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REGIONAL INTELLIGENCE REPORT™

BEACON ECONOMICS Prepared by Beacon Economics, LLC.

Santa Clara County

Fifth Edition

April 2015

U.S. Economic Outlook

The year 2014 came in like a lamb, but it is going out like a lion. After a year of decent growth in 2013, it was a bit of a shock to see the U.S. economy contract sharply in the first quarter of the year. But the forces that caused this slowdown were purely transitory and since then the nation has been growing at a 4% plus pace. Most impressive is that this growth is being driven almost exclusively by internal factors, given that the global economy continues to stumble.

Consumers have ramped up their spending, and are starting to borrow more. And while Black Friday was a dud relative to last year—we don't hear retailers complaining. This is a sign of growing strength in consumer spending—and the fact that many people don't feel the need to get up at 3:00 a.m. to wait in painfully long lines for discounted goods! Businesses are happy too: Profits continue to rise along with stock prices, they are investing more, and the pace of hiring is up. Public spending has finally stabilized after years of austerity. When all is said and done, expect 2014 to be a better year for growth than 2013 despite that first quarter glitch. Moreover, the really good news is that there is little reason to expect this pace of growth to slacken in 2015.

Beacon Economics expects this year to be modestly better than last year, with growth coming in a bit above 3%, largely driven by ongoing growth trends in consumer spending and business investment, with an additional bump from the housing market. The nation will finally begin to close some of the output gap, and labor markets will continue to advance. Here are the most important things that will occur next year, for better or for worse.

1. Incomes will finally start to rise: While corporate profits have been hitting regular record highs, this has come largely at the expense of worker wages, which have been mostly stagnant. But now that the labor markets have turned the corner there is enough compression in certain markets to push some of the gains to labor. This will become more widespread in 2015—and keep consumer spending growth rolling. Rising incomes will also encourage people to re-enter the workforce and participation rates will start to rise slowly.

2. Real estate recovery, part 2: The housing market will begin to come back in 2015, this time driven by the retail buyer. Mortgage credit is becoming easier to get. The average Fico score for those receiving a Fannie Mae prime mortgage has fallen from a ridiculous 760 in 2013 to below 740. Add in the new home equity created by rising prices—$6 trillion since 2012— and all this points to a second surge in the housing market. This time it will come with more demand for new units—expect single-family permits to finally break out of the 600K zone.

3. Inflation?: Price growth will be stable, as money supply growth remains constrained. While the pace of bank lending is picking up speed, we don't see it growing rapidly enough to cause all the QE money that is tied up in excess reserves to come spilling out into the economy. The lack of inflation implies low interest rates and a strong stock market.

4. Interest rates and the stock market: The global economy will continue to disappoint, but this will spur central banks to continue to loosen. Look for QE-type programs in Europe as well as Japan. China will also start working to stabilize growth. Interest rates will remain quite low and the U.S. dollar will continue its slow pace of appreciation. The fact that the U.S. will be the bright star on the international scene will continue to attract foreign investors—look for the stock market to continue its slow climb towards the sky.

All is not right in the United States. The nation continues to deal with ludicrous political gridlock in Washington DC, preventing reasonable conversations on needed policy changes in healthcare and the various public insurance programs, which are unsustainable in their current form. Growing inequality is an issue that must be dealt with, and there is little movement to try and fix a broken revenue system. And of course there will be another recession—there is always another one somewhere in the future. But none of this worries us in the near term, so expect a prosperous 2015!

California Economic Outlook

Beacon Economics remains bullish on the California economy. This shouldn't minimize the challenges that the state faces, without which California could propel even further ahead of the nation, but not reaching your full potential is a far cry from being an economic horror story. Realistically, California has outpaced the nation in several key areas despite its formidable issues. Beacon Economics' current 5-year forecast calls for ongoing improvement in virtually every aspect of the state's economy.

1. Jobs will continue to expand: California has already recovered more than the 1.3 million jobs lost during the downturn. Virtually every major industry in the state has returned to job growth. With tourism, business investment, housing, and consumers all moving forward at a respectable pace, Beacon Economics forecasts that the state's non-farm job base will continue to expand. Specifically, Beacon Economics is calling for employment growth to increase to 2.5% over the next year, with unemployment dipping to the low 6%-range by 2016.

2. Population is forecast to continue growing: Although domestic migration has remained negative over the past few years, this has been more than offset by natural increases and net foreign immigration to the state. Given the weakness of the dollar and the rising number of high-net-worth individuals abroad, California will continue to attract immigrants. Natural population increases are also expected to continue, which translates into overall population growth hovering in the 0.8%-1.0% per year range.

3. Housing and permits will drive growth: California's residential market is expected to remain a driver of growth into the future. Home prices should taper down from double-digit annual increases to growth that is more in line with incomes over the next few years. And, with both housing vacancies and inventories remaining low, the upward trend in new residential construction is also expected to continue. However, these new units are not likely to be enough to stem the tide of under-supply, so price growth is also expected to remain positive throughout the life of this forecast.

Despite our relatively optimistic outlook, Beacon Economics fully acknowledges that California faces substantial, though not insurmountable, challenges. The cost of housing is perhaps the single-most important policy issue facing lawmakers in the state today. While the policy prescription appears relatively simple—boost supply—the path to achieving that straight-forward objective is fraught with political difficulties. We are currently seeing a new wave of affordable housing measures pop up in municipalities across California. Unfortunately, these local ordinances are attacking the symptom of a much broader problem: We don't have enough housing in the state—affordable or otherwise. California desperately needs to expand its housing stock in order to manage housing costs – something that makes it more difficult and costly for businesses to recruit and retain critically needed talent.

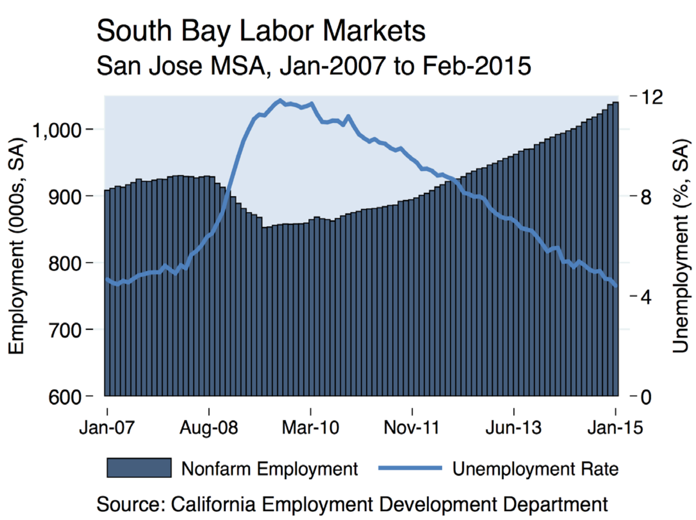
In addition to the state's housing woes, infrastructure remains a focus for future growth. Here again, the cyclical effects of the Great Recession are waning, but it remains to be seen how much of the uptick in government revenues will be allocated to improving California's infrastructure. The state has many unmet infrastructure needs and efforts that were canceled or delayed in response to belt-tightening associated with the recession. California's Infrastructure Report Card received a C grade in 2013, and the American Society of Civil Engineers estimates that California needs to invest as much as $65 billion per year in collective infrastructure needs.[1]

If the state does not shift its focus to these longer-term challenges now that revenues are growing and the economy is healing, California will be even further behind the eight-ball when the next inevitable business cycle rears its ugly head. With the economy expected to improve over the life of this forecast, now is the time to begin chipping away at structural issues to ensure California remains a driver of U.S. growth and prosperity.

[1]American Society of Civil Engineers, "California's 2013 Infrastructure Report Card."

Labor Market

Although the South Bay added thousands of jobs over the past year, that is perhaps not the most significant story to emerge recently about the local labor market. To begin, the South Bay added more jobs on a percentage basis than any other region in California over the past year. Total nonfarm job growth from February 2014 to February 2015 was 5.3% with 52,000 jobs added during that time. By comparison, total nonfarm employment in the second-fastest growing labor market in California, the Inland Empire, grew by 4.6% or 57,600 jobs overall. Total nonfarm employment grew by 4.4% in San Francisco and by 2.4% in the East Bay. The unemployment rate fell from 5.9% to 4.7% from February 2014 to February 2015. The labor market is growing throughout California, but nowhere is it stronger than in the South Bay.



Perhaps even bigger news is that the South Bay labor market was larger over the past few years than was believed even a few months ago. The U.S. Bureau of Labor Statistics released its benchmark employment revisions in mid-March, which recalibrated the survey-based data to actual unemployment insurance records filed by firms. As a result of this process, the South Bay employment figure was significantly higher after the benchmark revisions than was initially released. The BLS first reported that the South Bay added an impressive 39,000 jobs (4.0% growth) between December 2013 and December 2014. However, in the revised report, the South Bay is now estimated to have added an even stronger 49,100 jobs (5.0% growth) in that time. In other words, the labor market in the South Bay was larger in 2014 than originally estimated and it grew faster than in any other part of the state.

South Bay employment growth was led primarily by high-wage, high-skilled industries. The Professional, Scientific, and Technical Services industry, which employs over 13.7% of South Bay workers, grew by 9.7% from February 2014 to February 2015. Professional, Scientific, and Technical Services includes legal, architecture, scientific research and development, and accounting, among other services. These are industries that are fundamental to the strength of the South Bay's high-tech industries.

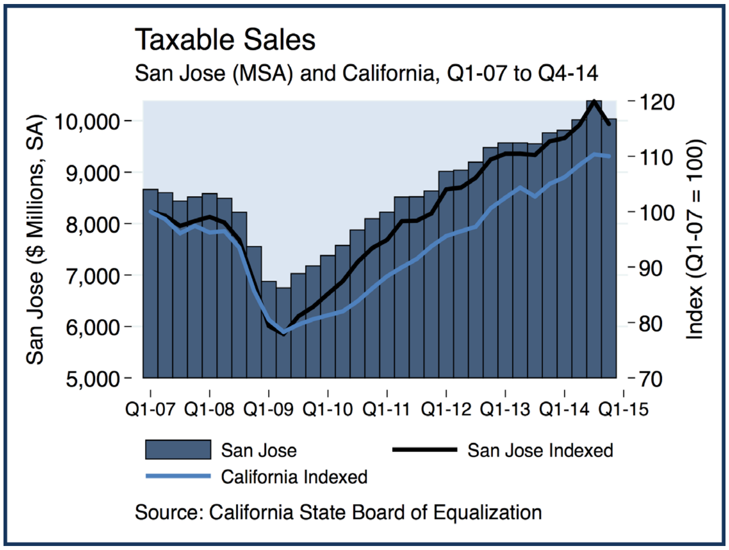
Employment growth in the Information industry, which constitutes 7.0% of all South Bay employment, was stronger than in any other industry at 16.2% year over year. Many of the jobs in the Information industry serve as the base of the Silicon Valley economy, such as software publishing, telecommunications, data processing and hosting. Real Estate employment grew by 7.0% year over year, while Construction employment grew by 5.8%, reflecting the strength of the residential and commercial real estate markets of the South Bay, as described in more detail below.

Local Spending

Consumer spending reached a new high in the South Bay late in 2014. From the fourth quarter of 2013 to the fourth quarter of 2014, taxable sales in the San Jose MSA (Santa Clara and San Benito Counties) increased 2.8%. This was well off the 8.8% year over year pace in the third quarter of 2014 but was still an impressive level of growth, especially since consumer spending in the South Bay has already exceeded its pre-recession peak. Taxable sales were 48.7% higher than their trough in the third quarter of 2009. South Bay spending lagged somewhat behind its neighbors; from the fourth quarter of 2013 to the fourth quarter of 2014, taxable sales increased 4.7% in the state overall, 5.1% in the East Bay, and 4.1% in San Francisco.

However, some of the difference between the South Bay and its neighbors was a slight temporary slowdown in taxable sales (-3.4%) from the third quarter of 2014 to the fourth quarter of 2014. Even then, taxable sales for the entire year of 2014 in the South Bay was 5.6% higher than for the entire year of 2013, with strong growth in the cities of Cupertino at 27.5%, and the City of Santa Clara at 8.9%.

One can credit low gasoline prices for some of the uptick in local consumer spending. In Santa Clara County, from the year-to-date 2013 (first to third quarter) to the year-to-date 2014, taxable receipts growth for Fuel and Service Stations was roughly flat at -0.2%, while nearly every other category of taxable receipts increased in that period. By comparison, Fuel and Service Stations spending increased across all of California by 1.0%. Autos and Transportation, which was responsible for much of the growth in consumer spending over the past several years, was the only other category of spending to fall, at 1.9% year over year.



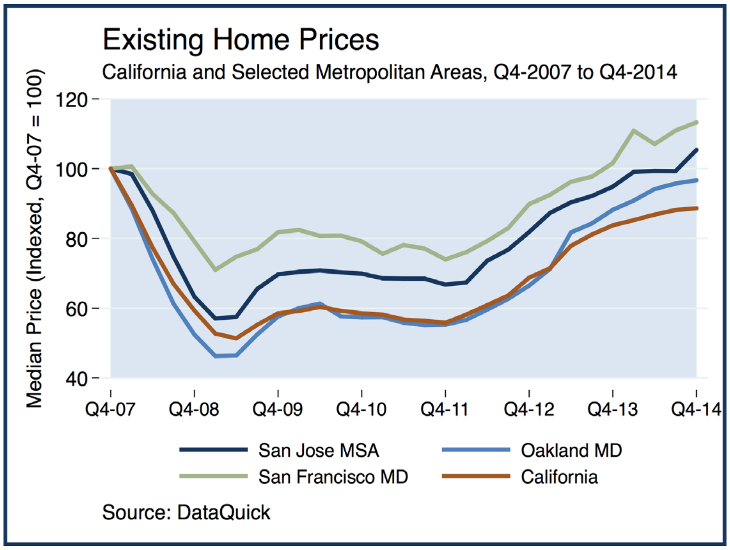
Business and tourist travel continues to thrive as the economy of the South Bay grows, leading to an increase in Restaurants and Hotels taxable receipts of 8.1% from the 2013 year to date to the 2014 year to date. This compares to 6.5% growth in Restaurants and Hotels spending in the state overall. With business travel and tourism growing in the South Bay, cities are adding more hotel rooms to keep up with demand. Milpitas recently approved construction of two new hotels offering a combined 252 rooms.[1] San Jose already has plans to build a number of new hotels in the city, adding potentially over 3,000 new hotel rooms. [2]

Some of the strongest growth in spending occurred in Business and Industry. With the South Bay economy continuing to grow strongly, businesses are investing revenue in business services and research and development. Business and Industry spending increased by 5.7% from the 2013 year to date to the 2014 year to date, compared to 3.7% in the state overall.

The real estate market of the South Bay is thriving, and in turn there was 9.3% growth in Building and Construction spending from the 2013 year to date to the 2014 year to date. Growth in the state overall reached 6.3% in that period. The strength of the local economy moving forward should continue to push South Bay consumer and business spending upward over the course of 2015, even as spending has reached a new high in recent quarters.

Residential Real Estate

The South Bay housing market has shown nearly unabated growth for the past three years. The existing single-family median home price reached a new peak in the fourth quarter of 2014 at $810,000. This was an 11.1% increase from the fourth quarter of 2013, faster than the pace of the East Bay (9.6% growth to $549,000) and only slightly behind the pace of San Francisco (11.5%), where the existing single-family median home price reached $983,000 in the fourth quarter of 2014. Clearly, despite having a high cost of housing compared to most metropolitan areas in the country, the South Bay remains much more affordable than the City of San Francisco. On the whole, affordability remains a concern in comparison to the state overall, where the median home price reached $383,000 in the fourth quarter of 2014 (5.9% year-over-year growth).



Home price appreciation has been especially steep in Sunnyvale, where the existing single-family median home price increased 19.1% from the fourth quarter of 2013 to the fourth quarter of 2014 to $1.2 million. In Santa Clara, the median price increased 10.3% in that period to $827,000, and in San Jose, the median price increased 10.9% to $736,000. Clearly, the growth in the housing market of the South Bay is not concentrated in any major city and prices are rising quickly throughout the area.

Rising home prices have not translated into an increase in home sales. Existing single-family home sales in the South Bay fell by 8.7% from the fourth quarter of 2013 to the fourth quarter of 2014. Sluggish home sales, even in the midst of a strong housing market overall, are not a sign of trouble in this case.

[1]Ian Bauer, "Milpitas Council Approves Two Hotels Near California Circle." San Jose Mercury News. March 4, 2015.
[2]George Avalos, "New Hilton Hotel Planned for North San Jose." Oakland Tribune. March 4, 2014.

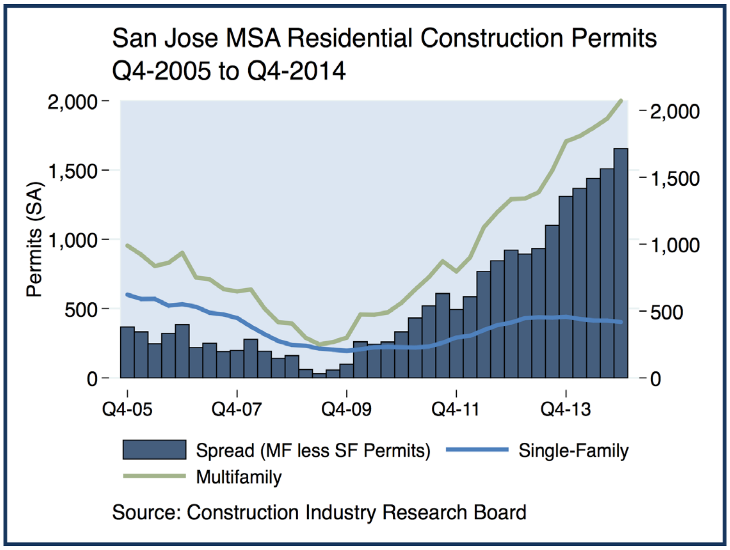
After years in which foreclosures reached over a thousand per quarter, foreclosures in the South Bay have dwindled to near-single digits. Seasonally adjusted foreclosures stood at just 108 in the fourth quarter of 2014, up from 81 in the third quarter but roughly even with the 117 foreclosures in the fourth quarter of 2013. The number of mortgages in default stands at 448 in the fourth quarter of 2014, compared to 444 a year prior. By comparison, 4,311 mortgages were in default in the second quarter of 2009.

With so few distressed properties on the market, there are much fewer homes going for sub-market rates. This is a great sign for the health of the housing market overall as most homeowners are able to keep up with their payments, but it leaves the housing supply very tight. As of February 2015, the South Bay housing market had 2.6 months of supply, which means that the existing supply of homes on the market would sell out in less than three months. Inventories are flat compared to a year ago (2.5 months of supply) and two years ago (2.4 months of supply), but half as large as in February 2010 (5.0 months of supply).

Home prices will continue to rise quickly if the supply of homes on the market does not increase. There are simply too few homes available right now in the South Bay, which makes it difficult for new homebuyers to enter the market. Also, with so few homes available and at a high price, it discourages inward migration to the South Bay. This does not take away from the strength of the housing market in the South Bay, which is good news for the community. However, It does show that the South Bay needs to encourage new construction if the interest is in making housing in the area more affordable for new and existing residents.

The same forces are true for apartments, where the lack of supply is driving rent prices up. The median apartment rent for the San Jose region stands at $1,931 per month, an increase of 8.6% from the fourth quarter of 2013 to the fourth quarter of 2014. The apartment vacancy rate is just 2.4%, which is as low as it has been since 2000. It is also lower than in any other part of the Bay Area. In San Francisco, the apartment vacancy rate stands at 3.2% and in the East Bay, the vacancy rate stands at 2.7%. With the price of homes in the South Bay as high as they have ever been, apartments are relatively affordable, even though their prices are rising as well. So far, the supply of new apartments is not keeping up with rising demand.

Apartment construction has nonetheless been very strong in recent years. A total of 7,687 multifamily residential building permits were issued over the course of 2014, including 2,072 in the fourth quarter of 2014 alone, which is more than have ever been issued in one quarter. The total number of permits issued in 2014 is 27.1% higher than in 2013 and 67.0% higher than in 2012. Beacon Economics has discussed the boom in multifamily construction in the past, and so far it shows no sign of waning. A ramp-up in multifamily construction is the best way to ensure that housing remains affordable in the South Bay, especially as home prices grow.



Single-family residential construction does not appear likely to slow down home price appreciation in the near future. The number of single-family residential building permits issued in the South Bay in 2014 totaled 1,715, a 5.2% decrease from 2013. Even as home prices grow, homebuilders have been reluctant to keep building. A faster and more accommodating permitting process to facilitate new construction would be a benefit to the residents of the South Bay, as affordability is becoming a bigger and bigger concern.

Commercial Real Estate

Commercial real estate construction has not been as strong as residential construction in recent months, however. Total annual nonresidential building permit values in the South Bay decreased by 39.1% from 2013 to 2014. The two largest categories of permits, office and alterations/additions, both increased in that period. Office building permit values increased 60.0%, while alterations/additions increased 9.5%, but that growth was negated by drop-offs in retail (-60.6%), industrial (-84.6%), and other nonresidential sectors (-89.8%), which includes medical buildings and small buildings or structures such as pump stations. Despite the decline in total nonresidential permit values, the growth in alterations/additions is optimistic news, suggesting that while retail or industrial firms may not be building new facilities, they are likely expanding existing ones. In addition, the growth in office construction corroborates the growth of the labor market for industries such as Professional, Scientific and Technical Services. Business activity is on the rise in the South Bay, even if some categories of commercial construction are not currently expanding.

This is not to say that commercial real estate is in a lull. Instead, with consumer and business spending growing steadily and with the labor market growing substantially, South Bay commercial real estate was the strongest it had been in several years by the end of 2014. Rent for office property in the South Bay stood at $34.40 per square foot in the fourth quarter of 2014, up 7.1% from the fourth quarter of 2013. The vacancy rate for office property fell 0.3% to 17.7%. This was slightly behind the pace of San Francisco (falling 1.2% to 11.7% overall) and the East Bay (falling 0.6% to 17.3% overall), but it is a very good sign for business activity and commercial construction in the South Bay moving forward.

Research and development commercial real estate is expanding as well. Rent for R&D properties in the South Bay increased by 3.1% to $14.22 per square foot from the fourth quarter of 2013 to the fourth quarter of 2014. The vacancy rate fell from 17.4% to 16.9% in that period. This is somewhat of a mixed bag for firms in Silicon Valley. On one hand, the falling vacancy rate should encourage new R&D construction in the region. On the other hand, as the supply falls, R&D rent is becoming less affordable than it has been in recent years. Rent has increased nearly every quarter since 2011, with steeper growth in the past few quarters. As discussed with regard to residential real estate, the most important way to make rents more affordable is to increase the supply of properties. In this case, it is a good sign for the health of the local economy that R&D property is in high demand, but affordability may become a growing concern if there is not enough new construction to meet that demand.

Rent for retail property increased by 4.1% to $32.51 per square foot, which is in between the rent in the Bay Area's most expensive market, San Francisco ($34.67 per square foot) and its most affordable market, the East Bay ($28.68 per square foot). The vacancy rate for retail property decreased much more in the South Bay over the course of 2014 than in neighboring areas: -0.8% year over year compared to -0.1% in San Francisco and -0.2% in the East Bay. The vacancy rate for retail property stands at 4.3% in the South Bay, compared to 3.3% in San Francisco and 6.0% in the East Bay. Economic growth has encouraged new business formation and expansion in the South Bay. It will continue to do so as the home to some of the world's largest firms and the epicenter of high-tech industry. Commercial construction will begin to catch up as the supply of commercial property in the South Bay becomes more and more scarce.

Venture Capital Funding

2014 was an outstanding year for business development in the South Bay, where venture capital funding was the second-highest in the country at $6.9 billion, behind only San Francisco at $15.7 billion. A total of 417 venture capital deals were struck, just under half of the deals struck in San Francisco (876 total).[3] Investment in software companies was extremely high as in most years. Tango, a Mountain View-based firm, received $280 million in venture capital funding in 2014.[4] Palantir Technologies in Palo Alto is believed to have raised an estimated $500 million in funding last year, increasing its valuation to $15 billion with the expectation of raising even more funding in 2015.[5] Consumer products firms, such as Nest Labs, Inc. ($80 million) and Roku, Inc. ($60 million), were some of the top venture capital recipients in the region last year.

The strength of business activity throughout the country and in much of the world is bringing more venture capital funding to the South Bay than in recent years. According to Venky Ganesan, the managing director of Menlo Ventures, whereas the emergence of the internet was the driving force behind the tech boom in the late 1990s, the emergence of mobile technology is the driving force behind the current boom.[6]

Despite concerns about another tech bubble in Silicon Valley, firms receiving massive amounts of venture capital funding are older and more stable than those in previous cycles. For instance, Palantir Technologies was founded in 2000 and has received roughly $1 billion in venture capital funding since that time. Seed stage funding receives just a small fraction of the funding of firms at later stages. For example, according to MoneyTree, in the second half of 2014, later stage venture capital funding totaled $2.4 billion in Silicon Valley, compared to just $129.3 million in funding for seed stage firms.

Unlike before, mutual funds and hedge funds are beginning to invest in startups, allowing those firms to delay going public. Low interest rates on U.S. Treasury bonds have driven hedge funds to fund tech companies. For instance, Coatue Management led a $158 million funding round in the third quarter of 2014 for Box, based in Los Altos.[7] With interest rates remaining very low, with perhaps a little uptick from the Federal Reserve in June, venture capital funding should continue to grow in the South Bay throughout 2015. This new money should lead to more growth in the high-skilled industries of the South Bay economy in the years ahead.

[3] "U.S. Venture Capital Investment Spanned 160 Cities in 2014." National Venture Capital Association. January 20, 2015.
[4] Brandon Butler, "12 Most Eye-Popping VC Tech Deals of 2014." Network World. December 15, 2014.
[5] Elizabeth Dwoskin and Telis Demos, "Palantir, Valued at $15 Billion, Is Raising More Money." Wall Street Journal. January 16, 2015.
[6] Heather Somerville, "VC Quarterly Report: Looking a Lot Like the Last Dot-Com Boom." San Jose Mercury News. August 11, 2014.
[7] Heather Somerville, "VC World Changing as Hedge Funds Target Tech Startups." San Jose Mercury News. November 11, 2014.

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