CALIFORNIA FORECAST

SALES TAX TRENDS AND ECONOMIC DRIVERS

APRIL 2020 REVISED

HdL Companies

Sierra Foothills, California

HdL provides relevant information and analyses on the economic forces affecting California's local government agencies. In addition, HdL's Revenue Enhancement and Economic Development Services help clients to maximize revenues.

HdL serves over 500 cities, counties and special districts in California and across the nation.

Delivering Revenue, Insight and Efficiency to Local Government Since 1983

HdL Companies
FY 19/20 & 20/21 FORECAST

Given the unusual circumstances we are all living in today, we have modified the April 2020 HdL Consensus Forecast. We are providing broader explanations about two major ongoing events which impact fiscal year 2019/20 and 2020/21 statewide sales tax trends. As is our tradition, we also offer context that supports our major industry group projections. We trust this information communicates clearly a broad understanding of where sales tax revenue is headed, knowing these vital resources are essential to addressing your communities needs during these trying times.

CORONAVIRUS (COVID-19) Impacts on California Sales Tax

The swift reaction by consumers and businesses to the outbreak of coronavirus (Covid-19) in the U.S. has caused a massive decrease in spending on certain goods and services. The national and state response combined with the uncertainty of how long the presence of the virus will disrupt the U.S. economy has made forecasting local government revenues particularly challenging. This forecast was developed in early April after numerous news updates detailing "shelter-in-place" related impacts, comparisons to previous economic downturns like the Great Recession, studying the data, reports and projections of many industry specific analysts and monitoring various updates up to that time.

The forecast assumes that the statewide 'shelter-in-place' directive will continue until the end of May 2020, although volume testing may allow health care agencies an understanding of the extent of the virus and implement more site specific containment actions that allow some businesses and schools to slowly reopen and return to work. Based on recovery reports from China and South Korea, our forecast still assumes that the virus will have run its course by the end of September, however it does not consider a return of the virus and potential economic impacts after the current period at this time. Under our 'end of May' scenario, declines in sales tax revenues are expected to continue through the fourth quarter of 2020 with only moderate gains for several quarters thereafter. With the most dramatic decreases expected during the first and second quarters of 2020, future comparisons to these periods will be positive. However, overall dollars will still be less than the same period in 2019 noting a prolonged flat rebound.

Already marginal or overly leveraged businesses still may not survive a lengthy shutdown even with federal subsidies and our observation from previous downturns; the return to previous spending patterns after significant income interruptions is not immediate and often evolves. Consumers may now take even more time to fully get back to previous leisure travel, dining and discretionary spending habits. Businesses similarly may become more cautious about capital investment and the number of employees to hire after emerging from an economic crisis. Business travelers who had to resort to teleconferencing may continue to teleconference. Formerly avid brick-and-mortar shoppers may find that online shopping and delivery services suits them just as well.

The percentage changes in HdL's quarterly forecasts are statewide. Every local jurisdiction has its own distinctive sales tax demographics and business characteristics and the depth of the impact will vary. Further, as individual client budget forecasts are constructed, we will continue to monitor for subsequent economic changes that may have not been reflected in earlier forecasts.

HDL CONSENSUS FORECAST – APRIL 2020

STATEWIDE SALES TAX TRENDS

TOTAL 1Q20 -7.5% | 2Q20 -36.1% | 2020/21 -1.5%

Autos/Transportation

1Q20 -12.0% | 2Q20 -55.0% | 2020/21 -6.3%

Numerous industry observers including Cox and JD Power have predicted 80% or more declines in auto sales while Shelter-in-Place (SIP) regulations are in force, similar to reported results from Chinese auto dealers in February. Anecdotal reports indicate sales may now indeed be declining near that amount. Once showrooms are fully reopened, sales are expected to remain depressed as consumers suffer from lob losses and heightened levels of economic anxiety. Recent industry forecasts from ALG, JD Power, RBC and others predict new car sales decreases anywhere from 10 to 34% in 2020 overall. HdL is projecting a decrease of 25% for the auto/transportation category as a whole, exceeding the 20% worst annual decline seen in 2008 during the Great Recession.

Building/Construction

1Q20 -7.0% | 2Q20 -40.0% | 2020/21 -0.1%

Recent regional decision makers have put most construction on hold; the threat remains that jurisdictions outside the Bay Area will stop work for prolonged periods during the next 3 months. Supply chain issues are a problem but manageable in the near term. Some jurisdictions are having difficulty keeping up with required inspections with some handling it remotely or others allowing self-inspection. As the pandemic continues, permit levels will decline, leading to less work for future periods. Without government incentives, housing development is likely to dry up as the effects of growing unemployment further limit the pool of prospective buyers. Commercial projects, although holding entitlements and permits, may no longer pencil. Even if construction demand remains strong after the pandemic passes, existing capacity limits will throttle growth as crews must first deal with the growing backlog of work.

Business/Industry

1Q20 -15.0% | 2Q20 -30.0% | 2020/21 -5.4%

Most categories within this group are expected to decline over next few quarters with the Coronavirus disruption of supply chains deepest in first and second quarters. Companies needing components for manufacture of consumer electronics, pharmaceuticals, machinery and trucks may be particularly impacted. Depending on inventory availability, there may be a temporary boost in the demand for food processing, medical, and telecommunication equipment and supplies. The major winner will be for industrial zoned fulfillment and logistics centers that also happen to be "point of sale" for the products that they ship. The Coronavirus quarantines are expected to accelerate the shift from brick and mortar stores to online shopping and produce double digit gains in those specific cases.

Food/Drugs

1Q20 5.0% | 2Q20 5.0% | 2020/21 2.0%

The current pandemic has not restricted access to grocery and drugs stores. While operational and safety modifications have occurred, consumers can still acquire household essentials at both chain and local establishments. Some products are in short supply, temporarily, as anxious shoppers acquire larger quantities of certain products. Cannabis businesses are also open and expected to perform fairly well, given the circumstances. The SIP mandates create expectations to merchandise from this group being delivered directly to homes or through curbside pickup.

Fuel/Service Stations

1Q20 -10.0% | 2Q20 -50.0% | 2020/21 0.0%

As a result of COVID-19, the consumption of fuel, have either slowed or stopped. The combination of strong supply and weak demand for fuel has pushed oil barrel prices down to historically low levels. Fuel prices in California are now averaging less than $3 per gallon. With lower prices and less fuel being consumed because of SIP restrictions, taxes generated are expected to significantly drop in the second quarter of 2020 and remain down until the middle of the first quarter of 2021. Oil prices should then increase into the range of $45 to $55 per barrel toward the end of 2021 and into 2022. However, oversupply may keep gas prices relatively low and moderate potential sales tax recovery.

HDL CONSENSUS FORECAST – APRIL 2020

STATEWIDE SALES TAX TRENDS

HdL Companies

TOTAL 1Q20 -7.5% | 2Q20 -36.1% | 2020/21 -1.5%

General Consumer Goods

1Q20 -15.0% | 2Q20 -45.0% | 2020/21 -2.5%

Core retail sales are expected to see significant drops as society practices social distancing measures to combat the spread of COVID-19 at the recommendation of health professionals and government leaders. With SIP orders expected to continue well into the second quarter of 2020, the effect on consumer spending and retail sales are expected to be extremely disturbed. Shuttered malls, shopping centers and retailer stores all will be adversely impacted. State and federal programs are being set up to assist small businesses to temper short term cash flow declines and permanent closures. While the immediate fallout subsides, brick and mortar retail sales are expected to be bleak into the summer months. As consumer confidence drops and employment woes set in, the effects are projected to negatively impact discretionary spending throughout the remainder of 2020.

Restaurants/Hotels

1Q20 -10.0% | 2Q20 -60.0% | 2020/21 -6.5%

The restaurant industry is reporting 65% drops in revenue and the hotel industry is reporting drops of over 85% due to the COVID-19 shelter-in-place. Restaurants and other facilities that prepare and serve food are restricted to delivery or take-out. Consumers are shifting their food spending to groceries as quarantines continue, which could impact the long-term outlook for the sector if dining habits change. After the shelter-in-place is lifted, dining rooms are expected to operate at reduced capacity for continued social distancing. This industry is very vulnerable to closure given the already increasing tight operating margins and staff costs pre virus impacts. Most major hotels have laid off most of the staff, while others have announced they will temporarily shut down.

Proposition 172 projections vary from statewide Bradley-Burns calculations due to the state's utilization of differing collection periods in its allocation to counties. HdL forecasts a statewide decrease of -8.19% for Fiscal Year 2019/2020 and -1.82% in 2020/2021.

State and County Pools

1Q20 15.0% | 2Q20 10.0% | 2020/21 7.3%

This is one segment that is expected to stay positive, even in the midst of the virus crisis. The primary driver is the coincidental arrival of new out of state taxes; early results from the Wayfair decision implementation, which launched in the second quarter of 2019 under AB147, added new revenues at the State and local level. The marketplace facilitator phase started October 1st; current and next year forecasting comprises Wayfair's total impact on anticipated use taxes distributed via the countywide pools. Online shopping surged in March as buyers complied with crowd avoidance mandates; some chose to stock up early expecting weeks of limited store access. Going forward, spending will be focused on high priority necessities, balanced against available retailer inventories and rapid increases in unemployment which shrinks overall purchasing capacity.

NATIONAL AND STATEWIDE
ECONOMIC DRIVERS

2020/21 | 2021/22

U.S. Real GDP Growth 0.1% | 2.0%

The current state of affairs in the global and U.S economy is unlike anything experienced in modern times, and like many forecasting organizations, Beacon Economics is working to fully grasp the scope of what is happening and exactly how it might shift the economic outlook. There are many potential outcomes to this crisis. And while it is easy to underestimate the resilience of the U.S. economy, that does not diminish the risks posed by the worldwide Coronavirus (Covid-19) pandemic – it is the greatest threat to the nation's economic expansion in over a decade. Despite it all, it is by no means fait accompli that the U.S. economy is about to fall into a recession of any scale, much less a major one At the center of the uncertainty are the actions being taken by businesses, consumers, and regulators to contain the disease. There have been wholesale cancelations of conferences, travel, sporting events, live entertainment, and really any forum in which large groups of people gather. Public health mandates, both voluntary and otherwise, have led many businesses to implement short run work-from-home policies for their employees and caused restaurants and bars across the nation to close temporarily. This sudden halt in economic activity will create turmoil in the economy in the coming weeks and it is highly likely that the U.S. economy will experience negative growth in the second quarter. But if the shock is short lived enough, the economy will catch up, possibly with a positive third quarter that makes up for much of the loss in the second.

U.S. Unemployment Rate 5.0% | 3.4%

The March employment numbers will surely be grim. Initial unemployment claims are already crashing some state's computer systems due to demand and will likely jump more quickly than ever before. Many businesses will continue to operate but will experience a loss in productivity driven by absent employees and the basic complications of unexpected work-from-home policies. But as dramatic as these changes are, such a shock is not necessarily recession causing. As long as current public health measures are sufficient to prevent the Coronavirus from becoming truly widespread across the nation, it is business delayed rather than business cancelled.

CA Total Nonfarm Employment Growth 1.5% | 1.3%

The fourth quarter of 2019 marked the end of ten years of strong expansion for the California economy. Over the course of the past decade, nearly 3.5 million nonfarm jobs were added to the state, at a growth rate of 23%. In the preceding decade, fewer than one-quarter of a million jobs were added to California's economy, a growth rate of 1.5%. However, the state is in a different economic reality than before the COVID-19 pandemic hit. The California economy does enter this crisis from a position of strength.

CA Unemployment Rate 4.0% | 4.0%

The big unknown is how long the shock to the economy will last. The CDC has recommended that public gatherings of more than 50 people cease for 8 weeks. In addition, we know that university closures will last for many months. While university employees will be paid, many businesses surrounding universities will be adversely affected as staff and students are their primary source of income. Coupled with federal stimulus, and a resumption of some semblance of normalcy within a couple of months, immediate economic hardship could be somewhat temporary, with consumption deferred to a later period. But those dark clouds could turn into a storm for the state's economy if this unprecedented draw down in peacetime consumption endures into the summer.

CA Median Existing Home Price $532,216 | $564,823

The state's strong fourth quarter paints a picture that is a far cry from the beginning of the year when the stock market had just seen a major correction, there was anxiety about trade uncertainty, and forecasts about a national and global slowdown were coming from all quarters. Unfortunately, the anxiety has returned due to the COVID-19 pandemic. Home prices won't drop under our baseline scenario, but the likelihood of them being affected continues to I crease the longer the situation drags on.

CA Residential Building Permits 126,449 | 131,572

The number of housing permits issued in the state peaked in the first quarter of 2018 and has trended lower since then. Even before this downturn, the state was in the midst of a housing shortage. As the shortage persists, it will create two primary effects. First, it will put upward pressure on housing prices, exacerbating affordability problems, and second (relatedly), it will shape the nature of the state's labor force.

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Beacon Economics has proven to be one of the most thorough and accurate economic research/analytical forecasting firms in the country. Their evaluation of the key drivers impacting local economies and tax revenues provides additional perspective to HdL's quarterly consensus updates. The collaboration and sharing of information between Beacon and HdL helps both companies enhance the accuracy of the work that they perform for their respective clients.