CUSTOM CONTENT

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MID-YEAR ECONOMIC FORECAST

Five Signs the Economic Forecast in SoCal is Bright

If you're a business owner, one of your main focuses is always steered toward what is happening in the economy. Whether it's on a national, regional, or local level, the economy will have an impact on your business and your employees. Here are five signs the economic forecast in SoCal is bright.

1. **Growth in Numbers**
   In 2018, the U.S. economy grew 2.9% (slightly up from 2017 and 2016). The greatest contributions of this growth came from government and business investment. Despite trade disputes, exports also saw a good year. The consumer savings rate was above 6% as disposable income used for debt fell to a record low. Wages are rising and consumer spending remains solid.
2. **Mean Credit Scores are Up**
   Today, the mean credit score of a borrower is above 750, compared to below 700 in 2006 when mortgage debt was expanding by 15% a year. Borrowers are also spending less of their income on housing (29%) than they were (37%) when they had lower credit scores.
3. **California Unemployment Rate is Low**
   The statewide unemployment rate was 4.2% in January 2019, which was slightly above the all-time low of 4.1%. Unemployment rates in the Inland Empire and Los Angeles were up a tick from the national level at 4.3% and 4.6% respectively. Meanwhile, the unemployment rate in Orange County was at a low 3.0%. Despite labor forces also increasing across the Southland, the labor market remains taut leaving job seekers with a plethora of options in their search.
4. **Venture Capital is Heating up in San Diego**
   San Diego is one of the top regions for healthcare innovation, particularly in the Medical Device and Biotechnology sectors which has made the region an attractive choice for venture capital investment. In 2018, San Diego County received a record $2.96B in investments. This is not only the trend in San Diego, but also across the country as venture capitalists are spending more money per deal. As San Diego remains one of the top regions for healthcare innovation, this trend is forecasted to continue.

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5. **Commercial Real Estate Market Remains Strong**
   The commercial real estate market remains strong throughout Southern California. Commercial rents have increased year-over-year but construction has also kept those same rents from increasing too much. The region is still seen as affordable. As of the fourth quarter of 2018, office rents in the Inland Empire are the lowest amongst neighboring regions at $22.93 per square foot with a vacancy rate of 16.8%. In Orange County, the rate is higher ($34.12) however vacancies remain lower (15.9%). Prices are slightly lower in San Diego ($32.79) along with the vacancy rate (15.7%). In Los Angeles, the rates are the highest ($38.91), however, the vacancy rates are the lowest (14.5%).

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For more information, visit torreypinesbank.com.

Source: 2019 Regional Intelligence Report, May 2019, prepared by Beacon Economics, LLC, presented by Torrey Pines Bank.

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MID-YEAR ECONOMIC FORECAST

UCLA Anderson Forecast Shares Challenges Ahead

Last month, in its second report for 2019, the UCLA Anderson Forecast offered new recession predictions based on the most recent GDP data and the most recent bond market data.

While the U.S Department of Commerce's release of a 3.1% growth rate for GDP in the first quarter was celebrated as evidence there is no recession in the near future, a closer look at the details behind that 3.1% number leaves less reason for celebration. Similarly, recent employment data may not appear as robust as reported, which affects the outlooks for the nation and California.

The current forecast opens with a paper on research by UCLA Anderson Professor Emeritus Edward Leamer that searches for recession precursors. "The first step toward making a recession forecast is looking at what was unusual in the four quarters before recessions," he writes.

Some of the most reliable indicators include weak residential investment and intellectual property (three quarters prior to recessions), and weak residential construction and consumer durables (two quarters before recessions.)

An inverted yield curve also emerges as an important and well-known part of a recession alarm.

"The effect of the first quarter of 2019 data is to increase the recession probabilities from near zero to 15% for the next year and to between 24% and 83% for the year after that," Leamer writes.

In addition, the expected number of quarters remaining in this expansion falls from 7.1 to 5.5 when the first quarter of 2019 data are included. That is just one quarter beyond a single year. In other words, he writes, "don't worry about the coming year; worry about the year after that."

His conclusion: "Don't celebrate the 3.1% GDP growth estimate for the first quarter of 2019." That data actually increases the risk of a recession in the next couple of years.

THE NATIONAL OUTLOOK

In one of his two papers in the current report, UCLA Anderson Forecast senior economist David Shulman sees very modest changes since the March 2019 economic forecast.

Based on a large inventory buildup, a substantial decline in imports, surprising strength in exports and a bulge in state and local spending on road repairs associated with this winter's storms, Shulman describes a "3-2-1 economy, where growth on a fourth-quarter-to-fourth-quarter basis was reported at 3.1% in 2018 and is forecast to be 2.1% and 1.4% in 2019 and 2020, respectively. For 2021, we are forecasting a rebound to 2.1%."

Concurrently, Shulman warns that "when the economy slows to 1% growth, the risk of a recession becomes very real, with the second half of 2020 being most problematic.

"With job growth slowing to a crawl of about 40,000 a month in 2020, the risk of a recession in the latter part of that year is nontrivial," he writes. "Inflation is forecast to run somewhat above 2% and the Fed will maintain stable interest rates until the second half of 2020, when we forecast two rate cuts. The downside risk to the economy comes from increased trade tensions and the upside risk would come from housing activity rising out of its stupor."

Shulman's second paper focuses on the commercial real estate market, where price increases have stalled at an annual 2.1% rate in the past three years and construction spending is in the process of leveling off. Of the four categories in the commercial real estate market (apartments, industrial, office and retail), only the industrial sector has soared in terms of new construction and rents, a result of rising demand from the e-commerce segment.

"E-commerce has accounted for 34% of the growth in the addressable market since 1999 and an astounding 47% of the growth in the five years ending in the fourth quarter of 2018," he writes.

With strong demand for close-in industrial space, the U.S. is seeing increased construction of multistory warehouses, the type that have typically been found only in Japan, Shulman writes. "It's no wonder that store-based retail is in a world of hurt"

As employment growth slows, construction starts will be reduced and asset values will modestly soften. The multifamily and industrial sectors will continue to do well, while the retail space remains problematic.

THE CALIFORNIA OUTLOOK

California's rapid job growth, with full employment for the past year, is slowing down. This is primarily based on employers having a hard time finding qualified new employees. However, employment is only part of the picture.

"The slowing growth in contracting sectors, such as nondurable goods manufacturing and retail, and more rapid growth in expanding sectors, such as information and scientific and technical services, have spurred faster state GDP growth than total employment growth would suggest," writes UCLA Anderson Forecast director Jerry Nickelsburg.

Reflecting an outlook that is similar to the nation's, the forecast expects modest changes to its previous update in March 2019 for the state.

"Weakness in housing as well as the slowing U.S. economy is reflected in a very modest growth rate in the U.S. in late 2020," Nickelsburg writes. "As a consequence, we expect California's average unemployment rate to rise slightly to an average of 4.6% in the first quarter of 2021. For the entire year for 2020 and 2021, we expect average unemployment rates of 4.3% and 4.4%, respectively."

Employment growth is expected to be 1.7%, 0.8% and 0.4%, while payroll jobs will likely grow at a rate of 1.4%, 0.8% and 0.6% for 2019, 2020 and 2021, respectively. Real personal income growth is forecast to be 2.9%, 1.9% and 2.1% in 2019, 2020 and 2021, respectively.

"The continued growth in real personal income in 2020 is reflective of the changing mix of employment in California and tight labor markets in high wage occupations," Nickelsburg writes. "Home building will be lower by about 9,000 units this year than previously forecast, but grow to about 146,000 units run-rate by the end of the 2021 forecast. The significant building rate toward the end of the forecast will be a response to easing zoning and regulatory requirements for developers, and an expected reduction in interest rates by 2021."

CONSTRUCTION INDUSTRY OVERVIEW

UCLA Anderson Forecast economist William Yu's paper on production and costs in the construction industry examined activity and spending in three major sectors: residential, private nonresidential and public residential investments.

Although construction activity has slowed in recent quarters, particularly in residential construction, the costs for some global commodities used in construction have remained high. Steel prices, for example, had been rising steadily since 2016. Only since 2018 have they been dropping, a decline that is puzzling, given the tariffs imposed on steel in 2018.

Labor costs, a significant part of total construction costs, have risen, a result of high hourly wage growth since 2014. The annual wage growth, between 3% and 3.5%, may signify a tight labor market supply. The power sector in private, nonresidential construction has seen the largest investment during the past few years, with increased activity in oil, gas and electricity facilities as the U.S. became one of the largest energy producers with a rapid surge of energy exports.

Cathay Bank/UCLA Anderson Forecast's second quarter U.S.-China economic report outlines the mounting trade dispute between the U.S. and China.

Amid the recent escalation of trade tensions, it appears that the two largest economies in the world are moving in a direction that some have named the Thucydides Trap, in which a rising power and the existent dominant power move inexorably toward conflict, in this case an economic one. The areas that will likely be most adversely affected will include consumer goods, intermediate and final manufactured goods, and technology.

"If increased new tariffs on some $200 billion of Chinese imports remain for a lengthy time, China's world factory, global supply chains, and the U.S. import and distribution system could be disrupted in a significant way," the forecast authors write. "We could see an accelerated exodus of manufacturers from China to avoid the current 25% tariffs and the potential additional 25% tariff on the balance of Chinese exports in the future."

On the U.S. side, consumers will see higher prices and producers a more difficult competitive environment. Can a new trade agreement be reached in the near future? The authors conclude that hardening positions on both sides will potentially make this more difficult to achieve.

The UCLA Anderson Forecast is available via Anderson.ucla.edu.

CPAs Believe Complex Financial Instruments Pose Risks

Financial instruments are a growing presence on company balance sheets, and business executives say more market awareness is needed to prevent another financial crisis, according to a recent survey by the American Institute of CPAs (AICPA).

When asked about their company financial statements, 59 percent of the CPAs surveyed reported having complex financial instruments such as mortgage-backed securities, interest rate swaps or other derivatives on their company balance sheets.

Of those respondents with complex financial instruments on their books:

- **69 percent** expect financial instruments to become more complex (57 percent slightly more complex, 12 percent substantially more complex) over the next one to three years, compared with 1 percent who expect them to decrease in complexity.
- **53 percent** believe there is not enough market awareness of complex financial instruments to prevent a financial crisis, compared with only 22 percent who believe there is adequate awareness.
- **55 percent** said they are concerned about the valuation of derivatives with 6 percent reporting significant concern and 49 percent reporting slight or moderate concern.
- **56 percent** said it would be easier to determine the value of complex financial instruments if they were measured and reported on a consistent and transparent basis.

Complex financial instruments historically have been difficult to value. That difficulty is seen as a major cause of the financial crisis that lead to the recession of 2008. The derivatives market exceeded $594 trillion in 2018. More than a quarter (28 percent) of respondents said they expect financial instruments to take a larger percentage of their balance sheets over the next one to three years, while only 15 percent see that decreasing.

"With financial instruments growing in complexity and taking up an increasing share of balance sheets, it is imperative that executives and finance teams understand these potentially risky investments," said Ash Noah, CPA, CGMA, managing director of CGMA learning, education and development for the Association of International Certified Professional Accountants (Association), the global organization that includes the American Institute of CPAs (AICPA) and the Chartered Institute of Management Accountants (CIMA). "A uniform framework to value financial instruments will provide companies the information they need to make better decisions and offer greater transparency to investors and other stakeholders."

The AICPA created a Financial Instruments Performance Framework to improve the consistency and transparency of fair value measurements for these complex instruments. It establishes documentation requirements and provides guidance on the scope of work supporting an auditable fair value estimate for financial instruments. The framework, along with the Certified in the Valuation of Financial Instruments credential (CVFI), will assure financial statements and disclosures are consistent and clearly supported.

"Creating standard processes for documenting and valuing these instruments will improve clarity and transparency within the valuation profession. This will provide executives, investors and regulators information on the value of these securities in a consistent manner," said Jeannette Koger, CPA, CGMA Association vice president for advisory services and credentialing.

The financial instrument questions were included as part of the second-quarter AICPA Economic Outlook Survey, which was conducted May 7-28. These questions received 680 qualified responses, of which 404 respondents reported having financial instruments on their balance sheets. The data above reflects those responses.

Learn more at aicpa.org.

MID-YEAR ECONOMIC FORECAST

Executive Outlook Holds Steady After Earlier Decline

Concerned about the outlook for both the U.S. and global economies, business executives have revised expectations downward for a number of categories that impact their companies, according to the second-quarter AICPA Economic Outlook Survey released last month, which polls chief executive officers, chief financial officers, controllers and other certified public accountants in U.S. companies who hold executive and senior management accounting roles.

Some 57 percent of survey takers expressed optimism about the U.S. economy's outlook over the next 12 months, the third straight quarter it's held at that level since dropping from 79% at the start of 2018. U.S. executives also continue to hold a dim view of the global economy, with only 35 percent expressing optimism, up a single percentage point from last quarter.

In recent quarters, business executives had kept a more upbeat view of expansion prospects and their own companies' outlook. That sentiment has gradually eroded over the course of the year, however, and both categories now stand at their lowest level since late 2016. The same holds true for 12-month revenue and profit expectations, which slid this quarter from 4.4 percent to 4.2 percent and 3.6 percent to 3.1 percent, respectively.

"While business executives' expectations for their companies and the perceived environment those companies will be operating in over the next year have been tracking downwards, there's been a slight disconnect between these for the past few quarters" said Ash Noah, CPA, CGMA, managing director of CGMA learning, education and development for the Association of International Certified Professional Accountants, the global organization that includes the American Institute of CPAs (AICPA) and the Chartered Institute of Management Accountants (CIMA). "In this quarter, we've seen a bit of a reset and the indicators are more closely aligned. With so much uncertainty over trade and other global issues, companies are taking a more conservative stance on their potential performance."

Availability of skilled personnel remains the top challenge for businesses, a position it has occupied since the third quarter of 2017. Two other staffing-related issues are among the top five challenges cited by survey takers this quarter: employee and benefit costs (No. 2) and staff turnover (No. 5).

With a tight labor market, business executives forecast a 2.7 percent increase in salary and benefit costs over the next twelve months, a 0.1 percent increase over last quarter's forecast. Asked for more specifics in a separate question, some 86 percent of respondents said they expected to raise salary and wages in the next 12 months, with most (64 percent) saying they expected those increases to fall between three and five percent. Only eight percent said they didn't expect to raise salaries and wages at all. These numbers track closely with results from the last time the question was asked at the end of 2018.

The AICPA survey is a forward-looking indicator that tracks hiring and business-related expectations for the next 12 months. In comparison, the U.S. Department of Labor's May employment report, scheduled for release tomorrow, looks back on the previous month's hiring trends.

The CPA Outlook Index—a comprehensive gauge of executive sentiment within the AICPA survey— fell a single point to 75 from last quarter. The index is a composite of nine, equally weighted survey measures set on a scale of 0 to 100, with 50 considered neutral and greater numbers signifying positive sentiment.

Other key findings of the survey:

- The percentage of U.S. executives who expressed optimism about their own company's prospects over the next 12 months fell from 65 percent to 62 percent, quarter over quarter.
- Survey respondents who said they expect their organizations to expand in the coming year also fell three percentage points to 63 percent.
- The number of business executives who said their companies have too few employees and are ready to hire immediately edged up slightly in the quarter from 26 percent to 28 percent. Those who want to hire but are hesitant because of uncertainty also edged up a tick from 15 to 16 percent. This hesitancy to hire was particularly pronounced in the largest companies (those with over $1 billion in annual revenue), with one-in-four reporting such qualms. That's much higher than other company segments.
- Inflation concerns slipped five percentage spots to 29 percent in the quarter and have dropped from 47 percent a year ago.
- Construction and health care providers were bright spots for positive sector outlooks in the quarter, while retail trade and manufacturing showed sharp drops in optimism.

A copy of the full report can be found on aicpa.org.

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