East Bay Economic Outlook

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by Christopher Thornberg

Senior Economist

UCLA Anderson Forecast

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Overview and Outlook:

Good news in the Bay Area—growth is back. All the major measures of business activity are up, from taxable sales to hotel occupancy rates to exports through the local customs district. Employment grew over the second quarter in all three major economic regions at a 1.4% annual pace. The East Bay has just about caught up to where it was a year ago. These gains were spread across many industries—including some of those that were the hardest hit in the wake of the 2001 downturn. And as impressive as the payroll numbers were, the household numbers were more so. The region overall added 22,000 household jobs as compared to 11,000 payroll jobs. Unfortunately it is difficult to gauge where these jobs are either by location or by industry. This positive news came on the back of a US economy that continues to perform well. Jobs are being added to the payroll statistics and production continues to rise, and inflation has slowed despite rising energy prices.

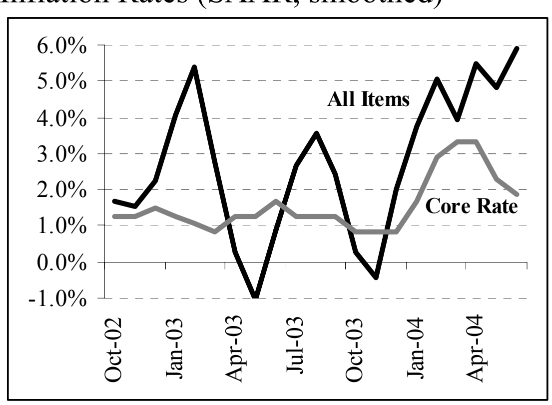
While its definitely looking sunnier on the bright side of the Bay, there are some clouds brewing on the horizon. Real estate prices surged yet again, and have grown at a double digit pace over the past quarter. In a market that was already overvalued, this is a distinctly disturbing trend. The longer this goes on, the harder the landing that will come behind it. And on the national level despite the solid growth over the last couple quarters the economy is not as rosy as some would have us believe. The US as a nation is over consuming. At some point in the future there must be a reckoning. These situations are a forecaster's toughest challenge. The question is not 'if' the economy must go through a substantial rebalancing, but 'when'. And as the saying goes, economists usually get the direction right but the timing wrong. We expect the rest of 2004 to be solid both for the US, the Bay Area and in particular the East Bay. But keep an eye out.

The National Economy: sunny now, but clouds on the horizon

The last few months brought a variety of good and not-so-good news for the US economy. The final GDP numbers recorded a 3.9% growth rate (SAAR)[i] for the first quarter of this year showing that the economic growth surge that started in the second half of 2003 continued into this year. Remember that the 2001 downturn was caused by the investment-profit imbalance that began in the late nineties in the midst of the Internet rush. During this period the nation saw a rapid increase in business spending that drove the economy forward at a breakneck speed, but this spending was not matched by growing business profits, an imbalance that could not last. The resultant collapse in business spending was what drove the economy into the recession. The first quarter numbers also indicated that business spending remained strong and corporate profits continued to rise; this imbalance is firmly removed from the system.

The corresponding wage-productivity imbalance (discussed in the previous EDAB quarterly report) within the US labor markets has also worked its way out of the system over the past few months and job growth finally started to pick up steam in February—doubtless much to the relief of the current regime in Washington DC. The US has added 1.3 million jobs since this past December, and many of these jobs are 'good' jobs—i.e., employment in traditionally high-income sectors. One nice side effect of this trend is the decline in the number of stories in the press regarding the negative consequences of outsourcing. Despite the fact that there is very little non-anecdotal evidence to support the hypothesis that outsourcing was responsible for the stagnant job growth in the US (and indeed, plenty of anecdotal evidence to the opposite--that foreign outsourcing to the US was creating jobs) the constant harping on the topic may have pushed politicians in Washington or more locally to make what would have been some extremely poor public policy choices.

Inflation Rates (SAAR, smoothed)



In the past two months some additional positive news for the US economy came from the CPI statistics. While rising crude oil prices have continued to push up energy prices, the core rate of inflation has slowed to below 2% (annualized rate). One warning to readers in the previous EDAB quarterly report was to watch inflation as one potential source of trouble for the economy. A rapid increase in prices would have forced the Fed to raise rates rapidly—having a potentially powerful slowing effect on consumer spending. This risk, while certainly not gone, has been reduced substantially. One result of this is that the price of the 10 year t-bill rose, and mortgage rates have actually fallen slightly over the past month even as the Fed raised the funds rates.

Furthermore at the last UCLA Anderson Forecast seminar a number of monetary economists were invited to give their views of the risks of inflation. Surprisingly most gauged the risk as relatively low—see the attached box for details of this argument. Despite aggressive rate action on the part of the Fed, there is not enough liquidity in the system to drive a protracted bout of inflation. The largest risk may lie in the central banks of Japan and China, where reserves of US cash have grown enormous in their nations' efforts to support the value of the dollar against their home currency.

Is Inflation a Threat?
Michael Bazdarich
Senior Economist, UCLA Anderson Forecast

Each time the economy has picked up over the last two decades, various market-watchers have warned of impending accelerations in inflation, so the latest such buzz is nothing new. I believe this present inflation "scare" will turn out to be just as inconsequential and frivolous as its predecessors.

Rising inflation comes when overly expansionary monetary policy pushes aggregate demand growth past the point where the economy's productive capacity (supply side) can't keep up with it. We clearly have not had excessive economic growth over the last four years, and the evidence is just as clear that we have not had overly expansionary Fed policy.

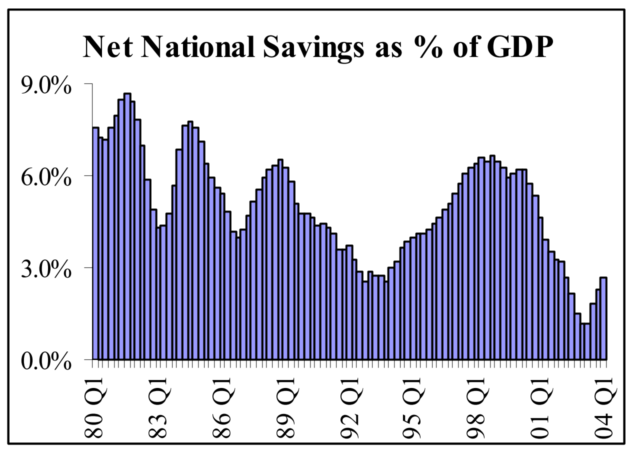
Only in the last twelve months has the U.S. economy begun to truly recover from the slump of 2000-2002. Levels of payroll employment, industrial production, and even factory orders are all lower now than they were in 2000 (when inflation pressures were nonexistent). When it comes to estimating capacity and excess capacity, one can always quibble with the Fed's numbers. However, when output LEVELS across the economy are lower now than they were four years ago, it is clear that there is substantial excess capacity in the economy, which precludes the risk of sustained accelerations in inflation.

Meanwhile, while short-term interest rates are somewhat below historical norms, the impact of Fed policy is best gauged via growth in the money stock. Money growth did accelerate in 2001, when the Fed was virulently fighting recession. However, it has been decelerating steadily ever since then. The M2 money stock grew only 4.6% for all of 2003, which is consistent with economic growth of about 1%. The M1 and M3 aggregates are growing similarly. As the Fed raises short-term interest rates over the next year, that will keep money growth under restraint, and ditto for inflation.

Yes, commodity prices have risen in the past year. They typically do in the early stages of an expansion, after having fallen during the recession. The recession declines do not drive DEFLATION, and the early-expansion rebounds do not drive inflation. Inflation is a macro phenomenon, driven by conditions across the economy, not by cost pressures in any one sector. Current macro conditions argue against a serious inflation risk at present

If this liquidity is reintroduced into the US at a rapid pace, this story may change quickly. So—it's still worth keeping an eye on the numbers here.

Industrial production also continues to rise in the US, and has recently surpassed the previous peak reached in 2000, just prior to the start of the economic downturn. New orders continue to rise, and exports to the rest of the world continue to expand. There is little mystery as to why the consumer confidence numbers continue to rise in the US. Yet while growth has been strong, another imbalance that also started during the Internet Rush of the late nineties remains a very serious issue for the economy as we move forward—the consumer-spending imbalance. Declining private savings is not a new issue—savings rates started to fall in the early nineties. However this wasn't a large problem at that time since the government deficit started to reverse itself around the same time as the US economy starting growing strongly. This left total national savings relatively balanced.



Unfortunately these public surpluses quickly disappeared as a result of the 2001 downturn; government budgets at every level have dipped into the red. At the same time we had a unique experience in the history of the nation—consumers continued to buy a record number of goods despite the economic problems the nation has been facing and the decline in wealth that occurred as a result of the stock market crash. In part this was due to the aggressive action by the Fed to reduce rates. While this helped minimize the overall depth and length of the 2001 downturn, it also had the effect of increasing the national savings deficit. The Bush tax cut intensified the problem further as the excess income individuals gained went immediately towards more consumption—reducing national savings even more. Net national savings (savings minus the depreciation of the existing capital stock) fell to an all time low level of 1% of GDP, and still remains at near these record low levels.

This conversation may seem contrary to much public discussion on consumer spending. Conventional wisdom is that growing consumer spending is good for the economy, not bad. In one sense this is correct. Most recessions in the US are led by declines in consumer spending, and hence this number has become a bellwether for the economy. Yet this correlation dangerously confuses cause and effect when we take the next step in the chain of logic to claim that consumer spending is always 'good' for the economy. Declining consumer spending is typically indicative of problems elsewhere in the economy -- rising oil prices, a collapsing housing market or something of that nature. Spending does not simply decline on its own thus causing a recession. And while consumer spending can help stabilize an economy in such turbulent times (hence the use of fiscal and monetary policy during recessions), consumption for a nation—as with an individual—has to stay within a sustainable range in the long run.

US Expenditures by Sector

	Q1 04	*Avg. **
Personal consumption	70.3%	62.7%
Durable goods	8.4%	8.4%
Nondurable goods	20.3%	26.9%
Services	41.6%	27.3%
Gross private investment	15.9%	15.9%
Nonresidential	10.3%	10.4%
Residential	5.4%	4.8%
Change in inventories	0.2%	0.8%
Net exports	-4.7%	0.0%
Exports	10.0%	6.3%
Imports	14.7%	6.3%
Government consumption	18.5%	21.4%
Federal	7.0%	11.3%
State and local	11.5%	10.1%

* This is the average percent of GDP consumed by the various sectors when trade was close to balance

Consumer spending in the US exceeded this long run level in the late nineties, and continued to exceed it right through the downturn. The following table compares spending by sector as a percent of GDP today with the national average during periods of time when the economy had balanced spending with income, when trade was balanced.[ii] Most sectors of the economy are about on par with where they should be—including the government sector.[iii] What is higher than the long run average is spending by private individuals. And not only are American consumers consuming too much (not saving enough) now, but they have built up a considerable amount of debt over the past few years that needs to be paid off.

The symptoms of the problem are clear. The trade deficit remains a substantial 4.7% of overall GDP—an unsustainably high rate. Private debt levels and debt servicing as a percent of income are now both at an all time high despite the record low interest rates we are enjoying.

And the government is running record high deficits in both absolute and relative terms. It is simply a given that consumption in the US, either by private consumers, businesses or the government, has to fall at some point in time in the future to bring our economy back into some sort of equilibrium. If this process occurs slowly, the economy can adapt with hopefully little economic turbulence. But if it happens rapidly we could quickly find ourselves in the midst of yet another recession. The economy is sunny now, but this may be a temporary state of affairs.

Bay Area Business Activity: Dr.—we have a pulse!

By almost any measure business activity has finally begun to pick up the pace in the East Bay and the Bay region overall in 2004. Preliminary estimates for first quarter taxable sales in Alameda and Contra Costa counties show them to be 8% above last year's first quarter, building on gains already registered in the last quarter of '03. They are also up by over 8% year over year in both San Francisco and San Jose—very strong given the fact that they are down by over a quarter from what they were 4 years ago. Airport traffic around the region is up. This is particularly true in Oakland, where traffic is 12% greater than last year at this same period.

Taxable Sales Preliminary Estimates
Adjusted rates, NSA, year-on-year changes

	Q4 03	ch	Q1 04	ch
ALAMEDA	$5,707,439	3.7%	$5,300,097	8.9%
CONTRA COSTA	$3,517,087	9.5%	$3,014,812	7.7%
FRESNO	$2,547,579	6.9%	$2,455,126	12.7%
MARIN	$1,017,515	-1.8%	$931,197	5.6%
NAPA	$497,993	-12.9%	$430,043	-2.0%
SACRAMENTO	$5,015,605	8.2%	$4,611,599	11.6%
SAN FRANCISCO	$3,184,046	2.9%	$2,821,849	8.5%
SAN MATEO	$2,992,150	-0.3%	$2,721,194	2.4%
SANTA CLARA	$7,269,456	3.4%	$6,718,200	9.5%
SONOMA	$1,784,993	1.7%	$1,624,786	8.9%

The value of exports moving through the San Francisco customs district is up by 13% over last year at this time. Hotel occupancy rates are also up across the region, but particularly so in San Francisco--10 percentage points higher than last year at this time. It seems that tourism has returned with a vengeance. Rates in the East Bay, with a much smaller tourist industry, stayed steady at 57%.

Office vacancy rates in all three markets also dipped in the second quarter. For the East Bay and San Jose this was good news given the increase in vacancies in the first quarter. Overall vacancy rates are now at 17% in the East Bay, down from the previous peak, while in San Jose they have moved below 20% again. This is a good trend, but keep in mind that the rates are still very high from a historical perspective. They will have to fall much further before this mouse works its way out of the snake. Don't look for any major surge in construction anytime soon.

As for employment, on this point I have to admit I have been pleasantly surprised over the past quarter. In my previous forecast for the region I downgraded my forecast for the regional employment—predicting instead that levels would remain relatively flat for the coming year. The downward revision to regional employment in 2003, combined with rising benefits costs and our prediction for a slow growing national employment situation all convinced me that the region would continue to lag. Yet in seeming contradiction to these drivers, the last three months saw all three of the major economies gain around 3,500 jobs each—representing an annualized pace of about 1.4% for each region. This is not that fast, but clearly a large improvement over the past few years. For the East Bay this gain erased much of the jobs losses experienced over the last 12 months, but San Jose and San Francisco are still

Employment by Region: Seasonally Adjusted

Payroll

	Jun-04	3-Month Ch		1-Year Ch	
San Francisco	951,200	0.4%	3,600	-0.6%	-5,800
San Jose	845,200	0.4%	3,100	-1.6%	-13,400
East Bay	**1,026,000**	**0.4%**	**3,600**	**-0.2%**	**-2,000**
Sacramento	757,900	-0.3%	-2,200	0.1%	900
Fresno	372,900	-0.5%	-2,000	0.3%	1,300
San Diego	1,266,800	0.5%	5,700	1.2%	15,600
Riverside / SB	1,127,400	0.4%	4,500	1.8%	20,400
Los Angeles	4,011,200	0.2%	10,000	0.4%	16,600
Orange County	1,434,500	0.0%	300	0.2%	3,100
Ventura	304,300	-0.1%	-200	-0.4%	-1,300

Household Employment

	Jun-04	3-Month Ch		1-Year Ch	
San Jose	820,200	1.1%	9,100	0.0%	0
East Bay	**1,202,400**	**1.0%**	**11,800**	**1.4%**	**16,300**
Sacramento	840,200	0.4%	3,600	1.7%	13,900
San Francisco	855,000	0.2%	1,800	0.5%	4,200
Fresno	401,900	-0.2%	-800	1.8%	7,300
Los Angeles	4,514,500	1.1%	50,300	1.0%	45,500
Riverside / SB	1,638,700	0.9%	15,000	3.4%	54,300
San Diego	1,453,000	0.9%	13,200	2.9%	40,500
Orange County	1,536,400	0.5%	7,700	1.7%	25,500
Ventura	412,600	0.3%	1,100	0.9%	3,600

behind from where they were a year ago. There is a long way to go, but the arrow is pointing in the right direction.

These surprising numbers are a result of many things. The national economy grew strongly in the first quarter of this year, tech spending has continued to grow and many businesses found themselves suddenly in need of new workers. This plus strong stock market returns and good profit numbers have encouraged many businesses, especially those in the information technology industry, to start thinking towards the future again. Part of this process includes beginning to build the workforce that will handle future growth. Add to this the growth in housing prices that are keeping homeowners feeling wealthy and you have a recipe for strong job growth, even in the economically hard hit Bay region.

As much as the Payroll numbers brought good news to the Bay Area, the Household number brought even better news, depending on what we are to make of them.[iv] The East Bay has added almost 12,000 household jobs over the past three months, and 16,000 over the past year, accounting for the fall in the unemployment rate. Some of these jobs certainly represent employment for people commuting to San Francisco for work. Yet the Bay Region overall added 22,000 household jobs—double the 11,000 payroll jobs added. Work is being found, but it's not immediately clear where, nor how 'good' it is from an income or benefit perspective.

This trend is not unique to the Bay region. California overall has added 100,000 more household jobs than payroll jobs over the past year—with much of this gain occurring in the past three months. Compare this to the rest of the US where 180,000 more *payroll jobs* were added to the economy than household jobs. Informal employment in California now equals approximately 10% of the regular covered payroll employment. Why such an extreme difference? California's large illegal worker population plays some role certainly, but this does not explain the different trends. It may well be due to the high cost of benefits for workers as mandated by the State. To avoid these expenses many companies may be using sub-contracting forms of employment instead of hiring employees in more formal fashions. Whatever the reason, this remains an ongoing issue for the State. From a social perspective these workers tend not to have the same benefits that covered employees do, putting more strain on the State funded support systems.

From an economic perspective it is unclear where these jobs are forming, how good the income is associated with them, and frankly how much of the income that is being earned is being reported. In a State that relies as heavily on income taxes as California, the loss of an accurate measure of employment and income is definitely problematic.

Looking back again at the payroll gains, these have occurred pretty much across the board. There was no one sector that drove the numbers, just a general rise across the board. This implies that some of the growth occurred in key core sectors as well—good news again. For the East Bay the gains were seen in Wholesale and Retail Trade, Finance and in Professional Services. San Francisco experienced their largest gains in Finance, Professional Services, Information and Health Services. For San Jose the news was particularly good as the gains were seen in Construction, Manufacturing, Wholesale and Retail Trade, and Information. Local Government continues to be one of the weaker sectors in the region, and while jobs in Leisure and Hospitality across the region are on their typical summer surge as indicated by the sharp increase in hotel occupancy rates in some areas, this year is still not as good as previous years.

With this change in the data, I have upgraded my employment forecast somewhat for the

Changes in Employment by Sector, March to June 2004

	East Bay		San Francisco		San Jose	
	Jun-04	Ch	Jun-04	ch	Jun-04	ch
Construction	69,500	-300	42,100	-800	38,100	1,000
Durable Goods	59,300	-300	22,400	300	159,500	1,100
Nondurable Goods	36,800	200	23,600	100	11,700	-200
Wholesale Trade	50,400	800	28,100	200	34,400	700
Retail Trade	108,600	400	94,600	500	81,800	1,000
Transportation	37,100	200	44,800	300	13,500	-200
Information	30,400	100	46,100	600	30,300	600
Finance & Insurance	50,200	700	68,800	1,000	19,900	0
Real Estate and Rental	18,700	100	22,100	0	15,100	-100
Professional Services	67,100	500	97,600	1,000	95,000	-900
Management Companies	23,500	-200	24,200	-800	15,000	0
Administrative Support	53,300	-100	55,600	-400	50,700	600
Educational and Health	118,500	-200	100,500	900	93,600	600
Leisure and Hospitality	80,800	-200	111,900	-600	67,200	-200
Other Services	38,400	300	37,400	100	24,200	-200
Federal Government	17,000	-300	21,800	-200	9,700	-100
State Government	48,200	100	30,200	-100	7,300	-100
Local Government	113,800	-300	75,200	-200	74,300	-800

region. I look for San Francisco and the East Bay to add 3,800 and 4,200 payroll jobs respectively over the second half of the year reflecting what we believe to be a slowdown in payroll job growth in the nation overall. San Jose will add 3,200 jobs. I expect solid growth in 2005 with the East Bay adding 12,500 jobs from Q4 to Q4. San Francisco and San Jose will add 9,000 and 17,000 jobs respectively. The latter figure reflects an economy that will be rebounding. Forecasts for 2006 are even better, but these numbers must be viewed with a large measure of caution, as they do not reflect the very real possibility of another downturn in the economy. One bit of good news on this potentially gloomy future—another downturn, when and if it does arrive, will not be technology based like the past downturn. Therefore the Bay Area will not be at the forefront of the downturn as they were in 2000.

Bay Area Employment Forecast
Payroll Employment, SA

	East Bay	San Francisco	San Jose
04 Q1	1022100	948500	843100
04 Q2	1025900	950800	845300
04 Q3	1028500	953200	847300
04 Q4	1030100	954600	848500
05 Q1	1032100	957100	854200
05 Q2	1036700	961700	861600
05 Q3	1039700	961900	861600
05 Q4	1042500	963700	865400
06 Q1	1045500	964800	867800
06 Q2	1050400	970000	872100
06 Q3	1055100	974400	876700
06 Q4	1060400	979200	881500

The Budget Situation

The big news item of the week is the final agreement in Sacramento on the budget for the current fiscal year. Taxes are not being raised—instead the budget is being balanced through a combination of (supposedly) temporary cuts in spending on education and local government support and borrowing. While in percentage terms these cuts seem small relative to local budgets it must be remembered that a large portion of local spending is fixed by law. The agreed upon cutbacks represents around 10 to 20% of the discretionary budget for counties—a steep drop in support for discretionary programs. While the plan is to provide the same level of support next year, due to rising costs this implies the real amount of services will have to be reduced yet again. Most importantly local governments (counties, cities, and special districts) have been negotiating for relief not today but in the future. Part of this comes by limiting the budget transfer from local governments to education spending from being permanent to being just for the next two years. The loss of the VLF revenues in the future will be made up from local property taxes. Furthermore the local governments have support from the Governor for a bill to be passed that will limit unfunded State mandates to two years. It remains to be seen what will end up in the final budget.

What is important to keep in mind is that the budget situation the State is in right now is structural, not cyclical. Revenues are up against State forecasts right now—but this is due to a downward revision in the forecast in January, not because of a growing California economy. Revenues for the fiscal year 03-04 are lower than were forecasted last year. The reality is that despite the cuts put into place by the Governor over the past 6 months, the State is still running a deficit and this deficit will grow worse in the future as a result of rising program costs, particularly in State health programs.

It isn't surprising why the Governor has such a strong anti-tax stance despite the apparent futility of trying to balance the State budget on the expenditure side of the equation. California is nationally recognized as one of the least business-friendly places to be because of taxes and its excessive regulatory structure. This reputation is not helping the efforts of the State to recover from the 2001 recession, and may be contributing to the large growth of informal employment. When faced with the immovable object of a state bureaucracy the irresistible force of economic activity may simply move around it.

California State and Local Taxes

FY 00-01		
Total Taxes	$5,016	$4,361
% of Income	15.3%	14.6%
By source		
Property Taxes	15.4%	20.7%
Sales Taxes	23.4%	25.0%
Income / Business	27.2%	18.7%
Other	34.0%	35.7%

What might be surprising is that the fact that California is *not* a high tax state—at least from the point of the average payer. In fiscal year 00-01 (the most recent year the data are available) the average person in California paid $5,000 in State and Local taxes and fees, about 15.3% of personal income in the same period. In the rest of the US this amount was $4,360 or about 14.6% of personal income. In short California is about average when it comes to spending.

If California taxes are about the same as the rest of the US as a share of income, why do we have such a reputation for being a high-tax state? The answer comes from *how* the State raises taxes, not how much. As a result of Prop 13 the State cannot raise additional revenues from property taxes. As a result, the State has come to rely more and more on income and business taxes. Remember that property taxes are effectively a tax on *wealth*, while income and business taxes are a tax on *effort*. Hence property taxes are not as economically distorting (or as business unfriendly) as business taxes. Additional taxes on wealth are spread across the entire population, and land largely on those who have the greatest wealth. Income taxes are lumped largely on the most currently productive members of an economy. Furthermore income taxes are simply easier to avoid due to the larger number of loopholes in the system.

Of course on top of this even within the categories, California creates extremely business unfriendly taxation patterns. It has a very progressive income tax system, levying some of the highest rates on high-income earners in the nation. While the social goals of such a plan are understandable, it nevertheless puts the State in a difficult position when trying to attract new businesses particular in high-income industries and entrepreneurs who might want to start new businesses in the State. California has many natural advantages such as location on the West Coast, climate, a great higher education system and so on. Yet these can only be leveraged to a point—and California seems destined to find that point.

But what is truly surprising is the inherent contradiction between the two tax systems. While the income tax system is very progressive, the property tax system is remarkably *regressive*. A plan that limits property tax growth for those who have owned property for many years creates gross social inequities—two neighbors in the same neighborhood receiving many of the same social benefits will nonetheless be paying vastly different sums into the system simply as a matter of when their residences were purchased. Proposition 13 levies the largest taxes on those who typically have the least amount of equity in their residence—i.e. new buyers. Last one in close the gate.

Besides the inequity, consider it from another perspective—as a percent of wealth. Consider a situation where two families live next door to each other in a prosperous neighborhood with a median housing price of $600,000. The first family recently purchased their property and have, say, 15% equity in their property ($90,000). When levied with the 1.5%

taxation rate ($9,000) this implies a tax on their wealth of 10% per year. The other family has been living in their residence for 20 years, and their home is mostly paid off. Of course this same family has enjoyed massive amounts of appreciation in the process—they paid probably one-third the current price or less. Yet this family is taxed at the original rate plus 2% per year. This would add up to about $3,000 per year, a tax rate of .5% on wealth. To sum up, the family with $90,000 in equity wealth pays a rate of 10% while the family with $600,000 in equity wealth pays approximately .5%--1 / 20th the rate of the younger, less well-off family. It is hard to understand how a State with such distinct social goals can justify such a system that levies so much of the burden on those least able to afford it. California government is currently worried about the low rate of home ownership. It strikes me that there is one very obvious, very good way to help raise ownership rates in the State sitting right in front of us.

There are typically two responses to this criticism of Proposition 13. The first is that retired individuals who are on fixed incomes would not be able to deal with increased tax rates as a result of the appreciation seen in the real estate markets. This ignores the fact that those who enjoy the protection of proposition 13 are also those who have the greatest wealth in their house! Remember that we save while we are earning income to support ourselves in later years—when we are retired we are supposed to be drawing on our wealth to pay our expenses. When housing prices appreciate this implies a real increase in the wealth of the individual owner in question. Since the State taxes at a rate of 1.5% percent, this increase in wealth alone would allow the homeowner to pay the increased taxes for 66 years. And there are a myriad of financial instruments out there that allow owners to pull equity out of their house in order to pay for ongoing expenses—both personal as well as social. Of course this reduces the wealth of the individual in question, but again this is why we invest in the first place—to help us pay our expenses after we retire.

The second is that Prop 13 was put into place for very good reasons—to control a State government that was fiscally out of control. As a relative newcomer to the State (I arrived in California in 1991 as a new graduate student) I hear quite often that I 'don't know how it was then'. This may be the reason Proposition 13 was passed, but judging by the experience of the late nineties it actually did very little to control State spending. Furthermore, the shift of the

State's revenue system to business unfriendly income taxes is as serious a threat —if not a more serious threat — to the long run health of the economy as what was happening in the 70's. Finally, even if the motivations behind Prop 13 were good, the way it was designed was extremely poor; it is both horribly inequitable and regressive as already pointed out. It places the burden of property taxes on those who can least afford it -- new families trying to make their futures in California. In short California's tax system puts the burden of public funding on those people who represent the economic future of the State.

The State of California is in need of some serious cash infusions. Our infrastructure is slowly sinking under the weight of the expanding population. Our schools are under-funded given the challenges faced in a region that has so many new immigrants, despite the large increase in spending seen in the late nineties. Of course this is not to take away from the criticisms leveled at the waste and lack of controls in so many areas of the State funding and compensation systems. But reform is a long-term process and the fiscal needs of the State are short term. While the Governor is doing a good job tackling the immediate problems of the State, we clearly need to have an overhaul of the taxation system to put California back on the growth path it once was.

Real Estate: Now that's a fire!

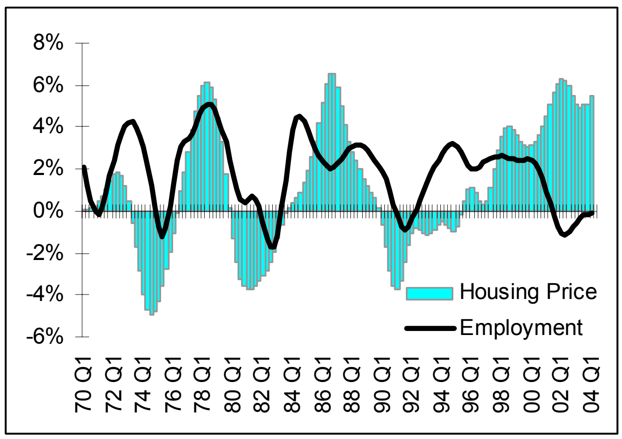
There is another area reflecting the peculiar economic circumstance the US currently finds itself in — the real estate markets. Prices across the Country, along with overall market activity, continue their extremely strong pace even as new homes are being put up at a record pace. California, of course, has been on the forefront of this rapid appreciation. The brief slowdown in price appreciation in the Bay Area that occurred at the beginning of the year has quickly reversed itself and Contra Costa and Alameda both saw amazingly rapid double digit increases in prices over the past quarter. Prices are up across the Bay Area, and even economically hard hit Santa Clara has seen prices rise by 13% since last year after prices had remained relatively flat over the previous two years. Total sales in the region are up over 10,000 units per month, greater even than during the Internet rush period. Building also continues its surge, as permits everywhere in the State continue to grow.

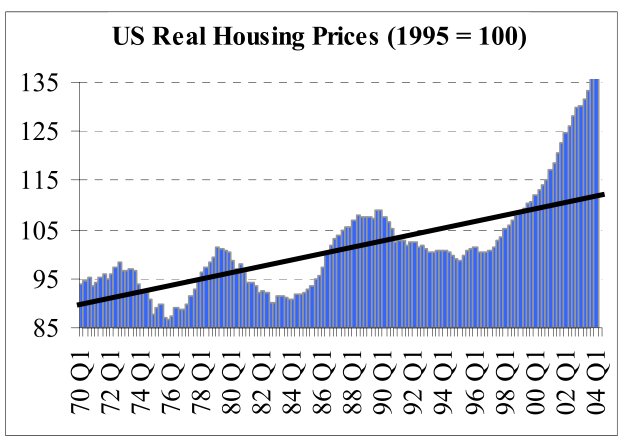
Median Home Prices: California

	Jun-04	1-Year	3-Month
Alameda	$489,000	15.3%	11.6%
Contra Costa	$458,000	19.3%	10.9%
Marin	$690,000	8.5%	2.7%
San Francisco	$653,000	16.0%	9.7%
San Mateo	$646,000	13.9%	10.1%
Santa Clara	$549,000	12.7%	5.6%
Solano	$358,000	18.5%	9.5%
Sonoma	$449,000	19.4%	7.9%
Los Angeles	$414,000	32.3%	10.4%
Orange County	$540,000	30.4%	11.3%
San Diego	$464,000	19.0%	9.2%
Riverside	$319,000	25.1%	6.3%
San Bernardino	$246,000	26.2%	11.3%
Ventura	$500,000	26.3%	8.5%

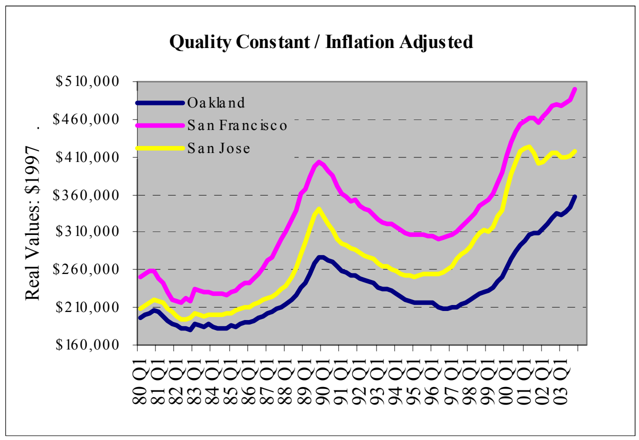
The path of prices both locally and nationally is truly unprecedented in recent US history. The following graph compares employment growth in the US with the real (inflation controlled) growth of home prices over the past 35 years. Historically real estate prices have a very specific pattern—they lag employment growth, but lead employment declines. Slowing home price appreciation preceded the 75, 81-83 and 90 downturns in the economy. Price appreciation accelerated after each of the first two downturns. The nineties was an unusual period in that the appreciation typically following a recovery was significantly delayed—price growth did not start to accelerate until 1997. This was one reason that two years ago I was of the opinion that prices were still in line with what was sustainable—we simply weren't as far into the cycle as we had been in the past. Declining employment in the US has almost always occurred along with a slowdown in price growth. Instead this time it has been met by continued acceleration. This has been true in almost every market in the US. Real prices now have moved farther from their long run trend than witnessed past, even as rates in the rental markets have begun to soften.

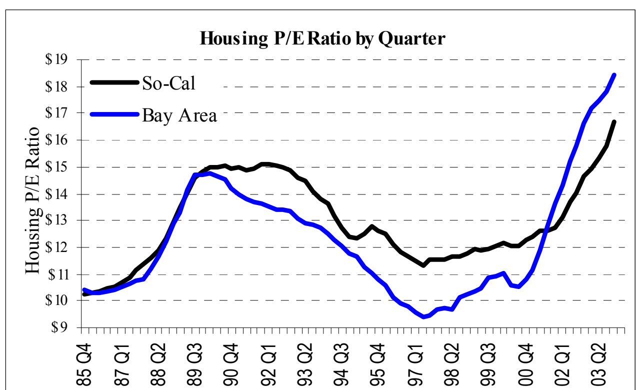
Real Home Price and US Employment
Growth Rates (smoothed)





The Bay Area differed somewhat from the rest of the nation—the run up in prices occurred in the late nineties as a result of the tech rush in the area. Prices flattened out in 2001 as tech started to experience its first cold spell. Nevertheless pent up demand remained an important supporter of the market, as did falling mortgage rates. My opinion has begun to change, however, over the past eighteen months as rents have continued to decline sharply in the region and mortgage rates have bottomed out. As discussed in the past, these are two of the major drivers in housing prices. Yet price appreciation has actually accelerated and is currently at its fastest pace ever. As prices have grown they have caught up to and clearly surpassed any level of sustainability. What's most surprising about this is that it has occurred during such a deep regional economic recession. Prices in the Bay Area are now in real terms 75% above where they were 7 years ago. Overall appreciation in the eighties was just 65% in real terms.



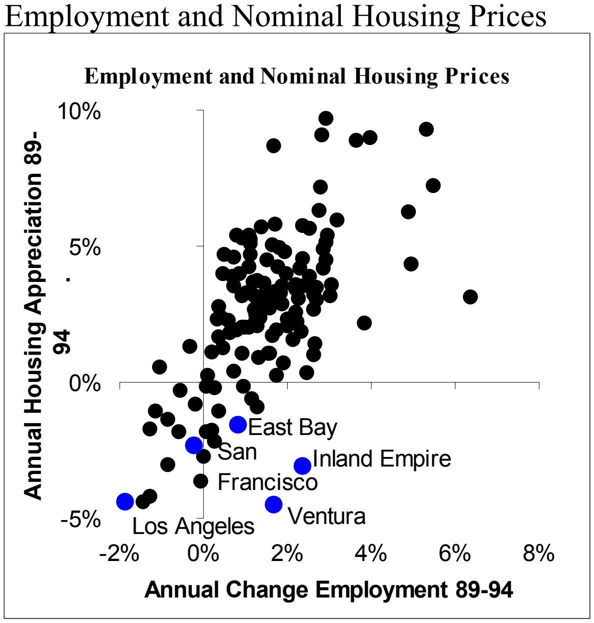


*P/E ratio is the ratio of the median housing price to the rental price of a class A apartment.

Despite the claims of many pundits, it is certainly not 'business as usual' in the real estate markets. One common claim is that the slow pace of homebuilding and low resale inventory levels can justify the current price level. Remember that low inventory levels are an *effect* of an overheated market, not the cause of one. People are snapping up properties trying to cash in on their built up home equity and lock in on low rates while they can. And while the supply of houses for sale may be somewhat tight right now, building has been accelerating both across the state and across the nation. And in any case there is a contradiction of sorts in the market. Remember that tight supply is a short-term issue that drives rents up—and of course rents have been falling. Housing prices, being based on rents both today and in the future, are necessarily long-term. The only way to reconcile these two divergent trends is to suppose that growth of rents in the future are going to be enormous—in fact they would need to double in real terms over the next decade—a pace never seen before. It is clear that the market has indeed entered a 'bubble' mode—where people are making purchase decisions not on the basis of the fundamentals, but based on the fear of being left out of the market any longer.

So is it time to sell and move the family into an apartment until this blows over? The discussion above should not be interpreted as a prediction that a massive price decline is in the works for housing. It is worth noting that *nominal* real estate prices have never declined for the US overall—at least over the past 40 years. Instead past bubbles have ended with nominal prices stagnating until the forces of income growth and inflation have allowed the fundamentals to 'catch up' with prices. The same can be said for regional prices. The following graph shows a cross-sectional look at home prices and employment growth across regions. Here we see that declines in nominal prices are associated primarily with declines in local employment. In short, without a major regional downturn there is little historical evidence that would support a major price decline for the US.

Employment and Nominal Housing Prices



Yet some caution remains in order. This time *is* unusual. Prices have moved farther beyond their long run trend than ever before because there was no slowdown in the wake of the last economic recession. Inflation rates are low, making it more difficult for the fundamentals to 'catch up' with nominal prices. And while it is true that it is very rare for price declines to occur when employment is growing, there are some examples of just this phenomena. The Inland Empire, Ventura and to a lesser extent the East Bay all exhibited this behavior in the early nineties. Most of the major cities in Texas also showed this combination of job growth and falling property prices after the oil price collapse in the midst of the economic expansion during the late eighties. In both cases there had been an extreme run up in prices prior to the bubble bursting, combined with some local economic weakness. For the California communities it was proximity to the hard hit Los Angeles economy. Texas was suffering from a collapsing oil industry. It remains to be seen if this bubble's collapse will fit the normal historical patterns, or if they have ventured into this more dangerous ground.

The best advice for potential buyers to follow at this point is not to buy for short run gain, but to concentrate on buying for the long haul. Avoid spending more than can be afforded, leaving space in your budget for potential economic problems in the future, and do not use adjustable rate mortgages unless your income can handle the potential for a major rise in rates.

Looking forward…

Recent months have brought some evidence that the consumer run that has been driving the economy over the past few years may be starting to slow. The June employment figures failed to live up to the growth seen in previous months. New housing permits slowed sharply in June, even though new housing sales remained at a record high level. Nominal retail sales in the US have actually declined in 2 of the last 3 months despite record prices being paid at the pump. Despite the continued frenetic pace of home sales, anecdotal evidence points to a rise in housing inventories and time on the market, particularly at the high end of the market. On top of this, there have been quite a few disappointing profit reports and predictions coming from corporate America, and as a result the major indexes have been in a bit of a slump recently—it seems as if they had indeed gotten ahead of themselves in recent months.

It should be cautioned that all these numbers have been seen in just the past few months, and one or two data points do not a trend make. Nevertheless the UCLA Anderson Forecast predicts a lower than expected growth rate for the second quarter—something in the range of 2.5 to 3%. We look for the rest of the year to fall around the 3% range, and employment to average around 200,000 jobs per month. And while there are many folks who want to believe that the economy is on track, the reality is that there are storm clouds on the horizon. The questions that remain are simply when this storm will move in, and how severe it will be. When (and some might argue if) the consumer slowdown finally does occur, a recession will only be 4 to 6 quarters behind. And while little discussion of this is occurring in Washington DC or on Wall Street now, investors and firms seem to be showing a degree of nervousness. Keep an eye out.

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[i] Seasonally adjusted annual rate.

[ii] The trade deficit is a measure of the difference between total gross domestic consumption (GDC) and total gross domestic production (GDP). When a nation consumes more than it produces, it has to borrow that extra batch of consumption from another nation—it runs a trade deficit. Trade surpluses are when production is greater than consumption. Trade deficits have little to do with trade barriers and other such distortions on trade as is often thought.

[iii] Remember that government consumption represents actual purchases by the government, such as spending on government employees and purchases of weapons for the military. This category does not capture transfers such as Social Security and Medicare payments. It also does not reflect the imbalance between revenues and expenses that is currently in place.

[iv] Remember that the payroll numbers come from a survey of employers, based on unemployment insurance. These numbers miss those who are self-employed, or simply aren't being recorded as 'official' employees.