The business outlook for Hawaii Island should be good into 2016. Robust tourism and rebounding residential construction will lead the way. The labor market is favoring workers, and higher confidence is being translated into strong real estate sales with appreciating values.

Last year, our concern was about how Hawaii Island’s economy would handle storms and lava. Nature proved sparing and people came together to deal with and mitigate the adverse effects. Hawaii Island has proved its resilience, and the economy continues to expand. Now the question is how the island will deal with uncertainties of the man-made variety, including:

- Financial problems at the Hawaii Health Systems and in particular Hilo Medical Center (HMC), and
- The continuing controversy over astronomy facilities atop Mauna Kea.

If more draconian cuts occur at Hilo Medical Center or elsewhere on the island, and if the Thirty Meter Telescope (TMT) construction is further delayed or even halted, 2016 could still be positive, but much less so.

Good News for Tourism

Among the neighbor islands, Hawaii is the least dependent on tourism for its economic base, and this dependence has declined in the last 15 years. (See Chart 1.) But this average masks the dual nature of the island’s economy. The west side is more tourist-dependent than either Maui or Kauai, while the Hilo side is even less impacted by tourism than Oahu.

Tourism dependence can be a blessing or curse depending on that sector’s economic cycles. In the last few years for Hawaii Island it has been somewhere in between. As Chart 2 shows, 2012 and early 2013 were good times for visitor arrivals with largely positive and significant growth rates. This came to a halt in late 2013 and it took a year for growth to return to consistently positive territory. In the end, for 2014 Hawaii Island experienced 10,000 more visitor arrivals, up 0.7% over 2013. This was the best year since the Great Recession, and visitor days reached a record 10.9 million.

The composition of visitors changed somewhat in 2014. Hawaii Island has always had more Japanese visitors than other outer islands, but a weak yen and still no direct airlift reduced their count by 14% in 2014. (See Chart 3.) Helping to offset this was a nearly 10% increase in Canadian visitors.

Revenues per room are at record levels and group incentive bookings are strong for both 2016 and 2017.

(Continued on page 2)
Visitor spending had some good years coming out of the 2008 – 2009 doldrums with growth rates frequently above 10%. (See Chart 4.) Total visitor spending was up 6% to $1.9 billion in 2014. However, on a per-person, per-day basis (Chart 5), spending increased between 2007 and 2015 for all the state’s counties except Hawaii Island.

In spite of strong visitor numbers, resort shops are experiencing mixed results. Queen’s Market Place seems to be doing well, but the Shops at Mauna Lani are struggling, and the King’s Shops have lost some tenants. At Hualalai, the shops are generally doing well.

Airline strategies are critical to the visitor industry and here we have a tale of two cities. Kona has seen large increases in domestic seats in early 2015. (Chart 6.) Even international seats (Canada) are up somewhat. However, Hilo is seeing double-digit declines in seats in 2015.

Cruise ship dockings were down by about 20% in the first part of the year.

Kona airport has received most of the state’s attention. Terminal modernization budgeted at $60-$70 million will have its design phase completed by December with construction starting next summer. A new regional firefighting facility is moving forward with construction expected to start in early 2017. This is a $61 million project with $20 million coming from the FAA. Parking lot improvements have finished Phase I at a cost of $2.5 million and Phase II is underway. Hilo is getting a new airport fire station at about $20 million.

On the east side there is optimism for the first time in years now that Hilton, through its Doubletree brand, will manage the Naniloa property. Doubletree should open with 120-150 rooms later this year. Multi-family residential construction is moribund island-wide. However, single-family residential permit growth has been occurring since early 2012. Construction data for Hawaii Island create a confusing picture. On the one hand, construction data for Hawaii Island create a confusing picture. On the one hand, new guest competition should bring long sought-for life to the Banyan Drive area. The changes also involve separating the hotel from the golf course, which may allow more flexibility in the renewal of the golf course and power plant acreage.

In spite of contradictory permits and jobs data, my discussions with those in the Hawaii Island construction industry indicate that times are good. Large contractors have

**ROBUST CONSTRUCTION, CONFUSING DATA**

In spite of prior expectations, the storms of 2014 and the lava flow in Pahoa seem to have had little impact on construction.

Construction data for Hawaii Island create a confusing picture. On the one hand, private building permits (Chart 7, on page 3) are up on a trend basis from less than $30 million per month in 2010 to more than $60 million per month in 2015. However, recorded construction jobs have been flat since early 2013, and declined by about 700 after mid-2014.

Multi-family residential construction is moribund island-wide. However, single-family residential permit growth has been occurring since early 2012. (Chart 8, on page 3.) Before the recession, single-family permits for the Kona side averaged above $40 million per month. Only recently has this figure started to approach this level again. Both Hilo and Waimea are showing signs of recent growth in single-family residential permits. They could soon see breakouts above the $10 million per month rate on a consistent basis.

In spite of contradictory permits and jobs data, my discussions with those in the Hawaii Island construction industry indicate that times are good. Large contractors have
backlogs going past 2016. Specialty high-end contractors are hard to find. Workers are being hired, and there are shortages in skilled construction fields such as operating engineers.

Single-family residential construction activity on the Hilo side looks hopeful. Hilo Hillside Estates has 56 lots, Punahou Mauka Estates has 37 lots, and Lake View Estates has 19 lots being sold and built on. A 49-lot subdivision is being developed on land below the Hilo Municipal Golf Course.

On the west side there are no new large-scale residential developments. The Hokulia project, which had much buzz last year, seems now to be mired in disputes between the developers and homeowners. The buzz seems to have shifted to the Kohanaiki Resort development with its multi-million dollar lots and homes.

Unfortunately, commercial development in Hilo is bogged down by issues associated with state leases for the Kanoelelehue tracts. In contrast, the Shipman Company is following up their commercial development, including the 100-employee HMSA operation, with rezoning of 250 acres of medium density development at the center of Keaau.

In addition to the airport construction noted above, public infrastructure remains robust. At Hilo Harbor, Pier 1 modifications have finished and the harbor is now able to accept roll-on/roll-off ships. Construction continues on the Pier 4 project. The Kumau Street construction has finished and the container yard is approaching 95% completion. At that point, Hawaiian Dredging and Healey Tibbitts will begin an 18-month, $43 million project to build the face of the pier.

The county will likely go into the bond market for about $100 million to finance some capital projects. It will spend $18 million on Waimea Park, $16 million on the Hilo Municipal Golf Course clubhouse improvements, $13 million on the Kapiolani Street extension, $4 million on Komohana Street and $9 million to move the fire station to Haihai Street.

LABOR MARKET TIGHTENS
As the economy continues to improve, labor shortages are starting to appear. Employers in all sectors are finding it harder to hire qualified help. Part of the problem is that Hawaii Island is subject to the same graying of the labor force as the rest of the U.S., and this trend is magnifying the short-term labor market pressures created by the stronger economy. Retail trade, state government and health care have been the three largest employing sectors. (Chart 9.)

About half the island’s sectors have seen job growth since 2010 and the other half have yet to recover fully from the last downturn. Professional and business services, a category that includes agency employment, has grown the most, followed by restaurants, retail trade and transportation.

(Continued on page 4)
Overall, total reported jobs (Chart 10) have remained flat since late 2013. However, the unemployment rate has continued to improve, following, but not catching up to, the state trend. Hawaii Island’s unemployment rate remains 1% above the statewide average.

**REAL ESTATE RECOVERY CONTINUES**

The real estate sector continues its slow climb out of the abyss of the Great Recession. As shown in Chart 11 the volume of single-family and condominium home sales both remained unchanged between 2013 and 2014. The pace of sales for 2015 appears to be on track with the good 2014 levels, but certainly not back to the boom years of 2004-05. Island-wide price patterns (Chart 12) reflect the strengthening economy. Single-family prices have recovered more from the low points of 2010 - 2011 than have condominium prices.

Single-family prices on the west side are, on average, more than twice as high as east-side values. (Chart 13.) In addition, prices started recovering earlier and more quickly on the west side.

The strength in the residential real estate sales has spread to the rental market where owners are starting to raise rents for the first time in seven years.

Commercial real estate is a mixed picture. The warehouse market remains soft with vacancies at 15% on the west side and 10% in Hilo. Rents are not back to pre-recession peaks. Office space is also harder to get in Hilo while the west side has a 20% vacancy rate. Retail vacancies are running at 15% on both sides of the island.

**OTHER ECONOMIC DRIVERS**

Hawaii Island benefits from a diversified economic base. However, this diversification is in some cases under threat from economic realities and social controversies.

**UH Hilo:** Consistent with national trends, enrollments are down slightly to about 4,000. The $33 million College of Pharmacy construction project should be underway this fall. University Village Phase II is going out again for development proposals that are more focused on commercial activity. The Master’s Degree in Heritage Management is underway, and the Aviation Sciences program is looking for a flight-training provider, and will then go to the Board of Regents for approval. An undergraduate program in Energy Sciences is being proposed.
Natural Energy Laboratory Hawaii Authority: NELHA continues to be an important part of diversifying the west side economy. A recent UH study found that NELHA and its tenants in 2013 spent $69 million locally, creating $123 million in statewide output, $5 million in taxes and 617 jobs. NELHA is renovating its primary building space and will open at the end of 2015 as a tech hub for the west side.

Some tenant turnover has occurred as might be expected in the ventures that are attracted to the site. Two new long-term tenants have signed up: a deep sea salt manufacturer and an ocean fish farming project that is a joint venture by Lockheed Martin and Kona Kampachi. OTEC is making a comeback with a 100-kilowatt turbine installed by Lockheed Martin to demonstrate technical feasibility. A hydrogen production company has moved in from Puna, providing opportunities to test hydrogen-based transportation options. The $10 million extension of Kahilihili Street is awaiting design approval with construction targeted to begin at the end of the year.

Diversified Agriculture: The island’s agriculture sector has had a good year in spite of nature’s vagaries. The damage to the papaya crop due to the weather was extensive, but production has recovered. The Canadian market remains good, and Japan has potential if the reluctance about GMOs can be overcome. Ka’u coffee has also survived the storms, and island-wide prices are up to the $1.50-$2.00 range for coffee cherries. However, margins are being squeezed by higher costs, including those associated with fighting the coffee berry borer.

The flower industry is largely an east-side venture. The number of operations has decreased over the last two decades, but slow growth is returning to the sector. Japan and the U.S. west coast are the major markets. Favorable weather and good flowering, especially on the west side have resulted in bountiful macadamia nut yields. Demand has been strong and farm prices for mac nuts (Chart 14) have hit an all-time high. These prices should provide incentives for more orchards to be planted.

Medical Sector: Quality and accessible medical care is obviously important and there is good news here. For example, Kaiser Permanente has expanded capacity in South Kona, Kona, and Hilo. Hilo Medical Center has achieved trauma center Level III status and ranked in the top 10% of U.S. hospitals US for quality and safety.

However, uncertainty abounds for HMC and other parts of the Hawaii Health System Corporation (HHSC). It has been clear for years that the business model for state hospital facilities has not been sustainable. Revenues are not keeping up with costs, especially since HHSC, like other parts of the state government, must increase funding of retirement promises. For HMC alone this is an $8-9 million hit in fiscal year 2016-17. In addition, 75% of HMC’s patients are on Medicare or Medicaid, and reimbursements are not adequate to cover costs. Lack of access to primary care physicians is driving many urgent cases into the emergency room.

Already HHSC has cut services and over 100 jobs in Hilo and Kona. Many are temporary workers, reducing some of the emotional pain, but not the economic consequences. If further cuts are necessary the damage to individuals, families and the economy will be even greater.

Mauna Kea: The mountain has an economic impact. The Canada-France-Hawaii observatory recently hired five local technicians for its operations. UH economists estimated that the $59 million in annual local spending by the observatories and their operations created $92 million in local output, $28 million in local income and 806 local jobs in 2012. Looked at another way, for every $1 million in local operating costs, the activities on the mountain add $1.6 million in local output, $500,000 in local earnings and 14 jobs. These numbers tell us what can happen as observatories are added or decommissioned. For example, the recent announcement that the relatively small Caltech Submillimeter Observatory and the UH Hoku Kea facility will be shut down will directly take $2 million per year spending out of the economy and eliminate 11 local staff jobs. Multiplier effects will increase these negative impacts in the long run. Offsetting this in the short run is the spending and employment required to decommission the sites and to return the areas to prior condition.

If not allowed to come to fruition, the absence of TMT would likely mean $20 million per year less in local spending, $10 million per year less in local incomes, and the absence of more than 275 jobs that would otherwise be there.
Tourism Boosts Hawaii’s Growth

Driven by a robust tourism sector, Hawaii’s economy is doing well. 2015 will be the sixth year of Hawaii’s GDP growth, leaving the Great Recession as an increasingly remote memory. (See Chart 1) While growth has been positive, and is expected to remain so into 2016, the rates of GDP growth have been modest: in the 2-3% range.

**Labor market:** As seen in Chart 2, total state jobs have returned to the pre-recession level of 635,000 and the unemployment rate has dropped to 4%. In fact, the tight labor market is now a constraint to growth as employers finding it more difficult and costly to hire.

Not surprisingly, these trends are not uniform among the state’s counties. Oahu and Maui have both recovered the jobs lost since the Great Recession. However, on Hawaii Island and Kauai, job growth came to a halt in late 2013 and has only recently rebounded. Total jobs are still 5% below pre-recession peaks on these islands.

Statewide personal income, adjusted for inflation, has continued to expand and is now 8% above the low point in 2009.

**Tourism:** The health of Hawaii’s economy remains tied to tourism. In 2014 tourism growth sputtered early, then came back strong in the second half. As a result, 2014 visitor arrivals grew a modest 2% over 2013, but this represented a record 8.16 million. (See Chart 3.) The news for visitor spending was less upbeat. Since 2013, spending growth has been somewhat erratic. (See Chart 4.) Total spending remained relatively flat over the last two years and has not kept up with inflation. Nevertheless, recent months have seen some up-tick in this important metric.

**Construction:** For five years we have been expecting construction to contribute to overall growth. After another year of waiting in 2014, this year shows more promise. Over 12,000 construction jobs were lost after 2007. (See Chart 5.) As of mid-2015 about 6,000 jobs had been recovered. Given the visible signs of construction activity and anecdotal evidence from industry insiders, stronger growth was expected. This proved not to be the case. The construction tax base actually declined for five consecutive quarters starting in July 2013 and only recently returned to positive growth. But there are reasons for optimism. Private construction permits are accelerating to their highest growth since 2012. This will help offset slower growth in government construction contracts awarded. (See Charts 6A and 6B.)

More jobs, higher incomes, and favorable financing conditions continue to stimulate demand for housing that is unmet by greater supply. As a result, single-family and condominium sales and prices are up everywhere. The Oahu single-family residential median price rose above $700,000 in mid-2015, up 10% from the pre-recession peak. Markets on all neighbor islands are also in recovery mode, but have yet to achieve their prior peaks.

**State tax revenues:** The rising economic tide has lifted many boats, including the state’s treasury. General Fund tax collection growth has been erratic on a quarterly basis due to swings in economic factors such as tourism spending, but also in tax collection practices such as income tax refund timing. On a fiscal year basis, general fund revenues were up by 10% in FY 2013, down by 1.8% in FY 2014, and up by 6.8% in FY 2015. On average, general fund revenues increased by 4.9% annually for the last three fiscal years. Spending this money will further boost economic activity.

In sum, the neighbor islands will continue to benefit from an overall strong state economy that is in its sixth year of expansion. Tourism is the primary force behind this trend, and construction will make an increasing contribution into 2016.
Global Economy Downshifts to Slower Growth Pattern

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

THE BIG PICTURE: MIXED

The global economy has downshifted into a period of slower growth in the aftermath of the financial crisis. World GDP (Chart 1) expanded at only a 3.4% rate over the past three years, down from a 5.1% rate during the five pre-crisis years, 2003-2007. Growth will be only 3.3% in 2015, according to the International Monetary Fund (IMF). Beyond the residual effects of the financial crisis, the slowdown has been caused by global shocks, including lower commodity prices, as well as varied regional factors. In addition, medium- and long-term trends, such as aging populations and lower productivity growth, are having an effect. Growth should be stronger in 2015 relative to 2014 in advanced economies, but weaker in emerging markets. By 2016, both advanced and emerging economies are projected to show mild acceleration, bringing the global growth rate up to 3.8%

In the developed economies, growth is expected to increase from 1.8% in 2014 to 2.1% in 2015 and 2.4% in 2016. The growth outlook for the U.S. has been downgraded following the weak first quarter, but Europe and Japan have been surprisingly strong. Despite the market turmoil accompanying the Greek bailout negotiations, the Eurozone is seeing quite robust recovery in domestic demand, as Europe’s expansionist monetary policy begins to gain traction. Japan is also experiencing stronger growth due to the effects of aggressive monetary policy and the falling yen, which is down some 37% vs. the dollar over the past three years, boosting the performance of Japanese exporters.

The projected 4.3% growth in emerging markets for 2015 marks the fifth consecutive year of decline. Several factors are behind the slowdown. Oil exporters have been hit hard by the falling price of oil, particularly countries like Russia and Venezuela, which were already in turmoil. In addition, the outlook for several other Latin American countries has weakened due to price declines in non-energy commodities. Finally, China, by far the largest developing economy, is experiencing slower growth as it tries to transition to a more sustainable, balanced growth model that is less driven by investment spending. As the impacts of these factors wane in 2016, emerging markets are projected to grow a little faster, at 4.7%.

THE U.S. ECONOMY: STRONGER GROWTH AHEAD

Recent financial troubles in Greece, China, and even Puerto Rico pushed the U.S. economy off the front page. That was a shame, because the news on the domestic economy has been mostly good. After a dismal, weather-affected, first quarter, the U.S. economy began bouncing back. Payrolls are growing at over 200,000 jobs per month, and in June the unemployment rate fell to 5.3%, lowest since 2008. Consumers began to pick up the pace in the spring, at last starting to spend the windfall from lower gasoline prices. Incomes grew a healthy 0.4% in April, May, and June. Importantly, the housing sector is also showing positive signs of recovery.

With unemployment approaching steady state, wage growth has assumed outsized importance as an indicator of labor market health. Average hourly earnings have hardly budged during the recovery, showing a 1.8% increase in July, barely above inflation. However, an alternative measure, the Employment Cost Index (Chart 2), which measures both wages and indirect compensation, has been trending upwards. Using a different approach, the Atlanta Federal Reserve looks at year-over-year wage growth for individual respondents to the Census Bureau’s Current Population Survey. This “same store” methodology minimizes distortions caused by the changing mix in the job market, possibly providing a more accurate gauge of labor market slack, and shows much stronger wage growth of 3.2% in June.

Inflation is still too low for comfort. The Fed’s preferred measure of inflation, the core Personal Consumption Expenditure (PCE) price index, was up 0.3% year over year in June, under the Fed’s 2% target for the 38th consecutive month. Inflation has also been pushed down by falling prices in non-energy imports due to the strengthening of the dollar. As these effects wane, inflation should move closer to the Fed’s 2% target.

Over the next couple of years, increases in consumer spending, business investment, and residential investment should drive the economy back to 2.5-3.0% growth rates. Underlying factors which should support growth in these categories of spending are higher average hourly wages, lower oil prices, and a bounce back in the rate of household formation. On the negative side, a major issue for the U.S. economy is the impact of the stronger dollar, which is already hurting manufacturing and exports. Exchange rate movements are unpredictable, affected for example by China’s recent devaluation of the yuan. However, the dollar’s rise stalled in March, and there is reason to believe that rapid appreciation will not resume. The dollar has appreciated much faster than

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GLOBAL ECONOMY (Continued from page 7)

would be expected by differences in inflation rates (Chart 3, on page 7). While the dollar is not especially overvalued relative to previous peaks in 1985 and 2002, and certainly could go higher, the persistent trade deficit will tend to push the dollar down. Excluding oil imports, which have plunged, the trade deficit is at record levels (Chart 4).

ALL THE TROUBLE IN THE WORLD

Another risk to the outlook is potential spillover from the troubled economies of Europe and China. The recent events in Greece could hardly have been more dramatic. Almost literally at the last minute, Greece was able to reach a deal with its creditors to prevent a collapse of the banking system and exit from the euro currency bloc, but only by acquiescing to economic reforms and budget cuts far more severe than those which had been rejected in a national referendum only days before. With street protests in Athens, the implementation of further austerity promises to be anything but smooth, nor does it seem likely that Greece’s economy can grow fast enough to meet its debt obligations. Even though the IMF, the European Central Bank, and most economists outside of Germany believe that Greece cannot escape its predicament without drastically modifying the terms of existing debt, any talk of meaningful debt relief remains verboten. Nonetheless, if Greece ends up exiting the Eurozone, the damage should be contained, as you might expect for a country that represents less than 2% of euro-area economy. Compared to 2012, when Greece was last on the verge of debt default, today there appears to be much less risk of financial contagion, and the risks to the U.S. economy are pretty small.

China is a different story. A financial crisis in the world’s second largest economy clearly has implications for the U.S., which is why the gyrations of the Chinese stock market are concerning. Since mid-2014, the Shanghai Composite Index increased 150% in less than a year, then fell 30% in about three weeks. These dramatic moves cannot be explained by any fundamental changes in the economic outlook, good or bad, but are instead largely the result of Chinese government policy. Never shy to pull economic levers, policymakers in China have deliberately set about boosting the stock market through measures such as increasing the availability of margin debt. Their aim has been to bolster economic growth by creating household wealth and by funneling capital to Chinese companies. Going forward, there is no guarantee that policymakers will be able to support the market. However, the wealth effects of the stock market are limited in China, where perhaps 10% of households own stocks, and Chinese companies rely relatively little on equity capital. Thus, we do not anticipate any more than a gradual slowing of the Chinese economy, even with further declines in the stock market. (If we are wrong, and China experiences a “hard landing”, there would likely be ancillary benefits to the U.S. in the form of lower commodity prices, which in recent years have been largely driven by demand from China).

IS ECONOMY UNDERACHIEVING, OR IS POTENTIAL GROWTH LOWER? YES.

“Potential growth” to an economist is the sustainable growth rate of economic output that can be achieved without causing inflation. Potential growth can be seen pretty well in hindsight, but can only be estimated at any point in time. While there is plenty of controversy about the exact level of potential growth, almost everyone agrees that it has been falling, due to slower expansion of the workforce and lower productivity growth (output per hour of work). The Congressional Budget Office (CBO) estimates that potential growth will only be about 2.1% over the next 10 years, down from a long-term average of about 3.3%. Most of the decline is due to slower expansion of the workforce — particularly because we are now past the multi-year demographic shift of women entering the workplace. However, there has also been a puzzling decline in productivity growth. Part of the problem is that lagging business investment has depleted capital stock. But worn-out factory equipment cannot be the whole story.

Over the past several decades, technological innovation has been the major driver of productivity growth. Could it be that many of today’s technological advances (e.g., social networking and mobile apps) are having less impact on economic output? There may be a measurement problem here, as output statistics fail to capture the full value of an increasingly services-based economy. There may also be a matter of timing — perhaps the full productivity benefits of nascent technologies will develop gradually (as has happened in the past).

This is not the first time we have wrestled with periods of slower productivity growth: In the 1930s some economists predicted a weak economy for many years to come due to slowdowns in population growth and technological advance — right on the cusp of a huge economic boom. Oh, well. Accordingly, today in our view, it is much too early to extrapolate from the recent decline in productivity growth, or the failure to identify (yet) technological advances on par with the internal combustion engine or mainframe computers in terms of economic impact.

Nonetheless, absent a sharp increase in immigration, for the next several years it appears that potential growth in the U.S. will be at least 1% lower than in the past. However, the economy can grow faster until the gap between actual and potential output, i.e., economic slack, is closed. Today, the CBO estimates the output gap to be about 4% of GDP (Chart 5), implying that we may have several years of above-trend growth.