Members Present:
Dan Anderson, Arizona Board of Regents
Tracy Clark, Arizona State University
John Lucking, ECON-LINC
Georganna Meyer, DOR
Elliott Pollack, Elliott D. Pollack and Co.
Martin Schultz, Arizona Public Service
Marshall Vest, University of Arizona
Don Wehbey, Department of Economic Security

Mr. Richard Stavneak, Director, JLBC Staff, opened the meeting at 9:45 a.m. and welcomed everyone to the Finance Advisory Committee (FAC) meeting.

Mr. Stavneak started the JLBC Staff presentation with an overview of state revenues and issues for the panel to consider. (Click here to view.)

Mr. Hans Olofsson, JLBC Staff, continued the presentation on Individual Income Tax.

Mr. Stavneak said the positive forecast for capital gains, especially from the stock market, may replace capital gains from real estate in the previous year. This volatility creates challenges in forecasting the individual income taxes.

Mr. Brian Cary, JLBC Staff, continued the presentation on Sales Tax Collections.

Mr. Elliott Pollack asked what the percentage of total sales tax is for contracting. Mr. Cary replied that contracting is more than 22% of the total this year versus 21% a year ago.

Mr. Pollack asked if the tax from a house is collected when the material is purchased or when the house closes. Ms. Georganna Meyer replied that she believes the tax is charged when the house closes.

Mr. Pollack stated that in looking at house closings, they have not come down at all. However, permits are at 50% less than a year ago. Contracting taxes are higher because the house closings have not yet decreased and prices are high because the houses that are closing were contracted and built 9 months to 1 year ago. Contracting revenues will fall, perhaps even go negative, in 6 months. If taxes are collected when houses are closed, there will be a problem.
Mr. Stavneak continued the presentation with a summary of the Big 3 Forecast Growth.

Mr. Pollack gave a slide presentation and handout on the national economy.  (Click here to view.)

Mr. Stavneak asked Mr. Pollack’s perspective relative to the state.

Mr. Pollack said that the contracting analysis shows that revenues will fall within the next 4 to 6 months.

Mr. Tracy Clark gave a presentation on the Arizona outlook.  (Click here to view.)  He said that there is weakness in retail sales and potential weakness in corporate and personal income tax.  The overall economy does not look bad; the impact on the revenues will be disproportionate.  Auto sales will be weaker. Retail sales have more downside potential because of the inability of people to refinance their credit card debt.

Mr. Marshall Vest asked if the year-to-date categories (illustrated on page 15 of the JLBC presentation) are Arizona based data.  Mr. Cary replied that it is Arizona based data.

Mr. Vest asked if the categories can be broken down to a mixed code basis.

Ms. Meyer replied that they are working on mixed data.

Mr. Vest asked what category manufacturing would be in the data.

Mr. Cary replied that in the mix code, the seller is included in the manufacturer and the product is subject to sales tax.

Mr. Tim Everill asked the panel for their perspective on the economy.

Mr. John Lucking said that Mr. Pollack pointed out the change in unit labor cost. The concern is the dollar declines substantially. Banking and international settlements, the reserves held for Russia and OPEC countries, that on the dollar are at 64% is an indication of things to come. Foreign inflation can pick it up because foreign business is more expensive and the U.S. exporters are more competitive, so they have a larger market. The dollar decline presents an increase to inflation. Also, with capital gains, there may be some people that take capital gains now rather than wait to see what Congress says next year or the year after. It might be a surprise ending with strong capital gains inflow. The key points are inflation and capital gains.

Mr. Dan Anderson agrees with the panel. One overall concern is the housing industry and the potential oversupply. With so many people that have gotten into the market place having been less than prime borrowers, how many of them will be able to sustain the payments in the months ahead. There may be more supply because of not only the existing supply, but also some of the houses currently occupied that can come into the marketplace. The state is better poised than most states for growth. It is going to be a slower economy, however, if there is a recession, it will be fairly mild and short-lived.

Mr. Martin Schultz said that from the company standpoint, although there is a slowdown in housing, there is still a continuing increase in hookups in subdivisions. There is great strength in the commercial market that is not slowing down, investments are being made and construction is continuing.

Mr. Marshall Vest said that as real estate and construction levels off, which is an industry that is at least a fourth of the growth in recent years, there is a significant risk of decline which will have an effect on the economy. The surprise is that measures of employment and personal income are good. The only slowdown is in the sales category. There has been little slowdown of real estate on the economy, but it will become visible in the future. This is not a recession, just slower growth.
Mr. Don Wehbey said that it is clear that the economy is slowing. He expected to see faster growth in the first and second half, but is seeing slowing in the second half. The second quarter QCEW report seems to appear similar to the first quarter. The economy, according to that data, still looks good. There is four quarter average wage growth above 12%. There is still high firm growth of 9%. There is employment growth of 5.9%. DES estimates show a slowdown, a new report shows unemployment growth of 4.7%. The Arizona economy has momentum going forward, even in the second quarter. It is another strong year. The issue still posing a risk is energy.

The meeting adjourned at 10:47 a.m.

Yvette Medina, Secretary

Tim Everill, Revenue Section Chief

NOTE: A full tape recording of this meeting is on file in the JLBC Staff office at 1716 West Adams.
Finance Advisory Committee

December 12, 2006

JLBC
General Fund Revenues Have Grown Rapidly in the Last 2 Years

- 20% FY ’06 Growth
  - Sales Tax = 16.7%
  - Individual Income Tax = 24.1%
  - Corporate Income Tax = 24.6%
- 2-Year growth for ’05 and ’06 of almost 40% greatest in at least 35 years.
Growth in 1st Five Months of FY 2007 Is Down From Last Year, But Still Double-Digit

- July-November revenues are 10% above last year.
- Sales tax is up over 9%.
- Individual income tax is up over 9%, although it is unclear how much of this increase was aided by ’06 “hang-over” — some payments reflect ’05 liabilities.
- Corporate income tax is up almost 22%.
FAC Forecast is a Component of “Big 3”
General Fund Revenue Consensus Estimate
UA Model Represents 50% of the Forecast

Big 3 forecast equally weights:

- FAC average
- UofA model - base
- UofA model - low
- JLBC staff forecast
- Remaining revenues (6% of total) are staff forecast
FAC Forecast More Cautious Since September

- Overall FY 2008 Growth Projection Declined From 6.9% to 5.0%.
- Long Term Average Growth is 7%

Sales Tax: 7.3% (September FAC), 5.8% (December FAC)
IIT: 7.2% (September FAC), 5.1% (December FAC)
CIT: 3.6% (September FAC), 1.0% (December FAC)
Overall: 6.9% (September FAC), 5.0% (December FAC)
While FAC Has Become More Cautious, Blue Chip Continues to Forecast Growth Near Historical Averages

![Bar chart showing personal income, retail sales, and job growth from 2006 to 2008. Personal income has an average of 7.2%. Retail sales have an average of 7.0%. Job growth has an average of 3.2%.]

Source: November 2006 Arizona Blue Chip
While FAC Forecasts Below Average Growth, the UA Low Model Represents A Recession Scenario
- “Big 3” FY 2008 Forecast Weighted Averages by Input

<table>
<thead>
<tr>
<th>Input</th>
<th>JLBC</th>
<th>UA Low</th>
<th>UA Base</th>
<th>FAC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
<td>8.6%</td>
<td>0.4%</td>
<td>5.1%</td>
<td>5.0%</td>
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</tbody>
</table>

JLBC
Evaluating the Odds of Flat Revenue Growth - How Does that Compare to the Odds of a Recession?

• National Blue Chip places the odds of a recession at 25% in the next 12 months
  – Based on responses from 55 panelists
  – 10 most optimistic place odds at average of 15%
  – 10 most pessimistic place odds at average of 36%

• Arizona Blue Chip was asked when the next recession would occur in Arizona
  – 13% said prior to 2008
  – 20% said 2008
  – 67% said 2009 or beyond
Individual Income Tax
4-Sector Consensus Forecast Calls For 5.7% Growth in FY 2008

*Adjusted for withholding rates.

FY 2006 Actual = $3.7 Billion
After 2 Years of Double Digit Withholding Growth, FY 2007 Collections Have Been Much More Uncertain

- Withholding YTD Growth is 6.3% Over FY 2006
- 46% Growth in Estimated/Final Payments Pulls Overall Average to 9.4%

Growth over same month in Prior Year
National Capital Gains Distributions Are Expected to Increase Dramatically
- Distribution Changes Help Explain Volatility in Income Tax Collections

- Losses from the last “bear market” have been used up.
- Distributions in CY ’06 are expected to increase by 50%.
- Arizona’s share may contribute $80-$90 million to FY07 IIT collections.
- These gains may be offset by less real estate activity.
Sales Tax Growth Rate
4-Sector Consensus Forecast Calls For 4.6% Growth in FY 2008

Fiscal Year

Year Over Year Percentage Change

Actual

Four-Sector Consensus

FY 2006 Actual = $4.3 Billion
FY 2007 Sales Tax Collections Have Slowed in Some Major Categories
- Overall Growth is 9.5%
- Contracting Activity Remains High While Retail Lags

FY 2007 Year to Date – (Through October)

* Represents 10% of total collections.
If Homebuilding Is Down, Why Has Contracting Growth Remained High?

- Nonresidential construction activity remains at high levels.
- With housing costs still high, some homeowners may be using their equity to improve their existing residences rather than move to a different home.
Some Retail Sales Categories Have Struggled in Recent Months

- Overall Growth is 5.0%
- Construction Related Retail Has Been Stronger Than Other Categories

FY 2007 Year to Date – (Through October)

* Represents 14% of total collections.
The Housing Slump and Fuel Prices May Be Affecting Sales Tax Collections

• Home price appreciation and low interest rates helped fuel consumer spending in FY 2005 and FY 2006.

• Higher interest rates have curbed demand for new homes and big-ticket items.

• High gasoline prices soaked up discretionary income and may have curbed spending on non-durable items.
Holiday Season Sales May Fall Short of Last Year’s Results

• The National Retail Federation projects holiday sales will increase 5% this year, down from 6.1% in 2005.
• Forrester Research forecasts U.S. online retail sales, much of which escapes taxation, will increase 23% in the 2006 holiday season from a year ago.
Corporate Income Tax Growth Rate
4-Sector Consensus Forecast Calls For 2.1% Growth in FY 2008

FY 2006 Actual = $874 Million
U.S. Corporate Profits are Expected to Slow
- Global Insight Forecast Comparable to Blue Chip
- These National Forecasts Support 4-Sector Revenue Projection
Big 3 Forecast Growth
Four-Sector Consensus Forecast Has Growth of 8.2% in FY 2007 and 4.8% in FY 2008

- ’07 Growth of 8.2% would be steep decline from 20% in ’06, but close to budgeted rate.
- ’08 Forecast is pulled down by flat growth scenario in the UA-Low Model.
- Without UA-Low, ’08 grows by 6.2%.
# FY 2007-FY 2010 Quartile Forecast Worksheet

<table>
<thead>
<tr>
<th></th>
<th>FY 2007</th>
<th>FY 2008</th>
<th>FY 2009</th>
<th>FY 2010</th>
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<tbody>
<tr>
<td><strong>Sales Tax</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>JLBC Forecast (12/06)</td>
<td>8.8%</td>
<td>8.5%</td>
<td>8.2%</td>
<td>7.0%</td>
</tr>
<tr>
<td>UA - Low (11/06 revision)</td>
<td>4.9%</td>
<td>0.3%</td>
<td>1.4%</td>
<td>4.5%</td>
</tr>
<tr>
<td>UA - Base (11/06 revision)</td>
<td>5.6%</td>
<td>3.8%</td>
<td>4.8%</td>
<td>6.5%</td>
</tr>
<tr>
<td>FAC (12/12/06 Survey)</td>
<td>7.9%</td>
<td>5.8%</td>
<td>5.3%</td>
<td>6.2%</td>
</tr>
<tr>
<td><strong>Average:</strong></td>
<td>6.8%</td>
<td>4.6%</td>
<td>4.9%</td>
<td>6.1%</td>
</tr>
</tbody>
</table>

|                     |         |         |         |         |
| **Individual Income Tax** |         |         |         |         |
| JLBC Forecast (12/06) | 9.1%    | 8.9%    | 8.3%    | 7.0%    |
| UA - Low (11/06 revision) withholding | 4.2%    | 2.7%    | 4.4%    | 6.9%    |
| UA - Base (11/06 revision) withholding | 8.1%    | 6.2%    | 6.6%    | 7.7%    |
| FAC (12/12/06 Survey)   | 7.9%    | 5.1%    | 5.8%    | 6.8%    |
| **Average:**         | 7.3%    | 5.7%    | 6.3%    | 7.1%    |

|                     |         |         |         |         |
| **Corporate Income Tax** |         |         |         |         |
| JLBC Forecast (12/06) | 15.0%   | 8.0%    | 5.0%    | 2.5%    |
| UA - Low (11/06 revision) | 23.4%   | -7.0%   | -13.3%  | -4.6%   |
| UA - Base (11/06 revision) | 27.9%   | 6.2%    | 0.0%    | 1.7%    |
| FAC (12/12/06 Survey)   | 8.1%    | 1.0%    | 3.7%    | 7.7%    |
| **Average:**         | 18.6%   | 2.1%    | -1.2%   | 1.8%    |

**Consensus Weighted Average:**

<table>
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<th>FY 2007</th>
<th>FY 2008</th>
<th>FY 2009</th>
<th>FY 2010</th>
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<td>8.2%</td>
<td>4.8%</td>
<td>4.8%</td>
<td>6.1%</td>
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**JLBC Weighted Average:**

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<th>FY 2008</th>
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<th>FY 2010</th>
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<td>9.5%</td>
<td>8.6%</td>
<td>7.9%</td>
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**UA Low Weighted Average:**

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<td>6.4%</td>
<td>0.4%</td>
<td>1.1%</td>
<td>4.7%</td>
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**UA Base Weighted Average:**

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<td>8.8%</td>
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**FAC Consensus Weighted Average:**

<table>
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<td>7.9%</td>
<td>5.0%</td>
<td>5.4%</td>
<td>6.6%</td>
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</tbody>
</table>
National Economy

Prepared for:
Finance Advisory Committee

Elliott D. Pollack & Company
December 12th, 2006

Negatives

• Slowing housing market.
• Consumer spending slowing.
• Inflation an issue?
Positives

• Employment still positive.
• Businesses lean and mean.
• Increase in exports.

Weakening economies are more sensitive to shocks.
Examples of Direct Shocks:

• Unexpected oil price escalation.

• Terrorist event (especially to financial or commerce infrastructure).

Examples of Indirect Shocks:

Collapse of housing prices
What is the national Blue Chip panel telling us?

United States Real Gross Domestic Product*  
Annual Growth 1970 - 2007**  
Source: U.S. Bureau of Economic Analysis & Blue Chip Economic Indicators

* Based on chained 2000 dollars.  
** 2006 - 2007 are forecasts from the Blue Chip Economic Indicators, November 2006.
ODDS OF A RECESSION
Source: National Blue Chip Panel

November consensus: 24.8%
October consensus: N/A
September consensus: 25.1%
August consensus: 26.9%

Consumer Energy Goods & Services Spending as a Percent of Personal Income
1971 – 2006*
Source: Bureau of Economic Analysis

*Data through third quarter 2006
Recession Periods
The future of oil prices is uncertain...

The longer they are high, the greater probability of viable alternatives being found.

Residential Investment as a Percent of GDP
1947 – 2006*
Source: Bureau of Economic Analysis

*Data through third quarter 2006
Non-Residential Structures Investment as a Percent of GDP
1947 – 2006*
Source: Bureau of Economic Analysis

*Data through third quarter 2006

Equipment & Software Investment as a Percent of GDP
1947 – 2006*
Source: Bureau of Economic Analysis

*Data through third quarter 2006
Value of Total Construction Put-In-Place*
Percent change Year Ago
January 1972 – October 2006
Source: U.S. Census Bureau

*Includes both residential and non-residential construction.
**Series reporting changed in August 2003. Data prior to 1994 is old series.

Are people making ends meet?
U.S. Real Personal Income
Percent Change Year Ago
1971 – 2006*
Source: Bureau of Economic Analysis

U.S. Real Retail Sales
Percent Change Year Ago, 3-Month Moving Average
1972 – 2006*
Source: Federal Reserve Board of St. Louis
National Employment*
Annual Percent Change 1975–2006*
Source: Bureau of Labor Statistics

Median Weeks Unemployed (S/A)
1972 – 2006*
Source: Bureau of Labor Statistics

*Non-agricultural wage & salary employment. Changed from SIC to NAICS reporting in 1990.
*Data through October 2006.
NOTE: The FOR includes debt service payments as a percent of disposable income. The FOR is a broader measure as it includes auto lease payments, rental payments, homeowner’s insurance and property taxes. *Data through second quarter 2006.

* 2006 -2008 forecasts are from Freddie Mac
Mortgage Equity Withdrawal as a share of Disposable Income
U.S.: 1971 – 2006*

Source: Bureau of Economic Analysis

Will inflation get ugly?
Consumer Price Index
Percent Change Year Ago
1971 – 2006*
Source: Bureau of Labor Statistics

- Three-month moving average. Data through October 2006.

Consumer Price Index
Percent Change Year Ago
2000 – 2006*
Source: Bureau of Labor Statistics

- Three-month moving average. Data through October 2006.
Personal Consumption Expenditures
Price Deflator (2000=100)
Percent Change Year Ago
1971 – 2006*
Source: Bureau of Economic Analysis

1971 Q1
1972
1973 Q1
1974 Q1
1975 Q1
1976
1977 Q1
1978 Q1
1979
1980 Q1
1981
1982 Q1
1983 Q1
1984 Q1
1985
1986 Q1
1987 Q1
1988
1989 Q1
1990
1991 Q1
1992 Q1
1993
1994 Q1
1995 Q1
1996 Q1
1997 Q1
1998
1999
2000 Q1
2001 Q1
2002
2003 Q1
2003 Q2
2004 Q1
2004 Q2
2004 Q3
2004 Q4
2005 Q1
2005 Q2
2005 Q3
2005 Q4
2006 Q1
2006 Q2
2006 Q3
2006 Q4

PCE
PCE - less food & energy

Data through third quarter 2006.

Recession Periods
30-Year Conventional Mortgage Rates
1982 – 2006*
Source: Federal Reserve Economic Database

3-Month Treasury
1982 – 2006*
Source: Federal Reserve Economic Database

*Data through November 2006.
Can business pull us forward?

Capacity Utilization Rate
1970 – 2006*
Source: The Conference Board

• Data through October 2006

Recession Periods
Total Plant Spending
Percent Change Year Ago
(Real Dollars)
1970 – 2006*
Source: Bureau of Economic Analysis

-25%
-20%
-15%
-10%
-5%
0%
5%
10%
15%
20%
25%

• Data through third quarter 2006.
• NOTE: Series was revised in March 2004. Data prior to 1990 was not provided.

Total Equipment & Software Spending
Percent Change Year Ago
(Real Dollars)
1970 – 2006*
Source: Bureau of Economic Analysis

-25%
-20%
-15%
-10%
-5%
0%
5%
10%
15%
20%
25%

• Data through third quarter 2006.
• NOTE: Series was revised in March 2004. Data prior to 1990 was not provided.
Net Percentage of Large U.S. Banks Reporting Tougher Standards on Business Loans
1991 – 2006*
Source: Federal Reserve, Board of Governors

Trade Weighted U.S. Dollar v. Major Currencies
1973 – 2006*
Source: Bureau of Economic Analysis

*Data through third quarter 2006
Government

Is the federal deficit a problem?
Government Receipts v. Outlays
Percent Change Year Ago
1982 – 2006*
Source: Department of the Treasury

-15%  -10%  -5%  0%  5%  10%  15%

Outlays  Receipts

*Data through October 2006, 12-month moving average.

U.S. Federal Surplus / Deficit
as a Percent of GDP
1968 – 2007
Source: White House OMB & Bureau of Economic Analysis

Note: 2007 are forecasts from the 2007 Mid-Session Review
U.S. Real Net Exports as a Percent of Real GDP
1971 – 2006*
Source: Bureau of Economic Analysis

Goods Exports as a Percent of Total Goods Produced
1990 - 2006*
Source: Bureau of Economic Analysis

*Data through third quarter 2006
Growth in U.S. Exports
As of Q3, 2006
Source: U.S. Census Bureau

<table>
<thead>
<tr>
<th>Country</th>
<th>2005</th>
<th>2006</th>
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<tbody>
<tr>
<td>Canada</td>
<td>10.2%</td>
<td>9.4%</td>
</tr>
<tr>
<td>Mexico</td>
<td>8.0%</td>
<td>9.9%</td>
</tr>
<tr>
<td>Europe</td>
<td>8.2%</td>
<td>20.7%</td>
</tr>
<tr>
<td>Pacific Rim</td>
<td>8.7%</td>
<td>15.2%</td>
</tr>
<tr>
<td>Latin America</td>
<td>20.0%</td>
<td>25.7%</td>
</tr>
</tbody>
</table>

U.S. Debt Held by Foreign & International Investors
1975-2006*
(Billions of Dollars, SA)
Source: Federal Reserve Economic Database

• Data through second quarter 2006.
Summary:

U.S. Economy...

U.S. OUTLOOK - 2007

- Consumer spending (+ / -)
- Housing (-)
- Business spending (+)
- Fiscal stimulus (+)
- Monetary stimulus (+ / -)
- Real incomes (+ / -)
- Businesses mean and lean (+)
- Productivity growth slowing (-)
- Job growth (+)
- Inflation (-)
- Low interest rates (-)
- Exports (+)
Arizona Update and Outlook

JPMorgan Chase Economic Outlook Center

Probability of Recession from the Yield Curve
(Neftci formula applied to 10 year - 1 year spread)

Source: JPMorgan Chase Economic Outlook Center calculations (last data point November 2006= 99%)
Index of Help Wanted Advertising in Newspapers
1990 to 2006

The Conference Board 1987=100
(last data point September 2006 US = 30 Arizona = 53)

Purchasing Managers Index
1990 to 2006

The National Association of Purchasing Managers and JPMorgan Chase Economic Outlook Center 1987=100
(last data point November 2006 US = 49.5 Arizona = 63.8)
Arizona Personal Income Growth

Forecasted growth rates from the November JPMorgan Chase Arizona Blue Chip Economic Forecast.

History: Bureau of Economic Analysis (percent change)

Personal Income Growth 1970 to 2006

Source: BEA (last data point Q2 2006 US = 7.3% AZ = 9.8% )
Arizona Population Growth

Forecasted is from the November JPMorgan Chase Arizona Blue Chip Economic Forecast.

History: ASU Center for Business Research (percent change)

Quarterly Arizona Population Growth 1970 to 2005

Source: ASU Center for Business Research (last data point Q4 2005= 3.8% )
Arizona Wage and Salary Employment Growth

Forecasts are from the November JPMorgan Chase Arizona Blue Chip Economic Forecast

Employment Growth 1991 to 2006

Bureau of Labor
(last data point September 2006 US = 1% Arizona = 5% )
Arizona Construction Employment Growth 1991 to 2006

Source: Arizona Department of Economic Security (last data point October 2006= 10%)

Arizona Manufacturing Employment Growth 1991 to 2006

Source: Arizona Department of Economic Security (last data point October 2006= 0.4%)
Arizona Services Employment Growth 1991 to 2006

Source: Arizona Department of Economic Security (last data point September 2006 5.3%)

Arizona Single Family Permits 1986 to 2006

Source: Arizona Real Estate Center 3 MMA SA (last data point September 2006)
Spot Oil Price West Texas Intermediate
1970 to 2006

Source: Dow Jones Energy Service (Dollar Per Barrel, Prior to 1982=Posted Price) (last data point November 2006=69.37)

Sales of Autos & Light Trucks
1987 to 2006

Source: BEA Millions of Units, SAAR (last data point September 2006=15.56)
Growth in Corporate Profits

History: Bureau of Economic Analysis (with IVA and CCAdj) (percent change)
Last two years are forecasts from the Blue Chip Economic Indicators  November 2006 Issue

S&P 500 Composite Stock Price Index
1965 to 2006

Source: Daily Press (last data point 10/13/06 = 1366)