ESCAPE VELOCITY: IS THE ECONOMY THERE? WHY BUSINESS CARES

ECONOMIC OUTLOOK AND FORECASTS:
The Nation, Southern California, and Orange County

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U.S. ECONOMIC OUTLOOK AND FORECASTS
Gravity, Orbits and Escape Velocity: The Trajectory of U.S. Recovery

“What goes up, must come down” — the old saying goes. True for most objects casually shot up from the earth’s surface into the atmosphere, the gravitational pull of the planet eventually returns them back down. But the return to earth is not a pre-ordained outcome: pack enough power when launching and the object may never come down, but circle perpetually around the earth’s orbit. Try the experiment again with even greater thrust and the object will “escape” permanently the earth’s gravitational pull and will never return. The object has thus reached “escape velocity.”

“Escape velocity” is the newest and edgiest buzzword to have invaded the macro-lexicon of today’s reporting on the health of the economy and its outlook. In econo-speak, it’s meant to denote the moment when the U.S. economy will be able to break free from the gravitational pull of the Great Recession and grow at a robust rate without undergoing sustained acceleration from fiscal and monetary policy. Since fiscal support has all but waned by now, escape velocity is viewed these days as a less-than-perfect approximation for when the Federal Reserve will begin to unwind its massive liquidity programs, unleashed to aid the ailing recovery.

Let’s review the evidence: in what appears an all-too-familiar routine, hard data since the onset of the recovery has swung from good to bad news to subsequently being followed by a mixed bag. Caught in this cycle, the Fed has busied itself in repeatedly upgrading and downgrading its outlook, which is firmly wedged within a tightly defined range of “moderate” and “modest” and variations thereof (“moderately modest” comes to mind). Economists and market analysts continue to extend the timing of an eventual take-off: if not this quarter then the next, if not this year then the next. This is further complicated by fiscal policy issues — the most recent federal government shutdown and the looming debt-ceiling have further added to the overall uncertainty. After all, it is rather difficult to discuss whether the economy is able to stand on its own in the shade of a shutdown and under the threat of “default.”

To date, the recovery has completed its fourth year — quite an advanced stage considering that the average U.S. post-war expansion is around 40 months. Yet few would consider this a mature recovery, and most would agree that the economy should have been much further along in the expansion process at this point in the cycle. Improvements in the labor markets have been painfully slow and employment today is still 1.4% below its pre-recession peak; real GDP has inched up at a snail’s pace
and is running roughly $1 trillion (5%) below potential, productivity gains have been disappointing; businesses are hesitant; consumer spending has been lackluster; and confidence has improved only incrementally (Figure 1). Moreover, the global economy has not helped: Eurozone has sunk to another recession (the second within a five-year period), and emerging markets — once dubbed the eventual engine of the global growth — have decelerated markedly over the past two years.

Concerns about the pace of the recovery, however, miss an important point: much has happened over the past four years and the economy is today in a stronger footing even when compared to the start of this year. While not a booming expansion, the current recovery is surely resilient. It managed to survive a number of crises and near-calamities: a full-blown, sovereign debt crisis in the Eurozone; a dramatic “debt-ceiling” debacle ending with a historic downgrade of U.S. credit rating; a near-headlong plunge over the “fiscal cliff;” across-the-board, ill-designed, sequester-related cuts; two U.S. election cycles; and countless political wrangling over virtually everything from the Affordable Care Act to Syria to budget cuts and any other matter one cares to add. Anyone of these shocks would have weakened a normally functioning economy, let alone one that was emerging from the very depths of a severe recession.

More importantly, the four years that have elapsed create a much-needed distance from the Great Recession. During this time, the healing has progressed in earnest in almost all sectors: the process of deleveraging is almost complete, the banking sector has regained its vigor, credit has normalized, corporate profits are near-record levels, and business balance sheets are healthy. Significantly, the housing recovery has staged a spectacular comeback over the past year, buoyed by organic, self-sustained growth that should continue to expand over the forecast horizon.

These improvements point to an overall upbeat outlook for the U.S. economy. We expect a steady, sustained expansion in economic activity that accelerates gradually over the forecast horizon, tentatively for the balance of 2013 and early in 2014 but more robustly after that.
This optimism should be tempered with some dose of caution. As has been the case for some time now, risks remain that policy missteps both domestically and abroad may halt momentum, producing the same sluggish, subpar, uneven growth we are accustomed to so far. On the domestic front, concerns abound on both the fiscal and monetary policy side. The unwinding of the Fed’s quantitative easing program will undoubtedly impact the recoveries both in the U.S. and abroad. On the fiscal side, new uncertainties have cropped up over the past few weeks; as of this writing, the federal government has been on “shutdown” for over a week and risks are rising that the standoff will engulf the ever-so-delicate debt-ceiling talks. While a temporary government shutdown will likely have a muted impact on growth, a debt-ceiling standoff would have severe consequences for the U.S. and global economy. On the global front, the Eurozone crisis, while significantly tamed compared to even one year ago, is not fully resolved given that the fundamental issues that plagueing the Eurozone region remain unaddressed. Moreover, the recent positive news from emerging markets may prove transitory, bringing forth renewed weakness in global growth.

Our baseline outlook assumes that none of the worst-case scenarios come to materialize over the forecast horizon: the government shutdown and the U.S. debt ceiling are resolved by mid-October (most likely through a short-term extension which buys time for more negotiations), the Eurozone crisis remains contained, and emerging economies perform better than in recent past. Below we lay out our outlook as it relates to these main factors and risks. This analysis provides the basic foundation for our national forecasts and serves as a cornerstone for our regional economic analysis of Southern California and Orange County.

In Search for Growth

The sluggishness of the recovery is nowhere more apparent than in the headline numbers of real GDP. After a comprehensive revision of the data (going back to 1929), we learned that the recession was only 0.1% shallower and the subsequent recovery only 0.1% stronger than initially estimated. In sum, not much changed in the outlook despite the fact that the data was revamped to reflect a new component of gross private domestic investment that captures intellectual property (consisting of software, R&D, and artistic creation). This new component added a total of $605 billion to real GDP in 2012, which caused growth for that year to be revised upward from a subpar 2.2% to a more respectable 2.8%. The momentum ebbed at end 2012/early 2013 when the economy grew by a feeble 0.1% in Q4 2012 and 1.1% in Q1 2013 (Figure 2).
U.S. real GDP has grown by a cumulative 9.2% since the depth of the recession (in mid-2009), and real GDP is now 4.6% higher than its pre-recession peak at the end of 2007. Though growth is better than the alternative, comparisons to pre-recession levels highlight starkly the depth of the recession and the sluggishness of the recovery. Few would argue that growing by a total of less than 5.0% for six years points to anything other than an incredibly stagnant economy. The good news is that more recent data signal improvement — the second quarter growth projections were revised to 2.5% from a meager 1.7%. While we expect real GDP growth for 2013 to come in at only 1.7% for the year (given the weak first half and the potential damage in the fourth quarter from the government shutdown), our projections for the next two years are more optimistic. We expect the U.S. economy to grow at a 2.5% clip in 2014 and 2.9% in 2015.

The labor market has continued to heal, but the pace of progress remains frustratingly slow given the devastating impact of the recession and the multi-year length of this recovery. Total employment levels have grown by 6.7 million since their trough in February 2010, but that still falls 2 million jobs short of the 8.7 million that were lost during the recession. The labor market picture gets even more grim when accounting for the fact that the U.S. working-age civilian population (aged 16 years and over) has grown by over 13 million since 2007. In fact, no other statistic illustrates more starkly the lackluster performance of the labor market than the employment-to-population ratio. After plunging to a 25-year low of 58.5% during the depth of the recession (from a pre-recession average of around 63.0%), the ratio has barely budged for the entire duration of the recovery (Figure 3).

One disheartening element during the recovery has been the lack of acceleration in job formation as the economy continued to heal. Employment rolls added a total of 1 million jobs in 2010, 2.1 million in 2011, 2.2 million in 2012 and are on pace to add another 2 million this year. While the 2-million-new-jobs-per-year pace is nothing to sneer at and matches the pre-recession pace, it is agonizingly too slow to erase the overwhelming wreckage of the recession. Moreover, the pace of job formation has downshifted somewhat in recent months — after averaging around 205,000 jobs per month in the first quarter of this year, payroll growth slowed to 155,000 in the following four months.

**FIGURE 3**
Treading Water: Employment to Population Ratio (percent)

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Another cause for concern is the quality of newly created jobs, especially during this year. Of the total number of new jobs added up until August, 60% are part-time positions. In contrast, in 2012 53% of jobs created over the same period (January-August) were full-time and only 47% were part-time. The trend was even more pronounced earlier in the summer when 80% and 77% of new jobs created in June and July were part-time. These developments may have to do with the impending implementation (and subsequent one-year delay) of the employer mandate of the Affordable Care Act (ACA), which requires that firms with the equivalent of 50 or more full-time workers offer health coverage. This may have encouraged employers to either rely on part-time work, keep their payroll below the 50 mark. So far, the evidence for the ACA impact is rather anecdotal, though it is certainly curious that the August survey (which occurred after the delay of the ACA employer mandate) shows a decline in part-time jobs relative to June and July.

Not only has employment risen in industries that rely more heavily on part-time work, it has also increased disproportionately in industries that pay below-average wages. Since the start of the recovery, a whopping 51% of jobs are created in occupations that offer wages in the bottom two quantiles of the distribution scale. In contrast, only 18.2% and 18.1% of the newly created jobs fall in the first and second wage quantiles (Figure 4). The lack of wage growth is certainly one of the contributing factors of the sluggish recovery and will continue to remain a concern over the forecast horizon.

The labor market is also plagued by a number of disturbing trends that are more structural in nature. Since the end of the recession, the labor force participation rate has plunged dramatically from around 66.0% in 2007 to a current 63.2% — a 35-year low. If the rate was equal to the 2000-2008 average, an additional 7.8 million people would be in the labor force and the unemployment rate would be around 3.0% higher than its current rate of 7.3%.
At the very core of the lackluster job formation is one simple factor: the missing start-ups. Historically, newly formed firms have been the engine of job growth in the U.S., whereas existing firms (those older than one year) tend to contribute negatively to net employment levels (Figure 5). The U.S. Census Bureau data on firm employment dynamics reveal that since 1977, hiring by new firms has added an average of 2.7 million jobs per year, whereas net employment has fallen by an average of -1.2 million per year at establishments more than one year old. In fact, existing firms have contributed positively to net employment in only 8 out of 34 years for which data are available.

New business formation has been exceptionally slow during the recession and recovery cycle. There were only 396,000 and 413,000 new firms created in 2010 and 2011, the lowest levels since records began. Moreover, the number of employees hired by new establishments has declined from an average of 7.5 employees in 1994 to a current 4.7 workers, due mostly to gains in technology and service outsourcing. Not surprisingly, the overall contribution to employment rolls from new firms has been rather weak since the end of the recession; after adding an average of around 3 million jobs per month over the past three decades, new businesses contributed a net of 2.4 million jobs in 2009 and 2010, and 2.5 million in 2011.

Going forward, we expect the labor market to improve over the forecast horizon, a bit more slowly in 2013 but at a slightly faster clip in 2014 and 2015. The factors that have restrained new business formation, while not fully removed, have certainly waned considerably with the distance from the Great Recession — small-business credit is expanding, lending standards are being relaxed, household cash savings are rising, and homeowner equity continues to improve. We expect employment gains to average around 178,000 jobs per month in 2013 and 190,000 in 2014. The rate of unemployment is expected to edge down gradually, averaging 7.5% in 2013 and 7.0% in 2014.
The View from the Trenches: U.S. Consumers and the Teflon Effect

If there is a take-away from the past four years, it is that U.S. consumers are not an overly pessimistic bunch. Sure, confidence is still depressed when compared to the pre-recession levels and — at a 2.2% rate — consumption growth is a full percentage lower than during the mid-decade boom years. Nonetheless, the resiliency of the U.S. consumer cannot be underestimated; despite labor market woes and sluggish income growth, consumption spending rose by 2.0% in 2010, 2.5% in 2011 and 2.2% in 2012.

Spending in durable goods has been remarkably strong, growing by an average of 6.6% in 2011, 7.7% in 2012 and by 7.3% in the first two quarters of 2013. This is due in large part to a notable increase in demand for auto vehicle sales, which — at a current annual pace of 16 million — are at the highest level since the fourth quarter of 2007 (Figure 6). In addition, expenditures on household furnishing and durable household equipment have also rebounded, sharply driven by a sizable, pent-up demand accumulated during the lean recession years and a strong rebound of the housing sector.

Income growth has been especially sluggish during this recovery though recent data point to some improvement. Average pre-tax income rose 3.0% in 2012 — the highest gain since 2007 — supported primarily by wages and salaries. More encouragingly, consumer balance sheets appear to be healthier now than at any point during the recovery. The U.S. household debt service as percent of disposable income has fallen to 10.4% from a high of over 14.0% before the crisis, while financial obligations as a percent of disposable income has dropped to 13.7% — the lowest level since 1980.

The picture of household income and wealth is nonetheless quite mixed. After sinking by a total of nearly 20% during the recession, net worth rebounded by an impressive 35% as of the latest reading, thanks to improvements in equity market and home values. In fact, household net wealth has set record values in every quarter over the past year. However, on a per-capita basis, real household net worth has yet to reach its pre-recession peak, declining from a high of $235,000 in early 2007 to a current $222,000. Likewise, real median household income is currently around $51,000 — below its pre-crisis level of around $55,000.
Going forward, we expect consumers to continue to add to growth, though the pace will remain subdued at least for the remainder of this year and early in 2014. Consumer spending should firm up more noticeably towards the end of 2014 and into 2015, when we expect a pickup in service expenditures. Overall, we project real personal consumption to grow by 1.8% in 2013, 2.4% in 2014 and a more robust 2.7% in 2015.

Onward and Upward: Housing on the Rebound

The housing market has staged a spectacular recovery over the past year. Though improvements are from very depressed levels, they are broad-based, self-sustained and organic. The S&P 500 20-City Case-Shiller Index rose by 12.4% (on a year-over-year basis) in July 2012, an improvement that was echoed by a similar rise in the Core-Logic home price index. As a result, only 7.1 million homeowners (14.5% of total mortgages) are now in negative equity — a significant decline from the 12.1 million (25% of total), with negative equity at the height of the housing crisis. At the end of the second quarter of this year, an additional 2.5 million homeowners returned to positive equity, thanks to continued improvement in home values. In addition, existing home sales have firmed up, rising 12.8% in August 2013 compared to their year-ago values.

Importantly, homebuilding has resumed at a brisk pace. Housing starts have risen from a historical low of 478,000 in Spring 2009 to a current 891,000 — an almost doubling of the levels. As a result, real residential construction has soared by 30.0% since the trough of the recession, contributing 0.3% and 0.4% to real GDP growth in the first two quarters of the year. Not surprisingly, the NAHB Homebuilder Sentiment Index has improved dramatically and currently stands at the highest level since early 2006 (Figure 7).

More recent data, however, point to a softening of these trends. Higher mortgage rates, which materialized earlier this summer as a result of the Fed’s “taper” talk, have restrained somewhat the pace of the housing recovery. Mortgage applications took a nosedive, housing affordability fell by 25%, and housing starts have plateaued at an annualized level of around 900,000. The profound impact of higher mortgage rates seems to have prompted the Fed to back away from its perceived desire to begin unwinding its bond-buying program. Since then, rates have fallen by roughly 50 basis points, which bodes well for the housing sector.

The housing recovery is currently in the midst of a significant transformation. Earlier gains were
largely driven by investor demand, which helped clear the inventory overhang and supported a robust increase in home prices. Now that bargain deals are largely exhausted, investor demand is unlikely to help any further. For a sustained, healthy rebound in the housing market, traditional buyers need to step in. There is certainly enough pent-up demand given the dramatic decrease in household formation rates during the recession. But households creation is still too slow when compared to the historical average: in 2012, 857,000 new households were formed, roughly half of the pre-crisis years. The sluggishness of the recovery is certainly an important factor in household formation. High student-debt levels, a weak job market and slow income growth have forced many young households to delay important life decisions such as marriage and home ownership.

Our outlook for the housing market is optimistic. We expect the recovery in the housing sector to continue, albeit at a more moderate pace than earlier this year. Pent-up demand from traditional buyers is expected to slowly materialize as household formation ticks up in the face of an improved outlook, a stronger labor market and more upbeat earnings. Housing starts are expected to rise by an average annualized pace of 930,000 in 2013 and 1.25 million in 2014.

“Taper” Tantrum: Financial Markets on Edge

Equity markets have had an impressive run this year, clocking in new gains and setting fresh new highs. From the start of the year to its most recent peak in mid-September, the S&P 500 rose by a spectacular 21%, boosted primarily by a highly accommodative monetary policy, a resolution of the fiscal cliff drama, relative calm from the Eurozone, a retreat in concerns about a “hard-landing” in China, and a much improved domestic outlook (Figure 8). All told, the four-year equity rally has lifted stock prices up by a total of 140% since March 2009.

The luster has waned somewhat since the start of the summer. “Taper” talk — the beginning of the end of the massive bond purchases by the Fed — that began in mid-May and extended throughout the summer began to grow louder, chipping away at market gains and increasing volatility. Equities fell and rose in tandem with the latest news on Fed taper. The impact was felt more acutely in stock and currency markets in emerging economies as sharp reduction in capital flows, further weakened an already fragile economic landscape.

By far, the largest impact of taper talk has been on the bond market. Yields on ten-year Treasury notes surged by more than 125 basis points from mid-May to early September, while 30-year conventional mortgage rates rose from 3.35% to 4.57% over the same period. This certainly has the potential to choke off the recovery in the housing sector as witnessed by a sharp reduction in mortgage applications.
over recent months. The housing recovery and the broader economy are not yet ready to contend with those levels, hence the recent decision from the Fed to stand pat on its bond-buying program.

Financial market volatility intensified further in early September on concerns about a possible strike on Syria and elevated global geopolitical risks. No sooner were those risks averted, when fiscal battles in Washington resumed, culminating with a partial federal government shutdown and a looming “debt-ceiling” deadline. While the markets seem to have shrugged off the shutdown (which is expected to have a muted impact on fourth quarter growth if it lasts a short time), it has shown signs of worry about the potential inability of Washington to reach a timely agreement on the debt ceiling. During the debt-ceiling talks of 2011, the S&P 500 lost nearly 17% over a period of less than two weeks. The market appears to be more patient now and is pricing in a resolution of the debt-ceiling standoff before its deadline, though the longer the shutdown continues the higher the odds of an unpleasant surprise.

We expect equity markets to show excessive volatility for the remainder of the year and early in 2014. Higher interest rates are also expected to characterize the investment environment going forward. Uncertainty about both fiscal and monetary policy should weigh heavily on the markets in the near term. But while the debt-ceiling showdown would certainly add to the volatility (and place some downward pressure on yields), some resolution (short or medium term) is expected by the mid-October deadline. More concerning for the markets should be the withdrawal of the monetary policy accommodation by the Fed and particularly the timing, the rate of reduction of bond purchases and the clarity of the Fed’s message regarding its shift towards policy normalization.

The effect has been low interest rates and a spectacular rally in the stock market, in the hope that these would shock the slumbering economy, revive the housing market and increase the pace of job formation. The link between the Fed and the real economy (particularly the labor market) is rather tenuous, which means that $3 trillion may be too high a price for too little growth.

The Long Goodbye: Federal Reserve and “Exit” Strategy

Gone are the days when central banking was boring. Since the crisis, policymaking at the Federal Reserve (Fed) has undergone a fascinating transformation which has dramatically expanded the role and the reach of monetary policy in the economy. After three rounds of quantitative easing, one “operation twist” and an extension of twist, the Fed’s balance sheet has exploded from $800 billion before the crisis to a current $3.7 trillion (roughly around 20% of U.S. GDP) (Figure 9).
At some point, everyone knows that the extraordinary measures put in place would come to an end. The understanding is that when the Fed stands down, the economy will have to stand up. It is obvious by now that the Fed is rather uneasy with “unconventional” policy and would like to return to normal sooner rather than later. It began hinting about a reduction in the pace of bond-purchases as early as February of this year. Taper talk got louder in mid-May and by the end of the Federal Open Market Committee (FOMC) meeting in June, the Fed set forth a timetable for tapering: it would stop buying bonds by the time the unemployment rate hits 7.0% and it will not begin to tighten interest rates until the unemployment rate has fallen below 6.5%.

The Fed seems to have been taken by surprise by the dramatic spike in interest rates and the turmoil in financial markets following taper-talk. To its thinking, a reduction in the pace of bond purchases still means further policy easing, since the Fed’s balance sheet would continue to expand, albeit at a slower pace. But that’s not how it works: the market perception is such that communications indicating an earlier or faster pace of bond-purchase reduction than what was previously expected, amounts to a tightening. Less overall buying by the Fed means more overall bond issues in the hands of investors — i.e., a “less accommodative policy” is a “tighter” policy.

Nonetheless, by the end of summer the market not only seemed to have come to terms with tapering but was expecting its announcement at the two-day September FOMC meeting. However the Fed decided to continue the current pace of bond purchases. No taper, no change. Worse, the Fed appeared to be taking back most of the guidelines it had provided in the summer, including the 7.0% threshold unemployment.

After so much talk, there is now more uncertainty and less clarity as to when and how fast the Fed will begin to wind down its bond buying program. The problem is that Fed statements are nuanced, complex, conditional, and data-driven. Moreover, the Fed seems to be rather unsure on what to use as a basis for tapering decisions. The benchmark it has used so far — the unemployment rate — is a less-than-perfect indicator, particularly since the fall in the unemployment rate does not mean that the overall labor market is healthy. Theoretically, it is possible for the unemployment rate to fall to its full employment level without any meaningful improvement in the job market. If all the unemployed workers give up and drop out of the labor force, the unemployment rate would decline but no one would mistake this for a healthy development.

It is obvious that the Fed needs to do a better job at spelling out its objectives and clarifying the means of attaining those objectives. First, it should make clear that its primary concern is to support growth. Second, it should lay out a clearer path on the pullback of its program; the reduction should be slow and gradual, and more importantly, it should emphasize that if the recovery wanes it is ready to reverse course and step-up its bond purchases. Third, it should use a broader set of indicators (not just the unemployment rate) as an approximate threshold for its policy shift. Fourth, it should also tie its decision to the rate of inflation. If some parts of the economy are improving but inflation is noticeably below the 2.0% target, it will again err on the side of policy easing. Fifth, it should explain that its policy depends on everything else, such as uncertainty about fiscal policy or potentially damaging shocks from abroad (Eurozone flare-up, China slowdown).

Our view is that the Fed would begin to scale back its bond purchasing program early in 2014, provided the fiscal standoff and debt-ceiling issues do not become too contentious. Where we differ substantially from the consensus is on the timing of an eventual tightening in interest rates; while most expect this to occur in either late 2014/early 2015, our view is that interest rates will remain low for a while longer and rate hikes won’t materialize until early 2016.
Lights Out: Fiscal Policy and the U.S. Recovery

For the first time in over 17 years, the federal government shut down on October 1, 2013, due to the failure of Congress to pass a continuing resolution (CR) to fund the government for the following fiscal year. It turns out that the shutdown can really only shut down approximately one third of the government — the rest, deemed “essential” workers, continue to work, albeit without pay.

A partial temporary government shutdown is more of a nuisance than a genuine threat to the recovery, as long as it is brief (one casualty is the government data that feed into our forecasts, so this report has been harder to put together than previous ones). Our estimates indicate that the shutdown is likely to chip away anywhere between 0.1%-0.3% from fourth quarter growth (in annual terms). However, the more serious threat is the debt-ceiling deadline: according to the U.S. Treasury, that ceiling will be breached on October 17. Predictions as to what would happen if the debt ceiling is not raised on time range from dire to catastrophic. Our own view is that while breaching the debt ceiling won’t bring total societal collapse given that the issue is not one of solvency but debt-payment-priorities, it will nevertheless have significant negative implications for the U.S. recovery and the global economy. Equity markets will likely slump, interest rates are expected rise, and sentiment will certainly take a nosedive.

Though it is still unclear how the impasse over the shutdown and debt ceiling will ultimately play out, our baseline scenario is that these issues will be resolved by the October 17 deadline either by a short-term extension that would set the stage for further negotiations, or a medium term solution, which would extend the debt-limit and fund the government for roughly one year. If there is a silver lining from the recent standoff in Washington, it may be that it has raised the possibility of a “grand bargain” — or at least some deal that would address the country’s fiscal sustainability in the long-run. There is also room to replace sequester cuts with a more sensible platform, which preserves the current amount of deficit reduction.

As we have argued for quite some time, the possibility of a “grand-bargain” should be wholeheartedly embraced by both parties. After all, the real threat to long-time growth does not come from discretionary spending, but rather from mandatory outlays (spending on Social Security, Medicare and Medicaid). According to the Congressional Budget Office (CBO), only a little more than one third of the total spending was discretionary in 2013 with 57% falling in the mandatory category. Projections are much worse ten years hence when discretionary spending is slated to make up only a quarter of federal spending, while mandatory outlays rise to around 61% (by then 15% of spending is projected to go to interest income) (Figure 10).

Our estimates indicate that the shutdown is likely to chip away anywhere from 0.1% to 0.3% from fourth quarter growth (in annual terms).

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**FIGURE 10**
Fiscal Spending: Mandatory, Discretionary and Interest Payments (percent of total spending)

- Mandatory
- Discretionary
- Interest Payments

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The good news is that short-term budget projections seem less ominous now than they did even a year ago. In 2013, the federal deficit is projected to come at around $750 billion (or 4.0% of GDP) — roughly half its levels in 2009. Forecasts for the next few years are even more encouraging: the deficit as percent of GDP is projected to fall to -2.3% by 2016, — roughly in line with its long-term historical average. This is largely due to the various negotiations of the past two years, which have reduced the ten-year budget deficit projections by a total of around $3 trillion. Roughly $585 billion were enacted through the various continuing resolutions passed into law in 2011. The Budget Control Act of 2011 (the debt-ceiling negotiations) cut the deficit by an additional $300 billion, with the fiscal-cliff deal providing an additional $750 billion. An additional $1.2 trillion in spending reduction will come from “sequestration,” with an additional estimated $250 billion from interest rate savings.

While these improvements are certainly welcome, the U.S. faces formidable budgetary challenges in the long term driven primarily by structural underlying forces, such as rising health care costs and an aging population. Deficits are projected to widen by mid-decade, rising to -3.5% of GDP by 2022 and -7.0% of GDP by 2042. High levels of debt, if persistent, will crowd out private investments, diminish investor confidence, lead to sharp increases in interest rates, destabilize financial markets and severely reduce long-run economic growth and standards of living.

As the World Turns: The Outlook for Global Economy

It has become painfully obvious recently that the chatter about the “great decoupling” between developed and developing economies was rather premature. Some went so far as to suggest that advanced economies were expected to occupy a more modest space in the new world order, overtaken by emerging economies. There were indications in the immediate aftermath of the financial crisis that this shift was indeed imminent. The recovery in the U.S. was exceptionally sluggish, Eurozone was engulfed in the sovereign debt crisis, and Japan seemed perpetually mired in a deflationary, low-growth spiral with no end in sight. In contrast, emerging markets rebounded sharply in the early stages of the global recovery, buoyed by a spectacular rise in global trade volumes and a hefty dose of fiscal stimulus.

But as 2012 rolled around, everything changed. Emerging market growth weakened dramatically due to domestic fiscal and monetary tightening and lower trade volumes as demand from advanced economies slumped. Brazil grew by less than 1.0% in 2012, China by a decade-low of 7.8%, and India by a mere 3.2%. In the meantime, the advanced world began to pace forward more confidently: the U.S. grew by a robust 2.8%, the Eurozone managed to hang together after the European Central Bank promised to do “whatever it takes” to save the euro, and Japan’s economy revived sharply after the 2012-year-end elections.

The world economy has come to rely more on advanced economies since the start of this year. Industrial production has remained relatively flat in 2013 for the emerging world, but it’s growing at 4% in the G7 economies. The Global Purchasing Managers Index (PME) rose to its highest reading in two-and-a-half years, spurred primarily by a strong upturn in the U.S. and more moderate gains in Europe, while the emerging market index remains trapped at the recession/expansion breakeven point (50).

More encouragingly, the outlook for advanced economies has improved compared to last year. Growth pick-up in the U.S. is certainly the main driver behind this, but economic activity in other advanced countries should also contribute. The U.K. economy posted a 0.7% growth in the second quarter of 2013, following a 0.3% growth in the first, and is set to expand at the fastest rate in over 15 years. After a harrowing five years and two full-blown crises, Eurozone doldrums have faded somewhat as the region appears to have finally escaped the grip of recession.
Having said that, the outlook for Eurozone is still extremely cautious. Contributions from the region will materialize mostly because it is expected to become “less of a drag” on global growth in the next few years rather than by expanding robustly. While growth is certainly better than no growth, the Eurozone economy will likely expand at an exceptionally modest pace, at least until end-2014. Fiscal austerity, while more moderate than in recent years, will likely chip away around 0.5% from GDP growth next year. More importantly, the core issues of the region have never really fully been addressed. A full resolution of the Eurozone crisis requires deep structural reforms that would liberalize labor markets, improve competitiveness and reform entitlement, especially in the core countries.

The Japanese economy has experienced a virtual renaissance during this year, boosted by fiscal and monetary support put in place by the new government. Policy easing and the splurge in spending have been massive: the Bank of Japan raised its inflation target from 1.0% to 2.0% and employed “unlimited,” open-ended asset purchases, while a 10.3 trillion yen fiscal stimulus package was put in place to boost the ailing economy. Results have been remarkable; annualized growth was an impressive 4.1% in the first quarter and 3.8% in the second. Inflation has also ticked up. With this newfound momentum, we expect the Japanese economy to continue to grow over the next two years, though at a more modest pace than in the first half of this year.

The outlook for emerging markets has also improved somewhat when compared to year-ago expectations, though we don’t expect a return to the stellar performance in the immediate aftermath of the recession. The growth in China will likely fluctuate somewhere between 7%-8% over the next two years as policymakers recalibrate the economy away from investment spending towards a more balanced and sustained growth path. Brazilian economy is expected to perform better this year compared to the previous two years, but significantly below the 5%-6% growth rate it posted in 2006-2008.

Overall, the global economy is expected to grow by 3.0% in 2013 and 3.7% in 2014, relying primarily on growth from the U.S., which has by far the most robust, self-sustained and organic recovery among advanced economies.
ORANGE COUNTY AND SOUTHERN CALIFORNIA

The healing process has continued in earnest over the past year for Orange County and the Southern California regional economies, repairing much of the damage done during the Great Recession of 2008-2010. In fact, 2012 proved to be a much better year for the region than most had anticipated, with employment gains totaling 34,400 for Orange County and 126,800 for the region as a whole. Unemployment rate for the county also dropped — from 8.1% in January to 6.8% in December 2012. Likewise, the unemployment rate for the broader region improved by 1.1%, declining from an average of 8.7% in 2011 to 7.6% the following year. Home prices have also firmed up appreciably, showing continued and accelerating appreciation throughout the course of last year and into 2013.

However, as highlighted in the discussion of the national economy, 2013 has faced an unusual array of issues such as political gridlock, geo-political turbulence, monetary policy uncertainty, and fiscal tightening, culminating in the current government shut down. While the prospects for the economy (both nationally and regionally) had brightened considerably, policy missteps over the past few months have clouded somewhat the overall outlook. Unless the current deadlock is resolved soon and there is a reasonable path charted at least for the near term, the ill-effects of political bungling could hamper the recovery both in our region and nationally.

Housing and Construction

Home prices in Orange County and the rest of the Southern California region rose at an exceptionally fast clip in the last 12 months (Figure 11). Though the average median single-family price remains at least 15% below its peak (reached in 2006), double-digit monthly gains have marked the improvement since August 2012. This bodes well for future consumer spending, given that home equity is the...

FIGURE 11
Orange County Median Single-Family House Price
(level and year-over-year percent change)
The current dramatic increase in home prices may not last. We expect it to show a cooling in the pace of acceleration of home price appreciation. However, the current dramatic increase in home prices may not last. Though local data for the most recent months are not available as of this writing, we expect it to show a cooling in the pace of acceleration of home price appreciation. In fact, the trend is already pointing in that direction; housing prices rose by 16% in June (on a year-over-year basis), down from the above-20% pace recorded in the first five months of the year. In addition, our quarterly survey of Orange County business executives (see page 33), was conducted at the end of September 2013, and indicates a marked change in the anticipated pace of acceleration of future home prices. A majority of those surveyed expect the median housing price to increase by no more than 5% over the next 12-to-15 months (Figure 12).

This is not a surprise given that the macroeconomic environment indicates continuing volatility in the last quarter of 2013 and well into 2014. The recent increase in mortgage rates due to the Fed’s “tapering” discussions has dampened the exuberant performance of the housing market in the early part of the year. The Fed is likely to be cautious in reversing its expansionary policies, even though such a change is inevitable. When it begins to slow down the rate of bond purchases (which, in our projections, will likely happen in early 2014), it will further fuel interest rate increases at the long end of the yield curve. However, the next few years will still be characterized by exceptionally low-interest rates by historical standards. We expect the Fed to start increasing rates no earlier than 2016, and even then the pace of rate hikes should be measured. This implies a tempering in housing price appreciation, but by no means a reversal of the positive upward trend seen over the last two years.

Construction activity in the Southern California region has also continued to improve markedly after a precipitous fall during the recession. Construction activity in the Southern California region has also continued to improve markedly after a precipitous fall during the recession. Housing starts have grown and permits have risen from a low of 2,200 in 2009 to 6,900 in 2012 in Orange County, and from 15,100 to 24,400 for the Southern California region. However, construction activity remains rather muted for the Inland Empire (Riverside and San Bernardino counties), growing from a cycle-low of 5,200 permits in 2011 to around 6,000 in 2012. The first half of 2013 has shown a much slower pace of increase in permits in all areas of the region and we expect that the permit activity for the year will not match the 2012 levels. Uncertainty over interest rates and the overall economy appears to have caused builders to become more cautious, especially for the balance of 2013 and early into next year.
Employment

Following the national script, Orange County’s labor market showed slow but steady progress over the past 12 months (Figure 13). Through August 2013, the county’s economy gained a total of 80,200 payroll jobs (6%) over the past four years. The pace of job formation over the most recent 12 months was identical to the same period last year, delivering a gain of approximately 32,000 jobs.

Nonetheless, job growth has been uneven across industry segments (Table 1). While most sectors seem to be building momentum — construction, for example, has added 6,900 jobs this year — a number of other sectors (Professional and Business Services, Retail Trade, and Trade, Transportation and Utilities) appear to have cooled down. Professional and Business Services, one of the largest employment sectors in the county, added only 3,100 jobs in the last 12 months compared to a gain of 11,400 over the previous 12 months. Retail Trade actually showed a loss of 1,500 jobs compared to a gain of 1,100 jobs in 2012, while Trade, Transportation and Utilities showed an increase of 900 compared to a gain of 1,800 over the same interval.

TABLE 1
Orange County Labor Market: Payroll Survey

<table>
<thead>
<tr>
<th></th>
<th>2009-2010</th>
<th>2010-2011</th>
<th>2011-2012</th>
<th>2012-2013</th>
<th>2010-2013</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Level</td>
<td>Percent</td>
<td>Level</td>
<td>Percent</td>
<td></td>
</tr>
<tr>
<td>Total Nonfarm</td>
<td>5,000</td>
<td>15,000</td>
<td>32,700</td>
<td>32,500</td>
<td>80,200</td>
</tr>
<tr>
<td>Construction</td>
<td>-2,900</td>
<td>2,100</td>
<td>2,000</td>
<td>6,900</td>
<td>11,000</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>-200</td>
<td>4,700</td>
<td>2,300</td>
<td>2,900</td>
<td>9,000</td>
</tr>
<tr>
<td>Durable Goods</td>
<td>600</td>
<td>4,600</td>
<td>2,400</td>
<td>3,200</td>
<td>10,200</td>
</tr>
<tr>
<td>Service Providing</td>
<td>8,200</td>
<td>8,200</td>
<td>28,400</td>
<td>22,700</td>
<td>59,300</td>
</tr>
<tr>
<td>Trade, Transportation &amp; Utilities</td>
<td>-600</td>
<td>1,400</td>
<td>1,800</td>
<td>900</td>
<td>4,100</td>
</tr>
<tr>
<td>Wholesale Trade</td>
<td>-300</td>
<td>-700</td>
<td>500</td>
<td>2,400</td>
<td>2,200</td>
</tr>
<tr>
<td>Retail Trade</td>
<td>500</td>
<td>1,400</td>
<td>1,100</td>
<td>-1,500</td>
<td>1,000</td>
</tr>
<tr>
<td>Transportation, Warehousing &amp; Utilities</td>
<td>-800</td>
<td>700</td>
<td>200</td>
<td>-</td>
<td>900</td>
</tr>
<tr>
<td>Information</td>
<td>-2,500</td>
<td>-700</td>
<td>400</td>
<td>100</td>
<td>-200</td>
</tr>
<tr>
<td>Financial Activities</td>
<td>-500</td>
<td>1,300</td>
<td>3,500</td>
<td>7,000</td>
<td>11,800</td>
</tr>
<tr>
<td>Professional &amp; Business Services</td>
<td>8,300</td>
<td>2,400</td>
<td>11,400</td>
<td>3,100</td>
<td>16,000</td>
</tr>
<tr>
<td>Educational &amp; Health Services</td>
<td>5,500</td>
<td>4,000</td>
<td>4,400</td>
<td>3,500</td>
<td>11,900</td>
</tr>
<tr>
<td>Leisure &amp; Hospitality</td>
<td>1,700</td>
<td>4,500</td>
<td>6,700</td>
<td>6,500</td>
<td>17,700</td>
</tr>
<tr>
<td>Government</td>
<td>-4,200</td>
<td>-6,000</td>
<td>-800</td>
<td>800</td>
<td>-6,000</td>
</tr>
</tbody>
</table>
Perhaps a more instructive way to assess the employment situation in the county is to trace the relative performance of its major sectors over the last few years (Figure 14). While the construction sector has turned a corner, its employment remains significantly below the level achieved four years ago at the height of the construction boom. Professional and Business Services employment, though improved compared to the height of the crisis, is still around 3.5% below its pre-recession peak. In fact, recent slower growth casts doubts on how much this sector will be able to contribute to the overall county growth in the near term. Employment in the high-tech sector has remained virtually flat over the past year, having risen marginally from its cycle lows. The only segment that has exceeded its pre-crisis level is Leisure and Hospitality, which is now almost 12% higher than its previous peak. It is interesting to note that the Food Services and Hospitality sector has continually expanded even during this sluggish recovery, a trend that partly reflects the growing evidence that the county is becoming an increasingly important destination for leisure and entertainment activities.

Civilian labor force and employment — another measure of employment obtained from a separate survey — has improved as well (Table 2). An increase in the labor force bodes well for the growth potential of the county; not only does it indicate population growth, but also a potential return of some discouraged workers (those who may have quit looking for work). The county’s labor force grew by 22,900 in the last 12 months compared to a gain of 11,500 in the previous 12 months. The impressive household employment gain of 48,200 in the last 12 months represents half of the total gains of the last four years. The unemployment rate has been steadily declining as well, from an average rate of 9.6% in 2009-10 to 7.8% rate in the last 12 months — a drop of almost 2.0% (currently the rate stands at a much lower 6.2%). As discussed in our national analysis, the precipitous drop in the household employment gain of 48,200 in the last 12 months represents half of the total gains of the last four years. The unemployment rate has been steadily declining as well, from an average rate of 9.6% in 2009-10 to 7.8% rate in the last 12 months — a drop of almost 2.0% (currently the rate stands at a much lower 6.2%). As discussed in our national analysis, the precipitous drop in the unemployment rate should be taken with some caution, since it tends to ignore individuals who have dropped out of the labor force thus overstating the health in the labor market.

**TABLE 2**

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Civilian Labor Force</td>
<td>12,100</td>
<td>900</td>
<td>11,500</td>
<td>22,900</td>
<td>35,300</td>
</tr>
<tr>
<td>Civilian Employment</td>
<td>9,800</td>
<td>11,200</td>
<td>30,000</td>
<td>48,200</td>
<td>89,400</td>
</tr>
<tr>
<td>Civilian Unemployment</td>
<td>2,400</td>
<td>-10,300</td>
<td>-18,600</td>
<td>-25,300</td>
<td>-54,200</td>
</tr>
<tr>
<td>Civilian Unemployment Rate</td>
<td>9.60%</td>
<td>9.70%</td>
<td>9.10%</td>
<td>7.80%</td>
<td>-1.80%</td>
</tr>
</tbody>
</table>
Both sources of data — payroll employment and the household survey — seem to paint a picture of slow and steady improvements of the county’s labor market. The rebound is undoubtedly slower than some of the past recoveries, such as the ones in the early 1990s and the dot-com recovery of 2001-02, but this is rather the consequence of the deep national recession caused by the financial collapse of 2008. Typically, recoveries following financial disasters are slower, some lasting as long as ten-to-twelve years.

Given the paucity of official short-term economic data at the county level, we continue to independently collect local and regional information. The Center for Economic Analysis and Forecasting at Cal State Fullerton has been conducting quarterly surveys of business executives’ expectations since 2001. The responses to the survey’s multiple questions are combined to create an overall index (OCBX) to provide an overall measure of the results. The index ranges from 0 to 1, with high values indicating an overall improvement in economic activity.

Historically, the index has been a highly reliable indicator in predicting near-term employment changes in the county (Figure 15). The latest survey of business executives carried out in late September (see page 33) shows some reversal from recent trends: after a significant two-quarter jump, the index retreated in the latest reading. This predicts payroll employment changes two quarters ahead, and we should expect some moderation in employment gains in the coming six months even though the absolute value of the index remains high.

![OCBX Index](image)

Our baseline scenario assumes that the national political gridlock will last for a short period. Current predictions are for a short term extension of the debt ceiling followed by negotiations on the Continuing Resolution and, hopefully, on other fiscal issues resulting from the sequester and those related to entitlement programs. But the uncertainty could last well into 2014. It is not possible to predict or estimate the exact amount of the damage in absence of a clear time frame, but given our estimates for the national economy, we expect slower growth in the Orange County and Southern California region during the rest of this year and in early 2014.
Our Orange County projections are for a gain of 28,200 payroll jobs (a 2.0% increase) in 2013 and an additional 35,900 jobs (a 2.5% increase) in 2014. The six-county Southern California region is expected to gain 106,000 jobs (an increase of 1.6%) in 2013 and an additional 142,000 (a 2.1% increase) in 2014 (Figure 16). Unemployment rates will also decline; the average annual rate for Orange County is expected to be 6.1% in 2013 and 5.6% in 2014, while for the Southern California region, the forecasted annual unemployment rate is 9.6% for 2013 and 9.2% for 2014. More details on the forecasts are provided in the tables following this report.

Robert Giuliano provided expert research assistance in preparation for these forecasts; any errors are the authors’ responsibility.