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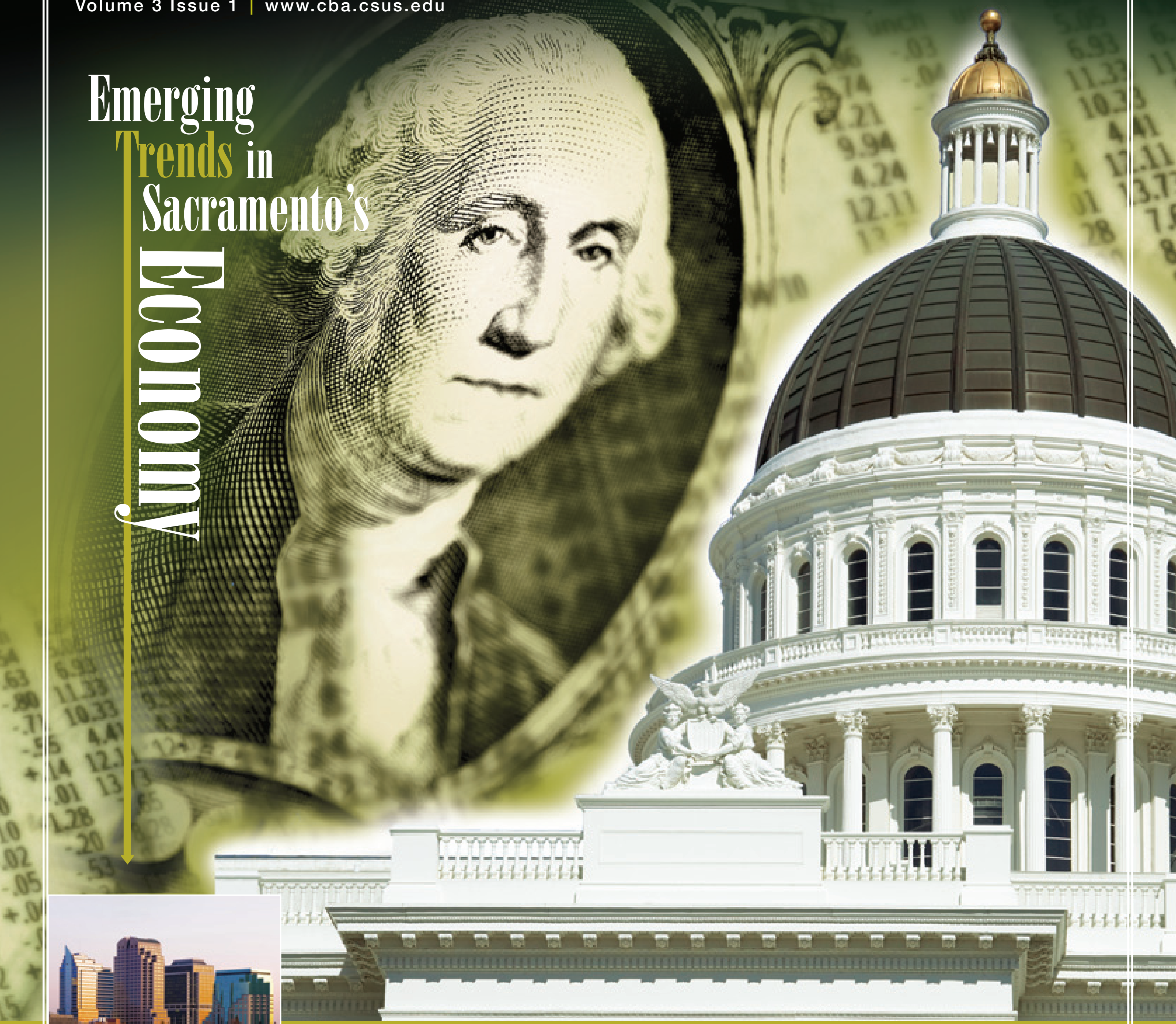
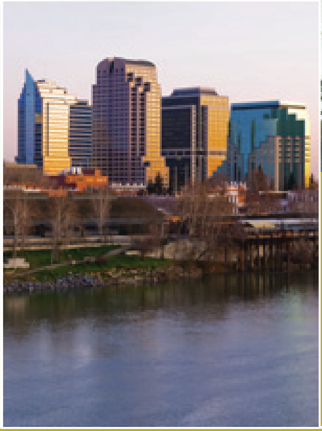
Emerging Trends in Sacramento's Economy





2011 Economic Forecast

NEW! SMALL BUSINESS SECTION

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SACRAMENTO STATE
COLLEGE OF BUSINESS ADMINISTRATION

January 2011

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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 pleased to share the fifth edition of the *Sacramento Business Review* - the most comprehensive, precise, and intellectually sophisticated analysis of the regional economy. For three years in a row, our team has accurately forecasted the economic and business climate and has provided thoughtful predictions.

With ten of Sacramento's very best financial analysts and researchers combining their skills and talent, the Sacramento Business Review has become the most credible source of independent thinking, insights, and research not found elsewhere in the region. I am delighted by your overwhelmingly positive response, as you have embraced the publication and have used it as your regional guide. Last year, we made countless presentations of our work in the community, and I received hundreds of emails and phone calls complimenting the great work.

Last year, we predicted that unemployment would worsen, housing and real estate would continue to drift in search of a bottom, bank credit would remain tight, and that all of these factors together would adversely affect the region's economic health. We further predicted that the recession in Sacramento could end as early as the second quarter of 2010 and that capital markets would bring stability to local corporations. We were right.

As we begin the year 2011, we feel more optimistic than we did last year. We realize there are multiple challenges that still confront us and dampen hopes for a rapid economic recovery. However, we believe the recession in Sacramento did end in 2010, paving the way for very gradual progress on the jobs front, with the business sector helping economic growth more so than consumers (who will stay pressured by the housing and government sectors). The worst of the credit crisis is behind us, with Sacramento banks healthier and better-positioned to lend money. The small business sector remains pressured, and our newly constructed Small Business Confidence Index shows a strong negative sentiment. However, the early financing indicators look promising. While 2011 may not feel like the year of the recovery, we believe we will be on the way.

With this issue, we renew our commitment to deliver the very best economic and financial research to the region. I invite your feedback. Please do not hesitate to let me know how we may improve future issues or if you wish to be a supporting sponsor. To download your free copy, please visit **www.sacbusinessreview.com**.

Warm regards,

Sanjay Varshney

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Contents

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sacramento BUSINESS REVIEW

Emerging Trends in Sacramento's Economy

2011 Market Forecast Executive Summary

Sacramento's Labor Market & Regional Economy: 2011 Outlook

- **Sacramento's recession ended in 2010, but it won't "feel" that way in 2011**
  While we estimate the local recession likely ended in mid-2010, some 12 months after the US recession ended, we believe 2011 will hold much of the same for the region – high unemployment, deleveraging and an overall economic drag from the real estate and government sectors.

- **Unemployment rate will stay in the 11.5-13.5% range in 2011**
  The Sacramento region is losing jobs at a slower rate, but the area's unemployment rate will remain stubbornly high through 2011. The under-employment rate is estimated at around 20%, and we believe the overhang of discouraged workers who have left the workforce is significant for the region.

- **Structural factors will lead to elevated unemployment longer-term**
  We believe structural inefficiencies that have developed in the Sacramento labor market will result in an elevated unemployment rate over at least the next 3-5 years.

- **The corporate sector will lead the economy this year**
  The corporate sector will likely show improvements in 2011 due to healthier balance sheets, growing profitability and a more business-friendly environment (tax cut extensions, increased merger and acquisitions (M&A) activity, less regulatory uncertainty). On the other hand, consumer spending, while improving, will generally still be plagued by a weak housing market, high unemployment, deleveraging and low income growth.

- **Government and real estate sectors will continue to be a drag on the economy**
  The New Year brings the same old challenges for these two sectors. We expect governments at all levels to remain under financial strain and the residential housing market to show declining prices well into 2011. The sizeable overhang from shadow inventory will make it particularly difficult for local housing prices to rebound.

Real Estate Trends in the Sacramento Region

- **Foreclosures, Foreclosures, And More Foreclosures**
  The housing market will continue to struggle in 2011, marking what will be the sixth consecutive year in a residential downturn. Foreclosure activity will continue to dominate the environment, as borrowers at all income strata are having difficulty paying their mortgages.

- **Commercial Rental Markets Stabilize In 2010**
  Leasing activity picked up across all property types in the commercial market as there became a growing sense that we are nearing the floor in rental rates, providing tenants the confidence necessary to commit to leases. Occupancy stabilized in 2010, albeit at low levels, after falling precipitously in 2009.

- **Retail Leasing Activity Is Perking Up**
  Driven by a shift in consumer preferences towards frugality, grocers and discount retailers were the most active during the year. "Mom & Pop" retailers are reemerging, taking advantage of space with existing tenant improvements that meet their needs (low startup costs). For the first time in a few years we saw new retailers announce plans to enter the region with multiple sites.

- **The Office Market Suffers From The Largest Vacancy Rate Of All Property Types**
  Although leasing activity was up in the office sector, it was mostly "negative" activity, with a large number of renewals or relocations focused around downsizing or aggressive economic incentives rather than business growth. Average vacancy remains in excess of 20%.

- **Positive Outlook For The Industrial Sector**
  After two years in negative territory, we expect a modest return of positive net absorption in the industrial sector and a slight drop in vacancy in 2011.

- **Investment Activity Is On The Rise**
  Purchase transaction volumes improved in 2010 with investors heavily focused on core-quality assets or value-add properties being offered at low price per pound metrics. Apartments have become a favored asset class due to its lower risk characteristics, advantageous financing options, healthy fundamentals, and favorable demographic story.

- **Opportunities Abound In The Real Estate Market**
  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.

2011 Sacramento Banking Industry Forecast

- **The Sacramento region's banks are now in better shape.**
We believe the worst of the credit cycle has passed and that most local banks are healthier relative to 12 months ago.

- **However, profit growth will remain challenging.**
With the risk of local bank failures seemingly in the rear-view mirror, bank management teams now face significant obstacles to growing their top and bottom lines.

- **Loan activity is not expected to accelerate due to weaker demand.**
While banks are now better-positioned to lend, a lack of demand from creditworthy borrowers will make loan growth difficult for banks, thus creating a considerable hurdle for improving net interest margins.

- **Charge-offs of nonperforming assets will continue to impact profitability.**
Though down from year-end 2009 levels, nonperforming assets for many local banks remain elevated and will almost certainly lead to continued charge-offs throughout 2011.

- **New regulations will result in higher operating expenses, especially for smaller banks.**
New federal regulations following last year's passage of the Dodd-Frank bill are expected to saddle banks with new compliance costs while also curtailing various fee income sources. Smaller banks are likely to feel a greater impact from these regulations.

- **Merger-and-acquisition (M&A) activity should pick up later in the year.**
Given the substantial pressures to improve profitability, we anticipate a rise in M&A activity toward the end of the year.

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

- **The global economy is in recovery but will be more pronounced in the emerging economies and the United States versus Europe.**
Potential risks to the recovery include: 1) an inability to contain the European sovereign debt crisis, 2) emerging economies tighten monetary policy too aggressively, 3) global interest rates rise too rapidly, and 4) additional shocks to the domestic housing market.

- **The backdrop for equities should be generally positive in the first half of the year.**
We expect a midyear correction as the Fed completes its quantitative easing program and equity bulls take a breather. If an oversold condition develops from the correction, an end of year rally would be likely. We favor a pro-growth, cyclical positioning in the first half of 2011 and a defensive posture in the latter half.

- **The tide has finally turned for bonds and the nearly three-decade bull market is over.**
Yields will rise across the curve and the Fed's efforts will contribute to above average volatility in the credit markets this year. We favor corporate, high yield and municipal debt relative to Treasuries.

The Small Business Economy

- **Sacramento MSA remains a service sector economy.**
The population growth story is not followed by large scale job creation other than in sectors that service the population, such as construction, wholesale/retail trade, healthcare, and business/ professional services.

- **SMEs drive the regional economy.**
SMEs account for one third the total employment, 96% of all employer firms, and most of the net new job creation nationwide. Taxable sales declined in the face of severe job losses as SMEs got hurt the most. Regional economic policies should become more pro-SMEs. Particularly, at the early stages of economic recovery, the role of SMEs is crucial. A more favorable and supportive business environment would be a great catalyst in the region's economic recovery.

- **SMEs got crushed by tight credit and fewer loan approvals during the recent crisis.**
The number of SBA loans and amount approved dropped precipitously. The positive turnaround in loan activity in 2010 provides optimism regarding the health of SMEs and the broader role they could play in the economic recovery. The financial drought may be finally over. While the recovery appears slow, the early financing indicators appear promising.

- **SMEs are very pessimistic about the economic fallout and future prospects.**
Our newly constructed Small Business Confidence Index reveals a negative outlook and continued pessimism regarding local support and access to credit. The business environment is perceived to be unfriendly. Small businesses hope for better days ahead for revenue and job growth.

Sacramento's Labor Market & Regional Economy: 2011 Outlook

Brian M. Leu, CFA, CAIA, Investment Officer, CalPERS
Yang Sun, Ph.D., Professor, College of Business Administration, Sacramento State

Key Points

- **Sacramento's recession ended in 2010, but it won't "feel" that way in 2011**
  While we estimate the local recession likely ended in mid-2010, some 12 months after the US recession ended, we believe 2011 will hold much of the same for the region – high unemployment, deleveraging and an overall economic drag from the real estate and government sectors.

- **Unemployment rate will stay in the 11.5-13.5% range in 2011**
  The Sacramento region is losing jobs at a slower rate, but the area's unemployment rate will remain stubbornly high through 2011. The under-employment rate is estimated at around 20%, and we believe the overhang of discouraged workers who have left the workforce is significant for the region.

- **Structural factors will lead to elevated unemployment longer-term**
  We believe structural inefficiencies that have developed in the Sacramento labor market will result in an elevated unemployment rate over at least the next 3-5 years.

- **The corporate sector will lead the economy this year**
  The corporate sector will likely show improvements in 2011 due to healthier balance sheets, growing profitability and a more business-friendly environment (tax cut extensions, increased merger and acquisitions (M&A) activity, less regulatory uncertainty). On the other hand, consumer spending, while improving, will generally still be plagued by a weak housing market, high unemployment, deleveraging and low income growth.

- **Government and real estate sectors will continue to be a drag on the economy**
  The New Year brings the same old challenges for these two sectors. We expect governments at all levels to remain under financial strain and the residential housing market to show declining prices well into 2011. The sizeable overhang from shadow inventory will make it particularly difficult for local housing prices to rebound.

> *"...we estimate the local recession likely ended in mid-2010, some 12 months after the US recession ended."*

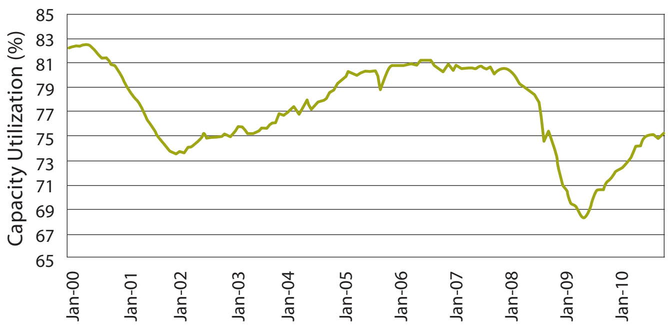
The New Year Brings Painfully Familiar Headwinds from 2010

While the local economic recovery is underway, unfortunately we see little that suggests a material improvement in the economic picture for 2011. The "official" end of a recession is generally characterized by the beginning of period-over-period growth in economic activity. As such, we estimate the local recession likely officially ended in mid-2010, some 12 months after the US recession ended. That said, we continue to believe the Sacramento region will experience a prolonged (and painful) U-shaped recovery, with job growth lagging economic growth by at least 12-18 months.

Many of the familiar headwinds from 2010 will again represent challenges, albeit to a lesser extent, in 2011 - including relatively tight credit markets, deeply distressed real estate markets, damaged household balance sheets, government deficits, and excess capacity. The economy is, to a large extent, still on a large dose of steroids. The combination of low interest rates, QE2, fiscal stimulus and renewed tax incentives have supported economic growth thus far. Ultimately, the current business cycle must eventually lead the economy back to health, and we believe that private sector sources of growth will begin to pick up this year as fiscal stimulus fades. We expect a gradual pick-up in final demand growth as businesses continue to invest in equipment and software, and to a lesser extent, consumer confidence recovers and households continue to spend.

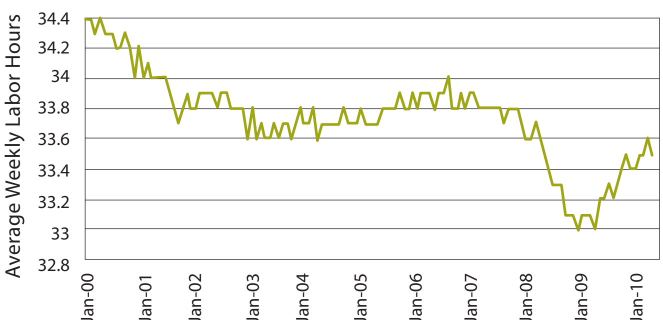
Sacramento's Labor Market & Regional Economy: 2011 Outlook

Figure 1 – US Capacity utilization is gradually increasing, but slack still remains



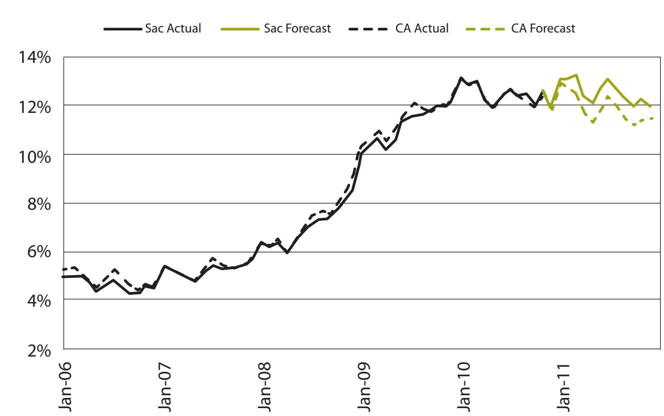
Source: Federal Reserve

Figure 2 – US Labor hours are increasing, but excess capacity still exists



Source: Bureau of Labor Statistics

Figure 3 – Outlook for Sacramento and California Unemployment Rates



> *"...the good news is that the Sacramento region is losing jobs at a slower rate."*

Inflation risks are low in the near-term

Excess capacity exists in almost every corner of the economy: unemployment is near post-war highs; industrial capacity utilization remains low (Figure 1); labor hours remain below historical averages (Figure 2); and office, apartment and home vacancy rates are near all-time highs. With the extent of spare capacity in the economy, we believe the risk of higher core inflation remains low. Accordingly, we expect monetary policy to remain accommodative through 2011 and into 2012.

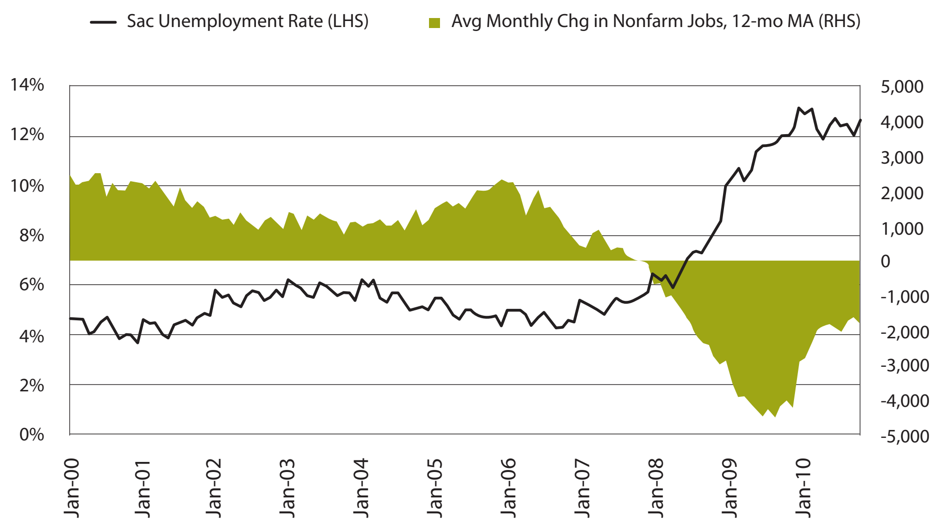
Unemployment rate will stay in the 11.5-13.5% range in 2011

Sacramento's regional unemployment rate stood at 12.6% (as of November reading), compared to 12.4% for California and US rate of 9.8% (US rate of 9.4% in December). We expect the regional unemployment rate to remain in the 11.5% to 13.5% range in 2011 (this relatively large range for the unemployment rate reflects the volatility that results from seasonality and changes in the labor force participation rate) (Figure 3). Indeed, we expect an early 2011 reading to show a 13%+ unemployment rate again before settling in the 12% range.

Pace of job loss will continue to improve

The bad news is that the area is still losing jobs, but the good news is that the Sacramento region is losing jobs at a slower rate (Figure 4). The average monthly change in non-farm payrolls (12-month moving average), has improved from a rate of 4,500 jobs lost per month in late-2009 to about 1,800 jobs lost per month in November 2010. We believe this average job loss trend, which shows steady improvement in 2010 (partly from the census hiring), is a better measure of the current employment situation than the sometimes fickle unemployment rate. We expect this pace of job losses to continue to decline in 2011, even if the unemployment rate does not fully reflect this trend.

Figure 4 – Rate of average monthly job loss has improved though 2010



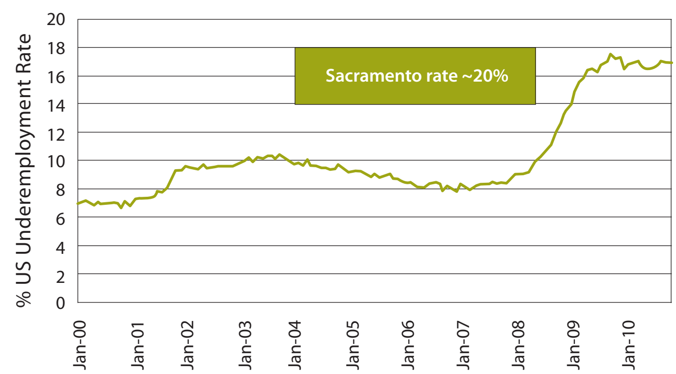
Source: EDD.

Under-employment rate of 20% and shrinking labor pool suggest a deeply discouraged workforce

The so-called under-employment rate is estimated at around 20% for Sacramento (Figure 5). This rate reflects the underutilization of the labor force and accounts for those potential workers who (1) have involuntarily taken on part-time work in lieu of full-time positions, (2) have been forced to work fewer hours, or (3) have simply ceased to actively look for a job, possibly discouraged from the tough labor market.

Indeed, the region has seen its labor force (those working or actively looking for work) dwindle by almost 3% (or by about 30,000) since mid-2009. This decline is worse in Sacramento than at the state or national level, which we attribute largely to deeply discouraged local job-seekers leaving the workforce in light of the unprecedented challenging local labor market – driven primarily by the higher local exposure to real estate and government. This shrinking labor pool, which we view as both cyclical and structural, will represent a significant overhang of potential workers "waiting in the wings" for the labor market to improve. This also suggests that the reported unemployment rate likely underestimates the true situation. In fact, we believe a paradox may emerge in 2011 whereby continued weak job creation may be accompanied by a falling unemployment rate as people leave the labor force. Conversely stronger economic growth may draw people back into the labor force leading to a higher unemployment rate.

Figure 5 – US Under-employment Rate Remains Elevated



Source: Bureau of Labor Statistics

Structural factors will lead to elevated unemployment longer-term

In addition to the cyclical factors affecting the local labor market, we believe structural inefficiencies have developed that will result in an elevated unemployment rate over at least the next 3-5 years.
These structural factors include:

- Mismatches between the skills of the workers who have lost their jobs and the skills needed in the sectors of the economy with vacancies;

- The inability of the unemployed to relocate because their homes are underwater (i.e. owe more than their home is worth);
- The effects of extended unemployment benefits on the duration of unemployed workers' search for a new job;
- The risk of an erosion of workers' skills after very long spells of unemployment.

Construction, manufacturing and financial sectors had structural job loss

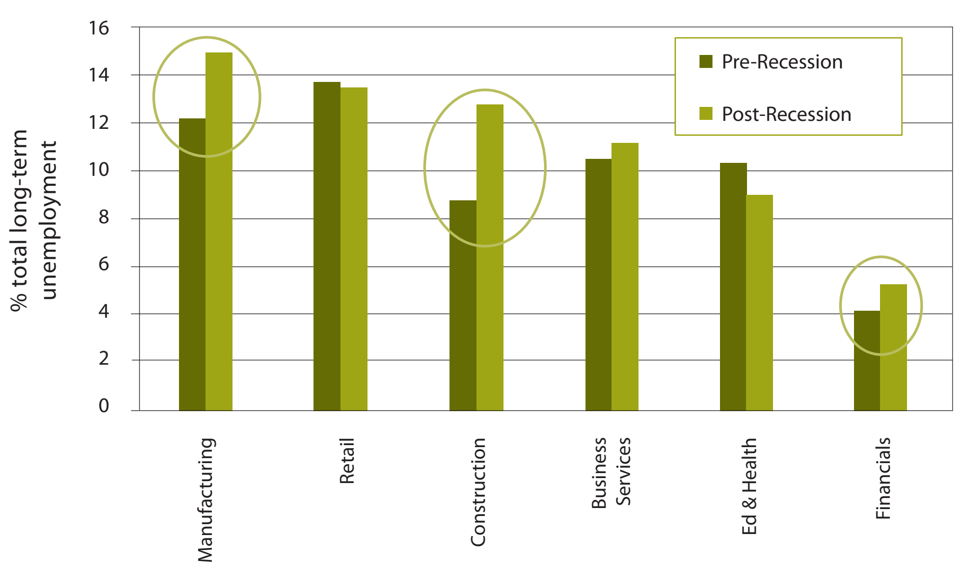
The construction, manufacturing and financial sectors in Sacramento have witnessed the largest job losses from their pre-recession peaks (-54%, -32% and -26%, respectively). National jobs data also reveals that the increase in long-term unemployment during the recession was in manufacturing and construction (and, to a lesser extent, financial services) (Figure 6). It is likely that part of this increase in these sectors will prove to be structural. First, employment levels in these sectors are unlikely to reach pre-recession levels for a long time given the collapse in those industries. Second, workers laid off in these areas may find it hard to relocate to others, especially if wage expectations are relatively high and skills are industry-specific.

The construction sector has been particularly hard hit by the local recession and bursting of the housing bubble. Construction has lagged the overall labor markets to date – unemployment remains above 20% and job openings have barely recovered. The ratio between the two, the "job-seekers ratio" (i.e. the number of unemployed persons per job opening), is significantly higher than in other sectors of the economy (Figure 7). For Sacramento, the construction sector, which was as much as 8.6% of total payrolls in 2005, is now just half that size at 4.3%. Given the gloomy outlook for construction, we believe this structural shift will contribute to an elevated Sacramento unemployment rate longer-term.

Beveridge Curve also points to a structural change

The Beveridge Curve, named after the British economist William Henry Beveridge (1879-1963), is a graphical representation of the relationship between the unemployment rate and the vacancy rate (Figure 8). During an economic contraction, the unemployment rate is high and the vacancy rate is low and vice versa during an expansion. While most business cycles can be captured along the downward sloping 45-degree line,

Figure 6 – Share of long-term unemployed by industry, US

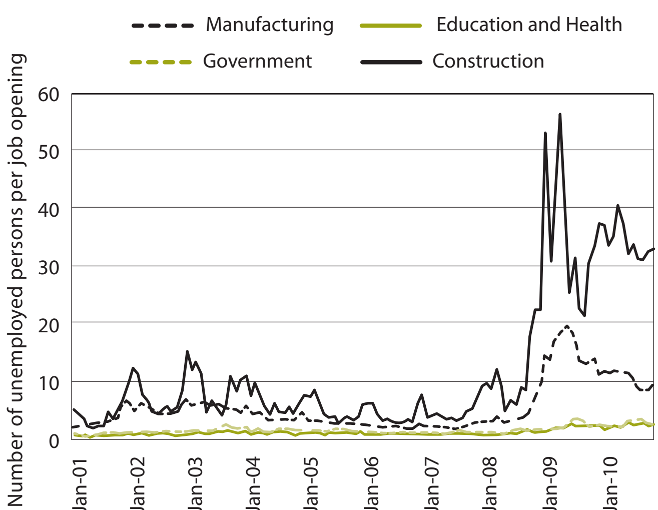


NOTE:
Pre-recession: average Jan-Dec 2007.
Post-recession: average July 2009 – August 2010.

Source: BLS, Barclays Capital

> *"…we would not be surprised if Sacramento does not see peak employment levels again for another 7 to 10 years."*

Figure 7 – Job-seekers ratio by industry, US



Source: Bureau of Labor Statistics

the curve itself can shift for the following reasons:

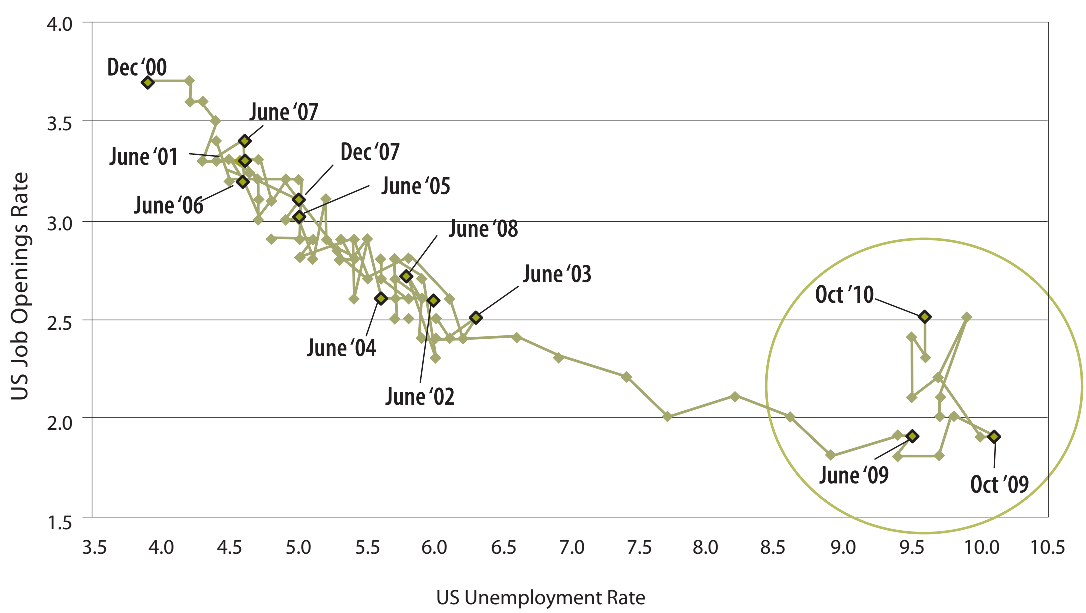
- Change in the efficiency of the labor matching process;
- Change in the labor participation rate;
- Change in the long-term unemployment rate;
- Change in frictional unemployment (due to job additions/separations).

We believe that the shift observed post-recession is a reflection of a skills mismatch and lower labor participation rate in the current economy that will lead to a slower recovery in the unemployment rate. This "secular unemployment" is partly a result of the depressed housing market and the increasingly efficient auto/manufacturing sectors, among other industries. These are traditionally the sectors that see a sizeable bounce off a recessionary bottom, but they are not playing that role this time around.

Sacramento may take 7-10 years to recover lost jobs

From peak levels, the region has lost 110,000 jobs (Figure 9). To help put this loss in perspective, we note that the last time the Sacramento region added 110,000 jobs, it took

Figure 8 – Beveridge Curve: Structural change in employment dynamics



Source: Bureau of Labor Statistics JOLTS approximately 6.5 years and was driven largely by the real estate boom. Given the structural nature of the job loss, we would not be surprised if Sacramento does not see peak employment levels again for another 7 to 10 years, despite an improving economy.

The corporate sector will lead the economy this year

Unlike in past recoveries, personal consumption and homebuilding, while very important for the region, will likely not play the leading role in 2011. The corporate sector, more than the household sector in our view, will likely show improvements in 2011 due to healthier balance sheets, growing profitability and a more business-friendly environment (tax cut extensions, increased M&A, less regulatory uncertainty). In particular, we believe business investments and net exports will help fuel broader growth next year.

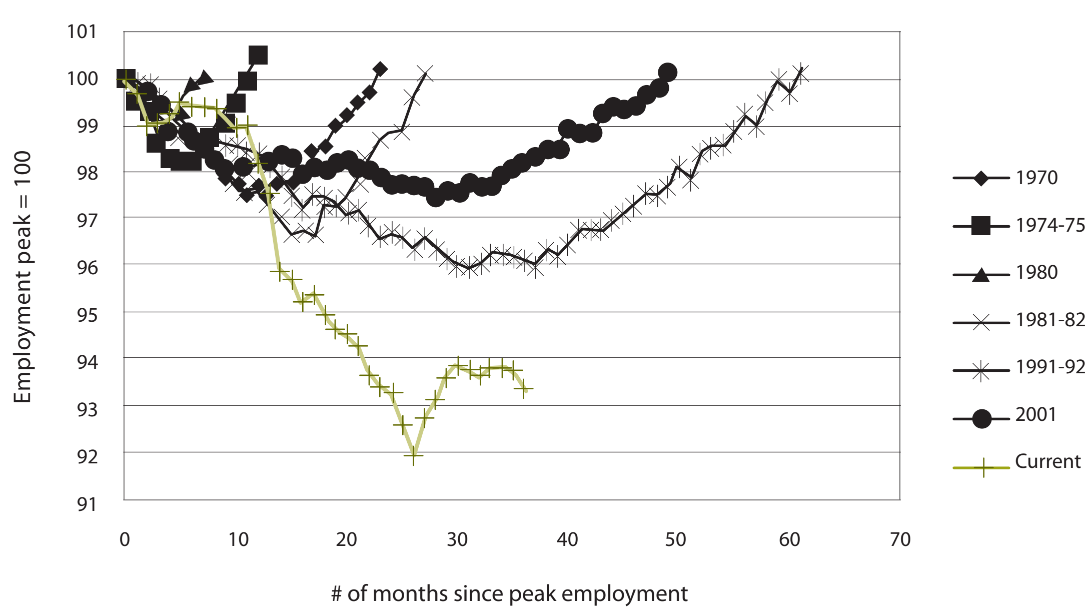
Consumer spending recovering, but still under pressure

Consumer spending, while clearly improving, will generally still be plagued by a weak housing market, high unemployment, deleveraging and low income growth. These headwinds are partially offset by a stock market rally and tax cut extensions that should have a positive effect on household wealth. In addition, the process of repairing household balance sheets has made progress, as evidenced by credit card balances which have fallen 14% from peak levels. Consumers are spending more out of income and savings, rather than credit. However, mortgage debt as a percentage of disposable income still stands at 77%, below the peak of 85% but well above the 50% at the start of the decade. Accordingly, we expect that corporate profits will continue to outpace household real disposable income growth in 2011.

Corporate profits should eventually translate into jobs

After a year of aggressive cost cutting, increasing productivity and widespread uncertainty in 2010, companies are entering 2011 well positioned to capture increased profits and reinvest for future growth. Companies are holding cash equal to 10% of their value - nearly two times higher than the average recorded since 1999, according to S&P. These cash-rich firms will likely be in a position to resume carefully hiring and making selective capital expenditures to meet future demand.

Figure 9 – U-Shaped recovery for CA will take longer than past recessions



Source: EDD

We also expect an active M&A environment as companies look to use cash to expand their businesses. Corporate leverage is now relatively low and M&A as a proportion of market cap is close to all-time lows and generally lags the cycle by 12 to 18 months.

In addition, many of the questions around the pace of recovery, regulation, taxes and the anti-business sentiment from Washington have been at least partially answered, paving the way for more certainty and increased spending.

Even though the drivers of this recession were unique, similar dynamics are at work in this recovery as in past recoveries – businesses have chosen to defer hiring, meeting rising demand with increased hours worked, temporary hires and other productivity gains. But eventually, businesses will reach capacity, final demand will become more stable, and firms will need to hire full-time employees.

Government and real estate sectors will continue to be a drag on the economy

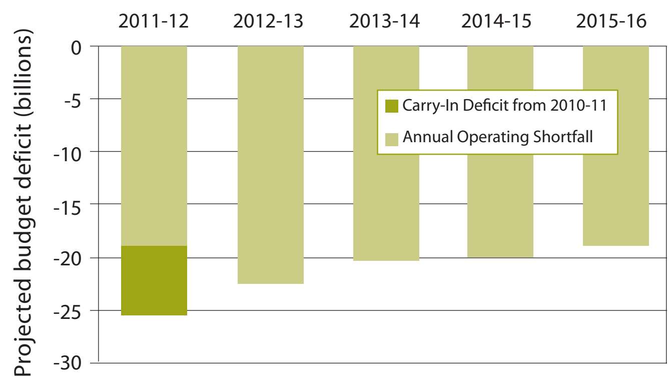
Two of the largest and most important sectors for Sacramento – real estate and government – have been two of the hardest hit during the recession. Realistically, this means Sacramento will likely lag the nation in its economic recovery, as the difficulties in these two sectors spill over into other industries and drag down overall growth. While we continue to look for bright spots in healthcare, green energy and other growing segments, the reality is that the statistics are troubling and suggest a long road to recovery.

Governments at all levels will be fiscally strained

Austerity, the 14th century noun defined as "enforced or extreme economy," set off enough searches last year that Merriam-Webster named it as its Word of the Year for 2010. In 2011, "austerity" may once again be the word of the year for Sacramento regional governments as they deal with budget woes and waning federal fiscal stimulus.

The state government is still projected to have at least a $25 billion deficit heading into the new budget season (Figure 10). The primary question continues to be "how long can the California government manage the deficit without more labor reductions?" For reference, every

Figure 10 – California Budget Woes Continue in 2011 and beyond



Source: Legislative Analyst's Office

1% reduction in the governmental workforce translates roughly into a 0.25% rise in the local unemployment rate. So, even a subtle reduction in government spending can have a major impact on the local economy. Governor Brown's recent budget proposal suggests sizeable state spending cuts are likely - including deep state worker pay cuts (~10%), shifting functions to local governments, and cuts to programs such as Medi-Cal, welfare-to-work, developmental services and higher education. We, along with local businesses and residents, will be carefully watching budget negotiations, but we continue to believe that the government sector will be a drag on local growth in 2011.

Residential housing market plagued by significant excess inventory

We view the housing market as one of the primary risks to the economic recovery. The housing market has significant multiplier effects within the economy and has historically been an important contributor to post-recession recoveries. Unfortunately, this time around we expect to see an overall drag on growth from housing, largely due to the significant excess inventory in the market.

In the US, an estimated 20% of residential borrowers are underwater (i.e. owe more than their home is worth), and an additional 33% of borrowers have equity cushions of 10% or less, according to CoreLogic. In addition, foreclosures hit a new high in 3Q 2010, increasing by 4% quarter-over-quarter, and foreclosure sales for September, including pre-foreclosure sales and REOs, accounted for 31% of all sales, according to RealtyTrac. But despite progress being made in clearing out foreclosures, we believe that "shadow" inventory (homes delinquent, plus foreclosures, plus REO), which some estimate would bring total inventory to almost two years worth of supply, will continue to represent a significant overhang on the housing market. That said, we believe the level of shadow inventory may peak in 2011 as banks work through foreclosures.

In Sacramento, the housing challenges are even more exacerbated than at the national level. The region, which witnessed one of the largest housing booms, also experienced one of the largest busts. The US Census Bureau reported Sacramento-area's housing vacancy rate reaching 7.4 percent between January 2005 and 2009, and that statistic has likely only increased since then. Sacramento also ranked in the top 10 cities for foreclosures during November 2010, according to RealtyTrac. Just as troubling is that California cities have had the longest delay in home foreclosures, averaging 367 days after the first late payment, according to LPS Applied Analytics – suggesting the backlog of potential foreclosures and shadow inventory is more severe in Sacramento than in the rest of the country. Accordingly, while home prices may hit their bottom in 2011 on a national average, Sacramento may likely still see pricing pressure into 2012.

This host of troubling data means the regional housing market will remain distressed well into 2011. This will be a significant headwind for the region's economic and employment recovery.

Sector-by-sector outlook for Sacramento labor market

Overall, we do not expect the region to add jobs on a seasonally-adjusted basis until 2H 2011 at the earliest. However we see some bright spots, such as the education and healthcare sectors and manufacturing sector, which are expected to show meaningful growth in 2011 (Figure 11).

Figure 11 – Sector-by-sector 2011 growth outlook for Sacramento labor market

Key Sectors	% of Local Economy	Expected Avg % Change y/y	Comments
Government	29.5%	-1% to flat	Budget woes at every level should lead to a general contraction. Lower property value reassessments may lead to less property tax revenue.
Ed & Healthcare	12.3%	flat to +1%	Fundamentals and long-term outlook very positive. Uncertainty around healthcare legislation may temper some growth.
Business Services	11.9%	-1% to -2%	Corporate spending and investments in equipment and software should gradually recover. Administrative and support services still likely to see weak demand.
Retail	10.9%	-1% to flat	Consumer spending is expected to improve in 2011, but underlying labor needs should be flattish. Ongoing shift to online sales will be long-term headwind.
Leisure	9.6%	-1% to -2%	Industry gaining some pricing power in the new year, but modest decline still likely.
Financials	6.0%	-3% to -5%	Tepid loan demand, relatively tight lending standards, and margin pressure will keep financial services firms from meaningful hiring in 2011.
Construction	4.4%	-5% to -7%	Residential housing shadow inventory will continue to steal away from new construction. Corporate real estate overhang is slowly improving, but excess capacity still prevalent. Infrastructure spending from Federal government beginning to fade.
Manufacturing	4.1%	+1% to +2%	Durable good orders show strengthening final demand. Food manufacturing also tends to be fairly resilient through downturns. Meaningful gains will be tough in this capital-intensive sector.

Source: EDD, Authors' estimates

Sources: Sacramento Metropolitan Statistical Area monthly employment data published by the Employment Development Department of the State of California; BLS, Federal Reserve, LAO, Barclays Capital, Bank of America Merrill Lynch, JP Morgan, and Goldman Sachs. As of our publishing date, the most recent monthly unemployment rate reading for Sacramento was for November 2010. 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

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

Key Points

- **Foreclosures, Foreclosures, And More Foreclosures**
The housing market will continue to struggle in 2011, marking what will be the sixth consecutive year in a residential downturn. Foreclosure activity will continue to dominate the environment, as borrowers at all income strata are having difficulty paying their mortgages.

- **Commercial Rental Markets Stabilize In 2010**
Leasing activity picked up across all property types in the commercial market as there became a growing sense that we are nearing the floor in rental rates, providing tenants the confidence necessary to commit to leases. Occupancy stabilized in 2010, albeit at low levels, after falling precipitously in 2009.

- **Retail Leasing Activity Is Perking Up**
Driven by a shift in consumer preferences towards frugality, grocers and discount retailers were the most active during the year. "Mom & Pop" retailers are reemerging, taking advantage of space with existing tenant improvements that meet their needs (low startup costs). For the first time in a few years we saw new retailers announce plans to enter the region with multiple sites.

- **The Office Market Suffers From The Largest Vacancy Rate Of All Property Types**
Although leasing activity was up in the office sector, it was mostly "negative" activity, with a large number of renewals or relocations focused around downsizing or aggressive economic incentives rather than business growth. Average vacancy remains in excess of 20%.

- **Positive Outlook For The Industrial Sector**
After two years in negative territory, we expect a modest return of positive net absorption in the industrial sector and a slight drop in vacancy in 2011.

- **Investment Activity Is On The Rise**
Purchase transaction volumes improved in 2010 with investors heavily focused on core-quality assets or value-add properties being offered at low price per pound metrics. Apartments have become a favored asset class due to its lower risk characteristics, advantageous financing options, healthy fundamentals, and favorable demographic story.

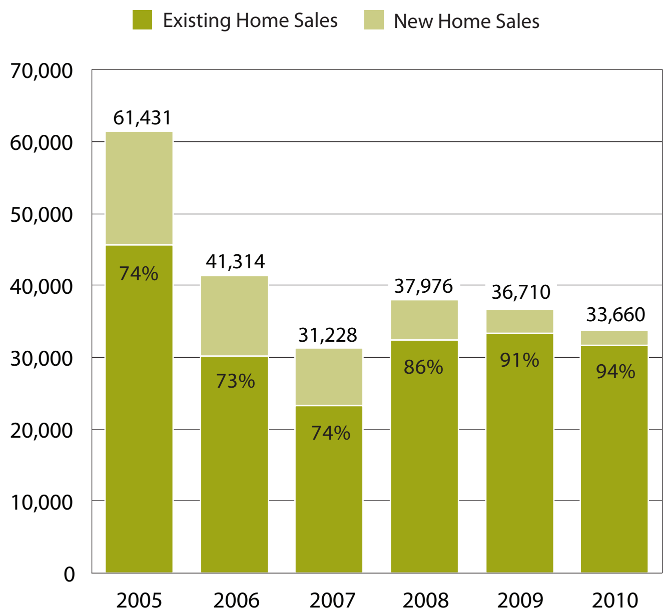
- **Opportunities Abound In The Real Estate Market**
Real estate users across all property types are exploiting today's evolving circumstances by upgrading location, quality of building, and/or leasing terms while investors are finding buys at what they perceive to be cyclically low pricing.

Following possibly the worst year on record in 2009, the staggering Sacramento real estate market found some "sea legs" in 2010, with rental fundamentals in many sectors stabilizing and leasing and sales activity returning to modest levels. The commercial market saw moderately more leasing activity, as there became a growing sense that we are nearing the floor in rental rates, providing tenants the confidence to commit to leases. While the general mood in the office sector remains bridled (aside from the residential market, it will be saddled with the longest road to recovery), the prevailing sentiment in the retail and industrial sectors is that the worst is probably behind us. Operating fundamentals in the apartment sector are actually quite good, with occupancy surpassing 94% and some market participants expecting rent growth to return as early as next year. Taken together, it was a welcome change from 2009.

It was housing that drove the overall market into a downward spiral to begin with, and we believe another challenging year in the residential sector will suppress any chance we will see a meaningful recovery this year. That doesn't mean we won't see bright spots or significant opportunities. Tenants and investors alike took advantage of "California on Sale" this past year, positioning themselves nicely for the next up-cycle, many at basis' of 50% or less of peak values. 2011 should be full of similar leasing and purchase opportunities.

Real Estate Trends in the Sacramento Region

Figure 1 – Residential
New Home Sales vs. Existing Home Sales | Sacramento MSA



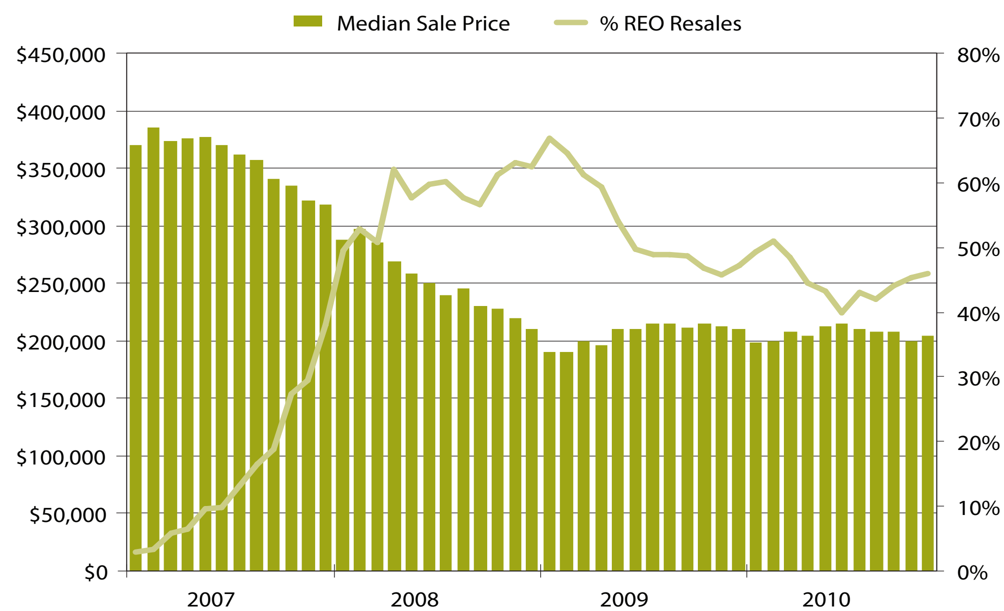
Source: Hanley Wood

Residential

2010 began on a somewhat positive note, as optimistic homebuilders actively acquired inventory of finished and partially finished lots throughout the region, pushing lot prices to levels we hadn't seen in three years. A trough in the median home price was established in early 2009 while tax incentives and other government props (including artificially low interest rates) fueled optimism that would-be homebuyers waiting for the bottom would be propelled off the sidelines.

Projected demand never really materialized and by mid-2010 homebuilders began to drop escrows, even forfeit deposits. D.R. Horton, Meritage, and Lennar all terminated finished lot purchase escrows. KB Homes walked away from a $500,000 deposit on lots in West Roseville. 2010 was perhaps the most challenging year for homebuilders since the downturn began five years ago, as new home sales fell to a new low, failing to reach even 2,000 units.

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

West Roseville accounted for more than 30% of the new homes that sold in the region, while, combined with Rocklin and Lincoln, Placer County overall accounted for nearly half. Other active new home markets included Elk Grove and Woodland.

Historically, the region has sold one new home for every three existing homes sold. Today, we sell one new home for every 10 homes that sell. So, when we talk about the housing market these days, we are really talking about existing home sales. Given the high concentration of REOs as a percentage of sales – 50% of current sales are lender owned sales - we are also largely talking about the sales of foreclosed homes.

The number of existing home sales fell slightly this past year while investors played a larger role, gobbling up REOs and other distressed properties that could be rented at an acceptable yield or fixed up and flipped for a reasonable profit. Conventional homebuyers need certainty, and with rising unemployment, seemingly no end to the pipeline of foreclosures, and a daunting state budget deficit likely to result in layoffs or pay cuts, there is a crisis of confidence that is causing paralysis.

95% of sales were of homes under $500k in 2010, as compared with 79% just three years earlier in 2007, reflecting both an organic drop in values and a change in the profile of homes being purchased. Trade-up buyers, who are typically a significant and vital part of a healthy market, are having difficulty transacting, as they face the challenge of selling their current home and encounter sober lending standards that require down payments, verifiable income, and solid credit. As a result, first-time home buyers and cash investors who tend to transact at the lower price segments have become a larger part of the market.

The housing market will continue to struggle in 2011, marking what will be the sixth consecutive year in a residential downturn. Foreclosure activity will continue to dominate the environment, as borrowers at all income strata are having difficulty paying their mortgages. REO activity may peak this year as banks, with stronger balance sheets and built-up loss allowances, are expected to work through foreclosures at a faster rate. The deep pipeline of foreclosures will remain a significant overhang on the housing market for some time.

Figure 3 – Foreclosure Activity
Sacramento | Arden | Arcade | Roseville | Woodland
California

Date	90+ Day Delinquency Rate	Foreclosure Rate	REO Rate
Oct-10	10.55%	3.50%	1.08%
Sep-10	10.57%	3.42%	1.11%
Aug-10	10.71%	3.39%	1.02%
Jul-10	10.81%	3.25%	0.92%
Jun-10	11.00%	3.21%	0.91%
May-10	11.22%	3.13%	0.89%
Apr-10	11.33%	3.15%	0.93%
Mar-10	11.58%	3.29%	0.91%
Feb-10	11.83%	3.35%	0.87%
Jan-10	11.86%	3.36%	0.89%

90+ Day Delinquency Rate: This measures the percentage of loans that are more than 90 days delinquent including those in foreclosure and REO (real estate owned).

Foreclosure Rate: This measures the percentage of loans in some stage of foreclosure including 90+ delinquencies through properties sold at auction.

REO (Real Estate Owned) Rate: This measures the percentage of loans not sold at auction which are then returned to the lender.

Foreclosure data for CoreLogic is reported based on the actual number of active mortgage loans rather than the total number of households in a given area, which provides more accurate results by removing paid-in-full mortgages from the equation.

Source: First American CoreLogic

Retail

Perhaps the sector that experienced the biggest change from the prior year was retail. Coming off a year full of high profile bankruptcies, a vacancy rate that nearly doubled and contract rents that fell 30% - 50%, we saw retail fundamentals stabilize in 2010 and a resurgence in leasing activity. Largely absent the previous few years, we saw new tenants begin to enter the region and several national tenants regain interest. Although it remained a challenging year for many, it was one in which the free-fall in rents and occupancy came to an end, and some positive indicators emerged. The prevailing belief is that the worst is behind us and that if building owners and tenants have survived this long they will likely weather the storm.

Occupancy reached a trough early in the year at roughly 85%, ending a five quarter skid, but remained stable the rest of the year, ending with a modest uptick to 85.8%. Average lease rates did fall throughout the year, but at a much slower pace than the previous year, providing some sense of a bottom and giving prospective tenants the confidence necessary to commit to deals. As a result, the region saw a marked increase in tenant activity.

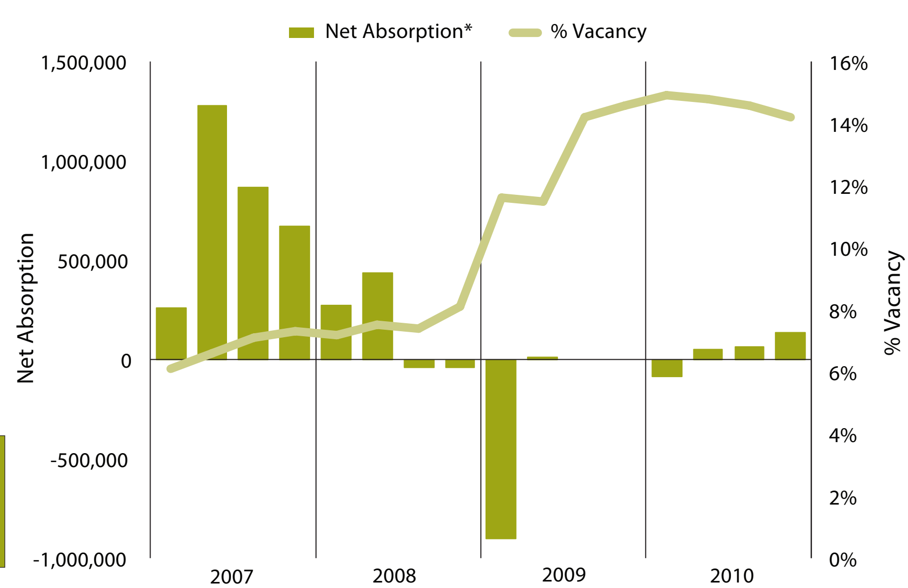
Part of what caused vacancy to spike the past few years were the closures of several "big box" stores, including Gottschalks, Linens 'N Things, Mervyns, Circuit City, Shoe Pavilion and others. These vacant spaces are now beginning to get backfilled. Whereas just a year ago the region had roughly 60 vacant "big box" properties with very little interest (for context consider that Los Angeles, a market with five times the population, had about the same number), about half of those properties now have deals working on them, and many will sign in 2011.

> *"Grocers and discount retailers were the most active during the year as consumer preferences shifted in response to the tough economy..."*

Grocers and discount retailers, such as Foods Co., Fresh and Easy, Grocery Outlet, Dollar Tree, Wise Buys, 99 Cent Store, were the most active during the year, as consumer preferences shifted in response to the tough economy. The same movement towards frugality has also changed the culinary scene, as some higher end restaurants have converted to more affordable formats, and everyday lunch and dinner spots have dominated new openings. Perhaps the most visible examples of this are the conversions of Bistro 33 to Spin Burger and Mason's to Cafeteria 15L at high profile midtown locations. Several national tenants are active again as well, including Michaels, Petco, Chipotle, Verizon, AT&T Wireless and Wal-Mart (with a smaller grocery-only concept). Even Starbucks, with its highly publicized closures in 2009, just signed a new lease in the market. For the first time in a few years, we also saw retailers announce plans to enter the market with multiple sites, including Sprouts Market, Henry's Farmer's Market, Sunflower Market, Pinkberry, Five Guys Burger & Fries, and Smashburger.

Although this past year offered some encouraging signs, it was not without casualties, most notably Hollywood Video, who shut down all 2,415 stores nationally, including 12 in the greater Sacramento region. Blockbuster is also in the process of closing 182 additional stores after declaring bankruptcy in September. Other notable closures in 2010 include the Hard Rock Café in the Downtown Plaza and William Glen, a well-known local gift and specialty store that just recently closed after 47 years. Also, Pottery Barn announced they will close their Arden Mall location in early 2011.

Figure 4 – Retail
Vacancy vs. Net Absorption | Sacramento MSA



Net Absorption: The change in occupied square feet from one period to the next.

Source: CBRE

> *"...the retail sector got hit with a double whammy – deteriorating economic fundamentals and a fundamental shift in consumer spending habits."*

Figure 5 – Retail
Retail Lease Rates in 2010 | Sacramento MSA

Big Boxes	$1.00 PSF, NNN	$0.40 –
Shops – A Centers	$2.25 PSF, NNN	$1.75 –
Shops – B Centers	$1.50 PSF, NNN	$1.00 –
Shops – C Centers	$1.00 PSF, NNN	$0.75 –

Source: CBRE

While this sector is beginning to gain momentum, it is important to recall that the retail sector got hit with a double whammy – deteriorating economic fundamentals and a fundamental shift in consumer spending habits. While consumers have given themselves permission to spend again – witness the recent growth in holiday sales – continued job losses, an increase in property foreclosures, and a depressed housing market will prevent any real recovery in 2011 and could undermine some of the progress made this past year.

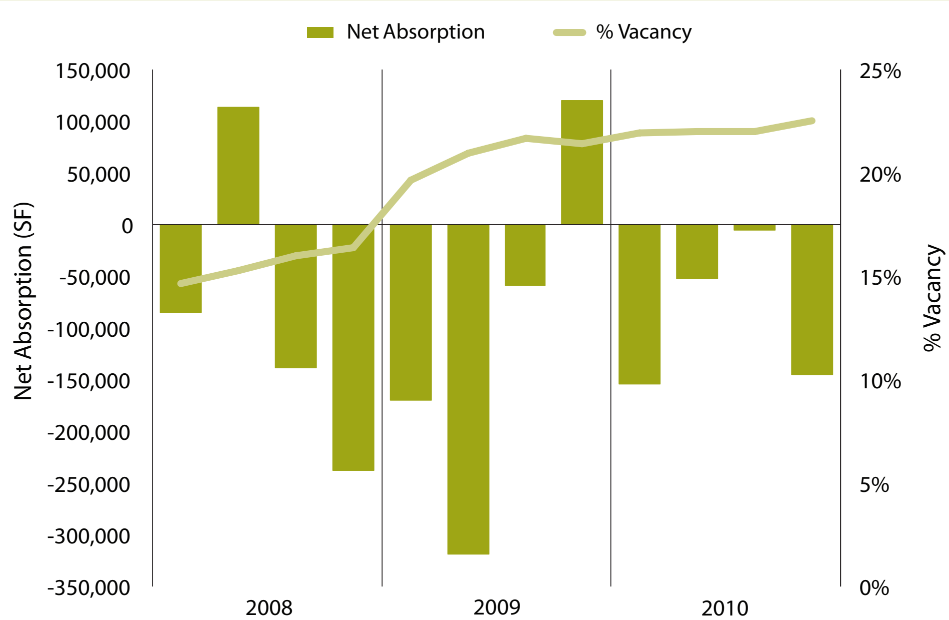
Office

The office market continued to struggle in 2010. We did see more activity, but it was primarily "negative" activity, consisting mostly of renewals or relocations focused around downsizing or aggressive economic incentives rather than business growth. We saw many businesses contract or fail, highlighted by the dissolution of one of Sacramento's oldest, largest, and most respected law firms. Just one year into a highly publicized 15-year lease on Capitol Mall, McDonough Holland & Allen PC shut down.

Vacancy hovered in the low 20%'s during the year, while the availability rate, which includes available sublease space, hit the mid 20%'s. These numbers do not offer a complete picture of the slack in the market, however, as we have no way to count what we believe to be significant underutilized or mothballed space, both commonly referred to as shadow space.

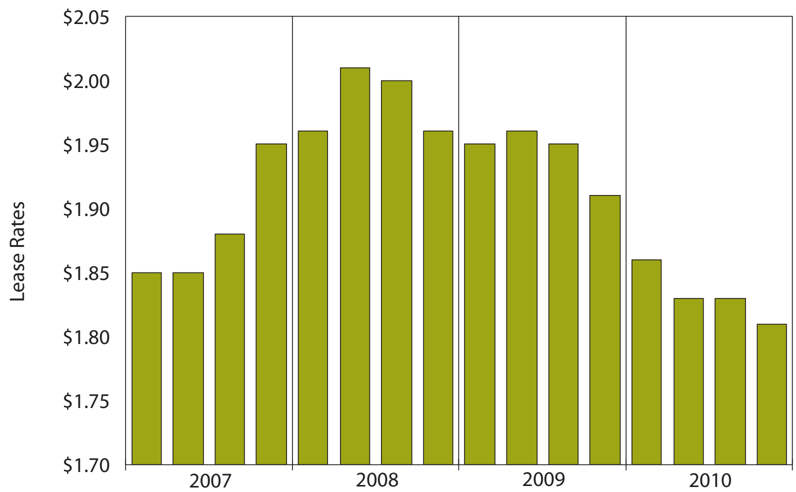
Perhaps the best indicator of market health is net absorption – the change in occupied space during the period – which was negative 350,000 square feet for the year. This decline represented the third year in a row this indicator was negative, totaling nearly 1.1 million square feet of lost occupancy over the three-year period. Given the forgoing, lease rates naturally went down, falling on average about 10%.

Figure 6 – Office
Vacancy Rate vs. Net Absorption | Sacramento MSA



Source: CBRE

Figure 7 – Office
Asking Lease Rates | Sacramento MSA



Source: CBRE

Public sector tenants, particularly state government-related tenants, continue to be the major driver of leasing activity, accounting for half of the top 10 lease transactions in 2010. The Army Corps of Engineers executed the largest transaction of the year, a 225,000 square-foot renewal. The Department of Fish & Game, Department of Alcohol & Drug Program, California Child Support Services, California Board of Equalization, and ACS, having won the contract to handle IT and business services for California's Medicaid program, all signed significant leases.

The largest private sector lease in 2010 was a renewal by Bank of America for 165,000 square feet along the Highway 50 Corridor. Private sector activity has been tepid, with most lease transactions in the form of renewals. With shrinking employment, many companies looked to downsize their space. This theme will continue in 2011.

We also observed sales activity that has allowed new owners to profitably reset lease rates to lower levels in some areas. One prime example was the sale of Prospect Greens, a 640,000 square foot, six-building project along the Highway 50 corridor for roughly $105 per square foot. This property sold five years ago for $160 per square foot. With this basis, the new owner is offering rates that are approximately $0.10 per square foot lower per month than the average for comparable Class A properties in the submarket. This theme will also continue in 2011.

Figure 8 – Office
Vacancy Q4 2010 | Sacramento MSA

Most Healthy Submarkets		Least Healthy Submarkets	
Midtown	14.2%	Point West	35.0%
Downtown	15.1%	Roseville/Rocklin	32.6%
West Sacramento	16.5%	Campus Commons	29.9%
East Sacramento	16.9%	Elk Grove	28.5%
Carmichael/Fair Oaks	17.8%	South Natomas	28.2%

Source: CBRE

For a longer run perspective on the status of the market, consider that 1) we have about 12 million square feet of vacant space in the region today and 2) during the past decade the region has averaged roughly 600,000 square feet of net absorption. Assuming the pace of absorption stays consistent, it could take 20 years to fill up all of today's vacant space. Alternatively, consider that we built roughly 11 million square feet of office space during the past decade. That means that even if we didn't build anything in the past 10 years, we still would be sitting with 1 million square feet of vacant space today. Now, while in practice it is not that simple – the supply/demand imbalances are surely different between Class A-D building and location segments – it does mean that, no matter how you calculate it, it will take at least several years before we see a healthy market again.

Industrial

Similar to the retail sector, the Industrial sector gained some stability in 2010. While net absorption – the change in occupied space - finished negative for the year, driving vacancy slightly higher, the rate of change slowed dramatically from the prior year. Similarly, contract rents fell, but also at a much slower pace, providing a sense that we are nearing the bottom and giving prospective tenants the confidence necessary to commit to leases. Concessions also stabilized, with an average of one month of free rent being offered per one year of the lease term. As a result, we saw a significant increase in tenant activity.

After a whopping 4% jump in vacancy during 2009 we saw a more modest 1% increase this past year to 13.3%. We also saw roughly 1.2 million square feet of negative net absorption in 2010. This figure is not insignificant for a market totaling 170 million square feet, but it was materially better than the four million square feet we lost the year before. The biggest losers were Rancho Cordova/Highway 50, West Sacramento, and the Power Inn Area, while the McClellan Park, I-80/Roseville Road, and Richards Boulevard submarkets saw significant increases in occupancy during the year.

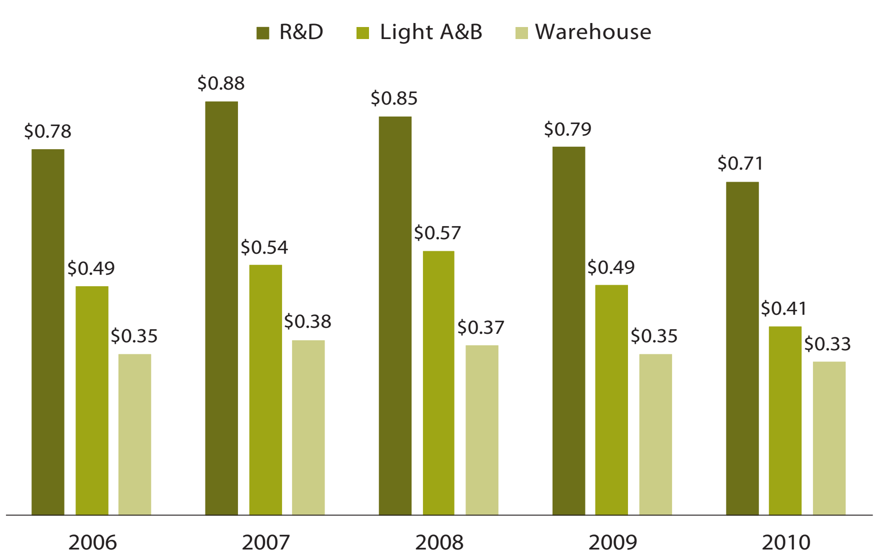
Part of what caused the jump in vacancy over the past few years was fallout from companies associated with building construction – think rental equipment companies, lumber companies, granite companies, and so on. This sector was severely impacted by the downturn and accounted for a large portion of the negative net absorption in 2009. While we did not see a repeat in the level of contraction and closures this past year, firms related to the construction sector continued to be a headwind in our move towards positive indicators. We do not see this changing in 2011.

However, we did see strong tenant activity in the food & beverage industry, including significant transactions by NorCal Beverage, Shamrock Foods, and SunFoods LLC. Medical related firms and solar equipment manufacturers remain active as well.

Figure 10 – Industrial
Winners and Losers by Submarket | Sacramento MSA

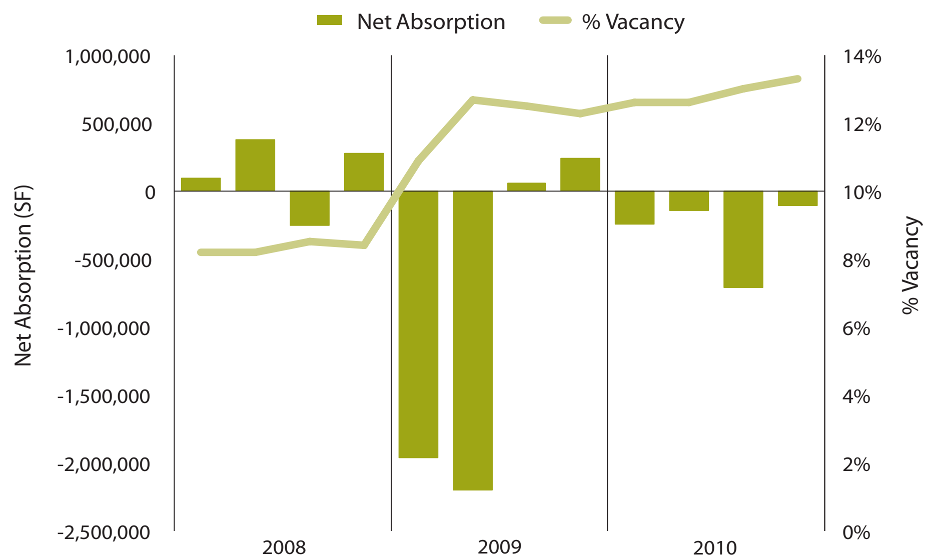
Positive Absorption 2010		Negative Absorption 2010	
McClellan Park	281,601	Rancho Cordova/Highway 50	(375,650)
1-80/Roseville Rd.	179,098	West Sacramento	(328,125)
Richards Blvd.	86,614	Power Inn Area	(321,514)
Folsom/El Dorado Hills	31,612	Northgate/Natomas	(258,264)
Roseville/Rocklin/Lincoln	12,678	Northeast Sacramento	(179,255)
South Sacramento	1,510	Elk Grove/Laguna/Galt	(154,864)

Figure 9 – Industrial
Average Asking Lease Rents | Sacramento MSA



Source: CBRE

Figure 11 – Industrial
Vacancy vs. Net Absorption | Sacramento MSA



Source: CBRE

Most market participants seem cautiously optimistic about the coming year, with the expectation that we will see positive net absorption and a slight drop in vacancy. They note a healthy level of tenant interest in larger buildings which, if a few of these deals get inked, would go a long way towards making that happen. Leasing activity is expected to remain strong among 10,000-40,000 square foot occupiers as well, historically a "bread-and-butter" segment for Sacramento. On balance, we are seeing some encouraging signs for 2011 but remain cautious of the possibility that the prolonged housing crisis may indirectly delay the beginnings of a recovery.

Investments

Transaction volumes began to improve in 2010, marking a transition from an abrupt slowdown in sales for virtually all of 2008 and 2009. Buyers of commercial properties were anxious about tenant quality, income stream stability and net absorption, or the lack thereof. Properties that garnered the most investor attention fell into two broad categories: 1) High quality assets that are typically newer in age, well-located, and boasting creditworthy leases with plenty of term, and 2) unstabilized "value-add" properties offered at low price per pound metrics. Apartments have become the "darling" of income generating investment properties due to its lower risk characteristics, advantageous financing options (Fannie Mae and Freddie Mac), healthy fundamentals, and favorable demographic story.

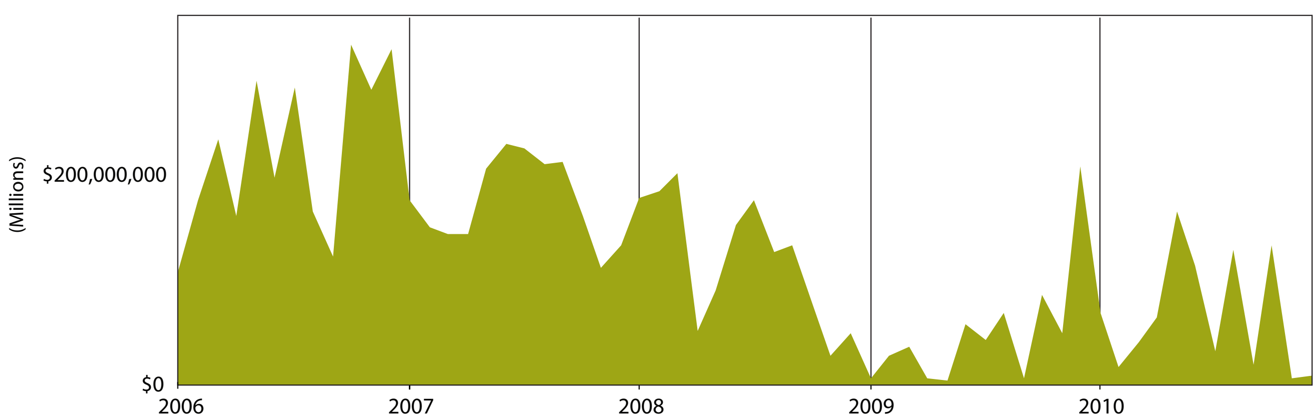
Debt was available to fund acquisitions. Where buyers were willing and able to provide 35%-40% in equity, lenders were pleased to compete for their business and rates were at historic lows. Refinancings were far fewer in number; unless a borrower were willing to remargin debt in place with new equity, lenders were generally unwilling to commit capital given the value degradation that has taken place over the last several years. Borrowers who lacked cash for loan paydowns were left to attempt to reach temporary accommodations with their lenders – short term resolutions that left both unsatisfied and anxious about the future.

The wave of foreclosures and subsequent REO offerings did not materialize as many had expected, except in the apartment sector, which saw the bulk of its share of REO offerings occur in 2010. Possibly the most noteworthy real estate event for the region this year was the foreclosure of The Railyards Project - the largest downtown redevelopment project in the U.S. We expect lenders, who have largely delayed their losses through "extend and pretend" practices, to begin in earnest to address problem loans through loan sales, loan modifications, and foreclosures in the near future.

The controversial sale of State of California portfolio, consisting of 11 high-profile office assets (six in Sacramento), was delayed pending the outcome of a suit brought on by three former state building officials who want to block the sale. Valued at more than $2 billion, if the sale does occur this year it would have a meaningful impact on sales statistics in the region and California.

Buyer capital will remain abundant and focused on core assets offering bond-style security with higher-than-bond returns. Similarly, value-added opportunities will draw strong interest from investors with heavy construction and management resources that look to earn significant "sweat equity" for nursing distressed properties back to health. Savvy investors know that bad times don't last forever and, at some point, the market will rebound. When that happens, those holding assets at exceptionally low cost bases' will be handsomely rewarded.

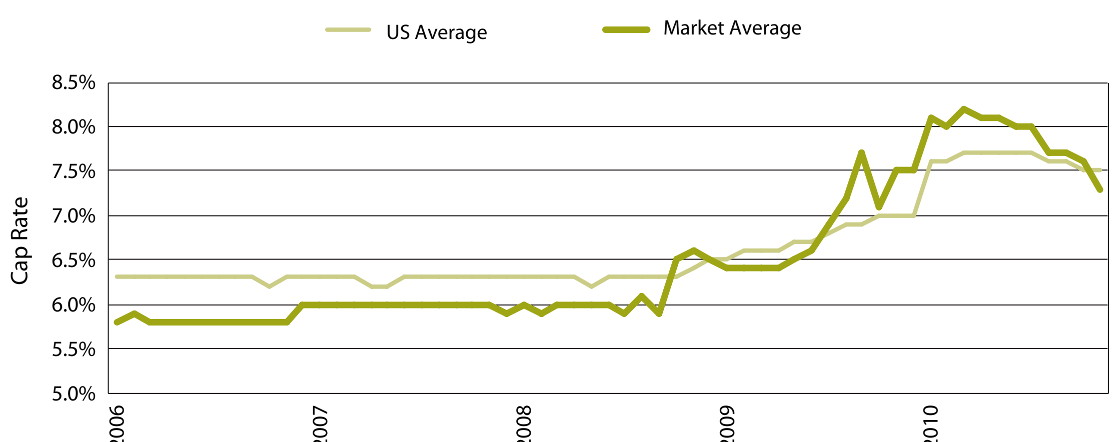
Figure 12 – Investments
Sales in Dollars Per Month through November 2010 (all property types) | Sacramento MSA



Note: Monthly, reported closed

Source: Real Capital Analytics

Figure 13 – Investments
Cap Rate (%) Sacramento Region Through November 2010 (all property types)



Source: Real Capital Analytics

2011 Sacramento Banking Industry Forecast

Local Banks are Healthier, but Growth Challenges Loom

Jonathan E. Lederer, CFA, President, *Lederer Private Wealth Management, LLC*
Anna V. Vygodina, Ph.D., Assistant Professor, *College of Business Administration, Sacramento State*

Key Points

- **The Sacramento region's banks are now in better shape.**
  We believe the worst of the credit cycle has passed and that most local banks are healthier relative to 12 months ago.

- **However, profit growth will remain challenging.**
  With the risk of local bank failures seemingly in the rear-view mirror, bank management teams now face significant obstacles to growing their top and bottom lines.

- **Loan activity is not expected to accelerate due to weaker demand.**
  While banks are now better-positioned to lend, a lack of demand from creditworthy borrowers will make loan growth difficult for banks, thus creating a considerable hurdle for improving net interest margins.

- **Charge-offs of nonperforming assets will continue to impact profitability.**
  Though down from year-end 2009 levels, nonperforming assets for many local banks remain elevated and will almost certainly lead to continued charge-offs throughout 2011.

- **New regulations will result in higher operating expenses, especially for smaller banks.**
  New federal regulations following last year's passage of the Dodd-Frank bill are expected to saddle banks with new compliance costs while also curtailing various fee income sources. Smaller banks are likely to feel a greater impact from these regulations.

- **Merger-and-acquisition (M&A) activity should pick up later in the year.**
  Given the substantial pressures to improve profitability, we anticipate a rise in M&A activity toward the end of the year.

"Entering 2011, we believe that the worst of the credit cycle has passed for the region's banks, most of which begin the year healthier relative to 12 months ago."

Heading into 2010, we were concerned that a number of the Sacramento region's[1] banks would not survive the year given the severity of problem real estate loans. While several local banks were shut down by regulators (and their assets subsequently acquired), most survived, and many were even able to raise new capital after charging off a bevy of bad loans.

Entering 2011, we believe that the worst of the credit cycle has passed for the region's banks, most of which begin the year healthier relative to 12 months ago. With concerns about their financial viability seemingly in the rear-view mirror, banks now face a new set of obstacles – growing their top and bottom lines.

These growth challenges stem from three main issues. First, a lack of significant loan demand from creditworthy borrowers will make it difficult for banks to increase net interest margins[2] despite the accommodative interest-rate environment from a steep, upwardly sloping yield curve.[3] Second, nonperforming assets remain at fairly elevated levels and will almost certainly continue to hamper profitability. Third, and perhaps most importantly, new regulatory legislation is projected to not only add to compliance costs, but also to curtail various fee income sources. Smaller banks will inevitably bear a larger burden from these new regulatory costs.

2011 Sacramento Banking Industry Forecast

Local Banks are Healthier, but Growth Challenges Loom

Considering the challenges to improve profitability within a regional economy still licking its wounds from the Great Recession, we expect that many local banks will begin to seriously evaluate strategic alternatives as the year wears on. We would therefore not be surprised to see merger-and-acquisition (M&A) activity start to pick up toward the latter half of 2011.

Most Banks in Better Shape

In the midst of a very difficult period with problem real estate loans during late 2009 and early 2010, many local banks were actually able to improve their capital positions by issuing new equity. Table 1 shows the regionally based banks that raised new equity since late last year. Thanks to these equity issuances, the banks had more capacity to write off bad loans and still end up with improved capital levels.

Table 1
Recent Equity Offerings by Local Banks

Bank	Offering Date	Offering Size ($s in millions)
American River Bank	December 2009	$23.8
Five Star Bank	December 2009	8.0
Redding Bank of Commerce	March 2010	28.8
North Valley Bank	April 2010	37.5
Gold Country Bank	May 2010	10.0
Sierra Vista Bank	July 2010	3.4
River City Bank	September 2010	20.0

Table 2 (top of page 29) illustrates how most of the Sacramento Region Banks[4] are in a better financial position relative to one year ago. Capital ratios have improved, especially for the larger banks. And, unlike last year, allowances for loan losses now exceed the level of nonperforming loans (on average). These trends reflect similar patterns occurring nationwide.

For these reasons, we are far less concerned about local bank failures during 2011. In fact, we believe that one of last year's most significant impediments to economic growth in the region – banks' inability and unwillingness to lend money due to capital constraints – has been removed.

That said, we are not yet convinced that loan growth will accelerate throughout Sacramento this year because of the area's dour economic conditions resulting from a still-weakened real estate sector, high unemployment, and state/local government budget crises.

Growth Challenges

Though we are encouraged that banks head into 2011 better-positioned versus one year ago, we remain convinced that most will face several significant growth obstacles during the next 12 months. First and foremost, tepid loan demand from creditworthy borrowers is expected to persist for some time. Meanwhile, a real estate market that has yet to generate a meaningful recovery will almost certainly lead to continued problem-loan pressures. And now, bank management teams have regulatory issues to address.

Tepid Loan Demand

Though most of the region's banks now appear more willing and able to make new loans, bank officers report that demand from creditworthy borrowers remains weak. As we noted in the Sacramento Business Review (SBR) July 2010 Mid-Year Update, a higher percentage of banks reported weaker loan demand from businesses, consumers, and commercial real estate borrowers. Regrettably for the banking sector, the most-recent Federal Reserve Senior Loan Officer Survey loan demand figures do not show considerable improvement relative to six months ago (see Table 3 on page 29). We anticipate that this trend will continue throughout the Sacramento region and that loan demand will not increase materially until mid-year at the earliest.

With prices for most residential and commercial real estate properties still well below their peaks, and with highly indebted consumers still "deleveraging" in the face of high unemployment and virtually non-existent wage growth, the number of creditworthy borrowers within the region has dwindled. Such trends are fairly common following deep, protracted recessions caused by banking crises.

Table 2
The Health of the Sacramento Region Banks: 2009 vs. 2010

Bank	Total Assets[1] ($s in MMs)	Tangible Common Equity Ratio[2] 9/30/09	Tangible Common Equity Ratio[2] 9/30/10	Total Loans[3] ($s in MMs)	Allowance for Loan Losses / NPLs[4] 9/30/09	Allowance for Loan Losses / NPLs[4] 9/30/10
El Dorado Savings Bank	$1,687	9.1%	9.3%	$433	2.69x	5.44x
River City Bank	1,002	9.0%	10.3%	527	0.58x	12.08x
Redding Bank of Commerce	916	7.5%	9.9%	649	0.65x	0.59x
North Valley Bank	891	5.8%	8.9%	536	0.36x	0.51x
First Northern Bank	727	8.5%	8.4%	468	1.38x	0.97x
American River Bank	581	8.6%	12.1%	353	0.42x	0.30x
Five Star Bank	403	9.7%	10.6%	318	0.67x	1.78x
Bank of Sacramento	373	7.6%	7.3%	247	0.60x	2.32x
Merchants Bank of Sacramento	173	10.0%	10.0%	57	N/A[5]	N/A[5]
Community 1st Bank	154	9.8%	8.8%	73	0.62x	0.26x
Community Business Bank	144	11.0%	9.8%	121	0.81x	0.54x
River Valley Community Bank	124	15.4%	13.4%	43	1.19x	N/A[5]
Folsom Lake Bank	115	13.8%	10.6%	74	N/A[5]	0.66x
Gold Country Bank	114	9.4%	12.1%	67	0.44x	0.20x
Sierra Vista Bank	100	8.8%	9.2%	72	0.59x	0.89x
Sutter Community Bank	57	10.8%	12.0%	51	1.44x	4.87x

	9/30/09	9/30/10		9/30/09	9/30/10
Weighted Average[6]:	8.6%	9.7%	Weighted Average[7]:	0.87x	2.82x
Average:	9.7%	10.2%	Average:	0.89x	2.24x
Median	9.3%	9.9%	Median	0.63x	0.77x

1) Total Assets as of 9/30/10
2) The Tangible Common Equity Ratio (TCE Ratio) is calculated by taking Total Equity Capital, net of Preferred Stock and Intangible Assets, as a percentage of Tangible Assets.
3) Total Loans as of 9/30/10
4) The figures show Allowance for Loan Losses as a proportion of Nonperforming Loans (NPLs).
5) Bank reported no Nonperforming Loans on this date.
6) Calculates the weighted average TCE Ratio based upon Total Assets.
7) Calculates the weighted average Allowance for Loan Losses / Nonperforming Loans based upon Total Loans.

Data Source: FDIC

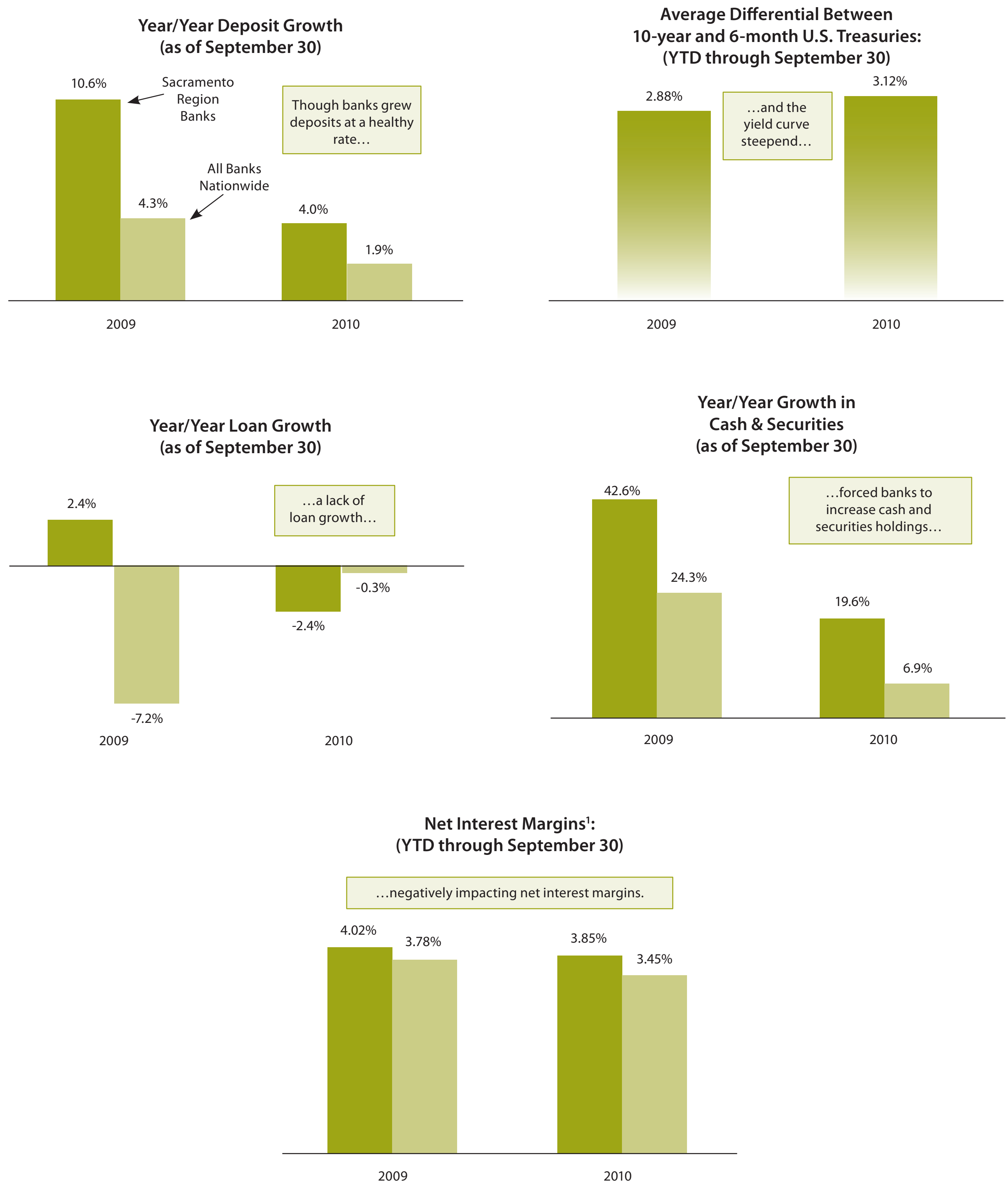
Table 3
Federal Reserve Senior Loan Officer Survey Data

Net % of Banks Reporting Stronger Demand for[1]:	2005[2]	4Q09	2Q10	4Q10
Commercial & Industrial Loans[3]	31%	-34%	-8%	-14%
Commercial Real Estate Loans	18%	-43%	-7%	2%
Consumer Loans	-14%	-25%	-17%	-6%

1) Figures show the percentage of banks reporting stronger loan demand minus the percentage reporting weaker demand.
2) 2005 data represent full-year averages.
3) Commercial & Industrial Loan demand figures are the averages from small-, mid-, and large-sized businesses.

Data Source: Federal Reserve Senior Loan Officer Surveys

Figure 1 – Tepid Loan Growth's Impact on Net Interest Margins
Sacramento Region Banks (in Aggregate) and All Banks Nationwide



1) The Net Interest Margins for the Sacramento Region Banks represent the weighted average of all 16 local banks (by Total Assets) for each period.

Data Sources: FDIC and the U.S. Treasury Department

According to the McKinsey Global Institute, a lengthy deleveraging period nearly always follows a financial crisis. The typical post-crisis deleveraging period starts roughly two years after the crisis and lasts 6-7 years.[5] Renowned economists/authors Vincent and Carmen Reinhart listed similar empirical evidence in their August 2010 report titled "After the Fall." Given these historical precedents, we expect loan demand to remain subdued for some time.

Pressures to Improve Net Interest Margins

Weaker loan demand makes it harder for banks to improve their net interest margins. Though today's yield curve is highly accommodative to the banking sector (because longer-term interest rates, at which banks typically lend, are much higher than shorter-term rates, at which banks pay depositors), banks still encounter difficulty increasing their margins when they have fewer opportunities to lend money at higher rates to creditworthy borrowers. As Figure 1 (page 30) illustrates, the steep yield curve manufactured by the Federal Reserve has not translated into better net interest margins for the Sacramento Region Banks (on average) due to nonexistent loan growth. Similar trends have been observed nationwide.

> *"Low loan demand has created a quandary for bank management teams seeking to drive margins higher."*

Should Banks Roll the Dice?

Low loan demand has created a quandary for bank management teams seeking to drive margins higher. Without a bevy of new loans on which to earn more favorable interest rates, banks are left with securities purchases as the next best alternative for earning a spread on depositor funds. With today's steep yield curve, banks currently can earn much higher rates on longer-term bonds compared to those on shorter-term bonds. However, it is important to remember that longer-term interest rates are still well below where they have been throughout most of the past several decades.
Banks must therefore decide whether now is the time to target higher spreads by buying longer-dated fixed-income vehicles. Should interest rates rise considerably from today's levels during the next few years, banks that have loaded up on long-term bonds without adequately hedging their interest-rate exposure would face several problems. First, their bond holdings would suffer losses if sold prior to maturity, as bond prices and interest rates move inversely. Second, their margins would almost certainly get squeezed because banks typically have to pay depositors more in a rising rate environment. For these reasons, banks must weigh the longer-term loss potential against trying to earn higher current spreads when deciding whether to "go out on the curve" with their securities purchases.

Alternatively, banks can play it more conservatively by holding a greater proportion of cash and short-term securities. While these holdings could conceivably be re-deployed in the form of new loans and/or new securities purchases at higher interest rates within the next few years, they will certainly not earn much of a spread in the current interest-rate environment. Thus, bank management teams must decide whether to 1) roll the dice and shoot for higher spreads today by purchasing longer-term securities or 2) insure themselves against potential spread problems down the road by holding shorter-term bonds (even though doing so translates into lower net interest margins over the near term).

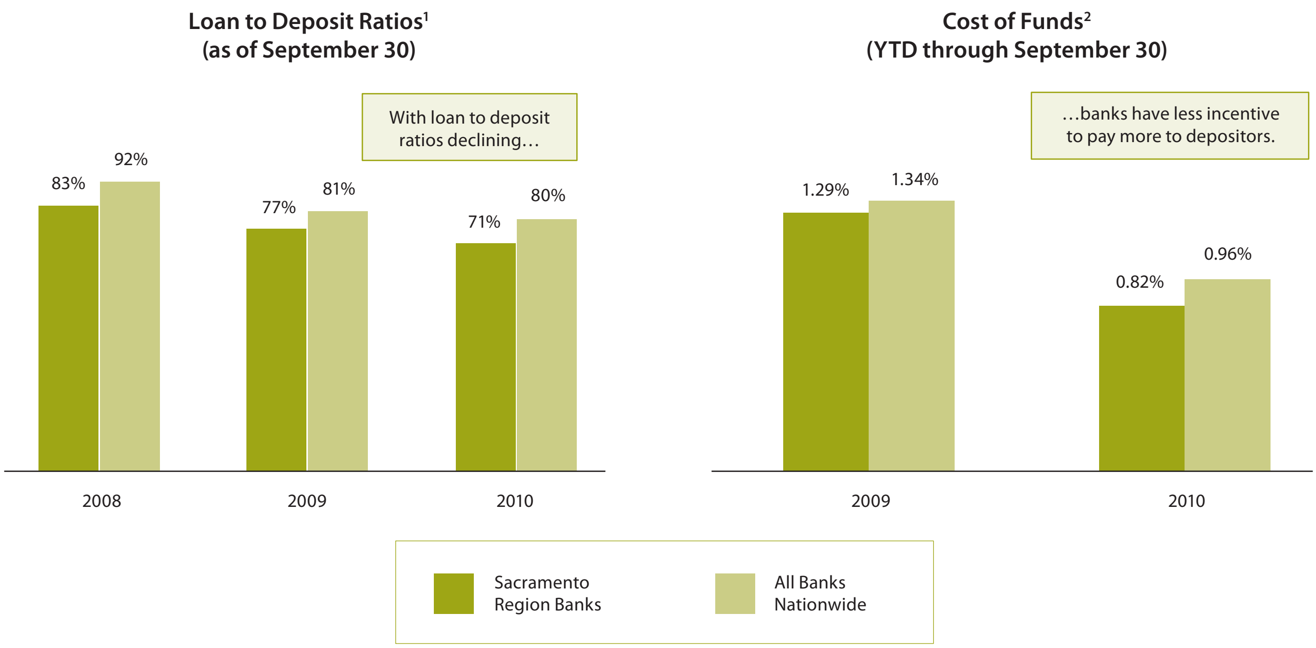
Depositors May Also Suffer

Depositors are also likely to be impacted should loan growth remain subdued this year. If banks continue to have a difficult time deploying capital toward new loans and/or higher interest-rate securities, one cannot easily envision them trying to sweeten the pot to lure more deposits. Figure 2 (top of page 32) shows how falling loan-to-deposit ratios have influenced a drop in rates paid to depositors. Unless loan growth picks up, we believe banks will focus more on "core" deposits (which traditionally pay less in interest to depositors) when trying to expand their deposit base.

Problem Loans Still an Issue

Considering the sizable exposure that the Sacramento Region Banks have to the commercial real estate (CRE) sector, we expressed serious concern about rising CRE default risk in the January 2010 SBR. During the past 12 months, most local banks have addressed their problem CRE loans. However, the specter of CRE loan defaults has

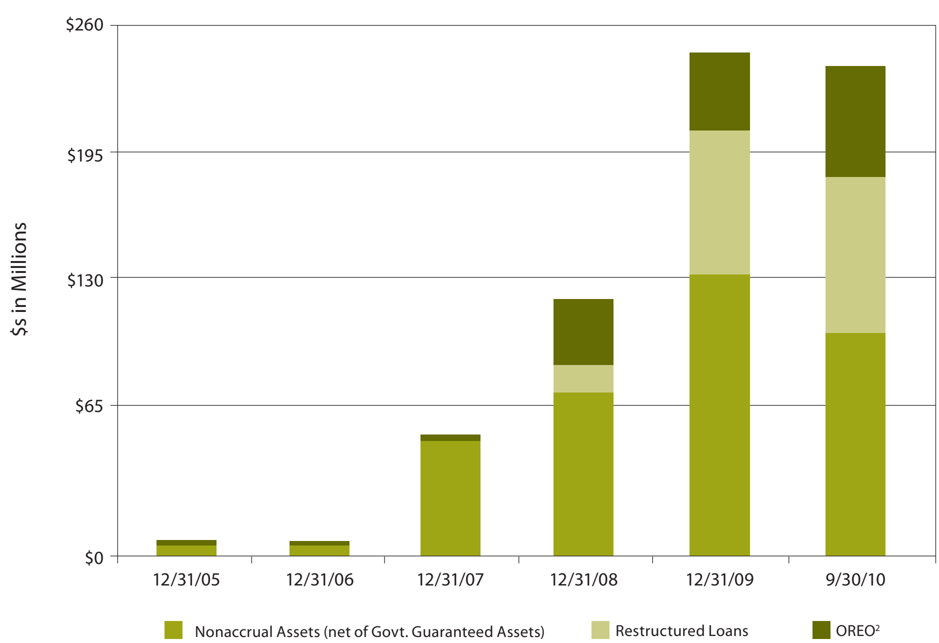
Figure 2 – Declining Loan-to-Deposit Ratios Mean Lower Deposit Rates



1) Loan to Deposit Ratios for the Sacramento Region Banks calculated using the aggregate sums of Total Loans and Total Deposits for all 16 local banks for each period.
2) Cost of Funds figures for the Sacramento Region Banks represent the arithmetic average of all 16 local banks for each period.

Data Source: FDIC

Figure 3 – Nonperforming Assets and Restructured Loans
Sacramento Region Banks[1] (in Aggregate) December 31, 2005 | September 30, 2010



1) The figures reported in Figure 3 exclude data from Folsom Lake Bank, River Valley Community Bank, Sierra Vista Bank, and Sutter Community Bank (since these banks started their operations after 2005).
2) OREO stands for Other Real Estate Owned (frequently as a result of foreclosures).

Data Source: FDIC

> *"…we expect ongoing problem-loan pressures throughout 2011, especially since real estate prices remain well below their peaks."*

not disappeared. Figure 3 illustrates how nonperforming loans, restructured loans, and OREO (other real estate owned, which frequently consists of foreclosed properties) for the local banks have fallen in aggregate since the end of 2009. But, as one can observe, the overall figures remain high by historical standards.

With the SBR real estate team forecasting continued weakness in residential and CRE prices during 2011, we expect ongoing problem-loan pressures throughout 2011, especially since real estate prices remain well below their peaks. Although we think the worst has passed for charge-offs, more large quantities of bad loans (relative to historical levels) will almost certainly be written off this year.

New Regulations to Increase Costs

In July 2010, Congress passed the 2,300 page Dodd-Frank Act (Dodd-Frank). According to the American Bankers Association, the bill is estimated to generate more than 5,000 pages of new regulations for traditional banks.[6] One area that is certain to increase compliance costs for all banks is adherence to rules and regulations set forth by the new Consumer Financial Protection Bureau.
And though formal details have yet to be fleshed out, new capital standards post-Dodd-Frank (and from the yet-to-be-finalized Basel III Accords) are expected to be more onerous, requiring banks to maintain higher capital levels.

The increased compliance costs, coupled with the higher regulatory capital requirements, will no doubt pressure returns on equity for all banks. However, smaller banks will more-than-likely bear a disproportionate share of the impact given their lack of scale. As one can observe from Table 4, which shows Efficiency Ratios[7] for the Sacramento Region Banks (segmented by asset size) relative to the five largest U.S. banks, smaller banks already pay more in operating expenses as a percentage of income because they are less able to spread their fixed costs across their (smaller) asset bases. The new regulations will therefore have a greater effect on their bottom lines.

Table 4 – Efficiency Ratios* by Asset Size

SACRAMENTO REGION BANKS WITH ASSETS: Less Than $500 Million	
Bank of Sacramento	75.8%
Community 1st Bank	95.9%
Community Business Bank	77.6%
Five Star Bank	48.3%
Folsom Lake Bank	88.1%
Gold Country Bank	118.5%
Merchants Bank of Sacramento	58.3%
River Valley Community Bank	58.1%
Sierra Vista Bank	91.0%
Sutter Community Bank	92.3%
Average:	**80.4%**
SACRAMENTO REGION BANKS WITH ASSETS: Between $500 Million and $1 Billion	
American River Bank	63.6%
First Northern Bank	83.0%
North Valley Bank	87.9%
Redding Bank of Commerce	46.4%
Average:	**70.2%**
SACRAMENTO REGION BANKS WITH ASSETS: Greater Than $1 Billion	
El Dorado Savings Bank	58.2%
River City Bank	66.3%
Average:	**62.2%**
LARGEST BANKS NATIONWIDE	
Bank of America	55.6%
Citibank	56.4%
JP Morgan Chase	66.8%
U.S. Bank	48.7%
Wells Fargo	52.5%
Average:	**56.0%**

* The Efficiency Ratio is a commonly used metric to measure a bank's operating expenses. It is calculated by taking noninterest expenses as a percentage of a bank's interest and noninterest income (combined). The Efficiency Ratios shown in Table 4 are for 2010 year-to-date through September 30.

Data Source: FDIC

M&A is the Probable Outcome

Given the aforementioned obstacles to greater profitability facing the local banking sector, we expect that bank management teams / boards of directors will start to seriously evaluate strategic alternatives as the year wears on. We would therefore not be surprised to observe a pickup in M&A activity toward the end of 2011.

We believe the most-likely M&A candidates are the smaller banks, considering the new regulatory burdens they will be forced to absorb. These smaller players may end up either merging with other banks of similar size or getting purchased by a mid-sized regional player. We do not anticipate that any of the larger "money center" institutions will look to acquire small or mid-sized banks in the region anytime soon.

The size of a bank's core deposit base will no doubt be a primary factor that acquirers will consider when evaluating strategic targets. Other important aspects of an attractive partner include branch footprint, credit quality, and, of course, valuation. Table 5 lists some metrics that potential acquirers / merger partners are likely to analyze when assessing the Sacramento Region Banks.

> *"We believe the most-likely M&A candidates are the smaller banks, considering the new regulatory burdens they will be forced to absorb."*

Publicly Traded Local Bank Stock Ratings

Within the six-county Sacramento region, 11 locally based banks are publicly traded on the OTC Bulletin Board. In Table 6, we present our ratings for each. Readers should note that all of these stocks have very low liquidity, so investors should definitely consider market impact[8] when trading shares.

Table 5 – Operational and Financial Metrics[1] for Sacramento Region Banks

Sacramento Region Bank	Total Assets ($s in MMs)	# of Offices in Region[2]	Total Deposits ($s in MMs)	% of Non-Int Bearing Deposits	Cost of Funds[3]	NPAs & OREO[4] as a % of Total Assets	TCE Ratio[5]	Efficiency Ratio[6]	Price / Tangible Book Value[7]
El Dorado Savings Bank	1,687	20	1,466	2.5%	0.70%	0.13%	9.3%	58.2%	NPT[8]
River City Bank	1,002	14	824	21.4%	0.64%	1.62%	10.3%	66.3%	0.6x
Redding Bank of Commerce	916	1	648	15.2%	1.09%	3.05%	9.9%	46.4%	NPT[8]
North Valley Bank	891	2	769	20.0%	0.95%	5.44%	8.9%	87.9%	0.8x
First Northern Bank	727	14	632	28.0%	0.57%	2.13%	8.4%	83.0%	0.7x
American River Bank	581	5	476	28.3%	0.67%	4.82%	12.1%	63.6%	0.9x
Five Star Bank	403	3	344	9.7%	1.38%	2.61%	10.6%	48.3%	NPT[8]
Bank of Sacramento	373	4	308	28.9%	0.56%	1.88%	7.3%	75.8%	0.9x
Merchants Bank of Sacramento	173	4	154	19.1%	0.67%	0.00%	10.0%	58.3%	NPT[8]
Community 1st Bank	154	3	136	16.0%	0.99%	4.64%	8.8%	95.9%	0.5x
Community Business Bank	144	3	121	20.5%	0.88%	3.73%	9.8%	77.6%	0.8x
River Valley Community Bank	124	1	106	20.3%	0.59%	0.54%	13.4%	58.1%	1.4x
Folsom Lake Bank	115	2	100	20.0%	1.21%	2.20%	10.6%	88.1%	0.8x
Gold Country Bank	114	6	98	32.9%	0.18%	2.04%	12.1%	118.5%	NPT[8]
Sierra Vista Bank	100	2	86	28.0%	1.04%	3.22%	9.2%	91.0%	0.6x
Sutter Community Bank	57	1	50	14.1%	1.02%	4.10%	12.0%	92.3%	0.5x

1) Data as of September 30, 2010 (unless otherwise noted)
2) Number of offices within El Dorado, Placer, Sacramento, Sutter, Yolo, and Yuba counties as of June 30, 2010
3) Cost of Funds figures are for 2010 year-to-date through September 30 and are annualized.
4) NPAs = Nonperforming Assets; OREO = Other Real Estate Owned
5) The Tangible Common Equity Ratio (TCE Ratio) is calculated by taking Total Equity Capital, net of Preferred Stock and Intangible Assets, as a percentage of Tangible Assets.
6) The Efficiency Ratio is determined by taking noninterest expenses as a percentage of interest and noninterest income (combined). The Efficiency Ratios shown are for 2010 year-to-date through September 30.
7) Price to Tangible Book Value (TBV) ratios use market prices as of 12/31/10 and TBVs as of 9/30/10. TBV is determined by subtracting Preferred Stock and Intangible Assets from Total Equity Capital.
8) NPT = Not Publicly Traded

Data Source: FDIC

Table 6 – Stock Ratings for Publicly Traded Sacramento Region Banks | December 31, 2010

Bank	Ticker	Price	Market Cap ($s in millions)	2010 Total Return	Price / Tangible Book Value[1]	TCE Ratio[2]	NPAs & OREO[3] as a % of Total Assets	Return on Equity[4]	Bankrate.com Rating[5]
OUTPERFORM									
River City Bank	RCBC	$48.00	$60.1	21.0%	0.6x	10.3%	1.62%	4.69%	4
Sutter Community Bank	SUTB	$3.25	3.1	8.3%	0.5x	12.0%	4.10%	0.40%	3
MARKET PERFORM									
American River Bank	AMRB	$6.00	$59.2	-23.7%	0.9x	12.1%	4.82%	0.88%	3
First Northern Bank of Dixon	FNRN	$4.50	40.8	-7.2%	0.7x	8.4%	2.13%	3.04%	3
Bank of Sacramento	GSCB	$9.30	23.9	55.0%	0.9x	7.3%	1.88%	1.27%	3
River Valley Community Bank	RVVY	$13.75	23.6	19.6%	1.4x	13.4%	0.54%	6.32%	4
UNDERPERFORM									
North Valley Bancorp	NOVBD	$8.95	$61.2	-14.4%	0.8x	8.9%	5.44%	-8.77%	2
Community Business Bank	CBBC	$5.50	11.5	96.4%	0.8x	9.8%	3.73%	3.07%	2
Folsom Lake Bank	FOLB	$6.40	10.2	-14.7%	0.8x	10.6%	2.20%	1.82%	2
Community 1st Bank	CFBN	$3.79	6.7	-41.7%	0.5x	8.8%	4.64%	-0.77%	1
Sierra Vista Bank	SVBA	$2.50	5.0	-65.7%	0.6x	9.2%	3.22%	-37.23%	2

Peer Group Average: 0.8x

1) Price to Tangible Book Value (TBV) ratios use market prices as of 12/31/10 and TBVs as of 9/30/10. TBV is determined by subtracting Preferred Stock and Intangible Assets from Total Equity Capital.
2) The Tangible Common Equity Ratio (TCE Ratio) is calculated by taking Total Equity Capital, net of Preferred Stock and Intangible Assets, as a percentage of Tangible Assets.
3) NPAs = Nonperforming Assets; OREO = Other Real Estate Owned
4) Return on Equity figures are for the first 9 months of 2010 and are annualized.
5) Bankrate.com ratings are as follows: 5 = Superior, 4 = Sound, 3 = Performing, 2 = Below Peer Group, 1 = Lowest Rated

Data Source: FDIC

The authors do not own shares of any of the banks listed in Table 6. The Sacramento Business Review cannot guarantee any of the forecasts made in this paper.

2010 Performance Review

The SBR Bank Index[1] trailed the benchmark KBW Regional Bank Index by a wide margin in 2010. We think this underperformance may be attributed to the economic lag that the region has experienced relative to the rest of the U.S. economy. As our colleagues have indicated, the recession in Sacramento likely ended one year after the national recession. Perhaps the KBW Regional Bank Index's 20% return last year marks a good sign of things to come for Sacramento's bank stocks in 2011.

Those basing their trading strategies on the SBR bank stock ratings last year would have fared substantially better than the SBR Bank Index as a whole. As the table below shows, cap-weighted portfolios of local bank stocks rated Outperform and Market Perform generated solid relative returns.

Among our better Outperform calls last year were River Valley Community Bank (up 43% in 1H 2010) and Bank of Sacramento (up 43% in 2H 2010). Our clairvoyant Underperform ratings included Sierra Vista Bank (down 45% in 1H 2010), Community 1st Bank (down 42% in 1H 2010), and American River Bank (down 24% in 2010).

We would be remiss if we neglected to mention some of our erroneous calls, which included Community Business Bank (up 38% in 2H 2010 as a member of the Underperform list) and Sutter Community Bank (down 35% in 2H 2010 while on the Outperform list).

	1H 2010 Return	2H 2010 Return	2010 Return
KBW Regional Bank Index	4.3%	15.5%	20.4%
SBR Bank Index	0.8%	-7.0%	-6.3%
SBR Outperform List*	7.0%	6.9%	14.4%
SBR Market Perform List*	18.3%	-9.6%	7.0%
SBR Underperform List*	-15.9%	-14.5%	-28.1%

** Returns for the SBR Outperform, Market Perform, and Underperform Lists are calculated on a cap-weighted basis.*

1) The SBR Bank Index tracks the performance of all publicly traded Sacramento Region Banks on a capitalization-weighted basis (i.e., a weighted average of returns by market capitalization).

Endnotes

1) *We have defined the Sacramento region to include El Dorado, Placer, Sacramento, Sutter, Yolo, and Yuba counties.*
2) *The yield curve measures the relationship between interest rates and maturities for U.S. Treasuries. An upward-sloping yield curve means that long-term interest rates are greater than short-term rates.*
3) *Net interest margin is the difference between a bank's interest income and interest expense, measured as a percentage of its average earning assets.*
4) *The Sacramento Region Banks include American River Bank, Bank of Sacramento, Community 1st Bank, Community Business Bank, El Dorado Savings Bank, First Northern Bank, Five Star Bank, Folsom Lake Bank, Gold Country Bank, Merchants Bank of Sacramento, North Valley Bank, Redding Bank of Commerce, River City Bank, River Valley Community Bank, Sierra Vista Bank, and Sutter Community Bank.*
5) *McKinsey Global Institute, Debt and Deleveraging: The Global Credit Bubble and Its Economic Consequences (January 2010), p. 9.*
6) *American Bankers Association, The Dodd-Frank Bill Has Enormous Consequences for Community Banks (July 2010), p. 1.*
7) *The Efficiency Ratio is determined by taking noninterest expenses as a percentage of interest and noninterest income (combined).*
8) *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*

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

Key Points

- **The global economy is in recovery but will be more pronounced in the emerging economies and the United States versus Europe.**
  Potential risks to the recovery include: 1) an inability to contain the European sovereign debt crisis, 2) emerging economies tighten monetary policy too aggressively, 3) global interest rates rise too rapidly, and 4) additional shocks to the domestic housing market.

- **The backdrop for equities should be generally positive in the first half of the year.**
  We expect a midyear correction as the Fed completes its quantitative easing program and equity bulls take a breather. If an oversold condition develops from the correction, an end of year rally would be likely. We favor a pro-growth, cyclical positioning in the first half of 2011 and a defensive posture in the latter half.

- **The tide has finally turned for bonds and the nearly three-decade bull market is over.**
  Yields will rise across the curve and the Fed's efforts will contribute to above average volatility in the credit markets this year. We favor corporate, high yield and municipal debt relative to Treasuries.

> *"The markets and economy remain in recovery mode, but nobody ever said it would be easy."*

Many are likely scratching their heads as they reconcile last year's 13% return of the S&P 500 in the face of a tepid economic recovery, persistently high unemployment and a moribund housing market. Indeed, the bond markets reversed course in November, ending with a spectacular thud even as the Fed stepped in to buy Treasury debt. Despite predictions of the crumbling of the EU, saber-rattling from North Korea and concerns about the demise of municipal finance, investors ended the year with a definite "risk-on" attitude.

The markets and economy remain in recovery mode, but nobody ever said it would be easy. We feel the equity rally that closed out last year should continue and government bond prices may drift lower into the spring. Equities may likely have a good-sized midyear pullback before recovering as 2011 ends.

Technology is one of our favored sectors for the coming year which bodes well for the share prices of many of the larger publicly-traded employers in the region.

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

Equity Market Review and Analysis

Equity investors entered 2010 with a single question on their minds: "How long can this market rally continue?" That question was answered in May as the combination of a massive oil spill and renewed fears of an EU sovereign debt contagion served as a stark reminder that while stronger, the global economy was still vulnerable to shocks.

A 15% correction ensued as markets struggled through the resolution of the Deepwater Horizon disaster, healthcare and financial system overhauls and slowing economic signals. US consumer confidence declined by nearly 20% and the term "double dip" reached an all-time high on Google searches over the summer months. However, just as things seemed at their bleakest point, a change in the winds came from the unlikeliest of places: Washington, DC.

For context, the developed world remains in the early-to-mid stages of a multiyear global deleveraging process, and despite the efforts of policymakers, businesses and consumers have opted for liquidity over leverage and have remained reluctant to increase their debt loads. As a result, the government sector has been filling the gap through continued deficit spending and balance sheet expansion, acting as the primary source of demand.

A November to Remember?

By mid-September, equity markets started to reflect the growing chances for a significant change in Congress and by extension, changes to the business climate. The Federal Reserve had overtly signaled their commitment to maintain low interest rates via open market purchases of Treasury securities and economic indicators started to tick higher. Momentum continued to build throughout October as the markets fully recovered their midyear selloff then pressed higher as the tax outlook became more favorable and the return to gridlock in the nation's capital ensured a slower-moving legislative body.

> *"... the economic recovery has been weaker than previous cycles, providing the Fed plenty of incentive to keep its short-term rate target of near zero."*

Equity Markets Outlook

Investors enter the New Year with the same question they had in 2010. Indeed, how long can *this* rally continue? Considering that economic momentum is increasing, short term interest rates remain low, the yield curve remains steep and credit conditions remain favorable (Figure 1), we believe that 2011 equity markets will look quite similar to the previous year's with a rally, correction, rally pattern. We highlight the reasons why below:

- **Interest Rates Still Favorable** – the economic recovery has been weaker than previous cycles, providing the Fed plenty of incentive to keep its short-term rate target of near zero. Longer term rates have risen mainly due to the combination of increased supply of Treasuries, decreased purchasing by foreign governments and an outlook for a stronger economy, which has incited fears of inflation. On the latter, inflation looks to be well contained, due to the still-sizeable output gap in the economy. At some point, longer term interest rates may climb to the point of choking off rising equity prices, but that risk remains low at this point.

- **Global Economic Growth** – though the US economy is recovering slower than anticipated, it is positive nonetheless. Further analysis reveals that growth remains uneven, occurring mainly in business spending rather than personal consumption sectors. We believe strong demand will continue to come from the emerging economies as the secular trends of urbanization and industrial development remain intact. Growth may be uneven between the economic regions, but regardless of the disparity, we see these forces being supportive of equities as the year unfolds.

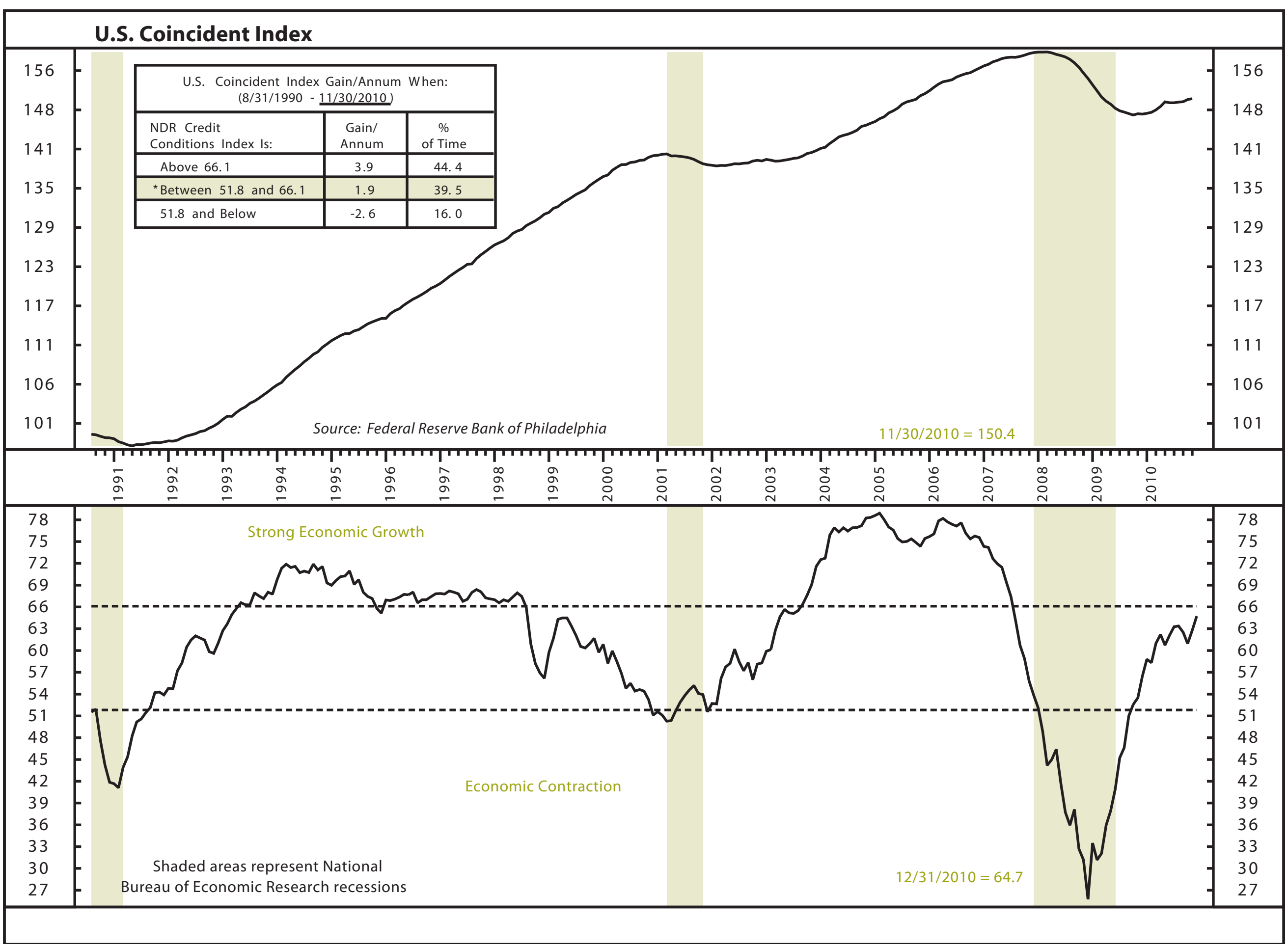
- **Liquidity and Sentiment** – the massive exodus from equities has started to reverse course. The preceding two years showed record inflows into bond funds as investors piled into the perceived safety of fixed income. This unsustainable trend has reached a turning point. Attitudes towards equities have shifted to the positive and technical strength is asserting itself across most global equity markets which should continue to run before any significant correction materializes.

- **Earnings Growth** – 2010 was a year of positive earnings surprises with over 70% of S&P 500 companies registering earnings 5% above analysts' forecasts through the third quarter. Strengthening global demand combined with persistently low labor costs will continue to provide a constructive backdrop for earnings and profit growth, although at a slowing pace.

- **Valuations Still Reasonable** – the 13% rise in equity prices has left the S&P 500 much closer to fair value, but nowhere near overvalued territory. Even temperate earnings growth combined with economic improvement will allow for multiple expansion across numerous valuation measures and should provide room for the equity markets to grind higher. From a relative perspective, equities

Figure 1. Credit Conditions and Economy Improving

Monthly Data 8/31/1990 – 12/31/2010 (Log Scale)



Source: Ned Davis Research Group | www.ndr.com

still remain extremely attractive when compared to bonds (Figure 2).

By mid-year, we shall see if the Fed's activities have accomplished their intended goals of sparking further economic growth. If this becomes the case, we would likely see some continuation of an equity market advance. However, given the continuing challenges in the housing and labor markets and the presumed conclusion of the Federal Reserve's Treasury purchases, we see the makings for a reasonably stiff midyear correction.

United States

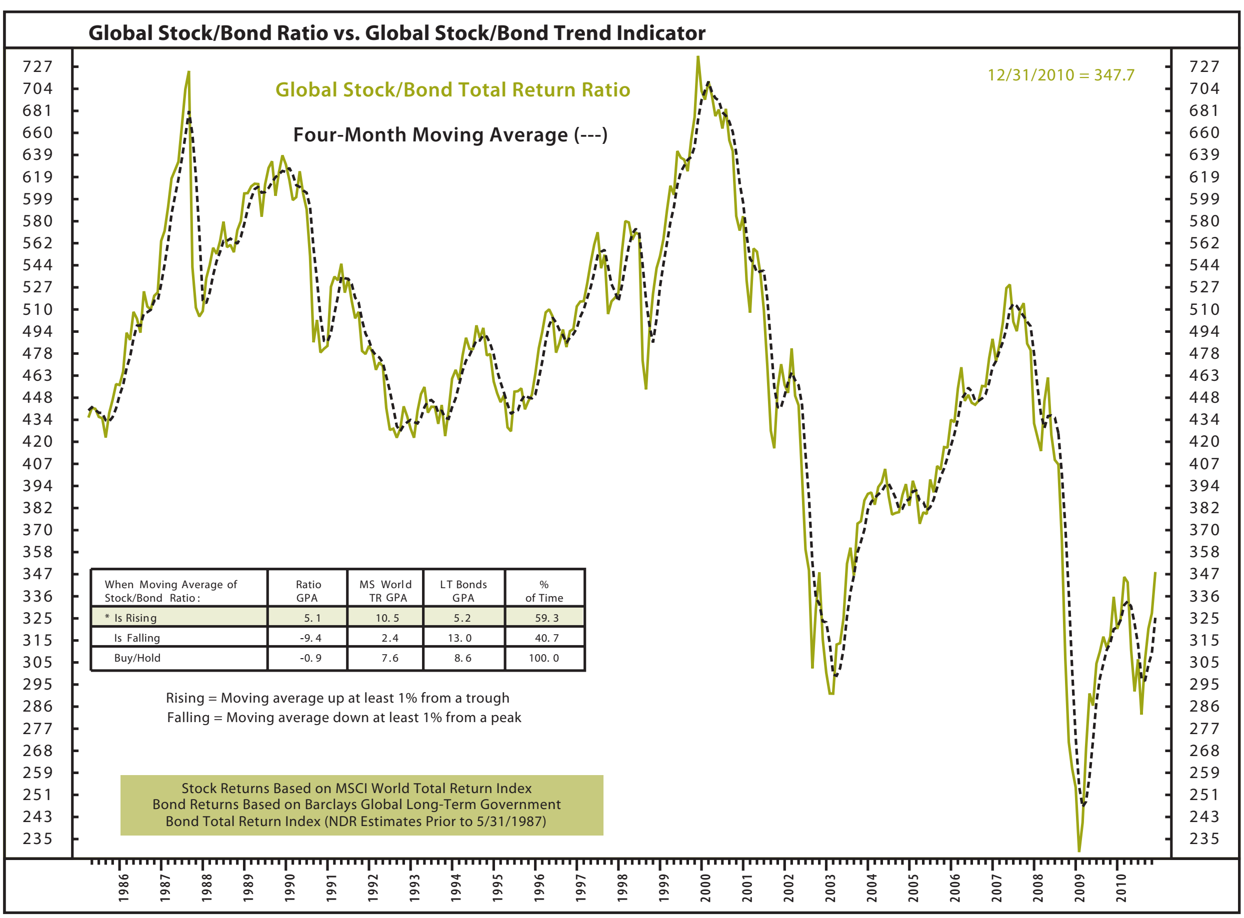
The US economy is further along in its recovery process and as a result its equity markets should continue their relative outperformance compared to Europe. US small caps easily outpaced large caps in the latter portion of 2010 and we feel this trend should remain intact during the first part of 2011. We expect a reversal midyear as long term interest rates and energy prices creep higher, creating financing headwinds for the small cap space and equities in general. At this point, sector positioning favors growth-oriented, cyclical sectors such as Energy, Industrials, Materials and Technology. Even though recent retail sales activity has been positive, we remain skeptical of consumer-sensitive sectors based on weak consumer balance sheets and sub-par employment levels.

Developed International

Europe remains mired in its sovereign debt problems, and its usual pattern of outperformance in a global economic recovery may not apply in this case. The situation is likely to seesaw back and forth until the EU and ECB take their lumps and come to grips with the solvency issue within Greece and Ireland. A better outcome remains for Spain and Italy whose issues are liquidity-driven and may be easier to resolve. The EU should be able to work through these challenges over

Figure 2: Déjà Vu? Stocks Still Attractive Relative to Bonds

Monthly Data 4/30/1985 –12/31/2010 (Log Scale)



Source: Ned Davis Research Group | www.ndr.com

time, but it may create a weight on their equity markets. We do not see the demise of the Euro as a legitimate risk, based on the amount of energy invested into its creation and the logistical nightmare it would cause to unwind the common currency. Japan will remain unloved from an investment perspective as it continues to deal with potential deflation over the year. As a result, we favor Germany, the UK and commodity-driven economies such as Canada and Australia.

Emerging Markets

We continue to generally favor the Emerging Markets based on their fundamentals of strong growth and relatively unencumbered financial systems. That being said, two causes for concern are inflation and frothy investor enthusiasm as we enter the New Year. As the trends of urbanization and infrastructure continue, the economies in this segment face rising costs of food, wage spikes and significant asset price inflation. These conditions alone do not create an overly dire situation, but as monetary policy tightens, it raises the chances for some dramatic selloffs during the year. Latin America looks slightly overvalued at this point, but attractive values can currently be found in Taiwan, Korea, China, Russia and Turkey.

Credit Markets Review and Analysis

2010 has likely marked the turning point of the 29-year bull market in bonds. After the 10-year Treasury yield briefly touched 4% in the first part of the year, the stock market's correction sent investors scrambling back to the familiar comfort of the government bond market. Near the end of summer, the very same shocks that drove the equity markets lower propelled the Treasury market to levels not seen since the financial crisis of 2008.

Discussions and fears of the Fed raising short term interest rates dissipated by midyear as uninspiring reports from the housing and labor markets provided plenty of evidence to keep monetary policy loose. To some degree, Chairman Bernanke and his team had already removed liquidity in the system by ceasing open market security purchases and letting many emergency credit facilities expire. Stability had been restored to the major banks in the financial system as TARP repayments were received ahead of expectations however economic growth targets were still not being achieved.

QE2 Sets Sail

The Fed, recognizing the economy was entering into a soft patch, started to float the idea of its next move in late August: the purchase of Treasury securities across the yield curve in an effort to spark growth and stave off deflationary pressures. The strategy, known as quantitative easing, would allow the Fed to temporarily support Treasury prices by purchasing $600 billion of US government debt and further expanding its balance sheet. The limited instances where central banks have historically used this radical technique showed that if successful, it was a very powerful force to shock the economy back towards stable growth. However, amid the controversy remained the legitimate question, "What happens if this *doesn't* work?"

> *"Bond investors rushed to move ahead of the Fed's actions and 10-year bond yields fell under 2.5%, the lowest level since November of 2008."*

Bond investors rushed to move ahead of the Fed's actions and 10-year bond yields fell under 2.5%, the lowest level since November of 2008. However, rates sharply reversed as a number of factors quickly hit the bond market with a sizeable year-end selloff (Figure 3):

- **Stronger Economic Data** – fundamentals in the domestic economy started to improve in the latter part of the year with stronger manufacturing and order growth and stabilization in the housing and labor markets.
- **Mid-Term Elections** – the Republican wins in November signaled that the Obama Administration would need to adjust its policies in the coming years, which we feel may result in faster economic growth and reduced tax revenues which would increase the supply of Treasuries.

- **QE2 Questions** – if growth were stronger than originally anticipated, the Fed may not need to complete all $600 billion of its announced purchases, thereby reducing a major support of prices in the market.

- **Foreign Governments** – ceased purchasing US debt for over 5 weeks, down from an average of $7.5 billion per week over the previous year.

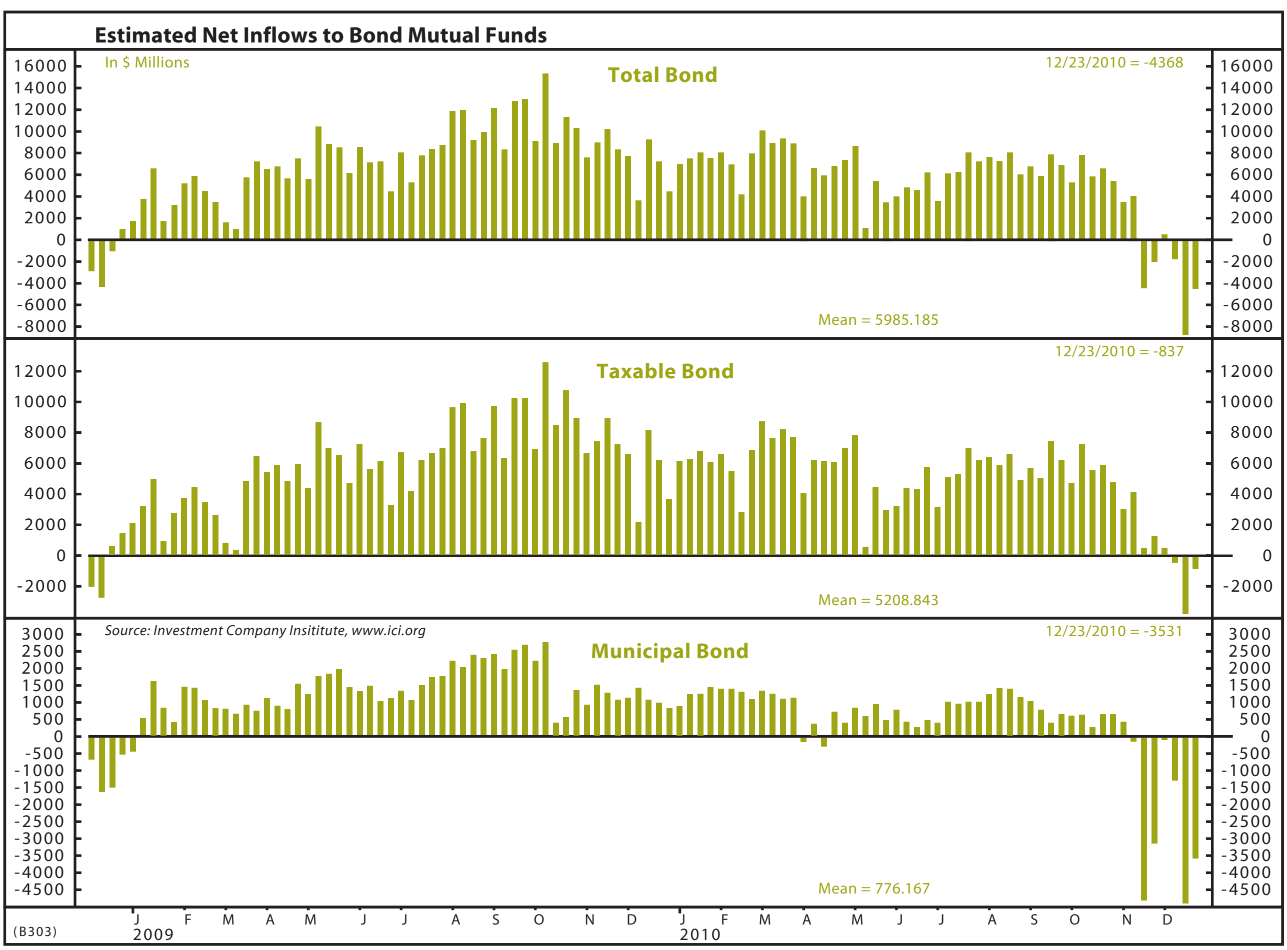
- **Bond Dealer Inventories** – were running at their highest levels since May of 2009, likely the result of anticipated purchases by the Fed. As the pricing environment shifted, excess supply was purged out to the markets, further accentuating the price swings in bonds.

Credit Markets Outlook

We feel 2011 will exhibit above average volatility as bond yields continue to move higher across the curve. The 10-year Treasury will likely reach 4% later in the year but should remain below 4.5%. It is doubtful that yields will see the lows of 2010, but any flare ups regarding the Eurozone debt crisis will send investors running to the relative safety of the Treasury market. Credit spreads will continue to contract and provide some value to investors in the coming year. Corporate debt remains attractive on a relative basis, particularly high grade debt of larger domestic financial institutions. Municipal debt looks undervalued relative to taxable debt but their prices will be volatile and subject to growing credit and solvency concerns over the year.

Figure 3. Bond Investors Headed for the Exits in Q4

Monthly Data 12/05/2008 – 12/23/2010 (Log Scale)



Source: Ned Davis Research Group | www.ndr.com

Treasuries

It appears the Fed will remain committed to quantitative easing but an increased supply and a weakening global appetite for US debt will counteract their efforts and weigh on prices. Yields, which move inversely to prices, are projected to rise along the entire curve. We expect the yield curve will remain steep as the Fed works to keep short term interest rates low while increasing inflation expectations push longer rates higher. Global instabilities will present tactical opportunities for periodic rallies throughout the year, but we remain wary of Treasury securities from an investment perspective.

Corporate

Within the credit markets, investment grade corporate securities continue to look attractive relative to government and agency debt. Fundamentally, corporate debt is benefitting from improved balanced sheets, stronger earnings and loose monetary policy. While the tailwinds of massive spread compression are not nearly as great as they have been in the past two years, we feel the risk-reward remains favorable. Debt of financial institutions is trading at a larger discount to other corporate bonds, but enactment of the Dodd-Frank bill and Basel III requirements have provided a greater degree of clarity and oversight in this segment. As a result, financial institution debt looks to have greater upside than its counterparts.

Municipal

Municipal bond prices should firm up after 2010's year-end slide. The selloff, triggered by renewed fears of potential default and a general lack of liquidity, allowed for one of the year's better opportunities to purchase high quality municipal bonds. Tax-equivalent yields have returned to very attractive levels within the public debt complex, especially when considering the chances for increasing tax rates post 2012. California debt prices will experience above-average volatility as the state struggles to rectify chronic budget shortfalls and waning investor confidence. November's passage of Proposition 25 may add further challenges to the state's credit rating, but California's fiscal woes remain ones of political willingness, versus actual ability to adequately service their debt. Our view remains somewhat sanguine since we believe the chances of a widespread default in this market segment are remote.

High Yield

The high yield market continues to look attractive amid the global economic recovery. Many below-investment-grade borrowers have refinanced much of their short term debt, and the 12-month default rate for more speculative credit continues to decline at a strong pace. Our outlook for positive earnings, high liquidity and economic growth leads us to favor high yield debt at this point of the market cycle.

Global

We feel 2011 will reveal dramatic differences in the credit markets of the developed and emerging economies. Developed credit markets will be subject to turbulence surrounding sovereign debt challenges, austerity measures and general lack of clarity surrounding exposure levels to affected nations. Conversely, emerging markets are benefitting from improving financial conditions, credit ratings upgrades and higher levels of economic growth. Though the longer-term backdrop is constructive for emerging market bonds, they carry a higher risk of tightening monetary policy and geopolitical shocks and may exhibit higher short-term volatility.

Sources:

BCA Research, Outlook 2011, January 2011

US Department of Treasury, Monthly 105(a) Report on TARP, December 2010

International Monetary Fund, World Economic Outlook, October 2010

International Strategy and Investment, Capital Chronicle, December 2010

Ned Davis Research, Investment Strategy, December 2010

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The Small Business *Economy*

Small and Medium Enterprises (SMEs)

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

Key Points

- **Sacramento MSA remains a service sector economy.**
  The population growth story is not followed by large scale job creation other than in sectors that service the population, such as construction, wholesale/retail trade, healthcare, and business/professional services.

- **SMEs drive the regional economy.**
  SMEs account for one third the total employment, 96% of all employer firms, and most of the net new job creation nationwide. Taxable sales declined in the face of severe job losses as SMEs got hurt the most. Regional economic policies should become more pro-SMEs. Particularly, at the early stages of economic recovery, the role of SMEs is crucial. A more favorable and supportive business environment would be a great catalyst in the region's economic recovery.

- **SMEs got crushed by tight credit and fewer loan approvals during the recent crisis.**
  The number of SBA loans and amount approved dropped precipitously. The positive turnaround in loan activity in 2010 provides optimism regarding the health of SMEs and the broader role they could play in the economic recovery. The financial drought may be finally over. While the recovery appears slow, the early financing indicators appear promising.

- **SMEs are very pessimistic about the economic fallout and future prospects.**
  Our newly constructed Small Business Confidence Index reveals a negative outlook and continued pessimism regarding local support and access to credit. The business environment is perceived to be unfriendly. Small businesses hope for better days ahead for revenue and job growth.

Will SMEs lead the way out of our economic mess?

As the Sacramento region reels under the pressure and problems of high unemployment, real estate market, retail malaise, unstable state and local government budgets, downsizing by large corporate employers, unfriendly business climate, and the inability to attract new businesses or industries to the region – the question is – what next?

The most overlooked and underappreciated segment of economic activity in the region – small and medium sized enterprises – may pave the way out of the recession and provide hope for leading the economic recovery cycle. This important segment co-exists in the shadows of government jobs (that largely define the culture and personality of Sacramento) and large publicly traded firms such as Intel and Hewlett Packard that have been gradually shrinking their operations here.

SMEs play a critical role in driving the US economic engine. They account for almost 65% of new domestic job creation, employ approximately 50% of all private sector workers, produce approximately 50% of US GDP (nonfarm and private), and represent 99% of all employer firms.

SMEs are essential for US economic growth and wealth creation and are the major drivers behind entrepreneurial spirit, innovation, private investment, and risk-taking. All these make the United States one of the best capital markets in the world. At the same time SMEs are much more vulnerable and sensitive to macroeconomic changes, economic downturns, financial market collapses, or asset bubbles. Given their size, they have a much smaller capacity to absorb economic shocks.

The greater Sacramento regional economy is dominated by SMEs. These firms employ fewer than 500 full time employees – and most firms have fewer than 20 employees. The Sacramento Metro Statistical Area (MSA) is limited to four counties in the great Sacramento area: Sacramento, Placer, El Dorado, and Yolo.

The Small Business Economy

The Sacramento MSA population is still growing but remains a service sector economy

Population has increased...

The Sacramento MSA is a large and vibrant economic region – larger than the total economies of half the states in the US and larger than many countries as measured by gross economic output. The population surges and growth have resulted from periods of relatively less expensive real estate making it attractive for people to move to this region. Approximately 2.2 million reside here (Figure 1), and the population has increased by 1% each year for the last 5 years. Of the four counties, the population of Sacramento County accounts for about 66% of the Sacramento MSA.

But taxable sales have declined...

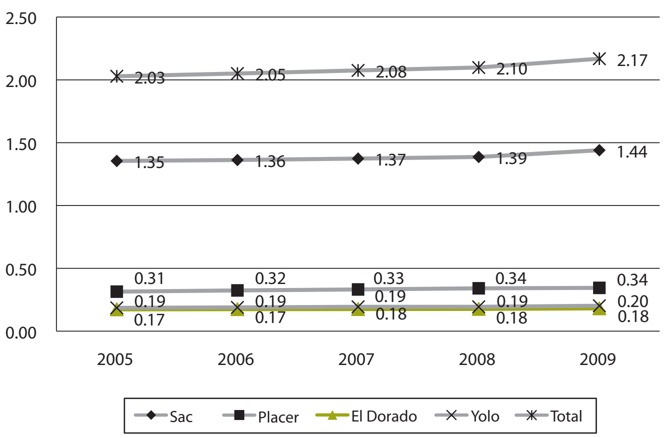
The regional economy and its impact can be measured in many different ways: size of economic output, total employment, total business taxes, total number of establishments, and the dollar value of labor income, among others. We use two parameters: 1) total taxable sales (revenue before tax) and 2) economic mix of major industries in the region. The total taxable sales have decreased by an average of 8% since 2006 (Figure 2) reflecting the negative impact from the recession in a retail based economy. Similar to the population statistic, Sacramento County accounts for two-thirds of our region's economy for total taxable sales.

And the service sector industry dominates...

Table 1 presents the breakdown of major industries in the region including SMEs. Based on the total number of establishments (firms), total employment, and total sales in 2007, seven industries dominate: Construction, Professional/ Scientific/Technology Services, Retail Trade, Healthcare and Social Assistance, Accommodation and Food Services, Wholesale Trade , and Finance and Insurance. We recognize that limited data availability makes it dated, but still provides a good understanding on the economic mix of the region.

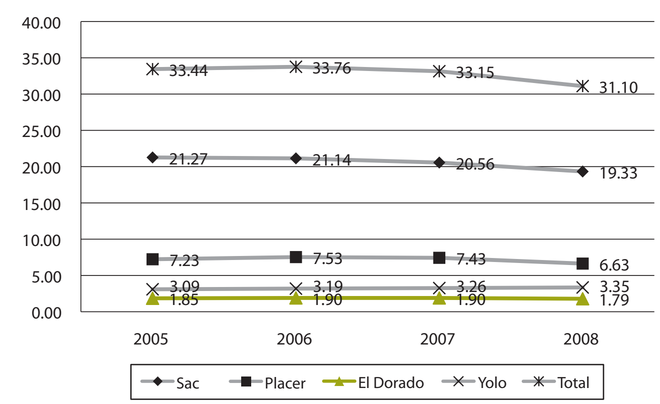
"Approximately 96% of the total employer firms in the region are SMEs and only 4% of the total establishments are large firms."

Figure 1:
Sacramento MSA Population Data (in Millions)



Source: Bureau of Labor Statistics

Figure 2:
Total Taxable Sales in Sacramento MSA (in Billions)



Source: Franchise Tax Board

Table 1: Industry Breakdown of Sacramento MSA – Top 7 Industries by Number of Establishments, Employment, and Sales						
Industry Name	2007 Establishment (in Thousands)		2007 Employment (in Thousands)		2007 Total Sales (in Millions)	
Accommodation and Food Services	3.33	8.37%	74.39	10.39%	3.63	2.14%
Construction	5.80	14.60%	68.13	9.52%	17.64	10.38%
Finance & Insurance	1.92	4.84%	49.71	6.95%	24.27	14.28%
Healthcare and Social Assistance	4.18	10.51%	94.89	13.26%	12.01	7.07%
Professional, Scientific & Technology Services	5.65	14.23%	48.01	6.71%	7.67	4.52%
Retail Trade	4.23	10.64%	101.79	14.22%	25.93	15.26%
Wholesale Trade	1.94	4.88%	32.86	4.59%	37.23	21.91%

Data source: Small Business Administration

Here are a couple of interesting observations. First, 37% of the total sales in this region come from 'Wholesale' and 'Retail' services. The construction and healthcare industries further add significantly to the economic mix making our region largely driven by the service sector. This makes us very vulnerable to economic shocks or downturns that result from changes in population, consumer spending, or service sector investments that tend to be economically sensitive.

SMEs create one third the jobs and half the economic output for the region

Approximately 96% of the total employer firms in the region are SMEs and only 4% of the total establishments are large firms (Table 2). Moreover, 83% of all firms hire fewer than 20 employees. SMEs employ 36% of the total labor force and provide 40% of the employment dollars in labor income (Tables 3, 4). The two pieces of data on employment and payroll are in line with typical SMEs in the US; mirroring the fact that roughly 50% of GDP is produced by SMEs. They present unrecognized potential in creating jobs and contributing to the economic wealth of the region.

The Sacramento MSA is an SME driven economy and the SMEs are a vital part of the region's economic development and growth. This underlines the importance of regional economic policies becoming more pro-SMEs. California is reputed to be the most business unfriendly state in the nation. To the extent policymakers can address the interests of SMEs by promoting a more favorable and supportive business environment, it would allow SMEs to serve as a catalyst in the early stages of the region's economic recovery.

"The Sacramento MSA is an SME driven economy and the SMEs are a vital part of the region's economic development and growth."

Table 2: Total Number of SMEs in Sacramento MSA (in Thousands)				
	Firm Establishment			
Year	Total	< 20 employees	< 500 employees	500+ employees
2005	38.13	31.88 (84%)	36.54 (96%)	1.59 (4%)
2006	38.82	32.32 (83%)	37.17 (96%)	1.65 (4%)
2007	39.18	32.61 (83%)	37.48 (96%)	1.69 (4%)

Data source: Small Business Administration

Table 3: Total Number of Employees at SMEs in Sacramento MSA (in Thousands)					
	Total Number of Employees				
Year	Total	< 20 employees	< 500 employees	500+ employees	Others (Gov., etc.)
2005	964.10	128.20 (13%)	353.35 (26%)	346.39 (36%)	264.36 (27%)
2006	980.60	131.97 (13%)	364.93 (37%)	357.09 (36%)	258.58 (26%)
2007	987.10	134.18 (14%)	357.53 (36%)	357.89 (36%)	271.68 (28%)

Data source: Small Business Administration

Table 4: Total Annual Payroll at SMEs in Sacramento MSA (in Billions)				
	Total Annual Payroll			
Year	Total	< 20 employees	< 500 employees	500+ employees
2005	27.11	4.36 (16%)	12.50 (46%)	14.61 (54%)
2006	28.85	4.60 (16%)	13.19 (46%)	15.65 (54%)
2007	29.42	4.65 (16%)	13.31 (45%)	16.11 (55%)

Data source: Small Business Administration

SMEs get crushed by tight credit but the financial drought may be over

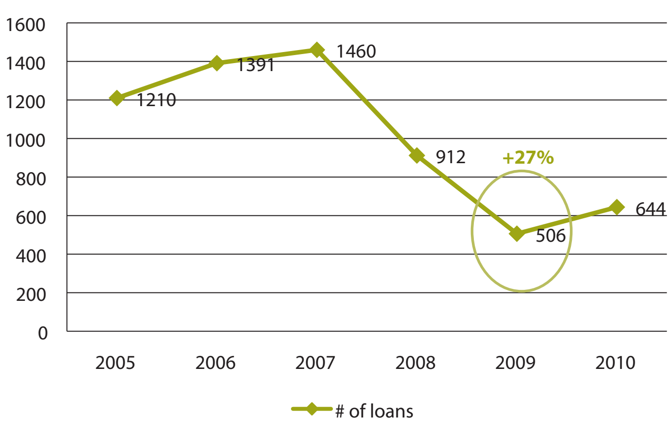
SMEs have various sources for their business financing needs, e.g., conventional bank loans, private debt and equity, etc. The US Small Business Administration (SBA) provides a variety of loan programs for SMEs, such as 7(a), CDC/504, and the Microloan program. The SBA loan programs play a significant role in SME financing and in meeting their cash flow needs. For this reason, we consider the SBA loan activity (7a and CDC/504) as a reasonable proxy for the overall trend in small business financing.

Table 5: Number of Loans Approved and the Dollar Value of Loans Approved in SBA Sacramento District

	2005	2006	2007	2008	2009	2010
Number of Loans	1210	1391	1460	912	506	644
Dollar Value (Millions)	393.98	390.86	407.77	310.15	166.82	192.34

Data source: Small Business Administration

Figure 3: Total Number of Small Business Loans Approved in SBA Sacramento District



Data source: US Small Business Administration

SBA loans declined precipitously…

The SBA reported that the total number of loans (both 7a and 504) and their total dollar value approved in the Sacramento District (20 counties) have decreased for the last two years (FY 2007-2008 & 2008-2009). During the FY 2007-2008, the total number of loans and their total dollar value approved decreased by 38% and 24% respectively. For FY 2008-2009 the total number of loans and their total dollar value approved decreased by 45% and 46% respectively. SMEs literally got crushed by the economic crisis and the resulting drought in financing.

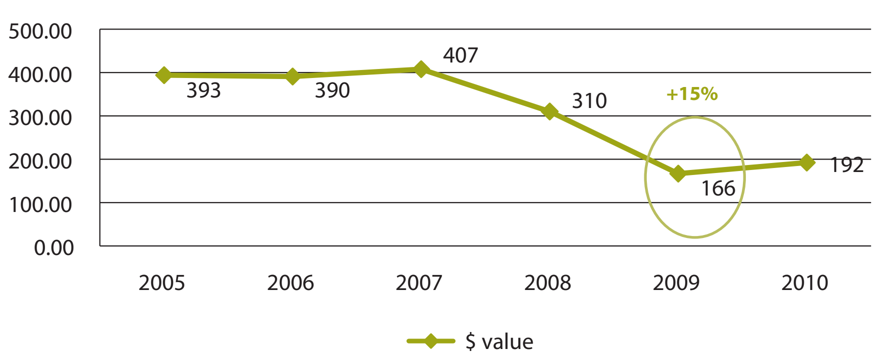
But found a bottom…

However, as of the most recent year (FY 2009-2010), both figures have turned around; the total number of loans and their total value approved increased by 27% and 15% respectively (Table 5). Figures 3 and 4 show the overall trend in loan applications approved and the dollar value of the loans approved. This positive turnaround in financing activity provides hope and optimism regarding the health of SMEs and the broader role they could play in the economic recovery.

Sacramento MSA financing not much different from District…

The financing trend for SMEs in the four-county Sacramento MSA is very similar to that of the SBA Sacramento District; both the total number of loans

Figure 4: Total Dollar Value of Small Business Loans Approved in SBA Sacramento District (in Millions)



Data source: US Small Business Administration and their total dollar value approved have drastically dropped since 2007, but these figures have leveled off and turned around since 2009 (Figures 5, 6). During the FY 2007-2008, the total number of loans and their total dollar value approved in Sacramento MSA decreased by 43% and 20% respectively. During the FY 2008-2009, the total number of loans and their total dollar value approved in Sacramento MSA decreased by 38% and 40% respectively.

However, for the most recent year (FY 2009-2010), the total number of loans approved in Sacramento MSA increased by 30% and the dollar value of loans approved was only nominally negative by 4%. This represents early signs of recovery as the regional economy attempts to resurge, even though they may be lagging somewhat behind that of the District or the State.

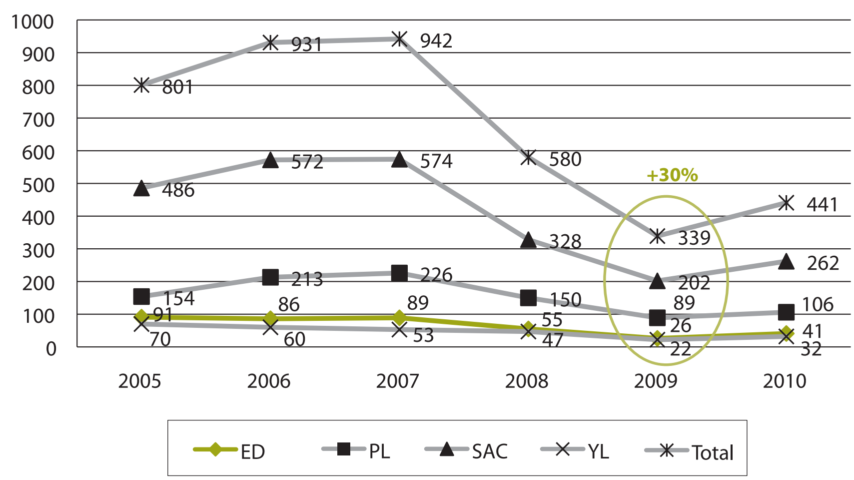
Other financing indicators appear promising…

In addition, two more small business financing indicators are analyzed: 1) the percentage of small business loan applications that were approved, and 2) the delinquency data of small business loans.[1] These two pieces of data reveal more evidence on SME health and their future outlook.

Based on one of the largest CDCs (Certified Development Companies) in the region, REsource Capital, the proportion of loans approved out of the total number of 504 applicants has increased in 2010 by approximately 40% (Figure 7). The total number of defaults declined in 2010, while they escalated since

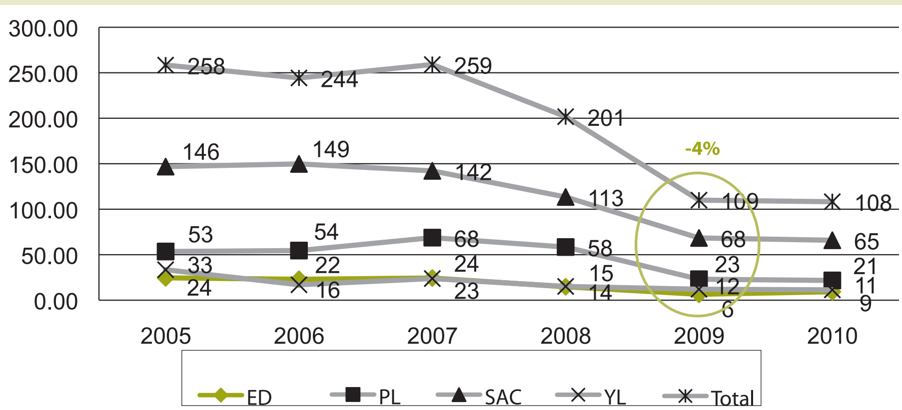
1) In these analyses, only CDC/504 data was used because of the data availability

Figure 5: Total Number of Small Business Loans Approved in Sacramento MSA



Data source: US Small Business Administration

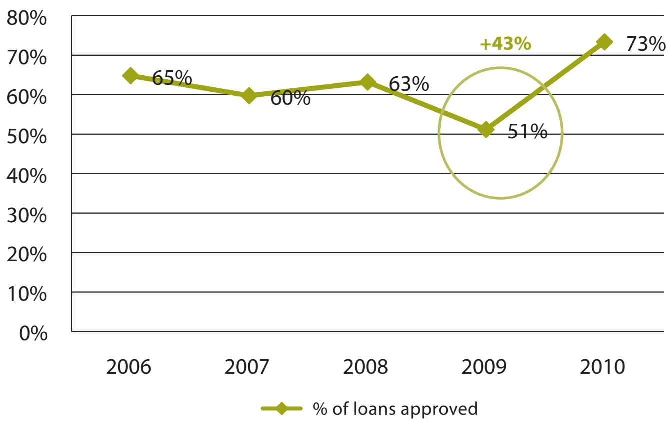
Figure 6: Total Dollar Value of Small Business Loans Approved in Sacramento MSA (in Millions)



Data source: US Small Business Administration

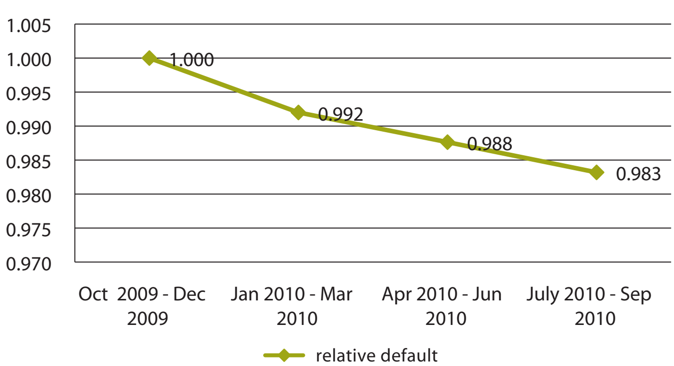
> *"While the recovery appears slow, the early financing indicators appear promising."*

Figure 7:
The Percentage of CDC/504 Loans Approved



Data source: REsource Capital

Figure 8: Delinquency Rate of CDC/504 Loans Default Rate Change (Oct. 2009 - Dec. 2009 as the baseline)



Data source: REsource Capital

the beginning of 2008 (Figure 8). These data points confirm the improving economic outlook for SMEs in the region. While the recovery appears slow, the early financing indicators appear promising.

Small business confidence index (SBCI) shows deep concern and pessimism

To directly assess the regional business outlook and degree of optimism/pessimism of SMEs, we created a Small Business Confidence Index (SBCI). The current survey relative values will be the baseline for calculating future index values.

The majority of the respondents for this survey were from the 'Service' sector (71%) that includes retail. The average business size, measured by the number of total employees, was 38.9 employees (median = 12 employees). The average age of the businesses was 18.7 years (median= 13 years). Table 6 summarizes the survey results and Figure 9 collectively compares the relative values for all 5 questions.

SMEs are negative on economic outlook and local support.

Small businesses are still dealing with the fallout from the economic recession and most do not see a positive turnaround in the near future. Also, institutional and

Figure 9: Relative Values

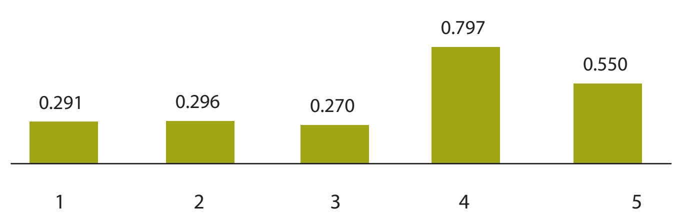


Table 6: Small Business Confidence Index Survey in Sacramento MSA

	Positive		Neutral		Negative		Relative Value[2]
Q1: Economic outlook	30	14.4%	105	50.5%	73	35.1%	0.291
Q2: Local supportiveness	32	15.3%	101	48.3%	76	36.4%	0.296
Q3: Credit accessibility	37	17.9%	70	33.8%	100	48.3%	0.270
Q4: Future revenue	102	49.3%	79	38.2%	26	12.6%	0.797
Q5: Likelihood of new hires	83	39.9%	57	27.4%	68	32.7%	0.550

2) Relative value is calculated as "positive responses/(positive responses + negative responses)"

> *"In contrast, the local small business community has a strong and positive attitude toward future business prospects for revenues and incoming new hires."*

business support from federal, state, county, and city levels is not seen as being friendly to small business.

SMEs are negative on access to bank credit.

The financial/capital markets for small businesses are extremely conservative and risk averse, and SMEs expect this trend will continue for a while. Even though SBA loan activity shows an increase in both number of loans and their dollar value approved, SMEs appear pessimistic about their ability to get credit.

SMEs cling to hope about better revenue and jobs in 2011.

In contrast, the local small business community has a strong and positive attitude toward future business prospects for revenues and incoming new hires. It is intriguing that SMEs expect to increase hiring and revenues against the extremely pessimistic economic backdrop. Possible explanations for these results are 1) strong entrepreneurial spirit, 2) wishful and optimistic business thinking, or 3) truly a leading indicator for better times ahead.

Is the service sector getting it right or simply in denial?

Interestingly, the 'Service' sector is significantly more confident and optimistic about the future economic outlook than others (Table 7, Figure 10). It expects a more positive business environment and prospects than does the manufacturing sector. Perhaps the economic hardship and negative impact have been felt more severely by the manufacturing sector relative to the service sector leading to a much slower recovery.

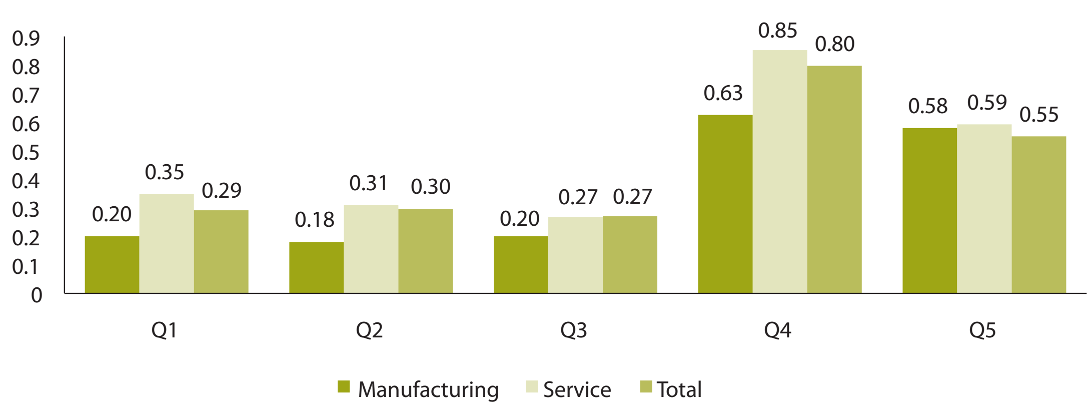
A difficult road ahead...

Overall, we do not expect any major change in SME health or jobs picture for 2011. We remain concerned about the prevailing business climate and sentiment. The uncertainty surrounding the external environment, including policy changes and fiscal challenges, prevent a clear picture on the economic progress. In spite of some early signs of recovery and SME optimism regarding future revenues and hiring, we expect a difficult road ahead.

Table 7: Summary of Relative Values by Business Sector

	Manufacturing	Service	Total
Q1: Economic outlook	0.200	0.348	0.291
Q2: Local supportiveness	0.180	0.309	0.296
Q3: Credit accessibility	0.200	0.267	0.270
Q4: Future revenue	0.625	0.852	0.797
Q5: Likelihood of new hires	0.579	0.592	0.550

Figure 10: SBCI Relative Values by Business Sector



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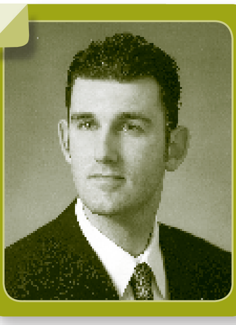

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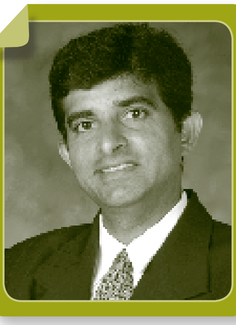

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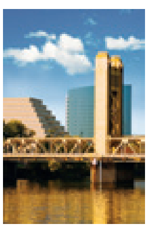

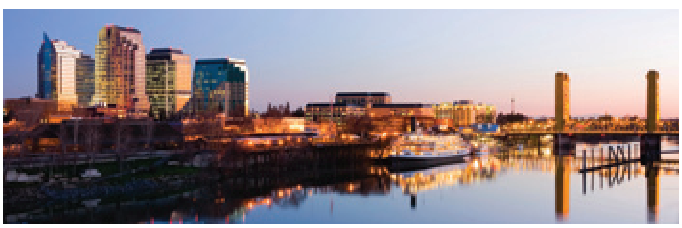

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