The California economy continues to boom, and so does real estate activity. Residential and nonresidential building activity is up for the fourth year in a row. Construction employment continues to rise as homebuilders expand developments at the fastest level since 1990, homeowner demand for remodeling grows, and commercial and industrial builders are pressed to meet the substantial demand reflected in low vacancy rates.

At the same time, despite rapid job growth in aggregate, some key industries in the state are seeing slowing employment growth or declines in jobs. Silicon Valley, the state leader in job and export growth for half a decade, has experienced drops in both manufacturing jobs and exports. However, the continuing growth, now based on a mix of services jobs and construction activity, is still bringing demand for new real estate product.

Statewide Employment Growth Remains Strong

California nonfarm employment expanded at an annual rate of 3.1% during the first half of 1999. With these gains, unemployment again dropped, reaching 5.2% in July 1999 (seasonally adjusted), still 0.9 points above the US level, but 4.5 points below the peak in winter 1992/1993.

The source of growth has shifted over the past two years. While manufacturing employment was a significant job producer for the state from 1995 through 1998, in 1999, the state has seen modest employment losses in manufacturing. Larger declines centering in high-tech sectors such as aerospace, electronics, computer manufacturing, and instruments have been partially offset by employment growth in construction-related durable sectors, and in nondurable sectors such as apparel, chemicals and food products.

Growth is currently being driven by the construction and services sectors. Employment in construction grew by an annual rate of 10% in the first half of this year, adding 55,000 new jobs over the past year. The services sector as a whole added over 200,000 new jobs from a year ago, with the largest increases being in business services, engineering and management, health services and recreation related services. A number of smaller finance, insurance and real estate sectors also experienced strong growth in the first half of the year. Real estate employment grew by 3.5%, adding 6,000 jobs over the previous year. This shift to cyclical products as the basis for growth may contribute to a moderating of growth in the near future.

Export Declines Do Little to Slow Momentum

Export declines continue in 1999, but with sectoral rather than general effects on the economy. In 1998, exports from California were down 4.2% statewide, with large declines in exports to the state's major Asian trading partners, but increases in sales to NAFTA and European trading partners. In the first quarter of 1999, exports picked up to some of the state's Asian trading partners, but sales dropped both to European countries and to Mexico.

Weakening exports were spread broadly across industrial sectors. The state's major high-tech exporting sectors experienced drops in exports of between 5-10% in the first quarter of 1999, while food and kindred products — the state's fifth largest export sector — saw a 13% drop in export sales.
Recent data is not available at the metropolitan area level, but data from as early as 1997 shows the drop in exports already being felt in the San Jose area, where high-tech sectors account for over 95% of exports. Export declines were also apparent in some other northern California markets (Oakland, Sacramento, Stockton, Chico, Redding), while most southern California markets did not yet show a changing export climate.

Regional Differences Mark Statewide Expansion

The growth experience in 1999 varies significantly among regions of the state, as shown in Figure 1. The fastest growing regions are typical of California's strong growth years — metropolitan areas on the periphery of the dense coastal metro areas. In the San Francisco Bay Area, the North Bay metro areas of Vallejo-Fairfield-Napa and Santa Rosa-Petaluma both have employment growth above 4% in 1999, as do Riverside-San Bernardino and Ventura in southern California. The southern part of the San Francisco Bay Area, the Silicon Valley area, has experienced the slowest growth of any California metro area (at 0.4%). In contrast, slower growing areas in southern California (Santa Barbara, at 1.5%, and Los Angeles, at 2.2%) nevertheless are adding significant numbers of jobs. Los Angeles has been the largest job producer of any region in the state in the first half of 1999, accounting for one-fifth of all California job growth.

Regional variation is particularly apparent in the manufacturing sector, where employment change is spread unevenly throughout the state. San Jose job losses of over 11,000, and much smaller losses in Los Angeles, Ventura, Santa Barbara, San Diego, Sacramento, San Francisco, and Monterey, counterbalanced by job gains of close to 7,000 each in Orange County and the Riverside-San Bernardino area, and smaller gains in a number of other northern and central California metro areas, resulted in a net loss of 6,400 jobs statewide.

The sectoral experience within manufacturing varies by location as well. Employment in all high-tech manufacturing sectors has dropped in Silicon Valley, San Diego and Los Angeles, while some high-tech sectors in other parts of the state have seen job gains. The Oakland metropolitan area has experienced job gains in both computer manufacturing and electronics sectors. Orange County and Sacramento have both lost jobs in computer manufacturing, but employment in electronics and aerospace is up in Orange County and electronics jobs are also up in Sacramento. Most Central Valley counties have benefited from a strong food-processing sector in 1999, but Sacramento has experienced job losses in that sector.

In the services sector, many high-tech related activities are growing despite losses in manufacturing. Only the San Jose metropolitan area is experiencing a drop in engineering and management jobs, and business services growth is slow in both San Diego and San Jose. In other parts of the state, both business services and engineering and management jobs are still expanding rapidly.

Population Growth and Housing Demand

California's rate of population growth slowed slightly in the last year, from a rate of 2% per year in
1997 to 1.65% in 1998. While natural increase continued at the same rate, estimates of foreign immigration are slightly lower than in 1997, and net domestic migration — the movement to and from other parts of the US — has dropped from the previous year. California’s Department of Finance estimates that California attracted about 9,500 more new residents than it lost to other states in 1998, compared to a net gain of 28,000 the previous year. (During peak growth years in the 1980s, California had a net gain of almost 200,000 from domestic migration, while the state lost over 300,000, net, annually through domestic migration during the recession of the early 1990s.)

In total, California’s population increased by over half a million in 1998. Los Angeles County alone accounted for almost one-fourth of the growth, while the five largest southern California counties (Los Angeles, Orange, Riverside, San Bernardino and San Diego) accounted for almost three-fifths of the state’s population growth. In contrast, the nine counties of the San Francisco Bay Area accounted for only 17% of the state’s population increase.

The annual rate of household growth remains below 1% in California, as shown in Figure 2, despite a population growth rate of over 1.6%, and an employment growth rate of 3% or higher. The household figures are heavily weighted by the Los Angeles metropolitan area, where new household expansion occurred at well below a 0.5% annual rate, based on California Department of Finance figures.

The relatively slow rate of household formation in the state is in part related to the slow pace of new housing construction relative to job formation and population growth. In 1998, the state added one housing unit for every 5.27 people, based on population and housing estimates from the California Department of Finance. Average household size in California is 2.94 persons per household.

**A Booming Housing Market**

Strong employment growth, moderate population growth, and a tight housing supply have led to a robust housing market in 1999. Construction activity is well below the peaks of the 1980s, but single-family permits are at their highest since 1989, and multifamily permits at their highest since 1990, as estimated in Figure 3. Single-family permits were up 11% statewide in 1998, to 94,000 units for the year, and are up by an additional 17% annual rate in the first half of this year. Multifamily units rose by 18% in 1998, to 32,000 units, and have risen by 14% in the first half of 1999. After several years of slow activity, Central Valley places had strong single-family and multifamily permit activity in 1998. The Riverside/San Bernardino area was also one of the state’s strongest for single-family permits in 1998, while the San Francisco metropolitan area saw strong multifamily activity. In the first half of 1999, the southern California area has dominated the growth in residential building activity in the state. Single-family permits have also continued to expand in the San Francisco Bay Area and the Central Valley, but multifamily permits are down from 1998 in both of these regions.

The growth in supply is more than matched by strong growth in demand. Resale activity is at its highest level in three decades. The California Association of Realtors
reports annual home sales at 628,000 in 1998. Sales activity for the first half of 1999 is up by 8% from the previous year. Median home prices reported by CAR reached $201,410 in 1998, exceeding the previous peak in 1991. Prices have risen further in 1999, up 9% in the first half of the year, and estimated at over $220,000 in May, June and July of 1999.

The San Francisco Bay Area has the state’s highest priced housing market, and by some measures, the most rapidly increasing prices. CAR reported median resale price for Santa Clara County detached homes was almost $400,000 in May of this year (fueled by readily available cash in Silicon Valley), and over $350,000 for the San Francisco Ray Area as a whole. In southern California, the median sales price was $275,000 in Orange County, $229,000 in San Diego, and $203,000 in Los Angeles. Sacramento, at $132,000, had a median sales price 9% above the Central Valley as a whole.

The Real Estate Research Council index, which reports home price changes tied to specific homes, rather than median prices, shows the strongest price increases in the San Francisco Bay Area, where the index rose 13.8% between April 1998 and April 1999. San Francisco, San Mateo and Marin show increases of 16% to 18%, while other North Bay counties show more modest increases, in the 6% to 8% range. In southern California, the price index has risen 10.4% in the past year. Orange and San Diego counties had increases in the 12% to 14% range, while the smallest increases were in San Bernardino County, at 6.9%. Looking beyond recent trends, the price increases are a greater threat to affordability for the San Francisco Bay Area than for southern California. While southern California prices have not yet reached pre-recession levels, Bay Area prices are at their highest ever, as shown in Figure 4.

Even with price increases, homes in California remain much more affordable than they were a decade ago, according to the CAR affordability index (Figure 5), but the affordability dropped slightly in the past year, and the gap with the US as a whole has widened. Affordability in May ranged from a low of 28% for the San Francisco Bay Area to a high of 59%

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**Figure 3**

California Residential Building Permits
Total Number of Units, 1967-1999E

![Graph showing California residential building permits from 1967 to 1999.](image)

**Figure 4**

Real Estate Research Council Home Price Indices
Southern and Northern California, 4/90-4/99

![Graph showing real estate research council home price indices from 1990 to 1999 for southern and northern California.](image)

Source: Real Estate Research Council of Southern California, Real Estate Research Council of Northern California.
for the Sacramento area. For the state as a whole, 36% of the population could afford to buy the median priced home, compared to 55% nationwide. This level is down four percentage points from the 1998 level.

The apartment market in California also reflects the overall pressures on the housing market. According to RealFacts data, reported by the Real Estate Research Council, apartment vacancy rates have remained below 4% in most southern and northern California markets. New construction combined with a weakening job market have led Santa Clara County to have the highest vacancy rate in the San Francisco Bay Area, at a modest 4.5%.

Apartment rents are highest in San Francisco, at $1,861/month in first quarter 1999, compared to a San Francisco Bay Area average of $1,166, and a southern California average of $894.

Nonresidential Markets

Nonresidential markets continue to show strength in many parts of California, but some markets are showing signs of peaking. While 1998 was another strong year, nonresidential construction is only slightly above 1998 levels in 1999, and some sectors, in some market areas, are beginning to experience a slowdown in building activity. Statewide, nonresidential permits were valued at $14.8 billion in 1998, a 20% increase over activity in 1997 (or 18%, accounting for inflation). For 1999, the Construction Industry Research Board predicts an inflation-adjusted increase of 3.6% in nonresidential building permits.

In 1998, the value of building permits was up for all three major real estate sectors — office, retail and industrial — as shown in Figure 6. Adjusting for inflation, industrial building activity was up by 50%, office activity was up by 13%, and retail by 7.5%. Before adjusting for inflation, nonresidential permits are up 8.2% for the first half of 1999. However, only retail permits show a significant growth for the first half of the year, up by 22% in current dollars. Office building activity has been flat, while industrial permits are down 18% compared to the first half of 1998.
Southern California led the growth in office building activity both in 1998 and in the first half of 1999. The value of office permits is also up in the Central Valley, but has been declining in the San Francisco Bay Area since 1998. Retail permits have shown stronger growth in the first half of 1999 than in 1998, with the suburban San Francisco Bay Area and the Sacramento area outpacing the rest of the state. Industrial permit activity, which remained strong in southern California and the San Francisco Bay Area in 1998, is down in both locations in 1999. In the Bay Area, permits went from an increase of 49% in 1998 (43% after adjusting for inflation), to a decrease of 46% in the first half of 1999. The shift is consistent throughout the region, with the exception of the Santa Rosa area. Only the Central Valley continues to show increased industrial permit activity in 1999.

The shift occurring in office and industrial building activity shows a more cautious approach to market signals in 1999 than was apparent in the late 1980s. For the state as a whole, office vacancies continue to drop and rents are still rising. However, in significant market areas, vacancy rates have started to increase.

Our statewide estimates show office vacancies at 10.3% at the end of 1998, down from 11.0% in 1997 (see Figure 7). However, vacancies have increased slightly in the San Francisco Bay Area, and remain above 10% for most of southern California. Vacancies have remained fairly stable in the Sacramento market over the past year, fluctuating in the range of 8% to 9% (according to CB Richard Ellis).

San Francisco, San Mateo and Santa Clara counties all experienced vacancy increases in 1998. In San Francisco and Silicon Valley, the market has stabilized in 1999, with slight drops in vacancies in the first half of the year — to 6.1% in San Francisco (Cushman and Wakefield) and 6.9% in Silicon Valley (Grubb & Ellis). San Mateo County's vacancy rate has risen further in 1999 and has gone from 1.7% in 1997, to 5.7% in December 1998, to 7.5% in the first quarter of 1999 (SAMCEDA). These changes reflect a combination of factors, including the construction of new space (some speculative) and the beginning of an economic slowdown, particularly in the South Bay.

Declining vacancy rates for southern California come mainly from the Los Angeles and Inland Empire (Riverside and San Bernardino County) markets. At the end of 1998, vacancies ranged from a low of 8.5% in Orange County to a high of 21.2% in the Riverside/San Bernardino area (according to Grubb & Ellis figures). Vacancies in Los Angeles dropped to 14.9% from 16.4% at the end of 1997, and Inland Empire vacancies had dropped to 18% by second quarter of 1999. However, Orange and San Diego counties have begun to experience small increases in vacancies in the first two quarters of 1999. Orange County vacancy reached 9.3% by second quarter 1999, and San Diego vacancies have risen from 7.6% at the end of 1998 to 7.9% in second quarter 1999.

Despite rising vacancy rates in the Bay Area and relatively high vacancy rates in southern California, office rental rates are rising in most of the state. Both downtown Los Angeles and the San Francisco market saw 22% increases in office rent in 1998. Suburban areas, the Sacramento area, and Silicon Valley saw more modest increases, primarily in the 10% to 14% range.

California's industrial market shows stabilization or a slight weakening in some markets, but continuing tightening in other market areas. In the San Francisco Bay Area, there are signs that a very tight industrial market has begun to ease in the East and South Bay. The largest change has been in the 680 Corridor.
area of Contra Costa and Alameda counties, where vacancies have risen from 9.1% at the end of 1998 to 12.5% by second quarter 1999. With increased vacancies has come a 12.7% drop in rent/square foot, according to CB Richard Ellis data. Grubb & Ellis data show smaller jumps in vacancy for the Oakland/East Bay Shore market area, which still experienced rent increases despite higher vacancies and negative absorption in the first half of the year. Silicon Valley had a significant increase in vacancy in 1998, to 9.1% by year-end, but vacancies stabilized in the first half of 1999, at the 8% to 9% level. Rents peaked in third quarter 1998 and have since dropped by 8.5% for R&D space and 15.5% for distribution space (Grubb & Ellis). The western part of the region - the San Francisco metropolitan area - has maintained a much tighter industrial market. Vacancies are below 3% in San Mateo County (SAMCEDA) and at 1% in Marin County (Keegan and Coppin).

In southern California, the Los Angeles and Orange County industrial markets remain very tight. Industrial vacancy in Los Angeles is down to 4.8% for second quarter 1999, and rents are up (Grubb & Ellis). Orange County vacancies, at 6.2%, are at their lowest on record for Grubb & Ellis, but asking rents have also dropped (perhaps due to the type of space on the market). Vacancy rates are steady in the Inland Empire, while rates have risen in San Diego, from 6.0% at the end of 1998, to 7.3% by mid-year.

Looking Toward 2000

Employment growth has been surprisingly strong in 1999, given overseas economic conditions and trends in the state's high-tech sectors. The integration of California with the global economy as a producer as well as an exporter may offer a partial explanation for the state's strength during this period, with gains in high-tech related services jobs offsetting losses in high-tech manufacturing employment. With this integration, recovery of Asian economies could be a mixed blessing, increasing export opportunities while raising production costs in California's high-tech sectors.

The diversity of economic activity in the state has offered a cushion to some sectoral losses. In addition, pent-up demand in real estate and services sectors is now fueling part of the continued growth. The strength of these factors is likely to carry over into California's economy in 2000. However, the dependence on cyclical sectors for recent employment growth, the ever-present possibility of interest rate increases, and the satisfaction of some pent-up demand, especially in the nonresidential area, may lead to a tempering of economic growth from the past two years.

In the residential market, pent-up demand has not been fully met, suggesting that prices will continue to rise (absent major increases in interest rates). Increased construction in 1999 could begin to bring a better balance to the housing market, particularly if employment growth also moderates. However, if recent projections of household growth in California are accurate, the California housing supply problem is long-term.

Construction activity in nonresidential markets has been more successful in bringing a balance to many California markets. With demand softening in major locations like Silicon Valley or San Diego, nonresidential construction activity may slow down in 2000, or vacancies will once again rise and rents drop.

With its economic strength restored, the key real estate issues facing California entering the next century and millennium are hauntingly reminiscent of those of a decade ago — congestion effects of urban agglomerations, balancing economic and environmental goals, housing availability, and affordability.

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