CALIFORNIA ECONOMIC OUTLOOK

June 2018

Bank of the West Economics

Executive Summary

- Annual job growth was 2.1% in California in 2017, positive for the seventh year in a row but the slowest pace since 2011. Job growth is forecast to decelerate to 1.8% in 2018 and 1.2% in 2019 as the economy overshoots full-employment and rising living costs and tighter financial conditions slow California's job growth engine.
- California's unemployment rate hit an all-time low of 4.2% in April. The rate is projected to hold at an average of 4.2% this year, but begin to rise in 2019 and 2020.
- The Bay Area had the tightest labor market with a 3.4% unemployment rate last year, followed by Southern California at (4.5%). Unemployment rates in the Central Coast (5.4%) and the Central Valley (6.6%) remain relatively higher, but have come down sharply over the past twelve months.
- The Federal Tax Cut and Jobs Act (TCJA) is expected to shave over $33 billion from the tax liability of California residents, providing at least a temporary boost to consumer and business spending. This is equal to approximately 1.6% of California after-tax income.
- However, there are provisions unfavorable to California under the TCJA, such as the state and local tax deductions being capped at $10,000 and the maximum mortgage balance on which taxpayers can deduct mortgage interest is limited to $750,000. Therefore, the boost to California after-tax incomes will prove smaller than other low tax states like Texas and the nation as a whole. These unfavorable provisions of the TCJA could also weigh on the California housing market over time.
- Even so, California home prices are expected to rise a sturdy 8.5% in 2018, but will moderate from that robust pace over the next two years.
- Bay Area home prices rose by over 12% last year and are forecast to increase by a similar pace this year (+10.9%). Beyond 2018, however, slowing job growth, eroding affordability, rising mortgage rates, and the lagged impact of tax reform will cause a noticeable slowdown in home price growth.
- Out-migration in California is expected to be more pronounced in the years ahead and will weigh on California's economic growth rate. Out-migration is expected to be most visible in the Southern California region. Net-migration is projected to turn modestly negative in the Bay Area, Central Coast, and Central Valley regions too, but will be less of a drag on economic growth in those regions.

California Fully Employed

California's job creation continues to outperform the nation, but job growth has slowed as more metro areas exceed full-employment. In April, California nonfarm payrolls were up 2.1% year-over-year compared to 1.6% nationwide. Job gains in California over the past twelve months have grown in all but one sector, led by construction (7.4%), education & health services (3.2%) and information (3.2%). The other services category, which includes dry cleaning, and equipment & machinery repair jobs, was the only major sector to contract over the year (-0.1%).

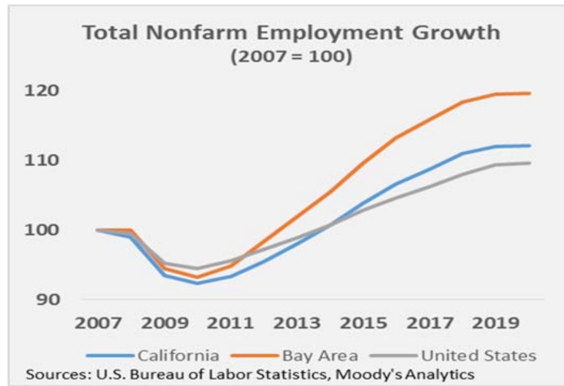
Construction and Health Care Lead the Way

On an annual basis, job growth in California was positive for the seventh straight year in 2017. The growth rate of 2.1% last year, while still robust for the late stage of the economic expansion was the slowest pace since 2011. Job growth is projected to decelerate to 1.8% in 2018 and then slip to 1.2% in 2019. Sectors with the sharpest deceleration in growth in 2019 are projected to be construction, manufacturing, education & health services and leisure & hospitality. California nonfarm payrolls hit a new record high of 17.098 million in April 2018.

California's unemployment rate fell to an all-time low of 4.2% in March, slightly above the U.S. rate of 3.9% but down sharply from 5.0% in April 2017. The unemployment rate is expected to remain at 4.2% on average this year, before rising over the next two years as job growth slows.

Total nonfarm job growth in the **Bay Area** was up 2.4% year-over-year in April, well above the national average. The Bay Area has consistently outperformed the state and nation in job growth throughout the expansion.

Bay Area Job Growth Decelerating

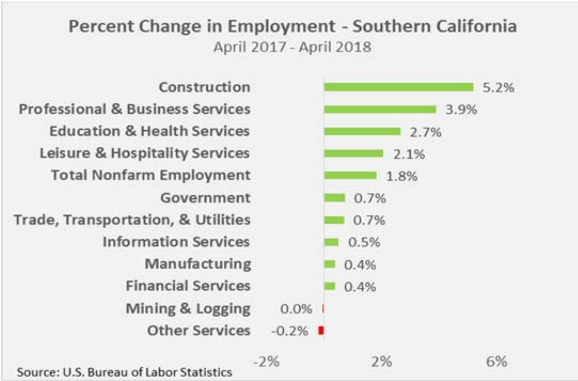


The Bay Area's late-cycle expansion is expected to continue, but will most likely feature slower job growth and steady income gains. Bay Area job growth is expected to average 2.0% in 2018 and just 1.1% in 2019. Sectors expected to contribute the most to the slowdown next year include information, professional & business services, manufacturing and financial activities.

However, there is some upside risk to the forecast. Genentech has floated plans to double its workforce, which could mean more than 10,000 new high-quality jobs for the region. Similarly, Gilead Sciences is getting a $28 billion cash infusion from the Tax Cut and Jobs Act that could result in additional hiring.

Total nonfarm job growth in **Southern California** increased 1.8% in April from the same time last year. This is below the state but above the national average. The fastest growing sectors were construction (5.2%), professional & business services (3.9%) and education & health services (2.7%).

Construction Fuels Jobs Gains in Southern CA



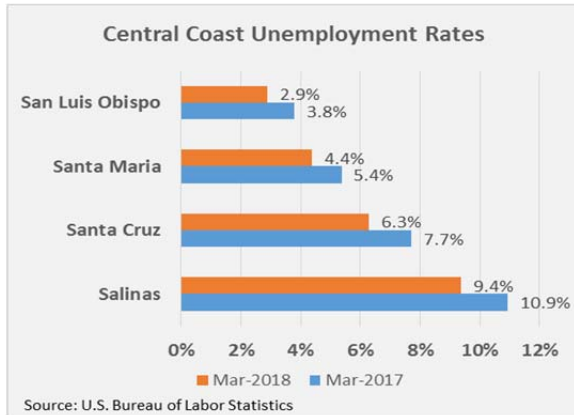
Job growth of 1.6% is expected this year in Southern California, down from 1.9% last year, and will then decelerate sharply to just 0.9% in 2019. Sectors forecast to slow the most next year include leisure & hospitality, construction and health services.

The unemployment rate is forecast to decline to a post-recession low of 4.2% in 2018, and then rise to 4.5% in 2019 as Southern California job growth slows markedly.

There is some additional downside risk to the Southern California forecast in the event of a widespread trade war. The Los Angeles Metro Division – which includes Los Angeles, Glendale and Long Beach – accounts for 3% of total U.S. employment but 12% of U.S. imports. A trade war with additional tariffs would hurt the region disproportionately as it ranks in the top half of all metro areas in export share of the local economy. Moreover, the metro area has a relatively small manufacturing base, so it would not benefit as much as some areas from protectionist measures by the Trump Administration.

Annual total nonfarm job growth in the **Central Coast** was a robust 2.3% in April from a year ago, supported by a gain of 3.6% in Salinas. Job growth continues to outpace that of the state and the nation. The fastest growing sectors were construction (+7.0%), other services (+4.5%) and government (+4.1%). The MSA with the lowest unemployment rate in the region was San Luis Obispo (2.9%), while Salinas had the highest at 9.4%. All four major MSAs in the Central Coast region had a lower unemployment rate relative to this time last year.

San Luis Obispo Continues to Outperform

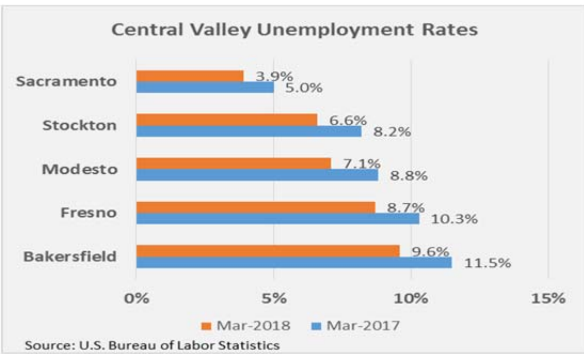


Job growth in the Central Coastal region of California is expected to accelerate from 1.7% to 2.0% in 2018, and then decelerate sharply to 1.3% in 2019. The sectors projected to contribute the most to the slowdown in job growth include construction, government and manufacturing. This will cause the unemployment rate, which is forecast to hit a post-recession low of 4.8% this year, to move up to average 5.2% in 2019.

Total nonfarm employment in the **Central Valley** rose a robust 2.4% in April compared to a year ago. This is on par with the Bay Area, and far exceeds the state and the U.S. growth rates over the same period. Sectors leading the way were mining & logging (oil production) (+5.5%), construction (+5.4%), trade, transportation & utilities (+3.5%) and education & health services (+3.0%). Clearly, rising oil prices and increased production is helping to support job growth in the region.

The only sector that lost jobs over the past twelve months was information (-3.3%). The Central Valley should maintain solid job growth this year of around 2.2%. Unemployment rates in the region continue to decline, but remain stubbornly high compared to other major metro areas around the state with the exception of the Sacramento MSA where the unemployment rate was a low 3.9% in March 2018.

Sacramento Labor Market Stands Apart



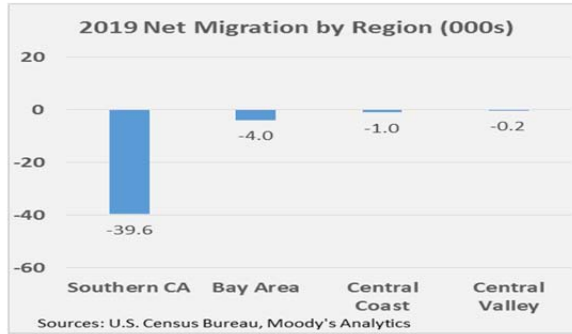
Job growth is projected to decelerate in 2019 to 1.2% and just 0.3% in 2020 in the Central Valley. The mining, construction, trade, transportation & utilities and manufacturing sectors are forecast to be the primary drivers of slower job growth in 2019.

The unemployment rate will rise along with slower job growth, reaching 7.0% in 2020 - 2.1 percentage points higher than the California rate. A sharp slowdown in net migration, partly due to higher home prices and tighter immigration laws, will weigh on the region's job growth.

Out-Migration Will Weigh on California

The high cost of living, particularly the cost of housing, congested roads and crowded schools will result in fewer people moving to California to take advantage of job opportunities over the forecast horizon. Out-migration is expected to be especially problematic in Southern California, with almost 30,000 more people leaving the region than moving in this year. This will be a demographic weight on economic growth in the region. Net migration is projected to remain modestly positive in the Bay Area and Central Valley regions this year, and remain flat in the Central Coast. By 2019, however, net migration will be negative across all regions.

Out-Migration Becomes an Economic Problem



How Federal Tax Reform Impacts California

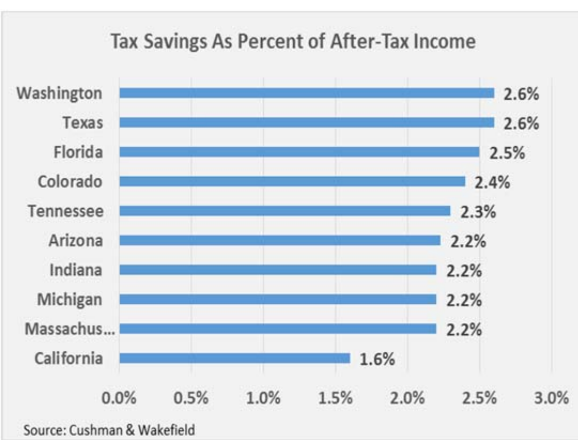
The Federal tax reform legislation passed in December 2017 (the Tax Cut and Jobs Act or "TCJA") was intended to lower Federal corporate and personal income taxes and broaden the tax base. In general, these Federal tax reform efforts should help bolster California economic activity, adding at least a temporary boost to consumer and business demand across the state. But more controversially, some provisions under the TCJA, such as state and local tax (SALT) deductions, and mortgage interest expenses were capped or limited. This will actually lead to higher Federal personal income taxes for some California taxpayers. It will also make California less competitive longer-term against other lower home value and lower tax states. This could aggravate chronic California economic problems from a high cost of living, domestic out-migration, and may even put downward pressure on home values in some areas.

In the TCJA, state and local income tax deductions were capped at $10,000; prior to the legislation these deductions were unlimited. In addition, the TCJA reduces the mortgage balance on which taxpayers can deduct interest from $1 million to $750,000 on new mortgages (existing mortgages are exempt).

Limiting the SALT deduction alone is projected to raise $650 billion in additional Federal tax revenue over 10 years, with over 95% paid by the top quintile of earners. In 2015, residents of California were responsible for about 20% of the total SALT deductions claimed. Therefore, the burden of these additional taxes will be greater in areas like California where personal incomes, property values and state and local tax rates are higher.

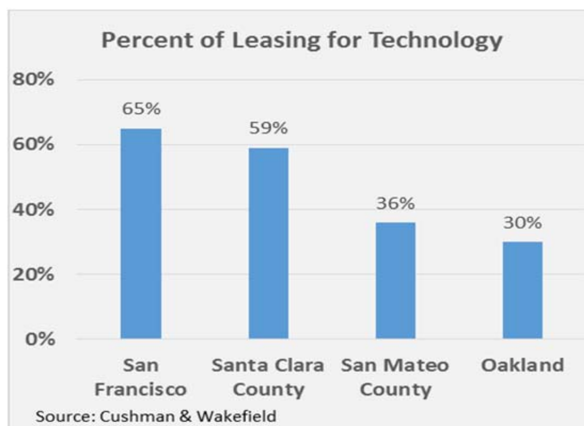
Taxpayers in all states should see their overall tax bill fall in 2019, but by different magnitudes. According to the Institute on Taxation and Economic Policy, the TCJA reduces the Federal tax liability of Californians more than residents of any other state: $33.3 billion. But given the huge size of the California economy and limits on SALT deductions, the decrease in taxes in California in 2019 is only equivalent to 1.6% of pre-tax income compared to 2.1% for all U.S. taxpayers. In contrast, Texas and Florida taxpayers, with no state income taxes and thus less impacted by SALT deductibility, will see their taxes fall by a far larger 2.6% and 2.5% of pre-tax income respectively.

Low Tax States See the Biggest Tax Reductions



Moreover, some regions of the state of California could benefit more than others from other provisions of the Federal tax reform bill. For example, the San Francisco metro area could benefit more than the state as a whole from the one-time repatriation of overseas profits. According to Cushman & Wakefield, of the approximate $2.6 trillion in corporate profits from U.S. companies parked in foreign bank accounts, technology companies Apple, Cisco and Google are responsible for a combined $372 billion. If these profits are repatriated, they could be used for new investment projects, salary and bonus increases, or returned to shareholders. All of these outcomes are potentially favorable for the continued expansion and vitality of the technology sector and, by extension, the Bay Area economy given the region's outsized exposure to the technology industry. The technology sector was responsible for 50% of overall office leases in 2017 in the Bay Area, with higher percentages in San Francisco and Silicon Valley.

Tech Companies Drive Leasing of Office Space

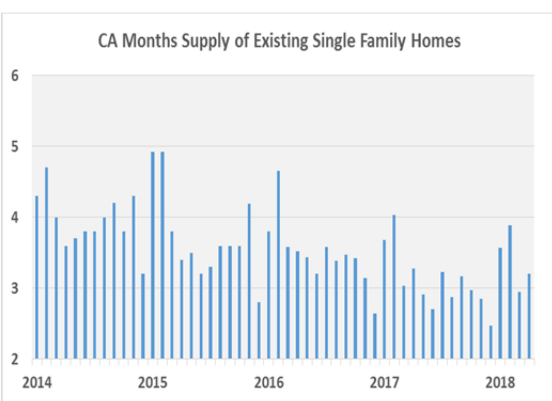


Housing Market is Still Solid – For Now

The **California** housing market kicked off the busy spring home-buying season with mixed results. According to the California Association of Realtors (C.A.R.), existing single-family home sales totaled 416,790 units at a seasonally adjusted annual rate in April, down 1.7% from the prior month but up 2.2% from April 2017. Home prices maintained their strong growth, with the median price increasing 3.5% from March and 8.6% compared to a year-ago. The median price of $584,460 is now just about 2% below the peak price of $594,530 that occurred in May 2007.

The marked price increase was partly due to a shift in sales to high-cost regions and robust price growth within expensive areas like San Francisco, Marin, San Mateo and Santa Clara counties. Year-ago price gains have been 7% or greater for ten of the past eleven months as a lack of inventory – particularly at the lower end of the market – continues to propel prices higher. As a result, the median number of days it took to sell a home in California remained low at 15 in April compared to 17 in April of last year. While the supply of homes increased in April, the numbers are still below year-ago levels, putting further upward pressure on California home prices.

Supply of Homes in California Starting to Rise

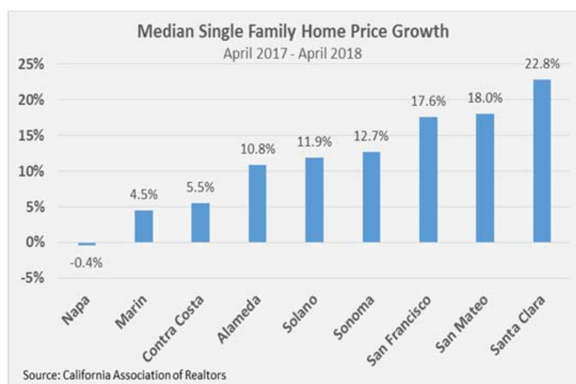


As the California economy enters the late stage of the economic expansion and job growth inevitably slows, the housing market will likely struggle to maintain its recent momentum. Consequently, home price growth is projected to moderate from its current robust pace. This moderation in home prices, which is projected to begin this year, is likely to be exacerbated by the net outmigration of California residents that is expected to start next year.

The **Bay Area** is still the housing market star performer in the state for the third consecutive month, with existing single family home sales increasing 6.1% year-over-year in April after expanding 3.1% in March. Five of the nine counties in the Bay Area posted increases led by Alameda (+14.5%) and Santa Clara Counties (+8.7%). Conversely, home sales in Solano County declined by almost 4.5% in March.

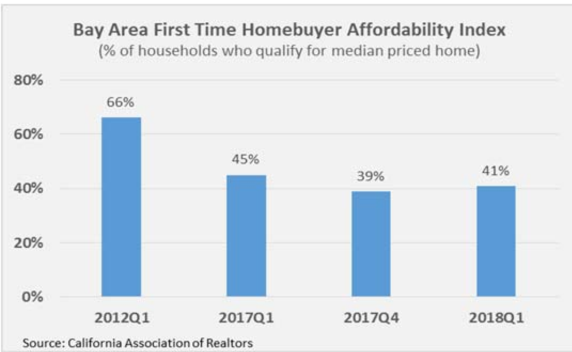
Home prices in the Bay Are remained robust in April with the region's median home price rising 14.1% to just over $1 million. April was the seventh consecutive month of double-digit price growth. Prices in eight of the nine counties increased, led by Santa Clara (+22.8%), San Mateo (+18.0%) and San Francisco (+17.6).

Bay Area Still Seeing Hot Home Price Growth



The Bay Area housing market is expected to remain strong this year because of its tight labor market and accelerating income gains. Beyond 2018, low levels of affordability, rising mortgage rates, and the lagged impact of tax reform, with limits on the deductibility of mortgage interest and state and local taxes, will weigh more heavily on the Bay Area housing market. Housing starts are forecast to turn negative in 2019 and home price appreciation will slow to gains more in line with personal income growth.

Bay Area Home Affordability Erodes



Moreover, the high cost of living in the Bay Area and the impact of tax reform on the willingness to purchase a home could lead to a sharp slowdown in in-migration. A survey done late last year by Redfin of homebuyers under contract or planning to buy a home in the coming year indicated that about 1 in 3 Californians would consider a move if they could no longer fully deduct state, local and property taxes.

Reversing five consecutive months of declines, the **Southern California** region posted positive sales growth in April. Existing home sales increased 1.6% year-over year in April after declining 5.9% in March. The increase was primarily driven by a 9.8% increase in San Bernardino. The rest of the region saw little or no growth and Ventura contracted by 6.7%.

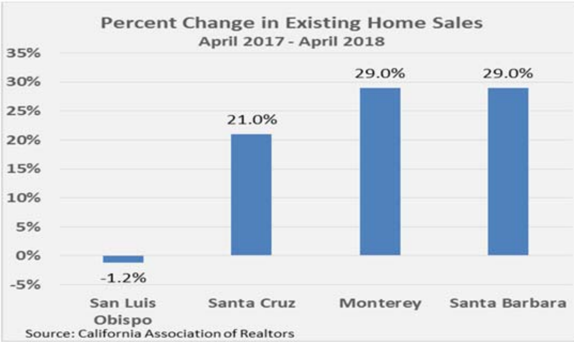
Home Sales Positive in Southern California

Home prices in Southern California continued a steady, upward trend with a 7.3% year-ago gain in April. All five counties in the region showed positive growth, led by San Bernardino (+13.5%) and Los Angeles County (10.1%). Conversely, home price growth in Ventura County was only 4.7%.

Southern California home prices are forecast to weaken over the next few years for the same reason other high-priced markets are: rising mortgage rates, the impact of tax reform, more specifically the limits on the deductibility of mortgage interest and state, local and property taxes. Moreover, out-migration in Southern California is expected to be more pronounced than in the Bay Area, limiting the demand for housing.

Existing home sales in the **Central Coast** region of California rose by a healthy 17.6% year-over-year in April. Monterey (+29.0%), Santa Barbara (+29.0%) and Santa Cruz (+21.0%) all experienced robust home sales growth, while San Luis Obispo turned negative (-1.2%).

Existing Home Sales Strong in Central Coast

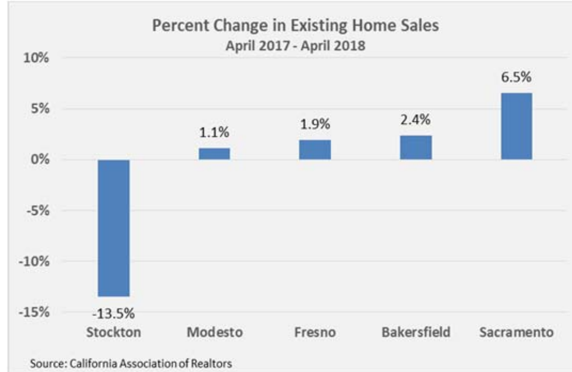


Buoyed by strong demand, home prices in the region increased by a robust 8.9% in April from a year ago. Santa Barbara (+14.4%) and Santa Cruz (10.3%) both recorded double-digit price gains while Monterey (+6.8%) and San Luis Obispo (+4.4%) advanced at more moderate rates.

The Central Coast housing market is expected to remain strong this year with housing starts up by 18% in response to sturdy job growth of 2.0%. However, homebuilding will soften in 2019 and 2020 as job growth slows dramatically and net migration turns negative. As a result, starts are forecast to decline at a double-digit pace in 2019 and home price appreciation will moderate.

Unlike the strength witnessed in the Central Coast region, existing home sales in the **Central Valley** advanced just 2.4% in April compared to a year ago. Homes sales in Stockton declined 13.5% while growth was weak in Bakersfield (2.4%), Fresno (1.9%) and Modesto (1.1%). The only county in the region with decent growth was Sacramento (+6.5%).

Fresno Leads Home Sales in Central Valley



Despite fairly weak home sales in the region, home prices skyrocketed by almost 10% in April. Sacramento, Stockton and Modesto led the way with respective gains of 13.2%, 10.3% and 8.1%. Home prices appreciated at a more moderate rate of 6.5% in Fresno, while they declined in Bakersfield (-0.7%). Tight existing home supply helps explain the disconnect between weak home sales and skyrocketing home prices in the Central Valley.

The housing market is projected to remain strong this year because of respectable job and income growth. Beginning in 2019, however, the housing market will begin to soften as job growth slows, net migration turns slightly negative, and mortgage rates rise.

Forecasts for California and Regions

CALIFORNIA	Historical		Forecast		
	2016	2017	2018[f]	2019[f]	2020[f]
LABOR MARKET					
Employment Growth	2.7%	2.1%	1.8%	1.2%	0.5%
Unemployment Rate	5.5%	4.8%	4.2%	4.3%	4.9%
INCOME AND SPENDING TRENDS					
Personal Income Growth	3.7%	4.1%	4.9%	4.7%	3.5%
Median HH Income ($)	67,739	70,400	72,651	75,299	77,998
Retail Sales Growth	3.5%	5.3%	4.3%	3.2%	1.2%
HOUSING MARKET					
Total Housing Starts Growth	4.2%	9.4%	5.1%	2.9%	2.0%
Med. Existing 1-Unit Home Price	5.2%	8.7%	8.5%	4.7%	4.5%
DEMOGRAPHICS					
Population Growth	0.7%	0.6%	0.6%	0.5%	0.5%
Net Migration (000's)	46.2	26.7	7.9	-21.2	-24.6

BAY AREA	Historical		Forecast		
	2016	2017	2018f	2019f	2020f
LABOR MARKET					
Employment Growth	3.4%	2.3%	2.0%	1.1%	0.3%
Unemployment Rate	4.0%	3.4%	3.1%	3.3%	3.7%
INCOME AND SPENDING TRENDS					
Personal Income Growth	5.0%	4.6%	5.2%	5.0%	4.0%
Median HH Income ($)	$88,211	$91,444	$94,382	$98,110	$101,981
Retail Sales Growth	3.2%	4.8%	4.2%	3.8%	2.0%
HOUSING MARKET					
Total Housing Starts Growth	6.6%	14.3%	5.2%	-2.0%	-3.7%
Med. Existing 1-Unit Home Price	6.3%	12.3%	10.9%	5.6%	5.1%
DEMOGRAPHICS					
Population Growth	0.8%	0.5%	0.5%	0.5%	0.4%
Net Migration (000's)	26.6	7.0	5.8	-4.0	-6.0

[1]The Bay Area includes Alameda, Contra Costa, Marin, Napa, San Francisco, San Mateo, Santa Clara, Solano and Sonoma counties.

SOUTHERN CALIFORNIA	Historical		Forecast		
	2016	2017	2018f	2019f	2020f
LABOR MARKET					
Employment Growth	2.7%	1.9%	1.6%	0.9%	0.2%
Unemployment Rate	5.1%	4.5%	4.2%	4.5%	5.0%
INCOME AND SPENDING TRENDS					
Personal Income Growth	3.3%	4.2%	4.3%	4.0%	3.2%
Median HH Income ($)	70,474	72,130	74,051	76,441	79,113
Retail Sales Growth	3.5%	5.1%	3.9%	3.2%	1.1%
HOUSING MARKET					
Total Housing Starts Growth	1.0%	1.5%	-0.3%	-3.3%	1.7%
Med. Existing 1-Unit Home Price	4.8%	7.6%	6.7%	2.6%	3.6%
DEMOGRAPHICS					
Population Growth	0.6%	0.5%	0.4%	0.4%	0.4%
Net Migration (000's)	-4.3	-19.6	-28.2	-39.6	-43.7

[2]The combined Southern California region includes Los Angeles, Orange, San Bernardino, San Diego, Riverside, and Ventura counties that is home to nearly two-thirds of Californians.

CENTRAL COAST	Historical		Forecast		
	2016	2017	2018f	2019f	2020f
LABOR MARKET					
Employment Growth	1.8%	1.7%	2.0%	1.3%	0.6%
Unemployment Rate	6.1%	5.4%	4.8%	5.2%	5.7%
INCOME AND SPENDING TRENDS					
Personal Income Growth	2.1%	3.0%	4.0%	4.1%	3.8%
Median HH Income ($)	69,872	72,159	74,179	76,688	79,612
Retail Sales Growth	3.3%	5.5%	3.7%	3.0%	1.5%
HOUSING MARKET					
Total Housing Starts Growth	-2.5%	38.1%	18.2%	-13.6%	-1.4%
Med. Existing 1-Unit Home Price	6.0%	7.0%	5.8%	3.6%	3.0%
DEMOGRAPHICS					
Population Growth	0.6%	0.4%	0.5%	0.5%	0.4%
Net Migration (000's)	1.2	-2.1	0.0	-1.0	-1.1

[3]The Central Coast region is comprised of Santa Barbara, Monterey, San Luis Obispo, and Santa Cruz counties.

CENTRAL VALLEY	Historical		Forecast		
	2016	2017	2018f	2019f	2020f
LABOR MARKET					
Employment Growth	2.8%	2.2%	2.2%	1.2%	0.3%
Unemployment Rate	7.6%	6.6%	5.9%	6.4%	7.0%
INCOME AND SPENDING TRENDS					
Personal Income Growth	3.4%	3.6%	3.8%	3.3%	2.9%
Median HH Income ($)	55,299	56,603	57,950	59,642	61,624
Retail Sales Growth	4.2%	6.7%	4.1%	3.2%	1.2%
HOUSING MARKET					
Total Housing Starts Growth	10.9%	19.7%	19.4%	11.6%	5.8%
Med. Existing 1-Unit Home Price	9.2%	9.2%	8.8%	3.8%	3.4%
DEMOGRAPHICS					
Population Growth	1.1%	1.2%	0.7%	0.6%	0.6%
Net Migration (000's)	24.8	32.1	5.2	-0.2	-0.7

[4]The Central Valley region is comprised of San Joaquin, Fresno, Madera, Sacramento, Placer, El Dorado, Yolo, Stanislaus, and Kern counties.