July 2012

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BUSINESS REVIEW

UPDATE

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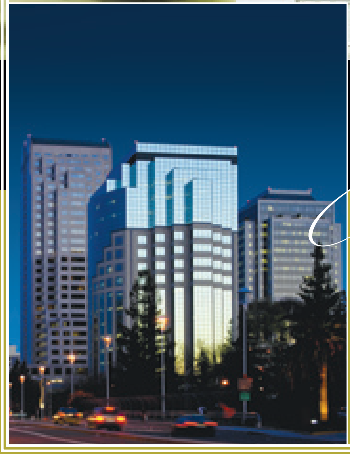
Emerging Trends in Sacramento's Economy



Your Best Guide to Sacramento's Economy

2012 Mid-Year Update

CFA SOCIETY OF SACRAMENTO

SACRAMENTO STATE
COLLEGE OF BUSINESS ADMINISTRATION

July 2012

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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 180 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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The College of Business Administration at California State University, Sacramento is the Capital region's educational institution of diversity that provides a strong foundation in business knowledge, skills, and values through collaboration among faculty, staff, and students in order to enrich their respective communities.

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The mission of the Institute for Business Research and Consulting (IBRC) in the College of Business Administration (CBA) at California State University, Sacramento is to satisfy research and business consulting needs of the greater Sacramento region. The IBRC provides sophisticated expertise and innovative business solutions to clients in areas such as business forecasting, economic impact studies, financial feasibility analysis, business process improvement, marketing, product development and pricing, entrepreneurship, strategic management, and business plan development.

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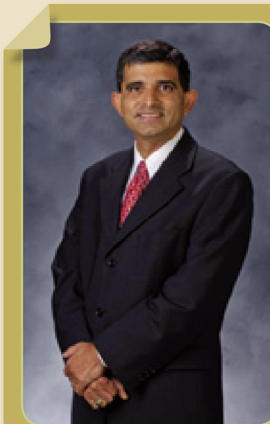
Message from the Dean

Dear Friends,



I am pleased to share the eighth edition of the *Sacramento Business Review* - the most comprehensive, precise, and intellectually sophisticated analysis of the regional economy. For over four 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. I want you to know that none of the analysts who produce the SBR forecast receive any monetary benefit or compensation, and do this work entirely as a public service to the region.

Unambiguously, our analysis shows that the regional economy bottomed out in 2011. Employment has stabilized and a slow recovery has been underway these past few months. Our new **SBR Financial Conditions Index** has stayed mostly flat because not much has changed to boost the anemic economic engine that still sputters in the absence of meaningful job growth or a stable housing market.

For the remainder of 2012, we expect the regional unemployment rate will hover in the 10-11.5% range with prospects for spending and job growth mostly unchanged. The residential market will continue its search for a bottom, while other real estate sectors will find more stability. While many of the banks generated higher profits last year driven by lower loss provisions, loan growth weakened in the absence of good investment opportunities. Our **Small Business Confidence Index** shows sustained optimism despite weakening credit conditions and declining SBA lending.

Policy uncertainty, election outcome, year-end fiscal crisis, weak global outlook, and regulatory constraints will weigh heavily on the regional economy making economic fundamentals take a back seat. Once the clouds dissipate and more certainty emerges, we are more optimistic about 2013.

Our team is 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
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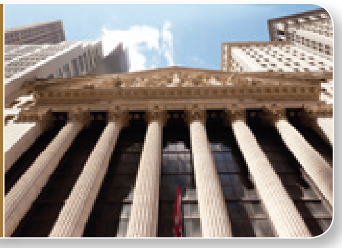


REAL ESTATE TRENDS IN THE SACRAMENTO REGION page 6

UPDATE

Sacramento's Labor Market & Regional Economy: 2012 Mid-Year Update

The first half of 2012 has unfolded largely as expected – a moderate slowdown in economic activity, underpinned by an uncomfortable level of uncertainty for Sacramento businesses and consumers. While the region continues to add incremental jobs at a very modest pace and local housing is showing some signs of improvement, we believe the rest of 2012 will witness little change to the elevated unemployment levels and slow spending growth in Sacramento.

Expect a Stubbornly High Unemployment Rate

The Sacramento regional labor market continues to improve, but as we have suggested before, the recovery process is taking a long time, with some starts and stops along the way. In line with our most recent forecasts, the regional unemployment rate has dropped to the 10-11.5% range in 1H 2012 ending at 10.8% in June – comparable to the rate for California (10.7%) but still well above the US unemployment rate of 8.4% (not seasonally adjusted). We still expect the local unemployment rate to stay largely in this low double-digit range for the rest of the year, as many businesses delay hiring decisions until the level of uncertainty diminishes. Nevertheless, the 12-month moving average of monthly job change has been positive for three consecutive months now, signaling that the underlying job growth trend remains positive (see Figure 1). That said, we estimate the underemployment rate, which reflects labor underutilization, remains in the 18% range, with a large number of discouraged workers still waiting for the local economic picture to further improve before rejoining the labor pool.

Uncertainty Hindering Potential Growth

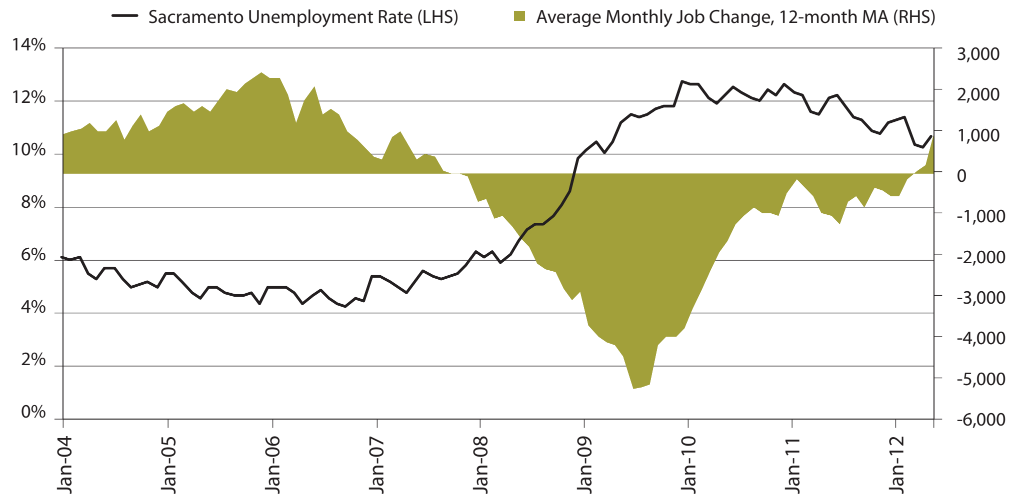
While we still believe there are reasons to be optimistic about the longer-term prospects for growth in the local economy, we expect that until the cloud of policy uncertainty abates, which is unlikely before the presidential election, economic and employment growth will continue to disappoint. A few years into the deleveraging cycle, the balance sheet of businesses and consumers have significantly improved and falling gas prices have likely recently added to disposable personal income. Nevertheless, business hiring and consumer spending have failed to rebound in line with past economic recoveries. We believe one of the main culprits is a lack of confidence. Fears around the impending year-end fiscal cliff, the European debt crisis and policy uncertainty before the election, have led decision-makers to exercise increasing caution about spending and hiring in this environment.

To be clear, the local economy continues to battle fundamental headwinds from the downturn as well. Personal income growth is modest, lending standards remain tight, fiscal tightening is expected at the state and local levels and many workers have been unemployed for an extended time. Furthermore, even though the regional housing market has shown some improvement, we expect the vast shadow inventory of foreclosure and distressed properties will make a significant acceleration in new construction and prices unlikely. Yet despite these negative headwinds, we believe employment and economic growth would certainly be higher if not for this cloud of uncertainty.

This is where economics meets politics head-on in this global economy. We would like to believe that Washington or European states can quickly come to a bi-partisan or multi-country agreement on fiscal policy, but history suggests that the political will necessary to reach tough agreements too often comes at the last minute or in response to periods of severe distress when the sense of urgency is highest. Our forecasts assume that resolution with the fiscal cliff and European solvency will eventually be reached, but not without a journey through intense brinkmanship and market volatility over the next year. In light of this, we continue to expect local economic and employment growth to be subdued over the rest of 2012 and into early 2013.

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

Figure 1
Average monthly job change turns positive



Source: EDD

Table 1
Sector-by-sector 2H 2012 growth outlook for the Sacramento labor market

Key Sectors	% of Local Economy	Expected Average % Change Y/Y	Change vs. Last Forecast	Comments
Government	27.6%	-1% to -2%	↓	Fiscal budget tightening (at federal, state and local levels) will continue to impair job growth.
Ed & Healthcare	12.8%	+3% to +4%	↑	Revised data shows even more consistent growth. Full recovery mode supported by strong fundamentals due to aging population. Near-term uncertainty around policy has abated.
Business Services	12.6%	flat to +1%	↓	Data was revised downwards. Corporate hiring and spending will be muted near-term given uncertain market and policy outlook, but positive cyclical forces should eventually kick in.
Retail	11.0%	+1% to +2%	↑	Healthier household balance sheets and lower gas prices should help support consumer spending, but weak job and income growth and uncertainty will dampen retail sales growth.
Leisure	9.9%	flat to +1%	–	Data was revised sharply downwards. We still expect subdued growth until consumer sentiment meaningfully picks up.
Financials	5.7%	flat to +1%	↑	More signs of positive growth, but tepid loan demand, relatively tight lending standards, and margin pressure will keep financial services firms from meaningful hiring in 2012.
Construction	4.7%	flat to +1%	–	Data was revised sharply downwards. Nevertheless, we are seeing signs of strength in housing and expect private construction jobs to grow modestly off of depressed levels.
Manufacturing	3.9%	-1% to flat	↑	Data was revised upwards. Activity has slowed as equipment spending has slowed and export markets are weaker due to a stonger dollar and weaker foreign demand.

↑ = we expect **higher** employment growth in 2012 vs. our mid-year forecast
↓ = we expect **lower** employment growth in 2012 vs. our mid-year forecast

This information is for educational purposes only...see full disclaimer on page 3.

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, Citigroup and Goldman Sachs. As of our publishing date, the most recent monthly unemployment rate reading for Sacramento was for June 2012. 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.

UPDATE

Real Estate Trends in the Sacramento Region

At the halfway point of 2012 the Sacramento real estate market sits largely where it began the year - inconsistent with some sectors on the path to recovery (apartments, retail, and despite a "speed bump" industrial), one still debilitated (office), and yet another one somewhere in between (residential). We see the markets largely bumping along in much the same way through the rest of the year.

Commercial Leasing

- While the office market is far from gaining any meaningful traction, it recorded two consecutive quarters of positive net absorption in 2012, marking the first time occupancy has increased during consecutive quarters since the first half of 2007. Despite this, regional vacancy remains essentially unchanged and highly elevated at 23.5%. Office sector demand is largely being driven by the healthcare sector, while austerity measures have resulted in a lack of public sector requirements and even consolidation. Downsizing, consolidation, upgrading, and blend-and-extend renewals will continue to dominate the landscape during the second half of the year.
- The retail sector is a relative bright spot, having experienced five consecutive quarters of positive absorption and ten successive quarters of declining vacancy rates. The backfilling of second generation big box space continues to drive retail leasing as national and regional retailers take advantage of long-term affordable lease rates. While non-anchored strip centers continue to struggle, vacancy and lease rates in some well-located Class A community/power centers are approaching pre-recession levels.
- The industrial sector hit a proverbial "speed bump" in its slow ascent from the bottom with over 1 million square feet of negative net absorption recorded in the first half of 2012. However, this is due primarily to one event - Hewlett Packard vacating 800,000 square feet in Woodland. Two potentially market defining transactions took place in the first half of 2012: Ridge Capital purchased the 290-acre, shovel-ready Southport Business Park and Indcor took control of the 23 million square foot West Coast Industrial Portfolio of which 1 million square feet is located in the Sacramento region. Both transactions resulted in the resetting of the owners' cost bases, which should allow these properties to attract national tenants to the region at competitive lease rates.
- The apartment rental market continues to be the healthiest of all property types with occupancy hovering in the 93-94% range and average rents up 3% year-over-year. Rent growth has been primarily limited to the highest quality properties while rents at lower quality properties have largely been flat. Look for this sector to continue to perform well through the remainder of 2012 and beyond, and for strong and widespread rent growth to occur once the employment picture improves.

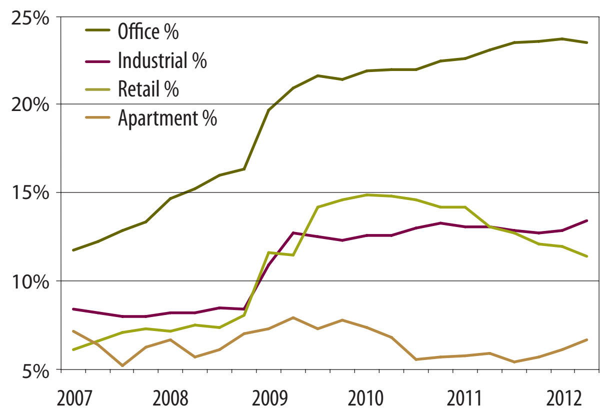
Investments

- As anticipated, we are seeing an increase in capital "overflowing" to our region from the Bay Area and other core markets in search of better yields.
- State-leased properties are more difficult to sell than before. The State's budget woes and their attempt to insert an "appropriations" clause into leases have tarnished their image, causing investors to underwrite State-leased properties in a more conservative fashion.
- Capitalization rates (current yields) across commercial properties have not moved much. Stabilized office and industrial properties are trading between 8.5% to 9.5%. Stabilized retail properties are trading a bit more aggressively these days, between 8.0% and 9.0%, reflecting this sector's slowly improving rental fundamentals.

Marc Ross, CFA, Real Estate Investment Broker, *CBRE, Inc.*
Sudhir K. Thakur, Ph.D., Associate Professor, *College of Business Administration, Sacramento State*

- The financing environment for investors has become slightly more favorable during the first half of 2012 - interest rates have dropped 40-50 basis points. However, lenders continue to prefer conservative loan-to-value ratios (e.g. 60%-70%) with recourse provisions on commercial properties.
- Apartments continue to be the favored asset class in all of real estate. Capitalization rates are in the low 5.0% range for the highest quality/best located properties up to the mid 6.0% range for stabilized B-/C+ properties. Debt options have never been more favorable, with interest rates below 4.0% and loan-to-value ratios in the 70%-80% range, providing positive leverage and highly attractive cash-on-cash return projections.

Figure 1
Sacramento MSA Vacancy Trends

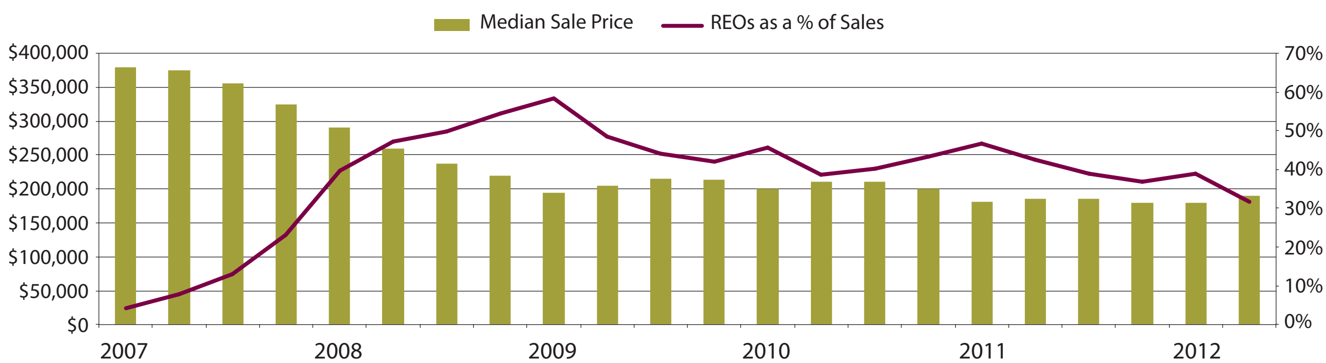


Source: CBRE

Residential

- The median sales price stabilized 18 months ago and has since hovered around $185,000. This equates to 2001 pricing for the region and represents a 56% decline from the peak in 2005. Pricing on a per square foot basis is down slightly year-over-year during the first half of 2012 with Yolo County experiencing the largest decline (-9.20%). West Sacramento (-11.20%) and Davis (-11.06%) are largely responsible for the drop. North Highlands (5.56%) was the only community with a meaningful gain in sale price per square foot.
- The percentage of REO sales dropped during the first half of 2012 from roughly 37% to 32%. Likely tied to the decrease in distressed sales, the number of home sales between $200,000 - $600,000 increased 12% in Second Quarter 2012 over the same period last year, while home sales under $200,000 grew by a modest 3%.
- New home sales are up nearly 20% during the first half of 2012 over the same period last year (1,070 vs 897), causing some homebuilders to begin to purchase finished lots again. However, we see the jump in new home sales being fueled more by the lack of alternatives (there is an extremely low inventory of existing homes for sale), frustration with the REO/short sale transaction process, and competition in the resale space from all-cash investors than from the return of classic demand drivers. The three most active master-planned communities in the region are located in Roseville (West Park and Fiddyment Farm) and Elk Grove (Madeira).

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



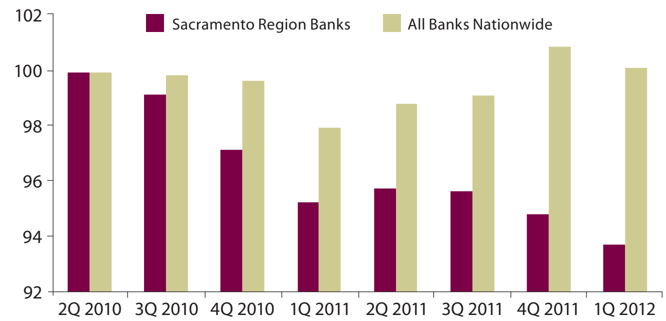
Source: MDA DataQuick

UPDATE

Banking Industry Update

Banks Continue to Improve Profitability via Lower Loan Loss Provisions

Figure 1
Gross Loans and Leases (Indexed) | Sacramento Region Banks & All Banks Nationwide | 2Q 2010 – 1Q 2012



Data Source: FDIC

In January's *Sacramento Business Review (SBR)*, we predicted that a lack of substantial loan demand from creditworthy borrowers, coupled with a flatter yield curve, would make it more difficult for local banks to increase their net interest income this year. We also forecasted that it would become tougher for banks to improve their bottom lines significantly, as year-over-year gains from lower loan loss provisions diminish throughout the course of 2012.

So far, these predictions are playing out mostly as expected. That said, our call for a pickup in local bank merger-and-acquisition (M&A) activity, which we initially thought would occur by late 2011, still has not come to fruition. We remain convinced that M&A activity involving the Sacramento Region Banks[1] is inevitable given the banking industry's longer-term growth challenges.

Regional Loan Growth Diverges from Growth Nationwide

Figure 1 illustrates how the Sacramento Region Banks have experienced declining loan balances during the past several years. Through the beginning of 2011, the declines paralleled those from the FDIC's composition of *All Banks Nationwide*. During the past year, however, we have observed a divergence in loan growth between the local banks and all FDIC banks nationwide. Part of this divergence can be explained by the fact that the Sacramento Region Banks have less exposure to Commercial & Industrial (C&I) loans, which have grown at a healthy pace since 2010. But a more significant factor is that the Sacramento region's economy has lagged those in many parts of the country since the national recovery began in 2009. This tepid recovery on the heels of such a severe recession has drastically limited the number of creditworthy borrowers locally.

Although we are encouraged by anecdotal evidence of increasing loan demand here in the region, we do not expect new loan volumes to increase materially throughout the remainder of the year. This projected lack of loan growth, coupled with further interest-rate spread compression (thanks to falling longer-term interest rates), is the onus behind our call for continued difficulties increasing top-line net interest income.

Lower Loss Provisions Drive Profitability

Table 1 provides evidence of how the Sacramento Region Banks, in aggregate, have had difficulty growing their net interest income over the past year.

Fortunately for most local banks, loan loss provisions continue to decline significantly. For example, loss provisions during the past six months for the Sacramento Region Banks (in aggregate) fell by 52.0% (when compared with the same time period last year). This substantial decline helped the banks increase their bottom-

Jonathan E. Lederer, CFA, **Investment Strategist,** *Wells Fargo Private Bank*

Anna V. Vygodina, Ph.D., Associate Professor, *College of Business Administration, Sacramento State*

Table 1
Income Statement for the Sacramento Region Banks (in Aggregate) | $s in 000s

	4Q 2011 to 1Q 2012	4Q 2010 to 1Q 2011	Year/Year % Change	2Q 2011 to 3Q 2011	6 Months % Change
Interest Income	$246,070	$253,094	-2.8%	$247,344	-0.5%
Interest Expense	(23,190)	(32,131)	-27.8%	(27,248)	-14.9%
Net Interest Income	222,880	220,963	0.9%	220,096	1.3%
Provisions for Loan Losses	(24,023)	(50,028)	-52.0%	(36,738)	-34.6%
Noninterest Income	46,713	51,759	-9.7%	49,050	-4.8%
Noninterest Expense	(173,755)	(174,343)	-0.3%	(169,556)	2.5%
Pretax Income	71,815	48,351	48.5%	62,852	14.3%
Net Income	**$51,853**	**$35,620**	**45.6%**	**$43,235**	**19.9%**

Financial information for the banks analyzed in January's SBR was as of September 30, 2011. The six-month period referenced reflects data through March 31, 2012 since June 30, 2012 data has yet to be released.

Data Source: FDIC

line net income by 45.6%. However, when compared with the prior six months (see right hand side of Table 1), provisions declined by 34.6%, and net income rose by 19.9%. We expect this trend, where provisions drop and net income increases at a diminished rate, to continue during the latter half of 2012.

M&A Activity: Waiting for Godot?

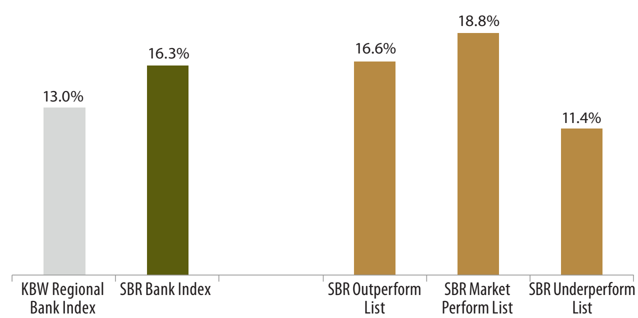
As mentioned previously, we had initially expected a pickup in local bank M&A activity back in late 2011. A lack of top-line growth opportunities along with rising cost pressures resulting from greater banking regulations provided the impetus for our belief that M&A amongst the smaller local banks would be a matter of when (and not if).

While most banks have been able to improve profitability on their own in recent quarters given their declining loss provisions, there is only so much juice that can be squeezed from that lemon. Should loan growth remain weak and net interest margins compressed, banks will be hard-pressed to substantially improve their bottom lines down the road. Therefore, we remain convinced that M&A activity will eventually occur.

Publicly Traded Local Bank Recommendations

Thanks to improved profitability at many local banks, the SBR Bank Index[2] delivered a healthy 16.3% return during

Figure 2
SBR Bank Index / 2012 Stock Rating Lists | Year-to-Date (through June 30) Total Returns



Data Source: FDIC

the first half of 2012. This return exceeded that of the widely referenced KBW Regional Bank Index's 13.0% increase. Figure 2 details how each SBR stock rating list performed (on a capitalized-weighted basis) through June 30.

1 The Sacramento Region Banks include American River Bank, Bank of Sacramento, Community 1st Bank, Community Business Bank, El Dorado Savings Bank, Farmers & Merchants 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, Sutter Community Bank, and Tri-Counties Bank.

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

UPDATE

The Small Business Economy
Strong Headwinds Ahead

Small Business Confidence Index (SBCI) Yields Mixed Signals

As widely expected, the Sacramento regional small business economy appears to have run into strong headwinds with political and regulatory uncertainty associated with year-end elections. Businesses appear to stay in a holding pattern and have adopted a "wait and see" approach. Small businesses are especially vulnerable to the expiration of Bush era tax cuts this December as many of them are sole proprietors. Job growth in the region has been tepid at best, and lack of confidence appears to be primarily responsible for a lack of business reinvestment in new hires.

The region continues to struggle to create new jobs, trails the state in economic recovery, and remains persistent in more negative (than positive) news. A recent study showed Sacramento ranked 8th from the bottom in economic growth among the 100 largest metropolitan cities in the U.S.

Lenders tighten standards and credit dries up

The beginning of the year saw financial markets stabilize somewhat, and access to credit improve dramatically over the first half of 2011. SBA lending provided some early signals for optimism but the cause for celebration appears to be short-lived. During the first 8 months of 2012, the total dollar volume of SBA loans approved in the Sacramento MSA decreased by approximately 37% from the previous year (Figure 1). Banks continue to stay conservative and lenders appear to chase a small and declining portfolio of high quality borrowers. While the first half of 2012 has brought a sharp decline in lending activity, small businesses can take small comfort in the fact that leading levels remain higher than those in 2010.

Our proprietary Small Business Confidence Index (SBCI) supports the data on decreased lending levels – SMEs have turned less optimistic on access to bank credit (Figure 2). Consistent with continued demise of manufacturing in the region with resultant job losses, SMEs in the manufacturing sector appear much more pessimistic on access to capital (Figure 3).

Economic outlook remains positive, despite challenges

In spite of regional challenges that run deeper than those in the rest of the state and in the nation, SMEs expectations of near term economic outlook and local supportiveness remain positive. Ironically, despite weak business growth with a number of business establishments declining, SME expectations improved from those from the last period (Figure 2). As expected, SMEs from the service sector foresee a more positive future for the next 6 months relative those in the manufacturing sector. A similar result holds regarding perceptions involving business support (Figure 4).

As California struggles to resolve its budgetary crisis, the state and region remain unattractive for doing business. This loss of confidence is consistent with job losses in the manufacturing sector with many more businesses leaving the state.

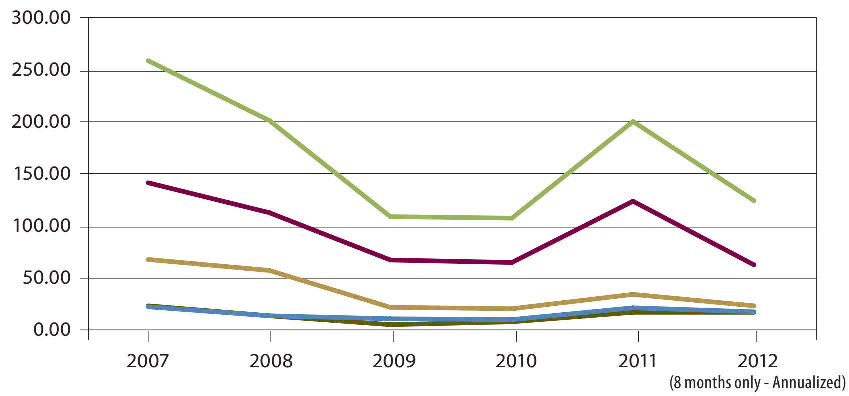
SMEs cling to hope for better days ahead

Despite the mixed signals regarding the economic outlook and credit accessibility, SMEs still remain optimistic regarding prospects for future business revenues and new hires. While unemployment is often a lagging indicator of the economy, we believe this optimism regarding future revenues and job growth may signal business intent to begin reinvesting once the clouds of uncertainty dissipate.

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

Much depends on the election outcome this coming November. Policy and ideology will drive business expectations. The hopes of the small business sector are precariously balanced, and one can only hope that policy makers will wake up to this call of crisis and take actions to restore the faith and confidence and get the economy moving forward.

Figure 1
Total Dollar Value of Small Business Loans Approved in Sacramento MSA (in Millions)



Data Source: U.S. Small Business Administration

Figure 2
Small Business Confidence Index Trend

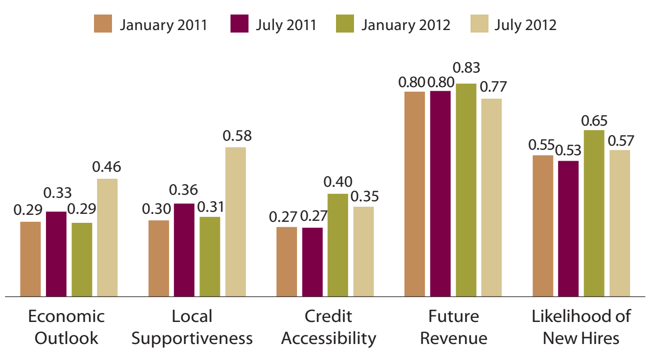


Figure 3
Small Business Confidence Index Trend • Manufactuing Sector

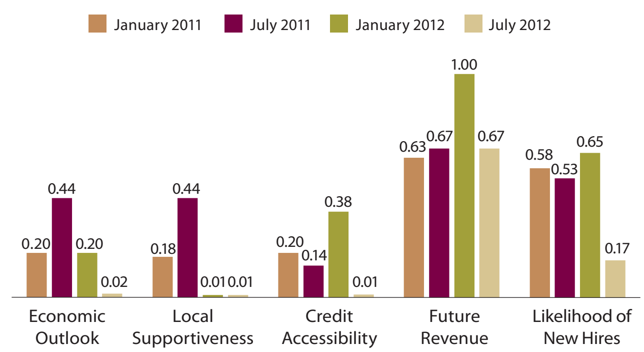


Figure 4
Small Business Confidence Index Trend • Service Sector

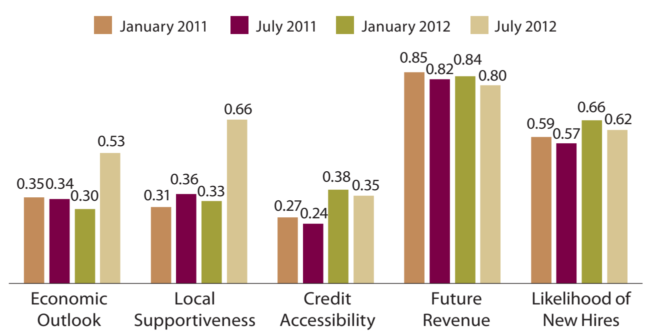
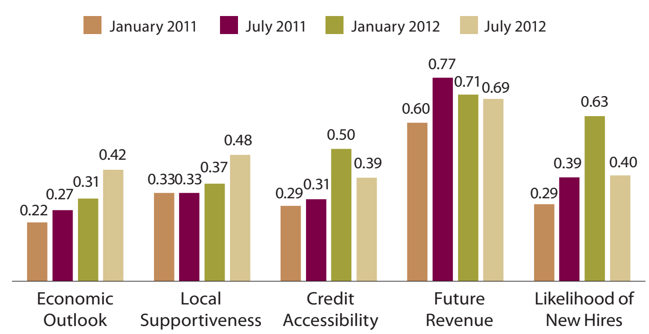


Figure 5
Small Business Confidence Index Trend • "Others" Sector



UPDATE

2012 Capital Markets Outlook

Our key point in January was that the capital markets would be dominated by policy action, not investment fundamentals, and to a large degree this has transpired over the first half of the year. A recap of the 2012 predictions, as well as their current status, is listed below:

Market	January Outlook	Updated Comment
Economy	Recovery-mode	On track, Europe remains wild card
Growth	Sluggish, but positive	Growth slowing, estimate revisions trending lower
Inflation	Weak	Inflation pressures easing, deflation fears reemerging
Stocks	Mildly bullish	1H volatile as expected; markets set for 2H run?
Regions	US, Emerging Markets	US best, Emerging marginally beating Eurozone
Sectors	Energy, Technology	Tech 2nd best sector YTD, Energy worst as oil prices fall
Bonds	Flat, but headwinds	Bond prices still rising but rate of change slowing
Regions	US, UK	US/UK outperformed, nearing time to swap to Bunds
Sectors	Corporates, Munis	Corporate and munis outperforming gov't bonds
Commodities	Weak, but stabilizing	Growth scare + strong Dollar = commodity headwinds
Sectors	Oil, Gold	Watch for 2H rebound if China reaccelerates

Macro Themes

Global growth is slowing as the impact of Europe's recession continues to weigh upon the rest of the world. Once again, the monetary policy spigots are wide open, but fiscal policy response is mixed as investors focus on three key issues:

- **Fate of the Euro** – the sovereign debt/common currency drama continues to plod along with little substantive progress to date. On a positive note, EU leadership is now openly discussing ways to move to a more integrated banking union, though Germany is still resistant to the idea. We believe that the Euro situation will be resolved in an orderly fashion, ultimately resulting in some form of debt mutualization and a corresponding establishment of a common banking authority; however, this outcome will take many years to be realized.

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*

- **US Economy/Elections** – the term "fiscal cliff" entered the global lexicon in February as Chairman Bernanke reminded the world of the impending tightening of US fiscal policy. The potential impact is severe and significant, with estimates that a full sequester could shave anywhere from 2%-4% off of 2013's GDP growth. Odds of this outcome are low, but not trivial. Our best estimate is that the current Congress reaches a short term compromise/extension, setting up the real debate for 1H 2013.

- **Chinese Economy** – the sustainability of China's economic growth rate is becoming more of the centerpiece of investment conversations, and concerns are rising as recent economic data has softened. Our view remains that the Chinese economy is in transition towards reacceleration. Though soft export data is troubling, our confidence is bolstered as key housing and credit growth measures are holding up well and the domestic policy stance has moved towards more easing.

Equity Markets

Broad equity markets should end the year higher from current levels, but will be subject to flare ups in the Euro debate and posturing surrounding the outcome of US fiscal policy. Expect more volatility in the second half of the year. Sentiment towards equities is near trough levels and earnings expectations have come down, setting up a low bar for positive surprises. We are sticking with our call to overweight US and emerging markets relative to Euro-area shares. The latter are meaningfully undervalued, but lack a catalyst to sustain higher levels. We will likely upgrade our view over the next 12 months, as EU leaders reach more milestones towards a lasting resolution.

Credit Markets

Persistent uncertainty, tepid inflation and central bank intervention will keep US government bonds in a low band trading range. Valuation is but one input to investment strategy and while US Treasuries are overvalued, they will likely stay that way for the foreseeable future. We continue to favor spread product over the government sector, namely corporate, municipal and high yield debt. All have outperformed the government sector this year and we expect that trend to continue. Regionally, German Bunds are starting to look interesting relative to US Treasuries.

Commodity Markets

Commodity prices have continued to sell off as China's economy slowed and dollar strength picked up. While in the later stages of a secular bull, we do not see enough evidence that the commodity trade is over just yet. China is key as the massive commodity buyer, and if our view that their economy is transitioning to a reacceleration mode, it stands that a cyclical bull market could be in the works. Like equities, we believe commodity prices will be meaningfully higher by year end and will be watching leading indicators for the telltale signs.

SBR Index July 2012

Although the region's economy has bottomed out in 2011, the recovery has been anemic and our index is little changed over the last six months. We continue to closely monitor the government sector's employment level, which is of critical importance to the region and is under pressure given the State's budget constraints.

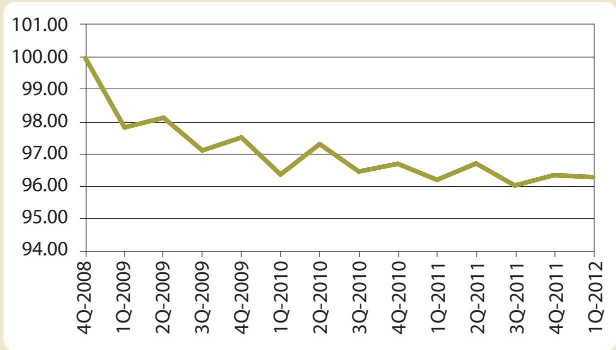


CHART DATA SOURCES:

Employment Development Department
MDA DataQuick
Federal Deposit Insurance Corporation
Sacramento Business Journal Book of Lists
Dow Jones

SOURCES:

1 BCA Research, *Strategy Outlook Third Quarter 2012*, July 6, 2012
2 Ned Davis Research, *Benchmark Focus*, July 2012
3 Wells Fargo Private Bank, *Asset Allocation & Strategy Report*, July 2012
4 Ned Davis Research, *The End parts 1 and 2*, July 2012

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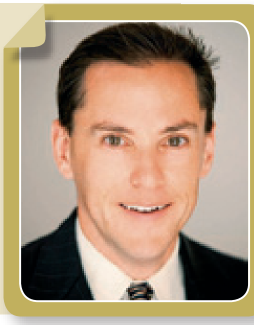

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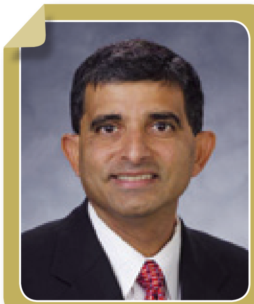

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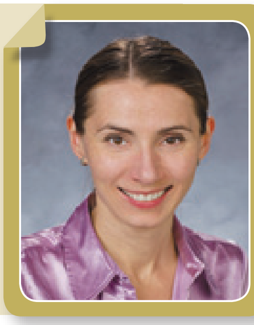

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