California Enters the Next Decade With Full Employment and Slowing Growth

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Introduction

In the California Report of late we have been following two trends. First, California unemployment rates, particularly in the largest job markets in the State, are extremely low. Therefore, it follows that the rate of hiring should slow down. Through April of this year, that had not happened. Indeed, the rate of hiring for non-farm payroll jobs increased by 0.2 percentage points from 2018's hiring rate. At some point capacity constraints become binding, and with the October job numbers in place, there are indications that this has occurred.

Second, the pace of growth in the U.S. is slowing. The 2nd and 3rd quarter estimates from the U.S. Bureau of Economic Analysis are for around 2% annual rate of growth. California has now caught up (caught down?) with GDP growth slowing considerably. It is now running at approximately 2.6% per annum on a year-over-year basis.

At present, and in spite of the trade tensions between the United States and China, the economic news remains positive. For example, the July county-wide unemployment rates from Marin to Santa Clara are below 2.2%; from Sonoma through the East Bay are below 2.7%; and in Southern California, Orange and San Diego Counties are at 2.8%. All are below the U.S. rate of 3.6%. To be sure, Los Angeles and the inland regions are not doing as well by this measure but, unemployment rates are falling there as well. In this California Report we review the output, employment, housing and trade statistic, and present the prospects for the coming 2 years. Since National economic growth is slowing at a slower rate than forecast three months ago, the California forecast is now slightly stronger than predicted last September.

Employment Retrospective

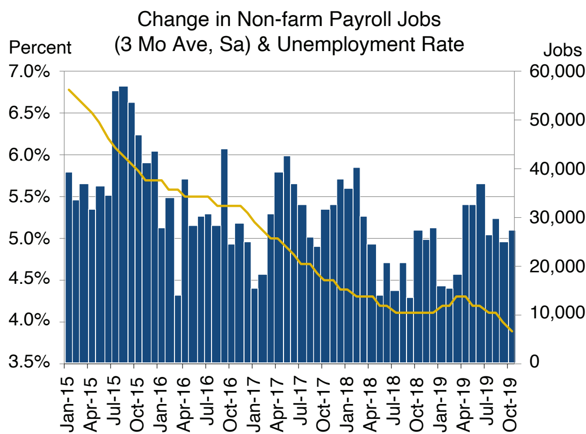
After bumping up to 4.3% last April, the unemployment rate has fallen to 3.9%, very much in the neighborhood of full employment. Part of this was due to a reduction in the labor force and partly due to additional job creation. It is likely, as labor demand in the State has remained strong, that the April labor force number was measurement error, rather than the lower labor force reported representing 200K more discouraged workers. After slowing last year to a monthly average of 23,000 net new non-farm payroll jobs, hiring increased to an average of 26,600 net new jobs per month through the first ten months of this year (Chart 1).

Although overall job growth in the State has remained robust through October, the high value-added sectors; information, professional and business services, and construction, grew at a smaller percentage over the three months ending in October 2019 compared to the previous three months. Growth in the lower value-added sectors of leisure and hospitality, wholesale trade, and other services has also slowed. The balance has been made up by faster hiring in government, temp and administrative services, finance, private education, and durable goods manufacturing.

This shift in the sectoral component of job growth is the reason why California GDP growth is slowing even though non-farm payroll job growth is not. As these are not usually fast-growth sectors, it suggests the more rapid job growth of the past year is abating. One can view this as a kind of "trickle-down" with support services receiving the benefit of previous growth in the high-value added sectors. Although we do not know if this will continue or reverse, with slower national and international growth, our thinking is slanted towards a continuation of this trend.

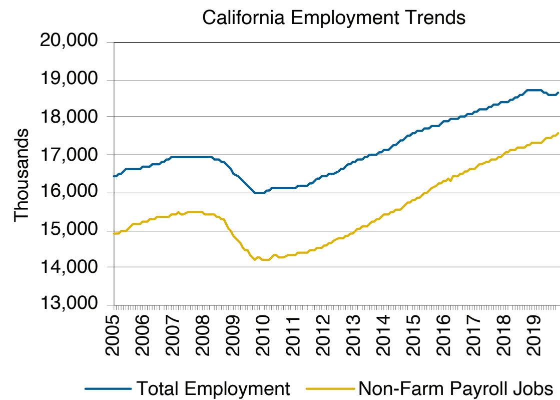
Healthy labor markets in California are also geographically widespread (Chart 4). In the last twelve months, with the exception of Los Angeles and Sacramento, California's major population regions experienced job growth in excess of 2% while the U.S. outside of California experienced only 1.35% growth, the same as Los Angeles. The risks to continued rapid growth continue to be the high cost of housing and the Administrations restrictions on international immigration.

Chart 1



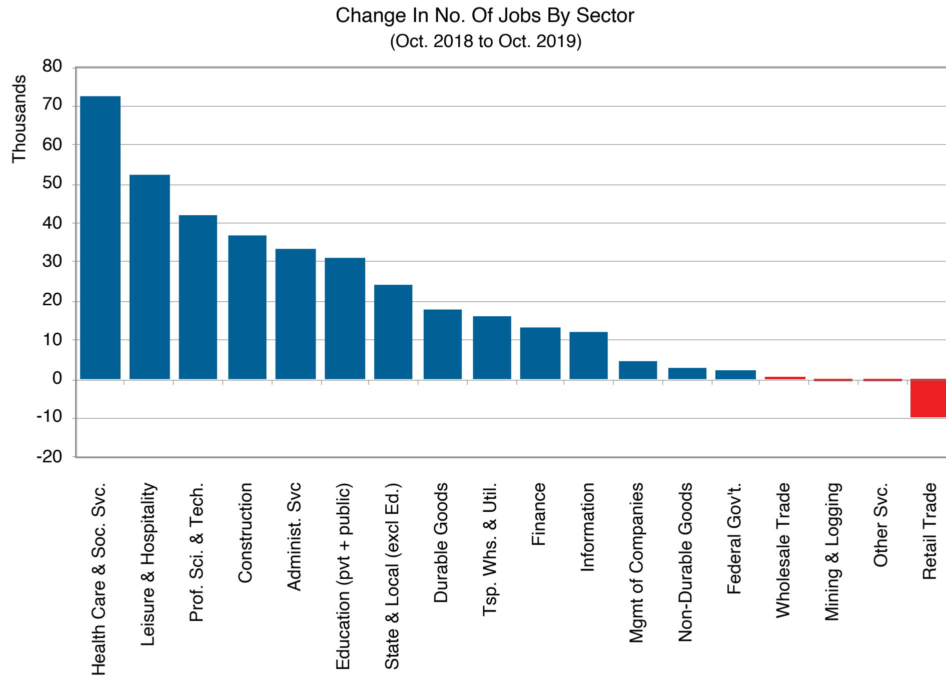
Source: EDD.ca.gov

Chart 2



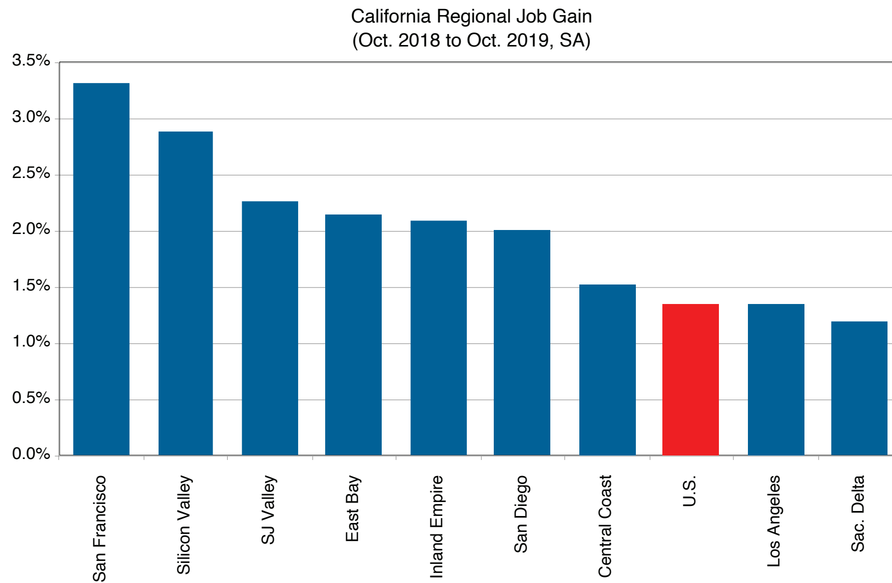
Source: EDD.ca.gov

Chart 3



Source: EDD.ca.gov, UCLA Anderson Forecast

Chart 4



Source: EDD.ca.gov, UCLA Anderson Forecast

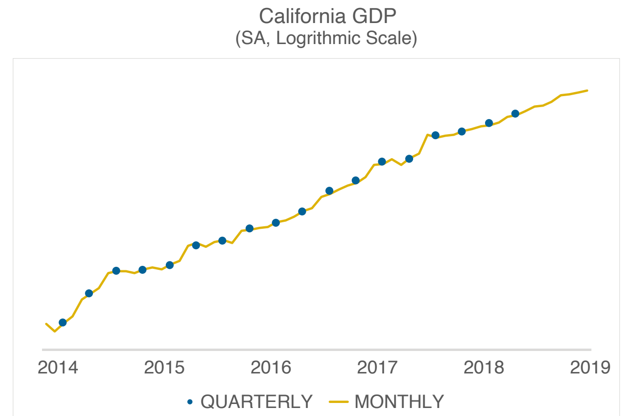
Anderson Forecast Monthly GDP Metric

The Anderson Forecast measure of monthly GDP for the State shows continued, but slowing growth. (Chart 5) The solid line is the Anderson Forecast Monthly GDP Metric and the circles are the quarterly GDP estimates from the U.S. Bureau of Economic Analysis. The UCLA Anderson Forecast metric is contemporaneous and is available shortly after the end of each month, unlike the quarterly BEA numbers which arrive with a considerable lag. The chart is in logarithmic scale, which means that straight lines represent constant rates of change. There is a clear flattening of the slope of the monthly line reflecting the slowing of the California economy from 3.5% growth rate to 2.6% growth.

This is still above the U.S. rate, and while we expect further slowing of the California economy as part of the U.S. economic growth slowdown in 2020, this differential is expected to persist. This is because the weakness in the U.S. economic outlook is due in part to weakness in autos, and California is less exposed to that sector than many other states. Under our assumption of increased imports and exports, California's logistics industry is due to grow more rapidly than the rest of the U.S., and California's tech industry, particularly in the southern part of the State should continue faster than U.S. growth rates.

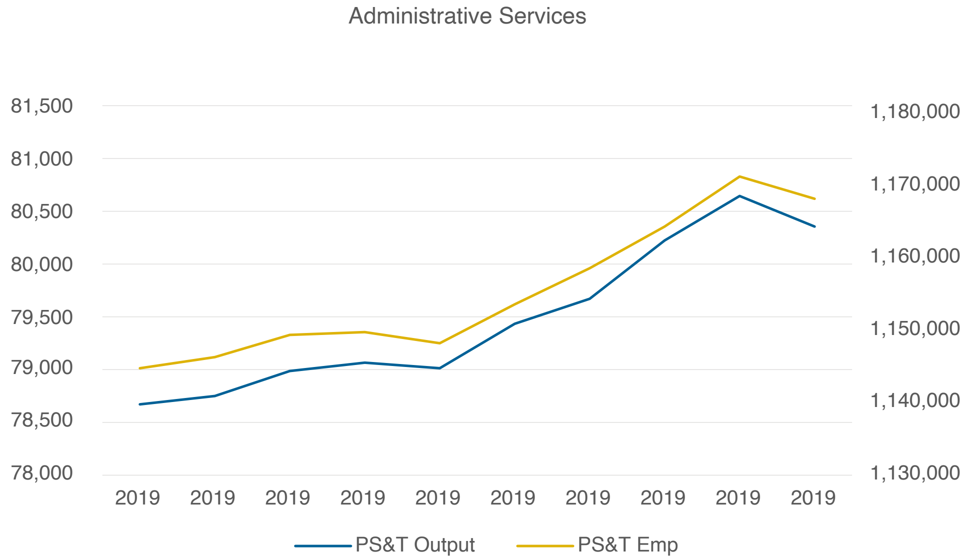
The reason for the slower California GDP growth lies in a shift in the sectors where growth is occurring. This is illustrated with two sub-sectors of Professional and Business Services. Chart 6 shows the output of Professional, Scientific and Technical Services, a high value-added sector. The scales are in the same proportion to each other. As employment grows so does output, but at a faster rate. Some of this is due to increases in productivity and some to increases in hours. In the most recent few months (to the right on the chart) employment growth slows. The decline in output with approximately the same number of jobs is a consequence of declining hours worked in this sub-sector. Chart 7 shows the same two series, output and employment, for administrative services. Here, one observes an increase in employment in recent months and an increase in output. However, the two are growing at approximately the same rate. Thus, employment in the sector grows, but the rate of growth of output (part of State GDP) grows more slowly than a similar increase in employment in higher value-added sectors.

Chart 5



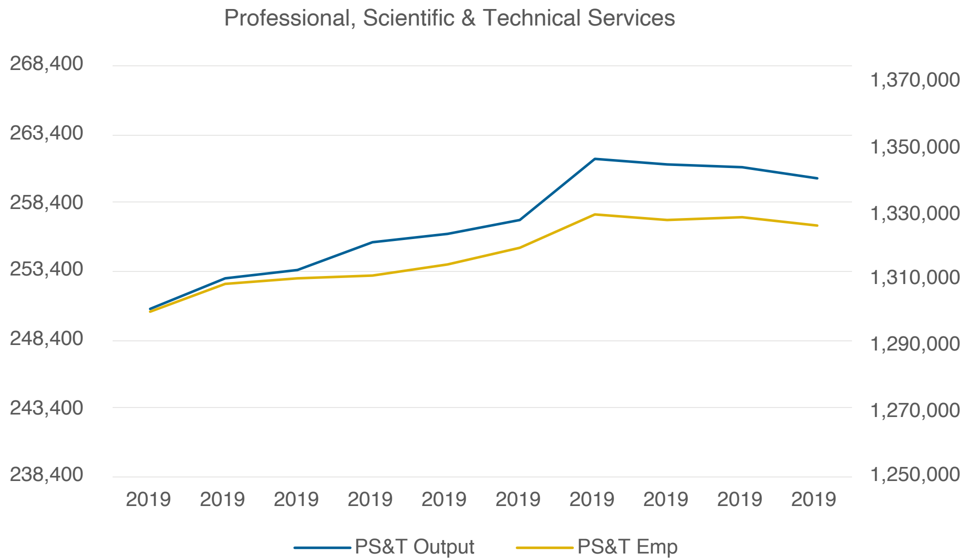
Source: BEA.gov, UCLA Anderson Forecast

Chart 7



Source: BEA.gov, EDD.ca.gov, BLS.gov UCLA Anderson Forecast

Chart 6



Source: BEA.gov, EDD.ca.gov, BLS.gov UCLA Anderson Forecast

Housing Market Retrospective

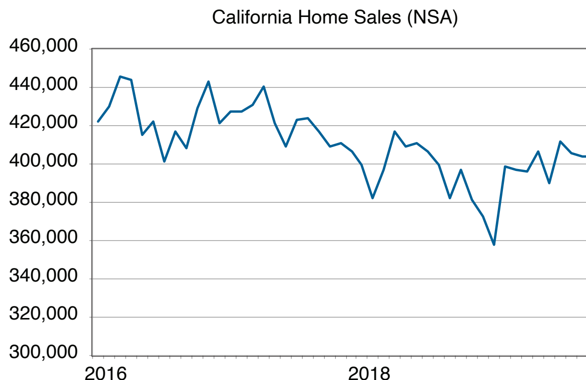
In the last two California reports we presented analyses of California's soft housing market and attributed the softness to expectations of slower price appreciation and possible interest rate cuts. With the recent decline in interest rates, the eight-month softness in housing markets seems to be over. Nevertheless, there is not a return to "normal" housing markets. The sale of single-family detached homes (Chart 8) has been relatively flat at 400,000 these past four months, and is now resting 3.6% below the 2015-2017 historical average as well as 2.6% below the September/October average for the same period. Median home prices have also stalled (Chart 9). Although up from one year ago, over the past six months there has been little to no appreciation in median values. It appears that the falling mortgage interest rates through the Spring of 2019 pushed up home prices but did little to revitalize the real estate market.

With little long-run price appreciation, flat existing real estate sales, and nervousness about the near-term future of housing markets, residential construction continues to languish. The annual rate of building has remained in the 100K to 115K rate since summer began (Chart 10). When one considers the fact that some of these permits were for rebuilding homes lost in natural disasters, the State has clearly fallen behind in home production relative to population growth and future needs, and this is not expected to change any time soon.

Even though there are moves afoot to increase housing production in the State legislature and in City Halls in some jurisdictions, our forecast is for a modest increase in the level of building followed by increased slack when the U.S. economy softens in late 2020, and then followed by a slow recovery of home building through 2021. There are several reasons for this. First there are capacity constraints in building. With elevated employment levels in construction, it is difficult to ramp-up to much higher levels in the short-run. Therefore, easing the permitting process in the face of an inelastic short-run supply, will have only modest impact.

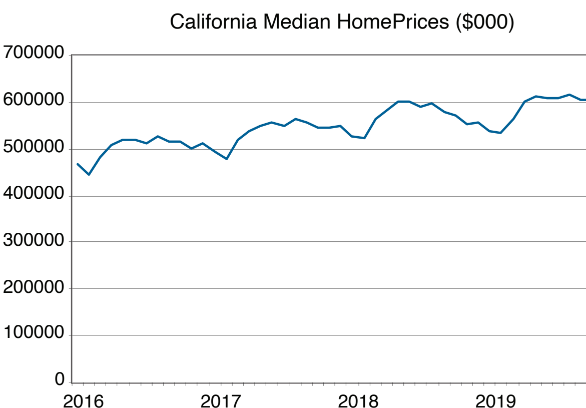
Moreover, there are geographical constraints not imbedded in the regulatory constraints. For example, shortly after Los Angeles accepted a higher home construction target from SCAG, a project in South Los Angeles on a long vacant lot near the Crenshaw transit line was turned down. The rationale for the rejection was that local residents, who are not affluent LA Westsiders, feared the project would be a gateway to the gentrification of their neighborhood. Ultimately, the 577 new homes may be built in the Crenshaw Corridor, but it will take time to sort out.

Chart 8



Source: California Association of Realtors

Chart 9



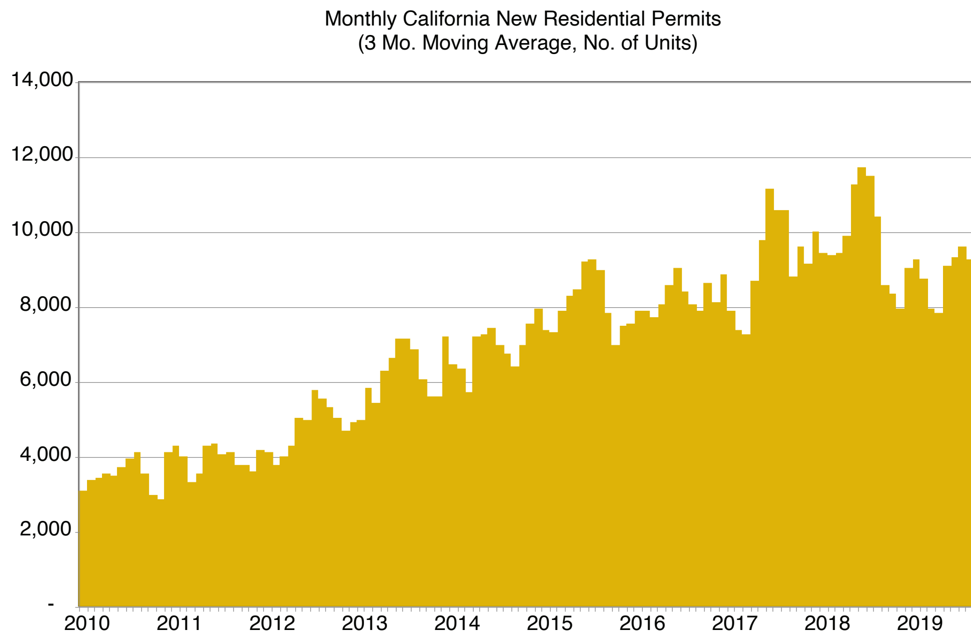
Source: California Association of Realtors

Trade and Trade Wars

Trade wars are on everyone's mind with respect to the economy. California, with large ports and supporting logistics industry, is more vulnerable to a direct impact than in other parts of the U.S., at least as far as trade disputes with China are concerned. The trade wars have indeed had an impact on California the past three months, but with respect to employment, not by much.

Total goods movement for the three months ending in October 2019 through the ports of Long Beach, Los Angeles and Oakland are down by 4.5% relative to the previous year. International air cargo at LAX and SFO is down by nearly 10% for the same period. Cargo movements through Ontario and Oakland airports, which are distribution centric airports, are also down over the past three months.

Chart 10



Source: U.S. Department of Census

Nevertheless, employment in the transportation, warehousing and utilities sector has not dropped significantly since summer. Though there is some cause for worry, particularly with the potential for increased trade tensions, at present the shift from brick-and-mortar to online retail has kept the trade war disruption from having a major impact on employment in the logistics industry. In addition, the backlog of demand for warehouse space, has kept absorption of new industrial buildings at high levels. To be sure, without the trade wars this industry would have grown, but at present it is holding its own. Although we do not expect significant disruption of trade between the United States and the industrial centers of Asia in the future, the possibility remains an important risk of the forecast.

The Forecast

The U.S. forecast update in December represents very modest changes to the outlook since the previous update last September. The weakness in housing still persists and we have lowered slightly the housing production forecast for 2020. The less pessimistic U.S. economic forecast for 2020 is reflected in the present forecast. The increase in the unemployment rate for the end of 2020 and the beginning of 2021 is a consequence of the slower growth during this period. It is followed by a rebound in economic growth and hiring in 2021. For the entire years 2020 and 2021 we expect average unemployment rates of 4.3% and 4.6%, respectively.

Our forecast for 2020 and 2021 is for total employment growth rates to be 0.9% and 1.3%. Payroll jobs are expected to grow at a 1.9% and 0.9% rate, respectively. This reflects the stronger growth in payrolls over the last year, even while total employment growth was weaker. Real personal income growth is forecast to be 2.1% and 1.9% in 2020 and 2021. The continued growth in real personal income in 2020 is reflective of the changing mix of employment in California and tight labor markets in high wage occupations. Homebuilding will be lower by about 5,000 units in 2020 than previously forecast, but we remain optimistic with regard to 2021 new residential construction. Needless to say, weakness in home building, even with the new eased regulations and zoning, means that the prospect for the private sector building out of the housing affordability problem over the next three years is nil.