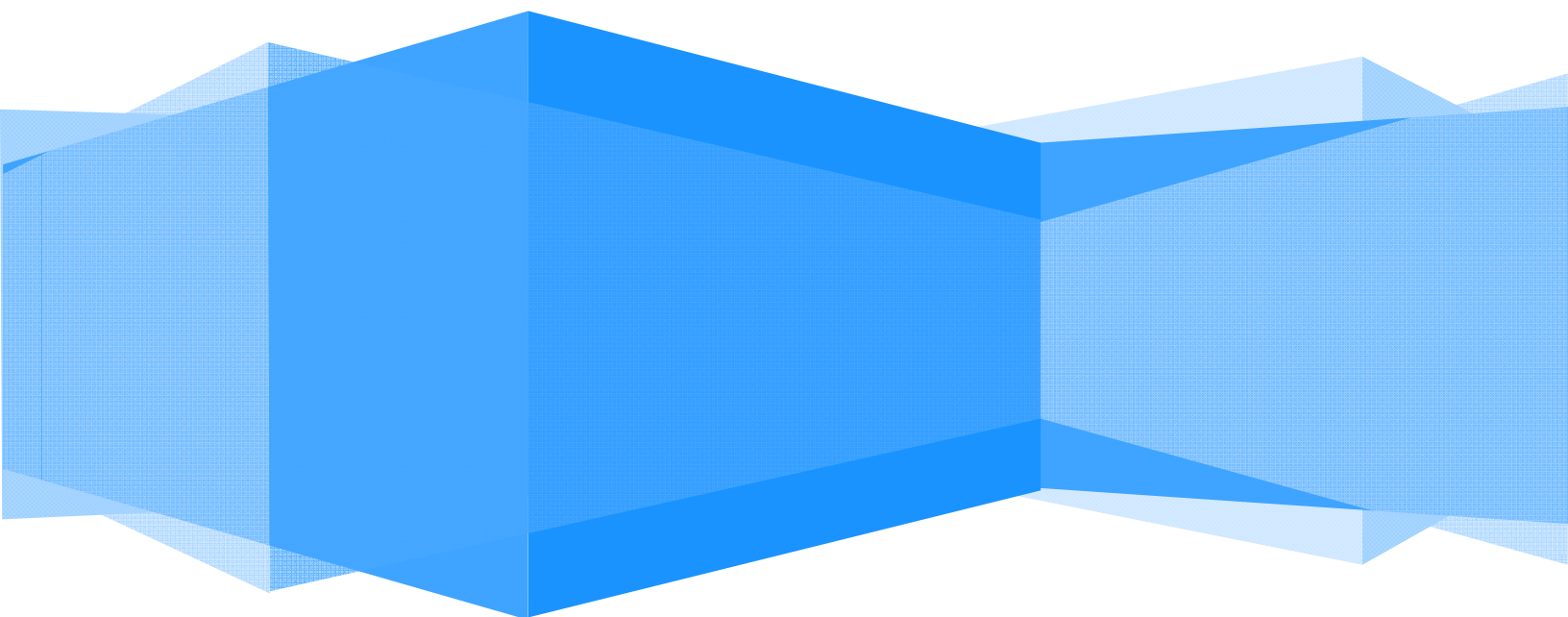




Economic Outlook

3rd Quarter 2009 News



Economic Trends

More evidence recession ending

Further evidence the recession is ending came in a recent report confirming that the economy shrank at an annual rate of just 1 percent in the spring. Many analysts say growth likely returned in the current quarter. Smaller dips in consumer spending and other areas during the April-June period led some economists to raise their forecasts for the July-September quarter. But with unemployment aid claims stubbornly high, Americans may benefit little from a recovery if jobs remain scarce and spending stays too low to fuel a strong rebound.

The Commerce Department estimated that the U.S. gross domestic product, the broadest gauge of economic health, shrank at an annual rate of 1 percent in the second quarter. The new estimate of the nation's output of goods and services was the same as an earlier estimate released last month.

The negative figure marks a record fourth consecutive quarterly decline. But it was far smaller than the nose-dive the economy had taken during the previous two quarters. Businesses did slash inventories at an even greater rate than had been expected in the spring. But economists were encouraged by upward revisions to consumer spending, exports and housing construction. Analysts had expected the second-quarter economic figure to show a drop of 1.5 percent.

"The big surprise in this report was that there was enough spending in the consumer sector and elsewhere to offset all the loss from inventory reductions," said Nigel Gault, chief U.S. economist at IHS Global Insight. Consumer spending, which accounts for about 70 percent of total economic activity, fell at an annual rate of 1 percent in the second quarter. It was a slight improvement from the 1.2 percent decline reported last month.

Gault predicted the economy will gain momentum in the current quarter and final three months of this year as businesses switch from trimming stockpiles to rebuilding inventories. He expects the GDP to jump to above 3 percent in the July-September quarter, boosted by the Cash from Clunkers auto program.

Growth likely will remain around 3 percent in the fourth quarter, Gault said. But then it could slip in the first half of next year as the support from inventory rebuilding begins to fade. Consumers, faced with bleak job prospects, won't likely be able to take up the slack, he said. Unemployment is not expected to peak until next spring, probably somewhere above 10 percent. The jobless rate is now 9.4 percent. White House economic adviser Christina Romer said the unemployment rate is likely to hit 10 percent this year.

Fed's Beige Book: Economy is steady but spending remains subdued

The U.S. economy continued to stabilize in July and August, but soft consumer spending amid a weak job market suggested that recovery will remain subdued. A recent Federal Reserve report said retail sales in most regions in July and August were flat, despite a boost to auto sales from the government's "cash-for-clunkers" program, which granted consumers a government rebate when they traded in certain older vehicles for more fuel-efficient models. Still, each of the Fed's districts

reported at least some signs of firming economic activity, with most indicating strengthening in residential real estate markets as well.

In its previous beige book report, published July 29, the Fed said most regions across the country were seeing signs the recession was easing. Most indicated the pace of decline had moderated in late spring and early summer.

The latest beige book said, "Reports from the 12 Federal Reserve Districts indicate that economic activity continued to stabilize in July and August." It said consumer spending remained soft in most districts, but a majority of the 12 districts said the "cash for clunkers" program elevated traffic. Consumer spending drives much of the economy. People are afraid to spend much because they have lost or are afraid of losing their jobs.

Labor-market conditions remained weak across all districts, but several also noted an uptick in temporary hiring and a decline in the pace of layoffs. Residential real-estate markets remained weak, but there were signs of improvement. Downward pressure on home prices continued in most areas. As for commercial real estate, demand for space remained weak.

On banking, the beige book said many districts reported credit standards were tight. Loan demand was described as weak. Most districts reported improvement in manufacturing production. The long recession has tempered inflation. Wage pressure remained minimal across all districts. Consumer prices were described as steady in most areas.

Unemployment Rate

Job pain deepens

California's jobless rate soared to 12.2 percent in August - the highest on record for the state and the nation's fourth-highest figure - fresh evidence the state has far to go before a recovery can materialize. One bright spot: The 12,000 jobs lost statewide last month were the fewest monthly job losses since April 2008, according to a report by the state Employment Development Department.

The East Bay jobless rate rose to the grim milestone of 11.5 percent. The jobless rate in the San Francisco-San Mateo-Marín region rose to 9.5 percent, the worst ever reported by the EDD for that area. The California and regional numbers are based in the EDD's current system of record keeping, which dated to 1990.

The current 12.2 percent jobless rate for California was well above the 11.9 percent level in July. The jobless rate in various parts of the South Coast region ranged from 9 to 13 percent in August. Substantially worse than the South Coast region were various parts of the Central Valley and Sacramento Valley regions, which ranged from 12 to 17 percent in August. But California's employment problems could be even worse than suggested by the EDD data, on a historical basis: A separate survey by the U.S. Department of Labor shows that the current jobless rate is the worst since at least 1976.

Even so, some economists were encouraged by the state's recent job-loss trends. "California employment, which has been in a free fall for some time, is showing signs that the parachute is open," said Brad Kemp, director of regional research with Beacon Economics. "The descent is slowing."

"Job losses are less than they were six months or a year ago," said Stephen Levy, director of the Center for Continuing Study of the California Economy.

Still, California has lost 741,500 jobs over the year that ended in August. The Bay Area lost 158,600 jobs over the same 12 months, an analysis of the EDD data shows. Every metro region in the Bay Area has been hammered by job losses over the most recent 12 months.

Retail Trends

Like the Great Depression, today's economic turmoil altering shopping habits

Carolyn O'Brien used to glide into Nordstrom, let the fashion moment seize her and buy whatever was in her price range, with little concern for sales or discounts. These days, she combs the racks at Macy's or JCPenney, where coupons and discounts mean savings of 40 percent or more.

"I don't buy anything unless it's on sale now, and not just a little sale, it has to be at least 20 percent off," said O'Brien, who works for the California Skin Institute as a patient care coordinator. And, she said, she may keep her thrifty shopping habits even after the economy rebounds. But will her new way of life outlast the current downturn?

The Great Depression witnessed a generational change in consumer behavior, when learning to live with less became a habit - and one that many clung to even when the good times returned.

U.S. consumer behavior changed drastically during the Depression, when 25 to 30 percent of the work force was unemployed. Frugality was the rule of the day, and a mindset many continued for the rest of their lives. But in the decades since, easy money policies led to an explosion of credit, and consumption. Now, with the current crisis, many who have never had to economize are being forced to do so for the first time in their lives. Credit isn't as readily available anymore, either.

Some economists are uncertain whether new, thrifty shopping habits will stick. It's "normal for families to adjust their spending in deep recessions or when personal financial trouble hits," said Steve Levy, an economist and director of the Center for Continuing Study of the California Economy.

The recession after the dot-com bubble burst saw spending fall, he said, as it did during the recessions of the early 1980s and 1990s. Historically, Levy said, consumers returned to old habits slowly over a few years, waiting until they felt secure that the economy and their jobs were stable.

The current consumer behavior most mirrors what happened in the early 1980s, when tax and interest rates were high and unemployment rampant, said Marti Kopacz, a retail distress expert with Grant Thornton, a corporate advisory and restructuring services firm. Just as they did then, consumers are trading down one level. A Nordstrom shopper, for instance, might switch to Macy's,

while a Macy's shopper might go to JCPenney or Kohl's. And those customers who have become comfortable buying basics at less-expensive stores may continue to do so even after things improve.

In fact, experts say the category hurting the most and the one that may take the longest to recover is luxury goods, because it's the one area in which consumers can delay purchases.

Retail Sales – August

Jobs, retail reports discouraging

Recently, claims for jobless aid fell less than expected and the number of people continuing to receive unemployment benefits rose - further signs that any economic recovery will be hindered by a weak job market and flat incomes. Most economists think the recession is over, but they say the jobless rate will keep rising until at least next summer as the economy struggles to mount a sustained recovery. That means household incomes will remain depressed and consumer spending, which accounts for 70 percent, will continue to lag.

"Firms are still not hiring, and that reflects deep pessimism about the sustainability of the economic recovery once government stimulus programs wear off," said Sal Guatieri, senior economist at BMO Capital Markets. "The lack of job creation remains a big headwind for cash-starved and credit-constrained consumers."

The nation's major retailers recently reported lackluster results from August back-to-school sales. Results in established stores fell 2.1 percent in August compared with the same month last year, a compilation of 31 retailer's results by the International Council of Shopping Centers and Goldman Sachs indicated. Some major discounters managed to exceed expectations.

In the chain store sales report, discounter Target Corp. and warehouse club operators Costco Wholesale Corp. and BJ's Wholesale Club Inc. said sales at established stores dropped but beat analyst expectations. A 5 percent jump at TJX Cos., which operated discount chains TJMaxx and Marshall's, topped expectations. But upscale retailers, including Saks Inc. and Nordstrom Inc., reported a weak month.

"Employers are nervous that the economy is growing only because of policy stimulus and that when the stimulus fades, it will weaken again," said Ian Shepherdson, chief U.S. economist at High Frequency Economics. Christina Romer, a top Obama economic adviser, said that unemployment could reach 10.3 percent next summer before starting to improve. Guatieri expects it to remain near 10 percent for most of next year.

Consumers cut debt by record \$21.6 billion in July

Consumers slashed their borrowing in July by the largest amount on record as job losses and uncertainty about the economic recovery prompted Americans to rein in their debt. Economists expect consumers will continue to spend less, save more and trim debt to get household finances decimated by the recession into better shape. However, such action is a recipe for a lethargic revival, as consumer spending accounts for 70 percent of economic activity. The Federal Reserve

reported that consumers ratcheted back their credit by a larger-than-anticipated \$21.6 billion from June, the most on records dating to 1943. Economists expected credit to drop by \$4 billion.

U.S. manufacturing activity, new orders grow

The U.S. manufacturing sector grew in August for the first time in 19 months, adding to evidence that the recession is ending. The better-than-expected reading by the Institute for Supply Management showed the highest number for its manufacturing index since June 2007. New customer orders jumped to a level not seen since late 2004. And in another sign of an improving economy, a gauge of future U.S. home sales rose more than expected in July to the highest point in more than two years.

Auto Sales – August

Clunkers fuels sales for some automakers

The Cash for Clunkers program boosted sales at Ford, Toyota and Honda in August as consumers snapped up their fuel-efficient offerings, but rivals Chrysler Group LLC and General Motors Co. withstood another month of falling sales. The Program, which ended on August 24, drew hordes of buyers into quiet showrooms by offering up to \$4,500 toward new, more fuel-efficient cars and trucks. The hefty rebates gave automakers and dealers a much-needed lift, spurring 690,114 new sales, many of them during August, at a taxpayer cost of \$2.88 billion.

Ford Motor Co. sold 181,826 cars and light trucks compared with 155,117 in August 2008, when high gas prices and growing economic uncertainty kept people away from showrooms. Two of Ford's vehicles - the Focus and Escape - were among the top selling cars under the clunkers program. Sales of the Focus rose 56 percent while those of the Escape crossover vehicle climbed 49 percent.

Japanese automakers Toyota Motor Corp. and Honda Motor Co. also posted gains year-over-year gains in August. Toyota sales rose 6.4 percent to 225,088, lifted by small cars like the Corolla, the best-selling clunkers vehicle. Going into August, five of Chrysler's most efficient vehicles were already at low inventory levels. Those vehicles - the Dodge Caliber, the Chrysler Sebring, the Jeep Patriot, the Jeep Compass and the Dodge Avenger - all qualified as Cash for Clunkers purchases.

Auto Sales – September

General Motors posted a 45% drop in September U.S. light-vehicle sales, while Chrysler's sales fell 42%. Ford saw much more modest drop of 5.1%. Among Japanese auto makers, Toyota said its September U.S. sales declined 16% from a year earlier, while Nissan saw its results fall 7% and Honda said its sales slid 23%. The auto industry was hurt by the expiration of the U.S. government's "cash for clunkers" rebate program.

UCLA Anderson School Forecast

In its third quarterly report of 2009, the UCLA Anderson Forecast concludes that the worst recession in seven decades likely ended in the current quarter, but then states that the negative impact of the downturn will last well into the next decade. Simply put, the Forecast believes that the roots of the recession originated in consumer over-indebtedness and that consumer spending, necessary for a robust recovery, will be tempered both by the unwillingness of financial institutions to lend and for consumers unwillingness to borrow. In California, the UCLA Anderson Forecast tentatively asserts that the state will join the nation in its economic recovery, but the incipient contraction of state and local government will dampen the impact of the national resurgence for at least the near future.

The National Forecast

In a report titled, "The Long Goodbye," UCLA Anderson Forecast Senior Economist David Shulman states, "after four quarters of decline, economic growth is resuming. They forecast that real GDP will increase at 2.1% in the current quarter and 2.3% in the fourth quarter. For all of 2010, they forecast quarterly growth to average 2% with noticeable improvement at the end of the year." Sluggish overall growth is predicted, as the unemployment rate will be above 10% well into next year. Shulman adds that the majority of short-term growth will come from a dramatic reversal in inventories, where after plunging at a revised annual rate of \$159 billion in the second quarter, real inventories are expected to increase by \$12 billion in the fourth quarter of this year. Two other important swing factors will be the recovery in exports and the long awaited rebound in residential construction.

Shulman's cautious view regarding growth rests on the belief that after a two-decade spending spree, first rooted in rising stock prices and later on rocketing home prices fueled by easy credit, has ended. Consumers, rather than relying on rising asset prices, will be saving as they did in the past, by a reduction in current consumption. Simply stated, "Credit impaired lower income consumers can't spend the way they used to and wealth impaired affluent consumers won't," Shulman stated.

The California Forecast

In California, there exists good news - all of it emanating from outside of Sacramento. In a report titled, "Will California Watch the Take-off from the Tarmac Once Again?" UCLA Anderson Forecast Senior Economist Jerry Nickelsburg states that the housing markets, where prices have adjusted to levels that make existing homes more affordable, sales are increasing and conditions are ripe for new residential construction. In trade and manufacturing, there is new evidence that demand for California-produced goods is increasing. Even in the very weak consumer sector, there are indications that the collapse of hospitality, retail, wholesale and transportation employment may be coming to an end.

But the downside is unemployment, which Nickelsburg says is "ugly" and will remain so for some time to come. "More rapid growth than can be expected over the next twelve months would be

required to bring the unemployment rate down," Nickelsburg states, asserting that the still-contracting state and local government sector only compounds the unemployment problems.

Overall, the forecast for California remains much as it did in June, the only change being a slightly more optimistic national forecast driven by increased consumer confidence and an increased demand for California produced goods. But no dramatic events have occurred to change the general nature of the forecast. On an annual basis, employment is forecast to contract 3.7% in 2009 and will barely grow at a 0.2% rate in 2010. The unemployment rate will grow to a high of 12.2% for 4th quarter 2009 and will average 11.6% for the year. Though the state economy will be growing by 2011, it will not produce enough jobs to get the unemployment rate below double digits until the end of that year. *

* Extracted from a press release issued by the UCLA Anderson School of Business.

Sources:

New York Times
San Francisco Chronicle
USA Today
Wall Street Journal
Caltaxletter
Labor Market Info