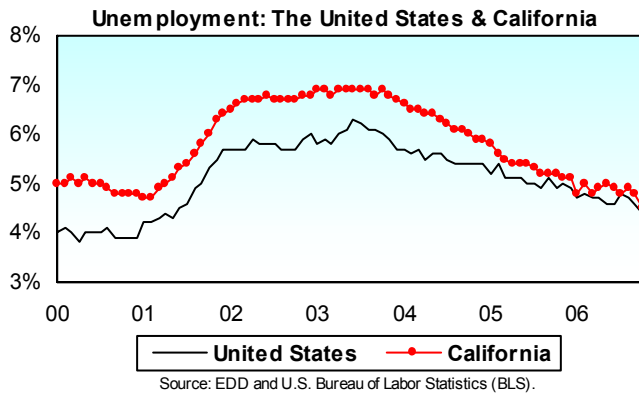




California's Two Growth Engines—One Stalls, the Other Keeps Going

The unemployment rate in California declined to 4.5% in October. The California Employment Development Department (EDD) stated in its press release that it was “a historical low.” Well, the jobless rate might have been close to zero at the height of the Gold Rush in 1849, but we don't know that for sure, because official labor force data series did not begin until 1976. What EDD meant was that the October rate was the lowest since 1976. The previous historical low was 4.7% recorded in January and February of 2001. (See the chart below.)



The labor market tightens.

A year ago in October 2005, the state's unemployment rate was 5.2%. The rate declined seven-tenths of a percentage point since then. The most recent jobless rate in California was only one-tenth of a percentage point higher than the U.S. average, which was at the lowest level since May 2001, at 4.4%.

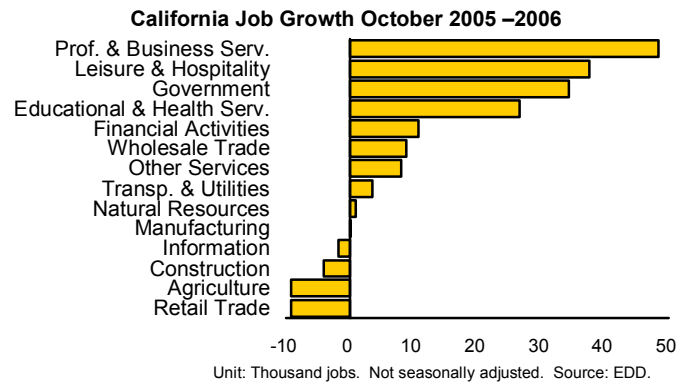
The household survey (the data the unemployment rate is based on) showed that the number of employed Californians increased by 92,000 in October, after seasonal adjustment. A separate survey of payrolls showed a much smaller gain of 9,300 jobs in October. The difference between these two numbers is startlingly large.

However, the gap between the 12-month gains of employment according to the household survey (+179,000) and the payroll survey (+164,000) is not as large. This suggests that single-month data can exaggerate differing trends in the two surveys.

The service-sector job growth continues.

So which industries are creating jobs? The following chart shows that the state's service sector keeps on churning out a large number of payroll jobs. The professional and business service segment—including lawyers, architects, travel agents, and many others—added the largest number of jobs (+48,800) between October 2005 and 2006. Other service sector

categories, leisure and hospitality (+37,600) and educational and health services (+26,600), also performed well.



Other than the natural resource sector, which has gained momentum because of increased oil and gas extraction activities, these service industries have also been the fastest growing industries in recent months.

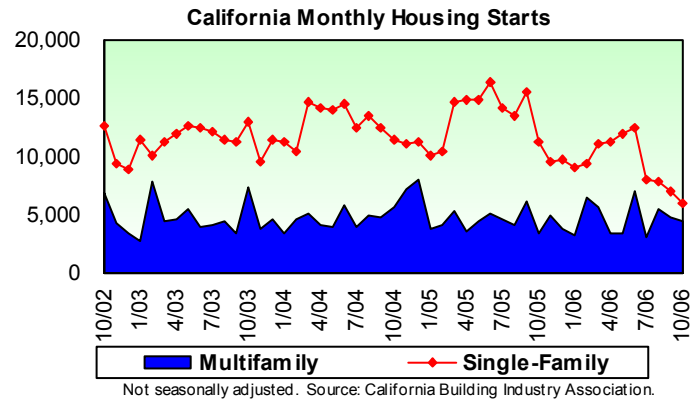
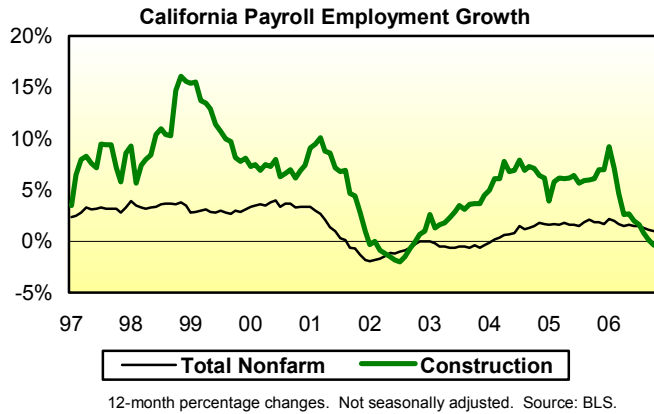
Between October 2005 and 2006, the 12-month growth rate of total payroll positions in California was 1.0%. During the same period, jobs in leisure and hospitality increased 2.5%, professional and business services 2.2%, and educational and health services 1.7%. These numbers clearly show that the service sector is the most important job growth engine in the state right now.

The number of construction jobs is flat.

Make no mistake, the service sector has been adding jobs for quite some time. Between October 2004 and 2005, professional and business service jobs grew at a robust 3.0%. Also strong were year-over-year increases of jobs in leisure and hospitality (+2.9%) and educational and health services (+1.7%).

However, the contribution of these industries was less noticeable compared with the spectacular growth of the housing-related sectors. In October 2005, the construction sector topped the list with 6.1% year-over-year growth. The financial sector—including mortgage lenders and real estate agents—had a similarly strong gain at 3.1%.

The chart at the top left of the next page compares twelve-month growth of all nonfarm jobs with that of construction jobs since 1997. It is clear that the building industry was adding jobs much faster than other industries between 2003 and 2005. We can say that the construction engine was “turbo-charged” over this period. (The sector had a period of even stronger expansion in the late 1990s.)



Lately, however, this formerly strong engine has ceased to propel the state’s economy forward. In August 2006, year-over-year growth of the construction sector (+0.8%) fell below the average for all nonfarm jobs (+1.3%) for the first time in almost four years. In October 2006, the twelve-month growth of the sector was down to -0.4%. It was the first time that the rate was negative since 2002.

Because the slowdown in new home construction has been so widely reported, some readers may be surprised that the number of construction jobs has not fallen more rapidly. There seem to be a few reasons why the construction sector still maintains some momentum. For one thing, construction activities of non-residential properties have accelerated. Demand for industrial properties seems to be particularly strong across the state, prompting new developments.

Within the residential sector, the emphasis for development has also shifted from single-family units to multifamily units. (See the chart on the top right.) In fact, the year-to-date permitting activity was up 6.0% for multifamily units as of October, while the figure was down 30.0% for single-family units. Additional strength of the housing sector comes from homeowners finally being able to hire contractors for remodeling projects and additions.

Job growth in the service sector will continue in 2007.

One thing is clear—the end of the housing boom does not mean the end of economic growth in California. The service-sector growth engine remains well oiled and strong. That’s why overall employment growth is projected to continue in 2007, although at a somewhat slower rate than this year.

Building permit data shows that an inventory correction in the housing market is in progress. As long as new home building activity remains weak, the number of construction jobs will likely decline further. However, the rapid pace of the adjustment suggests that the correction period may be relatively short. The major portion of the inventory correction could well be behind us.

This also means the length of time that the construction sector is a drag on the economy may be short. Unless the health of the housing market takes a sudden turn for the worse, the service sector engine alone should be able to carry the California economy nicely through 2007.

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Economic Forecast – December 2006

| UNITED STATES | 2005 | 2006 | 2007 | 2008 |
|-------------------------------|------|------|------|------|
| Real GDP Growth (%) | 3.2 | 3.4 | 2.6 | 3.2 |
| Unemployment (%) | 5.1 | 4.6 | 4.7 | 5.0 |
| Nonfarm Employment Growth (%) | 1.5 | 1.4 | 1.1 | 0.9 |
| CPI Change (%) | 3.4 | 3.3 | 2.0 | 2.2 |
| Federal Funds (%) | 3.2 | 5.0 | 5.1 | 4.5 |
| CALIFORNIA | | | | |
| Real GDP Growth (%) | 4.3 | 4.3 | 3.2 | 3.5 |
| Nonfarm Employment Growth (%) | 1.8 | 1.4 | 1.0 | 0.9 |
| Personal Income Growth (%) | 5.4 | 7.4 | 5.6 | 5.5 |

Bold: Actual. Gross State Product is now called “Gross Domestic Product (GDP) by State” by the U.S. Bureau of Economic Analysis which produces the data.

The information in this report is based on data available as of December 1, 2006, and has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed. We do not think it should necessarily be relied on as a sole source of information and opinion.