

# CALIFORNIA REGIONAL ECONOMIC OUTLOOK

California is forecast to add **334,000 nonfarm jobs (+2.2%)** in 2014, and another **356,000 jobs (+2.3%)** in 2015.

California job creation is expected to be led by **Professional & Business Services, Education & Health Services, and Leisure & Hospitality.**

**Bay Area** will remain the fastest growing region in California with healthy job growth in **Information, Tourism, and Construction.**

State of California sees operational budget surplus of **\$2.2 billion** this fiscal year- **first state surplus in a decade**



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## Executive Summary

California demonstrated its economic resilience throughout 2013 and the first quarter of 2014, despite lingering effects of the Great Recession, higher state tax rates, federal government shutdown and the fierce debt ceiling debate in late 2013.

The state added 447,400 nonfarm payroll jobs in 2013 and 1.3 million jobs from the end of recession through April 2014, according to California Employment Development Department. The state unemployment rate in April 2014 dropped sharply to 7.8 percent from 8.1 percent a month earlier and from 9.1 percent a year ago, narrowing the unemployment rate gap with the nation. We expect 334,000 additional nonfarm jobs in 2014 and 356,000 jobs in 2015 in California. Nearly two thirds of those jobs will be created in professional & business, leisure & hospitality, health and educational services sectors.

Expiration of federally-sponsored extended unemployment benefits in December 2013 directly impacted 220,000 unemployed Californians who were eligible for additional unemployment compensation after being unemployed for 26 weeks. This figure can potentially jump to 700,000 workers by the end of the year, if Congress decides *not* to renew the federally-sponsored program. This could cost an estimated \$4.3 billion in foregone statewide output, and a loss of 30,000 jobs, with \$1.2 billion in total earnings from what otherwise would have been generated in 2014.

Home prices in California have recovered 38 percent

since the 2011 market bottom, after the decline of 47 percent from the market's peak in 2006, according to Federal Housing Finance Agency (FHFA). FHFA purchase-only California Housing Price Index increased 20 percent in 2013, but this rate of growth may slow down in coming months, due to the expected increase in mortgage rates, high down payment requirements, decreasing affordability, lower investor activity, and a gradual increase in unsold inventory. We expect California median house prices to increase 7.5 percent in 2014.

According to the Legislative Analyst Office (LAO), California will have a budget surplus of \$2.2 billion during 2013-2014 that will largely be disbursed for additional K-12 education and community college spending. The budget surplus in 2014-2015 is projected to grow to \$3.2 billion, due to higher personal income, sales, and corporate taxes.

The downside risks for California include a potential cooling off in investment activity in the Bay Area, poor housing affordability and sluggish home sales, and a sharp decline in agricultural output in California's Central Valley and Central Coast due to the exceptionally dry weather. In contrast, rising household wealth, increasing business investment, and a stronger global economy could result in the jobs recovery and economic growth in the state being stronger than expected.

The Bay Area is projected to grow the fastest of any region of the state over the next few years as long as it remains competitive, continues attracting and retaining high-quality intellectual capital, and the elevated rate of IPO's, venture capital deals, and rapid

CALIFORNIA	2011	2012	2013	2014f	2015f
<b>LABOR MARKET</b>					
Employment Growth	1.1%	2.4%	3.0%	2.2%	2.3%
Unemployment Rate	11.8%	10.4%	8.9%	7.6%	6.8%
<b>INCOME TRENDS</b>					
Personal Income Growth	6.6%	5.0%	2.8%	5.2%	7.5%
Median HH Income	57,287	58,328	59,478	61,400	64,200
<b>HOUSING MARKET</b>					
Housing Starts Growth	4.0%	22.0%	34.8%	9.4%	19.8%
FHFA Home Price Index	-6.7%	5.8%	19.5%	7.5%	4.0%
<b>DEMOGRAPHICS</b>					
Population Growth	0.9%	0.9%	0.9%	0.9%	0.9%
Net Migration 000's	76.2	75.0	103.0	89.6	94.7

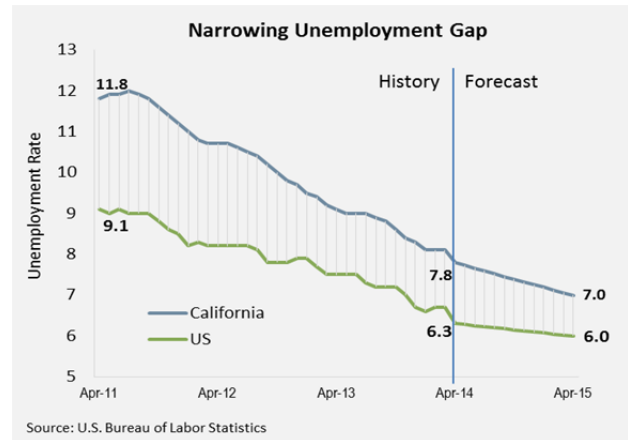
increase in equity prices does not lead to an overheating in the tech-heavy NASDAQ index triggering a sharp decline in stock prices.

### California Recovery Gains Momentum

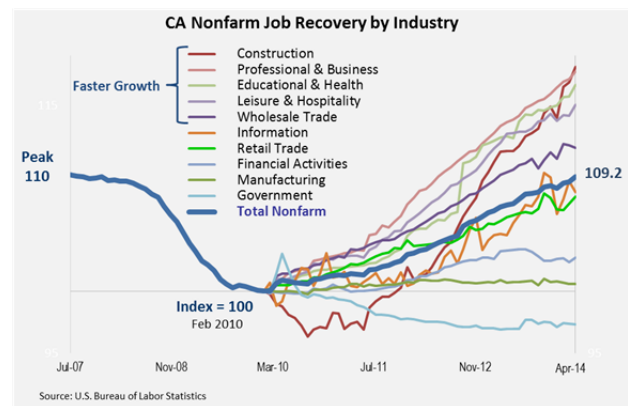
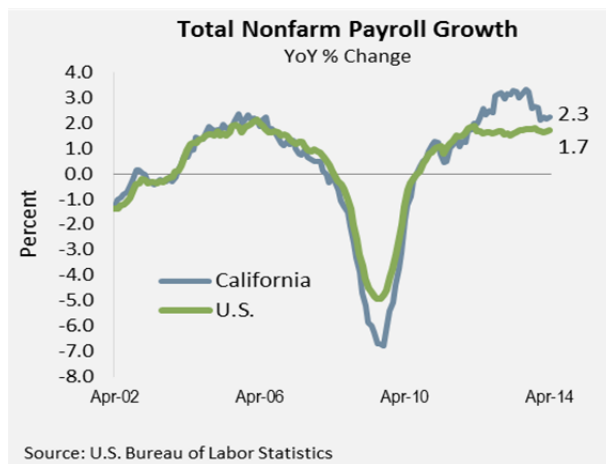
California added 447,400 nonfarm jobs in 2013, an impressive 3.0-percent annual increase. This was on top of an increase of 347,000 jobs or 2.4-percent gain in 2012 payrolls. The pace of job recovery in California has outperformed national job growth since March 2012 in part due to the natural rebound following the sharp and deeper plunge in jobs during the Great Recession. However, the state’s employment growth decelerated during the second half of 2013 and the first quarter of 2014 largely due to a slowdown in the services sectors.

Job growth appears to be bouncing back in the second quarter of this year. In April 2014, there were 15,424,600 payroll jobs in nonfarm industries, an improvement of 56,100 jobs from the month before. On a year-over-year basis, nonfarm payrolls were up 340,200 jobs, or 2.3 percent from last April. To put this in perspective, the Golden State demonstrated the 8<sup>th</sup> fastest payroll growth in the nation, and in numerical terms, the state created more jobs than all the jobs created in 31 other states combined. The state now is only 25,200 jobs shy of its pre-recession peak and should exceed that peak in the next month or two.

U.S. narrowed from 2.9 percent in April 2011 down to 1.5 percent in April 2014. We expect the unemployment gap to shrink further due to the solid and sustainable labor market recovery across major sectors in California.



California private sector employment performance has been even stronger, growing at an annual rate of 2.5 percent. The state’s private sector employment has already surpassed its pre-recession peak by 99,100 jobs. Since February 2010, the recession bottom for California employment, construction, professional & business services, education & health services, leisure & hospitality, and wholesale trade sectors have lead the expansion of nonfarm payroll growth. Meanwhile, employment in the information, retail trade, finance, and manufacturing sectors has increased at a slower pace than the statewide average.



While remaining above the national average, California’s unemployment rate of 7.8 percent has improved substantially during the last three years. The unemployment gap between California and the

The government sector has been a major drag on job growth in the state since 2011. As of April 2014, the sector has lost 152,700 jobs (-6%) from its pre-recession peak of 2.5 million employees in July

2008. Ninety-three percent of government job losses in the state have come from local governmental agencies. Over the past 12 months, the government sector in the state has returned to growth, adding 10,400 jobs, a 0.4 percent increase. State and local governments gained 15,700 jobs and the federal sector shrank by 5,300 payrolls. The loss of Federal jobs was primarily due to the job cuts in the defense sector and sequestration spending cuts in 2013.

The greatest payroll advances over the last 12 months in number of jobs occurred in professional and business services and education and health services, adding 89,500 jobs and 87,200 jobs respectively. The two sectors comprise over half of all nonfarm jobs created in the state.



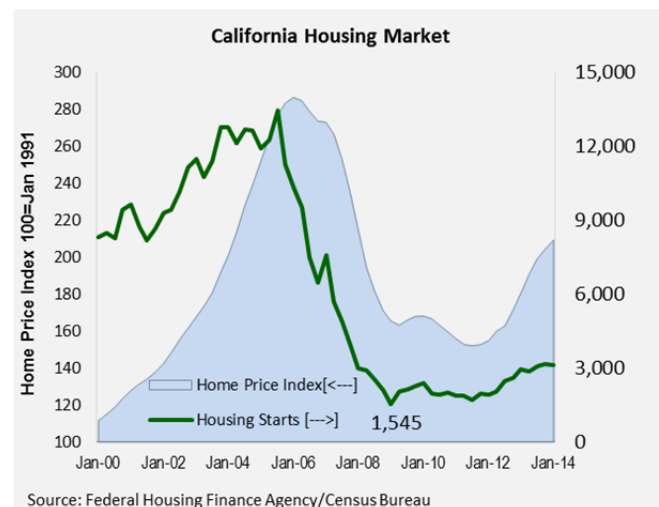
Construction in California grew the fastest on a percentage basis, increasing 6.2 percent since April 2013. This was a result of the increased housing demand in the state, decline of distressed housing inventory, strong pick-up in home prices, steady population growth, and positive expectations of homebuilders. Education and health services followed the lead with 3.9 percent annual growth, mainly concentrated in the health care and social assistance subsector. This gain has been partially driven by an increasing demand for medical services, rising health care spending, and expanding medical insurance coverage for Californians under the Affordable Care Act, which went into full effect in 2014.

Total nonfarm employment in California is projected to grow by 2.2 percent in 2014 and 2.3

percent in 2015, faster than projected national nonfarm employment growth for both years. Together, nonfarm payrolls are projected to grow by 690,000 jobs by 2016. And nearly two thirds of those jobs will be gained in professional and business services, education and health services, and leisure and hospitality. Employment in construction is expected to grow the fastest due to increased home construction activity and outsized job losses during the recession. In contrast, manufacturing is projected to continue its long history of declining employment, shrinking further in 2014 and 2015. Due to automation, productivity gains, higher than average production costs and outsourcing of low-skilled and labor-intensive manufacturing, the sector has lost 591,000 jobs in the state between January 2000 and April 2014, cutting out about a third of its previous workforce size.

### Housing Headwinds Materialize

California was one of the most severely impacted housing markets in the nation during the Great Recession, but the state’s housing sector improved broadly across major geographies during 2012 and 2013. The California purchase-only FHFA House Price Index dived 47 percent and single-family housing starts plunged over 88 percent before bottoming in January 2009. As the state economy rebounded strongly in this expansion, home prices have surged 38 percent and private housing starts have more than doubled. Nonetheless, housing starts remain at low historical levels in the state.



In 2013, prices for single family homes in California surged nearly 20 percent, while the number of housing starts increased 33 percent over the same period.

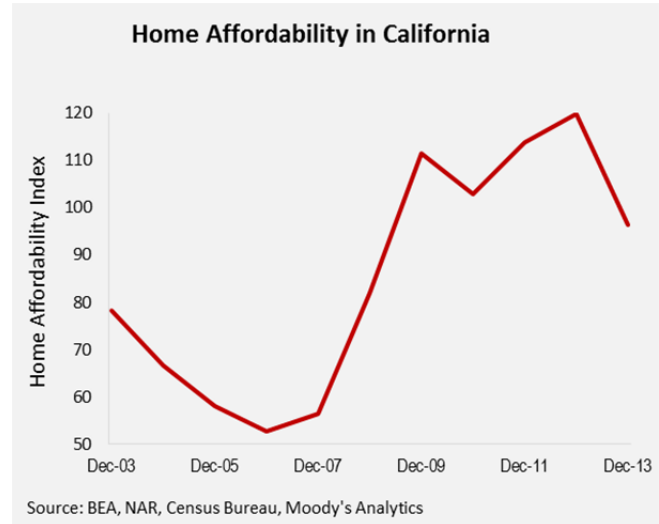
According to the California Association of Realtors, in April 2014, existing home sales dropped 7.0 percent from a year ago. This trend is typical across major housing markets in California. While remaining tight, the unsold inventory index increased over the last year from 2.8 months to 3.5 months of existing inventory, still well below the six- to seven-month supply that is considered normal in a healthy real estate market. The index illustrates the number of months necessary to sell the current supply of existing homes at the current sales pace. With surging prices, the unsold inventory index is expected to grow and eventually put some downward pressure on home price appreciation.

We expect California home prices to grow at a slower pace over the next few years due to continued tight lending standards, poor housing affordability, increased income disparity, and expected increases in mortgage rates in 2015. On the bright side, the fierce competition that emerged between primary home buyers and institutional real estate investors early in the expansion should fade. The strengthening economy should allow primary home buyers to slowly replace exiting institutional investors in the home sale market.

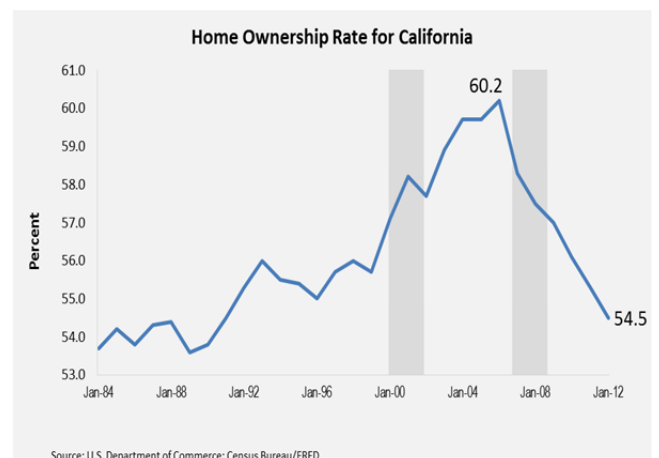
Another factor that can potentially delay the full recovery of the housing market in California is the new Federal Housing Administration (FHA) ruling on reducing the single-family FHA loan limits from \$729,750 to \$625,500 for the very high cost areas starting January 1, 2014. California, with higher-than-national-average housing prices, will be the first to feel the impact of the lower FHA loan limit.

The National Association of Realtor’s home affordability index (HAI) in California, a measure showing a family’s ability to buy a median priced home, will continue deteriorating through 2015. On the affordability index where 100 implies equilibrium between the median income and median home price, California is expected to sink below 80 by the end of 2015. An HAI of 100 roughly means that a family with the median income has exactly enough income to

qualify for a mortgage on a median-priced home. A value above 100 means that family earning the median income has more than enough income to qualify for a conventional loan, and an HAI reading below 100 indicates that the median-priced home is less affordable to a median-income earner. The calculation assumes a 20 percent down payment and the monthly payment does not exceed 25 percent of the median family monthly income.



Although the overall financial situation of Californians is expected to improve as the economy, labor force, and personal income levels in the state continue to rise, home ownership in the Golden State is becoming more of a challenge due to the acceleration of home prices and growing income inequality. California’s homeownership rate deteriorated 5.7 percentage points during 2006-2012 and shows no signs of improvement in the future.



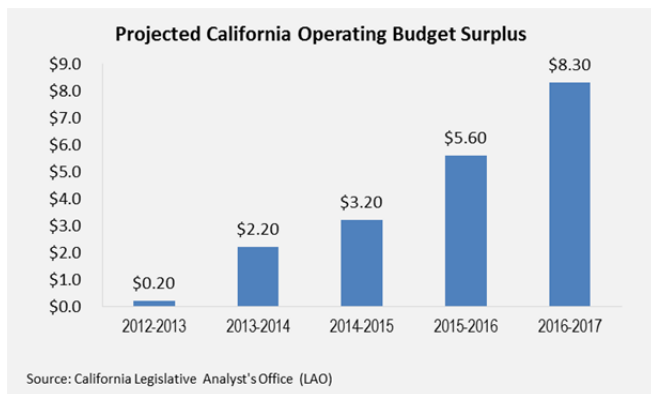


## Improving California Budget

With no changes to current state law and policy, the Legislative Analyst’s Office (LAO) projects that the State of California budget will have an increasing operating budget surplus and General fund reserve over the next few years.

For the first time in the last decade, California is expected to have an operating budget surplus of \$2.2 billion during the 2013-2014 fiscal year, thanks to increasing personal income tax collections and significant stock price growth throughout 2013. While state tax revenues are expected to grow by \$4.7 billion during 2013-2014, according to Legislative Analyst’s Office, projected state spending will be up only \$3.4 billion, with \$3.1 billion additional spending attributable to Proposition 98.

Enacted in 1988, General Fund Proposition 98 set rules regarding education funding in the State of California, essentially establishing a funding requirement known as the “minimum guarantee”. Proposition 98 guarantees an annual increase in education funding for K-12 education and the California Community Colleges System during years of strong economic growth in addition to adjustments for student enrollment growth and per capita general fund revenues. The remaining \$0.3 billion spending increase is expected to be used to reduce the state’s prison population.



The operating budget surplus in 2014-2015 is expected to top \$3.2 billion, according to LAO. Projected state revenues are expected to increase by \$5.8 billion, driven mainly by growing personal income taxes. Statewide spending is expected to grow by \$4.8 billion over the fiscal year, which will be

mainly allocated for Proposition 98 costs and infrastructure debt-servicing.

To help guard the state’s finances from a future moderate recession, the LAO, suggests California build a strong reserve of \$8 billion, from projected budget surpluses during the next two to three years to be able to better absorb the negative shocks of possible economic downturns. Under such a scenario, California might potentially face a \$900 million deficit in the first year of recession that could grow to \$2.4 billion in the subsequent fiscal year. Therefore, to continue funding existing programs and be able to pay for financial commitments undertaken in the past, the state should maintain a strong reserve balance.

The reserve figure reflects the main principle of the California Balanced Budget Act, (also known as Proposition 58; passed in 2004) requiring the state legislature to pass a balanced budget every year.

A recently revised California Governor’s budget proposal raises revenue projections for 2013-2014, partially offset by increased spending requirements under Proposition 98. The Governor’s office forecasts a combined \$2.0 billion higher tax revenues for 2013-2014 and \$843 million for 2014-2015 than their previous estimates. These increases will be mainly driven by greater personal income and corporate taxes.

The new proposal is to fully pay California teachers’ pension plan of \$74 billion over the next 30 years; an unfunded liability for teacher’s pensions called CalSTRS. Established in 1913, the California State Teacher’s Retirement System (CalSTRS) oversees pension programs of nearly 868,000 current, former, and retired teachers, comprising more than 2 percent of California’s total population.

## California Agriculture's Water Woes

California agriculture has grown significantly over the last few years and surpassed its four and a half year low by 61,500 farm jobs in April 2014, an impressive 18 percent increase from December 2009. Year-over-year, the sector added 36,500 farm jobs despite unfavorable weather conditions and water supply shortages throughout the state. California was ranked number one in farm receipts in 2012 with 11.3 percent of the U.S. total, according to California Department of Food and Agriculture. The total receipts of the state's 80,500 farms reached \$44.7 billion in 2012, a 3.2 percent increase from the previous year. The value of agricultural exports totaled a record-breaking \$18.2 billion in 2012, a healthy 7.7 percent increase over the previous year. The state's top-five valued commodities are milk, grapes, almonds, nursery plants, and cattle/calves, and together account for half of the total agricultural receipts for California.

Unfortunately, the severe drought that now covers nearly the entire state will be disruptive for agricultural production in 2014 and possibly 2015, causing sudden increases in commodity prices in local and global markets. On January 17, 2014, the Governor of California declared a drought emergency, and as of March 2014, 94 percent of the state agricultural sector was experiencing severe, extreme, or exceptional drought.

Based on California Farm Water Coalition drought-related loss projections of \$5 billion in agricultural production, we estimated that the drought will cost 37,600 direct and indirect jobs in the state originating from farming, food processing, warehousing, transportation and other related sectors with nearly \$1.5 billion in total wages and salaries lost. Clearly there is a growing need for effective and sustainable water conservation policies to secure reliable water supplies throughout the state. Looking ahead into the future, we are optimistic that California as the largest food producer in the U.S. will continue its reign as one of most productive agricultural places in the world.

## Summary: Healthy Recovery Continues

California's economy will continue to expand at a respectable pace in 2014 and 2015, despite the drought and outsized economic gains over the past several years. Both employment and personal income growth are expected to be above the national average over the forecast horizon. Population in the state is expected to grow steadily, just shy of 1.0 percent per year, nearly 0.2 percentage points faster than the national average. The most dynamic sectors in the state will continue to be professional and business services, leisure and hospitality, trade, and education and healthcare over the short and medium term. All private sector industries are expected to add jobs and create new business opportunities for investors in traditional and emerging industries.

Another important factor of the state's economic recovery is the better-than-expected budget outlook. Income tax revenues, the main driver of this positive force, will continue growing due to job and earnings advancement as well as expanding capital gains. However, this revenue momentum will be sustained only if payroll and earnings continue to improve and consumer spending strengthens further, which will translate to additional increases in personal income and sales taxes. Unfortunately, the state's positive balance sheet is not strong enough yet to eliminate inherited budgetary issues. California still needs more sustainable sources of tax revenue to tackle lingering problems such as public pension liabilities, and increasing health care costs.

Despite challenges associated with a higher than average unemployment rate, expiration of federally funded long-term unemployment benefits, critical drought, and water supply disruptions, California remains one of the strongest economic engines of the United States. It more than makes up for current limitations on growth with its highly-skilled work force, leading research universities, innovative spirit, cutting-edge technologies, trade capacity, and geographic proximity to major fast growing countries in the global economy.

## The Bay Area

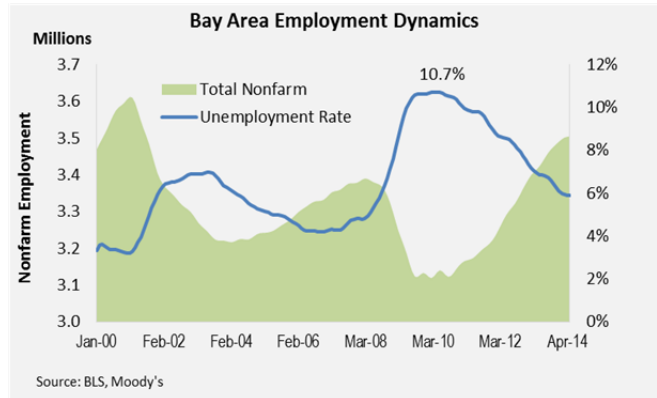


The economic recovery in the nine-county Bay Area – including Alameda, Contra Costa, Marin, Napa, San Francisco, San Mateo, Santa Clara, Solano, and Sonoma counties – is expected to be among the most vigorous of all U.S. metropolitan areas

in 2014. This is primarily due to the concentration of knowledge-based industries in the region, the high density of venture capital firms, and highly educated workforce. Growing tourism and trade, and, more recently, construction play a major role in the health of the regional economy.

Total nonfarm employment reached 3.5 million in April 2014, an increase of 103,000 jobs (+3.0%) from April 2013. Growing far faster than the state and national averages, the Bay Area created 30 percent of the state’s total jobs over the past year. The lowest unemployment rates in California prevail in the Bay Area. The unemployment rate in the Bay Area has been dropping rapidly, down to 5.8 percent on a seasonally adjusted basis in April 2014 from 6.9 percent a year ago, and a cyclical peak of 10.7 percent

at the beginning of 2010.



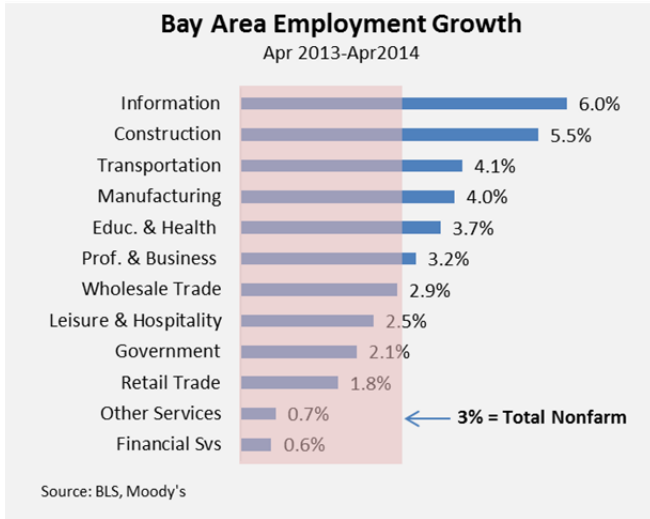
All non-farm industries in the region posted year-to-year job gains in April 2014. The largest annual payroll increase of 20,700 jobs was recorded in professional and business services, with nearly two-thirds of the payrolls being added in the professional, scientific, and technical services subsector. The second largest increase of 19,200 payrolls were posted in educational and health services during the same period with a great concentration in health care and social assistance.

The information sector grew at the fastest percentage rate of 6.0 percent during the last 12 months, adding 8,200 jobs. It was followed by an impressive 5.5 percent annual growth rate in construction jobs fueled by increased residential construction activity.

Employment in the financial sector grew at the slowest pace during last 12 months, adding only 1,000 jobs, an increase of 0.6 percent.

BAY AREA	2011	2012	2013	2014f	2015f
<b>LABOR MARKET</b>					
Employment Growth	1.7%	3.7%	4.1%	2.7%	2.8%
Unemployment Rate	9.7%	8.3%	6.8%	5.7%	5.2%
<b>INCOME TRENDS</b>					
Personal Income Growth	8.7%	7.3%	3.6%	5.9%	7.6%
Median HH Income \$	69,617	71,273	74,378	77,196	80,908
<b>HOUSING MARKET</b>					
Housing Starts Growth	34.5%	37.1%	33.4%	16.9%	24.2%
Med. 1-Unit Home Price	-7.7%	8.7%	24.6%	7.7%	3.9%
<b>DEMOGRAPHICS</b>					
Population Growth	1.2%	1.3%	1.3%	0.9%	0.9%
Net Migration 000's	42.4	51.9	59.2	38.5	30.4





Economic growth has been quite remarkable in Silicon Valley. San Jose, which added over 40,900 nonfarm jobs over the past year, grew 4.3 percent annually or 2.5 times faster than the national average payroll growth. And not surprisingly, the information sector, largely internet publishing and web search, took the lead, growing a whopping 10.0 percent since April 2013 or adding 5,800 jobs during the past 12 months.

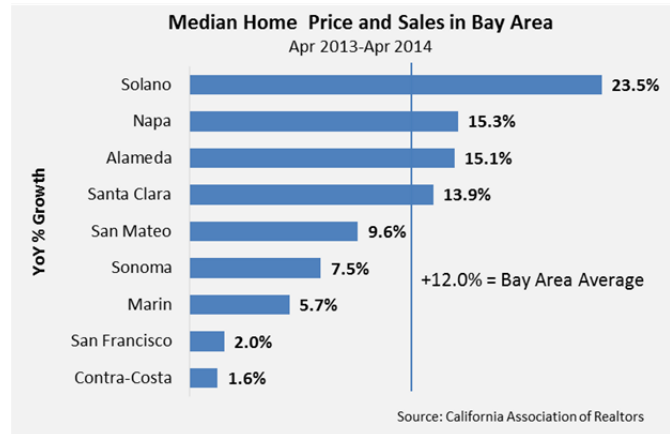
Employment in the Bay Area is expected to continue its outperformance of the state and national averages as well-established large tech companies continue growing and expanding their market shares and Bay Area start-ups attract the largest share of U.S. venture capital investment. The region is also forecast to add a considerable number of jobs in the educational services and health care, manufacturing, and tourism sectors.

In the first quarter of 2014, nearly half of all U.S. venture capital (VC) investment was in the Bay Area, totaling \$4.7 billion. This was more than double the amount of venture capital dollars deployed last year in the same quarter. The primary industries attracting VC investment in the region were software, IT services, consumer products and services, and media and entertainment. Bay Area VC investment amounted to 86 percent of the California total in Q1.

A correction in technology stocks and venture investing is a downside risk for the region that could eventually lead to layoffs in information and professional and business services as boom and bust cycles in Silicon Valley are common. However, we think this risk remain low over the near-term.

## Bay Area Housing

During the last 12 months, median existing home prices posted a strong 12 percent surge across the Bay Area, whereas existing single-family home sales declined a slight 0.3 percent.



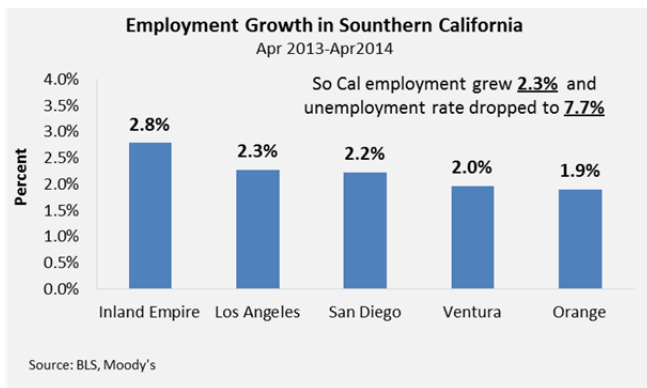
In April 2014, the largest annual price increase of 23.5 percent was recorded in Solano, followed by Napa (15.3 percent) and Alameda (15.1 percent) counties as home buyers shifted to relatively more affordable places in the Bay Area. In counties such as San Francisco, Marin, and San Mateo, where the median home prices are well above national and regional averages, the price increases during the last 12 months were milder. Existing home sales increased in five out of nine Bay Area counties during the last 12 months. Sonoma County experienced the biggest decline in sales (21.9 percent) and Contra-Costa sales grew nearly 20 percent from last April, driven mainly by volume of unsold inventory.

According to the latest *“Demographia Housing Affordability Survey: 2014”*, San Francisco and San Jose are ranked as the 3rd and 5th least affordable housing markets in the world, respectively, where the median house price is 9.2 and 8.7 times higher than the median household income in those MSA’s, based on 3rd Quarter 2013 data.

We expect the Bay Area housing market to cool down over the next few years due to diminishing housing affordability and disappearing distressed housing inventory.

## Southern California

The six-county Southern California economy continues to recover from the “Great Recession”. The region, including Los Angeles, Orange, San Bernardino, San Diego, Riverside, and Ventura counties, is the home of 21.5 million Californians, or two-thirds of the state’s population, with a real gross domestic product (GDP) of more than \$1.0 trillion, or 55 percent of California’s economy. Southern California’s unemployment rate dropped to 7.7 percent in April 2014 from a seasonally adjusted 9.1 percent a year ago. Southern California nonfarm employment increased by 188,600 jobs or 2.3 percent over the year, and 96 percent of those jobs were created in the private sector, of which nearly half were in Los Angeles County.



Government payrolls increased a modest 0.6 percent from April 2013, adding 7,200 jobs in Southern California as government spending growth remained tight. Despite the notable improvement in the labor

market over the last three years, the region is still 146,400 nonfarm jobs short of its pre-recession peak.

According to Bureau of Labor Statistics, Southern California’s strongest job growth in the past 12 months was in educational and health services and professional and business services, which added 50,700 jobs and 47,500 jobs, respectively. The job growth in these industries was heavily concentrated in administrative and support and health care and social assistance sectors. Construction payrolls grew the fastest in percentage terms at 8.6 percent, adding 28,600 jobs in the region during the last 12 months. This was clearly due to improving housing markets and positive sentiment among homebuilders, especially in multifamily construction. Housing starts in Southern California are already back to pre-recession levels.

Job growth in the region over the past year was offset by losses in manufacturing (10,800 jobs) and financial services (4,100 jobs) sectors, due to a steep decline in defense-related manufacturing orders, the high cost of doing business, and a stringent regulatory environment in Southern California. The unemployment rate improved substantially across all regions since April 2013, ranging from 5.5 percent in Orange County to 9.1 percent in the Inland Empire.

Construction, trade, transportation and utilities, professional and business services, education and health care, and leisure and hospitality sectors are projected to lead Southern California’s employment growth over the next two years given the resilient and diverse economic base, access to the nation’s key trading partners, large-scale capacity enhancements at

So. CALIFORNIA	2011	2012	2013	2014f	2015f
<b>LABOR MARKET</b>					
Employment Growth	0.6%	2.6%	2.8%	2.1%	2.2%
Unemployment Rate	11.5%	10.2%	8.9%	7.5%	6.7%
<b>INCOME TRENDS</b>					
Personal Income Growth	5.6%	4.3%	2.4%	5.0%	7.6%
Median HH Income	60,935	61,723	63,256	65,098	68,052
<b>HOUSING MARKET</b>					
Housing Starts Growth	26.5%	15.6%	37.2%	4.5%	17.9%
Med. 1-Unit Home Price	-3.5%	-1.6%	24.4%	7.0%	3.5%
<b>DEMOGRAPHICS</b>					
Population Growth	0.9%	0.9%	0.8%	0.8%	0.9%
Net Migration 000's	32.5	34.0	20.2	18.4	29.0

the ports of Los Angeles and Long Beach, modernization of LAX, and strong consumer presence.

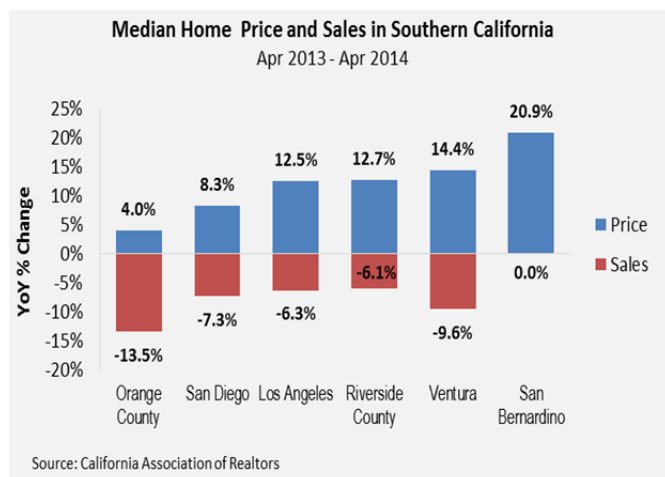
### International Trade

Southern California is a major foreign trade hub for the United States. The region has the nation’s largest ports, warehousing facilities and infrastructure to facilitate international trade with some of the United States’ largest trading partners: Mexico, Canada, China, Japan, and South Korea and other Pacific Rim countries. According to the U.S. Census Bureau, the ports of Los Angeles and Long Beach were ranked 1st and 4th largest ports by value of two-way waterborne trade respectively, totaling \$394.7 billion in 2013, and 3rd and 4th by value of seaborne exports, amounting for \$80.5 billion or 13.5 percent of the U.S. total.

Total container traffic at the Port of Los Angeles increased 10.3 percent in April 2014 compared to April 2013, and grew 9.7 percent at the Port of Long Beach during the same period. As state and regional economies continue recovering from the recession and global demand for goods strengthens, we expect this positive trend in the trade sector to become more sustainable in the next few years, creating thousands of new permanent jobs in the region.

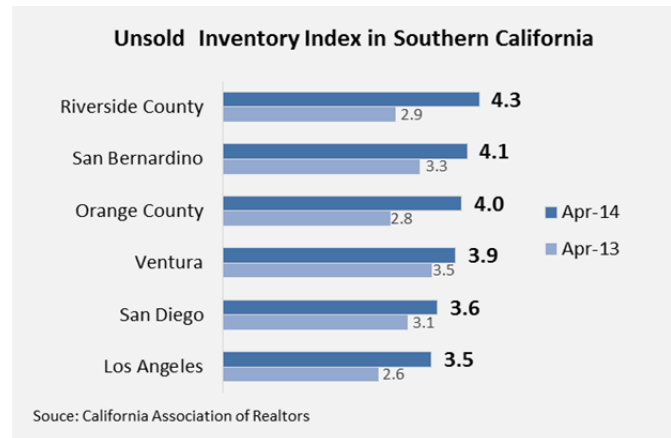
### Southern California Housing

As home prices extended gains across all counties in Southern California in the last 12 months, sales figures deteriorated in the region due to a drop in distressed housing inventory and declining affordability.



Home prices ranged from a moderate 4.0 percent increase in Orange County to a torrid 20.9 percent surge in San Bernardino since April 2013, while the number of houses sold dropped as much as 13.5 percent in Orange County and remained unchanged in San Bernardino as of April 2014, according to the California Association of Realtors data.

Southern California housing supply remains tight, by historical standards, but conditions have improved a bit on the margin. Month’s supply of existing homes increased from 2.6 months to 3.5 months in Los Angeles County, and for Orange County, the month’s supply index increased from 2.8 months to 4.0 months as of April 2014. Supplies remain well below the seven-month supply level considered normal in a healthy housing market.



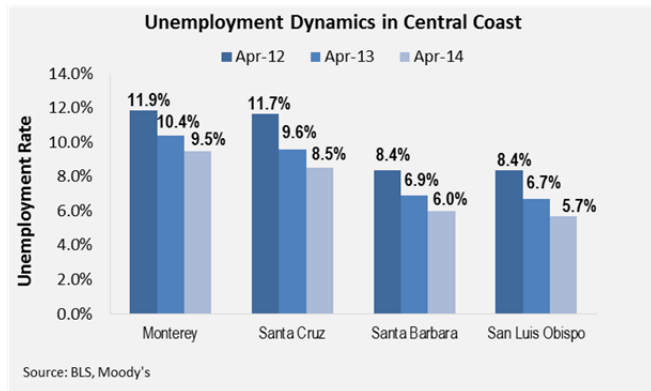
In 2014, we expect a moderation in Southern California home price growth to 7.0 percent as housing affordability has slipped and the cost of borrowing rises modestly. We expect Southern California existing home sales to be nearly flat this year as distressed housing inventory dries up and housing demand remains sluggish.

Potential downside risks in Southern California include a more severe slowdown in the housing sector that could have some negative spill-over effects on construction and service related sectors in the region such as architecture and engineering, interior design, building materials manufacturing, real estate and mortgage banking.

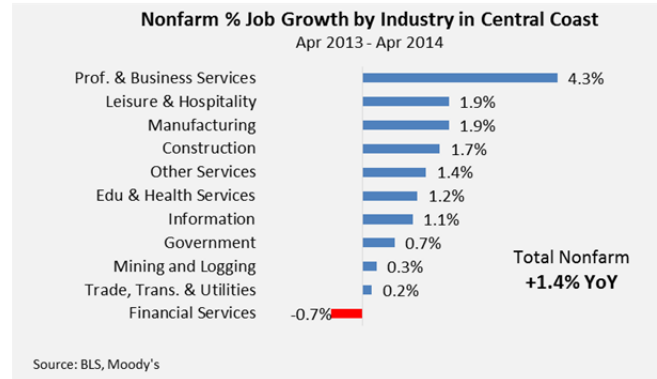
## Central Coast

The Central Coast of California with a total population of nearly 1.4 million residents, comprised of Santa Barbara, Monterey, San Luis Obispo, and Santa Cruz counties, was greatly exposed to the recent economic downturn in terms of housing and labor markets. But positive signs of economic stabilization and housing recovery were more visible here during the last 12 months. The region added 6,800 nonfarm jobs, an increase of 1.4 percent since April 2013, slower than the state’s average growth of 2.3 percent.

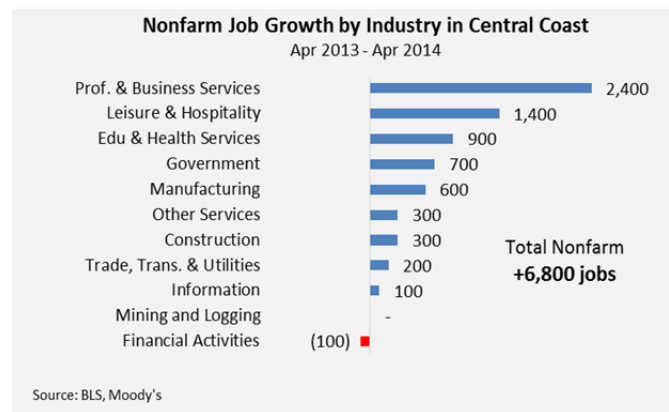
Unemployment in the combined region fell to 7.5 percent in April 2014 from 8.4 percent a year earlier. Unemployment improved notably during the last two years across all four counties; however, the overall regional improvement has been slower than the California average. The region still needs to create 4,100 jobs to reach its pre-recession peak.



Both on a numerical and percentage basis, professional and business services led the job growth in the Central Coast over the last year, adding 2,400 jobs, an increase of 4.3 percent.



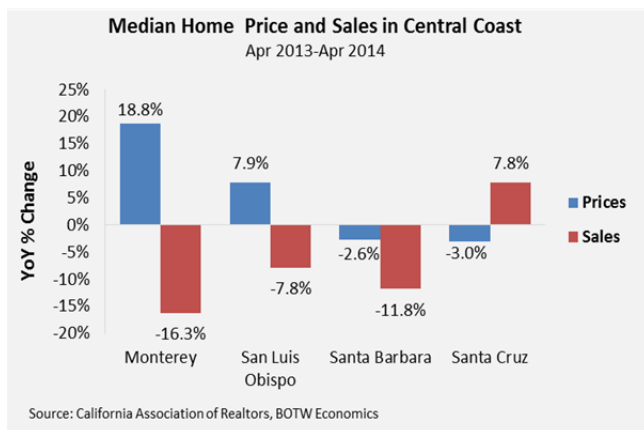
But job growth has been more broad-based than that with leisure and hospitality, manufacturing, and construction all growing faster than total nonfarm payrolls over the last 12 months, together adding 2,300 payrolls in the region. In contrast, financial services payrolls declined 0.7 percent since last April.



CENTRAL COAST	2011	2012	2013	2014f	2015f
<b>LABOR MARKET</b>					
Employment Growth	0.3%	2.6%	2.6%	1.3%	2.5%
Unemployment Rate	10.9%	9.7%	8.3%	7.3%	6.4%
<b>INCOME TRENDS</b>					
Personal Income Growth	6.2%	4.6%	3.5%	4.1%	7.1%
Median HH Income	56,878	57,616	58,892	60,348	63,153
<b>HOUSING MARKET</b>					
Housing Starts Growth	-28.4%	55.8%	16.5%	70.2%	18.4%
Med. 1-Unit Home Price	-8.5%	18.8%	21.9%	7.7%	2.8%
<b>DEMOGRAPHICS</b>					
Population Growth	0.7%	1.0%	0.9%	0.5%	0.7%
Net Migration 000's	0.3	5.4	3.0	-2.0	-0.2

## Central Coast Housing

Like other regions of California, the housing sector in the Central Coast of California has been strong during the most recent economic recovery. Yet, the latest California Association of Realtors April 2014 report indicates that home prices over the past 12 months increased in just two counties – 18.8 percent in Monterey and 7.9 percent in San Luis Obispo counties. During the same period, home prices declined modestly in Santa Barbara and Santa Cruz regions where the median prices are 35-40 percent higher than in other parts of the region. The same report also reveals that home sales were down in three out of four counties of the Central Coast due to diminishing distressed inventory, decreased affordability and relatively high interest rates compared to April 2013.



As the Central Coast economic expansion continues, we expect the housing market will follow, though at a much slower pace than it has over the past few years. Dry weather conditions are a downside risk that certainly could have negative ripple effects on agriculture and related sectors that are integral part of the region’s economy.



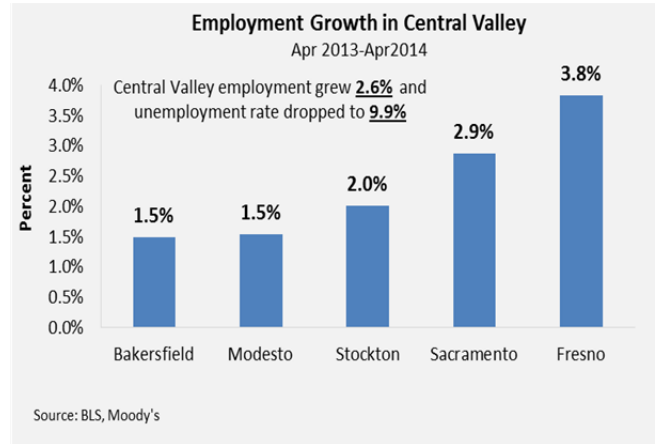
## The Central Valley



California's Central Valley is located in the central inland portion of the state, stretching nearly 450 miles from the Sacramento Valley in the north to San Joaquin Valley in the south. The Central Valley is home to nearly

seven million people, accounting for more than 18 percent of California's total population as of July 2013. The largest metropolitan areas in the region include Sacramento, Fresno, Bakersfield, Stockton, and Modesto, comprising two-thirds of the region's population.

In April 2014, nonfarm payrolls in the largest metro areas of the Central Valley increased by 46,400 jobs, or 2.6 percent, well above the state average growth rate. Most of this growth came from the Sacramento area. The April unemployment rate in the region remains at a high 9.9 percent, but is down from 11.0 percent a year ago.



Trade, transportation and utilities led the gains, adding 12,600 jobs in the Central Valley, followed by an increase of 9,200 jobs in professional and business services and 8,400 jobs in education and health care.

Information services experienced a modest decline of 700 jobs since last April. The government sector in the region saw a return of 7,300 federal, state and local government jobs. The state capital Sacramento was responsible for creating nearly two-thirds of those jobs—the only metro area in the Valley where the unemployment rate (7.5%) was lower than the state average for April 2014.

The seasonally adjusted unemployment rate in the agricultural heartland of California, Fresno, was 12.1 percent in April 2014, down from 13.1 percent a year ago, still holding well above the state and national average. Unemployment in the Central Valley always tends to be higher than the state.

CENTRAL VALLEY	2011	2012	2013	2014f	2015f
<b>LABOR MARKET</b>					
Employment Growth	0.2%	2.3%	3.0%	2.0%	2.3%
Unemployment Rate	14.3%	12.7%	10.9%	9.7%	8.9%
<b>INCOME TRENDS</b>					
Personal Income Growth	6.3%	4.5%	2.6%	4.5%	7.2%
Median HH Income	48,185	48,655	49,548	50,762	53,152
<b>HOUSING MARKET</b>					
Housing Starts Growth	--12.8%	28.9%	33.8%	30.9%	57.5%
Med. 1-Unit Home Price	-6.8%	7.5%	31.2%	9.0%	3.8%
<b>DEMOGRAPHICS</b>					
Population Growth	0.9%	0.8%	0.9%	1.0%	1.1%
Net Migration 000's	5.4	1.8	4.3	12.6	14.2

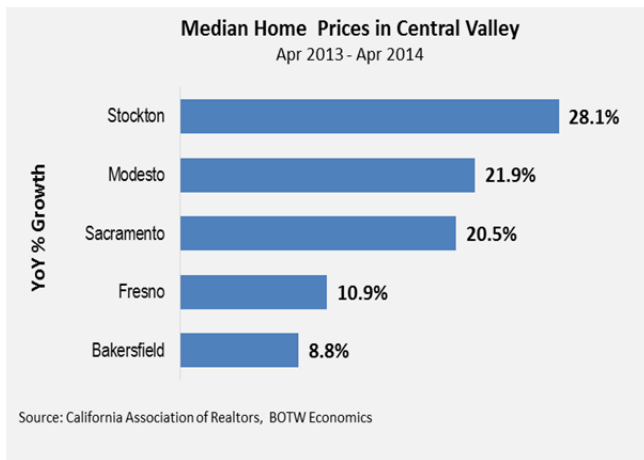
Since April of last year, Fresno employment increased by 11,600 jobs or 3.8 percent, while farming sector employment declined by 2,700 jobs during the same period. This was partly due to the exceptional dry climate in the Central Valley and subsequent reduction in agricultural production. Trade, transportation and utilities in Fresno reported the greatest year-over increase of 3,500 jobs, mostly concentrated in the retail trade subsector.

Bakersfield MSA, an integral part of the agriculture-heavy Central Valley, saw a modest decrease of 700 farm jobs since April 2013, a 1.4 percent decline from a year ago. The nonfarm sector increased 1.5 percent during the same time, adding 3,700 jobs mostly in trade, transportation, and utilities and construction.

The Central Valley is the most economically volatile region in California, and still faces many obstacles. The job recovery in the Central Valley has been relatively sluggish and is expected to grow at a slower pace in the next few years due to the three-year drought in California and the anticipated reduction in agricultural production associated with widespread water supply shortages. The region’s personal incomes are more closely tied to the agricultural sector than other parts of the state. This will be partially offset by above-average population growth and a return to balanced budgets and increased government spending in Sacramento.

### Central Valley Housing

On the housing side, most Central Valley metro areas have seen double-digit price increases compared to a year ago. The greatest median home price increases occurred in Stockton (28.1 percent), whereas the weakest increase took place in Bakersfield- up 8.8 percent.



As in other parts of the state, there has been an increase in the unsold housing inventory throughout the major urban areas of the Central Valley.

We expect a moderation of home price increases throughout this year and into 2015 in the Central Valley as sales remain subdued.

The discussions and information contained in this document are the opinions of BOTW chief economist Dr. Scott Anderson and economist Myasnik “Nik” Poghosyan and should not be construed or used as a specific recommendation for the investment of assets, and is not intended as an offer, or a solicitation of an offer, to purchase or sell any security or financial instrument. Nor does the information constitute advice or an expression of the Bank’s view as to whether a particular security or financial instrument is appropriate for you or meets your financial objectives. Economic and market observations and forecasts, such as those offered by Dr. Anderson and Poghosyan, reflect subjective judgments and assumptions, and unexpected events may occur. There can be no assurance that developments will transpire as forecasted. Nothing in this document should be interpreted to state or imply that past results are an indication of future performance.