

# EastBay

Q4 07



## ECONOMIC OUTLOOK



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

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## ***The East Bay Quarterly Forecast: The Silver Lining is Fading***

October 2007

Ryan Ratcliff

### **Summary**

The central story of the California economy continues to be real estate drag: as both construction and mortgage related job loss has accelerated during the summer, recent job growth has slowed to a crawl.

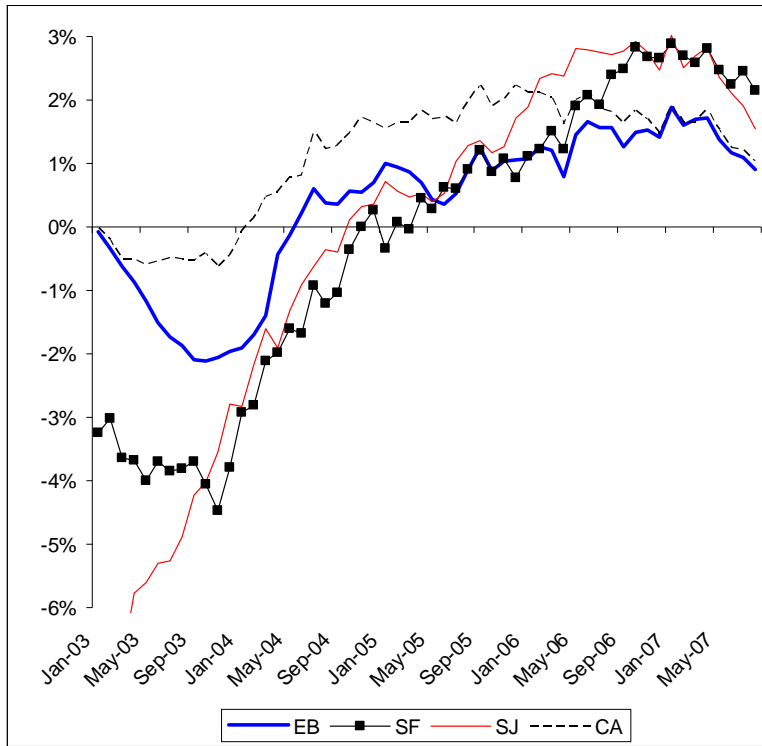
The Bay Area has fared a little better, but California's malaise has finally started to take its toll on the region. The East Bay has been the region's microcosm of California's wider problems: the downturn in Construction, the slowing of high-end service jobs, even the dubious distinction of having the Government sector as the biggest source of new jobs in the last five months. The other half of the Bay Area has continued to march to its own beat, fueled by the continuing recovery of high-tech service jobs; however, even the San Jose economy has showed recent signs of slowing.

Outside of residential real estate, commercial real estate has also been an important factor in the region's recent economic history – in large part because of the glut of office space left behind after the tech boom. In the East Bay, overall office vacancies have remained near tech bust highs, even as the rest of the region recovered. This appears to be a submarket issue: recent completions are enough to satisfy the moderate increase in demand in recent years, with Contra Costa seeing an increasing share of the activity. However, other parts of the East Bay continue to suffer from an overhang of office space.

### **Bay Area Job Markets**

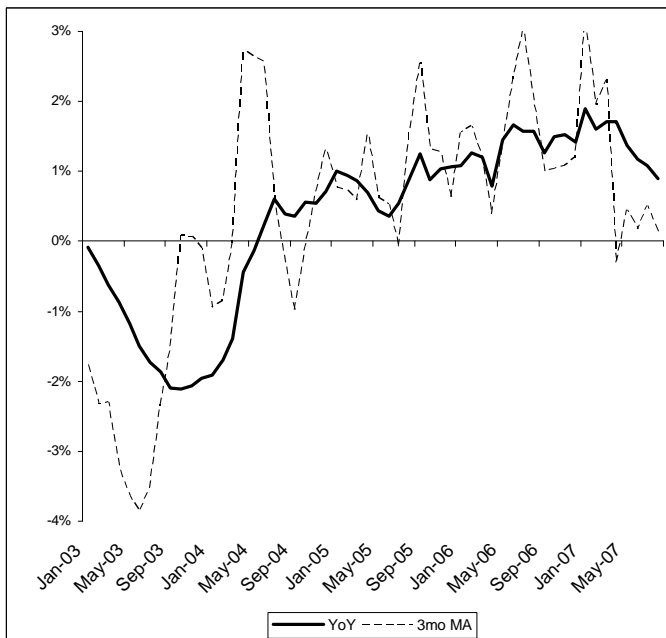
Unemployment in California has been rising steadily since the beginning of the year, and non-farm payroll growth has slowed to a crawl in the last five months. While the Bay Area job market has been the silver lining in the cloudy California economy for a year and a half, the luster is starting to fade.

**Figure 1: Year-over-Year NF Payroll Job Growth**



Source: CA EDD, UCLA Anderson Forecast

**Figure 2: Oakland MD NF Payroll Job Growth**

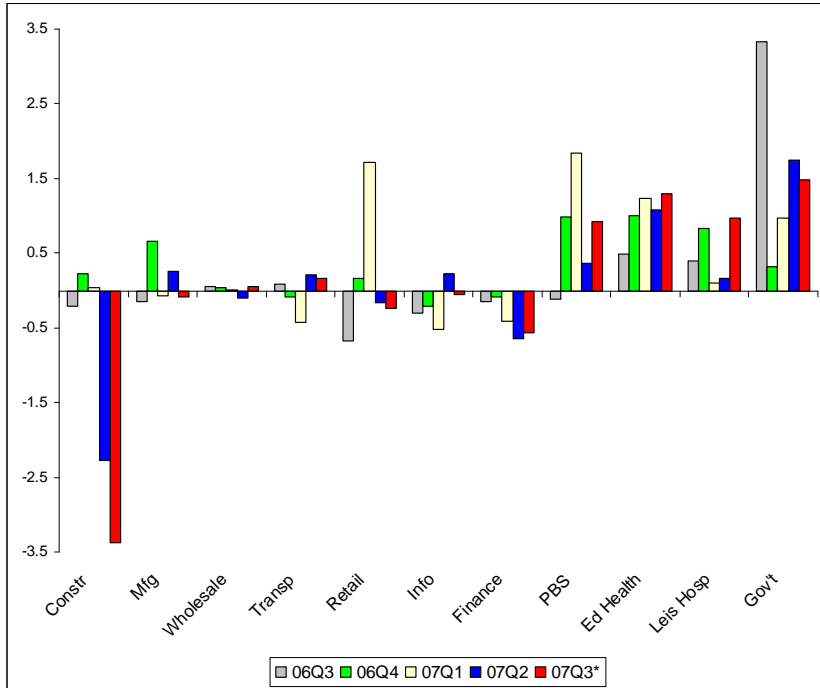


Source: CA EDD, UCLA Anderson Forecast

Every region in the Bay Area is seeing slower job growth in the middle of 2007. In the East Bay (Oakland MD), the job market continues to mirror the larger statewide trends. Unfortunately, that also means a substantial slowdown in payroll job growth in the recent months. The sources of this slowdown are the usual suspects. Seasonally-adjusted job losses in Construction employment have accelerated, and now total 7600 since the beginning of the year. Nearly half of those losses occurred in July and August. As we've pointed out before, the wide seasonal variation in Construction employment means that these numbers require careful handling.

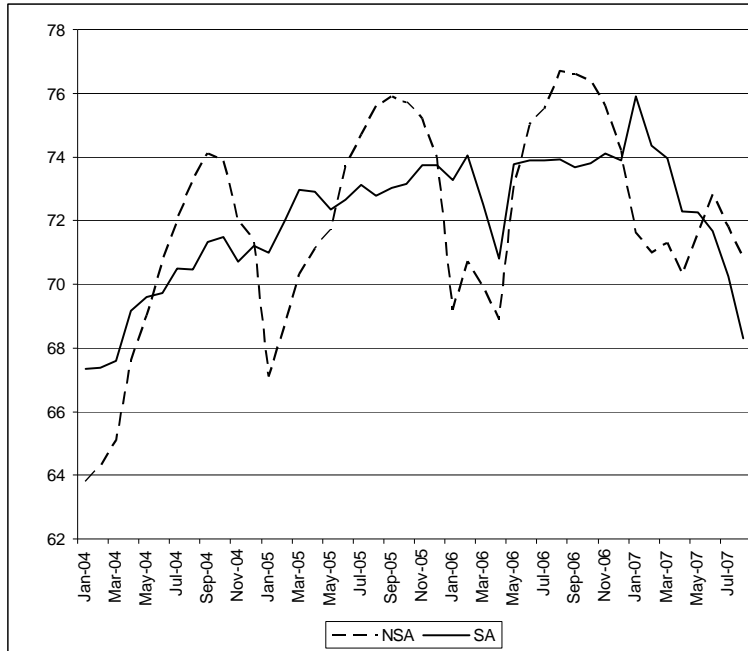
With this in mind, Figure 2 presents the raw employment data for the Construction sector, along with the seasonally-adjusted series. Let's start with the 2004-2005 period to get our bearings. The difference between the two lines gives us a good feel for the seasonal component: Construction employment tends to bottom out near the end of winter, adds a lot of jobs through August/September, and then sheds most of those jobs through the end of the year. To put it another way, the two lines cross in June and December: from December to June, we know that part of the drop in employment we're seeing is seasonal, just as we know that many of the jobs the Construction sectors is adding in summer will be cut in the fall. When we take away this predictable seasonal variation in 2004 and 2005, we're left with the seasonally-adjusted series, which shows steady growth over the period.

**Figure 3: Oakland MD New Jobs by Sector (1000s SA)**



Source: CA EDD, UCLA Anderson Forecast

**Figure 4: Oakland MD Construction Employment (1000s)**



Source: CA EDD, UCLA Anderson Forecast

2006 is when things start getting complicated in the East Bay Construction sector. In contrast to the previous years, employment in March and April stayed near the low of 70,000 reached in January, while the “usual” seasonal pattern would imply that Construction employment should already be rising by then. Thus, the seasonally-adjusted series shows a sharp decline in 2006Q2. However, seasonally-adjusted Construction employment is steady for the second half of the year, implying that the 2500 jobs gained and lost over that period represent nothing except the usual seasonal pattern.

Which bring us to 2007: Construction employment in the summer of 2007 was actually lower than in December. This implies that the underlying trend in the Construction sector must be so negative that it overwhelmed the usual seasonal trend for employment to rise through the summer. But this also suggests that we need to take this estimated 7600 Construction jobs lost since the beginning of 2007 with a grain of salt. Actual job loss in the unadjusted series is actually only about half that number -- the other half of the 7600 comes from job growth we “should have seen” given the seasonal cycle. Obviously, there are arguments in favor of using both numbers. On the one hand, if we want to get at the underlying trend in the Construction sector and compare it to trends in other, less seasonal sectors, the seasonally-adjusted number is the way to go. However, in periods of job loss like we’re seeing now, some observers feel that including outright job loss and the jobs Construction “should have gained” may overstate Construction weakness. But while we can argue about exactly how to measure the extent of the job loss, there is no argument that the Construction sector in

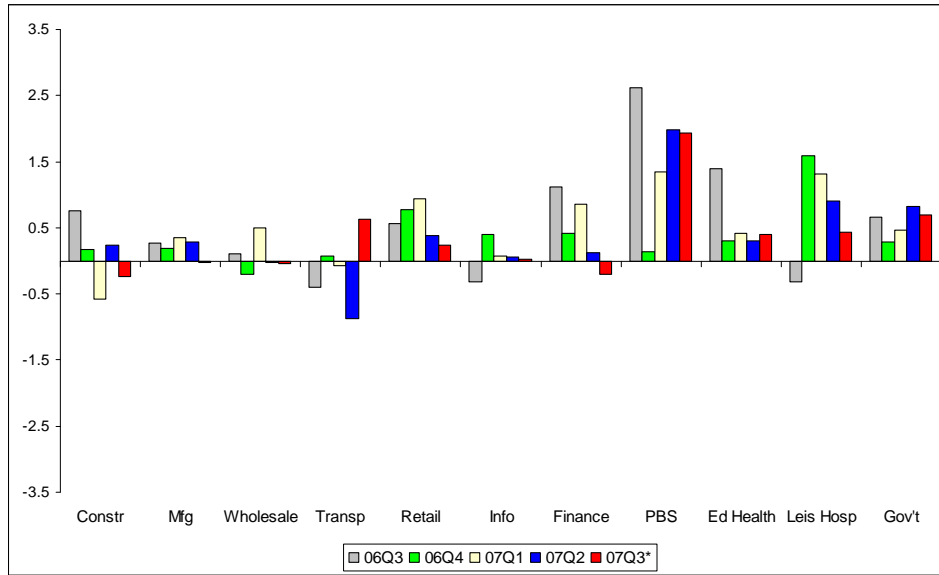
the East Bay has gone from an engine of job growth to a drag on the rest of the economy, and this drag has increased significantly in the second half of 2007.

The rest of the East Bay job market has also seen a continuation of the themes from our last report. Once again, the Government sector was the biggest source of new jobs in the first two months of 2007Q3, thanks almost entirely to the continuing boom in local government education hiring. The Education and Health Care continues to be a steady source of employment growth, while lending-related job losses continue to keep Financial Services weak.

However, two important sectors have shown renewed signs of life in the third quarter. Professional/Business Services(PBS) job growth in July and August has substantially outpaced the early summer – but not for the reasons you might expect. While earlier strength in this sector has come from computer-related consulting, the recent burst of job growth has come from everything else in the sector (unfortunately, the level of disaggregation in the payroll employment data doesn't give us any more insight than that). Similarly, a burst of hiring in the Accommodation and Food Services category made the Leisure and Hospitality sector the second biggest source of private-sector job creation in the East Bay so far in Q3 – outpacing Professional/Business services.

The San Francisco MD (San Francisco, San Mateo, and Marin Counties) has also been more of the same: a slight slowdown in growth, following the same sectoral patterns as earlier in the year. On the real estate front, Construction-related job loss has not really been a factor, though Financial Activities did show overall job losses in July and August, for the first time in 2007. PBS continues to be the major source of job growth, as the service side of the technology economy continues to claw its way back from the 2001 recession. Though the rise and fall of the tech sector has been a rollercoaster ride over the past ten years, the levels of PBS growth we're seeing now are close to "normal" – if any sense of normal can be gleaned from Figure 3.

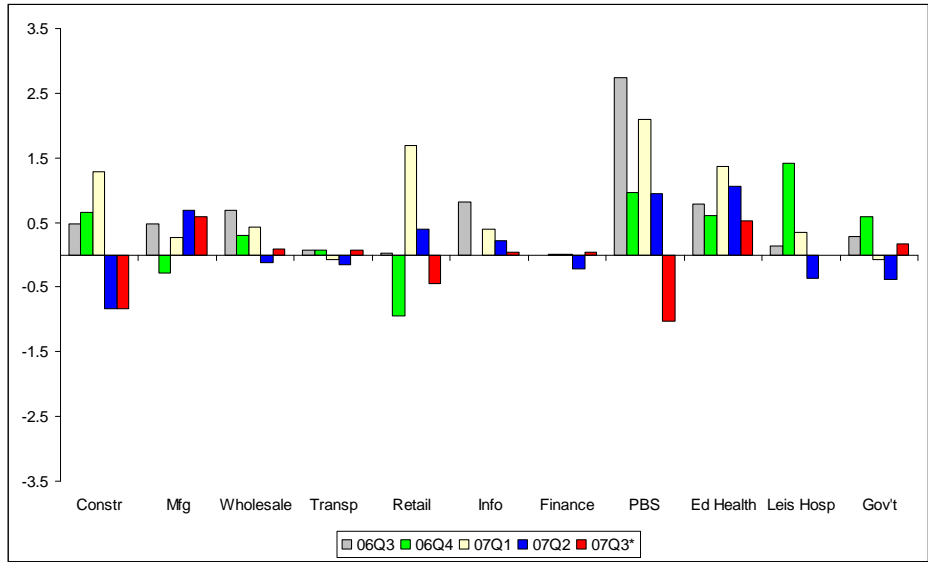
**Figure 5: San Francisco MD New Jobs by Sector (1000s SA)**



Source: CA EDD, UCLA Anderson Forecast

But while the rest of the Bay Area has essentially been more of the same, the San Jose MSA (Santa Clara and San Benito Counties) has seen a significant slowdown in job growth in the last five months. Of course, even with this slowdown, San Jose is still one of the fastest growing metros in California. Construction job losses are part of the story, but each of non-real estate sectors that were booming in 2007Q1 has seen a major slowdown in the third quarter. The PBS sector actually lost over 1000 jobs for the first time in recent memory. While this turnaround in one of the metro’s core industries may initial cause some alarm, a closer look suggests that both the early year boom and the more recent slowdown are transitory. The Professional/Technical Services component of PBS has show steady growth throughout 2007, but the Administrative Services component has seen an up-and-down swing of 2000 jobs over the course of 2007. This swing is almost entirely from the highly volatile Employment Services industry, which includes temp agencies.

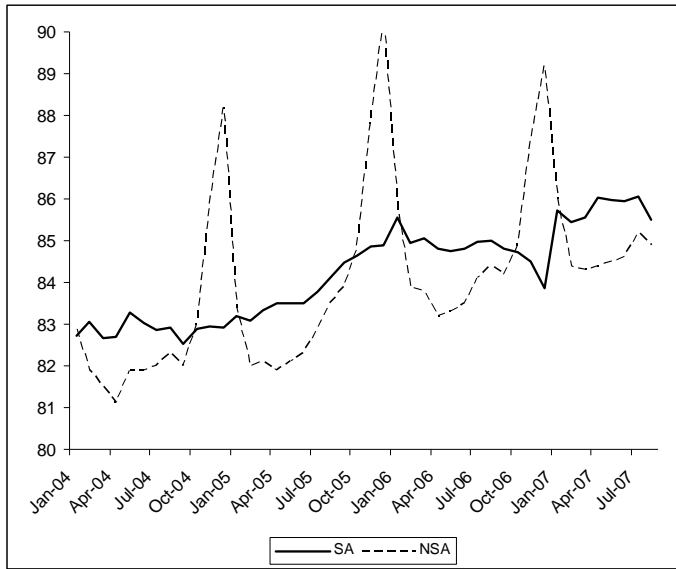
**Figure 6: San Jose MSA New Jobs by Sector (1000s SA)**



Source: CA EDD, UCLA Anderson Forecast

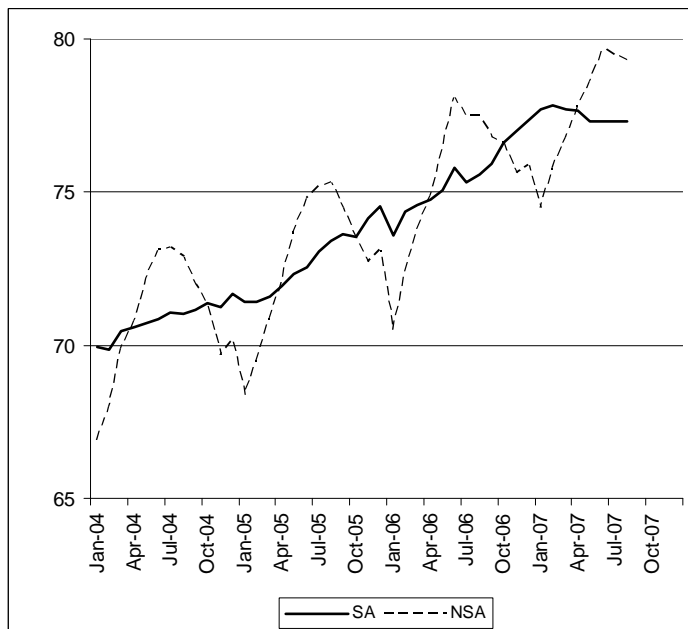
The slowdown in Retail Trade and Leisure and Hospitality employment growth in San Jose is another case of interpreting job losses relative to normal seasonal patterns. The holiday season in 2006 showed less of a seasonal surge in retail hiring than usual, but also saw less of an employment decline in the early months of 2007 – giving us the bump in seasonally-adjusted employment in 2007Q1. The slowdown in recent months comes in part from the mild decline in Retail Trade employment in August, at a time of year when employment should normally be rising. Similarly, the recent decline in Leisure and Hospitality employment comes from a less-than-normal increase of employment in the Arts, Entertainment, and Recreation category. Like the Construction sector, interpreting each of these declines is a bit tricky: when jobs in an industry grow by less than we expect, is it really job loss?

**Figure 7: San Jose MSA Retail Trade Employment (1000s)**



Source: CA EDD, UCLA Anderson Forecast

**Figure 8: San Jose MSA Leisure and Hospitality Employment (1000s)**



Source: CA EDD, UCLA Anderson Forecast

While the each sector's slowdown has an element of statistical "blippery" to it, there's no way around the conclusion that just about every sector of the San Jose economy seem to be slowing relative to the beginning of the year. Since much of San Jose's recent boom has been rebuilding the economy at the epicenter of the tech collapse, some slowdown in job growth was inevitable as the local economy returns to normal.

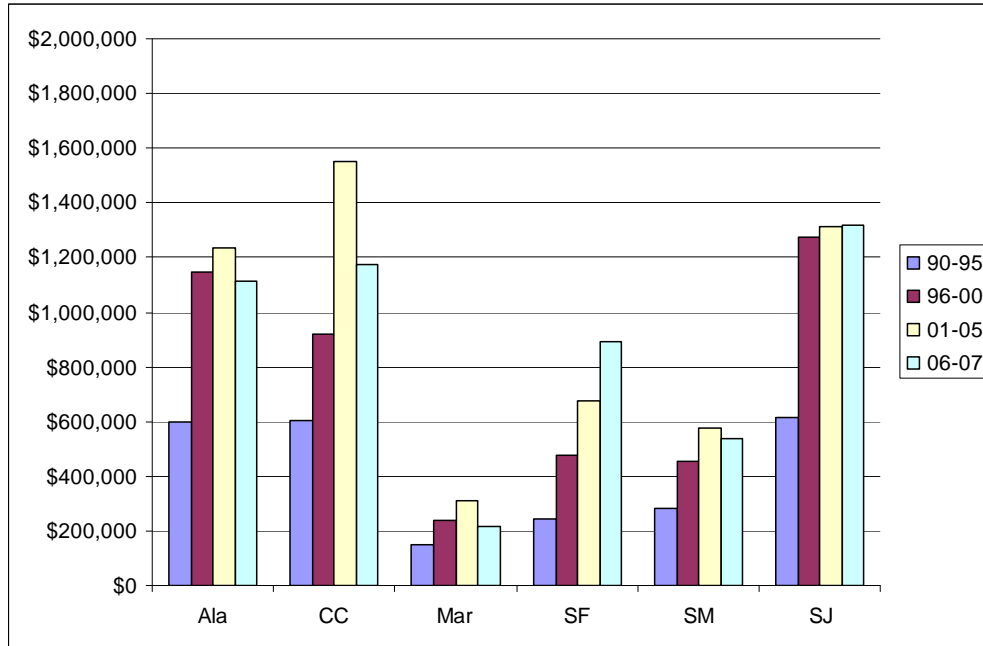
But even though year-over-year employment growth has dropped by more than 1%, San Jose remains one of the fastest growing of California’s major regional economies.

**Commercial Real Estate in the East Bay**

For California as a whole, most of what we need to know about real estate’s role in economy over the past five years comes from the residential side. However, the severity of the tech bust and the relatively small role that new building has played in the Bay Area together mean that we’re missing a significant portion of the story if we don’t take a look at non-residential construction. Of course, the relative importance of residential construction versus non-residential construction varies across the region. Figures 9 and 10 suggest that we can divide the six Bay Area counties into three groups.

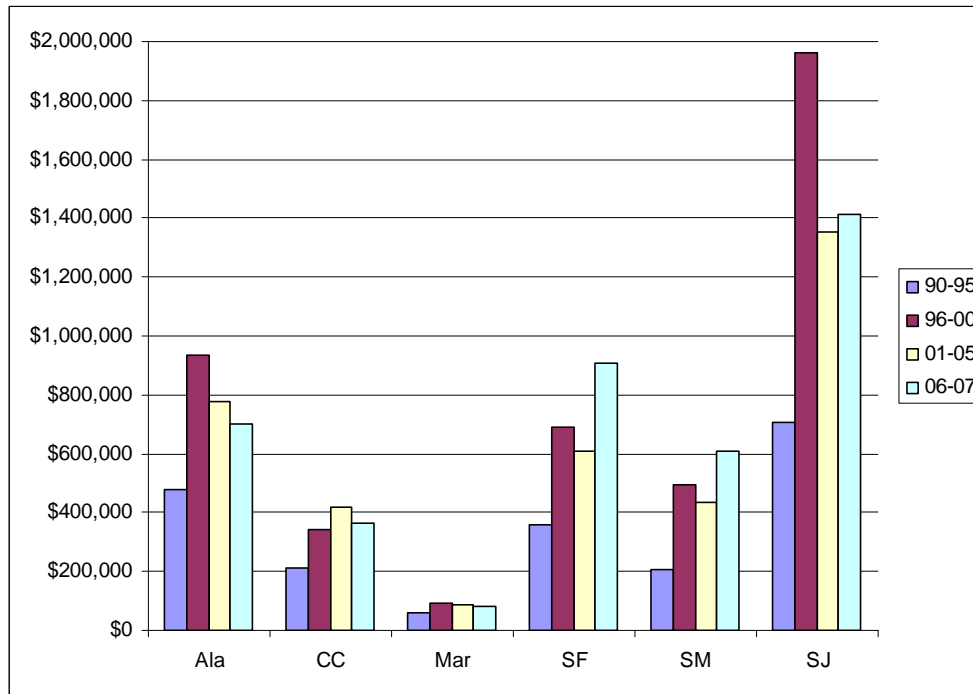
The first group is Alameda and Santa Clara Counties, where commercial construction has been the primary story. Both counties have seen the five-year average value of non-residential building permits falling steadily since the heyday of the late 1990s. At the same time, the residential building boom has been mostly a non-event in this group. The five-year annual average value of residential building permits in Santa Clara County has stayed roughly constant since the late ‘90s average, while Alameda County’s residential construction has shown a small but significant boom. Thus, construction activity of all sorts has been adding steadily less to the economies in this group.

**Figure 9: Average Annual Valuation of Residential Building Permits (\$1000s)**



Source: CIRB, UCLA Anderson Forecast

**Figure 10: Average Annual Valuation of Non-Residential Building Permits (\$1000s)**



Source: CIRB, UCLA Anderson Forecast

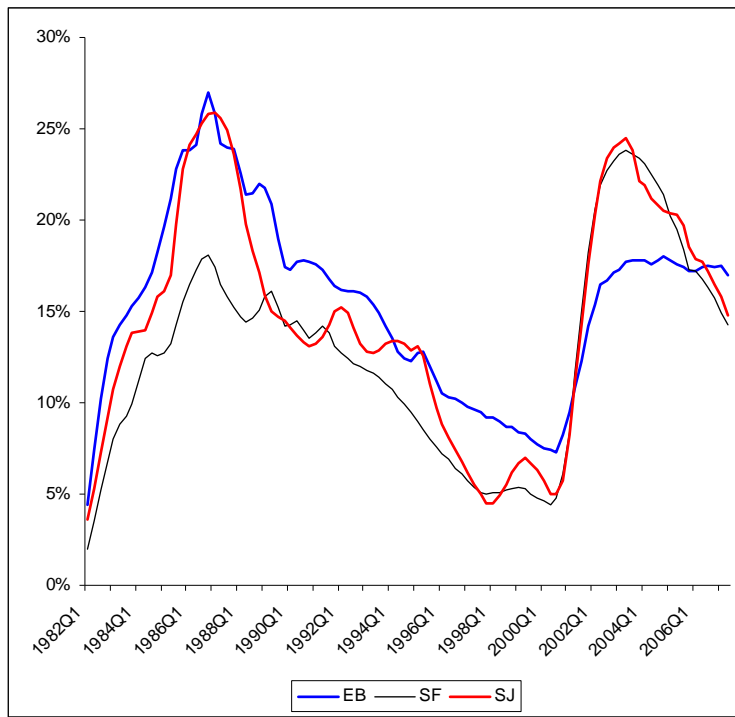
The second group of Contra Costa and Marin Counties is pretty much the opposite of the first group: here, the residential building boom is the primary story. As we have noted before, Contra Costa’s residential building boom was far and away the biggest in the Bay Area. Unfortunately, the drop in annual average value of residential construction in 2006-7 compared to the previous five years is also unparalleled in the Bay Area, and in fact rivals the commercial real estate bust in Santa Clara County in the wake of tech boom. At the same time, Contra Costa County is the only county in the Bay Area where the average value of non-residential construction was higher from 2001-5 compared to the late ‘90s. Marin County shares several of these features: after a small residential building boom in 2001-5, the average annual value of residential permits issued in 2006-7 is back down the levels seen in the late ‘90s. Also, the value of Marin County’s non-residential permits has been consistently dwarfed by residential construction, and has not seen much fluctuation over the period. The importance of residential construction and its recent swings means construction has made a big but volatile contribution to these economies – as it has to California as a whole. However, lumping Marin County’s small fluctuations in with Contra Costa’s building bust may be a bit unfair...

The last group (San Francisco and San Mateo Counties) represent the middle ground between the first two. Non-residential permit values represent the majority of construction activity over this 17 year period in both counties. They both experienced a small falloff in commercial construction in the wake of the tech boom, but average non-

residential permit issuance over the last two years has exceeded the level of the late 1990s. Lastly, while both of these markets have seen consistent increases in the value of residential permits, San Francisco has actually seen a higher average annual value of residential permits in 2006-7 than in any previous period, while San Mateo shows a slight decrease in the same period. Throughout the Peninsula, both residential and commercial markets are doing well, even as real estate in the rest of California sags.

The office market is a logical place to start looking more closely at non-residential real estate: it was the main beneficiary of the tech boom, and one of the main casualties of the tech bust. All three major metro areas saw a substantial spike in office vacancies in 2001, though the East Bay's spike was not nearly as severe as the San Francisco or San Jose metro areas. But in the years following the tech bust, we've seen some paradoxical behavior in office markets. Office-using employment in the East Bay has recovered to within 1% of its pre-recession levels, while San Jose and San Francisco are still 11% and 36% off their peak levels of office-using employment, respectively. Yet vacancy rates in the East Bay have yet to come down from their recession highs, while office markets in the other metros have seen significant drops in their vacancy rates. Why have vacancy rates remained higher in the East Bay? While its dangerous to make any statements that lump the office markets of downtown Oakland and Brentwood into the same category, we can still gain some insight from comparing the difference between net absorption (new demand for office space) and net completions (net additions to the supply of office space) across the metro areas.

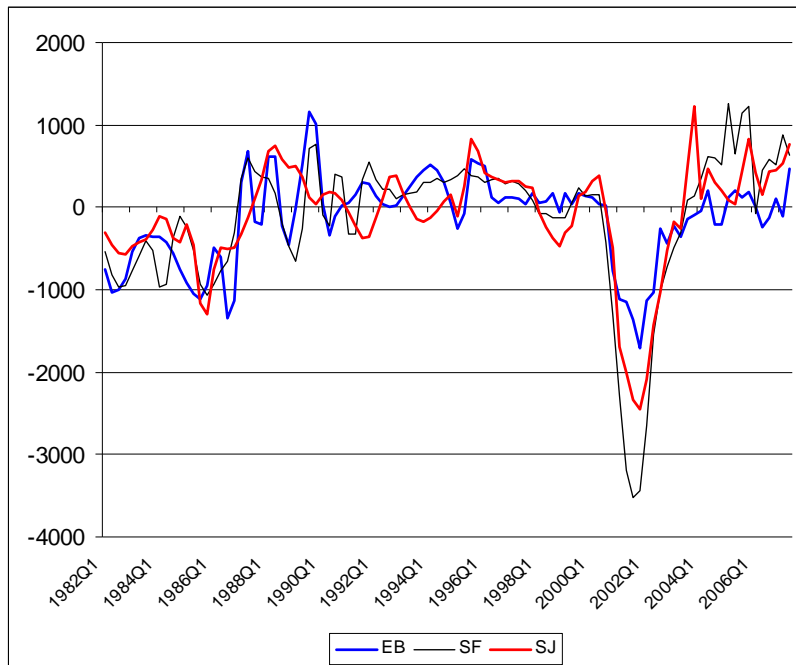
**Figure 11: Bay Area Office Vacancy Rates**



Source: PPR, UCLA Anderson Forecast

Office markets are highly inertial. When demand for office space throughout the Bay Area exploded in the late 1990s, even the frantic pace of building was not able to wholly satisfy this new demand, leading to historically low vacancy rates by 2000. Unfortunately, when demand for office space plummeted in 2001-2, the boom in office construction continued for another year and a half – most of these projects were already past the point of no return when demand fell. In this environment of negative net absorption and peaking completions, vacancy rates skyrocketed and office rents plummeted.

**Figure 12: Net Office Absorption (1000s sq. ft.) – Net Office Completions (1000s sq. ft.)**



Source: PPR, UCLA Anderson Forecast

With this glut of office space, it's hardly surprising that new additions to the stock of office space slowed to a trickle. However, as we've seen in the recent employment numbers, PBS employment has come back strong in the past two years in the Bay Area. The combination of faster growth in demand for office space and slower completions of new office space have brought vacancy rates down in the San Francisco and San Jose metros, and have spurred a recovery in rent growth. In the East Bay, demand has grown slower, allowing most new demand for office space to be satisfied out of net completions, rather than dipping into the existing inventory of vacant space. Thus, East Bay vacancy rates remain high even though office-using employment has mostly recovered from the 2001 recession. 2007Q2 shows a substantial increase in the difference between net absorption and net completions, but it is unlikely that represents a change from the existing trend: close to 700,000 square feet of office space are due to complete in the next 12 months.

It's worth reiterating that discussing a market as localized as office space at a level as broad as a two-county metro division can be a bit misleading: individual submarkets can be quite tight even though the metro as a whole may have high vacancy rates. In fact, Figure 10 suggests exactly this pattern: Contra Costa County has been responsible for a steadily increasing share of non-residential permit activity since 2000, while Alameda County saw the bigger share of construction during the tech boom. In an effort to gain more detailed insight into the local dynamics of East Bay commercial real estate, and to look further down the pipeline than we can with official statistics, the UCLA Anderson Forecast has partnered with Allen Matkins to develop a commercial real estate survey that asks major players in the market for their opinions of where the local markets are heading in the next 2-3 years. Results for the Los Angeles and Orange County office markets have already been released, and we anticipate implementing this survey in the Bay Area markets sometime next year.

### **Conclusions**

The East Bay economy has moved in virtual lock-step with the California economy for almost a year. As such, our forecast for California gives a good idea of what to expect for the East Bay in the next two years. Real estate drag will keep the rest of the economy growing at sluggish pace for at least four more quarters, but no other sectors currently look poised for any independent bouts of job loss. Contra Costa will continue to bear the brunt of the real estate problems, but Alameda County will not emerge unscathed. Of course, a sluggish economy also means sluggish demand for commercial real estate. Office space in the East Bay will see demand slacken, but the minimal pace of construction should keep vacancy rates about where they are. While there is some potential that the continued recovery of high-tech services in the region will offset some of the real estate drag and some of the impact on local office markets, this summer's evidence to date suggests that this hope is dimming.

## **Executive Summary of the 2007Q3 UCLA Anderson Forecast for the California Economy**

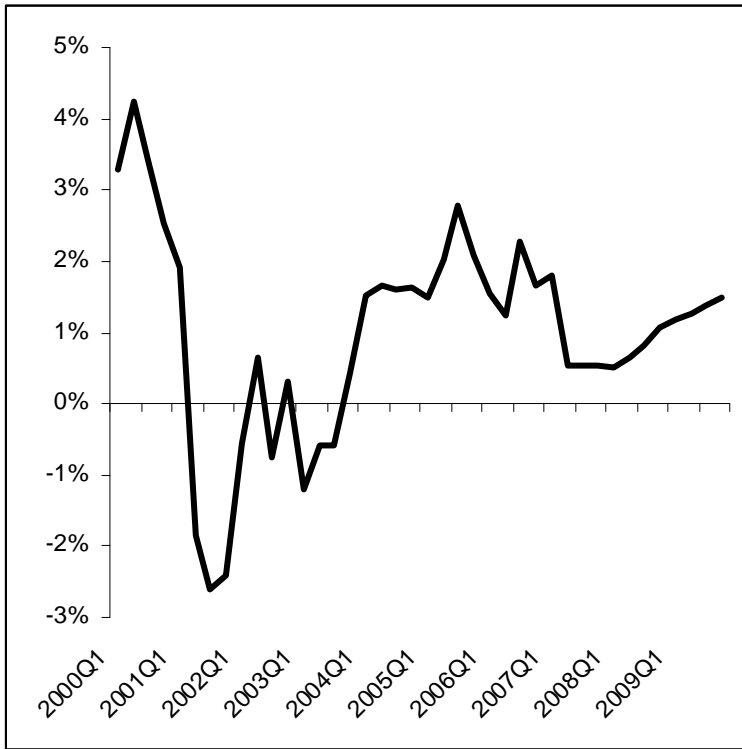
**By Ryan Ratcliff**

The second quarter of 2007 has largely lived up to our expectations, showing substantial job loss in real estate-related sectors and sluggish growth elsewhere. Unemployment and mortgage defaults continue to rise. While these fairly dismal results may sound a lot like the beginning of a recession, overall job growth remains positive, and personal income growth remained strong in the first quarter of 2007. In fact, these are the beginnings of exactly the economy we have predicted for some time: sluggish, but no recession. However, the difference between the two is getting smaller all the time....

The ongoing increase in mortgage defaults and foreclosures continues to occupy center stage in any discussion of local housing markets, with much of the debate centering on whether these trends are driven by cut-and-run real estate investors, or the consequences of the predatory exploitation of working class families. According to the results of our wide study of national, state, and local data on this topic, investors were a significant portion of the sales boom, and the defaults that have followed it. Nonetheless, the majority of mortgage defaults have occurred in owner-occupied homes. Furthermore, the counties in California with the highest foreclosure rates have been those with a combination of middle of-the-pack home prices, but extremely high usage of adjustable rate mortgages (ARMs) – exactly the combination we'd expect when working families stretch beyond their means to buy a home. But we find little evidence that mortgage defaults have led to wider financial distress for consumers.

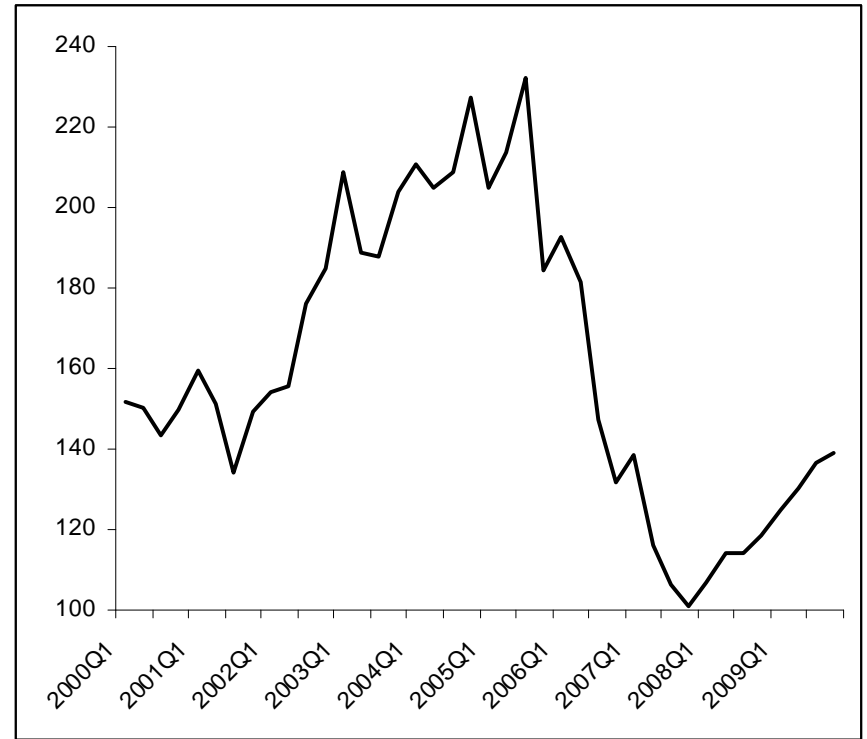
The end of 2007 will mark the peak of subprime ARM resets, so we expect to see mortgage defaults peaking sometime in the first half of 2008. With elevated foreclosures, a severe pullback in mortgage lending, and low levels of building activity, we predict that real estate markets will continue to be a drag on California growth through at least the end of 2008. With no other sectors picking up the slack, we expect to see overall growth in non-farm payroll employment of less than 1% through this time next year. This prognosis is worse than previous forecasts in part because of the worse-than-expected job loss in Financial Activities. Unemployment will reach a peak of 5.9% at the end of next year, with corresponding weakness in personal income and gross state product. A pickup in building permits and a moderation in mortgage problems in late 2008 / early 2009 marks the light at the end of the tunnel, with the California economy returning to relatively normal levels of growth by the end of 2009.

**Forecast of Growth in CA Non-farm Payroll Employment (SAAR)**



Source: CA EDD, UCLA Anderson Forecast

**Forecast of CA Building Permits Issued (1000 units, SAAR)**



Source: CIRB, UCLA Anderson Forecast

## **Executive Summary of the 2007Q3 UCLA Anderson Forecast for the U.S. Economy**

**By David Shulman**

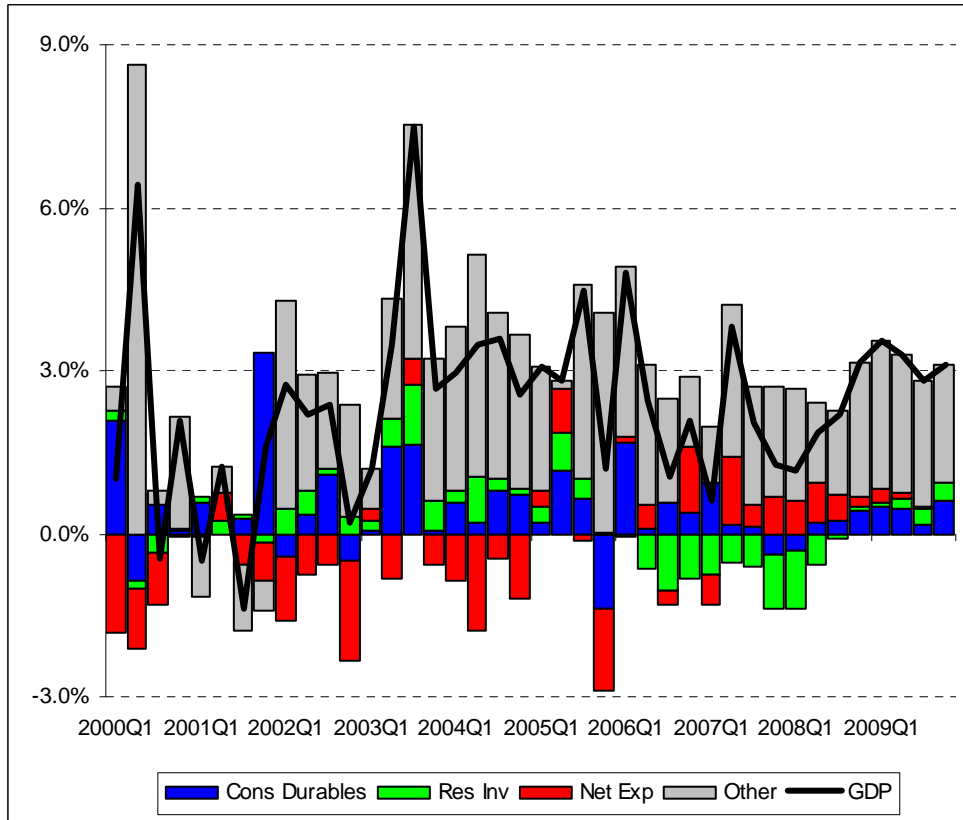
Despite the stronger than expected 4% growth in the second quarter, the re-pricing of hitherto very easy credit will cause the U.S. economy to have a “near recession experience.” Specifically, we forecast real GDP growth to be just above 1% for the fourth quarter of 2007 and the first quarter of 2008. Thereafter, we forecast growth to remain tepid for the balance of 2008 and return to trend 3% growth in 2009. Nevertheless, by mid-2008 the unemployment rate is forecast to reach 5.2%, up from the current 4.6%. Of course, when the economy slows to a 1% pace, it runs the risk of falling into an actual recession, just as when an airplane’s velocity gets too close to its “stall speed” and it falls out of the sky.

As in prior quarters, the source of our pessimism remains the on-going deterioration of the housing market. We have once again lowered our forecast for housing activity as the weight of ever-tightening credit standards and an ebbing of the builders' practice of building houses to get out of the underlying land exact their tolls. Where we previously predicted that housing starts would bottom in the 1.2-1.3 million-unit annual rate range, we have now marked down that forecast to 1.0-1.1 million units. Perhaps more importantly, we now believe that the recovery will be far more tepid with starts barely recovering to a 1.4 million unit annual rate by the end of 2009.

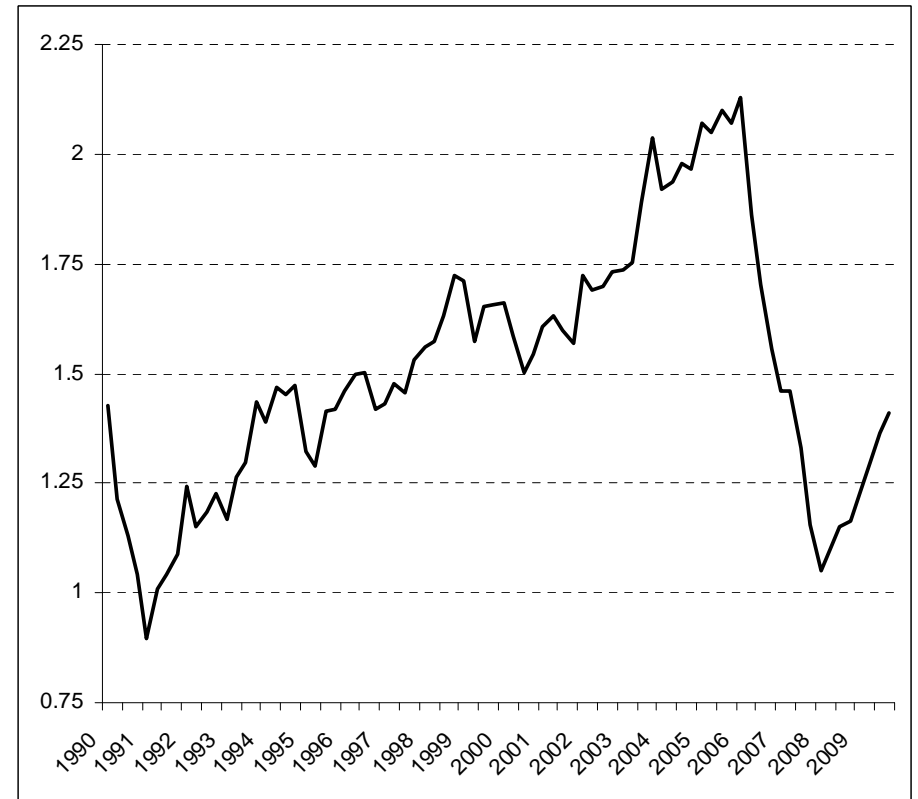
Although it has taken longer than we had previously forecast, the effect of housing weakness has finally spilled over into consumer spending on durable goods. Automobile sales have been soft, especially in the housing bubble states of California and Florida. As a result we are now forecasting that automobile sales in 2008 will be 15.7 million units, the lowest since 1998. Furthermore other consumer durables will suffer especially the housing related furniture and appliance categories and that will lead to an absolute decline in consumer durable spending in 2008.

Nevertheless, we are still sticking to our story that we will not have a classic recession. Why? The trade sector is rapidly improving as a strong global economy increases exports and a sluggish domestic economy reduces imports. Net exports will account for about 1/3 of the 1.8% growth we envisage for next year and corporate investment in equipment and software will be moderately strong.

**Forecast of US Real GDP Growth (line) and Contributions to Real GDP Growth (bars) from Durable Goods Consumption, Residential Investment, and Net Exports**



**Forecast of U.S. Housing Starts (millions, SAAR – Seasonally Adjusted Annual Rate)**



Source: BEA, UCLA Anderson Forecast

Source: Census Dept., UCLA Anderson Forecast