

**July 2008**  
*by Robert Sonora, PhD*

I am beginning to feel a bit like a stuck record. The national, state, and local economies are feeling the impact of a near “perfect storm” in the aftermath of the sub-prime meltdown. Rising inflation and unemployment (thought still pretty low), rapid increases in the price of food and energy; declining home values; etc. are all contributing to a sense of foreboding.

The University of Michigan Consumer Sentiment index is the lowest it’s been since June of 1980, see Figure 1 below. At that time the unemployment rate was 6.3% and climbing – it peaked at 11% two years later – and inflation was just under 15%.

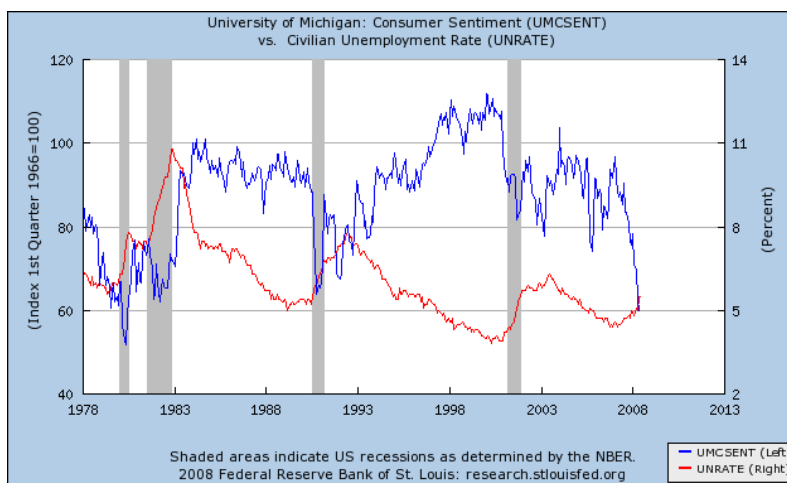


Figure 1. Consumer Sentiment and the unemployment rate  
(source: FRB St. Louis, FRED II)

### **Labor Market and Inflation**

The most recent figures show that national unemployment rate is a respectable 5.5%, Figure 1 above, low by historic standards, while inflation is started to creep up, to about 4.2%, though core inflation is still a moderate 2.3%. Of the most visible inflation rates, food prices have risen by 5%, household energy 11.9%, and motor fuel 21%. And with oil prices still rising, fuel prices can only be expected rise.

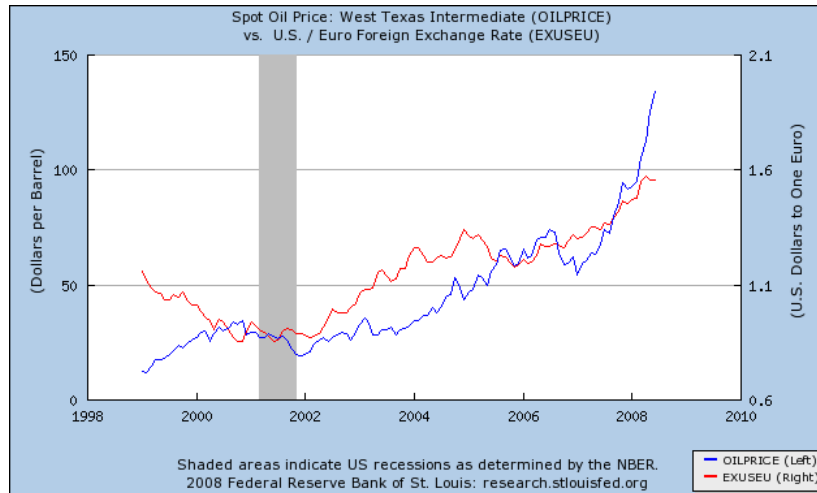


Figure x. Oil prices and dollar-euro exchange rate  
(source: FRB St. Louis, FRED II)

Couple this with poor agricultural production now and for the foreseeable future (flooding in the Midwest, drought in Australia, typhoon in Burma) with increased demand and there will be considerable price pressure on food prices as well.

Figure 3 shows the core (without energy and food prices), food and energy inflation from 1970 to today. As can be seen core inflation remains fairly tame, about 2.3% while food and energy prices are accelerating.

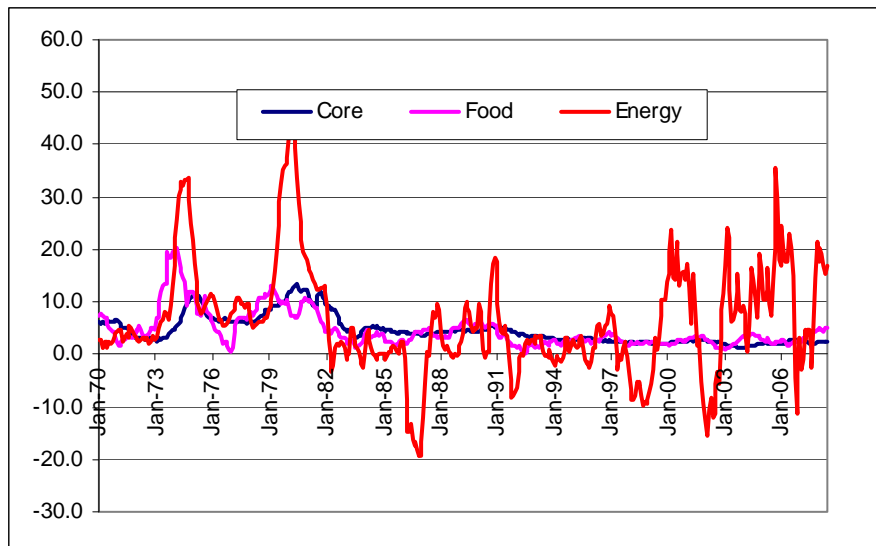


Figure 3 Core, food and energy inflation  
(source: FRB St. Louis, FRED II)

In the Four Corners area the confluence of this conspires for even higher prices here. Given the remoteness of the area, rising transportation and food costs will drive prices of these goods higher than in less isolated areas.

## Housing Sector

The Fed has been aggressively lowering the federal funds rate and offering banks and other financial institutions low rate loans to increase liquidity in these markets. The desired effect is what economists call the “monetary transmission mechanism” – more money impacts the real economy.

However, over the past five to six years, lower rates for banks have not been passed onto household consumers. The 30 year mortgage rate has become more or less fixed since 2000 at about 6%, while the fed funds rate as vacillated between one and 6.5% over the same period. Either we are in a “liquidity trap”; or lenders are demanding a far higher risk premium on consumer loans.

The Schiller index of housing US values in May fell 16% from a year ago – the most precipitous drop since the introduction of the index. The index for Denver fell by about 5%, quite tame by comparison, but this a secondary effect as housing prices in Denver have been flat since the recession a few years ago.

Figure 4 below is the Schiller-Standard & Poor Index of housing prices for Phoenix, Denver, LA and an overall Composite of ten metropolitan areas. As can be seen much of Denver’s correction occurred in the early 2000s just when Phoenix was starting take off. Both Phoenix and LA saw a much more precipitous drop than Denver.

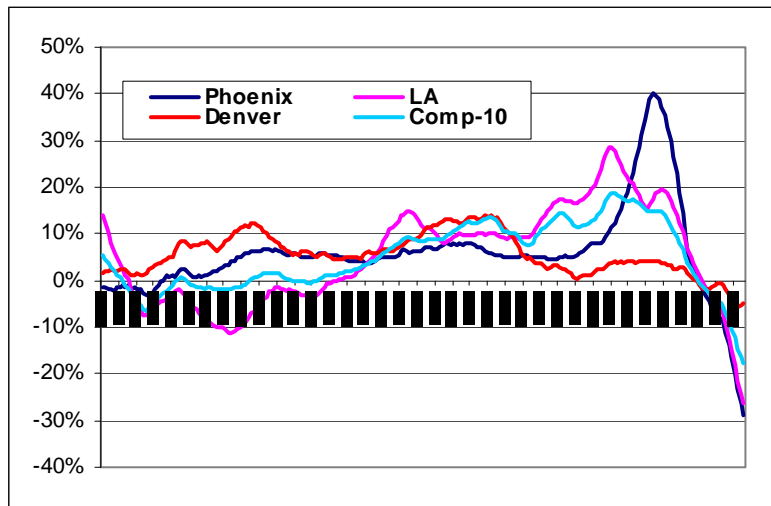


Figure x Schiller Index of Housing Prices  
(Source: Standard and Poor/McGraw Hill)

The effects of the tax refund will most likely be small and short lived. Many are taking their refund to pay down debt and increase their savings – in May the personal savings rate shot to 5% up from 0.4% in April, the highest since 1992.

## **Tourism**

All of this news does not, I'm afraid, bode well for tourism and construction – the areas largest sectors in terms of percent of total income. Higher fuel prices mean less miles traveled, either by air or air. According to a report by Farmers Insurance Group a 10% increase in fuel prices yields a 7% decline in miles driven – indeed over the years 2003-2007 the cumulative effect has been a 18% decline in miles driven.

On the other hand, higher prices for international travel mean more domestic travel. Moreover, the falling value of the dollar vis-à-vis the euro, UK pound, Chinese RMB, and Japanese yen mean more foreign tourists as well. And they will buy more goods.

## **Good News**

The only ray of light over the next 18 months or so will be producers in the energy and agricultural sectors. With oil on its way to \$150 a barrel, we will begin to see an increase in the price of natural gas, which lags oil prices by six months or so.

Increased demand and several negative supply shocks will buoy prices of corn, wheat, soy, etc. Even if the production of these goods isn't that high in this area, we can expect to see increases in the prices all agricultural goods as resources are diverted towards the production of these goods.

Another positive is the falling value of the dollar. It increases exports and has buffered the economy from further declines. Now all we need is to attract euro toting visitors to our corner of the world.

But a proviso must be attached to this, a falling dollar is partially responsible for the increase in oil prices. Given that oil is generally trading in dollars -- though several oil exporting countries have either abandoned, or are considering doing so, the dollar. However, \$150 per barrel may be the threshold price which sufficiently reduces demand slowing further price increases.