

Construction, Real Estate Slowdown Keeps California Job Growth Trailing Nation's

National Economy

The U.S. economy has entered 2007 with renewed vigor. Gross domestic product (GDP) expanded a respectable 3.4 percent in 2006, which is impressive considering that weakening home construction subtracted 1.2 percent from growth during the second half of the year.

Although off its peak, growth in consumer spending still looks healthy, with retail sales holding up nicely outside of the auto sector. Even housing-related sectors — such as home improvement and furniture — are proving resilient. January retail sales were further lifted by increased use of holiday gift cards, which have altered normal holiday sales patterns.

Consumer spending has been lifted by the decline in energy prices since mid-2006. But crude oil and gasoline prices have rebounded, and this likely will weigh on consumers in coming months. The rebound in energy prices is occurring at the same time we expect to see some pullback in spending because of lower home valuations.

Advisory council members are not forecasting a recession, but real consumer spending will likely slow somewhat from its 3.2 percent pace in 2006.

Business spending — which expanded a sub par 7.4 percent in 2006 — continues to disappoint. Firms are deploying their cash hoards for mergers and acquisitions (which set new records in 2006) and share repurchase, rather than investment in plants and equipment.

Business surveys indicate more caution in 2007. With earnings growth decelerating, investment spending likely will

expand a bit more slowly than in 2006.

While investment spending has remained subdued, businesses have continued to hire new workers at a rapid pace. Outside of construction and manufacturing, net payroll job additions have been running at an annual pace of 2 million.

There was a smaller hiring number in

a potential up-tick in inflation due to tight labor markets.

There is considerable excess liquidity in global financial markets, making it very difficult for the Fed to consider cutting interest rates. Although most investors expect the Fed to remain on hold throughout 2007, there remains a prospect

of a rate cut in the second half of the year if inflation continues to decelerate and economic growth moderates. But if core inflation were to revive unexpectedly, the Fed will not hesitate to raise interest rates.

The yield curve — measured by the difference between the 10-year Treasury note and the Fed funds rate — likely will remain inverted until the Fed reduces interest rates by 50 to 75 basis points.

This probably implies

the inversion will persist throughout 2007.

California Economy

The California economy slightly underperformed the national economy in 2006, after outperforming in 2005. California job growth slipped from 2 percent year/year in January 2006 to 1.1 percent year/year in December. Job gains totaled 170,300 for the year, only 9 percent of the U.S. job gain during that period.

California's unemployment rate stood at 4.8 percent at the end of 2006, down from 5.1 percent at the end of 2005. This is a bit higher than the national unemployment rate of 4.5 percent.

In March 2007, California will release its benchmark payroll job revisions for the year ending March 2006. Substantial upward revisions are anticipated in line with already-released national payroll job revisions, which exceeded 700,000 jobs.

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January, but this could be revised upward in line with frequent upward revisions seen in recent employment reports. Nevertheless, the advisory council anticipates somewhat slower job growth in 2007, another reason to expect slower growth in consumer spending.

Interest Rates

The Federal Open Market Committee (FOMC) remains on hold following the last hike in the federal funds rate, to 5.25 percent in June 2006. FOMC members continue to express concern about inflation. Core inflation, as measured by the core personal consumption expenditure (PCE) deflator, was 2.2 percent in December, above the Federal Reserve's comfort zone of 1 to 2 percent.

But core inflation has decelerated since mid-2006, in part due to slower growth in rent. The government also revised its productivity and labor cost data to reflect less worrisome increases in unit labor costs. Still, the Fed remains wary of

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This would be consistent with other data — such as state tax revenue — indicating stronger growth than previously released job estimates would indicate.

California's job growth may remain subdued relative to the rest of the country, mainly because the state's recovery has been more dependent on construction and real estate jobs in recent years. Last year the state saw a net decline of 9,000 in construction and real estate jobs, following a 69,000 decline in these job categories in 2005.

This decline in construction and real estate was offset by a 180,000 increase in other jobs, with the biggest gains in leisure and hospitality, business services, health care and education.

But this increase fell below the prior year's gain of 219,000 jobs outside construction and real estate. With housing markets stabilizing, construction and real estate job growth may flatten in 2007, while job gains in other categories may slow somewhat.

California growth has become more balanced across regions, with a notable improvement in the San Francisco Bay Area economy and labor market. While venture capital spending is well below levels seen during the dot-com boom, we observe increased start-up activity in Silicon Valley and subsequent increased demand for technically trained workers.

While the Southern California economy has seen a housing-induced slowdown, it continues to benefit from its diversity, with solid performances in international trade, technology, aerospace and tourism. Despite the recent slowdown, council members still believe that California's highly 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. For example, the Central Valley is seeing

price declines, which are weighing on the economy in that region.

The ongoing pickup in non-residential construction in California should be sustained in 2007, and this should partly offset the slowdown in residential real estate markets. And although U.S. capital spending is expected to remain subdued, California will continue to benefit from its focus on high technology capital goods, which are in strong demand both nationally and abroad.

California exports expanded at a double-digit rate in 2006, although exports

fact that interest rates are lower than previous cycles.

A negative implication of this adjustment is that home price depreciation erodes household wealth, which will have an impact on consumer spending. Effects of housing wealth usually take a couple of years to have an impact on the economy.

The combination of price depreciation and upward adjustments in variable rate mortgages is leading to increased mortgage delinquencies and foreclosures. There recently has been more severe pressure in the sub-prime mortgage market.

Advisory council members expect these problems to worsen, and possibly spread to prime mortgages. Furthermore, the council expects future home sales will be limited by more stringent mortgage lending standards. But the council does not expect a disaster in the mortgage markets, as long as growth in jobs and income growth remain healthy.

The California housing market also has shown signs of stabilization. But California's housing downturn remains more severe

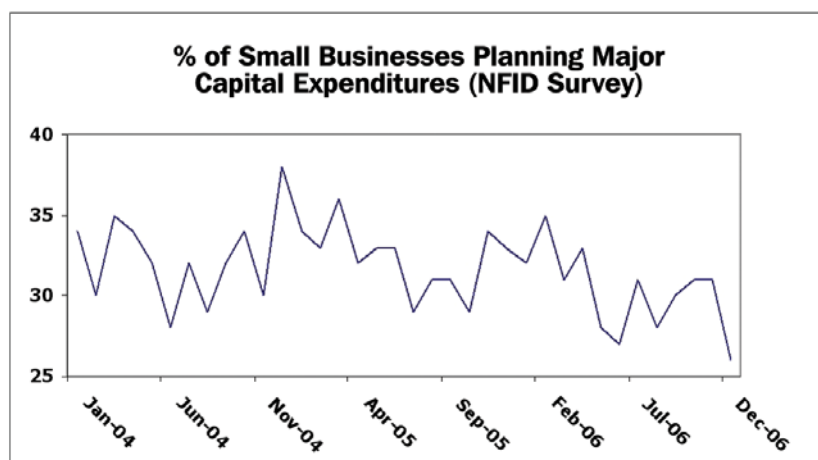
than the nation as a whole. Statewide home construction permitting was off more than 20 percent in 2006.

The California Association of Realtors (CAR) reports single-family home sales were down 15 percent year/year in December, compared to 7 percent decline at the national level. Median home prices were still up 3.7 percent year/year, according to CAR, compared to flat prices 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 equaled a 6.8-month supply in December, compared to only 3.5 months a year ago, but down from earlier year estimates of above a seven-month supply.

This is slightly above the national average of a 6.5-month supply. CAR reports that the sharpest sales declines have been concentrated in the Central Valley (-27

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may slow somewhat in 2007. Higher interest rates likely will slow growth in Europe and Asia, but growth will remain strong enough to ensure California export growth of 7 to 8 percent in 2007.

Real Estate

The U.S. housing market recently has shown signs of stabilization. Existing home sales have settled at around a 6.2 million annual rate, well below the peak of 7.3 million in mid-2005, but still very healthy by historical standards. Declining home prices combined with stable mortgage rates have improved housing affordability, helping to cushion sales.

New home sales have begun to increase again as homebuilders steeply discount homes and provide other incentives to reduce their inventories. Existing and new home inventories are well above their cyclical lows, but below their peaks during previous housing cycles. This reflects the rapid price adjustment and the

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percent), Sacramento (-26 percent), High Desert (-39 percent) and Riverside/San Bernardino (-41 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 has been rising at double-digit rates, with particular strength in office and hotel construction. The office sector should remain strong, with the main risk being a significant slowdown in payroll job growth. Construction of industrial facilities — which lagged during the current business cycle — also has picked up in recent quarters.

The council expects national industrial and office markets to maintain positive absorption trends into 2007.

The apartment sector was very strong in 2006, but could soften somewhat in 2007 as the glut of condominiums leads to 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. But the retail sector could surprise on the upside, if consumer spending sustains its recent rapid pace.

Similar trends are evident in California commercial real estate markets, with activity remaining vibrant throughout the state. Markets remain very healthy in Los Angeles and Orange County. Northern California markets generally are not as strong as Southern California, but have been improving rapidly. There has not been substantial over-supply in most regional markets, as high costs deter construction and rents still do not justify new commercial development. There also has been a recent pickup in public construction, both in California and nationwide.

Tourism

California's tourism sector remained strong in 2006, helped by sharp declines in gas prices during the second half of the year. Jobs increased 2.2 percent in California's leisure and hospitality industries last year, faster than any other sector. Hotel occupancy rates continued to rise and solid activity was reported at key Northern and Southern California tourist and convention destinations.

There is a considerable amount of hotel construction underway in the state, in large part to serve the conven-

credit card borrowing, which has slowed considerably over the past couple of years. Commercial and industrial lending — which has lagged in the current business cycle — is growing more slowly but remains strong.

The slowdown in consumer lending, the flat yield curve and the deteriorating asset quality (due largely to rising mortgage delinquencies) has begun to weigh on bank profits, which have been heavily reliant on household sector lending. Although bank loan credit quality and profits likely will diminish in 2007, the council expects the banking sector to remain healthy. There likely will be additional fallout among non-bank, sub-prime mortgage lenders, a number of which are domiciled in California.

Agriculture and Resources

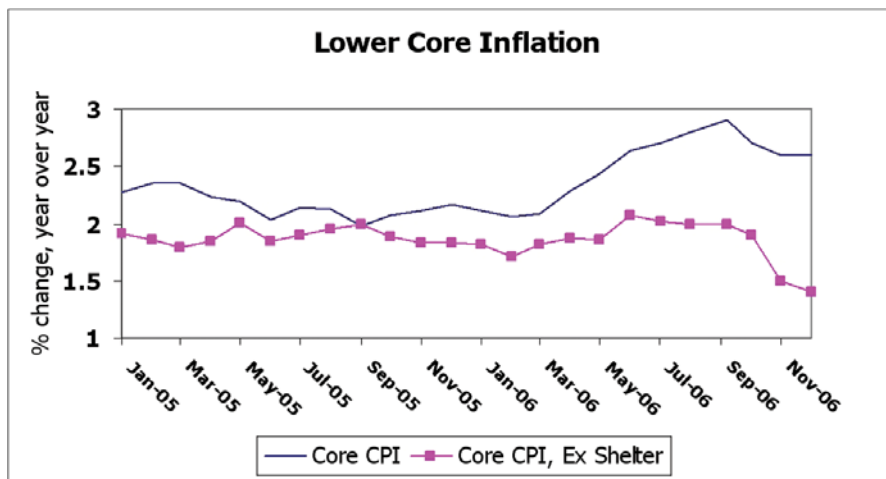
The big story in California agriculture has been the recent freeze, which destroyed approximately \$1 billion of the state's citrus crop and had an impact on the avocado harvest. Consumers will face

resultant higher prices for these commodities. Dairy and beef producers have faced higher feed costs, due to the rapid run-up in corn prices (due to rising ethanol demand), thus boosting prices for these commodities. This likely will be a permanent feature, given the rapid increase in demand for ethanol-based fuels.

Below-average rainfall has reduced California water supplies (snow pack is 40 percent of normal to date). But water supplies are sufficient following last year's wet winter. Without above-average late winter rain and snowfall, the state likely will experience some supply constraints in the coming year.

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

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tion business. But with the economy slowing, there likely will be somewhat slower growth in domestic tourism over the coming 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

Home equity lending and mortgage refinancing activity have declined over the past year, but recently have stabilized. Lending standards for households and business are a bit tighter, according to Fed surveys. Mortgage lending standards will tighten further as delinquencies rise and as lenders react to recent issuance of new regulatory guidance discouraging creative financing techniques such as interest-only loans and option-adjustable rate mortgages.

As home equity lending has declined, there is beginning to be a pickup in

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electric reliability problems and peak-capacity issues are unsolved.

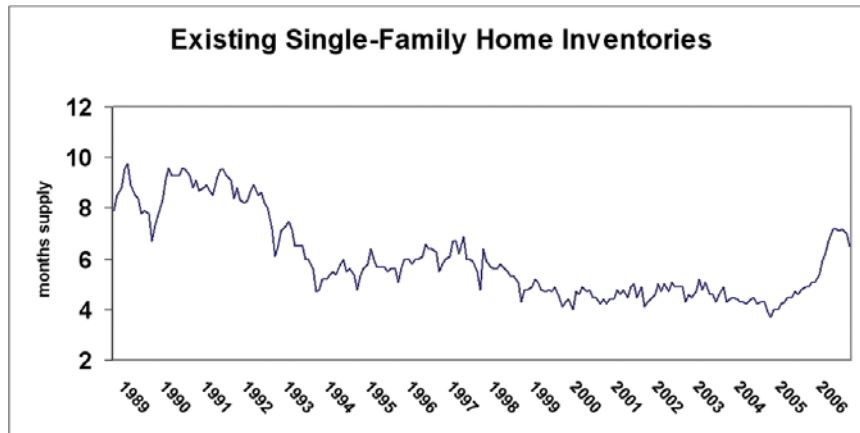
Utilities are investing heavily in upgrading their distribution infrastructure. This much-needed investment, which will likely go on for five to 10 years, will result in higher power costs.

Risks

A key risk going forward is the sustainability of consumer spending. Although consumers have shown amazing resilience, home price depreciation and rising debt burdens will weigh on them in coming quarters. This risk could intensify if there is a rebound in energy prices. Although the market consensus on oil prices has moved lower, the oil market remains highly vulnerable to supply shocks in unstable oil-producing countries.

Another risk revolves around the Fed's interest rate policy. Although the Fed appears content with its current monetary setting, it would not hesitate to raise

corporate bond markets. Rising finance costs would weigh both 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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interest rates if inflation re-accelerates due to tightening labor markets or other causes.

Finally, there is a risk of a negative event in the credit markets, which could lead to widening spreads in mortgage