Published by the W. P. Carey School of Business at Arizona State University

June 2006 Volume 22, Number 6

BLUE CHIP ECONOMIC FORECAST

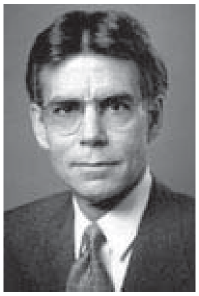
ARIZONA

W. P. CAREY SCHOOL of BUSINESS

BANK ONE

ASU ARIZONA STATE UNIVERSITY

AZ economy slowing, but the race is not over yet



By Elliott D. Pollack

Arizona's economy continues to expand at a rapid clip, with total employment growing by 5.3% in 2005 over 2004. For the first five months of 2006 employment has gained 5.2% over the similar period in 2005 (see chart).

The construction sector continues to expand as well – up 12.5% year-to-date through May 2006. This has raised some eyebrows, considering the slowdown in housing. As approximately two-thirds of all construction employment is related to single-family housing, some decline might be expected despite the fact that non-residential construction continues to increase. The onset of such a decline may be delayed somewhat since there is still a backlog of new houses, although not as many as a year ago.

The good news is that historically the state's economy has been able to continue to expand, though not quite as rapidly, even with a slowdown in construction employment. Since 1970, Arizona's construction employment has been negative in 12 of 35 years, while total employment only turned negative three years. Indeed, only in periods of a national recession did a decline in construction coincide with a decline in total employment for the state. Thus, what is likely to occur over the next year is simply a reduction in what has been a very rapid rate of growth.

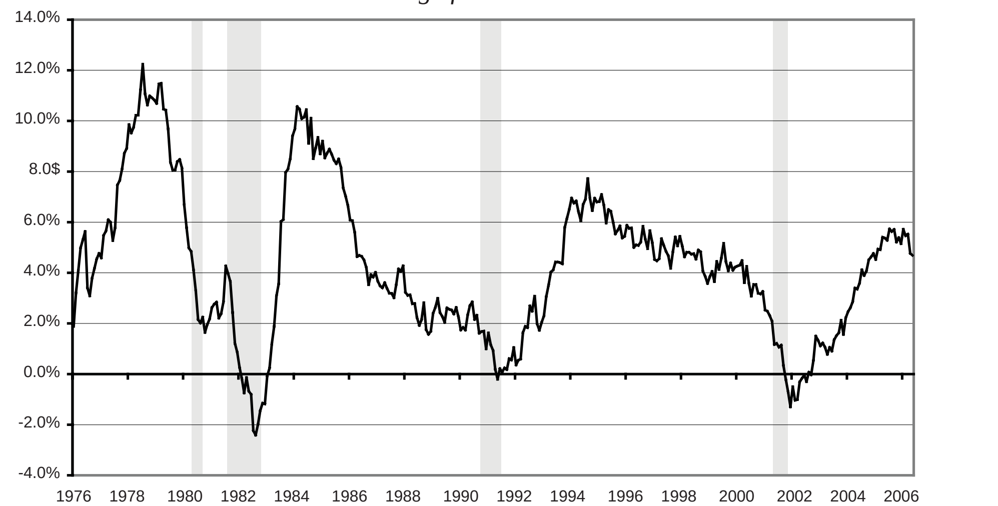
A slowdown in the rate of job growth can also be expected because consumer spending is likely to slow as well. Not only would it be normal for the rate of growth in consumer expenditures to slow as we get later into the cycle, but also consumers have taken an inordinate amount of money out of their houses over the last couple of years through refinancing. More than 50% of that amount generally ends up in the retail spending stream. During the 1990s and early 2000s, the average cash-out dollars as a percentage of refinanced amount was 7.8%. In 2004, this number jumped to 12.9%, and it is estimated to have been 21.3% during 2005. The total volume of cash-out dollars as a percent of total retail sales dollars represented less than 2.0% during the 1990s. In 2005, the volume of cash-out dollars was 6.8% of total U.S. retail sales.

As the level of refinancing slows due to higher interest rates and lower housing appreciation, both locally and nationally, it is likely that some cutback in consumer expenditures would occur as well. This, combined with heightened gas prices, should slow consumer spending from last year's torrid pace.

(Continued on Page 3)

Arizona Employment Growth

Percent Change from Previous Year



Source: Arizona Department of Economic Security

***Elliott D. Pollack** is president of Elliott D. Pollack and Company in Scottsdale, an economic and real estate consulting firm established in 1987. The views expressed in the following article are not necessarily those of the university or the W. P. Carey School of Business.*

2006 ARIZONA BLUE CHIP ECONOMIC FORECAST

SOURCE:	ANNUAL PERCENT CHANGE 2006 FROM 2005									AVERAGE RATE FOR 2006		
	AZ Current $ Personal Income	U.S. GDP Deflator (Chain)	AZ Real Personal Income	AZ Retail Sales	AZ Wage & Salary Empl.	AZ Mfg. Empl.	AZ Single-family Units	AZ Multi-family Units	AZ Pop. Growth	U.S. 3-Mo. T-Bills	U.S. 10-Yr. Treas. Notes	AZ Unempl. Rate
Arizona Department of Commerce	7.6 L	3.1	4.5 L	7.1 L	4.0	2.0	-7.0	1.5	3.0	4.4 L	5.3	4.5
Arizona Public Service	8.5	2.7	5.7	9.0 H	4.0	1.5 L	-5.0	0.0	3.0	4.5	5.0	4.6 H
ASU - Bank One EOC	8.7	2.7	6.0	7.6	4.9	2.5	-8.0	1.0	3.0	4.7	4.9	4.5
Department of Economic Security	8.6	2.9	5.5	8.4	5.5 H	2.5			2.9	4.8	4.8 L	4.3
ECON-LINC	8.4	2.8	5.6	8.0	4.8	3.0	-12.0 L	2.0	3.2	4.7	5.2	4.2
EconLit LLC	7.9	2.5 L	5.6	7.4	4.2	2.0	-5.0	0.0	3.0	4.5	5.2	4.3
Eggert Economic Enterprises Inc.	8.6	2.5 L	5.1	7.8	4.3	3.3 H	-6.3	-5.9	3.3	4.5	5.1	4.4
Elliott D. Pollack & Co.	8.0	3.0	5.0	9.0 H	5.0	3.0	-10.0	5.0 H	3.3	4.9 H	5.3	4.0 L
H. C. Reardon Economics	8.6	2.8	5.6	8.0	5.4	2.2	-7.0	0.0	3.2	4.8	5.0	4.4
Joint Legislative Budget Committee	8.2	2.7	5.5	9.0 H	4.4	2.1	-7.0	0.0	3.0	4.8	5.1	4.3
The Maguire Company	8.2	2.7	5.3	7.9	4.6	2.5	-8.0	0.0	3.2	4.6	5.0	4.6 H
Metropolitan West Asset Management	8.3	2.6	5.7	7.7	4.4	2.7				4.6	5.0	4.2
NAU - BBER	8.4	3.2 H	5.2	7.4	3.9 L	1.9	-7.0	-5.0	2.9	4.8	5.0	4.4
Salt River Project	8.6	2.8	5.8	7.9	5.0	2.5	-9.0	0.0	3.2	4.8	4.9	4.0 L
Stellar Capital Management	7.7	2.9	5.0	7.2	3.9 L	2.1	-7.5	4.0	2.8 L	4.7	5.0	4.5
UA - Eller College	9.4 H	2.8	6.5 H	7.6	4.9	1.9	-7.6	2.5	3.3	4.8	5.0	4.5
VisionEcon	8.0	3.2 H	4.7	8.3	4.4	2.6	0.0 H	-10.0 L	3.4 H	4.7	5.7 H	4.5
Wells Fargo & Co.	8.3	2.9	5.4	7.5	4.4	2.4	-6.0	1.0	2.9	4.5	5.1	4.0 L
Consensus — This Month	**8.3**	**2.8**	**5.4**	**7.9**	**4.6**	**2.4**	**-7.0**	**-0.2**	**3.1**	**4.7**	**5.1**	**4.3**
— Last Month	**8.3**	**2.8**	**5.4**	**7.9**	**4.5**	**2.3**	**-6.5**	**-0.7**	**3.1**	**4.6**	**5.0**	**4.4**

ARIZONA BLUE CHIP PANEL

Arizona Department of
Economic Security
Donald Wehbey

Arizona Public Service
Pete Ewen

Arizona State University
Bank One EOC
Tracy Clark

Arizona Dept. of Commerce
Kent Ennis

ECON–LINC
John Lucking

EconLit LLC
Dwight Duncan

Eggert Economic Enterprises Inc.
Robert J. Eggert, Sr.

Elliott D. Pollack and Co.
Elliott Pollack

H. C. Reardon Economics
H. C. Reardon

Joint Legislative Budget Committee
Staff

Metropolitan West Asset Management
Neal Helm

Northern Arizona University
Bureau of Business and
Economic Research
Dennis Foster,
Ronald Gunderson
and Max Jerrell

Salt River Project
Arlyn Herrera, Rebecca Holmes
and Karen Wolfe

Stellar Capital Management
Phoenix, Arizona
Stephen Taddie

University of Arizona
Eller College
Marshall Vest

VisionEcon
Debra J. Roubik

Wells Fargo & Co.
Scott Anderson

The Maguire Company
Alan Maguire

ARIZONA HISTORICAL TABLE

	AZ Current $ Personal Income (millions)	U.S. GDP Deflator	AZ Real Personal Income (millions)	AZ Retail Sales (millions)	AZ Wage & Salary Empl. (thousands)	AZ Mfg. Empl. (thousands)	AZ Single-family Units	AZ Multi-family Units	AZ Pop. (thousands)	AZ Unempl. Rate
2005	179,765	112.2	160,218	58,964	2,506.9	181.3	84,269	9,262	5,939	4.7
Percent Change	*9.3%*	*2.8%*	*6.3%*	*13.2%*	*5.3%*	*2.4%*	*1.0%*	*-1.7%*	*3.5%*	
2004	164,495	109.1	150,775	52,098	2,381.3	177.1	83,411	9,426	5,740	5.0
Percent Change	*8.4%*	*2.6%*	*5.6%*	*9.0%*	*3.7%*	*1.0%*	*27.1%*	*32.1%*	*2.9%*	
2003	151,708	106.3	142,717	47,818	2,296.4	175.4	65,649	7,135	5,578	5.7
Percent Change	*5.2%*	*2.0%*	*3.2%*	*5.3%*	*1.4%*	*-4.4%*	*18.0%*	*-19.2%*	*2.6%*	
2002	144,150	104.2	138,340	45,425	2,265.1	183.5	55,649	8,830	5,438	6.1
Percent Change	*3.8%*	*1.8%*	*2.0%*	*1.3%*	*0.0%*	*-9.0%*	*9.3%*	*-15.2%*	*2.7%*	

2007 ARIZONA BLUE CHIP ECONOMIC FORECAST

SOURCE:	ANNUAL PERCENT CHANGE 2007 FROM 2006									AVERAGE RATE FOR 2007		
	AZ Current $ Personal Income	U.S. GDP Deflator (Chain)	AZ Real Personal Income	AZ Retail Sales	AZ Wage & Salary Empl.	AZ Mfg. Empl.	AZ Single-family Units	AZ Multi-family Units	AZ Pop. Growth	U.S. 3-Mo. T-Bills	U.S. 10-Yr. Treas. Notes	AZ Unempl. Rate
Arizona Department of Commerce	7.2	3.1	4.1	6.5	3.2	1.0	-8.0	1.5	2.9	4.5	5.7	4.6
Arizona Public Service	7.8	3.0	4.7	7.5 H	3.7	1.0	-4.0	0.0	2.8	4.5	5.0	5.0 H
ASU - Bank One EOC	6.8	2.3	4.5	6.8	4.2	2.0	-7.0	2.0	2.8	4.7	5.1	4.2
Department of Economic Security	7.2	2.3	4.8	7.4	4.4 H	2.2			3.0	4.8	4.9 L	4.5
ECON-LINC	7.8	2.8	5.2	7.5 H	4.0	2.0	-5.0	2.0	3.1 H	4.5	5.5	4.4
EconLit LLC	7.5	2.6	5.1	6.9	3.8	2.0	-5.0	-2.0	2.9	4.4	5.3	4.1 L
Eggert Economic Enterprises Inc.	8.1	2.6	5.3	7.5 H	4.0	1.9	-6.0	-2.9	3.1 H	4.6	5.4	4.5
Elliott D. Pollack & Co.	7.5	2.8	4.7	7.5 H	4.0	3.0 H	-5.0	5.0 H	3.0	4.9	5.4	4.2
H. C. Reardon Economics	7.7	2.6	4.9	6.8	4.2	1.7	-2.0	2.0	3.0	4.8	5.1	4.6
Joint Legislative Budget Committee	7.4	2.3	5.1	6.5	3.7	1.0	-3.0	0.0	3.0	4.8	5.2	4.3
The Maguire Company	7.6	2.7	5.1	7.3	4.2	2.2	-8.0	0.0	3.1 H	4.4	5.2	4.4
Metropolitan West Asset Management	7.7	2.5	5.2	7.1	4.0	2.1				4.4	5.2	4.3
NAU - BBER	8.5 H	3.5	5.0	6.8	3.6	1.5	0.0 H	0.0	2.7	5.0	5.2	4.5
Salt River Project	7.5	1.8 L	5.7 H	6.5	4.0	1.0	-4.0	-2.7	3.0	4.8	4.9 L	4.3
Stellar Capital Management	7.1	2.0	5.1	6.9	3.6	2.0	-5.0	3.0	2.6 L	4.6	5.4	4.4
UA - Eller College	6.2	1.8 L	4.3	5.5 L	2.5 L	-1.0 L	-8.7 L	4.7	2.9	4.8	5.0	4.8
VisionEcon	6.1 L	3.7 H	2.3 L	6.7	2.9	1.6	-2.0	-5.0 L	2.9	5.2 H	6.7 H	4.8
Wells Fargo & Co.	7.8	2.6	5.2	6.0	3.7	2.0	-7.0	-1.0	2.7	4.3 L	5.0	4.1 L
Consensus — This Month	**7.4**	**2.6**	**4.8**	**6.9**	**3.8**	**1.6**	**-5.0**	**0.4**	**2.9**	**4.7**	**5.3**	**4.4**
— Last Month	**7.5**	**2.5**	**4.9**	**6.9**	**3.8**	**1.7**	**-4.0**	**1.7**	**2.9**	**4.6**	**5.3**	**4.4**

Basic data sources:
(1) Arizona personal income in current $, (2) Gross domestic product price deflator chain type [1992 = 100] and (3) Arizona personal income in 1992 $, Bureau of Economic Analysis; (4) Arizona retail sales, Arizona Department of Revenue, (5) Arizona total nonagricultural wage and salary employment and (6) Arizona manufacturing employment, DES; (7) Arizona single-family unit authorizations and (8) Arizona multi-family unit authorizations, ASU – AREC; (9) Arizona population, US Census Bureau; (10) 3-month Treasury bills, Federal Reserve Board; (11) 10-year U.S. Treasury notes yield FRB, H15; (12) Arizona unemployment rate, DES.

Arizona's economy: the race is not over yet

(Continued from Page 1)

Indeed, sector leadership in the national economy as a whole is likely to switch, as is normal in the later stages of expansions. The business sector should grow more rapidly, not only in terms of expenditures for equipment, but in plant expenditures as well. Capacity utilization now exceeds 81%, and corporations have never been as liquid as they are today.

Those factors suggest that while the rate of growth in consumer expenditures is likely to slow, the rate of growth in business expenditures is likely to accelerate. This also means that businesses will need to continue to hire in order to staff these new plants. This would lead to more jobs and more income growth that would help consumers.

Some have expressed fears that consumers could actually drag the economy into a recession later this year or early next. This seems unlikely. In addition to what has already been discussed, consumer net worth has been expanding rapidly over the last few years.

Somewhat surprisingly, it is not just housing, but liquid assets as well that have been increasing. Indeed, over the last three decades, the annual growth in household net worth averaged 8.2%. It has been growing by about 11% over the last three years. Tangible assets (real estate and consumer durables) have been growing at an annual rate of about 11.9%, while financial assets grew by 10.8% each year for three years. Over the last twelve months through the first quarter of 2006, total household net worth grew by 11.9% over the prior twelve months. Tangible assets grew by 13.6% and financial assets by 7.6% during this time frame.

"The good news is that historically the state's economy has been able to continue to expand, even with a slowdown in construction employment."

Consumers generally spend 5½ cents out of every dollar increase in net worth. However, this spending occurs with a lag that varies by type of asset. For example, according to a 2004 Harvard study, the lag in spending caused by housing appreciation tends to be less than the lag produced by increases in financial assets. The spending associated with housing appreciation is significantly realized within a couple of years, while it takes many more years for consumers to pillage their stock portfolio gains to buy that new plasma television. This suggests that the effects of the 2004-2005 jump in housing prices nationally are not yet over, but could be nearing their conclusion.

Despite these words of caution, consumers overall are still in pretty good shape and are not likely to pull the economy into a recession, given the amount of liquidity and the expectation of continued job growth. The expansion of the business sector should also help to keep the economy growing, albeit more slowly, over the next year.

— Elliott D. Pollack

SPECIAL QUESTION: THE PANEL RATES RISKS TO CONSUMER SPENDING

There was a significant shift in the consumer spending factors that most worry the panel in 2006 versus 2005. Last year they were concerned about a few factors, but not very concerned. This year their view of which factors are most worrisome, and of the importance of those factors, has changed. Rising interest rates and oil prices have sparked fears of increased inflation.

Interest rate increases in 2005 were mostly confined to short-term rates, and at the time it was unclear how much further the Federal Reserve was going to raise the Federal Funds rate. The Fed still has not explicitly announced when they will stop incrementally increasing the rate, but there is a growing consensus that they will at least take a breather after it reaches 5.25 percent. A Federal Funds rate of 5.25 percent is not very high by historical standards but it is significantly higher than the effective rate of 0.98 percent in December of 2003.

The Federal Funds rate is the rate banks charge each other for overnight loans of reserves they have on deposit with the Federal Reserve. This may not seem to have much relevance for consumer spending; however, banks use the funds rate to set both the prime rate and, by derivation, the rates charged on credit cards and other types of short-term consumer debt. Consumers will be constrained by higher prices for new short-term debt and to some extent by higher costs for existing debt.

History would suggest that during the sustained rise of short-term rates, long-term rates would also move up significantly, but history has proved to be a very poor guide over the last few years. Long-term rates have risen, but not nearly as much as might be expected. Recently, long-term rates have shown more willingness to move – which is worrisome – but they continue to remain somewhat resistant to change.

Of the many possible explanations for long-term rates staying low, two appear most likely: the seemingly insatiable desire of foreign governments and investors for US securities, and low inflation expectations. It is impossible to say when foreign investors will lose their taste for our securities, but inflation expectations domestically appear to be on the rise. This rise seems the most likely explanation for recent boosts in long-term rates, which will constrain durables purchases and the housing market. Inflation expectations can impact the economy even if they never come to pass, and actual inflation would further crimp spending.

Most economists believe that while a slowdown in consumer spending is likely, the drop will not be sufficient to cause a recession over the current forecast horizon. However, if interest rates, oil prices or inflation accelerate more than expected, the economy could be in trouble.

— Tracy Clark
Associate Director
Bank One Economic Outlook Center

RISKS TO CONTINUED CONSUMER SPENDING

Ranking by *Arizona Blue Chip* Panel (using a scale of 1 to 10, with 10 being the highest)

	2005	*2006*
Rise in Interest Rates	5.3	7.9
Rising Oil Prices	5.5	7.3
Higher Inflation	4.6	6.2
Weaker Housing Market	5.6	6.1
Consumer Debt Buildup	6.3	5.6
Drop in Consumer Confidence	5.7	5.4
Slower Employment Growth	4.8	5.1
Stock Market Correction	4.5	4.2
Consumer Demand Satiated	2.3	3.9

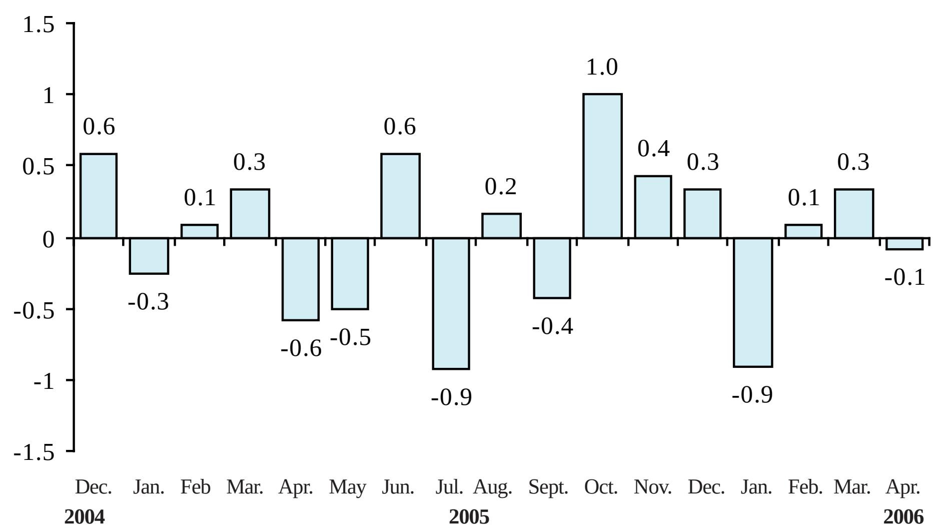
ARIZONA BLUE CHIP ECONOMIC FORECAST

ARIZONA BLUE CHIP (ISSN 1042–6787) is published monthly by the Bank One Economic Outlook Center, L. William Seidman Research Institute, W. P. Carey School of Business, Arizona State University, P.O. Box 874011, Tempe AZ, 85287–4011. E-mail subscriptions (PDF) are available at $99 for one year (12 issues). To order, call (480) 965-5543. Checks must be made payable to ASU Foundation. Funds will be deposited with the ASU Foundation, a separate nonprofit organization which exists to support ASU. Your payment is not considered a charitable contribution.

Robert J. Eggert Sr., Executive Editor
Tracy Clark, Editor
Lee McPheters, Contributing Editor
Elliott Pollack, Contributing Editor
Jim Dodson, Editorial Coordinator

LEADING INDEX

ARIZONA INDEX OF LEADING ECONOMIC INDICATORS
Percent Change from Previous Month



Source: Bank One Economic Outlook Center, L. William Seidman Research Institute, W. P. Carey School of Business, Arizona State University.