

Appraising the North Bay Economy: Navigating Through Recession

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The Agenda

- The local economy
 - National and state situations affect local economy
 - Banking of key importance now in facilitating a turnaround
 - Need to look at our region rather than counties
- Economic outlook
 - Recession is here: depth and duration unknown
 - Long-term outlook still strong in North Bay
- Local real estate
 - Risk exposure continues nationally
 - Recession initiates a strange test of an old model locally
 - Economic development in this region will dictate housing markets

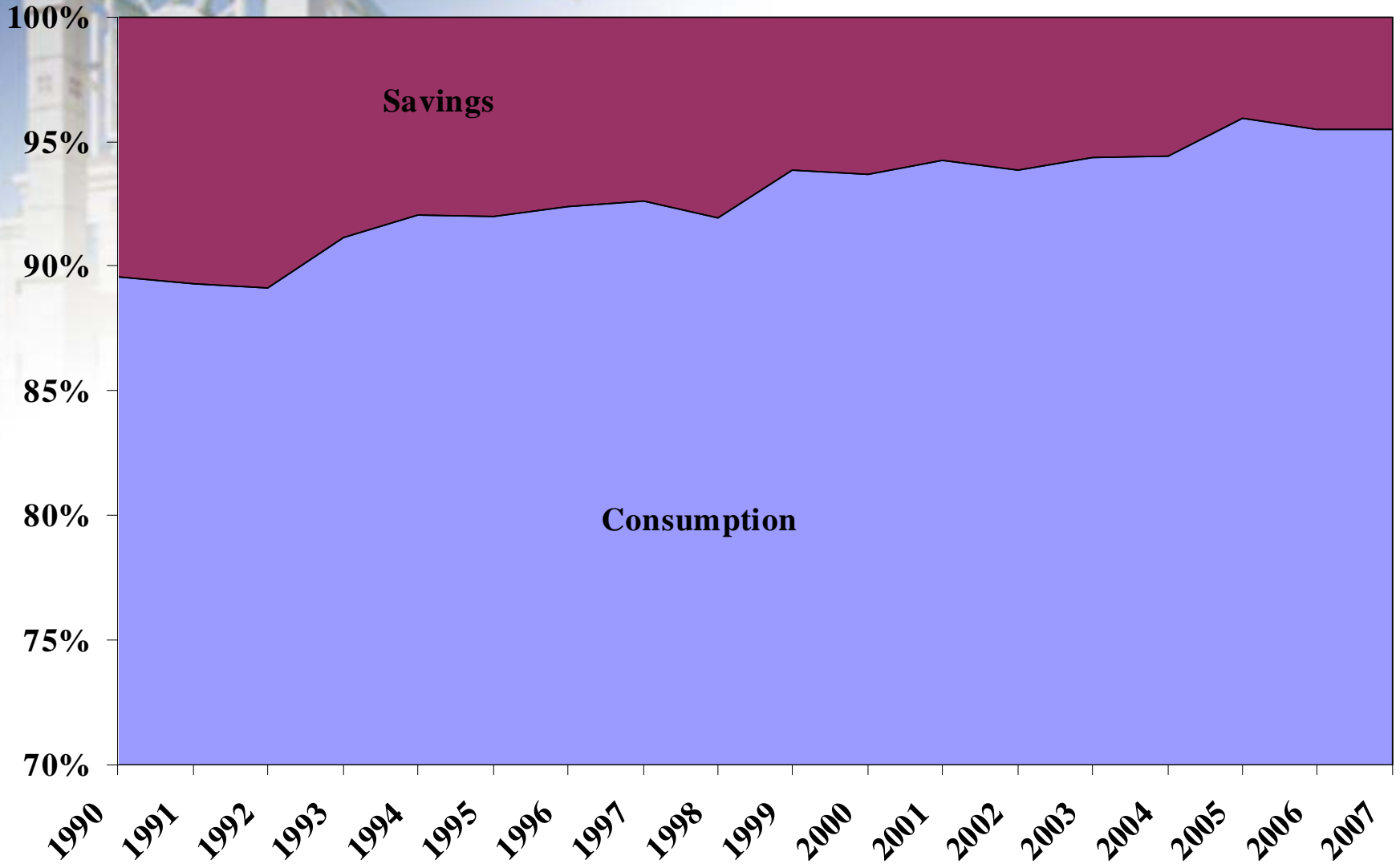
The Current Economic Situation

- Foreseen in direction, not in magnitude
 - Partially greed
 - Partially a lack of financial literacy
 - Partially cultural
 - Partially cyclic
- What is likely coming
 - More market sorting in banking and finance
 - More banking regulation, specific to documentation

All to blame

- Banks used a secondary market to move loans off their balance sheets
- Investors and brokerages purchased these assets
 - Gambled that housing prices would continue to rise on average
 - Homes salable in worse case, right?
- Consumption unabated throughout this decade
 - 9/11 had little effect on consumption
 - Housing prices, fueled by both good and bad lending, increase consumer wealth
 - Wealth effect: consumers spent more than their income, used home equity lines
- Banks, consumers and investors all wagered on home prices rising with minor downward cycles

US Disposable Income Since 1990

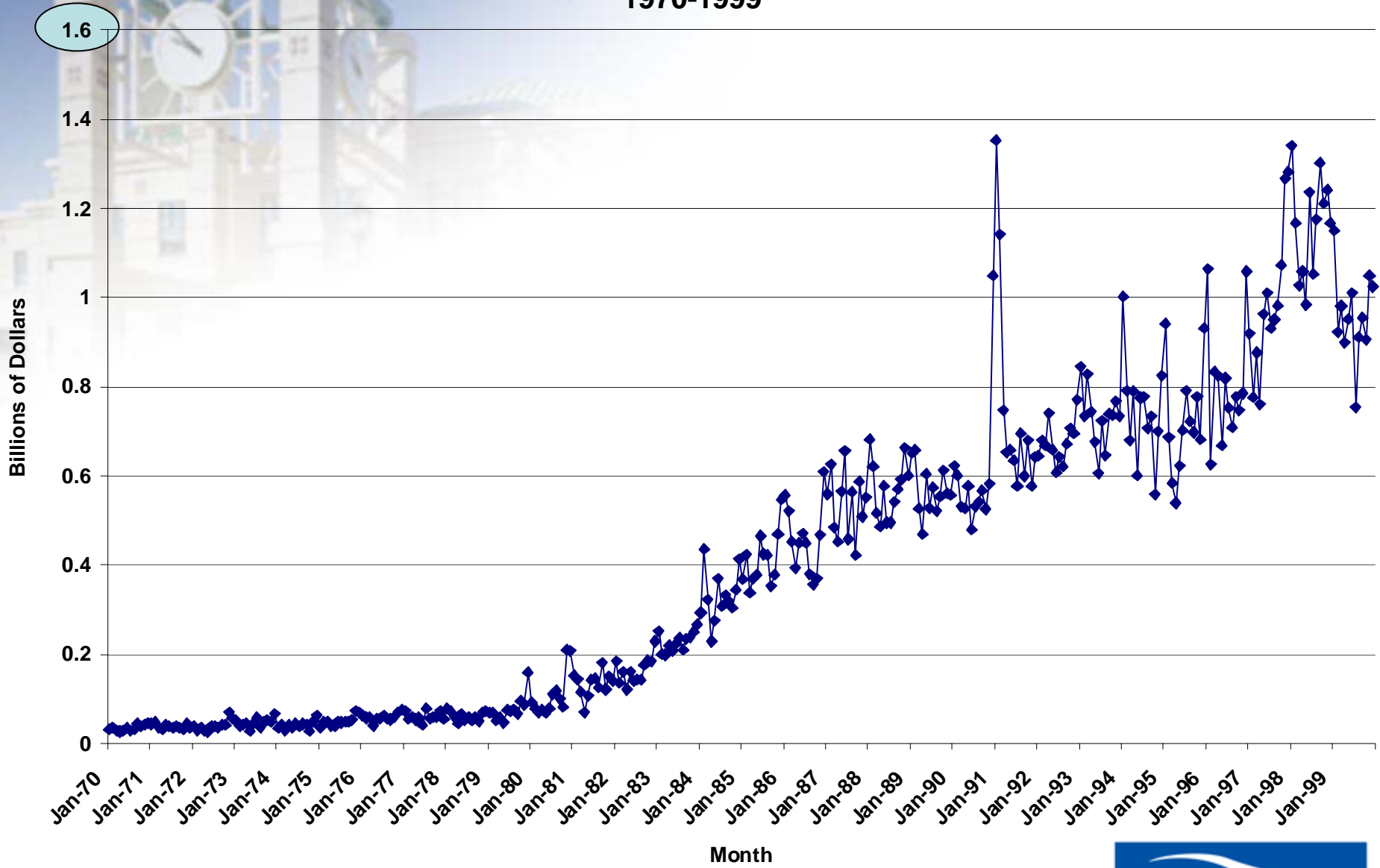


Source: Bureau of Economic Analysis

The Important Role of Banking

- Banking is both culprit and savior here
 - Riskiness drove current issues
- Classic model of growth
 - Investment from savings begets economic growth
 - Lending should be for investment, not consumption
 - Housing market became a mix of both
- Banks have now decided markets are too risky to lend much at all
 - Following charts show banks are nervous
- Local banks targets for consolidation, acquisition
 - Also a great place for a boom to start

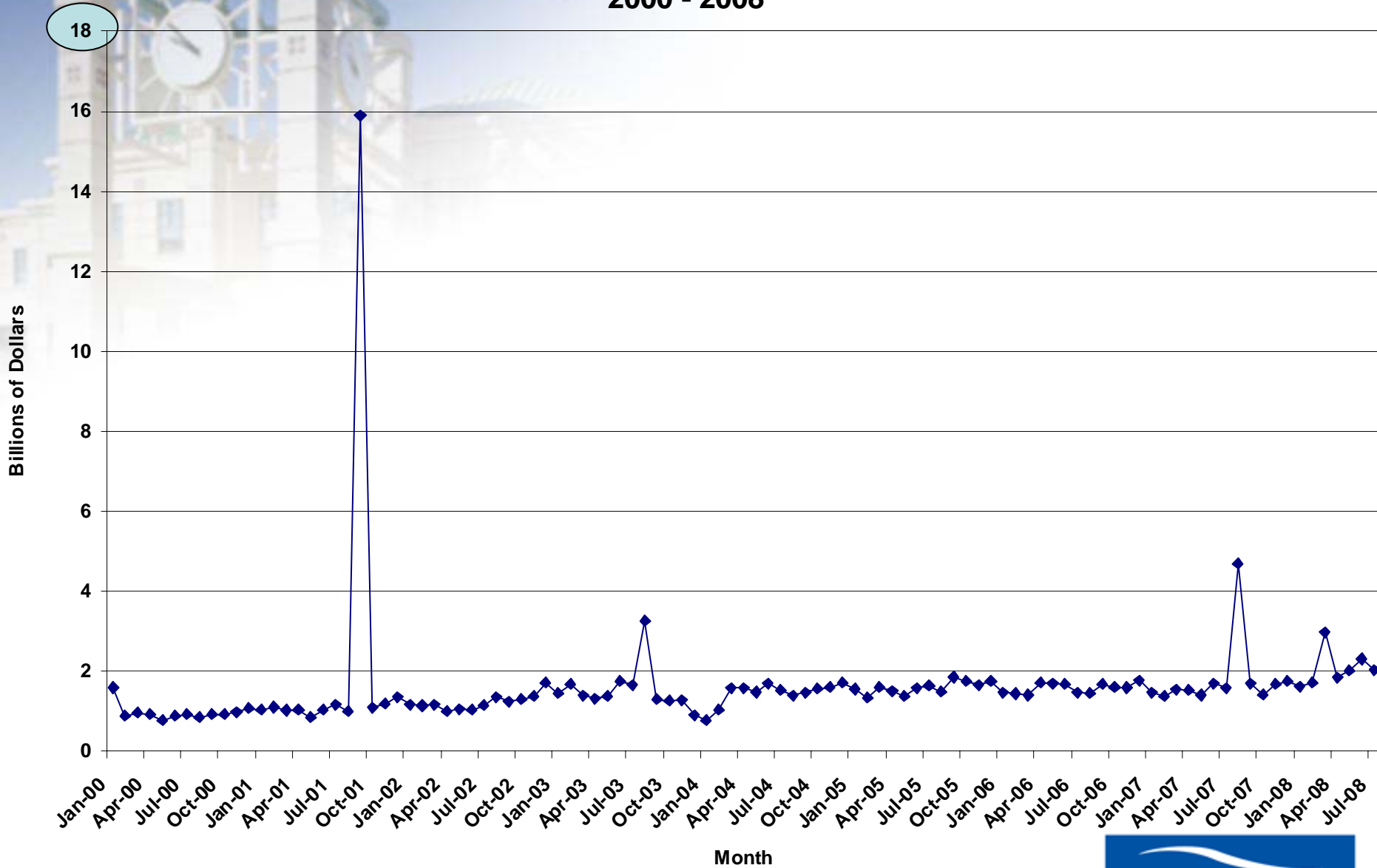
Excess Reserves at U.S. Banks (Loanable Funds Not Lent), 2008\$ 1970-1999



Source: Federal Reserve Board



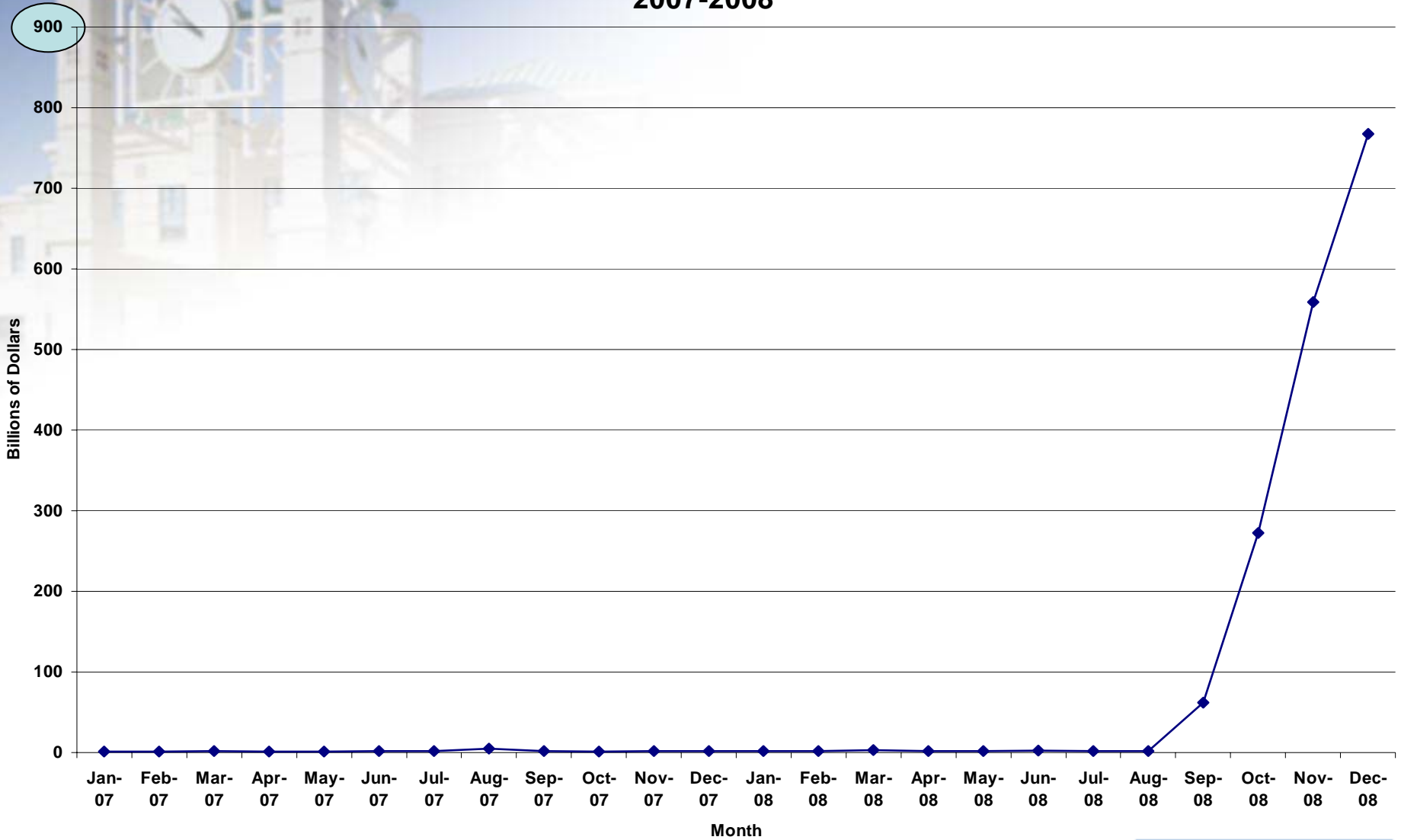
Excess Reserves at U.S. Banks (Loanable Funds Not Lent), 2008\$ 2000 - 2008



Source: Federal Reserve Board



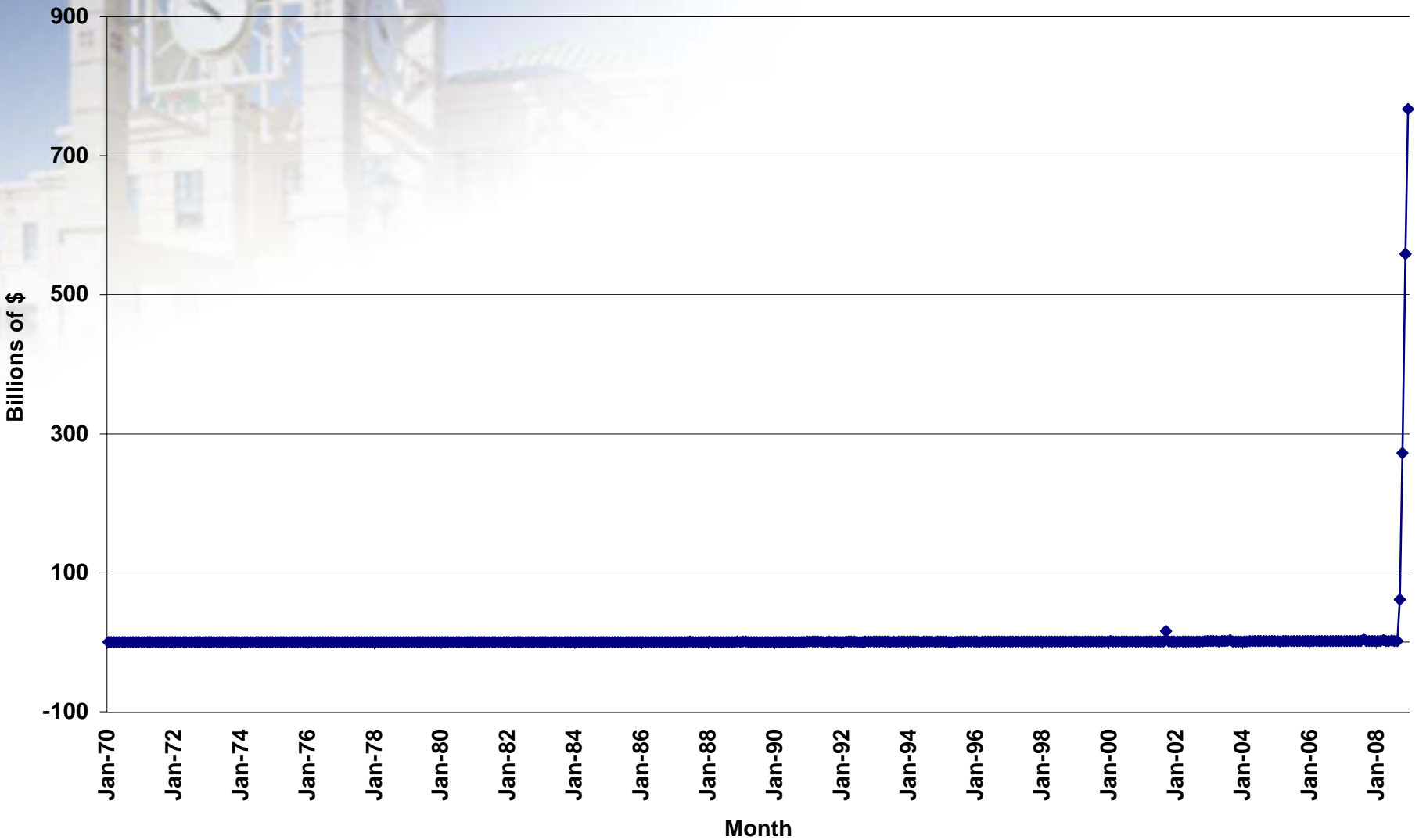
Excess Reserves at U.S. Banks (Loanable Funds Not Lent), 2008\$ 2007-2008



Source: Federal Reserve Board



Excess Reserves at U.S. Banks (Loanable Funds Not Lent), 2008\$ Jan 1970 - Nov 2008



Source: Federal Reserve Board

The Bailout Plan(s)

- Basically printing money to facilitate growth
 - Nothing more than repackaged monetary expansion
 - Includes automakers, school loans, State of California, etc.
- Inflation not an issue if circle remains unbroken
 - Assets slowly sold off as markets stabilize and rise
 - May be profits in the end(?!!)
 - Current gas price stability an anomaly
 - Deflation short-lived, if it technically happens
- More fiscal stimulus to come
 - By Feb 16, according to Obama

New Stimulus Possibilities

- Obama gave five sectoral targets (so far)
 - Energy
 - Education
 - Health Care
 - Social Insurance
 - Infrastructure

Possibilities (cont.)

- Need to consider supply-side versus demand-side as focus
 - Would providing tax breaks or subsidies for firms innovating energy products provide supply-side stimulus?
 - What about defense spending if trained personnel go back into labor force versus war veterans?
- High “social value” projects the key here
 - Energy seems like best in short-term
 - All of these have relatively high social value

Long-Term Effects (regardless)

- A decade of fiscal stimulus has made national debt soar
 - Is a \$2 trillion deficit, and \$1 trillion + for years to come sustainable?
- Current “monetary” package is fueled by a combination of debt and money printing
- Permanent cuts have larger short-term effects than temporary
 - Temporary cuts or spending provide better long-term signal of discipline
- Consider two major issues:
 - Salability of government debt in U.S. and CA; and
 - Inflationary effects of new stimulus in two or three years

California as Microcosm

- 2002 saw use of fiscal surplus spent on **permanent** spending
 - Current deficit of > \$40 billion
 - Federal spending may help state economies
- Bet on capital gains from stock market and housing speculation (began in 2002)
- **140,000 households provide 50% of income tax revenue for California**
 - Tax reform needed, tough politically

California's Fates

- Assume California will not go bankrupt
 - **Raise taxes (sales or cap gains): approx \$14.3 billion**
 - Prop 13 will not be repealed soon (though likely not a bad time to slowly phase it out)
 - Cap gains tax hike reduces capital gains seeking
 - Should not assume inelasticity for this revenue
 - **Cut spending: approx \$17.4 billion**
 - 2002 programs increased automatic spending
 - Now budget an effort to keep programs rather than find leaky faucets
 - **Borrow (or be bailed out): approx \$10 billion**
 - Most likely the first step, cannot be the only step
 - Will investors trust this debt?
 - **Reform is needed**
 - A consumer-led expansion may provide an ephemeral, illusory boost to state coffers

National and State Conclusions

- Policy close to providing all it can
 - Federal budget continues to grow
 - May be redirected and cut slightly in 2009-10 version
 - Monetary policy as aggressive as ever
 - Lowest cost of funds for banks in decades
 - Why are they not lending yet?
 - Consumer confidence continues to fall
 - This is the current driver (should not be), and is a fickle statistic
- State budget likely to affect services more than anything
 - Reform of some type needed
- Need a supply-side boost
 - This may come from a “New Deal” style of budget
 - More likely from environmental sciences and tech

A faded background image of a university clock tower with a large clock face, set against a clear blue sky. The tower is made of light-colored stone or concrete.

Quiz #1: Our First Navigation Checkpoint

Questions

1. How are we going to pay for \$2 trillion in new deficits?
2. Would a repeal of Prop 13 solve anything?
3. What problems might a repeal of Prop 13 cause?
4. Discuss two ways that local housing markets are affected national and international economics.

The Local Economy

- A broad mix of businesses and demography
 - Sonoma County considered the hub
 - Marin County mix of Sonoma and SF suburb
 - Napa County driven by wine and tourism
 - More is there, needs to be exploited
 - Lake and Mendocino tied to Sonoma economy in many ways
 - Is this the future growth area?
 - Solano County a mix much like Sonoma County
- Interdependence exists and should be considered in economic development

Local Economic Situation

- Short-term
 - Continued stagnation
 - Development efforts need to focus on two issues
 - Putting funding in hands of innovative businesses
 - Regional, not local or county, economic development
- Housing should be seen as follower, not driver
- Opportunities good for long-term development
 - Environmental Tech
 - Tourism and associated industries
 - Biotech/Health care
 - Wine and agriculture

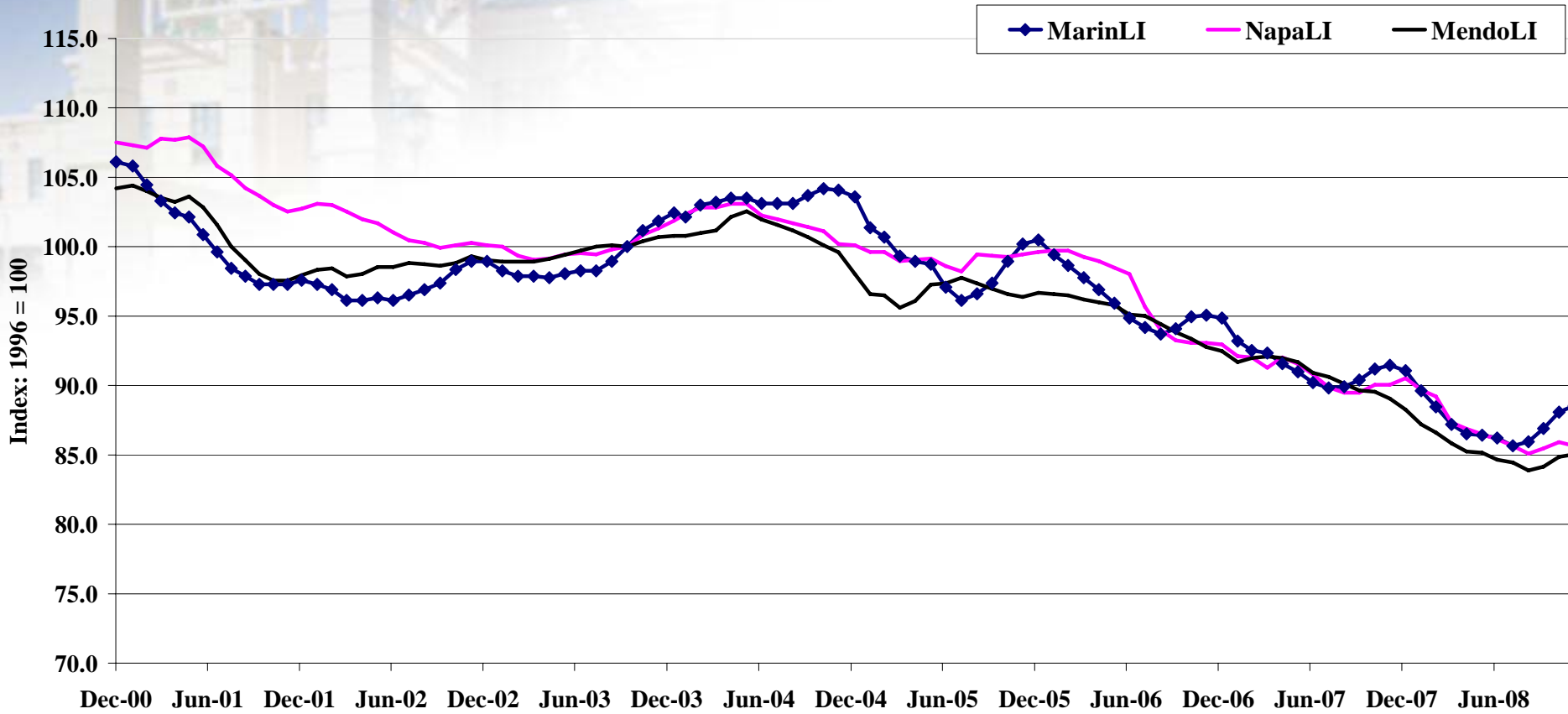
North Bay Indicators

- Leading and Coincident Indicator for Marin, Napa and Sonoma counties
 - Toby Tyler, SSU alum, provided initial methods
 - The leading tells us where we are
 - The coincident tells us where we are going
 - The combination suggests a cyclic shape
- The indicators show recession has been here for some time

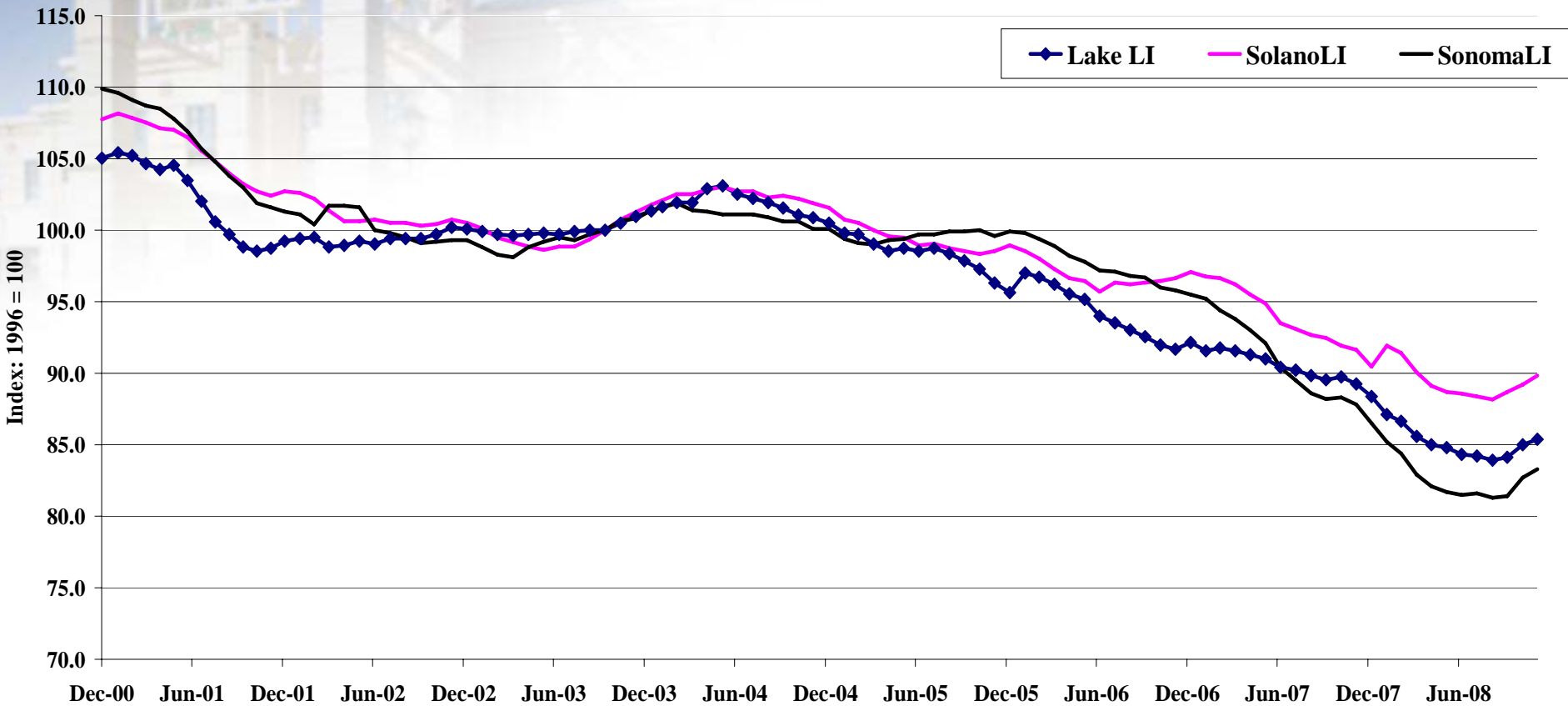
Leading Indicators

- Tyler Leading Indicators tell us where we are headed:
 - Default Notices (**Inverse**)
 - Building Permits (**Positive**)
 - New UI Claims (**Inverse**)
 - US Leading Index (**Positive**)
 - Help-Wanted Ads (**Positive**)
 - Ag Price Index (**Positive**)****
- As indicator increases, economy forecasted to move in **bolded** direction.

Tyler Leading Indicators: Marin, Napa, and Mendocino Counties



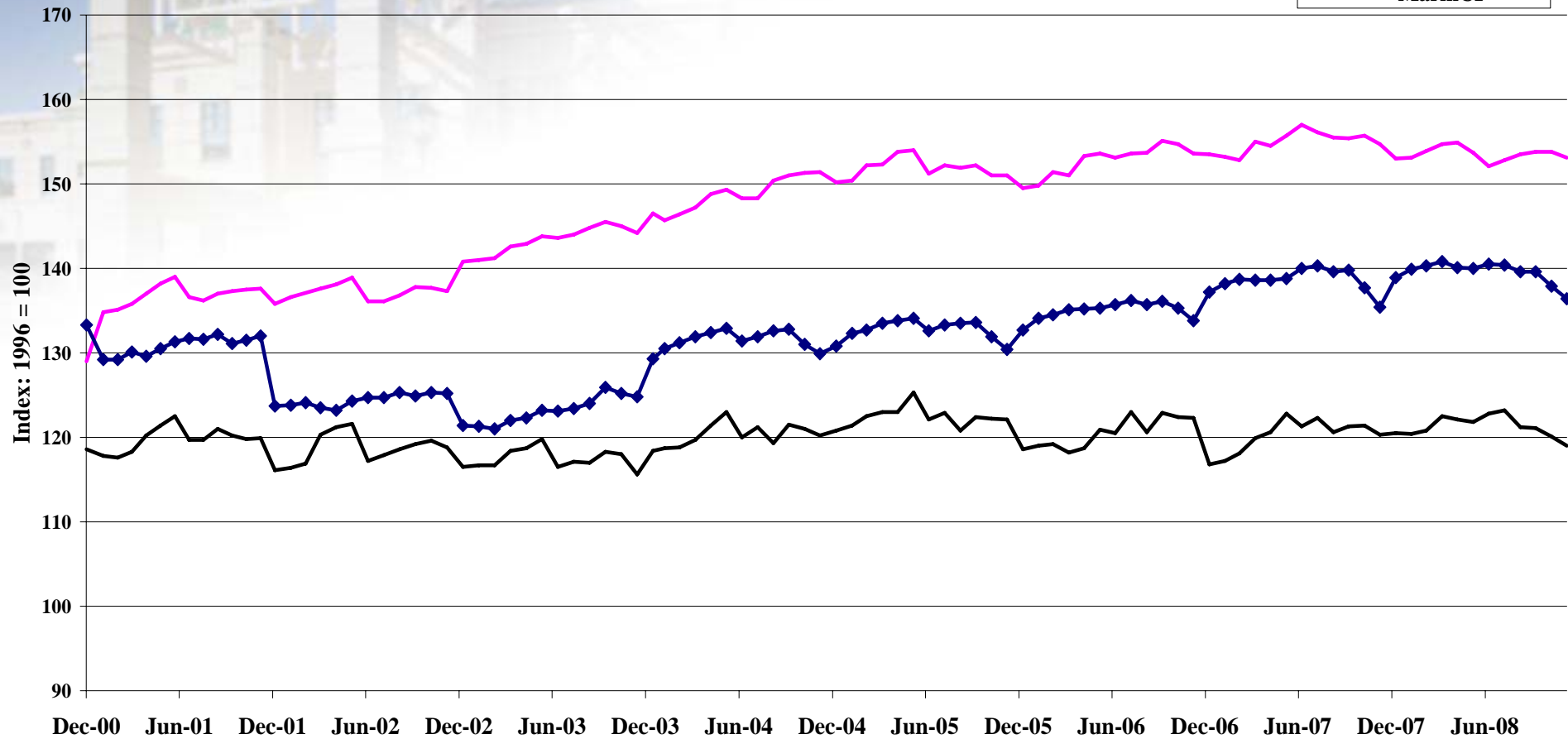
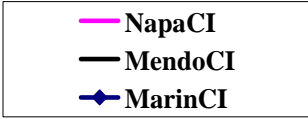
Tyler Leading Indicators: Lake, Solano and Sonoma Counties



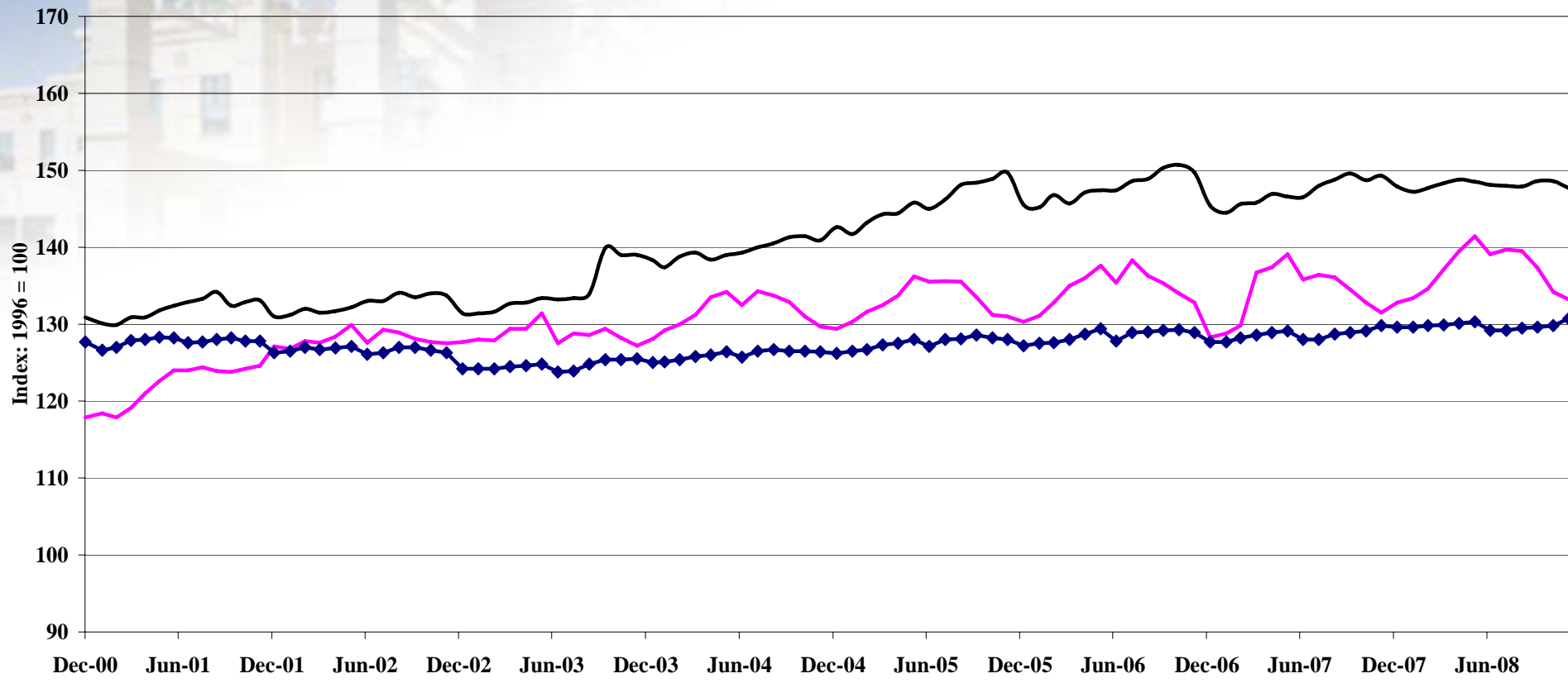
Coincident Indicators

- Tyler Coincident Indicators tell us where we are:
 - Non-agricultural employment
 - Retail Sales
 - Personal Income
- Once business and consumers receive positive signals, they hire and spend more as a reaction.
- The leading indicator drives the coincident.
 - Leading a mix of business activities, hiring and firing
 - Coincident a mix of employer and residential spending

Tyler Coincident Indicators: Marin, Mendocino, and Napa Counties



Tyler Coincident Indicators: Lake, Solano, and Sonoma Counties



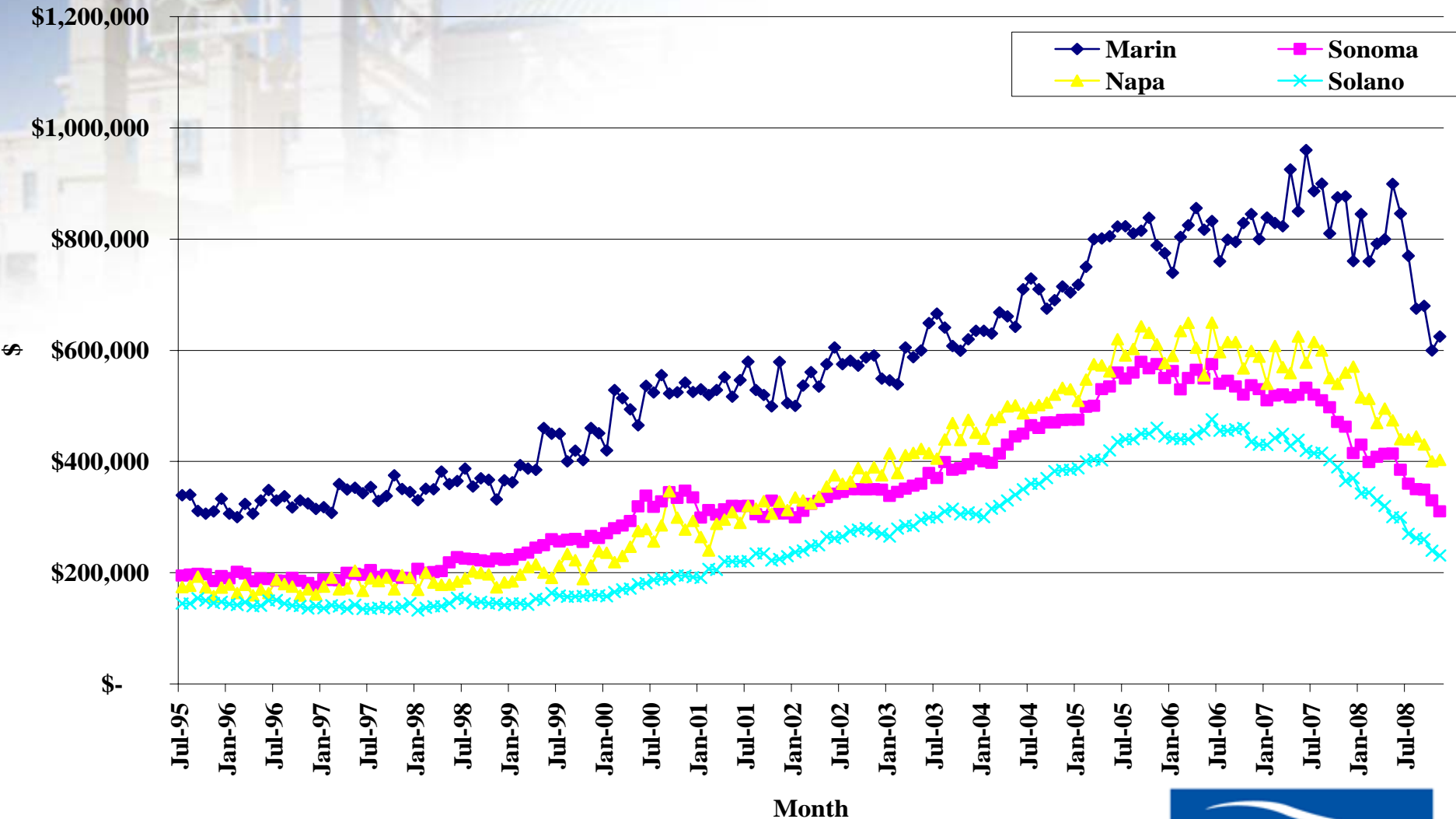
Local Housing

- The local housing market difficult to gauge concerning transition
 - As of Nov. 2008, Sonoma County down approx. 33% from Nov. 2007 in median home price (\$462,500 to \$310,000 at the median).
 - Down 46% from peak in Nov. 2005 (Marin down 32% from peak)
- Some regional perspective
 - Sonoma County (Sept. 2005, \$580K)
 - Stockton (Sept. 2005, \$385K, now \$130K)
 - SF (Nov. 2007, \$808K, now \$648K)
- The old model was driven by unemployment
 - Will it return (did it ever go away)?

Residential Real Estate

- Unemployment puts both supply and demand pressures on market
 - Supply: as unemployment rises, number of units rise
 - Avoided this in early 2000s due to wealth in both equity and housing
 - Which is the current driver?
 - Demand: as unemployment rises, fear over lost jobs reduces demand
 - Pricing should support this partially: will it?
- Interdependence: 96.6% correlation between Sonoma and Marin median home price
- Two big questions market has yet to answer
 - Was the old pricing correct?
 - Is the current pricing correct?

Comparison of Marin, Napa and Sonoma Median Home Price, 1995 - Present



Source: California Assoc. of Realtors and RAND Corp.



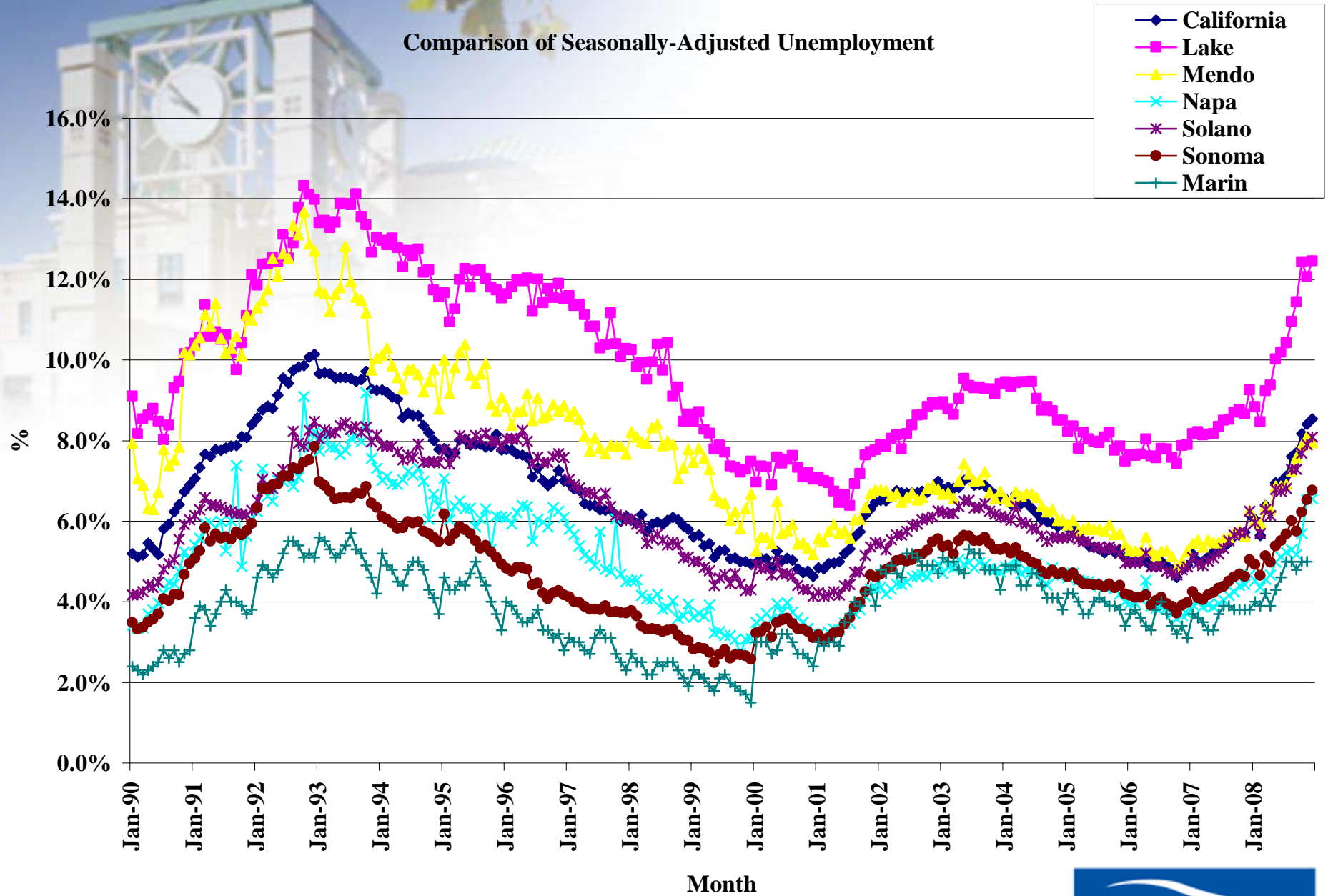
Commercial Real Estate

- Business outlook may look poor, but
 - Biotech still on the rise
 - Local manufacturing remains strong
 - Wine industry may expand
- Construction is likely to be project-specific rather than anticipatory
 - Financial stimulus may force some decisions to be made
- All the while, rents are falling

The Long Term

- Foundations
 - Is demand stable?
 - What are the supply conditions?
- Those that remain in their homes will reap long-term gains.
 - Aging demography an issue here also
 - Lake and Mendocino Counties likely to be longer-term growth areas(?)
- Supply and Demand for commercial space
 - Demand should remain, worse case as a movement from Bay Area otherwise.
 - Supply naturally to contract, especially as a reaction to recession
- Financial literacy a big deal going forward in residential real estate

Comparison of Seasonally-Adjusted Unemployment



Source: CA EDD



Economic Development

- In recession, good time to consider next boom in economic development offices
- Tourism
 - Casino growth still happening?
- Biotech already here and growing again
- Health Care connected to biotech slightly
 - Demography a bigger issue
- Environmental (Green) Tech likely a growth area in the future
 - Can companies like ZAP take advantage of this?

Tourism

- Lower \$ value helps stimulate tourism
 - Can long-term market be seized?
- California tourism provided natural flows
 - Can we rely on just this element?
- Wineries help for long-term flows
 - Have built a tourism arm that works
 - Natural link to restaurants and other hospitality industries here
- Internal and external demand here

Biotech and Health Care

- Biotech
 - Growing locally, like small version of late 1990s
- Health Care
 - Demography provides a long-term market
- Commercial vacancy rates relatively high
 - Slowly filling back up
 - Likely to target entrepreneurial firms in this space

Environmental Tech

- Local economy has a large community of high-tech engineers
 - And manufacturing firms based on innovations from those engineers
 - Need partnerships: private and public
 - Waste management tech
 - Solar panels
 - Hydrogen cars
- Can these firms begin and stay here?

Opportunities

- Why should appraisers care about economic development locally?
- Continued Export Expansion
- In-source jobs
- Stock markets are currently a historic bargain
- Need to consider “correct” growth
 - Living wage referenda coming: G,B&U
 - Where will workers live?
 - Transportation issues

Conclusions

- Navigating through recession depends on how you see the aftermath
 - 2nd half of 2009 better than first, 2010 some growth likely
 - Real estate markets likely to continue slow movements
 - Depends on banking somewhat
- Consumption and savings must walk together over time
 - Not equally, but you must save
 - Federal stimulus must stimulate supply-side (savings in a sense)
- North Bay will come out of this ok
 - We need to feel a supply-side, not demand-side jolt
- Economic Development
 - Think regionally
 - Public and private partnerships

Quiz #2

1. Should a secondary market for mortgages still exist?
2. Explain two ways recession may be triggered by housing market downturns?
3. How does local economic development affect housing markets? Provide two effects.



www.sonoma.edu/org/crea/reaa09.ppt