July 2010

UPDATE

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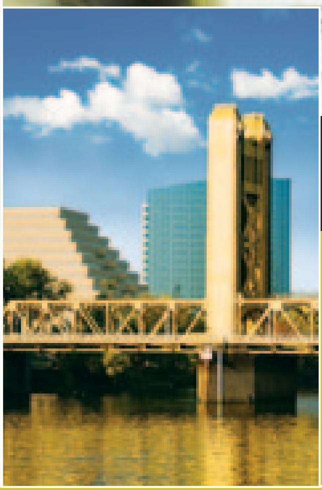
Emerging Trends in Sacramento's Economy



Mid-Year Update | 2010 Economic Forecast

Your Best Guide to Sacramento's Economy

CFA SOCIETY OF SACRAMENTO

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July 2010

sacramento BUSINESS REVIEW

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To educate consumers on the economic and financial health of the Sacramento region.

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Founded in 1991, the CFA Society of Sacramento operates as a member Society of CFA Institute. Our membership consists of over 160 regional investment professionals and academics and our mission is to utilize our collective investment knowledge, expertise and global network in order to function as a valuable resource to our members and to benefit our regional community.

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Message from the Dean

Dear Friends,

I am delighted to share the 2010 market forecast by the *Sacramento Business Review* with you. Already recognized for its credibility and independence, the *Sacramento Business Review* provides the most thoughtful, intellectually sophisticated, and comprehensive analysis of the Sacramento economy – prepared by the region's very best financial analysts and researchers. To download your free copy please visit ***www.sacbusinessreview.com.***

Despite the national economy rebounding, Sacramento unfortunately remains pressured with continued job losses, albeit at a slower rate, and heightened uncertainty due to a growing state deficit. Unemployment will hold at current high levels but will slowly improve. Housing and real estate continue to drift in search of a bottom, bank credit remains tight, non-performing loans continue to pose a challenge, and all of these compound to slow down economic progress. On the bright side, our recession in Sacramento may end as early as the third quarter of 2010 with economic growth despite weak employment outlook, and capital markets provide hope with stable local corporations and the SBR Index performing in line.

Warm regards,

Sanjay Varshney

Sanjay Varshney, Ph.D., CFA
Dean, College of Business Administration

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Sacramento's Labor Market & Regional Economy: 2010 Mid-Year Update

While the local recovery continues to gradually play out, we unfortunately have seen very little over the last six months to warrant raising our moderate growth outlook. We continue to believe the Sacramento region will experience a prolonged U-shaped recovery out of the recession, with a return to previous employment levels unlikely to occur before 2013. We expect the positive momentum of the current business cycle will eventually lead the national and local economy back to health, but the significant near-term headwinds and the general lack of confidence in the market will contribute to a bumpy road to recovery.

UPDATE

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Brian Leu, CFA

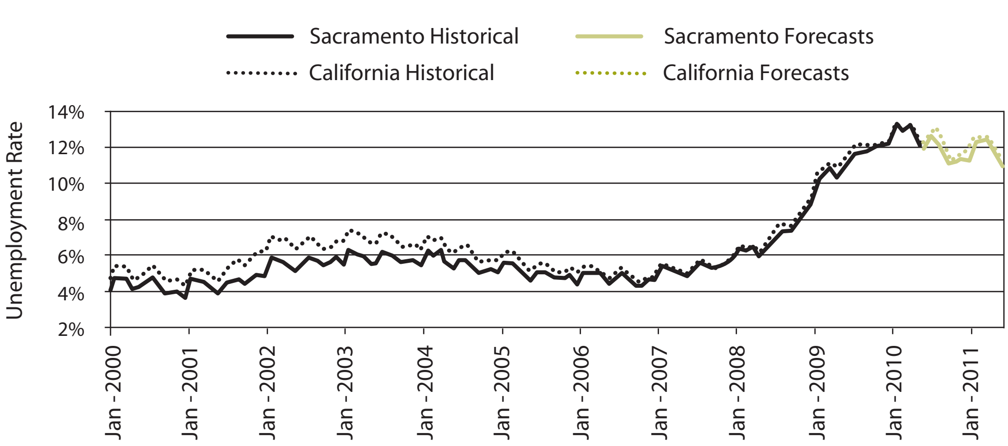

Yang Sun, Ph.D.

Regional Employment Picture Slow to Improve

In our last publication in January 2010, we reiterated our forecast for the Sacramento regional unemployment rate to exceed 13% in early 2010. With the loss of an additional 9,600 wage and salary jobs since we last published, the unemployment rate in 1Q 2010 finally touched the 13% level, marking the highest rate of unemployment in Sacramento this generation has seen. While the May 2010 unemployment rate (the latest release) showed an improvement to 12.0%, we believe this was largely driven by a combination of the hiring of temporary census workers and a drop in the participation rate with the departure of discouraged workers from the workforce (the unemployment rate does not count those who have stopped actively looking for work). In fact, after adjusting for these two factors, we estimate the true May 2010 unemployment rate likely remained above 13%. Indeed we also estimate the regional "under-employment rate", which includes displaced workers, still stands at about 19%.

Over the remainder of the year, we expect the regional unemployment rate to remain in the 11-12% range (see Figure 1), but we caution that this metric can vary unpredictably as workers leave and enter the workforce (denominator effect). At the June labor data release expected on July 16 (shortly after our publish date), we expect the Sacramento unemployment rate will have risen to above 12.5%, reflecting seasonal weakness and the turnover of census workers. Over the next year, we continue to expect a significant overhang to the reported unemployment rate figure even as the economic picture improves as displaced workers re-enter the workforce. That said, we are looking for nearly every sector of the economy to

Figure 1
California and Sacramento Unemployment Rates



either improve or hold steady (see Figures 2-8).

We note that the labor data from the EDD was revised earlier in the year, including a sizeable reduction in the historical growth of the Healthcare and Education sector. We now expect the Healthcare sector workforce to remain relatively flat to slightly up over the next year. We also believe the Construction sector has likely seen the worst of the job loss and will even benefit near-term by a seasonal boost in labor demand over the summer. The Government sector remains a major wildcard factor in the local economy, with another $19 billion state budget deficit to overcome through some combination of federal funding, program cuts, salary reductions, funding shifts and staff reductions. While the state government labor force has managed in general to remain surprisingly stable, county and local city governments have lost 8-10% of their workforce over the last year and are continuing to reduce staffing and spending in order to bridge budget gaps. The question will be "how long can the government sector cover budget deficits without dramatically reducing the workforce?" And while we think staff cuts are likely, we also recognize the possibility that the "extend and pretend" strategy of many organizations may delay the unpleasant cuts long enough for tax revenues to hopefully rebound and help fill in budget holes.

"...the key risk to our growth outlook is the necessary passing of the baton."

Double-Dip Recession Unlikely, but Growth Outlook Moderating

There is certainly cause to be concerned about the likelihood of another recession. The regional economy and consumer spending continue to face significant headwinds including a weak housing market, relatively restricted credit, high unemployment, and consumers and businesses still working to deleverage their balance sheets. One-time injections into the economy in the form of fiscal stimulus (such as the homebuyers' tax credit) and the census demand for labor are expected to fade, even as unemployment remains elevated. Furthermore, confidence around the recovery is being shaken with the increased uncertainty surrounding regulation and the prospect for future economic growth – including questions on the Gulf oil spill and energy regulation, financial regulatory reform, the impact of healthcare reform, the European sovereign debt crisis, and waning China demand.

While we believe these challenges will decelerate growth and will likely lead to more "negative surprises" from economic data points over the next year, we expect several underlying forces will help sustain the economic recovery. Monetary policy remains highly accommodative, with interest rate hikes unlikely before 2011. Energy prices, including gas prices, and mortgage rates are expected to remain generally low and should give consumers an extra boost. In addition, we believe the positive momentum of the business cycle, aided by the inventory cycle and increased productivity from previous spending cuts, will help support business growth. Finally, we believe global final demand, while moderating versus previous expectations, will support general economic growth here in the US, albeit at a slower pace.

While we don't foresee a double-dip recession as likely at this time, we clearly recognize that the key risk to our growth outlook is the necessary passing of the baton from policy stimulus to sustainable private sector final demand – which relies heavily on improving consumer confidence and the perception of risk in the economy. If confidence continues to wane and private sector income growth (which is closely tied to job growth) is insufficient to support higher consumption, the regional and broader economy could remain stagnant well into 2011.

Actual Data   Forecasts

Figure 2. Government Labor Outlook

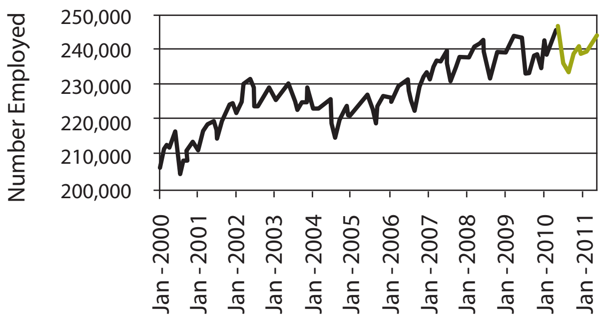


Figure 3. Education and Healthcare Labor Outlook

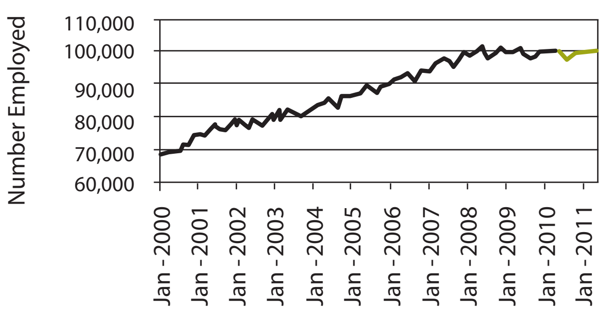


Figure 4. Technology and Professional Services Labor Outlook

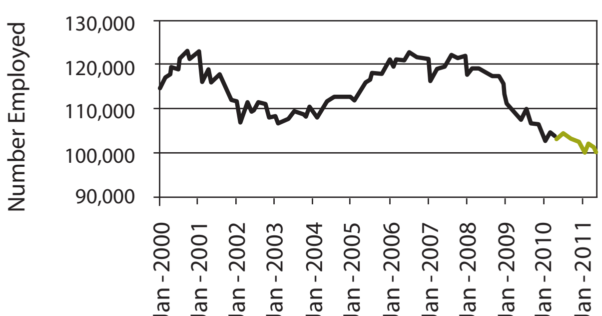


Figure 5. Financial Services Labor Outlook

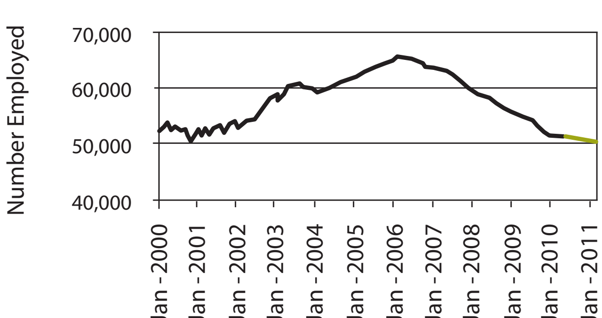


Figure 6. Retail Labor Outlook

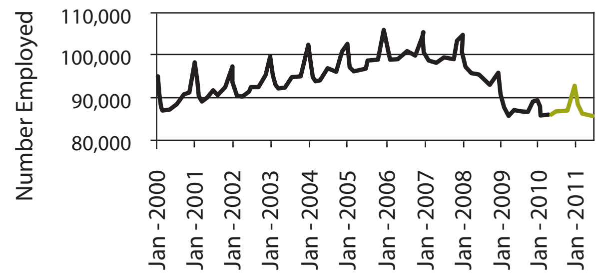


Figure 7. Leisure and Hospitality Labor Outlook

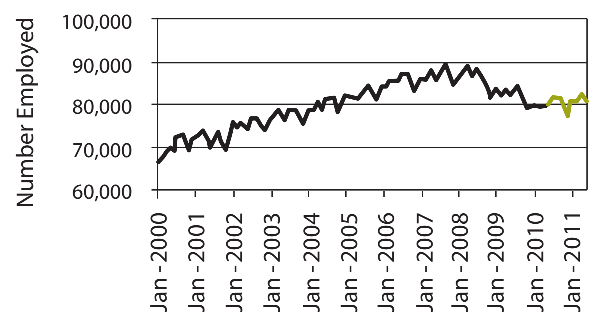
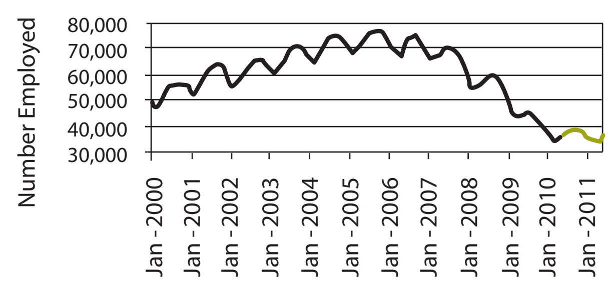


Figure 8. Construction Labor Outlook



Data Source: If not specifically labeled, the data is sourced from the Sacramento Metropolitan Statistical Area monthly employment data published by the Labor Market Information Division in the Employment Development Department of the State of California (available at http://www.labormarketinfo.edd.ca.gov). As of our publishing date, the most recent monthly unemployment rate reading was for November 2009. The Sacramento-Arden Arcade-Roseville Metropolitan Statistical Area (MSA) includes the counties of Sacramento, El Dorado, Yolo, and Placer. Since our analysis explicitly accounts for seasonality throughout the year, the employment figures in this paper are "unadjusted" figures.

Real Estate Trends in the Sacramento Region

UPDATE

Marc Ross, CFA, Real Estate Investment Broker, *CB Richard Ellis*
Sudhir K. Thakur, Ph.D., Professor, *College of Business Administration, Sacramento State*

Marc Ross, CFA

Sudhir Thakur, Ph.D.

Coming off the most challenging year in recent memory, the Sacramento real estate market during the first half of 2010 has been choppy, with mixed news and no clear signs of a pending recovery. While most commercial sectors have seen rental rates begin to stabilize, albeit at remarkably low levels, the market has yet to exhibit a systemic trend towards health.

Industrial

- Despite its troubles, the industrial sector remains perhaps the most resilient of the primary commercial product types. Rental rates, along with regional vacancies, have largely bottomed. At 12.6%, industrial vacancy is lower than that of the retail (14.8%) and office (22%) sectors.
- Net absorption – the change in occupied space from one period to the next – is still negative, but the velocity has slowed considerably in 2010. After losing nearly 4 million square feet of occupied space last year, we've lost less than 400,000 square feet this year through June.
- The most active tenants are large users in the food and beverage industries and medically-related users. Solar equipment manufacturers remain active as well.
- New on the scene is the emergence of rooftop leases to solar companies. In these transactions, a tenant will install solar panels and then sell the resulting power they harness to the electrical grid. While these deals do not show up in net absorption calculations, they do provide a new source of income for owners of some of the larger buildings that have enough rooftop space to justify the installation.

Retail

- After rising for three consecutive quarters, the regional vacancy rate remained unchanged during the last three months at 14.8%. Rental rates have begun to stabilize after falling precipitously in 2009 and early 2010 and transaction activity is increasing.
- Discount retailers remain among the most active tenants today. However, we are beginning to see the return of several national tenants inquiring about space, including Michaels, Petco, Chipotle, Verizon, AT&T Wireless and WalMart (with a smaller grocery-only concept). Even Starbucks, with its highly publicized closures last year, has been poking around. Landlords of second generation space, which is already outfitted with expensive tenant improvements, are also seeing a surge in demand.
- The pace of bankruptcies, particularly high-profile ones, has slowed considerably. The most notable casualty this year was Hollywood Video, which recently announced it was shutting down all 2,415 stores nationally, including 12 in the greater Sacramento region.

Real Estate Trends in the Sacramento Region

- Big box retail activity has been strong. Potential tenants, after studying the region, have come to the realization that this is an excellent time to lease space at cyclically low rents with maximum flexibility in lease terms. They are setting themselves up for long-term success in an environment that has strong demographics now and promises the same well into the future.

Office

- The change in calendar year has least affected the office market as the trend of rising vacancy and news of tenants contracting continued during the first half of 2010.
- The County of Sacramento has terminated several leases due to budget issues and the private sector continues to contract overall. Perhaps most notably, the region's second largest law firm, McDonough Holland & Allen PC, recently announced it is winding down operations one year into a highly publicized 15-year lease on Capitol Mall.
- Public sector tenants, particularly State government-related tenants, continue to be the major driver of leasing activity. The Army Corps of Engineers executed the largest transaction year-to-date, a 225,000 square feet renewal. ACS, having won the contract to handle IT and business services for California's Medicaid program, California Child Support Services, California Board of Equalization, and Alta California Regional Center all signed significant leases this year. Additionally, FEMA is investigating relocation from Oakland in early 2012.

Investments

- Investment sales activity has increased over the anemic levels of 2009, particularly in the multi-housing sector where distress driven sales have pushed deal volume through June to a level nearly equal that which occurred during all of last year.
- Commercial REO (real estate owned by banks), short-sale, and note-sale activity is increasingly dominating the landscape. However, the flood gates for retail, office, and industrial REOs have yet to open as some have predicted. An increasing number of commercial loans are being sold, modified, or otherwise worked out with existing borrowers.
- Buyer capital is abundant with demand the strongest at both ends of the quality spectrum – Class A properties and highly distressed value-add properties that can be purchased at super-low pricing metrics. Few high-quality assets have hit the market, resulting in a huge scarcity premium when they do become available.
- It was announced that the highly publicized State of California portfolio, consisting of 11 high-profile office assets (six in Sacramento), received over 300 offers and multiple bids in excess of $2 billion. If concluded this year, the transaction will have a huge impact on sales statistics across the country.

Residential

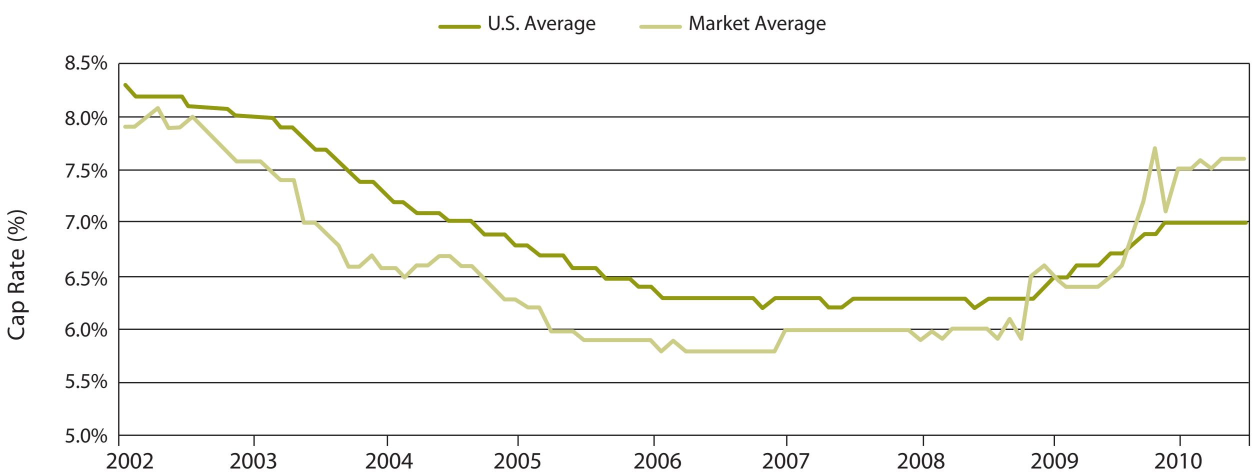
- Total home sales (resale, new, detached single-family, and condos) year-to-date through May are down slightly from the previous five months and from the same time period last year due largely to a significant falloff in new home transactions.
- REO (real estate owned by banks) sales still represent nearly half of all sales in the marketplace with no meaningful slowdown in the "pipeline" of future REOs as the percentage of extremely delinquent homes, defined as more than 90 days delinquent, remains elevated at over 11%.
- Median pricing has remained stable with a slight tick upwards. However, pricing in some of the most desirable infill neighborhoods, which were among the last to be affected by the economy, continue to face downward pressure, particularly in the $600,000+ segment.

Conclusion

One might characterize this market as having been upgraded from a critical to stable condition, but it still remains in the intensive care unit pending the outcome of the state budget crisis and the ominous threat it poses for the local economy. Any meaningful recovery must be precipitated by the return of fundamental demand drivers such as job and income growth and an increase in consumer spending.

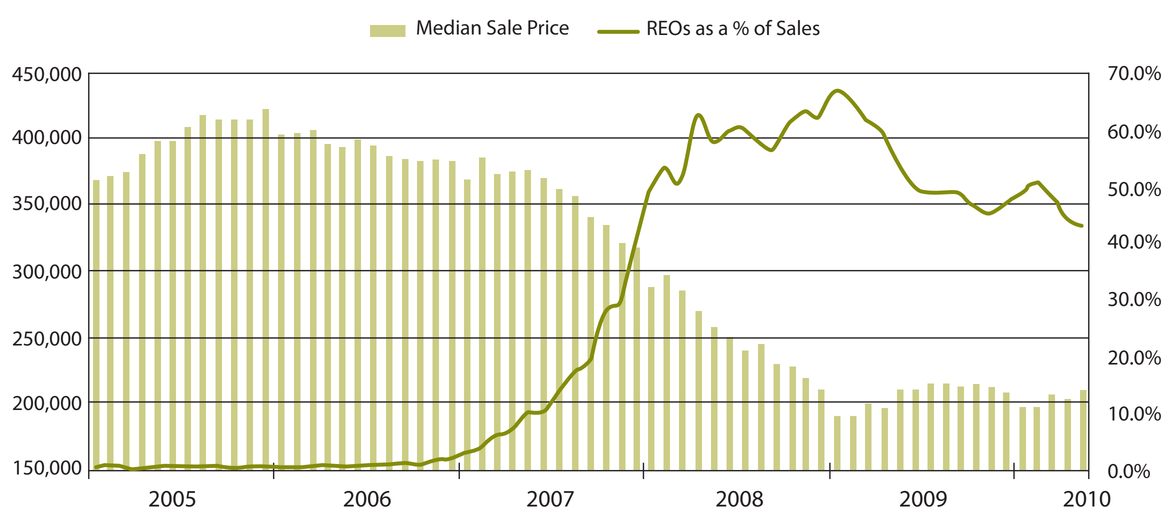
Still, many market participants are finding opportunities abound as real estate users across all property types are exploiting today's evolving circumstances by upgrading location, quality of building, and/or leasing terms while investors are finding buys at what they perceive to be cyclically low pricing.

Figure 1 – Investments
Cap Rate (%)/Sales through May 2010 (all property types) | Sacramento Region



Source: Real Capital Analytics

Figure 2 – Residential
Median Sale Price (all homes) vs. REOs as a % of Sales | Sacramento MSA



REO (Real Estate Owned) – property which is in the possession of the lender as a result of foreclosure.

Source: MDA DataQuick

2010 Sacramento Banking Industry Forecast

Banks Extending Loans, Just Not to New Borrowers

In January's Sacramento Business Review (SBR), we predicted that the region's banking industry would continue to face headwinds in 2010 because of problem real estate loans. Given the capital constraints caused by higher loan-loss provisions, we were not confident that the region's banks would open the spigots for new loans throughout the year. Although certain economic data has become more favorable during the six months since January's SBR was published, the region's banks still face an uphill battle with nonperforming loans. As a result, we expect the second half of 2010 to remain challenging for the local banking sector. The subsequent lack of lending growth is likely to continue hindering the strength of the Sacramento region's economic recovery.

UPDATE

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Denver H. Travis, Ph.D., CFA, Professor, *College of Business Administration, Sacramento State*


Jonathan Lederer, CFA


Denver Travis, Ph.D.

Tepid Loan Growth

Back in January, we forecasted that new loan growth in the region would remain fairly subdued during 2010. In the six months since the last SBR was published, total loans outstanding (in aggregate) for the 15 locally based banks[1] with more than 60% of deposits in the six-county region[2] have fallen by 2.6%.[3] While this regional decline was less than the 1.2% increase in loans for all FDIC-insured banks nationwide, it was not as severe as the 5.8% drop in loans outstanding for all insured institutions in California during the same time frame.

We believe that the lack of substantial new loan volume can be attributed to three factors. First, loan demand from both businesses and consumers, though improving, remains weak. In the latest Federal Reserve Senior Bank Loan Officer Survey from April 2010, approximately 20% of banks reported weaker commercial and industrial (C&I) loan demand from businesses (relative to the prior three months), while only between 10-15% reported stronger demand. Though these figures mark a sizable improvement from six months ago (when the percentage of banks reporting weaker C&I loan demand, net of stronger demand, was 43%), the demand pales in comparison to 2005 levels, when the number of banks reporting stronger C&I loan demand was more than 30% higher than those reporting weaker demand. As Table 1 shows, similar trends can be observed for commercial real estate (CRE) and consumer loan demand.

Banks Extending Loans, Just Not to New Borrowers

Table 1
Federal Reserve Senior Bank Loan Officer Survey Data

Net % of Banks Reporting Stronger Demand for[1]:	2005[2]	4Q09	2Q10
Commercial & Industrial Loans[3]	31%	-34%	-8%
Commercial Real Estate Loans	18%	-43%	-7%
Consumer Loans	-14%	-25%	-17%

1) *Percentage of banks reporting stronger loan demand minus percentage reporting weaker demand*

2) *2005 data represent full-year averages.*

3) *Commercial & Industrial Loan demand from Small-, Mid- and Large-Sized businesses has been averaged.*

Second, bank lending standards, though looser than they were during the depths of the Great Recession, remain tight by historical measures. With high unemployment and depressed real estate prices, banks have been less willing to make loans in such an environment. Many have been content just purchasing longer-term U.S. Treasuries, taking advantage of the "carry trade" opportunity that the Federal Reserve has manufactured by leaving its short-term target interest rate at virtually zero.

At the same time, bank balance sheets are still fairly constrained by the overhang from real estate loan delinquencies. The resulting higher loan-loss provisions reduce capital levels and lessen the ability to make new loans.

Due to the combination of the aforementioned factors, we believe that new lending will remain weak throughout the rest of 2010. This lack of substantial loan growth is likely to reduce the odds of a stronger economic recovery in the region.

"In spite of these positive trends, we still expect loss provisions to remain elevated through the end of the year."

Loan Problems Still Prevalent, Though Many Local Banks are Better Positioned

Our January outlook projected that loan loss provisions would remain elevated throughout the year due to problem residential and CRE loans. Thus far, our predictions have unfolded mostly as expected. Specifically, during the past six months, aggregate loan-loss provisions for the 15 locally based banks that we analyzed were 54% higher than total provisions made during the previous six months. Fortunately, the more recent trend has become more encouraging, as these banks set aside 55% less in reserves in 1Q 2010 relative to 4Q 2009.

Because the local banks set aside more in provisions, it now appears that most are better prepared to withstand loan losses (relative to six months ago). In particular, although noncurrent loans as a percentage of total loans outstanding for the 15 local banks analyzed rose by an average of 27 basis points (0.27%) since late 2009, the average allowance for loan losses as a percentage of total loans increased by 49 basis points (0.49%) during this time frame.

In spite of these positive trends, we still expect loss provisions to remain elevated through the end of the year. Given persistently high unemployment, coupled with the lack of improvement in delinquency rates throughout the six-county region, losses on residential mortgage loans are unlikely to subside despite modest median home price gains.

Perhaps more importantly, we do not think CRE loan problems will go away during the next six months. With CRE prices across almost all categories still down more than 30% from their peaks, many borrowers will almost certainly continue to have difficulty repaying loans. Furthermore, the most recent Federal Reserve Senior Bank Loan Officer Survey indicated that nearly half of the bankers surveyed have increased the use of CRE loan extensions since late 2009 (while only 4% said they have decreased the use of extensions). This information is consistent with the October 2009 survey data that we referenced in January's SBR – this data indicated that most construction and CRE loans maturing in late 2009 were being extended because they could not be repaid or refinanced. These ongoing issues with CRE loans, coupled with the sizable CRE exposure at most local banking institutions, lead us to believe that loan loss provisions will remain elevated through the remainder of the year.

Watch List Update

January's SBR included a watch list of six banks that we felt could come under increased scrutiny from regulators due to inadequate loss provisions and weaker capital levels. Since the January publication, one bank on the January watch list (Granite Community Bank) was shut down, and three others (Butte Community Bank, North Valley Bank, and PremierWest Bank) received orders from federal regulators.

The updated watch list (see Table 2) includes many of the same banks, with one new addition (Community 1st Bank). We remain concerned that these banks, which lack substantial capital cushions, have inadequate loan loss reserves considering their significant CRE exposure.

Publicly Traded Local Bank Recommendations

For the first-half of 2010, the SBR Bank Index[4] delivered a -2.2% return. This return fell below that of the widely referenced KBW Regional Bank Index's 4.1% gain. Figure 1 details how each local publicly traded bank performed through June 30.

January's SBR included recommendations for almost all stocks in the SBR Bank Index. During the first half of 2010, the local bank stocks on the SBR Outperform list delivered a solid 7% average return (on a cap-weighted basis), while those on the SBR Market Perform list generated an even more impressive 18% average return. The SBR Bank Index was clearly dragged down by those banks on the SBR Underperform list, as these stocks were down an average of 16% (on a cap-weighted basis).

Table 2
The "Watch List"

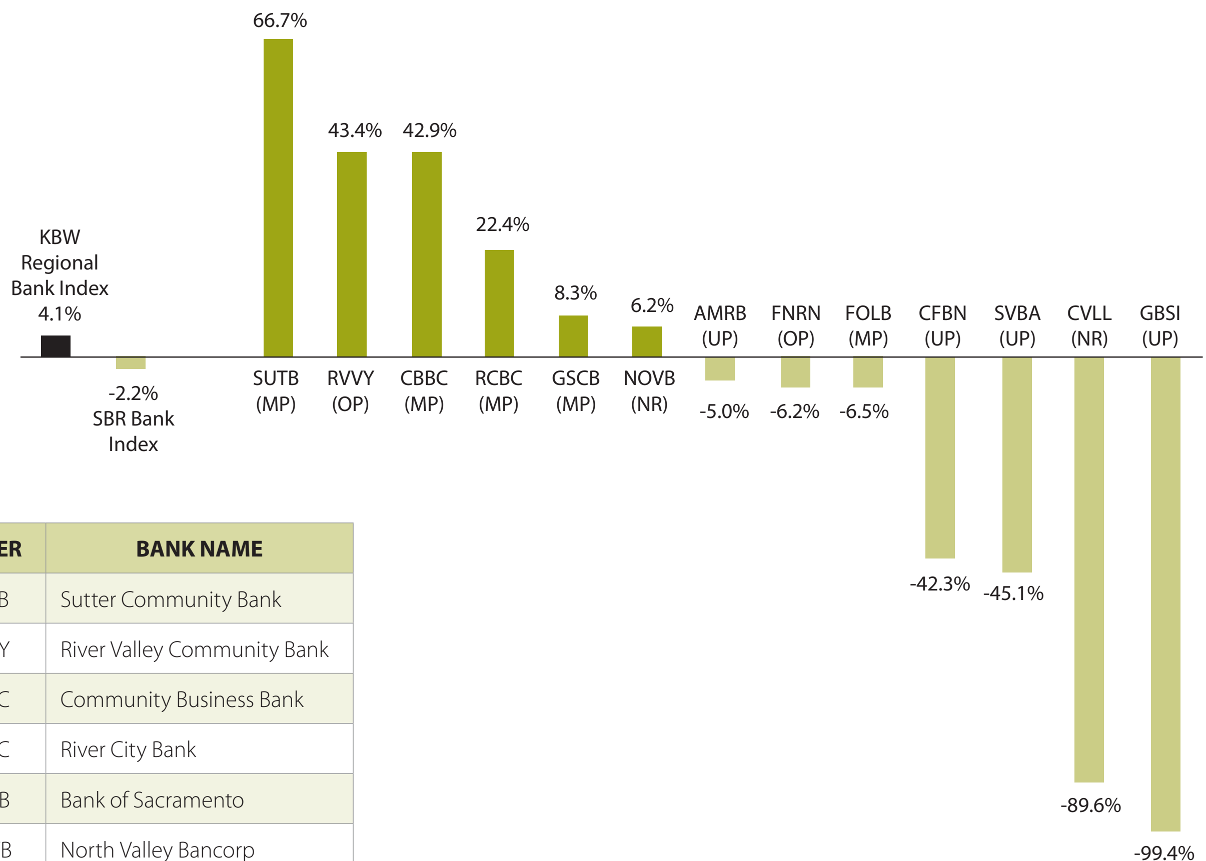
Bank	Headquarters	Allowance for Loan Losses as a % of Nonperforming Loans[1]	CRE & Construction Loans as a % of Total Loans	TCE Ratio[2]	Pro Forma TCE Ratio if 100% Loan Loss Allowance[3]	Bankrate.com Rating[4]
Butte Community Bank	Chico, CA	28%	58%	3.3%	0.0%	1
Community 1st Bank	Roseville, CA	17%	80%	8.7%	6.4%	2
First Bank	St. Louis, MO	38%	50%	3.7%	0.7%	1
North Valley Bank	Redding, CA	39%	63%	5.8%	3.8%	2
PremierWest Bank[5]	Medford, OR	45%	65%	5.7%	3.4%	1

1) Nonperforming loan balances were adjusted to exclude the percentage of nonperforming loans guaranteed by the U.S. government.
2) Tangible Common Equity (TCE) Ratio is calculated by taking Common Equity, net of Preferred Stock and Intangible Assets, as a percentage of Tangible Assets.
3) This column shows the pro forma TCE Ratio if the bank were to increase its loan-loss allowance to 100% of nonperforming loans (net of 35% tax benefit on provision).
4) Bankrate.com ratings are as follows: 5 = Superior, 4 = Sound, 3 = Performing, 2 = Below Peer Group, 1 = Lowest Rated
5) PremierWest Bank's TCE Ratio has been adjusted to reflect $32.7 million equity offering in April 2010.

Financial data from March 31, 2010 FDIC Call Reports

The "Watch List" (Table 3) on page 33 of the January 2010 edition has been updated. California Bank & Trust (CB&T) was previously included on this list because the authors included CB&T's portion of nonperforming loan balances acquired from two failed banks. After factoring in CB&T's proportion of nonperforming loans under new FDIC loss-sharing agreements, the authors determined that CB&T's allowance for loan losses as a percentage of its (adjusted) nonperforming loan balances was above the threshold on the aforementioned "Watch List".

Figure 1
Publicly Traded Banks Based in the Sacramento Region
Year-to-Date (through June 30) Returns



TICKER	BANK NAME
SUTB	Sutter Community Bank
RVVY	River Valley Community Bank
CBBC	Community Business Bank
RCBC	River City Bank
GSCB	Bank of Sacramento
NOVB	North Valley Bancorp
AMRB	American River Bank
FNRN	First Northern Bank of Dixon
FOLB	Folsom Lake Bank
CFBN	Community 1st Bank
SVBA	Sierra Vista Bank
CVLL	Community Valley Bancorp*
GBSI	Granite Community Bank

**Community Valley Bancorp is the holding company of Butte Community Bank.*

ABBREVIATION	JANUARY SBR RECOMMENDATION
OP	Outperform
MP	Market Perform
UP	Underperform
NR	Not Rated

Data Sources: Yahoo! Finance and OTC Bulletin Board

Given the considerable price moves in many of these local bank stocks through June, we have updated our recommendations for the second half of 2010. Readers should note that all of these stocks have very low liquidity, so investors should definitely consider market impact[5] when trading shares.

Table 3
Recommendations for Publicly Traded Banks Based in the Sacramento Region*
June 30, 2010

Bank	Ticker[1]	Year-to-Date Total Return[2]	Market Cap[3]	Price / Tangible Book[4]	TCE Ratio[5]	Allowance for Loan Losses as a % of Nonperforming Loans[6]	CRE & Construction Loans as a % of Total Loans	Bankrate.com Rating[7]
OUTPERFORM								
River City Bank	RCBC	22.4%	$49.9	0.6x	8.9%	106%	48%	2
Bank of Sacramento	GSCB	8.3%	$16.7	0.5x	9.5%	93%	73%	3
Sutter Community Bank	SUTB	66.7%	$4.8	0.7x	10.7%	213%	33%	3
MARKET PERFORM								
First Northern Bank of Dixon	FNRN	-6.2%	$41.3	0.7x	7.8%	61%	43%	3
River Valley Community Bank	RVVY	43.4%	$22.6	1.4x	13.1%	160%	58%	4
Folsom Lake Bank	FOLB	-6.5%	$11.2	1.0x	11.1%	117%	79%	3
Sierra Vista Bank	SVBA	-45.1%	$7.2	0.8x	8.1%	107%	56%	2
UNDERPERFORM								
American River Bank	AMRB	-5.0%	$73.5	1.1x	11.8%	46%	69%	3
North Valley Bancorp	NOVB	6.2%	$16.6	0.3x	5.8%	39%	63%	2
Community Business Bank	CBBC	42.9%	$8.6	0.6x	10.5%	43%	56%	2
Community 1st Bank	CFBN	-42.3%	$6.6	0.5x	8.7%	17%	80%	2
Community Valley Bancorp	CVLL	-89.6%	$1.0	0.1x	3.3%	28%	58%	1
				Mean: 0.7x **Median: 0.7x**				

1) Each of the stocks is traded on the OTC Bulletin Board.

2) Year-to-date returns through June 30th

3) Market capitalization as of June 30, 2010; Figures listed are in millions.

4) Tangible Book Value is determined by substracting Preferred Stock and Intangible Assets from Common Equity.

5) Tangible Common Equity Ratio (TCE Ratio) is calculated by taking Common Equity, net of Preferred Stock and Intangible Assets, as a percentage of Tangible Assets.

6) Nonperforming loan balances were adjusted to exclude the percentage of nonperforming loans guaranteed by the U.S. government.

7) Bankrate.com ratings are as follows: 5 = Superior, 4 = Sound, 3 = Performing, 2 = Below Peer Group, 1 = Lowest Rated

** The authors do not own shares in any of the banks listed in Table 3. The Sacramento Business Review cannot guarantee any of the forecasts made in this paper.*

REFERENCES

1 The 15 local banks analyzed were American River Bank, Bank of Sacramento, Community 1st Bank, Community Business Bank, El Dorado Savings Bank, First Northern Bank of Dixon, Five Star Bank, Folsom Lake Bank, Gold Country Bank, Granite Community Bank, Merchants Bank of Sacramento, River City Bank, River Valley Community Bank, Sierra Vista Bank, and Sutter Community Bank.

2 We have defined the Sacramento region to include El Dorado, Placer, Sacramento, Sutter, Yolo, and Yuba counties.

3 Financial information for the banks analyzed in January's *SBR* was as of September 30, 2009. The six-month period referenced reflects data from September 30, 2009 through March 31, 2010 (since June 30, 2010 data has yet to be released).

4 The SBR Bank Index measures the performance of the 13 publicly traded stocks based in the six-county Sacramento region. Performance is calculated on a capitalization-weighted basis.

5 Market impact is the extent to which buying or selling a stock moves the price. Market impact is greater when stocks are more illiquid.

Capital Markets Review:

The Global Markets and Their Impact on *Sacramento*

UPDATE

Jason Bell, CFA, Vice President and Senior Investment Manager, *Wells Fargo Private Bank*
Hao Lin, Ph.D., CFA, Professor, *College of Business Administration, Sacramento State*

Jason Bell, CFA

Hao Lin, Ph.D., CFA

Spring held a nasty surprise as mid-April marked the start of a stiff correction in the global capital markets. Investors became increasingly unnerved with concerns surrounding the European debt crisis, slowing growth in China and regulatory overhauls to the healthcare and financial systems. Fears were further exacerbated by the disturbing and tragic events surrounding the Gulf oil spill, sending bulls to the exits, global equities into the red and propelling Treasuries to double digit gains as the second quarter came to a close.

Despite the Q2 turbulence, we remain confident in the macro factors that underpin our global recovery thesis. Monetary policy remains accommodative and major financial institutions continue to heal themselves as charge offs and reserve building appear to have turned the corner. Though slowing, global GDP growth is still positive and business spending appears primed to ramp. Investor sentiment has turned overly pessimistic and attractive equity valuations are being ignored as the flight to safety trade has re-emerged.

Concerns of a "double-dip" recession in the US are overblown, but soft real estate and labor prices will still take quarters, if not years, to fully recover. Deflation, not inflation, has now become the greater near-term threat which may require another round of stimulative policy action by the Fed[1]. Eurozone economic measures are still consistent with sustained growth and the newly-weakened euro should provide a tailwind in export activity. However, any setback in consumer confidence or German manufacturing activity could increase the odds of a recession in the developed markets[2]. Growth in the emerging economies remains strong as China, Brazil and India have all beaten expectations[3].

Capital Markets Review:
The Global Markets and Their Impact on Sacramento

Short of a few surprises and timing nuances, many of our initial forecasts from January are unfolding as expected. We review them below:

1. **Volatility will trend lower (subject to event shocks)** – through April, this theme held true as both equity and credit market volatility (respectively measured by the Chicago Board Options Exchange Volatility index (VIX), and option-adjusted spreads (OAS)) slowly trended lower (see Figure 1). However, mid-April's return of risk aversion in the markets has pushed both of these indicators to back towards early-2008 levels.

2. **1H equity rally, Treasury yield curve to flatten** – our call for a rally in the first half of the year didn't last as long as we predicted. The 5% gain the S&P 500 eked out through early April quickly evaporated into an 8% loss by the end of June. We do expect a turbulent Q3 which will hopefully exhaust sellers and allow the markets to generate a slightly positive return by year end. The yield curve has flattened from record steepness and a preference for risk-aversion has pushed yields markedly lower across the maturity spectrum. We do expect for yields to rise across the curve as we move through the rest of the year.

3. **Favored sub-asset classes** – our expectation that emerging markets would outperform global averages has largely proved out so far. Though we didn't forecast the rapid decline in the Euro, our prediction that there will be no material difference in performance between the S&P 500 and EAFE (Europe, Australia and Far East) is holding steady, as their returns are within 1% of each other's to date. Our large cap versus small cap call has not performed according to expectations as small outperformed large by over 4% in the first half of the year[4]. Given our outlook for increased volatility in Q3, we believe large cap will make up some lost ground, but we believe it won't be enough to overcome the gap by year end.

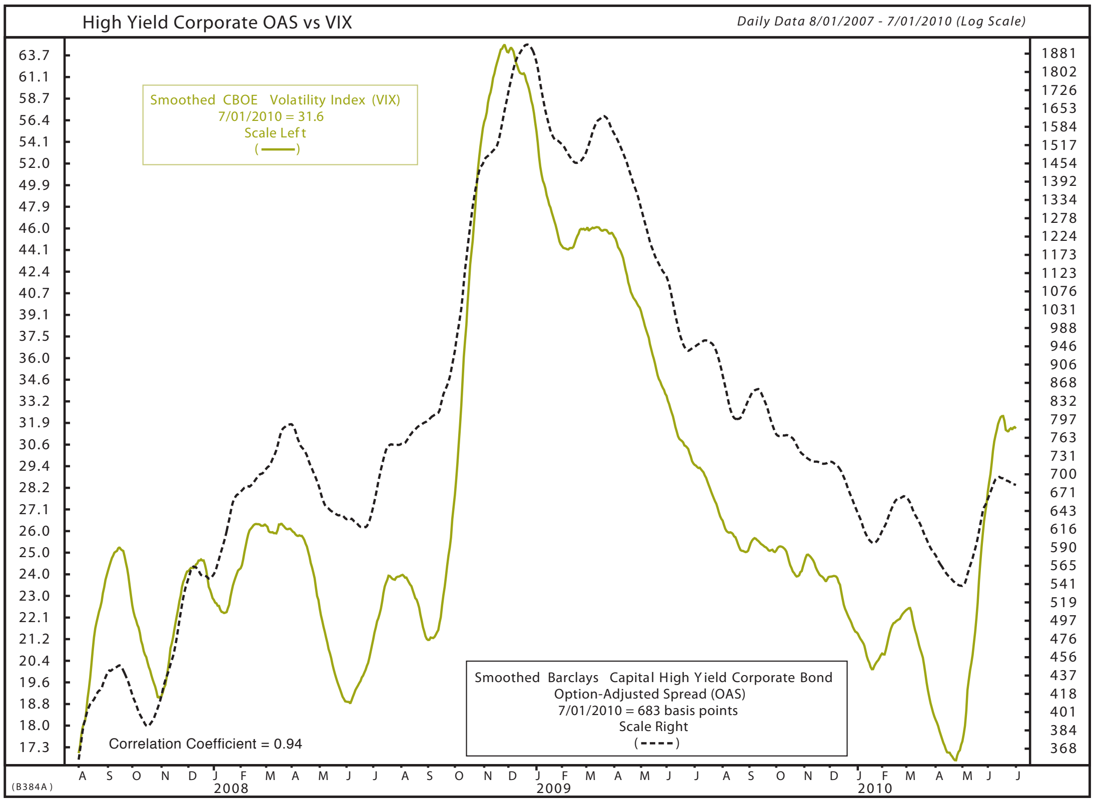
   Our credit market call favored spread product (corporate, municipal, global sovereign debt) versus Treasuries. With the exception of global sovereign debt, this call had been performing according to expectations. However June's continued sell off in the markets have placed Treasury returns currently ahead of the others. We believe the best is behind for Treasuries this year and see corporate and municipal debt outperforming in the domestic credit markets. Due to the evolving nature of the European debt crisis, we are adjusting our call and believe that Treasury returns will remain greater than foreign sovereign debt returns by year end.

4. **The SBR index will perform in-line with the S&P 500** – this call is performing according to expectations. The SBR index is nearly 70% cyclically-biased, with a larger exposure to technology, consumer discretionary and financial sectors, and only 30% exposed to the more defensive sectors such as consumer staples, telecommunications and utilities. In our 18 months of tracking the index, we have seen over a 98% correlation with the broad market, despite our employment-weighting methodology. We expect the index to track the S&P 500 for the remainder of the year with no material difference in performance. (see Figure 2).

Sources:

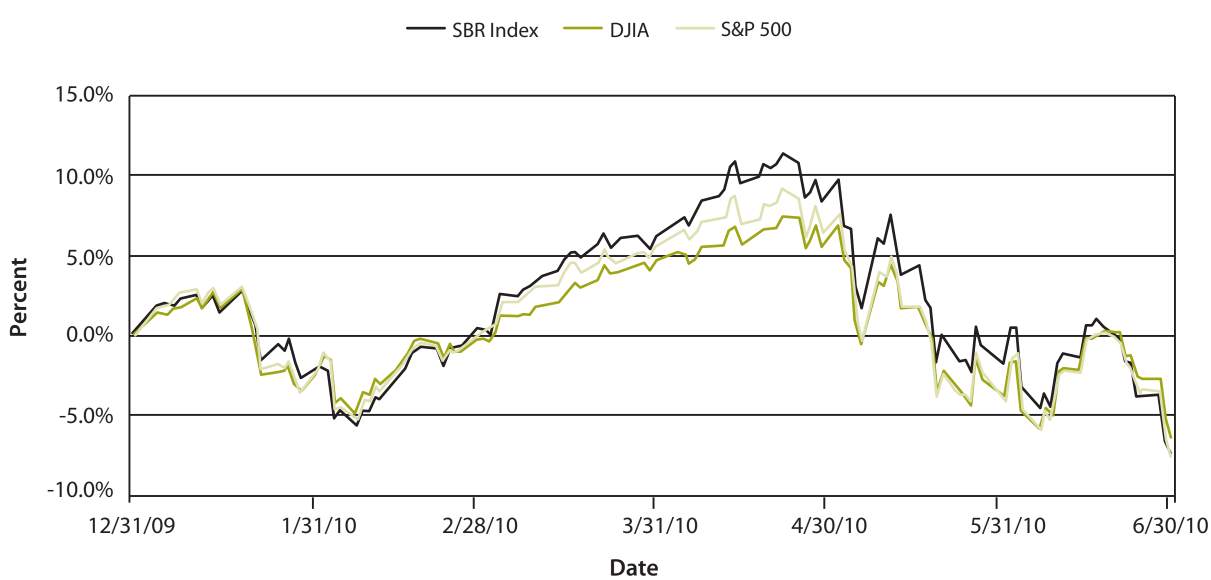
1 Wolfe Trahan & Co., Portfolio Strategy, June 30, 2010
2 Ned Davis Research, Global Comment, June 30, 2010
3 International Strategy and Investment, Capital Chronicle, July 1, 2010
4 Ned Davis Research, Chart of the Day, July, 1 2010

Figure 1: Measures of Market Volatility



Source: Ned Davis Research

Figure 2: YTD Return: SBR Index vs. DJIA, S&P 500



Note: The employment numbers for the SBR index constituents have been updated based on Sacramento Business Journal 2009 Book of Lists. The SBR Index and chart are authored by Hao Lin, Ph.D., CFA, Professor, College of Business Administration, Sacramento State.

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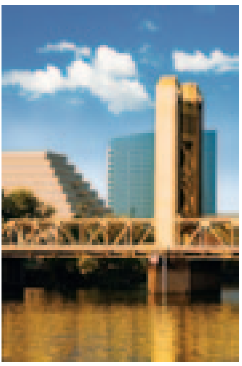

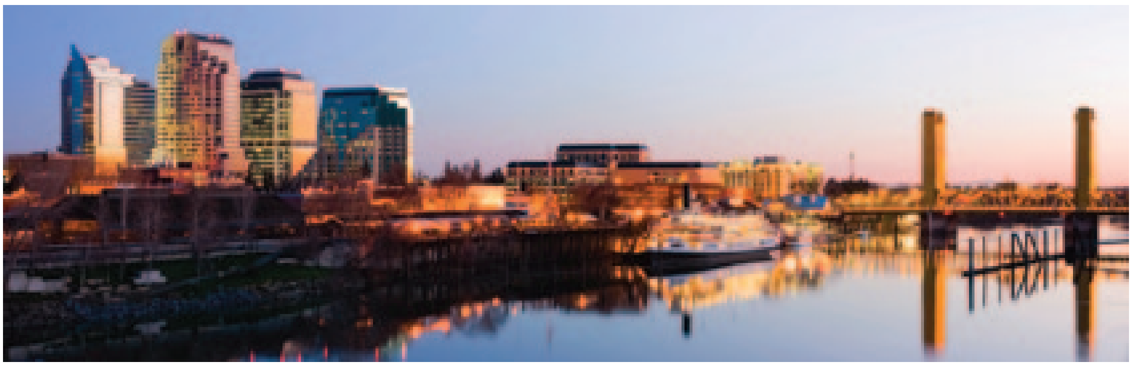

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