Arizona Blue Chip
June 2008

The Recession Debate

The media seems to be having a field day with the debate on whether or not we are in recession. The fact is, to the average person, it does not matter. It won't feel good either way. Whether we are in a recession or not, the economy is weak and it will take some time to fully recover.

National Outlook

Despite strong exports as a result of the weaker dollar and liquid corporate balance sheets, the near term economic outlook is far less than sanguine. For the consumer, a combination of factors including low savings rates, high debt levels, declining employment, the negative effects of a declining stock market and declining housing prices, all combined with increases in oil and food prices, will make this downturn tough. While it is always difficult to predict stock and oil prices, but employment growth will, indeed, be weak for the remainder of the year. The near term outlook for housing also calls for more price declines and below-trend permitting activity. This will be the case until supply and demand are back in balance and excess housing units are fully absorbed.

Even with relatively strong business balance sheets business lending standards by large banks have tightened. This tightening typically occurs near the onset of a national recession. High commodity prices, weaker productivity, and the effects of a broad-based economic malaise, could eventually take their toll on business profitability.

Overall, it is not a pretty picture. Again, until supply/demand imbalances in housing are corrected and consumers restructure their balance sheets, the economy won't feel good.

Recession Indicators

With that said, this article will discuss how to determine if we are in a national and/or local recession. While the media seems to be harping on "two negative quarters of GDP" as the definition of a recession, the definition of a recession is actually more involved. The National Bureau of Economic Research (NBER) actually has a dating committee. No, it will not fix you up on Saturday night, but it will tell you when recessions begin and end. Usually this is done after the fact and, thus, with the benefit of 20/20 hindsight. And, no, they do not look at one factor such as two quarters of decline in real GDP. While real GDP is one of the factors, NBER also looks at employment, real income, sales (both wholesale and resale), and industrial production. The dating committee attempts to identify periods of general weakness or decline in overall economic activity across the economy that lasts for more than a few months.

Not all of these factors necessarily have to be negative for there to be a "recession." In fact, there have been periods when a recession began before GDP turned negative, before retail sales turned negative, and before industrial production turned negative. It is actually a more comprehensive and accurate method of analyzing the business cycle. However, it also allows for some subjectivity to enter the equation.

Where do we stand know? We have had two quarters of very anemic growth in real GDP. Retail sales have actually turned negative, something that historically does not happen until after recession begins. Employment has turned negative, something that happens in the early stages of recession. And, industrial production is weak. Real incomes, net of transfer payments, are still up, but by a relatively modest amount. Thus, while I am not on the dating committee, based on these historic relationships, it is certainly possible that a recession has begun.

Arizona's Economy

Where do we stand in Arizona? Here the indicators are somewhat different because of data constraints. For example, both local income and gross state product data are reported with a lag and substantially revised well after the fact. Thus, they cannot be used as predictors of pending economic activity. However, local economic indicators do exist. Let us look at them one at a time.

Employment

Historically, employment in Arizona grows rapidly during periods of expansion and only declines well into a recession. This time around, employment turned negative in December 2007. As of March 2008, employment in Arizona was down 0.3% over March 2007. These numbers have more context with a relative comparison. In 2006, Arizona ranked 2nd in the country in terms of job growth. In 2007, our ranking slid to 22nd and for the first quarter of 2008 we slid to 40th. This is one of the poorest performances on record and may not even be the bottom. The major culprit is the weakness in jobs that are related to housing and construction. For example, in terms of construction employment, we fell to 49th in the country while the financial services industry fell to 47th. Interestingly, we seem to be leading the nation in terms of growth in government employment. This calendar year could realize the worst local employment decline since 1975.

Retail Sales

Retail sales are another local economic indicator that historically tends to mirror the business cycle with some precision. On a year-over-year basis, retail sales turned negative in August 2007 and continued to deteriorate through February 2008. This time around, retail sales proved to be much more cyclical than the general health of the economy. The housing boom resulted in individuals tapping into the equity in their home and then spending a portion of that equity. Retail sales increased dramatically, well above basic economic fundamentals during the period people were tapping into their equity, especially in 2003 through 2005. And, like all good things, the excess spending came to an end with a hard thud.

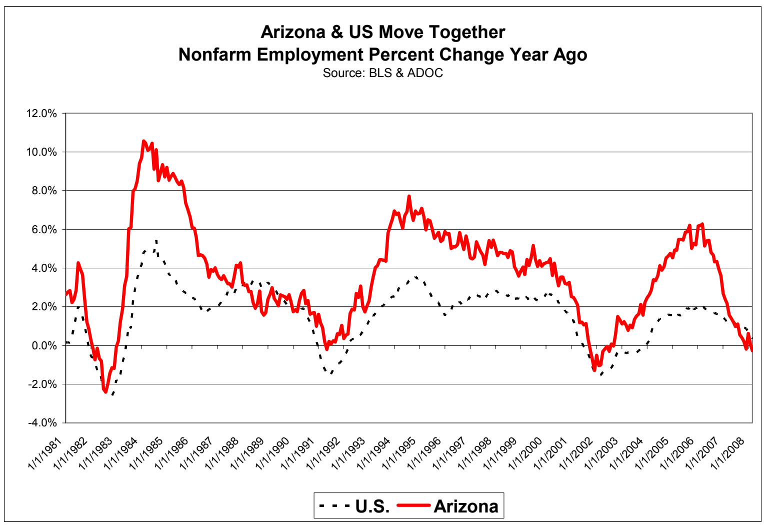
Housing

For Arizona, housing permits are another indicator of general economic activity. Unfortunately, this indicator is also overwhelmingly negative at the moment. Similar to retail sales, permitting exceeded the underlying economic fundamentals for about two years and has since fallen below trend levels. Since the peak in 2005, housing permits in Greater Phoenix, for example, are down by more than 72% - close to the most significant decline on record. In addition, supply/demand statistics indicate that even if we are near bottom, not a difficult call to make after a 72% decline, we will be going nowhere fast for the foreseeable future.

No one indicator tells the whole story. However, overall, virtually every major indicator in Greater Phoenix and Arizona indicate that we are indeed in a recession. Problems in housing and the credit markets, as in other places in the United States, have spread across the local economy. This will last for a while.

Relative Performance

Recessions in Arizona roughly coincide with recessions in the United States. But, the severity is usually different. During both times of economic expansion and recession, Arizona tends to outperform the nation as a whole. This is most noticeable in employment statistics. This time around will be different though. During the past expansion, the state significantly outperformed the country in terms of employment growth. During this recession, Arizona's employment situation will be worse (see previous employment discussion) than the U.S. as a whole.



Conclusions

The good news is that given enough time we will grow our way out of the economic downturn. Population flows and housing, once credit markets stabilize, will return towards normal. The underlying economic dynamics seem to continue to be favorable. Getting from here to there, however, is not going to be a lot of fun.