Remodeling the Economy: 2011 Midyear Economic Update

By Development Research Partners, August 2011

The nation's recovery appeared progressively more positive in early 2011 as the stock market stabilized, businesses reported higher profits, and consumer confidence improved. However, these positive signs belied fundamental economic weaknesses that became more apparent as commodity prices increased and the public debt crises unfolded both here and abroad.

The Metro Denver Economic Development Corporation's (Metro Denver EDC) **Midyear Economic Forecast** report includes national, state, and regional projections in key economic indicators such as employment, unemployment, retail sales, home sales/prices/construction, residential foreclosures, and commercial real estate (download report below).

Although the economy is in a fragile state, a return to recession is not inevitable. Confronting the nation's underlying vulnerabilities will be crucial to recovery.

- **The public sector debt challenge**. Total U.S. government debt today ($14.3 trillion) amounts to $46,450 for every citizen of the United States. Three decades ago, the per capita debt total was only $4,350. Many factors contributed to the higher federal debt level, including costly military engagements and an aging population that places an ever-greater burden on Social Security and Medicaid. Debt spiked further when the government spent billions in an arguably necessary effort to support the failing economy.

  Political disagreements aggravate these challenges, leaving households, businesses, and investors anxious. Uncertainty—the enemy of economic growth – seems likely to persist as most of the budget cuts promised under Congress' debt ceiling agreement have yet to be specifically identified or agreed upon.

- **The private sector is not filling the gap in anticipation of lower government spending.** With the economic role of government likely shrinking, a thriving private sector will prove indispensable for growth. Healthy corporate profits suggest many businesses accumulated wealth, but a profound lack of business confidence has kept employers from using new resources to hire. Results of the *Manpower Employment Outlook Survey* show, for example, that the share of U.S. employers planning no changes in staffing has been near or above 70 percent for 11 consecutive quarters.

  While the public sector has few quick fixes for its problems, even slightly more clarity on taxes, healthcare reform, banking regulations, and public finance would go a long way towards boosting business confidence. Policymakers also have a difficult challenge in implementing any further stimulus measures; to the extent businesses expect more government help, they may be less willing to act on their own.

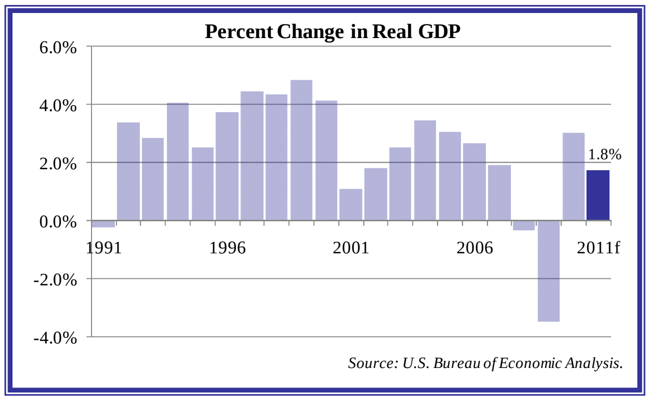
- **The household debt problem lingers**. In today's economy, weak job and income growth likely replaced unconventional mortgages as the chief source of strain on homeowners. Because a home mortgage is the single greatest liability for many households, a healthier housing market—one where foreclosure inventory is largely absorbed—is essential for more stable personal finances. The pace of foreclosure filings is slowing, but the extent to which foreclosures have merely been delayed by fallout from the "robo-signing" crisis—the signing of documents that haven't been read— is a troubling uncertainty.

"These challenges are difficult in themselves, but their interconnectedness makes them much harder to confront," explains Patty Silverstein, chief economist for the Metro Denver EDC. "The recent uncertainty in the economy suggests meaningful growth will not appear until these imbalances are resolved. Even though significant progress is dependent on the resolution of these vulnerabilities, it is important to note that Metro Denver is still maintaining elements of growth, albeit slow."

Despite the economic challenges facing Metro Denver on a local and national level, the region has sustained key assets that contribute to the area's overall health. Metro Denver's real estate market continues to perform better on several fronts compared to national levels. While home prices are declining very slightly in Metro Denver, they are expected to severely contract across the nation during the remainder of 2011. Apartment vacancies are down. Office, industrial, and retail vacancy rates are stabilizing and remain more promising than rates throughout much of the country. Employment growth is still expected to be too slow to reduce unemployment, but companies with a focus on health care and renewable energy are expected to add a respectable number of jobs this year.

U.S. Outlook

Gross Domestic Product (GDP)



- First quarter growth in the nation's GDP was almost imperceptible (+0.4 percent), and second quarter growth (+1 percent) was well below the level needed to affect unemployment.

  Weaker household spending was a major element in the sluggish growth. Spending could remain flat for at least another few months. Political conflict, still-high oil prices, and an unpredictable stock market left many consumers spooked. More important, job and income growth—the main factors of steady spending – continue to be slow. Further reductions in government spending will also put pressure on GDP in the coming quarters.

  Forecast: Real GDP growth in 2011 will total 1.7 percent, an increase below the 20-year historic average growth rate of 2.5 percent.

Employment & Unemployment

- While employers added jobs this year, government layoffs and consolidation in financial activities and other industries made already small net job gains even smaller.

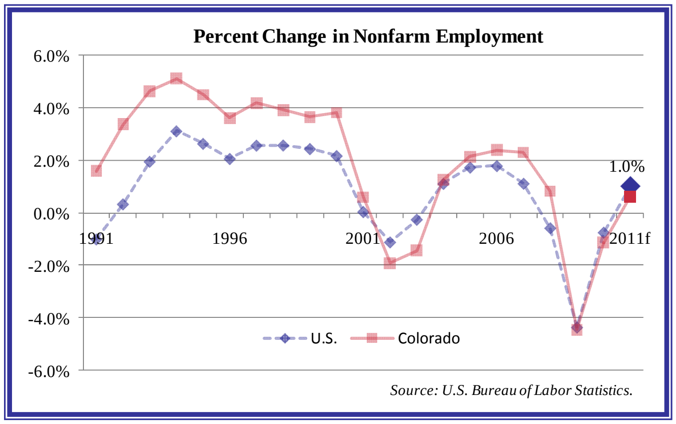
  An ongoing decline in business confidence will limit job market improvements through the end of this year. The weak government sector will dampen gains further. Government directly accounts for about one in six U.S. nonfarm jobs and indirectly supports jobs across all industries, especially professional and business services, construction, and education and health services.

  Forecast: 2011 nonfarm employment growth of one percent will be too slow to reduce the unemployment rate, which will average 9.2 percent for the year.

Colorado Outlook

Colorado has not been a standout state in recovery. The state's year-over-year employment gain in July (+0.7 percent) ranked 33rd fastest among rates for the 44 states that reported growth, and the state's seasonally adjusted unemployment rate (8.5 percent) was higher than rates in 27 other states. Reasons for this lackluster performance could include Colorado's late entry into the recession and the role the now-depleted construction sector played in Colorado's pre-recession growth.

Colorado—like all other states—will also struggle with the shrinking of the federal government, both directly in public sector layoffs and in slower growth for the many industries that rely heavily on government contracts. The state has a vibrant private sector with a proven ability to grow and attract investment, and Colorado's distinct concentration of entrepreneurial activity will help spur growth. However, significant headwinds from the public sector and the still-harsh economic climate for startups mean overall employment growth will remain unimpressive this year.



Forecast: Total nonfarm employment in Colorado will grow 0.6 percent in 2011, and unemployment will remain high at 8.8 percent.

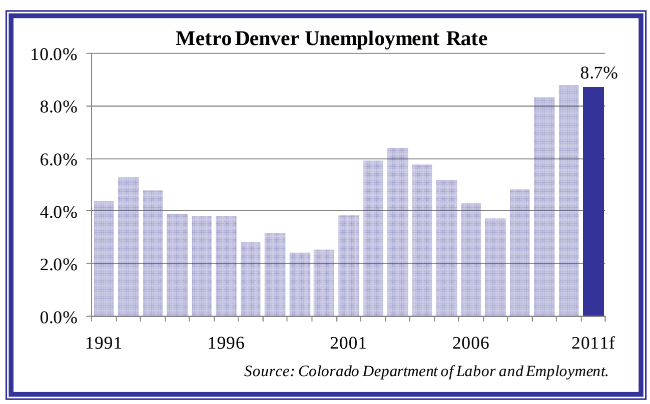
Metro Denver Outlook

Metro Denver, like Colorado, has experienced a struggling recovery. Nineteen of the nation's 25 largest metro areas reported job growth through the second quarter of 2011, but Metro Denver—with a slight drop in employment for the same period—was not among them. Reasons for the area's lagging performance are most likely due to geography and industry mix. Many of the metro areas experiencing a more robust recovery are located in Texas or the Northeast.

Despite slow recovery, Metro Denver has several advantages, including its comparatively healthy real estate markets. The region's home prices weathered the soft market better than prices in many other metros, and rapidly rising apartment demand is providing a much-needed boost for homebuilders. While Metro Denver's economy remains subject to national trends, better-than-average real estate indicators suggest the area is still a magnet location with good growth potential.

Employment & Unemployment

- Metro Denver employers' forward-looking hiring expectations for the third quarter were insubstantial; one in five employers planned to hire, a few (six percent) planned layoffs, and the vast majority (70 percent) planned no staffing changes. Results of the University of Colorado Boulder Leeds Business Confidence Index show 30 percent of Colorado business leaders expect "moderate" employment gains through September while just 1.3 percent expect "strong" hiring. These modest outlooks suggest many businesses are still too uncertain to hire with much conviction.



However, some businesses—particularly those focused on healthcare and renewable energy activity—will add appreciable numbers of jobs this year. Generally, the unease in the public sector and its influence on business confidence will continue to keep the pace of hiring slow.

Forecast: Metro Denver employment growth this year (0.5 percent) will be too slow to reduce unemployment noticeably, which will average 8.7 percent.

Retail Trade & Inflation

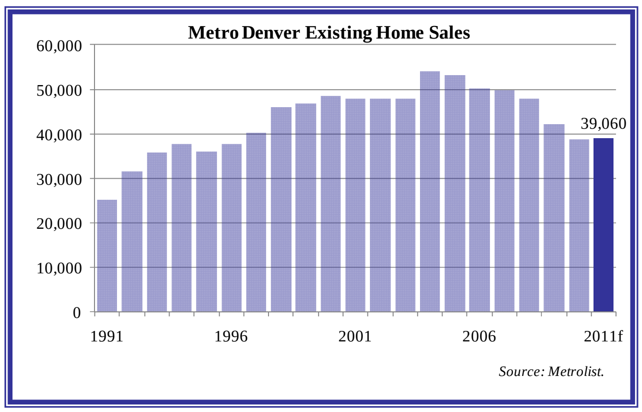
- Metro Denver retail trade sales during the first quarter were 2.7 percent higher than sales in the same months of 2010. Because the Colorado Department of Revenue delayed its release of retail sales statistics due to a software conversion, sales data for months after the first quarter are not yet available. Based on first quarter data and retail sales statistics at the national level, a modest increase in Metro Denver retail sales is expected this year.

  Note that a modest increase in sales might still appear weak when adjusted for inflation, which averaged 3.8 percent in the Denver area during the first half of 2011. While the early-year spike in food and fuel prices may ease through the rest of 2011, expected price increases for cotton and other commodities could mean households will continue to pay more for their essentials.

  Forecast: Retail trade sales growth in 2011 will reach a modest 5.5 percent, or 2.3 percent on an inflation-adjusted basis.

Home Sales

- The housing market remains in a contradictory state. Mortgage rates are still near historic lows, home prices are highly affordable, and many home sellers are motivated. At the same time, mortgage qualification standards are higher than they were before the recession, and many potential buyers doubt their job and income security. Complicating matters further are impending restrictions on jumbo loans and loans backed by the Federal Housing Finance Authority (FHA).



  Given today's incentives and deterrents for homebuyers, home sales will likely continue at a slow pace. Metro Denver sales through the first seven months of the year were 6.5 percent below sales in the same months of 2010, although the tax credit-driven sales push that occurred early last year made sales early this year look weak by comparison. Most likely, slow and steady activity this year will generate a similar number of sales as last year's boom-and-bust market.

  Forecast: Metro Denver home sales will increase a modest 0.6 percent in 2011 and total 39,060.

Home Prices

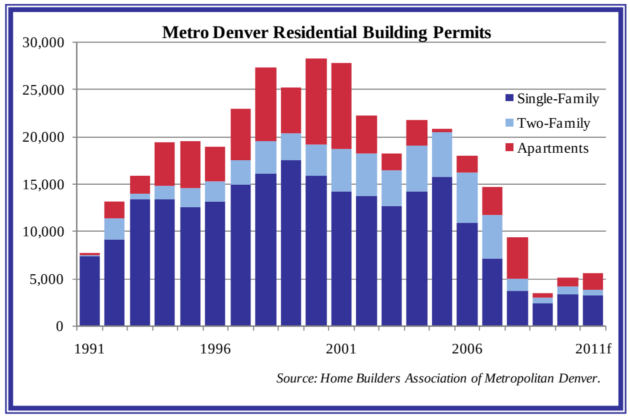
- Lagging home sales provided little support for prices. At the same time, a significant decline in unsold inventory (-25 percent in the first two quarters of 2011) has helped limit the price drop. Metro Denver's median home price in the second quarter ($232,700) was down a slight 0.9 percent over-the-year, while the nationwide median ($171,900) contracted more noticeably (-2.8 percent). Barring any significant increase in foreclosure sales, Metro Denver's median home price will decline slightly this year while the nationwide median will contract more steeply.

Forecast: Metro Denver's median home price will decline a slight 0.8 percent in 2011 to $230,600.

Home Construction

- Metro Denver officials issued 3.3 percent more residential construction permits in the first half of 2011 than they did during the same months of 2010. A major increase in apartment issuance accounted for the entire gain: apartment issuance was up 69.4 percent year-to-date in June, while permit issuance for detached homes and condominiums was down 2.2 percent and 22.4 percent, respectively.

With stagnant home sales and low prices, single-family homebuilders have few incentives to start large projects. As a result, the region's rapidly strengthening apartment market is one of the only sources supporting residential construction activity. Even with a considerable increase in activity, apartment permit issuance remains low by historic standards. The number of apartment permits issued through the first half of this year was less than one-fourth of the total issued during the first half of 2008.



Forecast: The number of building permits issued in 2011 will increase 8.5 percent and reach 5,585.

Residential Foreclosures

- Metro Denver public trustees started dramatically fewer foreclosures during the first half of 2011 than they did in the same months of 2010. What remains unclear is the extent to which lender caution and other fallout from the "robo-signing" crisis has merely delayed filings. Predictions of a second wave of foreclosure activity seem overblown, particularly because many of the unconventional loans that ignited the crisis have already been foreclosed. A small increase in foreclosure activity is possible next year as slow job and income growth keep pressure on households and lenders working through their backlogs.

Forecast: The total count of Metro Denver foreclosures will decline 29.5 percent in 2011 to 16,500.

Commercial Real Estate

- Direct office market vacancy in Metro Denver is stabilizing but remains high enough to prevent growth in rental rates. In the second quarter, the direct vacancy rate was 13.4 percent, and the direct average lease rate ($19.80 per square foot) was down 1.9 percent since the beginning of the year.

Forecast: Because demand for office property is closely tied to job growth, the direct office vacancy rate will remain above 13 percent for the rest of 2011 and will decline only slowly thereafter.

- Metro Denver's industrial market is outperforming the other property types, and some brokers say certain submarkets are running short of large blocks of space. Still, the fragile economy and property owners' concern for retaining tenants are keeping lease rates low. The second quarter direct industrial vacancy rate was 6.1 percent, and the direct average lease rate ($4.62 per square foot, triple-net) was down 3.3 percent over-the-year.

Forecast: The direct industrial vacancy rate will remain around six percent this year.

- The region's retail vacancy rates are stabilizing, but retail lease rates—like lease rates for the other property types—have yet to recover. The second quarter direct retail vacancy rate averaged 7.2 percent, and the direct average lease rate ($14.57 per square foot, triple-net) was down 4.3 percent over-the-year.

  Forecast: The move-ins and move-outs of several major retailers will, on balance, make for stagnant retail fundamentals this year. Direct retail market vacancy will average 7.5 percent for all of 2011.