



**Eller** COLLEGE OF MANAGEMENT  
THE UNIVERSITY OF ARIZONA

# ECONOMIC OUTLOOK 2012-13

The University of Arizona's  
31st Annual  
Forecast Luncheon

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Dean  
Halle Chair in Leadership  
Professor of Entrepreneurship  
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Director  
Economic and Business  
Research Center



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From an economic perspective, the result of the national steady demographic growth, economic contributions to Arizona from the

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**THIS WEEK**  
December 2, 2011  
In addition to the National Labor Force data, there was a good track of other data releases this week, continuing to transmit and encourage confidence. The Fed's House Price Index for Arizona was down 1.3 percent from the last quarter and just 0.2 percent from the same quarter of last year.

READ MORE >>>

**NEWS**  
The Flat Income Tax in Arizona: Another Shift in Tax Burden from High Income to Low- and Middle-Income Households  
November, 2011

Expectations Lowered for the Long Term  
September, 2011

RDDI COUNT 2011: Tracking Child Well-Being in the U.S.  
September, 2011

Income, Poverty, and Health Insurance Coverage: Estimates for the States  
September, 2011

Arizona's economy recovering, but has long way to go, Arizona Week interview with Marshall J. Vest.  
Paper, 2011

Arizona State Government Closes Budget Gap (For Now)  
June, 2011

**EVENTS**  
December 9, 2011, 10am to 12pm  
Annual Economic Outlook Luncheon at the Walter L. Pateros in Tucson. The nation's economy has barely grown during 2011, in the current state, the economy is vulnerable to shocks or policy mistakes. Learning lessons include the European debt crisis, premature tightening of U.S. fiscal policy, and continuing inflation. Housing markets, uncertainty is very high – and confidence of both business leaders and consumers is barely near recession levels. Mark your calendars for this not to be missed general forecast update.

REGISTER NOW

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## ON THE ROAD TO RECOVERY

- Recovery is underway and gaining momentum
- Strong headwinds continue to slow recovery
- Still facing a long road back

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## STRONG HEADWINDS PERSIST

- Hangover from financial crisis
  - Restrained credit growth
  - Eurozone's sovereign debt and banking crisis
- Depressed confidence
  - Congress debt ceiling debacle, S&P downgrade, "Super Committee" failure
- Business spending and hiring "on hold"
- Housing woes
  - Distressed sales
  - Falling prices
- Population mobility - lowest since 1948

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## RECOVERY UNDERWAY IN AZ

- No longer bouncing along the bottom
  - Acceleration as 2011 comes to an end
- Measures showing improvement
  - Wages
  - Employment
  - Consumer spending
  - Housing markets

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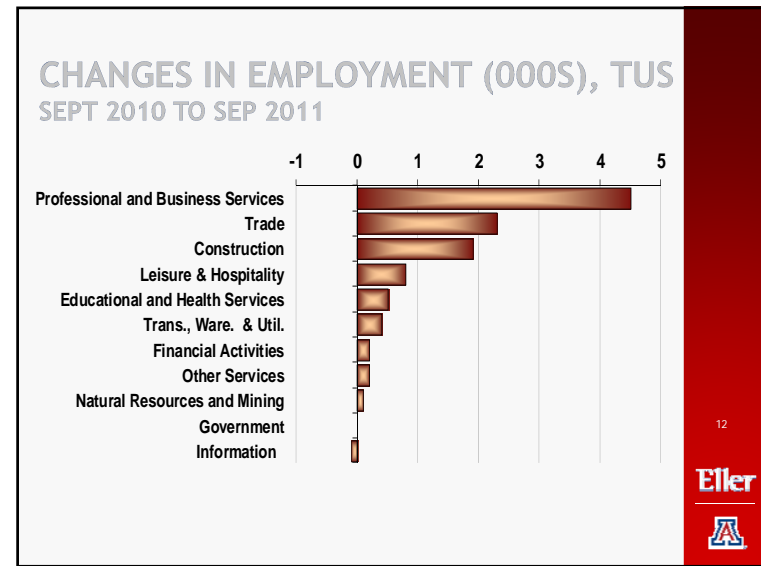
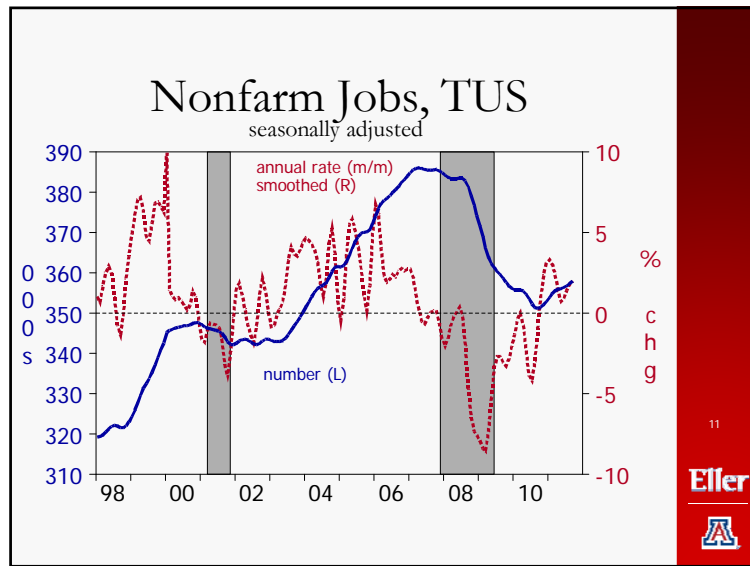
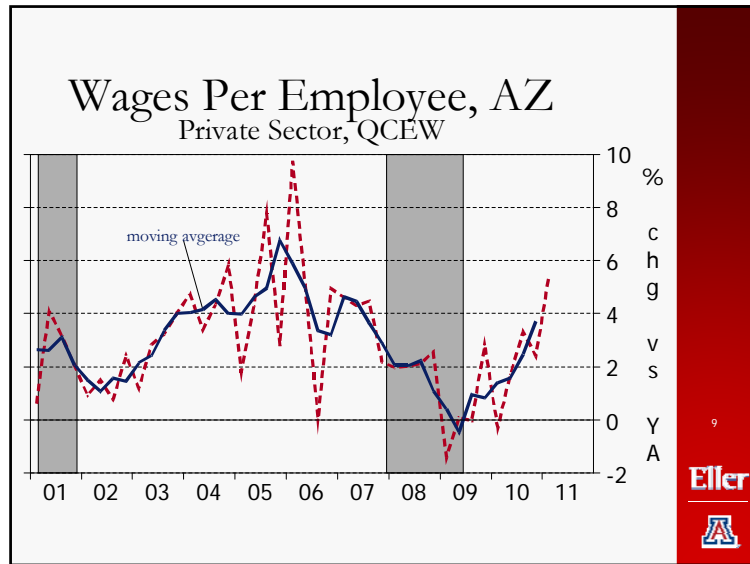


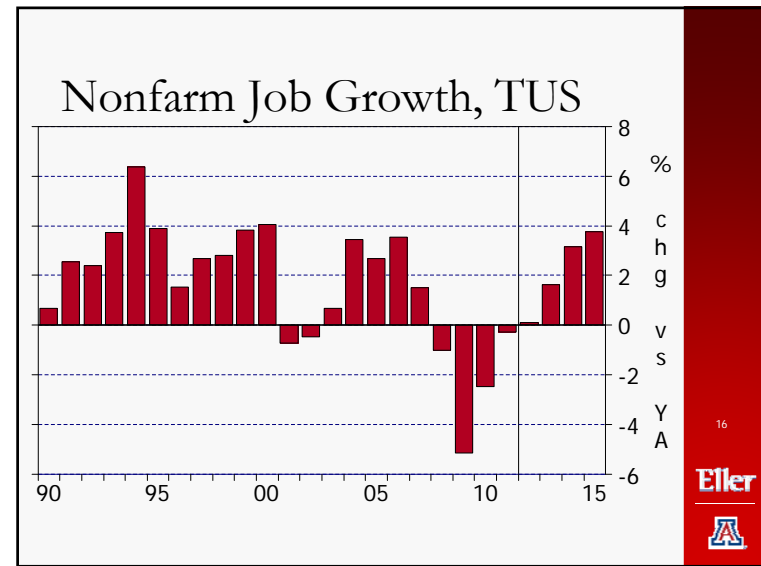
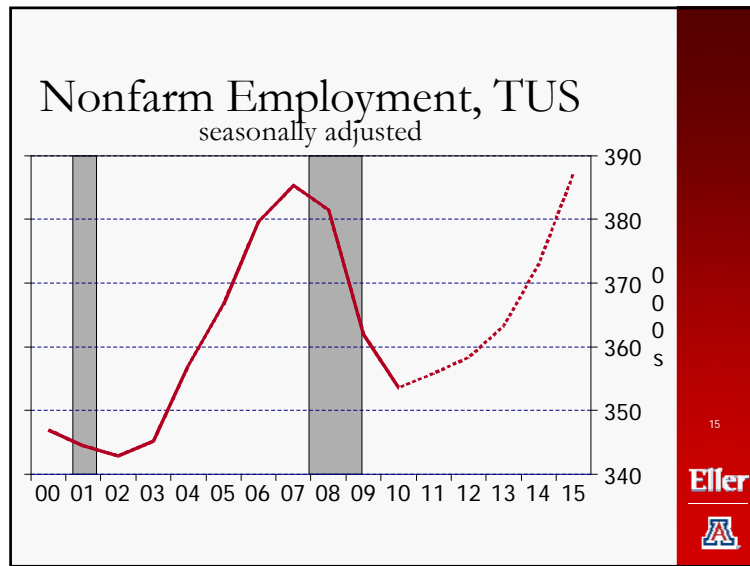
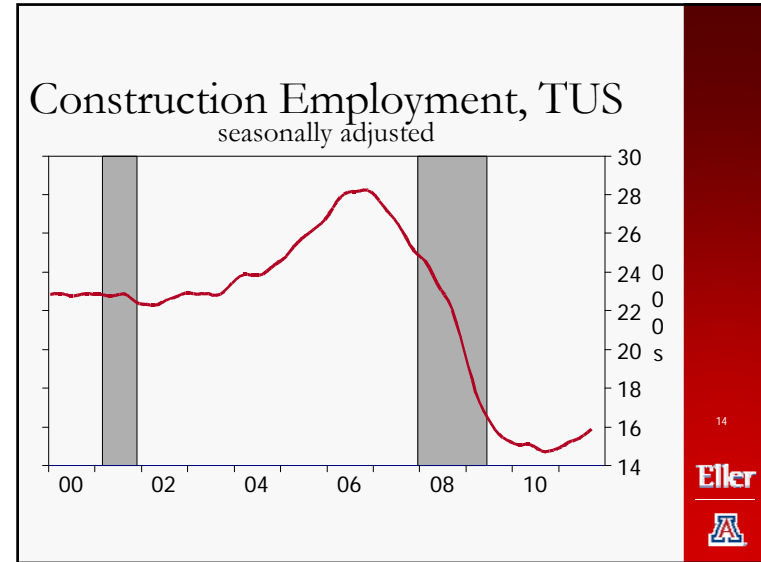
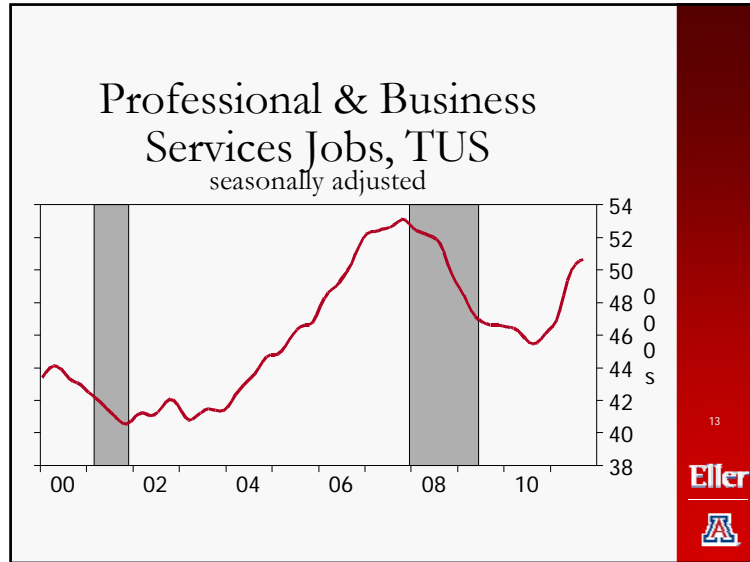
## PRIVATE SECTOR WAGES

- Jumped by 5.7% in 2011Q1
  - In 2009Q1, wages fell nearly 2%
- Inflation-adjusted wages remain 2% below their peak

8







### CONSUMER SPENDING

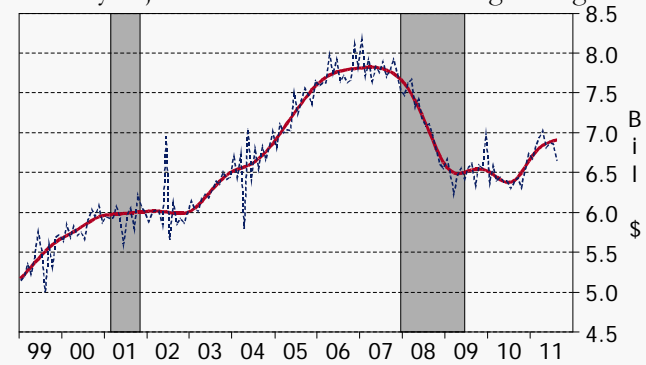
- Consumers still facing a long list of negatives
  - but spending anyway
- Retail sales up 9.1% through October (Y/Y)
  - Led by grocery stores and motor vehicles
- Restaurant & bar sales have fully recovered

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### Retail Sales, TUS

seasonally adjusted annual rate and moving average

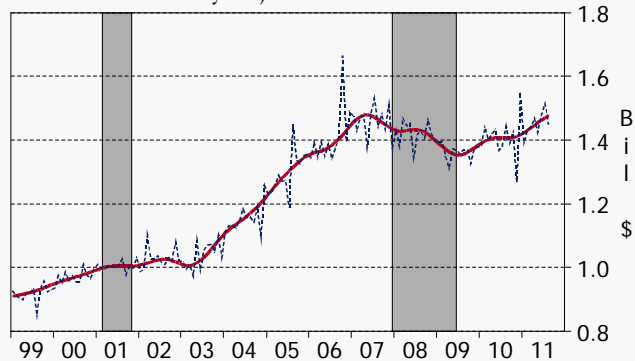


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### Restaurant & Bar Sales, TUS

seasonally adjusted annual rate

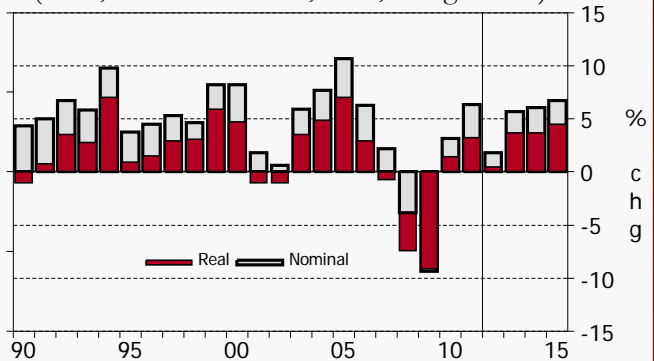


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### Retail Sales Growth, TUS

(retail, restaurant & bar, food, and gasoline)



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## HOUSING FUNDAMENTALS

- Positives
  - Housing affordability at record highs
  - Pent-up demand is increasing
- Negatives
  - Credit access still hard
  - Foreclosures high and huge backlog
  - Half of AZ homeowners with mortgages have negative equity
  - Massive overhang of empty homes
  - Household formation at decades low
  - Employment growth is slow

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## HOUSING MARKETS

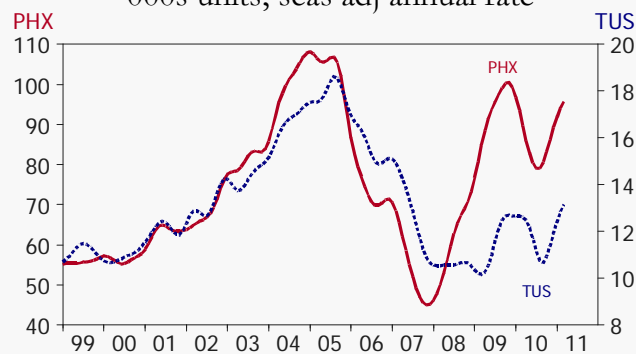
- Existing homes sales are headed higher
  - Strong investor demand
- Inventories very lean
  - 5-month supply in TUS
- Foreclosures notices down 15% this year
  - but still high
- Delinquency rates still very high, over 10%
- Prices are still falling
- Little construction of new units

22



## Existing Home Sales, MLS

000s units, seas adj annual rate

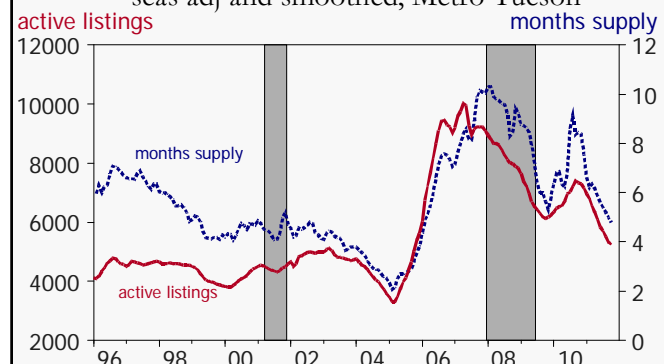


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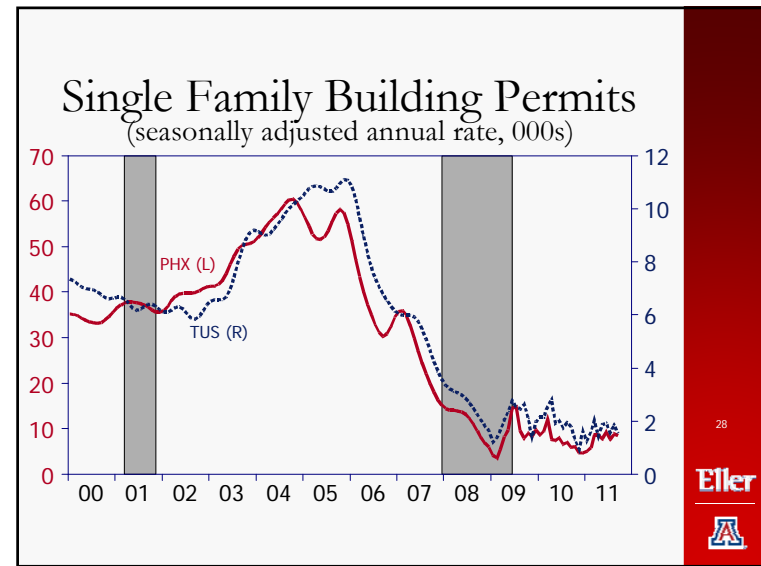
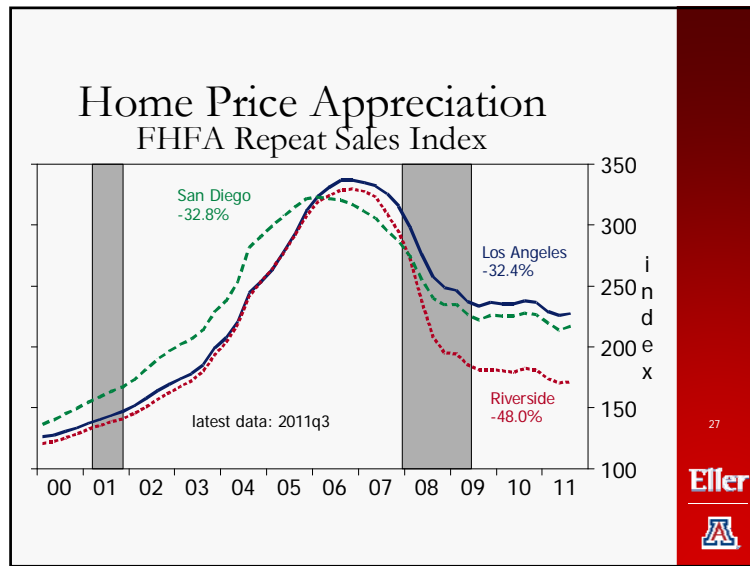
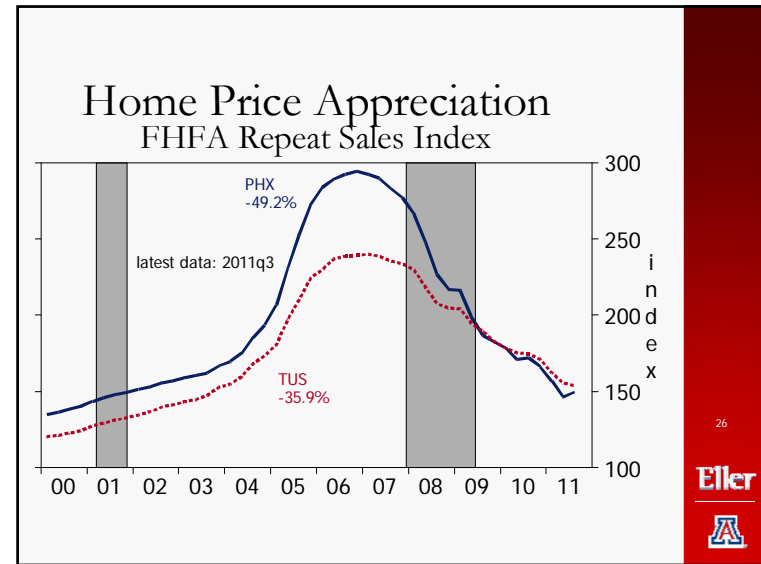
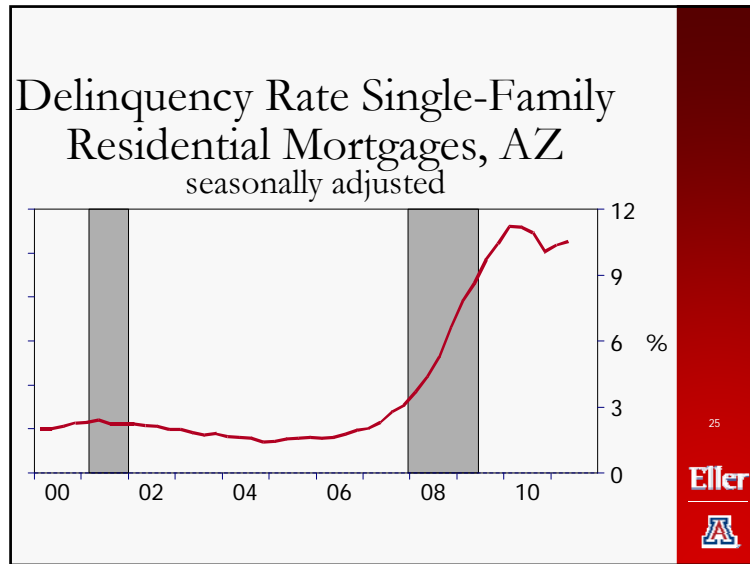
## Housing For Sale Inventory, MLS

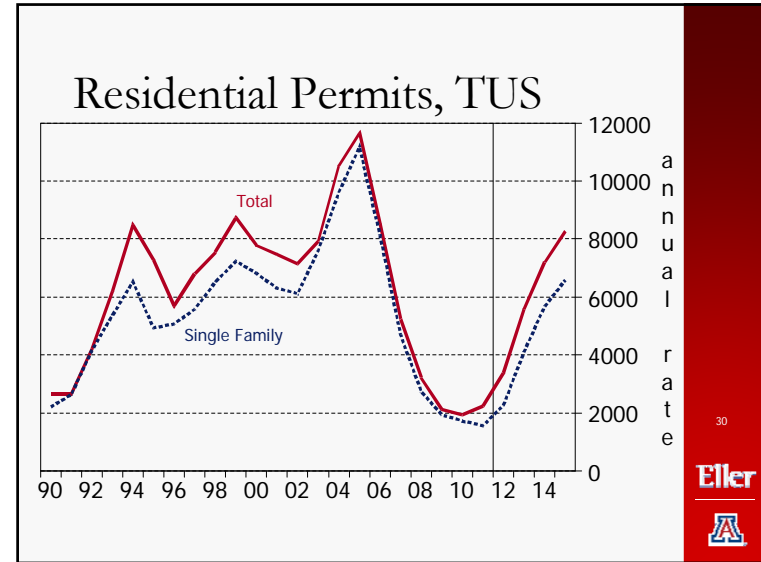
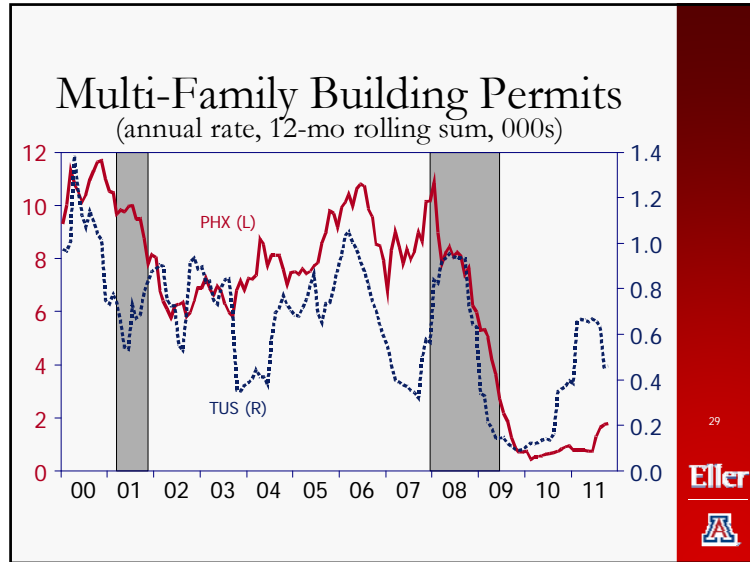
seas adj and smoothed, Metro Tucson



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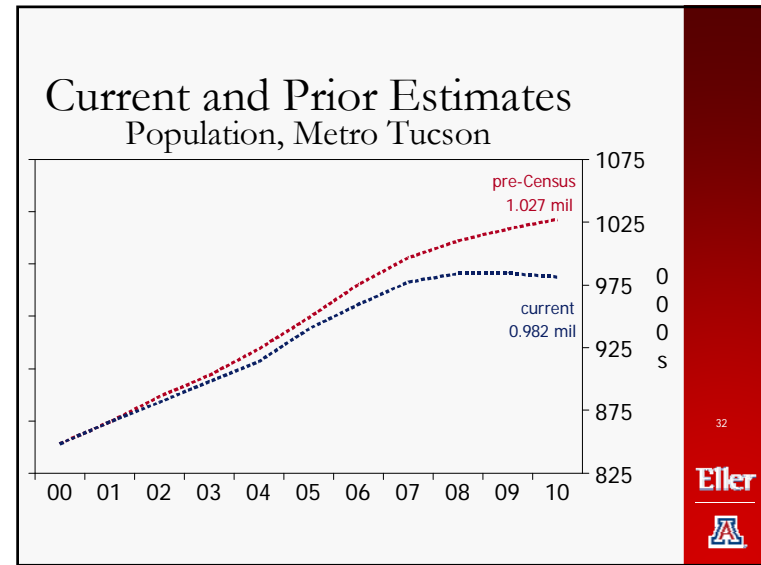


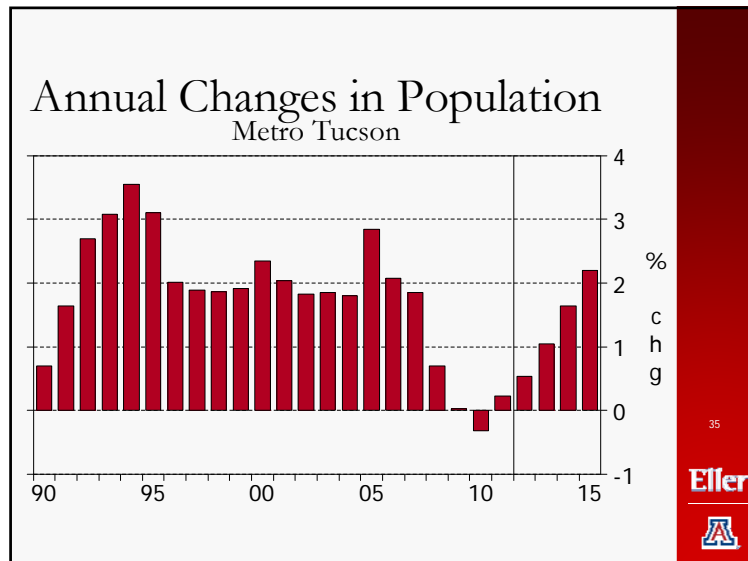
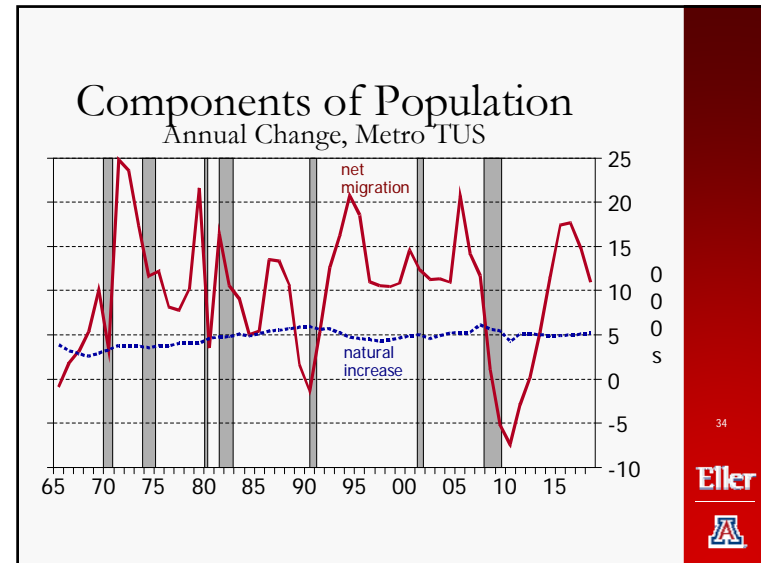
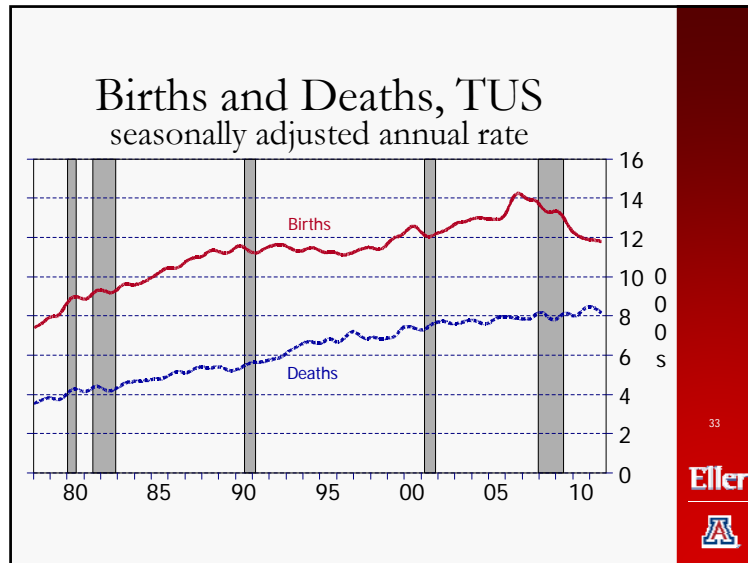




## DID POPULATION DECLINE?

31





### THE OUTLOOK

- Recovery in AZ is strengthening
  - No longer bouncing along the bottom
  - Most measures showing improvement
  - Acceleration as 2011 comes to an end
  - Still fragile, a lot of ground to make up



## THE OUTLOOK

- Pace of recovery should accelerate into 2012 and beyond
  - Slow by historical standards, restrained by
    - Housing markets
    - Reduced mobility of population
    - Lack of confidence
    - Cautious spending and hiring
    - Drag from public sector
- By 2015, damage from recession will be repaired
- On the road and making progress...

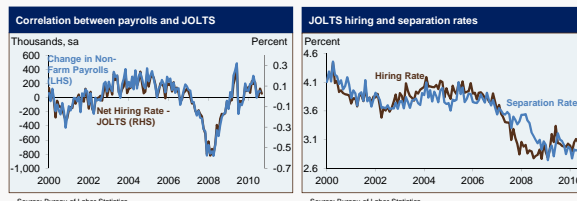
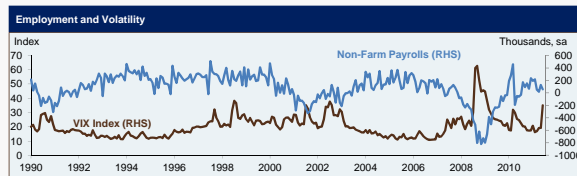
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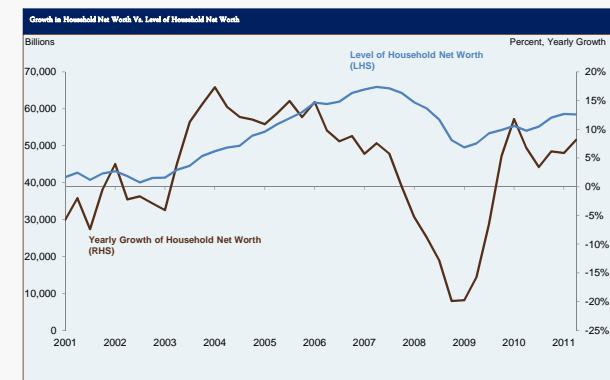
ANTHONY CHAN

Managing Director & Chief Economist  
J.P. Morgan Private Wealth Management

## WHY DOES EMPLOYMENT GROWTH REMAIN SLUGGISH?



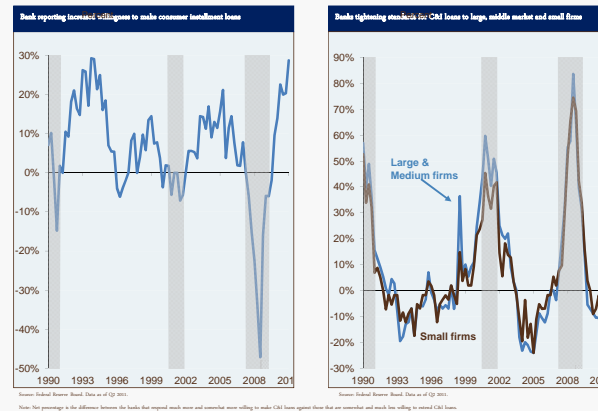
## DO CONSUMER'S HAVE ENOUGH WEALTH TO INCREASE SPENDING?



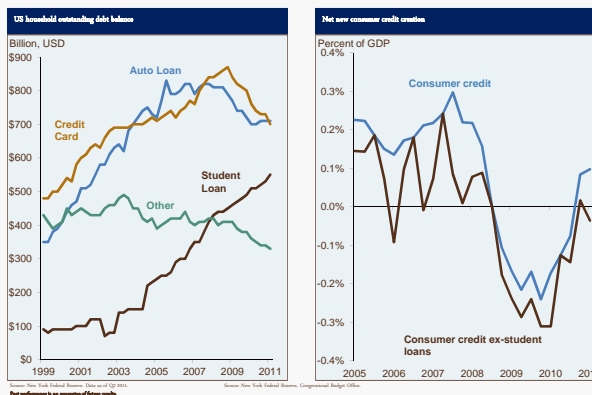
### CONSUMER'S NEED ADDITIONAL INCOME TO FUEL MORE SPENDING



### FEDERAL RESERVE SENIOR LOAN OFFICER OPINION SURVEY ON BANK LENDING

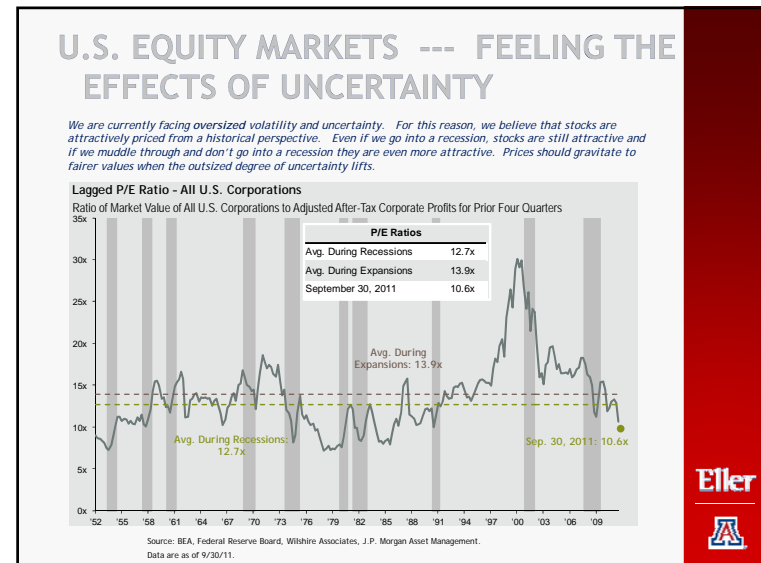
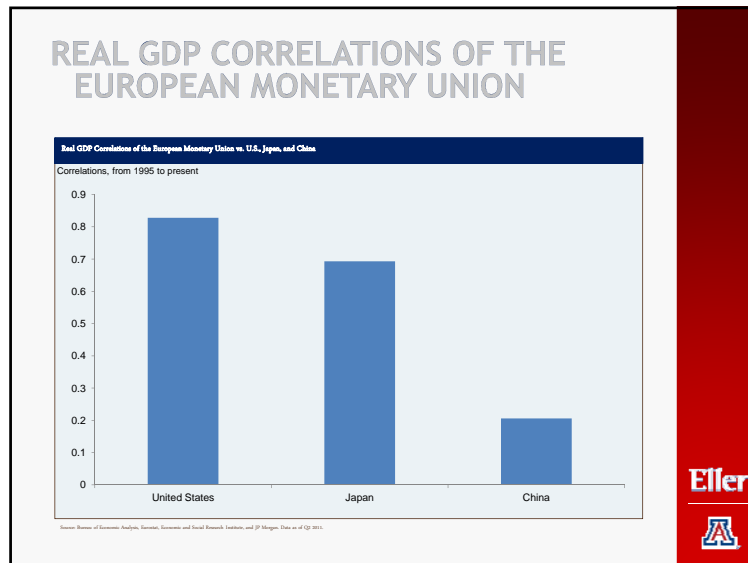
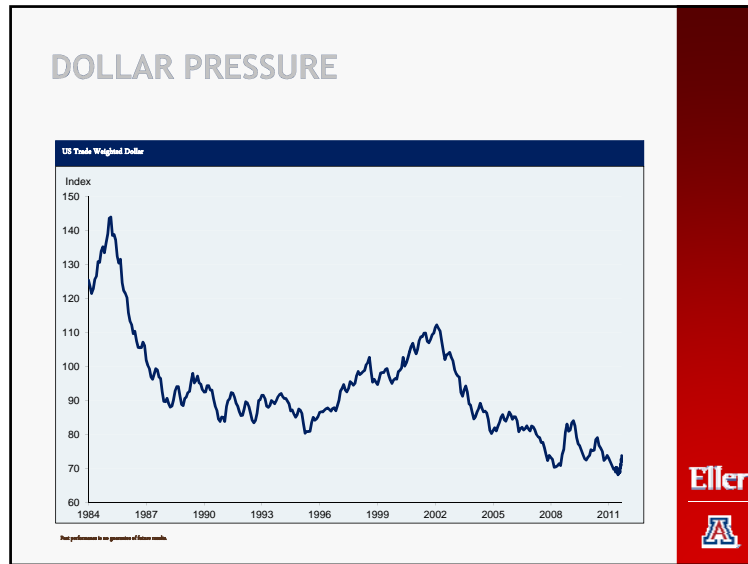


### CREDIT GROWTH



### BUSINESS SECTOR GRUDGINGLY EMBARKS ON SOME DEBT GROWTH

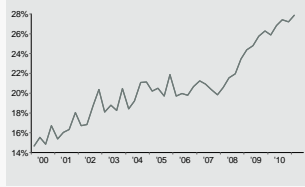




## UNCERTAINTY HAS ALSO PERMEATED THE U.S. CORPORATE SECTOR

The degree of uncertainty extends to corporate behavior. Huge amounts of cash are sitting on corporate balance sheets while dividend payouts are hovering at low levels. A reduction of uncertainty and an increase in business sentiment would unleash animal spirits and lead to faster employment growth and faster economic growth. The problem is that achieving this state of nirvana will not be easy.

**Corporate Cash as a % of Current Assets**  
S&P 500 companies – cash and cash equivalents, quarterly



**Dividend Payout Ratio**  
S&P 500 companies, LTM



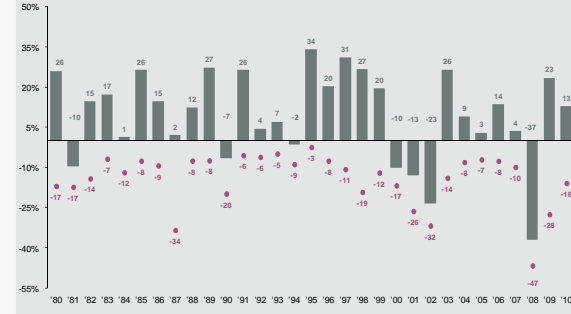
Source: Standard & Poor's, FRB, Bloomberg, FactSet, J.P. Morgan Securities, J.P. Morgan Asset Management. (Top left) Standard & Poor's, FactSet, J.P. Morgan Asset Management. (Top right) Standard & Poor's, FactSet, J.P. Morgan Asset Management. Data are most recent as of 9/30/11. It is not possible to invest directly in an index. Please see definitions of indices on pages 12 and 13 for more information. Past performance is not indicative of future results.



## VOLATILITY DOESN'T ALWAYS ELIMINATE POSITIVE RETURNS

Although volatility is very unpleasant, the record shows that stocks can go up even during periods of elevated volatility.

**Intra-year Declines vs. Calendar Year Returns**  
Despite average intra-year drops of 14.3%, annual returns positive in 24 of 31 years



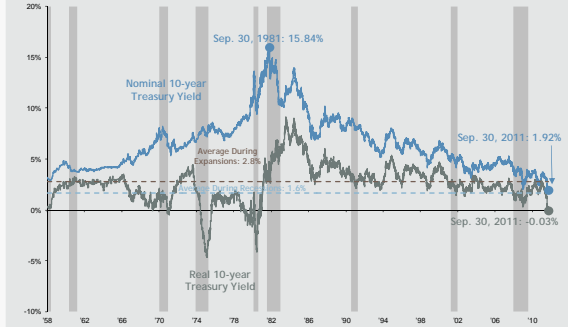
Source: Standard and Poor's, FactSet, J.P. Morgan Asset Management. Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops over periods of 6 months or less. For illustrative purposes only. Data are as of 9/30/11. Past performance is not indicative of future results.



## BUBBLE LIKE BEHAVIOR IN U.S. TREASURY MARKETS

Almost by any metric one uses --- it appears that a bubble in long-term Treasury yields has been induced by the Fed's Quantitative Easing and Operation Twist strategies should unwind at some point. This is a trend that will not last over the life of these long-term securities.

**Nominal and Real 10-year Treasury Yields**



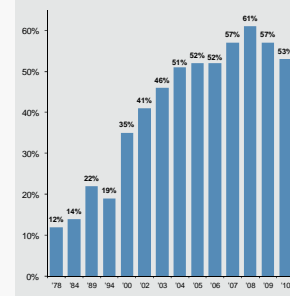
Source: Federal Reserve, BLS, J.P. Morgan Asset Management. Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core inflation for that month except for September 2011 where real yields are calculated by subtracting out August 2011 year-over-year core inflation. Data are as of 9/30/11.



## IS THE U.S. LOSING CONTROL OF ITS FUTURE DESTINY?

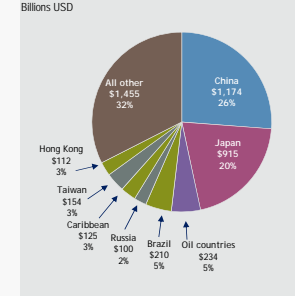
Another ominous trend is that the United States is losing some control over its long-term destiny given the growing share of foreign ownership of its Treasury securities. It is hard to believe that the U.S. influence will remain as dominant as it once was if this trend persists.

**% of U.S. Treasuries Owned by Foreigners**



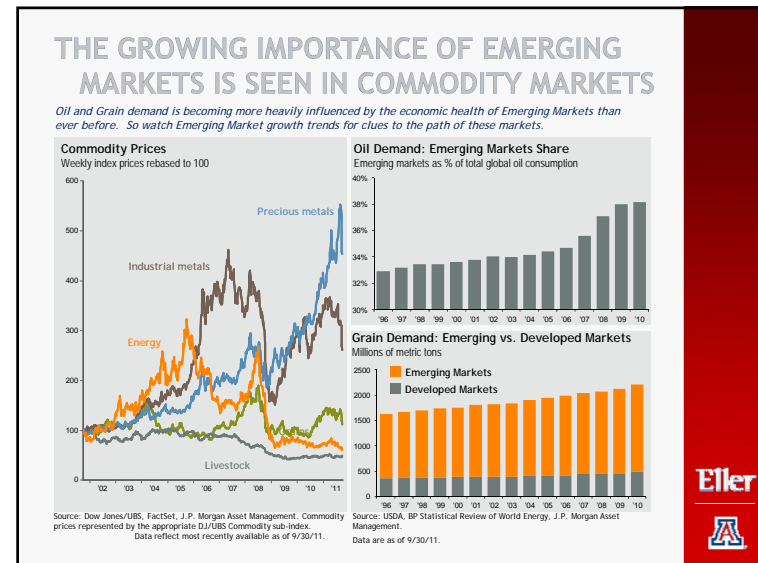
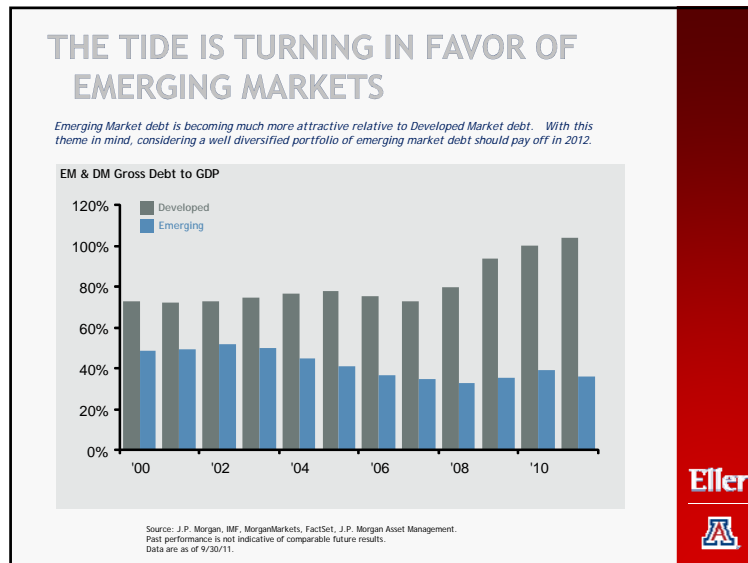
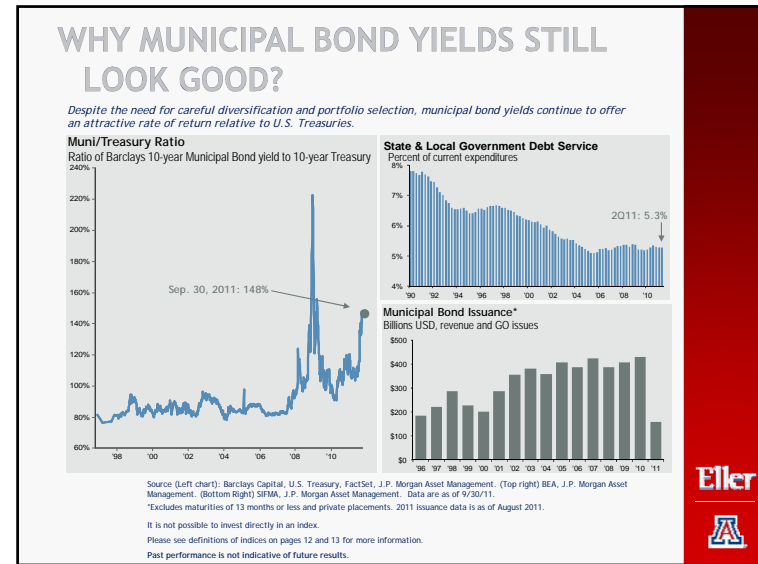
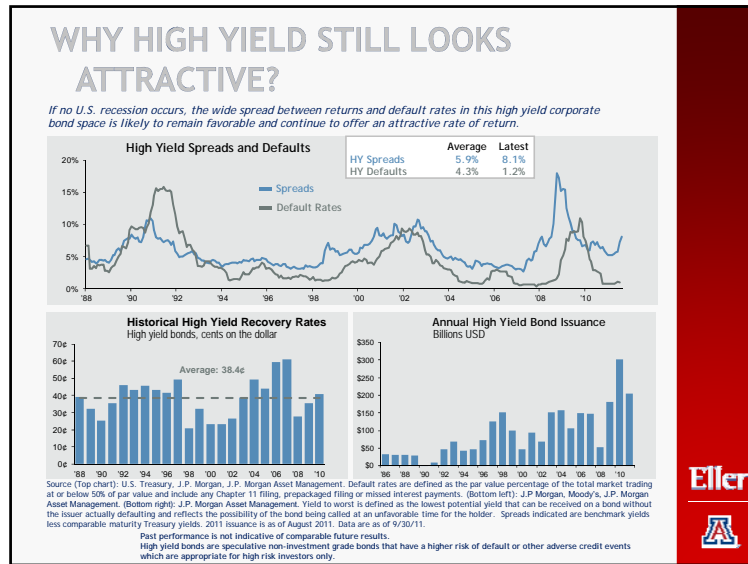
Source: J.P. Morgan Asset Management, U.S. Treasury Department TIC. Data reflects most recently available information as of 9/30/11, published by the U.S. Treasury in April 2011 for the period ending 6/30/10. Based on long-term marketable securities less bills outstanding.

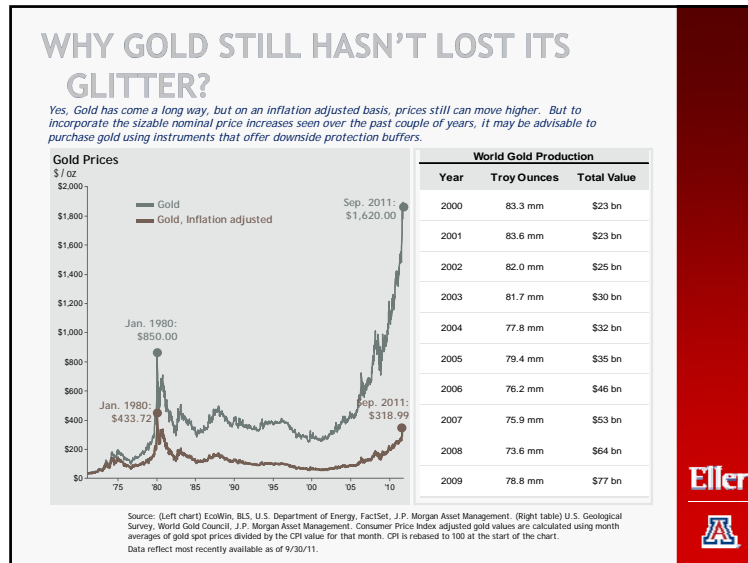
**Foreign Holders of U.S. Treasuries**



Source: J.P. Morgan Asset Management, U.S. Treasury Department TIC. Caribbean Banking Centers include Bahamas, Bermuda, Cayman Islands, Netherlands Antilles and Panama. Oil countries include Ecuador, Venezuela, Indonesia, Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Algeria, Gabon, Libya and Nigeria. Data on this page are updated annually each June to reflect revisions by Treasury. Data are as of July 2011.







## GERALD J. SWANSON, Ph.D.

Professor Emeritus of Economics  
Thomas R. Brown Professor  
in Economics Education

## CURRENT DEBT CRISIS

- ◉ Countries caught between a rock and a hard place

## CURRENT DEBT CRISIS

- ◉ United States is currently suffering from a bad case of the UN's

## THE UN'S

- UNEMPLOYABLES
- UNDERPERFORMING
- UNCERTAIN
- UNTRUSTWORTHY
- UNFUNDED
- UNSUSTAINABLE



## THIS AFTERNOON

- Focus on the implications of our unsustainable budget policy
- Compare our budget situation to the debt crisis taking place in Europe



## PUTTING THINGS IN PERSPECTIVE

- Germany is
  - 35% larger than France
  - 55% larger than Italy
  - 125% larger than Spain
  - 1000% larger than Greece
- United States is approximately
  - 400% larger than Germany
  - 4000% larger than Greece



## HISTORY OF EUROPEAN UNION

- Masstricht Treaty 1992
  - Created European Union - 27 countries
  - Set date for adoption of common currency - the Euro
- January 2002 - 17 European Union countries adopt the Euro



## EURO PROBLEM IN A NUTSHELL

- A common currency presupposes a **single government** with **fiscal and monetary** tools to protect it and the **political unity** to do so.



## FACT

- The European countries that are in crisis have more government than their economies can afford.



## SIZE OF GOVERNMENT PERCENTAGE OF GDP 2010

	<u>General Government</u>	<u>Central Government</u>
Ireland	67% GDP	59% GDP
France	57% GDP	25% GDP
Portugal	51% GDP	39% GDP
Italy	50% GDP	29% GDP
Greece	50% GDP	39% GDP
Germany	48% GDP	16% GDP
Spain	46% GDP	19% GDP
USA	40% GDP	25% GDP



## CRITERIA TO JOIN EURO-ZONE

- All states had to have their financial houses in order
  - Inflation at 1.5% or less
  - Budget deficits at **no more than 3%** of GDP
  - Debt to GDP ratio of **less than 60%**



### WHO IS MEETING THE CRITERIA?

- Only two countries
  - Poland
  - Czech Republic



### WHO IS MEETING THE CRITERIA?

#### Debt as a percentage of GDP

- 60% criteria

Japan	225%
U.S.A.	94%
Greece	160%
Italy	120%
Ireland	95%
Portugal	93%
Germany	84%
France	82%
Spain	60%



### WHO IS MEETING THE CRITERIA?

#### Deficit as a percentage of GDP

- 3% criteria

Japan	8.4%
U.S.A.	9.8%
Greece	10.5%
Ireland	10.0%
Spain	9.2%
Portugal	5.9%
France	5.7%
Italy	3.2%
Germany	2.5%



### CRISIS COUNTRIES

- PIGS
  - PORTUGAL
  - IRELAND
  - GREECE
  - SPAIN
  
- PLUS ITALY



## ITALY

- Too big to fail - to big to bail
- Third largest economy in Europe
- Debt 120% of GDP



## THE ITALIAN PROBLEM

- Do the math
  - Debt X interest rate = Interest on the debt
  - Debt 120% of GDP X 7% = 8.4% GDP debt service
- 8.4% OF GDP needed to pay interest on debt



## ITALY

- Problems
  - Aging and shrinking population
  - High risk premium on bonds
  - Second biggest debt in EU
  - Huge unfunded pension liability
  - Dysfunctional political system



## WHY ISN'T U.S. ON CRISIS LIST?

- Gross debt ratio to GDP - 94%
- Deficit as a percentage of GDP - 9.8%
- Huge unfunded liabilities - \$110 trillion
- Aging population
- Dysfunctional politics



## SOLUTIONS TO EURO CRISIS HOBSON'S CHOICE

- Work to meet criteria
  - Surrender budget sovereignty
  - Higher taxes
  - Major budget cuts
  - Liberalization of labor markets
  - Tolerate major recession
- Leave the Euro Zone
  - Default
  - Capital flight
  - Adopt old currency
  - Devalue old currency
  - Tolerate major recession



## CONCLUSION

- Lessons from crisis
  - Never become a
    - High tax
    - Slow growth
    - Entitlement state
  - Because the inevitable day of reckoning will be
    - Nasty
    - Painful
    - And not short



## CONCLUSION

- The Euro crisis could become our crisis
- We need **long-term solutions** to our debt and deficit problems now
- Not **election cycle solutions**



## GOOD NEWS

- Our economy is improving very slowly
- We need to change the UN's UM's




**YOUR ASSIGNMENT TO HELP  
IMPROVE THE ECONOMY**

- Don't go back to work today
- Go out ...

...and shop shop SHOP!

Happy Holidays!



**ECONOMIC  
OUTLOOK  
2012-13**

The University of Arizona's  
31<sup>st</sup> Annual  
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