Chapman Calls for a Recession in 2008

Orange, CA – The A. Gary Anderson Center for Economic Research at Chapman University released today the results of its 30th annual economic forecast for the U.S., California and Orange County. The forecast was presented to more than 1,200 Orange County business leaders at a conference held at the Orange County Performing Artscenter, Costa Mesa. Following are highlights of the forecasts.

2008 U.S. Forecast:

- The Anderson Center is forecasting a recession in 2008. Although real GDP growth is forecasted to dip to −1.0 and −1.9 in the first and second quarters, respectively, a pick-up in the second half of the year is expected to lead to slow but positive annual growth of 0.9 percent.

- Gains in nonresidential construction are no longer offsetting losses in residential construction. Current estimates point to a decline of $91 billion in total real private construction spending in 2007, and we are projecting an even steeper decline of $125 billion in 2008.

- Much of the recent increase in consumer spending has been financed by households cashing out a portion of their home equity gains by refinancing their loans. But total home equity cashed out is estimated to decline by almost $60 billion in 2007. We are projecting
an additional decline of $130 billion in 2008. The resulting negative hit on consumer spending will be considerable, especially when it is coupled with the impact of higher energy costs on reducing spending.

- The only major positive trend, at least with regard to spending, is a continuation of rapid growth in exports that is forecasted to hit 10.2 percent in 2008. This growth is explained, in part, by the fact that global growth, spurred on by emerging nations, has far outpaced that of the U.S.. In addition, the sharp fall in the U.S. dollar has made U.S. goods and services more competitive in global markets.

- Declines in construction spending, coupled with continued job losses in the mortgage banking industry and other real estate services, will have a pronounced negative impact on job growth. After peaking at 1.9 percent in 2006 and declining to 1.3 percent this year, U.S. payroll job growth is forecasted to drop to 0.2 percent in 2008.

- With the inventory of unsold homes increasing sharply and the confidence level of home builders reaching an all-time low, housing starts are projected to decline for the third consecutive year to approximately 1.1 million in 2008. This would be the lowest level of housing starts since 1991.

- An increase in the supply of homes available for sale (new, foreclosed and resale) points to further declines in housing prices. Following an average decline of 2.1 percent in 2007, home prices are forecasted to decline 4.8 percent in 2008.

- The Fed’s favorite indicator of price change, the core personal consumption expenditures price index, is forecasted to stay within the Fed’s comfort range with core inflation not exceeding two percent until the third quarter of next year.

- It’s too late, however, for Fed action to significantly affect overall spending through the first half of 2008. Lower short-term interest rates are also unlikely to reverse the major negative forces hitting the economy in 2008.

- We are projecting a sharp increase in foreclosures in 2008. Our estimates suggest a loss in bond value holdings resulting from these foreclosures to be roughly $350 billion. This loss in “paper wealth” is expected to lead to a significant decline in consumer spending and to further credit tightening.
• Chapman’s recessionary forecast is buttressed by a number of other leading indicators, including:
  - a drop in the consumer confidence index to below 100,
  - the growing difference in yields between junk bonds and treasuries,
  - a negative dip in the interest rate spread (difference between long-and short-term rates) and
  - a significant increase in the number of banks and financial institutions tightening lending standards.

2008 California Forecast:

• A sharp drop in home sales, decreasing mortgage originations, and subsequent decline in new residential construction are leading to a sharp downturn in jobs in real estate-related sectors. The slowdown in the construction and financial services sectors is indirectly affecting job growth in the retail and wholesale sectors causing broad-based weakness in overall job growth. California's payroll job growth declined from 1.7 percent in the first quarter to 1.1 percent in the third quarter of 2007.

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<th>PAYROLL JOB GROWTH</th>
<th>Yr/Yr % Change</th>
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<td>Los Angeles</td>
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<td>Orange County</td>
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<td>Inland Empire</td>
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<td>San Diego</td>
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<td>Oxnard/Ventura</td>
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<td>Santa Barbara</td>
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<td>California</td>
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• With slowdown in real GDP growth and declining construction spending, the Anderson Center’s California index of payroll employment indicator moves below the critical value of 100 in mid-2008 suggesting job losses in the second and third quarters of the year. On an annual basis, California is forecasted to generate about 12,000 jobs in 2008, an increase of only 0.1 percent.

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<th>PAYROLL JOB GROWTH</th>
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• With such weak payroll job growth and higher unemployment, total personal income will increase at a slow rate of only 3.1 percent in 2008. Income growth, along with darker consumer sentiment is obviously bad news for consumer spending. Total taxable sales is projected to increase at an annual average rate of 2.7 percent in 2008, slightly lower than the projected inflation rate of 2.9 percent.
Sluggish housing demand will extend into 2008. Tighter underwriting standards require potential borrowers to document their income and provide some down payment when purchasing a home or refinancing a mortgage. After five years of loose mortgage financing, lenders and potential borrowers face a new reality. This is reducing the pool of potential buyers. With soft demand and unsold housing inventory at near record level, resale single-family home prices, as measured by the California Association of Realtors, are forecasted to decline by 9.0 percent in 2008.

Total General Fund revenue for California is projected to increase from an estimated level of $98.8 billion in 2007-08 to $100.4 billion in ’08-09 – an increase of 1.6 percent. With expected total expenditure of $111.1 billion in ’08-09 and the Center’s estimated fund balance of only $135 million, the state will face an operating deficit of $10.6 billion in ’08-09.

2008 Orange County Forecast:

Current statistics show that the county generated only 500 jobs in the third quarter of 2007 as compared to the third quarter of 2006. Although the current job numbers will be revised in early 2008, there is little doubt that the economy is hurting from the demise of real estate-related activity.

Construction and financial activities are the weakest sectors of the economy followed by trade, transportation, and utilities which are indirectly affected by the housing market. The government sector, however, has added about 2,600 jobs. Surprisingly, the services sector grew at only 0.9 percent adding 5,800 jobs, feeble growth by historical standards. The dismal performance of the services sector is largely attributable to weak growth in the professional and business services sector, traditionally one of the strongest segments of Orange County’s economy.
Over the 2001-06 period when home prices appreciated annually at double-digit rates, we argued vigorously that the economic fundamentals (i.e. income, job growth, and mortgage rates) did not justify the historically high levels of housing demand and home price appreciation. Since 2001, Orange County created about 119,000 payroll jobs. With the exception of 2003, however, most of the new jobs were in below-average salary sectors while the jobs lost in 2002 were in higher-paying sectors.

With sluggish income growth and rapid home price appreciation, housing affordability index deteriorated sharply since 2002. In 2006, a potential homebuyer with median family income of $76,300 needed 49.9 percent of family income to purchase a median single-family home, even after taking into account the tax savings of deducting mortgage interest and property taxes.

The recent decline in short-term interest rates will not remedy borrowers' problems who are facing interest rate resets on their mortgages. Notices of defaults and foreclosures will continue to be around for a while. With weak housing demand and high level of inventory, our forecast calls for a decline of 8.1 percent in the resale single-family home prices in 2008.

The previous downturn in the housing market in the early 90’s was not short-lived. In Orange County, home prices declined for 54 months from the peak to the trough, decreasing 17.7 percent. It took another 51 months for the median price to reach back to its previous peak. A similar pattern occurred in many other regions of the state. Although there were significant job losses in the 90’s that sharply reduced demand for housing, in the current cycle, there is a different problem: a lack of housing affordability. Not only that, the job market is beginning to weaken considerably.
The combination of these factors suggests that the county is facing a multi-year downward spiral in home prices.

- Our forecast points to job growth on a quarterly basis to turn negative beginning the second quarter of 2008 and remain negative through the third quarter of the year. This trend indicates that the county will experience recession, based on our definition. In annual terms, the forecast calls for a loss of 2,400 jobs in 2008.
ABOUT THE ANDERSON CENTER FOR ECONOMIC RESEARCH

The A. Gary Anderson Center for Economic Research (ACER) was established in 1979 to provide data, facilities and support in order to encourage the faculty and students at Chapman University to engage in economic and business research of high quality, and to disseminate the results of this research to the community.

ANNUAL SCHEDULE OF CONFERENCES AND PRESS RELEASES

JANUARY  › Economic Forecast Conferences for Los Angeles County and the Inland Empire
           › California Purchasing Managers Survey
FEBRUARY  › California Leading Employment Indicator
MARCH     › California Consumer Sentiment Survey
APRIL     › California Purchasing Managers Survey
MAY       › California Leading Employment Indicator
JUNE      › Economic Forecast Update Conference for the U.S., California, Orange and Los Angeles counties, and the Inland Empire
           › California Consumer Sentiment Survey
JULY      › California Purchasing Managers Survey
AUGUST    › California Leading Employment Indicator
SEPTEMBER› California Consumer Sentiment Survey
OCTOBER   › California Purchasing Managers Survey
NOVEMBER  › California Leading Employment Indicator
DECEMBER  › Economic Forecast Conference for the U.S., California and Orange County
           › California Consumer Sentiment Survey