Southern California

Regional Intelligence Report

MAY 2022

Prepared by Beacon Economics, LLC
Presented by Torrey Pines Bank

Outlook for the Los Angeles, Orange and San Diego County Economies

Overview

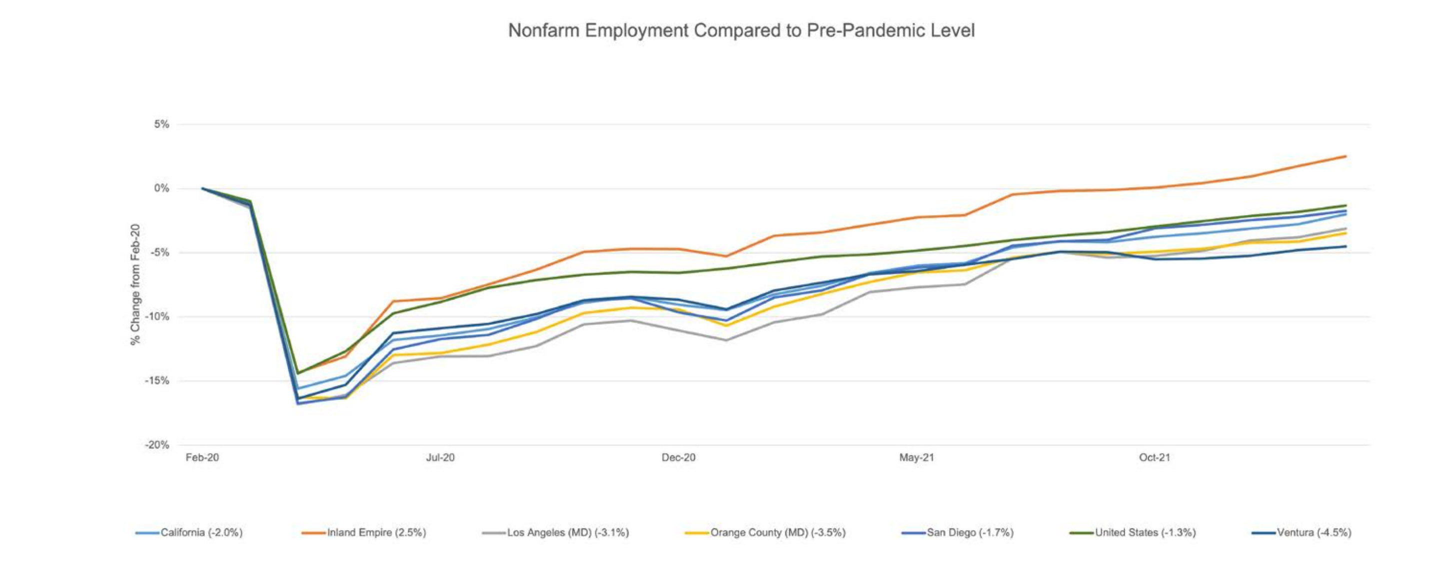
The pandemic recession and the economic recovery ended in the second half of 2021. As far as business cycles go, this one was truly unique. It was the deepest recession ever, the shortest in length and was followed by one of the most rapid recoveries in history. This was a supply-shock-driven recession without the long-term consequences that came from the burst asset bubble demand-shock that drove the Great Recession. While growth in Southern California has slowed, employment continues to inch gradually towards pre-pandemic levels.

Still, excessive consumer demand is driving inflation in the U.S. This can be seen in the strong growth in overall consumer spending, which has been growing faster than GDP overall since 2017 and is showing no signs of slowing down. As the Great Recession can attest, when consumer spending grows faster than output, it always ends badly.

How sustained will inflation be? The Federal Reserve seems to believe that a few rate hikes and the unsnarling of supply chains will quickly reduce the rate of price growth and, so far, the bond markets appear to agree. A careful analysis of the history of inflation suggests that other factors play an important role, including the federal deficit, wage growth and of course, the money supply, which is at the heart of monetary theory. Given the current tightness of U.S. labor markets, the lack of conversation about closing the federal deficit points to continued inflationary pressure.

Regional Employment

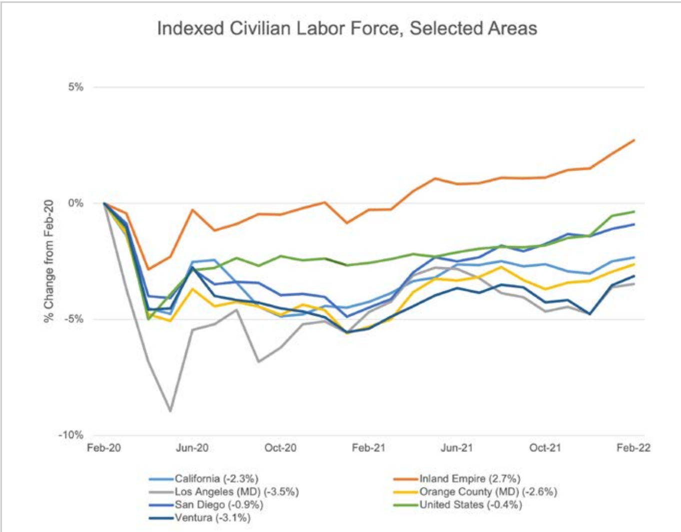
Recently released labor market data shows that employment growth in Southern California[1] was better in 2021 than originally estimated. In March, the California Employment Development Department (EDD) released revisions to their monthly employment survey estimates which indicate that the local labor market has, by-and-large, been recovering faster than originally thought. Each year the EDD releases an annual benchmark, in which monthly labor force and payroll data are updated. The monthly statistics are based on sample data from a survey of establishments and the benchmark incorporates official information with the more lagged, but more accurate, Quarterly Census of Employment and Wages (QCEW), which covers roughly 97% of all wage and salary employees in the nation. Prior to the revision, nonfarm employment growth for Southern California came in at just 1.9% from 2020 to 2021. However, after the revision, the annual growth rate ticked up to 3.5%.



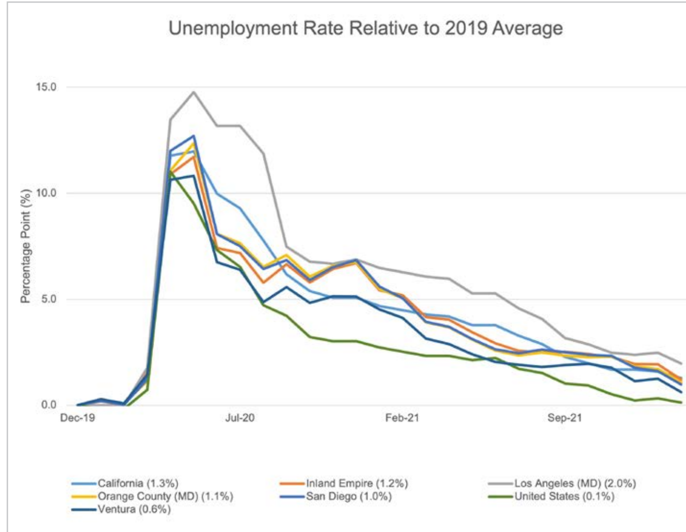
Source: California Employment Development Department (EDD)

At the regional level, San Diego has seen a quicker recovery in terms of nonfarm jobs added. As of February 2022, payrolls were 1.7% below their pre-recession peak, compared to Los Angeles and Orange counties where employment was down 3.1% and 3.5%, respectively. All three counties are expected to surpass pre-pandemic levels of employment either later this year or early next as things slowly but surely transition back to normality. The pace of job growth is also expected to cool as a dwindling supply of workers will limit the extent to which payrolls can expand. The good news is that labor force growth has continued to recover from the initial shock of the pandemic. However, the unemployment rate is trending closer to its 2019 average, a time when the labor market was drawing on a very limited pool of available workers. Los Angeles and Orange counties have some more ground to recover, while the unemployment rate in San Diego is only one percentage point above its 2019 average, still above the national rate where the labor market has minimal slack.

[1] *Here Southern California is defined as Ventura, Los Angeles, Orange, Riverside, San Bernardino, San Diego and Imperial counties.*

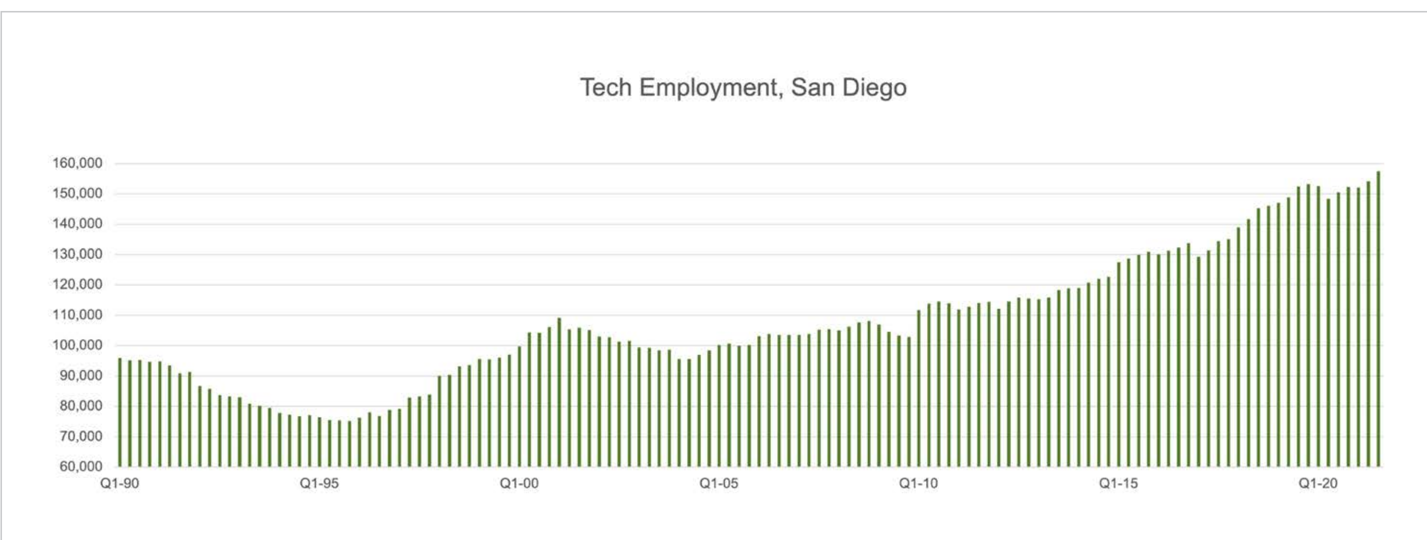


Source: California Employment Development Department (EDD)



Source: California Employment Development Department (EDD)

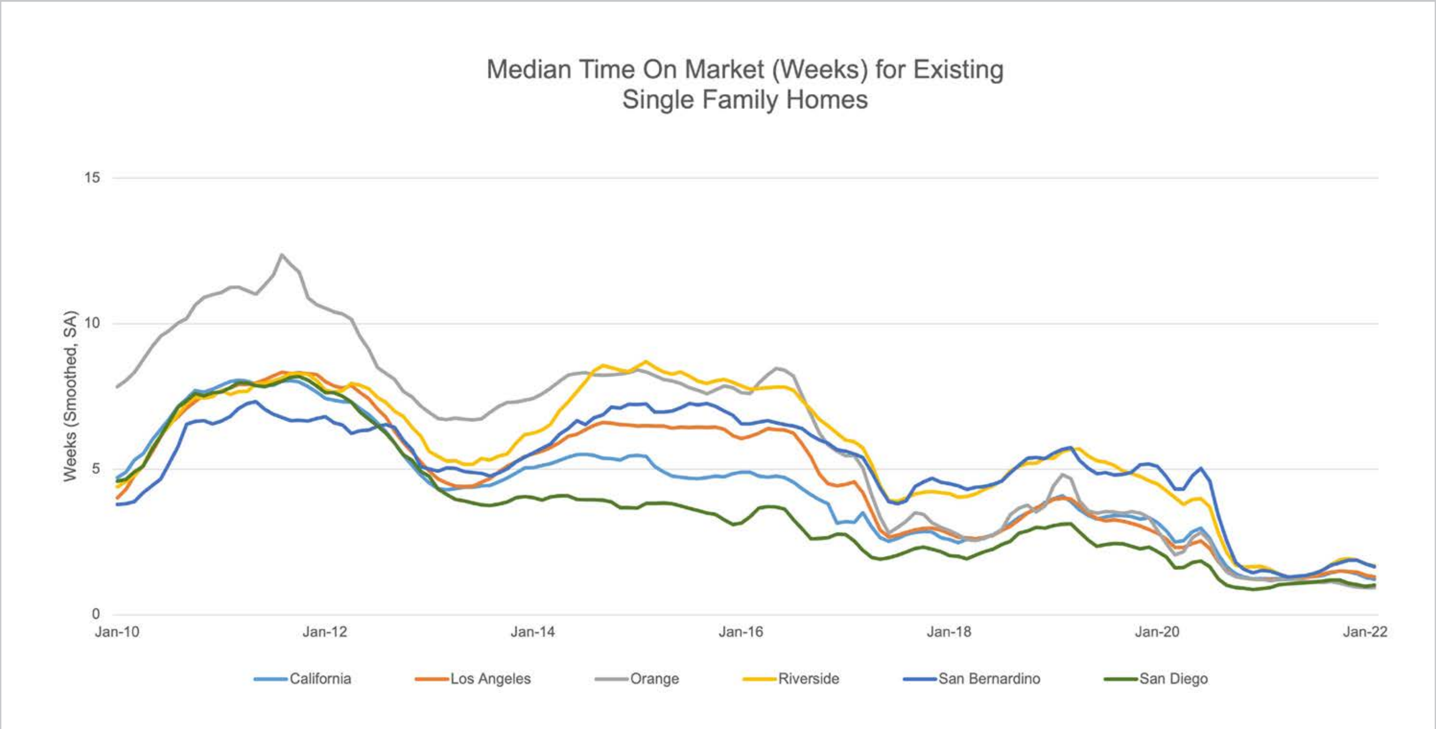
San Diego is clearly the front runner in terms of labor market performance. At the industry level, job growth has been robust in the Professional and Business Services sector, which by February 2022 had increased 7.2% over pre-pandemic levels. However, every other major industry is still recovering from the pandemic-driven recession. Underlying the impressive growth in Professional and Business Services is an expanding Tech Sector that has been increasingly driven by Tech Services. Although it's difficult to define exactly which industries comprise 'high-tech employment', the most accurate interpretation must rely on detailed sector breakouts. For that, Beacon Economics uses QCEW, which shows that tech employment continues to be dominated by tech industries oriented in services, particularly in Scientific Research and Development, which comprises more than one quarter of all tech jobs. Tech manufacturing in San Diego still exists, but not to the extent it did in the early '90s when, prior to the downturn in the aerospace industry, it accounted for nearly 70% of total employment.



Source: U.S. Bureau of Labor Statistics

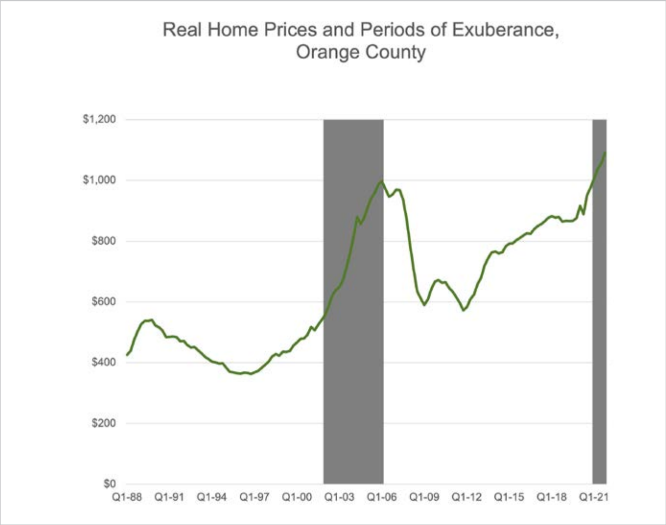
Residential Real Estate

There's no doubt that the pandemic energized the real estate market, both in Southern California and at the state and national levels. Among the primary factors driving the rapid upswing in prices and sales were a steady decline in interest rates and a shift in consumer preferences for more space. According to data from CoreLogic, across new homes, existing homes and condos, sales in San Diego County increased 23.5% year-over-year in 2021. While this was the fastest rate of increase in nearly 25 years, it was lower compared to rates seen in Orange (+33.7%) and Los Angeles (+40.4%) counties. Both locally and at the national level, housing markets have been on fire. Inventories of homes on the market have continued to decline and the homes that are listed tend to stay on the market for only a couple of weeks (see chart below).



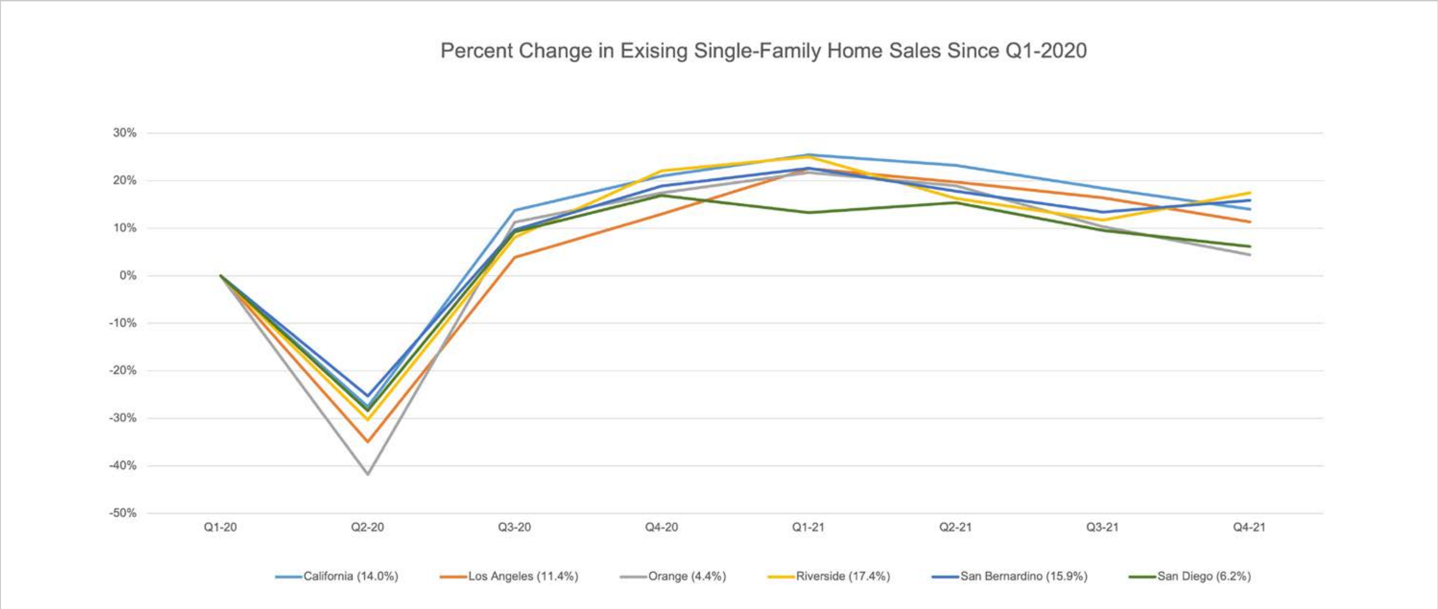
Source: California Association of Realtors

Housing supply has failed to keep up with demand for several years running and that's not likely to change any time soon. From a long-term standpoint, new home construction has remained well below average and the ongoing gap between supply and demand has raised concerns about a statewide housing shortage. Housing is clearly getting ahead of itself. Excessive price appreciation is not entirely sustainable, particularly in Orange County where, in the fourth quarter of 2021, prices for existing-single family homes were up 19.3% year-to-date. Price growth was more muted but still double-digit in San Diego (+14.6%) and Los Angeles (+12.1%). The chart to the right shows inflation-adjusted home prices and periods where home prices exhibited what appears to be explosive behavior ('exuberance'[2]).



Source: U.S. Bureau of Labor Statistics

The good/bad news is that rates are rising, which should keep real estate prices from running too hot. Rising rates will undoubtedly slow the pace of sales and limited inventories will keep prices from falling as home prices tend to be resistant to rising rates. How high rates will rise is anyone's guess at the moment. However, there is a big difference between a housing pause and a housing bust. The market respond to changes in interest rates is a good thing; prices must adjust to a higher carrying cost. Once that happens, the market should get back on track. The slowing pace of sales is part of that process and, as the chart below indicates, sales have started to cool off.

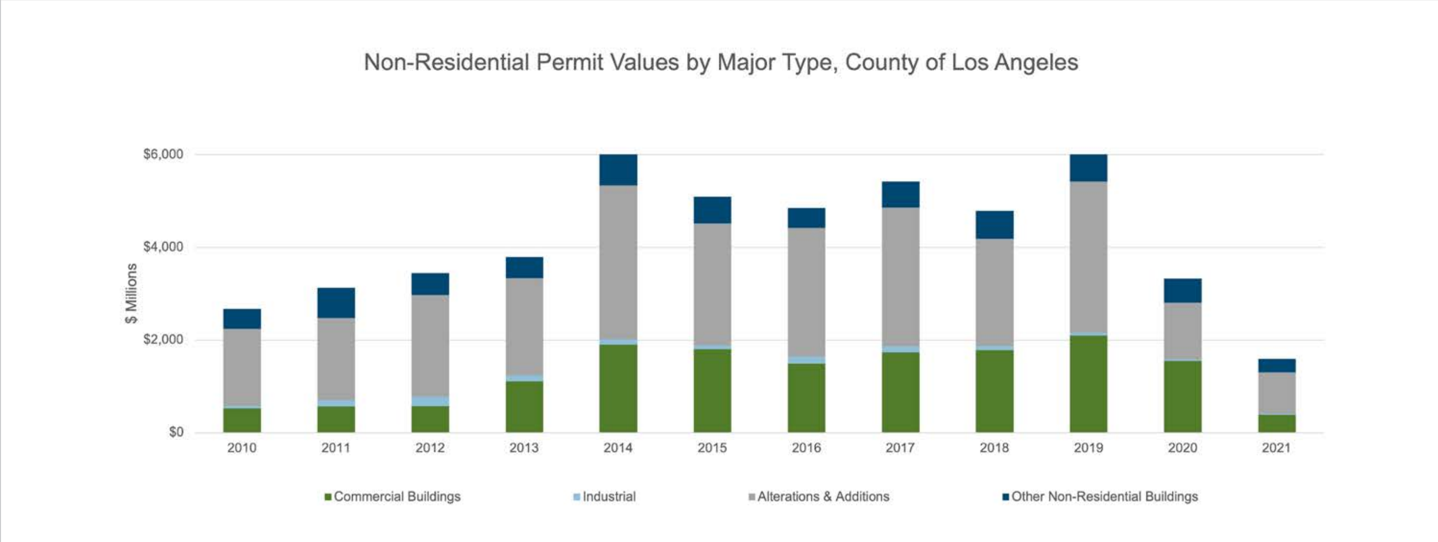


Source: CoreLogic

[2]*The formal definition of exuberance here is a statistical one and beyond the scope of this report. Interested readers are directed to Pavlidis, Efthymios, Alisa Yusupova, Ivan Paya, David Peel, Enrique Martínez-García, Adrienne Mack and Valerie Grossman. "Episodes of exuberance in housing markets: in search of the smoking gun." The Journal of Real Estate Finance and Economics 53, no. 4 (2016): 419-449.*

Commercial Real Estate

Commercial real estate has been erratic, particularly regarding non-residential construction projects. In the County of Los Angeles, the total value of non-residential construction projects dropped substantially in 2020 from 2019 levels, and the weakness continued into 2021, with permit values declining 52.1% relative to 2020, which was a tepid year to begin with. The cratering in values occurred across all major categories, including office (-43.2%), retail (-82.5%) and alterations (-27.6%). Orange County also saw a decline in non-residential construction permitting in 2021, with the total value of non-residential permits falling 10.1%. Some segments, such as office (+114.1%), retail (+71.4%) and industrial (+223.2%), saw a substantial uptick, but the decline in non-residential alterations resulted in a negative print for the County overall. San Diego was the standout among the three counties, with non-residential permits up 21.3% due in part to an uptick in office and industrial permitting.



Source: California Homebuilding Foundation/CIRB

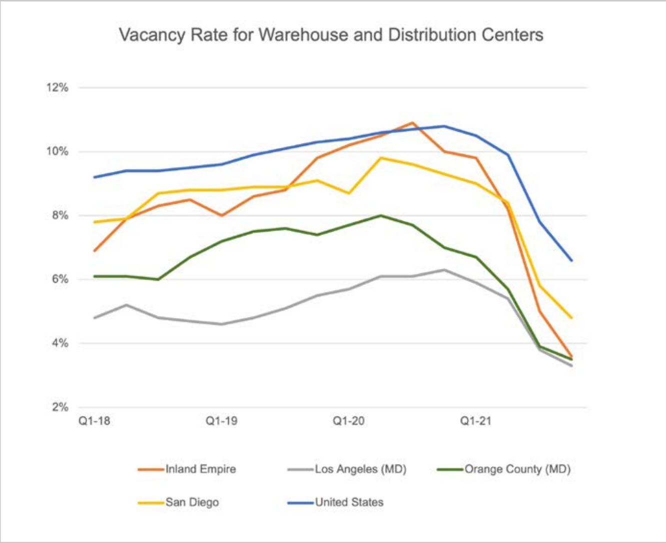
Despite a gradual transition toward open offices and more remote work, the office market has advanced steadily. Looking ahead, it's expected that the office market will continue to grapple with the changing face of office work. Indeed, if we look at office-facing employment and absorption of office space, it's clear that remote work remains prevalent in all counties. Throughout 2021, the County of Los Angeles added more than 51,000 employees in office-facing industries, but net absorption of office space in the county declined by more than 800,000 sq. feet. The same pattern was seen in both San Diego and Orange counties. Against the near-term backdrop of improving economic conditions, the outlook for construction activity remains positive. One of the driving forces of the non-residential space will be permits for alterations and additions. There are several reasons these permits constitute a sizable share of non-residential activity. One of the most immediate is a lack of developable land, but other factors are in play. However, the prospect of a more hawkish Fed and rising rates could limit the extent to which construction activity recovers in the near term.

COMMERCIAL PERMIT VALUATIONS IN LOS ANGELES, ORANGE, AND SAN DIEGO COUNTIES (FEBRUARY 2020 – JULY 2021)

	ORANGE COUNTY		SAN DIEGO		LOS ANGELES	
	2021 ($000s)	Annual Growth (%)	2021 ($000s)	Annual Growth (%)	2021 ($000s)	Annual Growth (%)
New Commercial	636,442	-14.3	571,629	4.6	385,456	-75.1
Office	132,059	114.1	264,272	1,219.2	137,416	-43.2
Retail	280,005	71.4	248,980	-36.8	157,040	-82.5
Industrial	46,820	233.2	125,420	217.8	27,845	-10
Other Nonres.	199,819	12.4	289,547	14.9	292,099	-43.8
Nonres. Alts./Adds.	781,914	-14.8	1,208,495	24.4	888,453	-27.6
Total Nonres.	**1,664,995**	**-10.1**	**2,195,092**	**21.3**	**1,593,852**	**-52.1**

Source: Construction Research Industry Board (CIRB)

The rise of e-commerce has also fueled demand for warehousing and delivery services, a trend that was already in place before the pandemic but which has since accelerated. This is readily apparent when looking at trends in vacancy rates for warehouse and distribution centers. Although the Inland Empire is a well-established logistics hub, demand for warehouse space due to the shift in consumer preferences has pushed vacancy rates to new lows. Following the first quarter of 2021, we see a convergence in vacancy rates for warehouse properties. Prior to the pandemic the spread between vacancy rates was fairly noticeable. For example, the spread between the vacancy rate for the Inland Empire and Orange County averaged roughly three percentage points, but that has since been erased. Indeed, some vacancy is normal and vacancy rates for warehouse property rates are fairly close to their lower bound. What's more, the growing shift to online retail and increased activity at the Port of Los Angeles should mean more trade traffic moving through Southern California's warehouses and distribution centers.



Source: Reis, Inc.

Prepared By Beacon Economics

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