

E C O N O M I C F O R E C A S T



Maui Still Growing, But More Slowly in '07, '08 Turn in housing market, slowdown in tourism cut into pace of expansion

Several things have happened on Maui over the past year that have put brakes on the county's economy — notably, a turn in the housing market, a continued slowing in tourism, and some county-level public policy moves that will have an effect on the economy.

Thus, the Maui economic picture is somewhat more downbeat in 2007 and 2008 than in recent times. However, remember that any economic cycle inevitably contains periods of cooling down; it's required for infrastructure to catch up and for slowly rising incomes to help bring affordability back.

Maui's Housing Market: Downturn Arrives in 2007

We've warned about an impending turn in the Maui real estate market for a couple of years. In 2007, it's happening. It's hard to overestimate

the effect that a dampening of real estate has on the overall economy:

- The market obviously affects construction.
- If home prices drop, buyers stay on the sidelines and wait.
- Home furnishings and durable goods sales decline along with home sales.
- Even general retail spending suffers if people feel they are worth less on paper — and their home is usually their biggest asset.

As the chart below shows, escalation in Maui home prices has been phenomenal — almost 26% in 2004 and almost 23% in 2005. In 2006, the market began to soften when the annual increase was only 2%. The median Maui single-



family home price was \$693,000 in 2006 — highest in the state.

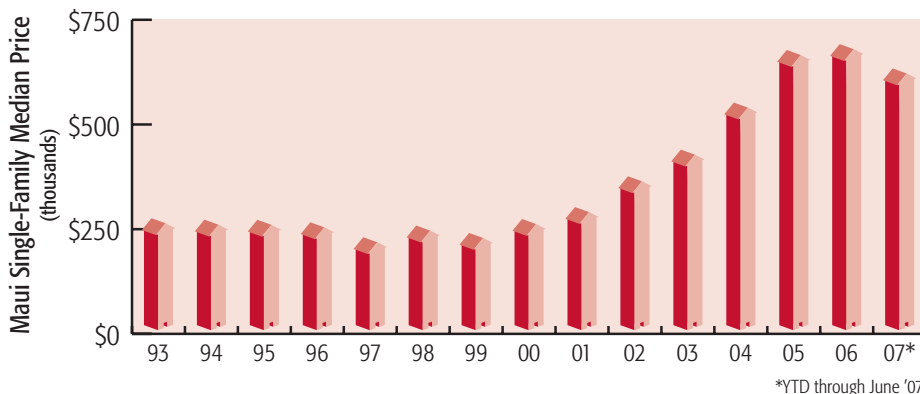
For the first half of 2007, prices are off about 10%. Once cooling starts, it usually doesn't reverse in just one year, though there usually aren't sharp declines, just a plateau with mild oscillations in price. (It's important to offer a caveat to the interpretation of real estate data for a sample as small as Maui's. Price and volume data can be distorted by the mix of properties sold in any given time period.)

The previous run-up for Maui home prices came to an end in 1993, as the Japanese-driven speculative boom was in its last throes. From then through 1997, there was a decline of over 16% in Maui single-family home prices. The present run-up in prices brought a staggering 200% rise from 1997 to 2006.

Such acceleration can't be good for any economy, and thankfully it doesn't continue forever. In fact, the faster and higher it goes,

(continued on page 2)

MAUI MEDIAN HOUSING PRICES COOLING NOTICEABLY IN 2007



Economic analysis by:

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Maui's Economy Growing More Slowly *(continued from page 1)*

the greater the subsequent correction usually is.

All this does not mean that real estate is a bad investment, even today. Let's assume someone was "unlucky" enough to buy at Maui's 1993 peak. They might have kicked themselves for the next 4 or 5 years as they saw the value of their home decline. But had they held on until 2006, they would still have seen a 150% appreciation — a healthy annual gain of 11.5%.

But the changes a new real estate environment will bring to Maui are several. For builders, it will mean more attention to pricing and more marketing.

For buyers, it will mean more shopping for price and less motivation to make a profit on a quick turnover. And for government officials, the challenge will be to make intelligent decisions based on market forces rather than trying perhaps well meaning but counter-productive policies.

The Maui commercial real estate picture has changed little since last year, with an industrial market that remains tightest in years. Demand for new industrial space is at least three times what brokers now see coming on line. So here we have another supply-side constraint on Maui's economy.

Maui's Labor Market is Even Tighter Than Statewide

If the Maui economy is slowing, you couldn't tell it from the unemployment rate. The state's labor market may be tight (see story below), but Maui's is even tighter — and actually seems to be getting more so, as the chart at right shows.

Maui job growth has showed signs of slowing, though some of that is due to the labor shortage (see charts on page 3).

(continued on page 3)

Statewide Economy Still Expanding, But at a Slower Rate

The recent slowdown in Hawaii's statewide economy has several sources. The real estate sector has cooled, causing repercussions in residential construction, development planning, and even consumer spending as people feel their wealth growing more slowly.

Slightly higher interest rates have begun to have an effect, too, and Hawaii is also experiencing its second straight year of flat visitor growth, after a strong 2005. And Hawaii inflation has accelerated significantly in the past year or so.

Still, the labor market remains very tight, and Hawaii continues to have one of the lowest unemployment rates in the nation. But as we've pointed out in recent years, the inability of employers to find workers slows the economy also.

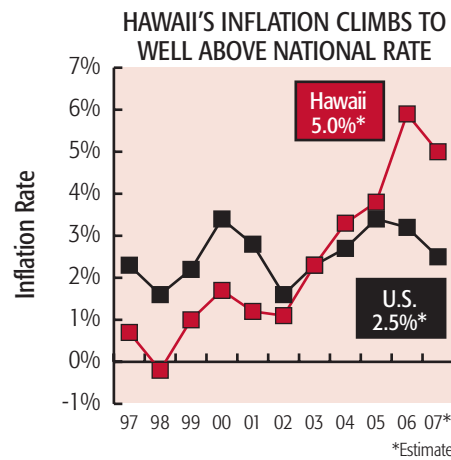
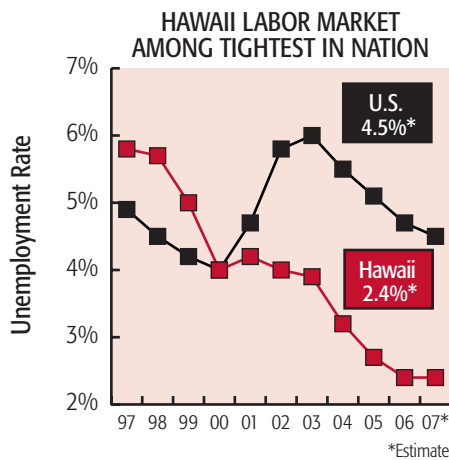
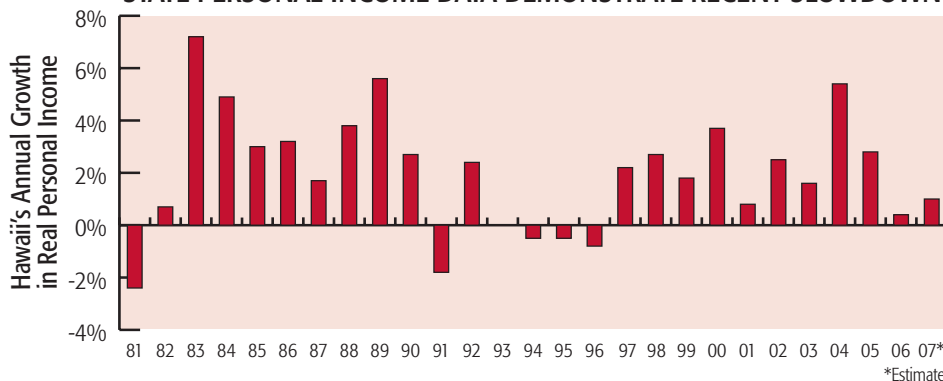
One frequently used aggregate measure of economic activity is inflation-adjusted personal income growth. As you can see in the chart at upper right, its growth fell noticeably in 2006, because skyrocketing Hawaii inflation took a bigger bite. In 2007, somewhat slower current dollar personal income and a continued high inflation rate — maybe just a little lower than the 2006 surge — could yield about 1.0% real growth.

But if that happens, Hawaii's current expansion will still total 11 years, two years longer than the last one that ended in the early 1990s.

Unemployment: Still No Relief on Labor Market Front

Despite a slowing economy, Hawaii has gotten no relief on the labor market front. Across all sectors of the economy, businesses still report worker scarcity at all levels, from entry to professional ranks. As the chart above shows, even though the national unemployment rate has fallen, Hawaii's jobless rate remains over two percentage points lower than the U.S. average.

STATE PERSONAL INCOME DATA DEMONSTRATE RECENT SLOWDOWN



Island Inflation Rate is High and Will Remain So

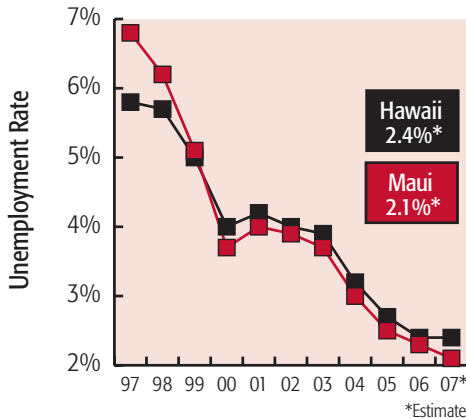
Boosted by energy and especially home prices, Hawaii's inflation rate has climbed very high. In 2006, the Honolulu Consumer Price Index rose almost 6%. We expect continued high inflation, because the recent rise in home prices feeds into the index slowly — as rents rise, leases are re-negotiated, and price pressures spill over into other parts of the economy. The chart above

illustrates that the Hawaii inflation rate was almost twice the national average in 2006, and we can expect more of the same in 2007.

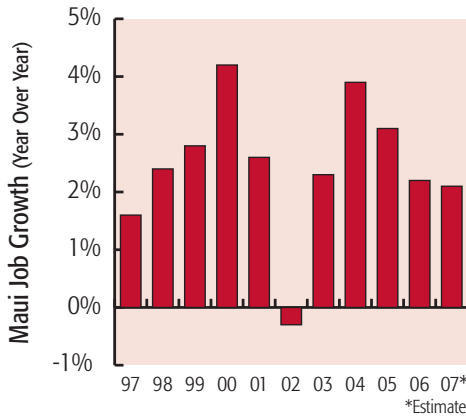
That high inflation rate is going to make it harder in 2007 to achieve positive rates of "real" — or inflated-adjusted — growth. For example, 5.0% growth in personal income or business sales looks pretty good, until you realize that when you subtract 5.0% inflation it leaves 0% real growth.

Maui's Economy Growing More Slowly (continued from page 2)

DESPITE COOLING OF ECONOMY, MAUI'S LABOR MARKET TIGHTER



MAUI'S JOB CREATION PACE SHOWS SIGNS OF SLOWING



Maui Visitor Picture Benefits From Upscale Reputation

In 2006, Maui's visitor industry had a very good year. Total arrivals grew 4.8%, despite a flat year for the state as whole. But Maui really excelled in total spending in 2006, with 10.7% growth. Clearly, Maui's reputation as a destination for upscale visitors paid off. During the first half of 2007, Maui didn't do as well. It lags all but Oahu in arrivals, and the 2006 surge in spending is proving hard to top.

The clear trends in the visitor industry remain in shifts toward time-share and cruise ships, as the chart above right shows. Although these growth numbers say nothing about absolute market shares, they speak volumes about gains and losses in those market shares. Hotels often express concern about time-share and cruise visitors absorbing air seats that might otherwise go to occupants of their properties.

Another trend in the Maui visitor industry worth noting is an apparent declining interest in golf. Several of those interviewed in this year's survey mentioned this phenomenon, though they have no definite ideas on the cause. They surmise

that it might include the game's time-consuming nature, competition from other Maui visitor activities, or perhaps the aging of baby-boomer golf enthusiasts.

Trends Toward Time-Share, Condo Hotels Apparent on Maui

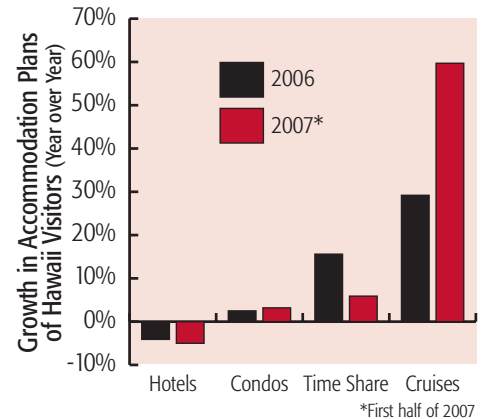
The trend toward time-share and condo hotels is quite apparent in changes in the Maui visitor plant:

- Kapalua Bay Hotel has been razed for a new property that includes both resident and transient units.
- Kapalua's Ritz-Carlton is being renovated, with plans for fewer guestrooms and the addition of residential suites.
- The Renaissance Wailea Beach Hotel is being torn down for a luxury condo hotel resort under the Baccarat label.
- In Kaanapali, Marriott's Maui Ocean Club has just finished the first of two new time-share towers.
- Kaanapali Ocean Resort Phase II time-share development continues, and a Phase III is in the wings.
- In Makena, Dowling Company has partnered with Morgan Stanley Real Estate to acquire the entire resort property from Prince Resorts Hawaii. Eventual plans are likely to include more residential units.

Growth of Isle Cruise Industry Limited by Pricing, Harbor Issues

One obstacle to the growth of the cruise industry is the high cost of operations on the Hawaii circuit and pricing pressures, which will result in the loss of one of the state's four Norwegian Cruise Line

VISITOR INDUSTRY TRENDING TOWARD TIME-SHARE, CRUISE SHIPS



vessels. The *Pride of Hawaii* is slated to leave, at least temporarily, for Europe because stateroom inventory has outstripped demand.

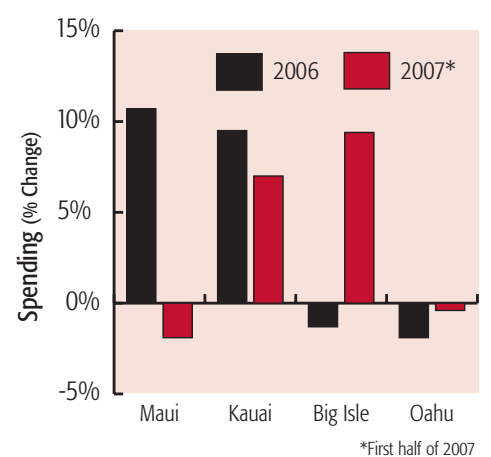
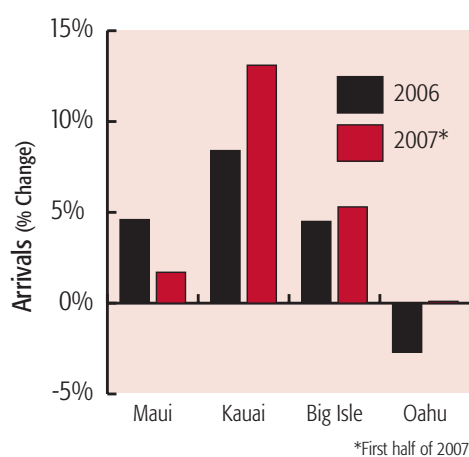
Another problem for the industry, as well as all other users of Hawaii's harbors, is lagging infrastructure. There is a clear consensus that the problems at Kahului Harbor — a lack of space and room to expand — are worse than anywhere else in the state.

Yet as dire as the waterfront problems are, land-side problems are even greater, with no space to accommodate cargo, cars, cruise passengers and other demands.

The main reason we neglect harbor infrastructure is that other problems of growth — highway and airport congestion, for example — are more visible. The harbors are out of sight, and thus out of mind — even in a relatively small island economy.

Maui's population has grown 32.6% in the last 15 years, far outstripping harbor infrastructure growth. Kahului Harbor is a modest three-pier facility built years ago for a plantation economy, not for a tourism-dominated island whose population has grown so fast. (continued on page 4)

MAUI TOURISM: STRENGTH IN 2006 FOLLOWED BY A WEAKER 2007



Maui's Economy Growing More Slowly *(continued from page 3)*

Maui's Retailing Trends Mirror Economic Slowdown

Maui retailing is showing some of the general slowdown trends on both the resort and the local retail sides. Queen Kaahumanu Center, representative of local retailing, estimates that 2007 sales are up about 2%, somewhat below recent years.

Still, demand for space is strong on both the local and resort retail side, and occupancies are high. For example, the Shops at Wailea has 98% occupancy and is considering an expansion.

Maui's High-Tech Sector Continues to Show Promise

Maui Economic Development Board (MEDB) in Kihei occupied its new 32,000-square-foot home in 2006 and tech companies in the Research and Technology Park have been bringing home competitive awards at the national and international level. Other growth signs:

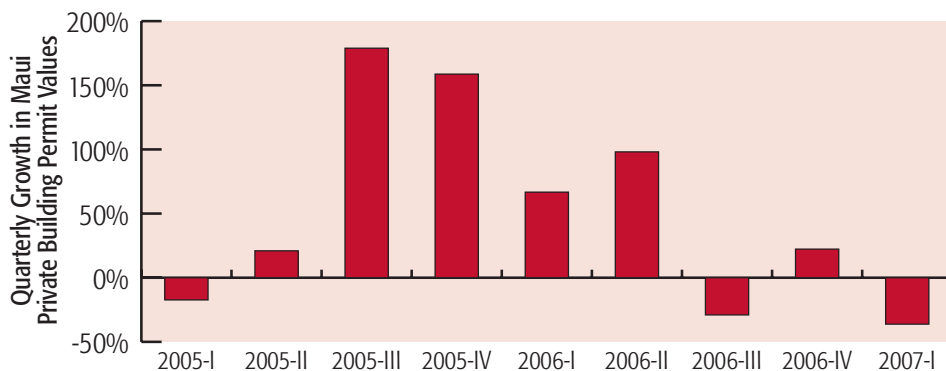
- High school graduates participating in the park's technology professionals program increased from 1% in 1999 to 20% in 2006.
- A new solar telescope is planned for the Haleakala summit.
- Monsanto, one of the Park's residents engaged in agricultural research, now employs over 400 people — up from 100 several years ago.

Maui Community College Still on a Growth Path

Positive developments at Maui Community College include:

- The new \$22-million, 400-bed student housing project in the Kahului area.

MAUI BUILDING PERMIT VALUES DECLINED IN RECENT QUARTERS



- The student life center reopened in 2007 after an \$8-million renovation.
- The first graduates in MCC's first four-year, fully accredited program — in Applied Business and Information Technology.
- Dedication of the Lahaina Education Center and a new \$800,000 classroom facility.

Maui's Agriculture Picture: Sugar, Ethanol, Pineapple

Highlights in Maui agriculture in 2007:

- Maui's lone remaining sugar operation, HC&S, reports that 2007 production is up some but prices are down from 2006. Sugar yields have been affected by drought.
- HC&S reports that, at today's energy prices, it is a toss-up between the return on sugar versus ethanol production. So the ethanol option is not being pursued aggressively, but is still being evaluated for the future. (HC&S potentially can produce more ethanol than can be consumed on Maui, which means exporting — something the company may not wish to undertake.)

- Maui Land & Pine is still committed to pineapple, with emphasis on the higher-end fresh fruit niche.

Construction: Housing Law, Permit Process are Worries

Maui construction is still booming — several Maui builders report they will be busy for at least the next several years — but there are signs of a cooling off further down the pipeline.

The chart above clearly shows a slowdown in permit growth. Builders report that the permit process is getting longer and harder; a more involved bureaucratic process, with the involvement of more agencies, gets most of the blame. There is also an underlying anti-growth sentiment on Maui, a natural outcome of the recent construction boom.

Many developers mentioned another factor — the 2006 County ordinance that increased the affordable housing component for new projects to 50% of all units. This means that builders must make their profit from a smaller percentage of market-priced homes, which could have the unintended result of actually reducing the total supply of new housing for Maui residents. The ordinance adds to the list of things that will slow Maui construction as time progresses.

Alexander & Baldwin continues its ongoing role in Maui development:

- Redevelopment of Kahului Shopping Center proceeds.
- Phase II of the Maui Business Park, adding 179 acres of fee simple light industrial lots to the Dairy Road area, may be available in early 2009.
- Site work is expected to start in 2008 on 65 acres of single-family residential lots in the Haliimaile area.



2008 U.S., Global Outlook: Different Year, Same Story?

By **Dr. Jack Suyderhoud** Professor of Business Economics, Shidler College of Business, University of Hawaii-Manoa

The U.S. and global economic forecast for 2008 looks very much like the one a year ago:

- Global economic growth remains good, especially in Asia.
- The U.S. economy is expected to do pretty well.
- Commodity prices are feeling the effects of the seven-year global economic expansion.
- Concerns about inflation are affecting both central bankers around the world and world financial markets.
- U.S. interest rates will not come down until the Federal Reserve is satisfied that U.S. growth has slowed and/or until their inflationary fears can be put to rest.

Global Economic Forecast: Average of About 5% for 2008

I expect global economic growth to continue in 2008 at around 5%, but that solid global average masks the variations across economies. The developed economies of the U.S., Europe and Japan will expand at substantially slower rates of 2 - 3%. While Japan's growth appears relatively anemic, it is reassuring that its economy is expected to be in the fifth year of slow-but-steady expansion.

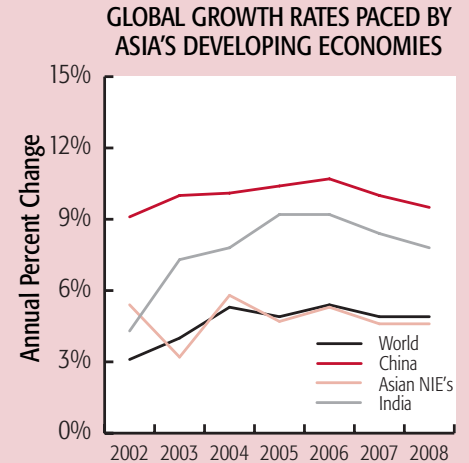
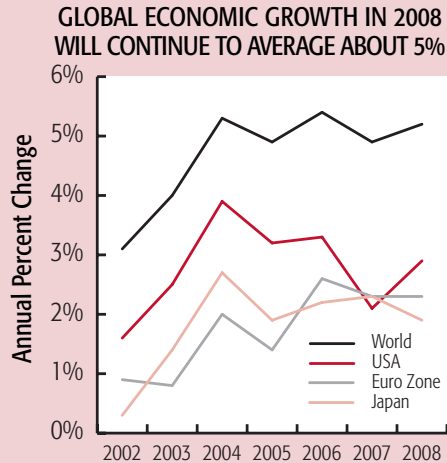
Not surprisingly, most of the global growth is occurring in the recently-developed and developing economies of Asia. China's growth is expected to be over 9% in 2008, with India not far behind, and Korea, Taiwan, Hong Kong and Singapore close to 5% real growth.

Increasing Oil Demand Paces Commodity Price Pressures

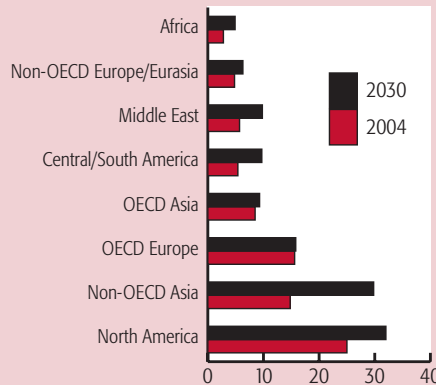
Strong growth has increased the demand for basic commodities including oil. Energy demand forecasts predict that nearly half of the increase in demand for oil up to 2030 will come from the developing economies of Asia (especially China and India).

However, the short-term outlook for gasoline prices is better. As shown in the chart at right, the U.S. Energy Information Agency expects oil prices to vary around the mid-\$60 range and gasoline prices to actually moderate somewhat in late 2007 and 2008 as refining output improves. Of course, this assumes no severe dislocations from political turmoil and extreme weather.

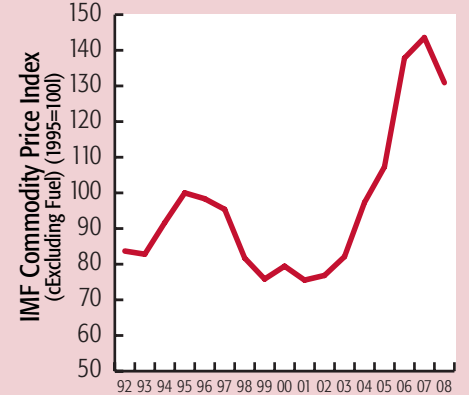
The impact of strong global demand is also being felt in the run-up in commodity prices for items such as foods and metals. The relationship



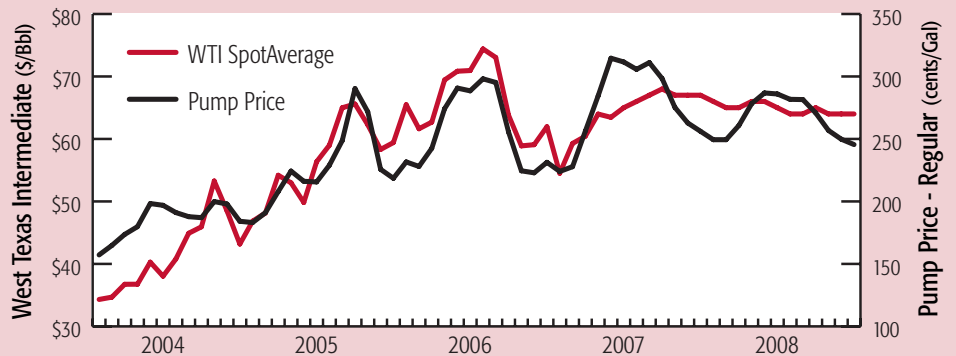
NEARLY HALF OF NEW OIL DEMAND WILL COME FROM DEVELOPING ASIA



RUN-UP IN GLOBAL COMMODITY PRICES SHOULD MODERATE IN 2008



GAS PRICES SHOULD MODERATE AS REFINING OUTPUT IMPROVES



between oil and food prices provides an interesting economics lesson. High oil prices have motivated public policies to substitute bio-fuels, including ethanol, increasing demand (and prices) for crops such as corn, and contributing to higher overall food prices.

U.S. Economy Expected To Be Stronger in 2008

U.S. economic growth is expected to be somewhat better in 2008, but the expected real GDP growth of 2.9% is not good enough to keep

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unemployment from rising slightly from the 4.6% average of 2007 to 4.8%.

Will inflation become an issue? As the chart at right shows, the Consumer Price Index shifted up in late 2006 but has been hard to gauge since then due to volatile food and energy prices. The so-called core inflation (excluding food and energy) has remained in the 2 – 2.5% range.

I believe that the Fed's actions not to lower interest rates in 2007 will help keep inflation at bay, in spite of the oil and food price patterns noted above. I think inflation will be modest in 2008, in the range of 2 – 3%.

I don't expect much of a change in interest rates in 2008. By the end of 2008, I predict that the yield on 10-year bonds will be a bit above the 3-month rate and thus the yield curve is expected to become a bit more normal at the short maturities.

International Aspects of the U.S. Economy

Part of the interest rate story relates to investment decisions of Asian central bankers who hold large amounts of U.S. dollar assets, either in cash or in U.S. government bonds.

Our need for foreign borrowing is caused by a lack of savings by U.S. households and businesses — and certainly the government doesn't save enough. However, the latter is improving. As shown at right, the U.S. budget deficit as a percent of GDP is now less than 2% of GDP — an improvement over time and in line with most countries.

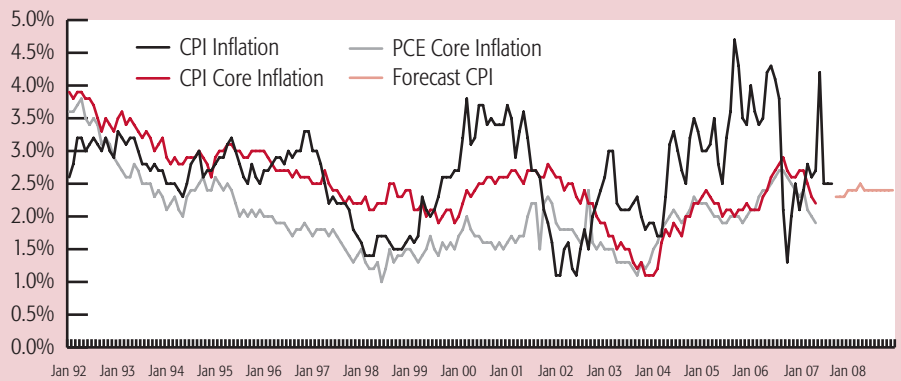
However, our current account (foreign trade) balance has improved only slightly. Our appetite for foreign products remains strong, financed by foreign lending to us or foreign purchases of our real and financial assets. We still borrow over \$2 billion per day from overseas. The trade deficit with China has deteriorated significantly.

Asian central banks (led by China) have used their trade surpluses with the U.S. to accumulate vast amounts of international reserves, evidence that these countries are keeping their currencies cheap to facilitate exports.

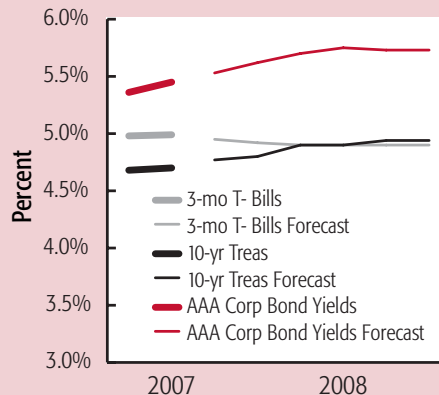
Given the large trade deficit and our relatively low interest rates (until two years ago), one would expect the value of the dollar to decline. As the figure at right shows, it has done so against the free-floating currencies such as the Euro. However, most analysts believe the Japanese yen should be stronger. China has only recently begun to allow the yuan to appreciate, but the extent of appreciation has been minimal.

Until the U.S. increases its savings rates and Asian economies allow their currencies to reflect fundamental economic forces, the U.S. will continue to run large current account deficits and be dependent on foreign capital.

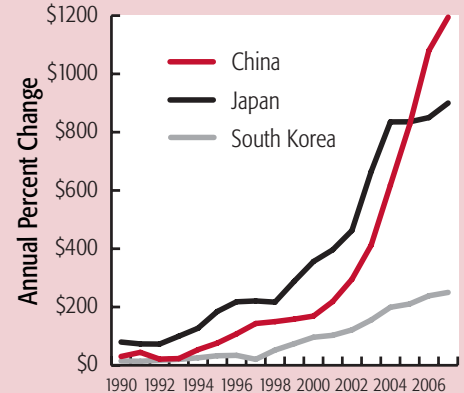
U.S. INFLATION RATE HAS BEEN HIGHLY VOLATILE SINCE 2006



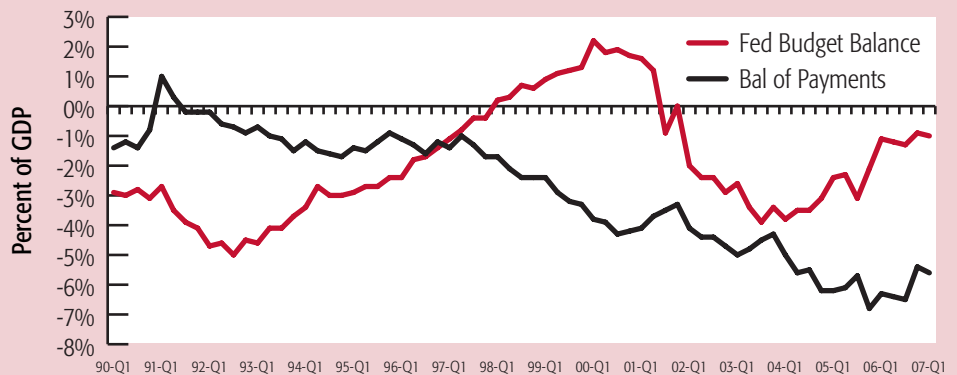
INTEREST RATE NOT MUCH CHANGE EXPECTED DURING 2008



CHINA LEADS THE WAY IN BUILDING INTERNATIONAL RESERVES



U.S. BALANCE OF TRADE LEVELS OFF, BUDGET GAP NARROWS



EXCHANGE RATE CHANGES VERSUS U.S. DOLLAR

