

EastBay

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ECONOMIC OUTLOOK

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**Authored by the
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The East Bay Report

Ryan Ratcliff

Summary

So far, 2008 has not been kind to the East Bay. Overall job growth has turned negative, homes sales are at record lows, and foreclosures continue to depress home prices. New employment estimates released last month have dramatically altered our picture of the Oakland MD in 2007. The good news: real estate related job losses were much smaller than preliminary estimates. Unfortunately, East Bay specialties like high-tech manufacturing and Education / Health Care are significantly weaker in the revised estimates, to the point where the bad news in non-real estate industries slightly outweighed the upward revision to real estate sectors. Instead of our previous story where the East Bay economy was a tug of war between real estate weakness and small gains in other sectors, these new estimates paint a more troubling picture for the East Bay: real estate weakness concentrated mostly in mortgage-related Financial Activities, coupled with a general malaise in local specialty sectors that are only indirectly tied to real estate. While it may be true for the state as whole, in the East Bay, what happens in real estate doesn't seem to be staying in real estate.

Looking forward, there's no relief in the immediate future. Real estate job loss will continue to be the main source of weakness for the rest of the year. The East Bay's Construction sector will fare better than most, but its Financial Activities sector will continue to be among the hardest hit in the state. This suggests that while real estate's impact on jobs may be less in the East Bay than elsewhere, the concentration of losses in the higher paying Financial Activities sector will mean an above average hit to personal income and local output. Other East Bay specialty industries have a similarly gloomy outlook. Silicon Valley's high-tech manufacturing sector experienced an impressive spurt of job growth in 2007, yet similar industries in the East Bay continued to lose jobs. California's coming budget crisis suggests further weakness in both the Education / Health Care and Government sectors, which had propped up recent job growth. The one silver lining in all this gloom is the steady growth of traffic through local ports, but we have yet to see this traffic result in bounty of new jobs. The stagnation we've seen so far in 2008 should continue through the rest of the year, but should not get significantly worse. We look to see some improvement at the end of the year, with 2009 seeing a return to normal growth

East Bay Job Market Update

With the recent release of the benchmark revisions to California's employment statistics, we can finally close the book on 2007. For California as a whole, the revised numbers for 2007 were worse than previous estimates, but did not contain any big surprises. Estimates of seasonally adjusted non-farm payroll growth in California between December 2006 and December 2007 were almost cut in half, revised from 78,800 (0.5%) down to only 40,700 (0.2%) – still positive, but just barely. Unfortunately, the new numbers show an outright decline in payroll employment through the second half of 2007, with January 2008's level of non-farm

payroll employment down 0.3% from its peak in July 2007. California job growth started decelerating in the summer of 2006, rather than in the spring of 2007, as the previous estimates indicated. This change in timing was almost entirely due to real estate related employment, with the slump in the Construction and Financial Activities sectors coming much earlier than we previously appreciated.

Figure 1: Year-over-Year Growth in CA Non-Farm Payroll Employment

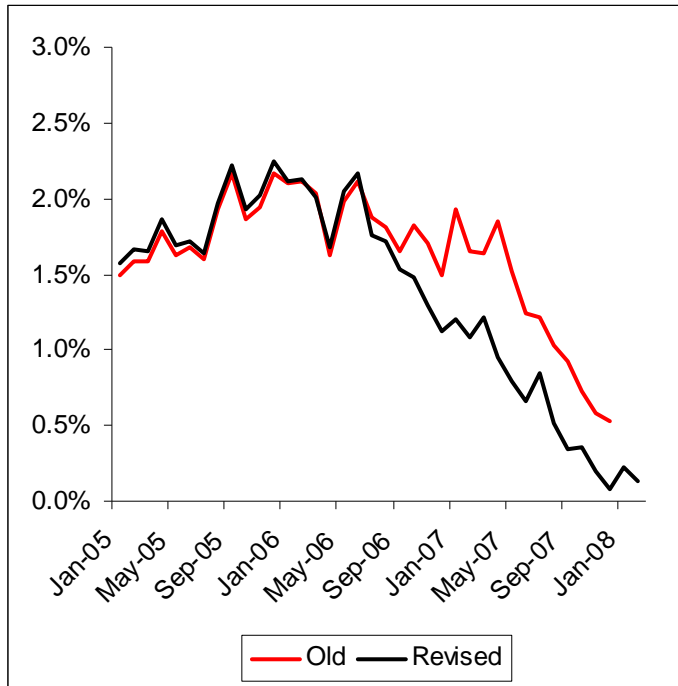
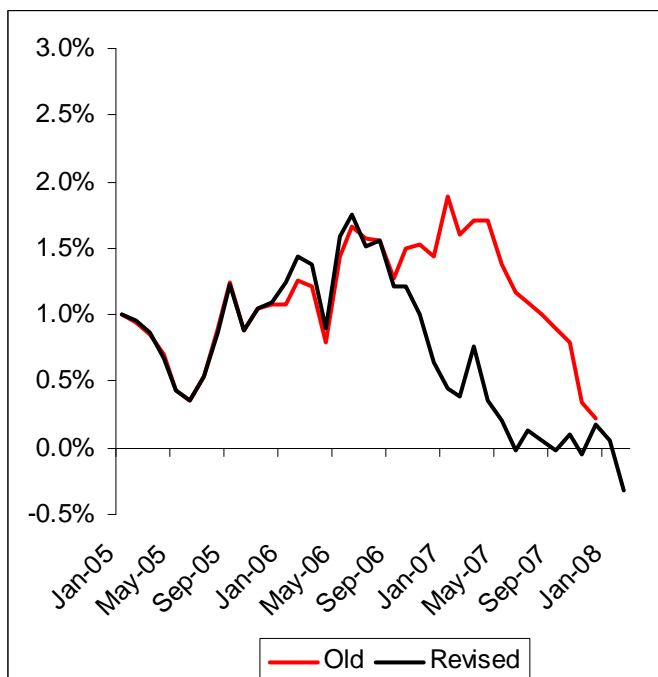


Figure 2: Year-over-Year Growth in Oakland MD Non-Farm Payroll Employment



The East Bay / Oakland MD received one of the most surprising metro-level revisions. At first glance, the overall outcome was very similar to California. Like California, the decline in real estate related employment was moved forward from the spring of 2007 to the summer of 2006. As a result, the new figures suggest that East Bay has seen virtually no job growth over the past 12 months. The surprising parts of these revisions are at the sector level. Previous estimates suggested that the East Bay's job growth was essentially a stalemate between real estate job losses and internally-oriented service employment growth (Education / Health Care, State and Local Government, etc.). According to the old estimates, from December of 2006 to December of 2007 Construction lost 7,400 jobs and Financial Activities lost 3,700 jobs. Over the same period, these losses were offset by the three big sources of job gains in the East Bay: Government (+5,500), Education and Health Care (+4,000), and Leisure and Hospitality (+2,000).

However, a closer look at March revisions reveals that the microcosm story no longer fits the data – in the new estimates, the most remarkable thing is how different the sectoral patterns of job growth are in the East Bay, relative to the state as a whole. Figure 3 shows 2007's percentage growth in the major employment sectors in the East Bay versus California. Some of these differences are good news for the East Bay. Ironically, the biggest positive revision was in Construction, which was not nearly as weak as we thought: instead of losing 7,400 jobs over 2007, the job loss in the East Bay Construction sector was revised to only 400, largely thanks to much smaller losses among subcontractors. This amounts to a -0.5% decline in 2007, compared to the -6.5% decline experienced in the state as a whole. In the 2008Q1, we have seen Construction losses increase, with Construction employment in March 2008 down 4,200 jobs relative to March of last year. Not surprisingly, these losses were concentrated in Residential Building Construction (-1,500) and Specialty Trade Contractors (-1,300). But even categories with little exposure to residential construction have lost jobs: Nonresidential Building Construction and Heavy and Civil Engineering Construction categories together lost another 1,000 jobs relative to March of last year. But even with these more recent losses, Construction employment in the East Bay is doing surprisingly well given the decline in building activity.

Other sectors where the East Bay is noticeably outperforming the rest of the state include Retail Trade (which grew by 0.6% while California suffered a -1.3% decline) and the Government sector (which grew at 3.5% in 2007, compared to 2% for the state as a whole). Food/Beverage and General Merchandise/Department Store employment were the major sources of strength in the East Bay Retail Trade, while local government hiring in education made the difference in the Government sector, growing at 7.5% over 2007.

Figure 3: Percentage Change in Payroll Employment, Dec '06 to Dec '07 (Revised Estimates)

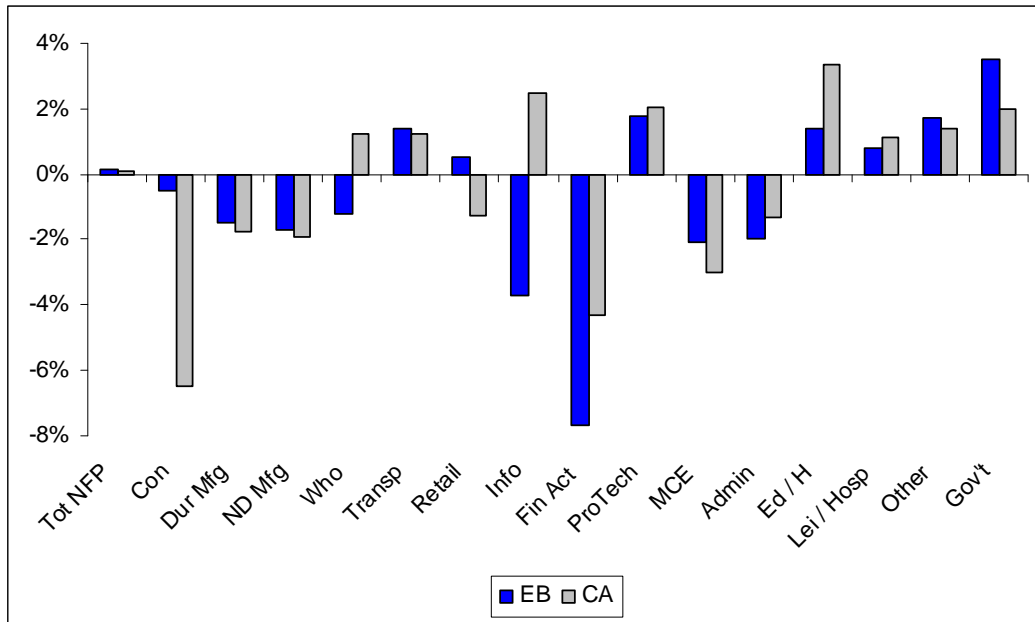
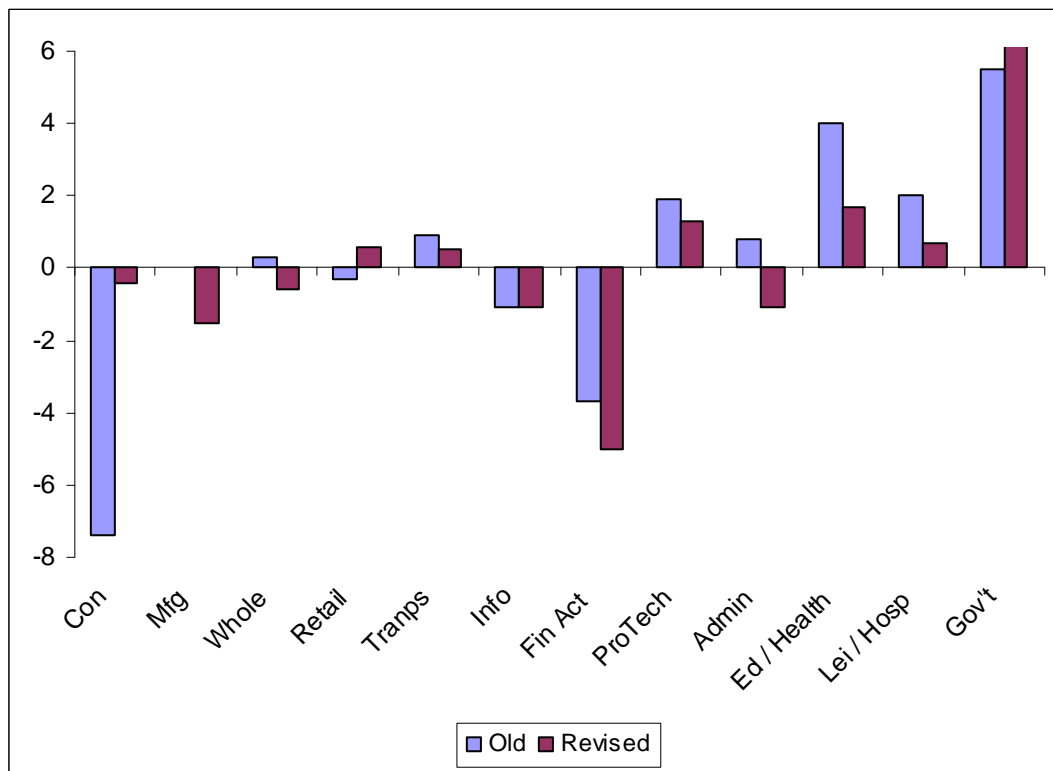


Figure 4: Change in Oakland MD Payroll Employment, Dec '06 to Dec '07 (Old Estimates vs. Revised Estimates, 1000s)



Unfortunately, for every sector that has outperformed the rest of California, there is another sector where the East Bay has been weaker. Estimates of Financial Activities job losses over 2007 in the East Bay were increased from -3,700 to -5,000, which translates to a -7.7% decline, compared to a -4.3% decline in California as a whole over the same period. In terms of the total decline in Financial Activities employment since the peak, these new estimates put the East Bay second to only Orange County. A large part of this comes from the East Bay's often underappreciated role as one of the centers of mortgage finance in California. We can use the idea of a "location quotient" to measure the concentration of employment in a local industry by comparing its share of local employment to the industry's share of national employment. Generally speaking, a location quotient over 2 represents a high degree of specialization in an industry. According to the 2006 Quarterly Census of Employment and Wages, Orange County had a location quotient of 3.63 for Real Estate Credit (non-bank mortgage lending), while Contra Costa location quotient for Real Estate Credit was 2.46, compared to only 1.6 in San Diego and 1.5 for California as a whole. Alameda County's is 0.47. Similarly, job losses in the Real Estate, Rental and Leasing sector have also hit the East Bay harder than most, thanks to Contra Costa County's above average concentration of both Real Estate Agents (location quotient of 1.95) and Real Estate Appraisers (2.07). While this above average exposure to real-estate related finance weakness is a big part of the story, the East Bay has unfortunately also experienced losses in locally concentrated financial sectors that are less directly related to the housing bust. Almost all of the negative revision to the Financial Activities sector came in the Insurance Carriers and Related Industries category. The EDD data isn't disaggregated enough to be more specific than that, but both health insurance and pension funds are local specialties that fall in this category.

With 2007's estimated real estate related job loss more than cut in half, we might expect the East Bay to be looking a lot better than we thought last quarter. Unfortunately, this good news from the real estate sectors was accompanied by downward revisions to just about every other East Bay employment category. Two sectors that are especially important to the East Bay economy received major negative revisions. Computer and Electronics Manufacturing had originally looked like it was contributing to small positive job gains in Durable Goods Manufacturing in 2007, but growth in this industry ended up being revised from +500 to -900. Similarly, the old estimates consistently identified the Education and Health Care sector as one of the biggest consistent sources of East Bay job growth in the past two years. However, the new estimates reduced 2007 job growth in this industry by 2,300 jobs (over 50%) as estimates of growth in non-government Education employment were reduced by 1,600 jobs. Administrative Services and Leisure and Hospitality also saw significant negative revisions of -1,900 and -1,500, respectively. Taken together, these revisions are bad news for the East Bay economy. Instead of our old story of a tug of war between real estate weakness and growth in local specialties, the new estimates suggest that real estate weakness was not as bad as it looked previously, but that several of the East Bay's specialty industries are also weaker than we previously appreciated.

Elsewhere in the Bay Area...

In the other Bay Area metros, the revisions to 2007's employment numbers were much less newsworthy. In the San Francisco MD, job growth in 2007 was revised up from 15,500 (1.6%) to 19,500 (2.0%), with most of the new growth coming from Construction and Leisure and Hospitality, where estimates of 2007 job growth were revised up by 1,800 and 2,500 jobs, respectively. The San Jose MSA revisions went exactly the opposite way: there was little change in overall job growth in 2007 (revised down to 10,400 from 12,800), but with some significant changes in sector level growth. In contrast to the East Bay, the San Jose MSA got major upward revisions in high tech sectors. Estimates of job growth in Durable Goods Manufacturing were more than doubled, from 2,300 to 5,400 new jobs in 2007, with most of the new jobs coming in the Computer and Electronics Manufacturing category. These impressive gains in high tech manufacturing are a stark contrast to the continuing slow bleed we see in the East Bay and the rest of California. Similarly, the new estimates of job growth in the Information sector were also more than double the previous estimates (2,300 vs. 900). However, the good news from high tech sectors was almost entirely offset by the big negative revision to Leisure and Hospitality employment in San Jose: job growth in this sector was revised from +2,200 to -500. Thus, the positive gains in high tech were wiped out by negative revisions to other sectors, leaving us with the same basic story as before: San Jose's economy is growing noticeably slower, but remains one of the bright spots in the California economy.

Figure 5: Change in San Francisco MD Payroll Employment, Dec '06 to Dec '07 (Old Estimates vs. Revised Estimates, 1000s)

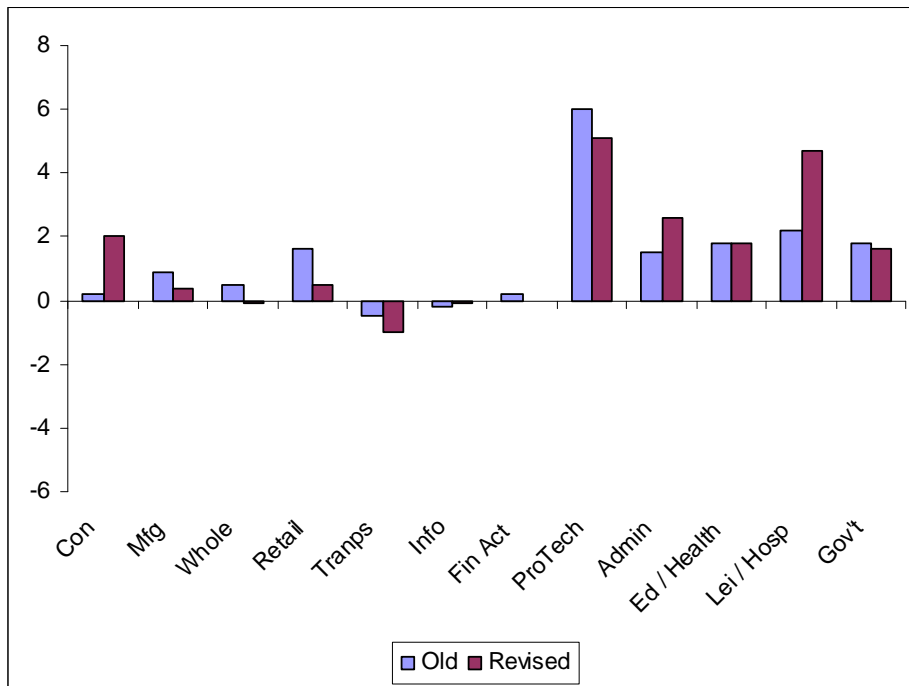
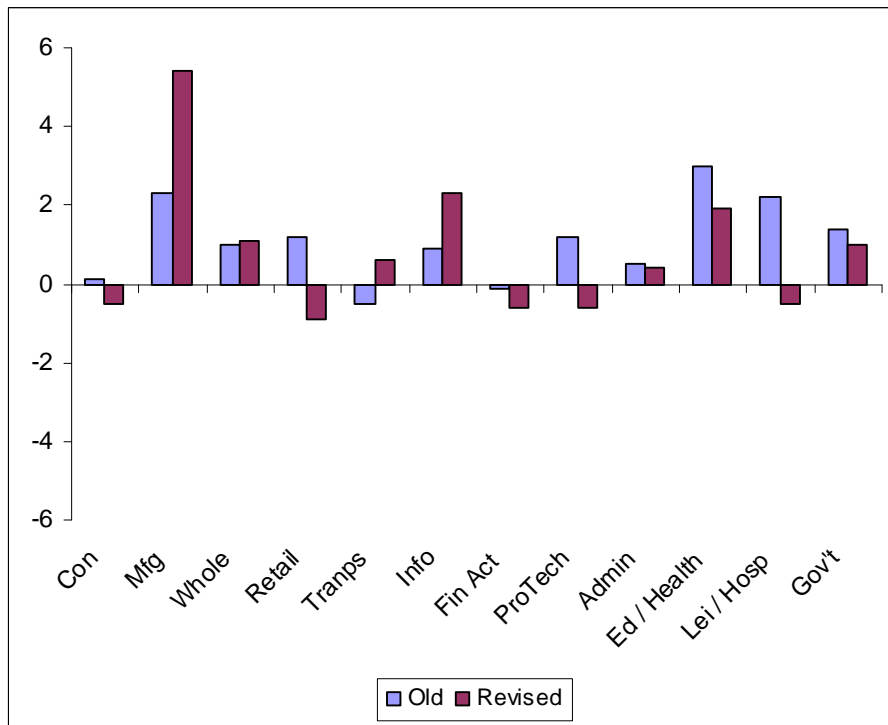


Figure 6: Change in San Jose MSA Payroll Employment, Dec '06 to Dec '07 (Old Estimates vs. Revised Estimates, 1000s)



While a lot of the discussion of these revisions often feels as interesting as a trip to dentist, in some cases we find that the revisions force us to alter our story of what's been driving growth in the local economy. We've known for some time that East Bay economy has slowed significantly in the past year, but we now find out it's for different reasons than we thought. Real estate has taken a big bite out of local job growth, but we now see that most of the casualties have come from the financial side instead of Construction. And instead of our image of a tug-of-war between real estate weakness and continued growth in non-real estate sectors, we now see that several East Bay staples like Education / Health Care seem to have their own reasons for weakness.

Our remaining task is to figure out what these changes mean for the East Bay outlook in 2008. Obviously, the first question we'll have to face is how real estate related sectors will fare, and in particular how the East Bay's odd combination of big losses in Financial Activities but small losses in Construction will play out. For some help in figuring this out, we'll look back at the last big construction slump in the East Bay, and we'll look across California today to see if there are any other regions with a similar combination of symptoms. After that, we'll need to also explore what we're likely to see in the non-real estate industries.

The Building Slump in Context

After three years of non-stop media coverage of the stunning turnaround in California's housing markets, it's easy to get lulled into thinking that this is the worst housing disaster since Noah and the Flood. And in some ways it is. But in terms of the decline in building activity, our

current situation isn't that different from the 1990s. Given the emerging puzzle of the strength of the East Bay's Construction industry in the face of a major decline in new building, taking a look back at previous building slumps can give us some insight into what to expect in 2008.

For some broad context, let's start with California. Our goal is to compare the current decline in building permits and construction employment to what happened in the 1990s, so we'll need to use some sort of index to put the two periods on equal footing. Figure 7 presents a graph in which the cyclical peak of a smoothed series for building permits is set equal to time zero, and the level of building permits at the peak of each cycle is set equal to 100 (these peaks occurred in Feb. 1990 and Oct. 2005). This allows us to compare both overall percentage decline in building permits (100 minus the current level), as well as the speed with which this decline occurred. In late 2007, we can see that California residential building permits declined by about 60% over two years, which is about exactly the same decline the we saw in California from 1990 to 1992. However, the path we've taken to get to this 60% decline is much different than before. In the 1990s, the majority of this decline occurred in a precipitous drop during the first year, while our current slump has been more a slow but steady decline. Figure 7 also includes a similar graph for the level of Construction employment, where the level of Construction employment at the peak of building permits is also set equal to 100. We see a similar pattern here: two years after the peak of building permits in 1990, California construction employment had fallen by just shy of 25%, while Construction employment has only fallen 7% over a similar period today. The big difference between today and the 1990s is of course the recession, which officially began in July of 1990 and ended in March 1991. As we've discussed time and time again in our national forecast, today's construction slump is a historical oddity: a recession would in most cases have already come and gone by this point in previous construction cycles. So while we have a recession-sized decline in building activity, job losses in Construction have been moderate by historical standards because the rest of the economy has held up better this time around – so far.

Figure 7: Index of CA Residential Building Permits (Smoothed) and CA Construction Employment (SA)

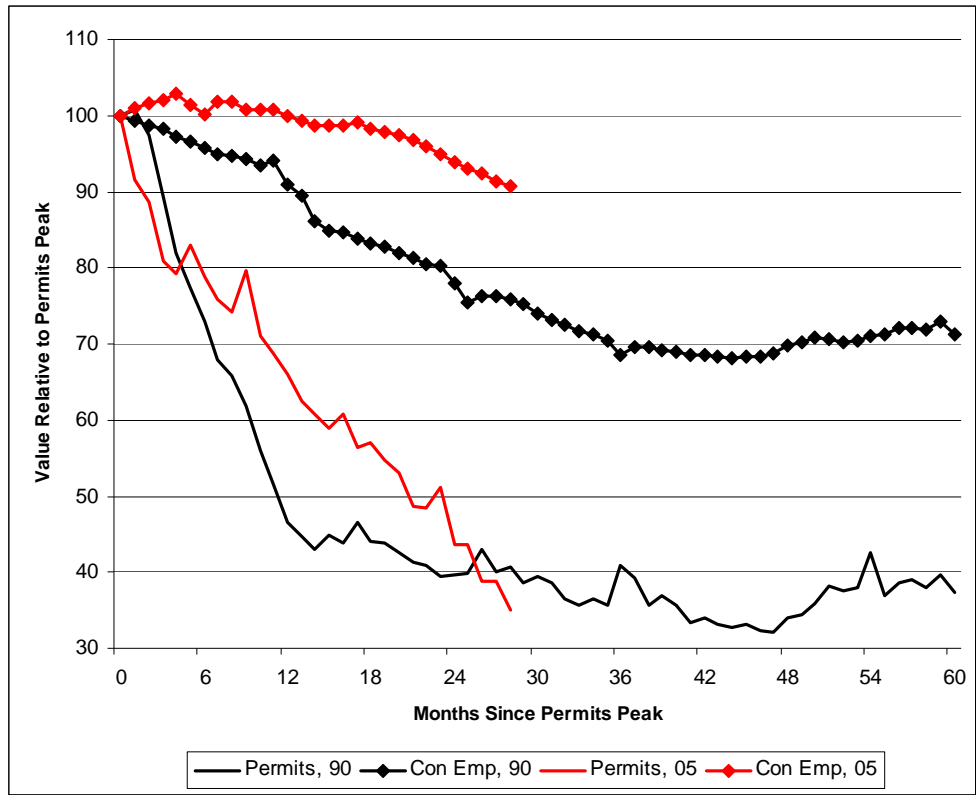
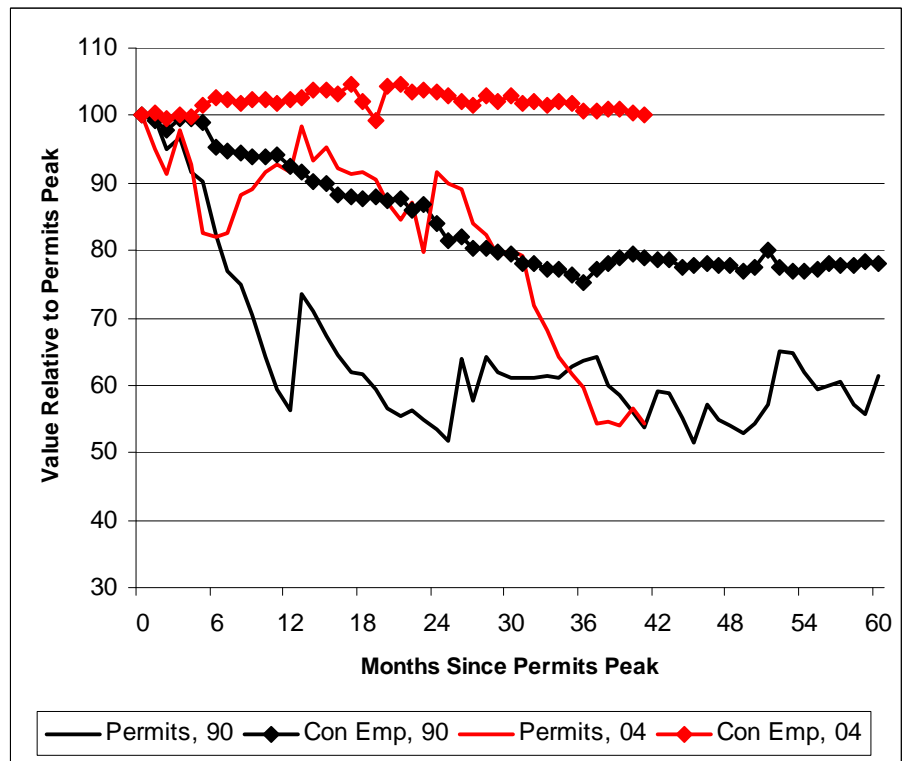
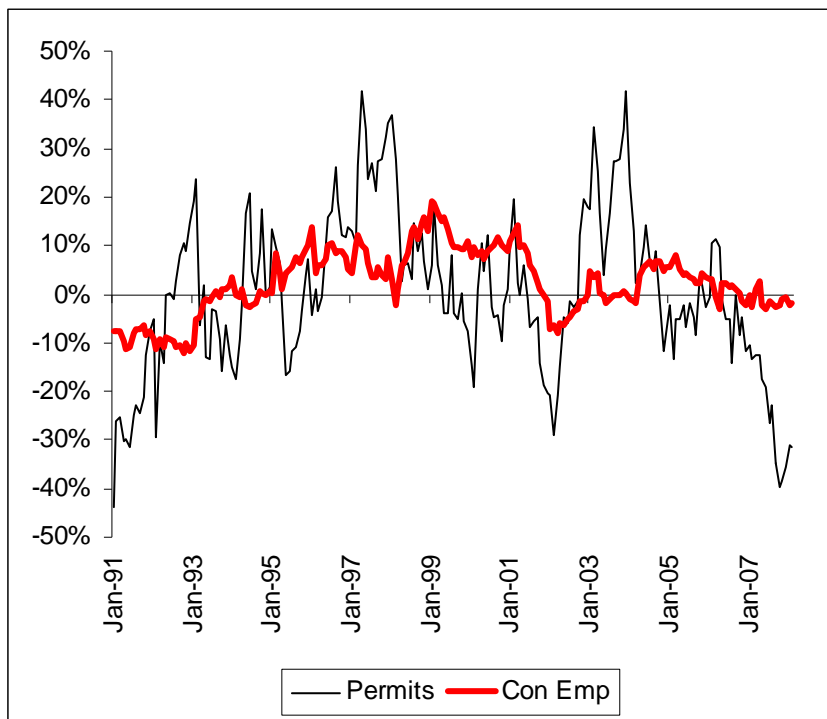


Figure 8: Index of Oakland MD Residential Building Permits (Smoothed) and Oakland MD Construction Employment (SA)



With this overall story for California in mind, let's apply the same analysis to the East Bay specifically. This involves a little bit of a fudge with the 1990s peak: the data for the East Bay only begins in January 1990, and is declining from the start. The peak of building permits may have occurred earlier, but we'll assume it begins in January 1990, and take comfort from the California data that this assumption probably isn't too far off. The first and most striking feature of Figure 8 is that decline in building permit activity is much smaller in the East Bay than in California in both slumps: 40-45% compared to 60%. We see the same differences in timing: the 1990s decline occurred over 1 year, while today's decline has taken close to 3 years to get to the same place. And it's no surprise that a smaller decline in building activity during the 1990s relative to the state average should lead to a smaller percentage decline in Construction employment. But Figure 8 once again underscores the central puzzle of the East Bay economy in 2008 – Construction employment is hanging tough at near the same level as at the peak of building activity. Interestingly, the unique history of the Bay Area gives another data point to consider: the late 1990s saw a mini-boom in East Bay building that was not paralleled in the rest of the state. As the tech bust slid into recession in 2001, we again see that recessions matter: a 31% decline in East Bay building permits over the three years from February 1999 to February 2002 saw an 8% decline in Construction employment. However, the employment decline didn't begin until March of 2001 – the exact beginning of the 2001 recession.

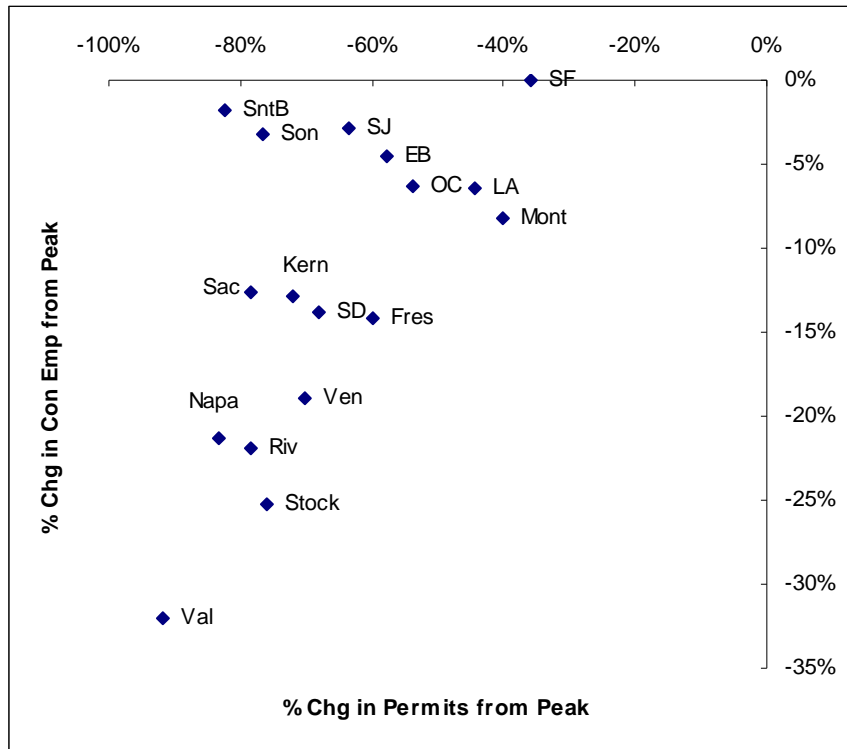
Figure 9: YoY Growth in Res. Bldg. Permits and Construction Employment, Oakland MD



What lessons are we left with after comparing today to the 1990s? First, the current decline in building permits is hardly unprecedented, but has occurred slower than in previous cycles. Second, the employment impact of the decline in building seems to be exacerbated by recessions. Unfortunately, this second point also muddies the waters when considering today's

slump: is the resilience of East Bay Construction employment simply the result of a relatively smaller decline in construction activity coupled to the lack of a recession in 2006-7? If that's the case, it may hold up. However, the fact we've seen an overall decline in California construction employment under similar circumstances leaves room for doubt...

Figure 10: CA Counties Percent Decline in Permits and Construction Employment from Peak



For more insight into whether the East Bay's Construction sector can continue to shrug off the decline in building, we can look at the other counties in California to see if this disconnect between building and employment is unique. Figure 10 plots a scatter diagram of the percentage decline in construction employment off its peak versus the percentage decline in building permits in major California counties. Overall, we see the expected relationship that the counties with a bigger decline in permits are also the counties with bigger declines in Construction employment. However, we also see that the East Bay is not alone in seeing 70-80% declines in residential building permits with relatively minimal declines in Construction employment: Santa Barbara, Sonoma, and San Jose Counties all show even more extreme versions of the same trend. This particular list of counties makes it unlikely that this commercial or heavy construction that is offsetting residential weakness – so what do these counties have in common? Figure 11 plots the level of Construction employment in each of these counties as index that is set equal to 100 at 2000's average level of employment, as an effort to measure both the size of the boom and the bust in Construction employment. We immediately see a common denominator among these counties: each of them experienced fairly significant declines in Construction employment during the 2001 recession, while the state as a whole did not. This is of course consistent with our story of the mini-bust in the East Bay in 2001. And with exception of Santa Barbara, each of the Northern California counties is at or below its level of Construction employment in 2001: in these counties, the construction

boom provided a return to normalcy in Construction, in contrast to the “overemployment” we have seen in other regions. This gives us a plausible reason why we might expect these smaller than average losses in Construction employment to hold up in these counties: less boom before means less bust now.

Figure 11: Index of Construction Employment, 2000 Average = 100

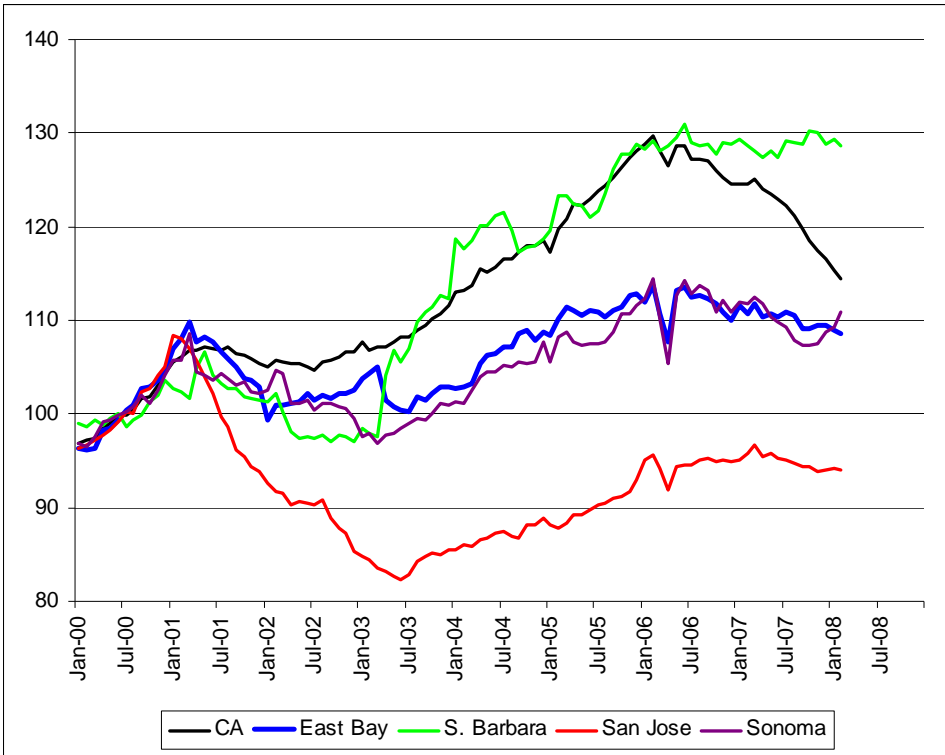


Figure 12: Decline in Financial Activities Employment Since Peak versus Total Increase in Fin. Act. from 2000 to Peak

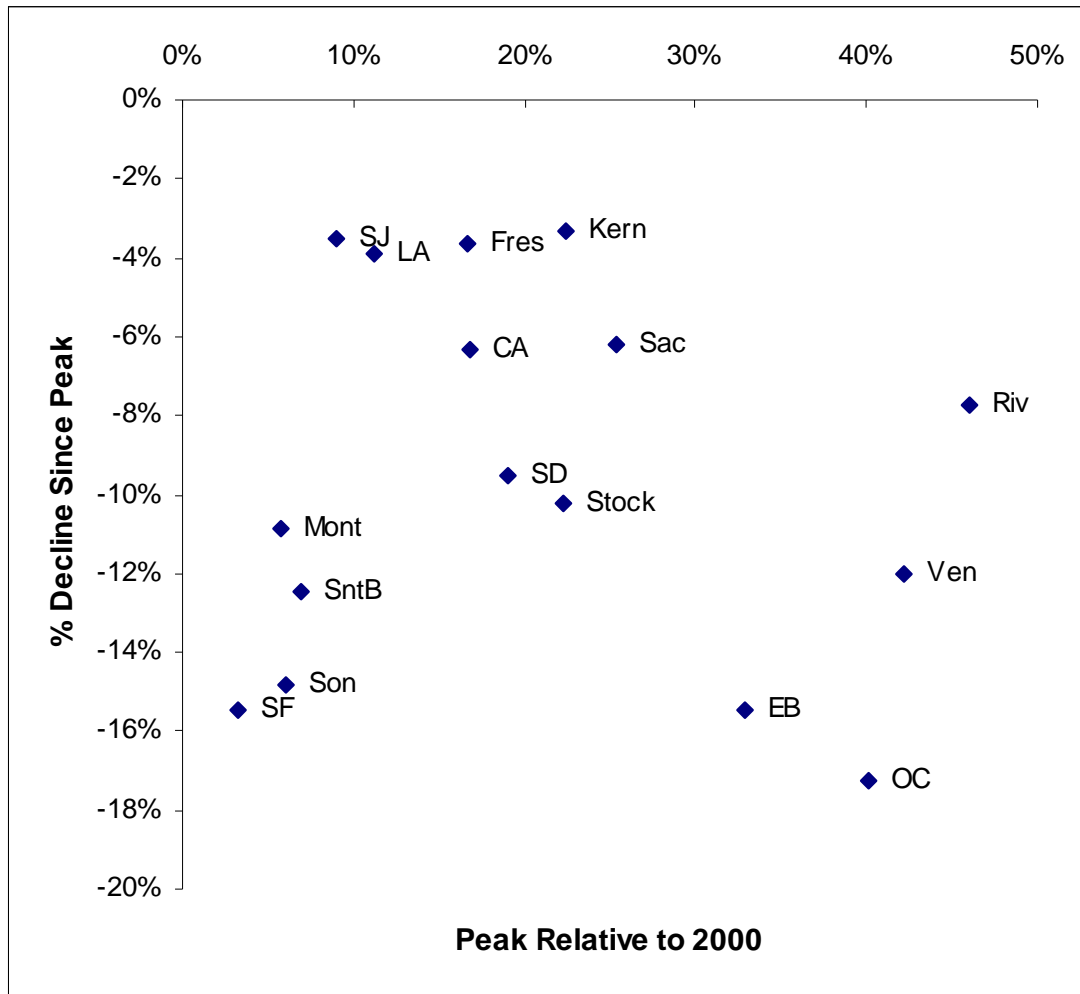
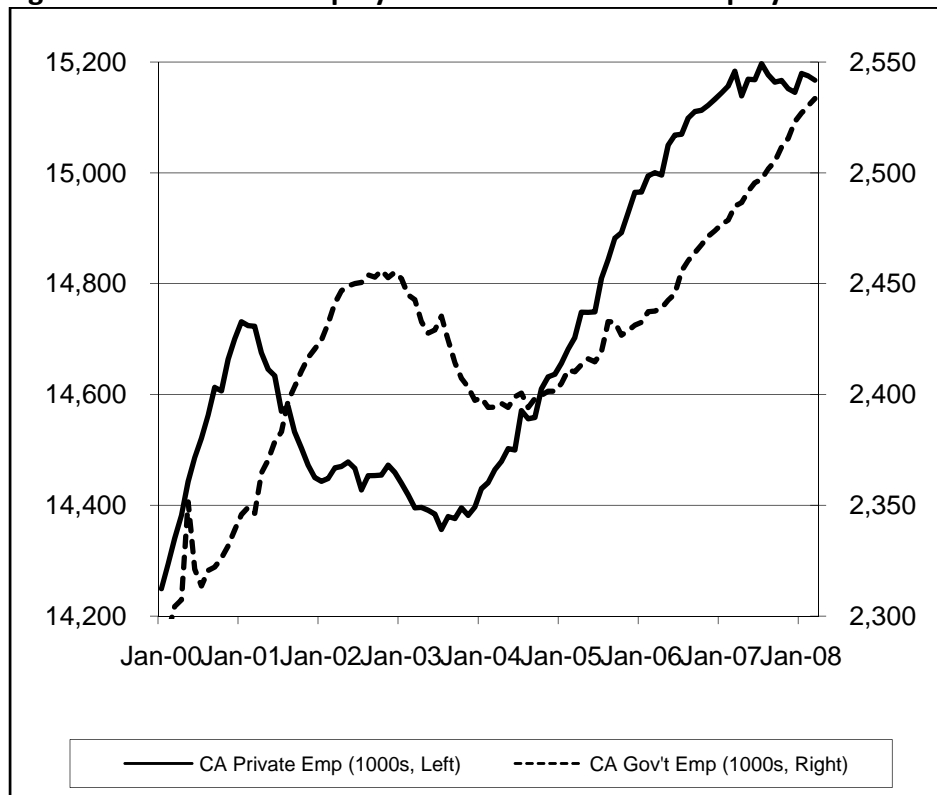


Figure 12 attempts to apply this logic to the finance industry: are the counties with the most weakness in Financial Activities employment today the ones that had the biggest booms? For the most part, the answer is yes; however, we once again have a few counties that don't line up with the trend. San Francisco, Sonoma, Santa Barbara, and Monterey Counties have experienced fairly significant declines in Financial Activities employment, yet did not see very big booms. Outside of Sonoma County, each of these counties has a 2005 location quotient for both Non-Depository Credit Intermediation and Real Estate Credit that are both below 0.5 – real estate related finance was not a big part their economy (small boom), but they too are suffering from the spillover effects. Sonoma County represents the odd duck, with a 2005 location quotient of 0.77 for Financial Activities (ie not a big local specialty), but a noticeable specialization in Real Estate Credit, with a location quotient of 1.61 in 2005. This is the worst case scenario – all the pain of the bust, but without the temporary benefits of the boom...

Looking Forward

As we look for the light at the end of the tunnel, there are two issues to consider: how much more damage will we see in real estate related sectors, and how much worse will the non-real estate funk become? While the East Bay has seen a decline in building activity on par with the rest of California, it has bucked the trend when it comes to the employment impact of this contraction. While the boom in Construction employment may have become excessive in other regions, in the East Bay it looks more like a return to trend, suggesting that Construction losses may be less of a factor here than in most other parts of the state. Unfortunately, while Construction losses have been minimal, Financial Activities job loss in the East Bay is the second worst in the state behind Orange County, and looks to be spreading beyond real estate finance. Financial Activities employment has not historically shown anything like Construction's cyclical swings, so the current situation is largely unprecedented, and feels more like a structural change in the economy akin to the aerospace contraction or the tech bust. As such, this makes the bottom extremely hard to predict. However, the concentration of job loss in Financial Activities relative to Construction does suggest some likely trends for the rest of the year. First, the overall volume of jobs lost to the real estate bust will be lower than many other parts of California, but the loss of these high value-added jobs will take a bigger bite out of personal income than would be the case in other areas. Second, the structural changes in the mortgage industry make these job losses a one-way trip. Since there's no cyclical bounceback like we've come to expect from construction, we should expect a slow recovery in 2009, as the rest of economy grows to replace the hole left by the overgrown mortgage sector – a smaller cousin of the jobless recovery in the wake of the tech bust.

Figure 13: CA Private Employment vs. Government Employment



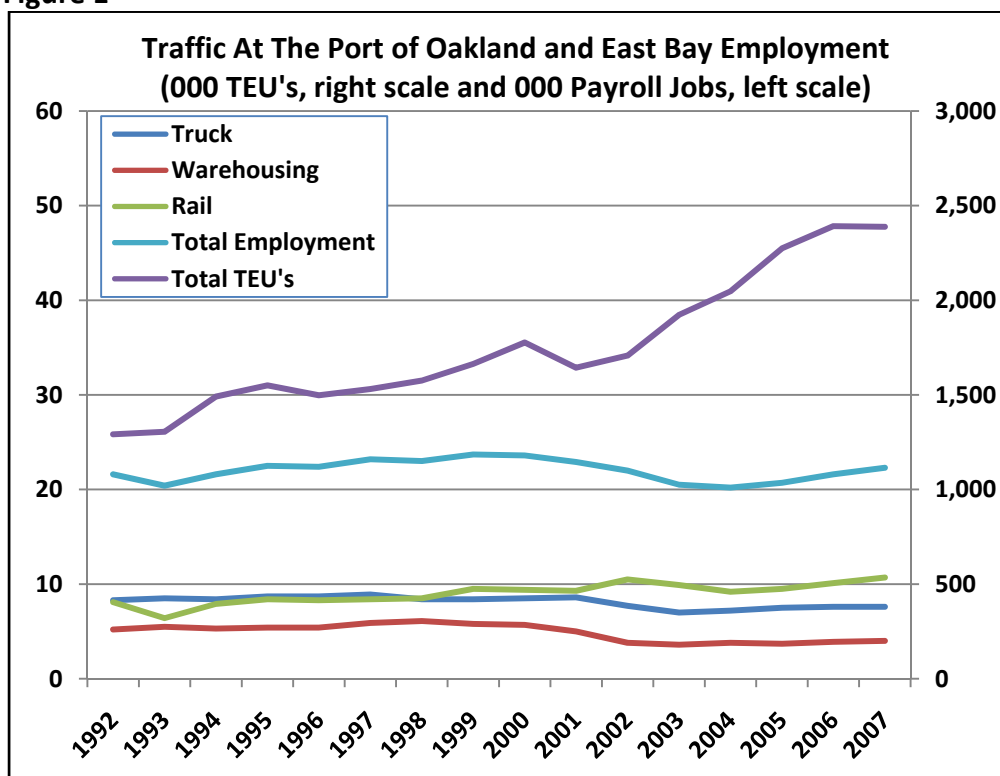
Outside of real estate, there are two other significant question marks for the East Bay outlook over the next two years, from the Manufacturing and Government sectors. While the service side of the high-tech sector is experiencing slower growth across California, the disconnect between the impressive performance of high-tech manufacturing in San Jose and the job losses in the East Bay is somewhat troubling. While recent history cautions against placing too much hope in any manufacturing sector, the best case scenario is that this trend is just late in coming east, and that the East Bay may get a much needed boost from this sector later in the year. Unfortunately, while there may be a small boost from manufacturing employment later this year, it will likely be undone by the local impact of California's budget crisis, which we will start to see in the second half of 2008. Predicting the exact mix of solutions that will come down from Sacramento is tricky to say the least. However, history offers some guidance for what to expect in terms of impact on the wider economy. In the recession of 2001, private sector employment in California suffered most of its losses in 2001, followed by a stagnant 2002. But Government employment continued to grow at a 3.5% annual pace until the beginning of 2002. The budget-induced contraction of Government employment didn't begin until late 2002, and continued on through 2003 (Figure 13). Ironically, in 2003 the Government sector became a drag on growth just as the private sector was beginning to get back on its feet, delaying California's recovery. We expect a similar situation this time around: housing weakness will have hopefully started to taper off by the end of 2008, but unfortunately this is probably right about when the inevitable cuts in state and local government should start to bite. Locally, we do not expect that this budget-related weakness will derail the East Bay's recovery in 2009, but it will be a drag on private sector growth

Port of Oakland: Growth with Few New Jobs

Jerry Nickelsburg

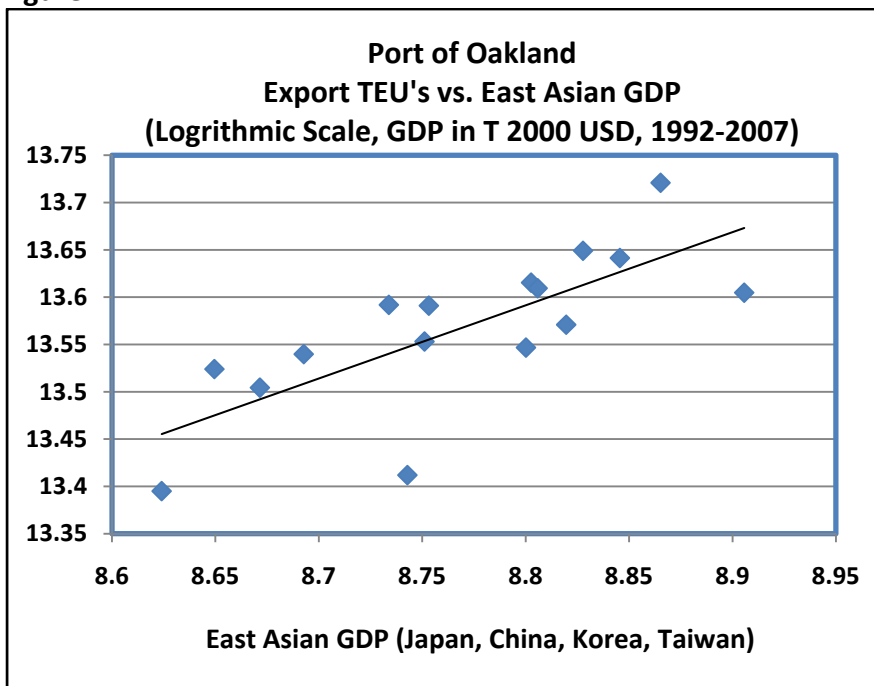
The Port of Oakland, and in particular the maritime port, has been a source of jobs for the region for some time. The U.S. Department of Transportation estimates that \$25 Billion in goods passed through the port in 2003 making the port the 9th busiest in the U.S. and the fourth busiest container port. The port itself creates about 10,000 direct jobs, but has a much larger impact on jobs derivative of port activity including rail, trucking and warehousing jobs. One of the interesting observations about modern seaport activity is that growth in the throughput of the port often does not show up in growth in these derivative jobs. Figure 1 shows this is the case for the Port of Oakland. From 1993 through 2000 there was steady growth in the number of TEU's (twenty foot equivalent container units) handled by the Port and some marginal growth in derivative jobs. Beginning in 2000, the Port of Oakland expanded infrastructure and carrying capacity including two intermodal terminals and dredging, and the total volume of TEU's through the port grew rapidly. However, the number of jobs in trucking and warehousing went down over this period. This paradox of port growth has two simple explanations. Competitive, congestion and environmental pressures induce ports to institute cargo carrying innovations which are, among other things, labor saving. Second, not all growth is equal. The total number of TEU's through the port does not generally dictate the labor requirement. It is the larger of the inflow or outflow of containers that approximately sets the labor requirements and if the smaller of the two grows while the larger does not, there is very little impact on local employment. This is exactly the case of the growth of the Port of Oakland since 2000.

Figure 1



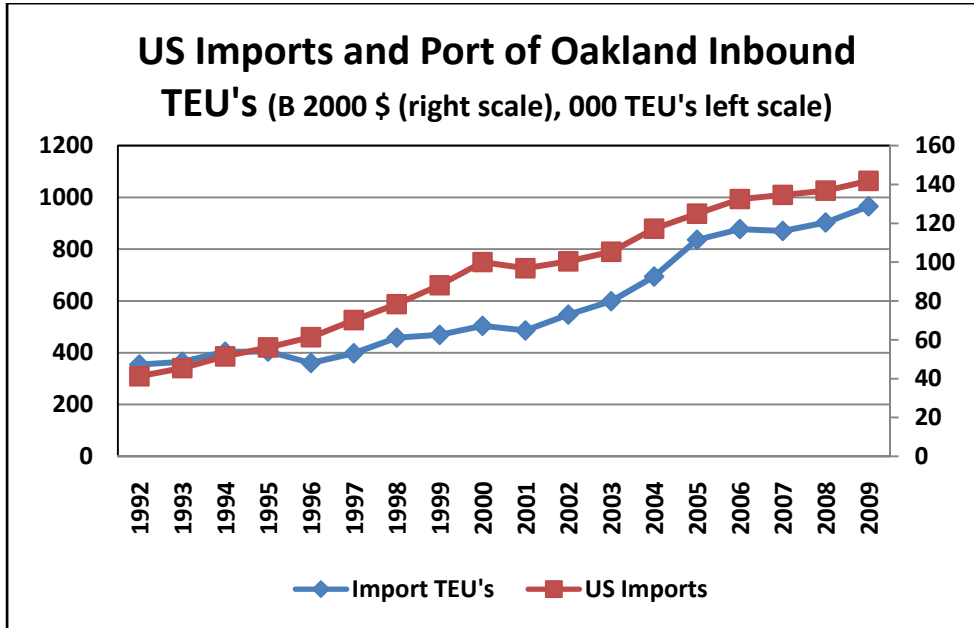
To understand the employment question and forecast the future evolution of port traffic it is useful to look at the component parts. The Port of Oakland is unusual in the U.S. in that export volume has been greater than import volume by weight and bulk over the last 20 years, and the value of imports are twice the value of exports. Its location close to Central Valley agricultural production and Northern California lumber and wood products production has provided the Port with a natural advantage in the export of products from these industries to a rapidly growing Asian middle class market. Consequently, unlike the Port of Los Angeles, outbound containers are mostly full. Figure 4 graphs Imports, Exports and Empties and illustrates that exports through the Port have been growing steadily since 1992 with a brief hiatus in growth during the economic slowdown of 2001. The primary destination of these goods is East Asia. The relationship between economic growth in East Asia, particularly China, South Korea, Japan and Taiwan, and exports through the Port as measured by TEU's is strong and sufficient to explain 87% of the growth over this period and is therefore the driver of our forecast of outbound TEU's (Figure 2).

Figure 2



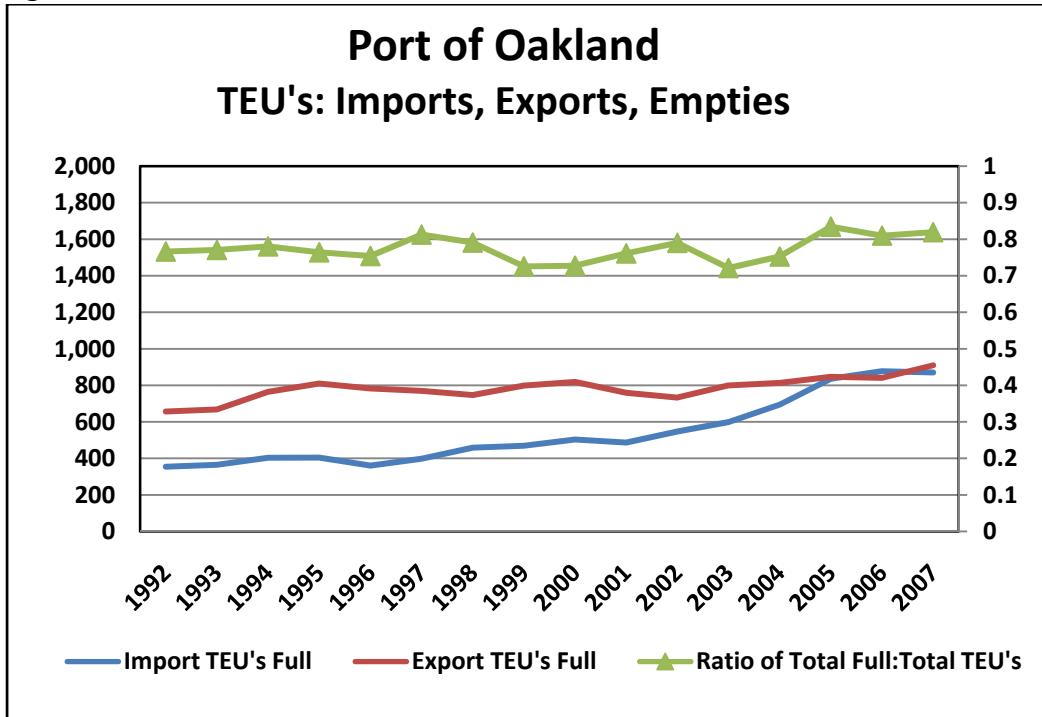
Imports have lagged behind exports at the Port of Oakland as the Ports of Los Angeles and Long Beach and the infrastructure of the Inland Empire provide stiff competition for imported goods into the U.S. Recent Investment in infrastructure by the Port of Oakland, a lowering of trade barriers with Asia, and well as capacity issues in Southern California have resulted in a more rapid growth in inbound TEU's since 2001 (Figure 3). The primary determinant of the import demand is the demand by U.S. consumers for imported manufactured goods. Through the last six years this demand has been strong. While the demand growth fell off in 2007 and promises to do so again this year, the unique position of West Coast ports to the manufacturing centers of Asia give them a unique advantage in capturing the increased national demand for imports.

Figure 3



With the steady growth in exports and the strong growth in imports why have more derivative jobs not been created? In Figure 4, Imports, Exports, and Empties, the top line is the ratio of the total number of inbound containers, both full and empty, to the total number of full and empty outbound containers. Although there is some variation year to year, the basic message is that the number of inbound containers stays approximately the same -- at around .79% -- of the number of export containers. So, while both are growing, the faster growth of imports is only filling inbound empty containers and not adding to the total container volume. In the Southern California ports the opposite is the case, it is the import containers that are dictating the number of container movements, not the export containers and increased exports are only filling empty outbound containers. The rationale for the lack of job growth is, whether empty or full, the containers have to get back to their origin to ship the next batch of product. Full is better for the container owner, but does not impact the logistical necessity of repositioning. Since handling a container by truck or rail is the pretty much the same regardless of its filling, or lack thereof, no new jobs are generated by the growth in the lower volume direction except to the extent that additional customs, bill of lading, and shipping paperwork administration is required to track and manage the goods inside of the container.

Figure 4



For the balance of the puzzle we return to the first chart. Notice that while there has been virtually no increase in overall employment, there has been an increase in rail employment. Rail is a much more efficient form of freight transport than trucking and the investment in the BNSF and UP intermodal terminals has routed more containers off of trucks and onto trains. As a consequence the increased traffic is able to move economically further inland to distribution centers and both warehousing and trucking employment has suffered. This is not to say that this is a bad thing. Fewer trucks on the road alleviate congestion and pollution and the lower cost of distribution keeps the ports competitive. But, in spite of the growth in the ports, one ought not to expect a big pop in growth rates of derivative employment. To be sure there will be some, but it will be modest compared to the volume growth.

To forecast the future volume of traffic through the Port we again look at export and import demand separately. Using the World Bank forecast for East Asia economic growth our model generates a growth of outbound TEU's of 5.3% for 2008 and 6.8% for 2009. Using our U.S. forecast for import growth, our model generates a forecast of 3.8% and 6.9% growth. These two forecasts, and the historical relationship between import and export TEU's yields a total number of TEU's handled in 2009 at 2.69M an average annual increase of 6.2% with exports volume greater than imports.

Uncharted Waters: Executive Summary of The California Forecast

Ryan Ratcliff

The California economy put up some up some downright ugly numbers at the end of 2007. The unemployment rate has risen over 1% since the end of 2006, and overall non-farm payroll employment has been stagnant in the second half of the year, with a small drop over the last six months. The major question we explore in this California Report is whether this is a recession, or the beginnings of one. We review over forty years of history, and look for the common denominators among the previous recessions in California, and how they compare to today. Three conclusions emerge:

1. The major economic indicators in California move in near lock step with their national counterparts. There has never been a California recession outside of a national recession.
2. With the exception of two most recent recessions (1990 and 2001), recessions in California show a V shape. Employment declines by an average of 2.4% over ten months, while real personal income falls 1.2% over twelve months. The shape of these recessions comes primarily from a sharp cycle in manufacturing employment that is less relevant in today's economy.
3. The two most recent recessions were both deeper and more severe. Manufacturing was again at center stage, but this time large permanent losses associated with structural changes in the economy created the more severe and protracted downturns.

Unfortunately, the current economy is hard to place on this map – we're in uncharted waters. Unemployment is spiking, but for reasons unlike any other increase in unemployment. Some California indicators look like the beginnings of a minor recession, but both the national situation and the balance of the California economy remain ambiguous. While Construction has been one of the major sources of cyclical job loss in California, it has always been the junior partner in recessions relative to Manufacturing. And with Manufacturing unlikely to generate job loss anything like its contributions to previous recessions, where does the job loss come from? The current contraction in mortgage employment is likely a permanent structural change in our economy, but it is an order of magnitude smaller than the shifts in manufacturing that drove the last two recessions. And with these two very junior partners, it's very hard to generate recession-level job losses.

We maintain that this very lackluster forecast should not be described as a recession. First and foremost, there has never been a California recession without a national recession, and we are not forecasting a national recession. While the continuing loss of mortgage-related employment does fit our conceptual model of a structural shock to the economy (like 1990 and 2001), both the current state of the California economy and our forecast fall short of the

weakness in previous historical episodes that we've chosen to label recessions. Both statistically and conceptually, today's economy is something new -- stinky, but new. Based on comparing the current economy to past recession episodes, we once again conclude that real estate weakness will remain a significant drag on the economy, leaving us treading water in 2008 -- but not slipping under the waves into recession.

Why This Time Really IS Different, Part 2

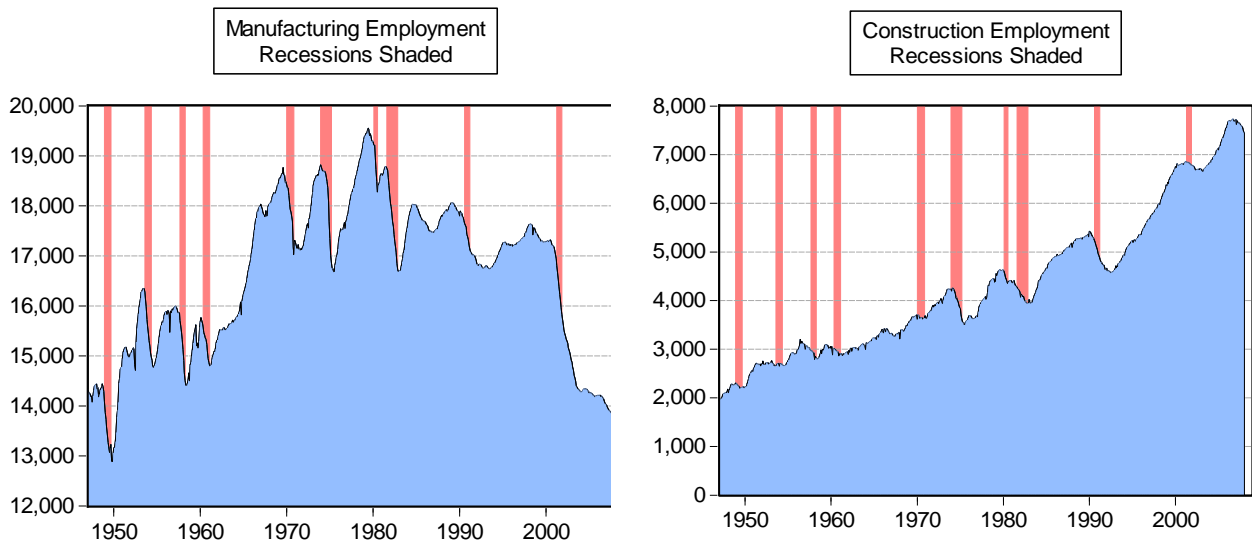
Edward Leamer

Making a Recession Call is Very Serious Business

Since I took over the reins of the UCLA Anderson Forecast in July 2000, only twice has the recession risk elevated substantially, in 2000 and again in 2006. Remember that the official recession months of the 2001 downturn are April 2001 to November 2001. In December of 2000, we predicted a 60% chance of a recession in 2001. In April of 2001, we raised the probability to 90%. When the audience asked why only 90%, the answer was "humility; but trust me we are in a recession." Meantime, almost everyone else said there was no recession, and no recession in the works. Then after the terrorist attacks on 9/11 many economists said this would cause a recession, even though the recession was already 5 months old and destined to live only two months more. It was not until December of 2001 that the National Bureau of Economic Research made it official: we really did have a recession in 2001. In other words, we got it right, and we stood alone back then.

Today, We Are in a Completely Different Position

The UCLA Anderson Forecast, since December 2005, has been predicting sluggish growth but no recession. And we are holding firm this time: no recession. This, of course, is counter to the recession forecasts that are coming from some of the most respected analysts on Wall Street.



Our no-recession story rests on two ideas. The first idea is the disconnect between housing and the labor market. This time owners are walking away from their homes in droves not because they lost their jobs, got divorced or had health problems, but only because home prices are falling all around the country. The second idea behind our no-recession story is the disconnect between the employment cycle in manufacturing and construction. Historically, the cycles in jobs in manufacturing and construction have been closely coordinated, moving up together in expansions and down together in recessions. But these two sectors disconnected in the recession of 2001. Construction jobs plowed through that downturn like it wasn't there at all, but manufacturing took a big hit, losing 3 million jobs. Furthermore, there has been no recovery of even one job in manufacturing, which is an historic first. From this we think that it is impossible for manufacturing to contribute much to job loss in the year ahead, and without a major contribution from manufacturing we are going to have sluggish growth but not a recession.

Recent Developments

Housing starts have collapsed from their high of 2.3 million units in January 2006 to their most recent level of 1.0 million units in January 2008. We are not used to seeing this kind of collapse that is not accompanied by a recession. But as discussed earlier, this time people are walking away from their homes not because they lost their jobs, but because declining home prices have turned their net worth in the house negative. *This time things are different.*

The most ominous aspect of this most ominous picture is that bump up in unemployment at the end of 2007. *Never before have we had an increase in unemployment of this magnitude that was not the beginning of a recession. But keep in mind we have been well aware that the housing problems would involve substantial job losses in construction and a sluggish economy more generally, so this kind of rise in the unemployment rate is not at all a surprise.* The surprise is that it took until the end of the year for the labor market to show real signs of softening.

Employment measured by the household survey continued to rise throughout all of 2007, but it did so at a much slower pace. Payroll jobs which had been growing at the 2% rate in 2006, slowed to about 1% at the beginning of 2007 and down to 0.8% at the end of 2007. This is, of course, an ominous trend that would turn the payroll numbers negative in 2009. *But, so far, the labor markets are slowing but not collapsing.*

Furthermore, a big component of every recession has been a significant dip in industrial production, spending and the manufacturing of consumer durables. So far industrial production is not showing anything like a recession dip, only somewhat slower growth in 2007 than in 2006. Likewise, growth of spending on consumer durables has slowed from the abnormal levels of 8% per year in the Internet Rush back in the late 1990s to still very healthy 5% at the end of 2007. The consumer is not the driver any more, but this is not a recession level correction. Not even close. As far as consumer spending and the impact of a negative wealth effect from declining home prices, if there is a quick halt to consumer spending, we will for sure have a recession in 2008. *It has been our view that the reaction to the reality of lower home prices will be slow and smooth, which is a reason to forecast slower growth in the future, not a recession.*

Conclusion

Thus our no-recession forecast remains nervously intact. We see a lot of problems in the first half

of 2008 as housing remains a drag on GDP growth and weakness in personal consumption expenditures contributes as well. The big recession risk today seems not to come from the wealth effect caused by problems with collateral *other* than housing (the credit crunch has already killed off the housing market), but rather from the insolvency problems that lending institutions are currently suffering from. This serious financial concern will be discussed in the following section by David Shulman.

Still, the Fed continues to dish out good news for Wall Street with ever lower interest rates. The labor market is sluggish and unemployment elevates to 5.5 percent by the end of 2008. But the housing drag on GDP dissipates in the second half of the year, and a normal economy returns in 2009.

The Credit Recession¹

David Shulman

For about a year, the U.S. economy has become enveloped in an ever widening and deepening credit recession, as distinguished from an economic recession, that is working to constrict financing to all but the most credit worthy borrowers. We have the specter of once proud financial institutions such as Citicorp, Merrill Lynch and UBS going hat in hand seeking cash from Sovereign Wealth Funds to replenish their loan loss depleted capital.

Credit Losses Multiply

Leveraged loans that were once thought to be readily marketable now sit on the books of both the investment and commercial banks at valuations well below par. All told reported credit losses in the system are now in excess of \$150 billion and growing. As a result, the credit spread for high-yield bonds have widened out from record lows last spring and to levels not seen since the end of the last recession.

High-Yield Bond Spreads Vs. Treasuries, Daily Data



The credit recession started in the subprime mortgage sector just over a year ago when HSBC and New Century Mortgage announced a significant increase in nonperforming assets and it soon spread to Alt-A, jumbo mortgages and home equity lines of credit. By August, LIBOR became a household word as the interbank loan market seized up. It then moved on to asset backed commercial paper that was issued by bank affiliated entities called "SIVs". Because the bond insurance companies both insured and invested in Collateralized Debt Obligations (CDOs) that were backed by the now defaulting subprime mortgages, the Triple-A credit ratings of the once staid insurers were now called into question.

The giant government sponsored mortgage lenders, Fannie Mae and Freddie Mac just reported multi-billion dollar losses stemming from the weak housing market. Sitting just below the

iceberg is the precarious position of the two major mortgage insurers, MGIC and PMI. Both of these companies are suffering huge losses and their survival is essential for Freddie Mac and Fannie Mae.

Thus far, the bulk of the pain has been concentrated in the financial sector, but should the current economic slowdown develop into a real recession it is likely that stocks will experience another leg down. Unlike the 2001 recession, where only stock prices declined, we now run the risk of a double-barreled hit to wealth coming from both the stock and housing markets.

Of Course, The Fed Has Not Sat Idly By

Over this period, the Fed cut the discount rate several times and made the most aggressive moves in cutting the Federal Funds rate since 1982. The Federal Funds rate has been cut from 5½% last summer to 3%. We expect another 1% cut to 2% by the middle of the second quarter. However, as noted above, the easier monetary policy is being offset by wider credit spreads. Thus the full benefits of the rate cuts are not being felt by both consumers and businesses.

What is at work here is the concept of the “financial accelerator”, a term first coined by Fed Chairman Bernanke when he was a distinguished academic.² Put simply, the financial accelerator enhances or dampens economic conditions through the actions of financial institutions in making credit more or less available to the public. For example, when times are good, loans are easier to get and with lenders being optimistic about repayment, credit spreads contract. When times are difficult the accelerator works in reverse as fearful lenders protect their balance sheets and become reluctant to make loans. This pretty much explains lending behavior from 2004 to the present and why money remains very expensive despite successive rate reductions by the Fed.

The real reason why housing will be in a rut for quite some time is that lenders as well as homeowners are in shock that house prices can go down absent significant declines in employment. There is no magic wand available for the Fed or fiscal policy to solve the crisis in housing market. As a result, the era of minimal or zero down payment home finance is over. Put bluntly, after years of easy credit, the American housing consumer is not ready for the more stringent mortgage terms of yesteryear and the shock of that will be severe. Although we are officially not calling for a recession, it will not take much to put the U.S. economy into recession. Should that occur, a two quarter decline in real GDP on the order of 1% a quarter would trigger absolute job declines this year and an unemployment rate of 6% by the end of the year. Indeed, if history and global experience is any guide, the hangover from the mid-decade credit boom could last for quite some time.³

Endnotes

¹ We are indebted to Jack Malvey of Lehman Brothers for this concept.

² See Bernanke, Benjamin S., *The Financial Accelerator and the Credit Chanel*, June 15, 2007.

³ See Reinhart, Carmen and Keneth Rogoff, *Is the 2007 Sub-Prime Crisis so Different? An International Historical Comparison*, AEA Meetings, January 8, 2008.