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Economics Group

Special Commentary

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California Economic Outlook: July 2010

Slow Recovery in Place, Daunting Long-term Challenges Remain

California's economic recovery continues to gain traction along with the nation, despite an unemployment rate problem, and state and local budget problems that far outstrip those faced by the nation at large. California has gained net jobs for five consecutive months now. Net job gains through May totaled 95,900. Despite this revival in state job creation in 2010, California has still lost a net 244,700 jobs from a year ago, a decline of 1.7 percent. Clearly, the state labor market has a long way to go before conditions materially improve. As of May, California had another 1,297,100 jobs to create just to get back to the level of employment in July 2007. Illustrating that point, California's unemployment rate remains well above the U.S. average at 12.4 percent in May, just two-tenths of a percentage point from its March peak, which was the highest rate on record for California going all the way back to 1976. California's unemployment rate is a full 2.7 percentage points above the U.S. average, and the unemployment gap has widened by eight-tenths of a percentage point over the past 12 months.

A slow recovery in private sector jobs in under way, though California has a long way to go before labor market conditions materially improve.

A major factor behind the stubbornly high unemployment rate in California so far this year is the large increases now occurring in the labor force as previously discouraged workers return to job hunting. California's labor force has been growing steadily, increasing by 238,000 people since January. When the labor force grows as fast as, or faster than, employment, the unemployment rate naturally remains high or can even rise, even though this is often a sign that the labor market is beginning to firm up.

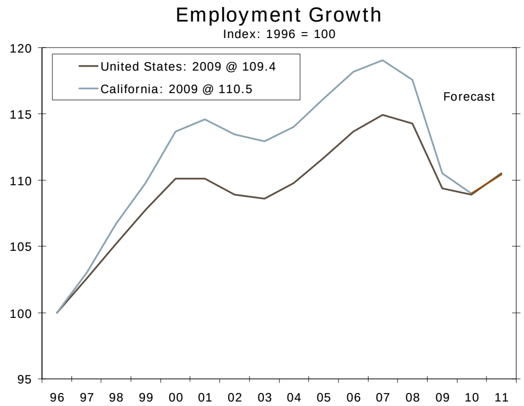
California personal income is starting to grow again, but growth in wages and salaries remains modest. Income growth in the state is still highly dependent on transfer payments from the state and federal governments.

State and local budget cuts are expected to remain a significant drag on the state's economic outlook over the forecast horizon, as California tries to close another budget gap of $19.1 billion. Under the governor's plan, 65 percent of the shortfall will be closed by expenditure reductions. Cash-flow problems could reemerge for the state this year but are not expected to be as severe as in 2009. Longer-term liabilities still loom on retirement- and infrastructure-related issues that could cause California budget issues for years to come.

State and local budget cuts are a significant drag on the economic outlook for the state.

While fears of a national housing market double dip are on the rise due to the sharp decline in home sales following the expiration of the homebuyer tax credit, we see less of a chance for a double dip in California, at least one that takes out the cyclical lows put in place in late 2007.

Figure 1



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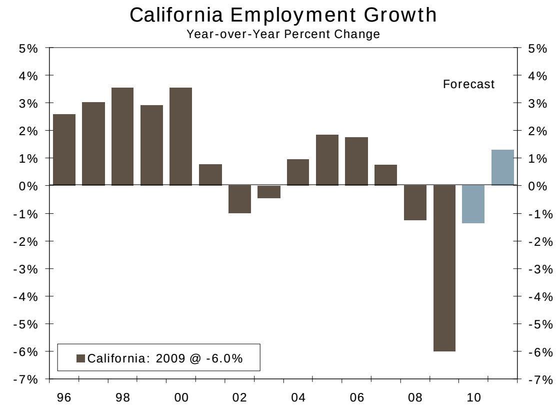


Source: U.S. Department of Labor and Wells Fargo Securities, LLC

California's Sporadic Job Growth

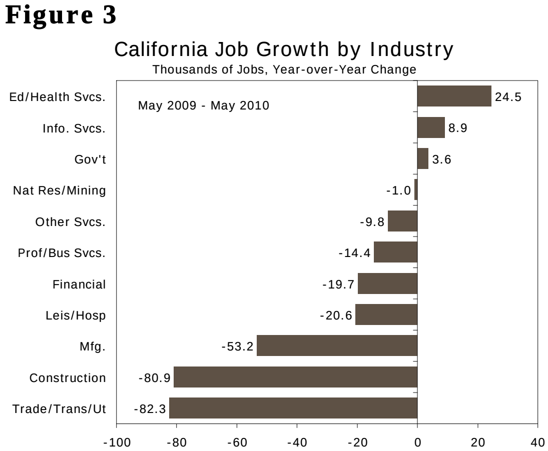
Job recovery in California remains fragile and uneven, heavily dependent on temporary help services and Census hiring.

The jobs recovery in California closely mirrors the one taking place across the nation. Year to date, California has added 95,900 jobs, or 0.7 percent of total nonfarm payrolls compared to a 0.8 percent gain across the United States. At this point, the jobs recovery in California appears fragile and highly uneven. California has added an average of 19,200 jobs a month to date, yet private sector employment growth was 45 percent less than that, at 10,500 per month. Temporary help services and Census hiring are responsible for the bulk of the hiring so far this year, 78,300 jobs to date. The balance of the job growth in the rest of the economy totaled only 17,600 jobs.

The biggest job gains last month, 30,000 jobs, came from government. Federal government positions increased by 32,900 jobs as the Census Bureau ramped up hiring. We expect those gains to disappear by the end of August. Information added 4,700 positions, professional and business services 4,200, leisure and hospitality 3,600, other services 2,400 and manufacturing 1,300. Job losses continued in construction, trade, transportation and utilities, and financial services.

Over the past year, the largest number of job losses have occurred in trade, transportation, and utilities, construction and manufacturing, which together account for about 88 percent of total nonfarm job losses in California over the past year. Job gains have been largest in education and health services (24,500), information (8,900) and government (3,600). Looking ahead, we see California payrolls slipping 1.4 percent in 2010 before increasing 1.3 percent in 2011.

Figure 3



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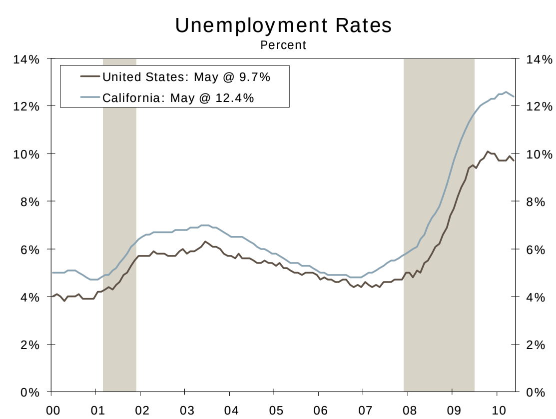

Source: U.S. Department of Labor and Wells Fargo Securities, LLC

California Personal Incomes Start to Grow

Though steady California job growth is important for consumer spending and thus the sustainability of the economic recovery, perhaps more important is an improving trend in personal income growth. Even with a horrific unemployment rate of more than 12.4 percent, this means that 87.6 percent of the labor force is still employed in California, and their spending will depend critically on how rapidly they can increase their incomes. On that front, the economic news is also improving for California, though the details of how the state is attaining that growth illustrates our call that the economic recovery for the state will remain a long and difficult one. The Commerce Department reported recently that California personal income increased 0.9 percent in the first quarter of 2010, after rising 0.5 percent in the fourth quarter. This was the first back-to-back quarterly increase in California income since summer 2008. Personal income in California is now higher than it was a year ago by 0.8 percent. Net earnings from work, including wages and salaries, worker fringe benefits and proprietors' incomes increased 0.8 percent over the quarter. Income from property, including rental income, dividends and interest received fell 0.4 percent. This data is not all that surprising given the high level of unemployment and continued financial market and real estate volatility. What was eyebrow-raising was the 3.2 percent increase in transfer receipts from Social Security, Medicare/MediCal and unemployment compensation on the quarter. Clearly, California's income growth is still highly dependent on government support and spending.

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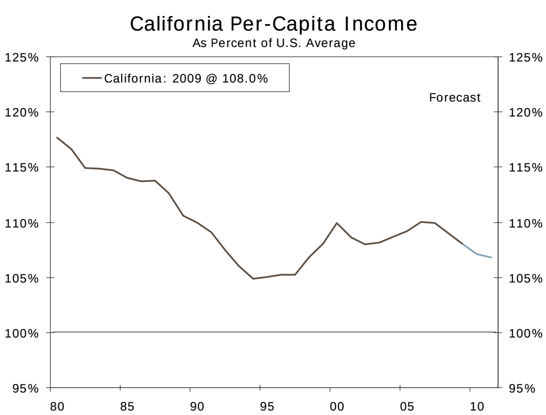
Still, the gradually improving trend is easily visible when one looks at the income gains by industry sector. Higher earnings were recorded by 17 of 24 industry sectors during the first quarter. Gains were lead by forestry, fishing and related sectors, up 16.2 percent over the quarter. Strong gains were also reported in administrative and waste services, private education, federal military and mining. On the other side of the spectrum, real estate and leasing earnings dropped 4.3 percent over the quarter, finance and insurance fell 2.0 percent and construction was down 0.5 percent.

Figure 5



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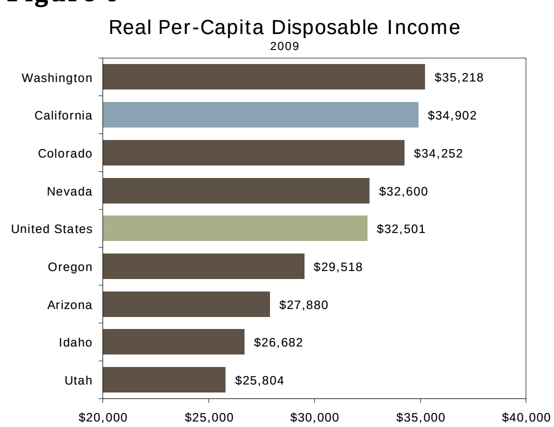


Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

State Budget Woes

While not the $60 billion gap the state had to close last budgetary cycle, the budget gap ahead remains a daunting challenge for the governor and state legislators. The May revision to the governor's 2010-11 budget revealed a budget gap of $19.1 billion that needs to be closed for the 2010-11 fiscal year. This includes a $7.7 billion shortfall for the current year, a budget year shortfall of $10.2 billion and a modest reserve of $1.2 billion.

Large expenditure reductions are likely at the state level.

The good news is that this gap is about $800 million lower than the $19.9 billion gap estimated last January. Special session-approved solutions raised about $1.4 billion in additional revenue since January and additional federal funds added another $700 million. These gains were partially offset by a $600 million reduction in estimated revenue, a $500 million increase in costs due to court decisions and federal law, population and caseload growth and a $200 million increase in reserves.

The majority, $12.4 billion of the $19.1 billion shortfall (around 65 percent of the total), will come from expenditure reductions under the governor's plan. The May revision of the governor's budget proposes eliminating child care programs, with the exception of pre-school and after-school care, and eliminating the California Work Opportunity and Responsibility to Kids Program and the CalWORKS program. The governor's budget also reduces funding for local mental health services by approximately 60 percent. Extra revenue would be found. Other revenue would raise another $2.1 billion, or 11.0 percent, of the total shortfall. Finally, alternative funding would raise $1.3 billion, or 6.7 percent, of the shortfall.

Assembly Democrats have countered the governor's plan with a state budget plan of their own that relies on borrowing $9 billion from investors and installing a new tax on oil production to pay back the loan over 20 years. Their proposal would block all social services cuts, sparing the state's welfare-to-work and subsidized child care programs from any reductions. Their plan would also suspend $2 billion in corporate tax breaks. They say their budget would avoid severe budget cuts and reduce fee hikes at universities, while giving $900 million in new money to local governments. The problem with this approach is that it does not tackle the long-term problem of state overspending, and would likely lead to more budget problems in future years. Senate Democrats, on the other hand, proposed $4.9 billion in added taxes to avoid the deepest cuts in Gov. Schwarzenegger's budget.

Significant cash shortfall problems could emerge again.

Even with the governor's budget plan in place, the State of California will face significant cash shortfall problems. In normal budget years, the state deals with cash issues by borrowing internally from special funds, usually around $8 billion-$16 billion. The state can also borrow externally by issuing revenue anticipation notes (RANs). These are intra-year borrowings only and range from a few billion to more than $10 billion. In 2009, the state had to deal with its cash shortfall with internal borrowings, RANs, intra-year deferrals, payment delays (tax refunds) and IOUs or registered warrants. Legislation enacted during the special session earlier this year provided the state additional tools to manage its cash in July and during key months of the coming budget year. Still, the state suspects it will need to obtain external financing early in the 2010-11 fiscal year, which may be difficult in the now more risk adverse financial market climate. Cash problems could intensify if the budget is extremely late or budget solutions do not materialize. So additional cash solutions may yet be required.

As if that were not enough, longer-term liabilities still loom, which could cause budget issues for years to come. The Legislative Analysts Office (LAO) estimates that the state still has long-term budget-related liabilities of $35 billion, retirement liabilities of $130 billion and infrastructure-related issues of around $70 billion that would need to be addressed at some point.

State and Local Taxes: Where Does California Stand?

California was a highly taxed state even before the most recent state budget problems. Thus, any proposals to further increase taxes in California could push California even further away from the national average and hurt the state's long-term ability to attract new business and industries. Businesses inside and outside the state often take such tax factors into account when making decisions on whether to expand or relocate. According to recently released figures from the Tax Foundation, in fiscal 2008, California had the sixth-highest state and local tax burden at $5,028 per person. Only Connecticut, New Jersey, New York, Maryland and Massachusetts came in higher. The national average for state and local tax burdens was $4,283 per person that year. The fact that no other Western state comes close to California's ranking puts even more competitive pressure on the state to bring its tax burden in line or face the prospect of dimming economic opportunity longer term. A quick scan of California's closest neighbors reveals the stunning nature of the current tax gap. Arizona was ranked 40th, Nevada 39th, New Mexico 46th, Oregon 24th and Washington 15th.

The state and local tax burden is the sixth highest in the nation.

Nationwide, the state and local national tax burden averaged 9.7 percent of income on a per-capita basis in fiscal 2008. The corresponding figure for California was 10.5 percent, making California's state and local tax burden by this metric also the sixth highest in the nation. Perhaps the most damning metric, the Tax Foundation attempts to rank how state and local taxes affect states' economic performance. California's overall index ranking was 48, worse than all other states except for New York and New Jersey. California ranked the lowest, 48th for individual income taxes and sales tax. California's rank for corporate taxes was less severe at 34, though this still puts California in the lower half of the state rankings on this measure. At the same time, unemployment insurance taxes and property taxes came in relatively low with rankings of 14 and 13, respectively.

California Housing - A Double Dip?

Fears of a double dip in the national housing market have intensified in recent months in the wake of the end of the homebuyer tax credit and the steep nearly 30 percent drop in national home sales that has swiftly followed. So what are the chances that California's housing recovery also derails?

California's housing market has been something of a leading indicator for the national housing market throughout this financial crisis. The decline in home sales and home prices was much swifter and steeper than in the rest of the nation in the early days of the housing bubble collapse. However, we have also seen California's existing housing market bounce back more robustly over the past two years. Home sales in California and the nation both bottomed in late 2007, but while sales have languished at relatively low levels across much of the nation, California home sales jumped, rebounding to pre-peak levels by late 2008. Since then, California home sales have held at those levels. As of May, California home sales were up only a modest 1.2 percent from a year ago. In contrast, national home sales have jumped 17.5 percent from a year ago with distinct spikes in demand surrounding the late November 2009 and April 2010 deadlines for the tax credit. The federal homebuyer tax credit appears to have had less of an effect on home sales across the state of California over the past year, so it should have less of an effect on the downside as we weather the aftermath of the expiration of the housing tax credit.

The federal homebuyer tax credit appears to have had less of an effect on home sales in California.

That is not to say there will be no negative effects; indeed, we expect California existing home sales to be somewhat weaker this year on average than last year, as sales decline into the end of 2010. The good news is that this temporary weakening of sales will not be enough to send statewide home prices reeling back to their financial crisis lows. Current market conditions appear much too balanced for a repeat performance of steep California housing price declines. We reach this conclusion even as we expect a rising supply of distressed home selling to reemerge over the near term.

Our forecast assumes no double-dip California or U.S. recession over the forecast horizon, though the pace of growth is expected to moderate. According to the California Association of Realtors, California home prices have been rising month to month since March 2009, with the exception of price declines in January and February of this year. California median home prices jumped to $324,430 by May 2010, a whopping 23.2 percent increase from a year ago. Existing home buying has been robust enough to push the state's unsold inventory sales ratio to a lean 4.6 months in May for detached properties. Inventory sales ratios remain highest in the Northern Wine Country (6.8 months), Santa Barbara (6.4 months), Orange County (5.8 months) and San Diego (5.6 months). Inventory sales ratios are lowest for Sacramento (2.4 months), San Francisco Bay (4.0 months) and Los Angeles (4.5 months).

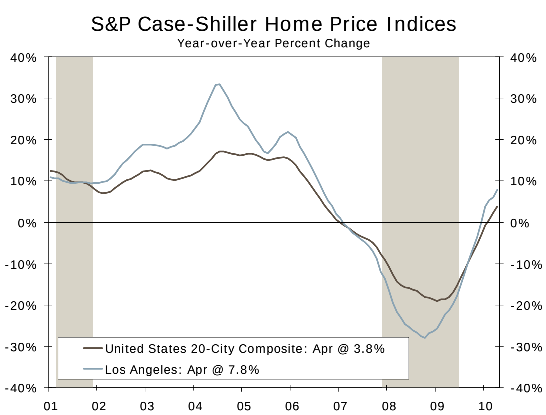
Signs of healing in the California housing market have only solidified over the past six months.

More balance in the housing market is also seen across price ranges. Inventory sales ratios in California plunged first in lower-priced properties, as vulture investors jumped in to purchase distressed properties. But with existing inventories now lean at those price ranges, we are now seeing inventory sales ratios drop smartly for higher priced properties. This is a very healthy development for the sustainability of the housing market recovery in California. It reduces the chance that the state will see a large home price reversal over the near term. For example, the months supply of million dollar plus properties dropped to 10.1 months from 16.3 months. The $750,000 to $1,000,000 range now has a supply of 5.5 months, well below the 7.5 months of inventory a year ago. Months' supply figures are back to normal or better in the $500,000 to $750,000 price range. Inventories are even leaner for lower-priced properties. Granted, these measures could deteriorate over the next 12 months, but that should not precipitate a cascade of steeply discounted home prices unless sustained over a prolonged period of time. Most likely, only a double-dip recession in California could recreate the conditions necessary for another plunge in California home prices.

So the signs of healing we saw in the California housing market in December have only solidified further over the past six months. It would now take sizable economic or financial shock to fully reverse the progress that has been made. Historically low mortgage rates should provide an important offset to expiring tax credits and a steady supply of distressed properties that are expected to continue to spill onto the market.

Housing affordability is the best it has been in California in decades. The California Association of Realtor's reported that the first-time buyer housing affordability index improved to 66.0 in the first quarter of 2010 from 64.0 in the fourth quarter of 2009. The higher the affordability index number the better it is for homebuyers. Affordability in the first quarter of 2010 was better in Sacramento County, the High Desert, Merced County and San Bernardino County than it was in the nation at large. This is an unusual turn of events for a state that has historically been financially out of reach for many Americans.

Figure 7



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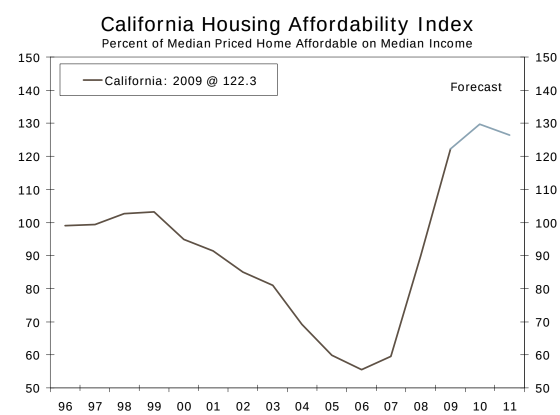


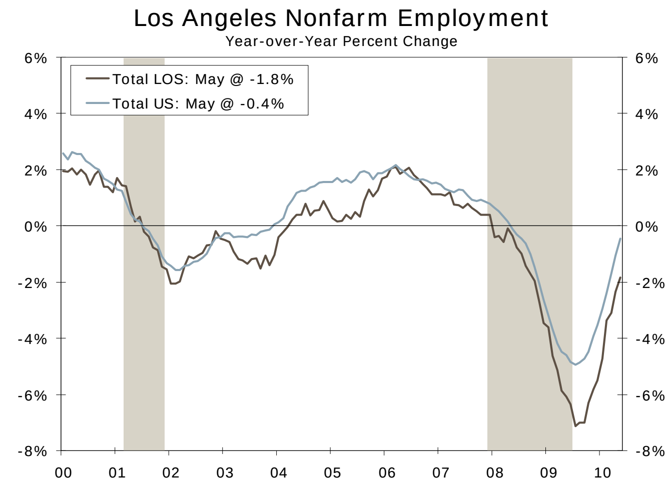
Source: S&P Corp., California Association of Realtors and Wells Fargo Securities, LLC

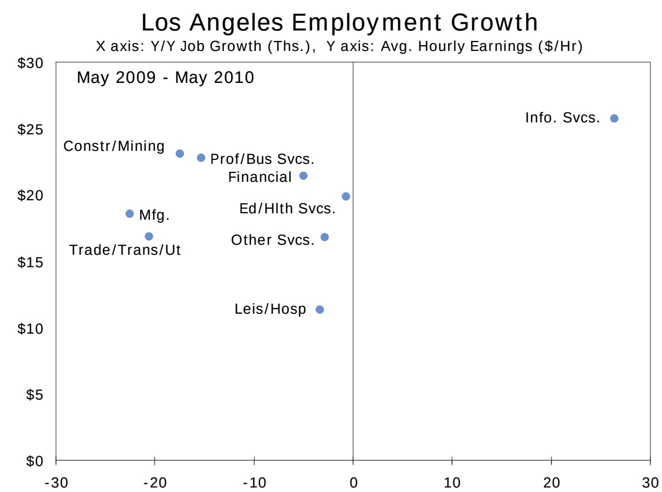
Conclusion: Tentative Signs of Recovery

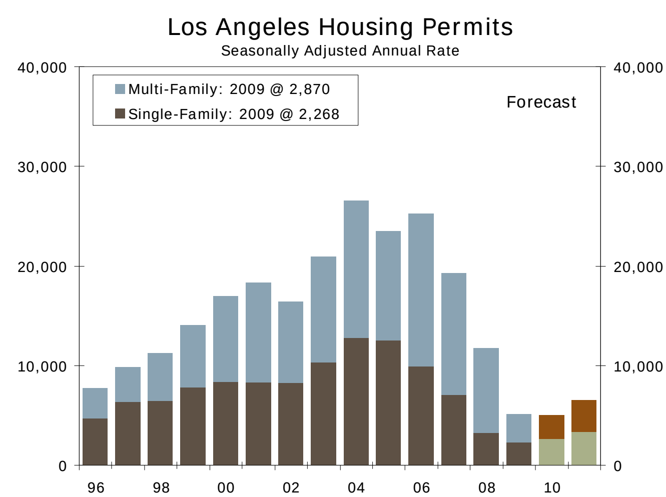
California is lurching toward a modest economic recovery from one of the deepest economic downturns in the state's history. Job growth remains highly uneven and fragile with the bulk of the net job gains so far this year found in temporary help services and Census hiring. We are currently forecasting California payrolls to contract 1.4 percent this year before expanding 1.3 percent in 2011. The state unemployment rate remains well above the national average and has widened by eight-tenths of a percentage point from the U.S. average over the past 12 months. State and local budget cuts are expected to be a major source of economic weakness over the forecast horizon. Large state level budget cuts are likely as the governor and state legislature try to close a $19.1 billion budget gap for FY 2010-11. Significant cash shortfalls could emerge once again as they did last year, but should fall short of the state having to issue registered warrants. Longer-term liabilities still loom for the state, however, so it is likely we will see continuing budgetary issues reemerging for many years to come. The state and local tax burden in California is among the highest in the nation and way out of line with its geographical neighbors. This will remain a long-term impediment to growth as businesses hold off on moving or expanding in the state. As we expected, California's housing market has been one of the brightest spots in this economic recovery in 2010. Signs of healing in the California housing market have only solidified over the past six months. The federal homebuyer tax credit appears to have had less of an impact on home sales in the state than it has in the nation. We believe only a true double-dip recession could push the California housing market to new cyclical lows. Travel and tourism have also come back strongly over the first half of the year, helping troubled California hotel operators. Commercial construction is expected to remain weak throughout the state this year. California exports continue to grow at a healthy pace, but slowing growth in Asia and Europe could reduce the importance of this driver of California growth as we move closer to the end of the year into 2011.

Los Angeles

- The Los Angeles metro area is recovering at a measured pace along with the nation and state. Most private-sector industries have ended mass layoffs and some are adding jobs, though at a tentative pace. Through May, the L.A. metro had shed 1.8 percent of total nonfarm jobs over the past year, comparable to the state's decline of 1.7 percent. The motion picture and sound industry added 22,900 jobs over the past year, the only major industry to add net jobs. Large job losses have occurred in manufacturing, retail and wholesale trade, transportation and construction.
- State and local government budget and job cuts stand to be a major drag on activity this year. Over the past year through May, local governments have shed 16,900 jobs in the L.A. metro area. The State of California shed an additional 4,500 positions. Together these losses are overwhelming federal job gains from Census hiring and federal fiscal stimulus spending. Federal job gains in the region over the past year have totaled 12,100.
- Tourism and air travel are coming back strongly, and will be an important support for the L.A. metro economy this year. According to PFK Consulting, L.A. County's hotel occupancy rate rose to 72.6 percent in March compared to 67.9 percent the year before. The average daily room rate was down only 0.4 percent to $140.50, so operators are now receiving modest gains in revenue per available room of around 2.7 percent. Santa Monica and the airport area had the highest occupancies in the region at 84.5 percent and 89.1 percent, respectively.
- Housing markets in L.A. are on the mend, though the market could lose some momentum in the wake of the homebuyer tax credit expiration. Through May, L.A. existing home sales were 3.7 percent above a year ago. Median home prices rose again in May and are now 10.6 percent higher than a year ago. Orange County sales were even stronger in May, jumping 15.9 percent on the month and rising 18.5 percent from a year ago. Even a higher median home price in Orange County of $505,747 did not keep home prices from advancing there. Home prices rose 3.0 percent in May and are now 6.7 percent above a year ago.



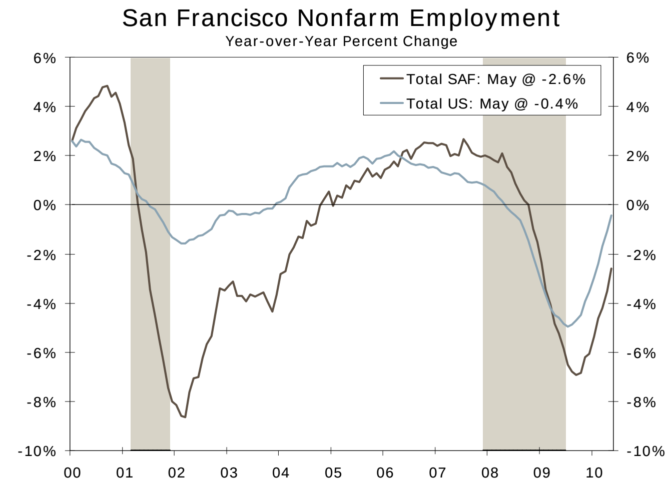


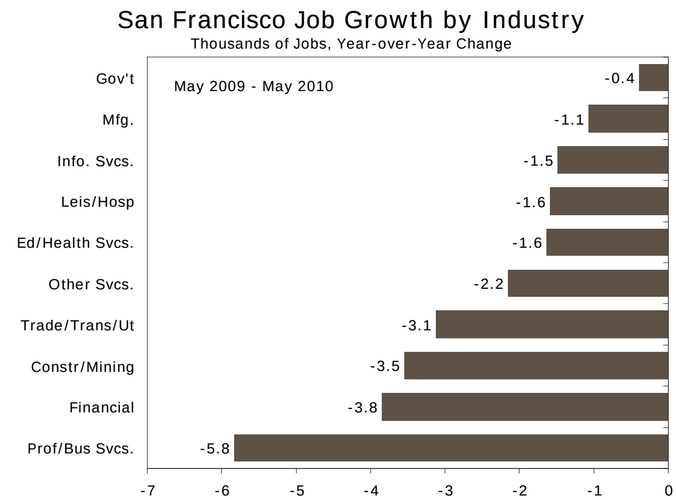


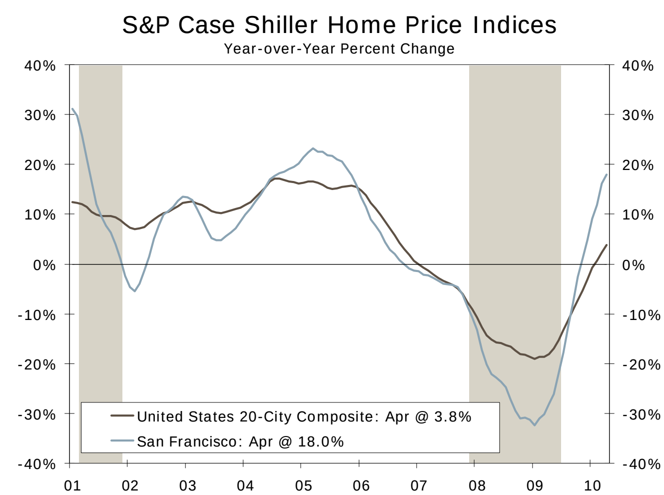
Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

San Francisco

- The San Francisco Bay Area is slowly emerging from a deep recession. The metro area's innovation and productivity engine remains intact. Financial services and computer and electronic product manufacturing remain at the core of that engine, but job losses have been deep in these sectors and the Bay Area has not yet recovered the peak total employment it had in 2000. Still, unemployment rates remain low by California standards with San Francisco, San Mateo and Marin counties sporting some of the lowest unemployment rates in the state in May. The San Francisco Metropolitan Division, which includes Marin, San Francisco and San Mateo counties, had an unemployment rate of 8.9 percent and Marin County's unemployment rate was the lowest at 7.9 percent.
- Private sector job creation remains weak with the majority of the job growth recently coming from leisure and hospitality and government due to Census hiring. Still, most industries are creating some jobs at this point. The metro area has a long way to go to recoup the lost jobs from this recession as nonfarm payrolls are still down 2.7 percent from a year ago, far worse than the 1.7 percent decline for California as a whole.
- The Bay Area housing market has come back solidly over the past year, though poor housing affordability, a high level of distressed sales and fallow demand following the tax credit expiration will keep the recovery contained going forward. Median San Francisco Bay home prices in May were $377,425, up 8.5 percent for the month and up 16.4 percent over the past 12 months. Home sales jumped 38.8 percent in May and are now 57.2 percent higher than a year ago.
- The Bay Area stands to gain market share in China as the Chinese finally embark upon appreciation of their currency against the U.S. dollar. This could help the region's exports to Asia over time. However, a much weaker euro and signs of slowing in Chinese and Asian growth could swamp this effect over the near term. The Bay Area continues to attract about one-fifth of total global venture capital investments, but deal flow and investment levels have fallen sharply with the economy. This has clearly hurt the region's ability to create jobs.



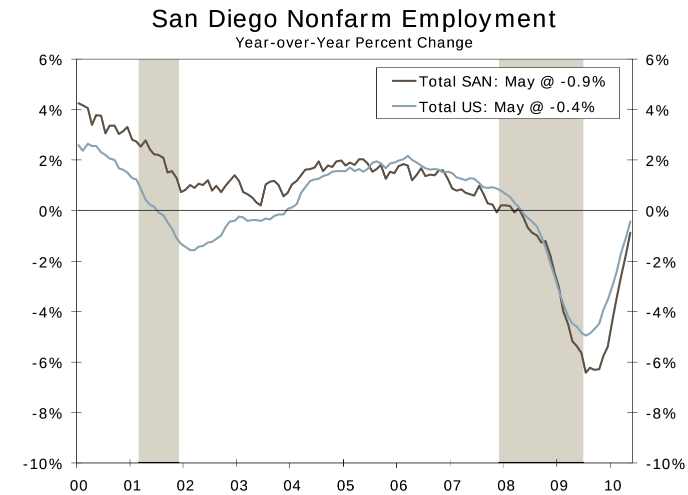


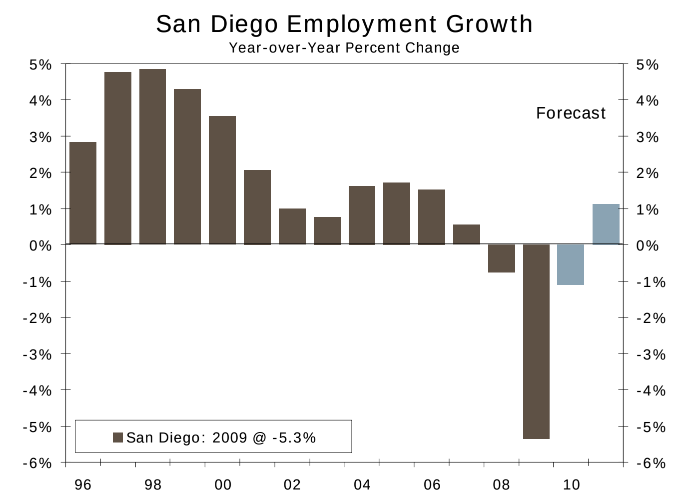


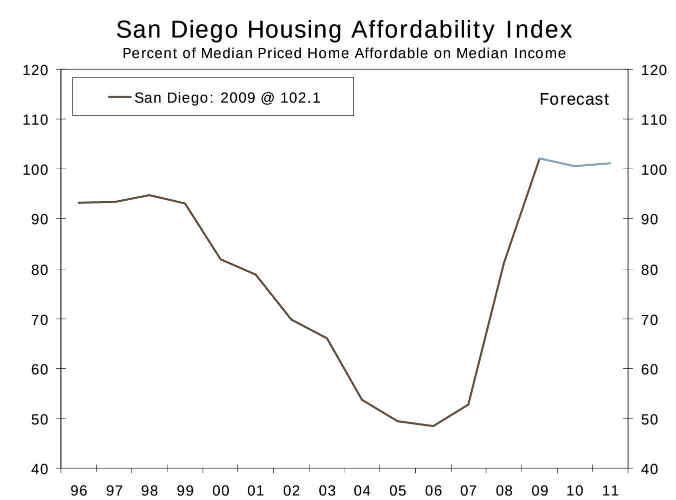
Source: U.S. Department of Labor , S&P Corp. and Wells Fargo Securities, LLC

San Diego

- Job growth has returned to San Diego County. The metro area is supported by a strong military presence, a large scientific and technical community centered on R&D and several leading universities. A majority of major industries added jobs in May led by leisure and hospitality, construction, other services, manufacturing, temporary help services and trade. Financial services remained a weak spot, shedding another 100 jobs in May. The metro area has lost another 11,900 jobs, or 1.0 percent of total nonfarm payrolls over the past 12 months. This is a far better performance than the state average, where job losses have totaled 1.7 percent of nonfarm payrolls. We expect San Diego to continue to outperform the state in job creation over the forecast horizon.
- San Diego's housing market continues to recover from one of the worse downturns ever. San Diego home sales accelerated as the federal homebuyer tax credit expired, boosting home sales in May by 18.0 percent on the month and 12.7 percent from a year ago. Home prices in May were less responsive than demand, rising only 0.8 percent on the month, though they remain 14.6 percent above a year ago. We expect home sales to weaken in the months ahead, but home prices are not expected to return to their cyclical lows with months of unsold inventory of detached homes in San Diego at only 5.6 months.
- San Diego hotels are seeing some noticeable improvement in occupancy and revenues as leisure and business travelers return after a long hiatus. San Diego's occupancy rate was 72.6 percent in March, up from 63.5 percent from a year ago, according to PKF Consulting. Revenue per available room rose by 5.9 percent. The Sports Arena/Old Town Area had the highest occupancy rate of 83.7 percent.
- Commercial construction remains a mixed bag in San Diego. Industrial permit values are down sharply, but office and retail permits are recovering nicely. A strong travel recovery has prompted more hotel permits to be issued this year after no permits were issued last year. Even as some commercial construction activity returns, total permit values for 2010 are still expected to remain well below last year's levels.



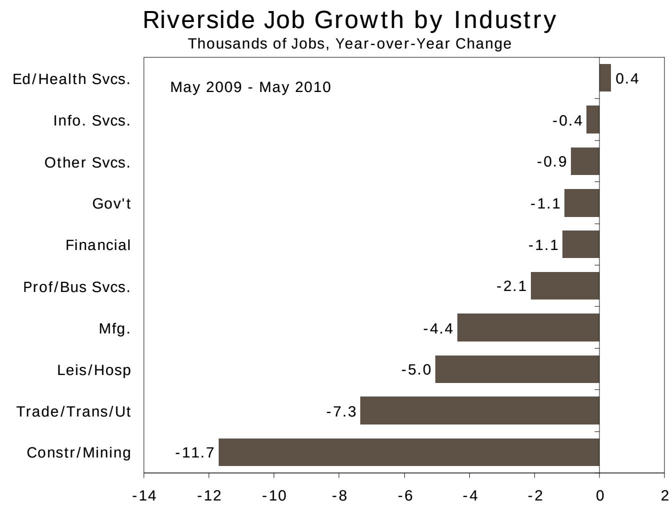


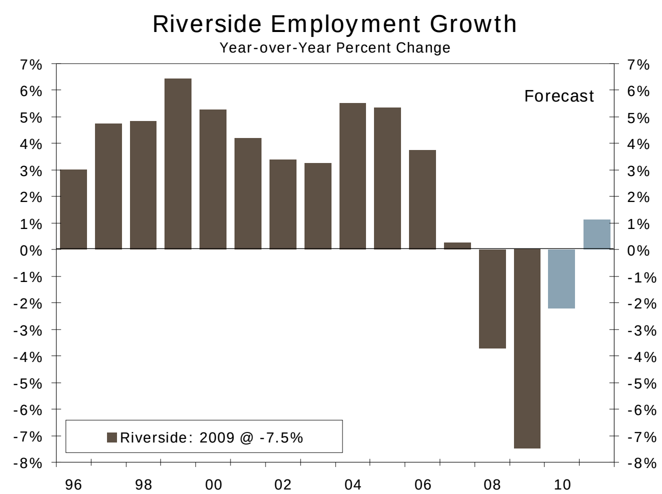


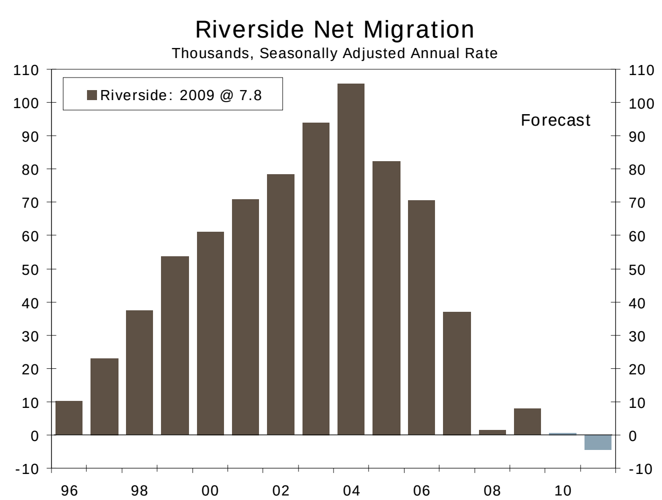
Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

Inland Empire

- Riverside and San Bernardino counties have been among the worst hit in southern California. The exposure of this region to the housing bubble was immense, but here too signs of economic stabilization are beginning to emerge. Job losses have subsided for the most part. The region added 3,800 nonfarm jobs in May, but two-thirds of the gains were due to federal government Census hiring. Notable monthly gains occurred in trade, transportation and utilities. Over the past 12 months, the Inland Empire lost another 35,200 non-farm jobs, 3.1 percent of the total. Health and social services was the only industry to report gains over the past year, adding 200 net jobs. Construction led the region in job declines, losing 11,700 jobs, or 16.8 percent of the total.
- Existing home sales in the Inland Empire area are not as encouraging as in the rest of the state. Existing home sales actually fell 3.5 percent in May and are now down 25.1 percent from a year ago. The homebuyer tax credit appears to have boosted sales in March, but no such boost was visible in April and May. Still, median existing home prices have already recovered appreciably, up 21.2 percent from a year ago. With home sales expected to remain weak over the rest of the year, further home price gains in the Inland Empire Area will be difficult. Indeed, a modest double dip in home prices is possible even with the median price already low by California standards at $194,959.
- Commercial construction is not faring any better than residential. Industrial permits so far this year are running about half what they were last year. No hotel permits have been issued and retail permits are flat compared to last year. It is clear that commercial construction in the Inland Empire area will have to wait at least another year, maybe two, before commercial activity starts clawing its way higher.
- Population growth and in-migration was the big economic driver for the Inland Empire, increasing demand for housing, retail trade and services. But the depth of this recession has stopped that in-migration. Most people move to a region primarily for economic opportunity. This deceleration in population growth has magnified the effects of the housing bubble.







Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

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