EastBay

Q3 08

ECONOMIC OUTLOOK

Created for the
East Bay Economic Development Alliance
&
The Contra Costa Council

Authored by the
UCLA Anderson Forecast

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The East Bay Quarterly Forecast 2008Q3

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July 2008

Summary:

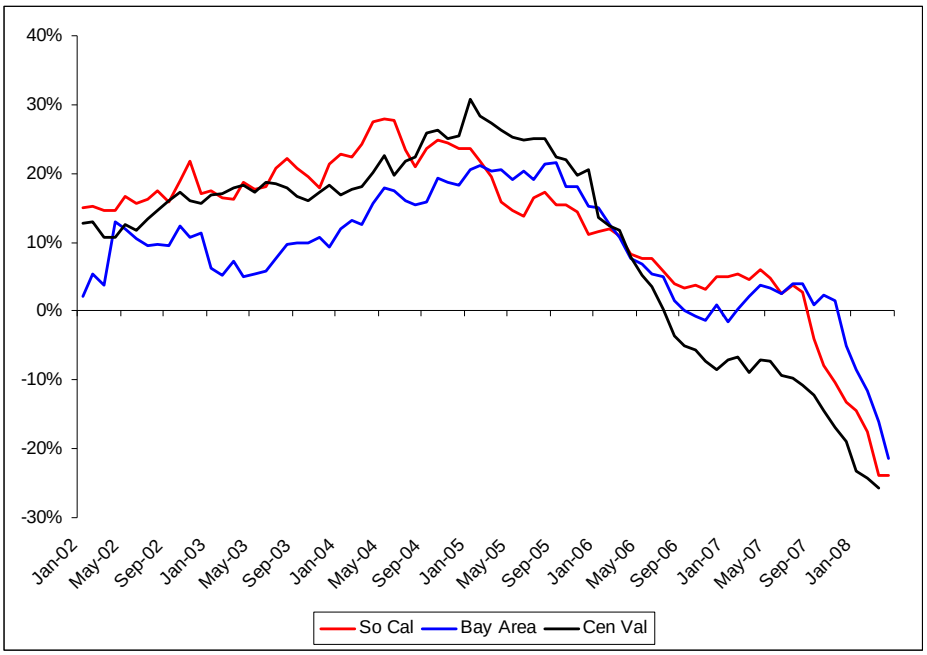
Most of the news from the East Bay has gone from bad to worse in 2008Q2. The moderate job loss of the first quarter has deepened, and house prices continue to plummet as distress sales dominate local resale markets. For the most part, the job losses in the East Bay have come from a combination of deepening losses in the usual suspects of the housing slump (Construction and Real Estate related Financial Activities), some spreading collateral damage (housing related Retail Trade), and some weakness in Government employment related to the restructuring of the Lawrence Livermore National Laboratory. As in the rest of California, "what happens in housing stays in housing" is still a reasonable description of where the main problems areas are, but unfortunately there is little growth to offset these areas of weakness in the East Bay Economy.

Oddly enough, there is a small dose of good news from the East Bay's housing market. While the surge in foreclosure activity has driven prices down faster than at any time in history, the upside is that for the first time in a long time, sales volumes in the Bay Area are rising – Contra Costa County is actually up relative to last summer's sales levels, as the steep drop in prices has brought some bargain hunters back to the market. Unfortunately, foreclosure activity is likely to continue rising through at least the rest of the year, keeping prices weak until at least this time next year. But the increases in sales volume are at least a flicker of light at the end of a very dark tunnel.

The 3 Phases of the Bay Area Housing Slump

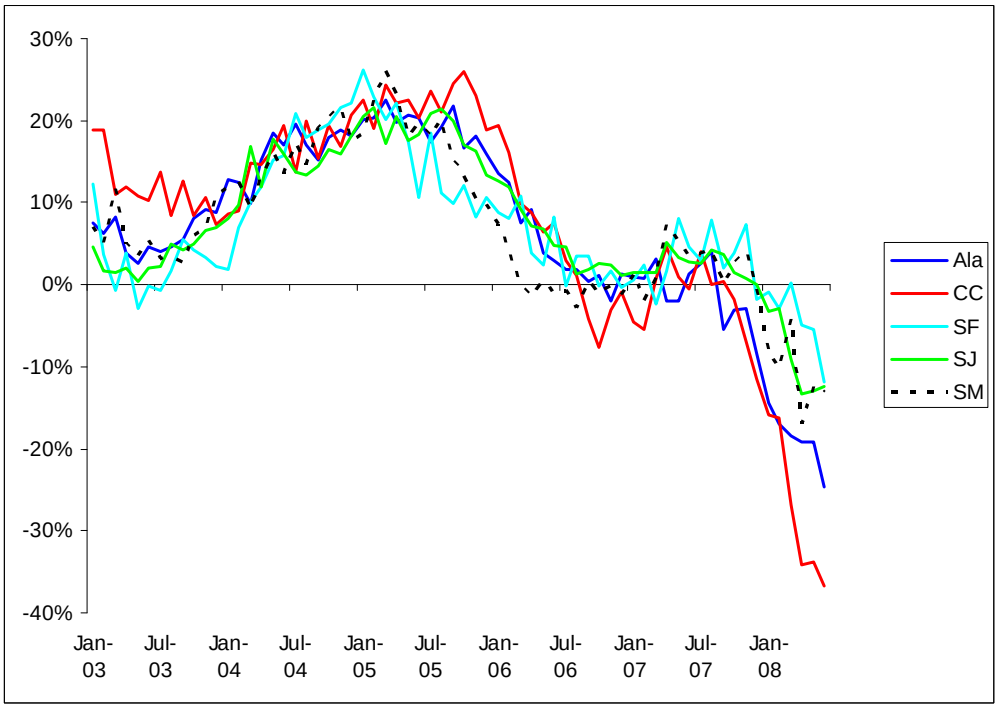
By most measurements, the Bay Area was the last of California's housing markets to peak. Mostly, this is because it was the last market to get going: in the aftermath of the tech bust, the Bay Area actually saw a small dose of home price depreciation in late 2001. After some ups and downs in 2002, it was only in late 2003 that the Bay Area experienced the dizzying acceleration of price growth that was sweeping the rest of the state. Examining the path of Bay Area home sales and home price appreciation (Figures 2 and 3) suggest that the housing market decline in the Bay Area has proceeded in three phases.

Figure 1: Year-over-Year Change in Median Sales Price of All Homes by Region



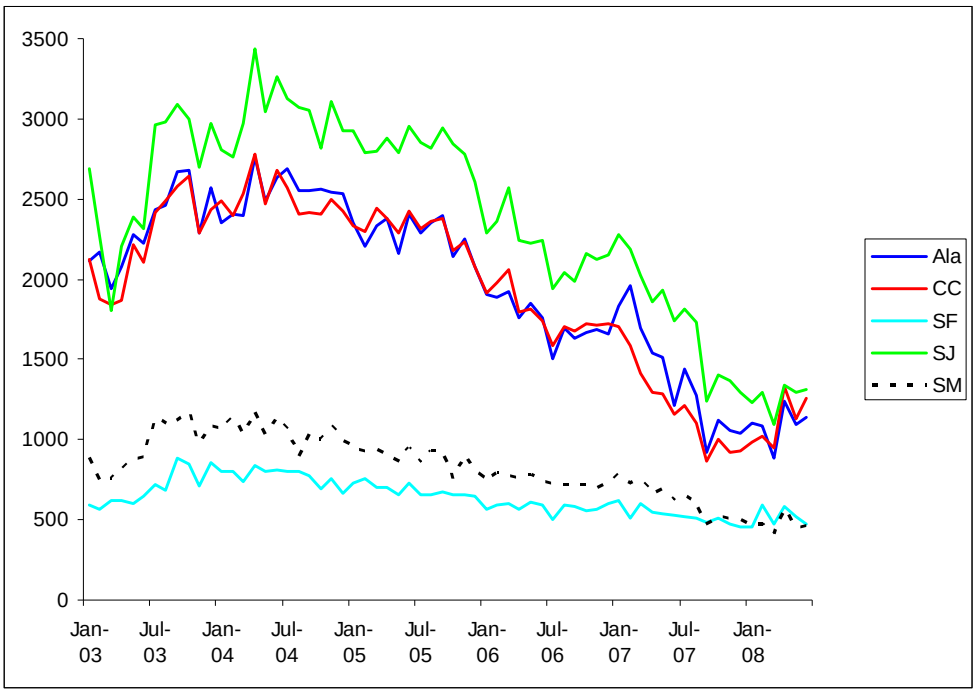
Source: Dataquick, UCLA Anderson Forecast

Figure 2: Year-over-Year Change in Median Sales Price of All Homes by County



Source: Dataquick, UCLA Anderson Forecast

Figure 3: Total Homes Sales by County (SA)



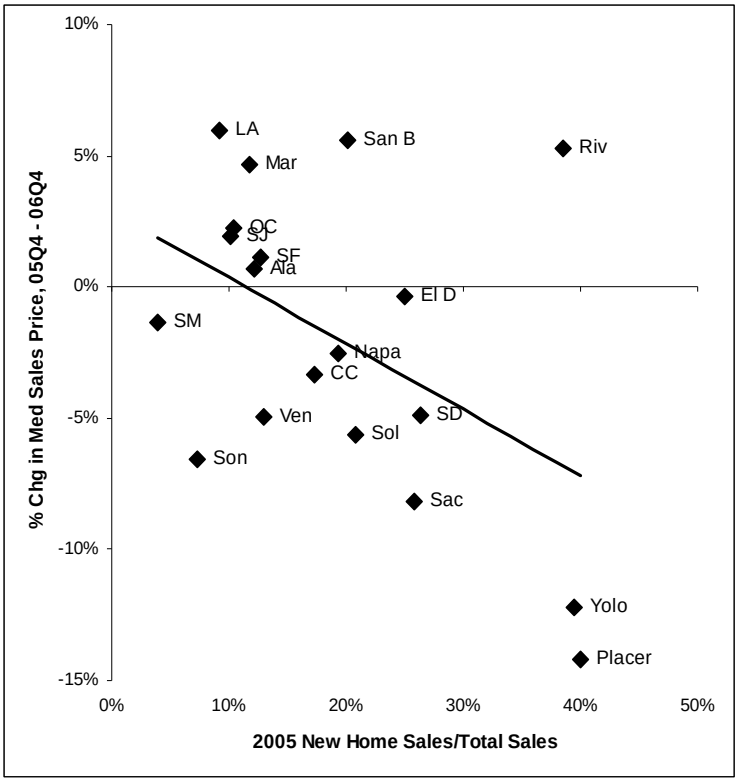
Source: Dataquick, UCLA Anderson Forecast

Phase 1: A Typical Housing Correction?

In the first phase, from the peak in summer of 2005 through 2006Q3, the year-over-year growth rates in median sales prices of all homes in the Bay Area dropped from over 20% to close to 0% by 2006Q3, with home prices essentially treading water around this 0% appreciation through the summer of 2007.

This is exactly what we expected to see in the Bay Area, for two reasons. First, while the economy slowed a bit in the latter half of this first phase, there was not major across-the-board job loss. The infrequent declines in resale home prices that we've seen in the past have always occurred in the wake of major job loss, like the early 1990s in Southern California, or the brief spate of depreciation in the Bay Area in 2001. In the absence of being forced to sell by job loss, owner-sellers preferred to just wait the slump in prices out: resale sales volumes collapse, but prices just go flat.

Figure 4: **New Home Sales vs. Median Sales Price in Phase 1**



Source: Dataquick, UCLA Anderson Forecast

Of course, Figure 1 shows that the Bay Area's experience was hardly universal: over this same Phase 1 period, median sales prices in the Central Valley were declining at between -5% to -10% a year, while Southern California's median home prices were still growing at 5% a year thanks to LA County. Figure 4 offers some insight into these differences: in this first phase, home prices were weaker in markets where new homes were a bigger share of total sales. As we've argued before, a builder does not have the luxury of waiting out a weak market the way an owner can: they have to move inventory, and in a weak market that means cutting prices. So in markets like Sacramento and Yolo Counties, where new homes represented 26% and 40% of total sales, the aggressive price cutting on new homes provides a double whammy to average house prices. There's the direct effect of having 30% of the sales prices in the sample fall, and then there's the secondary effect that requires owners who do want to sell existing homes to price to compete against these cheaper new homes. This is the second reason why we expected to see flat prices in the Bay Area: new homes accounted for 10% or less of sales in most Bay Area counties in 2005 – among the lowest levels in the state. However, Contra Costa County is the exception that proves the rule: new homes represented 20% of 2005's total sales in Contra Costa, and Figures 2 and 4 demonstrate that Contra Costa had the weakest home prices of any county in the Bay Area during this first phase of the Bay Area housing slump.

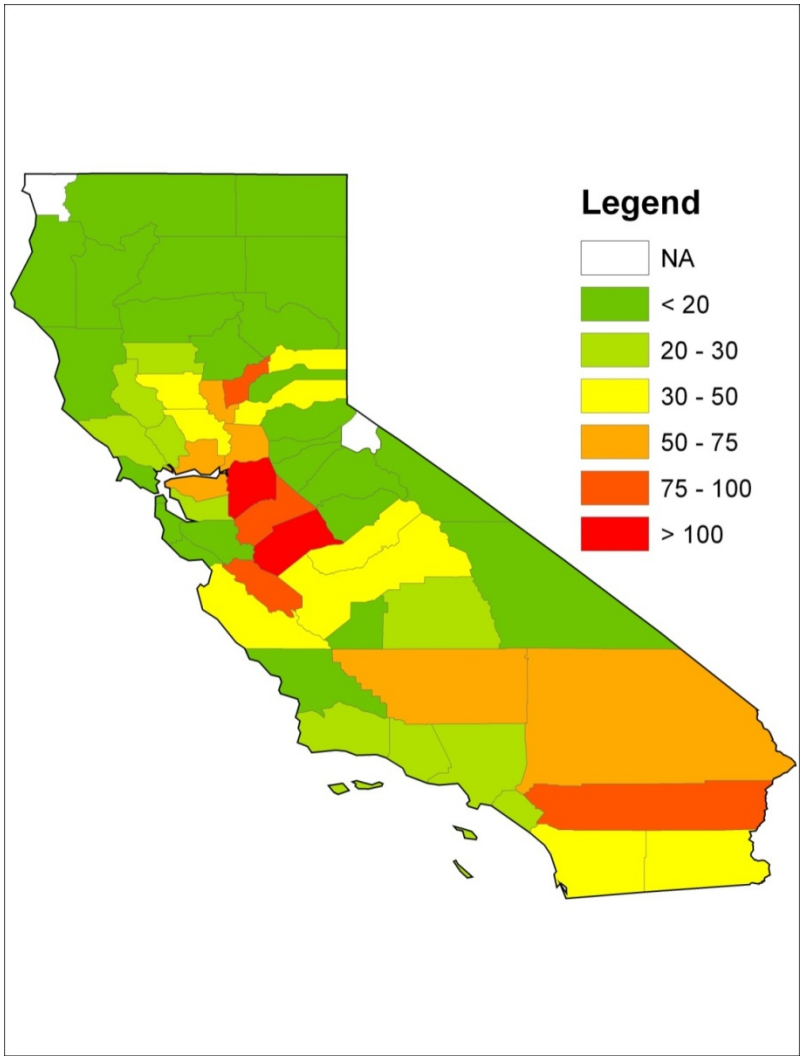
At the end of Phase 1 in late 2006 and early 2007, sales volumes were starting to look like they had found a bottom, and home prices looked like they were settling in for a long period of stagnation – a scenario we've often seen in the historical record. But then the bottom fell out: sales volumes hit new record lows, and median prices in the existing home market started plummeting again. Even markets like San Mateo and San Francisco Counties, which we thought would be relatively insulated from price declines, are now down over 15% from their respective peak median sales prices as of June 2008. This second precipitous drop in home prices marks the beginning of Phase 2, which began in the early summer of 2007 and lasted through 2008Q1.

Phase 2: The Foreclosure Storm

The unique feature of Phase 2 is the emergence of substantial declines in resale home prices, leading to a second round of overall home price weakness. While the California economy has avoided recession caliber job losses so far, we have seen an explosion of

foreclosure activity in the state that dwarfs the 1990s. This surge of foreclosures/distress sales in the absence of substantial job loss is historically unprecedented: now, widespread mortgage defaults are occurring not because of layoff-driven income losses, but because the slowdown in price appreciation shut off the only escape route from mortgages that many homeowners simply had no hope of ever servicing. We always knew that the cocktail of lax underwriting, low down payments, and exotic high-leverage mortgages that did not require even full interest payments would inevitably lead to some increase in foreclosures when the market turned. But not even the most rabid housing bears anticipated that these problems were so widespread that foreclosure rates would surpass the records set during some of the most severe recessions in California history.

Figure 5: Trustee Deeds of Sale per 10,000 Households

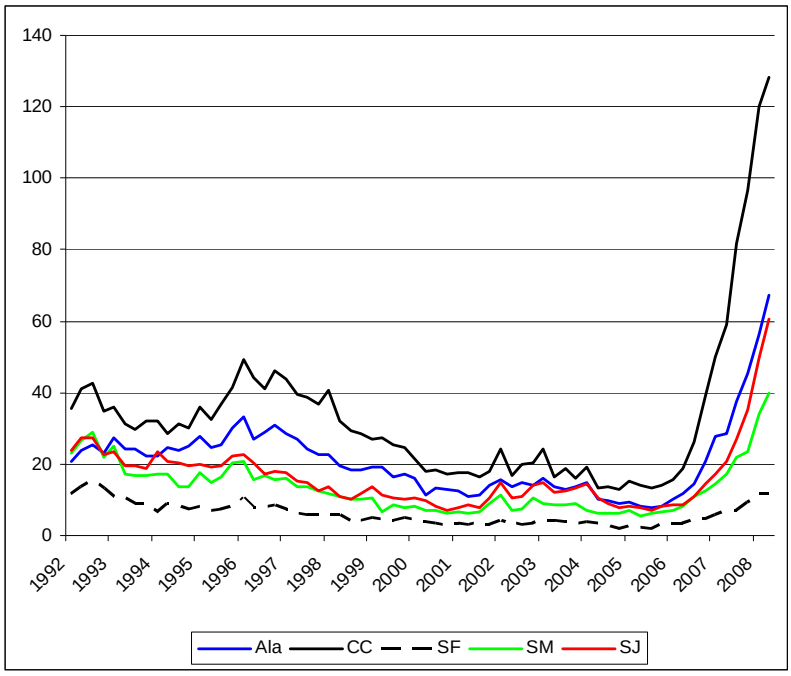


Source: Dataquick, US Census, UCLA Anderson Forecast

Figure 5 shows the number of Trustee Deeds of Sale filed per 10,000 households in 2008Q1. This number measures the intensity of the local foreclosure problem: Trustee Deeds of Sales mark the actual repossession of a home by the bank, and the scaling by household controls for population instead of letting LA County dwarf the rest of the state. While almost every county in California saw a massive increase in foreclosure filings in 2007, the worst of the problem once again seems concentrated in the inland areas.

Where does the Bay Area fit within the context of these larger trends? For the most part, the rise in Bay Area foreclosure activity has been among the mildest in the state. The intensity of mortgage defaults (Figure 6: Notices of Default per 10,000 households) in San Francisco County is actually still below the record set in the 1990s. In San Mateo, Santa Clara, and Alameda Counties, the increase in defaults has been more severe, but is still fairly mild when compared to the rest of the state. The exception is Contra Costa County, where the surge in defaults and foreclosures is more akin to the hardest hit inland areas. Of course, even within the counties, the foreclosure experience is far from uniform. Figure 7 presents Zillow.com's estimates of the share of buyers in the Bay Area who purchased homes between 2005 and 2008 in a

Figure 6: Notices of Default Filed per 10,000 Households

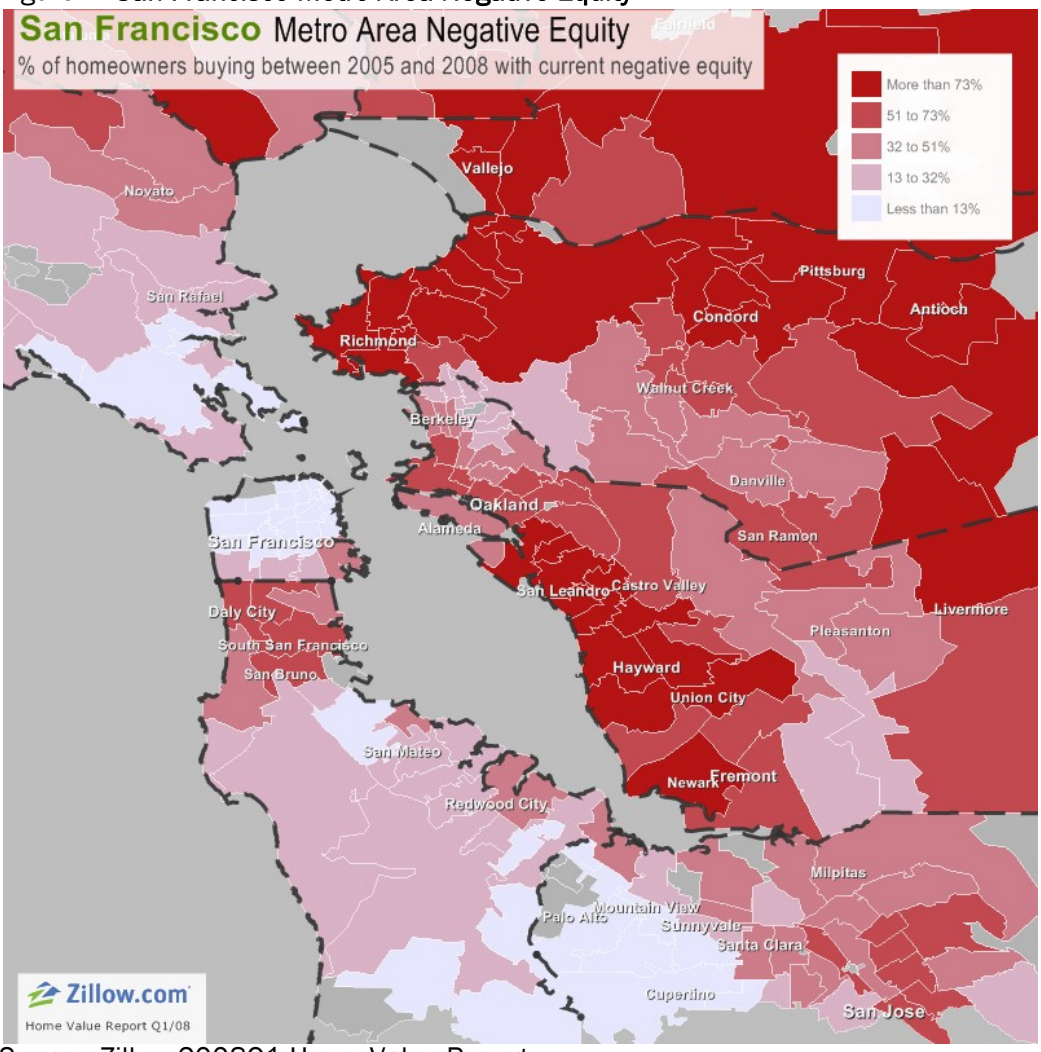


Source: Dataquick, US Census, UCLA Anderson Forecast

particular ZIP code and now have negative equity (i.e. they owe more on the house than its current estimated value). These concentrations of negative equity are highly but not perfectly correlated with foreclosure activity. Much of the negative equity is concentrated in more affordable areas within these regions: east Contra Costa County, Oakland, Hayward, South San Francisco, etc. Nevertheless, Contra Costa once again stands out relative to the rest of the Bay Area.

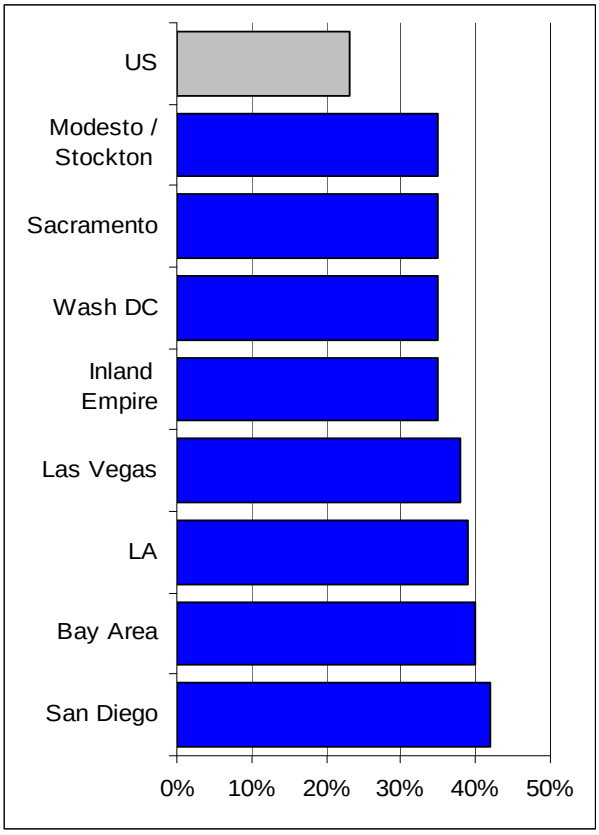
Why is Contra Costa County having so much more trouble with foreclosures than the rest of the Bay Area? As we've argued before, the common denominator among the foreclosure hotspots seems to be the widespread use of adjustable rate mortgages to purchase relatively modestly priced homes. High usage of ARMs alone was not a risk factor: in 2005, more than 80% of purchase mortgages in the Bay Area were some sort of ARM, as even relatively wealthy families stretched to afford some of the most expensive homes in the US. And not just any ARMs: interest only and negative amortization loans (which allowed borrowers to pay less than the full amount of interest due every month) were especially popular in the Bay Area. According to Loan Performance, 40% of purchase originations in 2006 in the Bay Area were some sort of interest only or negative amortization loan, compared to the national average of 23%. But only Contra Costa combined the highest usage of ARMs in the Bay Area (85%) with some of the most affordable homes in the nine-county region. Across California, this combination of using the riskiest loans to stretch to buy the cheapest homes has proven to be recipe for the worst foreclosure problems.

Figure 7: San Francisco Metro Area Negative Equity



Source: Zillow 2008Q1 Home Value Report

Figure 8: 2006 Share of Interest Only and Neg. Amortization Purchase Mortgages

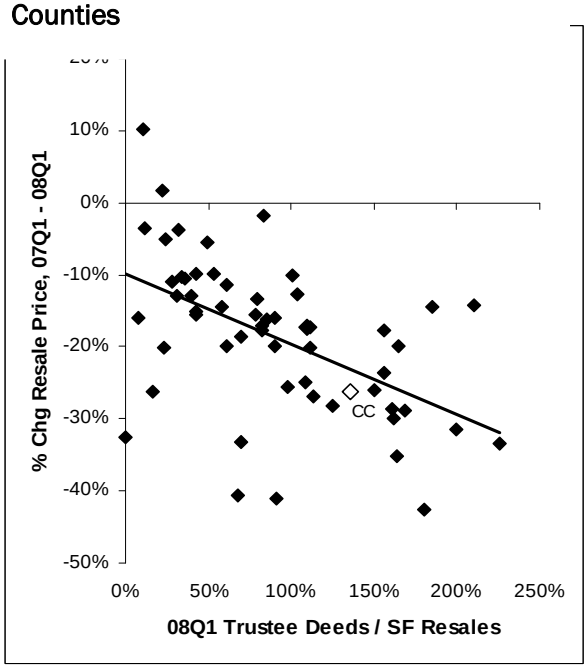


Source: Credit Suisse

trustee deed filings were 200% higher than resale volume in 2008Q1, while a low foreclosure area like San Francisco County comes in at only 23%. The vertical axis of Figure 9 is the percentage change in resale single-family home prices from 2007Q1 to 2008Q1: as we'd expect, the markets where foreclosure activity is high relative to sales are the markets where resale prices are weakest. Contra Costa County is highlighted in the Figure 9: with foreclosures in 2008Q1 representing 135% of total resales in 2008Q1, an above average level of foreclosures sales are a major factor in Contra Costa's above average price weakness.

Unfortunately, the hardest hit areas are trapped in a feedback loop: high levels of foreclosures depress resale prices, which push more homeowners into a negative equity position where foreclosure becomes the only way out, creating even more distress sales. According to estimates by Dataquick, resales of foreclosed properties accounted for 33% of all resale activity in California last quarter, and up to 70% in some of the hardest hit counties in the Central Valley. Figure 9 is a primitive attempt to gauge the impact of foreclosures on California county resale prices more directly. The horizontal axis is our approximation of this Dataquick metric: we compare the number of trustee deeds filed in a county in 2008Q1, divided by the number of existing single-family homes sold in the same period. This is an imperfect indicator of the importance of foreclosure sales in the resale market: since the trustee deed represents the transfer of the home to the lien holder, it's an inconsistent leading indicator of future distress sales, since it takes time for the repossessed property to be sold in the resale market. Nonetheless, this measure is consistent with our previous story about foreclosures: high foreclosure markets like San Joaquin County show that

Figure 9: Pct. Chg. In Median Sales Price versus Foreclosure/Sales Ratio, CA Counties



Source: Dataquick, UCLA Anderson Forecast

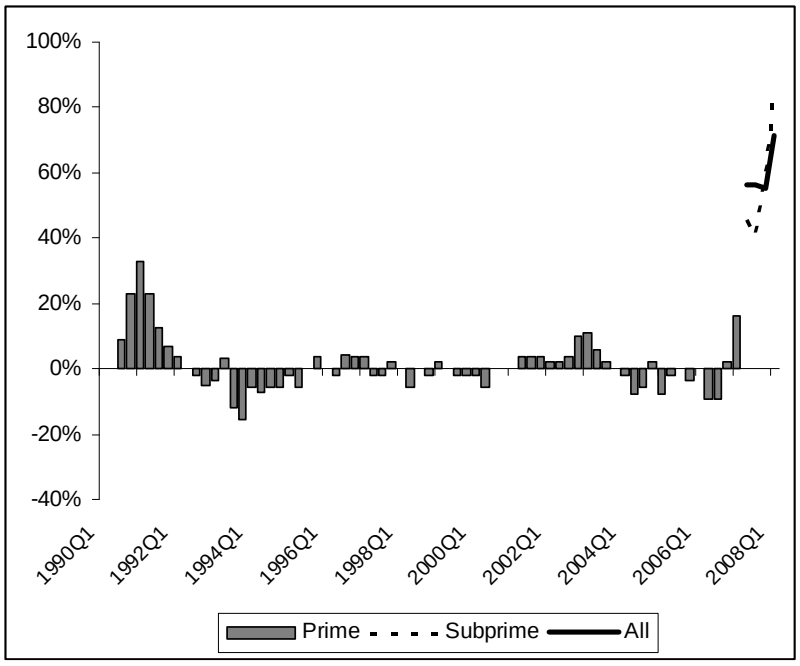
Phase 3: A Flicker of Light in a Dark Tunnel (Summer 2008)

The feedback loop between foreclosures and price declines has made Phase 2 of the real estate bust feel a lot like free fall, with no end in sight. However, the past couple of months have actually seen a small dose of good news: sales volumes in Southern California and the Bay Area are actually rising again. Several factors have combined to produce this small dose of upward momentum: steep price declines, lower interest rates, and an easing of the credit crunch may now be bringing bargain hunting buyers back into the market. Ironically, the areas with the steepest price declines are the areas with the biggest jump in sales: for instance, Contra Costa County and Riverside County have seen sales volumes in 2008Q2 higher than in 2007Q2.

It may be a little early to be celebrating the beginnings of Phase 3 – perhaps we're better off thinking of this as Phase 2.5. Obviously, the driving force in California housing markets in the near term will continue to be the shadow cast by a glut of foreclosed properties on the market. So the first question we have to answer is how much longer the foreclosure problem will last. In part, the answer depends on the rest of the economy, both nationally and locally. If our forecast that California will avoid major job loss in 2008 holds up, foreclosures will primarily be an issue of working through the unviable low down payment loans made in the last days of the boom. Two issues are relevant to this question: when did the spigot of bad loans get turned off, and how long on average does it take for an unviable loan to go bad?

The Fed's Senior Loan Officer Survey gives some insight into the first issue. The relevant question from the survey is "Over the past three months, how have your bank's credit standards for approving applications from individuals for mortgage loans to purchase homes changed?" Figure 10 shows the net percentage of respondents who replied that they have tightened lending standards (the break in the series at the end reflects a change to the questions in 2007Q2). 2007Q1 is where we see this percentage start to rise towards its current highs, giving us a reasonable estimate of the end of the funny money party.

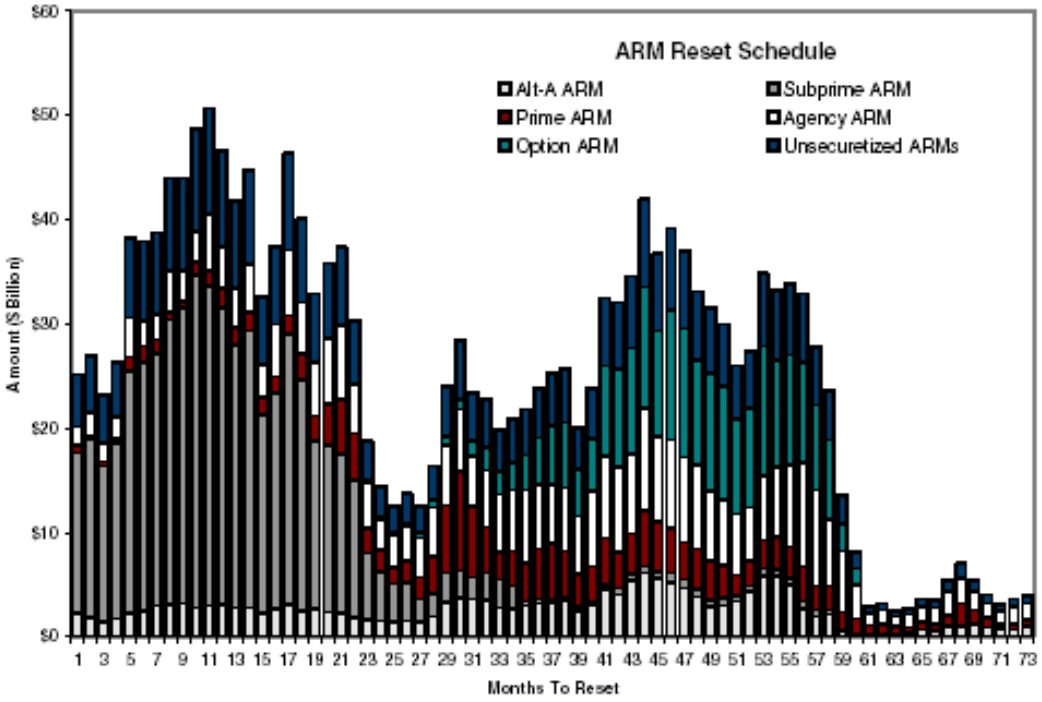
Figure 10: Fed Sr Loan Officer Survey: Net Share of Respondents Tightening Mortgage Lending Standards*



*Note: In 2007Q2, the survey was changed to disaggregate loans of different credit quality.

As for the second issue, Dataquick reports that most of the loans that defaulted in 2008Q1 in California were originated between August 2005 and October 2006, with a median age of just under two years – suspiciously close to the reset date of many of the 2/28 subprime ARMs so popular during the boom. Figure 11 shows Credit Suisse's estimates of the volume of ARM's that will be resetting nationally, starting in January of 2007. Since we're now at 19 month mark, we're still near the peak of resets – but on the back side. Of course, resets are only part of the foreclosure problem. But combine the Fed survey, the Dataquick estimates, and this reset pipeline, and a dim light starts to emerge at the end of the tunnel. If the end of 2006 was approximately the last bulge of bad loans, and these loans take an average of two years to go bad, we may see declining foreclosure rates in early 2009.

Figure 11: Volume of Adjustable Rate Mortgages Resetting per Month, Starting Jan. 2007



(Source: Credit Suisse)

Even so, another 9-12 months of distress sales will continue to wreak havoc on home valuations, as the combination of foreclosure discounts and the skewed mix of homes selling in this market render even the most carefully crafted measures of current home prices suspect. 2009 will likely be devoted to picking up the pieces, and discovering what houses are really worth in a market that isn't dominated by short sales and foreclosures. We still have a long dark road ahead, but at least we can see a flicker of the light at the end of the tunnel. While it's hard to find much good news about Phase 2, there is one tarnished silver lining in this dark cloud: the unprecedented speed of the price adjustment means that instead of several years of slow bleeding (like the 1990s), we have compressed the necessary adjustment into two years of intense housing pain. Mom always said it's better to just rip the Band-Aid off…

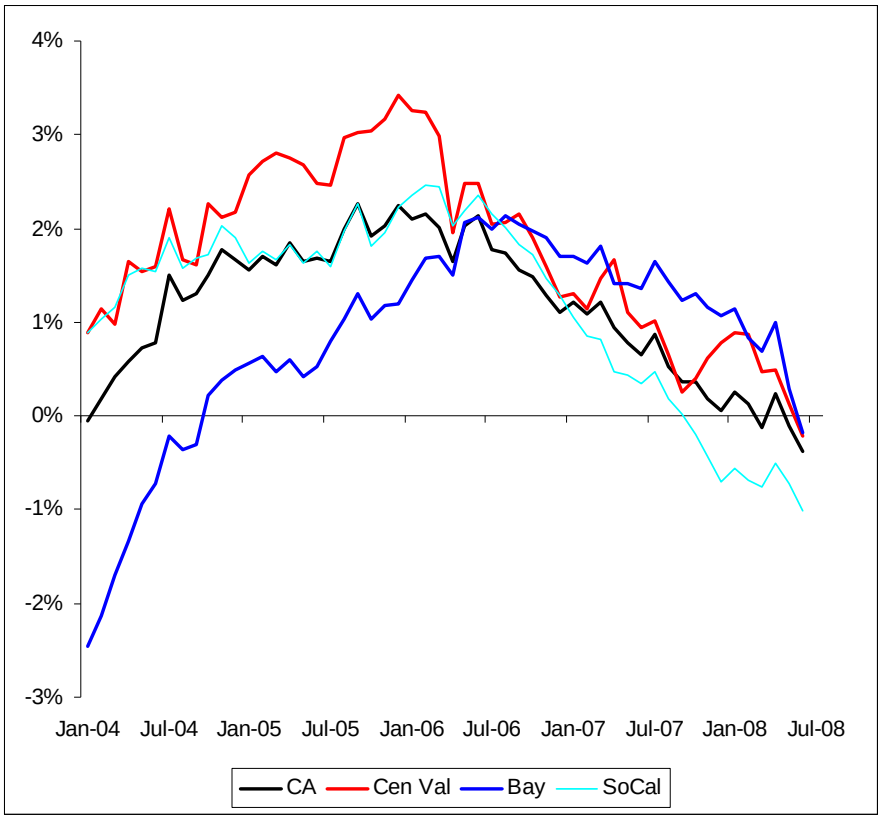
Bay Area Job Market Update

For a long time, we've argued that the deepening slump in California's housing market would take its toll on the wider economy. The slump in building activity would lead to substantial

job loss in Construction, while the contraction of home sales and the tightening of lending standards would lead to weakness in real estate related Financial Activities. Qualitatively, this has turned out to be a fairly accurate description of the California labor market's long, slow slide over the past two years. Quantitatively, the job loss in Financial Activities has far exceeded our expectations, losing almost as many jobs as Construction.

At the time of our last quarterly report, year-over-year non-farm payroll growth in California had turned negative, as weak-but-positive job growth in the Bay Area (San Francisco MSA) and Central Valley (Sacramento, Stockton, Modesto, Fresno, and Bakersfield MSAs) finally succumbed to the increased pace of job losses in Southern California (Figure 12). Since April, this situation has deteriorated even further, as both the Bay Area and Central Valley have seen year-over-year job growth grind to a halt in 2008Q2, while the contraction in Southern California employment has continued. In all three regions, non-farm payroll employment is below last June's level.

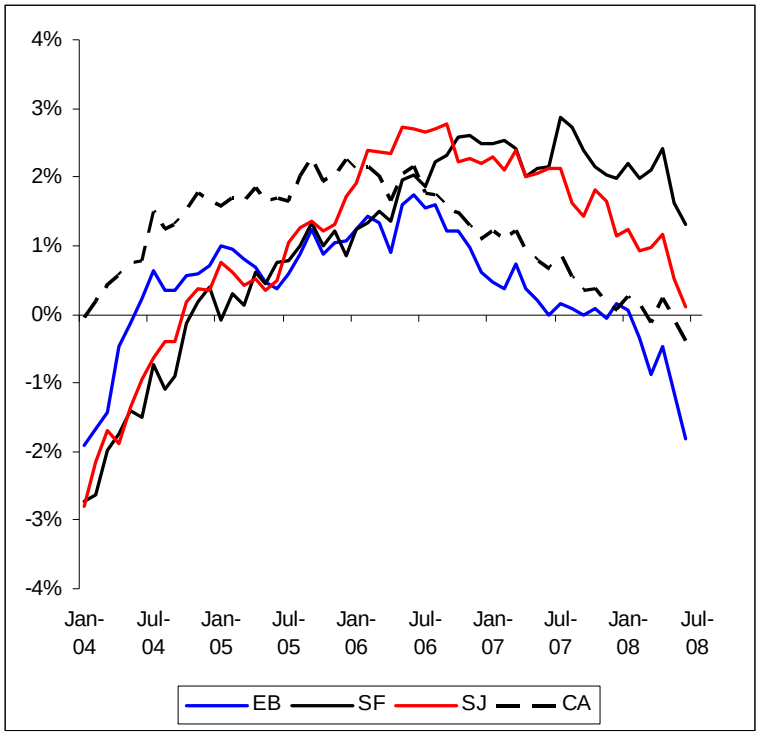
Figure 12: Year-over Year Growth in CA Non-Farm Payrolls by Region



Source: CA EDD, UCLA Anderson Forecast

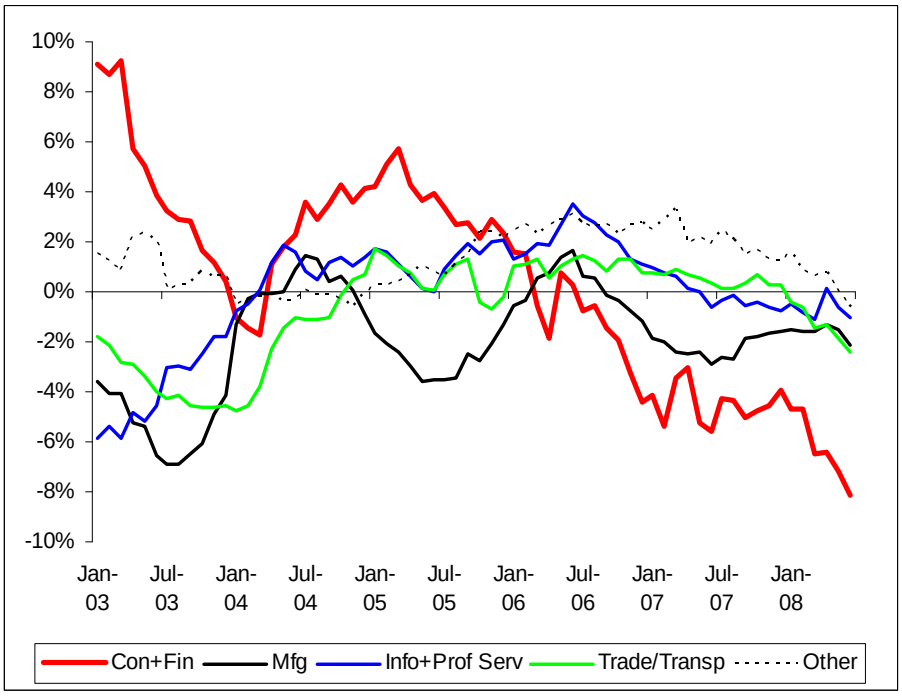
Until recently, the Bay Area had largely been the sunny spot in this gloomy story: it had a lower than average exposure to the construction boom, and the high-tech sectors were finally starting to get back on their feet. This has made the recent slowdown in the Bay Area especially sharp, with year-over-year payroll employment growth moving from 1% in April to -0.2% in June. In the past two years, the East Bay (Oakland MD) has been the primary source of weakness, while the San Francisco MD and San Jose MSA have enjoyed some of the highest job growth in the state. However, this trend changed significantly in the second quarter, with all three Bay Area economies showing sharply lower job growth in 2008Q2 (Figure 13).

Figure 13: Year-over-Year Growth in Bay Area Non-Farm Payrolls



Source: CA EDD, UCLA Anderson Forecast

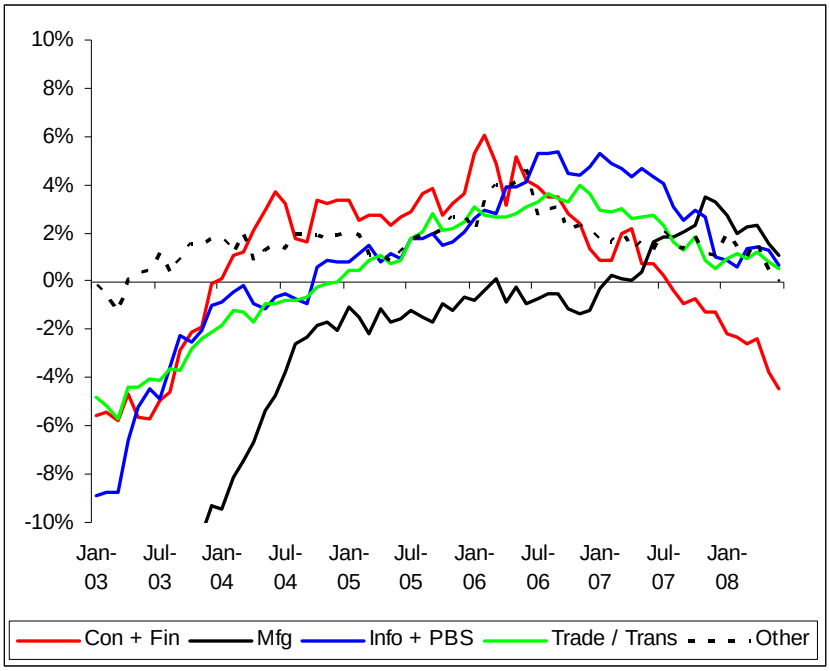
Figure 14: Oakland MD Year-over-Year Employment Growth in Major Sectors



Source: CA EDD, UCLA Anderson Forecast

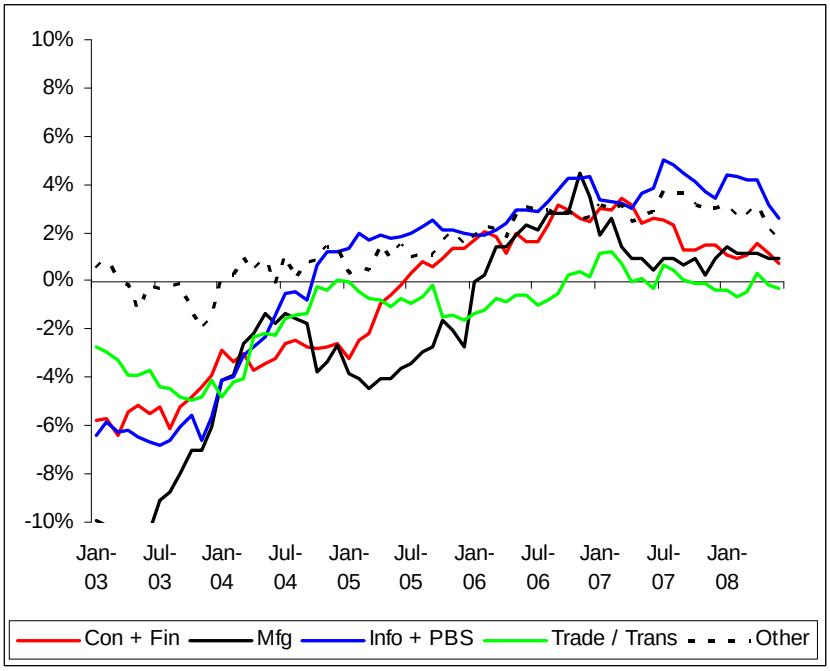
Figures 14-16 highlight the major trends in the Bay Area by showing year-over-year job growth in 5 groups of industries. Each of the three regions in the Bay Area is a variation on three themes: an asymmetric recovery in the high tech sectors, real-estate related job loss, and local idiosyncratic shocks.

Figure 15: San Jose MSA Year-over-Year Employment Growth in Major Sectors



Source: CA EDD, UCLA Anderson Forecast

Figure 16: San Francisco MD Year-over-Year Employment Growth in Major Sectors



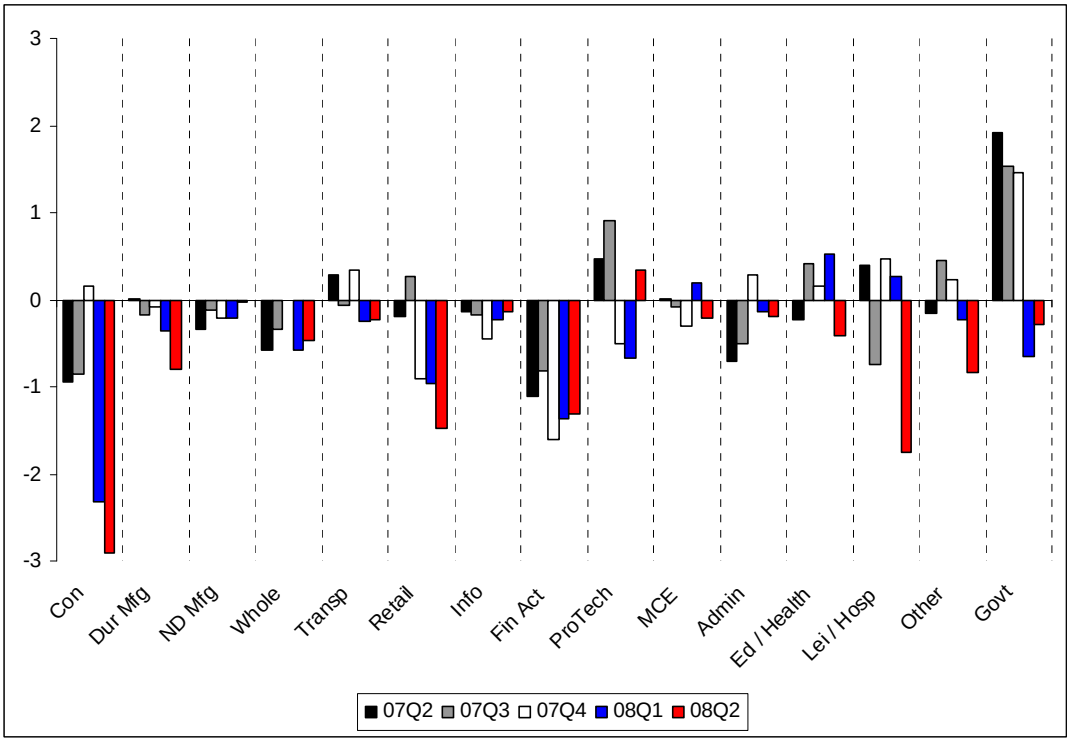
Source: CA EDD, UCLA Anderson Forecast

East Bay (Oakland MD)

Unfortunately, the East Bay has emerged as the weakest of the three job markets. It has experienced the worst real estate related job losses, it has experienced the shortest-lived recovery in high-tech, and has also been hit by some ill-timed shocks from the government sector.

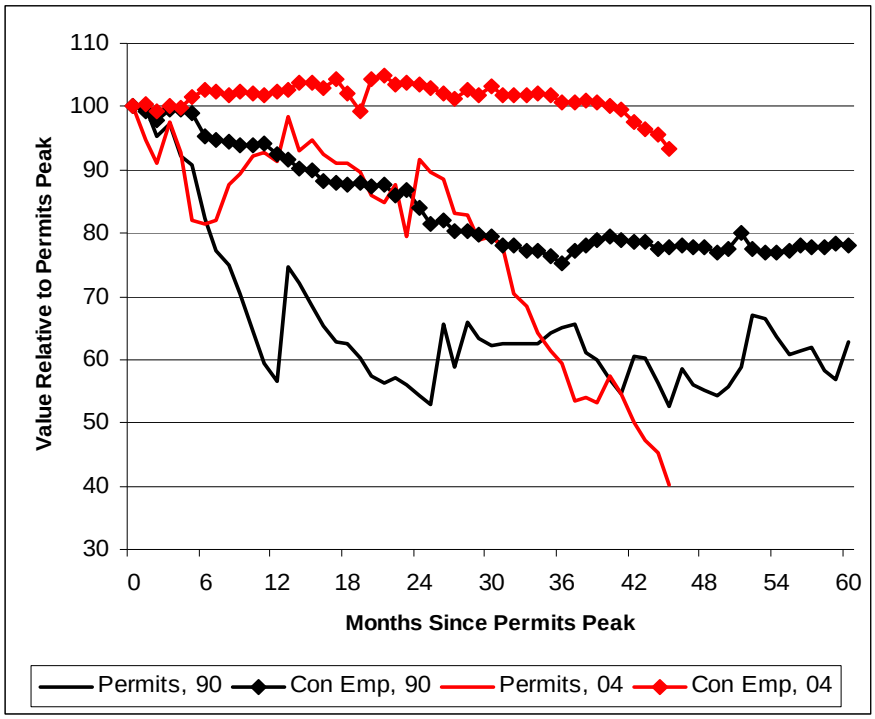
Job growth in the East Bay peaked in 2006Q2 as both manufacturing and high-tech service employment (Information and Professional/Business Services) shook off the tech bust doldrums to post solid gains. Combined with solid growth in Retail/Wholesale Trade and continued steady growth in other service sectors like Health Care, this tech renaissance was enough to offset the weakness that was already starting to emerge in the real estate sensitive sectors. Unfortunately, the recovery of the high-tech sectors was short-lived: over the course of 2007, both manufacturing and high tech services crossed back into negative territory. At the same time, real estate related job losses leveled off at around -5% year over year for most of 2007: Construction employment was flat, while real-estate related Financial Activities continued to lose jobs.

Figure 17: Oakland MD Sectoral Employment Changes by Quarter (1000s)



Source: CA EDD, UCLA Anderson Forecast

Figure 18: Updated Index of Oakland MD Res. Building Permits (Smoothed, SA) and Construction Employment (SA)



Source: CIRB, CA EDD, UCLA Anderson Forecast

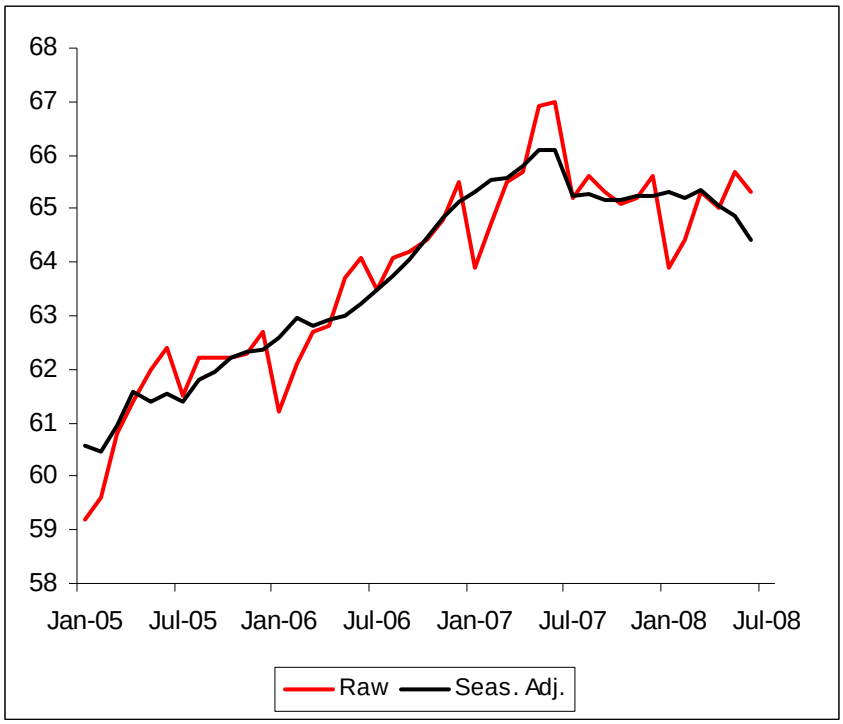
In 2008Q2, seasonally adjusted non-farm payrolls declined by 7,000 jobs (-2.65% on an annual basis). Close to half of this decline came from the Construction sector, which lost 2,900 jobs over this period. In some sense, this represents the numbers catching up with reality: the East Bay's decline in residential permit activity has made this correction inevitable. Unfortunately, Figure 18 suggests that these losses may be only the beginning. Looking back at the last big building slump in the East Bay, we see that in the 1990s, a 40% decline in building permit activity over a 16-24 month period led to a 25% decline in Construction employment in the three years following the peak of building permits. The coordination of the downturns in permits and Construction employment is obviously different this time around. But the relative magnitudes from the last building slump suggest that we've only seen the tip of the iceberg in East Bay Construction job losses: East Bay building permits are now down 60% relative to their peak. The lack of growth in Construction jobs has kept East Bay job growth weak for more than a year now; following the rest of the state into outright job losses in Construction has only made things worse.

On the Financial Activities side, we continue to see steady job losses, averaging 1,200 jobs a quarter since the summer of 2007. Not surprisingly, these losses have concentrated in the mortgage-heavy Credit Intermediation sector, but the Insurance Carriers and Related sector has also seen mounting job losses in the last year. As we discussed in the last East Bay report, Contra Costa County has one of the highest concentrations of mortgage-related employment in the state – not quite as high as Orange County, but higher than San Diego. These financial jobs are some of the highest paying jobs for any given level of educational attainment, so the loss of these jobs leads to a disproportionate loss of local personal income and output.

While real estate related job loss is a familiar story line in the East Bay, the deterioration of the Retail Trade sector is something new in 2008. In the most recent twelve month period (since June 2007), the East Bay has lost 3,100 jobs. Retail Trade job loss in 2008Q2 accounts for nearly half that total at 1,500 jobs. Fully 2,200 of these 3,100 lost jobs fall into the unhelpfully labeled Residual category, which the Employment Development Department suggests is primarily a combination of the Furniture and Home Furnishings and Building Material/Garden Supply categories. Contra Costa County in particular has an above average concentration of Building Materials stores, which accounted for 1.4% of the county's employment in 2006, compared to 1.04% for California as a whole. So most of the recent job loss in East Bay Retail employment is in sectors that are collateral damage in the housing slump: furniture stores suffer when home sales are low, and building supply stores suffer a double whammy from a slump in construction/remodeling and low home sales volumes. Outside of these housing-specific retail sectors, there is a trickle of job losses across the retail sectors, but not the catastrophe suggested by the aggregate numbers.

Last but not least, two of the biggest sources of recent weakness in the East Bay are just plain quirks. First is the loss of 1,750 Leisure and Hospitality jobs, with 1,000 of these jobs coming from restaurant related employment. In one sense, this is simply a continuation of the weakening that started in the summer of last year, and has been felt across the Bay Area. But part of this rather large drop comes from a break with seasonal trends: Food Service and Drinking Places employment has stayed flat at a time when we normally expect a summer hiring boom, leading to seasonally-adjusted job losses.

Figure 19: Oakland MD Food Service and Drinking Places Employment (1000s)



Source: CA EDD, UCLA Anderson Forecast

This weakening in restaurant employment has occurred across California, but has been most noticeable in building boom regions like the East Bay, or in the Riverside and San Bernardino

in Southern California. This suggests there are two forces behind this trend: a mild decrease in spending across the board, coupled with overextension of the restaurant industry in overbuilt areas. The second quirky source of East Bay job loss came from the State Government category. The most likely source of these losses is the one-off reorganization of the Lawrence Livermore National Laboratory. However, the budget crisis in Sacramento suggests that this sector is primed for further losses – just not from the same sources as 2008Q2.

San Jose MSA

San Jose represents the middle ground on our three themes: a strong recovery in high-tech sectors that has begun to slow a bit in recent months, moderate levels of real estate related job loss, and some weakening in Retail and Leisure/Hospitality.

San Jose was the center of the tech renaissance we discussed before, benefiting from a recovery in Professional / Technical Services and Information employment in 2006 and 2007, followed by a surprising but welcome recovery of high-tech manufacturing employment that continued through 2008Q1. This recovery lost a little bit of steam in the most recent quarter, but Manufacturing employment is still higher than last year in San Jose, which is at odds with just about every other economy in the state. Similarly, most other service sectors have slowed, but are still in positive territory for the last twelve months.

Just like the East Bay, Construction employment in San Jose in 2007 was showing a gradual trend of job loss, worsening in 2008. In 2008Q2, San Jose lost almost as many Construction jobs as the East Bay (2,000 versus 2,900), in a sector that is only two-thirds the size (46,500 Construction jobs in San Jose in March 2008, versus 69,500 in the East Bay). Real estate woes are taking just as big a bite out of the San Jose economy, but are concentrated in Construction rather than evenly split with Financial Activities. The slowdown in San Jose's overall job growth in the most recent quarter is a familiar story: real estate weakness dragging down the rest of the economy, but no other obvious source of significant weakness.

As the part of the Bay Area that is least exposed to real estate troubles, the San Francisco MD continues to see the best job market in the region. Real estate related jobs have actually been a positive contribution, with small gains in Construction offsetting smaller losses in Financial Activities. High-tech service employment has been booming in the 3-4% a year range since the summer of 2007, but has slackened slightly in the most recent quarter, being the primary culprit in San Francisco's overall slowdown this quarter. The metro has also benefited from a small but sustained spurt of growth in Manufacturing similar to what we've seen in San Jose. This makes the San Francisco and Oakland metros the polar opposites of today's Bay Area economy. Both economies are slowing. But while the East Bay has seen real estate take a big bite out of local job growth, the San Francisco MD has largely been insulated from these problems, with little or no building boom and a Financial Sector that is not concentrated in real estate finance. San Francisco has also managed to maintain good growth in Professional/Business services, even as San Jose has started to see its recovery in this high tech sector falter a bit

Looking Forward

The rest of 2008 is going to be pretty tough on the East Bay, as an overdue contraction in Construction employment comes together with continued weakness in Financial Activities and the beginnings of another ice age in State Government hiring, as the one-off losses related to the Lawrence Livermore National Laboratory are overtaken by the more widespread weakness expected when Sacramento finally passes a budget. Retail

employment has been putting up some ugly numbers, but a closer look reveals that this is more likely a contraction in housing-sensitive retail like furniture and building supplies, rather than widespread losses across retail sectors. Similarly, the big negative in 2008Q2 in Leisure and Hospitality was due to a less-than-expected seasonal bump in the already volatile restaurant sector. The fact that substantial job losses have yet to spill over to sectors outside of real estate is somewhat encouraging. If this best case scenario continues, we'll basically have more of these doldrums for the rest of the year. If the East Bay does start to see significant job losses outside these sectors, thing could get a lot worse. The recent bankruptcy filing by East Bay department store chain Mervyn's was somewhat ominous: in addition to this chain's direct importance to the region, it may also mark the beginnings of the more widespread decline in consumption that we've feared for some time. The balance of evidence from other parts of California at this time suggests that "what happens in housing stays in housing" – but it's hardly a sure thing.

Obviously, the fate of the East Bay housing market hinges in no small part on the answer to this question. More of the same on the jobs front will likely mean more of the same on the housing front. But if layoff-related distress sales compound bad-mortgage distress sales, we could see a return to the freefall of Phase 2. Another crucial variable right now is the mortgage market. The initial phase of the credit crunch last summer was simply not to loan money. Money is flowing now, and lenders are even offering interest only payment options again. Now the issue is price: over the past three months, uncertainty about Fannie Mae and Freddie Mac, bank failures, and stock market turbulence have played havoc with mortgage rates, often generating 0.5% moves in the space of a few days. While foreclosures will be the main story of 2008, whether we are able to consolidate the uptick in sales volumes that we've seen in recent months absolutely requires stabilization in the mortgage markets.

So far, we've mostly focused on the cyclical side of the current slump: a year more of distress-driven housing markets, a temporary but painful slump in building activity, some belt tightening in the state government, and so on. But there is one part of the aftermath of the housing bubble that will cast a much longer shadow over the East Bay economy: the unprecedented decline in Financial Activities employment. Since its peak in June 2005, this sector has shed 18% of its total employment, or just over 12,000 of some of the highest paying jobs in the economy. And, in our opinion, many of these jobs are not coming back. Thanks to a combination of low interest rates, a hunger for post-tech bust investment opportunities, and a slow-to-adapt regulatory environment, non-bank mortgage lenders became this decade's dot-com boom. Now that the market has turned, consolidation in this industry is inevitable. And this consolidation will leave a major hole in the employment base of the regions where it boomed the most: Orange County, San Diego County, and, unfortunately, the East Bay. 12,000 jobs is almost a year's worth of "normal" job growth in the East Bay, that will have to be made up from across the board growth in other sectors. Forecast economist Jerry Nicklesburg recently estimated that Orange County will not recover to its previous peak employment level until 2012. And simply replacing 12,000 finance jobs with retail or tourism is a terrible trade in terms of personal income in the region.

As sobering as these estimates are, these figures are relatively small in the scheme of structural adjustments: it's not the Rust Belt, it's not aerospace… it's not even on par with the tech boom. The same factors that have made the East Bay successful will continue to do so in the next decade – but the ride there will be a little bit rough.

The California Report: Did it Really Stay in Housing?

Jerry Nickelsburg, UCLA Anderson Forecast

Labor Market Update: Flying Low Through the Slowdown

Let's turn our attention to California by first taking a look at employment and unemployment for the first four months of 2008 as compared to the same period in 2007 and going through some of the numbers. California has been adding an average of 20,000 net new labor market participants per month over the last year but only creating about 3,500 new jobs per month. Unemployment has jumped from 5.25% in the first quarter of 2007 to 6.28% in the first quarter of 2008 and it has been at 6.2% since March. The current level is still substantially below the recession levels of near 7% experienced in 2002-2003, but a big jump nonetheless.

There has been virtually no growth in non-farm employment in the past three months. The principal culprits creating the drag in payrolls are construction and finance, and the housing sector related occupations, losing almost 120,000 jobs in the first quarter. With the exception of Retail; Trade, Transportation and Warehousing employment growth has slowed, but remained positive. Retail employment is down due in part to weak auto and department store sales. Manufacturing is still losing jobs, but at a rate no greater than in the boom days of 2004/2005. If we focus only on those sectors losing payroll employment, over 75% of the job loss is in our culprit sectors.

Did it Really Stay in Housing?

Our theme three months ago was "what happened in housing stayed in housing," and it appears to be as true today as back in March. Comparing actual to forecast, we underestimated the declines due to housing on the one hand and underestimated the gains in employment in the services sectors on the other. This is good news because if California maintains its elevation slightly above water, is just overcoming the drag from construction and finance and there is no generalized spread of contraction to the rest of the economy, then when those sectors do hit bottom, California will be poised to take-off once again.

A Picture of California's Regions

Slicing the numbers geographically yields an interesting picture of today's California economy. The Inland Empire and Orange County are the biggest losers through the first four months of 2008. The Inland Empire was hard hit by the housing downturn and without growth in imports, the driver of the region's logistics industry, the downturn has resulted in a net loss of 24,000 jobs.

Orange County is another story. It was the center of what was a boom and is now a shrinking industry: home mortgage finance. The industry was structured to handle the high volume of transactions experienced in 2004-2006 and must now adjust to the new and more sustainable level of activity. We will take a look at this later in the report to try to determine how long it will take Orange County to recover the jobs which have been lost by this structural transition. Ventura and San Diego have both experienced small declines in employment, again due to the housing downturn in the early part of this year.

On the positive side, the Bay Area and Los Angeles continue to carry the state with widespread job gains in the service and selected manufacturing sectors. Export oriented, diversified, and less exposed to the housing bubble, they continue to grow and benefit from both that growth which is taking place elsewhere in the U.S. and the boom in exports from the U.S. More surprising is the growth in jobs in the Central Valley and Central Coast. These two regions share three characteristics, they were both hit hard by the housing downturn,

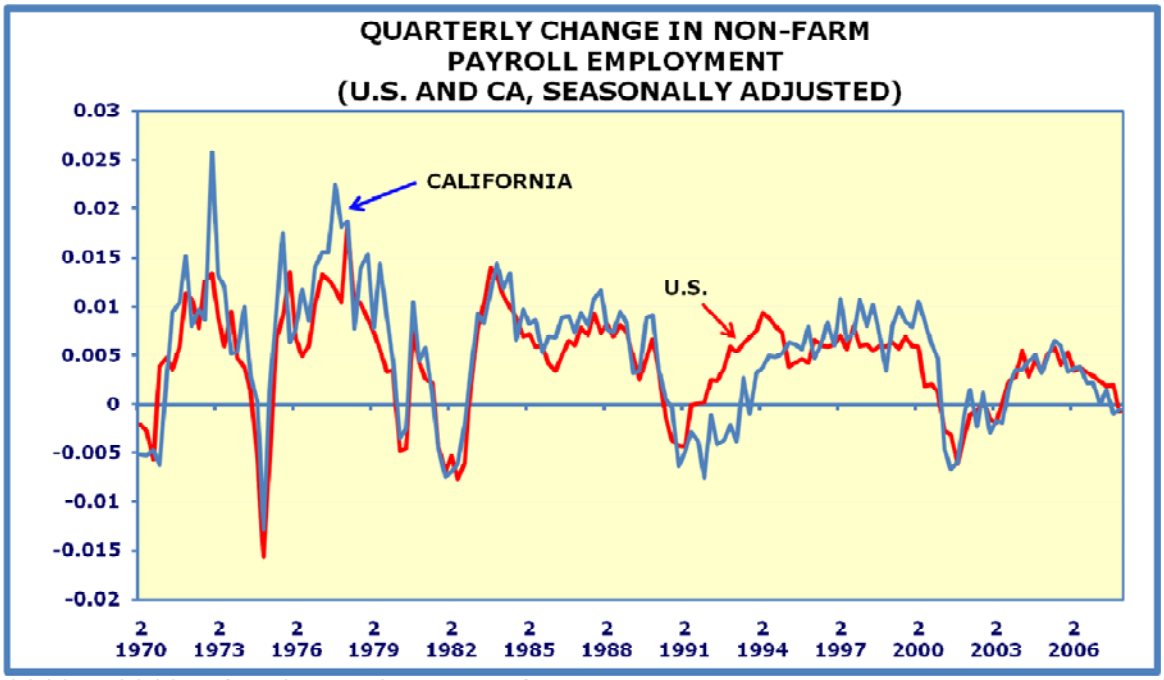
they are both major agricultural business centers, and they both continue to grow. This is a welcome surprise.

Structural Change: California and Orange County Employment

One striking characteristic of times of economic turbulence is that they often set into motion structural change processes which continue long after the turbulence has passed. It is important to distinguish the two, particularly as it appears that in California the Mortgage Finance Industry is undergoing structural adjustment which will play out quite differently than the slowing U.S. and California Economy.

The graph below tracks nonfarm employment rate for the nation and California since 1970. The recession periods are characterized by sharp drops in employment growth into the negative range and sharp increases back to normal. They are short-lived phenomenon and usually the U.S. and California move lock step together. The one exception is 1990 when California continued to shed jobs several years later than the U.S. This, of course, was the contraction in the aerospace industry.

Studying past instances of structural change in the nation's regional economies enabled us to develop a basic structural change recovery model to better understand what to expect for Orange County and the state overall. Recent growth in Orange County has been fueled by the housing bubble. Orange County's high recovery model score means that if the other sectors in Orange County don't start growing faster, and we see no reason why they should in an otherwise sluggish 2008/2009 economy, then it will take longer for the regional economy to recover from this important, but now much smaller industry. This means it will be around



2012 or 2013 before Orange County has fully regained the employment it lost in the home mortgage implosion. Since the mortgage finance industry is too small in and of itself to pull California employment growth negative there is no recovery story per se here, but the time to recovery, just as with the Bay Area in 2001 will be a drag on California growth.

Forecast and Conclusions

Our forecast is not much changed from three months ago. We are predicting a very weak California economy in 2008. The strength in exports of both goods and services in the Bay Area, and Los Angeles and in agriculture in the Central and Salinas Valleys will probably keep

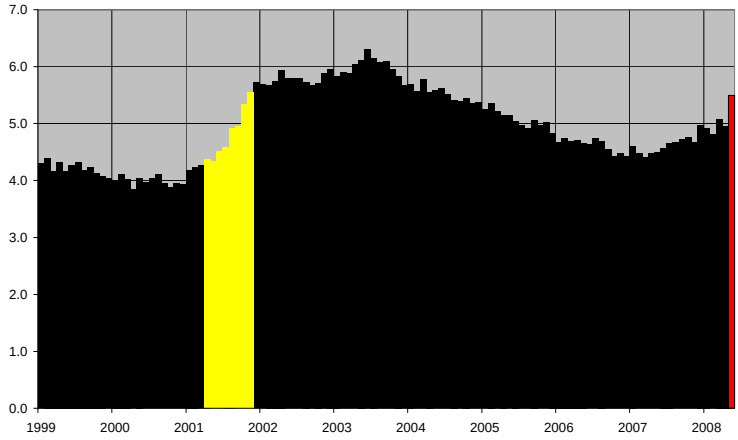
California employment flat the first half of the year. Real income and real taxable sales will both show small losses in the first half of the year.

The cry of a crisis in public finance is real as the slowdown in growth and in important tax generating activities will hit the coming fiscal year hard. After the first two quarters we will begin to grow again and personal income overall will achieve a 1.5% growth rate for the year. This is a tad faster than the U.S. economy. The faster growth for California is a reflection of California being heavy in those things driving the U.S. recovery as well as a slightly faster than average growth in the labor force.

The Nation: Muddied Waters

Edward E. Leamer, UCLA Anderson Forecast

Unemployment Rate: Recession in Gray



Until Friday, June 6, when the May unemployment level was released, I had written the title "Don't Celebrate; What Comes Next Isn't Going to Cheer You Up" as if the recession risks had substantially abated and we needed to shift focus to what comes next. Sure, the unemployment numbers in 2007 had risen, but in a rather mild way, consistent with our view that this time the troubles in housing would produce a disappointing outcome but not the catastrophic features of traditional recessions. But that May increase in the unemployment rate to 5.5 from 5.0 has shocked Wall Street and me too. That 5.5 is the only number I know that is clearly in the recession range. And just when I was about ready to take a victory lap, carrying my no-recession banner!

Nevertheless, I am holding on to what is now a shaky view: no recession this year.

It's a Hiring Strike, Not a Firing Binge

In a recession, jobs are easy to lose but hard to find. This time around jobs have been hard to find, but not easy to lose. The May data continue in that vein. Employment has fallen only a little bit, -24,000 jobs since the first quarter. The rise in the unemployment rate is mostly due to the increase in the labor force by 873,000 since the first quarter. This could be due to high school and college graduates struggling to find jobs in a tight labor market.

The Good News: The Housing Direct Drag on GDP Growth is Almost Over

With the reality of muddied water, let's turn our attention to some other data, first on housing. By measuring the contribution of residential investment to GDP growth during the sixteen housing downturns since 1947 we can study the total amount that housing subtracted from GDP from peak to trough. We find that the largest of these negative contributions was the 1973-75 period when housing subtracted a total of -2.33 from GDP over a period of 8 quarters for a rate per year of -1.16. The second worst contraction is the one we are now experiencing following the housing cycle peak in 2005Q4. Through 2008Q1, problems in housing have subtracted a total of 2.06 from growth, very close to the leader -2.33. When

the data for 2008 Q2 arrive, this may become the most severe housing contraction since the Great Depression. That is one reason for hope: history suggests this cannot go on much longer.

Furthermore, the data reveal that the business cycle peak often follows the housing peak by only a few quarters. By contrast this time, we are already an unprecedented 9 quarters into the housing adjustment and the data for GDP and payroll employment do not yet look like recession data. Thus, added good news: the unwanted recession is way overdue.

The Flip Side–Crude Oil Prices

With the good news comes the bad. Consumers are experiencing a relentless drumbeat of bad news telling them they are not as well off as they think and the unkindest daily slap in all our faces has been the incessant rise in the price of gasoline. Oil Prices: some variation of "since 2006, the price of a barrel of oil has more than doubled, peaking at just over $145 per barrel and as a result, we are actually starting to absorb the reality of much higher crude oil prices by cutting down our driving and trying desperately to unload our used SUVs to some unsuspecting buyers. Equally alarming is our dependence on imported oil that is now higher than it has ever been, increasing by a factor of three since 9/11 from 1% of GDP to over 3% today. The amount that is transferred to foreigners is massive. That represents a diversion of 2% of our income to foreign oil producers. There is going to have to be some serious belt-tightening soon enough.

The Logic of Our No-Recession Forecast

At this point, we need to repeat again why we think that this time the housing collapse will not lead into recession. The logic of our no-recession forecast rests on three disconnects:

(1) the disconnect between housing and the labor market, – Typically, construction jobs plummet with overall employment. Today construction jobs have spiraled downward, even as the rest of the jobs continue to grow, albeit slowly.
(2) the disconnect between the cycle in construction and the cycle in manufacturing, began in 2001. Historically, jobs in construction and manufacturing rise together in expansions and decline together in recessions with the remainder of jobs changing very little. But in 2001, construction jobs plowed through the downturn like it wasn't there, while manufacturing took a huge loss of 3 million jobs that it never recovered. Manufacturing and construction are typically reliable indicators of recessionary dips in the economy. But this time, construction is saying recession, while manufacturing is saying the same thing it has for years: we need fewer workers here. And because the rest of the job market is holding up, we don't anticipate having enough job loss to dip into a recession.
and (3) the disconnect between the cycle in housing and the cycle in consumer durables. Normally, the housing peak is followed by the consumer durables peak within a few quarters. But this time, absent the job loss that normally follows soon after the housing peak, we have not had great weakness in consumer durables. After nine quarters in which housing is subtracting from GDP, we still have consumer durables making a positive contribution. That's why GDP growth is holding up.

These disconnects have meant that "This time, what happens in housing, stays in housing."

Don't Celebrate; What Comes Next Won't Be That Great

It is possible that the data will get a lot worse very quickly and the U.S. will tip into a real recession. More likely, we think, we will experience only a mild slowdown. A little more of what we already had. Regardless of what happens this year, the future isn't what it used to be. There is going to have to be some belt-tightening. That's a recipe for sluggish growth.

Autos for sure are going to be weak, with conditions exacerbated by the alarming sharp rise in crude oil prices.

The Subprime Economy

David Shulman, UCLA Anderson Forecast

Although the economy will likely avoid falling into a formal recession, the economic outlook through the end of 2009 is decidedly subprime. In contrast to activity based recessions/slowdowns which are largely triggered by the tightening of monetary policy, recessions/slowdowns that are induced by asset price deflations are less sensitive to an easing of monetary policy and tend to have very long tails in the sense that it takes the economy a long time to fully recover. As a result, we forecast that growth in real GDP from 2007:3Q to 2009:4Q will average a tepid 1.2%.

In this environment, we envision the unemployment rate will reach 6% by the end of 2009. Should the 5.5% unemployment rate reported for May be confirmed by similar data in June, then our forecasted 6% unemployment rate would come much sooner. Moreover, because both headline and core inflation will remain uncomfortably high over the next several quarters, we believe the Federal Reserve has ceased cutting interest rates and that the next change in policy will be to increase the Federal Fund rate starting in mid-2009.

The Fed in a Box

Although the 2007-08 credit crisis is far from over, the Federal Reserve appears to be shifting its attention away from rescuing the financial system to dealing with its more traditional concern of inflation. To be sure the Federal Reserve sponsored rescue of Bear Stearns and the opening of the discount window to Wall Street investment banks has permanently changed the role of the Federal Reserve in the economy.

However, regulatory reform is next year's business. This year the Fed is facing the impact of higher commodity prices leaching into inflationary expectations. With headline inflation running at a 4% rate and core inflation in excess of the Fed's informal target of 2%, policy makers, despite the weak economy, are becoming increasingly concerned that inflation might not be as quiescent as previously thought. Moreover, inflation as measured by the producer price index will exceed 10% this year for the first time in a generation.

What is worrying the Fed is that real interest rates are lower now than they were during the deflation scare of 2003-04. Most observers now believe that it was the very low real interest rates of that period that set the stage for the housing and credit bubbles that came later. As a result, we do not believe that the tepid economic growth we are forecasting will prevent the Fed from raising interest rates in mid-2009.

To sum up, the witch's brew of the popping of the housing bubble, a wounded financial system, and increasing inflationary pressures coming from rising commodity prices will keep the economy on a subprime growth path for the next several quarters. If there is any good news here, it is that the economy thus far has avoided into falling into an outright recession. With any luck that downside eventuality will be avoided. Why? The recovery in net exports is adding just under 1% to real GDP growth. Despite all of the political trash talk attacking trade policy, it is reduced domestic demand for imports and booming exports that are keeping the economy out of recession. It seems that at least some of the contractionary forces have been outsourced to our trading partners.

East Bay Quarterly Indicators

Q2 2008

GDP & CPI

GDP - % Change from Preceding Period (US)			CPI (San Francisco)			CPI (US All Cities)		
Q1 06	Q1 07	Q1 08 (adv.)	Jun-07	Jun-08	% Change	Jun-07	Jun-08	% Change
4.8	0.6	0.6	216.123	225.181	1.21%	207.246	217.403	4.90%

Source: BEA, BLS

Labor

	East Bay			San Jose			San Francisco		
	Jun-07	Jun-08	% Change	Jun-07	Jun-08	% Change	Jun-07	Jun-08	% Change
Labor Force	1,277,000	1,293,900	1.3%	878,800	900,400	2.5%	944,000	972,700	3.0%
Employed Residents	1,215,700	1,213,300	-0.2%	836,400	845,800	1.1%	905,200	924,100	2.1%
Unemployment	4.8%	6.2%	29.2%	4.8%	6.1%	27.1%	4.1%	5.0%	22.0%
Payroll Employment	1,055,700	1,036,700	-1.8%	922,400	923,200	0.1%	992,000	1,004,800	1.3%
Goods Producing	168,500	160,600	-4.7%	214,700	213,800	-0.4%	89,300	91,600	2.6%
Service Providing	885,500	874,300	-1.3%	700,700	702,500	0.3%	899,800	910,400	1.2%

Source: California EDD

Non-Residential Vacancies

	East Bay			San Jose/Silicon Valley			San Francisco		
	Q1 2008	Q2 2008	Change	Q1 2008	Q2 2008	Change	Q1 2008	Q2 2008	Change
Industrial	4.2%	5.6%	1.4%	11.3%	11.0%	-0.3%	n/a	n/a	n/a
Office	13.6%	13.6%	0.0%	10.1%	11.3%	1.2%	11.2%	11.0%	-0.2%

Source: Rand Statistics, Grubb & Ellis

Construction Permits (by MSA)

	East Bay			San Jose			San Francisco		
	Jun-07	Jun-08	% Change	Jun-07	Jun-08	% Change	Jun-07	Jun-08	% Change
Residential	$ 203,709,968	$ 132,991,221	-34.7%	$ 159,019,604	$ 86,612,940	-45.5%	$ 159,490,122	$ 119,489,372	-25.1%
Non-Residential	$ 170,494,551	$ 148,255,655	-13.0%	$ 84,392,881	$ 220,823,419	161.7%	$ 242,037,453	$ 192,381,233	-20.5%

Source: Construction Research Industry Board

Tourism & Travel

	East Bay/OAK			San Jose/Peninsula/SJC			San Francisco City & SFO (average)		
	May-07	May-08	% Change	May-07	May-08	% Change	May-07	May-08	% Change
Hotel Occupancy	69.40%	69.60%	0.29%	71.70%	73.00%	1.81%	79.00%	79.55%	0.70%
Hotel Room Rates	$ 111.46	$ 114.04	2.31%	$ 132.12	$ 130.64	-1.12%	$148.95	$158.37	6.32%
Airline Traffic (total passengers)	1,234,736	1,006,429	-18.49%	924,289	872,310	-5.62%	3,080,467	3,321,296	7.82%

Source: PKF Consulting, OAK, SJC, SFO Airports

Home Prices/Sales

	Alameda	Contra Costa	Marin	Napa	San Francisco	San Mateo	Santa Clara	Solano	Sonoma
Median Price June 2008	$455,000	$378,000	$846,000	$440,000	$726,750	$690,000	$612,000	$300,000	$389,500
Annual % Change	-24.80%	-36.70%	-12.00%	-23.70%	-11.90%	-13.20%	-12.40%	-28.50%	-26.90%
Number Sold June 2008	1,441	1,528	258	113	571	565	1,626	511	565
Annual % Change	-6.20%	8.1%	-26.30%	-11.70%	-9.80%	-25.20%	-24.8%	12.80%	6.00%

Source: Data Quick

Trade

TEU Containers (Includes Full & Empty, Imp & Exp.)	Port of Oakland	
	Jun-08	Annual % Change
Imports	198,557	-0.30%

The East Bay EDA Quarterly Indicators sheet supplements the Quarterly Economic Forecast and is a compilation of local and national indicators compiled by the East Bay EDA from a number of sources. If you have any questions or suggestions regarding these indicators and/or their sources, please contact Stephanie Brown, Economic Development Analyst at (510) 272-6843 or visit http://www.eastbayeda.org