ECONOMIC FORECAST

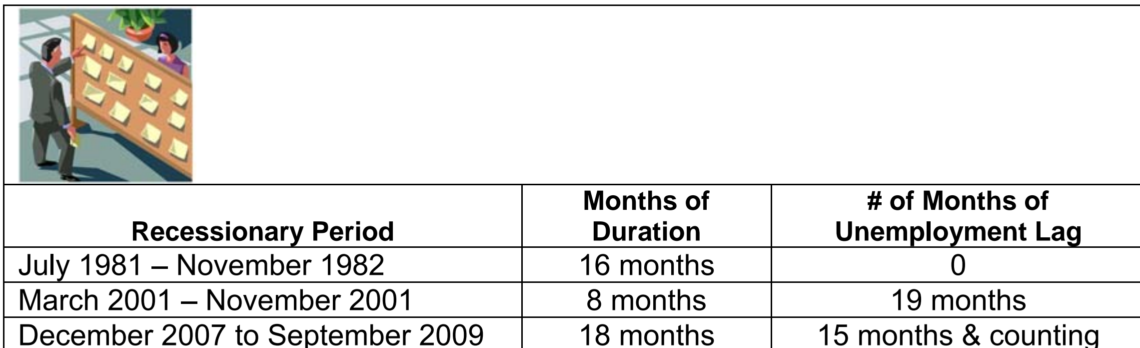
General Economy

The current recession officially ended in June 2009, according to the National Bureau of Economic Research (NBER), a private nonprofit research organization founded in 1920 that studies the science and empirics of economics, in particular the American Economy. The NBER, well-known for providing start and end dates of US recessions, made the announcement in September of 2010. Public sentiment remains cautious as the economic pain of lagging recovery continues to be felt.

Unlike other recessions that typically impacted a specific market or industry (e.g. finance, technology, aerospace), this recession cut across the board. There were deep impacts to housing markets, the construction industry, financial markets and manufacturing. The resulting fallout was seen in the high number of housing foreclosures, significant increases in unemployment and drops in household incomes.

Economic data released in November 2010 was positive, supporting predictions that recovery has begun. There were reported increases in auto registrations, median home prices and earnings. Additional good news related to declines in notices of default and the announcement by some banks agreeing to a moratorium on foreclosures until the current process is evaluated and possibly revised. Negative indicators included a significant drop in home sales and unemployment rates that continue to remain flat or rise slightly.

It is typical for employment recovery to lag the marked end of a recession as it takes time for industry and business to gear up and hire, once confidence is established. Unemployment on average does not began to rise until three to ten months after the beginning of a recession and continues to rise after a recession ends. At the national level, it takes an average of three to four years for employment to reach the prior peak level once a recession has ended. The chart below summarizes the length of past recessions and the average number of months after the recession before unemployment numbers began to trend down:

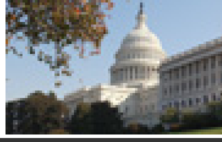


Recessionary Period	Months of Duration	# of Months of Unemployment Lag
July 1981 – November 1982	16 months	0
March 2001 – November 2001	8 months	19 months
December 2007 to September 2009	18 months	15 months & counting

Sources: NBER and Organization for Economic Cooperation and Development

Recent economic forecasts by the A. Gary Anderson center for Economic Research (Chapman University), the Institute of Environmental & Economic Studies (California State University Fullerton) and the UCLA Anderson Forecast all predicted that recovery has begun, but that recovery will remain sluggish through 2011 and into 2012.

National Economy



The U.S. Congressional Budget Office's monthly budget review for October 2010 was a mix of good news/bad news. Although there is improvement in the National budget, and signs of economic recovery, there are still significant imbalances that create concern.

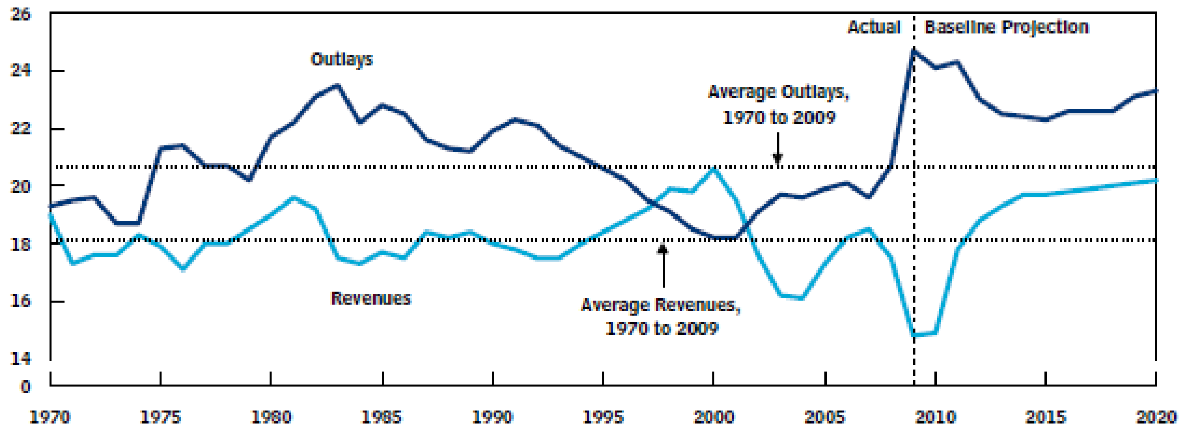
The total federal budget deficit for FY 2009-10 was $122 billion less than the FY 2008-09 deficit and fell from a 10% share of gross domestic product (GDP) to 8.9%. The problem is that the current deficit is still $1.3 trillion, and is the second-highest deficit as a percent of GDP since 1945. The Congressional Budget Office attributes the deficits to the following:

- Imbalance between revenues and spending, predating the current recession
- Sharp drop in current revenues offset by current elevated spending, and
- Costs of federal policies implemented in response to the economic condition

Receipts did increase by 3% from 2009, the first increase in three years; however, revenues are still 16% below their peak reached in FY 2006-07. Total revenues last fiscal year and current year to date are 14.9% of GDP, the lowest share since 1950. In contrast, current Federal spending as of October 2010 was 23.8% of GDP, the second highest amount since 1946. The positive news is that current spending has decreased 2% from prior fiscal year spending which ended at 25.0% of GDP. Key areas of increased spending included unemployment benefits which were 33.3% higher than the prior year and net interest on public debt which increased from 1.4% of GDP to 1.6% of GDP.

Federal stimulus programs including "Cash for Clunkers" and the "Homebuyers' Credit" created a temporary uptick in consumer spending and housing purchases. Home sales and other consumer spending are once again flattening out or decreasing as stimulus programs expire.

The following chart, prepared by the Congressional Budget Office, summarizes historical and forecasted National revenues and expenditures as a percentage of GDP. The gap between the two is projected to widen between now and 2020.



There has been overall economic growth at the National level since the recession ended. Per the Institute for Economic and Environmental Studies, growth since September 2009 has averaged 2.6%, "far below the 5.6% rate over the equivalent period after the 1981-1982 recession." Due to the drag on the economy posed by unemployment, the Congressional Budget Office and economists are still forecasting a long, protracted recovery.

California Economy

"*Two years after the nation fell into the longest recession since the 1930s, states are still groping to find the bottom of this grueling fiscal crisis amid double-digit unemployment, historic revenue drops and predictions of at least a couple more years of eye-popping budget deficits.*" – Susan Urahn, Managing Director, Pew Center on the States

Of all the States, California's fiscal troubles are probably the most widely known, with economists and media pondering whether California has reached the brink of insolvency. The state has a long history of budget deficits with deficits growing annually. Budget gaps are generally offset by the use of one-time sources, reserve draws and other one-time fixes. Additionally, lawmakers have not enacted set asides of 5% of general funds as permitted by law. In general, California is being run with risky practices and the persistent structural deficit is likely to continue for years to come.

From first quarter 2008 to first quarter 2009, State revenue declined 16.2%. The good news is that as of October 2010, revenue receipts were up 2.7% compared to the same period last year and year-to-date receipts are 0.9% above amount budgeted. Over 80% of general fund revenue comes from taxes on personal income and sales, both of which report initial signs of growth after experiencing significant declines related to

unemployment and changes in the housing market. Temporary increases in income tax withholding, sales tax and vehicle license fees are set to expire in 2011 which will lower revenue if not re-enacted.

The California economy and revenues continue to be impacted by changes in the housing market. Home values, while increasing, are still well below their peak. Initial increases in sales appear to be turning downward again. In 2009, foreclosures in California were the fourth highest in the nation. Unemployment has grown from 4.8% in September 2006 to 12.2% as of September 2010. Growth in earnings has not been significant enough to encourage growth in spending. All of this, coupled with new citizen-based legislation related to taxes and fees, creates continued uncertainty regarding how quickly revenue will rebound, and to what degree.

"Since the late 1990s, spending has on average increased by more than the rise in State population or inflation." (California Department of Finance, 2009)

Per the State Controller, October 2010 fiscal year to date expenditures were $768 million higher than anticipated; however this was the result of timing. Cash flow borrowing was completed early, allowing for timely payment of planned deferrals.

The Governor signed the FY 2010-11 State budget on October 8, 2010. At the time, the budget included $18.3 billion in deficit solutions, with only a $0.2 billion decrease in baseline workload adjustments. $7.5 billion in general fund spending was shifted to special funds, equivalent to a 32.3% spending increase by special funds. In November 2010, the Legislative Analyst's Office (LAO) released their analysis of the FY 2011-12 fiscal outlook. The LAO forecasts that the State must address a $25.4 billion budget gap between now and the date that the legislature enacts the FY 2011-12 budget. The $25.4 billion gap includes a current year projected deficit of $6 billion and a $19 billion gap between projected revenues and spending in FY 2011-12. The LAO further projects that the State faces annual deficits of approximately $20 billion per year through FY 2015-16. This gap will increase in FY 2012-13 when the State must repay borrowing of local property tax revenues and the full effect of Propositions 22 and 26 begins. The chart below summarizes the LAO projection for the current and next fiscal year.

LAO Projection of General Fund Condition if No Corrective Actions Are Taken

(In Millions)

	2009-10	2010-11	2011-12
Prior-year fund balance	-$5,375	-$5,371	-$4,591
Revenues and transfers	87,041	93,284	83,530
Expenditures	87,037	92,505	102,756
Ending fund balance	**-$5,371**	**-$4,591**	**-$23,817**
Encumbrances	1,537	1,537	1,537
Reserve[a]	**-$6,908**	**-$6,128**	**-$25,354**

[a] Special Fund for Economic Uncertainties. Assumes no transfer to the state's Budget Stabilization Account.

The LAO projections do not fully account for increasing unfunded liabilities and do not include cost of living adjustments in current departmental budgets. The LAO office has

acknowledged that the projection probably does not account for the full magnitude of fiscal impacts. The LAO, in promoting action now is quoted, "*Without immediate action to begin tackling the structural deficit for the long term, the state may not be able in the foreseeable future to move beyond its current stumble from one terrible budget problem to the next. As such, it will continue to be difficult for the state to address fundamental public sector goals – such as rebuilding aging infrastructure, addressing massive retirement liabilities, maintaining service levels of high-priority government programs, and improving the state's tax system.*"

Orange County Economy

Economic impacts have been deeper for many States and localities, while others have felt less of an impact. The following chart summarizes three key economic indicators for Orange County and peer Counties as of September 2010. Orange County reflects more positive numbers with the exception of foreclosures, where the County currently has the highest ratio of foreclosures to number of households.

	Foreclosure Statistics		Employment Statistics		
	Number of Households	Foreclosures	Total Labor Force	% Unemployment	Median Household Income
Los Angeles County	3,385,944	1 in 261	4,911,087	12.5%	$55,811
Orange County	**1,035,210**	**1 in 284**	**1,607,983**	**9.6%**	**$76,412**
Riverside County	769,138	1 in 118	911,540	15.3%	$58,464
San Bernardino County	687,352	1 in 114	856,713	14.2%	$56,367
San Diego County	11,138,388	1 in 245	1,569,015	10.6%	$64,890
Sources: Realty Trac, Inc. & U.S. Bureau of Labor Statistics					

Overall, October and November 2010 economic statistics for the County were positive. Manufacturer and consumer sentiment both climbed, indicating gaining confidence. It appears that Orange County may have reached the bottom of the trough and is headed for a period of growth. The October 2010 release of the UCLA Anderson Forecast indicated that economic activity is increasing in a number of sectors including manufacturing, professional, scientific, technical and hospitality services. According to the forecast, the growth in Orange County has been more rapid than the State as a whole.

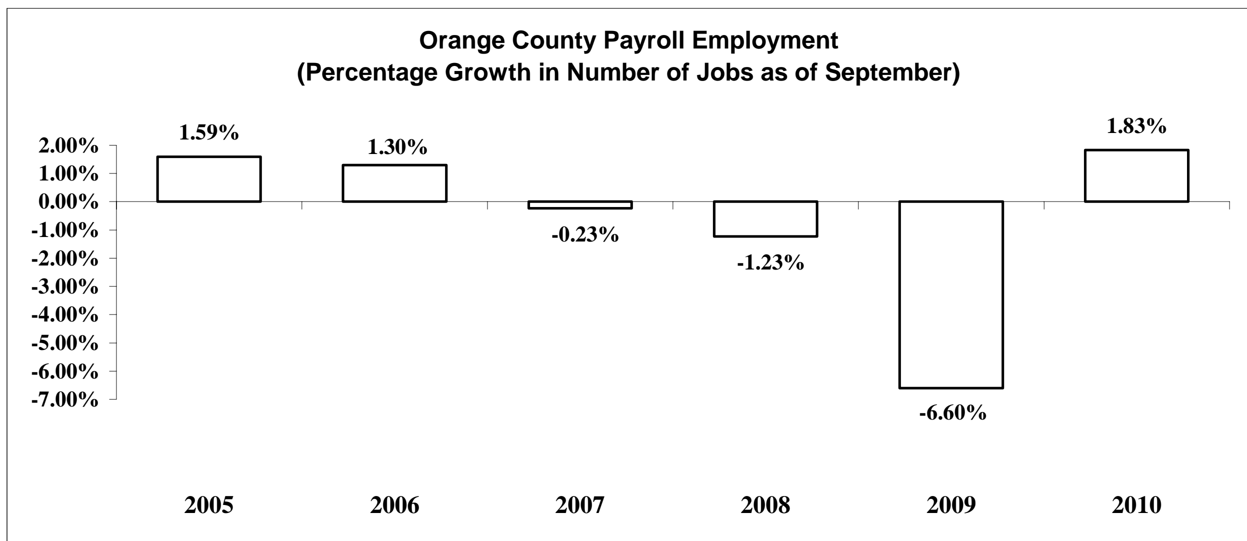
A review of recent trends in key indicators of the local Orange County economy is presented below:

Employment – UCLA reported that job creation has been positive in the County for most of the 2010 calendar year, with 24,500 private sector jobs created since January 2010. They cautioned that this is well below levels expected and the current pace of job creation will not materially lower the unemployment rate over the next six months.

Cal State Fullerton reports were not as positive, focusing on the number of jobs lost, 110,158 in 2009 alone. They also report that business expectations remain wary, and project a slower rate of expansion and hiring over the next six months.

Orange County unemployment rate was 9.6% as of September 2010, level with the National rates and well below State levels which were reported at 12.2%. In April 2010, unemployment dropped from 10.1% to 9.5% and has been at or near that point, with no significant rise since. Peer Counties are experiencing higher rates of unemployment (Los Angeles @ 12.5%, Riverside @ 15.3%, San Bernardino @ 14.2% and San Diego @ 10.6%). With the exception of Santa Barbara and Napa Counties, Orange County is the only county in California with unemployment below 10%.

Payroll Employment is a measure of the number of people being paid as employees by non-farm establishments and units of government. Monthly changes in payroll employment reflect the number of net jobs created or lost:



Source: California Employment Development Department

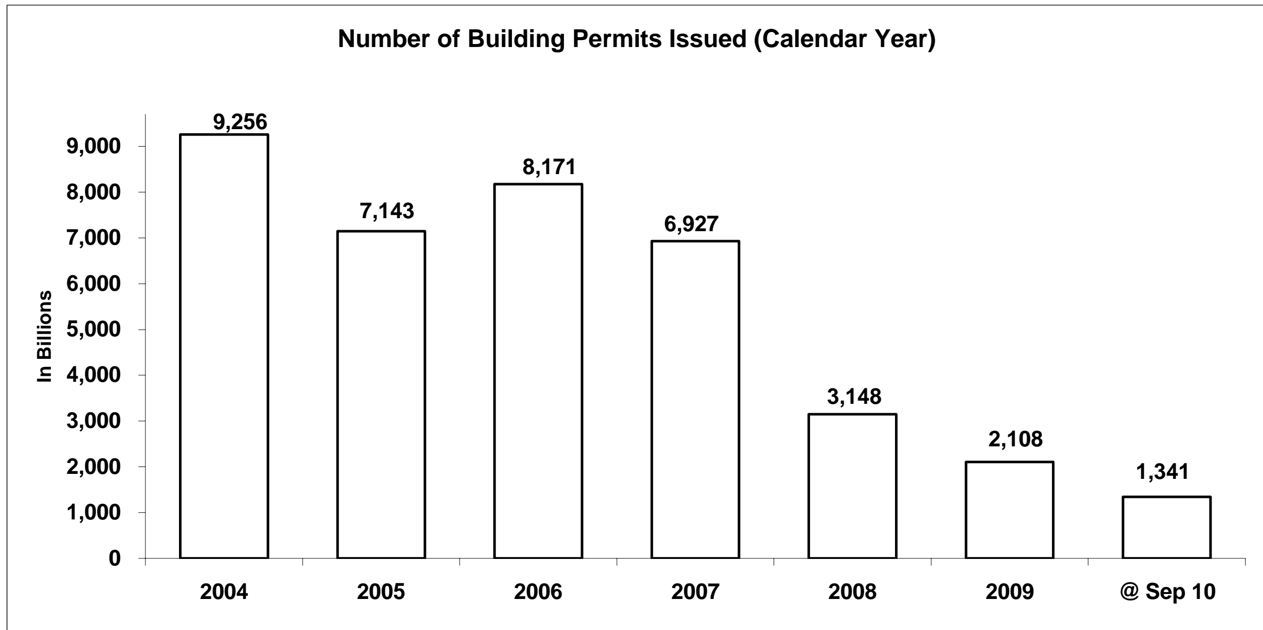
Housing – According to DataQuick, "Today's market can be characterized as much by activity that's not happening, as by the activity that is." DataQuick reports that we're still seeing distress-selling, bargain-hunting and entry-level buying with the rest of the market on hold. Key indicators released by DataQuick in October (see chart below) show a decline in sales volume for the County. There was a small uptick in the median price for the same period.

	Sales Volume			Median Price		
All homes	**Oct-09**	**Oct-10**	**%Chng**	**Oct-09**	**Oct-10**	**%Chng**
Los Angeles	7,409	5,470	-26.2%	$325,000	$325,000	0.00%
Orange	2,800	2,298	-17.9%	$436,500	$438,000	0.30%
Riverside	4,197	3,264	-22.2%	$190,000	$198,000	4.20%
San Bernardino	3,176	2,343	-26.2%	$150,000	$150,000	0.00%
San Diego	3,671	2,750	-25.1%	$325,000	$334,500	2.90%
Ventura	879	619	-29.6%	$365,000	$355,000	-2.70%
SoCal	**22,132**	**16,744**	**-24.3%**	**$280,000**	**$283,000**	**1.10%**

Source: DQNews

The Orange County Tax Assessor released a preliminary projection that the FY 2011-12 Assessed Roll of Values will grow by +/- 1%. The State LAO is projecting that housing markets will continue to create drag on the economy, with weak and minimal gains in pricing through 2016. While housing is now more affordable, credit remains tight and there are still a high number of foreclosure units that have not yet hit the market. As property taxes are approximately 74% of General Purpose Revenues, real estate activity has a significant impact on County recovery and growth.

Building Permits Issued are an indicator of strength within the housing sector. As noted in past Plans, future construction of single family homes will be limited as the amount of available land diminishes and the County transitions toward high density, high-rise buildings. Year-to-date permits as of September 2010 were 13.7% below the same period last year, but are 15.4% higher than the same period in 2008, indicating a turning in the construction market.



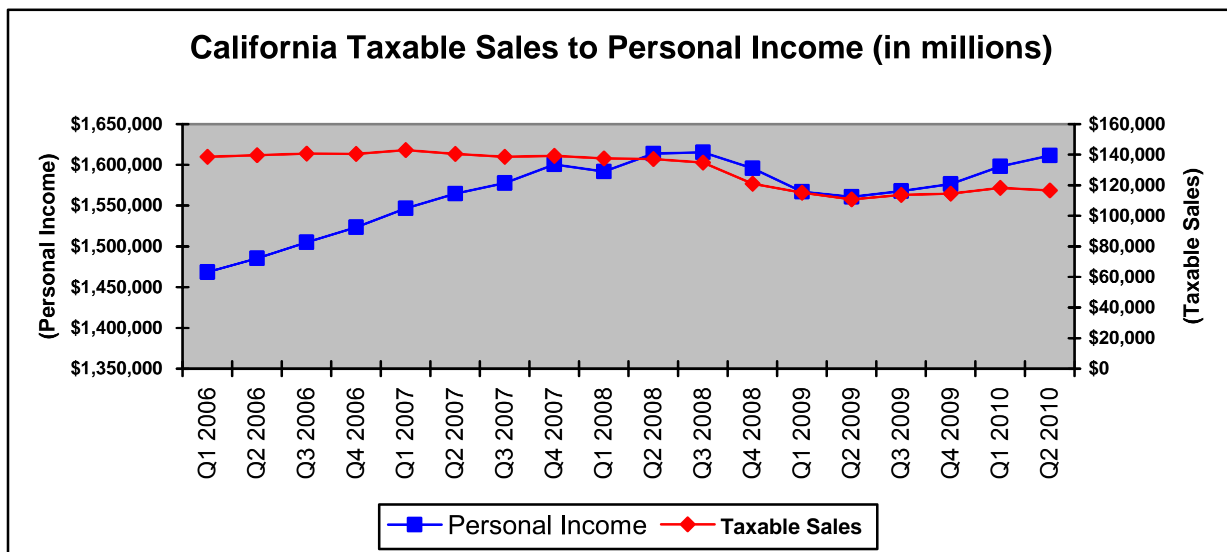
Source: U.S. Census Bureau

Taxable Sales – Taxable sales represent consumer spending transactions that are subject to sales and use taxes. The California Board of Equalization (BOE) reports sales on a quarterly basis, generally two quarters in arrears (The Department of Finance provides monthly projections two months in arrears). Taxable sales provide an indication of economic activity and drive County funding sources such as General Purpose Revenue sales taxes and General Fund Department sources such as Proposition 172 ½ Cent Sales Tax and a portion of Realignment Revenue. After steep drops the last two fiscal years, there are recent signs of growth in taxable sales. It should be noted that current year growth has been relatively low and receipts are still significantly below amounts realized in 2005.

Qtr 3 of Year	Taxable Sales (Billions)	Percent Change
2010 (F)	$12.83	3.3%
2009	$11.57	-15.2%
2008	$13.64	-4.3%
2007	$14.26	-2.1%
2006	$14.57	2.8%
2005	$14.17	9.2%
2004	$12.98	5.7%
2003	$12.28	8.1%
2002	$11.36	3.5%
2001	$10.98	-2.7%

Source - State Board of Equalization thru 2009
2010 Chapman Forecast (F)

Taxable Sales tend to decline when personal income declines. Over the last three calendar years, with increases in unemployment, and tightening of credit markets, the percentage of taxable sales to personal income has decreased, indicating that consumers remain cautious. In fact, the Federal Reserve Bank recently announced that consumers, both individuals and enterprises, are saving at rates comparable to those after the Great Depression. The chart below summarizes trends between taxable sales and personal income for the State of California. Data is not currently available for Orange County.



Conclusion

As projected in the 2009 SFP, recovery appears likely to pick up steam sometime in 2011, but is not anticipated to grow at a significant pace for at least another 18 to 24 months. Unemployment, the continued drag of housing markets and weak financial position of consumers has the potential to create long-term stress on County revenues, in particular property taxes, sales taxes, Public Safety ½ Cent Sales Tax (Prop 172) and Health & Welfare Realignment revenues.

Overall, the County appears to be in better growth position than the State and peer counties; however, it is still too early for the County to relax cautionary fiscal policy. Growth in ongoing expenditures such as salaries and benefits is likely to outpace revenues over the next five years and beyond. That coupled with what is expected to be slow or moderate economic growth, sets the stage for a continued need to make hard choices in order to ensure funds are available to meet critical services needs. Hope for the best, but stay the course, to ensure the County is poised to weather a slow recovery without sacrificing the quality of services our citizens expect.