REGIONAL INTELLIGENCE REPORT

BEACON ECONOMICS

Prepared by Beacon Economics, LLC

EastBay EDA

www.eastbayeda.org

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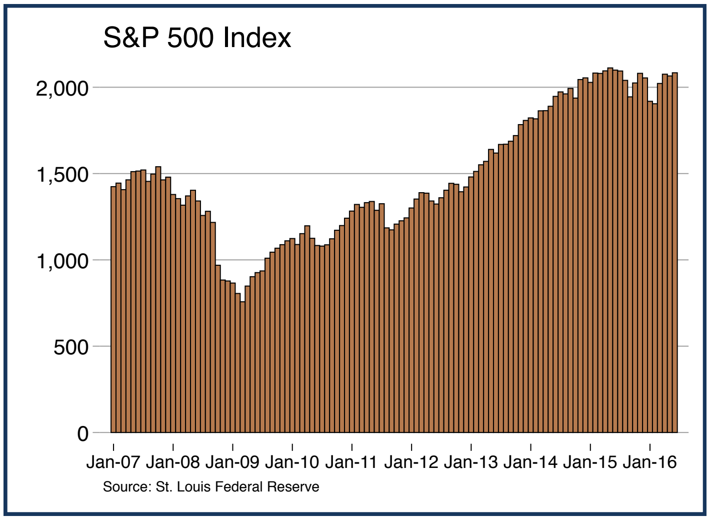
U.S. Expansion to Continue Despite Market Chaos

The U.S. stock markets are yet again in the midst of a major selloff. As the great Yogi Berra once said, “it’s like déjà vu all over again.” This will be the third major sell-off in the past year, the first two being the turmoil in August of 2015 and then again at the start of 2016. As with the last two rounds, the market’s reaction to global events is, to put it politely, completely hyperbolic. Beacon Economics does not see any significant chance of the nation’s current economic expansion ending in the next two years, although we do see growth slowing modestly as a direct result of an over-reaction by traders, not global events.

This isn’t to say that issues in the global economy—namely a wobbly Chinese economy and the Brexit—aren’t serious. They are. But these are serious issues that will play out over many years, not within a few months. This is a critical distinction. Sharp sell-offs such as the ones we have observed in the market over the past year are reasonable reactions to the potential onset of a U.S. recession where corporate profits fall sharply and the chance of a major corporate bankruptcy is heightened. But we see no chance that current global issues will cause a national downturn, and as such, the market gyrations are largely inappropriate.

Beacon Economics’ optimism stems from a couple of factors. First, any negative shock that could cause the U.S. economy to fall into a recession has to have three distinct features—the shock must be large, rapid, and sustained. If any of these features are missing, it will not set off the negative feedback loop of reduced demand, idling factors of production, and so on. Instead, the economy may slow a bit but will otherwise simply adjust around the problem.

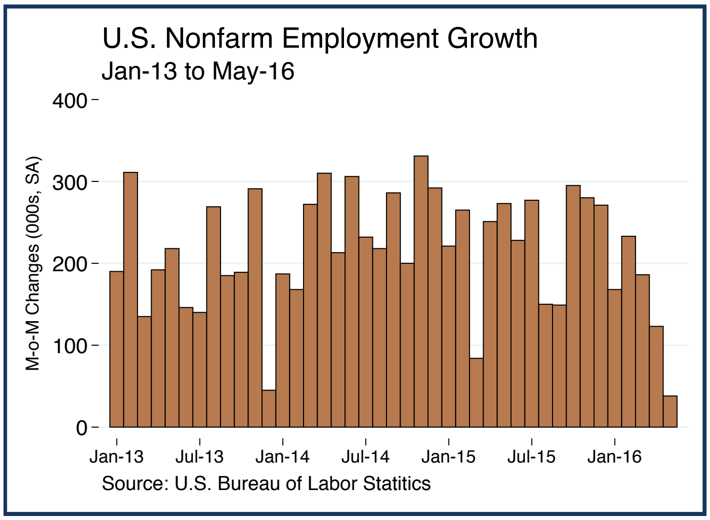


Current global events fail to meet two of these conditions—rapid and large.

The issues in the UK and China will not occur rapidly but will play out over a number of years. Britain, for example, will be in the EU for a full two years while a new arrangement is negotiated. And while China clearly has enormous issues with bad debt and excess capacity, these problems exist largely in the realm of state owned banks and companies. The Chinese government has over $3 trillion in excess reserves—real money that can be used to paper over these problems for many years. Both economies may slow in the short term but there is little imminent danger of either tipping into a major recession right now.

Even if we are wrong and one economy or the other does enter a recession, what difference does it really make for the relatively insulated U.S. economy? Exports are a relatively small share of our economy—and two of our three largest trading partners are Mexico and Canada. In 2015, 7.3% of U.S. exports went to China, while 5.4% went to the UK. The only major risk is from falling foreign earnings among U.S. corporations. But such losses will be met by the paring back of foreign operations—not domestic ones.

Second, it is worth noting that in modern history the U.S. economy has never suffered a recession driven by shocks emanating from outside the country. And the domestic economy seems be moving forward at a steady, sustainable pace. Consumer spending is up nicely, driven by better earnings and a solid job market. Real estate markets are still in recovery mode, and state and local sectors are finally able to begin investing more in local infrastructure and exports—despite slowing global growth and a strong dollar. Even the oil market seems to have hit bottom and is steadying. And remember that the overall economy is benefitting from low interest rates and cheap commodity prices, which are a direct result of the global slowdown.

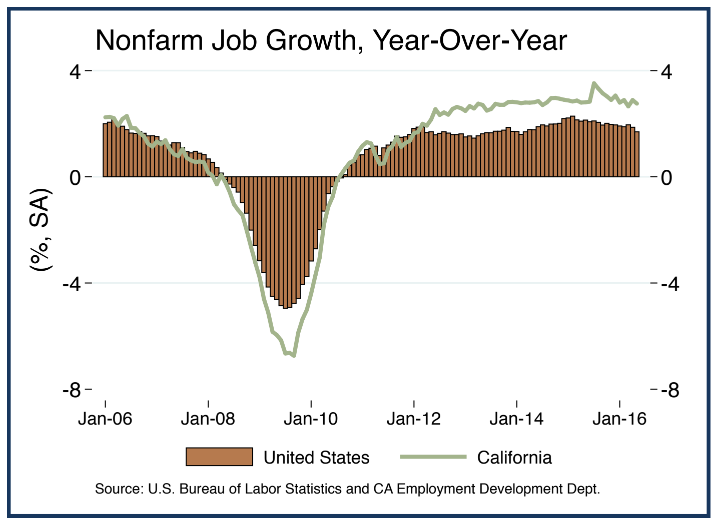


The one place where we do see some slowing in the U.S. economy is in the pace of business investment. However, this is not being caused by China or the UK but by the markets themselves. Such market volatility is truly unprecedented during a period of time when indicators of the real economy continue to show ongoing expansion at a steady, if modest, pace. Such wild gyrations will naturally and reasonably cause investors to become more risk averse. With less capital, businesses will have to reduce new investments—something that occurred in the first quarter of this year. Presumably, once the markets calm, as they have after the last two false alarms, the situation will improve.

Beacon Economics' assessment is not Pollyannaish; we have significant concerns. Rather than confronting its true structural problems, China instead seems to be reverting to a more centrist hardline regime. The Brexit vote is another example of the rise of populist/xenophobic political movements occurring in many countries, including our own. But these are worries that will play out over the next decade, not the next year. So for now, ignore the market theatrics. Over the next 24 months, the U.S. economy will do just fine.

California Stays on Track

As first half of 2016 drew to a close, the California economy maintained a steady course and is on track for a fifth consecutive year of economic growth, job creation, and lower unemployment. Nearly every major industry added jobs in the first several months of this year, while business activity increased and wages advanced modestly.



California ranked first among the 50 states in economic growth last year with a 4.1% gain. Gross state product grew at an estimated 2.0% rate in the first quarter of 2016, more than double the U.S. growth rate of 0.8%. The state also outpaced the nation in terms of job gains, with a 2.8% yearly increase in May compared to the nation's 1.7% rate. With continued job gains, California's unemployment rate fell to 5.2% in May, the lowest in nine years. Meanwhile, statewide taxable sales climbed by an estimated 3.4% in the first quarter of this year compared with the same period in 2015.

With few exceptions, California's major industries added jobs in yearly terms. Education led the state in percentage terms with a 6.0% increase (20,500 jobs) year-to-year in May, followed by Construction (5.5%), Professional, Scientific, and Technical Services (4.5%) and Health Care and Social Assistance (3.9%). In absolute terms, Health Care added the largest number of jobs (81,500) by far, with Government, Professional, Scientific, and Technical Services, and Construction also making significant contributions to job gains. Only Manufacturing and Mining and Logging lost jobs, representing 0.1% of all wage and salary jobs in the state.

Employment by Industry
California, May 2016

Industry	May-16 (000s)	YOY (000s)	YOY (%)
Total Nonfarm	**16,407.1**	**440.3**	**2.8**
NR/Construction	786.0	35.8	4.8
Prof Sci and Tech	1,255.2	53.8	4.5
Health Care	2,176.2	81.5	3.9
Leisure and Hospitality	1,882.4	64.4	3.5
Transport,Warehouse,Util	566.2	17.3	3.2
Wholesale Trade	738.7	20.9	2.9
Information	495.7	13.0	2.7
Admin Support	1,074.8	28.1	2.7
Government	2,501.7	58.4	2.4
Financial Activities	810.8	15.0	1.9
Management	234.3	4.3	1.9
Other Services	553.2	9.9	1.8
Retail Trade	1,688.5	30.0	1.8
Manufacturing	1,280.1	-12.1	-0.9

Source: Bureau of Labor Statistics & CA EDD

Throughout much of the current expansion, San Francisco and San Jose were at or near the top among California's metropolitan areas in terms of percentage job gains, and the first part of the year was no exception. Among the larger metropolitan areas, Stockton actually saw the fastest rate of growth at 4.4% from May to May, San Jose was right behind at 4.0%, while Anaheim (3.5%) edged out San Francisco (3.4%). Los Angeles County grew by just over 2% but its absolute gain of 96,100 jobs was well ahead of second-place Anaheim (53,500) and the Inland Empire (45,000). Every metropolitan area of the state added jobs in year-to-year terms during May of this year.

Employment by Metro Area
California, May 2016

Region	May-16 (000s)	YOY (000s)	YOY (%)
California	**16,407.1**	**440.3**	**2.8**
San Jose	1,076.5	41.2	4.0
Orange County (MD)	1,584.9	53.5	3.5
San Francisco (MD)	1,079.0	35.1	3.4
Inland Empire	1,383.6	45.0	3.4
South Central Valley	1,028.9	31.0	3.1
Other Bay Area	523.9	14.4	2.8
Central Coast	537.7	14.3	2.7
Oakland (MD)	1,116.8	26.8	2.5
San Diego	1,414.6	33.8	2.4
North Central Valley	1,340.1	30.6	2.3
Los Angeles (MD)	4,354.5	96.1	2.3
Other Southern California	351.8	5.7	1.6

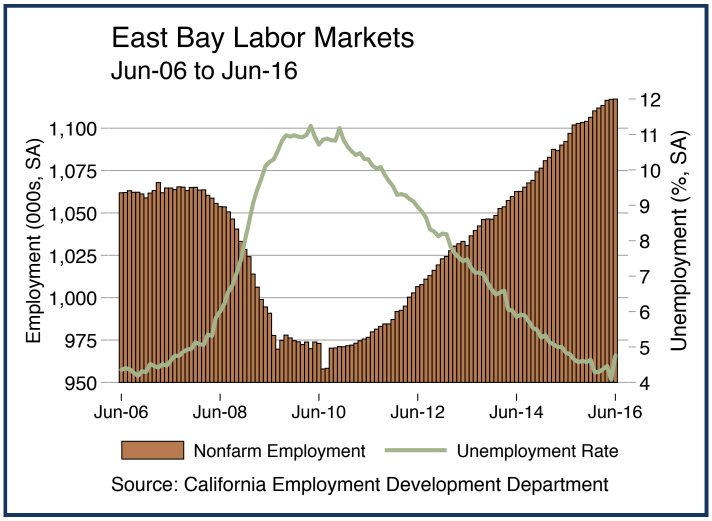
Source: Bureau of Labor Statistics & CA EDD

The California housing market continues to move forward although it is hardly back to full health. The median price of a home rose 5.3% from the first quarter of 2015 to the first quarter of 2016 on a 3.5% increase in sales, and low mortgage rates are constraining increases in monthly payments. However, lending standards are still very tight, and would-be buyers in many parts of the state face the challenge of coming up with a down payment that may be anywhere between $30,000 and $100,000. On the supply side, the supply of existing homes is lean, while new home construction has proceeded at a cautious pace through this expansion, although the pace of single-family construction accelerated in early 2016 even as multi-family construction trailed off. The effect of a less-than-healthy owner-occupied housing market has been a falling homeownership rate and higher rents. While the former may finally turn around this year, rents will continue to increase in markets where supply is constrained.

Just as the nation is poised to grow through the balance of this year, California's economy is fully expected to outpace the nation, both in terms of output growth and job growth. Job and wage gains in communities around the state will trigger increases in local expenditures, which mean continued improvement in local government revenues.

East Bay Employment

The East Bay economy remains on solid footing midway through 2016 as the region's labor market continues to post record high employment levels each month. As of June, total nonfarm employment in the East Bay reached 1,117,200 on a seasonally adjusted basis, a 2.3% increase over the same month a year prior.



While not growing as strongly as payroll employment, the labor force has maintained an upward trajectory as well. From June 2015 to June 2016 the labor force increased by 0.5%. This percentage increase was smaller than the labor force growth rate in San Francisco (1.2%) and San Jose (1.7%), but nevertheless signals a healthy labor market as more residents are looking for work. In fact, the unemployment rate in May reached a post-recession record as it dropped to 4.1%, the lowest rate since May of 2001. In June the unemployment rate edged up to 4.8%, but only because the labor force increased by 0.8% from May to June as more favorable labor conditions encouraged more residents to begin looking for work. While there is no firm definition of "full employment" in the East Bay, the region is certainly in that theoretical territory as the unemployment rate is markedly below the long run average of 6% going back to 1990.

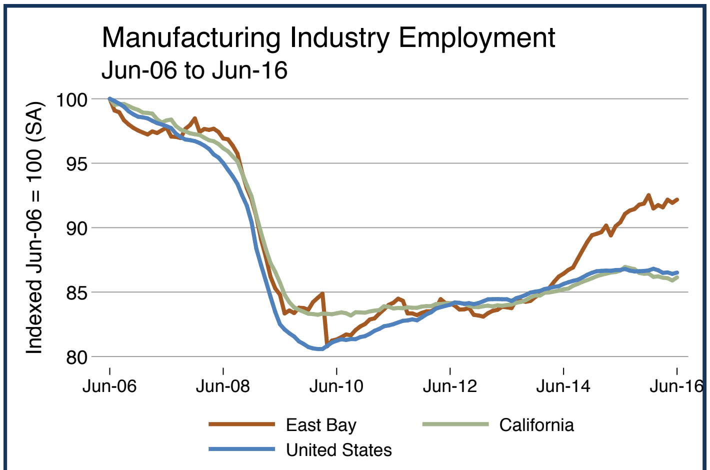
The latest job gains have been broad-based across industries as well, reflecting the robust nature of the region's expansion. Strong job growth in particular industries, such as Construction, indicates optimism by businesses and residents alike. From June 2015 to June 2016, the Construction industry added 4,540 new jobs to company payrolls, a 7.3% year-over-year increase. This is the fastest growth rate across all major industries, accounting for nearly one-fifth of the net increase in nonfarm employment over the period.

Employment By Industry
East Bay, June 2015 to June 2016

Industry	June-16	YoY % Chg. (%)	New Jobs (YoY)
Construction	66,390	7.3	4,540
Leisure and Hospitality	111,780	5.5	5,820
Utilities	5,860	5.3	290
Transport/Warehouse	33,830	3.9	1,270
Wholesale Trade	49,180	3.7	1,760
Education/Health	184,110	3.3	5,940
Real Estate	17,280	2.8	470
Prof Sci and Tech	95,570	2.7	2,530
Information	22,880	2	450
Manufacturing	87,930	1.9	1,680
Retail Trade	114,330	1.6	1,760
Other Services	38,420	1.4	530
Government	169,170	0.4	720
Admin Support	58,580	-1.3	-770
Finance and Insurance	32,400	-1.9	-640
Management	28,700	-4.2	-1,250
NR/Mining	780	-11.3	-100
Total Nonfarm	**1,117,200**	**2.3**	**25,000**

Source: California Employment Development Department

The Manufacturing industry also has been a bright spot for the East Bay over the last year, outperforming national and state job growth in the sector. From June 2015 to June 2016, Manufacturing employment in the East Bay increased by 1.9%, with durable and non-durable goods manufacturing sectors both contributing to the gains. In contrast, Manufacturing employment declined 0.3% in the nation and 0.1% in the state over the same period.



Source: Bureau of Labor Statistics

The City of Fremont has been a major player in the growth of the Manufacturing industry in the East Bay. The City's 27,000 Manufacturing jobs account for 23% of the workforce, and the City has streamlined the permitting process and has added business tax exemptions for biotech and clean-tech companies. Tesla Motors, Seagate, and Lam Research, for example, have together invested $500 million in manufacturing facilities in the City and have added 2 million square feet of high-end industrial space to the City's stock of 12.8 million square feet.[1]

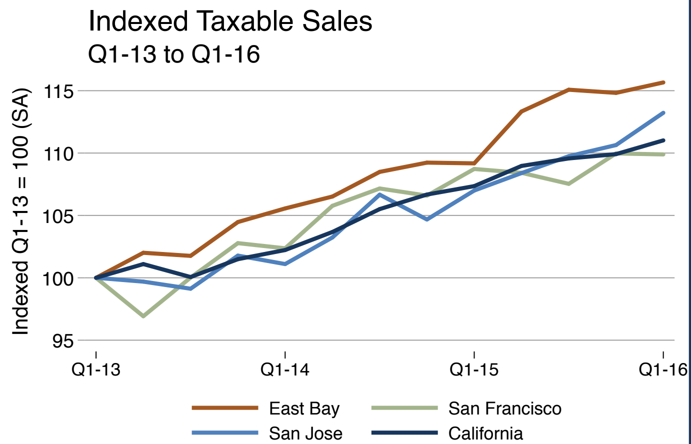
Most other industries also grew over the last year. The Education and Health Care industry made the largest contribution to nonfarm growth, adding 7,020 jobs to company payrolls from May 2015 to May 2016, a 4.0% increase that represents 26.1% of the net gains to total nonfarm employment. According to the 2014 American Community Survey, the most recent data available, the occupations adding the most jobs in this industry have been registered nurses, medical assistants, and personal care aides.

Wholesale Trade and Transportation and Warehousing, which together constitute the goods movement segment of the economy, saw sizable increases in percentage and absolute terms. Only the Natural Resources and Mining (-100), Finance and Insurance (-640), Administrative Support (-770), and Management (-1,250) industries had declining payrolls over the same period.

[1]http://www.eastbaytimes.com/breaking-news/ci_30045786/east-bay-cities-look-future-manufacturing

East Bay Spending

With continued improvement in the region's labor market, consumer and business spending has maintained a solid upward trajectory, continuing to outpace the other major Bay Area economies and highlighting the East Bay's rising role as an engine of economic growth in the Bay Area. In the first quarter of 2016, taxable sales in the East Bay totaled $10.8 billion, a 5.8% increase over the first quarter of 2015. This rate was substantially higher than the 1.1% growth in the San Francisco metro area and on par with San Jose's 5.8% growth rate. The East Bay's affordability advantage over the South Bay and San Francisco has undoubtedly contributed to the faster growth as more residents and businesses are spending their dollars locally.



Source: California Board of Equalization

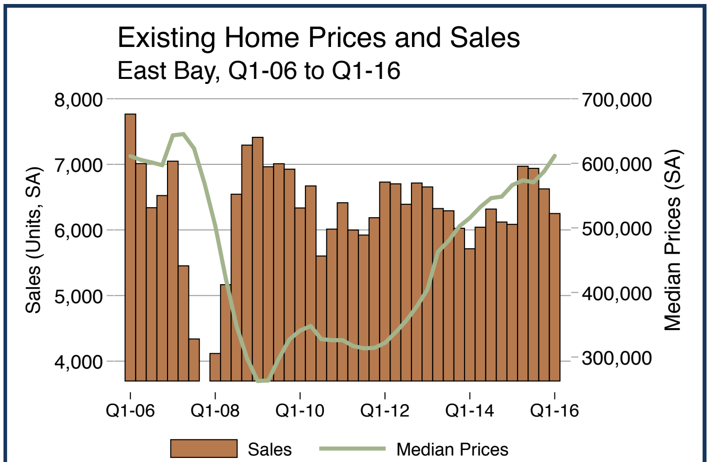
This strong growth in East Bay taxable sales is not only a continuation of a trend that began last year, when spending in the East Bay grew faster than in neighboring economies to the west and south, but was also an acceleration over annual performance in 2015. Total East Bay taxable sales in 2015 were 5.3% higher than in 2014, outpacing both San Francisco (3.0%) and San Jose (4.8%). The East Bay may see an even stronger 2016, if spending maintains its first quarter growth rate of 5.8% for the rest of the year.

Spending at restaurants and hotels was one of the major drivers of overall growth during the last year, along with spending on automobiles. The latest taxable receipts data from the HdL Companies shows spending in the Restaurants and Hotels category in the East Bay increased by 6.4% from the first quarter of 2015 to the first quarter of 2016, the fastest rate of growth across all categories and the second-largest dollar value increase. Spending in the Autos and Transportation Category had the largest increase in dollar value, up 4.7% year-over-year.

The strong growth in both of these categories indicates a confident consumer, willing to spend on big-ticket items like automobiles and possessing enough discretionary income to patronize restaurants and to travel. Granted, business travel accounts for some of this spending, but the data by and large show a healthy East Bay consumer driving a healthy regional economy.

East Bay Real Estate

The local real estate market has gained steam over the last few quarters as price growth has accelerated and sales volumes have held steady despite strong demand and low inventories. Affordability issues are front and center in communities across the East Bay, and with such a strong real estate market, it is hard to see those concerns going away soon.



The latest data highlight the difficulties buyers face and the rising equity for sellers as home prices reach new post-recession highs. As of the first quarter of 2016, the median price for an existing home was $611,600 on a seasonally adjusted basis, the highest since the third quarter of 2007 and just 5% below the all-time high of $645,200 set in the second quarter of 2007. Given tight supply and strong demand in the local housing market, Beacon Economics does not anticipate a notable slowdown in price growth in the near term.

Home price growth in the East Bay has accelerated over the last few quarters even as the San Francisco market has been losing steam. Annual growth rates in the East Bay have been picking up with each successive quarter, with year-over-year increase of 4.5% in the third quarter of 2015, followed by rates of 7.1% and 8% in the fourth quarter of 2015 and first quarter of 2016, respectively. On the other hand, at 3.5% year-over-year growth as of the first quarter of 2016, San Francisco's home prices have cooled comparative to the same period a year prior. Still, the East Bay remains relatively affordable compared to the South Bay and San Francisco.

The strong price growth in the East Bay, and indeed throughout the rest of the Bay Area, has left prospective residents in a tight situation. With so many areas beyond the reach of the average household, buyers are increasingly willing to consider once-overlooked markets. A recent article in the Mercury News[2] cited increasing demand for housing in Deep East Oakland, an area known to have higher crime rates than other parts of the East Bay. But East Oakland is one of the few places buyers can find a single-family home for less than $500,000 that does not need extensive remodeling, making it an increasingly attractive opportunity.

The strong growth in Construction employment noted in the previous section comes as little surprise given the high level of permitting activity over the last year. For all of 2015, 7,376 new residential units were permitted, a 43.2% increase over 2014. More recently, nearly 2,500 new East Bay residential units were permitted in the first quarter of 2016, a 40% increase over the same time a year prior.

[2]http://www.mercurynews.com/bay-area-news/ci_29975320/sizzling-housing-deep-east-oakland-lures-bay-area

What's ultimately needed to combat higher prices is an increase in the housing supply. It's basic economics. High demand and low supply lead to high prices. Increase supply, and the price will come down. Despite the solid permitting gains, the East Bay has just not built enough housing to keep up with population growth. During the post-recession period from 2010 to 2015, the East Bay population has increased by roughly 162,000, but over the same time period there were only 29,000 residential units permitted for construction. This works out to about 5.6 people per unit permitted, which was double the average household size of 2.8 in 2015.

Local governments have been trying to find ways to increase the housing supply, or otherwise reign in the cost of housing. The Alameda County Board of Supervisors recently voted to put a $580-million bond measure on the November ballot to help increase the supply of affordable housing. The Oakland City Council is looking into building tiny houses, and the City of Concord is exploring the introduction of a rent-control policy. The East Bay's Assemblyman Tony Thurmond is pushing for passage of AB 2406, which would streamline the process for creating junior accessing dwelling units in existing homes as a means to increase the housing supply.

Although these measures are well-intentioned, there are some issues that can't be handled locally. Red tape at the state level, particularly the California Environmental Quality Act (CEQA), has held back housing growth throughout the state. Protecting the environment is a worthy cause, but abuses of the CEQA process hold back housing developments across the state. Changing, not eliminating, CEQA can help alleviate affordability issues by allowing more housing development.

East Bay Forecast

With all the major indicators trending in the right direction, Beacon Economics maintains an optimistic outlook for the East Bay economy through this year and into 2017. The recent Brexit vote by United Kingdom residents roiled financial markets in the days immediately after the election, but the markets rebounded and, as of this writing, the S&P 500 just hit a record high. The UK's exit from the European Union is not expected to adversely affect the U.S. economy, and Beacon Economics expects national GDP growth just below 2% for all of 2016.

The East Bay is expected to be a bright spot in the larger Bay Area economy. It still holds an affordability advantage over the South Bay and San Francisco for residential and commercial properties. And although that advantage is slowly eroding, it will continue to serve the East Bay economy well in 2016.

The Construction industry is expected to continue to add jobs in 2016, based on the first quarter of the year. If the pace of permitting for the final three quarters of 2016 matches the first quarter, the Construction industry will be on track to make another outsized contribution to job growth for the region.

The East Bay housing market is expected to remain strong, with robust price growth in the near term. Although rising prices are making it harder for many households to come up with a 20% down payment, tight supply and historically low inflation and mortgage rates will continue to put upward pressure on home prices. The renewed acceleration in home price growth in the latest data is expected to continue over the next few quarters, and annual growth is expected to be in the 5% to 10% range for 2016.

BEACON ECONOMICS

About Beacon Economics

Beacon Economics, LLC is a leading provider of economic research, forecasting, industry analysis, and data services. By delivering independent, rigorous analysis we give our clients the knowledge they need to make the right strategic decisions about investment, growth, revenue, and policy.

Services

Economic, revenue and occupational forecasting

Economic impact analysis

Regional economic analysis

Economic policy analysis

Real estate market analysis

Industry and market analysis

About East Bay EDA

The East Bay Economic Development Alliance (Alliance) was created 25 years ago with the mission of establishing the East Bay as a world-recognized region to grow businesses, attract capital and create quality jobs. Representing a broad network of cross sector members and resources on the eastern side of the San Francisco Bay, the Alliance serves Alameda and Contra Costa Counties and contributes to one of the world's most dynamic regional economies.

EastBay EDA

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