

**GROWTH ON
THE HORIZON**

**2005
Economic
Forecast**



At long last, after two years of an economic “recovery” during which the US economy lost almost 1.1 million jobs, it’s finally time to break out the champagne. Employment growth resumed in September 2003, albeit only 67,000 jobs. In February 2004, for the first time in almost three years, more people were at work than during the same month a year earlier. At mid-year 2004, although employment was still 1.2 million below its March 2001 peak, the nation had regained over half of the 2.8 million jobs lost when the longest expansion in the nation’s history came to an end. Since January, job gains have averaged more than 200,000 per month, typical for a period of economic growth.

Between its low point in the third quarter of 2001 and the second quarter of 2004, output (real gross domestic product) has expanded by 9.2%. Growth averaged 2.8% in the second quarter, well below the revised 4.5% in the first quarter. Personal consumption expenditures decelerated sharply, as did national defense spending. Exports and residential fixed investment (housing) accelerated.

The Good

Consumers have been the driving force in the economic expansion. Consumer spending accounted for 72% of the 3.1% growth in output in 2003, while spending on housing (considered a consumer investment) accounted for another 12%. Business investment, government spending and net exports together added barely half a percentage point to 2003 growth. In 2002, consumers accounted for all of the output gain.

Despite slowly rising home mortgage rates, sales of new single-family homes rose 19.1% through June after increasing 11.6% in 2003. Sales of existing single-family homes increased 11.4% in the first six months of 2004, on top of a 9.6% gain in 2003. New residential construction also remained strong, with housing permits up 8.1% in 2003 and another 12.5% in the first six months of 2004. Single-family construction was stronger than multifamily, up 14.1%.

Growth is evident in other sectors of the national economy, as well. In the *business* sector, industrial production in June was 5.6% above its year earlier level, although slightly below what was reported for May. The capacity utilization rate was 77.2%, below its long-term average of 81.7% (1972-2003) but near the mid-point of the 70.9-85.2% range over that period. Available capacity is probably overstated because it fails to adjust for obsolete capital equipment and a faster pace of scrapping. The Manufacturers Alliance Business Outlook Index reached a 32-year high in June, indicating a

“real, robust expansion of manufacturing activity.” The Services Index signaled strong expansion in that sector of the economy. Small businesses were very optimistic at mid-year. Capital spending and hiring plans were strong, according to the National Federation of Independent Business and pricing power was increasing.

The expansion appears to have taken hold in other parts of the world, boosting US exports by 6.1% in the second quarter. Growth in Western Europe, where the recovery has lagged in Germany, France, Italy, the Netherlands and Portugal, was stronger than expected in the first quarter and manufacturing exports are up. A sustainable recovery seems to be underway in Japan after 12 years of economic stagnation. The Chinese government is attempting to slow the blistering pace of growth there (it averaged 9.6% in the first half of 2004) to around 7%. Industrialization continues to thrive, putting upward pressure on commodity prices. In 2003, it is estimated that China accounted for 30% of the global increase in demand for oil and 90% of the increased demand for steel.

The Bad

It’s the sweet spot in the business cycle – strong growth with low inflation and low interest rates. However, prices and interest rates were creeping up at midsummer and there is good reason to expect a slowing in consumer spending in 2005. Rising interest rates, a near-record debt burden and the lack of pent up demand are all negatives.

Personal income has not benefited to the extent one would expect in light of accelerating job growth. There are several reasons. A smaller percentage of the working age population is in the job market, down 0.8 percentage points since the recession’s end rather than the average 0.3 percentage point increase over the same period in the five previous expansions. The labor force

participation rate for 16-25 year olds has dropped 3.5 percentage points. In addition, there has been almost no increase in the average work-week, also atypical in an economic recovery. As a result, per capital personal income increased only 2.3% in 2003 and was up just 0.1% after adjustment for inflation. Sources of extra cash that augmented wage and salary income in recent years are disappearing – larger bonuses, larger tax refunds and home refinancing.

Consumer spending on durable goods declined in the second quarter of 2004 and retail sales fell sharply in June. Total retail sales, which grew at a 9.7% annual rate in the first quarter, slowed to 5.8% in the second. At mid-year, auto sales fell to their lowest level in six years as dealers eased back on loan rebates and loan discounts. Sales were down 1% in 2003, to 17 million units. Light truck sales (including vans and SUVs) accounted for 54.3% of the auto sales according to the National Auto Dealers Association, rising for the 11th consecutive year.

With the world economy in recovery mode, it is no surprise that commodity prices are soaring. Copper, tin, aluminum, platinum, oil and natural gas prices have surged in the last year. The *Economist* index of commodity prices was up 25% over the 12 months ending in June and indexes of spot prices for many individual commodities are at their highest level in 25 years. At mid-year, 29% of small businesses reported higher selling prices, the highest reading in the 20-year history of the series. This has not yet led to a significant increase in retail prices and consumer inflation, but the signs are there.

Core **inflation**, which averaged 1.1% in 2003, reached 2.6% in the first half of 2004. Consumer prices rose 2.3% in the 12 months ending in July, equal to their increase for all of 2003. For the month, prices were up 3.0%, with the cost of medical care up 4.5% and the cost of food and beverages up 3.8%.

Energy prices, particularly oil and gas, have been major contributors to accelerating inflation. Two-thirds of the 2004 gain was due to energy prices rising at a 36% seasonally adjusted annual rate. Petroleum-based energy costs were up 65.5%. In 2003, energy costs increased only 6.9%.

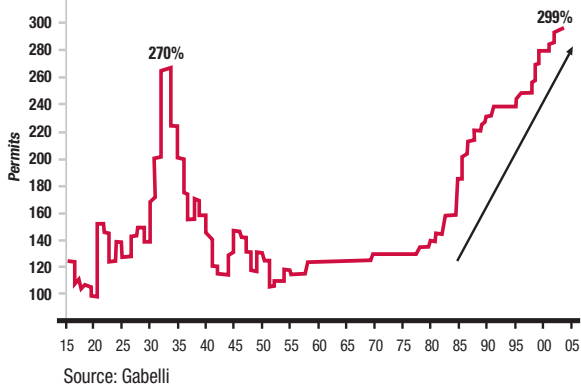
Interest rates are also climbing. The Federal Reserve raised the overnight Federal Funds rate in June, reversing a decline that began in January 2001. The 90-day Treasury bill reached a low of 0.9% in January, then climbed to 1.26% in June. The 10-year Treasury bond rose to 4.73% at mid-year from its low point of 3.33% a year earlier. The 30-year conventional mortgage rate has increased steadily from its low of 5.23% in June 2003 to 6.29% in June 2004. The rising use of cap-rate float-down mortgages that allow homebuyers to lock in low mortgage rates for up to a year has delayed the impact of rising mortgage rates on housing sales. However, rising rates make it unlikely that the recent pace of home and auto sales will continue.

The Ugly

The possibility of a bubble in housing prices has received a great deal of attention. More troubling is the financing that is supporting those prices. Local realtors report that they have not seen the plethora of innovative mortgage products being used today since the early 1980s. Not only do homebuyers use cap-rate float-down mortgages, they are taking out interest only loans, no-document loans (requiring no proof of income) and loans that require no down payment. Sub-prime mortgages for people with poor credit ratings have risen from \$17 billion in 1995 to \$195 billion in 2003. No-money-down loans have soared from less than \$1 billion to almost \$80 billion.

Debt is the biggest threat to the continuation of the economic expansion. Bill Gross, the bond guru at PIMCO, argues that the global economy is more imbalanced than at anytime in the last 25-30 years. His fundamental proposition is that bad things can happen in a leveraged economy. Problems arise when the maturity or distribution of the debt becomes imbalanced. Too much short-term as opposed to funded long-term debt has caused many a personal, corporate, and in some cases sovereign bankruptcy. Americans used to reassure themselves that we owe the debt to ourselves when confronted with mounting public deficits. Such was the case in the 1930s. Debt reached 270% of output but was dissipated by subsequent inflation in the midst of interest rate ceilings imposed during WWII and its aftermath.

Total Credit Market Debt (all sectors) as % of U.S. GDP



Today, debt has reached a new high of 299% of output and over 50% of outstanding Federal debt is held by foreign creditors. The global current account imbalance is the other side of our ongoing 5% of GDP trade deficit. If our foreign investors become less willing to hold our debt or demand higher returns on their investment, dollar depreciation is a legitimate response. And if that dollar depreciation is significant, swift – or both – then the economic and financial repercussions may be serious. Just as real short-term rates kept too low create asset bubbles and accelerating inflation, so real yields raised too high will pop existing asset bubbles and lead to economic recession.

The Future

Americans are incurably optimistic and will ignore the negatives for as long as possible. In addition, it's an election year and there are plenty of promises from politicians about how they

will make sure the economy hums along at high speed. 9/11 is ancient history and responsibility for the situation in Iraq is gradually being turned over to the Iraqis. Since perception is more important than reality in most cases, consumers are likely to spend their way through 2005, albeit at a slower pace, keeping the economic expansion in motion.

Output growth will average 3.3% in 2005, down from 4.1% in 2004 but strong enough to maintain employment growth. The unemployment rate will barely budge, averaging 5.4%, as discouraged workers return to the labor force. Housing starts will fall by 10.8% and auto/truck sales will contract by 3.6%, as rising interest rates, heavy debt burdens and little pent up demand cut into those sectors of the economy. Consumer inflation will accelerate to 3.1% as higher commodity prices work their way up the production chain. This will boost the 10-year Treasury bond rate to 5.9% and the 30-year conventional mortgage rate to 7.0%. The Federal Reserve will continue to raise short-term interest rates, albeit cautiously, pushing the 90-day Treasury bill rate to 2.5%.

The longer-term outlook for the expansion is dependent on consumers' ability to pay down debt out of income, rather than by cutting back on spending. It will require incredible luck and the proper alignment of all of the planets to accomplish this without a consumer led recession in the next few years.

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NATIONAL ECONOMIC INDICATORS

	2003	2004 ^e	2005 ^f	02/03	03/04 ^e	04/05 ^f
Gross Domestic Product (billions)	\$11,004.0	\$11,675.2	\$12,364.1	4.9%	6.1%	5.9%
Real GDP (billions of 1996 dollars)	\$10,381.3	\$10,806.9	\$11,163.6	3.0%	4.1%	3.3%
Unemployment Rate	6.0%	5.5%	5.4%	n/a	n/a	n/a
Housing Starts (million units)	1.85	1.85	1.65	8.1%	-	-10.8%
Auto/Truck Sales (million units)	17.0	16.5	15.9	-0.6%	-2.9%	-3.6%
Consumer Price Index (1982-84=100)	184.0	188.8	194.7	2.3%	2.6%	3.1%
90-Day Treasury Bill Rate	1.01%	1.30%	2.5%	n/a	n/a	n/a
10-Year Treasury Note Rate	4.01%	4.90%	5.9%	n/a	n/a	n/a
30-Year Conventional Mortgage Rate	5.82%	6.50%	7.0%	n/a	n/a	n/a

n/a = not applicable e = estimate f = forecast

The Colorado economy lagged the national economy coming out of the 2001 recession, with the Denver economy trailing even further behind. But, finally, in the second quarter of 2004, job growth was once again underway. Through June, 35,400 of the 117,500 jobs lost statewide since December 2000 had been regained.

Basic Industry

Basic industries are the sectors of the economy that bring new dollars into the state. They are the basis for growth, as the new dollars circulate through the economy. The most obvious examples are industries that produce goods sold outside of Colorado – manufacturing, agriculture and mining – but the state also exports services such as tourism, education, health care and business services. If a nonresident pays for them, the impact on the economy is the same.

Manufacturing: Manufacturing is Colorado's largest basic industry, accounting for 8.6% of gross state product in 2001 (the most recent data available). Productivity is high in manufacturing and it accounts for only 7.4% of the state's employment base, at an average salary of \$50,856 in 2003. The largest and most highly paid sector was computer and electronic product manufacturing, at 23% of total manufacturing jobs, paying an average salary of \$75,452, followed by petroleum and coal products manufacturing at \$68,744.

The outlook for Colorado's manufacturing industry is positive in 2005. The nation's information technology (IT) industry posted strong gains in 2003 and the first half of 2004, after plummeting in 2001 and languishing in 2002. Business outlays for IT equipment have surpassed the previous peak reached in the fourth quarter of 2000, fueled by the need to replace outdated IT equipment and the desire for productivity-enhancing technology. Consumers increased purchases at electronics and appliance stores at a double-digit pace in 2004.

Tourism: Travel across the nation continued to recover in 2003 and the first half of 2004, but remained below its pre-recession/pre-9/11 peak. The recovery has been driven by price-sensitive travelers in both the business and leisure market and, as a result, pricing is soft. Many of the major airlines are in bankruptcy; revenue per

available hotel/motel room remains below its pre-recession peak. However, total tourism-related sales made a positive contribution to output for the first time since 2000. Meeting and convention attendance rose 3.6% in 2003 and 7.8% in the final quarter of year.

The travel industry is the second largest generator of new dollars in Colorado, after manufacturing. Employment in the leisure and hospitality industry, a new category in the North American Industrial Classification System, was 11.4% of state employment in 2003, 245,500 jobs. It grew at an average annual rate of over 4% in the 1990s, reaching a peak of 250,900 jobs in November 2000, then declined through February 2004.

The occupancy rate at Colorado hotels and motels averaged 66.9% in June 2004, according to the Rocky Mountain Lodging Report. A year ago it was 65.8%. For the first six months of the year, occupancy averaged 56.3%, up from 55.0% in the first half of 2003. The average room rate fell in May and June, after rising in the first four months of the year relative to the same month a year earlier.

Airline traffic is soaring after a two year decline in 2001 and 2002. Passenger traffic at Denver International Airport rose 20.9% through June after increasing 5.2% in 2003. Traffic at the Colorado Springs airport rose 3.2% through June after falling 3.4% last year.

Agriculture: Gross farm income in Colorado was \$5,148.4 million in 2002 (data on farming and ranching only become available with a substantial lag), down 6.2% from a 5-year high in 2001. Cash receipts from the sale of agricultural commodities were \$4,880.5 million, with 71.7% from the sale of livestock and products and 28.3% from the sale of crops. Net farm income from the state's 31,400 farms (a gain of 500 from 2001) was \$711.2 million, down 35.8% and the lowest since 1997. Employee compensation (hired labor) rose 3.7% to \$364.4

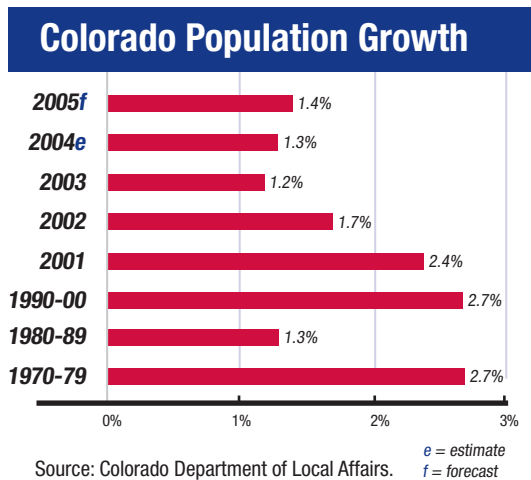
million, continuing its steady upward trend. Colorado ranked among the top five producers of sheep and lambs, cattle on feed, fed cattle marketings, market sheep and lambs, potatoes, sunflowers, carrots, lettuce, onions and spinach.

Mining: Rising petroleum and natural gas prices and an unrealistic desire for energy independence in the face of terrorism and trouble in the Middle East were good for Colorado's energy industry in 2003. State oil production is projected to reach 21.9 million barrels in 2004, up 2.8% from 2003 and 7.4% from 2002, according to the Colorado Oil and Gas Conservation Commission. The state also expects to produce 3 billion cubic feet of natural gas per day, up 10% from 2003. Cambridge Energy Research Associates expect natural gas prices to average \$6.62 per BTU by 2007, going as high as \$8 per BTU at times.

At mid-year, Colorado was on track to issue a record 2,700 permits to drill oil and gas wells. Natural resource and mining industry employment was at its highest level since May of 1998, although at 13,500 workers it is only 0.6% of the state's employment base. In 2003, oil and gas extraction paid an average salary of \$93,392. Despite rising oil production, Colorado has not been one of the top ten oil producing states since 1999. Production remains well below the record of 61.2 million barrels produced in 1956.

Population

State population growth slowed in 2003 in response to the lack of employment growth the two previous years. The state had a net gain of

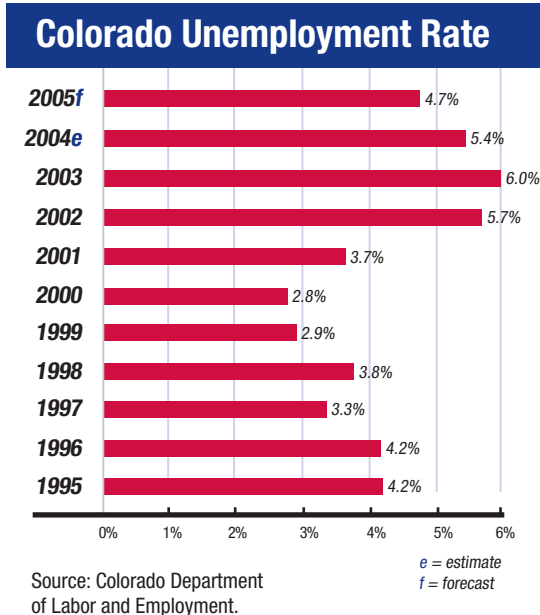


only 55,591 residents, almost all from natural increase (the excess of births over deaths). Net migration is estimated to be 16,541 and most of this was people arriving from outside the US. In fact, the US Census Bureau estimates that all of Colorado's net migration last year came from international migration. There was little additional population gain in 2004, only about 58,000. However, net migration was a bit stronger at 18,808.

Employment

One of the great mysteries of Colorado's recent economic performance is why the state and metro Denver have lagged the national recovery. The state was one of the last two to emerge from recession, according to Economy.com, and that did not occur until spring of 2004. Employment fell on a seasonally adjusted basis from its peak in December of 2000 through February of 2004. It was not until April of that year that more people were at work than a year earlier. Through June, employment was still slightly negative.

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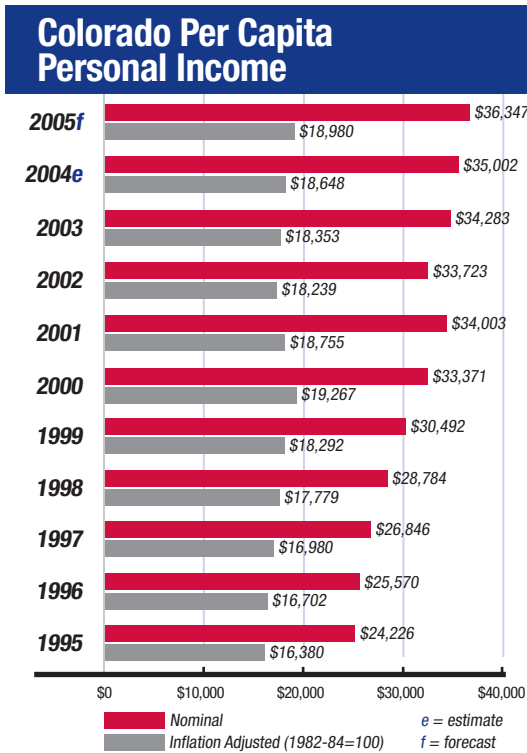


Before employment growth could resume, Colorado had to replace all of the jobs that disappeared when the technology bubble burst in 2001. Many of these jobs should never have been created and are gone for good. Replacing them with jobs in other sectors of the economy

was a slow process. It comes as no surprise that the state's largest job losses were in the information and manufacturing sectors, where employment dropped by more than 20%. They are being replaced by jobs in construction, trade and businesses services.

Income and Retail Sales

Per capita personal income rebounded in Colorado in 2003, up 1.7% to \$34,283, after falling by 0.8% in 2002. This was the first decline in nominal (current dollar) personal income since 1954, when it fell 5.7% over two years. Nominal per capita income is now at an all time record, although when adjusted for inflation it remains 4.7% below its 2000 peak. Inflation-adjusted per capita income is a rough measure of the standard of living, which declined in 2001 and 2002, then rose slightly in 2003.



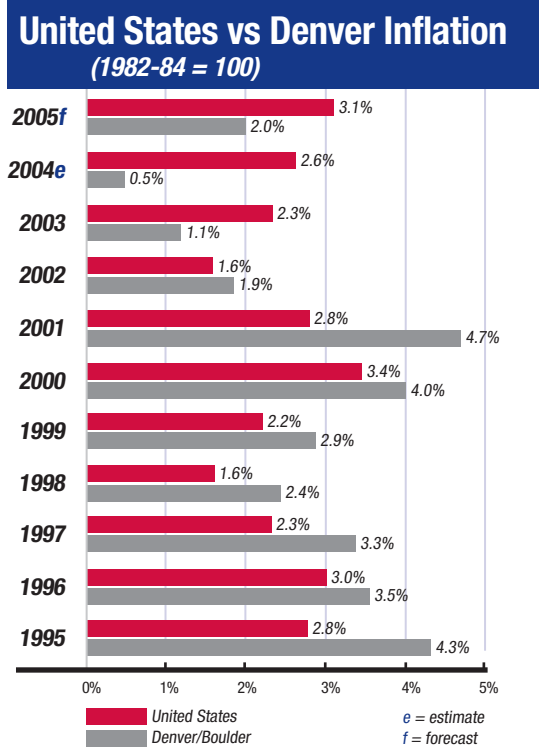
Source: Bureau of Economic Analysis.

Like consumers across the nation, Coloradans continued to spend throughout what was arguably the worst recession in the state since the 1930s. After rising a miniscule 0.3% in 2002, retail sales rebounded in 2003, up 1.8%. Through May of 2004, sales increased another

6.4%. The decline in travelers to the state, as well as more cautious spending by those who came, contributed to the softer performance of consumer spending.

Inflation

Colorado's inflation rate fell below the nation's in 2003 for the first time since 1991. The biggest single factor was the cost of housing. It increased 0.4% in the Denver-Boulder metro area in 2003 relative to a 2.4% gain for the nation. In the first half of 2004, local inflation averaged -0.7% relative to 1.9% nationally and declined 0.2% over the past 12 months. Once again, housing costs were the primary reason for the differential.

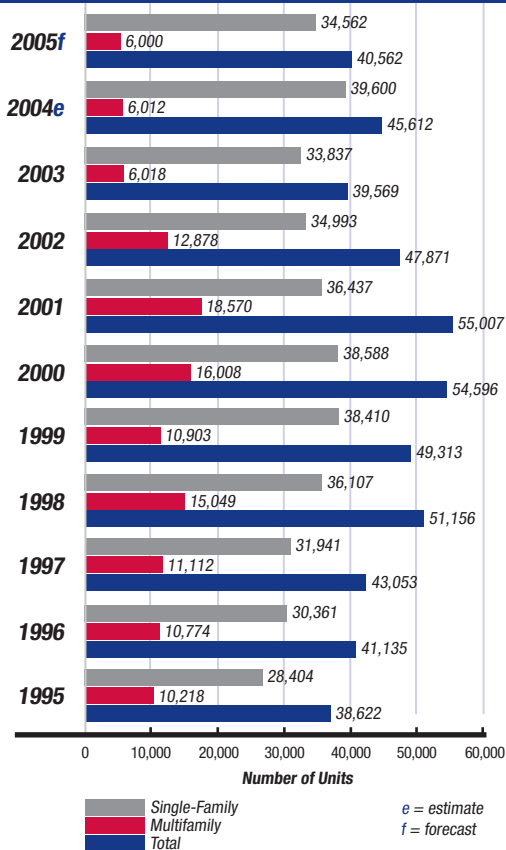


Source: U.S. Department of Labor, Bureau of Labor Statistics.

Housing

Housing permits in Colorado rose 24.1% through June. Single-family permits were up 22.2% and accounted for 84% of total new construction. In 2001, single-family permits were only 66% of the total. The permit increase follows three years of declining single-family construction, although multifamily construction held up through 2001. Multifamily is an extremely volatile component of the housing

Colorado Housing Permits



Source: U.S. Department of Commerce, C40.

market, ranging from an increase of 147% in 1992 to a decline of 51% in 2003.

Sales of existing homes were also strong in the first half of 2004. The Denver Board of Realtors reported a 16.0% increase in sales, a 3.5% increase in the median single-family price (\$243,000, June) and a small increase in inventory. For Colorado Springs, the Pikes Peak Association of Realtors reported a 14.7% increase in single-family sales and a 7.5% increase in the median price (to \$201,530). In 2003, sales rose 1.5% in Denver and 4.7% in Colorado Springs.

Nonresidential Construction

Between 1999 and 2003, the value of nonresidential construction contracts in Colorado fell 31.4%. This was a bit less severe than the 47%/6-year decline that ended in 1990.

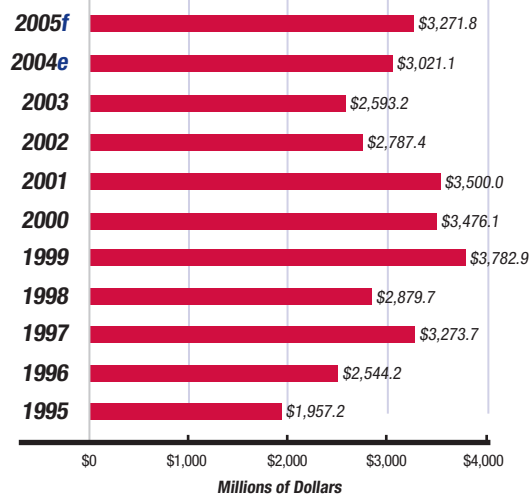
By mid-2004, the value of nonresidential contracts was up 18%. Retail construction was off 5%

and there were large declines in public building (-61%), amusement (-68%), industrial (-39%) and office (-40%) construction contracts, which together account for 30% of the total. Hospital construction was up 392% and accounted for 37% of contracts in the first half of 2004. Schools and colleges accounted for another 15% of nonresidential construction contracts and were up 17%. When these sectors are removed, nonresidential construction was down 25.2%.

In terms of vacant space, most sectors were showing positive signs in 2004 after a four-year slump. Fuller Commercial Real Estate expects graduation recovery in all market segments to continue. According to Frederick Ross Research,

Growth appears to be firmly underway in Colorado and will continue through 2003 unless the national recovery is derailed.

Non-Residential Contracts



Source: F.W. Dodge Construction Potentials Bulletin.

the office vacancy rate in metro Denver was 22.8% at mid-year, the retail vacancy rate was 9.5% and the industrial vacancy rate was 9.0%. All were down slightly from their 2003 peak. Colorado Springs realtors reported a very weak office market and a flat industrial market at mid-year, with tenants all looking for a deal. According to Turner Commercial Research, the office vacancy rate at mid-year was 9.4%, the industrial vacancy rate was 10.2% and the retail vacancy rate was 7.6%.

The Outlook

Growth appears to be firmly underway in Colorado and will continue through 2005 unless the national recovery is derailed. Job growth will average 2.5%, with employment finally passing its December 2000 peak. The unemployment rate will show little improvement from its mid-2004 level, averaging 4.7%, as discouraged workers return to the labor market.

Inflation will accelerate as higher commodity prices and rising labor costs work their way up the production chain. However, the Denver-Boulder CPI-U will remain below the nation's, at 2.0%, as home prices rise more slowly.

Population growth will accelerate slightly in response to employment growth in 2004. It will average 1.4% in 2005, with net migration accounting for 25,356 of the 65,056 increase. Per capita income will rise 3.8%, to \$36,347, providing a small increase in the standard of living. An improving tourist industry will help boost retail sales by 5.5%.

Nonresidential construction will remain relatively strong, having addressed its oversupply problem quickly in 2002 and 2003. Nevertheless, at \$3.27 billion in new contracts, it remains below its 1999-2001 level as office demand remains weak. Housing will be forced to compensate for overbuilding in 2003 and 2004 by cutting back 11.1% in new permits. Most of this will occur in the single-family area, down 12.7%, as higher mortgage rates, little population growth and sated demand all converge.

Beyond 2005, growth in Colorado is dependent on the direction of the national economy. The state will continue to be an attractive place for expansion and relocation, thanks to its well-educated, technically savvy labor force, reasonable cost of doing business and cost of living and its quality of life.

COLORADO ECONOMIC INDICATORS

	2003	2004 ^e	2005 ^f	02/03	03/04 ^e	04/05 ^f
Population	4,572,436	4,630,644	4,695,700	1.2%	1.3%	1.4%
Net Migration	16,541	18,808	25,256	n/a	n/a	n/a
Nonagricultural Wage and Salary Employment	2,150,400	2,169,754	2,223,997	-1.5	0.9	2.5
Unemployment Rate	6.0%	5.4%	4.7%	n/a	n/a	n/a
Personal Income (billions)	\$156.0	\$162.1	\$170.7	2.8%	3.9%	5.3%
Per Capita Personal Income	\$34,283	\$35,002	\$36,347	1.7%	2.1%	3.8%
Retail Sales (billions)	\$105.4	\$110.2	\$116.3	1.6%	4.6%	5.5%
Housing Permits (number of units)	39,569	45,612	40,562	-17.6%	15.3%	-11.1%
Nonresidential Building Contracts (millions)	\$2,593.2	\$3,021.1	\$3,271.8	-7.0%	16.5%	8.3%
Denver-Boulder Consumer Price Index CPI-U (1982-84=100)	186.8	187.7	191.5	1.1%	0.5%	2.0%

n/a = not applicable e = estimate f = forecast

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INFORMATION

For more information on the economy, contact Dr. Tucker Hart Adams at (303) 329-9218. For more data on the Colorado economy as well as updated forecasts, visit Dr. Adams' web site: www.coloradoeconomy.com.

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