Economic Outlook

While the current economic recovery is slower than previous recoveries, many sectors of the economy are improving. Home values are rising, credit conditions are improving, and household spending—typically the principal driver of economic recovery—is strengthening. Job creation, while still modest, also continues to improve.

However, as 2012 came to a close, uncertainty was building over domestic fiscal policies and global economic developments that tempered business investment. The effects of Hurricane Sandy also softened economic growth at the end of 2012.

This outlook assumes the economy will not incur sharp across-the-board federal tax increases or spending cuts in 2013 and that income tax rates rise only for higher income households.

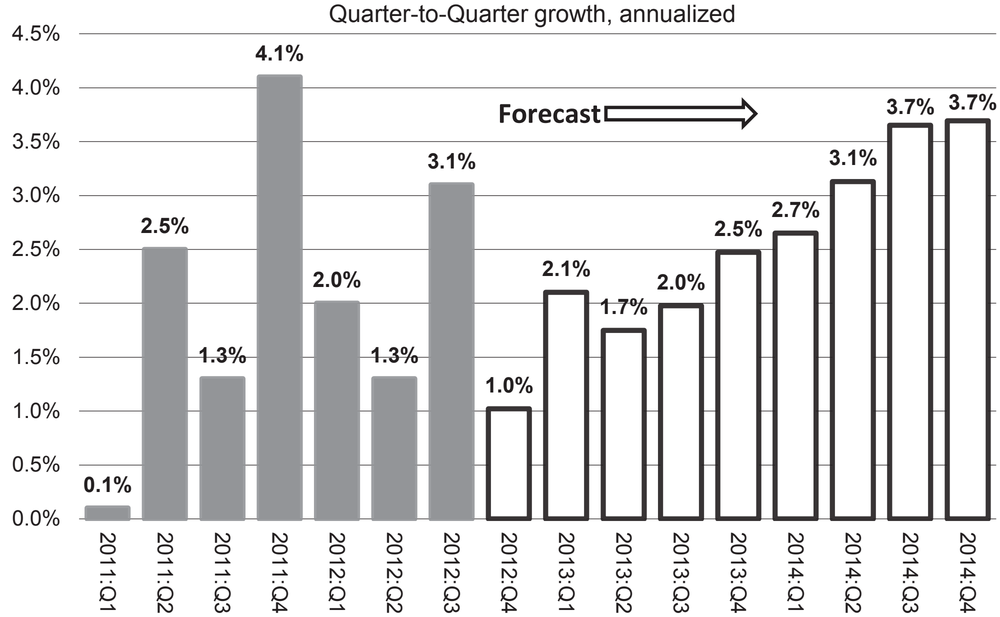
The Nation—Improving Amid Considerable Uncertainty

The nation continues to recover at a slow but steady pace. In addition to real estate, improvements are evident in such sectors as business services, leisure and hospitality, and natural resource extraction. Household formation is recovering in spite of modest employment growth. The demand for housing has spread from rental housing to owner-occupied homes. Home prices have improved in nearly all of the nation's major metropolitan areas. This improvement has improved consumer attitudes.

Job growth accelerated after a mid-year slowdown. The nation added nearly 158,000 jobs each month on average from July through November of 2012, compared to adding 153,000 jobs per month on average during 2011. In light of this modest improvement, the nation's unemployment rate fell toward the end of the year.

Consumer confidence improved steadily in the latter months of 2012. In November, consumer confidence was lifted to its highest level since February 2008. This improvement translated into stronger consumer spending. In the third quarter of 2012, consumer spending rose by 1.6 percent and contributed 1.1 percentage points to overall Gross Domestic Product growth (Figure ECO-01). In November, retail sales were 3.7 percent above the level a year ago.

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 Governor's Budget Forecast

In contrast to these positive developments, the outlook of many businesses became more cautious in the latter half of the year due to a weaker global economy and rising uncertainty about federal fiscal policy changes. Capital equipment spending is expected to remain an important driver of economic growth, but its momentum weakened toward the end of 2012. For example, spending on equipment and software fell slightly in the third quarter. The growth of industrial output slowed throughout 2012 and by the year's end was only growing modestly. After rebounding from the effects of Hurricane Sandy, industrial production in November rose 2.5 percent from a year earlier—a much weaker gain than occurred in 2011. Facing a slowing global economy and a strengthening dollar, export growth slowed in 2012. Near the end of the year, there were declines in exports of industrial supplies and materials, computers, motor vehicles and parts, and consumer durable goods.

California—A Recovery for Housing

Similar to the nation, California is also in the midst of an economic recovery that is modest by historical standards. However, the state's recovery has also gathered momentum because of better real estate conditions, faster job growth, and improved consumer attitudes. The state's housing market recovery effectively began early in 2012. The median sales price of existing single-family homes sold during the first 10 months of 2012 rose nearly 9 percent from the same months of 2011. The pace of existing home sales also trended up during 2012. These gains were supported by significant reductions in foreclosure activity and limited inventories of homes available for sale. During the third quarter of 2012, the number of Notices of Default recorded on residential properties in California was down over 31 percent from a year earlier and was at the lowest level since the first quarter of 2007.

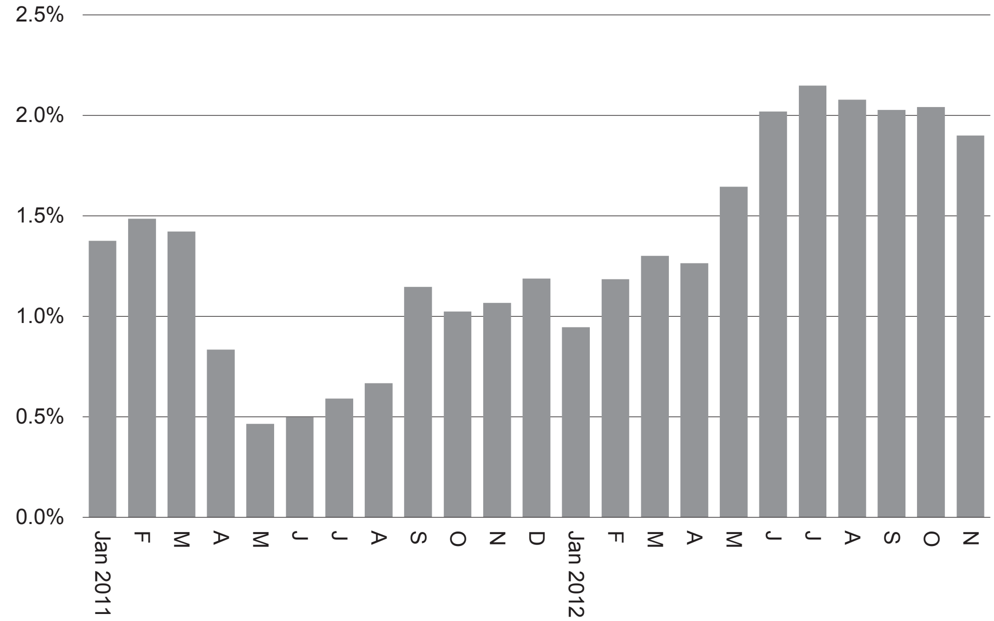
Employment gains improved in 2012, as shown in Figure ECO-02. During the first 11 months of the year, the state gained an average of 21,200 jobs per month, which is the strongest pace of job growth since 2005. Job growth came entirely from the private sector as government employment continued to decline throughout the year. Even though job gains included high-wage, high-technology industries such as computer systems design and scientific research and consulting, income growth moderated beginning with the last quarter of 2011. Total California personal income is projected to grow from $1,645 billion in 2011 to $1,728 billion in 2012. The growth in personal income included approximately $7 billion in additional wages from the Facebook Initial Public Offering, which accounts for more than 8 percent of personal income growth in 2012.

California personal income has historically grown slightly faster than the nation's as a whole. From 1980 to 2011, California's total personal income grew 6.1 percent per year on average, while the national income grew 6 percent. Over that time, California's personal income has become more concentrated. In 2010, the wealthiest 1 percent of income earners accounted for 21 percent of adjusted gross income compared to 10 percent in 1980.

Figure ECO-02

California Nonfarm Employment

Year-Over-Year Change in Nonfarm Employment



Source: California Employment Development Department

Consumer spending in California also improved in 2012. Taxable retail sales during the first half of 2012 grew 8.8 percent from the same period in 2011. New motor vehicle registrations issued during the first 10 months of 2012 increased over 25 percent from the same months of 2011.

Since the recovery began in 2009, California's economic growth has been dominated by high-technology and export-oriented industries located predominantly in major coastal metropolitan areas. However, in 2012, growth spread to other sectors and regions, thus improving economic conditions throughout the state. During the first 10 months of 2012, 23 of the state's 28 metropolitan areas added jobs. By contrast, only one area posted a job gain in 2010 and only 19 did in 2011. Home prices are recovering in most regions, including many of those that were hardest hit by the housing collapse, such as the Inland Empire and the Central Valley.

California's recovery was initially driven by growing business activity and investment. This trend slowed in 2012 due to China's economic slowdown, concerns about European economic troubles, and rising uncertainty about federal fiscal policies. This has been counterbalanced, however, by better consumer spending and attitudes that resulted from improvements in real estate conditions and modest but consistent job growth.

The Forecast

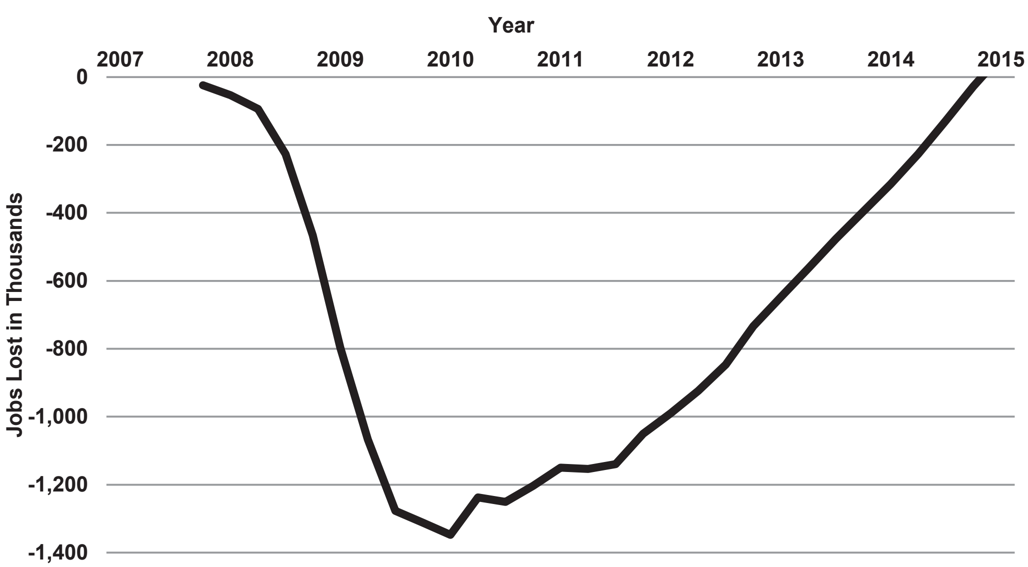
Both the national and state economies will continue to grow at moderate paces. This forecast assumes that a recession potentially caused by federal fiscal policies is avoided, economic growth in Europe stabilizes, and China and other emerging market economies improve.

According to the Index of Leading Indicators, the economy should continue to expand at a moderate pace in the near future. The Index is a widely followed economic indicator based on the average of ten economic statistics used to predict the direction of the economy over the next six to nine months. It is generally considered to be a good predictor of recessions and recoveries.

The turnaround of the nation's housing markets coupled with accelerating job growth has strengthened the recovery. As uncertainty over fiscal policy lessens, national economic growth is expected to reaccelerate in the latter half of 2013. Real Gross Domestic Product is forecast to grow 1.8 percent in 2013, 2.8 percent in 2014, and 3.4 percent in 2015.

California's recovery is also expected to improve, with home building and job growth. Nonfarm employment is projected to grow 2.1 percent in 2013, 2.4 percent in 2014, and 2.5 percent in 2015. As shown in Figure ECO-03, California should recover the jobs lost during the recession in the second quarter of 2015, which is two quarters earlier than

Figure ECO-03
Jobs Lost During Recession Not Recovered Until 2015



projected in the prior forecast. Total California personal income is projected to grow by $83 billion or 5.1 percent in 2012.

The principal risk to this outlook is the potential impact of a series of automatic federal tax increases and spending cuts that were set to take effect early in 2013 and the effect of federal actions regarding the debt limit. The forecast, developed in early December, assumed that the federal income tax rate for households earning more than $250,000 per year would return to pre-tax cut levels in 2013 and that payroll tax rates would not be raised at the beginning of 2013. Any effects of federal actions in early 2013 will be incorporated in the May Revision.

See Figure ECO-04 for highlights of the national and California forecasts.

Figure ECO-04

Selected Economic Data

United States	2012 (Estimated)	2013 (Projected)	2014 (Projected)
Real gross domestic product (percent change)	2.1	1.8	2.8
Personal consumption expenditures	1.9	2.0	2.6
Gross private domestic investment	9.1	6.4	10.0
Government purchases of goods and services	-1.5	-1.3	-1.2
GDP deflator (percent change)	1.8	1.7	1.5
GDP (current dollar, percent change)	4.0	3.5	4.3
Federal funds rate (percent)	0.1	0.1	0.1
Personal income (percent change)	3.5	3.8	4.8
Corporate profits before taxes (percent change)	5.9	0.3	0.7
Nonfarm wage and salary employment (millions)	133.3	135.2	137.4
(percent change)	1.4	1.5	1.6
Unemployment rate (percent)	8.1	7.8	7.4
Housing starts (millions)	0.8	1.0	1.3
(percent change)	25.3	27.9	31.4
New car sales (millions)	14.4	15.0	15.6
(percent change)	12.8	4.6	3.7
Consumer price index (1982-84=100)	229.8	234.0	238.6
(percent change)	2.1	1.9	2.0
California			
Civilian labor force (thousands)	18,437.4	18,562.6	18,757.8
(percent change)	0.3	0.7	1.1
Civilian employment (thousands)	16,488.9	16,780.0	17,117.6
(percent change)	1.6	1.8	2.0
Unemployment (thousands)	1,948.6	1,782.6	1,640.1
(percent change)	-9.8	-8.5	-8.0
Unemployment rate (percent)	10.6	9.6	8.7
Nonfarm wage and salary employment (thousands)	14,371.3	14,673.9	15,020.1
(percent change)	2.0	2.1	2.4
Personal income (billions)	1,728.4	1,802.0	1,900.3
(percent change)	5.1	4.3	5.5
Housing units authorized (thousands)	56.9	81.2	123.0
(percent change)	21.7	42.7	51.6
Corporate profits before taxes (billions)	168.3	180.1	185.7
(percent change)	4.6	7.0	3.1
New auto registrations (thousands)	1,352.3	1,441.3	1,542.9
(percent change)	15.2	6.6	7.0
Total taxable sales (billions)	558.5	592.7	634.6
(percent change)	7.8	6.1	7.1
Consumer price index (1982-84=100)	238.4	243.2	248.3
(percent change)	2.3	2.0	2.1

Note: Percentage changes calculated from unrounded data.

This page intentionally blank to facilitate double-sided printing.