

EastBay

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ECONOMIC OUTLOOK



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The Bay Area: Sunny Economic Skies with Housing Clouds

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Summary

In terms of jobs and real per capita personal incomes, the Bay Area economy has still not fully recovered from the recession of 2001. That said, year to date economic performance in 2006 is on par with the rest of the state for the first time since the late 1990s. Although still fairly anemic compared to five years ago, the local combination of technology and biotech is among the healthiest manufacturing centers in the state, and the technology-related service industry has also picked up steam in 2006. Within this overall recovery, the East Bay remains the fastest growing economy in the Bay Area.

However, the rapidly cooling housing market brings a hint of worry to this otherwise sunny picture. This is especially true in the East Bay, where Construction remains the biggest source of job growth so far in 2006 and new homes represent a significant share of total sales. With the median sales prices of all homes falling slightly year-to-date in the East Bay, real estate looks poised to move from an engine of local growth in 2006 to a drag on the rest of the economy in 2007. How big a drag will depend on whether other sectors of the East Bay economy can pick up the slack.

Employment: The Recovery Continues

So far in 2006, Bay Area job markets have been a classic good news / bad news story. The good news: in contrast to the rest of California, the Bay Area continues to see faster job growth in 2006 than in 2005. While the half-empty crowd will no doubt argue that this is partially due to the below average growth at the beginning of 2005, the Bay Area's year-to-date job growth (January through August) compares favorably with any other local economy in California. The bad news?

Throughout the Bay Area, total non-farm payroll employment has yet to recover to pre-2001 recession levels, though the East Bay should hit that milestone sometime early next year. Regional

unemployment also tells a good news/bad news story: unemployment has been steadily falling as the Bay Area gets back on its feet, but is still a little high by historical standards – by just about every measure, there's still some way to go in this recovery.

Figure 1: Year-over-Year Growth in Bay Area Non-Farm Payroll Employment

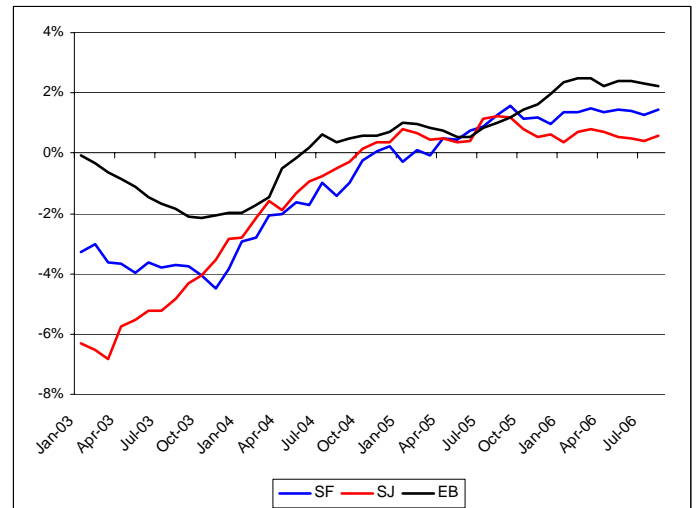
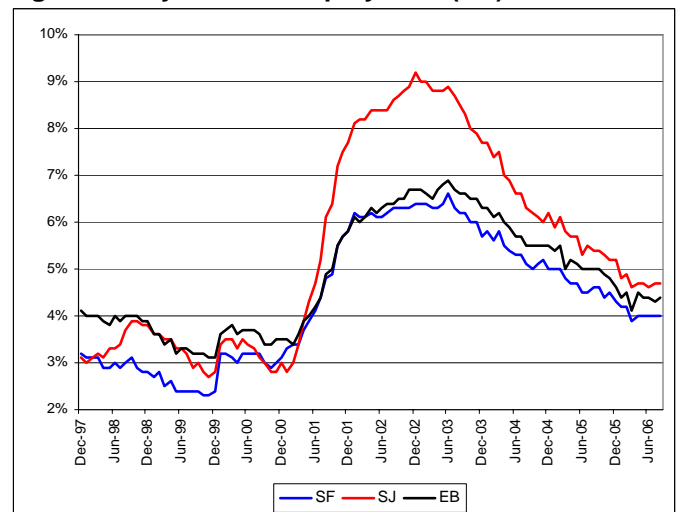
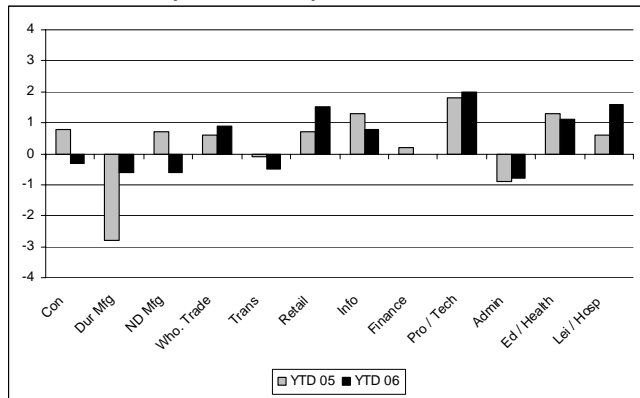


Figure 2: Bay Area Unemployment (SA)



Within the region, year to date job growth in the San Jose metro area (Santa Clara and San Benito Counties) has almost exactly duplicated the 2005 experience, adding 5900 new jobs from January to August of 2006 compared to 6000 over the same period in 2005. San Jose has gone from losing 3500 jobs in Manufacturing in the first eight months of 2005 to losing only 1200 jobs over the same period in 2006. Most of the turnaround has come in the Durable Goods sectors, with significantly slower losses in computer manufacturing tied to employment gains in electronic component manufacturing. Unfortunately, the gains in food processing made year to date in 2005 have been mostly reversed in 2006, washing out this year's improvement in Durable Goods employment.

Figure 3: New Jobs by Sector: San Jose MSA Year-to-Date (1,000s, SA)

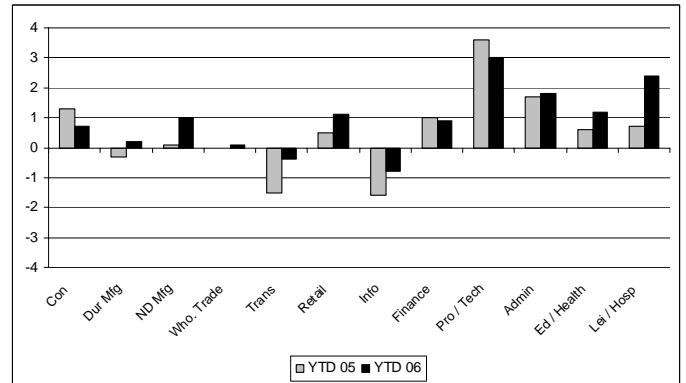


The service side of Silicon Valley also continues to improve. Just like 2005, the continuing rebound of technology services and consulting has made Professional / Technical Services employment the main source of job growth year to date in 2006, adding 2000 jobs from January to August. However, these gains were somewhat offset by a slowdown in internet and software related Information employment, which has added only 800 jobs year to date. These improvements in core sectors have buoyed the wider economy, with Retail Trade and Leisure/Hospitality adding twice the number of jobs year-to-date in 2006 as they did over the same period in 2005.

While San Jose is essentially holding steady, the San Francisco metro area (San Mateo, San Francisco, and Marin Counties) has seen a significant acceleration in job growth, adding 11,000 new jobs from January to August of 2006, compared to 6,500 in 2005. The trends in individual industries look very similar to San Jose. The 3000 new jobs in the Professional/Technical Services category has been the biggest source of jobs, though growth has slowed slightly relative to

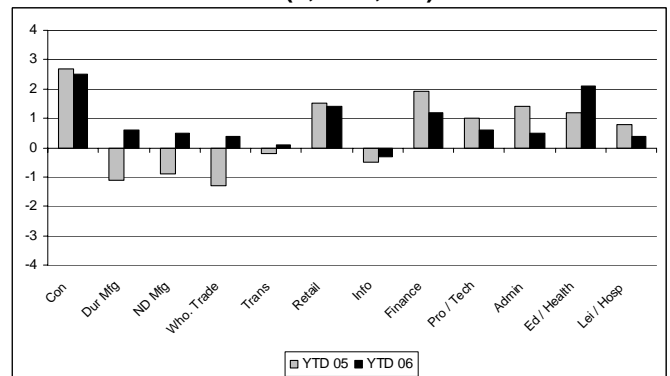
2005. Manufacturing has moved from a net loser year-to-date in 2005 (-200) to a source of jobs gains year-to-date in 2006 (+1200), with across the board improvements in both Durable and Nondurable Goods employment. The San Francisco metro has experienced a similar acceleration of service sector job creation as well: both Retail and Leisure/Hospitality have added more than twice the number of new jobs than by this point in 2005.

Figure 4: New Jobs by Sector: San Francisco Metro Division Year-to-Date (1,000s, SA)



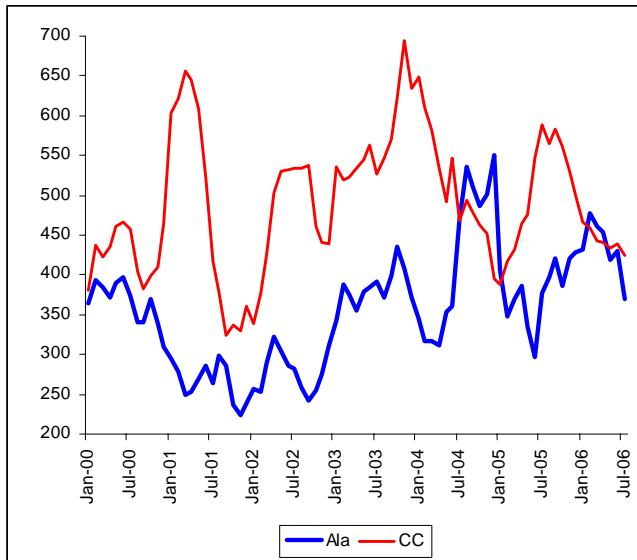
Like the rest of the Bay Area, the East Bay has also seen the Manufacturing sector stabilize, with year to date job gains for the first time since the 2001 recession. Unlike the rest of the Bay Area, the East Bay service sector has seen a mild slowdown, with Financial Activities, Professional/Business Services and Leisure/Hospitality all adding less jobs from January to August of 2006 than the same period in 2005. However, growth in Retail Trade employment remains strong (+1400 jobs year to date), and a strong showing in Educational Services (mostly university and private K-12) has also offset some of the slowdown.

Figure 5: New Jobs by Sector: Oakland Metro Division Year-to-Date (1,000s, SA)



However, the biggest source of new jobs in the East Bay in 2006 continues to be Construction, which added 2,500 jobs between January and August. With the rest of the state seeing flat or falling Construction employment, this continuing strength is somewhat surprising. Can the East Bay continue to buck the statewide trend? Usually, the best way to predict future changes in construction activity is to look at residential building permits. Unfortunately, permit data is notoriously volatile, and recent history offers mixed evidence. Permit activity in both Alameda and Contra Costa Counties has fallen off somewhat since the summer of 2004, but still remains at levels comparable to the boom periods of the late 1990s – it appears that the longer-term demographic move from the Peninsula to the East Bay (particularly Contra Costa County) is alive and well. That said, similar areas that serve as outlets for locals fleeing high homes prices in other parts of California (e.g. Riverside County) have seen Construction growth slow in 2006 – favorable demographics and price gaps have been little help in other areas of California. While the rest of California suggests that the East Bay’s boom in Construction employment is likely to slow in 2007, the jury is still out. The answer to this question will be one of the major drivers of the East Bay economy in the next year.

Figure 6: East Bay Residential Permits Authorized (SA, 6-mo MA)



East Bay Housing Markets Lose Their Fizz

As a whole, the Bay Area housing market has followed the pattern of the rest of California: sales volumes have dropped 33% from their peak in July 2004, and with median sales prices flat to slightly falling in 2006. The East Bay’s slowdown has looked similar on the sales side, with sales in Alameda County down 39% from their peaks, and sales in Contra Costa down 32%. However, the slowdown on the price side has been much more severe in the East Bay in 2006: through August, median sales prices have fallen 3.8% in Alameda County and 3.6% in Contra Costa County.

Figure 7: Bay Area Total Home Sales (area) and Median Sales Price (line) (SA)

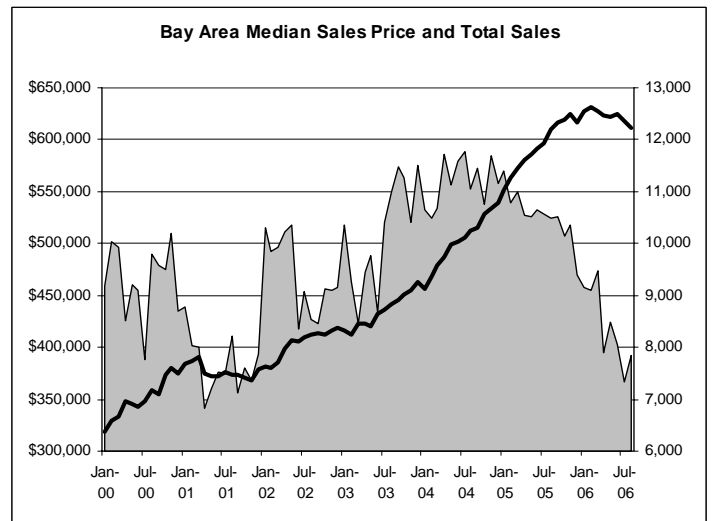


Figure 8: Alameda County Total Home Sales (area) and Median Sales Price (line) (SA)

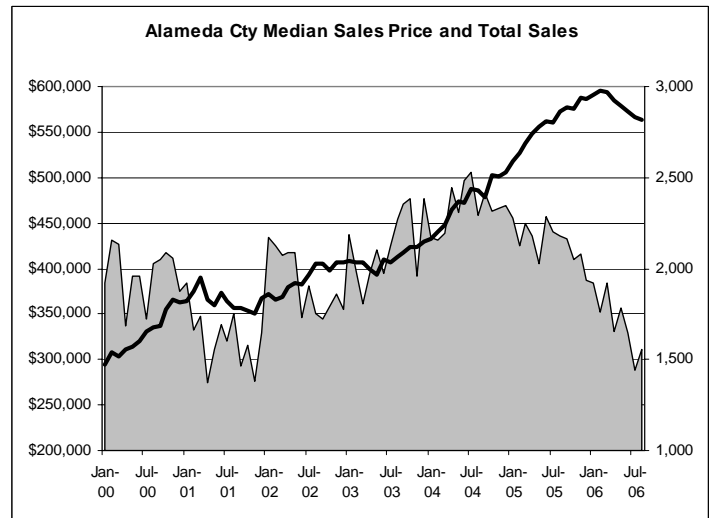
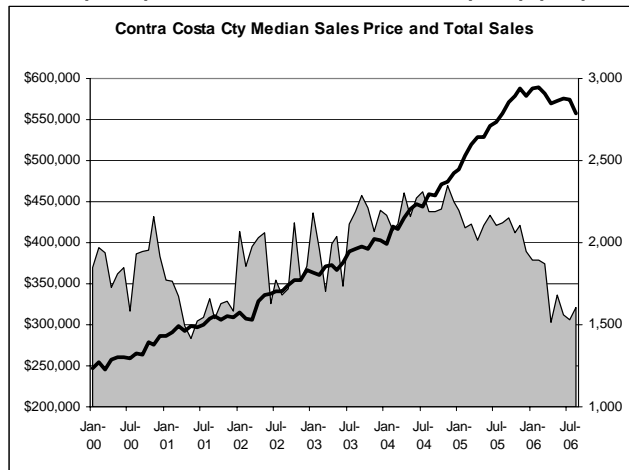


Figure 9: Contra Costa County Total Home Sales (area) and Median Sales Price (line) (SA)



At first glance, these price declines present a bit of a puzzle: historically, significant declines in nominal home prices normally occur only during recessions. The local experience during the last recession supports this view: while the rest of California's housing markets barely noticed the recession, the severity of job loss in the Bay Area economy led to moderate home price declines in 2001. So with the Bay Area economy as strong as it has been in five years, why are we seeing the median sales price fall in the East Bay?

There are two answers to this apparent contradiction. The first hinges on the role of new homes in East Bay housing markets. As we will discuss in the California Outlook section, the counties where new homes make up a bigger share of total sales have seen slower price growth in 2006. The East Bay counties fall in the middle of the pack: in 2005, new homes represented 12% of total sales in Alameda County, and 17% in Contra Costa County – far below the 25%-40% in the Sacramento area, but much higher than the 4% in San Mateo County and 10% in Santa Clara County. The share of sales that are new homes matters because builders historically have been much more willing to trade a lower price for a quick sale. Since builders are unwilling to hold unoccupied inventory and do not have the option of renting the houses (for fear of turning a new house into a used house), when demand slackens they will respond with significant price cuts. Owner/sellers, on the other hand, have been unwilling to accept lower prices in the past except when forced by job loss. Instead, homes are listed at prices that buyers are unwilling to pay, and the number of listings rises as the number of transactions falls – just as we're seeing in 2006. Thus, with housing market cooling in the relatively healthy Bay Area economy of 2006, we

should expect to see the price of new homes falling, but the price of resale homes basically flat. In markets where new homes make up a bigger share of total sales, the rapidly falling price of new homes will have a bigger effect on the median sales price, generating the relationship between share of new home sales and price growth that we've seen in 2006.

Fig.10: Alameda County: Median Sales Price of New Homes and Resale SF Homes (SA)

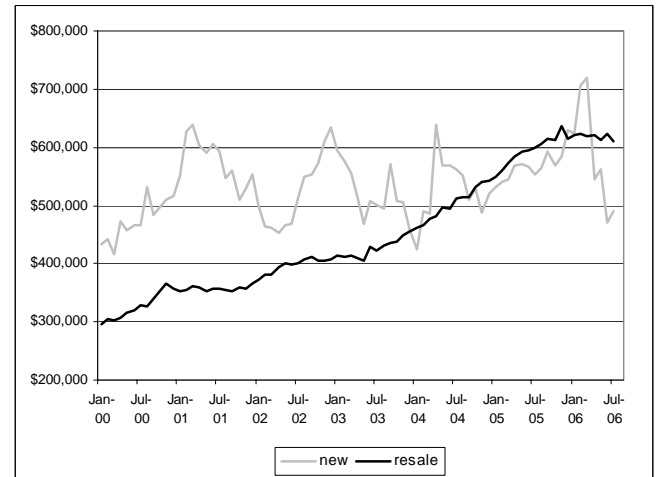
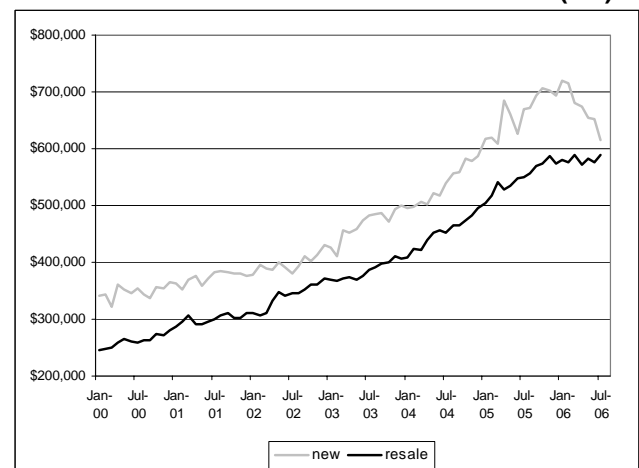


Fig.11: Contra Costa County: Median Sales Price of New Homes and Resale SF Homes (SA)



The role of new homes in the East Bay housing market is certainly part of the reason that median sales prices have fallen in 2006, but it's only part of the story – after all, Contra Costa County has a higher ratio of new homes to total sales than Alameda County, but has experienced less of a fall in median sales prices so far. A brief look at the median price of new homes sold in the two counties is enough to see why: the median price of a new home purchased in Contra Costa county has fallen just over \$100,000 since January 2006, but has fallen close to \$230,000 from March to July in

Alameda County! These new home prices are obviously the major source of the weakness in the East Bay's overall home price statistics.

Yet these \$100,000 swings in the median sales price of new homes in Alameda County are pretty suspicious, and point to the second explanation for why home prices in the East Bay have looked so weak – it is partially a statistical mirage. The median sales price statistics from Dataquick that we've looked at so far are just that: the middle of the price range of all homes sold during that month. So if one month sees a lot of new condo sales and the next month sees a new luxury development start selling, the median sales price can fluctuate wildly, driven by nothing other than the changing mix of homes sold. One look at volatility in the median sales price of new homes in Alameda County (which includes both detached homes and condos) suggests that these mix effects are a large part of what we've seen so far in 2006, and can help to explain why Alameda County looks worse off than Contra Costa even though new homes are a smaller share of total sales.

More evidence of the importance of these mix effects in the East Bay housing market comes from comparing the declines in Dataquick's median sales price to Office of Housing Enterprise Oversight's Home Price Index (HPI) for the East Bay. In the first two quarters of 2006, the median sales price in the East Bay dropped 1.5%, but the HPI rose 2.3%. This is significant because the HPI controls for mix effects by estimating appreciation based on repeat transactions on the same property. Thus, the HPI is an attempt to answer the question we really care about: how has the price of *the same house* changed in the last two quarters? According to the HPI, its price is rising at a slower rate than in previous years – but it's still rising. There are several areas in California where median home price is dropping while the HPI is still rising, indicating that mix effects are partially to blame for the declines in home prices we've seen in 2006. In fact, Sacramento is the only metropolitan statistical area in California to see a decline in the HPI so far.

So the bottom line on East Bay home prices in 2006 has been a double whammy: prices have been weaker than other areas because of the relatively high share of total sales that are new homes, but a large part of this weakness has come from a decline in the average quality of homes being sold recently. Controlling for these mix effects, the HPI suggests that home prices in the East Bay are still rising in 2006 – barely. But while these measurement issues make it hard to decide

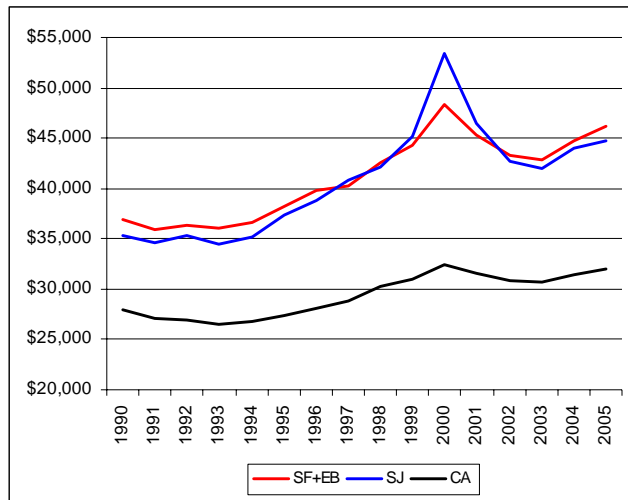
whether prices are flat or falling, one thing is clear: the East Bay's housing boom is long gone.

Home Prices, Housing Expenses, and Personal Income: Who Ate My Paycheck?

As will be discussed in the California Outlook, personal incomes in the state are still reeling from the lingering effects of the 2001 recession. Although nominal per capita incomes in California have been rising in recent years, real per capita incomes have still not recovered to pre-recession levels: continued weakness in the Bay Area has more than offset the small gains in Southern California. And while the cost of living has risen in just about every category, the biggest increases have come in housing expenses, as measured by the Shelter component of the CPI (which is discussed in more detail in the California section).

While the same broad theme of sluggish real income growth holds true in the Bay Area, the severity of the 2001 recession means that the specifics are a little different. First, nominal income growth has been substantially slower. From 2000 to 2005, nominal per capita incomes grew by 16% in the U.S. and by 14% in California. In contrast, nominal per capita incomes rose by only 7.5% in the combined San Francisco and East Bay metro areas (i.e. the San Francisco Metropolitan Statistical Area), and actually fell by 5.7% in the San Jose metro area. While the aftermath of the 2001 recession has kept income growth weak in the Bay Area, it has also kept inflation in check. From 1999 through the first half of 2001, the internet rush pushed overall CPI inflation in the Bay Area well ahead of the L.A. region: the overall price level rose 9.4% in the Bay Area compared to 6.3% in L.A. and 6% in the U.S. as a whole. Most of this increase came from housing expenses: the Shelter component of the Bay Area CPI rose by 15% over this period, compared to 6% in L.A. Not surprisingly, the 2001 recession radically altered these trends. From 2001 through the first half of 2006, the Bay Area's CPI Shelter Index has been almost flat, rising only 8%, which pales in comparison to the 29% increase in L.A.'s Shelter Index over the same period.

Fig 12: Bay Area Real Per Capita Incomes



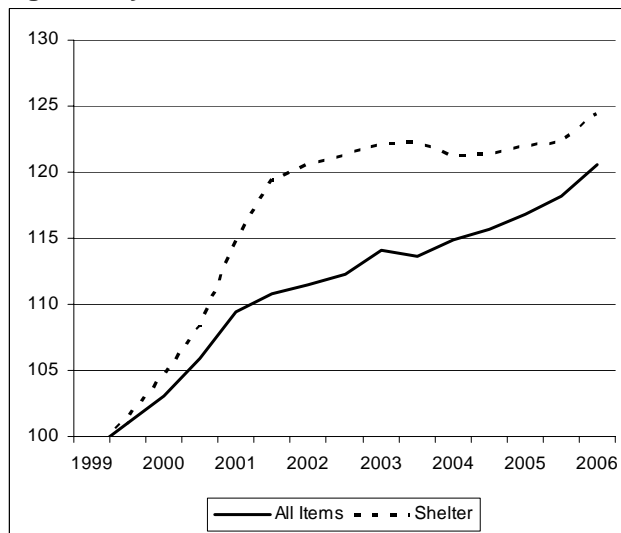
suggest that higher home prices are taking a bigger bite out of Bay Area paychecks than ever before.

Thus, while Bay Area per capita incomes remain among the highest in California, this distinction comes more from past success than recent strength. Real per capita income growth has been weak throughout California, for different reasons: Southern California has seen housing inflation eat away at nominal income gains, while the Bay Area has seen weaker nominal income growth but smaller increases in housing expenses.

Outlook and Conclusions

So far, the broader economic burden of California’s real estate slowdown has fallen outside the Bay Area. West of the Bay, real estate has not been a big contributor; in the East Bay, real estate remains the main source of job growth in 2006. 2007 in the East Bay will see the same trend most other parts of California have seen in 2006: real estate will move from being an engine of growth to a drag on the rest of the economy. This will most likely slow overall growth in the East Bay, but since there are no other sectors in the East Bay economy that look vulnerable to substantial job loss, the net result will be a slowdown, not a recession. Without recession-level job loss, history suggests that substantial declines in nominal home prices are unlikely: mix effects may exert some drag on median sales prices, but same home indices like the HPI will remain flat for the next several quarters.

Fig 13: Bay Area Consumer Price Index



So far, we’ve focused on the Shelter CPI as the measure of housing expenses, which attempts to measure only the increase in the cost of housing services, leaving out the “investment component” of housing. As such, it is the most conservative estimate of the impact of higher home prices on living standards. From 2000 to 2005, the Owner’s Equivalent Rent portion of the Shelter CPI (roughly how much the Bureau of Labor Statistics thinks it would cost an owner to rent an equivalent home) rose by 14.6% in the Bay Area. However, the Census’ American Community Survey estimates that total ownership costs for houses with a mortgage (i.e. mortgage payment, property tax, maintenance, etc.) in the Bay Area rose by 31.4% over the same period. While the academic debate about which measure more accurately captures the effect of home prices on standards of living continues, even the most conservative measures

The California Report

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Summary

So far, 2006 has unfolded about like we predicted. The housing market has continued to soften, and real estate related employment has moved from a major engine of growth in 2005 to a drag on growth in 2006. High home prices continue to eat away at income growth – real per capita incomes in California have yet to recover even 5 years after the recession.

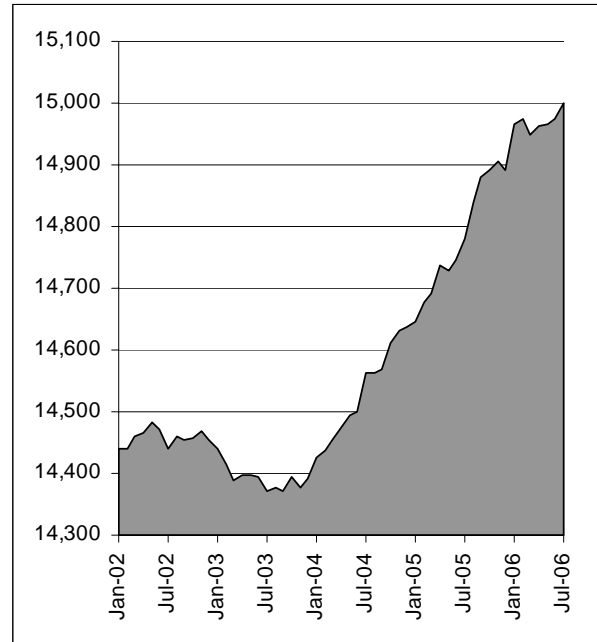
Looking forward, the forecast calls for a similar picture. Real estate sectors will continue to decline, but without significant declines in another sector, the net result will be a slowdown, not a recession. In the absence of recession, statewide home price are unlikely to experience significant declines. However, since builders are much more willing to lower home prices than owners, the handful of areas where new homes account for an above-average share of total sales activity could see some price declines.

Employment Trends in 2006

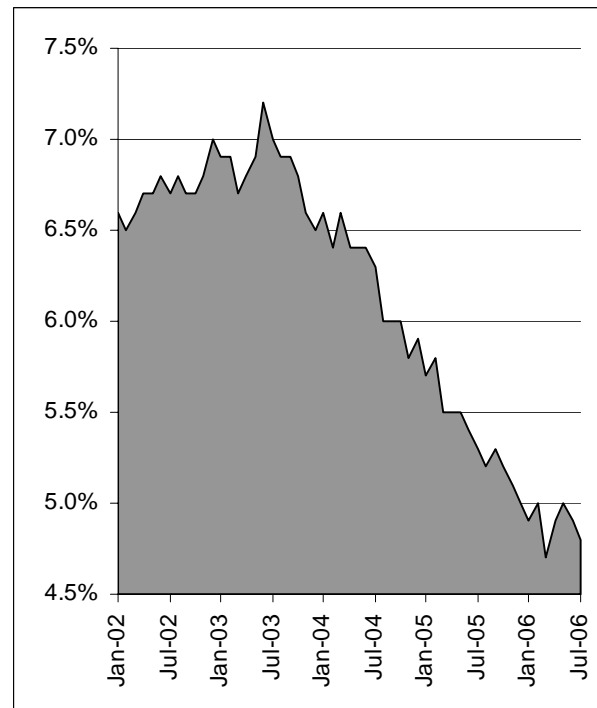
2006 has seen a moderate slowdown in the California economy, with growth in non-farm payroll employment falling from an average rate of 1.8% in 2005 to just below 1% in the first half of 2006. Unemployment remains at lows not seen since the end of the tech boom, but has mostly moved laterally in 2006.

California's slowing job market in 2006 has been shaped by three forces: a weakening real estate sector, a slightly less weak manufacturing sector, and steady-as-she-goes growth in most of the service sectors. The 61,000 jobs created by the Construction sector in 2005 were the biggest single source of job growth in California; however, 2006 has been much weaker. In raw terms, the Construction industry added 7,000 jobs in the first half of 2006. However, this increase is far below the usual first half seasonal surge that we would expect to see – the substantial seasonal swings in Construction employment make it difficult to differentiate trends from seasonal swings.

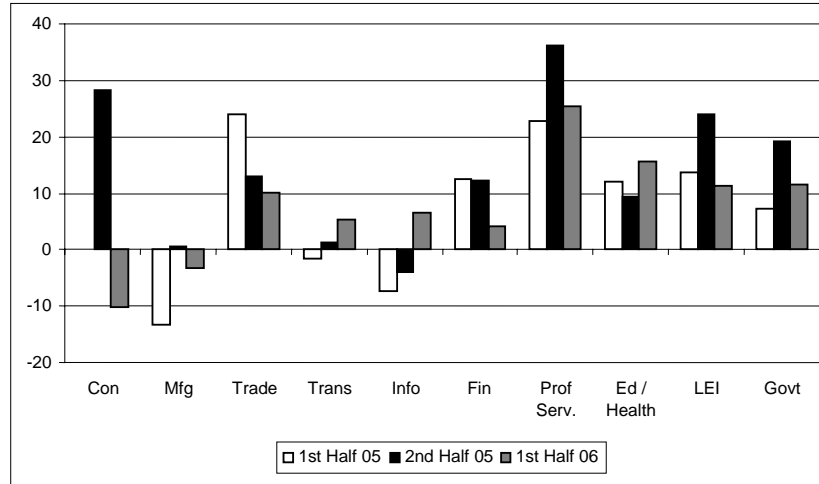
CA Non-Farm Payroll Employment (1,000s, SA)



CA Unemployment Rate (SA)



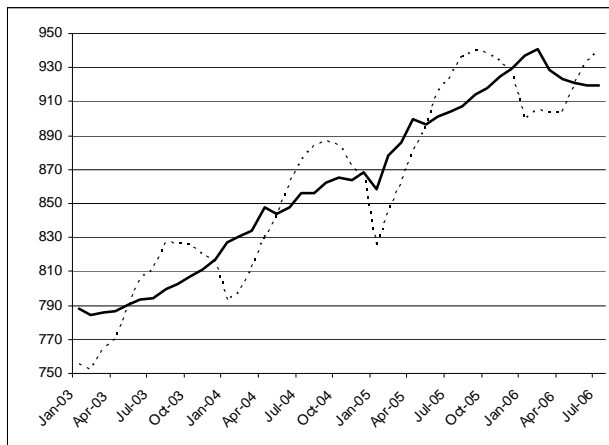
New Payroll Jobs by Sector (1,000s, SA)



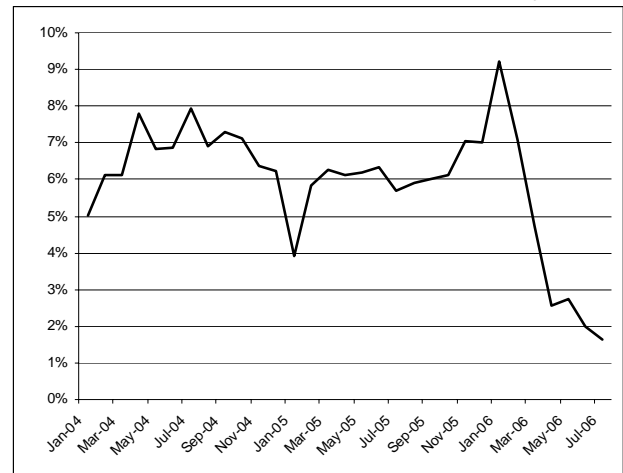
There are two ways around the seasonality: we can compare this July to last July by calculating a year-over-year growth rate, or we can calculate the average percentage surge we'd expect to see in the first half of the year, and compare the actual number of jobs to the expected number – a simplified description of seasonal adjustment. By either measure, the Construction sector is experiencing a major slowdown: the year-over-year growth in Construction employment has slowed from 6-9% to only 2% in July 2006. Similarly, Construction employment is about 10,000 jobs lower than we would expect given the usual seasonal patterns.

year-over-year growth rate is about the average for this time of year in Southern California, but is significantly below average for Sacramento County, which accounts for the bulk of the slowdown in the Central Valley.

CA Construction Employment (1000s; Bold is SA)



Year-over-Year Growth in Construction Employment



While every region has seen slower growth in Construction employment, the regional pattern has varied widely. In terms of year-over-year growth, Southern California and the Central Valley have seen similar slowdowns, but in terms of seasonally-adjusted data, the Central Valley has lost jobs, while Southern California has held steady – a 2%

Growth in Financial Activities employment has also slowed considerably as the real estate related components of this sector have felt the pinch from slowing housing markets and higher interest rates. Layoffs at major mortgage industry players like Ameriquest and Countrywide have made Orange County the primary casualty, but this slowing has occurred throughout Southern California. Growth in Non-Depository Credit Intermediation (which includes mortgage lenders) and Real Estate have essentially flattened out, while Activities Related to Credit Intermediation (mortgage brokers) has lost about 1800 jobs in Orange County since the middle of 2005. In fact, the high share of independent contractors in this industry means that the payroll employment data may very well understate the scope of these job

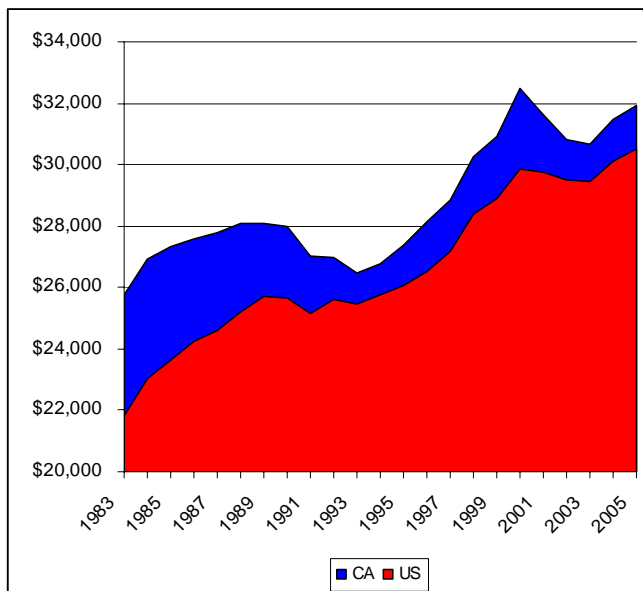
losses; nevertheless, even the payroll survey shows significant slowing in the financial side of the real estate sector.

Outside of the real estate portion of the economy, 2006 has been mostly more of the same for the state. In Southern California, accelerating growth in Leisure/Hospitality and Professional/Business Services has been able to offset some of the real estate weakness, but these local trends have not translated through to the state level. With service sector growth either about the same or slightly slower throughout the State as a whole, the only offset to the housing-related drag has been slightly less bad news from the manufacturing sector, as the slow but steady job losses in both durable and non-durable manufacturing have moderated in recent months.

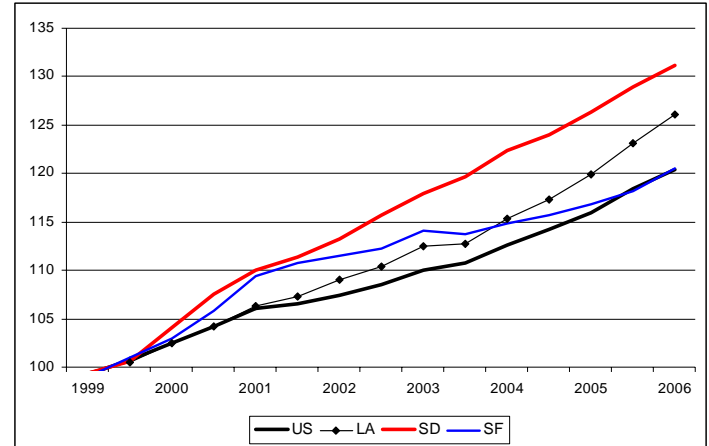
Incomes and Inflation

While California's nominal per capita income of \$37,036 in 2005 was over \$4500 higher than in 2000, adjusting for local inflation, real per capita incomes have still not recovered from the 2001 recession. Comparing the national experience with California, it is clear that part of the explanation is that the run-up in incomes at the end of the 1990s was in itself abnormal – funny money dot.com compensation led to a burst of above average growth, leading to a steeper drop as the tech boom busted. But an equal part of the explanation has been the increased cost of living in California, especially compared to the national experience. Since 1999, the Consumer Price Index for the U.S. as a whole has risen about 20%. The L.A. CPI has risen 26% over the period, and San Diego's has risen 31%. The Bay Area CPI has risen about the same as the national average, but this was more the result of a few years of high inflation followed by a few years of next to no inflation.

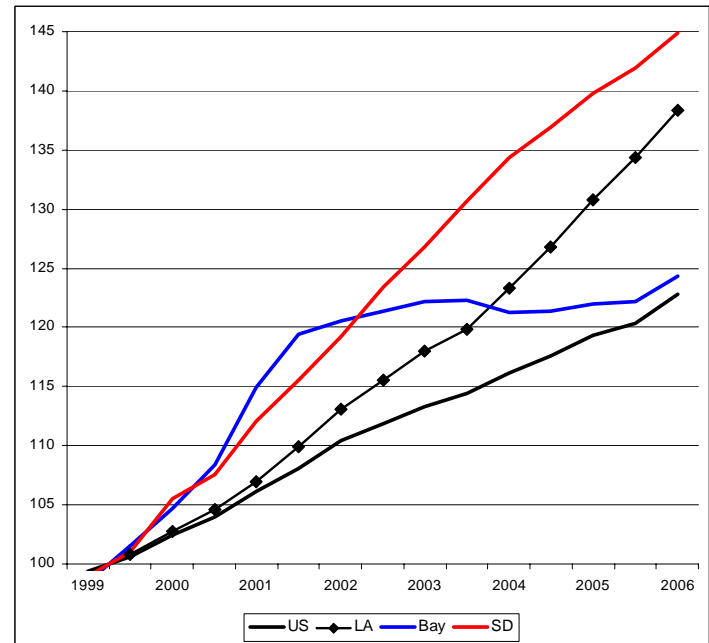
Real Per Capita Income (CPI, 2000 \$)



Consumer Price Index: All Items (1999=100)



Consumer Price Index: Shelter (1999=100)



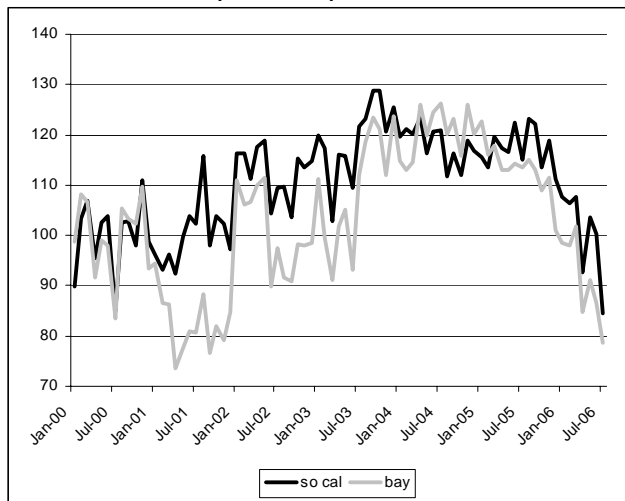
It should come as no surprise that the bulk of this divergence comes from California's red-hot housing markets. The shelter component of the CPI has three major components: rent of primary residence, owner's equivalent rent (roughly how much the Bureau of Labor Statistics estimates that it would cost a home owner to rent an equivalent home), and lodging away from home. Together, these shelter items receive about 40% of the total weight in the CPI index (the exact amount varies by region) – by far the biggest single item in the index. Overall, the nationwide housing boom has led to a 22% increase in the CPI's shelter index since 1999. Of course, L.A.'s increase was 38%, and San Diego's was 45%. If anything, these numbers are a bit conservative: the BLS goes to great lengths to separate the cost of housing services from the investment component of housing; thus, the over 150% increase in home prices in L.A. County from 1999 – 2005 dwarfs the 32%

increase in owner's equivalent rent. While there is continuing academic debate about which of these numbers more accurately reflects the impact of higher home prices on standards of living, even the conservative estimate imply that the housing boom has taken a serious bite out of real incomes in California.

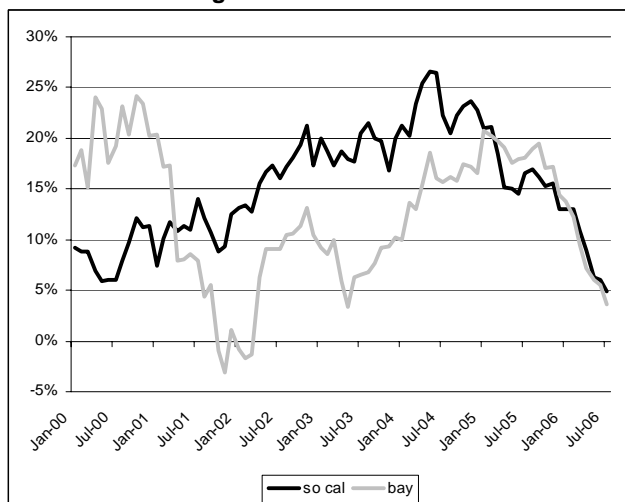
Housing Markets

The first half of 2006 has continued the slowing trend from the second half of 2005. Sales activity in both the Bay Area and Southern California has fallen over 30% from recent peaks, and year-over-year growth in median sales prices in the two regions has slowed to single digits. But within this broader trend of flattening prices, San Diego and several counties in the Sacramento region have actually seen declines in median sales prices.

Home Sales Index (2000=100)



Year-over-Year Chg in Med. Sales Price



For almost a year, the Forecast's California report has been arguing that we are unlikely to see significant declines in state home prices without a recession. So how do we reconcile this argument with the empirical fact that a handful of California counties have seen median sales prices fall in 2006?

Our answer comes in two parts. First, just when we would like an unambiguous read on what's happening with housing prices, different data sources are telling different stories. The table below compares the percentage change in OFHEO's Home Price Index from 2005Q4 to 2006Q2 to the change in Dataquik's median sales price over the same period. While the broad trends may agree, there are substantial differences. While the seasonally-adjusted median sales price in L.A. County grew less than 1%, the HPI for L.A. County was up over 6%. Several metro areas show positive appreciation in the HPI, but show declines in median sales prices. The discrepancy comes from a fundamental difference between the two measures. Median sales price is fairly straightforward: it is the middle of the price range of all the homes sold in that period.

The calculation of the HPI is much more involved calculation that tries to nail down the change in the price of a "constant quality" home by matching the sales price of the same home over two different periods across thousands of transactions. Generally speaking, economists tend to prefer to use repeat-sales measures like the HPI to gauge changes in home prices, since it controls for the changes in home mix and quality that could alter average sales prices even if the price of an "average" home was unchanged. In addition to changes in mix and quality, there are two other important reasons why these two measures might differ. The HPI focuses exclusively on detached resale homes, while the Dataquik figures include both resale condos and the sales price of new construction (new homes and new condos are averaged together).

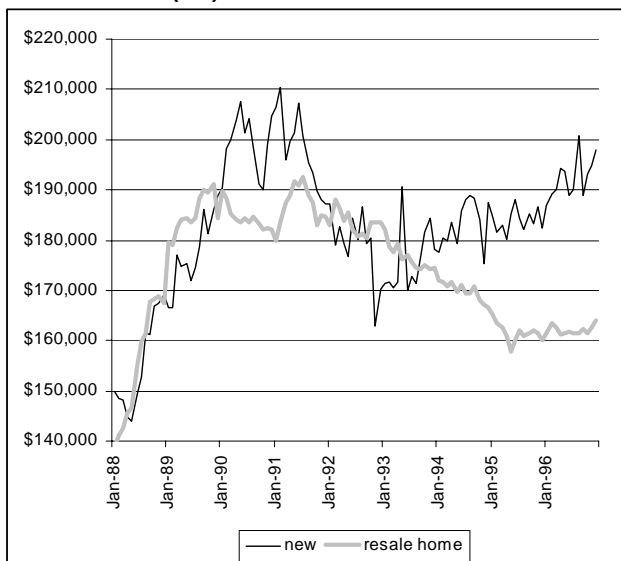
Last but not least, the HPI sample is derived from conforming Fannie Mae / Freddie Mac loans, so the absence of the higher end of the home price distribution may skew the index a little. However, this problem is not as bad as you might expect: although the conforming limit in 2005 was only \$359,650, 67% of the homes in the 2005 sample for California were valued at higher than this limit. Bottom line? In markets where the median sales price is falling but the HPI is rising, it's hard to sort out exactly what's going on with home prices – but we lean towards trusting the HPI.

Home Price Appreciation, Median Sales Price vs. OFHEO Home Price Index

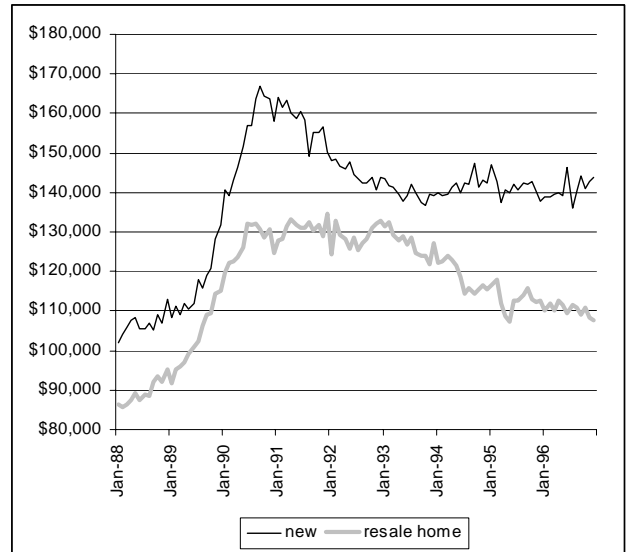
Metro	Pct Chg, 2005Q4 to 2006Q2	
	HPI	Med Sales Price
Sacramento-Arden-Arcade-Roseville	0.6%	-4.0%
San Diego-Carlsbad-San Marcos	0.8%	-5.2%
Santa Rosa-Petaluma	1.7%	2.3%
Napa	1.7%	7.4%
Vallejo-Fairfield	2.0%	1.5%
Oakland-Fremont-Hayward	2.3%	-1.5%
San Jose-Sunnyvale-Santa Clara	2.5%	2.1%
San Francisco-San Mateo-Redwood City	2.7%	1.9%
Oxnard-Thousand Oaks-Ventura	3.8%	-3.0%
Santa Ana-Anaheim-Irvine	5.4%	1.8%
Riverside-San Bernardino-Ontario	5.8%	1.0%
Los Angeles-Long Beach-Glendale	6.5%	0.9%

The second part of our answer focuses on the differing behavior of new homes and resale homes in a soft market – something that the Dataquick numbers can illuminate. The graphs below show the median sales price for resale houses and new homes in Southern California from 1988 to 1995. The path of these median prices during the recession is markedly different: the median price of new homes fell sharply, but bounced back sooner, while the median price of resale homes fell much more gradually, but for a more prolonged period of time. This could be another side effect of severity of the local recession; however, Sacramento County shows a similar pattern in home prices even though the recession was much less severe.

Southern California Median Sales Price of New and Resale Homes (SA)



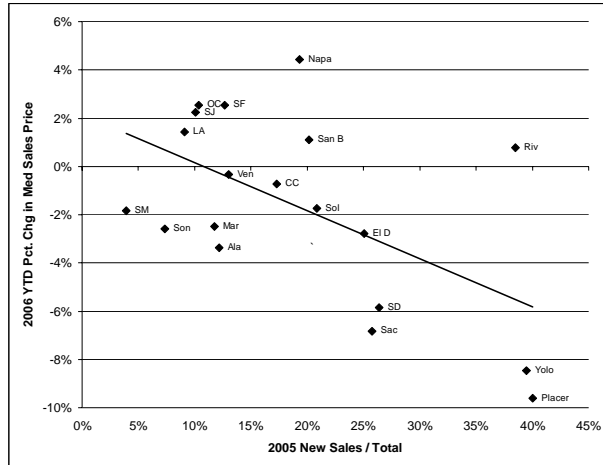
Sacramento County Median Sales Price of New and Resale Homes (SA)



Why would new prices be flexible downward in a soft market when resale prices aren't? While an owner could easily respond to a softening market by simply waiting to sell or renting out the house, builders can neither carry the inventory nor take the depreciation hit on renting a new home. Thus, builders will respond to a fall in demand by lowering the price, while resellers may simply retreat from the market. We have often explained the connection between recessions and falling aggregate home prices by arguing that job loss creates motivated sellers who need to raise cash quickly, and are therefore willing to trade a quicker sale for a lower purchase price. Our story about builders is just an extension of this logic: builders are always motivated sellers.

Let's apply this logic to the current market. Lack of any significant economic distress so far in 2006 has limited the number of motivated resale sellers, but the slowdown in sales should motivate builders to lower their prices. This argument offers several predictions. Since the bulk of home transactions are resale transactions, aggregate home prices should be mostly flat. However, regions where the sale of new homes makes a significant share of total sales should see slower or even negative growth in median sales prices. So far in 2006, both of these predictions have been true. The broad aggregates for home prices have flattened out, but haven't shown significant declines – which is consistent with the historical relationship that statewide home prices have only fallen in recessions. At a county level, we find that the counties with higher shares of new homes are also the counties which have experienced the weakest price growth.

2006 YTD Pct. Chg in Med Sales Price



levels of new construction relative to total sales could see moderate price declines.

So does this change our forecast for California housing markets in the next two years? Not really. We are still firmly convinced that the economy is the primary driver at the state level: statewide home prices are unlikely to decline significantly unless there is a recession. However, regions where new building is a substantial portion of the housing market may experience some price declines even if there is no recession in California, since builders and their willingness to lower prices make up a bigger chunk of the local market. So far, San Diego and the Sacramento region have followed this pattern. On the other hand, new homes made up 40% of new sales in Riverside County in 2005, yet prices are still rising. Whether this means that the other shoe has yet to drop in Riverside, or simply that there are demographic factors that continue to favor the housing markets in Riverside relative to other counties is still an open question.

Forecast and Conclusions

The main themes of last quarter's California forecast have carried over into this quarter. Building permits will continue to decline, bottoming out in 2008 as activity returns to levels seen in 2000. This decline in building activity will continue to weaken Construction, which will lose around 100,000 jobs over the life of the forecast. The weakness in real estate related Financial Activities will also continue, slowing overall growth in that sector. On the other side, a flattening out in Manufacturing employment and steady but not spectacular growth in the rest of the service sector will offset some of this weakness, keeping overall payroll growth around 1% through 2008. Slowing growth in nominal personal income and taxable sales will be offset somewhat by declining inflation: growth in real personal income and taxable sales will remain weak in 2007, but pick up some lost ground in 2008. Since we are not predicting a recession, we look for nominal home prices in the state to stay flat through 2008, though real prices will fall. However, a handful of regions with above average

Soft Landing with Turbulence Ahead

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Senior Economist
UCLA Anderson Forecast

While the U.S. economy appears to have seamlessly downshifted to a soft landing, we suspect that there will be turbulence ahead. To be sure, we are not forecasting a recession, but the glide path of the economy is about to get bumpy as the housing market continues to deteriorate. **We expect a sustained period of 1.5- 2% real growth, and before it is over there will be more than a hint of stagflation in the choppy air.**

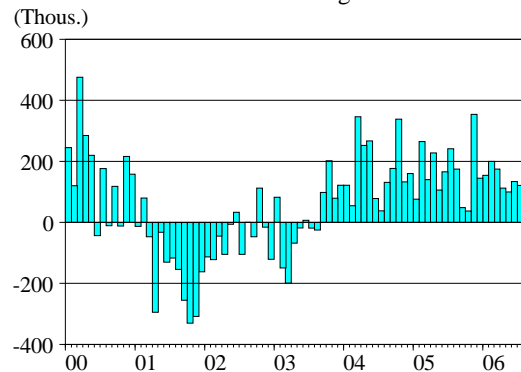
Specifically our forecast calls for real GDP growth to average 1.8% in the three quarters beginning in Q306 and ending in Q207, while core CPI will be increasing at an average rate of 3.2%. In this environment the unemployment rate would rise to 5.1% by the end of 2007, above the current level of 4.7%. While not a recession, it is hardly a pretty picture. The combination of sluggish growth and rising prices will have the look and feel of a low level stagflation. Although the term stagflation conjures up images of the mid-1970s, when output declined and inflation rose, the current cycle will appear rather mild. Nevertheless policy makers will have a great deal of trouble grappling with it. As we noted last quarter, the Fed remains in a box trying to simultaneously deal with weak output growth and an inflation rate higher than what it would like.

Thus we expect only a modest decline in the Federal Funds rate to 4.5% from the current 5 ¼% by mid-year 2007. We do not view our prediction of a rate cut in early 2007 to be all that bold. As of early September the very liquid Eurodollar market was pricing in a 50 basis point rate cut by September 2007. Because core inflation will remain stubbornly high, we do not anticipate the 10-year U.S Treasury note to drop much below 4 ½%. Rate cuts along with still strong business investment, an improving trade picture, and some easing in oil prices along with an end to the free fall in housing construction, will enable the economy to avoid recession and return to a 3.5+% growth path in 2008.

The Downshift

After growing a very strong 5.6% in the first quarter, real GDP growth slowed to 2.9% in the second. Although consumer spending remained strong over the summer, employment growth decidedly slowed. While gaining an average of 171,000 jobs a month from December 2003 to March 2006, employment growth declined to an average of 119,000 jobs per month in the five months ending in August. (See Figure 1)

Figure 1. Total Nonfarm Employment Growth
Jan. 2000 to Aug. 2006



Source: Bureau of Labor Statistics

Moreover, business equipment spending, after surging 15.6% in the first quarter suddenly declined by 1.6% in the second. That along with a 9.9% decline in residential investment was the major source of the deceleration. Partially offsetting the weakness were gains in nonresidential construction, up a stunning 22% and an improvement in net exports. The growth in nonresidential construction is being fueled by an apparently insatiable demand for commercial real estate by investors throughout the globe. We anticipate continued strength in this sector over the next year, albeit the pace will likely cool from the blistering growth of the second quarter.

Housing in Free Fall

When David Lereah, chief economist of the National Association of Realtors, says “I’m hoping for prices to drop,” you know the housing market is in big trouble.¹ With existing home sales off 12% and housing starts off 26% from their record peaks, **it has become obvious that the housing market is in major cyclical decline.** (See Figures 2 and 3) Moreover, real home prices have undergone their most precipitous decline in the history of the series and are now **down** from a year ago. (See Figure 4) In our opinion it is only a matter of time before nominal home prices are down on a year-over-year basis. Indeed according to the still illiquid house price futures market on the Chicago Mercantile Exchange indicates about a 5% **decline** in prices by next spring. Only a year ago it was practically unthinkable that home prices would actually decline.

Figure 2. Total Existing Home Sales
Jan. 2000 to July 2006

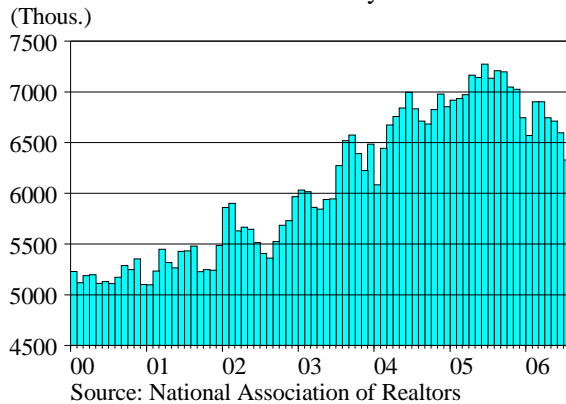


Figure 3. Housing Starts
Jan. 2000 to Aug. 2006

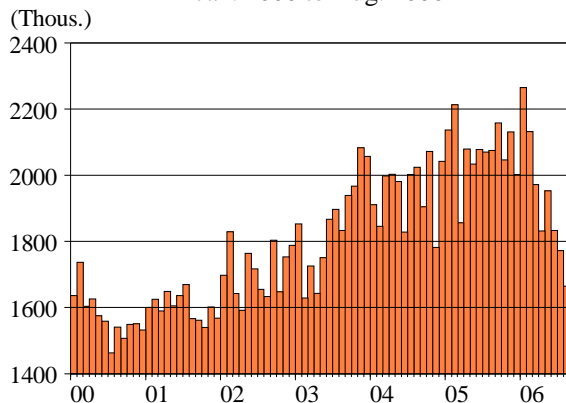
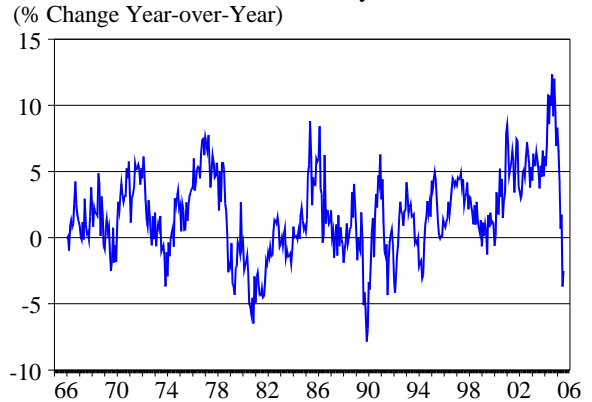


Figure 4. Real Existing Home Prices
Jan. 1963 to July 2006



Sources: National Association of Realtors, UCLA Anderson Forecast

For some time we have been forecasting that housing starts will bottom out in the 1.5-1.6 million unit range. In our view that range represents a **normal, not a depressed**, level for housing activity. Because even this “normal” level of activity is still well below current levels, it is likely to drive the economy to a below trend growth rate of 2%. The flight path from here to there will be turbulent.

If there is a risk to our housing forecast it is that housing will be worse rather than better than what we now expect. How so? As we noted last quarter housing declines typically run in excess of 50% from peak to trough. We are projecting a decline of around 30-35%. A housing start decline in excess of 50% by the end of 2007 could very well cause an actual recession. However, for modeling purposes we are assuming that starts bottom in the 1.5-1.6 million unit range as modest rate cuts and continued, albeit modest, employment growth dampens the decline.

The Fed’s Box

After raising interest rates by 25 basis points (one one-hundredth of a percentage point) for 17 consecutive meetings the FOMC finally called a halt to rate increases at its August meeting. We suspect that we have seen the last hike in the Fed Funds rate for a long time and in fact the next move will be to cut rates in early 2007. However, the Fed cannot only focus on the economic weakness that we, and for that matter their staff economists, are projecting. It also has to be wary of a persistent inflation that appears to be above what is consistent with price stability. Simply put, a long period of monetary ease combined with rising commodity prices, especially oil, and rising unit labor costs have put a whiff of inflation into the air.

(See Figure 5) To be sure the forces of globalization have dampened its effect, but core inflation as measured by the consumer price index of the personal consumption deflator will be above 2% for quite some time. (See Figure 6) The core CPI is running higher because it has twice the weight for the accelerating owners' equivalent rent component than the deflator.ⁱⁱ

Figure 5. Unit Labor Costs
2000:1Q - 2006:Q2

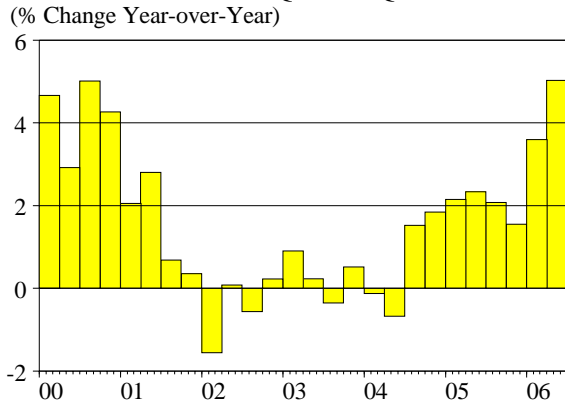
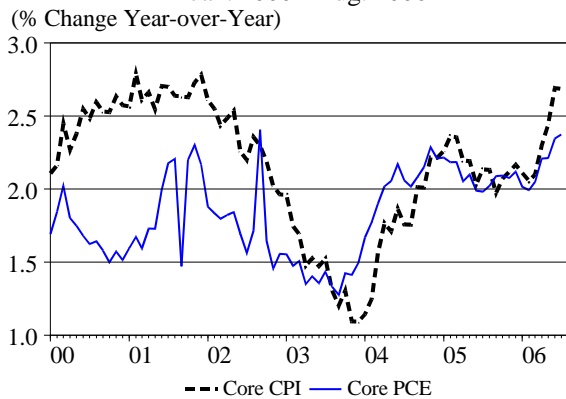


Figure 6. Core CPI Versus Core PCE
Jan. 2000 - Aug. 2006



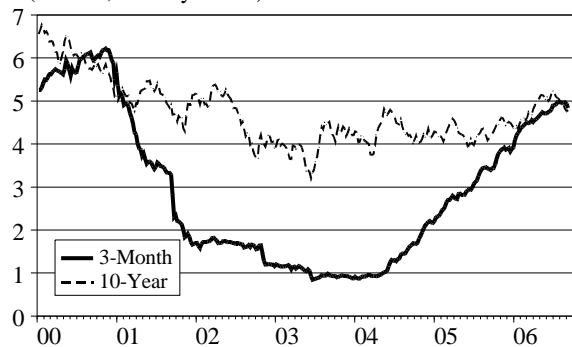
Sources: Bureau of Labor Statistics and Department of Commerce

The bond market has sensed the Fed's conundrum by inverting the yield curve with the 10-year U.S. Treasury note dropping to a recent low of 4 3/4%. (See Figure 6) All market maturities are trading below the 5.25% funds rate. Put bluntly, the market now believes that the Fed is done and there are easings ahead of us. Indeed, as we noted above, in early September the Eurodollar market was pricing in 50 basis points of easing by September 2007. However, because inflation will remain higher than the Fed would like, those easings will be small and grudging. Similarly the 10-year Treasury note will have trouble sustaining a rally below 4 1/2%. The

Fed will be on a tightrope because if they make a mistake here, it will be much harder to ring inflation out of the economy later in the decade. The worst case would be policy still too tight to avoid the below trend growth in output, but too loose to lower inflation.

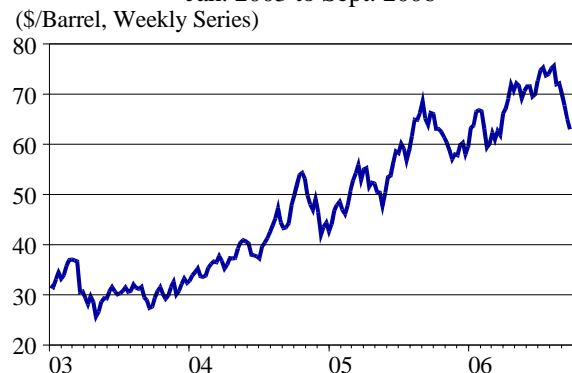
One factor making life simpler for the Fed has been the recent decline in oil prices. The price of oil has dropped about \$15/barrel since its early summer peak. Should the price stay at around its current \$60-65/barrel level or decline even further, it would make it far easier for the central bank to deal with the slowdown in economic activity as lower oil prices would be both stimulative in of itself and it would relieve the pressure on headline inflation. (See Figure 7)

Figure 7. Interest Rates
3-Month T-Bills vs. 10-Year U.S. Treasuries
Jan. 2000 to Sept. 2006



Source: Global Insight

Figure 8. Crude Oil Price
West Texas Intermediate
Jan. 2003 to Sept. 2006



Source: Global Insight

In summary, we forecast the economy is about to enter a period of several quarters of sluggish growth with inflation above the comfort level. The Fed will respond by gradually cutting the funds rate to 4 1/2%. Although not a recession, the

unemployment rate will modestly increase and those sectors of the economy tied to residential construction will be in a cyclical decline. More than a few commentators will call it stagflation. In time continued strength in business investment and trade along with a bottoming of the housing market will work to return the economy in 2008 to a 3-4% growth path.

ⁱ "Realtor Official Forecasts Decline in Home Prices," *The Wall Street Journal*, September 2, 2006, p.2

ⁱⁱ For a full discussion of the rental components see, Shulman, David, "Housing, Inflation and the Fed," UCLA Anderson Forecast, June 2006, pp.27-30.