Is there *really* light at the end of the tunnel?

By
Elliott Pollack

Arizona Blue Chip
January 2009

The economic situation in Arizona continues to deteriorate. Employment as of November was down more than 3% from a year ago and for the first eleven months of the year it was down 1.2%. It is likely that when employment is revised in February 2009, the number will be even worse. As of November, every sector with the exception of mining, health and educational services, leisure and hospitality services, and government were down from a year ago. Thus, 61.7 % of the economy is now in decline and only 38.3% is growing.

It is likely that 2008 and 2009 will go down as the weakest performance in the State's modern economic history. What started out as an inventory correction in single family housing caused by the overbuilding that occurred between 2003 and 2006 has been exasperated by a national recession, severe credit market conditions and the deterioration of the rest of the world's economies that affected our exports.

The worst still appears to be in front of us. Thus, the length and severity of this recession remains to be determined, but no end is presently in sight, either nationally or internationally. The average consumer has too much debt and little in the way of traditional savings. This was masked in the 1990's by strong stock market gains that made the average person who had a 401k or other type of retirement plan or stocks feel richer. It was masked in the early part of this decade by people using their house as a credit card as housing prices skyrocketed. Given the decline in consumer net worth, the average person feels considerably poorer and has cut back spending dramatically. Indeed, the only way to resolve the issue for the average person is to pay down debt and increase savings. However, this can only be done by spending less especially in an environment where employment and hours worked are declining.

The situation has also led to problems in the commercial real estate sector where vacancy rates are high, absorption is negative to low, and there is still a good deal of future inventory in the pipeline. The result will be pressure on rents and prices for the foreseeable future with the possible exception of the apartment sector. Cap rates are likely to go up.

There has also been a significant slow down in population growth. If you can't sell your house in Arizona, you probably can't sell it in California, Michigan, Pennsylvania, or other places people move from to come here. In addition, given the decline in jobs, incentives to move have been reduced. The result is that it will take longer to absorb the excess supply of housing. The only good news is that the long term underlying dynamics of Arizona and Greater Phoenix do not appear to have changed very much. This is just a cycle. It is a deep cycle. It is difficult to live them. But, it is a cycle none-the-less.

This does not mean that positive changes are not needed however. With the movement of much of the semiconductor industry overseas, Arizona will have to draw new base industries to the State. This should be done through a friendly tax structure for those types of companies and a minimization of red tape. It should not be incumbent on the State to have an industrial policy that picks winners and losers, but rather to create a situation where the environment is friendly for those companies who could otherwise be in Austin or San Diego or Denver.

Keep in mind that Phoenix is here because of Intel, JDE Software and American Express's regional office, not because of Dillard's and Circle K. They are here chasing income already in the State. Given the current political climate and problems with the State deficit, now would be a good time to consider restructuring some tax policies to make Arizona more attractive to those companies that could bring in wealth during the next recovery.

The point at which the economy will turn remains problematic. While comparisons with the second half of 2008 will be easy in the second half of 2009, any significant recovery will probably be farther down the line; perhaps 2010. The recovery, when it occurs, will likely be slow at first. The type of adjustments that the average person has to make that will take awhile. In addition, credit markets are not likely to recover quickly. Credit conditions in the future are more likely to look like the seventies and eighties. Indeed, 2002 through 2007 turned out to be an aberration in history in terms of ease of credit.