

SIXTH ANNUAL PPCO FINANCIAL FORUM

taste^{of} the state

MID-YEAR REPORT
2009



PP&CO

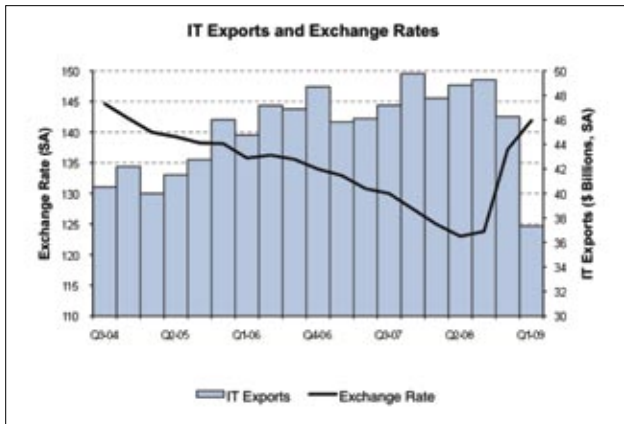
PETRINOVICH PUGH & CO LLP
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United States

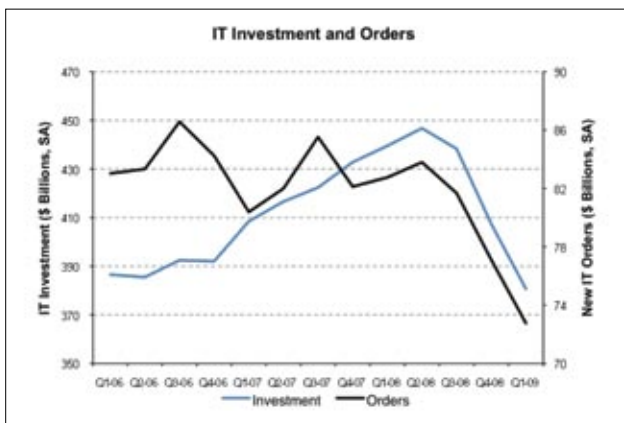
The current U.S. economic downturn is one of the worst in recent history. In terms of economic growth, the last two quarters rank as the 3rd and 4th worst on record in nearly 50 years. At the end of last year, corporate profits nationwide dropped 16.5% over the third quarter of 2008, following five consecutive declining quarters. This spells trouble for San Jose’s information technology (IT) equipment and software producers. Because businesses lag the consumer, both business investment in IT and new orders of computer and electronic capital goods were resilient through the beginning of the recession.

Real GDP Growth (% Annualized Rate)	
Q2-80	-7.8
Q1-82	-6.4
Q4-08	-6.3
Q1-09	-5.7
Q4-60	-5.1

However, businesses are catching up, and both investment and new orders have dropped off sharply over the past year and a half. Weak profits drove IT investment down by 6.5% in the first quarter of this year, after declining by 7.1% at the end of last year. New orders of computer and electronic capital goods fell by 5.6% in the first quarter of this year and are 12.8% lower than last year.



Foreign demand for U.S. goods and services has also fallen. Exports remained strong as the dollar weakened between 2004 and 2008. Yet, the dollar has appreciated in recent months driving exports down sharply. Through the end of 2008, U.S. exports of IT products were down by over 21%, and fell by another 19% in the first quarter of 2009. Despite this surge, we expect the exchange rate to slightly depreciate and remain flat in the medium-run—a boon for San Jose’s exports.



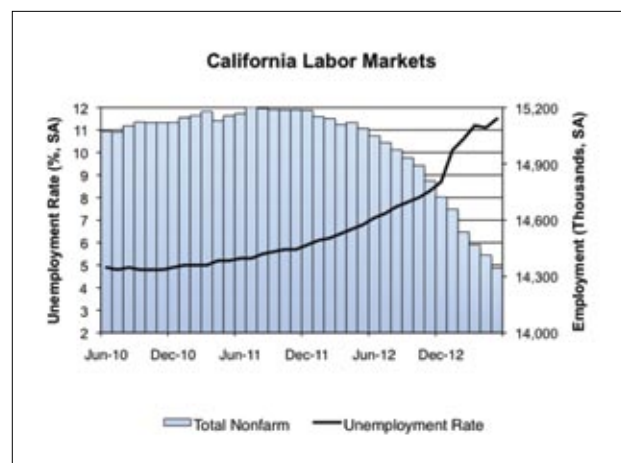
California

California is ground-zero for many of the nation's economic woes. The state's budget continues to deteriorate and the State Controller has warned that California may run out of cash to fund expenditures. Over 90% of the state's total revenues come from three sources: personal income taxes, corporation taxes, and sales taxes. Unfortunately, these are the areas being hardest hit by this recession.

Through May, California's total revenues were 15% (nearly \$13 billion) lower than they were last fiscal year. Personal income tax receipts are \$10.2 billion lower than last year, sales taxes are \$2.8 billion lower, and corporate taxes are \$531 million lower. And things are actually worse than they appear because those numbers mask the fact that the sales tax rate was increased last quarter and that a strict new underpayment penalty on corporate taxes has been imposed. Without these policy changes, the state's budget situation would likely look even worse. The Governor signed a bill in October that imposes a 20% understatement penalty on corporate tax. Companies were given the option to avoid the penalty by filing an amended return and paying their actual tax liability by May 31, 2009. As a result, corporate taxes soared to over \$2.1 billion by the end of June—an increase of over 1022% over last June. Thus, the results that we see in June are based more on policy changes enacted in Sacramento than a true rebound in corporate earnings.

Outside Sacramento, things in California aren't much better, especially in matters relevant to the San Jose region. On average, roughly one-fourth of the nation's exports of computer and peripheral products come from California. At the end of 2008, exports of these IT products had fallen by more than 24%. In the first quarter of 2009, California's IT exports fell by another 16%. This drove California's unemployment rate to a record high of 11.5% in May, on a seasonally adjusted basis. From its peak in July of 2007, California has shed over 860,000 jobs with almost 30,000 coming from the information industry alone. Although there are some signs of life in California's economy including rising residential building permits and increasing home sales—home prices, employment, and taxable sales have yet to turn the corner.

Category	2008/09 Revenues (\$ Millions)	2007/08-2008/09 Change (\$ Millions)	2007/08-2008/09 Change (%)
Corporate Taxes	\$7,771	(\$531)	-6.4%
Personal Income Taxes	\$39,196	(\$10,229)	-20.7%
Sales & Use Taxes	\$21,216	(\$2,840)	-11.8%
Total Revenues	\$72,626	(\$12,872)	-15.1%



San Jose

Labor Markets

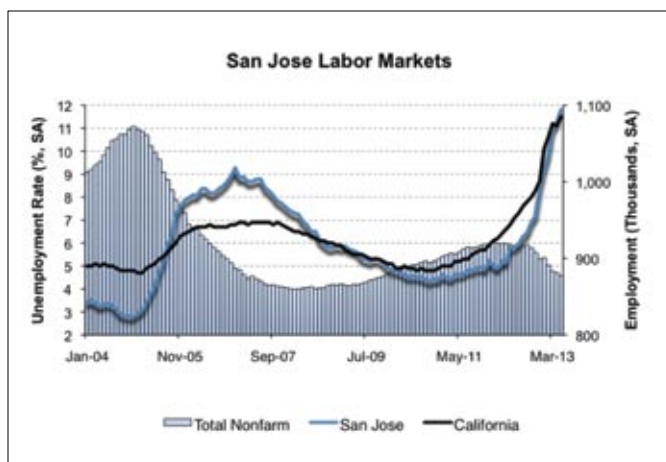
In some ways, this recession was slow in coming to San Jose. Employment in every sector in the region peaked later than in California overall with the exception of education and health services, which saw a slight dip in the first few months of this year but has since risen. This also highlights the extent to which the region's economy is tied to the IT sector, whose investment, orders, and exports remained resilient through the first part of this recession.

In other ways, San Jose's economy has been hit harder by the recession than the state as a whole.

At 11.8%, the region's unemployment rate is higher than the state as a whole. Indeed, May's unemployment rate is the highest on record in the current series, which began in 1990.

San Jose has shed over 43,000 nonfarm jobs or 4.8% from its peak employment in January 2008. The regions two largest sectors, professional and business services and manufacturing have declined by 11,100 and 9,600 respectively. Unsurprisingly, given the direct exposure to the housing market, construction and financial activities began contracting earlier, and have shed 11,000 and nearly 5,000 workers, respectively. The evaporation of home equity and increased savings caused trade, transportation, and utilities to shrink by 10,000 jobs as well. Information, government, and leisure and hospitality all peaked later, but have since shed roughly 7,000 workers.

Sector	Jobs Lost	Peak Employment	California's Peak Employment
Manufacturing	-11,108	May-08	May-98
Construction	-11,062	Mar-07	May-06
Professional	-9,622	Apr-08	Jan-07
Trade/Transportation	-9,471	Mar-06	Nov-07
Financial	-4,803	Jan-07	Jan-06
Information	-2,785	Sep-08	Jun-08
Government	-2,301	Sep-08	Jun-08
Leisure	-1,978	Oct-08	Jan-08
Other	-594	May-08	Apr-08
Natural Resources	-12	Mar-09	Sep-08
Education	1,485	Jan-08	Apr-08
Total Nonfarm	-43,889	Jan-08	Jul-07

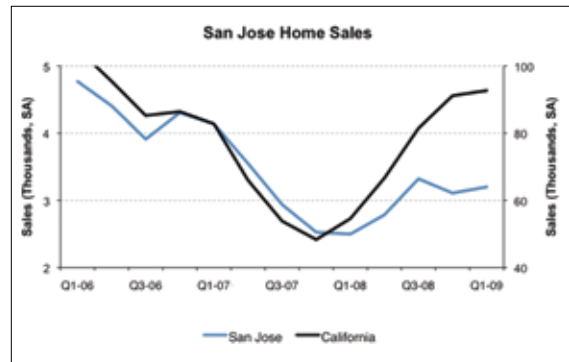


Real Estate

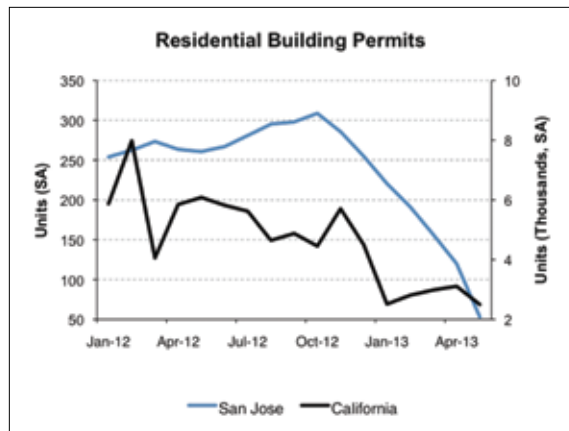
Fueled by the dot.com bubble in the late 1990s, home prices started appreciating much earlier in San Jose than in California. Between 2003 and 2007, the median home price in San Jose rose by \$488,000 or 162%. Since then, prices have fallen by \$366,000 or 46%—wiping out most of the gains over the past decade. However, California experienced a more severe housing bubble, with prices rising by 213% over the same period. Given the larger bubble, California prices have fallen faster, dropping 57% from their peak levels.



Low prices are enticing some buyers back into the market. Home sales in San Jose have increased by double-digit percentages for three quarters in a row. Unsurprisingly, since the state had larger price declines, California's home sales have rebounded even more strongly—rising by more than 50% for three consecutive quarters. Unfortunately, these home sales are not enough to clear the supply of nearly 10,000 foreclosed homes that has built up over the past three and a half years. And there are more foreclosures to come. Once the inventory is cleared and prices return to reasonable levels, new construction will resume.



The decline in nonresidential building permits has begun to slow in recent months. When recovery begins, the region will be on a healthier and more sustainable growth path.



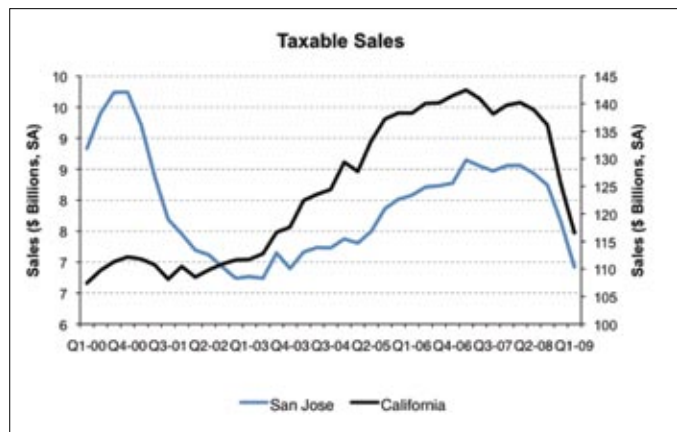
Income and Spending

San Jose has seen huge growth in personal income over the past two decades. Between 1990 and 2000, personal income grew by nearly 235%. Part of this is due to population growth, but per capita income also doubled between 1990 and 2000. During this time, San Jose became increasingly wealthy relative to California. Per capita income went from being 19% higher than California in 1990 to being more than 40% higher by 2007.

Personal and Per Capita Income				
Year	San Jose		California	
	Personal Income (\$ Thousands)	Per Capita Personal Income	Personal Income (\$ Thousands)	Per Capita Personal Income
1990	39,709,128	25,881	648,262,538	21,784
2000	92,947,240	53,733	1,103,841,912	32,734
2005	89,614,689	49,511	1,342,753,688	36,610
2006	98,252,329	53,730	1,445,580,645	38,979
2007	105,999,442	57,130	1,520,754,918	40,584

Additionally, as a share of the state's income, San Jose has been gradually increasing from 6.1% in 1990 to nearly 7% in 2007. At the peak of the dot.com bubble, San Jose saw a real spike in income, both in aggregate and on a per capita basis. Now that this recession has spread across all sectors of the economy, from the housing market to wage employment to the financial markets, we expect personal income to remain flat or fall slightly over the next year or two.

Consumer spending in San Jose has yet to show signs of turning around. In addition to turbulent labor markets, home equity has evaporated in the wake of falling home prices. In many cases, this bubble bursting has forced people to see that they need savings in addition to their home, and savings rates rise consistently over the past year. This combination of factors has dramatically reduced taxable sales in San Jose. From their peak in the first quarter of 2007, taxable sales have fallen by almost 20%. This is more than the 18.2% drop in the state, and has yet to show signs of slowing. In fact, over the last three quarters, the decline in taxable sales has been accelerating from -1.5% in the first quarter of 2008 to -9.5% last quarter. This is expected to continue until savings rates reach higher levels so that people feel comfortable spending again and until the labor markets stabilize.





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Petrinovich Pugh & Company provides auditing, tax advice, business consultation, and estate and financial planning for closely held businesses and individuals. The firm was founded in 1951 in San Jose, and it continues to make a mark on the history of Silicon Valley business. PP&Co serves a wide range of industries including construction, restaurant, real estate, golf courses, country clubs as well as general businesses. As long-established members of the community, PP&Co has many second and third-generation clients who continue to depend on the firm as trusted advisors.



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