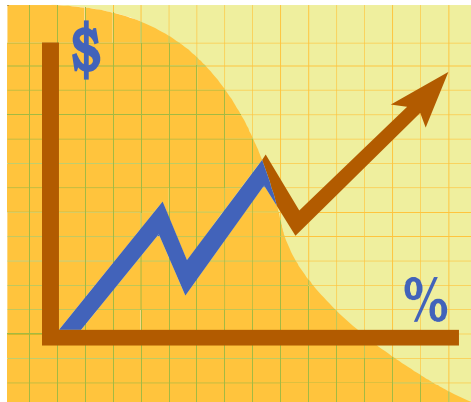


# Economic Development Board

Volume 3, Issue 3, Winter 2005

## Local Economic Report Series Winter 2005



Sonoma County  
**EDDB**  
Economic Development Board  
[www.sonomaedb.org](http://www.sonomaedb.org)

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



Winter 2005

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the Winter 2005 edition of the *Sonoma County Local Economic Report*. This report has three sections. Our research partner, Economy.com, provides an analysis on the local and the national economy in the first section. In section II, Robert Eyley, chair of the SSU Department of Economics, provides a perspective on economic conditions in Sonoma County. This is followed by Brad Zigler's summary of the stock performance of Sonoma County companies in section III.

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

- The economy of Sonoma County is on the path of recovery, and for the first time since 2001 the county will see positive job growth in 2005. Long-term growth potential is boosted by the November ballot approval of Measure M, which increases sales tax to support the widening of Highway 101 and other transportation improvements.
- Employment, after hitting the bottom in March 2004, has steadily climbed, and job growth over the year is now faster in Sonoma County than in any other Bay Area metro area.
- Manufacturing payrolls are holding steady, but the sector is not yet contributing to job growth.
- Commercial real estate has leveled off and is poised to improve in 2005 as job growth in service-producing industries improves. Industrial real estate markets remain weak. However, in the coming year absorption rates for properties may turn positive.
- The weakened dollar continues to support the local wine industry as the low value strengthens export sales while limiting demand for imports.
- The overall housing market is close to balance between supply and demand, and shows no short-term signs of weakening. With the median sales price for a single family home jumping in November to more than \$500,000, affordability is nearly at an all-time low, leading to a greater demand towards multifamily housing.

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  
Economic Development Board Foundation Research Initiatives Program  
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# Economic Development Board

Volume 3, Issue 3, Winter 2005

## Section I:

# Local Economic Report January 2005

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

# 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

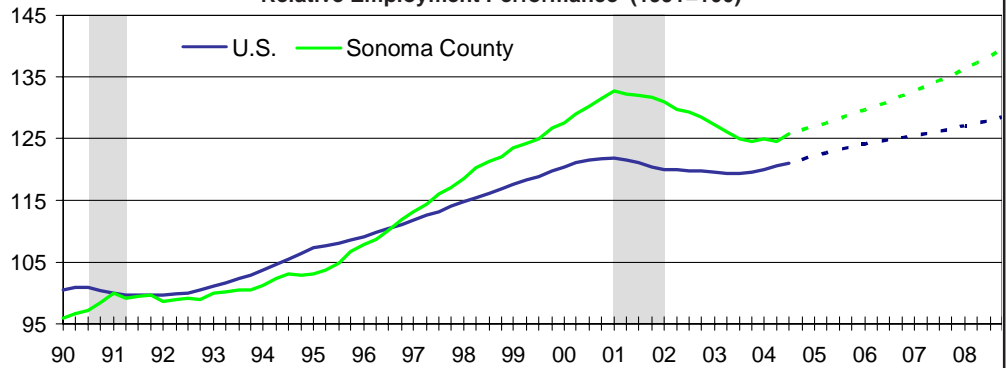
### COST OF DOING BUSINESS

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>	14.9	15.5	16.1	16.9	17.8
9.8	8.1	7.5	12.6	0.3	0.9	0.6	<b>% Change</b>	2.3	4.0	4.2	5.1	5.2
165.4	173.0	179.3	186.1	189.8	186.2	180.6	<b>Total Employment (000)</b>	180.1	183.6	187.7	192.3	197.9
5.0	4.6	3.6	3.8	2.0	-1.9	-3.0	<b>% Change</b>	-0.3	2.0	2.2	2.5	2.9
3.8	3.3	2.7	2.6	2.9	4.5	4.9	<b>Unemployment Rate</b>	4.5	4.2	4.1	3.9	3.7
9.4	8.4	5.8	14.8	2.5	0.4	1.5	<b>Personal Income Growth</b>	4.9	6.0	5.7	6.1	6.2
437.1	445.9	453.4	460.3	465.6	465.9	466.7	<b>Population (000)</b>	473.1	482.3	492.6	502.3	512.5
1,785	2,098	2,348	2,013	1,717	1,350	1,503	<b>Single-Family Permits</b>	1,276	2,000	1,856	1,826	1,907
176	964	688	492	866	578	749	<b>Multifamily Permits</b>	725	643	603	683	739
205.2	225.1	260.2	325.0	363.8	381.7	419.1	<b>Existing Home Price (\$Ths)</b>	482.5	517.4	531.2	550.4	570.6
2,839	5,163	4,499	3,990	8,651	10,396	13,816	<b>Mortgage Originations (\$Mil)</b>	7,184	3,571	3,303	3,639	4,107
7.0	7.1	6.0	5.3	3.6	-1.5	-0.8	<b>Net Migration (000)</b>	4.7	7.4	8.3	7.7	8.1
2,090	2,173	1,627	1,158	1,183	1,223	1,300	<b>Personal Bankruptcies</b>	1,223	1,070	1,034	1,053	1,027

## STRENGTHS & WEAKNESSES

### STRENGTHS

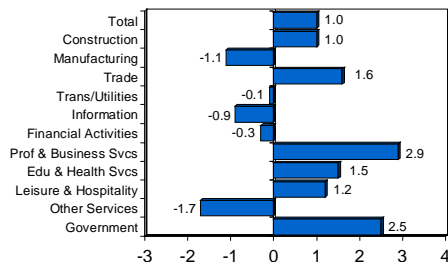
- High per capita income.
- High educational attainment of workforce.
- Attractive environment.
- Multiple basic industries drive economy.

### WEAKNESSES

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

## CURRENT EMPLOYMENT TRENDS

### November 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.
- Global business investment falters, limiting tech/telecom recovery.

## ANALYSIS

**Recent Performance.** The economy of Sonoma County (SON) is on a path of recovery. Employment hit bottom in March and has steadily climbed in the subsequent months. In fact, job growth over the year is now faster in SON than in any other Bay Area metro area. Moreover, the unemployment rate has fallen over the past year at the same time that the labor force has expanded—a sure sign of an improving labor market. In fact, the local jobless rate is well below the U.S. average and the gap is widening. Resulting improvements in income growth, combined with still-climbing house prices, has improved household balance sheets, as evidenced by declines in the number of personal bankruptcy filings in this year's second and third quarters. The only shadow of lingering weakness comes from a rise in the number of business bankruptcy filings in the third quarter, reversing more than a year of improvement.

**Narrow growth.** SON's rebound remains narrowly focused in tourism and retail, which is consistent with improving travel and tourism statistics elsewhere in California. Hotel occupancy rates in San Francisco have been rising for the past two years. Passenger travel through San Francisco's airport is up by nearly 15% over the past year. With SON depending on side trips from San Francisco to boost visitor arrivals, the improving Bay Area travel industry bodes well.

**Wine.** The strength of high-end retailing and the low value of the dollar support SON's wine industry. With luxury and near-luxury labels selling well, profitability should improve for the industry, contributing to stronger income growth in the coming year. The value of the dollar supports export sales and limits demand for imports, particularly from Europe and Australia, whose currencies have been among the strongest versus the dollar. Indeed, the value of export shipments of California-made beverages has surged this year to a record high, rising by nearly 40% over the year as of the third quarter.

**Technology.** Manufacturing is not contributing yet to job growth, but most manufacturers

are at least now holding payrolls steady. Net gains will be slow as cutbacks and consolidation among telecom equipment makers are still possible. U.S. domestic investment in telecom and technology products continues to rise at a double-digit pace and demand from Asia is accelerating, generating new demand for SON's tech-based industries. New hiring so far is very moderate but firms such as Motorola, Deposition Sciences and Teknovus offset some recent cuts by Texas Instruments and Alcatel.

Defense spending generates some moderate upside potential as demand rises for components of surveillance gear. The total value of defense procurement contracts in SON has held steady for the past three years, but the defense contracting growth will easily exceed inflation through the remainder of this decade.

**Real estate.** As with the labor market, commercial real estate has leveled off and is poised to improve in 2005. Both office and industrial availability rates largely held steady through the first three quarters of this year according to Keegan and Coppin/ONCOR. Absorption rates will turn positive in the coming year, particularly for industrial properties, which have seen little new construction over the past three years.

**For the first time since 2001, Sonoma County will see positive job growth in 2005. Many factors now support the economy, including improved global competitiveness due to the weak dollar, improving consumer confidence and personal income growth, as well as rising investment spending for improved technology. Long-term potential is boosted by the November ballot approval of a sales tax hike in the county to support widening of Highway 101 and other transportation improvements. SON has the potential to once again modestly outperform the U.S. economy by 2007.**

Steven G. Cochrane  
January 2005

## 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

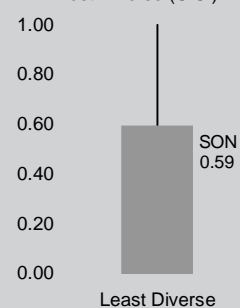
### Public

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

2003

### INDUSTRIAL DIVERSITY

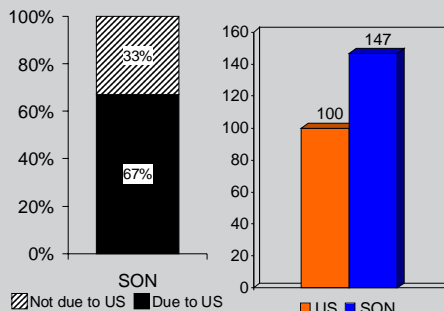
Most Diverse (U.S.)



### EMPLOYMENT VOLATILITY

DUE TO U.S. FLUCTUATIONS

RELATIVE TO U.S.

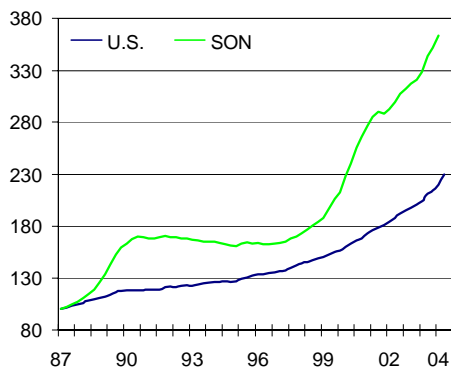


## COMPARATIVE EMPLOYMENT AND INCOME

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  
N/A

MOODY'S  
COUNTY Aa2

## MIGRATION FLOWS

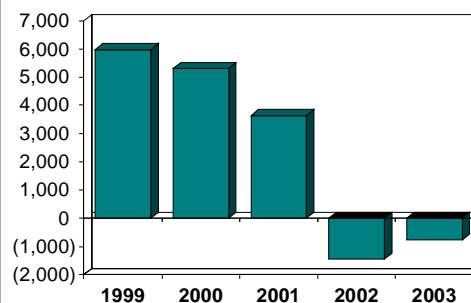
Into Sonoma County	Number of Migrants	Median Income
San Francisco	3,662	39,588
Oakland	1,233	31,640
Vallejo	834	31,768
San Jose	647	43,970
Los Angeles	527	19,558
Sacramento	509	23,954
San Diego	326	18,602
Riverside	245	22,553
Orange County	210	25,749
Seattle	158	21,355
Total Immigration	14,659	26,425

### 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

Net Migration -2,659 -625

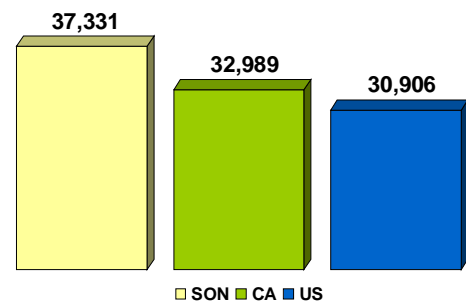
### Net Migration, SON



	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

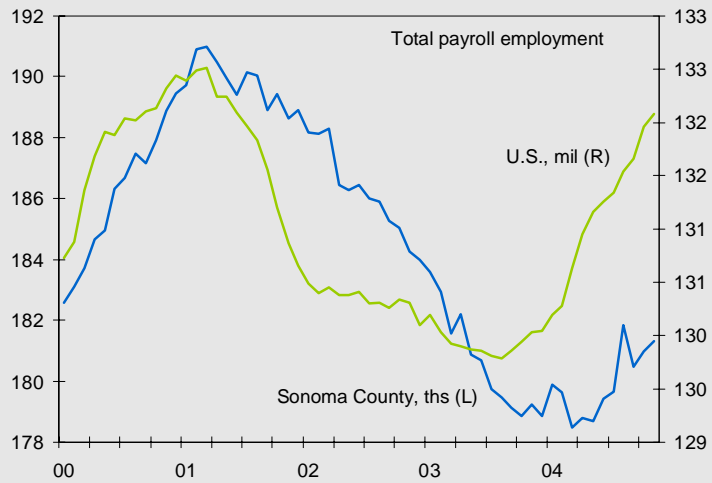
### PER CAPITA INCOME



Source: Bureau of Economic Analysis, 2002

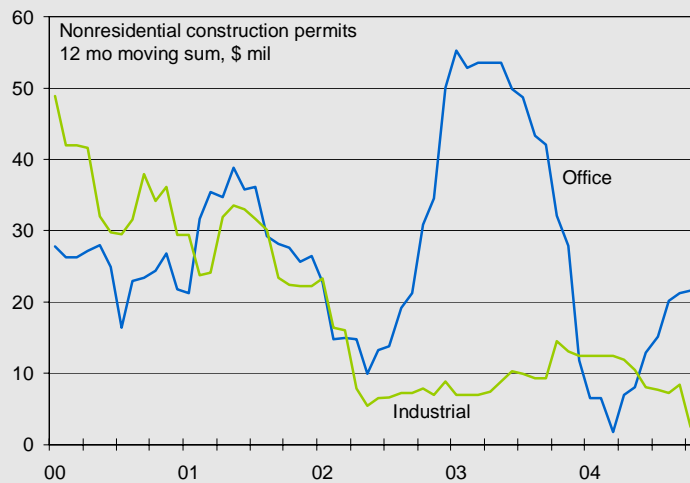
# Sonoma County

## Jobs Rebound Is Here; Still a Long Way to Go



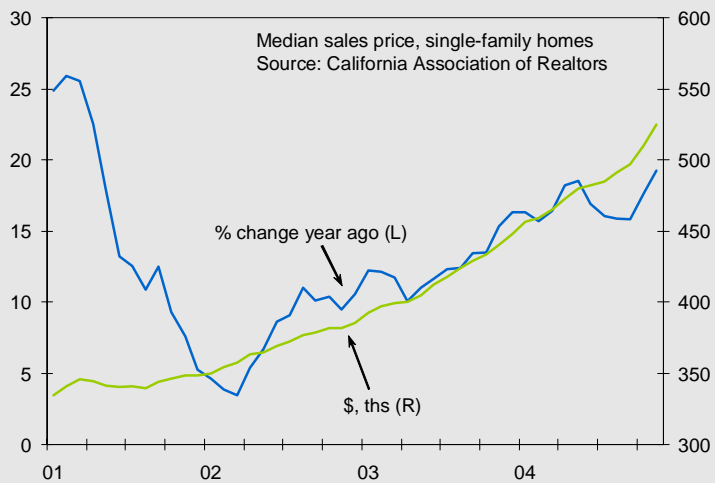
A turnaround is finally evident in SON. Employment finally hit bottom earlier this year, about a year after the U.S. economy began to create jobs once again. Thus, while the U.S. labor market may achieve a new employment peak in 2005, SON's new peak is not projected to occur until late 2006 or early 2007. Nevertheless, monthly gains in employment and income in the metro will support renewed vigor in local retailing and services and will help to offset some of downward pressure on housing markets caused by higher interest rates.

## Virtually No Industrial Construction; Some Office Investment



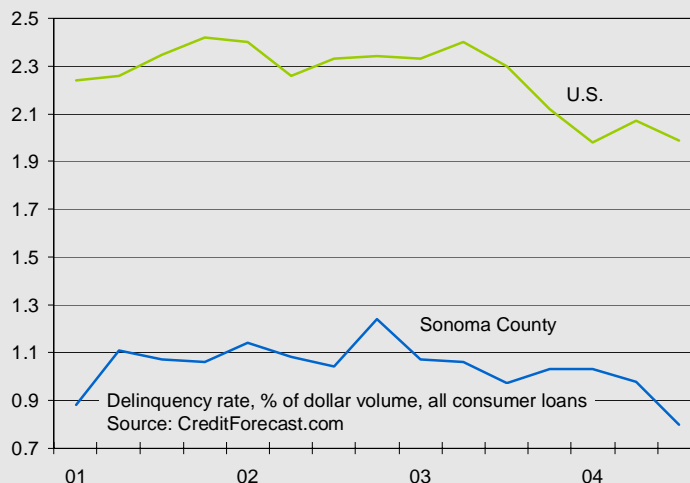
Industrial real estate markets remain weak as no payroll growth is yet evident in SON's manufacturing industries. Industrial production, however, is estimated to be up by just over 5% over the year, about equal with the national growth rate. Next year may see some positive absorption of space, but there is plenty of vacant space still available. Office markets are more mixed. Office-using employment is rising modestly, but new supply on the market has kept availability rates from falling this year. Expect demand for office space to improve next year as job growth in service-producing industries improves.

## Housing Market Is Still Fired Up



The housing market shows no sign of weakening through November. In fact, the median sales price for single-family homes jumped in November and broke the \$500,000 mark. Affordability is nearly at an all-time low. Thus, demand for multifamily housing will rise, and demand could shift toward the high end of the market as many middle-income households choose to opt out of the single-family market. The overall market, however, is closer to balance between supply and demand than at any time since early 2000. Any price correction from higher interest rates, therefore, should be modest.

## Very Good Consumer Credit Quality



Consumer credit quality in SON is stellar. The local delinquency rate is half the national rate, and it even turned down in the third quarter of 2004. The low rate is supported by ever-rising home equity that has been tapped by homeowners to pay off other debts. Also, it is helped by the fact that many households losing jobs during the long downturn simply left the area. Evidence of this comes from census estimates that SON experienced virtually no population growth in either 2002 or 2003.

# BROAD VIEW

## Executive Summary

The economy is enjoying strong growth. Real GDP is expanding at a 4% annualized rate, with households, businesses, government and exports contributing to the gain. The only significant economic drag is continued robust import growth.

The economy's growth is expected to slow in the coming year. By year-end 2005, real GDP is expected to be growing at close to a 3% pace. Behind the slowdown will be fading monetary stimulus and fiscal policy restraint, which will weigh on household and government contributions to growth, and the end of the inventory and replacement cycle, which will crimp businesses' contribution.

The expected slowdown would be even more pronounced if not for the weaker dollar and the salutary impact this will ultimately have on the nation's trade position. While the trade deficit is not expected to narrow much this year, even a steady deficit is a substantial improvement after years of substantial erosion.

**Fading monetary stimulus.** The Federal Reserve is engaged in a series of tightening moves it began this past summer. The moves are designed to ensure that the economy's growth slows to near its potential, estimated to be just over 3%, by the time the economy approaches its capacity.

Indeed, as long as the economy's growth is above its potential, policymakers are expected to hike the funds rate target by 25 basis points at each FOMC meeting. Consistent growth above 4% would prompt more aggressive tightening, and growth below 3% would induce policymakers to pause in their efforts.

Policymakers are expected to continue tightening in this measured way until the funds rate target is equal to the neutral rate. The neutral rate is that rate which neither supports nor constrains growth, and is equal to the long-run nominal GDP growth rate. This is estimated to be 4.5%, which is equal to the sum of 3% real GDP growth and targeted 1.5% inflation. It will take all of this year and part of next for policymakers to lift the current 2.25% funds rate target to its neutral rate.

Higher interest rates (long-term rates are also expected to soon begin rising with the Federal Reserve's moves) will weigh heavily on the growing list of arguably speculative housing markets across the

country. Household spending will also come under pressure as homeowners find it more difficult to raise cash via mortgage borrowing and realize capital gains through home sales.

**Fiscal restraint.** Federal fiscal policy is also quickly turning from supporting growth to restraining it. The federal deficit is set to narrow measurably from last year's record of over \$400 billion.

Federal outlay growth is slowing. Policymakers are working, seemingly successfully, to rein in the growth of discretionary nondefense spending, which has come to a virtual standstill. It was not long ago that spending was expanding at a double-digit rate. Barring a significant increase in defense outlays necessary to support military efforts in Iraq, overall spending growth this year will just keep pace with the growth in GDP.

Federal receipts are expected to soon jump as the tax cutting of recent years is over. Household tax bills have been rising since last spring, and corporate tax bills will soon rise sharply with the recent expiration of large businesses' accelerated depreciation benefits. Together, households and businesses will cut checks to the federal government this year that are some \$200 billion larger than last year.

**Replacement cycle.** Businesses' desire to continue ramping up investment, at least at the double-digit pace of the past year, will not only be tempered by tax considerations, but also by the imminent end of what has been a powerful replacement cycle.

This replacement cycle is evident in the rapid re-stocking of inventories. Businesses aggressively built inventories last year, a process that added nearly a percentage point to GDP growth. Much of the build was desired as stocks were falling relative to sales. At the current pace of inventory accumulation, however, inventories will keep pace with sales. Despite a record low inventory-to-sales ratio, businesses are not interested in letting it rise, thus ensuring that inventory gains will not add measurably further to growth.

The replacement cycle is also evident in the surge in spending on computer hardware and software. Spending recently surpassed the previous peak achieved soon after Y2K. Due to the rapid pace of technological change, most of the investment made around that time has become

economically unviable, forcing businesses to increase investment just to maintain their productivity gains and competitiveness. Most of this replacement demand, with the exception of communication equipment, which has a longer economic life, has now been satisfied, however.

**Stable trade deficit.** Growth in the coming year would be slower if not for an expected improvement in the nation's trade situation. The real trade deficit, which will reach a record at close to \$600 billion this year, is expected to narrow in 2005. While the decline in the deficit will be small, it will be the first in a decade, and trade will go from being a sizable drag on growth to a source of modest support.

Behind the anticipated improvement is the three-year long, 15% decline in the real broad trade-weighted dollar. The dollar is off by more than one-third vis-à-vis the euro, 25% against the Canadian dollar, and 10% against the yen.

The impact of the lower dollar on trade has been slow in coming, due to the expanded prevalence of currency hedging and long-term contracting. But this is changing, however, as prices for imported goods from Europe and Canada are now rising quickly.

The nation's trade situation will receive another boost when the Chinese revalue the yuan and begin a process toward a freely-floating currency. While the Chinese are publicly holding firm to their yuan-dollar peg, both external and internal pressures on them to change are mounting. A revaluation is expected sometime this year.

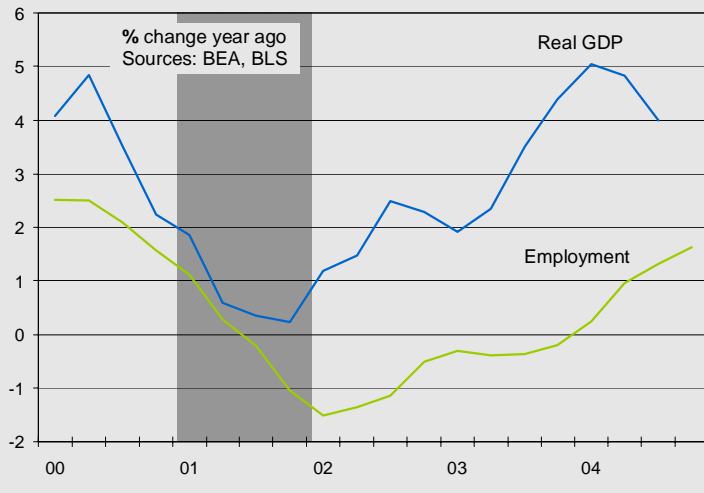
**Conclusions.** The economy is expected to experience a sturdy performance in the coming year. Real GDP growth will slow from last year's strong pace as the sources of growth begin to shift. Consumer spending, investment, and federal government spending growth will moderate, as monetary and fiscal policy stimulus fade into restraint, and pent-up investment demand is satisfied. Some of the slack will be made up by a stabilizing trade deficit. All of this is expected to go smoothly, but given that the catalyst for this shift is a lower U.S. dollar and somewhat higher inflation and interest rates, there are not inconsequential risks that there will be a bump or two along the way.

*Mark M. Zandi*  
January 2005

# BROAD VIEW

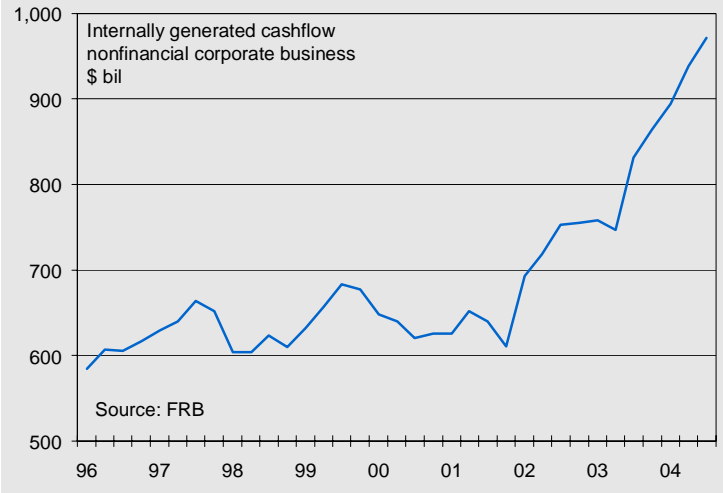
## Executive Summary

### A Sturdy Expansion



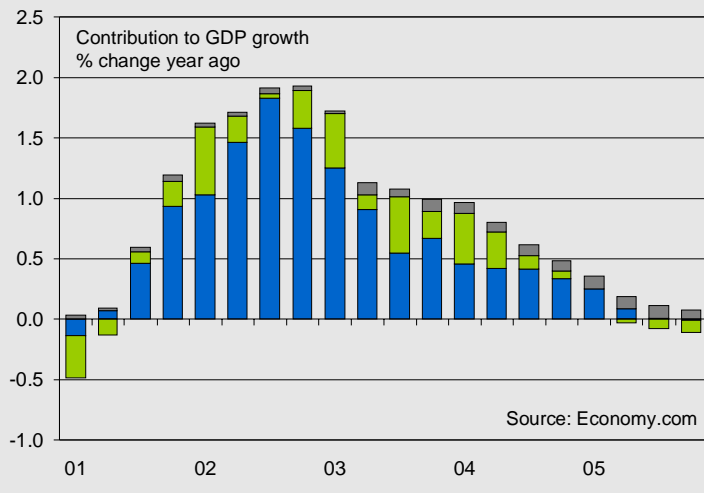
Economic activity is sturdy. Real GDP growth is currently expanding at a 4% annualized pace, and employment growth is approaching a 2% rate. The economy has nearly fully recovered from the recession and weak recovery during the first half of this decade. The job market was the last part of the economy to rebound, and payroll employment is set to surpass its March 2001 peak in the next month or two. The sources of growth remain broad based, with consumers, businesses, government, and our overseas trading partners doing their part. Only double-digit import growth remains a drag.

### Business Are Flush and Able to Expand



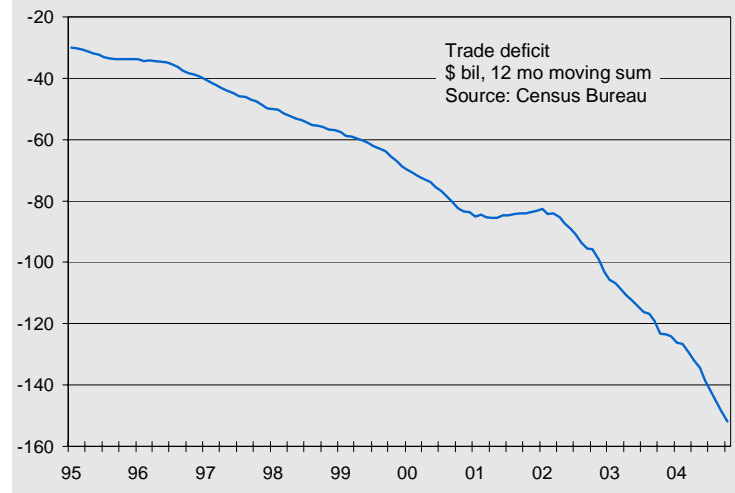
The economy's prospects for 2005 appear solid. Driving growth this year will be businesses looking to more aggressively use their ample cash positions and pristine balance sheets to further increase investment and hiring. Aside from the airline and sundry manufacturing industries, the financial position of businesses has arguably never been stronger. It is not a question of whether businesses are able to expand, but only whether they are willing. Business confidence has been fragile due to the series of shocks that befell businesses earlier in the decade. Memories of these events appear to be slowly fading, however.

### Fading Policy Stimulus



Expected real GDP growth of 3.5% this year is measurably slower than the strong 4.5% gain experienced in 2004. Fading policy stimulus is the principal reason for this expected slowdown. At their peak, monetary and fiscal stimuli contributed an estimated two percentage points to real GDP growth. With the Federal Reserve now tightening policy, fiscal stimulus over, and government spending slowing, policy is adding very little to growth. Given expectations of further rate hikes and more spending restraint, policy will turn restrictive as the year progresses.

### Ballooning U.S.-Chinese Trade Deficit



The economy's most significant imbalance is the nation's large and ballooning trade and current account deficit. The current account deficit is approaching a whopping 6% of GDP. This is far-and-away the largest it has ever been. Much of the erosion in the deficit is due to trade with China, which is largely due to China's heretofore steadfast commitment to pegging its increasingly undervalued yuan to the dollar. The Chinese are under significant pressure to change their yuan policy, but the longer they wait to make a change, the greater the risks to the entire global economy.

## Section II:

# January 2005 Outlook: Qualitative Forecast of Sonoma County's Economy

By: Robert Eyer, Ph.D.  
Chair, Department of Economics  
Sonoma State University

January 14, 2005

## 2005 Outlook: Qualitative Forecast of Sonoma County's Economy

Generally, macroeconomists find themselves looking at the same four or five statistics in assessing the economy's current position and its future. My brief statement here concentrates on two variables. First, interest rates are assured to rise; and it is hard to find an economist who does not believe rates are increasing. Also, employment levels will continue to rise. Sonoma County is currently at a stage where continue job growth, however, will drive local costs of living higher. Our hope is that local growth comes before interest rate growth. This is a time to use financial leverage and refinancing options while the getting is good.

Forecasted interest rate growth in 2005 comes from two sources. The last three years of low interest rates should finally force a contraction of funds available (supply decrease) while businesses should be taking advantage of low rates while they last (demand increase). These two shifts are interrelated, and are a long time in coming. As businesses demand more financial leverage, lending institutions have a profit incentive to charge slightly higher interest rates as demand rises. As businesses grow their inventories using this leverage, the financial markets will move toward equities and away from bonds. Investors are small lending institutions when buying bonds also, but they cannot charge higher interest rates directly. As investors buy more stocks, bond issuers sell debt with higher rates to attract investors, naturally moving the interest rate upward. Locally, if businesses are engaged in seeking and using financial leverage, growth should lead interest rate movements. The speed and magnitude of the interest rate rising is key: if interest rates surge due to unforeseen risks, both nationally and internationally, business growth can stagnate. Governmental deficits in both Sacramento and Washington DC make this surge quite possible.

Local job growth depends heavily on forecasted consumer demand and businesses taking risks. Sonoma County saw much of its recent employment losses more than come back during 2004, and job growth looks positive for 2005. The recent budget from the Governor's office has effects locally, and we need to prepare for them in education and government services. Also, our local job growth will support continued growth in cost of living and our housing market, a cost and benefit of local economic growth. It is here where we must be careful and understand how the interest rates, job markets, and cost of living all are bound to each other. Local job markets and costs of living are commanded by regional markets, the interest rate is a global market. Phenomena such as outsourcing may confuse this point; however, outsourcing is a by-product of high cost of living in local job markets. Understanding these linkages, and how Sonoma County depends on and is affected by surrounding counties and markets also needs to be front and center in local decision making for 2005 to seize the opportunities upon us.

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## Section III:

# Stocks in 2004: Outperformance Still a Hallmark

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

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## SONOMA COUNTY STOCKS IN 2004: OUTPERFORMANCE STILL A HALLMARK

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*This report was prepared by Brad Zigler, a Santa Rosa-based financial writer and editor. Mr. Zigler's work has appeared in the Journal of Indexes, Institutional Investor, Financial Planning, Mutual Funds, Futures, Registered Rep. and the North Bay Business Journal, among other publications. Previously the head of marketing, research and education at the Pacific Exchange and Barclays Global Investors, Mr. Zigler is the creator of the North Bay Stock Index. He holds investments in the North Bay Stock Index securities mentioned in this report.*

### REWARDS AND RISKS

Sonoma County stocks again outperformed broader market issues in 2004, but at a pace even better than exhibited in 2003. The Sonoma Sector of the North Bay Stock Index (NBSI) appreciated 17.16% while the contemporaneous rise in the Dow Jones Industrial Average (DJIA) amounted to only 3.63%. The NBSI, price-weighted like the DJIA, is a benchmark of more than two dozen publicly traded companies headquartered in the three counties north of the Golden Gate Bridge. The NBSI's Sonoma Sector was, until recently, comprised of ten stocks based in Sonoma County.

The 13.53% premium earned by Sonoma County stocks is more than double the previous year's outperformance. In 2003, the price appreciation of the Sonoma Sector bettered that of the DJIA by 5.34%.

While local issues gained ground on blue chips in 2004, they also become riskier. Sonoma Sector volatility, measured by the standard deviation of weekly returns, was 9.32% at year's end 2003. Twelve months later, volatility had increased to 15.05%. The Sonoma Sector's Sharpe ratio, a reward-to-risk metric commonly utilized by financial analysts, was 1.05 at the end of 2004. The Sharpe ratio represents the payback, in terms of a return over the Treasury bill rate, earned for shouldering the risk of a portfolio. According to most analysts, a Sharpe ratio of 1.00 or higher denotes "quite respectable" compensation for risk; a stock or portfolio exhibiting a ratio of 2.00 is deemed to offer "exceptional" recompense.

By comparison, the DJIA's 10.46% volatility yielded a Sharpe ratio of 0.22 for the blue chip benchmark in 2004. Figure 1 illustrates the 2004 price appreciation of the Sonoma Sector and its parent index, the NBSI, versus the DJIA.

The median Sonoma County stock rose 20.56% in 2004 as winners outpaced losers by a 7-to-3 margin in the local market. The three losing stocks represented 7.59% of the Sonoma Sector's price weight. At the bottom was etching machine producer Tegal Corp. (TGAL), the Sonoma Sector's top gainer in 2003. Banking remains the strong center of the local market, serving as a moderator of the Sonoma Sector's volatility.

In November, the ranks of the Sonoma Sector were trimmed when Petaluma-based Advanced Fibre Communications, Inc. (AFCD) merged into Tellabs, Inc. (TLAB). The local stock set, now numbering nine issues, is set to shrink further in early 2005 when Redwood Empire Bancorp (REBC) is acquired by NBSI component Westamerica Bancorporation (WABC).

Figure 1

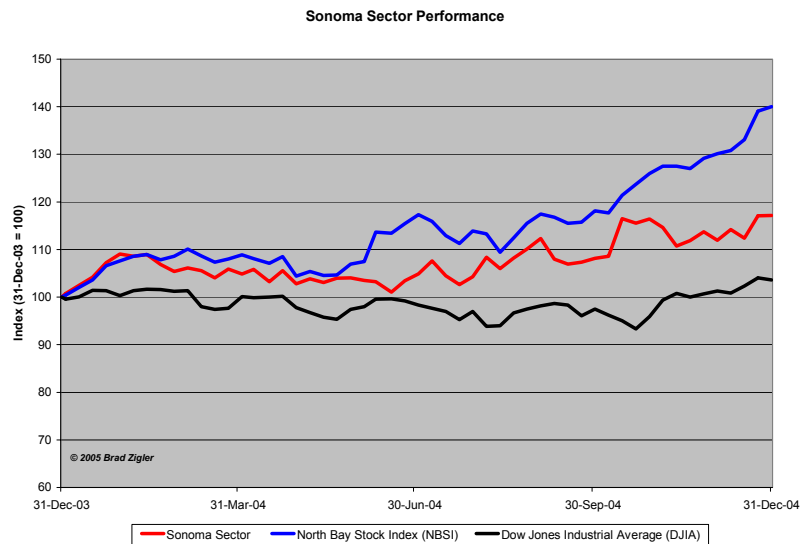


Figure 2

**Sonoma Sector Component Performance**

	Industry	2004 Gain/Loss	Volatility	Sharpe Ratio	31-Dec-04 Price	Liquidity Ratio
ZAP (ZAPZ)	Recreational Products	432.79%	200.83%	2.15	\$3.25	\$32,615
Burst.com, Inc. (BRST)	Software & Programming	36.28%	64.69%	0.54	\$1.54	\$37,331
Northern Empire Bancshares (NREB)	Regional Bank	30.08%	28.00%	1.03	\$22.50	\$74,905
SonomaWest Holdings, Inc. (SWHI)	Rental/Leasing	25.19%	50.44%	0.47	\$10.64	\$4,374
Sonoma Valley Bancorp (SBNK) <sup>1</sup>	Regional Bank	21.42%	51.33%	0.39	\$24.00	\$11,964
Exchange Bank-Santa Rosa (EXSR)	Regional Bank	19.70%	25.92%	0.71	\$141.25	\$27,354
Redwood Empire Bancorp (REBC)	Regional Bank	13.32%	22.43%	0.53	\$29.60	\$245,440
Advanced Fibre Communications, Inc. (AFCI) <sup>2</sup>	Communications Equipment	-21.52%	46.41%	-0.49	\$16.23	\$25,957,640
Spectrum Organic Products, Inc. (SPOP)	Food Processing	-33.73%	52.36%	-0.67	\$0.55	\$5,386
Tegal Corp. (TGal)	Semiconductor Equipment	-41.16%	91.26%	-0.47	\$1.63	\$483,842
<b>Mean</b>		<b>48.24%</b>	<b>63.37%</b>	<b>0.42</b>	<b>\$25.12</b>	<b>\$2,688,085</b>
<b>Ex-AFCI</b>		<b>55.99%</b>	<b>65.25%</b>	<b>0.52</b>	<b>\$26.11</b>	<b>\$102,579</b>

<sup>1</sup> SBNK split 3:2 on 27-Aug-04

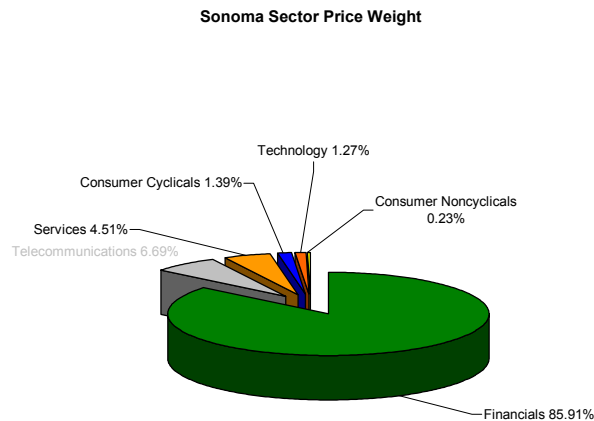
<sup>2</sup> AFCI return is annualized; merged with TLAB on 30-Nov-04

SECTOR AND INDUSTRY BREAKDOWN

In a single stroke, AFCI's merger with TLAB sucked two-thirds of the Sonoma Sector's existing market capitalization away. However, as NBSI is price-weighted, the diminution to the Sonoma Sector amounted to only 6% of the benchmark's left.

Still, the loss of AFCI as a standalone telecommunications stock raises the weight of other market segments within the Sonoma Sector. This is most especially true of financials which started 2005 at 92.50% of the benchmark's price weight, up from 85.91%.

**Figure 3**



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### *Financials*

Collectively, Sonoma County banks appreciated 20.73% in 2004 and earned a composite 1.14 Sharpe ratio. Financial stocks accounted for 73.17% of the Sonoma Sector's capitalization at year's end 2004.

- Northern Empire Bancshares (NREB) - Shares of Sonoma National Bank's corporate parent earned a total return of 77.87% in 2004 as the result of a \$5 per share dividend paid in May. The bank opened its first Marin County branch in July and set its sights on establishing a Contra Costa presence in early 2005.
- Exchange Bank-Santa Rosa (EXSR) - Sonoma County's oldest bank produced a total return of 24.30% for its shareholders last year as real estate lending opportunities in the higher-growth Sacramento market buoyed earnings.
- Sonoma Valley Bancorp (SBNK) - A 3-for-2 stock split and a 25-cent per share dividend figured into the Sonoma-based institution's 2004 total return of 23.20%. A newly branded Banco de Sonoma branch, catering to the Latino market, was opened in Boyes Hot Springs.
- Redwood Empire Bancorp (REBC) - With dividends, shares of National Bank of the Redwoods' holding company appreciated 17.00% in 2004. REBC's liquidity mushroomed when news of its acquisition by Marin County-based WABC was announced in August. The deal is set to close in early 2005.

### *Technology*

With a Sharpe ratio of -0.30, Sonoma County technology stocks lost an aggregate 18.72% last year. Technology stocks started 2005 representing 12.41% of the Sonoma Sector's market capitalization.

- Burst.com (BRST) - The Santa Rosa-based software maker's stock price rose 36.28% in 2004 as the prospects for its longstanding patent infringement lawsuit against Microsoft Corp. (MSFT) brightened.
- Tegal Corp. (TGAL) - The share price of the plasma etch and deposition systems maker slipped 41.16% last year as the result of declining revenues and increased expenses.

#### *Consumer Cyclical*

Volatility paid off in 2004 as 9.44% of the Sonoma Sector's market capitalization earned a Sharpe ratio of 2.15.

- ZAP (ZAPZ) - A new 52-week high of \$5.15 per share was hit in December on news of the placement of a \$3 million order for ZAPZ's SMART cars. Company plans for a previously announced 3-for-1 stock split were then scotched. ZAPZ shares posted a gain of 432.79% in 2004.

#### *Consumer Noncyclical*

The worst reward-to-risk proposition of 2004--sporting a Sharpe ratio of -0.67--was the Consumer Noncyclical sector. This segment represented 3.41% of the Sonoma Sector's year-end market capitalization.

- Spectrum Organic Products, Inc. (SPOP) - The stock of the culinary oils maker fell 33.73% in 2004 when the company was victimized by higher raw material costs.

#### *Services*

The single-stock services segment, accounting for 1.58% of the Sonoma Sector's year-end market capitalization, earned a Sharpe ratio of 0.47 in 2004.

- SonomaWest Holdings, Inc. (SWHI) - The share price of the Sebastopol-based commercial property lessor gained 25.19% for the year after hitting a 52-week high of \$11.25 in November.

#### *Telecommunications*

The last publicly traded telecommunications company in Sonoma County exited the scene with a Sharpe ratio of -0.49.

- Advanced Fibre Communications, Inc. (AFCI) - A weaker-than-expected earnings forecast for the Petaluma Internet equipment maker prompted acquirer TLAB to drop its takeover bid by \$350 million in September. By the time the merger deal closed in November, AFCI's share price had fallen 19.45% year to date. On an annualized basis, AFCI lost 21.52% in 2004.

## DIVIDENDS

Collectively, the annual dividend yield on Sonoma Sector stocks stood at 2.60% at year's end 2004, contributed entirely by four regional bank stocks. With dividends, the Sonoma Sector's total return was 22.79% for the year.

## LIQUIDITY

The mean market capitalization of Sonoma Sector stocks, including now-defunct AFCI, was \$220 million in 2004, belying a small-capitalization universe. However, with the sector's *median* market value at \$71 million, most local issues are actually "micro-caps." Without AFCI in the mix, the Sonoma Sector's mean and median market capitalizations shrink to \$83 million and \$71 million respectively.

Stock analysts often overlook small stocks, especially micro-caps. In fact, only two Sonoma Sector stocks--AFCI and REBC--were the subjects of sellside research in 2004. As a result, the sector is mostly "orphaned."

**Figure 4**

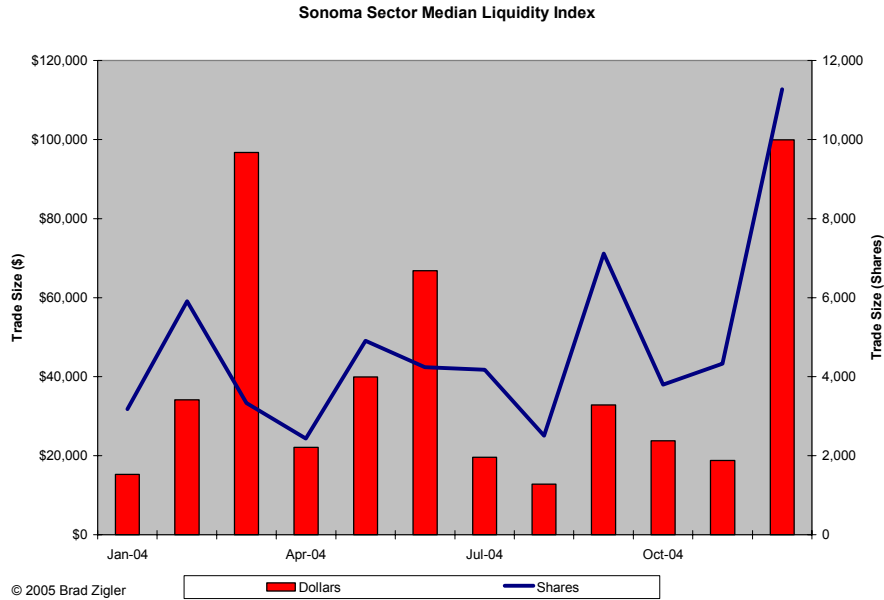
<b>Sonoma Sector Component Fundamentals</b>						
	<b>Average Volume</b>	<b>Shares Outstanding</b>	<b>Market Capitalization</b>	<b>P/E</b>	<b>P/B</b>	<b>Div Yield</b>
AFCI	2,362,100	88,900,000	1,450,000,000	68.13	1.45	
BRST	14,045	20,140,000	32,430,000	40.52	-4.51	
EXSR	202	1,714,000	110,870,000	13.49	2.03	2.81%
NREB	3,393	9,880,000	222,370,000	17.76	2.97	
REBC	7,070	4,950,000	143,160,000	22.38	4.91	2.91%
SBNK	590	3,210,000	71,710,000	18.50	8.94	2.08%
SPOP	9,276	46,390,000	25,510,000	18.33	4.33	
SWHI	167	1,110,000	11,820,000	176.83	2.42	
TGAL	812,849	46,560,000	60,530,000	-2.81	4.70	
ZAPZ	358,107	25,720,000	70,740,000	-4.58	6.43	
<b>Mean</b>	<b>356,780</b>	<b>24,857,400</b>	<b>219,914,000</b>	<b>36.86</b>	<b>3.37</b>	<b>2.60%</b>
<b>Mean Ex-AFCI</b>	<b>133,967</b>	<b>17,741,556</b>	<b>83,237,778</b>	<b>33.38</b>	<b>3.58</b>	

Despite their small market capitalizations and prices, some of Sonoma County's orphaned stocks exhibit surprising liquidity. The sector's average liquidity index, representing the size of a transaction necessary to move a stock's price by one percentage point, was \$2.7 million in 2004. A higher index signals the market's ability to absorb larger trades without a resultant change in a stock's price. The Sonoma Sector's mean liquidity index, it should be noted, was heavily skewed by AFCI.

AFCI's liquidity topped the list with a mean index of \$26.0 million; the least liquid issue in 2004 was SWHI at just over \$4,374. Without AFCI, the sector's mean liquidity index is \$102,579.

Sonoma County stock liquidity is strongly cyclical: spikes in liquidity typically coincide with the closings of calendar quarters.

Figure 5

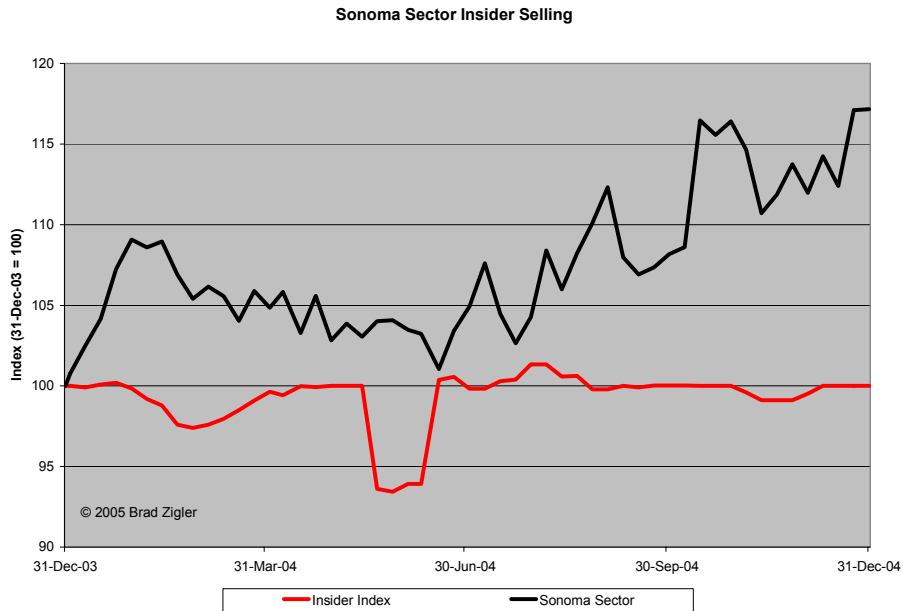


#### INSIDER TRANSACTIONS

Capitalizing on the overall rise in share prices, officers and directors of Sonoma County's publicly traded companies grossed nearly \$5.1 million in profits from insider transactions in 2004, nearly double the amount taken in 2003. Selling was skewed by SBNK's May liquidity event when the holding company bought back \$2.7 million worth of insider-held shares.

The Insiders Index, tracking a four-week moving average of transactions made by officers and directors, reflects the impact of the SBNK buyback as 2004's most significant single transaction. As can be seen in Figure 6, the index dropped to 93.42 as the result of the transactions. An index reading of 100 denotes balance in the dollar amount of sales and purchases. Readings below 100 indicate sales outweighing purchases, while readings above 100 signify net purchases.

Figure 6



**Sonoma Sector Insider Transactions**

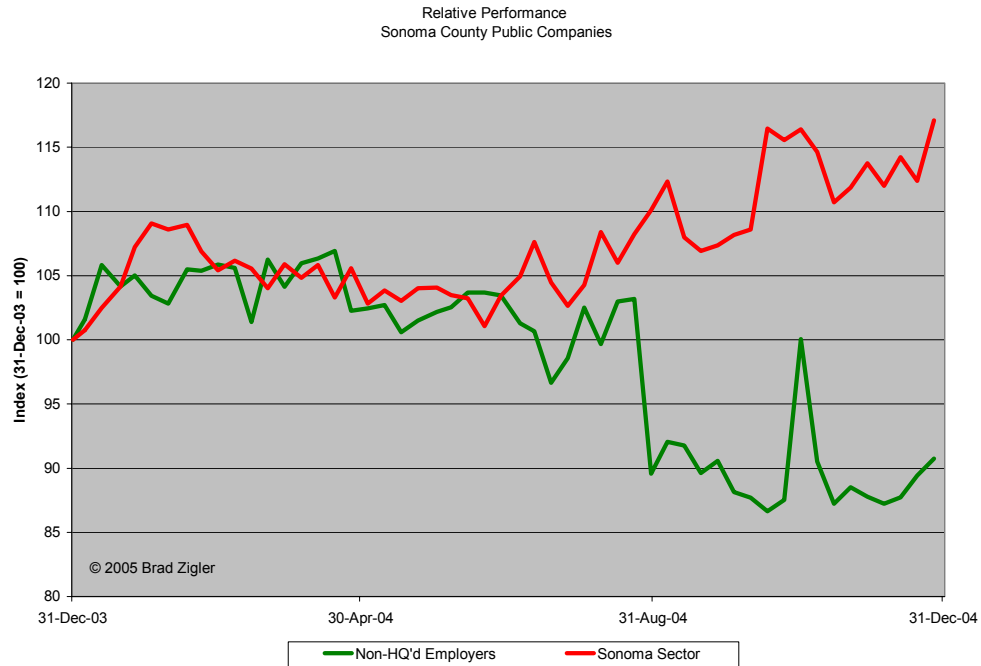
	<b>Purchases</b>	<b>Sales</b>	<b>Selling Ratio</b>
SPOP	23,500	966,613	41.13
REBC	96,149	629,654	6.55
SBNK	881,253	2,790,445	3.17
AFCI	2,017,329	3,564,294	1.77
SWHI		270,000	-
TGAL	122,149		-
<b>Total</b>	<b>3,140,380</b>	<b>8,221,006</b>	<b>2.62</b>

ALTERNATIVE SONOMA COUNTY EQUITY INVESTMENTS

For many investors, any publicly traded company with an operation in the neighboring area is a "local stock." There's, however, a distinct and historic difference in the performance characteristics of companies headquartered, versus those just operating, in Sonoma County.

Figure 7 illustrates the performance of an employment-weighted index of Sonoma County's largest non-headquartered public companies. Collectively, the ten companies represented in the index employ nearly 10,000 Sonoma County workers. In 2004, the composite weighted prices of these companies' common stock fell 9.26%, yielding a -0.40 Sharpe ratio.

Figure 7



The index of non-headquartered companies represents the Sonoma County employment-weighted performance of Agilent, JDS Uniphase, Safeway, Medtronics, Albertson's, Target, SBC, Longs Drug Stores, Cisco Systems and Home Depot.

#### LOOKING FORWARD

Recent research conducted by the University of Illinois has found that households nationwide exhibit a strong preference for local investment. Some 78,000 retail investors surveyed over a six-year period were found to hold nearly a third of their portfolios in local issues.

Most interesting, however, was the researchers' finding that these investors were able to exploit local information to earn excess returns over the broad market.

Collectively, Sonoma County stocks offered investors better absolute and risk-adjusted returns compared to the broader market in 2004. Still, individual Sonoma County issues can be very volatile and sometimes difficult to trade in size.

Sonoma County stocks, too, are becoming ever more concentrated. AFCI has already exited the marketplace and REBC is set to do so in early 2005. Even with the departure of REBC as a standalone entity, the sector's performance will continue to reflect the skill of the county's bankers in managing their institutions' share prices.

Holding all else constant, the loss of REBC will reduce the Sonoma Sector's mean market capitalization to \$76 million and raise the average issue's P/E multiple to 40.

*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.*