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East Bay Economic Outlook



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East Bay Economic Development Alliance

Authored by
Beacon Economics

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East Bay Economic Development Alliance

The East Bay Economic Development Alliance (East Bay EDA) is a public/private partnership serving the San Francisco East Bay (Alameda and Contra Costa Counties) whose mission is to establish the East Bay as a world-recognized location to grow businesses, attract capital and create quality jobs.

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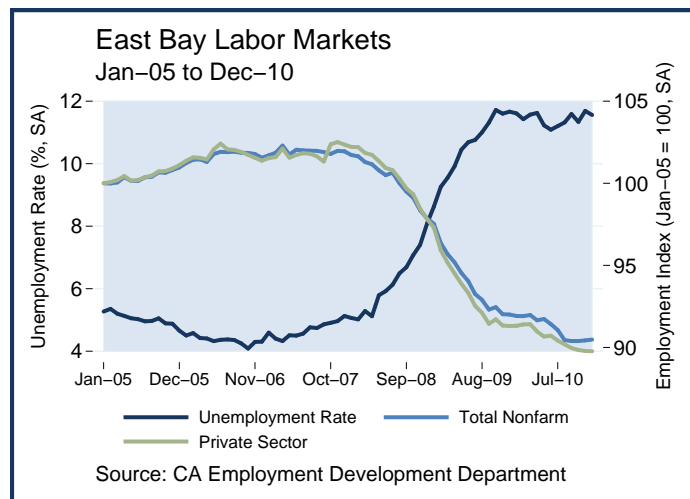
EAST BAY ECONOMY

EAST BAY LABOR MARKETS: STILL STRUGGLING

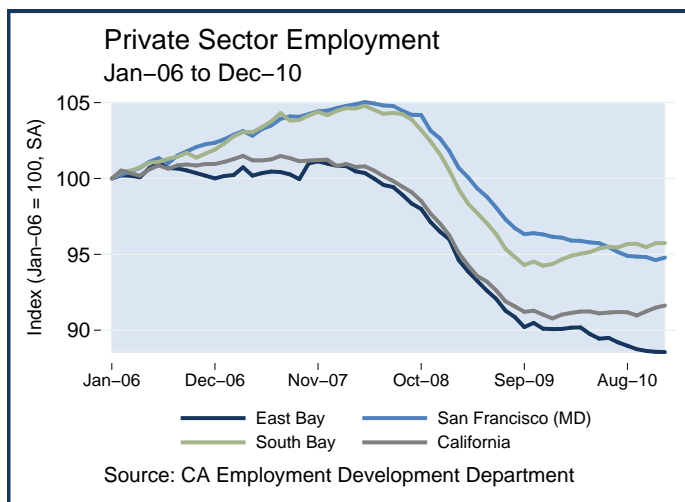
While labor market conditions have started to improve somewhat in the nation, California, and parts of the San Francisco Bay Area, the East Bay continues to struggle. As 2010 came to a close, private sector employment in the East Bay reached its lowest point since the downturn began more than three years ago. Moreover, the region is lagging other major Bay Area markets. The South Bay has led the recovery with solid private sector job growth since late 2009. San Francisco, and the state overall, recently saw modest gains in private sector hiring. The East Bay, however, continues to shed jobs.

The East Bay's lagging job market comes as little surprise given the region experienced one of the largest housing bubbles and subsequent declines in the state. This is in part due to the East Bay's concentration of employment in the construction industry, which continues to face severe difficulty. At the peak of the bubble in 2006, construction employment represented nearly 7% of all nonfarm jobs in the East Bay. This compares with only 4.5% of total employment in San Francisco, 5.2% in the South Bay, and 6% in the state overall. Unfortunately, the higher the climb, the harder the fall.

The unemployment rate in the East Bay remained elevated throughout 2010. The rate dropped briefly in mid-2010 due to the hiring of temporary workers in connection with the 2010 Census. However, as these jobs evaporated, the region's unemployment rate climbed back into the 11.5% range. Scratching the surface of this number **shows that the unemployment rate is likely to remain elevated in the East Bay for some time.**



The stability in the region's unemployment over the past three months is largely the product of discouraged workers dropping out of the labor force. This has a stabilizing short-run effect on the unemployment rate because as workers leave the labor force, they are no longer counted among the unemployed. However, as labor markets begin to improve, discouraged workers will re-enter the labor force, putting upward pressure on the East Bay's unemployment rate through the initial phase of the recovery.



Interestingly, the East Bay has seen some growth in its total nonfarm payrolls over the past three months despite falling private-sector employment. This was driven purely by an increase in government jobs during the last quarter of 2010, and bucks the trend observed statewide. Throughout California, private sector jobs are on the rise while total nonfarm employment has been slowed due to declining government jobs.

Why is the East Bay escaping recent government job losses? Unlike the rest of California, **the East Bay saw deep cuts to government employment, particularly state government, much earlier on.** The region saw state government employment drop by more than 5,000 jobs in late 2007, and the sector continued to trend downward through 2008, 2009, and 2010.

East Bay Recent Employment Performance

Industry	Dec-10 Empl't (000s)	1-Month Change (000s)	1-Year Change (000s)	1-Year Change (%)	2-Year Change (000s)	2-Year Change (%)
Payroll Employment	931.8	0.5	-15.7	-1.7	-75.8	-7.5
Total Farm	1.5	-0.0	0.0	0.8	0.1	10.5
Total Nonfarm	930.3	0.5	-15.7	-1.7	-75.9	-7.5
Total Private	763.0	-0.1	-13.0	-1.7	-68.4	-8.2
Natural Resources/Mining	1.2	0.0	-0.0	-0.0	-0.0	-0.0
Construction	45.3	-0.1	-4.8	-9.5	-14.9	-24.7
Manufacturing	75.8	-0.2	-3.9	-4.9	-13.2	-14.9
Wholesale Trade	42.6	-0.2	0.1	0.3	-3.6	-7.9
Retail Trade	97.4	-0.6	-2.3	-2.3	-6.3	-6.1
Trans/Warehouse/Util	30.9	-0.1	-1.1	-3.4	-4.5	-12.7
Information	23.2	-0.2	-1.1	-4.5	-3.8	-14.0
Financial Activities	50.4	0.1	-0.9	-1.8	-5.3	-9.4
Management	22.4	0.2	-0.3	-1.3	-1.4	-5.8
Professional	76.4	-0.6	-0.3	-0.4	-6.6	-8.0
Admin Support	45.2	0.2	0.3	0.7	-5.9	-11.6
Education/Health	129.5	-0.2	0.4	0.3	-1.4	-1.1
Leisure/Hospitality	85.3	-0.0	0.2	0.2	-2.3	-2.6
Other Services	34.3	0.2	0.7	2.1	-1.3	-3.7
Government	168.8	0.6	-2.6	-1.5	-7.3	-4.2

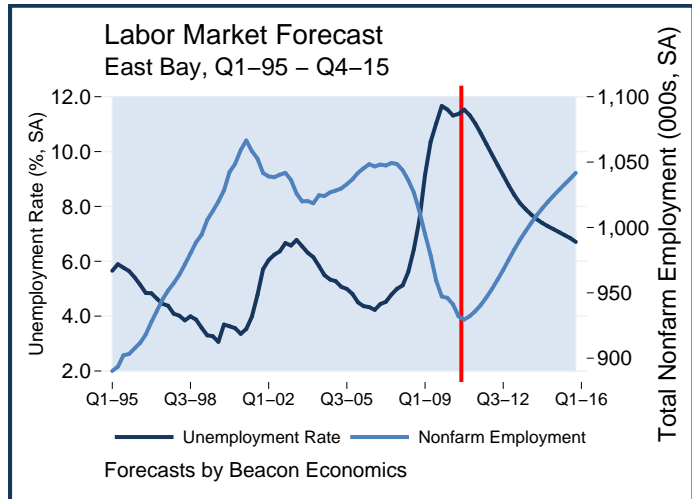
Source: California Employment Development Department

In contrast, much of the rest of the state was resistant to cuts to government employment until well into the recession. San Francisco and the state overall didn't see any significant job losses in government until well into 2009, and the South Bay held on into 2010.

Given the large decline in the East Bay relative to the rest of the state, **it is not surprising to see some of those jobs come back.** Through December, gov-

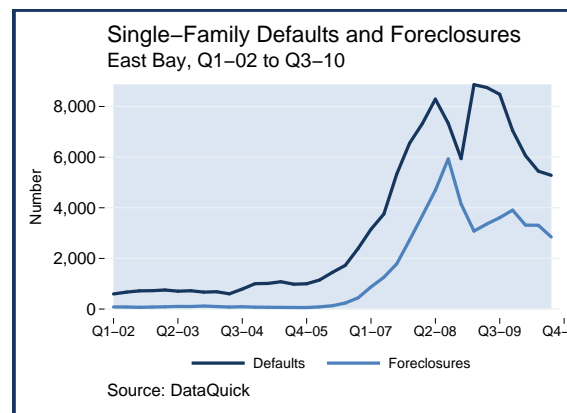
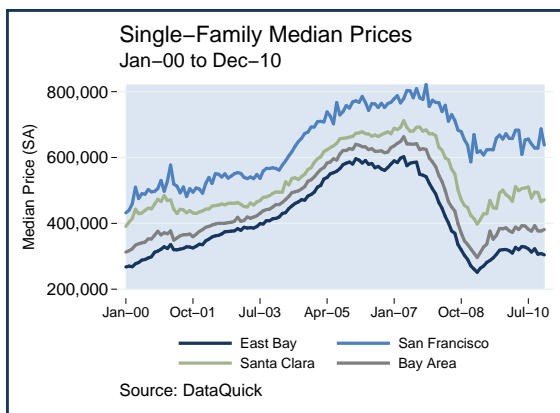
ernment had added back 3,775 of the more than 23,000 jobs cut throughout the recession.

Despite these trends, and some small gains in administrative support, private education, health care, and other services, most of the East Bay's industries continue to face job losses. Given the slow progress thus far, Beacon Economics is predicting a slow recovery for the region's labor markets. **Beacon currently forecasts that the unemployment rate will remain above 11% over the next few quarters, and won't drop below 10% until well into 2012-13.** The recovery has begun, but it will take time for the East Bay's labor markets to bounce back from such a severe downturn.



LONG, SLOW HOUSING RECOVERY BEGINNING IN EAST BAY

After several years of turmoil, the housing markets in the East Bay and across California have found some stasis. The median price of a home in the East Bay largely stabilized at around the \$320,000 range by mid-2010—leveling off at levels not seen since 2001. The region did see some modest declines in the last quarter of the year as sales dropped off in response to the expiration of key tax credits. Notwithstanding this policy-driven phenomenon, other indications point to a housing market that is gradually improving although the East Bay has a long way to go before it fully recovers.



One of the biggest improvements in the East Bay's real estate market is the **declining number of distressed mortgages**. In the second half of 2010, the number of foreclosures was at its lowest level since early 2007. This continues a trend that began in late 2008, when foreclosures reached their peak of almost 6,000 in a single quarter. Notices of default have also experienced sustained decreases in the East Bay, and were down more than 40% since peaking in the first quarter of 2009.

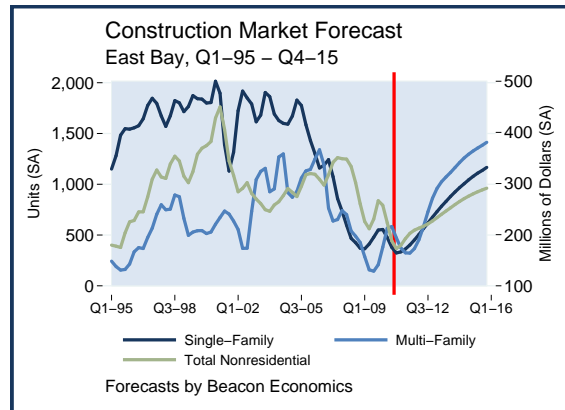
This is not to say that it will be smooth sailing for real estate in the East Bay going forward. Defaults and foreclosures, though down significantly from peak levels, still remain elevated compared to historical norms. Prior to the housing collapse, defaults in the East Bay averaged roughly 700 per quarter and foreclosures averaged roughly 80 per quarter. In the second half of 2010, both were well above this average with more than 5,000 notices of default filed and nearly 3000 entering foreclosure. Distressed properties will keep the East Bay's housing recovery tepid over the next few years, especially in terms of prices, but will also have implications for new construction.

East Bay Real Estate Market

Property/Indicator	2007	2008	2009	2010	2010	% Change	
	Q3	Q3	Q3	Q2	Q3	Q-o-Q	Y-o-Y
Existing SFR Median Price	624,518	349,803	300,465	353,827	328,947	-7.0	9.5
Existing SFR Sales	4,330	6,520	6,957	6,670	5,035	-24.5	-27.6
New Home Median Price	579,279	487,200	390,861	430,276	477,856	11.1	22.3
New Home Sales	1,416	957	752	759	486	-36.0	-35.4
Condo Median Price	430,114	288,224	233,008	231,167	222,919	-3.6	-4.3
Condo Sales	1,093	1,151	1,498	1,643	1,123	-31.7	-25.0
Defaults	5,333	7,335	8,480	5,446	5,282	-3.0	-37.7
Foreclosures	1,786	5,928	3,609	3,308	2,848	-13.9	-21.1

Source: DataQuick

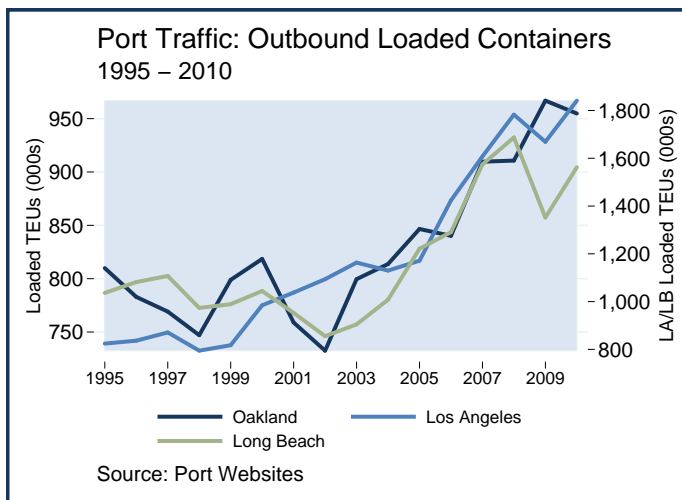
Given the softness in prices and the inventory of distressed properties that must be recycled through the system, **Beacon Economics forecasts a slow recovery in East Bay housing**: home sales will remain low through the first half of 2011, before rising incomes and gradually improving labor markets spur household formation and additional demand for housing units in 2012. Existing home prices are likely to hover around the \$350,000 range through mid-2012, though they may see some marginal declines, before starting to rise in line with income and population growth. **This will keep new construction activity depressed**, with residential permits remaining below 1,000 per quarter through mid-2012. However, improving economic conditions should see permits rise to more than 1,500 per quarter by 2013.



PORTS AND TRADE PLAY TO EAST BAY'S STRENGTHS

The Port of Oakland continues to be a boon to the East Bay, and has been bolstering an otherwise lackluster economic recovery. Although outbound port container traffic was down by 1.5% in 2010, this is the sum total of the decline in trade at the port during the entire recession. While both Los Angeles and Long Beach both saw their exports fall in 2009, exports at the Port of Oakland increased that year.

This is a trend that Beacon Economics expects to continue through the next several years. As the global economy rebounds (with forecasts of growth in the rapidly developing countries of East Asia reaching more than 10%), and the dollar continues to depreciate, **demand for domestic goods and services from abroad should continue to grow.**



A strong local port allows East Bay businesses to take advantage of growing demand from overseas, and creates significant job opportunities in the region. As businesses outgrow local and domestic markets, access to overseas markets enable them to expand beyond U.S. boundaries. This can lead to more hiring at local facilities to meet increased foreign demand for goods and services. It can also help to create jobs in ancillary industries that service the port – including

jobs in the transportation and warehousing industries, and wholesale trade.

Indeed, minimal slowdowns at the port in terms of container traffic coming in and out, has led wholesale trade employment to see a slight improvement over 2009. The sector added less than 1% of its workers back between December 2009 and December 2010, but this remains important because it was one of the few sectors in the East Bay to see any year-over-year growth. The transportation and warehousing sector, though relatively flat in recent months, has seen employment declines decelerate significantly as well.

One interesting contrast between **the Port of Oakland** compared with California's other major seaports is that it is a **net exporter**. This means that the number of containers leaving the Port of Oakland for foreign markets was larger than the number of loaded containers entering the Port from abroad. This is notable because it highlights linkages between container traffic at the port, and domestic production here in California. International trade in general serves as a bellwether for things ahead, but given the export-oriented nature of the Port of Oakland could mean a better indicator of domestic output here in California.

Port Container Activity, 2009 - 2010

Port	2009 YTD	2010 YTD	Change	
	Loaded Containers	Loaded Containers	Containers	Percent
Imports				
Oakland	702,841	802,919	100,078	14.2
Los Angeles	3,524,386	3,919,933	395,547	11.2
Long Beach	2,534,897	3,128,860	593,963	23.4
Exports				
Oakland	969,845	954,830	-15,015	-1.5
Los Angeles	1,668,911	1,841,274	172,363	10.3
Long Beach	1,352,053	1,562,398	210,345	15.6

Source: Port Websites

International trade in general serves as a bellwether for things ahead, but given the export-oriented nature of the Port of Oakland could mean a better indicator of domestic output here in California.

In addition, a concentration on exporting could help propel the East Bay's labor markets forward while local demand sources such as population and retail spending recover at a tepid pace. By focusing on providing goods and services abroad, the East Bay region could tap into the accelerated international growth that isn't likely in the East Bay as the local economy slowly gains steam.

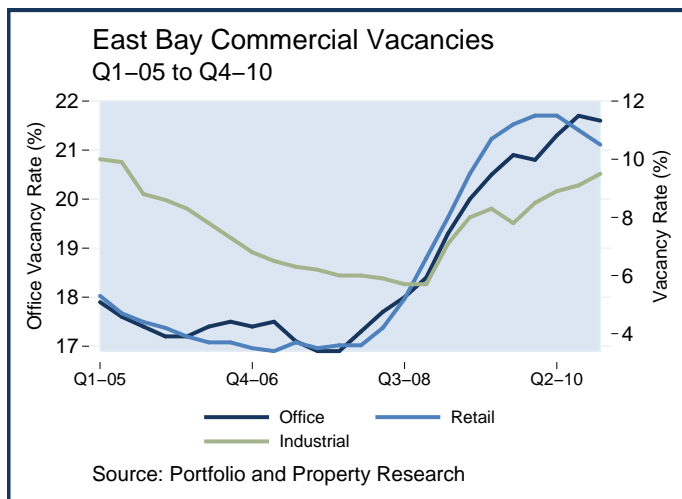
Currently, Beacon Economics forecasts continued strength in international trade, both at the Port of Oakland and nationwide. The broad-dollar exchange rate index continues to trend downward, and the trade gap closed sharply in the fourth quarter of 2010. In particular, the correction of the trade gap resulted from strong export growth, which should play well in the East Bay's strengths. The region is still reeling from the effects of the "Great Recession" but **the Port of Oakland, and increased international trade activity more broadly, are helping to put the East Bay back on the road to recovery.**

SLUGGISH COMMERCIAL MARKETS

In the wake of a lackluster employment recovery, it is unsurprising that the recovery in the East Bay's commercial real estate markets remains sluggish. During the downturn, the region's commercial real estate markets took a severe hit: vacancy rates in office space began to climb rapidly in early 2008. By mid 2010, vacancy rates in the East Bay were the highest they had been in over a decade. In addition, the effects of the recession on commercial real estate was not limited to a specific type of commercial property, but was instead spread across office, retail, and industrial markets.

The office market, which traditionally maintains higher vacancy rates in the East Bay compared with retail and industrial markets, has shot up to more than 20%. Certainly the decline in office-using employment has contributed to the reduced demand for office space in the East Bay. However, given that these sectors are expected to lead the employment recovery, demand for office space should begin to pick up slowly. **Beacon Economics forecast vacancy rates in the East Bay office market to begin coming down slowly in 2011**, and continue through the recovery, but historically "normal" levels in the 15% range are still a few years out.

Despite relatively lower vacancy rates relative to office building, retail space has also seen a sharp increase in vacancies in the East Bay. In fact, retail building saw the most dramatic increase in vacancy rates of all commercial property in the East Bay. Between 2006 and 2010, retail vacancies shot up from less than 4% to more than 11%. This was precipitated by a huge pullback on the part of consumers as the recession took hold. The more than 21% decline in taxable sales in the East Bay from its peak in early 2006 to its trough in mid-2009 forced many retailers to consolidate and drove others out of business completely.



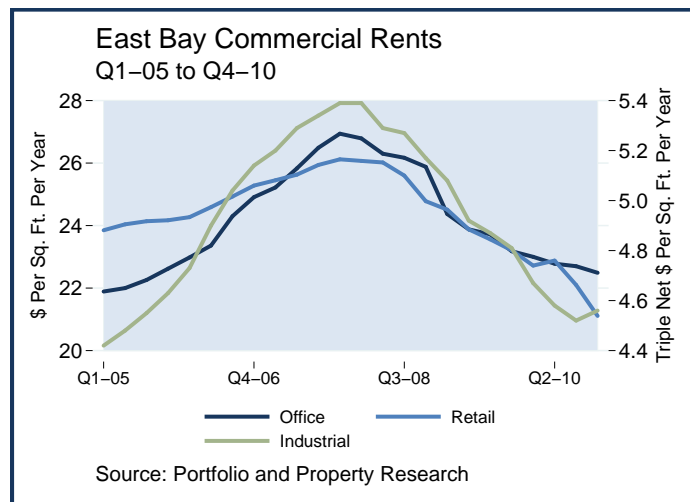
Fortunately, consumers are showing signs of life in the East Bay as the economy gradually recovers. The first 3 quarters of 2010 were up more than 3% from their 2009 levels, and we began to see retail vacancies come down in response. **By the end of 2010, retail vacancy rates in the East Bay had fallen from their peak of 11.5% to 10.5%.** Clearly, retail vacancies remain elevated, but the market is moving in the right direction.

With taxable sales expected to continue growing over the next few years, **Beacon Economics forecast that retail vacancies have peaked and will begin to fall slowly in coming years.**

Despite the news about the NUMMI plant closing in the East Bay, which captured headlines and stirred great concern, the industrial market saw the least dramatic rise in vacancies. Vacancy rates are up from their low in 2008 of just 5.7%, but by the end of 2010 they remained below 10%. One cause for concern is that vacancy rates continued to increase through the end of the year, while vacancies in retail and office began to inch down. However, given the strong boost in demand coming from abroad, **Beacon Economics expects to see industrial vacancy rates creep down slowly in 2011, and continue falling into 2012.**

Unfortunately for commercial property owners and operators, elevated vacancy rates have forced rents down across the board. Retail, which saw the largest increases in vacancies during the downturn, have suffered the greatest reductions in rents. Through the end of 2010, retail rents had fallen from their peak of \$26.12 per square foot per year to just \$21.11—a reduction of almost 20% that brings retail rents below their 2005 levels. On the other hand, office and industrial buildings both suffered a decline in rents, but both also ended 2010 higher than they started 2005. This suggests that the smaller rise in vacancies relative to pre-recession levels has helped to prevent rents from dropping as far as in the retail sector.

We have already seen vacancies start to come down in the East Bay in both the retail and office markets, and rents have started to increase in the industrial market—albeit at a tepid pace. As the economy begins to heal and consumers begin to spend more, vacancies will begin to fall and this will put upward pressure on commercial rents in the region. **While we expect industrial rents to continue to rise gradually, Beacon Economics forecasts that rents in the**



office and retail space will languish through this year and into 2012 as the labor markets begin their march back to job growth before beginning to rise in earnest in 2013. The East Bay's commercial real estate markets have suffered through this downturn, and although indications are that we've reached bottom, the road to recovery will be long and drawn out.

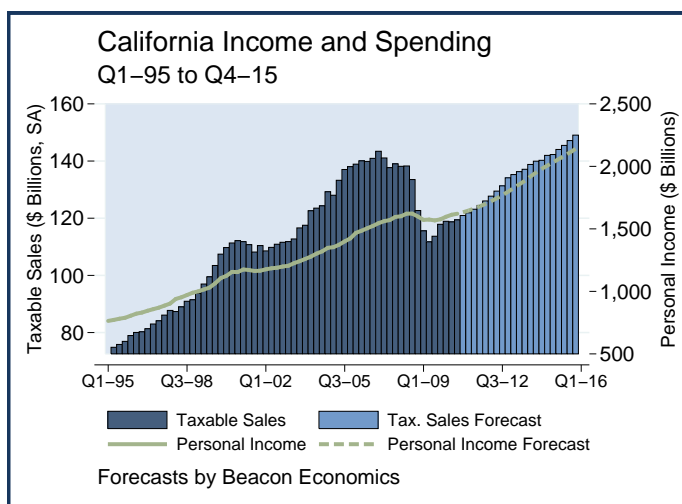
CALIFORNIA ECONOMY

WHAT'S NEW IN CALIFORNIA

The statistics on California's economy show that recovery is well underway, although times remain tough for businesses and residents across the state.

The Philadelphia Federal Reserve's "Coincident Economic Activity Index" shows that California has grown in nine of the last 10 months at an annual average pace of 1.5%. Personal income has also increased, and is nearly back to its pre-recession peak. In addition, California consumers continue to gain steam with nearly one and a half years of consistent growth. Indeed, the most recent data shows that California has bounced back by nearly 7% from the trough in taxable sales reached in the 2nd quarter of 2009. Still, the state is trying to make its way out of the huge hole left by the "Great Recession", and much healing remains before a return to full health.

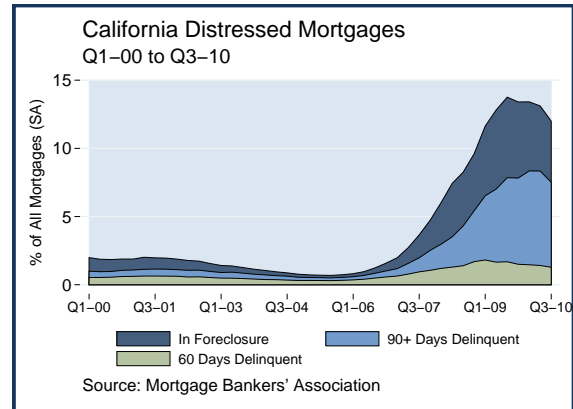
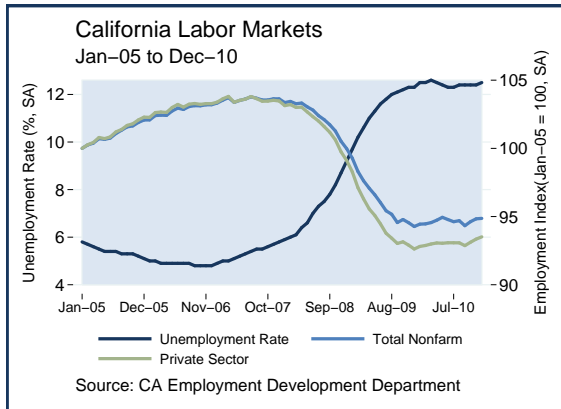
Labor markets continue to struggle, as the initial phase of the recovery has been rather jobless. The unemployment rate has been stuck at 12.4% for several months in a row and California has added back only 53,000 of the nearly 1.4 million jobs lost during the downturn. However, things are moving in the right direction: While many sectors have continued to shed jobs, several others (including Professional, Administrative, and Leisure and Hospitality) have more than offset those declines with positive job growth.



The housing market remains depressed as it works through problems in the mortgage industry following the housing collapse. The Mortgage Bankers' Association estimates that almost 12% of all mortgages in the state are seriously delinquent (60+ days past due on their payment or somewhere in the foreclosure process). Many more homeowners remain underwater on their loan—they owe more to the bank than their home is worth. Access to credit is still an issue in the housing market and builders remain

on the sidelines. Yet, housing too looks as if it is finding some stasis despite recent policy-related turbulence, and Beacon Economics sees growth on the horizon for California's real

estate market once the economy heals and jobs and households begin to grow. Only this time, the growth will be slower and more sustainable.



LABOR MARKETS BEGIN TO THAW

While the recovery thus far has been relatively jobless, there are indications that the labor market is beginning to thaw.

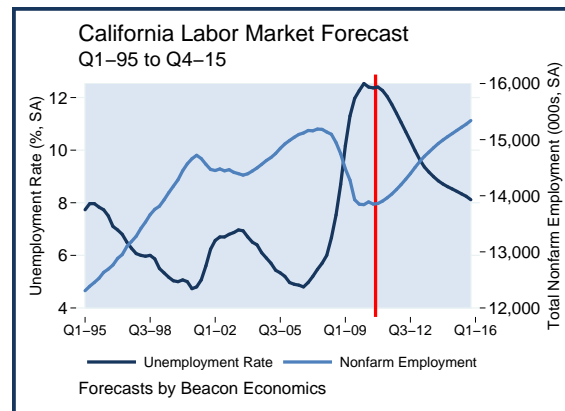
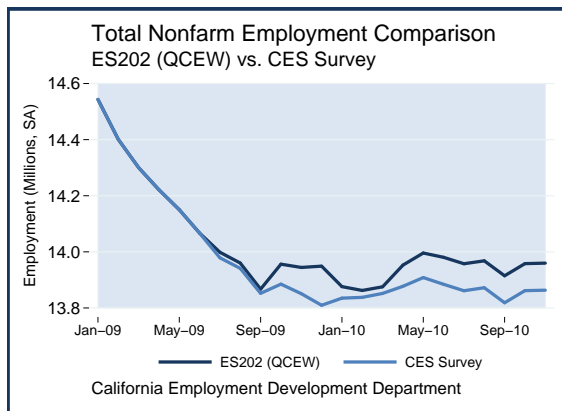
Professional and Business Services has been the primary driver of job growth thus far with increases of nearly 40,000 jobs in Administrative and Support Services and another 17,000 in Professional, Scientific, and Technical services. Because Administrative Support houses temporary workers in the service sector, it serves as a good leading indicator of job growth in other sectors. Following a recession firms typically take advantage of the flexibility that temporary workers provide before making long-term labor investments in permanent staff.

A healthy uptick in consumer spending has also spurred hiring in the Retail Trade and Leisure and Hospitality sectors. A weak dollar and a rebounding global economy have also boosted California's jobs picture through increased international trade. Both imports and exports are up significantly, which has created additional positions in manufacturing, natural resources and mining, and even the farm sector.

In addition to this job growth, estimates from the Employment Development Department (EDD) show that the ES202 or Quarterly Census of Employment and Wages (QCEW) is indicating stronger job growth than is currently being reported by the monthly Current Employment Statistics (CES) Survey. It is very likely that total nonfarm employment will be roughly 100,000 workers higher once the new benchmark series is released by the EDD in February.

This is not to say that California’s labor markets are in full recovery mode. In fact, many sectors continue to face difficulty. Despite recent gains, Construction employment remains severely depressed and low levels of permitting suggest that it will be some time before this industry recovers. Financial Activities, an industry heavily tied to the housing and credit markets, has yet to see any turnaround on the employment front. Government is another sector that has offset job growth seen in other industries. With budgets as strained as they are, Beacon Economics does not expect to see any significant gains over the next few years.

In light of these mixed results, Beacon Economics continues to call for a slow recovery. Beacon Economics is currently forecasting that the unemployment rate will remain above 12% through the first half of 2011, and won’t dip below 10% before the end of 2012. Total nonfarm employment will continue to grow at an annualized rate of 1.5% over the next year and will gain steam in 2012—growing at a rate of 2.7%. However, it will be well into 2015 before California reaches its pre-recession peak of 15.2 million jobs.

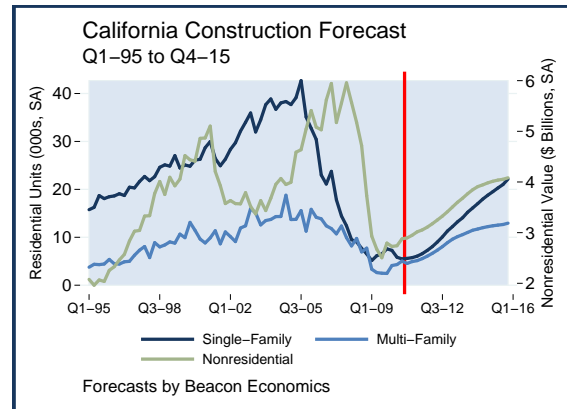
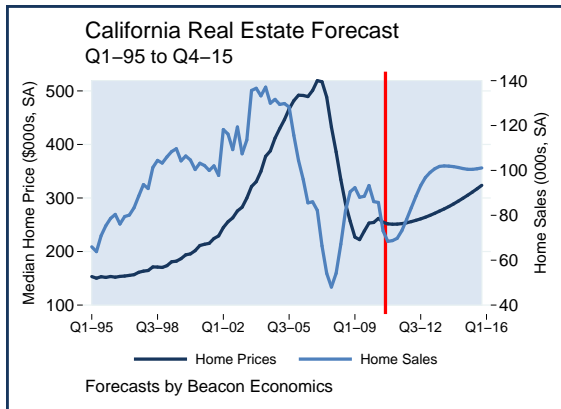


REMAIN PATIENT WITH REAL ESTATE

California’s real estate market is in much the same position as the labor markets. The state has reached bottom but the recovery leaves something to be desired. As noted, there are still several obstacles to a housing recovery in California. Chief among these are the number of distressed mortgages, the number of homeowners who are underwater on their mortgage, and access to credit. Yet, there are signs that the worst is over and that the housing market will begin to recover slowly.

After declining by more than 57% from peak to trough in the 2nd quarter of 2009, home prices have largely stabilized over the past year at around the \$250,000 range. There has been some weakness in home prices over the past few months, but this is largely the result of expiring

federal tax credits for new home purchases. Indeed, home sales dropped off dramatically in the 3rd quarter of 2010, which brought home prices down slightly. For many, this has signaled a pending “double-dip” in the housing market -- something Beacon Economics feels is unwarranted. The huge declines in home prices (as painful as they were to many homeowners) has dramatically increased the affordability of housing in California. This affordability coupled with historically low interest rates should prevent home prices from dropping much further.



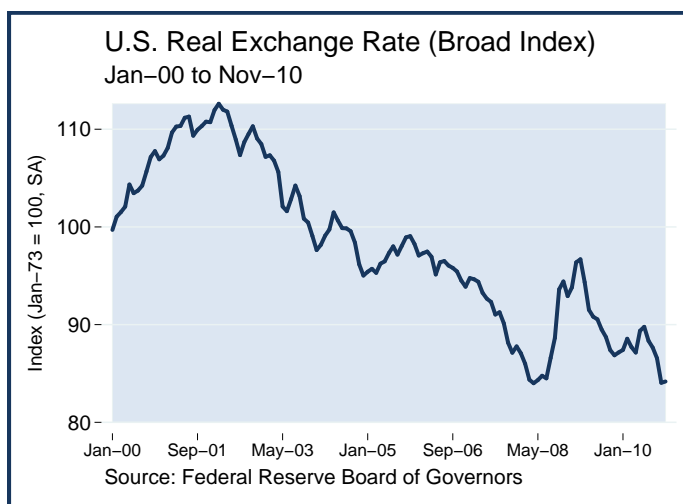
Household formation, which virtually ground to a halt during the recession as children moved back in with parents or took on roommates to make ends meet, should begin to pick up as the economy heals. Growth in the labor markets will spur new households to form, driving demand for new homes over the next few years. As a result, Beacon Economics expects home sales to remain fairly flat over the next two quarters, with a corresponding softness in prices. However, in 2012 California should breach the 80,000 sales per quarter threshold, which combined with rising incomes, will bring about modest price growth in 2012. However, the state will remain well below its 2007 peak of \$500,000+ through the life of the forecast.

Unfortunately, the low price of single-family housing will be a drag on new construction as builders wait for price appreciation before committing to new projects. Given the high cost of both land and construction in California, many projects simply do not make sense for builders currently. This is reflected in the state's permit statistics, which have hovered around 10,000 residential units per quarter—well below the 2005 peak. Beacon Economics predicts residential permits to remain low—40,000 to 50,000 units per year through 2012—before picking up again in 2013 and beyond. Growth in nonresidential construction will be tepid as well, although increased employment in the service sector will help to bolster demand over the medium-run.

CALIFORNIA'S TRADE BOUNCE

There is no doubt that California serves as a critical gateway into and out of the United States. Both Californian and other U.S. firms use the state's air and sea ports to access overseas markets with their goods and services. International firms also utilize California's ports to sell imported goods and services in the United States.

Not only has international trade been a boon to California's long-term health over the past 15 years, it is also helping to drive growth coming out of the recession. When the recession set in during 2008 and 2009, the American consumer pulled back sharply on their spending, causing California's imports to crash. And, given the global nature of the downturn, demand for U.S. goods and services fell off sharply as well. However, trade has been increasing at a healthy pace over the past 18 months—especially on the export side.



Sovereign debts issues in Europe have sent the dollar upward at a few points over the past year, but overall the dollar is trending lower. This has increased the relative affordability of U.S. goods and services abroad and has driven U.S. exports higher.

Another reason for California's success in international markets is due to the types of goods and services the state provides to the rest of the world. When taking a holistic view of the commodities that flow out of California's ports, they are the kind of high-tech/high-skill goods and services that play to the strengths of the state and nation—namely its skilled workforce, entrepreneurial spirit, and the ubiquity of technology in the economy. Indeed, nearly 20% of all goods shipped abroad from California's ports are electrical, sound, and tele-



vision equipment; and another 17% are for industrial machines including computers. Not only do these two groups make up more than one-third of all California exports, but they are both up by 21% and 34% respectively on a year-to-date basis through October 2010.

Strong growth in emerging markets such as China, India, and other East Asian nations, coupled with a weak dollar and a growing national debt here at home, should continue to drive exports higher. This will lead to stronger job growth in trade oriented sectors over the next few years including Transportation and Warehousing, Manufacturing of both durables and nondurables, and the Wholesale Trade sectors. The weak dollar will also help to drive international tourism to the U.S., and California remains a top destination for foreign travelers given the abundance and variety of attractions in the state. This should mean solid growth for the Leisure and Hospitality sector, and the Hotel sector will continue to heal as well.

UNITED STATES ECONOMY

THE BIG GAMBLE

The masses have spoken -- the weak recovery is not acceptable. The thumping the Obama administration took in the fall election can be traced directly to this issue -- not healthcare, gays in the military, tax rates on the ultra-rich or the other talking points of the republican party.

After the last two big recessions in the mid 1970s and early 1980s the economy grew at close to 6% in the aftermath. This time around the nation has averaged less than half that rate. As a result, the unemployment rate, which is typically falling by this point in a recovery, has remained stuck near 10%. The sources of the weakness are primarily consumer spending and housing. This shouldn't be a surprise since both sectors of the economy had swollen to unsustainable peaks in the bubble that preceded the crash. Regardless, the country wants growth, and it wants it now.

Economics is called the dismal science because it acknowledges that we live in a world of limited resources. This implies that we have to make tradeoffs -- if we want to consume more of A, we must give up some of B; we simply can't have it all. Monetary and fiscal policy regarding short-term economic growth are similar. We may make policy choices that will spur on growth in the here and now -- but this necessarily comes at a cost to future growth.

This is the tradeoff the Obama administration and the Federal Reserve accepted when they opted to extend quantitative easing and maintain the tax cuts put into place over the past 8 years. Given that the economy is finally starting to pull out of the doldrums -- growth in the 4th quarter of 2010 could reach 4% given current trends we have seen in consumer spending and trade flows -- these policies are sure to keep the recovery moving ahead at a solid pace for the next two years.

As such Beacon Economics has substantially improved our short term outlook. We expect the doldrums that have defined the recovery that started in the 3rd quarter of 2009 to finally come to an end with growth in 2011 averaging over 3%, and the trend accelerating through the year. Indeed, 2012 could end up seeing rates of growth close to 4%. With the acceleration of growth, unemployment will finally start to fall at a reasonable pace, to under 8% by mid 2012.

But how much will this cost us in the future? We will find out eventually. If we are lucky, it will be reasonably cheap and well worth the price. If we are unlucky we could end up in a situation worse than the mess that made our policy leaders take this big gamble in the first place, as the nation sees either rampant inflation or experiences a crisis in the public debt markets.

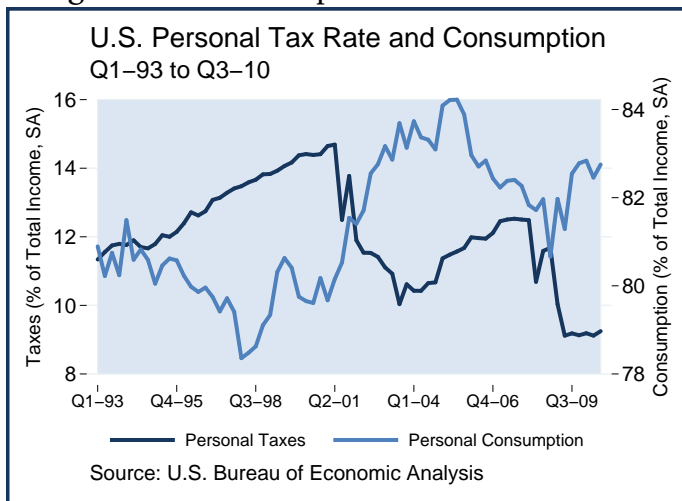
Beacon Economics continue to advise our clients to enjoy the present and ride what will be a solid wave of growth. But ultimately, concerns in the mid-term should temper any decisions regarding long-run investments.

The Great Recession was the end result of a decade long unsustainable runup in U.S. asset prices. This perceived increase in wealth and returns caused Americans to stop saving and the U.S. financial system to behave as if risk had largely been eliminated from the markets. The net result was a massive increase in the trade deficit and a credit bubble.

When the financial markets sagged back to historic norms the U.S. economy faced two big problems. The financial system seized up as it began the painful process of deleveraging, and Americans began to find thrift again, eliminating one of the primary drivers of economic growth.

All recessions have two components. The first is the pain caused by the initial shock to the economy and the resultant, necessary, changes in the structure of the underling economy. Deleveraging, the proper pricing of risk, and a return to savings are essential changes for the U.S. economy to get back on solid footing -- as painful as it might be in the short-run. Then there is are secondary feedback effects, when the economic turmoil creates reduced aggregate demand, more job losses, and further turmoil.

Given the primary and secondary effects this 1-2 punch could have produced a much deeper downturn but for one of the most aggressive interventions in an economy on the part of the government. Quantitative easing and TARP got the credit markets moving again. Further tax cuts got Americans to spend.



But, as noted, intervention is not free. It comes at some cost in terms of future growth. The lesser downturn is a weaker upturn. Fiscal deficits must be paid back through higher taxes. Monetary loosening must be countered with tightening or inflation. The tradeoff can be worth it regardless: Using these policies in hard times can stave off the vicious cycle of secondary impacts from the initial shock to the economy. That it comes at the cost of some future growth can be well worth

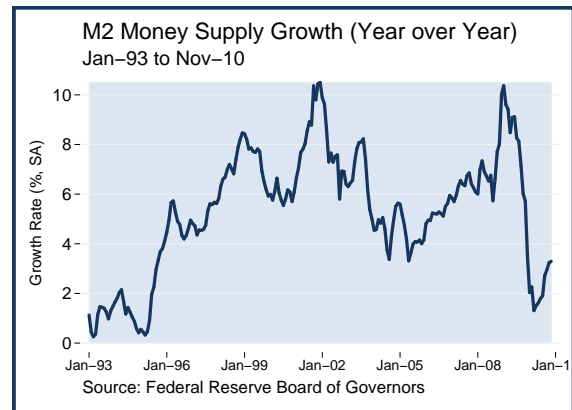
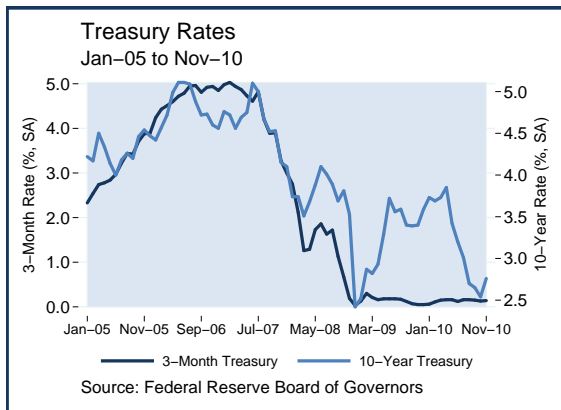
the effort.

But for the United States, the recent intervention went even further. The intervention was so aggressive it actually prevented the economy from fully recovering from the imbalances that got us into the situation in the first place. Low interest rates (and the perception of a government safety net) has cause asset prices to rise again, even before the bad debt from the last cycle has been cleared from the books of financial systems. American consumers are still over spending, using 82 to 83% of their income for spending as opposed to the long run average of 79 to 80%. These were the forces that continued to weigh heavily on the U.S. economy, preventing a rapid recovery.

The United States was about to realize this harsh truth at the start of 2011 when a variety of Bush era tax cuts from the 2001 downturn, and the stimulus tax cuts, were set to revoke. But the elections sent a clear message to the powers that be in Washington DC -- continued slow growth was not to be tolerated by the American public, despite the fact that the United States had not fully dealt with the problems that set off the recession in the first place.

To quench the anger of the mob, leaders decided instead to further stimulate the economy. Both tax cuts and quantitative easing have been extended. The gamble is clear -- if the United States can build up enough of a head of steam, it will be able to absorb the punishment of the inevitable tax hike and monetary tightening that will eventually take place to offset a debt crisis or massive inflation.

It will work in the short-run. The economy has gathered strength in recent months, and this momentum will now be carried into the new year. This is simply maintaining some of the current imbalances in the system. Consumers will be 'allowed' to continue to overspend as the tax cuts will remain in place. Of course the offset will be a growing Federal debt burden.



Some economists have called QE2 a failure since interest rates have started to rise. But Beacon Economics believes QE2 was never intended to keep interest rates low. Our firm believes that

rates have been too low, and the move up is a logical shift in the cost of debt. Instead QE2 was about convincing the deflationistas that prices would continue to rise.

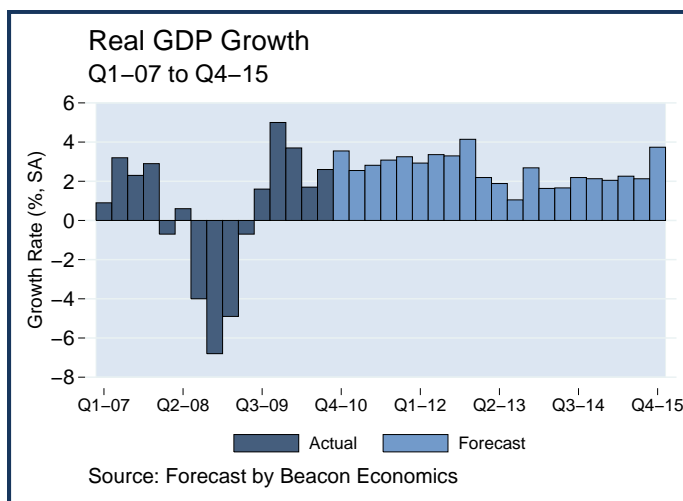
It was also about convincing the rest of the world that the United States could and would no longer be the consumer of last resort. The bubble in the United States caused an enormous trade deficit and an over-valued dollar as our over-spending stimulated the rest of the world's economy. Other nations, including but not limited to China, were reluctant to allow the dollar to fall, and used the U.S. position as the world reserve currency (and largest debtor) to keep the dollar inflated. QE2 put the world on notice that such shenanigans would no longer be tolerated -- and it worked. The dollar is weakening, and the trade balance which had been going in the wrong direction for some time has now finally started to close again.

It won't be all great growth. There will be some negatives. Much of the direct fiscal stimulus will be removed from the economy, even if the tax cuts are extended. Housing clearly has a ways to go before it will be a sustainable driver of the economy. There are still 2 million excess housing units (at least) in the nation, and rising interest rates will continue to dampen the market. Similarly, expect 3 to 4 million more foreclosures before all is said and done.

Despite all this, the economy will grow.

Eventually the drivers of this growth spurt will have to be removed. Tax increases will need to be put into place to start closing the Federal deficit. The excess liquidity of the monetary base will have to mopped up. The good news is that for now, neither of these issues seems to be pressing. This implies the nation has at least a couple of years - - and a presidential election -- to move through. But eventually monetary and fiscal discipline must be reasserted.

When it does, watch out.



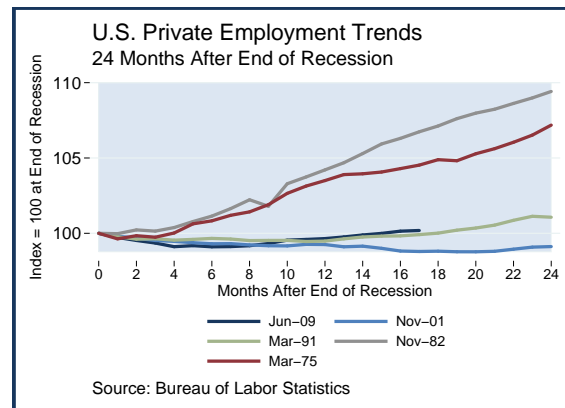
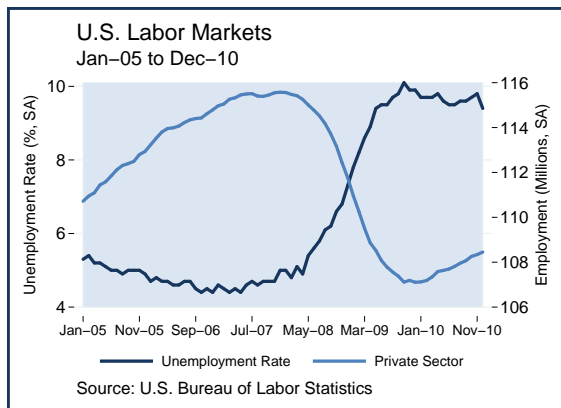
JOBS, JOBS, JOBS

There is no doubt that post-recession job growth in the United States has left much to be desired. Relative to the 8.5 million private sector jobs lost between December 2007 and December 2009, we still have a long way to go before the labor markets return to pre-recession levels.

Our nation's labor markets overall are consistently showing signs that we are on the mend. Total nonfarm employment has posted modest increases. And while the unemployment rate hovered around 9.6% before ticking up to 9.8% in November 2010, the private sector is faring better. By November, the private sector had added almost 1.2 million jobs to its payrolls from its trough.

Both incomes are rising and the average number of weekly hours is increasing, indicating that people are beginning to work more. Consumers are finding their footing again which has led to more than 100,000 additional jobs in retail and wholesale trade. Leisure and hospitality has also benefited, adding more than 180,000 positions over the past 11 months as people begin to dine out and entertain themselves again.

The administrative support sector has added over 520,000 new jobs since bottoming out in September of 2009. Not only is this a 7.4% increase from its low point, but it is also a signal of things to come: Traditionally businesses look to temporary workers to fill their short-term labor needs following a severe downturn. As the recovery gains steam, these workers are eventually replaced with permanent positions once employers feel confident enough to make long-term labor investments. Growing business investment and rising demand for professional services and high-tech goods should bring about a stronger recovery in service-sector jobs.



Despite many indications that the recovery is underway, many sectors have yet to turnaround—especially those connected to the housing meltdown. Construction, finance and insurance, and

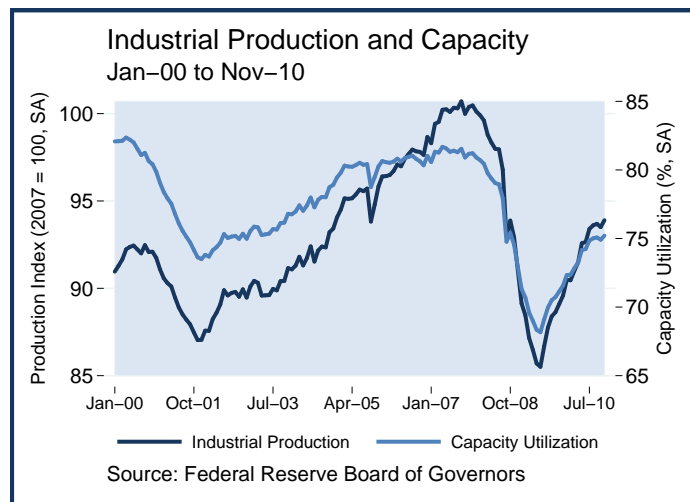
real estate continue to shed jobs, and all three remained at or near their lowest level of employment since the recession began. With household formation slowing dramatically and a large inventory of foreclosures and REO properties remaining in the system, residential permits have yet to see any significant increase. Beacon Economics expects to see only modest job growth in these sectors over the next several years.

There are more than 6 million people who have been unemployed for longer than 6 months. Many of these workers will find it difficult to reintegrate into the workforce given that a change in industry will be necessary in many cases. Unfortunately, regardless of how fast the recovery progresses, the unemployment rate will remain high for some time.

FACTORIES SWITCHING BACK ON

Another positive development in our nation's economy is that our factories are beginning to switch back on. This means good things across the spectrum. Stronger demand means rising income and profits for firms. This in turn generates demand for new workers, which then drives personal incomes and spending higher. Additionally, many developing nations in East Asia and elsewhere are returning to strong growth, generating increased demand for U.S. goods and services abroad.

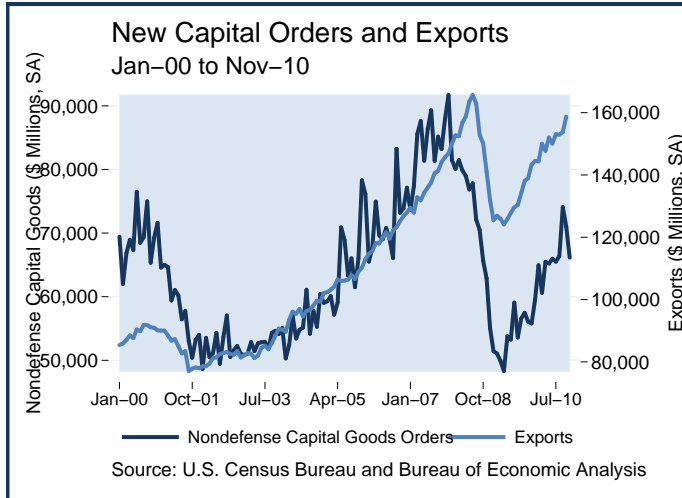
Since mid-2009, industrial production has been rising sharply across the manufacturing sector. Since its trough in June 2009, the Federal Reserve's index of industrial production is up almost 10%. Part of this is due to strong demand from abroad as the rest of the world recovers from the global downturn. The large injection of cash by the Federal Reserve's quantitative easing program has resulted in a weakening dollar, increasing the affordability of U.S. goods and services abroad.



As the Federal Reserve plans on a second round of quantitative easing, the dollar is expected to continue its downward trend. This will keep demand for U.S. exports strong over the next few years, and will keep the lights on at our nation's factories. Eventually, efficiency gains will

give way to new hiring as industrial capacity reaches critical mass. At 75% of existing capacity, factories still have some room to grow, but utilization of that capacity is rising quickly.

To some extent, the correction of huge imbalances in saving and spending in the United States has helped the nation to address its trade deficit. Despite opening slightly in the last few quarters, the trade balance contributed almost 1% to GDP growth during 2008 and 2009. Some of this was due to reduced spending on imports by consumers, which becomes more expensive for Americans as the dollar slides.



In addition to sending more goods abroad on a tide of currency depreciation, the nation's home grown businesses are beginning to expand as well. New orders for capital equipment (excluding defense products) are up sharply. This shows that U.S. firms are beginning to expand their existing capacity to meet a growing demand. Indeed, strong business investment in new equipment and software have also been contributing to growth out of the recession. Although

the past few years have been rough, now is the time to invest in capturing market share -- something firms are trying to do by expanding their IT infrastructure and building up their online presence.

ABOUT BEACON ECONOMICS

Beacon Economics is an independent economic research and consulting firm with offices in Los Angeles and the San Francisco Bay Area. We deliver economic analysis and data sites that help our clients make informed, strategic decisions about investment, growth, revenue, policy, and other critical economic and financial issues. Our nationally recognized forecasters were among the first to predict the collapse of the housing market and foretell the onset and depth of the economic downturn that followed. Our core areas of expertise include economic and revenue forecasting, market and industry analysis, economic impact studies, economic policy analysis, and international trade analysis.

SERVICES

- Economic & Revenue Forecasting
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