

Thriving in Sonoma County Navigating the Risks Ahead

Prepared for:

Sonoma County Economic Development Board

May 2005



Economy.com

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Sonoma County's Advantage in the Economic Recovery

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Sonoma County's Advantage in the Economic Recovery

Executive Summary

The U.S. economy is performing remarkably well considering that it continues to be buffeted by high oil prices, rising short-term interest rates and some slowing of the broader global economy. But the economy ebbs and it flows and even in the middle of economic expansions, such as the current period, the economy rarely moves in a straight line. Indeed, the economy is experiencing an energy price spike-induced ebb. Real GDP growth has slowed from close to 4% at the end of last year, to nearer 3%.

Oil prices of over \$50 per barrel have sapped some of the strength in consumer spending. Vehicle sales have been most affected. While unit sales have held up as auto makers have added more discounts to compensate for record gasoline prices, buyers are switching from larger less energy-efficient SUVs to cars. Consumer confidence and core retail sales, which exclude spending on vehicles and gasoline, have also moderated. Lower income households that spend more of their budgets on energy and have fewer other financial resources are particularly worried.

Judging by the surge in inventories nationwide, less voracious consumers have taken some businesses by surprise. The real inventory gain during the first quarter was over \$80 billion at an annualized rate. This is well over the \$50 billion gain estimated to be consistent with current sales growth. Manufacturing production and jobs are suffering a bit as businesses work to get inventories back in line with sales. Other factors, however, will buoy the economy in the near term. Business investment spending continues to rise at a double digit pace, supporting stable demand for durable goods. Low long-term interest rates help to buoy housing markets and the construction industry, generating jobs and supporting equity gains for homeowners. The low value of the dollar finally is generating some gains in export markets and the trade balance is beginning to narrow. Further, the weak dollar supports foreign tourism in the U.S. and directs U.S. travelers toward domestic destinations.

Thus, the near-term outlook is quite sanguine and barring unforeseen shocks, the economy should maintain a rate of growth around 3% through much of next year.

This bodes well for Sonoma County's economy, which has been struggling to gain traction in recent months. While the unemployment rate continues to fall and is below the U.S. rate, payroll employment figures show little improvement over the past six months. Total employment remains roughly 3% below its early 2001 peak.

Yet factors supporting the U.S. economy should generate a firmer foundation for the local economy in the months ahead. Accelerating income growth nationwide and in California will improve demand for travel and tourism. Similarly, the value of the dollar will entice more overseas visitors to California tourist destinations.

Business investment spending will support Sonoma County's technology-producing industries. The pace of spending on both telecom and medical equipment has slowed since late last year, but it remains positive and should accelerate next year, particularly for telecommunications equipment as some capacity constraints are reached and demand for new technology improves.

Risks are weighted to the downside over the coming year, however. The primary risk would arise if long-term interest rates were to rise more sharply than expected. This would have its greatest impact on the housing market, cooling the housing market with some risk of a correction in house prices. Second, higher long-term rates would put some downward pressure on the rate of business investment spending. The economy is growing rapidly enough that emerging production constraints in the near term

will drive investment spending upward, but if rates rise quickly, some investment spending would be choked off, with negative consequences for Sonoma County's durable goods producers.

Upside potential derives from the possibility that global demand growth for the county's goods and services could improve considerably if the dollar falls quickly versus Asian currencies once the Chinese yuan is allowed to be traded openly in foreign exchange markets. The most likely scenario is that the yuan would be allowed to trade only within a narrow range, minimizing the impact. But should a more liberal trading system be initiated, the dollar could fall by anywhere from 15% to 25% versus Asian currencies through the remainder of this decade.

Further upside potential for the forecast would emerge from stronger U.S. personal income growth in coming years. As labor markets begin to tighten in 2006, labor will gain more of an edge in wage negotiations, so that greater benefits of the economic expansion accrue to wages. Should this occur more quickly than expected, greater disposable income growth would benefit Sonoma County's wine, food, travel and tourism industries.

Sonoma County's Advantage in the Economic Recovery

The Broad Picture The economic expansion appears well-entrenched. Growth has become self-reinforcing, with current job gains sufficient to support solid spending and production increases, and more jobs.

Growth is no longer dependent on fiscal and monetary stimulus. Massive fiscal stimulus during the 2001 recession and the subsequent weak recovery have given way to increasing policy restraint. Effective tax rates are on the rise and the growth in outlays, though still strong, is slowing. Monetary policy remains stimulatory, given the continued low federal funds rate target, but the Federal Reserve is working diligently to move to a neutral policy stance.

The economy has yet to reach its capacity, at least in the job market, but at the current rate of growth it will be by this time next year.

There are risks, but the economy is seemingly hardy enough to absorb most of the most likely shocks. This is evident from how the economy has gracefully handled the surge in energy and other commodity prices. Growth has ebbed as prices have soared, but only modestly. Inflation expectations have also remained well-contained.

The economic policy debate has shifted in response. The discussion is no longer centered on how to lift near-term growth and create more jobs, but on longer-term concerns such as Social Security and tax reform, and the federal government's darkening long-term fiscal outlook.

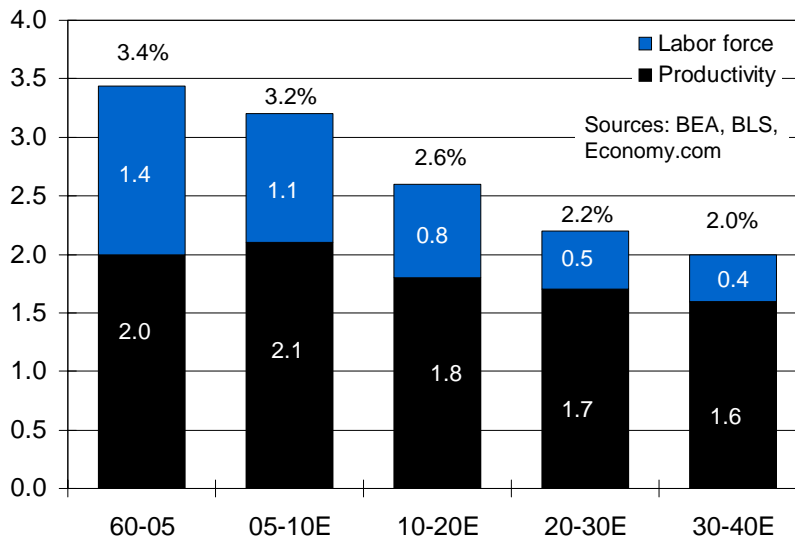
Underlying this new debate are forecasts of the economy's long-term performance. How to reform Social Security and the tax system, and how to address the looming budget crisis ultimately depend on the economy's long-term growth prospects, the length and vicissitudes of future business cycles, and the strength of long-term asset returns. This article presents Economy.com's long-term U.S. macroeconomic outlook.

Long-term growth. Long-term growth, as measured by the growth in real GDP, is composed of two parts. The first part is the rate of use of existing resources and technologies, which is the focus of short-run macroeconomics and involves projecting changes in the level of aggregate demand and the resulting split between output and price changes. The second part is the rate of expansion of the resource and technology base of the economy, which is the focus of long-term economic growth analysis and takes the rate of use of resources as given.

Economy.com's long-term macroeconomic outlook is composed of both parts. In the first two to three years of the outlook, the results are largely affected by aggregate demand projections, since the resource and technology base is taken as relatively constant. In the outlook for the years thereafter, the results are principally affected by factors that influence the growth of factor inputs, most importantly the labor force, and the productivity of those inputs.

The economy's potential real GDP growth through the remainder of this decade is expected to be just over 3% per annum. While this falls shy of the very strong growth of the past decade, it is comparable to the growth enjoyed over the longer historical period extending back to 1960.

Chart 1: Composition of Long-Term Real GDP Growth
Average annual growth



Potential growth is expected to slow below 3% a decade from now, however, and closer to 2% over the course of the subsequent quarter century. Behind this growth outlook are expectations for a moderation in productivity gains and a more pronounced slowing in labor force growth.

Productivity growth. Long-run or underlying productivity growth is ultimately driven by three factors, including the quality of the labor force, capital intensity and multifactor productivity.

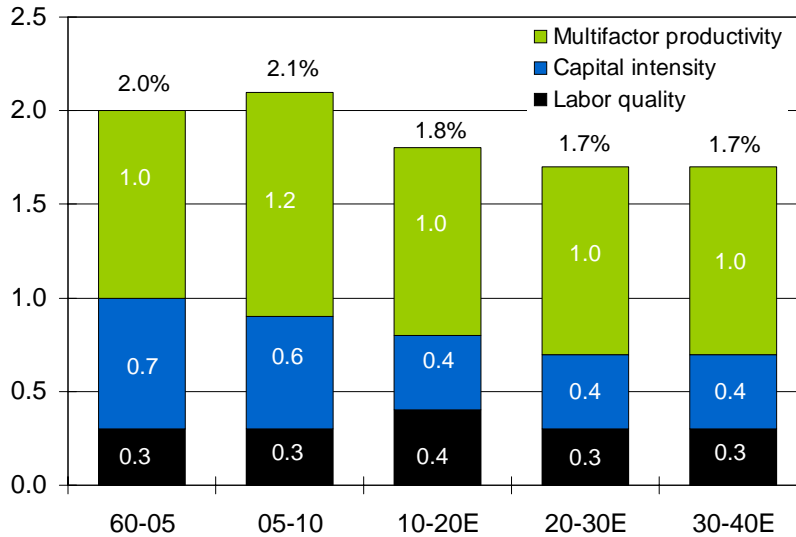
A more educated and skilled workforce is clearly more productive than one that is not. The quality of the workforce does change given demographic trends and changing returns to education.

Capital intensity refers to the amount and quality of the capital—equipment and structures—that labor has to work with. Labor that works with more sophisticated computers and offices with good internet connections, for example, will be more productive.

Multifactor productivity is effectively a catch-all, and includes anything that is not accounted for by changes in labor composition and capital intensity. MFP growth is determined by the pace of technological progress and how quickly and effectively new and existing technologies are implemented in business practices. If technology is advancing more quickly or is being implemented more effectively, then MFP will accelerate.

Since 1960, productivity growth has averaged 2% per annum. Of that growth, 30 basis points are attributable to the improving composition of the labor force, 70 basis points to growing capital intensity, and the remainder is due to growth in MFP.

Chart 2: Decomposing Productivity Gains
Nonfarm productivity growth



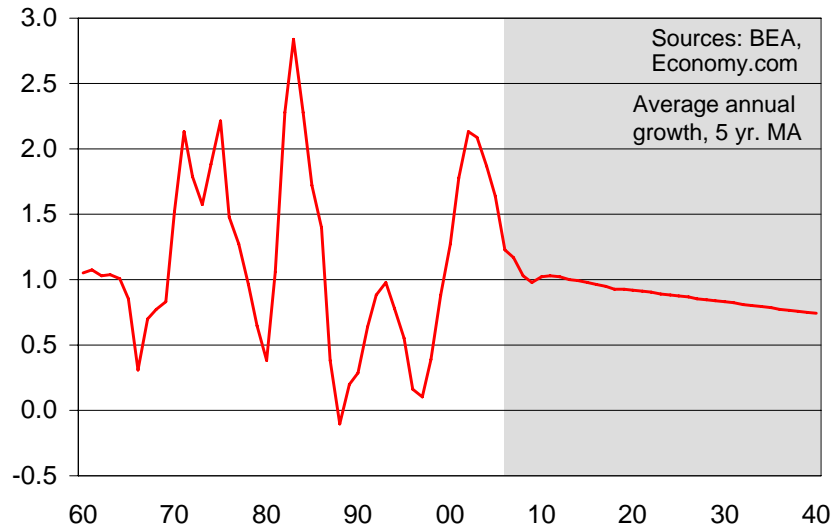
Capital intensity. Behind the anticipated moderation in productivity growth in coming decades is an expected slowing in the growth of capital intensity.

With the explosion in business investment in computer and telecommunication technologies in the lead up to Y2K, it is not surprising that increasing capital intensity added more to productivity growth during this period than any other time since World War II. The increase in capital intensity was nearly entirely concentrated in expanded investment in information processing equipment.

Despite the collapse in IT investment during the early part of this decade, increasing capital intensity will be an important contributor to future productivity gains. IT investment has already rebounded strongly as businesses are replacing their quickly depreciating stock of computer hardware and software.

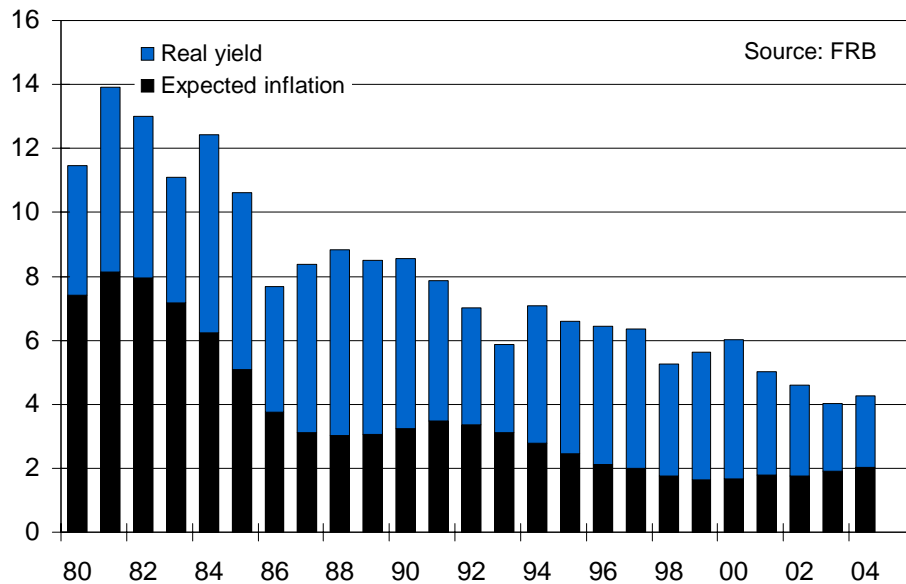
The growth in capital intensity over the long run is expected to fall a bit short of the growth experienced historically, however. The growth in the real net stock of capital per employee in coming decades is projected to be less than the approximately 1% per annum gain experienced since 1960.

Chart 3: Steady, but Slower Capital Accumulation
Net real capital stock per employee



Weighing on the growth in capital formation will be the end of the long-running decline in interest rates and the cost of capital. Ten-year Treasury yields have fallen by more than half over the past quarter century due to decelerating inflation and a narrowing in real long-term rates. With inflation now consistent with the Federal Reserve’s target and real yields expected to rise given the nation’s yawning current account deficit and massive need for global funds, the cost of capital is expected to move higher.

Chart 4: Steadily Falling and Now Low Long-Term Interest Rates
10 year treasury yield

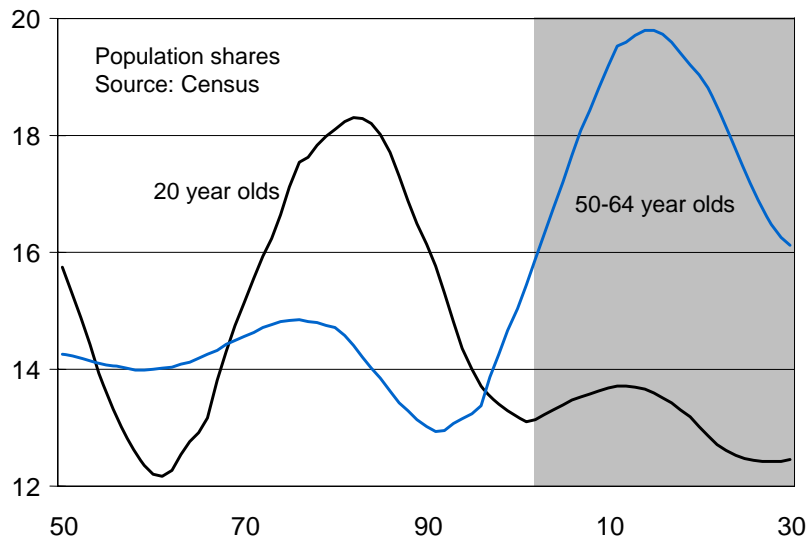


Workforce quality. Improvements in the quality of the workforce have been a small, but steady source of productivity gains. In the years following World War II, the workforce became more educated, but due

to a surge of new workers including females and young baby boomers, the workforce was very inexperienced.

Twenty-year-olds, with little if any work experience, surged as a share of the working age population in the 1960s and 1970s, peaking at close to one-third of workers by the early 1980s. Experienced 50-year-olds declined as a share of the working age population throughout this period. The quality of the labor force has been steadily improving since then. College graduates now make up some one-fourth of the population over the age of 25.

Chart 5: Work Force Experience



The quality of the workforce will continue to improve and add at least as much to productivity gains in coming decades as it has in recent past decades. The boomers are now aging into their most experienced, skilled, and thus productive working years. There will be more 50-year-olds than 20-year-olds a decade from now.

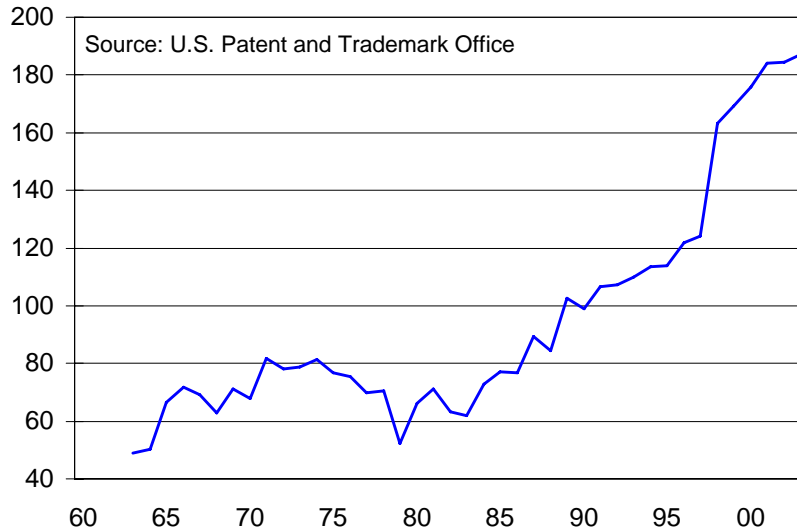
Multifactor productivity. Historically, the largest changes in productivity growth have been driven by changes in multifactor productivity growth. Between the end of World War II and 1973, MFP grew at now what seems like a whopping nearly 2% per annum. Between 1973 and 1995, MFP grew by a paltry 0.5% annually. This startling deceleration in MFP growth is the subject of considerable debate. Possible partial explanations include the oil price shock of that period, which made much of the nation's energy-intensive capital stock obsolete, and a slowing in the pace of technological change.

MFP has reaccelerated substantially during the past decade, back close to its pre-1973 pace. Fueling this acceleration is the heightened rate of technological change. Semiconductor technology in particular, which is so vital to gains in many other technologies, has advanced especially quickly. The number of transistors on a chip, and thus its processing power, has more or less been doubling every couple of years since the early 1980s.

While many factors have contributed to the heightened pace of technological change, increased business spending on research and development has been instrumental. The success of this R&D is evident in the

surge in new patents. In the early 1990s, the U.S. Patent Office granted some 100,000 patents each year. The rate is now nearly double that. All of this augurs well for the future pace of technological change and thus productivity growth.

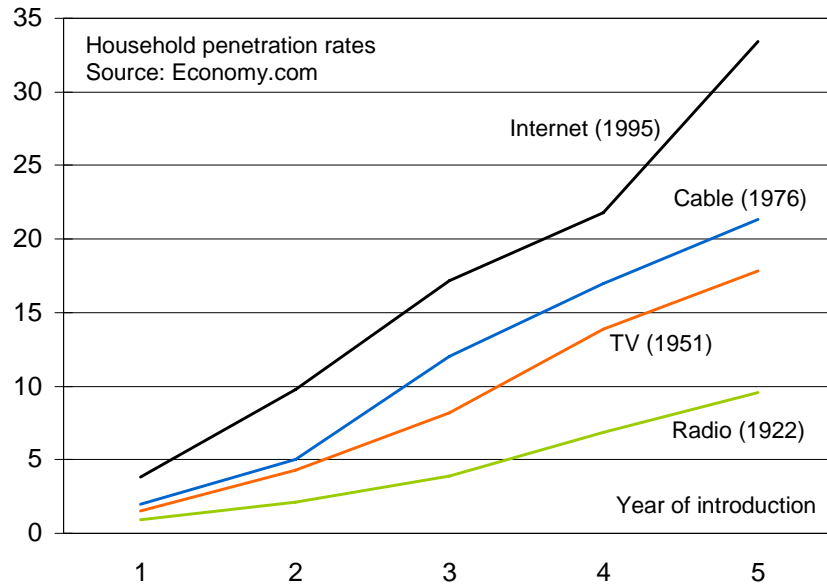
Chart 6: Greater R&D Pays Off
Ths of patents granted



Not only has the pace of technological change accelerated in recent years, but even more importantly, technology is being diffused and incorporated into business practices much more quickly. Synergies are developing across technologies as seemingly different as the microprocessor, the laser, fiber optics and satellites. Nowhere are these synergies more apparent than on the internet.

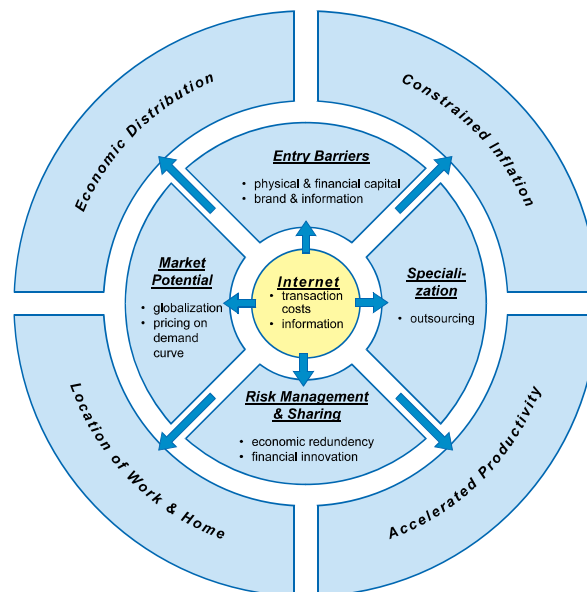
The acceptance of the technologies embodied in the internet has been unprecedented. Only five years after households and businesses were able to access the Web, there were some 50 million users. It took the cable TV industry a decade to reach 50 million customers from its inception in the early 1980s, 13 years for TV to reach that landmark, and 38 years for radio.

Chart 7: Increasingly Rapid Diffusion of New Technologies



The effective economic use of the internet has also been unprecedented. The web has reduced transaction costs between businesses and between businesses and consumers, allowing for the rapid dissemination of more and better information and lowering entry barriers into numerous industries. This in turn has heightened competitive pressures and forced businesses to specialize.

Chart 8: Internet Economics



Heightened competition is a direct result of lower entry barriers and enhanced information. Business specialization occurs as transaction costs across various business activities decline. The typical business today conducts a wide range of activities, including everything from the actual production of a good or service, to its distribution and marketing, and all the associated financial, accounting, legal and human

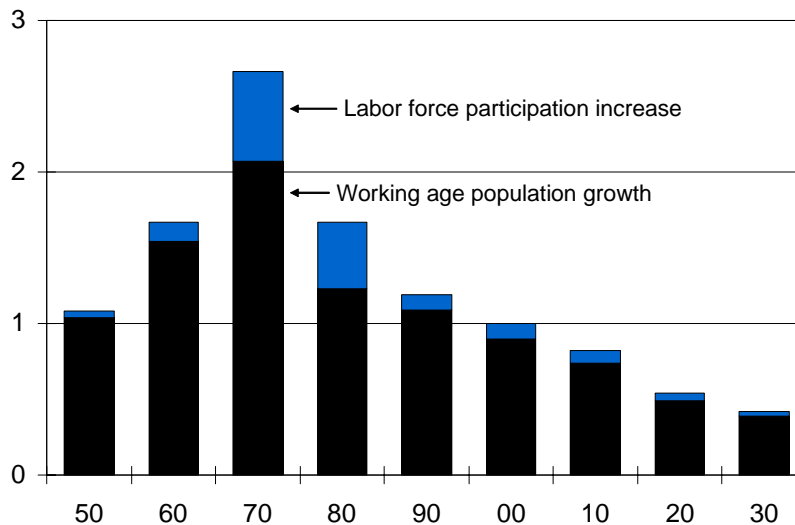
resource functions. Historically, the cost of doing these activities within the firm was lower than the cost of contracting for these activities outside the firm. The dramatic reduction in transaction costs afforded by the Web changes all that. Businesses increasingly concentrate on their very specific comparative advantage, and leave all else to other firms with their own advantages.

Despite the out-sized MFP gains of recent years, MFP growth in coming decades is not expected to be measurably different from that experienced on average over the past nearly 50 years. While the future may hold advances comparable in their economic importance to the internet, it is assumed that future advances will simply be on par with those experienced throughout the rest of our economic history.

Labor force growth. A more significant force weighing on long-term real GDP growth is an anticipated slowing in the growth in the labor force. Labor force growth is determined by the growth in the working age population and changes in the labor force participation rate.

Growth in the labor force has been slowing since the 1970s when it peaked at a 2.7% per annum pace. Growth is currently closer to 1% per annum. Behind this slowdown have been both slower working age population growth and much smaller gains in labor force participation. The labor force is expected to expand even more slowly in coming decades, as working age population growth slows further and participation rates level off.

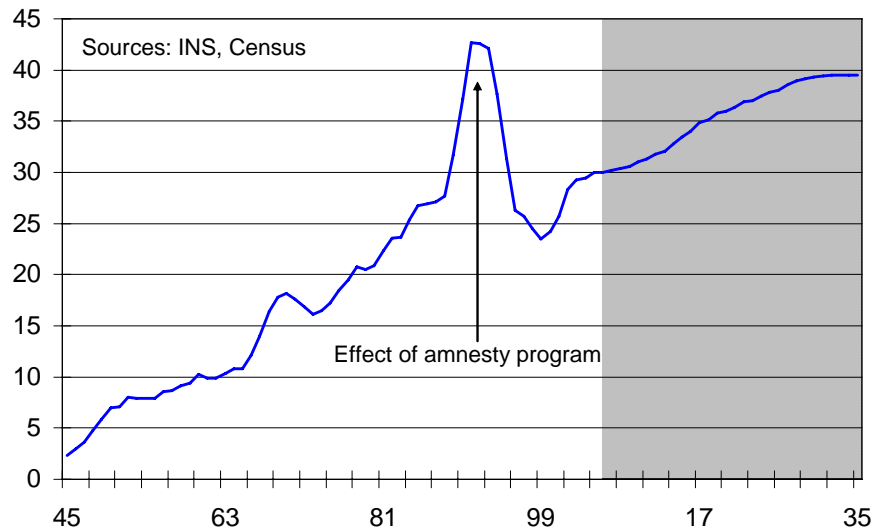
Chart 9: Labor Force Growth Will Decelerate
Average annual growth



Behind the slowing in working age population growth is the aging of the large baby boom generation into retirement. The leading edge of the cohort is now approaching their sixties. A quarter century from now, nearly the entire cohort will be in what is currently thought of as retirement age.

Working age population growth would actually begin to decline two decades from now if not for expected strong continued foreign immigration. Legal and illegal immigration together are currently running as much as 2 million annually, accounting for nearly one-third of the nation's population growth. Even stronger immigration is expected in coming years, accounting for a steadily rising share of population gains.

Chart 10: Foreign Immigration Is Driving Population Gains
Share of population growth due to legal immigration 5 yr. MA



While immigration has seemingly slowed in recent years in a less hospitable post-9/11 environment, it is expected to reaccelerate in coming years. The principal impetus for stronger immigration will be the increasingly tight job market resulting from the retiring boomers. This also suggests that the immigration laws will eventually change from being family-friendly to labor skill-friendly. Under current law, it is easier for foreign-born U.S. residents to bring overseas family members to the U.S., regardless of their skill level and educational attainment. This is expected to change as economic needs become more pressing.

Expectations that participation rates will rise only marginally in coming years is due in part to much smaller further anticipated gains in female participation. The steady increase in female participation rates experienced during the 1970s and 1980s has all but stopped since the mid-1990s.

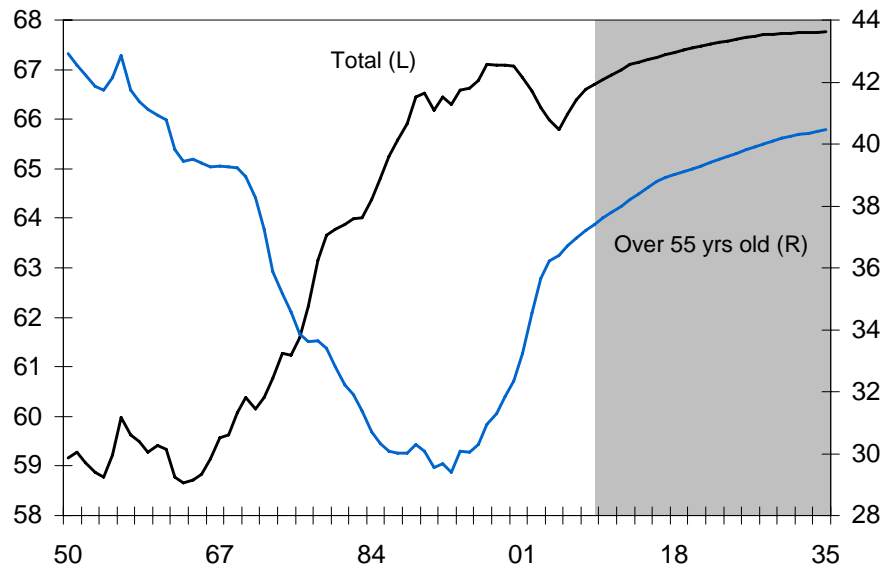
It was inevitable that the growth in female participation would eventually slow. The participation rate for females between the ages of 35 and 44, for example, rose from one half in the late 1960s to well over three-quarters currently.

Higher housing affordability will also constrain female participation rates. Strongly rising house prices and mortgage interest rates locked many households out of homeownership during the 1970s and 1980s. At its low point in the early 1980s, the household earning the median income could afford to purchase about one-half of the median priced home. For families to afford to purchase a home, two incomes were required, pushing females into the workforce for the first time. Since the late 1980s, however, lower mortgage rates and transaction costs and the increased availability of mortgage credit have made housing more accessible. Single-earner households have been on the rise. While housing affordability is now weakening given surging house price growth, and is expected to erode further as mortgage rates rise, housing is expected to remain much affordable than in the 1970s and 1980s.

Participation rates of older workers are expected to move higher, however. This is in part out of necessity, as many will have inadequate retirement nest eggs and will have to work longer. This pressure will only intensify given prospects for cuts in Social Security, private retirement plans, and healthcare

benefits. Rising participation rates of older workers will also be in part a lifestyle choice, as older workers are increasingly healthier and interested in remaining on the job. Indeed, these forces already appear to be having an impact.

Chart 11: Small Continued Gains in Labor Force Participation
Labor force participation rate



Long-run business cycle. Predicting the timing and nature of economic downturns far into the future can not be done with precision, but it is clear that recessions will occur, and when they do, they will be shorter and milder than those experienced on average since World War II. The length and duration of the 1990-1991 and 2001 recessions will be more typical of future downturns.

The business cycle represents the seemingly regular fluctuations in the economy’s performance. The cycle is defined by five phases, including expansion, peak, recession, trough, and recovery. The expansion is the longest phase of the cycle when the economy is enjoying generally steady gains in output and employment. The economy is operating close to its capacity and inflation is stable. The peak is a brief period at the end of the expansion, just prior to recession. At the peak, the economy is expanding strongly and operating above capacity, resulting in accelerating inflation and rising interest rates.

The economy ultimately succumbs to the higher interest rates, and a recession ensues. A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally evident in real GDP, real income, employment, industrial production, and wholesale-retail sales. Unemployment rises during recessions and capacity utilization falls. The economy is at its nadir at the trough of the cycle. Inflation is decelerating during the recession and at the trough, and interest rates are falling.

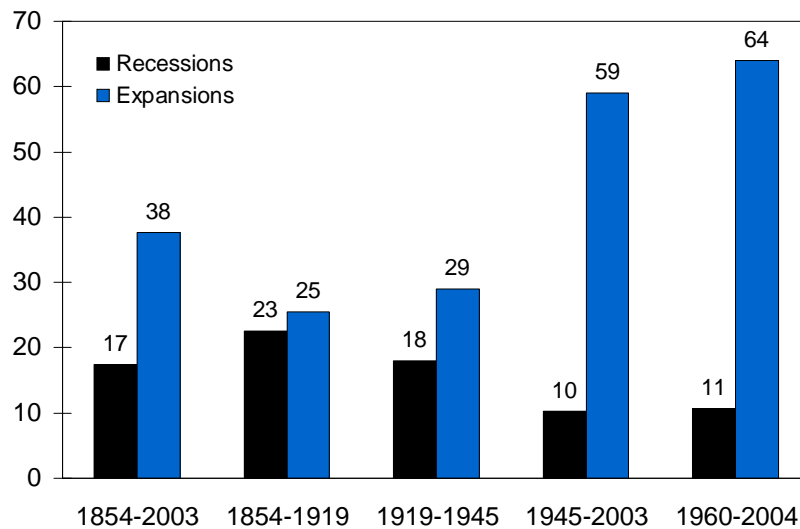
The recovery phase is the initial period after recession when the economy is generally expanding at its most rapid rate. The recovery ends and the expansion begins when output and employment surpass levels achieved in the previous peak.

The business cycle dating committee of the National Bureau of Economic Research, a group of well-known academic economists, is the official arbiter of the national business cycle. The NBER has determined that there have been ten business cycles since World War II. Cycles during the first 30 years

were short, lasting on average only five years. Cycles during the most recent 30 years have been much longer.

While the length of the business cycle has gotten longer, recessions have become shorter. In the period between the Civil War and World War II, recessions averaged more than a year and half. Since World War II, they have averaged less than a year. The past two recessions have been notably short, each lasting only eight months.

Chart 12: Longer Expansions, Shorter Recessions
Average length in months



Recessions have also become less severe. Percentage declines in real GDP, industrial production and employment and the increase in unemployment have been much less pronounced during the past two downturns than during the average post-WWII recession.

The increasing longevity of economic expansions and shortening of recessions is the result of several long-running structural changes shaping the U.S. economy and the dynamics of the business cycle, including the increased globalization of the economy, financial deregulation and innovation, a more flexible workforce and the heightened pace of technological change. These changes are impeding the development of those economic imbalances that often precede recessions, and they have heightened the ability of the economy to adjust to those shocks that ultimately induce recessions.

The economic imbalances that are a precondition of recession develop when households, businesses, and financial intermediaries become extraordinarily confident during the strongest points of expansions and take increasingly more speculative risks. Historically, these imbalances have included overbuilt real estate markets, overleveraged businesses and households, capital-short financial intermediaries, and bloated inventories.

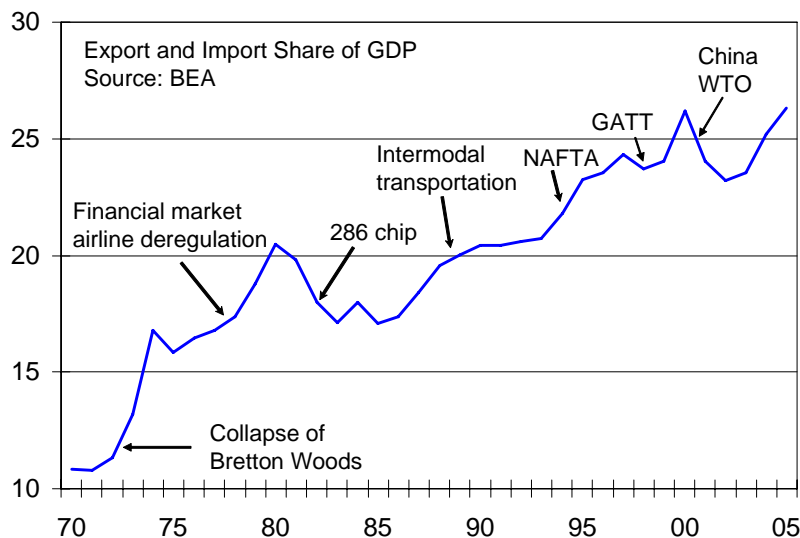
The prevalence of economic imbalances by themselves does not result in recessions. Another necessary condition for recession is the occurrence of one or a series of so-called exogenous shocks. Exogenous events are occurrences that by definition are inherently unpredictable. All of the nation's past economic recessions can be traced to such an event. OPEC-engineered oil price shocks were instrumental in inducing the 1974-1975 and 1980 recessions, and 9/11 contributed to the last recession, for example, while ill-conceived fiscal and monetary policy decisions have contributed to nearly all downturns.

Exogenous shocks induce recessions when the economy is burdened with imbalances, since it is when households and businesses are overextended that they lose confidence when events do not go as planned. A downturn only occurs when confidence is lost, and households and businesses aggressively rein in their spending and investment. When the economy is not struggling with imbalances, then households and businesses will shrug off unforeseen economic missteps, confidence is maintained, and recessions are avoided. The 1990s economic expansion sailed through a very serious contraction in the Mexican economy in 1995 and the global economic crisis in 1998, for example, largely because the economy was well balanced in those periods.

Monetary tightening often precedes economic downturns since higher interest rates exacerbate any economic imbalances that exist and expose the excesses that have occurred when the economy is performing at its best. Household and corporate debt loads rise and asset values fall with higher rates, for example, resulting in rising financial pressures. Monetary tightening after Y2K, for example, helped precipitate the bursting of the Y2K stock market bubble, which was a principal catalyst for the recession that began in early 2001.

Globalization. Increased globalization of the U.S. economy through greater trade, direct investment and foreign immigration has dampened the business cycle. Exports and imports of goods and services currently account for nearly one-third of GDP, up from one-fifth at the start of the 1990s and one-tenth at the start of the 1970s.

Chart 13: An Increasingly Global Economy



Trade law liberalization and international financial deregulation from the collapse of the Bretton Woods fixed exchange rate agreement in the early 1970s to the passage of the Nafta and GATT agreements in the 1990s have contributed to the globalization of the economy. Improvements in transportation, distribution and communication technology and infrastructure have also stimulated trade.

U.S. recessions during the past quarter century would have been substantially more severe if international trade were not as important to the economy. In the nadir of the 1973-1975, 1980 and 1990-1991

recessions, for example, year-over-year real GDP growth would have declined by as much as 1% more if it were not for an improving trade balance during those downturns.

Trade flows have also served to rein in the economy during the boom periods of expansions, forestalling wage and price pressures and thus subsequent downturns. Trade flows generally move countercyclically since U.S. and world economies are oftentimes at different stages in their business cycles. In the 1991 recession, for example, the Mexican and Japanese economies expanded by over 3% and the German economy grew by more than 5%. In contrast, when the U.S. economy was surging in 1994, the Japanese economy hardly grew and the German economy was decelerating quickly.

Moreover, the dollar generally moves procyclically, appreciating when the U.S. economy is strong and depreciating when the economy is weak.

Globalization does pose risks to the U.S. business cycle, however, by further exposing the economy to external exogenous shocks. The Mexican peso collapse and subsequent economic crisis, for example, was a factor in the slowing of the U.S. economy in the mid-1990s. Although by itself, the Mexican crisis was not sufficient to undermine the U.S. expansion, if combined with a similar crisis in Asia, for example, a U.S. recession may have occurred.

Financial deregulation. Financial deregulation and innovation are also dampening the business cycle by lifting constraints on credit availability to households and businesses.

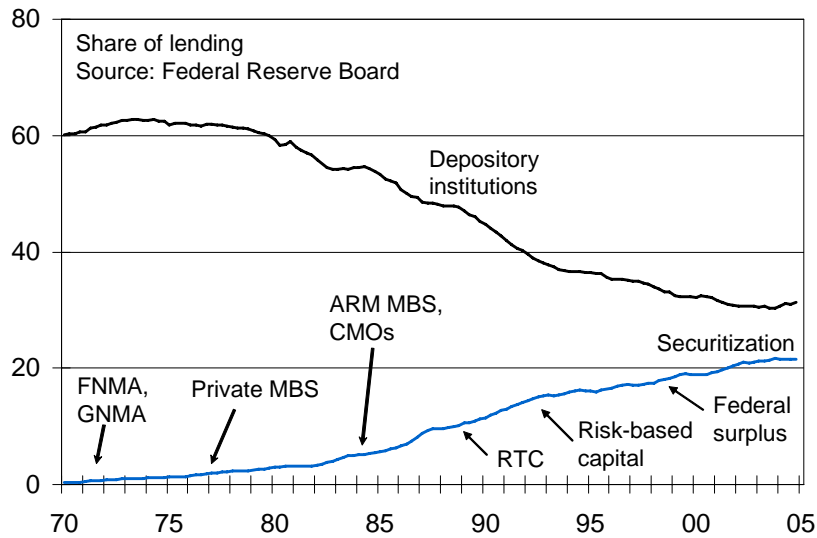
This is most clearly seen in the housing market. Prior to the commencement of banking deregulation in the 1970s, short-term housing demand was largely determined by the availability of mortgage credit. Mortgage credit availability was in turn determined by the availability of deposits at thrift and to a lesser extent banking institutions. Deposit flows were highly volatile, however, since deposit rates were regulated and set according to Regulation Q. When the Federal Reserve tightened monetary policy, there was substantial deposit outflows from thrifts and banks as investors moved their savings to higher-yielding money market instruments. During this period of disintermediation the mortgage and housing markets shutdown, significantly exacerbating the economy's problems.

Policymakers recognized the disruption to the economy resulting from swings in mortgage credit availability and phased-out Regulation Q by the early 1980s. Policymakers also facilitated credit availability with the expansion of the secondary mortgage market through the establishment and support of Ginnie Mae, Fannie Mae and Freddie Mac. Single-family mortgages owned and insured through mortgage pools by these federally sponsored institutions now account for approximately one-half of all outstanding mortgages. Mortgages are owned by investors worldwide, ensuring that mortgage credit is always available to homebuyers at some price.

Moreover, the growing plethora of mortgage products, which is in part the result of the depth of the secondary market, is providing homebuyers a wide range of pricing options. Homebuying decisions have become less dependent on the interest rate environment and more a function of demographic need. The result is that housing traditionally the most procyclical sector of the economy has been acting countercyclically in the current business cycle.

The consumer and commercial loan markets are also increasingly less subject to credit constraints. Capital is plentiful for all types of loans, ranging from credit cards and home equity loans to commercial mortgage loans. This is also largely due to the surging growth of the asset backed securities market, which has expanded rapidly since its inception in the early 1980s. The securities markets now provide nearly as much credit to households and businesses as traditional depository institutions.

Chart 14: Securitization of Financial Intermediation



Although credit has long been available to prime borrowers with relatively good credit and employment histories, the most rapid growth in lending in recent years has been to poorer B and C-quality borrowers. Until recent times, these borrowers were credit-constrained, foregoing spending during soft economic periods when incomes were weak but expected to improve and unleash their pent-up demand when the economy rebounded. This resulted in substantial volatility in consumer spending. With more ample credit currently available, consumer spending and the business cycle will be more stable.

Flexible labor markets. Greater flexibility in the nation’s labor markets is also dampening the business cycle. Labor market flexibility has been enhanced by the rapid growth of the contingent workforce. Contingent workers include independent contractors, those who work for temporary help agencies and contract firms and the self-employed.

Contingent workers can quickly be deployed to industries where demand for their services is strongest from industries where demand is weaker. The costs of shifting contingent workers to jobs where and when they are needed are relatively low since most do not receive severance or other benefits.

Labor markets have also become more flexible as employees are increasingly willing to shift the number of hours they work to meet changing demand for the goods and services they produce. Overtime hours are costly, but the costs and time involved with hiring and firing workers are more significant.

Labor market flexibility is also manifested in the willingness and ability of labor to relocate. Migration flows from the relatively weak California and Northeast economies to the stronger southern and western economies were substantial during the 1990s, for example. On average, close to 280,000 net domestic migrants left California each year during the decade, while over a combined 270,000 net domestic migrants left New York, New Jersey and Pennsylvania. These dramatic migration flows cooled overheating labor markets throughout the nation, and allowed that expansion to continue with only moderate wage pressures.

The increased flexibility of the workforce has come at a cost to some workers in the form of constrained compensation, underemployment and the economic and other costs of moving, but it has enhanced the economy’s ability to adjust to shifting conditions that could ultimately result in recession.

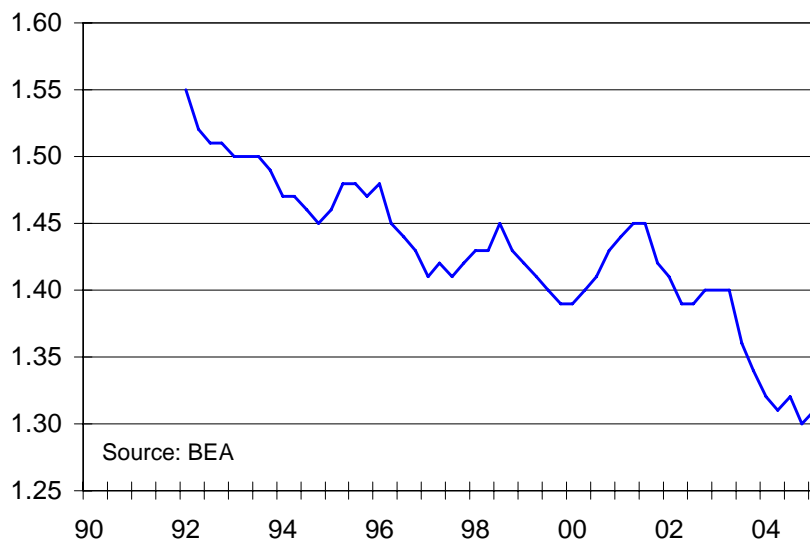
Technology. The business cycle is also being tempered by advances in information and other technologies. With more, better and timely information, it is less likely that businesses will make mistakes that result in substantial production and employment cuts.

This is most evident with respect to the management of inventories. In the recessions of the first 30 years following World War II, collapsing inventory investment accounted for nearly the entire decline in real GDP. During the past 30 years, inventory changes have become an increasingly smaller proportion of overall economic activity and thus contributor to its ups and downs.

Technology is reducing the role of inventory shifts in shaping the business cycle by reducing the amount of inventories that businesses hold relative to sales. This has occurred through the adoption of inventory management techniques such as just-in-time and materials resource planning, which have been made possible by advances and strong investment in computer, scanner and telecommunications technology.

The inventory-to-sales ratio is currently at a record low. Investment in inventory management techniques and equipment will remain robust, as the competitive pressures that prompted businesses to adopt new and innovative inventory management techniques in the first place remain in place. Technology is reducing the need for inventories and is thus a key contributor to the vagaries of the business cycle.

Chart 15: Record Low Inventory-to-Sales Ratio
Business IS ratio

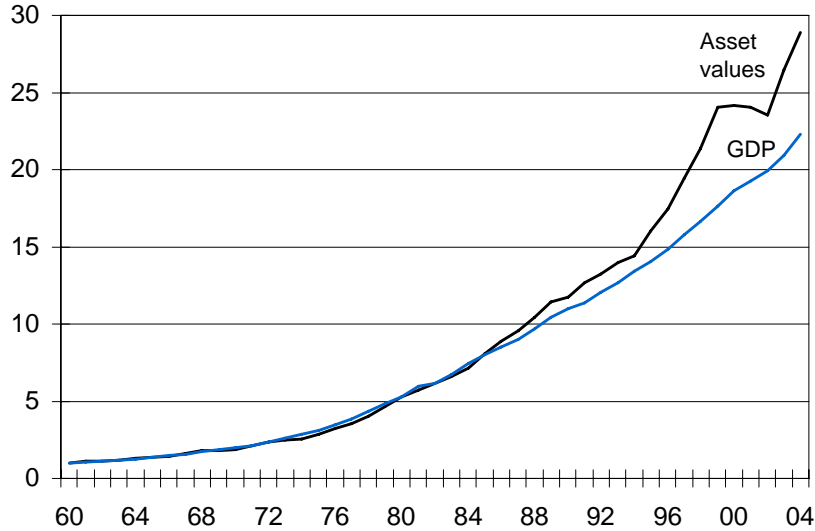


Long-run asset returns. The long-run return on the economy's assets, taken in totum, should closely mirror long-run real GDP growth. To see why, consider that the value of any asset must ultimately equal the present value of the future stream of what the asset produces. Stock values are determined by future corporate earnings growth, for example, and housing values by future housing services provided. The value of the economy's assets is thus tied to the future production of all goods and services, namely GDP.

Given expectations for slower economic growth in coming decades, asset returns will thus also slow. Compared to long-run historical returns, future returns will seem particularly paltry. Returns during the past quarter century have been especially strong due to rising valuations, as investors have been willing to

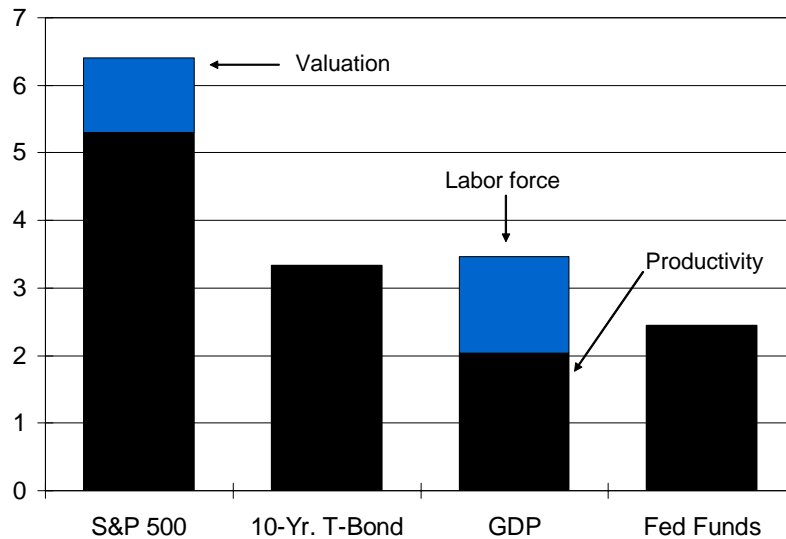
pay a higher price for the economy's assets than implied by the economy's growth. Since the early 1980s, the value of all household assets has risen nearly sixfold, while GDP has risen only fivefold.

Chart 16: Asset Values Have Outpaced Economic Growth
1960=1.0



Rising valuations have been concentrated in stocks. Despite the stock market's recent travails, real stock returns since 1960 have been just over 6% per annum. Of this, fully one hundred basis points of the return is due to a higher price-earnings ratio. The S&P 500 PE ratio was closer to 15 in 1960, compared to 20 today. As expected, average real long-term Treasury bond yields have been spot on with the just over 3% per annum real GDP growth experienced during this period. The return on cash, as measured by the real federal funds rate target, has averaged close to 2%.

Chart 17: Real Returns, 1960 to Present
Average annual growth



The increase in asset valuations during the past quarter century, however, will not be repeated going forward. Valuations rise when risk falls, which it has given the lengthening of the business cycle and the

shorter and milder recessions. Investors feel more certain about the economy's growth and thus future returns on the economy's assets. They are thus willing to pay more for them.

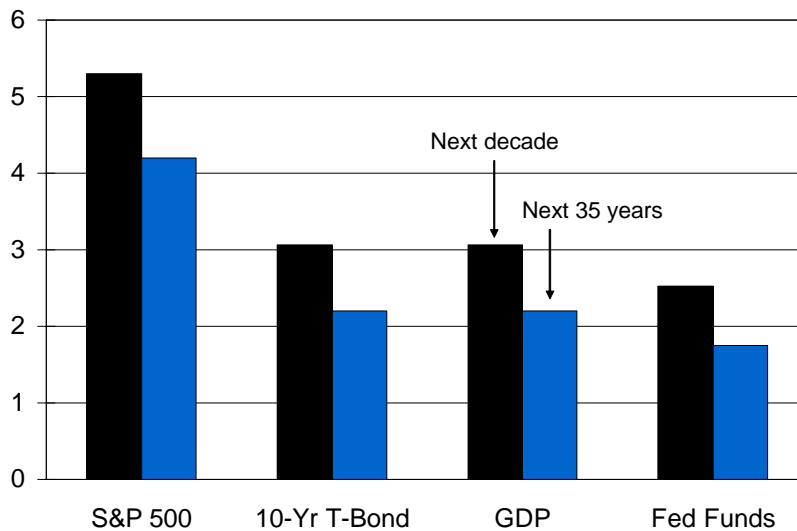
The steady decline in inflation and the increasing credibility of the Federal Reserve in maintaining low inflation have likely also added to valuations. Uncertainty regarding future inflation undermines investor confidence and thus asset values.

Globalization has further lifted asset values, as global investors have to date been aggressive buyers of U.S. assets. This reflects the more open global financial system, which allows previously fettered foreign households and businesses to invest in the relatively safe and liquid U.S. markets. It also reflects the lack of investment opportunities overseas, particularly given the heightened geopolitical uncertainty in most other parts of the world. The record large U.S. current account deficit is in part testimonial to robust global investor demand for U.S. assets.

The forces driving asset valuations higher in recent years are fading. The benefits of a less pronounced business cycle are largely, if not completely, embedded in valuations. Inflation and inflation expectations are as low as they can go, namely the Federal Reserve's target. Global investors are awash in dollars to invest given the ballooning current account deficit, and will not pay even higher valuations for U.S. assets.

Stock returns will experience the brunt of the more stable asset valuations, with real returns slowing to an expected 5% per annum pace over the next decade. Real 10-year Treasury bond yields will average near the expected 3% per annum real GDP growth. With even slower growth expected in the longer run, asset returns will also slow. Over the next 35 years, real 10-year yields are anticipated to average 2% and real per annum stock returns only 4%.

Chart 18: Slowing Real Asset Returns
Average annual growth



Conclusions. Broadly speaking, the economy's long-term outlook is for sturdy growth, low unemployment, and low inflation. Over the next decade, real GDP growth is expected to average close to 3% per annum; consistent with growth experienced during the past quarter century. The unemployment rate will average near 5%, and consumer price inflation close to 2%.

Growth is expected to slow in subsequent decades due largely to the aging of the population, but also due to slower growth in capital accumulation.

While the economy will experience future recessions, the business cycle has become longer and increasingly less volatile. The next downturn will likely be as modest and short-lived as the 2001 recession.

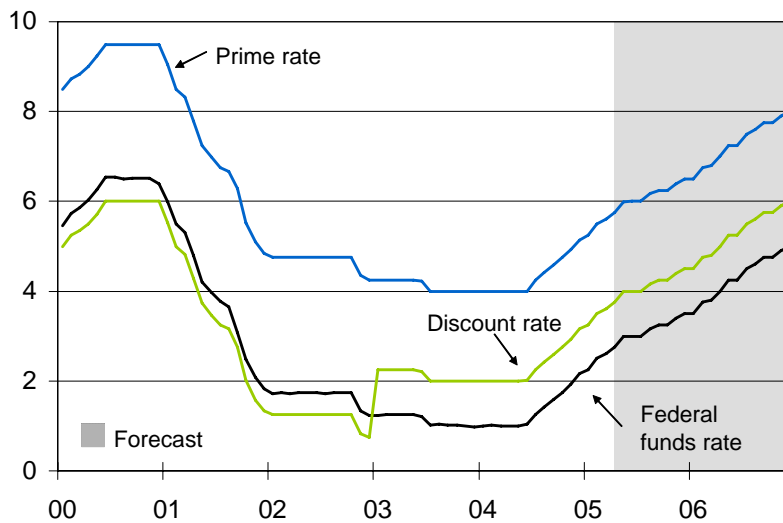
Long-run real asset returns, toted up across all assets, will be consistent with the economy's real growth. This is slower than the returns enjoyed in recent decades, however, as those gains were supported by rising valuations, reflecting the less volatile economy and increasingly more global financial markets.

The economy does face significant longer-term challenges, ranging from the possibility of further terrorist attacks, significant disruptions to fragile energy supplies, and mounting government fiscal problems that will only be exacerbated when the large baby-boom generation retires. These are substantial economic problems that will require significant preparation, policy debate and reform to be successfully overcome, but using the totality of the nation's history as a guide, they eventually will be.

Forecast Assumptions

Monetary policy. The Federal Reserve Board is engaged in a series of measured monetary tightening moves that is expected to continue into 2006. Since this process began a year ago, policymakers have raised the federal funds rate target by 25 basis points at each FOMC meeting. The funds rate target has risen from a forty-year low of 1% to its current 3%.

Chart 19: Monetary Policy



Despite the tightening, monetary policy remains accommodative. The real federal funds rate, as measured by the difference between the nominal target and expected CPI inflation implied in Treasury inflation protected securities, is just barely positive. The real funds rate has been near zero or below since soon after 9/11. That is has remained this low so far into the expansion is unprecedented.

Policymakers are expected to tighten again by another 25 bp at the late June FOMC meeting, and will continue tightening until the funds rate target reaches its neutral rate, or that rate at which policy is neither

stimulating nor restraining growth. There is substantial uncertainty regarding the precise level of the neutral rate. Estimates provided by FOMC members range from 3.5% to 5%.

Economy.com estimates the neutral rate to be 4.5%. This is equal to long-run potential nominal GDP growth, composed of 3% real growth (2% productivity growth and 1% labor force growth) and 1.5% targeted inflation (based on the core consumer price deflator).

The next significant move by policymakers will be to eliminate the “measured” language currently used in their policy statement. This policy, which was adopted just prior to the start of the monetary tightening, signals policymaker’s intent to raise the funds rate target by 25 basis points at the next FOMC meeting.

To date, the measured tightening policy has been very effective, substantially reducing uncertainty in financial markets, and thus contributing to low long-term interest rates. The policy has also reduced the odds of a financial misstep. Policymakers have so far avoided the severe economic dislocations, including the Orange County bankruptcy and the Mexican peso crisis that occurred when they aggressively tightened policy coming out of the early 1990s downturn.

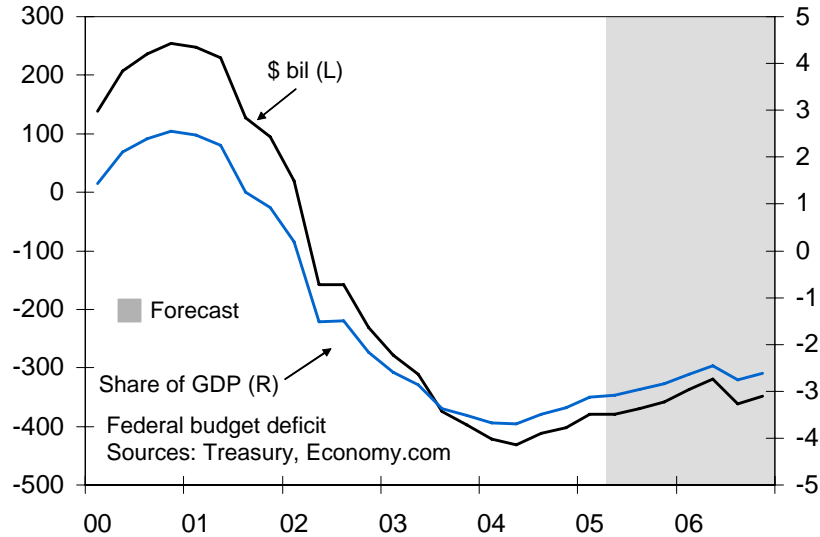
The benefits of the measured tightening policy appear increasingly outweighed by the costs of heightened risk-taking, however. This is most evident in high and quickly rising house prices and prices paid for commercial real estate in growing parts of the country. While there are strong fundamental reasons for higher real estate prices, recent price gains increasingly appear to be the result of speculation. Low long-term rates and resulting surge in house prices have also enticed homeowners to substantially increase their mortgage borrowing and leverage.

Risk-taking in global bond markets also threatens to become excessive. Junk corporate bond and emerging market debt yields are currently only several hundred basis points over long-term Treasury yields. The last time yield spreads were as thin was just prior to the late 1990s Asian financial crisis and Russian bond default.

Policymakers are assumed to briefly lift the funds rate target above the neutral rate in mid-2006, as it becomes evident that the risk-taking remains entrenched, the economy’s growth remains strong, and broader inflationary pressures are developing as the slack remaining in job and product markets is worked off.

Fiscal policy. The federal government’s fiscal situation remains poor, but is improving. The deficit this fiscal year is expected to be near \$375 billion. This is down from the record 2004 fiscal year deficit of just over \$400 billion. As a share of GDP, the standardized operating deficit in 2004, which adjusts for the impact of the business cycle on revenues and outlays and excludes interest payments, came in at 2.4%; the worst since World War II.

Chart 20: Fiscal Policy



Contributing to the recently more stable fiscal situation is the better economy, the end of the tax cutting, and less rapidly rising discretionary outlays. Further modest improvement in the deficit is expected through FY 2007.

This more positive near-term outlook assumes that federal defense and homeland security spending, which is currently close to \$600 billion annually, increases only slowly going forward. This in turn assumes military operations in Iraq continue at or near their current level through FY '07.

Spending related to Iraq is expected to wind down towards the end of the decade, but spending on other defense priorities are expected to increase. Defense spending is thus projected to remain close to 4% of GDP in the long-run. This is well below levels experienced during the Cold War, but it is well above the levels experienced during the late 1990s.

The deficit is expected to begin eroding again late in the decade. This assumes that the tax cuts implemented in the Bush Administration's first term are made largely permanent. Under current law these tax cuts are set to expire in coming years.

The widening future deficits also reflect the aging of the population and the increasing demands put on Social Security, Medicare and Medicaid. Given the daunting task of reforming the Medicare and Medicaid programs, no substantive progress is assumed to occur during the next decade. It is also assumed that there will not be any large scale privatization of social security. Privatization could have substantial budgetary impacts depending on how it is designed.

The President is also expected to pass some limited tax reform in FY 2006. This will principally include a scaling back of the alternative minimum tax. The budget impacts are expected to be small, however, as any lost revenue is expected to be made up for by the elimination of state and local income tax deductions.

Taken altogether, the federal government is expected to run a whopping cumulative deficit of well over \$4 trillion, equal to nearly 3% of GDP, between fiscal years 2005 and 2014.

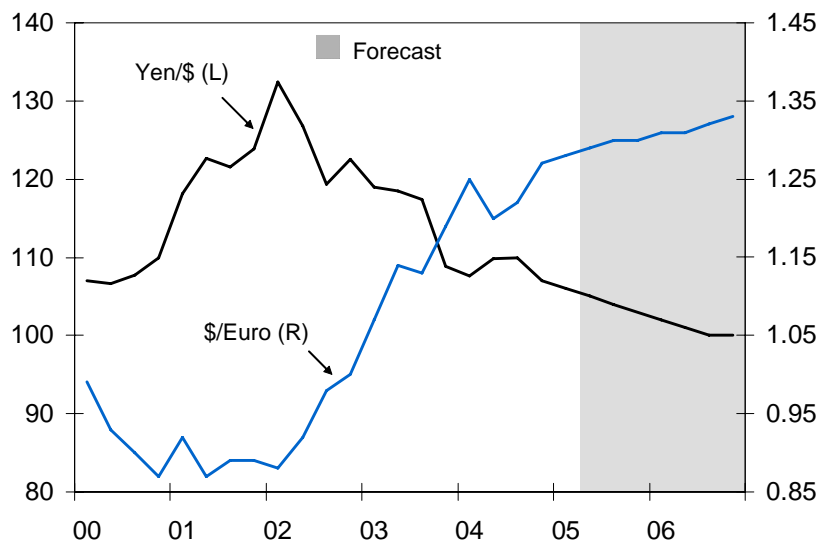
U.S. dollar. The U.S. dollar has gained some ground in recent weeks, but remains fragile. The most significant recent gains have been vis-à-vis the euro, which has fallen from a peak of over 1.35 to closer to 1.25 currently. The dollar has also strengthened a bit against the U.K. pound and Canadian dollar.

Behind the dollar's recent gains are the flagging Continental European economy and political disarray ignited by France's failure to ratify the EU constitution. The U.K. and Canadian economies have also downshifted under the weight of their strong currencies and somewhat tighter monetary policies.

The dollar is not expected to gain much further vis-à-vis these currencies, however. The European and Canadian economies are expected to stabilize, and these currencies are now approximately near their equilibrium values against the dollar.

A further decline in the real broad trade weighted dollar is expected this year, but this depreciation is expected to occur against the Chinese, Indian and other East Asian currencies that currently peg or heavily manage their currencies vis-à-vis the dollar. Pressure on China to revalue the yuan and outline a path towards a freely-floating currency is intense. China is assumed to adjust its peg sometime this year, and adopt a process towards an eventually freely-floating currency.

Chart 21: U.S. Dollar



The large and growing U.S. current account deficit will remain a long-term millstone on the dollar. The deficit is over 6% of GDP and continues to erode. Historically, significant economic and currency adjustments have been ignited in other major developed economies once their current account deficit approached 5% of GDP. An adjustment must eventually occur in the U.S.'s trade and current account, which is unlikely to take place without a continued depreciation of the dollar.

The real broad trade weighted dollar, which is down some 15% from its peak three years ago, is thus expected to decline by another 15% over the next three years. This decline is expected to be orderly, as the dollar will be supported by its status as the global economy's most important reserve currency and because oil and most other commodities are priced in dollars. The strong likelihood of ongoing global turmoil will also provide underlying support, as it will remain the principal safe haven for harried global investors.

Also limiting any decline in the dollar will be strong underlying U.S. productivity growth, particularly when compared to that being experienced throughout the rest of the global economy. This will continue to hold out the promise of better returns to global investors owning U.S. assets.

Energy prices. Oil prices have receded a bit in recent weeks. The price for West Texas Intermediate is currently trading close to \$50 per barrel, down from its recent record peak of over \$55 per barrel. Gasoline prices have also peaked, although they remain well above \$2 per gallon. Natural gas prices are elevated as well, trading at over \$6 per million BTU.

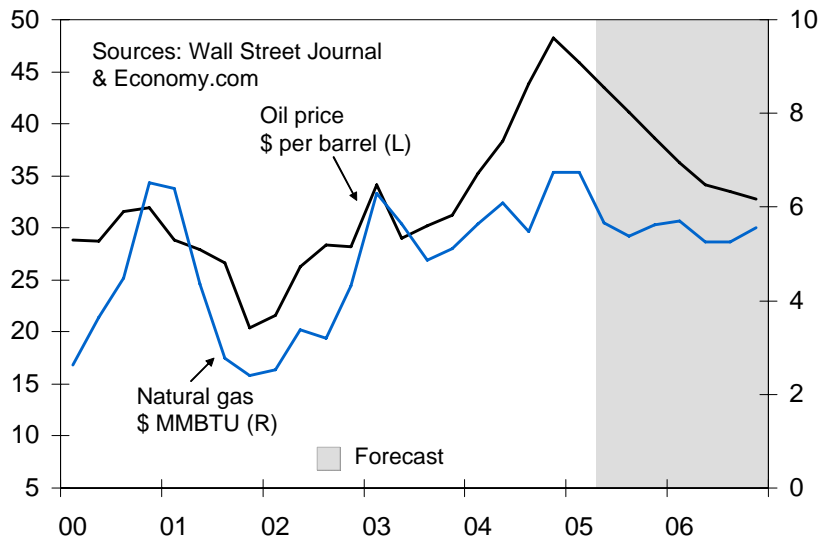
The catalyst for the higher energy prices has been surging global demand for energy, particularly from the booming Chinese and strong U.S. economies.

Global energy suppliers were also initially slow to respond to the higher prices. Their reticence was due in part to uncertainty regarding the sustainability of the higher prices. Large mergers within the industry and a rash of accounting scandals likely also distracted the management of energy companies and delayed investment in exploration and development.

Also adding to the higher prices have been ongoing concerns regarding the reliability of energy supplies from various global energy suppliers. Concerns with Iraq, Russia, Nigeria, and Venezuela remain particularly high. This risk premium also added as much as \$15 to the cost of a barrel of oil.

Energy prices are expected to moderate by this time next year, falling closer to \$40 per barrel. Global energy demand growth is slowing as the unsustainably strong growth in China and the U.S. abates. China and the U.S. accounted for well over one-half of the 2.5 million barrel per day increase in oil demand last year. This increase was the largest in thirty years.

Chart 22: Oil Prices



Global energy supplies are also expected to increase. Saudi Arabia has ramped-up production and has promised to increase its capacity. Oil from non-OPEC sources is also quickly increasing, as is clear from the rapidly growing number of rigs operating in North America. Rig counts are now as high as they have been since the early 1980s.

The more sanguine oil price outlook is also based on the expectation that Iraqi oil comes online more fully in coming months and that political problems in Russia and Venezuela are generally contained. Most importantly, however, the risk premium in oil prices is expected to slowly fade.

Natural gas prices are expected to remain elevated compared to oil prices until later in the decade when LNG terminal development is completed. Natural gas imports are currently constrained by a lack of available pipeline and seaport capacity. New exploration and development has also been limited and what exploration has occurred has not been as productive as anticipated. Natural gas accounts for nearly one-fourth of the nation's energy consumption.

Oil prices are expected to average \$37.5 per barrel through the remainder of this decade. Natural gas prices are expected to average \$6 per million BTU.

U.S. Economic Outlook

The economy ebbs and it flows. Even in the middle of economic expansions, such as the current period, the economy rarely moves in a straight line. Indeed, the economy is experiencing an energy price spike-induced ebb. Real GDP growth has slowed from close to 4% at the end of last year, to nearer 3%.

Oil prices of over \$50 per barrel have sapped some of the strength in consumer spending. Vehicle sales have been most affected. While unit sales have held up as auto makers have added more discounts to compensate for record gasoline prices, buyers are switching from larger less energy-efficient SUVs to cars. Consumer confidence and core retail sales, which exclude spending on vehicles and gasoline, have also moderated. Lower income households that spend more of their budgets on energy and have fewer other financial resources are particularly worried.

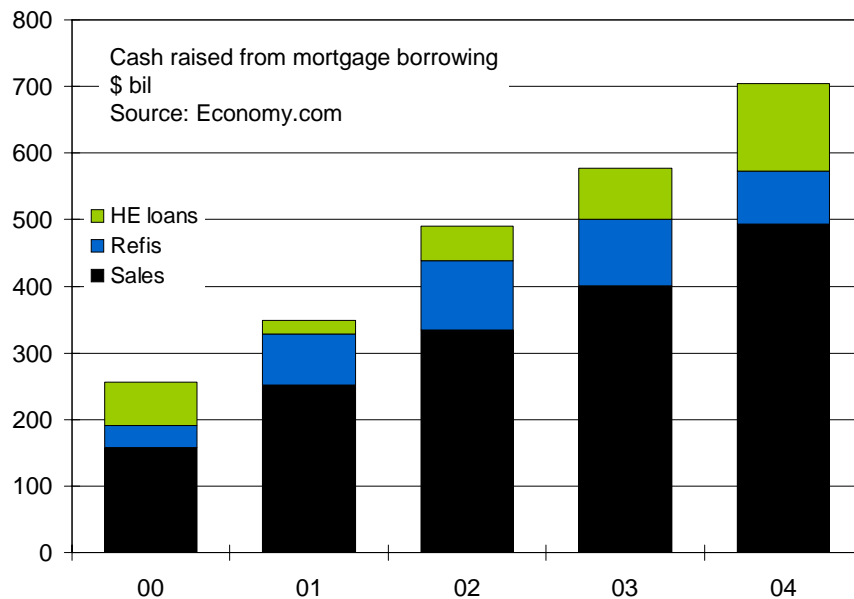
Judging by the surge in inventories, less voracious consumers have taken some businesses by surprise. The real inventory gain during the first quarter was over \$80 billion at an annualized rate. This is well over the \$50 billion gain estimated to be consistent with current sales growth. Manufacturing production and jobs will suffer a bit in the current quarter as businesses work to get inventories back in line with sales.

Housing boom. One constant throughout the economy's ebbs and flows in recent years has been the housing market. Housing activity has pushed steadily higher, and is arguably now as strong as it has ever been. Single-family homebuilding, home sales, and real house price gains continue to shatter previous records.

The contribution of the housing boom to the economy's growth has been enormous, accounting for an estimated one-fourth of real GDP growth over the past five years. The most obvious link between housing and the broader economy is through construction activity, real estate transactions, and mortgage finance. The multiplier benefits are substantial, as this activity generates demand in numerous supplying industries and the incomes earned drive spending elsewhere in the economy.

An even more important link has been through massive mortgage equity withdrawal. Homeowners took an estimated \$700 billion out of their homes last year through home equity borrowing, cash-out refinancing, and capital gain realizations via home sales. This is up from less than \$600 billion in 2003, and only \$250 billion in 2000. Based on Federal Reserve studies of what homeowners did with the cash raised in previous refinancing waves, approximately one-third of this cash is being used for debt repayment, one-third for home improvement and other investments, and the remainder on a wide array of consumer goods and services.

Chart 23: The Home as a Cash Machine



Housing is also driving broader growth via the nation's financial intermediaries. Residential mortgage loans, either whole or securitized loans, are approaching one-third of commercial bank assets. Given their currently pristine loan quality, the banking system is well capitalized and thus willing and able to provide credit to all borrowers.

Local governments flush with rising property tax revenues are also spending aggressively. This has been particularly fortuitous given the rapidly expanding demands on K-12 education for the aging baby boom echo generation, and cuts in grants from financially stressed state governments.

Thickening froth. Housing will be increasingly hard-pressed to support the economy's future growth, however. While housing demand has been driven by solid fundamental forces, most importantly being low mortgage rates and the explosion in mortgage credit, it appears to be increasingly driven by speculation.

Speculation infects demand when buyers purchase an asset simply based on the expectation that the asset's historically strong price gains will be repeated long into the future. While it can not be known for sure that speculation is driving asset demand until prices for the asset break, there are often signs.

In the housing market, one clear sign is a rising share of homes that are being purchased by investors. The investor share is indeed rising rapidly in hyped-up markets in California, Florida and in the Northeast. Another is the willingness of buyers to take on more leverage and risk to purchase a home. Interest-only mortgages, which were the domain of a handful of high-end homebuyers just a few years ago, accounted for more than one-sixth of mortgage originations during the last half of 2004 according to the Mortgage Bankers Association.

An approach to measuring the degree of speculation in housing markets is to estimate a model of house prices based on the various factors that determine demand and supply. While no model can completely capture all of the forces driving the housing market, if actual prices are measurably different from what the model expects, then the market may be affected by speculative fervor. Based on such an approach, markets accounting for nearly one-half of the nation's housing stock now appear speculative.

Speculation is not easily wrung out of asset markets, as hardened expectations are hard to change. When expectations finally change, however, they tend to shift quickly, sending prices tumbling. There also has to be a catalyst for such a shift. Usually, one of the fundamental forces driving demand and/or supply has to change. In the housing market, the likely catalyst almost certainly must be higher mortgage rates.

Conclusions. Mortgage rates are expected to rise in coming months. This can be stated with much certainty with regard to rates on adjustable mortgages, as they are tied closely to Federal Reserve policy. Policymakers are engaged in a series of tightening moves that seem set to push the funds rate target up from its current 3% to well over 4% by this time next year.

With ARM rates rising, pressure on homebuyers will build, but housing will remain resilient until fixed mortgage rates rise. Fixed rates are also expected to rise, but precisely when and by how much can not be stated with any certainty. Fixed rates are tied to long-term Treasury bond yields, which have remained surprisingly low. The weights on long-term rates, however, including a halting job market, a lack of business borrowing, and aggressive foreign Central Bank buying, appear to be lifting. Even a small rise in fixed rates will have a substantial impact on housing activity and thus on broader economic growth.

How this impending adjustment unfolds depends on when and how high long-term rates rise. If long-term rates soon begin to rise and rise moderately over an extended period, then the current expansion may stumble, but it will not falter. This is the baseline, most likely, outlook. Long-term Treasury yields are expected to move from just over 4% currently to over 5% a year from now. If long-term rates remain stubbornly low and the housing market becomes further juiced-up, however, the eventual and inevitable adjustment will be much more difficult.

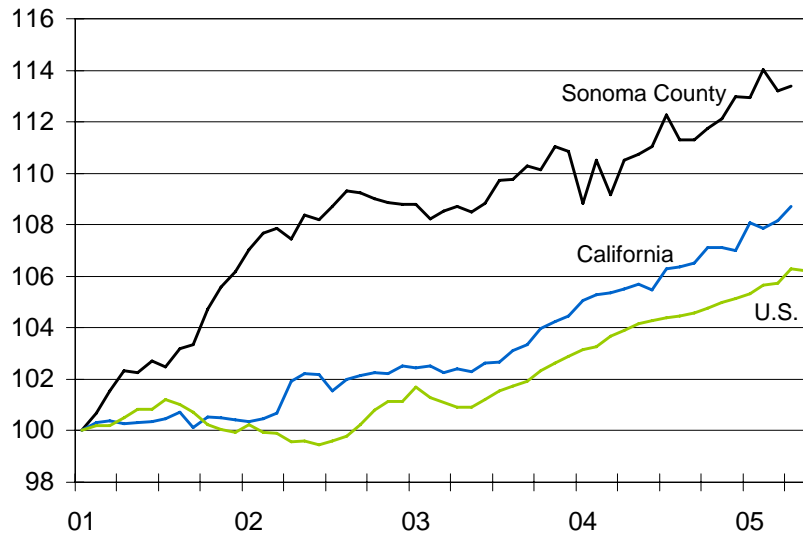
Thriving in Sonoma County: Navigating the Risks Ahead

This section reviews the recent performance of the Sonoma County economy and its near-term prospects for improvement. It describes how Sonoma County's basic economic clusters will fare under the assumptions described above for global and U.S. macroeconomic conditions.

Recent Performance. Sonoma County's economy is expanding, with moderate growth in employment and industrial production. The economy is not firing on all cylinders yet, but certain key indicators are very positive. The unemployment rate, for example, is at its lowest since late 2001. The strongest of the area's basic industries appears to be travel and tourism, which is seeing a good pace of hiring. The wine industry is enjoying improved pricing power and rising exports. Household finances appear to be in good shape with falling personal bankruptcy filings and accelerating house-price appreciation.

Hospitality. Arguably the strongest segment of the county's basic economy, employment in leisure and hospitality industries has risen by about 700 over the past year. The hotel occupancy rate for the Sonoma/Napa area rose to nearly 50% at the beginning of this year, up from 45% one year earlier according to PKF Consulting; room rates rose by 7.5% over this same period. With U.S. personal income growth accelerating—now up by nearly 7% over the year—and corporate profits up by nearly 14% for the year, the outlook for leisure and corporate travel looks better than at any time since the beginning of the 2001 recession. There is further upside potential from international visitors if Asian currencies are allowed to strengthen versus the dollar.

Chart 24: Strength of Hospitality Industry
Employment, Leisure & hospitality, Index: Jan. 2001=100



Considering the close links between winemaking and Sonoma County tourism, the improving outlook for the wine industry is an important local driver of the area’s tourism industry. The rebound in wine consumption, especially boutique wine, bodes well for Sonoma County’s tourism industry. Shipments of high-end and medium-priced wines from California continue to build on the momentum from 2004, reflecting firmer consumer demand. This increased interest in wine consumption is making winery visits and wine-related tourism all the more popular, especially in conjunction with the growing array of tourist activities in Sonoma County. Further, recent legal decisions allowing wineries to ship directly across state lines allows the wineries to develop direct relationships with consumers that can lead to visits to the county.

While there has been improvement in leisure travel to Sonoma County, the local industry enjoys improved but still moderate pricing power, particularly for accommodations. However, there may be some respite from this trend as hotel occupancy rates in San Francisco have recently firmed, suggesting that pricing power may soon return to Sonoma County as well.

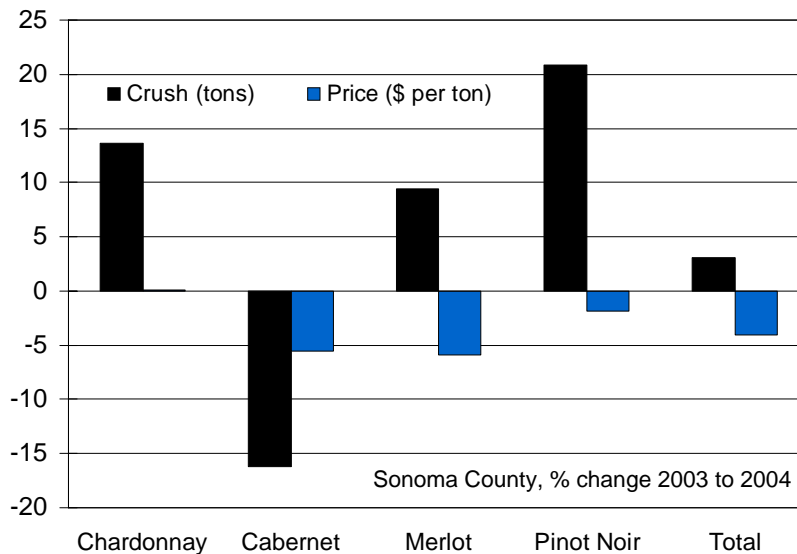
The broad-based decline in the U.S. dollar offers some support for pricing in Sonoma’s tourism industry. Favorable exchange rates overseas versus the dollar will no doubt boost the attractiveness of Sonoma County for international travelers, and it drives U.S. travelers to search for alternatives for overseas travel. The county’s sophisticated destinations offer such an alternative. The dollar has already declined approximately 12% against the euro through 2004, making the U.S. an attractive destination for European and other foreign travelers. As Sonoma County wines continue to gain international recognition, and if the dollar falls further versus Asian currencies, foreign interest in visiting the area should rise.

There could be some limits, however, to pricing power in specific segments of the Sonoma County tourism industry. Through the last several years, there has been a major buildup of hotel rooms, both in the county and in San Francisco. Both areas experienced major construction booms between 2001 and 2003 and new hotel rooms are now available. This increased supply may pose some downside risk to pricing, even if improved international travel buoys tourism demand in the county.

Wine and food products. The North Bay wine industry is in far better shape than it was one year ago. The industry is by and large emerging from its three-year slump, and is set to return to stronger growth in the next few years, even if a few soft spots continue to hound the industry, which will temper the industry’s recovery in the very near term.

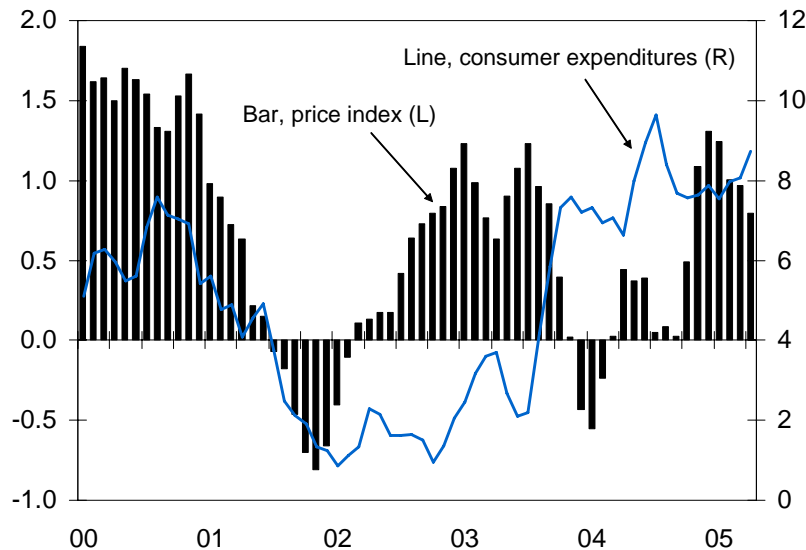
Severe cutbacks in production have helped the winegrape market largely come into balance over the past year. Nearly all varietals, with the notable exception of cabernet sauvignon, are currently in line with demand, according to several local sources; cabernet is still in excess supply, and is likely to stay so for at least another year.

Chart 25: Wine Production Up; Growers' Pricing Power Is Slow to Return



Consumer appetites for wine seem to remain strong. Consumer spending on wine and brandy for personal consumption is growing at a near-record pace, soaring by close to 9% on a year-ago basis. Low prices and increasing choices from imports seem to be fueling demand for wine, despite a moderation in overall consumer spending over the past few months. The inventory-to-sales ratio for wine and distillates at wholesalers is also very low currently as per Census Bureau estimates, as inventory growth slowed to a halt earlier this year. This suggests a potential uptick in wine demand and prices in the near term.

Chart 26: Consumers Are Spending More for Wine
Wine and brandy, % change year ago



Growth in wine imports has moderated markedly over the past year, despite healthy growth in demand. Data from the Census Bureau indicate that wine import growth slowed from a peak of 20% in late 2002 to around 4% in 2004. Meanwhile, exports continued to grow at a steady clip, up nearly 15%. All of this affirms improved bottom lines for domestic winemakers. The weaker dollar has certainly helped export growth. Still, increased price-consciousness among consumers is dampening domestic winemakers' margins.

The long-term outlook for Sonoma County's wine industry remains favorable. Improving name recognition and rising wine consumption globally are the positive fundamentals driving the industry's outlook. That said, the coming decade will not see the soaring demand, pricing power or solid profitability of the decade past.

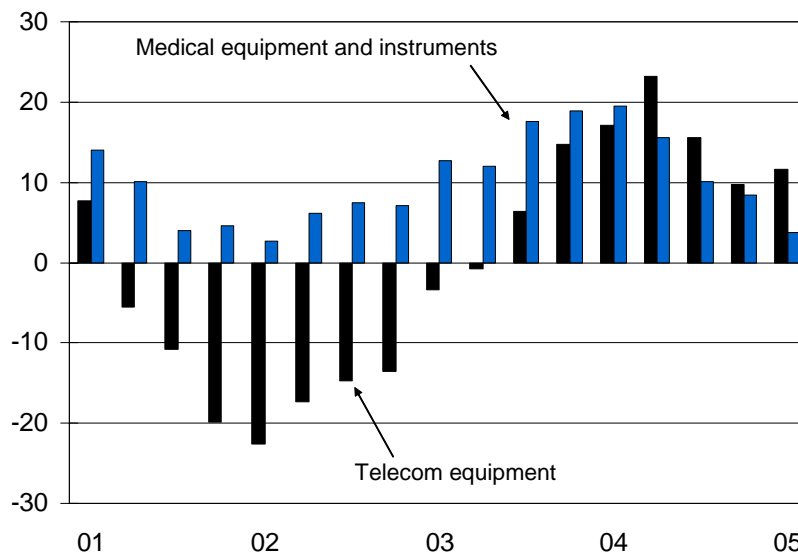
Demographic trends suggest healthy longer-term prospects. The Wine Market Council reports that per capita consumption of wine has been rising steadily since the early 1990s, last year crossing the 2.58 gallon rate set in 1982, and rising to a new record of 2.68 gallons per capita in 2003. Core wine drinkers—those who consume wine at least weekly—account for 12% of the total population but 80% of consumption, and this share of core consumers has risen between 2000 to 2003 after holding steady through the 1990s. Finally, the share of the core consumer in the population rises with age cohort, an encouraging sign in an aging nation.

In an effort to diversify away from the wine industry, Sonoma County is increasingly leveraging existing infrastructure. For instance, the olive industry is slowly becoming an attraction in Sonoma County. The sale of high-end olive oils and olive tastings are becoming a popular side attraction in places like Petaluma, where there is also a great deal of agriculture and specialty food production sold through farmers markets, specialty dealers and directly to restaurants.

Technology. Tech-producing industries in Sonoma County continue to show mixed results, which is not unusual for an industry known for a large number of start-up firms and R&D activity. For example, optical components manufacturer JDS Uniphase will cut 350 positions in Sonoma County by the end of this year as it consolidates manufacturing lines elsewhere. At the same time, however, medical device

maker TriVascular Engineering is searching for space to expand in the area and could add several hundred more workers as it proceeds through clinical trials and expands research. The outlook for the industry depends, in part, on biomedical and biotech venture capital, which rose by about one-third within the Bay Area during the fourth quarter of 2004 and the first quarter of 2005 over the previous four quarters.

Chart 27: U.S. Business Investment Spending
% change year ago



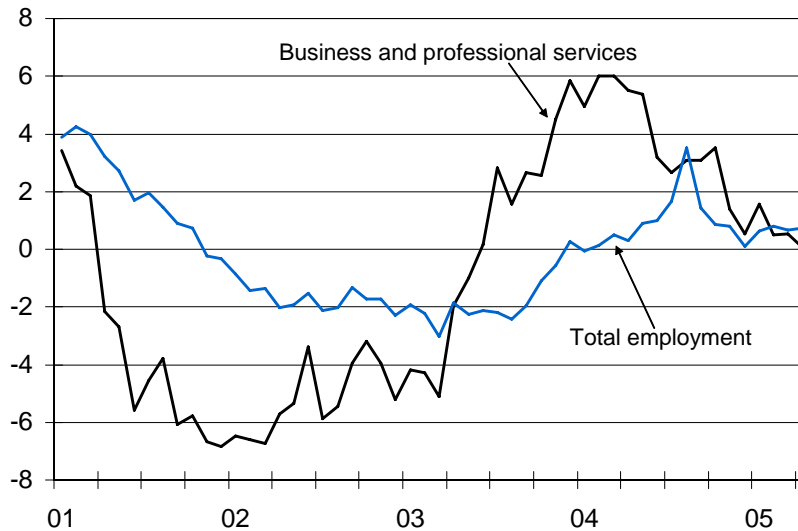
The outlook for telecom equipment is somewhat mixed. U.S. investment spending on communications equipment is expanding once again, seeing growth over the past year of more than 11%. Telecom service providers are investing in new equipment to compete with cable and wireless, but consolidation among national service providers could offset the impact of this, limiting overall demand for telecom equipment.

The key to the outlook for technology and telecom equipment is a continued rapid pace of business investment spending both domestically and abroad. Investment in telecom equipment now outpaces that of medical equipment, although both are decelerating. One year from now as the U.S. economy continues to expand and some capacity constraints begin to arise, investment spending may once again accelerate.

The outlook for medical equipment is more assured over the long term given advances in technology and expanding demand from an aging population. Upside potential is possible from a proposed tech incubator space at Agilent Technologies' former facility.

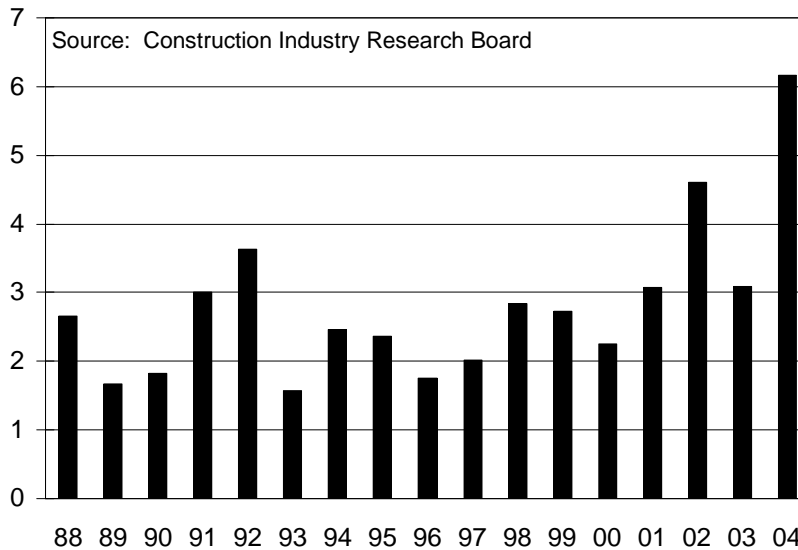
Professional services. Job growth among professional services has been disappointing. Indeed, the rate of growth of employment within the broad business and professional services industry has fallen to near zero. Financial services is falling, as is information services. With profitability still moderate among Sonoma County's basic industries, demand for outside professional services remains limited. There is considerable room for such industries to improve in the near term as local income growth accelerates. Some of the recent slowdown in services can be attributed to uncertainty regarding energy prices and the performance of the broader economy. But long-term interest rates have not edged upward with energy prices—the yield on the 10-year Treasury bond remains firmly anchored at about 4.0%—which helps maintain a sanguine outlook for business investment, consumer spending and demand for services in the local economy.

**Chart 28: Professional Services: Job Growth Has Eased
Employment, Sonoma County, % change year ago**



Retailing. A stable pace of household income growth and strength of the travel and tourism industry help to support retailing activity. Further, household balance sheets are improving in the county as indicated by a falling number of personal bankruptcy filings over the past four quarters. As measured by employment, however, the industry is holding steady but not expanding. Judging from construction permits issued for new retail space, however, optimism runs high among retailers. The value of retail construction permits in 2004 was its highest since figures became available in 1988.

**Chart 29: Retailing Optimism
Construction permits, retail space, \$ mil**



Indeed, optimism in retailing may be justified as consumers have maintained a steady rate of spending growth through the turbulence of the economy over the past two years. Moreover, the industry remains

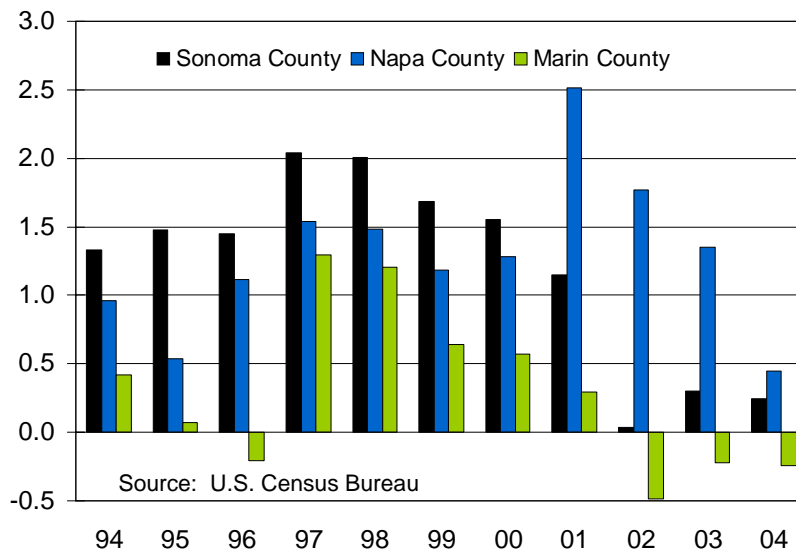
strongest at the high end where profit margins can be wider. On the other hand, lower-income household budgets have been squeezed more by high energy prices, putting some downward pressure on sales at discount stores and other lower-end department stores.

Should long-term interest rates finally begin to rise in the coming year, moderate to middle income households will face rising debt service burdens as interest rates on revolving debt and adjustable-rate mortgages begin to lift. Thus, the higher end of retailing is expected to perform better in the near term as higher-income households depend less on credit for consumption expenditures.

Demographics. One indicator of the struggle the economy faces in approaching a self-sustaining recovery is the very slow rate of population growth in the county. The Census Bureau estimates that during the year ending in mid-2004, the growth rate was a paltry 0.2%, little changed from the nearly stagnant pace of the previous two years. This contrasts with the statewide trend that has held steady with a rate near the U.S. average throughout this decade so far. California’s average is bolstered by the robust economies seen in southern and central California.

The county’s population growth reflects conditions seen throughout the Bay Area, which had a similarly weak 0.1% growth rate last year. Neighboring Napa County fared better with a 0.4% rate in 2004. Population in Marin County fell by 0.2%, its third consecutive annual decline.

Chart 30: Slow Population Growth
Total population, % change

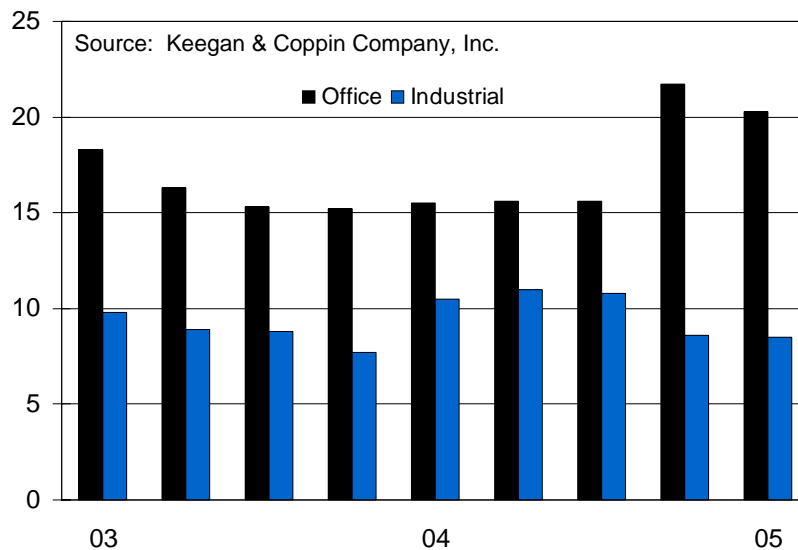


Population growth is expected to accelerate in coming years to exceed 1% annually once again and lead the U.S. and statewide averages. This rate of growth would be consistent with long-term trends and would be necessary to provide an adequate labor force for the expanding economy. Yet there is considerable downside risk to this outlook. First, housing affordability is nearly at an all-time low. Economy.com estimates that in 2004 the median-income earning household in Sonoma County could afford to buy a house priced at just 58% of the median sales price, which was \$498,000 for the North Bay region for the year according to the California Association of Realtors. Affordability has deteriorated further this year as the median sales price has risen to \$601,000 as of March 2005.

Second, the current rate of employment growth is not sufficient to attract a large stream of migrants into the county. Domestic net migration currently is negative. The one positive factor, however, is that Sonoma County currently has the lowest unemployment rate in the Bay Area at 4.0%. Elsewhere, rates range from 4.1% in Napa County to a high of 5.7% in Santa Clara County. None of these rates is remarkably high—the U.S. rate as of May is 5.1%. But, because migration tends to flow in the direction of higher unemployment to lower unemployment, there is some prospect for increased flows of households into Sonoma County. The greatest single source for net in-migration is the San Francisco metro division, which includes Marin, San Francisco and San Mateo counties. The second greatest source is the Oakland metro division, including Alameda and Contra Costa counties. The San Jose metro area, which includes Santa Clara and San Benito counties, ranks third.

Real estate. With office space-using employment rising moderately at best, demand for commercial real estate has been tepid. Indeed, it seems that demand is driven more by attractive lease rates and an opportunity to lock them in over several years, rather than by any surge in current demand. The vacancy at the former Agilent campus illustrates the current difficulties in the county’s nonresidential real estate markets. The area’s office vacancy rate shot up in the last year’s fourth quarter to above 20%, although absorption of smaller space elsewhere has been positive, reflecting the improvement in the local economy. In fact, commercial property markets vary a great deal with the county. According to Keegan & Coppin Company, the 2004 first quarter office vacancy rate (including sublease space) in Rohnert Park stood at a whopping 45%, yet the rate in Santa Rosa was a mere 11.7%. The Petaluma market was between the two at 26.9%. The county’s north corridor came in at 14.9%.

Chart 31: Office Vacancy Rates Are Quite High
Availability rates, Sonoma County, %



Office-space construction permits doubled in 2004 from 2003, indicating some optimism that was perhaps prevalent prior to the availability of space in Rohnert Park later in the year. Demand growth for office space will be moderate but positive in the near term.

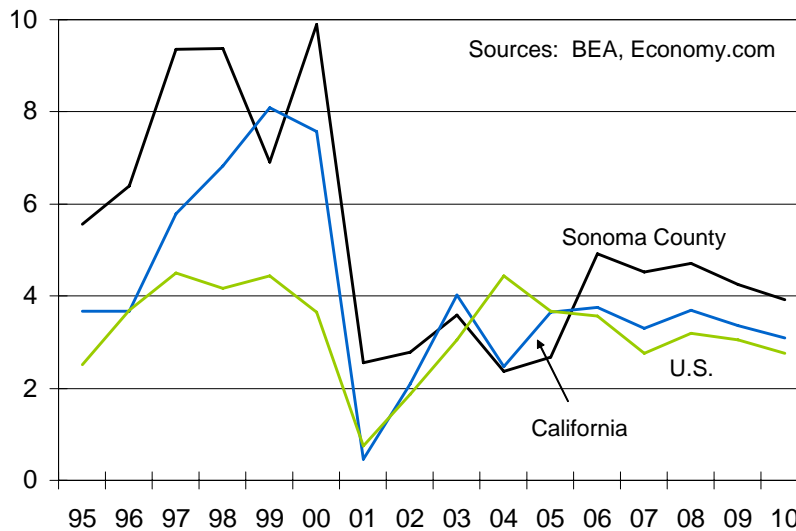
Industrial markets appear more balanced with an availability rate of 8.5% in the first quarter, well below the national average. Given that a number of small firms are garnering venture capital and other sources of capital infusion, the outlook for industrial space demand is reasonably good, although it will likely be

absorbed in small increments. Moreover, construction permit issuance has been slow for new industrial space.

On the retail side, accelerating income growth and shifting demand for higher-end goods and services will increase demand for space.

Near-term outlook. The outlook for Sonoma County’s economy remains good. For the first time since 2001, demand factors for all of the area’s basic industries are positive. The global supply of wine is more balanced with demand, some pricing power has returned for the wine industry, if not among grape growers, and the weak dollar is boosting exports. Domestic and international travel continues to rise. Investment and R&D spending support biotech, telecom and other tech-producing industries. Overall, Sonoma County is projected to return to above average growth through the rest of this decade, although it would be unrealistic to project rates of growth matching those of the second half of the 1990s.

Chart 32: A Sanguine Outlook
Gross product, % change



Risks. Rising interest rates pose the greatest near-term risk to the economy. First, higher rates would cool the housing market, with the possibility of causing some correction in house prices. While our baseline forecast does not call for a fall in house prices, an unexpected surge in interest rates could very well drive all speculative pressures from the market and cause a moderate price decline.

Second, higher interest rates would put some downward pressure on the rate of business investment spending. The economy is growing rapidly enough that emerging production constraints in the near term will be strong enough to drive investment spending upward, but if rates were to rise higher or more quickly than expected, some investment spending would be choked off with negative consequences for Sonoma County’s durable goods producers.

Upside potential derives from the possibility that global demand growth for the county’s goods and services could improve considerably if the dollar falls quickly versus Asian currencies once the Chinese yuan is allowed to be traded openly in foreign exchange markets. The most likely scenario is that the yuan would be allowed to trade only within a narrow range, minimizing the impact. But should a more

liberal trading system be initiated, the dollar could fall by anywhere from 15% to 25% versus Asian currencies through the remainder of this decade.

Further upside potential for the forecast would emerge from stronger U.S. personal income growth in coming years. As labor markets begin to tighten in 2006, labor will gain more of an edge in wage negotiations, so that the benefits of the economic expansion shift toward wages. Should this occur more quickly than expected, greater disposable income growth would benefit Sonoma County's wine, food, travel and tourism industries.

TABLES

Table 1: Sonoma County Clusters

Industries within clusters are listed by their North American Industry Classification System codes

Basic Clusters

- 1) Agriculture, Wineries, and Food Processing
 - 111,112 Farming
 - 311 Food manufacturing
 - 3121 Beverage manufacturing
 - 4238 Machinery, equipment, and supplies, wholesale
 - 4245 Farm-product raw material, wholesale
- 2) Information Technology
 - 5112 Software publishers
 - 5161 Internet publishing and broadcasting
 - 5181 Internet service providers and web search portals
 - 5182 Data processing services
 - 5415 Computer systems design and related services
- 3) High-tech electronics
 - 3341 Computer and peripheral equipment
 - 3342 Communications equipment
 - 3342 Audio and video equipment
 - 3344 Semiconductors and other electronic components
- 4) High-tech Instruments and Optical Goods
 - 3345 Navigational, measuring, electromedical, and control instruments
 - 3346 Manufacturing and reproducing magnetic and optical media
 - 3391 Medical equipment and supplies
- 5) Other High-value Manufacturing
 - 3332 Industrial machinery
 - 3334 Ventilation, heating, air-conditioning, and refrigeration equipment
 - 3351 Electric lighting equipment
 - 3352 Household appliances
 - 3353 Electrical equipment
 - 3359 Other electrical equipment and components
- 6) Resource-based Manufacturing
 - 316 Leather and allied products
 - 321 Wood products
 - 322 Paper manufacturing
 - 327 Nonmetallic mineral products
- 7) Financial Activities excluding real estate
 - 521 Monetary authorities - central bank
 - 522 Credit intermediation and related activities
 - 523 Securities, commodities, and other investments
 - 524 Insurance carriers and related activities
 - 525 Funds, trusts, and other financial vehicles
- 8) Tourism
 - 4811 Scheduled air transportation
 - 4812 Nonscheduled air transportation
 - 4853 Taxi and limousine services
 - 4855 Charter bus industry
 - 487 Scenic and sightseeing transportation
 - 4881 Support activities for air transportation
 - 5121 Motion picture and video industries
 - 5321 Automotive equipment rental and leasing
 - 5615 Travel arrangement and reservation services
 - 711 Performing Arts, Spectator Sports, and Related Industries
 - 712 Museums, Historical Sites, and Similar Institutions
 - 713 Amusement, Gambling, and Recreation Industries
 - 7211 Traveler accommodation
 - 7212 Recreational vehicle parks and recreational camps
 - 7221 Full-Service Restaurants
 - 7223 Special Food Services
 - 7224 Drinking Places (Alcoholic Beverages)

Non-basic Clusters

- 9) Engineering and Research
 - 5413 Architectural, engineering, and related services
 - 5417 Scientific research and development services
- 10) Legal Services
 - 5411 Legal services
- 11) Health Services
 - 621 Ambulatory health care services
 - 622 Hospitals
 - 623 Nursing and residential facilities
- 12) Other Professional Services
 - 3231 Printing and support activities
 - 5412 Accounting, taxes, bookkeeping, payroll services
 - 5414 Specialized design services
 - 5416 Management, scientific, and technical consulting
 - 5418 Advertising and related services
 - 5419 Other professional, scientific, and technical services
 - 55 Management of companies and enterprises
 - 5611 Office administrative services
 - 5612 Facilities support services
 - 5613 Employment services
 - 5614 Business support services
 - 5616 Investigation and security services
 - 5617 Services to buildings and dwellings
 - 5619 Other support services
 - 562 Waste management and remediation services
- 13) Retail Trade
 - 441 Motor vehicle and parts dealers
 - 442 Furniture and home furnishing stores
 - 443 Electronics and appliance stores
 - 444 Building materials and garden equipment and supplies
 - 445 Food and beverage stores
 - 446 Health and personal care stores
 - 447 Gasoline stations
 - 448 Clothing and accessory stores
 - 451 Sporting goods, hobby, book, and music stores
 - 452 General merchandise stores
 - 453 Misc. store retailers
 - 454 Nonstore retailers

Table 2: Leading Clusters in Sonoma County

- 1) Agriculture, Wineries, and Food Processing
- 2) Information Technology
- 3) High-value Added Manufacturing
 - a) High-tech electronics
 - b) High-tech instruments and Optical Goods
 - c) Other high-value manufacturing
- 4) Tourism
- 5) Professional Services
 - a) Engineering and Research
 - b) Other professional services
- 6) Retail Trade

Table 3: Sonoma County Historical Summary Indicators

	1999	2000	2001	2002	2003	2004	Annual Growth 99-04
Economy							
Gross Metro Product (Mil 96\$)	13.5	14.9	15.2	15.7	16.2	16.6	3.5
% Annual Change	6.9	9.9	2.6	2.8	3.6	2.4	
Gross Metro Product (Mil \$)	13.3	14.9	15.5	16.1	16.4	16.9	4.0
% Annual Change	7.7	11.5	4.1	4.1	2.0	2.6	
Non-farm Employment (Ths)	179.3	186.1	189.8	186.6	183.2	184.9	0.5
% Annual Change	3.6	3.8	2.0	-1.7	-1.8	0.9	
Components of Employment							
Mining and Natural Resources	0.4	0.4	0.3	0.3	0.3	0.3	-6.5
Construction	11.9	13.1	13.7	13.3	13.0	13.6	2.3
Manufacturing	29.2	30.2	30.4	27.3	25.3	24.3	-3.0
Trade, Transportation, and Utilities	33.2	33.6	34.1	34.1	33.9	34.0	0.4
Wholesale Trade	5.5	5.8	5.9	6.0	6.3	6.5	2.8
Retail Trade	23.5	23.7	24.1	24.0	23.8	23.6	0.0
Transportation and Utilities	4.1	4.1	4.0	4.1	3.8	3.9	-0.9
Information	3.6	4.1	4.5	4.2	4.0	4.2	3.0
Financial Activities	10.0	10.2	10.4	10.3	10.3	10.0	0.0
Professional and Business Services	19.5	20.6	20.0	19.0	19.0	19.7	0.2
Education and Health Services	21.1	22.0	22.9	23.3	22.7	22.6	1.1
Leisure and Hospitality	17.4	17.9	18.7	19.7	19.9	20.2	2.5
Other Services	6.3	6.4	6.8	6.7	6.4	6.4	0.3
Government	26.6	27.6	28.0	28.4	28.5	29.6	1.8
Labor Force (Ths)	249.0	256.3	261.6	261.9	256.6	257.2	0.5
% Annual Change	1.4	2.9	2.1	0.1	-2.0	0.2	
Number of Employed (Ths)	242.3	249.5	253.7	250.0	243.8	245.6	1.5
Number of Unemployed (Ths)	6.7	6.8	7.8	11.9	12.8	11.5	9.5
							Average
Unemployment Rate (%)	2.7	2.6	3.0	4.5	5.0	4.5	3.5
Income, Demographics, and Consumption							
Personal Income (Mil \$)	14,608.7	16,777.8	17,203.4	17,271.2	17,497.0	18,375.7	4.0
% Annual Change	5.8	14.8	2.5	0.4	1.3	5.0	
Real Personal Income (Mil 96\$)	14,970.1	16,777.2	16,851.4	16,680.7	16,583.4	17,041.7	2.1
Per Capita Income (\$)	32,151.9	36,383.2	36,946.4	37,076.0	37,421.7	38,745.8	3.1
Median Household Income (\$)	53,076.0	59,187.2	59,907.0	60,376.6	62,347.6	64,715.2	2.5
Personal Bankruptcy Filings	1,627.0	1,158.0	1,183.0	1,223.0	1,300.0	1,267.0	-9.8
Consumer Price Index	184.0	194.0	201.8	206.3	210.4	215.0	3.0
Population (Ths)	454.3	461.1	465.6	465.8	467.6	474.2	0.9
% Annual Change	1.7	1.5	1.0	0.0	0.4	1.4	
Age <4	28.0	28.0	28.0	28.1	28.1	28.4	-1.0
Age 5-19	96.5	98.4	98.4	97.5	98.2	99.9	1.3
Age 20-24	26.7	28.4	30.4	31.6	32.6	33.6	4.5
Age 25-44	135.1	133.2	131.5	128.7	126.4	125.8	-1.4
Age 45-64	110.0	115.0	118.7	121.2	123.7	127.3	3.5
Age >65	57.9	58.2	58.6	58.8	58.6	59.2	-0.1
Households (Ths)	171.1	173.4	175.1	175.2	175.9	178.8	1.2
% Annual Change	1.5	1.3	1.0	0.1	0.4	1.7	
Net Migration (Ths)	5.7	4.9	0.9	-1.7	1.8	6.2	
Residential Housing Market							
Total Housing Permits	3,036.0	2,505.0	2,583.0	1,928.0	2,252.0	1,941.4	Average 2,558.9
% Annual Change	-0.8	-17.5	3.1	-25.4	16.8	-13.8	
Single Family Permits	2,348.0	2,013.0	1,717.0	1,350.0	1,503.0	1,358.7	1,839.9
Multi Family Permits	688.0	492.0	866.0	578.0	749.0	582.7	719.0
Median Exist. Home Price (SA, Ths \$)	239.9	317.2	384.6	430.7	510.4	570.3	13.7
% Annual Change	13.8	32.2	21.2	12.0	18.5	11.7	
Existing Home Sales (Ths)	14.1	11.8	10.0	8.9	9.1	8.7	-7.4
Mortgage Originations (Mil \$)	4,064.2	3,816.6	8,947.9	10,209.1	13,048.1	9,615.0	22.4
							Average
Affordability Index	103.9	78.2	67.0	67.3	62.3	58.3	73.7
Nonresidential Construction							
Nonres. Building Permits (Mil \$)							Average
Total	226.2	208.8	211.7	244.4	199.2	238.6	219.2
Office Buildings	23.1	22.1	28.5	47.7	12.2	23.2	28.2
Retail Space	32.7	27.0	36.9	55.2	37.1	74.0	36.8
Industrial	54.2	31.0	24.7	8.8	10.5	4.0	26.6

Table 4: Sonoma County Forecasted Summary Indicators

	2005	2006	2007	2008	2009	2010	Annual Growth 05-10
Economy							
Gross Metro Product (Mil 96\$)	17.1	17.9	18.7	19.6	20.4	21.2	3.7
% Annual Change	2.7	4.9	4.5	4.7	4.2	3.9	
Gross Metro Product (Mil \$)	17.7	19.0	20.3	21.6	22.9	24.3	5.4
% Annual Change	5.1	7.3	6.7	6.5	6.1	5.7	
Non-farm Employment (Ths)	186.4	191.6	196.0	201.0	206.4	211.5	2.1
% Annual Change	0.8	2.8	2.3	2.5	2.7	2.5	
Components of Employment							
Mining and Natural Resources	0.3	0.3	0.3	0.3	0.3	0.3	-0.9
Construction	14.1	13.7	13.5	13.8	14.2	14.6	0.5
Manufacturing	24.2	24.4	24.4	24.5	24.6	24.7	0.4
Trade, Transportation, and Utilities	34.5	35.7	36.5	37.1	37.7	38.2	1.7
Wholesale Trade	6.7	7.0	7.1	7.2	7.4	7.5	1.8
Retail Trade	23.7	24.5	25.0	25.5	25.9	26.3	1.7
Transportation and Utilities	4.1	4.2	4.3	4.3	4.4	4.5	1.4
Information	4.2	4.3	4.5	4.7	4.8	5.0	2.9
Financial Activities	9.9	10.2	10.3	10.6	10.8	11.1	1.9
Professional and Business Services	19.9	20.8	21.8	23.0	24.4	25.6	4.3
Education and Health Services	23.0	23.9	24.7	25.5	26.4	27.2	2.9
Leisure and Hospitality	20.9	22.0	23.0	24.0	25.0	26.0	3.7
Other Services	6.5	6.8	7.0	7.2	7.4	7.6	2.6
Government	28.9	29.4	29.9	30.3	30.8	31.1	1.2
Labor Force (Ths)	259.5	266.4	273.0	279.3	286.4	293.8	2.1
% Annual Change	0.9	2.7	2.5	2.3	2.5	2.6	
Number of Employed (Ths)	247.9	255.0	261.3	267.9	275.2	282.4	2.2
Number of Unemployed (Ths)	11.6	11.4	11.7	11.4	11.3	11.4	-0.3
Unemployment Rate (%)	4.5	4.3	4.3	4.1	3.9	3.9	Average -2.4
Income, Demographics, and Consumption							
Personal Income (Mil \$)	19,319.4	20,711.1	22,017.2	23,336.0	24,705.8	26,078.3	5.1
% Annual Change	5.1	7.2	6.3	6.0	5.9	5.6	
Real Personal Income (Mil 96\$)	17,517.9	18,310.9	19,003.5	19,728.4	20,468.8	21,176.1	3.2
Per Capita Income (\$)	39,961.6	41,928.1	43,616.3	45,348.8	47,097.2	48,812.5	3.4
Median Household Income (\$)	65,003.3	67,540.6	69,915.1	72,258.0	74,552.6	76,750.2	2.8
Personal Bankruptcy Filings	1,255.8	1,032.0	1,073.7	1,137.4	1,131.1	1,186.9	-0.9
Consumer Price Index	219.3	223.7	229.1	234.1	239.1	244.1	1.8
Population (Ths)	483.4	493.9	504.8	514.6	524.5	534.2	1.7
% Annual Change	1.9	2.2	2.2	1.9	1.9	1.8	
Age < 4	29.0	29.8	30.6	31.5	32.4	33.4	2.4
Age 5-19	101.9	104.1	106.2	107.9	109.4	110.4	1.3
Age 20-24	34.8	35.9	37.0	38.2	39.7	41.3	2.9
Age 25-44	126.0	126.7	127.8	128.8	129.9	131.3	0.7
Age 45-64	131.6	136.2	140.6	144.3	147.9	151.2	2.3
Age > 65	60.1	61.2	62.4	63.9	65.3	66.6	1.7
Households (Ths)	183.1	187.6	192.3	196.7	201.3	205.8	2.0
% Annual Change	2.4	2.5	2.5	2.3	2.3	2.2	
Net Migration (Ths)	7.6	9.4	8.0	7.6	7.5	6.8	
Residential Housing Market							
Total Housing Permits	2,522.4	2,279.8	2,499.7	2,586.8	2,562.8	2,568.8	Average 0.3
% Annual Change	29.9	-9.6	9.6	3.5	-0.9	0.2	
Single Family Permits	1,842.7	1,737.0	1,847.4	1,868.7	1,850.2	1,835.2	-0.1
Multi Family Permits	679.7	542.8	652.3	718.0	712.6	733.6	1.3
Median Exist. Home Price (\$A, Ths \$)	609.0	624.1	642.6	667.4	686.4	705.7	2.5
% Annual Change	6.8	2.5	3.0	3.9	2.8	2.8	
Existing Home Sales (Ths)	9.1	8.4	8.7	9.2	9.4	9.7	1.0
Mortgage Originations (Mil \$)	7,182.1	5,583.0	5,882.3	6,452.0	6,655.0	6,900.8	-0.7
Affordability Index	52.1	47.4	47.7	48.3	47.5	47.5	Average -1.5
Nonresidential Construction							
Nonres. Building Permits (Mil \$)							
Total	221.9	241.7	251.9	262.2	286.3	299.0	5.1
Office Buildings	24.8	26.7	27.2	27.8	29.9	30.8	3.7
Retail Space	35.2	41.5	46.3	49.7	52.9	55.8	8.0
Industrial	34.2	41.3	46.2	48.8	53.0	57.8	9.1

Table 5: Sonoma County Historical Employment by Cluster
Thousands

	1999	2000	2001	2002	2003	2004	Compound Ann. Growth Rate	Pct. Share of Employment
							99-04	2004
Total	193.6	199.5	202.3	200.2	195.9	195.1	0.1	100.0
% Change	3.6	3.0	1.4	-1.0	-2.2	-0.4		
1. Agriculture/Food Processing	17.8	17.7	17.3	18.6	17.7	15.1	-2.8	7.7
% Change	5.8	-0.5	-2.7	7.7	-4.9	-14.7		
2. Information Technology	1.3	1.8	1.9	1.6	1.6	1.7	3.7	0.9
% Change	19.4	35.6	3.5	-15.5	-1.2	6.0		
3. High-tech Electronics	2.0	2.3	2.3	2.0	1.6	1.4	-5.2	0.7
% Change	-0.1	14.9	3.4	-13.4	-19.7	-12.3		
4. High-tech Instruments/Optical	8.9	9.4	10.0	8.0	6.3	5.4	-8.1	2.8
% Change	1.3	5.0	6.7	-19.8	-21.5	-14.6		
5. Other High-value Manufacturing	0.6	0.6	0.6	0.5	0.6	0.6	-0.2	0.3
% Change	-3.8	-1.8	-1.5	-5.0	5.7	1.8		
6. Resource-based Manufacturing	2.3	2.2	2.0	1.7	1.7	1.6	-6.1	0.8
% Change	0.4	-5.0	-9.9	-12.9	-1.8	-6.4		
7. Financial Activities	7.2	7.2	7.3	7.3	7.3	7.0	-0.4	3.6
% Change	6.5	-0.6	1.7	-0.1	-0.1	-3.5		
8. Tourism	13.9	14.5	15.4	16.3	16.3	16.3	2.6	8.3
% Change	3.7	3.9	6.0	5.8	0.2	-0.2		
9. Engineering and Research	2.0	2.3	2.3	2.4	2.5	2.6	4.0	1.3
% Change	15.0	13.9	-0.2	2.4	4.6	4.1		
10. Legal Services	1.0	1.0	1.1	1.1	1.2	1.2	2.5	0.6
% Change	2.6	1.3	2.9	5.0	2.9	2.7		
11. Health Services	15.8	16.5	17.0	17.3	16.8	16.9	1.1	8.7
% Change	2.9	4.1	2.8	2.2	-3.0	0.7		
12. Other Professional Services	16.7	17.2	16.4	15.2	15.1	15.7	-1.1	8.0
% Change	2.3	3.1	-5.0	-7.1	-0.9	3.9		
13. Retail Trade	23.5	23.7	24.1	24.0	23.8	23.6	0.0	12.1
% Change	0.9	0.9	1.6	-0.3	-1.1	-0.9		
Sum of Clusters	86.8	89.5	90.2	88.6	85.3	82.2	-0.9	42.1
% Change	3.1	3.1	0.8	-1.7	-3.7	-3.7		
Other	106.8	110.0	112.1	111.6	110.6	112.9	0.9	57.9
% Change	4.0	3.0	2.0	-0.5	-0.9	2.1		

**Table 6: Sonoma County Forecasted Employment by Cluster
Thousands**

	2005	2006	2007	2008	2009	2010	Compound Ann. Growth Rate	Pct. Share of Employment
							05-10	2010
Total	196.6	201.8	206.3	211.4	216.9	222.1	2.0	100.0
% Change	0.8	2.6	2.2	2.5	2.6	2.4		
1. Agriculture/Food Processing	15.1	15.2	15.4	15.5	15.6	15.8	0.8	7.1
% Change	-0.1	1.1	0.9	0.7	1.0	0.9		
2. Information Technology	1.7	1.8	1.9	2.1	2.2	2.4	5.9	1.1
% Change	1.4	6.8	7.6	7.5	7.2	6.9		
3. High-tech Electronics	1.5	1.5	1.4	1.4	1.4	1.4	-0.7	0.6
% Change	2.3	0.3	-1.7	-1.8	-0.6	-0.6		
4. High-tech Instruments/Optical	5.2	5.3	5.3	5.3	5.3	5.4	0.5	2.4
% Change	-3.2	1.6	0.0	0.1	0.7	0.6		
5. Other High-value Manufacturing	0.6	0.6	0.6	0.6	0.6	0.6	0.3	0.3
% Change	0.7	1.5	-0.2	0.0	0.5	0.2		
6. Resource-based Manufacturing	1.6	1.6	1.6	1.6	1.6	1.7	0.4	0.7
% Change	1.3	0.7	0.2	0.5	0.7	0.4		
7. Financial Activities	6.9	7.1	7.2	7.4	7.6	7.7	1.9	3.5
% Change	-2.1	3.5	1.2	2.3	2.5	2.2		
8. Tourism	16.7	17.6	18.3	19.1	19.8	20.6	3.5	9.3
% Change	2.9	5.1	4.1	4.1	4.1	3.8		
9. Engineering and Research	2.6	2.7	2.8	2.9	3.1	3.2	3.6	1.4
% Change	0.9	3.7	4.2	4.7	4.8	4.4		
10. Legal Services	1.2	1.2	1.3	1.3	1.4	1.4	3.1	0.6
% Change	-0.4	3.0	3.5	4.0	4.2	3.8		
11. Health Services	17.2	17.9	18.5	19.1	19.7	20.3	2.7	9.1
% Change	1.9	4.0	3.2	3.1	3.2	3.0		
12. Other Professional Services	15.8	16.5	17.3	18.3	19.3	20.3	4.3	9.2
% Change	1.1	4.3	5.0	5.5	5.7	5.2		
13. Retail Trade	23.7	24.5	25.0	25.5	25.9	26.3	1.7	11.8
% Change	0.5	3.3	2.4	1.8	1.6	1.5		
Sum of Clusters	82.8	85.6	88.1	90.6	93.3	95.9	2.5	43.2
% Change	0.8	3.4	2.9	2.9	3.0	2.8		
Other	113.8	116.2	118.2	120.7	123.5	126.2	1.7	56.8
% Change	0.8	2.1	1.7	2.2	2.3	2.1		

Table 7: Sonoma County Historical Gross Regional Product (Output) by Cluster
Millions of current dollars

							Compound Ann. Growth Rate	Pct. Share of Total Output
	1999	2000	2001	2002	2003	2004	99-04	2004
Total	14,585.8	16,266.0	16,547.1	16,995.0	17,502.1	18,230.3	3.8	100.0
% Change	10.6	11.5	1.7	2.7	3.0	4.2		
1. Agriculture/Food Processing	847.1	891.6	923.9	1,010.5	1,038.5	999.6	2.8	5.5
% Change	13.6	5.3	3.6	9.4	2.8	-3.8		
2. Information Technology	163.3	207.6	208.3	200.7	218.2	239.4	6.6	1.3
% Change	40.0	27.1	0.3	-3.6	8.7	9.7		
3. High-tech Electronics	262.5	364.4	260.4	249.6	247.5	251.0	-0.7	1.4
% Change	15.4	38.8	-28.5	-4.2	-0.9	1.4		
4. High-tech Instruments/Optical	982.5	1,238.6	1,022.2	891.9	825.7	833.7	-2.7	4.6
% Change	14.4	26.1	-17.5	-12.7	-7.4	1.0		
5. Other High-value Manufacturing	58.8	77.7	52.5	51.5	53.7	55.1	-1.1	0.3
% Change	25.1	32.2	-32.4	-2.0	4.3	2.6		
6. Resource-based Manufacturing	136.8	128.7	120.0	110.6	126.4	130.4	-0.8	0.7
% Change	10.5	-5.9	-6.8	-7.8	14.3	3.1		
7. Financial Activities	888.0	955.9	1,001.0	1,044.8	1,104.8	1,155.5	4.5	6.3
% Change	7.5	7.6	4.7	4.4	5.7	4.6		
8. Tourism	550.2	602.6	659.7	734.5	745.8	779.3	6.0	4.3
% Change	5.6	9.5	9.5	11.3	1.5	4.5		
9. Engineering and Research	248.3	307.4	302.9	314.1	342.6	367.8	6.8	2.0
% Change	19.3	23.8	-1.5	3.7	9.1	7.4		
10. Legal Services	120.2	132.0	137.0	146.3	158.4	170.1	6.0	0.9
% Change	5.7	9.9	3.7	6.8	8.3	7.4		
11. Health Services	906.0	981.7	1,073.5	1,161.2	1,180.6	1,233.3	5.3	6.8
% Change	5.1	8.4	9.3	8.2	1.7	4.5		
12. Other Professional Services	1,144.9	1,222.3	1,227.6	1,184.6	1,234.7	1,340.2	2.7	7.4
% Change	8.0	6.8	0.4	-3.5	4.2	8.5		
13. Retail Trade	1,327.8	1,393.3	1,453.2	1,610.2	1,653.9	1,723.2	4.4	9.5
% Change	5.0	4.9	4.3	10.8	2.7	4.2		
Sum of Clusters	5,585.3	6,305.6	6,110.6	6,247.7	6,360.6	6,589.1	2.8	36.1
% Change	10.6	12.9	-3.1	2.2	1.8	3.6		
Other	9,000.6	9,960.4	10,436.5	10,747.3	11,141.6	11,641.2	4.4	63.9
% Change	10.6	10.7	4.8	3.0	3.7	4.5		

Table 8: Sonoma County Forecasted Gross Regional Product (Output) by Cluster
Millions of current dollars

	2005	2006	2007	2008	2009	2010	Compound Ann.	Pct. Share of
							Growth Rate	Total Output
							05-10	2010
Total	19,160.8	20,559.2	21,936.4	23,370.6	24,789.8	26,201.5	6.5	100.0
% Change	5.1	7.3	6.7	6.5	6.1	5.7		
1. Agriculture/Food Processing	1,040.3	1,113.4	1,183.2	1,252.4	1,320.2	1,386.4	5.9	5.3
% Change	4.1	7.0	6.3	5.8	5.4	5.0		
2. Information Technology	254.2	275.9	297.2	321.1	345.2	369.4	7.8	1.4
% Change	6.2	8.5	7.7	8.1	7.5	7.0		
3. High-tech Electronics	266.1	287.0	306.9	328.3	350.0	371.7	6.9	1.4
% Change	6.0	7.9	6.9	7.0	6.6	6.2		
4. High-tech Instruments/Optical	876.6	941.5	1,004.7	1,068.9	1,131.3	1,192.5	6.3	4.6
% Change	5.1	7.4	6.7	6.4	5.8	5.4		
5. Other High-value Manufacturing	57.8	62.0	66.0	70.1	74.2	78.1	6.2	0.3
% Change	4.9	7.2	6.5	6.3	5.7	5.3		
6. Resource-based Manufacturing	138.5	148.9	159.1	169.4	179.6	189.5	6.5	0.7
% Change	6.2	7.5	6.8	6.5	6.0	5.5		
7. Financial Activities	1,216.4	1,308.2	1,400.4	1,493.9	1,587.5	1,681.2	6.7	6.4
% Change	5.3	7.5	7.0	6.7	6.3	5.9		
8. Tourism	819.7	881.0	942.2	1,005.9	1,068.9	1,131.8	6.7	4.3
% Change	5.2	7.5	6.9	6.8	6.3	5.9		
9. Engineering and Research	389.5	418.5	445.3	476.5	507.8	538.9	6.7	2.1
% Change	5.9	7.4	6.4	7.0	6.6	6.1		
10. Legal Services	178.1	190.9	203.7	216.8	229.8	242.7	6.4	0.9
% Change	4.7	7.2	6.7	6.5	6.0	5.6		
11. Health Services	1,294.1	1,384.3	1,474.5	1,564.4	1,652.4	1,739.1	6.1	6.6
% Change	4.9	7.0	6.5	6.1	5.6	5.2		
12. Other Professional Services	1,414.4	1,534.0	1,650.0	1,772.7	1,899.8	2,030.5	7.5	7.7
% Change	5.5	8.5	7.6	7.4	7.2	6.9		
13. Retail Trade	1,812.5	1,942.6	2,074.0	2,207.0	2,338.1	2,467.8	6.4	9.4
% Change	5.2	7.2	6.8	6.4	5.9	5.5		
Sum of Clusters	6,931.1	7,455.9	7,969.4	8,503.0	9,035.5	9,567.2	6.7	36.5
% Change	5.2	7.6	6.9	6.7	6.3	5.9		
Other	12,229.7	13,103.3	13,967.0	14,867.6	15,754.4	16,634.3	6.3	63.5
% Change	5.1	7.1	6.6	6.4	6.0	5.6		

Table 9: Sonoma County Historical Gross Regional Product (Output) by Cluster
Millions of 1996 dollars

							Compound Ann. Growth Rate	Pct. Share of Total Output
	1999	2000	2001	2002	2003	2004	99-04	2004
Total	14,672.6	16,266.0	16,411.1	16,593.6	16,799.3	17,113.4	2.6	100.0
% Change	10.0	10.9	0.9	1.1	1.2	1.9		
1. Agriculture/Food Processing	847.6	891.6	869.7	927.5	931.7	873.9	0.5	5.1
% Change	9.1	5.2	-2.5	6.6	0.4	-6.2		
2. Information Technology	163.7	207.6	200.8	190.7	205.6	222.0	5.2	1.3
% Change	37.4	26.8	-3.2	-5.1	7.8	8.0		
3. High-tech Electronics	202.2	364.4	342.9	370.7	410.7	430.3	13.4	2.5
% Change	53.2	80.2	-5.9	8.1	10.8	4.8		
4. High-tech Instruments/Optical	832.2	1,238.6	1,222.4	1,160.3	1,139.0	1,161.5	5.7	6.8
% Change	33.6	48.8	-1.3	-5.1	-1.8	2.0		
5. Other High-value Manufacturing	58.5	77.7	51.3	50.4	52.6	52.7	-1.7	0.3
% Change	23.0	32.9	-34.1	-1.6	4.3	0.2		
6. Resource-based Manufacturing	134.7	128.7	119.6	109.7	121.8	121.5	-1.7	0.7
% Change	5.3	-4.5	-7.1	-8.2	11.0	-0.3		
7. Financial Activities	895.7	955.9	992.3	1,009.6	1,069.1	1,103.3	3.5	6.4
% Change	6.2	6.7	3.8	1.7	5.9	3.2		
8. Tourism	570.5	602.6	647.7	713.0	708.1	720.7	4.0	4.2
% Change	1.8	5.6	7.5	10.1	-0.7	1.8		
9. Engineering and Research	252.5	307.4	291.0	298.2	320.0	336.8	4.9	2.0
% Change	16.9	21.7	-5.3	2.5	7.3	5.2		
10. Legal Services	122.2	132.0	131.6	138.9	148.0	154.7	4.0	0.9
% Change	3.6	8.0	-0.3	5.6	6.5	4.5		
11. Health Services	937.7	981.7	1,019.7	1,065.7	1,043.9	1,058.6	2.0	6.2
% Change	1.8	4.7	3.9	4.5	-2.0	1.4		
12. Other Professional Services	1,200.1	1,222.3	1,193.0	1,150.3	1,180.3	1,253.3	0.7	7.3
% Change	3.7	1.9	-2.4	-3.6	2.6	6.2		
13. Retail Trade	1,325.5	1,393.3	1,496.5	1,607.7	1,677.7	1,737.2	4.6	10.2
% Change	4.6	5.1	7.4	7.4	4.4	3.5		
Sum of Clusters	5,452.9	6,305.5	6,315.4	6,468.9	6,625.7	6,788.3	3.7	39.7
% Change	11.3	15.6	0.2	2.4	2.4	2.5		
Other	9,219.8	9,960.5	10,095.7	10,124.6	10,173.6	10,325.1	1.9	60.3
% Change	9.2	8.0	1.4	0.3	0.5	1.5		

Table 10: Sonoma County Forecasted Gross Regional Product (Output) by Cluster
Millions of 1996 dollars

							Compound Ann. Growth Rate	Pct. Share of Total Output
	2005	2006	2007	2008	2009	2010	05-10	2010
Total	17,571.6	18,434.1	19,268.4	20,177.1	21,033.8	21,857.2	3.7	100.0
% Change	2.7	4.9	4.5	4.7	4.2	3.9		
1. Agriculture/Food Processing	892.9	940.1	984.6	1,029.4	1,071.3	1,110.6	3.7	5.1
% Change	2.2	5.3	4.7	4.6	4.1	3.7		
2. Information Technology	229.1	242.9	256.3	272.2	287.6	302.7	4.8	1.4
% Change	3.2	6.0	5.5	6.2	5.7	5.2		
3. High-tech Electronics	440.6	464.5	486.9	512.6	537.4	561.6	4.1	2.6
% Change	2.4	5.4	4.8	5.3	4.8	4.5		
4. High-tech Instruments/Optical	1,190.2	1,244.8	1,297.8	1,353.3	1,403.7	1,450.8	3.4	6.6
% Change	2.5	4.6	4.3	4.3	3.7	3.4		
5. Other High-value Manufacturing	54.0	56.6	59.1	61.7	64.2	66.5	3.5	0.3
% Change	2.4	4.8	4.4	4.5	4.0	3.6		
6. Resource-based Manufacturing	125.7	132.1	138.4	145.1	151.2	157.0	3.8	0.7
% Change	3.4	5.1	4.7	4.8	4.3	3.8		
7. Financial Activities	1,131.1	1,188.0	1,245.7	1,306.2	1,364.1	1,420.3	3.9	6.5
% Change	2.5	5.0	4.9	4.9	4.4	4.1		
8. Tourism	738.0	775.1	812.5	853.0	891.4	928.6	3.9	4.2
% Change	2.4	5.0	4.8	5.0	4.5	4.2		
9. Engineering and Research	346.7	363.7	379.1	398.7	417.6	435.8	3.9	2.0
% Change	3.0	4.9	4.2	5.2	4.7	4.3		
10. Legal Services	158.5	165.9	173.4	181.5	189.0	196.3	3.6	0.9
% Change	2.5	4.7	4.5	4.6	4.2	3.8		
11. Health Services	1,081.8	1,130.2	1,179.4	1,230.0	1,277.0	1,321.6	3.4	6.0
% Change	2.2	4.5	4.4	4.3	3.8	3.5		
12. Other Professional Services	1,288.2	1,364.8	1,438.2	1,519.0	1,600.2	1,681.8	4.5	7.7
% Change	2.8	5.9	5.4	5.6	5.3	5.1		
13. Retail Trade	1,779.3	1,862.3	1,947.7	2,037.1	2,121.0	2,201.1	3.6	10.1
% Change	2.4	4.7	4.6	4.6	4.1	3.8		
Sum of Clusters	6,959.0	7,314.9	7,662.1	8,037.1	8,394.4	8,739.4	3.9	40.0
% Change	2.5	5.1	4.7	4.9	4.4	4.1		
Other	10,612.6	11,119.2	11,606.3	12,140.0	12,639.3	13,117.9	3.6	60.0
% Change	2.8	4.8	4.4	4.6	4.1	3.8		