



Economy White Paper Series

Housing in the Inland Empire: Where it's Been and Where it's Going

May 2018

Robert Kleinhenz, Executive Director of Research with Executive Summary by Christopher Thornberg



Executive Summary

This is a significant year for the Inland Empire. It's been a decade since the Great Recession hit the United States, the nation's worst downturn since the Great Depression, and it's the year that home prices in many communities across the region will regain the peak levels they reached in 2007 before the collapse in the market and the terrible spike in foreclosures that followed. Given this relatively recent history, residents of the Inland Empire are likely wondering whether the region is lining up for another crash. As the following report shows, the answer is assuredly 'no'. With the exception of nominal housing prices, the housing market and the structure of the economy and economic growth in the Inland Empire is nothing like it was a decade ago. Given the fundamental differences between now and then, expect the region's real estate market to continue to progress at a solid pace for the foreseeable future.

The Great Recession was a terrible shock to the United States. Nationally, the unemployment rate spiked to 10% as economic output declined by 5%. Moreover, the downturn had an outsized impact on California and, in particular, the Inland Empire. This is because the underlying root of the downturn—a housing market fueled to unsustainable levels of building, buying, and pricing by an enormous expansion of subprime

mortgage debt—was more prevalent in the state and Inland Empire economy than in the United States overall. By our reckoning, nearly half of the half a trillion dollars in bad credit during this period ended up in California. This inflow of cash did more than overheat the Inland Empire's housing market, it also fueled excessive spending by local residents, which drove overall spending in the region to unsustainable levels.

When the credit pump finally ground to a halt in 2007, it was clear that the landing was going to be a rough one. But, in many ways, the results were not as bad as many had feared. It was a sickening market drop, to be sure, but one that eventually turned into a strong rebound—unlike the aftermath of the comparatively mild recession of the 1990s, which saw almost no recovery in the region for the better part of

a decade. This is because the Inland Empire's economic fundamentals were much stronger in 2008 than they were in 1991. During the Great Recession, it was only the cycle that had to be worked through—without the structural changes that were a critical feature of the 1990's (the vast and permanent decline of much of the industrial base in the area along with an overbuilding of housing in the state).



Today, the national economy continues to move forward steadily despite being in the midst of the second longest expansion in U.S. history. And California, overall, is a driver of national growth, with one out of six jobs created in the Golden State. Currently, the biggest threat facing the state's future success – and the success of its regional economies – is housing, but not in the form of a bubble. Instead, this time, we are facing a true lack of supply.

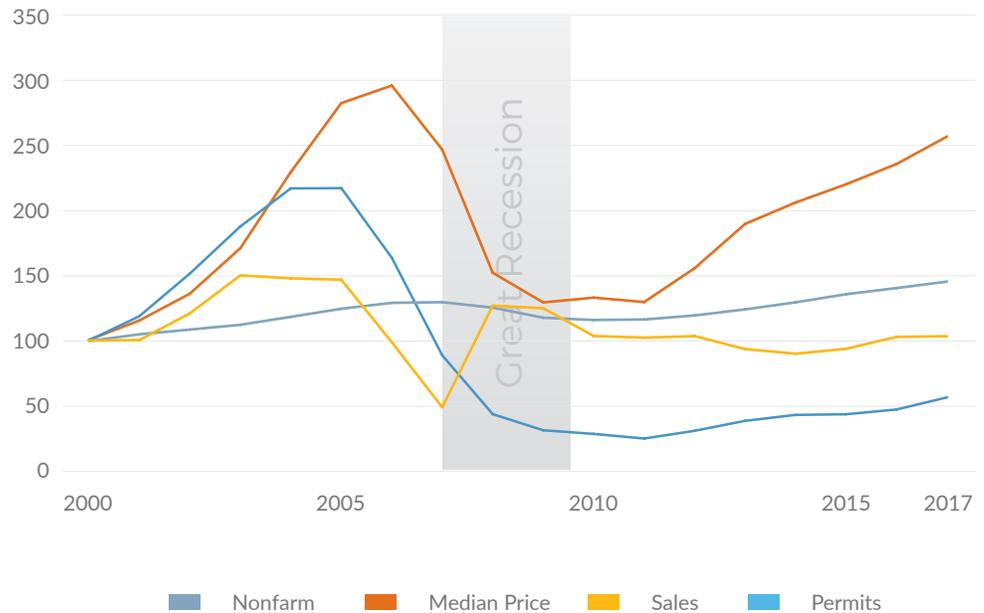
California's housing supply issue was evident even in the midst of the massive implosion that occurred in 2008 and 2009: When the pace of home foreclosures was at its peak, the state still had the second lowest housing vacancy rate in the nation. Today, the state's lack of housing supply has made the Inland Empire the fastest growing major economy in California. And the local housing market is showing all the usual signs of growth—from rising building permits to accelerating price appreciation.

The following report takes a look back and forward, illustrating just how different the Inland Empire's housing market is today as compared to 10 years ago. Prices are rising because of incomes and a lack of supply rather than bloated credit. The pace of building is not only slower than it was a decade ago, it is also slower than what is critically needed to maintain job growth rates in the region. Moreover, the local economy itself is being fueled by many sectors other than housing, including logistics, wholesale trade, administrative support, and healthcare. Together, the economic structure and trends that exist today suggest a solid outlook for those invested in the Inland Empire.

Introduction and Key Findings

Ten years ago, the U.S. economy was in the early stages of the Great Recession, caused in part by a global financial crisis that had its roots in the subprime mortgage meltdown. While much of the country was just beginning to experience the contractionary effects of the economic downturn, the Inland Empire was ahead of the curve, having already seen a collapse in home prices, a sharp decline in sales and new home construction, as well as job losses and rising unemployment.

IE Downturn Preceded Great Recession
2000 to 2015



The Great Recession was undoubtedly the most disruptive event to afflict the Inland Empire economy in recent decades. Recovery took much longer and was much more painful than is common for a typical recession. The region faced years of adjustments, with households going through foreclosures, businesses laying off workers, and local governments dealing with fiscal crises.

Shifting forward to early 2018, the current economic expansion in the nation is expected to become the second longest on record by midyear, as the U.S. economy has come back from the Great Recession with steady GDP growth, record high employment levels, and the lowest unemployment rate in over 15 years. At the same time, the economy of the Inland Empire has rebounded with job gains across its industries, an unemployment rate that has fallen to the lowest level in 25 years, and a housing market that has steadily gained momentum.

Given the length of the current economic expansion

and the fact that home prices have doubled since 2011, there are concerns about the Inland Empire's housing market, conditioned on the wreckage inflicted on the local economy and real estate market during the Great Recession and financial crisis. A number of questions loom over the current situation:

Will the next downturn be as bad as the last?

How does housing stack up? Is a housing bubble forming? Is a crash around the corner?

How do things look over the next 12 to 18 months?

This white paper answers these important questions as follows:



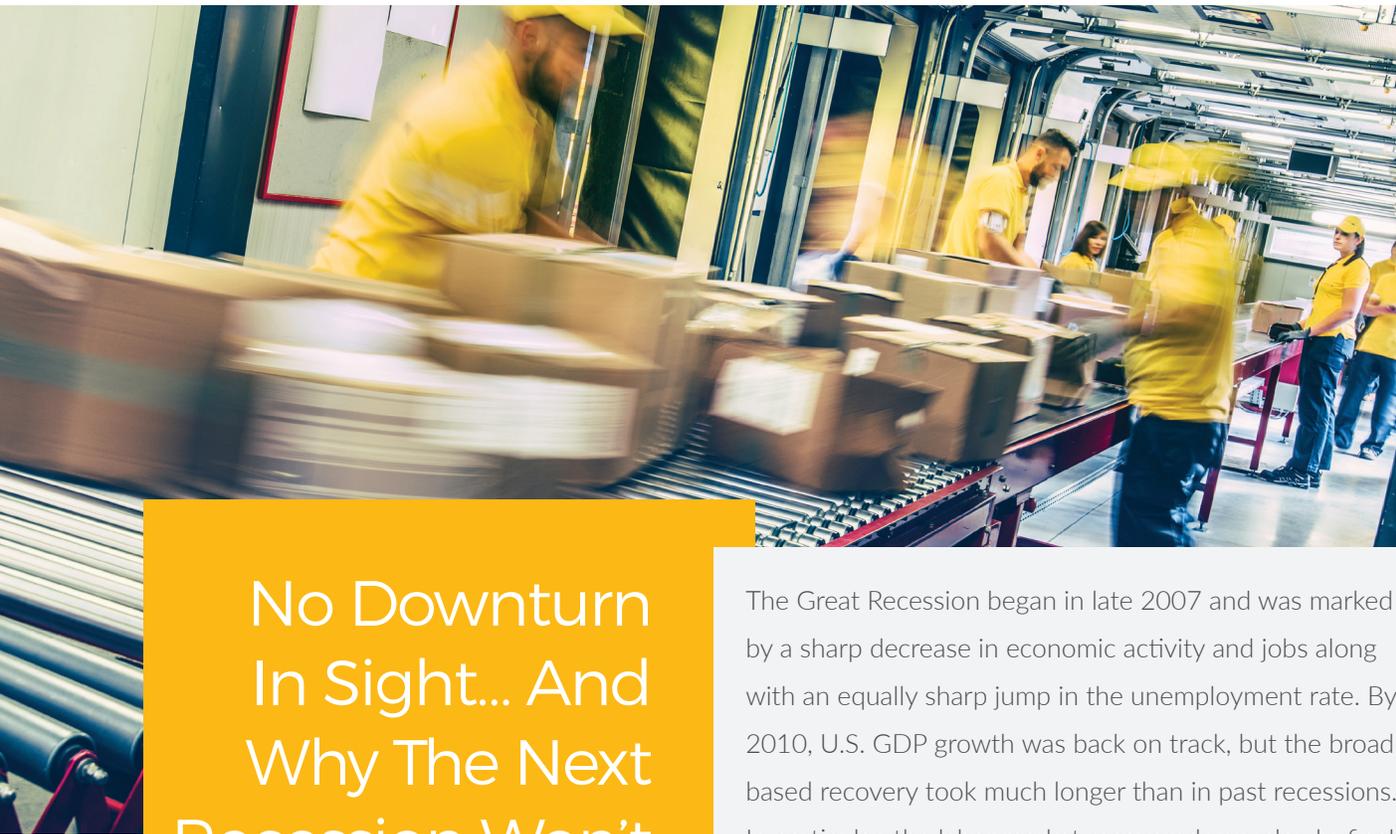
A recession is highly unlikely over the next several quarters and heading into next year. The memory of the last downturn may still be fresh, but when a recession does materialize, it won't be as severe as the Great Recession.



The Inland Empire's housing market was among the nation's hardest hit by the Great Recession and mortgage meltdown. It has made steady progress in recent years, but has yet to surpass its prerecession peak median home price. There are no signs of a housing bubble, which is what caused home prices to plunge in the last downturn. Like the state as a whole, construction activity in the region is up but remains far short of local housing needs, given recent growth in both the home owning and renting population. As in past cycles, households from across Southern California will choose to live in the Inland Empire because it has housing options and amenities that meet their needs.



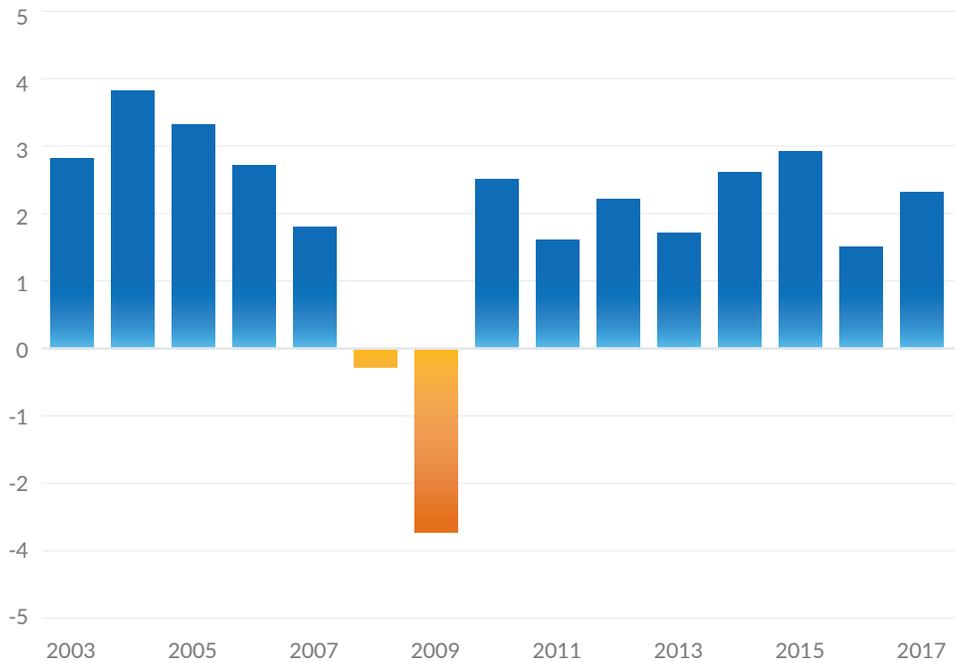
With continued growth in the economy, low interest rates, and increases in residential construction, the next 12 to 18 months may be the best opportunity for first-time home buying households and others to become homeowners. Meanwhile, the multifamily construction that has occurred in recent years will temper rent increases over the near term.



No Downturn In Sight... And Why The Next Recession Won't Be So 'Great'

The Great Recession began in late 2007 and was marked by a sharp decrease in economic activity and jobs along with an equally sharp jump in the unemployment rate. By 2010, U.S. GDP growth was back on track, but the broad-based recovery took much longer than in past recessions. In particular, the labor market recovered very slowly, finally gaining back recession-related job losses by 2014 and reaching full-employment just two years ago.

US GDP Growth Rate
Percentage Change



The U.S. economy has gained momentum over the last two years, and in 2018, is expected to post the highest GDP growth rate since 2014. This upbeat outlook is buoyed by solid job gains and a low unemployment rate, both of which have given rise to wage gains that fuel consumer spending. Recently passed federal income tax cuts will also leave most households with more after-tax purchasing power. In addition, business spending is up, not just because the economy is doing well but also because the recent tax cuts offer new tax breaks on investment expenditures. These gains in the private sector will be complemented by increases in government expenditures at the federal level – owing to the recently passed federal budget – as well as at the local and state level.

Although the pace of job growth nationally and in California has slowed in recent quarters, this is due to slower growth in the labor force rather than a slowdown in the economy. In fact, the nation recently hit a record high for job openings, and many employers are having difficulty in finding and hiring workers. The job openings are there, but the people to fill those jobs are not.

In all, the economy's fundamentals currently look good, but are there any warning signs of a recession on the horizon? The answer is that the usual precursors to a recession are not there right now. Yes, energy prices are on the rise, but there is no spike in view for the near future. The same may be said of inflation. And while interest rates are on the way up, that is more closely related to the bullish economic outlook rather than concerns over an inflation spike or uncertainty about the direction of the economy.

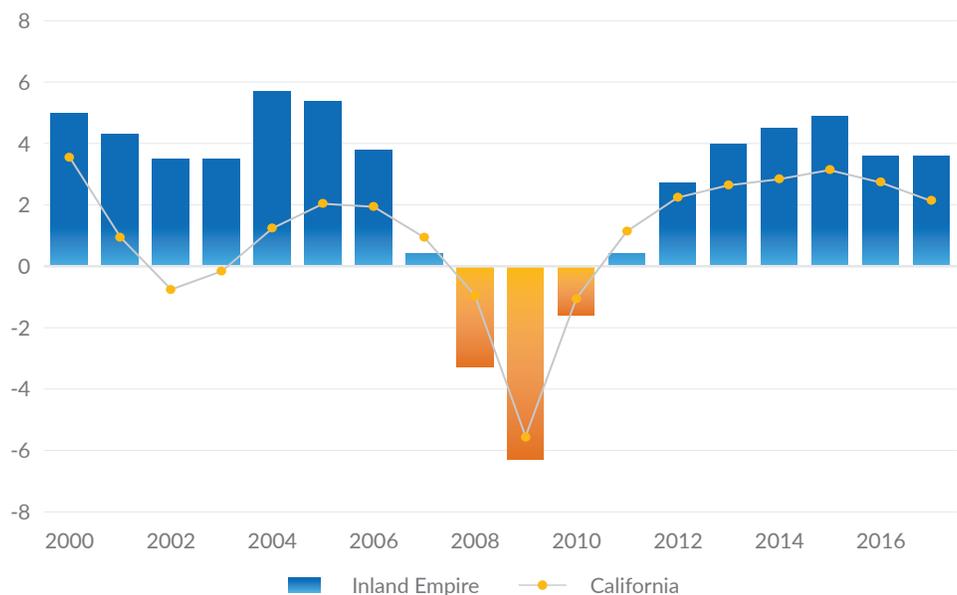
As strong as economic fundamentals are for the United States and California, the Inland Empire's economy is in even better shape. Like so much of inland California, the recession hit

harder in the Inland Empire than along the coast, and recovery in the region followed that of coastal counties. Still, the Inland Empire has outpaced the state in job growth each year beginning in 2012. The region's economy has averaged job increases of 3.5% or more over the last three years, enabling it to make an outsized contribution to statewide job gains. This trend has continued into 2018, with the Inland Empire seeing another 3.5% year-to-year job gain in February 2018.

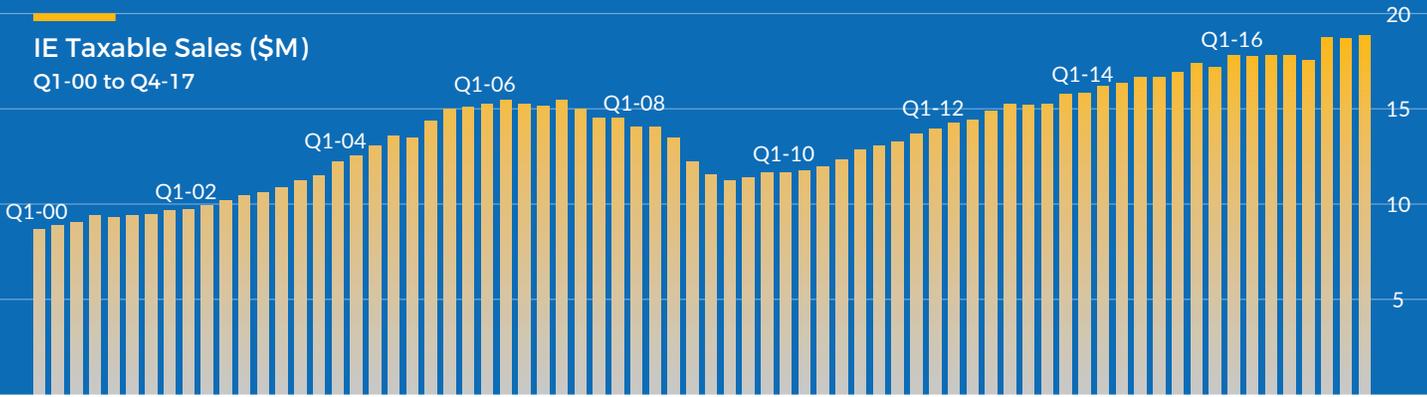
These employment gains have been led by the region's trademark Logistics industry, which has contributed one-fifth of the 162,000 jobs added in the area over the period from 2015 through 2017. The growth in the local Logistics industry has occurred in conjunction with increases in transportation sector activity across Southern California's ports and airports, which has been fueled by elevated levels of import and export activity. As is the case throughout the nation, the local Healthcare sector has also generated a significant number of jobs. Notably, however, the Inland Empire has also seen large gains in Leisure and Hospitality, Retail Trade, and Other Services, partly in response to the region's recent population surge. Construction jobs have also been on the rise, although they haven't yet returned to pre-recession levels. Moreover, local Government sector job counts have come back, a sign of better local fiscal health.

While the Inland Empire has consistently been among the nation's faster growing MSAs, as measured by job growth, other metrics have been equally impressive. The region's Gross Metropolitan Product increased by 4.0% in 2015 and 2.6% in 2016, outpacing the United States as a whole and three out of four MSAs nationally. Meanwhile, taxable sales have increased steadily since hitting bottom in 2009, and advanced by 3.8% last year.

IE Job Growth Outpaced CA
2012 to Present
(YTY % Change)



IE Taxable Sales (\$M)
Q1-00 to Q4-17



Industry job gains have brought about a dramatic improvement in the region’s unemployment rate. Having increased to 14% in the wake of the Great Recession, the annual unemployment rate fell to 4.8% in 2017, and as of February 2018 stood at 4.5%, the lowest monthly unemployment rate since 1990 and only marginally higher than California’s 4.3% rate, which is the lowest on record dating back to 1976.

Given current condition in the national, state, and regional economies, there is every expectation that 2018 will be a year of growth and expansion, with odds favoring a continuation of this trend into 2019. And while it might be natural to expect the next downturn

to look a lot like the previous one, that is unlikely to be the case based on the differences that exist in today’s economic fundamentals and those present on the eve of the Great Recession.

There are many reasons why the last downturn was called the Great Recession, including the greater-than-usual intensity of the contraction and the severity of the problems created in the financial sector. In its aftermath, somewhat cautious behavior by households and businesses, along with new regulations in the financial arena, suggest that when the next recession hits, it won’t be as “great,” that is to say, severe, as the last downturn.

IE Employment Rate Approaching CA and US



The IE Housing Market Now and Then

IE Housing Market
Quarterly Sales and Median Price

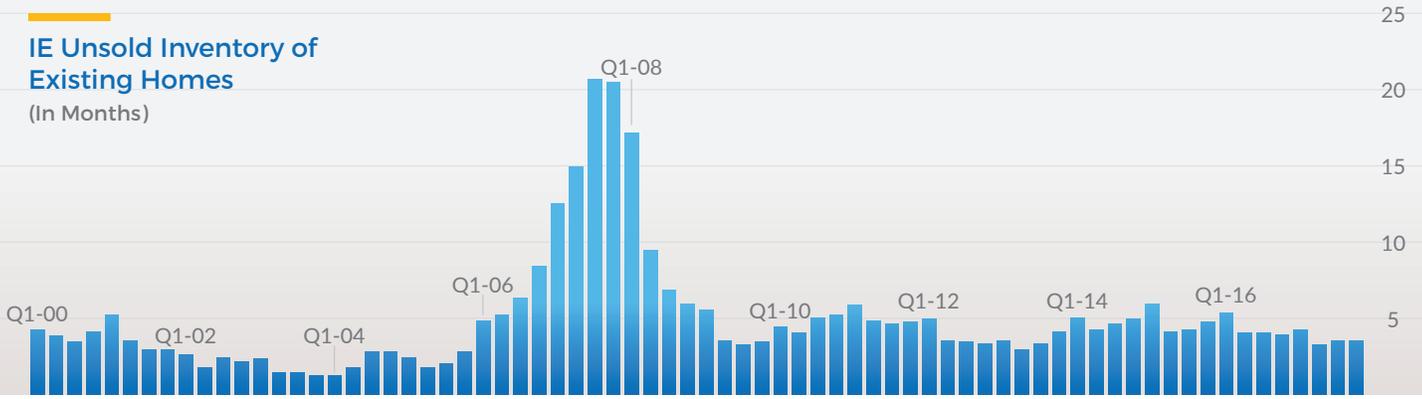


The Inland Empire's housing market has come a long way since the downturn of the last decade. Although the median price of a home in the region still falls short of its pre-recession peak, that median has registered steady gains since the economic recovery began in earnest in the first quarter of 2012. At \$339,800 in the fourth quarter of 2017, the area's median home price was 9.0% higher than one year earlier. While that is more than double the recession trough of \$155,900 from the second quarter 2009, it is still \$50,000 shy of the pre-recession peak of \$393,400, achieved in the first quarter of 2007.

Given the longevity of the current expansion, the accompanying income and job gains, and low interest rates, the housing market, arguably, should be doing better at this point in the economic cycle, both in the Inland Empire and across California. Yet, while sales have come back from the lows of 2007 and 2008, they appear to have reached a plateau in recent years. After falling by two-thirds from their pre-recession peak to a trough of 7,500 homes sold in the third quarter of 2007, sales have recovered to reach an average of 14,500 homes sold per quarter over the last eight quarters.

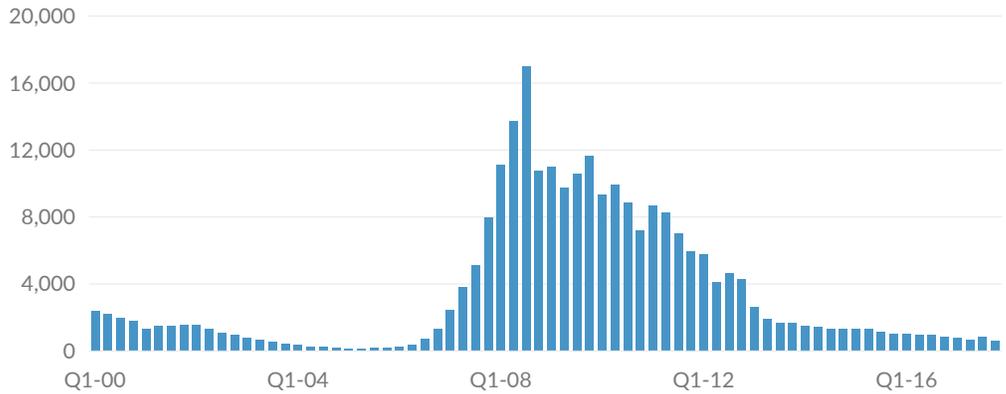
Sales gains have been held back in part by a lack of existing home inventory on the market and by construction of new single-family homes that is just a fraction of pre-recession levels. According to the California Association of Realtors, the supply of available homes for sale in the Inland Empire has remained below the historical average of 4.9 months of inventory for 7 quarters in a row, with the index at 3.6 months during the last two quarters of 2017.

IE Unsold Inventory of Existing Homes
(In Months)

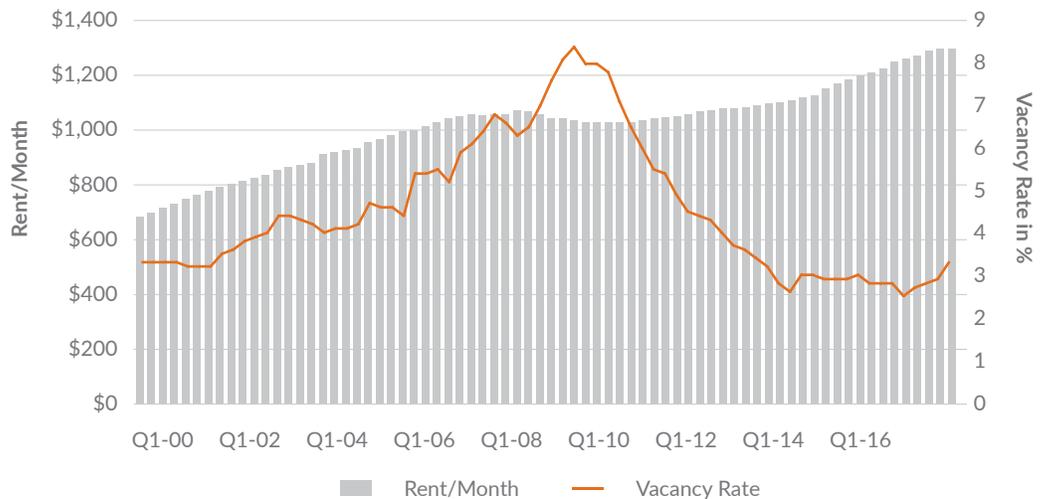


As a consequence of the housing crisis and mortgage meltdown of the last decade, foreclosures in the Inland Empire skyrocketed and many former homeowners who lost their homes were forced into the local rental market. The region's rental market has often been overlooked, but the demand for rental units mushroomed as former homeowners were displaced. The average vacancy rate for apartments plunged from 8.4% in late 2009 to less than 3.0% by early 2014. Meanwhile, rents rose steadily beginning in early 2011, and despite increases in multi-family construction activity in recent years, rents continue to increase today, rising by 2.7% year-to-year in the fourth quarter of 2017.

IE Foreclosures
by Quarter



IE Rental Market
Rent Increases Slow as
Vacancy Rate Edges Up



Remarkably, the number of renters living in single-family homes surged by 83,600 (+56%) between 2006 and 2016, increasing the share of renters from 17% to 25% among all single-family units. In some cases, former homeowners may have been able to remain in their homes as renters, while other households were able to capitalize on the increase in available single-family rentals and rent those properties rather than apartments.

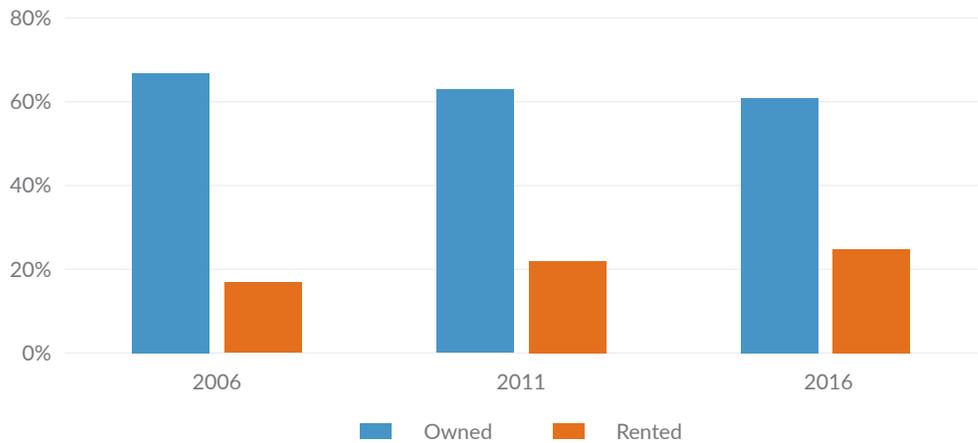
Recognizing that homeownership would be impaired for a period of time, but that the number of renters was on the rise, once residential construction in the Inland Empire got back on track in 2012, there was a somewhat larger response in multifamily construction and a more muted response in single-family home construction. The increase in apartment units may have subdued increases in rents, but the continued pressure on the rental market on the part of traditional renters and owners-turned-renters was compounded by the region's population growth, which advanced more quickly than in the state once the regional economy resumed growth.

Single-Family Housing Units

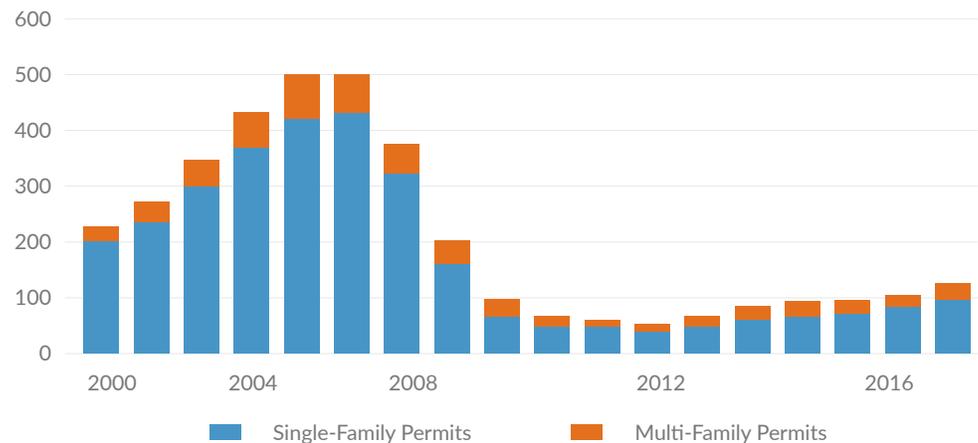
Owned Versus Rented

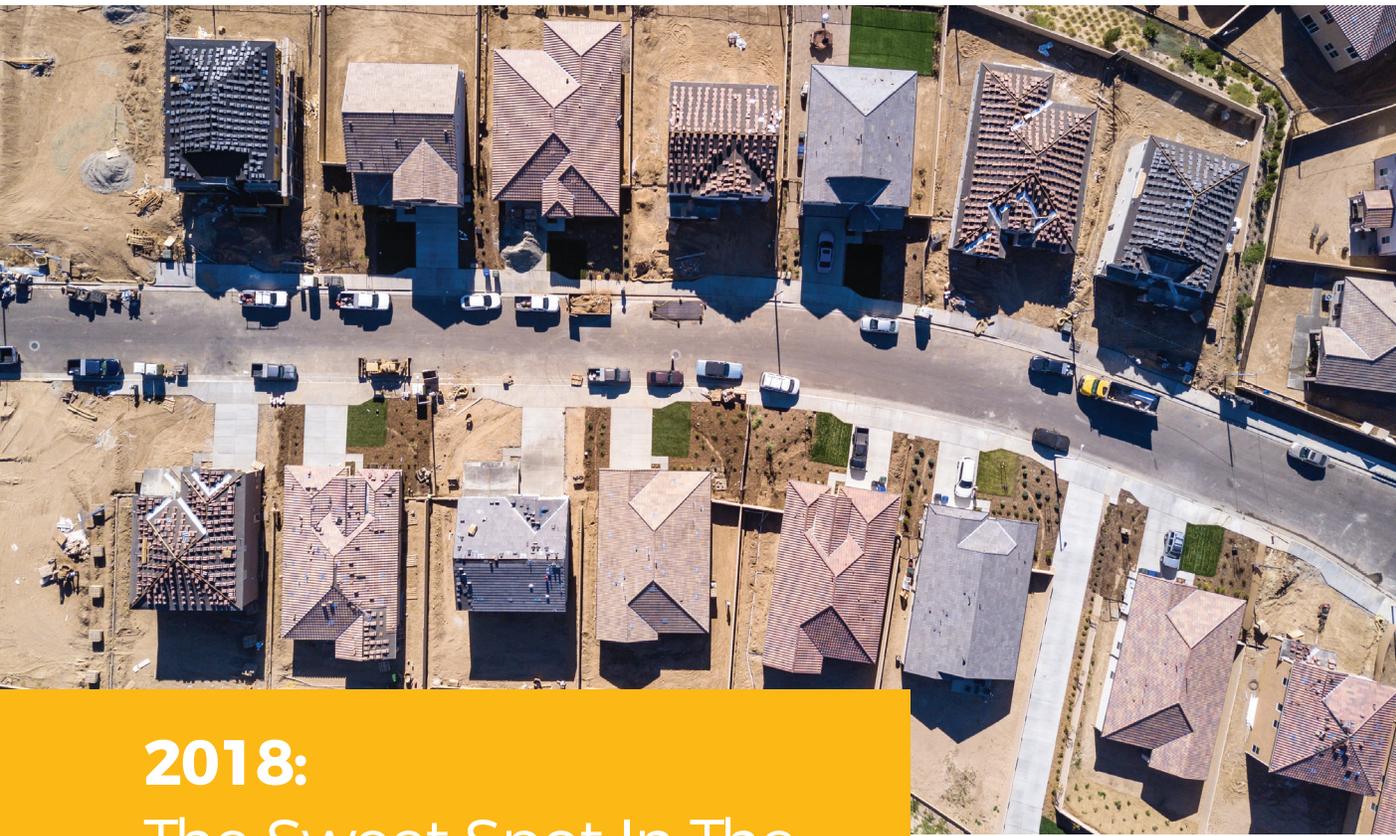
	2006	2011	2016	Change 2006-11	Change 2011-16	Change 2006-2016
Owner	710,259	710,695	710,773	436	78	514
Renter	147,782	198,980	231,337	51,198	32,357	83,555
Total	858,041	909,675	942,110	51,634	32,435	84,069

IE Homeownership Rate and Rentals of Single-Family Homes



Total Building Permits in the Inland Empire





2018: The Sweet Spot In The Current Housing Cycle?

While the Inland Empire's housing market has had its disappointments in the current economic expansion, a confluence of developments on both the supply side and the demand side of the market may make this year, and the next, the best in the current cycle. On the supply side, new home construction rose by one-fifth last year as both single-family and multi-family permits hit their highest levels in 10 years. Indeed, the region started strong this year, with building permit levels that are likely to surpass those of last year.

Moreover, as the median home price in the Inland Empire approaches its pre-recession peak, current homeowners who were able to hang on to their homes during the downturn will continue to recover equity, and at some point, be in a position to sell their homes, thus increasing the supply of existing inventory for sale. Moreover, to the extent that landlords and investors who own rented single-family homes choose to capitalize on the increase in home prices, there may be additional stocks of housing coming to market.

On the demand side, expected increases in household formation, coupled with income and job growth, have enabled more households to accumulate the savings needed for down payments. Additionally are low, but rising, interest rates, and an apparent easing of credit standards, as implied by a lower average FICO Credit Score on Fannie Mae loan acquisitions.

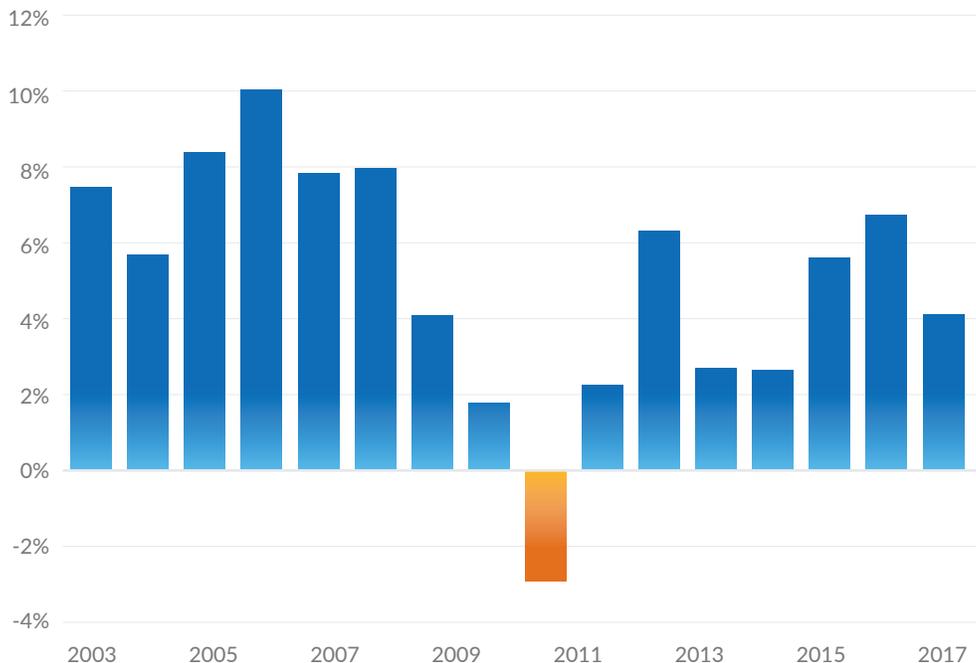
Significantly, demand for housing in the Inland Empire should be strong in the coming years because of the

affordability advantage the region holds over Los Angeles, Orange, and San Diego Counties. As of the fourth quarter of 2017, 43% of households in the Inland Empire could afford the median priced home in the region, well above Los Angeles (25%) and San Diego (26%) Counties, and more than double that of Orange County (21%). Put differently, the Inland Empire continues to serve as the affordability mecca for households willing to make a tradeoff between commuting and housing.

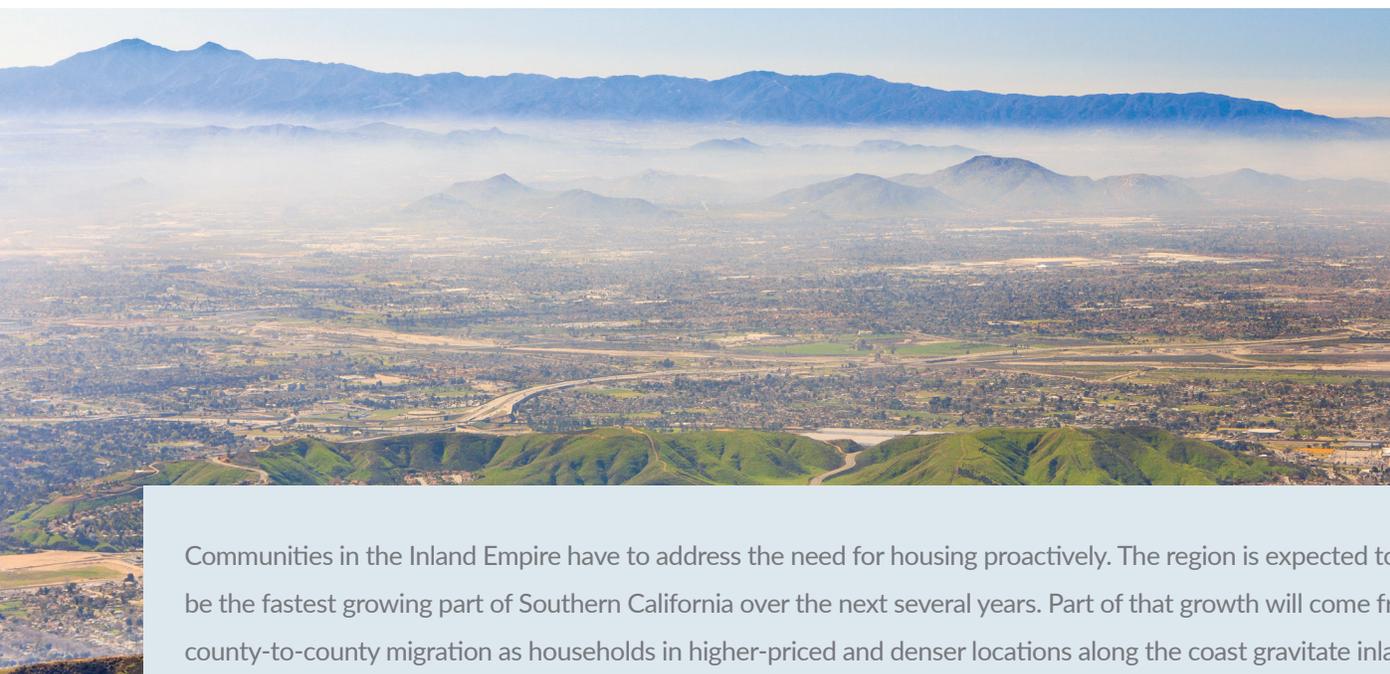
Single-Family Housing Units
Owned versus Rented

County	Q4-16	Q4-17
Inland Empire	46	43
Los Angeles	28	25
Orange	22	21
San Diego	27	26

Personal Income
YTY % Change



It is also important to acknowledge an essential ingredient the housing market: first-time buyers. In past housing cycles, first-time buyers were typically able to purchase a home when the market was at or near a price trough. However, at the time of the last price trough, would-be buyers could not get financing and investors systematically bought the available supply, in many instances outbidding first-timers who were able to secure financing. The lack of new construction in recent years in the face of an increasing numbers of households, has resulted in significant pent-up demand.



Communities in the Inland Empire have to address the need for housing proactively. The region is expected to be the fastest growing part of Southern California over the next several years. Part of that growth will come from county-to-county migration as households in higher-priced and denser locations along the coast gravitate inland where they can buy more home and more space at a more affordable price. In particular, it will be essential to identify and meet the needs of young households who will make up the future workforce of the region.

To reiterate, the Inland Empire has a supply problem above all else. The region needs more housing of all types – single-family and multi-family units, rental and owner-occupied units – for the entire spectrum of household incomes. As in the last cycle, developers will be able to produce and sell market rate housing for moderately-high and high income households, but because of the cost hurdles they face, they will once again be unlikely to deliver a sufficient number of units to meet housing needs beyond that.

The region must also acknowledge that if it wants to maintain its economic vitality over the long run, it has to find ways to accommodate anticipated growth by creating new employment opportunities for the new residents who will be moving in. If it maintains the status quo, large numbers of new residents will commute to Los Angeles, Orange, and San Diego Counties, and the region will pay a price in terms of highway congestion and pollution. To the extent that the Inland Empire can create jobs as well as housing, it will ensure a long-term and vibrant future for its residents and businesses.

About the Center for Economic Forecasting and Development

The UC Riverside School of Business Center for Economic Forecasting and Development opened its doors in October 2015 and represents a major economic research initiative in one of California's most vital growth regions. The Center produces a wide variety of research both independently and in collaboration with academic, business, and government partners. Research products include monthly employment analyses, quarterly regional economic forecasts, a quarterly business activity index, a white paper series, and a major regional economic forecast conference, hosted annually.

About The Author



Robert Kleinhenz, PhD

Robert Kleinhenz is Economist and Executive Director of Research at the UC Riverside School of Business Center for Economic Forecasting and Development and one of California's leading economists. Dr. Kleinhenz is a much sought-after specialist for his deep knowledge of the California and U.S. economies and their industries. Tapping nearly 30 years of experience in analyzing the national and state economies, as well as the economies of California's many diverse regions, he oversees economic research and public policy analysis at the Center. He is also Executive Director of Research at Beacon Economics LLC.



Christopher Thornberg, PhD

Christopher Thornberg is Director of the UC Riverside School of Business Center for Economic Forecasting and Development and an Adjunct Professor at the School. He is also the Founding Partner of Beacon Economics LLC. An expert in economic and revenue forecasting, regional economics, economic policy, and labor and real estate markets, Dr. Thornberg has consulted for private industry, cities, counties, and public agencies in Los Angeles, San Francisco and the Bay Area, San Diego, the Inland Empire, Seattle, Orange County, Sacramento, Nevada, and other geographies across the nation.