The Economic Outlook:  
*Is the bounce finally here?*

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*Senior Economist*
Today’s Speed Forecast

- The US Economy
  - A bit about how we got from there to here
  - Was that a recovery I heard?
  - What can we expect for 2004?

- Location, Location, Location
  - What cities are growing? Which aren’t?
  - What’s happening in the region?
  - Residential Real Estate: is that a pop I heard?
First: a bit of history…

The big Q: have the doldrums ended?
Top 10 **WRONG** reasons for the weak economy

10. Internet Spam
9. Kobe / Shaq infighting
8. Illegal downloading of music
7. France
6. “W” becoming President
5. Poor network TV fall ratings
4. India and China
A decline in manufacturing?

Employment: A victim of productivity gains and industry shifts
Top 10 **WRONG** reasons for the weak economy

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6. “W” becoming President
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4. India and China
3. Deflation dread disorder
Deflation Dread Disorder?

- Inflation holding steady at 2% Captain Greenspan!
- The US is NOT Japan!
Top 10 Wrong Reasons for the Weak Economy

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5. Poor network TV fall ratings
4. India and China
3. Deflation dread disorder
2. Weak Consumer Confidence
Look at what consumers do…

…not what they say!
Top 10 *Wrong* Reasons for the Weak Economy

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3. Deflation dread disorder
2. Weak Consumer Confidence
1. The September 11th Attacks / War on Terrorism
...it wasn’t 9-11...

Capacity Utilization

Unemployment

Start of recession
September, 2001
The Big Question: Sales cancelled or sales delayed?

Disasters create bounce, not bust, whether it’s a terrorist attack, an earthquake or a wildfire.
So why the recession and doldrums?

*It all started with the Internet Rush of the late nineties…*

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**Three imbalances created by the Rush**

- **Corporate Imbalance:**
  
  *Business investment without profit*

- **Consumer Imbalance:**
  
  *Why save when the markets are booming?*

- **Global Portfolio Imbalance**
  
  *Massive Current Account Deficits*
The collapse of business investment caused the 2001 downturn.
### How did we fare?

<table>
<thead>
<tr>
<th>Length</th>
<th>Total Change</th>
<th>Change in Unemployment*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GDP</td>
<td></td>
</tr>
<tr>
<td>Average</td>
<td>3.6</td>
<td>-1.9%</td>
</tr>
<tr>
<td>2001</td>
<td>3</td>
<td>-0.6%</td>
</tr>
<tr>
<td></td>
<td>2.7%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1.9%</td>
<td></td>
</tr>
</tbody>
</table>

**Why so mild?**
No consumer cycle!
Why the doldrums?

- The Internet Rush Hangover
  - Excess capacity
  - Labor market re-balance
  - An over-valued $US
  - Corporate Malfeasance
- Macroeconomic Uncertainty
  - Oil and State budgets

- Normal growth will return when the economy rebalances itself: the baton of growth needs to be passed from consumers and government back to business investors and foreign buyers
The Internet Rush hangover...

**Industrial Capacity Utilization**

- Hi-Tech
- Other Manufacturing

**Ratio Worker Real Compensation to Real Output**

- Internet Rush Period
- Long run trend
Where are we now?

Growth Rate Q3 2003

Is the recovery finally underway?

7.2%!
### Contributions to GDP Growth

<table>
<thead>
<tr>
<th>Category</th>
<th>Avg</th>
<th>Q3 03</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross domestic product</td>
<td>2.93</td>
<td>7.20</td>
</tr>
<tr>
<td>Personal consumption expenditures</td>
<td>2.12</td>
<td>4.66</td>
</tr>
<tr>
<td>Durable goods</td>
<td>0.44</td>
<td>2.05</td>
</tr>
<tr>
<td>Nondurable goods</td>
<td>0.56</td>
<td>1.61</td>
</tr>
<tr>
<td>Services</td>
<td>1.12</td>
<td>1.00</td>
</tr>
<tr>
<td>Gross private domestic investment</td>
<td>0.57</td>
<td>1.37</td>
</tr>
<tr>
<td>Fixed investment</td>
<td>0.54</td>
<td>2.04</td>
</tr>
<tr>
<td>Nonresidential</td>
<td>0.46</td>
<td>1.12</td>
</tr>
<tr>
<td>Structures</td>
<td>0.00</td>
<td>-0.05</td>
</tr>
<tr>
<td>Equipment and software</td>
<td>0.46</td>
<td>1.18</td>
</tr>
<tr>
<td>Residential</td>
<td>0.09</td>
<td>0.92</td>
</tr>
<tr>
<td>Change in private inventories</td>
<td>-0.03</td>
<td>-0.67</td>
</tr>
<tr>
<td>Net exports of goods and services</td>
<td>-0.25</td>
<td>0.84</td>
</tr>
<tr>
<td>Exports</td>
<td>0.49</td>
<td>0.88</td>
</tr>
<tr>
<td>Imports</td>
<td>-0.74</td>
<td>-0.04</td>
</tr>
<tr>
<td>Government consumption</td>
<td>0.49</td>
<td>0.27</td>
</tr>
<tr>
<td>Federal</td>
<td>0.19</td>
<td>0.11</td>
</tr>
<tr>
<td>National defense</td>
<td>0.13</td>
<td>0.01</td>
</tr>
<tr>
<td>Nondefense</td>
<td>0.06</td>
<td>0.10</td>
</tr>
<tr>
<td>State and local</td>
<td>0.30</td>
<td>0.16</td>
</tr>
</tbody>
</table>

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**The not-so-good news**

**The good news**

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*Yes, but... some cautions are in order*
The good news: A closer look

But has a ways to go...

A lower dollar is helping exports

Business spending on track

A trade war will not.
The big issue: consumers

Recovery in consumer spending? From what???
Why? Interest Rates…

US Real Interest Rates

Jan-90 to Jan-03
The perils of consumption without growth

The trade deficit: A long way to go

Consumer Debt
Very High
Not to mention government debt!
No rebound potential here!

- Time
- GDP
- Boom
- Bust
- Return to normalcy
- Expansion
- Recession
- Recovery

This Recession
Standard Recession
And the labor markets?

**IT and productivity**
*A two-edged sword*

Tough times for mid-skill workers
On the path to normalcy—but not there yet

- The recovery has arrived—but still at the initial stages
- Growth in the 4th quarter to slow sharply on weak consumer durable sales, but inventory restocking likely to help: 3%
- Look for normal growth rates in 2004, not a return to the go-go nineties
- Job growth will begin early next year, but will also be slow as productivity growth continues to reduce demand for workers
- Outstanding problems with States budget situation and low private savings still need to be addressed
The big worry?

Are we set up for another consumer cycle?
Closer to home...

Mediocre national trends reflect a wide variety of local results

There are always some good markets and some bad
Performance a function of industry mix

Bedroom communities and government centers did well

Service Centers and tourist locations did okay

Tech manufacturing centers and the surrounding infrastructure were hit hard

### Growth Regression Results

<table>
<thead>
<tr>
<th>Industry</th>
<th>Coef</th>
<th>t-stat</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail Trade</td>
<td>0.986</td>
<td>2.8</td>
</tr>
<tr>
<td>Wholesale Trade</td>
<td>0.663</td>
<td>1.4</td>
</tr>
<tr>
<td>Government</td>
<td>0.261</td>
<td>2.0</td>
</tr>
<tr>
<td>Construction and NR</td>
<td>0.207</td>
<td>1.1</td>
</tr>
<tr>
<td>Other Services</td>
<td>0.507</td>
<td>0.9</td>
</tr>
<tr>
<td>Leisure and Hospitality</td>
<td>0.051</td>
<td>0.4</td>
</tr>
<tr>
<td>Administrative Support</td>
<td>0.026</td>
<td>0.1</td>
</tr>
<tr>
<td>Education / Healthcare</td>
<td>-0.056</td>
<td>-0.5</td>
</tr>
<tr>
<td>Information</td>
<td>-0.492</td>
<td>-2.3</td>
</tr>
<tr>
<td>Professional Services</td>
<td>-0.503</td>
<td>-4.1</td>
</tr>
<tr>
<td>Real Estate and Rental</td>
<td>-1.315</td>
<td>-1.5</td>
</tr>
<tr>
<td>Non-Durable Goods</td>
<td>-0.303</td>
<td>-1.2</td>
</tr>
<tr>
<td>Finance and Insurance</td>
<td>-0.491</td>
<td>-2.1</td>
</tr>
<tr>
<td>Durable Goods</td>
<td>-0.725</td>
<td>-9.9</td>
</tr>
<tr>
<td>Transportation Utilities</td>
<td>-0.894</td>
<td>-3.5</td>
</tr>
</tbody>
</table>
Can you show me the way from San Jose?

4 worst employment shocks in major cities
Bay Area Employment Forecasts

Employment Forecasts: Bay Area
Payroll Employment, Seasonally Adjusted

East Bay
San Francisco
San Jose
And Sonoma?

Unemployment falling

Unemployment falling over time.
And Sonoma?

Payroll Employment: Dropping
## Sonoma Employment (SA)

<table>
<thead>
<tr>
<th>Category</th>
<th>April-03</th>
<th>October-03</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Civilian Employment</td>
<td>253,900</td>
<td>256,100</td>
<td>2,200</td>
</tr>
<tr>
<td>Total, All Industries</td>
<td>191,200</td>
<td>189,100</td>
<td>-2,100</td>
</tr>
<tr>
<td>Construction</td>
<td>13,500</td>
<td>13,600</td>
<td>100</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>24,800</td>
<td>23,100</td>
<td>-1,700</td>
</tr>
<tr>
<td>Wholesale Trade</td>
<td>6,000</td>
<td>6,100</td>
<td>100</td>
</tr>
<tr>
<td>Retail Trade</td>
<td>24,200</td>
<td>24,500</td>
<td>300</td>
</tr>
<tr>
<td>Transportation and Utilities</td>
<td>4,100</td>
<td>3,900</td>
<td>-200</td>
</tr>
<tr>
<td>Information</td>
<td>4,100</td>
<td>4,400</td>
<td>300</td>
</tr>
<tr>
<td>Finance and Insurance</td>
<td>7,400</td>
<td>7,500</td>
<td>100</td>
</tr>
<tr>
<td>Real Estate and Rental</td>
<td>3,100</td>
<td>3,200</td>
<td>100</td>
</tr>
<tr>
<td>Professional Services</td>
<td>18,800</td>
<td>19,000</td>
<td>200</td>
</tr>
<tr>
<td>Educational and Health</td>
<td>24,300</td>
<td>24,300</td>
<td>0</td>
</tr>
<tr>
<td>Leisure and Hospitality</td>
<td>20,600</td>
<td>21,000</td>
<td>400</td>
</tr>
<tr>
<td>Other Services</td>
<td>6,700</td>
<td>6,900</td>
<td>200</td>
</tr>
<tr>
<td>Federal Government</td>
<td>1,800</td>
<td>1,800</td>
<td>0</td>
</tr>
<tr>
<td>State and Local Government</td>
<td>25,300</td>
<td>23,500</td>
<td>-1,800</td>
</tr>
</tbody>
</table>
Real Estate Bubble Trouble?

Median House Appreciation: 95-03
Housing prices in Sonoma: Up too!

Median House Price
(detached single family)

- $0
- $50,000
- $100,000
- $150,000
- $200,000
- $250,000
- $300,000
- $350,000
- $400,000
- $450,000

- Jan-95
- Jul-95
- Jan-96
- Jul-96
- Jan-97
- Jul-97
- Jan-98
- Jul-98
- Jan-99
- Jul-99
- Jan-00
- Jul-00
- Jan-01
- Jul-01
- Jan-02
- Jul-02
- Jan-03
- Jul-03
And transactions steady

Median House Price
(detached single family)
Real Estate Bubble Trouble?

*Real Estate is an asset and HAS a fundamental value.*

Today’s price *should be* the present value of the future revenues.

\[
\text{Value} \approx \frac{\text{Today’s Rent}}{D - G}
\]

- **G**: Future rental growth rates
- **D**: Discount factor: mortgage rates, depreciation, taxes, risk premium
The fundamentals…

Rents: East Bay

Mortgage Rates
The Fundamentals Support Recent Housing Price Appreciation

Theoretical and Actual Prices

Indexes (96=100)—Bay Area Real Estate

Theoretical and forecasted prices derived from a simple asset price formula based on rental price appreciation, mortgage rates, taxes and depreciation and an estimated risk premium.
Job Growth and Housing Prices

Ann. Change Employment 00-03 vs. Ann. House Price Change 01-03 for SJ and SF
The risk: a rapid increase in interest rates

Scenario
What if interest rates rose to 7.5% by the end of 2005?

Theoretical Prices

A Liquidity collapse
Ironic: normal growth is a good thing for real estate

30 year fixed mortgage rates
The Forecast for Real Estate

- Mortgage rates to rise slowly: ~6.5% by the end of 2005
- Average housing price appreciation to slow in the US, as will sales
- Local job markets will drive local prices
- New housing to remain strong in Southern California as will retail, given strong population growth
- Will housing prices be a drain on business? Remember that housing prices are an EFFECT, not a CAUSE
Quarterly economic forecasts and forecast conferences that focus on ideas, not just numbers

**Upcoming Forecast Events**

December: The Global Outlook
March: Health Care, Workers Comp—the ongoing business cost crisis
Local events: Orange County and Sacramento

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