Sluggish First Quarter Below Expectations, But Weakness May Prove Short-Lived

First Quarter Growth Falls Short of Even Our Most Diminished Expectations

We noted in the March economic brief that first quarter real gross domestic product (GDP) growth activity would likely come in at a surprisingly sluggish pace. The Commerce Department's initial estimate came in even below those expectations, with real GDP expanding at a miniscule 0.1% annual rate during the first quarter.

The unusually harsh winter weather in the East and Midwest accounts for part of the weakness. There also was less inventory building during the quarter, which subtracted 0.6 percentage points from growth.

In addition, a quirky swing in trade subtracted nearly 0.8 percentage points off of first quarter output. The swing resulted from the earlier timing of the Chinese New Year, which fell in February this year as opposed to March of 2013. The earlier New Year apparently led to a surge in exports during the fourth quarter, which boosted GDP during that period as well as export activity at California's major container ports.

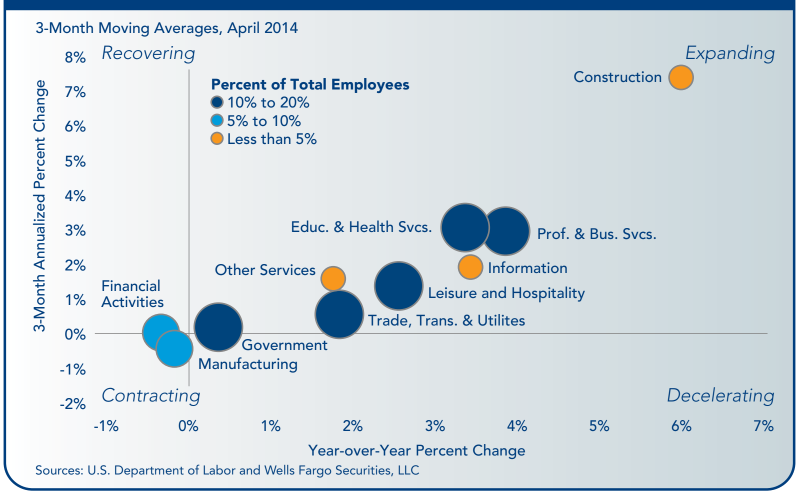
The first quarter of this year saw a payback for that boost. In addition to the swings in inventories and international trade, data on business fixed investment and consumer spending on goods generally were weaker than expected.

As additional data for the first quarter have been reported, it has become clear that real GDP growth will likely be revised down into negative territory. We suspect that this weakness will be short-lived, however. Real final sales to private domestic purchasers rose at a 1.6% pace during the first quarter and early indications for the current quarter suggest that growth has picked up at least modestly from that pace.

Trade through the Port of Los Angeles rebounded in March, with loaded containers increasing some 33.6% from their year-ago levels. Imports outpaced exports, however, so trade will likely be an even bigger drag on first quarter growth than initially reported.

We expect real GDP to rise at a 3% annual rate in the fourth quarter of this year and look for growth to average between a 2.5% to 3% pace during the second half of this year.

California Employment Growth by Industry



Sources: U.S. Department of Labor and Wells Fargo Securities, LLC

The improvement will be driven by an increase in capital spending, homebuilding and commercial construction. Government spending will also produce less of a drag than it has in the past few years and exports should also increase.

California

The weather remains a big concern in California, with the lack of precipitation this winter worsening the state's drought. The drought has not prevented the state from continuing to rack up big job gains, however. Technology, tourism, construction and retail trade continue to lead the recovery in job growth, which has helped trim the unemployment rate and revive demand for housing and commercial real estate.

Data through the first quarter of this year show nonfarm employment rising 2.4% from the prior year, although the pace of job gains slowed significantly during the first quarter. California's unemployment rate continues to trend lower, but remains well above the national rate at 8.1%.

Employment by Industry

Employment has increased across most major industries during the past year.

Construction employment has posted the strongest year-to-year gain, with payrolls surging 6.3%. The improvement is evident in both residential and commercial construction.

Employment in heavy and civil engineering has slowed, however, possibly reflecting the completion of several large infrastructure projects. The large percentage gain in overall construction employment reflects the continuing bounce back from incredibly depressed levels in recent years. In terms of jobs, construction posted the fifth largest gain, with 37,100 jobs.

Professional and business services continue to produce the largest number of new jobs in California, with 94,000 net new jobs added over the past year. This broad industry category captures much of the growth in the technology sector, which has been growing rapidly. Employment in professional, scientific and technical services has risen 3.8% over the past year, accounting for just under half of the entire sector's growth.

Employment in education and health series produced the second largest gain in employment over the past year, with 78,000 net new jobs added over the past year. About one-third of that gain was in health care services, reflecting modest gains at doctors' offices and outpatient facilities.

Employment at hospitals has declined slightly over the past year, reflecting margin pressures at many large hospital

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chains. The bulk of the growth occurred in the social assistance category, which saw employment surge 6.6% over the past year and added 40,300 jobs.

The split in health sector jobs is concerning in that employment is declining in most higher-paying parts of this industry category and growth the fastest in the lower-paying sectors.

Trade, transportation and utilities and the leisure and hospitality sectors round out the top four employment categories, based on absolute growth.

Retail trade employment is growing steadily but at a fairly subdued 1.9% over the past year. Traditional retailers continue to face an onslaught of competition from the online merchants. Sluggish wage and salary growth is an even more formidable hurdle for the industry.

Employment at online and catalog retailers was a rare bright spot, with payrolls climbing 5.7% over the past year. Employment also rose sharply at home improvement centers and garden equipment stores.

The strength in online retailing and continued growth in international trade have been strong drivers for wholesale trade, where employment has risen 2.6% over the past year.

Unemployment

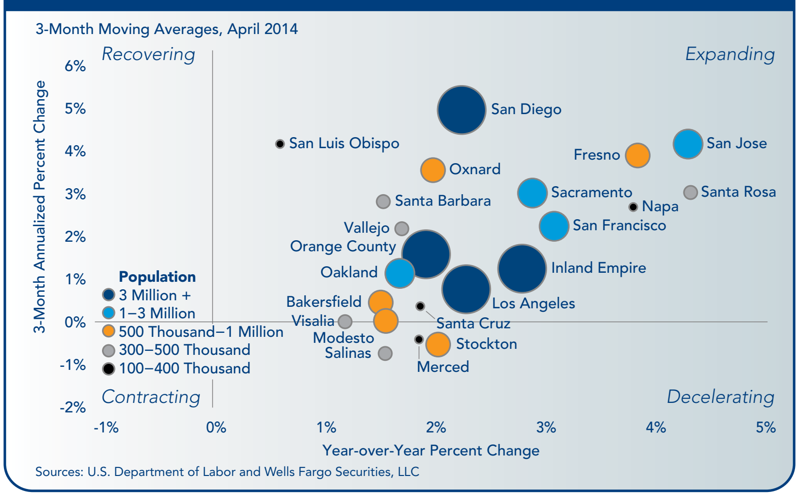
California's unemployment rate continues to trend lower and remained at 8.1% in March. The state's labor force is rising considerably faster than the nation's, reflecting the state's recent strong employment growth.

Much of the drop in unemployment during the past year has come from those who have been unemployed for 27 weeks or more.

We look for the unemployment rate to continue to drop another half percentage point this year, as construction activity strengthens and manufacturing improves. Both sectors were hit hard during the recession and have been slow to recover, which means many former workers are either marginally attached to the workforce or out of the workforce entirely.

The return of these workers is lifting both employment and labor force growth, which means that further improvement in the unemployment rate will likely be somewhat slower than what has occurred the past two years.

California Employment Growth by Metro



Sources: U.S. Department of Labor and Wells Fargo Securities, LLC

Leisure/Hospitality

Hiring in the leisure and hospitality sector rose a solid 2.5% over the past year, producing a net gain of 40,700 jobs. Most of that increase was at restaurants. Employment at amusement attractions rose 3.3%.

Employment in California's motion picture and sound recording industries rose 6% over the past year. This important category has been extremely volatile during recent years, however, even as the number of on-location production days has steadily increased.

Nearly all the growth this past year has been in motion picture and video production, which saw employment jump 12.7% and added 13,800 jobs on a year-to-year basis.

Northern California

The improvement in California's labor market is also evident across most major metropolitan areas.

San Jose-Sunnyvale-Santa Clara

The San Jose-Sunnyvale-Santa Clara metro area has seen the strongest growth over the past year, with nonfarm employment rising 4.3%, as the region has added 40,700 jobs. Growth in the region's tech sector, which accounted for 27.8% of nonfarm employment in September and was up 4.7% over the past year, produced a net gain of 8,235 new jobs.

Technology firms employ about 270,000 workers in the San Jose metropolitan area, which includes Santa Clara and San Benito counties. Total tech employment in the San Jose metropolitan area is 73.4% higher than the number employed in the San Francisco metropolitan division.

Household employment growth has risen more slowly in South Bay, however, climbing just 3.3% over the past year, which implies a significant number of workers are commuting into Silicon Valley from San Francisco, Oakland and other neighboring areas.

San Francisco

Overall office employment in the San Francisco metro division has risen 3.4% over the past year, netting nearly 12,500 new jobs. The tech sector has accounted for the bulk of the gain, and in September, tech-related employment was up 6.9% from a year earlier.

The rapid growth of the tech sector appears to be crowding out growth in some other areas. Employment in San Francisco's financial and legal sectors declined 0.7% over the past year. The trend is only slightly more positive when looking at the past three years, which saw employment in San Francisco's financial and legal sectors rise just 3%.

In terms of jobs, San Francisco's financial and legal sectors will likely be hard pressed for some time. Several large financial institutions have reduced their downtown footprint, with the freed up space going to rapidly growing tech companies. More reductions are on the way. San Francisco-based Charles Schwab & Company announced that it would relocate 1,000 positions out of San Francisco to other areas of the country, including Colorado and Texas, where the

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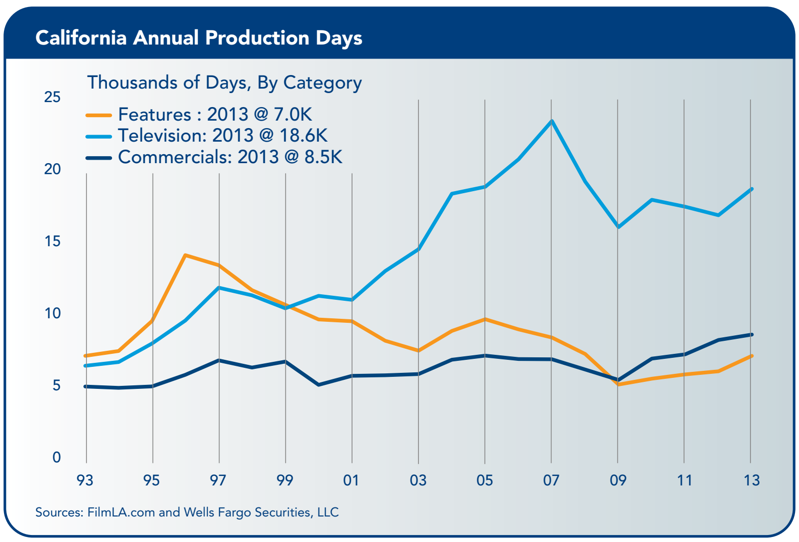
firm maintains sizable operations.

Oakland

Oakland has followed a more measured pace. Nonfarm employment has increased by a solid 1.9% over the past year, producing a net gain of around 20,000 jobs. Office employment is rising much more slowly, climbing just 0.9% over the past year. Despite the modest employment gains, the region's unemployment rate has come down sharply, reflecting stronger job growth in adjoining areas.



Southern California

Job growth has also remained solid in Southern California.

Inland Empire

Nonfarm employment in the Inland Empire has risen 2.7% over the past year, with improvement evident across the board. Higher home prices in coastal areas have led to increased population gains in the Inland Empire, which is helping revive residential and commercial construction. Activity has also picked up in the region's important wholesale trade and distribution sector.

In addition, stronger population growth is fueling hiring at retailers, restaurants and in professional services. The region's unemployment rate has fallen 1.1 percentage points over the past year to 9.4%.

Los Angeles

Employment has risen 2.1% in Los Angeles over the past year, producing a net gain of 87,500 jobs. As in other parts of the state, gains are broad based. Construction employment has jumped 8.8% over the past year, reflecting strong gains in both residential and commercial building. Industrial activity has been relatively sluggish, however, with employment in manufacturing declining 2.9%, reflecting losses in textiles and apparel, as well as aerospace and electronic equipment. Employment in wholesale trade and distribution is posting only modest gains.

The largest job gains continue to be in professional and business services, which saw employment jump 4.7% over the past year, as the sector added 27,700 jobs. About one-third of that gain has come in management, scientific and technical consulting. This high-paying category includes a number of tech professions. Employment has also increased in the region's important motion pictures industry, which added 9,300 jobs over the past year.

Orange County

Orange County continues to see strong gains as well. Nonfarm employment has increased 2.2% over the past year, with some of the strongest gains coming from construction, where payrolls have surged 12.2% over the past year, albeit from a very low level.

Hiring in business and professional services has also picked up, rising 3.8% over the past year, with some of the strongest gains coming in technology-related areas. Education and health services are another key growth area, with employment rising 3.4% over the past year. Hiring also increased in the region's important leisure and hospitality industry. Financial services continue to struggle, however, with employment falling 2.9% over the past year.

San Diego

San Diego has seen employment increase 2.5% over the past year, with improvement evident across virtually every major industry category. A big bounce back in construction has helped boost the top line employment figure. Construction employment has surged 9.9% over the past year and manufacturing employment inched up 1.3%.

Life sciences, communications technology and health care continue to be the major drivers of San Diego's economy. Employment in professional, scientific and technical services has increased 5.4% over the past year, with some of the strongest growth coming in research and development. Hiring in health care and social assistance has risen 2.8%.

San Diego's important tourist trade is also enjoying another strong year, helping drive employment higher at amusement attractions, hotels and restaurants.

Central Valley

The strong improvement along the coast is beginning to spread to the state's interior. Hiring has picked up substantial in the parts of the Central Valley, particularly Fresno. Other areas are still struggling, however, most notably Modesto and Stockton.

Housing

California's housing market continues to improve, even though recent sales data show activity moderating in recent months. The California Association of Realtors reports that sales of existing homes through the first quarter of this year are running 12.3% below their year-ago pace. The drop largely reflects the drawdown of foreclosure inventory across the state.

The median price of an existing home increased 14.9% over the past year to $435,470. Sales and price appreciation both slowed in recent months. Sales fell during each of the past five months and price appreciation has eased off a bit.

Supplies of detached single-family existing homes remain tight at just four months in March, which is up from 2.9 months one year ago. Homes are also taking slightly longer to sell than they did a year ago, remaining on the markets 35

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days, as opposed to 29.4 days a year earlier.

These trends, however, reflect more of a normalization of the housing market. Inventories are still extremely tight and with fewer distressed sales, the market is now more closely reflecting the underlying fundamentals, which continue to improve gradually.

More Households Opting to Rent

There are also some important changes taking place in California's housing market. Qualifying for a mortgage is much more difficult than it was at the height of the housing boom and more households are opting to rent. Moreover, more of those that are choosing to rent are doing so in areas closer to major employment centers, which means housing markets in the major metropolitan areas have improved much more than markets in the state's interior.

Younger households in particular are showing a greater desire for urban living, which is driving demand for rental units near mass transit. Housing costs in these areas are rising much faster than they are statewide.

The affordability migration, which typically takes place when housing prices rise in the Bay Area and Los Angeles, has been slower to materialize. Sales and apartment leasing are picking up in the Inland Empire, however, and parts of the Central Valley are also beginning to see home buyers return.

Residential Construction

Residential construction also has been slow to recover. Activity has improved, but much of the action has been in apartments, which helped multi-family permits rise 9.5% over the past year. Demand for apartments remains exceptionally strong, particularly in the Bay Area, where vacancy rates have fallen to just 2.9%.

Construction of new single-family homes has been more restrained, with permits through March rising 8.3% on a year-over-year basis. That increase, however, comes off an exceptionally low level and still leaves single-family permits well below the average pace seen before this past decade's housing boom.

Commercial Real Estate

Commercial construction activity has increased significantly over the past year, with most of the improvement occurring in the Bay Area and Los Angeles. Demand is being drive by the explosive growth in the tech sector.

Bay Area

Some 3.3 million square feet of office space are currently under development in downtown San Francisco and another 3.4 million is being built in South Bay, largely in huge new corporate campuses for Apple, Facebook, Samsung, Google and others.

The most recent REIS survey shows a total of almost 3.3 million square feet of office space currently underway in San Francisco County, with around 2.6 million square feet underway in the South Financial district.

The Transbay Tower accounts for the bulk of that space. The 61-story, 1.4-million-square-foot tower is currently slated to be completed in early 2017. Salesforce.com recently signed a lease for the lower 30 floors of the building, as well as the 61st floor at the top. The building, which will be the tallest on the West Coast, has recently been renamed the Salesforce Tower.

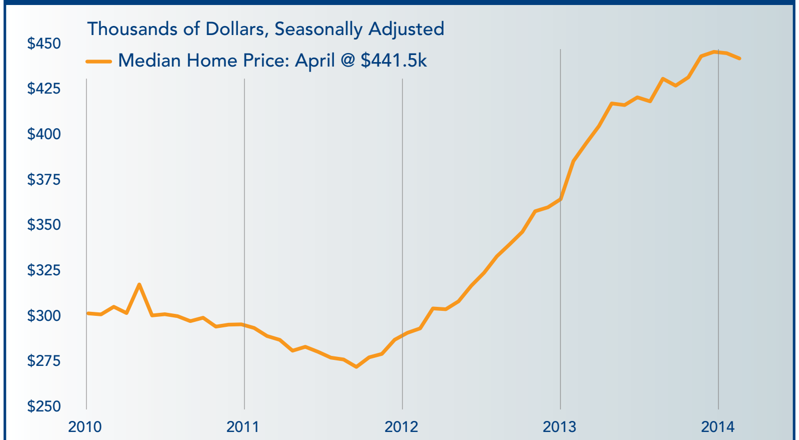
Other notable projects include 181 Fremont, a 51-story mixed-use tower, which broke ground late last year, and the second tower of One Rincon, a 50-story tower that should be completed by year-end, both in the SoMa district.

Los Angeles

Los Angeles has also seen a flurry of new construction. In the City of Angels, Korean Airlines is building the tallest building west of the Mississippi River, the New Wilshire Grand tower, which is expected to cost about $1 billion and earned the world record for the largest single concrete pour. The building should have office space, retail space and a hotel.

Although the high speed rail continues to face more hurdles before the project can move forward, other rail projects are in the works. Los Angeles is expanding its light rail network. Construction of the Metro Gold Line extension, which costs about a half-billion dollars, should be completed by the fall of 2015. In addition, crews broke ground on the new Crenshaw Line this year, which is expected to cost a little over $2 billion.

California Median Single-Family Home Price



Sources: California Association of Realtors and Wells Fargo Securities, LLC

Tourism

Leisure and hospitality payrolls increased 4.5% in the year, with much of that growth seen in the food service industry. Airport traffic is increasing, with steady gains coming from domestic travel and a surge in international passengers.

John Wayne International Airport, San Diego International, and the Norman Y. Mineta San Jose International airport all posted double-digit gains of international passenger traffic. The rise in international traffic was more subdued in San Francisco and Los Angeles, but remains solidly positive.

Although business travel to the state continues to grow, leisure travel appears to be rising at a faster clip. Employment at the state's amusement parks and

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arcades is 12.3% higher than a year ago on a three-month moving average basis.

The hotel industry is also faring well. Employment growth at accommodations has accelerated to its highest year-over-year rate since the year 2000, though the total number of workers employed in the industry still remains below its prerecession peak. The improvement has been fairly broad based, with occupancy rates increasing in every reported metro area except Tulare-Visalia and Redding-Chico.

In addition, the occupancy rate in California was already considerably higher than the national average. Revenue per available room, RevPAR, has jumped a sizable 10.6% over the past year, compared to the nation's 7.2% growth. Santa Rosa posted the largest gains, with San Francisco, Oakland and Napa Valley close behind.

Agriculture

The drought continues to weigh on the state's important agriculture sector. Short water supplies are challenging many farmers with substantially higher costs and increased operating uncertainty.

California has had a record dry year and is expected to experience a third year of dry conditions, despite the late precipitation falling on the state late in the season. This will again force acreage to be fallowed and increased the cost for many farmers to pump and/or buy more supplemental water. Livestock feeders expect to pay more for roughage this year.

Most operators are increasingly concerned about the performance of their wells and the possible impact of lower-quality water on some orchards and vineyards.

The open market price for supplemental water in 2014 is already three times normal and is expected to increase as the season progresses. This has and will continue to push up the cost for most growers and the income for the few which have water to sell.

Since there is no water to carry over and groundwater basins are being depleted, many growers are also concerned about water supplies for 2015, if precipitation is only normal or less next year.

Dairies

Milk prices for California dairies have strengthened and have reached record levels in recent months. This reflects strong export demand for the milk powder, which is benefitting from lower production in China and rising consumption there.

California dairy producers are also benefiting from lower corn prices, which are nearly 40% below their highs last year. Hay prices have held up, however.

Other Livestock

Prices for feeder and fed cattle are at record levels as producers continue to rebuild their herds. Feeders are also enjoying the low cost of corn, but cow/calf operators are paying more for hay, because of poor grazing conditions.

Fruits, Nuts and Vegetables

Freezing temperatures in December damaged as much as 40% of the citrus crop, increasing prices for quality fruit. Raisin prices fell as the California harvest came in 12% higher than the previous year and world production improved. Slightly lower production levels for almonds, walnuts and pistachios increased prices, as export demand remains strong.

Good weather has increased vegetable production, reducing prices. These producers are worried about the cost and availability of water this year, especially the quality of water for almonds.

Wine and Wine Grapes

Most California wine grape producers enjoyed good prices in 2013, as wine sales improve, but prices paid to growers on the spot market were not as good as 2012, especially in the Central Valley. The large crop last year moderated the higher prices received in 2012, but they will stay favorable, as long as the weak dollar continues to impede competition from imports. Plantings of new vineyards in California continue to increase. Wineries report significant reductions in their finished inventories, and consumers are showing signs they will pay slightly higher retail prices.

Field Crops

Field crop production will decline further this year, as more acreage is fallowed, due to the drought. Cotton prices are slightly stronger, but probably not high enough to offset the higher cost of water. Tomato prices are good, because processors need the product for their through-put. Rice plantings will decline sharply, as northern producers have loss water and may sell water to southern farmers.

Such reduction will have an adverse impact on processors and other third party interests, such as fertilizer/chemical sales/applicators.

Labor

Many producers reported shortages of labor in California last year. Fruit and vegetable producers have slightly increased their wages paid. They are apprehensive about future labor availability due to the improving economy in Mexico and possible federal regulatory changes requiring stricter worker documentation.

They are worried about Congress' inability to pass immigration reform legislation, designed in part to provide a more stable labor force for California ag producers. They will also experience higher costs resulting from the state's higher minimum wage and new health coverage requirements.

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*The California Chamber of Commerce **Economic Advisory Council**, made up of leading economists from the private and public sectors, presents a report each quarter to the CalChamber Board of Directors. This report was prepared by council chair Mark Vitner, managing director and senior economist at Wells Fargo Securities, LLC.*

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