

2003 Forecast Update

The national and Colorado economies muddled through 2002, getting by rather than getting on. An anemic recovery was unable to stem the job decline, as employment by place of work fell 0.1% at the national level and 1.9% in Colorado. This was in sharp contrast to a typical recovery, which creates a million new jobs during the first year.

The unemployment rate ended the year at 6.0% for the nation and 5.5% for the state. On an annual basis, Colorado's unemployment rate averaged 5.3%, substantially above the 3.7% recorded for 2001, when it reached a ten-year low of 2.7% in January. The stock market declined for the third consecutive year, the first time this has happened since 1938-41, then began 2003 with the worst January since 1931. Retail sales in Colorado were flat and sales tax revenues declined. Along with most other states, declining tax revenues produced a huge budget shortfall (close to \$1 billion in the fiscal year ending in June) and state jobs and expenditures are being slashed.

■ Is the Recession Over?

It's difficult to conclude that this describes a year of economic recovery and, in fact, we don't yet have an official end to the recession that began in March 2001. However, we have had four consecutive quarters of growth as measured by inflation-adjusted output (or real GDP), something that's never occurred during a recession.

2002 got off to a superficially strong start, with real GDP up 5.0%. A closer look shows that it had three unsustainable components—a surge of government spending in the aftermath of the September terrorist attacks (defense spending increased 11.6% in the first quarter), the positive impact of a serendipitous cut in tax rates and an

inventory replenishment to meet the demands of consumers who bought more than expected during the first nine months of the recession.

Growth slowed substantially over the next three quarters, averaging an anemic 1.4% in the October-December period. Consumer spending rose only 1%, while private investment fell for the first time in a year. These are preliminary data and are subject to substantial revision. Remember that the original estimates for 2001 showed only one quarter of contraction, leading some economists to argue that no recession was underway.

The September 11 events added uncertainty to the recession stew and this has been compounded by corporate accounting scandals and bankruptcies (9 of the 12 largest bankruptcies in our history occurred in 2001 and 2002), the situation in the Middle East and North Korea, drought, fires and, most recently, the Columbia explosion. If something could go wrong over the last 24 months, it probably did. Uncertainty—the threat of a disaster to which one is unable to assign a time or probability of occurrence, order of magnitude or even a definition of what it might entail—makes both consumers and businesses unwilling to make investments for the future.

In the first quarter of 2003, layoffs continue, business capital investment remains on hold and the stock market reacts wildly to the latest rumor or snippet of economic news. The decline in the national unemployment rate in January to 5.7% was largely illusory. Because holiday hiring was

To be uncertain is to be uncomfortable, but to be certain is to be ridiculous.

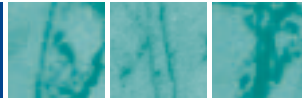
— Chinese Proverb

NATIONAL ECONOMIC INDICATORS

| | 2001 | 2002 | 2003f | 00/01 | 01/02 | 02/03f |
|--|------------|------------|------------|-------|-------|--------|
| Gross Domestic Product (billions) | \$10,082.2 | \$10,445.6 | \$10,811.2 | 2.6% | 3.6% | 3.5% |
| Real GDP (billions of 1992 dollars) | \$9,214.5 | \$9,440.2 | \$9,581.8 | 0.3% | 2.4% | 1.5% |
| Unemployment Rate | 4.7% | 5.8% | 6.3% | n/a | n/a | n/a |
| Private Housing Starts (million units) | 1.60 | 1.71 | 1.52 | 1.9% | 6.9% | -9.4% |
| Auto/Truck Sales (million units) | 17.5 | 16.7 | 15.6 | -1.7% | -4.6% | -6.6% |
| Consumer Price Index (1982-84-100) | 177.1 | 179.9 | 184.4 | 2.8% | 1.6% | 2.5% |
| 90-Day Treasury Bill Rate | 3.4% | 1.6% | 1.2% | n/a | n/a | n/a |
| 10-Year Treasury Note | 5.0% | 4.6% | 4.9% | n/a | n/a | n/a |
| 30-Year Conventional Mortgage Rate | 7.0% | 6.5% | 6.8% | n/a | n/a | n/a |

n/a = not applicable f = forecast

The Colorado Situation



well below normal, there were fewer seasonal layoffs in January. Hence, seasonal adjustments, which attempt to smooth out month-to-month in hiring, accounted for the statistical gains.

■ The Colorado Situation

Colorado benefited from the boom in technology and tourism in the 1990s and the state has suffered from the declines in both industries. By several measures, the state's downturn is more severe than the national recession and some economists argue that it is Colorado's most severe recession in the last 60 years.

Employment and Population: One must go back to 1944 to find a year when the employment losses in Colorado exceeded that experienced in 2002. In fact, the state has lost jobs in only five years since the Depression years of the 1930s.

| CO Employment Growth | |
|----------------------|-------|
| 1944 | -5.3% |
| 1949 | -1.9% |
| 1954 | -1.3% |
| 1986 | -0.7% |
| 2001 | -1.9% |

Job growth has important implications for population growth, as well as housing demand and residential and nonresidential vacancy rates. With job growth averaging 0.9% in 2001 and declining 1.9% in 2002, there is little prospect of positive performance in these sectors in 2003.

Despite the slow job growth, the most recent Census Bureau estimates place Colorado as the sixth fastest growing state in 2002, with 75,553 new residents edging the state's population above 4.5 million. Local demographers think this estimate is too robust and believe there was no more than a 20,000 resident gain from new arrivals to the state. When this is added to the natural increase of 37,600, it puts the number of state residents at 4,488,600, up 1.3%.

A troubling indicator for 2003 is the most recent Manpower, Inc. survey of hiring plans. Thirty seven percent of metro Denver employers plan job cuts in the second quarter, while only 20% plan additional hires. A year ago, only 3% planned to reduce employment. Layoff plans were less severe in Colorado Springs and northern Colorado, improving statewide results to 12% planning cuts and 25% planning to hire. Nationally, only 9% of companies plan to reduce employment. Despite

the continued layoffs, local companies report that they are still unable to fill some jobs. A survey by the National Federation of Independent Businesses shows a real mismatch between layoffs and hiring needs. Eleven percent of employers nationally report they are unable to find qualified workers to fill vacant positions.

Residential: Sales of existing homes were flat in metro Denver in 2002, with single-family sales posting a fractional gain and multifamily sales off 2%. In February, sales fell 7.7% and the average single-family price fell for the first time in 13 years. The lowest interest rates in four decades are making single-family homes affordable for many families who were previously in the multifamily or rental market. The 30-year fixed mortgage rate fell 1.3 percentage points over the course of 2002, to 5.9% at year-end, then continued to decline as 2003 unfolded.

11.7% of metro Denver apartments were vacant at the end of 2002, the highest rate since 1989. More than 9,000 new apartments were built last year and 4,000 to 5,000 units are scheduled to be completed in 2003. When free rent and other concessions are factored into the equation, the economic vacancy rate soared to 20.2% in December, double what it was a year ago. Douglas County, with the highest average rent, also had the highest reported vacancy rate at 22.3%. In Colorado Springs, the apartment vacancy rate was 11.8%, with the economic rate estimated to be around 25%.

Foreclosures also surged in 2002, up 56% in metro Denver to an 11-year high. Despite the increase, foreclosures were only 38% of their 1988 peak of 17,122.

Not surprisingly, new home construction declined throughout the year. Housing permits fell 12.9% after a flat 2001. Single-family activity declined for the second consecutive year. Multifamily permits were off 33.3%.

Nonresidential: The value of nonresidential contracts fell 20.9% in 2002, as Colorado moved quickly to bring the nonresidential market back into balance. This is the single most important factor that prevents this recession from matching that of the 1980s. Nevertheless, vacant space, particularly in the sublease category, depressed the Front Range market.

Denver's office vacancy rate rose to 22.8% in 2002, from 19.1% a year earlier. More than 19 million square feet of office space stood vacant

and absorption was a negative 1.9 million square feet. The highest vacancies were in Class A space, but most of the negative absorption was in Class B space, according to research reports by the Frederick Ross Company. Rental rates declined across the metro area, with a 10-15% drop in quoted rates in the Central Business District and Southeast Suburban sectors. Much of the 1.5 million square feet added to inventory was single-tenant campus properties coming back on the market as multi-tenant competitive space. About 20% of the vacant space is sublease space.

The industrial vacancy rate climbed less than one percentage point, to 9.2%. There was positive absorption in both warehouse and R&D/flex properties. The vacancy rate in flex properties remained steady at 21.5%. About 2.7 million square feet of new space were added, well below the five-year average of 3.7 million square feet. Rental rates declined.

The retail vacancy rate climbed only 18 basis points, to 8.8%, with absorption of 4.2 million square feet. There were 4.8 million square feet of new space built during the year and 90% was occupied at year end. Rental rates were flat.

The Colorado Springs situation was only a little better. Turner Commercial Research reported a year-end office vacancy rate of 11.8% and an industrial vacancy rate of 11.5%, if sublease space is included. The retail vacancy rate was 7.0%.

Tourism: One bright spot in a too often gloomy economy was skier visits at Colorado's

mountain resorts. Over the first third of the 2002-03 season, visits increased 18.4% to 2.9 million, according to Colorado Ski Country USA. While the biggest gains were at Front Range resorts and the smallest at the destination resorts farthest from the state's population centers, all enjoyed gains of 18% or better. Data are not yet available to track spending by these visitors, a measure more important to the health of the ski economies than skier days.

The continuing drought remains a threat to the travel industry in 2003. Despite heavy snow in February, the snow pack remained below normal. Golf courses and athletic fields are closed and watering restrictions remain in place.

■ Can Monetary and Fiscal Policy Turn the Tide?

The government has only a few tools at its disposal to try to get the economy moving again—cutting interest rates, cutting taxes and increasing spending. With interest rates already at 40-year lows, there is little stimulus available from this tool, as Japan has learned to its dismay. That leaves fiscal policy—taxes and spending.

While eliminating the double taxation of dividends is clearly a good business decision, it is unlikely to provide any immediate stimulus. Consumers report they would spend only 25% of a tax refund, saving the rest or using it to pay down debt. This is in line with what occurred with the \$300 tax rebate a few years ago, when 18% was spent.

COLORADO ECONOMIC INDICATORS

| | 2001 | 2002 | 2003f | 00/01 | 01/02 | 02/0f |
|---|-----------|-----------|-----------|-------|--------|-------|
| Population (000s) | 4,430,989 | 4,488,589 | 4,546,197 | 2.3% | 1.3% | 1.3% |
| Net Migration | 61,500 | 20,000 | 20,000 | n/a | n/a | n/a |
| Nonagricultural Wage and Salary Employment (000s) | 2,231,900 | 2,188,700 | 2,182,134 | 0.9% | -1.9% | -0.3% |
| Unemployment Rate | 3.7% | 5.3% | 5.5% | n/a | n/a | n/a |
| Personal Income (billions) | \$147.9 | \$148.7 | \$151.8 | 3.6% | 0.5% | 2.1% |
| Per Capita Personal Income | \$33,470 | \$33,128 | \$33,391 | 1.4% | -1.0% | 0.8% |
| Retail Sales (billions) | \$103.7 | \$103.1 | \$105.2 | 2.6% | -0.6% | 1.2% |
| Housing Permits (number of units) | 55,007 | 47,911 | 43,934 | 0.8% | -12.9% | -8.3% |
| Nonresidential Building Contracts (millions) | \$3,500.0 | \$2,770.1 | \$2,554.0 | 0.7% | -20.9% | -7.8% |
| Denver-Boulder Consumer Price Index CPI-U (1982-84=100) | 181.3 | 184.9 | 190.3 | 4.7% | 2.0% | 2.9% |

n/a = not applicable f = forecast

All in all, it is unlikely that fiscal policy will help the economy in the first three quarters of 2003. It takes too long to get legislation passed and implemented, and consumers and businesses react slowly to the changes. While it is important to implement sound, stimulative monetary and fiscal policies, they will not provide an instant cure.

■ The Year Ahead

The consumer holds the key to economic performance over the next 6-12 months. Indeed, if consumer spending had not remained strong in an atypical way during 2001 and 2002, the country would be mired in its longest, deepest recession in 75 years. If consumer spending does not hold up until business investment recovers, the second stage of a double-dip recession is unavoidable.

Unfortunately, the very behavior that moderated the downturn makes this unlikely. The pent-up demand that normally exists at this point in the business cycle isn't present. Since consumers did not defer purchases of durable goods and houses over the last two years, the new orders that would create jobs and put idle industrial capacity back to work are missing.

Confidence, debt levels and home prices are other crucial determinants of consumer spending. None of these factors argues for continued strength.

Job security is perhaps the most important determinant of consumer confidence. An economy that is not creating jobs is not a healthy economy, no matter what is happening to the stock market or home prices. The layoffs continue, albeit at a slower pace, making consumers less willing to spend. Consumer confidence has declined fairly steadily for the last year. The December and January Consumer Credit Index surveys showed sharp declines in consumer willingness to use credit.

Consumer borrowing increased once again in 2002, up 3.3%. On the positive side, this was the smallest rise in revolving credit (such as credit cards) in ten years and down sharply from the 6.9% gain in 2001. Low interest rates kept the minimum monthly principal and interest payments around 14% of after-tax income, at the high side of the normal range. Monthly payments rather than debt levels appear to drive consumer borrowing.

On the negative side, consumer debt now equals 107% of after-tax income, with about 22% of this non-real estate secured debt such as credit

cards. Thirty seven percent of credit card loans are subprime and defaults have doubled. The number of consumers worried about their ability to pay off non-mortgage debt rose to 46% in 2002. Bankruptcy filings are at an all-time high, both locally and nationally.

Much has been written about the housing bubble and the potential for home prices to fall. Despite the fact that more than half of US households own stocks, owner occupied homes are still the primary asset for most Americans. Household net worth relative to after-tax income is already at a seven-year low due to the decline in value of stock and mutual fund holdings. If home prices fall in 2003, this ratio will worsen. Studies show that the impact of changes in wealth are small and take about three years to be felt. Nevertheless, the dramatic increase in wealth in the 1990s added about \$500 billion each year to annual consumer spending of \$7 trillion, according to a Federal Reserve Board study. The downside potential as wealth declines is significant.

The potential for war in the Middle East, which is already causing oil prices to surge, muddies the inflation and interest rate outlook. If energy prices continue to rise, inflation will accelerate and long-term interest rates will increase. Higher inflation and interest rates will weaken an already shaky economy. Short-term rates, heavily influenced by Federal Reserve actions, will remain near current levels, falling slightly if the economy weakens.

The optimistic scenario is that we will continue to lurch and muddle through 2003, with things not getting much better but at least not getting much worse. We now give this only a 45% chance of occurring. More likely, at 55%, is a double-dip, consumer-led downturn lasting until at least the third quarter of 2003.

For the most up-to-date information on the Colorado economy, see Dr. Adams' web site at www.coloradoeconomy.com. Permission is granted to reprint from this Update with credit to U.S. Bank's Rocky Mountain Region Chief Economist Dr. Tucker Hart Adams.

■ February 28, 2003

Tucker Hart Adams

Chief Economist, Rocky Mountain Region, U.S. Bank