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CENTER FOR ECONOMIC FORECASTING & DEVELOPMENT

CITY OF RIVERSIDE

REGIONAL INTELLIGENCE REPORT

January 2018

REGIONAL INTELLIGENCE REPORT

UNITED STATES

2018: A TURNING POINT

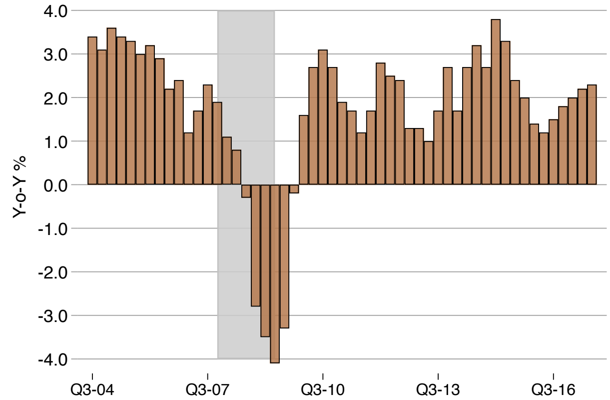
From a political standpoint 2017 will go down as one of the most chaotic periods in recent U.S. history, although it may well end up being overshadowed by 2018. Economically, on the other hand, 2017 was fairly ho-hum. Overall U.S. GDP output will have expanded by 2.3% in real terms once the fourth quarter is added. This is a better showing than in 2016, but a weaker one than the previous two years with exports and business investment looking stronger, while consumer spending has softened. And while output is up, job growth is weaker. U.S. employment growth will end up at slightly less than 1.5% December 2016 to December 2017—the weakest showing since the start of the recovery. Still, that annual growth represents over 2 million new jobs created.

While ho-hum may not excite, the sure and steady growth carries with it another advantage. The U.S. economy is now in the 9th year of its current expansion, and at this point there is little reason to believe that will end in 2018. In fact, this expansion will likely end up being the longest in U.S. history. Still, 2018 will be far from ordinary. The coming year will bring a number of important turning points, which will have far reaching implications for the economy in the years ahead.

Labor Shortages Mounting: The nation's slowing job growth is not due to a lack of labor demand—the job openings rate has been at or near an all-time high for the last few months. Instead, the slowdown in employment growth stems from a lack of available workers. The U.S. unemployment rate is now 4.1%, the lowest in 45 years with the exception of a few months during the massive tech bubble of the late 1990s—and today, the nation is not experiencing a major bubble of any kind. The labor shortage is hardly a surprise. Since the baby boomer generation there has been a sharp slowing in the growth of the working age population—from 1.5% in 1995 to half a percent over the last few years. The nation's workforce today is also, on average, considerably older, which partly accounts for the decline in the participation rate.

Real Gross Domestic Product

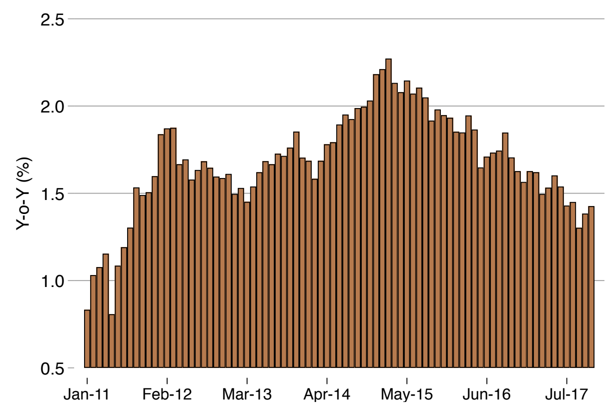
Year over Year, Q3-04 to Q3-17



Source: U.S. Bureau of Economic Analysis

Total Nonfarm Payrolls

Year over Year, Jan-11 to Nov-17



Source: U.S. Bureau of Labor Statistics

UNITED STATES

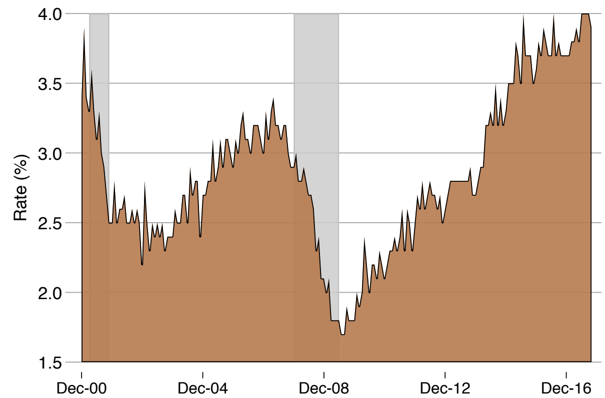
The labor shortage is being worsened by the clear antipathy that the current administration in Washington has towards immigrants coming to the United States. While we don't have reliable statistics at this point, anecdotal evidence suggests a sharp slowing in the inward flow of immigrants, legal or otherwise. Despite all this, politicians continue to tout job creation in connection with almost any policy put forward, despite the lack of workers to fill these positions (creating jobs is not the problem today). This labor shortage will benefit workers in terms of wage growth—but will also slow economic growth in the years to come.

A Deficit Low Water Mark: The changing demographics of the U.S. workforce are heralding another major change in the economy—growth in the Federal budget deficit. The national debt as a share of GDP has been steady over the last few years after a big jump in the midst of the 'Great Recession'. This is about to change. Over the next decade over 40 million people will be added to the retirement rolls, and will begin receiving social security and publicly funded healthcare. This surge will cause a sharp increase in Federal entitlement spending without a corresponding increase in the revenues to pay for them.

This disparity is why the Congressional Budget Office was forecasting a sharp increase in debt levels even before the Republican tax plan emerged, a proposal that will take this bad situation and make it worse. The GOP's tax plan, which is headed for a vote as of this writing, is mainly a massive cut in corporate taxes and an attempt to offset the loss in revenue by removing certain tax benefits, such as the mortgage interest deduction. Putting aside the clearly regressive nature of this plan, no credible economist on record believes the proposal will have anywhere near the growth impact needed to pay for itself. When will the Federal debt become untenable? That is almost impossible to guess at, but what is clear is that we will look back at 2018 as the year the tide turned.

Job Openings Rate: Total Nonfarm

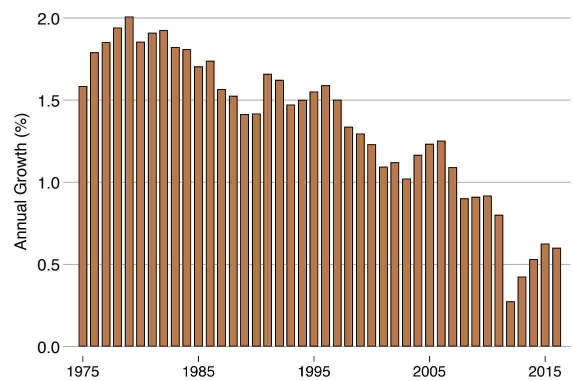
Dec-00 to Oct-17



Source: U.S. Bureau of Labor Statistics

Annual Growth: Adult Population

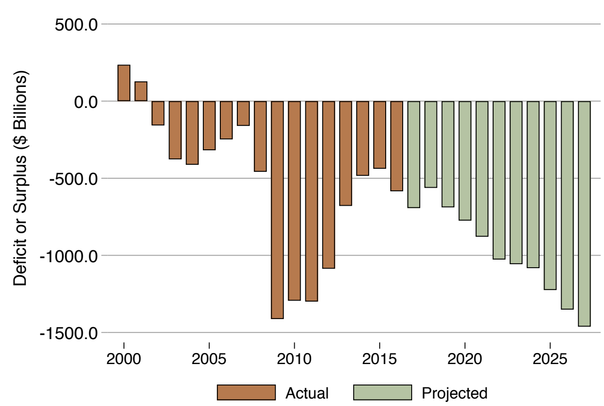
1975 to 2016



Source: Moody's Analytics

Historical and Projected Federal Budget Gap

2000 to 2027



Source: Congressional Budget Office

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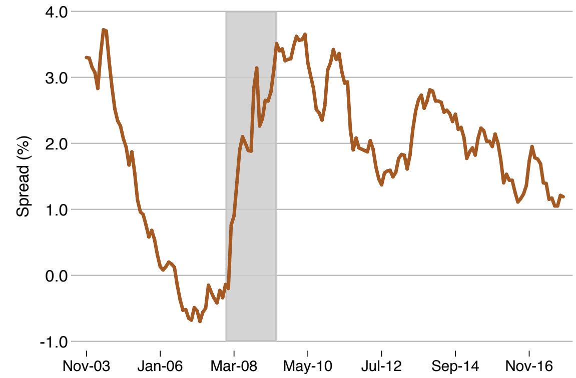
Tightening The Fed Noose: The GOP's tax plan will have another unintended consequence for the U.S. economy—higher rates and tighter lending markets. As noted, one of the primary features of the tax proposal is that it will lead to more government borrowing, which is broadly stimulative to the economy. But such stimulus is only desirable when there is slack in the system. At this point, no such slack exists. This suggests instead that the stimulus will be reflected in the economy either though higher goods prices or higher asset prices.

There is little sign of the former. Indeed, money supply growth has been decelerating lately. But there are plenty of signs of the latter with markets up 20% plus over the past year, and P/E ratios at their second highest level in the last eighty years. The U.S. economy suffered significantly from the past two asset bubbles and it is likely that the Fed will try to head off a third by being extremely aggressive in 2018 – and this will be on top of the three rate hikes that occurred in 2017. Such efforts will flatten the yield curve and slow lending. This will more than offset the modest stimulative effect of the tax cuts.

On the surface, 2018 looks to be a lot like 2017 in terms of economic growth. But dig a little deeper and growing frictions become apparent. These will begin to create problems in the economy in 2019 or beyond. So enjoy the current economic calm—before long, the ride is going to grow bumpy.

10-Year Treasury Minus Federal Funds Rate

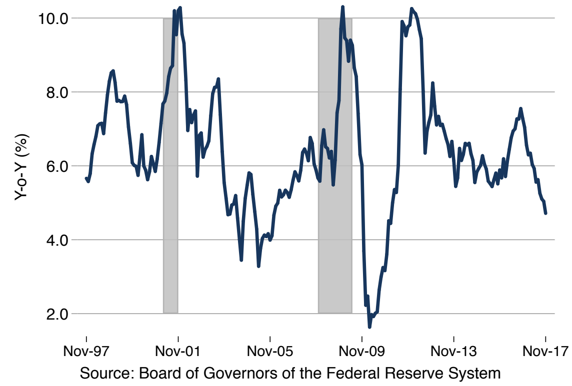
Nov-03 to Nov-17



Source: Federal Reserve Bamk of St. Louis

M2 Money Stock

Year over Year, Nov-97 to Nov-17



Source: Board of Governors of the Federal Reserve System

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ECONOMIC STABILITY IN MIDST OF SOCIAL AND POLITICAL TURMOIL

Late-night talk show hosts and others who find humor in political and social upheaval have had no shortage of material over the last year. The press and public alike have become accustomed to policy announcements via tweet from the White House, shocking revelations about public figures, and seemingly endless news about the chaotic state of affairs in our era. And, it's a safe prediction that there will be more of the same in 2018.

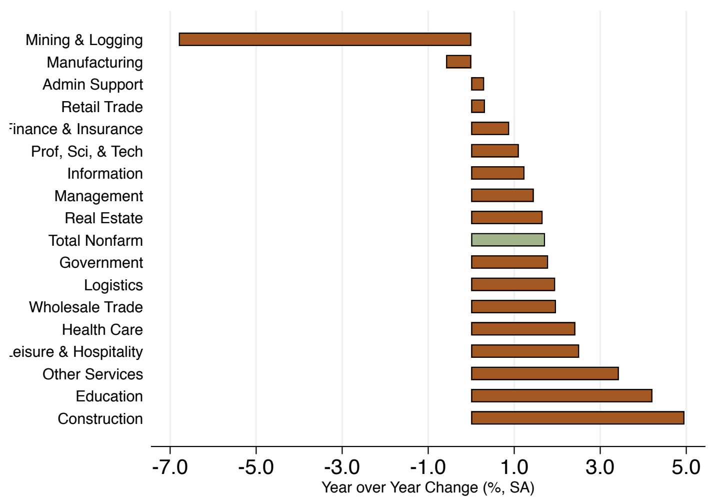
But in case you missed it, something's going right: the economy. An array of evidence points to the fact that the California economy has been humming along nicely, and that is expected to continue in the coming year, although the state must face long-term challenges, and the sooner the better.

LIKE A CAR IN OVERDRIVE

The state's unemployment rate is on track to finish 2017 below 5% for the first time in 11 years. California's unemployment rate is higher than the U.S. rate, but the differential between the two is now at its lowest in over 10 years. Looking across the state, a number of California counties have unemployment rates under 3%, but a few face rates above 7%, in many instances due to the composition of industries and substantial seasonal employment in those counties.

The state's industries have continued to add workers to their ranks, and this has pushed the unemployment rate down. Overall, nonfarm jobs grew 1.7% in year-to-date percentage terms through October 2017. Construction has led the way with a 5.0% increase, and nearly every other industry added jobs over the past year. The only exceptions were Manufacturing, which was down marginally, and Mining and Logging, which has been reeling from weakness in the energy sector for some time.

California Job Changes by Industry (YTD through Oct-17)



Source: California Employment Development

California Growth by Industry 2013 to 2017

Major Industry	Percentage Changes '13 to '14	'14 to '15	'15 to '16	'16 to '17
Total Nonfarm	2.8%	3.1%	2.6%	1.7%
Mining and Logging	2.9%	-8.9%	-14.6%	-6.8%
Construction	5.8%	8.5%	5.8%	5.0%
Manufacturing	1.4%	1.7%	0.3%	-0.6%
Wholesale Trade	2.1%	1.2%	1.0%	2.0%
Retail Trade	2.1%	2.0%	1.3%	0.3%
Transportation, Warehousing & Utilities	4.1%	6.2%	5.4%	2.0%
Information	3.0%	5.3%	7.6%	1.2%
Finance & Insurance	-1.3%	2.6%	2.8%	0.9%
Real Estate & Rental & Leasing	2.5%	2.4%	2.5%	1.7%
Professional, Scientific & Technical Services	2.6%	2.4%	2.6%	1.1%
Management of Companies & Enterprises	2.0%	1.1%	-1.0%	1.5%
Administrative & Support & Waste Services	4.5%	3.7%	1.9%	0.3%
Educational Services	3.6%	2.3%	2.7%	4.2%
Health Care & Social Assistance	2.8%	3.8%	3.5%	2.4%
Leisure & Hospitality	4.9%	4.1%	3.7%	2.5%
Other Services	3.8%	1.7%	2.2%	3.4%
Government	1.7%	2.0%	2.1%	1.8%

Source: California Employment Development Department

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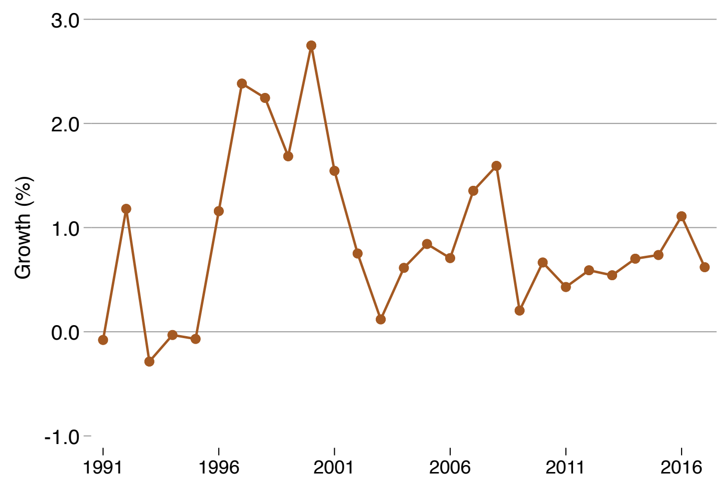
However, job gains overall and by industry have generally slowed significantly compared to recent years. For example, the state's 1.7% gain for total nonfarm jobs is more than a percentage point slower than the previous year and slightly more than half the gain seen in 2015. With few exceptions, job gains by industry in 2017 have been less than in the previous three years. In particular, there has been a dramatic slowdown in job growth in the Information and Professional Scientific, and Technical Services industries that led the state in the early stages of its economic recovery. In recent quarters, the consumer-facing segments of the economy have experienced the most notable employment gains: Health Care, Leisure and Hospitality, and Other Services.

To be sure, this slowdown is not symptomatic of a looming recession, but a shortage of workers. Following a 1.1% surge in 2016, the statewide labor force slowed to a growth pace of 0.6% in 2017, just two-thirds of the average rate since 1990. This has occurred as job openings across skilled and unskilled occupations alike have reached record high rates, based on data from the U.S. Bureau of Labor Statistics. Given slow growth in the labor force, California's labor market is like a car in overdrive, moving forward at a steady pace of about 1.5% job growth per year, incapable of moving any faster.

Other measures point to continued progress in the state economy. In the second quarter of 2017, California's Gross State Product increased by 2.6%, adjusted for inflation, the eighth fastest among the states and nicely ahead of the overall U.S. growth rate of 2.0%. California continues to be among ranks of the faster growing states, a constant source of surprise to its naysayers. Over the same period, nominal personal income grew by 3.4% in California compared to a 2.9% increase nationally, and with incomes, spending in the form of taxable sales has been on the rise, up 4.1% in the second quarter of 2017.

California Job Changes by Industry (YTD through Oct-17)



Source: California Employment Development Department

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SO WHY WORRY?

The near-term picture looks good, but long-term problems require attention now. Home sales have edged up, but the statewide homeownership rate remains stubbornly low because of unaffordably high prices. At the same time, rents have increased steadily in many parts of the state in the face of low apartment vacancy rates. It should be no surprise that net domestic outmigration, already negative for several years, surpassed 100,000 persons annually over the last two years. The high cost of housing in California is driving workers out, especially low wage earners. Based on estimates by Beacon Economics and others, the state should be adding approximately 200,000 new housing units annually but is building about half that amount. Connecting the dots, if the state does not build enough homes, out-migration will continue, stunting both increases in the labor force and the growth potential of the California economy.

As if the housing situation in California isn't already challenging enough, the Federal tax plan that passed in mid-December contains measures that will change the playing field for state residents. The homeownership rate in California is already considerably lower compared to the United States as a whole, mainly because the median home price is more than twice that of the nation. Historically, middle-income households in California have been able to count on the deductibility of mortgage interest and property taxes to soften the blow. The new tax plan will cut the limit on mortgage interest deductions from $1 million to $750,000 and also impose a $10,000 limit on state and local tax deductions. This will put the American Dream of homeownership further out of reach for more California residents.

Yet another long-term concern is the gulf between pension obligations and pension funding for state and local governments, which has widened in recent years and will continue to do so over the foreseeable future. Jurisdictions face a difficult choice: They can divert current revenues to pay down pension obligations, but this may diminish services to residents and much needed expenditures on infrastructure. A few communities have won tax hikes that will help support services and infrastructure investment, but they have been the exception rather than the rule.

Finally, while the state budget appears to be in good shape for now, and while California lawmakers have made contributions to the state's Rainy Day Fund for several years in a row, the situation could turn on a dime. It is well known that state revenues fluctuate widely with movements in the stock market. Having hit record-high territory in recent months, and knowing that there is a market correction somewhere in the future, it's just a matter of time before the state faces another challenging budget situation.

Each of these long-term problems can be addressed so as to stave off the worst consequences. But in each case elected officials and other stakeholders need to act now, while the economy is doing well, to tackle these challenges and ensure the long-run growth of California.

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EMPLOYMENT OVERVIEW

The labor market in the city of Riverside finished 2017 with strong momentum, which is expected to continue into the new year. Job growth across most sectors of the economy has been driving the unemployment rate downward. Total nonfarm employment increased by 2.3% from November 2016 to 2017. By comparison, nonfarm employment increased by 3.2% in Riverside County and by only 1.7% in California as a whole.

The unemployment rate in the city of Riverside stood at 4.1% in November 2017, falling by 1.3 percentage points from November 2016. By comparison, the unemployment rate in Riverside County was 4.3%, 1.3 percentage points lower than a year prior and the unemployment rate across the whole state of California was 4.6%; representing a 0.7 percentage point decrease. From November 2016 to 2017, the city's labor force expanded by only 1.6%.

A low unemployment rate and tapering labor force growth indicate that the city of Riverside is at or near full employment. Businesses are having difficulty filling open positions and thus not adding a substantial number of new jobs. Once full employment is reached, there will be minimal change in the unemployment rate; counting only those unemployed due to frictional or structural movements or by voluntary choice.

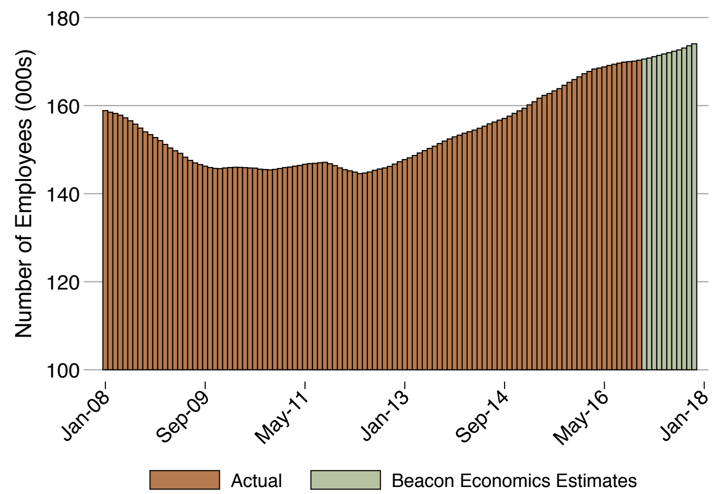
Employment is growing in many of the city of Riverside's largest industries. Employment in Education/Health increased by 1.7% from November 2016 to 2017. This supersector is the largest in the city, with 27,600 or 15.9% of all nonfarm jobs. Most of the jobs are in Healthcare, a sector that will continue to grow and be in high demand as the baby boomers age and the overall city population continues to increase.

The city's second largest industry, Natural Resources/Construction added 1,410 jobs in that time—an 8.6% increase. A constrained housing market has caused a recent increase in new housing development that is driving the construction industry.

Education/Health and Natural Resources/Construction are considered investment industries; they invest resources now that payoff in the future well beyond their initial costs. More educated students are better skilled workers in the future, healthcare prevention ends up costing

Total Nonfarm Employment, City of Riverside

Jan-08 to Nov-17



Source: Beacon Economics, California Employment Development Department

City of Riverside Employment By Industry

Jan-08 to Nov-17

Industry	Nov-17 (000s)	1-Yr. Chg. (000s)	1-Yr. Chg. (%)
NR/Construction	17.8	1.4	8.6
Transport/Warehouse	5.9	0.3	5.1
Financial Activities	6.1	0.2	2.8
Manufacturing	9.6	0.2	2.1
Prof, Sci, Tech, & Mgmt	6.4	0.1	2.0
Leisure & Hospitality	14.4	0.3	1.9
Other Services	5.0	0.1	1.7
Education/Health	27.6	0.5	1.7
Admin Support	13.1	0.1	1.0
Wholesale Trade	6.4	0.1	0.8
Retail Trade	16.4	-0.1	-0.9
Information	1.5	0.0	-2.4
Total Private	130.2	3.0	2.4
Government	43.8	0.9	2.2
Total Nonfarm	174.0	3.9	2.3

Source: California Employment Development Department

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much less than treatments, and housing and infrastructure development help a city grow and keep costs of living down. Only two industries in the city of Riverside lost jobs from November 2016 to 2017. Businesses in Retail Trade shed 142 jobs or 0.9% and businesses in Information shed 37 jobs, a 2.4% decrease in the relatively small industry's total employment.

Population growth in the city was relatively strong in 2016, with the total population increasing by 1.0% to 327,000 residents from January 2016 to 2017. By comparison, the population of nearby San Bernardino City increased by only 0.6% in that time, while the population of the state of California increased by 0.9%.

As population and employment in the city of Riverside increase and the labor market continues to tighten, industries will be forced to increase wages to attract workers to fill open positions. Yet, surprisingly, wages in some of the city's major industries have decreased. From December 2015 to 2016, the average wage in Health Care decreased by 6% to $44,800 and the average wage in Natural Resources/Construction decreased by 2% to $54,600. The decreases in wages in these industries are likely due to an increased hiring of entry-level and lower-skilled workers, perhaps as businesses struggle to find skilled labor or because the dynamics within these industries change over time.

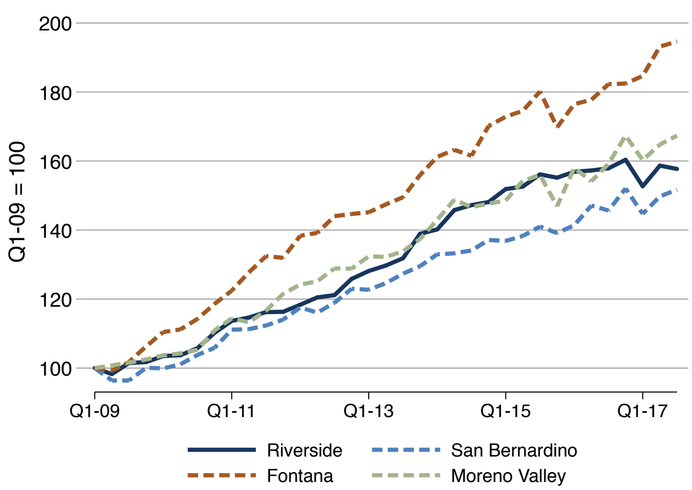
LOCAL BUSINESS ACTIVITY

The city of Riverside has experienced strong growth in consumer and business spending since the recession, but that spending growth is now starting to level. Taxable sales, which represent the total taxable goods spending in a region, are a key indicator of consumer spending growth over time. Taxable sales in the city of Riverside remained roughly flat from the third quarter of 2016 to the third quarter of 2017, at 0.1% growth.

On the other hand, taxable receipts, which reflect the total revenue that the city receives from state sales tax allocations, have generally been on the rise across most sectors in the Riverside County economy. Building and Construction taxable receipts increased 10.3% from the second quarter of 2016 to the second quarter of 2017, the strongest growth of any sector. Increased construction spending is a strong indicator of a healthy economy. Fuel and Service Stations taxable receipts increased by 7.3%, while Business and Industry taxable receipts increased by 7.2%. Much of the growth in fuel spending was in response to an uptick in gasoline prices, and business spending growth reflects the strength of commercial activity citywide. On the whole, consumer and business spending in the city of Riverside should continue to grow at a measured pace over the course of 2018.

Indexed Taxable Sales, Selected Cities

Q1-09 to Q3-17



Source: California Board of Equalization

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RESIDENTAL REAL ESTATE

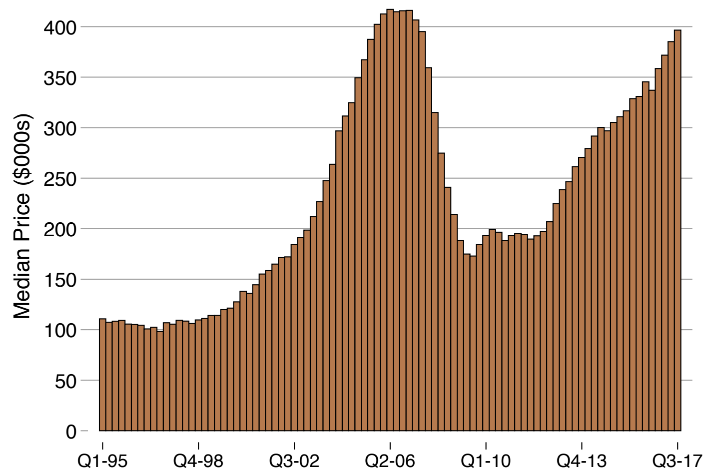
Like much of California, the city of Riverside faces a severe housing shortage that has caused home prices to rise substantially, even in the face of relatively flat home sales. Housing inventory for Riverside County fell from a 4.1 month supply average in the third quarter of 2016 to a 3.5 month supply average in the third quarter of 2017. Motivated by constrained inventory, the existing single-family median home price increased by 17.7% to $396,500 in the city of Riverside. Comparatively, in Riverside County, the existing single-family median home price increased by 8.9% to $362,100 and in the state of California, the median home price increased by 9.5% to $456,200.

Renters in the city of Riverside are also feeling a tight market as they face higher rents for their apartments. The average apartment rent increased by 4.8% to $1,280 from the third quarter of 2016 to the third quarter of 2017. During the same time period, the city's apartment vacancy rate increased 0.5 percentage points to 3.1%. For comparison, the apartment rents statewide increased by 4.1% and vacancy rates increased by 0.1 percentage points. Low vacancy rates leave renters with little choice and cause upward pressure on rental prices. Rents will continue to rise unless new construction eases the tight supply of multi-family housing.

Fortunately, new single-family and multifamily construction is growing. In the first half of 2017, there were 383 new residential permits issued in the city of Riverside, of which 287 permits were for multifamily units and 96 permits were for single-family homes. By comparison, only 108 new permits were issued in the first half of 2016, all of which were for single-family homes. More new residential construction is needed to keep homes affordable in the city of Riverside.

City of Riverside Median Home Prices

Q1-95 to Q3-17



Source: DataQuick

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COMMERCIAL REAL ESTATE

Further invigorating the construction industry, a large public project is in planning stages to turn an old Greyhound bus terminal and police sub-station into a state-of-the-art library and community space. With three stories and approximately 42,000 square feet, the library will be built on a raised platform, creating a pedestrian walkway and area for outdoor community activity below. Only 2/3 of the site is being used for the library, leaving the rest for a mixed-use development with high-rise apartments. The library is expected to cost approximately $43 million and have stationary bicycle desks to power electronic devices while residents work, become part of an offered business incubator, and participate in a newly available toy and lending center. No one can argue that this new library will not add value to the community. Ground is expected to be broken later this year with a tentative completion planned for second quarter of 2020.[1]

Employment and spending growth across most local professional industries has led to more demand for Riverside office space. The average office rent in the city increased by 0.5% to $23.19 per square foot from the third quarter of 2016 to the third quarter of 2017, while the office vacancy rate fell by 0.6 percentage points to 21.0%. By comparison, office rents in the Colton/Redlands/San Bernardino submarket increased by 1.7% and vacancy rates decreased by 1.3 percentage points. Office vacancy is falling in the city of Riverside even as developers have added an abundance of new office space. In the first three quarters of 2017, office building permit values reached over $7.1 million, compared to just $20,000 in the first three quarters of 2016. The growth in office space has benefited the growing local professional employment base and provided a boost to local construction employment.

Although employment in Retail Trade fell over the course of 2017, retail property rents increased by 2.1% from the third quarter of 2016 to the third quarter of 2017, even as retail vacancy rates increased by 0.2 percentage points to 6.8%. Comparatively, the Colton/Redlands/San Bernardino submarket experienced a 5.8% increase in rents and a 0.3 percentage point decline in vacancy rates. With Retail Trade employment declining in the city of Riverside in recent months, new retail development has slowed. Retail building permit values fell 18.5% from the first three quarters of 2016 to the first three quarters of 2017. As with so many other communities, brick-and-mortar is experiencing a transformation as it seeks to find its place in today's multi-channel retail world.

[1]Pacheco, Antonio. "Long-Delayed Main Library in Riverside, California gains steam." Archpaper.com, 16 Aug. 2017, archpaper.com/2017/08/main-library-riverside-california/.

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