

State Economy, Housing Market Keep Pace with Nation's; Job Growth Crawls Ahead

U.S. Economy

The U.S. economy has moderated to a 2 percent average growth rate over the last three quarters. The persistent slowdown in housing is largely responsible, with declining home construction subtracting around 1 percent from gross domestic product (GDP) growth over the last three quarters. As yet, the problems in housing have not seriously impacted other sectors of the economy.

To the contrary, consumer spending expanded at a robust 3.8 percent annual rate in the first quarter of 2007, down slightly from 4.2 percent growth in the fourth quarter of 2006. Going forward, there should be slower growth in consumer spending due to tighter credit conditions, variable mortgage rate adjustments, and lower home valuations. Still, members of the advisory council believe a recession will be averted, largely due to the healthy labor market and adequate gains in personal income.

There should be some acceleration in business spending in coming months. In recent quarters, business investment has been disappointing, as firms have used large cash hoards for share buybacks and mergers. If a recession is averted, businesses should regain confidence and begin to replace aging equipment and software.

Indeed, signs of revival were evident in the first quarter of 2007, when equipment and software spending increased at a 1.9 percent annual rate following a 4.8 percent decline in the fourth quarter of 2006. The state should also continue to see healthy non-residential construction spending, which will partially offset weak home construction.

Energy prices remain a key risk to the outlook. The recent rebound in oil and gasoline prices will reduce discretionary income and will erode consumer spending on non-energy items. The recent surge in food prices — in part tied to rising corn-based ethanol demand — will further reduce discretionary income.

While both energy and food prices, which together account for about a quarter of household spending, may subside in coming months, there remain considerable upside risks for both types of commodities. Energy prices, in particular,

in food and energy prices. Inflation, measured by the annual change in the personal consumption deflator, was 2.4 percent in March.

Core inflation, excluding food and energy prices, was 2.1 percent, slightly above the Federal Reserve's comfort zone of 1 to 2 percent. Productivity growth has decelerated, and the unemployment rate has declined to 4.4 percent, putting upward pressure on wages. Under these conditions, the Fed is inclined to sit tight.

The massive amount of excess liquidity in the global capital markets also makes it difficult for the Fed to ease monetary policy. Indeed, there remains a risk of additional Fed rate hikes if inflation accelerates. Members of the advisory council do not believe that this will be necessary.

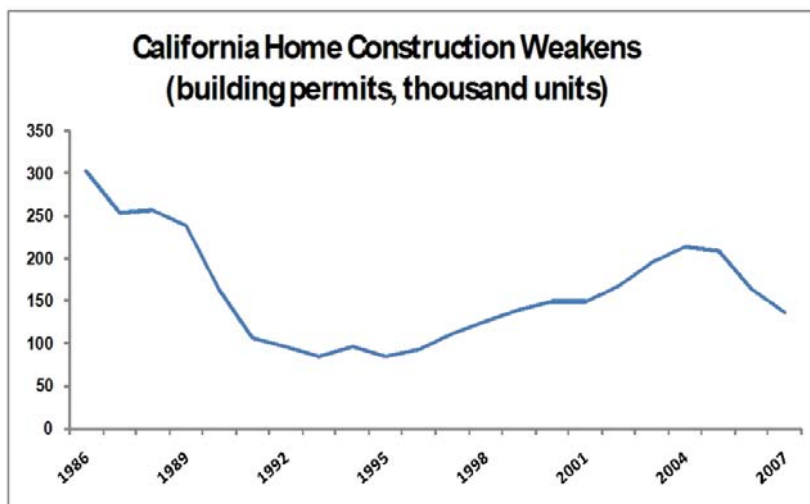
Most likely, the Fed will stay on hold for the remainder of this year, with an outside chance of a rate cut toward the end of the year, when there is more conclusive evidence of lower inflation. But this will be a difficult period for the Ben Bernanke-led Fed as it will face growing pressure from investors, businesses and politicians to cut rates in a slower

growth environment and in the lead-up to presidential elections. With the Fed on hold, the yield curve should remain fairly flat. Relatively low long-term interest rates will continue to cushion the housing downturn and provide ample liquidity to support business investment.

California Economy

Following substantial employment and personal income data revisions, it appears that the California economy has closely matched the performance of the U.S. economy over the last couple of years. Recently, California job growth has moved slightly ahead of the United States.

See Next Page



remain vulnerable to geopolitical developments, as well as the onset of the hurricane season. U.S. refiners have struggled to keep up with gasoline demand in light of changing fuel blending requirements and unanticipated bottlenecks at some refineries. Imported gas always can fill the gap, but, as we learned after Hurricane Katrina, this will lead to higher pump prices.

Interest Rates

The Federal Open Market Committee (FOMC) remains on hold following the last hike in the Fed funds rate, to 5.25 percent in June 2006. FOMC members have continued to express concern about inflation, accentuated by recent increases

State Economy, Housing Market Keep Pace with Nation's

From Previous Page

In March, state non-farm payrolls registered a 1.7 percent year-over-year gain, compared to a 1.4 percent increase at the national level. The strongest job gains remained concentrated in business services (+3 percent year/year), education and health services (+2.8 percent year/year), and leisure and hospitality (+2.7 percent year/year). Somewhat surprisingly, construction employment in March was 1 percent above year-ago levels. In part this reflects booming non-residential construction, but it also may be due to weather-related factors.

California's manufacturing sector has seen a modest decline in employment over the last year. But the state's manufacturers have fared better than other parts of the country due to their concentration in high tech capital goods and export-oriented industries.

California export growth accelerated from 6.2 percent in 2005 to 9.4 percent in 2006. This is partly due to the weaker dollar, but the state also saw solid improvements in exports to countries with more stable currencies. Exports to China increased 27 percent last year, solidifying China's position as the state's fourth largest export destination (after Mexico, Canada and Japan). With China still booming, another strong trade performance is expected this year. But there may be slower growth in exports to Mexico and Canada, as these economies are decelerating in response to U.S. slowdown. Mexico also is suffering from declines in U.S. remittances resulting from job losses in U.S. construction.

California's personal income expanded 6.4 percent in 2006, slightly above the 6.3 percent gain at the national level. Personal income tax receipts came in below Department of Finance estimates during the July 2006-March 2007 period, which could indicate somewhat slower growth. There should be a better reading on this once receipts are fully tabulated from the 2006 tax year.

Regardless, it is expected that the state economy will slow this year, in line with the U.S. economy. Still, it is comforting that the problems in the housing sector do not seem to have spread into other sectors of the California economy so far.

The San Francisco Bay Area has continued to show stronger economic improvement than other major California regions. There has been vibrant job growth in Silicon Valley, although employment levels remain below peaks of the dot-com era. While venture capital spending is also well below levels seen during the dot-com boom, there is increased start-up activity in Silicon Valley and subsequent demand for technically trained workers.

While the Southern California economy has seen a housing-induced slowdown (including considerable layoffs at large mortgage lenders in the area), it continues to benefit from its diversity, with solid performances in international trade, technology, aerospace and tourism. Despite the recent slowdown, council members maintain the view that California's diverse business structure will enable it to withstand the ongoing slowdown in the housing market. Going forward, regional growth differentials likely will reflect differences in housing market performance. Housing problems aside, there has been a convergence of growth rates between California regions over the last few years.

Real Estate

The U.S. housing market remains depressed. It is difficult to say whether housing starts and home sales have bottomed due to weather-driven volatility over the last few months. Regardless, advisory council members believe that home sales will remain sluggish for the rest of this year. Average home prices are down slightly from last year, but this hides substantial regional differences.

Fortunately, mortgage rates have remained stable, so that price declines have improved housing affordability. Homebuilders continue to manage their inventories with substantial price and in-kind discounts, putting downward pressure on existing home prices as well. Rapidly rising foreclosures are also contributing to price weakness.

While the pace of decline in home sales and construction will taper off, this is just the first stage of the housing downturn. The next stage, already underway, will result from tighter credit conditions, adjustable mortgage rate increases and the negative wealth effects of lower home valuations. These factors will have a

negative impact on consumer spending.

So far problems have been largely confined to the sub-prime mortgage market, but there also should be some credit deterioration in "Alt-A" and prime mortgage markets as well in coming months. Still, the advisory council believes that these problems will not become severe barring substantial weakening in the growth of jobs and income.

The California housing market has followed similar trends to the national market. But sales declines have been sharper due to the faster run-up in previous years. The California Association of Realtors (CAR) reports single-family home sales were down 20.8 percent year-over-year in March, compared to an 11.9 percent decline at the national level. Median home prices were still up 3.2 percent year-over-year according to CAR, compared to a 0.9 percent decline at the national level.

But California home price inflation peaked at a much higher rate than the U.S. average. Unsold single-family home inventories in California equaled an 8.7-month supply in March, compared to only a 4.7-month supply a year ago. This is slightly above the national average of a 7.2-month supply. CAR reports sharp year-over-year sales declines in the Riverside/San Bernardino (-48 percent), High Desert (-45 percent), Monterey County (-35 percent), Central Valley (-32 percent), Palm Springs (-30 percent), Ventura (-28 percent) and Sacramento (-26 percent) regions.

U.S. commercial real estate markets have continued to improve and are providing an economic offset to the deteriorating residential real estate market. Non-residential construction activity rose at double-digit rates last year, with particular strength in office and hotel construction. The pace of growth has slowed in early 2007, except for hotel construction, which continues to surge. But this may be a good sign since too much construction could lead to gluts that have characterized the commercial real estate sector in earlier decades.

The office sector should remain strong this year, with the main risk being a significant slowdown in payroll job growth. Construction of industrial facilities, which

See Next Page

State Economy, Housing Market Keep Pace with Nation's

From Previous Page

lagged during the current business cycle, has gained strength and should remain healthy in 2007. The apartment sector was very strong in 2006, but has softened (with substantial regional variations) as the glut of condominiums is causing some reconversion to apartment rental units. Vacancy rates in the retail property sector may rise as consumer spending slows and new construction catches up with absorption.

California's commercial real estate markets still enjoy solid market fundamentals, with activity remaining vibrant throughout the state. Markets remain very healthy in Los Angeles and Orange County. Northern California commercial real estate markets are still not as strong as Southern California, but have been improving rapidly. There has not been substantial oversupply in most regional markets, as high construction costs deter construction and rents do not always justify new commercial development. Still, with the economy slowing, there may be some oversupply over the next couple of years. San Diego and Orange County may see a rise in office availability as new speculative construction outpaces short-term demand.

Tourism

Based upon recent job reports and anecdotal information, it appears that California's tourism sector has held up in 2007, following a very strong 2006. State payroll data indicate that 40,000 leisure and hospitality jobs were created in the year ending March 2007. Including other tourist-related sectors (such as retail trade), the job contribution is considerably larger. Hotel occupancy rates have also continued to rise, although this could reverse, given the considerable amount of hotel construction underway in the state. With the economy slowing and gas prices soaring again, there is reason to expect a slowdown in tourism this year. But this could be offset by foreign tourism as the weaker dollar (especially against the euro) encourages foreign visits to the United States.

Banking

Mortgage and home equity lending continues to be crimped by the housing slowdown. As sub-prime mortgage

delinquencies have risen, there has been a notable tightening of mortgage lending standards. New regulatory guidance is discouraging creative financing techniques such as interest-only loans and option adjustable-rate mortgages. As home equity lending has declined, there has been some pickup in credit card borrowing, which has slowed considerably over the last couple of years. Commercial and industrial lending, which has lagged in the current business cycle, remains robust.

Fed surveys show continued lax lending standards for commercial and industrial loans, although these may also tighten up as the economy slows. The slowdown in consumer lending, the flat yield curve, and deteriorating asset quality (due largely to rising mortgage delinquencies) has begun to weigh on bank profits. Although bank loan credit quality and profits are expected to diminish further in 2007 (especially for smaller regional lenders), the council expects the overall health of the banking sector to remain sound. But there will continue to be fallout among non-bank, sub-prime mortgage lenders, a number of which are domiciled in California.

Agriculture and Resources

California agriculture continues to face cost pressures deriving from several sources, and it is unlikely that farmers will be able to fully pass on these costs to retail customers. The run-up in corn (and related grain) prices — resulting from soaring ethanol demand — has pushed up feed costs. Given the anticipated growth in ethanol demand, there will be little let-up in these price pressures. Rising energy costs and farm labor shortages also have hurt profit margins. Farmers face substantial water supply cutbacks during the coming year. The depreciating dollar has provided some offsetting positive impetus to profits.

Below-average rainfall (the Sierra snowpack is about 40 percent of normal this year) has reduced California water supplies. Although current water supplies (including reservoirs) are sufficient following last year's wet winter, most water districts are requesting voluntary (and in some cases, mandatory) cutbacks this year. Farmers face 50 to 85 percent of

normal water allocations this year.

The state's electricity supplies look sufficient in the short term due to some new capacity and rising electricity imports resulting from transmission line improvements. Still, California's medium- and long-term electric reliability problems and peak-capacity issues are unsolved. Utilities are investing heavily in upgrading their distribution infrastructure. This much-needed investment, which will likely go on for five to 10 years, will result in higher power costs.

Risks

With the economy growing at a subdued pace, vulnerability to exogenous events is higher than normal. Once again a key risk is oil and gasoline prices, which still have an upward bias tied to geopolitical events. With home valuations and home equity borrowing falling, higher energy prices will probably impact consumer spending more than it did last year.

Another risk revolves around Federal Reserve interest rate policy. Although the Fed appears content with its current policy stance, there is a prospect of higher interest rates if inflation persists near current levels.

Finally, there is a risk that a negative event in the credit markets could lead to widening spreads in mortgage and corporate bond markets. Rising finance costs would weigh on consumer and business spending.

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 Sheldon Engler, vice president and head of fixed income research, Charles Schwab Investment Management, Inc.

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