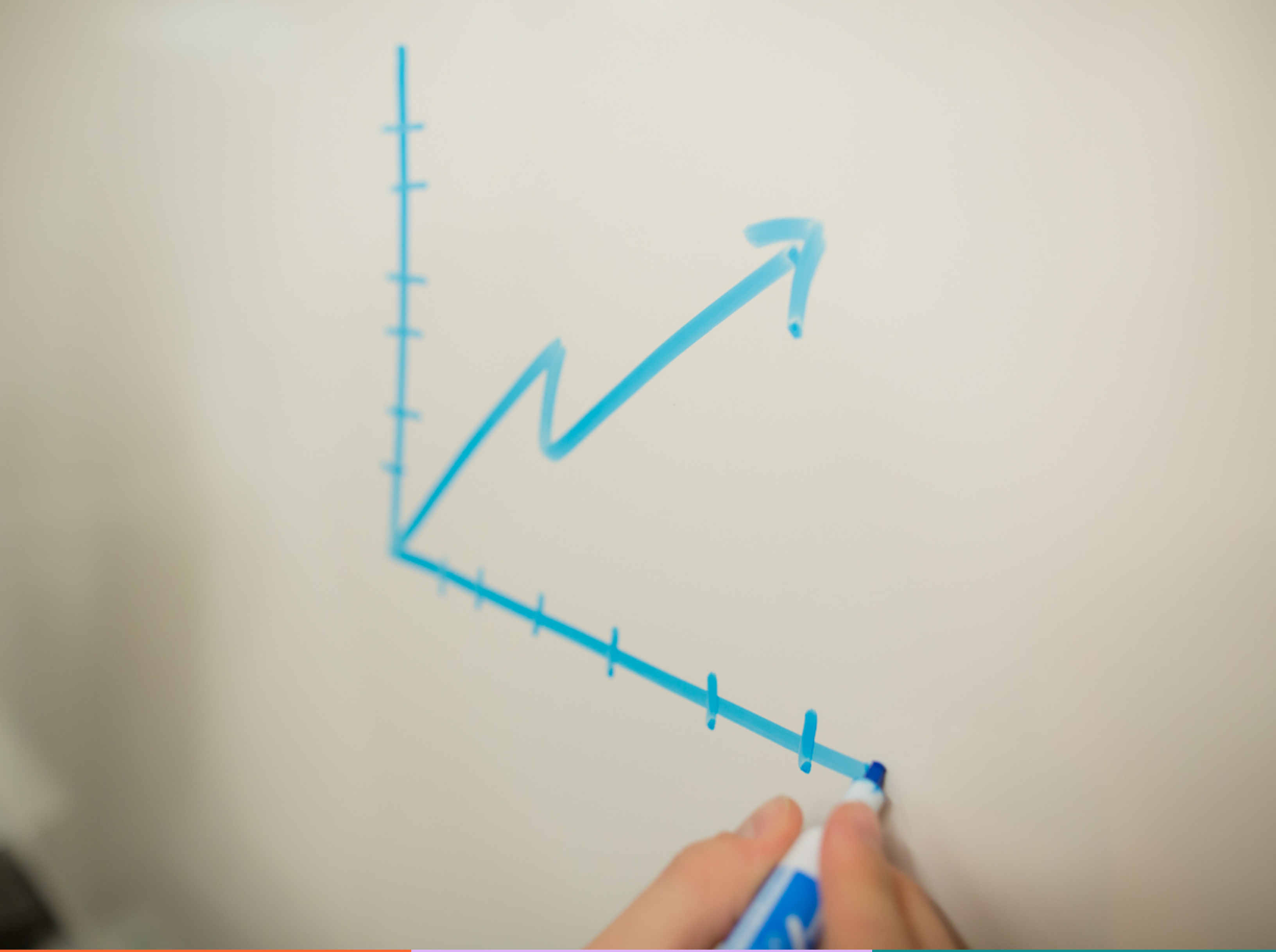

Sonoma County
Economic Development Board

Quarterly Economic Outlook

2024

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Executive Summary

Macroeconomic Outlook

A slower than Expected Start

The United States economy is growing at a sluggish 1.4% as of August 2024 as opposed to the annual 2.5% growth in 2023. This metric is largely attributed to the cooling job market. To date, the nation is adding fewer than 200,000 jobs per month, which is not enough to absorb all jobseekers, contributing to the low but growing nation-wide unemployment rate of 4.1%.

Is this Slowdown by Design?

While the numbers coming in are causing notable stress to consumers and corporations alike, much of the nation's economic slowdown has been carefully crafted by the Federal Reserve. The Fed's higher-for-longer federal fund strategy from 2022 to the first half of 2023 was designed to aggregate demand, cool of the hot job market, and allow inflation to ease. So far, inflation is moderating, for the Fed's 2% target rate is in clear view; albeit this restrictive monetary policy is likely not viable in the long-term, placing undue stress on all levels of the U.S. economy.

Impacted Actors

The primary actor most affected by the Fed's long-term strategy are consumers, specifically those in the bottom third of the income bracket. Although, even top earners are at risk. The positive so-called wealth effects brought on the pandemic, such as excess savings due to sheltering in-place and soaring home values and stock holdings, will falter if the Fed opts for its higher-for-longer strategy as the stock market will be at significant risk of selling off.

Higher interest rates also pose as a risk to the United States' banking system. While economic fallout from banks' credit tightening has been mitigated by credit offered through alternative lending methods, that strategy is unsustainable and the treasury yield curve remains highly inverted, calling into question banks' long-term profitability.

Microeconomic Outlook

Sonoma County:

As with the United States, Sonoma County's economy has cooled entering 2024; however, it remains a model micro-economy of California. Although that may be put into question in the coming months, for the Quarterly Census of Employment and Wages highlights that the county may be performing at a lower standard than forecasters originally believed. While healthcare remains a stable and growing industry, manufacturing and leisure/hospitality, two other vital industries to Sonoma, have faltered in recent years as payrolls, hiring, and earnings remain low. Population decline and an aging workforce are other key factors that are expected to make Sonoma County struggle to keep pace with more economically diverse parts of the state.

August 2024 Quarterly Economic Outlook

BY COLIN SEITZ

MACROECONOMIC OUTLOOK

The U.S. economy's growth has throttled back this year. Real GDP, which grew 2.5% in 2023, increased only 1.4% annualized in the first quarter of this year and is on track for similar growth in the just-ended second quarter. This tracking estimate is based on the monthly and weekly economic data released to date. The numbers could improve, but recent data have largely come in even softer than anticipated.

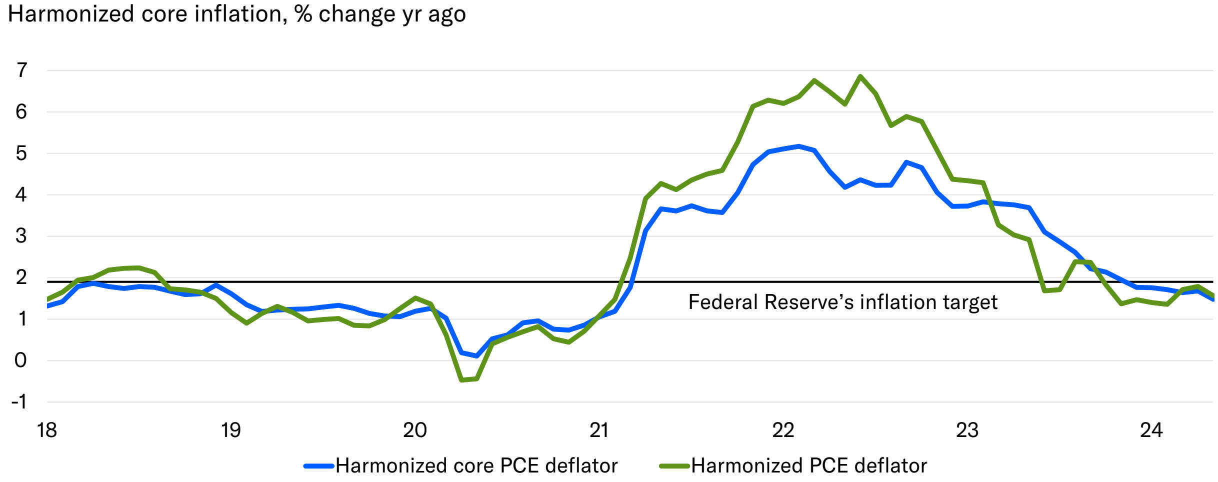
Job growth has also suddenly cooled. This has come into clearer relief with recent sizable downward revisions to monthly payroll job gains. Downward revisions of this size generally happen when the economy's growth is downshifting meaningfully and the survey of businesses used to estimate jobs is struggling to catch up to the reality of the pullback. Judging from the vagaries of the data, the economy is creating fewer than 200,000 jobs per month—not enough to absorb everyone entering the job market. Unemployment is on the rise.

Much of this economic slowdown is by design. The intent of the Federal Reserve's aggressive hikes in the federal funds rate in 2022 and the first half of 2023, and the high funds rate that has prevailed since—the Fed's higher-for-longer strategy—has been to weigh on aggregate demand, cool off the hot job market, and allow wage and price pressures to ease. Quantitative tightening, in which the Fed does not replace the Treasury and mortgage securities it owns as they mature and prepay, reinforces these efforts by putting upward pressure on longer-term rates.

Indeed, inflation is moderating, and the Fed's 2% inflation target is in clear view. Year-over-year growth in the consumer expenditure deflator, the inflation measure the Fed is targeting, has slowed to 2.6%. And so-called harmonized inflation, which excludes the vexed implicit cost of homeownership, also known as owners' equivalent rent—as is done in much of the world—is already firmly below the Fed's target (see Chart 1).

But there are mounting indications that the Fed's higher-for-longer strategy threatens to be too high for too long. Its restrictive monetary policy is putting undue stress on the economy. The longer the Fed maintains its tight policy, the more likely that policy will undermine the economy's growth. The odds of this happening are still low, but they are not inconsequential—and they are rising.

Chart 1: Inflation Is Already at the Fed's Target by Some Measures



Sources: BLS, Moody's Analytics

The softening job market is the most immediate worry. Unemployment remains low at 4.1% and consistent with a full-employment economy, but it has risen half a percentage point over the past year. It is also somewhat higher than in 2019, the last time the economy was thought to be at full employment. Indeed, most job market indicators, while consistent with a good job market, are now softer than just before the pandemic.

The surge in foreign immigration in the past several years makes it more difficult to decipher what is happening in the job market. The increase in unemployment, for example, probably has more to do with the strong immigration-fueled growth in labor supply than a weakening in labor demand. But the pullback in hours worked per week, the slide in temporary help jobs, and the lower number of open positions are more indicative of softer labor demand.

Hiring has also slumped. This may be explained in part by lower quit rates, as workers who quit en masse during the pandemic have landed in jobs that are higher-paying and more suited to their skills, education and interests. They are thus less inclined to switch jobs. This is particularly so for homeowners who are effectively locked into the mortgages they got when interest rates were exceptionally low. But weaker demand is likely also to blame since hiring is off most in industries struggling to maintain activity. These include information services, financial services, professional and business services, and retailing.

It is encouraging that although layoffs appear to be off their bottom—as evidenced by the recently higher initial claims for unemployment insurance—they remain historically low. One theory for the persistently low layoff rate is that businesses have had a difficult time finding new workers and retaining existing ones since well before the pandemic. This is likely to continue given demographic trends, including the aging of the workforce, more retirements, and tighter immigration restrictions. Employers are thus reticent to lay off, even if demand for their goods and services weakens. They are fearful of being unable to find new workers once demand picks up.

Another theory is that since many businesses are enjoying near-record profit margins, they are able and willing to forgo layoffs for longer than is typical when demand for their wares slumps. Behind their fat margins are the pandemic shortages that allowed many businesses to jack up prices by even more than the increase in their labor and other costs. Businesses also did an admirable job locking in extraordinarily low interest rates that prevailed at the height of the pandemic. Their lower interest payments have gone straight to the bottom line.

But these theories for firms' reticence to lay off workers feel somewhat tenuous. Yes, demographic trends and wide profit margins are consistent with labor hoarding, but as can be seen in the rash of layoffs that hit the tech sector last year, even high-flying companies will shift quickly from aggressively hiring to laying off workers. Indeed, once one company in an industry decides to reduce payrolls, others in that industry seem to follow quickly.

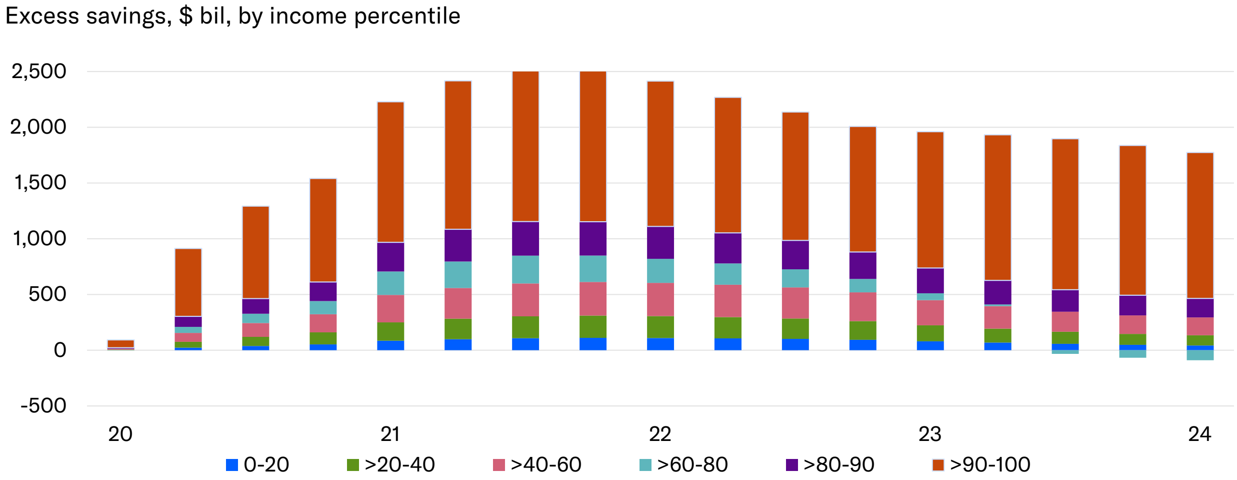
Historically, more layoffs are a necessary condition for a serious weakening in the economy and a recession. Layoffs spook consumers who turn more cautious in their spending, convincing businesses to reduce their payrolls even further. This ignites a self-reinforcing vicious cycle. That is not happening. But if initial UI claims, currently near 230,000 per week, move consistently toward 300,000, that would be a clear indication that such a dynamic is taking hold.

Consumers are also increasingly vulnerable to the Fed's higher-for-longer interest rate strategy. This is of concern because consumers have been the engine of growth since the pandemic hit. Indeed, consumers have been remarkably resilient spenders with real consumer spending up at a 2.5% per annum pace in the four-plus years since the pandemic began. That is precisely the growth in spending in the comparable period before the pandemic. American consumers also have propped up much of the global economy as avid buyers of goods and services produced overseas, which is clear from the much wider post-pandemic U.S. trade deficit.

Lower-income households, those in the bottom third of the income distribution, are not surprisingly most at risk from the higher interest rates. Their excess savings from the government's pandemic support are long spent, and when inflation was raging, they borrowed aggressively to maintain purchasing power (see Chart 2).

Lenders also meaningfully lowered their underwriting standards at about the same time as credit scores benefited from the collapse in borrowing during the height of the pandemic and the government requirement that lenders not report delinquent borrowers to the credit bureaus. Credit card, consumer finance (including buy-now, pay-later loans), and subprime auto lending surged.

Chart 2: High-Income Households Still Have Plenty of Excess Savings



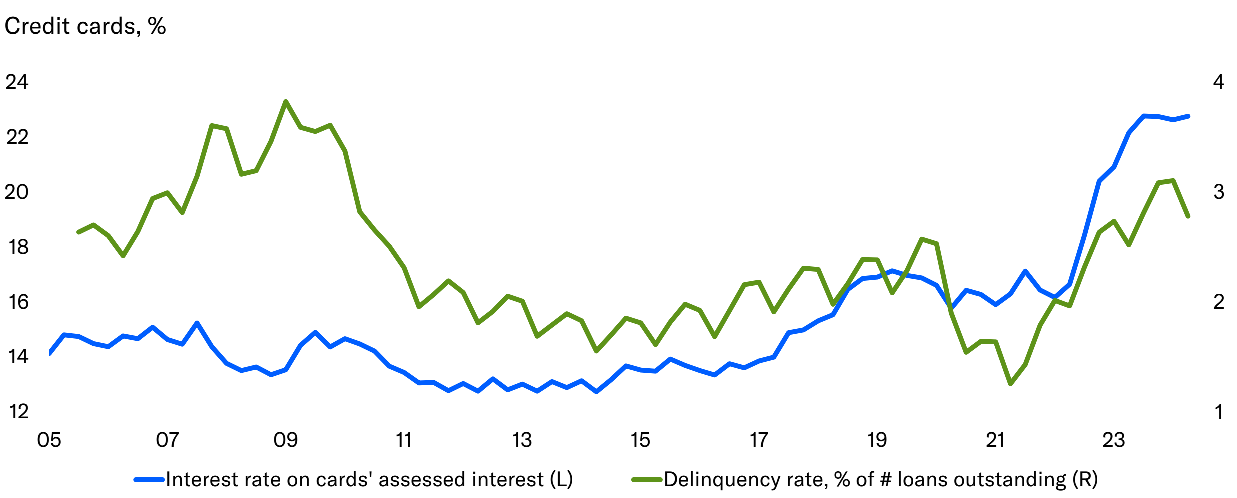
Sources: BEA, Federal Reserve, Moody's Analytics

This may have been financially manageable when interest rates were low, but it is much less so now when rates are high. Credit card rates are especially onerous, surging to a record of more than 22% (see Chart 3).

This reflects the Fed's tighter monetary policy and the general increase in interest rates, but the spread between credit card rates and lenders' funding costs has never been so wide. There are multiple reasons, including less competition among credit card lenders, but the higher interest expense is too much for many borrowers to bear, pushing delinquency rates to their highest since the aftermath of the Global Financial Crisis.

Although lower-income households in the bottom third of the income distribution are under significant financial pressure, they account for only about 15% of overall consumer spending. The economy cannot flourish if these households are struggling; there are too many problematic societal and political implications. But the economy can continue to post solid growth if middle-income and especially high-income households remain stalwart spenders.

Chart 3: Lower-Income Households Are Under Financial Stress



Sources: Equifax, Federal Reserve, Moody's Analytics

Households in the top third of the income distribution account for well over half of overall spending. To complete the picture, households in the middle third account for close to a pro-rata share of spending.

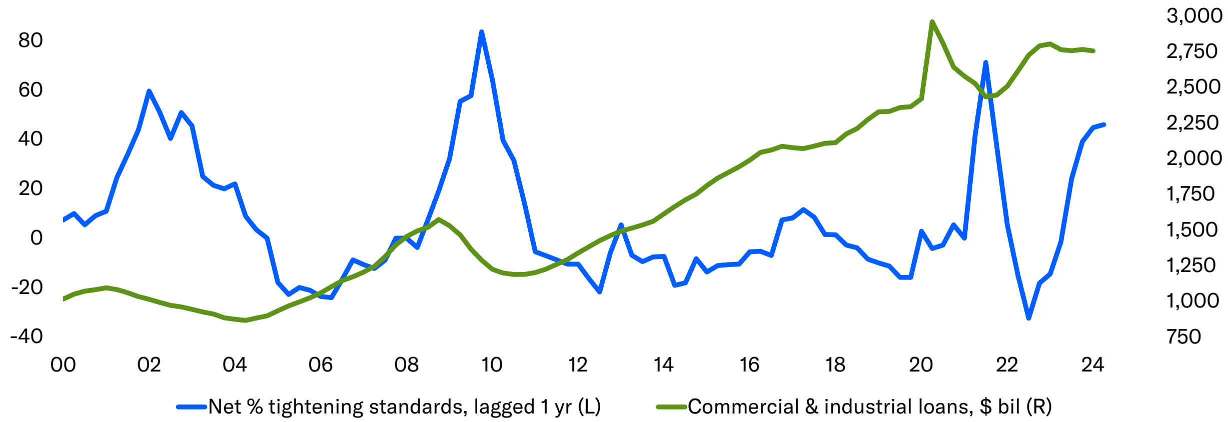
It is no exaggeration to say that high-income households are doing about as well as they ever have financially. As with all income groups, unemployment is low and wage growth is strong. What is different is their balance sheets. If high-income households have any debt, it is a mortgage loan with a low rate. The value of their assets has also soared since the pandemic hit as they are sitting on a mountain of excess savings built up during the pandemic when they were sheltering in place. Much of that cash remains in checking and money market accounts, where it collects significant amounts of interest income.

In addition, the value of their homes and stock holdings has surged by more than $40 trillion, equal to an astounding $1 million per high-income household on average. This increased wealth largely explains the willingness and ability of the wealthy to spend more than their incomes and save less. The aggregate personal saving rate has been hovering at 3% to 4%, about half of what it was before the pandemic.

These positive so-called wealth effects, which have been critical to powering consumer spending and economic growth, are highly vulnerable to the Fed's higher-for-longer strategy. Stock prices, in particular, rest on investors' expectations that the Fed will begin cutting rates by a quarter percentage point in September and by at least a quarter point each quarter through the end of 2025. This is what is currently implied in fed funds futures. If the Fed goes off this rate-cutting path and holds to its higher-for-longer strategy for even longer, the stock market will be at significant risk of selling off. The wealth effect could very well turn negative and the fallout on consumer spending and the economy potentially substantial. Not that Fed officials should be unduly swayed by worries that their policies will weigh on stock prices and the financial fortunes of the wealthy, but if they do not begin cutting rates soon, there could be significant economic repercussions.

The other significant casualty of the Fed's higher-for-longer strategy is the banking system, which continues to struggle more than a year after several high-profile bank failures sparked a broad-based deposit run that forced the Fed, the FDIC and other regulators to step in with extraordinary support. While these efforts succeeded in stemming the run and stabilizing the system, banks bowed and responded by tightening their lending standards. The cost and availability of credit and loan growth have been significantly affected. Commercial and industrial lending—lending by banks to small and midsize companies—has stalled, and C&I loans outstanding are about where they were at the start of the pandemic (see Chart 4). Bank underwriting of consumer loans and multifamily and other commercial real estate loans also has tightened significantly, and loan growth has slowed.

Chart 4: Last Year's Banking Crisis Still Impedes Lending



Sources: Federal Reserve, Moody's Analytics

To date, the economic fallout from banks' credit tightening has been mitigated in good part by credit provided by the nonbank part of the financial system. Strong growth in so-called leveraged lending and private credit, and sturdy bond issuance in the corporate bond market have gone a long way to offset the lack of bank credit extended to nonfinancial businesses and even to real estate (see Chart 5).

But the banking system remains under substantial stress. With the Fed's higher-for-longer strategy, the Treasury yield curve remains deeply inverted, as it has been for nearly two years. This is especially troublesome for banks' profitability. Their net interest margins are closely tied to the curve—they generally borrow shorter-term funds and lend those funds longer term at a higher rate. When the curve inverts and funding costs rise compared with lending rates, their NIMs and profitability weaken. Banks have done an admirable job managing their NIMs, but doing so has become more difficult since last year's banking crisis forced them to significantly increase their deposit rates. Given the lags between the yield curve and NIMs, those margins are set to decline at least through the end of the year and will continue to do so into next year unless the curve soon becomes positively sloped (see Chart 6).

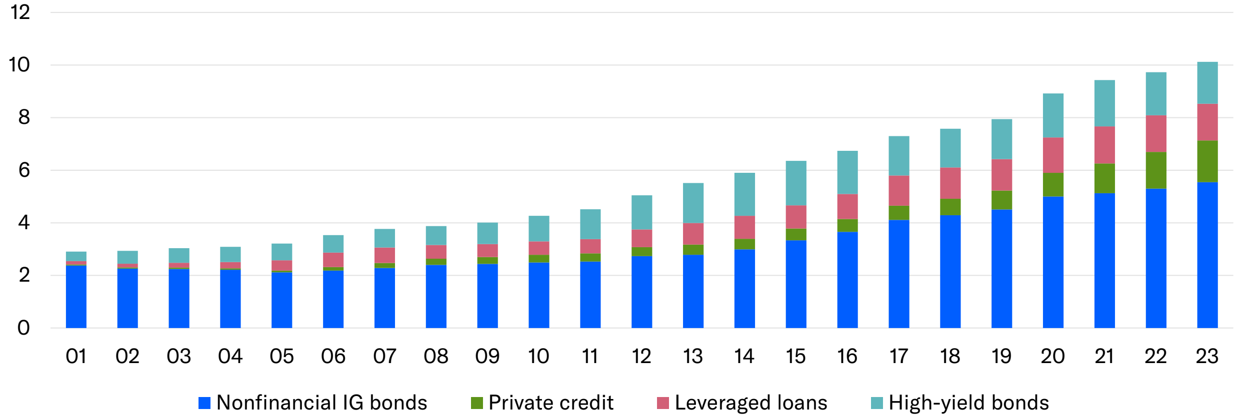
Banks are also dealing with weakening credit quality. The charge-off rate on all bank loans is as high as it has been in more than a decade and on the rise. How much higher it goes will partly depend on whether the Fed begins cutting rates soon. Many commercial real estate loans, especially on more troubled office and multifamily properties, are rolling over in the coming months. If rates remain high, more of these loans will fail to meet the interest coverage and other economic thresholds necessary to be refinanced. They will ultimately go delinquent and then default.

Banks are also under increased regulatory scrutiny with all its attendant costs. This is no surprise given last year's banking crisis, as regulators are on high alert. Symptomatic of this is the heated debate over the Basel III endgame capital regulations. While banks appear to have headed off the most onerous capital requirements—and much depends on the outcome of the election given candidates' starkly differing views on bank regulation—regulatory costs under almost all scenarios are unlikely to decline; it is more a question of how much they will increase. This is not meant as a commentary on whether these regulatory changes are appropriate, only that they add to the banking system's tough operating environment.

It is encouraging that recent ruminations from Fed Chair Jerome Powell and other Fed officials suggest they are getting close to cutting interest rates. Powell even invoked the risk that policy may be too high for too long. Investors believe the first rate cut will be in September and that this will be the start of a steady diet of rate cuts through next year. This requires that inflation and jobs numbers in coming months cooperate, but all of the trend lines look good. However, if the Fed does not begin cutting rates soon for whatever reason, the

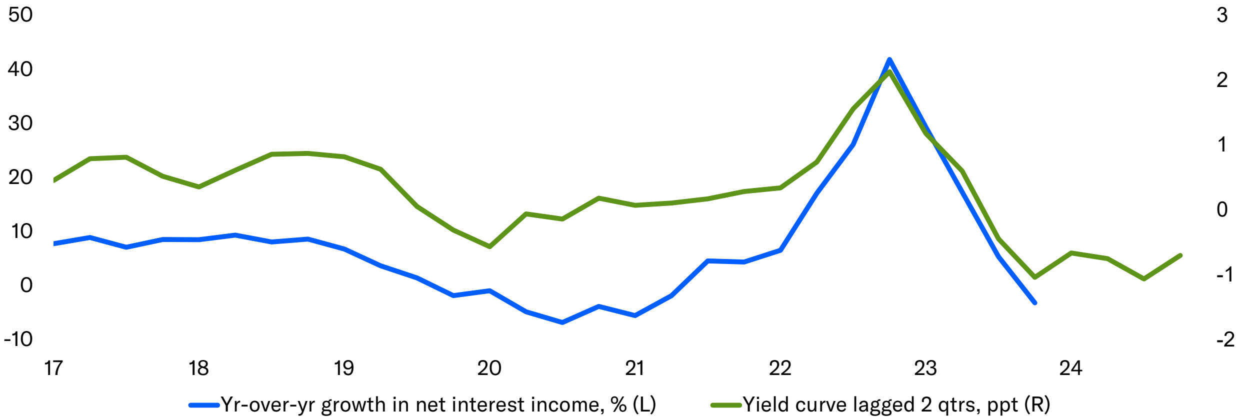
Chart 5: Lending by Nonbank Financial Institutions Soars

Value of U.S. debt outstanding by category, $ tril



Sources: IMF, Moody's Analytics

Chart 6: Inverted Yield Curve Pressures the Banking System



Sources: Equifax, Federal Reserve, Moody's Analytics

economic stresses identified here will intensify, others will materialize, and the economy will ultimately break. It should not come to this, but we will know soon.

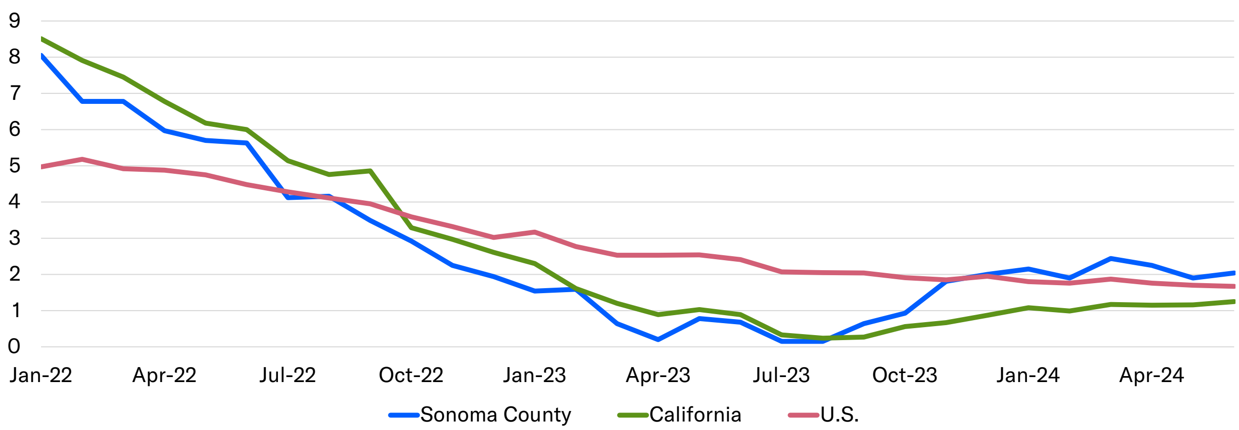
SONOMA COUNTY OUTLOOK

Sonoma County's economy has cooled following a strong end to 2023. Monthly employment gains have slowed, but not so much that the county has surrendered its lead on the state and the nation on a year-ago basis (see Chart 7).

That said, the more accurate but lagged Quarterly Census of Employment and Wages continues to point to a less favorable story. The most recent annual benchmark revisions revealed weaker growth last year than previously estimated and the most recent data point to another downward revision for this year. While the payroll survey data indicate a resurgence of growth in the fourth quarter that has carried through into the first half of 2024, the QCEW data suggest Sonoma County payrolls backtracked in the final months of last year (see Chart 8). The next round of benchmark

Chart 7: Sonoma County Outpaces the State and Nation...

Employment, % change yr ago



Sources: BLS, Moody's Analytics

revisions is a long way off, but it is likely that Sonoma County is not performing as well as it appears now.

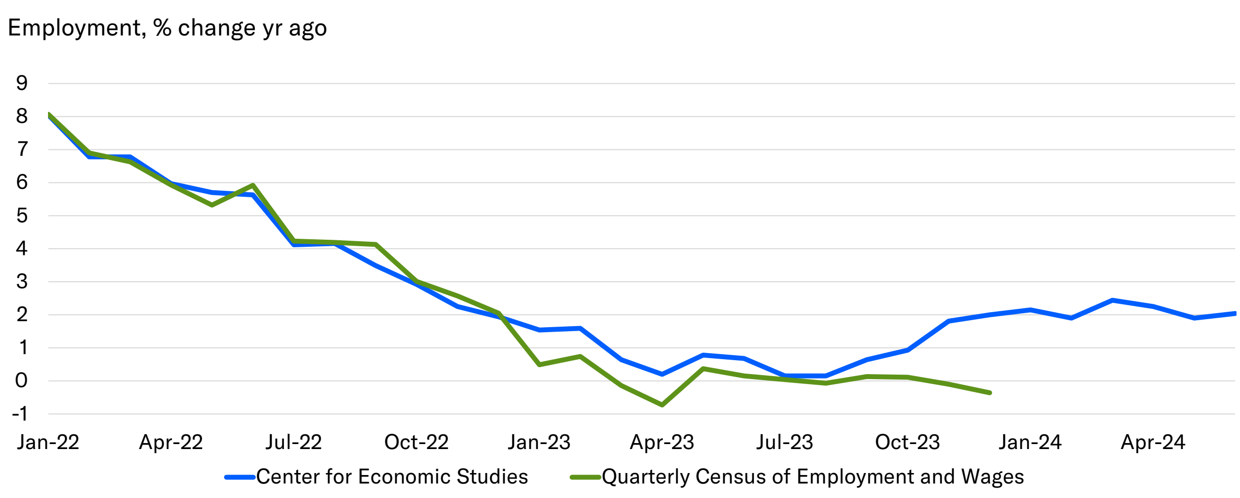
Manufacturing was revised lower in the latest benchmark revisions. Factory employment nosedived in the first half of last year before tapering off in the third quarter—a far cry from the modest decline that was initially reported. Since then, payroll estimates have shown that factory employment has at best moved sideways since the fourth quarter. On the other hand, the QCEW data suggest that payrolls contracted again in the fourth quarter, so another downward revision is likely in store. Falling food inflation provided less of a tailwind than expected in the second half of last year and producer sentiment dipped in response, weighing on payrolls. While last year's grape harvest set records and this year's is off to a good start, grape growers remain wary that demand for wine will be tempered by consumers' lack of confidence in the economy despite inflation approaching target. Expectations of fewer and later rate cuts from the Fed have shaved a bit of optimism from both producers and consumers. That said, with the first cut now expected in September, there is reason to believe that the second half of the year will be better than the first. At the very least, wineries and breweries will get a boost from tourist spending, which will be bolstered by the strong U.S. labor market.

Leisure/hospitality has lost its mojo. Payrolls have backtracked since the start of the year. On the upside, passenger counts at Charles M. Schulz airport were up 14% year over year in the second quarter after a disappointing first three months of the year. This suggests that demand for vacations is holding on even as travelers rein in their spending. Leisure/hospitality employment will rebound in the coming months, but growth will downshift thereafter as the labor market loosens and wage growth ebbs. Decelerating income growth will temper consumer spending from locals, but Sonoma County's world-class wineries, parks and favorable climate will ensure steady visitor demand for its offerings long term.

Healthcare remains a bright spot. Industry payrolls continue to march higher. That said, such stellar growth will not be sustainable long term. The aging population will support demand for health services, but a dearth of young working-age residents will create headwinds to net job gains. Sonoma County has been losing residents for years—and while those losses seem to be moderating, most of the improvement is attributable to older population cohorts. Therefore, healthcare demand should hold steady and keep a floor under payrolls, but opportunities for growth will be hard to come by.

Sonoma County's demographic challenges will remain the key headwind to growth. Affordability issues spurred out-migration and subsequently population losses in recent years. While the outflow of residents has slowed during the last two years, the outlook remains downbeat. Housing affordability ranks in the bottom decile nationally (see Chart 9) and price appreciation will outpace that in both the state and

Chart 8: ...But Downward Revisions Likely



Sources: BLS, Moody's Analytics

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