SONOMA COUNTY EDB ECONOMIC DEVELOPMENT BOARD

INDUSTRY INSIDER
FINANCIAL SERVICES INDUSTRY

INDUSTRY REPORT | 2023

ECONOMIC DEVELOPMENT BOARD

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SONOMA COUNTY BOARD OF SUPERVISORS

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EXECUTIVE SUMMARY

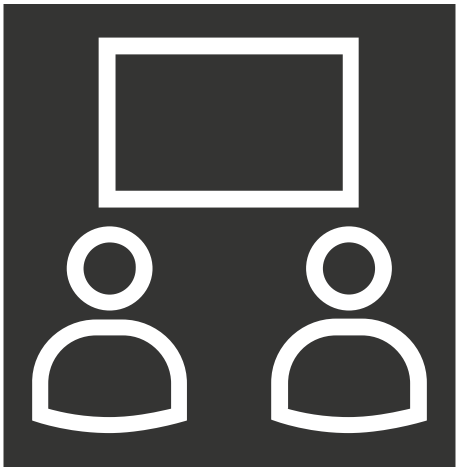
August 2023

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to present the 2023 Financial Services Industry Insiders report. Our research partner, Moody's Analytics, provided the research for this report. For additional information, questions, comments, or suggestions please contact us at (707) 565-7170 or visit www.sonomaedb.org.

HIGHLIGHTS

The local financial economy is faring well, despite the shocks of the Silicon Valley Bank failure and rising interest rates from the Federal Reserve. Job growth in the county is outpacing both the state and the nation, although economic growth in the industry is still below its full potential. Industry wages are 30% higher than the average wage county-wide, however, a slowing down of the economy may reduce demand for certain job classifications, especially those connected to crediting and lending. Although the past year has had shocks at national financial institutions, it is believed that the worst is over, and the financial industry is expected to fully recover by early 2024, contingent upon no further shocks to the system.

Rising interest rates has led to higher delinquency rates from consumer and commercial clients. Combined with the skittishness of individuals and firms to let their hard-earned dollars sit in a bank account due to the spring bank failure, the resulting lending problems could pose a risk to small and mid-sized banks in the region. Short term interest rates are currently higher than long term interest rates, which puts pressure smaller banks' viability. The banking crisis has impacted the overall economy with changes in lending standards and loan growth. It is projected that commercial and industrial loan growth, especially real estate loans, will slow in tandem with the job market.



Insurers are grappling with a more difficult pricing environment, informed by rising interest rates and slow credit growth. Higher interest rates and tighter underwriting standards are projected to limit demand for new loans, resulting in a reduced demand for asset managers in the local economy. The economy for consumers has recovered significantly from the pandemic, but savings have been drained and real wages are down. As such, insurers will have to strike a balance between raising rates with tightened consumer spending. This balance is tough to maintain, especially with increased risks associated with a worsening fire season. It is expected that insurance-related job growth will slow.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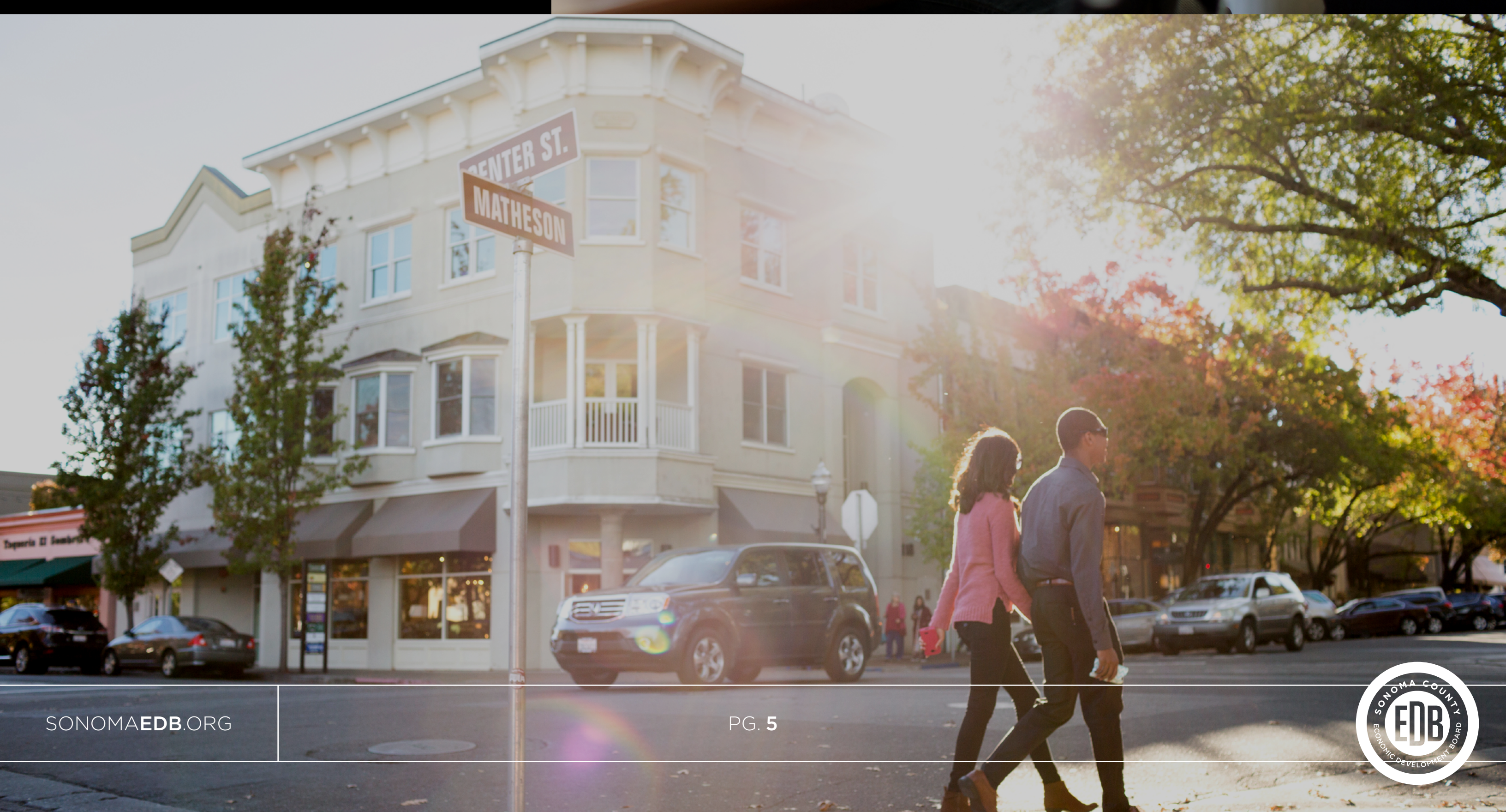

MATHESON

Recent Performance. Sonoma County's economy is in good shape, though job growth is slowing. Still, year-ago job growth is outpacing that of California and the West, and at around 3%, is advancing at a solid clip. The recovery from the pandemic was slower in the earlier stages of recovery; total nonfarm payrolls are just a touch off of their pre-pandemic levels, while the state and region both eclipsed those marks last year.

Sonoma's financial services industry has followed roughly the same path as the overall economy. Payrolls are still below their pre-pandemic levels but have made strides over the past year. Annual job growth is outpacing that in the state and region and is driving the overall job market. Financial services growth is responsible for about 5% of the net new jobs over the past year, compared with just 2% nationally.

Credit intermediation payrolls, which make up about a quarter of the county's financial services industry, have struggled under the weight of rising interest rates and weakness in equity markets. Meanwhile, insurers have fared better, as higher interest rates improve profit margins. Real estate and rental and leasing are the real standouts among the financial services industry. Rapid house price appreciation and strong rent growth over the past two years have pushed industry payrolls up nearly 10% over the past year, and the industry now makes up nearly half of total industry employment.

Finance makes up a smaller-than-average share of the county's workforce, comprising around 4% of local employment compared with nearly 6% nationally. However, the industry's importance to the economy cannot be understated, as it contributes a 15% share of the county's output and industry wages are about 30% higher than the average wage countywide.

Macro drivers. The U.S. economy remains admirably resilient, and odds of a recession beginning this year are receding. But the coast is far from clear. Recession risks will remain uncomfortably high well into next year given the Federal Reserve's unprecedented interest rate hikes to rein in inflation. Economic growth is below potential, and even small shocks could lead to recession. Therefore, it is important to examine the risks posed by the recent deal to suspend the Treasury debt limit, the end of the student loan payment moratorium this fall, and the mounting fallout from the banking crisis that hit during spring. While meaningful, these events are unlikely to steer the economy into a downturn.

The economy's resilience is clearest in the job market. Abstracting from the vagaries of the employment data, which are considerable due in part to low and falling response rates to the surveys upon which the data are based, job growth is steadfast at near 250,000 per month. There are modest job losses in manufacturing, information services and commercial banking, but not enough to suggest the labor market is at risk of faltering. Even construction, the economy's most interest-rate-sensitive industry, continues to add to payrolls as multifamily and infrastructure-related projects absorb workers who are losing their jobs building fewer single-family homes.

Employment is far and away the most important coincident measure of economic activity, and it is difficult to envisage a recession without significant job losses. The employment numbers are subject to substantial revisions, including the annual benchmarks to full-employment counts based on unemployment insurance records, but nothing suggests the economy is even close to losing jobs. The evidence shows hiring sturdy, job openings plentiful, and layoffs—though they have picked up—still low by historical standards.

Sturdy consumer spending also displays the economy's grit. Households are not spending with abandon, and their spending patterns have been shifting, but they are doing their part to keep the economy moving ahead. Real (after-inflation) spending is growing at a sturdy 2% pace. Consumers are the firewall between recession and continued growth, and the wall has held despite the heat of high inflation, which has forced households to draw down a big chunk of the excess savings they amassed during the pandemic.

But now with inflation moderating and real incomes rising again households no longer need to dip as deeply into savings to maintain their spending.

Buoyant stock prices and durable house prices are also signs of resilience. Stock prices are up more than 20% from their lows last year—a bull market. Investors are betting that interest rates are near a peak, and while corporate earnings are slumping, this comes after big increases during the pandemic and investors seem reasonably optimistic about their prospects. National house prices also have rolled over, but they are down only a couple of percentage points from their peak last summer. Most homeowners have fixed mortgages with rates near 3%; they have little incentive to sell while any new purchase will come with a new mortgage rate about double the old one. The upshot is that households are less wealthy than a year ago, but they remain much wealthier than prior to the pandemic. Household net worth has risen at more than a 10% per annum pace since just prior to the pandemic, double the elevated rate of inflation.

Recession worries have been top of mind ever since the Federal Reserve began its aggressive interest rate hikes more than a year ago. And with good reason. Historically, if the economy is struggling with high inflation and the Fed is aggressively battling that inflation, recession almost always follows. It is no surprise that the economy is growing slowly at below its potential and is vulnerable. It would not take much of a shock to undercut already-fragile sentiment and cause households and businesses to pull back on spending and investment and for the economy to suffer a downturn. Fortunately, the most immediate headwinds to the economy, including the debt limit legislation, the end of the student loan payment moratorium, and the banking crisis, do not appear to be serious enough to do in the economy. Together they will impede economic growth, but they will not undermine it. More challenges are dead ahead, but this economy appears on track to buck history and avoid recession

Industry drivers. The banking crisis that hit in March when Silicon Valley Bank and Signature Bank failed is likely to be the most significant, albeit most difficult to gauge headwind to economic growth. These dramatic bank failures sparked a loss of confidence in the broader banking system and serious deposit outflows. Small and midsize banks with a significant number of uninsured depositors were hit hardest.

The government's muscular response did quell the worst of the immediate fallout, but the banking crisis will undermine growth this year, and the impacts on the financial services industry will be pronounced.

The principal channel through which the banking crisis impacts the economy is through banks' lending standards and loan growth. If banks tighten their underwriting so aggressively that it impairs the credit businesses need to invest and run their operations, real estate operators require to finance commercial estate development and homebuilding, and households need for big purchases such as houses and vehicles, then the economy suffers. To date, the banking crisis' impact on underwriting standards and loan growth has been muted. Outstanding commercial and industrial loans have effectively gone sideways, while commercial real estate and consumer loans outstanding are still growing, albeit at a somewhat slower pace than before the crisis.

However, the banking system has other serious challenges it will need to grapple with in coming months. Meaningfully higher delinquency and default rates are next. Credit quality has been extraordinarily good since the pandemic hit given the extraordinary government support, forbearance, and those previously record low interest rates. But this is no longer the case, and credit problems are on the rise. Even without a recession, the losses could overwhelm smaller and midsize banks with thinner capital bases, more skittish depositors and shareholders, and outsize commercial real estate portfolios, particularly loans secured by office buildings and retail space in hard-pressed large urban areas. Some $1.4 trillion in commercial real estate debt will need to be refinanced through mid-decade, and this could prove problematic.

Although small and midsize banks are not typically considered systemically important, as their failure should not be enough to trigger a broader bank run, that may not be as true now given how skittish bank depositors and other creditors are and how quickly they are able to move their funds. There are also reasonable concerns regarding how much pressure a prolonged yield curve inversion—where short-term rates are higher than long-term rates—will put on bank net interest margins, profitability and, thus, their viability. There are also the risks lurking in the nonbank or shadow financial system that may be laid bare if rates remain high for too long. The nonbank residential mortgage lenders quickly come to mind.

The script for the banking crisis is not finished, and the economic fallout will continue into next year. However, our working assumption is that the worst is over. By early 2024, at the peak of the economic impact, the banking crisis will reduce real GDP by 0.4%.

Pricing. Financial services firms will grapple with a more difficult pricing environment this year. Higher interest rates, and tighter underwriting standards, will limit demand for new loans, especially for mortgages. Financial market instability and modest equity market returns will also crimp demand for asset managers, though with the worst of the banking crisis over, these will fare relatively better.

A prolonged yield curve inversion will weigh on net interest margins in the banking industry. With short-term rates higher than long-term rates, banks' net interest margins will be pressured lower, weighing on pricing and profitability.

The economic climate is proving a mixed bag for insurers. Higher interest rates are providing firms with lucrative opportunities to increase reinvestment income, and premium hikes have pushed surpluses to record levels. On the other hand, higher inflation in key sectors such as auto and healthcare has markedly increased claims costs as well. Further, insurers may be compelled to raise policy rates, though they will be constrained by a cooling economy and belt-tightening by U.S. consumers and businesses. As higher costs constrain margins, insurers will tread carefully and taper any near-term hiring plans, focusing on financial consolidation instead.

Long-term outlook. Sonoma County's financial services industries will throttle back in the near term. Tightening credit standards, slowing loan growth, and only modest equity market growth will all combine to slow job and output growth through the end of this year. A general slowdown in the economy will provide headwinds to growth across the financial services industry, but with the Fed likely pausing on interest rate hikes and receding recession odds, the pain will be short-lived, and the industry will accelerate in 2024 when interest rates begin to normalize.

Longer term, the industry will face some of the same challenges that the overall labor market will grapple with. Chief among these concerns are demographic trends. Net migration trends are improving, but the county is still losing residents on net. With persistent housing affordability issues, population declines are set to persist in the medium and long term. A dwindling working-age population will exacerbate labor supply issues and hold back business investment, and this will hamstring the long-term potential for the county's existing base of finance firms.

On the other hand, high quality-of-life metrics and low business costs relative to those in San Francisco will enable the county to capture outflows from the Bay Area. Should affordability concerns lessen as house prices retreat this year, demographic trends could improve and this would benefit the long-term outlook.

The outlook for insurance providers is more uncertain. Seemingly worse fire seasons every year have placed insurance carriers in a predicament between untenable premium hikes and refusing coverage. New statewide measures to make homes more fire-resilient and improve coverage will prove beneficial to the industry's long-term outlook but will raise costs to consumers and insurance providers alike.

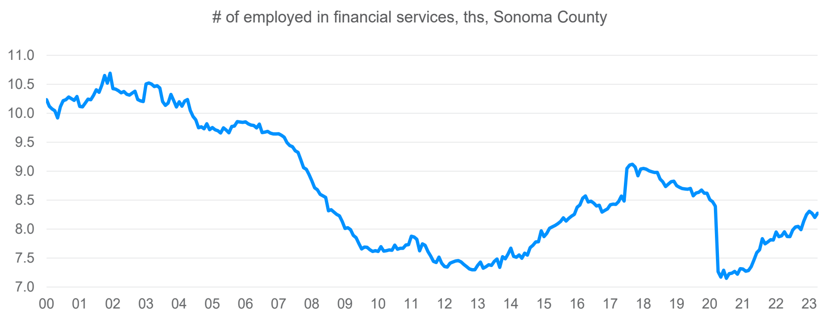
Upside risks. Consumer spending could exceed expectations and drive faster growth. The labor market is loosening but remains tight, keeping job and income growth elevated. Businesses, correctly, are calculating that the labor-supply issues in the aftermath of the pandemic are here to stay. This is leading 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. Uncertainty about the spending outlook has been elevated given the persistence of elevated inflation and the downbeat mood of consumers and businesses. Sentiment measures have consistently shown people pessimistic about the U.S. economy's near-term trajectory. Pervasive recession fears since early 2022 have primed people to believe a severe downturn is imminent. It may not take much loosening in the labor market for consumers to quickly hunker down and spend less.

Downside risks. Risks remain stacked to the downside but have shifted slightly. In the wake of a series of major bank failures in the U.S., financial conditions have tightened. After a decade of unusually low interest rates, it is possible to imagine other institutions will be similarly blindsided. However, idiosyncratic explanations may leave Silicon Valley Bank and First Republic Bank as relatively isolated disasters. The banking sector is on solid ground; this is particularly true for larger banks. Strong reforms in the aftermath of the global financial crisis are proving prescient.

Outside of the banking sector, overleveraged firms, also accustomed to lower-for-longer borrowing, are set to come under increasing pressure as rates rise. A string of corporate defaults or a significant widening of corporate bond spreads could dampen sentiment and soften investment. Further, as welcome as the resolution to the debt limit saga was, the impasse will generate financial market volatility. The U.S. Treasury slowed debt issuance when it was not clear that an agreement would be met. Now that the debt ceiling has been raised, there will be a wave of new bond issuance. This will cause yields to increase and further markdowns of bank assets.

Colin Seitz
June 2023

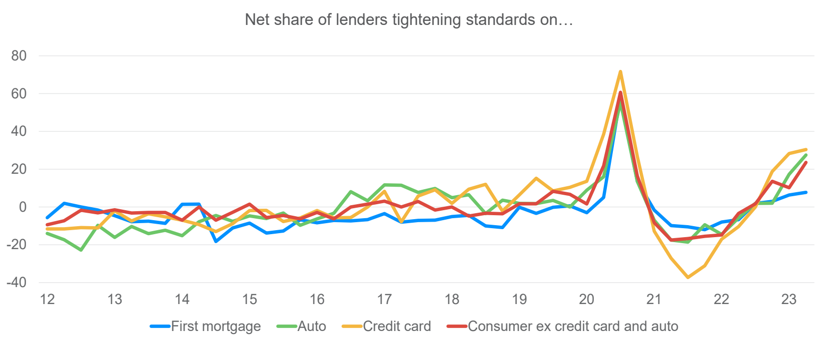
Finance Industry Still on the Mend



Sources: BLS, Moody's Analytics

Sonoma County's financial services payrolls are on the mend. Industry payrolls have ticked higher in the last year despite equity market instability and recession fears, but total employment has still not reached its pre-pandemic peak. With credit and loan growth pulling back, finance employment will advance only modestly through the end of this year, before accelerating in tandem with the U.S. economy late next year.

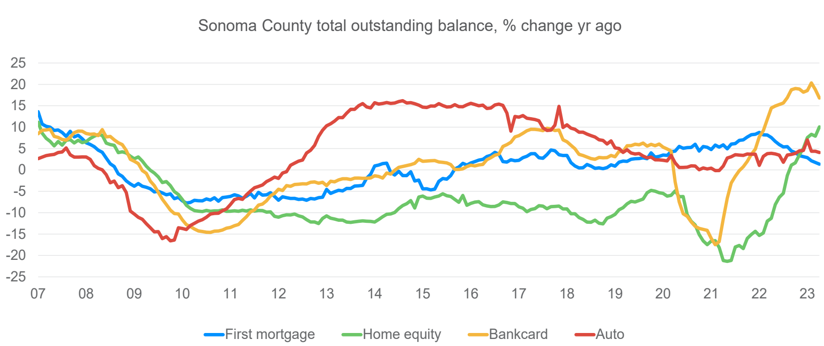
Creditors Continue to Pull Back



Sources: Federal Reserve, Moody's Analytics

Deteriorating loan performance and expectations of slower economic growth in the coming quarters have lenders tapping the brakes. Several survey-based datapoints suggest creditors are pulling back, sapping the flow of funds into the consumer and commercial markets. Data from the Federal Reserve indicate lenders raised standards during the second quarter across most retail products. Households have had more difficulty obtaining credit in the last four quarters, a trend likely to continue through at least year's end.

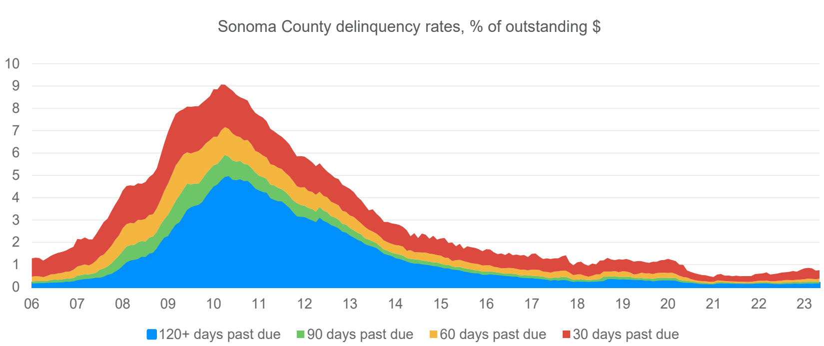
Credit Growth Is Weakening and Will Slow Further…



Sources: BLS, Moody's Analytics

Credit growth across most segments is beginning to pull back, and this is especially apparent in first mortgage lending. The slowdown in the housing market and elevated mortgage rates are crimping demand for new mortgages. Bankcard and home equity balances are elevated but beginning to pull back. Balance growth has been decelerating since last April; further slowing is expected. The lack of housing inventory will keep first mortgage lending in check while a softer jobs market and slower wage growth weigh on the credit card and consumer finance segments.

…But Pristine Balance Sheets Will Soften the Blow



Sources: BLS, Moody's Analytics

While credit standards are tightening, there has been no sign of a deterioration in credit quality. As a result of generous financial support from Congress in the form of unemployment benefits and direct stimulus, as well as elevated rates of saving among higher-income households, consumer credit performance remains in great shape. Delinquency rates will creep higher as the labor market slows and excess savings are dwindled down, but will remain low by historical standards.

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