



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

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The UCLA Anderson Forecast *Over 50 Years of Insight*

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THE LEADING INDEPENDENT FORECAST PROVIDING INSIGHT TO
DECISION MAKERS IN BUSINESS, ACADEMIA AND GOVERNMENT.



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

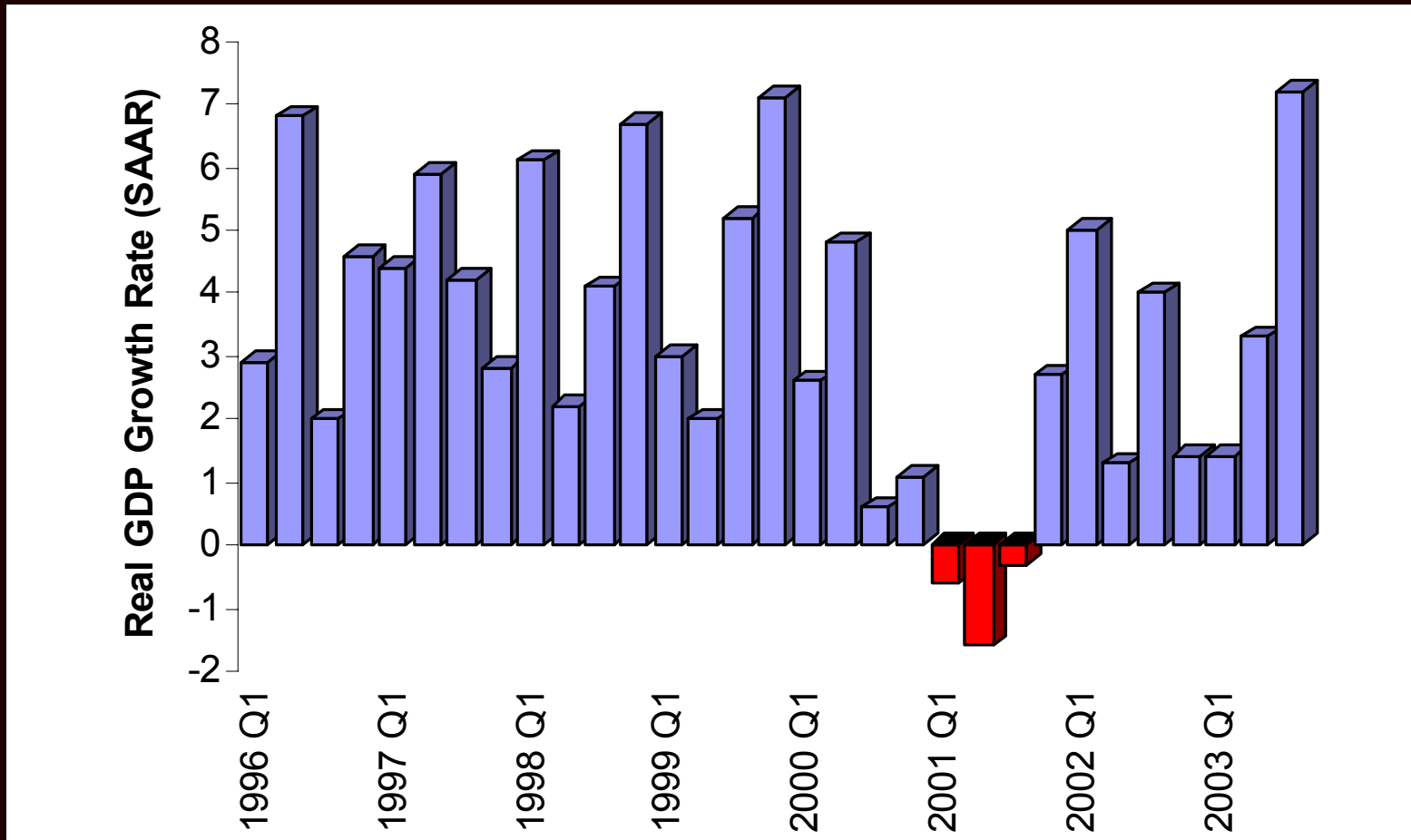
- What cities are growing? Which aren't?
- What's happening in the region?
- Residential Real Estate: is that a pop I heard?





First: a bit of history...

The big Q: have the doldrums ended?





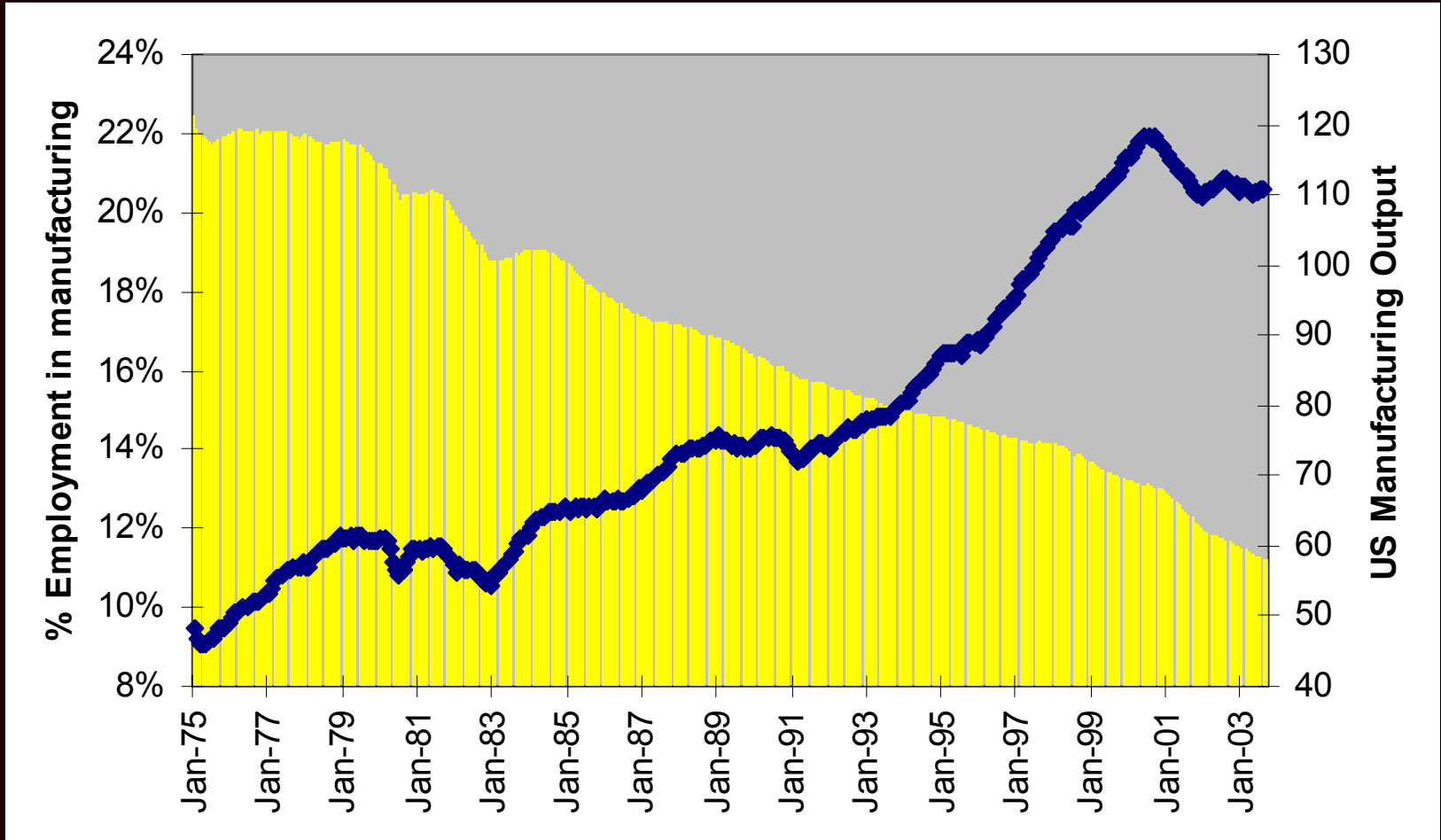
Top 10 WRONG reasons for the weak economy

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**



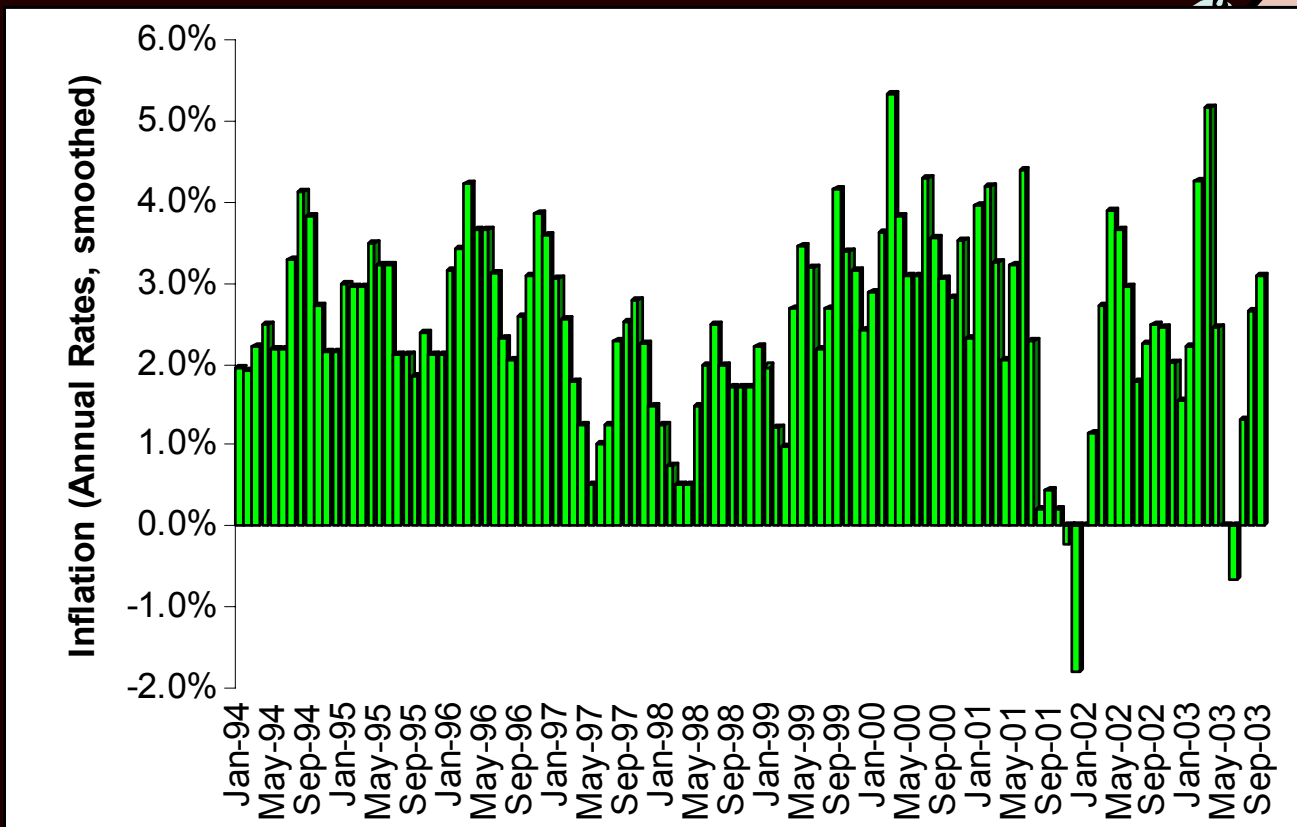
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3. Deflation dread disorder





Deflation Dread Disorder?



- Inflation holding steady at 2% Captain Greenspan!
- The US is NOT Japan!



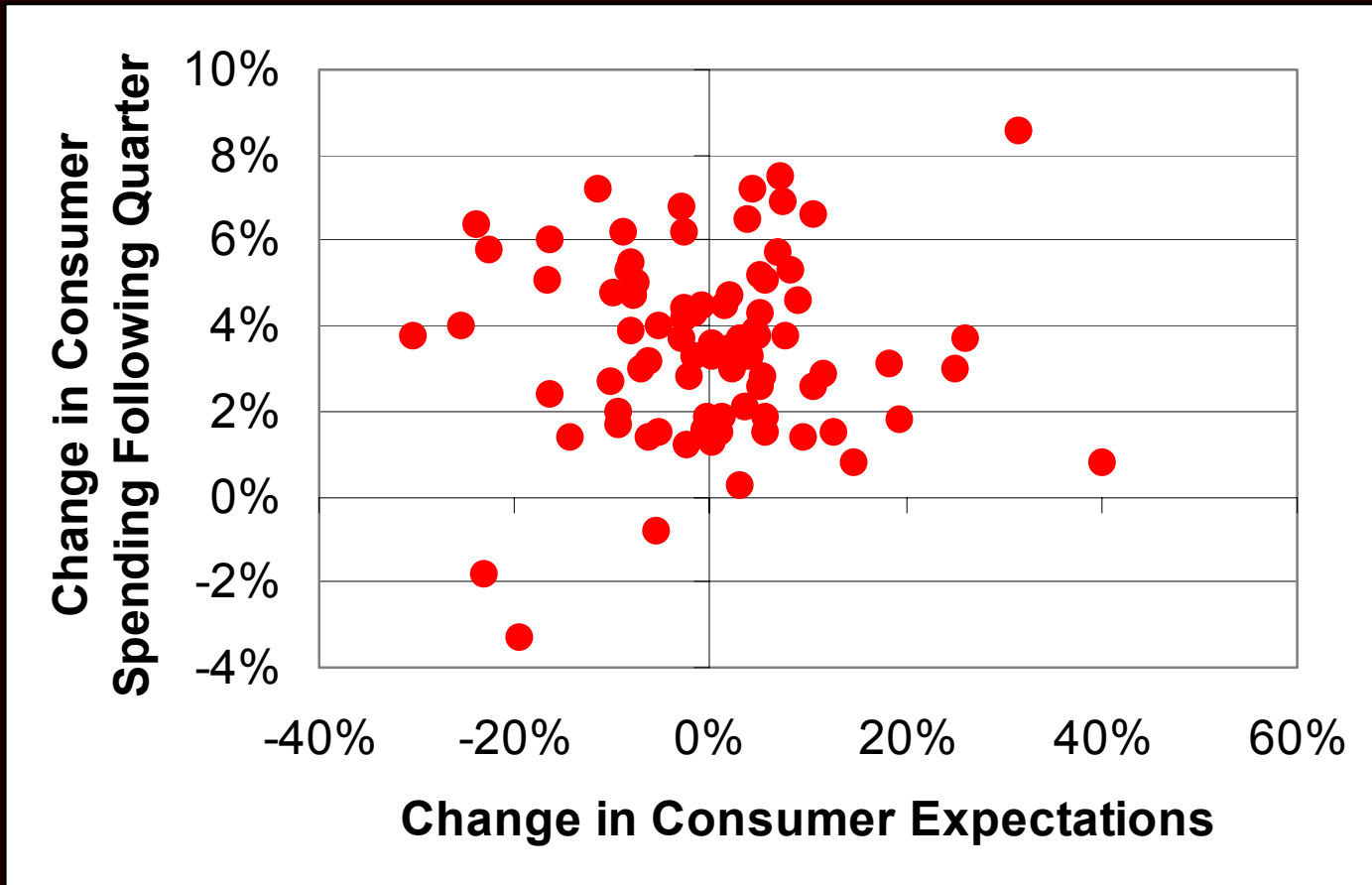
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2. Weak Consumer Confidence





Look at what consumers do...



...not what they say!



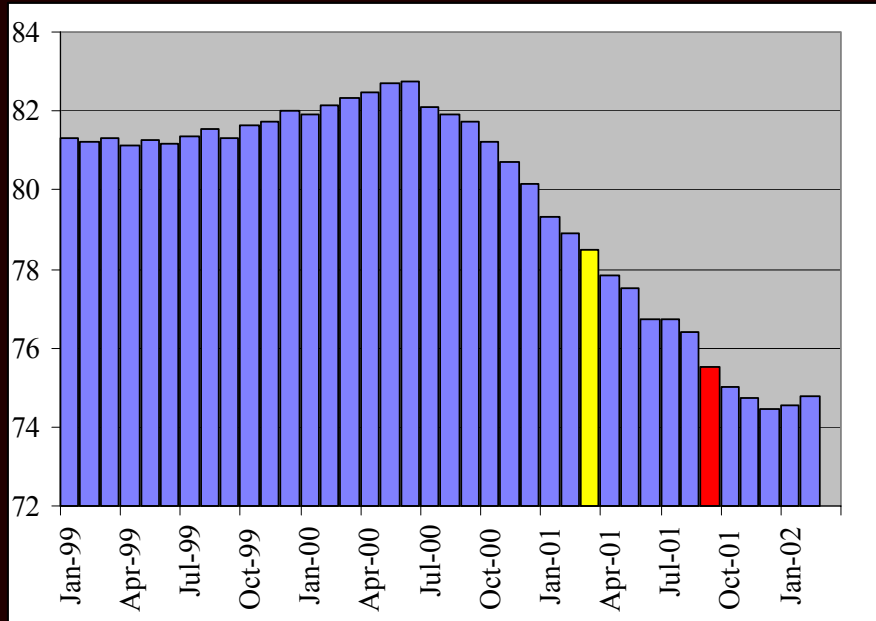
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2. Weak Consumer Confidence
1. The September 11th Attacks / War on Terrorism

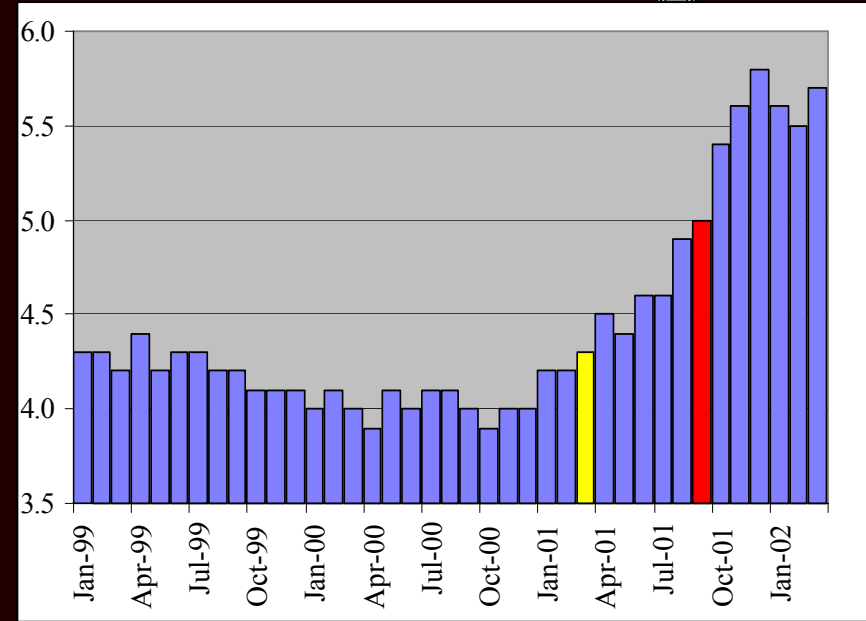




...it wasn't 9-11...



Capacity Utilization

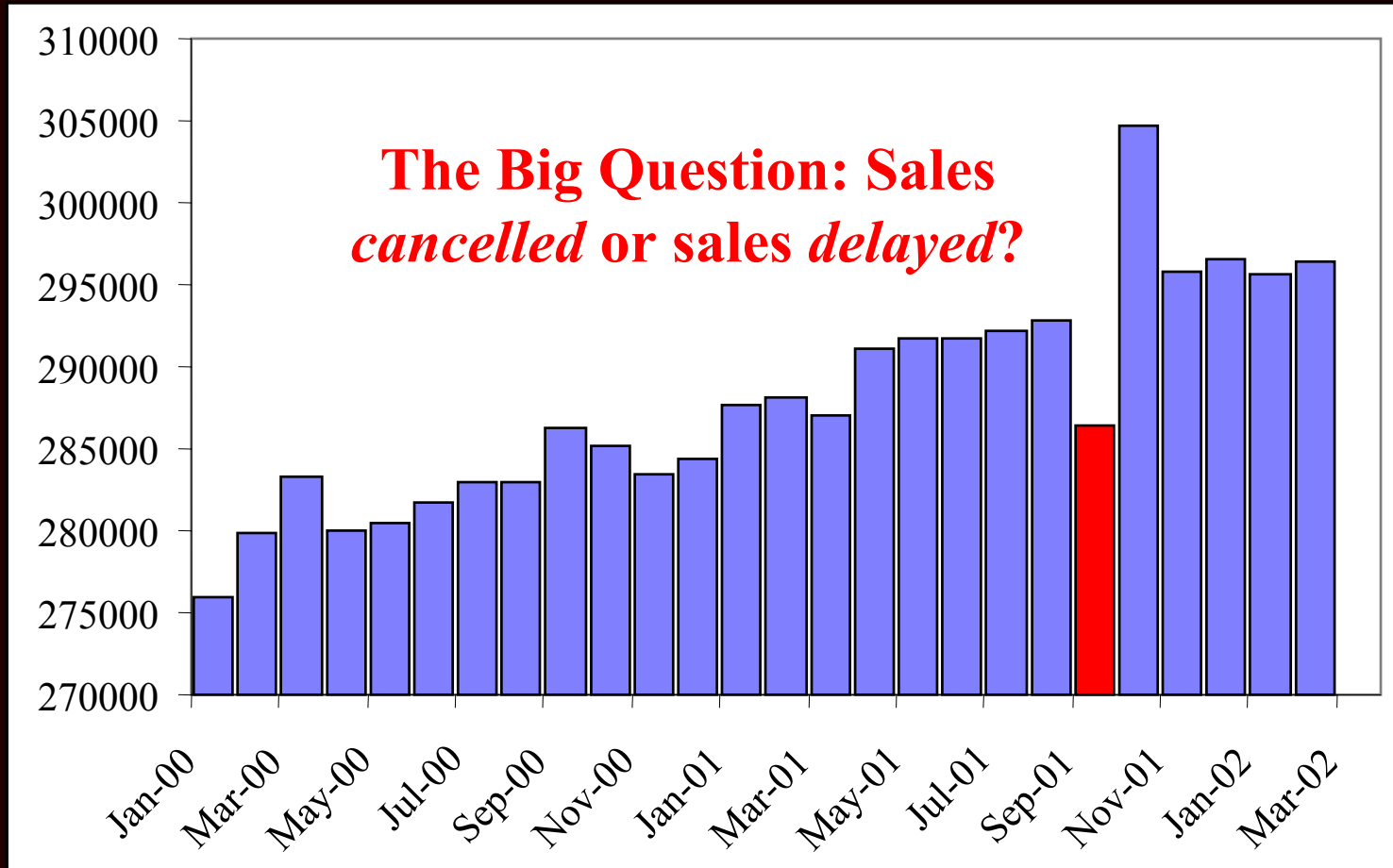


Unemployment

— Start of recession
— September, 2001



Retail Sales and 9-11



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...

Three imbalances created by the Rush



Corporate Imbalance:

Business investment without profit



Consumer Imbalance:

Why save when the markets are booming?

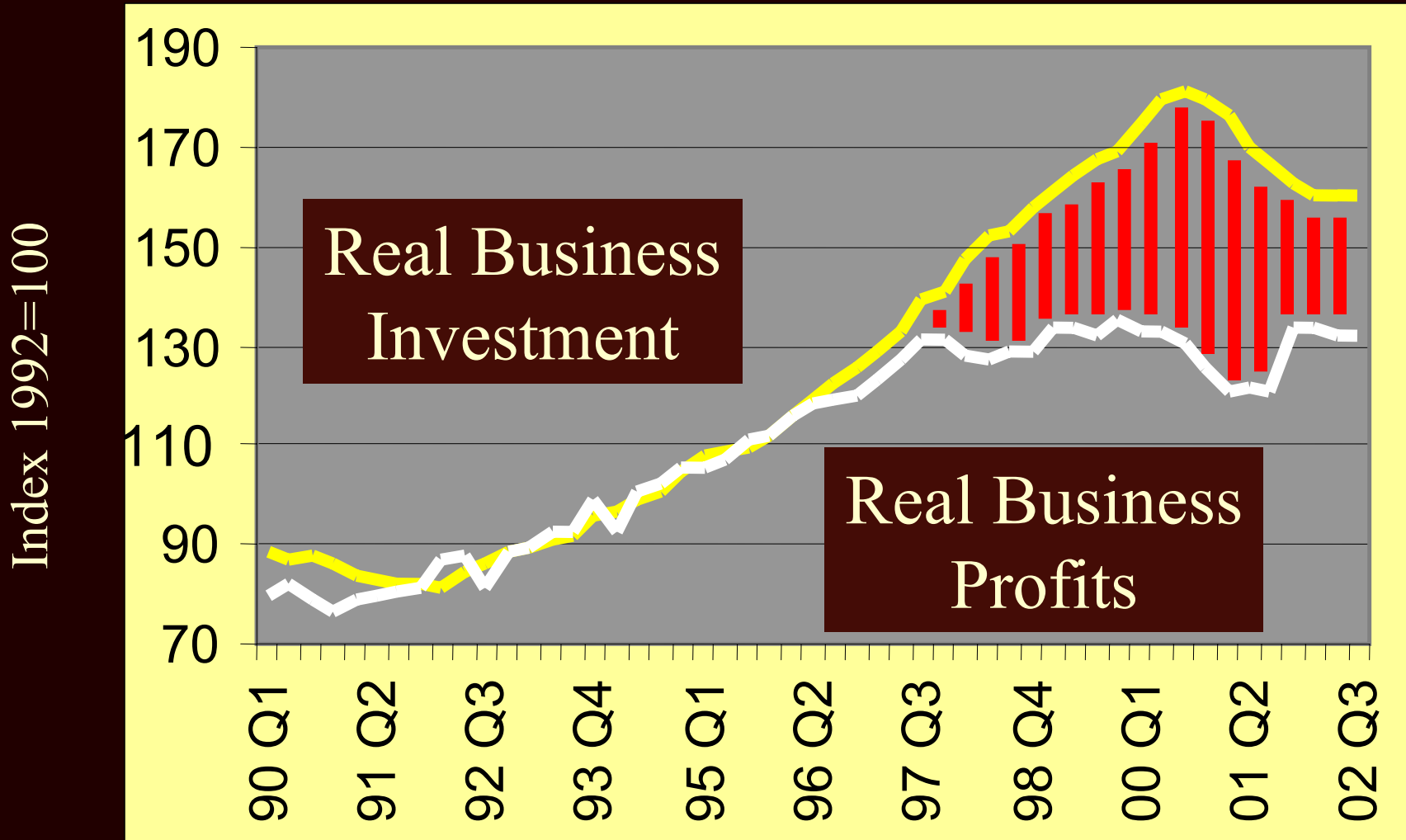


Global Portfolio Imbalance

Massive Current Account Deficits

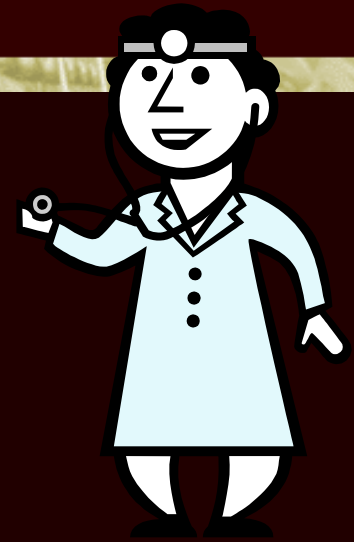


The collapse of business investment caused the 2001 downturn



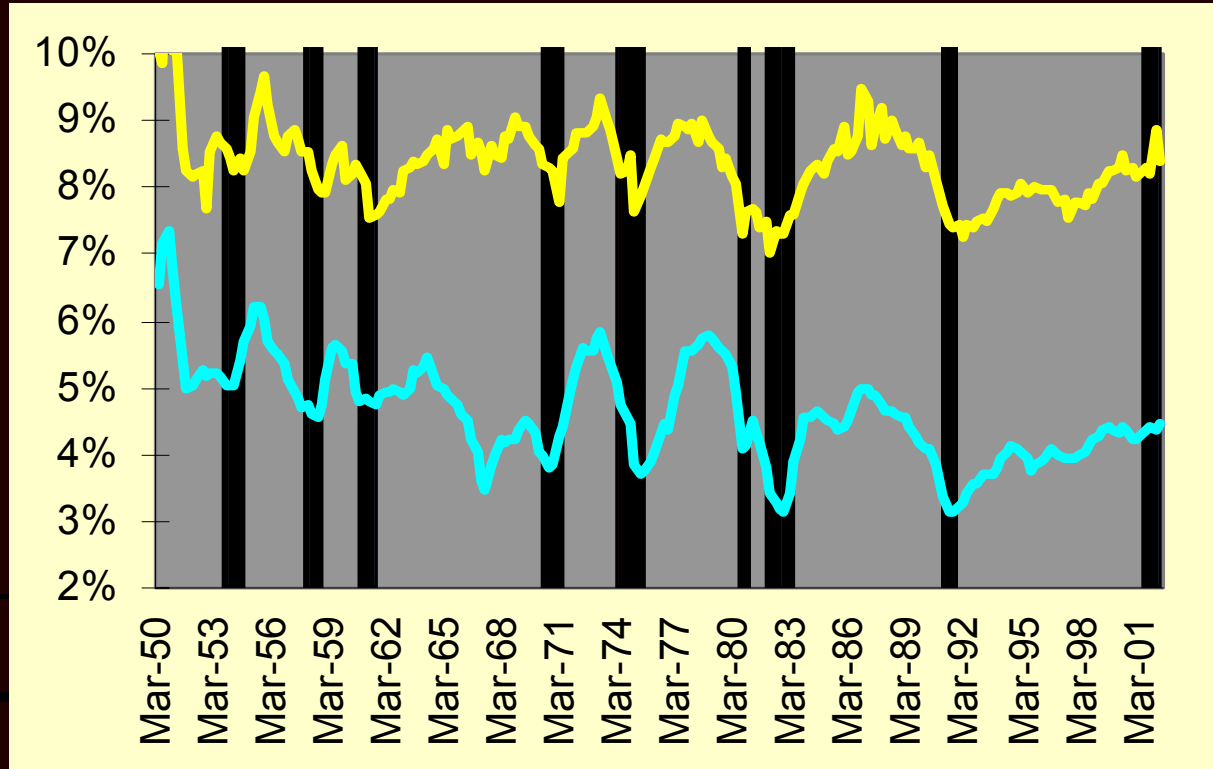


How did we fare?



	Total Change Length	Total Change GDP	Change in Unemployment*
Average	3.6	-1.9%	2.7%
2001	3	-0.6%	1.9%

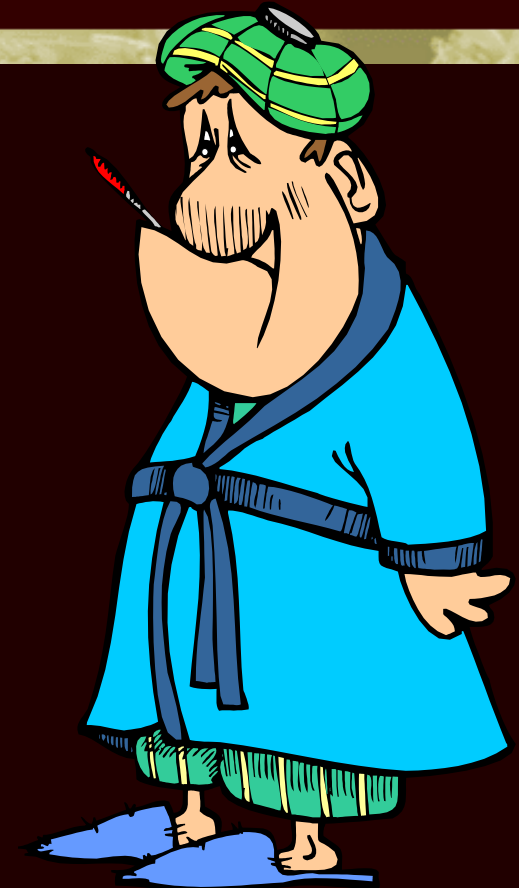
Why so mild?
No consumer cycle!





Why the doldrums?

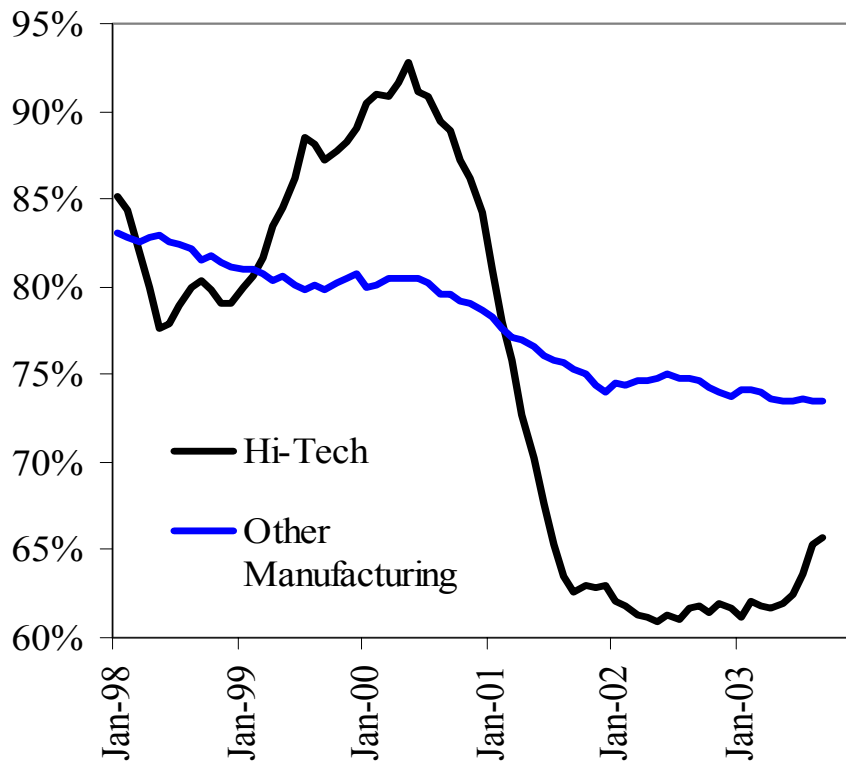
- **The Internet Rush Hangover**
 - Excess capacity
 - Labor market re-balance
 - An over-valued \$US
 - Corporate Malfeasance
- **Macroeconomic Uncertainty**
 - Oil and State budgets
- **Normal growth will return when the economy rebalances itself: the baton of growth needs to be passed from consumers and government back to business investors and foreign buyers**



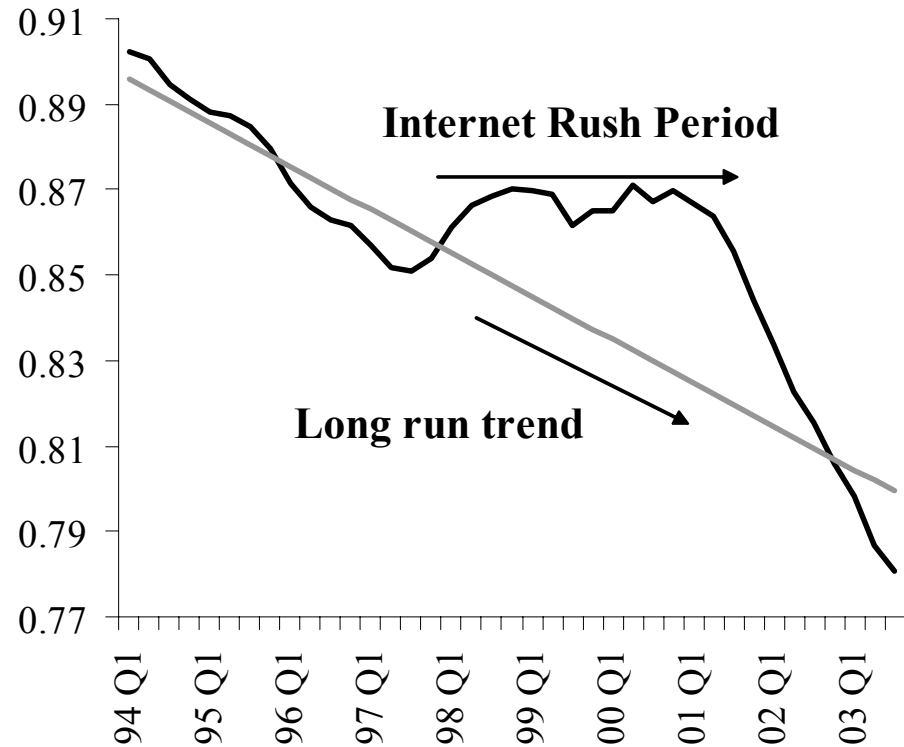


The Internet Rush hangover...

Industrial Capacity Utilization



Ratio Worker Real Compensation to Real Output





Where are we now?

Growth Rate Q3 2003



7.2%!



Is the recovery finally underway?



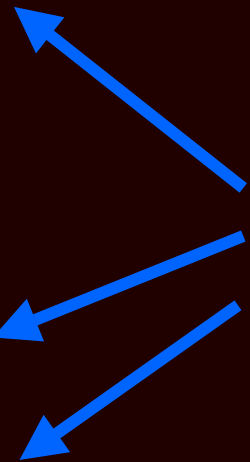
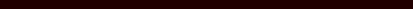
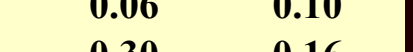
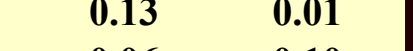
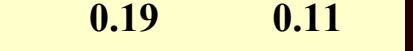
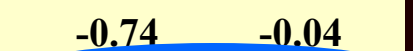
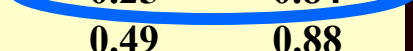
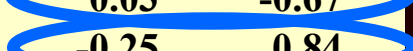
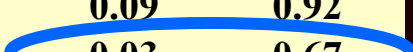
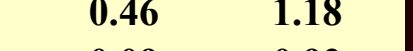
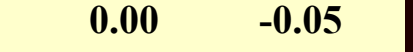
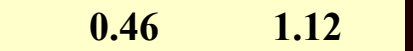
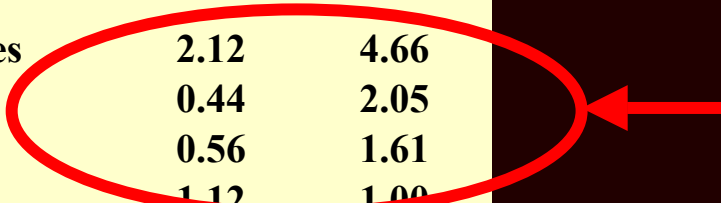
Yes, but... some cautions are in order

Contributions to GDP Growth

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

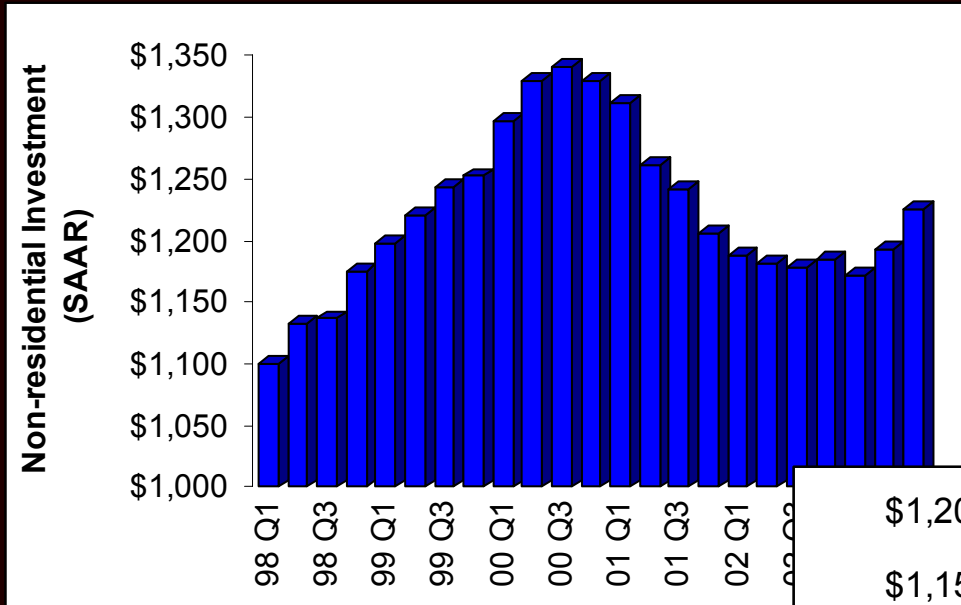
The not-so-good news

The good news





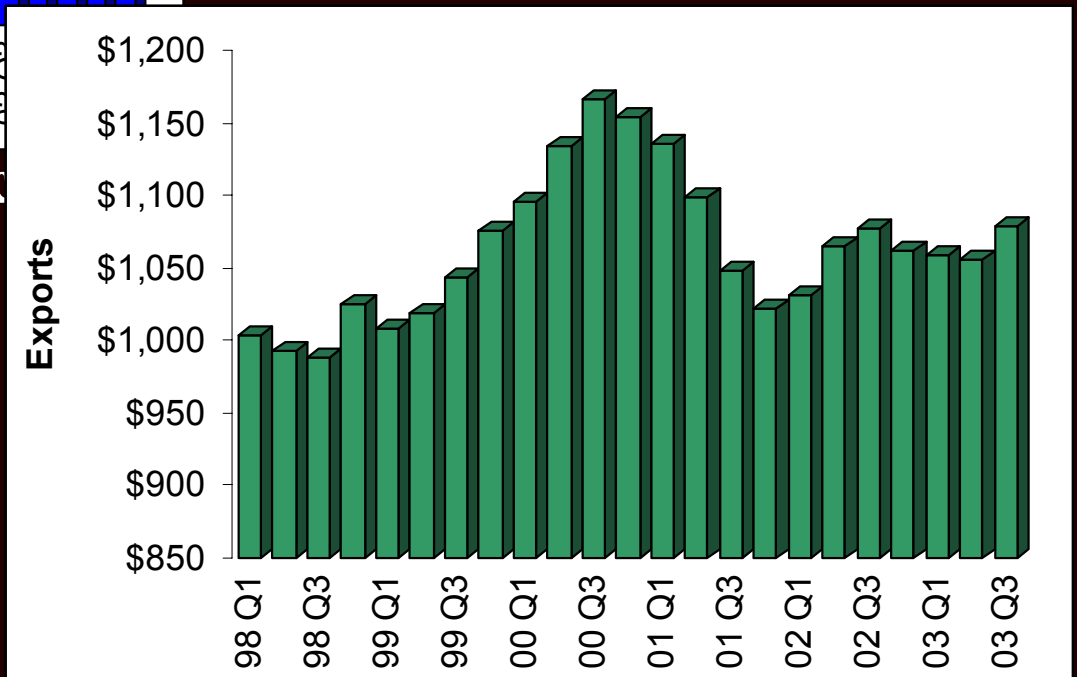
The good news: A closer look



But has a ways to go...

A lower dollar is helping exports

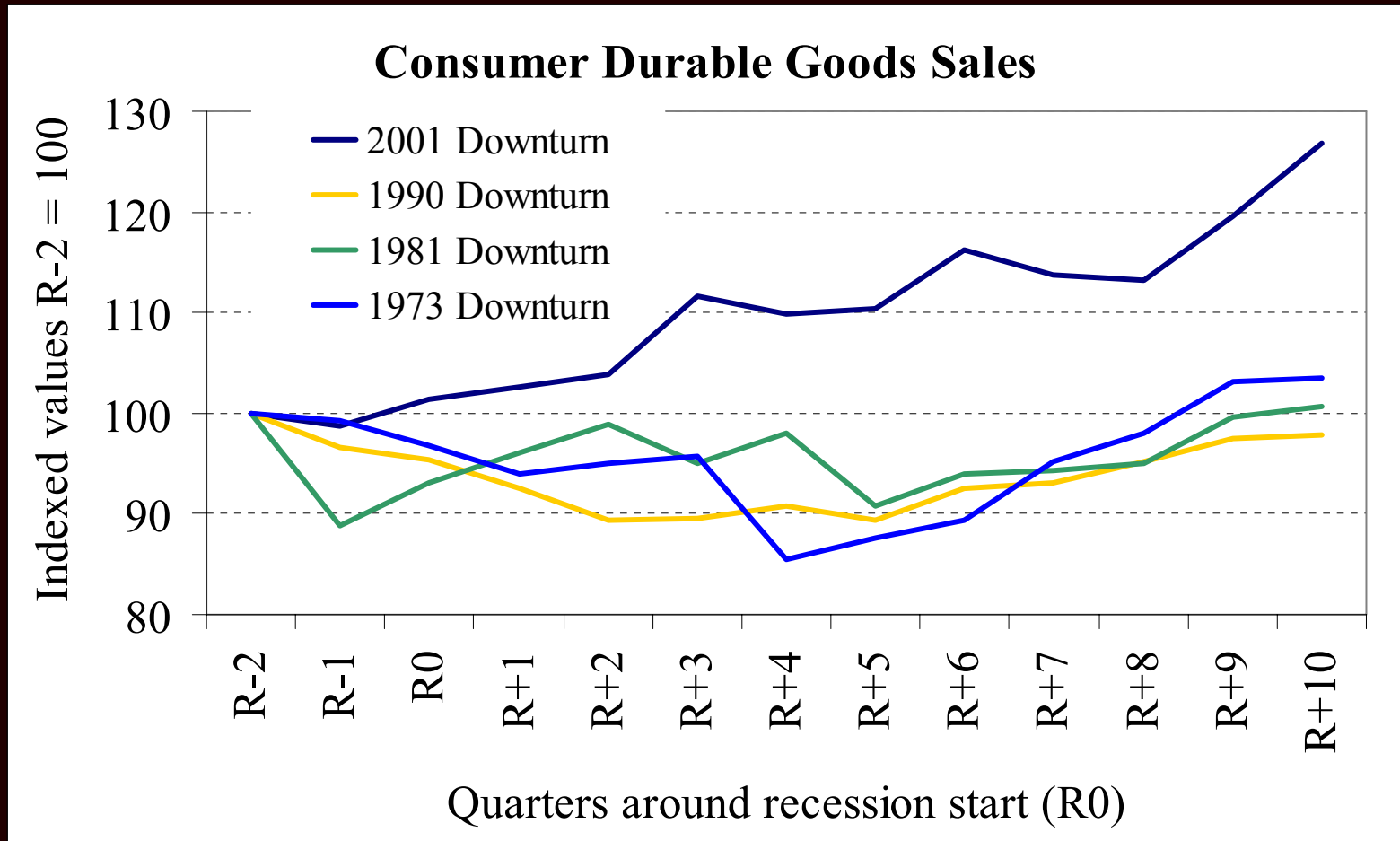
Business spending on trade



A trade war will not.



The big issue: *consumers*

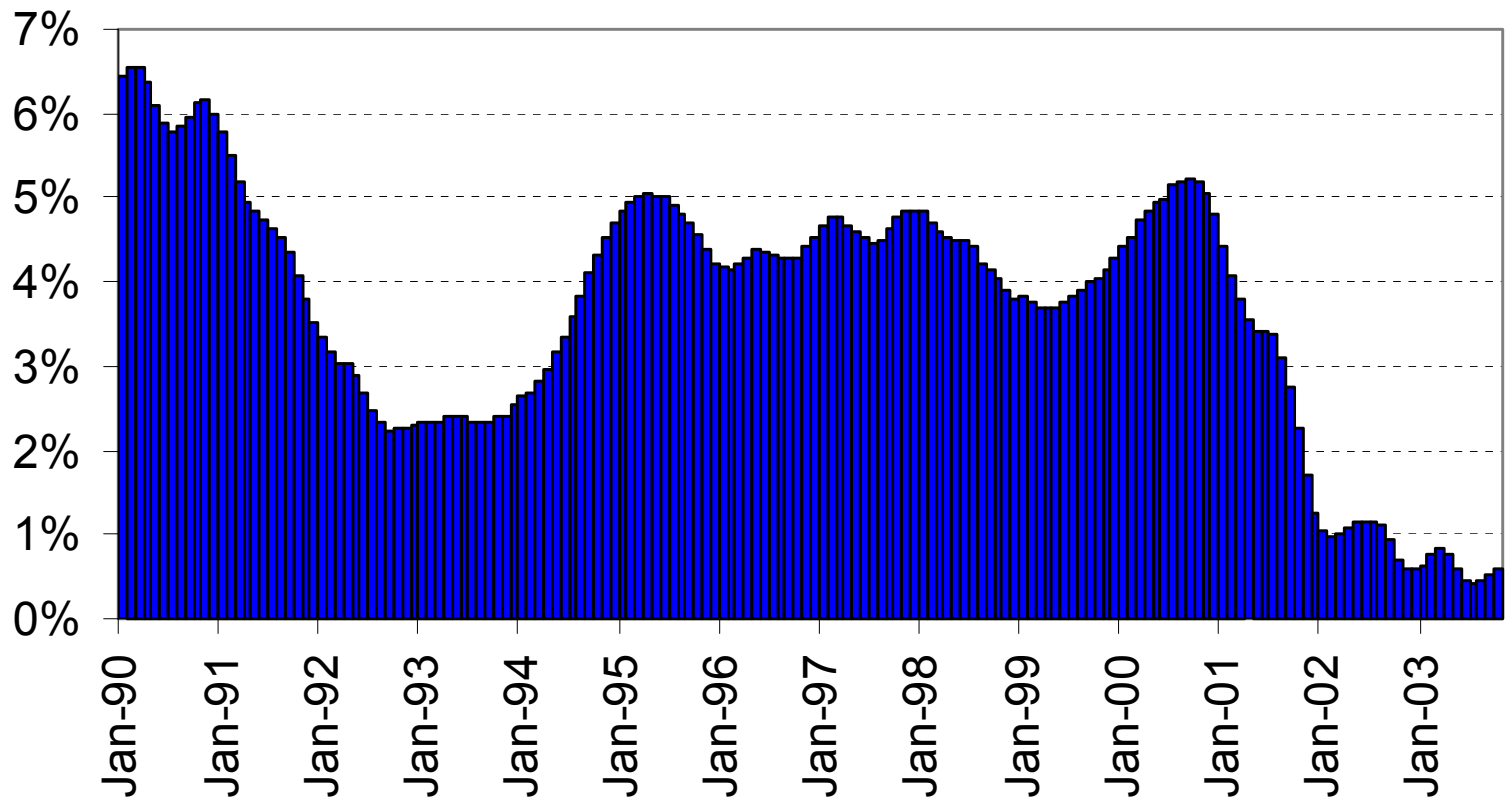


Recovery in consumer spending? From what???



Why? Interest Rates...

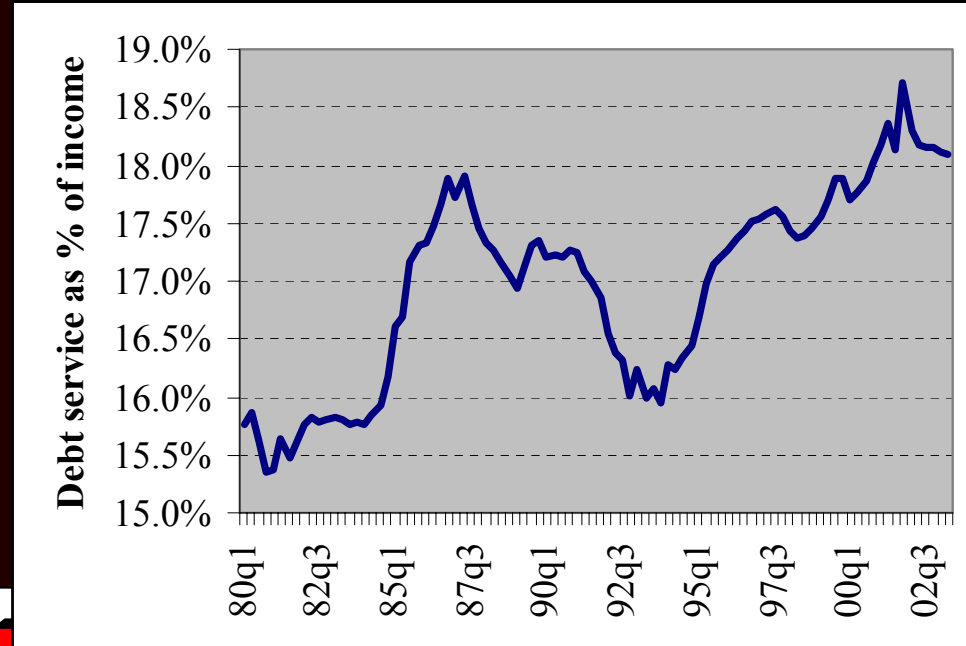
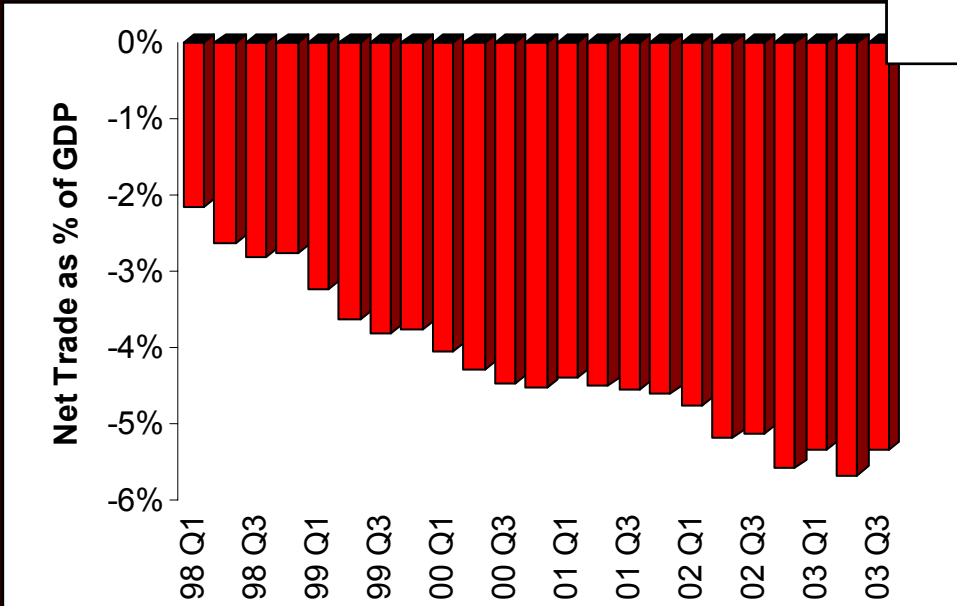
US Real Interest Rates





The perils of consumption without growth

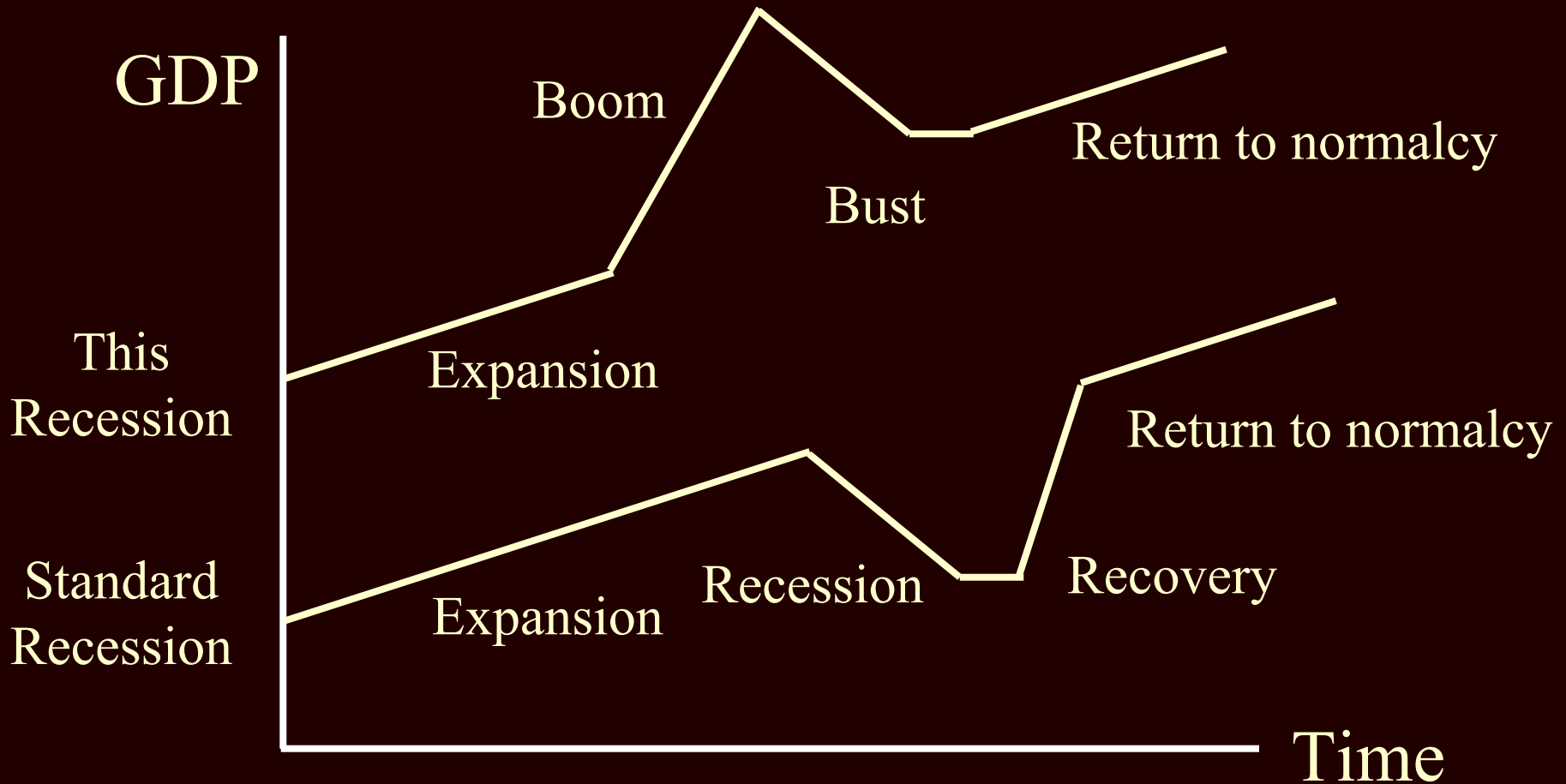
The trade deficit:
A long way to go



Consumer Debt
Very High
Not to mention
government debt!



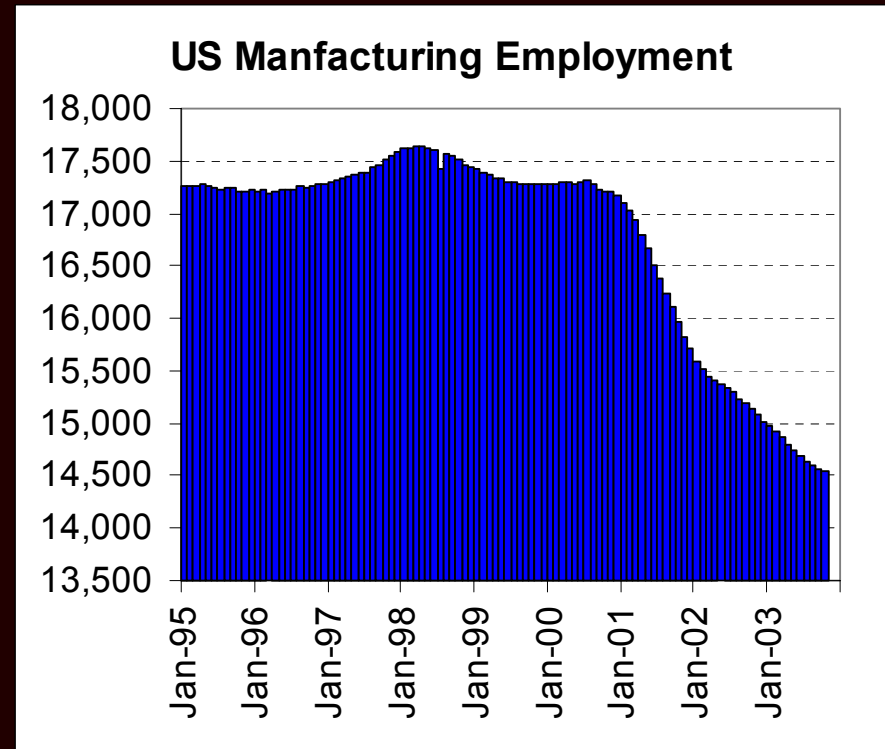
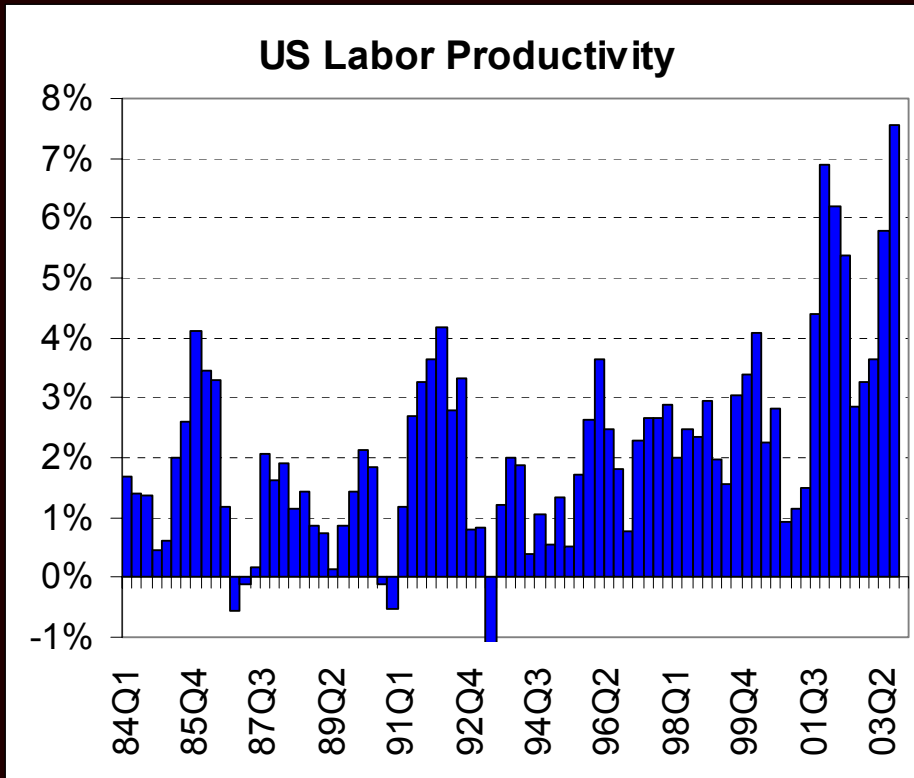
No rebound potential here!





And the labor markets?

IT and productivity *A two-edged sword*



**Tough times for
mid-skill workers**



The UCLA Anderson Forecast

On the path to normalcy—

but not there yet

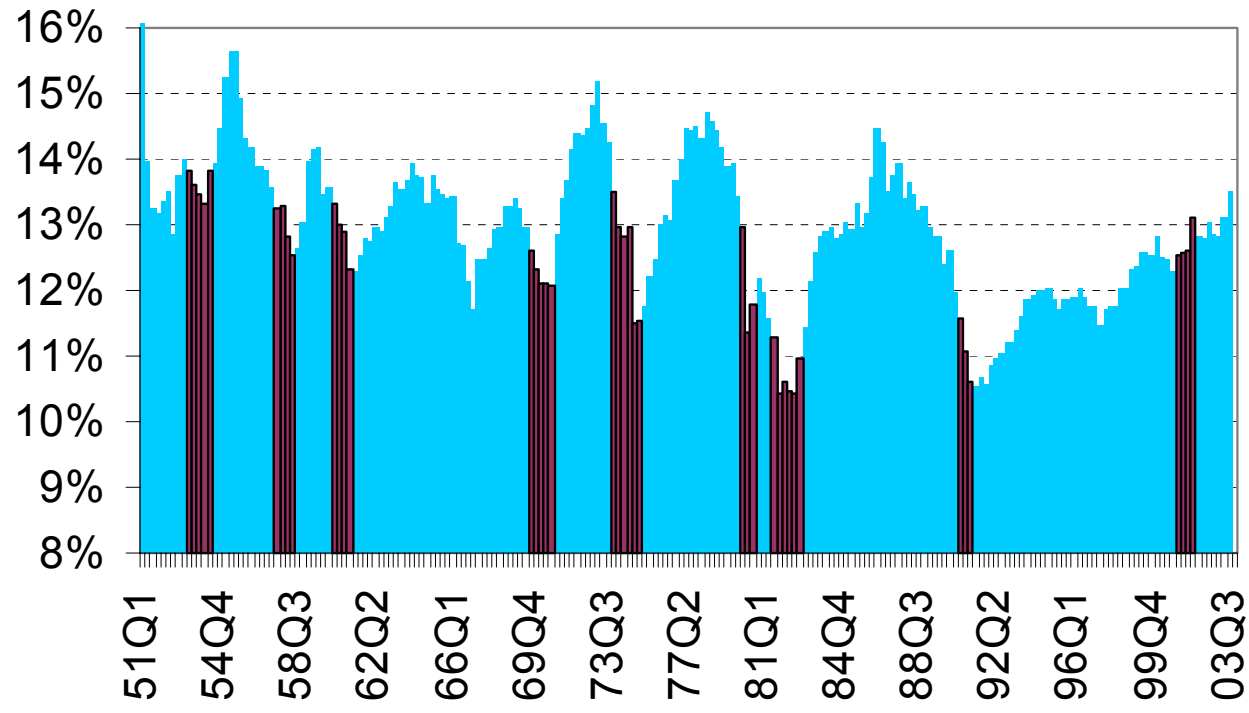


- The recovery has arrived—but still at the initial stages
- Growth in the 4th quarter to slow sharply on weak consumer durable sales, but inventory restocking likely to help: 3%
- Look for normal growth rates in 2004, *not a return to the go-go nineties*
- Job growth will begin early next year, but 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?

Consumer Durables and Residential Investment as % of GDP



**Are we set
up for
another
consumer
cycle?**



Closer to home...

Mediocre national trends reflect a wide variety of local results

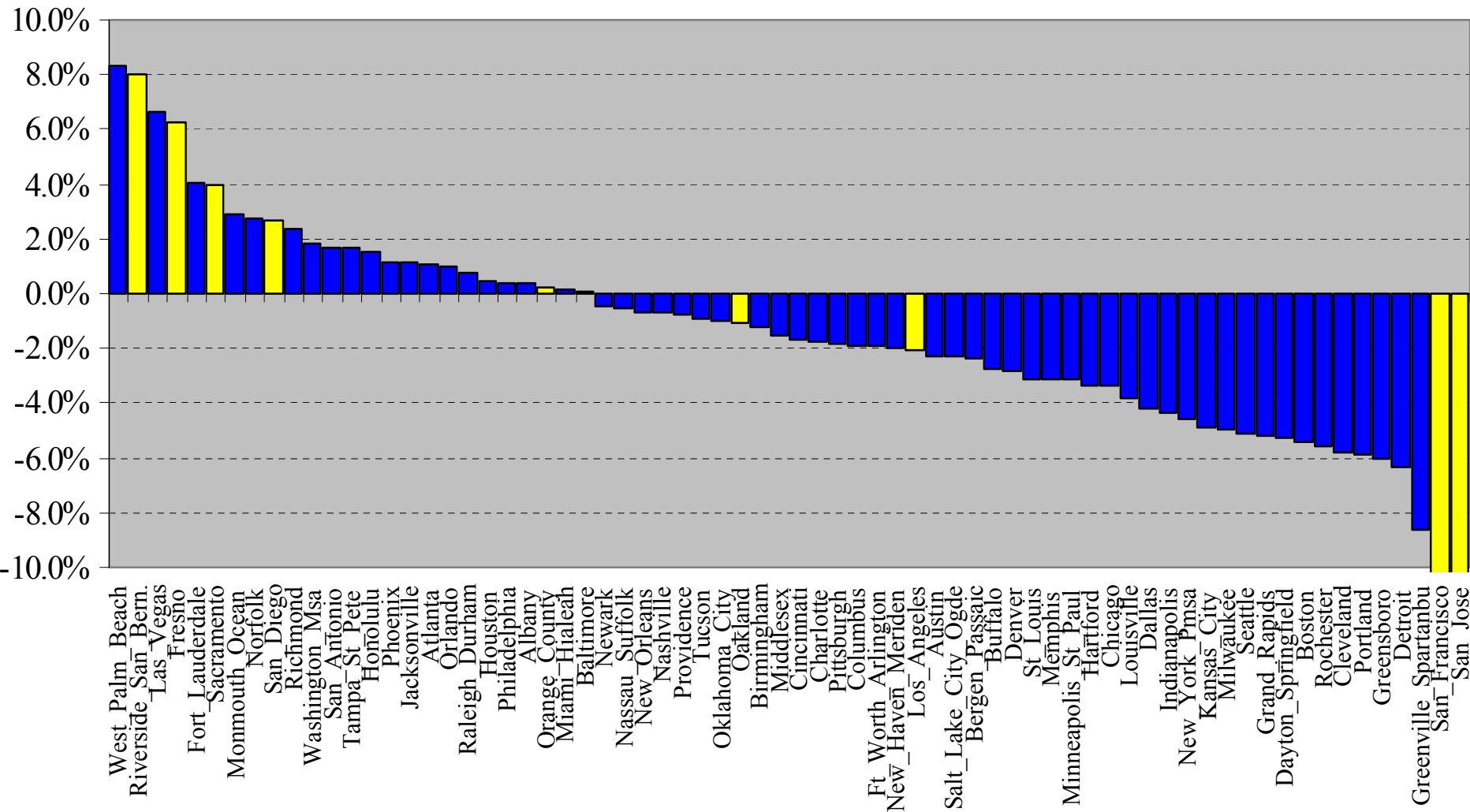


There are always some good markets and some bad



Local Performance of MSA's since 2000

Payroll Job Growth Q3 00 – Q3 03





Performance a function of industry mix

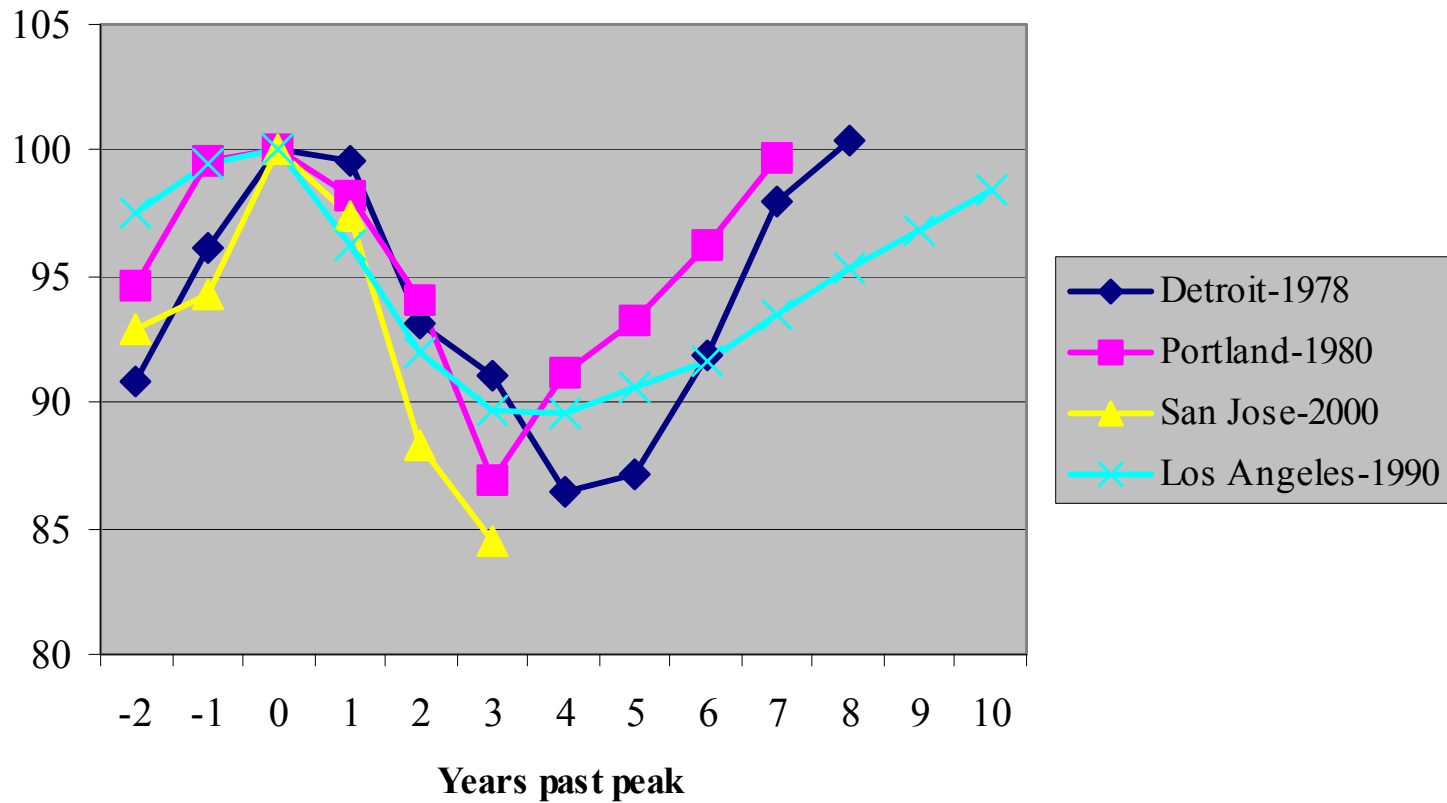
Growth Regression Results

		00-03	
		Coef	t-stat
Bedroom communities and government centers did well	Retail Trade	0.986	2.8
	Wholesale Trade	0.663	1.4
	Government	0.261	2.0
	Construction and NR	0.207	1.1
Service Centers and tourist locations did okay	Other Services	0.507	0.9
	Leisure and Hospitality	0.051	0.4
	Administrative Support	0.026	0.1
	Education / Healthcare	-0.056	-0.5
Tech manufacturing centers and the surrounding infrastructure were hit hard	Information	-0.492	-2.3
	Professional Services	-0.503	-4.1
	Real Estate and Rental	-1.315	-1.5
	Non-Durable Goods	-0.303	-1.2
	Finance and Insurance	-0.491	-2.1
	Durable Goods	-0.725	-9.9
	Transportation Utilities	-0.894	-3.5



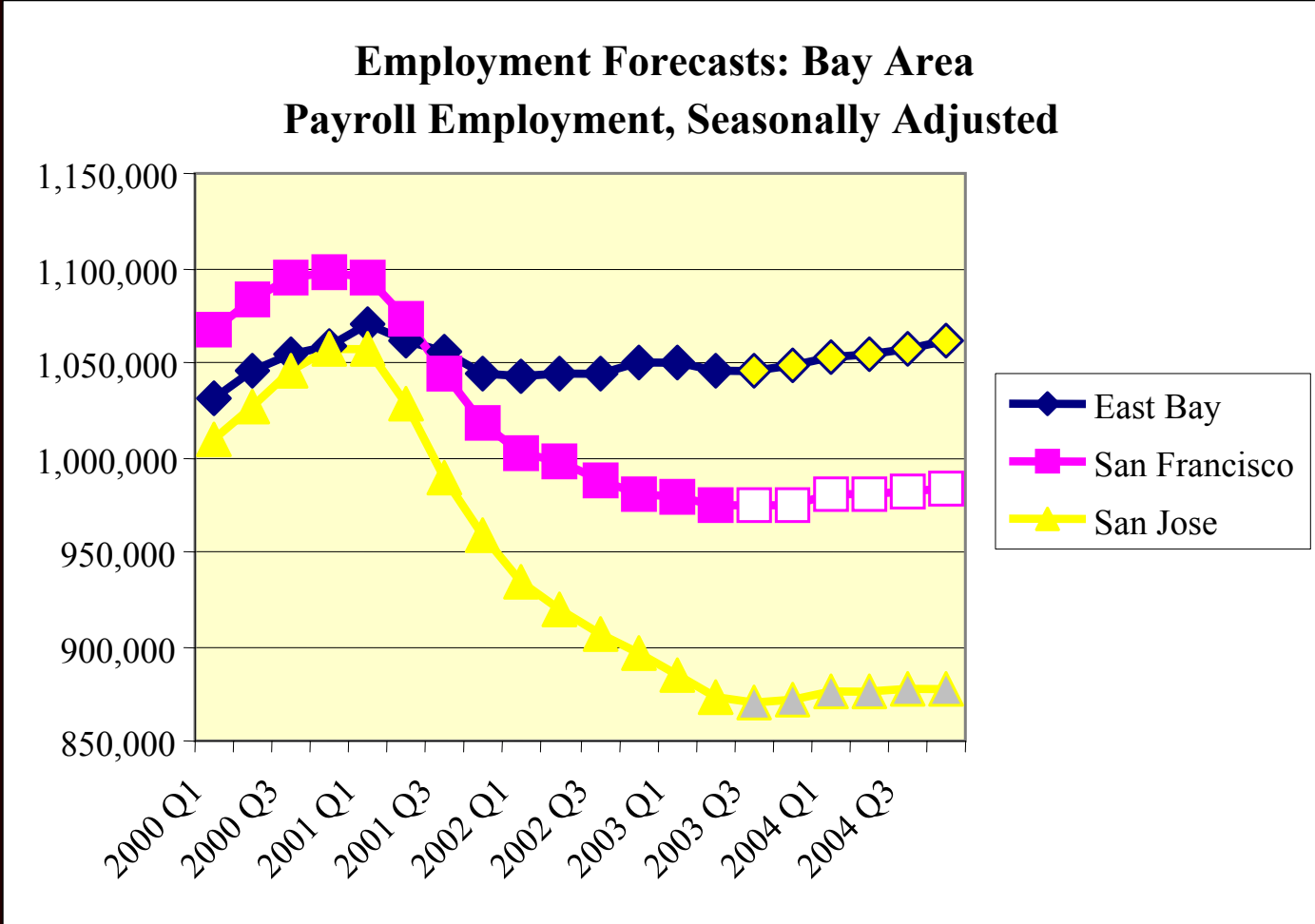
Can you show me the way from San Jose?

4 worst employment shocks in major cities





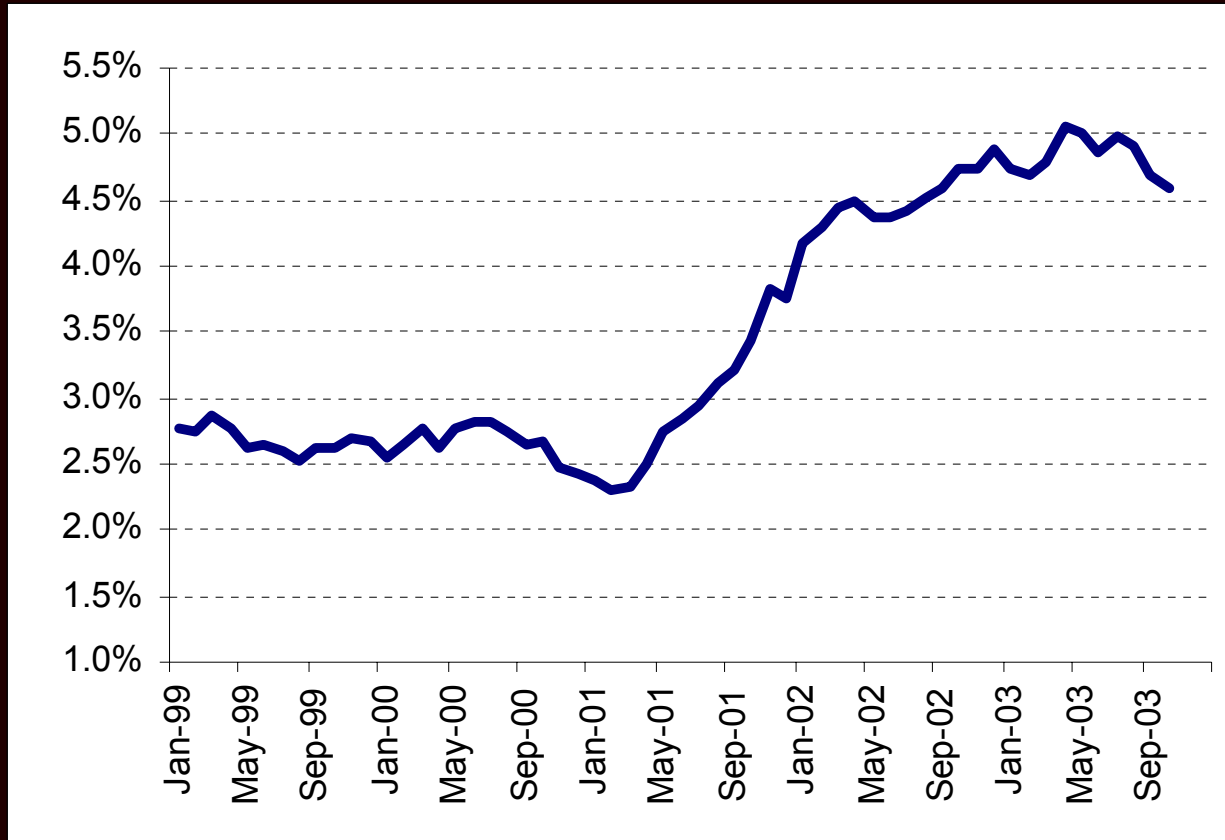
Bay Area Employment Forecasts





And Sonoma?

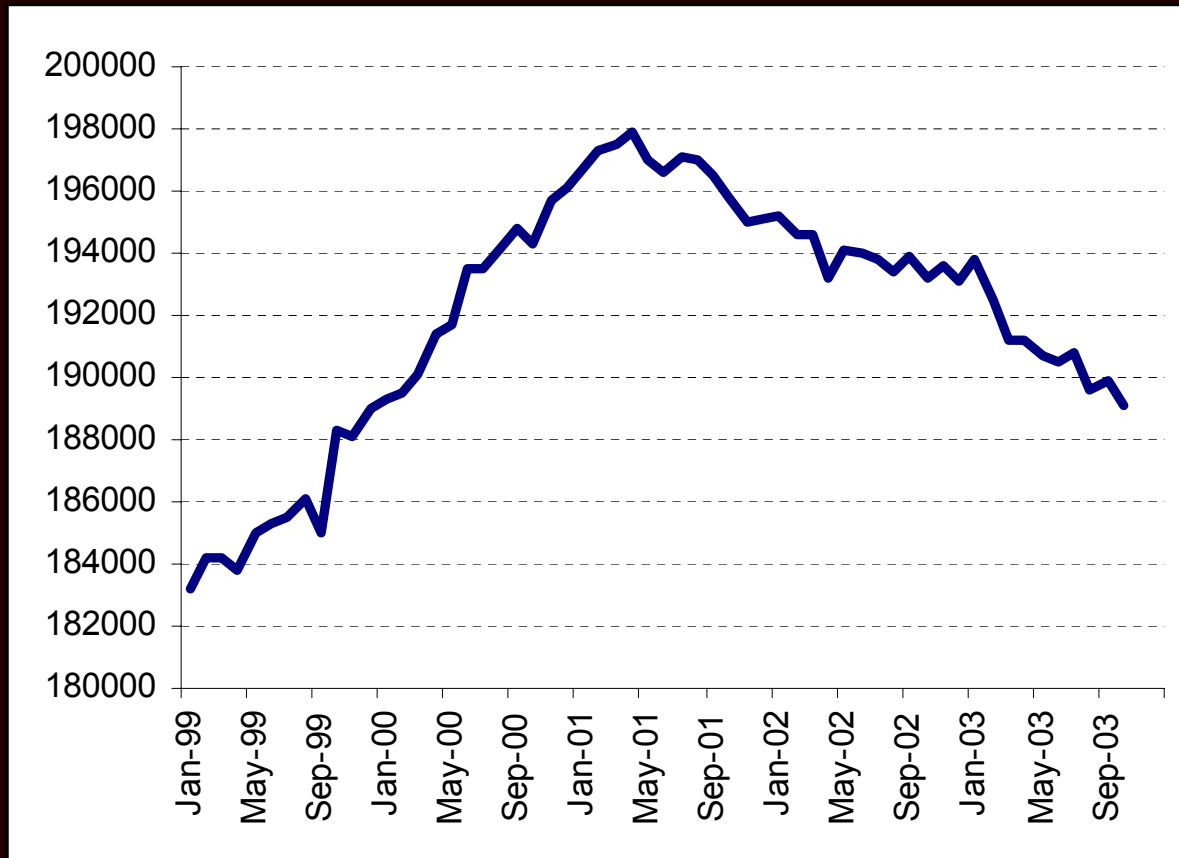
Unemployment falling





And Sonoma?

Payroll Employment: Dropping





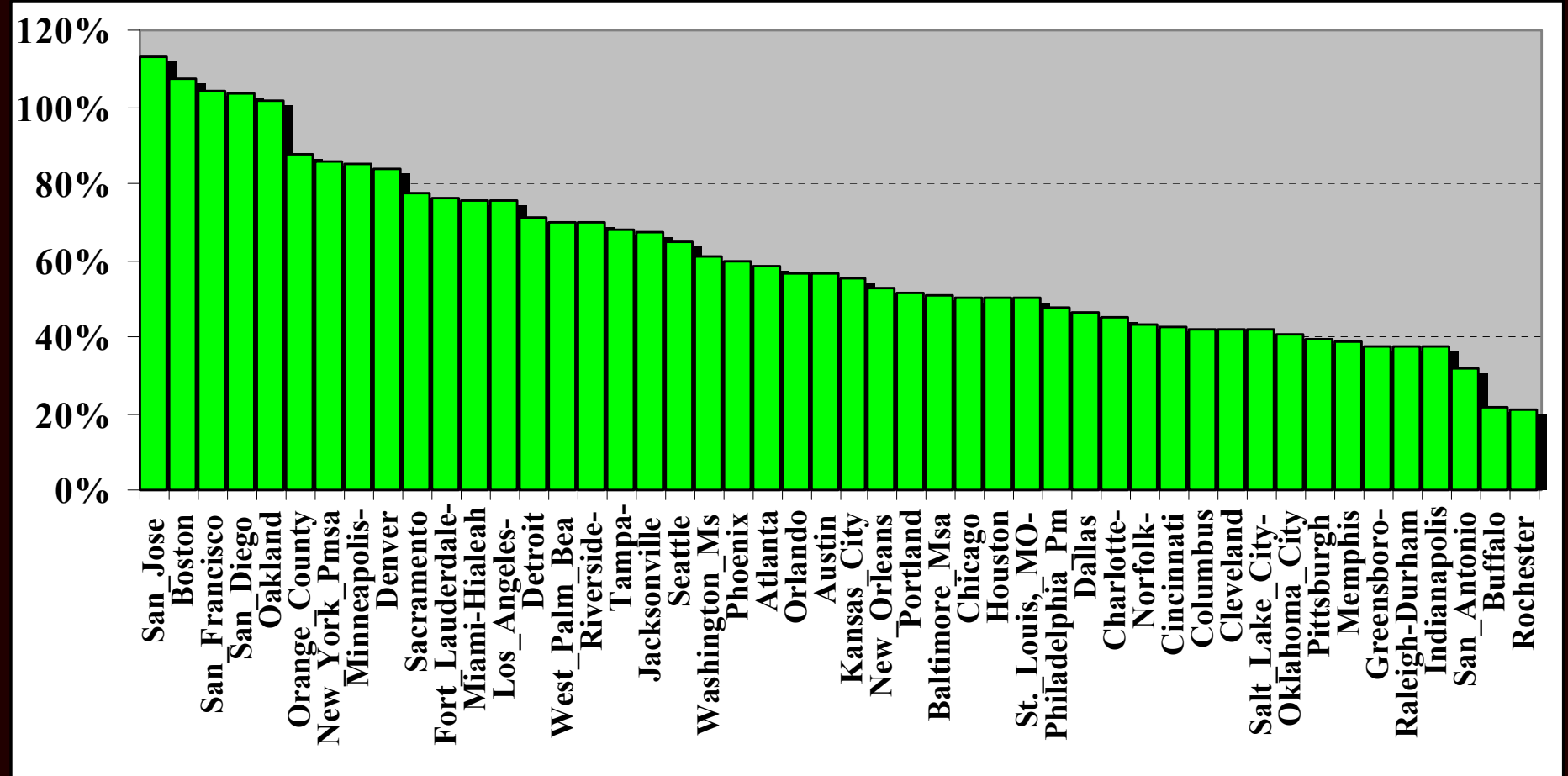
Sonoma Employment (SA)

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



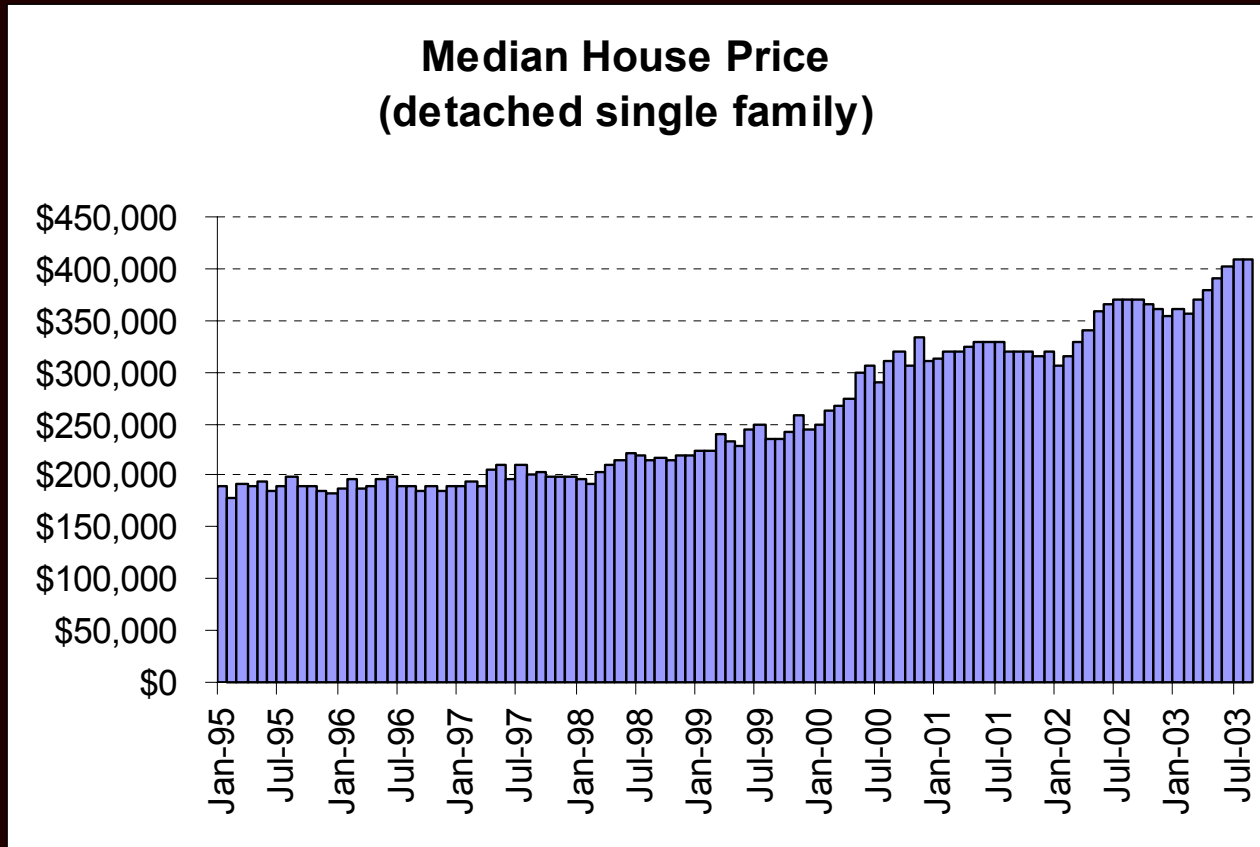
Real Estate Bubble Trouble?

Median House Appreciation: 95-03





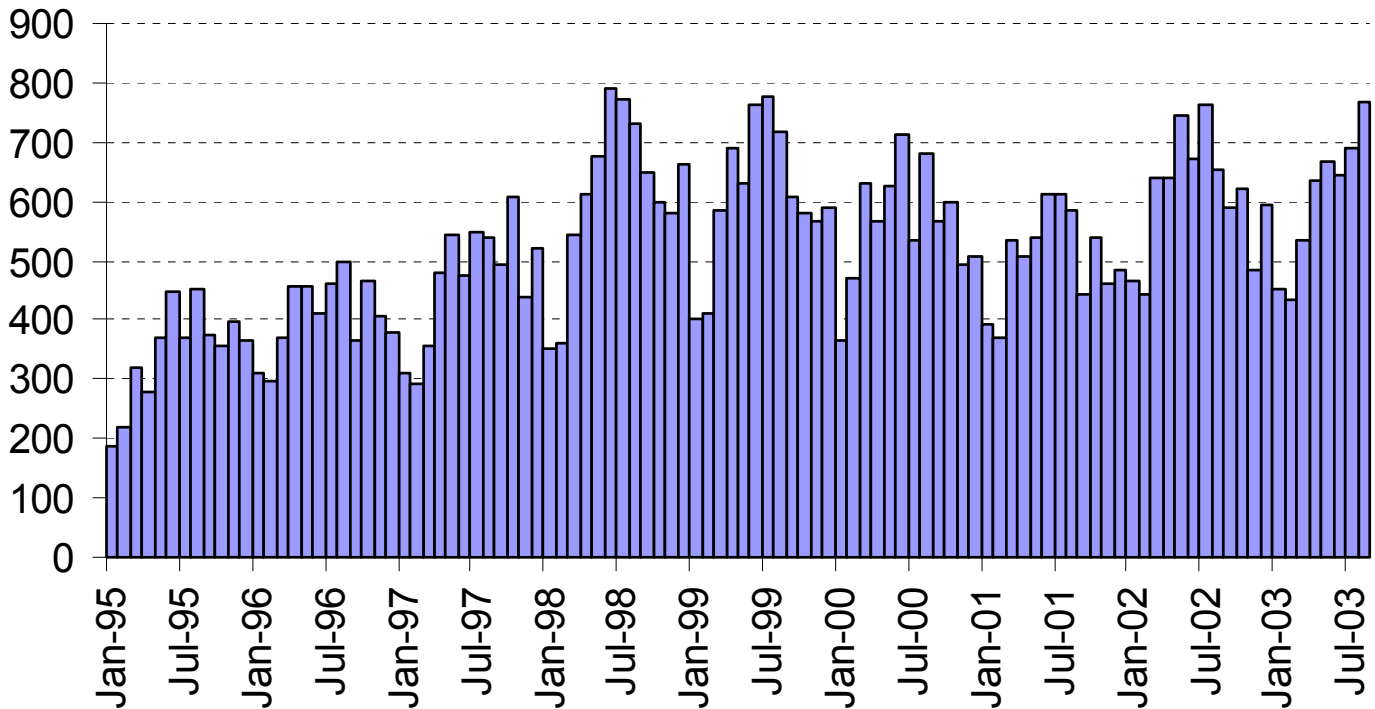
Housing prices in Sonoma: Up too!





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

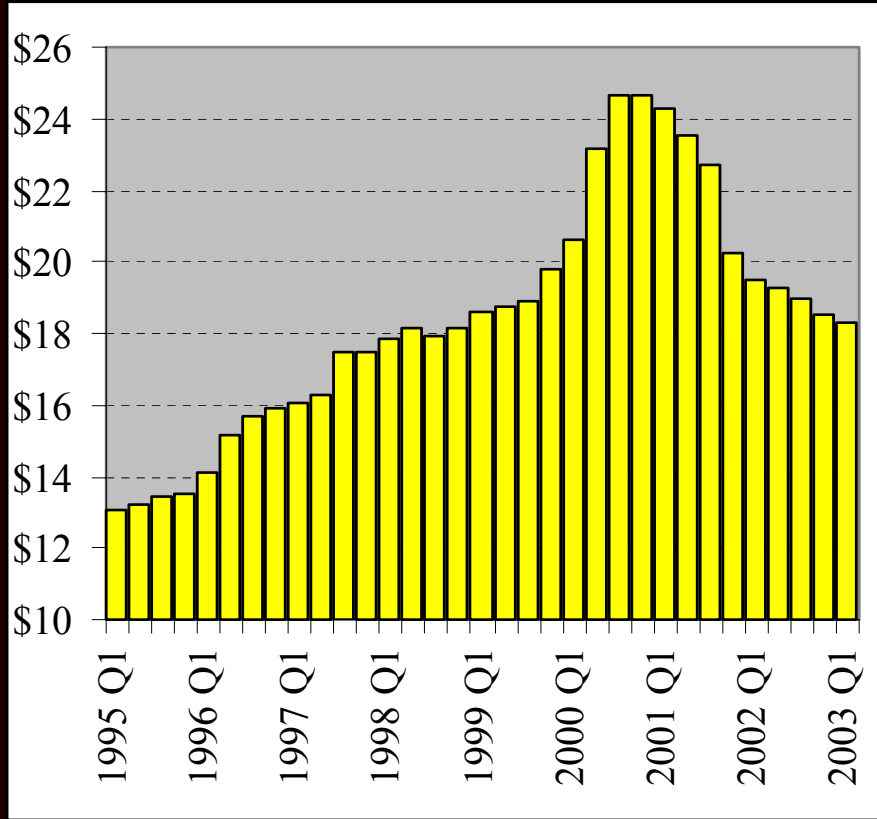
$$\text{Value} \approx \frac{\text{Today's Rent}}{D - G}$$

G: Future rental growth rates

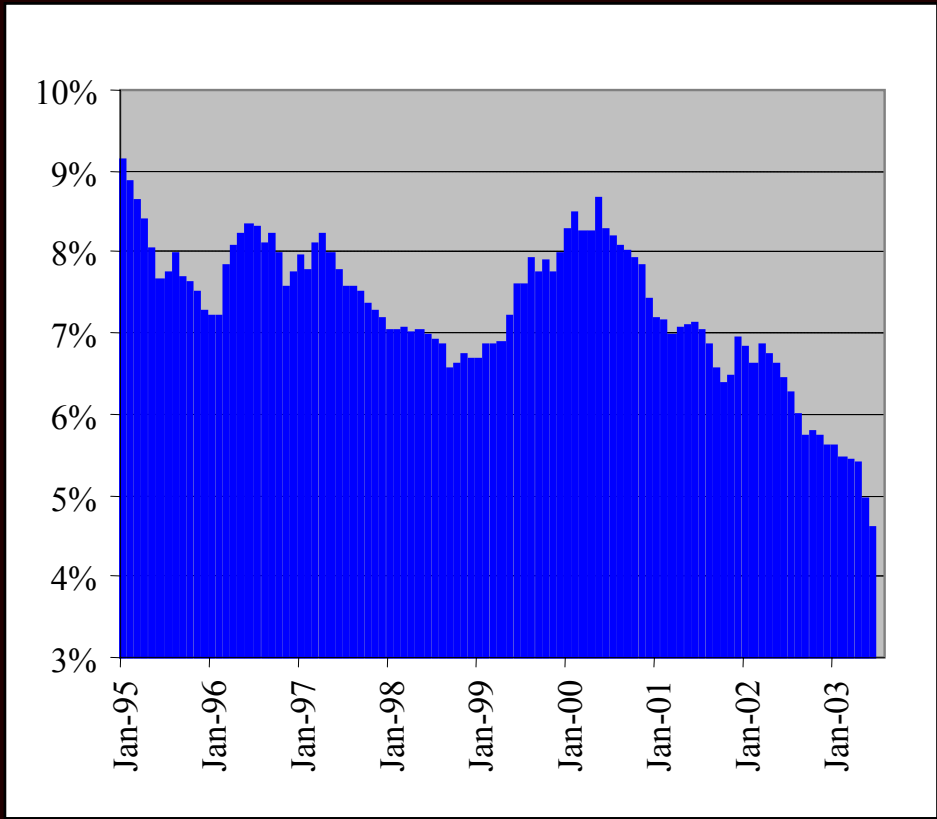
D: Discount factor: mortgage rates, depreciation, taxes, risk premium



The fundamentals...



Rents: East Bay

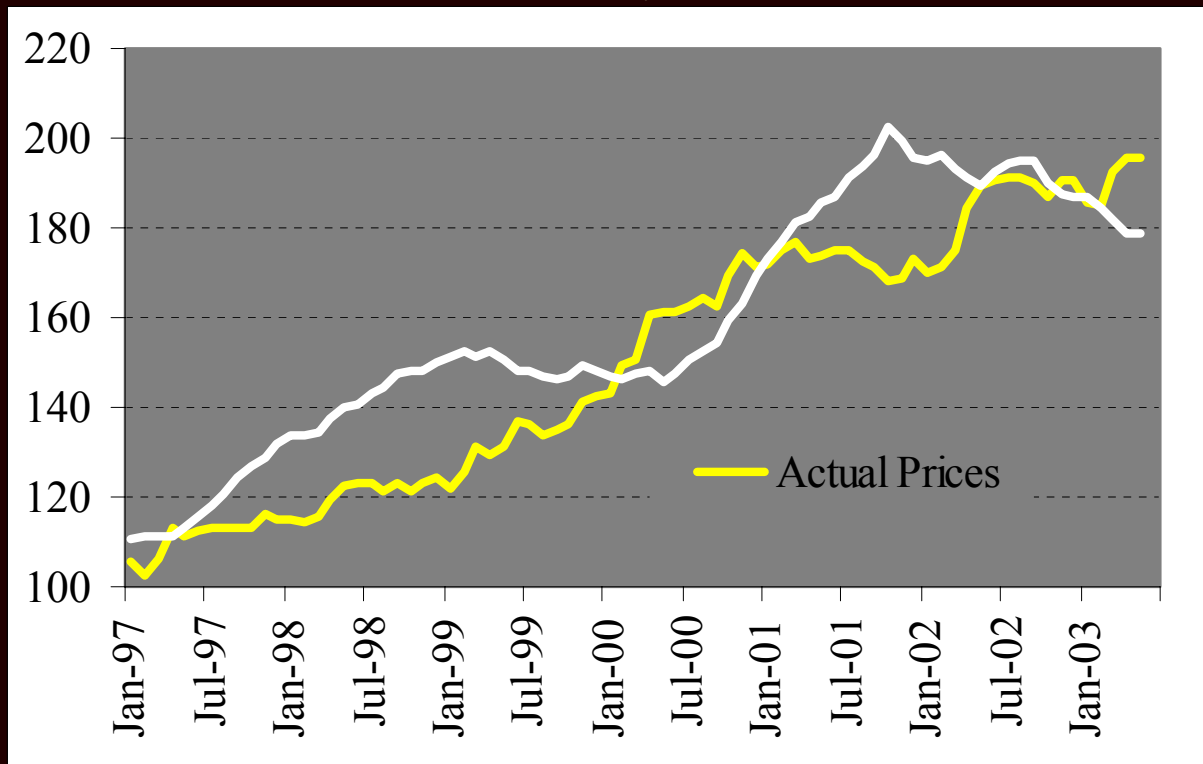


Mortgage Rates



The Fundamentals Support Recent Housing Price Appreciation

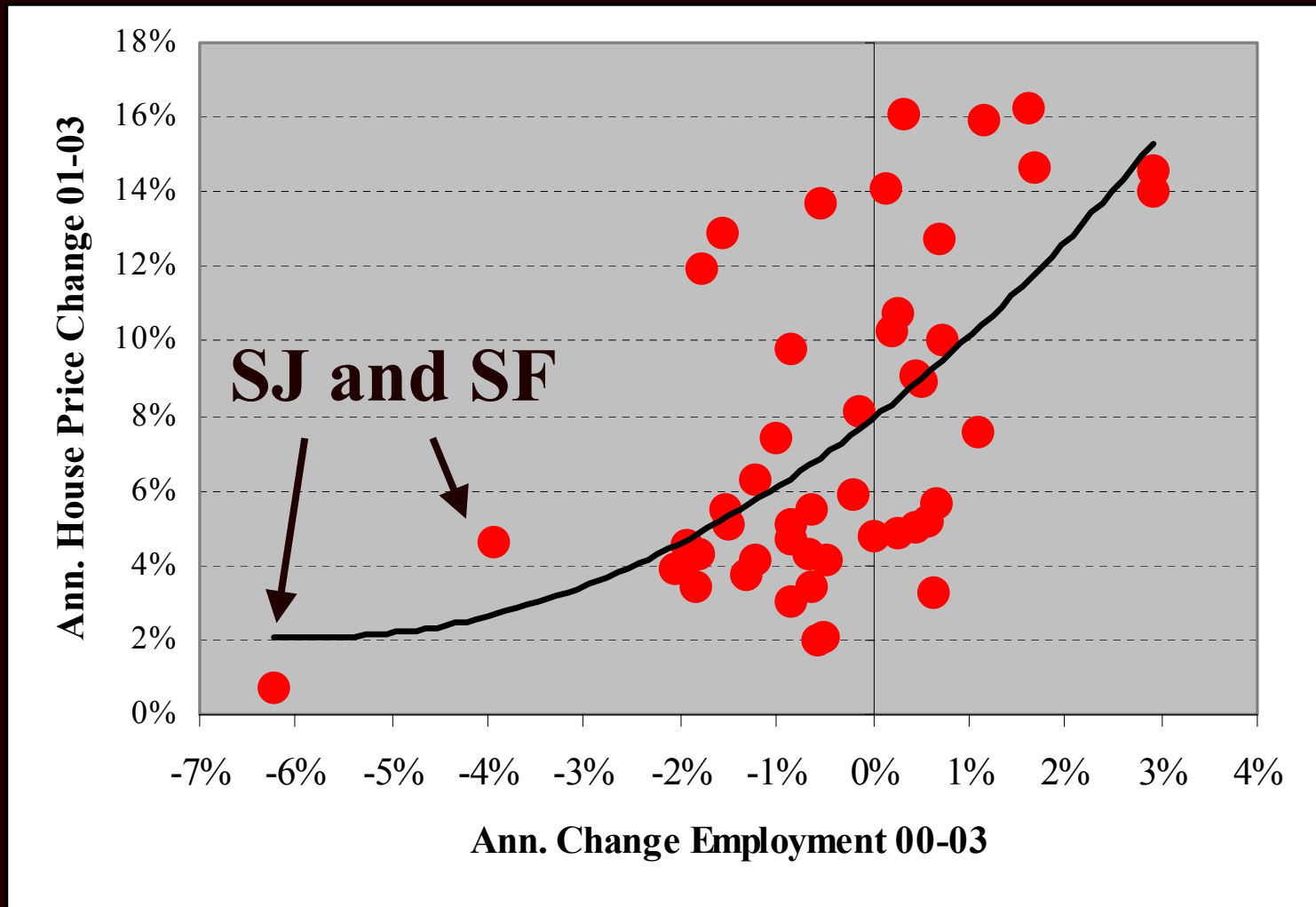
Theoretical and Actual Prices
Indexes (96=100)—Bay Area Real Estate



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

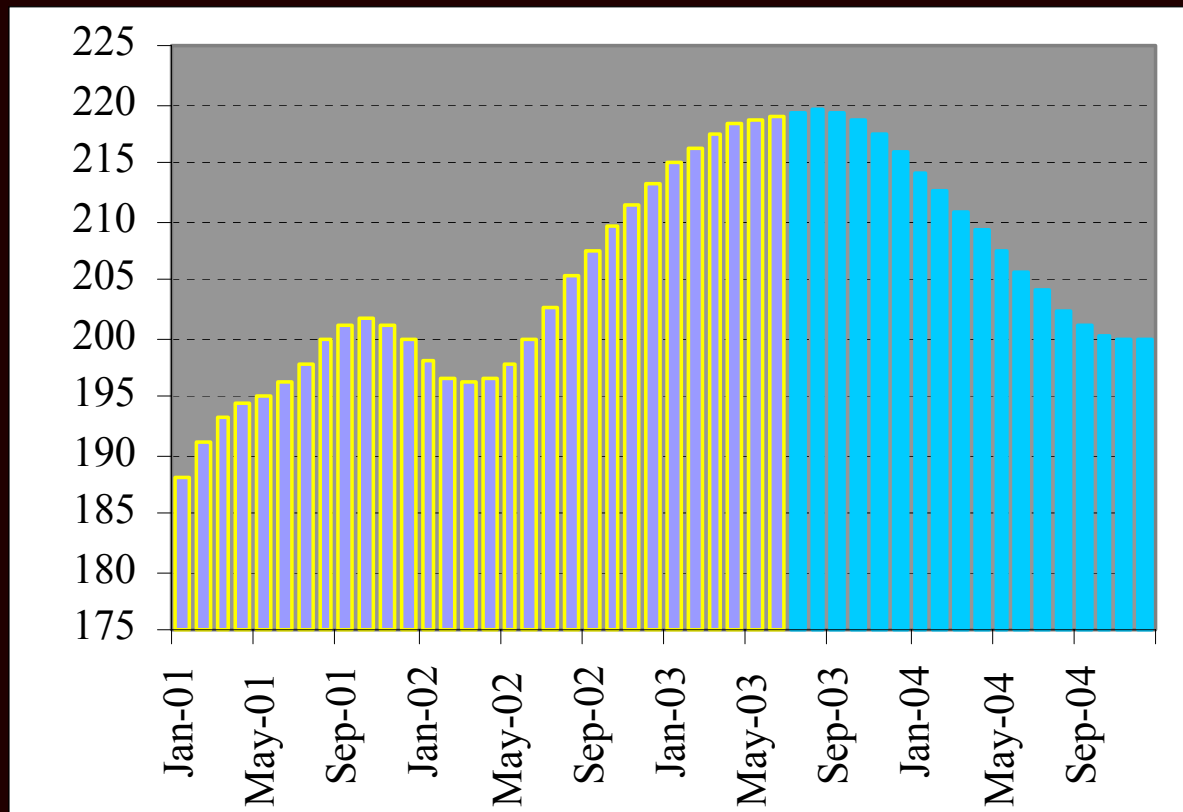




The risk: a rapid increase in interest rates

Scenario

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



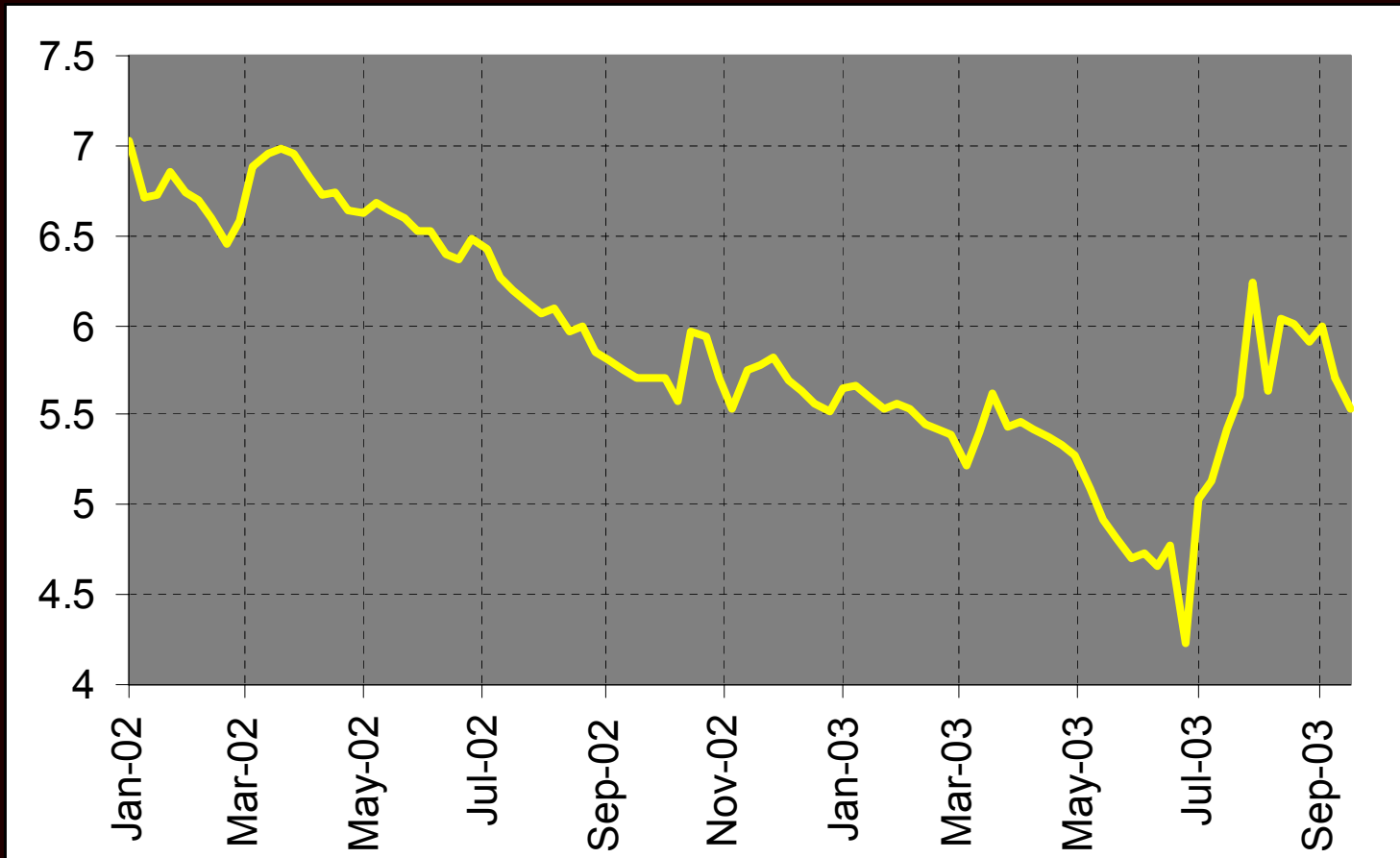
Theoretical Prices

A Liquidity collapse



Irony: 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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