



Anil Puri & Mira Farka

CSUF Economic Outlook and Forecasts Quarterly Update

U.S. Economic Outlook and Forecasts

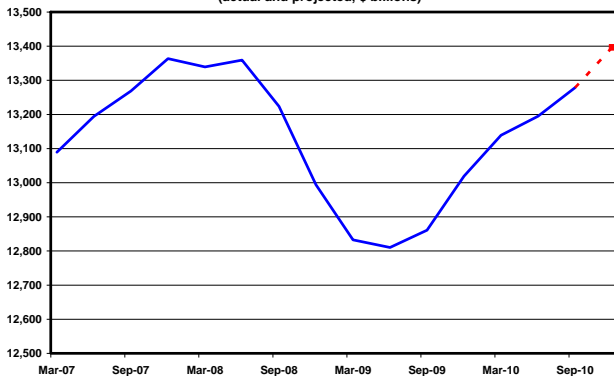
The national economy has improved since our last October 2010 forecast, with the recovery gaining traction and speed during the last two months of 2010. In fact, the strong year-end may be viewed as a turning point. This momentum is expected to carry over in the current year: the outlook for 2011 is now brighter than previously anticipated though the progress will be fraught with significant headwinds. The two-tier recovery is expected to persist with exports and capex leading the economic cycle, final demand and production supporting it and housing and cuts in state and local government spending restraining the growth. The combination of these forces implies a moderate recovery (below-trend compared to other recovery phases), but the more upbeat outlook suggests that the rebound is now more secure, the uptick in growth faster in 2011, and that the transition phase from non-fundamentals (the inventory cycle and government support) to fundamental forces (business and consumption spending) has currently reached a more advanced stage.

Recent economic indicators on production and spending have issued encouraging signals over the past two months. Consumers appear less hesitant to spend, business investments in equipment and software continues to post solid gains, and production indicators point to a broader sectoral growth during the next few months. An additional impetus over the near term is expected to come from the broad-reaching agreement reached late last year over taxes and unemployment benefits with the two-year extension in tax cuts, a one year two percentage point decrease in Social Security payroll taxes and a 13-month extension in

unemployment benefits. However, the positive impact of these developments could be blunted by challenges that remain ahead: the labor market continues to be weak, the housing market remains strained, state and local budgets are in shambles, gains from federal tax cuts may be partially offset by tax increases at the state and local level, and financial markets may experience renewed shocks from the European sovereign debt crisis, geopolitical turmoil in the Middle East, and domestic municipal market. The deteriorating geopolitical situation in Egypt carries unpredictable risks for the economy.

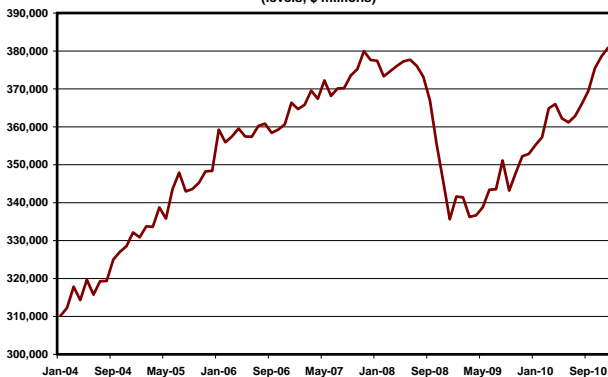
Real GDP and economic activity. After growing at a barely above-stall speed of 1.7% in Q2 2010 and a slightly more encouraging 2.6% in Q3 2010, advance data on real GDP show a more significant gain of 3.2% in Q4 2010 (Figure 1). In fact, recent economic indicators on production have issued decidedly more upbeat signals which indicate that this trend is likely to continue early in 2011: the Institute for Supply Management (ISM) manufacturing survey has posted advances for four straight months, the non-manufacturing activity survey has reached its highest reading since May 2006, industrial production has picked up speed after tapering off in the summer, and new orders showed renewed strength in the latest reading. We anticipate an RGDP growth rate of 3.3% in Q1 2011. Overall, the economy is expected to grow by 3.0% in 2011 and 2.9% in 2012.

Figure 1
Real GDP Level
(actual and projected, \$ billions)



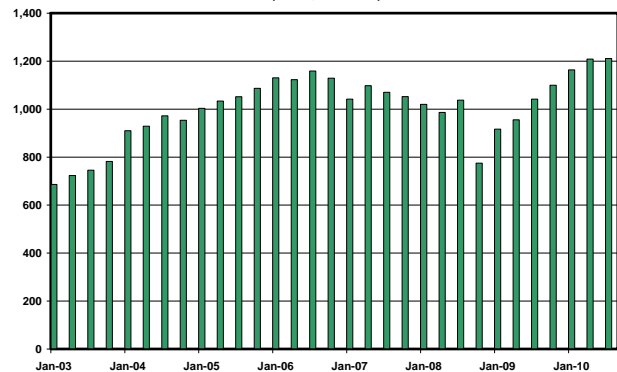
Consumption Spending. Consumer spending has strengthened over the past few months rising by an annual rate above 3% between the period from June to November. After a summer-time drop of 1.3%, retail sales have posted six consecutive months of gains, reaching fresh new highs in December 2010 (Figure 2). Consumers were more willing to spend during the holiday shopping season as evidenced by a decrease in the personal savings rate, from 6.3% in June 2010 down to 5.4% in December. Consumer spending should continue to strengthen over the year, buoyed by the recently enacted tax package, improvements in household wealth through rising stock prices, a lower debt to income ratio, and falling loan delinquency rates. As such, while consumer spending may not be a primary driver of the expanding recovery, it is expected to help shoulder some of the progress ahead.

Figure 2
Retail Sales
(levels, \$ millions)



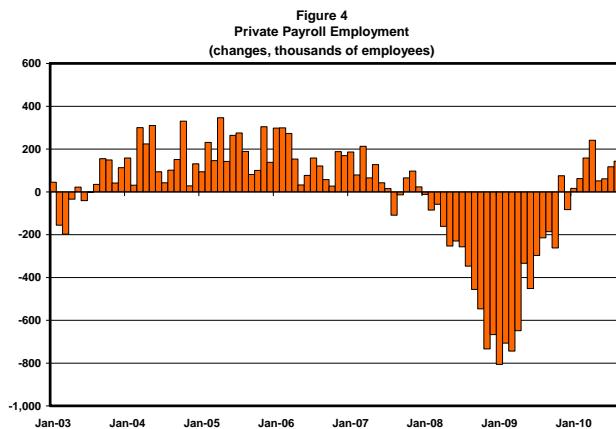
Business Sector. Business investments in equipment and software, which turned up sharply in the early phase of the recovery has continued to remain solid throughout 2010. Business fixed investments rose by 8.2% on a year-over-year basis in Q3 2010, up from 5.2% in Q2 2010, whereas investments in equipment and software increased by 18.7% (year-over-year), up from the 15.7% growth recorded in the second quarter. Corporate profits are currently at historically high levels, having risen by an average of 23% (year-over-year) during the first three quarters of 2010 (Figure 3). Large firms are especially well positioned to expand both investment and employment once they feel confident that the recovery is on a stronger footing. While credit conditions have also improved noticeably for small businesses, additional firming of final demand is needed before these firms expand operations.

Figure 3
After Tax Corporate Profits
(levels, \$ billions)



Labor Market. The outlook for the labor market is more cautious and while the employment situation will continue to improve, the pace of recovery will be sluggish. Job gains began to appear early in 2010, but the initial momentum – none too powerful to begin with – started to fade in the summer. The headline numbers have been harder to read because of the ebb and flow in the temporary Census employment. During 2010, private payrolls added only 1.3 million

jobs which is far below the 4.7 million jobs that were lost in 2009 (Figure 4). Moreover, at a 112,000 average pace of job creation per month, the 2010 data has fallen short of keeping up with the natural expansion of the labor force, which has left the unemployment rate at a stubbornly high level during this period. As the recovery continues, the pace of job creation should increase at a faster clip in 2011, averaging around 165,000 jobs per month. The unemployment rate is projected to decline gradually over the next two years and remain above 9% for most of 2011, reaching 8.9% towards the end of the year.



Housing. The housing market continues to remain a troubled spot and is expected to restrain the speed of the recovery in 2011. Housing imbalances persist, home prices have shown further weakness, mortgage credit is tight, and housing activity remains low. Although an outright free-fall seems to be well behind us, we expect housing to show persistent signs of weakness in 2011. Despite a temporary uptick in spring as homebuyers lock in low mortgage rates, home prices and sales should trend lower for the year, shedding an additional 5% from current levels. The commercial real estate sector will also remain anemic and while commercial property prices seem to have stabilized, significant time will be required to absorb the large amount of vacant office and commercial

space before we see any meaningful increases in construction in this sector.

Inflation. Inflation has generally trended lower during the year reflecting the moderate pace of the recovery and ample slack in resource utilization. The consumer price index (CPI), which includes both food and energy prices averaged 1.7% during 2010, whereas core inflation (which excludes volatile prices such as food and energy) posted a meager 1% increase for the year, down from the 1.7% rate recorded in 2009. Recent data indicate a significant uptick in commodity, energy and food prices which has escalated even further with the current events in the Middle East. Overall, inflation should remain contained over the forecast horizon, bottoming out and gradually rising over the course of the year. We expect headline inflation to rise by 2.0% in 2011 and by 2.2% in 2012. In the long run, whether an escalation in prices is ultimately avoided will depend on the ability of the Federal Reserve to reduce excess liquidity in a timely manner.

Financial Sector. The financial sector has continued to recover during 2010: banks continue to repair their balance sheets, lending conditions have shown signs of improvement, and after a mid-year reversal, equity markets soared by 22% to fresh new-highs since August 2008. Though lending standards continue to remain tight particularly in the mortgage markets, we expect a slight improvement in lending practices as banks grow more confident with the pace of the recovery. We also anticipate a slow but steady unwinding of the cash stockpiling by the banking sector as capital accumulation transitions into capital deployment, leading to consolidations and new acquisitions. Capital markets are expected to show renewed strength, but this may be moderated to a certain extent by weak demand for loans and regulatory pressures from the recently enacted financial reform. In addition, the financial sector will remain remarkably vulnerable to adverse developments in the domestic municipal markets and

renewed concerns about the European sovereign debt crisis.

Government Sector. The recent \$858 billion tax compromise passed in December is expected to bolster US GDP growth in 2011, partly at the expense of 2012. For the current year, the tax deal is expected to add 0.7 percentage points to growth with the biggest impact coming from the 2% decline in payroll taxes and the full expensing of business investment outlays. The expiration of these two provisions at the end of 2011 however, is expected to detract around 0.4 pp from growth in 2012. Some of the federal stimulus will also be offset at the state and local level where officials are planning dramatic spending cuts and even tax hikes. Faced with high unemployment and tame inflationary pressures, the Federal Reserve will keep rates on hold through 2011 and complete the second round of quantitative easing (QEII) by the end of the second quarter.

horizon, though concerns remain about Eurozone's strength, potential spillovers from peripheral economies (Greece, Portugal, Ireland) to main ones (Spain, Italy) and the deteriorating conditions in Egypt and the Middle East. US exports are currently running at their highest levels in more than two years; this trend is expected to continue in 2011 with the global recovery on track and a relatively weaker US dollar. Net exports are likely to provide a significant boost to real GDP particularly in the first half of 2011.

Global Economy. The global economy seems to have ended the year in a positive note with most economies posting solid growth rates in the second half of 2010. Economic activity has slowed down a bit recently, with growth stabilizing at a sustainable path. Expansion abroad should continue over the forecast

National Forecasts					
Year	RGDP	Consumer Prices	Unemployment Rate	Payroll Employment	Federal Funds Rate
2007	1.9	2.9	4.6	1.1	5.02
2008	0.0	3.8	5.8	-0.6	1.92
2009	-2.6	-0.3	9.3	-4.3	0.16

2010	2.8	1.7	9.6	-0.5	0.18
2011	3.0	2.0	9.2	1.0	0.22
2012	2.9	2.2	8.6	1.7	0.62

Southern California and Orange County

The Southern California region and its six counties (Orange, Los Angeles, Riverside, San Bernardino, Ventura and Imperial) have begun to emerge from the deepest recession since the 1930s, albeit the pace of the recovery is painfully slow. Based on the official data available since our October 2010 forecast and our in-house surveys and analysis, we believe that the prospects for growth for the broader region and for Orange County in particular, have improved.

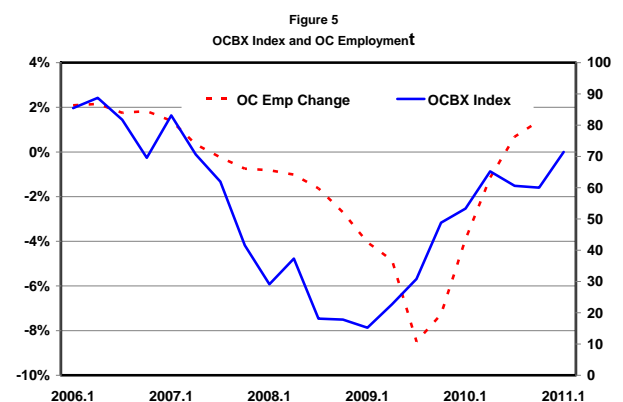
Employment. The unemployment rate for the region in December 2010 stood at 12.4% compared to 12.6% in September at the time of our annual forecast. On a yearly basis, the unemployment rate for 2010 was 12.4% compared to 11.5% for 2009. Unemployment rose despite the fact that the labor force shrunk by

155,000 people during this period as discouraged workers dropped out of the labor force given the lack of employment opportunities. In Q4 2010, the labor force for the region continues to be on a downtrend.

Orange County’s unemployment rate was 8.9% in December 2010, significantly below the 9.6% rate in September 2010. On an annual basis, the average unemployment rate for 2010 was 9.6% compared to 9.8% in 2009. Labor force patterns, however, similar to the broader Southern California region, are on a downtrend in the County, reflecting a disappointing

employment picture. In fact, the improved headline unemployment rate can be viewed simply as a statistical artifact since most of the decline can be accounted for by a reduction in the labor force rather than healthy employment trends.

Payroll employment data - a more reliable indicator - show that the Southern California region lost a total 202,700 (-3.1%) jobs in 2010 compared to 2009. Recent monthly data, however, indicates a slightly positive trend over the last four months of 2010 with a total gain of 94,000 jobs (1.5%) from September to December 2010. Similarly, though Orange County lost a total of 10,700 in 2010, it appears to have gained 15,000 jobs between September and December 2010. The trend in employment growth, in other words, has



turned positive in the last quarter of 2010. Most of the gains occurred in retail, financial, professional services and education. Unfortunately as anticipated in our previous forecasts, the construction sector, continues to shed jobs.

Currently, our outlook for employment in the County is slightly more upbeat than in our October 2010 report. In addition to the general improvement in the national economy, OCBX index -which anticipates future trends in the County’s economy based on a quarterly survey of the local business executives - has shown significant improvement (Figure 5). The OCBX index has been a reliable predictor of the two-quarters ahead payroll job growth for the County. Based on the improvement in the OCBX index in Q1 2011, we expect county employment growth to accelerate towards the end of the second quarter 2011. We are raising the forecast for Orange County payroll growth to 1.44% (compared to 1.25% in October 2010), for an overall gain of 20,000 in 2011.

Housing. Conditions in the housing market are improving in Southern California even though the latest data has not revealed the full extent of the improvement. Foreclosures continue to hobble the market and will remain a major source of concern

given issues in foreclosure proceedings. Sales activity is supported by low mortgage rates (though these are slightly up from rock-bottom levels), and this trend is expected to continue into the current year. Housing prices, however, are in a holding pattern and will continue in that range well into 2012. The median housing price for existing single family homes in Orange County stood at \$502,200 in November 2010 compared to \$499,600 in August 2010

