Economic Forecast Report

Economic Outlook and Forecasts:
The Nation, Southern California and Orange County

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Institute for Economic and Environmental Studies
Research Reports

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The Outlook in a Nutshell: No Double Dip, but a Painful Crawl

There is an old Chinese proverb that says “may you live in interesting times.” For the past two years we have been doing exactly that – living on the edge of uncertainty mixed with hope as the global economy rides one of the most powerful tidal waves in a generation. After a sharp and deep fall lasting for roughly one year, the “Great Recession” technically ended in the summer of 2009, making room for the much awaited economic recovery.

By and large, the recovery has been disappointing. Much as we cautioned in our last report, the rebound in economic activity has been weak and uninspiring with below-trend growth, above-average unemployment, and a myriad of headwinds that have severely constrained growth. A year into the recovery and the outlook darkened over the summer. After a solid fourth quarter in 2009, the rebound in economic activity slowed precipitously early in 2010, coming close to a screeching halt in the summer of 2010. The Q2 GDP numbers were revised sharply downwards – to a feeble 1.7%; labor markets have yet to show meaningful signs of life, the housing market appears to have taken another setback, and consumers continue to struggle. The slump in economic activity is largely due to the waning of the fiscal and monetary stimulus, the end of the inventory cycle, concerns over Europe’s sovereign debt, and adverse developments in international trade.

This report charts the future course of the U.S. recovery. We argue that although the economy is more vulnerable now than earlier in the year, it will not relapse into recession. Instead, the economy should continue to heal in what we have called “a recovery of two halves,” wherein the second half growth will move forward at a rate above stall speed, but still too slow to make a significant difference to the jobless rate. The summer scare should be viewed as a temporary stalling of a continued recovery, though the progress forward has downshifted from “moderate” to “modest.” The recovery should eventually become self-sustained and gradually pick up a bit more steam towards the end of 2011/early 2012.

The current consensus view seems disproportionately focused on negative factors and misses recent modest improvements. Business spending has picked up, corporate profit margins are at a record-high, private final demand seems more robust than previously
In the first half, the recovery was driven primarily by remarkable government largesse and a robust inventory cycle – two transitory and inherently non-fundamental forces. For a sustained expansion, however, consumption in the private sector – household spending and business investments – will need to take over. Until that happens, the economy will continue to remain in this awkward transition phase.

Nuts and Bolts: A Recovery of Two Halves

Though it is not unusual for nascent recoveries to stall for a quarter or two, the weakness of this recovery is rather startling. It is in sharp contrast with past experiences, where strong downturns are followed by years of above-average growth and rapid expansions. But this recession was not ordinary. As it recovers, the U.S. economy will undergo one of the biggest transformations in decades. To make matters worse, the GDP numbers were revised downward going back to the beginning of 2007, revealing that the recession was deeper than previously believed and the recovery weaker than anticipated (Figure 1). Since the official end of the recession, the economy grew by a mere 2.6%, far below the 5.6% rate over the equivalent period after the 1981-1982 recession.

In the “recovery of two halves” scenario, the second half, which will likely span the next six quarters, will be slightly more subdued than the first half. In explaining our outlook, we focus on three elements: 1) dragging fundamental forces (labor, consumption, household finance, housing market), 2) dimming bright spots (fiscal/monetary policy, investments, production, global environment), and 3) bright spots (corporate sector, financial sector, inflation). This discussion provides the basic foundation for our economic outlook and national forecasts and serves as the foundation for our regional economic analysis of Southern California and Orange County.
Dragging Fundamentals

Labor Market
The labor market has crawled along at a disappointingly slow pace during this recovery. Job gains began to appear early in the year, 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.

Private payrolls have added 763,000 jobs during the first eight months of this year – far below the 4.2 million jobs that were lost over the same period in 2009. As of October, the unemployment rate stands at a worrying 9.6% and if we were to add all the excluded categories – marginally attached, discouraged, and involuntary part-time workers – the actual unemployment rate jumps at 16.7%.

But not all is doom and gloom; August labor data came in better than expected showing that the private sector added 67,000 jobs and July payrolls were revised upward from an original 67,000 to 107,000 job gain. Temporary help services - a leading labor market indicator – has been on a clear upswing since the beginning of the year (Figure 2). Another welcoming sign is the jump in average hourly earnings by 0.3%, which bodes well for consumer spending. More importantly, private employment has increased in every month of this year, and though the pace of job formation is far below desired level, the overall trend is positive.

Despite these improvements, we fear that the labor market will remain a significant drag on the recovery over the short-term. The average pace of job formation - at 95,000 per month - is too weak to keep up with the natural expansion of the labor force (around 125,000 per month), much less absorb the 8.4 million jobs lost during the recession. More disconcerting is the fact that this recovery is resembling that of 1991 and 2001: though job growth has resumed sooner and may be slightly stronger now compared to the previous two recoveries, this is shaping up to be a “jobless recovery,” partly because the recession obliterated so many jobs that it would take years for them to be regained (Figure 3). Unemployment rate should remain above 9% well into 2011 and may yet rise from its present level as the labor force expands. Job growth is expected to be uneven over the next two years: some sectors – such as exports, capital goods, infrastructure, healthcare and education – are expected to post modest gains, while others (construction, retail, financial services) should drag the recovery cycle as these industries continue to restructure.
Consumer spending has been unspectacular — to say the least — during this recovery cycle. This is expected, given the formidable adverse forces facing the U.S. consumers: high unemployment rates; a “wageless” recovery; a gruesome, multi-year deleveraging process; and a significant decline in financial wealth. Real personal consumption expenditure, which fell by a total of 2.3% during the recession, the largest drop in post war era, has posted an overall gain of 2.2% from the trough of April 2009 through August 2010. This is below the historical average of 3.1% and far below the 4.2% average post-recession rate. Moreover, final demand continues to remain subpar; after declining for six consecutive quarters, final sales rose by an anemic 0.9% in the first quarter of 2010 and 1.17% in the second quarter. These levels become even more worrisome when compared to previous recoveries. Final demand has remained fairly flat during the four quarters since the official end of the recession, trailing well behind other recent recoveries (Figure 4).

Not surprisingly, consumers’ outlook on the economy remains gloomy. Confidence fell in September, suggesting that consumers continue to remain apprehensive about the future, particularly as it relates to the labor market and overall business conditions.

The good news is that consumer spending is growing, albeit at a snail-like pace. Real personal consumption has risen for seven consecutive months. Going forward, consumption spending is expected to grow, though at a depressed rate of around 2%. The expiration of unemployment benefits in November should take a bite out of consumption late in the fourth quarter. High unemployment...
rates and continued deleveraging will continue to restrain any meaningful upswing in household spending well into 2011. Consumers should continue to hobble during the next eighteen months for as long as the labor market remains weak and wage growth is restrained.

**Household Finances**

This recovery will drag longer than usual partly because of the draconian rebalancing of household balance sheets. The recession obliterated a massive $17.6 trillion in household net wealth, causing a sea-change in consumer behavior. Spending fell, savings increased and consumers began the long transition from credit-fueled spending to one that is more closely aligned with income growth. The household debt-to-income ratio, which had risen to 136% at the peak of the credit boom, has fallen to 125.9% - an improvement, but still well above historical norms of 80%, suggesting that additional adjustments are on the way.

Household net worth has rebounded by $4.7 trillion since the first quarter of 2009, but that is still 18.7% below the pre-crisis peak. The rebound in net worth is partially driven by a decline in outstanding credit as consumers pay down debts at a faster clip. Consumer-level data from the global credit information company, Experian, shows that average consumer debt has fallen for six consecutive quarters, dropping by a total of 5.3% during this period (Figure 5). The average available credit has shrunk even more rapidly, declining for eight straight months, for a combined total of 20.8%. Average credit card payments have stayed at around the
...the balance sheet repair process, while necessary in a post-credit bubble economy, will place additional strains on consumption, particularly in the short-term.

same level as before the crisis despite significant strains in income, whereas the number of open credit cards has fallen rapidly (Figure 6). Meanwhile, the number of late payments has risen by 36%, as consumers struggle with income loss, large debt service, and a weak labor market.

We expect the deleveraging process to continue in earnest over the next four years. This should lower the debt to income ratio to around 90% by the end of 2016, and increase household savings to around 6-8% over the period. Debt service should decline to 11.5% of disposable income late in the year, thanks in part to falling interest rates. Household net wealth will continue to increase for the balance of the year, but the support from deleveraging and the recent rebound in equity markets is likely to be restrained by softer housing prices. Overall, the balance sheet repair process, while necessary in a post-credit bubble economy, will place additional strains on consumption, particularly in the short-term.

Housing Market

The outlook for housing market has turned pretty grim and is unlikely to brighten in the near future. After picking up briskly in the first half of 2009, the pace of improvement began to slow, turning outright negative in the second quarter of 2010. Existing home sales slumped by 27.7% in July to the lowest level in history. Though sales in August firmed up by 7.6%, the latest number is still 19% below levels of a year ago. Housing starts have declined by 16% from April-August 2010, mortgage applications continue to remain in a downtrend despite low interest rates, and the National Association of Homebuilders Index (NAHB), which tracks builder confidence, is currently hovering around the low levels recorded at the height of the crisis. The rate of delinquencies has edged up to 10%, whereas foreclosures have remained above the 300,000 level for seventeen straight months.

Figure 7
Housing Demand Pullback from Expiration of Tax Credit
(level, millions of units)

Woes in the housing market are largely due to the expiration of a host of government programs. The homebuyer tax credit, which was extended through April 2010, pulled demand forward creating a significant vacuum in the market when the program ended (Figure 7). The lift on the moratorium of foreclosures and the termination of large-scale Mortgage Based Securities (MBS) purchases by the Federal
Reserve also had an adverse impact on the housing market. Nonetheless, a slew of government programs to the tune of $30 billion are still around to help homeowners avoid foreclosure. The programs have had limited success: as of February 2010, only around 170,000 loans had been successfully modified/restructured, which is only a fraction of the 2.8 million at-risk foreclosures and of the 6 million delinquent borrowers.

The outlook for the housing market over the next few quarters has downshifted; though the free fall is well behind us, leading indicators suggest that a strong rebound is unlikely. Constrained by weak demand, housing starts would pick up only gradually, reaching 1 million early in 2012. Foreclosures are expected to rise and sales should decline modestly compared to a year ago as high unemployment rates, tighter lending practices, and depressed home values drag down the recovery in the housing sector. Home values should trend lower over the next two quarters, shedding an additional 5% from current levels. Home prices at the national level are expected to remain relatively sluggish through 2011, before rising by 6-8% in 2012.

**Dimming Bright Spots**

**Fiscal and Monetary Policy**

The recovery thus far has been supported by unprecedented efforts on the part of the federal government and the Federal Reserve, which have combined for a massive price-tag of $4 trillion. Government spending has reached its limits and there seems to be little appetite for massive interventions even as the economic recovery limps forward.

Fiscal stimulus has provided a temporary boost in demand, adding on average 0.4 percentage points to the real GDP from Q1 2009 – Q1 2010. As a result, the fiscal deficit has risen to unprecedented levels estimated to reach $1.3 trillion (10.1% of GDP) in 2010, and $1.2 trillion (8.8% of GDP) in 2011. By all measures, the U.S. debt trajectory, if it remains on its current path, is unsustainable. While a fiscal crisis is not imminent over the foreseeable future, there are considerable risks that mounting debt will have a large, negative impact on economic growth in the long run.

In addition to long-term structural problems, an extraordinary increase in policy uncertainty is further hampering the recovery. The health care bill, passed by Congress in March 2010, has prompted uncertainty with regards to its implementation and its impact on individuals and businesses. The financial reform seems to have created some uncertainty for banks regarding the level of capital needed to be raised to comply with the new law. In addition, it is unclear as to whether the Bush tax cuts will be extended, whether potential extensions would apply to everyone or exclude the top-earners, and whether they would be permanent or temporary. The gridlock over taxes has severely hindered the ability of businesses to expand capacity and employment.

With improvements in the financial sector and the broader economy, the Fed began to slowly remove its overly accommodative bias early in the year. Many of the special liquidity lending facilities were closed and temporary swap arrangements with other central banks came to an end. But as the recovery falters, there are recent signs that the Fed is about to embark on yet another large-scale operation of Treasury purchases.

While a fiscal crisis is not imminent over the foreseeable future, there are considerable risks that mounting debt will have a large, negative impact on economic growth in the long run.
We expect the Fed to try and keep rates on hold well into 2011 and begin a round of quantitative easing early in November. The problem with this approach is that policymakers are almost out of ammunition and any further easing would do little to stimulate the economy given that rates are already at rock bottom.

**Business Investments and Production**

Business investments and manufacturing activity have been one of the bright spots in the early stages of recovery. Private domestic investments added 2.7% to real GDP growth in Q4 2009, and an additional 2.9% in the first half of 2010. This was largely due to inventory restocking after a sharp drawdown during the recession and a sizable increase in spending for equipment and software as firms replaced outdated capital.

Inventory restocking has led to sharp increases in production: industrial production rose for 14 consecutive months, posting an aggregate increase of 9% since its trough.

These improvements, however, are poised for a slowdown. The inventory cycle has, by and large, run its course: the contribution of inventories to economic growth in Q2 2010 was a mere 0.6%, far below the 2.6%-plus rate recorded in the previous two quarters. The Senior Loan Officer Opinion Survey conducted by the Federal Reserve, indicated that in Q2 2010 banks eased lending standards on commercial and industrial loans (C&I) for firms of all sizes. Nonetheless, the demand for loans remained weak, suggesting that firms are unlikely to undertake significant business expansions in the near future. This is partially attributed to the fact that there is still plenty of underutilized/unutilized capacity: industrial capacity utilization is at 74.6%, a full 5.9 percentage points below the 1997-2009 average of 79.2%. The ratio of new orders to inventories – a leading indicator of factory output – has been trending down sharply since May, suggesting a downshift in production activity ahead (Figure 8).

We expect business investments and production activity to continue to increase over the forecast horizon, although at a significantly more moderate pace.

**Global Economy and Net Exports**

The recovery has stretched around the globe, but the pace of the rebound is highly uneven across regions. While the strength of the rebound is weak and sluggish in advanced economies, developing nations have picked up speed and are growing again at rates near their pre-crisis peaks. China’s economy leapt by an astounding...
ing 8.7% in 2009. In Q2 2010, Brazil grew by nearly 9%, Peru by 12% and Argentina and Chile continued to post solid growth rates. In contrast, Japan’s economy seems closer to the brink of a recession double dip than any other advanced country. The recovery in some of the main European countries seems more solid than in Japan, though well below emerging markets’ pace: Q2 2010 real GDP grew by 3.9% in Eurozone and 4.9% in the U.K., whereas Germany posted a stunning 9%.

Going forward, the global recovery is expected to continue both in developed and emerging economies, though at a moderate pace. China’s growth rate has already downshifted from 11.9% in Q1 2010 to 10.3% in Q2 2010. Eurozone’s debt crisis, which sent shockwaves around the world early this year, will continue to weigh heavily on the recovery of some peripheral economies (Greece, Portugal, Ireland) and a few main ones (Italy, Spain). Fiscal tightening in the U.K. is expected to have an adverse impact on the pace of the recovery in the near-term. Overall, the global economy will expand over the forecast horizon, but at a more modest rate and below the 5% pace of the boom years.

The slower global growth ahead will have implications for U.S. net exports and U.S. growth. The boost from net exports has failed to materialize so far, shaving off 0.3% of real GDP growth in Q1 and an additional 3.5% in Q2. The second quarter subtraction from growth should be viewed as a one-off event; however, the widening of the trade deficit was due to a surge in imports from China, which was motivated by an impending change in Chinese export tariffs. As such, we should expect to see a narrowing of the trade balance supported primarily by an increase in exports (Figure 9). The support from exports however, will be less robust than previously expected due to the modest downshift in global growth.

**FIGURE 9**
Exports are a Source for Growth
(quarter-over-quarter percent change)

Nascent Bright Spots

**Corporate Sector**
The uneven nature of this recovery is best displayed in the corporate sector where large firms are posting near-historic profits, whereas small businesses are lagging substantially behind. Corporations have cut costs with abandon, decreased their workforce, borrowed at extremely favorable conditions by issuing bonds at ultra-low interest rates, retooled their operations to deal with lower revenue, consolidated their balance sheets,
Corporations are likely to stand on the sidelines for a while longer until a few indicators point to a clearer picture, such as the direction of the housing market, the effect of the waning fiscal and monetary stimulus on the recovery, changes in tax policy, and the midterm elections. The good news is that when some certainty returns and when demand firms up, large corporations will be well positioned to expand hiring and business operations.

**Financial Sector**

Eighteen months after reaching bottom, the financial sector staged a spectacular recovery, with equity prices soaring 67% from trough to peak. This has brought forth a substantial improvement in the health of the banking sector. Nonetheless, banks have remained reluctant to lend, hoarding vast amounts of excess reserves to the tune of $1.3 trillion (Figure 11). This has led to a sustained contraction of bank credit which, in turn, has further hampered the economic recovery. There are several reasons as to why banks are unwilling to lend: a possible double dip in the housing sector which would increase the rate of defaults, a large amount of commercial real estate loans that have not been written off, and uncertainty related to the amount of capital that needs to be raised as a result of financial reform.

These concerns, while valid, seem a bit exaggerated, at least as far as the big banks are concerned. Estimated losses from “toxic assets” have been sharply reduced from an original $4 trillion back in April 2009, to a current $2.3 trillion. Of these, around $1.5 trillion has been realized, which leaves only around $800 in potential write-downs ahead for the global banking system. Unrealized losses for U.S. banks are expected to be around $204 billion, almost half the amount estimated a year ago. Having said that, banks would need to raise capital to the tune of $5 trillion to refinance debt that will mature over the next three years.

![FIGURE 10](After-Tax Corporate Profits (level, billions))

Source: Global Insight and IEES
Ironically, the biggest threat to the financial sector going forward is the very cure that helped save the system from collapsing: unprecedented levels of government borrowing. Government balance sheets, which now contain a heavy dose of the banks’ “toxic assets,” have ballooned and sovereign debt may overwhelm credit demand, driving up interest rates. Concerns about long-run public debt solvency may place downward pressure on sovereign bond prices, thus adversely impacting the value of banks’ assets, which consist predominantly of government bonds. These concerns notwithstanding, we feel that the financial sector has recovered quite robustly during the past year which bodes well for the next phase of the recovery.

**Inflation**

Inflation has remained subdued during this year. The latest reading of the Consumer Price Index (CPI) points to a decline in inflation, with June and July numbers averaging 1.1%, below the 2.3% level seen earlier in the year. Core inflation, which excludes volatile prices such as food and energy, is even softer, averaging around 1% for the year.

Inflation should remain contained over the medium term, enabling the Federal Reserve to resume large-scale operations. Current inflation expectations are reasonably stable despite massive amounts of liquidity, given that excess money supply is pushing against slack capacity and resource utilization is well below normal levels. Inflation should remain near current readings for the balance of the year, edging steadily higher late in 2011 and 2012.

**Forecast Summary**

The U.S. economy should continue to grow at an uneven and modest pace over the near term. The recovery will bear a closer resemblance to a mild recession than to an expansion. The economy will remain in an awkward transition phase as the impetus from fiscal/monetary stimulus and inventory restocking is replaced by private demand. Consumer spending, labor markets and housing will remain a drag over the next six quarters and may not return to their full potential for a few years, as households repair their damaged balance sheets - a process that takes years to complete. A few bright spots
While the national economy has taken a particularly windy road to recovery, the local economies of Orange County and the Southern California region have also had their turbulent and tortuous twists and turns.

should help support growth: corporate profitability is at an all-time high, the financial sector is in a much stronger footing and inflation remains well contained.

We anticipate U.S. GDP to grow by 1.9% in Q3 2009 and 2% in Q4 2004. In annual terms, the U.S. economy should grow by 2.7% in 2010 and 2.6% in 2011. Consumption growth should continue to remain hesitant as high unemployment, deleveraging, and tight credit restrain household spending. The unemployment rate should nudge up slightly above the current level in Q4 2010 and remain above 9% well into 2011. A detailed summary of our projections for national variables is presented in Table 1, following this report.

Orange County and Southern California

While the national economy has taken a particularly windy road to recovery, the local economies of Orange County and the Southern California region have also had their turbulent and tortuous twists and turns. The level of frustration is expressed by all concerned, from policymakers to entrepreneurs; even the Federal Reserve’s Chairman Ben Bernanke has remarked on the “unusual uncertainty” surrounding the current economic environment. The problems are even more acute at the local level since, in addition to the volatility of the current economic trends, the data available for local economies are generally infrequent, sparse, and undependable. The vast majority of economic indicators are released at annual intervals, with the exception of employment and housing numbers, which are available monthly.

The local data suffer from small sample errors and are subject to substantial annual revisions. For example, at this time last year, according to the state’s Employment Development Department (EDD) payroll employment release, Orange County’s economy had lost 61,883 jobs through the month of August. But following its annual benchmark revision in February/March 2010, that value was revised drastically upwards to 100,213 jobs lost, a revision of 62% (Figure 12). Not surprisingly, forecasts based on earlier data turned out to be well off the mark. For example, we had predicted in September/October 2009 that the Orange County economy will show a loss of 58,300 jobs for 2009 and a small gain of 8,300 jobs for 2010, based on the 2009 EDD data. Instead, the revised data shows that the Orange County economy lost a breathtaking 110,158 jobs in 2009.
and is continuing to shed jobs in 2010, at a worse-than-expected rate. While one may not be sympathetic to the forecasters’ plight, business decisions based on imprecise data have real consequences.

Given the dearth of economic indicators at the local level, the Institute for Economic and Environmental Studies (IEES) searches for additional avenues to gather information on the region’s economy. One of the indicators is the Quarterly Survey of Orange County Business Expectations (OCBX) (a survey report is included at the end of the forecast tables). The survey is based on a large sample of local businesses and provides information on companies’ outlook for their own growth as well as for the broader economy, their hiring plans, inventory, sales, profits and other variables. The actual index, named the OCBX Index, is created based on the answers of business executives to a select group of questions, which provides a comprehensive measure of business expectations for the coming quarter. An index value of 50 and above implies continued expected growth in the county’s economy, while a value below 50 indicates a decline in economic activity.

The quarterly survey has had remarkable success in predicting the short-term economic outlook for the county. After reaching a low of 15.2 in the first quarter 2008, the index rose for the next several quarters and reached a high of 65.2 in Q2 2009. However, the index has been on a continued decline over the last two quarters. In its last reading for Q4 2010, the index stood at 60. Obviously, the overall gloom that has settled on the national economy, and the snail-like pace of the recovery have had a discouraging impact on Orange County’s executives, who seem to be adjusting their plans accordingly.

Orange County business executives continue to plan on adding workers, albeit at a slow rate. Their expectations for sales are modest, but they expect higher profits. The national measure of business sentiment produced by the Business Roundtable is more volatile, but is also consistent with OCBX. Both are indicating a slowdown in economic growth and a downshift in the overall business conditions, at least over the next six months.

![Business Expectations Remain Sluggish (OCBX Index and percent change in OC employment)](index level)

**FIGURE 13**

Orange County Housing Market

Much like the national picture, the Orange County and Southern California housing market have taken a turn for the worse since the first quarter of this year, and continue to remain in a severely weak condition. The termination of the housing support programs (in particular the tax credits) at the national and state levels seem to have simply
advanced demand, leaving in their wake a present situation of still-fledgling construction and disappointing real estate markets. Building permits for Orange County hit rock-bottom at 2,200 in 2009 from 3,200 in 2008 and 7,100 in 2007. Similar sharp declines were recorded in the six-county Southern California region (Orange, Los Angeles, Riverside, San Bernardino, Ventura and Imperial), where building permits collapsed from 50,800 in 2007 to 27,300 in 2008 and to 15,100 in 2009. Our estimates for 2010 show only a slight improvement for the year (Figure 14).

Home sales perked up in 2009 and part of 2010 thanks in large part to the support from government programs. Nonetheless, a disproportionately large number of sales were distressed sales. Low mortgage rates have certainly helped real estate markets, including home refinancing. As a result, Orange County home sales in 2010 are likely to be at about the same level as in 2009, exceeding last year’s level by a small margin (Figure 15). This would make the current year’s home sales the highest in the last four years. Having said that, buyers and sellers still face a great deal of uncertainty due to the accumulation of defaults and foreclosures which is expected to hit the market in the coming months. The rate of foreclosures has consistently underrepresented the true number of at-risk properties, given that banks have held back considerably on foreclosures even though the number of defaults has continued to march upwards. This has to do with the new regulations, problems with foreclosure procedures and strategic balance sheet calculations by banks. The situation is unlikely to improve in 2011 given the sluggishness of the recovery and problems in the housing sector.
Housing prices have begun to recover in Orange County after hitting bottom in Q1 2009. At their worst level during this recession, the median price of an existing single family home in the County, based on estimates from California Association of Realtors, fell by 42% to $423,000 in January 2009 relative to its peak of $731,000 in April 2006 (Figure 16). The current median price in July 2010 of $514,000 is 22% above the January 2009 level. The current prices are roughly the same as in Q3 2003, meaning that all the gains in home values from 2003-2007 were completely wiped out during the recession. This certainly has been a dizzying roller coaster ride for home values in Orange County.

The same pattern was repeated in other counties in Southern California, except that the gyrations were more severe in the Inland Empire. The plunge from the highest median price level was 59% for Riverside and 65% for San Bernardino. Since then, the median prices have recovered by 13% in Riverside and 16% in San Bernardino. For Los Angeles County, the median housing price fell by 52%, followed by an increase of 17% from the lower base (Figure 17). Housing recovery, as pointed out in the national scenario, will not take place without improvements in general economic conditions. At the same time, construction and housing will need to improve to sustain the recovery. Given the overhang of homes in default and foreclosures and a weak general economic recovery, we expect Orange County housing prices to show only moderate improvements, gaining approximately 2 – 4% on an annual basis in 2011. The pattern will vary depending on geography, local conditions, and housing price range.
Orange County Household Finance
Orange County households have embarked on a multi-year process of cutting debt and repairing their balance sheets. In fact, consumer-level data from the global credit information company, Experian, shows that the pace of deleveraging in the County is faster than the national average: from its peak of Q4 2008, household debt fell by a total of 7.7%, higher than the nation’s 5.3%. Average available credit has shrunk at a spectacular rate of 18.75% (Figure 18). The number of late credit card payments has risen by a remarkable 59% since 2005, whereas the number of open credit cards has fallen precipitously. Household debt is now at the same level as in 2004, whereas available credit has fallen to the lowest levels in the last six years. Given the credit exposure and current debt levels, our estimates indicate that Orange County households are half-way through the process of deleveraging. Much like their national counterparts, we anticipate that Orange County households will continue to pay down debt and rebuild their balance sheet for the better part of the next three years.

Orange County/Southern California Employment Analyses and Forecasts
While nationally, based on output and production indicators, the recession ended in June 2009, the employment situation continued to deteriorate and is still worse compared to other recessions at this stage of the recovery. In past recovery cycles, Orange County has performed better than the national economy, however, this recession is much different.

Orange County’s unemployment rate rose sharply as the recession got deeper, more than doubling within two years. The unemployment rate jumped from 4% in June 2007 to

FIGURE 18
Orange County Debt and Available Credit Has Fallen Sharply Since the Crisis (levels)

Source: Experian and IEES

FIGURE 19
Unemployment Rates (U.S. versus Orange County)

Source: EDD and IEES
9.4% in June 2009, the official end of the recession, and, after touching a high of 10.1%, has stayed in the 9.9-9.5% range. As shown in the accompanying chart, the County’s unemployment rate, which is typically below the national rate, has, during this recession, followed closely the national level (Figure 19). The situation in other counties in Southern California is no better with the unemployment rate, touching a high of 15.1% in Riverside and 13.3% in Los Angeles County. As in the case of the national economy, the real rate is even higher if one were to include the number of discouraged workers, marginally attached workers, and those that are employed part time for economic reasons. But no official data are available for such estimates at the local level.

During the recession, the region lost payroll jobs at a record pace. As is well recognized, employment is a lagging indicator and follows trends in output. As the output decline ended in June 2009, employment continued to fall and, in fact, was falling at its fastest rate at the end of the recession. In Orange County, job losses reached their worst in the third quarter of 2009, with payroll employment declining at an annual rate of 125,000 jobs. Over the three year period of 2007-09, Orange County lost 144,000 payroll jobs, 110,000 of which were lost in 2009 alone. In the first seven months of this year through July 2010, the County’s economy has continued to shed jobs at an annual rate of over 14,000. The Southern California region lost over 598,000 jobs over the three year period ending in 2009. As in Orange County, most of the job losses, over 460,000, occurred in 2009, and an additional 122,000 in the current year through August 2010.

Construction, historically a sizable and significant sector for the region and Orange County’s economies, was hit the hardest and dragged related industries and the overall economy. In the Southern California’s six-county region, over 121,000 construction jobs were lost over the 2007-09 period, and an additional 34,000 in the first eight months of 2010. This is the equivalent to a third of the sector’s total payroll employment. Financial Services, Professional and Business Services and Government are the other sectors with the largest losses. So far this year, payroll job losses for the region continue, albeit at a slower pace.

In Orange County, job losses in the Construction sector were almost 30,000 during the 2007-09 period, or 28.6% of its total payroll employment on an annualized basis. From a monthly peak of approximately 110,000 total payroll jobs in the third quarter of 2006, the Construction sector currently employs only about 65,000 workers. Professional and Business Services, one of the two largest Orange County industry sectors, lost 34,000
jobs during the three-year period of 2007-09. The other largest sector, Trade, Transportation and Utilities, lost 27,000 over the same period. In addition, Manufacturing and Financial Services were the other two sectors with sizable losses (see table below).

In its latest readings, the County’s economy has begun to slowly add jobs on a year-over-year basis, with a gain of 4,200 jobs in July 2010. The monthly trend now is certainly positive, albeit weak. The sector adding the most jobs so far this year is Leisure and Hospitality, with an annualized increase of 6,100 jobs, followed by service jobs in the Administrative and Professional sectors. In percentage terms, the subsectors of Finance and Insurance and Food Service and Drinking are showing the best pace (see table below).

<table>
<thead>
<tr>
<th>Orange County Sectors with Most Job Losses, 2007-09</th>
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<tr>
<td><strong>Absolute Numbers</strong></td>
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<tr>
<td>Professional &amp; Bus. Services</td>
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<tr>
<td>Construction</td>
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<tr>
<td>Trade, Trans. &amp; Utilities</td>
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<tr>
<td>Manufacturing</td>
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<td>Financial Activities</td>
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<tr>
<th>Orange County Sectors with Most Job Gains, January - August 2010</th>
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<td><strong>Leisure and Hospitality</strong></td>
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<td><strong>Adm. &amp; Support Services</strong></td>
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<td><strong>Prof. &amp; Technical Services</strong></td>
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<td><strong>Finance and Insurance</strong></td>
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**Orange County and Southern California Forecasts**

We stated in our October 2009 report that “any significant growth, especially in employment, is some time away, most likely in the second half of 2010 or early 2011.” If anything, the regional and national economies have been slower than expected in the first half of 2010. While the private sector job growth is showing modest improvements, it will take longer for local and state governments to get back on track. In fact, we expect a continuing decline in government jobs over the next two years. Only when tax revenues get a boost from a more robust economic growth will the state and local fiscal situation improve.
We have begun to notice some signs of improvement in Orange County’s employment picture, but net payroll jobs are still falling for the Southern California region as a whole. Given the severity of this recession, lingering problems in the housing sector, continuing restraint in lending to business and household, and slower global recovery we expect the Orange County and Southern California economies to grow at a modest pace in 2011 and recover a bit faster, but still below trend, in 2012.

We expect Southern California’s payroll employment to decline by -1.5% in 2010 (102,600 jobs), but in 2011 show a small improvement of 1.1% (68,800 jobs), and 1.9% or 123,000 job growth in 2012. For Orange County, the decline in 2010 is estimated to be -0.9% (-12,000 jobs), followed by gains of 1.3% (18,300 jobs) in 2011 and 2.3% (31,800 jobs) in 2012. For Los Angeles County, the forecasted changes are -1.5% (-56,500 jobs) in 2010, 0.8% (30,000 jobs) in 2011, and 1.3% (50,700 jobs) in 2012. For the Inland Empire, the forecasted growth rates are -2.6% (-29,400 jobs) in 2010, 1.6% (17,200 jobs) in 2011, and 3.1% (34,000 jobs) in 2012.

Unemployment rates in the region will decline only slightly, by approximately 1% in 2011 and another 2% in 2012. We will get back to the pre-recession unemployment levels only in 2014.

A detailed summary of our projections for regional variables is presented on the following pages.

Robert Giuliano provided expert research assistance for this forecast.
Any errors are the authors’ responsibility.