



Jay E. Orr
County Executive Officer
Executive Office, County of Riverside

April 24, 2012

Honorable Board of Supervisors
County of Riverside
Robert T. Andersen Administrative Center
4080 Lemon Street, 5th Floor
Riverside, CA 92501-3651

4/5th Vote

SUBJECT: FY 11/12 Third Quarter Budget Report

Board members:

Across the board, department managers are stepping up to meet the task of closing our current year budget deficit. The Sheriff and District Attorney, who each started the year with structural budget deficits, both report that they will end the year on target. The Department of Public Social Services reports closing their sizeable gap significantly. Even the Fire Department, which the Board directed to cut costs without closing fire stations, is containing costs to the extent possible, although they do request an additional \$1 million at this time to pay the state administration fee. Overall, the county general fund is on target to begin FY 12/13 with the beginning fund balance planned.

Looking out to FY 12/13 and beyond, the county still faces significant challenges. The Assessor currently projects he will reduce the county's assessed valuation next year by at least another 2 percent. Factoring in the losses of sales and use tax revenue to the newly incorporated cities of Eastvale and Jurupa Valley, we estimate reduction in this revenue of 19 percent next year. Looking out to FY 13/14, our economists at California State University, Fullerton, project modest growth, at best, in these and other keystone revenues over the next several years.

At the same time, beginning in FY 13/14, the county again faces escalating costs. Recently negotiated labor costs will begin going into full effect. The county's costs of backfilling pension obligations resulting from shortfalls in the Public Employee Retirement System's investment performance will begin to increase. Costs of operating the new public safety enterprise communications system are currently being analyzed, but we anticipate a greater level of general fund support might be necessary. Finally, the Board recently committed to construction of a new correctional facility, and contemplates further expansion of existing facilities. In addition to the costs of construction, the ongoing costs

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of operating such facilities are quite significant.

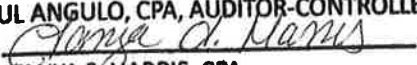
In order to adequately prepare to meet these additional cost burdens in FY 13/14, I intend to take swift action to begin ramping costs down to absorb these additional obligations within the constrained ongoing resources available. I will press for greater operating efficiency across departments, and put all options on the table to achieve more with less. I have advised departments with foreseeable need to downsize staffing further to begin that process now. In June, I will bring forward a recommended FY 12/13 budget that is structurally positioned to resolve existing budget issues and poise the county to address these future challenges.

IT IS RECOMMENDED that the Board of Supervisors: 1) receive and file this report and all its attachments; 2) approve the recommendations and associated budget adjustments contained in Attachment A; and, 3) approve Resolution No. 440-8885 amending Ordinance No. 440 contained in Attachment B.

Respectfully,



Jay E. Orr
County Executive Officer

FISCAL PROCEDURES APPROVED
PAUL ANGULO, CPA, AUDITOR-CONTROLLER
BY 
TANYA S. HARRIS, CPA


Approved by Barbara A. Olivier
Asst. County Executive Officer/
Human Resources Director

COUNTY OF
RIVERSIDE
STATE OF CALIFORNIA



COUNTY EXECUTIVE OFFICER'S

FY 2011-12
THIRD-QUARTER
BUDGET REPORT

Presented by

Jay Orr
County Executive Officer



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County Executive Officer
Executive Office, County of Riverside

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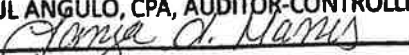
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Attachment A Summary of Recommendations

Attachment B Resolution No. 440-8885 Amending Ordinance No. 440

Attachment C Sales and Use Tax Update

Attachment D Economic Report from California State University, Fullerton

Attachment E Economic Report from Beacon Economics

Attachment F Quarterly Fleet Vehicle Report

A. EXECUTIVE SUMMARY

Several departments began the fiscal year with structural budget deficits, most notably the Fire Department, Department of Public Social Services (DPSS), District Attorney, and Sheriff. All departments are working diligently to close those gaps. The Sheriff and District Attorney both anticipate they will end the current year under their budget targets. DPSS significantly reduced their projected deficit and continues to work on cost containment. As directed by the Board, the Fire Chief also reduced costs to the extent he could without closing fire stations, but at this time requests \$1 million in order to pay the state administration fee. Due to an unanticipated liability judgment of which the department was not aware, Animal Services might not be able to end the year-end within its budget.

Discretionary revenues remain consistent with adjusted estimates made in the mid-year report. We project motor vehicle in-lieu revenue to come in \$4.6 million higher than the budgeted estimate, and project documentary transfer tax to fall \$1 million short. Although there is some uncertainty regarding the estimate for the county's redevelopment pass-through revenue, the Executive Office does not recommend further changes to budgeted revenue estimates at this time.

The Executive Office currently projects the general fund will end the year on target and begin FY 12/13 with the fund balance planned. Looking forward, many challenges remain. The county assessor anticipates dropping the county's assessed valuation by another 2 percent in FY 12/13, which will cause a further decline in property tax collections. Looking out to FY 13/14, our economists at California State University, Fullerton (CSUF), project only slight growth in assessed value under a positive economic scenario, and further decline if economic conditions in the county deteriorate. Loss of sales and use tax revenue due to the incorporations of Eastvale and Jurupa Valley will also be in full effect beginning in FY 12/13.

By FY 13/14, the county will face \$40 million in recently negotiated labor costs, projected to increase to \$160 million by FY 15/16, if current staffing levels remain unchanged. We also anticipate county contributions to PERS to increase one to two percent for the miscellaneous employee plan and two to three percent for the public safety employee plan. The operating budget for the new public safety enterprise communication system (PSEC) is currently being developed, and we expect it will require general fund support above current levels. Finally, and most critically, the Board recently made a commitment to the state regarding construction of a new correctional facility, and contemplates expanding existing facilities. Operating costs of new correctional facilities are substantial, and will begin to ramp up within the next few years.

To position the county to take on these additional costs within foreseeable economic constraints, the Executive Office recommends taking the measures necessary to achieve a structural balance in FY 12/13 to ramp toward accommodating these additional costs beginning in FY 13/14. This must include discontinuing use of one-time resources to nurse along budgets which are structurally unsound and not sustainable in the face of long-term commitments and economic conditions.

B. ECONOMIC OUTLOOK

GENERAL OUTLOOK

The California economy started off 2012 slowly, with job growth weaker than the later months of 2011, and construction and real estate activity subdued compared to the previous year. The California Department of Finance reports continued gradual growth in statewide non-farm payroll employment through February. Six major industry sectors saw employment gains while five lost. The largest job gains were made in the information sector, followed by manufacturing, education, health services, and professional and business services. Job losses occurred in government, trade, transportation, and utilities, among others. The state’s unemployment rate remained steady at the January level of 10.9 percent, ranging from 6.6 percent in Marin County to 27.1 percent in Colusa County. Unfortunately, the unemployment rate in Riverside County lost traction and rose again by 0.1 percent over the past quarter to 12.6 percent.

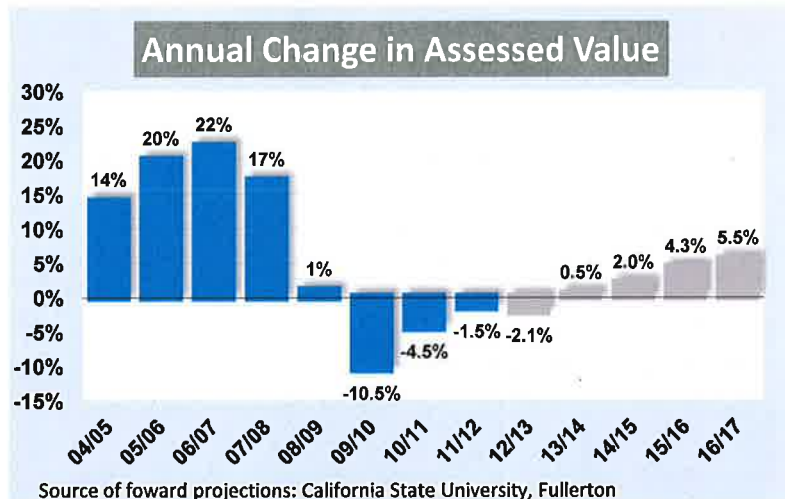
Statewide, issuance of residential construction permits increased 15 percent in January and February over the same period a year ago. Although home prices remain weak, sales improved modestly and inventory measures continue to improve. Existing homes sales in January and February remained unchanged from the same period a year ago, and the median home price declined 2.8 percent. During February, the index of unsold inventory receded slightly to 5.3 months, and the median days necessary to sell a home declined to 58.9 days, a drop of 9 percent from a year ago.

LOCAL OUTLOOK

Assessed Value

Exceptional growth in the county’s assessed property value began in FY 04/05, and started abruptly declining in FY 07/08.

For FY 11/12, assessed valuation decreased by 1.5 percent. The State Board of Equalization has confirmed that movement in the consumer price index for 2012



will permit return to the maximum two percent increase for properties subject to Prop. 13. The assessor’s early FY 12/13 assessed roll value projection reflects a 2 to 2.5 percent decrease. This decrease is primarily a result of declining commercial property values. The Executive Office will work with the assessor, California State University, Fullerton, and Beacon Economics to refine future year projections.

Building Permits

Due in part to the incorporations of the cities of Eastvale and Jurupa, overall building permit volume for single-family, grading, plan check, etc., in unincorporated Riverside County has dropped substantially. Building and Safety took in a total of 5,212 cases from July through February this fiscal year compared to 7,253 cases during the same period a year ago. Total intake dropped by 2,041 cases, or 28 percent. Likewise, receipts for the first eight months total \$3.5 million compared to \$5.5 million during the same period a year ago. (It should be noted that of the \$5.5 million, \$1.4 million is attributable to increased building activity resulting from the change in the building code regarding residential sprinklers.) Planning applications through February declined to 360 compared to 537 during the same period last fiscal year, a drop of 33 percent.



Documentary Transfer Tax Activity

Information from the Assessor-County Clerk-Recorder reflects mixed economic signals. Documentary transfer tax revenues are projected to decrease about five percent for the current fiscal year. On a positive note, third quarter document recordings and recording revenue have increased about four percent when compared to the same quarter in FY 10/11.

STATE BUDGET UPDATE

The state continues its slow recovery from recession, though recent gains are relatively small compared to cumulative losses since 2008 and the economic outlook remains mixed this year.

State Revenue

According to the state controller, revenues for March were \$233.5 million, 4.2 percent below the most recent estimates in the governor’s FY 12/13 proposed budget. The controller notes the upcoming months are most crucial because 35 percent of the state’s revenue for the entire fiscal year is expected during the last quarter.

Most of the revenue shortfall resulted from lower than anticipated corporate tax receipts, which came in 8.2 percent below projections. Sales tax receipts are down slightly, 1.7 percent below projections. Personal income taxes were down as well, at 1.8 percent below projections.

The state closed out the last fiscal year with an \$8.2 billion cash deficit. The combined current-year cash deficit is \$21.5 billion, covered by \$15.1 billion borrowed internally

and \$6.4 billion in external borrowing.

Overall, state revenues remain below projections in the governor's January 2012 state budget proposal. In addition, when he released his budget proposal, the governor urged the legislature to reduce the Cal-Works program by \$946.2 million in March in order to implement the needed reductions by October 2012. To date the legislature has not adopted that proposal. If it adopts the proposal later, reductions cannot be implemented in October and would go into effect later, thereby reducing the total savings. A court injunction that suspended cuts to the IHSS program stymied implementation of trigger cuts. However, cuts to Medi-Cal managed care were implemented.

State Budget Activities

The legislature continues to hold budget hearings on the governor's budget proposals, but has taken little action except to reject some proposals.

On March 22, 2012, the Senate budget subcommittee heard testimony from chief probation officers and others regarding the governor's budget proposal to transfer juvenile offenders in state custody back to their local communities for detention. The committee heard testimony but took no action.

The committee also heard significant opposition from consumer groups about shifting the Healthy Families program to Medi-Cal, but took no action.

Realignment Update

The Realignment Allocation Committee's discussions on the allocations will continue because the administration wants to wait until the governor's May revise to address both the funding structure and allocation formula.

Other Emerging Issues

The conference committee on pension reform met on April 13, 2012, and may issue a report in May 2012.

The governor's May budget revise may shed new light on how he plans to tackle the additional deficits that have appeared since his budget was released in January. The Executive Office will monitor any amendments to core county programs that may be impacted by actions taken to solve the state's growing deficit.

C. MULTIYEAR BUDGET OUTLOOK

LONG-RANGE PLAN

The county's multi-year budget plan incorporates projected expenditures and revenue four years ahead. As with any plan based on forecasts, revisions will be made as more information becomes available. At the beginning of the fiscal year, discretionary revenue was estimated to total \$584 million. Discretionary revenue continues to be projected to be \$578 million, a \$6 million decrease from initial budget estimates. The long-range projection for discretionary revenue anticipates a slight decline next fiscal

year followed by modest growth.

FUTURE RISKS TO A STRUCTURALLY BALANCED BUDGET

The county is making every effort to anticipate future fiscal impacts and develop a plan to mitigate them. While several potential impacts have been identified for upcoming fiscal years, the associated costs cannot be accurately quantified at this time. As the county makes plans for addressing budget challenges, ongoing funding sources will need to be identified for these items.

New Correctional Facility Operations

The county will build a new correctional facility and possibly further expand current facilities. As jail expansion takes place in the next five years, it will require additional resources for its operation. The county must identify funding for any ongoing increase in operations caused by such an expansion.

Public Safety Enterprise Communications Project (PSEC)

The public safety enterprise communications project (PSEC) implementation is near completion, and will improve communication coverage for county personnel. A post-implementation operating budget is currently under review. Ongoing cost increases not initially recovered from service rates, which typically recover only half the operating costs, may require additional funding.

Labor Related Costs

The county recently negotiated new agreements with various labor unions. While most of the agreements resulted in a savings for county departments in the short term, terms span multiple years and result in an overall increase to labor costs in FY 13/14. Human Resources reports that the added cost of labor contracts over the three year period of FY 13/14 through FY 15/16 will total approximately \$382 million.

In March, the California Public Employees' Retirement System (CalPERS) assumed annual rate of return on investments was reduced from 7.75 percent to 7.5 percent. This rate is used to calculate the contributions to be collected from the county to meet pension obligations to current employees and retirees. County contributions are expected to increase by 0.6 percent for miscellaneous employee plans and 1 percent for public safety employee plans in FY 13/14. Each one percent increase in CalPERS payments adds approximately \$10 million in total county costs.

D. THIRD QUARTER ACTIVITY

GENERAL FUND COMMITMENTS AND DESIGNATIONS

The county maintains a number of general fund commitments and designations of fund balance. The following table lists the balances of Board-established general fund commitments and designations effective through the recommendations in this report.

General Fund Commitments and Designations					
(in millions)					
	FY 10/11 Ending Balances	Adjustments for Budget Use	FY 11/12 Beginning Balances	Third Quarter Adjustments	Balance Upon Approval
Economic uncertainty	152.5	(27.8)	124.7	0.0	124.7
Disaster relief	15.0	0.0	15.0	0.0	15.0
Property tax system	18.6	(7.0)	11.4	0.0	11.4
SB90 deferral	1.4	0.0	1.4	0.0	1.4
Historic courthouse remodel	0.5	0.0	0.5	0.0	0.5
CAC remodel	0.5	0.0	0.5	0.0	0.5
Community improvement	0.4	2.4	2.8	(0.7)	1.3
ACO internal audits unit	0.1	0.0	0.1	0.0	0.1
DPSS realignment growth	0.0	0.0	5.7	0.0	5.7
Solar power plant program	0.0	0.0	0.0	0.4	0.4
TOTAL	189.0	(32.4)	162.1	(0.3)	161.0

DISCRETIONARY REVENUE

Property Taxes

The State Controller’s Office made an adjustment for vehicle license fee collections in excess of county allocations for the prior five fiscal years. Consequently, the county received \$4.6 million in revenue that was not previously budgeted. Other property tax related revenue continues to waver so this growth will likely be offset by shortfalls in other areas. The Executive Office will continue to monitor this revenue closely and make recommendations if necessary.

Redevelopment Pass-through Payments

In 2011, the governor signed AB1X26, dissolving redevelopment agencies throughout the state. This new law was challenged, but in December 2011, was upheld by the court. Consequently, dissolution of the county’s redevelopment agency and city redevelopment agencies throughout the county is proceeding per the new law.

Prior to this new law, the county received both contractually negotiated and statutory pass-through of tax increment from both the county and city redevelopment agencies. Under AB1X26 the county will no longer receive pass-through payments previously received under agreements with the county’s own redevelopment agency. These amounts, however, are relatively minor and will return to the county instead as regular property tax. County Counsel has opined that the county’s negotiated pass-through agreements with cities remain in full force as enforceable obligations under the new law. Based on this opinion, the Executive Office believes there should be no need for interruption in tax increment revenue received per the county’s pass-through agreements with the cities.

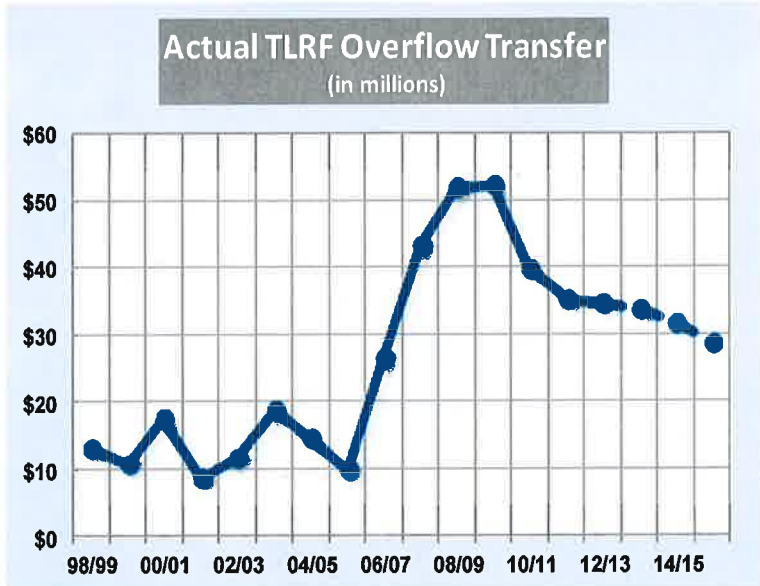
AB1X26 requires liquidation and distribution to the taxing entities of assets formerly held by redevelopment agencies that are not essential to meet enforceable obligations. As a

major taxing entity, the county will at some point begin receiving distributions of such excess assets from the county auditor-controller. To ensure such one-time distributions are not used to support ongoing operations, and thereby exacerbate the county's structural deficit, the Executive Office recommends the Board earmark all such receipts for capital projects.

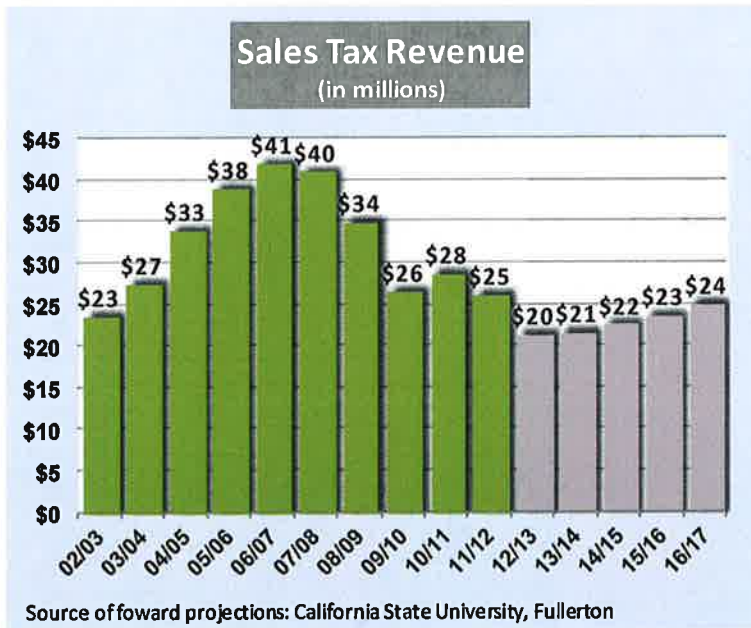
Recommendation 1: That the Board of Supervisors approve a policy position to designate toward general fund capital projects all revenue distributed to the county resulting from liquidation of the assets of former redevelopment agencies.

Teeter Tax Losses Reserve Fund (TLRF) Overflow

Under the California Teeter Plan, the county advances participating local agencies their property tax revenues based on assessed valuation. The county then retains all collected amounts, including penalties and interest for delinquent taxes. The tax losses reserve fund helps to manage revenues and expenditures associated with the program. Revenue that exceeds the cost of financing and tax loss reserves is discretionary revenue and is released to the general fund.



The rise in assessed value together with a spike in property tax delinquency rates significantly increased the Teeter Plan overflow in recent years. The overflow peaked at more than \$52 million in FY 09/10. However, with property tax delinquency rates declining, we continue to expect the associated overflow to be \$35.5 million this fiscal year. The trend will continue to erode this revenue over future fiscal years.



The chart shows both the historical and projected revenue from this source.

Sales and Use Taxes

Total sales and use tax receipts for all jurisdictions in Riverside County from the most recent quarter rose 10.1 percent from

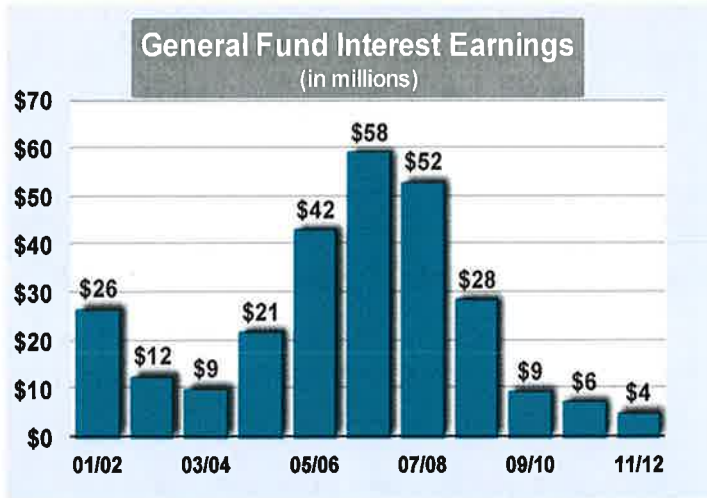
the same quarter a year ago, according to Hinderliter de Llamas & Associates (HdL), the county's sales tax consultant. This increase is comparable to receipts reported among counties in the region. However, HdL reports the county's own sales tax receipts were 23.9 percent lower than the same quarter a year ago. This differs substantially from the state overall, which increased 7.8 percent compared to the same quarter a year ago.

This drop in sales and use tax revenue is primarily attributable to the impact of the incorporations of Eastvale and Jurupa Valley. Factoring out the areas of Eastvale and Jurupa Valley, analysis of the data indicates taxable sales in the remainder of the unincorporated area are down across major business sectors on a year over year basis.

The FY 11/12 adjusted budget estimate for sales and use tax revenue is \$25.2 million, which remains consistent with HdL's current estimate. With the full effect of the Jurupa Valley incorporation considered, HdL currently projects sales and use tax receipts for FY 12/13 will total approximately \$19.8 million. This is consistent with the projection of our economists at California State University, Fullerton, who currently estimate receipts in FY 12/13 of \$20.4 million. Additional detail is provided in HdL's sales tax update contained in Attachment C and the report from California State University, Fullerton contained in Attachment D.

Interest Earnings

General fund interest earnings are a product of two factors: cash on hand and the rate at which interest is earned. Both have been significantly reduced in the last few years. As fund balance and interest rates increased, interest earnings grew substantially. However, as general fund reserves were drawn down and interest rates fell, interest earnings fell significantly.



Due to the protracted low interest rate environment, estimated annual interest earnings dropped from \$5.4 million to \$4.1 million during the first two quarters of this fiscal year. The Treasurer does not report any change to the \$4.1 million interest earnings projection. The forecast is contingent on no additional deterioration in interest rates or further declines in fund balances. The Treasurer will continue to provide updates as the year progresses.

Revenue Summary

In summary, although certain discretionary general fund revenues show signs of improving or stabilizing, other revenue estimates continue to weaken. The Executive Office projects another notable net decrease in discretionary revenue at this time.

The chart at right summarizes the county's estimated discretionary revenues. Overall, net discretionary revenue appears likely to be \$3.9 million higher than originally estimated.

General Fund Discretionary Revenue Projected
(dollars in millions)

	Budgeted Estimate	3rd Quarter Estimate	Variance from Budget
Property Taxes	259.8	259.8	0.0
Motor Vehicle In Lieu	186.7	191.3	4.6
Tax Loss Reserve Overflow	35.5	35.5	0.0
Fines and Penalties	27.0	27.0	0.0
Sales Tax *	25.2	25.5	0.3
Tobacco Tax	10.0	10.0	0.0
Documentary Transfer Tax	10.5	9.5	(1.0)
Franchise Fees	5.0	5.0	0.0
Interest Earnings	4.1	4.1	0.0
Misc. Federal and State	6.0	6.0	0.0
Other (Prior Year & Misc.)	8.4	8.4	0.0
	578.2	582.1	3.9

* Does not include public safety sales tax revenue

APPROPRIATIONS FOR CONTINGENCY

Contingency is intended to cover urgent, unforeseeable events such as shortfalls in discretionary revenue, unanticipated expenditures, uncorrectable departmental budget overruns and other mission-critical issues at the Board's discretion.

USE OF CONTINGENCY

	Cost Adjustment	Revenue Adjustment	Total Adjustment	Balance Available
Beginning Balance:				\$ 20,000,000
Adjustments to date:				
09/13/11 Stale dated warrant (Item 3.22)	\$502		(\$502)	
1st Qtr Rpt Planning	93,057		(\$93,057)	
11/01/11 Cash over/short (Item 3.4)	8		(\$8)	
12/06/11 NPDES compliance (Item 3.4)	\$ 163,052		(\$163,052)	
12/06/11 Stale dated warrant (Item 3.5)	\$ 120		(\$120)	
12/13/11 Land purchase (Item 16.2)	5,000,000		(\$5,000,000)	
2nd Qtr Rpt Revenue estimate adjustment		\$ (6,178,090)	(\$6,178,090)	
04/17/12 Capital fund reapprop. (Item 3.25)		10,800,000	\$10,800,000	
	5,256,739	4,621,910	(634,829)	
Actions recommended in this report:				
Fire	1,000,000	-	(1,000,000)	
				Contingency balance upon approval of this report = \$ 18,365,171
Pending issues:				
Waste reimb. for land purchase	(5,000,000)		\$5,000,000	
	\$ (5,000,000)	\$ -	\$ 5,000,000	

Projected year-ending contingency = \$ 23,365,171

The Executive Office cautioned departments that allocations from contingency are being minimized. The adjustments to appropriations for contingency are summarized in the table above.

E. DEPARTMENTAL STATUS

GENERAL GOVERNMENT

Executive Office

On November 8, 2011, (Agenda Item 16.2) the Board of Supervisors adopted a comprehensive solar power plant program, which included adoption of Board Policy B-29. The county has received \$1.2 million in solar franchise revenue from the Desert Sunlight project, and anticipates receiving more than \$600,000 per year from that project. The Executive Office recommends using the current proceeds to cover the costs of efforts by the Transportation and Land Management Agency, Planning, County Counsel, and the Executive Office to establish, implement and legally defend the solar power plant program. The Executive Office further recommends committing the balance of the current proceeds toward legal services.

Recommendation 2: *That the Board of Supervisors 1) approve and direct the Auditor-Controller to make adjustments to estimated revenue in the amount of \$1,216,548 and appropriations totaling \$858,858 pertaining to the Solar Power Plant Program; and 2) to approve commitment of the remaining unappropriated solar program revenue in the amount of \$357,690, as follows:*

Increase estimated revenue:		
10000-1102900000-725020	Franchises	\$1,216,548
Increase appropriations:		
10000-1102900000-525200	Legal services	297,920
10000-1102900000-525500	Salary & benefit reimbursement	123,755
10000-1102900000-551100	Contribution to other funds	<u>437,183</u>
	Total	858,858
Commitment of fund balance:		
10000-1102900000-330100	Committed fund balance	357,690
Increase appropriations:		
10000-1100100000-573400	Intrafund – Salary & benefit reimbursement	(42,760)
Anticipated increase in available fund balance:		
10000-1100100000-370100	Unassigned fund balance	42,760
Increase appropriations:		
10000-3120100000-573400	Intrafund – Salary & benefit reimbursement	(80,995)
Anticipated increase in available fund balance:		
10000-3120100000-370100	Unassigned fund balance	80,995

Increase estimated revenue:		
20200-3100200000-790600	Contribution from other county funds	437,183
Increase appropriations:		
20200-3100200000-525020	Legal services	50,000
20200-3100200000-525440	Professional services	19,316
20200-3100200000-529040	Private mileage	133
20200-3100200000-537020	Interfund expense – legal services	<u>320,829</u>
	Total	390,278
Anticipated increase in available fund balance:		
20200-3100200000-350100	Assigned fund balance for program money	46,905

Human Resources (HR)

At mid-year, Human Resources (HR) reported that claims against the Delta Dental fund exceeded revenue collected. At this point, HR requests approval to draw down reserves in the Delta Dental fund to meet funding requirements.

Recommendation 3: That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations in the amount of \$591,100 for Human Resource's Delta Dental fund, as follows:

Increase appropriations:		
45860-1130600000-523350	Administrative expense	\$ 91,100
45860-1130600000-534240	Dental claims	<u>500,000</u>
		591,100
Anticipated use of unrestricted net assets:		
45860-1130600000-380100	Unrestricted net assets	591,100

The Temporary Assignment Program (TAP) is 15 percent over target due to upfront payment of stipends to commissioners, leave payouts for terminating employees, and additional employees added for such special events as the Date Festival. The Treasurer-Tax Collector and DPSS also increased their use of temporary employees since mid-year.

Recommendation 4: That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations and estimated revenue in the amount of \$720,000 for the Temporary Assistance Pool, as follows:

Increase estimated revenue:		
47000-1131800000-777540	Reimbursement of salaries	\$225,000
Increase appropriations:		
47000-1131800000-510040	Regular salaries	150,000
47000-1131800000-510200	Payoff permanent-seasonal	75,000
47000-1131800000-510240	Per diem salaries	25,000
47000-1131800000-510280	Other pay - non-specified	225,000
47000-1131800000-518180	Budgeted benefits	95,000
47000-1131800000-510320	Temporary salaries	<u>150,000</u>
		720,000

Anticipated use of unrestricted net assets:

47000-1131800000-380100	Unrestricted net assets	495,000
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Registrar of Voters (ROV)

The Registrar of Voters (ROV) still expects to exceed its net county cost target for FY11/12 by approximately \$1.8 million due to SB90 cuts to the state budget. The department will continue to submit claims, but does not expect to receive reimbursement. This will leave the Registrar of Voters with only half of its anticipated revenue for FY 11/12. The department is preparing for the June 2012 Consolidated Presidential Primary Election immediately followed by the preparation for the 2012 Presidential Election. Ballot layout for the June election is in progress. Some ballot types will require two cards, which may increase the cost of the election. The Registrar is currently working to cut costs wherever possible and still maintain a proficient level of service. One such cost savings is the use of the United States Postal Service's non-profit agency election mail service.

Although the ROV will not receive all of the budgeted revenue, the budgeted expenditure level is appropriate at this time. The Executive Office recommends budget adjustments be made at year-end as necessary on actual expenditures incurred by the ROV at that time.

Economic Development Agency/Facilities Management (EDA/FM)

Facilities Maintenance

In addition to routine maintenance and special requests, the Maintenance division is responsible for service mandated by regulatory agencies, such as the South Coast Air Quality Management District, Environmental Protection Agency and the Occupational Safety and Health Administration. Generally, costs associated with compliance are not included in the productive hourly rates. However, the impact to the division's rates will be evaluated in the coming months and, if reasonable, revised rates could be brought back to the Board for consideration by July.

The financial impact of such mandated service, as well as some additional expenses specific to internal service departments, is being felt by the Maintenance division. Consequently, the department anticipates it could end the fiscal year in a negative position. However, the department will continue carefully monitoring these factors and institute cost-saving and revenue-generating measures wherever possible, and update the Board on the division's financial status as necessary.

Desert Expo

The Economic Development Agency held the Desert Expo February 17 through 26, 2012, and enjoyed record attendance. A budget adjustment is needed to reflect the additional revenue and expense resulting from the unanticipated number of visitors.

Recommendation 5: *That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations and estimated revenue in the amount of \$214,014 for the Desert Expo, as follows:*

Increase appropriations:		
22200-1920100000-525320	Security guard services	\$ 18,000
22200-1920100000-526530	Rent-lease equipment	40,000
22200-1920100000-529540	Utilities	34,267
22200-1920100000-537020	Interfund exp-legal services	6,617
22200-1920100000-537180	Interfund exp-salary reimbursement	<u>115,220</u>
	Total appropriations	214,104
Increase estimated revenue:		
22200-1920100000-741020	Admissions	87,387
22200-1920100000-741060	Carnival	33,073
22200-1920100000-741230	Fair time alcohol sales	14,095
22200-1920100000-741380	Parking	42,403
22200-1920100000-781120	Rebates and refunds	<u>37,146</u>
	Total estimated revenue	214,104

PUBLIC PROTECTION

Fire

The Fire Department began this fiscal year with a deficit of \$2.1 million. While the department's goal is to eliminate or significantly reduce its budget deficit and contain costs where possible, the Fire Chief has maintained municipal staffing and has not closed any fire stations, per Board direction. At this time, the Fire Department projects a shortfall of \$2.7 million for FY 11/12.

The Fire Department currently requests an additional appropriation of \$1 million to meet its obligation to pay the fourth quarter invoice from CAL FIRE. In addition, on November 30, 2010, (Agenda Item No. 3.40), the Board approved accepting a multi-year homeland security grant. The department requests a budget adjustment for \$300,000 in order to expend the balance of the grant funds in FY 11/12.

Recommendation 6: That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations and estimated revenue in the amount of \$1.3 million for the Fire Department, as follows:

Decrease appropriations:		
10000-1109000000-581000	Appropriations for contingency	\$1,000,000
Increase appropriations:		
10000-2700200000-525440	Professional services	1,000,000
10000-2700200000-546160	Equipment other	300,000
	Total	<u>1,300,000</u>
Increase estimated revenue:		
10000-2700200000-767220	Fed-Other operating grants	300,000

Sheriff

On March 29, 2012, the Sheriff reiterated for Board members the plan they unanimously approved during last year's budget hearings. That strategy avoided planned layoffs as

long as proposed savings could be reached through attrition. As presented, the target would be achieved by reducing the patrol force in unincorporated areas from 1.0 officer per 1,000 residents to 0.75 per 1,000. Also, no Sheriff's facilities would be closed. On September 13, 2011, the Board unanimously approved the final FY 11/12 budget. The Executive Office recommended, and the Board agreed, to leave labor savings in the Sheriff's budget to help close the gap. The collaborative effort left the department with a \$5.5 million structural deficit at the start of the fiscal year.

The Sheriff enacted an aggressive budget strategy to reduce the \$5.5 million deficit by the end of this fiscal year. Short of an emergency in any of the four areas of responsibility, and even in the face of AB109, the department projects a \$1.3 million surplus at fiscal year end.

District Attorney

The District Attorney reports he is "cautiously optimistic" that his office will end FY 11/12 on track and with a surplus in his first full fiscal year budget. The anticipated surplus is due primarily to his efforts to increase revenue, contain costs, and manage attrition. Although public safety realignment poses challenges, the District Attorney is operating well within state and local realignment allocations, and moving forward with an innovative effort to reduce recidivism. The Executive Office will continue to work cooperatively with the District Attorney to address these budget challenges.

Court Facilities

Payments made to the state for the county's share of utilities, maintenance, and repairs for court buildings have increased considerably. In addition, the historic courthouse was repainted this year at the request of the presiding judge, generating unanticipated costs. Consequently, county expenditures on court facilities were 11 percent over budget at the end of the third quarter. However, payments to court reporters are 20 percent below budget due to a reduction in capital trials and appeals. The Executive Office will closely monitor both budgets and request approval for an appropriation transfer, if necessary.

Probation Department

The Probation Department has net savings totaling \$175,006 and is on target to meet budget goals. Salary savings and major changes at juvenile facilities, including menu standardization and central purchasing, are reducing costs. In restructuring administration, the department also identified opportunities to streamline information technology and support responsibilities. To assist with continued reorganization, the department requests exchanging one office assistant III for one secretary II. This exchange has no net general fund impact.

Recommendation 7: *That the Board of Supervisors approve amending Ordinance No. 440 to add one IT supervising user support technician and one secretary II position and to delete one IT user support technician III and one office assistant III.*

In January, the governor's proposed FY 12/13 budget contained juvenile justice realignment measures, including elimination of state beds, charging counties for wards in state facilities, and recommending that counties begin planning to house violent

juveniles locally. The potential impact in FY 11/12 was estimated at \$1.38 million. However, to help counties make the transition, the state is assessing the fees specified by law but delaying collection. Following the governor's May revision of his recommended state budget, the department will evaluate further the impact of juvenile realignment on Riverside County.

As part of the continuing effort to implement public safety realignment, Probation requires authorization and budget adjustments to purchase vehicles and computer servers. The department also requests a budget adjustment to allocate realignment revenue to municipal police departments under provisions of a signed memorandum of understanding. Pursuant to that agreement, local agencies formed post-release supervision teams to identify and investigate non-compliant offenders.

Recommendation 8: That the Board of Supervisors 1) authorize the county purchasing agent to purchase 13 vehicles and six computer servers; and, 2) approve and direct the Auditor-Controller to make adjustments to appropriations and estimated revenue for a net total of \$755,960 for Probation, as follows:

Increase estimated revenue:		
10000-2600200000-755900	CA-AB118 Local revenue	\$755,960
Decrease appropriations:		
10000-2600200000-510040	Regular salaries	290,000
Increase appropriations:		
10000-2600200000-536240	Other contract agencies	755,960
10000-2600200000-546080	Equipment - computer	40,000
10000-2600200000-546320	Vehicles - cars/light trucks	<u>250,000</u>
		1,045,960

Animal Services

Meeting revenue targets continues to be a challenge for the Department of Animal Services, but the department expects cost-saving measures to offset any revenue decrease. However, Human Resources recently notified Animal Services of a settlement in a 6-year-old personnel case that could cost the department up to \$325,000. The department was unaware of the case and did not budget for the expense. The department will make every effort to offset the additional cost. However, that may be extremely difficult this late in the fiscal year, and the department may require additional general fund support.

Agricultural Commissioner

The Agricultural Commissioner estimates receiving more unclaimed gas tax revenue than anticipated. In addition, his office achieved some salary savings while positions were filled. The Agricultural Commissioner requests approval to apply these one-time windfalls toward long-deferred equipment and supply purchases.

Recommendation 9: That the Board approve and direct the Auditor-Controller to make budget adjustments to appropriations and estimated revenue for the Agricultural Commissioner, as follows:

Increase estimated revenue:		
10000-2800100000-752060	Unclaimed gas tax	\$20,000
Decrease appropriations:		
10000-2800100000-510040	Regular salaries	26,000
10000-2800100000-518100	Budgeted benefits	<u>24,000</u>
	Total	50,000
Increase appropriations:		
10000-2800100000-520800	Household expense	20,000
10000-2800100000-522310	Maintenance – building and improvement	10,000
10000-2800100000-523640	Computer equipment – non-fixed asset	30,000
10000-2800100000-526960	Small tools and instruments	<u>10,000</u>
	Total	70,000

HEALTH AND SANITATION

Community Health Agency

Effective July 1, 2012, the Community Health Agency will reorganize into three independent departments: Department of Public Health, Department of Environmental Health, and the Department of Animal Services. Staff currently assigned to the agency will be reassigned to one of the departments. As a result of this restructuring, the three departments anticipate the potential need for layoffs in some classifications and increases in others to meet the departments’ business needs. The Community Health Agency and the departments will work with Human Resources and the Executive Office to identify the affected classifications.

Department of Public Health

The Department of Public Health reports that although clinic revenue is under budget in some areas, increases in other revenue combined with salary savings will offset those shortfalls. Changes in grant funding may necessitate an appropriation transfer request prior to year-end.

The new Riverside County HealthCare program authorized January 1, 2012, began seeing patients in January. Public Health, along with the Riverside County Regional Medical Center (RCRMC) and the Department of Mental Health, continue to monitor out-of-network costs and other expenditures that reduce reimbursements available for distribution to county departments to offset program costs.

Staff began transitioning the Department of Public Health’s 12 family care clinics to RCRMC to facilitate creating a countywide health care system. Administration and budgetary responsibility for these clinics is anticipated to shift to RCRMC effective July 1, 2012. Resources may continue to be redeployed into the new fiscal year. Further budget adjustments, asset transfers, and other actions necessary to complete the transition will be requested as necessary in FY 12/13.

Department of Environmental Health

In the first quarter, the Department of Environmental Health reported that one-time costs

associated with a new facility lease had not been budgeted in the current fiscal year. The department indicated it would return to request a budget adjustment, if necessary. At this time, the department reports that salary savings will cover these one-time expenses, and it will submit a request to the Executive Office for an appropriation transfer.

California Children's Services

A shift by the state to assign more children to the Healthy Families program rather than the California Children's Services program has increased the county's share of costs. In addition, a change in the state's accrual methodology may reduce the department's allocation if current-year costs are carried over to the subsequent fiscal year. The department reports that increases in realignment resulting from an uptick in sales tax revenue will offset these increased costs. The department requests a budget adjustment to reflect the increase in revenue and expenses.

Recommendation 10: *That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations and estimated revenue totaling \$1,359,184 for Public Health, as follows:*

Increase estimated revenue:		
10000-4200200000-751210	CA Medi-Cal	\$ 693,184
10000-4200200000-751500	CA-realignment	462,123
10000-4200200000-751680	CA-grant revenue	<u>203,877</u>
	Total	1,359,184

Increase appropriations:		
10000-4200200000-530220	Support and care of persons	1,359,184

Riverside County Regional Medical Center Programs

Detention Health

At the beginning of FY 11/12, just 50 staff provided health services to both adult and juvenile detainees across the entire county detention system. The Board approved funding for an additional 66 positions. Detention Health Services reports that it is slowly making progress to recruit qualified staff for these additional positions. At this time, 99 positions are filled, offered, and/or pending background clearance. The remaining 17 positions are still in recruitment, and the department anticipates all vacant positions will be filled by the beginning of FY 12/13. Due to difficulty in filling positions, the department anticipates approximately \$1 million in one-time salary savings, reducing the need for general fund support this fiscal year.

Department of Mental Health

Detention Mental Health

Although Detention Mental Health is making progress in hiring staff to provide services to inmates in adult detention facilities, not all vacant positions are filled at this time. The department reports that of the nine added positions, five are filled and four are in recruitment. During the interim, staff serving in other areas of the Department of Mental

Health, as well as temporary employees, are being utilized to meet inmates' needs. Because of delays in hiring regular staff, the department anticipates saving approximately \$400,000 in general fund support that will not be required this fiscal year.

Mental Health Treatment

The Mental Health Treatment program requests authorization to purchase a dishwasher and two freezers for the Oasis Psychiatric Health Treatment facility to replace existing equipment that has reached the end of its useful life. The department has sufficient appropriations available to purchase the equipment.

Recommendation 11: *That the Board of Supervisors authorize the Department of Mental Health to purchase one (1) dishwasher and two (2) freezers for the Oasis Psychiatric Health Treatment facility.*

PUBLIC ASSISTANCE

Department of Public Social Services (DPSS)

The FY 11/12 budget included \$20 million in general fund support to offset potential increases in the county share of mandated and entitlement programs in FY 12/13. At this time, the Department of Public Social Services (DPSS) projects slightly less than \$14 million will be needed by year-end, resulting in just over \$6 million in savings. The resulting adjustments are explained further below.

The department anticipates state Realignment 2011 (AB118) revenue will continue at the pre-realignment level. Although receipts are tracking as expected for the first seven months, it is difficult to project how the year may end for this new revenue source. The department will continue to monitor this situation closely, as any shortfall in this revenue may result in the need for additional general fund support.

DPSS continues to target hiring toward growing programs, while restricting hiring in other program areas. The department indicates the resulting salary and operational savings will reduce the need for general fund support by approximately \$4 million. Child Care caseloads and expenditures are less than state estimates. Consequently, DPSS requests a budget adjustment to reflect reduced service and funding levels. The department recently applied for and was awarded \$700,000 in federal funding for a pilot program under the CalFresh Nutrition and Education program. The department requests a budget adjustment to appropriate the new grant funding.

Recommendation 12: *That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations and estimated revenue totaling a net decrease of \$4.3 million for DPSS, as follows:*

Decrease estimated revenue:		
10000-5100100000-760000	Fed-Public assistance admin	\$4,500,000
10000-5100100000-750300	CA-Public assistance admin	<u>500,000</u>
	Total	5,000,000

Increase estimated revenue:		
10000-5100100000-767220	Fed-other operating grants	700,000
Increase appropriations:		
10000-5100100000-525440	Professional Services	700,000
Decrease appropriations:		
10000-5100100000-530420	Child Care Services	5,000,000

Mandated Client Services

Revised caseload growth projections for in-home supportive services (IHSS) and a decrease in contracted services may result in general fund savings of \$1.1 million. In addition, if upheld, a temporary restraining order on implementing AB121 may eliminate projected savings of approximately \$1 million. However, while DPSS previously indicated a requirement for IHSS consumers to obtain physician certifications in order to continue receiving IHSS benefits might save \$2.2 million in the current year, consumers are obtaining the required certifications, so DPSS no longer projects such savings.

At mid-year, the department reported that implementation of the Community First Choice Option might generate \$2.7 million in general fund savings. However, given delays in approving the plan, it is unlikely savings will be realized until FY 12/13.

Categorical Aid

General fund savings of approximately \$800,000 generated in entitlement programs due to changes in caseload will be shifted within DPSS to cover increased costs of county-funded foster care.

Homeless

To maintain prior-year service levels, DPSS exhausted \$1.2 million of fund balance. In order to submit a balanced budget for FY 12/13, DPSS consequently proposes reducing contributions to shelter services by \$950,000. The department continues to work with shelter providers to determine the effects of the reduced funding.

Riverside County Children and Families Commission (RCCFC)

In March 2011, the Governor authorized AB99, which transferred \$1 billion statewide from county children and families commission trust funds to the state for direct health and human services to address the state's fiscal crisis. Several first five commissions filed suit challenging the bill. The Superior Court issued a favorable ruling in response to the legal challenge of AB99, which the state did not appeal. Consequently, the \$30 million set aside by the Children and Families First Commission in the event of unfavorable ruling can now be allocated in the most effective manner to benefit the community.

Community Action Partnership (CAP)

Community Action Partnership requests budget adjustments between budget units to align appropriations for salaries and benefits with actual departmental expenditures.

Recommendation 13: That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations by \$200,000 for the Community Action Partnership, as follows:

Decrease appropriations:		
21050-5200200000-510040	Regular Salaries	\$200,000
Increase appropriations:		
21050-5200300000-510040	Regular salaries	130,000
21050-5200300000-527780	Special program expense	50,000
21050-5200300000-526700	Rent-lease buildings	<u>20,000</u>
	Total	200,000

ENTERPRISE FUNDS

Riverside County Regional Medical Center

The Riverside County Regional Medical Center (RCRMC) reports improved revenue projections that might result in a better budget outcome than initially projected. However, cash flow continues to be a concern, and the department, the Executive Office and the Auditor-Controller’s Office continue to monitor this situation.

As noted elsewhere in this report, staff began transitioning the Department of Public Health’s 12 family care clinics to RCRMC to facilitate development of a countywide health care system. Administration and budgetary responsibility for these clinics is expected to shift to RCRMC effective July 1, 2012, although redeployment of resources may continue into the new fiscal year. Further budget adjustments, transfer of assets, and other actions necessary to complete the transition may be requested in FY 12/13.

Negotiated raises for nurses and other staff are projected to cost an additional \$2.6 million through the end of this fiscal year. RCRMC has sufficient savings in other operational expenditures to cover this added cost, and appropriations have been transferred to offset the resulting increase in salaries and benefits.

INTERNAL SERVICE FUNDS

Fleet Services

The number of county vehicles is gradually shrinking to meet the needs of the county’s workforce and mission. As a result, county departments saved \$94,296 in mileage charges and fuel purchases in the third quarter of this fiscal year. A total of 40 vehicles, 10 patrol and 30 general use, were withdrawn from service between January 1 and March 31, 2012, and are now pending sale. During the same period, 35 previously retired units, 14 patrol and 21 general use, were sold, for an additional savings of \$27,503. A report summarizing the vehicles sold and pending sale is contained in Attachment F.

Fleet Services projects expenses for services and supplies will exceed appropriations by year-end due to a 1.9 percent increase in fuel use and a 16 percent increase in fuel prices. Fleet Services projects these factors combined will result in a total increase in

fuel expenses and corresponding revenue of \$982,000, and requests a budget adjustment at this time to accommodate the increase.

Recommendation 14: That the Board of Supervisors approve and direct the Auditor-Controller to make budget adjustments increasing appropriations and estimated revenues in the amount of \$982,000 for Fleet Services, as follows:

Increase appropriations:		
45300 7300500000 527106	Fuel-bulk unleaded	\$982,000
Increase estimated revenue:		
45300 7300500000 777070	Fuel sales	982,000

SPECIAL DISTRICTS

Flood Control and Water Conservation District

The Flood Control and Water Conservation District has reviewed its budget and requests budget adjustments at this time to align appropriations for salaries and benefits with the actual allocation of time to the Special Accounting and Santa Ana NPDES funds. This need arises from the District's engineering staff working on projects in these activities rather than as anticipated in the original budget. There is no overall cost increase to the district, as other budget units will achieve corresponding cost savings. Sufficient fund balance is available in both funds to cover the additional appropriations. The District will continue to monitor its budget and make any necessary adjustments during the fourth quarter.

Recommendation 15: That the Board of Supervisors approve and direct the Auditor-Controller to make budget adjustments increasing appropriations by \$420,000 and release committed fund balance in the amount of \$150,000 for Flood Control, as follows:

Increase appropriations:		
15000-947180-510040	Regular salaries	\$155,000
15000-947180-518100	Budgeted benefits	<u>115,000</u>
	Total	270,000
Anticipated use of unassigned fund balance:		
15000-947180-370100	Unassigned fund balance – Flood	270,000
Increase appropriations:		
25190-947560-510040	Regular salaries	90,000
25190-947560-518100	Budgeted benefits	<u>60,000</u>
	Total	150,000
Release committed fund balance:		
25190-947560-330100	Committed fund balance	150,000

County Service Areas

County Service Area 51 received unanticipated revenue from the sale of water, community center rental, and improvements to the golf course. The CSA requests a budget adjustment to enable use of a portion of this revenue to offset administrative expenses.

Recommendation 16: *That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations and estimated revenue in the amount of \$45,000 for CSA 51, as follows:*

Increase appropriations:		
23525-905102-537180	Interfund exp-salary reimbursement	\$45,000
Increase estimated revenue:		
23525-905102-777300	Irrigation water service	45,000

Attachment A Summary of Recommendations

Attachment A Summary of Recommendations

For convenience, this section repeats the recommendations contained in the main report. There is no new information in Attachment A.

Recommendation 1: *That the Board of Supervisors approve a policy position to designate toward general fund capital projects all revenue distributed to the county resulting from liquidation of the assets of former redevelopment agencies.*

Recommendation 2: *That the Board of Supervisors 1) approve and direct the Auditor-Controller to make adjustments to estimated revenue in the amount of \$1,216,548 and appropriations totaling \$858,858 pertaining to the Solar Power Plant Program; and 2) to approve commitment of the remaining unappropriated solar program revenue in the amount of \$357,690, as follows:*

Increase estimated revenue:		
10000-1102900000-725020	Franchises	\$1,216,548
Increase appropriations:		
10000-1102900000-525200	Legal services	297,920
10000-1102900000-525500	Salary & benefit reimbursement	123,755
10000-1102900000-551100	Contribution to other funds	<u>437,183</u>
	Total	858,858
Commitment of fund balance:		
10000-1102900000-330100	Committed fund balance	357,690
Increase appropriations:		
10000-1100100000-573400	Intrafund – Salary & benefit reimbursement	(42,760)
Anticipated increase in available fund balance:		
10000-1100100000-370100	Unassigned fund balance	42,760
Increase appropriations:		
10000-3120100000-573400	Intrafund – Salary & benefit reimbursement	(80,995)
Anticipated increase in available fund balance:		
10000-3120100000-370100	Unassigned fund balance	80,995
Increase estimated revenue:		
20200-3100200000-790600	Contribution from other county funds	437,183
Increase appropriations:		
20200-3100200000-525020	Legal services	50,000
20200-3100200000-525440	Professional services	19,316
20200-3100200000-529040	Private mileage	133

20200-3100200000-537020	Interfund Expense – legal services	<u>320,829</u>
	Total	390,278

Anticipated increase in available fund balance:

20200-3100200000-350100	Assigned fund balance for program money	46,905
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Recommendation 3: That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations in the amount of \$591,100 for Human Resource’s Delta Dental fund, as follows:

Increase appropriations:

45860-1130600000-523350	Administrative expense	\$ 91,100
45860-1130600000-534240	Dental claims	<u>500,000</u>
		591,100

Anticipated use of unrestricted net assets:

45860-1130600000-380100	Unrestricted net assets	591,100
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Recommendation 4: That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations and estimated revenue in the amount of \$720,000 for the Temporary Assistance Pool, as follows:

Increase estimated revenue:

47000-1131800000-777540	Reimbursement of salaries	\$225,000
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Increase appropriations:

47000-1131800000-510040	Regular salaries	150,000
47000-1131800000-510200	Payoff permanent-seasonal	75,000
47000-1131800000-510240	Per diem salaries	25,000
47000-1131800000-510280	Other pay - non-specified	225,000
47000-1131800000-518180	Budgeted benefits	95,000
47000-1131800000-510320	Temporary salaries	<u>150,000</u>
		720,000

Anticipated use of unrestricted net assets:

47000-1131800000-380100	Unrestricted net assets	495,000
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Recommendation 5: That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations and estimated revenue in the amount of \$214,014 for the Desert Expo, as follows:

Increase appropriations:

22200-1920100000-525320	Security guard services	\$ 18,000
22200-1920100000-526530	Rent-lease equipment	40,000
22200-1920100000-529540	Utilities	34,267
22200-1920100000-537020	Interfund exp-legal services	6,617

22200-1920100000-537180	Interfund exp-salary reimbursement	<u>115,220</u>
	Total appropriations	214,104
Increase estimated revenue:		
22200-1920100000-741020	Admissions	87,387
22200-1920100000-741060	Carnival	33,073
22200-1920100000-741230	Fair time alcohol sales	14,095
22200-1920100000-741380	Parking	42,403
22200-1920100000-781120	Rebates and refunds	<u>37,146</u>
	Total estimated revenue	214,104

Recommendation 6: That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations and estimated revenue in the amount of \$1.3 million for the Fire Department, as follows:

Decrease appropriations:		
10000-1109000000-581000	Appropriations for contingency	\$1,000,000
Increase appropriations:		
10000-2700200000-525440	Professional services	1,000,000
10000-2700200000-546160	Equipment other	<u>300,000</u>
	Total	1,300,000
Increase estimated revenue:		
10000-2700200000-767220	Fed-Other operating grants	300,000

Recommendation 7: That the Board of Supervisors approve amending Ordinance 440 to add one IT supervising user support technician and one secretary II position and to delete one IT user technician III and one office assistant III.

Recommendation 8: That the Board of Supervisors 1) authorize the county purchasing agent to purchase 13 vehicles and six computer servers; and, 2) approve and direct the Auditor-Controller to make adjustments to appropriations and estimated revenue for a net total of \$755,960 for Probation, as follows:

Increase estimated revenue:		
10000-2600200000-755900	CA-AB118 Local revenue	\$755,960
Decrease appropriations:		
10000-2600200000-510040	Regular salaries	290,000
Increase appropriations:		
10000-2600200000-536240	Other contract agencies	755,960
10000-2600200000-546080	Equipment - computer	40,000
10000-2600200000-546320	Vehicles - cars/light trucks	<u>250,000</u>
		1,045,960

Recommendation 9: That the Board approve and direct the Auditor-Controller to make budget adjustments to appropriations and estimated revenue for the Agricultural Commissioner, as follows:

Increase estimated revenue:		
10000-2800100000-752060	Unclaimed gas tax	\$20,000

Decrease appropriations:		
10000-2800100000-510040	Regular salaries	26,000
10000-2800100000-518100	Budgeted benefits	<u>24,000</u>
	Total	50,000

Increase appropriations:		
10000-2800100000-520800	Household expense	20,000
10000-2800100000-522310	Maintenance – building and improvement	10,000
10000-2800100000-523640	Computer equipment – non-fixed asset	30,000
10000-2800100000-526960	Small tools and instruments	<u>10,000</u>
	Total	70,000

Recommendation 10: That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations and estimated revenue totaling \$1,359,184 for Public Health, as follows:

Increase estimated revenue:		
10000-4200200000-751210	CA Medi-Cal	\$ 693,184
10000-4200200000-751500	CA-realignment	462,123
10000-4200200000-751680	CA-grant revenue	<u>203,877</u>
	Total	1,359,184

Increase appropriations:		
10000-4200200000-530220	Support and care of persons	1,359,184

Recommendation 11: That the Board of Supervisors authorize the Department of Mental Health to purchase one (1) dishwasher and two (2) freezers for the Oasis Psychiatric Health Treatment facility.

Recommendation 12: That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations and estimated revenue totaling a net decrease of \$4.3 million for DPSS, as follows:

Decrease estimated revenue:		
10000-5100100000-760000	Fed-Public assistance admin	\$4,500,000
10000-5100100000-750300	CA-Public assistance admin	<u>500,000</u>
	Total	5,000,000

Increase estimated revenue:		
10000-5100100000-767220	Fed-other operating grants	700,000

Increase appropriations:		
10000-5100100000-525440	Professional Services	700,000

Decrease appropriations:		
10000-5100100000-530420	Child Care Services	5,000,000

Recommendation 13: That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations by \$200,000 for the Community Action Partnership, as follows:

Decrease appropriations:		
21050-5200200000-510040	Regular Salaries	\$200,000

Increase appropriations:		
21050-5200300000-510040	Regular salaries	130,000
21050-5200300000-527780	Special program expense	50,000
21050-5200300000-526700	Rent-lease buildings	<u>20,000</u>
	Total	200,000

Recommendation 14: That the Board of Supervisors approve and direct the Auditor-Controller to make budget adjustments increasing appropriations and estimated revenues in the amount of \$982,000 for Fleet Services, as follows:

Increase appropriations:		
45300 7300500000 527106	Fuel-bulk unleaded	\$982,000

Increase estimated revenue:		
45300 7300500000 777070	Fuel sales	982,000

Recommendation 15: That the Board of Supervisors approve and direct the Auditor-Controller to make budget adjustments increasing appropriations by \$420,000 and release committed fund balance in the amount of \$150,000 for Flood Control, as follows:

Increase appropriations:		
15000-947180-510040	Regular salaries	\$155,000
15000-947180-518100	Budgeted benefits	<u>115,000</u>
	Total	270,000

Anticipated use of unassigned fund balance:		
15000-947180-370100	Unassigned fund balance – Flood	270,000

Increase appropriations:

25190-947560-510040	Regular salaries	90,000
25190-947560-518100	Budgeted benefits	<u>60,000</u>
	Total	150,000

Release committed fund balance:

25190-947560-330100	Committed fund balance	150,000
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Recommendation 16: *That the Board of Supervisors approve and direct the Auditor-Controller to make adjustments to appropriations and estimated revenue in the amount of \$45,000 for CSA 51, as follows:*

Increase appropriations:

23525-905102-537180	Interfund exp-salary reimbursement	\$45,000
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Increase estimated revenue:

23525-905102-777300	Irrigation water service	45,000
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Attachment B Resolution No. 440-8885 Amending Ordinance No. 440**Resolution No. 440-8885**

BE IT RESOLVED by the Board of Supervisors of the County of Riverside, State of California, in regular session assembled on May 1, 2012, that pursuant to Section 4(a)(ii) of Ordinance No. 440, the Executive Office is authorized to make the following listed change(s), operative on the date of approval, as follows:

<u>Job code</u>	<u>+/-</u>	<u>Department ID</u>	<u>Class Title</u>	<u>Type</u>
86187	+1	2600700000	IT Supervising User Support Technician	Regular
13924	+1	2600700000	Secretary II	Regular
86185	-1	2600700000	IT User Support Technician III	Regular
13866	-1	2600700000	Office Assistant III	Regular

Attachment C Sales and Use Tax Update

Q4 2011



Riverside County Sales Tax Update

First Quarter Receipts for Fourth Quarter Sales (October - December 2011)

Riverside County In Brief

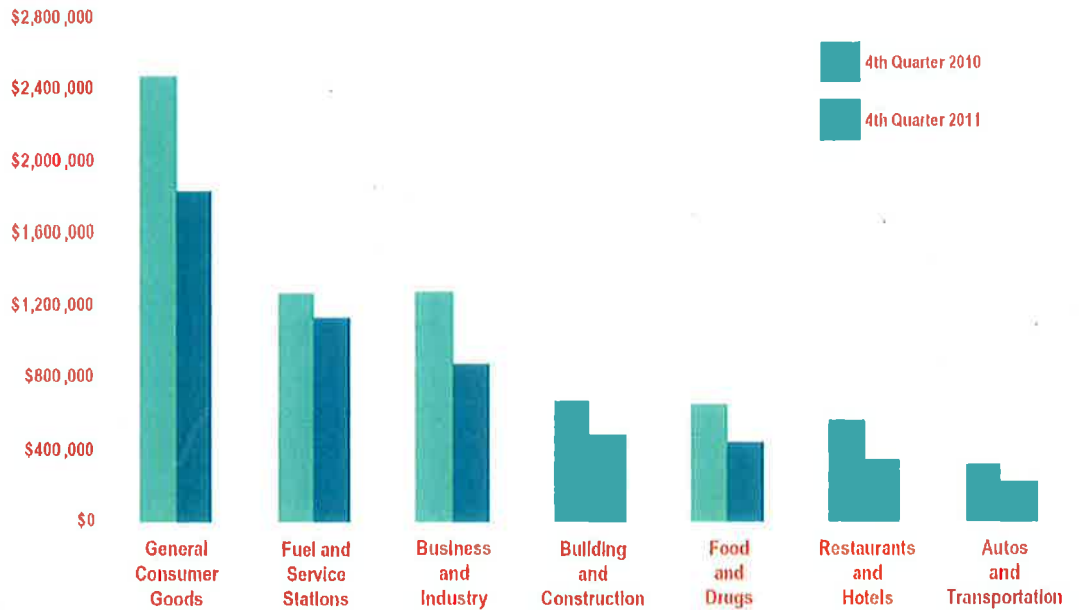
Receipts for the unincorporated area's October through December sales were 23.9% lower than the same quarter one year ago. Actual sales activity was down 22.4% when reporting aberrations were factored out.

The decline in all business groups reflects the shift of sales tax from the county to the newly incorporated cities of Eastvale and Jurupa Valley. Eastvale incorporated a year ago, however, this is the first quarter that shifts sales tax receipts to Jurupa Valley.

Same store sales in general consumer goods for this holiday season showed gains with new stores adding to the increase. An additional station partially offset the shift in service stations. Online use tax, several retroactive adjustments, a couple of new enterprises and a rise in agricultural equipment/products helped soften the decline in business and industry.

Adjusted for aberrations, taxable sales for all of Riverside County increased 10.1% over the comparable time period, while the Southern California region as a whole was up 7.6%.

SALES TAX BY MAJOR BUSINESS GROUP



TOP 25 PRODUCERS

In Alphabetical Order

Albertsons	Gucci America
Arco Travel Zone Center	Mecca Travel Center Subway
Blackgold Operations	Morongo Shell
Burberry	Nike
California Trusframe	Pilot Travel Centers
Calvin Klein	Ralph Lauren
Chevron	RDO Equipment
Circle K	Space Prada Miu Miu
Coach	Stater Bros
Dos Lagos Arco	Vestas American Wind Technology
French Valley Shell	Volvo Construction Equipment
G & M Oil	Vons
General Electric	

REVENUE COMPARISON

Three Quarters - Fiscal Year To Date

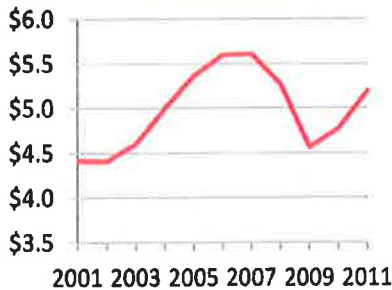
	2010-11	2011-12
Point-of-Sale	\$19,750,365	\$18,363,430
County Pool	1,978,793	2,107,696
State Pool	9,819	2,149
Gross Receipts	\$21,738,977	\$20,473,274
Cty/Cnty Share	9,988	0
Net Receipts	\$21,748,965	\$20,473,274
Less Triple Flip*	\$(5,437,241)	\$(5,118,319)

*Reimbursed from county compensation fund

California Overall

Retail sales in the final quarter of 2011, excluding onetime reporting aberrations, were up 7.8% compared to the same period in 2010. Strong 4th quarter sales brought statewide calendar year 2011 within 7.25% of the pre-recession peak reached in 2006. At their 2009 low point, retail sales were 18.6% below their 2006 highs.

CA Local Sales Tax Receipts In \$Billions



To close the remaining gap, annual retail sales need to grow by \$40.5 billion, a daunting task with high unemployment and weak housing markets still hindering growth. Retail sales have risen on strong demand for new autos, increased consumer spending, significant use tax receipts from alternative energy projects and federal stimulus funded infrastructure projects. However, rising fuel costs and continued economic uncertainties are expected to slow the rate of growth in the second half of this year.

Retailers downsizing ... creating new opportunities and challenges

A recent survey concluded that 53% of the U.S. population has made an online purchase and that 7% of all retail sales are now done over the Internet. With mobile and tablet shopping capabilities making online purchases ever easier, Internet market share is expected to hit 9% by 2016.

The ease of online research has sharpened price competition and brick and mortar retailers are racing to accommodate the new consumer patterns by focusing on enhancing the shopping experience. This includes the development of more intimate shopping environments, use of social media to reach buyers, higher levels of customer service, specialized merchandise that cannot be purchased elsewhere and expanding the selection of goods offered with in-store kiosks supplemented with timely deliveries.

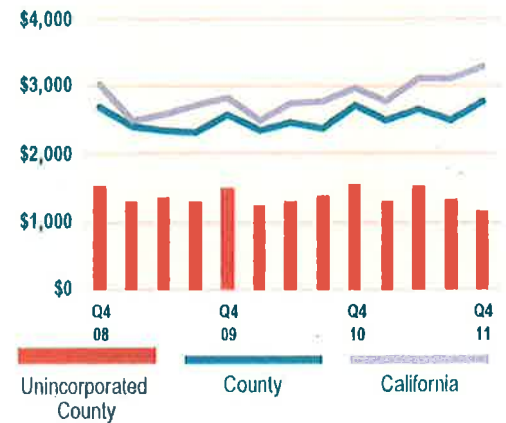
To cut overhead and compete on price, more retailers are going to the "endless aisle" concept of selling items not actually in the store. This allows the retailer to increase product variety in a smaller space.

Almost every major retailer has plans for either downsizing the footprint of new stores or subleasing space in existing stores.

On the plus side, this trend allows entrance into retail markets too

small for large format stores to be feasible. Less populous communities could find their retail bases growing with new compact stores offering the same or more merchandise as their larger counterparts. Communities with substantial existing retail could see new challenges in filling vacated space while also keeping up with the need for more inviting shopping environments.

SALES PER CAPITA



RIVERSIDE COUNTY TOP 15 BUSINESS TYPES

Business Type	Unincorporated County		County	HdL State
	Q4 '11*	Change	Change	Change
Contractors	330.6	-12.1%	3.3%	17.9%
Energy/Utilities	176.4	na	519.5%	-13.6%
Family Apparel	792.0	3.6%	9.1%	10.6%
Garden/Agricultural Supplies	93.9	68.6%	10.3%	9.6%
Grocery Stores Beer/Wine	132.8	-29.8%	14.1%	4.6%
Grocery Stores Liquor	179.1	-43.4%	-7.1%	-1.2%
Lumber/Building Materials	81.9	-59.9%	9.8%	8.2%
Restaurants No Alcohol	216.2	-41.2%	9.7%	7.3%
Service Stations	1,103.4	-12.2%	13.9%	14.7%
Shoe Stores	149.7	1.0%	4.6%	6.7%
Specially Stores	167.3	-4.2%	34.6%	2.1%
Trailers/RVs	77.3	-18.9%	10.0%	9.8%
Warehse/Farm/Const. Equip.	107.7	5.5%	16.6%	22.9%
Wineries	175.6	9.8%	14.3%	11.9%
Women's Apparel	431.3	25.1%	13.9%	6.8%
Total All Accounts	\$5,339.3	-26.2%	5.9%	7.8%
County & State Pool Allocation	738.1	-0.1%		
Gross Receipts	\$6,077.5	-23.8%		
City/County Share	0.0	-100.0%		
Net Receipts	\$6,077.5	-23.9%		

*In thousands



California Forecast: Sales Tax Trends and Economic Drivers

April 2012

HdL provides relevant information and analyses on the economic forces affecting California's local government agencies. In addition, HdL's Revenue Enhancement Services and software help clients to maximize revenues. HdL serves over 350 cities, counties and special districts in California and across the nation.





	2011-12	2012-13
Autos/Transportation	10.1%	6.5%
<p>The need to replace aging fleets and personal vehicles along with improved availability of new models following months of limited production in Asia have contributed to significant sales gains in recent quarters. Easing credit restrictions and consumer demand for better fuel efficiency is adding to auto manufacturers' confidence of a steady recovery although the pace of the recovery is expected to be slightly slower in 2012-2013 as economic uncertainty continues and the most critical pent-up demand is satisfied.</p>		
Building/Construction	7.3%	6.5%
<p>Resurgence in home remodeling is helping sustain home improvement chain store sales. Federal stimulus funded infrastructure and energy projects are finally underway and showing up in the sales tax data. Some regions of the state are also reporting significant upticks in permitting activity particularly for office/industrial space and multiple family housing.</p>		
Business/Industry	4.7%	4.0%
<p>Companies are continuing to invest in new technology and equipment but economic slowdowns in Europe and Asia and political discord at home will keep expenditures cautious and gains moderate. Much of the projected state-wide increase in this segment will be from onetime use tax related to the construction and equipping of new energy generation projects.</p>		
Food/Drugs	4.5%	3.0%
<p>Chains continue to combat inroads by warehouse retailers, dollar stores and new specialty concepts with new merchandise and prepared food offerings. However, most of the projected gain for this segment will come from higher prices on fuel sold by convenience stores and some grocery chains and from the inflationary impact of rising transportation costs on taxable merchandise.</p>		
Fuel/Service Stations	20.7%	6.0%
<p>Gasoline prices are becoming more reflective of International rather than declining local demand and the U.S. has recently become a net exporter of fuel products. The recent closure of several unprofitable U.S. refineries and unrest in the Middle East boosted speculation that supplies would become tighter which resulted in the recent jump in crude oil futures. Prices are expected to level off but not retreat significantly from current highs.</p>		
General Consumer Goods	4.7%	3.5%
<p>Improved employment confidence, credit availability and pent up demand has resulted in better than anticipated sales in recent quarters. Even so, consumers remain cautious and primarily oriented toward discounts and value. Most of the recent gains have been in the luxury and low cost segments while those marketing to the shrinking middle class continue to struggle. The competition to reposition and accommodate the growing trend toward online shopping is expected to increase the numbers of retail winners and losers in the coming year.</p>		
Restaurants/Hotels	6.5%	4.0%
<p>Increased business travel, growing employment confidence, austerity fatigue and the popularity of new fast-casual dining concepts are helping produce gains in some restaurant segments.</p>		
State and County Pools	8.2%	4.7%
<p>Private vehicle transactions have been on the rise as have equipment leases and out-of-state purchases of business equipment and supplies. The gains are expected to level slightly in 2012-13. The impact of State and Federal proposals to more effectively collect taxes on out-of state purchases remains unclear.</p>		
TOTAL	8.0%	4.7%

The **Proposition 172** growth factor is **7.6%** for Fiscal Year 2011-12. This factor varies from HdL's Bradley Burns growth rates due to differing collection periods and comparisons to prior year data that include onetime payment aberrations.



	2011-12	2012-13
U.S. Real GDP Growth	2.6%	3.1%
<p>U.S. real gross domestic product picked up at the end of 2011. The current estimate from the Bureau of Economic Analysis is 3% for the fourth quarter. Business investments in equipment and software, as well as inventory building, and consumer spending all contributed positively to real GDP last quarter. Even the residential component has started to add to growth. Beacon Economics is forecasting that the fiscal year will end with 2.6% growth continuing into 2012-13 at a 3.1% rate, though still well below post-recession norms.</p>		
U.S. CPI Inflation	3.0%	2.5%
<p>Overall CPI growth picked up in the second half of 2011. However, this could be due to rising oil and commodity prices rather than the aftereffects of the Federal Reserve's quantitative easing program, which is still lingering on bank balance sheets in the form of excess reserves and therefore has yet to exert much upward pressure on prices. With modest growth in the economy, we expect inflation to remain below 3% through mid 2013.</p>		
California Population	37,764,678	38,125,560
<p>The 2010 Census brought downward revisions to California's population base by a relatively large amount. Still, net migration, though still negative in 2011, was the least amount of out-migration that California has seen since 2004, and it is trending back toward positive territory. In addition, natural population increase continues to contribute to overall population growth. Population is expected to experience modest growth of 0.7% in 2011-12 and rising to 1% in 2012-13 as migration levels off.</p>		
California Total Nonfarm Employment Growth	1.1%	2.4%
<p>When the Employment Development Department released its benchmark revision in early March, there were some interesting changes. Our leading sectors in professional and finance categories look better than previously reported, while government and the other services sectors saw sharp downward revisions. Overall, the growth picture is slightly less positive over the past six months than previously reported, though the story continues to be one of improvement in California's labor markets. Expect nonfarm employment growth to increase by 1.1% this year and pick up momentum in 2012-13.</p>		
California Unemployment Rate	11.1%	9.8%
<p>The state's unemployment rate dipped below 11% for the first time since April 2009. These are solid gains driven by genuine expansion in California's labor markets. The unemployment rate is expected to continue its gradual decline—averaging 11.1% this fiscal year and falling below 10% in 2012-13.</p>		
California Existing Home Sales	324,724	343,048
<p>The gradual healing of California's economy coupled with affordable home prices and low interest rates have helped to spur home sales in the Golden State. Through February, home sales had increased for almost 7 months consecutively. As the labor markets improve and prices and interest rates remain low, home sales are expected to continue to grow—totaling almost 325,000 in 2011-12, and surpassing 340,000 in 2012-13.</p>		
California Median Existing Home Prices	\$ 239,300	\$ 242,500
<p>The increase in demand has started to give way to some very modest price appreciation. As sales increase and the share of distressed properties in the sales mix declines, home prices are expected to begin growing at a very tepid pace—though one that is more in line with income growth in the state and thus more sustainable.</p>		
California Multi-Family Building Permits	26,600	39,600
<p>Although single-family construction has been bouncing around the bottom, multi-family building permits have been on a consistent upward trend since early 2010. This is especially true along the state's coastal regions in the Bay Area and Southern California. This trend is expected to continue as space constraints and preferences shift a larger portion of the state's residential construction toward multi-family housing.</p>		



HdL Companies

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California's allocation data trails actual sales activity by three to six months. HdL compensates for the lack of current information by reviewing the latest reports, statistics and perspectives from fifty or more economists, analysts and trade associations to reach a consensus on probable trends for coming quarters. The forecast is used to help project revenues based on statewide formulas and for reference in tailoring sales tax estimates appropriate to each client's specific demographics, tax base and regional trends.



"Good information leads to good decisions."



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Beacon Economics, LLC has proven to be one of the most thorough and accurate, economic research/analytical forecasters in the country. Their evaluation of the key drivers impacting local economies and tax revenues provides additional perspective to HdL's quarterly consensus updates. The collaboration and sharing of information between Beacon Economics and HdL helps both companies enhance the accuracy of the work that they perform for their respective clients.

Attachment D Economic Report from California State University, Fullerton

CALIFORNIA STATE UNIVERSITY FULLERTON

Dr. Adrian R. Fleissig

Dr. Mira Farka

COUNTY OF RIVERSIDE

FORECASTS AND ECONOMIC OUTLOOK

for

COUNTY OF RIVERSIDE

16 April 2012
Revised 20 April 2012

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A. RIVERSIDE BUDGETARY VARIABLES

A1. Property Tax Revenue

The County of Riverside provided the Institute for Environmental and Economic Studies (IEES) with secured property tax data on 903,611 property parcels for FY 2011-2012. This secured property tax data differs from the Riverside County Assessor's records which has a total of 940,618 parcels. In contrast to the Riverside County Assessor's office, the data provided to us excludes a number of items such as tax exemptions, fixtures, trees & vines, unsecured property, personal property and a few other data which are subject to time-recording and other accounting issues. Despite these differences, the data provided by the county and analyzed by the IEES is fairly inclusive and represents 94.5% of the county's assessed valuation.

Property Tax Projections

The outlook for the county's assessment roll though improved compared to the height of the recession, remains exceptionally cautious especially in the near term. Housing prices are expected to decline slightly from their current levels and stabilize in late 2012 early 2013. Foreclosures are expected to pick up in 2012 compared to last year after the settlement between the state attorneys general and five major mortgage companies which means that prices will come under further pressure. The reassessment of commercial appeals will also take a while to be completed thus placing additional strains on assessment rolls. **More troubling, the assessment roll appears to have suffered a permanent decline since the crisis as increases in**

foreclosures and distress sales have prompted the reevaluation of over 200,000 of the county's properties (23% of total) to a lower base.

Our projections for Riverside County property values are based on econometric models that use a number of variables for forecasting purposes including data by type of property, failure to pay property tax installments, Proposition 8, Proposition 13, and property tax data from neighboring counties.

The forecasts are provided in Table 1. **The growth rates are representative of the projected growth of the County's property tax revenue.** Note that the data supplied to us by the County and displayed in Table 2 differ from the Assessor's Office data which shows commercial property values declining by -1.9% and non-commercial declining by -0.9% in FY 2011-2012. We project an overall decline of -2.1% in 2012-2013. This decline is due to Prop 8 re-assessments for commercial properties in the appeals process as well as Prop 8 reassessment decreases for residential properties reflecting lower housing prices earlier in the year. Property values are expected to remain roughly flat (increase only by 0.5%) in FY 2013-2014 as housing prices stabilize while commercial properties continued to be reassessed. In the long term, property values are expected to grow as housing prices rise, triggering a reversal of Prop. 8 and the commercial real estate market recovers.

Table 1 Ad Valorem Property Taxes Based on 94.5% of the Secured Property Tax Roll^{a,b}						
Fiscal Year	Commercial	Growth	Non-Commercial	Growth	Total	Growth
10-11	497,585,858	n/a	1,470,577,991	n/a	1,968,163,849	n/a
11-12	486,808,992	-2.2%	1,453,140,307	-1.2%	1,939,949,299	-1.4%
Forecast						
12-13	474,151,958	-2.6%	1,425,530,641	-1.9%	1,899,682,599	-2.1%
13-14	467,039,679	-1.5%	1,442,637,009	1.2%	1,909,676,688	0.5%
14-15	465,171,520	-0.4%	1,483,030,845	2.8%	1,948,202,365	2.0%
15-16	482,382,866	3.7%	1,549,767,233	4.5%	2,032,150,099	4.3%
16-17	502,642,947	4.2%	1,641,203,500	5.9%	2,143,846,446	5.5%
^a Data provided by the County of Riverside representing 94.5% of assessed valuation. ^b The growth rates are representative of the projected growth of the County's property tax revenue.						

The property tax projections in Table 1 represent a baseline forecast. However, if downside risks intensify such that the labor market fails to heal as projected, mortgage delinquency rates and foreclosures rise more than the forecast, conditions in residential and commercial real estate take another setback, and the overall recovery in the county turns out to be much weaker than expected, another likely scenario shows a larger reduction in property taxes. Under this "increased-risk-scenario", our forecasts are as follows: FY 2012-13 (-2.8%), FY 2013-14 (-0.4%), FY 2014-15 (1.5%), FY 2015-16 (4.6%) and FY 2016-17 (5.8%).

In FY 2011-2012 the ad valorem secured property tax revenue (excluding tax exemptions, fixtures, trees & vines, unsecured property, personal property, as well as data subject to recording and other accounting issues) for the 903,611 parcels was \$1,939,949,299 (see Table 2). This is lower than the revenue from the complete county property tax roll which amounted to \$2,051,876,922 and also less than the secured county tax roll which was \$1,973,857,128. Despite these discrepancies, the vast majority of property tax revenue is from secured property (land and structures) ad valorem taxes (1% of total assessed valuation) which account for 94.5% (\$1,939,949,299 of \$2,051,876,922) of the property tax revenue generated from the Riverside County Assessor's total property tax roll.

The parcels were classified into the following seven categories: Residential, Time Shares, Manufactured Homes, Vacant, Commercial, Agricultural and Unassigned Code (see Table 2 for more details). Note that for FY 2011-2012, there are 2,054 more parcels than in the data provided by the County for FY 2010-2011 when there were 901,557 parcels. Consequently, the historical data for the ad valorem taxes will differ relative to those reported in our previous study in April 2011. The analysis below is based on the latest secured property tax data provided to us by the County.

During the FY 2011-2012, the secured ad-valorem tax revenue from residential parcels (single and multifamily) totaled \$1,297,382,404, which accounts for 66.88% of all property taxes (Table 2). The next largest share in the amount of \$486,808,992 comes from commercial parcels, which account for 25.09% of property taxes. The remaining

categories total \$155,757,903 or 8.03% of property taxes in Riverside County.

Table 2
Ad Valorem Property Taxes^a
Fiscal Year 2011-2012

Type of Parcel	Dollars	Share of Property Taxes
Residential ^b	1,297,382,404	66.88%
Time Shares ^c	6,362,634	0.33%
Manufactured Homes ^d	41,608,490	2.14%
Vacant ^e	59,466,720	3.07%
Commercial ^f	486,808,992	25.09%
Agricultural ^g	48,085,356	2.48%
Unassigned Code ^h	234,703	0.01%
Total	1,939,949,299	100.00%

^a Data provided by the County of Riverside for 903,611 parcels.
^b Single and multifamily
^c Timeshare estates in a timeshare project pursuant to Section 2188.9 of the Revenue and Taxation Code.
^d Factory built manufactured homes
^e Vacant according to residential parcel codes
^f Apartment buildings, commercial building on leased land, vacant commercial, special use and all other types of commercial property.
^g Parcels under and not under an agricultural preserve act
^h Unassigned code are parcels that were not assigned to residential, commercial or agricultural

The real estate crisis, deep recession and the subsequent exceptionally weak recovery has had a profoundly negative impact on the county's assessment roll. As reported by the county's Assessor Office, assessed valuations fell by an additional -1.45% in FY 2011-2012 after declining by -4.25% in FY 2010-2011 and by an unprecedented -10.51% in FY 2009-2010. Translated into dollar amounts, the assessment roll has shrunk by a total of \$37 billion over the past three years, falling by an astounding \$25 billion in FY 2009-2010 (the largest county decline in the state of California), an additional \$9 billion in FY 2010-2011, and by an additional \$3 billion in FY 2011-2012. All told, the county's assessment roll has plummeted by a total of -15.6% since it peak in FY 2008-2009.

The decrease in assessment roll was largely caused by a continued downward revision of assessment values in the county as housing and commercial real estate markets continue to experience strains. This is in line with Proposition 8, which requires the Assessor to apply the lower value of either the property's Factored-Base-Year Value (established under Proposition 13 -- with an increase of no more than 2%) or its market value as of the lien date (January 1). For FY 2011-2012, the Assessor's office reviewed over 500,000 properties of which 414,528 received a reduction. The average decrease was \$133,881 for residential properties (compared to the base year) and \$1,098,553 for commercial property. The total decrease in assessed valuation as per Proposition 8 for FY 2011-2012 was \$44.3 billion, which is roughly the same as the decrease applied in the previous year.

The remainder of the nearly 1 million properties which were not subject to the Prop 8 assessment reduction experienced a 0.75% increase in FY 2010-2011 in assessed valuation -- in line with California inflation rate which rose by 0.75% from October 2009-October 2010. Though this was an improvement over the -0.237% negative inflation factor experienced from October 2008-October 2009, it is still below the 2% CPI maximum and was another contributing factor to the further weakening of assessment rolls during FY 2011-2012.

In order to get a better sense of the challenges facing property owners in the county, we also analyzed property tax delinquencies based on the data provided by the county. There were 61,716 (6.83%) property owners delinquent on paying their property taxes (at least

one installment) for FY 2010-2011 (the most recent data available). The number of property owners who paid one installment but were delinquent on the other installment was 12,818 (1.42%) and the number of owners delinquent on both was 48,898 (5.41%). The number of delinquencies has improved slightly compared to a year ago when 71,550 (7.94%) of property owners were delinquent on their taxes.

Lower delinquency rates likely reflect the transfer of foreclosed and distressed sales to banks or property owners that are more able to pay property taxes rather than by healthy improvements in the fundamentals of residents and businesses of the county. Nonetheless, quite a lot of progress has been made compared to two years ago when 89,112 property owners (10% of total) were delinquent on paying their property taxes. Though at a snail-pace, property tax delinquencies should continue to decline further over the forecast horizon partly due to the transference of distressed property to banks and new households who are less likely to be delinquent on property tax payments. In addition, improvements in labor markets, stabilization of home values and a general more upbeat overall tone to local macroeconomic data should contribute further to a reduction in property tax delinquencies. The progress ahead, however, will be slow and high property tax delinquencies will continue to remain a concern for the county for quite a while -- at least until the real estate market normalizes.

Non-Commercial Property

Home prices in Riverside County trended lower for the most part of 2011, ending the year around -0.8% below their December 2010 values. Nonetheless, the market seems to have stabilized in 2011 with the single-family median home price oscillating around the \$200,000 mark throughout last year, according to the California Association of Realtors. Home prices are up by around 14% from their April 2009 crisis-low values, though they have partially erased the 25% gain that occurred between the May 2009 - June 2010 period which was largely boosted by the temporary tax credits. Even with the current level of \$200,000, home prices are still more than 53% below the peak of \$431,713 recorded in June 2006.

The number of foreclosures, still very high, continued to trend lower in 2011 compared to the previous year, likely reflecting the efforts of the federal government and lenders to prevent foreclosures and the recent legal issues surrounding the foreclosure process. The County still has the highest foreclosure rate in Southern California, and the second highest in the state of California. A total of 41,319 mortgage default notices, auction sale notices and bank repossessions were recorded in the county in 2011 -- 1 in 19 households, which represents roughly 5.3% of the county's total residential properties. This likely underestimates the real number of properties that would have been foreclosed had the process not been interrupted by a number of concerns regarding the documentation and legal issues plaguing the foreclosure industry.

Further strains continue to weigh on the housing market in the Inland Empire region with around 43.7% owing more in their mortgages than the market value of their homes. While this is a considerable improvement over the 54.9% underwater mortgages recorded at the height of the crisis, there is little doubt that a large number of homes will end up in foreclosure at some point down the line or continue to remain distressed in 2012 and beyond.

Fundamental market forces have improved noticeably compared to the depth of the recession: job growth has finally resumed in the region and housing affordability has reached an all-time high with 69% of families able to afford the median home price. Nonetheless, a pick-up in demand for homes will take a while to materialize, given the still slow-pace of recovery in the region and low rates of household formation. Moreover, the shadow inventory of homes should restrain any meaningful appreciation in home prices until it is finally exhausted -- most likely in mid-to-late late 2015.

Housing market strains have negatively impacted the county's assessment roll. According to the Riverside County Assessor, in FY 2011-2012, 242,789 residential properties received a Proposition 8 reassessment, reducing the assessment roll by \$32.5 billion. In comparison, in FY 2010-2011, 258,521 residential properties received a Proposition 8 reassessment and the assessment roll declined by \$34.7 billion. Assessed values were also reduced for condominiums (\$3.5 billion), vacant land (\$2.1 billion) and other property (\$2.7 billion). Because the California Consumer Price Index rose by 0.753% (from October 2009-October 2010), the maximum possible increase (as

mandated by Proposition 13) in assessed value for existing property owners, was limited to 0.753% and most likely was only applied to houses purchased prior to 1999. The slight increase in factor-base was more than offset by Prop 8 reductions resulting in an overall decline in secured property values in 2011-2012.

Property tax delinquency rates for non-commercial property has improved relative to last year, though still remains high. We analyzed delinquencies on 861,889 parcels for non-commercial property provided by the county, which include residential, agricultural and unassigned parcels. The largest share of delinquencies came from owners of residential parcels who failed to make either one or both property tax installments. Single-family and multi-family delinquencies accounted for \$42,339,600 (56.7%) of total delinquent non-commercial property taxes. Delinquencies for vacant land (residential, mountain, desert and manufacture homes) was \$12,919,429 (17.3%) of total delinquencies. Delinquencies for agricultural property were \$7,248,706 (13.3%) and for Condominiums or Planned Unit Developments were \$3,753,051 (5.0%).

The contribution of non-commercial property to the assessment roll in FY 2012-2013 largely depends on two factors: 1) housing values in the first three months of 2012, and 2) the Prop 13 factor. Due to a high number of distressed sales, home prices trended lower at the end of 2011 and early in 2012. This means that properties under Prop 8 (which make up roughly half of the assessment roll) will likely receive a small reduction in their assessed valuation. The other (roughly) half of the roll -- mostly those properties purchased before 1999 -- are subject to a maximum 2% increase due to the fact that the

California CPI-inflation factor rose by 2.9% from October 2010-October 2011. Overall, non-commercial properties are likely to have a modest negative impact on assessment values for FY 2012-2013 compared to the previous fiscal year. Beyond this horizon, housing prices are projected to slowly increase which will raise assessed valuations and also begin the reversal of the Prop 8 temporary reductions.

Commercial Property

Parts of the commercial real estate market in the county experienced improvements in fundamentals in 2011 which indicate that this market is likely to begin to recover in 2012 and beyond. Nonetheless, the recovery seems to be two-tiered with industrial and multi-family sectors expanding while retail and office properties continuing to drag. The industrial sector has posted the strongest gain with manufacturing and logistics picking up steam as world trade volumes soared after the global recession. The market has experienced strong demand which has decreased its vacancy rate down to a pre-recession low of 6.3% (in Q4 2011). This trend is expected to continue and the vacancy rate for industrial properties should fall further in 2012. In fact, as of Q4 2011, the Inland Empire recorded the highest level of gross industrial space in the nation, which at 19.8 million square feet was just a notch below the 20 million recorded in boom periods. Similarly, rents for Class A&B Apartments have improved due to an increased demand for rental property (relative to homeownership) and are now only -6.4% below their all-time highs recorded in Q1 2008.

In contrast, office and retail markets continue to remain weak. Office vacancy rates remain high at 23.4% in Q4 2011 as professional and business job growth continues to remain exceptionally weak. This trend is expected to continue over the next few years partly due to a slow recovery in the housing market and partly due to the (still) high office vacancy rates in the neighboring counties. While 2011 proved also quite challenging for the retail market given modest consumption spending, the outlook for this sector is more upbeat due to the existence of a number of low-cost expansion opportunities for a number of retailers.

While activity has picked up and parts of the commercial real estate sector are showing some vitality, commercial values have yet to stage a meaningful recovery. This is due to the fact that the market has an abundant excess supply and the renewed demand has not yet pushed against capacity which is needed for a price pick-up. Overall, commercial property values should continue to experience re-assessment reduction over the next few years, reflecting in part some weakness in pricing until demand increases robustly. However, the main reason for continued assessment reduction is largely due to the complex and protracted assessment process involving commercial properties, which unlike the residential market, requires a thorough study of the fundamentals of each property. This process takes a long time, so we expect reassessment appeals regarding commercial properties to continue over the next two years. The lagged effect of this complex reassessment process will likely weigh on the County's Assessment roll even if commercial real estate prices begin to firm up slowly in the

meantime. It should be noted that we do not foresee a notable price pick-up in the commercial real estate market over the next few years, which means that assessed valuations for commercial properties will remain depressed.

For FY 2011-2012, 2,535 commercial properties received a Proposition 8 reduction in assessed valuation for a total amount of \$2.8 billion which is considerably higher than FY 2010-2011. During FY 2010-2011, 1,526 commercial properties had a Proposition 8 reduction in assessed valuation for a total amount of \$1.8 billion. The sharp increase in commercial properties receiving a Proposition 8 reduction is largely due to the efforts by the Assessor's Office to revalue commercial property in an expedient manner. In addition, the commercial real estate market followed the collapse in housing prices with a lag of around 18 months, which means that their reassessment has also lagged the residential market.

We analyzed 41,722 commercial parcels provided by the County for FY 2011-2012. These consist of apartment buildings, commercial building on leased land, vacant commercial, special use, and other types. While a relatively large the number of property owners defaulted on property taxes in FY 2010-2011, much like the non-commercial market, the number of delinquencies is lower than in FY 2009-2010. Failure to pay property taxes on vacant commercial properties in FY 2010-2011 (latest available data) was \$6,606,052 (27.7%) of all delinquent commercial properties. A further \$2,744,061 (11.5%) of all delinquent commercial property taxes was on special use parcels. Apartment buildings accounted for 1,614,316 (6.76%) of all

commercial delinquent taxes. Delinquencies on commercial properties are expected to edge down over the next two years as fundamentals continue to improve, but they will remain elevated relative to their historical values.

As previously mentioned, commercial properties will continue to place a downward pressure on assessment rolls over the next two years largely reflecting assessment appeals that will have to be resolved over this period. Assessed valuations for commercial property are expected to continue to decrease in FY 2012-2013 and FY 2013-2014 reflecting the protracted assessment process and price weakness. Given the complex process of reassessing commercial property, assessed values for commercial property are likely to also decrease slightly in FY 2013-2014. Beyond this horizon, assessed valuation for commercial properties is expected to stabilize and increase at a modest rate.

A2. Motor Vehicle Licensing Fee (in Lieu)

Motor Vehicle Licensing Fee (MVLFF) revenue is based on assessed property values (Table 3). In FY 2005-06, the state converted MVLFF revenue into property taxes in lieu of MVLFF. This source of revenue is linked to assessed valuation. Nonetheless, there are significant deviations from the assessed valuation trend. For example, during FY 2005-06, there was an underestimate of MVLFF for Riverside County. To correct for the underpayment, an additional payment was made in FY 2006-07, causing the MVLFF revenue in FY 2006-07 to be higher than what the actual payment should have been. Thus while this source of revenue tends to grow and fall at a similar rate to assessed property

taxes, the state adjustments for underpayments or overpayments distorts the underlying trend for MVLF revenue. There was a -4.4% decline in MVLF revenue during FY 2010-2011. In tandem with assessed valuation, we project a decrease in this source of revenue in FY 2011-2012 and in FY 2012-2013. In the long term, as the real estate market recovers, MVLF revenue will increase as assessed values rebound from depressed levels.

Table 3^a

Fiscal Year	Motor Vehicle Licensing Fees Dollars	Growth
Historical		
08-09	221,661,746	1.4%
09-10	197,932,854	-10.7%
10-11	189,210,416	-4.4%
Forecast		
11-12	185,615,418	-1.9%
12-13	183,573,648	-1.1%
13-14	184,858,664	0.7%
14-15	188,186,120	1.8%
15-16	195,713,565	4.0%
16-17	206,086,384	5.3%
^a Data provided by the County of Riverside		

A3. Taxable Sales Riverside County

The taxable sales data are from the County of Riverside which reports tax revenue derived from sales within the unincorporated areas. In addition to the deep recession and slow recovery -- which have had an adverse impact on the county's taxable sales, the incorporation of two areas Jurupa Valley and Eastvale have taken a significant chunk out of this source of revenue for the county. Since the incorporation of these two areas reflects a structural shift, the permanent loss of this revenue source will further depress taxable sales for the county at least in the near-term. More importantly, the sizable drop in taxable sales due to this incorporation tends to distort the real trend in sales, which move in tandem with the performance for the local economy. There is also some timing uncertainty between when incorporation occurs and when its effect on taxable sales for the county is fully exhausted from an accounting perspective.

For our projections, taxable sales from Eastvale are excluded from FY 2010-11 and in subsequent years. A portion of Jurupa Valley taxable sales is allocated to the County in FY 2011-12. In FY 2012-13 and beyond, taxable sales from Jurupa are excluded which assumes that all accounting procedures are implemented in FY 2012-13. Consequently taxable sales to Riverside County are projected to decline significantly in FY 12-13 by -21.9%. Taxable sales are expected to increase by 1.3% in FY 2013-2014 reflecting the sluggish recovery momentum in the county. In the long-term, taxable sales are projected to increase with growth rates exceeding 7% as the recovery in the county gains strength.

Table 4^a

Fiscal Year	Taxable Sales (dollars)	Growth
Historical		
08-09	34,181,132	-16.6%
09-10	25,761,880	-24.6%
10-11 ^b	25,317,375	-1.7%
Forecast		
11-12	26,102,282	3.1%
12-13	20,388,704	-21.9%
13-14	20,643,562	3.7%
14-15	21,510,592	6.5%
15-16	22,672,164	7.1%
16-17	23,987,150	7.5%
^a Data provided by the HDL. ^b Data for FY 10-11 include a projection for the last quarter as data are not available. Taxable sales from Eastvale are removed. ^c Projections in FY 11-12 include a portion of taxable sales from Jurupa Valley. ^d Projections in FY 12-13 exclude taxable sales from Jurupa Valley and thus assume that Jurupa Valley will be allocated their tax revenue in FY 12-13.		

A4. Proposition 172 Public Safety Sales Tax Projections

Proposition 172, the "Local Public Safety Protection and Improvement Act of 1993," was enacted in November 1993 and allocates a half-cent sales tax to public safety in cities and counties. The total sales tax revenue is distributed to cities in Riverside County as well as to the County. The state distribution of Proposition 172 revenue to Riverside County depends on the amount of taxable sales in Riverside County and on the Riverside County's share of total tax

revenue. Forecasts for the Public Safety Sales Tax are determined using the state formula and regression techniques and estimates are in Table 5. For Riverside County, the public safety sales tax projections are forecasted to increase modestly in FY 2011-2012. In the longer term, as the state and county economies recover, there should be growth in this revenue for the County.

Table 5^a

Fiscal Year	Proposition 172 Public Safety Sales Tax (in thousands)	Growth
Historical		
08-09	120,458,414	-16.7%
09-10	110,158,678	-8.6%
10-11	110,585,796	0.4%
Forecast		
11-12	117,331,530	6.1%
12-13	123,784,764	5.5%
13-14	130,840,495	5.7%
14-15	139,868,490	6.9%
15-16	150,078,889	7.3%
16-17	161,935,122	7.9%
^a Data are from the Riverside County		

A5. Documentary Transfer Tax

Documentary transfer tax is typically from a transfer of the ownership of real property and historical and projected values are in Table 6. The tax rate for the City of Riverside is \$1.10 for every \$500 of net consideration or value conveyed; the tax rate for all other cities and the unincorporated areas of the County of Riverside is \$.55 for every \$500 of net consideration or value conveyed. Documentary transfer tax is highly correlated with house sales, building permits, changes in interest rates which can trigger refinancing, changes in property values, changes in payroll employment, foreclosure rates, and other factors that cause a change in ownership. With persistent weaknesses in residential and commercial real estate, a slowdown in the foreclosure process, and a slow pick up in construction activity, documentary transfer tax is projected to increase by 9.6% in 2011-2012. This source of revenue should pick up more robustly in 2012-2013 as foreclosures pick up and distressed sales continue to dominate the county's housing market. In the long term, document transfer tax revenue is expected to grow more robustly reflecting genuinely improved real estate fundamentals.

Table 6

Fiscal Year	Documentary Transfer Tax Dollars	Growth
	Historical	
08-09	10,624,354	-21.2%
09-10	10,677,818	0.5%
10-11	9,958,654	-6.7%
Forecast		
11-12	10,914,685	9.6%
12-13	12,399,082	13.6%
13-14	14,159,751	14.2%
14-15	16,807,625	18.7%
15-16	20,101,919	19.6%
16-17	24,202,711	20.4%
^a Data are from the Riverside County		

B. RIVERSIDE COUNTY OVERVIEW FORECAST AND REPORT

The economic outlook for Riverside County has improved considerably compared to a year ago but the region still has a way to go as the recovery remains sluggish with below-trend growth, high unemployment rates and a real estate market that will weigh on growth and county's finances for the foreseeable future. The good news for the county is that the worst is behind it and its economy is no longer mired in the doldrums of the recession: labor markets have shown signs of life, housing affordability is at a record-high, activity has sprung up in some segments of commercial real estate market, and the post-recession surge in international trade volumes has supported

local growth. Nonetheless, the economic recovery in Riverside County continues to lag behind the Southern California region and the national recovery. The main challenge for a sustained recovery in the county continues to be the residential real estate market and segments of commercial real estate (office, retail) which are fundamentally weak and highly dependent on a broader recovery of the regional real estate market.

Going forward, we expect the Riverside economy to continue to heal, but at an exceptionally sluggish pace even when compared to the moderate growth of the national and Southern California economies. Labor markets will continue to improve and the local economy will add jobs, but the pace of job formation is expected to remain sluggish in the near-term given the deep recession experienced by the county. The unemployment rate is projected to decline slowly over the forecast horizon reflecting broader improvement of the labor market. Moreover, the pace of job growth will still remain too sluggish to provide a meaningful and sustained increase in discretionary income which means that retail sales are unlikely to surge over the next two years. International trade volumes will continue to help the economy, but the imminent global slowdown will likely translate in lower container traffic which means that growth in trade and logistics sectors will continue at a more moderate pace than in recent past. The housing market will bounce along after bottoming-out in 2012, but any meaningful recovery in this sector will be severely restrained by the large number of foreclosures that loom over the county. Housing affordability is one of the bright spots, but it is likely to become a

factor in the long-term rather than in the immediate future given that affordability has also improved in the neighboring coastal counties. State and (particularly) local finances will continue to weigh on the county's economy. Local budgets will continue to experience stress particularly since reassessed residential properties (valued at a significantly lower value per Prop 8) are unlikely to see a significant upward revision given strained conditions in the housing market. Moreover, the lagged effects of reassessed commercial properties are expected to negatively impact county's finances for a couple more years.

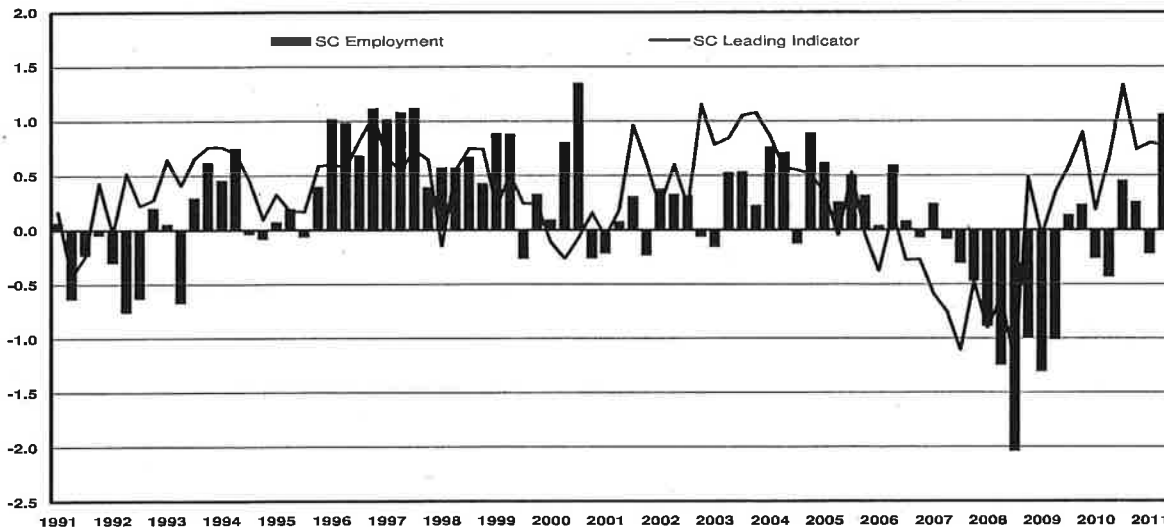
To analyze short-term economic conditions, the *Institute for Economic and Environmental Studies (IEES)* at California State University Fullerton has developed a leading economic indicator which has proven to be a reliable predictor of economic activity for the region over the near-term. Additionally, at the County level, employment and housing data provide an important indicator of overall regional economic conditions. The near-term and long-term economic outlook for Riverside County is discussed below using these measures, econometric models, and other data.

B1. NEAR TERM OUTLOOK AND FORECAST

Regional economic activity is interdependent in the Southern California region which includes Los Angeles County, Orange County, San Bernardino County, Riverside County, Ventura County and Imperial County. To gauge the short-term overall economic activity in Southern California region, the IEES has developed the *IEES Southern California*

Leading Economic Indicator. The *S.C. Leading Indicator* uses a combination of national and regional data to project economic activity in the region. At the national level, macroeconomic indicators used in the index include the money supply adjusted for inflation, the interest rate spread and the Standard & Poor's S&P500 stock index. Regional variables include nonfarm employment changes, the unemployment rate, building permits and the Pacific Region consumer confidence index. An increase (decrease) in the SC Leading Indicator implies an increase (decrease) in economic activity in the Southern California region in the next 3 to 6 months. The indicator has been found to accurately predict turning points in economic activity for Southern California (Figure 1).

Figure 1
Southern California Leading Economic Indicator and SC Employment



Source: California State University Fullerton.

The current 0.78% increase in the *S.C. Leading Indicator* suggests an improvement in economic activity in the Southern California region over the next 3 to 6 month horizon. The *Indicator* has now increased

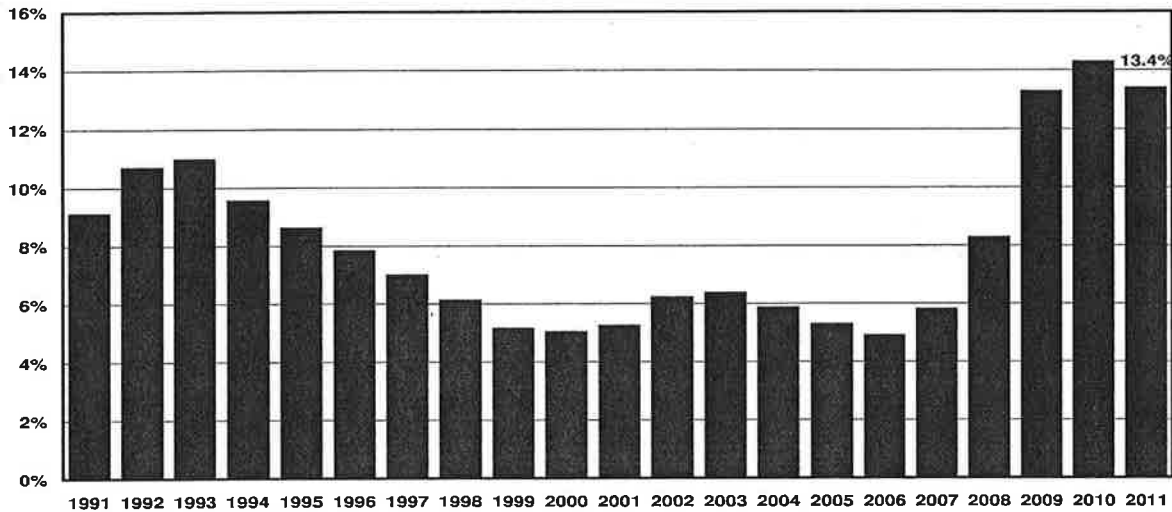
for nine consecutive quarters since its last decline in the third quarter of 2009. This suggests that economic activity in the Southern California region will continue to expand in 2012, though at a moderate pace. The economic recovery in Riverside County will also strengthen this year and the next, while still lagging behind most counties in Southern California.

Unemployment

One of the best news for the county over the past few months has been a steady decline in the unemployment rate which indicates that the region's labor market is finally on the mend. The unemployment rate has been on a downtrend declining from 14.3% in July 2011 down to 12.5% in February 2012. Measured from the cycle highs of the Great Recession, the unemployment rate has declined by 2.5% from a record 15.1% in July 2010 down to the current level.

In fact, at the current 12.5% level of February 2012, the unemployment rate for the Inland Empire is at its lowest point in the past three years. This is a very welcome sign particularly since the area's unemployment rate rose sharply during the recession averaging 8.3% in 2008, 13.3% in 2009, and 14.5% in 2010 before declining to 13.4% in 2011 (Figure 2).

**Figure 2
Civilian Unemployment Rate
Riverside-San Bernardino**



Source: Employment Development Department

Despite these encouraging improvements, it should be noted that the unemployment rate is still well above historical norms, which should continue to place additional strains on consumer finances and hamper the region's recovery. The pace of improvement in unemployment rate numbers is considerably below the vast majority of other regions where the recovery -- though slow -- has far surpassed that of the Inland Empire. For example, Inland Empire's unemployment rate is higher than that of surrounding counties with the Orange County unemployment rate having edged down to 7.8% and Los Angeles County down to 12.1%. Compared to other Metropolitan Statistical Area's (MSA), the latest December 2011 labor employment report ranks the Riverside-San Bernardino MSA in the top 6.5% highest unemployment rate out of the nation's 372 MSAs. For large MSAs with populations of 1 million and above, the Riverside-San Bernardino MSA has the second highest unemployment rate in the nation behind Las Vegas-Paradise MSA.

In addition, when considering a broader measure of unemployment which includes underemployed and "discouraged workers," the unemployment rate for the county is closer to 17%.

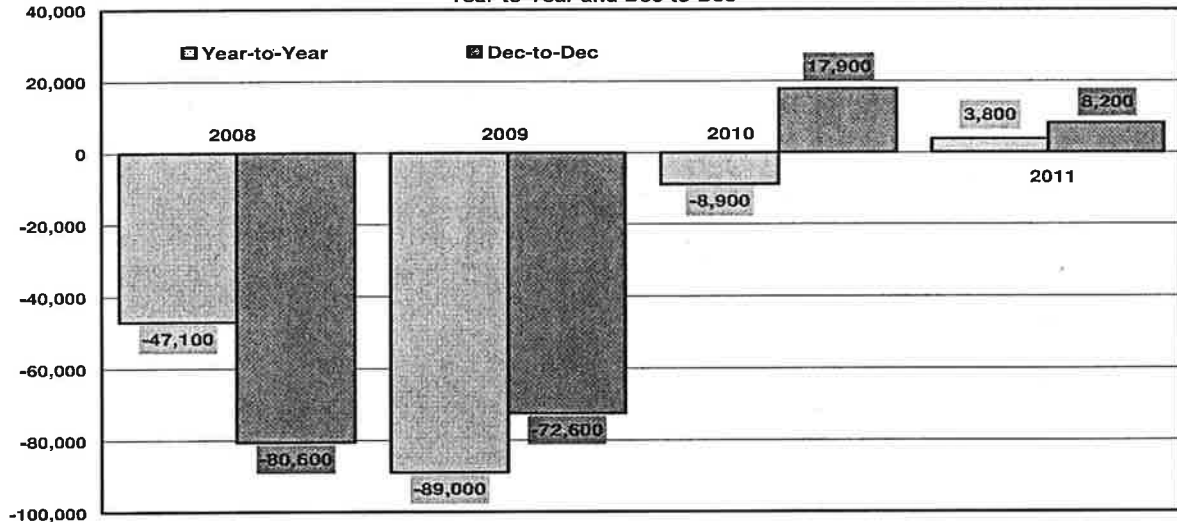
The outlook for the labor market is considerably brighter than one year ago. The labor market should continue to improve over the next few years, though the gains will be painfully slow given the depth of the abyss the recession left behind. The unemployment rate should drift down slowly over the next few years as the labor market continues to recover particularly in response to relatively stronger employment gains in the surrounding counties. The slow pace of the labor market recovery will likely keep the unemployment rate in double digits through the end of 2013.

Payroll Employment

After staggering job losses during the recession, the labor market for the Riverside-San Bernardino MSA has finally turned the corner and started adding jobs. This can be seen from Figure 3 below which shows changes in nonfarm payrolls using both annualized average data (year-over-year changes) and December-to-December changes. We display both measures because annual year-over-year changes based on annual average data tend to distort recent trends. For example, comparing the annual average data for year 2011 to year 2010 shows a gain of only 3,800 jobs. An alternative measure that gives a more accurate depiction of the current labor market is to compare nonfarm payrolls over a 12 month period using the December-to-December change. With this measure, from December 2010 to December 2011, 8,200 jobs

were added which is considerably higher than the annual average. The difference is even more pronounced when comparing nonfarm changes in year 2010. The December 2010 to December 2009 had a gain of 17,900 while the annual average year-to-year changes show a decrease of -8,900 jobs.

**Figure 3
Nonfarm Payroll Employment
Year-to-Year and Dec-to-Dec**



Source: Employment Development Department

The good news for the County is that, regardless of how the data is measured, the county added jobs in 2011. It is also important to note that in March 2012, the Employment Development Department revised the nonfarm payroll data considerably having previously reported that the region lost -23,600 in 2010 compared to 2009 whereas the most recent data only shows a decline of -8,900.

These job gains represent a welcome boost to the region given the massive job losses that occurred in 2009. Nonfarm employment has now increased for 8 months on a year-on-year basis since July 2011. The region has added an additional 13,500 jobs since July 2011. For 2011,

job gains were widespread through a number of sectors: the Service Providing sector gained a total of 8,800 jobs; 2,300 jobs were in Trade Transportation & Utilities, 3,000 in Educational & Health Services; and 2,500 in Professional and Business services. The construction sector continues to decline shedding an additional -1,600 jobs. While construction fell in 2011, job losses in this sector are considerably less than the sharp declines experienced over the previous five years. As of February 2012, the construction sector has lost a staggering -76,500 of jobs since the peak in June 2006. More encouragingly, employment in the manufacturing sector, has now increased for two consecutive years after four years of layoffs. Local governments slashed employment levels by -1,500 as property values plunged and tax revenues collapsed. Employment by the federal government declined by -500 jobs in 2011.

International trade increased just shy of 16% in 2011 compared to 2010. The recovery in international trade has a positive impact on the county's economy due to its geographic location since Riverside county serves as the main distribution center for roughly 75-80% of goods for the region's two ports (the Los Angeles Port and Long Beach Port). The increased demand from emerging markets and other global regions caused a sharp increase in international trade. While higher oil prices are expected to dampen trade in the first half of 2012, this is likely to be a temporary setback. Trade should continue to support the local economy in 2012 but at a more moderate pace compared to last year given the current slowdown in the emerging markets and weakness in the Eurozone.

The main force behind the strong economic growth in the Inland Empire prior to the Great Recession was from hiring in construction, manufacturing and the housing-related retail sector. In fact, from 2000-2007, Inland Empire added a total of 282,500 jobs -- or nearly 42% of California's 685,300 jobs. However, most of these jobs were wiped out during the recession. Though job growth has resumed recently in the region, employment rolls are currently around the same level as in 2003 despite the fact that during that time the county's population has risen by 23%. This means that going forward the challenges for the county's labor market remain formidable given the sizable drop in employment during the recession.

The labor market has improved considerably and is expected to continue to gradually improve over the forecast horizon. A host of sectors should continue to expand employment over the next few years, though at a slow pace in the short-term. Most jobs are likely to be created in Professional and Business Services; Health and Education; and Trade, Transportation and Utilities with the pace of job growth in this sectors still below the pre-recession years. We expect a modest pick-up in manufacturing jobs in the county given recent positive trends in this sector. The main sectors that will continue to experience setbacks are Construction and housing-related which will continue to lag the overall recovery. A recovery in these sectors is years away when the real estate sector stabilizes and foreclosures are no longer a major concern.

The Housing Sector

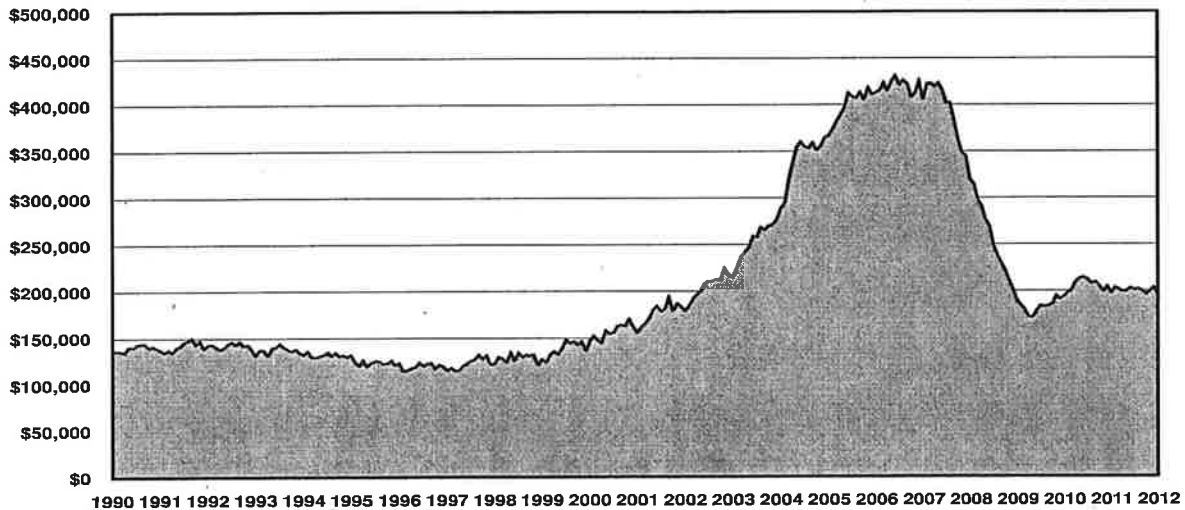
The housing market in Riverside County posted modest price declines in 2011, though at much more measured pace. In fact, according to the data from the California Association of Realtors (CAR), median home prices for single-family homes market appears to have stabilized around \$200,000 -- a notch below the 2002 prices. This suggests that the recent housing crisis has wiped out a decade's worth of gains for the county's residents.

Home prices for the County experienced a setback in mid-2010 as government's tax credit -- which temporarily boosted demand -- expired and the market experienced renewed weakness. Based on the recently revised data by CAR, which now includes a larger sample of transactions, single family median house prices rose from a cycle low of \$171,480 in April 2009 to \$214,335 in June 2010 -- a 25% increase. These gains were partially reversed in the following months of 2010 and in 2011. As of the latest data (February 2012), single family median house price is at \$203,640, up by 18.8% from its recession lows.

The apparent stabilization of home prices around \$200,000 is at far lower levels relative to the housing boom period which generated much of the County's economic growth. Single family median house prices increased from \$136,832 in January 1990 to a record high of \$431,713 in June 2006. At their peak, housing prices and income at the county level were grossly misaligned with only 32% of the borrowers able to afford the median home price.

The next three years witnessed a dramatic and relentless fall in housing prices which led to the most devastating loss in real estate value in the history of the County. The decline which began in June 2007 continued for 22 consecutive months (Figure 4). On a year-over-year basis, the free-fall lasted a total of 31 months. By the end of April 2009, home prices had declined by 60% relative to their peak values (June 2006). The sharp fall in housing prices devastated the county's economy, shrinking homeowner equity and shriveling property tax revenues. It continues to remain a major impediment in the county's recovery.

Figure 4
Median Price of Existing Detached Homes
Riverside County



Source: California Association of Realtors

Prices for new homes also remain depressed given low demand and sluggish job growth. The median price in the fourth quarter of 2011 for new attached homes was \$293,000 while for new unattached homes was

\$221,250. Prices for these types of housing are more in line with those recorded during the 2002-2003 period.

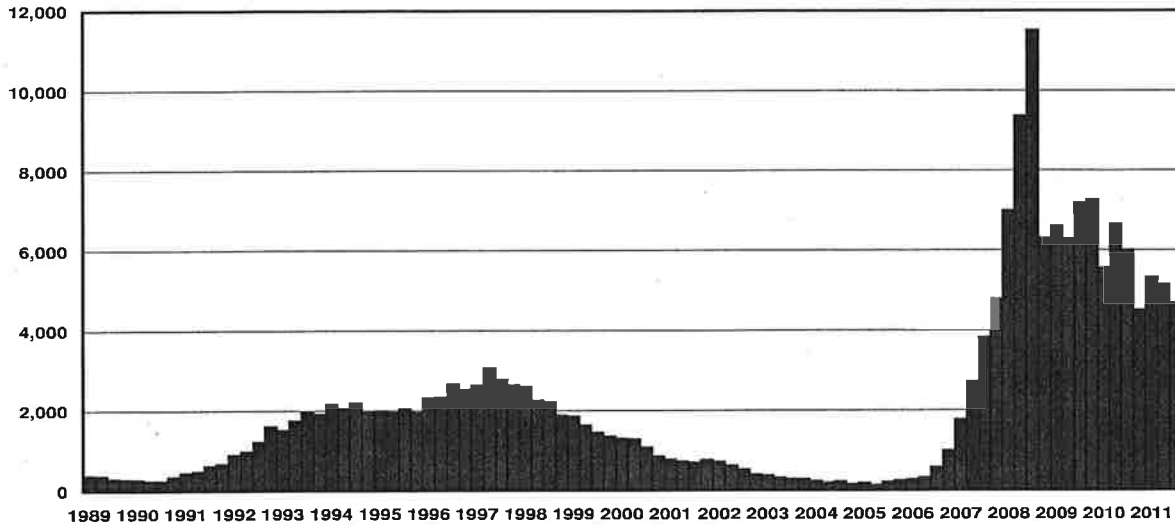
One positive development from the sustained drop in home prices is that housing affordability in the county has improved significantly over the past two years. It stood at 69% in the fourth quarter of 2011, which means that 69% of residents are able to afford the median priced home. At the current level, housing affordability is at the highest level in over twenty years and should help the region's economy in the long-term.

The large number of distress properties in the county is expected to weigh heavily on home prices over the next two years restraining demand even as the economic recovery continues to move forward and expand. We expect home prices to weaken slightly (-1% to -2%) from their current levels in 2012, stabilize at low levels in 2013 and post modest increases until mid-to-end 2015 when the excess inventory is expected to have normalized somewhat from its current historic-high level.

Foreclosure rates remain a major concern for the region with the county still experiencing the second-highest foreclosure rate in the state of California in 2011. While the number of foreclosure filings have declined, largely due to the moratorium related to legal issues, they remain at elevated levels. During the fourth quarter of 2011, there were 4,689 foreclosure filings in the county, which represents a decrease of 59.3% from a record-high of 11,523 in the fourth quarter of 2008 (Figure 5). Much of this decline is due to the moratorium on

foreclosures which was put in place in response to illegal filings and other irregularities in the foreclosure process.

Figure 5
Quarterly Foreclosures Riverside County



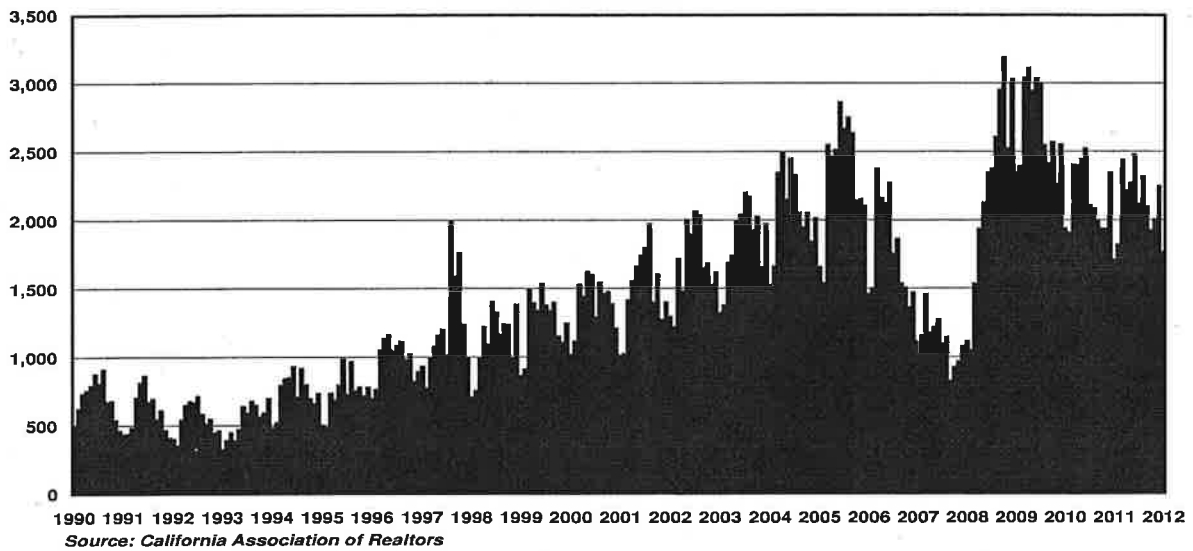
Source: Real Estate Research Council

The number of foreclosures is expected to increase in 2012 as the foreclosure process resumes its normal course after the settlement of the state attorneys' general with major servicers. In addition, though signs of economic pickup have recently spurred job growth in the county, much of the fundamentals needed for a meaningful housing recovery are simply not there yet. The unemployment rate remains high, the county has a significant amount of mortgages underwater (43.7%), and income growth has been minimal due to weak job creation. Nonetheless, while foreclosures in 2012 will exceed their 2011 level, they will be below the peak levels recorded during the crisis.

Sales activity has largely reflected distress sales in the region. In fact, 68% of sales in the county are distressed sales while

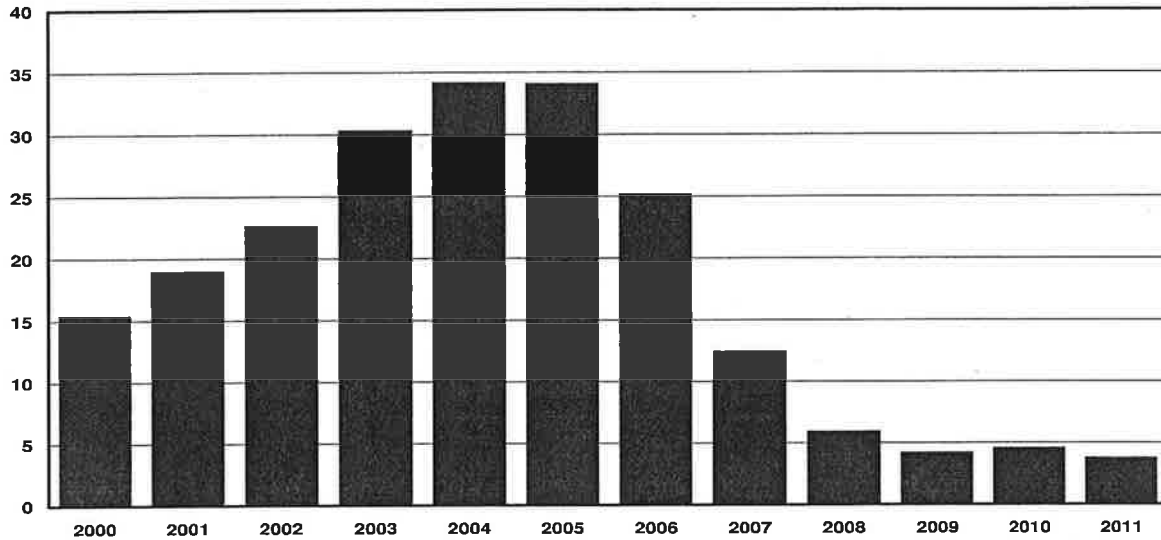
29% are short sales. This makes it difficult to assess real non-distressed activity since distressed sales account for such a large portion of transactions. According to California Association of Realtors, single family sales in the county fell by -2.7% in 2011 compared to 2010, but this likely reflects the interruption of the foreclosures process (Figure 6).

Figure 6
Single Family Sales (monthly units)
Riverside County



Given the large overhang of housing inventory, it is no surprise that construction activity remained at very low levels in 2011 -- resembling a mere shadow of its former self (see Figure 7). Annual new housing permits (single and multi-family) declined by -17.7% to 3,751 from the already depressed permit levels issued in 2010. In contrast, during the peak of the housing cycle in 2004-2006, building permits averaged over 31,100 units per year. Residential building permits are expected to remain at low levels over the next few years as weakness in the housing market limits new construction in the area.

**Figure 7
Residential Building Permits Riverside County (1,000s)**



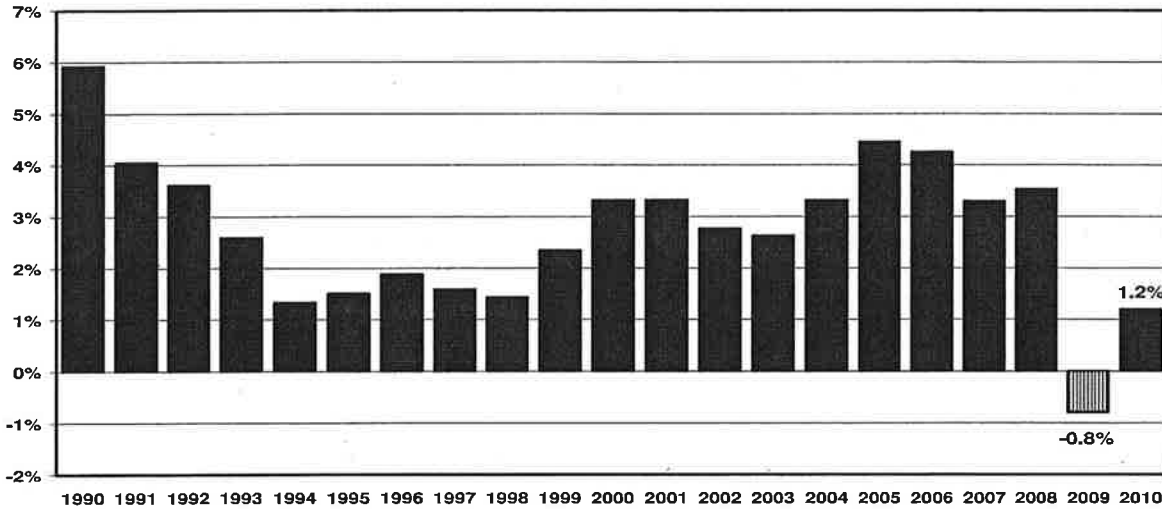
Inflation

Riverside County headline inflation (which includes food and energy prices) as measured by the consumer price index for the Los Angeles-Riverside-Orange Counties, increased by 2.7% in 2011 (Figure 8). This follows a 1.2% increase in 2010 and a -0.8% decrease in 2009. The current higher inflation rate is still within the 2000-2008 levels when inflation rose steadily averaging between 2.6% and 4.5% per year. The concern with higher inflation is mostly related to the recent escalation in oil prices which take a sizable chunk out of the county's residential income particularly since a good portion of its labor force commutes to the coastal counties for work.

Inflation is expected to edge up further in 2012 given higher oil prices and further improvements in economic activity. Nonetheless, some of this pressure will be partially offset by weak wage and income

growth as labor market continues to heal very slowly from the depth of the recession. While we project a steady increase in inflation over the forecast horizon, we expect inflation expectations to remain well-

Figure 8
Los Angeles-Riverside-Orange County
Consumer Price Index



anchored in the long-run.

Summary

In summary, the Riverside County economy will continue to heal over the next few years, but the healing process will be slow and take longer than the usual post-recession recovery. The labor market will continue to improve and the unemployment rate should decline steadily, but the pace of improvement should be below trend and certainly below the boom years in the middle of the past decade. The near-term future outlook for the county will be characterized by modest job gains, high but falling unemployment rates, a sluggish residential housing market and concerns about segments of the commercial real estate. The speed

of the economic recovery in the county is still heavily dependant on the real estate market which shows little signs of staging even a moderate recovery. Going into 2012, the lingering negative effects in the real estate market will most likely cause a decrease in assessment rolls in FY 2012-2013. The continued deep cuts in public sector spending from state and local government will further restrain economic growth. Inflation will increase in 2012, but should remain contained in the near term given the wide margin of slack in economic activity in the county.

B2. LONG TERM OUTLOOK AND FORECAST

The long term economic outlook for Riverside County is much more upbeat than the near-term path. While the county will likely struggle until the middle of this decade (largely due to its collapse of the housing market and weak employment growth), its long term prospects (beyond 2020) are bright. So while the short- and medium-term outlook for the county is for moderate growth, the long-term is decidedly more prosperous with growth rates settling somewhat below the stellar performance of pre-recession years, but far above the current sluggish pace.

As argued above, Riverside County continues to face some tough challenges in the near-term given the decline in property values, continual Proposition 8 reassessment of residential and commercial property values by the County Assessor's Office, and pending foreclosures. During the next few years, the County's economy should trail behind the southern California region and its performance will

depend heavily on the neighboring counties. In addition, the housing crisis will have a lasting impact on the county's economy as sharp declines in construction activity will contribute to a structurally higher unemployment rate for the foreseeable future and lower standards of living. While the local economy will continue to slowly recover from the recession, it will not resemble that of the pre-crisis. Some construction and manufacturing jobs may not return in the medium term and economic growth will trail significantly below the boom years.

Most of these issues are likely to be resolved by the end of the decade as the county's economy heals and as the distance from the Great Recession widens. As such, the long-run outlook for Riverside County remains positive given its fundamentals. Riverside County should outperform the coastal counties in the long-run given its large size and the availability of relatively affordable land. Other major advantages for the County are its location near the major ports, large swathes of undeveloped land, large storage facilities, affordable housing and relatively low rental rates. In addition, with many workers well trained in and specialized in areas such as logistics, construction and manufacturing, the county is poised to experience significant growth once these sectors recover.

Affordable housing in the county should attract many of the projected 78 million "baby boomers" who will retire over the next two decades. Given that much of the coastal communities are well developed, stronger growth in Southern California should attract more migration into the county in the long-term and boost the demand for

housing and goods and services. Stronger growth should support net migration into the county in the long-term which should boost demand for housing, retail and sales. The County's population is projected to grow by more than 2% from 2015-2030, which is far above the expected levels for the surrounding areas. This indicates that, in the long-run, comparative advantage will be restored and the County's economy will be driven once again by affordable housing, cheap and abundant land, and population growth.

The County will remain heavily involved in logistics because of its central location, proximity to the ports of Long Beach and Los Angeles, and its pivotal role in transportation and distribution of goods. This remains an important driving force for the local economy given an increasingly competitive global market and expanding trade volumes. As the Southern California region grows, Riverside County will be able to attract new business because of the relatively low cost of office, industrial, retail real estate and logistics. In addition, affordable housing will ensure that a skilled work force will be available to meet an increased demand for labor. Thus there are strong fundamental forces that will support the County's growth in the long-run.

B3. PROJECTIONS OF RIVERSIDE COUNTY MAIN ECONOMIC VARIABLES

**Table 7 (continued on next page)
Riverside County Forecasts¹**

Historical			
Year	Payroll Employment¹	Unemployment¹	Single Family Median House Prices²
2009	-7.3%	13.3%	\$182,603
2010	-0.8%	14.5%	\$206,179
2011	0.3%	13.4%	\$200,550
Forecast			
2012	1.5%	12.3%	\$198,946
2013	1.7%	11.4%	\$203,720
2014	2.1%	10.2%	\$211,054
2015	2.5%	9.3%	\$222,451
2016	3.1%	7.8%	\$237,133
2017	3.6%	7.0%	\$255,629
<p>1. Source: Employment Development Department 2. Source: California Association of Realtors. The data includes the 2011 revisions from the increased sample of transactions.</p>			

Table 7 (continued)

Year	California Consumer Price Index ¹	Consumer Price Index Los Angeles-Riverside-Orange Counties ²	Building Permits (in 1,000s) ³
Historical			
2009	-0.3%	-0.8%	4.2
2010	1.3%	1.2%	4.6
2011	2.6%	2.7%	3.8
Forecast			
2012	2.4%	2.2%	4.1
2013	2.3%	2.1%	4.7
2014	2.9%	2.7%	5.5
2015	3.0%	3.1%	6.7
2016	2.9%	2.8%	8.7
2017	2.8%	2.7%	11.0
1. All items with base period 1982-84=100, Source: California Department of Finance 2. All items with base period 1982-84=100. Source: Bureau of Labor Statistics 3. Source: Construction Industry Research Board			

C. U.S. MACROECONOMIC OVERVIEW FORECAST AND REPORT

"If you want the rainbow, you have got to put up with the rain" -- Dolly Parton once famously remarked. True enough, after a grueling wait of two and a half years fraught with near-recession risks, gloomy prognosis, and quasi-catastrophe scenarios, the U.S. economy has gathered strength and the recovery has picked up momentum. This positive trend, which began in the last three months of 2011, has continued in the current year. Improvements are broad-based: labor markets have strengthened, retail sales continue to tick higher, real activity has grown at a solid pace, business investments continue to expand, consumption spending has remained steady, credit markets have normalized, and corporate profits are at an all-time high. Add these up and the case for modest optimism is a solid one. The recovery is now more broad-based than at any point in time since the Great Recession, showing both signs of depth and resiliency.

Despite these encouraging developments, we expect the recovery to proceed at a moderate pace -- a notch below the U.S. long-run potential growth and well below the historical rates of previous post-war recoveries. Our "no boom, but less gloom" outlook is shaped by our belief that while the U.S. is finally experiencing a real cyclical recovery, structural challenges and external shocks -- while unable to choke-off the upturn in economic activity -- will nonetheless considerably restrain the strength and the pace of the expansion. While healing, the U.S. economy will continue to edge forward in moderate steps rather than by leaps and bounds, but the progress ahead will persist and become more robust with the growing distance from the

Great Recession. In sum, while the recovery is neither spectacular nor dramatic, it is nonetheless real.

Though 2011 proved to be a near-utter disappointment, it served an important purpose in establishing the resiliency of the current recovery. High oil prices early in the year took a sizable chunk out of discretionary spending, and Japan's tsunami and earthquake severely disrupted supply chains around the world. Midsummer blues brought forth renewed concerns from the Eurozone sovereign debt crisis, political brinkmanship over the debt ceiling eroded confidence, the U.S. credit downgrade further depressed sentiment, and revisions of real GDP figures revealed that the recession was much deeper than previously thought and the subsequent recovery significantly shallower. As of mid-September 2011, everything that could go wrong had gone wrong: the labor markets seemed frozen, financial markets were operating in panic-mode, housing showed no sign of life, consumers appeared shell-shocked, and businesses seemed paralyzed. Calls for an imminent double-dip grew deafeningly loud as the U.S. economy inched dangerously close to the cusp of another recession.

As we had anticipated, these fears were overstated and the U.S. economy proved more resilient than most anticipated. Q4 2011 recorded solid growth, marked improvement in labor markets, robust consumer spending, and export strength. We expect this trend to continue with the recovery becoming more mature, broader-based, and more self-sustained during the current year. A few positive factors should support growth going forward: labor markets are expected to improve further, income should grow reflecting higher employment levels,

business investments should remain robust, and production should expand further. There isn't one main driver supporting the moderate rebound ahead - just incremental improvements across a number of sectors.

Nonetheless, this cyclical recovery will remain moderate in the face of a number of structural challenges and external shocks. To start, this rebound is inherently more anemic than the garden-variety kind having followed in the footsteps of a severe housing crisis and a global financial near-collapse. The housing market, while stabilizing, is a long way off from a complete recovery given the looming supply of foreclosed homes, tighter lending standards and hesitant demand. Improvements in the labor market have been disappointingly slow when compared to the draconian job cuts during the recession and come amidst an alarming decline in labor force participation and a growing skills mismatch. Government spending is projected to become a drag on economic growth over the next two years as fiscal austerity measures (through automatic stabilizers) are set to kick in as the economy recovers. To make matters worse, fiscal austerity measures are expected to take effect in the short term -- when the economy is still fragile -- but fail to address long-term deficit reduction issues through entitlements and tax reforms.

There are three main risks to our baseline scenario of moderate and sustained growth. First, the Eurozone area, while no longer on the brink of a Lehman-like calamity, is nonetheless in the middle of a mild recession. Though its sovereign debt crisis has abated somewhat after the Greek debt restructuring, the fear still remains that

pressure may build on other vulnerable economies (such as Italy or Spain). Second, oil prices have risen steadily during this year, posing a significant risk to the world economy. Increased tension with Iran and escalating conflicts in the Middle East may place further upward pressure on oil prices with negative consequences for growth. Third, growth in emerging markets (notably China and Brazil) has slowed down markedly in the past few months reflecting a deceleration of internal demand and policy tightening aimed at containing inflationary pressures. Though we don't expect these economies to experience a "hard-landing", this downshift should negatively impact U.S. exports in the near-term. In addition, the U.S. presidential election is expected to fuel partisanship rancor, which means that there will be more uncertainty and less agreement on policy issues (taxes, entitlements) until after the election.

Below we provide an analysis of the U.S. economy and discuss our outlook and forecasts as they relate to some of the main components of the economy: (A) real economic activity, (B) inflation, (C) financial and government sectors, and (D) global environment. Section (E) details our projections of key national economic variables.

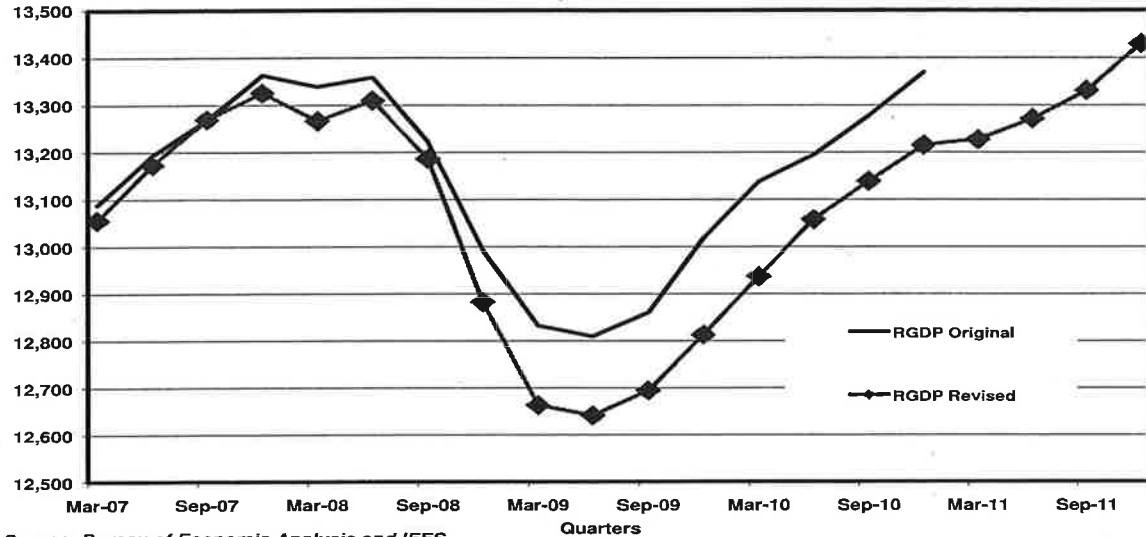
C1. Real Economic Activity

Real economic activity, as measured by real gross domestic product (RGDP), expanded by a solid 3.0% in 2010 after declining by -0.3% in 2008 and by an additional -3.5% in 2009. After the initial boost of 2010, the following year proved to be an utter disappointment: growth averaged a mere 0.75% in the first half of 2011

and a slightly more upbeat yet still anemic 1.8% in Q3 2011. Economic activity all but stalled in mid-year when it seemed that the U.S. economy was inching dangerously close to recession territory. Part of this was due to the dampening effect of higher energy prices and supply chain disruptions from Japan's earthquake and tsunami.

Mid-year panics related to RGDP numbers are now the norm rather than the exception. In what has become a depressing routine, U.S. RGDP numbers were revised downward yet again in late July revealing a disheartening story: real economic activity fell by an astounding -5.1% during the recession -- a much deeper collapse than the revised -4.1% (from an original -3.8%) reported a year earlier (Figure 1). At some point in Q4 2008, the economy was contracting at a shocking rate of -8.9%, the largest drop in five decades. The subsequent recovery turned out to be much flatter than previously thought having recovered from its pre-recession peak (recorded in Q4 2007) only in Q3 2011 -- more than four years after the initial decline -- even though the U.S. population grew by close to 10 million during this time.

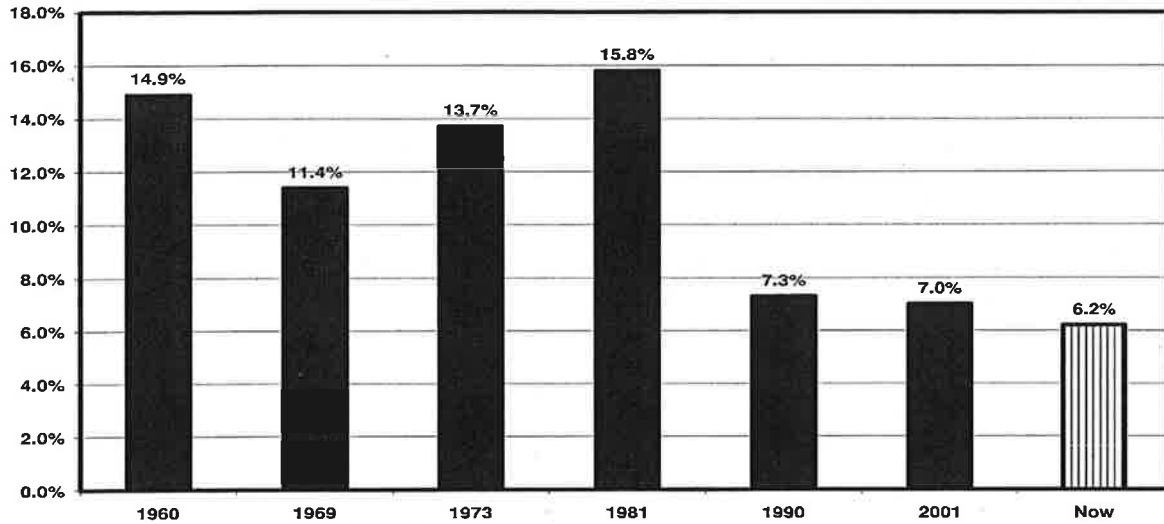
Figure 1
Mind the Gap
(Real GDP, level)



Source: Bureau of Economic Analysis and IEES

Though the pace of economic recoveries has downshifted significantly over the past 20 years, this recovery has been weaker even when compared to the previous two (in 1990s and 2001) which were similarly lackluster and slow. Prior to the recession of 1990, RGDP growth was in double-digits during the first ten quarters of each recovery, growing by a total of 14.9% after the recession of 1960, by 11.5% in early 1970, by 13.7% after the recession of 1973, and by 15.8% after the early 80s recession (Figure 2). In contrast, the economy grew by a feeble 7.3% in the 10-quarter span after the 1990s recession, by 7.0% after the recession of the early 2000s and only by 6.2% since the current recovery began. This is not surprising particularly in light of the fact that this recovery came in the heels of a housing and financial crisis and a balance sheet recession -- which takes a lot longer to repair than a garden-variety business cycle recession.

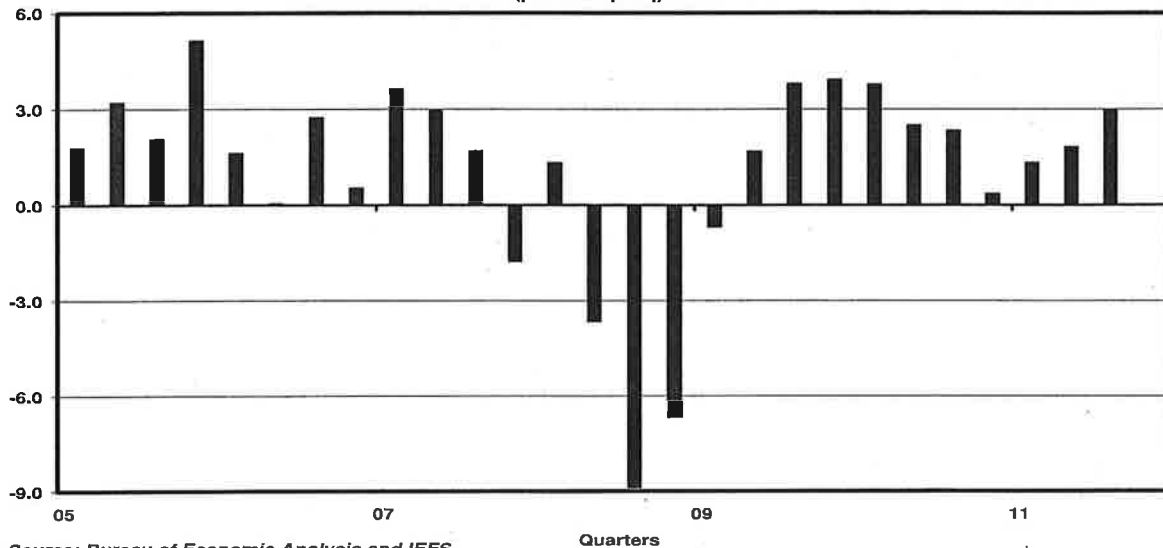
Figure 2
Real GDP gains in the first Ten Quarters of the Recovery
 (% change, total)



Source: Bureau of Economic Analysis and IEES

The good news is that 2011 ended on a strong note and most of the momentum has carried over in 2012. Growth came in at 3.0% in Q4 2011, which was revised upwards from a 2.8% early estimate (Figure 3). While this was the third largest increase in real GDP since the end of the "Great Recession," it is the biggest quarterly gain in 6 quarters. Improvements were broad-based with final demand firming up by 2.5% (q-o-q) and consumption spending edging up to 2.1%.

Figure 3
U.S. Real GDP Growth
(percent q-o-q)



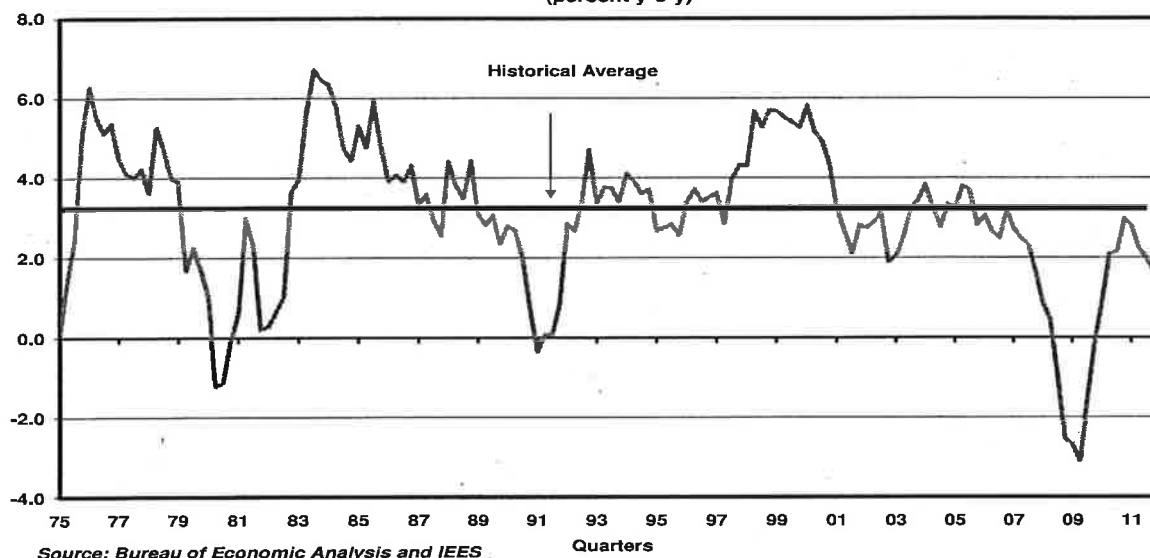
Source: Bureau of Economic Analysis and IEES

We expect U.S. real GDP growth to continue to expand during this year, though the cyclical recovery will be restrained especially in the first half by higher energy prices and a "soft-landing" of emerging market economies. Developments in the Middle East (particularly escalating tensions with Iran) and further fallouts from the European debt crisis present additional downside risks to our forecasts. In absence of such adverse shocks, U.S. real GDP is expected to grow by 2.4% in 2012 and by 2.6% in 2013, well below the "average" post-recession levels. Based on a number of macroeconomic trends discussed below, we expect the recovery to gain breadth and pace over the forecast horizon, but continue to be hampered by structural factors (labor, deleveraging, budget deficits) and remain vulnerable to external shocks (oil, Eurozone crisis, global slowdown). In the long-run, our overall assessment of the U.S. economy based on our econometric models is positive with long-run real GDP growth at roughly 2.5-2.7%.

Consumption Spending

Personal consumption expenditures make up the bulk of real economic activity, accounting for about 70% of real GDP. As such, any meaningful recovery would have to be supported, in part, by this component, given the sizable share of economic activity that this sector commands. Though holding steady at a 2.2% annual rate in 2011, real consumer spending during this recovery cycle is well below the historical average (roughly around 3.3% y-o-y) and far below the average post-recession rate (Figure 4).

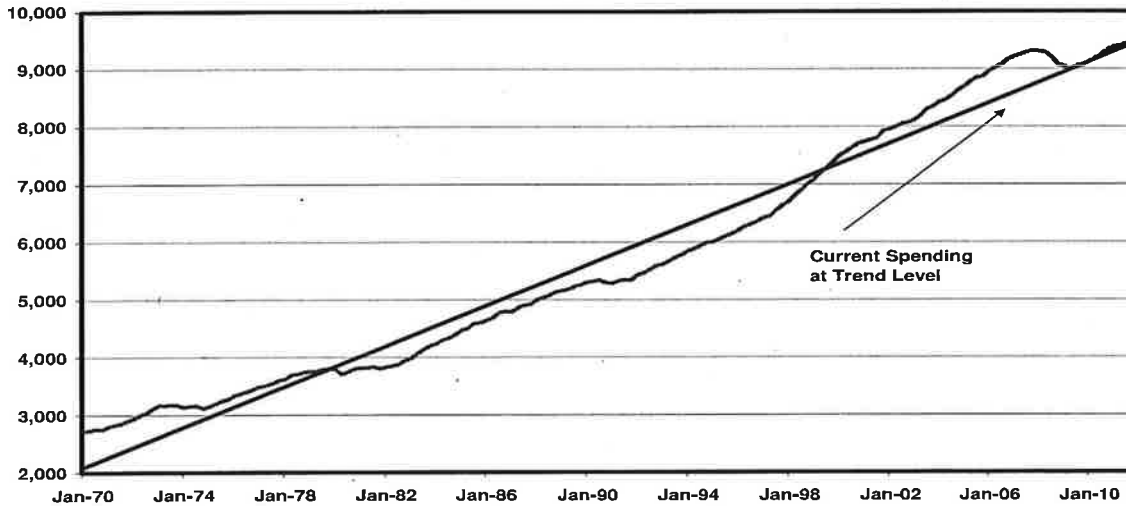
Figure 4
U.S. Consumption Expenditures
 (percent y-o-y)



In fact, over the 10-quarter period since the official end of the "Great Recession," consumption has risen by a mere average annualized pace of 1.5%, coming below the 2.9% rate of 2001 and the 2.5% in the early 1990s, and falling far short of the 4.5% pace of post-recession growth during the recoveries of 70s and 80s.

Consumer spending declined by an astounding -3.4% during the recession -- the largest drop in the post-war era. And while it has bounced back by a total of 5.4% since the trough of the recession, the gain is nonetheless tepid when compared to a double-digit pace set in earlier recoveries. More importantly, real consumer spending seems to have suffered a structural break from last decade's consumption boom and has now settled at a permanently lower rate which appears more in line with the historical trend (Figure 5). This indicates that the current rate of consumption spending will likely hold up over the forecast horizon and the excesses of the last decade will not be repeated.

Figure 5
Real Consumption Spending and Trend Level
 (level, billions of dollars)



Source: Bureau of Economic Analysis and IEES

The sub-par performance in spending is expected given the formidable forces weighting on consumers. Sluggish income growth, a gruesome multi-year deleveraging process, the lingering effect of home wealth depreciation, and tight access to credit for many potential borrowers, have restrained consumer demand. As the financial and housing crisis decimated household wealth, consumers began to pay down debt and boost savings at the highest rates in three decades.

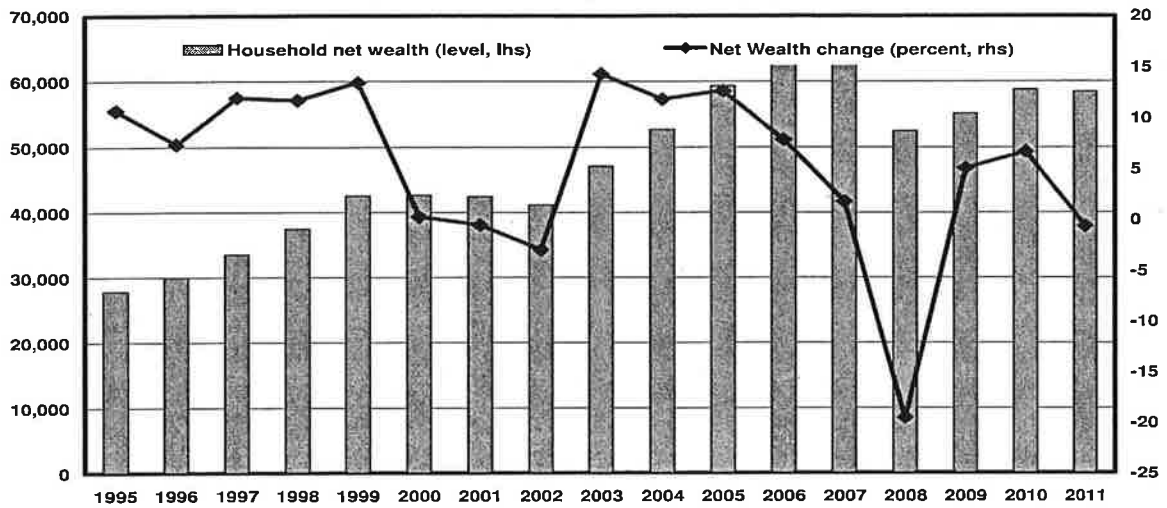
Income growth has been another soft spot for consumers; real disposable income grew only by 0.6% over 2011. Though wage and salary growth has picked up during recent months, reflecting continued improvements in the labor markets, private sector average hourly earnings have risen just 1.6% over the past year and real disposable income on a per capita basis is essentially flat. The current rise in gasoline prices is taking another sizable chunk out of disposable income, further eroding purchasing power. In general, every sustained 1-cent increase in gasoline prices, costs around \$1.05 billion in additional spending, which means that the recent 73-cent run-up in gasoline prices since the start of the year will roughly translate into an additional decrease of \$76.6 billion in household spending.

Despite these concerns, it is worth noting that consumer expenditures have improved meaningfully compared to a year ago. In particular, Q4 2011 recorded a surge in purchases of motor vehicle sales which, after plunging to a recession low of 9.5 million (June 2009) now stand at 15 million (adjusted annual rate) -- the highest level since February 2008. Much of this reflected the unleashing of the pent-up demand from exceptionally weak sales in spring and summer

2011 due to the dampening effects of the earthquake in Japan on motor vehicle supply. Real retail sales grew by a solid 4.4% average pace in 2011, though the pace of improvement downshifted somewhat early in 2012. Consumer confidence has continued to improve over the past few months, and as of the latest reading is standing at the second highest level since before the financial crisis.

Consumer balance sheets are now healthier than at any point during the recovery. Household net worth grew by 19.2% over the past 2 years, rising from a trough of \$49 trillion to the current level of \$58.8 trillion (Figure 6). This was largely due to gains from investments in equity markets which regained renewed strength in the final quarter of 2011. Despite these improvements, household wealth remains \$8.4 trillion below its pre-recession peak levels with financial assets around \$3.0 trillion lower and the value of household real estate holdings an additional \$6.7 trillion below peak levels. Household debt continues to decline reflecting continued contraction in mortgage debt which is only partially offset by a modest expansion in consumer credit. Household debt-to-service ratio has also fallen in tandem with reduced debt burdens and it now stands at the same level as in the mid-1990s.

Figure 6
Household Net Wealth
(billions of dollars and percent changes)



Source: Board of Governors of the Federal Reserve System and IEES

We expect consumption spending to continue to grow over the forecast period, albeit at a slower clip in the first half of the year than the most recent data suggests. On the plus side, gains in the labor market, the extension of tax-cuts and unemployment benefits, a lower debt to income ratio, and falling loan delinquency rates are expected to support consumer spending going forward. The pace of improvement however, will be restrained by persistently high energy prices, sluggish income growth, and continued weaknesses in the housing sector. Though some downside risks remain, especially with regards to oil prices, consumption should grow by around 2.1% this year and by an additional 2.3% in 2013.

Investment Spending and Production

Private investments, particularly investments by firms in Equipment and Software (E & S), have boosted growth over the past two

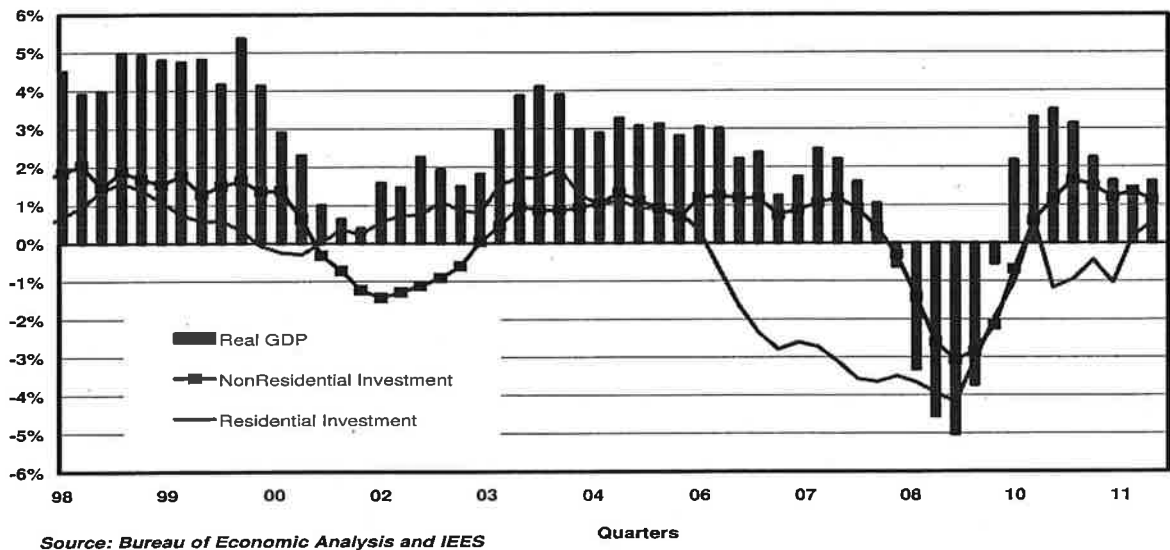
years -- adding around 1.9% to real GDP in 2010 and an additional 0.6% in 2011. In fact, business investments grew by a sharp 20.6% pace in Q4 2011, largely due to a build-up in inventory levels. Total private investment has risen by 19.5% since their trough in Q4 2009, though they still remain around -7.3% below their pre-recession peaks. Business fixed investment rose by a more robust 6.7% in 2011 compared to a 2.6% gain in 2010. This investment component, while remaining in positive territory, is expected to become a soft spot for real GDP growth in the first half of this year, particularly since shipments and orders were likely pulled forward into 2011 in order to take advantage of more generous tax treatments.

Outlays for equipment and software rose by a remarkable 16.4% in 2010 and a more subdued 10.2% pace in 2011 as firms replaced outdated capital and resumed capital spending that was deferred during the recession. Although spending for high-tech equipment and software has held up reasonably well, the latest data (Q4 2011) shows an appreciable slowdown in this trend. Investments in high-tech E & S are the only component of business investments that have fully recovered the losses inflicted by the recession and are currently around 3.3% above their pre-recession peaks. We expect this investment component to add to real GDP growth in 2012 as business sentiment and capital spending improve suggesting that firms may be more willing to expand production capacity and undertake new investments.

After plunging by an astounding -59% from its peak in 2005, real residential investments have finally increased for three consecutive quarters, posting an impressive 11.5% growth in Q4 2011. All told,

this sector has risen by 4.4% since its cycle-lows, in line with our last year's forecast (Figure 7). More encouragingly, home building has picked up at a consistent and steady pace, although the growth rates seem more impressive precisely because activity has resumed from an incredibly shrunken base. Though the current homebuilding activity is merely a shadow of its former self and it will be years before this sector returns to normal growth, gradual improvements in this component should be supportive of real GDP growth. In addition to new home construction, outlays on home improvements have also risen over the past few months as some remodeling projects are taken up after a near four-year inactivity in this front. We expect real residential investments to show gradual improvement over the forecast horizon, boosted primarily by construction of multi-family units.

Figure 7
Real GDP, NonResidential and Residential Investments
 (percent, year-on-year change)

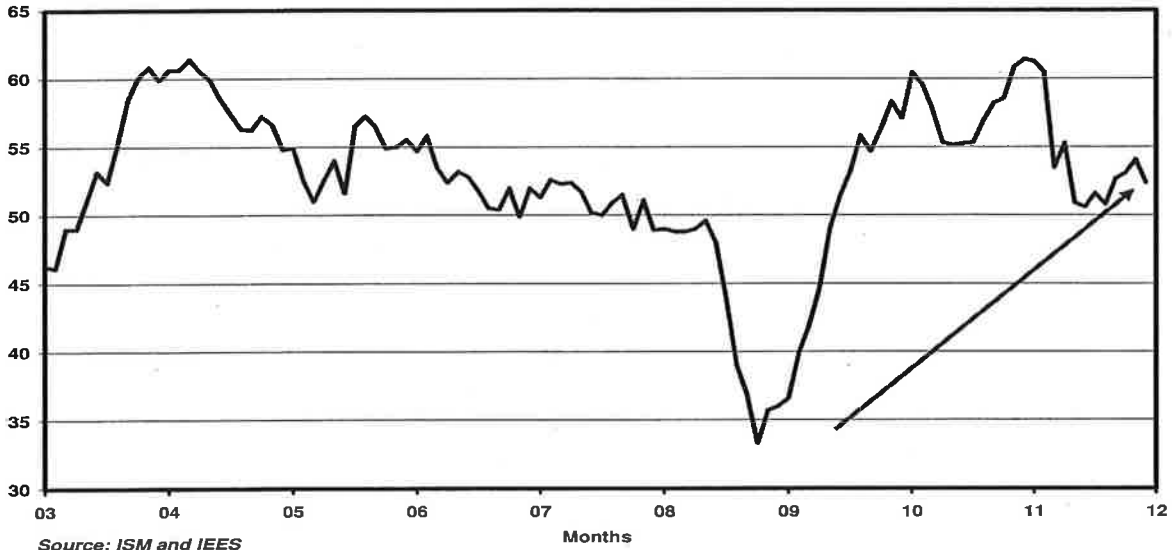


Non-residential investments, which comprises the larger portion of private investments and includes expenditures on structures (commercial buildings, retail stores, industrial plants, warehouses) and durable equipments (computers, information processing industrial and other equipments), rose by 8.7% in 2011, posting gains in every quarter of the year. Encouragingly, some of these gains were due to a robust pick-up in nonresidential structures which rose by 22.6% in Q2 2011 and by an additional 14.4% in Q3 2011. However, investments in structures slipped by -2.6% in the last quarter of 2011. Conditions in this sector continue to remain difficult: vacancy rates, though improved, are still high, property prices continue to remain low and financing for builders is still tight. Investments in mining and drilling facilities should resume after a drop in Q4 2011 supported by elevated energy prices and advances in technology for drilling and fracturing. Overall, we anticipate this investment component to post modest improvements for the balance of the year.

Production activity rose by an average annualized pace of 4.2% in 2011, below the brisk rate of 5.3% recorded in 2010. From the trough of June 2009, production has risen by an impressive 14.8% with capacity utilization improving from a low of 67.3% to a current 78.6% rate -- below the full-utilization level of 83%, but still a remarkable improvement. The latest data have softened a bit and point to a more moderate start of the year: the Institute for Supply Management (ISM) manufacturing survey fell back slightly in February after posting advances for four consecutive months (Figure 8). Nonetheless, the index is noticeably above the demarcation line of 50

that separates expansions from contractions, which means that production likely expanded early in the year albeit at a lower clip.

Figure 8
ISM Manufacturing Composite Index
 (level)



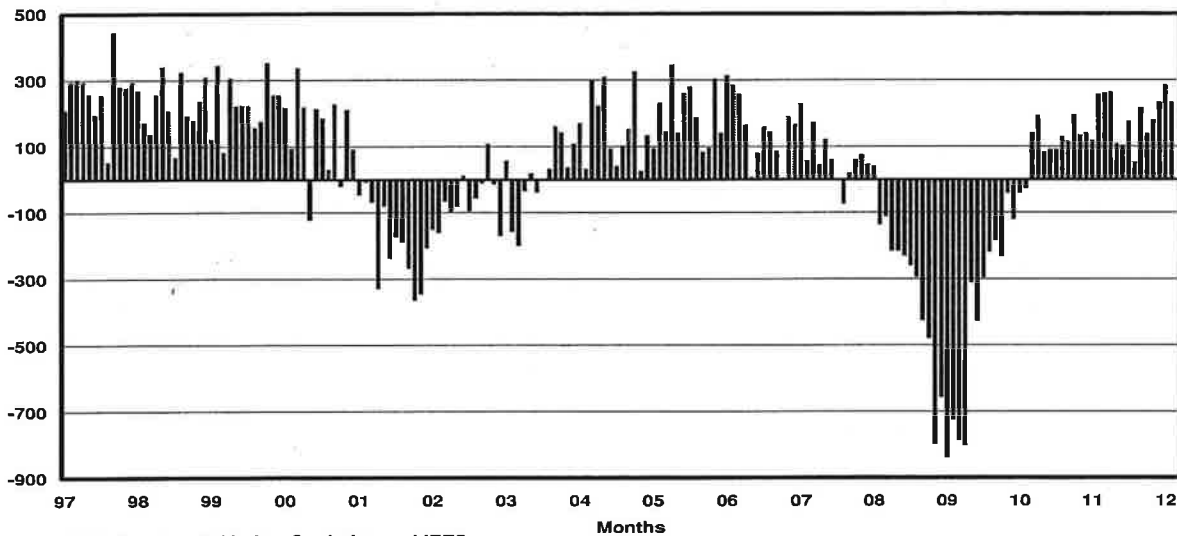
In addition, the non-manufacturing activity survey grew for the 26th consecutive month with the employment index soaring to its highest level in six years. We expect production activity in the manufacturing sector to continue to improve for the balance of the year, though the pace of increase will moderate slightly in the first half of the year. The service sector should continue to expand with further gains in employment which bodes well for the labor market.

Labor Market

One of the main reasons for renewed optimism in the new year is the brightened outlook for the labor market. After a gut-wrenching period of two straight years of job losses - which obliterated a total of 8.8 million jobs, and a frustratingly slow pace of job formation in

the subsequent two-year recovery, the pace of job growth has finally stepped up over the past three months. In fact, job creation has steadily edged up during the recovery averaging 132,000 jobs per month in 2010, 170,000 in 2011 and 259,000 in the first two months of 2012. Of course not everything went as smoothly as these figures would suggest: last year's job growth was similarly stellar in the first four months of the year (upwards 200,000 jobs per month) only to peter out to a mere 52,000 in mid-year as the economy seemed to tip ever closer to a double-dip recession (Figure 9). Nonetheless, Q4 2011 data showed continued improvement in employment numbers and the trend has spilled over and strengthened further in the current year.

Figure 9
Private Payrolls
(thousand of employees)



Source: Bureau of Labor Statistics and IEES

Improvements are broad-based: since the start of the recovery, the private sector has added a total of 3.9 million jobs, of which 2.1 million were in 2011. In fact, over 750,000 jobs were added during the past three months -- a sign that indicates momentum and strength.

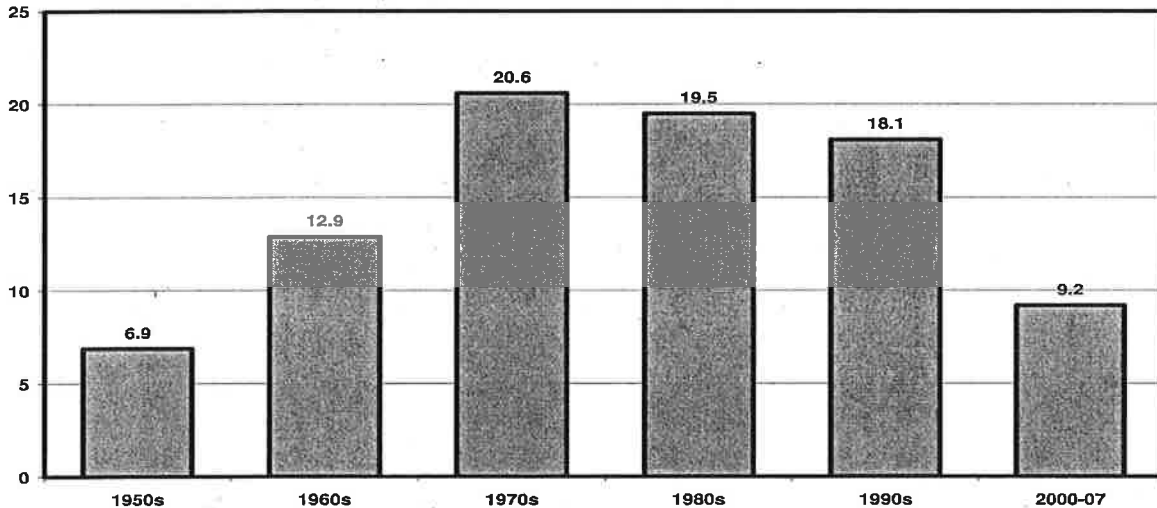
As of March 2012, the number of persons working part time for "economic reasons" declined to 8.1 million, roughly 1.3 million below the peak recorded one year earlier but still significantly above historical norms. The unemployment rate has fallen rapidly over the past 6 months -- declining from 9.1% in June 2011 down to 8.3% in March 2012. The number of long-term unemployed (those jobless for 27 weeks and over) has dropped to 5.4 million -- down from a cycle high of 6.7 million -- and now account for 42.6% of total unemployment.

Temporary help services, which is a leading labor market indicator, has been on an upswing since the start of the recovery more than two and a half years ago. Average weekly hours have also picked up indicating an increased demand for existing labor which should eventually translate into new hiring. Government layoffs seem to have abated lately after shaving off a total of nearly -600,000 jobs since September 2008. More importantly, private employment has increased for 24 consecutive months, and though early in the recovery the pace of job formation was far below desired levels, the overall trend and recent improvements are certainly encouraging.

It is now clear that the U.S. labor market is in the midst of a cyclical recovery, which will continue to expand over the near term and gain more traction bringing forth a much needed healing in this sector. Nonetheless, there are formidable structural forces restraining the pace of a meaningful rebound in employment that will likely hamper job growth during this entire decade. First, the pace of job formation downshifted significantly over the last decade prior to the crisis: the U.S. economy added a total of 20.6 million jobs in

the 70s, 19.5 million in the 80s, 18.1 million in the 90s, but only 9.2 million during the 2000-2007 period -- roughly half the number of the previous decades (Figure 10). Second, each subsequent recovery in recent times has become more "jobless" than the previous one. Pre-1990s, labor markets took on average 6-8 months to recover after a rebound of real GDP to pre-recession levels. This was extended to 15 months after the 1990s recession and to 40 months in 2001. In this cycle, two and a half years after the end of the recession, the labor market regained less than half of the total employment lost during the crisis which means that this recovery will be even more snail-paced than the previous two.

Figure 10
Total Payroll Employment per Decade
 (millions of employees, level)

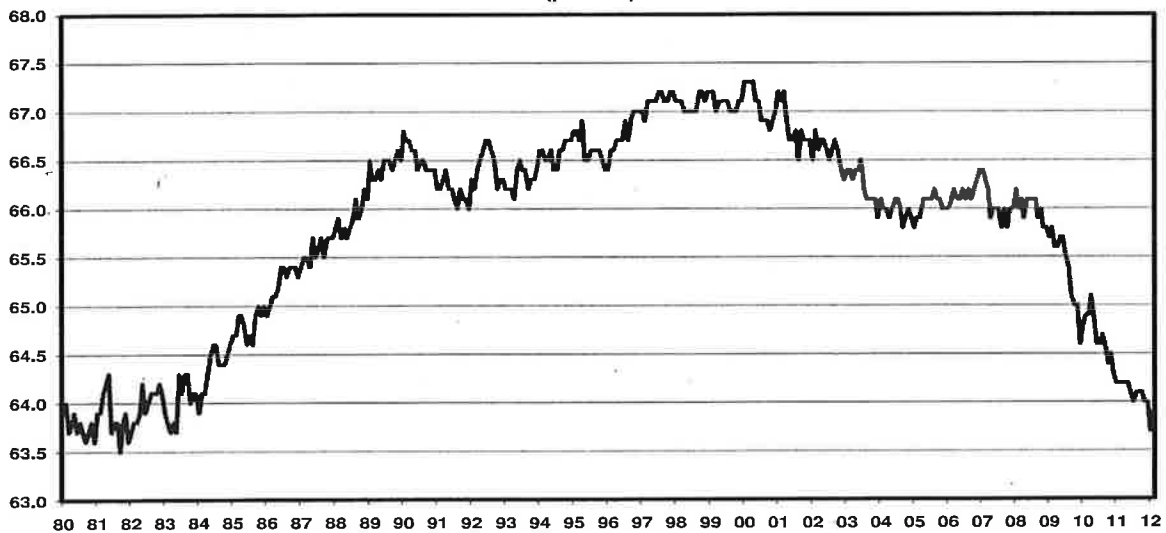


Source: Bureau of Labor Statistics and IEES

More concerning is a recent trend which points to a secular and consistent drop in labor force participation rates over the past decade, which has declined further after the crisis. The participation rate stands at 63.9%, significantly below the 66.4% rate recorded in

the years prior to the crisis. In fact, the labor participation rate is now at the same level as in 1983, when the labor force surged as women joined the workforce (Figure 11). Though the labor force tends to shrink somewhat after a recession as discouraged workers leave the market and rejoin when conditions are more favorable, this time around the decline seems to be more structural. Though it is tempting to ascribe this drop in labor force participation to the commencement of the retirement of the "baby boomers", it turns out that this demographic has actually increased participation rates since the crisis. A close inspection of the data reveals that this trend is largely due to two forces: the decline in participation rate of young adults (16-24 years old) and a discontinuation of the uptrend in female labor participation.

Figure 11
Labor Force Participation Rate
(percent)



Source: Bureau of Labor Statistics and IEES

Understanding the decline in labor force participation rates is important because it tends to obscure unemployment rate numbers. In

fact, there are reasons to be cautious about recent improvements in the unemployment rate which seem to be "out of sync" with economic activity: while the unemployment rate fell by a dramatic 0.8% in the past six months, real GDP rose by an exceptionally modest 2.1%. We suspect that the current unemployment rate paints a brighter picture than what is warranted by fundamentals which is partially due to the shrinking of the labor force and partially to seasonal adjustment patterns. Not surprisingly, if we hold labor force participation constant at pre-recession levels, even with the recent job growth, the unemployment rate turns out to be 11.2%!

Labor market issues are also more problematic after the Great Recession because of other undesirable features of the current cycle: the housing market collapse has further limited the mobility of the labor force adding an estimated 0.3%-0.5% to the unemployment rate, and the extension of unemployment benefits may have contributed an additional 0.2%-0.4% to that number. In addition, the quality of jobs added during the recovery is generally sub-par: retail trade, leisure and hospitality, temporary help and the home health-care industry account for over 40% of all the gains even though these sectors made up only 25% of all losses during the recession. These jobs tend to be generally low-paying and mostly part-time, which does not bode well for income growth and consumption spending going forward.

The outlook for the labor market is modestly optimistic. We expect job growth to continue over the forecast horizon, averaging around 165,000 jobs per month in 2012 and 180,000 jobs in 2013. Though robust, this rate is still not fast enough to quickly bring the

unemployment rate down to a level consistent with full employment (5% to 6% rate). The sheer size of job losses during the recession was so massive that even if the recovery was proceeding at a robust pace (300,000 jobs per month), it would take two and a half more years for the labor markets to normalize. If the pace of job creation was at a respectable 200,000 per month, the unemployment rate would reach a level consistent with full potential only by mid-2016. In total, the U.S. economy needs to add a total of 18.7 million jobs for the balance of the decade in order to keep up with the population increase and bring the unemployment rate to levels consistent with full employment. Our baseline scenario calls for job growth of 14.8 million during this time, which means that the unemployment rate will remain above full employment levels for quite some time. Short term, the unemployment rate is expected to remain elevated, reflecting the slow pace of job creation and an increase in labor force, averaging 8.4% in 2012 and 8.1% in 2013.

Real Estate Market

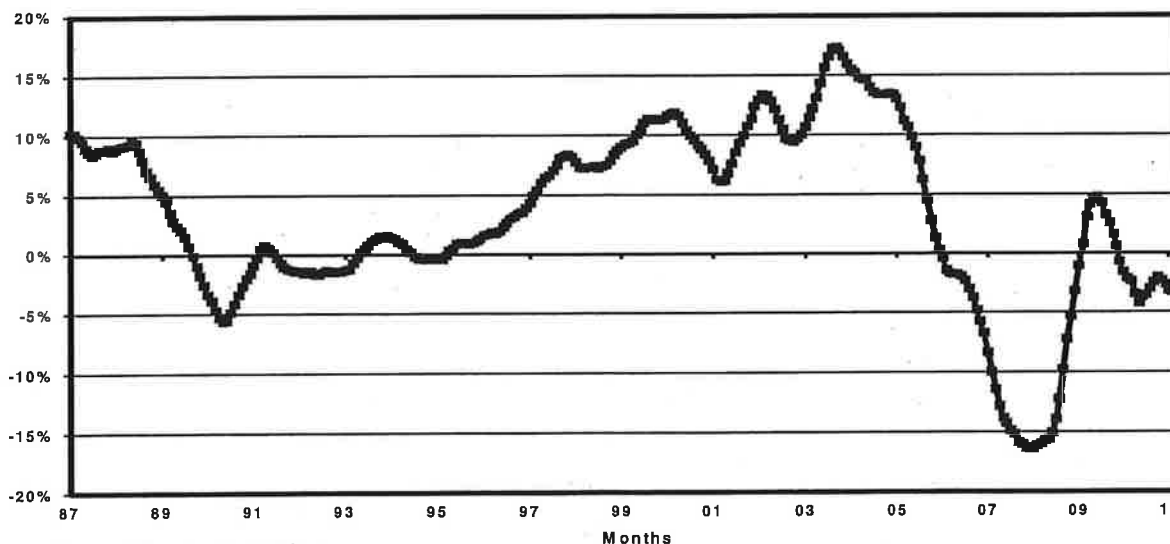
The national housing market has shown some signs of life lately particularly in the areas of sales and homebuilding activity. After slumping to a historical low of 478,000 units (annualized rate) in Spring 2009, housing starts have posted some gains and currently stand at 698,000 units. Most of this increase is due to a pickup in multifamily housing units, which has risen in response to increased demand for rental units and a rise in rental rates. Single-family home sales have also shown some tentative signs of improvement with

December and January breaking above 500,000 units (annualized rate) for the first time in almost two years, though this market is still a ways off from a normal recovery. A declining homeownership rate and slow pace of household formation indicate that demand for apartment rentals will continue to remain elevated: if recent trends hold up, we project the market will need close to 3 million additional apartment units over the next 4 years. This should boost investment in residential activity, which in turn is expected to contribute, albeit modestly, to real GDP growth.

Sales of existing homes have also picked up, growing by 8.8% in February compared to one year ago. This is largely supported by record-high home pricing affordability, low mortgage rates, some pent-up demand from the four-year slump and a more upbeat outlook on employment and income. Nonetheless, the uptick in home sales is still subdued and sales activity remains in a relatively low gear. We also suspect that some of this improvement may be due to seasonal factors and an unusually mild winter rather than a robust turnaround in fundamentals. New home sales have shown renewed weakness over the past two months, tumbling by -5.4% in January and by an additional -1.6% in February. New home sales activity recorded an all-time low in 2011, with only 302,000 units sold during the entire year. Despite this disheartening news, the latest data shows an 11.4% increase over the previous year, which indicates that sales are nonetheless firming up, even if the pace is irregular and still sluggish. More importantly, the inventory supply has dropped for 6 months which should support some construction activity in the near-term.

Despite these improvements in home sales and construction, prices have continued to trend lower reflecting continued pressure from existing oversupply, shadow inventory, and weak demand (Figure 12). Issues on the supply side are rather formidable: there are currently 3 million properties in various stages of distress. Of these, around 1.6 million are currently in the shadow inventory (6 months' supply), of which 800,000 units are seriously delinquent (3.1-months' supply), 410,000 are in some stage of foreclosure (1.6-months' supply) and 400,000 are already in REO (1.6-months' supply). Although there have been around 3 million distressed sales over the past two years, the shadow inventory in January 2012 is at the same level as in January 2009, indicating that distressed loans continue to weigh in the market. In addition, housing vacancies continue to remain elevated at 2.4% -- up from a historical average of 1.6%. As a result and in line with our forecasts, home prices have continued to decline, falling by

Figure 12
National House Prices: Case-Shiller Index
(percent y-o-y)



Source: Standard & Poor's

-3.1% in January 2012 compared to one year earlier. Excluding distressed sales, home prices are down -0.9% on a year-over-year basis.

Housing equity has shriveled to less than half its pre-crisis level, declining from a peak of \$13.1 trillion to \$6.1 trillion -- around the same levels as in 1999. Homeowner equity has shrunk from an average of 60% down to 38.4%. As of the latest data, 11.1 million or 22.8 percent of all residential properties with a mortgage are in negative equity with an additional 2.5 million borrowers having less than five percent equity (near-negative equity). Together, negative equity and near-negative equity mortgages accounted for 27.8% of all residential properties while the total mortgage debt outstanding on properties with negative equity stood at \$2.8 trillion. The total amount of underwater debt in the U.S. is estimated to be around \$750 billion, but persistent weakness in the housing market is expected to push this number higher in the short-term.

From the start of the financial crisis, a total of 3.3 million homes have been foreclosed, with around 860,000 having been completed in 2011. Around 1.4 million homes -- or 3.3% of all households with a mortgage -- were in foreclosure inventory in January 2012 compared to 1.5 million (3.6% of total) recorded one year ago. The share of mortgages severely delinquent (90+ days) fell to 7.2% in January 2012, down from 7.8% compared to one year ago.

The speed of foreclosures is expected to pick up this year after the recent settlement between the state attorneys and five major mortgage services to the tune of \$25 billion. Of this amount, \$20

billion will be used to provide financial relief for borrowers such as principal balance reduction and loan refinancing for underwater borrowers. An additional \$5 billion will be paid in cash to the federal and state governments of which \$3.5 billion will go to repay public funds lost as a result of servicer misconduct, while \$1.5 billion will be used to provide cash payments to borrowers whose homes were sold or taken in foreclosure between January 1, 2008 and December 31, 2011.

The federal government has stepped up its efforts in an attempt to alleviate the housing crisis. Policy recommendations vary from loan modification programs to a wide-scale rental conversion program of government and bank-owned REOs. The administration is attempting to expand its Home Affordable Refinance Program (HARP) and Home Affordable Mortgage Program (HAMP) to incentivize private lenders to modify mortgages and reduce principal balances. The Treasury and the Federal Reserve are actively promoting a program that would sell large blocks of homes owned by Fannie Mae and Freddie Mac to investors that will convert these properties into rental units with the hope that this will drawdown the oversupplied stock of housing and increase inventory in the undersupplied rental market

The outlook for the housing market while more upbeat than at any point during the recovery is still guarded. The market is expected to continue to improve in 2012 and beyond, though the recovery will be sluggish and uneven especially over the next 6-8 quarters. On the positive side, home sales and home construction will continue to increase after having bottomed out in mid-2011. Housing starts are

expected to average around 705,000 in 2012 and 780,000 in 2013 and construction should contribute modestly to real GDP growth during the forecast horizon. Even with these gains however, homebuilding activity will remain a shadow of its former self for quite some time, at least until the inventory overhang of homes is reduced to normal levels. Our forecasts project that with the current low pace of household formation and a decline in homeownership, home vacancy rates will normalize towards their historical average only in mid-2017. This means that home prices will continue to remain depressed well into the middle of the decade. We expect home prices to post an additional 1-2% decline in 2012, stabilize at the bottom early in 2013, and post steady but modest gains from 2014 until 2018 when conditions in the housing market are expected to return to more normal levels.

The commercial real estate market also experienced increased activity especially in late 2011 which has spilled over in the current year. More than 13,000 commercial real estate properties were sold in 2011, totaling \$250.8 billions in sales. Improvements are particularly impressive in the apartment and industrial real estate sector reflecting higher demand for rental units and a brisk pick-up in manufacturing and factory activity. Apartment vacancy rates dropped by 1.4% in 2011 and are now down to 5.2% -- the lowest level in more than 10 years. Vacancy rates for industrial space declined by 0.8% in 2011 driven by growth in manufacturing, retail and international trade. Industrial rents remain subdued however, reflecting the overbuilding that occurred in many markets over the last decade. Improvements in the office market have been less

dramatic but absorption has remained in positive territory while vacancy rates remain elevated at 17.3%. Retail space picked up steam in the second half of 2011, likely reflecting seasonal trends related to the holiday season. Rent growth for this sector also increased in Q4 2011 for the first time since 2008 and net absorption rose by 3.18 million units.

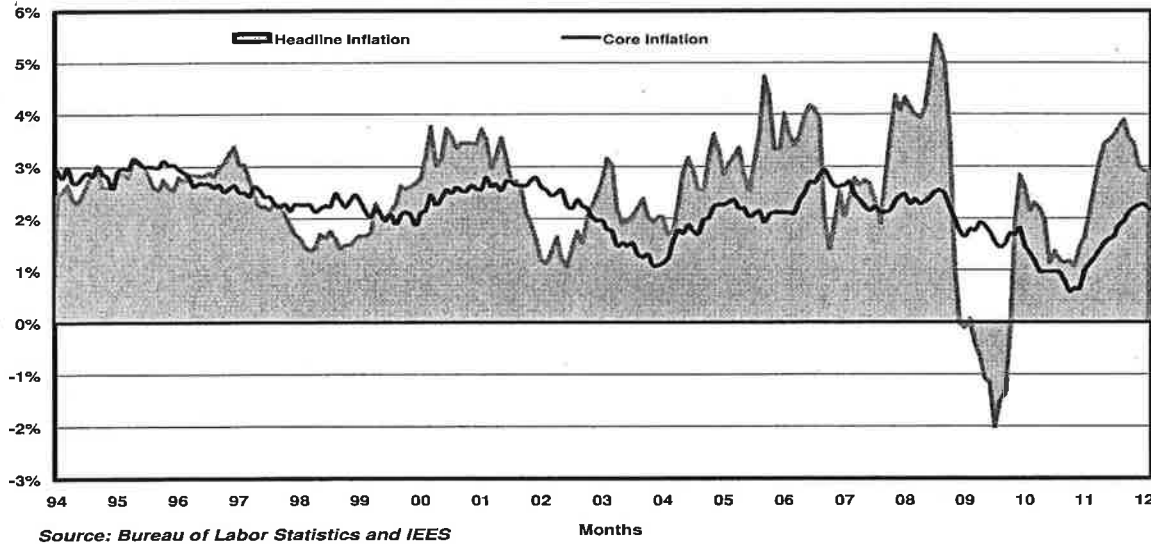
Going forward, this sector is expected to continue to improve. Sales should increase, activity is expected to expand (particularly in class A apartments), and vacancy rates should trend lower. Commercial property prices seem to have bottomed out in Q1 2011 after declining by a total of -48% from their record-highs of September 2007. Prices have trended upwards over the past few months and while we expect this trend to continue in the current year, the pace of improvement will remain subpar.

C2. INFLATION

Inflation surged in the first half of 2011 as higher global commodity prices spiked, but the pace of acceleration was more subdued in the second half following the decrease in crude oil prices. Headline consumer price index (CPI), which includes both food and energy prices rose by an average annualized pace of 3.1% in 2011, a sharp increase from the 1.6% rate recorded in 2010 (Figure 13). Similarly, core inflation (which excludes volatile prices such as food and energy) rose 1.7% in 2011 compared to a 1.0% annualized rate in 2010, reflecting modest but continued improvement in the economy

amidst massive amounts of liquidity. The employment cost index for wages and salaries remained subdued edging up by an average 1.7% pace in 2011 from a 1.6% rate in 2010. Energy prices fell back in the second half of 2011 after soaring to an almost 30% increase in the first half.

Figure 13
U.S. Headline vs Core Inflation
 (percent, year-on-year change)



Inflationary pressures are building up again early in 2012 reflecting higher energy prices, though the data has yet to fully capture the impact of the most recent increase. Headline inflation rose by 0.4% from January to February 2012, while core inflation ticked up by 0.1%. More alarmingly, the index for consumer energy prices is on the rise again, climbing by 3.2% from January to February. On a year-over-year basis, energy prices are up a shocking 12.4%, largely due to increases in crude oil and gasoline prices. Food prices have also risen persistently over the past year, but the rate of increase has slowed down markedly since late 2011.

Despite these developments, we expect inflation to remain contained over the forecast horizon, though at more elevated levels than in previous years. One of the main reasons behind a stable inflation outlook is that despite recent improvements, there is still ample slack in the economy and it will take a while before growth runs up against resource constraints which tend to drive up prices. Capacity utilization -- though remarkably improved compared to its crisis-lows -- is still around 5-6% points below the full utilization rate. Survey-based inflation expectations also seem well anchored and generally confirm our outlook: the 12-month ahead inflation rate, according to the Michigan Survey, was 3.3% as of its latest reading whereas long-term inflation (5 to 10 years) is expected to remain stable at around 2.9%.

We expect headline inflation to increase by 2.6% in 2012 and by 2.7% in 2013. Longer term, however, given the overly accommodative monetary policy of the last four years, the risks for a surge in inflation are non-negligible. Whether an escalation in prices is ultimately avoided will depend on the ability of the Federal Reserve to reduce excess liquidity in a timely manner.

Oil Prices

Oil prices are on the march again early in 2012, after a sharp increase in the first half of 2011 and a subsequent retreat later in the year amidst fears of a global recession. Brent oil prices have risen by 18% in the first three months of this year, pushing gasoline prices up by an average of \$0.65 during this time.

Escalations in oil prices are due to a number of factors with some weighting more than others. Buoyed enthusiasm about a sustained global recovery may have boosted demand up a notch, but not enough to justify the recent run up in oil prices. Supply disruptions and geopolitical concerns seem to be the more important driver behind higher oil prices: the world oil supply seems to have lost around 1.1 million barrels of oil per day over the past few months stemming from mechanical issues in the North Sea, a pipeline dispute in South Sudan, and from the implementation of sanctions on Iran. Oil inventories in advanced economies are at a five-year low, and the spare capacity in OPEC countries (particularly in Saudi Arabia) appears thin. More alarming is the escalating tensions with Iran: if the Strait of Hormuz is closed (even temporarily), oil prices are expected to escalate given that around 20% of the world oil supply passes through the Strait on a daily basis.

Oil supply shocks are more harmful to growth than demand shocks. Having said this, while we forecast oil prices to remain elevated, we do not envision a flare-up in geopolitical tensions to the scale that would propel oil prices to record-levels. The U.S. economy is also better insulated from oil shocks now compared to the 1970s, given improvements in energy efficiency over the past 30 years. Moreover, the U.S. recovery is currently at a more advanced stage, gaining momentum and resilience, and will likely withstand higher oil prices in the short-term.

Short term, recent increases in oil prices present risks for U.S. real GDP growth, particularly in the first half of 2012. A

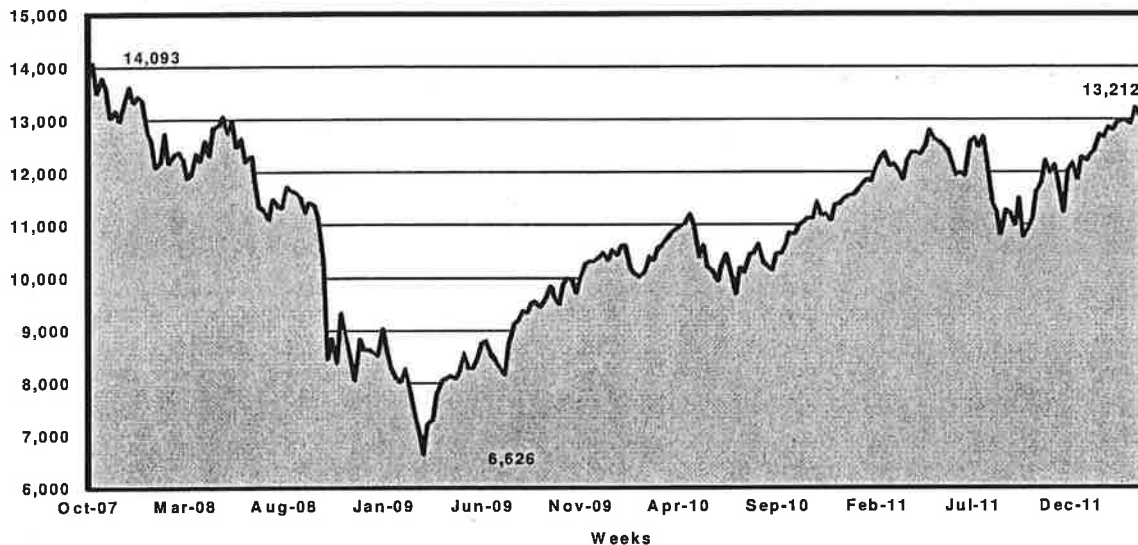
sustained \$10 increase in oil prices normally shaves off roughly 0.2% from U.S. growth. Crude oil prices have risen as much as \$20 per barrel so far this year, which if sustained should dent U.S. RGDP growth by around 0.4% in 2012-- a slowdown to be sure, but not enough to push the economy back into another recession.

C3. FINANCIAL AND GOVERNMENT SECTORS

Financial Markets

Year 2011 proved to be a wild ride for financial markets (Figure 14). Equity markets started the year quite well posting sizable gains in the first quarter due to strong earning reports, improved corporate profits, and an optimistic outlook on the pace of the global recovery. By mid-summer optimism was replaced by widespread panic brought on by the onslaught of negative macroeconomic news, the wrangling over the U.S. debt ceiling, the ensuing disappointing deal, and the subsequent U.S. credit-rating downgrade. The most damaging effect came from the escalation of the Eurozone debt crisis which sent investors from euphoria (when a solution seemed to be imminent) to outright panic (when policymakers could not agree on a containment path) from one hour to the next. Market volatility shot up: from August until mid-October, the Dow moved by more than 200 points in one day on 16 occasions, which amounts to 40% of the time. By October 2011, S&P500 had tanked by -17% from the cycle peak of May, entirely erasing all gains for the year.

Figure 14
Dow Jones Industrial Index
 (level)



Source: Bloomberg

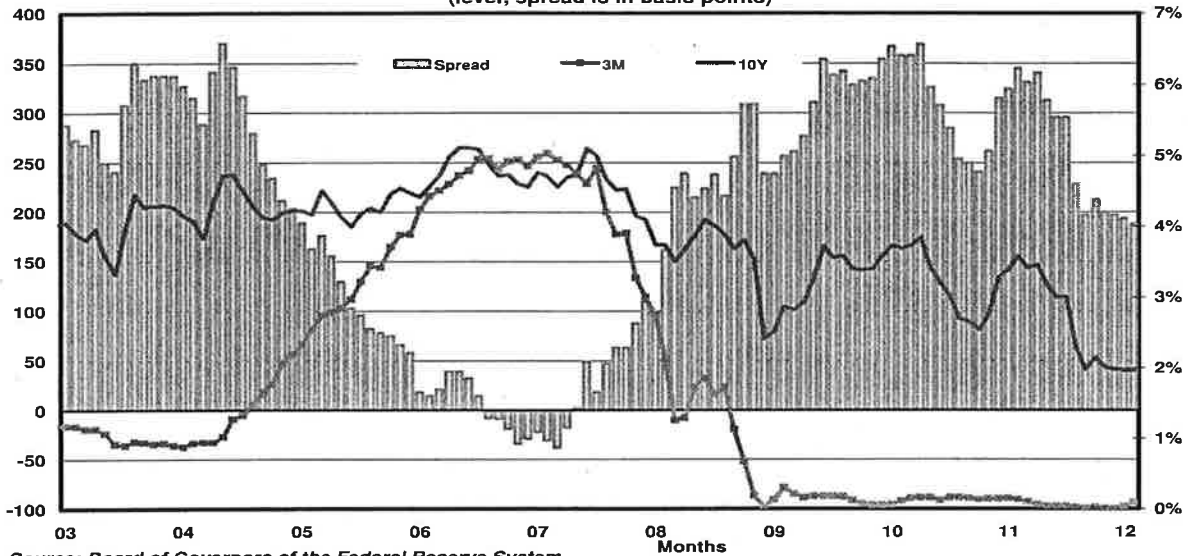
The last two months of 2011 and particularly the start of 2012 have been much kinder to equity markets. The S&P 500 has posted a stellar 26% increase from October lows -- of which 10.7% came in the first three months of 2012. In fact, equity indices now stand at their highest level since the onset of the financial crisis; S&P 500 is now only -11% below its all time-highs. Much of this is due to an improved economic outlook and a quelling of investors' fears on the fate of the Eurozone: better-than-expected economic data in the U.S. has reinforced the consensus view that the U.S. recovery will continue to expand, while the aggressive response from the European Central Bank (ECB) to shore up the European banking system and a successful restructuring of the Greek debt have eased concerns (at least for the time being) of a calamity from Europe.

Despite these developments, we expect financial markets to remain highly sensitive to news regarding developments in Europe,

macroeconomic data releases, and global outlook for economic growth -- particularly on the cooling of the Chinese economy. Equity markets are also expected to exhibit enhanced volatility and near-panics should any of the risk factors we have enumerated flare up and threaten the baseline case of a continued recovery in the U.S., a soft-landing for the Chinese economy and contained risks from Europe.

Yields on short-maturity rates have remained flat over the course of the year reflecting a holding pattern in the projected trajectory of policy rates. However, yields on longer-maturity Treasury bonds rose by more than 30 basis points since the start of the year, suggesting an upbeat outlook and a continued U.S. expansion. The spread between the 10-year and 3-month rates has increased sharply over the past two months, indicating renewed optimism about domestic growth prospects (Figure 15). Short rates are expected to move in tandem with policy rates, maintaining their current levels for the duration of 2012 and 2013. Long-term bond yields are expected to nudge upwards as recovery expands and inflationary pressures continue to build.

Figure 15
U.S. Yield Curve
 (level; spread is in basis points)



Source: Board of Governors of the Federal Reserve System

The banking sector came under renewed pressure early in the second half of 2011 as fears intensified on their exposure to European sovereign debt and a looming fallout from Europe. European banks presented a particularly worrisome threat given that they were woefully undercapitalized and heavily exposed to peripheral Euro debt. French banks are estimated to have an overall exposure of around €550 billion (30% of GDP), German banks have around €420 billion (13% of GDP), and the UK around €260 billion (10% of GDP). Though calculations on losses from potential charge-offs vary widely, a complete restructuring of at-risk sovereign debt may cost the European banking sector as much as \$350 billion in potential mark-to-market write downs.

The U.S. banking system did not fare much better at this time: U.S. bank shares fell precipitously in mid-2011 when the risk of a European break-up seemed all too real and the fragile recovery inched

closer to a double-dip recession. Despite the fact that direct U.S. bank exposure to Eurozone sovereign debt is limited (around \$150 billion, or 1% of GDP), the U.S. and European banking systems are closely interconnected with U.S. banks' exposure to their European counterparties totaling a whopping 12% of GDP. Some U.S. banks also remained significantly exposed to legal risks stemming from their mortgage lending operations and foreclosure practices.

Sentiment for the banking sector has improved considerably since December 2011. A European banking collapse appears to have been forestalled thanks to aggressive actions by the European Central Bank which is expected to inject a total of €1 trillion via the Long Term Refinancing Operations (LTRO) in the banking sector. The LTRO is a refinancing program with maturity of up to three-years, which should provide banks with low-cost financing until early 2015. In the U.S., the recent settlement of the state attorneys with five mortgage servicers has removed some of the uncertainty related to the settlement costs. In addition, 15 out of the 19 largest financial institutions passed the Fed's stress test which assumed a much darker scenario where the unemployment rate shoots up to 13% and house prices collapse by an additional 21% from their current levels. According to the results of the test, even with this dire backdrop under which the banking system is slammed with \$534 billion of losses over a two-year period, most banks would emerge with adequate capital thus successfully weathering the storm.

Going forward, we expect the banking sector to show meaningful signs of improvement and continue to heal. Bank credit expanded

modestly in the second half of 2011, its first increase since the first half of 2008, prior to the financial crisis. This trend is expected to continue into the current year as credit quality for most loans improves and economic activity continues to expand at a moderate pace. Aggregate delinquencies and charge-offs should also decline further, though they are expected to remain elevated compared to their pre-crisis levels. We also anticipate a slow but steady unwinding of the cash stockpiling by the banking sector as capital accumulation transitions into capital deployment, leading to consolidations and new acquisitions. Capital markets are expected to remain strong, but this may moderate to a certain extent due to regulatory pressures from the recently enacted financial reform. In general, the financial sector is likely to remain remarkably sensitive with respect to adverse developments in the Eurozone, a potential larger-than-expected global slowdown, and geopolitical risks (related particularly to Iran) which may cause an abrupt escalation in oil prices that could derail the fragile recovery.

The Government Sector

Fiscal Policy

The outlook for fiscal policy presents one of the biggest risks to future economic activity. The issue is that policymakers need to strike a fine balance: try to reduce the ballooning fiscal deficit (which has now grown to unsustainable levels) while keeping the fragile recovery intact. This is a formidable challenge even in normal times; in election years this task becomes virtually

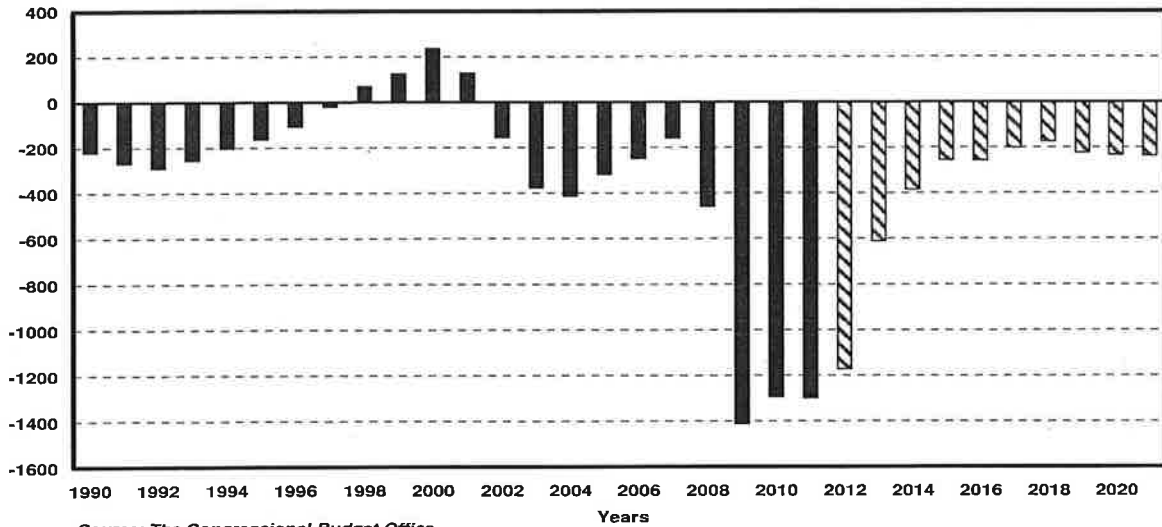
impossible, which is the reason why we don't expect any major changes to occur to the fiscal outlook until after the election.

The problem with more fiscal support is two-fold: first, with benefit of hindsight, fiscal stimulus so far has turned out to be too expensive, too ill-targeted, and too transitory. The American Recovery and Reinvestment Act (ARRA), which infused an unprecedented \$787 billion into the economy, boosted economic activity by less than it was expected and should become a drag on the economy in 2012 as many programs wind down. The \$858 billion tax compromise of December 2010 likely bolstered U.S. real GDP growth in 2011, partly at the expense of 2012. The "cash-for-clunkers" program and the homebuyer tax credit appear to have brought forward the demand for cars and housing, with sales taking another setback when the programs were terminated. The extension of payroll tax cuts and unemployment benefits approved by Congress in February 2012 to the tune of \$144 billion will most likely end up in additional gasoline expenditures given recent escalations in oil prices rather than provide additional boost for retail spending.

The second concern with increased government spending has to do with its finances: government books are in shambles and without a credible long-term commitment to draconian spending cuts and entitlement reforms, persistent budget deficits will have a detrimental impact on long-term growth. According to the Congressional Budget Office (CBO), the budget deficit was \$1.3 trillion in FY 2011 (8.5% of nominal GDP), roughly the same as the \$1.3 trillion in FY 2010 (8.9% of GDP) and slightly below the \$1.43 trillion recorded in FY 2011 (9.5% of GDP) (Figure 16). The deficit narrowed somewhat in

the first quarter of 2012 and is projected to grow by \$1.1 trillion in FY 2012 -- lower than during the past three years but much higher than the historical average. Left untouched, the U.S. national debt will be twice the size of U.S. real GDP by 2035. No economy can stay afloat with that much red ink.

Figure 16
US Budget Deficit: Historical and Projected
 (level, billions)



Of course, near-term fiscal austerity presents challenges for economic growth particularly in the current cycle of a sluggish and below-par recovery. The fading of the ARRA and additional spending cuts, agreed to during the August budget negotiations, will likely subtract between 0.6-0.8 percentage points from real GDP growth in 2012. Moreover, the Budget Control Act of August 2012 specified \$917 billion of cuts over 10 years and an additional \$1.2 trillion of cuts (over the 2013-2021 period) to be decided by the Joint Select Committee on Deficit Reduction (super-committee). The failure of the super-committee to come to some sort of agreement over the specific

measures that would yield the necessary \$1.2 trillion cuts would trigger across-the-board spending cuts during the 2012-2021 period split equally between security and non-security programs.

The fiscal drag is slated to be dramatically more severe in 2013 with the expiration of the Bush era tax cuts, the termination of the current payroll tax cuts and unemployment benefits, and the automatic across-the-board spending cuts of the Budget Control Act. If current law does not change and these deficit-reduction measures are allowed to take full effect, U.S. real GDP growth will likely be reduced by around 2.1 percentage points in 2013. In fact, the CBO projects that under the current law, U.S. real GDP will grow by a meager 1.1% in 2013, largely because of the draconian spending cuts and tax increases which are expected to significantly restrain growth. However, the CBO estimates that if all current tax cuts and provisions are extended then the budget deficit over the 2013-2022 period will be much higher -- averaging 5.4% of GDP instead of 1.5% if tax cuts are terminated. Under this alternate scenario, debt held by the public will rise to an unsustainable 97% of GDP by 2022 - the highest level since right after World War II.

Our baseline scenario assumes that some but not all tax cuts will be allowed to expire, which means that the budget and growth outlook will likely be somewhere between the CBO's baseline scenario (when all tax cuts expire) and an alternate scenario (when all tax cuts are extended). Nonetheless, the U.S. faces formidable budgetary challenges in the longer term driven primarily by structural underlying forces, such as rising health care costs and an ageing

population. Even if current law remains in effect and all tax cuts are terminated, spending for entitlement programs (Social Security, Medicare, and Medicaid) will push the budget deficits to unsustainable levels. High levels of debt, if persistent, will crowd out private investments, diminish investor confidence, lead to sharp increases in interest rates, destabilize financial markets and severely reduce long-run economic growth and standards of living.

It is therefore essential that policymakers begin to address the U.S. long-term fiscal challenges soon by restructuring federal tax policies, prioritizing spending, and reforming entitlement programs. This would mean a radical reform of the tax system - which should broaden the base, lower the marginal tax rates on individuals and corporations, change the mix of taxation away from labor and capital and towards consumption, and eliminate loopholes. Compared to other advanced economies, the U.S. taxes labor and capital too much and consumption too little which creates unnecessary distortions in the labor markets and reduces growth. On the entitlement side, bold steps should be taken to increase the eligibility age for Social Security and Medicare, remove the contribution cap, means-testing the programs, and converting the matching-funds Medicaid system to the cheaper state "block grants." This would simultaneously address long-standing fiscal deficits while at the same time ensuring the solvency of the entitlement programs.

A "grand bargain" of this scale may be hard to come by especially in an election year. In its absence, policymakers could agree on smaller steps that would support the recovery in the short term while

paving the way for long-term deficit reductions. For example, if tax cuts are to be continued, it is helpful to have them last for a longer stretch - say a 5-year horizon, which could arguably help reduce uncertainty for businesses when planning hiring or expansions. The same goes for easing and/or streamlining regulations. More importantly, doing the small things such as ending gridlock and paralysis while removing policy uncertainty should go a long way in restoring some of the much needed confidence in the economy.

State and Local Governments

State and local governments remain under significant fiscal stress stemming from low tax revenues, the fading of the support from the federal government, and continued weakness in the housing sector. Though state and local government revenues rose by 5.5% in Q3 2011 compared to the previous year, the increase was partially offset by a reduction in federal stimulus grants. Local governments are faring worse than state governments given that the vast majority of their funding comes from property tax receipts which have been generally flat over the past two years. In addition, local governments have experienced a decline in grants-in-aid from their state governments. Employment at the state and local level has declined by a total of 641,000 since the start of the recession, of which 421,000 jobs were lost since Q2 2010 when the private sector employment started to expand. The pace of job losses has moderated in the first three months of 2012 especially at the state level, though layoffs are expected to

continue at the local level as property tax receipts remain depressed and state aid declines.

The impending sequestration under the Budget Act of 2011 will weigh heavily on state and local governments, amounting to a reduction of more than \$6 billion in program aid to states and their municipalities. Though state tax revenues are expected to increase in 2012 due to an improving economic outlook, local tax receipts should decline yet again, largely reflecting the weakness in the housing sector which depresses property tax revenues (three-quarters of local government funding comes from this revenue source). The prospects appear even bleaker in the long-term with state and local governments facing unfunded pension and healthcare liabilities estimated to be a staggering \$3 trillion.

The Federal Reserve

Faced with sluggish growth and frequent near-recession slumps the Federal Reserve (Fed) has continued to pursue an extremely accommodative monetary policy. The Fed has held the target federal funds rate at the zero-bound since the onset of the financial crisis in late 2008. It has gone even further in terms of reassuring the markets of its low interest rate policy: in August 2013 at the height of the Eurozone crisis and the U.S. budget downgrade it pledged to keep interest rates at "exceptionally low levels at least through mid-2013." The time-frame for a low interest rate environment was extended further in January 2012, with the Fed expecting economic conditions to warrant low rates until end-2014. As a future guidance for interest-

rate policy, the Fed released for the first time in January 2012, its Economic Projections which included the FOMC participant's projections of the likely path of interest rates over the medium-term.

The Fed has also pursued other venues (notably quantitative easing) which were established at the height of the financial crisis to prevent a systemic collapse of financial markets, but that were subsequently repeated to support the fragile recovery. From December 2008 through March 2010, the Fed embarked on its first quantitative easing efforts (QE I) purchasing a staggering \$1.7 trillion in longer-term Treasury, agency and mortgaged-backed securities (MBS), which lowered the cost of debt by reducing long-term interest rates. Despite these extraordinary measures, the sluggish pace of economic recovery prompted the Fed to commence a second round of quantitative easing (QE II). In early November 2010, the Fed resumed its purchases of long-term Treasury securities with a targeted amount of \$600 billion. The program ended in June 2011 by which time the Fed balance sheet had swollen to \$2.7 trillion. In August 2011, in response to a darkened domestic and global outlook, the Fed embarked on "operation twist" - a QE-lite type program which lengthens the average maturity of its balance sheet by selling short-term issues and replacing them with long-term bonds. As of January 2012, the Fed holds approximately \$1.6 trillion in Treasury securities and \$853 billion in MBS.

We expect the Fed to keep rates on hold through much of 2013 and then begin to tighten in early 2014 (a bit sooner than the FOMC estimates). Though the sluggish pace of job formation seems to have spurred fresh concerns from policymakers at the Fed, we believe that

further quantitative easing is unlikely unless the Eurozone crisis worsens dramatically, job growth grinds to a halt and the Chinese economy experiences a hard-landing. We subscribe a low probability to all these events, and expect the Fed to remain alert to changing macroeconomic conditions, but on pause with regards to further easing. In the long-run, as the financial sector continues to stabilize and the broader economy improves, the Fed needs to carefully recalibrate its policy to simultaneously maintain a stable inflation rate while supporting economic growth.

C4. GLOBAL ENVIRONMENT

The outlook for the global economy has downshifted markedly in recent months. Concerns abound in both emerging and advanced economies, with an impending slowdown of the Chinese economy and continued sovereign-debt stress from the Eurozone largely dominating the outlook for the global economy. Conditions have deteriorated somewhat in emerging market economies since the second half of 2011 as domestic policy aimed at combating inflation and overheating and weakness in export volumes due to the crisis in Europe began to weigh on growth. The Chinese economy grew by a respectable 9.2% in 2011, but the rate of growth has slowed down appreciably in the current year and is expected to cool further in 2012 and 2013. More concerning, Chinese policy makers sharply downgraded the country's growth prospect for 2012 to 7.5% from an initial estimate of 8%, a move that spooked the markets and sparked concerns about a severe slowdown in the global economy. Elsewhere in the emerging world, growth has slowed down

markedly: Brazil grew by a feeble 2.7% in 2011 after a robust 7.5% in 2010, India's economy expanded by 7.4% last year compared to a stellar 9.9% in 2010, and South Korea grew by 3.6% in 2011 -- nearly half of the 6.2% pace recorded a year earlier.

The slowdown in emerging economies is expected to continue in the current year and into 2012, as weakness from Europe, and a slow recovery in the U.S. and Japan will continue to place additional strains on emerging market exports. Nonetheless, we expect emerging markets to grow over the forecast horizon given their strong domestic fundamentals, sound finances and generally healthy fiscal outlook. The Chinese economy is expected to experience a "soft-landing" and should grow at a pace above 8%, despite recent downshift in official growth estimates. The reversal of monetary policy tightening policy in Brazil, China, Indonesia and Thailand in response to a weakening global outlook should prove support growth in these countries. However, growth in emerging markets will come in at a lower clip than during the last two years given weaker export volumes to Europe, a still-high inflation rate, and efforts to rein in bank lending in China and the surging property market. Overall, we expect emerging economies to grow at a pace of 5.7% in 2012 -- below the 6.2% rate posted in 2011 and the 7.3% rate in 2010.

The main threat to the global outlook over the next six quarters comes from Europe. Though no longer on the verge of a devastating catastrophe which threatened the very existence of the single-currency market, the Eurozone debt crisis is far from over. All told, outstanding government debt for PIIGS countries (Portugal, Italy,

Ireland, Greece and Spain) totals around €3.3 trillion with Spain and Italy combining for a gigantic €2.5 trillion. Gross CDS exposure to PIIGS countries totals an eye-popping €500 billion, while net exposure is a more manageable €40 billion. More worryingly, fourth quarter real GDP contracted in the Eurozone and the current quarter is expected to show an additional roughly-equal size decline. We expect the single-currency region to experience a mild recession until mid-2012, followed by an exceptionally weak pick-up in economic activity over the next few years.

On the positive side, European policymakers have taken important steps in improving the debt sustainability of the highly indebted countries thus assuring the existence of the single-market, at least in the short term. First, European leaders agreed to abandon their initial insistence that private bond holders of sovereign debt be forced to take haircuts on future bailouts, which improved demand for Italian, Spanish and Portuguese bonds and lowered sovereign debt yields. Second, the ECBs Long Term Refinancing Operations (LRT0) provided a much needed low-cost financing for undercapitalized European banks by infusing nearly €1 trillion in the banking sector. Third, the successful restructuring of Greek debt which triggered a "credit event" and the subsequent CDS payouts in the estimates amount of \$3.2 billion, restored some faith in the functioning of the CDS market for sovereign bonds.

Despite these positive developments, the Eurozone debt crisis is not fully resolved. Actions by the ECB has calmed the markets and provided some much needed time for policymakers in the highly indebted

countries to implement structural reforms that would reduce debt ratios. These reforms however, are subject to complex negotiations and a long-winded political process. Even if they are fully implemented, it may take years before their beneficial impact are fully exposed, which means that the European sovereign debt issues will likely remain a concern for the global economy in the foreseeable future.

Going forward, the global economy to expand by a tepid pace of 3.5% in 2012, slightly below the 3.8% rate of 2011 and far below the 5.2% rate recorded in 2010. The bulk of growth should continue to come from emerging economies with advanced economies edging forward at modest rates. In the short- and medium-term, the advanced and developing world will likely contend with different issues going forward. In developing nations, primary causes for concern in the near-term are high inflation, potential asset price and real estate bubbles, a sudden acceleration of influx in capital flows, and currency-related issues. In the developed world, the main headwinds will be high unemployment, a deteriorating housing sector, concerns about the stability of the financial sector, and issues related to fiscal deficits and overall crushing debt burdens. The Eurozone sovereign debt crisis is expected to weigh heavily on the global outlook and on the region's prospects over the forecast horizon.

A slowing of the world economy means lower U.S. exports, which in turn, adversely impacts U.S. growth. Exports grew by a robust 11.3% in 2010 as trade volumes expanded, but the pace of growth was more muted in 2011 coming at 6.7%. As of Q4 2011, exports are just shy of their

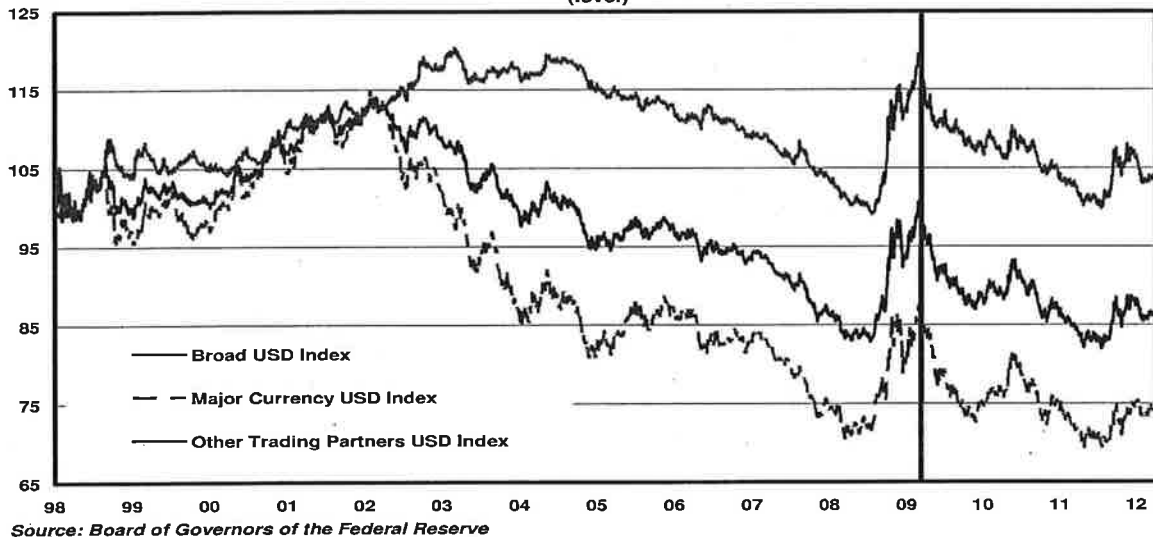
2008 record-levels, contributing 1.3% to real GDP growth in 2010 and an additional 0.8% in 2011. Imports have also increased recovering nearly 90% of their pre-recession levels, boosted primarily by increased demand for capital goods, motor vehicles and parts, and industrial supplies. Export growth is expected to downshift in 2012 due to a slowdown in emerging markets and continued weakness from Europe: more than a quarter of U.S. exports go to the EU, 28% to Asia and close to 15% to Central and South America.

The U.S. current account deficit has reflected broader trade patterns. After declining from a high of \$853 billion (6.4% of GDP) in the third quarter of 2006 to \$337 billion (2.9% of GDP) in the second quarter of 2009, the current account balance has widened slightly to -\$503 billion (3.3% of GDP). Our forecasts indicate that while the U.S. current account will remain negative over the next 5 years, the overall trend points to lower deficits with some short-term trend reversals.

The U.S. dollar fell in the first half of 2011 especially against emerging currencies as these countries experienced strong capital inflows due to robust economic performance (Figure 17). The trend however reversed sharply in the second half of the year as the escalation of the Eurozone crisis and concerns about a global slowdown prompted investors to seek the relative safety of U.S. Treasuries. Most notably, the Chinese yuan appreciated by 5.1% against the U.S. dollar in 2011 with the real effective exchange rate index rising to an all-time high. The dollar has remained largely flat against major trading partners in 2012, though it is expected to strengthen during

the first half of the year particularly against the euro as the European debt crisis continues to weigh on the single-currency. Barring a full-fledged crisis from Europe, the U.S. dollar should depreciate slightly in the second half of 2012, as fundamental forces resume and place further downward pressure in an effort to restore global imbalances.

Figure 17
US Dollar Indices
(level)



In the medium term, as the global recovery expands, the dollar will likely face renewed pressure. The biggest threat is the extremely accommodative stance of monetary policy which has infused a massive amount of liquidity in the financial system. In the long term, unsustainable levels of government deficits, large external imbalances, and the potential abandonment of the dollar peg from export-driven emerging economies, present formidable challenges for the U.S. dollar.

C5. Projections of Key National Economic Variables

Table 8a
National Economic Variables
Real Gross Domestic Product and Components
(percent)

Year	RGDP	Consumption	Residential Investment	Non Residential Investment	Exports	Imports
Historical						
2009	-3.5	-1.9	-22.2	-17.8	-9.4	-13.6
2010	3.0	2.0	-4.3	4.4	11.3	12.5
2011	1.7	2.2	-1.3	8.7	6.8	4.9
Forecast						
2012	2.4	2.1	8.6	8.3	5.9	6.2
2013	2.6	2.3	11.3	9.2	8.8	7.2
2014	3.3	2.8	10.7	6.3	10.1	8.4
2015	3.0	3.0	8.4	5.5	9.1	5.1
2016	2.7	2.9	6.3	2.8	8.5	4.1
2017	2.7	2.7	7.8	4.3	6.8	4.7

Table 8b
National Economic Variables
Inflation and Labor Market
(percent)

Year	Headline CPI	Core CPI	Wages & Salaries Employment Cost	Unemployment	Payroll Employment	Labor Productivity
Historical						
2009	-0.3	1.7	1.6	9.3	-4.4	2.4
2010	1.6	1.0	1.6	9.6	-0.7	4.0
2011	3.1	1.7	1.7	8.9	1.2	0.6
Forecast						
2012	2.6	2.1	2.1	8.4	1.6	0.7
2013	2.7	2.2	2.5	8.1	1.8	1.1
2014	3.0	2.4	3.1	7.6	2.0	1.7
2015	3.3	2.3	3.0	6.6	1.6	2.0
2016	2.9	2.0	2.8	6.2	1.2	2.2
2017	3.0	2.1	2.9	5.9	1.3	2.1

Table 8c
National Economic Variables
Financial Assets, Current Account, Exchange Rate
(percent)

Year	Federal Funds	3 Month T-bill	10-Year Note	30-year Mortgage	Current Account % of GDP	US Dollar Index percent change
Historical						
2009	0.16	0.15	3.26	5.04	-2.7	5.8
2010	0.18	0.14	3.21	4.69	-3.3	-3.6
2011	0.10	0.05	2.79	4.46	-3.2	-4.6
Forecast						
2012	0.16	0.11	2.32	4.13	-3.3	-1.8
2013	0.24	0.22	2.56	4.48	-2.7	-2.7
2014	0.82	0.93	3.12	5.01	-2.9	-4.3
2015	1.47	1.55	4.01	5.25	-2.5	-1.3
2016	2.56	2.33	4.45	5.36	-2.4	-2.2
2017	3.11	2.98	5.06	6.03	-1.9	-1.8

Attachment E Economic Report from Beacon Economics



A Revenue Forecast

County of Riverside, April 2012



BEACON ECONOMICS

This publication was created for:

The Riverside County Executive Office

Riverside County is the fourth largest county in the state, stretching nearly 200 miles across and comprising over 7,200 square miles of fertile river valleys, low deserts, mountains, foothills, and rolling plains. Riverside County shares borders with densely populated Los Angeles, Imperial, Orange, San Diego, and San Bernardino counties...extending from within 14 miles of the Pacific Ocean to the Colorado River.

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Introduction

Beacon Economics, LLC has undertaken a forecast of the assessed valuation and property tax, sales and use taxes, Proposition 172 revenues, and real property transfer tax revenues in the County of Riverside over the next five years.

As in previous editions, the forecast presented here uses standard time-series econometric techniques based on historical correlations and future trends. Beacon Economics' approach to forecasting follows a layered approach. National policy changes and external shocks are built into a U.S. model of a variety of indicators, including GDP, production, demographics, interest rates, government spending, taxes, savings, income growth, and real estate. A California model is then developed that incorporates macro trends at the national level with trends in the local labor market, including demographics, real estate, and business activity indicators.

Taking into account these state and national forecasts, a regional model is set up for the Inland Empire that uses the macro trends along with a variety of specific regional data to create a Riverside County forecast. This local forecast provides a broad outlook for the region's employment by industry along with the unemployment rate, consumer spending and income trends, population and components of change, residential real estate and construction, and nonresidential real estate and construction. Thus, in our regional assessment, we draw on detailed forecasts of the nation, state, and broader Inland Empire to provide a forecast of the activity and revenues that can be expected by the County of Riverside out to 2016–17.

In this edition, Beacon Economics' forecast incorporates an additional feature: the Riverside County Assessor's Office was consulted during the construction of our assessed valuation (AV) forecast model so that Beacon Economics might leverage their insights and their ground-level view of property values in Riverside County in 2012–13 when determining the likely drivers for future AV growth. This included a discussion of both residential and commercial properties as well as valuation appeals and reassessments. In addition, several new incorporations in the county, including the cities of Jurupa Valley and Eastvale, will mean that fewer dollars will flow to county coffers as these funds are redirected to the newly formed city governments. This report and forecast includes the effect of these recent incorporations, which have been netted out from the county's forecasted revenues.

Over the short run, this forecast shows that the worst is behind the County of Riverside. Still, it will take several years for the region to return to peak revenues, which means that there are still tough choices ahead for local policymakers. In this report we detail the current forecast and the major drivers of these results.

County of Riverside Revenue Forecast (\$ Millions)

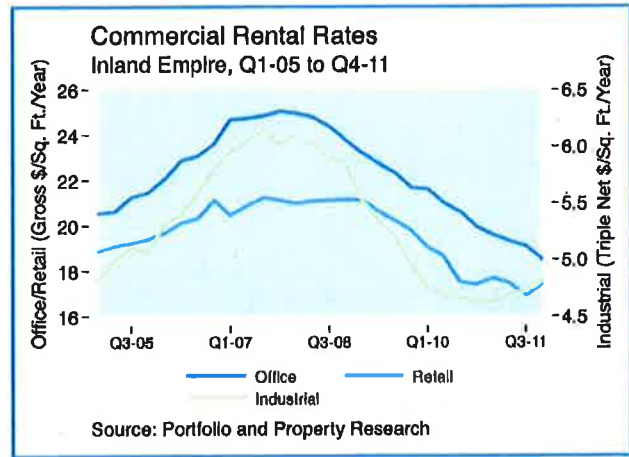
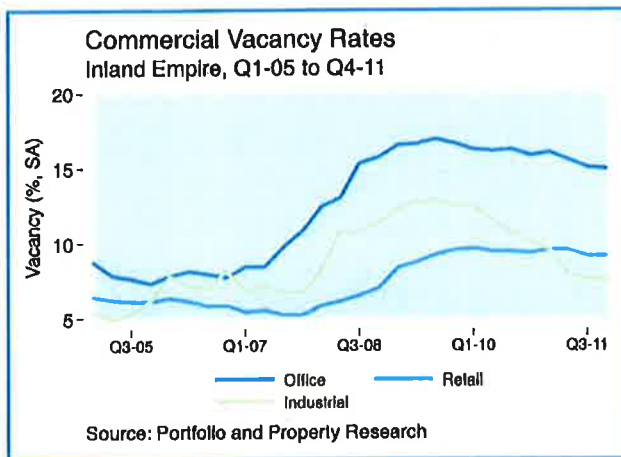
Variable	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Assessed Valuation	217,439.6	208,205.3	205,187.7	201,083.9	201,929.7	207,454.0	216,574.0	229,491.8
Property Tax Revenues	531.2	502.9	495.6	485.7	487.8	501.1	523.1	554.4
Sales & Use Tax Revenues	25.8	28.4	26.5	28.3	31.1	34.0	38.4	43.4
Transfer Tax Revenues	10.7	10.0	8.6	9.7	11.2	12.5	13.6	14.4
Proposition 172 Revenues	110.2	110.1	108.5	120.3	132.4	145.2	162.2	181.6

Source: Forecasts by Beacon Economics

Assessed Valuation

Currently, the Riverside County Assessor's Office is expecting that the AV roll for the 2012–13 fiscal year will decline by between 2.0% and 2.5%. Assuming that this is the case, the total AV in Riverside County will fall 17.2% from its peak in 2008–09. Indications from the local assessor are that the commercial portion of the property tax roll, which is roughly \$49 billion of the total AV in the county, is expected to remain roughly flat over last fiscal year, though there are outstanding appeals and other issues that could alter this figure slightly. Indeed, values have started to edge back upward for large industrial properties, and large multifamily apartments have seen some improvement as well.

Beacon Economics regularly tracks the performance of commercial property buildings available for lease in the Inland Empire, and our figures corroborate what the assessor's office is seeing on the ground. Although the broader region has not come rocketing back to pre-recession peaks, it's clear that the commercial leasing market has started to tighten. For example, vacancy rates for office, retail, and industrial/warehouse buildings have all peaked and started to decline. Unsurprisingly, given the surge in exports since the Great Recession ended in 2009, industrial vacancy rates have been trending downward for almost two years, at a much steeper pace than in either the office or retail markets. Still, these sectors have also started to turn around. The improvement has been slow, but both office and retail vacancy rates have dipped from the highs reached during the downturn.

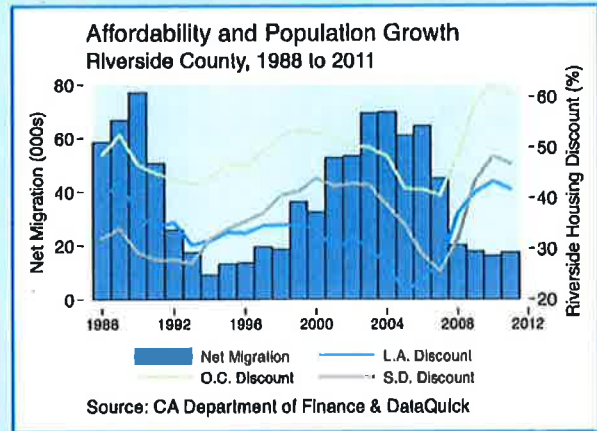
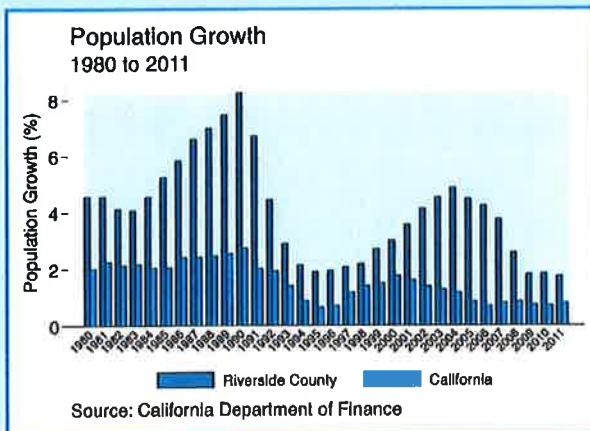


The reduction in vacancy rates has begun to put some upward pressure on rents—at least in the industrial and retail sectors. Unfortunately, the office market is currently maintaining a vacancy rate in excess of 15%, which may keep rent growth tepid until vacancies fall further. However, rising rents for industrial and retail space, combined with falling vacancy rates, suggest that cap rates are improving. This should create some modest upward pressure on the commercial AV roll in coming years.

According to the assessor's office, much of the downward pressure is stemming from the residential sector. Prices and sales faltered during the first part of 2011, though they have largely stabilized since then. During the first half of 2011, home sales dropped from roughly 3,500 per month into the low 3,200s. At the same time, median prices dipped, tumbling from almost \$200,000 to just \$190,000 in August 2011. However, since then, home sales have been gradually trending upward and median prices have climbed back to hover around \$195,000.

Fundamentals: Housing Affordability and Population Growth

Housing fundamentals show several encouraging signs, especially with regard to Riverside's AV base. First, let's consider population growth. Prior to the housing bubble, the Inland Empire (including Riverside County) was one of the fastest-growing regions in California—outpacing the state overall in every single year since 1980, usually by a factor of two. In large part, this was driven by the relative affordability of the area in comparison with the nearby coastal employment centers of Los Angeles, Orange County, and San Diego. However, during the housing bubble, prices increased more in Riverside than they did in these surrounding metropolitan areas, which eroded much of the affordability that Riverside had previously offered prospective residents.



Now that prices have fallen farther in Riverside County than in these other markets, the relative affordability of the local economy is almost as high as it has ever been. This should rekindle that old incentive for more migration to Riverside County in coming years, which will create additional demand for homes and drive either new home construction or price appreciation for existing homes (with a mix of both being the most likely outcome).

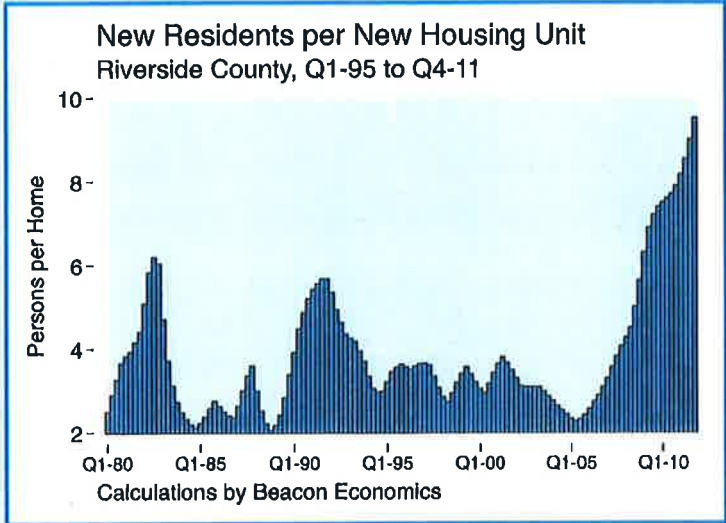
Our estimates show that the recent volatility in the housing market in Riverside County and across the state is a function of the cyclical fluctuations associated with the re-starting of foreclosure processes after the “robo-signing” debacle. Looking at the fundamentals—affordable prices relative to incomes, historically low interest rates, and an undersupply of housing in the state and in Riverside County—Beacon Economics predicts that the worst is behind us with respect to the housing market. The AV roll should stabilize in 2013–14 and should increase slowly thereafter as Prop. 13 effects begin to take over. Indeed, even defaults and foreclosures, which indicate the amount of stress in the local housing market, have been trending downward steadily in Riverside County.

For the purposes of this forecast, we are utilizing the lower-end estimate of AV decline from the assessor’s office (-2.0%) as our estimate of AV change in 2012–13. In the subsequent years, our forecast of property values for both commercial and residential property is driven by employment and labor market expectations, population growth, home prices and sales, new construction, and other structural drivers of property values.

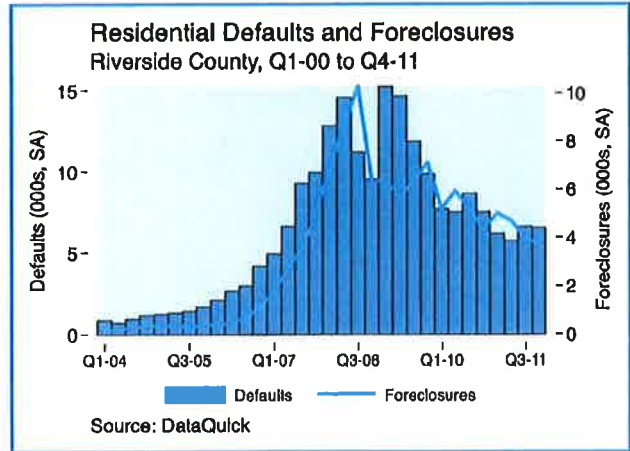
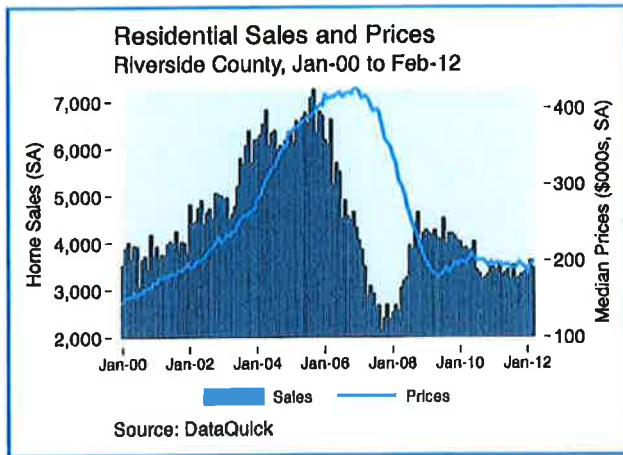
Fundamentals: Housing Vacancies and New Construction

There is still not enough housing in Riverside County, despite the surge in building that took place during the housing bubble. According to the California Department of Finance (DOF), Riverside County currently has a housing vacancy rate of 14%, which is higher than the statewide average of 8%. Nonetheless, with the current pace of construction (which remains very slow), the stock of vacant housing units will erode as the economy heals. During the bubble, homebuilders were putting up one new housing unit for every two new residents in Riverside. Currently, this number has ballooned to just one new housing unit for every 10 new residents, which suggests that either household size will start to increase or new construction will have to resume at some point to address the lack of available housing from a macro perspective.

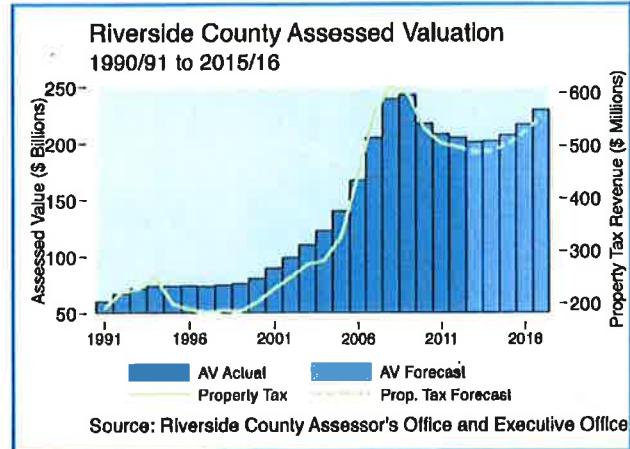
Beacon Economics expects that both residential and commercial construction will begin to pick up during the second half of 2012. Multifamily housing in particular is expected to do well, given the shift among many Riverside County residents from ownership to rental housing and the consequent bump in rents that has accompanied that trend. Much of the nonresidential construction activity will remain on the alterations/additions side of the equation for 2012, though by 2013, Beacon Economics expects to see increased permitting for new commercial buildings as well.



According to our calculations, which draw on information from the local assessor's office, the economy still has a long way to go. Beacon Economics expects that home prices and sales will remain fairly flat during the next six months as the economy continues to get back on its feet. However, population growth in the region and the increases in affordability will contribute to price appreciation as well as to new construction and home sales. Specifically, expect prices to stay around \$195,000 through the end of 2012, and to subsequently increase at a modest pace that tracks increases in income (3% to 5%).



The current forecast shows AV declining this year, in keeping with the assessor's expectations of the residential market. However, Beacon Economics expects that the county will see a return to growth in its property tax roll in 2013-14: Prop. 13 increases will start to kick in, new residential and commercial properties will be built, new residents will move in, and existing residents will form new households. Specifically, Beacon Economics is calling for growth of 0.5% in 2013-14, with AV picking up steam in later years, rising 2.5% in 2014-15, 4.8% in 2015-16, and by 5.5% in 2016-17.



Taxable Sales, Sales/Use Tax, and Prop. 172 Revenues

Unlike the property market, consumer spending in Riverside County has taken a less ambiguous turn toward recovery. In fact, according to data from the State Board of Equalization and HdL Companies, growth in taxable sales actually accelerated during the fourth quarter of 2010. This is due in large part to a gradually healing economy.

It's important to note that the current forecast takes into account the impact of the newly incorporated areas of Jurupa Valley and Eastvale. Since these have become incorporated cities within Riverside County, some resources, such as sales tax revenues, will be affected when these areas receive their sales tax revenues directly. According to estimates from HdL Companies, these newly incorporated areas represent roughly 3.7% of the total sales tax generated within the county and roughly 25% of the General Fund's sales tax base. Therefore, Beacon Economics has performed a forecast of total taxable sales in Riverside County's unincorporated area out to 2016-17, and then netted out this percentage of revenues that will now be directed towards Eastvale and Jurupa Valley. It is expected that this will provide a more accurate picture of the sales tax revenues available for the county's budget.

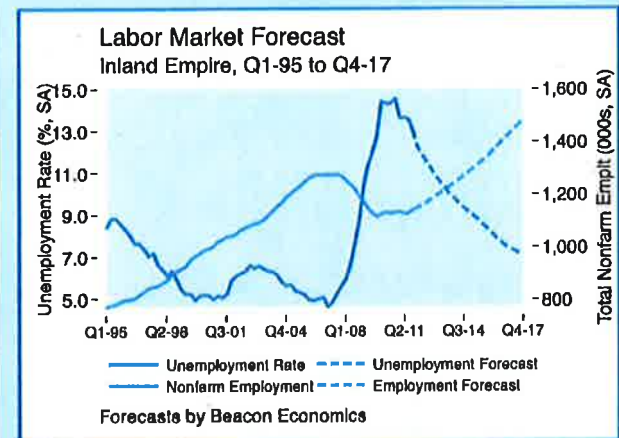
However, it is important to point out that despite this one-time reduction in the sales tax base associated with these new incorporations, the unincorporated areas of Riverside County have consistently outpaced the incorporated areas in the county. The unincorporated areas grew faster during the expansion than the incorporated areas of the county, and since hitting bottom, growth in the unincorporated areas has outstripped the county's incorporated areas consistently as well. Thus, although we expect this incorporation phenomenon to have a downward influence on sales tax revenues over the short run, the unincorporated areas are expected to continue outperforming the rest of the county once these one-time reductions in the sales tax base are absorbed.

Labor Markets

Inland Empire Employment

Industry	Job Growth Dec-09 to Feb-12	
	Jobs	%
Admin Support	12.3	16.4
Education/Health	6.6	4.9
Leisure and Hospitality	5.7	4.7
Manufacturing	3.9	4.6
Transport, Warehouse, Util.	3.6	5.4
Wholesale Trade	2.8	5.8
Prof Sci and Tech	2.7	7.5
Farm	2.1	14.4
Retail Trade	2.0	1.3
Other Services	1.6	4.4
Management	0.2	2.3
NR/Mining	-0.0	-0.5
Information	-0.3	-2.3
Government	-2.9	-1.3
Financial Activities	-3.0	-7.3
Construction	-3.4	-5.4
Total Nonfarm	31.7	2.9

Source: Employment Development Department



In addition, although not the sole determinant of our forecast, which includes a variety of economic indicators from population growth, tourism, income growth, and business spending, recently revised labor market statistics show that total nonfarm employment in the Inland Empire hit bottom in December 2009, and had a lackluster year in 2010, adding relatively few jobs. However, during the second half of 2011, local employment growth picked up in earnest. Since reaching bottom, the region has now added back almost 32,000 jobs, or 2.9% of its employment base. Importantly, this labor market recovery has begun to broaden out to a variety of important sectors. Administrative support has seen the largest job growth, both in terms of the number of jobs and on a percentage basis. This sector is an important bellwether for a labor market recovery because it includes temporary workers—employers have traditionally preferred to hire temporary workers during times of economic uncertainty, waiting to see whether the uptick in demand following a deep recession will be sustained.

Fortunately, these gains in temporary hiring have given way to permanent job growth in other sectors. Manufacturing, wholesale trade, and transportation and warehousing have all posted solid growth since hitting bottom, aided in part by a weak dollar and strong export performance at the ports of Los Angeles and Long Beach. Given that the dollar remains weak relative to historical norms and that our major trading partners have begun economic expansions as well, exports (and thus employment growth in these sectors) are expected to remain robust during the coming years.

However, consumer-oriented sectors have also posted solid job growth. Leisure and hospitality has added 5,700 jobs since December 2009, and retail trade has expanded by 2,000 positions. After several years of decline, spending by Riverside County residents has led to increased demand for retail, hotel, and restaurant workers. Several sectors, including construction, government, and financial activities, continue to face difficulty, but recently these losses have been more than offset by expansions in other parts of the economy.

Riverside County Taxable Sales Growth (%)

Fiscal Year	Unincorporated Areas	Incorporated Areas	Difference
Historical			
2000-01	15.7%	10.6%	5.1%
2001-02	-3.1%	5.2%	-8.3%
2002-03	9.9%	8.8%	1.1%
2003-04	16.7%	14.6%	2.0%
2004-05	21.4%	13.7%	7.7%
2005-06	14.7%	11.3%	3.3%
2006-07	-0.2%	0.2%	-0.4%
2007-08	-5.6%	-6.7%	1.1%
2008-09	-14.8%	-15.3%	0.5%
2009-10	-10.1%	-3.8%	-6.3%
2010-11	8.8%	7.5%	1.4%
Forecast			
2011-12*	-12.5%	8.8%	-21.3%
2012-13	13.9%	11.4%	2.5%
2013-14	9.9%	9.6%	0.2%
2014-15	9.4%	9.2%	0.2%
2015-16	12.9%	11.6%	1.3%
2016-17	13.0%	11.8%	1.2%

Source: California State Board of Equalization

*Note: Decline in 2011-12 driven by new incorporations

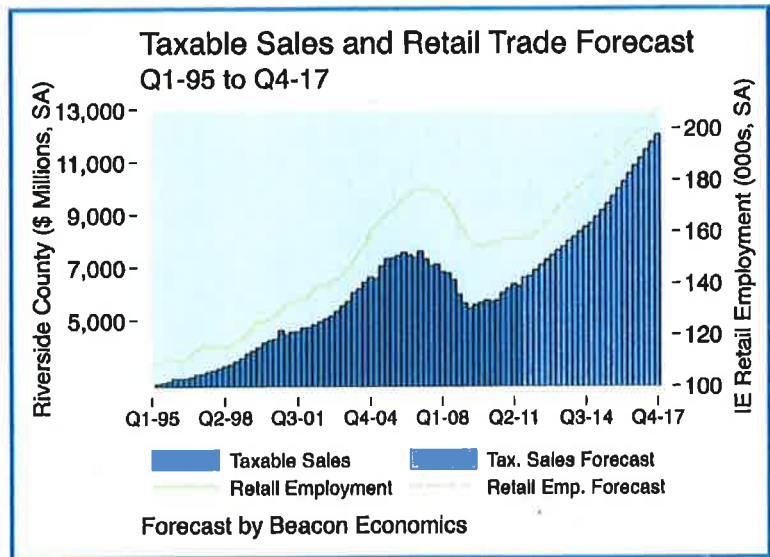
**Sales Tax Revenue by Category
County of Riverside**

Category	Q4-10	Q4-11	% Change
Autos\Transportation	8,018,564	8,902,223	11.0
Building\Construction	5,262,239	5,477,948	4.1
Business\Industry	6,580,826	6,442,812	-2.1
Food\Drugs	3,855,418	4,066,648	5.5
Fuel\Service Stations	7,507,658	8,599,537	14.5
General Consumer Goods	19,494,228	20,338,826	4.3
Restaurants\Hotels	6,603,377	7,201,528	9.1
Transfers & Unidentified	-1,679	-4,051	-141.3
County & State Pool	6,034,267	8,702,786	44.2
Total	63,354,898	69,728,256	10.1

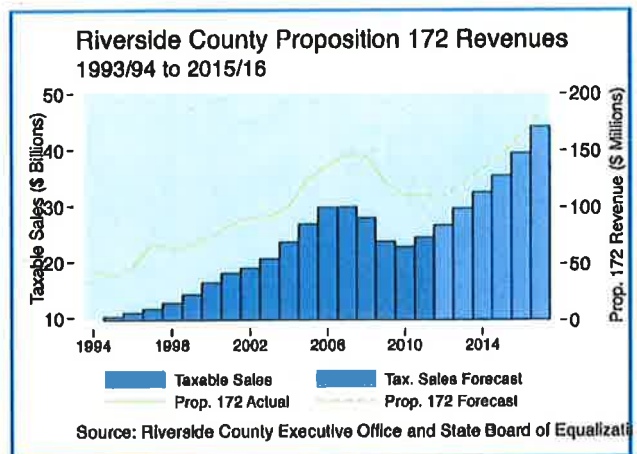
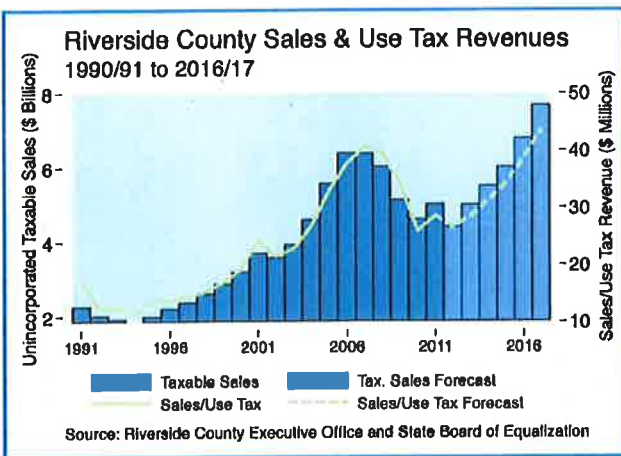
Source: HdL Companies

Beacon Economics is forecasting that the labor market recovery in the Inland Empire will continue throughout 2012 and beyond. The unemployment rate in the region has already dipped from a peak of 14.8% in November 2010 to 12.2% in February 2012. We expect the unemployment rate to continue to fall, dropping to 11.1% by the end of 2012 and into the single digits by late 2013. Nonfarm employment is expected to continue to expand as well, gaining momentum later in 2012. By mid-2013, the region's employment base will hit 1.2 million again, and it is forecasted to breach 1.3 million by 2015.

The improvement in the labor market has certainly played a part in the rebound in consumer spending that Riverside County is currently experiencing. According to HdL Companies, sales tax revenues increased by 10.1% during the final quarter of 2011. This follows a third quarter where sales tax receipts grew by more than 9% on a year-over-year basis. Importantly, this recovery has also been broad-based across various segments of the economy. Auto dealerships saw the largest increase at the end of the year, rising by 11%, but restaurants and hotels also reported strong growth during the fourth quarter. Gas stations also posted



double-digit growth, which was not surprising given the spike in gas prices during the final months of 2011. Even more importantly, all other categories of spending (with the exception of the business and industry category) saw positive growth during the fourth quarter.



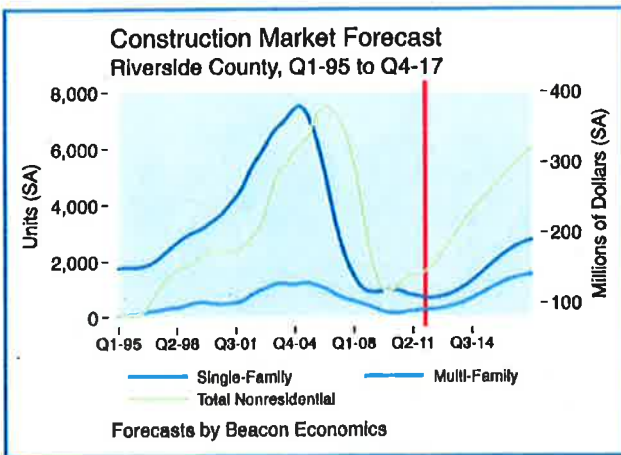
In total, Riverside County experienced a 28.5% decline in taxable sales from the peak in the first quarter of 2007 to the trough in the second quarter of 2009. However, since then the county has posted two years of uninterrupted growth in taxable sales on a year-over-year basis. Real GDP in the United States remained positive in the final quarter of the year,

driven in large part by consumer spending. With the labor markets gaining steam and the local unemployment rate declining, Beacon Economics is forecasting that taxable sales will continue to do well—hitting the pre-recession peak in mid-2013 and slowing slightly thereafter as several federal income tax cuts are slated to expire. As the economy picks up in 2014 and 2015, we expect growth in spending to accelerate again as well.

As a result of the redirection of funds, Beacon Economics is forecasting that sales tax revenues in the County of Riverside will take a hit in 2011-12, but continue to improve thereafter as the economic recovery will overtake the new incorporations in 2012-13. We currently estimate that Riverside County will end the 2011-12 fiscal year down roughly 6.8% in sales tax revenues (which is roughly where they are tracking through the first half of FY2011-12), and due entirely to the incorporation effect, which is a one-time event. However, as the economy continues to heal, the sales tax base (even after losing these newly incorporated cities) will begin to grow again in 2012-13. We expect growth next fiscal year to be modest as the federal tax cuts expire, thereby reducing disposable income growth for a period of 9-15 months. However, as the economy gains steam in 2014 and beyond, Beacon Economics expects that sales tax revenue will begin to pick up steam as well, exceeding its pre-recession peak of \$41 million by 2016-17. Given that Prop. 172 revenues are generated from the taxable sales in the state, Beacon Economics forecasts that Prop. 172 revenues will follow a similar path over this course of time, though they will be relatively flat during the current fiscal year.

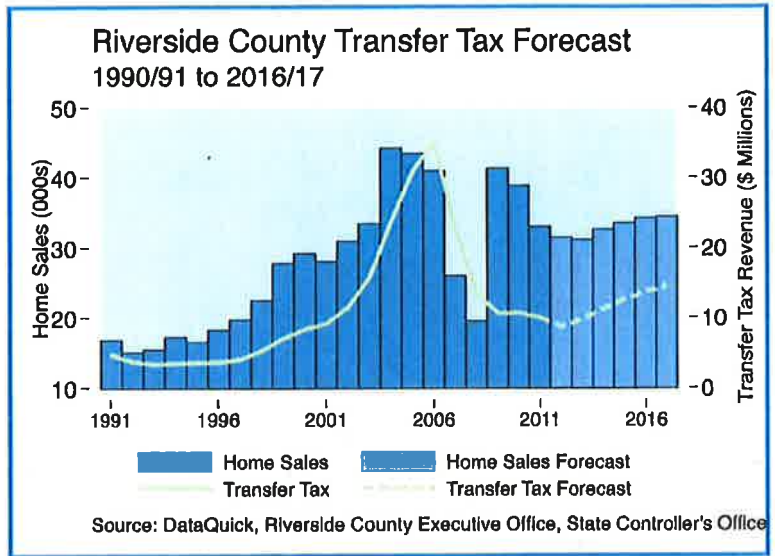
Real Property Transfer Tax Revenues

As noted, the first half of 2011 saw both home sales and prices stumble slightly. However, over the past six months, home sales have gradually increased and prices are back to around \$195,000. One interesting feature of the Great Recession is that household growth slowed dramatically during this time. Due to the weak labor markets and the high levels of unemployment, many younger residents and recent graduates were forced to live at home with their parents. In addition, many older residents moved in with their children as the economy deteriorated. Some families even joined together to split the cost of housing, putting additional downward pressure on new household formation.



However, as the labor markets improve and these folks gradually get back to work, they will be looking to form new households. This will be aided by both low mortgage interest rates, which are as good as they've been in years, and home prices that are back in line with incomes from a historical standpoint.

Defaults and foreclosures, though trending downward solidly, remain elevated compared with "normal" times, and unemployment remains high as well. We are expecting that home sales activity will remain modest, but as the economy continues to improve, sales will begin to increase during the second half of 2012. As a result, Beacon Economics is forecasting that transfer tax revenues will decline by roughly 13% during 2011–12, but will begin to increase in 2012–13 as sales pick up during the second half of the current year. As the economy gets back to equilibrium, home sales are expected to level off at around 8,800 per quarter. At that time (around 2015–16), we expect transfer tax revenue growth to dip back into the single digits and continue to expand at its historical average pace of 5% to 8%.



Summary

Overall, Riverside County has clearly turned the corner toward recovery in the wake of the Great Recession. Employment growth has returned, and the region has added more than 2.5% to its employment base. The commercial markets appear to have hit bottom and vacancies have begun to edge downward. The residential side of the market has also found bottom, though improvement has been slow. Based on our discussions with the County's Assessor's Office, and taking into consideration the weakness in the local residential markets during the first half of 2011, Beacon Economics forecasts that AV will be down again in 2012–13. However, we expect the property tax roll to begin increasing again in 2013–14—modestly at first as Prop. 13 increases begin to kick in and picking up steam after that.

The rebounding economy has also helped to boost consumer spending in the region. Sales tax revenues have already started to bounce back, and even after accounting for the newly incorporated cities within the county, which will have a negative impact on sales tax revenues during the current fiscal year, Beacon Economics is forecasting that both sales tax revenues and Prop. 172 revenue will continue to increase in 2012-13 and beyond.

Home sales have remained tepid, but we have observed modest increases in Riverside County over the last six months. Beacon Economics expects transfer tax revenue to fall during the current fiscal year. However, as the economic recovery gains traction, transfer tax revenues will pick up in 2012–13—new households will be formed, the population will expand, and the area will once again attract new residents moving inland in search of affordable homes with access to the large employment centers along the coast.

BEACON ECONOMICS

The County of Riverside still has a ways to go to get back to peak, but the economy is certainly moving in the right direction. Property and transfer taxes will experience additional declines this year, but will return to growth after that. Sales and use taxes will continue to move forward as the economy heals. Many tough decisions still remain for local policymakers, but we're finally beginning to see a light at the end of the tunnel.

About Beacon Economics

Beacon Economics is an independent economic research and consulting firm with offices in Los Angeles and the San Francisco Bay Area. The firm's internationally recognized forecasters were among the first and most accurate predictors of the meltdown in the U.S. mortgage market—and among a relatively small handful of researchers who correctly calculated the depth and breadth of the financial and economic crisis that followed. The firm focuses on providing objective, fact-based economic studies and analytics, long- and short-term economic forecasts, public policy analysis, and balanced counsel to those making financial, business, and economic decisions. Beacon Economics has served as the lead economic advisor to the California State Controller since 2008 and its Founding Partner is Chair of the Controller's Council of Economic Advisors.

Services

- Economic & Revenue Forecasting
- Business, Industry, & Market Analysis
- Economic Development Analysis
- Ports & Infrastructure Analysis
- Public Speaking
- Expert Testimony

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Attachment F Quarterly Fleet Vehicle Report

Units Sold by Departments 01/01/2012 to 03/31/2012	
NAME	Total
BUILDING AND SAFETY	1
COMMUNITY HEALTH AGENCY	2
DISTRICT ATTORNEY	1
DPSS	1
EDA-ADMINISTRATION	5
HUMAN RESOURCES	1
PROBATION	1
PURCHASING AND FLEET SERVICES	2
RCRMC	1
SHERIFF	18
TLMA CODE ENFORCEMENT	2
Grand Total	35
Units at Auction House Pending Sale	
NAME	Total
AGRICULTURAL COMMISSIONER	2
COMMUNITY HEALTH AGENCY	2
DISTRICT ATTORNEY	4
DPSS	3
EDA-ADMINISTRATION	12
PROBATION	1
RIVERSIDE DISPATCH	1
SHERIFF	15
Grand Total	40