

# Economic Development Board

Volume 3, Issue 2, Fall 2004

## Local Economic Report Series Fall 2004



Presented By  
Sonoma County Economic Development Board  
in partnership with  
Sonoma County Workforce Investment Board



October 2004

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the Fall 2004 edition of the *Sonoma County Local Economic Report*. This report has three sections. Our research partner, Economy.com, provides an analysis on the local economy in the first section. In section II, Robert Eyster, chair of the SSU department of economics, provides a perspective on local economic conditions. This is followed by Brad Zigler's summary on stock performance of Sonoma County companies in section III.

*Key highlights from Economy.com's Local Economic Report include:*

- Sonoma County's economic outlook is moderately positive, with the worst of the economic downturn over. While near-term growth will be moderate, the economy is expected to improve over the long-term.
- One of the most positive signs of improvement in the economy is growth in the region's industrial production. Despite low market prices and strong competitive pressures, the vitality of many of the county's primary industries is recovering. These industries include wine production, telecommunications equipment and medical instruments.
- Business bankruptcy filings have fallen by more than one-third over the past year, which may portend fewer closings and fewer payroll cutbacks in the near term.
- Housing demand appears strong as price appreciation exceeds 15% and shows little sign of slowing. Additionally, multifamily home construction has accelerated, reflecting a shift to accommodate affordability.

Thank you for your continued interest in Sonoma County's economy and the Economic Development Board's research efforts. As always, if you have any questions or comments please feel free to contact me at (707) 565-7170.

Yours sincerely,



Ben Stone  
EDB Director



**With Acknowledgment and Appreciation to the Underwriters of the  
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# Economic Development Board

Volume 3, Issue 2, Fall 2004

## Section I:

# Local Economic Report

Prepared for the Sonoma County Economic Development Board  
by: Steve Cochrane of [Economy.com](http://Economy.com)

# BROAD VIEW

## Executive Summary

The sudden slowing in the economy, which began in June, continued through August. Real GDP is currently growing at close to a 3% pace, which is off measurably from the 5% growth experienced at the start of the year and is insufficient to reduce the still large number of unemployed and underemployed.

Consumers have turned particularly cautious. Higher energy prices, the end of the tax cutting, and somewhat higher interest rates are all weighing on spending. Same-store chain store sales and vehicle sales are flat from a year ago, despite increasingly aggressive discounting.

Businesses have seemingly been taken by surprise by the suddenly more reticent consumer, as inventories have surged this summer. Inventories of vehicles and consumer-related tech products are notably overladen. This will weigh on production and jobs in the coming months.

This is a bit disconcerting given that stronger job growth is necessary to ensure that the expansion remains intact, let alone thrive. Underlying job gains appear to be hovering near 150,000 per month. This is barely enough to generate the gains in wage income necessary to keep consumers spending and the expansion moving forward.

**The wherewithal.** Businesses are expected to become more aggressive in their hiring. This optimism is largely based on businesses' strong financial positions characterized by ample cash flow and clean balance sheets.

Corporate profits and cash flow have surged. Since bottoming out nearly three years ago, after-tax profits have risen by nearly 75%. Only one other time, in the wake of the early 1970s recession, have profits expanded as much for as long.

Driving profitability is consistently robust productivity gains, which when combined with unchanging labor compensation growth, have resulted in falling unit labor costs. The nearly four-year slide in such costs is unprecedented. Falling interest payments due to low interest rates and weak borrowing and the lower U.S. dollar that has lifted overseas profits are also adding to bottom lines.

Cash flow is also receiving a boost from the accelerated depreciation tax benefit businesses receive on any investment they make in equipment and software before year's end. This benefit has substantially

reduced businesses' tax bill this year, pushing the effective corporate tax rate to a record low.

With so much cash, businesses have little need for credit. Commercial banks are still having difficulty making commercial and industrial loans, and there is little net new issuance of corporate bonds. Total liabilities of nonfinancial corporations are barely growing. What short-term liabilities businesses do have are increasingly covered by their liquid assets. The quick ratio, which is the ratio of liquid assets to short-term debt, has soared and is currently as high as it has been in well over 30 years.

Businesses' pristine financial health is evident in the lack of any financial problems. Net chargeoff rates on C&I loans have fallen sharply and corporate bond defaults are increasingly rare. The yield spread between lower-rated corporate bonds and risk-free Treasuries, a measure of investors' credit concerns, has declined sharply over the past year and is currently as low as it has been since the 1998 Asian financial crisis and Russian bond default.

**But unwilling.** The impediment to stronger growth is thus not businesses' abilities to expand, but their willingness. Business confidence seemingly remains fragile, easily shaken if sales do not come in according to plan.

This is evident in the recent weakening in Economy.com's weekly survey of business confidence. The survey, which began in late 2002, has close to 250 respondents each week. Respondents are generally mid- and high-level business managers in a wide range of industries in all parts of the world, although a substantial majority is from the U.S. Nine questions are posed in the survey, ranging from broader questions regarding current conditions to more specific questions regarding hiring and investment decisions.

Responses to the survey have turned notably less positive since peaking this past May. Confidence is off across the globe and all industries. Businesses' assessment of current conditions has experienced the sharpest decline. Less than 30% of respondents currently believe that conditions have improved since the last time they took the survey, while 20% said they have weakened. This is the highest percentage of negative responses since last April during the height of the Iraq War, and the net of 10% is the lowest since last October.

Businesses have also turned appreciably less optimistic regarding their prospects later this year and early next. Expectations peaked at the end of 2003, presaging the very strong conditions that prevailed through this past summer. The recent decline in expectations augurs poorly for future growth.

Across all nine questions, the difference between the percentage of positive responses and negative responses has fallen to 30% on a four-week moving average basis. This compares to this past spring's peak of 40% and the low of 5% recorded during the height of major hostilities in Iraq in the spring of 2003. Survey readings of over 40% are consistent with a booming economy, while a reading below 10% is consistent with recession. Readings between 10% and 25% (the average reading over the more than a year-and-one-half that the survey has been conducted) are consistent with a growth recession.

While the current 30% reading is thus consistent with an expanding economy, the recent weakening in business confidence signals that the strong growth experienced during the past year has and will continue to moderate.

**Conclusions.** That businesses have the financial wherewithal to expand ensures that the expansion will continue. The expansion will remain disappointing, however, until businesses become more willing to put their financial firepower to work.

This should happen with time. Businesses are surely still smarting from the events of the past several years. The corporate accounting scandals and the aggressive legislative and regulatory response are likely still weighing on psyches. Latent concerns regarding terrorism are also proving hard to shrug off, and even the heightened political rancor in the lead-up to the election may be fueling some angst. Barring any future major shocks, however, these fears will fade and the economy will eventually regain its form.

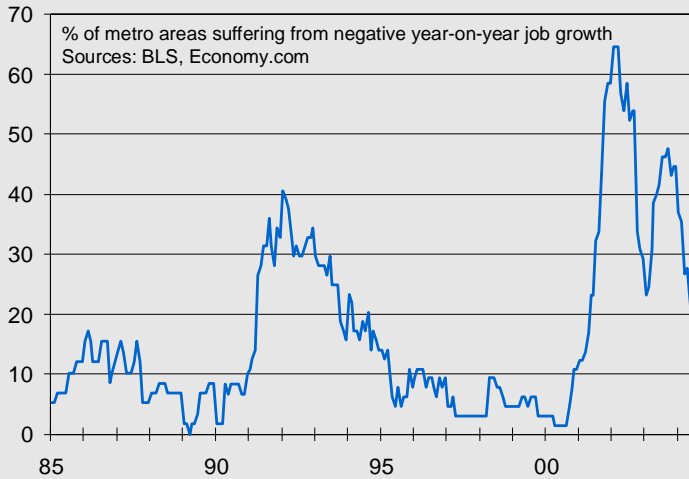
There is a not inconsequential risk, however, that businesses' skittishness may derive from more fundamental persistent worries ranging from the cost of healthcare and pensions for their employees to their ability to rely on cheap energy. The economy's prospects will then more closely hinge on whether policymakers will be able to address these quickly intensifying economic challenges.

*Mark M. Zandi  
September 2004*

# BROAD VIEW

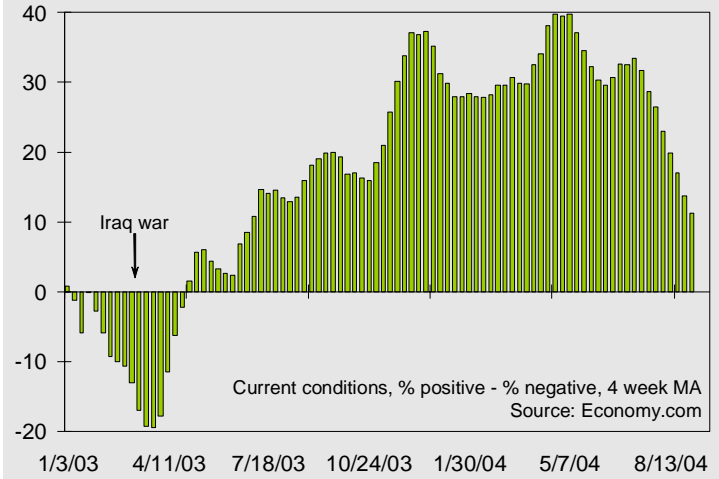
## Executive Summary

### On the Mend, but It's Been Disappointing



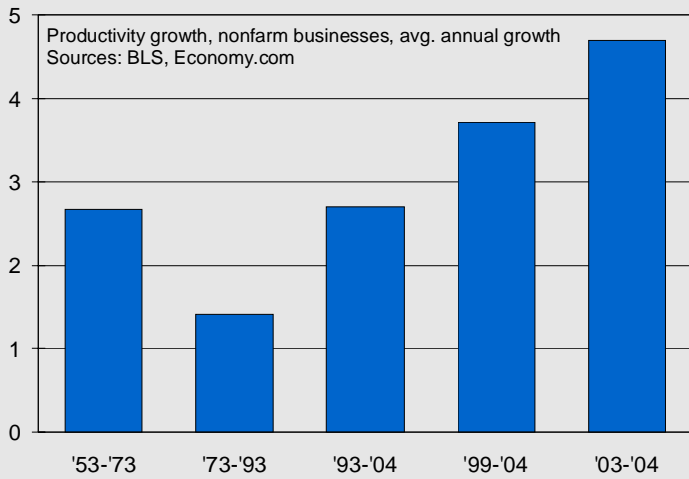
The economy continues to expand, but the expansion remains disappointing. After a brief period of strong growth following the end of major hostilities in Iraq, the economy has suddenly turned softer. Retail sales, vehicle sales, factory orders, employment, and a host of other indicators have posted only modest gains since the spring. The expansion's disappointing progress is evident regionally. Some one-fourth of the nation's over 300 metro areas are still experiencing year-over-year job declines. While down substantially from the 2001 recession, this remains high by the standards of past expansions.

### Business Sentiment Is Slipping



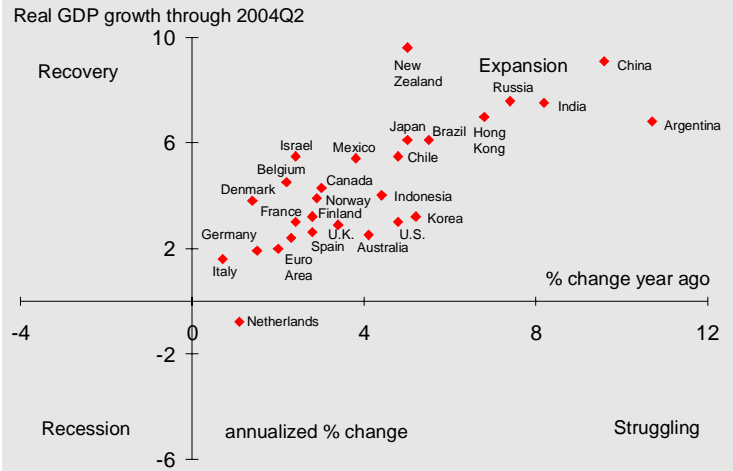
Weighing on the expansion is fragile business confidence. Responses to Economy.com's weekly global business confidence survey have weakened measurably since the spring. Businesses have turned particularly less upbeat regarding current conditions. Only just over 10% more of the responses to the nine questions posed in the survey are positive than negative, down from an early May peak of 40%. Cautious businesses are an impediment to stronger growth, as they remain unwilling to aggressively expand investment and hiring.

### Fundamental Reason for Optimism



Despite the economy's difficulties, it remains fundamentally strong. This is evident from the ability of the economy to generate robust productivity gains. Productivity growth over the past decade has averaged over 2.5% per annum, and over the past five years, growth has accelerated to over 3.5% annually. Productivity gains have slowed sharply in the past couple of quarters, but this reflects temporary cyclical factors. The incorporation of IT technology into various business practices, the principal driving force behind the gains, continues apace.

### Strong Global Economy



The U.S. economy should also receive a lift from a better global economy. For the first time since the late 1980s, the entire global economy is experiencing consistent growth. China and India are leading the way, but growth has accelerated in economies ranging from Brazil and Argentina to Australia and Indonesia. The important Canadian and Mexican economies have also strengthened. Only the continental European economy continues to lag, but even this economy is now growing. Stronger overseas economies combined with a weaker U.S. dollar should continue to fuel U.S. exports.

# SONOMA COUNTY

**EMPLOYMENT GROWTH RANK**  
Best=1 Worst=325

2003-05

**246**  
4th quintile

2003-08

**68**  
2nd quintile

**MSA LIFE CYCLE PHASE**  
Growth/Mature

Best=1 Worst=325

**VITALITY**

**284**  
5th quintile

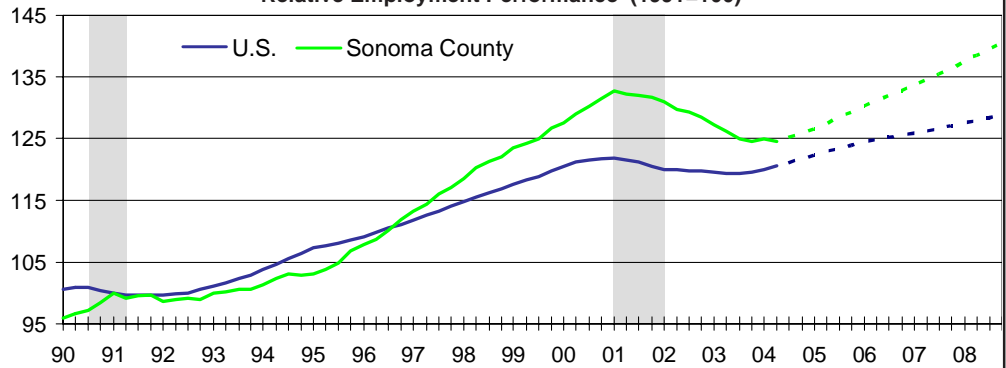
**COST OF DOING BUSINESS**

U.S. = 100%  
**118%**

**COST OF LIVING**

U.S. = 100%  
**127%**

## Relative Employment Performance (1991=100)



1997	1998	1999	2000	2001	2002	2003	Indicators	2004	2005	2006	2007	2008
10.9	11.8	12.7	14.3	14.3	14.5	14.5	<b>Gross Metro Product, C\$B</b>	14.8	15.3	16.0	16.7	17.4
9.8	8.1	7.5	12.6	0.3	0.9	0.6	<b>% Change</b>	1.8	3.7	4.2	4.3	4.4
165.4	173.0	179.3	186.1	189.8	186.2	180.6	<b>Total Employment (000)</b>	179.7	183.7	188.9	193.9	199.5
5.0	4.6	3.6	3.8	2.0	-1.9	-3.0	<b>% Change</b>	-0.5	2.3	2.8	2.7	2.9
3.8	3.3	2.7	2.6	2.9	4.5	4.9	<b>Unemployment Rate</b>	4.5	4.3	4.2	4.0	3.8
9.4	8.4	5.8	14.8	2.6	1.1	1.8	<b>Personal Income Growth</b>	5.7	6.0	5.7	5.9	6.0
437.1	445.9	453.4	460.3	465.6	465.9	466.7	<b>Population (000)</b>	473.1	482.6	493.3	503.0	513.1
1,785	2,098	2,348	2,013	1,717	1,350	1,503	<b>Single-Family Permits</b>	1,272	1,912	1,878	1,856	1,927
176	964	688	492	866	578	749	<b>Multifamily Permits</b>	881	630	620	697	748
204.9	224.7	259.6	324.5	363.0	381.3	420.3	<b>Existing Home Price (\$Ths)</b>	462.5	472.8	486.7	502.7	519.3
2,839	5,163	4,499	3,990	8,651	10,372	13,808	<b>Mortgage Originations (\$Mil)</b>	6,488	3,061	3,102	3,352	3,692
7.0	7.1	6.0	5.3	3.6	-1.5	-0.8	<b>Net Migration (000)</b>	4.7	7.7	8.9	7.7	7.8
2,090	2,173	1,627	1,158	1,183	1,223	1,300	<b>Personal Bankruptcies</b>	1,218	1,086	1,043	1,059	1,041

## STRENGTHS & WEAKNESSES

### STRENGTHS

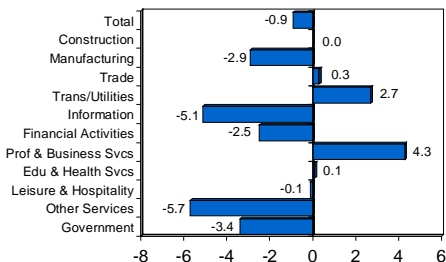
- High per capita income.
- High educational attainment of workforce.
- Attractive environment.
- Multiple basic industries drive economy.

### WEAKNESSES

- Global wine prices still weak.
- High cost of living.
- Complex regulatory environment.
- Local government finances constrained by state budget crisis.

## CURRENT EMPLOYMENT TRENDS

### July 2004 Employment Growth % Change Year Ago, 3 mo MA



## FORECAST RISKS

SHORT TERM ↑ LONG TERM ↓ RISK-ADJUSTED RETURN, '03-'08 **0.73%**

### UPSIDE

- Business investment quickly accelerates for high-tech telecom and optical equipment.
- Improving U.S. income growth boosts hospitality and wine industries more strongly than expected.

### DOWNSIDE

- Housing market suffers price correction as interest rates rise, while economy remains weak.
- Global business investment falters, limiting tech/telecom recovery.

## ANALYSIS

**Recent Performance.** The worst of the downturn is over for Sonoma County (SON). Employment has leveled off since late last year, although no discernable upward trend is evident yet. Moreover, the size of the total labor force continues to shrink, indicating the economy is weak enough so that job seekers are searching elsewhere for employment. The number of personal bankruptcy filings continued to rise through the second quarter indicating continued stress on household finances. This trend occurs despite the support to homeowners' equity from house-price appreciation in the mid-teens. On the positive side, industrial production is rising, although its rate of growth is slower than the national average. Further, the number of business bankruptcy filings has fallen by more than one-third over the past year, which may portend fewer closings and fewer payroll cutbacks in the near term.

**Technology.** Indeed, net payroll cuts among SON's technology producers appear over. Employment in industries that produce electronic instruments has held steady since February. Thus, the nearly three-year downturn for the industry appears to be over. Biotechnology also no longer appears to create friction for the economy, at least in the near term, as Medtronic is planning a near-term expansion of R&D and marketing operations and is searching for additional space in SON. Oddly enough, this comes at a time when Medtronic still says that it will be transferring some manufacturing operations overseas, exemplifying the uncertain path that has characterized biotech for many years.

The planned Medtronic expansion also comes on the heels of broad layoffs by Agilent as they, too, have shifted manufacturing overseas. This means that on net, hiring among tech firms may not rise for some time.

**Demand trends.** The demand outlook for a number of SON's tech products will improve in the near term and the long term. The medical instruments industry already sees stronger demand in Europe and in domestic markets as the

population ages and technology improves. Furthermore, telecom and electronic equipment demand is firmer now than at any time since the 2001 recession as business investment nationwide is rising by 20% year to year. The greatest downside risk remains price constraints due to international competition and resistance in markets to higher prices. Thus, while local tech production may rise, revenue growth, and thus any new hiring, may be muted.

**Wine.** The wine industry similarly continues to face price constraints, in this case due to continued oversupply and international competition. Shipments of high-end and medium-priced wines from California rose last year, reflecting firmer consumer demand. But revenues were up by only low single-digit rates due to discounting in the market. Another positive sign is that sales through restaurants and other hospitality venues rose last year as well. Given that U.S. domestic income growth is now rising 5% over the year, versus 2% at this time last year, and that this year's domestic winegrape harvest faces a number of downside risks, wine demand and prices may firm in the coming year. Thus, the outlook for the industry continues to improve.

**Housing.** A weak economy has not stalled demand for housing. Price appreciation exceeds 15% and shows little sign of slowing yet. Single-family construction has slowed in recent months and multifamily has accelerated, reflecting a shift to accommodate deteriorating affordability.

**Overall, the outlook is moderately positive for Sonoma County. Generating some upside potential for the economy longer term is continued strong domestic investment spending and improved overseas markets, which will support electronics and telecom equipment. While near-term growth will be moderate, the economy is expected to outperform over the long term.**

Steven G. Cochran  
September 2004

## EMPLOYMENT & INDUSTRY

### TOP EMPLOYERS

Agilent Technologies, Inc.	2,500
St. Joseph Health System	2,370
Sonoma State University	1,799
Kaiser Permanente	1,423
Optical Coating Laboratory	1,300
JDS Uniphase Corporation	1,220
Safeway, Inc.	1,218
Medtronic, AVE	1,200
Kendall-Jackson Wine Estates	900
Sutter Medical Center	859
State Farm Insurance Company	846
Albertsons, Inc.	770
Target Corporation	724
Amy's Kitchen	650
Hansel Dealer Group	650
Advanced Fibre Communications	600
SBC Communications, Inc.	600
Longs Drug Stores, Inc.	585
Cisco Systems, Inc.	550
Home Depot	550

Sources: North Bay Business Journal, February 2004 & The Santa Rosa Press Democrat, June 2003

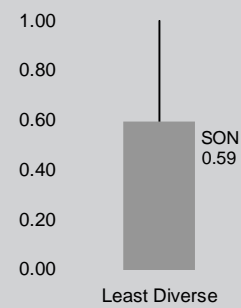
### Public

Federal	1,750
State	5,710
Local	19,335

2003

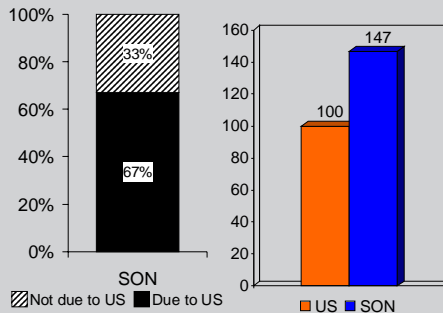
### INDUSTRIAL DIVERSITY

Most Diverse (U.S.)



Least Diverse

### EMPLOYMENT VOLATILITY DUE TO U.S. FLUCTUATIONS RELATIVE TO U.S.

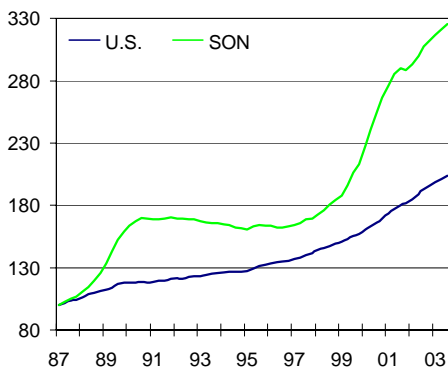


## COMPARATIVE EMPLOYMENT AND INCOME

Sector	% of Total Employment			Average Annual Earnings		
	SON	CA	US	SON	CA	US
Construction	7.1%	5.5%	5.2%	\$51,765	\$51,381	\$42,625
Manufacturing	13.9%	10.7%	11.2%	\$60,725	\$63,009	\$56,809
Durable	54.4%	63.5%	61.8%	nd	\$70,713	\$58,993
Nondurable	45.6%	36.5%	38.2%	nd	\$49,416	\$53,244
Transport/Utilities	2.1%	3.3%	3.7%	\$44,118	\$54,465	\$50,127
Wholesale Trade	3.4%	4.5%	4.3%	\$50,371	\$58,305	\$57,061
Retail Trade	13.2%	11.0%	11.5%	\$29,291	\$30,893	\$25,599
Information	2.2%	3.3%	2.5%	\$61,085	\$82,441	\$67,026
Financial Activities	5.7%	6.2%	6.1%	\$36,538	\$47,817	\$47,280
Prof. & Business Services	10.4%	14.6%	12.3%	\$39,751	\$50,577	\$47,113
Education & Health Services	12.5%	10.7%	12.8%	\$37,025	\$40,628	\$37,101
Leisure & Hospitality Services	10.9%	9.7%	9.3%	\$15,888	\$21,080	\$18,105
Other Services	3.5%	3.5%	4.2%	\$24,154	\$23,760	\$22,665
Government	14.8%	16.8%	16.6%	\$47,726	\$53,093	\$47,365

Source: Percent of total employment - Economy.com & BLS, 2003; Average annual earnings - BEA, 2002

### HOUSE PRICES



Source: OFHEO, 1987Q1 = 100, NSA

### LEADING INDUSTRIES

NAICS	Industry	Employees (000)
7221	Full-Service Restaurants	6.9
3121	Beverage Mfg.	6.1
FR	Farms	5.4
4451	Grocery Stores	5.2
PH	Private Household Workers	3.9
2360	Construction of Buildings	3.6
6211	Offices of Physicians	3.6
3345	Navig., Measuring & Control Instr. Mfg.	3.4
5617	Svcs. to Buildings & Dwellings	3.4
7211	Traveler Accommodation	3.2
3391	Medical Equipment & Supplies Mfg.	3.1
4521	Department Stores	2.8
2383	Building Finishing Contractors	2.7
8111	Automotive Repair & Mainten.	2.4
4441	Building Material & Supplies Dealers	2.3
	High-tech employment	12.5
	As % of total employment	6.5

Source: BLS, Economy.com, 2003

### CREDIT QUALITY

FITCH	MOODY'S
N/A	COUNTY Aa2

## MIGRATION FLOWS

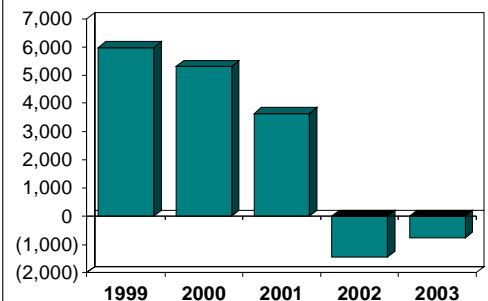
Into Sonoma County	Number of Migrants	Median Income
San Francisco	3,662	39,588
Oakland	1,233	31,640
Vallejo	834	31,768
San Jose	647	43,970
Los Angeles	527	19,558
Sacramento	509	23,954
San Diego	326	18,602
Riverside	245	22,553
Orange County	210	25,749
Seattle	158	21,355
Total Immigration	14,659	26,425

### From Sonoma County

San Francisco	1,940	31,606
Sacramento	1,352	32,170
Vallejo	1,036	35,365
Oakland	931	27,778
Los Angeles	474	18,297
San Jose	445	39,558
San Diego	434	17,673
Phoenix	349	30,391
Riverside	317	24,736
Redding	303	34,687
Total Outmigration	17,318	27,050

<b>Net Migration</b>	<b>-2,659</b>	<b>-625</b>
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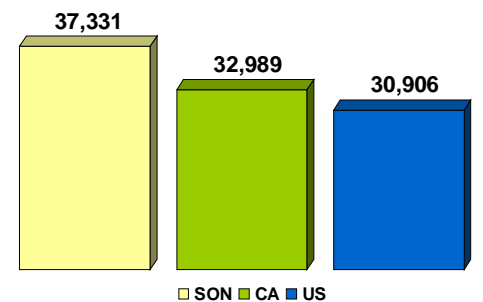
### Net Migration, SON



	Domestic	Foreign	Total
1999	2,929	3,055	5,984
2000	2,292	3,021	5,313
2001	979	2,667	3,646
2002	-4,121	2,668	-1,453
2003	-3,437	2,665	-772

Source: IRS (top), 2003; Economy.com & Census Bureau, 2003

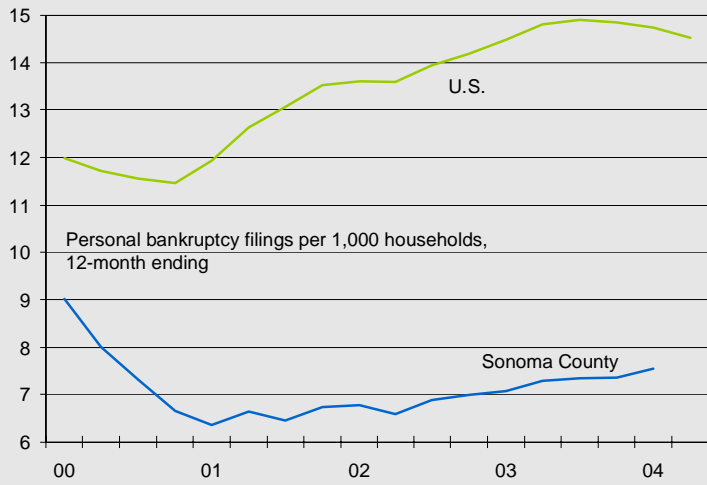
### PER CAPITA INCOME



Source: Bureau of Economic Analysis, 2002

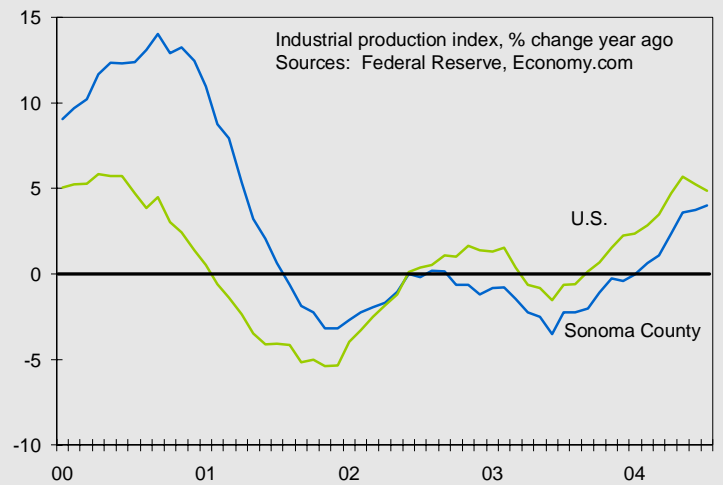
# Sonoma County

## Personal Bankruptcy Filings Low but Rising



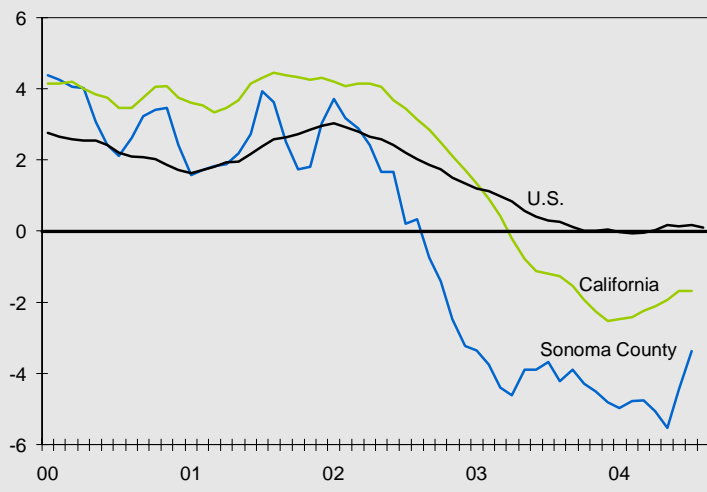
High per-capita income and rapidly rising house-price appreciation contribute to SON's low bankruptcy filing rate. Nevertheless, the rate continued to rise through the first quarter even as it fell nationwide and across California. Clearly, SON's economic recovery remains tentative and job growth has yet to turn around. Moreover, the risks are on the downside as rising mortgage rates may very soon put a halt to rising house prices so that the equity cushion no longer expands. This will become risky if the local economy remains weak in an environment of rising mortgage rates.

## Industrial Production Struggles to Catch Up



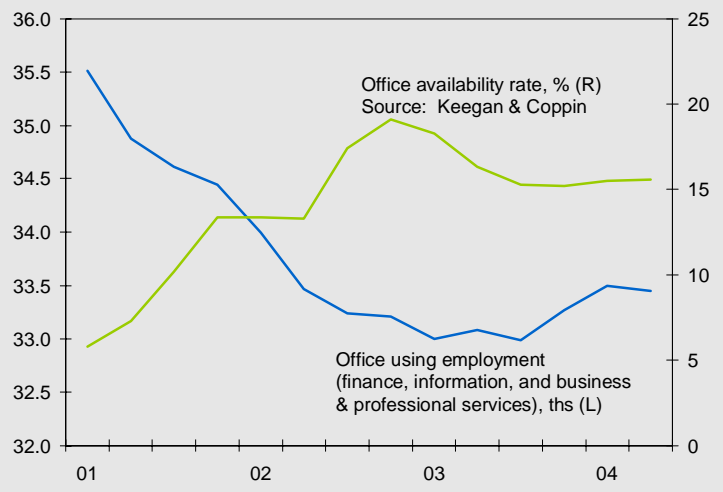
One of the most positive signs of improvement in the economy is positive growth in the region's industrial production. SON's turnaround lagged the national average by about six months, and even while its rate of growth is now positive, it is slower than the U.S. Given that the area's two major manufacturing industries, winemaking and telecommunications equipment, were hit hard by the 2001 recession, this pattern should be no surprise. SON's recovery in manufacturing will continue to lag in the near term, as low market prices and competitive pressures remain strong in these industries.

## State and Local Government Employment Gets Hit



The weak local economy and the state fiscal crisis have combined to hit SON very hard, with state and local government employment declining at twice the statewide rate. The quality and quantity of local government services contribute to both the quality of life and the business climate in a metropolitan area. Thus, there is some risk that these features could deteriorate. Quality of life is a critical factor in an area such as SON where high costs can add friction to economic vitality. Fiscal constraints may hinder local and state hiring for one more year.

## Office Market Will Improve



As elsewhere in the Bay Area, office markets deteriorated quickly with the past recession. Already there is some improvement in office vacancies and the economy has stabilized. Indeed, office space using employment has risen moderately over the past year and is expected to continue to expand in the coming year. Thus, while the vacancy rate has risen slightly in recent quarters, it should begin to improve once again in this year's second half. Following a year of virtually no new construction, permits for office construction jumped in this year's second quarter.

## Section II:

# Sonoma County Economy October 2004: Still Searching

By: Robert Eyer, Chair Economics Department  
Sonoma State University

## Sonoma County Economy, October 2004: Still Searching

The Sonoma County economy, like our macroeconomy, has yet to find an industry to lead sustained growth; however, the future looks bright for a couple of key reasons. First, personal income is rising, and strongly in comparison to the last three years. This motivates local consumption, as does slow-moving interest rates. The Federal Reserve's latest policy movements have yet to make significant differences in interest rates, especially mortgage rates. Our local housing market, like other housing markets, is a combination of supply conditions, mortgage rates, and local employment and population patterns. While we have had net emigration and mass layoffs over the last year, consumers seem to be purchasing homes and using low interest rates to refinance and consolidate debt, thus continuing to consume. This consumption pattern is also a state and national trend, helping local tourist industries which classically thrive over summer.

Second, Sonoma County seems to be through major mass layoffs and business confidence is rising in trend. As tech firms locally begin to move forward, our local economy should follow. The outsourcing (or offshoring) phenomenon was really a by-product of the last decade's growth. Localized high wages and cost of living forced employers to seek lower cost options. These problems were exacerbated by changes in California's worker compensation costs to firms. In the past, recessionary job shifts were somewhat regional; Sonoma County was the beneficiary of high wages, cost of living, and real estate prices in Silicon Valley in the mid-1990s, and took on similar characteristics thereafter. If these mass layoffs are now over, in a strange way, we should see some re-hiring: if forecast demand for biotechnology, medical, and telecommunications equipment comes to fruition, local firms will need workers. The forecast for job growth in Sonoma County is thus net positive.

There are two major caveats to that positive forecast, which do not yet make the outlook negative, and both based on uncertainty. First, interest rates have pressure to rise, the unfortunate result of government deficits and higher energy prices. The Federal Reserve has tried to provide a signal to financial markets with rate hikes recently, to speed that change. Economists hope that interest rates rise in a predictable fashion; locally, any additional uncertainty may curb hiring trends if other business costs rise in value. Second, general uncertainty over our Presidential election and international security causes some stagnation in business planning and firms using available funds for growth. Will consumer demand continue to rise if the gas price continues to rise? Will new taxes be levied by the state or federal government if a new President is elected? Will the conflicts in the Middle East remain red hot which changes international economic flows? These questions are just a few facing many local firms that drive Sonoma County's economy, from tourism to wine to biotech. Sonoma County's diversified economy cannot diversify generalized business fears that affect the US economy as a whole. Cautious optimism is a trite way of describing our current business reality in Sonoma County, but it does work. High tech is most likely the industry the US economy will follow into a sustained boom, but our recent stagnation signals that no industry has moved forward yet. Given all that, the 2005 economic results should provide a good signal for 2006 and 2007.

Robert Eyler, Chair  
Economics Department  
Sonoma State University

## Section III:

# Sonoma County Stocks In Third Quarter 2004: Still Outperforming

By: Brad Zigler, a Santa Rosa-based writer and editor  
for several financial publications

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## SONOMA COUNTY STOCKS IN THIRD QUARTER 2004: STILL OUTPERFORMING

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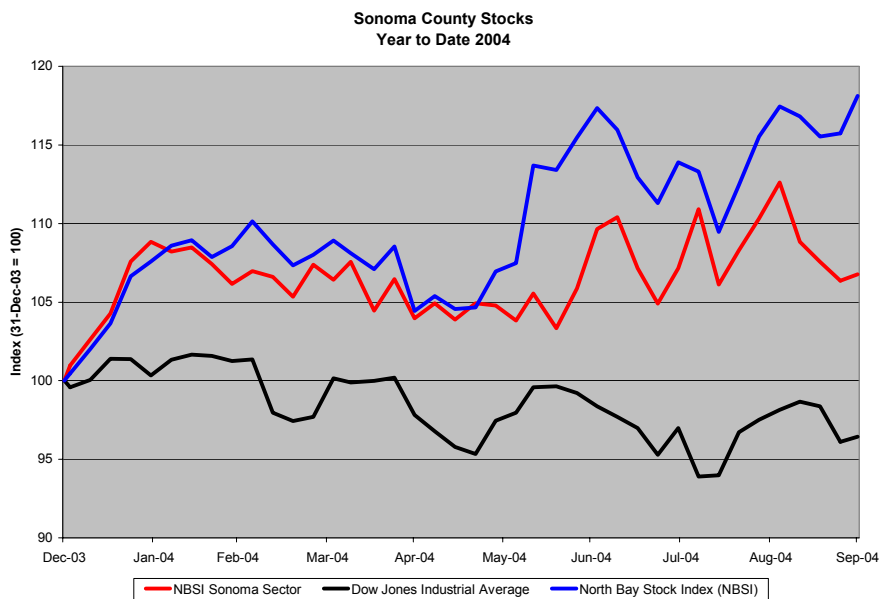
*This report was prepared by Brad Zigler, a Santa Rosa-based writer and editor for several financial publications including the Journal of Indexes, Institutional Investor, Financial Planning, Mutual Funds, Futures and Registered Rep. Mr. Zigler, previously the head of marketing, research and education at the Pacific Exchange and Barclays Global Investors, is also a columnist for the North Bay Business Journal and the creator of the North Bay Stock Index. Mr. Zigler holds positions in the Sonoma County securities mentioned in this report.*

### REWARDS AND RISKS

Local stocks continued to outperform broader market issues through 2004's first three quarters at a better pace than exhibited in 2003. Not counting dividends, the North Bay Stock Index's Sonoma Sector clocked a 6.76% year-to-date gain through September 30 compared to a loss of 3.57% posted by the Dow Jones Industrial Average. This 10.33% spread represents a near doubling of last year's outperformance when the Sonoma Sector bettered the Dow by 5.34%.

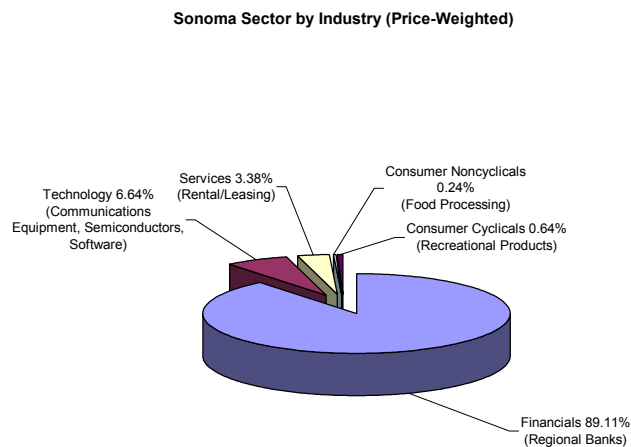
While local issues have gained ground on blue chips, they've also become riskier. Last year, Sonoma County stock volatility, measured by the standard deviation of weekly returns, was 9.32%. That figure represented a one-year prediction of price fluctuations, up or down, from the Sonoma Sector's 2003 ending level. At present, the Sonoma Sector's current gain is within those parameters: the local stock set is gaining ground at a 9.01% annualized rate.

In 2003, the payback on Sonoma stocks was 3.29 times the risk. By the end of the 2004 third quarter, however, local stock volatility nudged up to 11.05%, yielding a 0.61 reward-to-risk ratio. In contrast, the Dow's 13.68% current volatility puts the blue chip benchmark's reward-to-risk ratio, at -0.26, clearly in the red.



Year to date, the median Sonoma stock is up 10.16%. At the bottom of the heap, three stocks, representing 6.41% of the benchmark's weight, finished the third quarter in negative territory. Two of those issues, Advanced Fibre Communications, Inc. (AFCI) and etching machine producer Tegal Corp. (TGAL), were the darlings of the Sonoma Sector in 2003. The biggest gain to date in 2004, at 195.08%, was scored by alternative vehicle distributor ZAP (ZAPZ), which was 2003's worst loser. That said, the engine driving the local stock set, as well as tempering the volatility of other issues, is still the banking sector.

#### INDUSTRY BREAKDOWN



#### *Financials*

Regional banks account for 6.02% of the Sonoma Sector's year-to-date return. Contributors include:

- Northern Empire Bancshares (NREB) - Shares of Sonoma National Bank's corporate parent rose 19.65% as assets topped \$1 billion. Sonoma National also opened its first Marin County branch in July.
- Sonoma Valley Bancorp (SBNK) - A 3-for-2 stock split and a 25-cent per share cash dividend were this year's highlights as the Sonoma-based institution's stock climbed 16.86%.
- Redwood Empire Bancorp (REBC) - Up 8.65% for the year, liquidity in shares of National Bank of the Redwoods' holding company ballooned when news of its acquisition by Marin County-based Westamerica Bancorporation (WABC) was announced in August.
- Exchange Bank-Santa Rosa (EXSR) - Mining for real estate lending opportunities in the higher-growth Sacramento market has helped Santa Rosa's Exchange Bank increase revenues. The bank's stock has gained 8.47% thus far this year.

## *Technology*

Adding 0.45% to the Sonoma Sector's year-to-date return characteristics are:

- Burst.com (BRST) - This software stock's price fluctuates largely on investor confidence in the company's patent infringement lawsuit against Microsoft Corp. (MSFT). Prospects brightened this year as the stock gained 13.27%.
- Advanced Fibre Communications, Inc. (AFCI) - Tellabs Inc.'s (TLAB) \$1.85 billion bid for AFCI ratcheted down to \$1.50 billion when the Petaluma Internet-equipment maker forecast weaker-than-expected earnings. AFCI's share price has fallen 21.09% since the beginning of the year.
- Tegal Corp. (TGAL) - Declining revenues and increased expenses fueled a plunge, now at 53.79% year to date, in the share price of the plasma etch and deposition systems maker.

## *Services*

Contributing 0.23% to the Sonoma Sector's bottom line is:

- SonomaWest Holdings, Inc. (SWHI) - An 11.78% upsurge in the stock price of the Sebastopol-based commercial property lessor reflects the company's improving financial condition after finally becoming profitable.

## *Consumer Cyclical*

The Sonoma Sector's return was enhanced 0.04% by:

- ZAP (ZAPZ) - Volatility is the middle name of this Santa Rosa-based company. Over the past year, ZAPZ has traded between 15 cents and \$4.20 per share. By the end of the third quarter, ZAPZ posted a year-to-date gain of 201.64%.

## *Consumer Noncyclical*

The smallest contribution, 0.02%, to the Sonoma Sector's performance was turned in by:

- Spectrum Organic Products, Inc. (SPOP) - By September 30, the share price of the culinary oils maker had fallen 18.07% as increased raw material costs bit into margins.

## DIVIDENDS

Collectively, the annual dividend yield on Sonoma Sector stocks stood at 2.24% in the third quarter, contributed entirely by regional bank stocks.

## LIQUIDITY

Sonoma Sector stocks are decidedly smallish as far as market capitalization is concerned. Capitalization averages \$219 million currently, but with the median Sonoma County stock's market value at \$57 million, most are actually "micro-cap" issues. Stock analysts often overlook small stocks, especially micro-caps, limiting their exposure to investors. As a result, these "orphaned" stocks can often be illiquid.

Many Sonoma Sector stocks, despite their small market cap or price, exhibit surprising liquidity. The median liquidity index for county stocks now stands at 7,506 shares. The liquidity index represents the size of a transaction necessary to move a stock's price by 1%-- the higher the ratio, the more liquid the issue's market. Weighing a stock's liquidity index against its average trading volume creates a context for comparison. In that light, ZAP (ZAPZ) stands out with the county's highest coverage ratio--8.90-- while Exchange Bank-Santa Rosa's (EXSR) coverage ratio of 0.72 makes it the least liquid local stock.

#### Sonoma Sector Component Stocks

	Industry	30-Sep-04 Price	YTD Gain/Loss	Volatility	Reward/ Risk*	Avg Daily Volume	Liquidity Index
ZAP (ZAPZ)	Recreational Products	\$1.84	201.64%	159.94%	1.68	60,544	6,801
Northern Empire Bancshares (NREB)	Regional Bank	\$20.70	19.65%	31.74%	0.83	3,001	3,493
Sonoma Valley Bancorp (SBNK)	Regional Bank	\$23.10	16.86%	23.81%	0.94	482	446
Burst.com, Inc. (BRST)	Software	\$1.28	13.27%	61.28%	0.29	50,363	37,208
SonomaWest Holdings, Inc. (SWHI)	Rental/Leasing	\$9.50	11.78%	45.71%	0.34	1,090	527
Redwood Empire Bancorp (REBC)	Regional Bank	\$28.38	8.65%	21.56%	0.53	8,363	9,087
Exchange Bank-Santa Rosa (EXSR)	Regional Bank	\$128.00	8.47%	16.91%	0.67	154	215
Spectrum Organic Products, Inc. (SPOP)	Food Processing	\$0.68	-18.07%	48.89%	-0.49	26,500	8,210
Advanced Fibre Communications, Inc. (AFCI)	Communications Equipment	\$15.90	-21.09%	43.81%	-0.64	2,782,863	1,224,775
Tegal Corp. (TGAL)	Semiconductor Equipment	\$1.28	-53.79%	84.45%	-84.92	398,863	224,890
	<b>Median</b>	<b>\$12.70</b>	<b>10.22%</b>	<b>44.76%</b>	<b>0.44</b>	<b>17,432</b>	<b>7,506</b>

\* Reward-to-risk ratios are based on *annualized* returns.

#### INSIDER TRANSACTIONS

Officers and directors of Sonoma County's publicly traded companies grossed nearly \$3.8 million in profits from insider transaction in the first three quarters of this year, nearly 45% more than what was taken over the entirety of 2003.

#### Sonoma Sector Insider Transactions\*

	Purchases	Sales	Ratio
Spectrum Organic Products, Inc. (SPOP)	\$23,500	\$716,613	30.49
Redwood Empire Bancorp (REBC)	\$68,149	\$629,656	9.24
Sonoma Valley Bancorp (SBNK)	\$1,171,203	\$2,790,445	2.38
Advanced Fibre Communications, Inc. (AFCI)	\$2,042,329	\$2,778,812	1.36
SonomaWest Holdings, Inc. (SWHI)	\$0	\$270,000	
Tegal Corp. (TGAL)	<u>\$115,494</u>	<u>\$0</u>	
<b>Total</b>	<b>\$3,420,675</b>	<b>\$7,185,526</b>	<b>2.10</b>

\* Some transaction values have been extrapolated

#### CONCLUSION

Fidelity Magellan Fund's former manager Peter Lynch often counseled shareholders to "invest in what you know." Investing in local companies is one manifestation of Lynch's dictum. By seeing operations first hand, investors can quickly understand the impact of a company's operating strategy and customer service policy. Additionally, local media coverage offers insight into company affairs that may not be found in national sources.

On the whole, local stocks reward investors with less risk compared to the broader market, but individual issues can still be very volatile and difficult to trade.

Sonoma County stocks, too, are highly concentrated. Much of the returns generated by the local stock set are based upon the market savvy exhibited by Sonoma County's financial institutions. Concentration will likely become an even larger issue when, and if, merger transactions remove Advanced Fibre Communications, Inc. (AFCI) and Redwood Empire Bancorp (REBC) from the Sonoma Sector.

**Note:** *The foregoing information and discussion on Sonoma Sector stock performance was obtained by the County of Sonoma from Mr. Zigler and is presented for the convenience of the reader. Any opinions expressed are solely those of Mr. Zigler and not of the County of Sonoma. The information provided here is not intended to replace other stock performance reports, investment publications, and the like and should not be used as the sole source for investment decisions. You should perform your own research and evaluation before making any investment decisions. Although the information presented here is believed to be accurate, the County of Sonoma does not guarantee its accuracy and assumes no liability for investment results that may occur following your use of the information provided herein.*