

# REGIONAL INTELLIGENCE REPORT



Prepared by Beacon Economics, LLC



www.eastbayeda.org

Fourteenth Edition

February 2017

## The National Economy

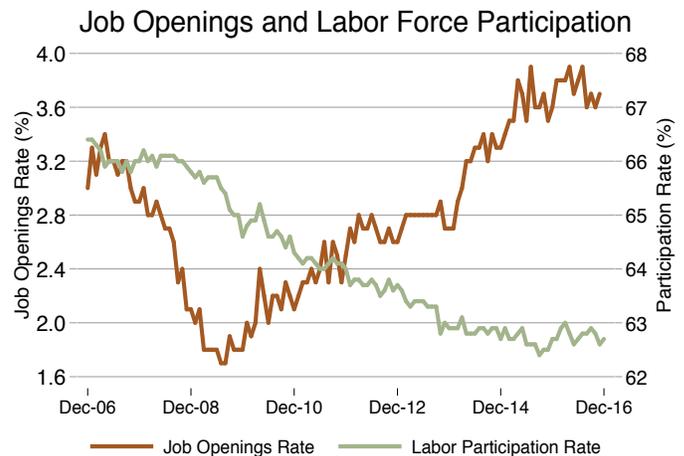
The election that put Donald Trump in the White House was a shock to the vast majority of pollsters who predicted a victory for Hillary Clinton. Our economic outlook over the last year implicitly (and incorrectly) assumed a Clinton win, a split Congress, and continued political gridlock in Washington DC. Instead, Republicans now control the Oval Office, the Senate, and the House. However, contending factions in the Republican Party may pose an impediment to President Trump's stated economic policy priorities.

Donald Trump's victory stems from the frustration of many who see an economy in decline, driven by bad regulations, bad trade deals, and bad tax policies. Rhetoric aside, the U.S. economy is in the 7th year of economic expansion, albeit at a below average pace. Given current economic fundamentals, the economy should remain on track. Labor markets are at full employment, wages are starting to rise, and asset prices are at or near record high levels. Meanwhile, GDP growth in the 4th quarter came in at 1.9%, somewhat faster than the 1.5% growth rate for all of 2016.

Consumer spending remains one of the bright spots and a source of momentum in the U.S. economy, responding to both job growth and ongoing wage gains. Meanwhile, the recent drag in business investment stems largely from the continued commodity glut and the resulting sharp declines in oil and natural gas exploration, which have shaved almost a full percentage point off overall GDP growth in the last two years. The oil and gas glut is still with us, as are low energy prices. Meanwhile, both new and existing home markets continue to be disappointing.

This can be traced in part to Dodd-Frank, which was intended to create a safer credit environment for consumers through measures that were aimed at the lending community, but has resulted in much tighter underwriting requirements and reduced credit accessibility compared to historic standards. This has served to hold back the pace of new building, homeownership, and house sales—a problem that explains the overall softness of the market.

There has been a modest slowing in job growth, but this is mainly because the tight labor market is making it more difficult for employers to find talent. Meanwhile, the labor force participation rate has edged up, despite the aging of the nation's workforce, which suggests it should continue to fall. People are being drawn back into the labor market in a significant way for the first time in a decade.



Source: U.S. Bureau of Labor Statistics

Despite these positive trends, throughout his campaign, Donald Trump promised to enact policies to 'fix' the economy, but which actually have the potential to disrupt the current trajectory of slow, steady growth. Recessions are caused by real shocks to the economy that have three characteristics—they have to be large, rapid, and sustained. Here are three policy options voiced by Trump in his campaign that could create just such a situation.

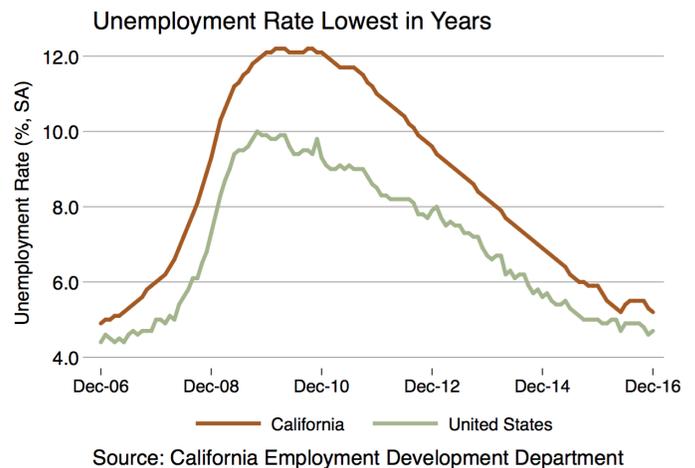
- Slashing taxes may stimulate the economy in the short run, but will also increase the Federal budget deficit and may lead to sharply rising interest rates and a weaker dollar.
- Efforts to back out of NAFTA or the WTO, and start a trade war with China will result in sharply falling imports AND exports, disruptions of supply chains, and a rise in consumer prices. (It should also be noted that the U.S. exit from TPP will potentially strengthen the hand of China, both from a trade perspective and in terms of global security).
- President Trump's stated desire to find and deport millions of undocumented residents in the United States would also cause massive disruptions in supply chains and consumer spending.

Any of these three policies, if pursued vigorously, has the potential to cause a recession and to do long term damage to the economy. At this point, it would be speculative to estimate the likely impact of these policies on the economy without more specifics. Whether any of these comes to pass depends largely on how well the new Trump administration works with Congress.

## The California Outlook

California has stayed on course with a solid economic performance through the end of 2016, outpacing the nation in terms of economic growth and job creation, albeit at a slower rate than last year. Virtually every industry in the state continues to add jobs and the unemployment rate is lower than one year ago.

Through December of 2016, nonfarm jobs in California grew at 2.5%, compared to 1.8% nationally. The state unemployment rate moved sideways in the mid-5% range in recent months as job growth and wage gains have drawn more people into the labor force. Health Care and Social Assistance has led the way with the largest absolute private sector job gains in the state, followed by Leisure and Hospitality, Professional, Scientific, and Technical Services, and Retail. Only Manufacturing, Administrative Support Services, and Mining & Logging have lost jobs. Government also saw large gains, while California's farm employment is on track to hit its highest level in over a dozen years.



Regional economies across the state continue to grow. Many areas have hit new records for employment, and unemployment rates have declined to their lowest in several years. Smaller regions may lead the state in terms of percentage job gains, but Los Angeles County routinely adds by far the largest absolute number of jobs.

Statewide spending activity continues to rise, with taxable sales increasing by over 2.8% through the first three quarters of 2016, and the data release for the busy holiday season is still ahead. Taxable receipts by consumers as well as businesses experienced modest increases through the first three quarters of this 2016.

Meanwhile, the housing market has been mixed, with prices advancing modestly despite many hurdles that have limited sales activity. On the demand side, would-be buyers face high down payment requirements and credit standards that are tight by any measure, with the average FICO score on mortgage originations with Fannie Mae averaging 750 for several quarters running. On the supply side, homeowners have been slow to list their homes, in part because of their desire to recover equity that was lost during the housing crisis. New home construction has struggled since the recession, with permit levels that remain well below the long-run average. On the rental side of the market, high demand for apartments has driven vacancy rates down and rents up.

All in all, California's economy is poised for continued growth over the next several quarters, outpacing most other states in the nation. Still, California continues to face nagging policy problems including a chronic housing shortage. Rising home prices and rents mean that the state is not producing enough housing<sup>1</sup>.

This is not exclusively a low-income problem, but one that extends to middle-income households as well. In many parts of the state, rent as a share of income exceeds the 30% threshold that is considered to be the norm. This has ramifications for employers who find it increasingly difficult to hire and retain qualified employees. Solutions will be hard to come by, but must include reducing the permitting and regulatory burdens associated with construction costs, and possibly, tax reform.

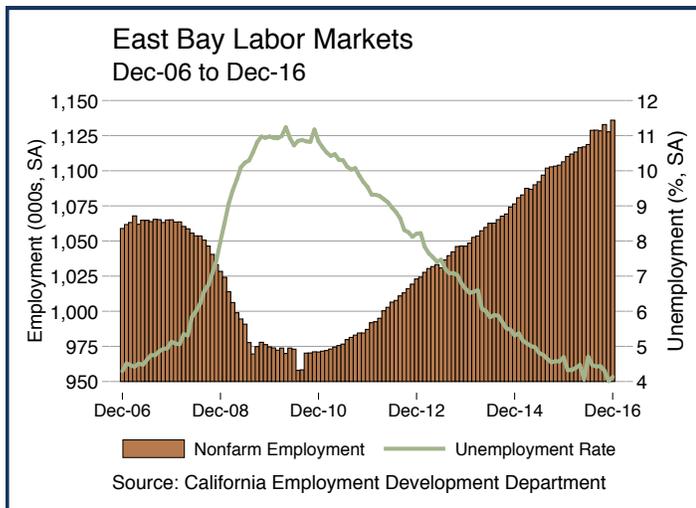
---

<sup>1</sup>For example, a 2015 California Legislative Analyst Office report (California's High Housing Costs: Causes and Consequences) indicates that Alameda County's housing needs are three times the long run average annual pace of construction.

## The East Bay Outlook

In the East Bay the economic expansion has continued steadily into the second half of 2016. Payroll and Household employment levels continue to rise in line with statewide gains, and higher income is boosting local spending. Home prices and residential construction activity are increasing, and new firms are scooping up commercial space and opening their doors to the region's workforce and consumers.

Payrolls have continued to rise in the East Bay, although at a slower pace than in recent years; total nonfarm employment increased 2.7% from December 2015 to December 2016, outpacing statewide gains. Payroll increases have been accompanied by rising incomes for local workers, with the average annual wage up 3.7% on a nominal basis from the second quarter of 2015 to the second quarter of 2016, to more than \$68,800 annually.



Household employment in the East Bay increased by 1.4% to 1,336,000 over the last year. The region's unemployment rate declined to 4.1% in December 2016. More residents are seeking work, and the region's labor force has expanded by 0.8% over the last year. With employment opportunities increasing, the region's unemployment rate should remain low over the next year. And with payroll employment outpacing household employment growth many of these new employment opportunities should be in the East Bay.

At the industry level, job growth remains broad-based, with the majority of East Bay sectors expanding their payrolls over the last year. This has resulted in employment opportunities being created across the wage and skill spectrum over the last year, with high-skill sectors like Professional, Scientific, and Technical services boosting payrolls along with low-skill sectors like Leisure and Hospitality also increasing payrolls over the period.

The Health Care sector provided the most new jobs in the East Bay over the last year, adding 6,700. The Leisure and Hospitality sector also provided a significant number of new jobs in the East Bay over the last year, adding 6,200. Gains in hospitality jobs were aided by last year's opening of the Hyatt Place Hotel, Emeryville's first new hotel in a decade.<sup>2</sup> There are also new restaurants, including Emeryville's Yuzu, which opened late last year,<sup>3</sup> and Oakland's Gastropig, which opened in January.<sup>4</sup> These businesses and others in this industry will thrive as incomes across the Bay Area rise and as business and leisure travel to the region continues to expand. These trends can also be seen across the state, however they are more pronounced in the East Bay, with year-over-year growth rates in the East Bay outshining the state overall.

### Employment by Industry

#### East Bay, December 2015 to December 2016

Industry	Dec-16 (000s)	1-Yr Chg.	1-Yr Chg. (%)
<b>Total Nonfarm</b>	<b>1,136,000</b>	<b>29,600</b>	<b>2.7</b>
Utilities	5,870	340	6.1
Real Estate	17,690	1,010	6.1
Leisure and Hospitality	114,480	6,200	5.7
Construction	69,110	3,710	5.7
Prof Sci and Tech	100,010	5,290	5.6
Education/Health	187,990	7,800	4.3
Transport/Warehouse	34,780	1,220	3.6
Wholesale Trade	49,640	1,490	3.1
Finance and Insurance	33,170	900	2.8
Information	23,260	430	1.9
Other Services	39,030	630	1.6
Government	171,270	2,520	1.5
Management	28,950	290	1.0
Retail Trade	115,000	720	0.6
Manufacturing	86,350	-1,630	-1.9
Admin Support	58,670	-1,110	-1.9
NR/Mining	740	-210	-21.8

Source: California Employment Development Department

<sup>2</sup><http://www.bizjournals.com/sanfrancisco/news/2016/12/02/ensemble-hotel-emeryville-hyatt-place-opens.html>

<sup>3</sup><https://evilleeye.com/in-the-neighborhood/restaurants/yuzu-ramen-broffee-ready-grand-opening/>

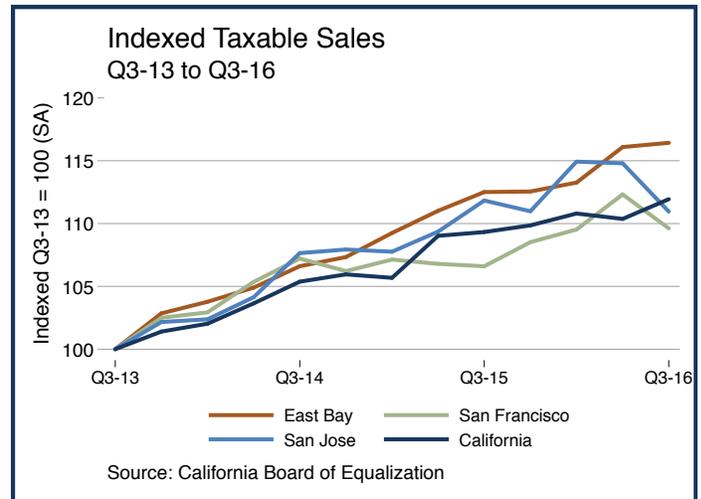
<sup>4</sup><http://www.mercurynews.com/2017/01/04/eggslut-north-gastropig-eatery-opens-in-oakland/>

The Professional, Scientific, and Technical Services and Construction sectors have been significant sources of new jobs in the region for some time. From December 2015 to December 2016, the Professional, Scientific and Technical Services sector in the East Bay added 5,300 positions, a 5.6% increase. The Construction sector increased payrolls by 3,700 from December 2015 to December 2016, a 5.7% gain. With another solid year of permitting activity in the region, this sector should see continued gains as developers tap into strong demand for real estate in the region.

Despite widespread growth, not all sectors in the East Bay expanded payrolls over the last year. After several years of expansion, payrolls in Manufacturing contracted as the sector lost 1,600 positions from December 2015 to December 2016. Even so, over the last two years the sector has expanded payrolls by 1,245, or 1.5%, countering small declines in Manufacturing sector payrolls across the state over the same period. While Manufacturing employment levels may be falling over the short-term, output levels remain strong. Indeed, in 2015 real manufacturing sector in the Bay Area increased to its highest value since 2010, increasing by 4.3% from 2014 to 2015.

Rising incomes and job counts have also paved the way for increases in local spending. Taxable sales in the East Bay expanded by 3.5% from the third quarter of 2015 to the third quarter of 2016, outpacing the 2.1% growth in the state over the same period. At the county level, spending grew at a faster pace in Alameda County (4.5%) than in Contra Costa County (1.7%). Some of the East Bay's largest cities also saw growth, with Fremont (10.6%) and Hayward (10.7%) posting sizeable gains and Oakland (0.9%) posting a minor gain.

According to taxable receipts from HdL Companies, most spending categories in the East Bay increased during 2016. The category posting the largest gains so far in 2016 was Autos and Transportation, with taxable receipts expanding by 7.8% from the third quarter of 2015 to the third quarter of 2016. Increasing expenditures by residents and visitors have also spurred growth in the hospitality industry, with taxable receipts growing by 4.1% year over year at local restaurants and hotels.



Signs of the region's flourishing tourism industry can also be seen at Oakland Airport and at local hotels. The highest passenger count at Oakland Airport in nine years occurred in 2016. Driving some of this growth was the introduction of new domestic routes from Spirit Airways<sup>5</sup> and new international routes from Norwegian.<sup>6</sup> In line with this uptick in air traffic, revenue per available room at local hotels increased to \$123.31 during the first ten months of 2016, a 7.8% increase over the same period in 2015.<sup>7</sup>

Business spending also increased steadily in 2016. Following the gains in Construction sector employment, taxable receipts for Building and Construction goods expanded by 1.8% year over year. Business-to-business spending also increased, growing by 6.3% year-over-year. This additional spending on new capital goods and facility improvements highlights the optimism many businesses in the East Bay are feeling about their growth potential and the overall health of the region's economy. This uptick in spending could also be felt at the Port of Oakland, where activity set a record in 2016 with throughput of 1.83 million loaded TEUs during the year.<sup>8</sup>

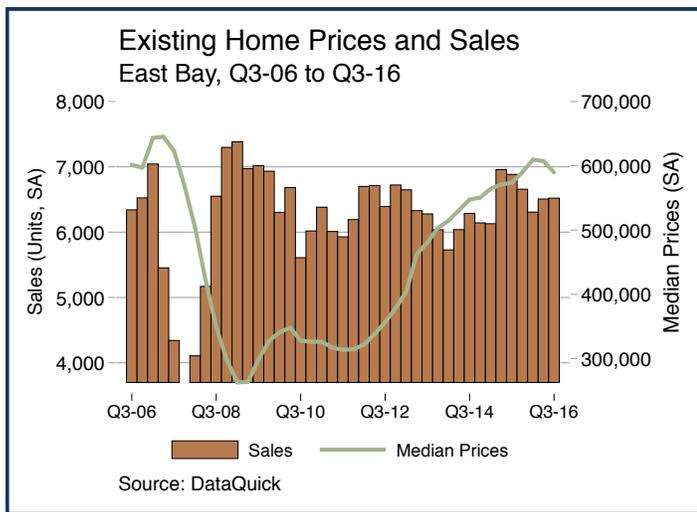
<sup>5</sup><http://www.eastbaytimes.com/2017/01/10/new-flights-from-oakland-set-airport-record/>

<sup>6</sup><http://www.mercurynews.com/2016/09/07/oakland-airport-to-launch-bay-areas-first-direct-flights-to-spain/>

<sup>7</sup>PKF Consulting: Trends Report

<sup>8</sup><http://www.eastbaytimes.com/2017/01/09/port-of-oakland-sees-record-growth-in-2016/>

Although the latest data indicate that home price appreciation has cooled from recent years, the residential real estate market in the East Bay advanced at a steady pace through the third quarter of 2016. The median price for an existing single-family home increased to \$589,600 in that quarter, a 2.8% increase over the same quarter one year ago and behind the state's 5.2% increase over the same period. Sales of existing homes also contracted during that time, with 6,520 homes sold in the third quarter of 2016 on a seasonally adjusted basis, 5.3% less than in the third quarter of 2015.



Low inventories coupled with strong demand fueled much of the gain in the median price. In November 2016, there was just a 1.5-month supply in Alameda County and a 1.9-month supply in Contra Costa County, well below the region's long-run average and the state's average of 3.1 months of supply. This is partly a result of an unfriendly regulatory environment and pushback from opponents of development.

Driving much of the demand is the region's clear affordability advantage over neighboring areas: The average home in the East Bay costs about half as much as the average home in San Francisco (MD) and roughly two-thirds as much as the average home in San Jose.

Ultimately, the region will need to find a balance between affordable housing to accommodate the region's growing traditional population and new luxury developments aimed at attracting workers from San Francisco and San Jose. Balanced development will be necessary to prevent existing residents from being driven out by the region's high housing costs.

The East Bay's rental market remains solid. Absorption of recent new units demonstrates continued strong demand for rental properties, which keeps vacancy rates low across the region. In the third quarter of 2016, only 3.1% of all rental units in the East Bay were vacant. At the same time, the cost of East Bay rents grew 3.2% year-over-year in the third quarter of 2016, outpacing rent growth San Francisco (0.5%) and San Jose (1.4%). In addition, with the Alameda Marina housing project<sup>9</sup> and the Serra Apartments in Fremont<sup>10</sup> moving forward, the rental market in the East Bay should see continued gains in the coming years.

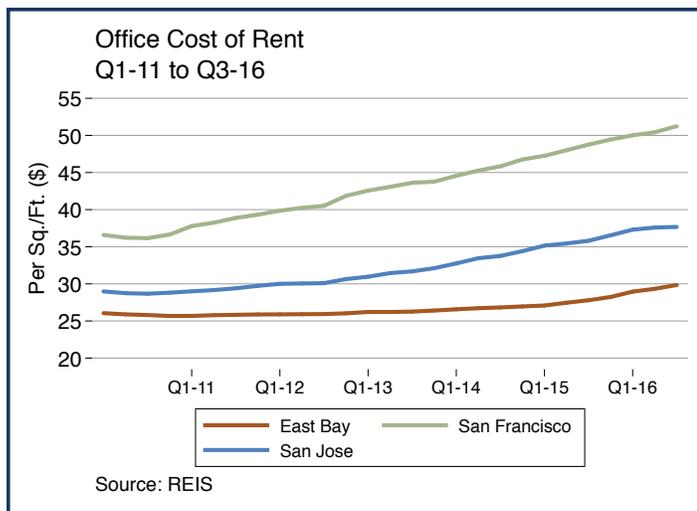
Strong demand for single-family and multi-family real estate has fueled permitting activity in the region, though not yet enough to meet demand. During the first eleven months of 2016, single-family permitting in the East Bay totaled 3,589 units, a 9.2% increase over the same period of 2015. Permitting for multi-family residences is also on the rise, up 3.0% during the first eleven months of 2016 from the same period of 2015. This follows a very solid year for the Construction sector, although considerably more building will be necessary to alleviate the region's housing shortage.

Like much of the rest of the East Bay's economy, the region's commercial real estate market is growing at a healthy pace. New stock continues to come on line, occupied stock is increasing, and rents remain affordable compared to neighboring San Francisco and San Jose, making the region attractive to new and relocating businesses.

<sup>9</sup><http://www.bizjournals.com/sanfrancisco/news/2016/11/14/alameda-marina-housing-bay-west-pacific-shops.html>

<sup>10</sup><http://www.eastbaytimes.com/2016/12/22/fremont-planners-approve-179-unit-apartment-complex/>

The office market in the East Bay continues to improve, despite elevated vacancy rates. Office vacancy rates dipped to 14.1% in the third quarter of 2016, a 1.6-percentage point decline from the previous year. And although only a minimal amount of new stock came on line in the last year, the uptick in occupied stock highlights gains in office-using employment in the region. For example, in a joint venture, University of California, San Francisco Health and John Muir Health recently signed a 15-year lease for 96,000 square feet of office space in Berkeley.<sup>11</sup> As a result of the overall rise in demand, the cost of rent at office properties across the East Bay increased 7.4% from the third quarter of 2015 to the third quarter of 2016.



The Retail market in the East Bay has also grown over the last year, although at a more modest pace. As wages have risen and employment opportunities have increased, the resulting jump in disposable income has allowed residents and visitors to spend more on non-essential goods. With new retail space coming on line over the past year, occupied stock grew by 0.2%. This pushed rents higher; by 1.6% from the third quarter of 2015 to the third quarter of 2016.

The demand for industrial space in the East Bay is also on the rise. With increasing demand for warehouse/distribution properties, the Logistics sector has fueled much of the growth. From the third quarter of 2015 to the third quarter of 2016, more than 1.6 million square feet of new warehouse/distribution space came online in the East Bay.

At the same time, vacancy rates at warehouse/distribution properties declined by 0.7 percentage points as occupied stock increased by 2.0% over the period. In line with this growth, the industrial real estate firm Prologis Inc. broke ground on a 256,000-square-foot industrial building, the first ground-up development in the \$1.2-billion master-planned Oakland Global Trade and Logistics Center.<sup>12</sup> The state's passage of the Adult Use Marijuana Act (Proposition 64) will likely not have an appreciable impact on warehouse space in the region. Much of the demand for marijuana is already being met by the state's legalization of cannabis for medical use. Growth in the industrial market has not been limited to warehouse/distribution properties. In part because of recent growth in the Manufacturing sector and the region's tech firms, the flex and R&D sub-market has continued to grow in the East Bay. Vacancy rates dipped to 12.1% at flex/R&D properties in the third quarter of 2016, a 1.4 percentage point decline from one year ago. Rents in the region have increased, growing 2.9% at flex/R&D properties over the last year.

The continued strong demand for commercial real estate in the East Bay has also fueled permitting activity. During the first eleven months of 2016, non-residential permitting activity totaled \$1.80 billion, a 15.7% increase over the same period in 2015. Similar to the gains seen in rents and vacancy rates, most new permitting activity is on the commercial side of the market, with sizeable gains during the first eleven months for 2016 over the same period in 2015. In addition to the new office and retail space in the works, businesses are upgrading and renovating existing spaces, with 2016 marking another strong year for non-residential alterations and additions.

<sup>11</sup><http://www.bizjournals.com/sanfrancisco/news/2016/09/08/ucsf-john-muir-joint-venture-berkeley-lease.html>

<sup>12</sup><http://www.bizjournals.com/sanfrancisco/news/2016/11/17/oakland-prologis-army-base-facility-break-ground.html>

Beacon Economics' outlook for commercial space in the East Bay remains positive. Lower rents and more available land than in San Francisco and San Jose, along with proximity to a highly skilled and dynamic workforce; make it an attractive place for firms to locate. Another draw for the East Bay is continued population growth. While many communities in California have experienced modest population growth because of negative net migration, the East Bay is continuing to draw both domestic and international migrants. The East Bay attracted a net of almost 17,000 new residents from both international and domestic migration between 2015 and 2016. This trend can also be seen in business formation in the region, with the number of business establishments in the region expanding by 4.4% from the second quarter of 2015 to the second quarter of 2016.

## Forecast

The election of Donald Trump has created uncertainties in our economic outlook. Trump's promises during the campaign ranged from modestly economically stimulating to downright recession-causing dangerous. Even so, the nation and the East Bay are in the midst of a seventh year of economic expansion and, given current economic fundamentals, there is little reason to think it will end soon. Our outlook for the East Bay remains positive, despite uncertainty about economic policy going forward. With the unemployment rate at 4.0%, the region is essentially at full employment. This will put upward pressure on wages in the region, with per capita income expected to pass the \$68,000 mark in early 2018. Beacon Economics expects the employment expansion to remain positive but at more modest levels, with employment growth for 2017 ranging from 1.9% to 2.1%.

The region's economy will be driven forward, in part, by its continued affordability advantage relative to San Francisco and San Jose as well as its growing base of high-skilled firms. Additionally, increasing leisure options in the region will make the region increasingly attractive to families and professionals who have been priced out of San Francisco and San Jose.



**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.



[www.eastbayeda.org](http://www.eastbayeda.org)

Analysis. Answers.

© 2016 Beacon Economics, LLC. All rights reserved.