REGIONAL INTELLIGENCE REPORT™

BEACON ECONOMICS Prepared by Beacon Economics, LLC

CITY OF ONTARIO SOUTHERN CALIFORNIA

City of Ontario

Fourteenth Edition February 2016

United States: Glass Still Half Full

At first blush 2015 went out with more of a whimper than a bang. GDP growth in the final quarter came in at 0.7%, the manufacturing sector looks stuck in neutral, the global economy seems to be floundering, commodity prices keep falling, and to top it off, the stock market has stumbled hard in the first few weeks of this year. It seems to paint a picture of an economy that lost the momentum it had started to build early in 2015.

Yet, if you put the screaming headlines to one side and take a closer look at the data it turns out that things are really no worse now than they were a year ago. While there are clearly issues that continue to interfere with the U.S. economy's ability to get past the 3% pace of growth, on the other side of the equation, there are plenty of positive indicators suggesting that, at worst, 2016 will see growth remain in the 2.5% range.

With the fourth quarter GDP estimate, average quarterly growth for the year was 1.8%, down from last year's 2.5%. But growth in gross output isn't the best indicator of the economy's health—growth in final demand is. And, as it turns out, businesses, consumers, and the government increased their spending in 2015 by close to 3% per quarter—on par with 2014 and better than 2013 by a good margin. Overall, final demand grew at an average pace of 2.5% in 2015 – down only slightly from 3% in 2014, but quite a bit above 2013's pace of 1.5%. The slowing in output growth is due to reduced inventory accumulation and export growth. This is a function of the weak global economy and commodity glut that has resulted. There is little reason to think that domestic demand won't continue to support the economy in 2016.

Consumer spending is a particularly bright spot and continues to be largely driven by ongoing gains in the labor markets. Despite issues surrounding commodities and exports, the job markets are chugging forward with almost 900,000 new positions added in the last three months of the year in a variety of sectors. The retail industry overall saw solid numbers despite ongoing pressure on traditional brick and mortar stores (online and non-traditional retail more than made up the difference). Even manufacturing saw positive employment gains despite the glum outlook. Consumers are also being given a lift by easier access to credit, weak inflation figures, and improved balance sheets as a result of the real estate recovery.

On the industrial side of the economy—things are doing fairly well. Most of the turmoil has been based on a sharp slowing in the mining sector. Most other sectors are fine or even thriving—such as autos, airplanes and electronics. As for mining itself, it should be remembered that the sector represents less than 2% of the U.S. economy and less than one-half a percent of employment. This can cause turmoil in some areas but simply isn't broad based enough to do more than create modest headwinds for the economy. History backs up this mild view: We saw a similar collapse occur in the mid-1980s and it neither sank the U.S. economic expansion nor created any sort of major financial retraction.

Looking at real estate, housing continues to move slowly forward. Mortgage debt is finally expanding, household formation is picking up, and overall housing vacancies are down. With home affordability still relatively good, 2016 should see rising homeownership levels, more construction activity, and steady price appreciation.

And despite recent wobbles in the equity markets, in reality, the financial state of the U.S. economy is solid. Debt levels are steady and asset prices remain reasonable given low interest rates (and yes, interest rates have stayed low despite the Fed raising the Funds Rate in December). In the end, we may find that the slowing of the Chinese economy has put, and will continue to put, far more profound downward pressure on rates than any Fed policy.

Beacon Economics' bullish forecast is for another boring year of 2.5% GDP growth, and ongoing gains in real estate prices, employment, and most indicators. And while some may be discouraged by what they feel is too slow of a trajectory, consider the parable of the tortoise and the hare. The frustrating slowness represents an economy that is at a point in time where it has more potential in front of it than activity behind it. This implies that the current expansion may well end up being one of the longest ever. Only time will tell.

California Follies

Given all the negative rhetoric aimed at the state over the past decade, California has a lot to crow about. In the last 4 years the state has accelerated to become one of the fastest growing in the nation. Consider the recent data:

- California has added almost 900,000 jobs in the last two years—almost twice as many as the slowing, oil-dependent Texas economy. Unemployment is below 6% – rapidly re-converging with national levels.
- In the first half of 2015 (the latest data available) California grew its gross output at twice the rate of Texas—a distinct contradiction to the idea that business climate is the primary driver of economic success.
- California's employment growth is broad based. Both professional services and hospitality jobs are booming in the state, providing a mix of jobs for high and low skilled workers. The western part of the San Francisco Bay Area remains the fastest growing regional economy in the state, but Fresno and the Inland Empire are number 3 and 4, respectively, completely contradicting the notion that only the state's coastal areas are in recovery.
- Tourism is hot again and hotels across California are packed. With almost an 80% occupancy rate, it is understandable why new hotels are being built across the state.
- Taxable sales are above their previous peak by a solid margin, and continue to grow rapidly. The sources of growth are construction, business spending, and hotels/restaurants. Traditional consumer goods are adding little to the pot with inflation at such a low pace.
- Non-residential construction has returned to normal levels in California. The hot economy has filled state coffers with tax revenues and the current fiscal year will likely come in a few billion dollars over initial projections.
- California's housing market continues its strong recovery. The mortgage delinquency rate is lower in the state than in the nation overall, and home price appreciation is higher than the national average by a good margin. At the state level, median prices have reached $400,000 for the first time since 2007. The San Francisco Bay Area leads the way in price appreciation, but Fresno and San Bernardino Counties have both seen median prices grow at a double digit pace in the past year. Home sales are still slow relative to the last peak, but tight inventories and low interest rates have contributed to the ongoing rise in prices.
- To top it off, the rains have returned and the huge snow pack that is building in the Sierra Mountains will help refill reservoirs this summer, giving at least short-term relief to the water shortage.

This doesn't mean all is well in the land of sunshine. California continues to face numerous longer-term issues—problems with effects that might quickly re-emerge, or drags on the economy that prevent even greater growth and prosperity.

The current spell of good news should allow state legislators to take on these economic challenges with solid analytic work and bold legislation. Unfortunately, state leaders have been too busy over the past year and a half with sex (considering condom laws for the pornography industry), drugs (creating the Bureau of Medical Marijuana Regulation), and rock and roll (you can now drink a beer in public while riding on a 10 person booze-bike) to make much headway in tackling some of the larger economic hurdles that can and will cause even California's formidable economy to stumble.

What are some of the core economic issues state leaders should be focusing on?

Comprehensive Revenue Reform: The large budget surplus California is currently enjoying comes in part from the passage of Proposition 30 a few years ago, which expanded the income tax on high-income earners. The surplus has encouraged some interests in the state to try and make the tax increase permanent. The problem is the failure to recognize the other driver of the surplus—huge gains in financial markets over the last few years.

What the markets give, they can (and do) take away even more quickly – and California's tax system internalizes that market volatility. With or without a Proposition 30 expansion, a major or even minor financial downturn will quickly push the state back into another deep hole, creating all sorts of turmoil on the expenditure side. California needs to sharply reduce its reliance on personal income taxes and focus instead on more stable property taxes, service sales taxes, and various usage fees to make up the difference.

The Housing Affordability Crisis: Housing costs in California are rising rapidly for both rental and for-sale units. The state also has one of the lowest housing vacancy rates and one of the highest rates of over-crowded housing in the nation. Much has been made of the impact that high housing costs have on low-income households—but even middle class Californians are feeling the pain. The burden (as a share of income) on those who own a home is higher in many places than on those who rent.

There is little doubt that state legislators see the problem at the top level—but they have proven remarkably adept at avoiding confronting the true drivers, namely barriers to new residential construction. Instead, they discuss moratoriums on condo conversion, consider expanding rent control, or create plans to develop 'affordable' housing at a pace that wouldn't even cover the increase in the shortage as California's economy expands rapidly.

The housing crisis is going to become acute in the very short term. California has been growing its payroll workforce at a pace of 3% per year—but its labor force at only a 1% pace. This can only continue when there is slack in the workforce (unemployment rates are high), a situation that is clearly ending now that unemployment has dropped below 6%.

California needs to allow private developers to build more by alleviating the regulatory and tax barriers that slow the process and drive up costs. Yet there seems to be little interest in reforming the state's major barriers (Prop-13, California Environmental Quality Act) or in forcing local cities to zone more (and tax less) new residential construction.

Water Policy: As the rains have returned and the snowpack has been building in California, it would be easy to forget about water issues. But the water crisis isn't over. The state is far from repairing the damage that has been done due to emptying waterways and digging ever deeper for ground water. And there will be another drought – likely worse than the last one.
The solution should not be desalination, nor should it be many of the expensive strategies being offered. Rather, the state should focus on allocating this scarce resource to its best uses. Over the course of the last 6 years of drought, California's exports of hay—a very water intensive crop— have almost quintupled from 30 million to 140 million kilograms annually. In other words the state has been functionally increasing exports of water at a time when Californians have been asked to cut back on water use.

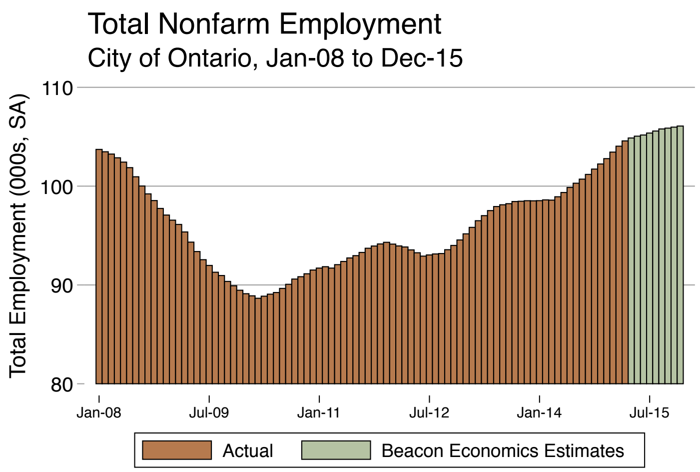
The worst part is not that we are exporting water, but that we are exporting it at prices far below what we pay for it. Hay typically earns farmers roughly $25 per acre foot used—compared to $1700 to create fresh water through desalination.

Why this clear arbitrage—selling agricultural water to cities for anywhere between $25 and $1700 per acre-foot—is not happening is a bit perplexing to an economist. Surely it has something to do with the myriad of local water agencies that govern the state's water supplies with relatively little oversight. The focus is everywhere but where it needs to be.

While it is easy to poke fun at some of the laws and regulations that Sacramento has recently focused on, other important topics have been tackled including vaccination rules to protect children, reducing police violence, and greater education to help prevent sexual violence. But just because the state is on the mend doesn't mean that legislators should ignore mid- and long-term economic challenges even if they are politically thorny topics. Maintaining the status quo simply makes the state vulnerable to the next round of potential calamities that it will assuredly face.

Employment

Total nonfarm employment in the city of Ontario increased by 4.4% year over year to 106,275 in December 2015, based on data from the California Employment Development Department (EDD) and Beacon Economics' estimates. More jobs are being added in Ontario than in the greater Inland Southern California region, which expanded its employment base by 3.6% over the same period.



Source: California Employment Development Department

Employment by Industry in the City of Ontario

Industry	Dec-15	YOY Chg.	YOY (%)
Finance & Insurance	2,300	175	8.9
Prof, Sci, Tech, & Mgmt	6,350	500	8.4
Construction	4,275	300	7.5
Education/Health	7,750	525	7.3
Leisure & Hospitality	7,325	500	7.3
Other Services	2,900	175	6.7
Wholesale Trade	10,975	675	6.6
Manufacturing	13,125	650	5.3
Real Estate	1,300	50	4.5
Retail Trade	13,350	400	3.1
Transport/Warehouse	15,975	400	2.6
Admin Support	12,450	225	1.8
Government	5,575	100	1.7
NR/Mining	750	0	-0.4
Information	1,850	0	-0.5
Total All Industries	**106,275**	**4,450**	**4.4**

Source: EDD & Beacon Economics

Helping nonfarm employment reach new levels were job gains across most industries. The industries with the strongest job growth were Finance & Insurance (8.9%) and Professional, Scientific, Technical & Management (8.4%), two industries that tend to provide a higher proportion of high-skilled, high-paying jobs.

The Logistics and Distribution industry, Ontario's as well as Inland Southern California's flagship industry, is still the region's largest source of employment. Together, jobs in the Transport/Warehouse, Wholesale Trade, and Retail Trade industries accounted for 33.1% of the jobs created over the year, and as of December 2015 account for 37.9% of the jobs in Ontario. The Logistics and Distribution industry creates many jobs in Ontario, but other industries are contributing significantly to local job growth. Indeed, job creation in Ontario is occurring in many industries, pay grades, and skill levels.

Employment in Ontario's Construction industry also demonstrated robust growth. Job counts grew by 7.5% from a year before, reaching 4,275 jobs in December 2015. Job growth in this industry has been strong throughout Inland Southern California.

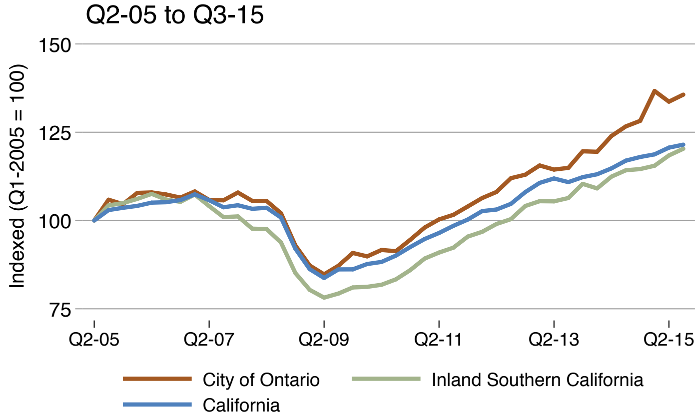
Average wages also continued to grow in Ontario. The average annual wage grew by 3.0% year over year to $44,500 in the first quarter of 2015, while the average annual wage in San Bernardino County grew at half that rate.

With local establishments boosting employment counts, many of Ontario's residents have been able to improve their employment status. The city's unemployment rate improved to 8.8% in 2014, compared to an estimated rate of 17.4% in 2011, according to the most recent data provided by the U.S. Census American Community Survey. Furthermore, based on where Ontario's unemployed workers were last employed, the industries with the lowest unemployment rates in 2013 and 2014 were Wholesale Trade, Financial Activities (which includes both Real Estate and Finance and Insurance), and Construction – indicating that local businesses in these industries may now have a harder time finding local experienced workers to hire since many are already employed. On the other hand, employees who previously worked in Retail Trade, Other Services, and Administrative Support had the highest unemployment rates in Ontario – so local businesses in these industries may have an easier time finding local experienced workers to hire.

Ontario's labor market has made great strides since the hard times of the Great Recession. Recent employment growth is expected to continue and will provide local residents the resources to fuel consumer spending within Ontario and throughout the region.

Local Spending

Taxable sales in Ontario continued to grow at a healthy pace through the third quarter of 2015. Over the year, taxable sales increased 7.1% to almost $1.8 billion during the third quarter of 2015. Local taxable sales growth continues to outpace taxable sales growth in Inland Southern California (5.3%) and California (3.9%). Equally impressive, taxable sales in all categories, but Fuel and Service Stations are up year over year.



Source: California Board of Equalization

Among spending categories, Business and Industry has been growing the most throughout San Bernardino County. Spending grew almost 30% from the third quarter of 2014 to the third quarter of 2015, primarily because companies have been coming to the region for industrial space. Local authorities have their site set on remodeling Ontario Airport and redeveloping the land around the airport to attract more airlines and passengers.[1] Ontario Mills, California's largest outlet mall, is expanding to feature ten new stores, including UNIQLO, North Face, and Tommy Hilfiger; all ten tenants are expected to be operational by summer.[2] Similarly, Trident Case is relocating its headquarters to Ontario and iFly, an indoor skydiving business, is expanding to Ontario.[3]

Automobile purchases continue to grow at a rapid pace as well. Spending in the Auto and Transportation category grew by 14.4% from the third quarter of 2014 to the third quarter of 2015.

Spending at Restaurants and Hotels grew by 7.3% from the third quarter of 2014 to the third quarter of 2015. And while much of the spending in this category is from locals, the contribution from tourists also continues to remain strong. For example, the average hotel room rate in Ontario grew by 7.8% in 2015 YTD (through November) from the same a period in 2014 and has grown by 22.7% since the same period in 2010 – all while occupancy rates have been improving.

Spending on Fuel and Service Stations continues to decline nationwide because oil remains at historically low prices. This is great news for areas like Ontario, where oil production is a small or nonexistent part of the local economy. Local residents can spend less to obtain the energy they need and spend more on other goods and services that stimulate the local economy.

Sales Tax Receipts by Category in San Bernardino County

Category	Q3-2015 ($000s, SA)	YOY Chg. (%)	2 Yr Chg. (%)
Business and Industry	19,845	29.6	38.7
Autos and Transportation	15,012	14.4	22.6
Building and Construction	7,131	13.9	19.8
Restaurants and Hotels	7,915	7.3	16.8
General Consumer Goods	18,565	6.9	11.5
Food and Drugs	3,697	3	10.6
Fuel and Service Stations	9,890	-13.9	-6.7
Total	**91,518**	**9.9**	**17.8**

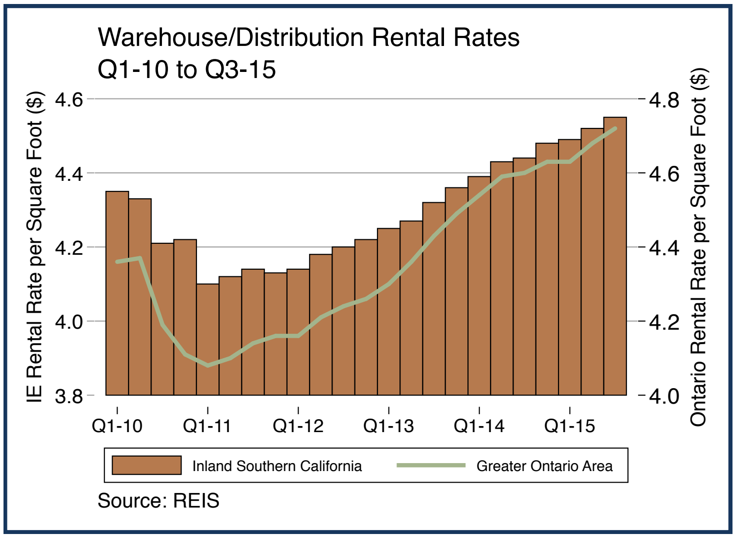
Source: HdL

Local spending, and its subcategories, are expected to continue on their current trajectories, as the local economy continues to hum and oil prices remain low.

[1] Neil Nisperos, "New CEO envisions restoring Ontario airport as economic engine", Inland Valley Daily Bulletin, February 10, 2016, available at http://www.dailybulletin.com/business/ 20160121/new-ceo-envisions-restoring-ontario-airport-as-economic-engine.
[2] Neil Nisperos, "Ontario Mills expansion to feature 10 new stores", Inland Valley Daily Bulletin, February 10, 2016, available at http://www.dailybulletin.com/business/ 20160126/ontario-mills-expansion-to-feature-10-new-stores.
[3] Neil Nisperos, "Coming to Ontario: Skydiving without leaving the building", Inland Valley Daily Bulletin, February 10, 2016, available at http://www.dailybulletin.com/lifestyle/ 20160203/coming-to-ontario-skydiving-without-leaving-a-building.

Commercial Real Estate

While Ontario contains an abundance of non-residential properties, industrial space remains highly attractive due to its proximity Los Angeles County and its accessibility to transportation services and infrastructure. Yet over the last year, commercial real estate experienced growing demand for all types of properties. Rents across all types of commercial property in the Greater Ontario Area continued to creep upward. In the third quarter of 2015, retail rent increased by 1.9% year over year, office rent increased 2.2%, and industrial rent increased 2.6% according to REIS, Inc.



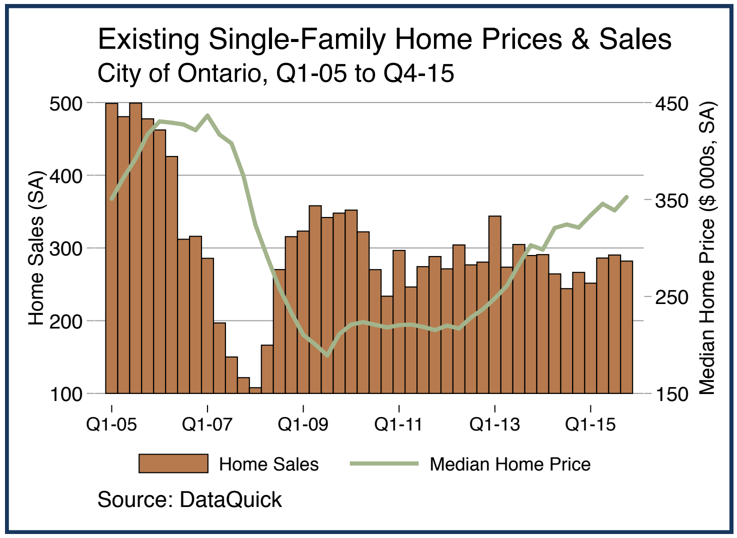
Similarly, vacancy rates continue to trend lower. In the third quarter of 2015, retail vacancy rates fell 50 basis points, office vacancy rates declined by 30 basis points, and industrial vacancy rates dropped by 120 basis points in the Greater Ontario Area.

Supply has been added slower than it has been absorbed. However, construction activity suggests that a change is expected soon and subsequently, rents may stabilize. The value of industrial permits in Ontario grew by 230% to $120.3 million in 2015; retail permits surged 143% to $16.6 million and office permits increased from $0 to $240,000 in the past year.

Residential Real Estate

The housing market showed improved signs of life at the end of 2015. The median price for an existing single-family home increased by 9.8% year over year, to $352,500 in the fourth quarter of 2015. Despite the value increases and tight supply, Ontario real estate prices remain more affordable relative to other Inland Southern California areas and coastal regions. In the fourth quarter of 2015, the median home price was $421,800 in Chino, $482,800 in Rancho Cucamonga, and $403,600 in California. Moreover, Ontario home prices are still below their pre-recession levels. Indeed, prior to the financial crisis and housing crash, the median home price in Ontario was $84,000 greater than the most current estimate.

Sales volume, which had been low a year ago, grew by 4.2% in 2015, reaching 1,110 single-family home sales. Nevertheless, homes in the area remain in short supply. Countywide, the inventory tightened to four-months worth of supply, whereas a six- to nine-month supply reflects a more balanced housing market.



Increased demand for housing is being met by an increase in supply. Over 290 single-family units were permitted in 2015. Furthermore, homes continue to get built and sold in Ontario Ranch, a master planned residential development of 2,800 acres.

Similar to single-family housing, demand for multifamily housing has also been growing. Apartment rents rose by 3.8% year over year to $1,240 per unit in the third quarter of 2015. Meanwhile vacancy rates fell by 130 basis points to 3.4%.

With home prices and rent prices rising, the levels of affordability have been changing. In 2015, the proportion of income spent on a monthly mortgage payment that includes taxes, insurance, maintenance on a single-family home was estimated at 38.4%, based on median household income, median existing single-family home price, current interest rates, and a 20% down payment. In comparison, the proportion of income spent on a monthly mortgage payment was 45% in 2006. On the other hand, the average price of apartment rents in 2015 would take up 36.4% of median household income among renter households. This figure is considered normal, yet appears much greater when compared to costs that averaged just 29.1% of income in 2006. All in all, the cost of housing in Ontario remains affordable for both homeowners and renters.

BEACON ECONOMICS

About Beacon Economics

Beacon Economics, LLC is a leading provider of economic research, forecasting, industry analysis, and data services. By delivering independent, rigorous analysis we give our clients the knowledge they need to make the right strategic decisions about investment, growth, revenue, and policy.

Services

Economic, revenue and occupational forecasting
Economic impact analysis
Regional economic analysis
Economic policy analysis
Real estate market analysis
Industry and market analysis
EB-5 economic analysis
Public speaking
Expert testimony

For more information, please visit www.BeaconEcon.com.

CITY OF ONTARIO SOUTHERN CALIFORNIA

Analysis. Answers.