California Economic Forecast

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NOT A STRONG RECOVERY, BUT A RECOVERY NONETHELESS

by Mark Schniepp

Momentum will build during 2010

As the U.S. and California economies recover from the Great Recession of 2008-09, Southern California will also rebound from the deepest of economic contractions in 60+ years. The regional economy has been mostly impacted by the depression in housing especially in values, and the unprecedented collapse of credit availability. However, the financial panic that gripped the world in 2008, and the extraordinary economic weakness that ensued have contributed as much to regional weakness as the bursting of the housing bubble.

Between September 2008 and March 2009, the nation experienced an economy that was spiraling downward, in freefall. The economic recovery began in the summer and is gradually gaining traction though it still is unconvincing to most people. Economic indicators are collectively rising, there is clearly better news in the housing sector, the stock market has rallied 53 percent over the last 11 months, and consumer confidence has improved.

The regional economy is in the early stages of recovery. The labor market took a decisive step toward stabilization at the end of 2009 as layoffs slowed, but firms have yet to add to their payrolls. Some new job growth is being observed, though the evidence is far from convincing. Until the creation of jobs is more evident, the recovery will not be widely recognized.

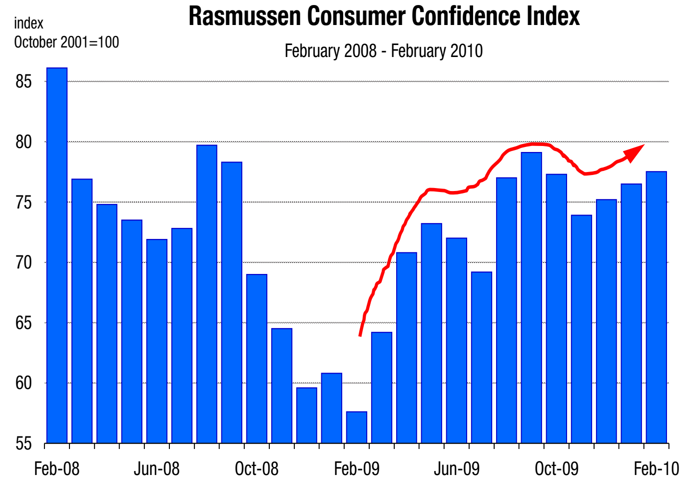
The unemployment rate, currently at 12 percent in Southern California, will rise further in the region this year. The retail sector will suffer through another year of weak sales, and little improvement is expected in the office market. Vacancy rates of 20 percent and higher are common in the principal metro areas of Orange, Riverside, San Diego, Ventura and Los Angeles Counties.

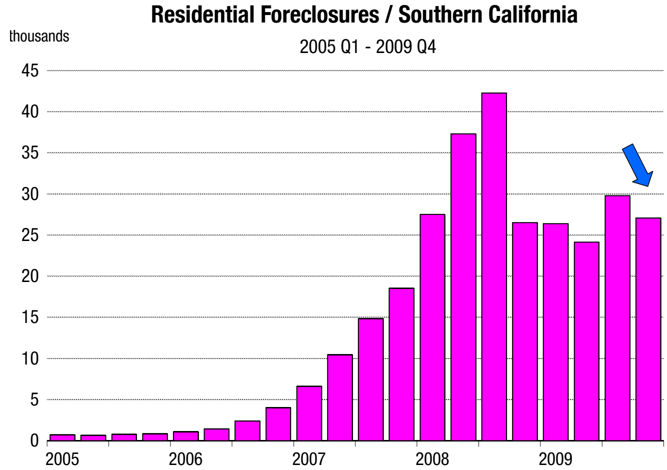
But as the labor markets improve, the problems with commercial real estate will also start to fade. There is misery in nearly all business sectors right now, but that misery is slated to abate during 2010, the transition year for this economic cycle.

The Rasmussen Consumer Index, which measures the economic confidence of consumers on a daily basis, has risen two points in February to 78. Consumer confidence is up 20 points from the level measured one year ago. However, Nationally, just 7% of adults rate the U.S. economy as good or excellent. Fifty-five percent (55%) still give the economy a poor rating.

Housing is poised to recover (as long as foreclosures behave)

A more conventional housing recovery is scheduled for this year. Through December 2009, the median home value in Southern California has rallied 19 percent (since March 2009) and home sales remain impressive. Fewer





of them are distressed, and more importantly, the rate of foreclosures is not rising.

The big “if” is whether they remain in decline. If so, home prices will continue to rise, albeit slowly, reflecting a change in the mix from distressed sales to more conventional home sales. It is becoming generally perceived that selling values have reached a bottom. Consequently, sideline buyers are slowly entering the market and conventional home sales are improving. Ultimately, they will dominate the real estate recovery. A more convincing housing recovery should occur in 2010 providing homeowner distress remains contained.

But even if foreclosures rebound to form a second peak (as they did in the last housing cycle in the mid 90s), a relapse in selling values is still unlikely because the general economy is improving.

The Outlook

Further job contraction is forecast for Ventura, Santa Barbara, the Inland Empire and Orange Counties in early 2010. Cost-cutting concerns will remain a key focus of firms, even as the economy begins to grow again this year. Consequently, labor markets will continue to contract, and a large amount of commercial office space will remain vacant. Unemployment rates remain high.

While the general economy shows improvement later in 2010 due to the rebound in the existing home market, additional time must pass for new housing production to ramp up; consequently, a more convincing recovery in the new housing market potentially occurs in 2011. At this time, most housing projects are on hold pending the improvement in market conditions.

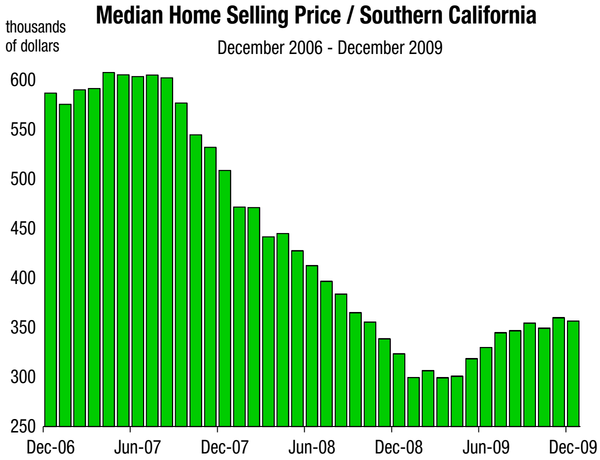
New building hit rock bottom in 2009, the fourth consecutive year that the level of housing production declined in the region. There is growing pressure for new housing throughout Southern California.

Constraints stand in the way however, including new regulations such as the MS4 emissions reduction. Other regulations associated with containing the production of green house gases will also affect land use and traffic

California Economic Forecast Staff

Mark Schniepp Matt Mullens Bryant Mogin

(805) 692 - 2498 www.**californiaforecast.com**



system decisions in the region. Consequently it is near impossible to forecast new project development over the next several years because of regulatory obstructions.

Home Sales and Selling Values

If the number of foreclosures continues to decline, housing values will stabilize. Fire sale prices for REO sales will no longer weigh in on selling values, depressing neighborhood housing markets in all areas of Southern California.

Selling values have stabilized and the market bottom (reached early last year) is finally being acknowledged by patient sidelined buyers. Mortgage rates remain low and affordability has improved dramatically over the last 3 years. All of these conditions together with easing credit markets will produce greater demand for homes.

Home sales will continue rising in 2010, extending the rebound that began in 2008. However, by mid to late 2010, a more conventional housing market will represent the kind of transactions that characterize the rebound.