REGIONAL INTELLIGENCE REPORT™

BEACON ECONOMICS Prepared by Beacon Economics, LLC

East Bay EDA
www.eastbayeda.org

Eleventh Edition

United States: Glass Still Half Full

At first blush 2015 went out with more of a whimper than a bang. GDP growth in the final quarter came in at 0.7%, the manufacturing sector looks stuck in neutral, the global economy seems to be floundering, commodity prices keep falling, and to top it off, the stock market has stumbled hard in the first few weeks of this year. It seems to paint a picture of an economy that lost the momentum it had started to build early in 2015.

Yet, if you put the screaming headlines to one side and take a closer look at the data it turns out that things are really no worse now than they were a year ago. While there are clearly issues that continue to interfere with the U.S. economy's ability to get past the 3% pace of growth, on the other side of the equation, there are plenty of positive indicators suggesting that, at worst, 2016 will see growth remain in the 2.5% range.

With the fourth quarter GDP estimate, average quarterly growth for the year was 1.8%, down from last year's 2.5%. But growth in gross output isn't the best indicator of the economy's health—growth in final demand is. And, as it turns out, businesses, consumers, and the government increased their spending in 2015 by close to 3% per quarter—on par with 2014 and better than 2013 by a good margin. Overall, final demand grew at an average pace of 2.5% in 2015 – down only slightly from 3% in 2014, but quite a bit above 2013's pace of 1.5%. The slowing in output growth is due to reduced inventory accumulation and export growth. This is a function of the weak global economy and commodity glut that has resulted. There is little reason to think that domestic demand won't continue to support the economy in 2016.

Consumer spending is a particularly bright spot and continues to be largely driven by ongoing gains in the labor markets. Despite issues surrounding commodities and exports, the job markets are chugging forward with almost 900,000 new positions added in the last three months of the year in a variety of sectors. The retail industry overall saw solid numbers despite ongoing pressure on traditional brick and mortar stores (online and non-traditional retail more than made up the difference). Even manufacturing saw positive employment gains despite the glum outlook. Consumers are also being given a lift by easier access to credit, weak inflation figures, and improved balance sheets as a result of the real estate recovery.

On the industrial side of the economy—things are doing fairly well. Most of the turmoil has been based on a sharp slowing in the mining sector. Most other sectors are fine or even thriving—such as autos, airplanes and electronics. As for mining itself, it should be remembered that the sector represents less than 2% of the U.S. economy and less than one-half a percent of employment. This can cause turmoil in some areas but simply isn't broad based enough to do more than create modest headwinds for the economy. History backs up this mild view: We saw a similar collapse occur in the mid-1980s and it neither sank the U.S. economic expansion nor created any sort of major financial retraction.

Looking at real estate, housing continues to move slowly forward. Mortgage debt is finally expanding, household formation is picking up, and overall housing vacancies are down. With home affordability still relatively good, 2016 should see rising homeownership levels, more construction activity, and steady price appreciation.

And despite recent wobbles in the equity markets, in reality, the financial state of the U.S. economy is solid. Debt levels are steady and asset prices remain reasonable given low interest rates (and yes, interest rates have stayed low despite the Fed raising the Funds Rate in December). In the end, we may find that the slowing of the Chinese economy has put, and will continue to put, far more profound downward pressure on rates than any Fed policy.

Beacon Economics' bullish forecast is for another boring year of 2.5% GDP growth, and ongoing gains in real estate prices, employment, and most indicators. And while some may be discouraged by what they feel is too slow of a trajectory, consider the parable of the tortoise and the hare. The frustrating slowness represents an economy that is at a point in time where it has more potential in front of it than activity behind it. This implies that the current expansion may well end up being one of the longest ever. Only time will tell.

California Follies

Given all the negative rhetoric aimed at the state over the past decade, California has a lot to crow about. In the last 4 years the state has accelerated to become one of the fastest growing in the nation. Consider the recent data:

- California has added almost 900,000 jobs in the last two years—almost twice as many as the slowing, oil-dependent Texas economy. Unemployment is below 6% – rapidly re-converging with national levels.
- In the first half of 2015 (the latest data available) California grew its gross output at twice the rate of Texas—a distinct contradiction to the idea that business climate is the primary driver of economic success.
- California's employment growth is broad based. Both professional services and hospitality jobs are booming in the state, providing a mix of jobs for high and low skilled workers. The western part of the San Francisco Bay Area remains the fastest growing regional economy in the state, but Fresno and the Inland Empire are number 3 and 4, respectively, completely contradicting the notion that only the state's coastal areas are in recovery.
- Tourism is hot again and hotels across California are packed. With almost an 80% occupancy rate, it is understandable why new hotels are being built across the state.
- Taxable sales are above their previous peak by a solid margin, and continue to grow rapidly. The sources of growth are construction, business spending, and hotels/restaurants. Traditional consumer goods are adding little to the pot with inflation at such a low pace.
- Non-residential construction has returned to normal levels in California. The hot economy has filled state coffers with tax revenues and the current fiscal year will likely come in a few billion dollars over initial projections.
- California's housing market continues its strong recovery. The mortgage delinquency rate is lower in the state than in the nation overall, and home price appreciation is higher than the national average by a good margin. At the state level, median prices have reached $400,000 for the first time since 2007. The San Francisco Bay Area leads the way in price appreciation, but Fresno and San Bernardino Counties have both seen median prices grow at a double digit pace in the past year. Home sales are still slow relative to the last peak, but tight inventories and low interest rates have contributed to the ongoing rise in prices.
- To top it off, the rains have returned and the huge snow pack that is building in the Sierra Mountains will help refill reservoirs this summer, giving at least short-term relief to the water shortage.

This doesn't mean all is well in the land of sunshine. California continues to face numerous longer-term issues—problems with effects that might quickly re-emerge, or drags on the economy that prevent even greater growth and prosperity.

The current spell of good news should allow state legislators to take on these economic challenges with solid analytic work and bold legislation. Unfortunately, state leaders have been too busy over the past year and a half with sex (considering condom laws for the pornography industry), drugs (creating the Bureau of Medical Marijuana Regulation), and rock and roll (you can now drink a beer in public while riding on a 10 person booze-bike) to make much headway in tackling some of the larger economic hurdles that can and will cause even California's formidable economy to stumble.

What are some of the core economic issues state leaders should be focusing on?

Comprehensive Revenue Reform: The large budget surplus California is currently enjoying comes in part from the passage of Proposition 30 a few years ago, which expanded the income tax on high-income earners. The surplus has encouraged some interests in the state to try and make the tax increase permanent. The problem is the failure to recognize the other driver of the surplus—huge gains in financial markets over the last few years.

What the markets give, they can (and do) take away even more quickly – and California's tax system internalizes that market volatility. With or without a Proposition 30 expansion, a major or even minor financial downturn will quickly push the state back into another deep hole, creating all sorts of turmoil on the expenditure side. California needs to sharply reduce its reliance on personal income taxes and focus instead on more stable property taxes, service sales taxes, and various usage fees to make up the difference.

The Housing Affordability Crisis: Housing costs in California are rising rapidly for both rental and for-sale units. The state also has one of the lowest housing vacancy rates and one of the highest rates of over-crowded housing in the nation. Much has been made of the impact that high housing costs have on low-income households—but even middle class Californians are feeling the pain. The burden (as a share of income) on those who own a home is higher in many places than on those who rent.

There is little doubt that state legislators see the problem at the top level—but they have proven remarkably adept at avoiding confronting the true drivers, namely barriers to new residential construction. Instead, they discuss moratoriums on condo conversion, consider expanding rent control, or create plans to develop 'affordable' housing at a pace that wouldn't even cover the increase in the shortage as California's economy expands rapidly.

The housing crisis is going to become acute in the very short term. California has been growing its payroll workforce at a pace of 3% per year—but its labor force at only a 1% pace. This can only continue when there is slack in the workforce (unemployment rates are high), a situation that is clearly ending now that unemployment has dropped below 6%.

California needs to allow private developers to build more by alleviating the regulatory and tax barriers that slow the process and drive up costs. Yet there seems to be little interest in reforming the state's major barriers (Prop-13, California Environmental Quality Act) or in forcing local cities to zone more (and tax less) new residential construction.

Water Policy: As the rains have returned and the snowpack has been building in California, it would be easy to forget about water issues. But the water crisis isn't over. The state is far from repairing the damage that has been done due to emptying waterways and digging ever deeper for ground water. And there will be another drought – likely worse than the last one.
The solution should not be desalination, nor should it be many of the expensive strategies being offered. Rather, the state should focus on allocating this scarce resource to its best uses. Over the course of the last 6 years of drought, California's exports of hay—a very water intensive crop— have almost quintupled from 30 million to 140 million kilograms annually. In other words the state has been functionally increasing exports of water at a time when Californians have been asked to cut back on water use.

The worst part is not that we are exporting water, but that we are exporting it at prices far below what we pay for it. Hay typically earns farmers roughly $25 per acre foot used—compared to $1700 to create fresh water through desalination.

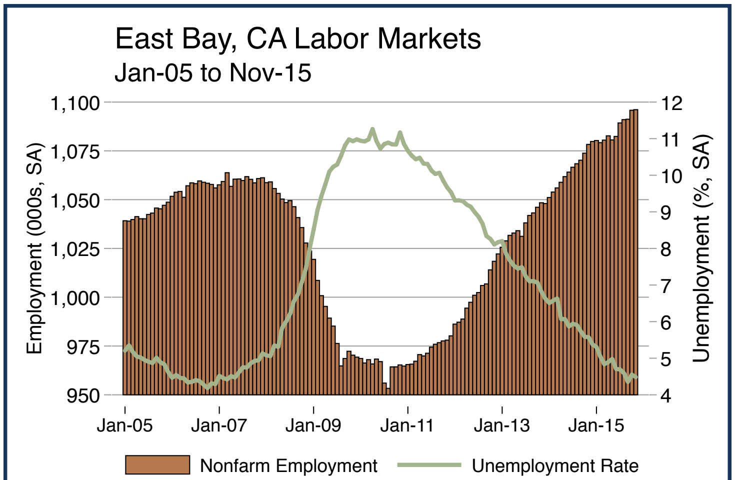
Why this clear arbitrage—selling agricultural water to cities for anywhere between $25 and $1700 per acre-foot—is not happening is a bit perplexing to an economist. Surely it has something to do with the myriad of local water agencies that govern the state's water supplies with relatively little oversight. The focus is everywhere but where it needs to be.

While it is easy to poke fun at some of the laws and regulations that Sacramento has recently focused on, other important topics have been tackled including vaccination rules to protect children, reducing police violence, and greater education to help prevent sexual violence. But just because the state is on the mend doesn't mean that legislators should ignore mid- and long-term economic challenges even if they are politically thorny topics. Maintaining the status quo simply makes the state vulnerable to the next round of potential calamities that it will assuredly face.

East Bay Employment

The East Bay labor market continues to move forward as employment levels reach new highs amid solid hiring. Total nonfarm employment in the East Bay rose 1.7% year over year to almost 1.1 million—its highest level ever—while the region's unemployment rate fell 1.18 percentage points to 4.5% in November 2015. The unemployment rate still has to fall about 0.4 percentage points before it reaches its pre-recession lows. Nevertheless, the healthy labor market is encouraging previously discouraged workers to return to the labor force and search for jobs. Over the last year, the East Bay labor force has expanded 0.4% to 1.37 million. Beacon Economic's current forecast is for the unemployment rate to trend at pre-recession lows, between 4% and 4.5%, over the next five years.

Several industries have been making strong contributions to recent employment gains, pushing overall employment to a new high virtually each month. Over the year, the top five fastest-growing sectors in the East Bay were Leisure & Hospitality (5.4%), Natural Resources/Construction (4.5%), Transport/Warehouse (4.2%), Administrative Support (4.1%), and Professional, Scientific, & Technical Services (2.3%).



Source: California Employment Development Department

Employment in the East Bay is doing well because companies of all shapes, sizes, and specialties continue to relocate and/or expand, especially from San Francisco and the Silicon Valley, for cheaper rents, more space, better amenities, and the growing customer base. The most significant moves and expansions in 2015:

- Parsons Brinckerhoff
- Visual Supply Co.
- Workers Compensation Insurance Rating Bureau of California
- Pandora Media
- California Institute for Regenerative Medicine
- Brown & Toland
- Huge Inc.
- Women's Foundation of California
- Pivot Learning Partners
- MM Design Group
- Otis McAllister Inc.
- 99designs
- California Humanities
- Lennar Multifamily Communities
- 21 Tech
- Fluid
- Sierra Club
- CoreLogic Inc.
- Uber Technologies[1]

Future reallocations and expansions include:

- Flax Art and Design, a well-known art supply company, just announced it will be uprooting itself from San Francisco and moving to 15th Street and Martin Luther King Drive in Oakland.[2]
- Penumbra Inc., a medical device company, will be leasing additional space at the Harbor Bay Business Park in Alameda.[3]
- Abaxis Inc., a veterinary medical technology company, will be leasing additional space at 3280 Whipple Road in Union City.[4]

[1]http://media.bizj.us/view/img/7781812/overtooakland.pdf
[2]http://www.bizjournals.com/sanfrancisco/blog/2016/01/oakland-scores-another-sf-stalwart-as-flax-moves.html?ana=e_du_pub&s=article_du&ed=2016-01-05&u=hCOEseLMeYqzrZoXAlnF%2FTlSqHc&t=1452055239
[3]http://www.costar.com/News/Article/Penumbra-Re-Ups-Expands-in-East-Bay/178557
[4]http://www.costar.com/News/Article/Abaxis-Expands-into-Third-Building-in-East-Bay/178559

Secondly, East Bay employment is blossoming because local existing businesses are growing and hiring rapidly. For example, 31 East Bay companies are ranked in the Bay Area's 100 fastest growing companies of 2015.[5]

Although overall employment in the East Bay continues to make strides, it is important to note employment subsectors that are lagging behind. The Financial Activities industry in the East Bay contracted 4.1%, shedding 2,010 jobs, in the last 12 months. This was due to a 5.9% decline in the Finance and Insurance subsector, a loss of 1,910 jobs year-over-year. The reduction appears to have concentrated in the East Bay because the number Finance and Insurance jobs grew 0.4% year over year in San Francisco and remained flat in Santa Rosa, San Jose, and Vallejo.

Employment by Sector
East Bay, November 2014 to November 2015

Sector	15-Nov	YOY Chg. (%)
Leisure & Hospitality	110,260	5.4
NR/Construction	64,670	4.5
Transport/Warehouse	32,140	4.2
Admin Support	63,080	4.1
Prof, Sci, & Tech	94,620	2.3
Retail Trade	113,190	2.1
Other Services	38,510	1.1
Government	168,540	0.8
Management	30,320	0.7
Education/Health	177,700	0.7
Manufacturing	83,610	0.7
Information	21,290	0.5
Wholesale Trade	45,970	-1.3
Utilities	5,110	-2.1
Financial Activities	47,090	-4.1
Total Nonfarm	**1,096,100**	**1.7**

Source: California Employment Development Department

The East Bay is losing jobs in the Finance and Insurance industry for three main reasons. First, certain business segments and financial products have become unfavorable and/or unprofitable in current and anticipated future market conditions. Financial and insurance companies are also investing more in IT to automate certain processes and tasks—once done by humans—to reduce costs.

Second, employees are losing their jobs as more people are using at-home, do-it-yourself computer programs and online resources to do their own taxes and financial planning.

Third, San Francisco remains the recognized financial center of the West Coast, discouraging the Financial and Insurance subsector from migrating to or expanding in the East Bay as quickly as other employment sectors.

Overall, with a few sector exceptions, it can be said that the steady migration and expansion of firms along with employment growth in the East Bay have been creating strong fundamental demand for residential and commercial real estate for some time. Unlike the past, however, employment and corporate presence have escalated to such a degree that companies are now confidently investing capital in East Bay infrastructure projects. For example, TIAA-CREF recently bought a 312,885-square-foot tech park in Newark, a sub-market that historically has not attracted big investors. Yet TIAA-CREF made the purchase and will be making renovations to the campus-like property for two main reasons. First, "this cycle [of] sustained tenant growth and activity throughout the valley" is creating demand in these previously less popular sub-markets.[6] Second, light manufacturing and R&D space is becoming scarce in Silicon Valley, so "an increasing number of Silicon Valley companies focused on healthcare, biotech, and hardware are moving up to the Fremont-Newark area."[7] With the pace of company relocation and employment showing no signs of slowing, more investors will follow TIAA-CREF's lead in the new year.

East Bay Spending

As the East Bay attracts more people and firms that contribute to economic activity, local spending is following suit. Taxable sales growth in the East Bay has surpassed growth in the South Bay and San Francisco. In the third quarter of 2015, taxable sales rose 6.1% year-over-year to $11.6 billion in the East Bay, compared to 0.3% in San Francisco and 3.0% in the South Bay. East Bay spending growth has also been ahead of the state overall as California total taxable sales grew by 3.9% over the same time period.

Alameda County made the largest contribution to East Bay spending gowth with a 6.8% year-over-year increase to $7.6 billion, and Contra Costa County's spending rose 4.9% to $3.9 billion. In Alameda County, the City of Alameda has made one of the largest contributions to overall growth and has seen

[5] http://www.bizjournals.com/sanfrancisco/blog/2015/10/100-fastest-growing-private-companies-bay-area.html
[6] http://www.bizjournals.com/sanfrancisco/blog/2016/01/tiaa-cref-snaps-up-newark-tech-park.html?ana=e_du_prem&s=article_du&ed=2016-01-05&u=hCOEseLMeYqzrZoXAlnF%2FTlSqHc&t=1452054657
[7] http://www.bizjournals.com/sanfrancisco/blog/2016/01/tiaa-cref-snaps-up-newark-tech-park.html?ana=e_du_prem&s=article_du&ed=2016-01-05&u=hCOEseLMeYqzrZoXAlnF%2FTlSqHc&t=1452054657

some of the fastest spending growth in the county. From the third quarter of 2014 to the third quarter of 2015, taxable sales in the City of Alameda grew 28.9%. In absolute terms, the City of Fremont saw the largest increase in taxable sales growth, $75.9 million,or 8.6%.

The spending gains in the East Bay were broad-based, with nearly all categories experiencing strong growth from the third quarter of 2014 to the third quarter of 2015. Most notable were gains in the Building and Construction (10.6%) and Autos and Transportation (10.0%) categories. Spending in the Fuel and Service Stations category continued to shrink (down 14.9%) because of low oil prices.

Sales Tax Receipts by Category, East Bay

Category	Q3 - 2015 ($ 000s)	YOY Chg. (%)
Building and Construction	9,201.4	10.6
Autos and Transportation	19,417.8	10.0
Restaurants and Hotels	12,376.9	8.5
Business and Industry	18,757.5	6.9
Food and Drugs	6,353.4	5.8
General Consumer Goods	24,068.5	4.5
Fuel and Service Stations	9,174.7	-14.9
Total	**115,578.8**	**5.3**

Source: HdL Companies

Building and Construction spending in the East Bay has been trending steadily higher over this last year, and recent construction permit trends indicate spending in this category will continue to grow at a strong pace in the near term. Year-over-year growth for Building and Construction spending during each of the first three quarters of 2015 was in double digits.

Over the same time period the value of nonresidential construction permits was 10.9% higher than the first three quarters of 2014. Permitting for new commercial and industrial structures contributed to the year-to-date growth and were 37.5% and 60.6% higher respectively. Total nonresidential permit growth would have been higher if not for an 8.9% decline in the value of permits for alterations and additions to existing structures. Residential permitting was even stronger as over 5,600 new housing units were permitted during the first three quarters of 2015, a 62.0% increase over the same time period in 2014.

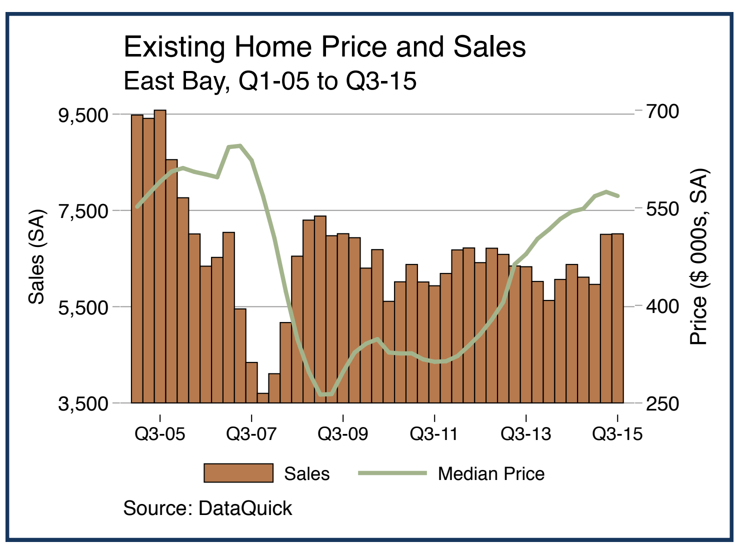
Across the state Auto and Transportation spending has been quite strong as more people have found employment and incomes have risen. California taxable sales for Autos and Transporation were 8.9 higher from the third quarter of 2014 to the third quarter of 2015, and most of this was due to new vehicle purchases. Correspondingly, according to the California Department of Finance, new vehicle regestrations were 8.7% higher over the same time period.

East Bay Real Estate

East Bay housing continues to be a seller's market because of tight housing supply, rising prices, and relative affordability. Job opportunities are on the rise in the East Bay, and the region's housing is attractive to commuters inside and outside the East Bay. The result is a hot housing market with steady momentum heading into 2016.

The median home price for the region ticked down slightly from the second quarter to the third on a seasonally adjusted basis, but this is just a blip in the data, as the longer-run trend is quite clear. For the first three quarters of 2015, the median price for an existing home was 7.3% higher than in the same year-to-date period in 2014. And at $568,000 as of the third quarter, the median existing home price in the East Bay remains the most affordable compared to San Francisco ($1,080,300) and the South Bay ($876,270).

Owners are taking notice of the higher prices and are taking advantage of this seller's market to cash out their equity. As of the third quarter of 2015, existing home sales were 10.0% higher than in the same time a year prior. That's the second consecutive quarter of double-digit year-over-year sales growth, and nothing on the horizon indicates that this momentum should slow, given the region's economic expansion and the relative affordability advantage the East Bay has over the major job centers in San Francisco and the South Bay.



Supply remains tight in the East Bay, however. Even though there has been an increase in sales volume, the homes have been snapped up quickly and have not changed the overall market inventory. According to the California Association of Realtors (CAR), the current inventory of homes for sale as of November 2015 would be exhausted in two months in Alameda County at the current pace of sales. Contra Costa County was only slightly better at 2.3 months. These numbers are little improved from our last report and highlight how tight the East Bay housing market is.

Not surprisingly, rents in the East Bay are growing at a strong pace. As of the third quarter of 2015, the average apartment rent in the East Bay was $1,701, a 6.1% increase over the same time a year prior. Nevertheless, the region's relative affordability is strong as rents in San Francisco ($2,517) and the South Bay ($2,074) remain markedly higher.

Apartment vacancy rates in the East Bay are also indicative of the tight supply on the rental side of the market. As of the third quarter of 2015, the apartment vacancy rate was at a historically low 2.5%, putting upward pressure on rents.

The City of Oakland has made efforts to increase its rental supply.[8] The City Council voted on January 5 to ease residential parking requirements allowing more secondary units, such as backyard cottages, to enter the market. The vote was seen as one of the fastest ways to increase the rental supply in the City and rein in rent growth.

The robust trends in the East Bay real estate market have encouraged builders in the region. For both single-family and multi-family housing, construction permitting is running strong. During the first three quarters of 2015, 2,732 single-family homes were permitted for construction, up 38.0% from the same year-to-date period in 2014. Over the same period in 2015, 2,921 new multi-famiy homes were permitted, a 93.3% increase over the first three quarters of 2014.

East Bay Forecast

Beacon Economic's outlook for the East Bay economy is quite optimistic, and for good reason. The Bay Area economy has experienced strong growth these last few years, and the East Bay is poised to take advantage of it due to its relative affordability advantage in both residential and commercial real estate. This affordability advantage will continue to attract new firmst and residents, putting upward pressure on home prices, construction, and business and consumer spending.

It has been our view for quite some time that the East Bay would reap the benefits of its proximity to the business centers in San Francisco and the South Bay, and we are beginning to see that take shape. The region's affordability brings more former commuters to the region, and they spend most of their wages locally.

With more and more talent residing in the East Bay, businesses have more reason to move to, or expand in, the region. Most notable has been Uber Technologies, headquartered in San Francisco, which took note of the fact that 20% of its workforce lived in Oakland; so it bought the former Sears building in downtown for expanded corporate operations.

Our current forecast is much in line with our previous projections. The migration of residents and business to the region has been built into our forecasts for several years, and we expect positive growth across the region's economic indicators.

Specifically, we expect nonfarm employment in the East Bay to increase by roughly 20,000 jobs in 2016 as the unemployment rate drops to 4.3% by year's end. Spending growth should remain in the 5% to 10% range in 2016, and we expect home prices to grow by roughly 10% annually.

[8]http://www.eastbayexpress.com/SevenDays/archives/2016/01/06/oakland-eases-rules-on-secondary-units-to-add-new-rental-housing

About Beacon Economics

Beacon Economics, LLC is a leading provider of economic research, forecasting, industry analysis, and data services. By delivering independent, rigorous analysis we give our clients the knowledge they need to make the right strategic decisions about investment, growth, revenue, and policy.

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About East Bay EDA

The East Bay Economic Development Alliance (Alliance) was created 25 years ago with the mission of establishing the East Bay as a world-recognized region to grow businesses, attract capital and create quality jobs. Representing a broad network of cross sector members and resources on the eastern side of the San Francisco Bay, the Alliance serves Alameda and Contra Costa Counties and contributes to one of the world's most dynamic regional economies.

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