

Downward Trend Slows in California While U.S. Economy Begins to Improve

U.S. Economy Turns Up

Many economic statistics for the nation turned sideways or up during the past summer months, a definite improvement over the dismal reports of last winter and spring. Reflecting the underlying trends, the government's initial estimate of gross domestic product (GDP) in the third quarter came in at a +3.5 percent annual rate, a welcome change following four quarters of decline.

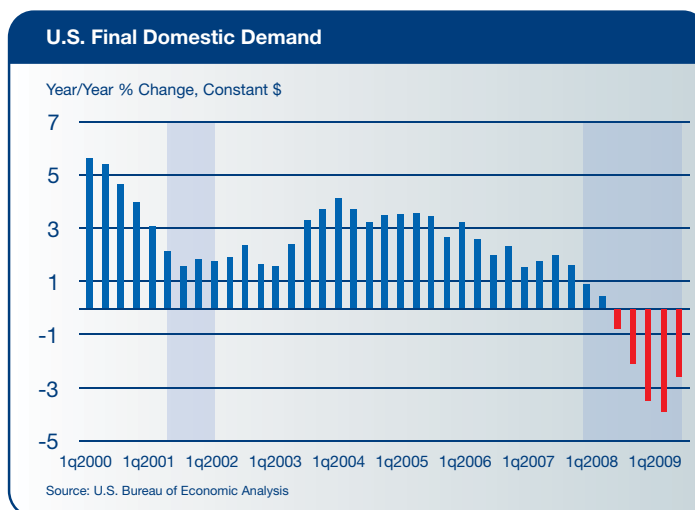
Progress was widespread in the third quarter, though not yet universal. Consumer spending, exports, residential investment and government spending all increased. Collectively they contributed +4.9 percentage points to third quarter GDP growth. Private-sector inventories were reduced by an estimated \$131 billion last quarter, a somewhat slower pace than in the spring quarter. This change had the effect of adding +0.9 percentage points to the economy's growth rate.

However, on the downside, reduced business spending for new plant, equipment and software and higher imports sliced -2.2 percentage points from GDP growth last quarter.

Domestic Demand Down

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 down by -2.4 percent last quarter compared with third quarter 2008. This performance continued the downward trend in place since summer 2007 and marked by far the worst five-quarter performance since quarterly GDP data became available in 1947.

Last quarter's decline was smaller than the previous three quarters, reflecting the economy's improving momentum. However, the 2008-2009 downturn was deep. Many months will elapse before the economic activity returns to its former level.



Other economic news has been mixed. Non-farm payroll employment across the nation has declined every month since December 2007, and the cumulative loss through October 2009 exceeded -7.3 million jobs.

Job counts have fallen most rapidly in construction, manufacturing and professional and business services, especially temporary help services. Indeed, these three sectors together accounted for 70 percent of the drop-off in total employment. There also have been significant declines in transportation, wholesale and retail trade, information (especially publishing), and in the financial and real estate sectors.

Meanwhile, the nation's unemployment rate moved up from 5 percent in December 2007 to 7.2 percent in December 2008 and then to 10.2 percent in October 2009, the highest level since April 1983 following the last deep recession.

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

Inflation Trends Favorable

In a bit of positive news, recent trends on the inflation front have continued

generally favorable. Excluding food and energy, consumer inflation rates are running at about 1.5 percent. However, energy prices, which had declined markedly from the highs set a year ago, increased over the summer. Recent crude oil prices have reached the \$75/barrel to \$80/barrel range, compared with under \$50/barrel in March.

In California, regular gasoline is priced around \$3/gallon, well below the mid-2008 peak of almost \$4.60/gallon, but above the \$2.20/gallon common this past spring.

Caution

Concerns about this recession have lessened markedly in recent months, as incoming monthly information turned from negative to mixed and sometimes positive. Indeed, the recession appears to have ended already in many industrial nations and developing countries. Accordingly, most economic forecasters have marked up their projections for 2009 and 2010.

The Economic Advisory Council applauds the improvement in the economic activity, but remains wary about the strength of the upcoming recovery. Many nations have experienced very steep declines in employment, domestic and export sales. In the past, such synchronous downturns have been followed by slow recoveries, especially when financial crises have occurred. Some caution about the recovery seems appropriate.

Interest Rates and Financial Markets

The Federal Open Market Committee (FOMC) has held the fed funds target within a range of 0 percent to 0.25 percent since mid-December 2008, about as low as interest rate policy can go. The Fed's main concern continues to be the weak economy, and the FOMC shows no inclination to raise rates soon despite the

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recent upturn. Conditions in some parts of the credit markets have improved, and demand for several of the Fed's specialized facilities is shrinking, as shown in the chart. Investors have been seeking higher returns in this low-rate environment, causing corporate and emerging market bond spreads to narrow. Bond issuance has increased markedly in recent months.

However, credit conditions for households and small to mid-size business firms remain tight. Most households and firms without access to capital markets still face credit quality constraints when they try to obtain new mortgages and business loans. The Fed continues to use its balance sheet to support the functioning of those credit markets that are not yet functioning properly.

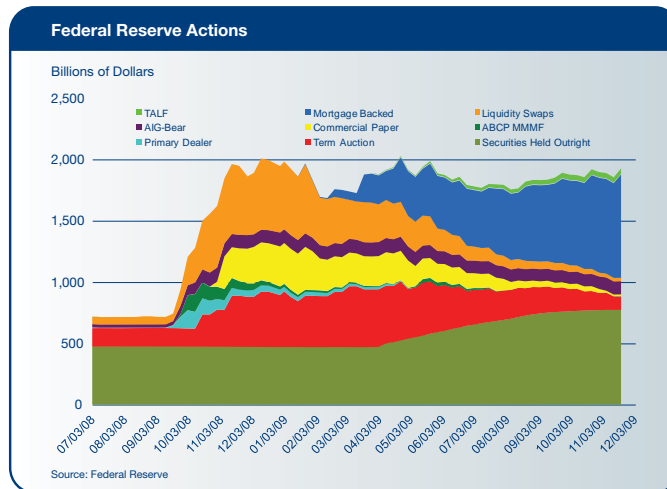
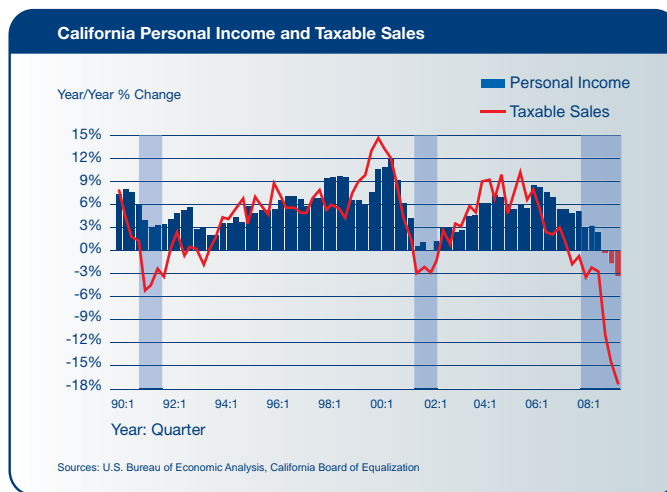
In particular, the Fed's holdings of mortgage-backed securities have increased substantially, along with purchases of other asset-backed securities through the Term Asset-Backed Securities Loan Facility (TALF). The advisory council's prognosis: the financial situation has improved significantly, but the central bank has not yet exited the field of battle.

California Economy Still Weak

California's economy continued to weaken during the past quarter, though the downturn has slowed. The state lost at least -940,300 non-farm jobs between December 2007 and September 2009, a distressing figure. About 85,000 jobs disappeared in the July-September quarter, but this was smaller than the first quarter plunge of -252,300 jobs.

California's unemployment rate rose to 12.2 percent in September 2009 from 7.8 percent in September 2008 and 5.9 percent in December 2007. The latest jobless reading was the highest since World War II.

Other broad-based indicators also



paint a gloomy picture. Personal income earned in California decreased by -3.3 percent during second quarter 2009 compared to second quarter 2008 (latest data available). A year earlier that figure was +3.2 percent. This has been the first three-quarter decline 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 have weakened substantially since early 2007.

By second quarter 2009, the estimated year-to-year decline had fallen well into double digits. Sales declines have been most severe for California's motor vehicle dealers, followed by building

materials dealers, household furniture and appliance stores. Sales of gasoline stations also have declined due to lower fuel prices.

Though the rate of deterioration may be slowing, the ongoing weakness in personal incomes, corporate profits and taxable sales threatens the state's operations, as tax revenues continue to come in below expectations. The budget package passed in July included several one-time "fixes," and there are concerns about looming deficits in the coming fiscal year. In any event, the decisions taken to date constrain the state's ability to support the economy as well as state-funded activities of local governments and school districts.

Employment Decline

Employment performance among the state's industries was mostly negative over the 12 months to September. On the plus side, the only major sectors with higher job counts were health care and social assistance, the state government and the federal government. Job counts fell in all other major sectors.

Employment declined the most in California's construction, manufacturing, retail trade, administrative and support

services, and leisure and hospitality sectors. Together, firms in these five industries reduced payrolls by -495,000 workers, while other sectors reported smaller declines.

Exports Decline

Exports of goods made in California have declined sharply—by -22.3 percent during the first nine months of 2009. The largest category of exports—high tech manufactures (computers, peripherals and so forth)—dropped by -20.9 percent in dollar terms, while California agricultural products (farm produce, livestock and beverages) fell by -12.4 percent. Transportation equipment exports decreased by -27.4 percent, while non-electrical machinery exports sagged by

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-25.3 percent. Exports of other important California-made products also declined, including chemicals (down by -17.2 percent) and miscellaneous manufactures (-16.2 percent).

Regional Performance

Comparing the state's major metro areas, regional employment performance continued weak in the third quarter of 2009, though most areas showed little change from the previous quarter. All of the state's major metro areas continued to report large year-to-year losses in non-farm employment.

Job losses were relatively moderate in three areas of the Central Valley—Bakersfield (-2.8 percent), followed by Modesto and Fresno (at -3 percent and -3.7 percent respectively). Orange County, San Diego, Los Angeles, Stockton and the Oakland Metropolitan Statistical Area reported “middling” losses in the -3.8 percent to -4.1 percent range.

At the other end of the scale, employment declines were most severe (-5.2 percent to -6 percent) in Ventura County and the Riverside-San Bernardino metro area.

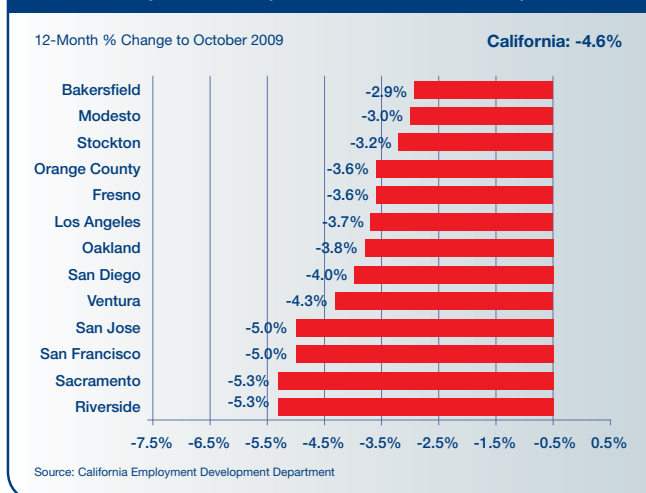
The employment downturn continued unabated in the San Francisco Bay area during the third quarter, and worsened in the San Jose metro area. Construction activity has fallen around the Bay. Retail trade job counts are decreasing, especially in San Francisco. Manufacturing job losses have swelled, particularly among San Jose's high tech manufacturers, which have cut back output and employment this year in response to reduced demands for computers and electronic products.

In the San Francisco area, the sharp downdraft in tourism this year has resulted in job losses in the area's hospitality industries and caused financial pain for local governments.

Southern California

In Southern California, the downturns in manufacturing and construction combined with retail industry distress have caused large employment losses across the region. A severe cutback in

Job Trends by Metro Area (October 2008–October 2009)



freight traffic through the area's ports has caused problems for the ports themselves and in transportation, wholesale trade and the distribution centers of Los Angeles, Orange County and the Inland Empire. The slowdown in tourism is a growing concern in San Diego and Los Angeles.

The region's entertainment sector presents a mixed picture. On the one hand, domestic and international box office demand for films has been good this year. Also, entertainment companies are taking advantage of the state's new filming incentives to schedule productions in California.

However, recent sharp declines in advertising revenues have impacted broadcast TV and newspapers, with consequent reductions in employment. Another note of caution: new Department of Defense proposals imply modest declines in procurement budgets and will have a mixed-to-negative impact on the region's key aerospace industry.

Agriculture and Resources

This year is proving to be a difficult one for California's agriculture sector. Prices of several important products have weakened considerably, including dairy, some nuts and grapes. Demand for premium California-grown products has softened, as recession-weary consumers at home and abroad economize on luxuries. California-grown exports decreased by -10.9 percent over the year through September. Feed costs have declined as well, but concerns about

farms' profitability persist.

Drought restrictions have become a reality (see below), forcing many California farms to tap limited groundwater supplies. Hard decisions are being made about which products to produce and which to reduce or eliminate. With water short and prices uncertain, many fields are being fallowed, with trees as well as crops at risk.

Water Concerns

Water is a serious concern across the state. The recent string of dry years—including 2008-2009—has left storage at very low levels in California's water systems and the Colorado River area. The State Water Project and the Central Valley Project both restricted deliveries in 2008 and 2009. Water that must transit the Delta faces further severe cutbacks.

The near-term outcome depends on a new Delta fish plan still being developed by the U.S. Department of Fish and Wildlife, but water allocations to parts of the Bay Area, Southern California and the San Joaquin Valley are likely to be reduced significantly. Already, mandatory reductions in urban water use have been implemented.

The Legislature has passed and the Governor has signed a package of water bills to help resolve the state's water problems. Full implementation will require voter approval of \$11 billion in new bonds to pay for the necessary improvements.

The supply of electricity in California should be adequate in the near term, as industrial demand has weakened in the recession. However, electricity prices are moving sharply higher, reflecting the utilities' costs associated with mandated investments to reduce their environmental footprints and to improve their distribution networks.

Real Estate/Construction

The California housing market has been operating on two different tracks for months now. Here are some interesting statistics for the state's re-sale home market:

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- Existing single-family homes sales in California increased by +2.1 percent over the year to September 2009, while condo sales were up by +10.8 percent.

- Prices continued to fall, with the median price of single-family homes sold in September 2009 (at \$296,090) down by -7 percent compared to September 2008.

- The number of homes available for sale represented 4.2 months supply (at September's sales rate) compared to 6.5 months a year earlier.

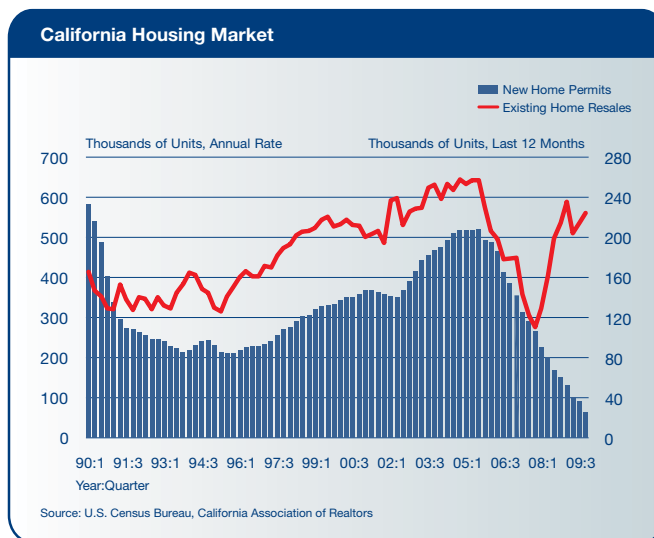
Existing Home Sales Healthy

Existing home sales have been quite healthy (greater than 500,000 annual rate) since September 2008. Compared with a year ago, sales have increased markedly in the inland areas of California that experienced high foreclosure rates and where large numbers of lender-owned REO (real estate-owned) homes are on the market.

"Distressed" sales, i.e., at low, "distressed" prices, have accounted for well over half of home sales, which initially pushed down the state's median price. However, the supply of these lower-priced homes is running below demand, as bank foreclosures slowed in the second and third quarters. A change in the availability and geographical mix of sales—which includes somewhat higher sales in the higher-priced coastal counties—has boosted the state's median home price in recent months.

In addition to relatively low fixed mortgage rates, the federal government is offering temporary tax credits to encourage would-be homebuyers to act. Further, the plunge in transaction prices means many home sales in California will fall inside this year's conforming loan limits (up to \$729,750 in 2009).

However, the outlook for home sales is uncertain. Government incentives likely are pulling forward some home purchases from later in 2010 and 2011. On the supply side, mortgage defaults have grown as labor market conditions deteriorated. Thus, the availability of foreclosed homes is unlikely to shrink,



though when lenders will bring these homes onto the market is uncertain. While the housing market environment looks favorable at present, significant further improvements in the pace of sales seem unlikely until the economy—and buyers' confidence—begins to improve.

Residential Construction Activity Low

Residential construction activity continued at very low levels across the state during the third quarter, though activity was higher than in the first-quarter, the low point for this down cycle. Total housing permits were issued at an annual rate of 34,900 units during third quarter 2009, up by 4.4 percent from first quarter 2009. That moderate overall increase hid what really has happened since the first quarter: single-family home construction activity increased by 34 percent, while multi-family permits dropped off by -32 percent. While any improvement is welcome, the current construction pace represents a drastic decline of -85 percent from the peak construction level of 2004.

New home builders still have sizable inventories of unsold homes and lots, though construction of new homes has dropped significantly and effective selling prices are falling. The unsold inventories are shrinking, especially detached single-family units. However, inventories of attached housing units (condominiums and apartments) continue at uncomfortably high levels. Finding buyers for all of the unsold condominium

units likely will take a while.

Despite the favorable buying incentives, 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.

Commercial Sector Troubles

California's commercial real estate markets also have developed deep fissures. Specifically, availability rates have risen markedly over the past year, and external development funding has virtually disappeared. The situation is most problematic for retail, office and industrial space. Retail sales have declined, and retailers' access to financing has been limited by the credit crunch. Several chains have 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 is plunging. Even so, vacancies are surging and rents are dropping because so many stores are closing down. Most areas in California are experiencing higher 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 Demand Falls

Demand for office space also has fallen, reflecting weaker employment trends in most office-based industries. Many firms are reducing headcount and vacating or subleasing space. Vacancies are highest and rising in Ventura County (25.4 percent), the Inland Empire (23.6 percent), San Diego (21.6 percent), the San Francisco Peninsula (19.9 percent), Sacramento (19.7 percent), Orange County (19.4 percent) and San Jose (19.1 percent).

Farther behind but still high, are Oakland (16.9 percent), Los Angeles (15.6 percent) and San Francisco (15.4 percent). Rents are weakening in most locations. Statewide, the value of new office construction permits plunged by

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-82.8 percent in the first nine months of 2009 compared with the same period in 2008. Though the office construction pipeline is shrinking, vacancies are likely to continue rising until employment begins to turn around.

Industrial vacancy rates are also on the rise, though new construction is slowing sharply here as well. Demand for warehouse and distribution space has slackened, reflecting the dim outlook for retail sales across the United States, as well as the plunge in international trade. Demand for high tech and biotech space also appears weaker since the financial crisis last fall and the downturn in the high tech industry.

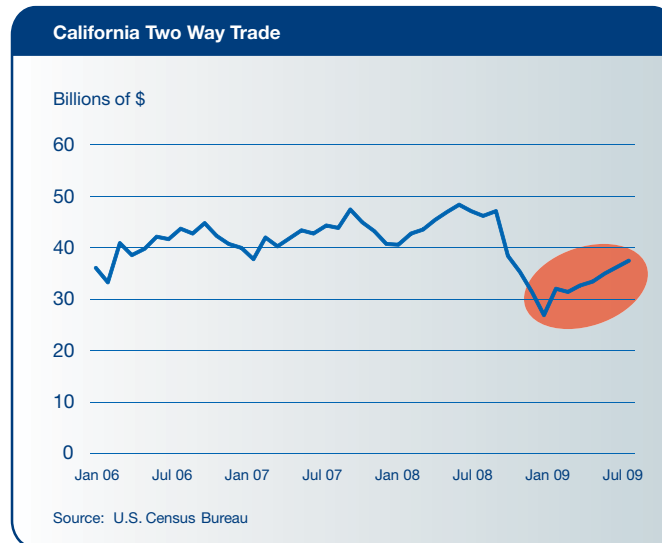
The lowest vacancy rate is in Los Angeles County, at 3.2 percent, followed by the East Bay at 3.6 percent and Orange County at 6.5 percent. Vacancy rates are highest in San Jose (13.2 percent), the Inland Empire (12.8 percent), San Diego (12 percent) and Sacramento (11.8 percent). These are areas where substantial new construction took place even as demand for distribution space dwindled.

Non-Residential Building Permits

The total value of non-residential building permits in California declined by -48 percent during the first nine months of 2009 compared with the same period in 2008. Permits for new buildings dropped by -64 percent, while the value of alterations and additions (which are more often owner-financed) fell by -26 percent.

During the first nine months, total non-residential permit activity increased only in San Luis Obispo/Paso Robles (+10.8). The biggest percentage declines in permit activity occurred in some Central Valley areas: Stockton (-74.6 percent), Visalia (-69.3 percent), El Centro (-68.2 percent) and Madera (-66.1 percent).

However, the largest dollar declines



have occurred in Los Angeles (down by -\$1.7 billion), San Francisco and San Jose (-\$1.4 billion combined) and Riverside-San Bernardino (down by -\$989 million). Together, these four areas accounted for 46 percent of the total statewide decline in non-residential permit activity through September 2009.

Financing has become extremely difficult to obtain for most types of commercial real estate projects, so permit values are expected to continue at low levels through much of 2010. As projects currently under construction are completed, the construction pipeline will empty out, a good thing as market fundamentals continue to deteriorate.

Risks

Risks are mostly to the downside. The economy is nearing the bottom of a serious, lengthy recession. Uncertainty is high. While rates of descent are slowing in California—suggesting the cyclical trough is close—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, and the results are beginning to show. However, the

financial industry’s problems are complex and won’t be “cured” as long as the general economy lingers at current low levels. At present, most financial institutions appear reluctant to engage in many forms of ordinary business and consumer lending, which exacerbates the current credit crunch and will retard the economic recovery.

A second set of risks concerns the state’s still-troubled housing industry. Rising joblessness and mortgage delinquencies could cause mortgage lenders to continue tightening credit requirements, taking sales volumes back down again. California’s new home markets can’t begin to

approach normal until unsold inventories are reduced significantly. That process is currently under way. However, there continues to be concern about “shadow inventories.”

Industry observers believe that mortgage lenders own a significant number of foreclosed homes but haven’t put them up for sale yet. A flood of homes repossessed by lenders into the marketplace would slow sales of builders’ standing inventories, drive home prices down and retard recovery in this important sector.

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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 D. Sidhu, vice president and chief economist for the Los Angeles Economic Development Corporation.

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