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from Beacon Economics

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Beacon Economics, LLC is an independent economic research and consulting firm focused on helping our clients make informed, strategic decisions about investment, growth, revenue, policy, and other economic and financial issues.

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This publication was prepared by:

Christopher Thornberg, Founding Principal
5777 West Century Boulevard, Suite 895
Los Angeles, California 90045
310.571.3399
Chris@BeaconEcon.com

Jordan G. Levine, Director of Economic Research
5777 West Century Boulevard, Suite 895
Los Angeles, California 90045
424.646.4652
Jordan@BeaconEcon.com

For further information about this publication, or about Beacon Economics, please contact:

Victoria Pike Bond
Director of Communications
415.457.6030
Victoria@BeaconEcon.com

Sherif Hanna
Managing Partner
424.646.4656
Sherif@BeaconEcon.com

Or visit our website at www.BeaconEcon.com.

U.S. Forecast

Key Chapter Findings

- Beacon Economics forecasts the U.S. economy to accelerate in 2011 and expects growth rates in the 3% to 4% range. While growth will likely continue into 2012, there are significant mid-term worries as the economic expansion is being driven by fiscal and monetary policies – policies that will need to be reversed eventually. At best the recovery will slow in 2013 as these problems are properly addressed. Alternatively, a lack of resolve could lead us into yet another recession
- Gross domestic purchases increased by 6.5% in the fourth quarter of 2010, the strongest showing since 2006. Growth in domestic production increased by less (2.8%) but this is only because of a reduction in the pace of inventory accumulations. As gross purchases continue to grow, actual output will also increase, having a beneficial, secondary effect on labor markets.
- U.S. exports are growing and will likely continue to do so as demand continues to increase from major trading partners including China, Mexico, Canada, Korea, and Japan. At the writing of this report, events stemming from Japan's massive earthquake are still unfolding, and while the human tragedy is enormous, we do not foresee a significant impact on the global or U.S. economy based on the historical resilience economies have shown in the face of such shocks.
- Rising oil prices are less of a threat to the U.S. economy than many perceive. In 2010, the average American used 3.5% or his or her income on energy purchases – considerably less than the 6% used during the oil shock in the 1970s.
- Home prices in the United States are at near-record affordability levels and we believe they are at or near their bottom. Over the next two years, expect sales and production to be in neutral mode.
- American consumers are still overspending with savings rates starting to drift down from an already too-low rate of 6%. As for government spending, the Federal deficit is currently over 10% of GDP.A major issue is that the United States is largely dependent on foreigners to purchase this massive quantity of debt. The Fed will eventually have to scale back, given the potential for inflation, and foreigners may begin to grow shy if inflation rears its ugly head.

Reading the newspaper today can lead to a case of mental whiplash. The front page continues to show us dismal statistics on economic growth and the labor markets. And alongside of these statistics are stories voicing more worries—rising oil prices as a result of the uprisings in the Middle East, increasing fears of U.S. inflation driven by commodity and food costs, and of course ongoing public deficit crises at the national and local levels contributing to political bickering and generating at least one claim of massive municipal defaults in the near future. Yet when you flip to the financial section of the paper you see that the S&P is up 12.5% over the last quarter with bullish Wall Street predictions for the rest of the year, the 10-year Treasury yield is still below 3.5%, risk premiums on high-yield bonds have sunk below the average long-run levels, and cap rates for commercial properties are dropping despite falling rents and rising vacancies. The quick shifts in outlook make you want to go straight to the comics and throw the rest away.

At Beacon Economics, our views sit between the two extremes. On the one hand, we expect the U.S. economy to accelerate and we feel that 2011 will be an above-average year for growth—in the 3% to 4% range—short of some unlikely turn of events. On the other hand, there are significant mid-term worries regarding the current path of the economy. The primary driver of the expansion remains fiscal and monetary policies—policies that are going to need to be reversed eventually lest a major financial crisis occur in the U.S. At best this reversal, properly managed, will slow the expansion sharply. At worst we could end up in a situation where the cure ends up being worse than the disease. The difference between these two outcomes will be determined by the political battles being fought across the nation's capitals.

Even though some of the headline numbers seem weak, the reality is that the U.S. picked up a lot of steam in the fourth quarter of 2010. Gross domestic purchases increased at 6.5% after lagging at about 1% for the first three quarters, one of the strongest showings since 2006.A closing trade deficit, a suddenly resurgent consumer, and a bounce in real estate sales all contributed to the surge.

The headline gross production growth was only 2.8%, but this was because the growth in demand was offset by a reduction in the pace of inventory accumulations. But given that inventory-to-sales ratios are at long-run average levels, as long as demand growth continues apace there is no reason to presume that inventories will continue to be run off this year. As such, continued growth in gross purchases will be matched by growth in actual output, with the secondary benefits finally being seen in the labor markets.

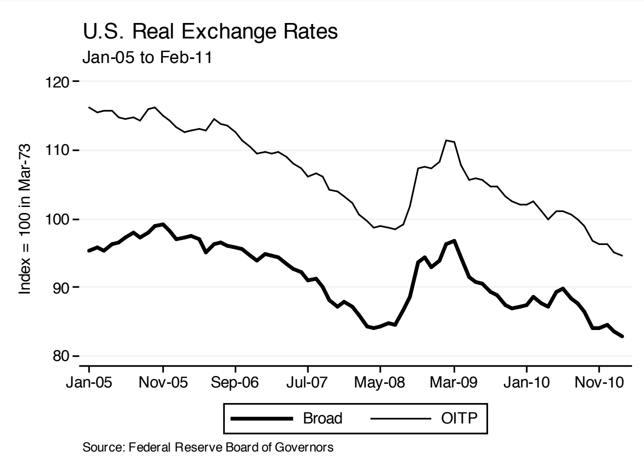
Although our forecast is in a bit of a flux given the unsettled nature of current events, we still expect a growth in demand to continue as we move through 2011, driven by consumer spending, exports, and capital investments. We will discuss these positive current trends and then examine the perceived but less immediately troublesome economic worries, before we finally consider the real threats to the recovery.

Consumer Spending

In the fourth quarter of 2010, consumer spending was stronger for several reasons. First, incomes are increasing for those who have jobs, by 2% year over year in real terms. This isn't fast, but it's definitely an improvement. Second, even though households continue to carry a record amount of mortgage debt, because of low interest rates the cost of carrying outstanding balances has fallen back to normal values. The more reasonable costs, combined with stronger consumer confidence and a rising equity market, has led Americans to increase their non-mortgage debt for the first time since the recession began in 2007.The net result is that the strength of the fourth quarter has carried over into this year, as can be seen in trends in automotive sales and retail sales despite the continued slack in the labor markets.

Foreign Trade

Exports are growing well and will likely continue to do so. The increase in exports is being driven in part by solid growth in our major export markets, including China, Canada, Mexico, Korea, and Japan. It is also in part the result of the continued real depreciation of the U.S. dollar, which has made our products more competitive in the world market. While the nominal exchange rate is often the focus of most discussions on exchange rates, the real rate—which takes into account relative price changes—is actually a more important measure. While price growth in the United States remains at a mild 1% (and less for export products) inflation is heating up in many developed nations. Take China, a country that has borne much of the brunt of U.S. frustrations over overt efforts to manipulate the value of our currency. Yet in China the inflation rate is 5 percentage points higher than here in the United States; thus, the Chinese yuan has effectively appreciated by 5% relative to the dollar this past year. Overall the U.S. dollar is 15% cheaper relative to the currencies of our trading partners than it was in 2005.



At the writing of this report, the fallout from a massive earthquake in Japan is still unfolding. The human tragedy is clearly enormous as aid rushes in from across the globe. The question facing us in this report is how the disaster might affect our economic outlook. The answer is that it will not have a significant impact. History has shown that economies are remarkably resilient to such shocks. Industrial production in Indonesia continued to grow in 2005 following a catastrophic tsunami—caused by an earthquake in the Indian Ocean on the day after Christmas 2004—that claimed an estimated 250,000 human lives. Earthquakes in San Francisco and Los Angeles have only created a one-quarter ripple in growth, first slowing and then accelerating as the economy caught up to pre-event trends.

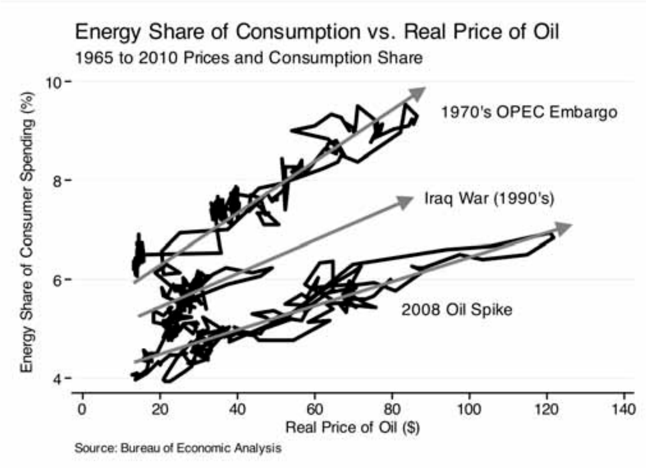
Business Investment

Lastly there is business investment. During the recession of 2008-09, the pace of capital investments fell below the rate of depreciation—for the first time since the Great Depression, the U.S. capital stock actually stopped growing. But spending has been bouncing back as capacity utilization has risen. Given the strength in consumer spending and foreign demand, we expect utilization rates to continue to rise. Add this to easier credit conditions and the accelerated depreciation companies can enjoy this year for capital purchases, and we can expect this part of the economy to grow. We now turn to some of the supposed threats to the economy – threats we believe are less menacing than perceived.

Oil Prices

The important qualification with respect to oil prices is that we can’t be certain what will happen in the Middle East in the coming months. But it is clear that oil prices in their current range are not a threat to the economy. First of all, energy is simply a smaller share of the personal budget than it used to be. In the fourth quarter of 2010, the average American used 3.5% of his or her income for energy purchases, considerably less than the 6% at the peak of the oil shock in the 1970s. And Americans get much more mileage from the same amount of energy—indicating there is greater elasticity of demand now than before. When oil prices shot up to record high levels in 2008 (50% higher than in the seventies in real terms), the proportionate impact on consumer spending was much more muted, inasmuch as its growth as a share of overall spending was much smaller.

Indeed, the commonly heard claim of a correlation between the slowing of the economy and high gas prices in 2008 is a complete misconception. The U.S. economy stayed in a mild recession as gas prices went to record (nominal) levels, and dipped into the steepest part of the downturn even as oil prices came crashing down.

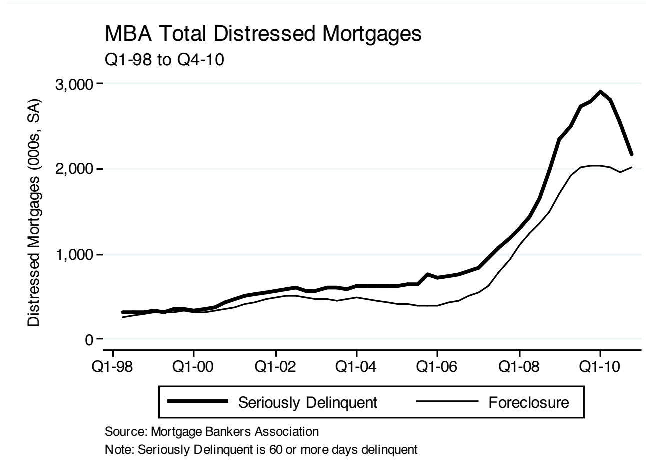


This isn't to say that oil and oil prices might not become a problem—but not yet. Our guess is that oil prices would have to hit the $160 range for a significant period of time before prices began to have a significant negative impact on the economy.

Real Estate

Recent releases from the S&P/Case-Shiller home price index yet again show a market with sagging prices. Robert Shiller, one of the co-creators of the index, released a forecast indicating he thought home values would fall another 20% before finally bottoming out. If it were to occur, a further decline in home values would set off another wave of foreclosures. Frankly, we find this scenario highly unlikely. While it is true that the market is still oversupplied in some areas, prices have already fallen to a level that, when combined with low interest rates, puts home prices near a record-high affordability level. Short of a sharp increase in interest rates—a possibility that seems at best remote for now—we don't see this happening.

This isn't to say that we expect home prices to come bouncing back either. Even though the excess supply of housing units is finally starting to be absorbed, and there has been a decline in the number of seriously delinquent mortgages, there is still a simple lack of homeowner equity in the market. Until equity starts to build, foreclosures will remain a dominant source of supply, and prices will not be able to come off the very low bottom where they currently rest. Expect sales and production to be a neutral force over the next two years.



A very similar statement can be made for the commercial markets. While aggressive intervention by banks in their portfolios headed off a wave of foreclosures in the commercial market, vacancy rates are still quite high, and rents continue to weaken. Look for little in the way of new construction for the near future.

State and Local Budget Problems

The budget struggles of local and state governments as they grapple with record deficits present another source of worry for the markets. Meredith Whitney made waves in the municipal bond market when she predicted a tidal wave of defaults. With all due respect, we feel that Ms. Whitney's primary contribution is to bolster the conventional wisdom that there is no such thing as bad publicity. Yes, there are budget gaps, but debt levels aren't that high; at 1.3 times receipts, the budget gaps remain below long-run averages, and with low interest rates the burden is quite small. And while pension liabilities are a huge issue, they won't really have an impact for a decade or more. The funding gap can continue to be ignored in the short term.

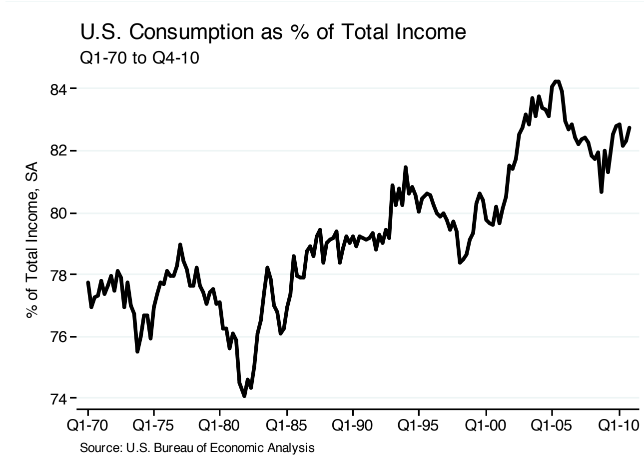
Notably, the budget problems are not due to declining revenues. In fact, it is quite the opposite; revenues have been rising at a decent clip. But no concrete steps were taken to address the budget gaps of the past three years—instead, temporary measures and accounting gimmicks were the primary means of balancing the budget. Now all of that avoidance is catching up to us. But once the current gaps are filled, spending growth can occur on a normal basis.

Lastly, it must always be remembered that public defaults are a political rather than economic choice. For all but the smallest areas, there is a certain amount of revenue that can be raised if there is the political will to do so. Look for local government to be a drag on the economy in the near term, but not to set off any new financial crisis.

For each issue discussed above that we don't have to worry about, there are other challenges that do pose legitimate concerns. The good news is that they aren't immediately pressing, but eventually the following situations will need to be addressed.

Consumers and the Federal Deficit

Although the American consumer is recovering nicely, the elephant in the room that is being ignored is that Americans are still overspending. Savings rates are actually starting to drift down again, from a still too-low rate of 6%. The savings rate dropped to 5.4% of disposable income at the end of the year and spending surged ahead. Furthermore, spending levels are already being artificially supported by the low tax rate Americans are currently enjoying as a result of both the Bush tax plan and the stimulus tax cut plan. The low tax rate sounds nice, but it's really no different than the personal borrowing binge that began a decade ago, only this time it's the government that's doing the borrowing for consumers.



And this is real money we are talking about. The deficit is currently in the $1.3 trillion to $1.4 trillion range, over 10% of GDP. This will stay in the higher portion of single digits for the next two years at least, leaving the federal deficit with a net debt rate of 80% to 85% by the end of the next fiscal year. (Of course, these figures do not include unfunded losses that Fannie Mae and Freddie Mac may eventually incur.) Given that many developed nations carry similar debt loads with little difficulty, one could presume that the debt load could be safe for the U.S.

But there are a few significant issues that need to be considered. The United States is largely dependent on the Federal Reserve and on foreigners to purchase this massive quantity of debt. The Fed will eventually have to scale back, given the potential for inflation, and foreigners may also begin to grow shy if inflation should raise its ugly head. The good news, in the short run, is that worldwide turmoil creates a degree of risk adversity in the world financial markets—making the U.S. bond a more desirable product for now and keeping rates low.

In general, the more debt a nation is currently carrying, the smaller leeway it has to use fiscal policy in the event of future economic challenges. It isn't clear that we should be using all of our ammunition at this point. In addition, the growing cost of the debt service is a problem that could grow exponentially if there is even a hint of inflation in the U.S. economy. This will force a rapid increase in taxes if Congress still does not have the stomach to enact a massive change in one or more of the major entitlement programs, as there simply isn't enough latitude in the discretionary programs (outside of defense) to make cuts that would close the budget gap. And remember—while it is easy to bail out Greece or Ireland, who can bail out a quarter of the world's economy?

As for the current budget battles, it is clear that the rules both sides have stuck to—namely, to ignore entitlement costs and defense spending—suggests that they won't be able to truly reduce the deficit anytime soon. Most of the debate will center on the merits of the cuts rather than on the quantity, and as such the federal government will be a mild drag on the economy as it cuts spending slowly while debt continues to pile up. We don't foresee any problems with the deficits in the short run, but they will have to be dealt with in the next few years or the situation could grow into crisis proportions. Thus there is the potential for another painful but necessary contraction in consumer spending. We only hope that this next time the problem is managed appropriately.

Inflation

The path of prices is always difficult to forecast, but this time the experts seem all over the map—a fitting metaphor for the economy overall. Some experts claim deflation is still a threat, although this segment has shrunk rapidly in recent months. Other experts claim that we are heading toward hyperinflation, while still others say we are already in an inflationary environment that is being masked by the high jinks of the Bureau of Labor Statistics. And of course, there is another opinion, shared by Ben Bernanke, the chairman of the Federal Reserve, that the price level is doing just fine, thank you very much. So which is it?

My personal money is split between options 2 and 4. In the short run, the price level is just fine. Yes, commodity prices are going up, but the pass through to final goods is small even in a full employment economy. With slack in the system, as currently exists, the pass through will be even smaller. The Fed has done a masterful job with quantitative easing to date. Recognizing that most of the funds would remain in the banks in the form of excess reserves (à la Japan in the 1990s when Japan attempted quantitative easing), the Fed put in 20 times as much as it needed to offset the deflationary drop in monetary velocity.

But at the same time, the Fed should already be thinking about an exit strategy. M2 growth, the best leading indicator of inflation, began to accelerate in the second half of 2010. It's still too slow of a pace to worry about, but the stabilization of the lending markets and the slight growth in some sectors support the idea that banks may begin to use a portion of these reserves for lending, a process that will surely lead to faster acceleration. One might wonder what the purpose of the second $600 billion injection of liquidity into the market underway right now is going to accomplish in the grand scheme of things; the risk-reward profile seems to be considerably tilted in the risk direction.

One thing is clear: current rates on 10-year bonds are reflecting at best a moderate acceleration of price growth in coming years. If Bernanke pulls off this trick and succeeds, we may well end up in a new era of low interest rates, not unlike the time before the 1970s and inflation. If not, and inflation does creep into the system, the pain to the economy will be enormous.

The Financial Markets

Given the worries outlined above, it perhaps seems amazing that the financial markets are as bullish as they appear. The equity markets worldwide are moving back toward their previous peaks, risk premiums have dropped to pre-recession lows, and the bond markets are showing no signs of worry regarding U.S. sovereign debt levels or the potential for inflation. Cap rates are falling in commercial markets as well, despite high vacancy rates. Given that the markets appear to be taking most of the good news as having a degree of sustainability, it makes sense to me that the next two years could be good for asset values. But... it also seems as if asset prices are already a little high given the growth potential for the U.S. economy. As such, much of these gains may not stay in the system. When a correction may occur is hard to say, as always. But the uncertainty surely suggests that the massive ups and downs of the markets over the past two decades have not ended.

To summarize, the next year will be good for the U.S. economy. Strong growth in business spending and exports, along with normal growth in consumer spending, will offset the flat construction sectors and the modest drain from public spending cuts. This growth will likely continue into 2012, depending on how many of the one-year tax cuts get extended once again, a virtual certainty as we move into an election year. But the problems have not been fully removed from the system, just papered over with massive amounts of policy. At best, the recovery will slow in 2013 as these problems are properly addressed. Alternatively, a lack of resolve could lead us into yet another recession, this one driven by the policy decisions made to minimize the last one.

U.S. Historical Table

United States	Q4-2008	Q1-2009	Q2-2009	Q3-2009	Q4-2009	Q1-2010	Q2-2010	Q3-2010	Q4-2010	Q1-2011
National Real GDP ($ Bill.,SAAR)	12,958.20	12,797.00	12,769.00	12,821.20	12,986.10	13,112.50	13,180.00	13,268.50	13,378.50	13,479.74
Growth (%,SAAR)	-6.80	-4.90	-0.70	1.60	5.00	3.70	1.70	2.60	2.80	3.06
Real Personal Consumption ($ Bill.,SAAR)	9,166.30	9,154.10	9,117.00	9,161.60	9,182.90	9,225.40	9,275.70	9,330.60	9,425.90	9,508.34
Real Investment ($ Bill.,SAAR)	1,753.80	1,529.50	1,453.20	1,494.50	1,585.70	1,690.20	1,791.50	1,855.10	1,742.80	1,784.85
Real Government Expend. ($ Bill.,SAAR)	2,530.70	2,511.50	2,549.30	2,559.30	2,550.30	2,540.20	2,564.90	2,589.60	2,579.70	2,564.71
Real Net Exports ($ Bill.,SAAR)	-477.70	-389.20	-342.00	-390.80	-330.10	-338.40	-449.00	-505.00	-395.00	-378.16
Total Nonfarm Empl. (Mill, SA)	135.06	132.81	130.96	129.96	129.43	129.32	129.96	129.88	130.13	130.42
Growth (%,SAAR)	-4.68	-6.50	-5.48	-3.01	-1.64	-0.32	1.98	-0.23	0.76	0.90
Unemployment Rate (%,SA)	6.90	8.20	9.27	9.67	9.97	9.70	9.63	9.57	9.63	8.95
Personal Income ($ Trill.)	12.36	12.09	12.20	12.16	12.24	12.35	12.52	12.60	12.72	12.86
Growth (%,SAAR)	-2.88	-8.25	3.70	-1.29	2.49	3.69	5.51	2.53	3.86	4.48
Savings Rate (%)	4.60	4.86	6.50	5.12	5.03	4.95	5.63	5.41	4.92	4.91
Tax Rate (%)	11.68	10.03	9.12	9.18	9.13	9.19	9.18	9.35	9.48	8.90

Forecasts by Beacon Economics

U.S. Forecast Table

United States	Q2-2011	Q3-2011	Q4-2011	Q1-2012	Q2-2012	Q3-2012	Q4-2012	Q1-2013	Q2-2013	Q3-2013
National Real GDP ($ Bill.,SAAR)	13,587.54	13,720.04	13,842.19	13,960.58	14,045.39	14,163.54	14,247.16	14,283.80	14,324.04	14,392.47
Growth (%,SAAR)	3.24	3.96	3.61	3.47	2.45	3.41	2.38	1.03	1.13	1.92
Real Personal Consumption ($ Bill.,SAAR)	9,570.76	9,661.52	9,740.70	9,845.56	9,899.87	9,954.60	10,001.35	9,996.66	9,967.71	9,977.92
Real Investment ($ Bill.,SAAR)	1,826.40	1,857.78	1,900.65	1,942.46	1,999.35	2,072.78	2,107.87	2,134.70	2,149.63	2,158.59
Real Government Expend. ($ Bill.,SAAR)	2,562.31	2,551.00	2,534.82	2,517.67	2,510.04	2,502.42	2,489.27	2,483.74	2,484.34	2,484.71
Real Net Exports ($ Bill.,SAAR)	-371.93	-350.26	-333.98	-345.11	-363.88	-366.26	-351.33	-331.29	-277.64	-228.75
Total Nonfarm Empl. (Mill, SA)	130.89	131.54	132.30	133.17	134.08	135.03	135.92	136.67	137.30	137.89
Growth (%,SAAR)	1.45	2.02	2.33	2.63	2.78	2.87	2.64	2.23	1.88	1.72
Unemployment Rate (%,SA)	8.84	8.75	8.56	8.29	8.03	7.61	7.28	7.06	6.92	6.84
Personal Income ($ Trill.)	13.01	13.20	13.38	13.57	13.79	14.00	14.05	14.15	14.32	14.50
Growth (%,SAAR)	4.75	6.11	5.59	5.92	6.63	6.26	1.20	3.11	4.66	5.14
Savings Rate (%)	4.86	4.81	4.76	3.96	4.46	4.71	3.96	3.95	4.45	4.70
Tax Rate (%)	9.05	9.15	9.25	10.00	10.06	10.17	10.57	10.85	11.11	11.38

Forecasts by Beacon Economics

California Forecast

Key Chapter Findings

- While California's labor markets are slowly improving, the state will be living with a double-digit unemployment rate through the remainder of 2011 and into 2012.
- Home sales in California will gradually begin rising, although prices will remain relatively flat through 2011 and into 2012.
- In the current fiscal year, California sales tax revenue is nearly 1% higher than it was in the previous fiscal year. This is a result of solid improvements in taxable sales across the state.
- During the recent recession, California lost far fewer residents than it did during the recession of the 1990s. Between 2004 and 2010, the state lost fewer than 500,000 residents, just over 1% of its base.

We Want Some J-O-B-S

The good news is that California is traveling down the road toward economic recovery; however, that road is proving to be difficult to navigate as it is littered with the lingering effects of the recession. Among the most positive recent developments are the new employment figures released by the Employment Development Department (EDD). Each year, the EDD updates their benchmark employment series based on a census of employers in the state. These new numbers released in March paint a much better picture of California's labor markets. Specifically, the update shows 60,000 more positions in total nonfarm employment than in the earlier release. Indeed, the prior estimates indicated a decline in employment of nearly 1.4 million jobs from peak to trough, while the new estimates show a slightly smaller decline at 1.35 million jobs. Additionally, we have added back more than 110,000 jobs through the end of 2010 since hitting bottom, rather than the 87,500 positions previously cited.

Along with the education and health care sectors, which were relatively unaffected by the recession, administrative support and professional, scientific, and technical services have been contributing to the economic rebound—accounting for more than half of all the job gains since the trough. Farm employment, wholesale trade, and transportation and warehousing have also seen some solid increases over the past six months, helped, in part, by rising international trade at the ports of Oakland, Los Angeles, and Long Beach.

Despite these encouraging signs, other sectors are struggling to get out of the slump. Unsurprisingly, given the nature of this specific downturn, sectors tied to the housing market have yet to see much job growth. The real estate, rental, and leasing industry hit a new low in January, and, with the exception of a strong January number, construction has yet to emerge from the doldrums. Even the retail sector, which has seen some decent growth on the spending side, has not been able to translate these gains into a significant number of new positions relative to its job base. Some sectors, including financial activities and "other services" have continued their downward slide into 2011. These mixed signals suggest that even though we are well on our way down the road to recovery, the severe nature of the recession means it's going to be a long journey.

Demographics Hold Steady... for Now

Traditionally, the strain of recession has caused population growth to slow dramatically, as California residents leave the state in search of better opportunities elsewhere. This time is no different, although domes-

California Industry Employment Changes
Peak to Trough, Great Recession of 2007-2010

Industry	Trough Month	Trough Employment (000s)	Jan-11 Employment (000s)	Change (000s)	Change (%)
Total Farm	Dec-09	349.0	384.1	35.1	10.1
Total Nonfarm	Sep-10	13,847.9	13,971.2	123.3	0.9
Educational/Health	N/A	N/A	1,812.4	N/A	N/A
Administrative	Sep-09	828.2	884.4	56.2	6.8
Prof./Sci./Tech.	Dec-09	995.2	1,023.9	28.7	2.9
Leisure/Hospitality	Mar-10	1,481.9	1,509.4	27.5	1.9
Construction	Sep-10	543.2	568.1	24.9	4.6
Wholesale Trade	Dec-09	632.2	651.7	19.5	3.1
Retail Trade	Aug-09	1,504.4	1,520.6	16.2	1.1
Information	Apr-10	420.1	432.9	12.8	3.0
Local Government	Sep-10	1,645.1	1,656.9	11.8	0.7
State Government	Jun-10	478.1	489.5	11.4	2.4
Manufacturing	Sep-10	1,236.7	1,246.4	9.7	0.8
Federal Government	Apr-08	246.6	254.1	7.5	3.0
Transport./Warehous./Util.	Nov-10	463.2	468.2	5.0	1.1
Management	Dec-10	188.1	190.8	2.7	1.4
Mining/Logging	Dec-09	25.3	27.2	1.9	7.5
Financial Activities	Jan-11	756.6	756.6	0.0	0.0
Other Services	Jan-11	478.1	478.1	0.0	0.0

Source: California Employment Development Department

tic out-migration has been slightly smaller in magnitude so far. From 1991 to 1998, when unemployment reached a peak of 9.8%, we saw almost 1.5 million Californians leave the state, representing almost 5% of the prerecession population. Population growth remained positive, though below 1%, during the 1990s due to strong increases in new births and continued immigration from abroad.

In the current recession, we have seen a much smaller share of our prerecession population leave the state. So far, fewer than 500,000 residents have migrated out of California, which is just over 1% of our base. This is in spite of the fact that this recession has been much deeper and more substantial, with unemployment peaking at 12.5%.

There are several distinctive features of this recession that are causing California to buck the historical trend of experiencing domestic out-migration. First, this recession was felt across the country, with several states—including some of our closest neighbors—experiencing double-digit unemployment. Thus, the perceived benefits of moving to another state have not been as strong of a pull. Second, as hard as the housing meltdown has been for those who bought homes during the bubble, prices have fallen to some of their most affordable levels in many years. In addition, population growth overall has maintained a slightly higher rate than in the 1990s. This is due in part to international immigration, which has run more than double the out-migration of domestic residents, rather than matching the numbers as was the case in the 1990s. Natural increase in our population

Population Growth in California
Comparison of 1990s and 2007-10 Recessions

	1991-1998	2004-2010
Domestic Out-Migration	-1,492,726	-483,423
Foreign Immigration	1,511,155	983,904
Natural Increase	2,385,923	1,871,946
Population Growth	2,404,352	2,372,427

Source: California Department of Finance through new births (taking into account the attrition through deaths) has also continued at a healthy pace through 2010.

Recent data show that California's demographics have held steady through 2010, but we may continue to see slow population growth as more of our current residents consider moving to other states. During the 1990s, the exodus of Californians took place over a seven-year period. We have so far seen six years of out-migration from 2004 to 2010, and the unemployment rate remains naggingly high. Home prices are more affordable, however, which could help to stem the tide. And, with a weak dollar and a rebounding global economy, we should continue to see more international immigration, which will help to bolster our housing market, boost consumer spending, and ultimately help our labor markets.

State Budget Improving, but Needs Work

California's annual struggles to address its state budget problems have long been a source of contempt for newsmakers, political candidates, and the public alike—in many cases for good reason. California continues to face a budget shortfall that is far too large, and lawmakers would be wise to act sooner rather than later to address it with permanent solutions.

Revenues have begun to improve over the past six months, and we are on track to end this fiscal year with higher revenues than we received during the last fiscal year. Personal income taxes have been coming in consistently higher than the figures from last year and are higher than the recently released estimates from the Department of Finance (DOF). Increases in employment statewide and rising hours for existing workers have both contributed to the rise in personal income. Increases in efficiency and productivity are no longer producing a dampening effect, and we are beginning to see rising jobs, wages, and incomes. And, after curbing their spending during the Great Recession, California's consumers are beginning to open their wallets again. Sales tax revenues are nearly 1% higher than in the last fiscal year, with solid improvements in taxable sales across the state, although they are tracking only slightly above DOF's estimates. This all a welcome respite for our beleaguered budget, but it is also good news for the economic community: some of the most up-to-date indicators show that the fundamentals in California continue to improve.

However, from a fiscal standpoint, we still need to address the budget fiasco. Many of the increases in revenues were based on temporary solutions to fill gaps over the short run, but most of these will expire unless an extension is passed by the voters, as proposed under the governor's budget. Although sales tax revenues and their underlying base—taxable sales—are growing again, this is due to a temporary increase in the tax rate in addition to a growing base. A reduction in both the sales tax and the personal income tax rates are slated to take place under current law in June, and thus far Governor Brown has had little success in drumming up Republican support to place the extension of these rate increases before voters. The Department of Finance estimates that the expiration of the rate increases will result in a loss of almost $3.3 billion personal income taxes for general fund revenues over the next two years and that the state will have a bigger hole to fill in terms of lost sales tax revenue. This means that consumer spending and income will have to rise faster to make up the difference, which is unlikely given the slow recovery we are forecasting.

Some progress has been made on the expenditure side, but so far there has yet to be any consensus in Sacramento on what will be prioritized. The underlying economy is improving, but that is only half of the battle in dealing with California's budget gap. We need serious, long-term solutions on both the revenue and expenditure side if we are going to dig ourselves out of this $20 billion hole .

California General Fund Revenues
Comparison of Fiscal Year 2009-10 and 2010-11

Revenue Stream	2009-10 $ Millions	2010-11 $ Millions	Change $ Millions	Change Percent
Corporation Tax	4,266	4,146	-120	−2.8
Personal Income Tax	26,952	31,838	4,886	18.1
Sales and Use Tax	17,608	17,745	137	0.8
Big 3 Total	48,826	53,729	4,902	10.0
Other Revenue	3,397	3,413	15	0.5
Total Revenues	52,224	57,142	4,918	9.4
Non-Revenues	1,760	1,833	72	4.1
Total GF Receipts	53,984	58,974	4,990	9.2

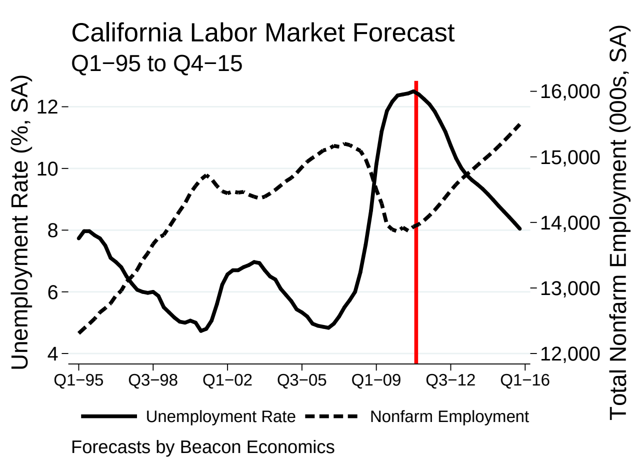
Source: California State Controller's Office

Forecast Highlights

There is no doubt that California is heading down the road to recovery. The labor markets have begun to improve, and recently released estimates indicate a healthier economy than initially reported. The state's budget has seen increases in revenues, further reinforcing the belief that our fundamentals are moving in the right direction, and we have seen relative stability in our demographics considering the depth and extent of the downturn.

However, there are still many challenges ahead, which is why Beacon Economics is forecasting a steady but prolonged recovery for California's economy. The labor markets will continue to improve, but we will have to deal with double-digit unemployment for the remainder of 2011 and 2012. Total nonfarm employment will keep growing, but it will be several years before we get back to our prerecession peaks. The housing market, whose fundamentals in terms of affordability are improving, will continue to face significant numbers of distressed properties, a large inventory of unsold homes, and slow household formation as the economy slowly heals. Sales will gradually begin to improve, but prices are expected to remain relatively flat through 2011 and into 2012, before starting to climb upward at a more modest pace. New construction activity will remain weak, which will limit the number of construction jobs California will be able to regain over the next few years.

The good news is that international trade will continue to bolster the state's economy. A weak dollar and rising demand from abroad will spur additional hiring at and around our ports and airports, boosting revenues for farms, export-oriented businesses, and tourism. The mini-investment boom that we are experiencing around the nation will also benefit California through increased demand for our manufactured products and for our professional, scientific, and technical services. The worst is definitely behind us and continued growth is ahead, but remain patient—this was a severe recession and it will take time to recover.



State Historical Table

California	Q3-2008	Q4-2008	Q1-2009	Q2-2009	Q3-2009	Q4-2009	Q1-2010	Q2-2010	Q3-2010	Q4-2010
Total Nonfarm Empl. (Mill, SA)	14.96	14.76	14.50	14.29	13.96	13.89	13.86	13.92	13.87	13.94
Growth (%,SAAR)	-3.37	-5.39	-6.84	-5.65	-8.77	-2.05	-0.84	1.71	-1.40	1.83
Unemployment Rate (%,SA)	7.53	8.63	10.13	11.20	11.87	12.17	12.37	12.40	12.43	12.50
Personal Income ($ Bill)	1,622.13	1,598.97	1,571.78	1,574.64	1,567.69	1,576.48	1,596.98	1,613.06	1,621.13	1,638.26
Growth (%,SAAR)	0.10	-5.59	-6.63	0.73	-1.75	2.26	5.30	4.09	2.02	4.29
Taxable Sales ($ Bill, SA)	133.10	123.28	115.48	111.64	113.30	115.63	118.79	118.60	119.00	121.66
Growth (%,SAAR)	-13.93	-26.38	-23.02	-12.66	6.11	8.47	11.41	-0.66	1.36	9.24
Single-Family Home Prices ($ 000s, SA)	289.48	255.53	227.31	222.64	238.51	251.70	254.96	262.55	255.78	251.26
Growth (%,SAAR)	-44.23	-39.29	-37.38	-7.96	31.70	24.04	5.28	12.44	-9.92	-6.89
Single-Family Home Sales (000s, SA)	82.24	89.68	92.72	88.18	88.81	92.28	86.57	85.87	73.92	78.92
Growth (%,SAAR)	124.86	41.36	14.30	-18.22	2.91	16.58	-22.54	-3.21	-45.10	29.94
Single-Family Permits (000s, SA)	7.74	6.44	5.18	6.17	6.56	7.47	7.34	5.84	5.58	6.78
Growth (%,SAAR)	-46.57	-51.85	-58.36	101.59	28.10	67.75	-6.97	-59.73	-17.04	118.60
Multi-Family Permits (000s, SA)	6.98	7.72	3.39	2.63	2.53	2.43	4.22	4.32	5.15	5.57
Growth (%,SAAR)	-73.33	49.67	-96.30	-63.88	-14.13	-14.29	802.65	10.00	102.87	36.69
Nonresidential Permits ($ Bill, SA)	4.72	3.72	2.94	2.68	2.51	2.78	2.74	2.75	2.91	2.74
Growth (%,SAAR)	-31.07	-61.63	-60.91	-31.23	-22.55	49.70	-5.51	1.40	25.37	-20.88
Population (Mill)	38.24	38.33	38.40	38.48	38.55	38.64	38.73	38.83	38.94	39.05
Growth (%,SAAR)	0.94	0.85	0.80	0.78	0.80	0.85	0.94	1.05	1.12	1.18
Net Migration (000s)	11.92	5.61	2.33	2.07	4.85	10.66	19.50	31.37	38.23	44.09
Natural Increase (000s)	77.04	75.41	74.00	72.81	71.84	71.10	70.58	70.28	70.18	70.26

State Forecast Table

California	Q1-2011	Q2-2011	Q3-2011	Q4-2011	Q1-2012	Q2-2012	Q3-2012	Q4-2012	Q1-2013	Q2-2013
Total Nonfarm Empl. (Mill, SA)	13.97	14.03	14.11	14.19	14.28	14.38	14.49	14.58	14.66	14.73
Growth (%,SAAR)	1.01	1.75	2.11	2.42	2.68	2.83	2.85	2.62	2.24	1.92
Unemployment Rate (%,SA)	12.40	12.25	12.08	11.84	11.52	11.19	10.74	10.33	10.01	9.79
Personal Income ($ Bill)	1,661.60	1,685.49	1,716.21	1,745.15	1,776.00	1,810.18	1,842.81	1,852.14	1,870.96	1,895.63
Growth (%,SAAR)	5.82	5.88	7.49	6.92	7.26	7.92	7.41	2.04	4.13	5.38
Taxable Sales ($ Bill, SA)	124.90	126.00	128.45	130.39	133.01	133.87	135.41	136.50	136.14	135.40
Growth (%,SAAR)	11.11	3.56	8.02	6.16	8.29	2.61	4.66	3.25	-1.02	-2.16
Single-Family Home Prices ($ 000s, SA)	249.96	250.30	251.90	252.61	254.86	256.89	258.52	258.95	260.89	263.58
Growth (%,SAAR)	-2.04	0.53	2.58	1.14	3.60	3.23	2.57	0.67	3.02	4.18
Single-Family Home Sales (000s, SA)	78.10	76.96	78.30	79.77	81.87	84.75	87.91	91.07	94.03	96.62
Growth (%,SAAR)	-4.08	-5.71	7.13	7.73	10.95	14.84	15.78	15.18	13.62	11.50
Single-Family Permits (000s, SA)	7.47	8.03	8.66	9.46	10.35	11.36	12.43	13.74	14.90	15.89
Growth (%,SAAR)	47.66	33.14	35.51	42.39	42.94	45.45	43.18	49.46	38.25	29.19
Multi-Family Permits (000s, SA)	6.06	6.50	7.12	7.95	8.90	10.03	11.22	12.67	13.80	14.76
Growth (%,SAAR)	39.78	33.02	43.84	55.20	56.83	61.61	56.38	62.88	40.47	30.82
Nonresidential Permits ($ Bill, SA)	2.79	2.86	2.90	2.97	3.04	3.13	3.22	3.28	3.36	3.44
Growth (%,SAAR)	7.38	11.04	5.24	10.51	9.62	11.74	11.84	8.53	9.12	9.77
Population (Mill)	39.17	39.29	39.41	39.53	39.65	39.77	39.89	40.01	40.13	40.24
Growth (%,SAAR)	1.21	1.22	1.23	1.22	1.22	1.21	1.21	1.21	1.20	1.20
Net Migration (000s)	46.71	48.25	48.55	48.23	47.56	46.79	46.00	45.33	44.56	43.60
Natural Increase (000s)	70.48	70.83	71.27	71.81	72.41	73.07	73.79	74.53	75.32	76.12

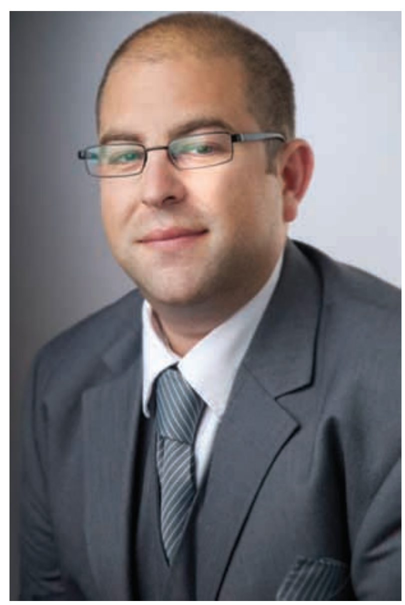
Forecasts by Beacon Economics

About the Authors

CHRISTOPHER THORNBERG, *FOUNDING PARTNER*

Dr.Thornberg is widely considered to be one of California's leading economic forecasters. An expert in economic forecasting, regional development, real estate dynamics, and labor markets, he was one of the earliest and most adamant predictors of the housing market crash and of the economic recession that followed. In 2008 he was appointed as chief economist for California State Controller John Chiang as well as chair of the Controller's Council of Economic Advisors. He also serves on the advisory board of Paulson & Co. Inc., one of Wall Street's most successful hedge funds. Dr. Thornberg holds a Ph.D in Business Economics from The Anderson School at UCLA, and a B.S. in Business Administration from the State University of New York at Buffalo.

JORDAN LEVINE, *DIRECTOR OF ECONOMIC RESEARCH*



Mr. Levine specializes in forecasting key economic indicators such as real output, employment, home prices, consumer spending, and new construction. He has extensive background and experience analyzing the national economy including gross domestic product, international trade, employment and labor force, and real estate markets. He plays an active role in the firm's major consulting projects including conducting economic analysis for the Office of the California State Controller, the Los Angeles Area Chamber of Commerce, and Paulson & Co., Inc. Mr. Levine holds an M.A. in International Economics with Merit from the University of Sussex and a B.A. in Business Economics from the University of California, Santa Barbara.

Beaconomics delivers current analysis of where the U.S. and California economies are headed directly from the renowned forecasters at Beacon Economics. Published quarterly, the analysis includes the latest statistics on unemployment, home prices, personal income, taxable sales, GDP growth, and other major indicators of the economy. In addition to this report, Beaconomics is an extensive data website filled with updated statistics for both the U.S. and California economies. Subscribers to Beaconomics receive a summary analysis by email each quarter with links to both the full report and to the searchable data site. Follow leading indicators and trends in the economy by signing up to receive Beaconomics at www.beaconecon.com/beaconomics

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Beacon Economics, LLC is a leading provider of economic research, forecasting, industry analysis, and data services. By delivering independent, rigorously researched analysis, we give our clients the knowledge they need to make the right strategic decisions about investment, growth, revenue, and policy.

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Southern California
5777 W. Century Blvd.
Suite 895
Los Angeles, CA 90045
(310)571-3399

Northern California
1299 Fourth Street
Suite 400
San Rafael, CA 94901
(415)457-6030