



INDUSTRY INSIDER FINANCIAL, REAL ESTATE & CREATIVE INDUSTRIES

INDUSTRY REPORT

2022



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CONTENTS

- 4. EXECUTIVE SUMMARY
- 6. FINANCIAL, REAL ESTATE & CREATIVE
INDUSTRIES: SONOMA COUNTY



EXECUTIVE SUMMARY

August 2022

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to present the 2022 Financial, Real Estate, and Creative Industries 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.

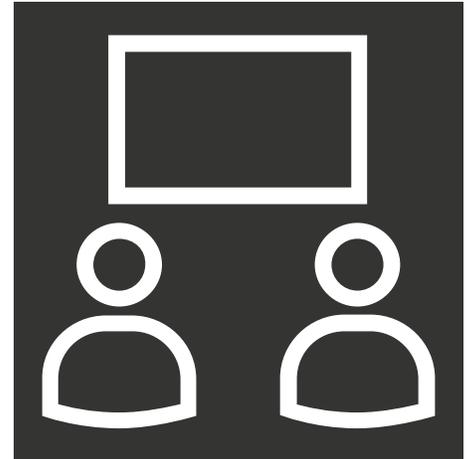
HIGHLIGHTS



Growth of new establishments in Sonoma County has outpaced that of the U.S. and other mid-sized California metro areas. There is demand for supporting local financial institutions through credit and capital. Local banks saw significant increases in net income in 2021. The second largest bank in the county, Summit State Bank, reported a 40% annual increase in net income in 2021. Markets in 2022 will be defined by geopolitical uncertainty and tighter monetary policy. Interest rates are predicted to rise, and mortgage rates will rise along with them. Sonoma County's financial services employment has not yet recovered from the pandemic. It is predicted to grow slowly and only replace its job losses in the mid-2030s.



Sonoma County's house price appreciation is strong but remains below California and U.S. averages. Slower house price appreciation will make the area more affordable. Months of supply in housing are down to about half a month, well below the three-month standard constituting a sellers' market. However, rising mortgage rates will slow the pace of sales. Permit issuance for multifamily units are nearly six times as high as that of single-family units. Multifamily units will be a key source of more affordable housing and increase housing supply. While most of the commercial real-estate market struggles to accelerate post-pandemic, the industrial market stands out, with vacancy rates lower than pre-pandemic levels.



The creative sector in Sonoma County has stabilized and will contribute only minimally to further employment and income growth. Software publishing, computer system design, and biomedical research make up over half of total creative cluster employment and wages. Unfortunately, these industries are not likely to grow significantly in Sonoma County in the coming years as large firms favor expansion in areas with lower costs, either elsewhere in the U.S. or overseas. Low business costs relative to San Francisco still support Sonoma as a design hub, but relative to other tech centers, costs in Sonoma County are high and cause the industry to trail behind that of other locations in the Bay Area and the U.S.



Recent Performance. Sonoma County's economy is once again pressing on the accelerator, and the county is making up ground on California and the U.S. Nonfarm payroll growth has outstripped the national pace by a comfortable clip over the past year, but a steeper initial drop in payrolls still leaves the county further from recouping its pandemic-related job losses. All told, payroll employment is down 6.5% from February 2020, compared with 4.5% for the U.S. Leisure/hospitality has made significant progress in recent months, but the industry remains the hardest hit by the pandemic and payrolls are 15% below pre-virus levels. Manufacturing was quicker to recover, but its growth has stalled since the initial recovery. The jobless rate is continuing to trend lower, though much of it is due to a labor force that is only beginning to inch higher. The housing market is in good shape. House price appreciation is strong but cooling and behind the national average. Permit issuance is accelerating at a robust pace, but this is due to a surge in the multifamily segment.

Macro drivers. This year may be an even better year for the economy than 2021, although growth will slow following the rebound from the pandemic in 2021; we expect real GDP to increase 4% and monthly job gains to average 330,000. The outlook for the labor market remains bright, as the pandemic is expected to weigh less heavily on hiring. Job gains will total about 4.5 million in 2022 after more than 6 million jobs were added last year. All jobs lost during the pandemic will be recovered by the second half of 2022 and the labor market will return to full employment in early 2023 as more workers are drawn back to the labor force. Hard-hit consumer industries, which bore outside losses, will drive gains as the economy further normalizes.

The unemployment rate will eclipse pre-pandemic lows and fall to 3.5% by year's end. This improvement is a bit misleading given the hole that remains in labor force participation. Even as more workers come off the sidelines, employers will face increasing difficulty filling jobs because of the seismic shift of retiring baby boomers and the desire of many workers to change careers post-pandemic.

Inflation should also moderate significantly in the coming year. The CPI is expected to slow to less than 3% by the end of 2022—not too far from the Fed's target. Oil and natural gas prices are retesting their highs given Russia's invasion of Ukraine, but there are reasons to believe they will not stay elevated for extended periods of

time. There is plenty of excess capacity globally to produce more oil and gas, and producers will not be able to resist doing so for long given the profits they are able to make. Oil should be flirting with its long-run price of close to \$69 per barrel by late in the year.

Financial services. Stock markets had quite the bull run in the pandemic era. Comparing year-end real Standard & Poor's 500 price returns from the onset of each recession to the end of the following expansion since 1950, stocks in 2020 and 2021 outperformed every single cycle, including the end-1990s stock rally that led to the 2001 dot-com bust. Sonoma County's financial institutions enjoyed a record-setting year on the back of the strong financial market performance and recovering economy. Growth in new establishments has kept ahead of that of the U.S. and California's midsize metro areas, generating demand for credit and capital and supporting local financial institutions. Summit State Bank, the second-largest bank in the county by assets, reported a 40% annual increase in net income in 2021 compared with a year prior. Meanwhile, Santa Rosa-based Exchange Bank posted a solid increase in net income, up 8% in 2021 compared to a year earlier.

Tighter monetary policy and increased geopolitical uncertainty will define markets in 2022. Interest rates will rise steadily over the coming year and weigh on asset prices even as supply-chain constraints ease. The 10-year Treasury yield will firmly move above 2% by mid-2022 and to around 2.5% by the end of 2022, with the pace of rate increases slowing as inflation moderates by year's end. Equity values will decline throughout 2022, despite stable, if not spectacular, earnings growth.

Overall growth will slow as big-ticket spending wanes due to higher borrowing costs. Mortgage lending, which makes up more than 70% of total consumer credit balances, is highly sensitive to interest rates, which will rise steadily throughout 2022. The Federal Reserve has telegraphed several rate hikes this year to normalize monetary policy that was engineered to accommodate growth and keep credit flowing during the pandemic. We expect four 25-basis point hikes this year. As these rate increases are announced, borrowing costs on home and auto loans will rise, curbing demand. COVID-19 Omicron risks are fading, and unsecured lending will continue to gain steam as the transition to spring invites growth in services spending that has been depressed since 2019.

Sonoma's financial services employment has hardly rebounded since the onset of the pan-

demic, extending its secular decline from 2018. With markets turning less supportive this year, financial services employment will grow only modestly and will not recoup its job losses until the mid-2030s.

Real estate. The nationwide housing market is scorching, and house price appreciation is robust nearly everywhere; 94% of U.S. metro areas recorded double-digit annual price growth as of November 2021. Sonoma County's house price appreciation is strong but trails the national and state averages and is slowing after peaking in mid-2021, with weaker population growth holding back more rapid growth. This is not necessarily bad news; Sonoma County's housing market is one of the most unaffordable nationally, ranking just outside the top 20. Slowing house price appreciation will ease affordability concerns.

Most measures of housing demand are flashing green. Months of supply at the current sales pace is down to half a month, with three months typically considered a sellers' market. Home sales have slowed because of extremely low supply, but the trailing 12-month pace has marked its strongest year in more than a decade. Any available homes are being snapped up, and home sales will likely continue to moderate as the market rebalances and house prices begin to ease. Rising mortgage rates will provide an additional speed limit to home price growth as interest rates are projected to climb through 2022.

Permit issuance is bifurcated between the single- and multifamily markets. Single-family permit issuance showed no meaningful acceleration in 2021 compared to a year prior, but still sits on the high end of its historical performance save for the buildup following the Tubbs Fire. On the other hand, the multifamily segment is advancing nearly six times as fast to close out 2021 than a year prior. While this has smaller multiplier effects on the broader economy, they are a key source of more affordable housing and will provide a solid increase in housing supply that will cushion the declines in single-family home affordability.

The commercial real estate market mostly stagnated in 2021. After rising in mid-2020, both the office and retail segments have seen their vacancy rates hold roughly steady as COVID-19 continued to linger and nonessential business closures, contagion fears, and work-from-home arrangements remained commonplace for much of the past year and a half. Retail vacancy rates have shown some signs of improvement over the last three quarters and

boast a more optimistic outlook than the office market as more companies commit to long-term remote-work plans. The industrial market is the standout, with vacancy rates already below their pre-pandemic levels. The surge in e-commerce and nationwide goods purchases is likely to slow as spending shifts more to services that have been unavailable for the last two years. Yet, the county's collection of food and beverage manufacturers will keep vacancy rates steady.

Insurance. Sonoma County avoided significant damage from fires in 2021, a welcome respite after being ravaged by the Tubbs Fire and Glass Fire in previous years. Nonetheless, 2021's fire season in California, coupled with the still-lingering effects of fires in years past, has left the insurance landscape in Sonoma complicated.

The devastation of 2020's fire season and ongoing complications from previous years' payouts led California to enact new measures designed to improve fire insurance coverage. In 2020, the state insurance commissioner took a step to prevent property insurance companies from dropping a slew of homeowner customers, banning insurers for a year from canceling coverage for people residing in or near areas where the state's 16 wildfires burned last year. It protects 140,000 policyholders living close to where the Kincade Fire sparked in north Sonoma County in late October from losing coverage on their properties. State officials unveiled a framework of "home-hardening" steps that Californians can take for their residences to prevent wildfire damage and ultimately help reduce insurance premiums or the risk of being dropped by their carrier. There are currently 12 insurance companies that offer discounts for wildfire safety on a voluntary basis within California and represent about 40% of the overall market, and officials want the framework to increase the numbers of carriers participating by putting specific details in place.

According to the Department of Insurance, the number of non-renewals in Sonoma County triggered by insurance companies increased in 2020 to 2,829 policies from 2,341 in 2019. That is a relatively small number given the approximately 147,000 homeowner policies that were either renewed or were new ones in 2020. However, there has been a sizable growth in the number of local homeowners who have had to rely on the state FAIR plan, which is the state's insurer of last resort. There were 689 county residents who signed up for

the FAIR plan in 2020 and an additional 517 who renewed their FAIR policies for an overall total of 1,206.

Creative cluster. Sonoma County's creative industries have stabilized, and further contributions to employment and income growth will be minimal. High-paying software publishing, computer systems design, and biomedical research payrolls have held steady in recent years, contrasting with the surging traditional Bay Area powerhouses. These industries, which make up more than half of total creative cluster employment and wages, will add few new workers over the coming years, as Sonoma's top tech and medical device firms favor expansions in low-cost locations in the U.S. and overseas over Sonoma.

For example, Medtronic is consolidating its fulfillment and logistics operations in Memphis. While its Sonoma County operations are unlikely to be affected, the company is shifting resources toward lower-cost destinations. Keysight Technologies, another crucial anchor of Sonoma's creative cluster, posted strong revenue gains in 2021, but there have been no mentions of any expansion in the county.

Long-term outlook. Sonoma County's financial services, real estate and insurance industries will fare well in the near term as the economy marches into an accelerated recovery. While most of the industries have weathered the COVID-19 recession, an improving labor market nationally and locally will be an added boon to the housing market this year and next. Longer term, however, demographics may impose a speed limit on the residential real estate market. Net in-migration has slowed substantially over the past three years, as deteriorating housing affordability has created barriers. Affordability concerns have eased somewhat in the past two years, but house price appreciation is forecast to outstrip the national average by a significant margin in the near term, further eroding affordability.

The outlook for the insurance industry 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.

Low business costs relative to those in San Francisco and plentiful access to venture capital will still support Sonoma County as a global

design hub, but rising business costs relative to other tech centers will handicap efforts to retain and grow its high-paying tech industries. As a result, the creative cluster's share of total employment will trail that of the Bay Area economies and the broader U.S.

Upside risks. Consumer spending could exceed expectations and drive faster growth. Last year, a fresh round of fiscal stimulus drove the U.S. saving rate above 20% and excess saving fueled consumption growth. As a result, the saving rate declined by the end of last year close to the pre-pandemic rate and is expected to decline further this year. If baby boomers, in particular, spend like they have in the past, the saving rate could come down even more. Further, if widespread worker shortages drive wages higher than expected, consumer spending could rise even more.

Sonoma may become an attractive destination for remote workers fleeing San Francisco, given its high quality of life and more spacious homes. A reversal in migration trends would supercharge the housing market and provide a larger customer base for the county's collection of financial services firms. There has been little evidence of this yet, but it could become prevalent as more work-from-home arrangements are solidified in the Bay Area.

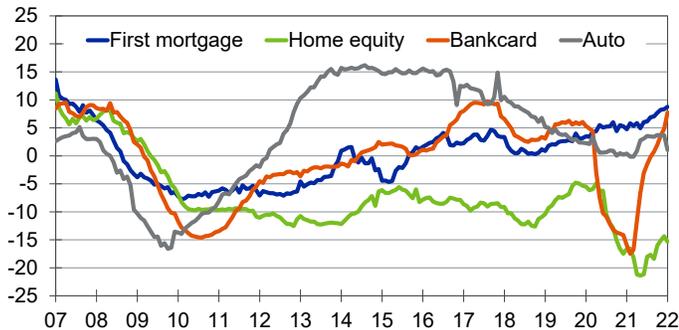
Downside risks. Risks remain stacked to the downside but have shifted slightly. Although the Omicron variant's economic fallout appears weaker than Delta's, evidenced by a positive January job surprise, global labor market and supply-chain frictions might still dent corporate profits. In this context, fewer monetary policy options are available than before. The January inflation surprise instead creates pressure toward more tightening. A sharper equity market correction than built into the baseline remains a prominent downside risk. This could stall the recovery in financial services employment and chip away at a source of job growth.

Climate change is a growing risk, not only to the insurance industry but also to residents and real estate markets. Another devastating wildfire season throughout the state has demonstrated the havoc a natural disaster can wreak on Sonoma's insurers, and should they become increasingly risk-averse and deny coverage to parts of the county, this could create more problems for homeowners and further discourage in-migration to the area.

*Colin Seitz
February 2022*

Sharp Recovery in Consumer Lending...

Sonoma County total outstanding balance, % change yr ago

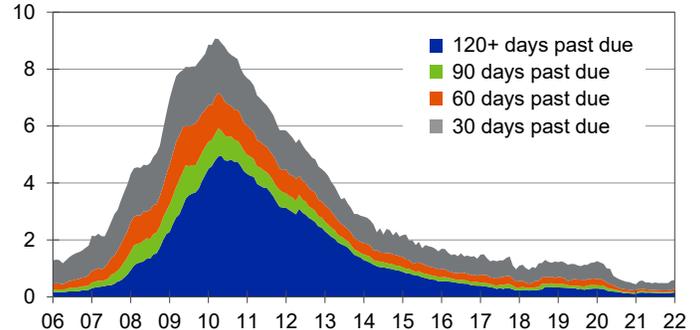


Sources: Equifax, Moody's Analytics

Outstanding bankcard balances are rapidly climbing as the effects of fiscal stimulus payments unwind and spending on travel, entertainment and leisure begins to pick up. Home equity continues to fade from relevance as cash-out mortgage refinancing and the use of credit cards and personal loans to finance home improvement spending have supplanted new home-equity loan lending.

...But Balance Sheets Remain Pristine

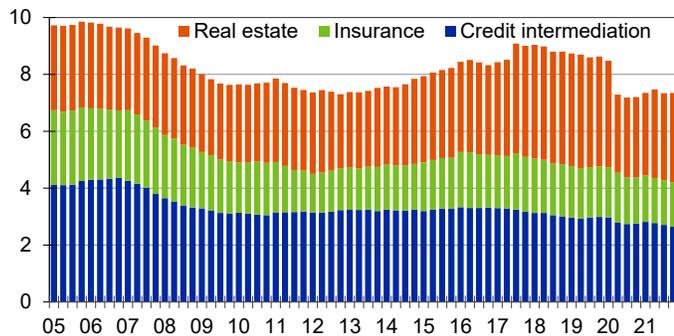
Sonoma County delinquency rates, % of outstanding \$



Despite a significant pickup in consumer lending, 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 vastly improved in 2021, and the end of most forbearance programs has had little effect on credit quality in Sonoma County.

Finance Payrolls Struggle to Break Higher

Financial services employment, ths

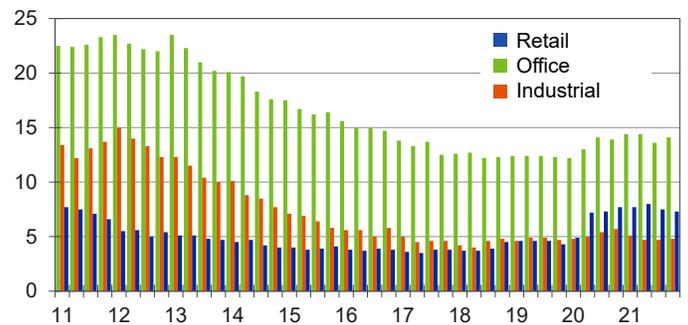


Sources: BLS, Moody's Analytics

Sonoma County's financial services payrolls have held up well in the pandemic, but contributions to job growth will be slim moving forward. Despite last year's financial market tailwinds, employment remains near its post-crisis low, and support will begin to unwind this year. The tight purchase market has already lifted real estate and insurance payrolls, and further gains will rest on credit intermediation, which has traditionally expanded at a more modest rate.

Vacancy Rates Little Changed

Commercial vacancy rate, %



Sources: Keegan & Coppin Co., Moody's Analytics

Vacancy rates have climbed higher as nonessential businesses were forced to operate remotely or closed altogether in the wake of the pandemic, and fear of contagion sapped demand at local retailers. White-collar services firms may shift permanently toward remote work to reduce operating expenses and provide flexibility for employees. Companies are also increasingly looking outside their immediate office locales to capitalize on talent in other locations by offering remote-work opportunities, as well as to reduce labor expenses.



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707 - 565 - 7170

141 STONY CIRCLE, STE. 110, SANTA ROSA, CA 95401