U.S. Economic Outlook and Forecasts

"We have deep depth" -- Yogi Berra famously remarked decades ago about the New York Yankees. Much like the Yankees of Yogi Berra’s years, the U.S. economy has been remarkably resilient over the past year in spite of enormous challenges, policy setbacks, and a number of ominous external shocks. As we expected, the more gloomy scenarios were averted, but the close-calls were too many and, at times, the brush with disasters too high for comfort.

Our outlook for the U.S. economy is moderately upbeat and perhaps the most optimistic we have offered since the end of the Great Recession. We expect the recovery to continue to gain strength and expand during the current year and beyond: a bit more tentatively in 2013 but rather buoyantly in 2014 and 2015. The private sector is expected to plow ahead with its "deep depth," offsetting losses from the public sector which will remain a drag on growth in the foreseeable future.

On the near-term risks, fiscal consolidation in the U.S. and the Eurozone crisis continue to remain the two top concerns threatening immediate growth prospects. On the fiscal front, the good news was that calamitous results were averted at least for the time being: the economy did not dive off the cliff (though the end-year deal was the most marginal one could imagine), the debt-ceiling has been "suspended" for a few months (most likely until mid-summer), the government shutdown was averted (until end-September), while sequestration took effect on March 1st.

The Eurozone crisis still presents the largest downside risk to the forecast and a flare-up in the region can easily derail the global economic recovery. Nonetheless, the fundamental issues that plague the Eurozone region continue to remain unaddressed and any adverse development seems to reignite a full-blown crisis. More importantly, the region continues to sink deeper into recession territory which will likely stretch over this entire year, only to be followed by extremely stagnant growth in 2014 and beyond.

We expect U.S. real GDP to continue to expand during this year, boosted primarily by steady consumption, robust motor vehicle sales, continued business investments and ramped-up construction spending (particularly in the residential sector). Growth is likely to be more restrained in the first half of the year (mostly because of reduced spending due to tax increases and higher gasoline prices) and pick up more robustly in the second half of the year and beyond (bolstered primarily by the housing sector). U.S. real GDP is expected to grow by 1.9% in 2013 -- weighted down mainly by the fiscal drag -- and by a more robust 2.6% in 2014.

Consumption Spending. Consumers have held steady during the three-year recovery, with real personal expenditures growing by 1.8% in 2010, 2.5% in 2011 and 1.9% in 2012. Though still below the long-term average (of around 3.2%), the resilience of consumption spending during this recovery period is quite noteworthy.
The start of this year saw a drop in consumer confidence: apparently the expiration of the payroll tax cut did come as a surprise to many consumers whose take-home pay took a hit as of January 1, 2013. Nonetheless, we expect consumption spending to continue to grow over the forecast period, albeit at a slower clip in the first half of the year. Overall, consumption should grow by around 1.9% this year and by an additional 2.3% in 2014.

**Business Sector.** One of the brightest spots which is expected to contribute substantially to future growth is the pick-up in real residential investments. This sector has risen by a total of 19.8% since its cycle-lows in early 2011. In addition to new home construction, outlays on home improvements, remodeling and expenditures on durable goods will also continue to rise further. We expect real residential investments to expand at a brisk pace over the next few years, rising by 17.2% in 2013, and 22.4% in 2014. This should add around 0.5% to U.S. real GDP growth in 2013 and an additional 0.6% in 2014.

Business investments in Equipment and Software (E & S) should grow by roughly 4.7% in the current year, below the 6.9% pace recorded in 2012. Manufacturing output is also expected to increase this year but at a slower pace than in 2012. Much of this cycle slowdown is due to the impact of fiscal tightening and the still-fragile business confidence.

**Labor Market.** The labor market has continued to heal over the past year with the economy adding a total of 2.2 million jobs in 2012. The good news is that the pace of job creation has steadily edged up during the recovery, averaging 85,000 in 2010, 175,000 in 2011 and 183,000 in 2012. The unemployment rate has come down from a cycle high of 10% to the current 7.7%, declining by a total of 0.4 percentage points in 2012.

Despite these positive developments, the recovery in the labor market has been extremely sluggish with plenty of slack in most sectors. When compared to their pre-recession peaks (December 2007), employment levels in the majority of sectors are underwhelming with only 5 (out of 15) sectors showing employment gains (Figure 3).

Our outlook is for continued improvement in the labor market, particularly in the second half of this year and beyond. We expect job growth to average around 175,000 jobs per month in 2013 and 200,000 jobs in 2014. The unemployment rate is expected to remain elevated during the forecast horizon reflecting the slow pace of job creation and an increase in labor force, averaging 7.5% in 2013 and 7.1% in 2014.

**Real Estate.** At the very core of renewed optimism about the strength of the recovery is the recent rebound in the housing market. In line with our expectations, housing turned a corner in early 2012, gaining momentum steadily over the course of last year and into 2013. Improvements are broad-based, though from extremely depressed levels: sales, prices, starts and permits all posted remarkable gains compared to the depressed levels of the past 6 years.

Perhaps the brightest spot in the housing recovery is the pick-up in construction which is expected to continue in earnest in 2013 and beyond, contributing substantially to U.S. GDP growth. In February 2012, housing starts rose at the second fastest pace in over four years, while permits for future construction rose at the fastest rate since 2008 (Figure 4).
Yields on short-maturity rates have remained flat over the course of the year reflecting a holding pattern in the projected trajectory of policy rates. Short rates are expected to move in tandem with policy rates, maintaining their current (low) levels in 2013 and 2014. However, long-term bond yields are expected to move upwards by around 30-40 basis points in the second half of this year as the recovery continues to expand.

The Federal Reserve The Fed has embarked on three separate episodes of bond-buying (quantitative easing), with the boldest one announced in September 2012: another round of quantitative easing with the length of the program tied to the outlook for the recovery in general and the labor market in particular. The link to economic activity was reinforced further in December 2012, when the Fed announced that it will not raise interest rates as long as unemployment remains above 6.5%, while inflation expectations are anchored at below 2.5%. Since last fall, the Fed has continued to purchase a total of $85 billion per month in long-term securities: $40 billion in agency mortgage-backed securities (MBSs) and $45 billion in long-term Treasuries. As a result, the Fed’s balance sheet has surpassed $3 trillion dollars (more than triple the pre-crisis levels). By the time QE3 will end, the Fed’s balance sheet is estimated to reach $4.2 trillion, or roughly 25% of US GDP.

Over the next 2-3 years, one of the biggest risks facing the U.S. economy is related to the timing, manner, and speed with which the Fed “exits” from its overly lax policy stance. It is likely that, as the recovery continues to gain traction, the Fed will provide more explicit guidelines about the end of QE3, much as it did with regards to its interest rate policy. We expect the Fed to keep rates on hold this year and the next, and begin to tighten in early-to-mid 2015. QE3 will likely be tapered-off rather than come to an abrupt halt, with the Fed continuing the bond-buying program into early 2014.

Fiscal Policy. Perhaps the only positive coming out of the final hours of 2012 was that the economy was not pushed over the cliff and some certainty was established (at least with respect to taxes). On the tax front, marginal-tax rates were extended for all but the top income individuals (those earning $400,000+ or married couples over $450,000). Perhaps the most important item (other than the permanent extension of marginal tax rates) is expiration of the 2% payroll-tax cut, which is estimated to raise the tax burden on households for 2013 by around $110 billion. In addition, the sequester took effect on March 1, 2013, consisting of $1.2 trillion in spending reduction over the nine-year period (2013-2022).
The various negotiations of the last two years have reduced the 10-year budget deficit projections by a total of around $2.4 trillion. Roughly $585 billion were enacted through the various continuing resolutions passed into law in 2011. The Budget Control Act of 2011 cut the deficit by an additional $860 billion, with the fiscal-cliff deal providing an additional $750 billion. An estimated $250 billion in interest-rate savings brings the total to around $2.4 trillion. If the sequester were to proceed as planned, then the total deficit reduction over a ten-year period would be around $3.6 trillion (when compared to the 2010 baseline). Rough estimates indicate that an additional $200-$300 billion is needed to put the budget deficit in a sustainable trajectory (roughly around 3% of the GDP).

![Fiscal Policy Impact on real GDP Growth in 2013](image)

We expect the fiscal contraction from the "fiscal-cliff" deal and the "sequester" to chip away around 1.2 percentage points from real GDP growth in 2013. Tax hikes from the cliff negotiations will likely reduce growth by around 0.7 percentage points while a full-implementation of the sequester will subtract another 0.5 percent. The reconstruction efforts to rebuild the Northeast in the wake of the devastation left by hurricane Sandy is expected to add around 0.1-0.2 percent to real GDP, which brings the total effect of the fiscal drag on GDP to around 1 percentage point (Figure 6).

### Global Economy

The outlook for the global economy has improved compared to a few months ago as worse-case scenarios are avoided and global risks recede. The slowdown in emerging economies witnessed through much of 2012 appeared to have come to an end by the fourth quarter of 2012. Concerns over the Eurozone crisis abated significantly after the European Central Bank (ECB) promised to backstop some of the eurozone’s weaker bond markets and policymakers took some steps towards banking and financial market integration.

The outlook for emerging market, though improved, is still below the levels seen in the immediate aftermath of the Great Recession when these economies grew rapidly as global trade rebounded sharply. The performance of advanced economies will continue to remain disappointing over the course of this year, but improve in 2014. Japan’s economy seems poised for a revival from a deep slumber, largely due to significant expansionary fiscal and monetary policy undertaken by the new government.

The main threat to the global outlook over the next six quarters comes from Europe. We expect the Eurozone recession to continue until the end of this year. Even the region’s recovery, when it occurs, will be shallow and exceptionally sluggish as these countries grapple with high levels of debt, a need for structural reform, and adverse demographics.

Going forward, the global economy should expand by a tepid pace of 3.5% in 2013, slightly above the 3.2% rate of 2012. The bulk of growth should continue to come from emerging economies with advanced economies edging forward at modest rates. The Eurozone sovereign debt crisis is expected to weigh heavily on the global outlook over the forecast horizon.

### National Forecasts

<table>
<thead>
<tr>
<th>Year</th>
<th>RGDP</th>
<th>Consumer Prices</th>
<th>Unemployment Rate</th>
<th>Payroll Employment</th>
<th>Federal Funds Rate</th>
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<tbody>
<tr>
<td>2010</td>
<td>2.4</td>
<td>1.6</td>
<td>9.6</td>
<td>-0.07</td>
<td>0.18</td>
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<tr>
<td>2011</td>
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<td>3.1</td>
<td>8.9</td>
<td>1.2</td>
<td>0.10</td>
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<tr>
<td>2012</td>
<td>2.2</td>
<td>2.1</td>
<td>8.1</td>
<td>1.7</td>
<td>0.14</td>
</tr>
<tr>
<td>2013</td>
<td>1.9</td>
<td>1.8</td>
<td>7.5</td>
<td>1.6</td>
<td>0.16</td>
</tr>
<tr>
<td>2014</td>
<td>2.6</td>
<td>2.3</td>
<td>7.2</td>
<td>1.9</td>
<td>0.16</td>
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</table>
Orange County’s economic recovery has proceeded in line with the national trend, though at a slightly more upbeat pace. While the national unemployment rate dropped from a high of 10 percent in October 2009 to 7.6 percent in March 2013, Orange County’s rate of unemployment fell from a high of 9.2% in January 2011 to the current level of 6.5% in February 2013. Historically, the County’s unemployment rate has been below that of the nation as a whole. However, during the Great Recession it rose above the US rate and remained at this above-national level for several months. One of the main reasons for this is the dramatic collapse of the housing sector in the County, which surpassed the overall slump in the nation. If that is correct, we should expect the County to show a sharper recovery and faster decline in unemployment rates now that the housing market has begun to recover rather strongly in Orange County as well as nationally.

Southern California’s average annual unemployment rate for 2012 was 10.6 percent; again an improvement from a high of 12.6 percent during 2010. Since our annual forecast in October 2012, Orange County’s recovery over the past six months appears to have been somewhat stronger which, besides a genuine uptick, may partly be the result of the annual benchmark labor market data revision in February. Data at the county level tend to display significantly more volatility than the national data.

**Employment**

Orange County payroll employment rose by 31,600 during 2012, which represents a 2.3 percent increase. This is an impressive improvement in light of the anemic 15,000 job gain posted in 2011 and dramatic jobs losses over the preceding three years which combined for a total of 161,000. It is interesting to review the relative performance of different sectors as the recession did not hit all the sectors the same way. This also helps shed light on where we may expect job gains to occur in the coming years.

The table below shows the relative size of major County employment sectors based on 2012 employment levels. Also shown is the loss of jobs during the three years of 2007-10 and then the recovery for the 2010-12 period. The largest losses occurred in Construction (-35,000), Manufacturing (-29,967), Professional and Business Service (-29,808), Financial Services (-24,183), and Retail Trade (-21,058). In relative terms, the loss in Construction was the largest, shrinking that sector by a third of its total size. Interestingly enough, Education and Health Services was the only sector that continued to add jobs during this time. The gains in the last two years have been relatively modest with Professional and Business Services adding the most jobs followed by Education and Health Services and Manufacturing.

Another way to analyze the sector performance is to examine the changes in total employment over the past few years. This is shown in Figure 1. With the exception of Health Care and Leisure and Hospitality, employment levels in all major sectors of Orange County (such as Construction, High-tech and Professional & Business Services), are below their pre-recession peaks in 2007.

![Figure 1](image-url)

The six-county Southern California region (Orange, Los Angeles, Riverside, San Bernardino, Ventura and Imperial) showed similar trends. The overall job loss during 2007-10 for the region was 684,000 or a 9.4 percent decline. Construction, Manufacturing, Trade, Transportation and Utilities, Financial Services, and Professional and Business Services were the sectors losing most jobs. During 2010-12, a slow recovery added only 173,000 jobs for a gain of 2.6 percent. The start of 2013 is continuing the trend of moderate job growth throughout California. The state unemployment rate has fallen to 9.6 percent and household employment is showing meaningful growth. The unemployment rate would have fallen more were it not for an increase in labor force as an improving economy is inviting more people to back into the labor force. Orange County Business Expectations.
The Institute for Economic and Environmental Studies at Cal State Fullerton, conducts a quarterly survey of business expectations for Orange County. It complies its finding in a sentiment index (OCBX) which provides a comprehensive measure of business expectations over the next few months. Its value varies from 0 to 100 with a value of above 50 indicating expectations of continued economic expansion. Its latest reading for the second quarter of 2013 was 91.6. This is the highest value for the index in the last several years, indicating a significant turnaround in business expectations for Orange County (Figure 2). The OCBX index has proven to be a good indicator of near term employment changes, as shown in the figure below. We expect to see a continued improvement in employment over the next six to twelve months.

In the supplementary questions we asked respondents, most now believe that California economy will recover faster than national economy, a reversal after several quarters of expectations of a slower economic growth for the state economy. In another sign of the change in business perceptions, it now appears that the state of the economy has become a relatively smaller cause for concern while anxieties over taxes and government regulations have heightened.

**Employment Forecasts**

While Orange County’s economy is receiving a much-needed boost from the robust pick-up in real estate and construction activities and continued expansion in the Leisure and Hospitality sector, its other major sectors – high tech and business and professional services – are continuing their slow improvement. These sectors are more tied to the national and global markets and their progress will follow the broader trends rather than local developments.

As is clear from our US and international outlook, we expect continued improvement in the US and global economic performance but it will be moderate for the rest of this year. As such, we anticipate a similar improvement in the County's overall economy. Payroll employment is projected to increase by 36,000 (or 2.5 percent) during 2013 and 37,000 (or 2.6 percent) in 2014. These forecasts are slightly more upbeat than those we provided in October 2012, given the steady improvement in the US and global economic activity over the last six months.

The challenges of sustaining these trends will test the Federal Reserve Bank’s dexterity in managing the recent monetary expansion as well as Europe’s ability to hang together. We also expect the Orange County's average annual unemployment rate to drop to under 7 percent for 2013 and to 6.3 percent for 2014.

Improvement in the housing sector has perhaps been the most impressive story over the last few months. A strengthening economy and lower inventory levels have pushed up home prices both nationally and in Orange County. The number of foreclosures has declined substantially. Though the initial impetus for the decline in foreclosures came from bank irregularities that put a (temporary) halt to the foreclosure procedures, the improving financial position of households have recently resulted in a genuine improvement with fewer homes going into delinquency. There has been little addition to the stock of housing due to lack of any significant amount of construction. In Orange County the inventory is just under five months, a level not seen since 2006. The scarcity is even more pronounced in the lower-end, especially for homes under $500,000 level. It now takes an average of 55 days to sell a house, the same time as in 2006, before the Great Recession. The number of foreclosures fell from about 4,100 at the end of 2008 to 1,000 at the end of 2012.

Housing prices in Orange County have stabilized and begun an upward trend since the middle of 2012. From its lowest point in 2008 until the end of 2012, the median housing price in the County has increased by an impressive 30%. The trend is continuing and we expect the median price to show an average annual increase of 7 to 10 percent for 2013. On a monthly basis, the median price in December 2012 was up by about 20 percent compared to December 2011. But we expect this rise to moderate during this year, perhaps reaching lower teens.