


Financial, Real Estate & Creative Industries Insider

2016
SONOMA COUNTY

SONOMA COUNTY
EDB
ECONOMIC DEVELOPMENT BOARD

SONOMA COUNTY
WORKFORCE INVESTMENT BOARD

2016 Financial, Real Estate & Creative Industries Insider

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the 2016 Financial, Real Estate & Creative Industries Insider for Sonoma County. Our research partner, Moody's Analytics, provided the research for this report.

Highlights of the 2016 Financial, Real Estate & Creative Industries Insider include:

- Despite low inflation and global uncertainty, Sonoma County's financial institutions will strengthen as sturdier balance sheets and rising incomes will fuel demand for mortgage and consumer lending.

- Stronger wage growth will unlock pent-up demand in the residential real estate market, boosting household formation and residential construction. Commercial vacancy rates have fallen swiftly over the past year and stand at their lowest levels in more than a decade.

- The outlook for the creative industries is generally bright, driven by growth in engineering and scientific consulting services, as well as a thriving arts community.

- The past two years have seen the best back-to-back performance for the job market since the tech stock bubble in the late 1990's, and the labor market will reach full employment by this summer.

Thank you for your interest in the Economic Development Board's research. For additional information, questions, comments, or suggestions please contact us at (707) 565-7170 or visit www.sonomaedb.org.

Sincerely,

Pamela Chanter
Pamela Chanter
Chair
Economic Development Board

Ben Stone
Ben Stone
Executive Director
Economic Development Board

Sonoma County: Financial, Real Estate & Creative Industries

Recent Performance

Sonoma County made large strides in the second half of 2015, and its economy has returned to full health. Output, employment and incomes have fully recovered the ground lost during the Great Recession, and the county's economy is adding jobs at a faster pace than the U.S. economy. Tourism and viticulture— Sonoma's principal economic drivers—are fully engaged, and tech-related professional services also provide support. The jobless rate fell below the U.S. average in 2013 and ended 2015 at 4.3% even amid steady labor force growth.

The labor market is fast approaching full employment, and the greater competition for workers is lifting wages. Average hourly earnings rose steadily over the course of the year while the average workweek has lengthened.

Sonoma County's real estate market made halting progress in 2015. House prices rose at a steady clip. According to the California Association of Realtors, median house prices have recovered 75% of their peak-to-trough loss, on par with the state average. However, flagging sales of existing singlefamily homes kept builders on the sidelines and prevented a broader recovery in residential construction from taking hold. Issuance of construction permits for single-family homes remains at a four-year low. Multifamily units continued to make up an outsize share of residential construction.

Macro Drivers

The U.S. economy decelerated in the second half of 2015 as energy firms cut back on investment and the strong dollar depressed exports. Widening credit spreads, China's slowing economy, and the broader slowdown in emerging markets also subtracted from growth. Despite these challenges, the economy advanced by 2.4% in 2015, shy of expectations at the start of the year but on par with its average over the course of the recovery. The Moody's Analytics forecast calls for the economy to advance at a similar pace this year, sustained by greater consumer spending and a more robust recovery in the housing market.

The modest outlook for output growth stands in contrast to the white-hot labor market. The economy added 2.7 million jobs in 2015 on top of the 3 million new positions created the prior year. Together, the two years represent the best back-to-back performance for the job market since 1998-1999, when the tech stock bubble was in full swing. At the current pace of gains, the labor market will reach full employment by this summer.

Full employment will bring tangible benefits for the economy, most importantly in the form of better wage growth. The pickup in wages will do more to lift consumer spending. Better wage growth will also help households accumulate sufficient savings for a down payment, boosting household formation, home sales and residential construction.

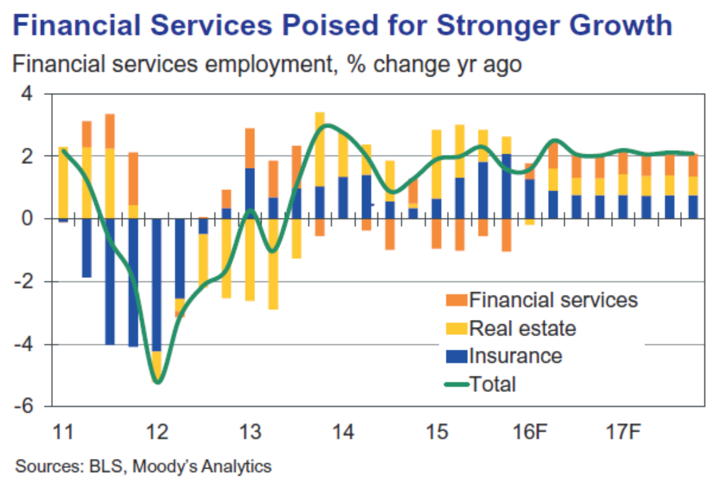

Chart: *Employment in Sonoma County's real estate, insurance and financial services declined precipitously following the closure of Sonoma Valley Bank in 2010 and the departure of State Farm's Sonoma-based regional headquarters the following year. However, robust growth in loan volumes and stronger earnings at Sonoma-based financial institutions have restored the industry to growth. Sonoma's financial services will make a stronger contribution to hiring over the next two years as the local labor market tightens and demand for mortgage and consumer lending accelerates.*

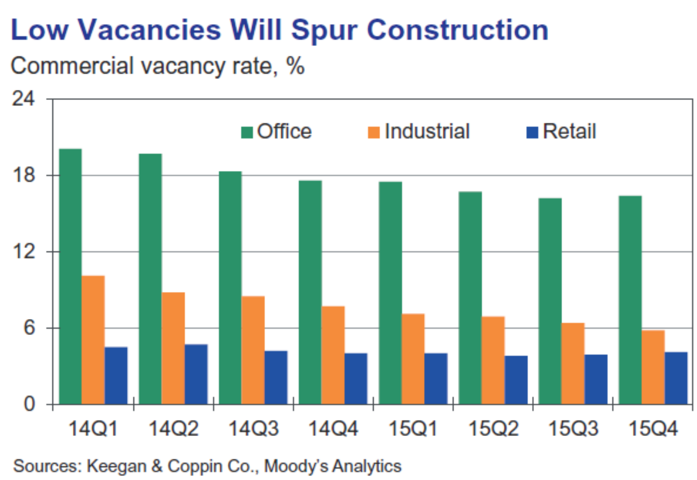

Chart: *The market for commercial real estate tightened in 2015. Office vacancy rates fell to their lowest level in more than a decade as office-using employers ramped up hiring. New construction growth will be largely limited to healthcare providers, but vacancy rates for industrial space are poised to decline as Sonoma's winemakers, craft breweries, and medical device makers move forward with plans for expansion. Greater startup activity in Sonoma County, concentrated largely in biotech, will brighten the prospects for industrial space.*

Low productivity remains a hurdle and explains in part why, despite less than spectacular output growth, the job market has logged such strong gains. Though businesses faced few incentives to invest in labor-saving technologies earlier in the recovery, this will soon change as the job market tightens and wage growth accelerates. More concerning is the drop in business formation, a proxy for risk-taking and innovation. The psychological damage of the recession may have tamed entrepreneurs' appetite for risk. The shift in sentiment could deal a more permanent blow to productivity, with large negative consequences for living standards, household wealth, and the nation's fiscal position.

The plunge in oil prices will be a net positive for the economy as consumers spend the windfall from low gasoline prices. However, the plunge in crude will cut into business investment as energy firms scale back exploration and production.

Financial Services

After six years of near-zero interest rates, the Federal Reserve has finally embarked on the process of normalizing monetary policy. The Board of Governors raised the federal funds rate by 25 basis points at its December meeting, the first rate increase in nearly a decade. Because of the large quantity of reserves in the financial system, the Fed has introduced new policy instruments to guide the federal funds rate, but so far, the new measures have proved effective.

Stubbornly low inflation in the U.S. and global uncertainty will likely push back the Fed's timetable for future rate increases. Nevertheless, higher short-term rates will pose a substantial risk to smaller financial institutions that rely primarily on deposits. The Fed's still-large balance sheet and monetary easing in Europe and Japan will press down on yields at the longer end of the curve. Meanwhile, higher short-term rates will raise the cost of capital.

Despite these challenges, Sonoma County's financial institutions will strengthen. Santa Rosa-based Exchange Bank, the largest community bank in Sonoma County, recorded a 19% rise in net income in 2015, helped in part by the recovery of nonperforming loans. Earnings at Summit State Bank, also headquartered in the county, rose as loan volumes grew for the second consecutive year. Overall asset quality is good and consumer credit is close to pristine. According to Equifax, delinquency rates for mortgage, bank and credit card loans have fallen to prerecession levels and remain well below the state and national averages. Sturdier balance sheets and rising incomes will fuel demand for mortgage and consumer lending, underpinning the strong outlook for financial services employment.

Real Estate

Sonoma County's housing market is holding onto earlier gains, but homebuilders struggled to gain momentum over the course of 2015. While the nominal value of home sales reached its highest point since 2005, sales volume was relatively muted and ran at less than half its trend before the housing boom. House price appreciation has eased from its peak in 2013, but house prices are still rising at nearly twice the national rate. Rapid house price gains have hurt affordability and home sales and have discouraged builders from adding to supply. The pace of single-family construction remains moored at a four-year low.

Stronger wage growth this year will be the catalyst for unlocking pent-up demand. As the labor market tightens and wage growth accelerates, more households will take the leap into homeownership, boosting household formation and residential construction.

The market for commercial real estate will tighten as business conditions improve and national and local firms expand their footprint in Sonoma County. Vacancy rates for office, industrial and retail space fell swiftly over the past year and stand at their lowest levels in more than a decade, according to Keegan & Coppin Co. The office vacancy rate in Sonoma County fell to 16% in the fourth quarter of 2015 as office-using industries from finance to healthcare expanded with vigor. Lower vacancy rates, especially in the Santa Rosa and Petaluma submarkets, have helped to spur new construction. Downtown Santa Rosa will welcome its first new office building in more than 10 years as construction on the Museum on the Square complex draws to a close, while rapid growth in Sonoma's healthcare industry will prime demand for new office space. Sutter Medical Center recently completed work on a new urgent care center in Santa Rosa, while Kaiser Permanente will break ground on a new medical campus in Santa Rosa this spring.

Competition for industrial space will intensify over the coming year as Sonoma's winemakers, craft breweries, and medical device makers push forth with plans for expansion. The industrial vacancy rate fell nearly 2 percentage points over the past year to 5.8%, its lowest point since the dot-com boom. Planet One Products, a maker of appliances and accessories for wine storage, moved its headquarters to the vacated Cisco Systems building in Petaluma last year, more than doubling the size of its production and warehouse space. Low vacancies will spark new construction: Synergy Health will complete work on a new plant in Petaluma this year, where it will produce sterilization equipment. The vacancy rate for retail space held firm at 4% as greater leasing activity was offset by the opening of new shopping centers. The Deer Creek Village shopping complex, one of two new malls opened in the last two years, will create additional space for retailers upon completion in early 2016.

Moody's Analytics Financial, Real Estate & Creative Industries

Insurance

Health insurers operating in Sonoma County will benefit from a growing pool of insured residents, although the industry will still need time to adapt to regulations put in place by the Affordable Care Act. Insurance premiums are expected to rise little this year, while insurers face greater cost pressures because of the Medical Loss Ratio requirement, which mandates the use of at least 80 cents of each dollar on services to members.

The extension of the ACA's employer mandate to businesses with fewer than 100 employees introduces a degree of uncertainty to the outlook. While the mandate could initially raise costs for boutique wineries and smaller craft brewers, it will further drive demand for insurance as smaller businesses roll out new insurance plans.

California's persistent drought will present an opportunity for another local insurance segment, crop insurers. Many wine grape growers took advantage of federal subsidies to upgrade their insurance policies in 2015, and the extension of federal subsidies this year will benefit local providers of crop insurance such as Santa Rosa-based American Ag Credit.

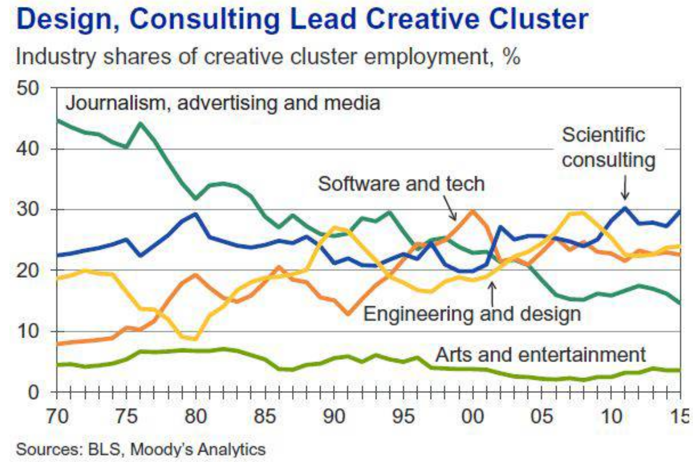

Chart: *Sonoma's creative industries will outpace the rest of the economy thanks to robust gains in scientific consulting services and spe-cialized design. However, the cluster will not recover its former importance because of the subdued outlook for software and tech services. In contrast to the strong rebound at the state and national levels, employment in computer systems design and software devel-opment has fallen by one-third since the tech boom. Creative arts will thrive but will not move the needle on total output or employ-ment because of their small share of the cluster.*

Creative Cluster

The outlook for the creative cluster of industries is generally bright, but slower growth in the sciences and technology share of the cluster will temper its near-term prospects. Employment in creative industries has grown faster than in the rest of Sonoma's economy over the past two years thanks to rapid growth in engineering and scientific consulting services, but there is still much ground to recover. Employment in tech-related services such as software development and life sciences research has remained largely flat during the recovery while the two industries rebounded swiftly at the state and national levels. As a result, the creative cluster's share of the economy has fallen below the average for the Bay Area and the state.

Top tech employers Keysight Technologies and Medtronic continue to maintain a large research presence in the county but will contribute less to hiring than they did earlier in the recovery. Meanwhile, hiring by smaller tech firms and startups remains meek. Given tech's large share of the cluster, slower growth in tech-related services will weigh on the overall outlook for creative industries.

Sonoma boasts a thriving arts community, and the share of total employment in the creative arts is among the highest of midsize counties. As the local labor market tightens and income growth solidifies, artists and performing arts companies will benefit from increased discretionary spending on arts and entertainment. Sonoma is fast-emerging as a hub for visual and graphic design, and local wineries' push for more distinctive labeling will bolster local design professionals.

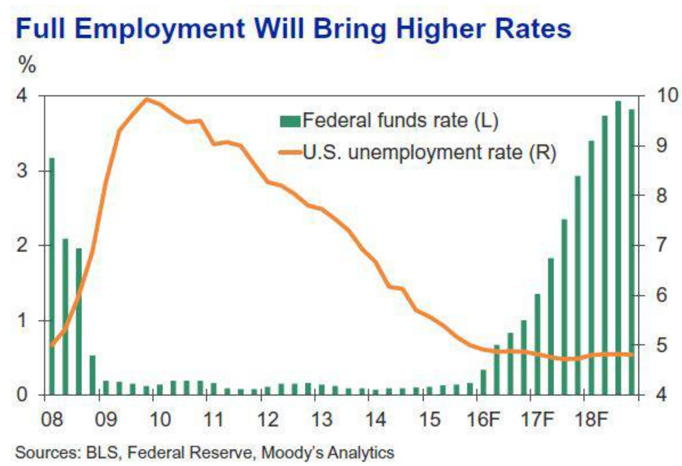

Chart: *Strong earnings growth at Sonoma County-based financial institutions will lift finance and insurance employment over the next two years. The sector has struggled since the closure of State Farm Insurance's regional headquarters in 2011, while the mid-2013 spike in mortgage interest rates added further strain. However, strengthening household and business sheets will drive a rebound in demand for financial services, boosting earnings and returning the sector to growth. Finance, insurance and real estate payrolls will grow by nearly 2% in 2015 and 2016.*

Moody's Analytics Financial, Real Estate & Creative Industries

Long-Term Outlook

After several lean years, Sonoma's financial services and real estate industries are back on their feet and will make a larger contribution to the economy as wage growth accelerates and the housing recovery kicks into high gear. Strong population growth and improving income growth will boost demand for single-family homes, and the large economic multiplier from singlefamily homebuilding will boost finance, insurance, and other housing-related industries. The large retiree cohort will also lift demand for asset management and insurance services.

Sonoma County's low business costs relative to the Bay Area and large pool of skilled labor will drive growth in the creative cluster, though as a share of total output and employment, creative industries will remain below the average for the Bay Area and the rest of California. Recent growth in biotech and specialty life sciences research is promising, but will not result in many new positions.

The outlook for the creative arts share of the cluster is more upbeat. Sonoma's vibrant arts community will flourish as disposable incomes grow and local arts councils help artists to better market their wares.

Upside Risks

Better than expected population growth would pay large dividends for Sonoma's finance, real estate and insurance industries. Population growth has rebounded following its post-recession swoon, and with housing affordability deteriorating in neighboring Marin and Napa counties, in-migration to Sonoma could strengthen. The demographic bonus would spur an even stronger recovery in residential construction and consumer industries while also boosting mortgage and consumer lending and demand for insurance products.

As the U.S. economy improves, rising tourist visits to Sonoma County will lend upside potential to the creative arts. Local art galleries and performing arts companies will benefit as consumer sentiment strengthens and visitors to Sonoma's wineries seek broader options for leisure. Integrating the arts into the tourist experience will not be easy since wineries will remain the primary tourist attraction, but recent efforts by local arts councils to promote local galleries and performing arts companies are a good start.

Downside Risks

Further strain in Europe and emerging markets would weigh more heavily on exports of locally produced wines as well as telecommunications and medical equipment. A larger than expected hit to exports would hamper the outlook for the sciences and technology share of the creative cluster. Despite recent financial turmoil, emerging markets are rapidly scaling the value-added chain, and the offshoring of high-wage research and development positions could imperil tech-oriented creative professions in Sonoma County.

Greater uncertainty over the path of monetary policy could hurt Sonoma's financial services and real estate industries, especially if the Fed significantly delays or is forced to reverse plans to raise rates. A new round of quantitative easing would further pressure long-term yields, squeezing profits at Exchange Bank and other local financial institutions.

Jesse Rogers
Ilir Hysa
Moody's Analytics
February 2016

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Economic Development Board
141 Stony Circle, Ste. 110
Santa Rosa, CA 95401
(707)565-7170
www.SonomaEDB.org