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East Bay Economic Outlook

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East Bay Economic Development Alliance

Authored by
Beacon Economics

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East Bay Economic Development Alliance

The East Bay Economic Development Alliance (East Bay EDA) is a public/private partnership serving the San Francisco East Bay (Alameda and Contra Costa Counties) whose mission is to establish the East Bay as a world-recognized location to grow businesses, attract capital and create quality jobs.

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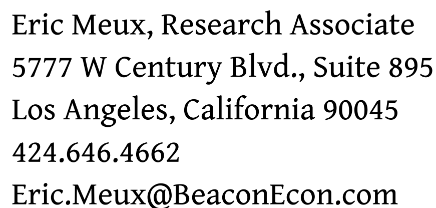

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Overview

Economic recovery in the East Bay may be lagging other areas by some measures, but close scrutiny of a broader range of indicators shows that in many respects the East Bay is poised for respectable growth in the years ahead. Total nonfarm employment growth in the East Bay lags that of the San Francisco Metropolitan District (MD) and the South Bay, however data on employment, labor force, and the unemployment rate from the household survey paint a different picture. While local businesses may report slow hiring, East Bay residents are finding work in other areas. Fast growing industry employment in San Francisco (MD) and the South Bay, as well as record high home affordability in the East Bay, are driving these trends.

Spending by consumers and businesses in the East Bay continues to be strong, and in the last year has grown faster than other regions in the Bay Area and the state overall. All spending categories exhibited growth from the third quarter of 2010 to the third quarter of 2011. The fastest growing categories include fuel and service stations, autos and transportation, and food and drugs. The recovering economy and improved household balance sheets are seen as responsible for this sustained growth.

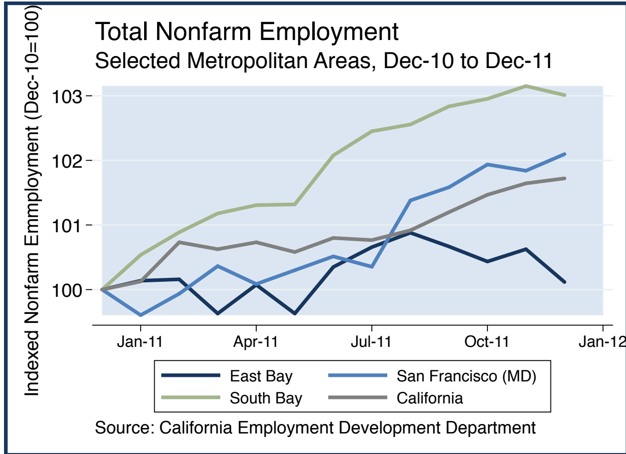
In the local real estate market there are still many challenges, but the worst is behind us. Existing home prices have stabilized over the last few months and are more in line with incomes in the region. Home affordability compared to San Francisco (MD) and the South Bay is at record high levels, which should drive net migration in the East Bay and give the recovery a boost as we move forward. The new home segment of the market continues to drag on the broader real estate market, but as income and population growth reach an equilibrium with home prices we should see a reduction in the current inventory of existing homes and a subsequent increase in new home sales.

While some indicators of the East Bay's economic recovery have shown mixed results over the past year, international trade is clearly a bright spot. In particular, export activity at the Port of Oakland continues to be strong. A weak dollar continues to make U.S. goods more affordable on international markets. This has translated into strong growth in areas that California performs especially strong in. Specifically, the weak dollar and improving global economy have driven growth in both agricultural exports from north and central California farms as well as in high-tech exports like computer equipment, aircraft, and pharmaceuticals. With the outlook for international trade remaining strong, exports should help keep port activity up and contribute to the broader recovery in the East Bay.

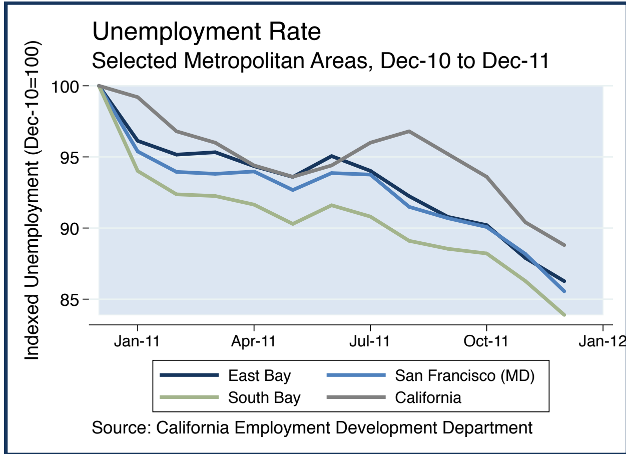
East Bay Economy

Labor Market

The East Bay's labor markets are showing genuine signs of improvement, despite lackluster job growth according to the payroll survey. The payroll figures, which are derived from surveying employers to determine the number of people who work in the area, show that gains in East Bay employment continues to lag behind those of San Francisco (MD) and the South Bay, as well as behind those in the state overall. Since hitting the post-recession bottom, industry employment has seen only modest improvement during the second half of 2011.

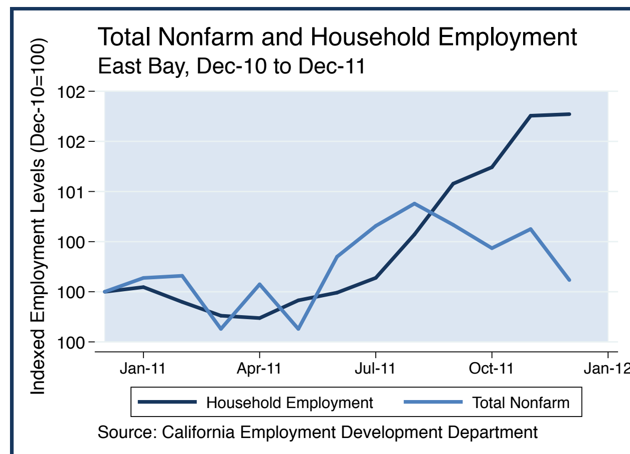


But the payroll survey does not tell the whole story. As has been the case for the last year the household survey, which measures employment based on who lives in the area, paints a much different picture. The unemployment rate in the East Bay has been steadily declining throughout the year, closely tracking that of San Francisco (MD) in the last half of 2011. The drop in the East Bay's unemployment rate did slightly underperform the decline in the rate in the South Bay, but it dropped faster than the rate in the state overall. The unemployment rate in December 2011 stood at 9.7% —finally dipping into the single-digits after peaking at 11.7% in November 2010, and currently well below the statewide average of 11.1%.

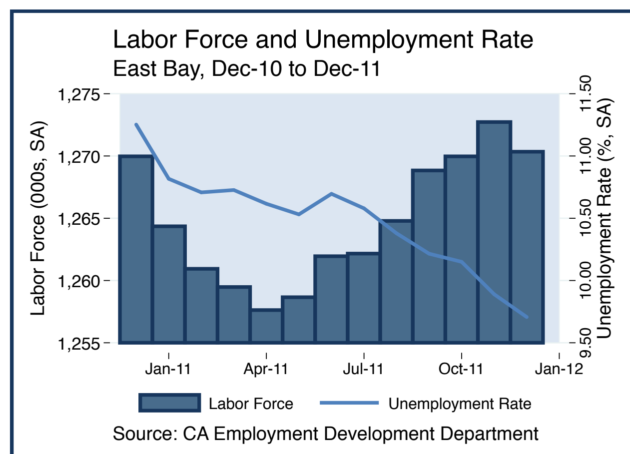


The unemployment rate isn't the only labor force statistic that highlights the differences in what the two employment surveys are capturing. The payroll survey shows East Bay industry employment increased by only 0.1% from December 2010 to December 2011, but the employment level from the household survey shows a 1.8% increase in the same year-over-year period. Furthermore, as the unemployment rate has gone down in the second half of 2011 we

have seen the labor force expand, which means that more East Bay residents are resuming their job searches. Thus, the unemployment rate in the East Bay is genuinely declining rather than merely showing decreases because people are becoming discouraged and no longer looking for work. The divergence between these two surveys, and in particular the strength in the household figures, demonstrates how inter-connected the Bay Area economies are.



San Francisco (MD) and the South Bay both have a high concentration of workers in professional and technical services —sectors that have been benefiting disproportionately from the surge in business investment nationally. However, the expansion in payrolls in these areas benefits East Bay residents. The employment data from the payroll survey and the household survey clearly show that while businesses in the East Bay are not hiring at the same pace as businesses in the neighboring regions, residents in the East Bay are finding work at almost the same pace, or faster, than residents in neighboring regions and in the state overall. We know from the data on commuting patterns that East Bay residents are willing to drive outside of the immediate area for gainful employment, taking advantage of the job growth in the broader economy. Despite a brief stumble in December, household employment is up by nearly 23,000 since hitting bottom last year; 12,700 residents re-entered the labor force and another 10,200 have moved from unemployment to employment.



Of late, much of California's woes, which are primarily cyclical in nature, have been attributed to more structural issues—namely a bad business climate. When compared to other states such as Texas and Georgia, it is often found that California has too many taxes, too many regulations, and too much government. The San Francisco Bay Area is one of the regions that is leading California in the economic recovery, and compared to the top metropolitan areas in Texas and Georgia, the Bay Area is easily holding its own. Although we are unable to break out the East Bay specif-

ically, data from the Bureau of Economic Analysis shows that real GDP in the Bay Area grew at a faster annual rate than in Atlanta throughout the previous decade leading up to the recession. In addition, real GDP in the broader region actually declined less on a percentage basis than in Dallas from 2009 to 2010. Clearly, the argument that California is insufficiently business friendly is less than persuasive.

Real GDP Annual Growth Rates

	Long Run	Pre-recession	Post-recession
MSA	2001-2010	2001-2008	2009-2010
Dallas	2.7%	3.2%	-17.4%
SF Bay Area	1.3%	2.3%	-10.1%
Atlanta	1.2%	2.2%	-8.6%

Source: Bureau of Economic Analysis

The recovery has taken longer to get going in the East Bay because the region was hit harder by the downturn, but we expect the East Bay to return to solid growth as the recovery takes hold. We are already seeing evidence in the manufacturing sector that clean-tech could be one of the employment growth drivers. The professional, scientific, and technical industry employment is currently up nearly 4% from December 2010 to December 2011 period. The education and health sector is also showing strength and resilience, up 3.2% during the same year-over-year period, despite a 1.5% drop in September of 2011. Beacon Economics forecasts that the total nonfarm employment recovery will accelerate in 2012 and maintain an upward trend in the years to come, reaching its pre-recession peak in 2015. The unemployment rate will continue to decline and should dip below 9% by the beginning of 2014.

Consumer and Business Spending

Local spending by consumers and businesses has clearly turned the corner toward growth. Spending, as measured by taxable sales, has been on a near-constant upward trend in the East Bay, which has added back more than 16% of its taxable sales since hitting bottom in the second quarter of 2009. This is slightly lower than the gains posted by the neighboring regions. Since hitting bottom, taxable sales have rebounded a bit more strongly in San Francisco (MD) (18%), and the South Bay (23%), as well as in the state overall (17.5%). This upward trend is apparent in virtually all regions across the state, but in the last year the East Bay has outperformed its neighbors and the state overall with a higher percentage increase from the second quarter to the third quarter of 2011, as well as on a year-over-year basis.

Percent Change in Taxable Sales

Region	Q3-10 to Q3-11	Q2-11 to Q3-11
East Bay	10.7%	2.6%
California	9.8%	0.4%
San Francisco (MD)	9.7%	0.8%
South Bay	7.1%	-4.8%

Source: California Board of Equalization

Looking at taxable receipts by category can give us a good idea of where the increased spending is concentrated. All major categories exhibited growth from the third quarter of 2010 to the third quarter of 2011, indicating that the spending recovery is gradually becoming more broad-based. Fuel and service stations had the largest year-over-year increase, which is not surprising given the surge in oil prices and the consequent increase in gas prices during the summer. However, autos and transportation are also doing well, up 9.2% year-over-year. The pent-up demand for long-term durables is finally being tapped as consumers start to make purchases they postponed during the downturn and the initial stages of the recovery. Basic items like food and drugs (6.5%), general consumer goods (3.3%), and restaurants and hotels (5.4%) are all seeing increased activity. Even the building and construction materials sector (5.6%) has seen modest increases towards the end of 2011. Business-to-business spending was up 5.8% over the same period, a promising signal that local businesses are ready to ramp up spending again as the economy recovers.

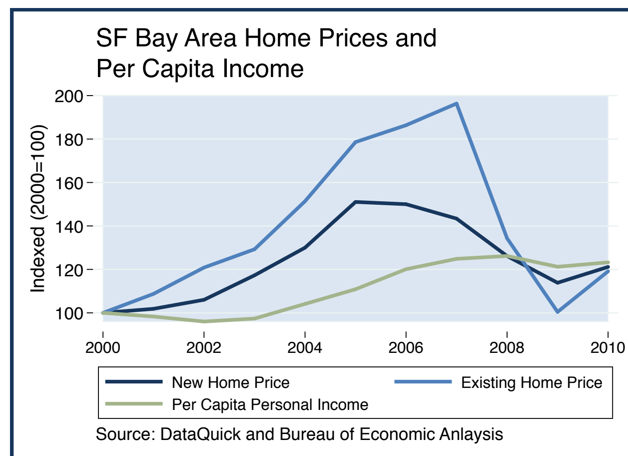
Higher oil and gasoline prices account for some of the increase in transportation expenditures, but an uptick in recreation activity and business travel in the area, a trend we are seeing in other parts of the state, could also be contributing to improvements in revenue. Hotel data from Visit California, the official consumer website for the State of California, shows average daily rates, occupancy rates, and revenue per available room all increasing steadily from the third quarter of 2010 to the third quarter of 2011. Average daily rates increased 5.5% year-over-year, occupancy rates increased 5.3% year-over-year, and revenue per available room increased by 14.3%. Combined with the taxable sales data, these increases in hotel activity signal a healthy recovery that will help spur local employment prospects in the quarters ahead.

Air traffic at Oakland International Airport (OAK) has been stagnant for the last few years and is one of the weak links in the spending category. But in the last few quarters we have seen an uptick in demand. From June 2011 through November 2011 seasonally adjusted traffic increased 8%, with October being the only month registering a decrease. Most of the traffic

from OAK is associated with business travel; as we see job gains increase in 2012, we should see an associated increase here as well.

What is driving the increases in spending? There are several factors at work. In addition to a gradually healing labor market and better overall economic conditions, household balance sheets have improved considerably since the onset of the Great Recession. As painful as the downturn was, it forced a correction of several fundamental imbalances that had built up over the previous three decades, including excessive amounts of personal debt and minimal savings. Since the collapse, national household debt as a percentage of disposable income has fallen from a high of 135% in the third quarter of 2007 to 119% in the third quarter of 2011. And, despite falling slightly in the last three quarters, the national savings rate is currently at almost 4% —this is probably still too low, but it is well above the 1.3% at the peak of the bubble in 2005. While this data is only available at a national level, we are seeing the same consumer behavior in the national arena as we are on a regional level. The region's consumers will continue to feel more comfortable spending as household balance sheets improve and the recovery progresses, which will in turn help fuel further employment gains in the quarters and years ahead as we get back to pre-recession levels.

Real Estate



Source: DataQuick and Bureau of Economic Anlaysis

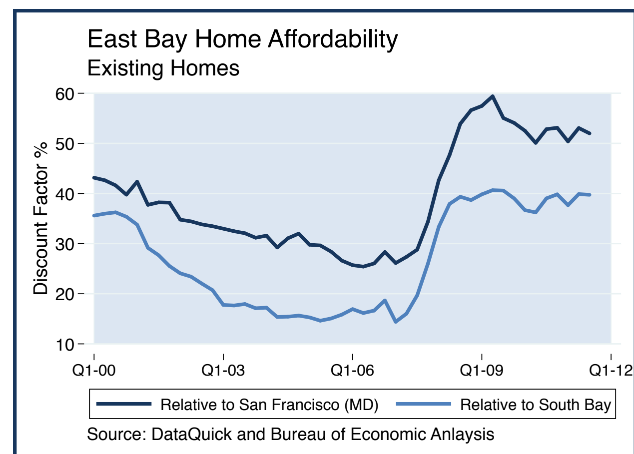
The residential real estate market in the East Bay —and throughout the region and state —continues to pose a challenge; however, there are many signs that the worst is behind us. Prices of existing homes have been stable for the last few quarters, staying within the $318,000 to $323,000 range since the fourth quarter of 2010. This is a good thing. During the peak of the housing bubble, home prices in the region were higher than could be supported by incomes in the area, which ultimately precipitated the housing collapse. According to data from the Bureau of Economic Analysis, even though per capita personal income in the San Francisco (MSA) grew at a relatively steady 1.9% annual rate through 2010, income did not rise sharply when home prices spiked. Median home prices are now in line with regional incomes, and in the years ahead we should see the two move together at a more sustainable rate of growth.

In fact, with interest rates so low, the area is seeing record levels of affordability. Beacon Economics expects that the record levels of affordability in the state will be a major driver of growth in the years to come, given that prices have fallen further in California than in many other states. In addition to improvements in absolute affordability in terms of prices and incomes, relative home affordability in the East Bay has also increased dramatically, given that home prices have fallen faster in the East Bay than in San Francisco (MD) and the South Bay.

One definition of this relative affordability is the ratio of prices between two areas, which represents the percentage savings on housing costs reaped by living in one area over another. Beacon Economics uses this definition in its analysis of home affordability in the Bay Area.

This affordability discount factor in the East Bay relative to the South Bay and San Francisco (MD) is at historically high levels. The time has never been better to buy an existing home in the East Bay and commute to work in the South Bay since the discount factor is near an all-time high of 40%. Compared to existing homes in the San Francisco (MD), the relative percentage savings is even higher than in the South Bay, although it has come down slightly from the peak reached in the second quarter of 2009. Commuting to the San Francisco (MD) also costs more. East Bay home ownership savings are definitely there and should continue to drive net migration and economic growth for the East Bay in the quarters and years ahead.

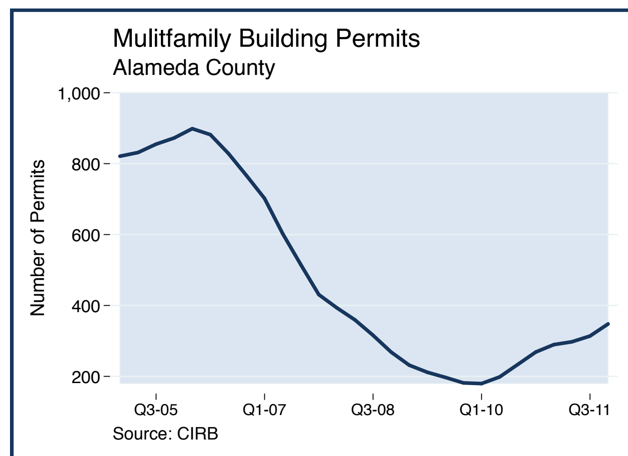
From the second quarter of 2011 to the third quarter of 2011 we did see median prices decline; however, this trend was not limited to the East Bay. The quarter-over-quarter declines for existing homes were the smallest in the East Bay (1.3%), slightly larger in San Francisco (MD) (3.5%) and the South Bay (1.5%), and also larger in the state overall (1.9%). Sales for existing homes in the East Bay also declined in the third quarter of 2011, down 2.9% from the second quarter. However, on a year-over-year basis, sales are still up 5.9%.



Prices and sales for new homes have been following a different trend in the last year, reaching new post-recession lows in the second and third quarters of 2011. However, this comes as no surprise during a recovery period, given the price differential between new and existing homes. In the third quarter of 2011, the seasonally adjusted median price for new homes was $370,634 compared to $318,908 for existing homes. At these prices, people moving to and

within the East Bay are more likely to opt for an existing home, which puts downward pressure on new home prices and sales due to the decreased demand for that segment of the market. In addition, new homes are also competing with the distressed sales that are lingering in the inventory across the state. Once the majority of homes in the current inventories clear, we should see the new home market pick up speed again.

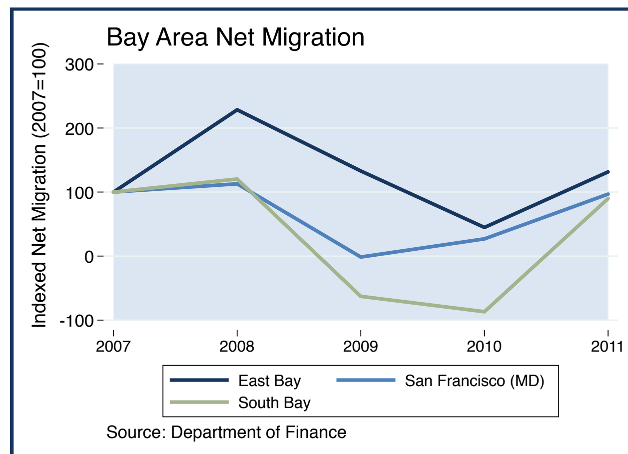
The good news is that the number of distressed properties in the East Bay has clearly peaked, with the number of defaults and foreclosures following a steady downward trend the last few years, albeit with some volatility along the way. Although defaults and foreclosures remain elevated relative to historical norms, they are substantially lower than their peak levels and are trending in the right direction. The third quarter of 2011 saw an uptick in defaults for the East Bay, as well as in virtually every county in the state; however, this is partially attributed to the end of the "robo-signing" scandal, which allowed banks to start sending out default notices again. This slight increase in recent default notices indicates that foreclosures will see a similar bump in the coming quarters, but we expect both to resume their downward trend in the first half of 2012.



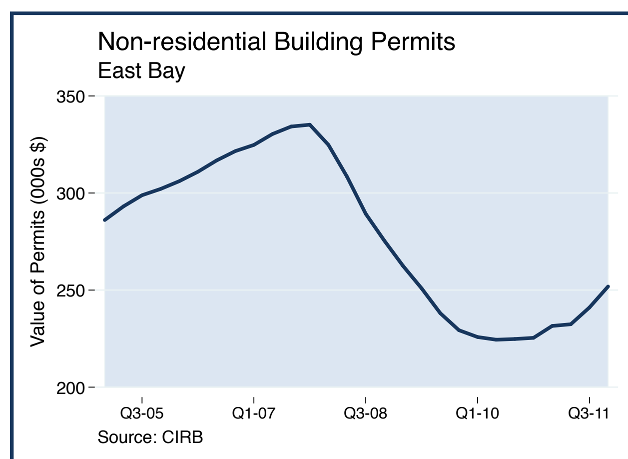
Looking ahead to new home construction in the East Bay, Beacon Economics sees subdued activity in the short term but brighter prospects next year and beyond. The total number of residential building permits has been flat since the recession and has yet to establish a solid upward trend. This comes as no surprise, given the current weak market for new homes and the stock of distressed homes that still need to be worked through the system before new construction can begin in earnest. The number of single family home permits is down on an annual basis as well as on a quarterly basis. Permits for multifamily homes have been showing more signs of life in Alameda County —up 10.8% from the third quarter to the fourth quarter of 2011, and up 29.5% from the fourth quarter of 2010 to the fourth quarter of 2011. Contra Costa County, on the other hand, is testing new lows, with the number of multifamily permits down 26.3% quarter-over-quarter and down 48.5% year-over-year. The county's low permitting levels has continued to drag down the overall permit statistics for the East Bay.

The increase in multifamily home-building permits in Alameda County is most likely due to its close proximity to the faster-growing South Bay and the employment prospects there. This bodes well for construction employment in the East Bay, which was decimated after the recession. We may already be seeing signs of this in the December employment data: the construction sector posted the most new jobs and the highest percentage gain for the November to December period, up 1.2% month-over-month and posted 600 new jobs. Construction employment has increased 2.5% since bottoming out in March 2011.

The increase in multifamily permitting is likely indicative of a broader trend in the area toward a larger mix of multifamily housing. The younger generation has shown a particular preference for this type of accommodation and we expect this segment to represent a larger share of residential construction going forward. The supply of distressed properties on the market could limit the speed in which the real estate market clears inventories and lowers housing vacancies. But, even though housing vacancies are elevated by historical standards, California still has one of the lowest housing vacancy rates in the nation. So, while total residential permits are still hanging around the bottom, Beacon Economics expects that they will pick up steam in 2013 and beyond as net migration increases.



The East Bay, San Francisco (MD), and South Bay have all generally followed the same population trends in terms of new migration. But since the housing bubble peaked in 2007, the East Bay has maintained a higher relative rate of net migration, evidence of people moving to the East Bay to take advantage of the more affordable homes. Beacon Economics forecasts that this net migration to the East Bay will continue to increase in the years to come. It may slow in terms of percentage growth over time, but it will remain positive and higher than it has been for many

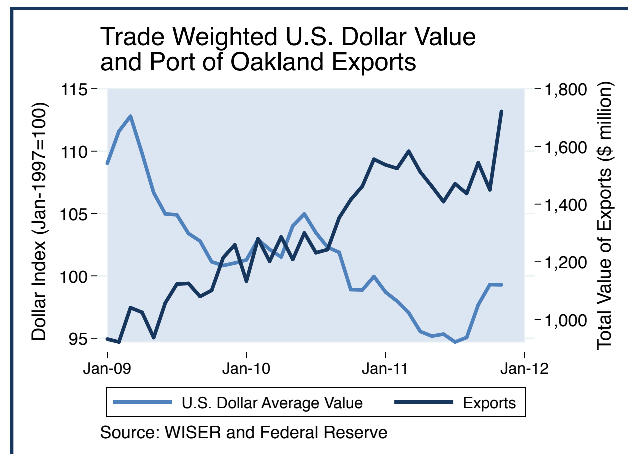


years. This should help strengthen the housing market and government revenues will also benefit from an increased local spending base.

On the commercial side of the real estate market, the trends have been more promising in the last few quarters. The total value of non-residential permits has been steadily increasing since bottoming out in the second quarter of 2010, with permit values up 4.5% from the third quarter to the fourth quarter of 2011, and up 11.7% year-over-year. The largest gains are in the hotel and amusement sectors, which makes sense given the gains we are seeing in taxable sales and hotel data. Commercial vacancy rates have been in decline for retail, office, and industrial properties for the last several quarters and are all below their post-recession highs. As the recovery continues, we should see even more improvement from the commercial side of the real estate market.

Ports and Trade

The Port of Oakland is a major asset to the East Bay, and with a weaker U.S. dollar in today's trade environment, it is poised to take advantage of the higher trade activity that occurs when our goods become less expensive to other countries. For the last several years, the total value of exports going out of the Port of Oakland has been in a steady upward trend, increasing nearly 18% from November 2010 to November 2011. Over the same period, the value of the dollar decreased by a small amount but only because there was a spike in value in the last few months of 2011 due to the European debt worries and the subsequent decline in the Euro.



Port statistics on container movements confirm the increased activity we see in the trade data. The number of loaded export containers has increased steadily since July of 2011 with only one month of declines through November 2011. Additionally, the Port of Oakland is a major gateway to overseas markets for many of California's farmers. In general, agricultural exports from the state have done very well in 2011, increasing 12.4% from January 2011 to November 2011 on a seasonally adjusted basis over the same period in 2010. At the Port of Oakland there was an even greater increase in the value of agricultural exports, up 21.3% for the same year-to-date period. Agriculture products are not the only commodities leaving the port. Of the top ten commod-

ity exports in 2011, a little more than half are from the high tech and manufacturing sectors, highlighting the diversity of the region's economy.

Some of the percentage gains, however, may not be as great in real terms due to volatile food prices, but all of these port and trade statistics, taken together with our other data points, show solid evidence of a region in a positive recovery. This increased trade activity has helped to add over 3,500 jobs in the wholesale trade and transportation and warehouse sectors from November 2010 to November 2011. The December employment numbers show a drop in both of these industries, accompanied by a drop off in container activity at the port and the strengthening of the U.S. dollar. Nevertheless, we have seen increased activity at the port for several months prior to this dip and we expect these overall upward trends to continue. The Port has been a boon to the region's economic recovery and remains one of the brightest spots in the East Bay. Strong exports are expected to continue to bolster the upswing.

Exports by Commodity Type
Port of Oakland, Through November 2011

Commodity	Port Exports ($000s)		Growth Rate (%)	
	2010 YTD	2011 YTD	2009-10	2010-11
Edible Fruit/Nuts/Citrus Fruit/Melon Peel	2,795,713	3,493,272	28.7	25.0
Meat/Edible Meat Offal	1,706,210	2,177,344	21.1	27.6
Industrial Machinery/Computers	843,016	1,021,884	14.6	21.2
Beverages/Spirits/Vinegar	628,684	735,095	11.8	16.9
Iron/Steel	536,115	705,823	54.5	31.7
Vehicles/Parts	505,675	651,011	12.5	28.7
Electric Machinery/Sound Equip/Tv Equip	632,007	598,048	25.7	−5.4
Inorg Chem/Prec Rare-Earth Met/Radioact Compd	541,022	550,007	13.1	1.7
Optic/Photo/Medic Or Surgical Instrments	377,334	435,567	1.5	15.4
Dairy Prods/Birds Eggs/Honey/Animal Products	296,742	400,375	135.6	34.9

Source: WISER

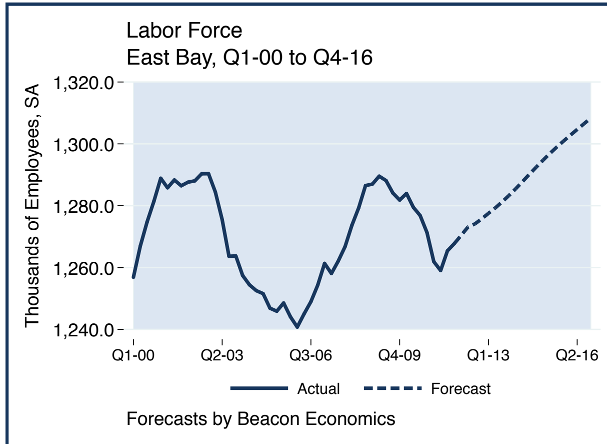
Conclusion

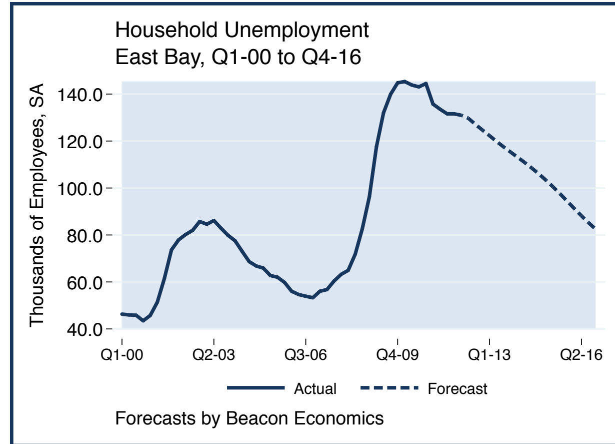
While the industry employment recovery in the East Bay may be lagging San Francisco (MD), the South Bay, and the state overall, household employment has greatly improved in the last half of 2011. The unemployment rate dropped faster in the East Bay than in the state overall from December 2010 to December 2011, and the expanding labor force indicates the drop in unemployment is a genuine decline as opposed to people becoming discouraged and stopping their job searches.

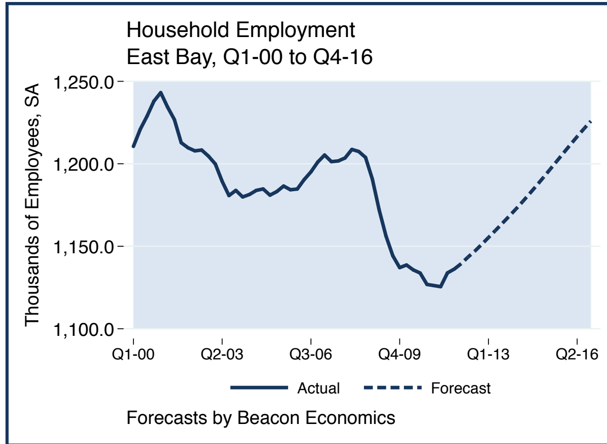
Consumer and business spending remains strong throughout the state. The East Bay in particular has seen larger increases on a percentage basis than San Francisco (MD), the South Bay, and the state overall from the third quarter of 2010 to the third quarter of 2011. The year-over-year spending increases were up for all categories, and in conjunction with increased port activity in the second half of 2011 should provide a boost to the East Bay's economic recovery.

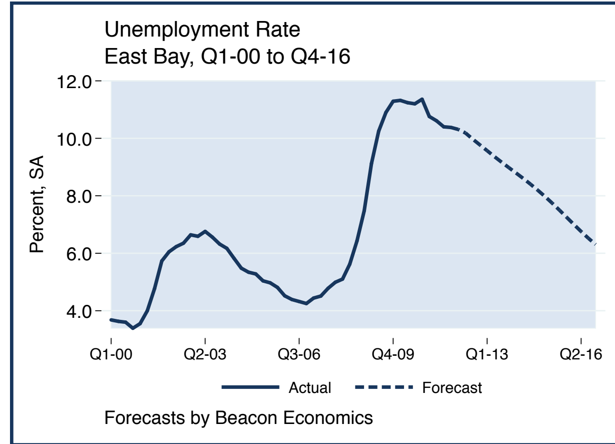
The local real estate market continues to struggle, particularly for the new home segment of the market, but the worst is behind us. Home prices are now more in line with regional incomes and the area is poised for growth in the years ahead. When the housing bubble burst the East Bay felt the effects more than the neighboring regions, which in turn put housing affordability relative to San Francisco (MD) and the South Bay at record high levels. Beacon Economics expects this home affordability to drive increases increases in net migration, which in turn will give the local real estate market a boost as well as further increase consumer spending levels in the East Bay as we move forward.

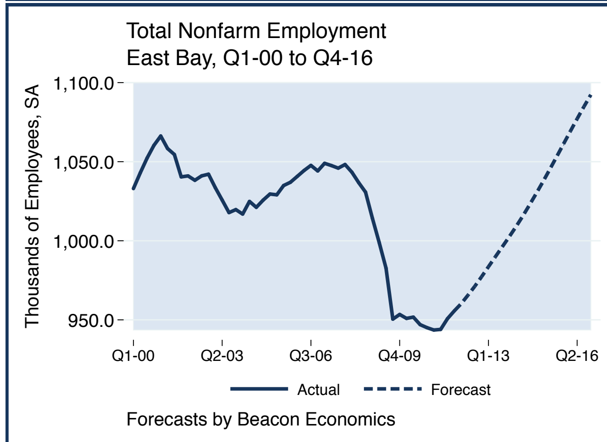
Detailed Employment Forecast

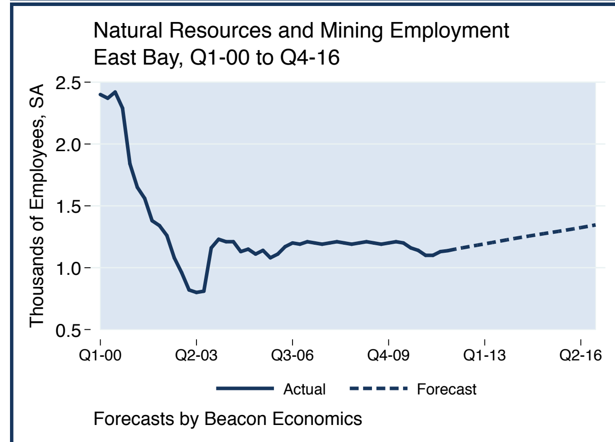


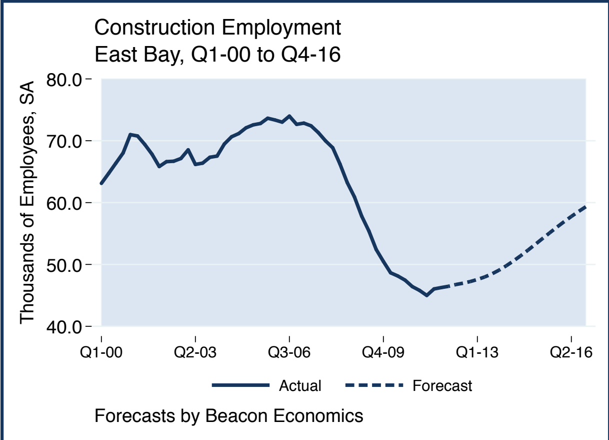


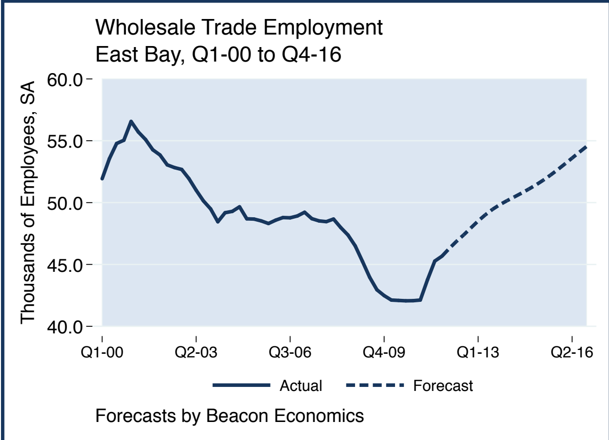


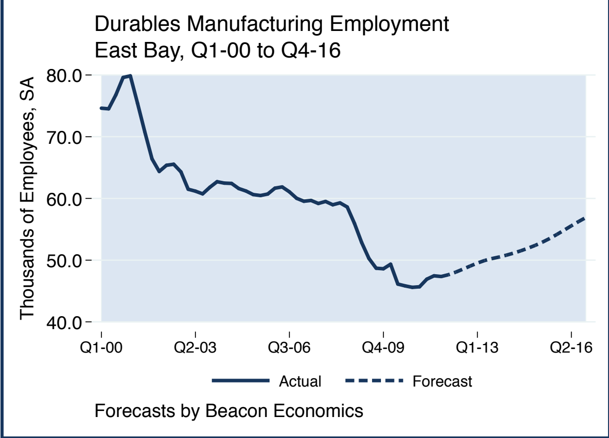


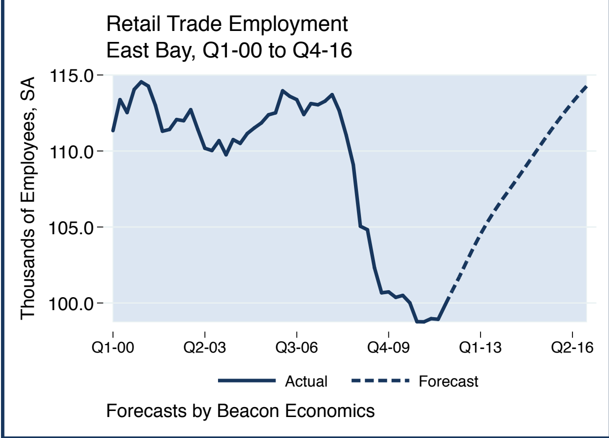


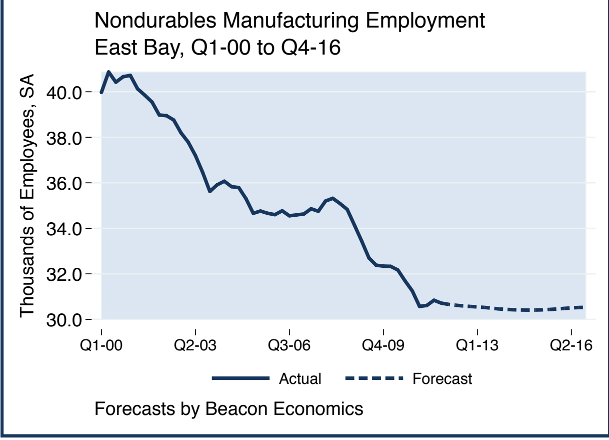


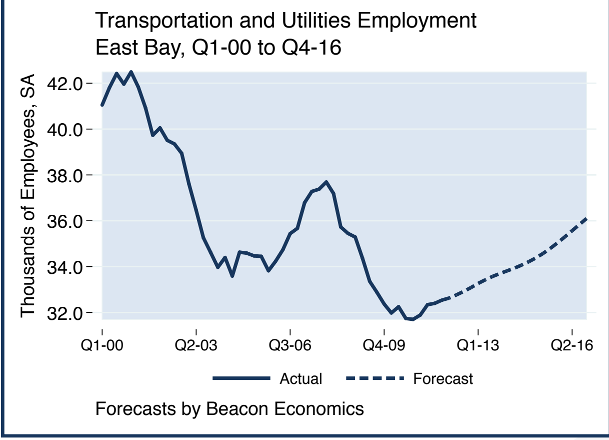

Construction Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
80.0
70.0
60.0
50.0
40.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics

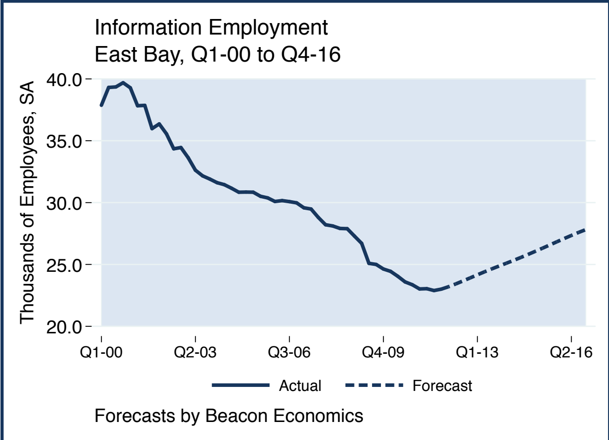

Wholesale Trade Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
60.0
55.0
50.0
45.0
40.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics

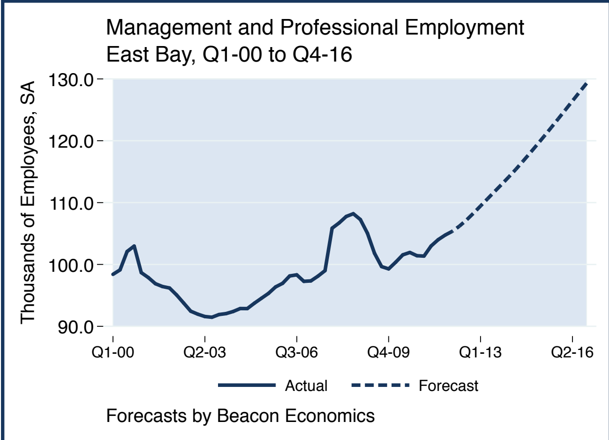

Durables Manufacturing Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
80.0
70.0
60.0
50.0
40.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics

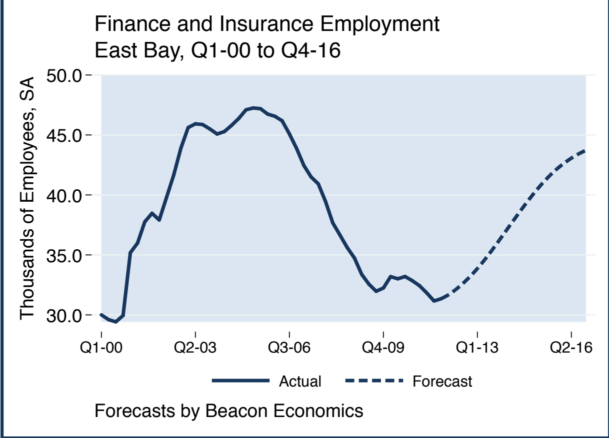

Retail Trade Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
115.0
110.0
105.0
100.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics

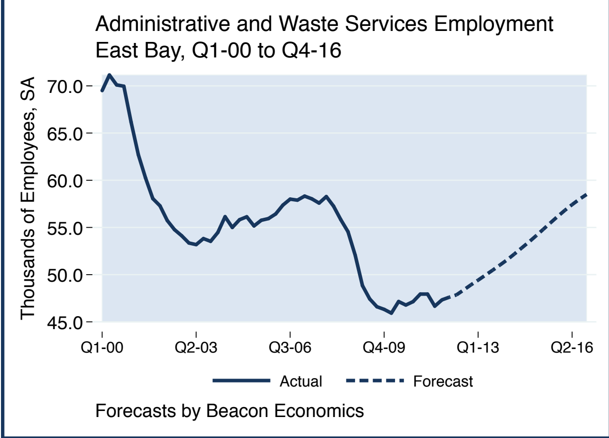

Nondurables Manufacturing Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
40.0
38.0
36.0
34.0
32.0
30.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics

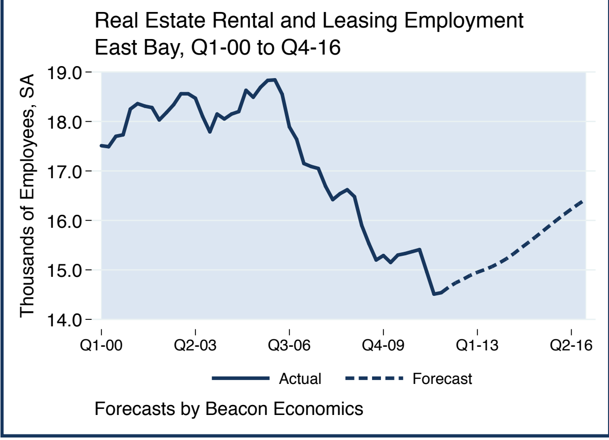

Transportation and Utilities Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
42.0
40.0
38.0
36.0
34.0
32.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics

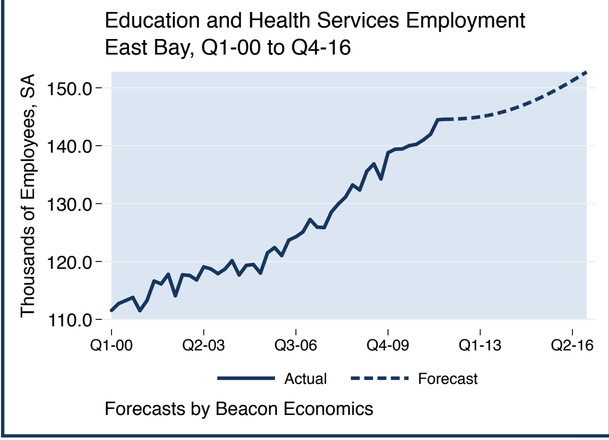

Information Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
40.0
35.0
30.0
25.0
20.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics

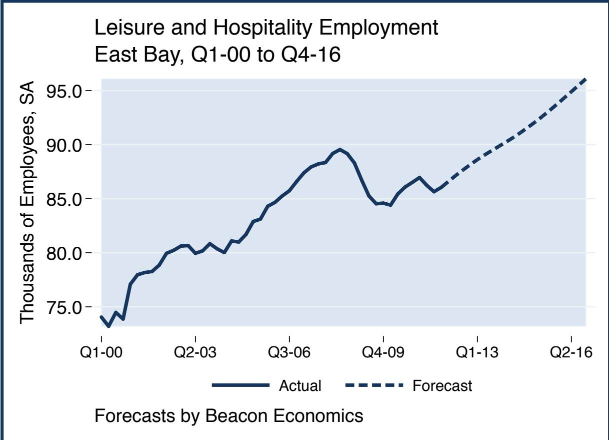

Management and Professional Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
130.0
120.0
110.0
100.0
90.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics

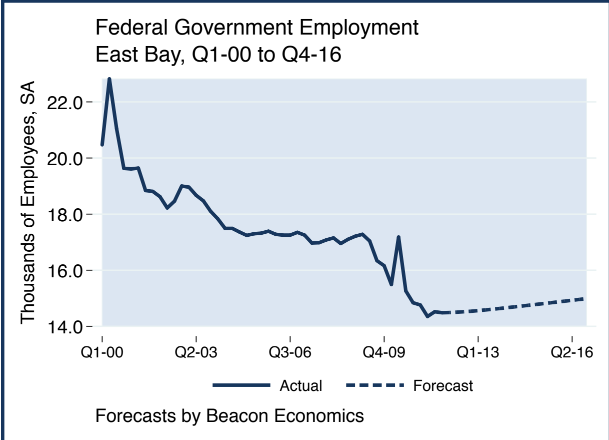

Finance and Insurance Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
50.0
45.0
40.0
35.0
30.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics

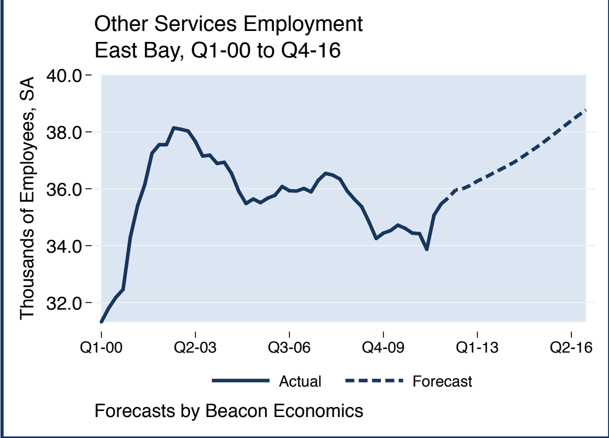

Administrative and Waste Services Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
70.0
65.0
60.0
55.0
50.0
45.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics

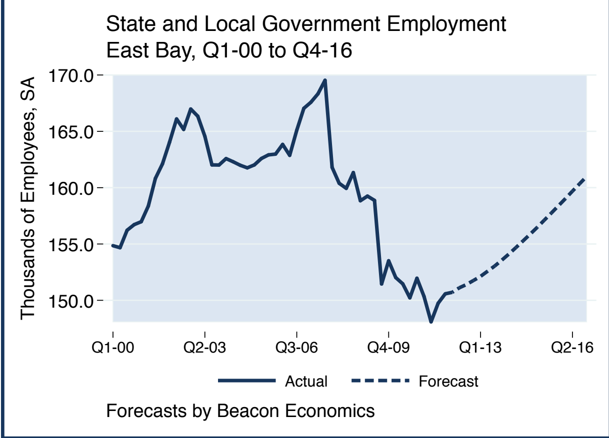

Real Estate Rental and Leasing Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
19.0
18.0
17.0
16.0
15.0
14.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics


Education and Health Services Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
150.0
140.0
130.0
120.0
110.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics


Leisure and Hospitality Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
95.0
90.0
85.0
80.0
75.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics


Federal Government Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
22.0
20.0
18.0
16.0
14.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics


Other Services Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
40.0
38.0
36.0
34.0
32.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics

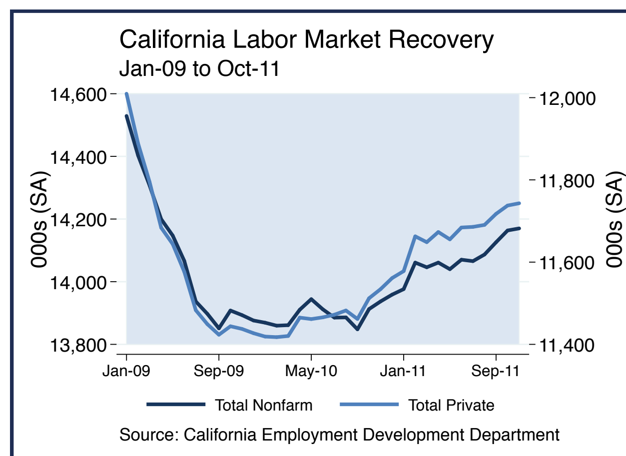

State and Local Government Employment
East Bay, Q1-00 to Q4-16
Thousands of Employees, SA
170.0
165.0
160.0
155.0
150.0
Q1-00
Q2-03
Q3-06
Q4-09
Q1-13
Q2-16
Actual
Forecast
Forecasts by Beacon Economics

California Economy

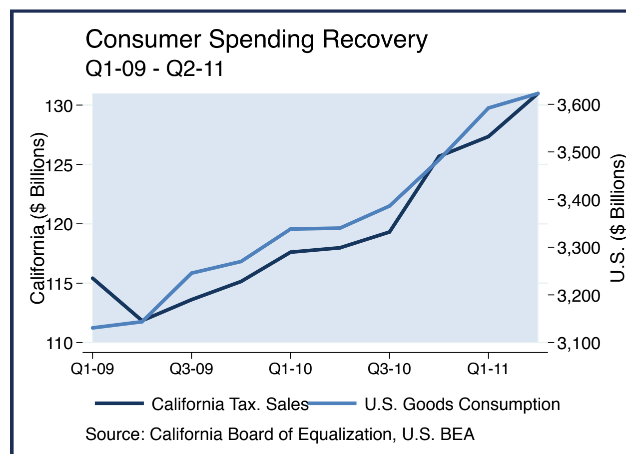
California Pulls Ahead

Although California's economic recovery got off to a lackluster start, the Golden State has recently started to outpace the United States. Current statistics clearly indicate that California *is* on the road to recovery, and despite reports in the popular press, the state is not headed for a second recession over the short run. In fact, the labor markets have made a manifest turn for the better–adding more than 2.2% to its nonfarm payrolls since hitting bottom in September 2010. In addition, this growth is occurring despite continued job losses in the government sector.

Separate out private sector employment, and the state has done even better, posting 2.5% growth over the same period. This equates to roughly 250,000 jobs–clearly not enough to correct the 1.3 million jobs lost during the Great Recession, but a steady move in the right direction and a far cry from another recession. It is also important to keep in mind that job growth is typically the last thing to turn around in a recovery, which suggests that the underlying fundamentals of the California economy are growing even faster.



Indeed, when examining the underlying drivers of economic and job growth in California, the statistics point to an economy that is beginning to outshine the rest of the United States. Consumer spending is a prime example. There is no doubt that consumers have shown steady increases in spending over the past two years almost consecutively. And while this is true both in California and in the U.S., California has actually outperformed the nation. Specifically, taxable sales in the Golden State have risen by more than 17% since their trough in the second quarter of



2009. That compares with 15.7% in the U.S. overall in terms of goods purchases on a nominal basis. This extra growth in California has developed despite the fact that the state fell nearly twice as much as the U.S. overall (-19% vs. -9.7%) and that California hit bottom one quarter later.

Not only have taxable sales bounced back strongly since reaching bottom, but current data shows that the recovery is fairly broad-based in terms of which sectors are benefitting. Every major business sector has posted year-over-year gains in sales tax receipts. Fuel/Service Stations have led the way, which is hardly surprising given the increase in gas prices during the first half of the year. However, all of the other spending categories have posted solid increases as well. California's consumers are clearly spending more on eating out and on staying in hotels. Californians are also buying more cars than they were a year ago. Even the Building Materials/Construction sector is experiencing increases in expenditures.

California Statewide Sales Tax Distributions

Business Category	Q2-10	Q2-11	Change
Autos And Transportation	151,180,176	163,595,137	8.2%
Building And Construction	87,210,817	91,160,650	4.5%
Business And Industry	179,366,137	189,813,474	5.8%
Food And Drugs	73,435,542	75,794,524	3.2%
Fuel And Service Stations	134,005,194	176,578,453	31.8%
General Consumer Goods	281,531,257	298,247,545	5.9%
Restaurants And Hotels	142,293,626	152,151,381	6.9%
Other	125,467,648	141,789,214	13.0%
Total	1,174,490,397	1,289,130,379	9.8%

Source: HdL Companies

All this points to an economy that is in recovery mode, but it also speaks to a wider sentiment among Californians that things *are* getting better. Many of these categories like autos and building materials are expenditures made for medium-term durables, which are highly sensitive to economic fluctuations. Such purchases were postponed during the downturn as consumers fell into a "wait-and-see" mode, creating a certain amount of pent-up demand that is now expressing itself across the state. In addition, the fact that these expenditures are increasing means that Californians are feeling bullish enough about the future to make longer-term purchases.

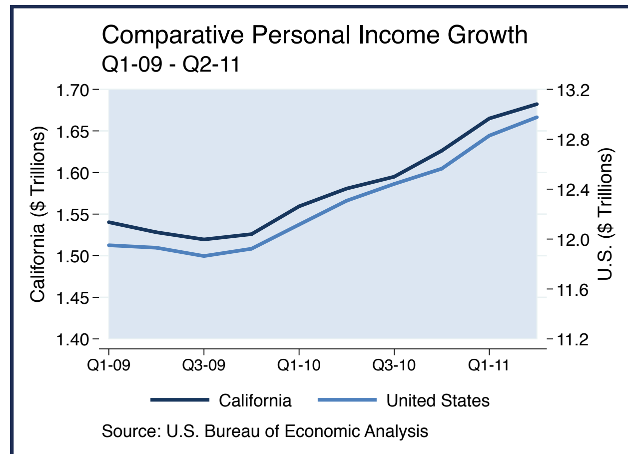
Income has also posted a healthy recovery in the state, which is undoubtedly playing a role in consumers' increased willingness to spend at the state and national levels. Importantly, personal income in California, which stood at $1.68 trillion in the second quarter of 2011, has already surpassed its pre-recession peak after almost two years of consecutive growth on a quarterly basis. Here too, California is starting to lead the nation with almost 11% growth in

Comparative Labor Market Statistics

Industry	California Oct-11 Employment (000s, SA)	California Y-o-Y Change (000s)	California Y-o-Y Change (%)	California Annual Average Wage	United States Y-o-Y Change (%)	United States Annual Average Wage
Admin Support	919.9	47.00	5.38	36,868	3.68	33,347
Leisure and Hospitality	1,533.9	37.80	2.53	22,857	1.65	18,885
Prof Sci and Tech	1,066.3	36.70	3.56	93,020	3.67	76,851
Health Care	1,522.6	34.10	2.29	50,070	2.17	41,242
Information	456.7	25.40	5.89	114,956	−1.78	83,656
Construction	567.8	17.10	3.11	53,261	0.40	47,696
Wholesale Trade	662.6	14.90	2.30	66,441	1.55	66,101
Educational Services	325.3	12.20	3.90	43,021	2.28	41,184
Local Government	1,665.0	9.30	0.56	54,824	−1.39	42,086
Manufacturing	1,250.3	8.30	0.67	76,770	1.93	60,542
Retail Trade	1,517.4	5.90	0.39	30,668	1.11	26,256
Finance and Insurance	513.6	2.70	0.53	113,499	−0.28	115,655
Utilities	58.5	0.69	1.20	120,938	0.76	102,080
NR/Mining	27.5	0.40	1.48	32,088	10.49	58,030
Management	188.4	−0.33	−0.17	114,768	1.38	122,265
Transport/Warehouse	409.7	−0.53	−0.13	45,660	2.09	44,211
State Government	486.6	−1.20	−0.25	62,867	−1.32	48,807
Other Services	484.3	−2.40	−0.49	25,597	0.65	29,047
Federal Government	253.0	−4.00	−1.56	67,103	−0.91	67,593
Real Estate	243.2	−5.00	−2.01	53,005	0.86	46,311
Total Nonfarm	14,151.6	239.00	1.72	55,445	1.21	48,596

Source: U.S. Bureau of Labor Statistics

personal incomes from trough compared with just 9.7% growth in incomes nationwide over the same period. Not only does this illustrate how the recovery is beginning to accelerate vis-a-vis the nation, but is also indicative of the quality and wages of the jobs that are being produced here.



Overall, California's recovery has been led by strong business investment nationally and across the globe. With much uncertainty in the market regarding the strength and sustainability of the recovery, many firms have opted to maximize efficiency and productivity through capital investments on equipment and software rather than making long-term labor investments. This has been a boon to California—especially in technology-heavy regions like San Jose and San Diego, which have thus far led the state's employment recovery.

Most of California's newly added jobs have been in the high-skilled, high-productivity sectors that the state does best. For example, the majority of the job growth thus far has been in

Administrative Support, Professional/Scientific/Technical Services, Health Care, and Information. With the exception of Administrative Support, these sectors offer relatively high wages. In fact, the quality of the jobs being created is an area where California clearly outshines the rest of the nation.

Of the nearly 240,000 jobs that California has added over the past year (from October 2010 to October 2011), almost 60% of those jobs have been created in sectors that pay at least $50,000 per year on average. This is a far greater share of the $50K + jobs created in the U.S. overall, where the high-wage group represents less than 40% of jobs created over the same period. California is not only outpacing the nation in terms of growing *faster*, but it is also creating a better *quality* job for its workers. A detailed discussion of the state's recovering job market by industry is included later in this chapter.

Job Growth by Wage Group

Annual Annual	Calfiornia Job Growth Oct-11 (000s, YoY)	Percent of Job Growth	
		California	United States
Over 50	138.7	58.0	38.0
Under 50	100.4	42.0	62.0
Total	239.0	100.0	100.0

Source: U.S. Bureau of Labor Statistics

California's Export Growth

Commodity	2010 TYD ($ Millions)	2011 YTD ($ Millions)	% Change	
			2009-10	2010-11
Electric Machinery/Sound Equip/TV Equip	20,276.92	21,207.92	19.74	4.59
Industrial Machinery, Including Computers	17,958.29	20,072.18	32.26	11.77
Optic, Photo, Medic, Or Surgical Instrments	11,675.20	12,446.35	18.78	6.61
Nat Pearls, Prec Stones, Pr Met, Coin	4,332.40	5,397.72	63.29	24.59
Vehicles And Parts	4,455.11	5,256.67	13.24	17.99
Edible Fruit & Nuts; Citrus Fruit Or Melon Peel	4,508.60	5,250.13	21.05	16.45
Aircraft, Spacecraft, And Parts Thereof	4,435.47	4,987.41	−10.49	12.44
Mineral Fuel, Oil Etc.; Bitumin Subst; Mineral Wax	3,073.19	4,634.69	23.03	50.81
Plastics And Articles Thereof	2,999.87	3,338.18	16.98	11.28
Pharmaceutical Products	2,823.41	3,057.98	13.59	8.31
Total	104,483.17	117,923.91	19.25	12.86

Source: Wiser Trade

In addition to growing consumer demand from domestic sources, international trade has also been playing a large role in speeding up California's recovery. This is particularly true on the

export side. With the dollar falling to some of the lowest levels in recent memory, U.S. goods and services have become increasingly affordable abroad. And, given this state's proximity and infrastructure to access the East Asian markets, which have been expanding at above average rates recently, California has benefitted disproportionately from the increase in seaport and airport activity.

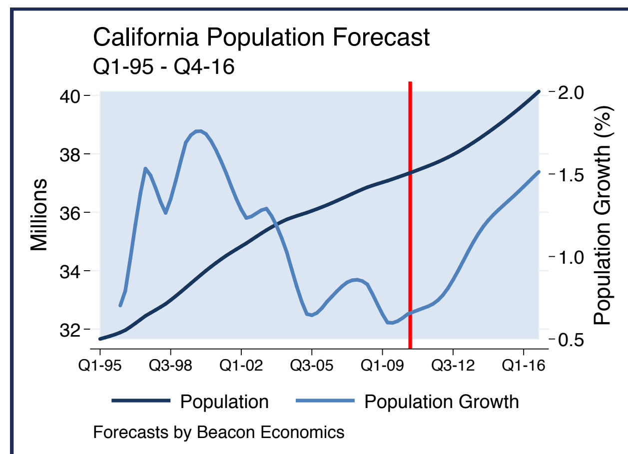
The state's foreign trading partners have increased capital expenditures on equipment and software, which are some of California's largest exports. Both electrical and industrial machinery (includes computers) have posted solid gains over the last two years. Additionally, other high-technology exports have continued to do well including medical devices, and in 2011, aircrafts. Commodity exports have also done well in recent years. California, known as the "world's salad bowl" because so much of the state's agricultural produce supplies grocery stores across the globe, has seen natural resources, fruits/nuts, and fuels/oils all post double-digit growth on a percentage basis over the past two years.

In sum, despite a bombardment of negative economic news suggesting that a double-dip recession is impending, all of the data points to a continued recovery in the Golden State. This is further supported by the fact that California's economy has recently begun to pick up steam and outpace the nation. To-date, California has added back a larger proportion of its job base relative to the United States overall—particularly with respect to private-sector jobs. Income and consumer spending have also begun to grow at an accelerated rate. In addition, strong demand from abroad has continued to bolster the local economy and help California climb out of the Great Recession. Things got off to a slow and bumpy start here in California, but all indications are that the recovery *has* taken hold and the state is beginning to lead the nation into a new phase of economic growth.

Forecast Highlights

Based on an analysis of the underlying data, Beacon Economics is forecasting that California's economic recovery will continue, and even gain steam, as we enter 2012 and beyond. Given that home prices have fallen so far in the state, housing is at one of the most affordable levels seen in years. Part of this is due to the historically low interest rates Americans continue to enjoy thanks to the Federal Reserve, but also to the fact that home prices are back in line with incomes. This should stimulate some in-migration into California, both by foreigners attracted by the weak dollar and low property prices, and by U.S. residents who want to enjoy the quality of life California offers.

In addition, California's population has been trending toward a more diverse demography over the last few decades. Specifically, minorities (especially Hispanics) make up an increasing share of the population. Many of these ethnic groups have historically higher fertility rates relative to the non-Hispanic population, something that should further stimulate new population. As a result, Beacon Economics is forecasting that population growth will pick up in coming years. California is expected to exceed 1% growth in 2012 and accelerate to the 1.5% range by 2016. By 2015, California's population is forecast to breach the 40 million threshold for the first time.



Fortunately, unlike states like Florida, Nevada, and Arizona, which have an excess supply of housing due to massive overbuilding during the bubble, California still does not have enough housing to meet its needs. According to the 2010 Census, California's housing vacancy rate was just 8.1%—one of the lowest vacancy rates in the nation despite vigorous building during the bubble years. And, given that the state's population is expected to grow, there will almost certainly be new residential construction activities kicking off over the next 2 to 3 years.

While there are significant differences in various regions across the state, historically California has not built enough. In the years before the bubble, the state was seeing roughly one new residential unit permitted for every three new residents in the state. At the peak of the housing bubble, the latter number dropped to around one. In other words, at the height of the bubble, California was building one new home for every new person added to the population base. In some areas, like Ventura, Sonoma, Santa Clara, Los Angeles, and others, there was more than one new unit for each new person.

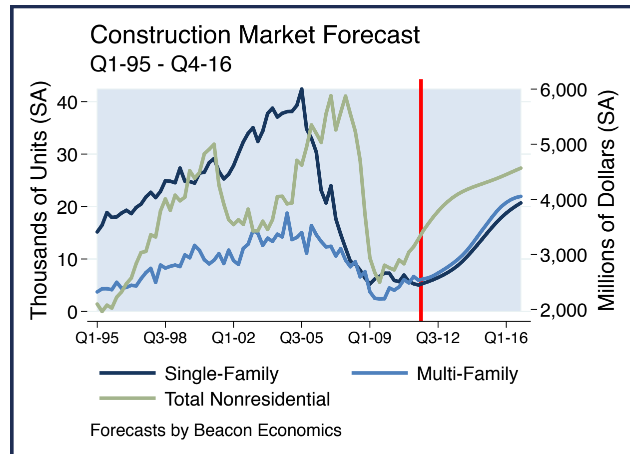
Despite a temporary increase in activity during the boom, the severe under-building that has taken place over the past 24-30 months, contributes to California's need for more housing. In 2009 and 2010, the level of permitting relative to population growth has been weak. Even with the slow population growth of the last few years, places like Napa, Ventura, Merced, and Imperial Counties are permitting one new residential unit for every 10 new residents on the low end. These are the extreme cases, but even in more moderate markets, the ratio is around six. This means that one of two things will happen in California going forward:

Housing Demand Fundamentals

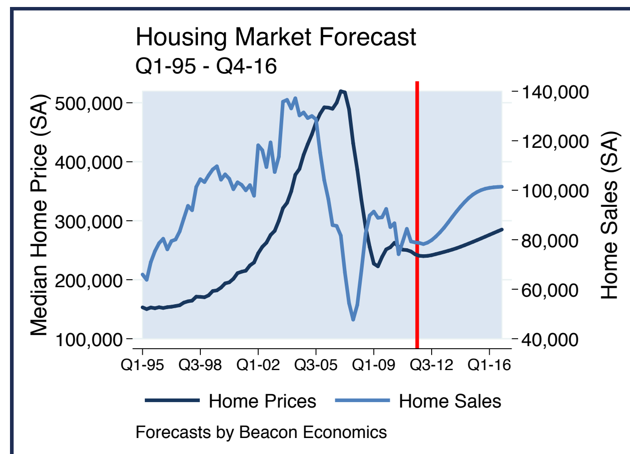
County	Average New Residents Per New Home (1995 - 2003)	2005 New Residents Per New Home	2009 New Residents Per New Home	2010 New Residents Per New Home
Imperial	3.3	1.1	16.3	25.2
Merced	2.4	1.5	26.3	14.1
El Dorado	1.8	1.6	7.7	13.3
Ventura	3.3	0.8	15.6	11.6
Stanislaus	3.3	1.6	5.5	11.4
Napa	2.8	1.0	9.5	10.3
Sutter	3.8	1.5	19.1	9.8
Sacramento	3.0	1.9	12.0	9.4
Sonoma	2.7	0.2	8.8	9.2
Riverside	2.9	2.4	9.0	8.6
San Diego	2.8	0.9	10.6	8.1
Tehama	2.2	1.6	7.1	7.9
Colusa	5.2	3.0	5.1	7.6
San Bernardino	4.2	2.8	3.9	7.4
Yolo	3.0	1.5	7.5	7.3
San Joaquin	2.8	2.4	6.9	6.5
Kern	3.0	2.3	6.8	6.0
Orange	4.0	1.2	7.5	5.8
Madera	4.1	1.5	13.9	5.8
Contra Costa	3.3	1.1	9.3	5.6
Santa Barbara	3.2	1.1	13.6	5.5
Placer	1.8	2.1	5.5	5.3
Tulare	2.7	2.7	6.7	5.0
Humboldt	1.0	1.5	3.0	4.6
Fresno	3.1	1.7	5.0	4.6
Lake	3.7	1.1	3.6	4.3
San Luis Obispo	2.1	1.1	5.4	4.2
Kings	4.6	2.5	3.8	3.7
Santa Clara	2.5	0.4	17.3	3.2
Los Angeles	5.4	0.4	2.8	2.8
Butte	1.7	0.9	3.0	2.1
Shasta	1.3	0.7	2.1	2.0
Glenn	1.1	0.9	0.2	0.7
California	3.3	1.4	7.2	5.7

Source: U.S. Bureau of Labor Statistics

1. The average household size in California will have to increase, which means more over-crowding; or
2. California will need to start building new residential units to accommodate future population.



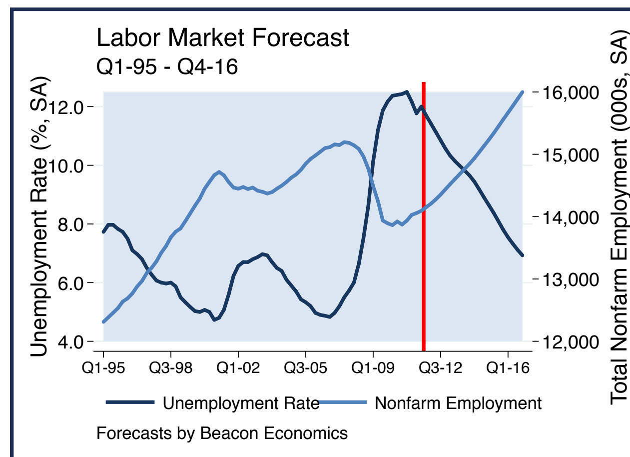
Our view at Beacon Economics is that the latter is the only reasonable answer to the housing question. Home prices in the state, although affordable relative to historical norms, remain well above the national average. For example, the highest-priced area in Texas has roughly the same median home price as some of California's most affordable markets such as the Inland Empire. Allowing household size to increase by not increasing the housing stock will only put more upward pressure on prices, which could make it even harder for California businesses to pay their workers a decent wage or recruit the best and brightest to the state.



The process will not happen overnight. There is a significant stock of distressed inventory that needs to be re-absorbed before new construction can begin in earnest. However all indications are that that re-absorption is well underway. Defaults and foreclosures have been trending down consistently over the past year, and the Mortgage Banker's Association reports that only 3% of all mortgages in the state remain in the foreclosure process. Indeed, we've already begun to see some new multi-family construction along the coast.

Beacon Economics forecasts that single-family permits are expected to remain tepid in 2011 and the 2012 before starting to pick up in 2013. Multi-family will see stronger growth over the short-run and should begin to play a larger role in the residential mix as geographic limitations of available land in coastal areas and the preference among the younger generation for multi-family housing skews the mix in that direction.

Home prices, which have stabilized, are not expected to post any significant growth over the next 12 months. However, prices are not expected to decline much more either. Affordability conditions will prevent prices from falling much lower because lower prices stimulate added demand and "bargain hunters" which put upward pressure back on prices. Sales, which have tapered off slightly as the Federal government has pulled back from the housing market, are expected to remain relatively flat in 2012 as the economy gradually heals and the recovery accelerates. However, by 2013, sales should begin to pick up as new households form and the labor markets get back to "normal."



The state's labor markets, which have already turned the corner solidly, will continue to improve. Tech-oriented sectors will keep leading the recovery and coastal employment centers like San Diego, San Jose, Orange County, Los Angeles, and San Francisco will continue to do well. And as the recovery takes hold, inland areas that were slow out of the gate (*e.g.* Inland Empire, East Bay, Stockton) will start to see growth pick up and will eventually grow at a faster rate than the more built-out coastal areas. By 2015, Beacon Economics forecasts that California will reach its pre-recession peak of more than 15 million jobs and the unemployment rate will dip into the 8% range.

California Labor Market Review

According to the popular press, the economy is headed for a dark, dark place. The sky is falling, we are on the verge of another recession, and, if we believe some prominent commentators, there's absolutely nothing that can be done to prevent it. But if you actually look at the data, a different picture emerges.

Although California's labor market is still recovering from the massive turmoil of the past few years, the outlook is finally beginning to get better. And more importantly, the industries that are growing will pave the way for further improvement. An economic expansion is clearly under way.

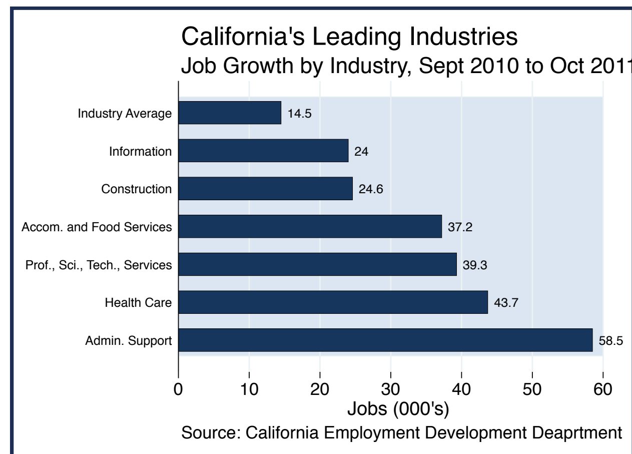
It has been about a year since the California labor market hit bottom. Since that time, the state has added 303,700 jobs, for an annual average growth rate of 2%, and the unemployment rate has dipped from 12.5% to 11.7%. Although this pace of job growth is relatively slow for this point in a recovery, and although the unemployment rate is still unacceptably high, there are nonetheless encouraging points to consider.

To be sure, some industries continue to shed jobs, while others have been relatively flat. But there are a few that have broken out to lead the way, and these leading industries can be put into three groups: those that took a big hit during the recession and have begun to snap back, those that did not experience a downturn, and those that are tied to one of California's core strengths.

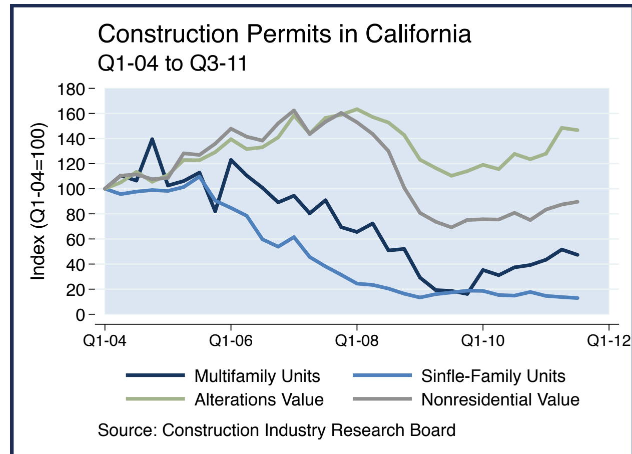
Hard-Pressed Industries Begin to Rebound

First, the snap backs. When a hard-pressed sector turns around and shows rapid growth, it is an important indicator of the direction that an economy is headed. The primary victims of a recession tend to overshoot to the downside, careening past any reasonable equilibrium. This is borne out of the natural human tendency to overreact to bad news. When times are tough, some business owners act as though the sky were falling. In this situation, employers remain overly cautious, hiring again only after conditions have improved substantially. It's telling, therefore, that some of these battered sectors have again begun to show signs of recovery in California.

Since September 2010, one of the largest job creators in the state has been the construction industry. That's right, construction. After being decimated by the housing bust, with the number of positions falling by more than 40%, construction employment has been increasing for the past year, and there are a few reasons why. First, the industry overreacted. Even after the panic ended and the market began to stabilize, the industry continued to shed workers. Second, the reality is that the construction market is on the mend.



It's true that building activity for single-family housing—one of the largest contributors to construction demand—has continued to languish. Despite some minor upticks, the overall trend is still down. But the other major components of building activity have all shown signs of life, dating back as early as 2009. With increased demand in multifamily housing, alterations, and nonresidential construction, employers have no longer been able cut back and have added 24,600 jobs since September of last year, for an annual average increase of 4.2%.



Another industry that was hit hard during the recession was administrative support. This industry covers a wide range of functions, including back-office support, employment placement and temporary staffing, building security, and janitorial services. During the recession, these services were cut early and heavily, with jobs declining by 18%, twice as steep as the 9% drop for the state overall. But as the business climate has begun to improve, companies have started to reacquire these services as a response to increased workloads. As a result, the industry has added more jobs (58,500), and grown at a faster rate (with an annual average rate of 6.3%) than any other industry in the state since September 2010.

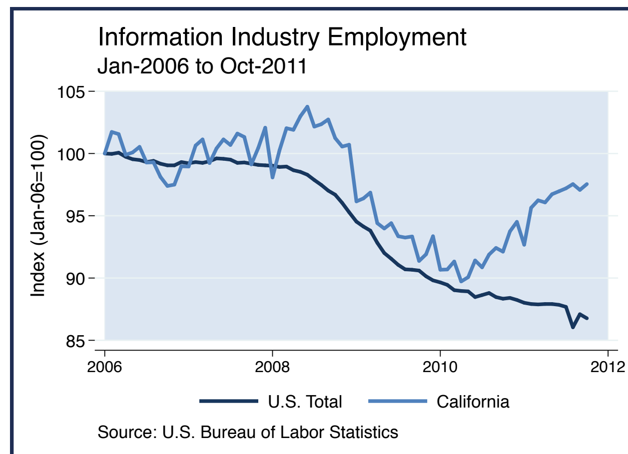
Some Industries Never Turned Down

The health care industry, unlike construction and administrative support, never experienced a recession. Growth slowed somewhat in 2008 and 2009, but demand for health services, along with demand for workers, continued to increase throughout the downturn. In general, this industry tends to be "recession proof," as people often sacrifice luxury goods and entertainment expenses before skimping on health care. And because this industry tends to be well-paying, it has provided an important boost to the California economy, even during the most trying of times.

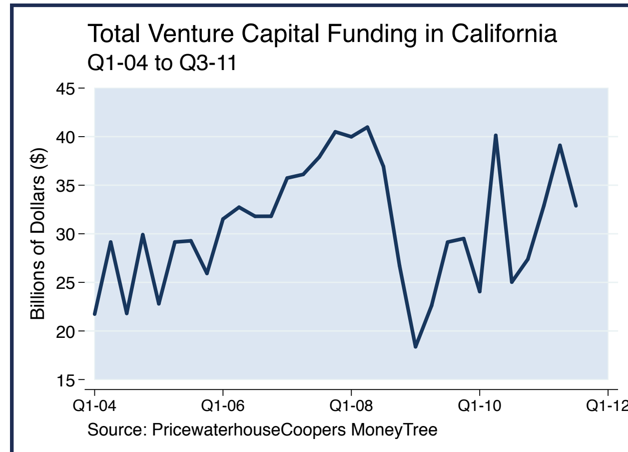
California Sees Growth in Core Industries

California has a particular strength in several segments of the economy, and these have generally been performing well over the past 13 months. Both the information industry and the

professional, scientific, and technical services industry take advantage of the state's highly educated workforce, proclivity for technological innovation, and dominance in the entertainment market. In addition, the accommodation and food services sector taps into the state's vibrant tourism market. It should come as no surprise, then, that growth in these sectors has outpaced growth in the state overall.



In California, the information industry is largely made up of software publishers and TV and movie production companies. Across the rest of the country, however, the industry is dominated by telecommunications firms and book and newspaper publishers. This difference has created two distinct trends, with information employment growing strongly in California but continuing to decline across the nation. As business investment has begun to grow again, and as a healing economy has pumped life back into the previously struggling entertainment industry, this California-oriented sector has added 24,000 jobs (at an annual rate of 5.1%) since the state hit bottom.



One of the main drivers of this hiring is the prevalence of venture capital funding in California. Because of the large number of workers with science and technology skills, and because of the state's reputation for cutting-edge research, California receives roughly 50% of all VC money across the country. Since sinking dramatically in 2008 and 2009, VC flows have come back with a vengeance, creating new opportunities for companies—and workers—in the information industry.

Much of this investment funding also goes into firms in the professional, scientific, and technical services sector. In California, this industry consists heavily of IT consulting and design firms, engineering and technical companies, and scientific research labs. These types of establishments benefit from VC inflows, and as such, have seen a spike in demand over the past year. Because California has a highly skilled workforce and an entrepreneurial, inventive at-

mosphere, investors are willing to bet huge sums of money on the brainpower of the state. This translates into jobs, helping to fuel 39,300 new positions—a 3.5% annual growth rate since September 2010.

And lastly, because of its beaches, ski resorts, and other tourist destinations, California has one of the largest tourism industries in the world. The accommodations and food services industry, which largely consists of hotels and restaurants, has benefited from a rebounding economy. Rising incomes, as well as an improved business climate, have prompted a resumption in both leisure and business travel. In addition, because of a decline in the value of the U.S. dollar, California has seen an increase in international travelers. With 37,200 new jobs since the trough, this industry has grown at an annual rate of 2.7%.

California's leading industries account for 227,300 new jobs since September of 2010, a full 75% of the new positions in the state. And while the recovery is still ongoing—and in some cases painfully slow—there are clear, positive indicators that sustained growth is on the horizon. Beacon Economics continues to believe that the economy is on the mend and that rosier days are ahead, and recent employment trends support this outlook.

U.S. Economy

Turning The Corner: 2011 Arrived With A Whimper, But It's Going Out With A Bang.

The U.S. economy is picking up steam. That may seem hard to believe given that GDP grew by a mere 2% in the third quarter of 2011—and that was on top of a dismal first half of the year. But the important number is not the Bureau of Economic Analysis' (BEA) estimate of national output, but gross demand, since ultimately demand drives production.

Gross demand for U.S. produced products grew by very solid 3.55% in the third quarter, after being functionally flat in the first quarter and growing at a 1.6% annualized rate in the second quarter. We didn't see it in the headline number because of a huge runoff in inventories. Apparently businesses believed the negative rhetoric regarding the U.S. economy and decided not to expand output at the same pace as sales.

The good news of course is that a run down in inventories today means a build up tomorrow as demand remains strong. There is currently a limited amount of data on demand available for the fourth quarter—and it is looking very good. Consumer spending has jumped, durable good shipments are rising, there has been a small increase in housing starts, and durable goods orders continue to rise along with industrial production. Trade numbers show a shrinking deficit, with exports driving the show. Short of some sharp pullback in one or more of these indicators, it looks as if fourth quarter growth could come in at 4% or higher. This will give the markets a healthy boost in late January when the initial estimate is released.

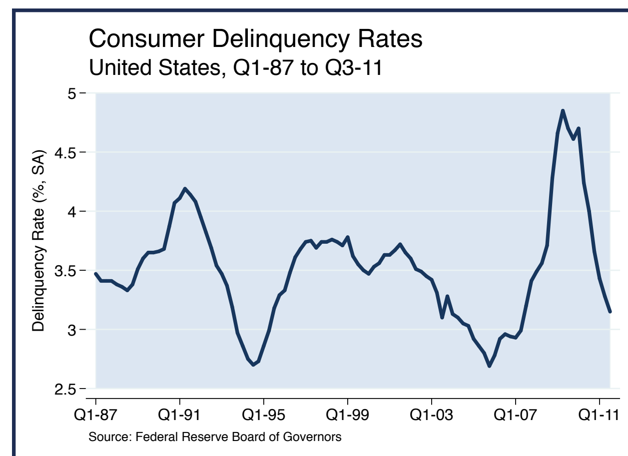
What is driving growth? There is no one specific driver—and there doesn't have to be. Economies are full of feedback effects. Jobs don't form until consumers start to spend, and consumers don't spend until they are confident they can keep their jobs, or find new ones if unemployed. But the default mode in any economy is growth, and following a recession—once the worst of the negative shocks wear away—the small gains seen in the economy begin to interact with each other to create the positive feedback effects that drive a recovery. It was always a matter of when, not if.

Real GDP Growth

Category	Q3-11	Average 1992-1997	Difference
Gross Domestic Product	**2.00**	**3.21**	**-1.21**
Gross Demand	**3.55**	**3.18**	**0.37**
Gross Domestic Demand	**3.06**	**3.50**	**-0.44**
Personal consumption	**1.63**	**2.40**	**-0.77**
Durable goods	0.41	0.63	−0.22
Nondurable goods	−0.11	0.46	−0.57
Services	1.33	1.30	0.03
Fixed investment	**1.45**	**0.79**	**0.66**
Structures	0.33	0.08	0.25
Equipment and software	1.08	0.62	0.46
Residential	0.04	0.09	−0.05
Change in private inventories	**-1.55**	**0.03**	**-1.58**
Net exports	**0.49**	**-0.32**	**0.81**
Exports	0.59	0.60	−0.01
Imports	−0.09	−0.92	0.83
Government	**-0.02**	**0.31**	**-0.33**
National defense	0.26	0.02	0.24
Nondefense	−0.10	0.04	−0.14
State and Local	−0.17	0.25	−0.42

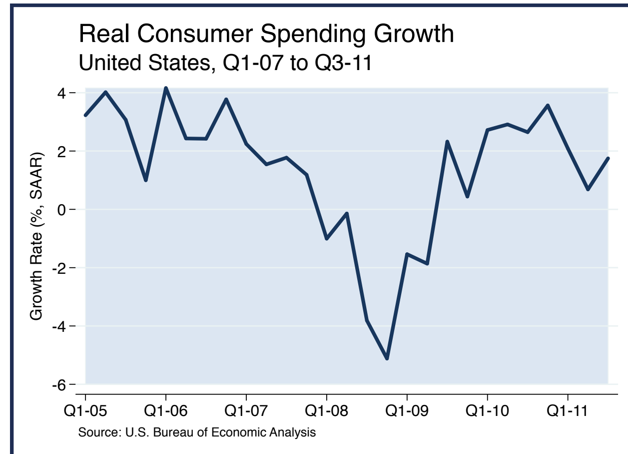
Source: U.S. Bureau of Economic Analysis

The return of the consumer has clearly helped. The labor market recovery has been slow at best, but the numbers have been improving as of late. And incomes have been rising since the recession ended, albeit slowly. The flattening of spending in the first half of the year was not caused by anything fundamentally wrong in the economy, but instead by a temporary spike in energy prices and a shortage of Japanese manufactured cars at dealerships.

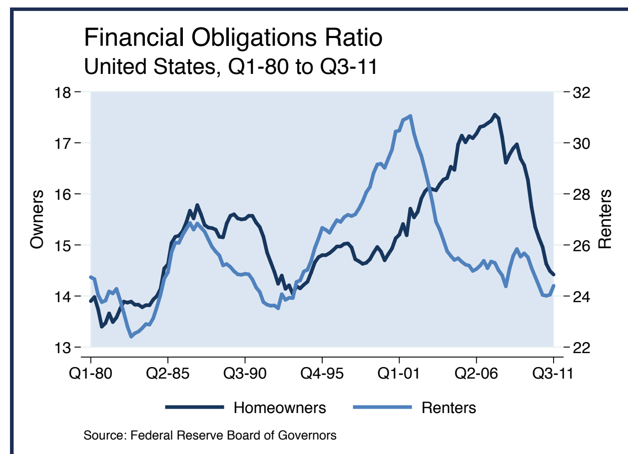


Moreover, the fact that delinquencies on non-mortgage loans have been falling sharply over the last two years is a strong leading indicator that spending growth should not experience any sustained pullback. Indeed, falling delinquencies have much more predictive ability than consumer confidence numbers, but unfortunately it is the latter that receives the bulk of the

press coverage. Leverage is not a problem for households either, and no, the United States is not in the midst of a massive deleveraging cycle. Low interest rates have pushed the financial obligation ratio, an estimate of the share of household incomes that go to servicing existing debt, to levels not seen since 1992.



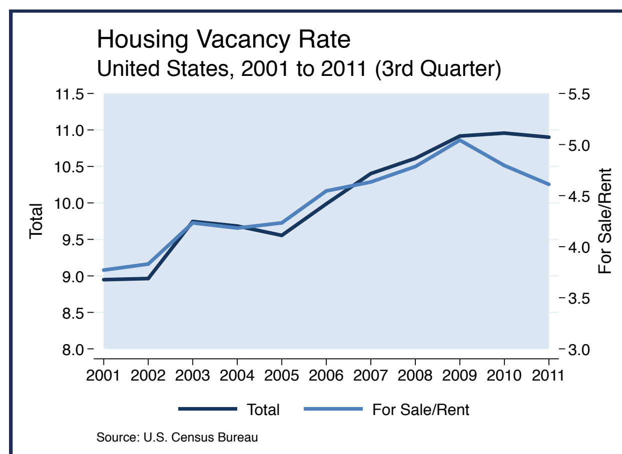
Business investment is finally starting to pick up as well, something reflected in both capital goods orders and in steady increases in outstanding Commercial and Industrial loans from banks. Part of this spending is due to nothing more than the forces of time and depreciation—eventually businesses needed to start putting money back into their firms. Strong export growth has been adding significantly to the demand for U.S. products as well, driven by the weak dollar. Construction in no longer a large drag on the economy, and as long as the overall momentum of growth in the fourth quarter carries into 2012, this part of the economy will start to add to the bottom line next year as well. Indeed there are signs that housing starts are finally starting to creep up now that much of the excess supply has been absorbed and housing vacancy rates are finally starting to fall. And while there are substantial issues leftover from the housing bubble—mainly the low equity ratio in many households—things are starting to turn the corner. Equivalently non-residential vacancies are also starting to fall—leading to growth in the commercial market.



The greatest drag on the U.S. economy in coming years is going to come from the public sector. Even as state and local governments can finally start cutting their spending in response to stronger revenue growth, the Federal government will have to start grappling with the largest peacetime deficit ever seen. Beacon Economics' hope is that there will be enough positive momentum in the private sector that a careful closing of the gap—one that includes both revenue increases and spending cuts—can be managed without sinking the nascent recovery.

This isn't to say everything is fine in the nation. The United States is still far behind in the recovery and has a long way to go (if this were a more normal recovery, the U.S. economy would be 4% to 5% larger right now). In the meantime millions of American families continue to feel the pinch as employment levels remain far below their peak in 2007. Some pundits have suggested that the problem is a lack of jobs—but this is completely backwards. Employment is a lagging indicator—it follows the economy. The first step in fixing the employment problem is better economic growth—and it appears that this is starting to kick in.

Clearly there are risks associated with this recovery. A major meltdown in Europe is one—but Beacon Economics feels this scenario has been overblown. Another major issue is inflation. While price growth is currently in a desirable range, with an increase in monetary velocity and lots of excess liquidity in the system, inflation could kick in putting the Fed in the uncomfortable position of deciding what is most important to deal with in the short run. And of course closing the Federal deficit in a reasonable way means political compromise—something that is clearly absent in Washington these days.



Despite all this, Beacon Economics is more bullish on the economy that we have been for some time.

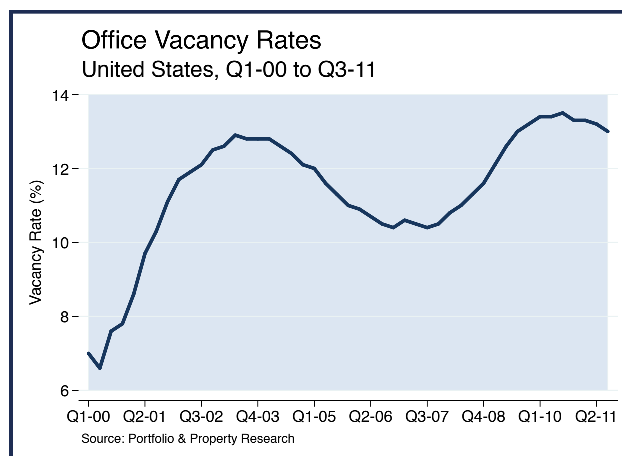
Confidence Vs. Reality

The improving economic landscape flies in the face of the many commentators who jumped on the economic 'sky is falling' bandwagon earlier in the year. Beacon Economics never subscribed to the double dip theory put forward by some forecasting groups, or even the prolonged stall theory put forward by others. While economic growth certainly slowed at the start of the year, the drivers of the deceleration were transitory—or in other words didn't have the staying power necessary to create a long-term slowdown.

But what of the stumbling stock market, collapsing consumer and executive confidence, rising risk spreads and all the other indications of psychological turmoil? When considering the economy, we have to draw a distinct difference between real economic numbers—outstanding

bank loans, manufacturing orders, train loads of goods and so on—and other looser "confidence" statistics.

While confidence numbers can tell us something about how people are feeling, what they are doing is what is important for predicting the future. And while the stock market, consumer confidence and other such confidence indicators are correlated with real estimates of what is happening in the economy, the correlation is not perfect. Many times the real data point in one direction while the confidence data point in another—and this is very often the case immediately after a recession has hit the economy. This may be a symptom of what we might call the national PRSD—Post Recession Stress Disorder.



Had the economy not been struggling to pull out of the deep hole it had fallen into during the recession, not much would have been made of those mild shocks that hit in the first half of 2011. But in an economy still grappling with high unemployment and a large output gap, these shocks end up having a larger influence on public discourse and opinion than usual.

Many of the groups who were calling for a second recession relied too heavily on confidence numbers, and not enough on real numbers. By doing so they ignored the historic drop in correlation between confidence numbers and actual economic indicators that seems to occur within periods of recovery. None of the real data supported the onset of another downturn. Indeed, even as the rhetoric was reaching a peak of panic in September, all the major indicators began to point in the right direction.

Public perception certainly isn't being helped by the current political climate. Both sides of the aisle spin select portions of the news as negatively as possible, in order to score political points. For the Republicans it has been necessary to downplay any positive news in order to highlight the failings of the current administration. As for Democrats, they continue to overstate the plight of the middle class, in order to demonstrate Republicans' heartlessness in demanding a balanced budget.

The Importance Of Revisions

Economic forecasting is an exercise in both trying to figure out what is going to happen tomorrow, and what may have actually happened yesterday. Government agencies release estimates of economic activity before they complete information. This is good inasmuch as it allows for some glimpse of what is happening in a relatively current way, but it is bad since it often leads to errors and the need for large revisions in the data.

Such issues became important earlier this year when the BEA dramatically revised U.S. GDP numbers for three back years when they released the second quarter data. The changes showed the downturn was worse than originally estimated—something that made sense given the loss of jobs. It also dramatically slowed the estimate of growth that had been made in the first quarter, even though it made 2010 look like a much better year for growth than originally estimated. Many commentators focused on the former, while completely ignoring the latter.

Also important have been revisions to employment numbers recently. The following table shows changes made to estimates in private payroll growth over the past few months. The numbers have all been revised upwards as more data has become available. This in itself is an important pattern. The Current Employment Statistics (CES) survey used to estimate current payroll employment has a known bias—when the economy is slowing it tends to over-estimate jobs growth. When the economy is picking up speed it underestimates growth. This pattern of revisions is strongly indicative of a labor market that is showing solid signs of recovery.

Employment Revisions by Report Month

Report Month	Employment Month May-11	Jun-11	Jul-11	Aug-11	Sep-11	Oct-11	Nov-11
Jun	73	57					
Jul	99	80	154				
Aug	99	75	156	17			
Sep	99	75	173	42	137		
Oct	99	75	173	72	191	104	
Nov					220	117	140

Source: U.S. Bureau of Labor Statistics

The same pattern is being seen in unemployment numbers as well. The number of new claims for insurance dropped sharply over the past few months, and the national unemployment rate fell 0.4% from October to November. Many pundits, eager to put a negative spin on this figure, pointed out that much of the drop was due to the decline in the number of people in the labor force.

The problem with this spin is that the levels of employment and unemployment that come from the Current Population Survey (CPS) are notoriously volatile on a month-to-month basis.

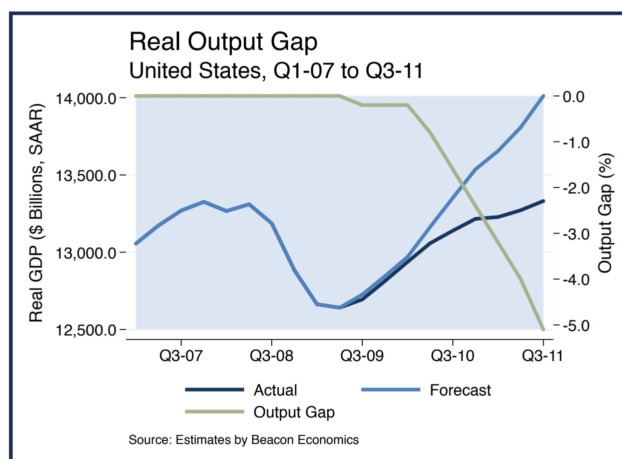
One can only look at the ratios (the unemployment rate) and have any degree of short-run confidence. More important are long-run trends in the levels. Over the past two years estimates of the size of the labor force have actually stayed fairly steady, neither rising nor falling. The drop in the unemployment rate is the real deal.

More negative spin has surrounded consumers and consumer spending. The reports have been that consumer spending has been rising, even as real incomes have seemingly stalled in recent months. Income growth has slowed, and what little there is has been swallowed by rising prices leaving real aggregate personal income only slightly higher now than in was last year at this time. So how can we explain rising consumer spending? Only through a drop in savings—something that has many analysts worried.

But Beacon Economics does not believe this is what is happening, and bases its conclusions on two important data points. Estimates of income are subject to revisions—albeit on a less frequent basis than other parts of the economic picture. The fact that one, nominal GDP is growing faster than estimates of gross national income (theoretically they should be equivalent) and two, employment estimates have been upwardly revised, point to an upward revision in income levels the next time the BEA gets around to it. This will diminish yet another fear of the bears.

The Slow Recovery

Do not mistake Beacon Economics' bullishness with being Pollyannaish. As far as recoveries go, this one continues to be a disappointment. While the recession ended in the middle of 2009, we have yet to see the recovery growth rates we have seen after serious recessions of the past. If we use past business cycles as a guide and apply the average recovery path to the current economy, we could argue that the United States economy is 'behind' by nearly 5% as of the third quarter of 2011. This largely explains why unemployment has stayed stubbornly high.



There are numerous reasons for the slower than normal recovery. One was the tyranny of excess inventories—particularly in housing. During the housing boom from 2001 to 2007 the

nation overbuilt its housing stock by roughly 3.5 million units, relative to population growth. Much of the inventory was going to have to be burned off, by allowing the population to catch up to the current stock. This has been occurring over the last few years, and a simplistic ratio of population to housing units is almost back to trend line. Lower inventories are starting to show in the vacancy statistics as well as in housing starts and permits.

Another reason for the slow recovery is consumer spending—too much consumer spending. Many of the public policies regarding consumers have focused largely on getting consumer spending to grow rapidly, as it did after the deep 1982 and 1974 recessions. This is a classic case of the general fighting the last war. In these past downturns external issues caused the decline in consumer spending. Once the shock ended, spending rapidly jumped back up to normal levels, pulling the economy along with it.

This time however we entered the recession with U.S. consumers vastly over-spending. Savings rates were close to zero and the nation had opened an enormous trade deficit. The United States was on an unsustainable spending spree, and it was the nation's trading partners who were benefiting from the extravagance. While much is made of the housing and financial excesses earlier in the decade, which led to the turmoil in 2007 and 2008 and played a part in driving the recession, the role that consumer over-spending played has been largely ignored. The downturn in consumer spending was a necessary part of the recovery of the U.S. economy, not a bad side effect of other problems.

The recovery was going to have to come from the external accounts, not from consumers. This is a slow process. The United States is an enormous economy, and growth in demand from the rest of the world was unhurried partly because of global economic weakness, and partly because of a basic intransigence by many of our trading partners who see exports to the United States as a primary driver of their economies. Regardless, the process of external rebalancing had started to occur during the first stages of the recession as the sagging U.S. dollar boosted exports even as consumer spending weakened in late 2007 and the first half of 2008. But when Lehman Brothers failed and the markets were rattled, the U.S. economy became a safe haven. The dollar rose sharply and the healing here came to an abrupt end.

Alas, boosting consumer spending has remained a central part of policy efforts to spur economic recovery, rather than focusing on boosting U.S. production through massive infrastructure investments or export promotion. This isn't to say that the tax cuts and extensions of unemployment benefits haven't had some positive effects on the economy in the short term, but ultimately they are delaying the inevitable—that consumer spending eventually has to fall as a share of the economy.

And in the mean time, the relationship between consumer spending and the trade deficit continues to be evident. Much of the stimulative value of recent tax cuts has spilled out of the nation through an increased demand for imports. So as the U.S. government continues to borrow, our trading partners continue to benefit. The good news is that with income and job growth, the consumer side of the economic ledger might be rebalanced without another pullback in growth. For this to happen, consumer spending will have to grow slightly slower than incomes—with exports, business spending, and construction playing a larger than normal role in driving growth over the next few years.

Finally there is the skills issue. The high tech boom of the late 1990s promised to fundamentally change the way that businesses operate. Low skilled jobs began to be replaced by cheap capital, increasing labor productivity and ultimately enriching the U.S. population. Of course the offset to this miracle was the painful adjustment low skilled workers would have to go through in order to adapt to the new realities of labor demand.

This process moved slowly, and for a long time much of the pain was covered up by the plethora of new low skilled jobs that were created during the construction and retail boom. Then the recession accelerated the pace of technology adoption by cost-conscious firms and ended the excess demand for workers in retail and construction. The nation is now going through that painful adjustment period—not unlike what happened in the 1970s when the first great wave of change rippled through the economy. There is little that public policy can do to address the skills problem in the short run, except to assist the displaced as best as possible through this tough time.

There is no industry where the process of replacing low skilled workers with technology is more evident than in the manufacturing sector. With exports booming, business investment starting to heat up, and demand for cars and planes on the rise, the manufacturing sector has been on a tear. Yet despite the increased output, the sector has only added back a paltry 300,000 of the jobs it lost—and it is still 5 million jobs below where it was in 2000. All this new output has been gained through capital investments rather than the hiring of workers.

The implication is that now, more than ever, the United States needs to invest in its education systems—both for currently displaced workers as well as for the next generation now in school. Unfortunately, dramatic cuts in education at the local government level show the opposite happening. This is a sad commentary on the short sightedness of many of our policy makers.

Economic IEDs

So today's million dollar question has to do with the various risks that threaten to knock the United States off its path to recovery. These risks can be sorted into four categories, in declining importance:

1. Europe
2. The Federal Deficit
3. Inflation
4. Tax Increases

The ongoing struggles of the Euro Zone to deal with their sovereign debt issues have been covered ad nauseam in the media. At points the rhetoric reached an extreme level—with prognostications of the EU breaking up, causing a meltdown in the global banking system that, according to the estimates of one large Swiss bank, would lead to a 40% decline in GDP across Europe.

Such a scenario would require the European Central Bank (ECB) to sit idly by as the world falls apart around them. This seems, at best, unlikely. The point of having a central bank is that it becomes the lender of last resort during a crisis. This implies that those running the ECB can backstop the European banking system in the event of some massive run on the banks. The ECB could even more or less support national deficits though the same mechanism, if necessary. It may not have the 'capital' on hand to do such things, but that is irrelevant. Ultimately it has something more important—the power of the monetary printing press.

It is hard to imagine a scenario where ECB leaders, with a clear vision of recent financial catastrophes to guide them, would not step up to the plate at a time of severe crisis. One might presume that Germany, with its anti-inflation stance, would not allow such a move. But ultimately any official move against an action of the ECB would take years to work their way through the various legal systems in Europe, by which time the crisis would be long over.

So why hasn't the ECB acted? For the same reason the Federal Reserve and U.S. Treasury were rightly worried about rescuing the big banks on this side of the Atlantic—moral hazard. This fancy term simply means that those who are not held responsible for their mistakes are liable to repeat them. Bail a bank out from the losses incurred by making risky bets, and that bank will surely make those same bets again. Bail a nation out of its deficit problem, and that government is not likely to do the hard work necessary to fix its spending problems.

So the ECB is playing a game—allowing enough chaos to seep into the system to force various governments to start cleaning up their deficit problems, while not letting those problems get out of hand. They have to play this game before all the EU nations end up looking like Greece—pushed to the brink of ruin in a situation where there are no winners.

The greatest risk to the United States comes not through the banking and financial system but through exchange rates and the stock market. If things get too out of hand in Europe, expect the dollar to rise as cash moves here, seeking a safe haven (Japan and Switzerland are not big enough to handle all the demand). This would snuff out the bright light of rising exports in the U.S. economy. And of course the stock market has been excessively volatile given its fears over Europe. If there is a large shock it could cause a sharp decline in the markets, and a rise in risk spreads.

It is not likely that declines in the markets or exports would push the nation into a new recession. But it would surely take the wind out of the strong numbers we are currently seeing.

Of course it isn't just Europe that is having sovereign debt issues. The U.S. government continues to run a massive deficit as well. While this isn't a short-term crisis—debt levels in the nation are reasonably low on a net basis—ultimately, borrowing close to one trillion dollars per year is simply not sustainable. The country clearly needs to move back towards a balanced budget, a process that should occur through a combination of revenue increases and cuts in spending.

Unfortunately little progress has been made to date. The Republicans have a single track agenda of preventing any sort of revenue increases, and the Democrats have drawn lines in the sand on issues of social insurance programs and reforms in government spending. Instead of having a cohesive plan to slowly unwind the problem, U.S. leaders are instead proceeding in fits and starts. Thankfully, the turmoil in Europe has turned the bond markets' attention away from of the U.S. problem. The challenge is to prevent the situation from spiraling to the point where the problem grows out of control and tough, rapid decisions need to be made. Want to see the impact of going cold turkey on a Federal deficit? Take a look at the precarious state of the Greek or Irish economies. This is not what anyone in the United States wants or needs.

Balancing the budget will require both increased revenue and spending cuts. But aren't tax increases bad for growth? That is the mantra of Grover Norquist, his followers, and their local representatives here in California who are allied with the Howard Jarvis Taxpayers Association. But repeating that line over and over again doesn't make it true. There is no evidence that 'high' tax states grow slower than 'low' tax states. And even as overall personal tax rates have been lowered in recent years, the recovery has remained tepid. Even high tax Europe grows

almost as fast as the United States once demographic differences are taken into account. Most of the gap in growth seems to be related to stricter labor laws rather than anything having to do with the structure of taxes.

Indeed, the rhetoric surrounding tax increases has become dangerously close to ridiculous. One favorite line is that higher taxes will discourage small businesses from hiring more workers. Apparently the people repeating this (including some of those vying for the Republican presidential nomination) have never taken a basic accounting class. Otherwise they might understand that small businesses are taxed on their net, not gross, income, so revenue spent on hiring a new worker is not taxed. Income taxes should play little to no role in hiring decisions. The one place where this isn't the case is with corporate taxes—which are a tax on the returns to capital. Beacon Economics would favor a reduction in these taxes—offset by the removal of tax perks received by the largest and most profitable corporations.

No one is a fan of paying taxes—particularly when the money is wasted on special interest groups and pork barrel projects. But that doesn't change facts regarding the limited relationship between tax rates and economic growth.

Finally there is the issue of inflation. In 2011 the deflation chupacabra was finally put to rest. The Federal Reserve put enough new liquidity into the system to offset the decline in monetary velocity. It did so by injecting trillions of dollars into the banking system—most of which remains there in the form of excess reserves. While much of the recent jump in prices has been driven by energy and food, the core rate did jump above 2% over the course of the last year. At the same time estimates of money supply growth have accelerated even when taking into account changes in the rules that govern the ability of banks to offer interest on demand deposits for large firms.

With the fears of Europe at the top of the financial world's concern list, there has been little attention focused on the risk of inflation. And while it seems unlikely that inflation will become an immediate problem, the potential is there. Keep an eye on excess reserves and bank lending. If the economy does take off in 2012, inflation may be coming down the pike faster than many would like, especially the Federal Reserve.

About Beacon Economics, LLC

Beacon Economics, LLC is an independent economic research and consulting firm with offices in Los Angeles and the San Francisco Bay Area. We deliver economic analysis and data sites that help our clients make informed, strategic decisions about investment, growth, revenue, policy, and other critical economic and financial issues. Our nationally recognized forecasters were among the first to predict the collapse of the housing market and foretell the onset and depth of the economic downturn that followed. Our core areas of expertise include economic and revenue forecasting, market and industry analysis, economic impact studies, economic policy analysis, and international trade analysis.

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