BUSINESS LEADERS BLCI CONFIDENCE INDEX®

Arizona
Second Quarter 2008
Volume 6 • Number 2

Arizona's BLCI Falls to New Low

The Arizona *Business Leaders Confidence Index®* (BLCI) declined by 3.5 points, to a reading of 36.9. That's the lowest reading yet for our survey that began in mid-2003. A number below 50 indicates worsening conditions. The index has declined in each of the past four surveys, stretching back to the second quarter of 2007.

News about economic conditions has been especially downbeat since the beginning of the year, and many forecasters nationwide have revised their forecasts downward to include a short and mild recession during the first half of this year.

Arizona, because of its high concentration of employment in growth-related sectors and the record-setting decline in housing markets, is suffering commensurately. At this level, the Arizona BLCI is consistent with an economy that's contracting. Our survey, conducted in early March, is forward looking, i.e., panelists were asked to record their expectations for the second quarter. With the BLCI below 50 and still dropping, they are not expecting conditions to improve during the second quarter.

THE OUTLOOK	
National Economy	28.5
Arizona Economy	34.5
Industry Sales	45.0
Industry Profits	40.0
Industry Hiring	37.9
Capital Expenditures	35.3
BLCI	36.9

Index above 50 indicates expanding economy.
Red - Decrease from previous quarter
Green - Increase from previous quarter
Black - Same as previous quarter

The BLCI is an Accurate Indicator

How accurate a predictor is the BLCI? Pretty accurate is the answer.

To address this question, the first step is to identify actual measures of the economy to use as benchmarks. Although there is no best measure to compare to the overall BLCI, there are good measures for two of the BLCI components – the national outlook and hiring intentions.

The national outlook component index can be compared to the nation's output of goods and services, i.e., gross domestic product adjusted for inflation (real GDP). Panelists are asked to provide their *expectations for the coming quarter* with the question "do you expect the nation's economy to get better, worse, or stay the same?" If our index value rises and real GDP growth accelerates, that's a correct call. Likewise, if the index falls and growth decelerates, that's also accurate. Since our survey began in mid-2003, our panelists have correctly predicted changes in real GDP nearly 70% of the time.

Our question related to employment asks whether panelists expect industry hiring to increase, decrease or stay the same. Nonfarm employment statewide is the appropriate benchmark here. With this component, panelists are being asked about the *level* of employment, not its growth rate. So, if our index for hiring moves up and employment increases, that's a correct call. Likewise for a downward movement and a decrease. For hiring intentions, our panel members have correctly predicted the future 83% of the time.

Unfortunately, no benchmarks are available for profits, sales, or capital expenditures. The state outlook component also lacks a comparable measure. Statewide GDP is not available quarterly – and annual estimates are not reported in a timely fashion. Other measures such as retail sales are not broad enough to compare to industry sales (which include wholesale transactions as well as retail). Employment is probably the best single indicator for the state economy, but we've already used that to assess the hiring component.

Even though we are unable to assess some components including the overall BLCI, the data we do have shows that our panel members are accurately predicting changes and are thereby adding value to our understanding of the business climate.

What we have learned is that for the state and national outlook components, the *growth rate* is the right measure – not absolute levels. Moreover, if an economic outlook index moves below 50, that does not mean panelists expect the economy to *contract*, but rather that there is an expectation for growth to be less than the previous quarter. More experience with our survey is needed to determine what index number is consistent with a contracting economy.

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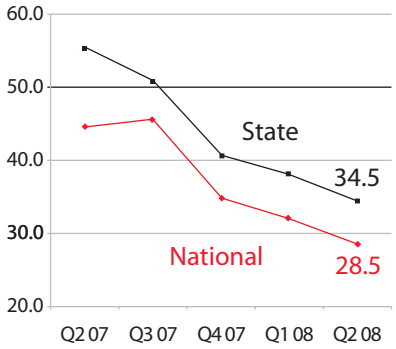
Panelists Expect National and State Economic Conditions to Worsen

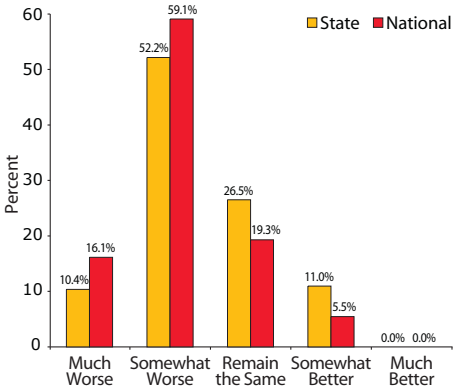
It likely will be the end of this year before the Business Cycle Dating Committee of the National Bureau for Economic Research (NBER) officially identifies the month at which the national economy peaked. That's assuming that the contraction now believed to be underway meets the criteria for recession, i.e., sufficient ground is lost (depth), the contraction lasts at least a few months (duration), and contractionary forces are present across a wide swath of the economy (dispersion). Before then, describing current conditions as a recession is merely a forecast.

Expectations for National and State Economies



Panel members expect the contraction to continue during the second quarter, as expectations for the Arizona and national economic outlook remain well below 50 and continue to decline from last quarter's survey.

Expectations For Arizona & National Economic Conditions 2nd Quarter 2008



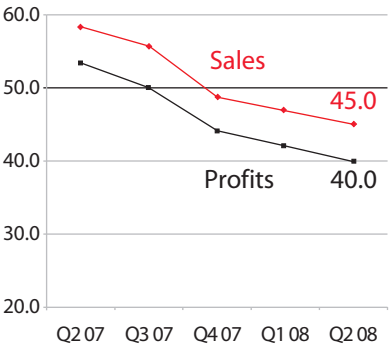
More than three-fourths (75.2%) of our panelists expect the **national economy** to *worsen* in the second quarter; more than 16% expect things to be much worse. Only 5.5% expect the national economy to do *better*, while 19.3% expect conditions to remain the same.

Nearly two-thirds (62.6%) of our panelists expect **Arizona's economy** to *worsen* during the second quarter. Only 11.0% expect conditions to *improve*. More than one-quarter (26.5%) expect the state's economy to remain the same.

Panel members continue to be more upbeat for the Arizona economy than they are for the U.S. The state component index is six points higher than the national component index. The state component index now stands at 34.5, down 3.7 points from last quarter. The national component index fell below 30 for the first time, declining 3.5 points to 28.5.

Industry Sales and Profits Expected to Decrease

Sales and Profits Expectations

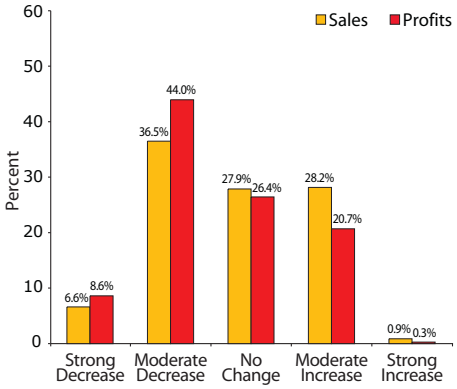


The sales and profits components of the BLCI are highly correlated as shown in the chart on the left. Expectations for industry sales remain the strongest BLCI component at 45.0, but fell in the current survey by a little less than two points. The profits component index is exactly 40.0.

The numbers of panelists expecting **sales** to increase (29.1%) are overshadowed by those expecting a decrease (43.1%). Approximately 28% expect no change in sales.

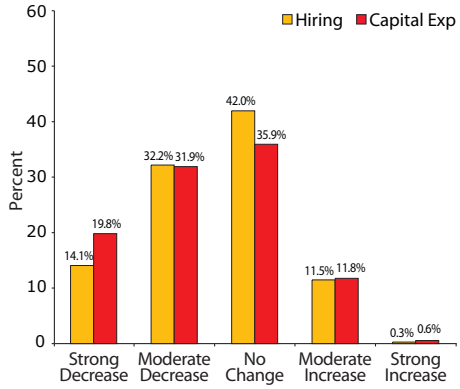
In our survey, expectations for **industry profits** fell 2.0 points to an index value of only 40.0. Nearly 53% of panelists expect profits to decline during the second quarter, while 21.0% expect an increase, and 26.4% see no change.

Industry Sales and Profits Expectations 2nd Quarter 2008



Caution Evident for Expansion Plans

Industry Hiring and Capital Expenditures Expectations 2nd Quarter 2008

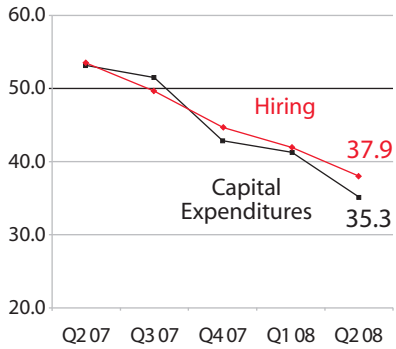


BLCI panel members indicated that they will remain cautious with regard to expanding their operations during the second quarter as scores for both hiring and capital expenditures moved below 40 for the first time.

The **capital spending** component fell 6 points to 35.3. Only 12.4% of our panelists expect to boost capital spending during the second quarter, compared to 51.7% preparing for a decrease. Nearly 36% expect no change in spending for capital items.

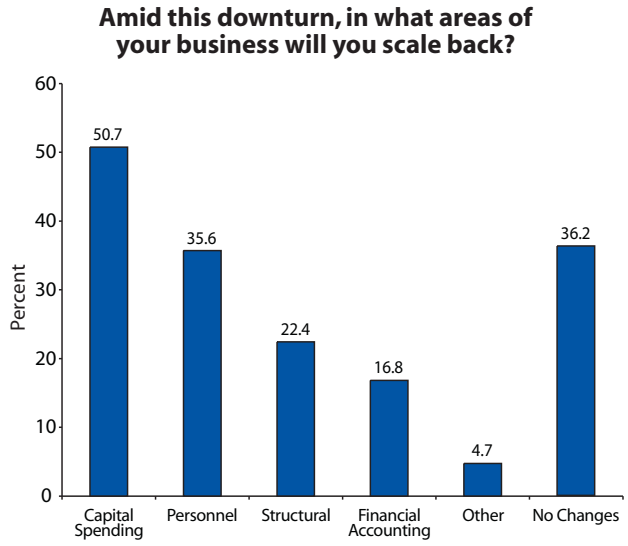
Hiring plans for the first quarter fell 3.9 points to 37.9. Less than 12.0% of our panelists expect their industry to add workers, while 46.3% expect decreases. Exactly 42.0% foresee no change in hiring.

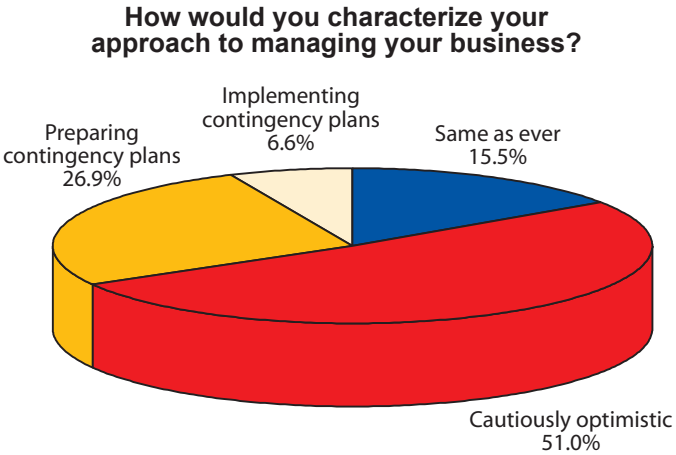
Expectations for Capital Expenditures and Hiring



Topical Question Series: Decision Making During Uncertain Times Economists may disagree on many things, but almost all of them agree that America is either in the midst of a recession or at least a significant slowdown. This leaves many business owners and operators in a strategic bind. We asked our panel members how they are responding to this environment. Are they using this lull as an opportunity to invest in the future and strengthen their competitive position? Or are they hunkering down, scaling back and bracing for a continued cyclical downturn?

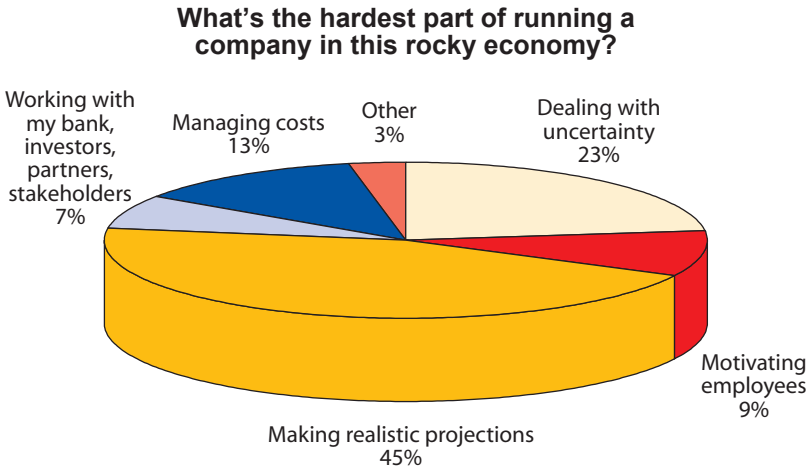
When asked "*Amid this downturn, in what areas of your business will you scale back? (Choose all that apply),*" more than half said they will cut capital spending (decrease outlays for new equipment, cut costs and overhead, etc.). Secondly, they will cut personnel (implement layoffs, furloughs, hiring freezes, etc.). A little more than one-in-five will make structural changes such as shutting down poor-performing divisions or field offices, reduce or eliminate ancillary products/services, etc. Another 16.8% will engage in financial accounting solutions such as taking write-offs, seeking financial or accounting assistance, etc. It is noteworthy that more than one-third indicated that they are not implementing cuts as they see no need to scale back.





Our second question asked "*How would you characterize your approach to managing your business during these challenging economic times?*" More than half of our respondents are cautiously optimistic, "making conservative bets for the short-term but bolder investments for the long haul." More than one-in-four are "preparing contingency plans based on worst-case economic assumptions." A small 6.6% are "implementing contingency plans" Finally a significant 15.5% are functioning the "same as ever — no change in my strategy, vision or decision-making."

Panelists were then asked "*What's the hardest part of running a company in this rocky economy?*" Forty-five percent replied "making realistic projections — or setting realistic goals — in this economic environment." Another 23% indicated "dealing with the uncertainty — not knowing when the pain will end." Managing increases in labor, energy and other operating costs (13%), motivating employees while cutting costs and asking more of them for less, (9%), and working with my bank, outside investors, partners and/or other stakeholders (7%), followed in that order. Another 3% of our panelists offered other responses including "business is great, no problems, ramping up" Others mentioned the "manipulative news media that is affecting clients"; the uncertainty of government policies and/or government inaction; and maintaining cash flow.



Arizona BLCI by Component and Region All six components declined compared to the prior survey, and all remain well below 50, the dividing line between increasing and decreasing expectations. The capital expenditures component slipped the most, by six points, to 35.3. The national outlook component, which recorded the lowest score, fell to 28.5. Expectations for the state economy decreased to 34.5, making it the second weakest component. Sales expectations remained the strongest component, with a reading of 45.0, down only 1.8 points. Hiring expectations fell 3.9 points, suggesting that panel members will be very cautious with hiring in the second quarter.

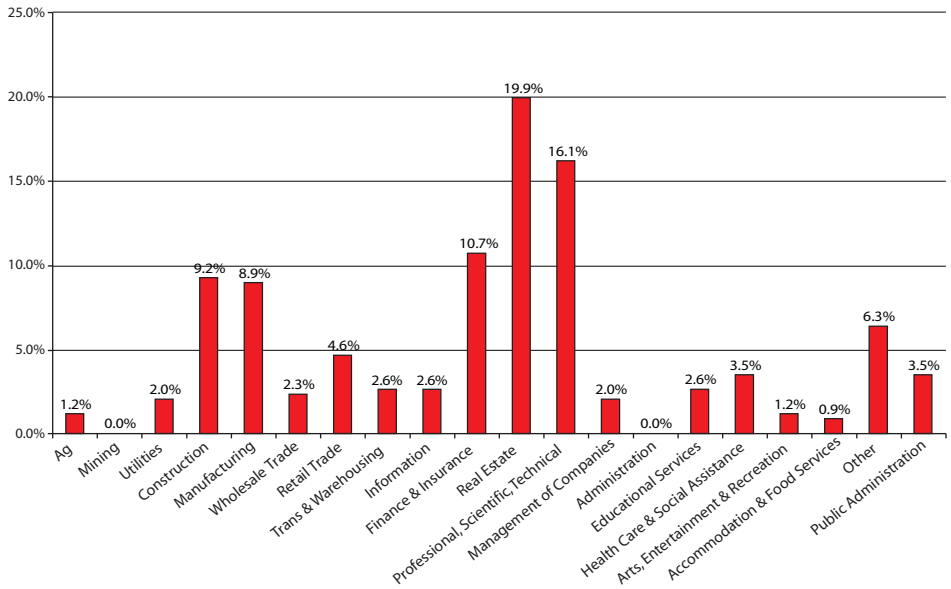
Panelists in the Non-Metro Areas remained the most optimistic at 40.7, and recorded the highest scores for all six index components. The Metro Phoenix BLCI fell by a significant 5.0 points and is now in line with the Metro Tucson index.

Index by Component and Region Q2 2008

	State		Region		
	Arizona	change from Q1	**Phoenix-Mesa Metro**	**Tucson Metro**	**Non-Metro Areas**
Sales	45.0	-1.8	45.8	43.6	50.7
Profits	40.0	-2.0	38.1	40.1	46.3
Hiring	37.9	-3.9	38.7	36.4	43.4
Capital Expenditures	35.3	-6.0	36.3	34.2	38.2
State Outlook	34.5	-3.7	32.5	35.6	36.0
National Outlook	28.5	-3.5	28.6	28.3	29.4
BLCI	**36.9**	**-3.5**	**36.7**	**36.4**	**40.7**

BLCI Calculation Notes Panelists are asked to choose their responses from a five-point scale that includes Strong Decrease, Moderate Decrease, No Change, Moderate Increase, and Strong Increase. A numerical value ranging from –2 (Strong Decrease) to +2 (Strong Increase) is assigned to each of these. A score is then calculated for each question and transformed into a scale that ranges from 0 to 100. Index values above 50 indicate expectations for increases (or better conditions), and index values below 50 indicate expectations for decreases (or worsening conditions). The BLCI combines the six components using equal weighting.

Distribution of BLCI Panelists by Industry



Both total panel membership and the number completing the survey continue to expand. Many thanks to all of our panel members for making this survey a useful and reliable indicator. We make no pretense that this survey is representative of all business leaders in Arizona. What we report here are the responses of the panelists who completed our survey. As we continue to grow the size of the panel, we will continue to add analysis for individual industries and sub-state areas. Please join us in early June for our look ahead to the third quarter 2008.(Visit www.blci.com/arizona.)

Compilation and analysis provided by Marshall J. Vest, Director of the Economic and Business Research Center at the Eller College of Management, The University of Arizona.

Compass ON BUSINESS

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