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FALL ECONOMIC FORECAST

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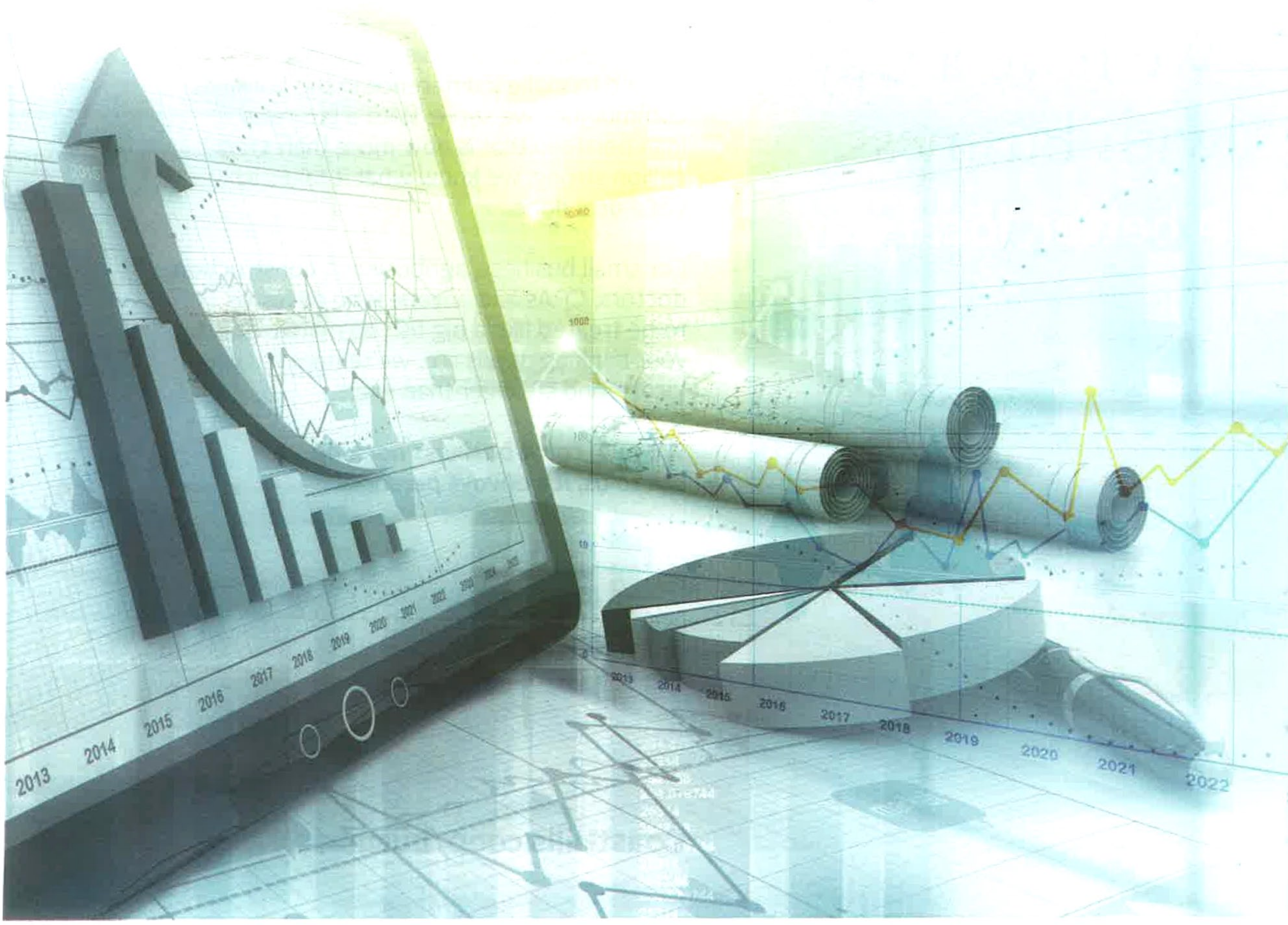

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The Economist ROUNDTABLE

While the U.S. transitions into a new political era and California prepares for its future, the tri-county region is starting to fix some of its major problems like the housing and labor shortage. To get a current economic update on the Tri-Counites, the state and the U.S., we asked four regional economists about how the economies in Ventura, Santa Barbara and San Luis Obispo counties will fare in the near future and beyond. Weighing in on this year's Fall Economic Forecast are: Matthew Fienup, executive director of the center for economic research at California Lutheran University; Peter Rupert, director of the UC Santa Barbara Economic Forecast Project; Mark Schniepp, economist for the California Economic Forecast; and Mark Vitner, managing director and senior economist at Wells Fargo.

By Robert Shutt
Staff Writer

1) What is the current state of the tri-county economy?

• **Fienup:** We noted in the previous economic roundtable that the tri-county region has underperformed the state by traditional economic measures for several years. The September data release from the Bureau of Economic Analysis provides reason for real concern. Economic growth has slowed across the Tri-Counties.

In San Luis Obispo County, economic growth slowed from 2.8 percent in 2015 to 0.6 in 2016. Admittedly, given the relatively small size of the San Luis Obispo County economy, we can't rule out the possibility that this is just normal variability. As you move south through the Tri-County region, the situation gets significantly worse. The growth of Santa Barbara's economy slowed from 4.8 percent in 2015 to -0.7 percent in 2016. We will await next year's revision of the data by BEA for confirmation that Santa Barbara's economy actually contracted, but the decline in growth is certainly real. By comparison, economic activity in Los Angeles and Orange counties grew by more than two percent in 2016.

In Ventura County, the bottom fell out. The BEA estimates that Ventura County's economy shrank by nearly 3 percent in 2016, led by a loss of more than $1 billion of output in non-durable manufacturing. The 2016 figure is the BEA's first estimate and will be revised 12 months from now, but it is reasonable to conclude that Ventura County suffered a significant recession in 2016. Revised estimates for the two previous years indicate that the Ventura County economy saw nearly no growth in either 2014 or 2015. Together, 2014-2016 represents the slowest period of growth of any three consecutive years since the turn of the millennium. The past three years are worse even than the period that includes the financial crisis and the Great Recession.

Policy matters. The general decline in economic performance, and the fact that the magnitude of the decline varies across the tri-county area, is no accident. San Luis Obispo County has shown an openness to growth and development, while Ventura County has largely been hostile to any new economic opportunity. It does not surprise us that San Luis Obispo's performance has been stronger than Ventura County's or that Santa Barbara's performance is intermediate between the two.

• **Rupert:** Employment growth has been lagging the U.S. and California numbers. Over the last year, local employment (civilian employment) has grown by 0.07 percent while California and the U.S. grew by 0.77 percent and 1.18 percent, respectively. For nonfarm payrolls, Santa Barbara, 1.48 percent, looks a bit better, with an annual growth rate right in between the U.S., 1.45 percent and California, 1.58 percent. The unemployment rate, which is currently at 4.8 percent, has increased by 0.3 percentage points since May.

As for housing, data shows some signs of improvement in local housing markets. Santa Barbara's Zillow Home Value Index grew by 0.4 percent in August, matching the growth of California and the U.S. However, the year-over-year growth in Santa Barbara, 1.8 percent, remains far below that of California's 7.1 percent and the United States' 6.9 percent. The market health index — Zillow's measure of market healthiness that ranges from 0 to 10 and is based on a combination of home value growth,

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MEET the PANELISTS

Matthew Fienup
Economist
California Lutheran University

Matthew Fienup is the executive director of the California Lutheran University Center for Economic Research and Forecasting. He took over for Bill Watkins in November 2016.

Fienup holds a master's degree in economics from UC Santa Barbara, and he is currently working on his doctorate's degree in environmental economics at the Bren School of Environmental Science and Management at UCSB. His specialty is applied econometric analysis and the economics of private land use. He is also active in the issues surrounding urban growth restriction and groundwater management policy in Ventura County.

Peter Rupert
Director
UC Santa Barbara Economic Forecast Project

Peter Rupert serves as chair of UC Santa Barbara's Department of Economics, executive director of the Economic Forecast Project and associate director of the Laboratory for Aggregate Economics and Finance, founded by Nobel Laureate and Henley Professor of Economics, Finn E. Kydland.

Prior to joining UCSB, Rupert spent 12 years as senior economic adviser at the Federal Reserve Bank of Cleveland and has held appointments at the University of Western Ontario, State University of New York, Buffalo, West Virginia University, USC and the Birkbeck College at the University of London. Rupert received a bachelor's degree in economics from Santa Clara University and a doctorate degree in economics from the University of Rochester.

Mark Schniepp
Economist
California Economic Project

Mark Schniepp is the director of the California Economic Forecast. The California Economic Forecast has been preparing publications and presentations for more than 25 years. The firm was founded in 1989 by Schniepp as the private consulting arm of the UC Santa Barbara Economic Forecast Project.

Schniepp left UCSB in early 2000 to devote a full-time effort to the California Economic Forecast. The company has expanded rapidly since that time and has developed into a full-service economic consulting firm with expertise on the California economy. He earned his doctorate degree in economics from UCSB in 1985.

Marc Vitner
Managing Director, Senior Economist
Wells Fargo

Mark Vitner is a managing director and senior economist at Wells Fargo and is responsible for tracking U.S. and regional economic trends. He also writes for the company's Monthly Economic Outlook report, the Weekly Economic & Financial Commentary, and provides regular updates on the housing markets, commercial real estate, regional economies, and inflation. His commentary has been featured in the New York Times, Wall Street Journal and Bloomberg.

Originally from Atlanta, Vitner earned his bachelor's degree in economics from the University of Georgia, his master's degree in business administration from the University of North Florida and has completed further graduate work in economics at the University of Florida.

ECONOMY

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foreclosure rates, home equity, and market inventories —improved from 5.9 to 7.6 percent.

• **Schniepp:** The tri-county economy is healthy in some sectors and struggling in others. We're near the peak of the current business cycle, and many parts of the economy are working well.

All three counties are at "full employment" conditions. Full employment typically occurs when the unemployment rate falls below 5 percent, signaling that almost everyone who wants a job already has a job. In the tri-county region, tight labor markets have started to lead to faster wage growth, with local workers now getting more substantial raises. This is the principal by-product of a full employment economy.

When full employment conditions are reached, firms can only increase their employee headcounts by hiring new high school and college graduates, recruiting workers from other companies, or recruiting workers from outside the tri-county region. This limits the hiring potential for the local economy, and usually leads to slower job creation.

But in parts of the tri-county economy, job growth is actually accelerating. Why? Because of rapid growth in the food and dining industry. There has been a resurgence in demand for restaurants and bars, and this has provided more job opportunities for millennials, and for people without college degrees. Over the last few years, these segments of the workforce have had the highest need for new opportunities, and the market is now delivering.

•. Unemployment rates are at cycle lows.

• Employment growth remains positive though slowing way down in Santa Barbara and SLO counties.

• Employment growth has accelerated in Ventura County but principally due to lower paying labor markets.

• Residential building has improved in all three counties.

• Commercial real estate remains strong in Santa Barbara and SLO counties although the retail sector has softened in lockstep with the rest of the U.S. The industrial market is tight in Ventura County and the office sector is only gradually improving there.

• Tourism remains strong along the central coast and in all coastal areas of California.

• Home prices continue to rise to new record highs and apartment vacancy rates remain extraordinarily tight.

• **Vitner:** Overall, the economy looks to be in solid shape. Job growth has been solid and the unemployment rate has fallen to its lowest level in decades. The quality of jobs is improving and workers and that is putting upward pressure on wages in the leisure and hospitality sector. Growth in technology, professional services, construction and logistics is helping the economy balance its reliance on the leisure and hospitality sector.

> **High home prices have made it very hard for companies to recruit and retain qualified workers.**
>
> **Mark Schniepp**
> *California Economic Project*

BY the NUMBERS

Unemployment rates: January-August 2017

SLO County	Santa Barbara County	Ventura County	California	U.S.
3.7%	4.6%	4.6%	4.9%	4.5%

2) What are some sectors that are growing rapidly in our region and what do you think is causing that growth?

• **Schniepp:** The main drivers of economic growth are now restaurants and bars, construction and health care.

Over the past two years, the food and dining sector has created almost 3,000 jobs in Ventura County, almost 2,000 jobs in Santa Barbara County, and more than 1,000 jobs in San Luis Obispo County. These are big numbers. Employment in food and drinking establishments in all three counties is currently at an all-time record high.

Demand is being generated by busy households and millennials who lack the time for meal preparation, and by the new lifestyle trend of experiential spending. Young professionals used to spend their paychecks on cars, furniture, and electronics, but now prefer food, festivals and craft beer.

Some of these new jobs are being created in traditional sit-down restaurants, but most are in "fast casual" places like Chipotle and Panera. These establishments have upended the fast food industry, and are a real force in the current economy.

After several years of lackluster construction activity, there has been a partial resurgence in new home building. This has been a much needed, much anticipated development, not only for the jobs it can provide, but also to ease pressure on the housing crisis. Housing demand is now at very high levels, but few new homes have been built over the last decade, leading to sky-high prices and rents. Restrictions on development can make it very tough to build anything in parts of our region, but high levels of demand are now convincing policy makers to green light more development projects.

Health care employment has been increasing unabated for many years, primarily due to the aging population and the mandate that everyone purchase health insurance.

• **Fienup:** There is little to point to in terms of rapidly growing sectors. In terms of total economic output, education, health services and government both grew by small positive amounts in 2016 in all three counties. This is part of a broader, post-recession economic trend in California.

Significant growth in manufacturing (specifically, non-durable) continues in San Luis Obispo County. This is joined by an uptick in construction. These are signs of San Luis Obispo County's relative friendliness to growth as well as spill-over effects from the giant economic engine that is Silicon Valley and the Bay Area, to its north. Santa Barbara has also seen an uptick in Manufacturing and Construction, but at a lower rate than San Luis Obispo. Ventura County's economic troubles are led by a one-year, 2.4 percent decline in output in non-durable manufacturing. Ninety-three percent of Ventura County's non-durables are chemicals, so think bio-technology when considering this decline.

• **Rupert:** The sectors that are seeing strong employment gains are goods producing, 5.3 percent, and leisure and hospitality, 5.9 percent. It would be interesting to know how these industries are doing throughout California, especially in local counties. If there are strong gains in these industries throughout the state, maybe it points to a broader trend in these industries. Or if Santa Barbara's gains are much stronger than other counties, then you could say Santa Barbara's is gaining popularity as a tourist destination or a manufacturing base, probably in north county and Goleta, relative to nearby regions.

• **Vitner:** Higher education and health care have long been key drivers for the tri-county region. Construction has improved this past year, particularly in Ventura County, which is seeing stronger residential and commercial construction.

3) Where is the tri-county economy struggling and why?

• **Rupert:** The large declines over the year in information -4.1 percent and professional and business services, -4.9 percent.

• **Schniepp:** The problem areas are now housing affordability, employee retention, and the retail industry.

There is currently what is being called, a housing crisis. And the housing crisis is the direct result of the growth of demand for homes exceeding the growth of housing supply. There has been a slight resurgence in home building, but the tri-county region has generally been undersupplied for almost a decade. The lack of building has lead to substantial housing price appreciation and an accelerating problem with housing affordability. In many parts of the tri-county region, buying a home now requires a large down payment and a hefty mortgage liability, pushing a larger percentage of would be buyers out of the market. Rental housing rates are also rising fast in the South Coast of Santa Barbara in the major cities of Ventura County.

Creative solutions have been proposed, such as a ban on short-term rentals, the adoption of public-private housing partnerships, and higher density housing in Santa Barbara, but cumulatively, these efforts are relatively ineffective compared to approving more housing. However, because of the desirability of the region together with the absence of the political will to seriously address the affordability issue, the housing crisis will persist and remain a drag on economic growth in the future.

High home prices have made it very hard for companies to recruit and retain qualified workers. Some corners of the tri-county region are now losing jobs in finance, business, and tech services, partially because people would rather live in other parts of the state or country with more affordable housing options. These high skill, high wage jobs are critical to maintaining a dynamic economy.

The retail industry is struggling across the U.S., including the local economy. Stores are closing as demand softens for the in-person shopping experience, and places like Santa Barbara's State Street are dealing with high retail vacancy rates.

Problems are prominent in a wide array of subsectors, including department stores, clothing stores, office supply stores, furniture stores, sporting goods stores, and electronics stores. Consumers are migrating online at a rapid rate, with e-commerce sales now accounting for 10 percent of all retail purchases nationwide.

The exceptions are auto dealerships, gas stations, grocery stores and supercenters like Walmart and Costco. Why have these segments bypassed the greater retail fallout? Because it's hard to buy their goods online, or in the case of supercenters, because they already

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ECONOMIST

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offer a combination of convenience and low price that is competitive with the online experience.

The next challenge will be determining how to use this vacated retail space. Alternative ideas have called for a conversion of space into housing to ease the housing crisis. However, if landlords simply lowered their prices, spaces would sell or lease.

• **Vitner:** The key challenges for the tri-county area are providing affordable housing options for younger workers. The region's service-oriented economy tends to pay relatively low wages, which is making it harder for employers to find the workers they need.

• **Fienup:** Housing affordability is approaching crisis levels. There is no doubt that a lack of building has artificially driven up housing prices, even by the standards of Coastal California. There is also no doubt that the lack of affordability constrains local businesses, limiting their ability to attract and retain a qualified workforce. Creative policies like Santa Barbara's Average Unit Density incentive program and San Luis Obispo's Ag Clustering are positive innovations. Much more needs to be done at the local level.

4) Are there any signs that point to potential problems in the economy?

• **Vitner:** The economy typically endures a recession about every five years but the last recession was more than eight years ago. So, in a sense, we are due. Recessions do not just happen, however. Inflation is low and the Fed appears to be cautiously removing the stimulus they put in place to offset the Great Recession so a recession still seems to be a distant prospect but the risks are increasing.

Right now, the risks of overheating are more apparent in the tri-county area, with home prices and rents rising and workers scrambling to find affordable housing options.

• **Schniepp:** As I mentioned in question 3, the economy is generally healthy, but the lack of housing, especially in Ventura and Southern Santa Barbara County is a threat to business retention and recruitment. Population growth slows and the result is further strain on the retail sector.

In Ventura County, SOAR looms as the most potential obstruction of business vitality and growth going forward. I talked about this last year and it's more of an issue now because the growth control was renewed by public referendum last November and it will be in place until the year 2050 throughout the county.

SOAR has already had a deleterious impact on the economy over the last four or five years. There has been unprecedented downsizing and defection of companies in Ventura County. And not much new company in-migration. The labor market recovery has been relatively anemic, and finding housing---to own or to rent—has been horrific. Consequently, this has impacted recruitment and retainment.

The other major problem is longer term, and it's the shutdown of Diablo Canyon by PG&E by 2025. This will deprive SLO County of a major source of property taxes. Many businesses will be potentially impacted by the closure of the power plant and the direct loss of 1800 jobs. And though PG&E has agreed to pay $85 million to adjacent cities and the school district, SLO County will still loose a major economic entity that has provided high paying jobs and significant economic stimulus over the last 30 years.

• **Rupert:** Housing market weakness, recent weakness in employment growth, as well as three consecutive months of increasing unemployment rate in Santa Barbara County.

• **Fienup:** We trust large incumbent employers when they communicate what makes it difficult to conduct business in the Tri-County region. Amgen recently announced plans to pare its Ventura County based workforce by nearly 10 percent, at the same time that it is building a new, 136,000-square-foot facility in Tampa, Fla. The reason Amgen cited for moving their workforce to Tampa was "affordable cost of living and the potential for growth." The economic outlook for each of the Tri-Counties is only as bright as each county's willingness to cultivate growth. In Ventura County, that outlook is bleak.

5) What are some suggestions you have for businesses in the region as recreational cannabis becomes legal Jan. 1?

• **Schniepp:** The legalization of the cannabis industry would only be a plus for the economy, as it will generate new revenues for local government agencies and make available more hemp products to consumers and industry. However, in this region, these effects will be very small. Most of California's cannabis is grown in the northern part of the state, and consequently that region will receive the most benefit.

When new cannabis storefronts open, there will be a small amount of job creation for cashiers, security guards, and similar types of workers. But these effects will be limited because cannabis stores will not account for a major portion of the retail market.

In Santa Barbara County, the opening of retail storefronts may be delayed beyond Jan. 1 because some government agencies are still developing their regulatory guidelines for cannabis sale and production. Ditto Ventura County.

There certainly are more opportunities for greenhouse production of cannabis, in Santa Maria, Carpinteria, Oxnard and elsewhere. However, new production appears to be on the minds of many growers throughout the state, so be ready for faster growth of supply than the growth of demand. When that occurs, cannabis prices will continue to decline so adjust your business plan pro formas accordingly.

• **Fienup:** We have heard anecdotes from at least one tri-county community bank of local farmers walking in to a branch office with bags containing hundreds of thousands of dollars in cash, hoping to make a deposit. We have also heard deep concern expressed by professionals in the farm-credit system stemming from their inability to underwrite any activity related to cannabis production and their fear that farmers will seek to secretly engage in such activity. Until cannabis cultivation and sale is legalized at the federal level and businesses can access federally insured banking institutions, we would recommend extreme caution.

• **Rupert:** I'm not sure what to make of this question. In terms of the ag sector in Carpinteria, for example, I think that the traditional industries, such as cut flowers, will face even tougher times. Already production has shifted to Central America due to labor costs.

6) What advice would you give to businesses that are trying to adapt to rapidly advancing technologies like driverless cars?

• **Fienup:** Our primary advice is not to businesses but to policy makers. There is no doubt that driverless cars are a disruptive technology, perhaps the most significant one since the advent of the internet. Even as the economy at large will benefit from the tremendous efficiency gains that disruptions of this type produce, there will undoubtedly be winners and losers in the transition that is coming. Winners will generally be those who can rapidly adapt.

Policy makers should seek to remove barriers to business formation and expansion, barriers which constrain economic activity and make adaptation more difficult. Communities should seek to create an environment which allows dynamic change and growth. This will not only mitigate the costs of the technological disruptions which are just around the corner, it may start to offset the slow economic decline that is already underway in parts of the tri-county region.

• **Vitner:** I would advise businesses to not go overboard about the prospects for driverless cars but to start incorporating there increased use over the medium-term horizon. Businesses should already be adapting their operations so that they are more user-friendly for ride-sharing services, with safe and convenient drop-off and pick-up points. This should pave the way for driverless vehicles as well. Parking is generally regulated but should be designed in a way that it can be changed as technologies emerge.

• **Rupert:** Retail will continue to struggle until they can deliver an experience (in a city's) downtown. Online sales will put many retailers in trouble. Driverless cars will have an impact on the way people shop, eat, and drink. Taxi cabs, Uber and Lyft may have to change its business plan.

• **Schniepp:** Businesses have to anticipate and adapt to rapidly changing technologies faster than ever before, simply because new technologies are impacting us faster than ever. Technology such as: Autonomous vehicles; online retail; office market innovations; short term vacation rentals; Uber and Lyft; intelligent agents (Alexa, Microsoft Cortana, Google Now, Google Home); and augmented and virtual reality.

Autonomous cars will disrupt a wide range of industries, including trucking and delivery services, taxi services, parking garages and lots, car insurance, auto dealers, auto parts, and gas stations. If your business has a focus in any of these areas, it's time to start preparing.

Over time, truck drivers and taxi drivers will become entirely obsolete, and there may no longer be a need for downtown parking structures. In fact, individual car ownership is likely to be replaced by a network subscription to vehicles that are summoned. And we will request rides with our smartphones when we need to get somewhere, much like we do now when requesting Uber or Lyft. The cars would be owned by ride-service companies, and people will simply pay by the mile.

Under these conditions, there may no longer be a need for gas stations on every corner, and there will almost certainly be a major upheaval in the auto insurance market. Just as important, local auto dealerships would be unnecessary, leading to major reductions in sales taxes for local government agencies.

Currently, the technology is present, and Uber is already offering a limited number of driverless rides in Pittsburgh and in Tempe, Ariz. But the largest challenge will be overcoming the regulatory environment, which could take many years.

Governments will need to decide how to develop, tax, and maintain safety standards for this new technology, and their decisions will shape the ways that businesses can provide driverless services. We all know that the driverless revolution is coming, but the speed and direction of this revolution will depend on how governments respond.

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