The U.S. economic outlook has unfolded broadly in line with our expectations since our last annual forecast of October 2006. The downshift in economic activity, which began in the last two quarters of 2006, has continued in earnest into the current year (Figure 1). The economic slowdown is no longer in question - a cursory look at the data readily confirms that the economy has lost steam and is poised for further weakness in the months to come. Some of the factors contributing to this downshift were easy to spot; some a bit more latent and others have yet to materialize. The first half of the report discusses these risk factors and their potential implication for the U.S. economy before we turn our attention to Orange County and Southern California.

A straightforward way to track current economic developments is to follow a simple accounting technique placing macroeconomic indicators into main categories according to their impact in the economy: “negative factors,” “positive factors” and “uncertainties.” In the “negative” category, troubles in the housing market win first place. With it, issues in the subprime market, foreclosures, tighter lending practices, potential credit crunch and liquidity issues exacerbate the housing problem, dampening significantly economic activity. Lower residential construction, the lack of investment opportunities, a softening of the labor market, turmoil in the financial sector, high oil prices, higher unit labor costs and lower productivity, make the “negative” category seem dauntingly endless.

On the “positive” side, strong global growth, low interest rates, higher export growth, healthy US corporate balance sheets and the easing of interest rates by the Federal Reserve, offer some respite amidst the current growing concerns. There are, however, a few “uncertain” factors whose performance will have a significant impact in
determining the fate of the U.S. economy in the coming months - consumer spending, long-term interest rates and inflation.

While some analysts and market researchers have contended that the U.S. economy is already in a recession, others maintain a more agnostic view to this prognosis. Without discarding the concerns raised by the first group, our outlook aligns more with the second one. We believe that the U.S. economy, while poised for a significant slowdown for the remainder of this year and the next, will undergo a painful “near-recession,” coming close to but ultimately sidestepping a full-blown recession. Below we lay out our “near-recession” scenario as it relates to the major risk-factors currently weighting on the economy: the real economy, housing, the subprime issue, inflation, financial markets, and the global economy. This discussion provides the basic foundation for our economic outlook and national forecasts.

**Real Economic Activity**

The slowdown in U.S. economic growth during the last two quarters of 2006 has spilled over to the current year. Real gross domestic product, which measures economic growth, increased by only 0.6 percent in the first quarter of 2007 - the lowest growth rate since the fourth quarter of 2002. The U.S. economy grew by a healthy 3.8 percent during the second quarter of 2007, although the outlook for the second half seems less upbeat.

Consumer spending remains one of the main factors generating the current economic growth. With the exception of a seasonal decline in the second quarter of 2007 (largely due to the escalation of oil prices), consumer spending has remained relatively strong rising by an average of 3.1 percent (on a year-over-year basis) during the first half of 2007. In addition, at 6.4 percent, income growth continues to remain robust. So far, it seems that the slowing of the housing market has had a limited effect on consumer expenditure, indicating that households have continued to finance their spending by relying on the accumulated net wealth of their home equity and strong income growth. Nevertheless, as home values decelerate or even decline from their high levels, we expect the current housing correction to have a significant adverse impact on consumer spending over the next 6 to 18 months (Figure 2).
Housing Market

The question on housing market is no longer posted in terms of “will it happen” but rather “by how much” and “when will it bottom out”. Existing home sales slumped by 12.8 percent in August (on a year-over-year basis) and are down by 7 percent in 2007 compared to last year. Housing starts declined by 20 percent in August compared to one year ago and are expected to decline by an average of 16 percent during the remainder of this year (Figure 3). The slowdown in housing starts, residential construction and house prices, although likely to remain a drag on economic growth for the remainder of 2007 and 2008, are expected to minimize the large gap between consumer demand for housing and excess supply, bringing forth a more sustainable equilibrium in the housing market.

The slew of disappointing data from the housing front has eroded homebuilder confidence and has surpassed the low-levels of the housing market recession of 1991. While some market overreaction may be in order (after all the indices were at almost record high-levels in August 2005), the sentiment echoed by the National Association of Home Builders indices is clear: the housing market is in the midst of a major correction which is unlikely to bottom out within the next 6-8 months (Figure 4).

The effect of housing on economic activity in its simplest form is twofold: 1) through consumer spending and 2) through construction investment. To the extent that home sales are expected to continue to decline over the next six quarters, it is prudent to assume that lower residential investment spending would take a sizable bite from economic activity. On the positive side, we may expect some of that residential investment to continue to shift into non-residential spending. But the most important impact of the housing market in the economy is through consumer spending, which depends more on house prices than other aspects of the housing market. Despite lower home sales, the change in house prices has not yet hit negative territory. In the second quarter of 2007 house prices were up 3.2 percent in
nominal terms (on a year-over-year basis) and 0.5 percent in real terms. While we expect real house prices to decline further from their current levels, we do not think that an outright plunge is likely.

The Subprime Sector

This year saw a new term coined in financial jargon: the subprime market. The subprime sector consists of loans intended for borrowers with high risk who were able to get home financing through credit markets that “securitize” these loans selling the rights of resulting cash flows to investors with high risk appetites such as hedge funds, pension funds, etc. (Figure 5). The majority of subprime loans are adjustable-rate mortgages (ARM) and as the Federal Reserve continued to maintain its tightening bias over the past three years, the subprime loans showed increasing signs of delinquencies. The fraction of subprime ARMs past due ninety days or in foreclosure reached nearly 15 percent in July 2007, roughly triple the lows seen in mid-2005. With the number of foreclosures increasing at an alarming rate, investors who originally bought the securitized instruments were forced to sell at distressed prices incurring sizable losses. Several of the largest national subprime lenders such as New Century Financial Corp. and American Home Mortgage Investment Corp. collapsed as the subprime foreclosures increased in numbers.

As we argued in our mid-year update, woes in the subprime sector were the trigger rather than the primary cause of the current credit concerns. By mid-July, it became apparent that the subprime issue was no longer contained within the groups of unfortunate homeowners who were issued these loans or the investors who bought the securitized mortgage products. Credit agencies downgraded numerous securities backed by subprime or Alt-A mortgages lowering investor confidence and causing many to abandon these products altogether. As investor risk aversion increased and the confidence in evaluating market products plummeted, risk premiums rose encompassing a broader range of products including those unrelated to the mortgage market. Attempts at “containment of the subprime market” did not work; instead the risk spread almost universally through a broad range of asset classes, creating liquidity issues, credit crunch concerns, housing market blues and financial market instability.

In our view, we have yet to see the breadth and depth of the “subprime” issue. While we expect the problem to have more ripple effects throughout the system, the measures taken recently by several regulatory agencies should help. The Conference of State Bank Supervisors has partnered with the American Association of Residential...
Mortgage Regulators to develop more uniform enforcement rules in the highly fragmented market of brokers and lenders. Congress is considering tax relief for certain real estate losses related to refinancing. The Federal Reserve issued principle-based guidance describing the standards that banks should follow to ensure that borrowers are provided loans which they can afford to pay. The Board of Governors of the Federal Reserve has launched a pilot program to review underwriting standards and consumer protection practices for nonbank subsidiaries of bank holding companies, nondepository institutions, independent mortgage lending companies and mortgage brokers. Most importantly, the Federal Reserve lowered its target rate by 50 basis points in its September meeting. This policy move is highly important - it provides the much-needed liquidity, restores consumer confidence, quells investor skepticism in a broad-range of asset classes and provides financial stability.

Inflation

Inflation has moderated to a certain extent during the current year from its relatively high levels of 2006. The consumer price index (CPI), which includes both core and energy prices, has risen by 2.4 percent in 2007, markedly below the 3.3 percent average of 2006. The decline in CPI inflation is partly due to the lagged effect of decreases in energy prices and partly caused by the continued tightening bias maintained by the Federal Reserve. At 2.4 percent, core inflation (which excludes food and energy products) is a nudge below the 2.5 percent level recorded during 2006. Core inflation has important policy implementations since it is the measure of inflation targeted by the Federal Reserve. Despite modest declines during the past three months, the average core inflation rate remains above the 1-2 percent targeted level of “inflation comfort zone” of the Federal Reserve (Figure 6).

The fate of inflation is yet to be determined. On the one hand, high wage and labor costs, lower productivity rates, and escalating oil prices should increase the rate of inflation. Conversely, soft domestic demand, the cumulative effect of the past tightening bias of the Federal Reserve, lower seasonal energy prices and contained inflation expectations should help moderate the pace of inflation. We expect the anti-inflationary forces to exert the larger impact on the near-term inflation. With a sizable housing market correction and sluggish growth rates, domestic demand is expected to decline placing downward pressure on prices. As such, inflationary pressures should moderate during the remainder of 2007 and early in 2008. We expect consumer prices to remain below 3 percent in 2007 and in 2008.
Oil prices, which are an important determinant of inflation, have oscillated from highs of $80 per barrel last summer to lows of $50 early this year and back up to $84 at the end of this summer (Figure 7). The current run-up in oil prices is driven both by demand and supply-side factors. On the demand side, China’s and India’s imports of crude oil and the driving season has put upward pressure on oil prices. On the supply side, cutbacks in production from OPEC, increased geopolitical tension in the gulf region, low levels of refinery utilization and Iran’s resolve to continue with its uranium enrichment program have placed additional strains on oil prices.

While we expect oil prices to remain elevated during the next few months, we think that a modest cyclical reversal is likely during the winter months. We expect that the slowing of the U.S. housing market, particularly in new residential constructions, will put downward pressure on oil prices over the next year. This trend should be further reinforced by more moderate growth rates in China and India as these countries adopt monetary and government policies to rein in their rapidly increasing inflation rates.

Financial Markets and Corporate Sector

Perhaps the most significant news on the policy front during this year was the 50 basis point cut by the Federal Reserve in its September meeting. While some analysts have argued that this may be too little too late, the response from the stock market participants thus far seems to be positive. Confidence is restored to a certain extent after an unusually tumultuous summer, where a 100 point swing in the Dow within half an hour seem to be the norm rather than an exception. The policy action from the Federal Reserve was three purposes: 1) provide liquidity in the market, 2) restore investor confidence, and 3) stabilize financial markets. Fed’s lowering of the target funds rate from 5.25 percent to 4.75 percent has had the desired effects so far.

Given the continuing credit concerns, especially in the mortgage market, the housing market correction and a potential slowdown in consumer spending, our forecasts indicate that the Fed will cut rates by another 25 basis points towards the end of this year, and an additional 25 basis points in the first quarter of 2008. These policy actions should restore some stability in the market and steer the economy away from its current “near-recession” territory.

Equity markets have been excessively volatile during the current year. The Dow Jones Index set a record-high level in July 2007, risk premia were low during most of
the first half of the year and the volatility index (VIX) hit highest levels since early 2003 (Figure 8). Two shocks spiked volatility and caused major sell-offs in the market in 2007 (Figure 8). The late February/early March decline was largely attributed to the subprime sector while the late July decline was primarily driven by risk re-pricing and a loss of investor confidence stemming from credit concerns. We expect equity markets to stabilize during the remainder of the year as the rate cut by the Fed increases appetite for risk and restores the much-needed confidence in financial markets.

The spread between the 3-month T-bill and the 10-year U.S. Treasury remained inverted during the second half of 2006 and early into 2007, signaling lower expected economic activity. The spread turned positive in the second quarter of 2007 and has increased dramatically after the Fed’s rate cut, with the 3-month T-bill falling below 3.7 percent and the 10-year note settling at 4.6 percent. The decline in both the 3-month T-bill and 10-year Treasury note reflect the market response to the recent cut in the federal funds rate (Figure 9).

With the Fed likely to lower the targeted federal funds rate further, the 3-month T-Bill should drop to 3.4-3.5 percent over the next few months. In contrast, the 10-year U.S. Treasury yields are determined both by domestic activity as well as international factors. In particular, the large amounts of long-term U.S. Treasury securities accumulated by emerging market economies in order to sustain a low currency value that stimulates exports has contributed to the low global interest rate environment of the past few years. Current foreign holdings of U.S. Treasuries have declined as foreign investors search for higher return on their investment and attempt to avoid currency risk from a depreciating dollar. As equity markets stabilize, purchases of U.S. Treasuries will decline causing a modest increase in long yields to 4.8 percent by the end of this year and slightly higher by the end of 2008.
Corporate after-tax profits reached new record-highs during the first half of 2007 (Figure 10). Many analysts have wondered if profit margins, being overstretched for a quite while, are set for a decline towards their historical average values of around 5 percent. In our opinion, corporate profitability, while set to moderate from its current levels, will continue to remain strong over the next several years given the present global environment. Simply put, international trade has facilitated the transaction of economic objectives across borders with the U.S. reaping the benefits of corporate profitability and emerging economies expanding their employment levels. This situation is sustainable as long as the need for job creation in emerging markets supersedes their objectives of higher returns on invested capital. With above 40 percent of the population yet to be absorbed from the farming sector, tight capital controls and a weak banking sector, the support for job growth will continue to remain China’s primary goal over the next decade.

The Global Environment

The U.S. current account deficit has declined over the last two quarters, reversing to a certain extent the record-high deficit of $840 billion in the third quarter of 2006. In the second quarter of 2007, exports rose by 7.5 percent while the growth rate of import was -2.7 percent, the first decline since 2003. Despite these changes, the current account deficit still constitutes a whopping 5.9 percent of the GDP, a large deficit by historical standards (Figure 11).

The modest decline in the current account deficit is a direct consequence of slower...
economic growth in the U.S., continued global economic growth, and a weaker dollar. For a substantial reduction in the current account deficit, foreign demand would need to grow more than 1.5 times faster than U.S. demand. While a reduction in the current account deficit should continue since exports are expected to grow at an average rate of 7.3 percent and imports at 2.4 percent in 2007, these projected rates are not large enough to bring forth an immediate rebalancing of the current account deficit.

The global economic landscape has evolved in a manner that indicates a partial decoupling from the U.S. economy. Growth rates in Europe have remained robust and Japan has shown significant signs of recovery from the decade-long economic slump. China and India continue to grow at high rates, despite attempts from their governments to slow down the economy. Although hard to distinguish between political rhetoric and genuine commitment for change, the Chinese government in particular, has reiterated several times the need for a meaningful restructure of the economy from an export-led growth to a more consumer-centric force. Unfortunately these are structural changes that would require more than an administrative edict from the central government and we remain skeptical with regard to how fast and how effectively the Chinese government will be able to take meaningful steps towards reshaping its economy in the short-run.

As the global economy becomes less US-centric, this may help the performance of the US economy in the short-run. Exports have rebounded and imports declined due to a combination of stronger growth abroad and a weakening of the dollar. A rebound in net exports may give US Gross Domestic product that extra boost that is much needed to overcome the current soft-patch.

Since its peak in early 2002, the U.S. dollar has depreciated 33 percent against industrialized currencies and only by around 6 percent against emerging markets (Figure 12). The dollar has posted additional declines during the current year, losing close to 7 percent against major currencies and 3 percent against other trading partners. This trend is likely to continue with the dollar depreciating (in broad terms) at a steady 4-5 percent over the next three years.

The global economic landscape has evolved in a manner that indicates a partial decoupling from the U.S. economy.

As the global economy becomes less US-centric, this may help the performance of the US economy in the short-run.

A rebound in net exports may give U.S. Gross Domestic product that extra boost that is much needed to overcome the current soft-patch.

FIGURE 12
U.S. Dollar Indices (level)
The National Forecasts

Gross Domestic Product (GDP) averaged 2.2 percent during the first half of this year, significantly below the 3.3 percent average recorded in 2006. The labor market has also reflected continued weakness. The average job creation per month for the current year stands at 122,000 markedly below the 184,000 average during 2006 (Figure 13). This indicates that while the economy has retained its capability for job creation, growth in nonfarm payrolls has slowed down considerably compared to 2006.

We expect the labor market to display softness in the months to come given the recent problems in housing market and financial sector. Nonetheless, the easing by the Federal Reserve and healthy corporate balance sheets should moderate potential job losses.

We anticipate an overall U.S. GDP growth rate of 2.0 percent in 2007 and 2.4 percent in 2008. Consumption growth should also moderate from its current levels as the slowdown in housing restrains the wealth-based spending of households. We expect that consumption spending will grow by 2.8 percent in 2007 and 2.6 percent in 2008. Unemployment rate is expected to rise from its current low level due to the decrease in housing activity, averaging 4.6 percent for the current year and 4.8 percent in 2008. We expect the lower pace of job creation to continue during the remainder of this year and the next with payroll rates rising by 1.2 percent on an annual basis in 2007 and 1.0 percent in 2008. A detailed summary of our projections for other national variables is presented in Table 1 following this report.

Orange County

Much like the U.S. economy, Orange County’s growth has slowed down this year compared to 2006. Orange County has historically grown at a higher rate than the national economy and has had a lower unemployment rate. Given the diversity of its economy, it has in the past borne the effects of slow growth better than some other
regions, such as the Silicon Valley. Based on 2006 employment figures, the following table indicates the broad diversity of the County’s economy.

<table>
<thead>
<tr>
<th>Sectors</th>
<th>Employment Share</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction</td>
<td>7.0% Local</td>
<td></td>
</tr>
<tr>
<td>Retail Trade</td>
<td>10.5% Local</td>
<td></td>
</tr>
<tr>
<td>Transportation, Warehousing and Utilities</td>
<td>1.9% Local</td>
<td></td>
</tr>
<tr>
<td>Information</td>
<td>2.1% Local</td>
<td></td>
</tr>
<tr>
<td>Educational and Health Services</td>
<td>9.1% Local</td>
<td></td>
</tr>
<tr>
<td>Government</td>
<td>10.3% Local</td>
<td>40.9%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>12.1% Local+External</td>
<td></td>
</tr>
<tr>
<td>Wholesale Trade</td>
<td>5.5% Local+External</td>
<td></td>
</tr>
<tr>
<td>Financial Activities</td>
<td>9.1% Local+External</td>
<td></td>
</tr>
<tr>
<td>Professional and Business Services</td>
<td>18.1% Local+External</td>
<td></td>
</tr>
<tr>
<td>Leisure and Hospitality</td>
<td>11.2% Local+External</td>
<td>55.9%</td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td>3.2%</td>
</tr>
</tbody>
</table>

“Local” sectors are those that primarily depend on the local economy for their markets while “External” sectors rely more on national or international markets. The external sectors, therefore, are more sensitive to changes in the national and global economic conditions than are the local sectors. The impact on the local sectors comes primarily through changes in income and employment at the local, i.e., county and regional, level. Orange County's economy is nicely balanced between the two categories and is thus less sensitive to external shocks.

As a result, we would expect the county's economy to also weather the current financial turmoil better than some other areas of the country. There are, however, special factors in this shock that have to do with mortgage industry, which happens to have a large presence in the county's economy.

**Housing and Construction**

Orange County has experienced a large increase in housing prices in the last ten years. Average median housing price for existing homes has gone up from $228,000 in 1997 to $708,000 in 2006, an increase of over 300 percent. (Figure 14) Although this is higher than the 110 percent increase in the national median price, the upward trend in housing price during this period was a nation-wide phenomenon. Affordability for first time buyers, as defined by the California Association of Realtors, declined to a low of 21 percent in the second quarter of 2006 and is currently at approximately 23 percent. While the housing permits and construction activity kept pace during this ten-year period with an average of $10,000 building permits a year, it has had little impact on the rise of prices.
Yet the Orange County housing prices have not necessarily widened their lead over other regions of Southern California (Figure 14). For example, in 1991, the median Orange County housing price was 10 percent above the median in Los Angeles County and 77 percent above that in Riverside County. By 1996, the margins for Orange County housing had increased to 25 percent and 88 percent, respectively, over the two counties. These margins reached their peak in 2001 to 48 percent over Los Angeles and 106 percent over Riverside County. But by 2006 the Orange County median housing price was only 23 percent higher than in Los Angeles County and 71 percent higher than in Riverside County, ratios much closer to those prevailing in 1991. This may be due to the fact that Los Angeles and Riverside counties have experienced a much higher rate of housing price increase during the last few years than Orange County. It still leaves Orange County as one of the more expensive housing markets in the country.

It appears that the housing price increase in Orange County has been a part of the national trend as well as the worldwide asset price inflation rather than a local phenomenon. Median prices, of course, do not provide a complete profile of the housing price scenario. It is likely that the upper end of the housing price range in Orange County has shown a much greater appreciation than most other areas. But such changes are not captured by the median price concept which simply shows the mid point of sales price range without giving any extra weight to prices above or below that point.

There is little doubt that the current slowdown in housing is affecting all markets. Housing sales in Orange County were down 26.5 percent in 2006 compared to 2005 (Figure 16). In the January-July 2007 period, these are down another by 16.5 percent. Since the sales data are based on closings, these values do not yet show the result of the recent financial turmoil. We expect a substantial sales decline, from 30 to 50 percent, over the coming year.
Housing prices tend to lag sales activity since these, too, are measured as of escrow closings. While there has been substantial discounting of new home prices by builders over the past three quarters, existing home owners have thus far been reluctant to lower prices. This phenomenon has shown signs of change lately given the large number of homes on the market and we expect it to accelerate in the coming months. The unsold inventory will take almost twenty months to clear at current sales levels. The estimated median time on the market in the second quarter of 2007 was between 50 to 60 days (Figure 17). But given the deteriorating housing market conditions it is sure to increase substantially in the coming months.

Housing construction as measured by housing starts began to slow down in 2003. The average number of housing starts during 2003-06 was 8,500 compared to the average annual rate of 11,000 for the period 1997-2002. We expect housing starts to dip to approximately 6,000 for 2007 and 2008. Residential construction expenditures increased by only 12 percent from 2003 to 2006 but non-residential spending jumped by 134 percent for the same period. Both of these expenditures are expected to decline for the remainder of this year and in 2008.

The Employment Situation

Output measures such as gross domestic product are available for the national economy but at the local level, in the absence of a similar matrix, employment data are the best source to assess economic conditions. Payroll employment in Orange County grew by 29,000 for a 2 percent increase in 2006. Civilian household employment, another measure for jobs, grew by 23,500 for a 1.5 percent increase. The comparable rate for both series for the U.S. economy was 1.9 percent. The difference in the two measures arises from different survey samples. Payroll survey is conducted for establishments while the household survey is of individuals. The unemployment rate for the County was 3.4 percent in 2006 compared to 3.8 percent in 2005.

The 2006 rate of job growth was the second highest for Orange County since the recession of 2001. The highest rate occurred in 2005.
It is commonly understood that job growth, more than any other factor, supports housing prices. It is instructive, therefore, to also examine employment data...

**FIGURE 18**

**Orange County Sectoral Growth (Jan. - Aug. 2007)**

- Government: 1.2%
- Leisure and Hospitality: 1.3%
- Edu. and Health Svs: 3.0%
- Profess. & Bus. Svs: 0.2%
- Financial Activities: -0.9%
- Information: 0.1%
- Trade, Trans. & Utilities: 1.2%
- Manufacturing: -1.0%
- Construction: -0.6%
- Total Nonfarm: 0.2%

In summary, therefore, the Orange County economy has...
turned in a much weaker performance in the first eight months of this year compared to the same period last year. Assuming that the EDD does not substantially revise these data in its benchmarking revisions in February 2008, the current full-year growth will lag that of the last two years.

**Orange County Forecasts**

Expectations of businesses and households about the future trends affect their current behavior. In a situation where sufficient hard data such as output are not available, sentiment data can provide important and timely information. To fill this data gap, the *Institute for Economic and Environmental Studies* has been conducting quarterly surveys of Orange County business executives since 2002. Based on the survey responses a comprehensive index of business expectations called OCBX is calculated. It has a range of 0 to 100. A value of 50 or above indicates continued expansion of economic activity while a value below 50 would indicate a downturn in the local business conditions.

The latest survey conducted in the last week of September has an OCBX value of 41.6 (Figure 20). Not only is this value below 50 thus indicating a downturn, it also is the lowest recorded value of the index since the beginning of hostilities in Iraq in early 2003. The subprime mortgage collapse and ensuing credit tightening coupled with housing market decline were obviously behind this reaction. Federal Reserve Bank’s 50 basis points reduction in the funds rate and the lowering of the discount rate have yet to show their impact. The survey results also indicate lower expectations for sales and profitability and higher expected wage costs. Interestingly, however, local businesses have no plans to reduce their workforce or lower their inventories at this time. They may be in fear of a severe downturn but they are not yet sure enough of that event to start making cutbacks in their planned operations.

Our measure of business expectations, OCBX, when compared with national sentiment indexes, such as the Business Roundtable’s CEO Economic Outlook Index, has a good track record in anticipating trends.

Stock market indices have rallied following the Fed’s interest rate cuts. It may, however, only indicate investors’ satisfaction with the Fed’s willingness to respond to the possible slowdown in the economy. But it should not be interpreted as a sign of health of the economy. Other signals such as orders for durable goods, service

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**FIGURE 20**

*Business Expectations Orange County and the U.S.*

Our measure of business expectations, OCBX, when compared with national sentiment indexes, such as the Business Roundtable’s CEO Economic Outlook Index, has a good track record in anticipating trends.
sector growth, and home sales continue to point downward. The most recent U.S. payroll employment report showing 110,000 jobs gain is just in line with expectations of a slowing economy. Housing sector, in particular, has not hit the bottom and may not do so for several months, given the inventory of unsold homes and the complexity of untangling the subprime mortgages. Inflation, while currently appearing to be tame, has potential to explode and could be the major surprise of 2008.

Orange County’s economy, given its diversity as noted above, is likely to weather the coming slowdown better than some other areas of the country. Nevertheless, we expect a much weaker job growth in 2007 and 2008 compared to the last two years (Figure 21). Contraction of the housing sector will have an impact on the overall economy, especially construction, retail and services related to housing. We are projecting growth rates of 1.0 percent in 2007 and 1.1 percent in 2008. These translate to an increase of 15.3 thousand jobs in 2007 and 17.1 thousand in 2008. Low as these numbers are, these compare well with jobs losses of 10,000 in the recession of 2001-02 and 57,000 in 1991-93. Given large upward adjustments at benchmarking that EDD has made in recent years to the Orange County data, we are skeptical of the extremely slow growth that their current monthly surveys are showing. As is the case for the national economy, however, we are not predicting a recession or a decline in overall employment in the County. We expect the unemployment rate to increase to 3.7 percent in 2007 and 3.8 percent in 2008 compared to a 3.4 percent rate in 2006.

We expect housing markets in Orange County to continue its downward adjustment over the next 12 to 18 months. Housing starts in the County are expected to decline to 6,500 in 2007 and 5,900 in 2008 compared to 8,300 in 2006. In October 2006, we predicted a decline of 2 to 4 percent in 2007 in the median housing price in Orange County. The current trend seems to indicate that this forecast will come to bear. We anticipate this price adjustment to continue with a further 5 percent decline in the median price in 2008.

Southern California Forecasts

Construction makes up a much higher proportion of the Inland Empire’s employment than it does of the Los Angeles and Orange Counties’ economies. Since 1991, the share of construction employment in the Inland Empire’s economy has jumped from
6.5 percent to 10 percent while it has increased by from 5 percent to 7 percent for Orange County and 3.3 to 3.8 percent for Los Angeles. As a result, the current housing slowdown is expected to hit the Inland Empire economy more severely than other regions in Southern California (Figure 22).

On the other hand, in 2006 Los Angeles county posted, for the first time since the recession of 2001, payroll employment growth of over one percent (Figure 23). Its average unemployment rate also fell below 5 percent since the early nineties. The current slowdown, however, is likely to affect all the counties in the region. We expect Southern California to grow by 1.0 percent in 2007 and 1.3 percent in 2008 in terms of payroll employment. The unemployment rate is expected to rise to 4.8 percent for each of the two years. Detailed tables at the end of this report provide forecasts for all the counties in the region.

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