

ECONOMIC OUTLOOK AND FORECASTS

The Nation, Southern California and Orange County

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U.S. Economic Outlook and Forecasts

A lot can happen in one year. In fact, quite a lot has happened since our last October report that has altered dramatically the economic landscape and its outlook. One year ago, the entire global financial system was on the brink of a near-collapse, threatening to drag with it virtually every sector of the economy. The crisis sent policymakers around the world scrambling to stop the free-fall by embarking on the largest government intervention since WW II.

After staring into the abyss of “worse” and “worst” nightmarish scenarios of non-functioning financial markets, skyrocketing job losses, implosion of global demand, and a relentless eroding of consumer and business confidence, the U.S. and the global economies seem to have finally turned a corner.

The outlook of an “imminent recovery” has now become the consensus view amongst economists, market analysts, and policymakers. The stabilization of the financial sector, a decrease in the pace of job destruction, the near-bottoming of the housing market, and an increase in industrial production suggest that the worst of the Great Recession is behind us. The debate is now framed in terms of the speed, quality and sustainability of this recovery, with the majority expecting a sluggish, below-trend growth and even a double-dip recession. Concerns about the breadth and vibrancy of the recovery are not misplaced: vigorous consumer deleveraging, tepid household spending, weak labor markets, fragility in the financial sector, tight credit, and issues in commercial real estate present formidable downside risks to future growth.

This report lays out a slightly more optimistic outlook than the consensus view on the trajectory for recovery. Our forecasts indicate a faster-than-expected growth scenario with considerable bumps over the next six quarters which is likely to cause a zigzag but not a trend reversal on the growth path. Far from being “rosy,” our outlook is cautiously optimistic and builds on the notion that the recovery is starting from a much lower base, where too much (output, labor, costs) was cut too fast. A mere reversal on the trends of a few key factors should boost the growth rate in the mid-to-upper 3% range over the next 18 months, stronger than the lukewarm rate of 2%-2.7% forecasted by the consensus. Even this faster growth scenario would simply provide a modest recovery from the remarkably steep declines of the last few quarters, returning most macroeconomic indicators to their pre-recession levels by mid-2011. This is not a return to “normalcy” but rather a bounce to a “new normal” where two years after the recession, the level of output would still be 10% below what it could have been had the crisis never happened.

Several factors will aid the recovery. Firms had little excess employment at the start of

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Recent economic data, however, indicate that the worst of this recession may well be behind us. In fact, this report makes the case that a sustainable recovery in the U.S. is underway, which will likely be speedier and more volatile than what market analysts anticipate.

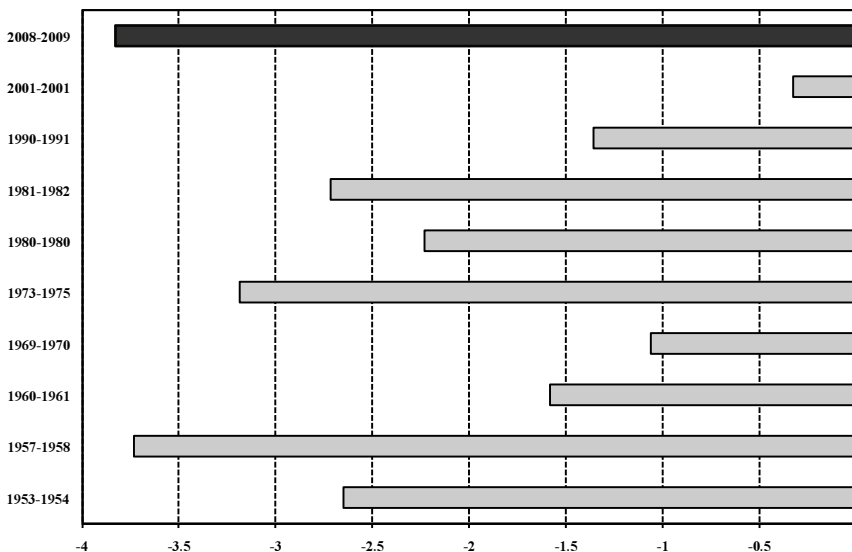
the recession and after shedding jobs at an alarming pace are now leaner than ever. Residential investments have bottomed out and are expected to rise, the inventory cycle has reached a turning point, and exports have swung back as the global economy (and especially emerging Asia) mend faster. Moreover, fiscal and monetary policies are expected to remain loose until well into 2010 and the effect of the back-loaded stimulus plan is expected to take hold more firmly in 2010 and 2011. Consumers will lag rather than lead in our recovery scenario as they struggle with high unemployment rates, losses in home equity and the repair of their badly damaged balance sheets.

In this report, we lay out our “faster-and-bumpier than expected” recovery scenario as it relates to the main factors and risks that characterize this outlook. This discussion provides the basic foundation for our economic outlook and national forecasts and serves as a cornerstone for our regional economic analysis of Southern California and Orange County.

The Case for Economic Recovery

Since the onset of the crisis in early 2008, real economic activity (as measured by real GDP) has fallen by a total of -3.9%, the largest decline of any postwar recession (Figure 1). So far, the economy has contracted for four consecutive quarters, an unprecedented back-to-back decline since the introduction of quarterly GDP data in 1947. In addition, the current recession is, at 21 months, the longest postwar recession surpassing the previous record-holders of 1973-75 and 1981-82, both lasting 16 months.

FIGURE 1
Cumulative Declines in Real GDP during Recessions (Percent)



Recent economic data, however, indicate that the worst of this recession may well be behind us. In fact, this report makes the case that a sustainable recovery in the U.S. is underway, which will likely be speedier and more volatile than what market analysts anticipate. To be clear, our view does not imply an overly robust recovery: it simply calls for a higher and faster growth forecast over the next two years spurred by the very severe declines we have seen during this recession. The U.S. economy has fallen so sharply that it would take a sustained growth of around 8% over the next two years just to return to the real GDP trend-path observed in 2006. We don't see these growth rates materializing, since consumers are unlikely to lead the recovery. But growth rates in the range of mid-to-upper 3% are possible in the short term, even without a sustained boost

in consumption spending. In explaining our outlook on how the economy will transition from recession to recovery, this report purposely takes a simple approach: “it accentuates the positive and eliminates the negative.”

Eliminating the Negative...

Investments

Residential investments, inventory investments and consumer spending have together accounted for 3% of the 3.9% decline in real GDP during this recession. Trend reversals in these indicators (eliminating the negative) would be a boon for economic recovery. In other words, progressing from “worst” to “bad” to “less bad” can go a long ways towards economic stabilization.

In fact, the much smaller (-0.7%) decrease in real GDP in the second quarter of this year (compared to a -6.4% drop in Q1) was largely due to a slower pace of decline in a host of investment indicators (Figure 2). Residential investments improved from -38.2% (Q1 2009) to -22.8% (Q2 2009), subtracting -0.66% from real GDP compared to the -1.33% in the first quarter. Moreover, the latest monthly indicators suggest that the drag from residential investment has stopped and it is estimated to add roughly 0.5% to the GDP growth in the current quarter. Nonresidential investments, however, while moderating from -39.2% to -10.9% in the second quarter, are not likely to add to the economic activity any time soon given the strain in commercial real estate market.

We expect residential construction to reach the levels of early 2008 only in the third quarter of 2011. This projection would still be 38% below the peak levels of late 2005/early 2006, and is consistent with housing starts of approximately 1 million per year. Investment in equipments is projected to grow at a similar pace as in the post-2001 recession, posting an average growth rate of 4 - 5% over the next 3 years. This forecast is a bit conservative given that at the onset of this recession cycle there was no excess capital investment, unlike the post-90s tech boom.

The drawdown in inventories has been quite remarkable during this crisis (Figure 3). In fact, at an annual pace of -8.6%, real inventories fell faster in the second quarter of 2009 than in any other quarter in the postwar era. It does seem that the inventory cycle has reached a turning point which suggests that, at a minimum, the pace of inventory reduction should slow down significantly. This

FIGURE 2
Real GDP, NonResidential and Residential Investments
(Percent, Year-over-Year)

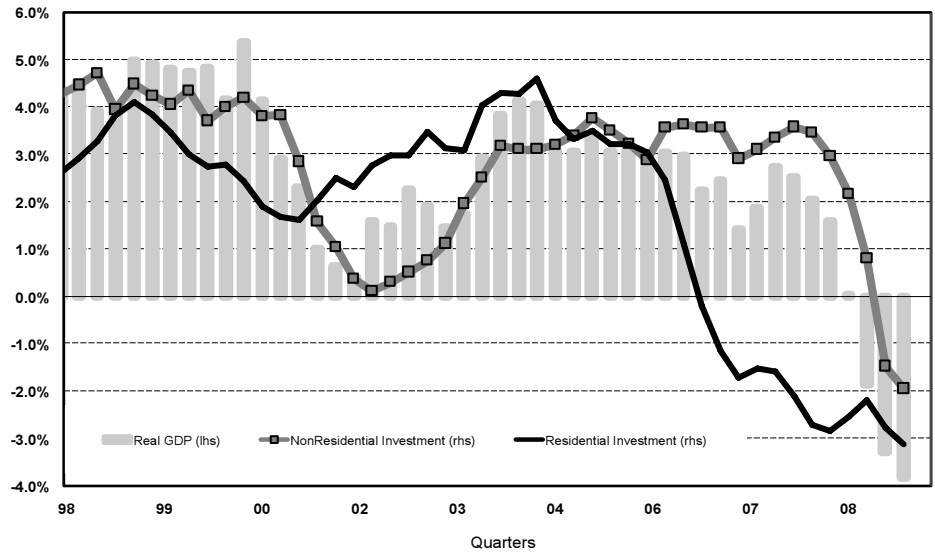


FIGURE 3
Real Inventories at Lowest levels
(Percent, Quarter-over-Quarter)

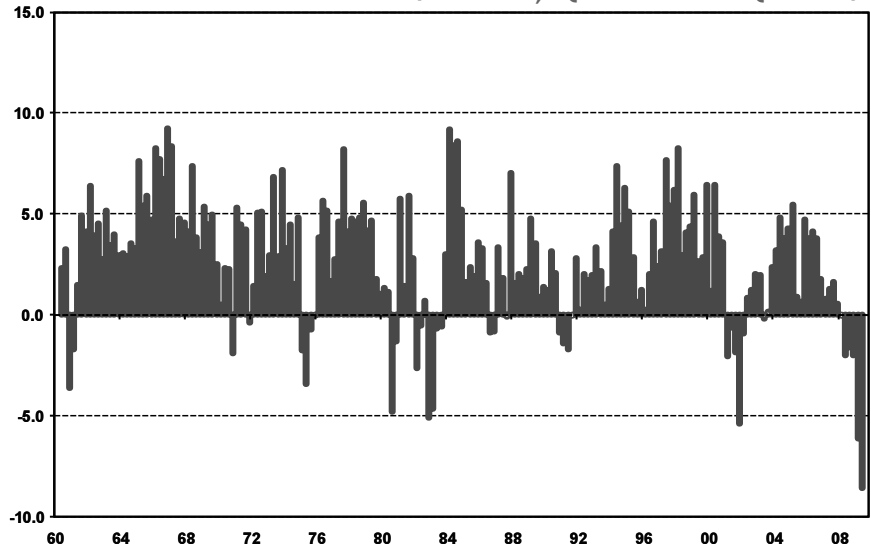
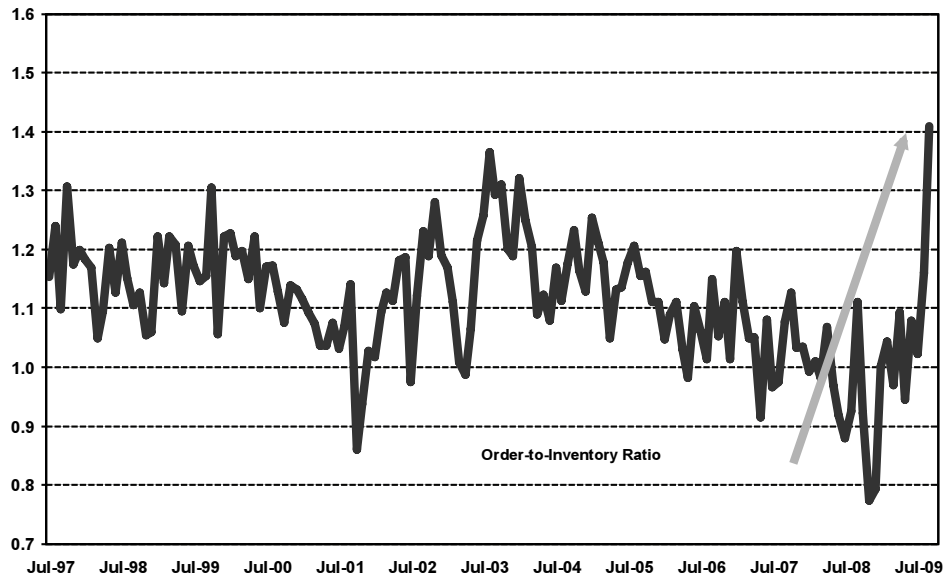


FIGURE 4
ISM Survey: New Orders to Inventory Reach High Levels
(Ratio)



improvement should contribute positively to real GDP growth: after shaving off on average about 1.8 percentage point (pp) in economic growth during the first two quarters, inventories are expected to add 1.9 pp in the second half of this year.

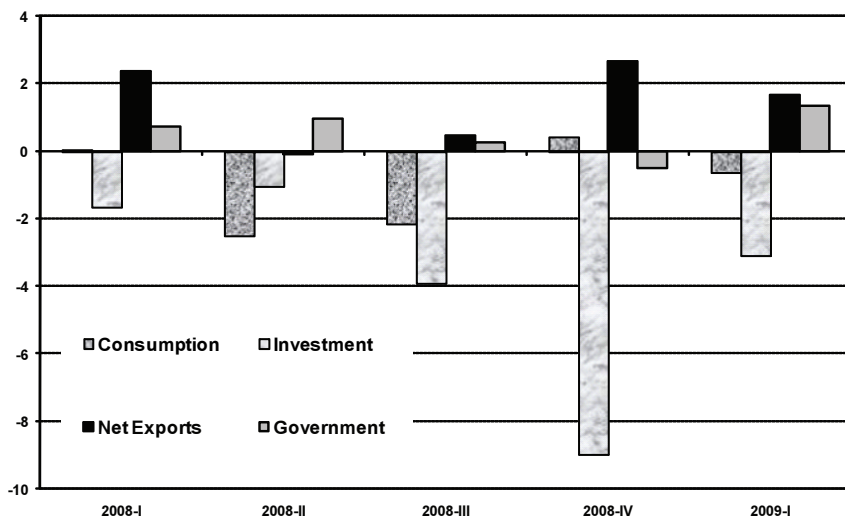
Now that inventories are cut to the bone, production is likely to pick up. There are clear signs of a technical rebound; the latest report of the Institute for Supply Management (ISM) shows that new orders have bounced up significantly and the ratio of orders-to-inventories rose to its highest level since 1975 (Figure 4). It should be noted that unlike inventory adjustments which tend to

have a transient effect, improvements in production and investments are necessary factors for a sustained growth.

Net Exports

As recovery takes hold in the global economy faster than in the U.S. (in particular in emerging Asia), export growth is expected to outpace imports, providing yet another boost for U.S. real economic growth. Falling exports subtracted 1.9 percentage points

FIGURE 5
Contribution to Real GDP
(Percent)



from U.S. GDP over the past four quarters. This trend has reversed lately, with exports decreasing by only 5% in the second quarter, compared with a decline of 29.9% in Q1 2009. More importantly, the latest export orders from ISM have swung into positive territory which should bode well for the U.S. economy. In the last two quarters, net exports have contributed positively to U.S. growth adding, on average, 2.2% to real GDP (Figure 5).

A possible threat to these positive developments is the emergence of protectionism which may lead to unwanted and dangerously escalating trade wars. The American Recovery and Reinvestment Act was chock-full of “buy-America” provisions, and in September the U.S. announced a stiff tariff

on Chinese tire imports despite opposition from U.S. tire manufacturers. With an ever-increasing consumer-oriented, up-and-coming middle class, emerging Asia has seen a rapid import growth which is helping the global economic recovery.

Consumer Spending

Perhaps the strongest arguments for a weak recovery is the implosion of consumer demand, which suffered its largest four-quarter drop since 1951. The erosion of housing and financial sector wealth, combined with continued job losses have severely strained the U.S. consumer. Between Q3 2007 and Q1 2009, U.S. households lost a total of \$14.2 trillion in net wealth, causing a sea change in consumer behavior. Consumers have retrenched, embarking on a long and arduous process of repairing their balance sheets by lowering debt and increasing savings. Total household debt dropped by 1.7% in Q2 2009, after declining by 1.1% in the first quarter. While income received a boost from stimulus-related tax cuts in the first half of 2009, most of the transfer income (about 80%) was saved rather than spent. The spending-to-income ratio, which had risen to 130.6% in the heydays of early 2008, fell to 125.6% as of Q2 2009 – an improvement, but still above historical norms suggesting that additional adjustments are in the pipeline.

Things are not likely to improve significantly for consumers in the near term, but they are also not likely to get much worse. In fact, a few encouraging signs have sprung up lately:

after seven consecutive quarters of declines, household net worth rose by \$2 trillion in Q2 2009, largely driven by an increase in financial assets. Also, with home prices showing signs of moderation, the value of real-estate-related household assets has begun to stabilize in the second quarter. Final sales of domestic product firmed up by 0.7% during Q2 2009 after declining by over 4% in the previous two quarters, and household spending is up 0.6% so far this year (Figure 6).

Despite these glimmers of hope, we don't expect the U.S. consumer to bounce back vigorously over the next six quarters. Most of the recent increase in consumption is "borrowed" rather than self-propelled: the widely popular "cash-for-clunkers" program, which has now expired, added a sizable chunk to spending and stimulus tax cuts did lend a helping hand. High unemployment rates and continued deleveraging will continue to restrain any meaningful upswing in household spending, particularly in early 2010 as some consumer-friendly fiscal programs come to an end. For a self-sustained recovery, however, sustained consumer spending is needed and we project that this will pick up in 2011 after the labor market has stabilized and consumer balance sheets look healthier.

FIGURE 6
Final Demand Has Stabilized
(Percent, Quarter-over-Quarter)

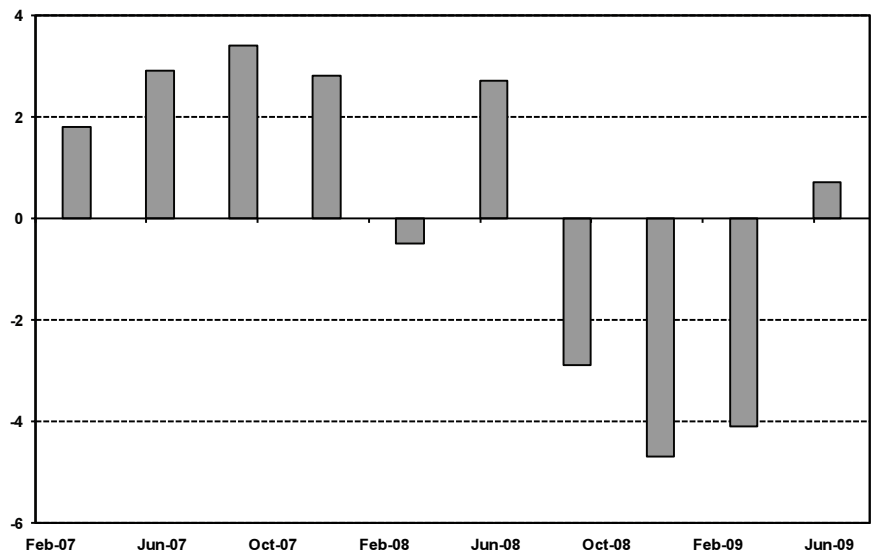
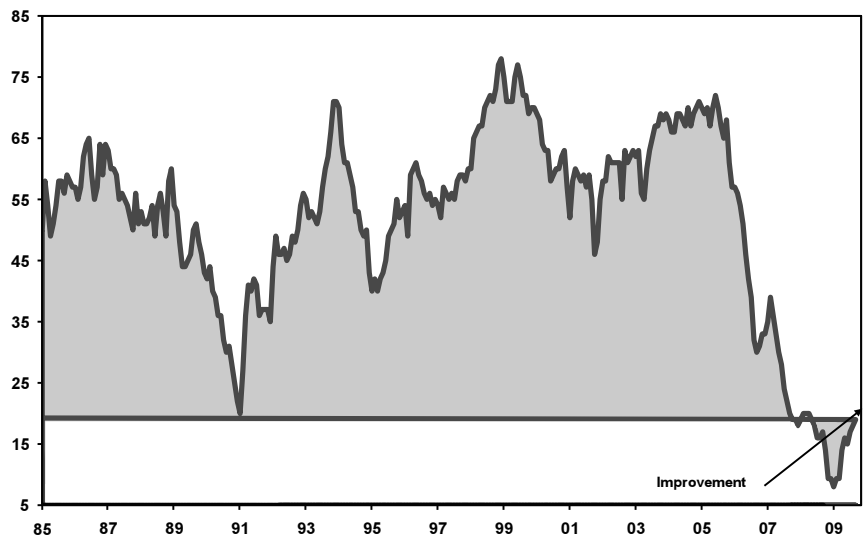


Figure 7
NAHB Homebuilder Sentiment Index
(Level)



Real Estate Market

Recent housing dynamics reflect a bounce from extremely low levels and indicate that some form of stabilization is about to emerge in the real estate sector.

The housing market has taken a real beating during this recession: from the first quarter of 2006 to the first quarter of this year, new home sales plunged 70%, single-family starts plummeted 79% and the Case-Shiller home price index dropped by 32% - the largest declines since WW II. After these relentless cuts, just about every measure of housing activity has shown improvement in Q2 2009. New home sales rose by 0.7% on a monthly basis, housing starts bounced to their November 2008 levels and the Case-Shiller index recorded the first quarter-over-quarter increase in three years. The main indices compiled by the National Association of Homebuilders (NAHB) – homebuilder confidence, single family sales and buyer floor traffic - though still depressed, have improved from their record lows (Figure 7).

Recent housing dynamics reflect a bounce from extremely low levels and indicate that some form of stabilization is about to emerge in this sector. Housing starts are leveraged to sales which suggests that new home construction should continue to increase over the next few quarters just to keep the inventory/sales ratio from hitting rock-bottom. This increased activity is expected to add around 0.5% to GDP growth. Nonetheless, given the high unemployment rate, low consumer confidence, and tight lending standards, the inventory of unsold existing homes is expected to remain high, moderating the effect of the rise in new construction.

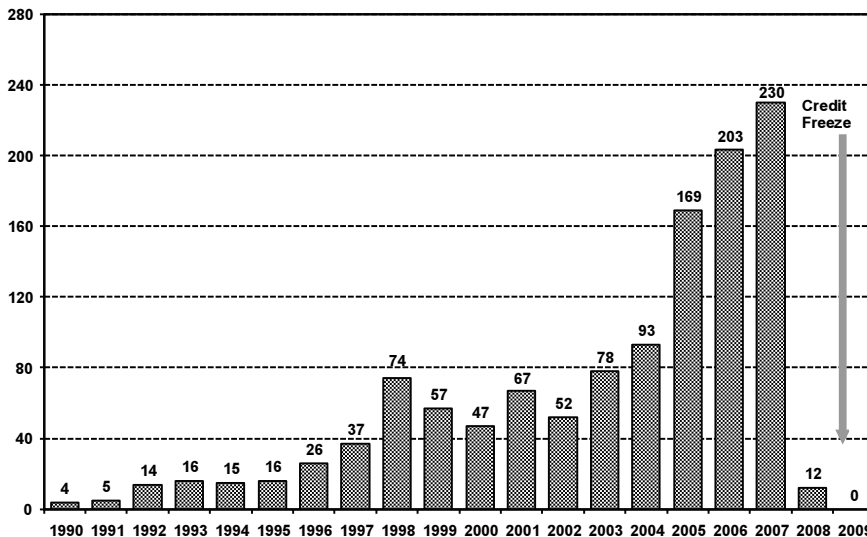
House prices are even harder to read: there is some evidence that prices at the low end of the market have begun to stabilize, while price declines are concentrated at the high end where limited pricing for jumbo mortgages is restraining sales. The rate of delinquent mortgages reached a record-high of 9.24% in the second quarter of 2009 and foreclosures spiked to a fresh record of 4.3%. With the five-month moratorium on foreclosures coming to an end, the number of forced sales entering the market in the second half of the year is expected to increase, placing significant downward pressure on house prices.

Overall, the prognosis for the housing market in the next several quarters remains mixed: housing activity is expected to show signs of life and existing sales should remain hesitant, whereas house prices are expected to bottom-out and stabilize at lower levels.

The commercial real estate market on the other hand, presents a gloomier picture and will be the next troubled spot. According to FDIC, one sixth of all construction loans were in trouble in the second quarter of this year, placing additional strains on regional and local banks which are the major lenders to small businesses (Figure 8). All indicators suggest that this market is a particular danger zone: commercial property prices fell 5.1% in July from the June level, property values are

down nearly 39% below the peak of October 2007, and the current market transaction volume is the lowest since 2001. Things are likely to get worse before they get better: office vacancies are expected to rise to 20% in mid-2010, industrial vacancies from 13% in Q2 2009 to 16% by Q2 2010, and retail vacancies to edge up from the current 11.7% to around 13% in Q2 2010.

Figure 8
Commercial Credit Freeze
(U.S. CMBS Issuance - Billions)



Labor Market

The true measure of this recession is revealed by the extent of the carnage it has inflicted on the labor market. Since its onset in December '07, the crisis has obliterated a total of 7.2 million jobs, pushing the number of unemployed to 15.1 million and doubling the unemployment rate to 9.8% (Figure 9). The prospect of a new job is so discouraging that many unemployed Americans have stopped looking at the fastest rate in nearly a decade. At 9.2 million, the number of workers employed part-time for “economic reasons” has increased to its highest level since the Bureau of Labor Statistics started tracking this information. If we add all the excluded categories – marginally attached workers, discouraged workers, and involuntary part-time workers – the actual unemployment number becomes a frightening 16.8%, higher than in any period during the post war era. Some states have fared even worse: in California, the actual unemployment rate is estimated to be 20.3%.

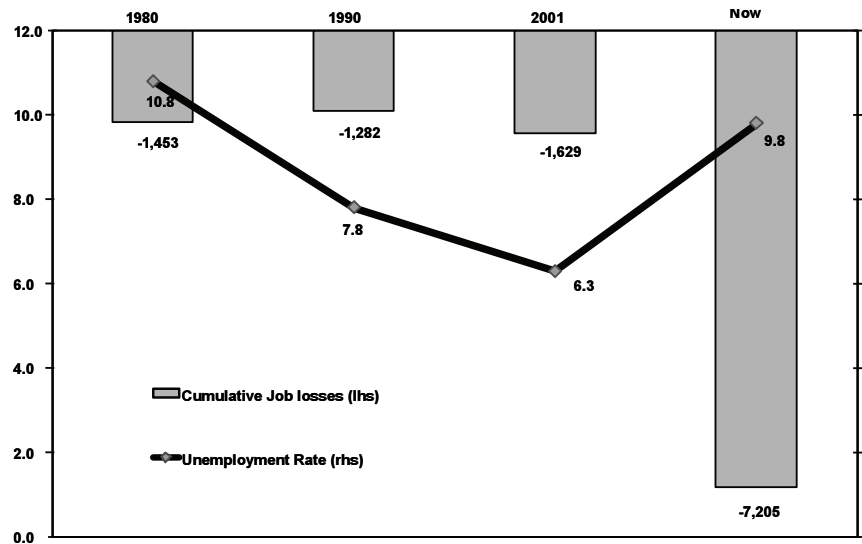
Some jobs may never return even after a full-blown recovery as the new economy that emerges from this recession will not fully resemble that of the pre-recession. Manufacturing jobs, which fell from a historical average of 18 million to 14 million during the first few years of the millennium, will continue to drift downwards. A reallocation of workers is likely in the construction sector, at least over the medium-term horizon. Other sectors will stabilize towards the end of this year and are likely to show signs of life only in early/mid-2010, led by health and education sectors.

The latest payroll numbers seem to indicate that the frantic job-shedding has abated; job losses peaked in Q1 2009 and have remained in the 200,000-300,000 range since then. This is comparable to the pace of job losses in the last two recessions. Similarly, initial and continuous claims peaked in April 2009 and have been falling, albeit at a sluggish pace. Stabilization in the labor market requires that job losses decline to around 50,000-75,000 per month and jobless claims fall below the 400,000 level, which is likely to happen early in 2010.

While companies are not expected to embark on a hiring binge, jobs are likely to return a bit sooner than in the last two “jobless recoveries” of 1991 and 2002. To be clear, this recovery will by no means be “job-full” and the unemployment rate will remain uncomfortably high well into 2011, but the process of job creation is likely to follow with fewer lags than in the past. In 1991 and 2002, unemployment reached a peak 15 and 19 months after the recession had ended; this time around, we expect to see a peak in unemployment in the first quarter of 2010, which should fall somewhere between 5-6 months after the official end of the recession.

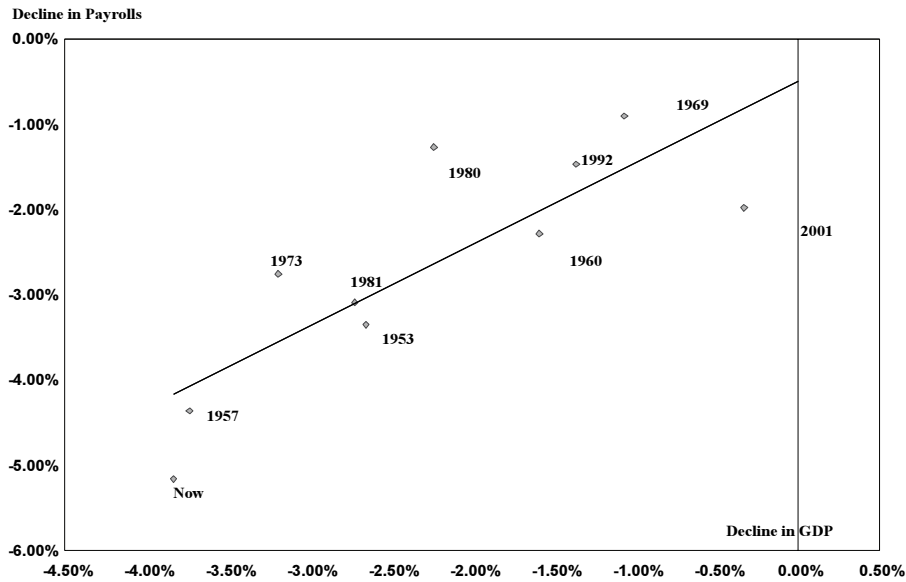
There is a case to be made for a departure from previous recessions. First and foremost, jobs have been cut harder and faster relative to the decline in GDP in this cycle relative to the 1991 and 2002 recessions (Figure 10). This has eliminated virtually any minimal hiring excesses and with a drastic cut in inventories and investment spending, businesses are now leaner than in the past. Moreover, labor productivity increased just before the

FIGURE 9
Cumulative Job losses and Unemployment during Recessions (Percent, Year-to-Year)



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FIGURE 10
Jobs Are Reduced More Severely than Usual
(Reverse Scale)



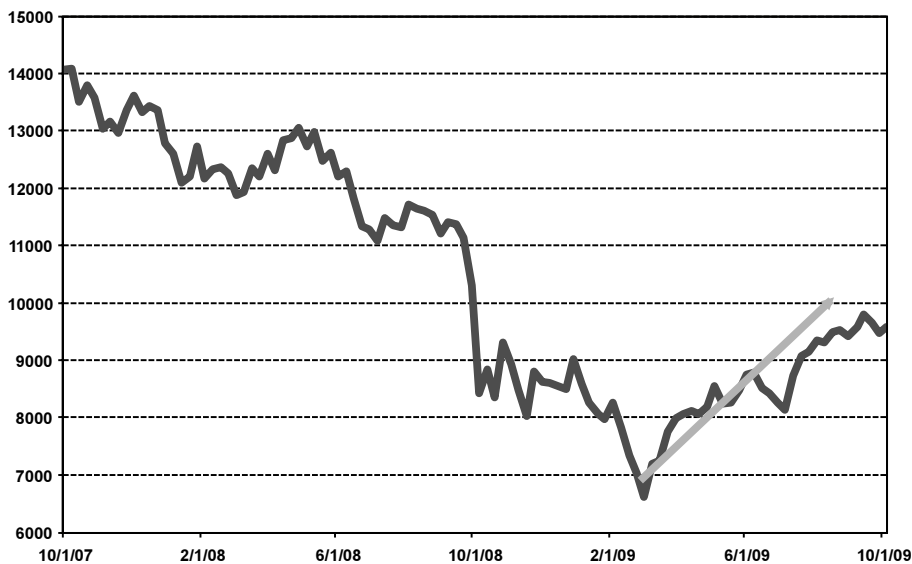
current recession and has remained at the same level, suggesting that layoffs may have been more front-loaded here than in 1991 and 2002. And financial headwinds, while much stronger this time around, hit the corporate world in the middle rather than at the tail-end of the recession unlike the S&L crisis of 1991 and the corporate scandals of 2002.

The Financial Sector

One year after Lehman’s collapse and \$3 trillion later in government largesse, the financial market seems to have taken a collective sigh of relief. In fact, since March 2009, the banking sector has improved significantly: governments are willing to guarantee all sorts of bad debt in banks’ balance sheets, money is

cheap, deposits are plentiful and borrowers quite desperate. The stock market soared 51% from a 12-year low in March, as the deepest recession since the 1930 wanes (Figure 11). Results from the 19-bank “stress test” conducted by the Treasury Department revealed a capital shortfall of just \$75 billion. Eight of those stress-tested banks felt confident enough to pay back \$63 billion of capital the government had injected in them last year. The spread between banks’ overnight borrowing costs and the federal funds rate has dipped down to below 0.25%, indicating that trust between banks has returned and credit markets have eased up back to normal. With implicit guarantees from the government and an abundance of taxpayer dollars, Wall Street seems to have put last year’s near-collapse on the back-burner. Banks have piled up new risks, expanded their balance sheets (which are now 40% bigger than in 2005), and have become larger entities than before the crisis.

FIGURE 11
Stock Market Has Rebounded
(Dow Jones Industrials - Level)



Looking closely at the facts suggests that this euphoria may be a bit overblown. Though the estimated amount of losses from “toxic assets” has declined from \$4 trillion to around \$3.4 trillion over the past six months, much of these losses loom large in the horizon. U.S. banks are expected to incur a total of \$1.02 trillion in losses of which only \$628 billion has been recognized. Globally, the numbers are even more worrisome: commercial banks have recognized \$1.3 trillion through the first half of 2009 but face another \$1.5 trillion of potential write-downs ahead. Banks in U.S., UK and Europe must refinance an unprecedented \$1.5 trillion in bank borrowing, which is due to mature

by 2012. And although bank earnings are recovering, they are still too weak to offset the anticipated write-downs over the next 18-months. In the U.S., the worst losses are expected to occur on “traditional” mortgages, which were never bundled up into Mortgage Backed Securities to begin with, and have not been marked down to reflect depressed values.

Accentuating the positive...

Fiscal and Monetary Policy

With a total price tag hovering above \$4 trillion in direct loans, guarantees, spending stimulus, balance-sheet rebuilding, and a myriad of other programs, the federal government and the Federal Reserve have been able to stop the financial meltdown and prevent the deep recession from evolving into the Second Great Depression. The government stimulus spending alone added 1.3 percentage points to the second quarter 2009 GDP. This is quite an impact if we keep in mind that the gigantic \$787 billion stimulus package was relatively back-loaded with less than 20% hitting the economy in 2009. The bulk of the stimulus, 75% of the money is expected to be in the works during 2010. This should provide a substantial boost in economic activity throughout 2010 and a visible effect in early 2011.

In terms of sheer size, the American Recovery and Reinvestment Act is the largest and boldest countercyclical fiscal stimulus in history. With an estimated GDP impact of 2.5% in 2009 and 2010, it rivals the New Deal of the 1930s, which provided a GDP boost of only around 1.25%. The unprecedented collapse in consumer and business confidence, the credit crunch and the relentless erosion of wealth have reduced the net multiplier effect of the fiscal stimulus at least through much of 2009. But recent positive signs indicate that the multipliers may well improve in early 2010. More importantly, this fiscal thrust buys precious time for all: for the financial sector to become more robust, for consumers to repair their balance sheets, and for the corporate sector to liquidate inventories and shed excess labor.

Government stimulus has provided a temporary boost in demand over the short-term horizon. If these programs end, this may trigger an unwanted pullback in spending. The widely popular “cash-for-clunkers” program may have brought forward the demand for automobiles, which suggests that now that the program is over, sales will slip from 14.1 million to roughly 10 million in September/October. Similarly, the \$8,000 first-time home-buyer credit may have temporarily boosted the demand for homes. According to National Association of Realtors, 350,000 of the 1.8 million buyers who will claim the credit this year would have not purchased a home without it. The program is set to expire at the end of the year together with the “bonus depreciation” incentive offered to businesses to partially expense capital investments. There is a strong push to extend these programs and similar ones beyond the current year, so there is a real possibility that the fiscal stimulus will stretch well into 2010.

The Fed has maintained its “kitchen-sink” approach to the crisis. After lowering the short-term rate close to the zero bound, the Fed has abandoned all traditional tools of policy-making, engaging in what is now known as “credit easing.” To improve the functioning of the credit markets and provide additional support to the economy, the Fed has established and expanded a number of liquidity programs ranging from underwriting commercial paper to guaranteeing certain money market funds, expanding currency-swap agreements with foreign central banks, and lending directly to market participants.

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Fiscal and monetary policy is expected to remain lax until well into 2010 as inflation remains low, markets normalize, and the recovery takes hold. The Fed is likely to...keep rates unchanged well into 2010 and the fiscal impact should wane in 2011...but by then the recovery forces...should gain a stronger footing.

As a result of these actions, the Federal Reserve's balance sheet has swollen from \$870 billion before October 2008 to upwards \$2.3 trillion.

Fiscal and monetary policy is expected to remain lax until well into 2010 as inflation remains low, markets normalize, and the recovery takes hold. The Fed is likely to wind down its asset purchase programs, taper off its credit programs, and keep rates unchanged well into 2010. The fiscal impact should wane in 2011, especially as the Bush tax cuts come to an end (which amounts to a tax hike of around \$300 billion), but by then the recovery forces enumerated above should gain a stronger footing.

The Global Economy

There is mounting evidence that the global economy, and emerging Asia in particular, is faring much better than the U.S. China, Indonesia, South Korea and Singapore grew by an average annualized rate of above 10% in the second quarter. Taiwan's industrial production rose by an astounding 89% and India, though less impacted by the global crisis, recorded a 14% annualized increase in industrial production. Even sluggish Japan, Germany and France grew on a quarter-over-quarter basis in Q2 2009. The rebound is largely due to strong government support in both developed and developing nations, but other forces are also at play: the thawing of the global trade after the crisis and a bounce in domestic demand in emerging Asia spurred by a more targeted and effective fiscal stimulus have proven to be key factors during the recovery.

We expect this trend to continue with emerging market economies bouncing back faster than developed nations and providing the bulk of global growth. This requires that the world economy recovers without the push from U.S. consumers. Several arguments support this scenario: 1) consumers abroad do not face the massive deleveraging issues of the U.S. consumers, 2) emerging market economies entered this recession with far healthier government finances, external balance and international reserves than rich countries, and 3) infrastructure investment needs are still massive in most of the developing nations. Despite the lift from emerging economies, the volatile recovery of developed nations will be a drag on the global economy over the next couple of years, causing growth to settle below the 5% pace of the boom years.

Long Term Implications and Risk Factors

There is an old saying in economics that there is "no free lunch." The massive government debt accumulated during the crisis will certainly cause problems if fiscal and monetary support is not withdrawn at the right time. This requires a fine balancing act, which, if not executed properly, will likely reverse any gains during the current downturn and set us up for a bigger crash. Though the time of reckoning may be a while away (perhaps in 2011 and beyond), three interrelated issues need attention: government debt, inflation and the future of the U.S. dollar.

Government Debt

In the G20 as a whole, budget deficits have swung from 1.1% of GDP to 8.1% of GDP in 2009, thanks to an unprecedented government intervention. In the U.S., government actions have left the economy saddled with a \$1.58 trillion budget deficit in fiscal year 2009, and a shortfall of about \$9 trillion between 2010 and 2019 (Figure 12). Counting

current and future obligations, the U.S. public debt is approximately \$50 trillion. By all measures, the U.S.-debt trajectory, if it remains in its current path, is unsustainable. The downgrade of UK's sovereign credit rating has sparked concerns that U.S. debt may be next. To allay such fears and avoid a second crash, the U.S. government will need to proactively advocate its "exit strategy" and convince the markets that it is able to manage debt and drain liquidity fast once economic conditions permit.

Inflation

Large deficits make it tempting for governments to inflate it away (or repudiate it). The U.S. is particularly vulnerable to the inflationary solution: spending cuts and tax increases are politically unpopular with the legislature and debt-monetizing may be the easier way out. For now at least, inflation is well contained with core CPI slowing to 1.4% in August and headline Consumer Price Index (CPI) bottoming at -2.1%, year-over-year, in July 2009 – the largest contraction since 1949. Inflation expectations are also well-anchored, but this may not last long if worries intensify that the Fed may not be able to apply the brakes on time.

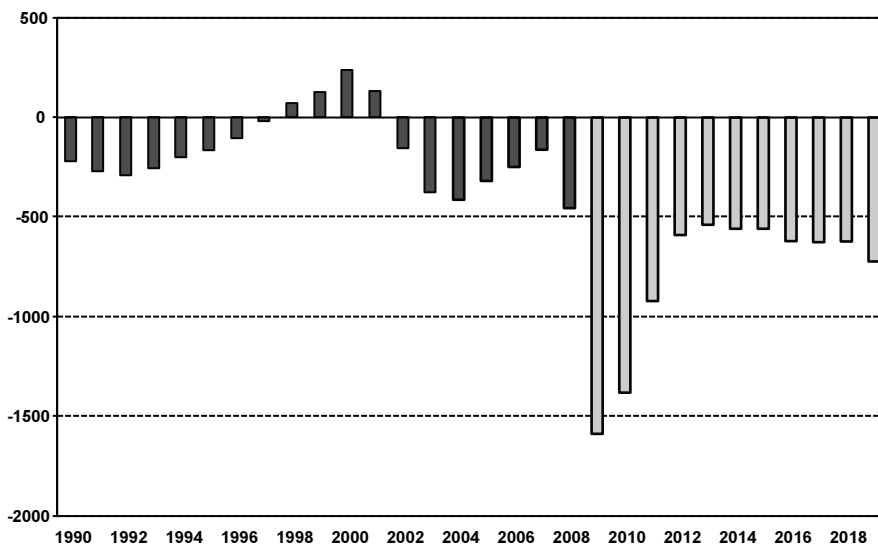
The Value of the Dollar

As economic recovery gains strength, the biggest threat to the dollar is the shift from reckless consumer spending in the pre-crisis era to unprecedented spending by the government. Large external imbalances, the reluctance of export-driven emerging economies to abandon the dollar peg, and a weaker recovery in the U.S. relative to the global economy place further downward pressure on the dollar. China has recently voiced concerns about the potential inflationary impact of the U.S. fiscal stimulus on its \$1.5 trillion investment in U.S. government securities. On a more worrisome note, Chinese officials have also called for an alternative currency reserve system that would offer more stability for its foreign exchange reserves. In the foreseeable future however, the dollar is likely to remain the dominant reserve. The dollar, however, faces steady depreciation over the next few years. A dollar crisis can ultimately be avoided only if 1) fiscal excesses are eliminated, and 2) China shifts gradually from an export nation to a consumer-driven economy.

The Morning After

The U.S. economy has begun a long climb out of the deep abyss. We believe that the recovery will be more brisk, but also more uneven than anticipated as the economy moves to a "new normal" where not all changes are reversible and not everything that is lost will be fully recovered. The movement will be supported in the short-term by temporary boosts from fiscal and monetary stimuli, inventory build-up and increase in net exports. Consumer spending and labor markets will remain a drag over the next eight quarters as banks and households work to repair their damaged balance sheets.

FIGURE 12
U.S. Budget Deficit: Historical and Projected
(Level, Billions)



We believe that the recovery will be more brisk, but also more uneven, than anticipated as the economy moves to a "new normal" where not all changes are reversible and not everything that is lost will be fully recovered.

...job losses in Orange County and the Southern California region in this recession have been the worst in recent memory. ...the current recession is also affecting the Southern California region more severely than the nation due to higher concentration of housing related sectors.

We anticipate a U.S. GDP growth rate of 3.9% in Q3 2009 and 2% in Q4 2009. In annual terms, the U.S. economy will contract by -2.5% in 2009 and grow by 3.3% in 2010. Consumption growth will continue to remain sluggish as high unemployment, de-leveraging and wealth erosion restrain household spending. Job losses are expected to wane with payroll numbers stabilizing by the end of this year and early in 2010. The unemployment rate is expected to average around 9.9% in Q4 2009 and reach a peak of 10.5% in mid-2010. A detailed summary of our projections for national variables is presented in Table 1 following this report.

Orange County and Southern California

Anatomy of Job Losses

Following the national trend, job losses in Orange County and the Southern California region in this recession have been the worst in recent memory. The only other slowdown in the last thirty years that could potentially be compared to the current one occurred in 1990-92. The nineties recession was exacerbated by a shrinking and restructuring of the defense sector. That structural change affected Orange County and Southern California more severely than the nation, with recession lasting longer here given the proportionately greater concentration of defense-related industries in the region during that time period. Similarly, the current recession is also affecting the Southern California region more severely than the nation due to higher concentration of housing related sectors here and the severity of downturn in that sector. Below, we provide an in-depth analysis of the reach and breadth of job losses in the region.

From the beginning of this recession at the end of 2007 to August 2009, a period of twenty months, payroll employment has fallen by 6.9 million in the nation, 609,900 in the five-county Southern California area (Orange, Los Angeles, Riverside, San Bernardino, and Ventura) and 115,000 (92,800 on an annualized basis) in Orange County. These losses amount to a 5% reduction in the level of payroll employment in the U.S., 8.3% in Southern California, and 7.5% in Orange County.

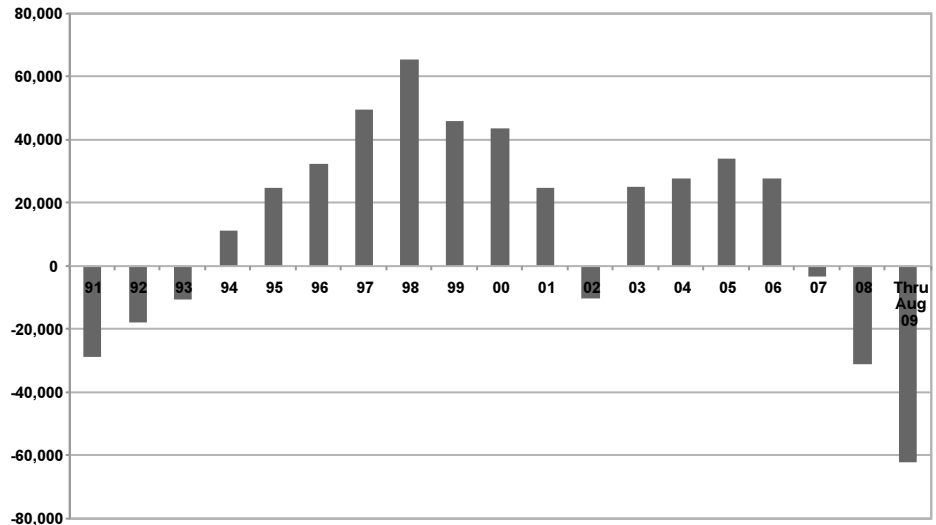
% Change in Payroll Employment, Jan '08 - Aug '09			
	OC	US	SC
Total Nonfarm	-7.5%	-5.0%	-8.3%
Construction	-19.2%	-19.0%	-21.9%
Manufacturing	-8.7%	-14.6%	-11.3%
Trade, Transportation & Utilities	-12.9%	-5.9%	-11.9%
Wholesale Trade	-10.0%	-6.6%	-7.7%
Retail Trade	-16.0%	-5.3%	-14.7%
Information	-11.0%	-6.7%	-8.0%
Financial Activities	-8.4%	-6.5%	-8.5%
Professional & Business Services	-7.1%	-8.3%	-9.0%
Educational & Health Services	0.5%	4.0%	-0.4%
Leisure & Hospitality	-0.1%	-2.9%	-3.5%
Government	-6.6%	0.5%	-6.1%

The depth of this employment loss is shocking. Given that the average annual rate of employment growth has been 17,400 per year (or 1.34% change) since 1990, the losses in this recession are equivalent to more than 5 years' job growth in Orange County. Not surprisingly, the sector with the most job losses in percentage terms is construction which had shed 19.8% of its total base, or over 18,900 jobs, since the beginning of 2008. In absolute terms, retail trade was the biggest loser with 27,500 jobs, or 16% of

the total. Within retailing, the subsectors losing most jobs were building materials, clothing and restaurants. Professional and business services was the next largest sector with a loss of 19,800, followed by manufacturing with a loss of 15,600. Only the education and health services sector has shown a minor gain of 700 jobs. In other words, almost no sector was spared and the losses have been devastating and deep throughout the economy. In fact, the pattern of job losses was similar throughout Southern California, with the Inland Empire suffering proportionately more in the construction sector.

As is typically the case in any recession, not all the sectors of the economy were hit equally. For example, as shown in the accompanying table, construction – which made up 6.4% of Orange County's total payroll employment in early 2008 - lost 16.4% of the 115,000 total jobs that were eliminated. Professional and business services, the largest industry cluster with 18.1% of the total job share, suffered a 17% loss, roughly in line with its share of employment. However, retail trade employment was responsible for almost a quarter of the job losses (23.9%) while making up only 11.3% of the total employment base. Education and health services, 9.7% of total employment, was the only sector with a small gain (700).

FIGURE 13
Orange County Payroll Employment Changes
(Year-to-Year)



Orange County Job Losses		
Orange County	Share in Total Employment	Share of Total Loss
Total Non-farm	100.0%	100.0%
Construction	6.4%	16.4%
Manufacturing	11.7%	13.6%
Wholesale Trade	5.7%	7.6%
Retail Trade	11.3%	23.9%
Information	2.0%	3.0%
Financial Activities	7.8%	8.6%
Professional & Business Services	18.1%	17.0%
Educational & Health Services	9.7%	-0.6%
Leisure & Hospitality	11.5%	0.2%
Government	10.7%	9.4%

Taking a closer look at the construction sector, since it has been one of the most significant sectors both in our region and nationally, an interesting fact emerges about its relative decline. Construction's share of total employment in Orange County has fallen from 6.4% to 5.6% in this recession (January 2008 - August 2009). Nationally, the decline was from 5.4% to 4.6%, and for Southern California from 5.1% to 4.3%. But in terms of total jobs lost, construction has made up 20.6% of the national job loss and a relatively smaller proportion of 16.4% for Orange County and 13.4% for Southern California. In other words, as important as construction is viewed to be to Southern California, in this recession the decline in construction employment has been

Construction, along with the high-tech, leisure and professional and business services sectors, make up the most significant clusters in Orange County. ...while the construction sector declined by the largest amount, other sectors...were also hit very hard...

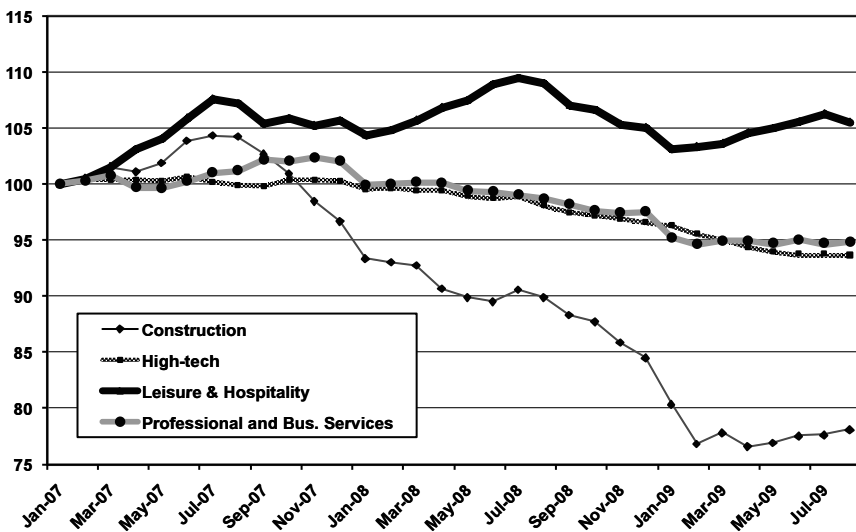
proportionately larger nationally than in our region. The Inland Empire suffered relatively more because of its heavier dependence on the construction sector. The job losses in Riverside and San Bernardino counties in the sector were 21.5% of the total losses and the industry's share fell from 8.1% to 6.3% in total employment.

Loss of Construction Jobs				
	Share of Construction Employment in Total		Loss as % of Base Construction Employment	Loss as Share of Total Payroll Job Losses
	Dec 07	Aug 09		
US	5.4%	4.6%	-19.0%	20.6%
SC	5.1%	4.3%	-21.9%	13.4%
OC	6.4%	5.6%	-19.2%	16.4%

Construction, along with the high-tech, leisure and professional and business services sectors, make up the most significant clusters in Orange County. A closer look at this four-sector group, as shown in Figure 14, reveals that while the construction sector declined by the largest amount, other sectors such as high-tech, professional and business services and leisure industries were also hit very hard, albeit with a slower pace of job losses.

The unemployment rate in Orange County during this recession from the end of 2007 to August 2009 has risen from 4.2% to 9.6%, in the U.S. from 4.9% to 9.7%, and in Southern California from 5.5% to 12.5%. The long and deep recession has led many discouraged workers to drop out of the labor force. As is true nationally, the actual unemployment in Orange County and Southern California is even higher than the official estimates indicate. The unemployment rate is unevenly distributed, with younger, unskilled population experiencing much higher rates.

FIGURE 14
Orange County - Major Sectors' Employment Trends



Housing and Finance

Housing markets all across have been at the center of this downturn. Orange County was the first place where signs of trouble appeared with the fall in the fortunes of mortgage companies such as Ameriquest and New Century. After reaching a high of \$743,000 in April 2007, the median price for a detached single-family home in Orange County, according to the California Association of Realtors, fell to a low of \$423,000 in January 2009. It has recovered to \$500,000 in July 2009 (Figure 15). The lowest median price of \$423,000 recorded in January of this year was previously reached in December 2002. In other words, over 75% of home price appreciation that occurred from December 2002 to April 2007 was completely wiped out in the 18 months from April 2007 to January 2009.

To be sure, the rate of home price decline in year-over-year terms in Orange County shrank to -6.9% in July 2009 from a high of -32.9% in November 2008. The trend is

evident in other Southern California counties as well (Figure 16). San Bernardino and Riverside counties experienced much sharper declines, but there, too, the rates of depreciation appear to be moderating. The data for last several months, however, is suspect because a large number of transactions were for foreclosed properties. Unfortunately, this trend will not end soon since a substantial re-setting of variable mortgage rates in 2010, the end of governmental support, and continuing economic distress will bring forth more foreclosures for quite some time.

After declining to a historic monthly low of under 600 in January 2008, the sales of detached single-family homes in Orange County have recovered to almost 2,000 units per month in August 2009. Even

though a lot of this activity is tied to foreclosure sales, it is an indication of insatiable household/ investor appetite for housing in the County. We expect for this healthy growth to continue well into 2010 in Orange County as well as the whole Southern California region in the present conditions of low mortgage rates and continuing foreclosure activity.

Housing permits in Orange County took a steep tumble, dropping -55.4% from 2007 to 2008 and by another -54% from 2008 to 2009 on an annual basis. The declines were much larger in Riverside and San Bernardino counties, but less so in Los Angeles county (see tables at the end of the report).

Non-residential construction in Orange County fell by -28.2% from 2007 to 2008 and is declining at an annual rate of -52.3% in 2009 compared to 2008 (Figure 17). During the period of 1995 to 2006, nonresidential construction in Orange County had been increasing at an average rate of 16.5%. This includes a slight contraction during the 2001-02 recession. But this average rate is well above other economic indices that measure the rate of growth for the county.

FIGURE 15
Orange County Median Price - Single Family Existing Homes
 (Source: California Association of Realtors)

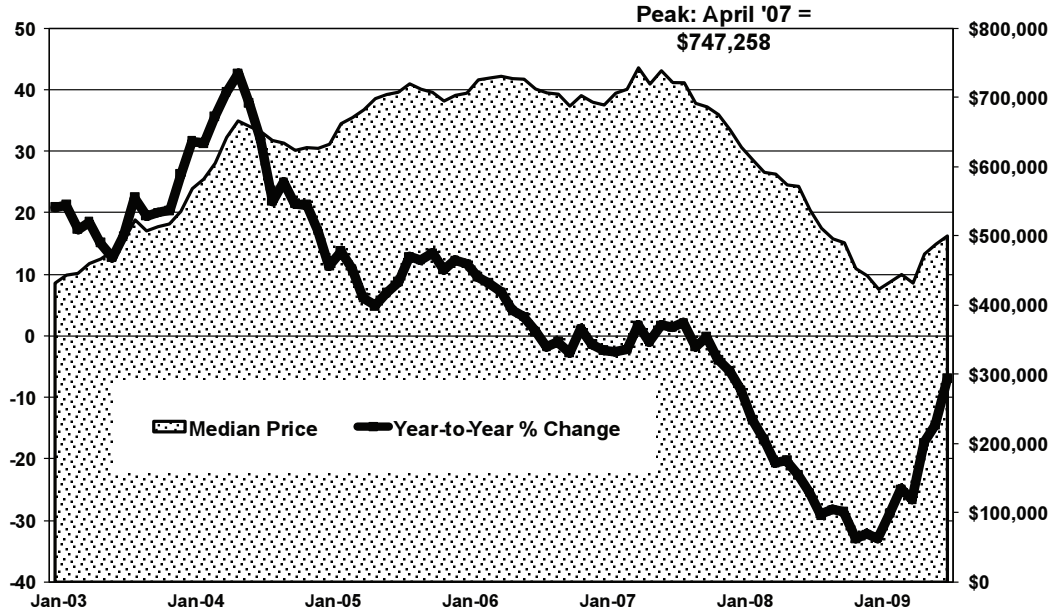
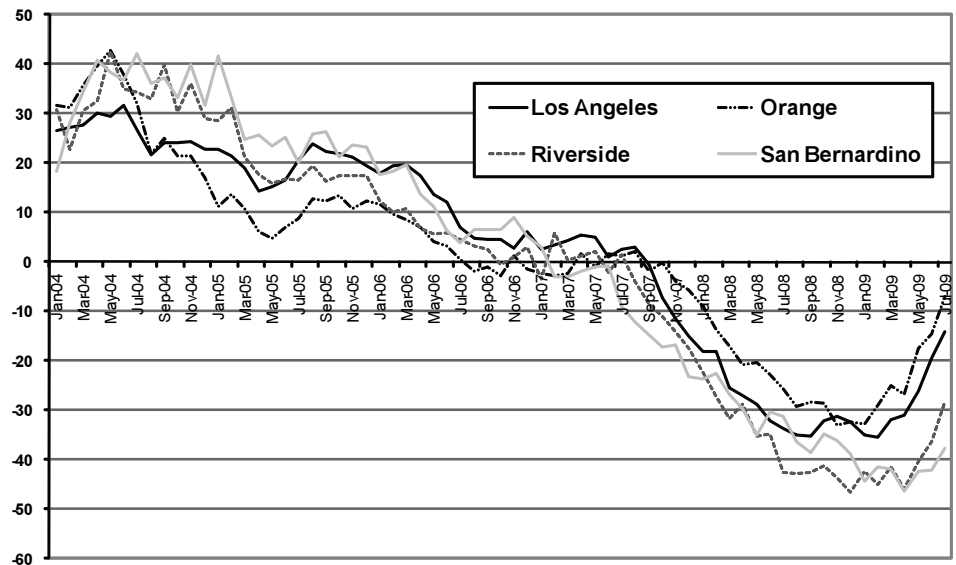
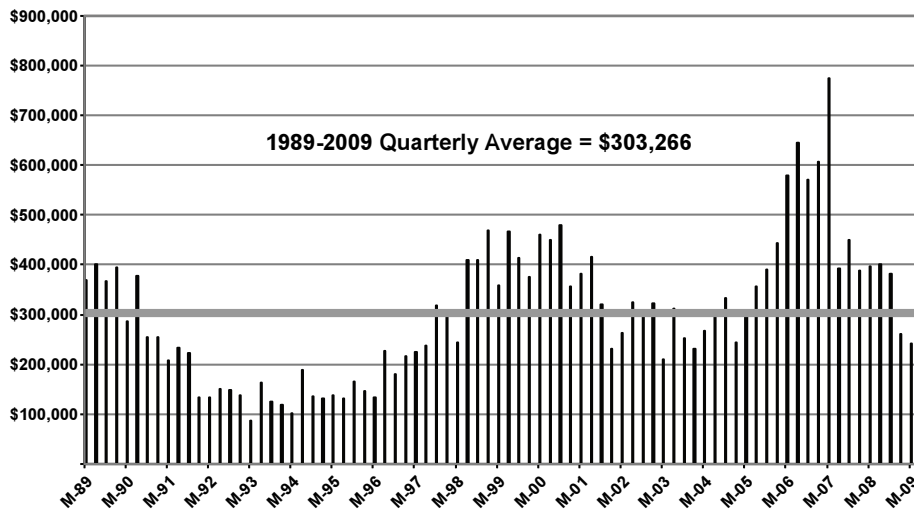


FIGURE 16
Median House Price Change
 (Percent, Year-over-Year)



The current financial crisis is now centered on an expected sharp decline in the commercial property sector where financing has become extremely difficult to obtain. The unwinding of toxic assets by banks in the coming year will put substantial strain on their pricing. Any recovery in the commercial real estate is expected to occur much later than in the rest of the economy.

FIGURE 17
Value of Non-Residential Construction - Orange County



As our analyses and forecasts for the nation point out, while the economy is beginning the process of recovery from the deepest downturn since the Great Depression, the prognosis for improvement is guarded.

The financial services sector has shrunk dramatically in Orange County over the last three years. From a high of 138,000 employees in 2006, the sector now employs 108,000. Two-thirds of these 30,000 job losses occurred in the credit intermediation category that includes mortgage, banking and related services. It is highly unlikely that these jobs will be coming back to this sector any time soon.

A looming state budget crisis continues to add to the economic woes of the state. The national recession is, of course, partly responsible for the dire financial

status of California governments, but structural imbalance between revenue and spending with several mandated items has added to the budgetary complications. All levels of government have laid off workers and furloughs are cutting into work hours and incomes. There is little likelihood of an early resolution of the situation and it will be a continuing drag, even if the national picture improves, on the state's recovery for at least the next two-to- three years.

Orange County and Southern California Forecasts

As our analyses and forecasts for the nation point out, while the economy is beginning the process of recovery from the deepest downturn since the Great Depression, the prognosis for improvement is guarded. We believe that in Orange County and Southern California, as in the nation, preliminary signs of the end of major negative trends are evident such as in housing and finance sectors. The slide in economic activity as measured by indicators of production is almost over. Yet, any significant growth, especially in employment, is some time away, most likely in the second half of 2010 or early 2011.

The Institute for Economic and Environmental Studies at Mihaylo College conducts quarterly survey of business expectations. Its latest survey for the 4th quarter of 2009 indicates a definite upward trend, following three previous positive readings, in business executives' sentiment for improvement in the overall economy as well as their own businesses. The overall improvement in the region's expectations is also consistent with that of other national surveys (Figure 18). The Orange County Business Expectations (OCBX) index survey has correctly predicted changes in the county employment in the past, and there is some indication that it will do so in the current situation as well.

We expect a slowdown in job losses into early 2010 and then a small improvement in the second half. For Orange County, we expect the county will lose approximately 58,300 payroll jobs in 2009 for a -3.9% loss. Regionally, Southern California is expected to lose 278,000 jobs for a 3.9% loss. The losses in Los Angeles County are expected to be 147,000 or a -3.6% loss, Riverside and San Bernardino Counties 60,400 or a -4.9% loss in 2009 (Figure 19).

Small growth, about half of the average increase, in payroll jobs is expected in Southern California in 2010.

Orange County payroll gains will be approximately 9,900 or a 0.6% increase on an annual basis in 2010 and 24,200 for a 1.7% increase in 2011. The unemployment rate in the County is expected to come down to 8% in 2010 and 6.2% in 2011. Details for other counties are provided in the tables at end of this report.

FIGURE 18
Orange County and U.S. Business Expectations

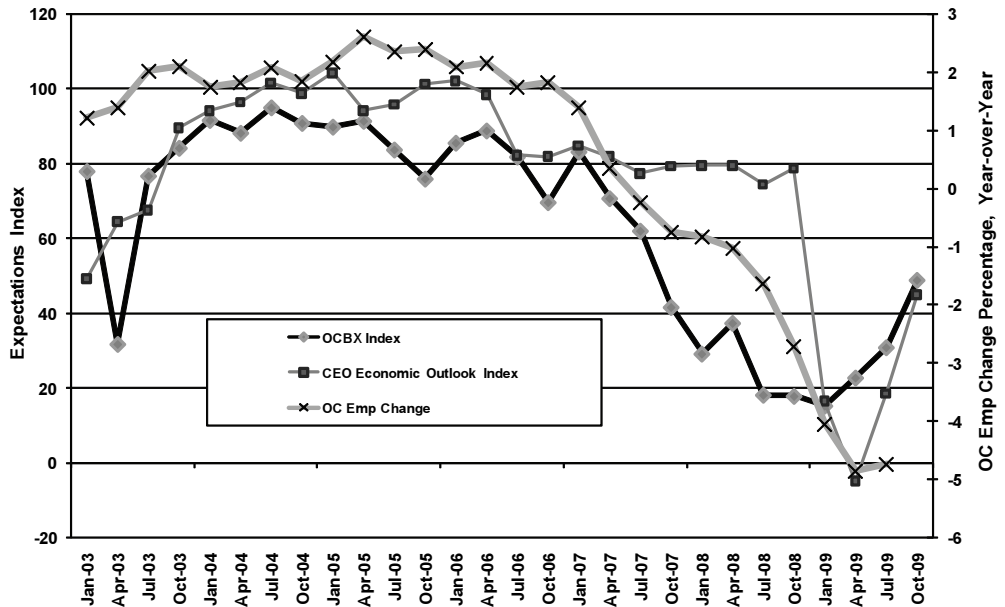
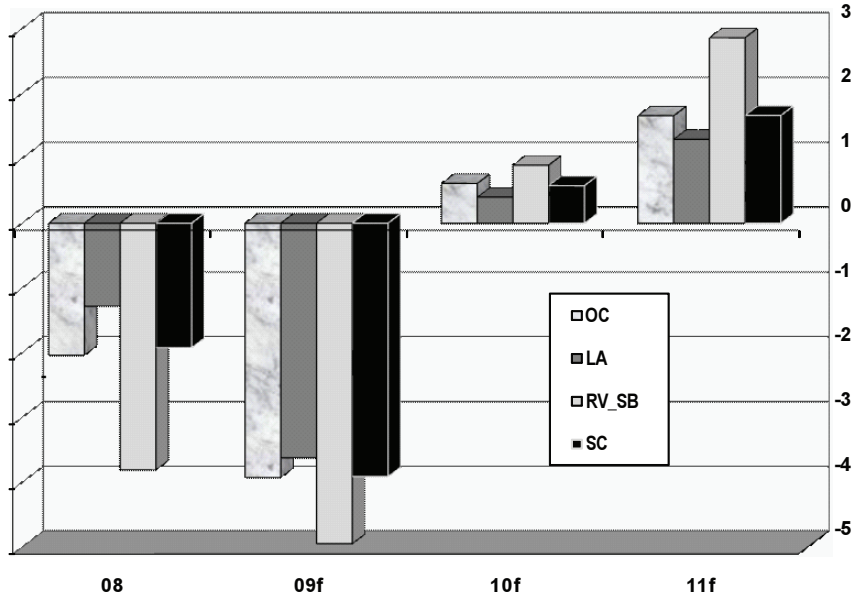


FIGURE 19
Orange County and Southern California Forecasts
(Percentage Change in Payroll Employment)



Robert Giuliano's expert assistance is gratefully acknowledged.

Any errors are the authors' responsibility. For historical data, data by county and surveys, contact Karen Emas