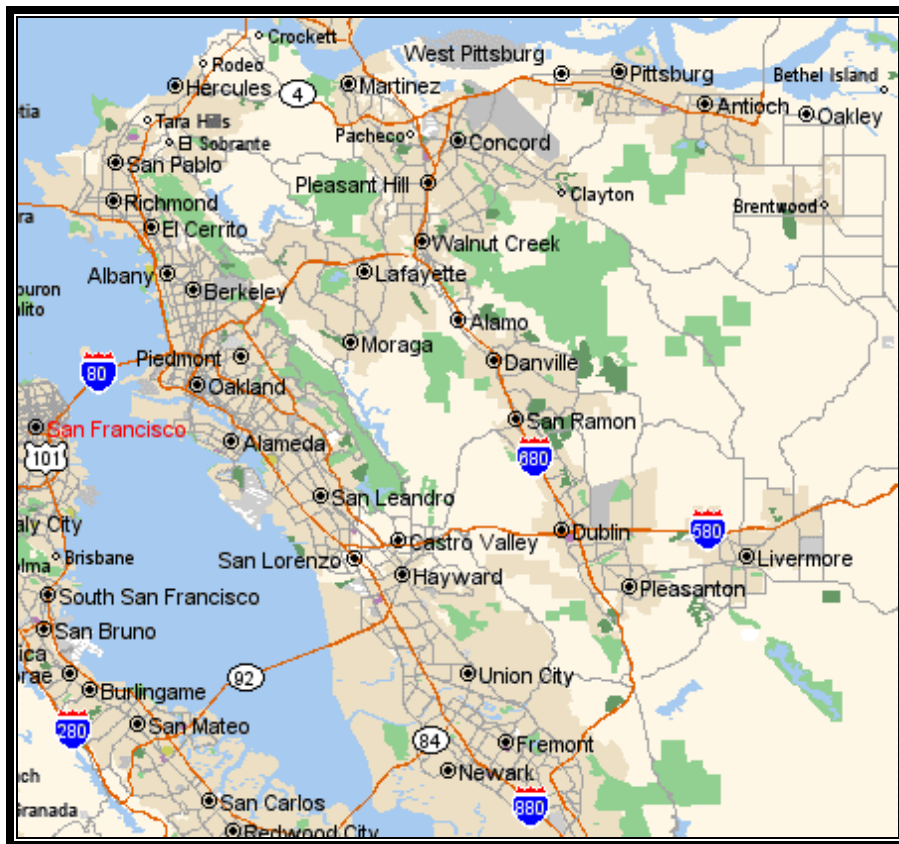


East Bay Economic Forecast

July 2003

Created for the East Bay Economic Development Alliance of Business
by the UCLA Anderson Forecast
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Local Economic Indicators July 2003

	East Bay			San Jose			San Francisco		
<i>Labor*</i>	<i>Mar-03</i>	<i>Jun-03</i>	<i>Ch</i>	<i>Mar-03</i>	<i>Jun-03</i>	<i>Ch</i>	<i>Mar-03</i>	<i>Jun-03</i>	<i>Ch</i>
Labor Force	1,311,681	1,309,327	-0.2%	931,483	924,846	-0.7%	932,070	933,656	0.2%
Household Employment	1,227,562	1,226,955	0.0%	851,340	847,982	-0.4%	876,766	880,391	0.4%
Unemployment	6.4%	6.2%	-0.3%	8.6%	8.3%	-0.3%	5.9%	5.7%	-0.2%
Payroll Employment	1,048,857	1,042,077	-0.6%	879,218	869,236	-1.1%	975,895	971,730	-0.4%
<i>Goods Producing</i>	167,445	165,684	-1.1%	229,372	225,201	-1.8%	91,919	90,492	-1.6%
<i>Service Providing</i>	877,159	872,783	-0.5%	645,007	640,295	-0.7%	880,534	878,088	-0.3%
<i>Government</i>	184,961	182,411	-1.4%	97,595	97,158	-0.4%	132,783	131,910	-0.7%
<i>Travel Data*</i>	<i>Feb-03</i>	<i>May-03</i>	<i>Ch</i>	<i>Feb-03</i>	<i>May-03</i>	<i>Ch</i>	<i>Feb-03</i>	<i>May-03</i>	<i>Ch</i>
Hotel Occupancy Rates	55.5%	55.4%	-0.1%	60.0%	51.7%	-8.3%	61.7%	68.1%	6.4%
Hotel Room Rates	\$96.93	\$97.15	0.2%	\$112.90	\$104.16	-7.7%	\$143.28	\$147.53	3.0%
	<i>Jan-03</i>	<i>Apr-03</i>	<i>Ch</i>	<i>Jan-03</i>	<i>Apr-03</i>	<i>Ch</i>	<i>Jan-03</i>	<i>Apr-03</i>	<i>Ch</i>
Airport Passenger Data	1,168,372	1,086,494	-7.0%	877,153	874,070	-0.4%	2,531,554	2,191,764	-13.4%
<i>Vacancies</i>	<i>Q1 03</i>	<i>Q2 03</i>	<i>Ch</i>	<i>Q1 03</i>	<i>Q2 03</i>	<i>Ch</i>	<i>Q1 03</i>	<i>Q2 03</i>	<i>Ch</i>
Industrial Vacancy	10.8%	10.2%	-0.6%	15.6%	15.8%	0.2%	12.2%	12.1%	-0.1%
Industrial Availability	13.9%	13.9%	0.0%	16.6%	16.5%	-0.1%	13.6%	12.9%	-0.7%
Commercial Vacancy	16.8%	17.7%	0.9%	23.2%	21.5%	-1.7%	18.7%	19.3%	0.6%
Commercial Availability	18.4%	19.8%	1.4%	24.3%	22.4%	-1.9%	20.6%	20.6%	0.0%
<i>Construction</i>	<i>Jan-Feb 02</i>	<i>Jan-Feb 03</i>	<i>Ch</i>	<i>Jan-Feb 02</i>	<i>Jan-Feb 03</i>	<i>Ch</i>	<i>Jan-Feb 02</i>	<i>Jan-Feb 03</i>	<i>Ch</i>
New Units	2,617	2,397	-8.4%	825	1,311	58.8%	1,020	839	-17.8%
Residential New Buildings	\$588,198	\$497,940	-15.3%	\$175,141	\$306,916	75.2%	\$181,288	\$172,741	-4.7%
Residential Alterations	\$112,521	\$141,055	25.4%	\$76,826	\$89,627	16.7%	\$148,214	\$149,778	1.1%
Non-Residential New Buildings	\$131,307	\$137,733	4.9%	\$121,764	\$81,895	-32.7%	\$392,474	\$38,111	-90.3%
Non-Residential Alterations	\$136,864	\$119,656	-12.6%	\$161,018	\$169,558	5.3%	\$125,564	\$105,630	-15.9%
<i>Median Prices New and Used Homes</i>	Alameda	Contra Costa	Marin	Napa	San Francisco	San Mateo	Santa Clara	Solano	Sonoma
May-02	\$391,000	\$345,000	\$588,000	\$345,000	\$571,000	\$532,000	\$461,000	\$265,000	\$339,000
Feb-03	\$396,000	\$347,000	\$553,000	\$361,000	\$543,000	\$523,000	\$456,000	\$270,000	\$336,000
May-03	\$402,000	\$376,000	\$595,000	\$419,000	\$556,000	\$552,000	\$462,000	\$301,000	\$365,000
3 month ch	1.5%	8.4%	7.6%	16.1%	2.4%	5.5%	1.3%	11.5%	8.6%
1 year ch	2.8%	9.0%	1.2%	21.4%	-2.6%	3.8%	0.2%	13.6%	7.7%

All Data Seasonally Adjusted (SA)

Source: Dataquick

OVERVIEW: Hitting a pothole on the road to recovery

The East Bay has been the one strong point in an otherwise dismal Bay Area economy. Its diverse economic base, the relative lack of exposure to the high tech bust, and the fact that it is the most affordable place to do business in an area that is just starting to remember that the bottom line is important even in a new economy. Yet the recent weakness in the US economy, caused by a slowdown in consumer and state and local government spending, has caught up to the region. Payroll employment fell slightly over the past quarter and taxable sales have fallen relative to last year when consumers, still in low interest rate frenzy, bought cars and furniture at a rapid pace. Hotel occupancy rates have fallen as business traffic is again slowing down. The forecast for the national economy is the same as for the region—slow growth as we slowly move back towards normalcy.

Real estate prices are starting to cool off some, as it looks like the era of falling mortgage rates may have finally reached bottom. Falling bond prices, if they stick, will lead to rising mortgage rates. Expect the market to lose a substantial portion of its liquidity if rates rise even half a point. Prices will soften and the building boom will likely slow down. How severe the backlash will be depends on how fast mortgage rates increase. As of now the forecast for slow growth will keep mortgage rates from rising rapidly, thus avoiding a potential crisis.

Nevertheless, the fundamentals of the local economy remain in place. The non-residential rental markets seem to have pulled out of their free-fall of just a year ago, and people continue to move into the East Bay, unlike the shrinking labor pools to the west and south. More important, business spending on technology is yet again on the rise, and that will help pull the entire region up. We feel that as the US economy slowly picks up speed over the next few quarters, the East Bay will follow quickly behind and remain the strong point of the Bay Area economy. Still, do not expect a return to the go-go years of the late nineties, only modest growth. And the potential downsides remain. When mortgage rates begin to rise, this will rapidly dampen the hot real estate market. In addition, the State budget situation will be a large drag on the economy.

THE NATIONAL ECONOMY: Darkest before the dawn?

The big news this week was that the National Bureau of Economic Research, the official arbiters of business cycles, finally announced that the recession of 2001 ended in November of that year, and that the US economy has been in an expansion since this time, albeit a very weak one. Quite a relief! Unfortunately the current expansion hit a soft patch in the second quarter of 2003 as seen in the various measures of economic performance. Purchases of non-defense capital goods slipped slightly after growing through most of 2002, and retail sales have flattened out, especially for automobiles. The only strong sector in the US economy continues to be the housing sector. Unemployment, after remaining stable at 5.8% for nearly a full year, has risen by nearly half a percentage point. Payroll employment also continued its slow steady decline, with an additional 150,000 jobs lost since March to add to the 175,000 lost over the first quarter.¹ Annualized, this represents a pace of job loss of around .5% annually, not large but certainly not good.

The recent weakness in the US economy stems from the fact that there is no sector of strength to pull the economy forward. US output is demand driven, with demand coming from four areas—consumers, government, businesses and overseas. Consumer demand has been pulling the economy forward over the past two years, but this driver is losing steam. Aggressive rate cuts by the Federal Reserve at the outset of the downturn kept consumer spending on new houses and cars strong, and minimized the overall impact of the downturn on the economy.

¹ The primary source of job loss was production workers in manufacturing, but it would be a mistake to pinpoint the overall job market weakness as being there as the declines seen in this sector are consistent with the secular long-run decline in manufacturing's share of employment in the US. Rather the net loss of payroll jobs is due to the failure of the services sectors to produce the additional it traditionally has.

The downside of this policy has been to create a surge in consumer debt. The total household debt burden is now nearly 97% of annual household disposable income, up from 76% in 1994. Debt service payments have risen to over 14% of disposable income. It is clear that this sector will not be able to pull the economy forward as well as it has, especially given that interest rates are currently unsustainably low. When they begin to increase this debt burden will also increase.

As for the other drivers, none of these appear to be able to pick up the reins of growth either.

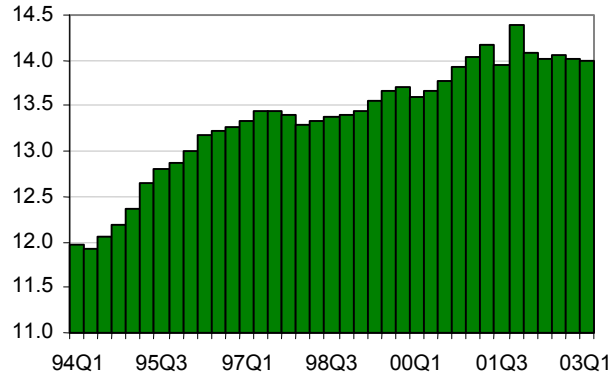
While the Federal Government has ramped up spending as a result of its overseas operations, this has been more than offset by flat state and local government spending in the wake of the budget crises that have hit almost everywhere. External demand is still slow because of a weak world economy and the still over-valued dollar, although the dollar is starting to soften. Finally business investment, the portion of aggregate demand that created the recession in the first place, remains stagnant as businesses struggle to find profits and deal with the overcapacity problems that were created during the height of the Internet rush. While technology has shown some signs of life (see below) these gains have been offset by continued weakness in investment in non-residential structures and in the transportation industries.

While this all looks bad, there are some silver linings that suggest a return to growth. First, while *payroll employment* has been falling, *household employment* has been rising, albeit very slightly. Remember that household employment picks up self-employed workers and agricultural jobs not counted in the payroll numbers. More households with jobs, even if not formal payroll jobs, imply more disposable income and more consumers spending on goods and services.

Also, we need to remember that employment is generally a lagging rather than leading indicator. Falling or flat employment today reflects weakness earlier in the year, not necessarily later. Indeed, rising unemployment in the US over the past few months is primarily a function of an expanding labor force, not falling employment. An expanding labor force implies that formerly discouraged workers may be feeling that their opportunities have increased enough to warrant a new job search—again a good sign for the economy. Investors seem to have improved their outlook as well. The stock market has been rising strongly for a number of months now, and bond prices have also begun to fall.

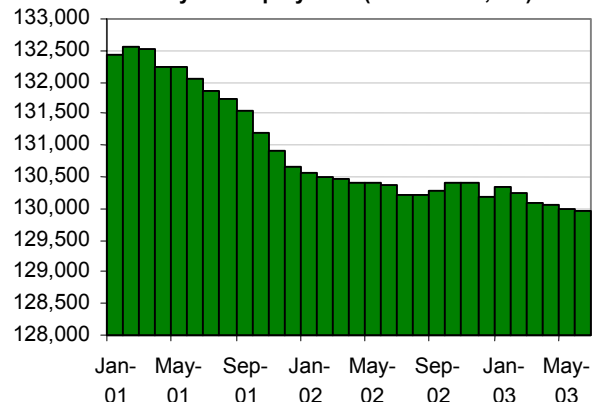
Other good news comes from corporate profits, which have been on a solid growth path for the last two quarters after slipping through most of 2002. A return to profitability will eventually lead to a return to hiring and investing on the part of businesses. Also encouraging has been the decline of the US dollar. A falling dollar implies that American made products are cheaper, spurring growth in external demand. It also makes visiting the US a more attractive option, although it is unclear what impact the ongoing security issues will have on this sector of the economy.

Consumer Debt Service as % of Disposable Income



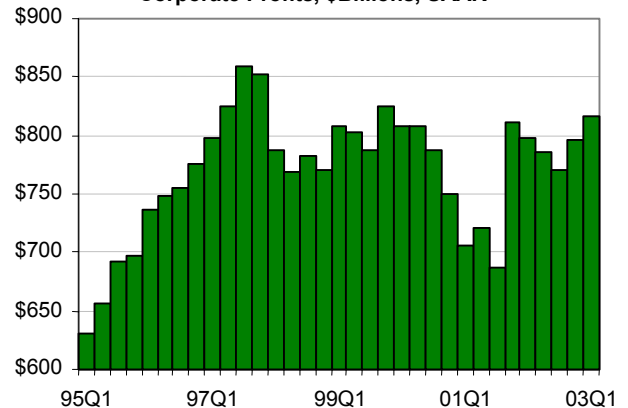
Source: Bureau of Labor Statistics

US Payroll Employment (Thousands, SA)



Source: Federal Reserve

Corporate Profits, \$Billions, SAAR



Source Bureau of Economic Analysis

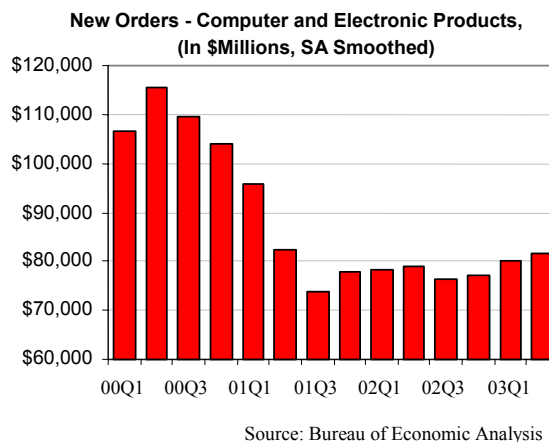
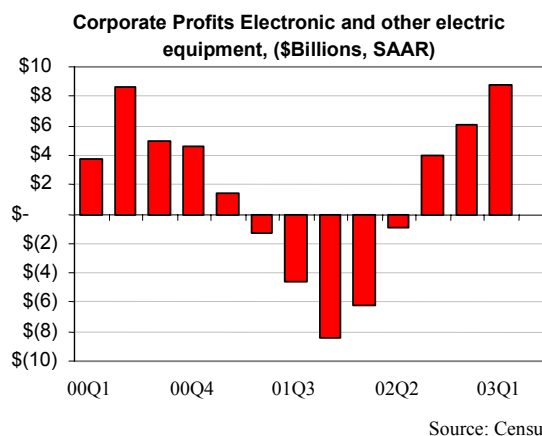
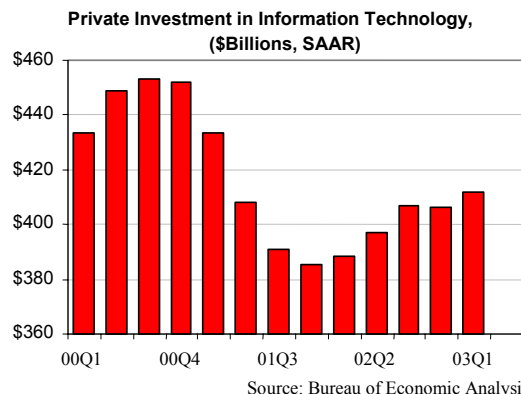
Still, the potential downsides to the economy are large. If interest rates do spike up substantially, rapidly rising housing prices have created a potential problem in that sector of the economy (see further on). Similarly the ongoing state budget crises here in California as well as across the US don't bode well either. Finally the US trade deficit and low domestic savings rates are imbalances that began in the midst of the Internet rush and have yet to experience a substantive correction. Even if the economy manages to avoid the landmines, the needed reversal in business investment will occur slowly, and labor markets and consumer spending will also remain weak. Hence, the UCLA Anderson Forecast has revised its growth forecast down slightly. We see continued sluggish growth through the end of 2003, and potentially into the first quarter of 2004. When we finally shake off the sluggishness, only look for a return to normal growth, not an economic rebound as typically experienced at the backend of a business cycle. Look for growth in 2004 to be 3%.

TECHNOLOGY: The longest march begins with a single step

While the US economy remains in a slow growth mode, things are starting to look somewhat better for the information technology industry—good news for the beleaguered Bay Area economy. On the consumption side, private investment in information technology capital goods got back on track after a weak fourth quarter of last year. Seasonally adjusted purchases topped \$412 billion in the first quarter of 2003. On the production side, new orders of computer and electric products have continued their slow increase from the bottom hit nearly two years ago, and have topped \$80 billion for two quarters running, the first time this has occurred since the second quarter of 2001.²

Perhaps more importantly for the production side, corporate profits for firms that produce electronic and other electric equipment in the US reached \$8.8 billion in the first quarter of this year, its highest level since the first quarter of 1998. All these positive results have certainly been reflected in the stock market and in the bottom lines for many of the major firms in the region. Intel, Yahoo, Oracle and other firms have all posted better than expected profits over the past quarter.

While these numbers are not as directly important for the less tech-dependent East Bay as for its two neighboring economies, nevertheless the East Bay's



² It is easy to confuse 'supply' and 'demand' side measures of economic performance. Demand side statistics are those that tally up the actual purchases of goods by the various groups of buyers *within* the nation. These numbers are released in the GDP statistics and at the highest level are broken into the gross purchases by businesses, consumers and the government. Since these goods may be purchased from firms located within the US or from firms overseas (through imports) the Census also tracks purchases being made *from* domestic firms—these are the Shipments and New Orders numbers that are released on a regular basis. This is what I refer to as a supply measure of output.

economy is impacted by the health of its neighbors. While the East Bay has been performing well relative to its neighboring economies, improvements elsewhere will quickly spill over. Look for second quarter investment growth numbers to be slightly subdued due to the temporary interruption of the war in Iraq, but to be on track by the third quarter.

All these variables are indicative of an industry that is slowly, but surely, returning to a degree of prosperity. However, a degree of caution is in order. Purchases and orders are still far below the peaks reached in 2000, and we should not expect that they would be returning to those levels anytime soon. It must be kept in mind that it was the 1998 to 2000 period that was the economic anomaly in the tech industry, not the present. It was this period of excessive exuberance that pushed the US into the recent recession in the first place by creating an investment-without-profits bubble that inevitably collapsed. In short, while a currently popular bumper sticker in the Bay Area reads “Please God, let there be another bubble!”, I wouldn’t bet the house that investors would be inclined to go along with that sentiment.

Another issue that has gained considerable press recently has to do with outsourcing in the industry. The issue is real—there is more than a little anecdotal evidence that many companies have found it more affordable to send rote tasks to offshore programming operations, particularly in India.³ Such claims have caused politicians to start to talk about maintaining jobs here in the US through subsidies or other such policy tools. Yet before we hold India up as the great destroyer of American jobs, a bit of perspective is needed.

First, let’s recognize that outsourcing in Silicon Valley is nothing new. Indeed, you might even call it something of a tradition. It is a natural process in the life cycle of any product that as certain tasks within the production process become more standardized they are moved offshore to places where labor costs are lower. There are few industries that have experienced the rapid product cycles that the computer industry has, and portions of the business have always been moving away. Memory chips, CD-ROM drives and the PC itself all represent examples of this process. It happens on the service side of the industry as well. For example, technicians in the Philippines may answer calls made to Dell Computer’s telephone help lines.

Despite all these changes the industry continued to thrive in the region. The reason is that outsourcing strengthens a high-tech industry like information technology, rather than weakens it. By reducing the cost of producing a product—through outsourcing or through the equivalent process of technological advances in the production process⁴—a company increases its profit margin, increases the total number of units sold and the business expands. In short, jobs lost on one end of the production process are made up for on the other end because of increased efficiency—and often the new jobs are better paying.⁵

This is not to say that outsourcing has not had any impact on the US economy. There has been a secular decline in manufacturing employment, especially on the production end, for over two decades. This is happening in part because of outsourcing, and also because of rapid laborsaving technological change.

³ Of course not all job losses in California manufacturing are due to outsourcing. Quite a few of the losses are also due to rapid productivity gains in manufacturing. Information technology and computerization has allowed modern manufacturing firms to create more with fewer people. Even without outsourcing and trade, it is highly likely that productivity gains alone would have caused a decline in manufacturing employment.

⁴ Let’s alter the outsourcing story somewhat. Imagine that a genius computer programmer developed a new algorithm that actually wrote other simple programs and thus reduced the need for programmers to produce much of the simple code work that they now do. This would be equivalent to the outsourcing that now takes place—yet you would be hard pressed to find policy makers who would want to pass laws that would pay firms to not use this new technology.

⁵ The argument that would be made here is that Indian firms are absorbing jobs at every level of the production process. But of course, this isn’t true, nor is it likely to be true for many years. Most of the high end design decisions need to be made close to buyers—in short, in the tech hungry 1st world. Furthermore the United States remains the primary center for IT research and development, and again business wrapped around newly developed products will have to be based here. While India has many potential programmers, the time delays, the lack of an efficient legal system, corruption and the overall infrastructural difficulties of running a business there will prevent it from becoming an area that will foster extensive innovation in the IT industry for many years.

Why has this recently become an issue? It is not because the process of outsourcing has sped up, nor that technological development has slowed down. Nor is the timing an accident. Now that the tech collapse is over, many people with highly honed technology skills are wondering why they have yet to find employment comparable to what they were enjoying in the late nineties. It is natural for these people to look overseas and find blame there. But in reality the problems started right here.

The late nineties period was a bubble in every sense of the word—investment in the industry, capitalization rates in the equity markets, and the level of employment and wages in the sector were all highly out of alignment with the true potential of the industry to produce profits. The industry has returned to a more realistic level, and while it will survive and prosper it will not return to the heady days of a couple years ago. While the economic hemorrhaging has stopped in San Jose and San Francisco as a result of the slow return of tech investment both here and abroad, a significant amount of rebuilding will need to take place in local industries other than information technology before solid economic growth will return. Meanwhile, many workers who had found profitable employment in the industry during the boom years may have to look elsewhere.

CALIFORNIA: Poor and getting poorer

Not surprisingly, California's economy is still in a slump. Like the US overall, non-farm employment declined through the first two quarters of the year, but the total job loss was over 1%, considerably higher than the losses in the US overall. The patterns of weakness within the state have shifted somewhat, spreading throughout the State. San Jose and San Francisco both continued to lose jobs, but at a slower pace than before. However formerly expanding payroll employment bases in San Diego, the East Bay, Sacramento, and Orange County have all seen negative growth rates in the past few months. The ongoing weakness in the US economy overall, and the budget situation are in part to blame for this problem. Workers' compensation issues and higher energy prices may also be playing a role, but disentangling the various effects is nearly impossible.

However, the overall changes in employment in the state may not be as bad as they look. As in the US overall, household employment and payroll employment have been moving in opposite directions. In California, however, the difference is much larger and growing rapidly. The informal sector in the State has grown by 25% over the past year, and currently over 10% of the State's workforce is not counted in the payroll statistics, well over 1.6 million jobs. Over half of these jobs are in the greater Los Angeles region, with the balance occurring in the agricultural communities. The Bay Area has very few, proportionally. These jobs are not all agricultural and domestic—surprisingly, over 20% of these jobs are in manufacturing. Many of these workers are likely to be classified as 'independent contractors' enabling firms to avoid paying costly workers' compensation premiums as well as other benefits. Some workers may also be illegal. In any case, it is certainly true that the State is losing a considerable portion of payroll tax revenues as a result of this problem.

California Regional Employment (SA)

	Changes		
	Total as of Jun-03	Jun-02 to Dec-02	Dec-02 to Jun-03
Payroll Employment			
California	14,722,000	0.2%	-1.1%
San Francisco	973,000	-1.5%	-0.6%
San Jose	870,000	-2.5%	-2.4%
Sacramento	749,000	0.3%	-0.2%
East Bay	1,044,000	0.5%	-0.5%
Los Angeles	4,014,000	-0.4%	-0.4%
Orange County	1,408,000	0.5%	-0.6%
Riverside - SB	1,087,000	0.5%	0.0%
San Diego	1,238,000	0.0%	-0.3%
Household Employment			
California	16,415,000	0.9%	0.3%

Source: California EDD

The UCLA Anderson Forecast predicts an end to the state economy's downturn in the last quarter of 2003, with a resumption of employment growth. By that time, the national economy, still having its own problems with sustained recovery (and California is one of those problems) should have enough regional strength outside of the West Coast to pull California into a modest recovery. Growth of payroll employment will gradually improve to a gain of 2% in 2004. The improvement will be based on a rebound

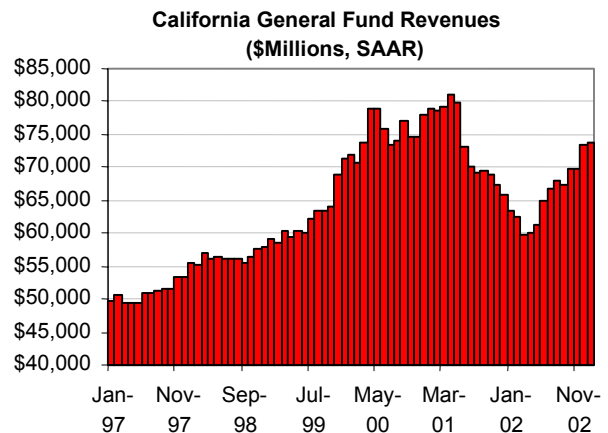
in global purchases of California output, including entertainment goods and services, tourism services, information technology equipment and software, and defense goods. The state's unemployment rate, currently at 6.7%, will remain stubbornly high, averaging 6.7% in 2003 and 6.5% in 2004. This will be significantly higher than the national jobless rate in both years. Although this forecast projects an improvement in California high-tech manufacturing later this year and in 2004, the gains in jobs will be muted by the relentless efforts of manufacturers, in technology goods and elsewhere, to improve profit margins. High-cost operations in California will generally not be favored in expansion decisions.

In addition to cost issues, the state government's large deficit position and its uncertain resolution are also obstacles to the predicted expansion. The budget cure measures announced in the Governor's May revision have a multi-year trajectory, acknowledging that a "quick fix" on the expenditure side of the budget is neither likely nor desirable, and improvement in revenues will take time, even with higher taxes. So many options for budget remediation are currently on the table that it is difficult to predict a final package for the coming fiscal year. What is certain is that the budget problem is not going away soon.

As soft as the economy currently is, it is not the primary reason for the fiscal problems in the State. What most people might find surprising is that the State's revenue situation isn't all that bad. In fact according to the numbers collected by the State's Department of Finance, the stream of cash currently flowing into the coffers in Sacramento is above the level it was four years ago.⁶

The budget gap problem in the State is instead an expenditure issue. In 2000 and 2001 there was an enormous increase in State income tax revenues due to stock options and capital gains, generated in turn by the bubble in the equity markets. It was the State revenue streams in these years that were anomalous, not the current level of revenue. And despite all the warning signs that these revenues were at best short term, Sacramento quickly increased spending to match their newfound prosperity. The problem was that most of these spending increases were permanent—such as the hiring of new employees, increasing pay and benefits for current employees and expanding the services provided by many of the State's social programs. The income streams that generated such heady plans have since disappeared, but the new obligations remain. This is where our problem lies.

What many are failing to realize is that the oft cited \$38 billion shortfall is an estimate of the revenue shortfall only from January 2003 through the end of fiscal year 2003-04. It would be a mistake to think that our budgetary difficulties will be over at the end of this fiscal year. State revenues will not be returning to their former levels anytime soon, and expenditures will not be dropping without substantial changes in the current level of services being provided. Regardless of your views on the merits of social programs, the fact is that the spending plans put into place in Sacramento in the boom years of 2000 and 2001 have created a much larger gap between expenditures and revenues than the \$38 billion figure recognizes. To put this in perspective, if State revenues grow at the historical pace of 7% per year from their current levels, and State spending grows at a very modest 3% per year—barely covering the cost of inflation—the budget gap would not be closed until 2009, and the State would have wracked up something along the lines of \$130 billion in debt.



Source: California Department of Finance

⁶ It should be noted that there is no link between the current budget problems in Sacramento and the energy crisis that gripped the State just a short time ago. When the major utility firms were on the verge of becoming financially insolvent, the State stepped in to become the buyer of last resort for California energy consumers. They did so with the understanding that all expenses incurred would be reimbursed through higher electricity rates charged to consumers in the future, not from general or special fund tax revenues. Or in other words, the \$12 billion or so the State ended up spending has already been covered through higher taxes—on our utility bills. It plays no part in the oft cited \$38 billion budget deficit the State is now facing.

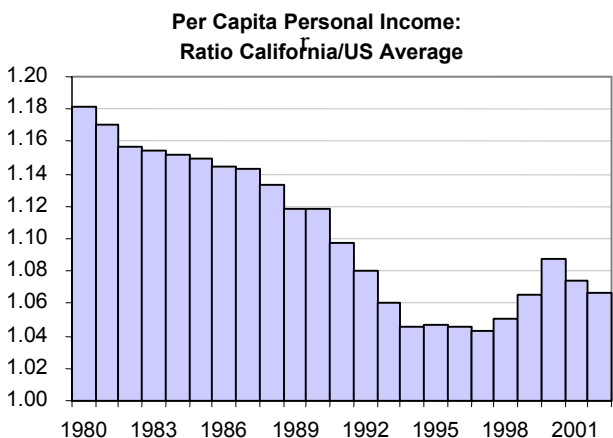
It's time for California to realize that the revenue gap currently in place is permanent, and can only be fixed through increased taxes or decreased spending. Short-term fix-it plans and one-time funding sources will simply not do the trick.

We are often asked to comment upon the economic impact on California of proposed expenditure cuts and tax increases. Estimates of the likely impact range from "none" (i.e., it is hard to find any impact on employment of past tax increases) to "substantial", meaning possibly in the hundreds of thousands of jobs. A mid-range estimate for the next year would assess the likely impact, for the fiscal year of 2003-2004, at about 50,000 state and local government jobs. From a current employment level of about 2.2 million in California state and local government, total employment by mid-2004 is likely to be about 10,000 fewer. In a normal year, however, growth in state and local government would probably be 2%, or at least 40,000. Thus the shortfall is closer to 50,000 than 10,000.

The full extent of California's substandard performance has been revealed by the state Board of Equalization's figures on taxable sales. Roughly equivalent to the national data on retail consumer spending (with some wholesale components mixed in), the taxable sales data have shown no increase in two years. The absolute decline in sales in 2002 was the first decline in this indicator since 1993, and was entirely a product of the severe slump in the Bay Area. With some indication that the Bay Area economy is stabilizing, taxable sales will resume growth at a modest rate of 2.1% in 2003, and will improve to a 5.0% rise in 2004.

Most economic reports for California during the year to date have failed to confirm that the economy has resumed growth in jobs, real income, or retail sales. A major exception to the pattern of weakness has been the continued boom of the residential real estate market, where a chronic shortage of new housing, not alleviated by the highest level of new home building in more than a decade, has produced statewide median home price appreciation of more than 50% over the last three years.

One consequence of California's extended economic difficulties, centered as they have been in relatively high-paid technology industries, has been a significant decline in the state's per capita income.⁷ As recently as the mid-1980s, California per capita income was 15% higher than the national average. By the early '90s, the loss of high-paying aerospace jobs following the end of the cold war had lowered California's edge to about 3%. Then came the information technology boom of the late '90s and California opened up a gap of more than 8%. After 2000, the boom turned to bust, and, by the end of 2002, the gap had closed to only 2 percentage points. While there is nothing wrong with being average, there are consequences. The problem with California's increasingly average incomes is their inadequacy to qualify for average home prices and apartment rents, which are more than twice the U.S. averages.



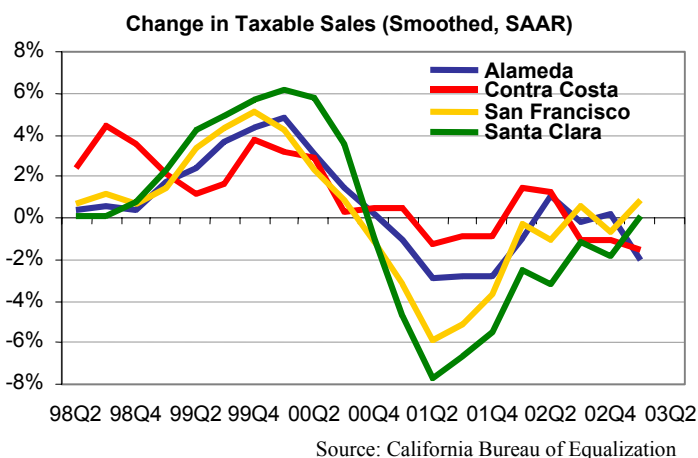
California personal income will be on a gradual growth trend in 2003 and 2004, as employment earnings stabilize and incomes related to financial investments and property ownership improves. The increase in personal income predicted for 2003 is 2.5%, following a gain of only 0.9% in personal income in 2002. Barring any further precipitous shocks to the financial markets, a gain of 4.3% in personal income is forecasted for 2004.

⁷ Immigration has also played a role in falling personal income, as many of these new arrival are unskilled workers from other nations. However, the short turn declines in personal income within the state have been more closely related to short run economic problems.

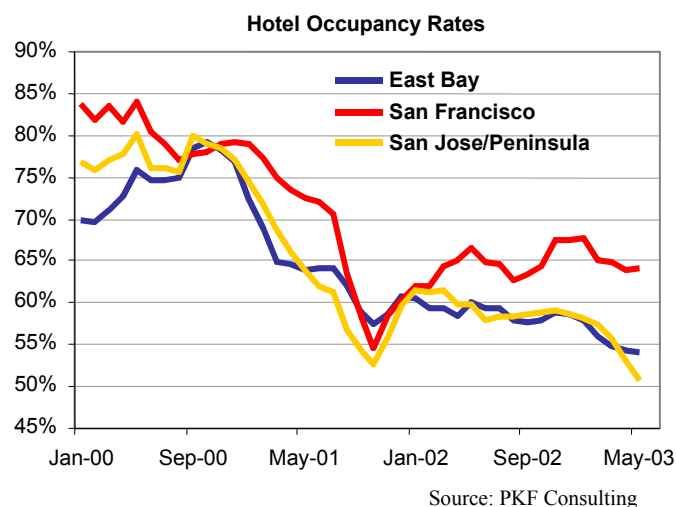
EAST BAY BUSINESS CONDITIONS: Soft

As the weakness in the US economy shifts from technology to a more general economic malaise, the patterns of weakness in the Bay Area have begun to even out. Silicon Valley and San Francisco are still suffering, but are on a positive path. In contrast the relatively strong East Bay has seen some key indicators of business activity in the area begin to fall.

Taxable sales, the best measure of retail activity at the local level, dropped substantially across the Bay Area through 2001. However the rate of decline was substantially lower in the East Bay region as job losses were much smaller than in the two neighboring economies. In 2002 taxable sales in Contra Costa and Alameda actually recovered somewhat, even as San Jose and San Francisco saw a continued contraction. Preliminary results from the last quarter of 2002 and the first quarter of this year show a reversal in this pattern for the first time—the stabilization of the sales in the West and South Bay, while retail activity actually dropped slightly in the East Bay after a strong summer season. In part this is because the East Bay benefited from strong purchases in consumer durables seen in the middle of last year nationally as interest rates continued to fall, where the desperate economic situation in the other two regions precluded a strong consumer reaction to these incentives. Hence we do not think that this pattern represents a new downward trend for the region. However we are not forecasting positive growth for the next few quarters either.

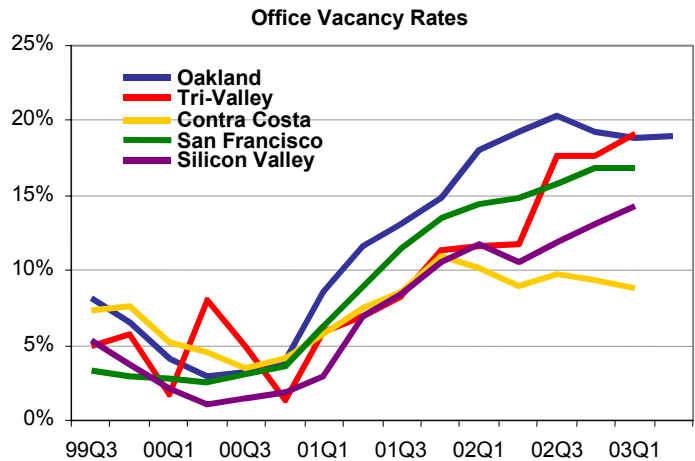


Hotel occupancy is another important indicator of business activity in the region. The return of tourism has benefited this market in San Francisco, as domestic travelers have made up for a decline in international tourism. Yet the numbers for the East Bay and San Jose are less promising. After both regions remained at roughly 60% occupancy rates through 2002, this year has seen a decline from this formerly stable level to 55% for the East Bay and 50% for San Jose. The San Francisco airport area also saw a similar decline. There has been a commensurate drop in room rates as well, nearly 20% this year over last. Most of the weakness in the area is in smaller, less expensive hotels (less than 150 rooms and < \$80 per night), as people upgrade into more comfortable accommodations as a result of the weak market.



Interestingly, while hotels in the East Bay are not doing well, this certainly is not a function of air traffic through the area. As of April of this year Oakland International has had over 4.1 million passengers moving through its terminal, up 14% from the same period in 2002. In contrast San Francisco is down 8% from 9.2 million to 8.4 million, and San Jose has fallen from 3.5 million to 3.2 million, also a decline of 8%. It is clear that Oakland's position as a hub for the high-flying Southwest Airlines is making it the terminal of choice for increasingly cost conscious travelers heading to or from the Bay region. This is good news for the local facilities managers, but the impact on the patterns of local traffic is unclear.

While these markets show soft current demand, better news comes from the commercial and industrial markets. After a freefall in occupancy rates and rents the region is finally starting to see some stability in non-residential space, although it is clear that a recovery is a ways off. Office vacancies in the Oakland and in the Tri-Valley (Dublin, Livermore, Pleasanton, Danville and San Ramon) regions have leveled off at 19%, while in San Francisco it actually fell from 24% to 23%. San Jose saw another increase in vacancy space, but available space⁸ actually fell implying that that market may be a quarter or so away from stabilizing.



Source: Colliers International

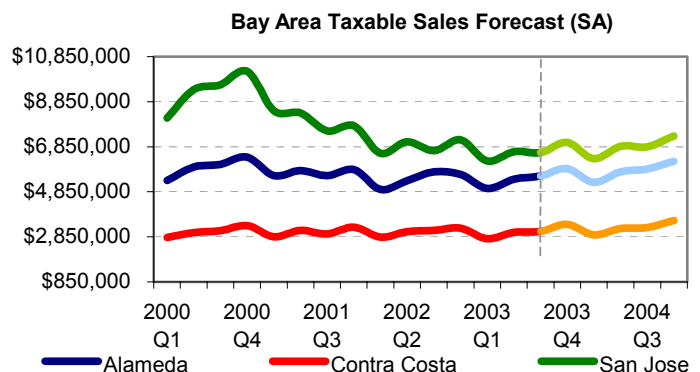
Still, it remains a buyer's market, as rental prices remain at low levels. For example in the Oakland market class A office space currently leases at around \$2.25 per square foot, down from \$4.25 at the peak in 2000. Construction activity across the region has substantially dried up, and it will likely remain that way for a number of years, as the excess inventory will absorb most new demand in the area.

East Bay Office	Total Space	Vacant	Available
ALAMEDA NORTH	1,994,499	26.4%	28.2%
ALAMEDA SOUTH	1,874,896	25.3%	27.5%
BERKELEY DT	1,460,766	11.8%	17.1%
BERKELEY WEST	1,209,837	11.1%	11.1%
EMERYVILLE	4,412,533	21.1%	22.5%
OAKLAND CBD	11,590,746	16.2%	19.0%
OAKLAND GEN	877,357	4.0%	5.3%
OAKLAND JLS	847,833	14.9%	15.9%
OAKLAND OAP	1,910,497	18.2%	18.3%
RICHMOND	1,232,992	22.7%	22.9%
SAN LEANDRO	576,868	10.2%	11.2%
MARKET TOTAL	27,938,824	17.7%	19.8%

Source: CB Richard Ellis

East Bay Industrial	Total Space	Vacant	Available
RICHMOND	12,786,116	10.1%	19.5%
BERKELEY	7,167,430	2.7%	4.4%
EMERYVILLE	4,154,433	11.0%	14.2%
OAKLAND	32,372,607	6.9%	11.3%
ALAMEDA	3,541,253	10.9%	10.9%
SAN LEANDRO	21,943,069	5.7%	11.2%
SAN LORENZO	1,161,099	0.0%	11.4%
HAYWARD	39,954,944	9.5%	13.5%
UNION CITY	13,086,084	9.0%	11.2%
FREMONT	40,220,824	17.3%	18.3%
NEWARK	9,938,028	13.6%	17.0%
MARKET TOTAL	186,325,887	10.2%	13.9%

The outlook for taxable sales in the region matches the outlook for the economy overall—tepid. We expect this year's taxable sales in both Alameda and Contra Costa to be about the same level seen in 2002, with the holiday season being stronger than the last two years but still shy of the peak hit in 2000. For 2004 we expect a mild 4% growth rate.



EAST BAY EMPLOYMENT: Shrinking

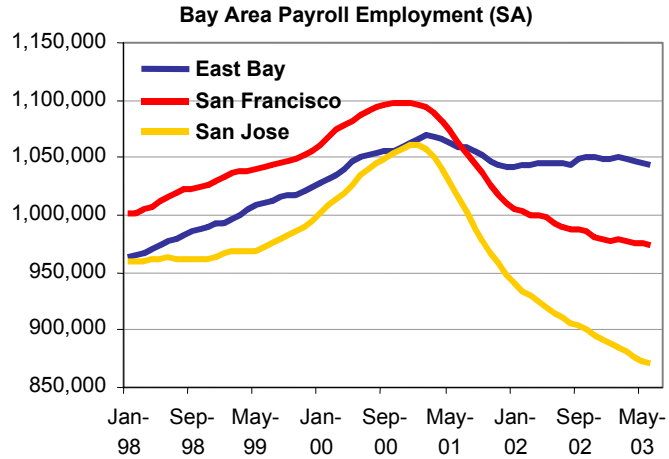
The Bay Area, like most of the US, hit another soft patch over the past quarter. For the East Bay this soft patch represented the first net loss of payroll jobs since 2001. For San Francisco and San Jose it implied

⁸ Available space adds what is currently vacant to what space is under lease but is available for sublet.

a delay in the slowdown of job losses that we had initially forecasted in the last East Bay Quarterly Forecast. San Francisco's employment base dropped to 973,000, while San Jose continued its precipitous drop with payroll numbers falling to 870,000, a level not seen since 1995. Unemployment has leveled off across the region despite the payroll job losses.

In part this is due to an increase in informal jobs in the area, albeit at a much smaller scale than seen in other portions of the state. However the primary and more foreboding reason is the fall in the total labor force as workers in the San Jose and San Francisco areas simply stop their search for employment or move out of the region

altogether. San Francisco has seen its labor contract by nearly a full percent over the past year. San Jose has seen its labor force shrink by 3.5% in the last year and overall it is down 10% from the peak reached in 2000. The East Bay has been the only portion of the area that has experienced a substantial increase in its labor force, although this has distinctly slowed in recent months. The problem with a reduced labor pool is that the prospects for future growth are lowered. It also implies that the local commercial real estate market will have an over-capacity problem for many years, reducing investment and land values.



Source: California EDD

Looking closer at the East Bay, it can be seen that the job losses over the past six months are spread across the entire workforce, rather than being based in any one particular sector. This is important, as substantial losses in one sector could be a sign of long run problems in a region. Instead, given all the uncertainty in the economy right now, the East Bay business community is simply in a 'wait-and-see' mode.

There are no large layoffs occurring, but businesses are holding off on hiring decisions until they have a better idea of what is to come in the rest of 2003. In the production and trade portion of the economy losses in manufacturing have been largely offset by a still strong construction and retail sector, although we expect this pattern to change in the coming year. Jobs in computer and electronic manufacturing have remained

East Bay Payroll Employment by Sector

	June 2003	Share	Change Dec-Jun
Total, All Industries	1,044,000		-5,700
Construction	66,400	6.4%	700
Mfg: Computer and Electronics	23,100	2.2%	0
Mfg: Other Durable Goods	38,100	3.6%	-1,400
Mfg: Nondurable Goods	37,300	3.6%	-600
Wholesale Trade	51,400	4.9%	-1,000
Retail Trade	111,300	10.7%	1,600
Transportation	35,900	3.4%	0
Information	33,200	3.2%	-800
Finance and Insurance	42,700	4.1%	500
Real Estate and Leasing	18,300	1.8%	-200
Professional and Technical	69,100	6.6%	-400
Management of Companies	24,900	2.4%	200
Administrative and Support	56,900	5.5%	700
Educational Services	17,500	1.7%	400
Health Care and Social	108,400	10.4%	1,100
Entertainment, Recreation	15,000	1.4%	-800
Accommodation and Food	65,400	6.3%	-1,000
Other Services	37,700	3.6%	-1,100
Federal Government	18,300	1.8%	-200
State and Local Govt Edu	86,200	8.3%	-3,000
Other State and Local Govt	77,700	7.4%	-1,700

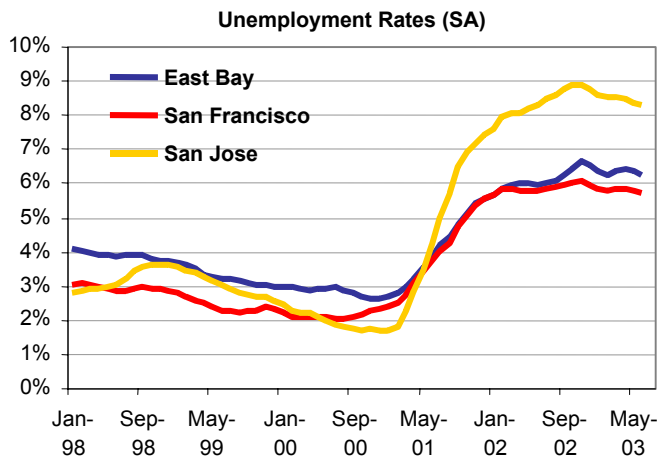
Source: EDD (Seasonally Adjusted)

flat, reflecting the slow tech turnaround. However 1,400 jobs were lost in other durable goods manufacturing sectors. Wholesale trade jobs also showed weakness with a loss of 1,000 jobs. These jobs are often closely linked to manufacturing and business activity throughout the region. Retail, which

employs over 10% of the workforce, added 1,600 jobs, but the patterns within this sector reflect weakening consumer durable sales—employment in auto and furniture and other consumer durables fell while it increased in non-durable retail goods such a clothing, food and sporting goods. Transportation employment stayed flat, with small losses in air transport being offset by gains in other sectors.

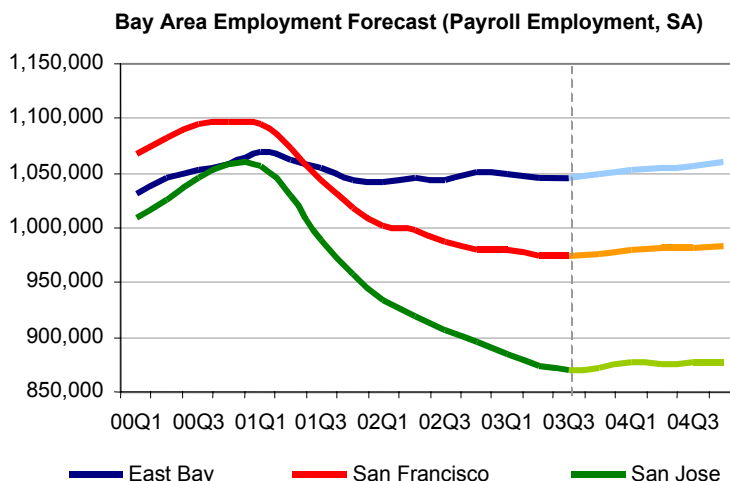
In the service portion of the economy results were again mixed. Finance, healthcare, administrative services and private educational services all saw some small increases. Accommodations, recreation, professional and technical services and other services saw job losses.

The largest weakness in the local economy is clearly state and local government employment. The East Bay saw a loss of 5700 public sector jobs over the past 6 months, and given the budget issues in Sacramento, look for this sector to show continued weakness into the near future. Of the 150,000 plus jobs in this sector, nearly 15,000 of these jobs have been created in the last two years. All these positions are potentially threatened.



Source: California EDD

The slowing of the US economy over the past few months as well as the ongoing budgetary problems in Sacramento have caused the Forecast to downgrade its outlook for the Bay Area. As a result of the weak employment situation in San Jose and San Francisco we see East Bay employment leveling off in the third quarter of this year but adding back some jobs by the end of the year. We see the East Bay adding a mild 1% to its payroll labor force in 2004, with total employment hitting 1.06 million in the fourth quarter. Employment will continue to fall in San Jose until the fourth quarter with job growth remaining flat in 2004. San Francisco will not be back to a million jobs by the end of 2004.

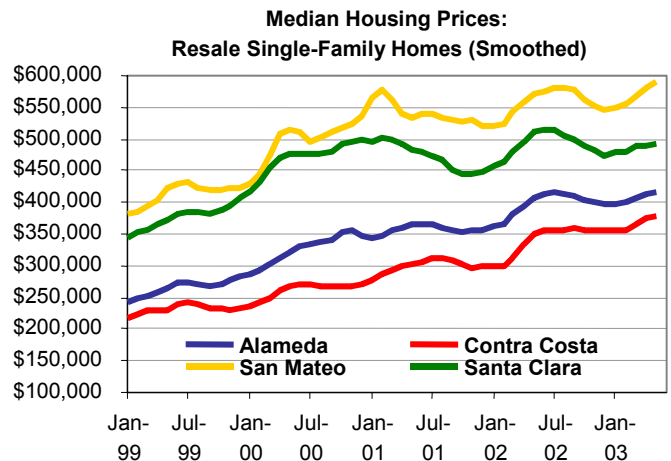


Source: California EDD/Anderson Forecast

RESIDENTIAL REAL ESTATE: Ready to lose steam?

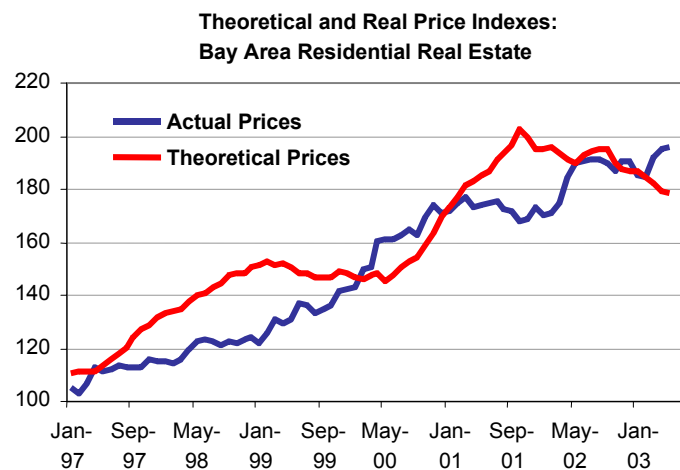
The real estate market in the Bay Area has continued its up and down pattern of the past three years. The market softened considerably at the beginning of the 2001 downturn throughout the region, but particularly so in San Jose and San Francisco. However the historically tight housing market combined with record low mortgage rates created a new surge in prices in early 2002, surprising many economists who expected a dramatic crash in prices in the area as the full extent of the tech bust revealed itself. The market has continued to follow an up and down pattern since then. The last few months have see another flattening in prices. San Mateo saw median prices rise to almost \$600,000 before the market softened. Prices in Santa Clara have leveled off below \$500,000. Prices in Alameda Have again reached the peak set in 2002 at \$425,000. Contra Costa continues to catch up to its relatively more affluent neighbor, and the median price of houses sold there hit a new high of \$375,000 over the past few months.

The question on everyone's minds is whether real estate in the region is in a bubble and whether we can expect a crash in prices in the near future. To answer this question we first have to understand that houses, like all assets, have a fundamental price. This price is equal to the expected present value of the future revenue streams that are attached to that asset. In non-financial babble terms, this implies that today's property values are a function of the rent that the property would currently earn if on the rental market, the growth rate of these implied rents in the future, and the discount rate which is in turn a function of mortgage rates. There are some other adjustments that would need to be made due to taxes, depreciation and market risk, but in general these effects are relatively constant over time and therefore have little impact on short run price movements.



Source: DataQuick

Using this concept, we can create a measure of the 'theoretical' price a property should receive as a function of rental growth rates and mortgage rates. Of course this is at best an estimate, since we are using simplistic methods to create the market's expectation of future rental growth. Still, this is a better metric than having none at all. This theoretical price can then be compared to actual price changes, and if they move together this is evidence that prices are indeed supported by the fundamentals. This is shown in the lower figure.



Data Smoothed, Source: DataQuick

In fact while prices for real estate assets in the region have been rising at a record pace, it must also be realized that the two major drivers of asset values have also been changing at record paces. Aggressive Fed action has created mortgage rates lower than they have been at any time since the early 1960's. And while the Internet rush of the late nineties caused an enormous surge in new non-residential construction across the region, oddly this did not transfer over into the residential sector. With the exception of Contra Costa County, the number of new residential units built in the 6-County Bay region actually fell from 1997 through 2001. As a result, rental growth rates shot up sharply and have been growing despite that economic slump in the region. To put this in some perspective, the Southern California economy experienced a similar increase in prices in the late eighties. This, however, occurred without rising rental growth rates—the building boom was creating new units faster than households were moving to the region—and in a period of time when mortgage rates were steady. In short, that was a true asset bubble.

In 2001 rents continued to rise and mortgage rates continued to fall. This drove theoretical prices up, but the market flattened. Likely this is a function of the simple measure of expectations I use compared to actual expectations in the market differing during this difficult period in the local economy. But pent up demand and mortgage rates that continued to fall maintained the market, and prices began to rise again when it became apparent that property prices were not going to deflate. Since then, however, rental prices have definitely started to soften due to the movement of many people out of the area, but mortgage rates have remained a primary driver of appreciation since 2001.

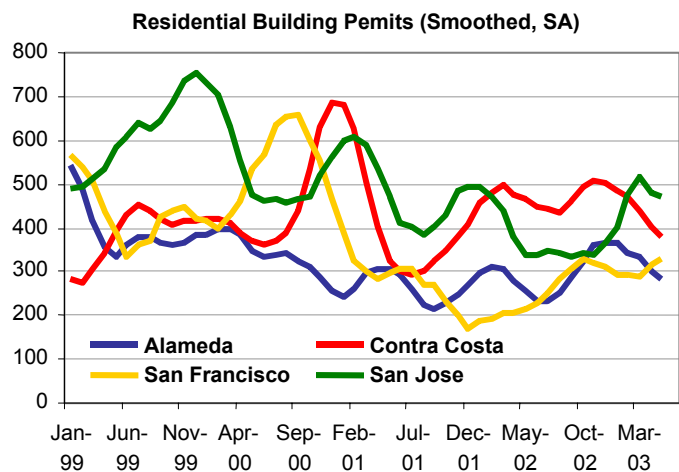
Prices	Resale Houses			Resale Condos			New Houses		
	May-02	May-03	Change	May-02	May-03	Change	May-02	May-03	Change
Alameda	\$410	\$415	1.2%	\$315	\$325	3.3%	\$486	\$500	2.9%
Contra Costa	\$358	\$380	6.1%	\$252	\$275	9.1%	\$401	\$460	14.9%
Marin	\$665	\$655	-1.5%	\$380	\$409	7.6%	\$899	\$701	-22.1%
Napa	\$342	\$412	20.5%	\$258	\$302	17.1%	\$391	\$493	26.1%
San Francisco	\$600	\$585	-2.5%	\$494	\$520	5.3%	\$629	\$502	-20.2%
San Mateo	\$574	\$599	4.4%	\$370	\$372	0.5%	\$571	\$682	19.5%
Santa Clara	\$511	\$491	-3.9%	\$333	\$342	2.9%	\$480	\$574	19.6%
Solano	\$255	\$290	13.7%	\$150	\$191	27.3%	\$359	\$406	13.0%
Sonoma	\$359	\$390	8.6%	\$223	\$260	16.6%	\$371	\$387	4.3%
Bay Area	\$439	\$446	1.6%	\$321	\$333	3.7%	\$438	\$484	10.5%

Sales	Resale Houses			Resale Condos			New Houses		
	May-02	May-03	Change	May-02	May-03	Change	May-02	May-03	Change
Alameda	1,573	1,564	-0.6%	552	511	-7.4%	135	189	40.0%
Contra Costa	1,512	1,460	-3.4%	406	369	-9.1%	314	364	15.9%
Marin	326	294	-9.8%	129	103	-20.2%	5	15	200.0%
Napa	119	134	12.6%	28	21	-25.0%	61	45	-26.2%
San Francisco	384	348	-9.4%	202	151	-25.2%	76	91	19.7%
San Mateo	753	668	-11.3%	201	186	-7.5%	26	15	-42.3%
Santa Clara	1,742	1,662	-4.6%	689	539	-21.8%	128	146	14.1%
Solano	667	626	-6.1%	76	72	-5.3%	163	143	-12.3%
Sonoma	746	668	-10.5%	150	169	12.7%	75	50	-33.3%
Bay Area	7,822	7,424	-5.1%	2433	2121	-12.8%	983	1,058	7.6%

Source: DataQuick

Does this imply that there is no downside risk? There is. What mortgage rates giveth, so they can taketh away. Current mortgage rates are likely to be unsustainable in the future. Indeed, the recent speech by Greenspan caused 10-year bond prices to fall, and this is one of the leading indicators of mortgage rates. If these prices remain low, look for mortgage rates to rise in the near future, and property prices to flatten or even decline. If rates rise sharply this could be the start of a major crisis in the sector. For those who bought at high prices, the situation will not be bad—the low interest rates on the debt offset the higher price. But if families move and *need* to sell, they will need to absorb significant capital losses since the property prices will be much lower. This capital gains problem will cause market liquidity to fall substantially, and tend to disrupt the natural movement that households make from smaller, inexpensive quarters to those that are nicer. Demand for new units will fall as a result. Indeed it seems as if the market is already anticipating this.

The number of new residential units has fallen in every market in the area over the past few months, with the exception of San Francisco which saw a surge in permits for multifamily housing, likely in part to convert over-capacity in the non-residential market into something that can generate revenues.



Source: DataQuick