

# **East Bay Economic Outlook**

## **January 2006**

Created for the East Bay Economic Development Alliance for  
Business  
And the Contra Costa Council

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Sponsored by the Alameda County Solid Waste Authority

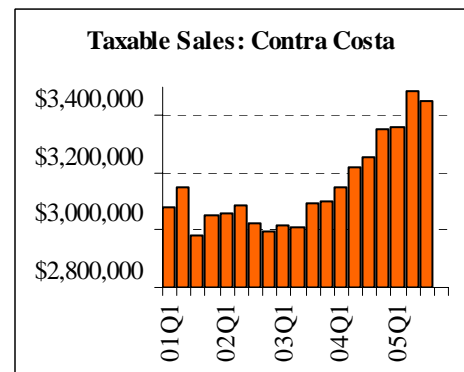
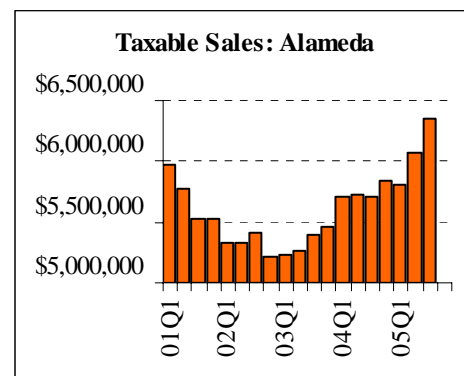
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## Overview and Outlook: Recovery continues for now

The past year was good, but not great. The East Bay continued to lead the recovery with solid job growth, and rapid increase in taxable sales not to mention the continued frantic pace of home building. San Jose has balanced out, and with an expected upward revision to the job numbers will likely show positive job gains for 2005. San Francisco lay somewhere in between these two economies. The job growth and overall expansion of the economy is largely due to continued consumer spending, although the tech industry that plays such an important role in the region is starting to regain some traction with solid profits and rising exports.

With the recovery and solid revenue growth the new budget for the state is heavy on education and lighter on health. No substantial reform to the budgeting process has been achieved, as the calm has lulled the need to tackle difficult political issues. It still leaves a gap between revenues and expenditures of about \$6.5 billion, an amount to be made up by the remaining \$7 billion left over from Propositions 57 and 58. Even with modest expectations about gains in revenues and a modest increase in the total budget, this still leaves the State, and by definition the local governments, on a razor edge. Any slowdown in the economy during the coming year could easily undermine the revenue projections and put the state back into dire fiscal straights.

As for the year ahead, look for an up and down economy. The external sector, driven both by continued growth in the information technology industry and biotechnology and a mild recovery in the East Bay's manufacturing sector will be offset by a slowdown in both new homes being built and overall consumer spending as the real estate market will continue the cooling trend that began in late 2005. Taxable sales growth will slow, but still be positive, in the 4% range. Interest rates and inflation will remain stable. Employment in the East Bay will stay on its current course, and pick up about 1.5% growth according to the payroll numbers, and slightly more according to the household survey. Unemployment will remain stable. San Jose and San Francisco, still in recovery mode,



will grow about 1% each. Towards the end of 2006 things will become more uncertain, depending critically on the speed of readjustment in consumer spending and the housing market. Our new Fed chairman will likely face his first test even as we approach the end of the year. We can hope that his challenge is not too severe.

## The Year Behind: The Boom Continues

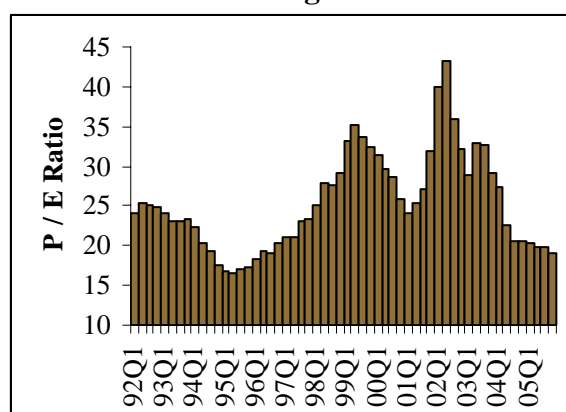
2005 is over, and while the last few statistics are yet to come in, by any measure, it was clearly a solid year of economic growth for the nation. This was reflected by the continued recovery of the economy in the Bay Area. Consider the national economy first. The new 4<sup>th</sup> quarter numbers were fairly poor, coming in at only a 1.1% growth rate (seasonally adjusted and annualized). Still, third quarter GDP growth was a solid 4.1% rate, the 10<sup>th</sup> straight quarter of above average growth for the US economy, with an average pace of 4.1%. While the late nineties had a faster growth rate (between 1997 and 1999 the nation averaged an astonishing 4.7% rate) it never had 10 straight quarters of above average growth. The 1.1% growth rate is a low number, but some return to normalcy was in the works. The big question is whether this number represents the beginning of a new trend, or just a reversion to the long run mean. This we will discuss further on.

Despite the disappointing GDP report in the final quarter, there was plenty of other good news from 2005. One was the continued expansion of the manufacturing sector, and business spending in general. Manufacturing output rose by 4% in 2005, the second such year of strong gains. New orders for manufactured goods also strengthened in the last few months of the year. On top of this, corporations continue to

rake in record profits. In aggregate, real (GDP deflator adjusted) corporate profits have risen 60% since 2001. While the stock market has been doing quite well in recent months, the market is not overheated the way it was in the late nineties. Indeed the P/E ratio for the S&P 500 actually fell over the last three quarters. While this is not a recommendation to 'buy', selling clearly isn't imperative either.

One reason for the high level of profits is that business spending has remained low relative to profits. The graph to the left shows this ratio starting in the late eighties. If you pull out the massive run-up in business spending that began in 1997 (and led ultimately to the 2001 recession) you can see a slow downward drift in this statistic. Currently it is running about 1 to 1, down from 1.4 to 1. A recent article in the *Economist* noted this same trend across the developed world, and concluded that 2006 might see a surge in business spending. The problem here is that

**S&P 500 Price Earnings Ratio**



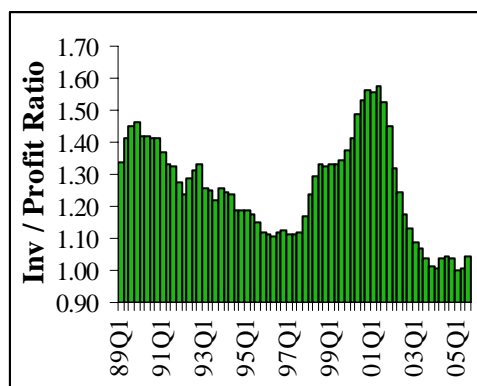
it is easy to confuse nominal and real trends. These data do not say that real business spending is slowing, only that the ratio of nominal spending to profits has been declining.

The next figure shows real business investment in information technology goods, first deflated by the investment deflator and then deflated by the overall GDP deflator. The difference between these two is that the GDP deflator is a measure of broad changes in the level of prices for the entire economy, as opposed to just investment in business products. Real investments continue to climb at a very solid pace, and are 20% higher than during the peak on the late nineties. However real *spending* on business investments, as determined by the GDP deflated series, is still some \$50 billion below the previous peak. The continued technological advancements in information technology make it possible for firms to invest in more and more, even as they spend less and less.

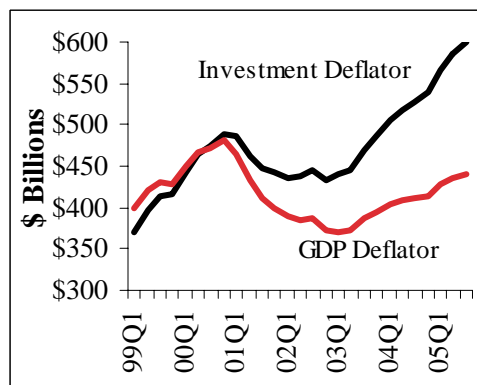
While manufacturing output and overall business spending is up in the US, manufacturing employment remains strangely stagnant. While manufacturing employment often loses much ground during economic cycles, the rebound that occurs when the economy is back up and running typically brings many of these jobs back. Not this time, as manufacturing employment has remained stuck at 14.3 million, a record low in both absolute terms and as a percent of the overall workforce. Much of this has to do with the continued shift from labor-intensive industries to capital-intensive industries in manufacturing, in large part due to international competition. It also has much to do with the rapid rise in worker productivity fueled in large parts by the investments in information technology just mentioned.

Nevertheless the once stagnant labor market got moving this year, and payrolls increased by 1.66 million jobs. While this 1.5% growth rate is lower than the long-run average, it needs to be kept in mind that for a number of years the overall growth of the working age population has been slowing as well. With the unemployment rate sitting at about 5% it is clear that the labor market remains solid.

**US Business Investment/Profit Ratio**

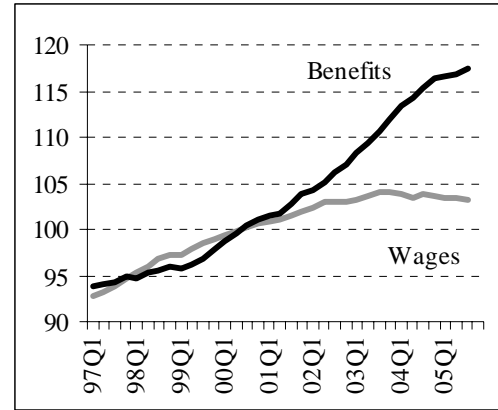


**US Real Business IT Investment**



One issue with the labor market appears to be the lack of wage growth seen in US labor markets. The reason for this, however, has more to do with the continued rise in benefit costs. As noted in past essays, rising benefit costs do not hurt employment; they simply reduce take home pay due to the fungible nature of the pay package. In real terms the cost of benefits provided by employers has risen by 18% since 2001, much of it driven by rising healthcare insurance premiums despite the various cost-sharing actions put into place by corporate America. While the increase in costs has slowed recently, until some substantial reform to our broken healthcare system takes place we can expect that rising costs will continue to dampen the gains in our take home pay.

**Real Employment Costs by Type  
Index Values, Year 2000 = 100**



The conversation on the issue has begun to surface again in Washington DC, and the State of the Union speech contained some policy goals for the year ahead in this area. While the problems with the healthcare system in the US are too complex and numerous for a full discussion here, it is worth making one basic point. Too often the debate on healthcare seems to revolve around the concept that we as a nation consume too little healthcare. In aggregate, this simply isn't the case. Indeed the opposite is true -- Americans consume too much healthcare. The US spends nearly twice as much on healthcare per person as Switzerland which has the second highest per capita expenditures. We spend more public money per capita on government provided healthcare than Canada—a nation that has a purely public system.<sup>1</sup>

The problem is that our system, as it currently exists, encourages too much consumption because individuals covered by insurance, whether public or private, do not directly internalize the true costs of the services they consume. What is often forgotten is that even if an individual is covered by insurance, in the end all that consumption must be paid for, typically through higher insurance premiums, higher taxes or greater government debt. In short there is no free lunch, or in this case, free hospital visits. Throw in our litigious legal system and numerous special-interest driven government regulations that prevent a hospital from finding the most cost effective way to deliver care and we have a first rate crisis on our hands. Those not fortunate enough to have the

<sup>1</sup> The World Health Organization (WHO) collects these statistics on an annual basis, and publishes them on their website, [www.who.org](http://www.who.org).

income to pay these high premiums are pushed out of the system altogether. With the leading edge of the boomers hitting 60 this year, the problem will not be going away, but getting worse in coming years. As this debate progresses, do keep in mind that discussion about insurance profits and insurance coverage misses the point altogether. These discussions about to whom the buck is passed, critically miss the fact that our system is not an efficient way to allocate healthcare.

Getting back to the broader discussion of the economy, while growth remained strong in '05, the fear of inflation began to raise its head by the end of the year. The Bureau of Labor Statistics reported that, due to the spike in energy prices seen in the wake of hurricanes Katrina and Rita, in the third quarter inflation hit the fastest rate seen since 1990, 5.1% (annualized).

Still, we do not see inflation as a long run issue. Already the pace has slowed to a 3.7% rate in the 4<sup>th</sup> quarter, and more importantly the spike in energy prices does not seem to have trickled over into the rest of the economy. The core rate of inflation (with food and energy goods removed) actually slowed in the 3<sup>rd</sup> quarter to a 1.5% annual rate, and overall will come in at 2.2% for the year, slightly above the Fed's target zone.

With gas prices from September to December falling from a US average of \$2.96 to \$2.19, there is likely to be less inflationary pressure over the next few months. And if you are still not convinced about the issue of inflation, listen to the Wall Street bond traders who have continued to buy up those 10-year bonds. The rate has actually fallen right through the holidays to below 4.4%.

Credit remains cheap in our economy. At this moment in time you can expect the Fed to continue to tighten over the next few months, as Bernanke will try to slide into Greenspan's shoes with a minimum of fuss. The 4<sup>th</sup> quarter GDP numbers, though, will weigh heavily on our new chairman's mind. After all, he is hoping he will not be faced with the same set of problems that greeted his predecessor shortly after he arrived in office, namely a collapsing stock market and slower than normal economic growth.

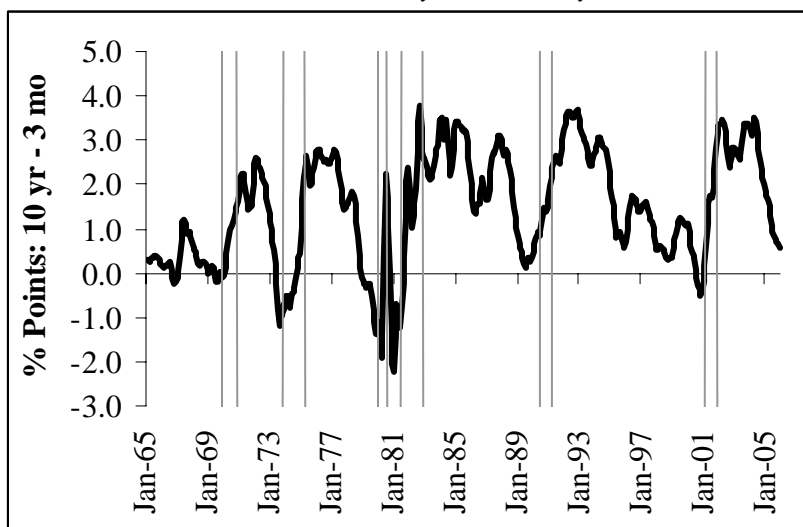
Although cheap long run credit is considered a source of growth for the US economy, with the Fed tightening the federal funds rate, the short run interest rates have started to approach the level of the long run rate. In economic parlance, this is referred to as a flattening of the yield curve. While the concept of the yield curve may seem unclear, it really is nothing more than the difference between short run and long run interest rates. This statistic is watched closely when it becomes 'inverted' (a fancy way of saying that short run rates are greater than long run rates) because this is one of the strongest predictors of upcoming economic problems. The following

picture shows the percentage difference between the interest rate on a 10-year and a 3-month t-bill, along with up and down lines showing the start and end of past US recessions.

As can be seen in the chart, before the start of every recession going back to the late sixties there was an inversion (or something close to an inversion) of the yield

### The Yield Curve and US Business Cycles

*Steepness of the yield curve measured by the difference in interest rates on 3 month and 10 year treasury bonds.*



curve. The exact reasons for this pattern are still under debate, and much of this discussion is a bit too arcane for extensive discussion here. But in short, an inverted yield curve implies that the market expects future short run interest rates to be considerably below where today's current short run interest rates are. As a result the current long run interest rate (which is by definition the average of the current short run rates and the expected future short run rates with a risk premium thrown in) ends up lower than current short run rates--an inverted yield curve.

This decline in the expected future short run rates may be driven by a number of potential drivers:

1. Expectations of Fed loosening (as when the Fed chief moves to boost aggregate demand to mitigate the effects of a recession)
2. Expectations of future economic turmoil causing businesses to pull back on spending and reducing the demand for capital and credit.
3. Expectations of a demand for bonds as investors move away from risky profit-driven stocks.

In any case, the point here is that every past inversion of the yield curve has predicted the coming of a recession quite well.<sup>2</sup>

<sup>2</sup> For those econ-junkies, take a look at Arturo Estrella's excellent FAQ on yield curves from the New York Fed webpage. [http://www.ny.frb.org/research/capital\\_markets/ycfaq.html](http://www.ny.frb.org/research/capital_markets/ycfaq.html)

What is also clear is that the yield curve has flattened considerably in recent months. Before we call this prima facie evidence of an economic slowdown, there are two things to keep in mind. First is that the yield curve has produced false signals before, such as in the mid sixties. Of course there was a major acceleration in government spending at that point in time driven by the escalation of the Vietnam War. Further, while rates have fallen, they have not hit 0 yet, and indeed they are just slightly below where they were in January of 1996, when the economy was about to take off on a 5-year growth spurt. In other words, keep a wary eye out, but for the moment the yield curve is not sending out a red danger light.

So what about this 4<sup>th</sup> quarter 1.1% growth rate? Is that foretelling economic trouble in the works? The answer is no, not yet. The slowdown in growth was going to occur at some point in time through a basic reversion to the mean. The largest driver of the slowdown in growth was the slowdown in the purchase of new automobiles—hardly a surprise given the number of vehicles sold over the course of the summer, as many of the US auto companies were conducting record sales events in a bid to hold off the financial problems that were threatening the big 2.

Of course given recent headlines it seems clear that their efforts have not helped matters much, and more tough times are in the works for the Midwest as Ford and GM begin the painful process of shuttering inefficient facilities. Consumption of non-durables and services remained solid, not a standard characteristic of a consumer led economic slowdown.

The other driver of the slowdown was an unexpected drop in government spending, primarily in defense spending. This is likely to be a one-time slowdown, given the ongoing mission in Iraq. Make these two figures neutral (0) and the US continued to grow at an average pace. Added to this is the fact that the yield curve, while flattening, still has some steepness and that other important leading indicators, primarily hours in manufacturing, new orders for manufactured goods and residential building permits are still at high levels. For these reasons it is clear that the US economy will not see the 2005 4<sup>th</sup> quarter slowness continue into the first part of 2006.

## **Jobs in California and the East Bay**

The state added a solid 190,000 payroll jobs through 2005 (Q4 to Q4), a 1.3% growth rate. The Bay Area also enjoyed a decent, but not spectacular 2005. The East Bay employment is currently estimated to have grown almost 2%, faster than the state, adding close to 20,000 new jobs over the course of the year. San Francisco added 6,500 jobs bringing the MSA's total new jobs up to 26,500. San Jose, which had started to show some positive growth in the end of the

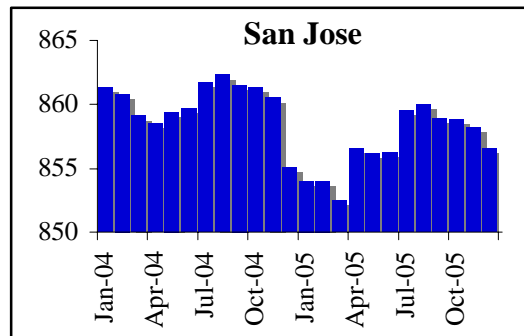
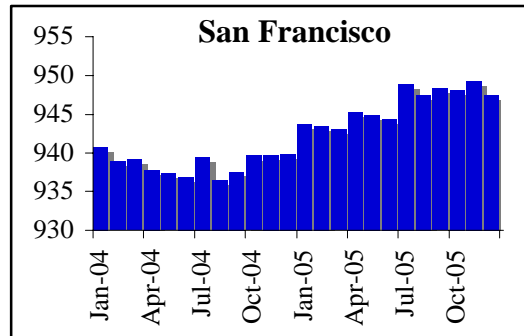
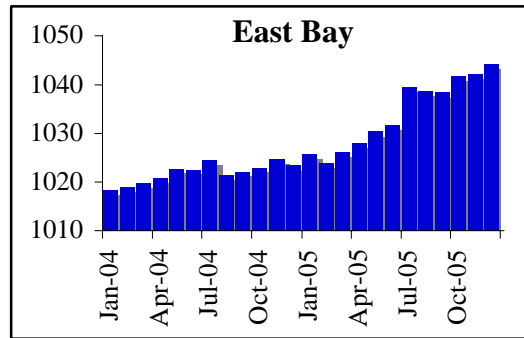
year slipped back yet again, and ended up flat, growth wise.

Of course these numbers have to be taken with some degree of caution. The estimates of local area payroll jobs are based on a survey of companies that is recalibrated every year on the basis of the much more thorough but slower arriving ES202 payroll statistics collected through the unemployment insurance program. The re-benchmarking of the current sample occurs at the start of each year, and these changes can be substantial.

In any case, while it is difficult to say what the final revisions will be, a preliminary analysis shows that the East Bay is likely to see its overall level of employment remaining the same after the revisions, while San Francisco's will be reduced by a marginal amount (less than one half of one percent). San Jose will be the winner in the revisions, likely to see an upward revision of something less than 1%, making 2005 a positive growth period if not a period of strong growth.

Still the labor markets both in the Bay and across California look stronger than the payroll numbers would indicate on their own. The unemployment rate for the state has remained at a low 5.1% rate. In San Jose it's slightly higher, but in the East Bay the rate is below average at a 4.7% rate. The strength of local labor markets is better measured by the

### Bay Area Payroll Employment



### California Regional Employment Profiles

	Payrolls			Unemployed		
	Q4 05	Abs	%	Rate	Ch	
California	14,915.3	189.1	1.3%	5.1%	-0.7%	
Los Angeles / OC	5,540.7	40.9	0.7%	4.5%	-1.3%	
<u>San Fran-East Bay</u>	<u>2,001.0</u>	<u>26.4</u>	<u>1.3%</u>	<u>4.7%</u>	<u>-0.5%</u>	
San Diego	1,286.8	17.2	1.4%	4.3%	-0.1%	
Inland Empire	1,186.6	20.3	1.7%	5.2%	-0.2%	
<u>Sacramento</u>	<u>877.6</u>	<u>13.9</u>	<u>1.6%</u>	<u>4.7%</u>	<u>-0.3%</u>	
<u>San Jose</u>	<u>863.0</u>	<u>-0.9</u>	<u>-0.1%</u>	<u>5.4%</u>	<u>-0.5%</u>	
Fresno	291.5	2.6	0.9%	8.7%	-1.1%	
Ventura	289.0	3.5	1.2%	4.9%	-0.3%	
Bakersfield	220.7	7.0	3.3%	7.8%	-1.3%	
Stockton	208.3	2.6	1.2%	7.2%	-0.7%	
<u>Santa Rosa</u>	<u>188.1</u>	<u>0.3</u>	<u>0.1%</u>	<u>4.3%</u>	<u>-0.2%</u>	
Santa Barbara	173.4	3.3	1.9%	4.3%	-0.3%	

unemployment rate in many ways, because it reflects the number of people looking for new jobs who can't find one. Low unemployment rates reflect the fact that people who are looking for jobs are successfully finding them.

The key here is that many of these new jobs are not showing up on the payroll statistics, but instead in the informal workforce as has been discussed in past reports. Overall the informal workforce in the state has expanded from 1.14 million to 1.74 million between 2000 and 2005, a gain of 600,000. To put this in perspective, the total payroll workforce is only 245,000 jobs ahead of where it was in 2000. In the Bay area the number of informal workers is up by 100,000 from where it was in 2000, while the number of payroll jobs is down by 330,000. Overall across the state two thirds of these informal jobs exist in the greater Los Angeles region, but the Bay Area is definitely starting to add its own hidden economy.

#### **East Bay Employment by Sectors**

	Q4 05	Ch 04-05
Civilian Employment	1,235,200	35,200
Total Non-farm Payroll	1,051,200	20,100
Health Care	104,800	5,000
Construction	76,500	4,900
Finance / Insurance	51,900	2,700
Leisure / Hospitality	84,100	2,700
Nondurable Goods	37,500	1,700
Retail Trade	114,800	1,400
Educational Services	21,000	1,200
Administrative Supp.	57,000	800
Real Estate Rental	19,300	700
Transportation	35,100	700
Professional	70,500	600
Mgmt of Companies	21,800	100
Information	30,200	-100
Wholesale Trade	48,400	-500
Government	177,800	-500
Other Services	36,300	-600
Durable Goods	63,100	-800

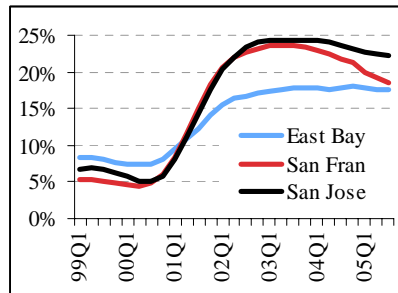
In terms of the types of jobs being added to the East Bay economy over the past year, real estate and healthcare continue to be the primary drivers of growth. Overall the region added 20,100 non-farm payroll jobs (Q4 to Q4) and 35,200 according to the household survey. Healthcare added something like 5,000 jobs over the last year. Of course this was the same sector that saw substantial reduction during the revision last year. It remains to be seen if this will occur again, although the overall gains are not as large as they were last time. Construction and finance follow, along with leisure and hospitality. Again like the rest of California, the East Bay's internal sectors, those driven by local demand, continue to create most of the jobs. The non-durable goods manufacturing sector added 1,700 jobs in 2005, more than compensating for the loss of 800 jobs in durables. Overall manufacturing, while not recovering, at least has begun to stabilize. The same is true for the important information sector.

## Construction and the Economy

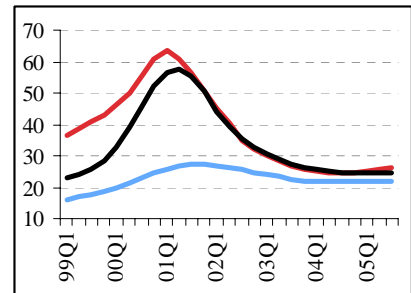
Of course the driver of California growth has been, in large part, the continued boom in the residential real estate industry. Where this is heading will speak volumes about the growth of the economy in 2006. But before discussing this, let's first take a look at the non-residential markets in the Bay region. The building boom of the late nineties created a huge surplus of commercial space in the region, pushing vacancy rates up close to 25% in San Jose and San Francisco. The East Bay got off comparatively lightly, with vacancy rates hitting only 17%. Vacancy rates have been dropping in recent months, falling below 20% in San Francisco. Still, they remain at historically high levels, and rents remain flat in all three regions.

### Non-Residential Markets

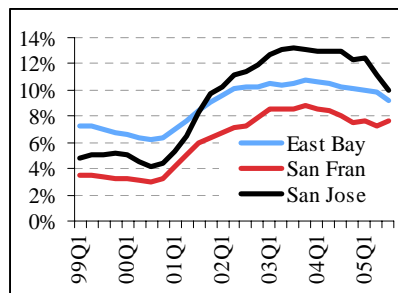
Office Vacancy



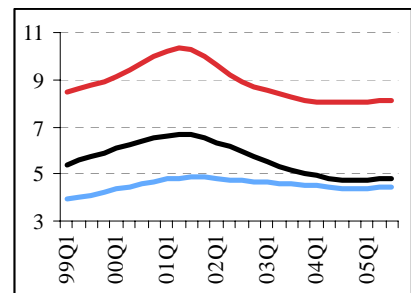
Office Rents (\$/s.f./year)



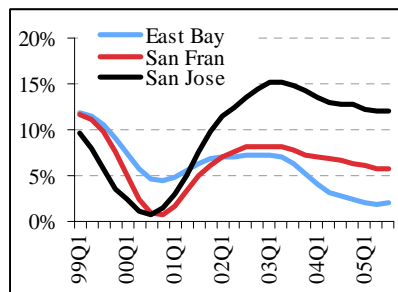
Industrial Vacancy



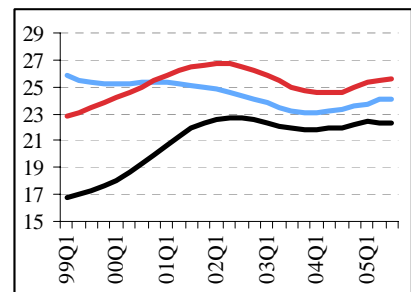
Industrial Rents (\$/s.f./year)



Retail Vacancy



Retail Rents (\$/s.f./year)



Source of Data: Portfolio & Property Research

When will rents start to rise and new construction start again? The magic level of vacancy rates seems to be about 10%. When vacancy rates fall below this level the market starts to warm up again. How long until this happens? Unfortunately it will take a while. The last time vacancy rates were this high was in the early eighties, following the construction boom in the seventies. It took over a decade for the excess space to be absorbed. Expect office markets to remain tepid at best for the foreseeable future.

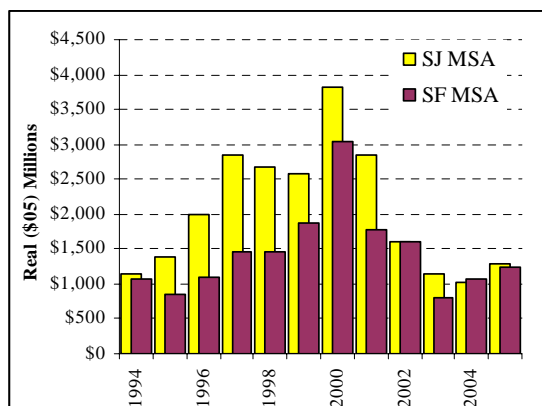
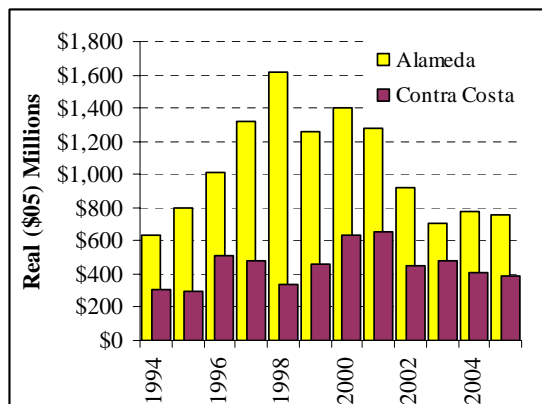
Industrial and retail markets paint a somewhat better picture. Industrial space enjoys

single digit vacancy rates in all three markets, and overall rates are not that far above where they were in the late nineties. Still, rents remain flat here and the pace of absorption is still relatively slow with the exception of San Jose. Retail has remained the strongest component of non-residential property, on the back of ongoing consumer spending. In the East Bay retail vacancy rates are actually lower than they were during the boom years of the late nineties. In San Francisco retail vacancy rates are where they were in 1999, and they are only slightly higher in hard-hit San Jose. This remains the one market where building is still going on. This is due in large part to the frenetic pace of home building occurring at the moment. When the housing markets begin to cool, you can look for retail to follow along.

Given the still weak level of demand relative to supply, it is not surprising that the pace of Bay Area spending on non-residential markets remains flat in real terms. The increase in permit value seen over the last couple years is more due to the increasing costs of building rather than due to a real increase in building. Overall investment in each of the three regions was about \$1.2 billion, with a large portion of the permits going towards improvements on existing structures. There is very little new construction except for retail.

While the non-residential markets are cool, the residential markets remain red hot. The median price of an existing single family home rose by 16% in Alameda County (Q4 to Q4) and 21% in Contra Costa County. This brings the seven-year total price increase for the Bay region up to a whopping 137%, or a 13% annual average increase. This is a long run of rapid real appreciation never experienced before in any major US market

**Bay Area Non-Residential Construction**  
Real Permit Values, millions in \$2005



**Median Sales Price for an Existing Single Family Home (\$000's)**

	Q4 98	Q4 04	Q4 05
Alameda	\$242.8	\$530.0	\$617.5
Contra Costa	\$225.0	\$475.0	\$576.6
Marin	\$382.5	\$813.8	\$917.1
Napa	\$185.0	\$513.8	\$607.0
San Francisco	\$339.0	\$722.5	\$795.0
San Mateo	\$364.0	\$710.5	\$793.0
Santa Clara	\$336.3	\$600.0	\$714.6
Solano	\$151.5	\$391.5	\$460.3
Sonoma	\$217.3	\$495.3	\$584.3
Bay Area	\$274.0	\$556.0	\$650.0

until the current real estate boom. There is a lot of room for concern regarding what it will mean for the overall economy when this unprecedented increase in housing wealth finally comes to an end.

At the same time that prices have continued their impressive appreciation, the number of new homes being built has also remained strong, though somewhat slowed in 2005. By the end of the year Alameda had 4,400 new permits while Contra Costa added 6,100 more. By this measure the pace of building in the East Bay appears too high.

The population to housing ratio is about 2.6 for the overall region, yet the pace of population growth is less than 2 times the pace of new home building.

Of the types of housing units being built in the East Bay about one third of the total are multi-family units, which could be condos or apartments, while the other two thirds are in single family homes. Oakland, Dublin, the unincorporated areas of Contra Costa County and Emeryville account for most of the multi-family housing, while much of the single family housing is being built in the eastern portions of the counties, particularly along Route 4. A balanced economy should have room for both types of housing.

Unfortunately, in addition to the mismatch between single family and multi-family residential construction, neither category is addressing the true shortage in the California economy, low rent apartments for low-income workers. California has the worst crowded housing in the contiguous 48 states, with 8.3% of all housing units having 1 or more residents per room (not per bedroom).

### Population and Home Building: 03-06

	Changes Jan 03 to Jan 06			2004
	Pop.	Units	Ratio	Pop / Home
Alameda	26,900	14,600	1.8	2.6
Contra Costa	36,800	18,500	2.0	2.7
San Fran MSA	27,900	12,150	2.3	2.3
San Jose MSA	53,600	19,050	2.8	2.8

### Residential Permits by East Bay City 2003-2005, U = unincorporated areas

	Single Family	Multi-Family	Total
Contra Costa U.	4,825	2,023	6,848
Brentwood	4,001	308	4,309
Oakland	775	2,504	3,279
Dublin	712	2,201	2,913
Livermore	914	523	1,437
Pittsburg	1,004	330	1,334
Hercules	1,181	151	1,332
Hayward	1,107	192	1,299
Oakley	924	96	1,020
Emeryville	-	1,006	1,006
Fremont	386	524	910
Pleasanton	681	174	855
Berkeley	55	772	827
Richmond	429	383	812
Antioch	736	4	740
Concord	459	150	609
Union City	329	248	577
Alameda U.	386	162	548
Alameda	311	62	373
San Pablo	202	89	291
Pleasant Hill	42	166	208
Walnut Creek	122	70	192
San Leandro	111	6	117
Danville town	74	9	83
San Ramon	38	39	77
Martinez	41	4	45
Pinole	29	2	31
El Cerrito	19	-	19
Albany	15	-	15
Piedmont	7	-	7
Newark	5	2	7
<b>Total</b>	<b>19,920</b>	<b>12,200</b>	<b>32,120</b>

Second worst is Texas with 4.7%. The fixed costs of buying land, building under existing building codes and the long fights that developers have with local zoning boards who fight against any sort of dense housing simply do not allow these developments to be feasible without some public subsidy such as tax credit programs. The worst problems are of course in the southern portions of the state, but it is starting to hit the Bay area as well. In Alameda county 6.2% of all residential units are crowded. To put this in perspective the average rate for the entire US is around 2%.

With the lower income population continuing to grow in the state and Bay Area (due largely to continued immigration from Latin America) the problem is likely to get worse. Ironically the end of the current high-end housing building boom will also make things worse, since the issue is currently being ameliorated through a trickle down effect as new units now being purchased allow older less expensive units to be freed up. While the long run social consequences of this situation are unclear, it represents a problem for businesses looking to locate in areas where all skill levels of workers have affordable housing available. The state is currently preparing laws to try to reduce the problem, but it is not clear whether the changes in local zoning laws will be sufficient to encourage more development.

At the moment, the patterns of development in the region are encouraging more commuting. To establish a more well rounded set of industries in the outlying areas, more effort will be required to create lower cost rental units in those areas.

San Jose and San Francisco saw 4,050 and 5,850 new residential permits respectively. The pace of building in these latter two economies would seem about right given population growth. The San Jose MSA (with San Benito) has been adding slightly less than 18,000 new residents per year over the past three years, and has added 19,000 new units over that three-year span, a ratio of about 2.8 to 1, exactly the same as the current population per home rate for the region. The San Francisco MSA is similarly balanced. Yet even in these two regions the numbers are a bit deceiving because of the increasing household sizes.

If you are still skeptical of my worries about ‘over building’, you need look no further than the housing vacancy statistics. Between 2000 and 2004 overall

**Housing Vacancy**

*Source: Census American Community Survey*

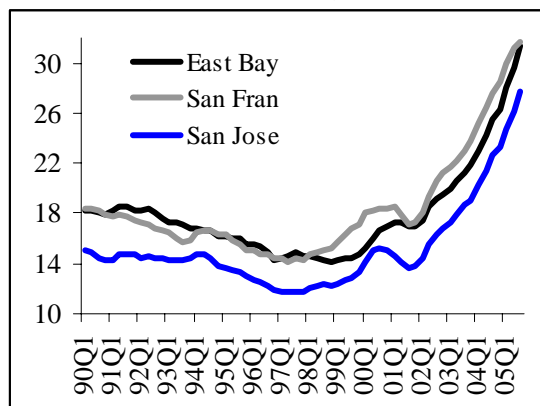
	East Bay	San Fran	San Jose	US
2000	4.3%	5.0%	3.8%	9.6%
2001	4.5%	6.2%	3.9%	9.7%
2002	4.7%	6.1%	4.8%	10.0%
2003	5.8%	7.4%	5.9%	10.3%
2004	7.0%	7.0%	6.0%	10.4%

vacancy rates in the East Bay increased from 4.3% to 7% and from 5% to 7% in San Francisco. While these rates are still lower than for the US overall, the rate of increase is considerably faster. More recent apartment statistics from other sources (the 2004 American Community Survey is dated roughly at the midpoint of the year, and the 2005 data has not yet been released) has rental apartment vacancies leveling off in all three Bay region communities and actually starting to fall a bit. This is likely due to the fact that prices have hit a level far beyond the means of many potential new buyers, and these folks have to find accommodation in rental units for the time being. The question then is what will happen to the vacancy rates for all the new units currently in production with fewer buyers able to get into the market.

So where is the market heading? The complete discussion of whether we are or aren't in a bubble market has been addressed in a number of past EDAB reports. The short answer is that we are in a bubble. The following chart shows the ratio of the median price of a condo in the three regions relative to the average annual rent of an apartment. Remember that when you buy a house, what you are investing in is a stream of rental values today and in the future. In short this ratio is the equivalent of a P/E ratio for a stock.

### Bay Area Housing PE Ratios

*Calculated as median price of a condo divided by the average monthly rent for an apartment*



Now proper P/E ratios are not constant. They rise with expectations of greater future growth and fall with a rise in interest rates. Yet neither of these forces has been in play since the first quarter of 2003. Mortgage rates have bottomed out and have been rising, albeit slowly. Rents remain weak, and given the pace of building are unlikely to rise rapidly in the near future. Despite this, prices have continued to skyrocket, and the P/E ratio has climbed 60% over the last three years.

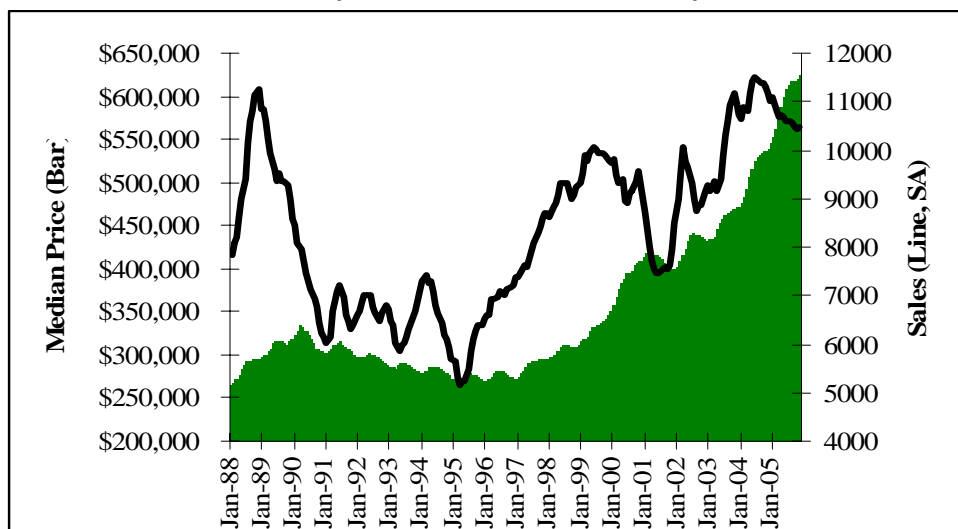
So where is the market now? The market has slipped past its peak, and while still hot is showing the first signs of substantial cooling. The following graph shows real median prices for the Bay area (in 2005 dollars) and overall sales activity, including both existing and new homes (Dataquick statistics). By past experience we know that the first signal that the market is starting to slip comes from declines in market activity. The market is still very hot, with seasonally adjusted total sales of 10,500 units in November. This is down about 9% from the peak it hit not

too long ago. The drop is just now starting to take pressure off the market. Inventory levels are starting to rise and price appreciation has slowed somewhat.

Still, one can point out that the decline in unit

sales was much more dramatic in the late eighties before the market saw real prices flatten out. Furthermore there was a substantial dip in activity in 2001 and 2002 that quickly reversed. But as much as I hate to use that oft-abused phrase, this time does seem to be different. The late eighties ended so dramatically in part due to the fact that it corresponded with a dramatic withdrawal of credit from the market due to the ongoing S&L crisis. There are already warning signs that the abundant credit that has been filling the market is starting to leave, although there is still plenty in the system. And while the slowdown in 2001 was substantial, considering the damage to the local economy inflicted by the tech bust, it is truly amazing that it wasn't a more dramatic decline. Rapidly falling mortgage rates buoyed the over-heated market and caused the rest of the nation to experience stronger real estate activity. This time there is no prospect of a fall in the mortgage rates, and it is occurring against a backdrop of slowing markets across the US.

**Bay Area Real Estate Activity**



### **Looking ahead for 2006: Greenspan's Legacy on the Line**

Looking ahead in 2006, growth is likely to continue for the first part of the year, though not at the pace we have seen over the past three years. Not all is right in the mighty US economy, and Greenspan's legacy is not yet assured. These issues include the real estate bubble, as already discussed, the ongoing current account deficit and the continued decline in personal savings rate. The final income statistics for 2005 are in, and for the first time since 1933 the personal savings rate (defined as disposable income minus total current expenditures divided by disposable income) has dipped into negative territory. The trade deficit remained overall at a -5.5% of overall GDP, and the government deficit continued to accrue at a \$300 billion dollar a year pace.

All these are related—they reflect a nation on a spending binge that simply cannot last. Part of this spending binge is the fault of Congress and the President. Deficit spending can be helpful during economic downturns to stabilize the economy. Clearly the economy has not needed stabilizing over the past three years, with the solid growth rates seen. These massive deficits don't threaten the economic health of the nation directly, but what they do represent is a massive inter-generational transfer of wealth. The legacy of those on the verge of retiring will be a massive amount of debt to be paid off by the following generations, not to mention the cost of supporting Social Security and Medicare. The personal part of the spending binge is being driven by consumer who feel house rich, and want to spend some of that wealth on current consumption through reduced savings.

The general consensus is that the bubble is going to begin to deflate in 2006, accompanied by a slowdown in new homes being built and continued declines in market activity. We may be experiencing the beginning of the decline now, but the market still feels stable because most people attribute the current weakness to the natural slowdown in market activity that occurs around the holidays. The softening of the market will be more apparent when the spring surge doesn't come with the expected strength it normally does.

The big question over the coming year is what it means for the rest of the economy. This of course boils down to the speed of adjustment. If the market continues its gentle slowdown and prices simply flatten, the overall impact may be a general weakness across the economy. Construction and financial activities will take a large hit, but the continued increase in strength in the external portions of the economy can balance this out.

If, on the other hand, the coming slowdown in housing is rapid, we all better lookout. A consumer shock combined with rapidly declining demand for new homes could cause a recession on par with, if not worse than, the nation's last one. Moreover, in the Bay region, the pattern of pain this time will be largely reversed from 2001 with the East Bay taking the largest hit of the three regions.

The forecast for the Bay area in 2006, then, is steady as she goes for the first portion of the year. Expect employment to continue at about a 1.5% pace for the East Bay, while San Francisco and San Jose will see about a 1% gain. Taxable sales will grow at a more normal pace, slowing from the rapid gains seen over the course of last year. Home building will slow through the year, and apartment vacancies will continue to fall. The non-residential sector vacancies will continue to drop, but there is no major recovery on the horizon for new building activity, and the one major driver of growth—retail—will start to cool as spending growth slows.

Toward the end of the year the situation definitely looks shakier. How fast the market cools will determine what the end of the year looks like. Keep an eye out and look for the next quarterly report.