

Economic Outlook

Rebounding from the effects of last year's hurricanes, the national economy grew at its fastest pace in two and a half years in the first quarter of 2006. A pickup in consumer spending, a snapback in business investment in equipment and software, and a jump in defense spending led the way. Labor markets strengthened and tightened with the economy's renewed growth. The average monthly job gain in the first quarter of 2006 was bigger than the average monthly gain in 2005, and the unemployment rate fell to a level not seen since the spring of 2001. In addition, manufacturing remained strong, particularly high-tech manufacturing, and residential construction increased slightly, even though home sales continued to slide. The Federal Reserve tightened policy two times during the quarter, but hinted that their long string of tightening moves might be near completion. The generally good performance of the national economy in the first quarter did not, however, reflect the run-up in oil prices and the dramatic increase in gasoline prices that occurred between mid-March and the end of April. The effects of higher energy prices will be seen in the economic statistics released in the coming months.

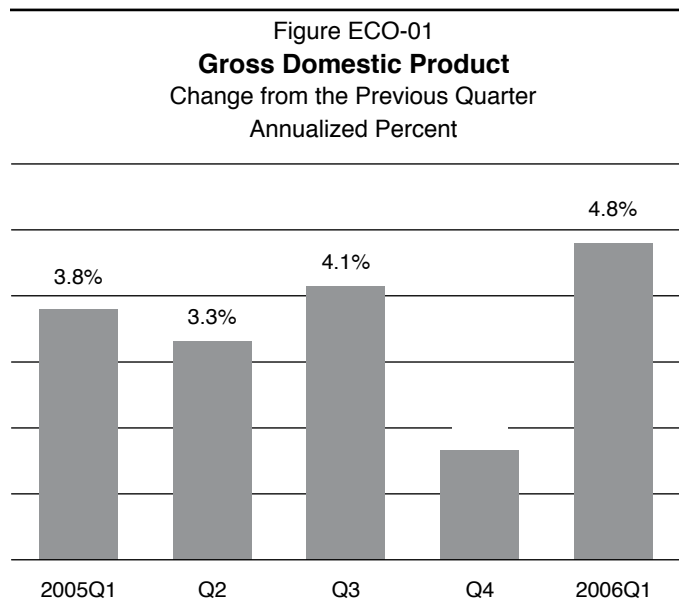
California's economy continued to create jobs at a good clip in the first two months of 2006, but a rainy March brought the first decline in employment in ten months. Even so, the state's unemployment rate fell to a five-year low as labor markets continued to tighten. Home building and home sales continued to cool in the first quarter, and home price appreciation moderated further. The value of nonresidential permits grew strongly, however, and office and industrial vacancy rates continued to either fall or remain at low levels. The state's tourism industry improved, as evidenced by higher hotel/motel occupancy and room rates. Personal income growth remained solid in the fourth quarter of 2005. Exports of

made-in-California merchandise and port activity remained strong in the first two months of 2006. The San Francisco Bay Area economy continued to improve in the first quarter.

The national and California economies continued to expand solidly in the first quarter of 2006 despite higher energy costs and slowing residential real estate and construction. Those headwinds picked up in recent months and will likely slow the growth of both economies as the year proceeds. The risks to the outlook have increased.

The Nation

Adjusted for inflation, national economic output (real GDP) grew by 4.8 percent at an annualized rate in the first quarter of 2006, a considerable improvement over its 1.7 percent gain in the fourth quarter of 2005 (Figure ECO-01). A turnaround in consumer spending on motor vehicles and parts accounted for most of the improved growth. This spending fell sharply in the fourth quarter of 2005 before bouncing about a third of the way back in the first quarter of 2006.



An acceleration in business investment in equipment and software-transportation and information processing equipment, in particular-also was a significant contributor to the increase in real GDP growth. Residential construction’s contribution to real GDP growth, however, fell slightly in the first quarter, but investment in nonresidential structures contributed to the increase in real GDP growth. A swing in inventory investment, from a sizeable accumulation in the fourth quarter of 2005 to a drawdown in the first quarter of 2006, limited the gain in output growth considerably.

Net exports (exports minus imports) fell again in the first quarter of 2006. Exports grew quickly, but imports even more so. The deterioration of net exports was less in the most recent quarter than in the fourth quarter of 2005, however.

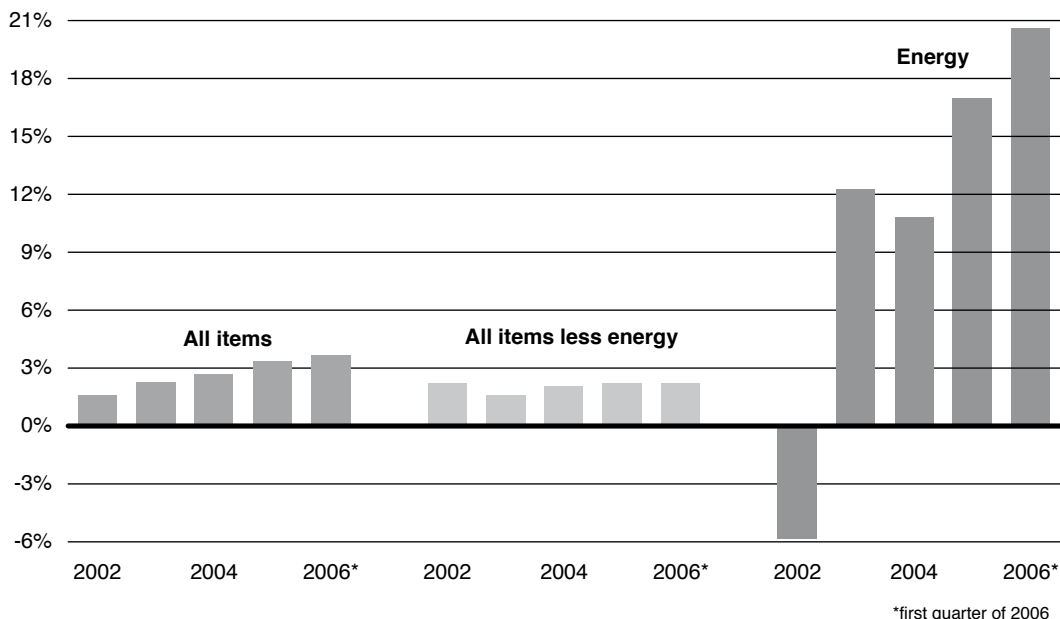
A swing in national defense spending was the third major contributor to the improvement in real GDP in the first quarter. This spending fell by \$11.6 billion in the fourth quarter of 2005 before rising by \$12.2 billion in the most recent quarter.

The gain in real GDP growth was reflected in the nation’s labor markets. Nonfarm payroll employment increased for the thirty-first consecutive month in March, and the average gain in the first three months of this year, 197,000, exceeded the average monthly gain for all of 2005-165,000. Job gains continue to be widespread across major industry sectors. The national unemployment rate has trended downward for almost three years and was 4.7 percent in March. Other than in January, when the unemployment rate was also 4.7 percent, that was the lowest rate since July 2001.

Both new and existing home sales slowed in the first quarter of 2006 on a seasonally adjusted basis. In fact, new home sales have trended downward since reaching a record high in July 2005 and existing home sales since June 2005. Inventories of unsold houses-both new and existing-have increased.

Rising energy prices were the paramount concern of Americans in March and April. The average retail price for regular gasoline rose by about 65 cents per gallon in the nation over the two months, and the spot price for oil by about \$14 a barrel. The consumer price index for energy was 21 percent higher in the first quarter of 2006 than in the first quarter of 2005 (Figure ECO-02). Soaring energy prices have pushed up general inflation measures

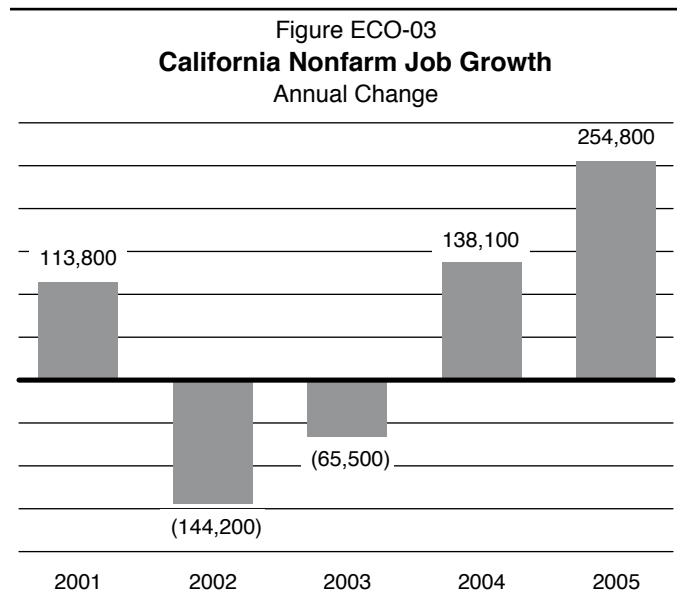
Figure ECO-02
U.S. Consumer Inflation
 Annual Percent Change in CPI-U



and slowed economic growth in the last year, but they have not appreciably affected the prices consumers pay for other goods and services. For example, the consumer price index that strips away energy prices was 2.2 percent higher in first quarter of 2006 than a year earlier—the same percentage increase as in 2005 as a whole (Figure ECO-02). The rate in the first quarter of 2006 does not reflect the increase in energy prices in April but coming quarters may.

California

Statistics released since January put in sharper focus the improvement in the California economy during 2005. The annual benchmark revision of employment statistics revealed that more jobs were created in the state during the year than initially thought—255,000, the best gain in five years (Figure ECO-03). Nine out of the 11 major industry sectors saw employment grow in 2005. The state’s unemployment rate has trended downward since October 2003, when it was 6.9 percent, to 4.8 percent in January 2006 and March 2006, the lowest rate since February 2001.



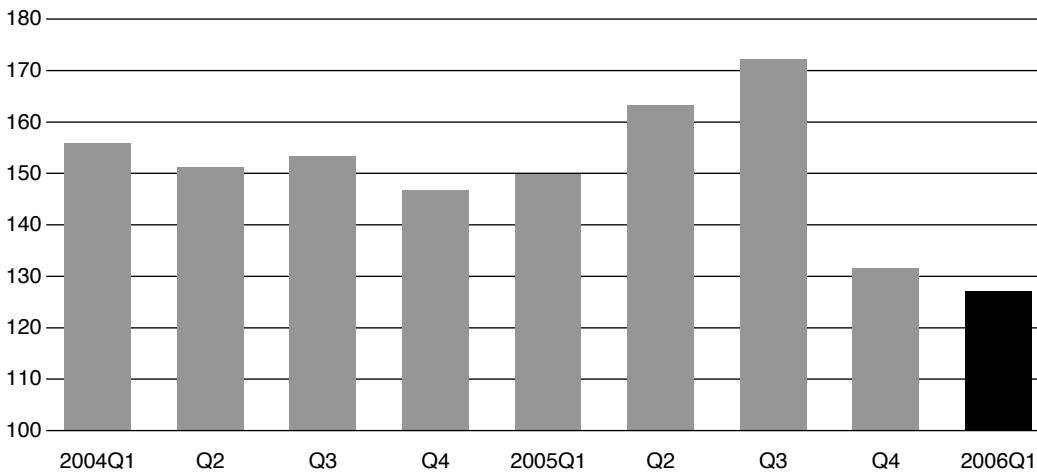
California personal income grew by 6 percent in 2005. California’s personal income growth has outstripped the nation’s as a whole since the first quarter of 2004. Taxable sales were 6.4 percent higher in the first half of 2005 than in the first half of 2004—in line with personal income growth in the state in the first half of 2005, but not as strong as the growth in taxable sales in the first half of 2004.

Made-in-California exports grew by 6.2 percent to \$116.8 billion in 2005, just shy of the peak level reached in 2000. High-tech exports fell slightly in 2005, but exports of transportation products, miscellaneous manufactured products, agricultural products, and food and kindred products all grew at double-digit rates and chemical exports just slightly less than that.

Leading export destinations, in order, were Mexico, Japan, Canada, Mainland China, South Korea, Taiwan, the United Kingdom, Hong Kong, and Germany. State exports expanded to all these markets, except the United Kingdom and Hong Kong. California deliveries to Germany grew by 16 percent and to Mainland China by 15 percent, the biggest gains among the state’s major trading partners. Made-in-California exports grew by 6.7 percent in the first two months of 2006.

California residential real estate markets and residential construction began slowing in the second half of 2005 and continued to slow in the first quarter of 2006. The number of residential units permitted fell sharply in the fourth quarter of 2005 and slightly in the first quarter of 2006 (Figure ECO-04). Except for a small gain in August 2005, total home sales have been down from a year earlier in every month since March 2005. Inventories of unsold houses, while not at worrisome levels, have grown over the last four to six months. Home price appreciation has slowed in the last six months, but year-over-year price gains for resale homes remain in double-digits, while those for new homes have dipped into the single digits.

Figure ECO-04
California Single-Family Home Construction
 1,000s of Permits, Seasonally Adjusted at Annual Rate



A much welcomed development in 2005 was improved job growth in the San Francisco Bay Area. As recently as August 2004, nonfarm payroll employment was below its year-earlier level in the Bay Area, while it was up 1.6 percent in Southern California.

In March 2006, nonfarm payroll employment in the Bay Area was 1.5 percent above its year-ago level, not much different from Southern California, where it was up by 1.6 percent.

The Forecast

Higher energy prices, somewhat higher interest rates, and further slowing of residential construction and real estate markets will slow economic growth in both the nation and California in 2006 and 2007. A rebound in consumer spending in the first quarter of 2006 fueled strong output growth in the nation, but that will be difficult to duplicate in the second quarter. The strong growth in the first quarter had more to do with weakness in the national economy in the fourth quarter of 2005—the result of the hurricanes—than strength in the first quarter of 2006. For example, motor vehicle sales were at an annualized level of 17.6 million in January 2006—the highest rate since July 2005. Since January, however, sales of motor vehicles have been quite lackluster—16.6 million in February and March and 16.7 million in April. With the April level below the first quarter average, it will be difficult for second-quarter sales to top the first-quarter level, even if gasoline prices had not increased so much in March and April. So, it is unlikely that vehicle sales will contribute to national economic growth in the second quarter. Monthly economic statistics released in May and June will likely reflect to a greater extent the sharp run-up in energy prices in March and April.

Real U.S. GDP will grow by 3.3 percent in 2006 and 3.0 percent in 2007, down from 3.5 percent in 2005, but still sufficient to allow for job growth in both years (Figure ECO-05). Housing starts will fall in 2006 and again in 2007. Corporate profits will be strong again in 2006 but flat in 2007.

On an annual average basis, California personal income will grow by 6.2 percent in 2006 and 5.8 percent in 2007 (Figure ECO-06). California job growth will fall slightly to 1.6 percent in 2006 and 1.5 percent in 2007. On an annual average basis, construction employment will increase slightly in 2006—although falling during the year—and fall in 2007. Housing permits will decline by 9.1 percent in 2006 and 7.8 percent in 2007.

Figure ECO-05
Selected U.S. Economic Indicators

	2005 (Est.)	2006 (Projected)	2007 (Projected)
Real gross domestic product, (2000 dollar) (Percent change)	3.5	3.3	3.0
Personal consumption expenditures	3.5	3.3	3.0
Gross private domestic investment	6.1	6.2	4.2
Government purchases of goods and services	1.8	1.4	1.7
GDP deflator (2000=100) (Percent change)	2.8	2.8	1.9
GDP, (Current dollar) (Percent change)	6.4	6.2	4.9
Federal funds rate (Percent)	3.2	5.0	5.0
Personal income (Percent change)	5.5	6.1	5.6
Corporate profits before taxes (Percent change)	35.8	13.5	(0.3)
Nonfarm wage and salary employment (Millions)	133.5	135.5	137.5
(Percent change)	1.5	1.5	1.5
Unemployment rate (Percent)	5.1	4.7	4.8
Housing starts (Millions)	2.1	1.9	1.8
(Percent change)	6.3	(8.1)	(6.2)
New car and light truck sales (Millions)	16.9	16.7	16.8
(Percent change)	0.0	(1.2)	0.9
Consumer price index (1982-84=100)	195.3	200.9	205.6
(Percent change)	3.4	2.9	2.4

*Forecast based on data available as of April 2006.
 Percent changes calculated from unrounded data.*

Figure ECO-06
Selected California Economic Indicators

	2005	Percent change	Projected		2007	Percent change
			2006	Percent change		
Personal income (\$ billions)	1,341.7	6.3%	1,425.1	6.2%	1,507.2	5.8%
Nonfarm W&S employment (thousands)	14,798.3	1.8%	15,029.0	1.6%	15,255.3	1.5%
Natural resources and mining	23.4	2.4%	24.0	2.5%	24.5	2.2%
Construction	905.7	6.5%	913.2	0.8%	884.5	-3.1%
Manufacturing	1,510.9	-1.4%	1,517.4	0.4%	1,530.2	0.8%
High technology	395.9	-0.7%	399.8	1.0%	403.9	1.0%
Trade, transportation, & utilities	2,817.6	2.3%	2,867.6	1.8%	2,917.8	1.7%
Information	472.6	-2.0%	465.0	-1.6%	476.8	2.5%
High technology	206.6	-1.2%	206.1	-0.2%	213.0	3.4%
Financial activities	930.3	3.1%	950.5	2.2%	947.7	-0.3%
Professional and business services	2,154.2	3.3%	2,220.5	3.1%	2,296.3	3.4%
High technology	270.2	3.3%	281.0	4.0%	297.0	5.7%
Educational and health services	1,586.2	1.7%	1,610.3	1.5%	1,642.4	2.0%
Leisure and hospitality	1,475.4	2.5%	1,513.2	2.6%	1,552.2	2.6%
Other services	508.0	0.8%	516.1	1.6%	527.5	2.2%
Government	2,414.0	0.8%	2,431.3	0.7%	2,455.4	1.0%
Unemployment rate	5.4%		4.9%		4.9%	
Housing permits (thousands of units)	208.9	-1.9%	190.0	-9.1%	175.1	-7.8%
Consumer price index (1982-84=100)	202.6	3.7%	209.8	3.6%	215.8	2.9%

*Forecast based on data available as of April 2006.
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