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Arizona 2012 forecast: Still sick, but recovering

December 07, 2011

If Arizona's economy were a hospital patient, she would be out of intensive care, but still in the hospital. In other words, the economy is doing better and certainly on the road to recovery, but it isn't recovered yet. And the patient is not likely to feel healthy again for another couple of years: the economy won't be back to normal until at least 2015 or so.

That was the assessment shared by Lee McPheters , director of the JPMorgan Chase Economic Outlook Center at the W. P. Carey School of Business, and real estate expert Elliott Pollack, president of consulting firm Elliott D. Pollack and Company. The two gave their patient prognoses December 7 at the 48th Annual Economic Forecast Luncheon, co-sponsored by the economics department at the W. P. Carey School of Business and JPMorgan Chase.

Arizona's real estate market: "agonizingly slow" recovery

Arizona's real estate market, said Pollack, will continue its "agonizingly slow recovery" in 2012, which is likely to be better than 2011. "You don't go from having a heart attack to running a marathon overnight," Pollack explained. "The problem is on its way to being resolved, but it's not resolved yet."Elliott Pollack's slides

Pollack said the root of the problem in the housing market is excess inventory -- and the solution will come from a depletion of that excess inventory. "Think of what's going on in the housing market as what would be going on at any manufacturer or retailer who found themselves with a substantial oversupply of a product (in this case, 50-55,000 housing units in Greater Phoenix). The product would be put on sale. If it didn't sell at a certain price, the price would then be lowered until the seller found a market clearing price."

"That's exactly what's going on in the housing market at the moment," Pollack said. "Think about what happens, though, once the excess supply is sold. If there is a normal demand for the product, prices would jump up rapidly and new production would increase. That's exactly what will happen to the housing market." When? "Somewhere around 2015."

Moving from single-family housing, Pollack called the apartment market the "brightest spot we've had in many years." Vacancy rates fell from 14 percent in 2010 to 10 percent in 2011. "And while there are a lot of apartments in the planning stage, there are only 1,177 under construction at the moment. Thus, vacancy rates are likely to decline farther, putting significant upward pressure on rents. This will bring forth new construction."

Pollack's assessment of the other commercial sectors was not as optimistic. "Roughly one out of every four square feet of office space in the metro area is vacant," he said. "Given the outlook for employment (slow growth), there will be no serious improvement in 2012 or 2013 and a full recovery will probably not take place until about 2016."

Pollack said that the market for industrial space looks better than for office space, but only by a bit. "Vacancy rates fell to 12.2 percent in the third quarter from 12.8 percent at the end of 2010," Pollack said. Build-to-suit projects make up 87.5 percent of industrial construction activity.

The retail real estate market is having problems, too, which Pollack said is not unexpected -- given low population growth and the relatively modest recovery in retail sales. At the end of the third quarter the retail vacancy rate was 12.4 percent, up a bit from the end of 2010. "The recovery will be slow here too, extending to the middle of the decade," Pollack said.

Like the housing market, the commercial real estate markets are "in the process of getting better," Pollack said. "The good news is that they're not getting worse."

Arizona employment: job growth positive, but still below average

According to McPheters, Arizona will end 2011 as a top ten growth state, now adding jobs faster than the national average, after a weak start in the first half of this year. But that doesn't reflect a roaring recovery -- Arizona's job growth is still below its long-term average (3.7 percent), and lower than during previous recoveriesLee McPheters' slides

The jobs that Arizona's economy has added since employment bottomed out represent just twenty percent of the 324,000 jobs Arizona lost since the peak in late 2007. "Neither this year's job growth, nor next year's job growth, will be sufficient to effect a large change in unemployment or in consumer confidence," McPheters said.

Not recovered yet, but the patient is getting better: Arizona employment is expected to increase by 45,000 jobs -- 1.8 percent -- in 2012. That compares to a 1.0 percent growth rate (23,800 jobs) in 2011. And some industries, of course, will fare better than others. "Industries expected to expand employment in 2012 include health care, transportation and warehousing, trade, and activity related to leisure and hospitality," McPheters said.

"Arizona health care employment has been particularly recession resistant, adding more than 50,000 jobs in the past five years. Arizona currently ranks second among all states in the rate of growth in the health care industry," McPheters explained. Manufacturing jobs were up too, he said, for the first time since 2006. Manufacturing employment grew 1.5 percent in 2011 and is forecast to grow another 2 percent in 2012.

Government jobs, on the other hand, decreased in the past three years (for the first time since 1981). "Government jobs are usually a source of stability, but now they are subtracting from growth," McPheters explained. Those declines can be attributed to slower rates of population growth (many local government jobs are tied to population), as well as "cost cutting and leaning" at the federal and state levels.

"When population recovers, local government employment will rise. But federal and state jobs are not likely to be future source of employment growth," McPheters said.

A different kind of consumer

In cycles past, consumers drove the economic recovery. But where consumers used to be the driving force in the economy, McPheters said, they won't be in the years ahead.

Pent-up demand for purchases like motor vehicles pushed retail sales up significantly. Arizona retail sales rose 7.5 percent in 2011 and are forecast to increase by 8 percent in 2012. But otherwise, consumer expenditures "have not been robust in this recovery either at the national level or in Arizona," McPheters said.

McPheters added, "Instead of spending, consumers have sought to deleverage, paying down debt and increasing saving beyond the near-zero levels of the mid-decade. Falling home prices and stock market gyrations have reduced consumer net worth and consumer confidence has been persistently low."

"In the 1970's, women entered the workforce to boost family income, which allowed the middle class to spend more," McPheters explained, "but then real wages per worker stopped increasing as much. So over the last decade consumers offset weak wage growth by borrowing, in large part against their homes. Now that's much harder to do. Families now have to make ends meet with the resources they have, so they're saving for the larger expenditures like vacations and even autos."

McPheters said that part of the "new normal" is that consumers are not as willing to go into debt. Which means, for now at least, less spending.

Population growth a "key catalyst" for economic recovery

What Pollack described at the housing market "problem" he said boils down to two factors: "There are still too many vacant units and there are too few new households." The excess inventory he talked about as the root cause of the housing market's ills won't dissipate until population growth speeds up.

Pollack's prognosis was this: "The good news is that the patient is getting better. But he will not get better rapidly, he will get better slowly. It could take another three plus years for a full recovery. By that time, prices will be up substantially. How quickly this happens really depends on population growth and employment growth."

Indeed, McPheters said that population growth has historically been "a key catalyst" for economic expansion in Arizona. "The typical pattern of recovery has seen population flows to the state increase in response to job opportunities, very often accompanied by a boom in housing and commercial construction." Not so this time around.

"In the current cycle, inflow is affected by stagnant real estate markets across the nation. Newcomers cannot sell their homes and relocate to Arizona." Population is projected to increase by 1.5 percent in 2012 -- far below the 3.3 percent population growth Arizona experienced in the boom years of 2005 and 2006. Again, recovering, but still sick.

Arizona and the West shall rise again -- but not tomorrow

It used to be that Arizona led the nation in economic recovery -- in large part driven by population growth and construction activity. But not so this cycle, McPheters said. "All of the headwinds restricting growth at the national level apply to Arizona. Although the Arizona recovery is tepid at best, every key indicator is expected to be improved in 2012 compared to 2011, including jobs (up 1.8 percent), incomes (up 6 percent), and retail sales (up 8 percent). But no indicator will be sharply better until the national economy moves onto a faster growth path."

That's not, however, to say that Arizona won't once again be a leading growth state. "In every other recovery Arizona was a top five growth state 3-4 years after the end of the recession. Arizona will be again," McPheters explained.

"For now, Arizona is just following along the national trend. But nothing fundamental has changed. Arizona is still attractive (in fact, Arizona once again has relatively affordable housing). There is pent up demand to move here. As home prices stabilize nationally and job opportunities in Arizona improve, then population inflows to Arizona will accelerate."

Then -- and it's not likely to be before 2015 -- we might discharge the patient from the hospital as having fully recovered.

Bottom line

- In Arizona's real estate market, 2012 is likely to be better than 2011, but the recovery will continue to be slow. Prices for single-family houses and new construction starts likely won't be significantly better until 2015.
- Apartments are the lone bright spot in commercial real estate, with vacancy rates down to 10 percent in 2011 from 14 percent in 2010. The office space market might improve by 2014, with full recovery in 2016 or so. The market for industrial space is only a bit better, with build-to-suit projects representing most of the activity. Retail vacancy rates were actually up a bit from 2010. Not recovered yet, the commercial real estate markets are in the process of getting better.
- Arizona employment is expected to increase by 45,000 jobs -- 1.8 percent -- in 2012. That compares to a 1.0 percent growth rate (23,800 jobs) in 2011. But it's still below Arizona's long-term average employment growth (3.7 percent), and lower than during previous recoveries.
- Pent-up demand for purchases like motor vehicles pushed retail sales up significantly. Retail sales rose 7.5 percent in Arizona in 2011 and are forecast to increase by 8 percent in 2012. But where consumers used to be the driving force in the economy, they won't be in the years ahead.
- Population growth has historically been "a key catalyst" for economic expansion in Arizona. Not so this time around. Population is projected to increase by 1.5 percent in 2012 -- far below the 3.3 percent population growth Arizona experienced in the boom years of 2005 and 2006.
- It used to be that Arizona led the nation in economic recovery. But not so this cycle. While every key Arizona economy indicator is expected to be improved in 2012 compared to 2011, including jobs (up 1.8 percent), incomes (up 6 percent), and retail sales (up 8 percent), no indicator will be sharply better until the national economy moves onto a faster growth path.