

# Economics Group

## Special Commentary

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# Arizona Economic Outlook: 2019

## The Arizona Economy Continues to Sizzle

The Arizona economy continues to heat up. Arizona has consistently ranked among the fastest growing states over the past two years, with the latest data placing it in the top ten for employment, population and real GDP growth. Arizona’s success has come against a backdrop of stronger national economic growth, as robust consumer spending, fiscal stimulus and solid gains in business fixed investment contributed to 2.9% real GDP growth nationwide in 2018. We anticipate a more moderate outcome in 2019 as some of the fiscal stimulus fades, but look for real GDP to expand at a still-solid 2.5% pace. That more modest pace for the nation will put a lower ceiling on economic growth in Arizona, but the Grand Canyon State should remain near the head of the pack, as job growth and in-migration remain strong.

Arizona boasts a number of attributes which are increasingly viewed as valuable to relocating businesses, namely strong population and labor force growth, relative affordability and a business-friendly regulatory environment. Arizona’s real GDP grew 3.5% year-over-year in the third quarter, and has outpaced the nation for the past two years. The state’s economy has proven incredibly resilient in the face of intensifying macro headwinds. Retaliatory tariffs and a large scale produce recall put immense pressure on the state’s agriculture industry, especially in the Yuma growing region. Trade tensions also threatened to derail industry sectors exposed to international trade. Exports, however, managed to rise 7% in 2018, reversing two consecutive years of declines.

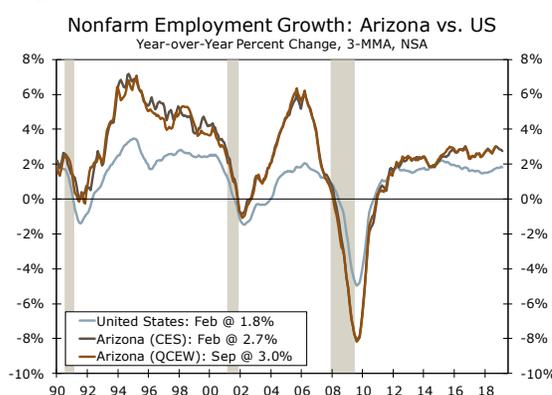
Arizona’s labor market continues to improve, with relatively low unemployment and broad-based job gains as nearly every sector adds to payrolls. Traditional growth drivers such as healthcare and tourism continue to expand at a solid clip, driven by strong population growth, sturdy job and income growth and buoyant consumer confidence. Hiring in manufacturing is also making a comeback, reinvigorated by unshackled defense spending following last year’s budget deal. The breadth of improvement suggests Arizona’s economic success should prove lasting.

*Arizona has consistently ranked among the nation’s fastest growing states.*

**Figure 1**



**Figure 2**



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

Together we’ll go far



*The improvement in labor force growth reflects a broadening in economic gains.*

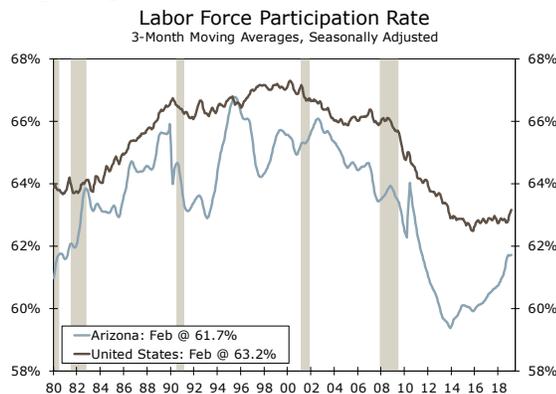
**Payrolls Showing No Signs of Cooling**

Total nonfarm payrolls rose 2.7% on a year-over-year basis in February, making Arizona the third fastest growing state behind Nevada and Utah in terms of employment growth. The unemployment rate has been edging higher recently, hitting 5.1% in February. The increase, however, has been due to labor force growth outpacing household employment growth. This recent trend is not surprising. The Arizona labor force has increased at a faster pace on a year-over-year basis than any other state for the past seven months. At a time when the availability of labor ranks as the top issue for businesses, a higher unemployment rate may not be all that bad, suggesting the presence of additional labor market slack to accommodate further growth.

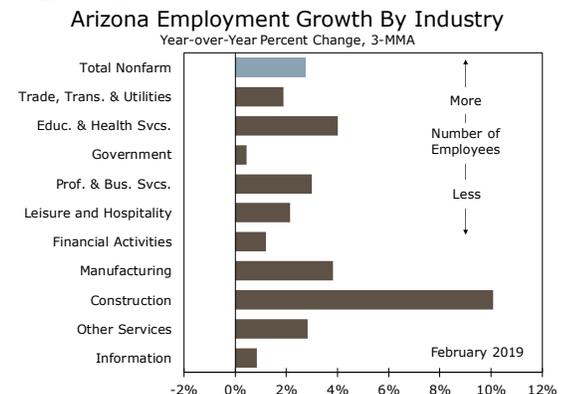
The improvement in labor force growth also reflects a broadening in economic gains. Virtually all of Arizona’s metro areas have seen hiring improve over the past 12 months. Phoenix, which accounts for nearly 75% of Arizona’s employment base, saw payrolls rise 3.1% year-over-year in February. Tucson has seen more modest gains, with payrolls advancing 1.7%. After nearly a decade of modest growth, Tucson has finally regained the jobs lost during the recession, and hiring continues to move in the right direction. Other areas of the state, such as Yuma and Prescott, are also performing well, as economic growth continues to broaden to the state’s smaller metro areas.

Job growth has been widespread, with every major industry expanding headcounts over the year. The state’s blue collar sector has seen some of the strongest growth, reflecting strong hiring in construction, manufacturing, trucking and warehousing. The state’s massive healthcare sector also continues to register solid payroll additions. A growing number of retirees continue to flock to the state to take advantage of the unique combination of a warm and stable climate, relative affordability and one of the nation’s leading healthcare ecosystems. Arizona’s tourism industry continues to benefit from strong consumer and business spending, which continues to propel hiring at resorts, hotels, restaurants and bars in both the state’s larger metro areas and the more rural parts of the state, which are full of diverse natural amenities including the Grand Canyon, Sedona, Monument Valley and the Hoover Dam.

**Figure 3**



**Figure 4**



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

**Arizona Becomes a “Fintech Sandbox”**

Hiring in Arizona’s influential financial services sector has struggled recently, slowing to just 1.1% year-over-year in February. Some moderation was expected given the industry-wide shift towards cost controls and greater efficiencies through technological innovation. The sector outlook in Arizona is considerably brighter, however, as the state continues to see numerous large financial firms such as Voya, Allstate and Freedom Financial either relocate to the region or expand their existing footprint in the state. Arizona also recently became the first state to enact a regulatory “fintech sandbox”, which allows companies to pursue innovation without cumbersome regulatory burdens. The designation gives the state a significant competitive advantage over other locales in contention for this nascent industry segment and will likely attract the attention of financial service providers throughout the country.

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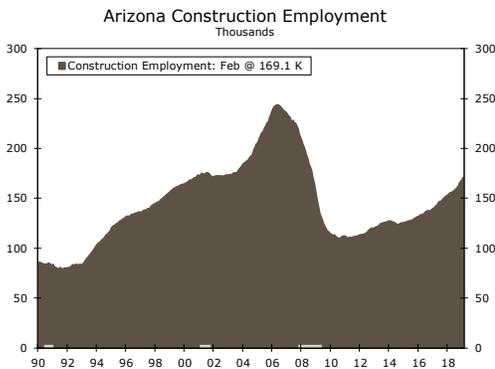
**Construction Continues to Build Momentum**

The flurry of broad-based economic activity is most clearly evident in the surging number of residential, commercial and transportation projects striving to keep pace with Arizona’s rapid population and employment growth. Construction employment has gained considerable momentum over the past two years and surged 10.7% on a year-over-year basis in February. The recent strength in construction employment is welcome news, as it had been lagging considerably behind prior norms. Builders are still scrambling for skilled trade workers, and intense competition for subcontractors has restrained construction activity.

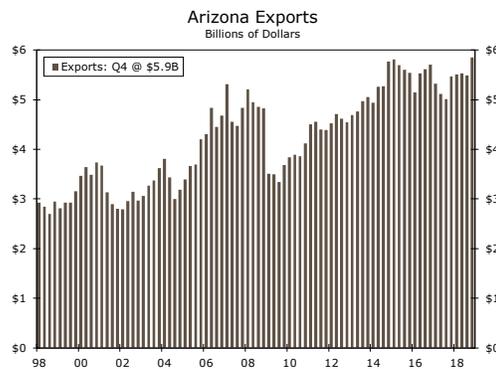
Given the large number of projects currently in progress or in the late planning stages, demand for construction workers should remain strong. Some of the more notable projects include a new headquarters for Caterpillar’s Surface Mining & Technology Division, which will also bring roughly 1,000 engineers, product developers and support positions to Tucson. The Rosemont Mine, a proposed \$2 billion project, is another potential mega-project that would bring 2,500 construction and support jobs to the Tucson area. Construction is slated to begin sometime this year. Furthermore, the state has increasingly garnered national attention as the site of a proposed wall along the southern border, although both the scope and political feasibility of such a project remain uncertain. The Trump administration’s recent emergency declaration, however, will create 11 miles of fencing as well as road and lighting improvement along the US-Mexico border in Yuma.

*The flurry of economic activity is most evident in the surge of construction projects.*

**Figure 5**



**Figure 6**



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

**USMCA to Boost Arizona Industrial Markets**

Given the state’s close economic ties with Mexico, Arizonans likely paid close attention to the trade negotiations over the past year, which ultimately resulted in the signing of the United States Mexico Canada Agreement (USMCA). While the USMCA serves to reduce some of the uncertainty surrounding the structure of a successor trade agreement to NAFTA, the path to ratification has become somewhat more ambiguous and mired in political uncertainty. That said, we still anticipate the USMCA to ultimately become law. Tariffs placed on several major trading partners and the general uncertainty surrounding the fate of future trade relationships have caused businesses to reevaluate existing supply chain networks, which appears to be boosting U.S. manufacturing. Furthermore, while the core tenants of the legacy NAFTA deal were left in place, several key changes in the preliminary agreement, such as more stringent labor compensation requirements in Mexico and boosted North American content requirements, should strengthen the state’s manufacturing and industrial markets

*Trade is vital to the Arizona economy.*

Trade is vital to the Arizona economy, with activity roughly the equivalent of 13% of the state’s GDP. After declining for two consecutive years, exports from Arizona increased 7% in 2018, bolstered by rebounding transportation equipment and mineral and ore exports. Mexico is by far the state’s largest trading partner. In 2018, roughly 400,000 northbound trucks from Mexico were processed through one of Arizona’s nine border crossings, creating huge demand for logistics services,

warehouses and distribution facilities in many of the surrounding industrial markets of Phoenix, Tucson and Yuma. More recently these border crossings have become flashpoints in the trade and immigration negotiations. Staffing has been stretched thin, as officers have been reassigned to areas without fencing or other barriers, resulting in long wait times for trucks crossing the border.

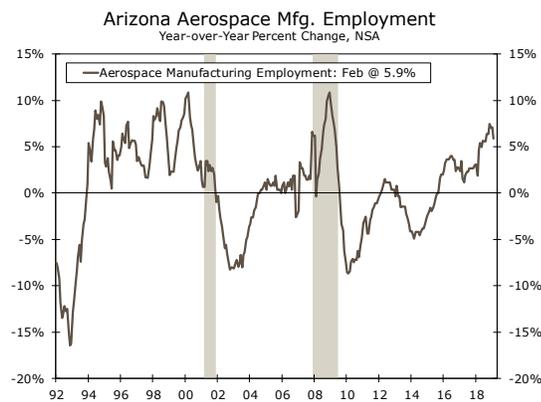
Growing trade volumes have also spurred the need for more efficient and cost-effective freight networks. In 2018, the Phoenix-Mesa Gateway Airport saw the arrival of SkyBridge Arizona, the nation's first international air logistics and processing center with Mexico. Easy access into many Southwest markets has attracted a wide array of industrial users to the area. Amazon, the largest industrial tenant in Phoenix, continues to expand its footprint with a new distribution site for smaller flex drivers and independent contractors in Tucson, which is rapidly becoming a prominent regional logistics hub. In addition to the region's well-placed geography, there are several strategic economic development programs in place to boost the competitiveness of the state's transportation and logistics sector.

**Budget Agreement Providing a Boost to Manufacturing**

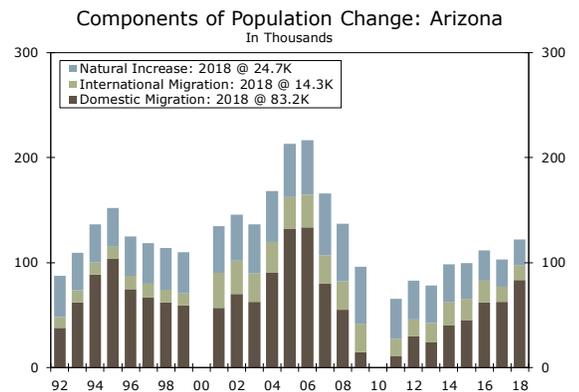
Despite mounting trade tensions, the manufacturing sector has strengthened considerably over the past 18 months. Payrolls rose 3.8% year-over-year in February, propelled by a resurgent aerospace cluster. The Bipartisan Budget Act of 2018 increased federal spending caps originally imposed by the Budget Control Act of 2011, which has been a boon for the state's many defense contractors and military installations that rely heavily on federal defense spending. Aerospace products and parts manufacturing employment, which captures headcounts at many of Arizona's largest defense contractors, ramped up this past year, following several years of declines linked to austere federal budgets. On the heels of several large defense contract awards, Raytheon continues to expand its Missile Defense divisional headquarters in Tucson, adding new manufacturing capacity and more than 2,000 engineering and technical positions. The federal government is the largest employer in many areas of the state, which uniquely positions Arizona to reap the benefits as federal spending is further unleashed over the next several years. In addition to hosting several large air force bases in Phoenix and Tucson, Arizona is home to numerous military installations such as Fort Huachuca in Sierra Vista, Marine Corps Air Station in Yuma and Camp Navajo in Flagstaff.

*The federal government is the largest employer in many areas of the state.*

**Figure 7**



**Figure 8**



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

**Arizona Remains a Magnet for Retirees**

One of the driving forces behind Arizona's economic success has been consistently robust population growth. Arizona is well accustomed to rapid gains in population and has frequently ranked among the top ten fastest growing states. The trend continued in 2018 as the state's population grew 1.7%, the fourth fastest pace of any state. Domestic migration accounted for 68% of the overall gain, reflecting a net gain of 83,240 residents from other states. Much of that increase was likely owed to a continued influx of retirees, thanks to the state's abundant healthcare resources, relatively low costs of living and favorable climate. One consequence of Arizona's large retiree population is the number of deaths once again outpaced births in 2018, bringing the

*Arizona had the fourth fastest growing state population in 2018.*

contribution to population growth from natural increases to the lowest level since statistics began being compiled. That said, the persistence of strong job growth in Phoenix and Tucson's growing higher education system has been a potent attraction for younger persons, which should serve to temper Arizona's aging demographics over time.

**Tight Supply Slowing Home Sales**

With the housing crisis firmly in the rearview mirror, the Arizona housing market continues to improve. Home prices finally returned to their prior peak level in nominal terms this past year and foreclosures have fallen to a fraction of the level seen at the height of the downturn. That said, Arizona experienced a moderation in housing activity similar to the slowdown experienced nationally in 2018, brought on by the combination of low for-sale inventories, rising home prices and higher mortgage rates. After trending lower for much of the past 12 months, existing home sales ended January 17.2% below year-ago levels. Sales have been limited by an exceptionally low inventory of homes on the market. While single-family homebuilding has steadily marched higher, home builders have been reticent to ramp up construction in a meaningful way this past year given the scarcity of labor, rising building material costs and lack of desirable lots. After strengthening in the first half of 2018, new residential construction eased towards the end of the year alongside slower sales. Moreover, the state is home to a rising proportion of mature homeowners who represent a more passive market segment and whose incentive to move was reduced even further after refinancing at historically low mortgage rates.

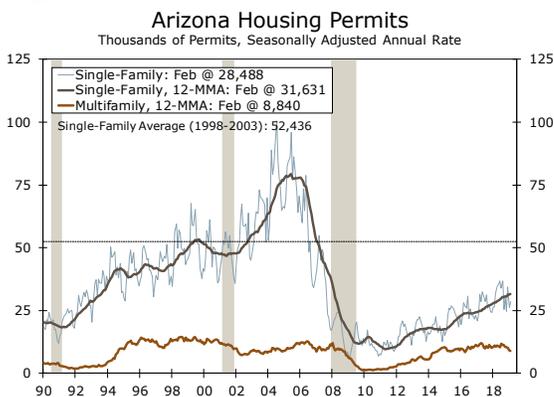
Alongside slower sales, home price appreciation has started to lose momentum. Prices are holding up better than many other major Western markets, however, bolstered by the steady stream of equity-rich new residents from out-of-state. According to the Case-Schiller Home Price Index, prices in Phoenix rose 7.5% in January, the second fastest pace of any of the major markets covered in the survey. This stands in stark contrast to many other major metro areas such as San Francisco and Seattle, which are seeing prices moderate after years of colossal increases. Arizona also remains a popular destination for investor capital which is providing upward pressure on prices. In 2018, nearly 4.5% of all transactions were cash sales to investors, the highest of any state. Given the lower trajectory of sales, prices will likely continue to moderate throughout 2019, especially at higher price tiers where sales have slowed the most. Some price moderation is welcome, as affordability relative to other regions in the West remains one of the state's key competitive advantages.

The lack of single-family supply is bolstering demand for rentals, notably in Phoenix, where apartment rents are rising at a pace much faster than the rest of the country. Rents increased 8.2% year-over-year in the final quarter of 2018, the fastest pace of any major market. With vacancy rates near an all-time low, building in Phoenix continues to ramp up, especially with a slew of new apartment buildings under construction in Downtown Phoenix, Scottsdale and Tempe. After remaining stagnant for the past few years, several new apartment buildings are also being developed in Tucson.

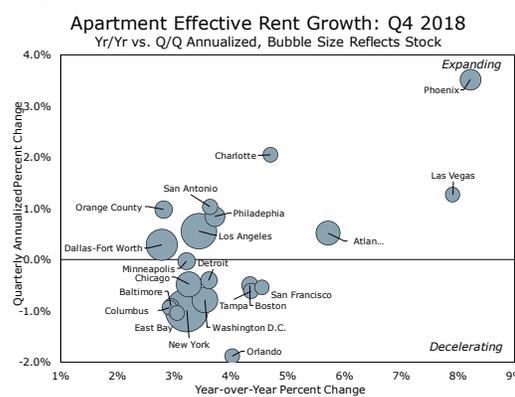
*With the housing crisis firmly in the rearview mirror, the Arizona housing market continues to improve.*

*Affordability relative to other regions in the West remains one of the state's key competitive advantages.*

**Figure 11**



**Figure 12**



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

## Summary & Outlook

Despite a slowing in the national economy, Arizona's economy appears to have maintained strong momentum at the start of 2019. Data through the first two months of 2019 show nonfarm employment rising 2.7% on a year-over-year level, with hiring up solidly across every key industry category. Some of the largest gains are occurring in relatively high paying blue collar industries, including construction, manufacturing and trucking & warehousing. Despite the strength in job growth, the unemployment rate has ticked up to 5.1%, due to stronger labor force growth reflecting an influx of new residents and job seekers. The latest employment data reflect the annual revisions, as well as updated population estimates, which sometimes change dramatically in rapidly growing states like Arizona.

We expect Arizona to remain a leading state for overall growth in 2019. The state continues to see an influx of new industry relocating from other parts of the country, where housing has become less affordable and qualified workers have become even harder to find. At this point of the business cycle, Arizona's higher unemployment rate is a comparative advantage. Housing and office space are also relatively more affordable in Arizona than in other major Western markets.

The influx of new industry has helped diversify the state's economy, which is still largely built around industries tied to the state's historically strong population growth and tourism. Construction, education & health care and the leisure & hospitality sectors rank among the fastest growing parts of the economy, and this should remain true in coming years. Construction has largely lagged behind population and employment growth during this cycle, resulting in strong growth in home prices and both residential and commercial rents. Development has remained more disciplined than in past cycles, reflecting higher upfront costs, better real-time information about costs and demand, and a strong institutional memory of the 2007-2009 financial crisis.

Arizona's economy has also become far more diverse. Development efforts have shifted toward attracting more intellectual capital to the state. Some of the biggest wins on this front include Raytheon's huge expansion of its missile defense operations in Tucson, home to manufacturing operations as well as R&D facilities. The Mayo Clinic also announced a major expansion of its operations in North Phoenix. The nearly \$650 million investment will essentially double its local presence. Arizona has had a great deal of success attracting fintech companies and research in autonomous vehicles. The focus on R&D has also spilled over into higher education, resulting in even stronger ties between the state's major universities and industry.

With the national economy slowing, Arizona is one of only a handful of states where we have raised economic growth projections for 2019. We still have economic growth moderating this year but from a stronger level and to a stronger overall pace. We estimate that Arizona's economy grew 3.6% in 2018 and look for real GDP to rise 3.3% this year. Economic growth is being bolstered by gains in high value-added industries, such as defense, health care, financial services and real estate. Overall job growth is expected to moderate to a 2.3% pace this year, following a 2.8% gain in 2018. Even at that more modest pace Arizona will easily outpace the nation as a whole and rank among the fastest growing states in the country.

While our estimate of job growth has increased, we left the unemployment rate relatively unchanged, with the annual average for 2019 expected to be just below last year's 4.8%. The jobless rate began the year at 5.1%; getting to our 4.7% average for the year would require job growth to remain strong and labor force growth to moderate somewhat.

Home building should also remain strong this year, with single-family starts accounting for much of the growth. Arizona is seeing an influx of workers from other parts of the West where home prices have skyrocketed in recent years. The new tax law also makes such a move more attractive. Many of these newcomers are arriving with a fistful of dollars following the sale of their property elsewhere, which is pulling home prices higher and reducing affordability for local buyers. Apartment development appears poised to slow amid a rush of new deliveries. The apartment market has defied expectations repeatedly, however, as demand has proved stronger than expected.

***Despite a slowing in the national economy, Arizona's economy appears to have maintained strong momentum at the start of 2019.***

***We expect Arizona real GDP to grow 3.3% in 2019.***

Arizona Economic Outlook

	Actual					Forecast				
	2012	2013	2014	2015	2016	2017	2018	2019	2020	
Real Gross Domestic Product by State, \$ Millions	268,289	270,149	273,407	279,455	288,267	297,162	307,860	318,019	327,560	
Annual Rate	1.9%	0.7%	1.2%	2.2%	3.2%	3.1%	3.6%	3.3%	3.0%	
Nominal Personal Income, \$ Millions	236,456	242,572	257,067	270,807	280,988	296,649	312,965	328,613	344,386	
Nominal Personal Income, Percent Change	4.7%	2.6%	6.0%	5.3%	3.8%	5.6%	5.5%	5.0%	4.8%	
Real Median Household Income, \$	50,320	55,453	51,050	54,060	58,328	61,125	63,815	66,239	68,492	
Population, Thousands	6,557	6,635	6,734	6,834	6,945	7,049	7,172	7,302	7,422	
Change in thousands	83	78	99	100	112	103	123	130	120	
Percent Change	1.3%	1.2%	1.5%	1.5%	1.6%	1.5%	1.7%	1.8%	1.6%	
Nonfarm Employment, Thousands	2,462	2,520	2,570	2,636	2,709	2,777	2,856	2,921	2,970	
Change in thousands	51	58	50	66	72	68	79	65	50	
Percent Change	2.1%	2.3%	2.0%	2.6%	2.7%	2.5%	2.8%	2.3%	1.7%	
Unemployment Rate, Annual Average	8.3%	7.7%	6.8%	6.1%	5.4%	4.9%	4.8%	4.8%	4.7%	
Total Housing Permits	21,693	23,765	27,254	30,836	35,900	37,981	41,154	42,700	45,500	
Single-Family Permits	16,121	18,237	17,281	22,620	24,409	27,588	31,707	34,600	37,400	
Multi-Family Permits	5,572	5,528	9,973	8,216	11,491	10,393	9,447	8,100	8,100	
FHFA Home Price Index, Percent Change	4.0%	13.7%	9.2%	6.2%	6.9%	8.6%	9.1%	7.8%	6.4%	

Sources: National Association of Realtors, Federal Housing Finance Authority, U.S. Department of Commerce, U.S. Department of Labor, Moody's Analytics & Wells Fargo Securities  
Forecast as of: April 09, 2019

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