

Update: United States Economy: Second Quarter 2011

Economic growth in 2011 was weaker than previously reported. Persistently high rates of unemployment suggested that the economy required more stimulus. With large budget deficits and low interest rates, policy options appeared limited.



The longevity of the economic recovery was called into question. New data indicated that growth slowed. The protracted debate over the debt ceiling and disagreements over how to reign in the deficit dampened consumer confidence and contributed to increased volatility in financial markets. The unprecedented downgrade in the U.S. credit rating and debt problems in the Euro-zone added to the prevailing uncertainty. A market analyst characterized the recent developments as a game of whack-a-mole, an endless process of old and new problems emerging to spook investors.

Through August, upheaval in financial and foreign exchange markets contributed to an erosion in consumer and business confidence regarding the sustainability and strength of the current recovery. Data showed that growth slowed, surveys pointed toward declines in manufacturing, and job creation remained tepid. The prolonged wrangling over the extension of the debt ceiling, lingering uncertainty regarding the federal budget, and potentially limited options for future monetary policy left many economic analysts anticipating that fiscal and monetary policy will carry a neutral, if not restrictive, effect on future economic activity.

Fiscal Policy

The mid-summer Congressional debate over the extension of the debt ceiling vividly demonstrated the wide divide held by lawmakers over how to rein in the federal deficit. Fed Chairman Bernanke provided a pointed assessment in his Jackson Hole speech when he stated, "...the country would be well served by a better process for making fiscal decisions. The negotiations that took place over the summer disrupted financial markets and probably the economy as well, and similar

Table of Contents

Recovery in doubt.....	Page 1
Economic growth slowed	
Debt issues caused upheaval in equity markets	
Fiscal policy	Page 1
Debt ceiling debate	
Revisions to budget deficit	
Monetary policy.....	Page 2
Options in light of weak economic activity	
Gross domestic product.....	Page 3
Economy weaker than reported	
Yet to regain pre-recession levels	
Recent trends	Page 4
Softening in manufacturers plans	
Inventories react to slow sales	
Rebound in car & retail sales	
Employment.....	Page 5
Job growth remains disappointing	
Financial Trends	Page 5
Rates sharply lower in August	
Yen, Swiss franc & gold viewed as investor safe havens	

September 2011
Volume 3, Issue 2

events in the future could, over time, seriously jeopardize the willingness of investors around the world to hold U.S. financial assets or make direct investments in job-creating U.S. businesses.” Considering that some of the more contentious budget negotiators were calling for the elimination of the Federal Reserve or at least its independence, those uncharacteristically blunt comments by a Fed Chairman may not hold much sway.

The Congressional Budget Office (“CBO”) released an August update of the budget and economic outlook. The revised forecast by the CBO placed the fourth quarter to fourth quarter growth in GDP at 2.3% in 2011 and 2.7% in 2012. Both rates were considered to be sluggish for a period of recovery. Due to this slow growth, the rate of unemployment would remain high, averaging 8.9% by the fourth quarter of 2011 and 8.5% in the final quarter of 2012. The achievement of the 2.3% 4Q/4Q growth in 2011 would require an annualized growth of 3.9% in the second half, a turnaround from the 0.7% annualized growth in the first half. Based upon CBO analysis of existing legislation, fiscal policy will provide decreasing support for economic activity in 2011 and will significantly retard the growth in the economy during 2012 and 2013.

Revised estimates for the fiscal 2011 budget deficit equaled \$1.3 trillion or an 8.5% share of GDP. CBO out-year estimates assumed that current laws were not changed. Included in the assumptions was that the Bush-era tax cuts expired, Medicare payments in 2012 were reduced by nearly 30% and \$1.2 trillion in budget cuts occurred. Based upon these assumptions, the deficit share of GDP would fall to 6.2% in 2012, 3.2% in 2013 and 1.6% in 2014.

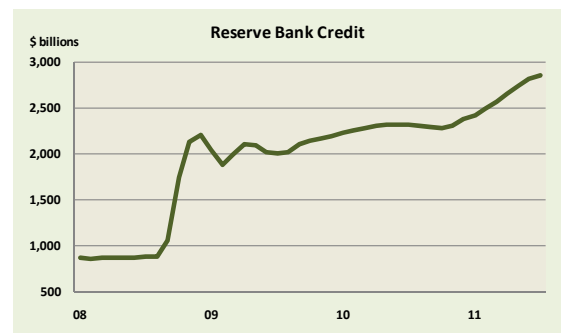
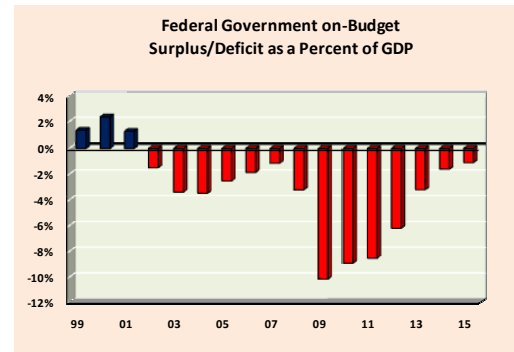
Monetary Policy

The statement issued after the August 9 meeting of the FOMC presented a sober assessment of the state of the U.S. economy. Economic growth so far in 2011 was quite a bit slower than the FOMC expected earlier in the year. While job growth picked up early in the year, conditions in the labor market deteriorated in recent months and the unemployment rate edged up. Household spending flattened, and housing remained depressed. Investment in business equipment expanded, but investment in commercial buildings continued to be weak.

Some of the weakness in economic activity was due to temporary factors such as the impact on household income of higher prices for food and energy and the supply disruptions following the earthquake in Japan. These restraining forces appeared to have abated and the economy should have stronger growth in the second half. But it was clear to the FOMC that not all of the weakness was due to one-time factors—and in light of this, the FOMC revised down expectations for the future pace of the recovery.

On the inflation front, the FOMC noted that inflation has moderated recently as energy and commodity prices have declined from their peaks. Longer-term inflation expectations remained stable. The Committee expected rates of inflation to settle over upcoming quarters at levels that were at or below those consistent with the FOMC mandate to promote full employment and price stability.

The Federal Reserve’s program known as Quantitative Easing, part 2, ended as scheduled on June 30, 2011. Over the eight months from November 2010 through June, the Fed purchased intermediate-term treasury securities at a rate of \$75 billion a month for a total of \$600 billion. Through QE-1, QE-2 and other stimulus measures, reserve bank credit had risen at a rate in excess of 220% over the past three years.



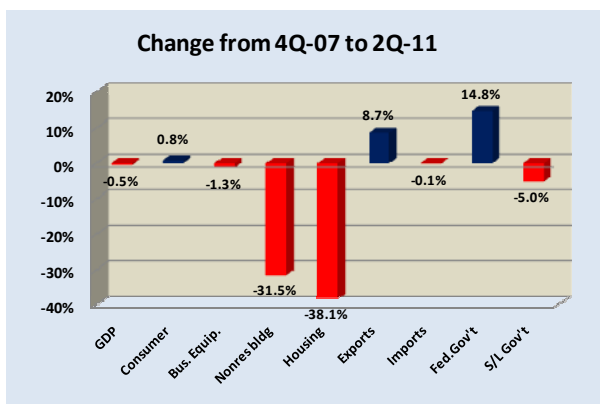
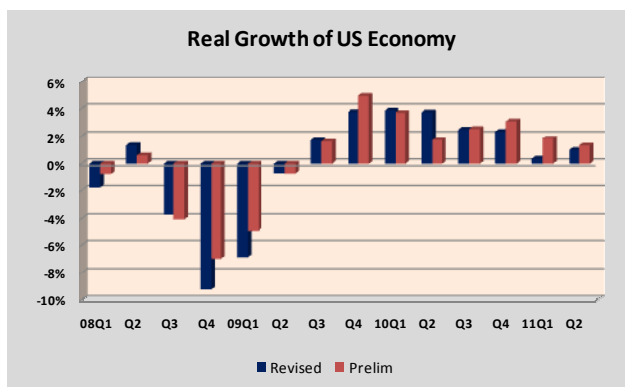
In light of the current outlook, the FOMC announced that it would keep short-term interest rates exceptionally low at least through mid-2013. Following the release of the FOMC's August statement, market interest rates moved generally lower, which should provide some support for increased economic activity and jobs. Post-meeting conditions remained unsettled and equity markets showed subsequent volatility in prices.

At the Jackson Hole gathering of central bankers, Fed Chairman Bernanke acknowledged that the U.S. economic recovery was less robust than the Fed had expected. Even so, the economy experienced positive events for this recovery, such as the 15% increase in manufacturing activity from the recession trough, improved household balance sheets and reductions in commodity prices. Nonetheless, high rates of unemployment, especially high levels of long-term unemployment, represented a force that may significantly and adversely affect the longer-term performance of the economy. The Jackson Hole speech did not foreshadow any additional monetary policy stimulus. Chairman Bernanke stated that the Fed has a range of tools that could be used to provide additional stimulus. Such measures will be considered at the September meeting of FOMC, which has been extended to a two-day meeting to allow a fuller discussion on the economy and policy responses.

Gross Domestic Product

Whether it is a soft patch or a deep hole, recent data made it clear that the national economy slowed significantly in the first half of 2011. It is becoming difficult to refute the observation that the economy is in a growth recession. The reason that jobs aren't growing is that the economy hasn't grown sufficiently to generate jobs. The late July 2011 annual revision of the national income and product account data revealed that the recent recession was steeper and the subsequent recovery was milder than previously reported. Output declined 0.3% in 2008, instead of being unchanged as originally reported. The decline in 2009 was 3.5%, not 2.6% as previously reported. Revised growth for 2010 at 3.0% was essentially unchanged from the preliminary estimate of 2.9%.

Revised estimates showed that growth decelerated beginning in the second half of 2010. The first quarter 2011 growth rate was revised substantially to 0.4% from the earlier estimate of 1.9%. The lower growth resulted from reduced spending on consumer services, a slower rise in inventories and a higher volume of imports, a sector that offsets domestic output. The 1.0% growth in the second quarter 2011 was well below market expectations. Consumer spending edged only slightly higher as the steep decline in spending on motor vehicles was more than offset by moderate gains in other consumer spending. Business investment and residential construction were sources of growth in the second quarter, while inventories acted as a damper on growth. The trade sector had a generally neutral effect on second quarter growth. For the third consecutive quarter, government spending was a drag on total output, with reduced state and local government spending offsetting the upturn in federal defense spending.



The trade sector had a generally neutral effect on second quarter growth. For the third consecutive quarter, government spending was a drag on total output, with reduced state and local government spending offsetting the upturn in federal defense spending.

Due to the downward revisions in GDP over the past three years, the U.S. economy through the second quarter of 2011 remained 0.5% below the previous peak in output, a contrast to the preliminary data findings that the economy had regained its prior peak by the fourth quarter of 2010.

The rate of inflation picked up in the first half of 2011, with higher prices for food and energy boosting inflation in the consumer and import sectors. The GDP price deflator rose 2.5% in the first quarter and 2.4% in the second quarter. For the first two quarters of 2010 the rate of inflation equaled 1.5%. Prices of gross domestic purchases climbed to 4.0% in the first quarter and 3.3% in the second quarter, compared with rates of 1.5% for all of 2010.

Recent Trends

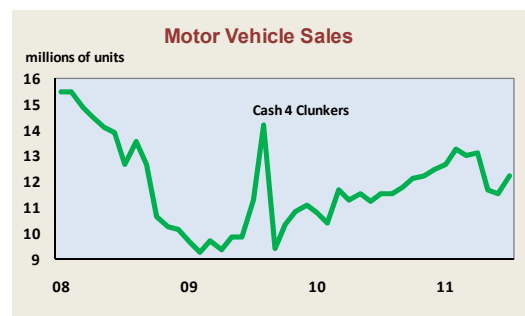
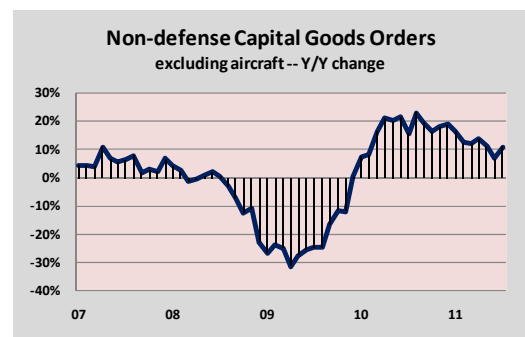
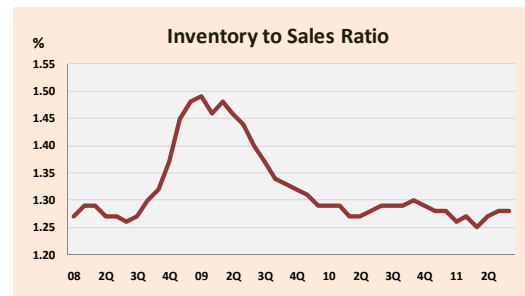
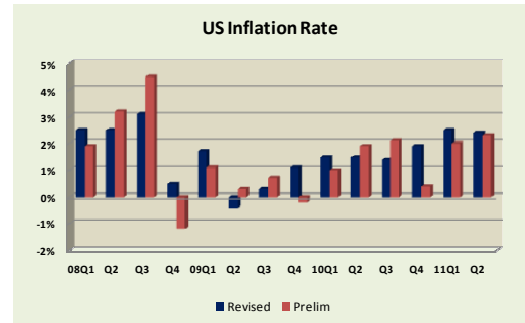
The factory index surveyed by the Institute for Supply Management (ISM) revealed a surprisingly sharp decline, falling from 55.3 in June to 50.9 in July. The July reading edged close to the 50 demarcation between expanding and declining activity. The index was the lowest since the economic recovery began two years ago. All five components of the index fell in July, led by declines in employment. Supplier deliveries and inventories also were sharply lower.

As retail sales slowed, the inventory-to-sales ratios for the first two months of the second quarter climbed to 1.28 from 1.25 in March. Due to efforts to limit unintended supplies, spending on inventories yielded a neutral impact on growth in the second quarter. The recently indications of softening economic activity are likely to limit planned inventory investments in the current quarter.

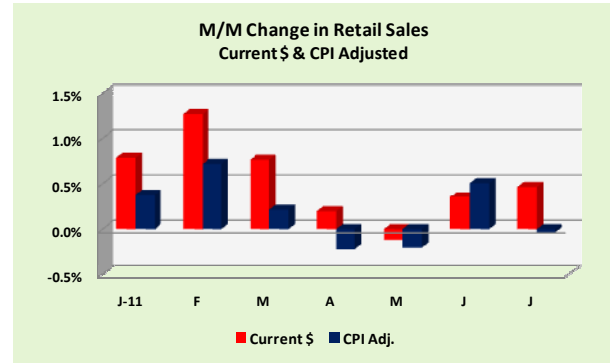
Orders for durable goods fell in June and rebounded in July. Transportation bookings, notably in the aircraft sector, contributed to the recent volatility in orders. Excluding transportation, orders were relatively steady, up 0.6% in June and 0.7% in July. Non-defense capital goods orders, excluding aircraft, declined 1.5% in July, following the 1.9% surge in May and the 0.6% gain in June. Although orders declined in July, YoY growth rose to 10.8% from 6.8% in June.

Sales of cars and light-duty trucks picked up in July, following two months of declines. Motor vehicle sales equaled an annualized rate of 12.2 million units in July, up from 11.5 million units in June. Nonetheless, sales were well below the high so far for the year of 13.2 million units. On a YoY comparison, July sales were up only 2.3%. The import share of motor vehicle sales declined to 22.3%, the lowest reading since early 2006. With the dollar under downward pressure, especially against the Japanese Yen, the market share for imports is likely to remain low.

Retail sales were affected by a variety of factors, including supply disruptions following the earthquake in Japan and significant volatility in fuel and food prices. Retail sales, not adjusted for



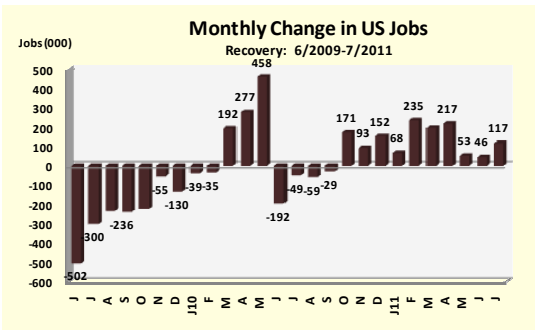
inflation, evidenced considerable swings in growth month to month ("M/M"). In contrast, sales, adjusted by the consumer price index, generally weakened beginning in March, as reflected in the chart on the M/M change in current and inflation-adjusted sales. Nominal sales grew 0.5% in July, while price-adjusted sales fell 0.03%



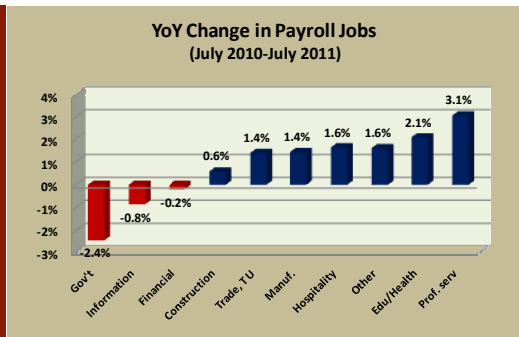
Important future data to watch will be the pace of sales and orders following the unsettling events of the S&P degrade of the U.S. government credit rating, the worsening in the Euro-zone debt crisis and the significant volatility in equity markets. The late August report from the University of Michigan showed that U.S. consumer confidence declined to its lowest reading since August 2008. The July survey of small business owners showed that optimism regarding future economic activity fell to the lowest level since last September and that the percentage of firms with job openings declined.

Employment

During the first seven months of 2011, the U.S. economy generated 930,000 jobs, a total that nearly matched the jobs created for all of 2010. Recent trends, however, were disappointing, especially the uneven pattern of growth of payrolls. The impressive increases in employment in February through April were followed by anemic gains in May and June and a slightly larger gain in July. A headwind in the creation of total jobs was the steady decline in government-sector jobs. On a YoY comparison, government employment was down 2.4% in July, with declines reported on the local, state and federal government levels. In recent months, there was an acceleration in the rate of decline in state and local government jobs. The jobless rate in July equaled 9.1%, down from 9.2% in June yet up from 8.8% in March. The average duration for unemployment equaled 40.1 weeks, and 44.4% of the unemployed had been out of work for more than 27 weeks.



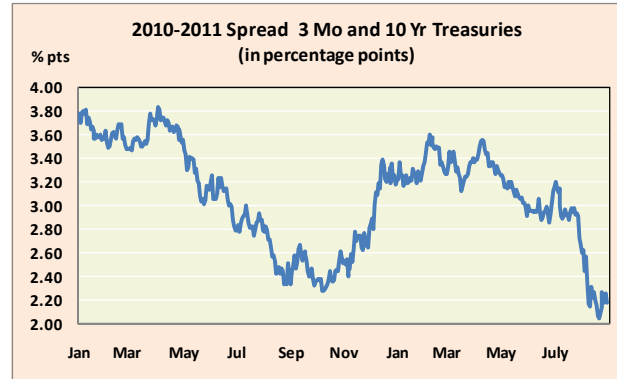
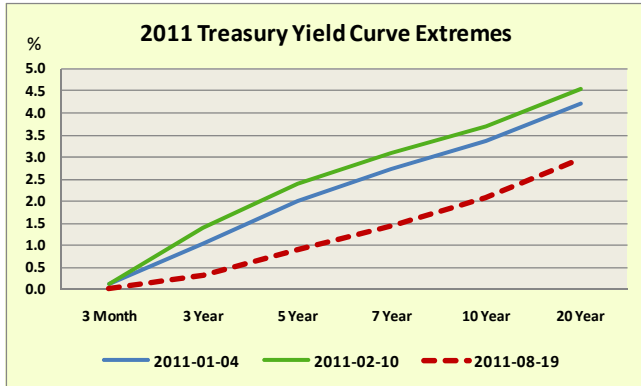
43 months after the peak in the business cycle, payroll jobs are 4.9% below that peak level.



Financial Trends

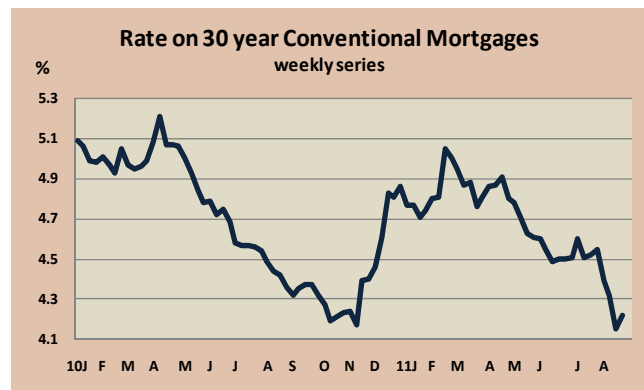
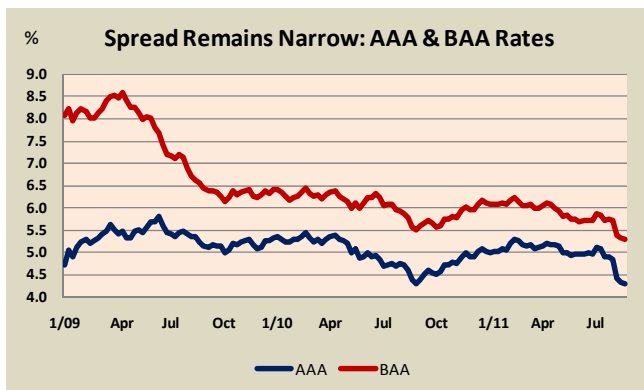
For the first eight months of 2011, the peak in interest rates on U.S. treasuries generally occurred in early to mid February. Partially defying logic, treasury rates plummeted to their lows for the year immediately following the credit rating downgrade by S&P. As equity prices plummeted in early August 2011, investors showed a preference for the safety and liquidity of treasuries over alternative investments. During one August trading day, investor demand for treasuries pushed the inter-day rate for 10-year treasuries below 2% for the first time in history.



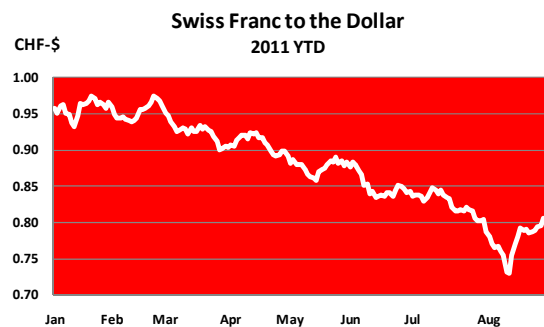
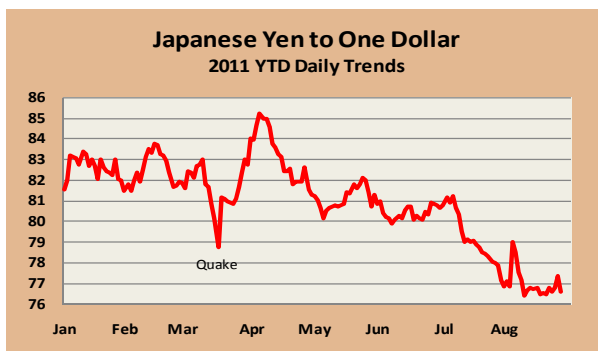


For the first eight months of 2011, the yield slope between three month and 20-year treasuries narrowed from a peak of 443 basis points in February to a low of 295 basis points in August. The spread between three-month and ten-year treasuries retraced the lows that were last reached in late 2010 and established a new record low for the spread.

From the beginning of July to late August, the rate on AAA-rated corporate bonds declined 80 basis points, while the decline in BAA-rated bonds equaled 59 basis points. Thus, the risk spread widened to 98 basis points as of August 19, compared with the recent low in the spread at 75 basis points. The rate on a 30 year conventional mortgage fell to a weekly low of 4.15% in late August, a decline of 90 basis points from the high for the year.



The S&P downgrade coincided with renewed concerns over the viability of sovereign debt for many European countries and the ability of the Euro to withstand this period of financial instability. Market sentiments created a flight to safety by investors into the Japanese Yen, Swiss franc and gold. Concerted efforts were made by the Japanese and Swiss central banks to limit the appreciation of their currencies. Gold began July at a price of \$1,480/ounce, peaked on August 23 at \$1,880 and ended the month at \$1,825 for a two-month price appreciation of 23%.



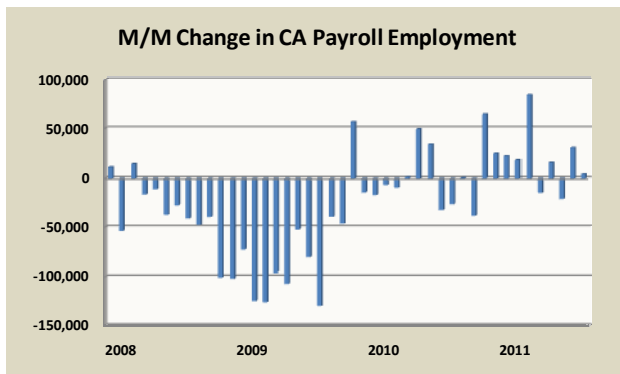
Update: California Economy: Second Quarter 2011

Job growth was uneven and the jobless rate was second highest in the nation. The economy showed signs of expansion, especially in tech and manufacturing centered areas such as the Silicon Valley and Los Angeles. Housing remained the weakest link.



Employment

The California economy realized a gain in payroll jobs during the first seven months of this year, yet the path to the gains was not steady or consistent. Payrolls expanded by 102,200 jobs in the first two months of this year, a good beginning to the year. In the next three months, the state lost 21,100 jobs only to more than recoup those losses with the June-July gain of 34,900. For the first seven months of this year, the state reported an increase in non-farm payroll employment of 116,000. This gain contrasted with the first seven months of 2010 when 9,200 payroll jobs were created.



The YTD gains in employment would have been 15% higher if government employment had not declined. The business and professional services sector led the major industries with the steepest growth in jobs YTD. The education and health care services sector was in second position. These two industries accounted for 1/2 of the YTD increase in payrolls.

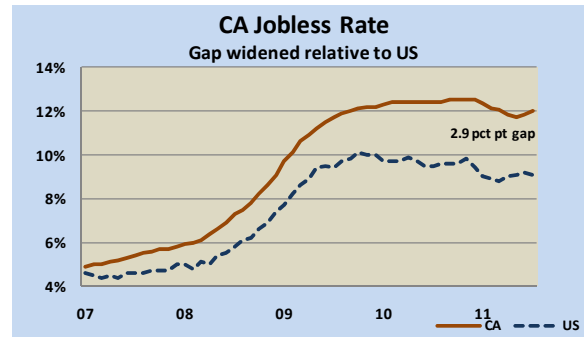
The jobless rate is based upon a survey of households, not from payroll data. Household employment declined by a

Table of Contents

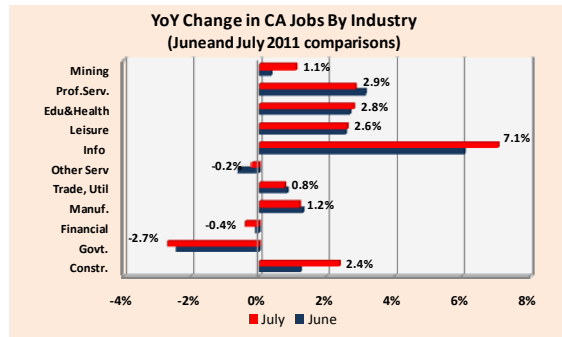
- California Employment Page 7
 - No consistent recovery in jobs
 - Cuts in government jobs
 - Jobless rate gap widening versus U.S.
 - San Jose area rebound in jobs
- Consumer..... Page 8
 - Income hurt by slow job growth
 - Supply disruptions hold down auto sales
 - Gasoline prices slightly lower
 - Food and fuel prices pushed up inflation
- Construction Page 9
 - Housing permits fall to record low
 - Existing home sales up YoY, prices down
 - Home prices in LA, SD, SF renewed YoY declines
 - Commercial building plans up
 - CRE fundamentals improving in Silicon Valley, LA, SF
- State Budget Page 10
 - FY 2011 ended with a \$1.8 billion positive funding gap
 - FY 2012 budget with \$15 billion in spending cuts

total of 30,700 in the first seven months of 2011. The household survey revealed that 136,000 left the labor force, allowing the number of unemployed to decline by 105,400. These general trends produced a reduction in the jobless rate from 12.5% in December 2010 to 12.0% in July. The July jobless rate placed California in second place based upon the ranking of unemployment rates by states. At 12.0%, California ranked behind Nevada at 12.9% and was well ahead of Michigan and South Carolina, which were tied for third place at 10.9%.

The July jobless rate for the state contrasted with the 9.1% national rate. The resultant gap of 2.9 percentage points was below the record differential of 3.4 percentage points that occurred in January of this year.



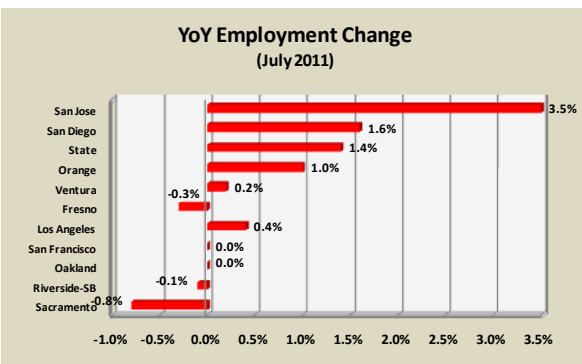
The slow growth in jobs and persistently high rates of unemployment prompted many Californians to stop looking for a job, thus dropping out of the labor force. The size of the California labor force peaked in January 2009. Since then through July 2011, 274,900 have left the labor force, a drop of 1.5%. The labor force participation rate, which is measured relative to the civilian, non-institutionalized population over 16 years of age, fell to 63.0% in July, the lowest rate since early 1977.



In July, eight of the eleven major California industries reported YoY gains in employment. Over the past year, payroll employment expanded by 189,400 jobs. The rise in jobs was led by the 59,400 increase in business services employment, with education and health care services industry reporting a 50,200 job gain. The information industry showed the steepest percentage growth, up 7.1%. The construction industry compiled six consecutive months of YoY job gains. The total YoY increase in construction jobs over the past six months equaled 28,700 or 0.6% of the 4.54 million construction jobs that were lost during the prior 52 months of YoY declines. The financial services and other services sectors experienced small

YoY job declines in July, while total government employment was down 2.7% YoY.

Of the ten major metropolitan areas in the state, five reported YoY job gains in July, while three reported job losses and two areas were unchanged. The San Jose area rebounded briskly, with YoY job growth of 3.5%. Job growth in San Jose was stimulated by increased hiring in the information sector and from expansion funded by a series of successful initial public stock offerings. San Diego and Orange Counties reported YoY job growth in excess of 1% in July. Areas still suffering YoY job losses were Sacramento, Riverside-San Bernardino and Fresno.



Two of the ten major metropolitan areas reported July rates of unemployment below 10%. The low jobless rates equaled 8.8% for San Francisco and 9.3% for Orange County. The high jobless rates were 16.7% for Fresno and 14.7% for Riverside/San Bernardino.

Consumer Sector

California personal income increased 1.4% in the first quarter of 2011, easing from the 1.8% advanced in the fourth quarter. The first quarter growth rate placed California 48th lowest

growth rate nationwide. Only the farm states of South Dakota and Iowa reported lower first-quarter growth in income. The primary reason for California's slow income growth was the lack of jobs. The rise in California's workplace net earnings equaled 1.5% in the first quarter, compared with the national average of 2.2% and was the third lowest in the nation. Also contributing to the low income growth was the 0.3% decline in transfer payment receipts. Income from dividends, investment and rents showed a 0.25% gain, which was among the highest growth rates in the nation.

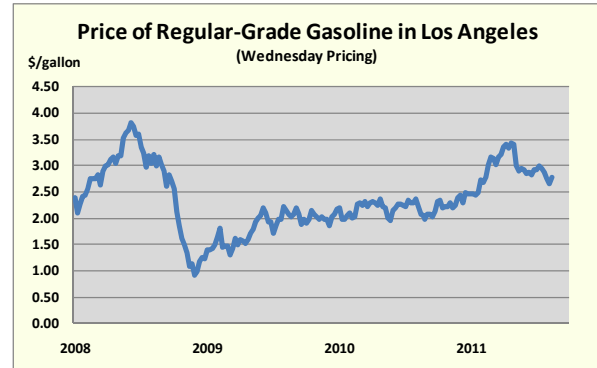
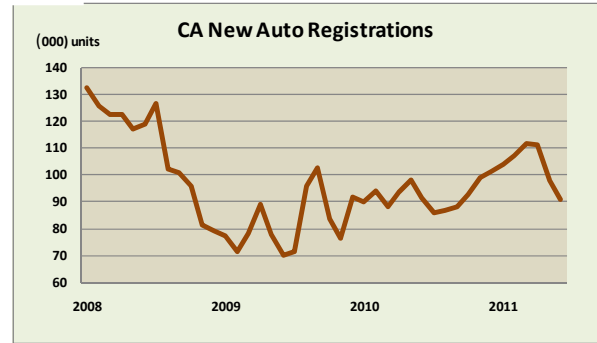
New auto registrations were quite brisk in California from December 2010 to April 2011. The May and June data showed a steep deceleration in registrations, largely due to the limited inventories of motor vehicles from Japan caused by the supply disruptions following from the March 2011 earthquake and tsunami. If national trends proved to be valid predictors of auto buying in California, it is likely that registration activity will pick up in July and August.

In auto-dependent Southern California, trends in gasoline prices greatly impact consumer spending, especially on other and discretionary purchases. The retail price of regular gasoline in Los Angeles trended higher from August 2010 through April 2011. Since the April peak in prices, the price of gasoline declined nearly 19% through August. Unlike the pattern in 2008, when the peaking in gasoline prices was followed by a steep and rapid decline, current trends implied that gasoline prices had settled in a high plateau.

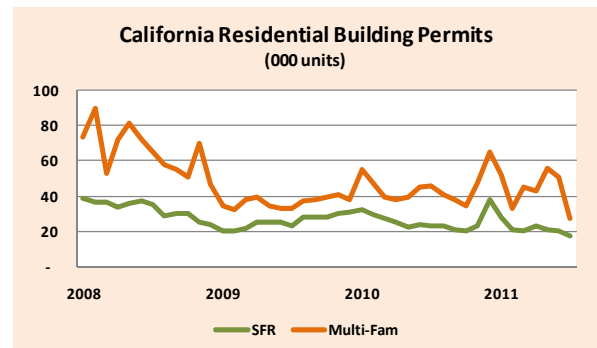
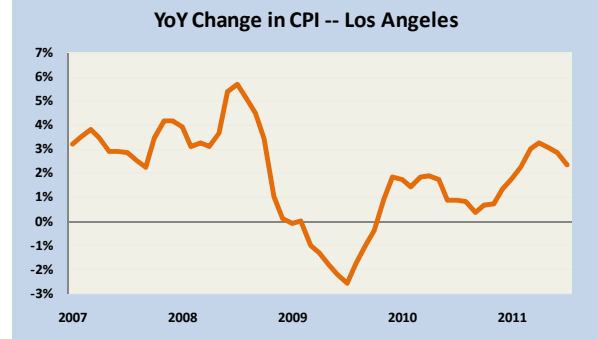
Gasoline prices contributed to the run-up in the rate of inflation, as measured by the consumer price index for Los Angeles. This index recorded YoY increases in excess of 3% in the March through May 2011 period, before edging to a 2.4% YoY rate in July. The recent trends contrasted with the negative YoY rates for most of 2009 and the sub-1% rates for most of 2010.

Construction

The housing industry in California continued to be disappointing. Building permits plunged to a record low in July. Total housing permits fell 41.3% on a YoY basis to an annualized rate of 27,100 units. Single family permits were off 26% YoY and multi-family were 56.5% lower. The magnitude of the decline was attributable to changes in building codes that went into effect in January. To avoid the code changes, permits needed to be applied for prior to January and be issued prior to July 1, 2011. One analyst



Higher prices for food and fuel pushed local area inflation to their highest YoY increases in two years. Recently, higher prices for apparel and for used cars and trucks placed upward pressures on prices.



posited that permits issued late last year and earlier this year may have borrowed from second-half 2011 activity. Permits averaged 47,000 units in the first half of this year, compared with 44,000 units in the first half of 2010 and 45,000 units in the second half of last year – not a significantly large amount of “borrowing”.

Sales of existing homes in July were up 4.5% on a YoY comparison, yet declined 4.1% compared with June. The median price of a home sold declined 7.6% on a YoY basis and was down 0.3% on a monthly basis. The inventory of unsold homes equaled 5.5 months in July, which was essentially unchanged from the year-earlier level. The YoY unsold inventory rose for all major price points. The median number of days to sell a single-family home equaled 52.1 days, up from 42.4 days a year earlier.

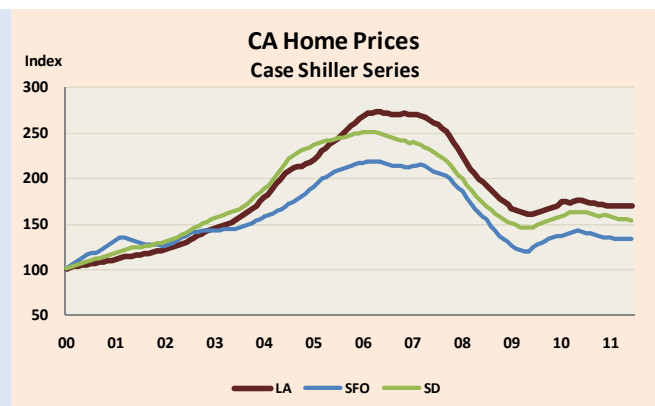
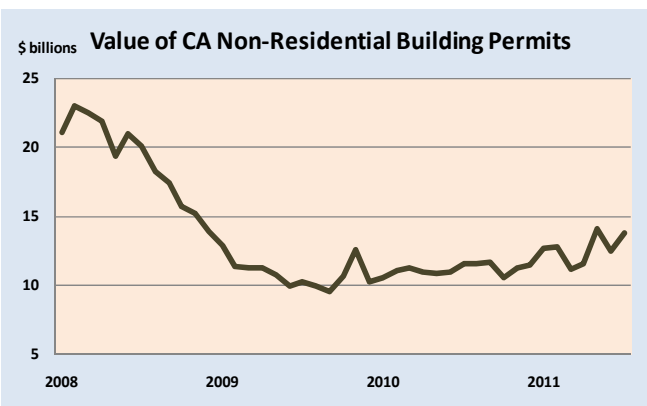
As was the case for all 20 cities in the Case-Shiller index, home prices in Los Angeles, San Diego and San Francisco reported YoY declines in June. Prices for the California cities had been positive on a YoY basis generally throughout 2010, yet resumed a negative course in 2011. These trends supported the findings of a recent report by Fannie Mae that 21% of California homeowners with a mortgage owed more than the current value of the home.

Permit valuation for non-residential construction in July increased 11% over June and 19% on a YoY basis. The July advance only partially reversed the 12% decline that occurred in June. During July increased valuations for industrial and hotel permits more than offset the declines in permit valuations for office and retail properties.

Conditions appeared to be improving for commercial real estate, notably for industrial properties in Los Angeles and the Silicon Valley and for office buildings in San Francisco and the Silicon Valley. Renewed manufacturing in the apparel, aerospace and metal products industries boosted demand for industrial space in Los Angeles. The Silicon Valley experienced recent gains in manufacturing activity. Demand for warehouse space increased for the sixth consecutive quarter. The Silicon Valley recorded during the first half one of the region’s most robust periods for the office market since 2003. San Francisco had the most active market for office space in over four years, punctuated by increased rents, fewer concessions and decreased allowances for tenant improvements.

State Finances

The state generated \$1.8 billion more in revenues than in expenses during fiscal 2011. Receipts from personal income and sales taxes exceeded estimates, while spending on state operations came in below expectations. Including the \$9.9 billion deficit from fiscal 2010, the state ended fiscal 2011 with a combined deficit of \$8.2 billion. The state budget enacted for the 2011-12 fiscal year was designed to close a \$26.6 billion budget gap. The new fiscal year budget required \$15 billion in spending cuts. General fund spending was projected at \$85.9 billion for fiscal 2012, which was down 6.1% from actual spending in fiscal 2011. Revenue increases and other changes were enacted to close the budget gap. Expectations that economic activity will continue to improve contributed to the closing of the estimated two-year budget gap of \$27.2 billion.



Celebrating **10** Years
Helping Silicon Valley Grow!



THE SMARTER CHOICE IN BUSINESS BANKING.®

1.866.BRDGBNK • BRIDGEBANK.COM/TEN

SAN JOSE • PALO ALTO • SAN FRANCISCO • EAST BAY
ORANGE COUNTY • BOSTON • DALLAS • RESTON

Research and analysis provided by Carpenter & Company

NOTE: The information contained in this report was obtained from sources deemed to be reliable. Every effort was made to obtain accurate information, however, no representation, warranty or guarantee, expressed or implied, may be made as to the accuracy or reliability of the information contained herein.