The outlook for the US economy has evolved broadly in line with our expectations: The recovery has continued to expand, though the pace of growth has been generally below what is expected at this stage of the business cycle. Our view is that the economy will expand more robustly gaining strength and pace over the forecast horizon. In fact, the next three years will likely be the strongest consecutive years this decade, as growth comes in closer to the historical trend rates, though still below the historical average post-recession rates.

There are four main reasons for this optimism. First, it appears that fiscal policy may no longer act as the growth-deterrent factor it has been given the year-end budget deal and the early-year increase in the debt ceiling -- both of which proceeded without the usual drama. Second, the private sector has rarely been in better shape: Profit margins are high, business debt levels are quite manageable, corporate coffers are flush with cash, and low US energy prices have dramatically improved the global competitiveness of US businesses. Third, the housing sector -- an emerging bright spot in 2013 -- will continue to contribute importantly to growth even though the pace of improvement may be a bit more restrained due to higher mortgage rates and a waning of investor interest. Fourth, global and policy risks have receded markedly since our last report: Issues related to the Eurozone debt crisis while not fully resolved no longer present an imminent threat to the global outlook, the Chinese economy appears to have averted a "hard-landing," and the much-awaited "tapering" from the Federal Reserve has finally begun with minimal adverse impact (so far) on growth or financial stability.

Economic Activity: Shaking Off the Winter Chills

Real GDP grew by 1.9% in 2013, almost a full percentage point below the 2.8% rate of 2012 and broadly in line with the 1.8% growth recorded in 2011. Going forward, we expect real GDP to expand faster over the next two years than it has in recent past but the pace of improvement will be a steady march rather than a gallop. The momentum from the second half of 2013 is not as strong as initially envisioned: Q4 GDP, for example, was revised down sharply from a high of 3.2% to a current 2.6%. In addition, much of the strength in numbers came from an inventory build-up which is expected to reverse course and restrain growth in the first half of 2014 -- real final sales grew only by 2.5% in the third quarter of 2013, even though real GDP growth came at a solid 4.1% (Figure 1).
Weather effects are also expected to take a heavy toll on economic activity in the first quarter of 2014. When coupled with the slower rate of inventory accumulation, real GDP growth in the first quarter appears to be hovering around 1.1-1.2%.

The outlook for growth is more bullish in the second half of the year: weather setbacks and the inventory cycle are simply temporary factors: By mid-2014 and beyond, the strength of the private sector, the waning impact of the fiscal withdrawal and robust housing construction should bolster growth. We expect real GDP to grow by 2.6% in 2014 and a more robust 3.1% in 2015.

**REASONS FOR OPTIMISM**

**The Private Sector is Doing Fine...**

**Business Outlook**

One of the main reasons for a more upbeat outlook over the next few years comes from the strength in the private sector: Real output growth from this sector grew by 2.5% in 2011 (relative to an overall 1.8% growth in real GDP), by 3.0% in 2012 (compared to an RGDP growth of 2.8%) and 2.3% in 2013 (relative to a 1.9% RGDP growth) (Figure 2). The business sector is in the best shape it has been in years: Profit margins are at record-highs, balance sheets are healthy, and corporations have accumulated roughly 2 trillion dollars in cash with an additional 1.95 trillion from multinational companies remaining outside the U.S.

Despite these continued improvements, companies have been reluctant to expand. Our outlook is that this reluctance will dissipate somewhat over the course of this year and in the following two years. Productivity growth has edged down substantially since the height of the crisis which means that if firms are planning to expand output they would need to hire more labor. Investment in Equipment and Software continues to remain below historical levels suggesting there is room for spending. The average age of capital stock is the oldest it has been for decades, which means that some replacement - especially in equipment-- is warranted to replace old and worn-out capital. In addition, US businesses have a significant competitive edge globally: The unconventional oil and gas revolution that has occurred in the US over the past few years, means that US businesses pay one third of energy-related costs paid by European businesses and one-fifth of costs paid in Japan and in the rest of Asia.

**Housing Rebound to Continue**

The housing market has made a spectacular comeback since mid-2012. Compared to their cycle-lows, home sales are currently up 33%, home prices by 23% (according to Case-Shiller Price Index), and the share of homeowners with negative equity has dropped from 25% to a current 13%. More encouragingly, construction has picked up dramatically: Real spending on residential investments is up 33% from its trough at the height of the crisis and housing starts have almost doubled from a historical low of 478,000 to a current 907,000.

We anticipate that housing market will continue to add significantly to economic growth. The early housing market rebound was largely due to investor demand: "All-cash" transactions (which usually represent investor demand) jumped to a high of 30% since 2009 which mortgage purchase applications for home purchase (which represent traditional home-buyers) are hovering at 15-year lows (Figure 3). Anecdotal
evidence suggests that investor demand has begun to wane now that home prices have firmed up and the bargain-deals are no longer available, which may have led to a softening in the housing data as of late.

Going forward, we expect housing starts to average around 1.1 million this year and 1.3 million in 2015. Home price appreciation will continue albeit at a lower clip than in 2013, posting 7%-9% gains this year and 5-7% in 2015.

**Smaller Drag from Fiscal Policy**

For the first time in years it appears that fiscal policy will not be the growth-restraining factor it has become as of late. The bipartisan budget deal of December provides some relief from the sequester, avoids further defense cuts, and restores some funding for non-defense discretionary programs. More importantly, the agreement covers fiscal years 2013-2014 and 2014-2015, thus providing some predictability about the path of fiscal policy, at least in the near term.

Fiscal austerity weighed significantly on growth in 2013 when the expiration of the payroll tax cut, an increase in the marginal tax rate of high-income households and the mandatory across-the-board sequester cuts collectively combined for a -1.3% drag on real GDP growth (Figure 4). The drag will be significantly less in 2014; federal fiscal policy is expected to chip away around -0.3% from real GDP growth, a large part of which is due to the expiration of emergency unemployment benefits for 1.3 million long-term unemployed (amounting to around 25 billion dollars).

**CHALLENGING SPOTS**

**Labor Market Pathologies**

Perhaps the most defining characteristic of this recovery has been the unmistakable gulf that separates the output and labor markets: Though sluggish, output growth seems vigorous when compared to the snail-paced recovery in employment (Figure 5).

Of course, quite a lot of progress has been made: The economy has recovered nearly all of the 8.7 million jobs lost during the recession, job growth has continued for three and a half years, and the unemployment rate has dropped from a cycle high of 10% to a current 6.7%.

A number of abnormalities appear to be plaguing the recovery in the labor market. Though the overall employment is just shy of its all-time high of December 2007, full-time employment is still a staggering 3.8 million below its pre-recession peak, suggesting that a large number of newly created jobs are part-time. Moreover, temp employment has risen by 62% since the end of the recession, surpassing by far the 5.7% total growth posted by the non-temp sector over the same period. Though temp work is usually one of the first sectors to pick up during the early stages of the recovery, 56 months into the recovery hardly qualifies as "early stage."

Going forward, we expect the labor market to continue to improve, albeit at a similar pace as it has over the past few years. Nonfarm payrolls should increase by an average of around 200,000 jobs per month over the next couple of years. The unemployment rate is expected to average 6.5% in 2014 and 6.1% in 2015.
The Household Sector

Consumer spending picked up steam in the second half of 2013 after an expected slowdown in the first half due to marginal tax rate hikes in the upper-income households and the expiration of the payroll tax cuts. Real spending on durable goods rose by a healthy 6.9% (on a year-over-year basis) buoyed primarily by spending in motor vehicles (due to pent-up demand during the lean post-recession years) and by expenditures on furnishing and household appliances spurred by continued improvements in the housing market (Figure 6).

We expect consumer spending to contribute to growth over the forecast horizon. There seems to be still quite a lot of pent-up demand for motor-vehicles, auto loans are growing and interest rates for new auto loans continue to remain at historical low levels. Consumer credit continues to expand at a healthy 5% pace. Household balance sheets are in the best shape compared to any point during the recovery. The household debt-to-GDP ratio is at historical low levels and household delinquencies have declined across the board.

RISKS

Monetary Policy

While dangers from fiscal policymaking appear to wane over the next couple of years, uncertainty about monetary policy has increased. As of this writing, the Fed is buying $55 billion securities per month -- down from the $85 billion pace of the past eighteen months ($30 billion in Treasuries and $25 billion in MBS). At its current course, the tapering is expected to end sometime in the fall by which time the Fed’s balance sheet would have swollen to $4.4 trillion dollars with the Fed owning around 40% of all MBS securities and about 25% of the US Treasuries.

Going forward, the biggest source of risk concerning monetary policy is the timing and pace of interest rate hikes. The forward guidance policy -- the message that the Fed has used since the end of the recession to anchor expectations about the future path of policy has become more opaque especially since the current unemployment rate is only a hair above the Fed’s stated 6.5% threshold. Faced with this new reality, the Fed qualified that interest rates would stay low even beyond the 6.5% level. Indeed, in the latest meeting, the Fed dropped the 6.5% threshold altogether announcing that it would use a tapestry of indicators − “a wide range of information” – to guide its decision-making.

Our view is that interest rates will continue to remain at the zero-bound for quite some time with the first rate hike occurring by end-2015/early 2016. This is a bit longer than the consensus view, but it is grounded in the outlook that a slowly recovering labor market will also be accompanied with below-target inflation rates. The Fed will be hard-pressed to justify rate hikes in the face of low inflation and a still-unhealthy labor market, at which point the liftoff may be pushed out beyond the current consensus horizon.

Financial Markets: Unsettling Times Ahead

Equity markets had another spectacular run in 2013, in fact, the best since the end of the recession when measured from year-end to year-end. In all, the market rose by nearly 30%, buoyed in large part by the accommodative stance of monetary policy and an improving outlook for the US economy.

These developments are encouraging but they also raise concerns about market froth. Indeed, the market does appear to be somewhat bubbly from a variety of metrics. The inflation-adjusted PE ratio (price-to-earnings) is around 26, far above its historical average (of around 16) and dangerously close to correction levels (the measure hit 30 on Black Tuesday in 1929 and an all-time high of 44 before the dot-com collapse of late 1999). Margin debt has set historical highs in both nominal and real terms suggesting highly leveraged positions on the part of the investors (Figure 7). The market capitalization as percentage of nominal GDP is at 125% -- below the record-highs set in the late 1990s, but well above its historical value. Junk bond yields are also nearing record lows and investors’ stock allocations are near
their highest levels since 2007. In addition, corporate income
gains in 2013 may also be a bit misleading due to massive
write-offs in 2012.

Orange County and Southern California

Orange County’s economic recovery is in line with the
national trend, albeit slightly more upbeat. While the U.S.
unemployment rate dropped from a high of 10 percent
in October 2009 to 6.8 percent in March 2014, Orange
County’s rate of unemployment fell from a high of 9.2 percent
in January 2011 to the current level of 5.8 percent in March
2014. Historically, the County’s unemployment rate has been
below that of the nation as a whole, but during the Great
Recession, it rose above the US rate and stayed higher for
several months. This is due in large part to the severe fall of
the housing sector in the county relative to the nation. As
the housing sector continues to recover, we expect further
improvements in unemployment rates. The broader Southern
California region has also improved dramatically: The annual
unemployment rate for the region in 2013 was 8.5
percent; a significant improvement from a high of 12.6
percent during 2010.

Employment
Orange County payroll employment rose by 36,000 during
2013 for a 2.5 percent increase, approximately the same
amount as in 2012. The two years’ solid growth comes after
a huge loss of 141,000 jobs during 2007-2010. This is an
impressive turnaround; in fact, over the three-year period
from 2010-13, Orange County has gained approximately
88,000 jobs of all the total job lost during the devastation of
the Great Recession.
It is useful to review the relative performance of different sectors during and after the recession since the downturn did not hit all the sectors the same way. Table 1 shows the relative size of the County’s main employment sectors based on the level of employment in 2013. Also shown are the employment dynamics during the recession (2007-2010 period) and the subsequent recovery (2010-2013).

### Table 1

<table>
<thead>
<tr>
<th>Sector</th>
<th>2013 Size</th>
<th>Share of Total</th>
<th>Wage &amp; Salary Emp.</th>
<th>2008-2010</th>
<th>2010-2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Nonfarm</td>
<td>1,454,242</td>
<td>-155,092</td>
<td>-10.66%</td>
<td>88,292</td>
<td>6.46%</td>
</tr>
<tr>
<td>Prof. and Bus. Serv.</td>
<td>264,450</td>
<td>-28,667</td>
<td>-10.84%</td>
<td>19,792</td>
<td>8.09%</td>
</tr>
<tr>
<td>Leisure and Hospitality</td>
<td>187,842</td>
<td>-4,275</td>
<td>-2.28%</td>
<td>19,208</td>
<td>11.39%</td>
</tr>
<tr>
<td>Edu. and Health Serv.</td>
<td>181,883</td>
<td>-4,317</td>
<td>-2.38%</td>
<td>14,525</td>
<td>8.05%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>157,875</td>
<td>-29,992</td>
<td>-19.00%</td>
<td>7,475</td>
<td>4.97%</td>
</tr>
<tr>
<td>Government</td>
<td>148,275</td>
<td>-7,067</td>
<td>-4.77%</td>
<td>-4,017</td>
<td>-2.64%</td>
</tr>
<tr>
<td>Retail Trade</td>
<td>145,725</td>
<td>-19,892</td>
<td>-13.65%</td>
<td>4,442</td>
<td>3.14%</td>
</tr>
<tr>
<td>Financial Activities</td>
<td>112,475</td>
<td>-24,183</td>
<td>-21.50%</td>
<td>9,008</td>
<td>8.71%</td>
</tr>
<tr>
<td>Wholesale Trade</td>
<td>79,208</td>
<td>-9,317</td>
<td>-11.76%</td>
<td>1,617</td>
<td>2.08%</td>
</tr>
<tr>
<td>Construction</td>
<td>77,333</td>
<td>-35,033</td>
<td>-45.30%</td>
<td>9,317</td>
<td>13.70%</td>
</tr>
</tbody>
</table>

Job losses were concentrated in a handful of sectors: the largest decline occurred in Construction (-35,000), Manufacturing (-29,992), Professional & Business Service (-29,667), Financial Services (-24,183), and Retail Sales (19,892). In relative terms, the loss in Construction was the largest with that sector’s employment shrinking by an unprecedented 45 percent. Interestingly enough, Education & Health Services was the only sector that continued to add jobs during this time.

The good news is that some of the most hard-hit sectors have also rebounded quite strongly over the past three years. The gains were led by Professional & Business Services (19,792) and Leisure & Hospitality (19,208) sectors, followed by Construction, Education & Health Services and Financial Activities.

For a more complete picture of labor market dynamics in the county, it helps to focus on the changes in employment levels by sector (Figure 8). With the exception of Health Care and Leisure & Hospitality, employment in all major sectors of Orange County (Construction, High-tech and Professional & Business Services) is still below the level it was in 2007.

The six-county Southern California region (Orange, Los Angeles, Riverside, San Bernardino, Ventura and Imperial) showed similar trends. The overall job loss during 2007-2010 for the region was 660,000 -- representing a sizable 9 percent decline. Construction, Manufacturing, Trade, Transportation and Utilities, Financial Services, and Professional & Business Services lost the most jobs. The region recovered 410,000 jobs for a 6.1 percent gain during 2010-2013, of which 198,000 were gained in 2013 alone. The start of 2014 is continuing the trend of moderate growth throughout Southern California. The annual average unemployment rate has fallen to 8.5 percent and household employment is showing meaningful growth. More encouragingly, it appears that an improving economy is inviting more people back into the labor force.
Orange County Business Expectations (OCBX)

The Center for Economic Analysis and Forecasting at Cal State Fullerton conducts a quarterly survey of business expectations for Orange County. Its overall index (OCBX) provides a comprehensive measure of such expectations. Its value varies from 0 to 100; a value of above 50 indicating expectations of continued economic expansion. Its latest reading for the second quarter of 2014 was 88.1. The index has been on a steady climb since the second half of 2013 though the latest reading showed a slight loss primarily due to seasonal factors. The OCBX index has proven to be a reliable indicator of near term employment changes, as shown in Figure 9. This means that we should see a continued but moderate improvement in employment for (at least) the next six months and beyond.

Delving into the details of the survey, a few things of interest jump out. While the state of the economy continues to be a significant concern for local Orange County businesses, the level and intensity of such concern has abated somewhat over time. Interestingly, government regulation and oversight has now become a cause of major concern. Also international competitive threats are now occupying more of businesses’ attention (Figure 10).

Employment Forecasts

As discussed in our US national picture, we expect continued moderate improvement in the US and global economy in the first half of 2014 that will pick up momentum in the second half of 2014 and through 2015. A similar trend is expected in the County as well. We expect payroll employment to increase by 38,000 (2.7 percent increase) during 2014 and 41,000 (2.8 percent increase) in 2015. These forecasts are slightly more upbeat than those we offered in October 2013 given the steady improvement in the US and global economic activity over the last six months. Orange County’s economy continues to benefit from an increase in real estate and construction activities, continued employment gains in the Health Care sector and expanding payrolls in the Leisure and Hospitality sector. The county’s other major sectors – high tech and business and professional services – are also beginning to rev up. These sectors are more tied to the national and global markets and their progress will likely follow more closely the trends in these markets. We expect the Orange County average annual unemployment rate to drop to just below 6 percent in 2014 and to 5.5 percent in 2015.

Housing

Housing employment and construction both have improved significantly though both have a long way to go before getting to the pre-recession levels. Construction employment in Orange County, as shown earlier, declined by 45 percent during the recession for a loss of over 35,000 jobs but it has gained back over 9,000 of those jobs. Housing starts throughout Southern California fell unexpectedly in 2013 but are showing a much better performance in early 2014 and are expected to continue to improve. Spending on residential and commercial developments continued to show healthy growth in 2013 and is expected to maintain that pace. As in the national housing markets, Orange County’s housing prices continue to go up. Strengthening economy and lower inventory levels have been pushing up prices of housing. The number of foreclosures has gone down substantially and there has been little addition to the stock of housing due to relatively slow improvement in construction. Annual increase on the basis of Corelogic data for Orange County housing price for an existing single-family home was 19.3 percent for 2013 to a level of $625,000. The increases were higher in Los Angeles, Riverside and San Bernardino counties, 25.1 percent, 25.7 percent and 23.2 percent respectively. We expect 7-9 percent increases in the region in 2014 and 5-7 percent in 2015 because of the reasons discussed above.

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