



A. Gary Anderson Center for Economic Research

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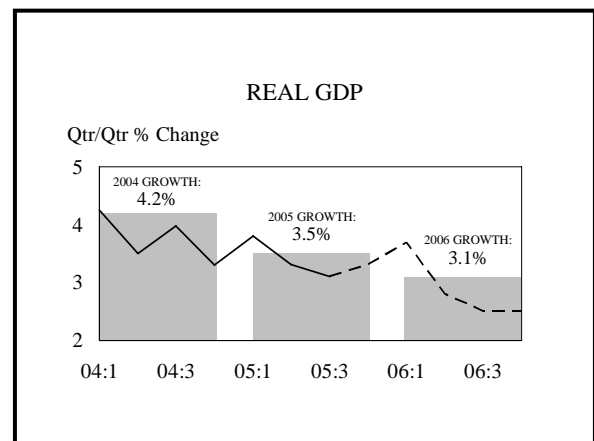
The Chapman University Economic Forecast For the U.S., California and Orange County

Orange, CA – The A. Gary Anderson Center for Economic Research at Chapman University released today the results of its 28th annual economic forecast for the U.S., California and Orange County. The forecast was presented to more than 1,000 Orange County business leaders at a conference held at the Hyatt Regency, Irvine. Following are highlights of the forecasts.

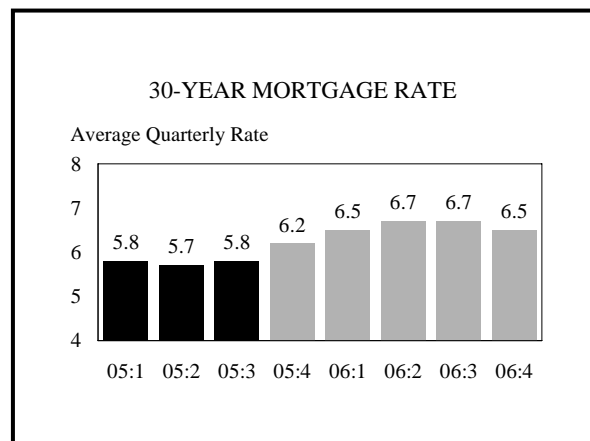
2006 U.S. Forecast:

- Last year, at its December 2004 conference, the Anderson Center forecasted real GDP growth of 3.5 percent in 2005. That turned out to be a bulls-eye.

Our forecast for 2006 calls for continuing positive real GDP growth of 3.1 percent. This would mark, however, a second year where the average annual rate of real GDP growth has slowed since the peak year during the current expansion of 4.2 percent registered in 2004.



- Much has been made about the Federal Reserve Board's seemingly aggressive action since mid-2004 in ratcheting up the fed funds rate. Our model for the U.S. economy suggests that it's not the nominal fed funds rate but rather the real (inflation-adjusted) fed funds rate that's important. And the real fed funds rate is still well within a range where it is acting to stimulate economic growth.
- The continuing availability of capital funds, as reflected by the positive difference between long-and short-term interest rates, and the extraction of home equity made possible by rapid housing appreciation and used to fund consumer spending are other very important factors explaining the strength of the national economy.
- There is increasing evidence that inflation is taking a toehold and is likely to build as higher energy prices work their way to final goods prices. Inflation, as measured by the CPI, is estimated at 3.4 percent for 2005, up significantly from the 2.7 percent registered in 2004. We believe that price pressure will begin to moderate next year as energy prices stabilize and even decline a bit. We are forecasting an average annual rate of inflation of 3.7 percent in 2006.
- We expect the Fed to continue increasing the fed funds rate from 4.0 percent currently to 4.75 percent by mid-2006. Given our forecast that price pressure will ease, the real federal funds rate is projected to increase through year-end 2006 and move into a restrictive range that will tend to dampen economic growth. It will mark the first time since the 2001 recession that the real fed funds rate will no longer be stimulative.
- Residential construction has been an important engine of economic growth since the end of the 2001 recession. But increasing mortgage rates, coupled with diminished expectations regarding future housing prices, suggest that housing construction will slow. Our forecast calls for the average annual rate of housing starts to decline from more than 2.0 million to 1.8 million units – a drop of about 12 percent.



2006 California Forecast:

- The most current data released by the Employment Development Department (EDD) show that California's payroll employment increased by 223,000 in the third quarter of 2005 compared to the third quarter of 2004 – an increase of 1.5 percent. Over the same period of time, the number of self-employed increased by 214,000 – an increase of 11.1 percent. In

fact, since the beginning of the recovery in the first quarter of 2002, year over year percentage changes in the number of self-employed consistently outpaced growth in payroll employment.

- Strong productivity growth enabled employers to satisfy higher demand for their goods and services with their existing workers. Also, high healthcare costs, workers' compensation insurance and overall employee compensation are forcing employers to rely on outsourcing and use independent contractors and consultants, increasing the number of self-employed. Finally, the strength of the real estate market, construction sector and refinancing activity attracted a large fraction of the labor force to work as real estate agents, mortgage brokers, or independent construction contractors increasing the rank of self-employed.

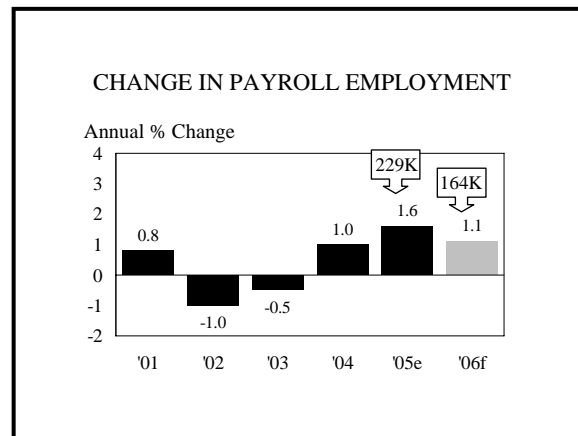
CHANGE IN EMPLOYMENT
2004:3 TO 2005:3

Thousands of Jobs, Seasonally Adjusted

	2004:3	2005:3	Change	% Change
Payroll Employment	14,587	14,810	223	1.5
Self-Employed	1,922	2,136	214	11.1
Civilian Employment	16,509	16,947	438	2.7
Labor Force	17,583	17,865	282	1.6
Unemployment Rate	6.0	5.1	-0.9	—

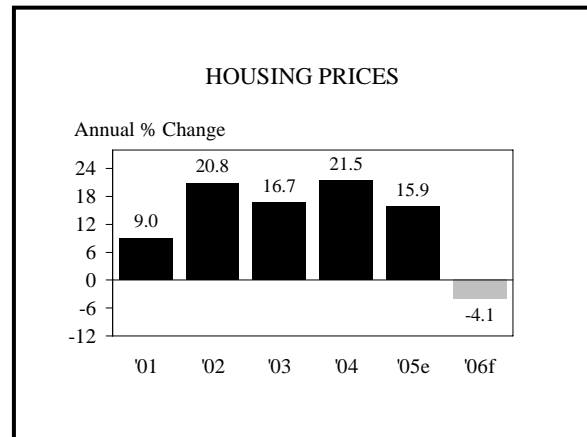
- The strength of the real estate sector is supported by analyzing payroll employment growth. Since the end of the recession in 2001 over 40 percent of the 532,000 new payroll jobs were created in the construction and financial services sectors. Projected higher interest rates will lead to slower job growth in the financial activities, real estate and construction sectors in 2006.

- Overall, we forecast payroll employment to grow by 1.1 percent in 2006 – an increase of 167,000 jobs. The professional & business sectors (2.3 percent), leisure & hospitality sector (2.0 percent), and educational & health services sector (1.7 percent) are forecasted to outperform all other sectors.



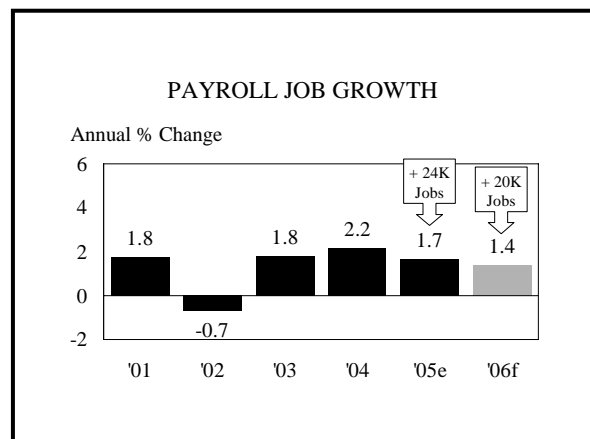
- Slower employment growth is projected to reduce growth in personal income and that, in turn, will negatively impact taxable sales spending. Total personal income is forecasted to increase from an estimated level of \$1,344 billion in 2005 to \$1,418 billion in 2006 – an increase of 5.5 percent. Total taxable sales is forecasted to grow only by 4.7 percent. This is a significant drop compared to growth rates of 8.1 percent in 2004 and 6.5 percent in 2005.

- Over the last three years, economic fundamentals in our model suggested a lower rate of home price appreciation and signaled negative home price appreciation in 2005. Our forecasts of higher long-term interest rates were a contributing factor in underestimating price appreciation. More importantly, positive consumers' psychology continued to be the main driver of housing demand and home sales activity surged in spite of a steady drop in housing affordability.
- With projected increases in interest rates the affordability index, currently at 15 percent, will not improve in 2006. This along with the gradual shift in homebuyers' expectations should lead to a softening of demand throughout the next year. On balance, our model calls for a decline of 4.1 percent in the price of single-family detached homes in 2006.



2006 Orange County Forecast:

- Mirroring our forecast for real GDP in the nation, our forecast for the most comprehensive measure of our local economy, payroll job growth, suggests a continuing slowdown in 2006. After peaking at a 2.2 percent growth rate in 2004, current estimates point to job growth of 1.7 percent in 2005. We are forecasting another drop to 1.4 percent, or the creation of around 20,000 jobs, in 2006.
- Over the last seven years, construction jobs in Orange County have increased a phenomenal 50.5 percent, as compared to 16.5 percent in the U.S.. Moreover, it's likely that a significant portion of the growth in the county's second most rapidly sector, financial activities, was also related to construction via the impact of mortgage activity. Together, these sectors accounted for one-third of all the jobs created between 1998 and 2005. After serving as a major engine of economic growth, the tide should turn by the last half of 2006 when we expect the construction sector will actually begin to lose jobs.



- The overall economic slowdown in the county will extend to taxable sales, which is forecasted to decline from a growth rate of 6.3 percent estimated for 2005 to 5.1 percent forecasted for 2006.
- Building permit valuation is forecasted to drop from \$3.5 billion in 2005 to \$3.4 billion in 2006. The \$100 million decline is expected to occur on the residential side, with nonresidential permit valuation remaining about the same as last year.
- It currently takes 50 percent of a family's income to make a mortgage payment in Orange County but only 20 percent, on average, in the nation. People may be willing to take 50 percent of their income to make a housing payment if they expect appreciation to remain in high gear. Any slowdown in appreciation, however, could seriously erode that expectation and lead to downward pressure on prices.
- Housing appreciation has already receded from its lofty high in 2004, and we are projecting a continuing decline in average annual housing appreciation from 10.3 percent in 2005 to -4.2 percent in 2006.

