EastBay

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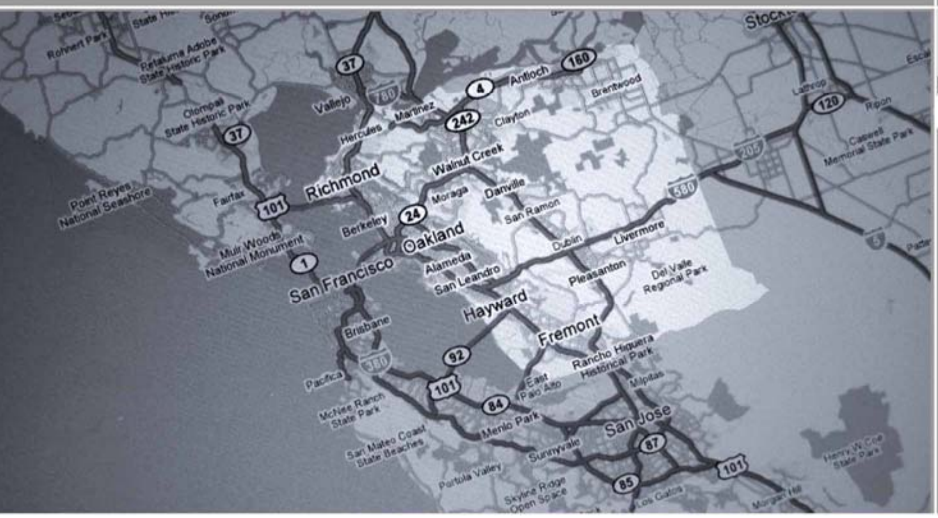

ECONOMIC OUTLOOK

Created for the East Bay Economic Development Alliance

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The East Bay 2010: Waiting for Jobs

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"VLADIMIR:
We have to come back tomorrow.
ESTRAGON:
What for?
VLADIMIR:
To wait for Godot.[1] "

"The recovery is at hand and there is widespread anticipation of better times in 2010 … With respect to employment the worst seems to be over. ..and the pattern is suggestive of job increases in the early part of 2010."

This was the lead in to our last East Bay Report in January. Three months later we appear to be in the same place with unemployment high and not getting worse on average. There is no net gain in employment, though there is evidence of continued growth in output. Our anticipation of the recovery taking hold and net job gain by the end of the first quarter has not materialized and the East Bay economy, while not stalled, is not moving noticeably either. At the end of the play *Waiting For Godot*, a little boy runs up to Estragon and Vladimir, the protagonists, and proclaims that Godot is not coming today but maybe tomorrow. This is the story of East Bay jobs. Soon, maybe tomorrow, but so far jobs have not arrived on the scene. In this East Bay report we benchmark the current employment, trade and housing situation, and slide our forecast back a couple of months as we await the recovery in employment.

The business of economic forecasting involves analyzing the plethora of current economic data and through the use of our models, comparing it to past experience. In the past, the end of a deep recession has been characterized, in part, by rapid recovery in jobs. In the four recessions from 1958 through 1981, the average job recovery in California during the first six months of expansion was nearly 1% of the end-of-recession labor force. The last two recessions were characterized by the aerospace contraction and the dot-com bust, and they are atypical of California's recession recoveries. If the typical pattern had occurred in the current recession we would now have seen 130,000 more jobs in the East Bay than have materialized. This delayed recovery in employment is most likely due to two factors: expectations and consumer debt.

What makes this recession different from other deep recessions of the post-war period is the presence of a financial panic and the notion emanating from some economists in Washington and

[1] Samuel Becket, *Waiting for Godot*, http://www.samuel-beckett.net/Waiting_for_Godot_Part2.html

Wall Street, but not shared by the Anderson Forecast, that this recovery is fragile and might not take hold.

There have been many panics in U.S. economic history. The Panic of 1907 has been viewed by many as comparable to the Panic of 2008 as it began with the failure of the Knickerbocker Trust Company, a large unregulated bank,[2]and ran its course with a liquidity crisis spilling over to the real economy[3]. It is interesting to note that the financial system reform growing out of this panic resulted in the Federal Reserve Act. While the comparisons might indeed hold, objective data on the 1907 panic and on other panics in the 19th and 20th century do not exist and cannot be incorporated into our models. Inferences that have been drawn from the single observation of 1907 suggested that confidence should have been restored and hiring begun by now.

But the U.S., California, and the East Bay are very different in 2010 than they were 100 years ago. So the impact of a financial panic on business expectations and business hiring today is not well understood. What we are observing is business growth without jobs. During the recession firms were quick to cut labor costs, and now that they are experiencing an increase in demand, are not yet forming expectations of a rapid enough recovery to warrant hiring. Increased output is coming from extending hours and increasing productivity. But this cannot continue without limit and hiring will need to start perhaps very soon.

Consumer debt is also playing an important role in the underwhelming expansion. National consumer revolving credit grew by over 10% between 2005 and 2008. It has been falling since that time as households get their personal balance sheet in order and consumer debt is now nearly at 2005 levels. This is a good thing for the long run health of the economy, but not such good news for the East Bay. Ramping down the level of debt means consumers are not spending as much on consumption goods.

This affects the East Bay's retail, wholesale, logistics, warehousing and distribution sectors. The March retail sales numbers for department stores suggest that households might be close to increasing consumption levels, but consumer debt is still quite high. With slow growth in the consumption and business being reluctant to jump in and hire additional employees, the lag between the recovery in economic activity and jobs is attenuated. Our data do not admit a good estimate of the amount of the attenuated and our forecast in this regard has some risk associated with it.

The key sectors to watch for as the recovery unfolds are international trade, domestic distribution, manufacturing, health care, government and technology. The recovery will be export and technology led, and as such, the East Bay will be well positioned to grow rapidly

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[2] William L. Silber, *When Washington Shut down Wall Street: The Great Financial Crisis of 1914 and the Origins of America's Monetary Supremacy*. Princeton: Princeton University Press, 2007

[3] Abigail Tucker, "The Financial Panic of 1907: Running from History," *Smithsonian.com*, October 10, 2008
Robert F. Bruner and Sean D. Carr, *The Panic of 1907: Lessons Learned from the Market's Perfect Storm*, John Wiley & Sons, Inc., 2007

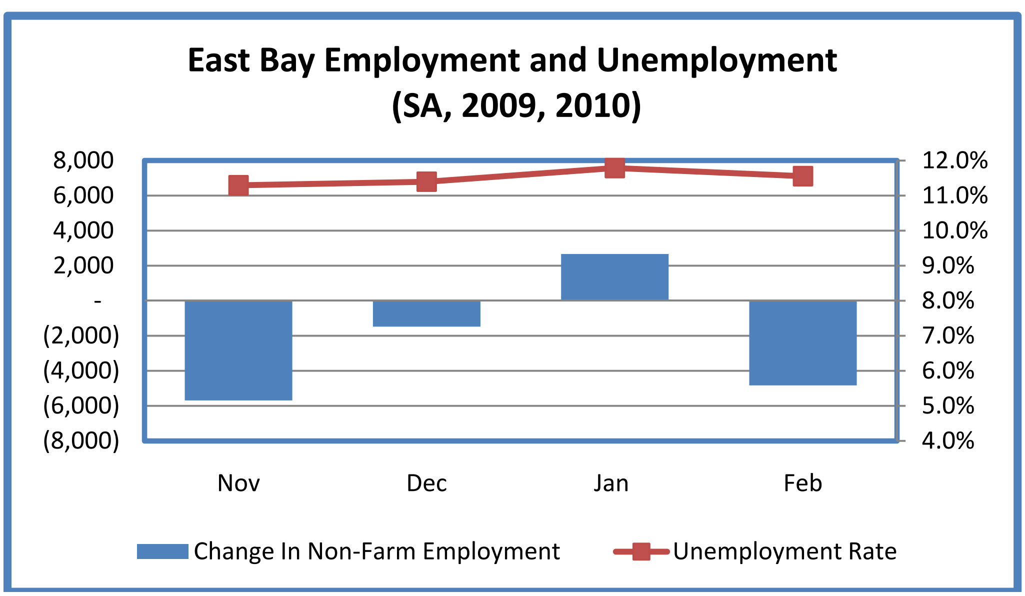
once the drag created by slack consumer demand, business expectations, and the reduction of government is behind us.

Private Sector Employment Retrospective

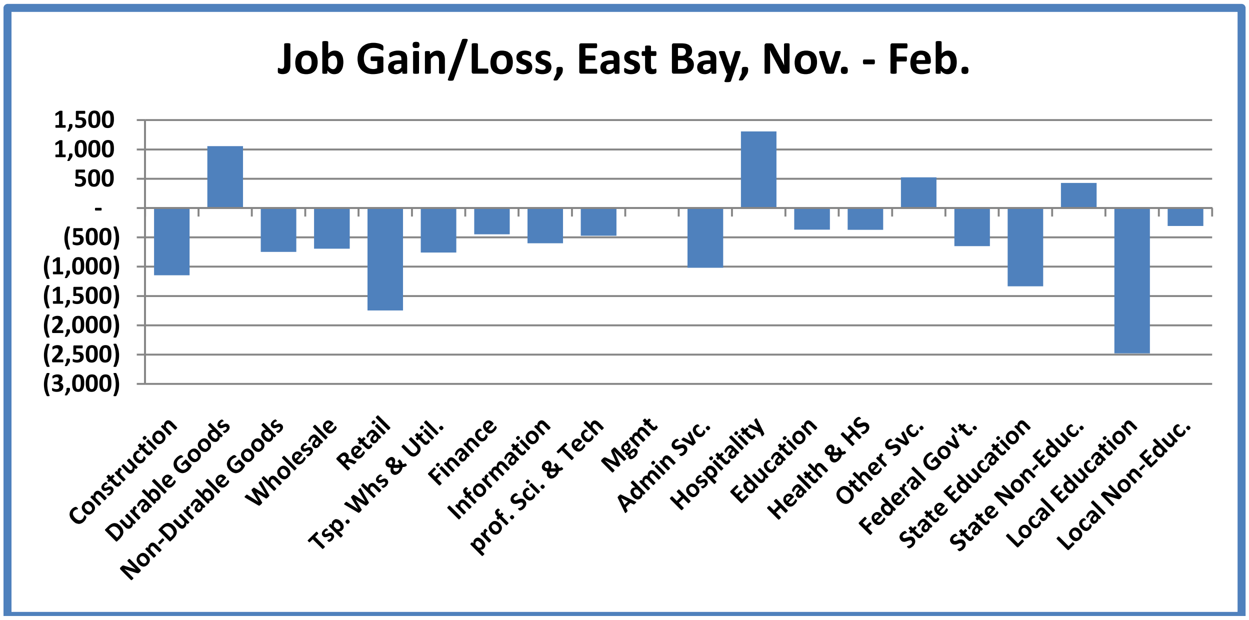
In the months since October 2009 the East Bay unemployment rate has been virtually unchanged. It stood at 11.5% in October and 11.6% in February 2010. However, this is only because the labor force shrunk by 20,000 people. In fact there are 9,000 fewer payroll jobs in the East Bay today than there were four months ago. From a statistical point of view this is not huge. It represents a reduction of only 1% of all payroll jobs. However, it is a reduction and an indication that labor markets remain very weak in the East Bay[4].

Breaking down the job gain and loss by sector it can be clearly seen that the weak labor markets in the East Bay are widespread. Two sectors showing some job gains are the hospitality sector and non-education state government. Clearly we cannot take too much from this. The former depends on continued increases in consumer demand and business travel to sustain job growth, while the latter is clearly not sustainable due to the state's 2010/2011 fiscal year budget shortfalls. The other services sector had a modest gain over the last four months, but this sector is a catch all for everything not easily defined, and generally follows the rest of the economy.

The only bright spot in the sectoral employment picture is durable goods manufacturing. Over the past four months durable goods manufacturing employment registered a solid gain of over 1,000 new payroll jobs. Though the trade data indicates that this should continue, the closing of NUMMI will offset some if not all of the gains through March.



[4] http://www.labormarketinfo.edd.ca.gov/



Trade and Manufacturing: Continued Signs of Growth

The most encouraging sign for future job growth in the Bay Area comes from international trade. As the recovery shapes up it appears that growth by the Bay Area's trading partners coupled with a weaker dollar has generated increased demand for California's natural resources and manufactured goods.

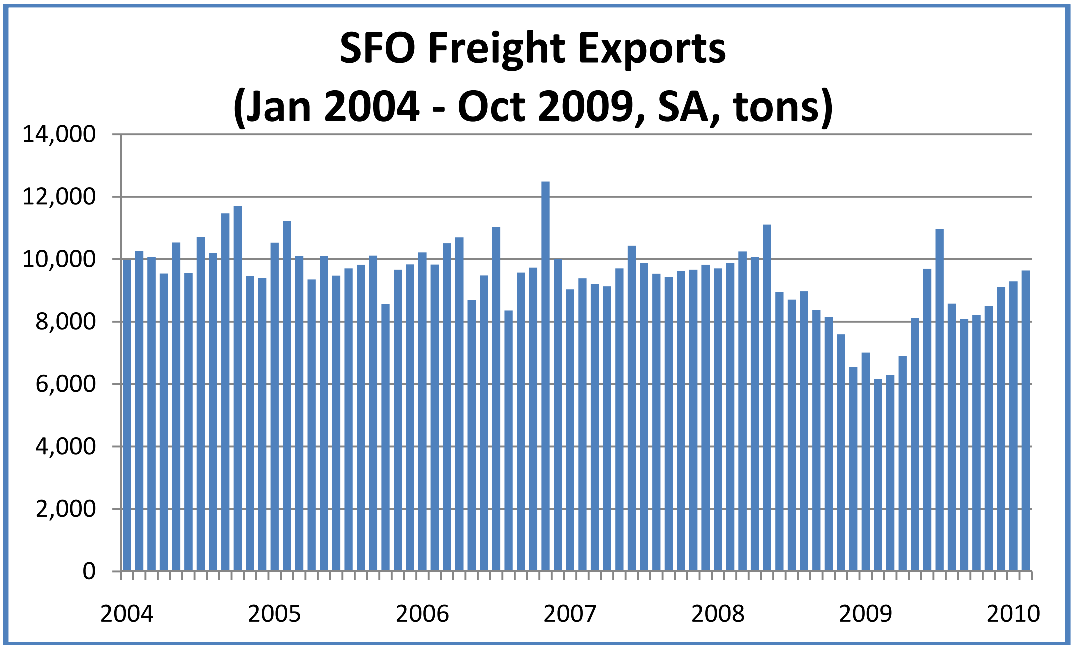
The growth of exports through California's seaports has been relatively steady since the trough in the 1st quarter of 2009. The Port of Oakland, which is a conduit for exports of raw and processed food, raw materials, and forest products from the Central Valley and North Coast, and machinery from Bay Area factories, has seen a steady rise of traffic and has returned to pre-recession levels of activity.

California's high value goods typically travel by air cargo. The split between the two Bay Area airports with substantial air cargo traffic, SFO and OAK, relates to both location and destination. SFO is the principal port of embarkation for international exports, while SFO and OAK share in the domestic air cargo traffic. SFO exports are also now back to near pre-recession levels[5]. This indicates a demand for manufactured goods which is at least in part, reflected in the gain in non-durable goods manufacturing in the East Bay.

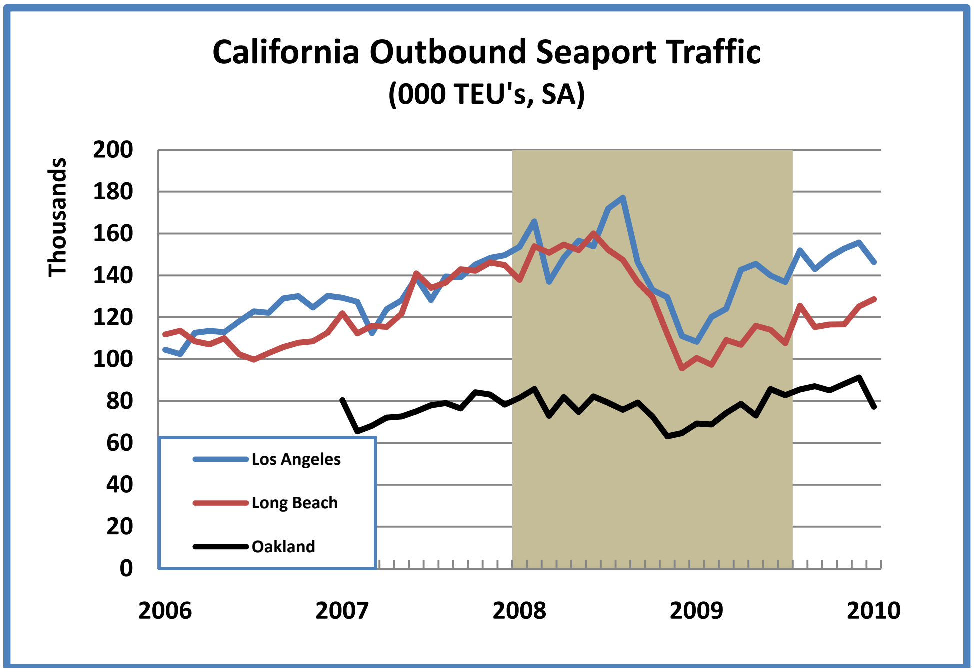
At OAK no such gain in traffic is being observed[6]. February 2010 cargo traffic was below that of the previous recession wracked February 2009. Since domestic traffic is dominated by small

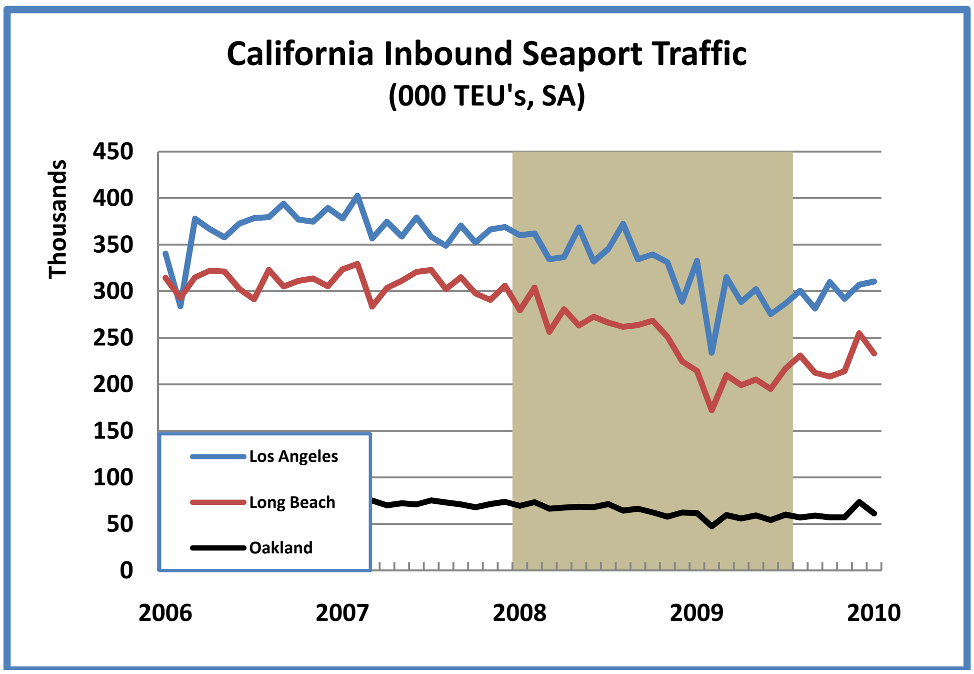
[5] http://www.flysfo.com/web/page/about/news/pressres/stats.html
[6] http://www.oaklandairport.com/airport_stats.shtml

package delivery services, the fall off in traffic from consumer purchases appears to have swamped any increase that might have obtained from the new orders for durable goods reported in the national statistics[7]. But overall export growth bodes well for these sectors as they end up as the leading sectors in the early part of the recovery.



[7] http://www.census.gov/manufacturing/m3/





The Ceridian-UCLA Pulse of Commerce

More telling are the results from a new index from the UCLA Anderson Forecast. The UCLA Anderson Forecast is partnering with Ceridian Corporation to bring to market an exciting new index for tracking and forecasting the US economy[8]. The Ceridian-UCLA Pulse of Commerce Index (PCI) is a series of indexes which are national, regional and sub-regional in scope. The data underling the Ceridian-UCLA Pulse of Commerce Index come from credit-card swipes for the purchase of diesel fuel at over 7,000 truck stops all over the country. The interstates that crisscross America are the arteries along which products flow that are the lifeblood of the economy. If the goods do not move, the economy turns comatose. Rather than measuring the pulse at a couple of locations, like the wrist and the neck, Ceridian has in effect, installed sensors at truck stops all over the United States that measure the flow through this arterial system.

Less than a second after a credit card is swiped at a truck stop to authorize the purchase of diesel fuel, the transaction is recorded on Ceridian's computers in Nashville, Tennessee. Most of the other data that we rely on to track the economy are based on after-the-fact surveys filled out by individuals whose memories may have dimmed and who have mixed incentives to provide accurate information. The Pulse of Commerce Index is based on real transactions, observed instantaneously, with rich geographic detail.

By tracking the volume and location of fuel being purchased, the Pulse of Commerce Index closely monitors the over-the-road movement of produce, raw materials, goods-in-process and finished goods to U.S. factories, retailers and consumers. Working with economists at the UCLA Anderson School of Management and Charles River Associates, Ceridian releases the index monthly for the nation overall and for the nine Census regions. The geographic detail of the data offers vast possibilities for studying details of local economies.

These data help shed light on the health of regional economies such as the East Bay. The Ceridian-UCLA Pulse of Commerce Indexes are computed for the State of California, for neighboring states and for California counties. Each of these regions includes one or more segments of the arteries of the system. Here we focus on traffic from Sacramento to Salt Lake City, the principal east/west artery for truck traffic to and from the Bay Area. The index clearly tracks the course of the Bay Area economy and has the unique advantage of being a real time indicator. For the past two recessions, the index has trailed the economy turning down only after the recession began. In the last recession the index turned down only when consumer demand weakened in the middle of 2008. After bottoming out in the summer of 2009 the index has grown, but remains well below its previous peak. The latest month's data still do not indicate any substantial growth in I80 traffic and by implication does not give us a good fix on when demand will be strong enough to generate significant net new jobs in the East Bay.

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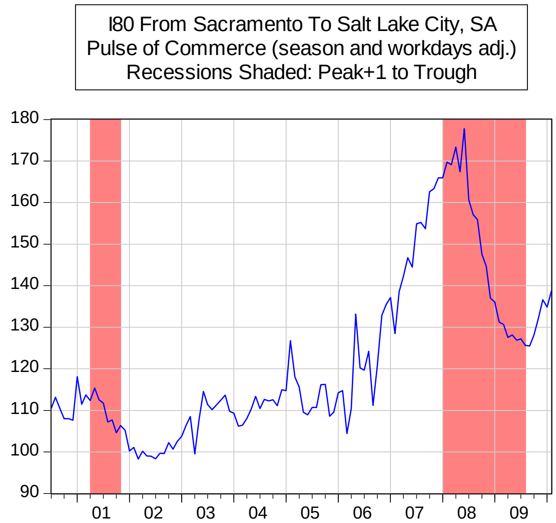
[8] Most of this section was taken from: Edward E. Leamer, "The Ceridian-UCLA Pulse of Commerce Index, The Western States, California Counties and Western Interstate Highways," *UCLA Anderson Forecast Quarterly Report*, March 2010.



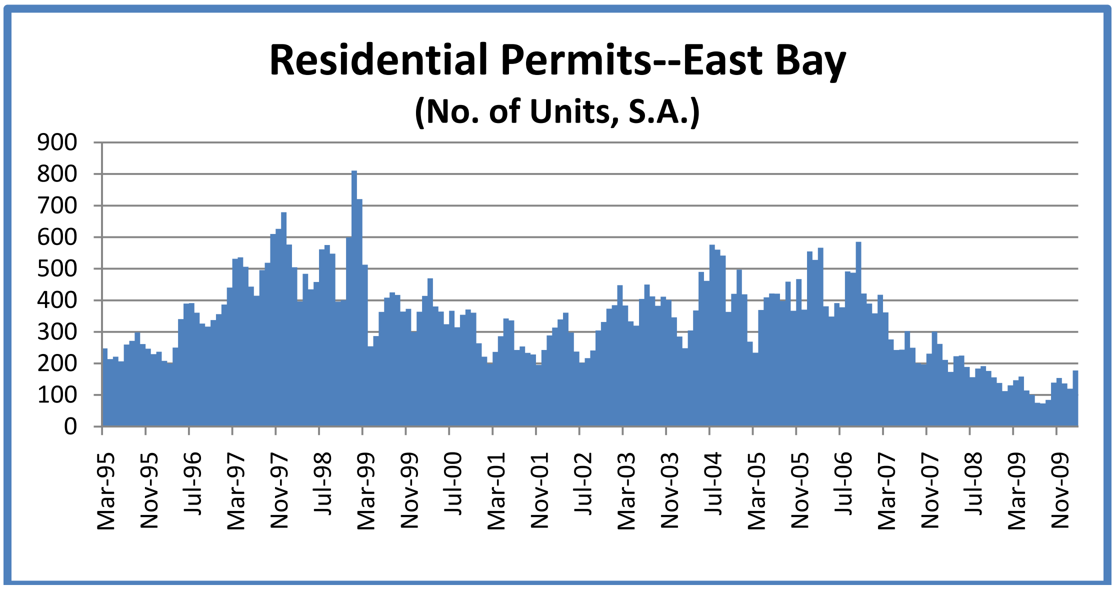
The Housing Market: A Bottom But No Ascent

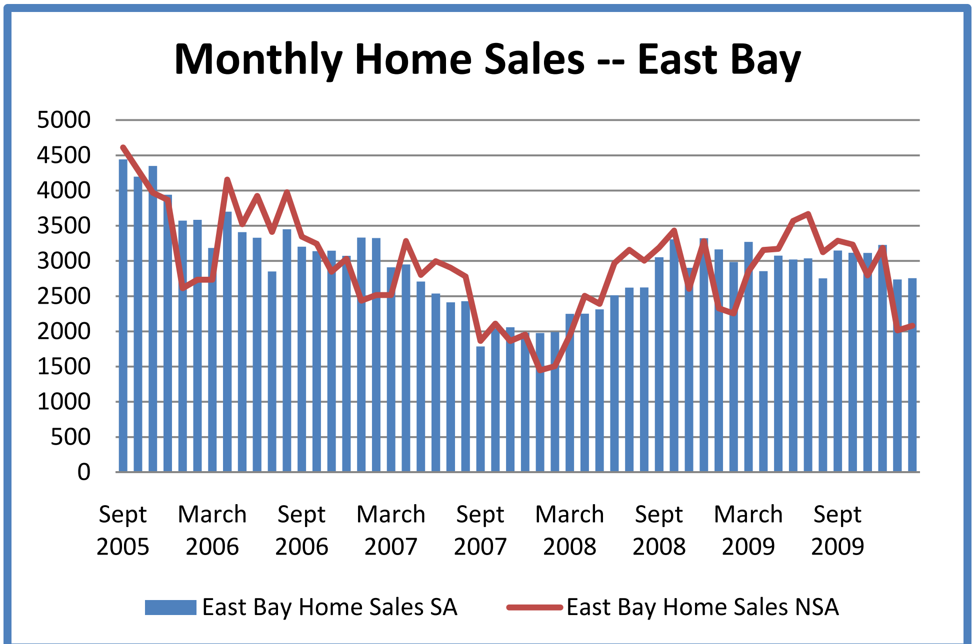
Another stalled sector in the East Bay economy is found in the housing markets. It is the beginning of the fifth year since housing prices and home sales peaked in the U.S. Builders were a little slow to respond to falling demand, but by the beginning of 2007 applications for new residential building permits in the East Bay had fallen off a cliff. Over the past year residential construction has been lower than at any time during the last three housing cycles. Picking a turning point in residential construction is always a risky proposition, and the data are not yet admitting of any signal that East Bay housing is in the throes of an incipient recovery. Hanging over this market is the potential for reductions in government employment in the near term. Nevertheless, there are no signs that the housing market will worsen in the coming months and conditions may be ripe for the opposite to occur.

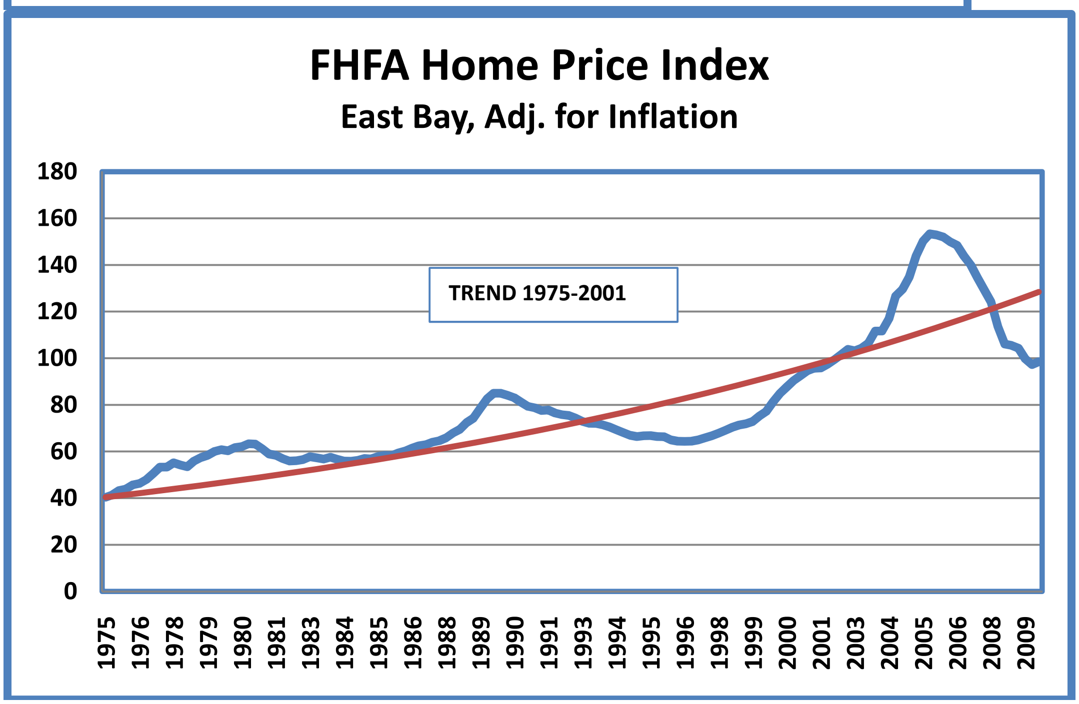
The 2004-2006 exuberance in housing markets drove prices to unsustainable heights above fundamental norms. Housing is an investment as well as a purchase of shelter and therefore must carry a positive return. After adjusting for inflation, the historical return in the East Bay (1975-1995) was about 0.6% per quarter. If the return is calculated through 2002 it is slightly higher. Sustained appreciation above those returns is only possible if immigration adds substantial incremental demand to the housing market. The 2004-2006 incremental demand was not from a larger population, but from speculative purchases based on anticipated continued appreciation. The subsequent wave of foreclosures resulted in an unprecedented decline in home prices in the East Bay. This leads us to our first sign of a turn in the market. If one invested in a home in the East Bay in 1975 and sold it today, the home would have earned almost exactly the 1975-1995 average rate of return and less than the 1975-2002 average rate of return. In other words, all of the excess in price appreciation from the speculative bubble has now been wrung out of the market.

On the down side home sales are no longer picking up. After an initial boost driven by government incentives home sales have fallen back to very low levels. While sales are still above those of late 2008, they are not robust by any means. Does this mean more price depreciation? The Case / Shiller S&P index of home prices for the entire San Francisco MSA has been rising steadily over the last four months and prices as measured by the FHFA index have stabilized and are not falling. So pricing data indicate a bottom, but weak sales suggest it is not a very solid bottom.

What is encouraging though is the reduction in inventory. There are various estimates of inventory available, but the best estimates all suggest that inventories in the coastal areas of California, including the Bay Area are now at very low levels. So, combined with low inventories, the existence of some buyers in the market, little new construction coming onto the market, and prices which now make the East Bay housing affordable once again all increase the chance of a near term turn in real estate and residential construction. These are the precursors to builders being able to plan new construction and thus a recovery in residential construction.







East Bay Outlook

In the last East Bay outlook we were optimistic about the potential for export trade to turn around and lead the East Bay recovery. We still are. Exports continue to grow and employment in durable goods manufacturing, the source of 10% of job loss during the recession, is growing once again. With the IMF predicting an earlier and faster recovery of more of California's trading partners[9], we expect these positive trends to continue. The balance of the trade sectors will begin to see some growth induced by last quarter's inventory correction in the U.S., but robust growth in these sectors will not return until consumers start spending again.

In addition to manufacturing, the next quarter should see the beginnings of a recovery in residential construction and the ultimate infusion of investment in renewable energy products, health care and infrastructure. None of these will happen quickly, but they are clearly on the way. The first allocation of research funds from the Department of Energy saw 20% go to Bay Area firms and the first allocation of $5B of medical research and technology funds resulted in over $200M in grants to Bay Area research projects. These funds were for storage technologies, CO^2 scrubbing technologies, transmission technologies, and for primary research in to disease prevention and control. The balance of the funds has been allocated and while California received a lower percentage in the second round, the percentage going to the Bay Area remains high.

Infrastructure funds, which make up a large part of the Obama National Recovery Act, are typically slow to arrive. Engineering, EIR's, land assemblage, public input and legal wrangling must all be put to bed before contracts are let and workers are hired. The first of these projects has begun in Southern California and Bay Area projects are not far behind. Venture capital investment also dipped in the fourth quarter, but is still above its recession lows.

Our national forecast foresees slow growth from the current quarter through the end of 2010 as U.S. consumers align their personal balance sheets with today's reality and as energy, autos, and finance adjust to a new, larger role for the Federal Government. The state forecast is also not much changed from last quarter and calls for a more muted 2010 as the contraction in state expenditures through the middle of the year will provide a drag on state growth. This will be felt more heavily in the East Bay than in many other parts of California and we are expecting very modest growth in East Bay income and employment through the next two quarters. Thereafter, California should grow faster than the U.S., led by all three sub-regions of the Bay Area, Los Angeles and Orange Counties.

All forecasts are best guesses at where the economy is going and this East Bay Forecast is no different. What is different about this forecast is the asymmetry of the risks. The chance of being very wrong on the downside is not too great given the state of the recovery and all of the indications of stabilization and modest growth. Another dip in employment and income would require either a stalled recovery in Asia, which does not seem very likely, a sharp rise of interest rates by the Federal Reserve, also not very likely, another serious financial panic, also probably not in the cards, or some unpredictable catastrophic event. Baring these, history tells us that we are in a recovery and our forecast is towards the lower end of what one ought to expect in such a recovery.

There is a far greater risk of being wrong on the up side though. Deep recessions are usually followed by rapid expansions. If the expectations we discussed at the beginning of this essay

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9 *World Economic Outlook (WEO): Sustaining the Recovery*, International Monetary Fund, October 2009.

change dramatically inducing consumers to be confident in their spending and business to be optimistic about the growth in demand for their products, the growth of income and employment in the East Bay could be much faster than we are predicting.