

The Good, the Bad and the Ugly

As we approach spring of 2002, signs of economic recovery are mixed. Although there is mounting evidence that the pundits in Cambridge (the six academic economists who sit on the Business Cycle Dating Committee of the National Bureau of Economic Research) will eventually rule that the downturn ended in late 2001 or the first quarter of 2002, businesses and consumers see little evidence of improvement.

It isn't unusual for the general public and the analysts to be at odds over the course of the economy. The unemployment rate and corporate profits are lagging indicators of economic activity, yet they are critically important to the public's outlook. In March, when the recession began, few in Colorado outside of the advanced technology sector would have agreed that the economy was contracting. Following the 1980-82 and 1990-91 recessions, many of the same concerns we hear today were voiced - a fragile economy, slow recovery, pressure on earnings.

The Good: Inflation adjusted output rose 1.4% in the fourth quarter of 2001, sharply higher than the preliminary estimates. Consumer spending on discounted items, as well as stronger than expected foreign trade, were the primary drivers. The Conference Board's Index of Leading Economic Indicators rose in January for the fourth consecutive month, but declined in February. New residential construction in January was the highest in almost two years.

Factory orders rose throughout most of the final quarter of 2001. Manufacturers have been mired in recession for 18 months, accounting for the bulk of the nation's job losses. The Manufacturers Alliance index, while still projecting a decline in the first quarter, has risen to 40%, up from its 29-year low of 35% in June. Inventories were slashed by a record amount in the fourth quarter.

Although executives of major corporations remain pessimistic, small business owners are more upbeat. One-third of those surveyed in the quarterly InSight poll in January said their company was expanding, up from 20% three months earlier. Only 16% said

their firm was cutting back. Nineteen percent plan to add staff and 38% plan significant spending. However, most said conditions in January were worse than in the fall. A similar survey by the National Federation of Independent Businesses reported 42% of respondents expect economic improvement in the next six months. The optimism index hit a 24-month high.

Job layoffs show some signs of bottoming out. In mid-February, a key gauge of the number of Americans losing their jobs fell to its lowest level in six months, an indication that companies are reducing the speed at which they layoff employees. Thirty-one percent of respondents to the Manpower Inc. quarterly survey plan to add staff in Colorado in the second quarter, up from 25% three months ago. Cuts are planned by 9%, down from 15% in the November survey.

Consumer spending rose in both December and January when auto sales are excluded. However, after record sales in October (and a record 2.9% increase in consumer spending) in response to 0% financing, auto sales fell sharply in both months, down 1.1% and 4.3%, respectively.

Although at first blush it appears to be bad news, the projected \$106 billion federal budget deficit is a plus for growth in 2002. The deficit is a sharp shift from the \$231 billion surplus expected only a year ago. During an economic downturn, economic theory suggests that government spending should exceed tax revenues to stimulate the economy, with surpluses reserved for periods of economic health.

Wholesale prices plunged 1.9% in 2001, the biggest drop in 18 years, thanks to a dramatic decline in energy prices. The *Economist* commodity price index is at its lowest level in 15 years. Consumer inflation averaged only 2.8% last year. With energy prices low and unemployment still rising, there are few signs of incipient inflation.

In Colorado, inflation also slowed in 2001. Although the cost of living in the Denver-Boulder metropolitan area rose 4.7% for the year, it cooled substantially from its 18-year high of 5.4% over the

first six months. In the second half of the year, it averaged only 3.8%, with prices rising a modest 0.6% between the first and second quarters.

In a state where livestock comprises more than 60% of agricultural production, rising expenditures on beef are good news. Americans spent a record \$57 billion on beef in 2001, up 8%, to \$205 per capita, even though consumption declined slightly from 66.1 pounds per capita to 65 pounds.

The Bad: Heavy debt loads borne by both corporations and consumers are a major threat to economic recovery. Low interest rates encouraged consumers to take on more debt throughout the recession. Corporate debt rose \$137 billion during the nine months of recession in 2001, relative to \$5 billion during the 1990-91 downturn. Non-financial corporate debt now stands at a record 59% of net worth and more than half of commercial banks are restricting lending. This isn't surprising since profit margins in corporate America are at 19-year lows and bankruptcy filings surged 19% to a record 1.49 million in 2001.

Colorado fared a bit better. The bad news is that bankruptcies rose 20.4% to 18,725. The good news is that this was below the record of 19,075 in 1997. The number of business bankruptcies reached 468, below the 506 filed in 1997.

Venture capital investment in the state plunged 72% in 2001, ahead of the 63% drop nationwide. Still, Colorado ranked 6th nationwide, with 111 companies attracting \$1.4 billion, according to a PricewaterhouseCoopers survey.

The mounting accounting scandals at Enron and other large corporations will have an undetermined impact on growth in corporate America. Tighter accounting and auditing standards are likely to subtract 1-3 percentage points from corporate earnings in 2002.

The Denver economy slowed rapidly in 2001, according to economic indicators compiled by the Denver Chamber of Commerce. Fourteen of the 17 indicators in the index contracted, with the worst of the downturn beginning around mid-year. Prior to

mid-year, Colorado had the third fastest population growth in the country, according to the Census Bureau, averaging 2.2% through June. That is down from a 2.7% annual average in the 1990s.

Consumer spending and the rising unemployment rate, are good indicators of the problems that have engulfed Colorado. Last year, retail sales increased only 2.8%, in sharp contrast to the 11.3% increase in 2000. The unemployment rate, which hit a cyclical low of 2.7% in January 2001, climbed to 5.1% at year-end. The state had a net gain of only 18,000 jobs, a 0.9% increase. In the fourth quarter, Colorado was one of only seven states in which the number of workers exhausting their unemployment insurance benefits more than doubled. About 95,000 Coloradans are drawing unemployment benefits, up 80% over the last 12 months. Among the state's 15 largest employers, the only four with job growth were grocery and discount stores. Health care, telecoms, airlines and manufacturers all posted employment declines. In total, according to a *Denver Post* report, two-thirds of the state's top 100 employers cut their workforce in 2001 and another two dozen companies have already announced job cuts totaling 4,200 in 2002. During 2001, the rate of job loss in Colorado was double the national rate.

Home sales in metro Denver fell 1.6% to 47,832 units in 2001, although the dollar volume of sales set a record. The average price posted a 7.3% increase. The number of homes under contract dipped 13.1%, while the inventory of homes on the market at year-end soared 40.4%. Listings rose through February, but sales continued to decline. Colorado Springs had a better year. Single-family sales rose 4.2%, while multifamily sales increased 18%.

Million dollar home sales in metro Denver declined 11.7%, with 173 properties changing hands. In mountain resorts, sales fell for the first time in ten years, off 20% to \$3.75 billion.

The apartment vacancy rate in metro Denver reached a ten-year high of 8.7% in the fourth quarter. The average rental rate decreased 0.7% to \$821.61, excluding discounts, concessions, etc., which increased to an average of 6.8%.

The Really Ugly: Japan's economy continues to worsen and its deflation and debt crisis constitute a systemic risk to the world economy. The banking system is essentially insolvent, with a negative net worth of more than \$1 trillion. The government continues to underwrite an ever-increasing level of debt and wasteful government spending programs, even though the debt to GDP ratio is 130% and rising at 6% per year. There are no attractive alternatives to the Japanese crisis and the government seems incapable of choosing between unattractive alternatives.

Office vacancy rates experienced the sharpest increase ever recorded, up 4.2 percentage points to 13.5% at the end of 2001. In Colorado, the situation was even worse. The Frederic Ross Company reported that the office vacancy rate in metro Denver more than doubled to 19.3% at year-end, with negative absorption of 4.1 million square feet. The *Denver Business Journal* reported that 25 office buildings were empty at year-end and another 30 had more than half of their space available. Along the US 36 corridor in northwest Denver, Ross reported a 35.2% vacancy rate at year-end. Brokers estimate that 59% of this office space will be vacant when two projects are completed, likely the highest sub-market vacancy rate in the country. At the end

of 2000, the US 36 corridor boasted a 1.6% vacancy rate. South of Denver, in Colorado Springs, the office vacancy rate, including sub-lease space, was 13.1% at year-end, according to Turner Commercial Research.

Industrial and retail vacancy rates also rose. Denver's industrial vacancy rate increased 3.2 percentage points to 8.2%, an eight-year high. R&D/flex class space saw vacancy rates more than triple to 20.3%. The retail vacancy rate climbed 2.5 percentage points to 8.5% as three large tenants declared bankruptcy and returned 1.5 million square feet to inventory. New supply of 5.7 million square feet is currently under construction or redevelopment according to Ross, with about two million square feet to be completed in 2002.

Tourism, Colorado's second largest industry in terms of bringing new dollars into the economy, was particularly hard hit in the fourth quarter of 2001 and the problems are likely to continue in 2002. Skier days in November and December declined 14%, passenger traffic at Denver International Airport plunged 19.6%, restaurant spending was off 7.8% and spending at stores frequented by travelers declined 1.0%. The hotel occupancy rate

COLORADO ECONOMIC INDICATORS

| | 2000 | 2001 | 2002 ^f | 99/00 | 00/01 | 01/02 ^f |
|--|-----------|-----------|-------------------|--------|--------|--------------------|
| Population (000s) | 4,325 | 4,407 | 4,488 | 2.6% | 1.9% | 1.8% |
| Net Migration | 61,594 | 49,689 | 48,724 | n/a | n/a | n/a |
| Nonagricultural Wage and Salary Employment (000s) | 2,212.9 | 2,231.9 | 2,240.8 | 3.8% | 0.9% | 0.4% |
| Unemployment Rate | 2.7% | 3.7% | 5.4% | n/a | n/a | n/a |
| Personal Income (billions) | \$140.4 | 148.0 | 153.5 | 10.0% | 5.5% | 3.7% |
| Per Capita Personal Income | \$32,949 | \$33,583 | \$34,202 | 4.4% | 1.9% | 1.8% |
| Retail Sales (billions) | \$100.6 | \$103.4 | \$107.1 | 11.3% | 2.8% | 3.5% |
| Housing Permits (number of units) | 54,596 | 54,537 | 40,957 | 10.7% | (0.1)% | (24.9)% |
| Nonresidential Building Contracts (millions) | \$3,476.1 | \$3,456.3 | \$3,103.8 | (8.1)% | (0.6)% | (10.2)% |
| Denver-Boulder Consumer Price Index CPI-U (1982-84=100) | 173.3 | 181.3 | 186.6 | 4.0% | 4.7% | 2.9% |

n/a = not applicable

f = forecast

in metro Denver averaged 62.5% for the year, down 6.1 percentage points, while the average room rate fell 1.2%, according to the Rocky Mountain Lodging Report.

The Implications: Although the recession may officially end early in 2002, that will bring little comfort to Colorado businesses and consumers. Job growth will average a measly 0.4%, as the unemployment rate trends upward through mid-year. Population growth will continue to slow, with fewer people moving to the state. Personal income and retail sales will expand in the 3.5% range, barely ahead of the local inflation rate of 2.9%.

The real estate and construction industries will feel the most distress. Housing permits will decline 24.9%, to 40,957 units. Multifamily permits will experience the biggest drop, down 41% to 10,655. Single-family construction will also shrink, off 16.9% to 30,302 units.

By 2003, recovery will be well underway. There are no fundamental problems underlying the Colorado economy and the state will be well-positioned to take advantage of the next economic expansion.

For the most up-to-date information on the Colorado economy, go to www.ColoradoEconomy.com

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Permission is granted to reprint from this Update with credit to U.S. Bank's Rocky Mountain Region Chief Economist Dr. Tucker Hart Adams. For more information on the economy, contact Dr. Tucker Hart Adams at (303) 585-5060.

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