

Economics Group

Special Commentary

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Arizona: Growth, but at a Low Gear

Executive Summary

The Arizona economy is still recovering from the recession and the collapse of the housing market, which confirms our earlier suspicion that growth will continue, but at a lower gear than what the state was accustomed to during the happy old housing-market-driven-growth days. While state nonfarm employment is coming back, it is doing so very slowly. This year, we expect nonfarm employment growth of approximately 2 percent, the first annual gain since 2007 when nonfarm employment rose 0.6 percent.

The Arizona economy will continue to grow, but at a lower gear than what the state was accustomed to during the housing-market-driven-growth days.

Although almost all major sectors pitched in with positive growth rates during the year, several sectors are still shedding jobs or are barely growing, including professional and business services, government employment and other services employment. Even construction employment has improved during 2011, up 0.54 percent on a year-ago basis in November. Although, it is still more than 50 percent below the peak employment in 2006 and will probably not reach pre-crisis levels for many decades.

Also, the manufacturing sector, another area that has languished for more than a decade, has strengthened somewhat during the year, growing 3.4 percent on a 12-month basis in November. However, the sector is still down 19 percent since the last employment peak in April 2006 and is 27.4 percent lower than it was in January 2001. Thus, while we expect the Arizona manufacturing sector to come back, it will be at a slow pace, and most likely will never recover its past vigor unless there is a serious effort to attract more manufacturing investment into the state.

Figure 1

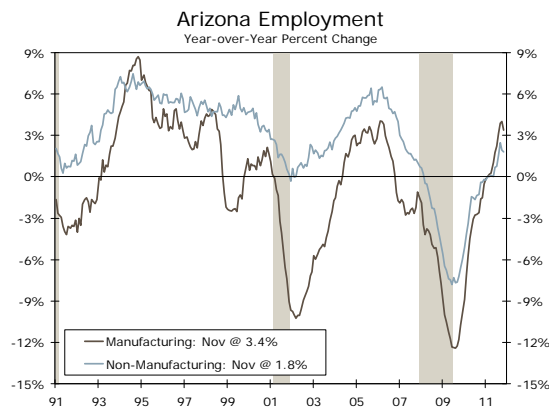
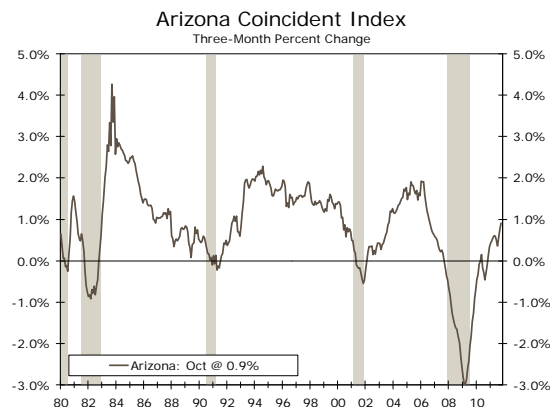


Figure 2



Source: U.S. Dept. of Labor, Federal Reserve Bank of Philadelphia and Wells Fargo Securities, LLC



The state's foreclosure rate could reach its historical level in 2016.

The Housing Market: Tough Days Are Still Ahead

The Arizona housing market continues to move sideways while median prices continue to drop. Today, median home prices are at levels not seen since 1999 for single-family homes and housing affordability is at levels not seen since 2003, according to Arizona State University's Realty Studies website. At the same time, Arizona's foreclosure rate stood at 3.09 percent in September 2011 compared to 3.14 percent for the previous month and 3.82 percent in September 2010. Thus, the foreclosure situation continues to improve, but at a snail's pace. The same is true with the 90+ day delinquency rate, which dropped to 7.45 percent in September from 7.64 percent in August and 10.5 percent in September 2010.¹ Thus, although the housing market is clearly improving, it is happening very slowly. At these rates, the foreclosure rate could reach its historical level in 2016, and the delinquency rate could do so by 2019. Of course, these values assume that the rate at which foreclosures and delinquencies decrease maintains its recent pace, which is a big assumption. However, this provides an idea of the problems that face the Arizona housing market and the size of the challenges ahead.

Figure 3

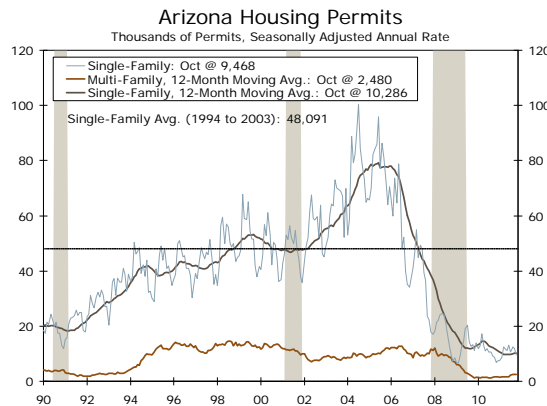
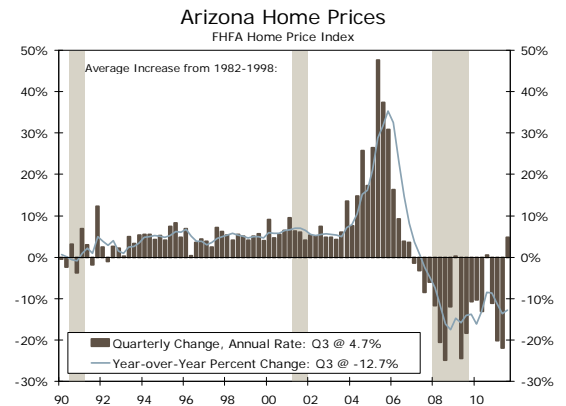


Figure 4



Source: U.S. Department of Commerce, FHFA and Wells Fargo Securities, LLC

A recovery in home prices is still a ways off, which means the negative equity issue will persist for some time.

Home prices continue to be under pressure in this environment and they are still affecting the number of homes that have negative equity or are underwater. After home prices fell at a 22.3 percent annual rate during the second quarter, home prices managed to grow at a 4.7 percent annual rate during the third quarter. However, home prices remain negative on a year-ago basis and a recovery in home prices is still a ways off, which means the negative equity issue will persist for some time. The days that Arizona could count on strong population growth are over, at least for now, and thus home prices will most likely remain under pressure for some time.

Arizona must reestablish itself as a place where business flourished in order to restart immigration. In the past, Arizona was chosen for its warm weather and as a place for retirees to live out their retirement years, a prospect almost ruined by the Great Recession, the housing market collapse and the need by future retirees to delay their retirement due to the wealth lost over the past several years. Therefore, while the state's promise to retirees is still intact, the timing of these individuals moving to the state may be off by some years. Thus, the state has to recreate a better environment for job creation and attract new industries. This could prove to be a difficult process in this hyper-competitive market, not only versus the rest of the world but also within the United States. The expectation that hoards of retirees will flood into the Arizona heartland in search of a good retirement community may be delayed for some years. When retiree inflows finally do improve, the retirees' income levels may be downgraded, which would further contribute to relatively slower growth than what was expected before the crisis when everyone expected to retire "relatively rich."

¹ Data on foreclosures, delinquency rates and negative equity are from CoreLogic, Inc.

Thus, we expect the economy of Arizona to continue to grow, but at a very modest pace—a pace that will feel uncomfortably weak and not allow for a rapid decrease in the unemployment rate.

Snail Pace Employment Growth

Arizona's nonfarm employment disappointed in November by posting a 0.18 percent drop, month on month, after three consecutive months of positive readings in August, September and October, according to the BLS. However, year-over-year employment remained positive, increasing 1.91 percent in November after posting 2.06 percent for the year ended in October. Interestingly enough, one of the most dynamic sectors in terms of employment in the state has been the construction sector. However, following a typical trend in November, construction employment dropped 4.32 percent on the month. However, construction employment has experienced monthly increases for the past four months, and remains positive on the year, as employment increased 0.54 percent year over year. Construction employment is very low, close to 110,000 compared to the peak employment of 244,000 recorded in June 2006. Manufacturing employment has also contributed to growth during the year, although November's reading was down 0.59 percent on the month, the first negative reading of the year. However, on a year-ago basis, manufacturing employment increased 3.39 percent, and while it is still 19 percent below the previous employment peak in 2006, at least the sector has shown positive growth.

One of the most dynamic sectors in terms of employment in the state has been the construction sector.

Figure 5

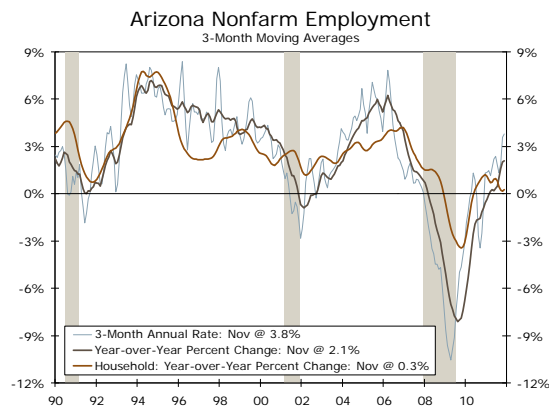
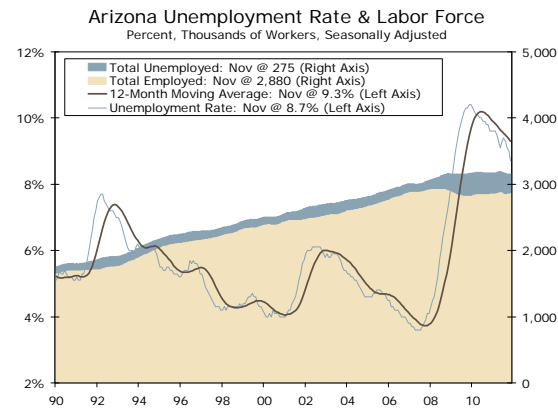


Figure 6



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Financial jobs have also been hard to come by in Arizona. After three consecutive months of declines, financial jobs were slightly up in November, increasing 0.74 percent month over month. On a year-ago basis, financial jobs have managed to post positive readings for the past seven months, and were up 1.61 percent year over year in November. Employment in the professional and business services sector increased 0.38 percent in November and was up 0.32 percent year over year. Even though the sector posted a small but positive growth rate in 2010, 0.56 percent, we expect this sector to experience negligible, if any, growth during 2011.

Nationwide, the education and health service employment sector continues to grow at a very high rate, as has been the case for the last decade. Even during the worst of the recession, Arizona experienced strong growth rates in this sector's employment, posting 2.94 percent annually in both 2009 and 2010. This was down from an average growth rate in employment of 5.52 percent during the period 2002–2008. This performance continues unabated, and we expect employment in this sector to go back to close to trend growth of 5 percent in 2011. So far, employment in the education and health services industries has grown at an average of 4.67 percent during the first 11 months of the year, we expect the sector to be close to 5 percent for the year as a whole.

We expect employment in the education and health services sector to grow close to 5 percent in 2011.

The mining sector has also seen some improvement in employment even though the sector's employment levels in the state are very small compared to total employment, hiring approximately 10 to 11 thousand workers. Employment in the mining sector was severely affected by the decrease in metal prices during and after the Great Recession, declining 21.74 percent in

2009 before edging up 0.93 percent in 2010. The volatility in commodity prices during 2011 has not been good for recovery in employment in this sector but we still expect the mining sector to contribute positively to this year's employment growth in the state.

Arizona's unemployment rate has dropped because of job creation.

The Arizona unemployment rate dropped to 8.7 percent in November from 9.0 percent in October, a drop mirroring that of the national unemployment rate. But the most important news about the two consecutive drops in the unemployment rate was that during both months the labor force actually increased, up 0.08 percent in October and 0.02 percent in November. This means that the unemployment rate dropped because of job creation rather than a drop in the size of the labor force, or the number of people looking for jobs as it was the case at the national level.

Arizona and Its European Links

One of the biggest risks for the coming year is the potential effect of a serious crisis in Europe due to the sovereign debt crisis started by Greece more than a year ago, which is now spreading to Italy and potentially to other Eurozone countries. The solution to this dilemma is not easy to determine because a Eurozone crisis would have many direct and indirect consequences on the world economy as well as that of Arizona.

By looking at the data for Arizona's 2010 exports, it is clear the direct effects of a major Eurozone crisis is relatively low to mild, depending on whether you look at exports to Europe as a percentage of Arizona's Gross State Product (GSP) or as a percentage of its total exports. As we published in our Nov. 14 report, "U.S. States with Exposure to a European Recession" (found on our website), Arizona's exports to European countries as a percentage of GSP is only 1.15 percent. However, if we take exports as a percentage of total Arizona exports, the importance of the European countries increases but still remains relatively low, with Arizona's exports to Europe representing about 10 percent of the state's total exports. Thus, as a group, exports to Europe rank third in importance after Mexico and Canada. The biggest share of Arizona's exports, or 51.5 percent, goes to three countries: Mexico (32.3 percent), Canada (12.5 percent) and China (6.6 percent). If taken as an individual country, the most important Eurozone country is Germany with 4.2 percent of all Arizona exports.

The indirect and financial effects of a Eurozone crisis could be damaging to the Arizona economy.

We do not expect a Eurozone crisis to severely affect the Arizona economy through the state's trade links with the European countries. However, the indirect and financial effects of such a circumstance are normally more damaging than the real, or trade-related, effects; and those could be as severe as those that affected the Arizona economy during the previous crisis.

Figure 7

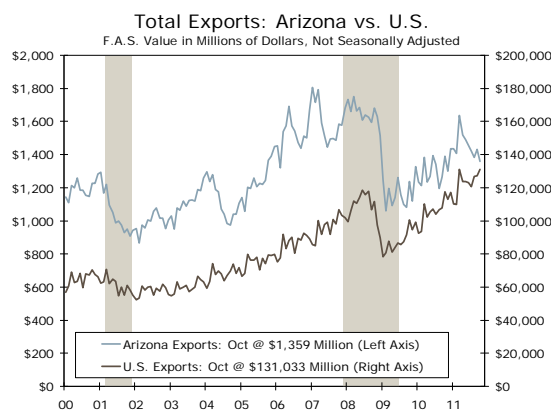
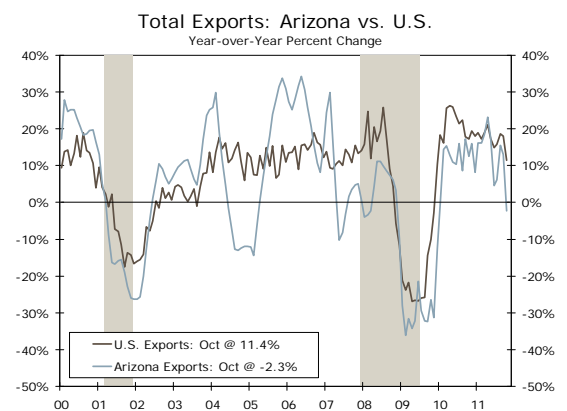


Figure 8



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

State Finances are in Check for Now

As has been the case for almost every state during the recession and during the slow recovery, Arizona's fiscal issues continue to be delicate even though the problems have been more manageable than those in other states. Most of the efforts to put the fiscal house in order have been temporary, such as expense rollovers that will come back to haunt state finances in the

coming years, the voter-approved temporary increase in the sales tax rate and increases in fees that some sectors of the political spectrum continue to dub as different than an increase in taxes so their “no-new-taxes” mantra can survive even as these fees increase.

On the expense side, the efforts have been borne fundamentally by cuts to higher education, which represent approximately 10 percent of total government expenditures; and Medicaid at 29 percent of total spending; while no cuts are expected to affect lower education and prisons, which represent 38 percent and 10 percent, respectively, of total government spending in Arizona.²

Spending cuts have been borne fundamentally by cuts to higher education.

We should expect the fiscal situation for the state to continue to improve as the economy continues to recover. However, as with the economy, the pace of improvement will be slow. The risks to the Arizona economy remain high, however, as the international environment remains fragile and a severe European crisis could hit the state even though its links to Europe remain limited.

Summary and Conclusions

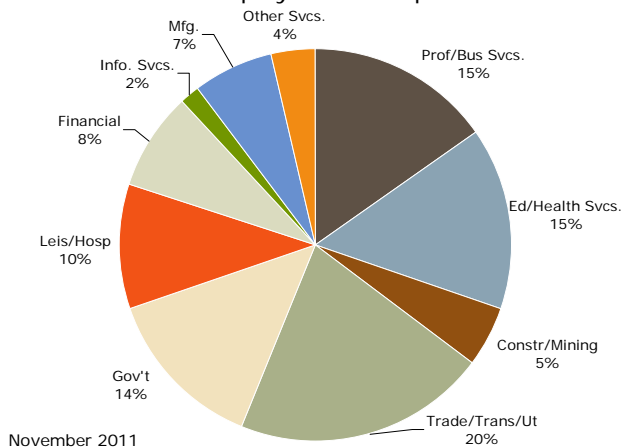
The state of Arizona is slowly but surely coming out of the worst economic recession since the Great Depression, with a housing market that is making progress but that has several years to go to come to terms with the excesses during the housing boom. Manufacturing employment should continue to add to the employment prospects while the service sector also continues to expand. However, growth will be slow and the recovery will not feel like one until the housing market can come back with some strength, something that we do not foresee for several years.

² See, “Arizona’s State Government Closes Budget Gap (For Now),” by Marshal J. Vest, Director, Economic and Business Research Center. Eller College of Management, The University of Arizona, June 16, 2011.

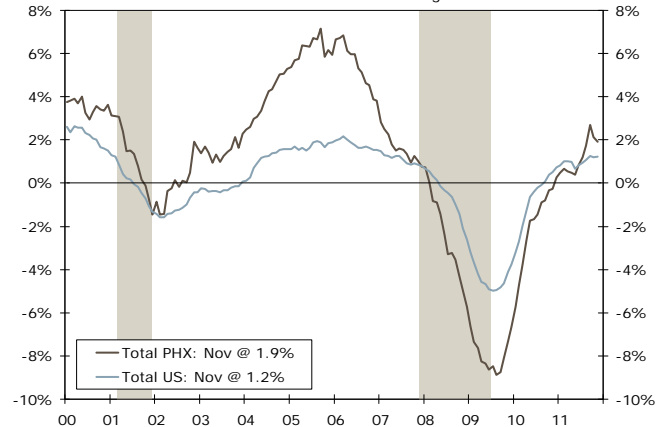
Phoenix

- The Phoenix area has slowly added jobs after falling 12.8 percent peak to trough in September 2010. Nonfarm employment growth has been driven by the education and health services and trade and transportation sectors. Health and education services have added nearly 13,000 jobs over the past year.
- Growth in solar energy has provided a welcomed boost to the region's construction sector. Arizona's Sun Program has created more than 700 construction jobs this year, and the construction of Solana Generating Station in Gila Bend is expected to continue to add jobs through 2012. Once opened in 2013, it will require 85 highly trained staff.
- Furthermore, Intel Corp., one of the area's largest employers, has announced plans to invest more than \$5 billion to build a new chip manufacturing facility at its site near Chandler. This project is expected to create at least 2,000 jobs in construction and manufacturing.
- The Phoenix housing market remains subdued, with home prices currently down 13 percent year over year. Prices are expected to eventually bottom out in 2013.
- There are several downside risks to economic growth in the state's capital. With an economy heavily tied to the healthcare, solar energy and government sectors, the pressures to continue improving the state's fiscal situation, coupled with the uncertainty over the federal budget may weigh heavily on future growth.

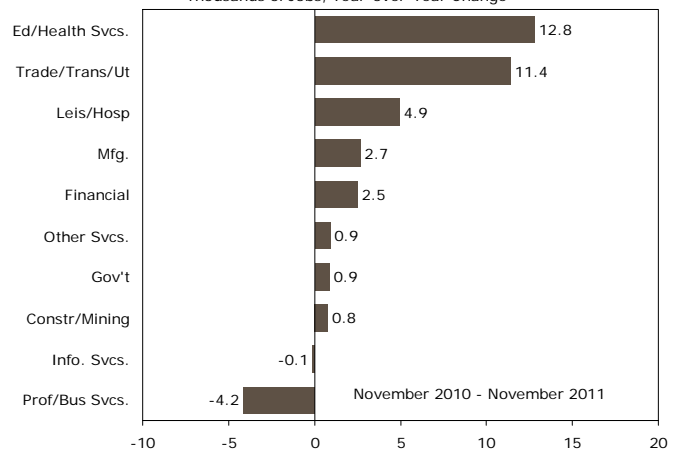
Phoenix Employment Composition



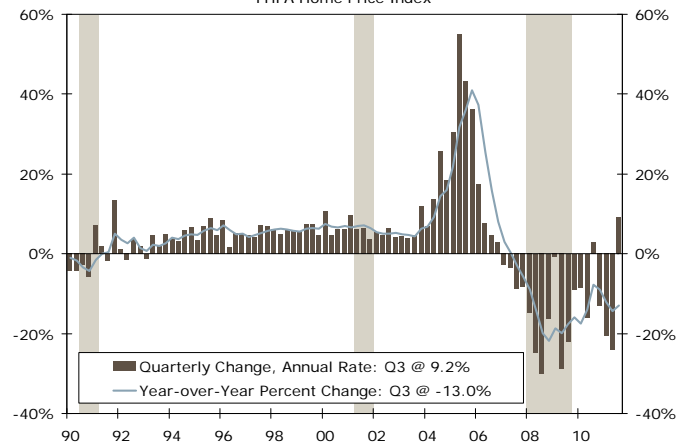
Phoenix Nonfarm Employment
Year-over-Year Percent Change



Phoenix Job Growth by Industry
Thousands of Jobs, Year-over-Year Change



Phoenix MSA Home Prices
FHFA Home Price Index

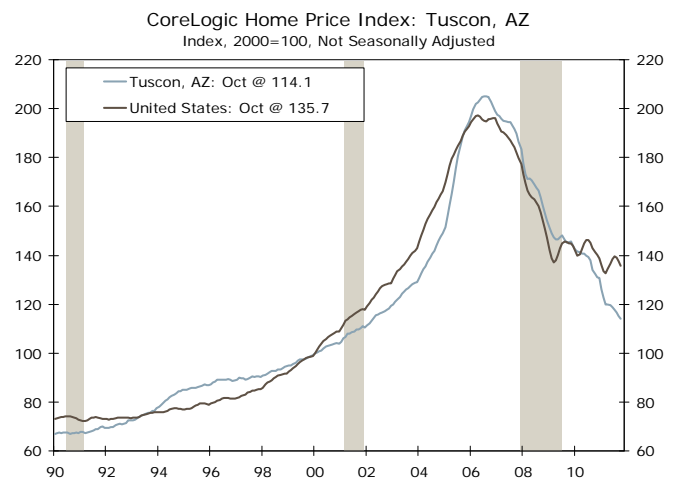
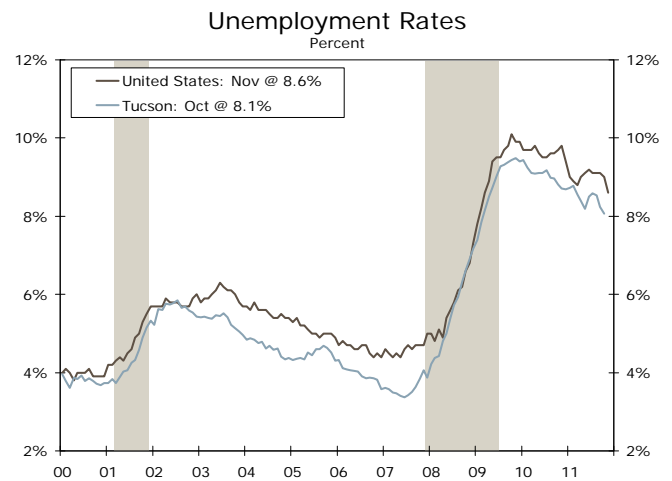
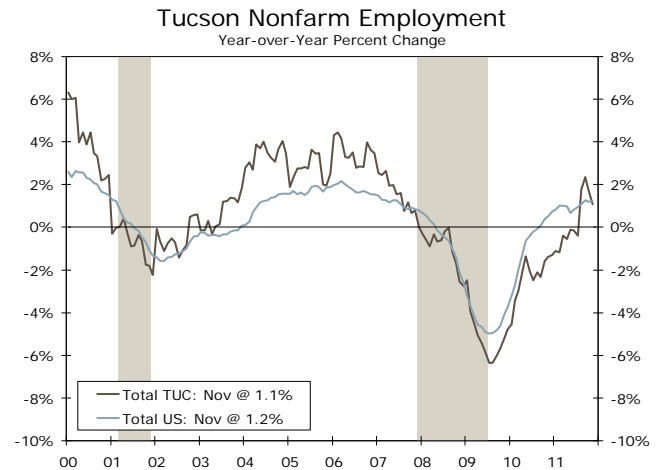
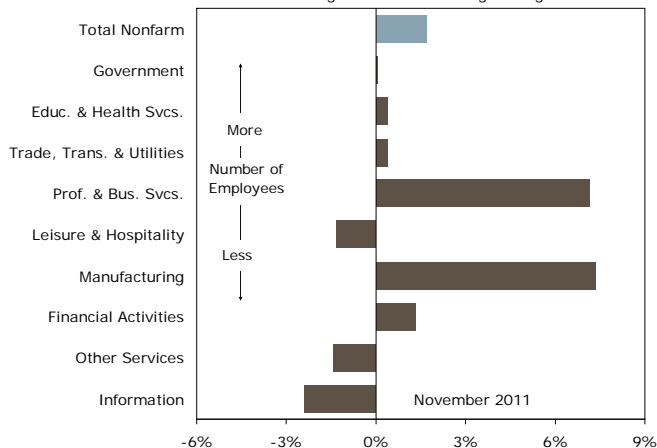


Source: U.S. Department of Labor, FHFA and Wells Fargo Securities LLC

Tucson

- After three years of consistent declines in nonfarm employment, Tucson has begun to experience continued growth in nonfarm payrolls. Employment in the metro area has increased 1.1 percent year over year. However, recent gains in professional & business services and education & health services have been largely offset by losses in leisure & hospitality and government.
- The unemployment rate is at its lowest level since February 2009; however, the state's fiscal crisis poses a significant headwind to recent employment growth. The government sector accounts for 22 percent of the region's employment.
- The area's dependence on defense manufacturing poses a downside risk to economic growth due to federal and state budget tightening. Raytheon Missile Systems, one of Tucson's largest employers, is facing a cut of \$435 million by the Department of Defense in fiscal-year 2012.
- The Davis-Monthan Air Force Base, a significant economic presence in Tucson, injected about \$1.10 billion into the local economy and has employed thousands of civilians, is now facing an uncertain future. Having already committed to eliminating 60 civilian positions in fiscal-year 2012, the training unit's f-16s will soon be phased out and whether the next generation of fighter jets comes to Tucson is unknown.

Tucson MSA Employment by Industry
Year-over-Year Percent Change of 3-Month Moving Average

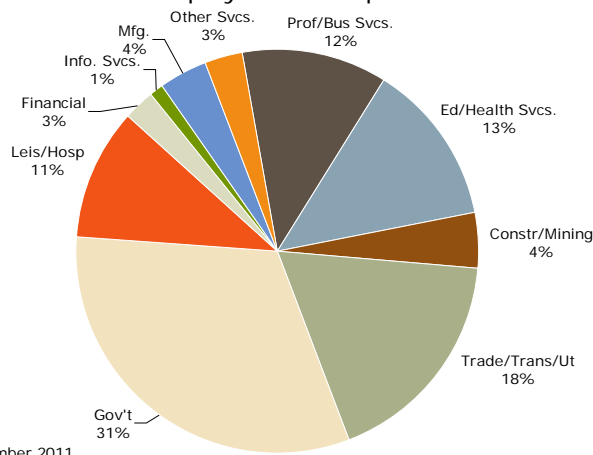


Source: U.S. Department of Labor, CoreLogic, Inc. and Wells Fargo Securities LLC

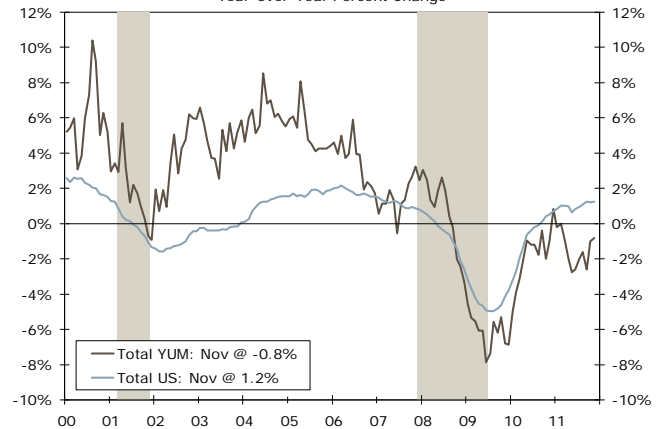
Yuma

- Yuma continues to struggle adding payrolls. The region's nonfarm employment is down 0.8 percent year over year, compared with 1.2 percent and 1.9 percent increases for the United States and Arizona, respectively.
- Yuma's unemployment rate remains elevated at around 25 percent, currently the second highest in the nation.
- One reason for the poor performance of Yuma's nonfarm employment is that the region relies heavily on government employment, which currently employs around 31 percent of the labor force.
- Yuma looks to the solar energy industry for future growth. Low labor costs and tax incentives, combined with ample land and access to West Coast energy grids, will attract solar panel construction projects into the area.
- Yuma's agricultural industry faces some near-term headwinds. The state's commercial citrus farming, the majority of which is in Yuma, finds increasing competition from other states and abroad due to upward pressure on fuel and pesticide costs. Furthermore, Arizona's immigration laws are making it difficult to find enough migrant farm workers.
- Yuma faces a future of weak income growth and continued dependence on low income jobs. As the population continues to age, an increasing share of personal income will come from transfer payments.

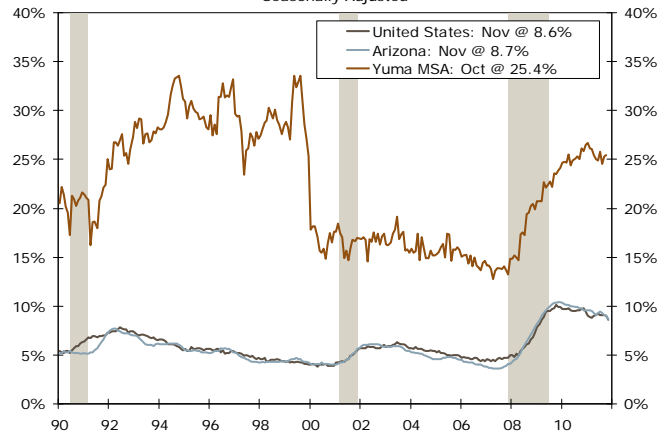
Yuma Employment Composition



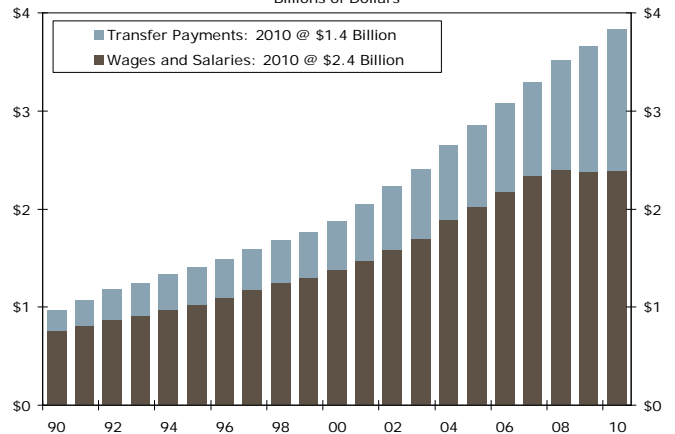
Yuma Nonfarm Employment
Year-over-Year Percent Change



Yuma MSA Unemployment Rate
Seasonally Adjusted



Yuma MSA: Wages & Salaries vs. Transfer Payments
Billions of Dollars



Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

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