REGIONAL INTELLIGENCE REPORT
BEACON ECONOMICS Prepared by Beacon Economics, LLC
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The Big Gamble

November's votes were tallied, and it was clear that the masses had spoken—the weak recovery the US was experiencing was not acceptable. The thumping the Obama administration took in the fall can be traced to this more so than any other "hot button" topics surrounding the polls.

In the aftermath of the last two big recessions, in the mid-1970s and early 1980s, the economy grew at close to 6%. 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%. Underlying the tepid recovery are primarily weak consumer spending and housing—not particularly surprising, given that these components of the economy had swollen to unsustainable peaks in the bubble that preceded the crash.

The economy had started to pick up some speed through 2010 as a result of imbalances working their way out of the system and the initial set of stimulus packages put into place in 2009. While the labor markets were essentially flat, income growth started to pick up. Exports gained speed at the end of the year, and with easing in the credit markets borrowing became easier for businesses and consumers. The net result was a sharp acceleration in demand growth in the 4th quarter—6.9%. This huge gain was only masked by a sharp reduction in inventories—gains that will be made back in 2011.

This acceleration could have slowed yet again as the Bush tax cuts and the stimulus tax cuts came to an end. Equivalently, foreign investment in the US was starting to push the value of the dollar back up again. But the masses had spoken—they wanted growth and wanted growth now. After the elections QE2 was announced, along with the nearly full extension of tax cuts.

Economics is called the "dismal science" because it acknowledges that we live in a world of limited resources. This implies that we have to compromise: 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 policies regarding short-term economic growth are similarly constrained. We may make policy choices that spur on growth in the present—but this necessarily comes at a cost to future growth.

That 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 these policies should keep the recovery moving ahead at a fairly solid pace for the next two years.

As such, Beacon Economics has substantially improved its short-term outlook. We expect the doldrums that have defined the recovery, since its start in the 3rd quarter of 2009, to finally come to an end, with growth in 2011 averaging over 3% and accelerating through the year. Indeed, 2012 could end up seeing growth rates close to 4%. As growth accelerates, 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 not, we could end up in a worse situation than the mess that made our policy leaders take this big gamble in the first place, as the nation falls victim to either rampant inflation or a crisis in the public debt markets. Either way, we can be certain of higher taxes and interest rates at some point down the line.

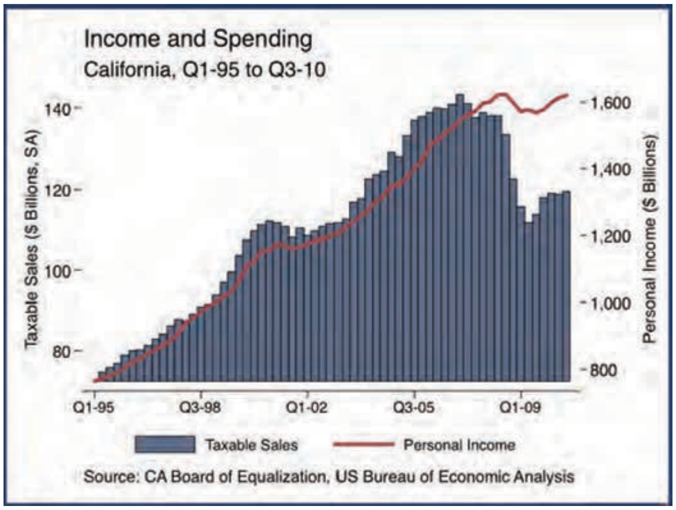
Thus, we continue to advise our clients to enjoy the present and ride what should be a solid wave of growth. But ultimately, concerns in the mid-term should temper any decisions regarding long-run investments.

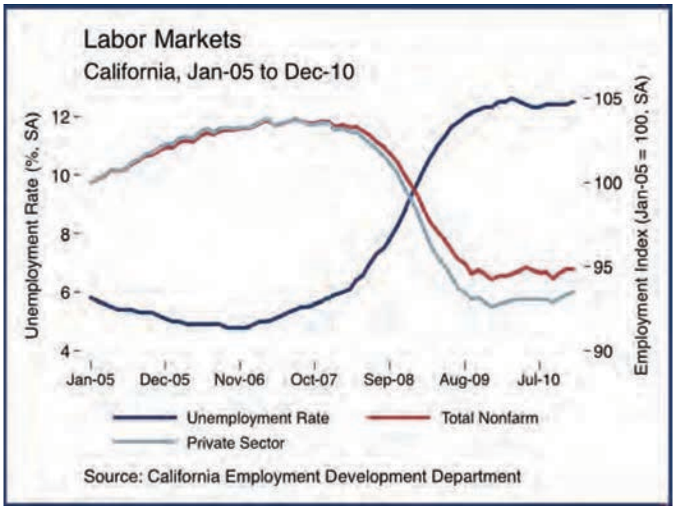
Getting Back on the Horse

The statistics on California's economy show that the recovery is well underway; however, some components of the economy are rebounding fairly quickly, while others continue to languish. It is important to remember that we are still at or very near the bottom. To use a parallel from physics (an old joke quips that all economists are failed physicists): we are currently overcoming a considerable amount of inertia; once things get moving and gain some momentum, growth will accelerate. Thus, times continue to be tough for businesses and residents across the state, as the economy slowly reawakens.

The Philadelphia Federal Reserve's "Coincident Economic Activity Index" shows that California's economy has expanded in nine of the last 10 months, averaging 1.5% growth on an annualized basis. Personal income has also risen steadily and is almost back to its pre-recession peak. As personal income has recovered, so too has consumer spending, which continues to gain steam in California with nearly a year-and-a-half of consistent growth. Indeed, the most recent data show that taxable sales have bounced back almost 7% from the trough reached in the second quarter of 2009. Still, we are trying to make our way out of a huge hole left by the "Great Recession" (to put things in context, taxable sales fell 22.1%), and there is a long climb ahead of us before we reach peak capacity.

The labor markets continue to struggle, as the recovery has been rather jobless to date. The state's unemployment rate has been stuck between 12.3% and 12.6% for over a year, and California employers have only added back 87,500 of the nearly 1.4 million jobs lost during the downturn. Although it offers little comfort to the





many Californians who are still out of work, this trend jibes with the experience of recent recessions ('92 and '01) and is likely the new reality of economic cycles—we are not going to see the type of rapid post-recession employment recovery typical of earlier downturns. At least things are moving in the right direction: While many sectors have continued to shed jobs, several others (including professional and administrative services, and leisure and hospitality) have more than offset those declines with positive job growth.

Similarly, the housing market remains depressed as it tries to work through problems in the mortgage market intrinsic to the housing collapse. The Mortgage Bankers' Association estimates that almost 12% of all mortgages in the state are seriously delinquent (60+ days past due or in foreclosure). Many more homeowners remain underwater on their loans—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. Nonetheless, housing appears to be finding some stability, despite recent policy-related turbulence, and growth is on the horizon for California's real estate markets—once the economy heals, and jobs and households begin to grow. While there is some fear of a significant double-dip in home prices, affordability and historically low interest rates should combine to counter the inevitable future influx of foreclosed properties. Prices may fall slightly, but they cannot go much lower before demand seriously ramps up, bringing them back to equilibrium. Thereafter, free of the uncertainty created by outstanding foreclosures, prices will rise; only this time, growth will be slower and more sustainable.

Economic Update

The good news is that the descent of Inland Southern California's economy has truly come to an end, and chances of a double dip back into recession are almost zero. Today, 'flat' is the operative word for the region (comprised of both Riverside and San Bernardino Counties). Although the unemployment rate fell slightly in December, in aggregate Inland Southern California has yet to produce a significant number of new jobs. While some industry sectors, including Wholesale Trade, Professional/Business Services, and Transportation and Warehousing have shown some improvement in recent months, others such as Construction, Leisure/Hospitality, and Retail Trade continue to face difficulty. The region's housing markets remain flat as well, with home prices falling slightly in the second half of 2010 as sales slumped in the wake of expiring homebuyer tax credits.

Still, 'flat' means that Inland Southern California is beginning to see light at the end of the tunnel. Incomes and taxable sales have been trending up for several consecutive quarters – and these are the first signals of recovery in a region that was among the hardest hit in the state. With that in mind, Beacon Economics has focused its analysis here on a longer run issue that we believe must play a significant role in the area's recovery – matching employment opportunities with local skills and businesses. Inland Southern California needs to find a way to retain residents who leave the region each day to work in neighboring counties, and to substitute workers imported from surrounding areas with locals.

Employment Dynamics

It is a well-known fact that Southern California has some of the worst rush hour traffic in the United States, if not the world. These conditions result from a fairly severe disconnect between where people live and where they work. Due to differences in cost of living, wages, and job opportunities, people tend to reside significant distances from their places of employment.

This is particularly true of Inland Southern California, an area that is considerably more affordable than the nearby coastal Counties of Los Angeles, Orange, and San Diego, but also one where wages are considerably lower. Thus, many people who live inland, drive towards the coast for work. And even though the major cities in the Riverside-San Bernardino-Ontario MSA are relatively close to the coastal employment centers, the sheer number of commuters overwhelms the transportation network.

The U.S. Census Bureau's Longitudinal Employer-Household Dynamics database provides specific insights into the particulars of employment flows in the area. Through the data we are able to identify where disparities exist between employee characteristics and available jobs. This information should provide workforce and business development agencies, as well as business planners, with valuable guidance as to where to direct their efforts.

Inland Southern California has a net surplus of labor, with some 22.5% more working residents than there are available jobs. Furthermore, a much larger share of the region's working residents, 41.2%, commute out of the area, sustaining the widely held perception of Inland Southern California as a bedroom community. Thus, there is an in-area labor force efficiency of just 58.8%. This exodus, in turn, creates a shortfall in the local labor supply, leading to an influx of workers from outside the area, who fill 27.9% of the region's jobs. This results in an in-area employment efficiency of 72.1% – the proportion of jobs located in Inland Southern California that are also filled by locals. This underscores the lack of sufficient employment opportunities for local residents, which is exacerbated by the fact that more than 300,000 workers annually are imported into Inland Southern California to fill jobs.

Employment Flows, 2008

Measure	Count
Jobs Located in RV-SB-ON	1,100,111
Employed Residents of RV-SB-ON	1,348,178
Residents Employed Locally	793,197
Workers from Other Regions	306,914
Outflow of RV-SB-ON Residents	-554,981
Net Worker Flow	**-248,067**

Source: U.S. Census Bureau, LEHD

It is important to keep in mind that these data reflect employment at a fairly early point in the recent recession, even though job losses in the area began relatively early, in mid-2007. When the 2009 data are released, we can expect to see significantly lower figures.

Commute - Patterns

An investigation into where Inland Southern California residents work reveals few surprises at the county level—95.3% work within the area or in adjacent coastal counties. Workers are fairly evenly distributed between San Bernardino and Riverside Counties, with close to 400,000, just under 30%, employed in each County. A large number of Inland Southern California's residents commute to Los Angeles and Orange Counties, which are closest to the region's major population centers; far fewer people make the longer trip to San Diego County. Thereafter, the shares of individual counties become very small (<1%). Interestingly, almost 4,000 people work in the Las Vegas, NV area (Clark County), and in Santa Clara County in the Bay Area, putting them into the top ten.

The cities that provide the most jobs for Inland Southern California's working residents fall within the region—the City of Riverside actually commands the largest share, followed by San Bernardino. The biggest cities in Los Angeles, San Diego, and Orange Counties employ a significant share of working residents, although due to Orange County's sprawling, suburban character, Anaheim is the last of the top ten cities, while San Diego comes in sixth.

In terms of where workers in the Riverside-San Bernardino-Ontario MSA reside, we see the same pattern as with residents—although Riverside now tops the list, the same five counties supply 95.3% of the area's labor. A much larger share of workers come from within the area, while the percentage of employees coming from Los Angeles, Orange, and San Diego counties is much lower. Still, there are significant numbers of workers in the region who live in surprisingly distant counties-Sacramento and Alameda are in the top ten. While this quite possibly arises from discrepancies between official and actual place of residency or employment, some of these are likely long distance commuters who work in the area during the week and return home on weekends.

In line with the larger percentage of locally residing workers, almost all of the top cities where workers live are within Inland Southern California. In fact, the only city in the top ten not in Riverside or San Bernardino Counties is the City of Los Angeles.

Counties Where Workers Reside, 2008

County	Count	Share (%)
Riverside	412,392	37.5
San Bernardino	380,805	34.6
Los Angeles	148,426	13.5
Orange	59,381	5.4
San Diego	47,296	4.3
All Others	51,811	4.7
Total	1,100,111	100.0

Source: U.S. Census Bureau, LEHD

Counties Where Residents Work, 2008

County	Count	Share (%)
San Bernardino	399,880	29.7
Riverside	393,317	29.2
Los Angeles	262,381	19.5
Orange	160,287	11.9
San Diego	68,537	5.1
All Others	63,776	4.7
Total	1,348,178	100.0

Source: U.S. Census Bureau, LEHD

Inflow/Outflow Analysis

When we look at the characteristics of workers who commute into and out of the Riverside-San Bernardino-Ontario MSA, there are some surprising similarities between the two groups. The age distribution is very similar, although there is a slight leaning towards younger workers coming into the area. A similar proportion of workers travel to fill jobs in goods producing sectors as come into the area for the same type of work. However, a significantly larger percentage of the inflow workers are employed in trade, transportation, and utilities, filling lower-paying positions, while a greater share of outflow workers are employed in the other service sectors and, consequently, tend to earn higher wages. It is a small leap to deduce that these workers opt for longer commutes to enjoy the dual benefits of higher compensation and lower living costs.

The differences between commuters into and out of the area and those who work and live in the region are far more pronounced. Those who both live and work in the area are somewhat older, indicating a possible preference among older workers to live closer to their place of employment. This in fact may drive some of the influx of younger workers, as they are brought in to fill lower-paying, entry-level jobs. The distribution of interior flow workers is also much more heavily skewed towards the Other Services sectors. It is fairly likely that many workers in Education, Health Care, and Professional and Business Services are local residents—Administrative Services, in particular, is heavily concentrated in the region. This coincides with the proportions seen in the various earnings categories, however, it also indicates that the relatively large Retail Trade, and Transportation and Warehousing sectors draw on employees from outside the area. Finally, while we believe many locals work in the Hospitality sector, it is quite probable that there is a shortfall of local labor in this industry that must be bridged with younger workers living in adjacent counties.

Overall, while there are clearly some gaps between local worker characteristics and locally available jobs, we do see quite a bit of overlap in the commuting population. This indicates that more jobs in Inland Southern California could theoretically be filled by local residents. The key factor that drives younger workers to commute out of the area is likely the difference in available wages. Similarly, they may often move into the area for its affordability. By cultivating new business formation and working to attract existing businesses into the region, Inland Southern California could alleviate some of this strain and take advantage of the local available workforce. Focusing on education to attract high-skilled jobs into the region would help raise wages and incomes, and could potentially lead to greater labor force efficiency. Ultimately, until Inland Southern California's job base expands significantly, a considerable amount of commuting cannot be avoided due to the significant excess of available labor.

Worker Characteristics, 2008

Attribute	External Jobs Filled by Residents		Internal Jobs Filled by Nonresidents		Internal Jobs Filled by Residents	
	Count	Share (%)	Count	Share (%)	Count	Share (%)
Jobs	554,981	100.0	306,914	100.0	793,197	100.0
Age ≤ 30	176,387	31.8	111,567	36.4	224,174	28.3
Age 30 – 54	304,186	54.8	152,865	49.8	443,420	55.9
Age ≥ 55	74,408	13.4	42,482	13.8	125,603	15.8
Earn ≤ $15,000	117,391	21.2	77,884	25.4	180,337	22.7
Earn $15,001 - $39,999	211,804	38.2	126,330	41.2	334,111	42.1
Earn ≥ $40,000	225,786	40.7	102,700	33.5	278,749	35.1
Goods Producing	115,102	20.7	56,249	18.3	143,763	18.1
Trade, Transport, Utilities	146,217	26.3	103,111	33.6	158,959	20.0
All Other Services	293,662	52.9	147,554	48.1	490,475	61.8

Source: U.S. Census Bureau, LEHD

BEACON ECONOMICS

About Beacon Economics

Beacon Economics, LLC is an independent economic research and consulting firm with offices in Los Angeles and the San Francisco Bay Area. We deliver economic analysis that help our clients make informed, strategic decisions about investment, growth, revenue, policy, and other critical economic and financial issues. Our core areas of expertise include economic and revenue forecasting, market and industry analysis, economic impact studies, economic policy analysis, and international trade analysis.

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