Chapman University

Press Release

A. Gary Anderson Center for Economic Research

FOR RELEASE:
ONLINE: June 16, 2011; 10:00 a.m.
PRINT: June 17, 2011

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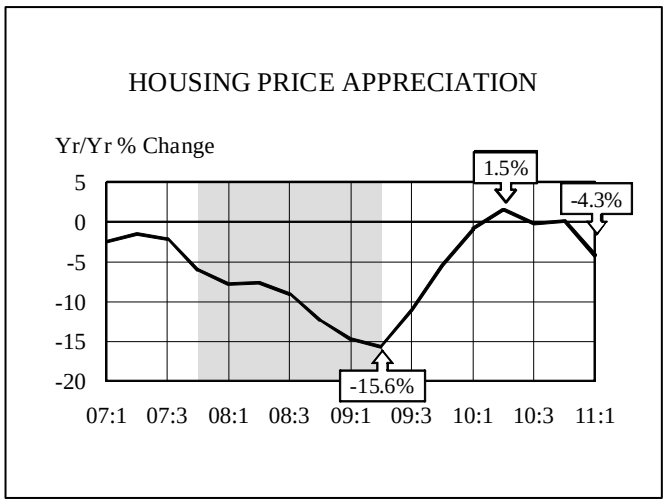
The Recovery Downshifts But Not In Reverse

Orange, CA – The A. Gary Anderson Center for Economic Research at Chapman University released today an updated economic forecast for 2011 and its forecast for the year 2012. Forecasts of national, state and local economic performance were presented to Orange County business and community leaders assembled at The Hilton, Costa Mesa, California.

Following are highlights of the forecasts. The complete results are reported in the *Economic and Business Review*.

2011-12 U.S. Forecast

- The lower-than-expected real GDP growth of the first quarter, coupled with a spate of bad news on job growth and the Purchasing Managers Index, has led many to conclude the recovery has stalled.
- A number of temporary shocks to the economy, such as the spike in gasoline prices, the Japan quake and the federal budget impasse may account for the stall.
- Most ominous, though, in terms of its impact on the economy, is the 4.3 percent decline in housing prices during the first quarter. Continued declines in housing prices will increase the number of foreclosures and distressed properties, placing pressure on the banking and financial system. Even



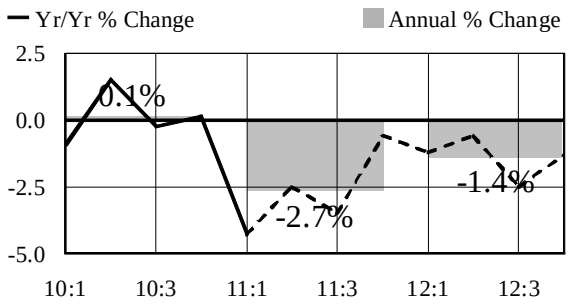
more damaging to the economy would be the negative wealth effect resulting from lower housing prices.

- Our forecast suggests that housing prices in the nation will continue to depreciate, declining 2.7 percent in 2011 and another 1.4 percent in 2012

- Our forecast for housing prices indicates a number of countervailing factors:

  – On the plus side, housing has never been more affordable.
  – In addition, the natural increase in demand occurring because of new household formation and replacement housing is forecasted over the next two years to be high enough to absorb most of the excess supply of vacant housing units.
  – A very positive sign that such absorption is beginning to occur is the sharp decline of vacant rental units from 10.6 percent to 9.7 percent over the last year. This represents a decrease from almost 1.1 million vacant rental units in the first quarter of 2010 to roughly 700,000 vacant units in the first quarter of 2011. Such a sharp drop suggests that new households are deciding to rent rather than buy a home. Eventually, though, as rental vacancies continue to fall and rental rates increase, a home purchase begins to look more economically attractive.
  – Potential homebuyers will stay on the sidelines (renting) until there is greater confidence that the downturn in housing prices has come to an end.
  – The major reason for our forecast of declining home prices is the huge inventory of more than 2 million homes in foreclosure. Although the number of homes in foreclosure appears to have peaked, the average number of days that

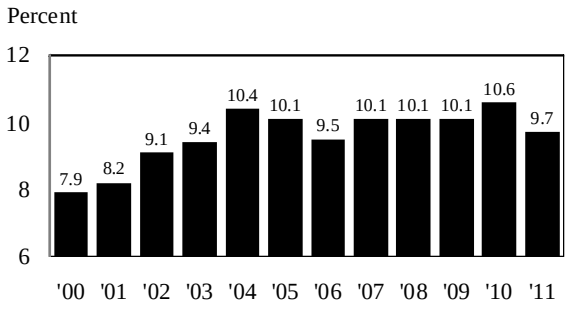
HOUSING PRICE APPRECIATION



HOUSING UNIT SUPPLY-DEMAND ANALYSIS FOR 2011 TO 2012

Supply:	
Excess inventory of vacant units	1,403,000
New production	1,261,000
Total supply	2,664,000
Demand:	
New household formation	2,400,000
Replacement housing	600,000
Total demand	3,000,000

RENTAL VACANCY RATE DURING THE FIRST QUARTER OF THE YEAR



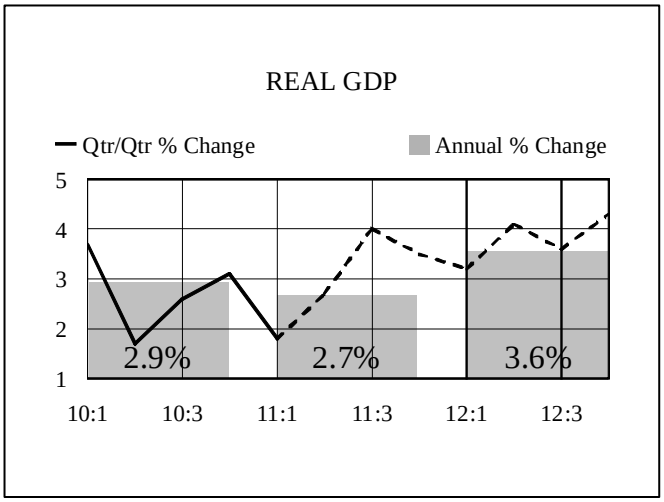
a home has been in foreclosure has increased from 400 days in January 2010 to almost 600 days in April of this year. If new terms can't be worked out with existing owners of homes in foreclosure, there is continuing downward pressure on housing prices as these homes are put up for sale or auction.

- The negative wealth effect of the housing price declines we are forecasting represents a decline of $680 billion in households' net worth. This loss, however, is more than offset by gains in the value of financial assets of more than $3 trillion resulting from a 20 percent increase in stock markets over the last year. As a consequence, the net wealth effect is positive, thereby giving families the wherewithal to fuel higher consumer spending.

- The 12 percent decline in the trade-weighted value of the U.S. dollar over the past year is projected to have a positive economic impact in the short run by pushing exports higher. The Chapman forecast calls for net exports to move from being a major drag in the economy (a drop of 16.4 percent in 2010!) to being a stimulus (growth of 4.4 percent in 2011).

- Increases in net exports, coupled with positive growth in investment and consumer spending, will keep the recovery going. Real GDP growth is forecasted to increase 2.7 percent in 2011 and 3.6 percent in 2012.

- Job growth is finally taking hold and picking up some forward momentum. We are forecasting job growth of 1.2 percent in 2011 and 1.4 percent in 2012. This creation of 3.4 million jobs will help bring the unemployment rate down to 7.5 percent by the end of next year.



- As the economy picks up steam by year-end, the Fed will increase the federal funds rate. We believe that will happen, at the earliest, in the first quarter of 2012, and we are forecasting an increase in the fed funds rate from 0.2 percent to 1.8 percent by the end of the year.

  Long-term interest rates, like the 10-year treasury bond, will increase 100 basis points, from 3.5 to 4.5 percent.

- Inflation, as measured by the year-to-year percentage change in the All-Items CPI, will remain below 3.0 percent through 2012. The likelihood that the drop in the value of the U.S. dollar will precipitate a hike in inflation is low. More importantly, economic growth is not forecasted to be rapid enough to lead to a sharp increase in wages and salaries and other costs that would place significant pressure on core inflation.

2011-12 California and Orange County Forecast

- The severity and depth of the Great Recession is evident when job losses during this recession are compared to the recessions of 1990-91 and 2001. In the 2001 recession, California lost about 365,000 jobs over a 28-month period, the unemployment rate peaked at 7.0 percent and the economy generated enough jobs to reach the previous peak employment in 21 months. In the 1990-91 recession, California lost 517,000 payroll jobs over a 34-month period and the unemployment rate hit a high of 9.9 percent. It took 30 months for the payroll employment to recover to its previous peak level. This time around, California lost 1,366,000 jobs over 38 months with unemployment rate peaking at 12.5 percent.

CALIFORNIA'S
LAST THREE BUSINESS CYCLES

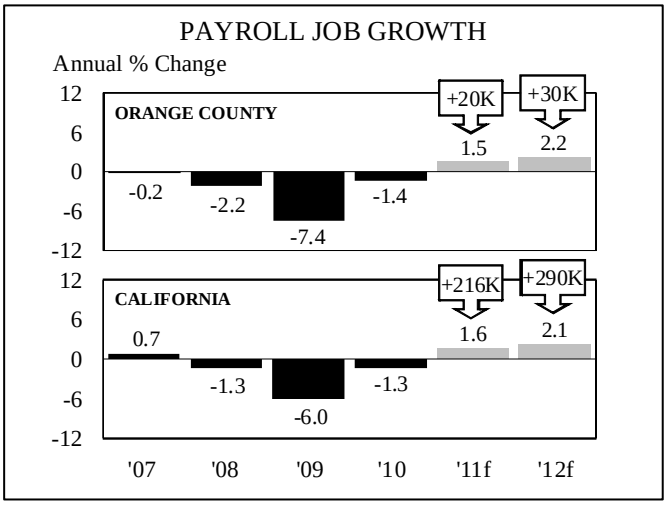
	1990-91	2001	2007-09
Peak Payroll Employment (in thousands)	12,534.0	14,726.7	15,214.3
Trough Payroll Employment (in thousands)	12,017.1	14,361.8	13,847.9
Job Losses (in thousands)	-516.9	-364.9	-1,366.4
Number of Months from Peak to Trough	34	28	38
Peak Unemployment Rate	9.9%	7.0%	12.5%
Number of Months from Trough to Previous Peak	30	21	?

- The benchmark payroll employment data released in February indicate that California gained about 83,000 jobs in 2010, compared to the U.S. job gain of 940,000. Since the California's economy is roughly 13.0 percent of the U.S. economy, the data suggest that California is underperforming the U.S. during the current recovery.

- Declines in home prices and the demise of the construction activity explain the depth and the length of the recent recession. The current residential and nonresidential permit statistics show that construction spending has hit bottom and is expected to rebound about 6.0 percent in 2012.

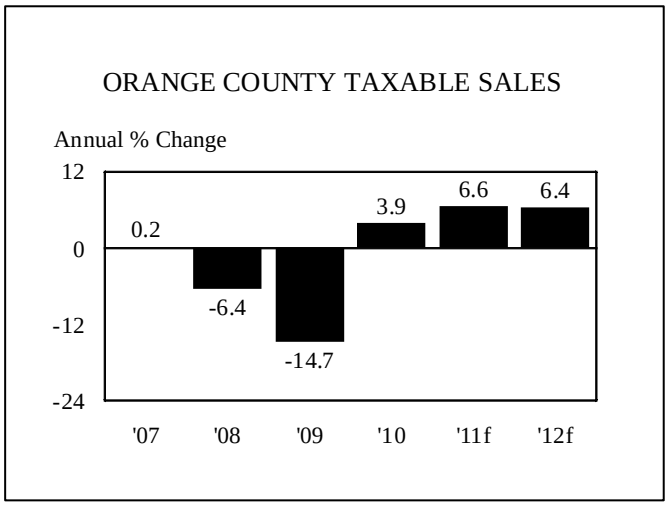
- Trends in construction spending, real GDP and real exports point to a pickup in overall job growth. Quarterly job growth is forecasted to increase steadily from the current growth rate of 1.4 percent to 2.4 percent by year-end 2012.

- On an average annual basis, the total number of payroll jobs in Orange County will increase by about 20,000 jobs in 2011 and 30,000 jobs in 2012. This translates to growth rates of 1.5 percent in 2011 and 2.2 percent in 2012, roughly the same as California's job growth projection.



- The job recovery will be broad-based. With the exception of federal civilian employment, all sectors are projected to show a positive payroll job growth in 2012. The fastest growing jobs will be in the professional & business, education & health services and leisure & hospitality sectors.

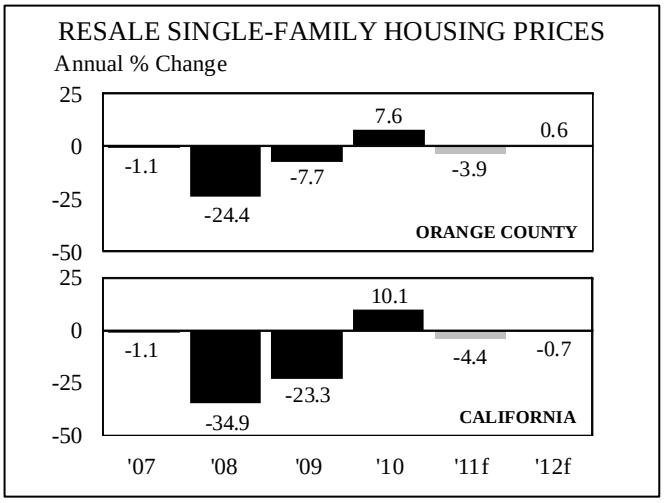
- Improving job market, lower unemployment rates and personal income growth should positively affect consumers' spending. Barring any unexpected oil supply disruption, we believe that gas prices should remain in the range of $3 to $4 a gallon. With that backdrop, our forecast shows a significant rebound in consumers' taxable sales spending in 2011 and 2012.



- There are countervailing forces affecting the housing market. Lower home prices, increasing income and low mortgage rates improved housing affordability. That, along with improving job market, should induce home buying activity, but higher underwriting standards are excluding many potential buyers from the market, leading to a weak sales activity.

- On the supply side, the major headwind is a high and persistent level of inventory, particularly stressed properties. There are still a large number of stressed properties held by the financial institution in what is known as shadow inventory. In addition to the existing level of inventory, exotic adjustable mortgages originated in 2006 are still due to be refinanced in 2011. These homeowners are underwater. As a result, many households are choosing to short sale or let their properties to be foreclosed. The good news is that 2006 was the last year of mortgage bubble and financial institutions did not originate many exotic adjustable mortgages in 2007. Hence, this points to a slowdown in the *new* supply of stressed properties in 2012.

- On balance, our forecast calls for housing prices in California and Orange County, measured by the median price of a single-family home, to show a decline of about 4.0 to 4.5 percent in 2011 and show virtually no appreciation in 2012.



ABOUT THE ANDERSON CENTER FOR ECONOMIC RESEARCH

The A. Gary Anderson Center for Economic Research (ACER) was established in 1979 to provide data, facilities and support in order to encourage the faculty and students at Chapman University to engage in economic and business research of high quality, and to disseminate the results of this research to the community.

ANNUAL SCHEDULE OF CONFERENCES AND PRESS RELEASES

JANUARY
- Economic Forecast Conferences for Los Angeles County and the Inland Empire
- California Purchasing Managers Survey

FEBRUARY
- California Leading Employment Indicator

MARCH
- California Consumer Sentiment Survey

APRIL
- California Purchasing Managers Survey

MAY
- California Leading Employment Indicator

JUNE
- Economic Forecast Update Conference for the U.S., California, Orange and Los Angeles counties, and the Inland Empire
- California Consumer Sentiment Survey

JULY
- California Purchasing Managers Survey

AUGUST
- California Leading Employment Indicator

SEPTEMBER
- California Consumer Sentiment Survey

OCTOBER
- California Purchasing Managers Survey

NOVEMBER
- California Leading Employment Indicator

DECEMBER
- Economic Forecast Conference for the U.S., California and Orange County
- California Consumer Sentiment Survey