The Chapman University Economic Forecast for the U.S. and Los Angeles County

Los Angeles, CA — The A. Gary Anderson Center for Economic Research at Chapman University released today the results of its 14th annual economic forecast for the U.S. and Los Angeles County. Following are forecast highlights.

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 Los Angeles County Forecast:

• Since the end of the recession in late 2001, Los Angeles County lost 32,000 payroll jobs – a decline of 0.8 percent. In contrast, payroll employment grew by 1.7 percent in California and the nation, and 5.8 percent in Orange County over the same period.
Education & health services along with leisure & hospitality sectors generated the largest number of new payroll jobs and were the fastest growing sectors. The construction and financial activities sectors combined created 27,000 jobs. In fact, 26 percent of new payroll jobs were generated in the real estate related sectors. Manufacturing, the weakest sector of the local economy, lost 98,000 payroll jobs — a decline of 17.1 percent.

The Chapman Employment Indicator Series shows a gradual and steady decline from the third quarter of 2005 to the fourth quarter of 2006. Payroll employment growth is expected to follow a similar trend with year-over-year quarterly changes to decline from a growth rate of 1.0 percent in the fourth quarter of 2005 to 0.6 percent in the fourth quarter of 2006.

In annual terms, we forecast payroll employment to increase by 0.8 percent in 2006, creating 32,000 new jobs. Job growth in leisure & hospitality, information, and professional & business services sectors will outpace growth in the other sectors of the economy.

Weak job creation will reduce growth in personal income which, coupled with higher interest rates, will negatively affect consumer spending. As a result, total taxable sales is forecasted to increase by 4.4 percent in 2006 compared to an estimated growth rate of 6.1 percent in 2005.

Rapid increases in home prices are sharply reducing housing affordability in the county. In fact, only 13.0 percent of households in Los Angeles County can now afford to buy a median-priced home. Homebuyers have used creative financing such as interest-only loans and adjustable mortgages to purchase homes that they could not have afforded using traditional financing. Increases in short-term rates are making these alternative mortgages more expensive, further deteriorating affordability.
Our forecast calls for the rate of housing appreciation to fall sharply in the first quarter of 2006 and turn negative beginning the second quarter of this year. On an annual basis, we are forecasting a decline in the median detached single-family resale home prices from an estimated 17.7 percent in 2005 to -5.1 percent in 2006.