

# U.S. Economic Upturn Continues; State's Economy Weak, But Signs Point Up

## U.S. Economy

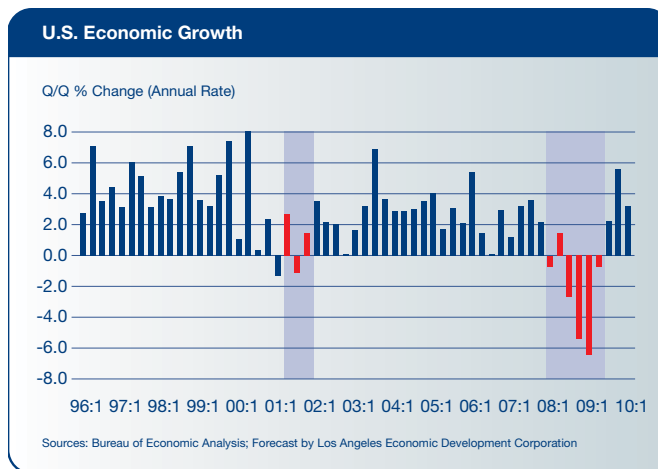
Many economic statistics for the nation have turned up during the last three to six months, a welcome improvement over last winter and spring. Reflecting the underlying trends, the government's preliminary estimate of gross domestic product (GDP) in the first quarter came in at a +3.2 percent annual rate, after a +5.6 percent uptick in the fourth quarter.

Progress was widespread in the first quarter, but not universal. Consumer spending, business investment in equipment and software, exports and federal government spending all increased. Collectively, they contributed +4.1 percentage points to first quarter GDP growth. Private-sector inventories actually grew by \$31 billion last quarter, the first uptick in two years. This change had the effect of adding +1.6 percentage points to the economy's growth rate.

On the downside, however, higher imports, lower spending by state and local governments, reduced business spending for non-residential structures and lower residential investment sliced -2.5 percentage points from GDP growth last quarter.

As shown in the chart, final domestic demand (which includes spending by U.S. consumers, business firms and all levels of government, but excludes changes in inventories and net exports) was up by +1.2 percent last quarter compared with first quarter 2009. This increase was the largest since late 2007 and marks the economy's continued improvement after a very deep downturn.

Other economic news has been more mixed. After declining for nearly two years, non-farm payroll employment across the nation has shown signs of stabilizing recently, rising twice in three months during the first quarter. Even so, the recessionary losses have been severe. By March 2010, the cumulative loss in employment was -8.3 million jobs.



The biggest job losses were in manufacturing, construction, professional and business services, especially temporary help services, and retail trade. These four sectors together accounted for about four-fifths of the drop-off in total employment.

There also have been significant employment declines in information (especially publishing), transportation, wholesale and retail trade, and in the real estate and financial sectors. Meanwhile, the nation's unemployment rate, which peaked at 10 percent in fourth quarter 2009, edged down to 9.7 percent during first quarter 2010.

Not surprisingly, consumer sentiment continues at very low levels. Weak consumer confidence reflects the current poor labor market conditions and continued anxiety about the personal impact of the recession.

### Zero Inflation Rate

In a bit of positive news, recent trends on the inflation front have continued generally favorable outside of energy. Excluding food and energy, consumer inflation rates are running near 0 percent. Crude oil prices, while volatile, have ranged around \$85/barrel lately, nearly twice the level of early 2009. In California, regular gasoline is hovering around \$3/gallon.

Concerns about the nature of the recovery have replaced recession worries

as incoming monthly information turned increasingly positive.

The California Chamber of Commerce Economic Advisory Council applauds the improvement in economic activity, but remains wary about the fundamental strength of the upcoming recovery once the impacts of expansionary monetary policy and federal stimulus programs begin to wind down.

In addition, past recoveries have been slowed by financial industry restructuring. Some caution about the recovery still seems appropriate.

### Interest Rates/Financial Markets

While it acknowledges the economic recovery is under way, the Federal Reserve's main concern continues to be low levels of resource utilization (i.e., high unemployment rates and low capacity utilization). The Federal Open Market Committee shows no inclination to raise rates soon from current rock-bottom levels despite the improving economic situation.

Meanwhile, the Fed has wound down most of the specialized facilities created during the financial crisis. The remaining issue concerns when and how to dispose of the Fed's huge portfolio (\$1.25 trillion) of mortgage-backed bonds.

Conditions in many parts of the credit markets have improved markedly. Corporate and emerging market bond spreads have narrowed, leading firms and nations to issue large volumes of new debt. Despite the progress being made, capital market participants remain skittish, as shown by their reaction to the troubles of some European nations.

Outside of the capital markets, credit conditions for households and small-to-midsize business firms still remain tight. Households and firms face strict credit quality constraints when they apply for new mortgages and business loans from commercial banks.

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Indeed, banks' consumer and commercial bank loan balances are decreasing. Many non-money-center banks are wrestling with delinquency problems and consequently are reluctant to take on additional risks.

The Advisory Council's prognosis: The financial situation has improved significantly, but it's unclear when the central bank will be able to return to traditional policymaking.

### California: Still Weak, But Signs Point Up

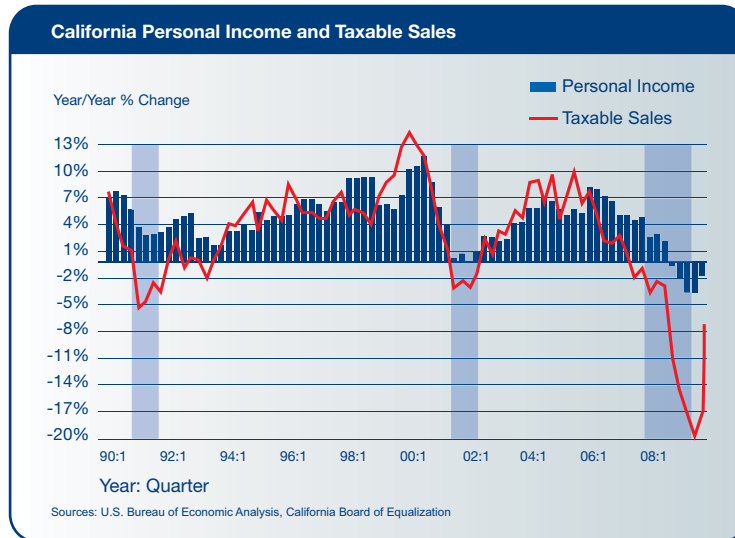
California's economy began to see some positive signs during the last quarter, though not in labor markets. The state lost an estimated 1.37 million non-farm jobs during 2008 and 2009, a most distressing figure. About 10,000 more jobs disappeared in the January-March quarter, but this was the smallest quarterly loss since late 2007.

California's unemployment rate was 12.5 percent during first quarter 2010, compared with 10.2 percent a year earlier and the cycle low of 4.4 percent during first quarter 2007. Recent jobless rates were the highest since before World War II.

Other broad-based indicators paint a somewhat less gloomy picture. Personal income earned in California decreased by 1.5 percent during the fourth quarter of 2009 compared to fourth quarter 2008 (latest data available). This marked the fifth consecutive quarter of decline, the first sustained drop in personal income since quarterly data were recorded. Problems in the state's construction, manufacturing and finance sectors accounted for much of the drag on the state's earnings growth.

Taxable sales sagged markedly in the recession, plunging by about -15 percent during 2009. The estimated year-to-year decline, however, halved during the fourth quarter, a sign of progress.

Though data are sketchy, sales declines have been most severe for California's motor vehicle dealers, furniture stores and building materials



dealers. The dollar value of taxable sales appears to have hit bottom in the second quarter of 2009 and turned up during the second half of the year.

Similarly, the level of personal income may have troughed in the third quarter. Both figures are still subject to revision, however.

Probably reflecting the changing economic momentum (and conservative revenue forecasts), tax receipts have been coming into the General Fund faster than expected.

For the nine months ending March 2010, tax revenues were about \$2.3 billion better than expected, bolstered by higher receipts of the major taxes. In addition, government disbursements ran \$572 million below expectation over this period, meaning the General Fund's deficit (receipts less spending) was \$2.8 billion smaller than expected.

California is not yet out of the woods, however, as the state still faces a chronic budget gap. Some caution about the budget situation still seems to be warranted.

Employment may finally have reached bottom in California, as non-farm job counts in March were 32,000 higher than December (on a seasonally adjusted basis)—a welcome sign. The state lost a total of -443,000 non-farm jobs over the 12 months to March, however, with most industries reporting negative results.

On the plus side, the only major sectors with higher job counts were

private educational services, health care services and the federal government. Job counts fell in all other major sectors.

Employment declined the most in California's construction, manufacturing, retail trade, state and local government, professional, scientific and technical services, retail trade, and leisure and hospitality sectors. Together, firms in these six industries reduced payrolls by about -332,000 workers, while other sectors reported smaller declines.

Exports of goods made in California increased by +16 percent in January–February

2010 after a sharp decline (-17 percent) during 2009. The largest category of exports—high tech manufactures (computers, peripherals and so forth) jumped by +23.6 percent in dollar terms. Exports of California agricultural products (farm produce, livestock and beverages) rose by +18.2 percent, while non-electrical machinery exports grew by +20.6 percent. Exports of other important California-made products also increased, including chemicals (+16.3 percent) and miscellaneous manufactures (up by a stunning +39.2 percent). Transportation equipment exports provided a negative note, decreasing by -17.5 percent.

### Metro Areas

Reviewing the state's major metro areas, regional employment trends continued weak in the first quarter of 2010, though most areas showed smaller job losses than in the previous quarters. All of the state's major metro areas continued to report significant year-to-year losses in non-farm employment.

Job losses were relatively moderate in two areas of the Central Valley—Stockton (-1.7 percent) and Modesto (-1.8 percent), followed by Bakersfield, Fresno and Sacramento (at -3.3 percent, -3.4 percent and -3.5 percent respectively).

Four Southern California metro areas—San Diego, Orange, Los Angeles and Ventura counties—reported losses of

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-2.8 percent or -2.9 percent. Employment declines were most severe (-4.5 percent) in Riverside-San Bernardino, however.

Bay Area performance ranged from San Jose (at -2.9 percent) to Oakland metropolitan statistical area (MSA) and San Francisco MSA (both reporting -3.9 percent).

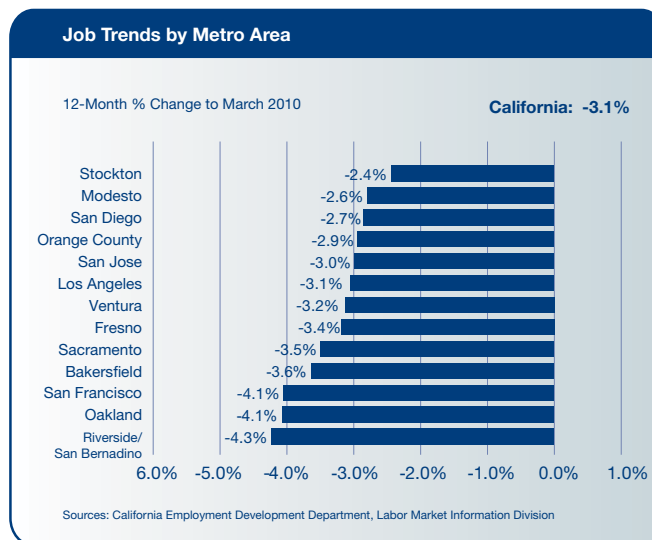
In the Bay Area during the first quarter, the level of employment edged up in the San Jose metro area, flattened out in the San Francisco area and fell more slowly in the Oakland area (using seasonally adjusted figures).

Compared with last year, construction activity has fallen around the bay, with job counts down by -11 percent (East Bay) to -20 percent (San Jose area). Retail trade jobs continued to decrease, especially in the East Bay.

Manufacturing job losses were smaller in San Jose, as several high tech manufacturers added workers in response to increased demand for their products. In the San Francisco area, travel and tourism indicators look better this year, with higher passenger traffic through San Francisco International Airport and increased hotel occupancies (though room rates have continued to fall).

Demand for temporary employees also has turned up throughout the Bay Area, an early signal of economic recovery. However, local schools and governments have reduced head counts.

Non-farm employment drifted upward across Southern California during the first quarter on a seasonally adjusted basis. Compared with early 2009, the downturns in construction and manufacturing combined with retail industry distress continued to generate employment losses across the region. Freight traffic through the area's ports has turned up strongly, with both exports and imports on the rise. The change has had an impact, not just on the ports themselves, but also on the transportation, wholesale trade and distribution centers of Los Angeles, Orange County and the Inland Empire.



The region's entertainment sector looks better this year. Domestic and international box office receipts for films have continued to increase. Also, entertainment companies are taking advantage of the state's new filming incentives to schedule productions in California.

In addition, television and cable producers have purchased a large number of new pilots and more commercials are being developed. Southern California also is seeing some progress on the tourism front, with occupancies up (though room rates are down).

Aerospace firms are stable for the moment. However, new U.S. Department of Defense proposals for fiscal year 2011 include declines in several procurement budgets of regional interest, which could have a mixed-to-negative impact on the region's key aerospace industry. Also, state/local employment is falling due to the tight budget situation.

### Agriculture/Resources

California's agriculture sector is seeing some improvement in early 2010 after a difficult 2009. Prices of several products have increased, including dairy, protein products, nuts, citrus and grapes. Demand for premium California-grown products is still soft, but beginning to improve.

California-grown agricultural exports increased by +18.2 percent in the first two months of 2010 over early 2009. Declining feed costs helped to mitigate

most concerns about farms' profitability.

Many California farms were forced to tap limited groundwater supplies in 2009 and had to reduce production. While winter precipitation has been normal across the state this year, the state's farms still face difficult decisions in the year ahead.

Water continues to be a serious concern everywhere in California. The recent string of dry years, up through 2009, left storage at very low levels in the state's water systems and the Colorado River area.

While the rainy season was better this last winter, the State Water Project and the Central Valley Project will have to restrict deliveries again in 2010, though perhaps not as much as in 2009. Water that must transit the Delta faces more cutbacks to protect fish. A package of water bills to help resolve the state's water problems, which requires \$11.8 billion in new bonds, is up for voter approval in November.

The supply of electricity in California should be adequate in the near-term, as industrial demand weakened markedly during the recession and will take some time to recover. Electricity prices are moving sharply higher, however, reflecting the utilities' costs associated with mandated investments to reduce their environmental footprints and to improve their distribution networks.

### Real Estate/Construction

Existing home sales in California have been quite healthy (greater than 500,000 sales transactions, at an annual rate) since September 2008. Here are some recent statistics for the state's resale home market:

- Existing single-family home sales in California increased by +2.5 percent over the year to March 2010, while condo sales were up by +27.8 percent.

- Prices have stabilized or risen in many areas; statewide, the median price of single-family homes sold in March 2010 (at \$301,790) was up by +20.8 percent compared to March 2009.

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● The number of homes available for sale represented 5 months supply (at March's sales rate) compared to 5.6 months a year earlier.

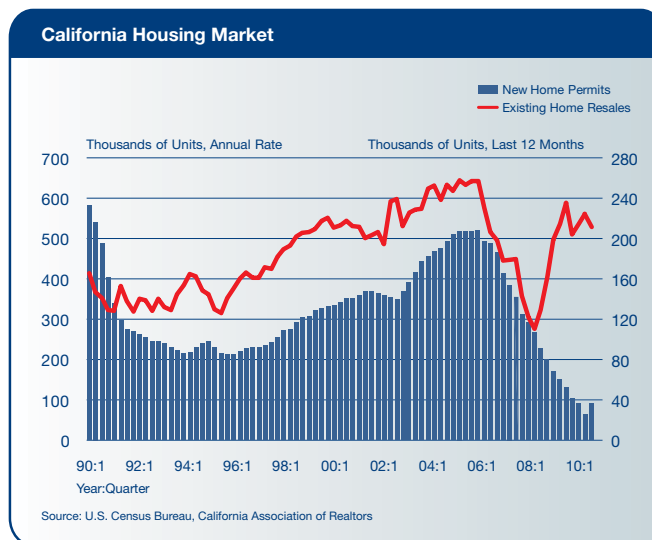
Several factors supported the housing market in the first quarter. Mortgage rates were relatively low, due at least in part to the Federal Reserve's purchases in the secondary mortgage market, which ended in March. In addition, the federal government offered temporary tax credits to encourage would-be homebuyers to act. This program ended in April.

The plunge in transaction prices means many home sales in California now fall inside the government housing agencies' conforming loan limits (up to \$729,750 in 2009), which increases the availability of mortgage loans to well-qualified buyers.

However, the outlook for home sales is uncertain. The end of the Federal Reserve's mortgage purchase program and expiration of buyer tax credits imply that demand for homes will weaken, at least for the next six months or so. On the supply side, mortgage defaults have continued to grow.

While the availability of foreclosed homes has declined in recent months due to banks needing more time to complete processing, the volume of distressed homes seems unlikely to shrink, though when lenders will bring these homes onto the market is uncertain. While the housing market environment looked favorable last quarter, significant further improvements in the pace of sales seem unlikely until the economy—and buyers' confidence—begins to revive.

**Residential construction activity** continued at very low levels across the state during first quarter 2010, though activity was higher than in all quarters of 2009, the low point for this down-cycle. Total housing permits were issued at a preliminary annual rate of 43,800 units during first quarter 2010, up by +28 percent from first quarter 2009. Single-family permits jumped by +34 percent, while multi-family permits rose by +22 percent over the year.



While any improvement is welcome, the current construction pace represents a drastic decline of -79 percent from the peak permit level of 2004. Furthermore, much of the surge of activity seen over the winter reflected builders' efforts to attract first-time buyers using federal tax credits. It's not clear how strong the underlying level of demand will be in the second half of 2010 after these programs have expired.

As construction collapsed, new home builders' inventories of unsold homes have shrunk noticeably, especially single-family detached units. Inventories of attached housing units (condominiums and apartments), however, are dropping more slowly. Finding buyers for all of the unsold condominium units will take a while longer.

Industry observers do not expect any significant improvement in new home construction before late 2010, with some areas not reaching bottom until a year later.

**California's commercial real estate markets** also have developed deep fissures. Specifically, availability rates have risen markedly over the last year, asking rents are falling, and external development funding has virtually disappeared.

The situation is most problematic for retail, office and industrial space. Retail sales declined sharply during the recession. Though sales turned up

late in 2009, several chains declared bankruptcy or closed down altogether, and this trend is expected to continue in the near term.

With most lenders unwilling to commit new funds for commercial real estate development, construction of new retail space has plunged. Even so, vacancies are surging and rents are dropping.

Most areas of California are experiencing high retail vacancies. The biggest problems appear to be in Riverside-San Bernardino and areas where large amounts of retail construction took place in recent years.

### Office Space/Vacancies

Demand for office space was mixed in the first quarter, as high vacancy rates continued to reflect weaker employment trends in most office-based industries. Many firms are still reluctant to hire new workers and are vacating or subleasing excess space. However, in some areas, office vacancy rates declined slightly in the first quarter.

In San Diego County, the average office vacancy rate was 20.4 percent in 1q10, compared with 21.1 percent during 4q09 and 21.6 percent during 3q09.

In San Jose, the rate declined to 18.6 percent after edging down to 19 percent (4q09) from 19.1 percent (3q09). In Oakland, the rate fell to 15.7 percent in 1q10 from 17 percent (4q09).

Meanwhile, in Ventura County, the rate also fell for the second consecutive quarter to 15.8 percent (4q09) from 16.5 percent (3q09) and 16.7 percent (2q09) [latest data available].

In the Inland Empire, office vacancy rates rose to 24 percent (after holding steady the previous quarter).

Vacancies also continued to rise in Sacramento (20.6 percent), San Francisco (17.6 percent) and Los Angeles (16.6 percent).

Orange County experienced a sharp increase—jumping to 26.9 percent during the first quarter from 19.9 percent (4q09).

Unsurprisingly, rents continue to weaken in most locations. Statewide, the

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value of new office construction permits jumped by +87 percent in first quarter 2010 compared with early 2009. However, the level of activity was very low, -72 percent below 1q2008. Though the office construction pipeline has nearly run dry, vacancies in most areas will likely continue rising until employment turns around.

Industrial vacancy rates also were on the rise during the first quarter, though construction activity grew by +129 percent from 1q09 (to a level still -47 percent below 1q08).

The lowest vacancy rates were in Los Angeles County, at 3.4 percent, followed by the East Bay, at 4.7 percent, and Orange County, at 7 percent.

Vacancy rates were highest in San Jose (15.2 percent), Sacramento (12.8 percent), San Diego (12.5 percent) and the Inland Empire (11.9 percent). These are areas where substantial new construction took place even as demand for distribution space dwindled during the recession.

The total value of non-residential building permits in California dropped by -7.3 percent during first quarter 2010 compared with early 2009. Permits for new buildings declined by -11.9 percent, while the value of alterations and additions (which are more often owner-financed) fell by -4.5 percent.

Several major metropolitan areas posted significant gains in total non-residential permit activity during the first three months of 2010 compared with the same period last year: San Francisco (+61.5 percent), Oakland (+48.1 percent), Sacramento (+39 percent), Ventura (+27.1 percent), Orange County (+15.1 percent) and the Inland Empire (+13 percent).

Lagging behind were San Jose (-33.5 percent), San Diego (-29.5 percent) and Los Angeles (-14.9 percent).

It is extremely difficult to obtain financing for most types of commercial real estate projects, so owner-financed projects will account for a larger share of activity than normal this year. These



are typically smaller projects, suggesting that non-residential permit values will continue at relatively low levels through much of 2010.

### Risks

Risks appear to be more balanced than in previous reports. The economy has just passed the bottom of a serious, lengthy recession, and the *level* of activity is still low. Uncertainty is high because we do not know yet what the recovery will look like.

One key risk would be renewed volatility in global capital markets. Central banks and governments around the world have poured trillions of dollars into their financial sectors. While the results are clear, markets are still fragile and easily upset (consider the recent reaction to disclosure of Greece's debt woes).

The financial industry's problems, however, won't be "cured" until loan problems are dealt with and capital ratios restored, not easy in such a weak economy. Another round of financial instability would cause many financial institutions to cut back on lending even further. Small and medium-size businesses would bear the brunt of this change because they rely heavily on commercial bank financing.

A second set of risks concerns the state's still-troubled housing industry.

The housing and residential real estate industries have been supported by several federal government programs that just ended. Mortgage rates could well increase just as home sales relapse. We simply don't know if the industry—already weakened after several bad years—will be strong enough to weather such a downturn.

There is an upside risk best described as "Optimism returns." Consumers and businesses have been worried about the economy and their own financial situations for more than two years now.

And yet the economy is definitely beginning to stir. Retail sales have improved and so have international trade flows. Industrial

production rates are rising, especially in the state's high technology sector, as businesses discover they've reduced their inventories too much and need more to support the current increase in their sales. Attitudes are beginning to improve right along with revenues.

Economic recoveries often begin slowly, and then run faster than economists project. The council would be delighted if this recovery follows such a path!

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*The California Chamber of Commerce Economic Advisory Council, made up of leading economists from the private and public sectors, presents a report each quarter to the*

*CalChamber Board of Directors. The council is chaired by Nancy Sidhu, vice president and chief economist, Los Angeles County Economic Development Corporation.*

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