

**Almaden Valley-Willow Glen Rotary Club
Rookies, 1535 Meridian Avenue**

**Thursday, September 29, 2022
12:00 – 1:00pm**

“COVID-19 and the Local Economy”

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COVID-19 inserted a level of uncertainty in the global economy that has made normal economic analysis difficult.

Silicon Valley is a global magnet for high-risk venture capital. When times are good, they're very good. When things turn down, the descent can be dramatic.

It's like when Warren Buffet said, "It's only when the tide goes out, that you learn who was swimming naked".

COVID has been a monumental health and humanitarian crisis of global significance.

COVID painfully impacted the most vulnerable American households, creating serious economic dislocation.

Silicon Valley has the highest level of income and wealth inequality in the U.S., which increased dramatically during COVID.

The average net worth in the U.S. increased 25% in the last three years.

The COVID disruption impacted the way we engaged with others in social activities, how we interacted with others in the workplace, how we traveled, how we shopped, and even how we purchased groceries.

Business investment, retail sales, home construction, exports, consumer and government spending, all reached record levels of decline in 2020.

The federal government, and to a lesser extent the State, reacted to the crisis quickly, by providing a huge financial stimulus to boost the economy; \$2.5 trillion in direct payments, \$1 trillion in tax relief.

In my opinion, the federal stimulus was excessive and completely undisciplined.

The purpose of a stimulus is to put money in the hands of people, expecting the people will spend that money, boosting the economy.

During COVID, people could not spend the money they received, because everything was shut down. So, many people saved their stimulus and, in some cases, their unemployment checks.

Result: A significant increase in savings, not spending, which is contrary to the purpose of the stimulus payments to begin with.

During COVID, Americans were stockpiling savings, which reached a 30-year high. Consumer loans and credit card balances reached their lowest level in years.

Suddenly, beginning in the last half of 2021, Americans started spending at record levels.

Consumer spending is the primary driver of the U.S. economy, accounting for 70% of economic activity.

Robust consumer spending, combined with widespread product and worker shortages created the highest inflation since the 1980's.

In the Bay Area, consumer spending dropped sharply in the face of high inflation.

The Consumer Confidence Index, which measures consumer's future outlook for income, business, and labor markets, also declined in August.

Major retailers, including Walmart and Amazon, continue to pull back hiring in response to shifting consumer behavior.

The consumer price index inflation measure climbed to 8.3% in August, down from 9.1% in June, still the highest since 1981.

Most economists believe inflation will persist well into next year, and Chris Thornberg of Beacon Economics believes it's going to get worse. He believes mortgage rates could go to 10%.

There is still too much money circulating in the economy to effectively combat inflation.

The U.S. economy has run headfirst into the perfect storm of high demand and low supply, soaring prices and rising interest rates.

Inflation is wiping out strong gains in wages and salaries, which have flowed to American workers.

While gasoline prices have dropped, everything from food and rent to automobiles (new and used), all cost more than a year ago.

In the past year, grocery prices have increased 13.5%, the biggest increase since 1979.

There are two types of inflation. First, the cost of materials and products. The second is more intractable – labor inflation.

There are many causes of runaway inflation:

1. Supply chain disruptions
2. Worker shortages
3. The enormous financial stimulus from the federal government during COVID
4. COVID shutdown in China
5. Russia's invasion of Ukraine
6. A Federal Reserve that kept interest rates too low for too long
7. Corporate greed, corporations taking advantage of the economic disruption

The wave of major corporate mergers has killed or reduced competition, particularly the airlines, banks, and other industries, giving surviving companies the leverage to demand price cuts from suppliers, hold down workers' pay, and pass higher costs to consumers.

Federal Reserve Chair Jerome Powell pledged to do whatever it takes to curb inflation.

The Fed increased its benchmark interest rate by one quarter of a point in March, one-half point in May, three-quarters of a point in June, three-quarters in July, and again, a second three-quarters of a point in September, the most aggressive drive in 3 decades, to tame inflation.

The likelihood that the Fed can engineer a so-called “soft landing” and reach its 2% target, is diminishing. Many analysts believe the Fed can’t defeat stubbornly high inflation without inflicting some pain, most likely in the form of higher unemployment.

Others believe you’re not in a recession when you have a solid job market and economy that has created 2.7 million jobs, unemployment at 3.7%, and nearly 11 million job openings.

The supply chain disruptions is the most serious problem facing the American economy right now. Our ports are hopelessly clogged.

It takes 9 days for a ship anchored in Long Beach/LA harbors to unload, an increase from just two days in 2019.

The shortage of Silicon chips, required for nearly every product like automobiles and computers, is most serious. It may be two years before that problem is resolved.

Supply chain bottlenecks and higher wages are causing companies to pass higher costs onto consumers.

All this economic chaos and uncertainty has resulted in a labor shortage, particularly a shortage of service workers.

The U.S. services sector employs a majority of Americans.

But is there really a labor shortage?

Is it a job problem or a worker problem?

The economy has shifted from jobs, jobs, jobs to workers, workers, workers.

The number of job openings increased to 11 million in August. There are still two job openings for every unemployed worker.

Despite the fact that 12 million jobs lost to COVID have been recovered, there are still 5 million fewer jobs today than there were in February 2020.

The job markets in both California and the Bay Area experienced significant slowdowns in employment in August, and have yet to fully recover from the jobs lost from the pandemic.

The Bay Area has regained only 87.6% of jobs lost, Silicon Valley 97.1%.

California's unemployment rate increased to 4.3% in August, higher than the nation at 3.7%.

The one bright spot is tech companies.

Hiring by the tech sector was so robust in August that the Bay Area would have had a net loss of jobs in August, without tech.

"Thank goodness for tech," declared Russ Hancock, CEO of Joint Venture Silicon Valley.

Americans are quitting jobs at a record pace.

In the month of May, 4.3 million U.S. workers quit their jobs, the highest on record, a sign that workers are confident they can find better pay or improved working conditions elsewhere. Workers are enjoying historically strong job security.

It's referred to as the "great resignation". The song, "You can take this job and shove it" comes to mind.

Actually, it's really the "great reshuffle".

COVID also gave many people time to re-think their lives and careers, and many have decided to ditch previous jobs in industries like restaurants and hospitality for higher pay and benefits in transportation and warehousing, providing a more consistent work schedule.

Workers have discovered they can leverage a chaotic labor market to their advantage, a rare opportunity to demand better pay and working conditions.

Finally, retirements accelerated during COVID.

Three million people have dropped out of the labor force unprecedented!

There is a belief among some economists that if inflation doesn't subside soon, some retirees may un-retire, as their pensions won't cover dramatic increases in the cost of living.

The long-term future of the job market is somewhat clouded as more baby boomers are leaving the labor force than Millennials (born after 1980) and GenZers (born after 1996) are entering the labor force.

In the long-term, this could have serious consequences.

Baby boomers grew up in households with 3 or 4 children. Demographers tell us that Millennials are having an average of 1.2 children.

Consequently, there won't be sufficient GenZers (the children of Millennials) to maintain a stable workforce in the future.

Increased immigration and robotics are the only solution to meet our future workforce demands.

Universal Pre-K education would allow more women to enter or re-enter the labor force.

Americans, however, have been poisoned by anti-immigration sentiments, and the political rhetoric that comes with it.

Long-term, the Bay Area economic challenges remain; housing, transportation and economic competitiveness.

California is a large, diverse economy. That diversity is a strength because it creates a broader economic base.

Silicon Valley's economy is structured to resist long-term declines in economic activity. Big tech has a special kind of resilience because innovation is the driving force behind our success.

Economic uncertainty and COVID didn't stop venture capital investments, however.

Venture Capital, led by a record number of megadeals in the Bay Area, hit a record high, reaching \$105 billion last year and \$29 billion in the 3rd quarter alone. Angel investments were also up 21% year over year.

While venture capital funding is still above historical averages, the number of deals has dropped 32% in the first half of 2022.

There are significant differences between the 2008 Great Recession and the COVID Recession. The 2008 recession was caused by subprime mortgage credit fraud, and excessive risk-taking by major financial institutions.

Worker layoffs back then, were more permanent. The U.S. economy didn't fully recover from the Great Recession until 2015.

The huge spike in unemployment, in which 22 million jobs were lost virtually overnight, the fastest decline in economic history, was directly related to the sudden health pandemic, outside of the normal financial system; workers laid off from profitable, sustainable businesses that were ordered to close.

So, what are some of the economic implications of this pandemic on our real estate markets? The most obvious – the travel, hospitality, and leisure sectors. They were hit first and hit hardest.

Hotels that depend primarily on business travelers, the largest source of hotel revenue, suffered the most. During COVID, business travel was down 85%.

Recently, hotel occupancy and room rates have jumped dramatically. Rates are up as much as 30% with occupancy at 70% and 80% in popular tourist areas.

Investment interest in hotels, however, is booming. In Santa Clara County, hotel investment is up 174%.

The San Jose Marriott in downtown San Jose was valued at more than \$200 million as part of a 25-hotel sale transaction. That's \$400,000 a room. A 59-room iconic hotel in Monterey County sold for \$2.5 million a room.

The airlines and hospitality industries are dependent on each other.

The airline and aerospace industries have been in a severe state of disarray. The disaster for the travel industry in 2020 was ten times worse than 9/11.

Leisure and business travel is improving as the public gains confidence in the health and safety of airline travel.

As businesses, however, become comfortable with Zoom and Webinars, this could have a more permanent impact on business travel, and ultimately, on lodging.

Next, the retail sector.

The one sector that is increasingly weaker is retail.

Fear of social contact and plummeting consumer confidence exacerbated the serious challenges already facing the retail sector, particularly in-store retailers.

Restaurants, food and beverage outlets, and major malls suffered from compulsory, or self-imposed access restrictions.

Bloomberg reported that 11,000 restaurants, more than 10% of all restaurants in the U.S., closed permanently last year.

According to CBRE, it will be at least a year or two before the restaurant market comes back from free-fall, as the public feels more comfortable.

The increasing prevalence of online shopping vs. traditional brick-and-mortar stores, all point in the same direction: online sales continue to grow exponentially faster than in-store sales.

The retail bubble has burst, and the problem is not cyclical. I believe it's a "forever" trend.

Retail malls are leading the retail mess.

It's referred to as the "unmallings of America".

One major retail researcher projects, that 30% of the nation's 1,100 malls will close in the next 4 years. He stated, "malls as a property type are dead. Malls are only worth the dirt they sit on. Their structures have no value". Think about that.

The French company, the principal owner of Valley Fair and Oakridge malls, the largest owner of retail malls in the world, announced it will divest the company of all malls in the U.S. over the next three years.

Forbes reported that nearly 16,000 retail locations closed permanently last year, compared to 7,000 in 2019. 60% of those were mall-based.

CBL Properties, one of the nation's largest mall owners with 90 malls, filed for bankruptcy in 2020.

The U.S. is simply “overstored”!

Traditional shopping centers, particularly malls, are being repurposed to “consumer centers” with a mixture of uses, including fitness, health and wellness, co-working operations, or are being converted to things like offices, affordable housing, distribution centers for e-commerce, classrooms, churches, museums, and even transitional space for the homeless.

San Diego’s Horton Plaza, a 900,000 sq. ft. open-air, five-level retail mall encompassing 6 ½ city blocks, has been redeveloped as a mixed-use tech and life science hub.

Local elected leaders must give up their love affair with retail shopping centers for the sales tax revenue, as in-store retail is a declining enterprise.

With the inevitability of autonomous cars, vast surface parking lots, present an opportunity for housing development.

Millennials are a driving force behind e-commerce. Millennials grew up in a “one click” world, where speed and convenience is expected, indeed demanded.

The decline of the middle class is having a profound effect on retailers. Deep-discount retailers (Dollar Store) are doing extraordinarily well.

The barrage of retail bankruptcies, store closures, and diminishing revenues; it truly has become survival of the fittest, as name-brand, debt-laden retailers like Circuit City, Mervyns, Blockbuster, Borders Books, Loehmann’s, Sports Authority, Linens ‘N Things, Toys R Us, Payless Shoes, Forever 21, Tuesday Morning, Orchard Supply, J. Crew, Lord & Taylor, Brooks Brothers, Stein Mart, Pier 1 Imports, and Sears, continue to disappear or file for bankruptcy.

One retail leader described it as the “three C’s” - Closures, Consolidations, and Contractions.

Excess Space Solutions Company projects that retailers are expected to downsize their storefront space by 40 to 50 percent over the next 10 years.

Nevertheless, e-commerce sales still represent only 18 percent of total retail sales, while four in every five U.S. consumers regularly shop online, and 40% of those online shoppers buy something on Amazon once a month.

Are there winners? Walmart, Target, Costco, and Amazon.

Amazon's market cap reached \$1.2 trillion, which is greater than the market cap of the other top 15 retailers combined. The others include Walmart, Costco, Target, Nordstrom, Best Buy, and 10 others.

Amazon's acquisition of Whole Foods sent shock waves through the grocery industry. One industry expert described it as, "Amazon declaring war on every supermarket and corner store in America".

Many believe that Amazon, Apple, Google, and Facebook are abusive monopolies, and that our markets are no longer competitive.

Google has 92% market share and accounts for 22% of the S&P 500 alone. Apple owns 4 of the 5 biggest apps, 79% of smart phone profits, and became the first \$3 trillion company.

Facebook has 2 billion subscribers, nearly as many as Christianity has followers.

At the same time, we are seeing a transformational turn in the retail industry.

It's called "clicks to bricks". Established e-commerce retail brands, have been opening brick-and-mortar retail locations, benefitting from their e-commerce brand and success, building a retail presence, and improving their distribution footprint.

Global unrest, stock market declines, rising interest rates, and an uncertain economy caused Silicon Valley home prices to decline 4.5%, and home sales to fall 30% in Santa Clara County. Homes are staying on the market nearly twice as long as just weeks ago.

Mortgage rates have increased 60% in Silicon Valley, pushing monthly mortgage payments past what buyers can afford, causing home sales to drop 27% in June.

CoreLogic forecasts that home price growth will decline to single digits, reflecting a more normal housing market; a healthy market correction.

Bay Area home prices are more volatile than the national average. They typically rise faster during boom times and fall further during recessions because the region is tied to the boom-bust tech sector.

In Silicon Valley, however, luxury home sales are impacted more by the stock market than mortgage rates. Wealthy tech professionals, driven by record stock prices and low interest rates, purchased expensive homes.

Apartment rents have fully recovered, up 19.8% for both new leases and renewals.

In San Jose, the median rent for a 2-bedroom apartment is \$3,150.

As interest rates rise, wannabee homebuyers will be forced to rent, which is positive for the multi-family rental market.

The jury is out on the long-term impact of teleworking on the office market. Most experts believe they will ultimately settle on a hybrid approach.

It's hard to predict how many workers will eventually return to the office.

Intense networking is an important component of Silicon Valley's ecosystem. It's hard to successfully network on Zoom.

What impact has COVID had on commercial real estate?

Silicon Valley's commercial property market recorded its biggest year ever in 2021 according to CBRE.

132 Office and R&D buildings representing 15.1 million square feet of space were purchased last year.

LinkedIn, Tesla, Google, Apple, Amazon, and Facebook completed major leases and property acquisitions in the fourth quarter of 2021.

The market for office space in Silicon Valley, however, cooled off significantly in July reaching a vacancy rate of 14%, according to Colliers.

Demand for R&D space, on the other hand, is way up with rents at record levels. Biotech is leading that surge.

The Silicon Valley industrial and warehouse markets remain very active. Locally, industrial and warehouse vacancy was 2.6% in June, below pre-COVID levels.

Who are some winners from the pandemic?

The healthcare industry of course – healthcare, clinics and labs, medical device manufacturers, entertainment (Netflix), tech companies like Facebook, Apple, Google, and Microsoft, teleconferencing like Zoom and webinars, and of course, Amazon.

On-line retailers are benefitting, accelerating the impact of e-commerce on brick-and-mortar retailers.

The increase in on-line shopping created a demand for more logistic facilities.

Logistics, data centers and the life sciences are on fire, and it's not a one-off, but a serious trend.

As consumers shift from in-store purchasing to online, and consumers demand faster shipment, even same-day delivery, e-commerce distribution centers must be located in city centers.

Then, there is “reverse logistics”, the need to facilitate the increase in the number of returns. This will continue to fuel demand in the logistics sector.

Industrial real estate, particularly warehouse, the last mile of distribution, will be the most desired asset class this year.

Single family is also expected to be strong, including the newest trend; single family detached homes for rent. Millennials are driving the demand for this type of product.

Hospitality and retail bring up the rear.

COVID also took its toll on tax revenues. Government spending is an important component to a healthy economy. There is a connection between economic growth and tax revenues.

When tax revenue declines, so does government spending.

McKinsey & Co. analyzed the impact of automation on job growth and concluded that 46% of jobs could be replaced by the current methods of automation by 2030.

A Stanford computer science professor said at the 2019 JVSV Conference, that 50% of all jobs could be automated by Artificial Intelligence.

For example, there are 3.5 million truck drivers and 700,000 bus drivers in the U.S. who will be displaced by autonomous trucks and buses.

Cruise, a subsidiary of General Motors, and Waymo are operating robot cars without back-up drivers on the streets of San Francisco today.

Driverless technology has moved out of the R&D phase. By 2023, you will be able to “text-up” an autonomous taxicab. You can do that today in Chandler, Arizona.

Finally, I would like to comment on the concern over the “Great California Exodus”. While it is a concerning trend, it is not a crisis.

In 2021, more than 280,000 people left California for other states, than people who moved to California from other states. That’s a net loss of 7/10 of 1%, in a state with 40 million people.

Where did these Californians go? Texas, Arizona, Nevada, Washington, and Oregon. Where did the new Californians come from? Texas, Arizona, Nevada, Washington, and New York.

Most workers who left the Bay Area stayed in California for cheaper housing.

Most Silicon Valley companies are adjusting the compensation to reflect the lower cost of living for employees working remotely from another state, or a less expensive area of California.

The population slowdown is triggered by a slump in births, reduced immigration, a rise in deaths, many COVID related, and a steady stream of people leaving California.

In Silicon Valley, only four major companies have left California. By and large, their workforce didn’t follow. Tesla is still manufacturing automobiles in Fremont. Tesla also recently leased a 325,000 square foot office building in north San Jose.

Apple purchased five office buildings in Cupertino last year.

We never want to lose population, particularly because recently California lost a congressional seat. But crisis? ... No. A concerning trend? Probably.

Apple is worth nearly \$3 trillion; Google \$2 trillion; Facebook \$1 trillion. 80% of all tech R&D occurs right here in Silicon Valley. That's not going to change anytime soon.

I think the demise of Silicon Valley is grossly exaggerated.

These are my observations today. But in this economy, tomorrow could be completely different. Stay tuned!