Regional Commentary — February 12, 2021

San Francisco Welcomes the Year of the Ox

The Lunar New Year Again Comes at a Critical Juncture for the Bay Area

Economist(s)

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Summary

Welcome to the Year of the Ox

The Lunar New Year arrives amid hopes COVID infections and hospitalizations will continue to decline, and vaccinations will continue to increase. Progress at slowing the spread of the virus and re-establishing a safe environment for workers, students and consumers is essential in order for a sustainable recovery to take hold. The Bay Area was an early Ground Zero for the pandemic and the region has been hit unusually hard as lockdowns have been more severe and lingered longer than in many other parts of the country. The growing acceptance of working remotely has provided some resilience to the region, but also presents some long-term challenges. The coming year should see considerable improvement, but risks remain elevated.

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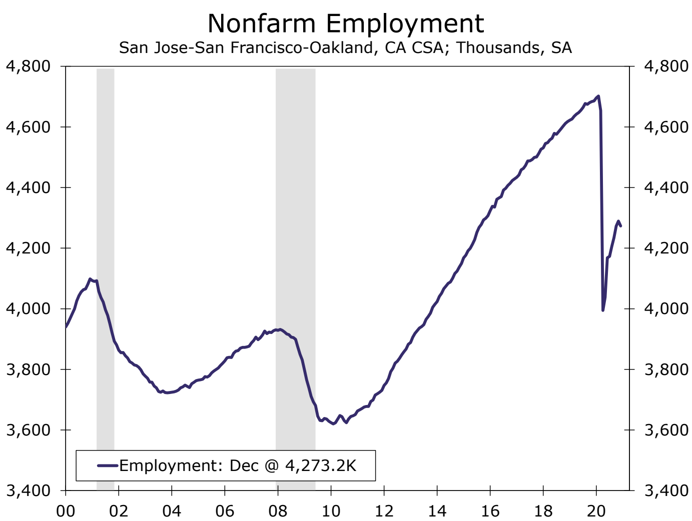
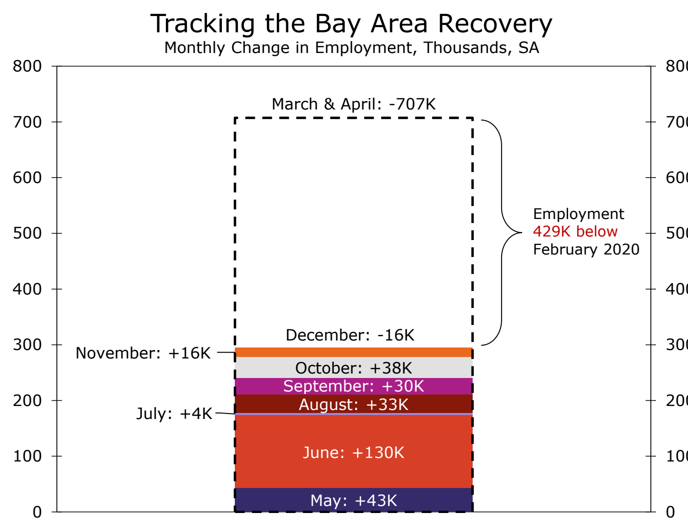
The Bay Area has seen an outflow of residents this past year, and several businesses, including Oracle, McKesson, Charles Schwab, Palantir and Hewlett Packard Enterprise, have either relocated their corporate headquarters or major operations to other parts of the country. The greater San Francisco Bay Area remains the global epicenter of most aspects of the technology sector and still accounts for the lion's share of venture capital deployed each year. While no other metro areas have yet to duplicate the Bay Area's ecosystem, several competitors are nibbling away at the region's core competitive advantages and rivals to the region can no longer be shrugged off.

While there have been a flurry of reports highlighting the challenges facing the Bay Area, we continue to believe the region will see a return of economic growth this year focused on its inherit strengths in technology and strong trade ties with Asia. Traits of the Year of the Ox include diligence, dependability and determination—all of which will be needed in abundance to get the Bay Area's economy back on track in 2021. Those born this year are Metal Ox's, a distinction that last occurred in 1961. Metal Ox's tend to thrive in organizations where hierarchies are not well established or strong, a trait well suited for the Bay Area's large technology and innovation sectors.

We continue to believe the Bay Area will see a return of economic growth this year.



Source: U.S. Department of Labor and Wells Fargo Securities



Source: U.S. Department of Labor and Wells Fargo Securities

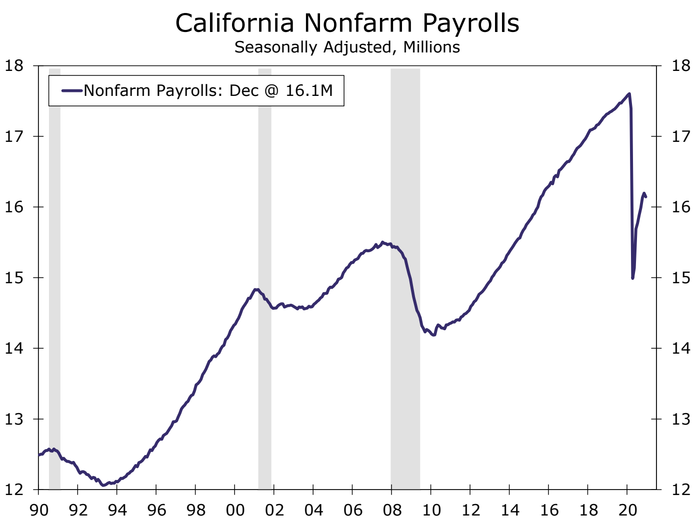
In with the Ox, Out with the Rat

Just as there was a great deal of anticipation for the arrival of 2021, the arrival of the new Lunar Year is being looked to for a restart to the good economic times that were prevalent before the pandemic. The Year of the Rat was certainly a challenging period for the Bay Area, the nation and much of the world. Last year, the Lunar New Year fell on January 25, when COVID was still thought to be more of a threat to global supply chains than to global health or the U.S. economy. By most measures, the U.S. economy and the Bay Area were booming during the year prior to that, with the nation's unemployment rate at a 50-year low of 3.5% and California's unemployment rate at a modern era low of 3.9%. Gains from the record-long economic expansion were extending more broadly throughout the economy, with real median household income rising by a record 7.3% and the poverty rate falling by 1.3 percentage points to a record low of 10.5%.

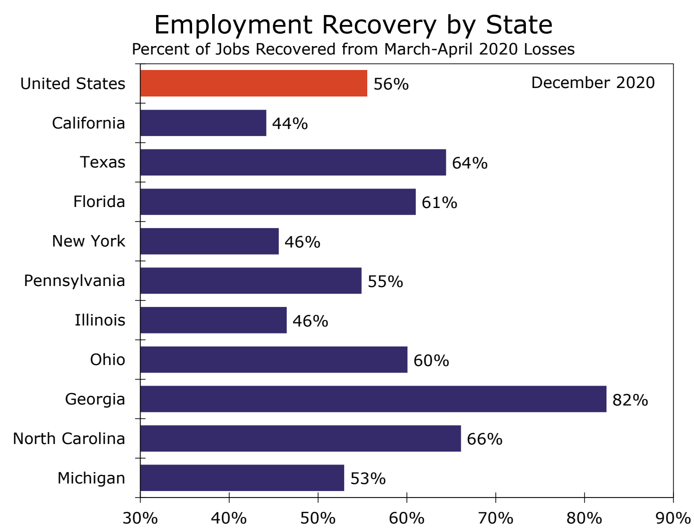
Less than a week after the 2020 Lunar New Year, the U.S. Department of Health and Human Services officially declared COVID a public health emergency. At that time, there was only one confirmed case of COVID in the United States and that was from someone who recently returned from travel in China. By the end of February, COVID outbreaks were confirmed in the San Francisco Bay Area, Seattle and New York—prompting some local lockdowns. The first confirmed death occurred on February 29, and within two weeks, the nation had embarked on a national lockdown to slow the spread of the virus, sending the economy into a tailspin of previously unimaginable proportions. More than 22 million jobs were lost across the United States in March and April and the unemployment rate spiked to a post-World War II high of 14.8%. California lost 2.6 million jobs and saw its unemployment rate spike to a modern-era high 16.4%.

The Year of the Rat proved to be the most challenging year for the U.S. economy in modern memory.

While economic activity improved once the national lockdown ended, the Year of the Rat proved to be the most challenging year for the U.S. economy in modern memory. Real GDP ended the year with a decline of 3.5%, which was the largest annual decline since 1946. While economic growth bounced back in the second half of 2020 and the unemployment rate declined, gains were exceptionally uneven. Workers in many high-contact occupations, such as restaurants, bars, hotels, entertainment venues and personal services, such as saloons and fitness centers, were particularly hit hard, with employment falling more sharply and recovering much more slowly. Economic mobility was stymied and income and wealth inequality worsened. The recovery also varied by state, with states that maintained stringent lockdowns and those more dependent on travel and tourism recovering much more slowly than states choosing to allow businesses to re-open when they could safely do so. The latest data show California adding back just 44% of the 2.6 million jobs it lost in March and April, compared to a recovery of 56% for the nation as a whole. By contrast, Georgia has added back 82% of the jobs it lost over the same period, which is the highest percentage of the nation's 10 largest states.



Source: U.S. Department of Labor and Wells Fargo Securities



Source: U.S. Department of Labor and Wells Fargo Securities

San Francisco's Boom Quickly Turns to Bust

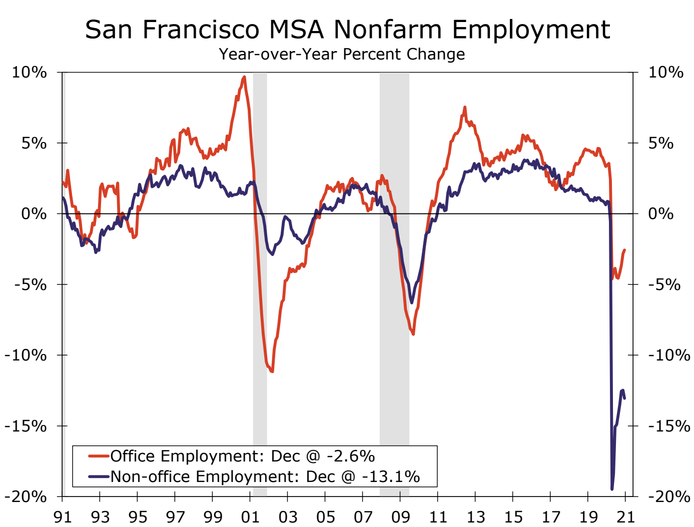
San Francisco's economy was at the forefront of the nation's more than decade-long economic boom. Nonfarm employment rose 2.4% per year during the five years preceding the pandemic, a pace one and half times faster than the nation as a whole. During this period, the Bay Area added about 527,000 jobs, just over one-third of which were added in the San Francisco-Redwood City-South San Francisco and Marin County metro divisions. The San Jose-Sunnyvale-Santa Clara metropolitan area accounted for another 25% of that growth and Oakland and East Bay accounted for 20%. The remaining 20% was scattered throughout the outlying areas of the Bay Area—Napa, Sonoma, Stockton and Modesto. The surge in job creation led to a development boom in downtown San Francisco, the San Francisco Peninsula, Silicon Valley and more recently in Oakland and East Bay.

Efforts to contain COVID hit the San Francisco Bay Area's economy exceptionally hard and the impact was felt almost immediately. Employers eliminated 707,000 jobs in the Bay Area in March and April of last year, with the bulk of job losses coming in high-contact industries, such as restaurants, bars, hotels, entertainment venues, retail stores and personal services, such as hair salons and fitness studios. Health and education were also hit hard, as doctor visits, therapy sessions and elective surgeries were all put on hold. While the largest job losses were in San Francisco, Oakland and San Jose, the outlying areas of the Bay Area actually accounted for a larger proportion of the region's job losses relative to their share of employment growth during the five years preceding the pandemic. One reason outlying areas were hit harder is that fewer workers in those areas can easily work remotely.

The greater ability to work remotely is evident in the split between office employment and non-office jobs. Office employment is essentially the sum of jobs in business and professional services, financial services and information services. This category captures the bulk of the region's tech workforce and saw employment fall much far less at the onset of the pandemic and recover much faster than non-office employment. San Francisco, Oakland and San Jose lost 86,100 office jobs from February to April, a 5.9% drop. Employment has since rebounded 2.8%, replacing roughly 45% of those earlier job losses. By contrast, non-office jobs, which accounted for 70% of Bay Area's employment prior to the pandemic, tumbled 18.5% from February to April and have since rebounded 8.7%, replacing just 38% of their losses at the onset of the pandemic.

The Bay Area has a greater proportion of office workers working remotely than just about any other part of the country.

While office jobs held up better than employment elsewhere and recovered more rapidly, the bulk of those office workers have shifted to working remotely. The Bay Area has a greater proportion of remote workers than just about any other part of the country. Data from Kastle Systems showed few office workers have returned to their offices. San Francisco, home to more than half the Bay Area's office workers, has seen just 12.4% of its pre-pandemic office workforce working back in the office. San Jose (15.5%) has the third fewest proportion of workers returning to the office, behind New York (10.1%) and San Francisco.



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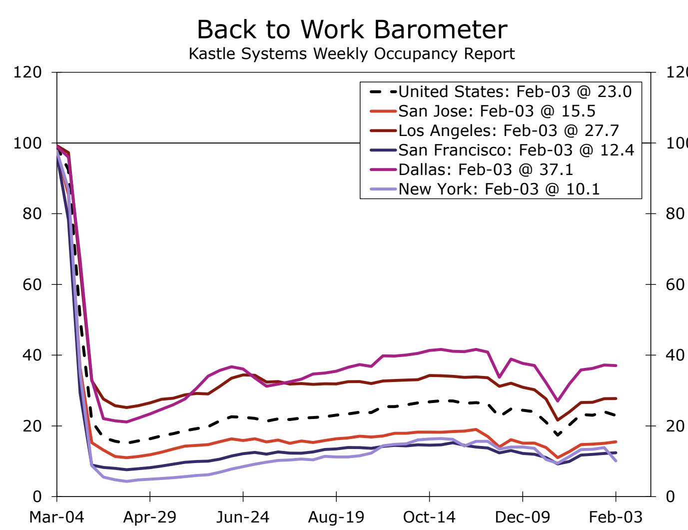


Source: Bloomberg LP and Wells Fargo Securities

Remote Work Is a Disruptive Force for the Bay Area

While the ability to work remotely has provided a degree of resilience to the Bay Area, that resilience has come at a price. The University of California, Berkeley economist, Enrico Moretti, found that each job in the Bay Area's creative/innovation economy supports five jobs in the service sector. With so many Bay Area creative/innovation workers now working remotely, this multiplier has undoubtedly diminished, which has contributed to greater job losses in non-office employment. The impact is easy to see from street level. Fewer workers returning to the office means fewer workers commuting to work, going out to lunch, meeting colleagues after work, buying clothes, getting their clothes dry-cleaned and having their shoes shined or repaired. The impact on small businesses has been palpable, and the recovery of that critical part of San Francisco's economy has been agonizingly slow.

With more people working remotely, more residents are moving away from the Bay Area's city center. Many are moving to outlying areas of the Bay Area or to Sacramento, while others are leaving the state and working remotely from their new homes. The Bay Area's service sector has also been negatively affected by a drop in business and leisure travel to the region and less immigration from overseas, which has been the source of much of the region's population growth in recent years.

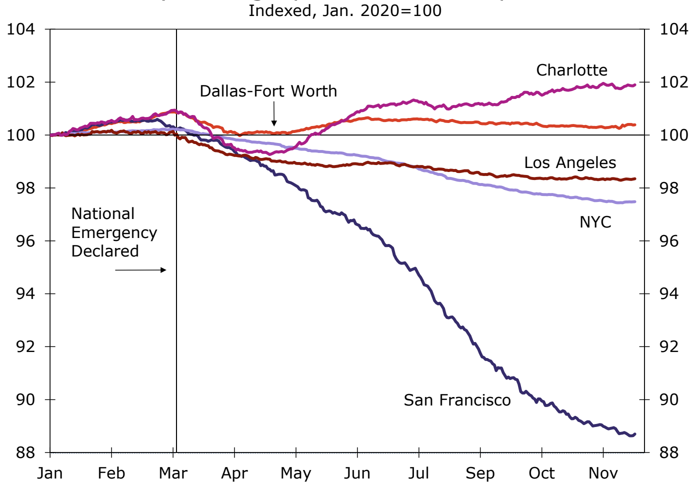
The exodus from the Bay Area is thought to be the second-largest current out-migration behind New York City.

The outflow from the Bay Area has garnered considerable attention, including a January 14 *New York Times* article titled “They Can't Leave the Bay Area Fast Enough.” The article is filled with real life anecdotes that capture the sense of frustration many Bay Area residents are feeling. The exodus from the Bay Area is thought to be the second-largest current out-migration behind New York City. In both cases, most of the folks that are “leaving” are moving to the suburbs, exurbs or less congested neighboring metropolitan areas where housing is more affordable and there is more open space. Sacramento is one of the key destinations for folks leaving the Bay Area. Others are following the NFL's Raiders to Las Vegas or moving to other western metro areas. There has also been a huge move to Texas, where many large Bay Area companies have relocated, as well as parts of the Southeast.

The outflow from the Bay Area is not a new development. The region has been experiencing an accelerating net domestic out-migration for the past five years, meaning more people moved from the Bay Area to other parts of the country than moved from other parts of the country to the Bay Area. The region's population continued to grow, however, due to the continued inflow of residents from overseas. COVID put the breaks on immigration and also prompted even more people to flee the high-cost regions of the Bay Area, including some of those shiny new apartments in downtown San Francisco. The shift to remote work and restrictions on bars and restaurants has made paying some of the nation's highest rents far less appealing. Particularly when those higher rents only secure a small apartment that now has to also serve as your office, favorite restaurant, coffee shop and primary area of entertainment. Moreover, the lack of street traffic has made the region's chronic homeless problem much more obvious, while fears of crime have also increased.

Daily Asking Apartment Rents per SF

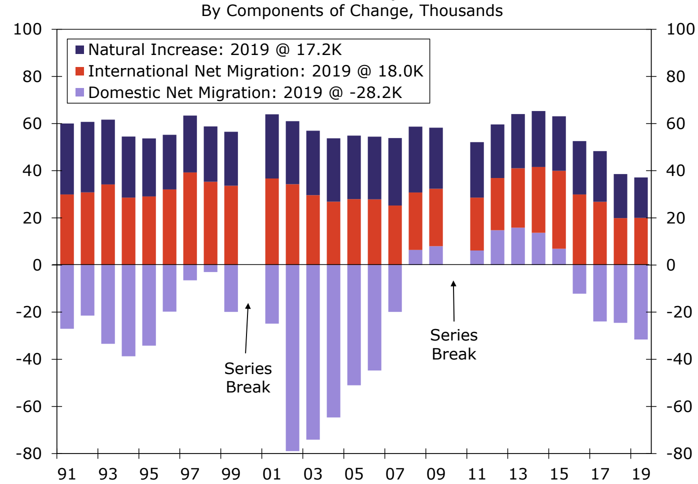
Indexed, Jan. 2020=100



Source: CoStar Inc. and Wells Fargo Securities

San Francisco MSA Population Growth

By Components of Change, Thousands



Source: U.S. Census Bureau and Wells Fargo Securities

We do not mean to downplay the magnitude of the out-migration from the Bay Area. We believe this is the largest sustained outflow from the Bay Area since the Tech Bubble burst around the turn of the century. The comparisons end there, however, because the tech boom is still in full swing. This past year saw a string of successful large initial public stock offerings (Airbnb, Doordash, Snowflake, Unity Software, C3.ai) that has carried over into 2021. Bay Area startups also accounted for the bulk of venture capital deployed in 2020 and there are a number of highly-valued tech firms poised to go public this year. Moreover, the tidal wave of special-purpose acquisition companies (SPACs), is unlocking wealth tied up in many privately held companies, effectively accelerating their way to the public market. The SPAC boom admittedly gives off a certain aura of the waning days of the tech bubble. Most of the companies SPACs are acquiring, however, at least so far, have established operating histories and promising prospects.

While the Bay Area's status as the global hub of the tech sector remains secure, the region's dominance has diminished. New areas of innovation have gained significant traction in recent years, most notably Austin and Denver, and others, such as Raleigh-Durham, Northern Virginia, Miami, Nashville and Tampa are gaining momentum. The emergence of new tech ecosystems outside Silicon Valley predates the pandemic. Many Bay Area firms have been shifting operations to lower cost parts of the country where they could find the skilled workers that they need, and the COVID-induced recession accelerated this shift. Austin has clearly come the closest to replicating the Bay Areas tech ecosystem. The region increasingly looks and feels like a part of the Bay Area and is home to one of this year's largest IPOs, Bumble. The shift to remote work should help accelerate growth in many of these emerging innovative economies, as the widespread acceptance and adoption of web conferences makes it easier for startups in other parts of the country to meet with venture capital firms and other parts of the Bay Area's tech ecosystem.

The Bay Area has also seen an accelerated exodus of corporate headquarters of established firms and a handful of startups. The more notable moves include Oracle, relocating its headquarters from Redwood City to Austin, HP Enterprises, relocating its headquarters to Houston, and Charles Schwab, which announced it was moving to the Dallas area. Palantir also moved its corporate headquarters to Denver. The movement of corporate headquarters also predates the pandemic, but appears to have accelerated amid the shift to remote work and development of credible talent pipelines in many other parts of the country. The outflow will hurt more than the region's pride, as office space and apartments are put back on the market and rents decrease. Ultimately, however, it will also help bring the Bay Area economy, which was clearly overheating, back into balance.

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Some of the shine has clearly come off the Bay Area's latest gold rush. Workers from around the country are no longer making a beeline for the Bay Area to strike it rich at the next tech sector startup and long established companies, and even a few startups, are leaving the Bay Area for emerging tech markets elsewhere. While the exodus of the residents and businesses is notable and concerning, the Bay Area economic prospects are anything but gloomy. Employment has been recovering since bottoming out in April. After losing 707,000 jobs in March and April, Bay Area employers have added back 279,000 jobs through December. And while December marked a bit of a setback, with the region losing 16,000 jobs that month, most of those layoffs were in the hard-hit hospitality sector, which saw business suffer and employment falter as COVID infections surged again. More recently, the pace of new infections has decelerated and plans to re-open the economy are moving forward again. Moreover, while overall employment declined in December, tech employment rose to a new high.

While 2021 will certainly bring new challenges, we doubt 2021 will be the year the Bay Area's Ox gets gored. We expect the San Francisco Bay Area's recovery to gain momentum over the coming year. Our latest forecast for calls for U.S. real GDP to rise 5.3% in 2021 and 5.1% in 2022. The Bay Area's rebound should easily top this pace, as more of the Bay Area's economy has been locked down more harshly than in the country as a whole. We expect real GDP to rise 6.5% in the Bay Area this year and look for another 145,000 jobs to be added back. Of course, much depends on what happens with COVID. We expect new infections to continue to fall off through the summer and look for vaccinations to continue to ramp up. We also expect more vaccines and treatments for COVID to be approved. Mutations to the virus remain a key risk. The return to the office is another big question mark, particularly given the greater ability for Bay Area residents to work remotely. We expect to see a soft re-opening of offices this summer and a more pronounced return to the office environment later this fall and in early 2022. Business travel and tourism will not pick up in a major way until 2022 an 2023.

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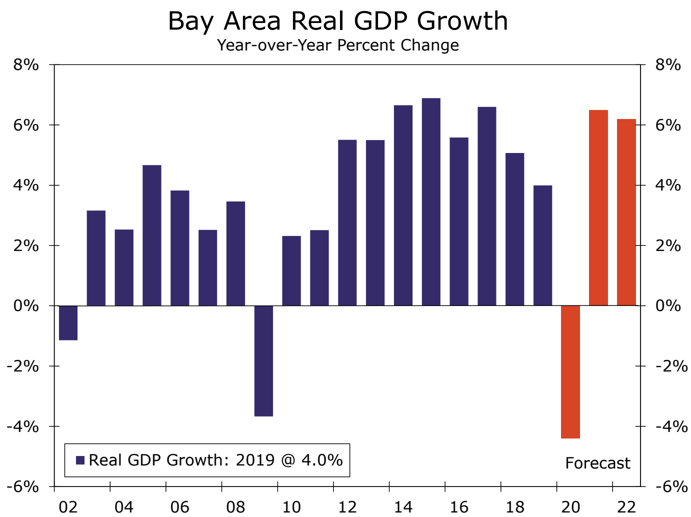

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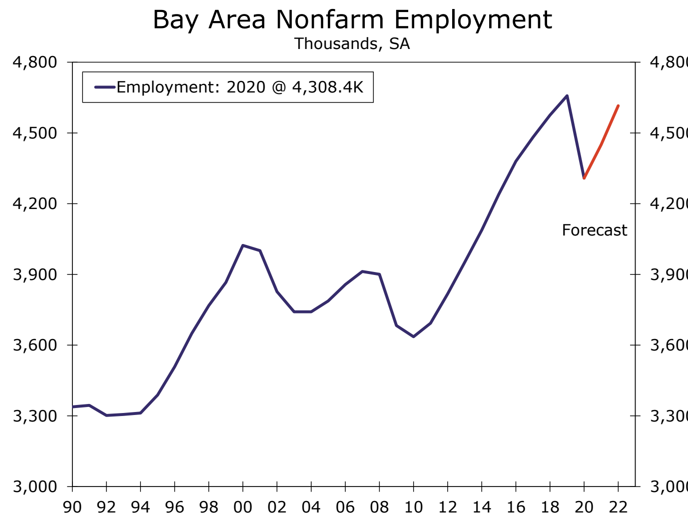

Source: U.S. Department of Labor and Wells Fargo Securities

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