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Further Slowing Economic Forecast for 2014

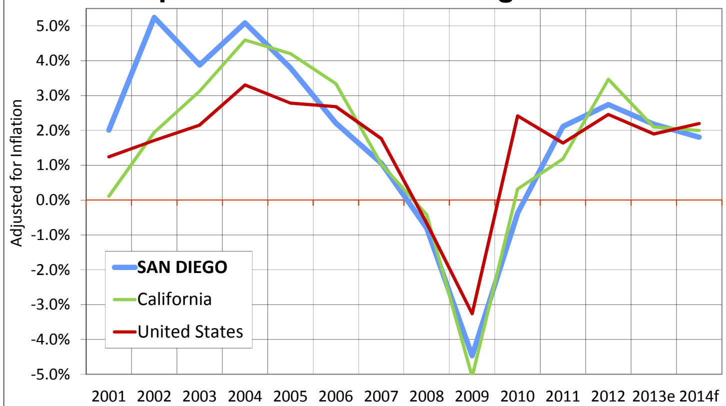
Summary of San Diego 2014 outlook

San Diego's 2014 economic momentum is projected to trail growth across the U.S. and California. The slowing rate of growth is the result of higher taxes implemented nationally and statewide, cutbacks of military spending particularly significant for San Diego's highly defense based economy, and further fallout from policy changes associated with the Affordable Care Act. The pace of economic expansion remains stubbornly sluggish and recovery continues to be uncertain and frustratingly slow.

Following an acceleration of job growth in 2012, the number of jobs added in 2013 slightly softened. In the fourth year of recovery, we project San Diego's *total payroll jobs* by the end of 2014 will at last approach pre-recession highs set in 2007.

San Diego's unemployment rate will continue to improve,

Comparison of Annual Change in GDP



Source: U.S. Department of Commerce, Bureau of Economic Analysis.
e: estimate, f: forecast by National University System Institute for Policy Research.

SELECTED SAN DIEGO COUNTY ECONOMIC INDICATORS

Indicator	Actual 2009	Actual 2010	Actual 2011	Actual 2012	Estimate 2013	Forecast 2014	Annual Percent Change 10/09	11/10	12/11	13e/12	14f/13e
Gross Domestic Product											
(billions)	$163.6	$163.9	$169.9	$177.4	$184.3	$191.5	0.1%	3.7%	4.4%	3.9%	3.9%
Inflation Adjusted Change+							-0.4%	2.1%	2.7%	2.2%	1.8%
Population*	3,091,579	3,115,810	3,128,734	3,150,178	3,172,700	3,195,700	0.78%	0.41%	0.69%	0.71%	0.72%
Change	27,143	24,231	12,924	21,444	22,522	23,000	-11%	-47%	66%	5.0%	2.1%
Net Domestic Migration	-10,662	-9,531	-19,400	-16,239	-18,578	-19,400	-11%	104%	-16%	14.4%	4.4%
Net International Migration	11,861	8,249	8,424	13,183	16,500	18,000	-30%	2.1%	56%	25.2%	9.1%
Natural Increase	25,945	25,514	23,900	24,500	24,600	24,400	-1.7%	-6.3%	2.5%	0.4%	-0.8%
Employment											
Labor Force	1,554,900	1,574,100	1,582,200	1,599,100	1,607,600	1,628,300	1.2%	0.5%	1.1%	0.5%	1.3%
Employed	1,405,600	1,408,200	1,423,500	1,456,300	1,489,600	1,517,600	0.2%	1.1%	2.3%	2.3%	1.9%
Unemployed	149,300	165,900	158,700	142,800	118,000	110,700	11.1%	-4.3%	-10.0%	-17.4%	-6.2%
Unemployment Rate	9.6%	10.5%	10.0%	8.9%	7.3%	6.8%	0.9%	-0.5%	-1.1%	-1.6%	-0.5%
Payroll Industry Employment	1,241,700	1,233,000	1,243,200	1,268,600	1,291,700	1,312,700	-0.7%	0.8%	2.0%	1.8%	1.6%
Change	-67,900	-8,700	10,200	25,400	23,100	21,000					
Construction											
Residential Units	2,946	3,494	5,370	5,675	8,255	9,000	18.6%	53.7%	5.7%	45.5%	9.0%
Multiple Units	1,168	1,224	3,125	3,478	5,690	6,400	4.8%	155%	11.3%	63.6%	12.5%
Single Units	1,778	2,270	2,245	2,197	2,565	2,600	27.7%	-1.1%	-2.1%	16.8%	1.4%
Taxable Sales (billions)	$39.7	$41.6	$44.6	$47.9	$49.5	$51.0	4.8%	7.1%	7.6%	3.3%	2.9%
Inflation Adjusted Change							3.4%	3.9%	5.9%	2.1%	0.8%
Per Capita	$12,851	$13,359	$14,242	$15,221	$15,609	$15,946	4.0%	6.6%	6.9%	2.5%	2.2%
Inflation Adjusted Change							2.6%	3.5%	5.2%	1.3%	0.06%
Inflation Rate											
San Diego Consumer Price Index (CPI-U: 1982-84=100)	242.3	245.5	252.9	257.0	260.1	265.5	1.3%	3.0%	1.6%	1.2%	2.1%

+Adjusted for inflation by Implicit Price Deflator for California. *Population as of January 1 of following year.

Sources: U.S. Department of Commerce, Bureau of Economic Analysis; California Department of Finance; California Employment Development Department; U.S. Bureau of Census; California Board of Equalization; U.S. Department of Labor, Bureau of Labor Statistics.

e: estimate, f: forecast by National University System Institute for Policy Research.

falling to the lowest level of the past six years. Employment growth, however, is not keeping pace with working age population increases of the labor force. Much of the improvement in unemployment rate results from shrinking numbers looking for work as jobs being added.

We forecast consumer spending,, as reflected by taxable sales, will improve as inflation modestly rises over the coming year.

Population growth is likely to be very modest, dampened by continuing net out-migration of residents. Meanwhile international migration rebounds and natural population increases remain steady.

We see housing prices flattening in 2014, as residential construction continues to slightly improve.

Overall 2014 will not shape up as a year of accelerating recovery but largely, and unfortunately, "more of the same." Financial crises take longer to recover from than other downturns. The United States has also given itself several self-inflicted wounds. Finally, San Diego faces the same headwinds it often experiences during downturns of defense spending. The combination of these factors leads us to be somewhat pessimistic and cautious in our outlook for the upcoming year.

The national outlook

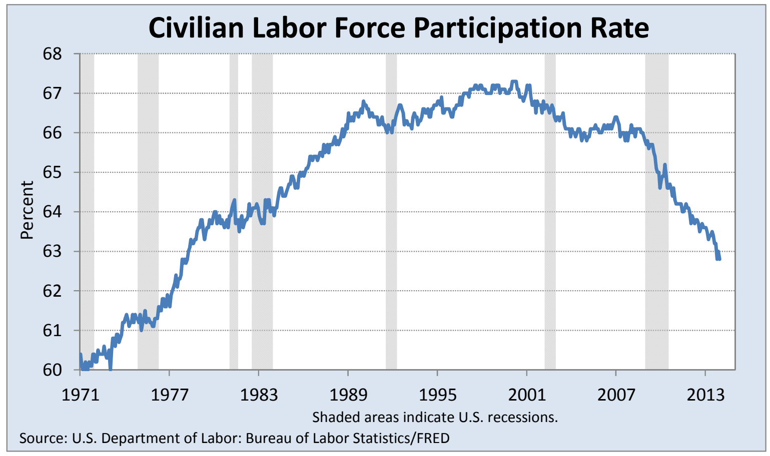
San Diego's economy, like every other large U.S. metro area, is heavily influenced and dependent upon national conditions. Current circumstances at the national level remain quite mixed and there is significant degree of variance between forecasts. On the one hand, most forecasts focus on the continuing ongoing recovery. Consensus among forecasters is U.S. economic activity will accelerate in 2014. Some even proclaim we are "over the hump" and the economy will at long last be sailing along unrestrained by the forces associated to the "Great Recession".

Among 51 prognosticators surveyed in the *Wall Street Journal*'s economic forecast survey, forecasts for "real" U.S. GDP growth in 2014 range from 2.0 to 4.1 percent.[1] The *UCLA Anderson Forecast* foresees 3.0 percent growth[2], while *Beacon Economics* projects 2.7 percent.[3] We anticipate somewhat lower growth at the national level, chiefly because we believe there is lingering weakness in respect to business expansion and headwinds that exist as the *Federal Reserve* unwinds its stimulus efforts.

Fed stimulus

Much of the uncertainty about 2014 at the national level comes from the very challenging and unprecedented task before the Federal Reserve. The Fed has undertaken stimulus measures without inflation measurably stirring. At some point, however, rising interest rates are significant risk factors. The economy's addiction to low interest rates underlies surging stock prices, while low borrowing costs have raised corporate profits and made possible the record wave of stock buybacks. The same is true for the real estate market buoyed by record low interest rates incentivizing institutional investors with historically easy financing to buy large stocks of price reduced housing.

That the Fed continues such massive stimulus or Quantitative Easing (QE) at all underlies the economy's fragility and unsustainability. The economy's addiction to low interest rates encourages surging stock prices, while low borrowing costs raised corporate profits and made



possible the record wave of stock buybacks. The same is true for the real estate market buoyed by record low interest rates incentivizing institutional investors with historically easy financing to buy large stocks of price reduced housing.

A concern is that as the Fed pulls back we will see stocks falter, real estate will cool off, and as a result, consumer confidence and spending will weaken. Moreover, the projected winding down of such massive QE is unprecedented and there is great uncertainty among economists whether the Fed has the skill and tools to do so without roiling markets and creating turmoil. For these reasons we see tapering of QE as one that will create drags at the national level, not necessarily from the lessening of stimulus but because of the uncertainties and worries of how the broad economy will respond.

Disjointed employment statistics

The Bureau of Labor Statistics (BLS) indicates employment continue to recover as the number unemployed fell by 1.9 million in 2013, yet 10.3 million remain unemployed. Since the low point of the recession, more than 7 million jobs were added. In terms of total jobs, however, the nation remains below pre-recession levels and in the meantime population also continues to expand resulting in a smaller percentage of job-eligible civilian population (non-institutionalized individuals age 16 and older) actually being employed.

As of December 2013, another 2.4 million people are classified as "marginally attached" to the labor force. These individuals wanted and were available for work, had looked for work sometime in the past year, but had not searched for a job in the four weeks prior to being surveyed by the BLS. Although clearly remaining unemployed, they are no longer counted among unemployment figures.

By the end of 2013, the ratio of employment to population sunk to nearly 63 percent, the lowest level in more than 35 years.

National economic conditions will be greatly impacted by what happens with these individuals dropping out of the labor market. If labor participation rates continue to remain at present levels there is every reason to believe that job growth is going to remain muted. There will be just too much of a drag on confidence and consumer spending to make up lost ground. Until the labor force resumes historically normal growth, including those missing workers falling out of the labor force, the economy cannot be expected to resume normal growth rates.

ACA impact on the economy

2014 is a critical year for the Affordable Care Act (ACA). The exchanges have now been up and "running since October and the window for coverage this year will close in March. Close observers are seeing both positive and very troubling signs in respect to the pool of individuals signing up for coverage. Uncertainty remains about how the incentives on the individual mandate will play out and the delay on business compliance with the ACA's requirement is another source of uncertainty. This on top of the fact that 16 million Americans work directly in the health care service sector and that the industry continues to navigate through the changes the law mandates on our nation's healthcare system.

We believe that until there is more certainty about how the ACA will evolve, up to and including whether the risk pool of previously uninsured individuals is sustainable, the ACA will be a drag on national economic performance. Irrespective of one's opinions about the law, it is simply the case that ACA represents a fundamental change in this very large segment of the U.S. economy and until there is more clarity, economic growth is likely to be muted.

Uneven California rebound

California's economy fell deeper in the depths of recession than the nation and lagged in recovery until growth accelerated in 2012 and 2013. Much of the recent gains are attributed to the boom occurring in the San Francisco Bay Area. Although recovering international trade somewhat helped Los Angeles, Southern California continues to significantly lag San Francisco-San Jose metro areas.

Unemployment across the state reached a peak in October 2010 of 12.4 percent, behind only Nevada and Michigan. As of December 2013, the rate had fallen to 8.3 percent, still the fifth-worst in the U.S., with 1.5 million Californians still looking and unable to find work.

SAN DIEGO GROSS DOMESTIC PRODUCT

Year	GDP (Billions)	Percent of Calif.	Percent of U.S.	Constant Dollars* S.D.	Constant Dollars* Cal.	Constant Dollars* U.S.
2001	$114.475	8.54%	1.12%	2.0%	0.1%	1.2%
2002	$123.271	8.89%	1.17%	5.2%	1.9%	1.7%
2003	$131.024	8.97%	1.18%	3.9%	3.1%	2.2%
2004	$141.494	9.01%	1.20%	5.1%	4.6%	3.3%
2005	$151.388	8.96%	1.21%	3.8%	4.2%	2.8%
2006	$159.582	8.87%	1.20%	2.2%	3.3%	2.7%
2007	$166.017	8.87%	1.19%	1.1%	1.0%	1.8%
2008	$167.732	8.83%	1.18%	-0.8%	-0.4%	-0.7%
2009	$163.644	9.00%	1.18%	-4.5%	-5.1%	-3.3%
2010	$163.875	8.88%	1.14%	-0.4%	0.3%	2.4%
2011	$169.888	8.90%	1.14%	2.1%	1.2%	1.6%
2012	$177.410	8.86%	1.14%	2.7%	3.5%	2.5%
2013e	$184.293	8.88%	1.15%	2.2%	2.1%	1.9%
2014f	$191.492	8.88%	1.14%	1.8%	2.0%	2.2%

*Adjusted by GDP implicit price deflator.

Source: Bureau of Economic Analysis, U.S.Department of Commerce; e: estimate, f: forecast by National University System Institute for Policy Research.

Many parts of California are also being left behind as multiple inland areas continue to face double-digit unemployment rates and additional foreclosures. Two inland cities, Stockton and San Bernardino, declared bankruptcy in 2012. The Census Bureau's supplemental poverty measure, which takes into account the cost of living and public benefits, shows California's poverty rate of 24 percent is the highest in the nation.

The *Economist* magazine states in their "The not so Golden State" report on California, "...beyond the gilded strip of land between San Francisco and San Jose is another California, an inhospitable place plagued by overregulation, mindless bureaucracy, high taxes and endless lawsuits. Last May, six months after the state raised its top income-tax rate to the highest in the land, Chief Executive magazine named it America's worst for doing business—for the ninth year in a row."[4]

Hanging over the state are mounting debt liabilities of some $355 billion, mostly from unfunded promises to provide pensions and health care for retired public service employees. Financing this debt requires some combination of higher taxes, epic court battles to retroactively reduce benefits, and/or decrease spending in other areas to pay down the liabilities. All of these strategies will have negative impacts on the state's economy and each year Sacramento delays in addressing them increases the size of the ultimate bill.

The third and perhaps most serious problem is the crisis of poverty and social immobility, particularly among Latinos (who will soon become the state's largest ethnic group). Under the Census Bureau's "supplemental poverty measure", which includes cost-of-living adjustments and non-cash benefits, California highest poverty rate in the nation continues to grow. Almost a quarter of California's 38.2 million residents cannot pay for basic necessities. While having always drawn in poor immigrants, upward mobility seems to be stalling for too many Californians.

San Diego's economic trends

San Diego's gross domestic product (GDP), the most comprehensive measure of economic activity, exceeded gains in both California and the U.S. during 2011 and 2012. San Diego's 2.7 percent increase in 2012 was the most vigorous since before the recession in 2005.

San Diego's pace of increase is estimated to have slightly slackened in 2013 to 2.2 percent. This estimate is largely based upon evidence of comparative job growth. The expansion of the U.S. economy also slowed from 2.5 percent in 2012 to 1.9 percent in 2013.

With state and national conditions as the backdrop, we see the local region struggling to maintain the growth experienced in 2013. **Therefore, we project further slowing to 1.8 percent in 2014.**

Four specific factors have the most impact on San Diego's economic fortunes: Federal spending, innovation clusters, tourism, and real estate.

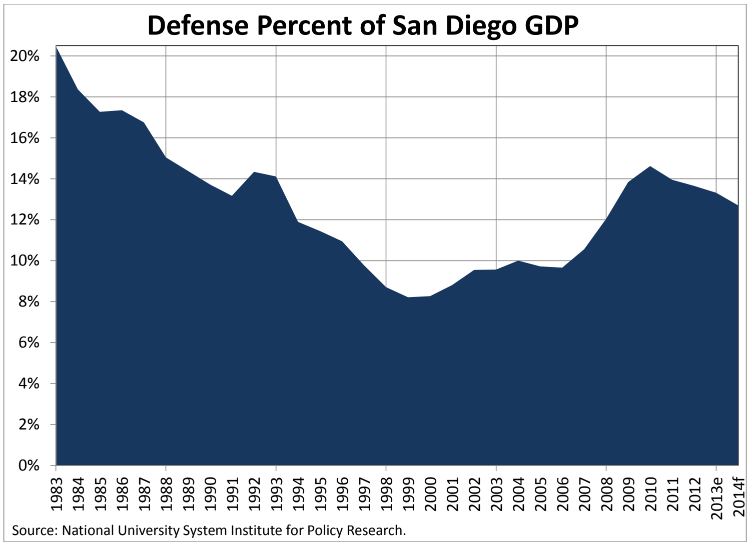
Government, including military operations, directly account for 18 percent of San Diego's GDP. Contributions from government expenditures rose significantly over the past decade almost entirely due to the expansion of military spending, while state and local government sectors otherwise enacted significant budget cutbacks. Defense contracting is also deeply ingrained among San Diego industries supporting base operations and developing and producing modern systems, weapons and applications for the military. Cutting-edge private sector efforts additionally serve defense efforts in intelligence gathering, cyber security, and other electronics and computer software systems.

As a percentage of the economy, we foresee defense spending directly shrinking from 14.6 percent of San Diego's GDP in 2010 to 12.7 percent in 2014.

Despite manufacturing employment shrinking in San Diego, production dollars continue to rise as high-value manufacturing production expands. The value of manufacturing produced in San Diego increased 21 percent between 2007 and 2012 to $51.1 billion. Over this same period, however, manufacturing employment fell 8.9 percent (-9,100 jobs). Another 1,000 manufacturing jobs were lost in 2013. The threat of manufacturing production relocating or expanding away from San Diego also remains a threat.

Obviously, current production processes in San Diego employ more highly skilled (and higher compensated) workers to manufacturer higher valued products. San Diego is a concentrated hub for research and innovation in biotechnology, genomics, communications, software development, cyber-security and clean-tech. The historic aerospace sector also prospers with the military's expanded use of unmanned aerial vehicle (UAV) systems developed and produced in San Diego.

Additional opportunities exist for San Diego manufacturers to further expand operations in Mexico under maquiladora and other bi-national partnerships. The San Diego-Tijuana bi-national region provides competitive costs, distance and time advantages over far-flung and less secure Asian operations. Because of higher value production and bi-national advantages, we foresee the value of manufacturing production in San Diego



Source: National University System Institute for Policy Research.

rising in 2014, although job numbers may not be as robust.

San Diego's technology sectors for the most part continued to thrive through the lagging recovery. Altogether technology industries make up 6.7 percent of San Diego employers, but directly account for 11 percent of all regional jobs, and 22 percent of all payroll wages. The annual average wage among San Diego tech companies is $104,200 as of 2013, nearly double the County's overall average wage of $54,325. Separating out non-technology jobs from overall average leaves non-tech employees averaging $48,200, less than one-half technology company's average wage.

We believe 2014 should be a relatively decent year for San Diego's technology-oriented industries outside of defense and medical devices. It seems, as of this writing, that Washington is attempting to avoid the fiscal crises and address the budget impasses leading to sequestration. This should be good news for San Diego's research institutions and universities, critical both in the short and long term for growth in these sectors.

Both professional and business services and the health care industry rose significantly relative to the local economy over the past decade. Healthcare continually led gains even during the recession. Home to a significant and expanding population of aging retirees, and home to cutting edge health care delivery systems, San Diego requires ever more services as health providers significantly expand facilities and services.

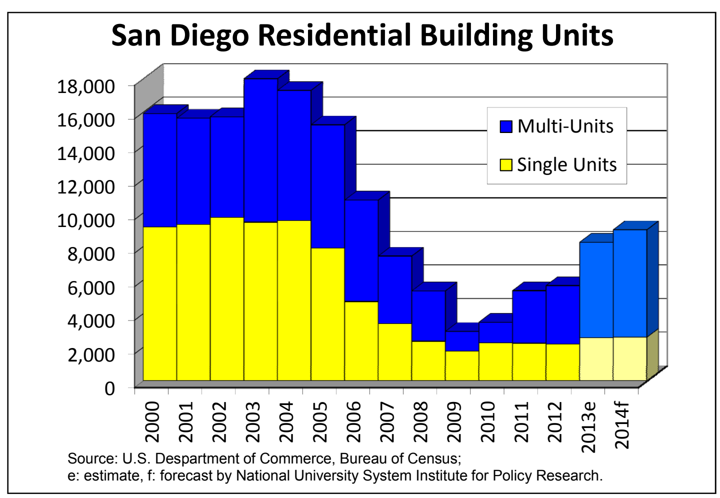
Travel and tourism continues to stage significant recovery with visitor numbers rebounding and both hotel occupancies and room rates rising. Attendance at San Diego attractions and events are also increasing. With 33 million estimated visitors in 2013, San Diego reestablished record numbers for both overnight and day visitors. Hotel occupancy levels are also approaching pre-recession levels near 74 percent.

After several years of severely reduced building activity, the construction industry shows some improvement the past two years. Both residential and nonresidential construction projects are appearing in pockets around the county.

Real estate activities are crucial as they account for nearly one in every five dollars generated by the San Diego economy. More than two-thirds of new residential construction in 2013 will be for multi-unit building.

Housing was a big plus in 2013, with housing prices rebounding strongly thanks to the dwindling inventory of for sale homes and record low mortgage rates. Sales activity started strong, but slowed as the year progressed. Lower prices caused by increased inventory may somewhat offset the negatives of higher interest rates and stagnant employment and incomes, but home sales are likely to further flatten in 2014.

Looking forward, we expect about 9,000 residential units to be pulled in 2014. With no major new public infrastructure projects scheduled to begin in 2014, we think employment gains in this sector will continue to be modest and well under the peak of 95,000 such jobs recorded in 2006. That said, after having lost 42 percent of those jobs during the recession, recovering from less than 55,000 to



Source: U.S. Despartment of Commerce, Bureau of Census;
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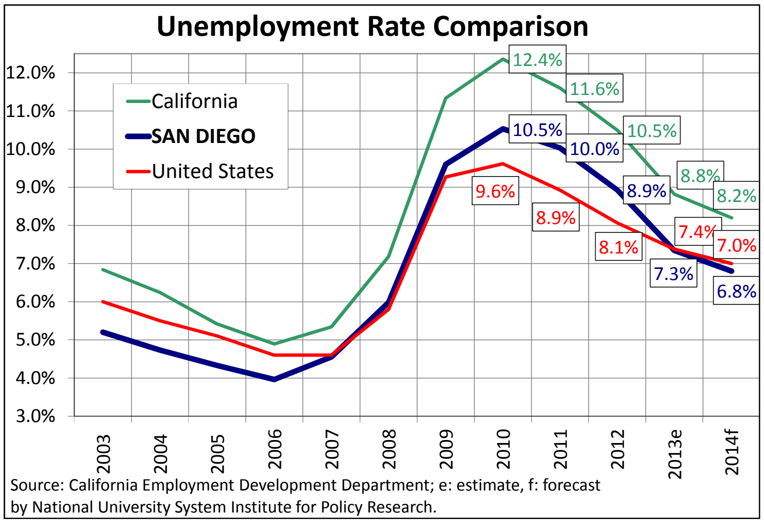


Source: California Employment Development Department; e: estimate, f: forecast by National University System Institute for Policy Research.

more than 65,000 construction jobs in 2014 will be a major triumph.

Employment outlook

While economic production is improving, employment in San Diego, as in the rest of the nation, remains below pre-recession peaks. Between the high point of payroll jobs reached in June 2007 to bottom in late 2009/early 2010, San Diego lost 102,200 jobs. Since that time, approximately 80,400 jobs have been added as of December 2013, just 21,800 jobs shy of the former peak.

Nearly every major industry sector in San Diego added jobs in 2013. The most noteworthy exceptions were manufacturing, Federal government, information, and real estate sectors.

Otherwise, overall employment improved led by strong gains in accommodations and food services, construction, healthcare, retail/wholesale trade, and education.

Taking into account these issues, we are forecasting another 21,000 total jobs to be added in 2014. This should at last approach the record number of payroll jobs existing in San Diego prior to the recession.

San Diego's **unemployment rate** improved enough in 2013 to post an annual average of 7.3 percent just edging below the rest of the nation at 7.4 percent. California averaged a marginally higher rate of 8.8 percent. The improvement resulted from both increased job numbers and lower labor force participation as previously noted.

In 2014, San Diego is projected to further fall below the national unemployment rate to 6.8 percent, compared with projections for the nation at 7.0 percent, and for California at 8.0 percent.

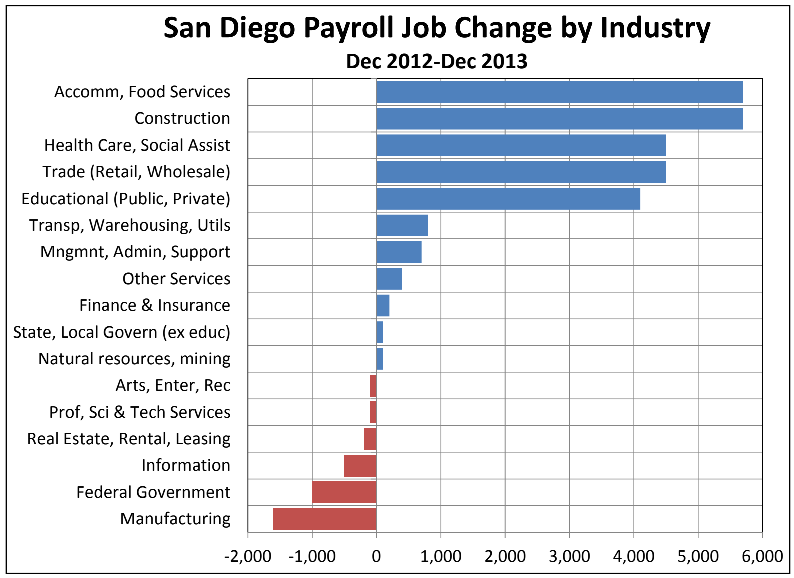
San Diego's **population** will reach nearly 3.2 million in 2014. As a metropolitan area, San Diego ranks as the nation's 17th largest and 5th largest as a county.

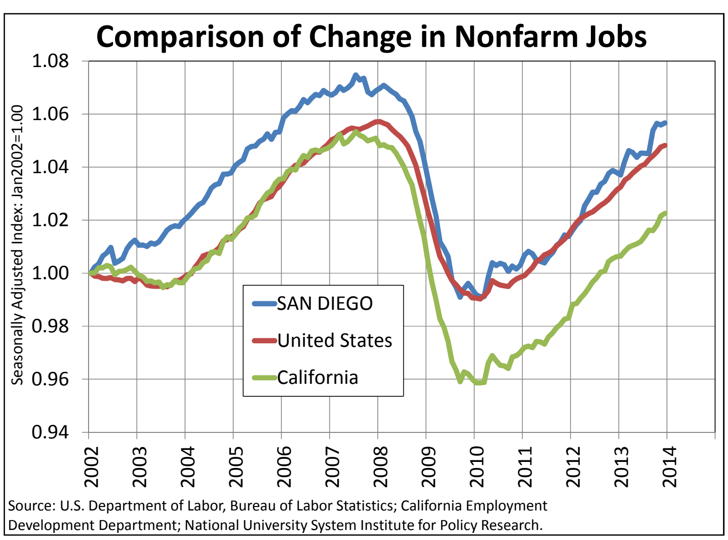
Migration the past several years shows more residents moving away than international migrants moving to San Diego. Only due to natural increase, births of residents, has San Diego's population increased the past few years – between 21,000 and 23,000 per year.

With lower levels of population growth occurring almost entirely by babies, demand for additional housing remains somewhat muted. Consumer sales, business activity, and tax revenue increases are also somewhat moderated with this type of population growth.

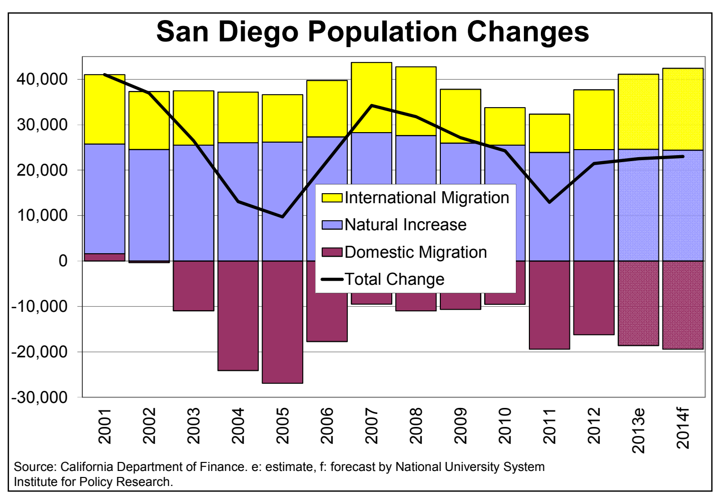
Slow growth in consumer spending will continue in 2014 with employment and income growth languishing.

Consumer spending in San Diego as measured by **taxable sales** is rising but still not recovered to pre-recession levels. After adjusting for inflation, sales volume remains lower than annual sales rec-





Source: U.S. Department of Labor, Bureau of Labor Statistics; California Employment Development Department; National University System Institute for Policy Research.



Source: California Department of Finance. e: estimate, f: forecast by National University System Institute for Policy Research.

San Diego Forecast

(Continued from page 5)

orded between 2000 and 2007.

San Diego's **inflation rate** decelerated from 3.0 percent in 2011 to 1.6 percent in 2012 and an estimated 1.2 percent in 2013. Lower gas prices from previously high levels helped diminish overall inflation. We forecast a modest uptick of inflation to 2.1 percent in 2014 as national economic headwinds in respect to employment keep higher rates largely in check.

Conclusion: Guarded outlook for 2014

Falling into recession remains a persisting possibility in 2014, particularly dependent upon the Federal Reserve's unwinding of stimulus and interest rate increases. The stalling economy reflects the long slog the economy continues to face, continuing uncertainty and skittishness in the private sector and more regulatory drags on growth emanating from Washington. We hope that 2014 will be a year of transition, one in which the uncertainties that serve as drags on growth are resolved and allow a more robust and sustainable recovery to take hold in 2015.

Dashboard Observations–December 2013

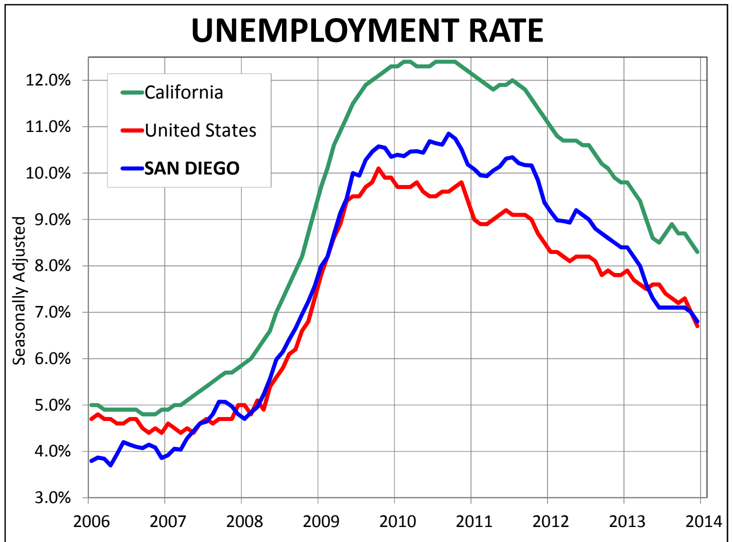
By Kelly Cunningham, Economist and Senior Fellow

Nearly all dashboard indicators showed improvement in December 2013. Although residential construction was down from the previous month, over the year the number significantly increased. For the year 2013 recorded the highest number of housing units being built since 2006 before the recession fully hit the real estate market.

Unemployment dropped to a post-recession low of 6.4 percent. That represents a considerable drop from 8.2 percent last December 2012.

The number of business licenses issued by the City of San Diego jumped significantly over the month and improved for the year.

Like national indices of the stock market, San Diego's stock index of local companies shows considerable improvement. The 34 percent increase over the year reflects record levels set by stock investors in locally traded public companies.



Source: U.S. Department of Labor, Bureau of Labor Statistics; California Employment Development Department; National University System Institute for Policy Research.

Indicator	Dec 2013	Month Change (Sea. Adj.)	Annual Change
Unemployment Rate[1] San Diego County	6.4%	-0.1% ▲	-1.8% ▲
Residential Building[2] Units authorized for construction San Diego County	794	-44% ▼	118% ▲
New Business Licenses[3] Issued by City of San Diego	1,102	31% ▲	4.6% ▲
San Diego Stock Index[4] San Diego based companies	163	0.9% ▲	34% ▲

[1]California Employment Development Department.

[2]U.S. Bureau of the Census.

[3]Business Tax Program, City of San Diego.

[4]Second Thursday of month, Bloomberg News, San Diego Daily Transcript.

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[1]"Economic Forecasting Survey", *Wall Street Journal*, January 2014, online.wsj.com/public/page/economic-forecasting.html

[2]*UCLA Anderson Forecast*, www.uclaforecast.com

[3]*Beacon Economics*, beaconecon.com

[4]"The not so Golden State", *The Economist*, January 25, 2014, www.economist.com/news/business/21594967-all-silicon-valleys-vibrancy-california-can-be-lousy-place-do-business-not-so

[5]News Release: GDP by Metropolitan Area, Advance 2012, and Revised 2001–2011, *U.S. Bureau of Economic Analysis*, September 17, 2013, www.bea.gov/newsreleases/regional/gdp_metro/gdp_metro_newsrelease.htm.

[6]"Recent Revisions of San Diego GDP Shows Uneasy Economic Recovery Continues", *National University System Institute for Policy Research*, San Diego Economic Ledger, November 2013, Volume 8, Issue 4, page 4, www.nusinstitute.org/assets/resources/pageResources/Economic_Ledger_GDP_Nov2013.pdf

[7]As of 2nd quarter 2013, "Quarterly Census of Employment and Wage", U.S Bureau of Labor Statistics.

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