Business Forecast Report

San Joaquin Valley 2014

Volume 3, Issue 1

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San Joaquin Valley

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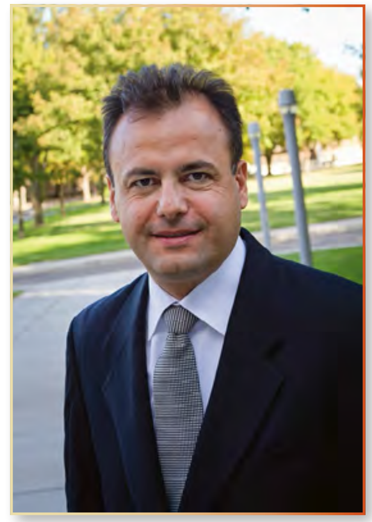
FOSTER FARMS ENDOWED PROFESSOR OF BUSINESS ECONOMICS



Dr. Gökçe Soydemir joined California State University, Stanislaus as the inaugural Foster Farms Endowed Professor of Business Economics in August 2011. Dr. Soydemir brings strong expertise and experience in business analysis and forecasting and has published extensively on applied econometrics, regional economics, financial forecasting, market analysis and international finance.

Dr. Soydemir received his Ph.D. in Economics from Claremont Graduate School, Claremont, CA; an M. Phil. in International Finance from Glasgow University, Scotland, U.K.; and a Bachelor of Science in Economics from Middle East Technical University, Ankara, Turkey. He has several years of central banking experience co-constructing and forecasting large and medium scale macro-econometric models. In addition, he has conducted independent policy research on monetary economics.

Contents

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Benedict Cipponeri, Vitaly Polovin and Benjamin Ross
in the preparation of this report.

Executive Summary

The San Joaquin Valley economy continued to make further progress toward levels that existed before the recession. Rebounding from all-time lows, home values increased more than 20 percent in 2013. The improvement in the housing sector was most visible in single-family building permits, which registered a 37 percent yearly increase. Government employment halted its decline in 2013 and is projected to begin its gradual upward trend in 2014. However, information employment — following a flat trend — worsened further in 2013. Valley total employment increased at about the same pace as it did in 2012. All counties, including Madera, posted growth in total employment. Valley total employment average yearly growth registered at 2.5 percent.

The fastest employment growth occurred in a farm-related sector — wholesale employment — followed by construction employment. Education and health employment grew more slowly than the 10-year benchmark rate, along with manufacturing employment. Average yearly growth in total employment in the past 10 years — a benchmark indicator of long-run performance — increased from 0.69 to 1.07 percent consecutively in the past three years. When compared to this benchmark rate, the 2013 performance at 2.5 percent was more than twice its long-run rate. Now exhibiting a well-defined structural trend, the Valley economy is projected to grow at this faster pace in 2014 and 2015.

Despite the Federal Reserve's inflated balance sheet, prices rose only 1.5 percent annually, a rate below the typical rate of 2.4 percent for the western region. Weekly wages annual growth continued to lag in 2013 and is projected to grow less than the inflation rate. Lagging wages is a sign of lingering excess supply in the labor market, leading to depressed wages and salaries relative to the state and the nation.

In the 2014 and 2015 forecasting interval, Valley jobs are projected to maintain their momentum. All categories of employment are projected to grow faster than their 10-year rates, with the exception of information employment, which is projected to remain flat, at best. The improvement in the housing sector is projected to push beyond rising home prices and interest rates in 2014 and 2015. However, this improvement may be at a more moderate pace. Rising mortgage costs caused a dramatic fall in mortgage activities. Home refinancing demand fell to nonexistent levels, causing banks to lay off staff from mortgage operations. An important leading indicator — foreclosure starts in California, finally reverted back to pre-recession levels in 2013.

Downside risks at the national and global level that put a drag on Valley economic recovery include the Federal Reserve's tapering uncertainty, ongoing sequestration, rising long-term interest rates, and worsening instability in the Middle East. The prevailing expectation is that the Federal Reserve will end its bond-buying program sometime in 2014.

As consumers continue to put their financial affairs in order, more feel confident about their future prospects. Consumer wealth is driven by rising home values. Rising consumer confidence and wealth help improve consumption expenditure, which ultimately culminates in greater national demand for wholesale, manufacturing and farm-related goods from the Valley. While much improvement is needed, the Valley economy gathered momentum in the past two years. In the worst-case scenario, the Valley economy is projected to maintain this momentum gain in 2014 and 2015.

Introduction

In this report, we provide an assessment of past, current and future trends in the Valley economy. Our medium-term projections span from the beginning of 2014 to the end of 2015.

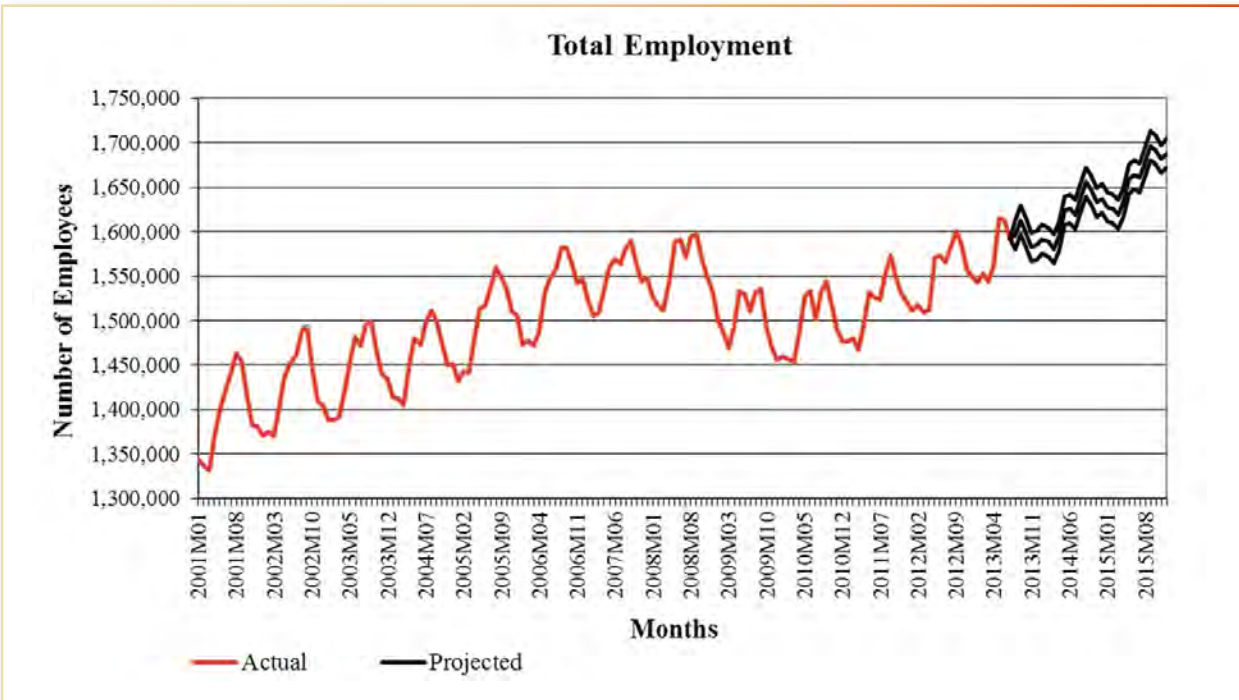
As in previous reports, we forecast a range, rather than a point. The actual realizations are expected to fall within the upper and lower bands. We generate forecasts using realizations up to August 2013. The yearly average figures for 2013 on the following bar charts are also from the first eight months of the year.

The remainder of this report is organized as follows: Section B provides a discussion of San Joaquin Valley labor market conditions and forecasts; Section C reports the region's housing market conditions; Section D reports prices and inflation; and Section E reports depository institutions and capital markets. Section F provides a summary, along with concluding remarks.

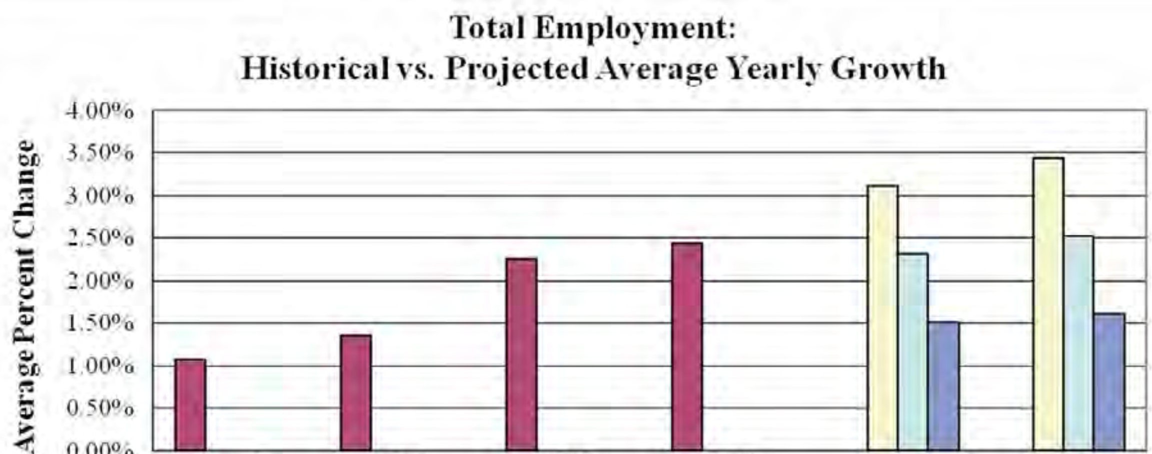
We are grateful to the Valley community for the continued strong support and constructive input in making this project a success since its inception three years ago. Our aim is to provide valuable insight on the key economic indicators from the Valley, relative to the state and the nation.

Employment Indicators

The gap between where the Valley employment is now and where it would have been if the recession had not occurred has narrowed further in 2013. Provided that the Valley total employment continues to grow at the same pace as it did in the past two years, employment levels that have prevailed before the recession are projected to be reached by the third quarter of 2015. For the first time in our reporting, employment grew in all eight counties of the Valley. With the exception of information employment, all categories of employment improved. Government employment stayed flat in 2013. Model forecasts for 2014 and 2015 point to growth in all categories except information employment, which is projected to switch from a negative to a horizontal trend.



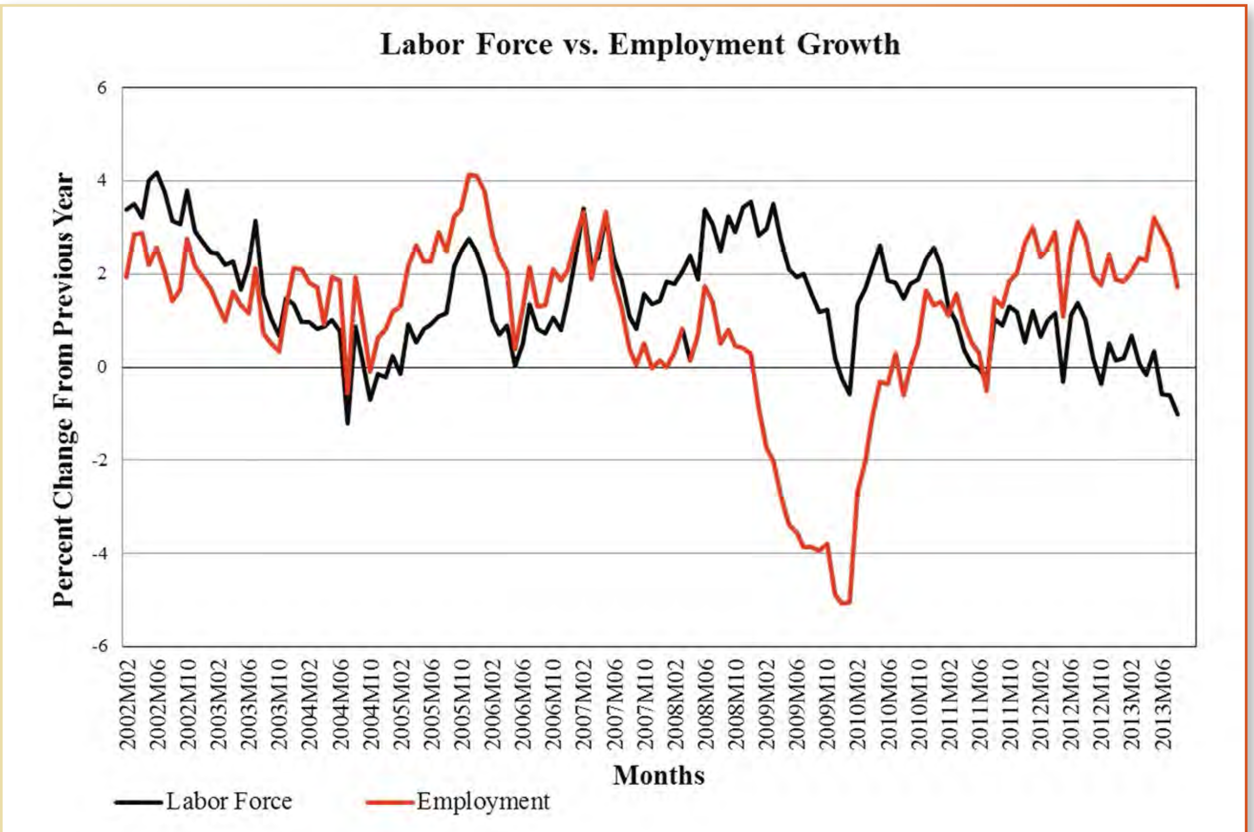
The fastest growth in employment continued to occur in the wholesale sector, followed by construction. Average yearly growth in employment in the past 10 years — a benchmark indicator of long-run performance — increased from 0.69 to 1.07 percent consecutively in the past three years. When compared to this benchmark rate, 2013 performance at 2.5 percent was more than twice its long-run rate. Now exhibiting a well-defined structural trend, the Valley economy is projected to grow at this faster pace — 2.3 and 2.5 percent in 2014 and 2015 respectively.



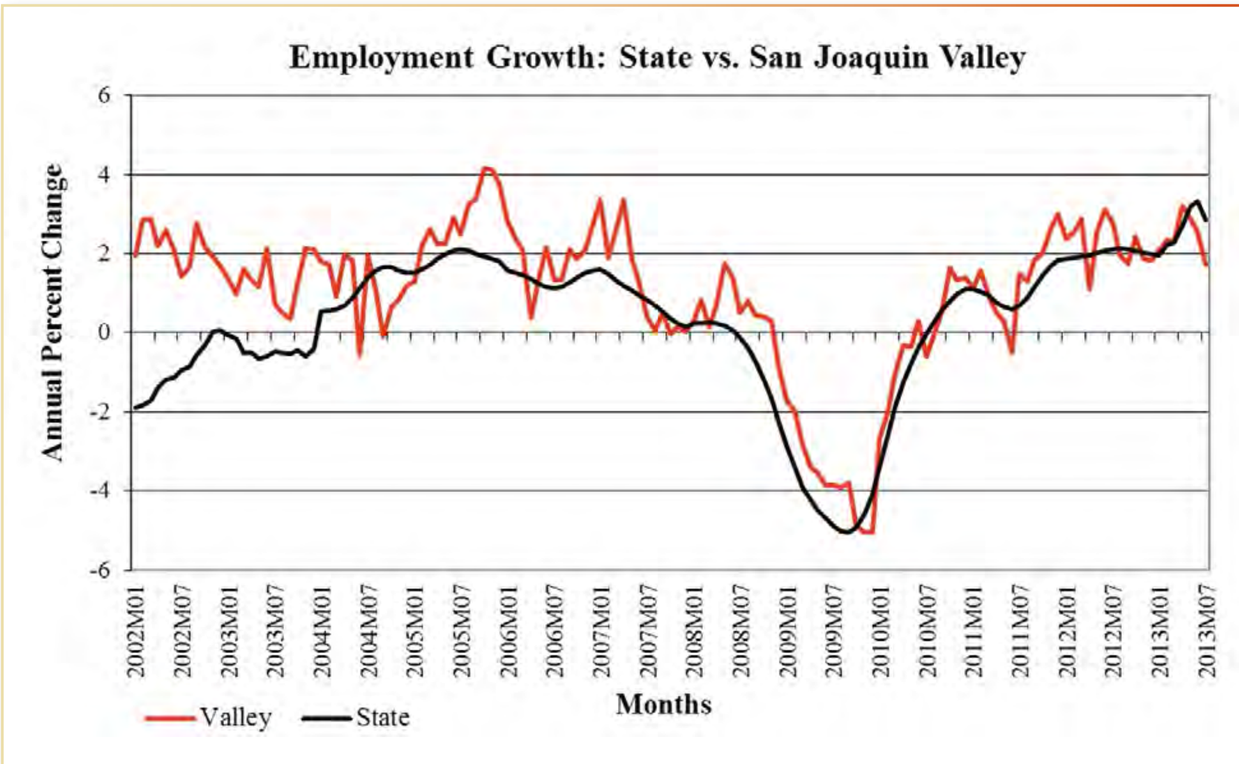
	Sample Average	2011 Average	2012 Average	2013 Average	2014 Forecast	2015 Forecast
Actual	1.07%	1.35%	2.26%	2.43%		
Optimistic					3.11%	3.44%
Most Likely					2.31%	2.52%
Pessimistic					1.51%	1.61%

The Conference Board's consumer confidence index serves as a reliable leading indicator to gauge future consumer activity. Ongoing recovery and the rise in home values increase consumer wealth and confidence. Despite short-term fluctuations, the consumer confidence index has been rising steadily since January 2009, and now exceeds 80 points. As consumer confidence grows, it ultimately affects consumption expenditure, which makes up two-thirds of the U.S. economy and serves as the engine of growth.

Structurally, employment growth exceeds labor force growth in the Valley. As would be expected from a recovering economy, the vertical distance between the two continues to widen. The labor force, at the current moment, displays a downward trend. However, as employment continues to grow and exceeds a threshold level, the labor force is projected to slope upward again to reflect the influx of labor in the Valley, similar to that experienced in the boom years before the recession.

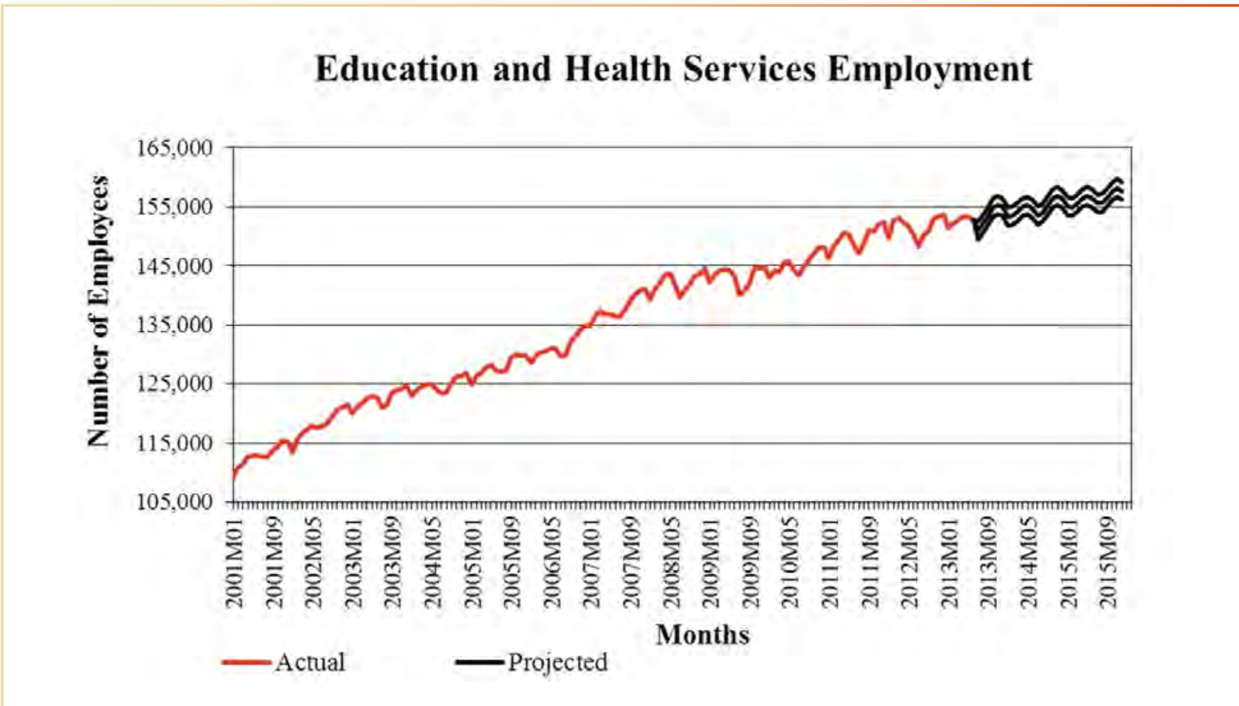


Consistent with its historical pattern, employment growth in the Valley should exceed the state's. However, particularly in the second quarter of 2013, employment growth in the Valley lagged behind state employment growth. Because the Valley economy is a region of growth with relatively abundant land, labor and capital, one would expect employment growth in the coming months to exceed that of the state.

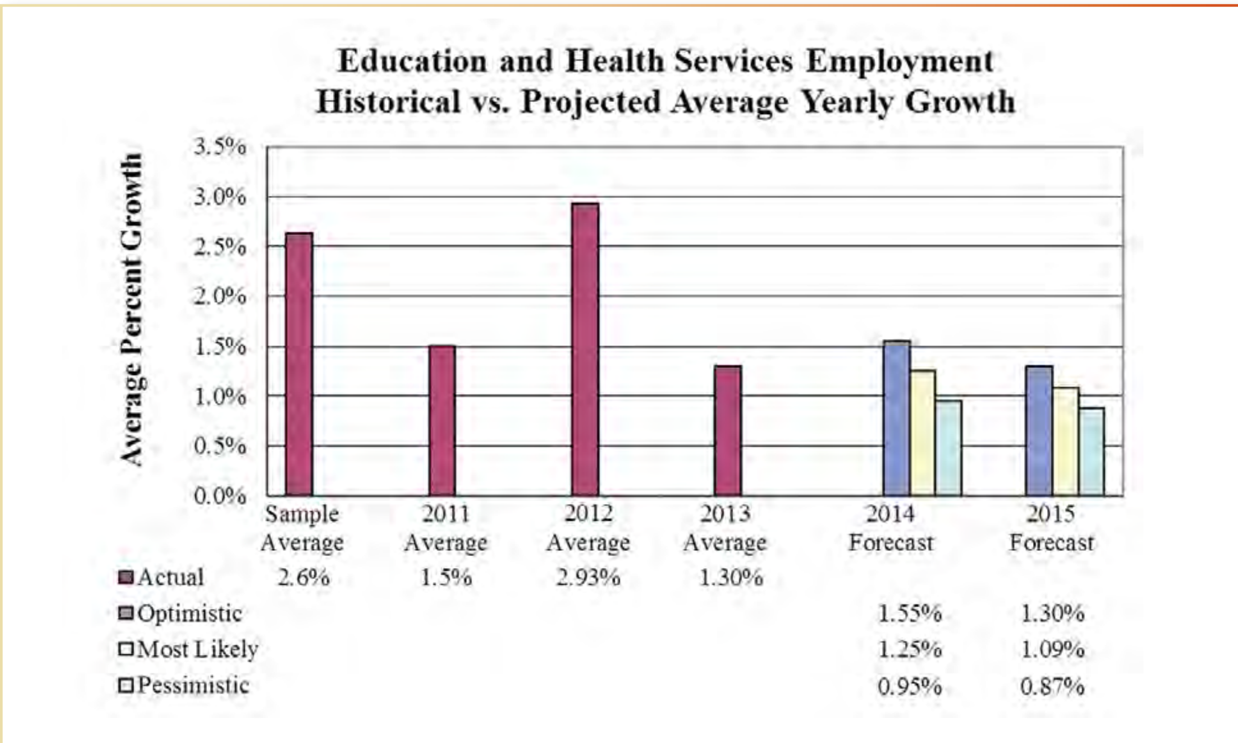


Real GDP growth in the last three quarters registered at 0.1, 1.1 and 2.5 percent, respectively, consistent with our earlier prognosis of accelerating growth. Real GDP mostly oscillated around a value of 2.2 percent in 2012 and 2013. Our projections continue to point to an average annual growth of 2.5 percent in 2014 and 2015.

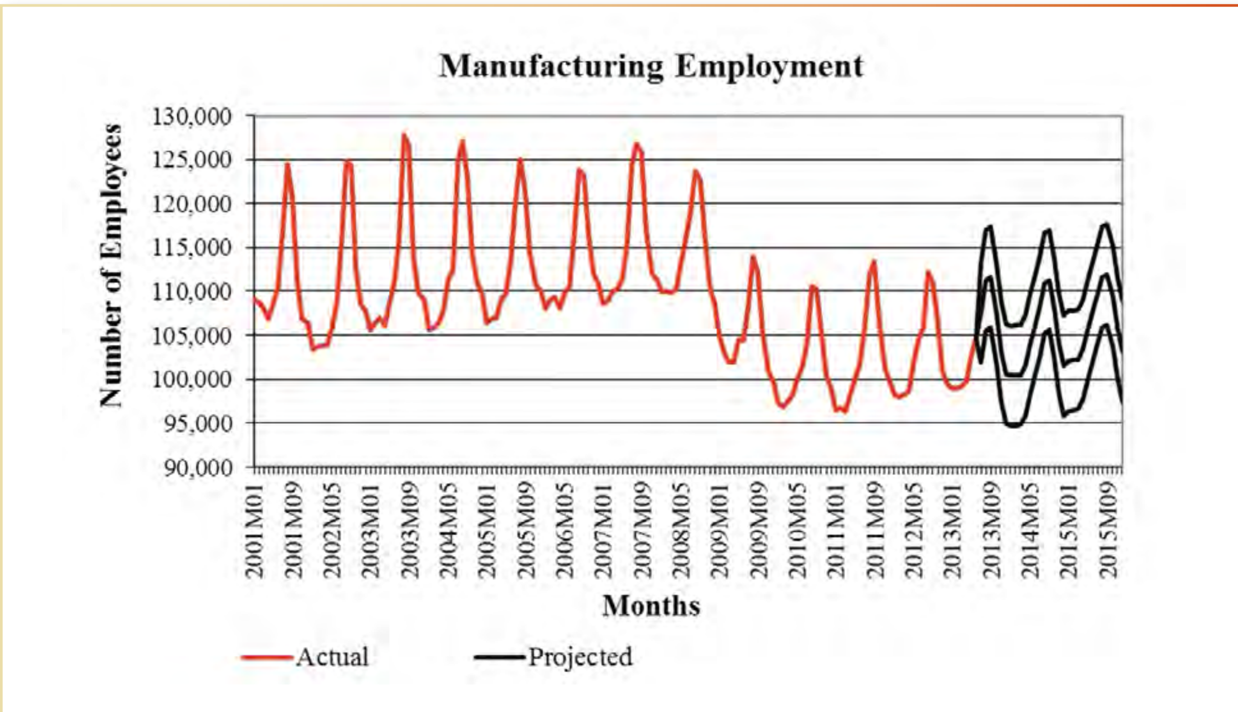
Education and health services employment in the Valley continued to increase, but at a slower pace than before. The rate of increase in 2013 was smaller than 2012 for Fresno, Merced and Stanislaus counties. Financial difficulties from the government budget squeeze caused a weaker performance of education employment than in previous years.



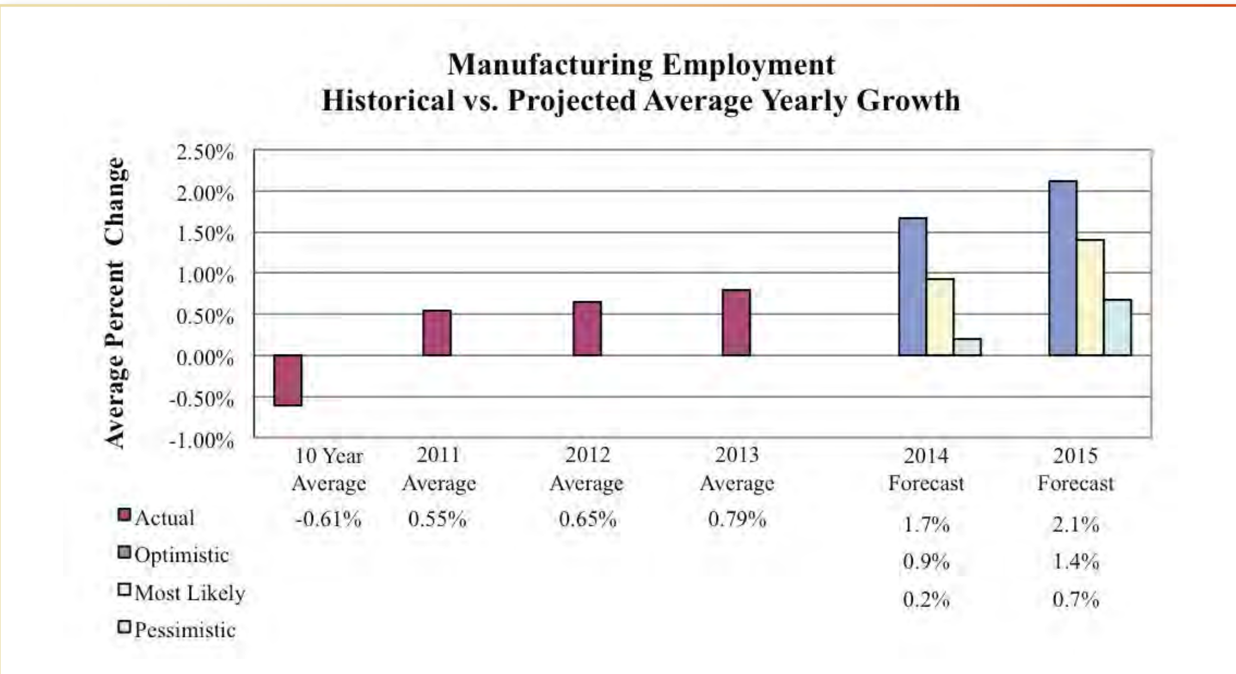
The past two years, Valley education and health services employment has grown significantly less than its long-run benchmark rate of 2.6 percent. The lower-than-average rate of growth is projected to continue into 2014 and 2015, with a yearly rate of 1.17 percent. Towards the latter part of the forecasting interval, increased demand resulting from health care reform might cause the realizations to fall closer to the optimistic value.



Manufacturing employment growth in 2013 was trivial compared to 2011 and 2012. The newly-forming trend became much flatter with new numbers in 2013. If the new trend continues to be flatter than the pre-recession trend, it will be difficult for manufacturing employment to close the discrepancy that had emerged during the recession period.

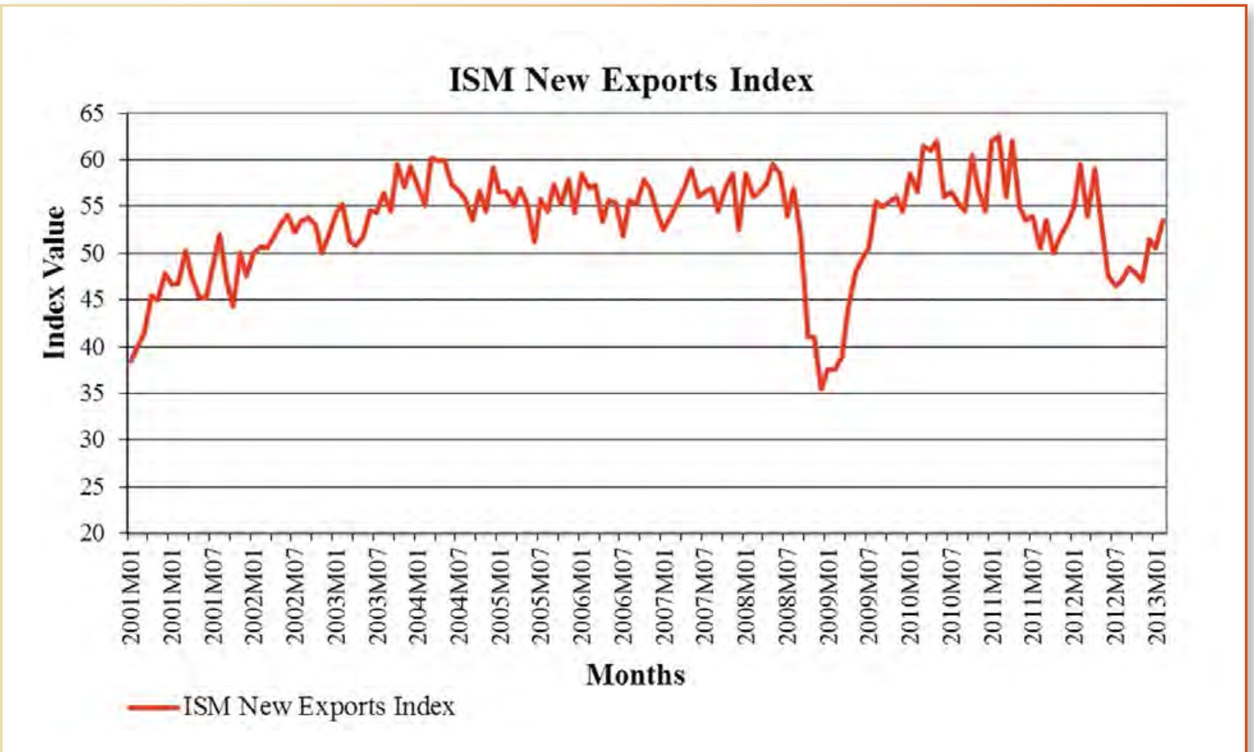


Valley manufacturing employment is projected to grow at an average annual rate of 1.2 percent in 2014 and 2015. The long-run benchmark rate continued to edge closer to positive territory. The marginal change was only 0.1 percent, bringing the benchmark rate from -0.7 percent to -0.6 percent. Naturally, manufacturing employment is projected to grow higher than this benchmark rate. However, the growth is not yet at the desirable levels needed to bring about a steeper trend.

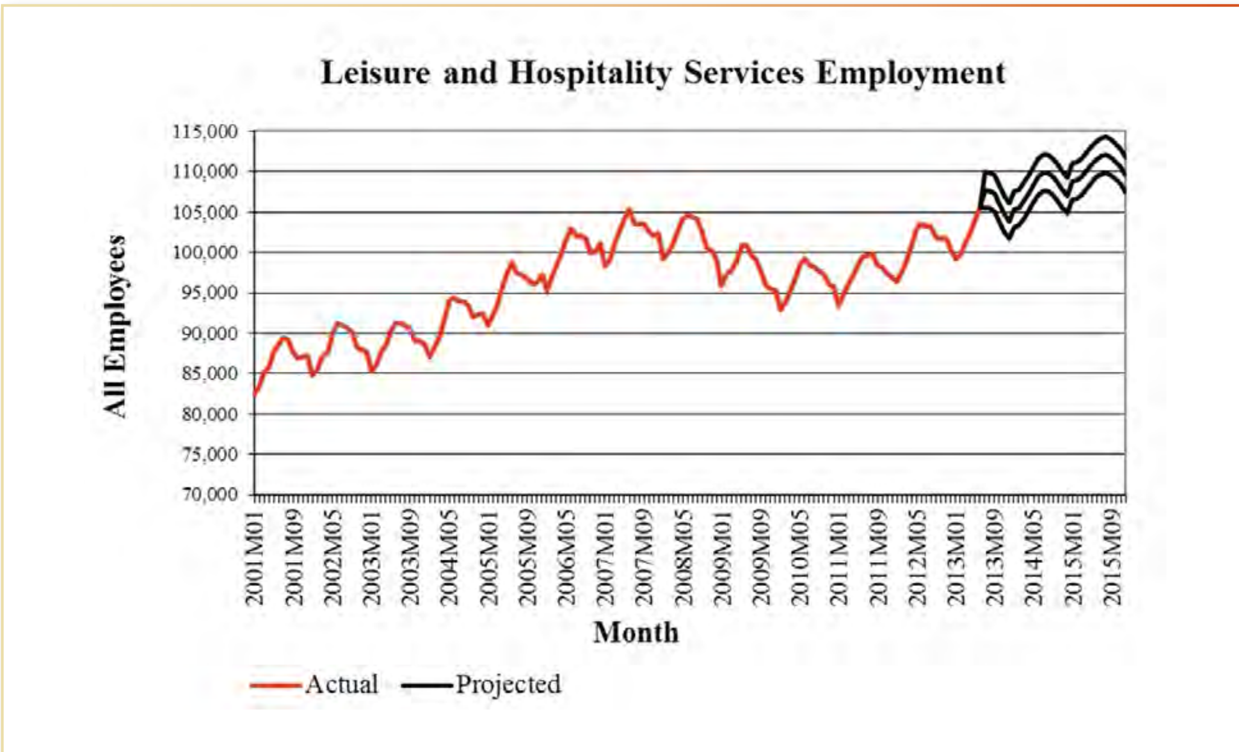


The Institute for Supply Management's (ISM) purchasing managers index (PMI) is a composite index of five "sub-indicators" that has some power predicting the beginning and ending of recessions. PMI exceeded 55 points for the first time since the first quarter of 2011. Until only very recently, the PMI had hovered just a little above 50, which is the threshold value for economic expansion.

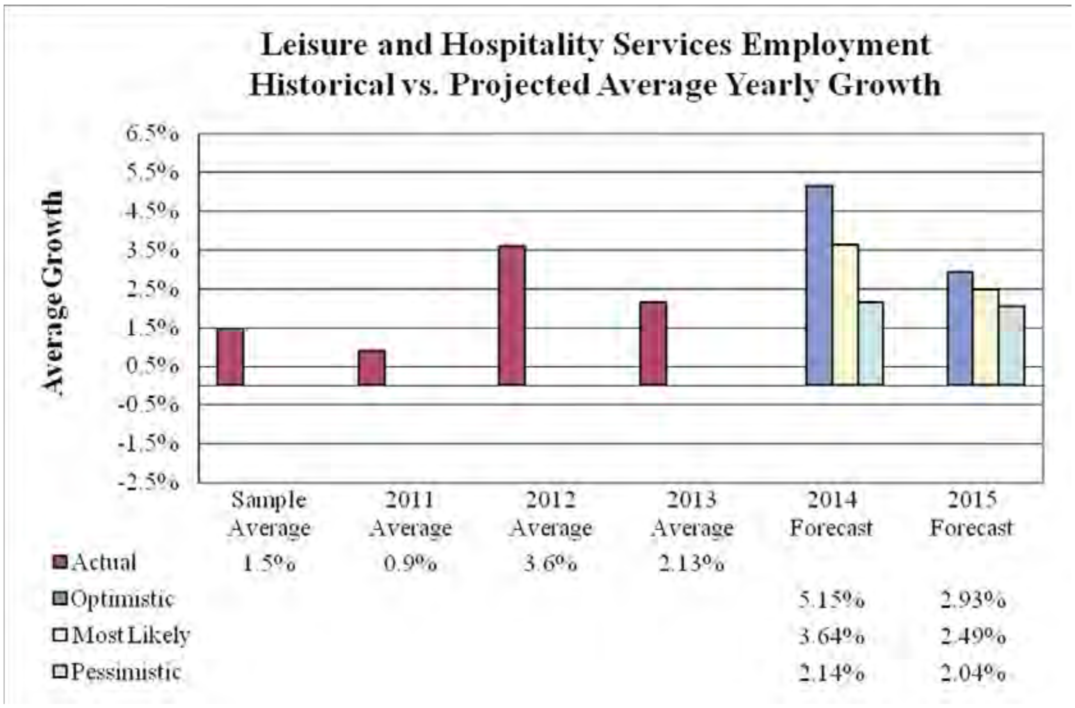
ISM's new exports index has also been on the rise since the first half of 2012, en route to catching its long-run index value of 55 points. Both the ISM new exports index and purchasing managers index consistently point to an expansion in the manufacturing sector.



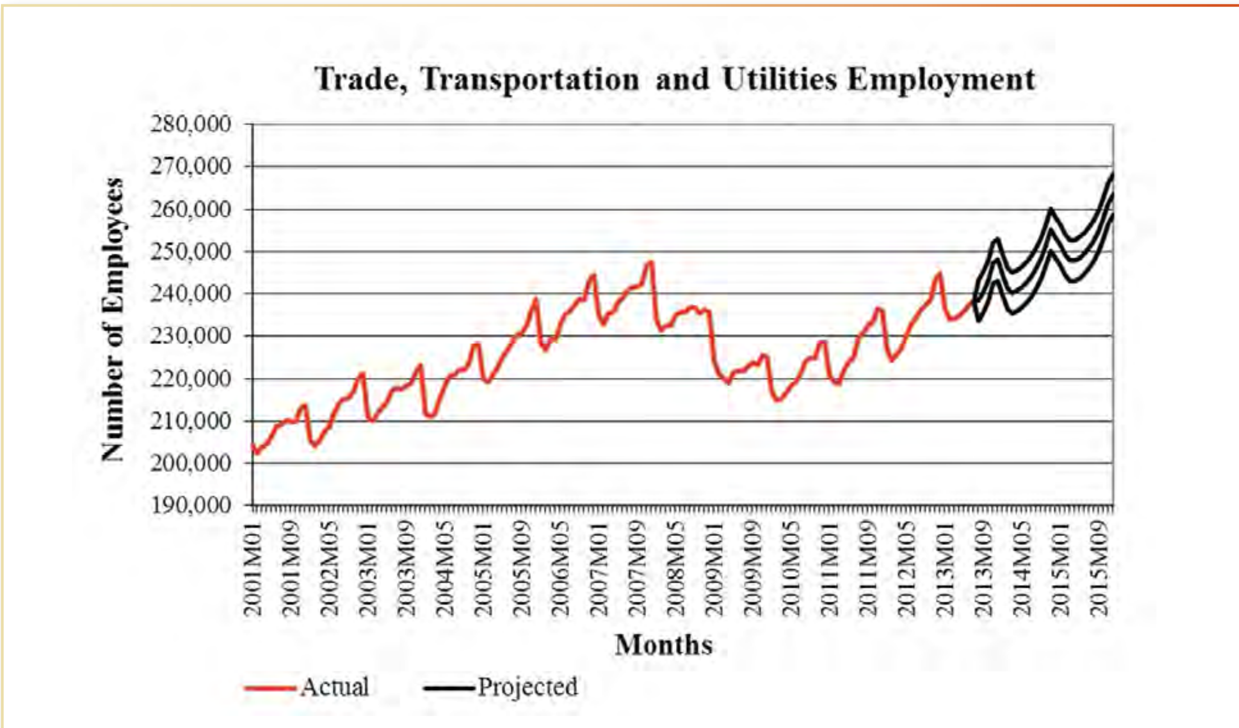
Leisure and hospitality services employment continued its upbeat performance in 2013. The hotel occupancy rates remained high, pointing to ample business opportunities for potential investors in this sector. In 2013, employment in this category grew 2.13 percent and the 10-year benchmark rate steadily rose over the past three years to 1.5 percent.



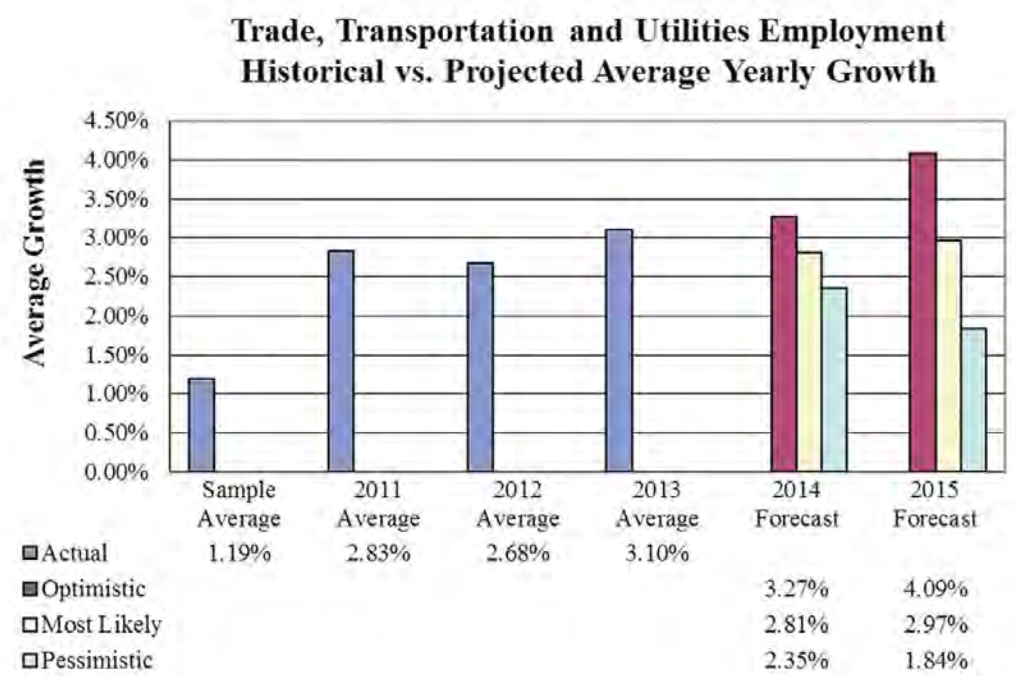
Valley leisure and hospitality services employment is projected to grow at an average annual rate of 3.06 percent in 2014 and 2015. The existing demand in the market for leisure and hospitality services underscores the need for more transportation infrastructure in this sector.



The trade, transportation and utilities employment 10-year average growth continued to increase from 0.88 percent in 2009 to 1.19 percent in 2013. The 3.1 percent yearly growth in 2013 was the highest since the recession. Trade, transportation and utilities employment now appears to be one of the categories in which the Valley is strongest.

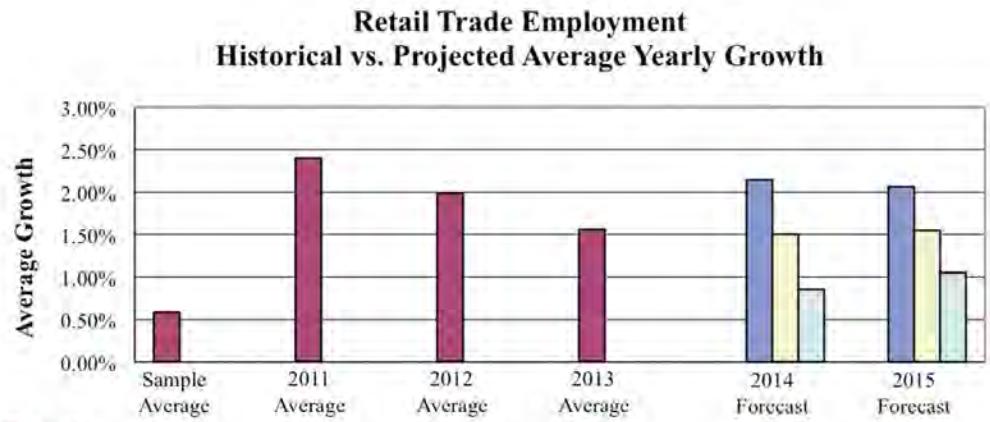


Trade, transportation and utilities employment is projected to grow at a yearly rate of 2.81 percent in 2014 and 2.97 percent in 2015. High crop yields in the Valley contributed to employment demand in this category.



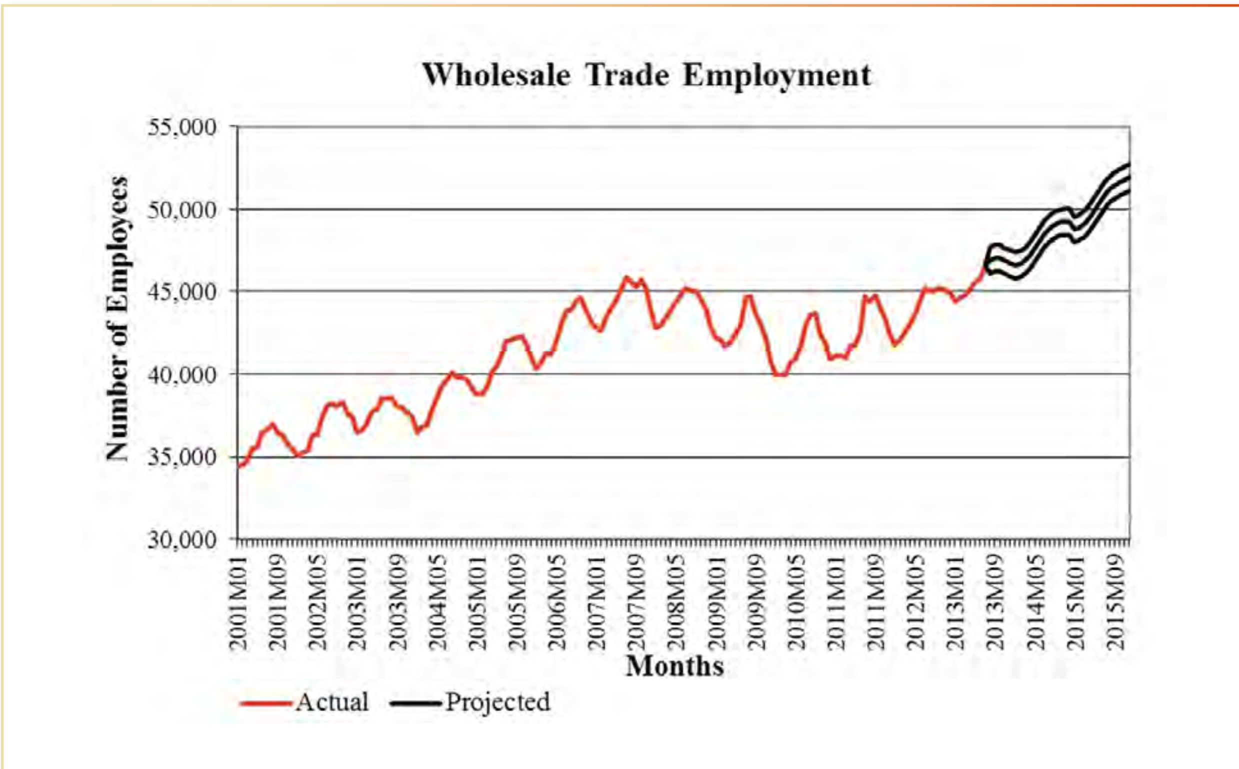
Despite a weaker performance than in 2012, retail employment growth in 2013 was about three times its 10-year benchmark rate of 0.59 percent. One reason for the downbeat retail employment performance in 2013, compared to 2012, is the lagging wages in the Valley, depressing demand for retail goods.

Retail employment is projected to grow similarly to 2013, at best, with an annual average growth of 1.53 percent in 2014 and 2015. Unlike wholesale employment, retail employment is not currently a sector in which the Valley has a competitive advantage.



	Sample Average	2011 Average	2012 Average	2013 Average	2014 Forecast	2015 Forecast
Actual	0.59%	2.40%	1.99%	1.56%		
Optimistic					2.15%	2.06%
Most Likely					1.50%	1.55%
Pessimistic					0.86%	1.05%

Wholesale trade employment, a farm-related category, continued to perform better than retail trade employment. In 2013, wholesale employment superseded its growth in 2012 and 2011, displaying promising performance. Seasonal variations continued to become smaller in 2013, pointing to a new structural pattern. Wholesale employment was the fastest-growing category of employment in the Valley in 2013.

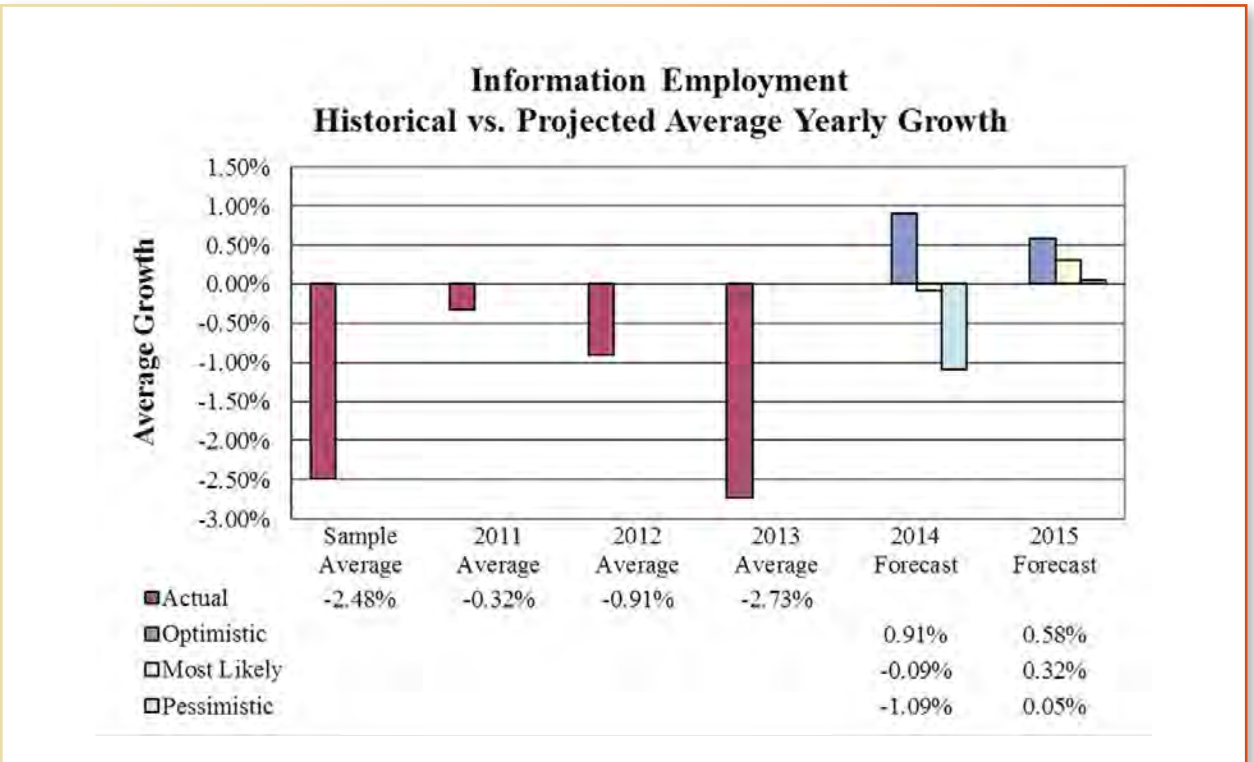


Each year since the recession, wholesale employment has added an additional 0.5 percent to its growth. The annual average yearly growth is projected to materialize around 4.84 percent in 2014 and 2015. This rate is about the same rate that prevailed in 2012, pointing to a level of performance capable of maintaining the strong growth of previous years.

	Sample Average	2011 Average	2012 Average	2013 Average	2014 Forecast	2015 Forecast
Actual	2.09%	2.79%	3.05%	4.62%		
Optimistic					4.99%	5.67%
Most Likely					4.68%	4.90%
Pessimistic					3.71%	4.45%

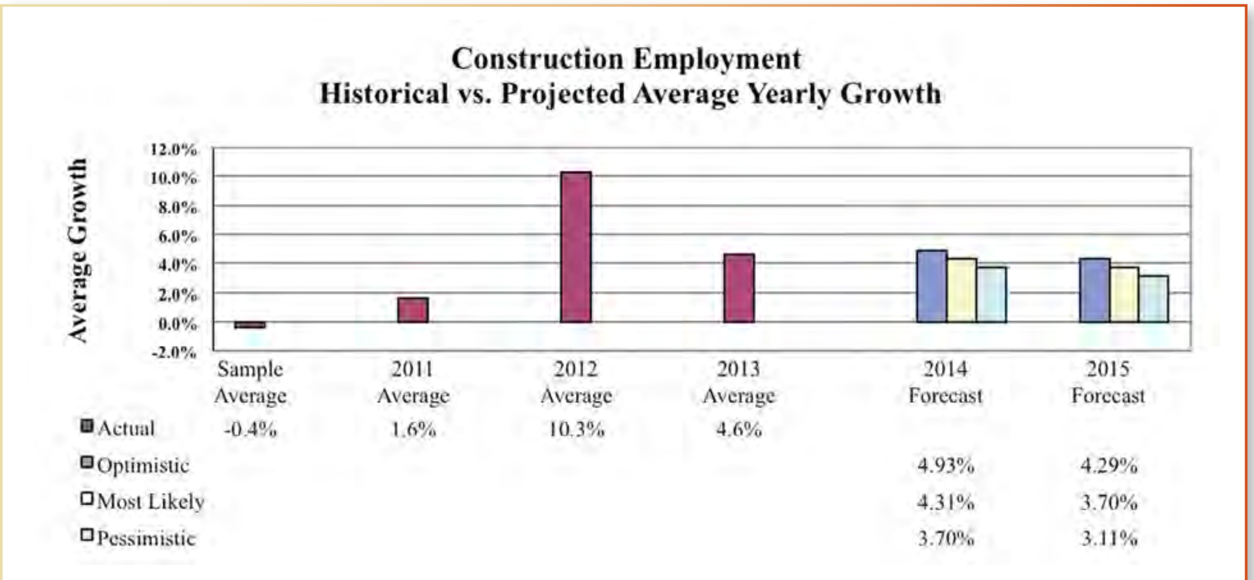
Valley information employment did not sustain the improvement it displayed in 2012. Information employment registered a significant yearly decline of -2.73 percent in 2013. Unlike other categories of employment, information employment failed to recover since the end of the recession in January 2009.

Information employment was the worst performing sector in 2013. Consistent with a recovering local economy, however, the projections point to a small growth at an annual average rate of 0.1 percent. Information employment will most likely exhibit a prolonged flat trend before beginning to improve.

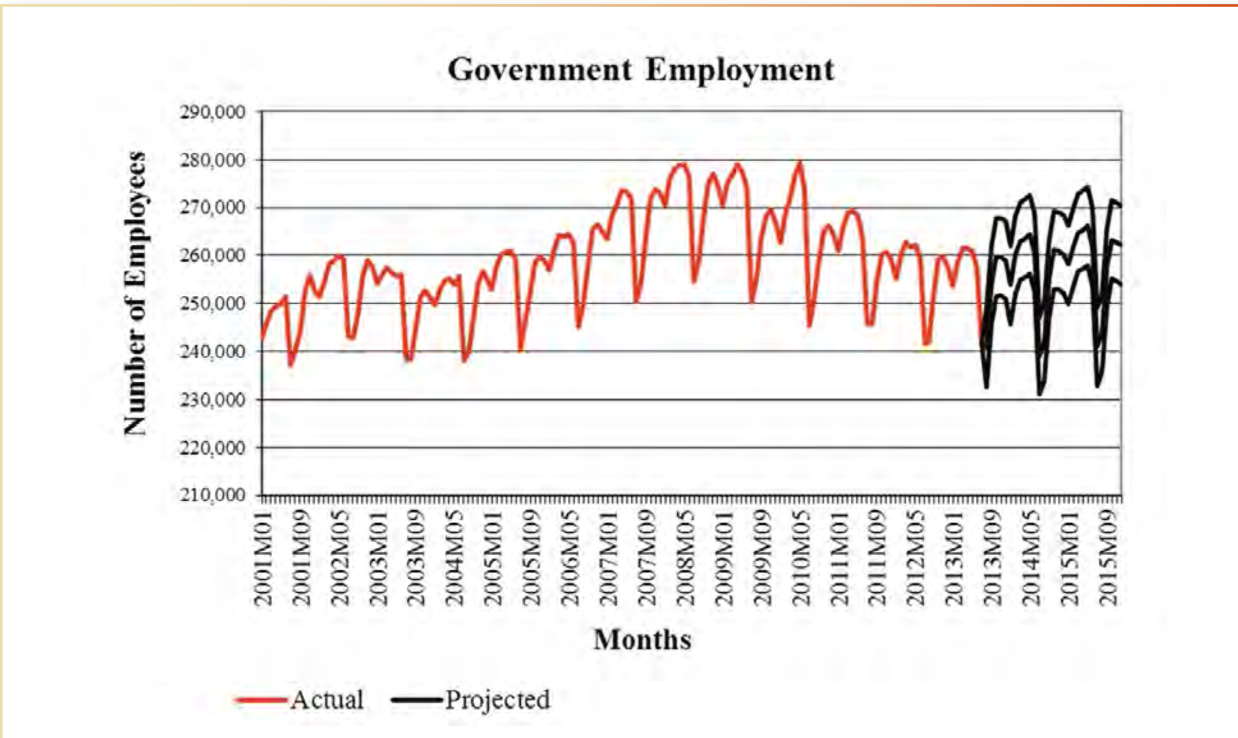


Construction employment was the second best performing sector, after wholesale employment, in 2013. The Federal Reserve's bond-buying program in 2013 contributed to the significant improvement in the housing and construction sector. Rebounding from all-time lows, construction employment posted a very significant growth in 2012. Growth in 2013, however, was more in line with its typical growth.

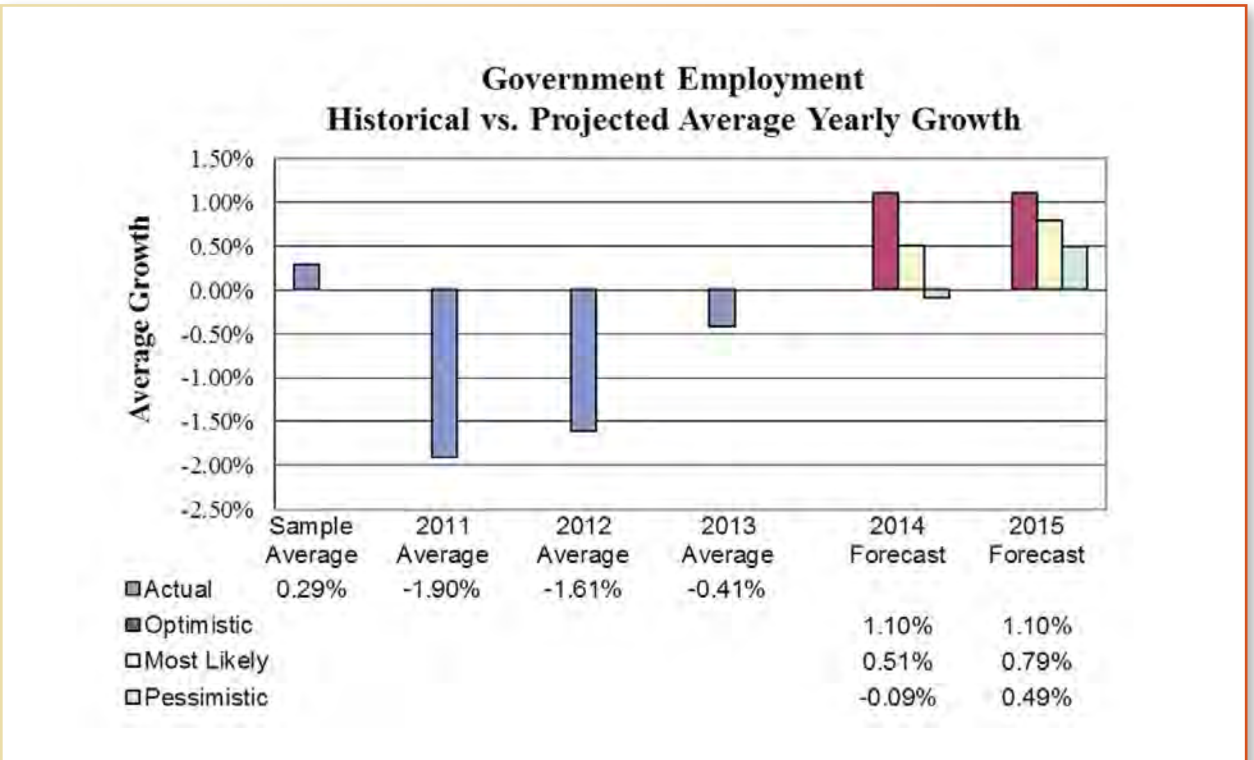
Consistent with this type of pattern, projections point to an annual average growth of 4.0 percent in 2014 and 2015. The consensus expectation that the Federal Reserve will start its tapering of bond-buying activities will likely dampen growth in the forecasting interval. Nevertheless, the improvement in the housing market is expected to push beyond rising prices and mortgage rates.



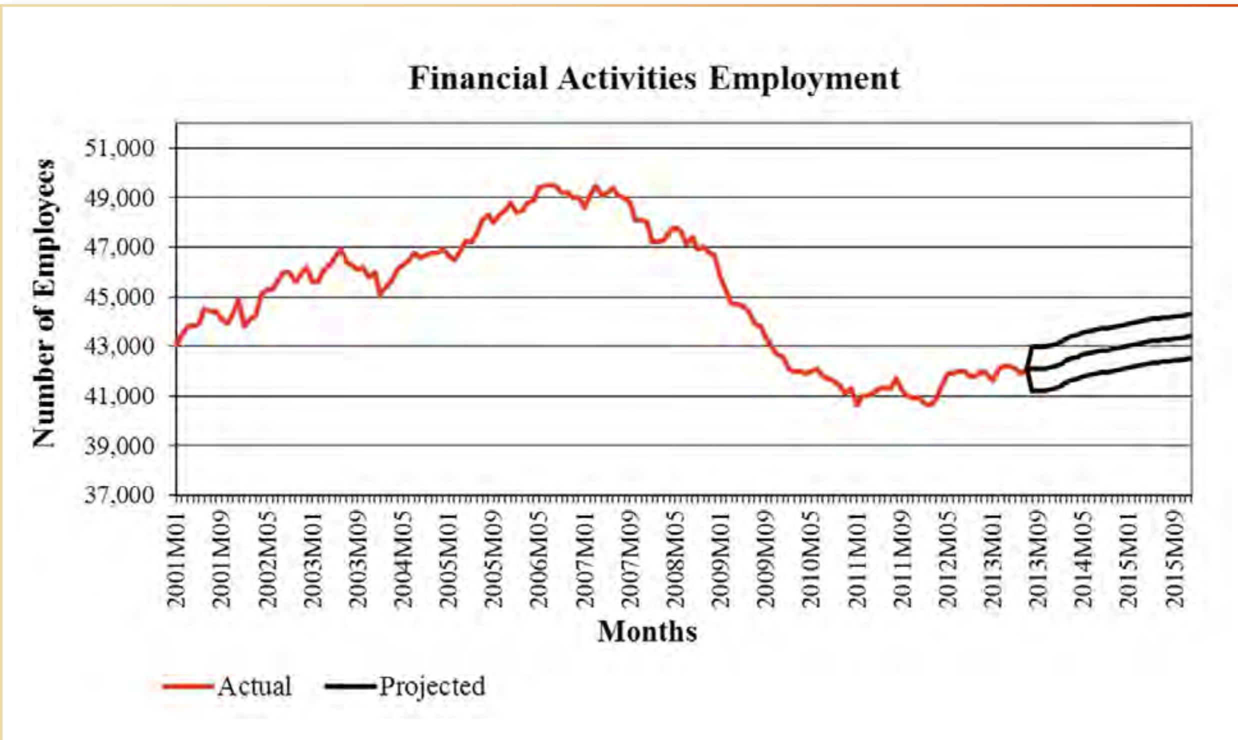
After posting very significant declines in 2011 and 2012, the downturn in government employment stopped in 2013. In a recovering economy, government employment begins to increase in proportion to the overall economic activity.



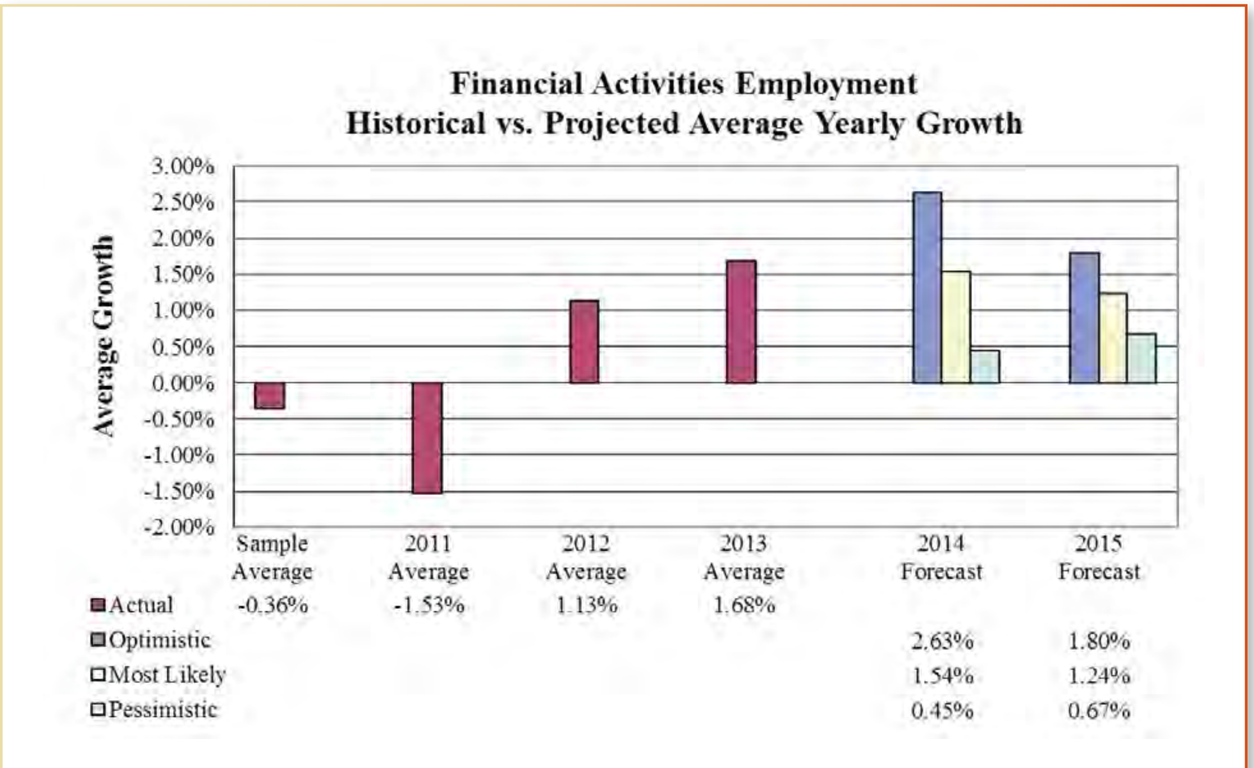
The performance in government employment in 2013 was consistent with this view. The decline was trivial in 2013 relative to previous years, at an annual rate of -0.41 percent. In 2014 and 2015, government employment growth is projected to enter into positive territory at an annual average rate of 0.65 percent.



Financial services employment had a turning point in 2011 — which appears, so far, to be permanent, given the numbers from 2012 and 2013. Despite slow progress, financial services employment continued to improve in 2013. The growth in 2013 at 1.68 percent was at the fastest pace in the past three years.



When the long-term interest rates rose quickly from 3.5 percent in May 2013 to 4.8 percent in August 2013, refinancing demand ceased to exist. This abrupt shift in mortgage demand caused a dramatic fall in banks' mortgage operations, causing layoffs of personnel. Therefore, the improvement in financial services employment in 2014 and 2015 is projected to be, at best, similar to 2013 at an annual average rate of 1.39 percent.

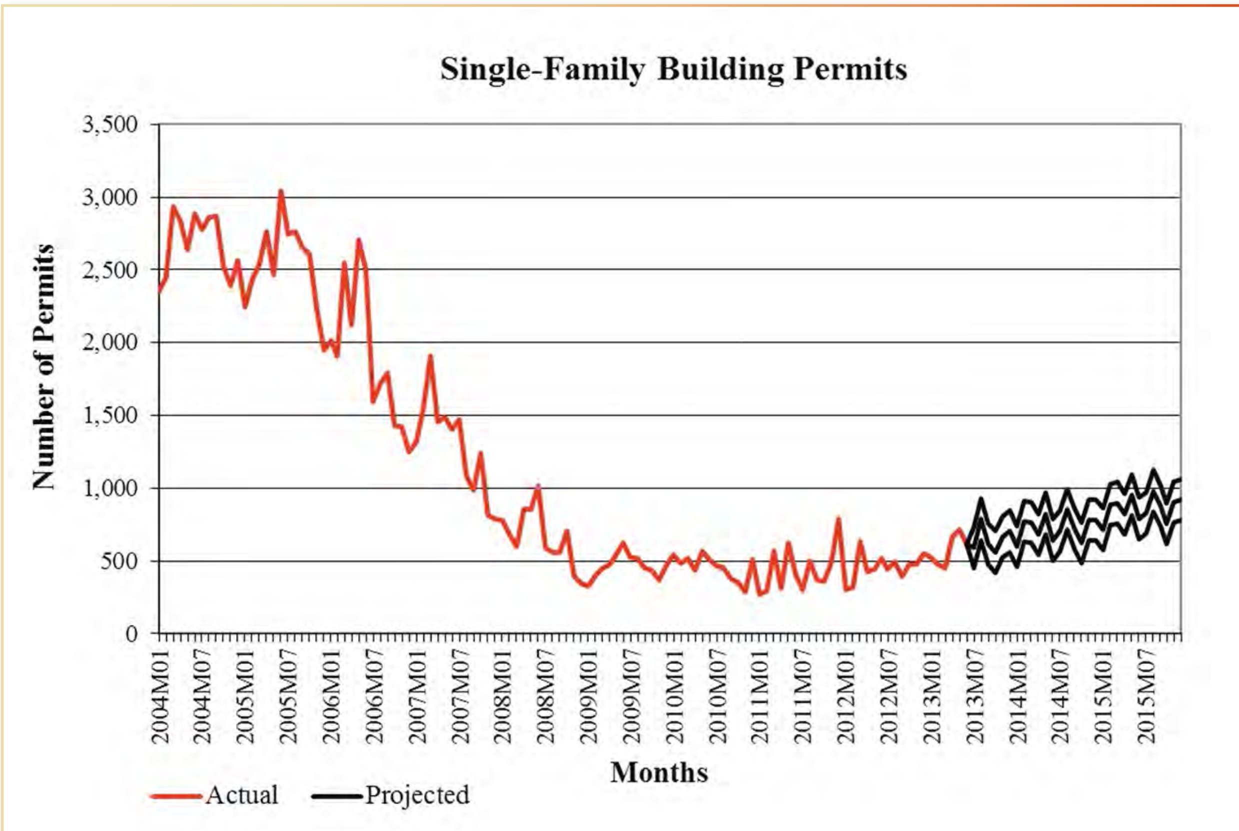


The fastest growth in employment occurred in wholesale, followed by construction employment. The worst performance was displayed by information employment. The decline in government employment was very negligible, pointing to growth in the coming months. All other categories continued their improvement from 2013. All counties reported growth in total employment, including Madera. Merced and San Joaquin counties had the fastest employment growth in 2013.

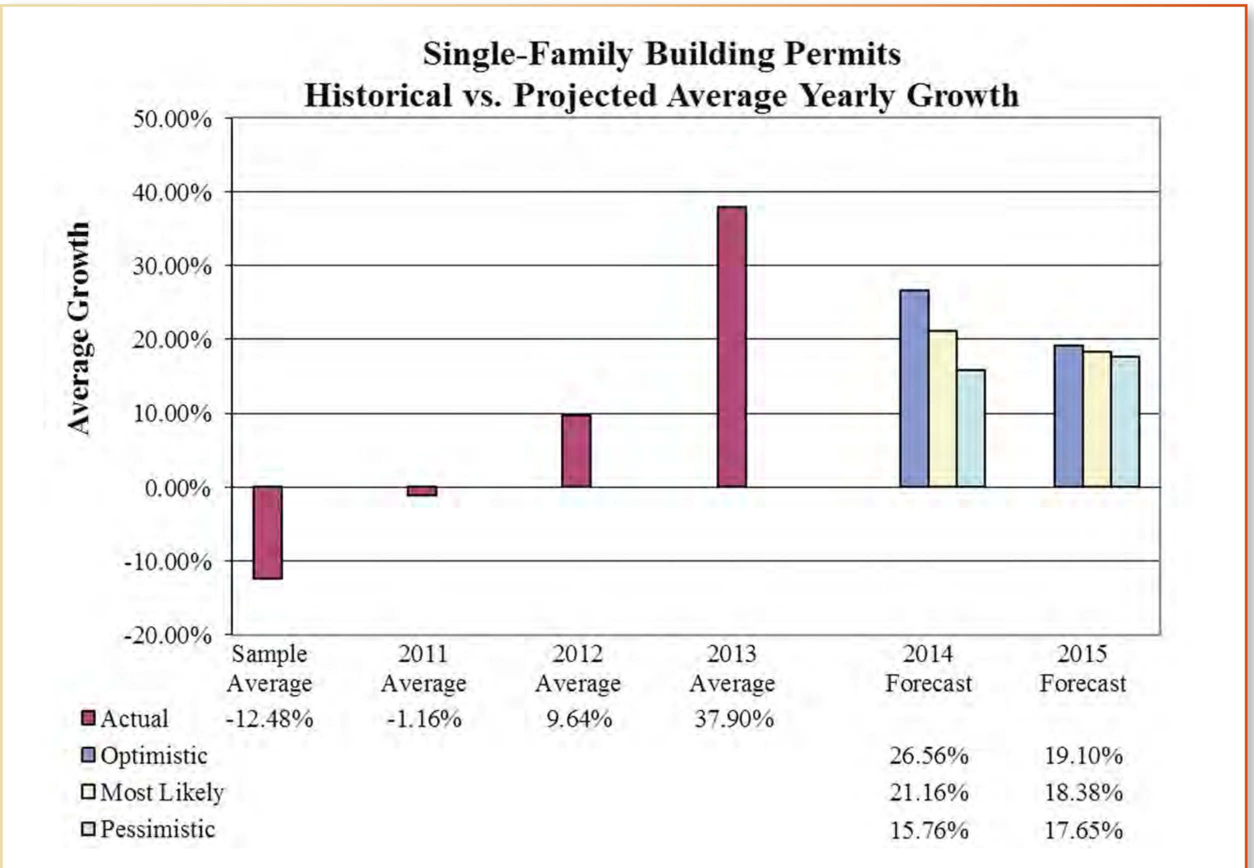
Housing Sector

Single-family building permits are recorded according to the eight major Metropolitan Statistical Areas (MSA) of the San Joaquin Valley. These MSAs are determined by the Bureau of Labor Statistics. The eight MSAs of the Valley are Bakersfield-Delano, Fresno, Hanford-Corcoran, Madera-Chowchilla, Merced, Modesto, Stockton and Visalia-Porterville.

Single-family building permits displayed a very steep positive trend in 2013. The yearly increase in 2013 was phenomenal, at 37.9 percent. This growth was three times the growth observed in 2012, at 9.64 percent, which was already a very high figure since the recession.

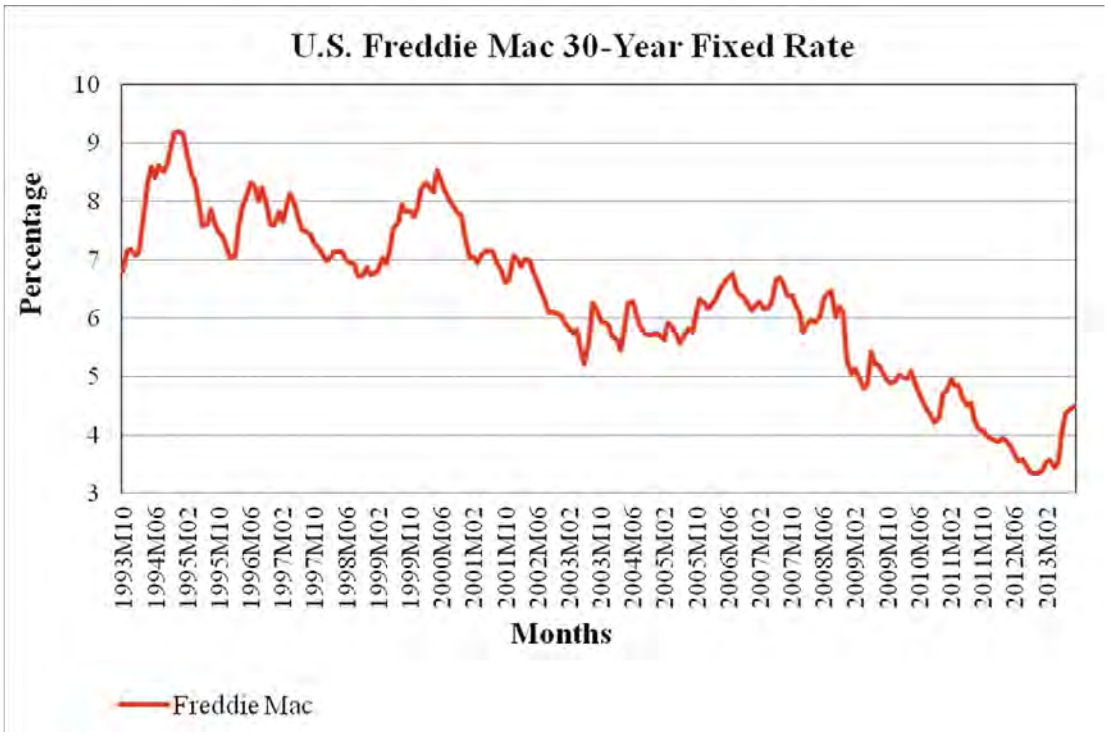


Considering the recent spike in long-term interest rates and the Federal Reserve's expected tapering activity in 2014, projections point to strong growth, but less than the rates observed in 2013. The growth in single-family building permits is projected to reach an annual average rate of 19.72 percent in 2014 and 2015.



Foreclosure starts in California began to fall drastically beginning in the fourth quarter of 2011. Foreclosure starts are now back to pre-recession levels and in line with the structural pattern. Foreclosure starts are now projected to remain steady around a value of 0.5 percent.

One concern over the medium-term horizon is the rise in long-term yields. Thirty-year Freddie Mac fixed rates and the U.S. Treasury government bond yields have begun to increase in 2013, halting their long decline since the beginning of the recession. The rise in long-term yields has brought refinancing demand to zero and is projected to put some drag on housing recovery and any potential bubble that may otherwise have formed had the yields not risen.



One of the most significant developments in 2013 was the improvement in housing prices in the Valley. The average yearly rate of increase in home prices was 9.55 percent in 2013. The increase in home values reached as high as 25 percent in some areas, such as Northern and Central San Joaquin Valley.

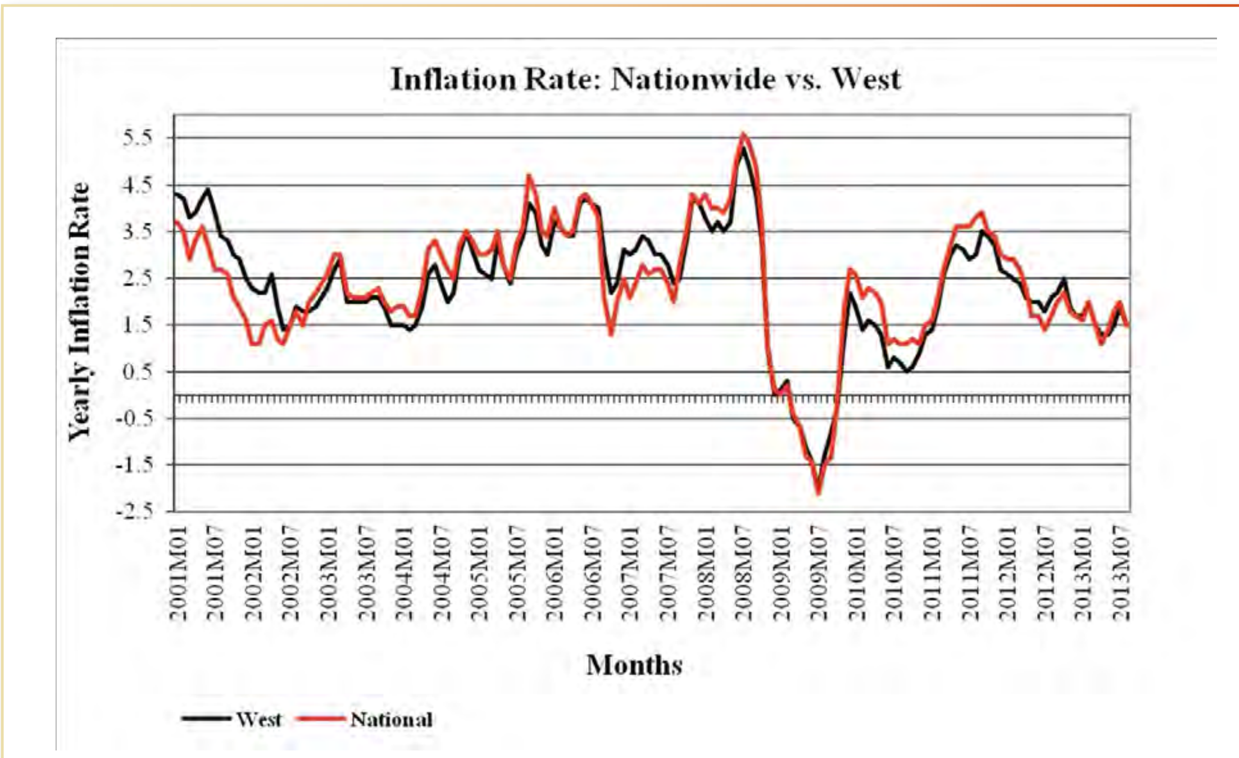
Valley housing prices posted positive growth consecutively in 2012 and 2013. This trend is expected to continue in the coming months, given that the increase in housing supply is falling behind the increase in demand. The increase in demand, however, is expected to be curtailed somewhat as the long-term yields continue to increase. The Federal Reserve's future tapering activity is also a factor expected to dampen demand activity. For the moment, however, the Federal Reserve has reiterated its commitment to easy monetary policy and no tapering activity.

	Sample Average	2011 Average	2012 Average	2013 Average	2014 Forecast	2015 Forecast
Actual	3.29%	-7.72%	0.76%	9.55%		
Optimistic					17.34%	20.02%
Most Likely					16.43%	19.31%
Pessimistic					15.52%	18.60%

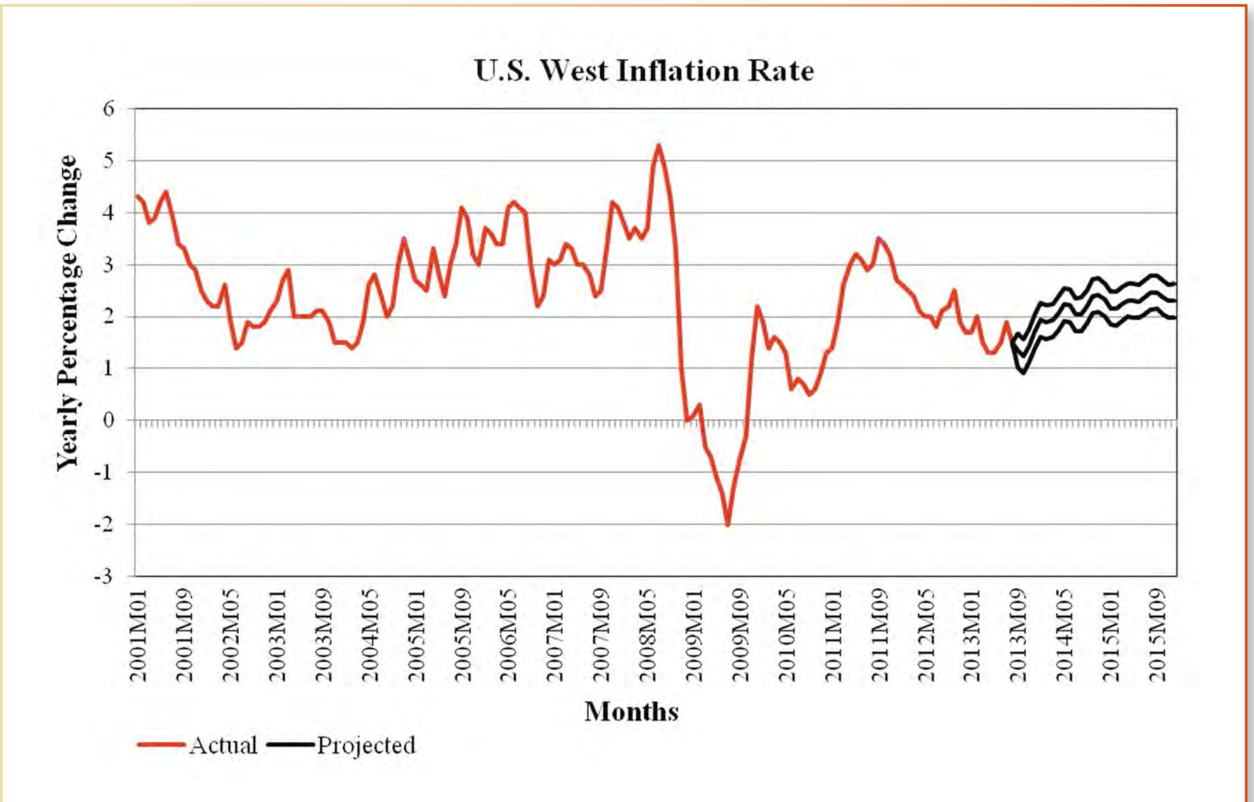
Nevertheless, because housing prices are rebounding from very low figures, the improvement is expected to be in the double digits. The projections point to an average annual increase of 17.87 percent in 2014 and 2015.

Inflation and Prices

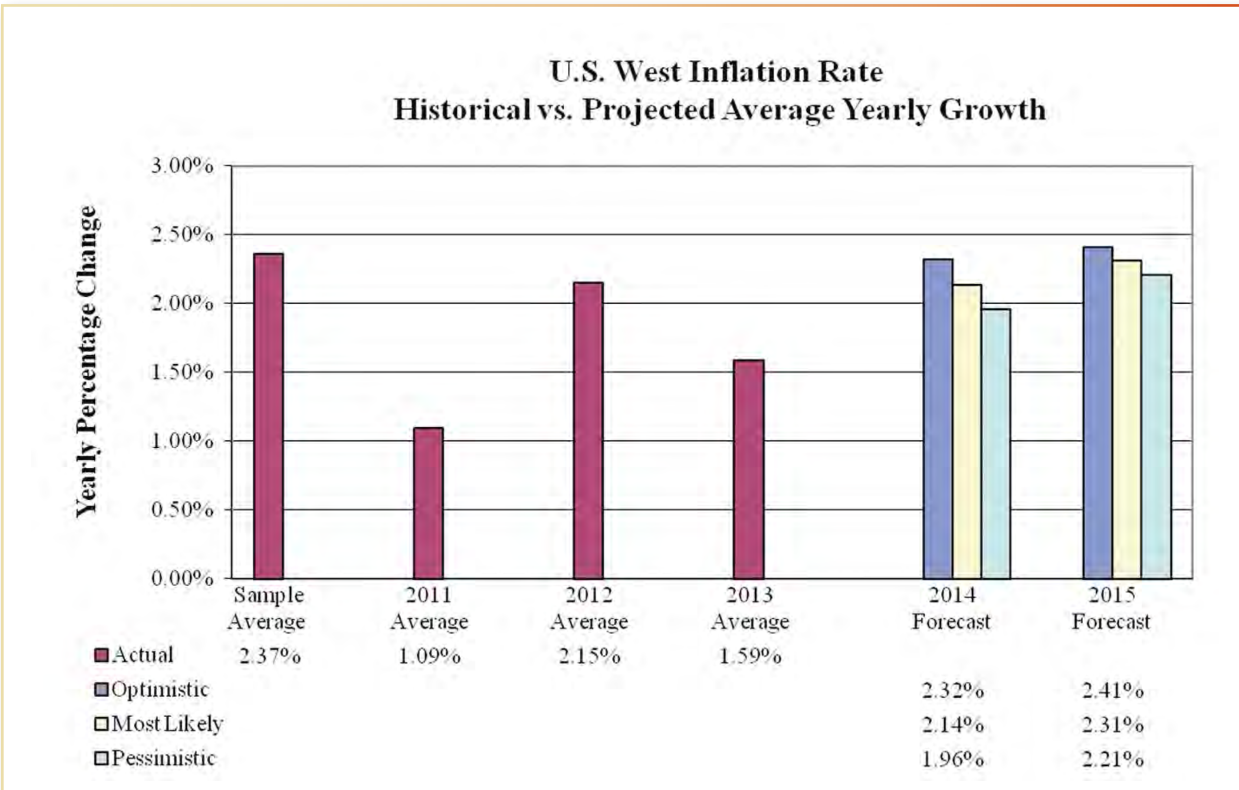
Because of the stability in oil prices and the direct and indirect effects on prices, inflation remained low in 2013. In the first quarter of 2013, inflation fell below its long-run rate and stayed low for the rest of the year.



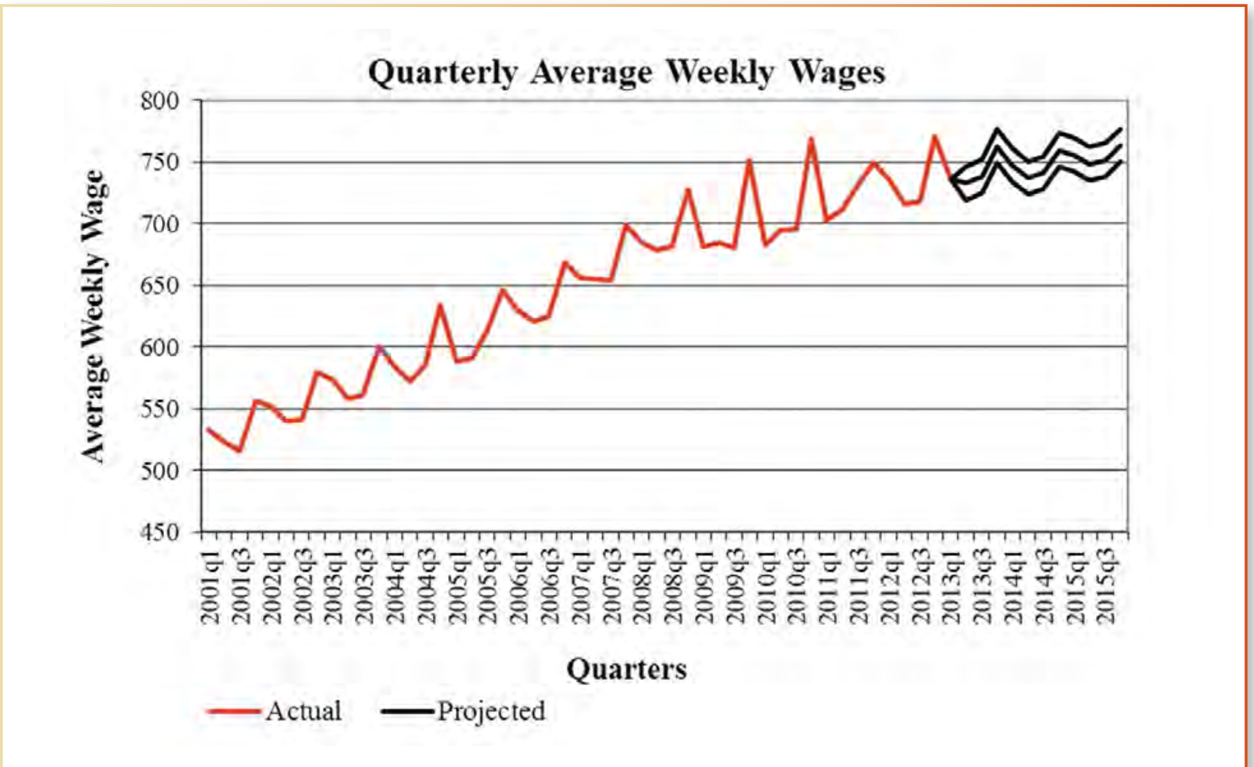
Aggregate demand expanded at about the same rate in the western region and at the national level. In 2013, the average increase in price levels in different regions began to converge as all regions entered into recovery phase. There was little difference, as a result, in inflation rates between the west and national averages.



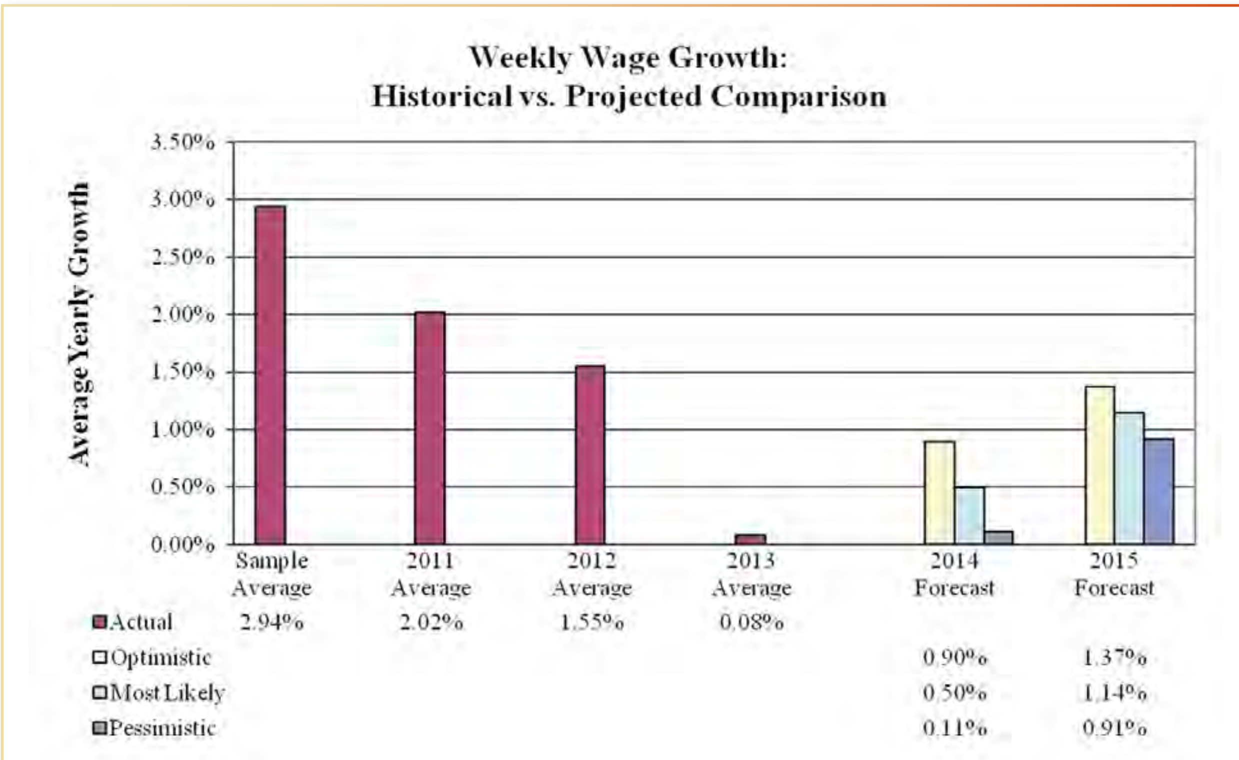
Inflation rates are expected to remain moderate in the coming months. In the worst-case scenario, inflation is expected to come close to its long-term rate of 2.4 percent. The projections point to an average annual increase of 2.22 percent in 2014 and 2015.



As long-term yields continue to rise, the resulting interest parity conditions with other countries will most likely attract international capital flows back to the United States. The increased demand for the U.S. dollar will attract international investors to invest in higher-yield U.S. assets. Along with a positively performing U.S. stock market, the U.S. dollar will appreciate against other currencies. The appreciation of the U.S. dollar will be most visible against currencies of emerging market countries. With the arrival of 2013 numbers, the 10-year benchmark growth rate in wages continued to fall from 3 percent to 2.9 percent. The average yearly increase in 2012 was 1.55 percent. First-quarter growth was non-existent, at 0.08 percent, while inflation registered at 1.5 percent. Valley weekly wages rose at an even slower pace in 2013 than 2012.



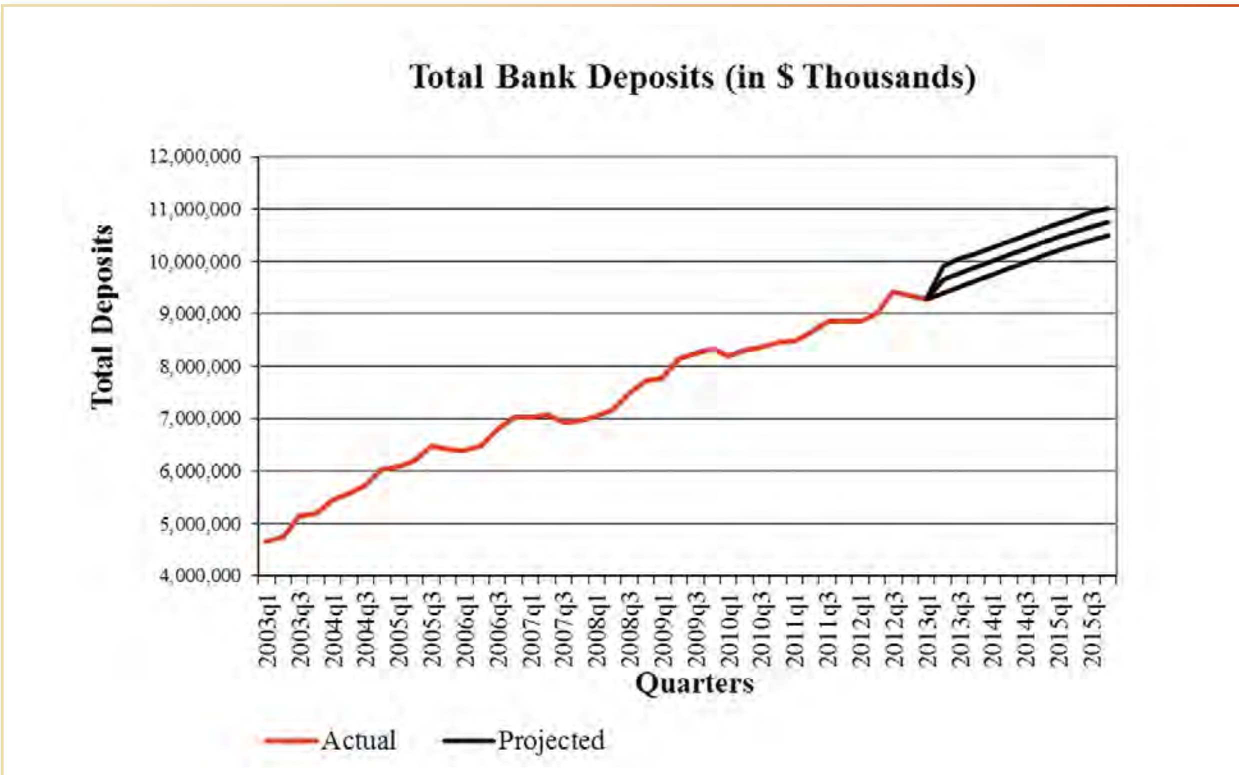
Upon casual observation, one can easily see the average weekly wages series becoming concave to the horizontal axis. Average weekly wages clearly display a pattern that increases at a decreasing rate toward the latter part of the sample. With inflation rates remaining lower than anticipated, weekly wages are likely to grow at a slower pace. Valley weekly wages are projected to increase at an average yearly rate of 0.82 percent from 2014 to 2015. The projected linear trend is expected to stay relatively flat when compared to previous years, due to unemployment rates falling at a slower rate than they did in the aftermath of previous recessions.



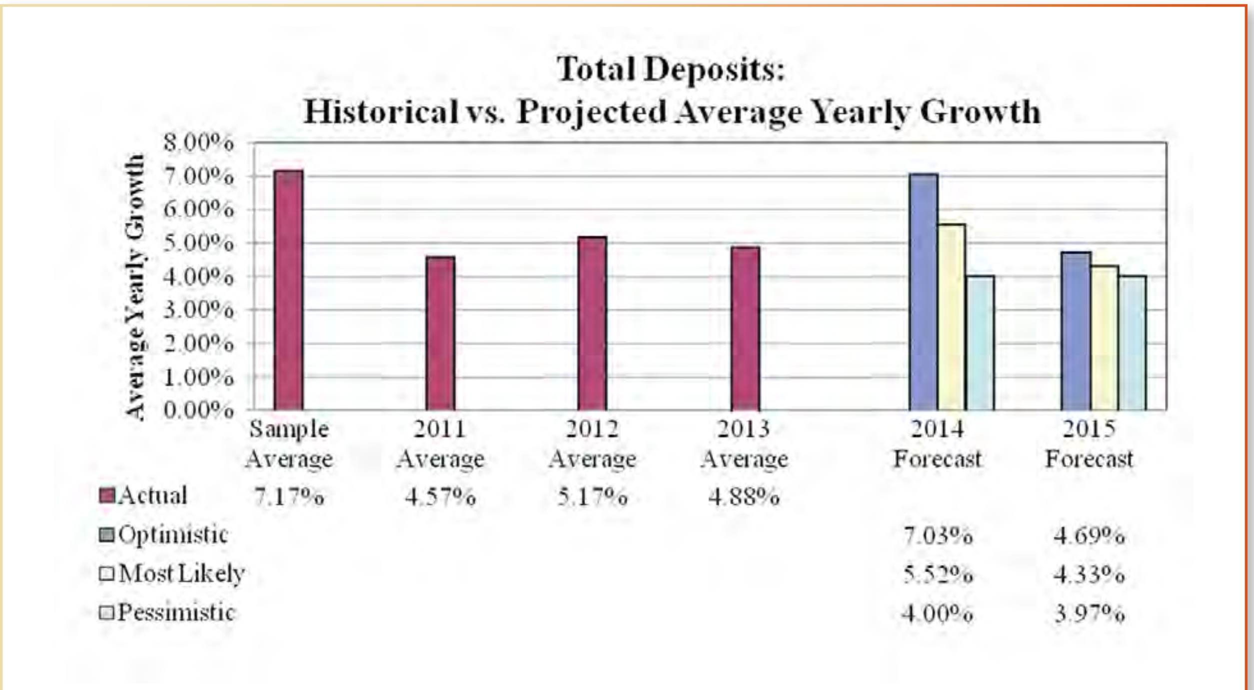
The 2012 weekly wage growth had not kept up with inflation. This pattern continued in 2013. The average weekly wage increase was very negligible in the Valley at 0.08 percent, while inflation was at 1.59 percent. Valley residents realized a decline in their purchasing power when inflation registered more than the growth in average weekly wages. Additionally, nominal wages stayed approximately constant in 2013.

Banking and Capital Markets

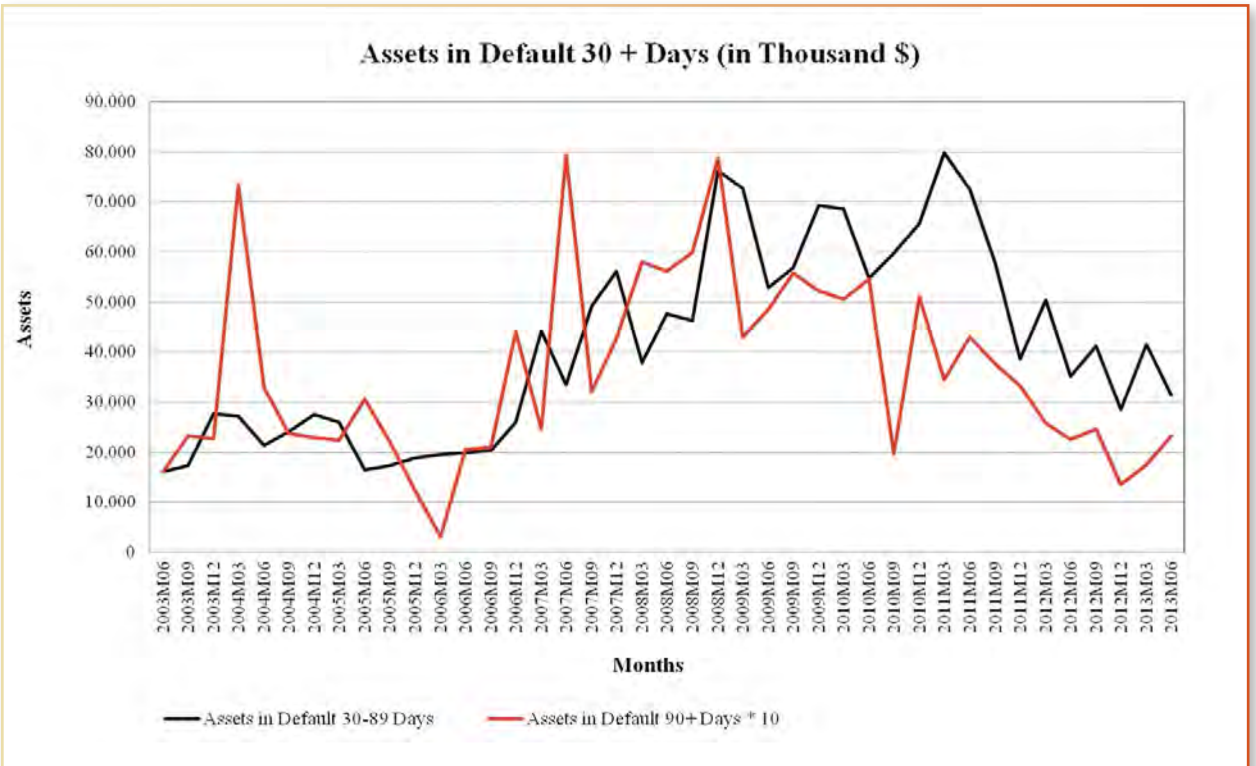
Community banks in the Valley continued to perform better in 2013. Bank deposit growth in 2011 and 2012 were 4.57 and 5.17 percent, respectively. In the first quarter of 2013, bank deposits grew by 4.88 percent. In a recovering economy, investment in risk-bearing assets increases to take advantage of higher-risk adjusted returns. The stock market continued to reach new highs in 2013.



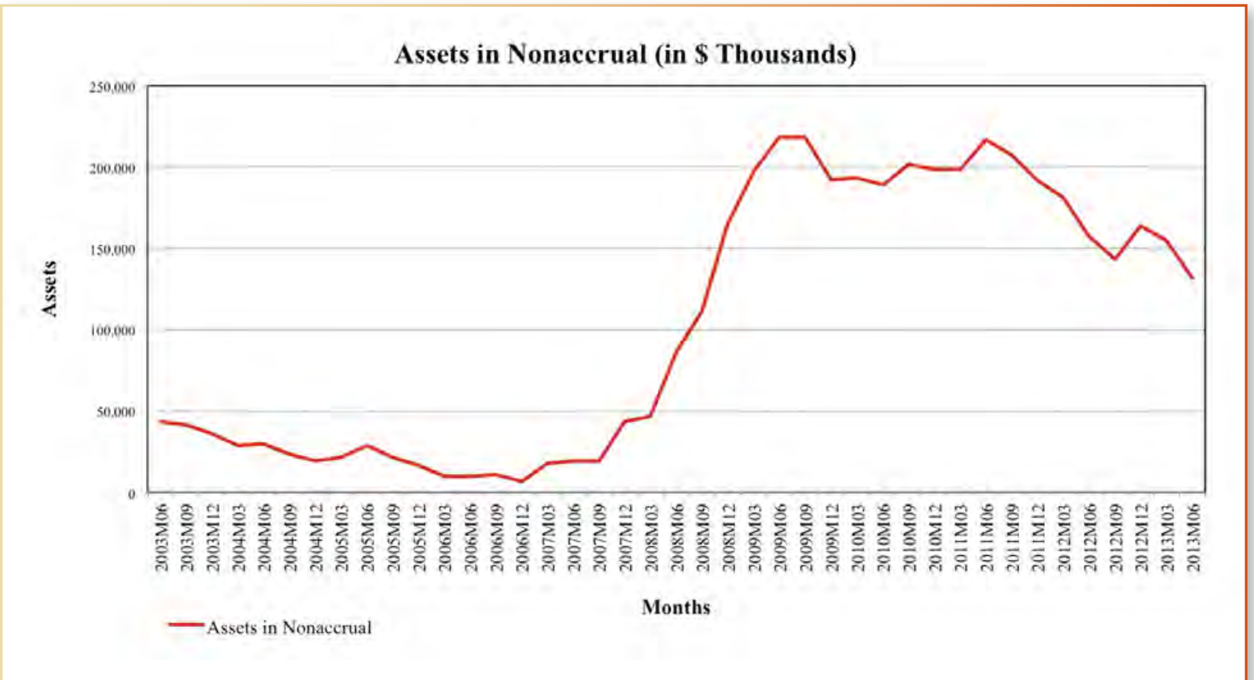
Bank deposits are expected to continue their robust growth since the recession. However, there was a slight decline in the 10-year benchmark rate from 7.58 to 7.17 percent. Bank deposits were one of the few series in the report that posted a decline in the 10-year benchmark rate. Such a pattern suggests that the increase in investing in risky assets is taking place at a faster rate than the increase in cash holdings.



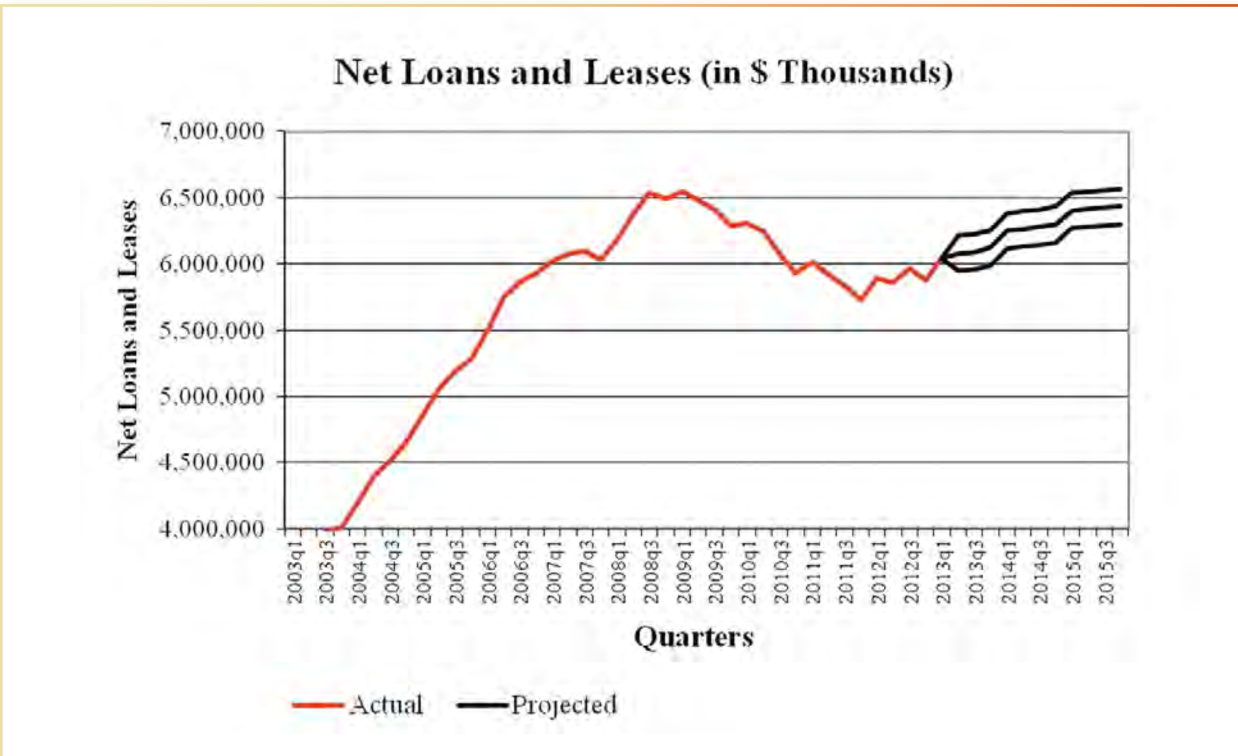
The improvement in the consumer balance sheet activity is clearly evident from the bank assets in default 30 to 89 days and 90-plus days. Their decline from the second quarter of 2011 continued and became negatively sloped towards the latter part of the sample. Despite a short-term rise in the 90-plus category, bank assets in default are expected to fall further in the upcoming months.



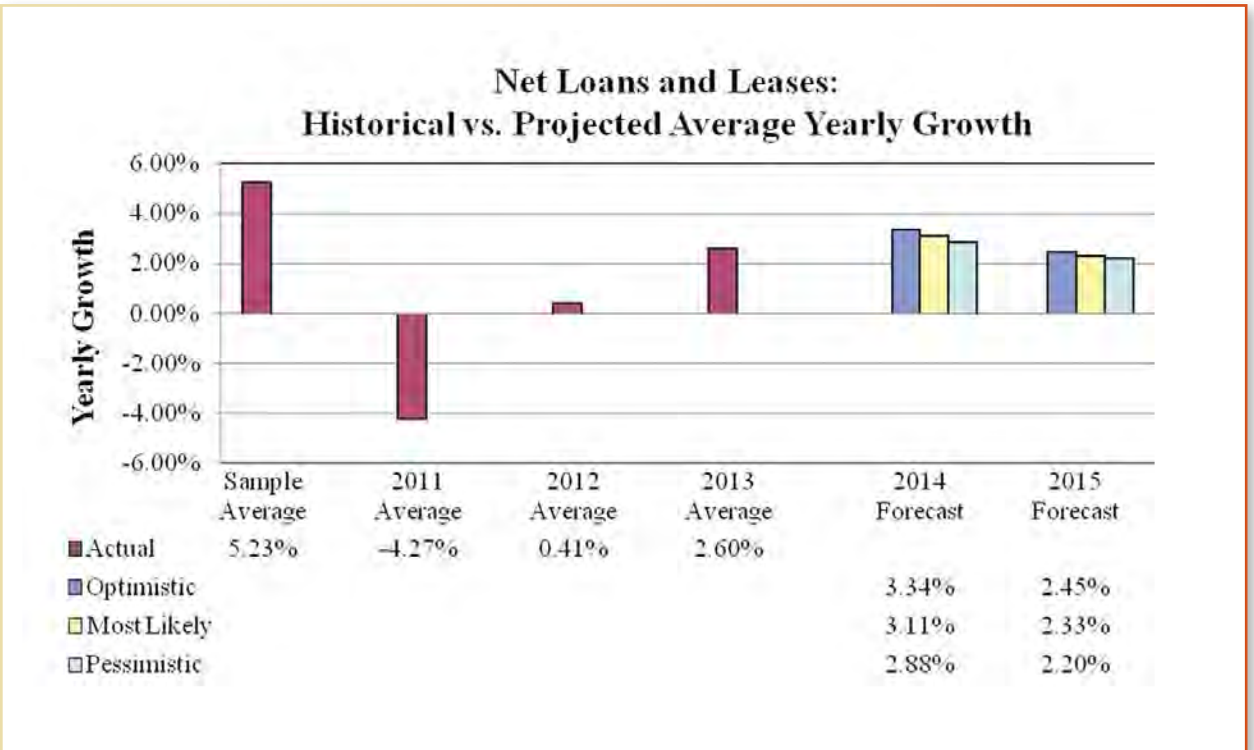
Bank assets in nonaccrual paint an even better picture of post-recession consumer balance sheet activity. During the recession, assets in nonaccrual rose exponentially. Toward the end of the recession and afterward, the series became horizontal but did not decline. In late 2012 and early 2013, bank assets in nonaccrual began to clearly decline for the first time since the recession.



The percentage change in Valley net loans and leases entered into positive territory for the first time since the recession. In 2012, net loans and leases posted net positive growth of 0.41 percent. The first quarter of 2013 numbers were even better, registering 2.06 percent growth. In 2012 and 2013, banks have clearly begun to extend loans and leases in the Valley.



However, the recent increase in long-term interest rates is likely to put a drag on net loans and leases activity. Refinancing activity fell drastically to non-existent levels when the long-term interest rates began to increase in the second half of 2013. Projections point to an average yearly increase of 2.72 percent in 2014 and 2015.



Improvement in mortgage financing is projected to continue. Despite the Federal Reserve's announcement of the continuation of their easy monetary policy, the consensus expectation of the market is that the Federal Reserve will begin tapering in mid-2014. Such expectations inevitably dampen future net loan and lease activity expected to take place in the coming months.

Summary and Concluding Remarks

While there is still some way to go, the Valley economy made additional progress toward attaining the levels that existed before the recession. Growth was most visible in the housing sector, where single-family building permits jumped 37 percent in 2012. Home values increased more than 20 percent in the Valley.

The fastest growth in employment occurred in wholesale employment. Construction employment was the second-fastest growing sector in the Valley. Information employment performed the worst and registered a significant negative growth in 2013. Government employment worsened, but by only a negligible rate, indicating an end to an era of decline since the recessionary period. Valley aggregate employment grew 2.56 percent. Our projections point to growth in 2014 and 2015 by roughly the same rate at 2.46 percent.

Following its exponential rise, bank assets in nonaccrual had stayed constant after the recession. In late 2012 and early 2013, assets in nonaccrual clearly began to decline, showing further strengthening of consumer balance sheet activity and confidence.

All farm-related categories of employment continued to perform better in 2013. Manufacturing employment rose, but less than in previous years following recessions. Education and health services employment grew less than its 10-year benchmark rate. Projections now point to a slightly faster pace in 2014 and 2015. All counties posted positive growth in total employment for the first time since the recession, with Merced and San Joaquin counties growing most in 2013. Employment grew less than the state's rate in Fresno, Kern, Stanislaus and Tulare counties.

Rising home values continued to increase consumer wealth and confidence. The housing sector is projected to push beyond rising home prices and interest rates. However, the improvement in the housing sector may be dampened in 2014. In the worst-case scenario, 2014 and 2015 projections show that the Valley economy will maintain the same momentum gain as in the previous year.

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