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OSPB Summer Economic Outlook, August 2018

Executive Summary

In December 2017, while finalizing the economic forecast underlying the FY 2019 Executive Budget, OSPB saw reasons for optimism on the horizon, but believed – based on the best national data available at the time – slowing employment growth necessitated assuming slower revenue growth in the upcoming fiscal year. By late March, that opinion was clearly no longer current.

Conditions today have changed dramatically, both for Arizona and the nation. All major indicators now suggest a significant improvement in the rate of economic growth since approximately the end of 2017. Further, revisions to historical data series by the Bureau of Labor Statistics (BLS) have revealed that a bad sample produced overly pessimistic figures for Arizona's employment growth, largely responsible for depressing OSPB revenue estimates, which resulted in a forecast that did not anticipate the FY 2018 revenue surge. According to revised BLS estimates, employment growth for Arizona was 2.1% in 2017, or **61% faster** than under the December data.

After averaging just 2.2% per year since the end of the Recession, current indicators suggest an imminent return to Real Gross Domestic Product (RGDP) growth rates of over 3.0%. According to the Federal Reserve Bank of Atlanta's *GDPNow* indicator, Q3 2018 growth should be **4.3%**. Revised forecasts from both the Congressional Budget Office and IHS Global Insight project growth of at least 3.0% in 2018 and 2019. OSPB's own internal estimates support a range of 3.0-3.5%. All parties agree that the recently enacted federal *Tax Cuts and Jobs Act* is at least partially responsible for the improvement.

Finally, OSPB considers that rising personal incomes and wages – strengthened by a tightening labor market, faster economic growth, and moderate inflation – are supporting a resurgent consumer, which in turn is fueling robust growth in State tax revenues. Sentiment surveys suggest a consumer at or near the highest confidence levels seen in the past *two* economic expansions. Through June, ongoing General Fund revenues are up **7.1%**, and are more than \$120 million over the recently enacted budget forecast. These data provide a strong foundation to support the Governor's spending commitments for the next three years.

While prospects for the next 12-18 months are strong, OSPB is more cautious about the economy beyond that period. This 107-month expansion cycle looked stable when growth was tepid; in the face of unexpected acceleration, the possibility of a return to a more normal business cycle looms.

While consumers remain confident due to rising incomes, there is a marked divergence in the data when consumers talk about future inflation and interest rate expectations. Sustained by the Federal Reserve, higher future interest rates and prices could eventually offset favorable job and income prospects, leading to a tightening that could slow both the economic expansion and the growth in tax revenue.

OSPB will continue to monitor these indicators to ensure that the State is prepared for any changes, supported by a conservative budget posture and significant cash reserves.

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Authored By: Glenn Farley, Chief Economist
Attachment: Summer Economic Outlook, 8-22-2018



2018 Summer Economic Outlook

August 22, 2018

Governor's Office of Strategic Planning and Budgeting

Economic Outlook

In Brief

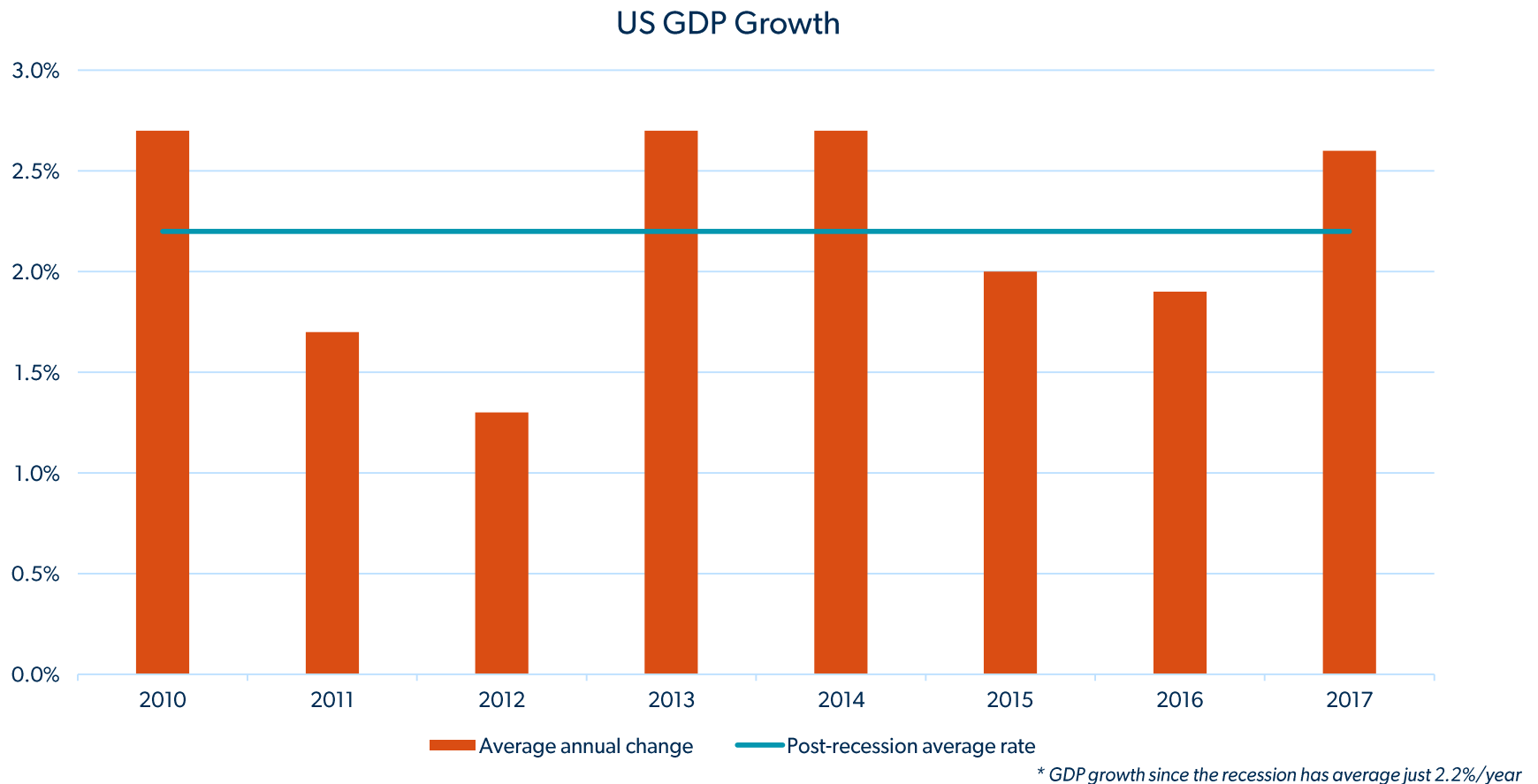
- US growth should be over 3.0% this year
Capital investment and consumer spending key growth drivers
- Monetary & fiscal policy has been supportive
Absence of new policy support, Fed tightening could slow future growth, but short-term prospects bright
- Growth in Arizona has been strong
Housing and job markets (esp. manufacturing) driving Arizona's class-leading growth

Key Indicators

Strong, positive near-term outlook

US GDP Growth Has Lagged...

Typical recoveries see 3.0%+ growth



...But projections are accelerating

Outlook suggests imminent return to 3.0%+

GDPNow (*Federal Reserve Bank of Atlanta*)

- Q3 2018 US GDP (August 9, 2018): +4.3%

US Bureau of Economic Analysis

- Q2 2018 US GDP (July 27, 2018): +4.1%

Budget & Economic Outlook (*Congressional Budget Office*)

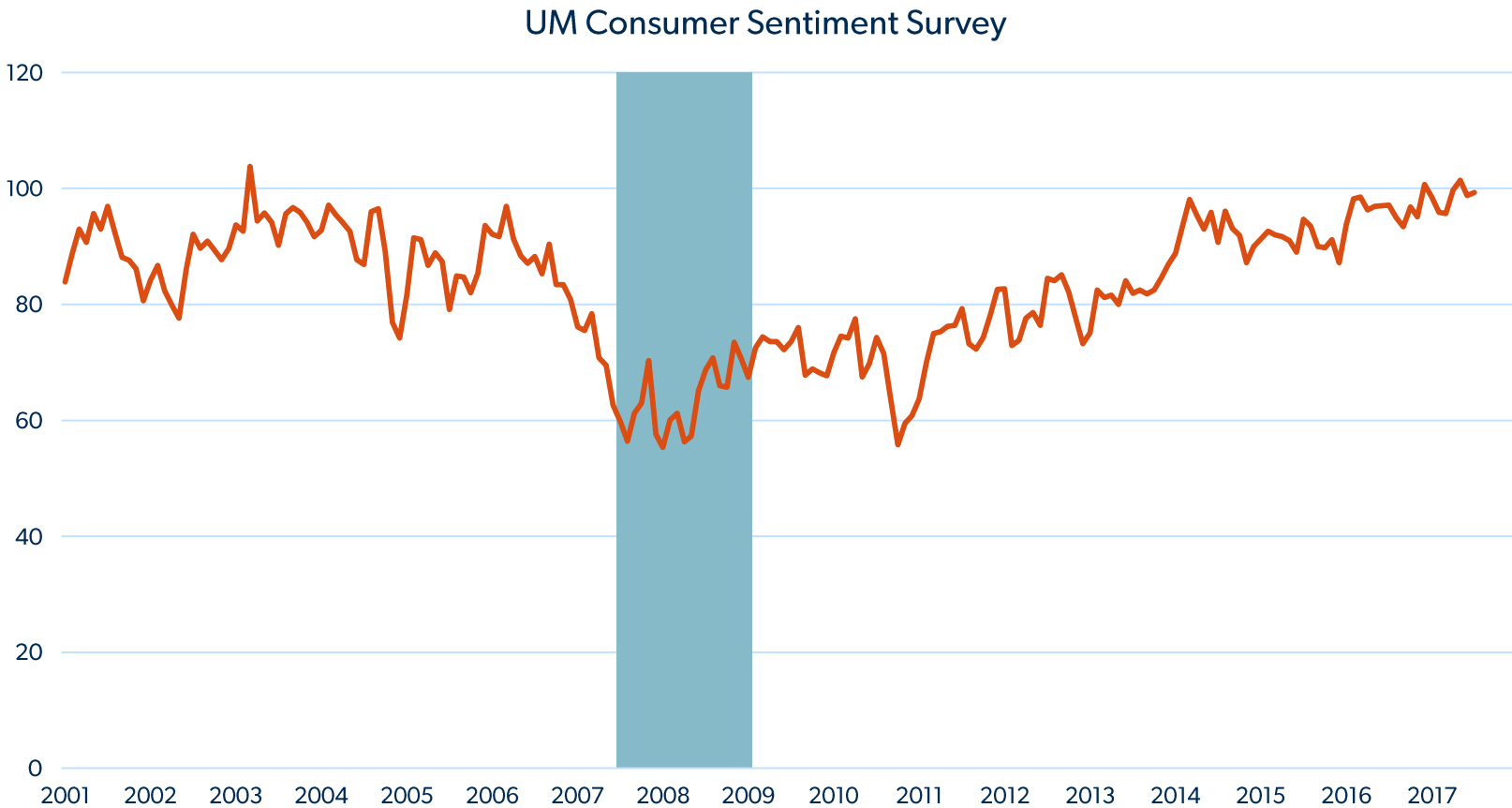
- CY 2018 US GDP (April 9, 2018): +3.3%

US Economic Outlook (*IHS Global Insight*)

- CY 2018 US GDP (March 8, 2018): +3.0%

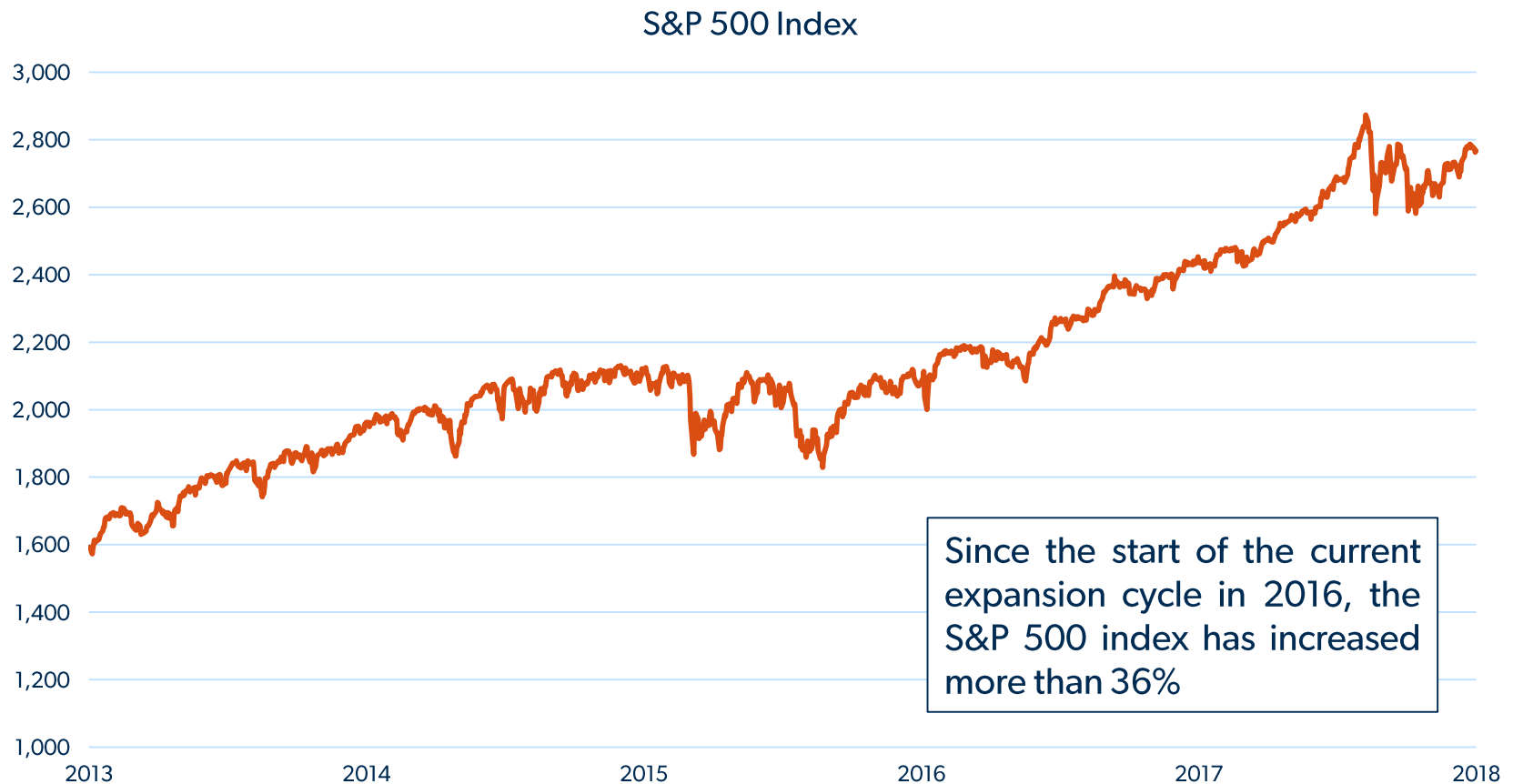
Consumer Sentiment is Strong

Near peaks from past two economic cycles



Equity Prices Remain High

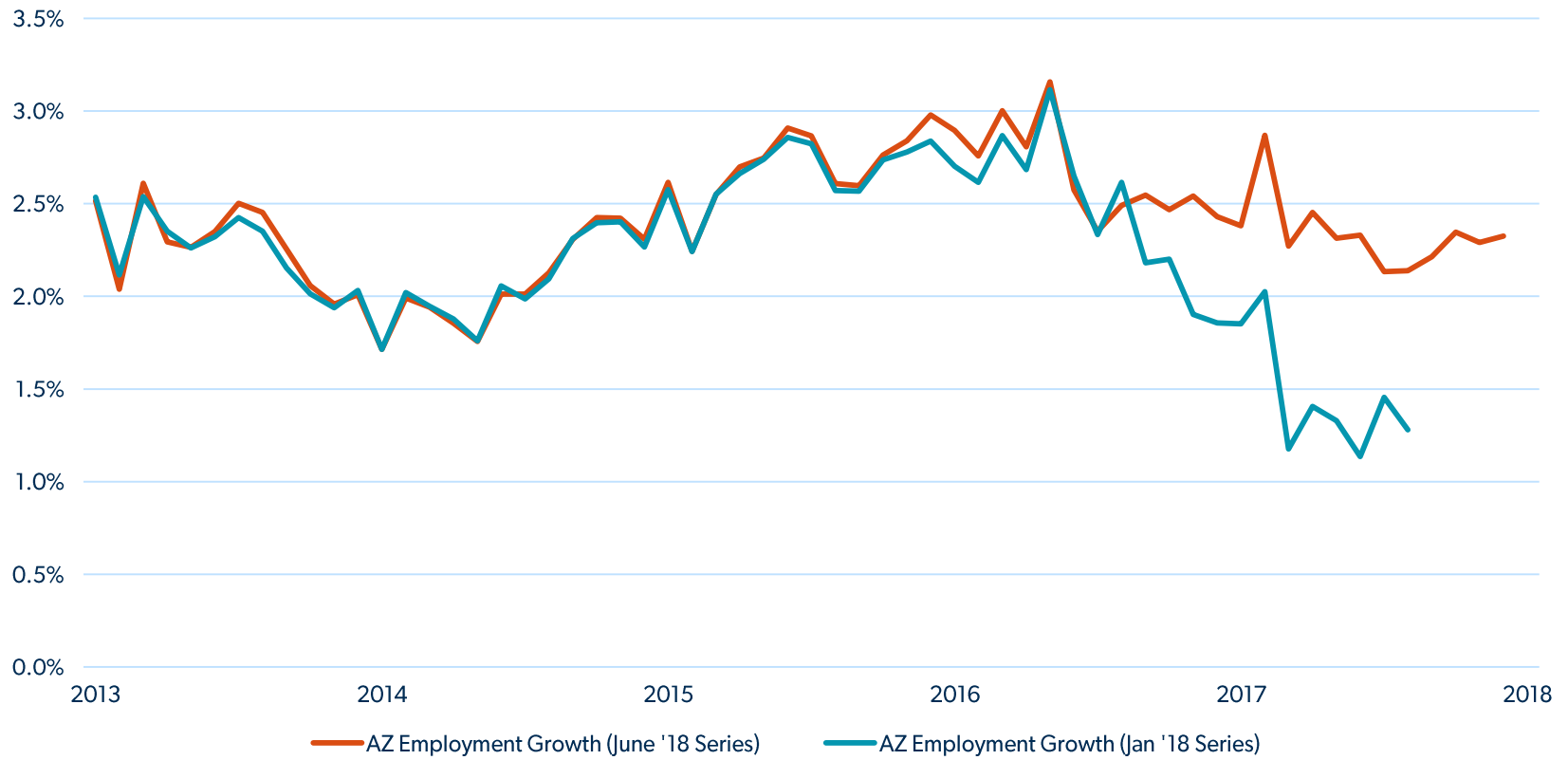
Recent correction so far hasn't changed trend



Arizona Stronger Than Thought

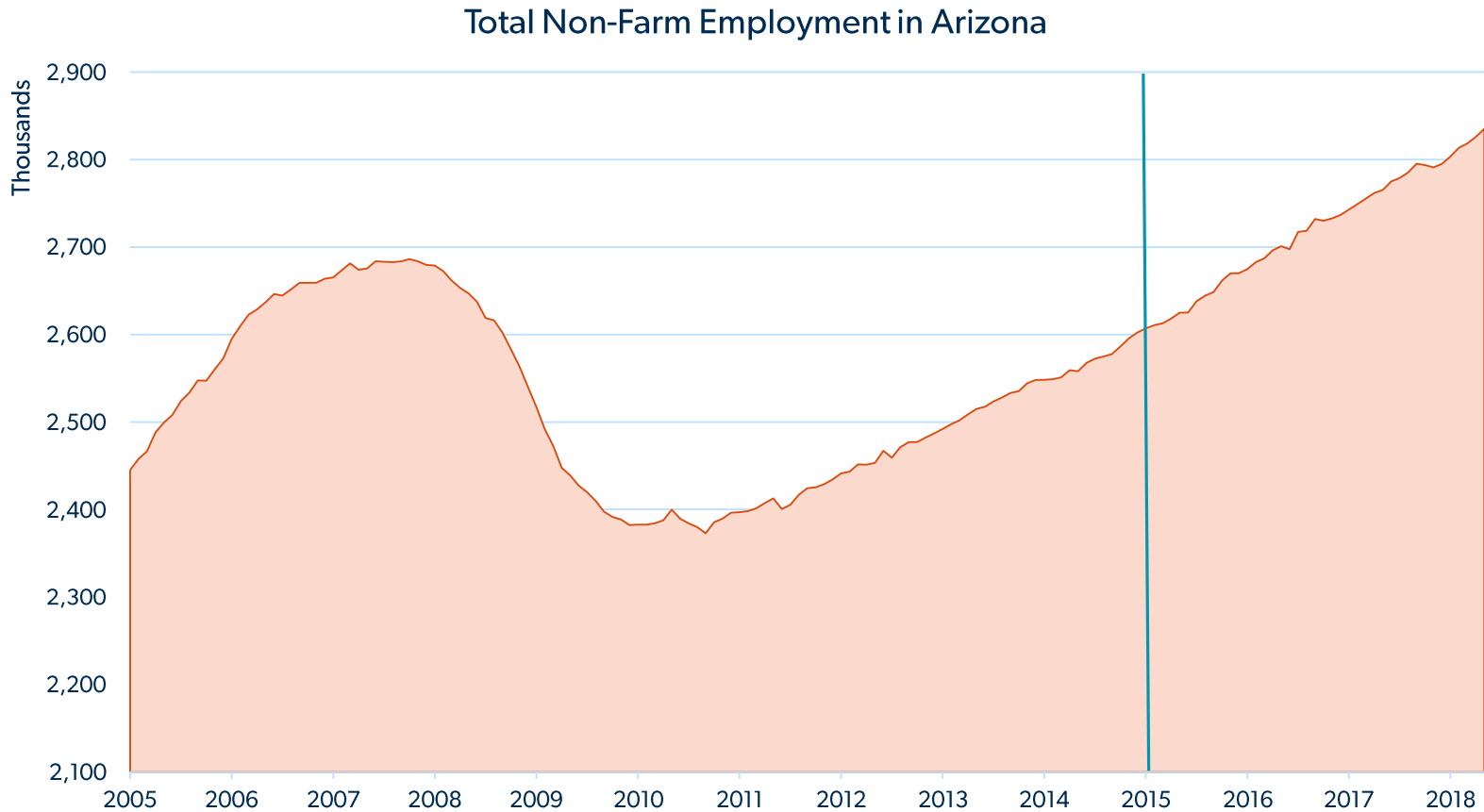
Substantial upward revisions to employment data

Historical Employment Growth in Arizona



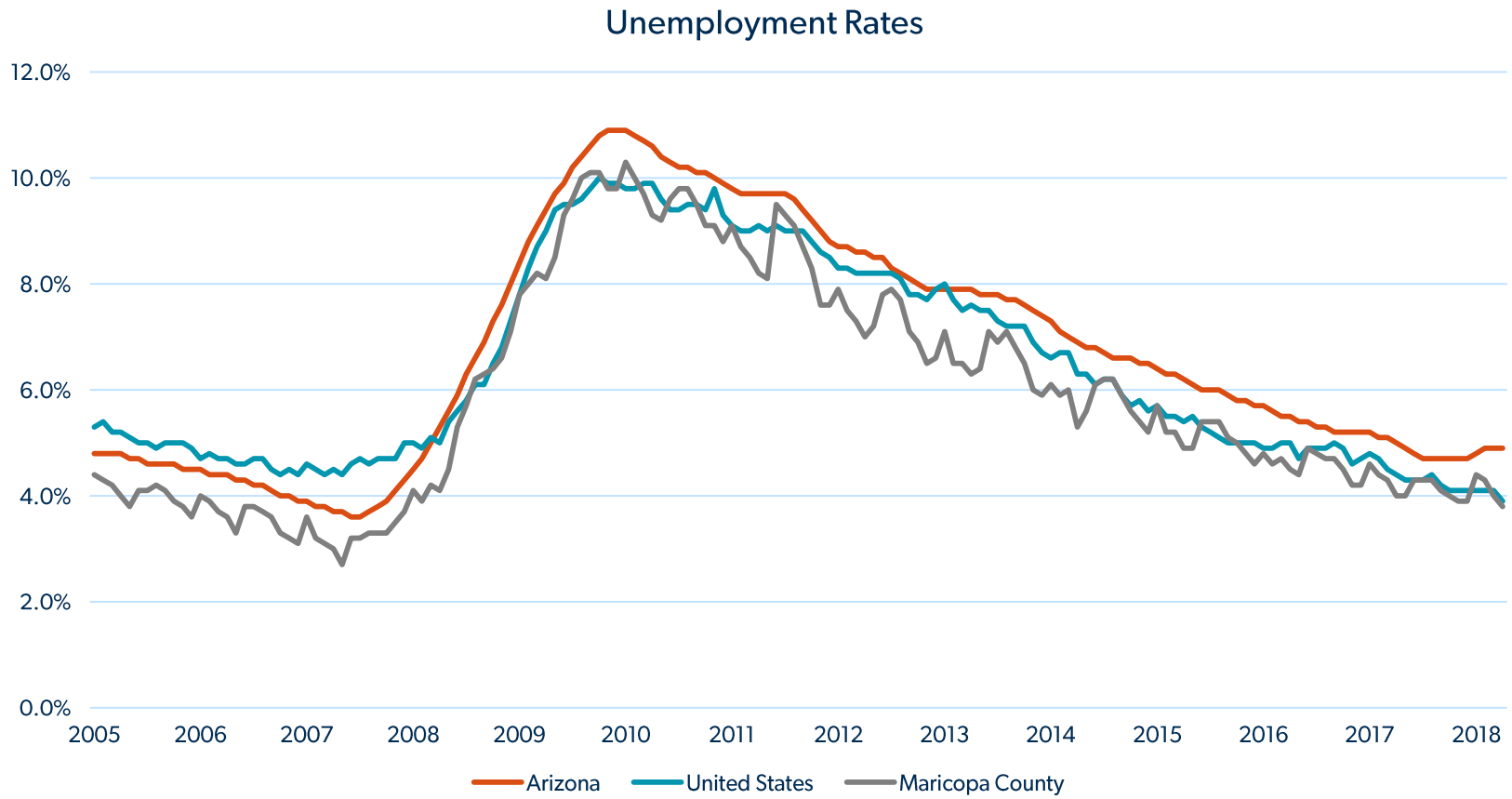
Total Employment at All-time High

Nearly 240,000 non-farm jobs have been added since 2015



Unemployment Rates are Falling

National and State rates at post-recession lows



Trading Partners Also Growing

Mexico poised to grow faster this year

- USCB: Mexico is Arizona's largest international trading partner
- OECD: Mexico's GDP will grow at +2.5% in 2018

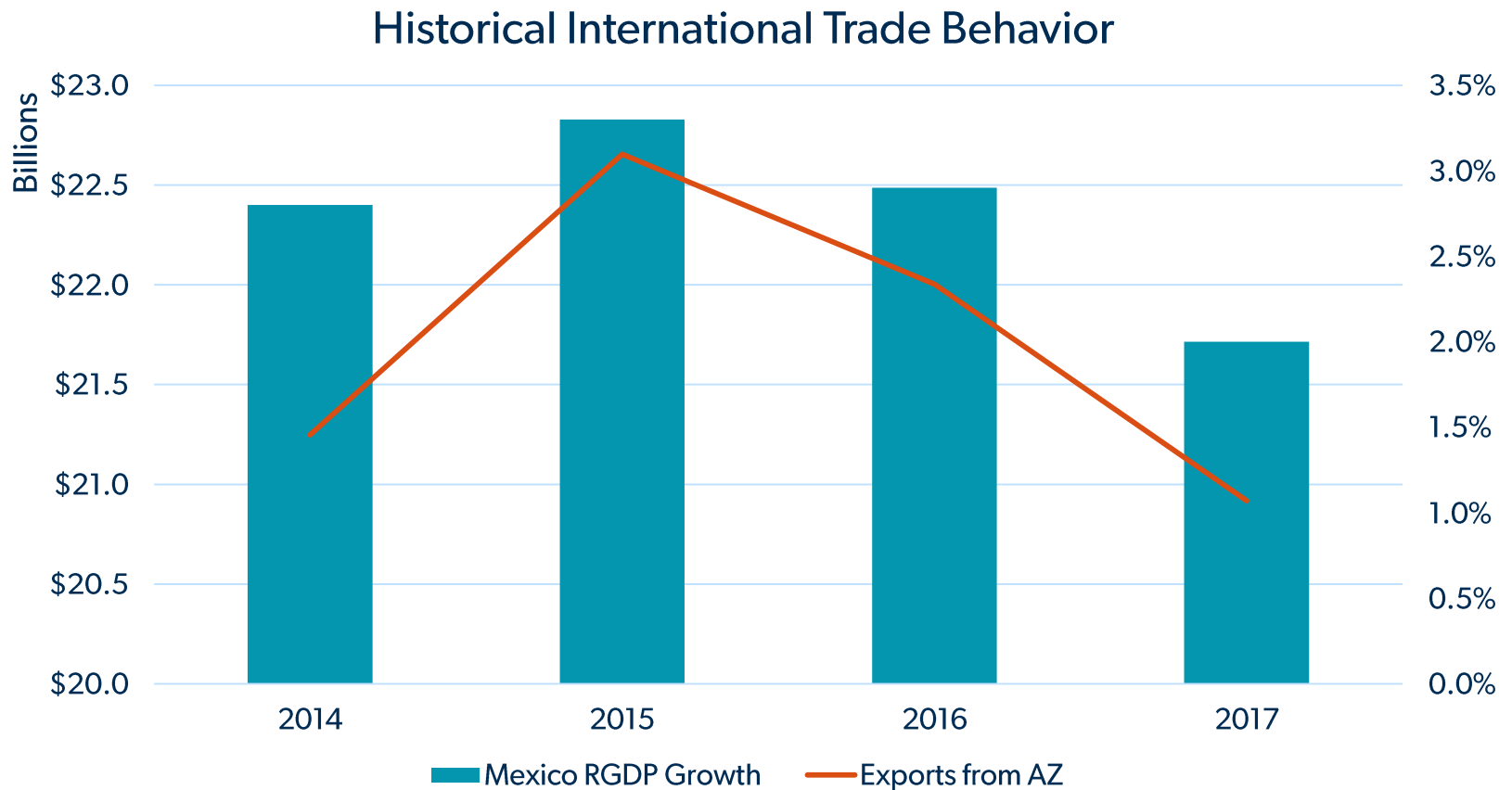
Real GDP Growth in Mexico

2017	2018	2019
2.3%	2.5%	2.8%

* OECD Economic Outlook, May 2018

Arizona's Exports Tied to Mexico

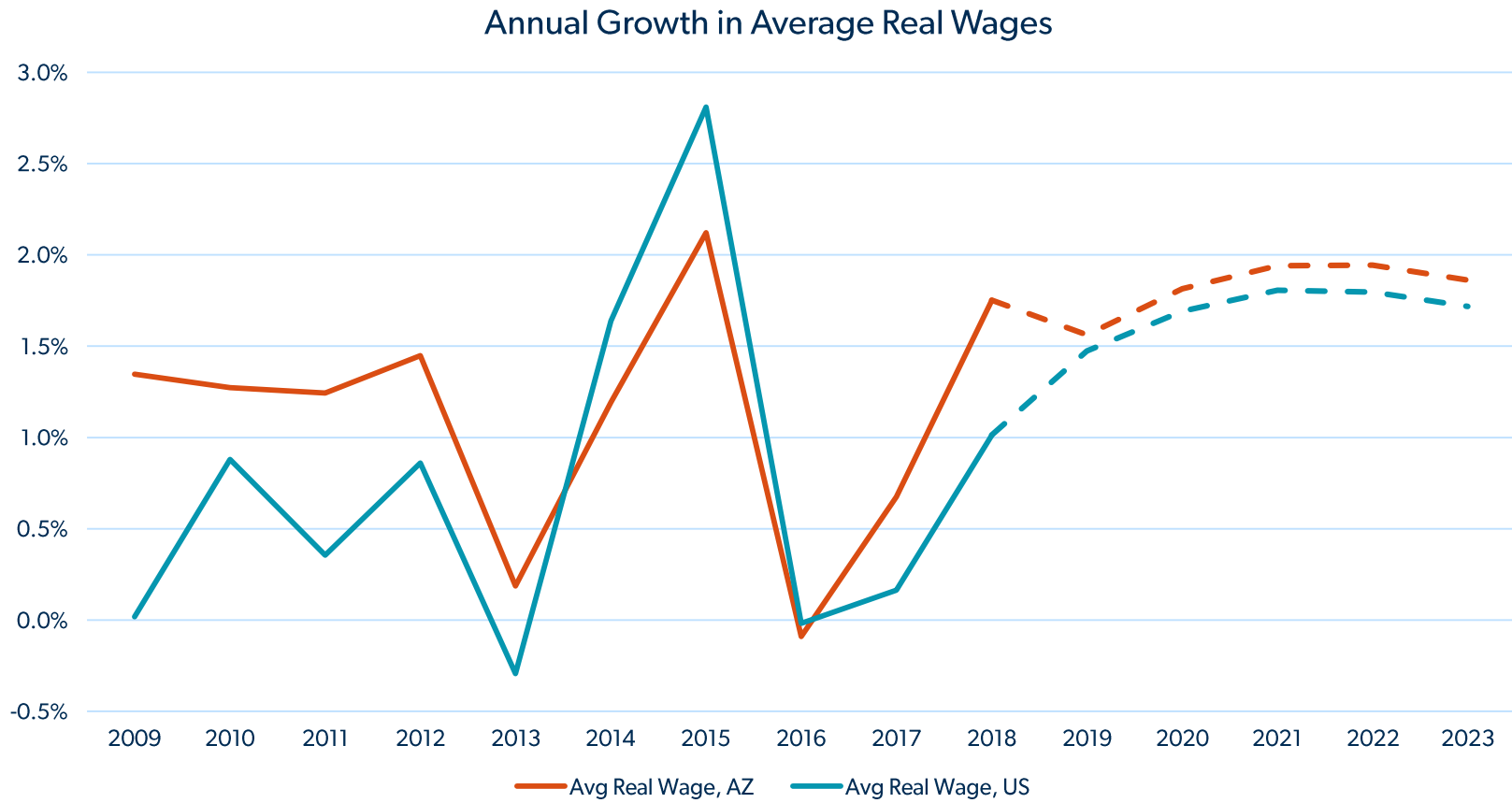
Slower growth last year correlated with declines



* United States Census Bureau, Total U.S. Exports

Wage Growth may be Accelerating

However, overall rates remain moderated

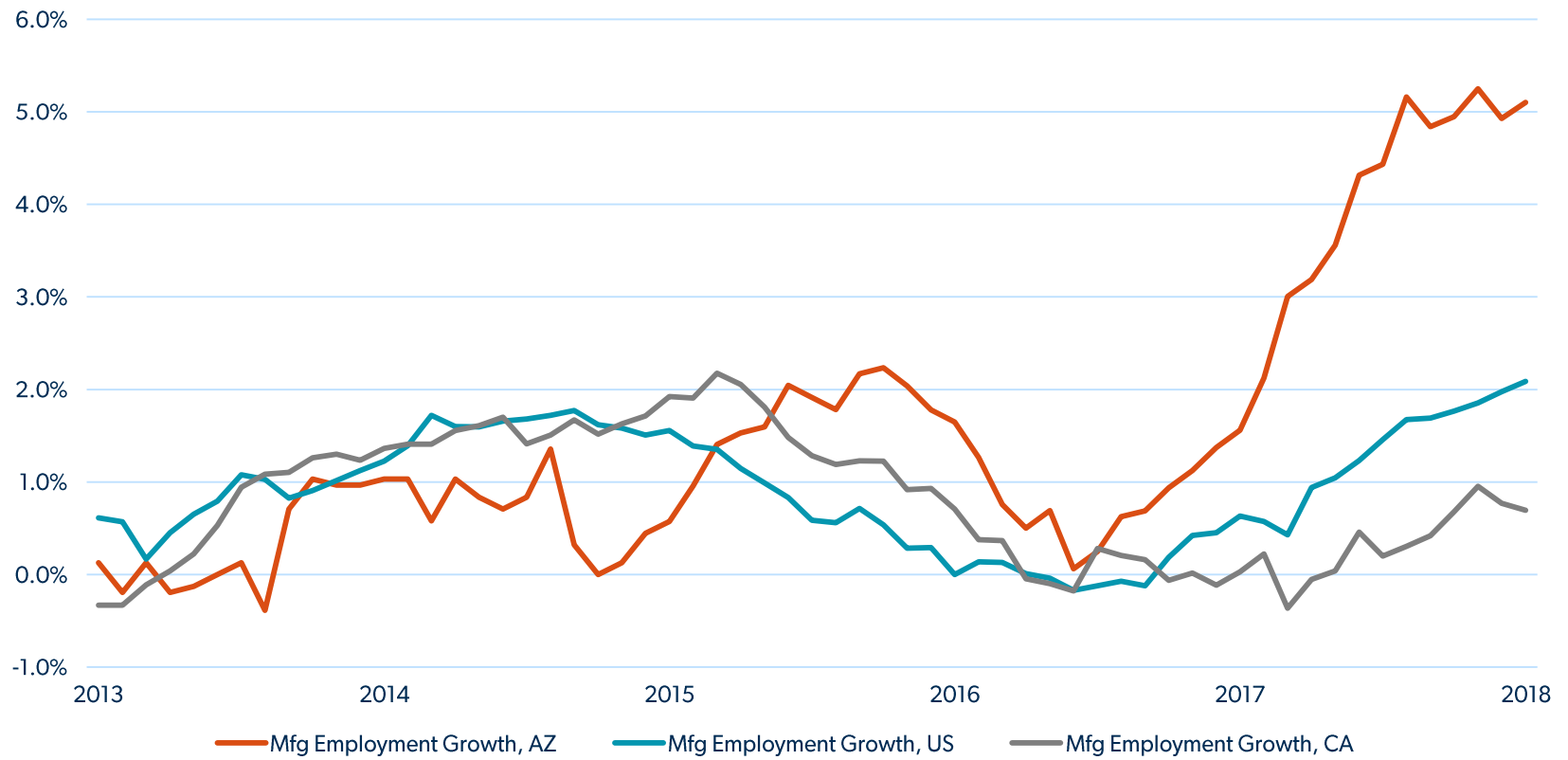


* IHS Global Insight, June 2018

Manufacturing Renaissance

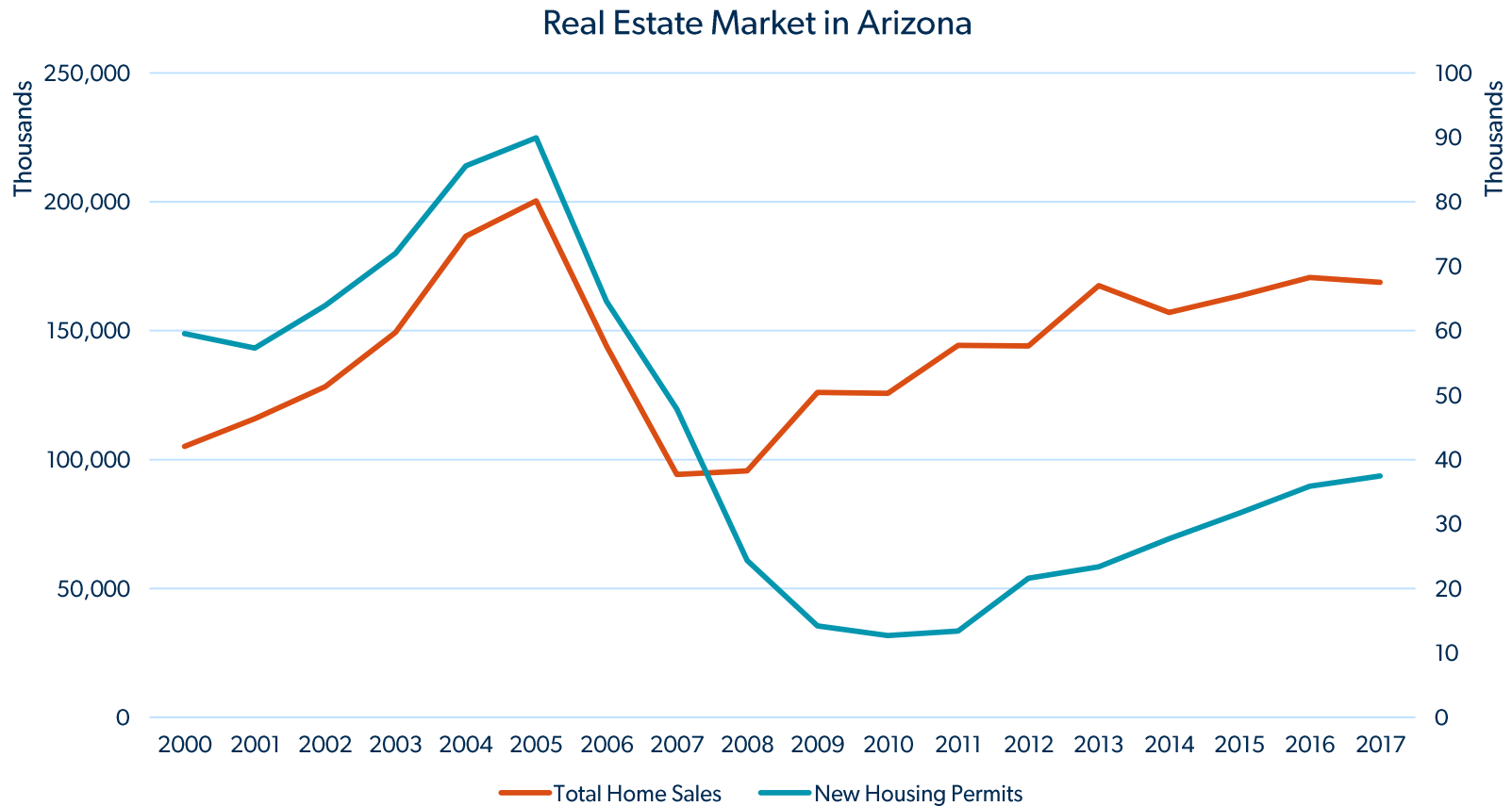
Unprecedented growth in Arizona's mfg employment

Growth in Manufacturing Employment



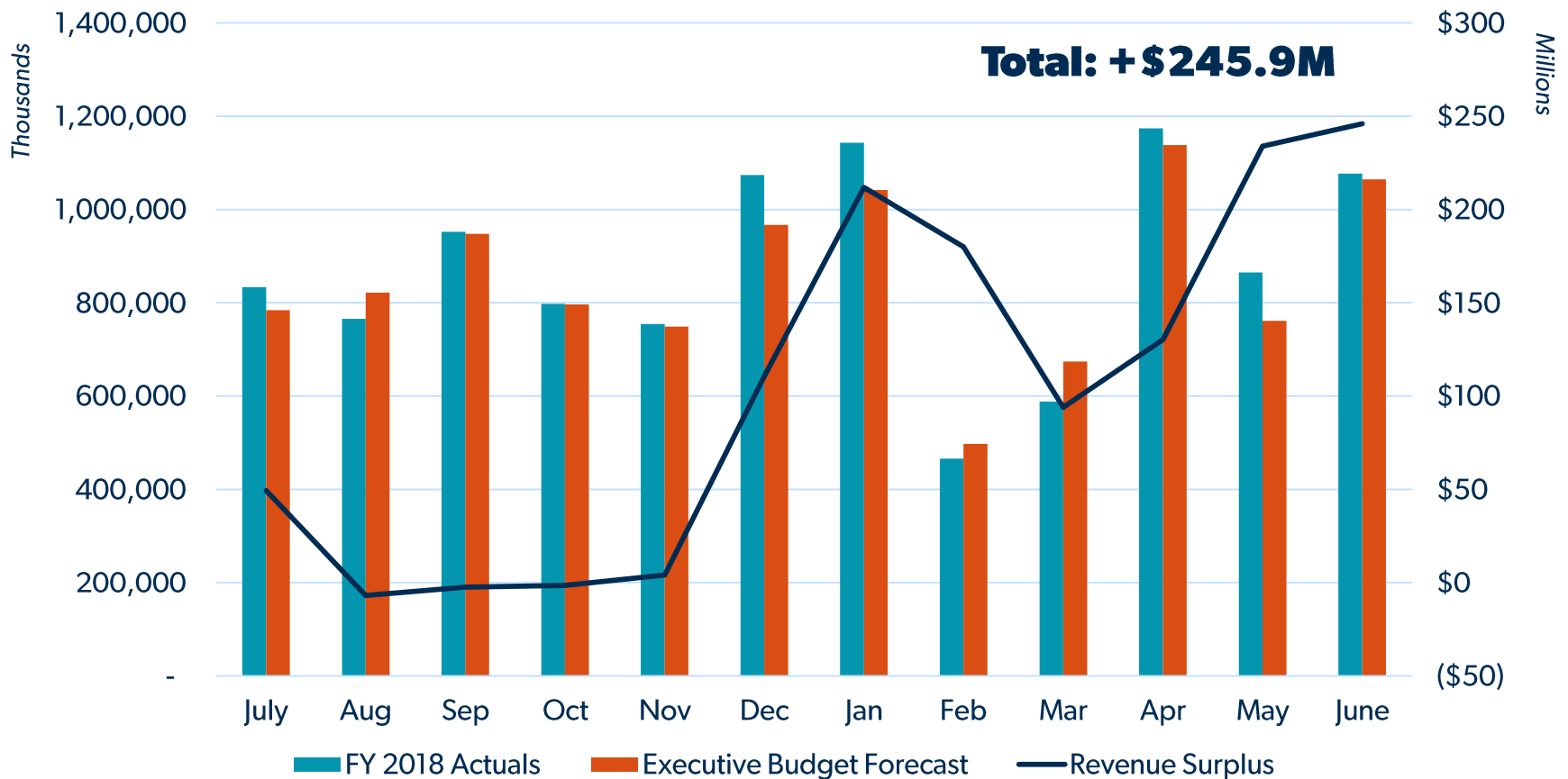
Housing Market is Recovering

Rising prices, rates so far haven't stymied sales



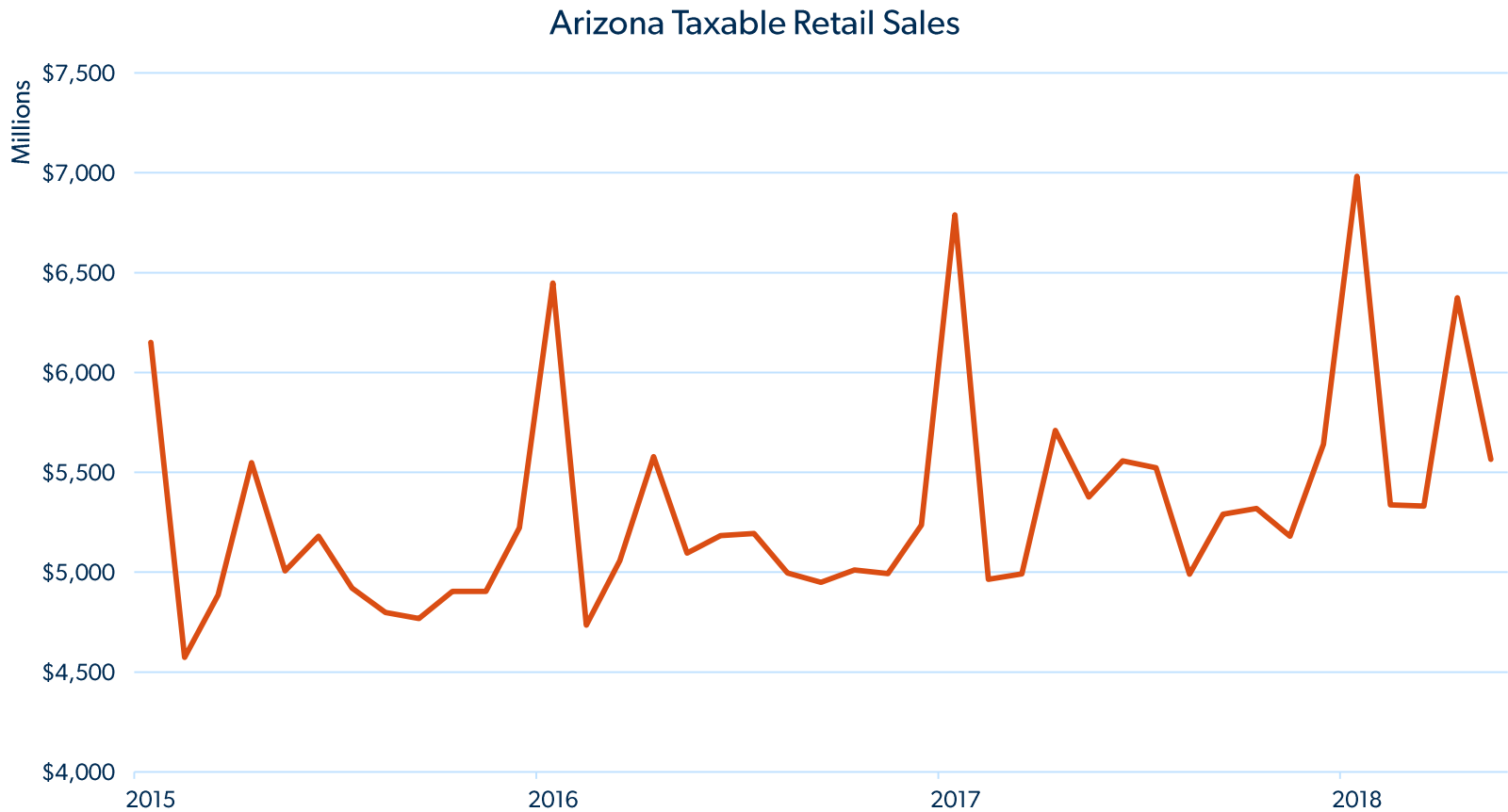
Strong GF Revenue Performance

FY 2018 revenue growth strongest since 2013



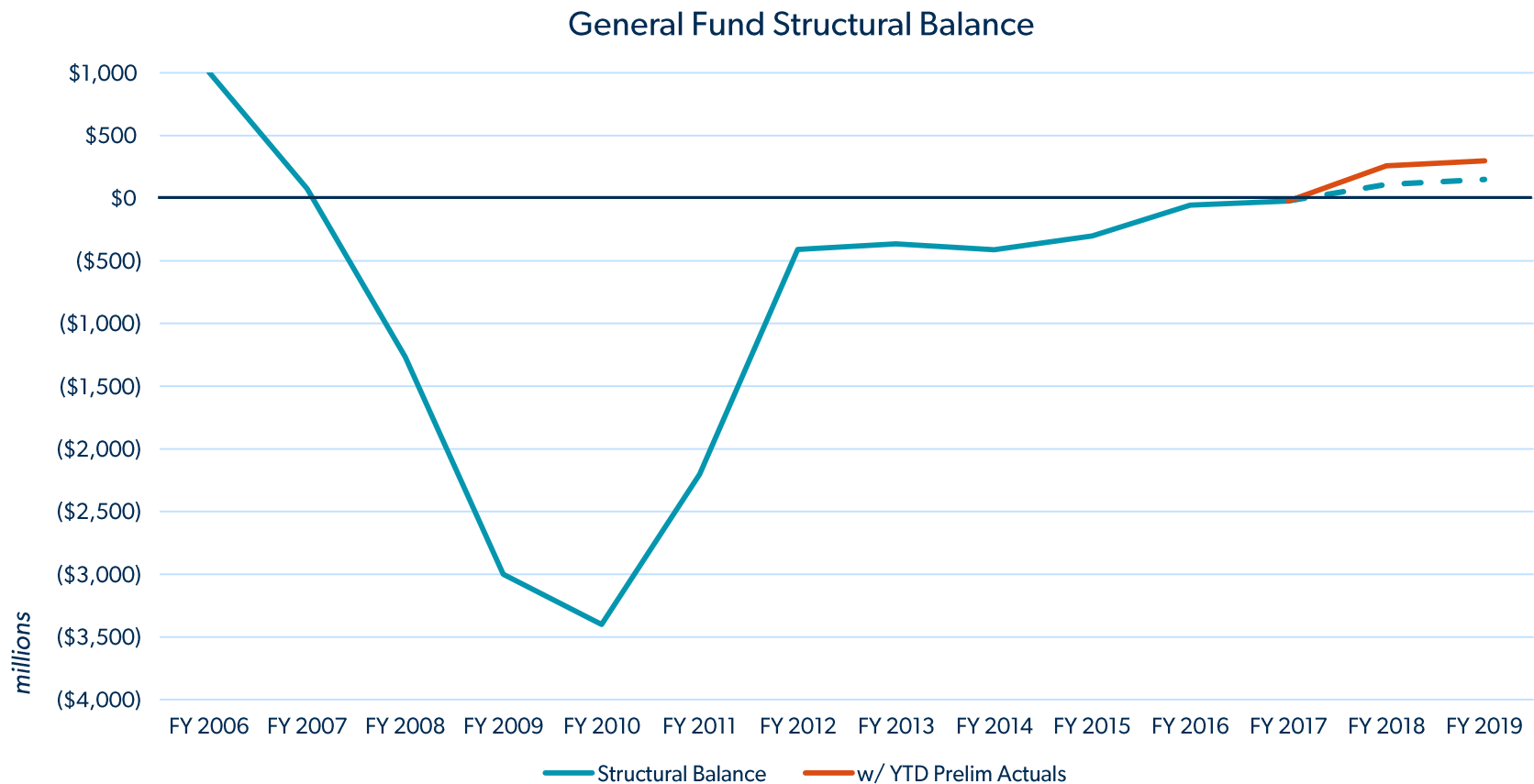
Taxable Retail Sales are Growing

This suggests a strong GF revenue base



Structurally Balanced State Budgets

For the first time since the Great Recession

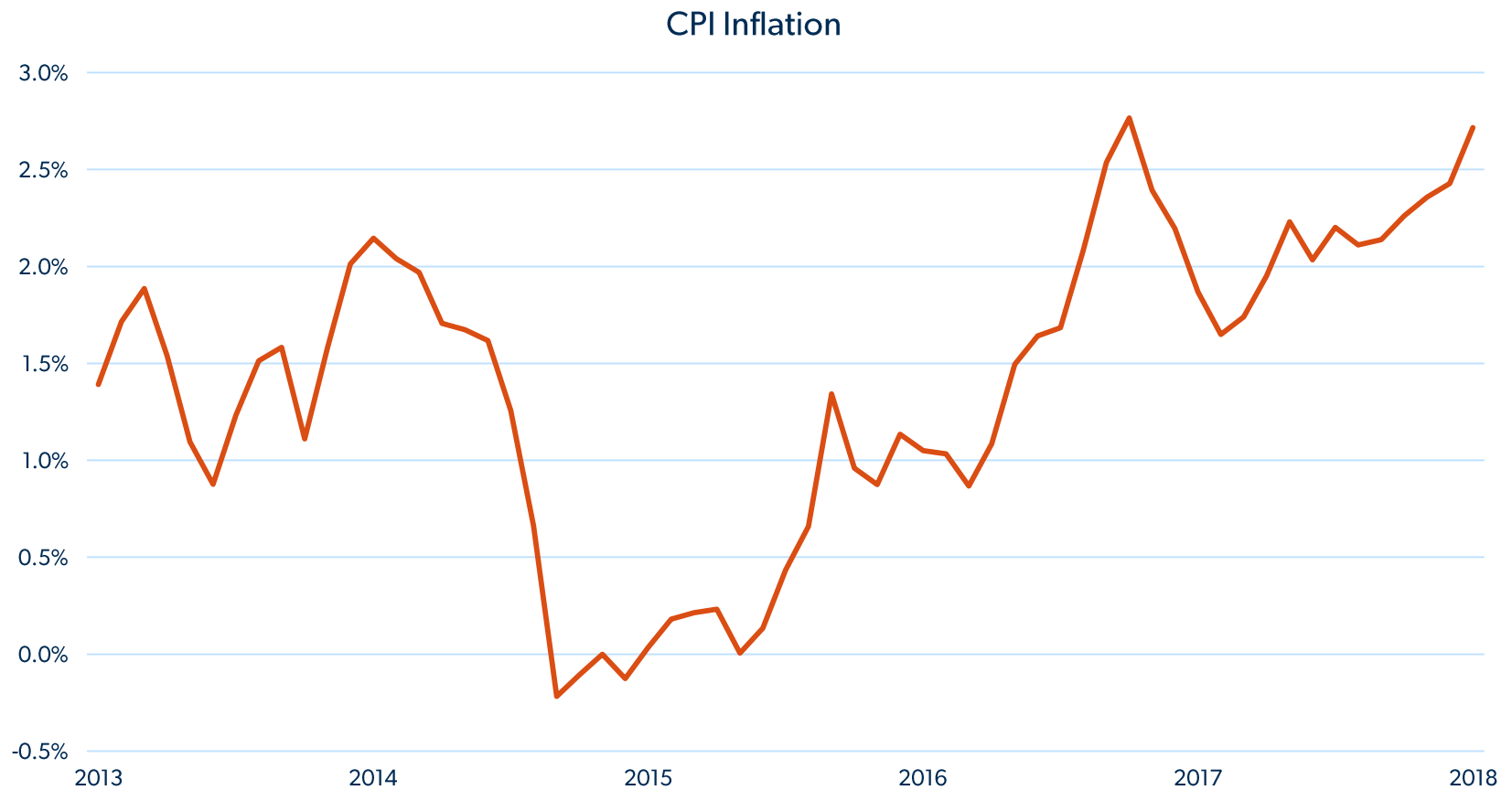


Key Risks

Overall short-term risk is muted

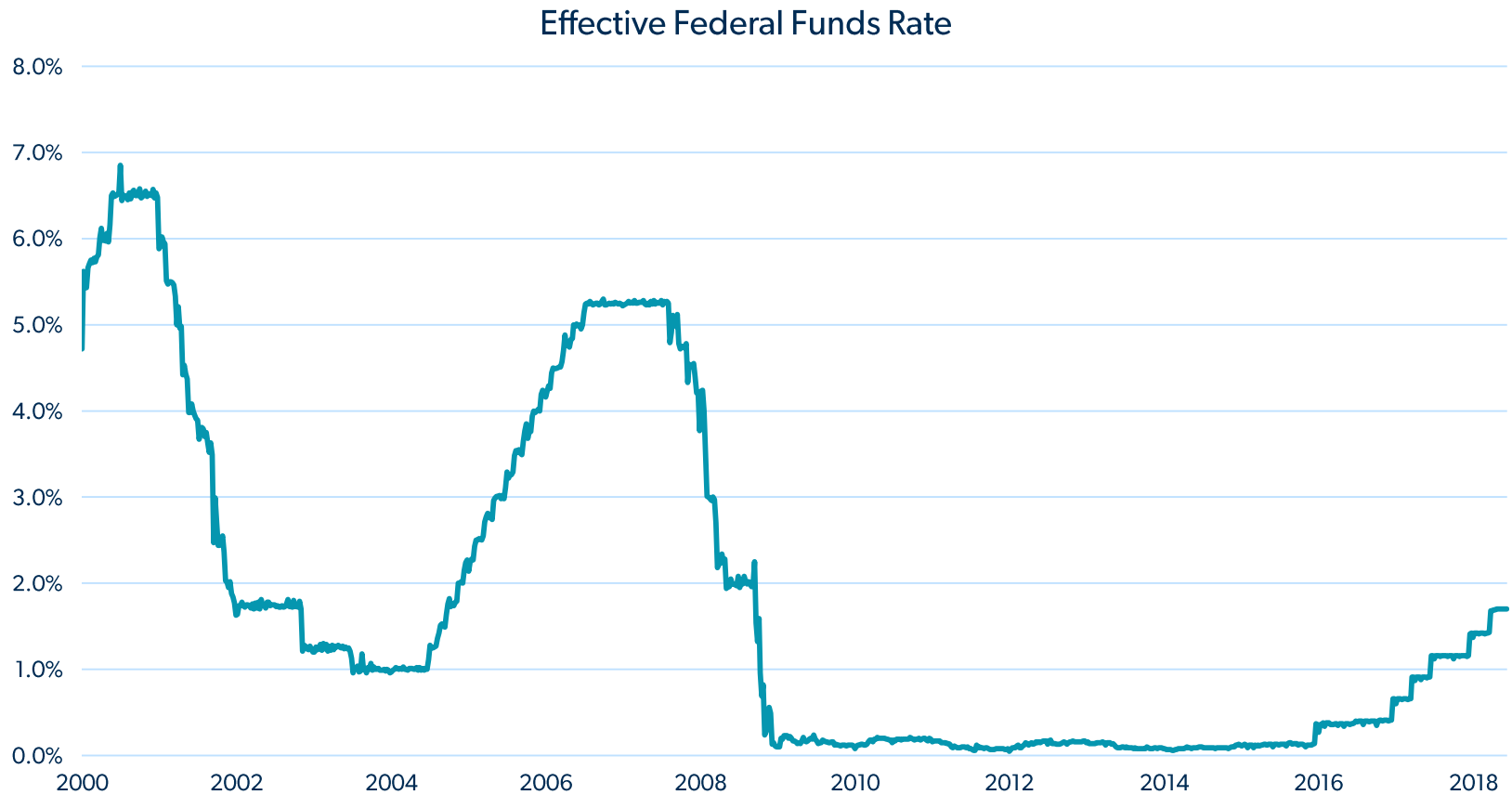
Inflation Rates Are Picking Up

Could Encourage Consumers, Fed to Tighten



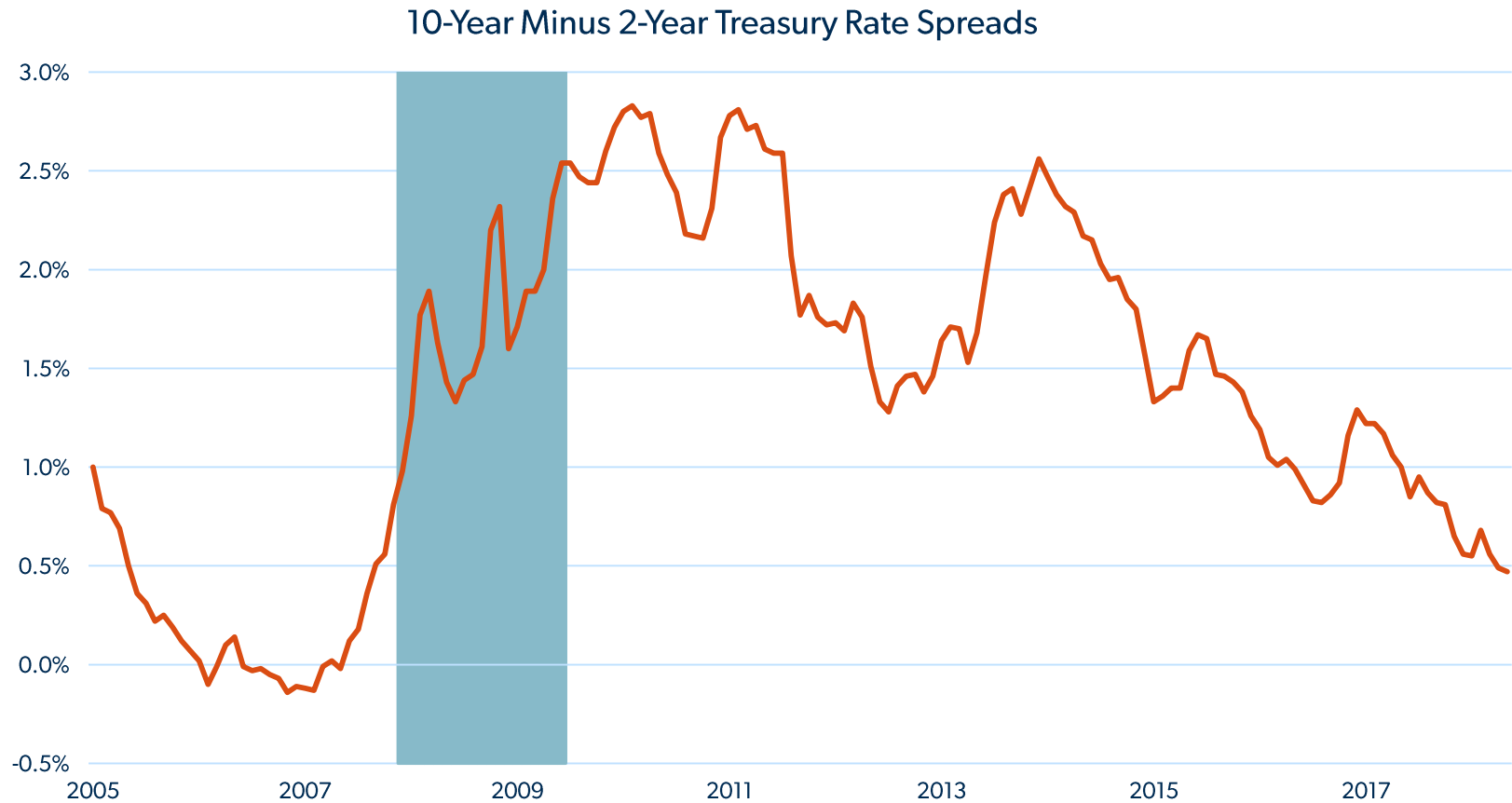
Target Rates are Rising

But are still well below historical norms



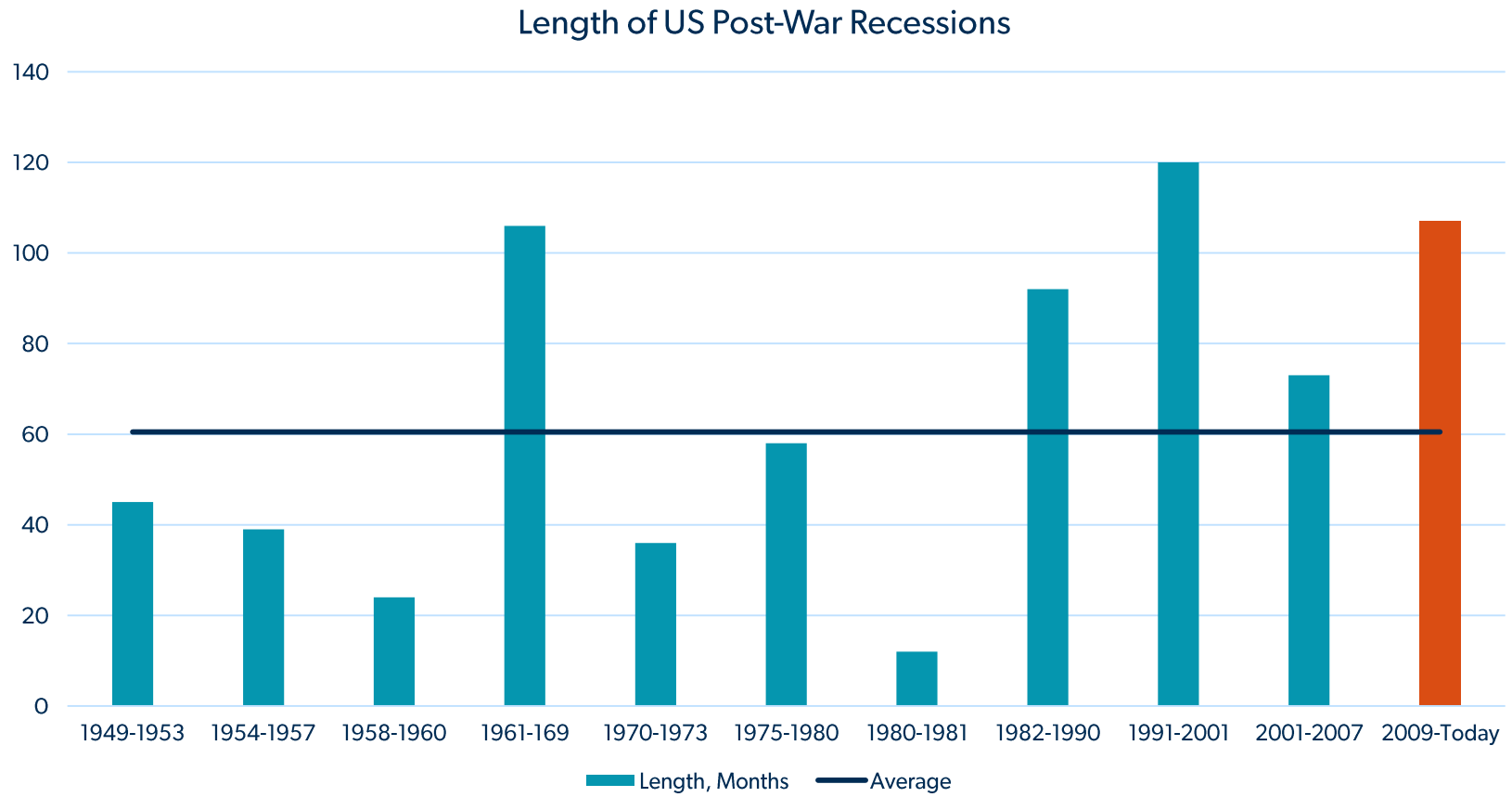
Treasury Spreads are Falling

Typically, tightening spreads precede recession



This Expansion is Long

The average expansion lasts less than 6 years



Conclusions

Overall prospects strong over next 2-3 years

Conclusions

- Near-term acceleration in national and state growth
Policy and economic fundamentals highly supportive
- Higher inflation and interest rates should buoy short-term revenues
Medium-term implications necessitate re-evaluation later
- Arizona will do better than the average state
Relatively low costs of living and doing business promote cross-state migration of investment and labor