

## Economics Group

### Special Commentary

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# California Economic Outlook: December 2009

## Slowly Stepping Away from the Economic and Financial Abyss

As in the nation, California's economy is showing important signs that it too is emerging from recession. California manufacturing surveys returned to expansion in the third quarter and California technology companies have been reporting strong third quarter earnings and improved sales outlooks for coming quarters. The recovery in the state's key technology sector will be a key growth driver for the state, especially for Northern California over the near term.

A number of factors are behind this improving trend. Aggressive inventory cutting in the first half of the year has slowed and some businesses are actually boosting production to replenish the stockpiles, a good sign that businesses see stable demand ahead. A weak dollar and strong demand from Asia is boosting California exports and helping California businesses get back on their feet. A drop in food and energy prices and moderation in housing costs are giving workers real improvement in their buying power. Those that have held on to their jobs have seen their real hourly earnings rise to a 5.0 percent growth rate, the best earnings growth rate seen in more than a decade. This is helping consumer confidence rebound and core retail sales stabilize, despite continued bad news on the employment front. Most importantly, California's housing market is slowly shifting to a positive from a negative. Existing home sales in the state hit bottom two years ago, and existing home inventories have been worked down to levels where selective new residential construction will resume next year. Home values appear to be stabilizing, and some neighborhoods will gradually return to steady but modest home price appreciation.

Still, California faces serious structural challenges that will impede a strong recovery in the state. California has one of the highest costs of doing business in the country and in the region, according to Moody's Economy.com. California's cost of doing business is 17 percent above the U.S. average, 19 percent above Texas and 24 percent above Oregon. This is a huge competitive disadvantage when businesses are paying more attention than ever to cutting costs. New business incorporations in California have slumped about 30 percent from 2007. Less venture capital investment, higher business costs and taxes certainly could be playing a role here. New businesses are an important engine for new job creation, and California is missing out.

Finally, this recession has done more damage to California's economy than most others, which is bound to leave lasting scars. California has lost more than a million jobs in this recession so far, about 14 percent of the national total. Home values across the state have fallen by about 56 percent peak to trough. The state's unemployment rate is likely to rise above 13 percent before it peaks sometime in the middle of 2010, nearly three percentage points above the U.S. average. Nearly 700,000 Californians have been unemployed now for more than six months. Rising unemployment worsens California's household credit problems and leads to tougher choices on how to balance the state's fiscal challenges going forward. None of the cyclical and structural problems are insurmountable, but they will take time to heal and fix. So while California is no longer staring into the abyss, it is likely to remain a relative underperformer economically over the forecast horizon. We expect a net job loss in California of about 1.2 percent in 2010, following a drop of 4.3 percent in 2009, even as modest growth resumes.

***California faces serious structural challenges that will impede a strong recovery in the state.***



## Employment

The latest data from the California Employment Development Department show only marginal improvement in California's labor market. We anticipate an uneven and sluggish jobs recovery as California's economy returns to growth next year. The state lost another 10,200 net non-farm jobs in November, but this follows a solid one-month gain of 31,100 jobs in October.

The breadth of job creation remains mixed, however. Five industries added jobs in November, lead by professional and business services, construction, information, mining and logging and other services. Six industries continued to shed them in November, including manufacturing, trade, transportation, utilities, finance, leisure and hospitality, education & health and government. Net job losses are expected to continue to plague California in 2010, but the pace of decline will diminish as the recession eases. We estimate California lost 4.3 percent of its payrolls in 2009 and will likely shed another 1.2 percent in 2010.

The largest number of jobs have been lost in construction (-118,200) and manufacturing (-114,000) over the past year, a reflection of the steep declines in residential and commercial building across the state and the sharp pull back in consumer spending and business investment. On a percentage basis, job losses in the information sector (-6.7 percent) have been substantial, as advertisers pulled back from traditional print publications.

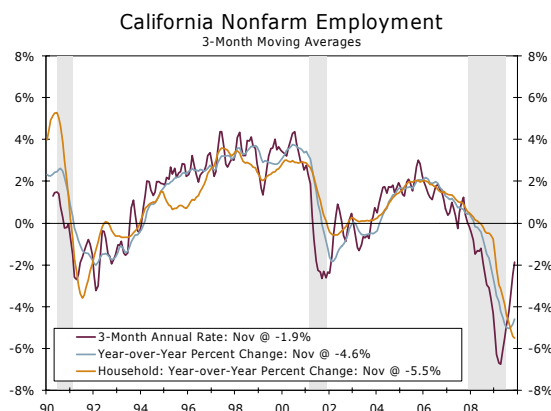
Regionally across California, job losses over the past year have been more severe in Northern California than Southern California. Sacramento (-5.0 percent), San Francisco (-4.9 percent) and San Jose (-4.7 percent) have all lost more jobs than the state average through November. This could change next year as technology and manufacturing exports help lead the statewide recovery. In Southern California, most major metro areas are seeing fewer job losses than the state, except for the Inland Empire, which has lost 4.6 percent of its non-farm payroll over the past 12 months. The Inland Empire of San Bernardino and Riverside Counties have outsized exposure to the manufacturing and transportation declines of Southern California, while overbuilding in residential and commercial properties was rampant. Nonfarm payrolls declined 3.3 percent in San Diego, 3.5 percent in Los Angeles and 3.6 percent in Orange County.

Moreover, the quality of the jobs that are being created across the state is not what they once were. California's per capita income in 1980 was 18 percent above the national average. Today, California's per capita income is just 6 percent above the national average. The majority of the jobs that are being created in California today tend to be lower-wage and lower-skilled positions.

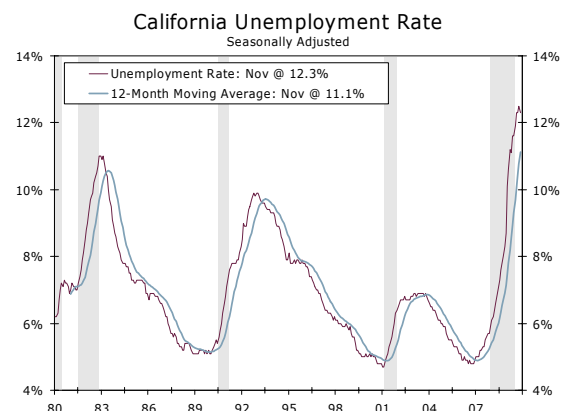
***Uneven and sluggish jobs recovery expected.***

***The quality of the jobs that are being created across the state is not what they once were.***

**Figure 1**



**Figure 2**



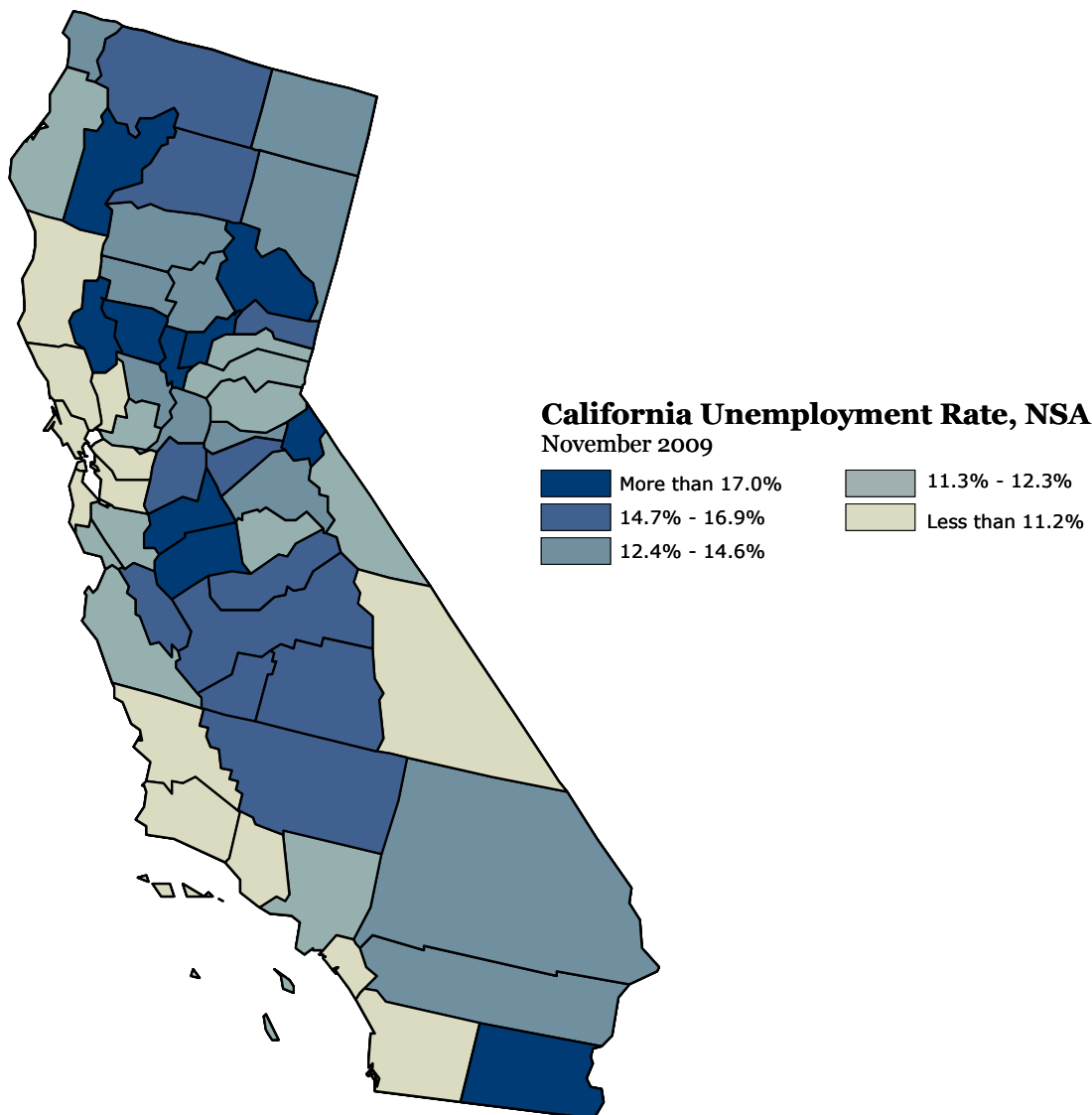
**Source: U.S. Department of Labor and Wells Fargo Securities, LLC**

The unemployment rate in the state improved to 12.3 percent in November from 12.5 percent in October. A decline in California's labor force of 19,000 workers certainly aided the decline in the unemployment rate, but the number of workers defining themselves as unemployed dropped even further, down 45,000 in November. We do not expect California's unemployment rate to peak until the middle of 2010 at around 13.0 percent. The unemployment rate for young workers, ages

16-19, continued to rise at a rapid pace in November to 32.4 percent from 23.5 percent a year ago. The long-term unemployed now comprise about a third of those unemployed in California, suggesting a slow return to pre-recession levels of unemployment. Those unemployed for more than six months rose to 693,000 in November, a 170.4 percent increase from a year ago. If one includes those who are working part-time involuntarily (i.e., for economic reasons) and persons not in the labor force but who want a job, the California unemployment rate would rise to 21.3 percent. Not quite Great Depression levels of unemployment, but closer than any one cares to be.

Regionally across California, the highest unemployment rates are found in Central California and Northern California outside the San Francisco Bay Area. Fresno and the Inland Empire have the highest unemployment rates in the state for large metro areas at 16.5 percent and 14.2 percent, respectively.

**Figure 3**



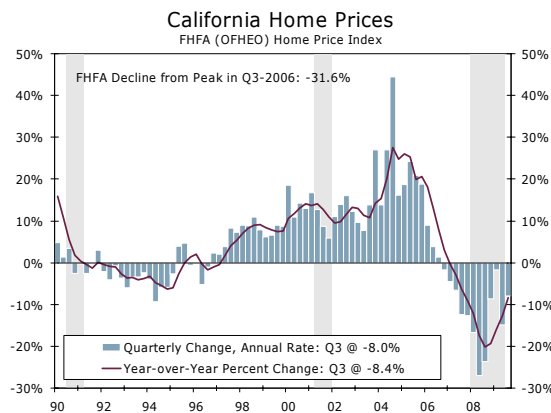
Source: California Employment Development Department and Wells Fargo Securities, LLC

**Housing market turns from a negative to a positive.**

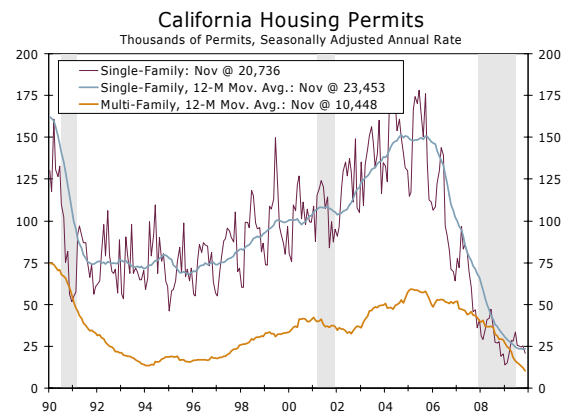
## Housing

California existing home sales jumped 87 percent from December 2007 to December 2008, and sales have continued at that level in 2009. Unsold existing home inventory has plunged to 4 months in October from around 15 months in January 2008, according to the California Association of Realtors. Unsold inventory has dropped across all price ranges this year, but demand has been strongest for homes \$500,000 and lower. Unsold inventory at the \$300,000 and less category is now only 2.8 months. The foreclosure moratoria and the federal loan modification program, along with the first-time home buyers' tax credit, have clearly helped reduce existing home inventory and stabilized prices. Median existing home prices have been rising now in California for eight consecutive months. Median home prices in California, at \$297,500, are currently \$52,330 above their February 2009 low, a 21.3 percent increase off the bottom. The California housing market appears to be normalizing, and that should induce more homebuilding activity next year. We expect California housing permits to rise modestly for the first time in five years in 2010. Mortgage delinquencies and home foreclosures remain a serious threat to the sustainability of the California housing recovery, however, and will likely limit the rebound in home construction next year, especially in hard-hit areas of the state such as Central Valley, Riverside, and San Bernardino.

**Figure 4**



**Figure 5**



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

## Commercial Real Estate

Problems in California's commercial real estate markets continue to fester and worsen. The decline in commercial real estate values and their impact on bank credit losses, especially on smaller community banks, will be a significant headwind against a looser credit environment and a stronger expansion for the state. Commercial building activity in California is nearly non-existent. According to Rosen Consulting, California office permit valuations totaled \$27.9 million in August, down from an October 2006 peak of \$432.5 million, a decline of 93.5 percent. Office vacancy rates continued to climb in all major metro areas of the state in the third quarter. Los Angeles had the lowest office vacancy rate at 15.7 percent. The highest vacancy rates are found in San Bernardino-Riverside at 23.8 percent and San Jose at 20.6 percent. Office rents are declining in all major metro areas, with the largest declines in San Francisco, down 10.6 percent over the past year. Office rents have fallen a comparatively small 1.1 percent Sacramento.<sup>1</sup>

Industrial permit valuations in California are currently running about 96 percent below their June 2005 peak. Industrial vacancies continue to rise as firms try to shed unused or underutilized capacity. The highest industrial vacancy rates for major metro areas in California are found in Inland Empire and San Jose, at 26 percent and 23 percent, respectively, in the third quarter. Los Angeles and Sacramento have the lowest industrial vacancy rates with both at 18.1 percent, followed by Orange County at 21.2 percent. Rents of industrial properties are falling

<sup>1</sup> Office vacancy and rent data were obtained from Reis, Inc. and are as of Q3 2009.

across the board. Rent in Inland Empire declined 4.57 percent, the largest decline in the state. The smallest rent declines were recorded in San Francisco and Orange County, at 1.29 percent and 2.01 percent, respectively.<sup>2</sup>

Retail permit valuations remain depressed. Retail permit valuations are down approximately 83 percent from their peak. California consumers are reeling from lost housing wealth and above-average job loss. It is estimated that California retail sales dropped to \$110.7 billion in the second quarter of 2009, a 19.3 percent decline from the year before.

### High Tech Comes Roaring Back

While we anticipate a disappointing economic recovery for California in 2010 by historical standards, this certainly does not appear to be the case for California's high-tech industries. The data released so far suggest a "V-shaped" recovery in this sector to be well underway. According to data from the Semiconductor Industry Association (SIA), worldwide semiconductor sales by October had already retraced nearly all of the large declines recorded last year. A surge in PC sales and cell phones is helping to drive the increase in semiconductor sales. Together, these two categories comprise 60 percent of semiconductor demand. Strong demand for technology equipment is evident from Asia and Europe, but survey data from CEO surveys suggest that companies are planning to utilize some of the cash they have been hoarding on their balance sheets to ramp up capital expenditures here in the United States. In the third quarter, global semiconductor sales jumped 19.5 percent. European sales jumped 21.4 percent, Asia Pacific sales rose 20.4 percent, and the Americas saw an 18.8 percent rise. Global semiconductor sales are projected by the SIA to grow 10.2 percent in 2010 and 8.4 percent in 2011. Total semiconductor capacity utilization jumped to 87 percent in the third quarter from 56.8 percent in the first quarter.

Figure 6

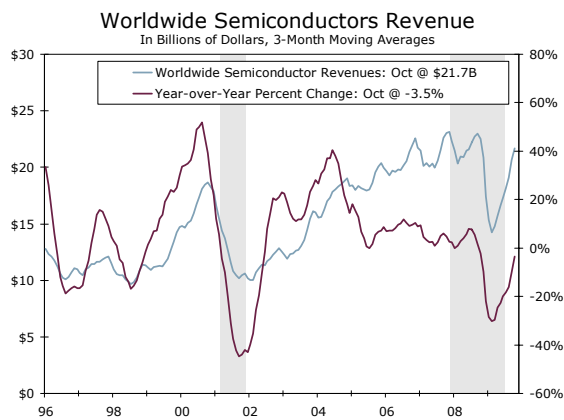
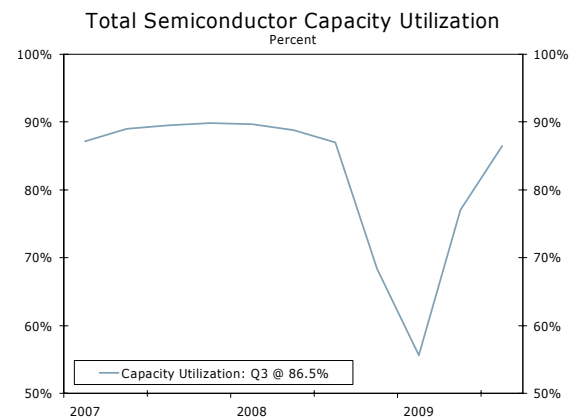


Figure 7



Source: Semiconductor Industry Association and Wells Fargo Securities, LLC

### Exports

All indications are that the weaker U.S. dollar and strong demand from parts of Asia and the developing world will be an important support to California growth over the coming year. California's exports grew 6.7 percent from September to October, though October exports were still lower than the year before by about 10.9 percent. Exports to Japan have plunged the most, still down 18.0 percent from a year ago. Exports to Canada are down 15.6 percent from last year. California exports to China, however, have risen 4.6 percent from last year, bucking the global downturn over the past year and a strong indication that robust growth has reemerged there. Container statistics at California's major ports suggest that California's exports are rapidly turning the corner. Export containers at the Port of Oakland rose 17.2 percent in October compared to the year before. Export containers through the Port of Los Angeles rose 12.0 percent

**California's high-tech sector and manufacturing industries will be the first beneficiaries of the global economic recovery.**

<sup>2</sup> Industrial vacancy and rent data were obtained from Property Portfolio Research and are as of Q3 2009.

year-over-year in October. Air freight shipments remain soft however. LAX reports air freight is still lagging behind last year, down 12.5 percent year-to-date through October.

### **Tourism**

Hotel occupancy and room rate data suggest that California's travel and tourism industry continues to struggle, though in some respects conditions have stabilized at low levels. According to PKF Consulting, San Francisco's occupancy rate recovered to 87.5 percent from 82.4 percent a year ago. Room discounting remains the norm, however. The average daily room rate continued to decline by 4.6 percent. The highest occupancy rate in the Bay Area is in the Financial District, at 91.0 percent from 86.2 percent last October. The Financial District's average daily room rate slipped another 4.9 percent. San Jose/Peninsula remains a weak spot, with the area's occupancy rate of 66.1 percent, down from 68.7 percent a year ago. The average daily room rate fell 14.0 percent. Total passenger traffic at LAX is down 7.1 percent year-to-date through October. International traffic is leading the declines, down 11.7 percent year-to-date, while domestic traffic is down a more modest 5.3 percent.

### **Summary and Outlook**

California technology and manufacturing industries appear poised for a cyclical recovery in activity, which will eventually lead to more hiring in those industries. Northern California, particularly San Jose and San Francisco, stand to gain from this trend. California's housing market is slowly shifting from a negative to a positive in the outlook for the state. We expect some moderately higher residential building in the state for the first time in five years. It will be a while longer before small businesses, retailers and service businesses feel the full impact of this recovery and start adding to their own payrolls. Many manufacturers are still shedding capacity to reflect the new lower level of demand, and there is still plenty of room for businesses to expand working hours from their current workforces and hire temporary workers before they go on a permanent hiring spree.

Moreover, the economic recovery remains fragile, relying heavily on government intervention and spending. The probability of another moderation in demand remains high for the second half of 2010 and into 2011. Many California businesses may be content with temporary hiring until there is more visibility on the sustainability of the recovery and the strength of consumer and business demand. Lost housing wealth and double-digit unemployment in California is likely to remain a major headwind for consumers, keeping them on a frugal spending trajectory, as they pay down debts and boost their savings. State budget constraints could lead to accelerated state and local job loss later in 2010 and into 2011 if more Federal aid is not found to stave them off. California commercial real estate markets have not yet hit bottom. Commercial building is effectively at a standstill across the state. Commercial property values continue to decline, and rents are being slashed. This will continue to be a thorn in the side of the California economy and the health of California's banks. Longer term, rising state and local tax rates, a high cost of doing business and slowing population growth will weigh on California's potential growth rate. California is likely to remain a relative underperformer economically over the forecast horizon.

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