

2008

spring update

MIDYEAR ECONOMIC FORECAST

By Anil Puri & Mira Farka

The National Economy

Economic conditions have deteriorated markedly since our October 2007 forecast. Real economic activity, consumer spending, investment, and consumer confidence have slowed down at an extraordinary pace. The troubles in the housing market seem to be far from over with foreclosures at record highs, a good portion of subprime loans becoming delinquent, and the spillovers from the mortgage market to the broader financial sector continuing at earnest. Additional strains are plaguing the already fragile economic and financial system: a rapid increase in oil, energy and food prices, and a continued weakness in the labor market.

Despite the slew of adverse economic data, the textbook definition of a recession—two consecutive quarters of negative growth—has not yet occurred. There is much debate, with some believing that there is no recession and others contending that we are undergoing the worst recession since World War II, perhaps comparable to the Great Depression. We do not subscribe to either scenario. Our view is that the U.S. economy is undergoing a severe economic downturn and will remain in a “recessionary mode” during the current year, rebounding in early- to mid-2009.

Economic growth as measured by gross domestic product (GDP) increased by an anemic 0.6 percent in the fourth quarter of 2007, ending the year at 2.2 percent, slightly above our 2.0 forecast (Figure 1). We expect

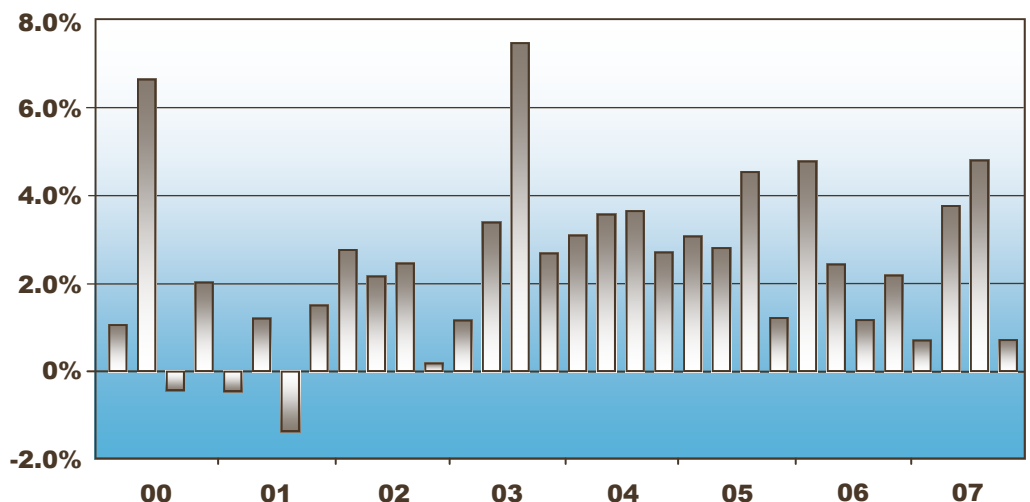
the growth rate of GDP to show continued weakness during the first half of 2008, posting a 0.4 percent increase in the first quarter and shrinking by -0.3 percent in the second quarter.

Consumer expenditure remained relatively robust in 2007, growing at an annual pace of 2.9 percent, a nudge below the 3.1 percent rate recorded in 2006. Consumer spending was the main supporting force of U.S. economic growth in 2007, cushioning the blows of the housing market downturn and the credit market meltdown. Nevertheless, the resiliency of the American consumer is being tested as falling home prices, declining home-equity withdrawal, rising debt, the credit crunch in the mortgage market, high oil and food prices, and a deteriorating labor market take their toll on consumption spending. The pace of consumer expenditure slowed to 1.9 and 1.6 percents during the months of January and February 2008 (Figure 2). We expect consumer spending to remain below trend during the first half of the current year.

There are mitigating factors, however, which should offset some of the burdens on consumers. First, the \$152 billion fiscal stimulus in the form of tax rebates is slated to reach households in May. The fiscal stimulus amounts to about 1 percent of the GDP. If consumers spend at the usual rate of \$.70 cents per \$1, the fiscal package will provide a boost of

U.S. Real GDP Growth

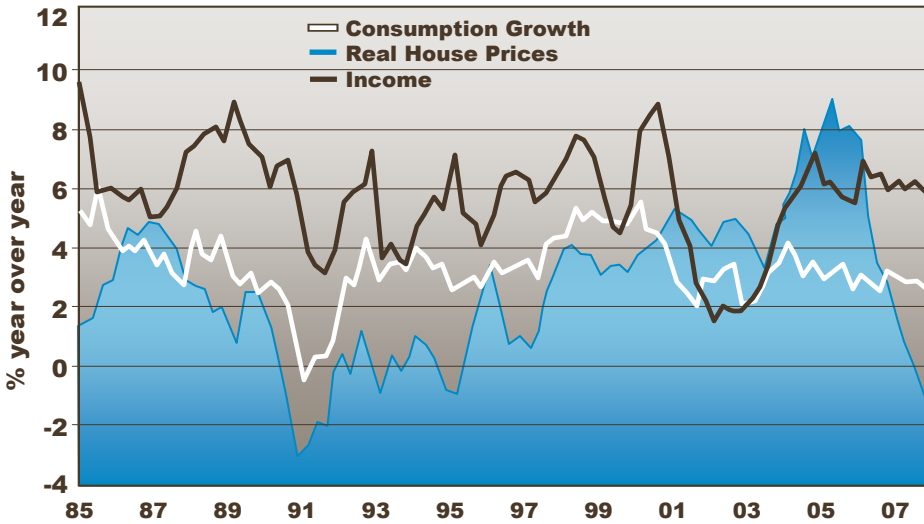
Figure 1



Anil Puri is co-director of the Institute for Economic and Environmental Studies (IEES) and dean of the Mihaylo College of Business and Economics. Mira Farka is Research Associate at IEES and assistant professor of economics. We thank Robert Giuliano for his expert research assistance.

U.S. Consumption and Real House Prices

Figure 2



the national home prices by 6 to 8 percent.

The issues in the housing sector have broad implications for the economy. They directly impact consumer spending, decrease confidence and have significant effects on the broader credit and financial markets given the exotic financial instruments developed in recent years to finance mortgage loans. The numbers are indeed staggering: the overall value of housing stock is \$21 trillion, the value of subprime loans is estimated at \$1.3 trillion, of which 21 percent are currently delinquent, around 2 million interest rate resets are expected to occur before mid-2009, and financial losses from the subprime

around 0.7 percent to GDP. Second, the Federal Reserve's (Fed) efforts to head off financial instability seem to have had a positive effect, as monetary easing has narrowed investment-grade credit and mortgage spreads and improved the ability of some borrowers to access capital markets. Third, mortgage resets may turn out to be less painful than previously anticipated largely due to aggressive rate cuts undertaken by the Fed. The average current rate on all outstanding subprime ARMs is 8 percent and is expected to decline further with future rate cuts, a much lower number than the 11 percent ARM reset rate that prevailed over much of last year.

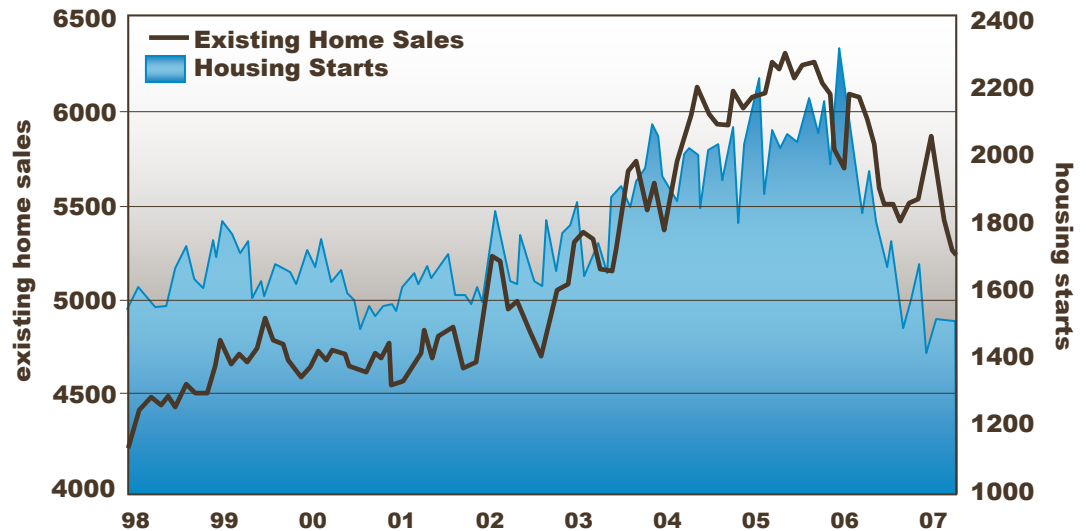
mortgage meltdown are expected to reach \$350 to \$400 billion over the next two years.

The financial and economic consequences of these losses are clear: a rise in financial losses erodes lender capital and promotes further deleveraging of the banks' balance sheets as capital ratios decline. Falling house prices further intensify the deterioration in mortgage credit quality, prompting lenders to tighten borrowing practices which in turn limit housing demand. The imbalance between housing supply and demand will widen, thus further contributing to the downward spiral in the housing cycle. To be sure, there is an end to the cycle with construction reaching a bottom and prices declining and restoring housing affordability to levels consistent with housing recovery. In our opinion, this scenario will come to fruition in mid-2009, as the current downturn in the housing market works its way through the economy and the financial sector.

Yet conditions in the housing market have continued to deteriorate with the bottom still not in sight. Housing starts declined 25 percent during 2007 compared to a year ago, and the February numbers show a further decrease of 28 percent. Existing home sales fell 23.8 percent in February and home prices declined by 8.2 percent (Figure 3). Although rebounding from their December lows, the main indices compiled by the National Association of Homebuilders (NAHB)—homebuilder confidence, single family sales and buyer floor traffic—continue to hover near record lows. In addition, new buyers have scaled back demand for homes waiting for the bottom in the current housing market correction. We believe that the housing market correction will continue during this year and in early 2009, with sales likely to decline an additional 10 percent, housing starts by around 15 percent and

Existing Home Sales and Housing Starts

Figure 3



Inflation continues to remain one of the major risk factors for the U.S. economy in 2008. Higher oil, food and commodity prices coupled with aggressive rate cuts by the Fed, have contributed to an increase in inflation rate. Headline inflation has averaged 4.3 percent during the first two months of this year, much higher than the 2.9 percent rate recorded during 2007.

Excessively high oil and commodity prices have increased inflationary pressures. Oil has recently hovered above \$115 per barrel. The escalation in oil prices can be attributed to several factors: continued high demand from emerging Asia (notably China and India), supply interruptions, geopolitical risks, OPEC's refusal to increase production and the weak dollar. The depreciation of the dollar accounts for approximately 30 percent of the increase in the price of crude oil. Gasoline prices have set record-highs, draining on average about \$65 billion from consumer spending so far this year. Similarly, higher food prices are estimated to decrease discretionary income by another \$30 billion over the same period. We expect oil and gasoline prices to remain elevated over the next four months, declining in early Fall prior to U.S. elections.

The more worrisome statistic—core inflation— continues to remain elevated, partly due to wage and unit labor cost increases and pass-through of current and previous energy prices. Core inflation averaged 2.4 percent during the first two months of this year, up from 2.3 percent a year earlier (Figure 4). The range is outside the 1 to 2 percent “inflation comfort zone” of the Fed, which is consistent with long-run sustainable growth.

But the Federal Reserve has concentrated on growth employing conventional and unconventional tools to prevent a hard landing of the economy. The Fed took aggressive steps in lowering the federal funds rate by 300 basis points during the period of September 2007 and March 2008, bringing the policy rate down to the current 2.25 percent. In mid-March, the Fed offered to lend \$200 billion of U.S. Treasury securities to primary dealers. In an extraordinary rescue mission, the Fed and the Treasury orchestrated the sale of the near-bankrupt Bear Sterns securities firm by JP Morgan Chase. While these precedent-setting and unconventional methods

have raised much criticism, our view is that these moves were necessary to forestall a credit crunch and deepening of recessionary pressures.

We anticipate another 50 basis point cut over the next six months. This should take the federal funds rate to a low of 1.75 to 1.50 percent. But as inflationary pressures mount, we expect the Fed to scale back its rescue operations for the remainder of the year. Unlike early in the decade, the Fed is not likely to keep this accommodative bias for too long and will raise rates as soon as signs of economic stability arise, perhaps as early as mid-2009.

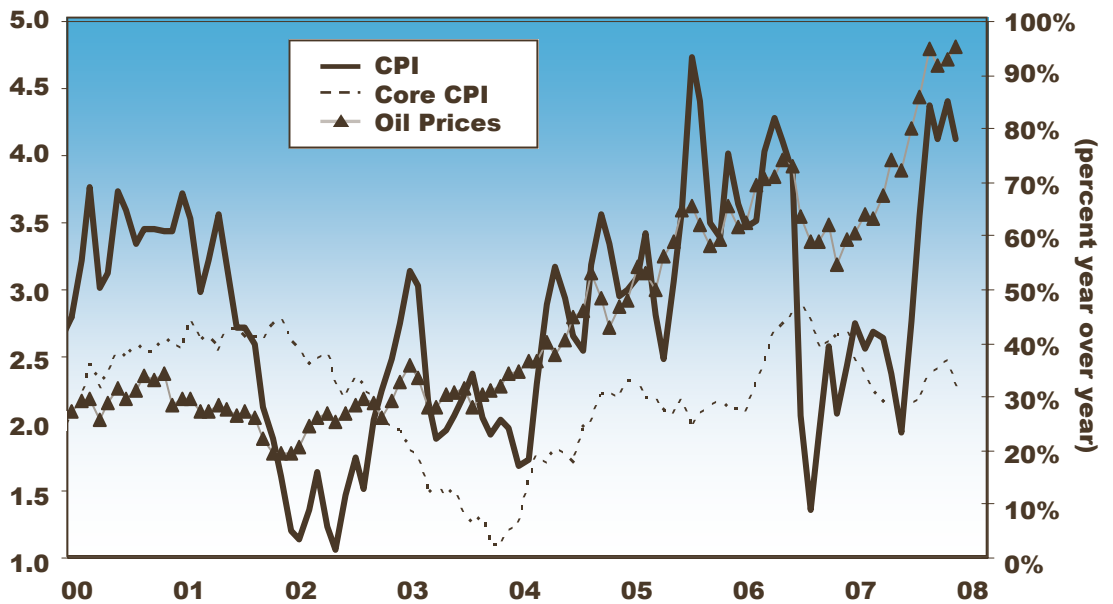
Having masterminded several rescue operations for Wall Street, the Fed, the Treasury and the Congress, are hard-pressed not to extend a similar assistance to Main Street and the overburdened U.S. homeowner. Some of the relief is already in the works. The fiscal stimulus tax rebate should help consumers. In addition, the Office of Federal Housing Enterprise Oversight (OFHEO) and the Federal Housing Administration (FHA) have developed measures to help homeowners. We anticipate that some elements of these proposals will be passed by the Congress in the next few months.

Orange County

Orange County felt the first tremors of the subprime mortgage crisis several months before the national economy was affected. Two of the largest national subprime mortgage lenders located in Orange County, Ameriquest and New Century, suffered significant financial losses in 2006. Ameriquest, after sustaining major losses on their mortgage-lending sector, cut back on the issuance of high-risk subprime loans in 2006, and New

U.S. CPI, Core CPI, and Oil Prices

Figure 4



Century declared bankruptcy in early 2007. Job losses and commercial property vacancies followed. As of March 2008, employment in the Credit Intermediation and Related Activities sector had shrunk to 35,600 from a December 2005 high of 55,100, shedding a total of 20,000 jobs.

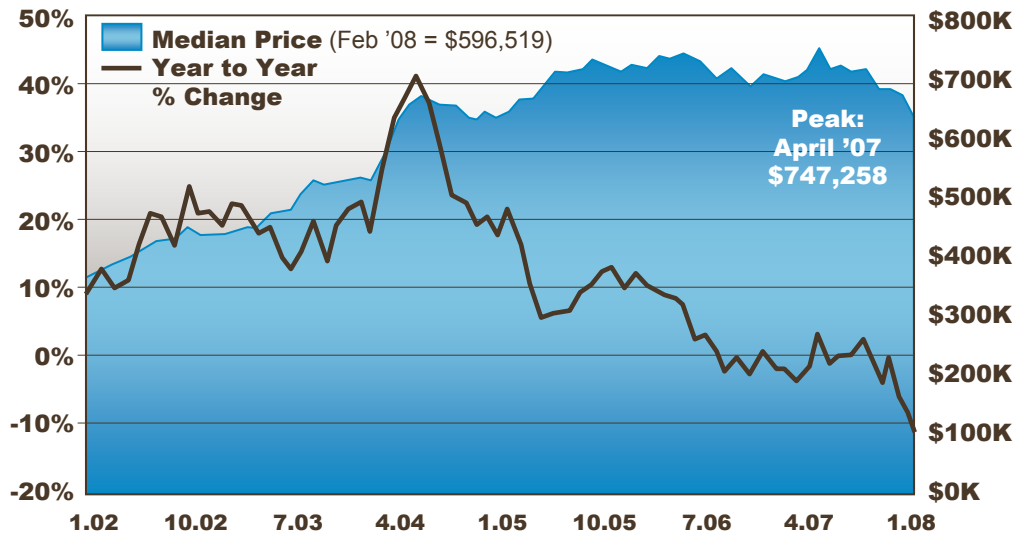
Housing prices in Orange County have also taken a tumble (Figure 5). Based on California Association of Realtors' data, after reaching a peak of \$747,000 in April 2007, the median price of an existing single-family home fell to \$597,000 in February 2008. This is a decline of 22 percent over a period of 22 months or approximately 1 percent a month. The current median house price is at about the same level as in February 2004.

The main questions today are how deep will the housing/credit crunch go and how far, and what its impact will be on the rest of Orange County's economy.

Total payroll employment, the best measure of economic health for the local economy, stood at 1,513,000 jobs for 2007. This represents a decline of 0.4 percent from 2006. The California Employment Development Department in its annual benchmark revision substantially lowered these numbers compared to the monthly estimates it provides and distributes. The average unemployment rate for Orange County for 2007 was estimated to be 4.5 percent

O.C. Median Price Single Family Existing Homes
(Source: California Association of Realtors)

Figure 5



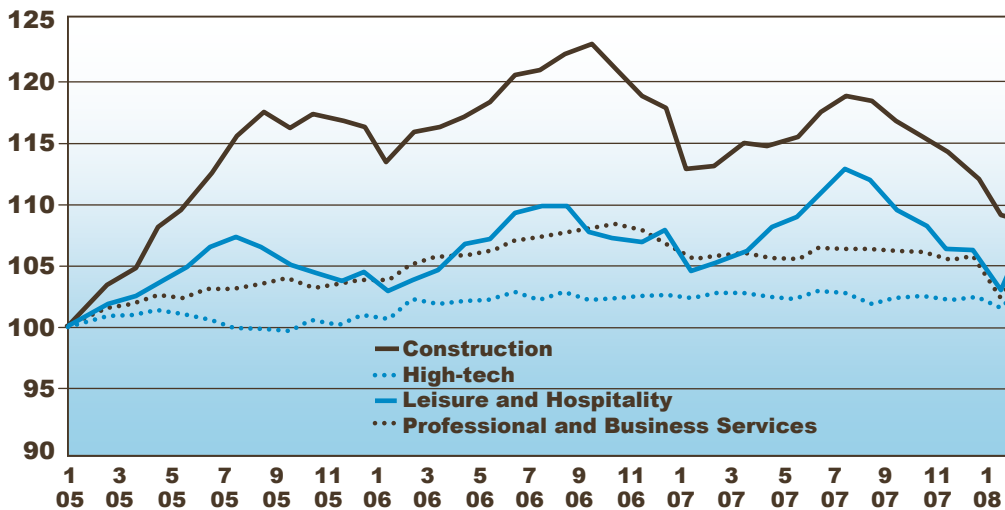
compared to a 3.9 percent rate for 2006. In the first three months of 2008, payroll employment is declining at an annual rate of 1.6 percent. The unemployment rate in March stood at 4.6 percent. This compares with a 1.1 percent average rate of growth in the national payroll employment in 2007. Yet employment at the national level has been declining lately. The U.S. economy has lost 131,000 jobs in the last three months. The national unemployment rate stands at 5.1 percent in March 2008.

Job losses in Orange County are not concentrated only in the subprime and construction sectors. Manufacturing, Information, and Professional and Business Services also lost jobs in 2007 (Figure 6). But employment levels increased in Educational and Health Services, Trade, and Leisure and Hospitality sectors. These trends are continuing in 2008 with the exception of Leisure and

Hospitality industry which is showing the first signs of job losses.

O.C. Employment Sectors Index

Figure 6



A longer term look at the national and our regional economies provides some interesting contrasts. Indexing the national and the local economies to adjust for scale, it appears that the economies of Orange County and the U.S. are following similar trends. After suffering major setbacks in the early 1990s from significant declines in defense spending, the County's economy grew

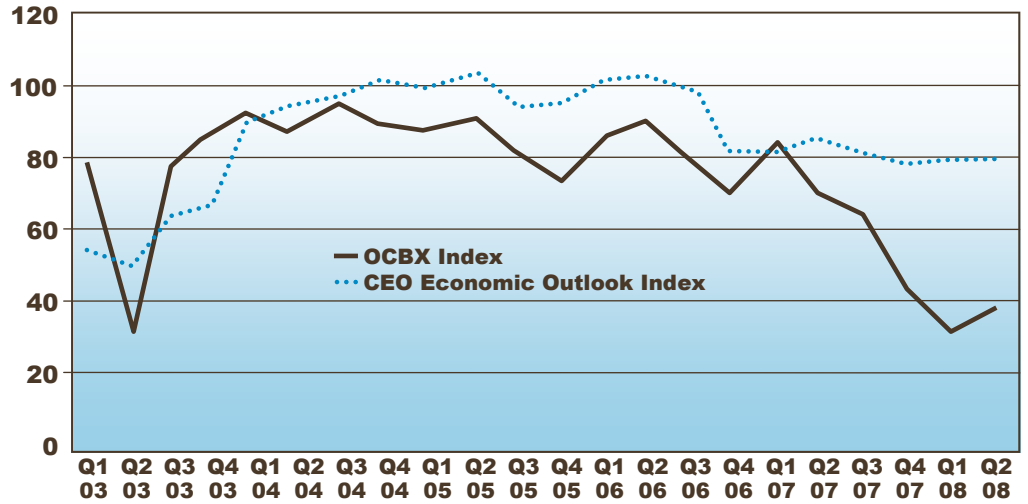
more slowly than the national economy through the end of the decade. But after the tech bust of 2001-02, the County grew at a faster rate than the national economy. It appears, however, that the current slowdown has again brought the county employment to the same relative level as the national economy. Inland Empire, not surprisingly, has been growing at a much faster rate while Los Angeles County has shown stagnant employment levels with little net gains since the early 1990s.

The diversity of Orange County's economy is a major factor in its resiliency in adjusting to external shocks. While it received major blows in the early 1990s from defense cutbacks and is currently being buffeted by the mortgage/credit crisis, its prognosis is not critical. As shown in the accompanying chart, several major sectors have been contributing to the County's growth (Figure 7). The County is expected to weather this storm better than other areas of the country which, much like Orange County, rely heavily on construction and housing sectors.

The Orange County Business Expectations Index (OCBX) developed and maintained by Cal State Fullerton's Institute for Economic and Environmental Studies (IEES) takes a reading of the sentiments of senior business executives about the state of the local and national economies. The index, after reaching record-low value in its five year history, improved slightly during the second quarter of 2008 (Figure 8).

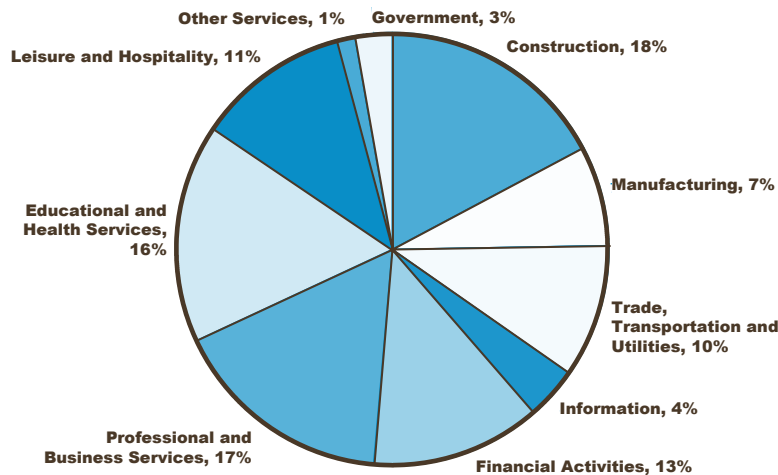
O.C. and U.S. Business Expectations

Figure 8



O.C. Growth Sectors 2002-05

Figure 7



Orange County executives, while continuing to remain highly cautious and very concerned about the state of the economy both locally and nationally, show little sign of panic. They are managing their inventories and payrolls well but continue to expect moderate growth in revenues and profits for their companies. The housing and credit crises have not affected most of the businesses outside of the housing related markets.

Forecasting under these turbulent conditions involves more than usual risks. We believe that the downward momentum for the economy is continuing to build from cutbacks in the financial and housing sectors and from increasing strains in related industries. High oil and commodity prices are adding to the slowing of global economies. We expect these factors to lead to very slow growth or moderate declines in the U.S. Gross Domestic Product in the first three quarters of 2008. The mitigating factors are the lower exchange value of the dollar, stimulative domestic fiscal and monetary policies, and a continued strong performance of global U.S. companies. We anticipate an overall U.S. GDP growth rate of 1.4 percent in 2008 and 2.7 percent in 2009. We expect inflation to become one of the main issues for policymakers and the Federal Reserve to be more concerned with mopping up excess liquidity by the end of this year.

In Orange County, though further downward adjustment in housing prices and related industries is expected for the remainder of the year and possibly into early 2009, we believe that more than half of the anticipated adjustment has taken place. Although the pace of job losses so far is below that of the first three-month losses of the 1991-1992 and 2001 recessions, further weakness in economic activity and labor market are

anticipated through the rest of this year (Figure 9). We expect non-farm payroll in the county to decline by approximately 1 percent for all of 2008 but show slow positive growth next year. Although the continuing economic slowdown is technically not a recession yet, it will definitely feel like one before it is over.



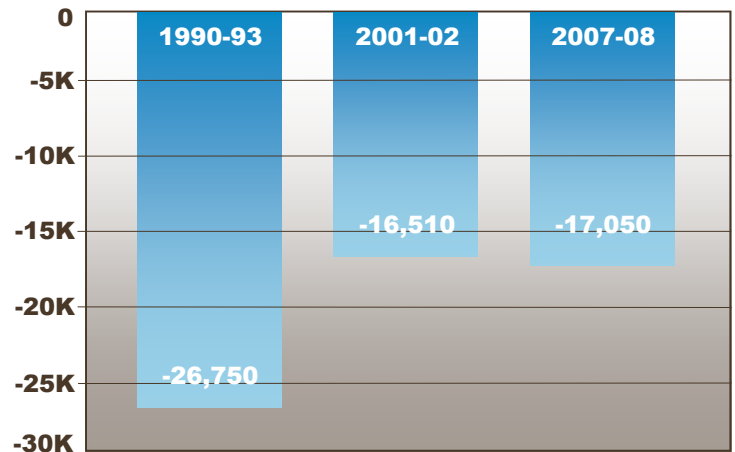
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Employment Losses
First 10 Months of Slowdown

Figure 9



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For registration and sponsorship information, please contact Ginny Pace at 714.278.2566 or gpace@fullerton.edu