

CALIFORNIA FORECAST

SALES TAX TRENDS AND ECONOMIC DRIVERS

SEPTEMBER 2020



Yosemite National Park, 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.

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FY 20/21 & 21/22 FORECAST

As California continues to address all aspects of COVID-19, we have modified the September 2020 HdL Economic Forecast. Given the dramatic onset of the pandemic, we are sharing explanations about how second quarter 2020 sales tax results compared to our forecast for this time period. Information is summarized by major industry groups. It is our hope these explanations not only capture what occurred this past spring but will be helpful in explaining how fiscal year 2019/2020 sales and transactions tax results were affected by this public health crisis.

HdL 2Q20: Forecast vs Results

As part of preparing our April and June economic forecasts earlier this year, we acknowledged the second quarter of 2020 (April to June period) would be the bottoming out months for sales tax revenues. Beginning in March, shelter in place orders coupled with county-based health and safety decisions triggered immediate closure of businesses, a spike in unemployment and much uncertainty about economy recovery. Unlike prior calamities in our nation's history, the COVID-19 pandemic was unique for many reasons, not the least of which was closing entire industries that generate sales and transaction taxes so vital for governments to deliver public services.

The high second quarter unemployment rates were primarily felt in the lower wage service sectors which produced a lesser share of total sales tax revenues. Knowledge workers including professionals, analysts and marketers continued to work at home; they found extra cash to spend because of reduced commute and work-related costs as well as less entertainment/travel options. Though much of the quarter's government relief payments were spent largely on rents, utilities, debt, and savings, the money was not distributed proportionally to income losses, thereby also triggering temporary increases in discretionary income for some beneficiaries. Low interest rates and favorable lending practices allowed the extra money to be spent on previously put off items such as autos and home improvements.

To our surprise, the Autos/Transportation results were better than expected in the second quarter of 2020. While new vehicle sales were reported to be down 34% nationally, auto-related tax receipts dropped only 17% in California. Car dealers proved adept at transitioning to online sales; unprecedented government stimulus and rock-bottom interest rates were effective in avoiding worst-case possible outcomes. Furthermore, consumers had more disposable income to spend after the cancellation of vacation plans. Many thought it could be a good time to find a deal, taking advantage of attractive manufacturer incentives. Some bought a new car to avoid public transportation and ride hailing services. Others justified their purchase as an escape, wanting a new vehicle for road-trips. Recreational vehicle and boat sales were especially strong as families looked for new activities to share. Finally, car pricing has hit record levels after automotive production was curtailed earlier this year while manufacturers worked to make assembly-lines safe and, in some cases, temporarily transitioned to the fabrication of medical equipment.

Second quarter results from Building/Construction were 3.3% lower than this time last year, right in line with forecast assumptions. Activity temporarily dipped following two months of job site shutdowns ordered in six Bay Area counties and a 5% decline in Los Angeles county output. Around the interior of the State, from Central California to the far northern areas, construction spending increased. Meanwhile, statewide consumer spending on home improvements drove up returns at outlets which posted record gains as home improvements occurred at a robust pace.

The Business/Industrial group reduction was slightly less than projected because of unanticipated increases in agricultural related expenditures and demand for equipment, supplies and technology to accommodate work and school at home conversions. One-time transit projects also produced temporary gains for the group overall.

Lack of dining opportunities along with stay at home mandates drove sales from full-service grocery stores up by 8%. Cannabis retailers were deemed essential; the addition of new merchants partially contributed to the 40% growth by this sector. Overall performance of the Food/Drugs group was slightly better than our estimates.

The full brunt of COVID-19 struck the Fuel and Service Stations industry hard during this time. While regular and diesel gas pump prices in California began to go back up at the beginning of the quarter, this did not translate into an increase in sales tax associated with fuel. People stayed home and did not travel or participate in many road trips. The airline and travel industries were hit hard, and this translated to lower sales tax on jet fuel. Total sales tax in the industry dropped 47% in the quarter completely attributable to lack of demand and consumption of fuel. Results varied in different parts of the State, depending upon the severity of shelter in place orders, local reliance on workers and facilities that supplied diesel fuel for the trucking industry.

General consumer goods receipts did better than projected declines, coming in 38% lower than the same period in 2019. Categories that exceeded expectations included electronics, home furnishings, sporting goods, and specialty stores. Statewide, these categories still reported extreme losses ranging from declines of 36% to 51%. Sporting goods/bike stores decreased only 11%. As households became local offices and learning centers it was clear spending shifted to categories that improved these spaces like home furnishings. Discount department stores, expected to perform well, grew market share and accounted for over 43% of revenue in from this group. Overall big box retailers declined which is attributed to reduced fuel consumption/prices that are combined with store transactions reported by some companies.

Restaurant spending hit a low point in April. The varying levels of restrictions across the state resulted in varying performance for restaurants in the second quarter. Restaurants in the Far North, Sacramento region and San Joaquin Valley were not hit as hard as the rest of the State. These areas boosted the statewide losses. Diners were anxious to return to restaurants and rushed to eat out during the re-opening in June. This behavior proved to be a momentary lift on restrictions, but provided a much needed, albeit small boost to casual and fine dining at the end of the quarter.

Our forecast for State and County Pools was inclusive of the Wayfair decision for both remote sellers plus newer marketplace facilitator taxpayers. Expectations were housebound families would be more judicious in spending, focusing on essential products and limiting discretionary spending. However, robust shopping pushed this group up 29%. Record numbers of online customer accounts were created during the shelter weeks. Online sales from segments like shoes, furniture, leisure wear and exercise equipment were beyond expectations. The largest impact emerged from general retailers who exceeded estimates; revenues from this sector rose \$71 million, a 264% improvement. Significant store closures across the State along with generous temporary unemployment benefits helped spur a greater than anticipated growth by the pools.

Pandemic based sales tax outcomes over the last two quarters of fiscal year 2020/21 have influenced our most recent September economic forecast. While these projections are a statewide perspectives, we remained focused on fine tuning budget estimates and addressing unique concerns based upon the expectations and needs of each client.



HDL CONSENSUS FORECAST – SEPTEMBER 2020

STATEWIDE SALES TAX TRENDS

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 **TOTAL** 2020/21 | 2021/22
0.6% | 8.4%



Autos/Transportation

2020/21 | 2021/22

0.7% | 4.4%

Vehicle sales have bottomed and are beginning a recovery that will take 2-3 years, according to forecasts from WardsAuto and the Center for Automotive Research. High consumer debt and work-from-home policies are likely headwinds, but sales will be pushed forward by strong natural demand. Recent surveys indicate the biggest concern for car dealers is not economic issues but a shortfall of popular SUV and truck models on dealership lots after production was disrupted earlier this year. Consequently, vehicle pricing is at record levels. While lack of choice and fewer incentives may temporarily hamper sales, the higher pricing will be supportive of tax receipts going forward. Production issues should also be resolved in time, with WardsAuto reporting that North American factories recently reached 100% capacity utilization for the first time since 2005.



Building/Construction

1.6% | 5.0%

Despite seven straight quarters of declining construction permit issuance, delays caused by Covid-19 workplace standards slowed projects enough to create a backlog that will mask the decrease of future development inventory through November for the Bay Area and Southern California regions. Between January and June, expect Bay Area and Southern California total construction levels to remain static while outlying areas will see growth because of the continuing need for affordable housing. Reconstruction of fire damaged structures should begin within 6 months after the fires are completely extinguished.



Business/Industry

0.4% | 6.0%

Initial recovery is primarily related to accommodation of pandemic and climate-related changes. Strong demand for warehouse and shipping technology and equipment support the shift to online shopping in addition to home offices and virtual classrooms. Climate induced investment in irrigation and agricultural technology remains. Anticipate a strong rebound in medical equipment and pharmaceuticals once pandemic controls allows return of elective and non-emergency medical procedures. Unprecedented fires and hurricanes may temporarily close some production capacities and cause new supply chain interruptions. Expect uneven gains through fiscal year 2020-21 with overall improvement not until 2021-22. Each jurisdiction's experience will differ according to the size and character of its specific business/industrial base.



Food/Drugs

2020/21 | 2021/22

3.5% | 3.0%

Most entities within this group remained open as essential businesses during the shelter in place orders. As such, people had to adapt to eating at home more often; this trend should continue for grocers and food sellers who have ramped up home delivery in a big way. Cannabis companies are adding new tax revenues as more establishments become open with approval from local jurisdictions. Drug store consolidations or reductions are likely in over-saturated markets.



Fuel/Service Stations

-5.9% | 12.2%

Oil demand and consumption has plummeted throughout the globe. OPEC eased back production by two million barrels per day in early August. Saudi Arabia sees fuel demand wavering among the coronavirus flare-ups around the globe; they cut pricing for October oil sales. Inventory levels for U.S, European and Asian producers are above levels for what is typical right now. United States production slowed from a year ago. COVID-19 has significantly curtailed demand for jet fuel. With economic signs reflecting downward pressure on the fuel industry, we forecast taxes declining for the next three quarters with recovery beginning in the spring of 2021.



General Consumer Goods

1.5% | 9.4%

Brick & mortar's turbulence lingers as merchants navigate economic headwinds while trying to balance reopening stores with public health and safety concerns. Consumer spending saw a quick recovery in June as retailers began opening doors but has leveled off since July at just under 15% of pre-COVID levels. New demand for electronics, appliances, and home furnishings spurred by the need to create work from home and virtual learning environments are anticipated in the short term. Federal stimulus combined with a lack of outlays on fuel and entertainment allowed households to make use of excess discretionary income. Initial third quarter reports show spending being tempered as unemployment benefits expired and consumer confidence staggered to a six-year low. Our projections have tax volumes staying below the pre-pandemic peak through fiscal year 2021-22.

HDL CONSENSUS FORECAST – SEPTEMBER 2020

STATEWIDE SALES TAX TRENDS

HdL Companies

 **2020/21 | 2021/22**
TOTAL 0.6% | 6.4%



Restaurants/Hotels

2020/21 | 2021/22

-15.5% | 20.1%

Restaurant spending has slowly started improving, but the Governor's Blueprint for a Safer Economy imposes capacity limits for indoor dining with the best scenario allowing indoor dining at 50% capacity. The CDC has released a study that is leading health officials to state that eating out is one of the riskiest activities for COVID. Large gatherings are still not allowed. As Paycheck Protection Program (PPP) loans run out, many types of restaurants are facing dire situations; the forecast assumes that 20% will not survive the restrictions. Restaurants with drive-thrus are a valuable asset and are performing better. The unknown timing for indoor dining and the changing weather ahead present the next obstacles for restaurants. The industry is being hit hard and the recovery will lag far behind other industry groups.



State and County Pools

2020/21 | 2021/22

12.9% | 8.0%

Thrust forward by the pandemic, online sales still dominate a growth pattern in contrast to most of the on-the-ground retailer's short-term declines noted above. Recent shelter in place mandates created some category winners, especially from direct to consumer and marketplace facilitator companies. The coronavirus spurred many more customers shopping on the web while much of the retail industry addresses location closures, layoffs and bankruptcy. The final implementation of the Wayfair decision in California occurs in the first months of fiscal year 2020-21 and will influence the forecast for that year. Thereafter, consumer's behavior continues a steady ascent into more essential and discretionary spending away from stores; next year's increase reflects this trend.

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 increase of 0.32% for Fiscal Year 2020/2021 and 8.42% for 2021/2022.

NATIONAL AND STATEWIDE ECONOMIC DRIVERS



U.S. Real GDP Growth

2020/21 | 2021/22

12.4% | 2.4%

One month the economy was fine, the next it was in complete freefall. With the second quarter behind us, we have a good idea of the damage generated by the pandemic – output dropped almost 12% from the fourth quarter of 2019 to the second quarter of 2020, the sharpest decline ever recorded. The big question is where does the economy go from here? A collapse in consumer spending occurred, but not because people couldn't spend money (driven by a collapse of wealth), but because fear and caution surrounding the disease itself prevented them from spending. A prime example is the healthcare industry. Over one-third of the decline in consumer spending occurred from a drop in healthcare consumption. Healthcare is not a cyclical sector and did not experience a single quarter of lower spending in previous cycles. Therefore, the hit this time was not driven by reduced demand but because the healthcare system deferred non-essential visits until the virus was brought under control. So to answer the big question – there will be a bounce in economic activity in the second half of 2020, aided by the resumption of delayed spending.



U.S. Unemployment Rate

7.2% | 5.1%

As dramatic as the second quarter numbers have been, there is plenty of evidence indicating that the shocks to the economy are largely transitory. The enormous surge in unemployment was not driven by true job losses but by temporary layoffs. At 14.7% in April 2020, the U.S. unemployment rate reached a post-WWII high. However, in the subsequent months, the unemployment rate has steadily and consistently declined to 8.4% as of August 2020, as businesses continue to reopen and economic activity continues to resume. Additionally, the share of the labor force that was truly unemployed – either lost their job permanently or have entered the labor market and are looking for work – was roughly 3% in April, substantially lower than the 8% plus rate seen back at the peak of the Great Recession. In a less positive sign, the unemployment rate for those who are truly unemployed increased in the following months, reaching 4.1% in July.



CA Total Nonfarm Employment Growth

-2.3% | 4.4%

California's labor market began to recover from the effects of the COVID-19 pandemic in May and has continued that recovery through August, adding 885,000 jobs. There was a slowing of job growth through July and August, but that was in large part a reaction to the resurgence of the virus in the form of renewed public health mandates. Yet, even with this moderation in employment growth, the previous four months account for some of the strongest month-over-month job gains in the state's history. Notwithstanding these record-breaking gains, California has only regained 33% of the jobs that were lost in March and April. Considering the trauma sustained by the state's economy, the key question centers on how long it will take the labor market to recover. Simply put, the roughly 2.6 million jobs lost in March and April will not return over night, even after the spread of the virus is fully contained. Indeed, about 100,000 jobs were added to the state's economy in August, and while this is a positive sign, if the state continues to add jobs at this rate, it will take until the second half of 2021 to reach February 2020 levels.



CA Unemployment Rate

2020/21 | 2021/22

9.9% | 7.4%

One ostensibly positive sign is that the state's unemployment rate fell to 11.4% in August, a 4.1-percentage-point decline relative to April, although this remains a far cry from the 3.9% rate enjoyed one year ago. It could be the case that the month-over-month decline was driven more by a decline in the state's labor force than by an increase in employment. California's labor force – the sum of the state's employed and unemployed – contracted for the second consecutive month, losing 117,100 workers in August. From a year-over-year perspective, the labor force has declined by 3.7% – a steeper drop relative to the 1.9% decline in the nation overall. Since February, the number of people looking for work in the state has fallen by 807,000, a sign that many workers have become discouraged and have stopped actively looking for employment. A possibly better sign is that 50% of the state's unemployed workers report their layoff as temporary, and that they should be returning to work in the coming months. Notably, however, in April more than 70% of the state's workers described their unemployment in these terms. The shrinking number of people who identify as being temporarily unemployed creates concern that many existing layoffs are turning permanent.



CA Median Existing Home Price

\$505,006 | \$527,356

While the impact of the pandemic has been broad-based throughout the economy, the impact on the residential housing market has been relatively mild. Homebuyer sentiment took a hit in the early months of the pandemic, as buyers and sellers grappled with the new constraints of homebuying in a pandemic. Statewide, year-over-year home price appreciation fell to 0.7% in the second quarter of 2020, the lowest rate recorded since the 2008-09 recession. Meanwhile, home price growth tracked into negative territory on a quarterly basis, falling 4.1% from the first quarter to the second quarter of 2020. Fortunately, California's housing market is recovering swiftly, in tandem with the nation as a whole.

Monthly data show home sales in a high growth climate, with significant activity occurring in more rural parts of the state such as the Central Coast, Sierra/Gold Country, and north Bay Area counties. Prices are recovering as well. The resumption of sales at higher ends of the market is helping prices increase overall, while the persistence of low housing inventory adds upward price pressure in response to the surge in demand.



CA Residential Building Permits

92,879 | 108,215

The COVID-19 pandemic has had less of an impact on the residential housing market than most other sectors of the economy. The quintessential V-shape recovery seen in home prices and sales testify to this dynamic. Residential construction activity in California declined in the second quarter of 2020, (despite most construction activity being deemed "essential"), and the state permitted roughly 5,000 fewer permits relative to the first quarter of the year. Thereafter, residential permitting has recovered rapidly, returning to pre-COVID levels in July. Beacon Economics considers housing to be among the least affected sectors going forward.

HdL Companies

120 S. State College Blvd., Suite 200

Brea, CA 92821

Telephone: 714.879.5000 • 888.861.0220

Fax: 909.861.7726

California's allocation data trails actual sales activity by three to six months. HdL compensates for the lack of current information by reviewing the latest reports, statistics and perspectives from fifty or more economists, analysts and trade associations to reach a consensus on probable trends for coming quarters. The forecast is used to help project revenues based on statewide formulas and for reference in tailoring sales tax estimates appropriate to each client's specific demographics, tax base and regional trends.

Beacon Economics LLC

5777 West Century Boulevard, Suite 895

Los Angeles, CA 90045

Telephone: 310.571.3399

Fax: 424.646.4660

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 between Beacon and HdL helps both companies enhance the accuracy of the work they perform for their clients. In addition to forecasting, Beacon specializes in economic impact analysis, sustainable growth and development, housing and land use, and regional economics.



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