The National Economy

And the band played on...

The political theater that is playing out in Washington D.C. has been dominating headlines across the globe and creating political uncertainty here at home. To call the situation a crisis may be premature at this stage—but the potential is very real. The question is what, if anything, does it all mean for the health of the broader U.S. economy?

The answer so far seems to be 'very little'. In fact, the economy is clearly gathering momentum despite the kabuki dance going on at the highest reaches of power. The most recent read on industrial production, for example, was over 2% higher in April than one year earlier—when production was declining. Similarly, the Institute for Supply Management (ISM) Purchasing Manager diffusion indexes are back to levels not seen since 2015, prior to last year's economic slowdown.

The better numbers in 2017 stem from the fading of the global commodity glut, a problem that began with the sharp downward movement of commodity prices in 2015. Falling prices hurt many commodity producing economies—from Saudi Arabia to Brazil to Texas to California’s Central Valley. This in turn caused a sharp pullback in investment in commodity producing industries. The international scope of the problem created another negative shock to the U.S. economy by way of falling exports.

But boom-bust cycles are common in commodity markets, and overall, this swing was relatively modest. It certainly never had the capacity to end the current U.S. economic expansion, and as noted, it has already started to fade. Oil prices have stabilized at around $50 per barrel, and pumping and drilling activities are rising to a lower (but more sustainable) pace of activity. The global economy is growing again and, domestically, business investment and exports are once more contributing to economic growth, in fact, accounting for the bulk of growth in an otherwise weak first quarter. This improvement will surely help buoy the economy for the balance of the year.

The U.S. economy has been pushed through the bust by steady growth in the consumer spending sector, which has contributed close to 2% to GDP growth throughout the year. There was a sharp slowing in consumer spending in the first quarter—but this has been a recurring part of the seasonal patterns for the last few years. The slowing was mainly driven by a rise in the savings rate, which followed a sharp drop in savings in the 4th quarter of last year—a big Christmas followed by a bigger Christmas hangover.
Spending picked up in the second quarter of 2017, and will likely remain solid through the rest of the year. After all, labor markets are the tightest they have been in over a decade, which in turn is putting upward pressure on wages. Add to this the fact that interest rates remain low and the debt burden on U.S. households is close to a record low level as measured by payments.

In short, the U.S. economy is lining up for yet another 2% to 2.3% growth year—not great in terms of speed, but then again, there is little sign of an end to the expansion in sight. This appears to be at odds with a growing concern in some circles that the current expansion is getting long in the tooth. In July, the U.S. economy entered its 9th year of an economic expansion that started in 2009—not a record yet length-wise, but getting close.

But economic expansions do not have life cycles. Rather they are permanent until cruelly murdered by some negative shock to the system. Predicting a recession is a function of foreseeing that shock. At this point, there are some pressure points in the economy—but nothing in its current form could cause an economic downturn.

Still, those pressure points are something to keep an eye on. A major area to watch is the Federal Reserve and the banking system. After the 2016 election, the Federal Reserve sharply changed their policy plans and began to raise the Federal Funds rate. The Fed has stated that full labor markets are the primary reason for the change. But that explanation never held water. Historically, within a low inflation rate regime, unemployment has little impact on price levels.

Beacon Economics has speculated that the Fed has been wary of the emergence of yet another financial bubble, this time driven by Wall Street deregulation, tax cuts, and the repatriation of billions in overseas retained earnings into an asset market that is already at a reasonable price level. If this speculation is accurate, then the Fed has been caught off guard by the inability of the current presidential administration to push forward its agenda even as the small spurt of inflation seen at the start of this year peters out. The rate increases are now being hit on the other end, by rising bond prices, flattening the yield curve sharply and putting a damper on bank lending. The Federal Reserve is now...
between an inflation rock, wanting inflation to pick up a little, and a political hard place—and it will be interesting to see how they respond in coming months.

Regardless, in the end, we still land back in the political chaos of Washington. If things continue to play out along their current trajectory, in many ways, the economy will look not unlike it did in the last few years of the Obama administration, except it is now political disorder rather than partisanship that is preventing any action. In some ways, this may be preferable to short run policy changes that could have profoundly negative impacts on the economy. And through the political turmoil, as has been the case for a long time, our nation continues to ignore the many pressing long run issues that need to be dealt with before they become truly dangerous crises.

The California Economy

California at Cruise Speed

Like the U.S., California’s economy continued to roll forward in the first half of 2017. The unemployment rate edged down, nonfarm jobs maintained an upward trajectory and grew at a modest pace, and economic activity in the state advanced at a somewhat faster rate than the nation as a whole.

As of June, the state’s wage and salary (nonfarm) jobs grew by 1.6% year-over-year, corresponding to a year-over-year gain of, 261,400 jobs. Most of the state’s private industries added jobs in yearly terms in the first half of 2017. Health Care led the way in absolute terms with 51,400 jobs added as of June (year-over-year), followed by Construction (+46,500), and Leisure and Hospitality (+44,200). Consistent with recent trends, Manufacturing (-9,900) and Mining and Logging (-1,200) both lost jobs, but they were joined by Information (-1,500). By contrast, the Government sector registered a year-over-year increase of 34,400 jobs as of June.

Although the California economy has continued to grow, the pace of growth has slowed markedly in recent months: The 1.6% employment gain in June 2017 was less than half of the 3.3% rate achieved one year earlier. The slowdown was evident across all industries, too. Health Care grew by 2.4% year-to-year in June 2017 compared to a 3.8% gain in June 2016, while Professional Services slowed from 2.0% growth a year ago to 1.0% in June 2017, and Leisure and Hospitality saw a 2.3% increase this year, well behind the 3.6% gain of last year. In a significant reversal of trend, Information was down by 0.3% year-to-year in June after an impressive 7.6% yearly gain a year ago.

Keep in mind that California has seen impressive job gains over the last five years. From 2012 through 2016, statewide job gains averaged 2.7% growth per year. That is more than double the 25-year average of 1.1%, and was outpaced only in the late-1990s when the rate of growth hit 3.2%, also over a five-year stretch. Moreover, the slowdown is not exclusive to California. In fact, U.S. job growth slowed from 1.7% annually in April 2016 to 1.6% in April of this year. So, while job growth in California has decelerated, the state is still adding jobs at an above-average rate.
Limits To Growth

So, what accounts for the broad-based slowdown in job creation in recent months and can (or should) anything be done about it? A few things come to mind.

**Labor market constraints:** With the state's unemployment rate hitting a 16-year low of 4.7% in June and labor force participation stabilizing at just over 62% for now, which changing demographics have made the new norm, the labor market is effectively at full employment. However, data on job openings at the national level suggests that a large number of positions are going unfilled, presumably because of a lack of qualified job applicants. While comparable data for California are not readily available, the national trend very likely applies to California and is one possible limit to job growth in the state.

**Housing affordability:** Housing affordability concerns are ever-present in California and become more problematic when the economy is expanding. While not at an all-time low, housing affordability has edged down in recent years as home prices have risen. And homeownership, which slid from nearly 60% prior to the Great Recession to 53% in the second quarter of 2016, finally reversed direction and climbed to 55% in early 2017. Stress in the owner-occupied market has spilled into the rental market, contributing to low vacancy rates and upward pressure on rents across much of the state. Affordability problems hit low and middle income households hardest, and as a result, these households have left the state in larger numbers than those with higher incomes. Arguably, housing affordability challenges are a second limit to job growth in the state, and likely exacerbate the job mismatch problem mentioned earlier.

**Uncertain outlook:** While the notion that uncertainty can lead to inaction makes sense, it is not so easy to find hard evidence to confirm such a connection. Still, it stands to reason that firms must make plans regarding future sales, capital expenditures, and hiring, but will sit on their hands, or at best tread slowly, if their outlook for the future is cloudy for any reason. Federal policies regarding trade, immigration, health care, and taxes are akin to the “rules of the road” for businesses and employers. Given that those rules may change under the current Administration in Washington, there is every incentive to wait and see what will transpire. To the extent that this includes hiring decisions, we have yet a third limit to job growth.

**Conclusion: Overcoming Limits To Growth**

But there are ways to ease these limits to growth. For one, California relies on immigrants as a key component of its labor force, like the U.S. as a whole. If the current presidential administration could come up with an immigration policy that acknowledges the essential role of immigrants in the U.S. economy, labor force constraints in California would be eased and the state could add to its workforce.

For another, addressing the problem of housing affordability can slow state-to-state outmigration. At the state and local level, that means increasing supply by taking steps to enable more home construction, especially that which aligns with the state’s housing needs. In fact, demand-side efforts to make homeownership more affordable (loan programs, interest rate subsidies, and the like) won’t ease the housing affordability problem if our communities and cities do not build more units. As for the clouds of uncertainty that surround the current politico-economic environment, California, its communities, employers, and residents must make their way forward cautiously and hope that the clouds will clear in the coming months and years.

To be sure, Beacon Economics is NOT anticipating a recession in the near future. Rather, the state labor market has hit cruise speed and is adding jobs at a steady, if slower, pace than it experienced during the acceleration phase of the last few years. And despite the slowdown in job growth, many signs point to continued growth in the overall economy. California will continue to outpace the nation as a whole. Wages will rise over the foreseeable future, driving household spending. Most of the key sectors of the state economy will continue to add jobs, albeit at a slower pace. And single-family home construction has accelerated in the last two quarters. If sustained, it will not only lead to more construction employment, but also unleash additional spending on household items such as white goods and furnishings.
The East Bay Economy

The East Bay economy has exhibited signs of a slowdown in the most recent data, much like the rest of the Bay Area and the state overall, but the region is by no means facing a decline in economic activity. This slowdown is being driven by fundamental market forces: supply and demand. Specifically, the region is being affected by a labor shortage.

The slowdown can most readily be seen in the region’s labor market statistics, and the supply of, and demand for, labor are prime factors. As of June, total nonfarm employment in the East Bay stood at 1,152,500 on a seasonally adjusted basis, a 2.0% increase over the same period a year earlier. This is down from the 2.2% rate of job creation for the first half of 2017, and from 3.3% growth in 2016.

The slowdown in the East Bay has been milder than in other Bay Area metropolitan areas. San Francisco nonfarm job growth in June was 2.2% year over year, down from 4.1% growth in 2016, and San Jose job growth slowed to 1.7% in June from 3.1% in 2016.

In the midst of this slowdown in job growth, it is critical to consider supply and demand. First is the demand. Most business indicators at the national, state and local level do not show a decline in business activity that would cause a decline in the demand for labor. U.S. gross domestic product growth is trending at its post-recession average, industrial production is reversing from declines stemming from the collapse in oil prices that plagued the energy sector, and stock markets continue to reach record highs.

If the demand for labor has not weakened, the slowdown in employment growth can be attributed to a slowdown in the growth of the labor supply, and the Labor Force statistics from the California Employment Development Department support this. During the first half of 2017 the labor force in the East Bay grew 0.3%, whereas the number of employed East Bay residents increased 0.8%. A similar imbalance can be seen in 2016, when the labor force grew 1.7% and employed residents increased 2.3%. In fact, the growth in the number of employed residents has been higher than the growth in the labor force every year since 2011.

Simply put, the pace of job creation cannot continue to increase if the supply of labor, the labor force, is growing at a slower rate. It is only a matter of time before the slack in the labor market (the number of unemployed and those who dropped out of the labor force) left over from the Great Recession is depleted. Future job growth will be bound by the growth in the supply of labor. The primary constraint to labor force growth in the East Bay, discussed in more detail below, is the lack of housing in the East Bay, and throughout the Bay Area.
It’s true that other factors have also contributed to the slowdown in job growth, including job losses in particular industries. However these are transient factors as opposed to a decline in economic activity. In June 2017, Retail industry employment in the East Bay declined 1.8%, but this was part of a larger trend across the nation as brick-and-mortar establishments continued to lose market share to online retailers.

The Administrative Support industry was also a drag on overall employment growth in the first half of this year. Payroll employment in this sector declined 1.7% over the first half of 2016, but the losses here were concentrated in the Employment Services subsector, which is associated primarily with temp agencies. With a tight labor market in an expanding economy, temporary workers are in less demand as offers for full-time work take precedence.

Outside these two sectors, nonfarm employment grew 2.5% year over year in June, noticeably higher than the 2.0% headline growth number. The industries that have been fueling the job gains point to the strength of the local economy despite the slowdown. Payroll employment in the Professional, Scientific and Technical Services industry, much of which comes from the growing Tech industry in the East Bay, increased by 4,207, or 4.4%, year over year in June. The gains in this sector come amid a steady flow of venture capital funding. In the first two quarters of 2017, $1.02 billion in venture capital funding went to companies headquartered in the East Bay, according to research data company Pitchbook. This was down slightly from the $1.05 billion in the first half of 2016 but still represents strong investor confidence in East Bay companies.

The Construction industry and the Education and Health industries also made solid contributions to payroll job growth over the period, 4,871 and 5,122 respectively, as well as the public sector, which added 4,686 jobs to Government payrolls.

One of the effects of lower employment growth is a slowdown in the growth of consumer spending in the East Bay. In the first quarter of 2017 taxable sales in the region grew 3.8% over the first quarter of 2016, down from 4.7% growth in 2016. This matches the deceleration in statewide taxable sales over the same period, from 3.9% in 2016 to 2.7% in the first quarter of 2017. On the plus side, growth in wages picked up after a flat year in 2016, which will help support spending growth in the near term. In the first half of 2017, average weekly earnings increased 3.4% year over year, a marked improvement over the 0.1% decline in 2016.

Similar to the labor market dynamics, spending growth in the East Bay has fared better than to the west and south. Taxable sales in San Francisco grew 1.9% from the first quarter of 2016 to the first quarter of 2017, down from 2.9% growth in 2016. Mostly due to a strong first quarter of 2016, San Jose taxable sales actually declined 0.7% year over year in the first quarter, down from 2.8% growth in 2016.

One of the primary causes of the slowdown in the supply of labor is the lack of housing in the region, and the affordability of the current housing stock. If there are not enough homes to house new workers, the local labor force simply cannot grow enough to sustain the job growth of the last few years. This forces many people to endure long commutes to the growing job centers throughout the Bay Area. Even with commuters, labor force growth will be constrained without significant investment in transportation infrastructure.
The constrained housing supply has maintained steady upward pressure on home prices in the East Bay, making the region increasingly unaffordable to lower- and even some middle-income households. As of the first quarter of 2017 the median price of an existing home in the East Bay was $667,615 on a seasonally adjusted basis, a 10.3% increase over the same time a year earlier. This was on par with price growth in the San Francisco (11.4%) and San Jose (9.2%) metropolitan areas. This was an acceleration over 2016 price growth, which was in the single digits for all three major Bay Area metropolitan areas. The East Bay does, however, retain a significant affordability advantage relative to San Francisco and San Jose, where the median prices of existing homes in the first quarter were $1,211,288 and $974,936 respectively.

There does not appear to be much improvement in the region’s housing supply. Permitting for residential units was lower to start the year, and the inventory of homes for sale is virtually unchanged from last year. In the first quarter of 2017 there were 2,164 residential units permitted in the East Bay, an 18.4% decrease over the first quarter of 2016. Most of the decline is due to a 22.7% drop in permitting for single-family units. Fewer single-family permits is not in itself an issue, particularly if it signals a transition to multi-family housing, but permits for those structures were also lower to start the year.

One positive data point in the first quarter was an uptick in sales of existing homes, but strong demand quickly absorbed these homes coming onto the market as the number of homes on the market remained little changed. In the first quarter of 2017 there were 6,598 resales on a seasonally adjusted basis, a 3.1% increase over the same quarter in 2016. This was an improvement over the 2.2% decline in all of 2016, but market inventories remained virtually unchanged at 2.1 months’ supply in Alameda County and 2.4 months’ supply in Contra Costa County, both well below historical averages.

Faced with a housing situation that can no longer be ignored, the Technology industry, one of the main growth engines throughout the Bay Area, has emerged as a leader in the push for more affordable housing. Silicon Valley executives have recently provided financial backing for a new political and housing advocacy venture in Sacramento called California YIMBY (Yes In My Backyard). The advocacy group is pushing for more housing, affordable or not, to increase the overall housing supply, which ultimately would help keep price growth in check.¹

Google, taking a more direct approach to finding affordable housing for its workforce, has ordered 300 pre-fabricated homes from Factory_OS, a startup. Efficiency gains in the manufacturing of these homes cuts construction time at least 40%, and the units can be used for multifamily housing that’s estimated to be 20% cheaper than traditional construction.²

A housing project in El Cerrito is another prime example of the kind of development needed to alleviate housing and traffic concerns that come with urban population growth. On July 12, the City Planning Commission approved the Mayfair Project, a 223-unit multifamily-housing development near the El Cerrito Del Norte BART station. The project not only brings more high-density housing to the area but also places residents next door to mass-transit options, which helps alleviate traffic congestion.³

Although none of these efforts come close to fixing the Bay Area’s housing woes, they are the kinds of developments the region needs to push for to make any kind of progress. Ultimately, the economic growth potential for the East Bay, and the broader Bay Area, is tied to the housing supply. Without more housing, the labor force cannot grow at a rate fast enough to meet the labor demands of local businesses, thereby hampering their growth and overall economic output.

**Forecast**

Beacon Economics’ forecast represents an optimistic outlook throughout the remainder of 2017 and assumes that the U.S. economy will grow at a moderate pace, much as it has in recent years. Because of uncertainty surrounding President Trump’s policies, there is an inherent uncertainty within this forecast. Beacon continues to closely monitor policies as they are announced. Depending on which policies are enacted, Beacon will adjust its economic outlook accordingly.

More locally, the East Bay economy is trending in the right direction, and nothing on the immediate horizon signals a reversal of that trend. The regional labor market is in good health despite a general slowdown in job growth. The residential real estate market has been characterized by low inventory, which has kept upward pressure on prices and restricted sales, but Beacon expects inventories to return to historical norms over the next few years as new structures come online and owners are enticed by higher prices to put their homes up for sale.

Looking out over the course of 2017, total nonfarm employment is expected to grow roughly 1.7% over 2016 levels. This is down from the 3.2% growth in 2016 and reflects the general slowdown we have seen in nonfarm job growth during the first half of 2017. The unemployment rate is expected to edge down slightly and end the year just below 4%. As more East Bay residents find jobs, more residents are expected to return to the labor force amid rising wages, which will result in the unemployment rate staying largely unchanged.

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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.

Services

- Economic and revenue forecasting
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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.

www.eastbayeda.org