Los Gatos Rotary Club

Los Gatos Lodge Dining Room
50 Los Gatos-Saratoga Road, Los Gatos, CA 95032

Tuesday, November 26, 2019
1:00 – 1:30 p.m.

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“Boom, Bubble or Bust – The Silicon Valley Real Estate Cycle”

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The Headline Reads: “*Leading Economic Indicators Defy Recession”*

What are those indicators?

*Consumer Confidence (which dropped to its lowest level since 2017)
*Housing Starts
*Workers Hours
*Interest Rate Spreads
*Unemployment
*Industrial Production
*And more …..

Well, forget the indicators. We will have a recession! I can’t say when for sure, but no later than the end of 2020. It’s not really when that is important. It’s why.

How can I make that prediction?

There are other, mostly political, factors that can override the “Leading Indicators” and trigger a recession. What are they?

* International Trade Tensions; Tariff Wars
* Political unrest and continued dysfunction and gridlock in Washington D.C.
* Divided government does impact real estate markets because it creates uncertainty

* Interest Rates determined by the Federal Reserve
* Exploding Budget Deficit hits $1 trillion
* Inflation
* Debt: Revolving consumer debt, student loan debt, national debt. Unfounded public pension liabilities ($300 trillion) U.S. overrun with debt
* In 1980's, debt was 150% GDP. Today it is 330% GDP

You noticed I didn't mention the stock market. A stock market decline generally follows a recession. It doesn't create or precede one.

Finally, we will have a recession, because we always do. We have cycles, and our cycles in Silicon Valley tend to be faster and steeper going up and coming down.

The recession may have already started as the U.S. economy slowed sharply by 30% in the second quarter of this year, to 1.9% in the third quarter. We have been enjoying nearly nine consecutive years of prosperity since the end of the Great Recession. So, we are due, really overdue for a recession.

Another projection. The next recession, correction, adjustment, whatever you choose to call it, will be a relatively "soft landing". I call it a "normal" recession.

No meltdown of real estate markets, like in 2008, is anticipated.

I'd like to give you a brief update of the Silicon Valley real estate market including the current status of each property type. When I'm finished, hopefully you will have a better idea of where we are in the real estate cycle. And a little on the most fascinating generation in a hundred years; the Millennials.

Our economy, in general, is on a very solid foundation. Job growth and household incomes remain significantly higher than the state or the nation.

In San Jose, the median household income increased 21.8% in the last 3 years to $110,000, the 10th highest in the U.S.

For the first time in history, the Bay Area has 4.1 million jobs, fed by the technology sector. We are adding jobs in spite of record home prices, traffic jams, and labor force constraints. The boom in the job market is so robust that over the first six month of 2019, the Bay Area produced 41% of all new jobs in California, led by Santa Clara County.

If California was a country, it would be the 5th largest economy in the world, passing the U.K., and the Bay Area GDP surge would make the Bay Area the 18th largest economy in the world.

The unemployment rate in Santa Clara County is 2.6%, lower than the state at 4.0% and the nation at 3.5%. That is equivalent for "full" employment which limits job growth.

Extremely low unemployment rates in Silicon Valley have driven the cost of tech talent to an all-time high, creating a serious high-tech labor shortage.

Employers, particularly technology companies, are having problems hiring skilled employees due to sky-rocketing housing costs. The lack of affordable worker housing is making it impossible for employers to fill existing jobs.

There are, however, some clouds in the horizon, some self-inflicted.

U.S. factory activity hit a decade low last quarter, dropping the manufacturing index to the lowest level since 2009.

People often ask me is there a difference between the current boom and the "Dot-Com Boom" in the 90's. My answer: A very big difference.

During the Dot-Com Boom 19 years ago, commercial real estate development was largely speculative, often leasing to high tech startups with little or no earnings.

Tenants leased more space than they needed, expecting growth that never occurred, when the market went from Dot-Com Boom to Dot-Com Bust.

Today, major well-established companies like Google, Apple, Samsung, LinkedIn, and Nvidia with real earnings and profits, are acquiring land and buildings, favoring ownership over traditional long-term leases.

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) are entering the labor force.

An Oxford University study projected that 40% of all jobs will be displaced by digital technology (Artificial Intelligence) in the next 40 years. Think about that.

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

Waymo, the self-driving unit of Google, expects to deploy robot cars <u>outside</u> of the testing environment next year.

Many of our younger generations, e.g., Gen. X, Gen. Y, Millennials and now Gen. Z, no longer believe that homeownership is an essential component of the American dream.

Individuals under 30 are projected to form 20 million new households over the next 10 years, a majority of which will be rented. Lifestyle preferences of Millennials have shifted toward renting.

Home ownership fell for the twelfth straight year in 2018, to the lowest rate since 1967. More U.S. households are renting than at any point in 50 years. Home ownership rates for young adults under 25 are just 22% nationally, and less than 5% locally.

Many young folks have resigned themselves to a life of non-ownership, abandoning the dreams of their parents and grandparents.

First, young folks saw trillions of dollars of homeowner equity evaporate with the collapse of the housing market, during the “Great Recession”. So many don’t consider homeownership an investment that automatically appreciates in value.

Millennials are the most educated generation on record. But, college graduation often comes with as much as six-figure student debt, which makes qualifying for a home loan more problematic for first-time home buyers.

Between 2004 and 2018, student debt increased by a factor of six from $260 billion to $1.46 trillion! Student loan debt is greater than the federal budget deficit.

In a recent survey, 22% of Millennials responded they do not want to purchase a home ever!

In Silicon Valley, Millennials comprise 29% of our population. They are changing the marketplace for housing, embracing the urban culture. More and more, they prefer urban city living and compact development, in sharp contrast with the historical pattern in America since World War II.

Sixty-six percent of Millennials chose place over job. Where they want to live is more important than the job they select. Millennials rank work/life balance as the No. 1 most important factor in their job satisfaction. Having a private office is No. 9 on the list.

It’s called the 18-hour city, a work-live-play lifestyle, including a desire to live in an area in close proximity to where one works, dines, shops and entertains.

A flexible work schedule is essential for Millennials. Short commutes – preferably walking or cycling to work. It’s called a “work/walk” environment – a vibrant location close to shopping and entertainment, urban amenities like fitness facilities, access to rail transportation are high on the preference list of younger folks.

Millennials are driving less, evidenced by a sharp decline in the number of driver license applications submitted by younger people.

Only 44% of Millennials obtained a driver license within 12 months of the minimum age, and 28% hadn’t received a driver’s license by age 20.

Millennials have embraced the sharing economy. Ride sharing, Lyft and Uber, bike sharing, and now scooters are exploding.

Finally, Gen X, Gen Y, and Millennials are much more mobile. They can do the same work in New York, London, San Francisco, or Singapore, and maybe all four. So why get tied down with a mortgage?

Older people believe that renting is throwing your money away. An increasing number of young people believe that owning is throwing your freedom away.

Millennials are now the largest generation in the workforce, and they are driving the agendas of how companies operate, what workplaces look like, and what technology in the workplace is expected.

Millennials are delaying marriage to their mid-30's, or even their early 40's. Marriage is clearly associated with home buying. Consequently, Millennials will probably own one less home during their lifetime. Older to marry, longer to rent. Later marriages are contributing to a higher demand for multi-family housing.

Now, to real estate market trends.

MULTI-FAMILY/APARTMENTS

The Silicon Valley multi-family housing market has been remarkably consistent, leading all property sectors in 2018 and recording eight years of strong performance.

The apartment occupancy during this period has hovered from 95% to 99%. In the metropolitan San Jose area, apartment rents have increased a whopping 52% since 2010, with vacancy below 5%.

Today, apartments near public transit command a 15% rent premium. The median rent for a one-bedroom apartment in San Jose is $2,500/month. Apartment demand depends on a host of demographic and lifestyle trends.

Significant job growth has provided a healthy foundation for apartment demand. Multi-family turnover rates fell to the lowest level in two decades.

We are seeing a marked increase in "for rent/lease" signs outside of major apartment complexes in addition to concessions such as free rent and reduced deposits to attract tenants, a clear signal that the peak of the apartment market has passed.

SINGLE-FAMILY

The median price of single-family homes in Santa Clara County have more than doubled from January 2013.

As 2019 comes to a close, median home prices in Santa Clara County have declined by 15% to $1.1 million. South Bay home sales plummeted 26% from the previous year to the lowest level in two decades, and residential building permits dropped 11% year over year, driven by high land and construction costs.

Homes are staying on the market longer, sellers are receiving fewer offers, and even fewer above the asking price, and sellers are making more concessions. Bidding wars in the San Jose Metro area have dropped from 80% to just 13% year over year, a clear indication that the market has cooled.

For years, for-sale inventory has been at historic lows, resulting in too much money chasing too few homes, causing home prices to skyrocket.

Affordability is particularly critical for first time home buyers. 35% of Millennials in the Bay Area live at home with their parents, and 60% live in multi-family apartments.

Homes purchased by absentee buyers (investors) dropped 50% since 2013. Foreign buyers, the Chinese in particular, have reduced their investment in U.S. residential real estate by 56% in the past year, much of it in California.

Trade wars, a strong dollar, and Chinese restrictions on moving currency out of China, is believed to be the cause.

This will have a positive impact on the stability of the housing market. There is a latent risk when investors, rather than individual home buyers, purchase residential property.

Investors need an exit strategy, and they tend to move out of an investment about the same time. That can have an unsettling effect on the residential marketplace in the future.

All cash transactions, a staple in wealthy Silicon Valley, have also dropped significantly.

The one predictable indicator for single-family residential property in Silicon Valley is schools. Neighborhoods with excellent schools experienced fewer declines in market value during the recession, and these same neighborhoods experienced greater increases in value during the recovery.

OFFICE/R&D

The Silicon Valley office market closed on another record year. That is 8 years of positive office leasing, a much longer period of expansion than the “dot-com boom”, 19 years ago.

Office vacancy in Silicon Valley has declined from 25% in 2009, to 5.4% at the end of the third quarter.

The frenzied leasing activity of 2015 and 2016 has slowed due in part to the significant increase in the supply of new office space.

In Silicon Valley, 10.5 million square feet of office space was under construction in the third quarter of this year, the most since 2000. 60% of new office space is pre-leased before completion of construction.

Google has 20 million square feet of office space under lease in Silicon Valley, most of it in Santa Clara County.

The fundamental question is: Is the technology sector becoming overvalued, evidenced by an office market that has outpriced itself? Will the “tech bubble” burst? I don’t think so. But quite a bit of air is set to come out of that bubble.

Office obsolescence is impacting the market as single-story concrete tilt-ups constructed in the 1960’s and 70’s, are being demolished in favor of larger, more modern, denser buildings.

Employee densification, designed to improve efficiency and lower the cost per employee, is having an impact on office leasing. Putting more employees in less space has become a trend.

The average space a company needed for each employee declined sharply, from approximately 225 square feet in 2012 to just 120 square feet today.

Office tenants are downsizing their space requirements at the same time they are increasing their employee head count. Think of the impact this has on parking and traffic planning.

High tech companies want open floor plans with fewer cubicles and offices. This is called a “collision environment,” promoting direct collaboration between employees.

Tech managers believe productivity increases when people interact directly more often. The rule of thumb is 50% workspace (“me space”) and 50% collaboration space or (“we space”).

WAREHOUSE AND INDUSTRIAL

I remain bullish on the industrial and warehouse markets. Vacancy countywide was 1.5% for warehouse and was 4.6% for industrial at the end of the third quarter.

Occupancy of warehouse property recorded the largest gain since 1994, the fourth straight year of positive net absorption. However, ongoing concern over trade wars and tariffs, and a slowing economy, could negatively impact industrial property.

Online commerce is one of the strongest drivers of industrial demand. As retailers continue to offer fast shipment, often next-day delivery, strategically located distribution centers, called fulfillment centers, are essential.

The e-commerce impact on both the retail and warehouse sectors is enormous.

The “on demand” economy is dramatically changing our priorities. Blockchain and Artificial Intelligence are changing the future of commercial real estate.

Disruptive companies like Amazon and Airbnb are changing the way we value real estate.

Amazon is developing smaller warehouse facilities closer to where people live, in pursuit of faster, cheaper delivery. Amazon recently announced one-day shipping for Prime members, and Amazon believes same day delivery in every major U.S. market is inevitable!

Last year, Amazon was awarded a patent for “Airborne Fulfillment Centers” or AFCs that would float at an altitude of 45,000 feet, stocked with products waiting to be delivered. Within moments after an order is placed, drones housed in these AFCs would deliver the goods, requiring little power as they glide down to reach their destinations.

Amazon has not stopped there. They filed a patent application for an underwater storage facility. Aquatic product-filled warehouses would contain watertight containers outfitted with cartridges that mimic the swim bladders of fish to control depth.

To retrieve a container, acoustic waves would be sent to activate the cartridge necessary to send a particular package to the surface.

According to Amazon, “these underwater warehouses could stack products in endless piles of boxes with no need for humans or robots to move them around, thus eliminating the inherent inefficiencies of the pathways and shelving needed in traditional land-based warehouses”.

You can’t make this stuff up!

Amazon has implemented new technology installed in several cashier-free convenience stores, including 3 in San Francisco, in which a customer can pick up a product and walk out of the store. No checkout.

A combination of sensors, cameras, and computer vision, detect your credit card and the value of products purchased, charge your credit card upon exit, and electronically send you a bill.

RETAIL SECTOR

The one sector that was slow to recover is retail. The retail sector was terribly overbuilt. During the “dot-com boom,” there was a glut of strip, power centers, and malls, built on the framework of the old model, that people would walk in the door of a storefront and shop.

The increasing prevalence of online shopping vs. traditional brick-and-mortar stores, all point in the same direction: Online sales are growing at three times the rate of in-store sales, and that trend is accelerating.

In September, U.S. retail sales experienced the biggest drop in nearly a year.

Today, the brick-and-mortar retail industry is in turmoil. The retail bubble has burst, and the problem is not cyclical. I believe it's a "forever" trend. Traditional retailers were very late to e-commerce.

Retail malls are leading the retail mess. Mall traffic is way down, and mall vacancy hit a six-year high last year. Nearly every major retailer is looking at their store footprint, and are closing stores, as landlords brace for another round of store closures.

Gone are the "bookend" department store anchors in shopping malls.

One major retail researcher projects that 30% of the nation's 1,100 malls will close in the next 4 years.

Between 2007 and 2017, the number of micro-businesses (fewer than 10 employees) declined 8.1 percent in metro San Jose.

The U.S. is simply "overstored"! In the first quarter of last year, retailers closed a staggering 77 million square feet of space.

Many small tenants have co-tenancy clauses in their lease, allowing them to exit before the lease expires, if major tenants close.

Vacant malls and retail chain stores are being repurposed and converted to things like offices, affordable housing, distribution centers for e-commerce, classrooms, churches, and even transitional space for the homeless.

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

Only high-end malls are prospering. (Valley Fair, Stanford and Santana Row)

The retail shopping centers would be even worse, if it wasn't for solid growth in food, fitness and entertainment space. Restaurant sales exceeded grocery sales for the first time last year.

Investment in retail properties plunged 19% year over year. A leading retail economist said, "droves of traditional properties are being repurposed or simply demolished."

Millennials are a driving force behind e-commerce. Millennials grew up in a "one click" world where speed and convenience is expected. Millennial consumers spend more on travel, leisure, entertainment, and "the experience", over possessions. The 3 "F's" – Food, Fitness and Phone.

Millennials favor swapping, sharing, and renting vs. owning.

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

High-end retailers are also doing well. Mid-level retailers, however, are struggling, consistent with the decline in America's middle class.

The barrage of retailer bankruptcies, store closures, and diminishing revenues, it truly has become survival of the fittest as the name-brand retailers like Circuit City, Mervyns, Blockbuster, Borders Books, Loehmann's, Sports Authority, Linens 'N Things, Toys R Us, Payless Shoes, Forever 21, Orchard Supply, and Sears continue to disappear.

What's this world coming to … even Hooters and Frederick's of Hollywood have closed some restaurants and stores.

One retail leader described it as the "three C's": closures, consolidations, and contractions.

Nevertheless, e-commerce sales still represent only 10.7 percent of total sales, while 60 percent of U.S. consumers shopped online at least once last year.

Seattle-based Amazon accounted for 53% of e-commerce growth last year. The entire retail industry shared the remaining 47%.

Amazon's market cap reached $1 trillion last year ($879 billion yesterday), 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."

Recently, Amazon announced the company will open a new supermarket chain with dozens of grocery stores under the Amazon brand name. It's a flat out "food fight."

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

Google has 92% market share. Facebook owns 4 of the 5 biggest apps and 79% of smart phone profits. Facebook has 2 billion subscribers, more than 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, are opening brick and mortar retail locations, benefiting from their e-commerce brand and success, building a retail presence and improving their distribution footprint.

CONCLUSION
Over the course of my lifetime, we have seen enormous progress worldwide: Polio is nearly cured; hunger has dropped nearly in half; life expectancy has increased from age 46 to 71. We have survived the Great Depression and the Great Recession.

We have done it through collective action to meet emerging challenges. The top of the list today for me is climate change/global warming. If we do not get this under control, there will be no place for any of us to hide.

If we want a strong and free economy that does not stallout over multiple years, we must reassert trust in our institutions, be they locally or globally.