3 • HAWAII REAL GDP GROWTH, 1988-2013

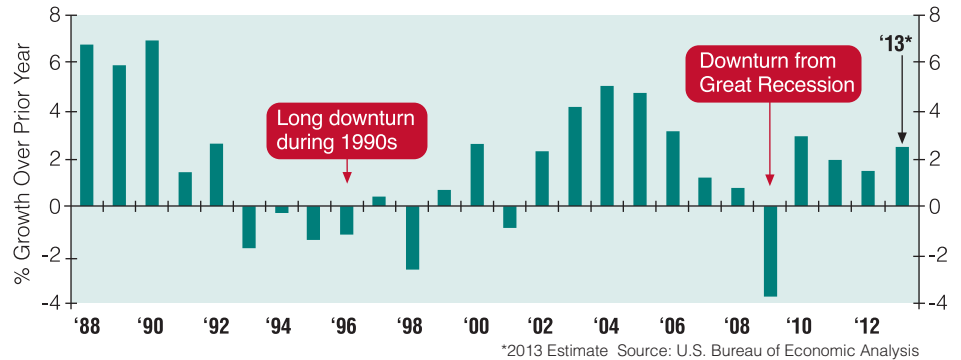


CHART 4 • HAWAII REAL PERSONAL INCOME, 2007-2013 (2008\$)

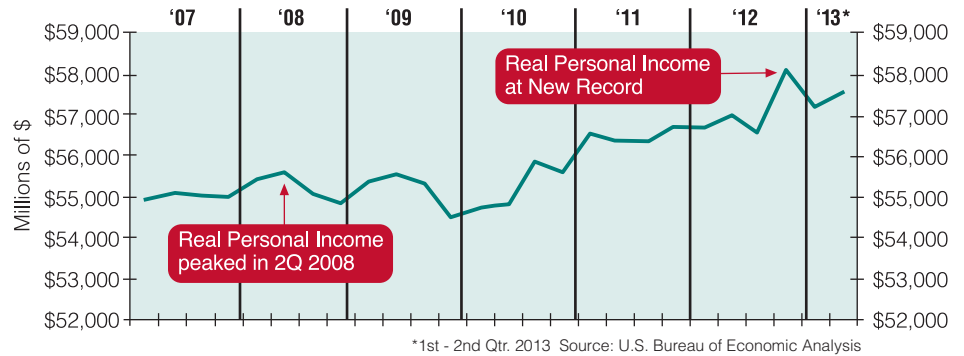
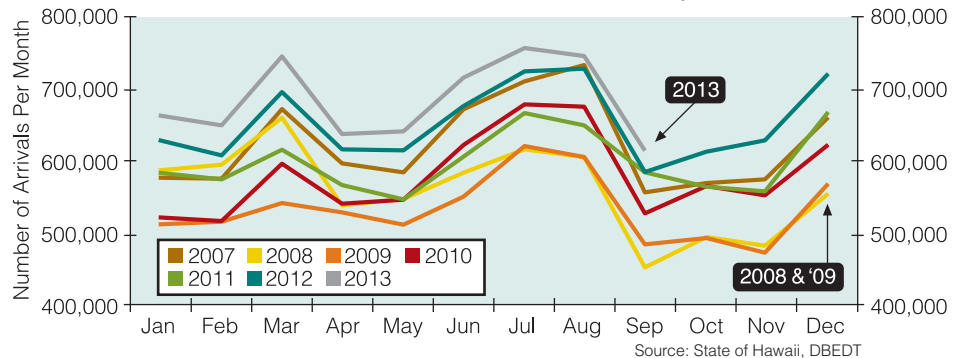


CHART 5 • STATE VISITOR ARRIVALS BY AIR, 2007-2013



effect of the Great Recession and our recovery that began in 2010. (See Chart 4.) But note that in 2011 we hit a bump in the road to recovery. This was mostly attributable to the uncertainties created by the deficit and debt debate in Washington at that time.

Since 2011 we have been reaching new highs in personal income, and we are well above pre-recession levels, even after adjusting for inflation.

Tourism Sector: Pulling Economy Along

Not surprisingly, tourism has been the locomotive pulling along Hawaii's economy. Visitor arrivals bottomed out in mid-2009 and have experienced a strong comeback since then. (See Chart 5.) Arrivals numbers to date in 2013 put us on a record pace: statewide arrivals through August 2013 are up by over 263,000 compared to the same period in 2012. We will be above 8 million arrivals by the end of this year.

Meanwhile, visitor spending has been growing at an even stronger clip. As seen in Chart 6, seasonally adjusted spending has been on an upward trend since 2010. Note again the bump in the road in 2011. Since 2011, visitor expenditures have grown at an annual rate of 12%. Through August 2013 visitor expenditures are \$400 million above the same period in 2012. Driving much of this has been hotel room rates that have seen robust increases in the last two years.

Slower Tourism Recovery For the Neighbor Islands

Given all this good news, why are we not feeling better about the economy? One reason may be that the benefits of the tourism boom have not been uniformly felt across the state. As seen in Chart 7, the recovery of tourism in the Neighbor Islands has not been as fast as on Oahu. While Maui finally returned to pre-2008 arrival figures in 2012, both Hawaii Island and Kauai are still below their 2008 peaks.

From So-So to Good in Construction Sector

Historically, the construction industry has also been an important source of growth. However, the industry requires a good underlying economy in order for investors, developers and employers to overcome uncertainties and take the plunge. Hence, the sector tends to lag the overall economy.

A good measure of the sector's current health is the state General Excise Tax base for construction activity. After the dismal contractions from 2008 until mid-2011, we are seeing consistent and robust growth. (See Chart 8.)

As a result, construction jobs have returned, partially. As seen in Chart 9, we lost more than 12,000 construction jobs statewide between 2008 and 2011. The good (or bad) news is that nearly half of those have returned.

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CHART 6 • STATE VISITOR SPENDING, 2007-2013 (\$MILLIONS)

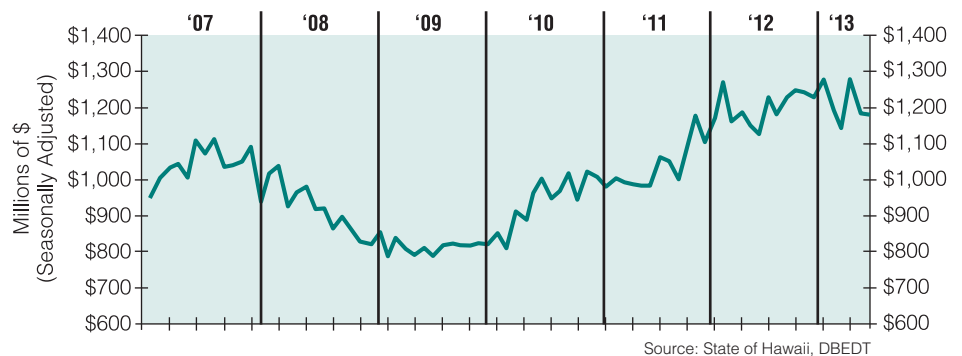


CHART 7 • NEIGHBOR ISLAND ARRIVAL TRENDS, 2008-2013 (JANUARY 2008=100)

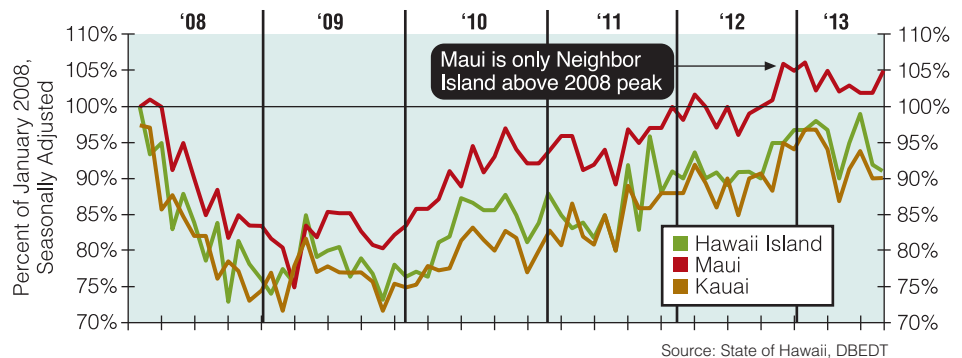


CHART 8 • STATE G.E.T. CONTRACTING TAX BASE, 2006-2013

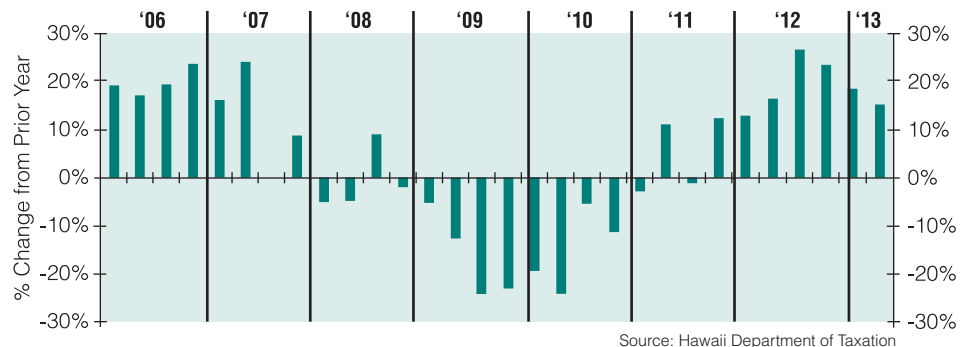
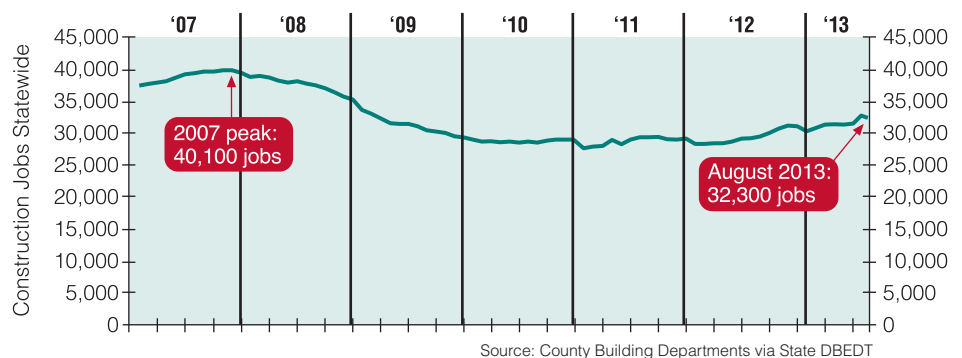


CHART 9 • STATE CONSTRUCTION JOBS, 2007-2013



State Outlook

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Looking ahead, lumpiness in the nature of the forward-looking data, especially in government contracts, makes it hard to discern a pattern. (See Chart 10.) However, statewide private construction permits and government contracts awarded have shown generally positive growth since the beginning of 2012. The increase in permits and contracts means a good construction year is expected in 2014.

Jobs and Unemployment: Continued Good News

The overall labor market has benefited from the underlying economic strength. Labor is always a lagging statistic, so improvement in labor conditions usually starts only after the economy is on a firm footing. Total state jobs are up by 28,000 since their low-point in 2010, and the unemployment rate has decreased to less than 4.5%, much better than the 7.1% peak, but still some distance from the pre-recession levels of less than 3%. (See Chart 11.)

However, job growth has not been uniform across the state's counties or across all sectors of the economy. Chart 12 shows that the leisure and hospitality sectors have added the most jobs since 2010, while government (mostly federal) jobs are still below their 2010 levels.

Likewise, job growth has not been uniform across Hawaii's counties. Chart 13 shows county jobs relative to January 2008. Oahu was impacted the least by the contractions in the job market and has now returned within 3% of the peak employment last reached at the end of 2007. The Neighbor Islands had more serious fall-offs in employment ranging up to 12% of total jobs. Their recovery has been generally steady but also slower. Among the Neighbor Islands, Maui has been the fastest to recover and is now within 6% of the prior peak while Hawaii Island and Kauai are still 7% below their peak jobs.

CHART 10 • PRIVATE PERMITS, GOVERNMENT CONTRACTS, 2007-2013 (QUARTERLY GROWTH)

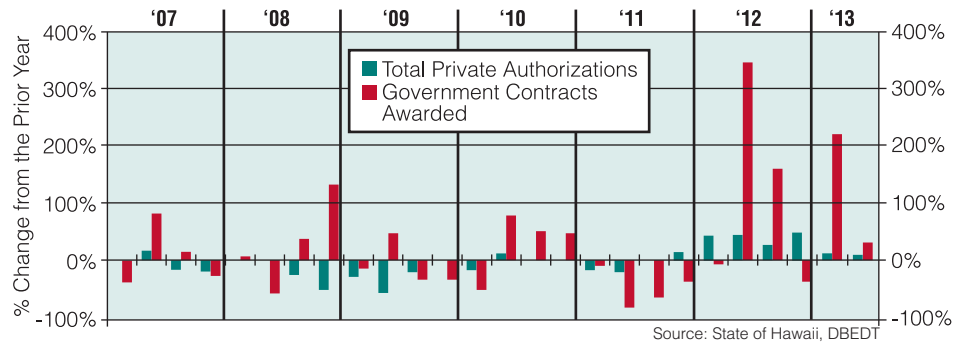


CHART 11 • STATE JOBS AND UNEMPLOYMENT, 2007-2013

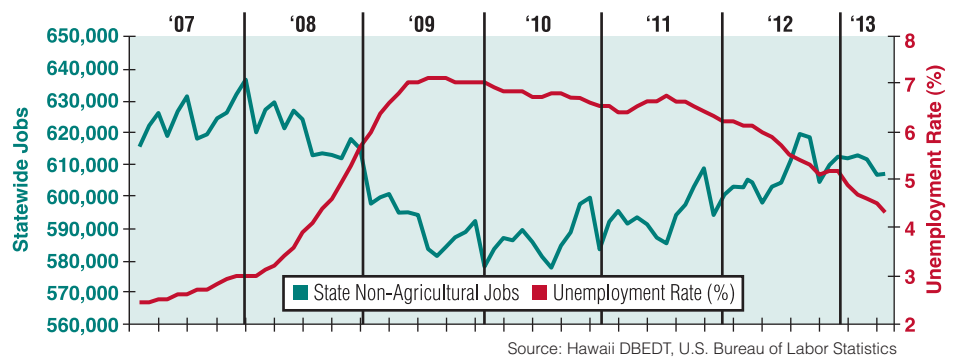


CHART 12 • HAWAII JOB INCREASES BY SECTOR, JANUARY-JULY 2010 TO JANUARY-JULY 2013

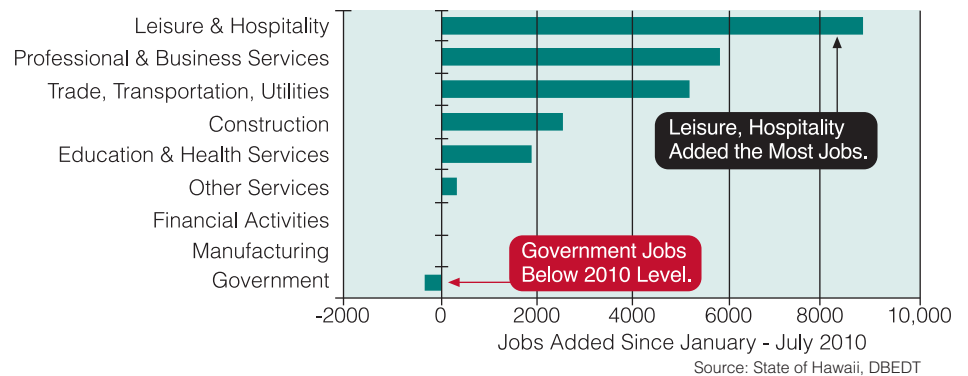
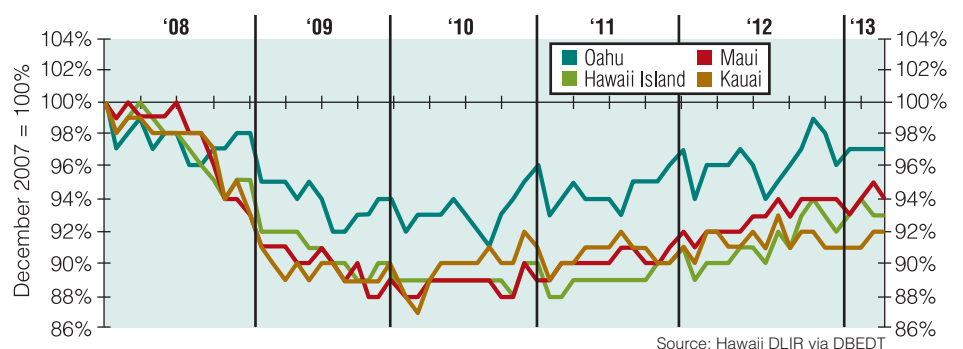


CHART 13 • JOB PATTERNS AMONG THE COUNTIES, 2007-2013



Thanks to Consumer Spending, Retailing Is Looking Great

As jobs and incomes rise, consumer spending is sure to follow.

Retail sales have experienced a strong rebound from 2009. As seen in Chart 14, the seasonally adjusted retail tax base is now well above pre-recession highs.

More evidence of retail strength is reflected in merchants' credit and debit card volume as monitored by First Hawaiian Bank's Business Activity Report. This is published quarterly by the bank, and shows that consumer card spending continues to grow at healthy, but recently slowing rates. (See Chart 15.)

Leading the growth in the last year have been hotels and other visitor-related sectors.

Car sales are always a good barometer of the economy's health. Data from the Hawaii Automobile Dealers Association (Chart 16) shows that retail car and light truck sales are expected to increase by more than 10% in 2013, marking four consecutive years of growth.

Real Estate Industry Also Showing Strength

By historical standards, interest rates have been and will likely continue to be very low through 2014. Combined with the growth of employment and incomes, the low interest rate environment means that home affordability is up and demand will remain strong. Real estate statistics confirm this. For example, Oahu units sold (Chart 17) have seen a nice recovery from the 2009 low.

The strong demand is also evidenced in Oahu resale median prices. (See Chart 18 on page 6.) Both condo and single-family prices are rebounding to levels not seen since 2007.

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CHART 14 • STATEWIDE RETAILING TAX BASE, 2007-2013

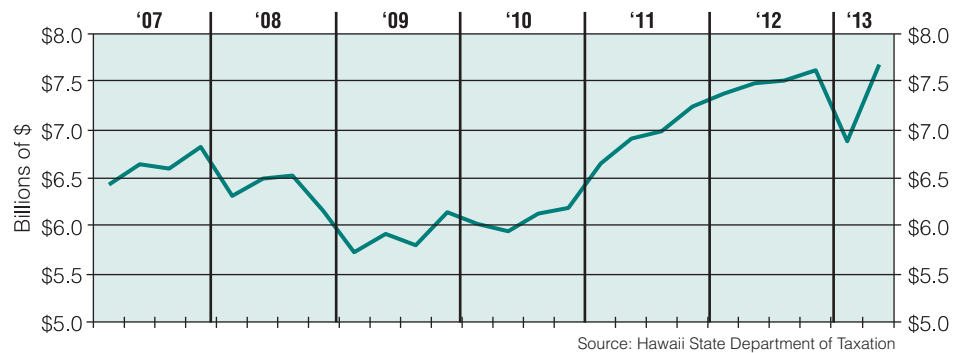


CHART 15 • HAWAII CREDIT CARD SPENDING GROWTH, 2010-2013

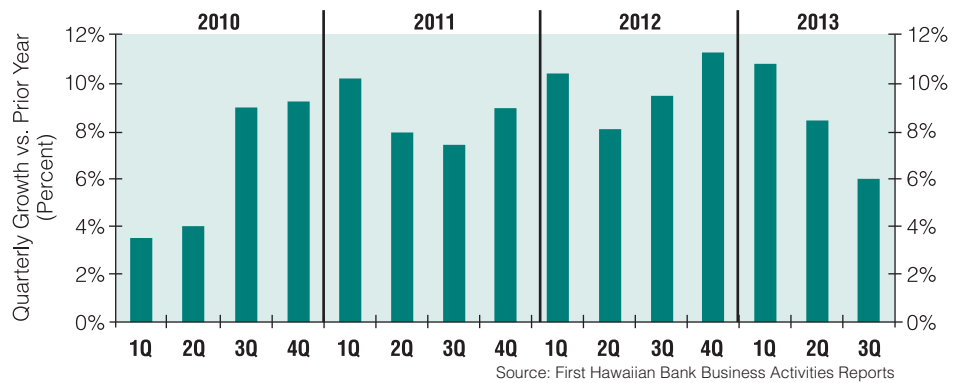


CHART 16 • HAWAII NEW VEHICLE SALES, 1989-2013

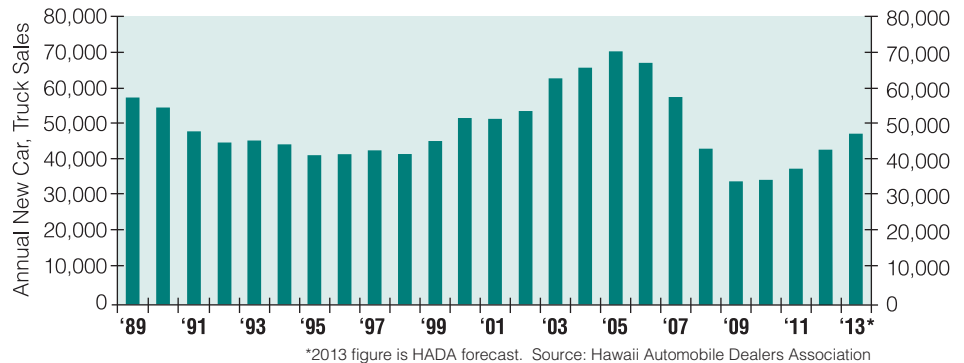
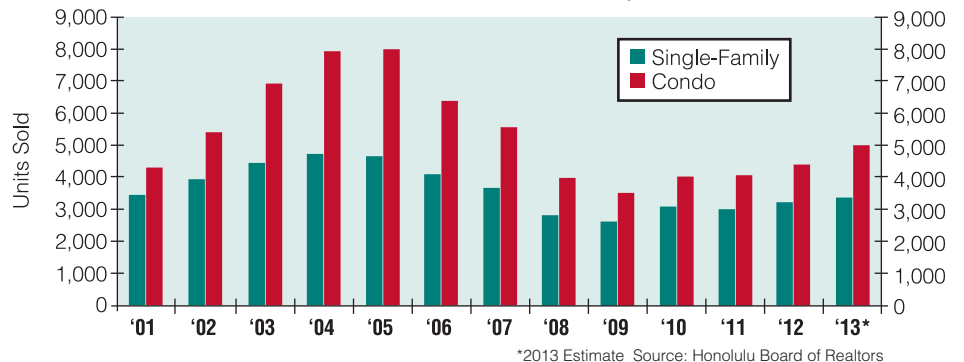


CHART 17 • OAHU HOME RESALES, 2001-2013



State Outlook

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The improving real estate trends are also being experienced on the Neighbor Islands. However, they went through more serious market contractions than Oahu. (See Chart 19.) As a result, in spite of improving prices, Neighbor Island markets are still more than 20% below their prior peaks.

State, County Finances Benefit From Strength

Among the many beneficiaries of the improving economy has been the state-local government sector. 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.

At the state level, after some dismal quarters in 2008 and 2009, general fund tax collections are once again showing steady growth, with fiscal year 2013 yielding \$500 million more revenues than the prior fiscal year. (See Chart 20) While the state has many challenges, such as unfunded liabilities and infrastructure backlogs, its fiscal situation has not been this good in years.

In Sum, Happy Prospects (With Some Caveats)

There is much to be happy about in tourism, incomes, jobs, retailing and real estate. Yet, not all sectors and islands have benefited equally from the rebound. While this lack of uniformity is not unexpected, it does create a sense among some that the economy is less robust than it actually is.

Given what we have been through the last few years, these forecasts are happily optimistic. Yet in the wake of the Great Recession, angst remains not far below the surface. Indeed, there are some caveats — a not-so-short list of things that can go wrong. Here are my top picks, in order of importance and likelihood:

- Dysfunctional D.C., version 10.5
- The Fed: Moving from papering to tapering

CHART 18 • OAHU RESALES MEDIAN PRICES, 2001-2013

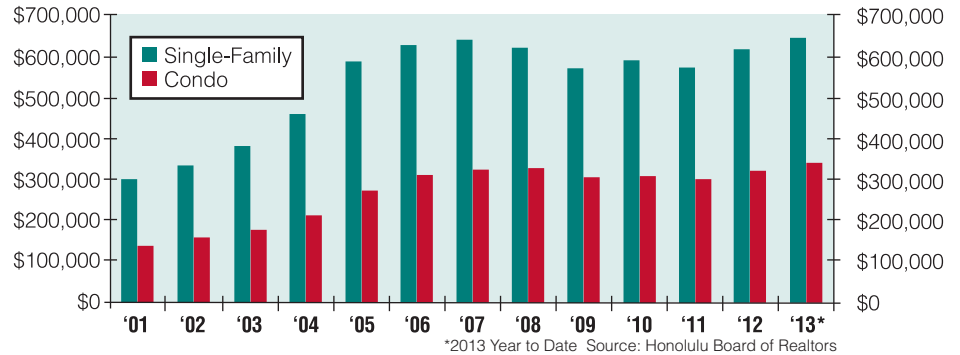


CHART 19 • SINGLE-FAMILY RESALE MEDIAN PRICES BY COUNTY (2006=100%)

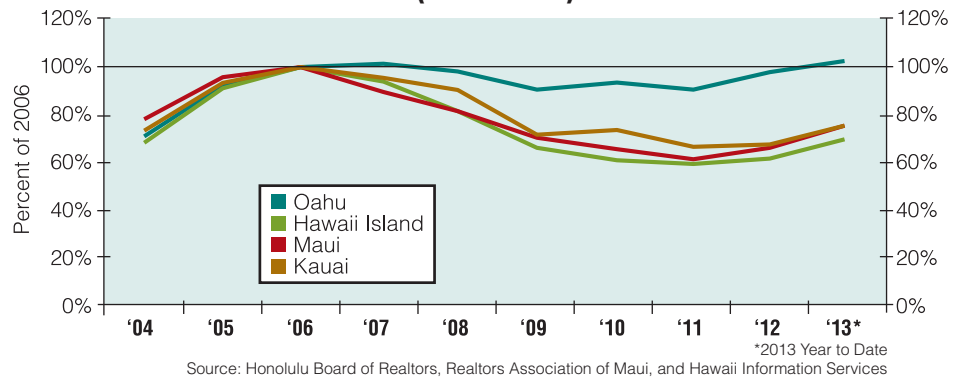
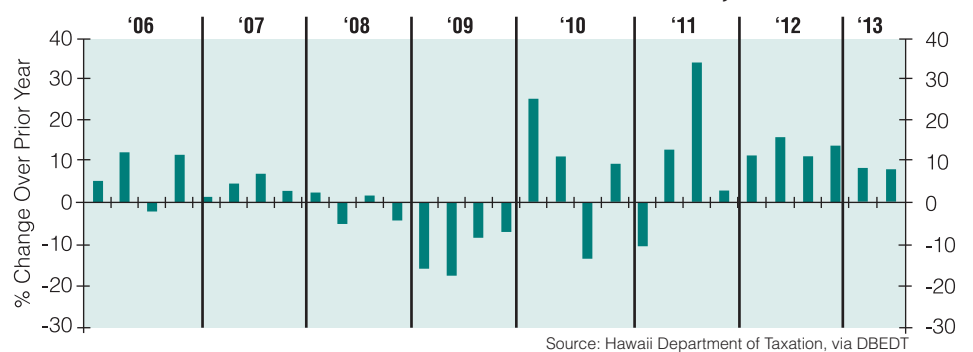


CHART 20 • STATE GENERAL FUND GROWTH RATES, 2006-2013



- Obamacare: What if the roll-out falls flat?
- Mired in the Mideast
- Euro crash
- Asian contagion

As an example, remember the 2011 “bump in the road” that we saw in several of the charts above. That was a direct result of the national slowdown associated with the collapse of consumer confidence that resulted from the deficit and debt dysfunctions in Washington at that time. We have all heard the anecdotal evidence of how sequestration

and the recent shutdown have impacted Hawaii. However, we await the data to see how the overall economy has been impacted. Perhaps consumers are becoming immune to these D.C. games and thus the impacts will be muted. However, if we repeat the 2011 experience, 2014 growth will be adversely affected.

That said and hoping for the best out of Washington, I believe that 2014 will be a good year for Hawaii’s economy.

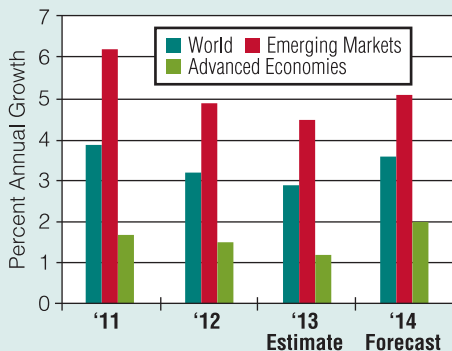
Moving Towards Resynchronized Growth: Economic and Market Outlooks for 2014

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

The world appears to be entering a synchronized global upturn, although growth patterns are changing, with mild acceleration in the major advanced economies even as China and other emerging markets have been cooling off. In aggregate, global activity should strengthen moderately in 2014, with the main impulse coming from the advanced economies:

- The U.S. economy is accelerating,
- The euro area is exiting its longest-ever recession, and
- Japan has been rebounding strongly under the spell of Abenomics (although Japan will lose some momentum due to tighter fiscal policy in 2014).
- Meanwhile, growth rates in emerging markets should remain well above those in advanced economies, albeit down from recent cyclical peaks (see Chart 1). China in particular should escape a hard landing, due both to supply-side reforms and its now-traditional reliance on fiscal stimulus through infrastructure investment.

CHART 1 • REAL GDP GROWTH, 2011-2014

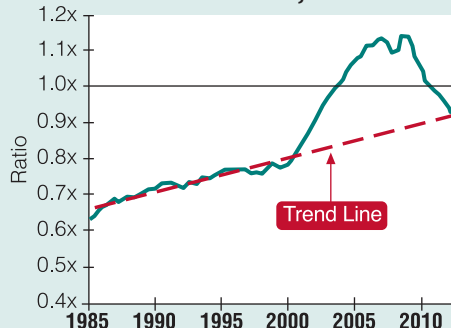


Source: International Monetary Fund, World Economic Outlook Database, October 2013

The U.S. Growth Outlook

Assuming the economy escapes self-inflicted wounds from a prolonged government shutdown, or worse, a failure to raise the debt ceiling, we expect growth to return to close to a “normal” rate of 3% in 2014, up from about 1.6% in 2013. The biggest swing factor is fiscal policy. In 2013, between tax hikes and the sequester, fiscal contraction has amounted to about

CHART 2 • RATIO OF HOUSEHOLD DEBT TO PERSONAL INCOME, 1985-2013



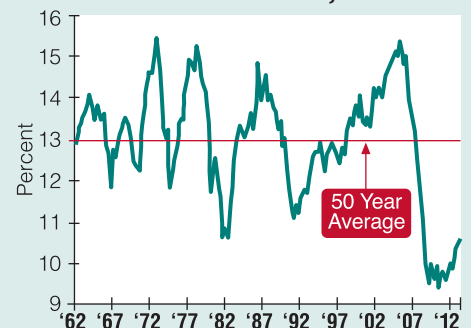
Source: Bureau of Economic Analysis

1.5% of GDP. Under current law there is little incremental fiscal drag in 2014, so a reasonable base case assumption would be for about 1.5% of acceleration next year, just due to fiscal policy, although the final shape of the budget has yet to be determined.

What of the larger, private-sector economy? Generally the key indicators such as employment, personal income, and manufacturing production indicate gradual overall improvement in economic conditions, and there are other signs pointing to accelerating economic growth going forward:

- Households have made significant progress in clearing excess debt acquired prior to the financial crisis (see Chart 2). Because of low interest rates, the proportion of income required to service existing debt has plunged.
- A key positive going forward is the recovery in the housing market, an important cyclical economic sector as well as a driver of household net worth and consumer confidence. Nationwide home prices troughed about 20 months ago. Rising home prices are gradually reducing the number of homeowners “underwater” on their mortgages, and new construction is also up sharply, although still well below peak levels.
- There is a great deal of pent-up demand in the cyclical parts of the economy. For example, the auto industry is now benefiting from consumers at last making long-delayed car purchases. But cyclical

CHART 3 • CYCLICALS AS PERCENTAGE OF ECONOMY, 1962-2013



Source: Bureau of Economic Analysis

CHART 4 • REAL INTEREST RATES, 2007-2013



Source: Bloomberg, Bureau of Labor Statistics

sectors are still far below normal as a proportion of GDP (see Chart 3), an unsustainable position which will lead eventually to a snap back in sales.

Monetary Policy and the Fed

The Fed’s decision at the September FOMC meeting to delay tapering large-scale bond purchases took the market by surprise, but probably should not have. Growth had slowed over the summer, and the Fed also noted the recent sharp rise in real interest rates (see Chart 4), as well as noting the potential economic impact of a government shutdown or a failure to raise the debt ceiling.

Evidently the Fed is in no hurry to tighten monetary conditions. Rather, the push to end bond purchases is probably related to doubts about the continued efficacy of Quantitative Easing, and a preference to use forward guidance as the main tool of unconventional monetary policy. (There is quite a bit of evidence that the Fed can

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Economic and Market Outlooks

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effectively influence interest rates by shaping market expectations about the future course of monetary policy, without actually having to intervene in bond markets.)

We continue to expect that the first actual rate hikes will not occur before 2015, because, with the large amount of slack in the economy, there is little prospect of imminent inflation (see Chart 5), and because the Fed is increasingly de-emphasizing the 6.5% unemployment target which was supposed to signal the onset of tightening. (Falling labor force participation makes the headline unemployment number a very imperfect measure of the health of the labor market.)

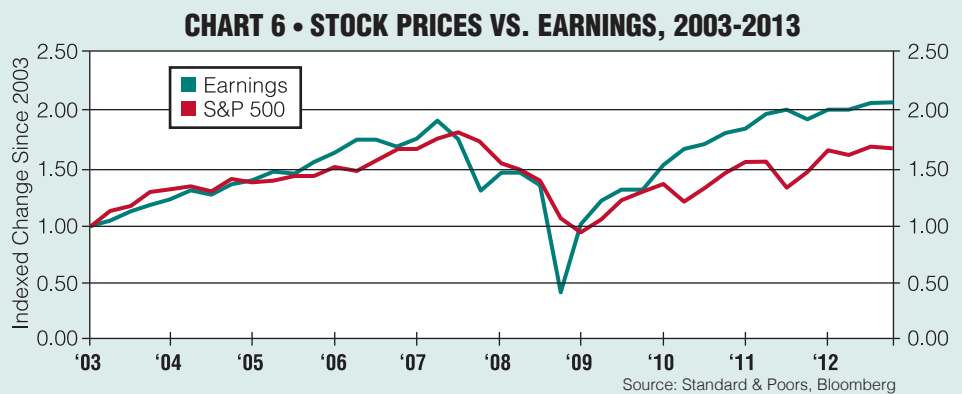
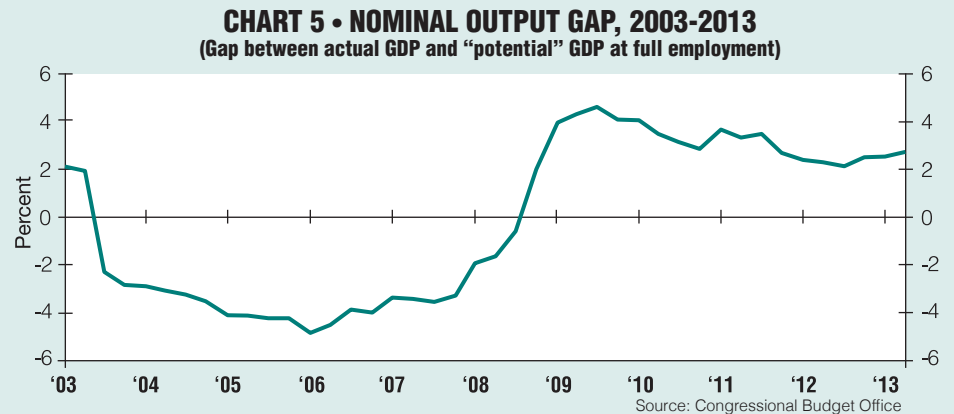
Is the Recovery “Artificial”?

There is widespread agreement that excessive debt, the popping of the housing bubble and the subsequent financial crisis were the causes of the Great Recession, but there is less agreement on why the recovery has been so painfully slow.

Some pin the blame squarely on “supply side” factors such as excessive regulations, Obamacare, and uncertainty about future taxes, which, it is argued, hold back hiring and business investment. This view also argues that any recovery so far has been largely artificial, fueled by government borrowing and ultra-low interest rates.

Others say the main problem faced by businesses is a lack of consumer demand. They note that real economic activity usually takes a long time to recover after a financial crisis, due to consumers paying down debt and tighter credit conditions. It certainly appears that the current recovery fits this pattern. The corollary of this more expansive view of the economy is that a real recovery is underway, which should accelerate as economic headwinds begin to fade.

Despite the sluggish recovery, the stock market has reached record highs. To some market observers the cause of



this apparent disconnect is, once again, the Fed. In this view, the stock market is being fuelled only by low interest rates and an expansion in the money supply. However, stock prices are ultimately determined by profits, which grew spectacularly in the early years of the recovery and are still positive (see Chart 6).

Market Outlook

The outlook for financial asset prices is, as always, subject to considerable uncertainty, particularly in the near term. At least we can confidently predict that market volatility will be elevated as investors try to gauge the timing and impact of the wind-down of monetary stimulus. In our view, both the economic and market resurgence is based on more than Fed policy. Therefore both should be able to withstand the withdrawal of monetary accommodation, particularly as such a shift is likely to happen only as economic fundamentals strengthen. The investment implication is that tighter monetary conditions present a

risk to the stock market but do not negate the positive long-term outlook.

It is hard to foresee any more than minimal returns for bonds, whose principal value will be eroded sooner or later by higher interest rates. However, notwithstanding the recent sharp rise in rates, bond prices rationally reflect continuation of low short-term rates for the next several years, and thus are not, in our view, in a bubble.

Perhaps the surest prediction one can make regarding the markets is that returns generally will be lower than over the past 30 years. Total return from bonds is likely to be in line with current minuscule yields (or lower) — say 3% for the broad bond market. Meanwhile stocks, hit by two historic bear markets in a decade, are unlikely to see prices rise faster than earnings as they did in the 1980s/90s, which experienced a huge expansion in valuation ratios. A reasonable estimate for stocks is that prices will rise in line with earnings growth of approximately 5%, plus a 2% dividend yield for a total return of about 7%.