Sonoma County
Economic Development Board

Manufacturing Industry Insider

2024

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March 2024

Executive Summary

Recent performance

Varied success

The manufacturing sector in Sonoma County has witnessed varying performances, with food manufacturers demonstrating resilience and growth, while beverage manufacturers are facing a period of deceleration after a robust expansion in the previous years. Recent data suggests that manufacturing employment in Sonoma County may experience slower progress in the near future, posing potential challenges.

Macro-economic landscape

Despite reports of large layoffs in various industries, unemployment insurance filings have remained stable. Inflation has returned to the Federal Reserve's target level, as measured by the consumer price index, and their mandate of achieving full employment and stable inflation may lead to lower interest rates, although it is unclear when those changes will be issued.

Outlook

Durable and nondurable goods

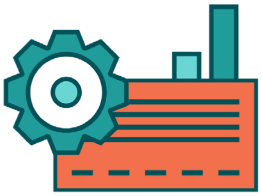
Both durable and nondurable sectors experienced fluctuations in production levels, but the outlook appears brighter for durable goods producers. Federal incentives, such as the CHIPS act and Inflation Reduction Act, are expected to drive investments in the medium term, particularly in areas like semi-conductor and battery production. The rise in domestic production of essential components aligns with the increasing demand for consumer and business goods, supported by advancements in AI and remote work technologies.

Workforce

Moderating labor costs and commodity price increases are anticipated to impact operating expenses, although overall commodity prices are projected to remain lower than in previous years. Industrial vacancy rates have been on the rise, potentially lowering the price ceiling for industrial leases.

Long-term outlook

Sonoma County's manufacturing sector has opportunities in organic food production and automation technologies. The labor market, although showing signs of loosening, remains tight, meaning job growth will slow. There is potential for wages to rise later in 2024 associated with the deceleration of job growth.



Recent Performance. Sonoma County's manufacturing industry is making progress. Manufacturing payrolls are ticking modestly higher. Food manufacturers performed well during the past year, while beverage manufacturers are slowing after robust growth in 2022. Combined, these two industries account for more than three times the share of industry employment than they do at the state level and have been crucial in driving growth in manufacturing in recent years. This is especially important as the electronic testing and telecommunications industry is a shadow of its size from the 1990s and contributes less to job and income growth.

Despite the steady progress marked in the payroll data, the Quarterly Census of Employment and Wages provides a more accurate but lagged total count of jobs in the county and suggests that Sonoma County's manufacturing industry is in worse shape through the first half of 2023. The QCEW data indicate a sharper correction through the first half of the year, so revisions to manufacturing employment will likely show weaker progress among Sonoma County's manufacturers. This is especially apparent among food manufacturers, where the QCEW data point to a significant contraction in the second quarter of 2023, giving up most of the strong gains from the prior year.

Macro drivers. The U.S. economy is performing well, and near-term prospects are good. This has become a mantra for us as the economy remains resilient. It is early in the first quarter, but our tracking estimate for annualized real GDP growth in the quarter is just less than 3%. The job market also continues to produce lots of jobs, with payrolls increasing by an average of near 250,000 jobs per month over the past year. Unemployment remains firmly below 4%, as it has for the past two years, and all demographic groups are enjoying the low joblessness. Annual inflation is hovering near 3%, which is still above the Federal Reserve's target, but the rate has moderated consistently since peaking in mid-2022, and the Fed's target is coming into view.

Bolstering the view that the labor market is in no danger of slowing sharply has been the weekly data on the number of people filing for unemployment insurance benefits. The levels of new UI filing have been extremely low for most of the past two years. Only briefly in early 2023 did UI claims rise to levels that warranted some additional attention, but they quickly fell during the summer months. Continuously low levels of UI filings have again coincided recently with media reports of large layoffs in several industries, notably tech, finance and retail. Yet UI claims have not budged.

The quits rate—the share of workers who are leaving jobs voluntarily, presumably for better opportunities—has been trending lower. Slower job growth and churn will be a weight on income growth. People who change jobs normally get larger raises than workers who stay put, and higher unemployment may weigh on workers' requests for raises. Like the labor market, but perhaps to a greater degree, balance sheets remain strong but are clearly past their peak. Wealth typifies this situation. After peaking in the first quarter of 2022, wealth fell with the stock market and barely hit a new high at the end of the second quarter of 2023. However, the recovery proved fleeting as wealth fell below both those peaks in the following quarter.

Aside from the growth in the cost of housing, inflation has already returned to the Federal Reserve's inflation target, at least as measured by the consumer price index. With market rents flat to down in the past year—and likely to remain soft given all the multifamily supply set to hit the market this year and further push up vacancy rates—housing costs, which are tied to rents, should slow substantially in coming months. Aside from an unexpected spike in oil prices or widespread disruption to global supply chains, inflation will be back consistent with the Fed's target by year's end.

It appears increasingly likely the Fed will soon achieve its dual mandate of full employment and low and stable inflation. Therefore, it is increasingly untenable for the Fed to maintain the fed funds rate at 5.5%, which is 3 percentage points above the Fed's own estimate of r-star. While it would be desirable for the Fed to begin cutting rates at the next meeting of the Federal Open Market Committee in a few weeks, we expect policymakers will wait until the May meeting. They will then cut the funds rate by 0.25 point at every other FOMC meeting, more or less, through spring 2026. Whether Fed officials move in March or wait until May probably will not make much difference, but there is a not-inconsequential risk that they will wait too long. The longer they do so, the greater the chance the economy may falter for reasons that are increasingly difficult to defend.

Industry drivers. Manufacturing is primed for a strong rebound this year. The sector experienced a strong beginning to 2023, but this was followed by a period of stagnation for the majority of the year. By the final quarter, a decline in production had set in once again. The impact of these production difficulties has been more pronounced among producers of nondurable goods, with output volumes falling approximately 3% since their highest point in the economic cycle in early 2022. On the other hand, producers of durable goods have fared somewhat better, with a decrease in production of just 1.4% from the highest point in the cycle. Despite these declines, the current levels of production for both categories are approximately equivalent to the average levels in the five years before the onset of the pandemic.

Nondurables producers will have varying levels of success this year. Many nondurables industries such as printing and support, textiles, and petroleum and coal manufacturing face structural issues that will work to drive down production. Despite the poor outlook, advancements in automation as well as replacement of capital stock and improvements in energy efficiency will keep many firms investing, even if some production is being lost. The larger domestic nondurables industries such as food and beverage and chemical manufacturing will see activity pick up further over the next year. Falling food prices will support more consumer spending on food and beverage products.

This bodes well for Sonoma County. Furthermore, strong visitor spending and arrivals are supporting growth in local breweries and wineries, and a strong grape harvest at the end of 2023 in both quality and tonnage will provide a tailwind for local winemakers. Sonoma County's organic producers are reaping the benefits from their early entry into the organic food and beverage market. Despite the cost advantage that conventional offerings hold relative to organic products, coupled with inflation pressures that made consumers more cost-conscious, organic food sales continued to outpace their nonorganic counterparts and doubled the pace of growth in 2022.

The outlook is also much brighter for durable-goods producers. Advanced manufacturing takes center stage. New orders and production of information processing equipment jumped in the fourth quarter, which augers well for further gains this year. Federal incentives through the CHIPS Act and the Inflation Reduction Act will drive investments in the medium term. On a real chain-weighted basis, nonresidential manufacturing structure investment rose $14 billion in 2023, the largest quarterly increase on record. The increase in domestic production of semiconductors, batteries, and other related components will be important channels for new business investment. These products are needed for everyday consumer and business goods such as phones, computers and cars, and they are critical to the burgeoning fields of artificial intelligence and other renewable energy products such as batteries. New production facilities this decade will help drive rapid gains throughout the forecast horizon, with the computer and electronic product industry forecast to surpass transportation as the nation's largest manufacturing industry in the early 2030s. Sonoma County will benefit from these trends, albeit to a slightly lesser extent given that its manufacturing base is more downstream from semiconductor production. The rapid development of artificial intelligence and persistent remote work will benefit local electronic testing and broadband equipment makers, along with ongoing modification efforts of the internet infrastructure and demand for smart-home and other household devices that rely on mobile connectivity. This will drive sales for Sonoma County-based Keysight and broadband equipment maker Calix.

The aging global population and older workers who remain in the workforce for longer than previous generations will sustain demand for advanced medical procedures and medical equipment, including those produced by Medtronic, Claret Medical and Endologix.

Pricing. Softening crop prices will provide a much-needed respite for food and beverage producers. After surging because of the Russian invasion of Ukraine, crop prices have nosedived and sit nearly 20% lower in the fourth quarter of 2023 compared with a year prior. While they will increase modestly moving forward, they will stay far below levels seen during much of 2022. Growing competition in the organic space will apply some restraint. Additionally, reduced input costs and generally slowing inflation pressures will ensure price increases do not match the pace seen over the past year.

Still-improving supply chains and slowing wage growth as the labor market downshifts in the next year will keep price increases only modest throughout the next year. Global semiconductor production is also on the rise, which will help durable manufacturers that rely on these chips for their control systems.

Operating expenses. Sonoma County's manufacturing cluster will see some respite from moderating labor costs. There are already signs that the labor market is cooling despite headline job growth coming in strong. The employment cost index rose 0.9% in the fourth quarter. This marks a slowdown from the 1.1% growth in the third quarter and was slightly below expectations. Wage growth also moderated to 0.9% in the fourth quarter, and year-over-year growth edged lower to 4.3%. Benefits for private workers increased 0.6% after rising 0.8% in the prior quarter. While the labor market remains tight, wage growth is moderating. Labor costs are a substantial share of operating expenses for the county's various manufacturing firms, and easing wage growth will slow the pace of growth in operating expenses.

Commodity prices will advance at a modest pace, but price increases through the next year will still leave overall commodity prices much lower than they were throughout much of the past two years. Energy prices are likewise off their highs and will be pressured lower because of increased supply. Record-high U.S. oil output and rising supplies from major producers including Canada, Guyana and Brazil have offset subdued production from Saudi Arabia and Russia.

Industrial vacancy rates rose throughout 2023 and strong industrial building will keep vacancy rates elevated compared with the previous two years. Industrial rents will therefore pull back slightly given elevated vacancy rates. Local research and development facilities have avoided most cost-cutting efforts, but the trend toward lower-cost tech spaces in the South and Mountain West will provide another avenue for firms looking to trim costs.

Long-term outlook. The mainstreaming of the organic food movement will create new opportunities for county producers, especially as some consumers prioritize environmental and ethical practices in the production of the food and clothing they purchase. The county's reputation as a haven for sustainable and organic farming practices will help burnish its advantage as organic food sales grow as a share of total food sales, but mass-market organic brands at large food stores will require that Sonoma County's brands remain ahead of the curve.

Greater automation and a general push toward labor-saving technologies will slow the pace of job additions even as county producers grow their operations. Thus, manufacturing's contribution to countywide job and income growth will be contingent on entrepreneurs' ability to innovate across product lines and to pioneer new product segments.

Robust growth of food and beverage manufacturing facilities within the county itself has also cleared some of the inventory of industrial space. Still, recent progress in industrial building is a welcome sign, and according to commercial real estate firm Keegan & Coppin, there are still several planned expansions that will increase the supply of industrial buildings in the county and enable firms to expand their operations.

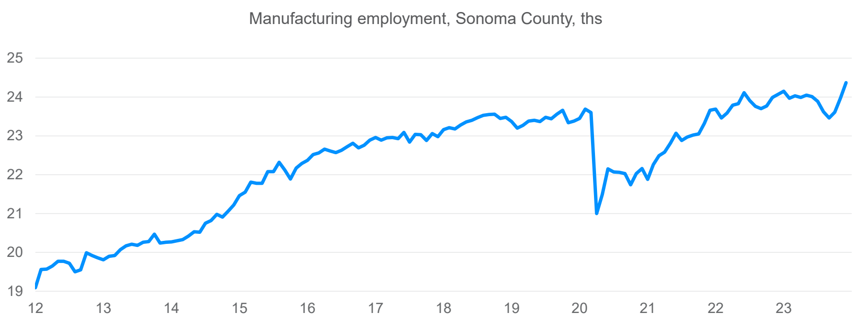
Land and labor constraints that are rearing their heads throughout the state are becoming even more apparent in coastal areas, and Sonoma County is already experiencing waning housing affordability. Net migration made modest improvements in 2023, according to high-frequency data from Equifax, but the county still lost residents most of the year. Stronger demographic trends will be crucial to incentivize more firms to locate in Sonoma County. The housing market will rebalance and a slower pace of house price appreciation will improve affordability, but it is crucial that it does so quickly to ensure that the supply of workers continues to grow and outruns labor supply shortages.

Upside risks. Decades-high inflation and policy tightening by the Fed to bring it down will weigh on consumer spending. Nevertheless, the insatiable U.S. consumer has been surprisingly resilient. The baseline forecast could again underestimate consumer spending, which would result in faster growth. The labor market is loosening but remains tight, keeping job and income growth elevated. Businesses, correctly, are calculating that labor supply issues in the aftermath of the pandemic are here to stay, leading them to retain staff despite slowing demand. This dynamic could push household income up faster than expected. As much of the income is spent, the economy would grow above expectations—particularly benefiting Sonoma County manufacturing producers that rely heavily on consumer spending, most notably the food and beverage industry.

Downside risks. If the Fed misreads financial conditions or overestimates the U.S. economy's strength and leaves policy too restrictive for too long, business investment and consumer spending will turn downward, weighing heavily on the economy. Conversely, if the Fed mistakenly eases policy too quickly, inflation could come roaring back. This would entrench higher inflation expectations from consumers and businesses because the central bank would have sacrificed credibility. This would make ridding the U.S. economy of elevated inflation even more difficult and lead to a prolonged and painful economic downturn. However, this risk is diminishing since the Fed has now lifted policy above what Moody's Analytics considers sufficiently restrictive, and inflation shows a clear downward trend.

Colin Seitz
February 2024

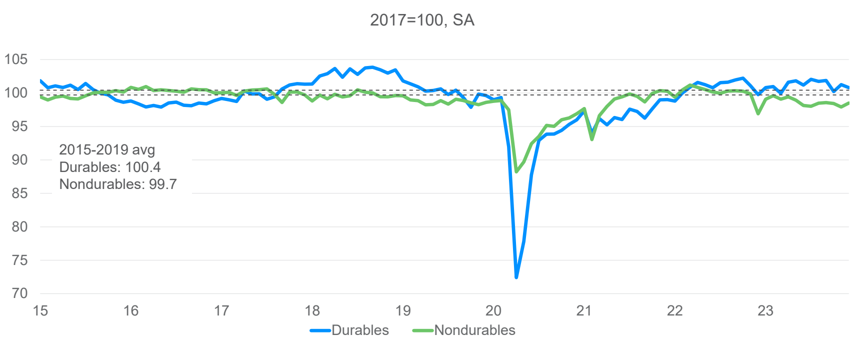
Manufacturing Employment Crests New Heights



Sources: BLS, Moody's Analytics

Sonoma County's manufacturing base had shifted away from high tech toward nondurable goods manufacturing in the early 2000s, and growth prospects are tilted toward food and beverage manufacturing. High-tech manufacturing payrolls have moved higher in recent years, but the growth of food and beverage manufacturers ensures they will command a growing share of manufacturing employment.

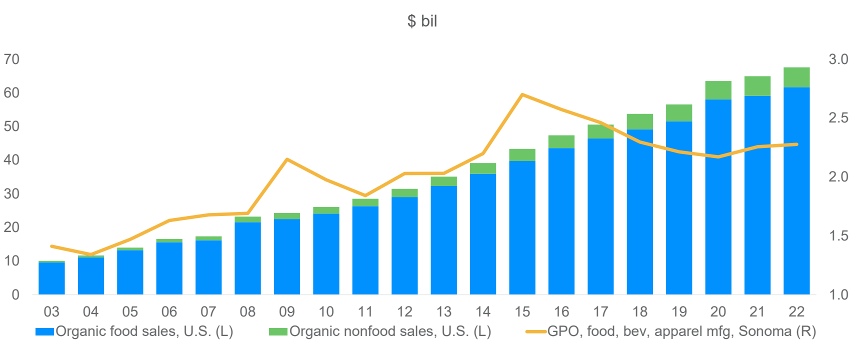
U.S. Industrial Production Down but Not Out



Sources: Federal Reserve, Moody's Analytics

After a solid start to 2023, manufacturing production leveled off for much of last year before resuming its decline in the fourth quarter. Production struggles have been felt more by nondurable goods producers, where the volume of output is down around 3% from its cyclical peak in early 2022. Durable goods producers have performed better, with production down only 1.4% from its cyclical high. In both cases, however, production is roughly on par with the averages in the five years leading up to the pandemic.

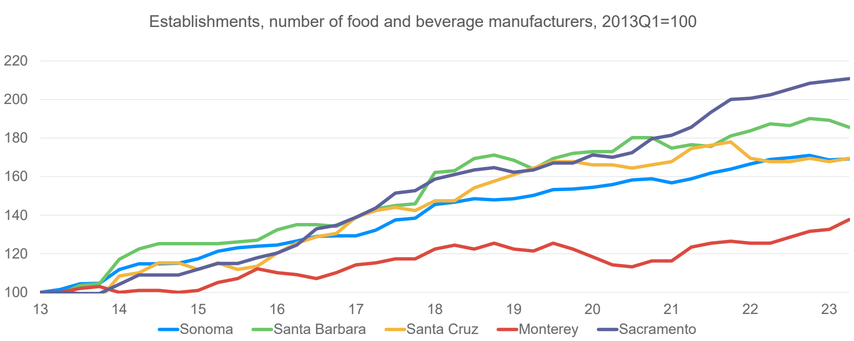
Organic Sales Climb and Output Presses Higher Again



Sources: U.S. Organic Trade Assn., Moody's Analytics

Organic food and nonfood sales continue to grow at a robust pace, and this is a boon for Sonoma County-based manufacturers that specialize in these products. The pace of growth in organic products once again outpaced the broader nonorganic market, signaling that consumer appetite for organic and healthy alternatives remains strong even in light of inflation pressures that chipped away at budgets for much of 2022.

Sonoma's Largest Manufacturing Cluster Sees Steady Progress



Sources: BLS, Moody's Analytics

Food and beverage makers have been a key source of growth in Sonoma County's manufacturing base, but the pace of growth in new establishments is beginning to slow as the market matures. The number of establishments in Sonoma County dwarfs that in most of its peer counties, so the slowdown in growth relative to smaller food and beverage hubs is no surprise. The sturdy growth during the past year is a welcome sign after a brief slowdown during the pandemic.

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