Economic Outlook

The national and California economies continue to recover at a modest pace. There are some signs the economy gained strength in the first quarter of 2013. Consumer spending boosted growth more than expected, while housing permits, home values, and construction jobs all grew. Industry sectors across the board added jobs, and unemployment fell.

Weaker global growth and reduced federal government spending will likely prevent acceleration to a more robust pace. At the time of the Governor's Budget, the forecast assumed across-the-board federal tax increases and major spending cuts would be avoided in 2013. With federal spending cuts now in place and the sunset of the payroll tax holiday, the outlook is weaker than the prior forecast. The recovery is expected to be slower than the Budget forecast.

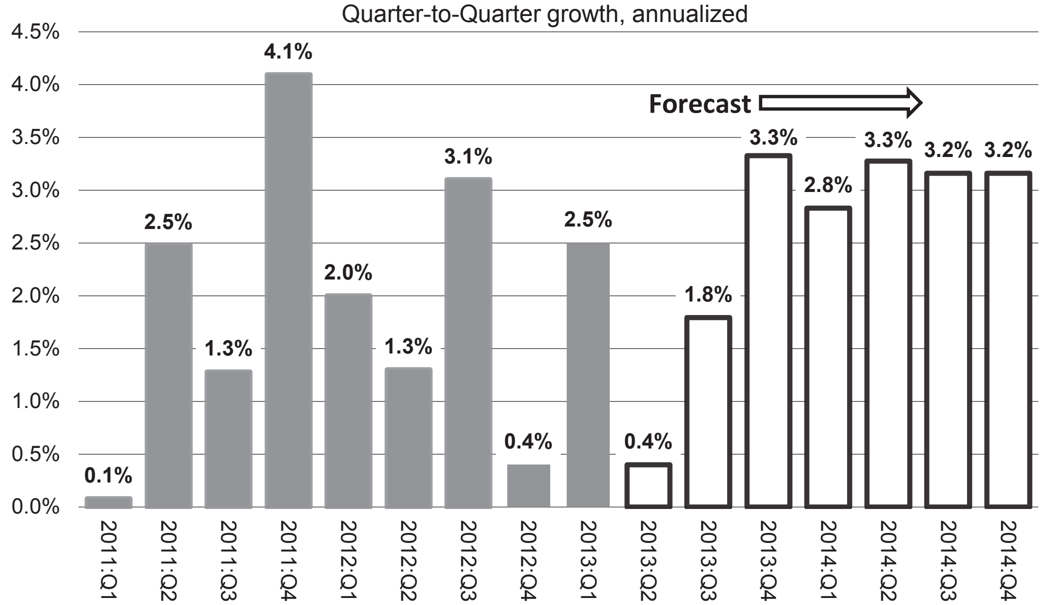
The Nation – Slow Recovery

The national economy has continued to grow at a slow pace. While the risks of another recession have receded, the determination of the federal government to cut spending in the near term has lowered overall demand and uncertainty has likely dampened consumer confidence.

The Governor's Budget forecast assumed that federal income taxes for households earning more than $250,000 would return to pre-tax cut levels, payroll taxes would not be raised, and automatic spending cuts would be averted by a more permanent agreement on deficit reduction.

The current forecast includes the higher federal income taxes on households earning more than $450,000 a year, expiration of the payroll tax holiday, and automatic spending cuts. The 2-percent increase in payroll taxes shows up directly in a lower rate of personal income growth. Automatic spending cuts and the higher federal income taxes for upper-income households are reflected in slower national economic growth during 2013 (Figure ECO-01).

Figure ECO-01
U.S. Real Gross Domestic Product
Quarter-to-Quarter growth, annualized



Source: U.S. Bureau of Economic Analysis; CA Department of Finance May Revision Forecast

Nonfarm employment continues to rise, with an average of 205,000 jobs added per month in the first quarter of 2013. The unemployment rate continued to fall, sliding to 7.6 percent at the end of the first quarter, but this was due partially to declining labor force participation. Hourly wages have been stagnant, and in April, weekly earnings for private sector workers fell by 0.4 percent due to fewer hours worked. Therefore, the reduction in the unemployment rate does not directly translate to higher personal income growth.

The inventory of existing homes for sale was 4.7 months in March 2013. This is well below the levels of the last six years, when inventories rarely dropped below 7 months. This indicates that demand is now outstripping supply. With the Case-Shiller index of home prices increasing for thirteen straight months (through February 2013), more owners may be encouraged to put their homes on the market.

Inflation has remained at low levels, and the Federal Reserve is expected to continue to keep interest rates low. With global demand slowing, commodities prices, including food and fuel, are not expected to rise quickly.

California – Recovery is Proceeding Slowly

In conjunction with the national economy, California is growing at a slow but steady pace, albeit slower than at the Governor's Budget forecast. After a steeper fall than the nation, the State's recovery is proceeding somewhat faster, and is spreading to more sectors and areas. The largest change to the California forecast comes as a result of federal changes. These changes will slow growth through lower federal spending in California, including unemployment insurance for the long-term unemployed who have exhausted regular unemployment benefits (lasting 26 weeks). In addition, the sunset of the payroll tax holiday directly lowered personal income growth by 2 percent in 2013, lowering consumer demand. The housing market is recovering, with median prices rebounding and new permits increasing. Jobs are being added at a fast enough pace that the unemployment rate is steadily falling and is now below 10 percent.

The housing market is showing signs of a more sustainable recovery. After hitting a low of close to 200,000 units in the middle of 2007, sales of existing single-family homes have rebounded to above 400,000 units (Figure ECO-02). Inventories of homes for sale are low, indicating demand is outstripping supply. More permits for new housing units are being issued. These trends are not confined to the coastal areas, where the housing recovery started last year, but have spread to inland markets.

There are also indications that sales are being supported by investment firms buying up homes to refurbish and convert to rentals. This is likely a reflection of high rental prices and low interest rates. Conversions of homes for sale into rental properties should help limit rental price increases and help support the housing sector. Median prices of single-family homes have risen to above $350,000 after consistently being below $300,000 as recently as the beginning of 2012. Rebounding prices should bring down the stock of underwater mortgages and bring more houses onto the market.

This shift has raised some concern about whether investment firms can effectively manage rentals. There is also concern that first-time homebuyers are being squeezed out of the market by investors who have the ability to pay cash, given current cash reserves

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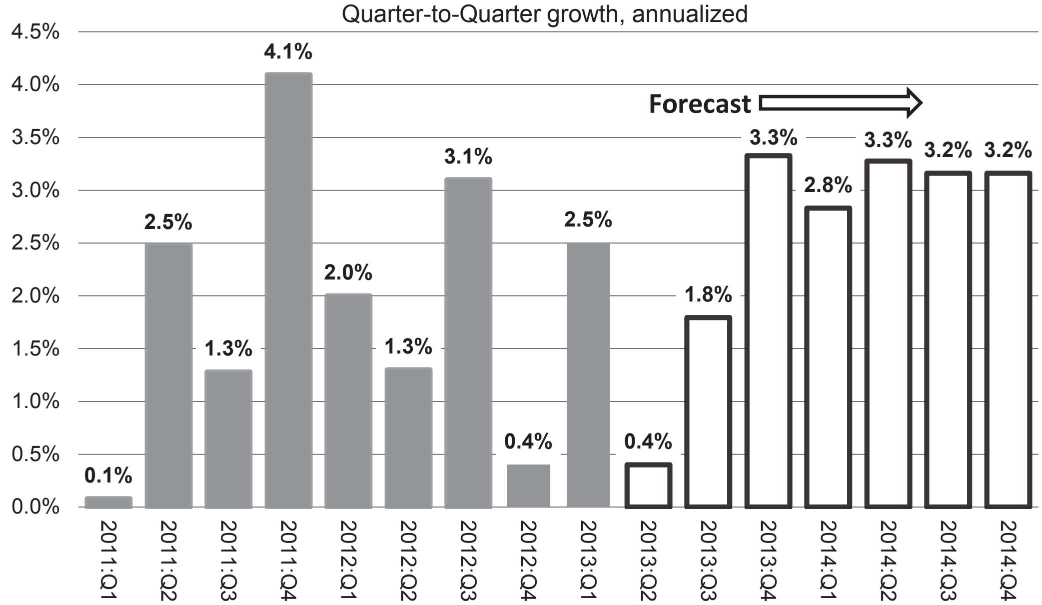

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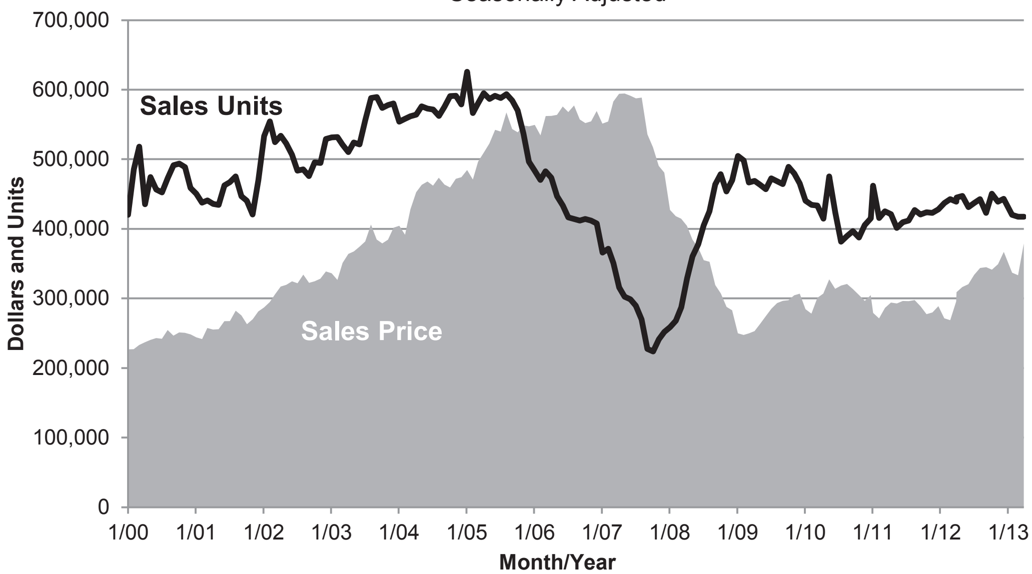
Figure ECO-02
California Median Home Price and Sales
Existing Single-Family Homes
Seasonally Adjusted



Source: California Association of Realtors

and a lack of other investment opportunities with higher yields. On the other hand, it is expected that the investor demand will be a temporary phenomenon as they draw down their cash to buy up the stock of foreclosed homes. Once house prices rise and individuals begin to sell and buy in larger numbers, large-scale investors are expected to concentrate on managing their housing portfolios. With mortgage rates expected to remain low for the next few years, the demand from investors should benefit California homeowners by helping transition the housing market back to a higher rate of buying and selling.

Jobs are being added at a steady pace, and the unemployment rate is falling despite an expanding workforce. More sectors are adding jobs, both in higher-wage sectors such as professional services, and in sectors such as construction and leisure and hospitality. Educational and health services have been growing, and this trend is expected to continue as the Affordable Care Act is implemented over the next few years. The number of jobs is expected to reach 2008 levels by the end of 2014. However, the unemployment rate will fall slowly as the California civilian labor force continues to expand from 18.21 million in 2008 to 18.77 million in 2014.

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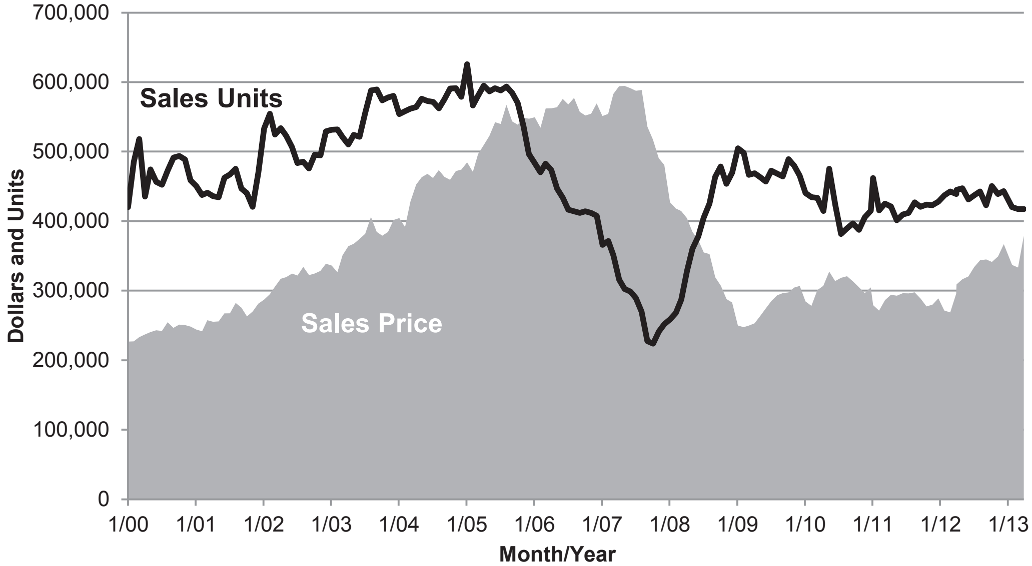

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Manufacturing jobs continue to decline, although the share of high-technology manufacturing jobs is holding steady. After strong export growth of 19 percent in 2010 and 11 percent in 2011 to compensate for the large fall in 2009, the pace slowed in 2012 to 1.6 percent for made-in-California exports. Overall, corporate profits remain high at the national level compared to gross domestic product. Continued investment by businesses, particularly in computers, should benefit California industries in these sectors.

Risks to the Forecast

The California and national economies are expected to continue their modest pace of growth, albeit with a weaker outlook than the Governor's Budget forecast. With unemployment falling, the housing sector slowly recovering, and monetary conditions offsetting fiscal tightening at the federal level, growth is becoming more sustainable. However, the expiration of the payroll tax holiday at the beginning of 2013 has notably reduced disposable income, and with consumers now preferring a higher saving rate, it will be some time before the economy is completely recovered.

Risks to the outlook include international, national, and local factors:

- Very slow growth in Europe will weaken global growth. This will also likely keep the US dollar strong in comparison, limiting export growth.
- Asian growth could slow. A sharper downturn in the State's major trading partners such as China, Japan, or South Korea would reduce exports and make California more reliant on domestic sources of growth.
- National fiscal policy could further reduce growth. Congress remains sharply divided about the appropriate pace for deficit reduction. While a recession is unlikely, another few years of slow growth would be costly to the still large numbers of unemployed workers.
- California's recovery could fail to take hold. Even with steady job growth and an improving housing market, uncertainty about future growth could cause individuals and businesses to delay spending, creating a self-reinforcing lower rate of expansion.

See Figure ECO-03 for highlights of the national and California forecasts.

Figure ECO-03

Selected Economic Indicators

United States	2008	2009	2010	2011	2012	2013 Projected	2014 Projected
Nominal gross domestic product, $ billions	$ 14,292	$ 13,974	$ 14,499	$ 15,076	$ 15,685	$ 16,211	$ 16,947
Real gross domestic product, percent change	-0.3%	-3.1%	2.4%	1.8%	2.2%	2.0%	2.8%
Contributions to real GDP growth							
Personal consumption expenditures	-0.4%	-1.4%	1.3%	1.8%	1.3%	1.5%	1.8%
Gross private domestic investment	-1.7%	-3.6%	1.5%	0.6%	1.2%	1.0%	1.2%
Net exports	1.2%	1.1%	-0.5%	0.1%	0.0%	0.0%	-0.2%
Government purchases of goods and services	0.5%	0.7%	0.1%	-0.7%	-0.3%	-0.5%	0.0%
Personal income, $ billions	$ 12,460	$ 11,867	$ 12,322	$ 12,947	$ 13,407	$ 13,787	$ 14,485
Corporate profits, percent change	-17.4%	7.5%	26.8%	7.3%	6.8%	1.0%	2.8%
Housing permits, thousands	905	583	605	624	816	--	--
Housing starts, thousands	900	554	586	612	782	970	1,265
Median sales price of existing homes	$ 196,600	$ 172,100	$ 173,100	$ 166,200	$ 177,200	--	--
Federal funds rate, percent	1.9%	0.2%	0.2%	0.1%	0.1%	0.2%	0.2%
Consumer price index, percent change	3.8%	-0.4%	1.6%	3.2%	2.1%	1.8%	1.9%
Unemployment rate, percent	5.8%	9.3%	9.6%	8.9%	8.1%	7.7%	7.3%
Civilian labor force, millions	154.3	154.2	153.9	153.6	155.0	156.1	157.5
Nonfarm employment, millions	136.8	130.9	129.9	131.5	133.7	135.7	137.9
California							
Personal income, $ billions	$ 1,611	$ 1,517	$ 1,564	$ 1,645	$ 1,730	$ 1,767	$ 1,868
Made-in-California exports, percent change	7.8%	-17.1%	19.2%	11.1%	1.6%	--	--
Housing permits, thousands	65	37	45	47	58	82	121
Housing unit change, thousands	95	70	36	36	45	--	--
Median sales price of existing homes	$ 348,490	$ 274,960	$ 305,010	$ 286,040	$ 319,340	--	--
Consumer price index, percent change	3.4%	-0.3%	1.3%	2.6%	2.2%	1.9%	2.0%
Unemployment rate, percent	7.3%	11.4%	12.3%	11.8%	10.5%	9.4%	8.6%
Civilian labor force, millions	18.2	18.2	18.3	18.4	18.5	18.6	18.8
Nonfarm employment, millions	15.0	14.1	13.9	14.1	14.4	14.7	15.0
Percent of total nonfarm employment							
Mining and logging	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
Construction	5.3%	4.4%	4.0%	4.0%	4.1%	4.2%	4.4%
Manufacturing	9.5%	9.1%	8.9%	8.9%	8.7%	8.6%	8.6%
High technology	2.5%	2.5%	2.5%	2.5%	2.4%	2.3%	2.3%
Trade, transportation, and utilities	19.0%	18.8%	18.8%	18.9%	18.9%	18.9%	18.7%
Information	3.2%	3.1%	3.1%	3.0%	3.0%	2.9%	2.9%
Financial activities	5.6%	5.6%	5.5%	5.4%	5.4%	5.4%	5.4%
Professional and business services	14.9%	14.6%	14.9%	15.1%	15.5%	15.8%	15.9%
High technology	2.1%	2.2%	2.3%	2.4%	2.5%	2.5%	2.6%
Educational and health services	11.6%	12.5%	12.8%	13.0%	13.1%	13.2%	13.2%
Leisure and hospitality	10.5%	10.7%	10.8%	10.9%	11.1%	11.3%	11.3%
Other services	3.4%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%
Government	16.8%	17.6%	17.6%	17.1%	16.5%	16.1%	15.9%

Forecast based on data available as of April 2013.
Percent changes calculated from unrounded data.