



Economic Update: Midyear 2009

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Introduction

- Global issues
 - Recession spreading, no safe haven
- Domestic issues
 - Federal and state budgets provide a mix of good and bad news
 - Light starting to show for end of recession
 - Stock market an indicator of investor confidence and forecasts
 - Policies will force growth: is it the “right” growth?
 - California budget situation means less productivity and income
 - No matter what
- North Bay Economy affected from all levels
 - Insurance industry potentially a growth industry
 - Whole life products may replace Roth IRAs and other “retirement” vehicles
 - Regulatory environment may change financing of insurance companies

Where are we now?

- Financial Markets Stabilized
 - Nationalized banking system losses
 - Confirmed no companies are too big to fail
- Real economy has shown signs of hitting bottom
 - Unemployment may stay relatively high until inflation begins to show its face
- Reform needed, but lagging
 - Federal and state (banking and budget)
- Inflation unlikely before late 2010, but...
 - Oil prices are a precursor to another commodities market rally based on the dollar
- Decoupling not happening
 - Emerging markets still very much tied to US and Europe

Paraphrased from “The Baseline Scenario” (baselinescenario.com)



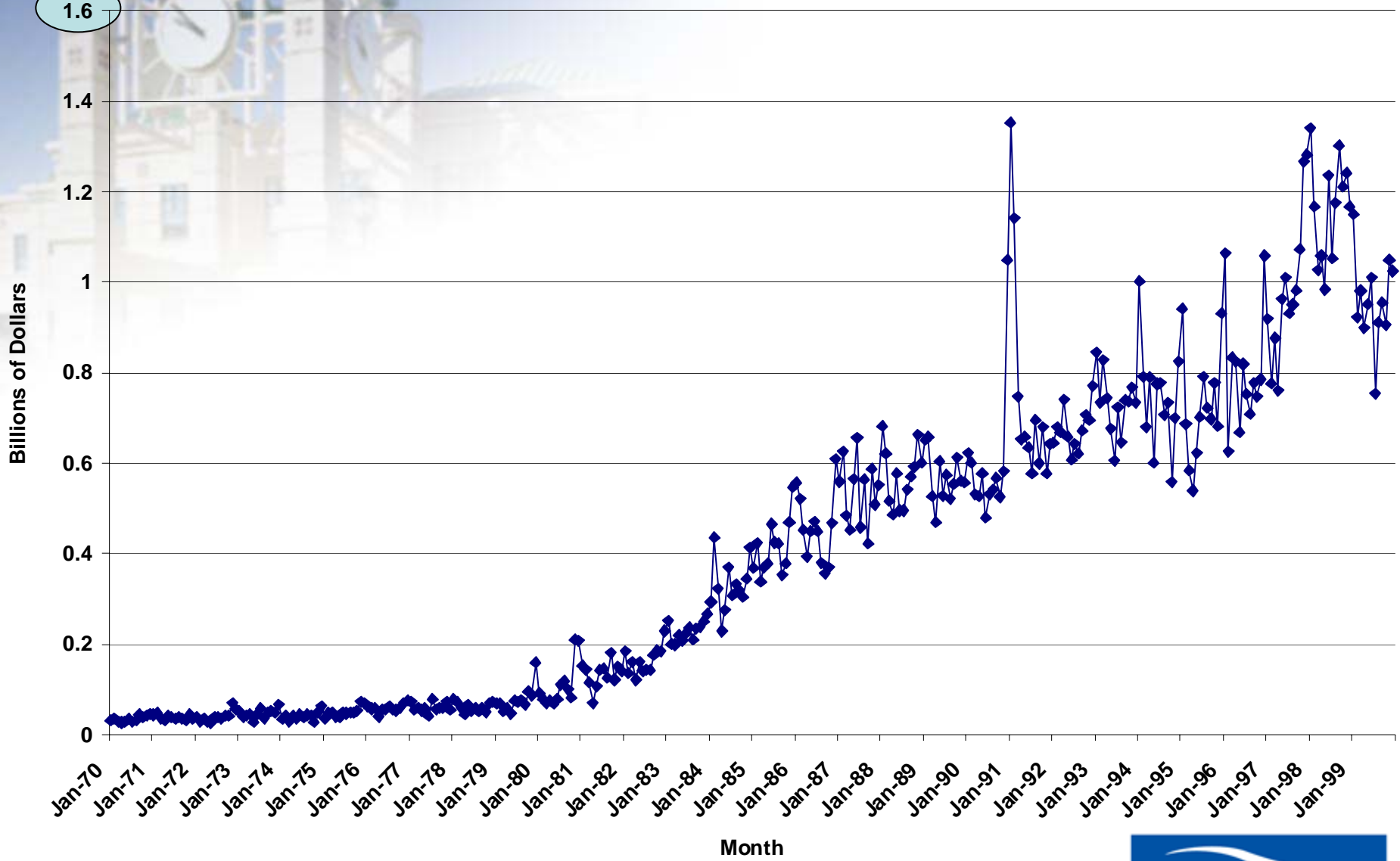
Domestic Macroeconomy

- Continued recession through first half of this year
 - “Thud” will hit and you won’t really know it
 - Stock market’s recent rally may be a sign of this
- Why will recession end
 - Expanded fiscal stimulus:
 - creates or saves jobs, income losses reduced
 - Job creation through innovation, not through consumption, now provided incentives
 - Incentives and prices currently very good for businesses
- Monetary policy at a policy endpoint
 - What else could possibly be done?
 - Why have banks not started lending again?

The Important Role of Banking

- Banking is both culprit and savior here
- Banking central in our classic models of growth
- Banks still see too much risk generally
 - Following charts show banks remain nervous
- Local banks targets for consolidation, acquisition
 - Also a great place for a boom to start

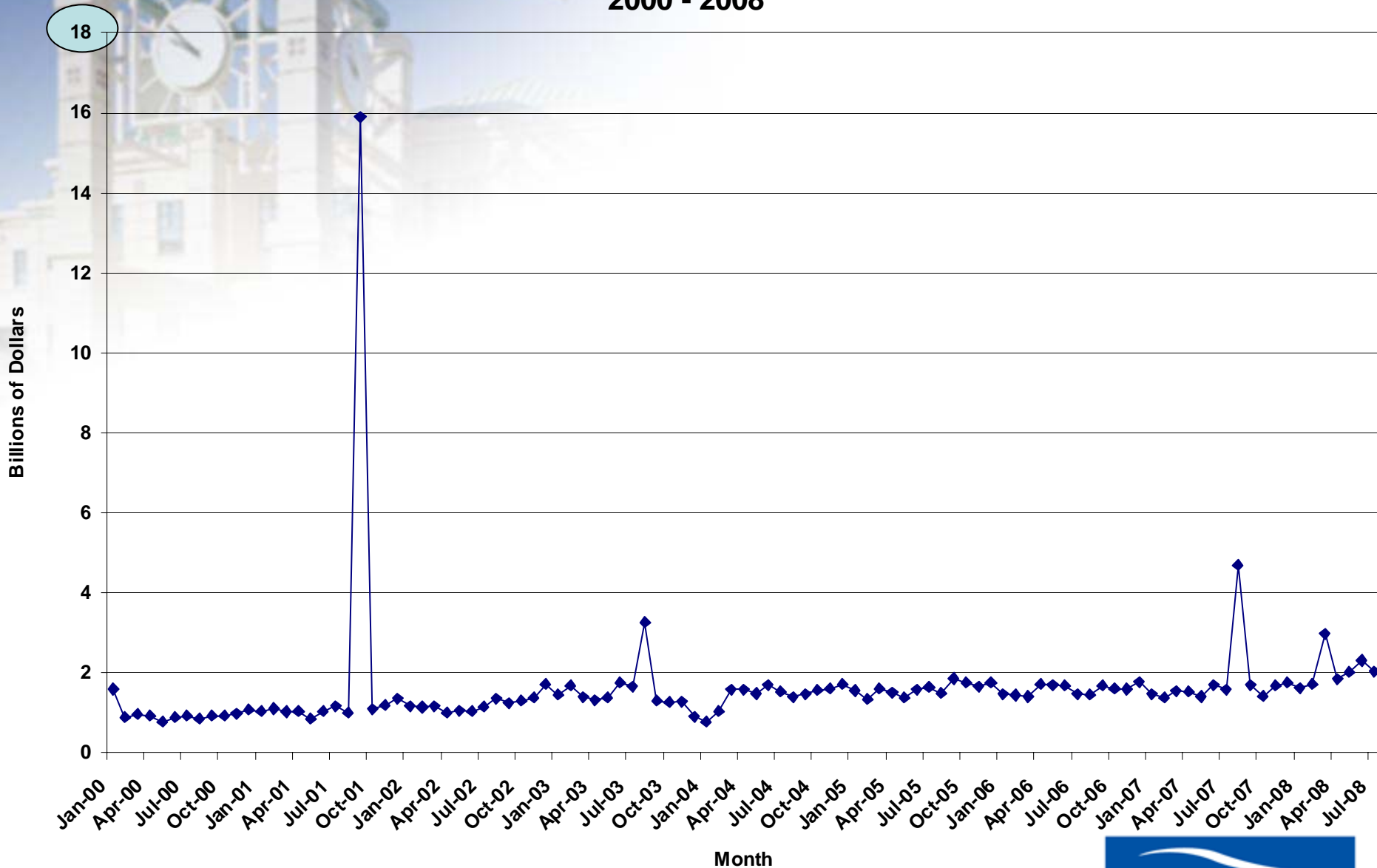
Excess Reserves at U.S. Banks (Loanable Funds Not Lent), 2008\$ 1970-1999



Source: Federal Reserve Board



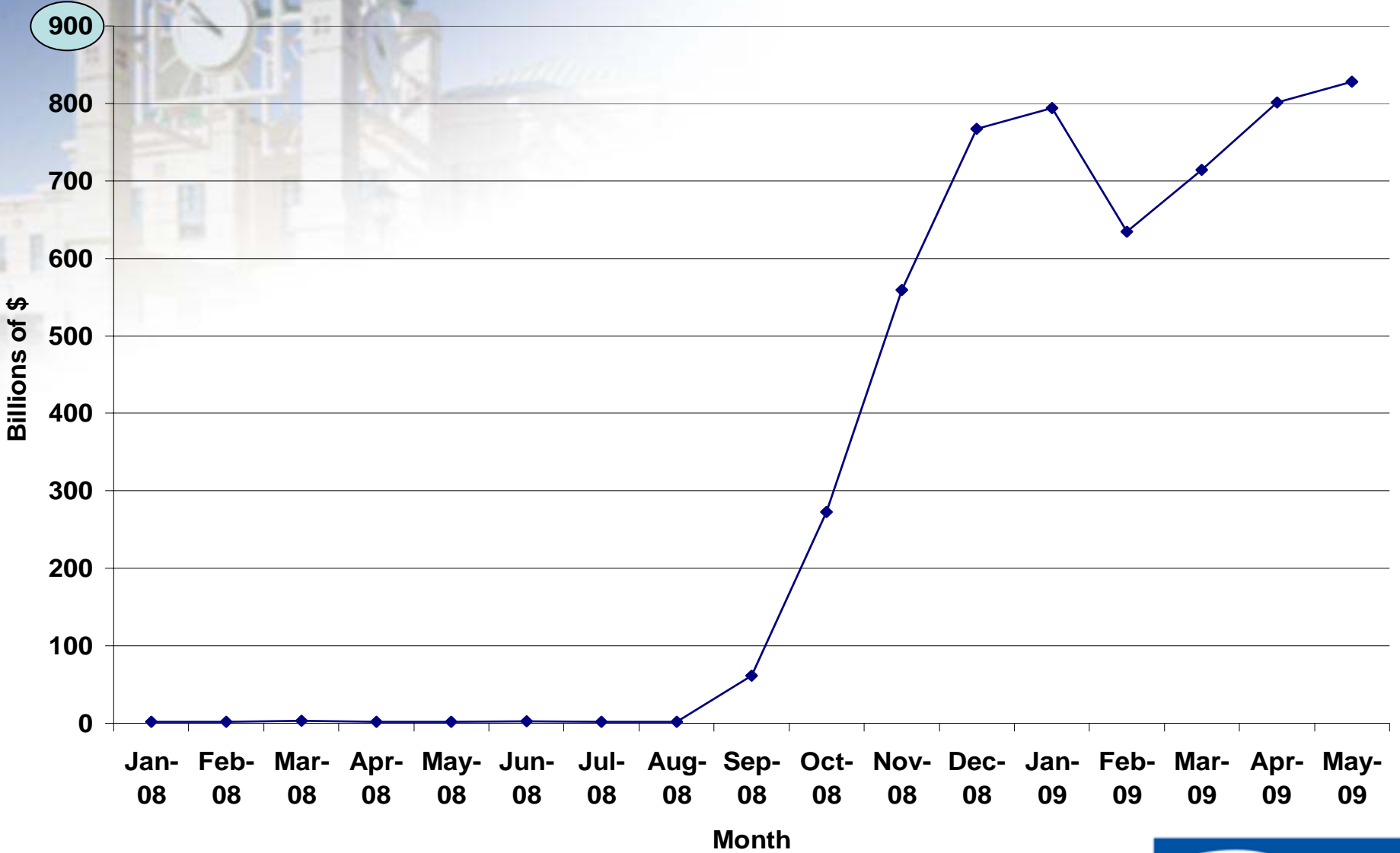
Excess Reserves at U.S. Banks (Loanable Funds Not Lent), 2008\$ 2000 - 2008



Source: Federal Reserve Board



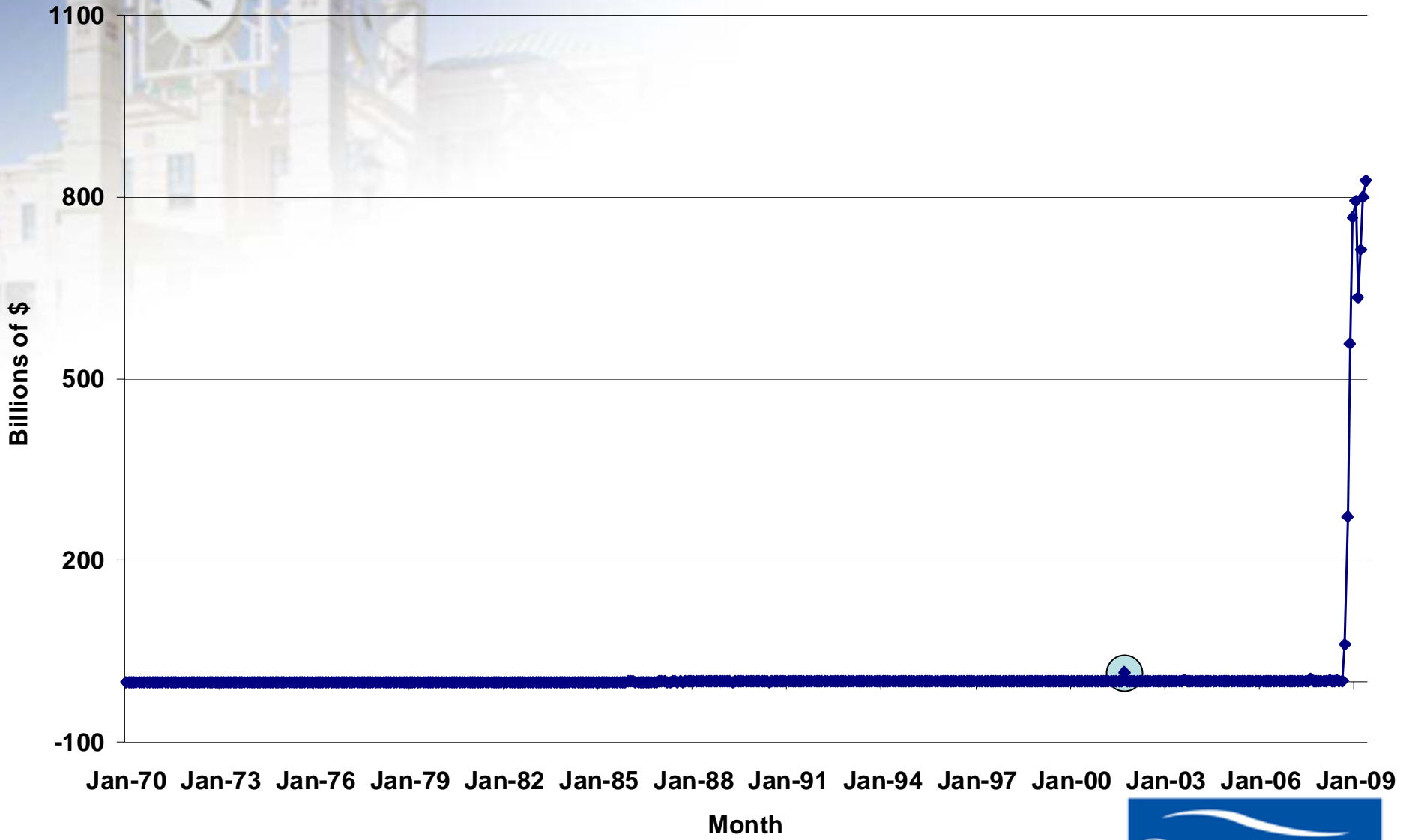
Excess Reserves at U.S. Banks (Loanable Funds Not Lent), 2008\$ Jan 2008 - April 2009



Source: Federal Reserve Board



Excess Reserves at U.S. Banks (Loanable Funds Not Lent), 2008\$ Jan 1970 - April 2009



Source: Federal Reserve Board



Two Good Things about Insurance Markets

- Trend rising in purchase of “traditional” investments
 - Simple savings vehicles, universal life/whole life products
 - Likely to continue, especially if gains continue to rise versus equity markets
 - Rising long-term rates in the United States help this story
 - Inflation hedge
 - Use of money long-term as a “bank” without putting a home at risk
- Financial literacy may become agent’s job here
 - Financial planning for clients

Signs of Hope Rather Than Apocalypse

- Link between S&P 500 and labor markets
 - Historically, S&P 500 index and national unemployment linked
 - When S&P 500 hits bottom, 5 – 6 months later is when unemployment peaks on average since 1948
 - S&P 500 trough was on March 9, 2009: about 34% growth since
- Federal stimulus and stable interest rates remain as incentives: need to be seized
- New financial regulations: transactions will have a new risk filter

Comparison of Equity and Labor Market Rebounds, 1947-Present

Econ Cycle	Date of:		Number of Months Stock Market Bottoms Before Job Market	Percent Gain in Stock Market* From its Low Until Job Market Low
	Stock Market Bottom	Job Market Bottom		
1	Jun-49	Oct-49	4	13.3%
2	Aug-53	Aug-54	12	27.9%
3	Dec-57	Jun-58	6	13.1%
4	Oct-80	Feb-81	4	18.8%
5	Jun-70	Nov-70	5	19.9%
6	Sep-74	Apr-75	7	37.4%
7	Mar-80	Jul-80	4	19.2%
8	Jul-82	Dec-82	5	31.3%
9	Oct-90	May-91	7	28.2%
10	Sep-02	Aug-03	11	23.6%
Average			6.5	23.3%

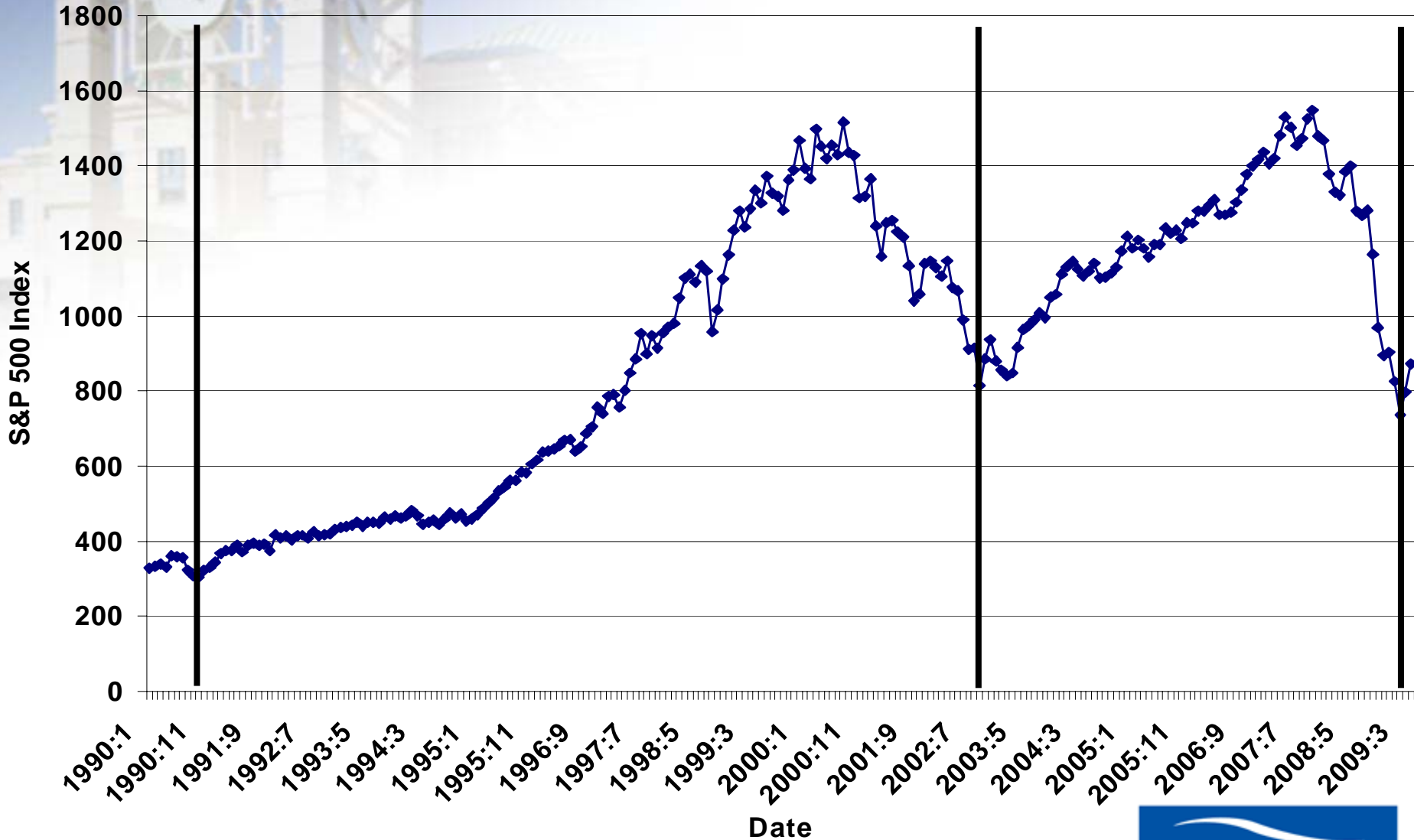
*Stock Market data based on monthly closing values

Source: Wells Fargo Capital



S&P 500 Monthly Close, Jan 1990 – May 2009

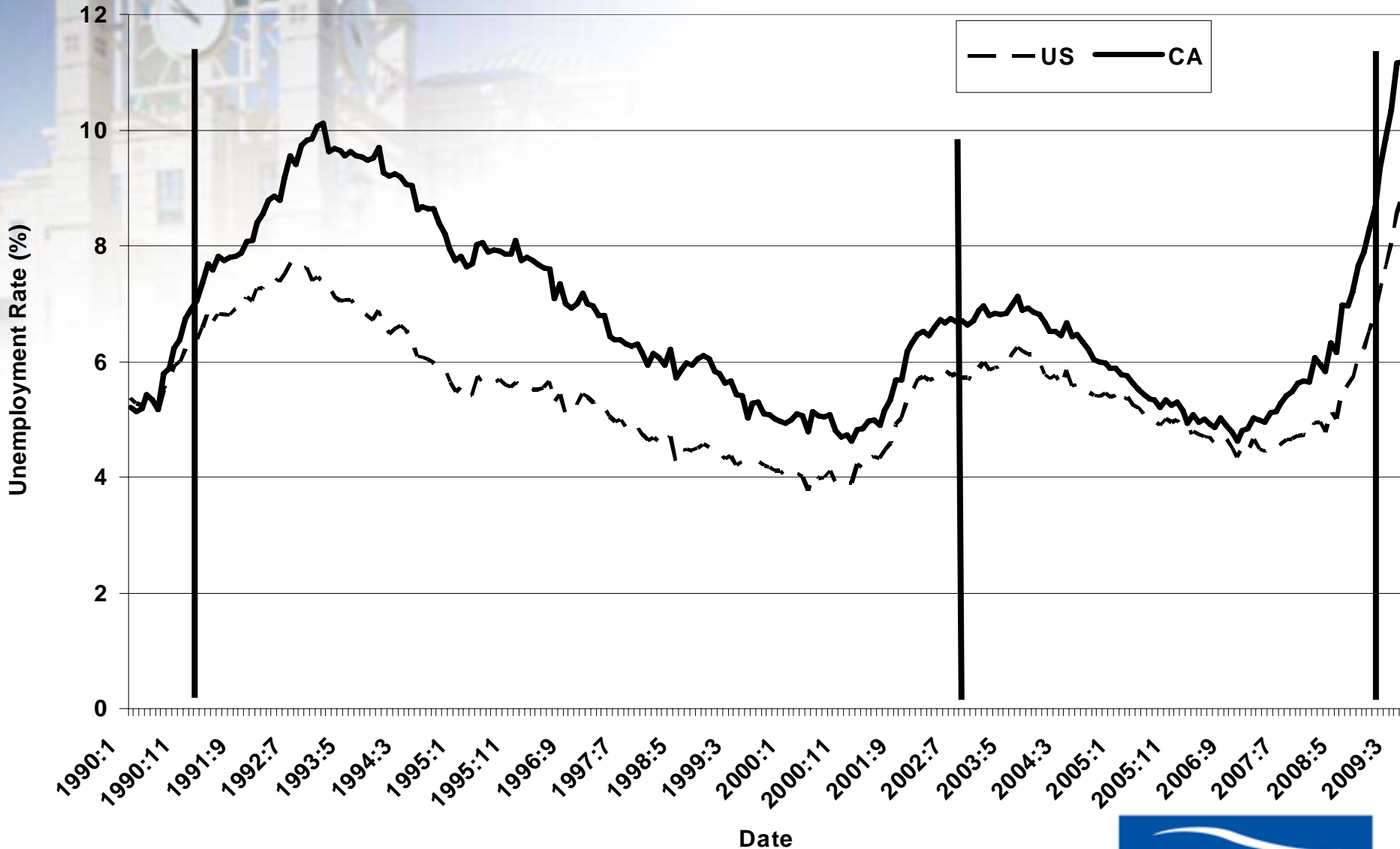
Vertical lines represent bottom of cycle



Sources: Economagic.com, CREA at SSU



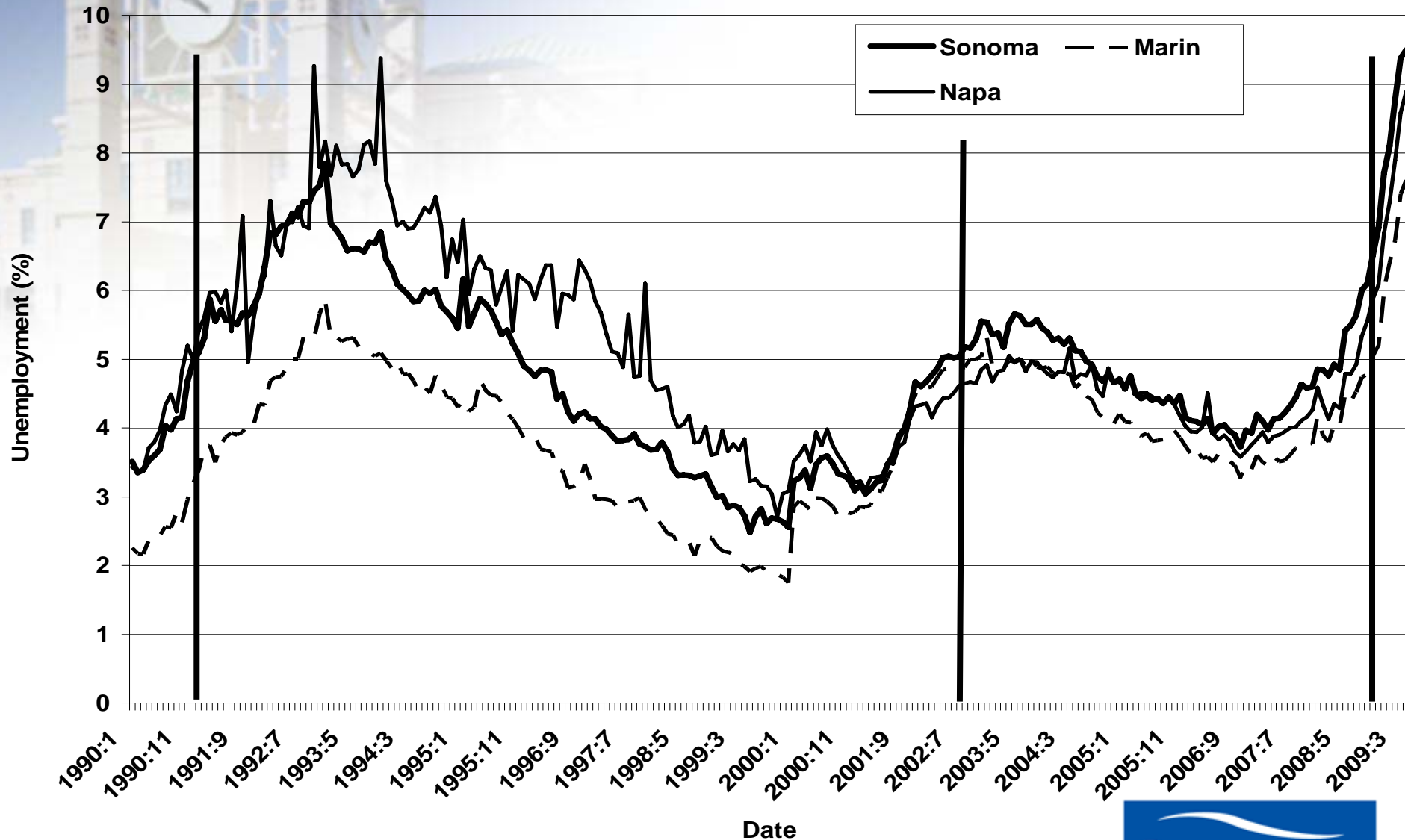
US and CA Monthly Unemployment, Jan 1990 – Apr 2009



Sources: California EDD and CREA at SSU



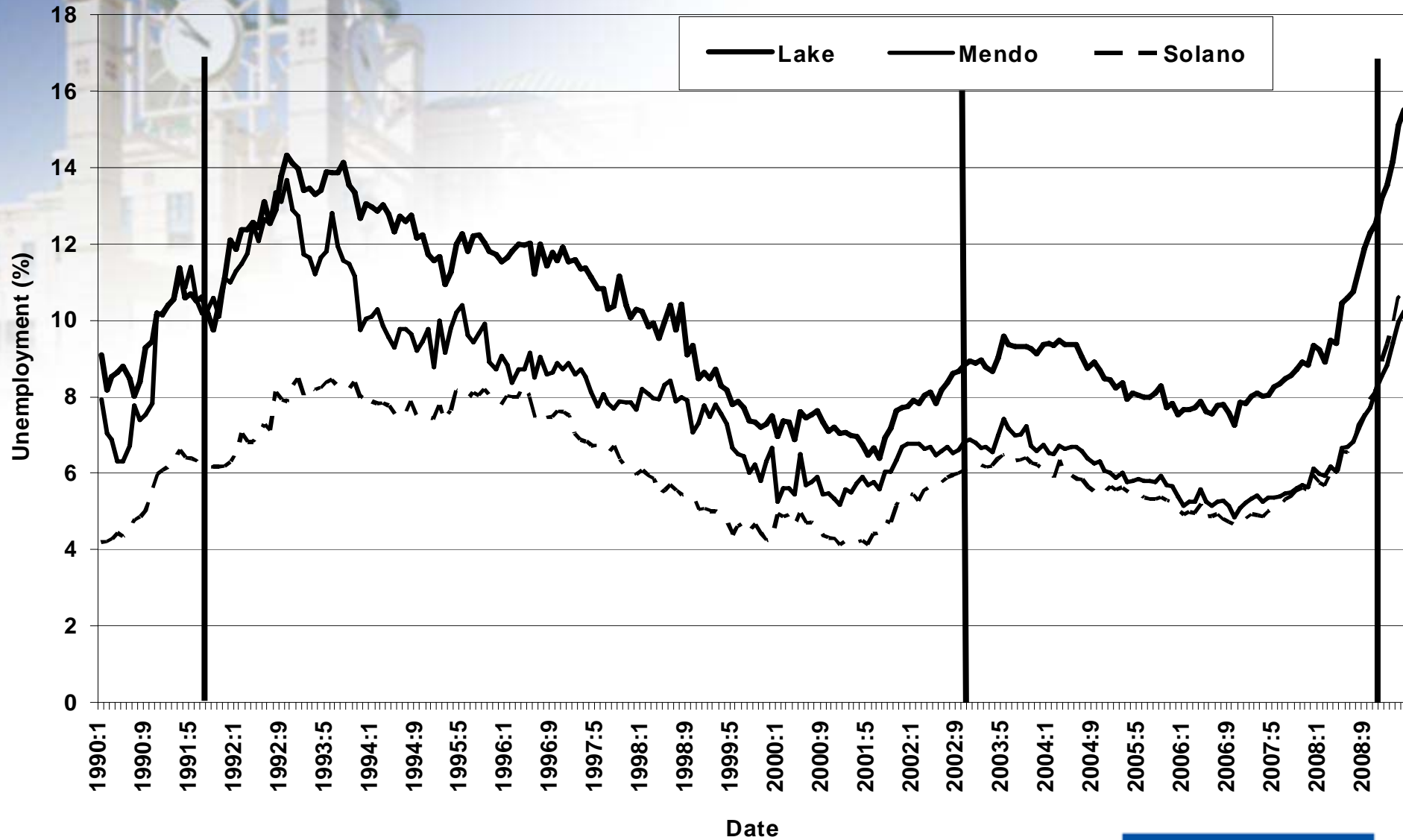
Unemployment for Marin, Napa and Sonoma Counties



Sources: California EDD and CREA at SSU



Unemployment for Lake, Mendocino and Solano Counties



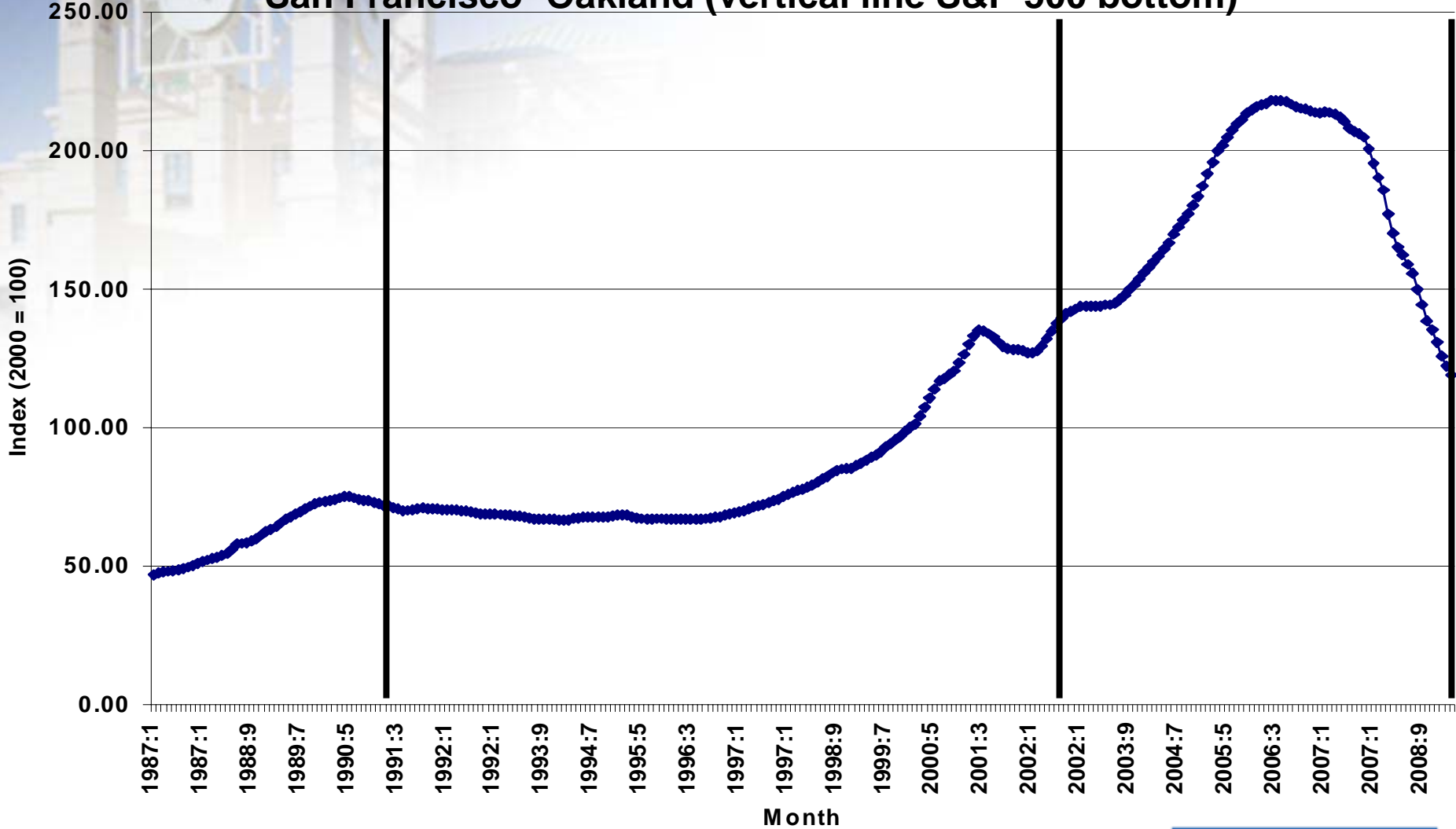
Sources: California EDD and CREA at SSU



Residential Real Estate

- Unemployment puts both supply and demand pressures on market
 - Supply: as unemployment rises, number of units rise
 - Demand: as unemployment rises, fear over lost jobs reduces demand
- Interdependence: 96.6% correlation between Sonoma and Marin median home price since 1995
 - Similar across North Bay: which county is the driver?
- Two big questions market has yet to answer
 - Was the old pricing correct?
 - Is the current pricing correct?

Case-Shiller Index of Home Prices, Seasonally Adjusted, 1987-2009, San Francisco- Oakland (vertical line S&P 500 bottom)



Source: Standard and Poor's and CREA at SSU



California's Future (??)

- 2002 saw use of fiscal surplus from capital gains taxes spent on **permanent** spending
 - We are now paying for that in current deficit of > \$40 billion through 2009-10
 - Federal spending may stimulate state economies
 - Lag structure here between federal and state budgets affects speed of growth
 - Cannot rely on this model
 - Pension system to be stretched soon
 - School spending in CA now 50th in nation (≈\$18K per pupil)
 - **Opportunity: public-private partnerships in education**

California's Options

- Budget gap closed through borrowing(??)
 - Depends on ability to sell debt
 - Depends on amount of fiscal stimulus to state government
- **Reform is needed (another good thing)**
 - A consumer-led expansion may provide an ephemeral, illusory boost to state coffers
 - Tax reform: What about Prop 13?
 - Budget reform: need a change to 2/3 vote and term limits?
 - How can one vote hold up this process?

North Bay Economic Outlook

- Recession for North Bay through 2009
 - Regionally mild compared to both California and U.S. overall
 - Bottom to hit soon: thud not heard for a few months
 - Indicators beginning a slow turnaround
- Housing should be seen as a follower not leader
 - Exposure of North Bay to real estate markets is a microcosm of local economy
 - Services and population-serving first
- Recognize regional connections
 - All counties are going to scramble for firms
 - Housing markets should react not drive



www.sonoma.edu/org/crea/statefarm1.pdf

