July 2011

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Emerging Trends in Sacramento's Economy

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2011 Mid-Year Update

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JULY 2011

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Message from the Dean

Dear Friends,

I am pleased to share the sixth edition of the *Sacramento Business Review* - the most comprehensive, precise, and intellectually sophisticated analysis of the regional economy. For over 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.

This past 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 were right.

While 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. The worst of the credit crisis appears behind us, with Sacramento banks healthier and better-positioned to lend money. However, loan demand has not picked up due to weak demand from creditworthy borrowers. The region added 23,000 non-farm jobs in the most recent four months – our best performance in over a decade. But unemployment remains higher than the Statewide average. The industrial and retail real estate sectors have stabilized and the multi-housing sector is actually doing well, even though the office and single family residential sectors continue in search of a bottom. The small business sector remains pressured by the economic recession and our newly constructed Small Business Confidence Index shows continued negative sentiment. In contrast, larger private sector firms have benefitted from record levels of productivity and have plentiful cash on their balance sheets.

We are committed to delivering 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

Sanjay Varshney, Ph.D., CFA
Dean, College of Business Administration
(916) 278-6578** | **cba@csus.edu** | **www.cba.csus.edu

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sacramento BUSINESS REVIEW

Emerging Trends Sacramento's Economy

Sacramento's Labor Market & Regional Economy: 2011 Mid-Year Update

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

The Sacramento region had an unemployment rate of 12.3% as of June 2011, up from 11.7% in May due primarily to the seasonal addition of job seekers, and is consistent with our forecast in our last publication but still well above the US unadjusted unemployment rate of 9.3%. For the balance of 2011, we expect the Sacramento unemployment rate will stay in the 11-13% range. On a positive note, the rate of job loss (12-month moving average), our preferred measure of the employment situation, has shown steady improvement from a rate of 5,000 jobs lost per month in late-2009 to about 300 jobs lost per month in June 2011 (see Figure 1). While we still expect a prolonged U-shaped recovery, we note that the region gained over 23,000 nonfarm payrolls over the last four months, the first time that has happened in over a decade. That said, we find this recent strength in the regional job figures surprising, especially given the weakness at the national level, and fear that these preliminary numbers may get reversed or adjusted in the coming months.

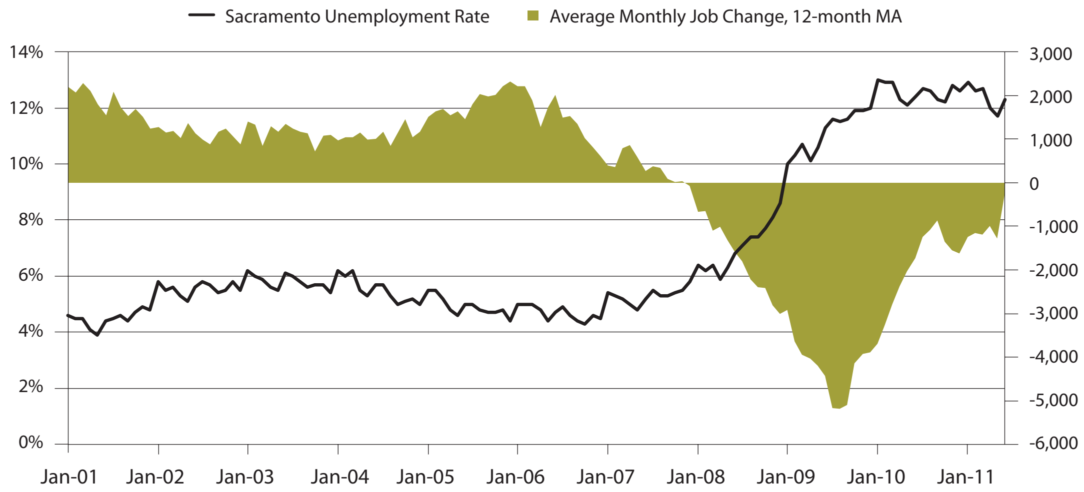
Private sector not running with the baton

We have asserted in previous publications that a key catalyst to our growth outlook is the necessary passing of the baton from policy stimulus to sustainable private sector final demand – which relies on improving consumer confidence and the perceived economic risk. A sustainable recovery depends heavily on the engine of growth transitioning from the public sector to the private sector. We believe the weakness in US economic activity in the first half of the year and the most recent disappointing US jobs report clearly suggests that the private sector is not yet running on its own two feet.

While some of this weakness can be partially explained by production disruptions stemming from the Japanese earthquake and higher commodity costs as of late, we believe the headwinds from deleveraging and the fading of fiscal support is still making it hard for the US to sustain

Sacramento's Labor Market & Regional Economy: 2011 Mid-Year Update

Figure 1
Rate of average monthly job loss is steadily improving



Source: EDD

above-trend growth. In general, large corporations are not translating profits into hiring as quickly as expected, despite relatively healthy balance sheets. While record profitability and productivity should eventually lead to more spending on capital and labor, we believe CEOs and business owners are showing a reluctance to invest when the outlook for business activity is still so uncertain. The most recent JOLTS report from the Bureau of Labor Statistics showed a rise in layoffs, suggesting businesses still see sustained weakness in demand. In addition, corporations may be facing an awkward outlook: on one hand, if they reduce hiring, they risk another US recession; on the other hand, if they increase hiring, they potentially risk margins falling short of consensus forecasts.

That said, there are reasons to believe the second half of 2011 will bring faster economic growth. Monetary policy remains extremely accommodative and will likely remain so in the near-term given the slack in the economy and outlook for low core inflation. Oil prices and commodity costs have retreated from earlier spikes, boosting household real income growth – though increases in consumer confidence remain inconsistent. We continue to believe healthy balance sheets and strong profit margins should eventually lead to increasing investments and fuel a virtuous cycle of recovery.

Recovering lost jobs may take up to 7 to 10 years

Never before has employment been this far below its prior peak this far into a recovery. Not only has the job loss in Sacramento been unprecedented – over 110,000 jobs from peak levels – but the headwinds to local economic growth are significant and the slow pace of recovery we have seen has reflected these challenges. As we highlighted in our last publication, the real estate and government sectors are expected to continue to be a drag on the local economy – driven primarily by excess inventory and budget pressures, respectively. In addition, the significant overhang from discouraged workers who have either left the workforce or taken involuntary part-time work is growing, which will represent an increase in the supply of workers once the outlook for the economy improves. Accordingly, we believe this drop in the labor force participation rate of workers in Sacramento will actually work to keep the unemployment rate elevated even as the number of job openings increase.

Furthermore, the labor data continues to suggest that there are structural impediments keeping the unemployed from transitioning into available job openings, leading to an elevated unemployment rate near-term. These structural impediments

"The last time the Sacramento region added 110,000 jobs, it took about 6.5 years and was driven largely by the real estate boom."

include (1) a skills mismatch between job-seekers and vacancies, (2) geographic immobility of workers because of underwater homes, (3) the effects of extended jobless benefits, and (4) the risk of skills erosion after long spells of unemployment.

The last time the Sacramento region added 110,000 jobs, it took about 6.5 years and was driven largely by the real estate boom. Given the headwinds in this recovery, we would not be surprised if Sacramento does not see peak employment levels again for another 7 to 10 years.

Table 1
Sector-by-sector 2H 2011 growth outlook for Sacramento labor market

Key Sectors	% of Local Economy	Expected Average % Change Y/Y	Change vs. Last Forecast	Comments
Government	28.7%	-1% to -2%	↓	Budget woes at every level should lead to a general contraction. Property reassessments likely to imply less tax revenue.
Business Services	12.6%	-1% to flat	↑	Corporate spending and investments in equipment and software should gradually recover.
Education & Healthcare	12.4%	flat to +1%	–	Fundamentals and long-term outlook very positive due to aging population. Uncertainty around healthcare legislation may temper some growth.
Retail	10.4%	-1% to -2%	↓	Consumer spending is expected to improve in 2H'11 but consumer confidence remains fickle. Retail labor growth has been slower than expected.
Leisure	10.3%	flat to +1%	↑	Industry gaining some pricing power in new year, but modest growth still likely. Recent improvement in the "food services and drinking places" and "accomodations" categories.
FInancial	5.8%	-2% to -4%	↑	Tepid loan demand, relatively tight lending standards, and margin pressure will keep financial services firms from meaningful hiring in 2011.
Construction	4.7%	-2% to -4%	↑	Residential housing shadow inventory will continue to steal away from new construction. Recent gains are in the "Residual Construction" category, which may not be sustainable.
Manufacturing	4.0%	flat to +1%	↓	Growth mainly from food manufacturing which tends to be fairly resilient through downturns.

↑ = we expect **higher** employment growth in 2H '11 vs. our last full-year forecast
↓ = we expect **lower** employment growth in 2H '11 vs. our last full-year forecast

Sources: Sacramento Metropolitan Statistical Area monthly employment data published by the Employment Development Department of the State of California; BLS, Federal Reserve, Barclays Capital, Bank of America Merrill Lynch, JP Morgan, Morgan Stanley and Goldman Sachs. As of our publishing date, the most recent monthly unemployment rate reading for Sacramento was for May 2011. The Sacramento-Arden Arcade-Roseville Metropolitan Statistical Area (MSA) includes the counties of Sacramento, El Dorado, Yolo, and Placer. Since our analysis explicitly accounts for seasonality throughout the year, the employment figures in this paper are "unadjusted" figures.

Real Estate Trends in the Sacramento Region

UPDATE

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

We continued to bump along the bottom during the first half of 2011 with many market participants still searching for signs of a recovery. The industrial and retail sectors continued to show signs of stabilization while the office and single-family residential markets have yet to find their footing. The most radiant bright spot is the multi-housing market, where rental fundamentals are healthy and properties at the highest end of the quality spectrum have been able to raise rents aggressively.

Industrial

- The industrial sector saw limited transactional activity through the first half of the year, the bulk of which occurred in the larger user segment. The region posted two consecutive quarters of modest positive absorption (197,836 total square feet) for the first time since the first and second quarters of 2008. Vacancy remained steady at 13%.
- Several large occupiers remain in the market for 100,000+ SF spaces, particularly in the food and home goods segments. Gymboree recently leased 200,000 SF in Dixon and Olam Tomato Processers leased nearly 300,000 square feet in Woodland. We expect these large blocks of available space will soon be in short supply.
- Average asking lease rates have remained relatively flatt so far in 2011, though landlords have exhibited a willingness to price deals aggressively for credit tenants and/or longer term leases.
- We expect more executed leases from the larger users in the second half of the year and that available Class A spaces will fill up (caused largely by tenants upgrading) while the rental fundamentals of Class C buildings in undesirable locations to continue to deteriorate.

Retail

- The retail market continued with its long, slow climb up from the bottom. The regional vacancy rate, which reached nearly 15% at the end of 2009, is now down to 13%. Although rental rates in most cases remain significantly off peak levels, there are a few examples of rents rebounding within the most premium spaces.
- Tenant activity is up and value is in! Discount retailers remain among the most active tenants today, including Dollar Tree, 99¢ Only, and Grocery Outlet. Several national retailers are also looking for space, including Hobby Lobby, Dick's Sporting Goods, WalMart (neighborhood market), Sunflower Markets, and Sprouts. Even the smaller "mom & pop" retailers are becoming more active, with many taking advantage of the current market environment to trade up to more efficient and better located space.
- Closures in high-profile locations continue to highlight the narrow margin for error in operating a retail business in the current challenged economy. Market at Pavilions, Spin Burger at 16th & K Street, and California Pizza Kitchen at 16th & L Street, all

closed this year after opening to much fanfare during the past year or two in highly desirable locations. Also, Borders just announced it is liquidating all its stores.

- While there is justifiably renewed optimism on behalf of market participants, a robust recovery will necessitate new job growth and for the housing market to materially improve. We see the near term as one of continued but gradual improvement.

> *"The median home price reached a post boom trough during the first half of 2011 and is down 13% year-over-year."*

Office

- After six consecutive quarters (and over 3 years on an annual basis) of negative net absorption, the office market continues to search for a bottom. With over 400,000 SF of negative net absorption through the first half of 2011 alone, the regional vacancy rate reached a record high of 23% and average asking lease rates continue to fall from their peak in 2008.
- Leasing activity has generally picked up but it represents activity without the market growing. It is all about renewals with companies maximizing their real estate and minimizing their out of pocket capital expenses. The largest lease transactions during the first half of the year exemplify this - Nationwide signed a new lease but downsized to 99,500 square feet, Delta Dental renewed for over 97,000 square feet, and ECMC took over the federal contract for Ed Fund and signed a lease for the space, but only took half leaving the remainder vacant.
- Historically one of the major drivers of leasing activity in the market, public sector tenants have remained quiet during the first half of 2011. The highly publicized headquarter relocation for FEMA has been delayed for at least a year, while State government related tenants are only renewing and not expanding.

Investments

- Commercial investment sales activity has only increased modestly over the trough levels of 2009. Transactional velocity through the first half of 2011 has not been as strong as anticipated at the end of 2010.
- Commercial REO (real estate owned by banks and other lenders), short sales and note-sales activities have negatively impacted pricing. However, these kinds of assets have not yielded as many purchasing opportunities as many have predicted. In some cases, lenders or similar entities are choosing to modify existing debt structures, particularly with larger, well known sponsors. In rare instances, foreclosed properties are being held and repositioned by lenders or similar entities.
- Investment capital is abundant with the strongest demand being for stabilized core assets or highly distressed properties with repositioning opportunities. While Sacramento market conditions have proved challenging for some investors with reduced purchasing power, others have taken advantage of the depressed pricing environment to load up for the next up-cycle. Stronger buyer demand has caused capitalization rates to settle a bit after rising through most of 2010.
- The apartment sector has become the most sought after property type given its comparably low risk profile, healthy rental fundamentals, and highly favorable outlook combined with available and desirable financing options. Several investors who formerly focused on the commercial or single-family sectors exclusively have recently crossed over to investing in apartments.

Residential

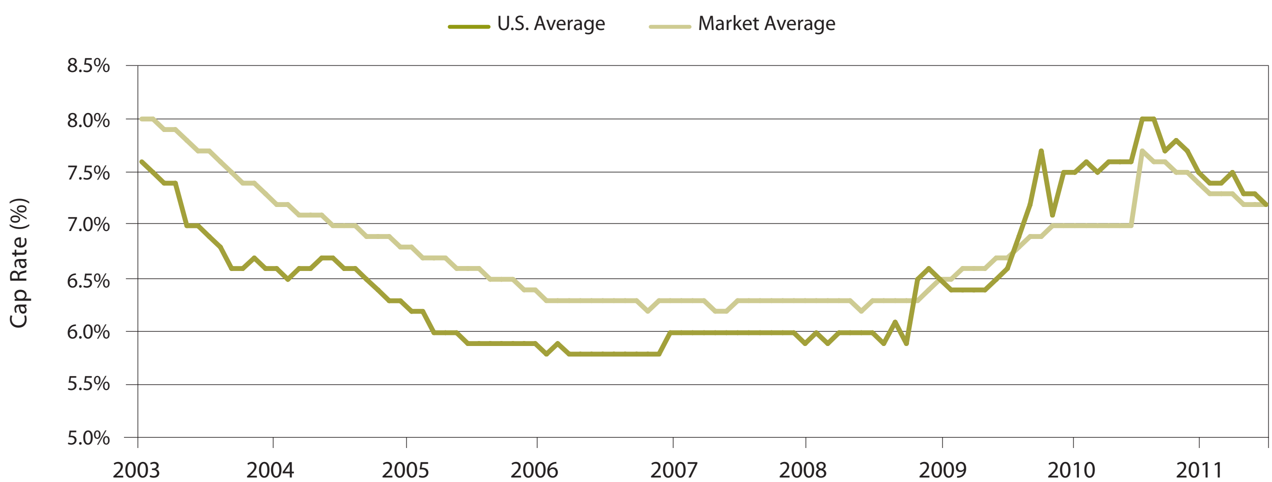
- The median home price reached a post boom trough during the first half of 2011 and is down 13% year-over-year. This has become a more meaningful gauge of the trend of "organic" pricing as the composition of sales has remained consistent year-over-year.
- New home construction is on pace to set a new low in 2011 while the most optimistic homebuilders are focusing their attention at this point on 2013 starts – seemingly forsaking next year already.

- The good news is that Notice of Default filings, which represent the beginning of the foreclosure process, have reached a 4 year low in the region (and state). The bad news is that the number of foreclosures has risen since the last half of 2010 and year-over-year.
- REO (real estate owned by banks) sales still represent nearly half of all sales in the marketplace which continue to suppress pricing for non-distressed homes. We do not anticipate any improvement in the market during the second half of the year.

Conclusion

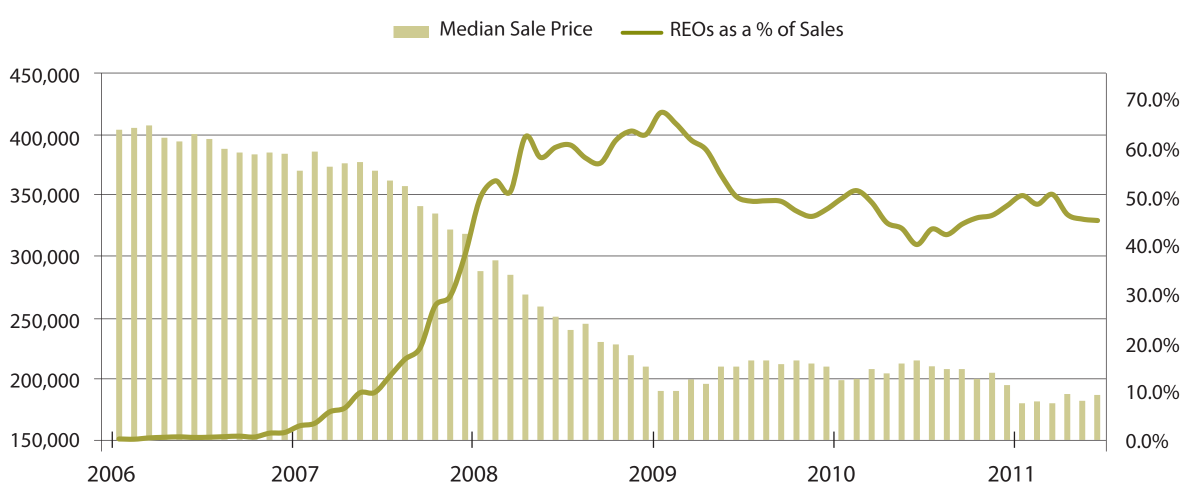
Most real estate market participants, whether they are homebuyers, investors, retailers, or other types of businesses need some level of certainty before they give themselves permission to transact. With persistently elevated unemployment, heightened financial distress of all sorts, and a well-publicized budget crisis at all levels of government, there is both a crisis of confidence and diminished capacity to transact that will continue to grip the real estate market in the near term.

Figure 1 – Investments
Cap Rate (%)/Sales through May 2011 (all property types) | Sacramento Region



Source: Real Capital Analytics

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

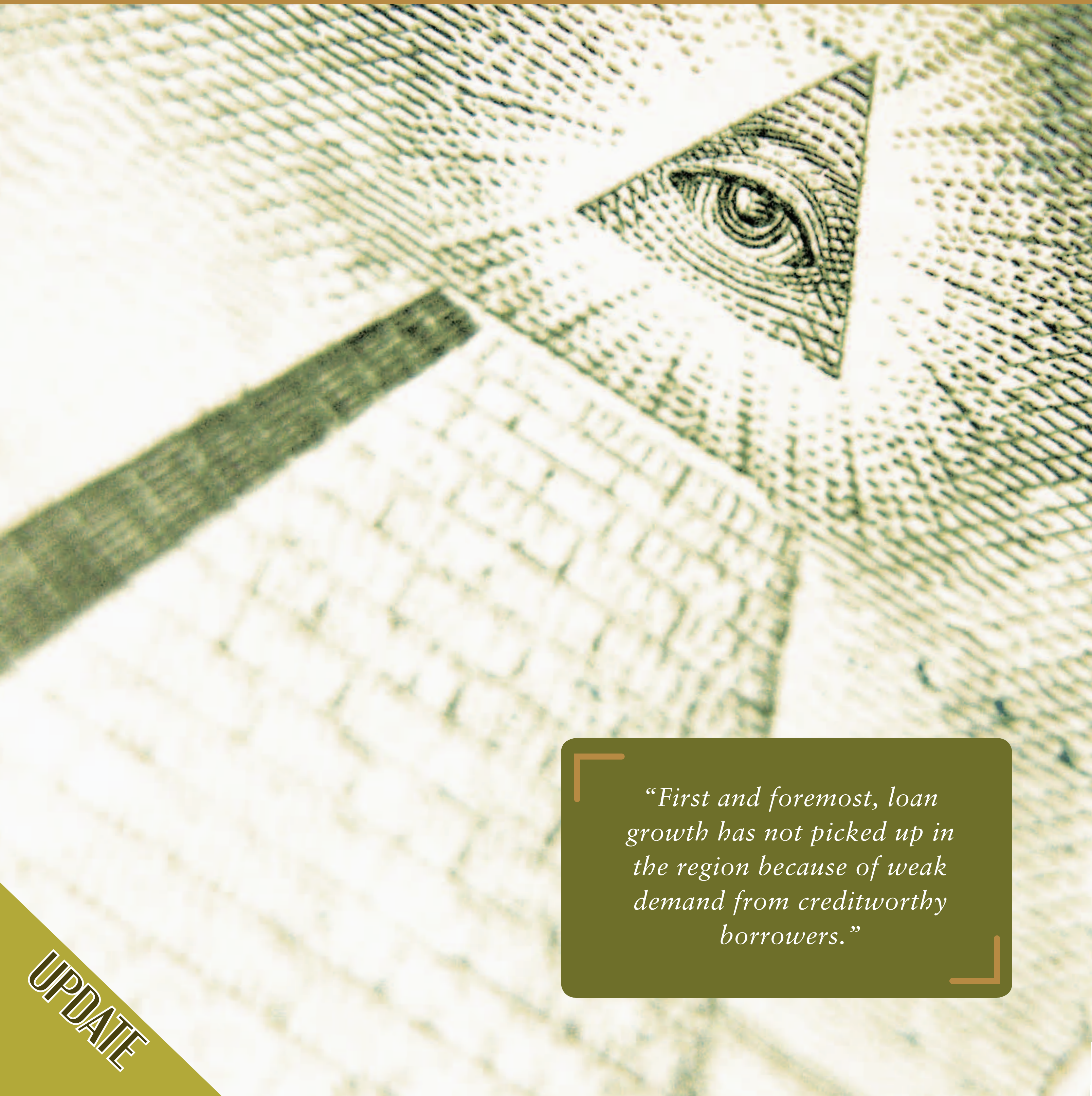


REO (Real Estate Owned) – property which is in the possession of the lender as a result of foreclosure.

Source: MDA DataQuick

2011 Sacramento Banking Industry Forecast

Banks Continuing to Face Challenges



"First and foremost, loan growth has not picked up in the region because of weak demand from creditworthy borrowers."

UPDATE

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

In January's *Sacramento Business Review (SBR)*, we predicted that the region's banking industry would face some significant growth obstacles, most notably weaker loan demand. We also believed that still-elevated nonperforming real estate loan balances and higher regulatory compliance costs would create an overhang on bank profitability. As a result, we forecasted a potential increase in merger-and-acquisition (M&A) activity toward the end of the year, given the aforementioned growth challenges.

Thus far, our predictions are playing out mostly as expected. First and foremost, loan growth has not picked up in the region because of weak demand from creditworthy borrowers. Therefore, most of the Sacramento Region Banks[1] have seen their net interest margins[2] decline sequentially in recent quarters. Fortunately for most local banks, loan-loss provisions have declined, enabling these banks to offset some of the impact of weaker net interest margins. However, considering that nonperforming loans remain an issue for a number of local banks, we expect to see continued loss provisions for those who are under-reserved. We also have yet to witness a material increase in operating costs due to the new regulatory environment, but this is because the laws have only recently been implemented. We therefore believe compliance costs will trend upward as the year unfolds. Finally, the pick-up in M&A activity has yet to occur, but we didn't expect it to until later this year (at the earliest).

Loan Growth Still Weak

As Table 1 illustrates, most of the Sacramento Region Banks have seen a notable decline in their loan balances during the past six months since the last *SBR* was published. This decline parallels what is occurring nationwide, as total loans and leases for all FDIC-insured banks fell by nearly 2% since the beginning of 4Q 2010.

Table 1
Gross Loans and Leases | Sacramento Region Banks

	TOTAL LOANS		
Bank	**9/30/10**	**3/31/11**	**% Change**
Redding Bank of Commerce	$648,713	$619,258	-4.5%
River City Bank	$526,521	$519,095	-1.4%
North Valley Bank	$536,296	$494,509	-7.8%
El Dorado Savings Bank	$433,104	$436,463	0.8%
First Northern Bank	$467,841	$435,562	-6.9%
American River Bank	$353,103	$333,624	-5.5%
Five Star Bank	$318,161	$326,928	2.8%
Bank of Sacramento	$246,751	$237,551	-3.7%
Community Business Bank	$121,368	$106,621	-12.2%
Gold Country Bank	$66,836	$75,312	12.7%
Folsom Lake Bank	$73,506	$73,896	0.5%
Community 1st Bank	$73,369	$69,147	-5.8%
Sierra Vista Bank	$71,874	$65,329	-9.1%
Merchants Bank of Sacramento	$56,921	$57,974	1.8%
Sutter Community Bank	$50,745	$48,166	-5.1%
River Valley Community Bank	$42,896	$41,087	-4.2%
TOTAL	**$4,088,005**	**$3,940,522**	**-3.6%**
	ALL BANKS NATIONWIDE -1.9%		

Financial information for the banks analyzed in January's SBR was as of September 30, 2010. The six-month period referenced reflects data from September 30, 2010 through March 31, 2011 (since June 30, 2011 data has yet to be released).

Data Source: FDIC

2011 Sacramento Banking Industry Forecast

Banks Continuing to Face Challenges

We noted in the January *SBR* how debt balances typically decline following a deep recession caused by a banking/financial crisis. Empirical evidence shows that over-indebted borrowers have "deleveraged" for an average of 6-7 years, beginning roughly two years after the crisis has occurred.[3] History would therefore suggest that the region's banks are unlikely to see a substantial increase in their loan balances throughout the remainder of 2011.

> *"History would therefore suggest that the region's banks are unlikely to see a substantial increase in their loan balances throughout the remainder of 2011."*

Economic Impact of Subpar Credit Growth

Because the Great Recession of 2008-2009 was a "balance-sheet recession," the recovery in the United States (and the Sacramento region) has differed from the typical post-World War II economic recovery, where private sector credit growth played a key role. Table 2 illustrates how robust U.S. economic recoveries following deep recessions occurred while private sector credit was growing at an extremely healthy clip.

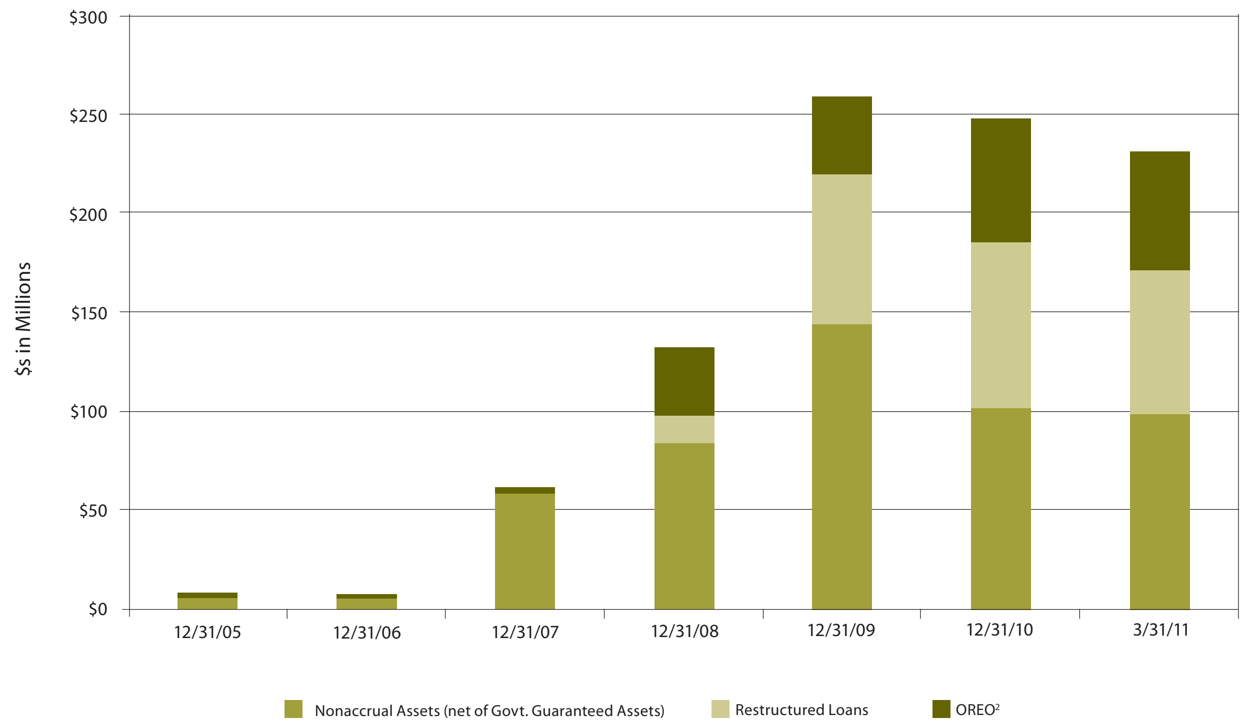
By looking at Table 2, one can easily contrast these robust recoveries with the weak current economic climate, where private sector credit growth during the first 18 months of the recovery has been negative. Should bank credit continue to decline in the Sacramento region, the *SBR* team believes the strength of the local economy will remain constrained.

Table 2
U.S. Private Sector Credit Growth | First 18 Months Following Recessions Since World War II

Recession Period		GDP Decline During Recession	GDP Growth in Recovery (First 18 Months)	Private Sector Credit Growth (First 18 Months)
Q4 1969	Q4 1970	-0.2%	8.8%	15.4%
Q1 2001	Q4 2001	-0.3%	2.7%	12.7%
Q2 1960	Q1 1961	-0.5%	9.7%	13.6%
Q3 1990	Q1 1991	-1.4%	4.8%	5.5%
Q4 1948	Q4 1949	-1.6%	16.7%	23.4%
Q1 1980	Q3 1980	-2.2%	1.4%	17.0%
Q2 1953	Q2 1954	-2.5%	9.9%	19.5%
Q3 1981	Q4 1982	-2.6%	11.7%	18.6%
Q3 1957	Q2 1958	-3.1%	9.8%	16.7%
Q4 1973	Q1 1975	-3.2%	7.5%	11.9%
Q4 2007	**Q2 2009**	**-4.1%**	**4.5%**	**-6.2%**

Data Source: U.S. Bureau of Economic Analysis

Figure 1
Nonperforming Assets and Restructured Loans | Sacramento Region Banks[1]
December 31, 2005 – March 31, 2011



1) The figures reported in Figure 1 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

Banks Still Working Through Problem Loans

Figure 1 is an updated version of a graphic showing Nonperforming Assets and Restructured Loans for the Sacramento Region Banks since late 2005. As one can see, banks have been making progress dealing with their problem loans since late 2009. However, their nonperforming assets remain elevated relative to historical levels.

While a handful of locally based banks (e.g., River City, El Dorado Savings, River Valley, and Merchants) have made generous allowances for loan losses relative to their nonperforming loan balances, others will likely to have to increase loss provisions during the next six months unless their nonperforming asset situations somehow improve. These higher provisions would adversely impact profitability.

"For the first half of 2011, the SBR Bank Index delivered a 3.5% return."

Publicly Traded Local Bank Recommendations

For the first half of 2011, the SBR Bank Index[4] delivered a 3.5% return. This return exceeded that of the widely referenced KBW Regional Bank Index's 2.7% decline. Figure 2 details how each local publicly traded bank performed through June 30.

Figure 2
Publicly Traded Banks Based in the Sacramento Region | Year-to-Date (through June 30) Total Returns

ABBREVIATION	JANUARY SBR RECOMMENDATION
OP	Outperform
MP	Market Perform
UP	Underperform

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

* *The authors do not own shares in any of the banks listed in Figure 2. The Sacramento Business Review cannot guarantee any of the forecasts made in this publication.*

Data Sources: Yahoo! Finance and OTC Bulletin Board

REFERENCES

1 The Sacramento Region Banks include American River Bank, Bank of Sacramento, Community 1st Bank, Community Business Bank, El Dorado Savings Bank, First Northern Bank of Dixon, Five Star Bank, Folsom Lake Bank, Gold Country Bank, 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.

2 Net interest margin is the difference between a bank's interest income and interest expense, measured as a percentage of its average earnings assets.

3 For more information regarding post-crisis deleveraging, please refer to the McKinsey Global Institute's January 2010 report titled "Debt and Deleveraging: The Global Credit Bubble and Its Economic Consequences."

4 The SBR Bank Index measures the performance of the 11 publicly traded stocks based in the six-county Sacramento region. Performance is calculated on a capitalization-weighted basis.

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

UPDATE

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*

"Fortunately, economic growth remains a function of both employment growth and productivity."

Despite an incredible slate of events in the first half of 2011, the global equity markets ended the period in slightly positive territory. The continuing advance of 2010's bull market paused in February, as uprisings in Tunisia, Egypt and Libya created significant concern about geopolitical stability in the Middle East, sending oil prices on a two month spike. Investor confidence was shaken again in early March, as Japan struggled to contain a potential nuclear disaster resulting from one of the largest earthquakes in modern history and a devastating tsunami. The markets soon recovered, only to vacillate again in May and June, as global debt issues resurfaced in the face of improving domestic housing data.

Looking forward into the second half of the year, investors face the resolution of the Eurozone debt woes, political brinksmanship on the American debt ceiling and suddenly-wobbly US employment data. Regardless of the headline issues, our view is that the economy has a decent potential to surprise to the upside, as energy prices have receded, global business spending and credit demand have started to recover and emerging economies appear close to the end of their tightening cycles. Fortunately, economic growth remains a function of both employment growth and productivity. Barring any major shocks, increased labor productivity should compensate for anemic payroll growth, allowing US GDP to resume towards a more normal trend.

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

> *"...the Great Recession and the global debt bubble have truly led to a bifurcated recovery between developed and emerging economies."*

The upcoming earnings season could prove to be a near term catalyst, as analysts and investors look to glean any trend changes in corporate earnings growth. Discussions will likely swirl around the ultimate effect of QE2 and will/should there be a QE3 program in the future. We think the Fed and Treasury will stand pat, as monetary and financial conditions remain accommodative and the economy and the markets continue to work their way through Q2's soft patch.

While we had never imagined the chain of events from January to June, many of our initial calls are unfolding as expected. We review them below:

1. **Divergent recoveries between Emerging and Developed Economies** – the Great Recession and the global debt bubble have truly led to a bifurcated recovery between developed and emerging economies. While America, Europe and Japan remain mired in sub-par economic recoveries, elevated unemployment and structural deficits, emerging economies have proactively tightened controls to stave off unwanted inflation and position themselves for continued growth. As a result, emerging markets, while trailing global benchmarks for 1H 2011, are primed for recovery in the second half of the year.

2. **Stock market rally 1H, followed by correction** – so far, this year's pattern has been eerily similar to 2010's, but we do not expect the same second half results as last year. The S&P 500 returned a welcome 6% to date. However June's volatility and the change in sector leadership during Q2 may be indicating that our prediction for a second half correction could unfortunately materialize. Looking into Q3 and beyond, we expect volatility to increase, as the attempts to resolve the complex global issues surrounding the markets meet with progress and setbacks.

3. **Favored sub-asset classes** – the results for our first half equity calls were mixed. In the broad markets, we favored the US over Europe and small cap stocks over large - both predictions proved accurate. Our domestic sector calls for Energy and Industrials to return more than the broad S&P 500 performed as expected; however, Materials and Technology lagged. Regarding our country calls, the UK, Germany, Korea and Russia outperformed their respective benchmarks, but Canada, Australia, Taiwan, China and Turkey trailed.

   Our credit market calls are all performing as expected. To date, intermediate municipal, corporate and high yield indexes have all bested the US Treasury markets. Within the corporate bond complex, financial institution bonds have earned a slightly higher return than their industrial counterparts.

Sources:

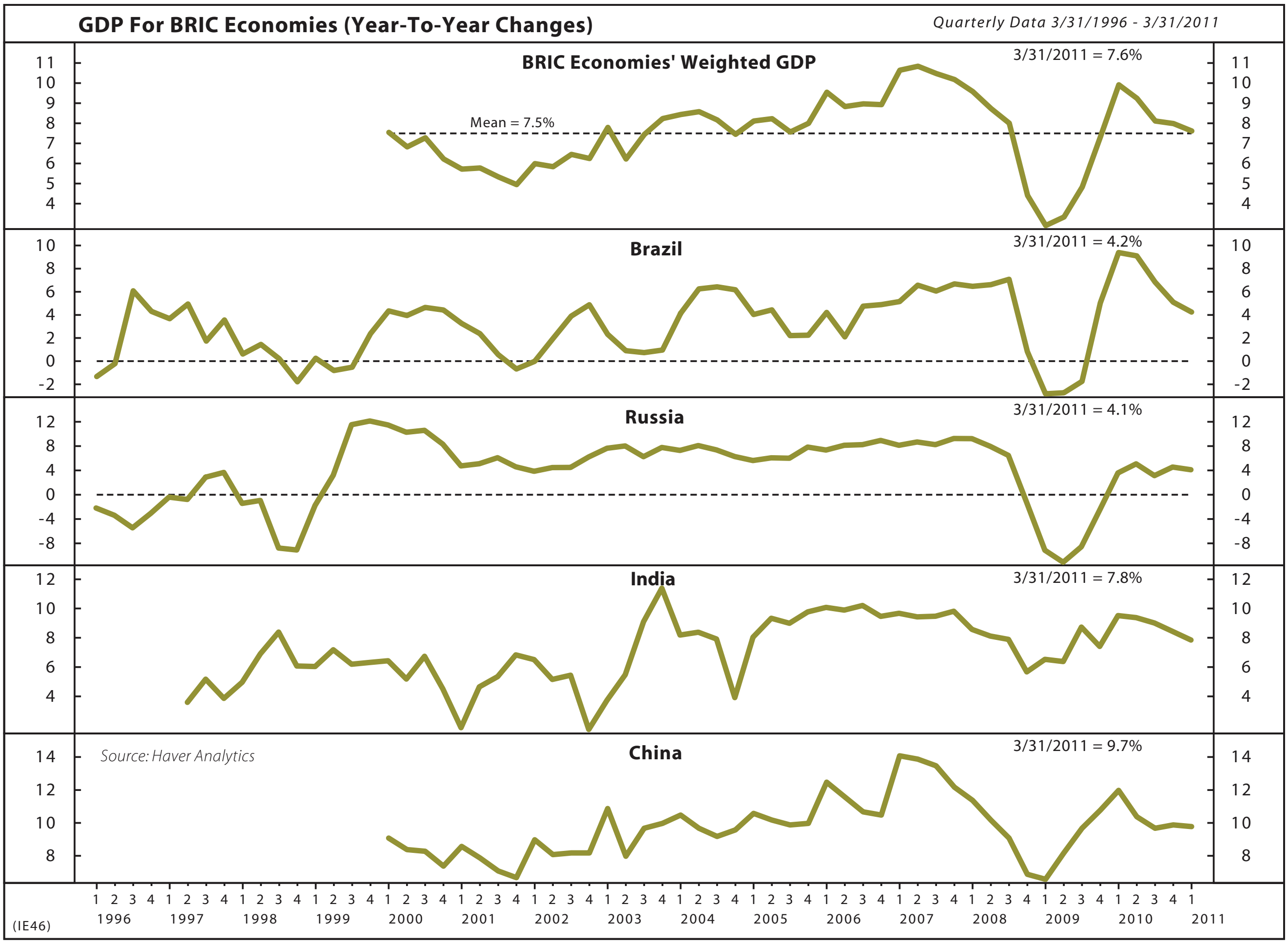
[1] BCA Research, *Third Quarter Strategy Outlook*, July 8, 2011

[2] Ned Davis Research, *Stock Market Focus*, July 2011

[3] Wells Fargo Private Bank, *Global Capital Markets Monitor*, July 2011

[4] BCA Research, *US Investment Strategy*, July 11, 2011

Figure 1
Emerging Market Economies Back On Track



Source: Ned Davis Research

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The Small Business *Economy*

Small Business Confidence Index (SBCI) Shows Continued Major Concerns

UPDATE

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

> *"SMEs remain pressured by the economic recession and most do not see an immediate recovery."*

SMEs remain pressured by the economic recession and most do not see an immediate recovery. However, they are more optimistic today about an eventual turnaround than they were at the start of the year (a rising optimism trend by approximately 14%). Also, while they do not view the federal and local constituencies as business friendly, they feel more optimistic regarding a positive change ahead (a rising trend by approximately 22%).

In January 2011, we introduced our proprietary Small Business Confidence Index (SBCI) that directly measured the regional economic outlook and degree of optimism (pessimism) of small and medium enterprises (SMEs). Our current analysis uses the *Relative Values* of the January 2011 survey as the baseline values to calculate changes, and present current trends.

Economic outlook remains weak

While local SME expectations of economic outlook, local supportiveness, and future revenue have improved since January 2011, their relative values and resulting the overall economic picture remain weak. Expectations regarding credit accessbility and likelihood of new hires remain relatively unchanged or negative. Continued stress and pessimism continue to pervade the SME thinking.

SMEs are VERY negative on access to bank credit

The total dollar amount of SBA loans in the Sacramento MSA has significantly increased during the recent 7 months (October 2010 – April 2011). However, local SMEs remain pessimistic regarding the overall accessibility to bank credit or business loans. The capital markets for small businesses remain very conservative and risk averse, and SMEs expect this trend will continue for a while.

SMEs cling to hope for better revenue and jobs ahead

Despite the pessimism regarding future economic outlook and access to credit, SMEs remain optimistic regarding prospects for future business revenues and new hires. This is likely due to: 1) strong entrepreneurial spirit in the local SME community, 2) wishful and optimistic business culture in the region, 3) a leading indicator for better times ahead.

Table 1
Small Business Confidence Index | Sacramento MSA | January 2011 versus July 2011

	Positive		Neutral		Negative		Relative Value	
	January 2011	July 2011	January 2011	July 2011	January 2011	July 2011	January 2011	July 2011
Q1: Economic outlook	14.4%	19.3%	50.5%	41.5%	35.1%	39.2%	0.291	↑ 0.331
Q2: Local supportiveness	15.3%	19.7%	48.3%	45.5%	36.4%	34.7%	0.296	↑ 0.362
Q3: Credit accessibility	17.9%	17.2%	33.8%	35.8%	48.3%	47.0%	0.270	⇔ 0.268
Q4: Future revenue	49.3%	50.9%	38.2%	36.3%	12.6%	12.7%	0.797	⇔ 0.800
Q5: Likelihood of new hires	39.9%	35.4%	27.4%	33.0%	32.7%	31.6%	0.550	⇔ 0.528

Our current survey shows: 1) the majority of the respondents were from the 'Service' sector (70%), 2) the average business size, measured by the number of total employees, was 31.8 employees (median = 6 employees), and 3) the average age of the businesses was 14 years (median = 11 years).

Manufacturing sector is now more optimistic than service

In contrast to the January 2011 survey, it is the manufacturing sector (rather than the service sector) that saw a rise in confidence levels. SMEs in the manufacturing sector have an improved economic outlook and are more optimistic regarding favorable support from federal and local constituencies. Interestingly, the *'Others'* sector (Agriculture, Healthcare, Waste Management and Recycling) showed the best improvement in expectations regarding future revenues and new hires. Could these be the newly emerging areas to serve as a catalyst in the much needed economic recovery?

Figure 1
Small Business Confidence Index Trends | January 2011 versus July 2011

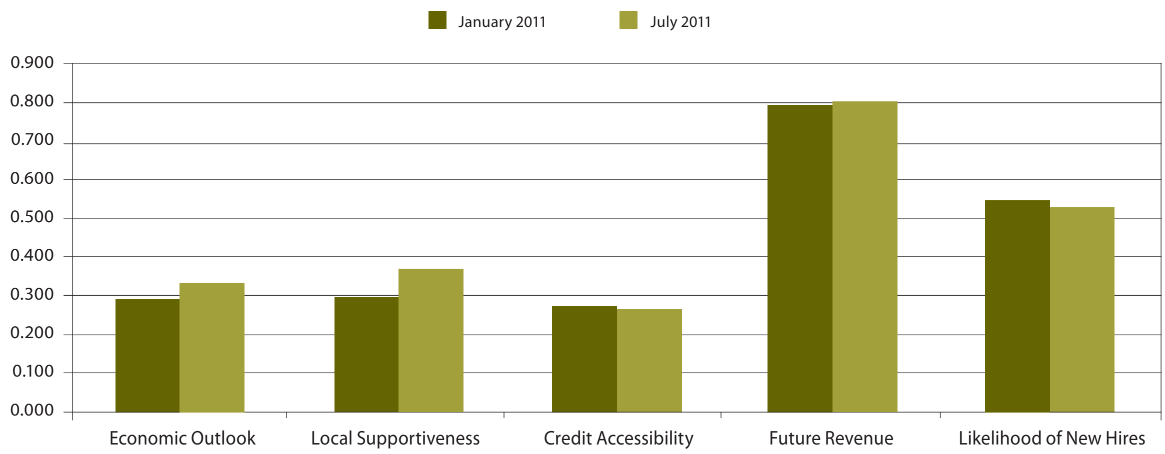


Figure 2
Total Number of Small Business Loans Approved (Millions) | Sacramento MSA

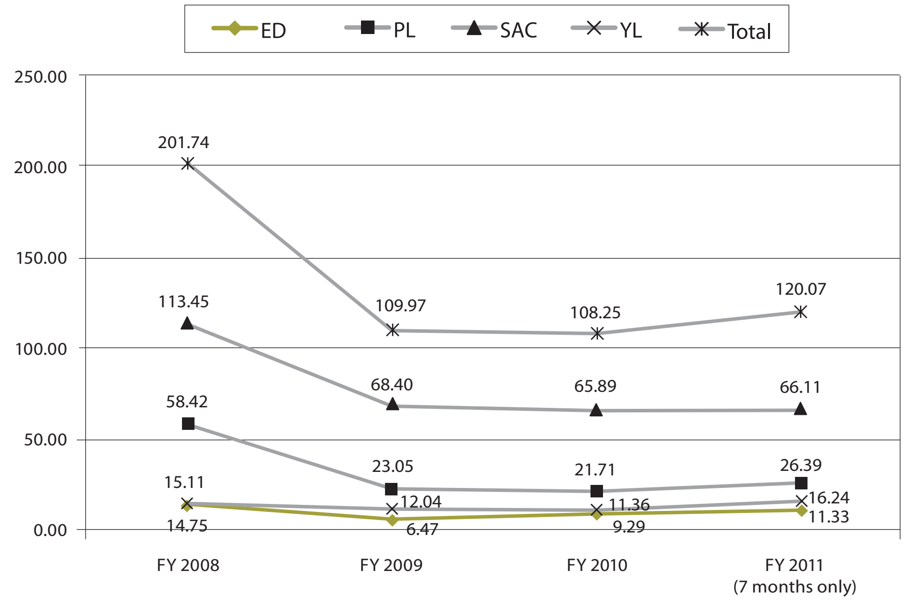


Table 2
Relative Values by Business Sector

	Manufacturing		Service		Other	
	January 2011	July 2011	January 2011	July 2011	January 2011	July 2011
Q1: Economic outlook	0.200	↑ 0.444	0.348	↔ 0.341	0.222	↔ 0.269
Q2: Local supportiveness	0.180	↑ 0.444	0.309	↑ 0.361	0.333	↔ 0.333
Q3: Credit accessibility	0.200	↓ 0.143	0.267	↔ 0.242	0.286	↔ 0.310
Q4: Future revenue	0.625	↔ 0.667	0.852	↔ 0.825	0.600	↑ 0.769
Q5: Likelihood of new hires	0.579	↔ 0.533	0.592	↔ 0.566	0.292	↑ 0.393

Figure 3
SBCI Trends in the Manufacturing Sector | January 2011 versus July 2011

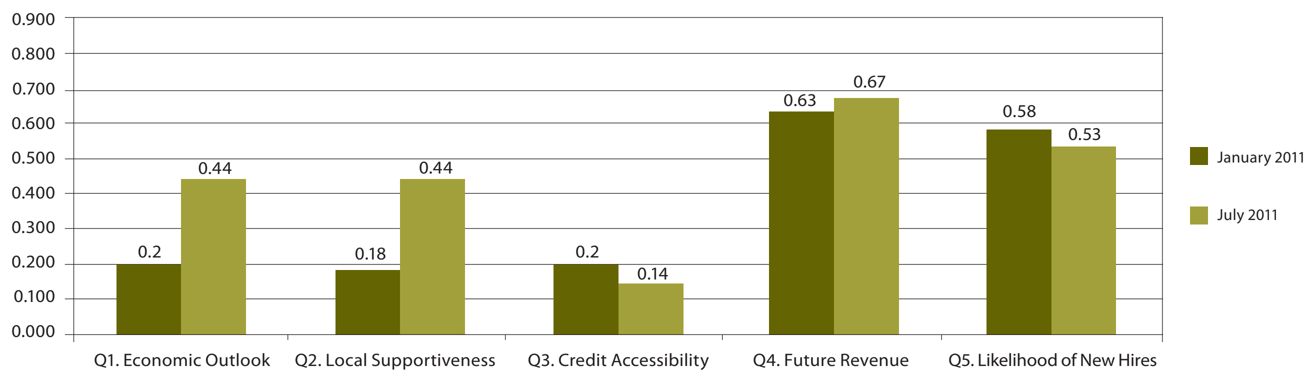


Figure 4
SBCI Trend in the Service Sector | January 2011 versus July 2011

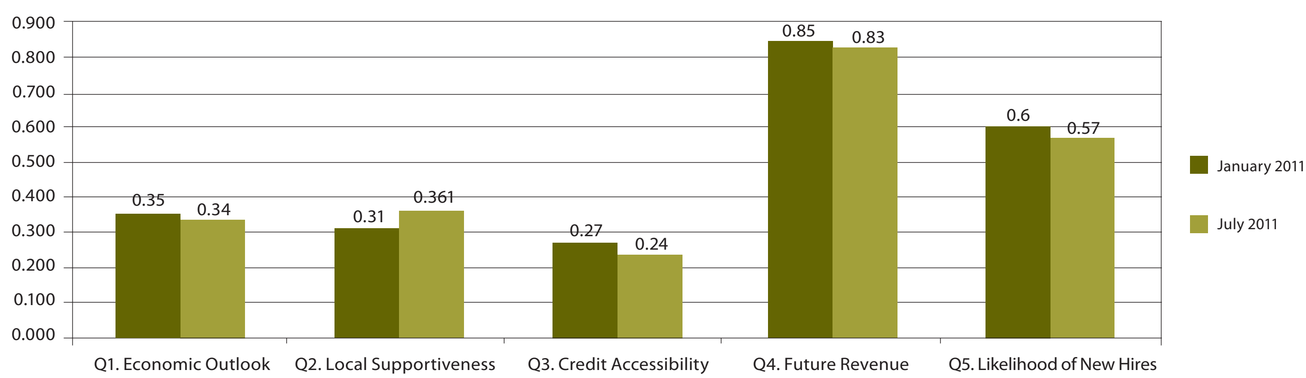
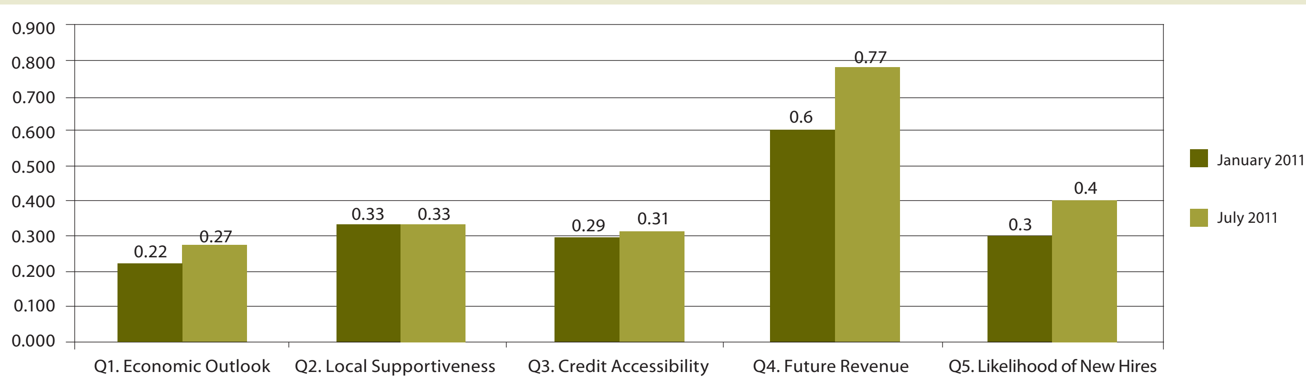


Figure 5
SBCI Trends in the "Others" Sector | January 2011 versus July 2011

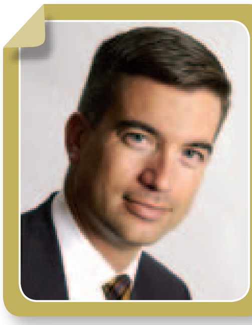


Sacramento Business Review Authors

Seung Bach, Ph.D.

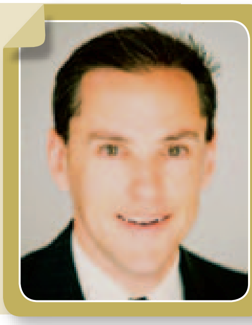
Seung Bach is an Associate Professor of Entrepreneurship and Strategic Management in the College of Business Administration at California State University, Sacramento. He earned his Ph.D. in Business Administration at the University of Tennessee, Knoxville and his MBA at the George Washington University, Washington D.C. His expertise is in the areas of new venture creation, small business management, entrepreneurial transitions, innovation and corporate entrepreneurship, and global management and strategy.

Jason Bell, CFA



Jason Bell is a Senior Vice President and Senior Investment Manager for Wells Fargo Private Bank, where he manages funds for selected clients and leads the firm's Domestic Equity Sector Strategy team. He is a Chartered Financial Analyst and holds a business degree from the University of the Pacific, as well as an MBA from the University of California at Davis. He currently serves as a senior volunteer leader at CFA Institute, representing approximately 10,000 members in the Western United States.

Jonathan E. Lederer, CFA



Jonathan Lederer is the founder and president of Lederer Private Wealth Management, a Sacramento-based registered investment advisory firm. Jonathan graduated with his MBA from the University of Michigan's Ross School of Business and received his BA from the University of California, Berkeley. Jonathan has been a CFA charter holder since 2003 and is currently the CFA Society of Sacramento Vice President.

Brian M. Leu, CFA, CAIA

Brian Leu is an Investment Officer at CalPERS and a member of the team responsible for trading the global internal equity and futures portfolio. Prior to joining CalPERS, he worked at Roseville-based DCA Partners supporting the firm's investment banking business and private equity investments. Previously, Mr. Leu was a member of the Equity Research team at Deutsche Bank Securities and an investment analyst at a long-short hedge fund in NYC. Mr. Leu earned his MBA from the NYU Stern School of Business and an Economics degree from Duke University and also holds the CFA and CAIA designations.

Hao Lin, Ph.D., CFA

Hao Lin is an Assistant Professor of Finance in the College of Business Administration at California State University, Sacramento. He has a Ph.D. in Finance and MS in Financial Mathematics, both from the University of Warwick in England. His expertise is in the areas of financial markets and market microstructure. Hao holds the Chartered Financial Analyst (CFA) designation and serves on the Board of Directors of the CFA Society of Sacramento.

Sacramento Business Review Authors

Marc Ross, CFA

Marc Ross is a real estate investment broker at CB Richard Ellis, specializing in the sale of multi-housing properties in the greater Sacramento region. Marc graduated with his MBA in Real Estate and Finance from the University at California, Davis in 2001 and has been a CFA charter holder since 2001. He received his BA in economics and business administration from Rhodes College in Memphis, Tennessee.

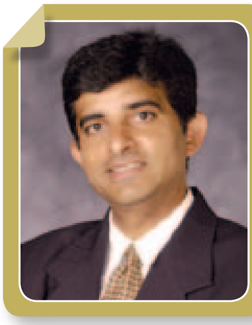
Yang Sun, Ph.D.

Yang Sun is an Assistant Professor in the College of Business Administration at Sacramento State. In addition to his Ph.D. in Industrial Engineering from Arizona State University, he has a Six-Sigma Black Belt. He also received an engineering degree from Tsinghua University. He has research interests in the areas of Supply Chain Management, Global Operations Strategy, Lean and Six-Sigma, Technology Management, Managerial Economics, Operations Research and Applied Statistics, and is a recipient of the Dean's Research Award and the university's Outstanding Scholarly and Creative Activities Award.

Sudhir Thakur, Ph.D.

Sudhir Thakur received his MA in economics and urban planning from Punjab University (1996) and University of Akron (1998), and doctorate degree in economic geography from The Ohio State University (2004). He is currently an Associate Professor in the College of Business Administration at California State University, Sacramento. His research interests are in the areas of: economic geography, development economics, technological change and regional development, and geospatial analysis and modeling.

Sanjay Varshney, Ph.D., CFA



Sanjay Varshney is Professor of Finance and Dean of the College of Business Administration at California State University, Sacramento. At age 31 he became one of the youngest deans in the country to lead a business school. His prior experience includes working at University of San Francisco, Citigroup, Arthur Anderson, and as a portfolio manager. He earned an undergraduate degree in Accounting and Financial Management from Bombay University, a Master's degree in Economics from the University of Cincinnati, and a Ph.D. in Finance from Louisiana State University in Baton Rouge. He also holds the Chartered Financial Analyst (CFA) designation. Dr. Varshney serves as the Chief Economist for the Sacramento Business Review.

Anna Vygodina, Ph.D.

Anna Vygodina is an Associate Professor of Finance in the College of Business Administration at California State University, Sacramento. She holds Ph.D. degree in Finance from University of Nebraska, Lincoln and MBA with Economics minor from University of Nebraska at Omaha. Anna's research interests are in exchange rates, speculative tensions and heterogeneous expectations in the capital markets.

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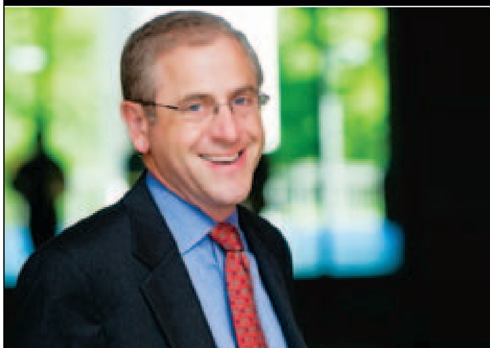

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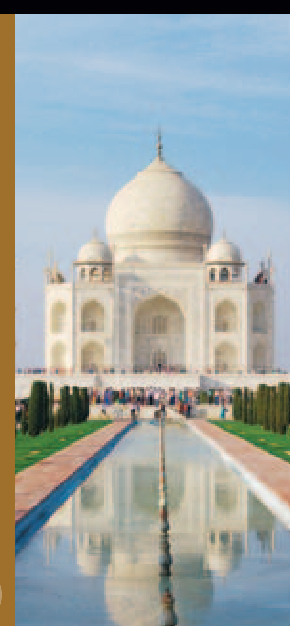
Joe Antognini | Professor, Department of Anesthesiology and Pain Medicine | Department of Neurobiology, Physiology and Behavior | UC Davis Health



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