COLLEGE OF BUSINESS AND ECONOMICS
CALIFORNIA STATE UNIVERSITY, FULLERTON

2007 spring update
MIDYEAR ECONOMIC FORECAST

By Anil Puri & Mira Farka

The National Economy

The economic landscape has developed broadly in line with our expectations since our last forecast in October 2006. The anticipated economic slowdown continued during the second half of last year and has spilled over to the current year. The risk factors are generally the same ones we emphasized in our October forecasts: a sluggish housing market, tight labor conditions, rising inflation, and lower productivity. A few other potentially disturbing developments have recently surfaced: the subprime mortgage meltdown and increasing uncertainty in the equity market. There are, however, a few encouraging indicators: job growth continues at a moderate pace, unemployment remains low, and consumer spending and personal income remain strong. In addition, a pause in the rate-hiking cycle of the Fed, relatively low long-term interest rates, and robust growth abroad has helped moderate the extent of the slowdown of the U.S. economy.

Economic growth as measured by gross domestic product (GDP) increased by a modest 2.5 percent in the fourth quarter of 2006, ending the year at our forecasted rate of 3.3 percent. The robust annual number was largely due to the 5.6 percent increase in economic activity recorded in the first quarter of 2006. The last three quarters of the year averaged a much lower 2.3 percent (Figure 1). Given current cyclical factors, we expect the growth rate of GDP to weaken further to 2 percent in the first quarter of 2007.

The major factor currently softening the blows on the U.S. economy is consumer spending. Despite a sluggish housing market, the resiliency of the American consumer remains high. The growth rate in personal consumption expenditures for 2006 was 3.3 percent, a nudge below the 3.5 percent spending recorded in 2005. Consumption expenditures continue to remain strong in 2007, with a year-over-year increase of 5.5 and 5.6 percent in the months of January and February. In addition, income growth is robust for the current year. So far, it seems that the slowing of the housing market has had little effect on consumer expenditure (Figure 2). Part of the reason for this phenomenon is based on the fact that consumers adjust their lifestyles to changes in wealth at gradual rather than instantaneous rates.

The near-term prospects for the housing market remain uncertain. Existing home sales declined 8.5 percent during 2006 compared to the previous year. Housing starts

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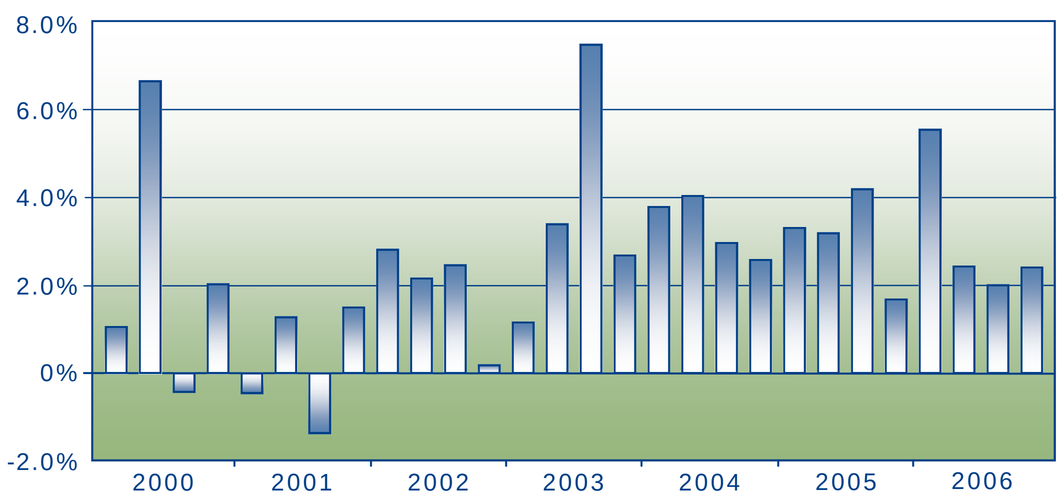
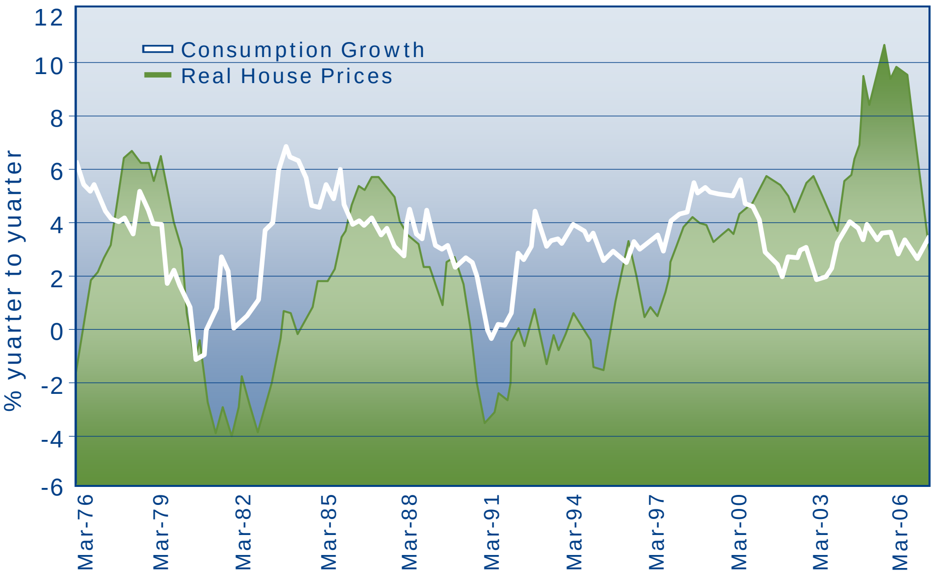
U.S. Real GDP Growth

Figure 1



U.S. Consumption and Real House Prices

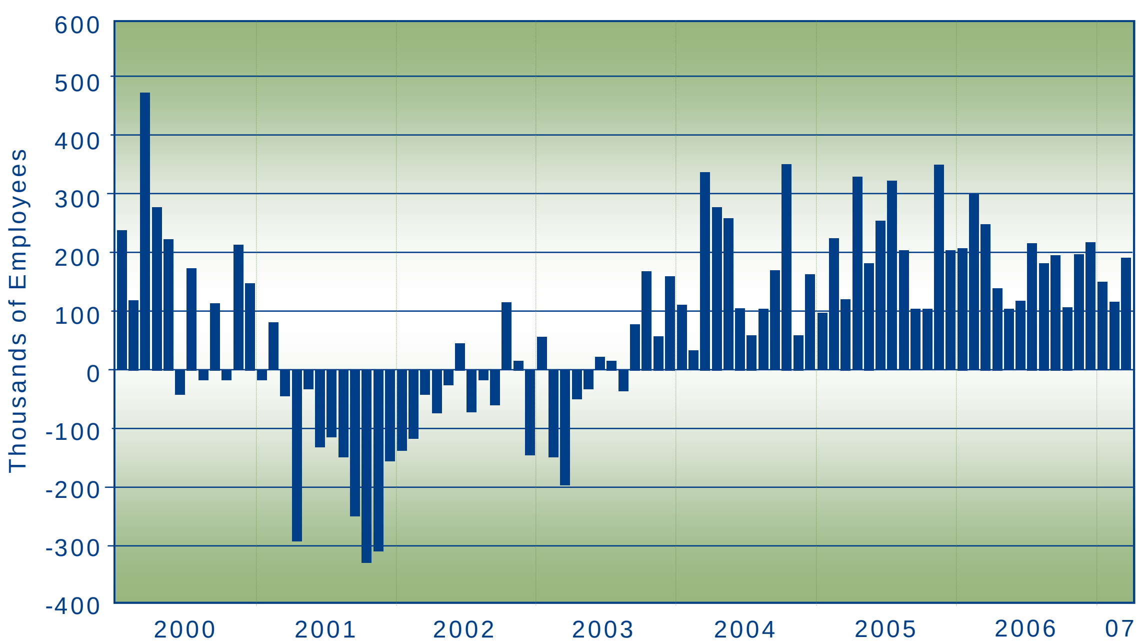
Figure 2



declined 12 percent during 2006. The median house price has declined from previous peaks and inventory of unsold homes continues to set record-high levels. The direct effect of the current slowdown in the housing market is expected to have three main effects: 1) continued contraction in construction activity, 2) collateral damage in related industries such as furniture, home appliances, real estate brokers and mortgage finance, and 3) potential adverse effects on consumer spending. We believe that the housing market correction has still quite a ways to go this year, with sales likely to decline an additional 8-10 percent, housing starts by around 18 percent and house price corrections of 4-5 percent.

Nonfarm Payroll

Figure 3



Much of the recent debate regarding housing foreclosures is focused around the issue of subprime borrowing. But the latest foreclosure data supports our view that subprimes are not the major driving force behind this phenomenon. Job losses, divorce and major medical expenses continue to remain the main source of foreclosures. In addition, foreclosure rates have gone up not in those areas experiencing the largest corrections, but in those places where regional economies are stagnating and job losses abound. Our main concern regarding the subprime market is a potential tightening in lending standards and increased borrowing regulation which are likely to change the housing outlook for many years to come.

Labor markets have remained remarkably robust during 2006 adding an average of 184,000 jobs per month. At 4.5 percent, unemployment remains at record low levels. The latest employment report showed an additional increase of 180,000 jobs indicating that the economy has retained the capability of job creation, albeit at a more moderate pace than during the previous years (Figure 3).

Despite this positive news, risks to the downside in the labor market remain high as labor conditions are unusually tight. Productivity has declined from a 3.3 percent annual rate in the first half of 2006, to 1.8 percent in the second half. At the same time, wage and labor compensation have increased at a brisk pace and the economy is operating at full capacity—two factors that have contributed importantly in placing additional strains on labor markets.

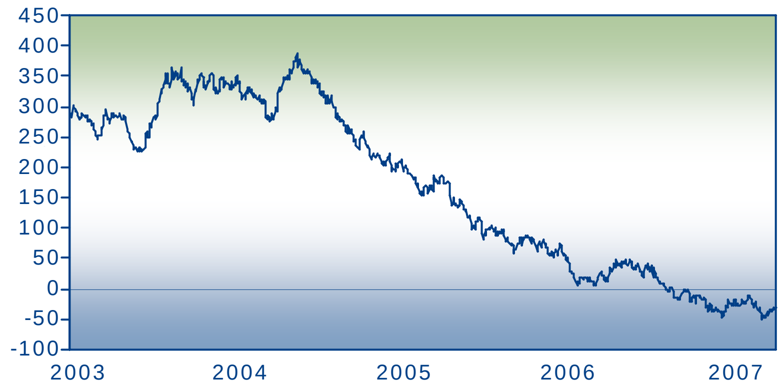
Inflation continues to remain a major risk factor for the U.S. economy in 2007. During 2006, headline inflation rose by an average of 3.2 percent. Inflation has declined to 2.2 percent for the current year. The recent decline in headline inflation is primarily due to a deceleration of energy prices. The more worrisome statistic, core inflation, continues to remain elevated, partly due to wage and unit labor cost increases and pass-through of previous energy prices. The year-over-year core inflation for February of this year records a high of 2.7 percent, up from 2.1 percent a year earlier.

As we anticipated in our October report, after a plunge during late summer–early winter, oil prices have currently risen to around $65 per barrel. The increase is largely driven by supply cutbacks from OPEC, increased geopolitical tension in the Gulf Region, and a continued high demand for crude oil. We think that a modest cyclical reversal and leveling at around $65 is highly likely during the summer months.

Faced with this mixed bag of data, the Fed is cautiously waiting on the sideline for new economic developments to unfold. On the one side, the housing market slump, tight labor markets, troubles in the subprime sector and their impact on a potential credit crunch may tilt the policy bias towards a more accommodative stance. On the other hand, an uncomfortably high core inflation, rising wage and labor costs and higher oil prices, call for future tightening. Financial market analysts are split on future moves of monetary policy: the Fed funds futures market is pricing some probability of a rate decline as early as August and longer futures have fully priced a 25 basis points decline in rates by October. We disagree with this market view and believe that, barring any unforeseen unraveling in the credit markets due to a precipitous decline in housing (which we deem highly unlikely), the Fed will stay on pause for the remainder of the year.

The spread between long- and short-term bonds has declined during the current year, although the yield curve is still inverted (Figure 4). After reaching a low of 4.42 percent in early December, the 10-year note has risen to 4.62 percent. During this time, the 3-month T-bill declined from a slightly above 5 percent level to the current 4.9

U.S. Treasury Yield Curve Spread — Figure 4



percent, most likely reflecting a lower probability of future Fed tightening. Net foreign holdings of U.S. Treasuries have continued to decline, contributing to the current rise in long-yields. We expect the 3-year note to hover at the current levels during the first half of '07, ending the year a bit above the 5 percent level. Given the continued decline in appetite for U.S. Treasuries of foreign central banks (notably Japan and China) and an increase in inflation expectations, we anticipate long-yields to rise modestly above their current levels, reaching 5.1 percent by year-end.

The global economic environment seems to be holding up pretty well, despite a U.S. slowdown. Growth rates in Europe have remained robust despite repeated tightening by the ECB, and Japan has shown significant signs of recovery from the decade-long economic slump. China and India continue to grow at high rates, despite attempts from their governments to slow down their economies.

Strong growth rates abroad confirm the idea that a partial de-coupling of the U.S. economy from the world economy is in the works. A partial de-coupling portends good news for the U.S. economy as it may take away some of the bite from the current downturn. Exports have rebounded and imports declined due to a combination of stronger growth abroad and a weakening of the dollar. A rebound in net exports may give U.S. gross domestic product that extra boost that is much needed to overcome the current soft-patch.

We anticipate an overall U.S. GDP growth rate of 2.4 percent in 2007 and 2.8 percent in 2008. We anticipate that weakness in economic activity will be concentrated on the first half of '07, with the second half picking up growth.

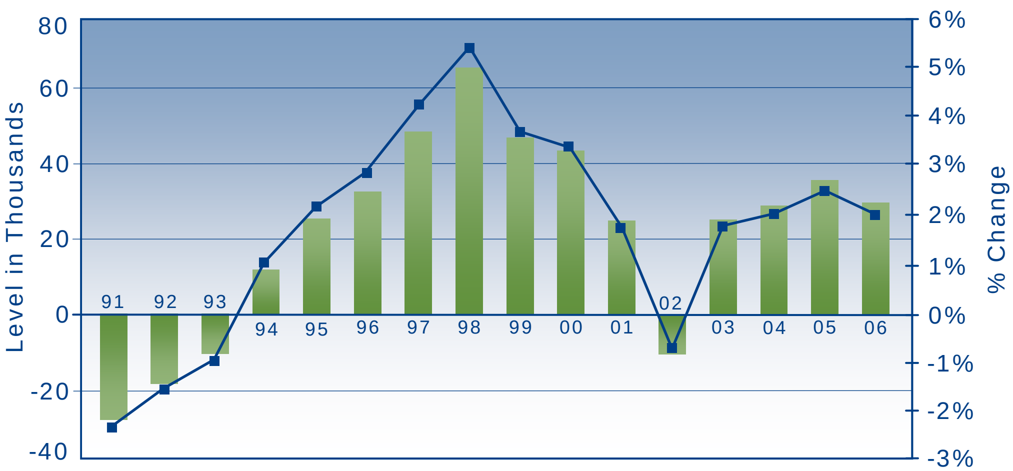
Our projections for the first quarter GDP are 2.3 percent and second quarter 2.5 percent. We also expect core inflation to moderate modestly from its current levels averaging 2.6 percent in 2007 and 2.4 percent in 2008.

Orange County

The Orange County economy, following the pattern of the national economy, showed some slowdown in the second half of 2006 that has continued into early 2007. Total payroll employment grew by 2 percent or 29,100 jobs in 2006 compared to a growth rate of 2.4 percent or 34,200 jobs in 2005. The average payroll growth has been slowing. From an annual average rate of 1.8 percent in the second half of 2006 it slowed in the first two months of 2007 to a rate of 1.2 percent (Figure 5). The unemployment rate, however, stayed at 3.4 percent in 2006, same as in 2005, even though it has gone up slightly in the first two months of 2007 to an average of 3.5 percent. Unemployment rate and labor force series are less reliable at local levels compared to the payroll information, but both data indicate a slowdown in economic activity, as predicted in our October 2006 forecast.

O.C. Payroll Employment

Figure 5



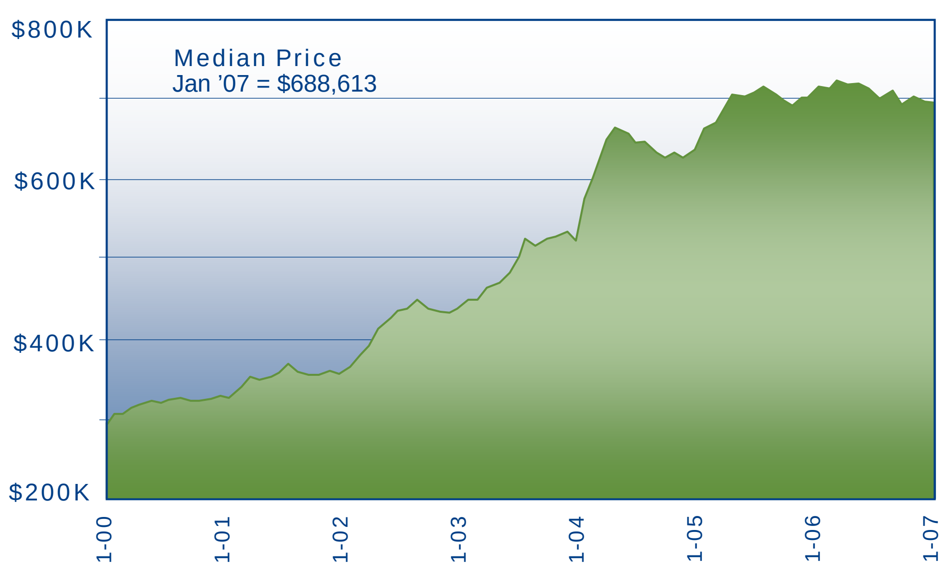
The slowdown in payroll jobs growth is related primarily to the housing and auto-related segments. Construction employment growth slowed to a 4.7 percent annual rate in the second half of 2006 compared to a rate of 9.9 percent for the same period the previous year. In the first two months of this year it is growing only at 2.1 percent. The Building Materials and Motor Vehicles and Parts Dealers sub-sectors are showing equivalent declines.

The turmoil in the subprime sector has hit Orange County particularly hard since it is home to a number of mortgage lenders including the top two in the country, Ameriquest and New Century. Ameriquest started downsizing in 2006. New Century, that popularized subprime mortgages, has now become the prime target for troubles in that market. It was forced to stop making such loans and, in fact, sought bankruptcy protection in March 2007. As the overall economy softens, the borrowers at the bottom of the scale who took out mortgages with little or no down payment and had poor borrowing have defaulted in the very early months of their loans. Lenders such as New Century that rely on Wall Street for their funding to a large degree have seen their sources of new money evaporate over night (Figure 6).

This meltdown and its impact continue to reverberate not only on the mortgage sector but

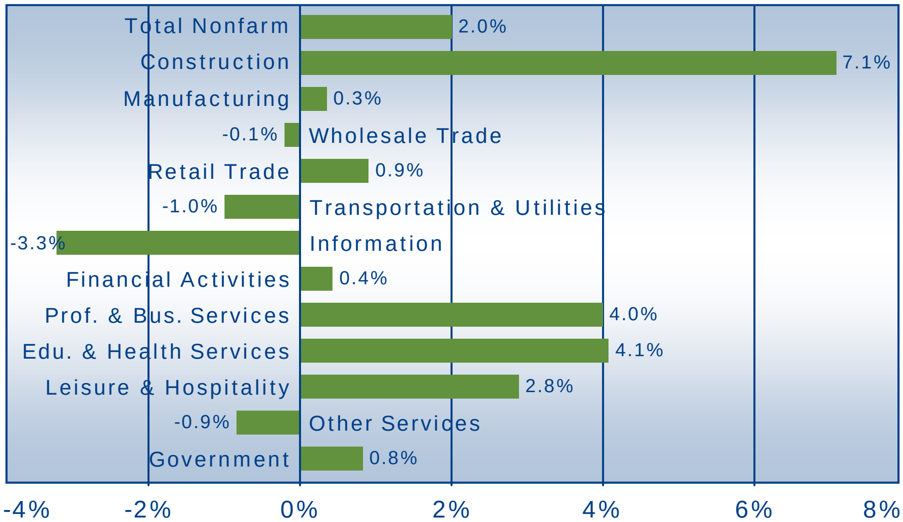
Median Price of Existing O.C. Homes

Figure 6



Orange County Payroll Employment Growth by Sector, 2006

Figure 7



the overall economy as well. While so far the official data show only a small decline of 3,500 jobs in the financial intermediation industry, we expect these losses to grow for the remainder of the year (Figure 7).

On the positive side, Professional and Business Services, the largest employment sector in the County, continues its expansion. Buoyed by increases in Professional and Technical Services growth it more than offset the losses in the Management of Companies sub-sector. Education and Health Care related jobs have shown the greatest gains in the second half of 2006 and are continuing.

The quarterly survey of Orange County business executives, OCBX, conducted by the Institute for Economic and Environmental Studies, indicates continuing slowdown over the next quarter (please see the College website www.business.fullerton.edu quarterly for the results). Its overall index of expectations for the second quarter of 2007 stood at 70.6 compared to 83.1 in the first quarter and 69.6 in the fourth quarter of 2006. A value above 50 indicates continued growth (Figure 8).

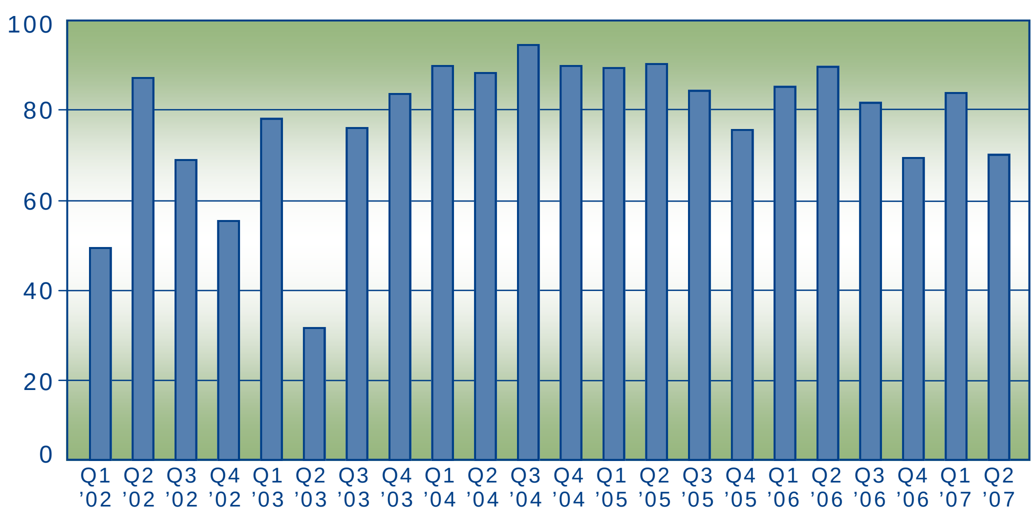
It appears that after a slight lift, the business executives in Orange County have again lowered their expectations of the overall economic activity. Other components of the survey show that OC executives expect their sales and profits to decline. They are cautious about hiring but currently do not see escalation of wage costs. The general state of the economy continues to be their main worry. They also expect the local economy to do better than the national economy. In a special question, when asked about the impact of the meltdown of the subprime loans market on the County economy, the opinion was roughly evenly divided among the three options of severe, moderate, and low negative impact.

Interestingly enough, though most builders have pulled back, many continue to plan for future construction. Housing permits for Orange County increased by 15 percent in 2006 though the starts in the second half of the year were essentially the same as in the previous year for the same period. There is some evidence that the number of starts in early 2007 is much slower. Riverside-San Bernardino and Ventura counties, in particular, show declines in the permitting activity that began in 2006.

O.C. Business Expectations Index (OCBX)

Institute for Economic and Environmental Studies

Figure 8



We expect the six-county (Orange, Los Angeles, Riverside, San Bernardino, Ventura, and Imperial) regional economy of Southern California to continue to grow in 2007 and 2008 but at slower rates. Our forecast for the Southern California payroll employment growth is 1.8 percent for 2007 and 1.9 percent for 2008. For Orange County, we expect growth rates to be 1.7 and 2.0 percent for the two years. These forecasts are consistent with our overall outlook for the U.S. economy.

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