July 2013

sacramento

BUSINESS REVIEW

UPDATE

Volume 5 Issue 2 | www.cba.csus.edu

Emerging Trends in Sacramento's Economy

Your Best Guide to Sacramento's Economy

2013 Mid-Year Update

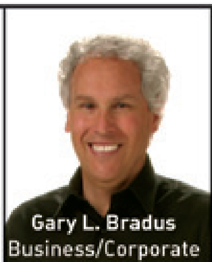
CFA Society Sacramento

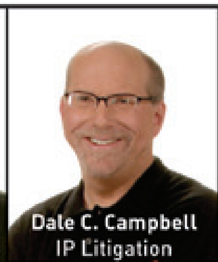
SACRAMENTO STATE
COLLEGE OF BUSINESS ADMINISTRATION

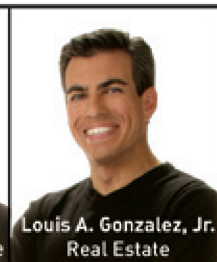
super|cool

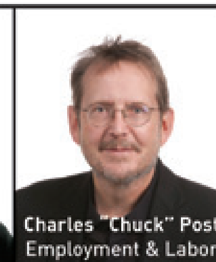
Congratulations to our 7 attorneys who were included in the

Top 25 Sacramento Super Lawyers List for 2013









In total, 29 Weintraub Tobin attorneys were named 2013 Northern California Super Lawyers and Rising Stars

2013 Northern California Super Lawyers

David C. Adams, Securities & Corporate Finance
Brendan J. Begley, Appellate
Gary L. Bradus, Business/Corporate
Dale C. Campbell, Intellectual Property Litigation
Chris Chediak, Business/Corporate
Janet Z. Chediak, Estate Planning & Probate
Jim Clarke, Tax
Edward J. Corey, Jr. Estate & Trust Litigation
Kelly E. Dankbar, Estate & Trust Litigaton
Paul E. Gaspari, Business Litigation
Louis A. Gonzalez, Jr., Real Estate
Shawn M. Kent, Business/Corporate
David L. Krotine, Real Estate
Mike A. Kvarme, Real Estate
Hilary L. Lamar, Estate Planning & Probate
Audrey A. Millemann, Intellectual Property Litigation
Alden J. Parker, Employment & Labor
Scott M. Plamondon, Employment Litigation
Charles "Chuck" Post, Employment & Labor
Lee N. Smith, Environmental
C. Darrell Sooy, Banking
Lizbeth "Beth" West, Employment & Labor

2013 Northern California Rising Stars

Taylor W. Bentley, Business/Corporate
James Brannen, Business Litigation
Shauna N. Correia, Business Litigation
Meagan D. Christiansen, Employment & Labor
Chelcey E. Lieber, Employment & Labor
Jeffrey Pietsch, Business/Corporate
Daniel C. Zamora, Litigation

About Super Lawyers

Super Lawyers is a rating service of outstanding lawyers from more than 70 practice areas who have attained a high-degree of peer recognition and professional achievement. Only 5% of lawyers practicing in Northern California are selected for inclusion annually. Lawyers who receive the highest point totals in the Northern California region are also recognized in the Sacramento Super Lawyers Top 25 List.

weintraub|tobin

weintraub tobin chediak coleman grodin law corporation

weintraub.com

Sacramento | San Francisco | Los Angeles

JULY 2013

sacramento BUSINESS REVIEW

www.sacbusinessreview.com

MISSION

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

CFA SOCIETY SACRAMENTO

Founded in 1991, the CFA Society Sacramento operates as a member Society of CFA Institute. Our membership consists of more than 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.

SACRAMENTO STATE COLLEGE OF BUSINESS ADMINISTRATION

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.

INSTITUTE FOR BUSINESS RESEARCH AND CONSULTING

The mission of the Institute for Business Research and Consulting (IBRC) in the College of Business Administration 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.

DESIGNER

Carrie Dennis, Carrie Dennis Design

SACRAMENTO STATE COLLEGE OF BUSINESS ADMINISTRATION CONTACT INFORMATION

www.cba.csus.edu | (916) 278-6578

Message from the Dean

Dear Friends,

I am pleased to share the 10th edition of the *Sacramento Business Review* – the most comprehensive, precise, and intellectually sophisticated analysis of the regional economy. For more than five years, our team has accurately forecasted the economic and business climate and has provided thoughtful predictions. With 13 of Sacramento's very best financial analysts and researchers combining their skills and talent, the *Sacramento Business Review* (SBR) 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 to 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; they do this work entirely as a public service to the region.

Earlier in the year, our forecast for 2013 was very optimistic. We predicted that real estate markets would see recovery, unemployment would decrease to a high single digit, local banks would continue to improve their financial health, the local government sector would stabilize, and equities would remain the favored asset class with lower systematic risk. **We were absolutely right**.

However, the region continues to face headwinds with unemployment higher than the national average, banks struggling with loan demand to increase their top-line revenue, and small businesses facing tough choices in the face of the fiscal cliff and Affordable Care Act implications. Overall, 2014 promises to bring better news and a stronger economy. Our **Small Business Confidence Index** shows high optimism for the next year. The regional residential housing markets continue to be hot with lack of housing inventory, increasing demand, and low interest rates. The median sales price for the Sacramento region has increased significantly while the percentage of REO sales continues to decline. Our **SBR Index** has shown sustained stability and predicts continued improving conditions for the region. While jobs growth remains weak, the unemployment rate for the region has dropped sharply and should be helped further by improving home values.

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, PhD, CFA,
Vice President for Economic and Regional Partnerships | Dean, College of Business Administration
(916) 278-6578 | ***cba@csus.edu*** | ***www.cba.csus.edu***

Sacramento Business Review is presented by

THE INSTITUTE FOR BUSINESS RESEARCH AND CONSULTING

CFA Society Sacramento

SACRAMENTO STATE COLLEGE OF BUSINESS ADMINISTRATION

Contents 2013 Mid-Year Economic Forecast

SACRAMENTO'S LABOR MARKET & REGIONAL ECONOMY

page 8

REAL ESTATE TRENDS IN THE SACRAMENTO REGION

page 10

Sacramento Business Review *Authors*

Seung Bach, PhD

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 PhD 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 Strategist for Wells Fargo Private Bank, where he manages funds for selected clients and participates in national investment research efforts. He holds the Chartered Financial Analyst designation and a business degree from the University of the Pacific, as well as an MBA from the University of California, Davis. He currently serves as a senior volunteer leader at CFA Institute, representing approximately 10,000 members in the Western United States.

Nuriddin Ikromov, PhD

Nuriddin Ikromov is an Assistant Professor in the College of Business Administration at California State University, Sacramento. He received his PhD in real estate finance from the Pennsylvania State University. Nuriddin's research interests include real estate market efficiency, experimental economics, and valuation.

Jonathan E. Lederer, CFA

Jonathan Lederer is an Investment Strategist for Wells Fargo Private Bank. He 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 held the Chartered Financial Analyst designation since 2003 and is currently Vice President of the CFA Society Sacramento.

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, Brian was a member of the Equity Research team at Deutsche Bank Securities and an investment analyst at a long-short hedge fund in New York City. Brian earned his MBA from the New York University Stern School of Business and an economics degree from Duke University and also holds the Chartered Financial Analyst and the Chartered Alternative Investment Analyst designations. He is also currently President of the CFA Society Sacramento.

Sacramento Business Review *Authors*

Hao Lin, PhD, CFA

Hao Lin is an Associate Professor of Finance in the College of Business Administration at California State University, Sacramento. He has a PhD 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 designation and serves on the Board of Directors of the CFA Society Sacramento.

Lan Liu, PhD, CFA

Lan Liu is an Assistant Professor of Finance in the College of Business Administration at California State University, Sacramento. She received both her PhD in finance and MSc in economics and finance from the University of Warwick in England. Her research focuses on portfolio risk management, forecasting, and performance measurement. Lan holds the Chartered Financial Analyst designation and is the Treasurer of the CFA Society Sacramento.

Joe Niehaus

Joe Niehaus analyzes and evaluates the safety and soundness of community banking institutions for the Federal government. He has worked as an intern in the CalPERS Global Equity and Corporate Governance units as well as at Palo Alto Investors, where he performed data analysis on oil and gas exploration and production companies. Joe graduated from California State University, Sacramento, with a bachelor's degree in finance. Joe also served five years as an Electronic Intelligence Analyst with the U.S. Navy.

Marc Ross, CFA

Marc Ross is a real estate investment broker at CBRE, Inc., specializing in the sale of multi-housing properties in Northern California and Northern Nevada. Marc graduated with his MBA in real estate and finance from the University of California, Davis, in 2001 and has held the Chartered Financial Analyst designation since 2001. He received his BA in economics and business administration from Rhodes College in Memphis, Tenn.

Yang Sun, PhD

Yang Sun is an Assistant Professor in the College of Business Administration at California State University, Sacramento. In addition to his PhD 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.

Sacramento Business Review *Authors*

Sudhir K. Thakur, PhD

Sudhir Thakur received his MA in economics and urban planning from Punjab University in 1996 and University of Akron in 1998, and doctorate degree in economic geography from The Ohio State University in 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, PhD, CFA

Sanjay Varshney is Vice President for Economic and Regional Partnerships 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 the 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 PhD in finance from Louisiana State University in Baton Rouge. He also holds the Chartered Financial Analyst designation. Dr. Varshney serves as the Chief Economist for the *Sacramento Business Review*.

Anna Vygodina, PhD

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

Supporting Sponsors

Wells Fargo — The Private Bank

Sacramento State — College of Business Administration

CFA Society Sacramento

SMUD™

CBRE

weintraub | tobin — weintraub tobin chediak coleman grodin law corporation

UPDATE

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

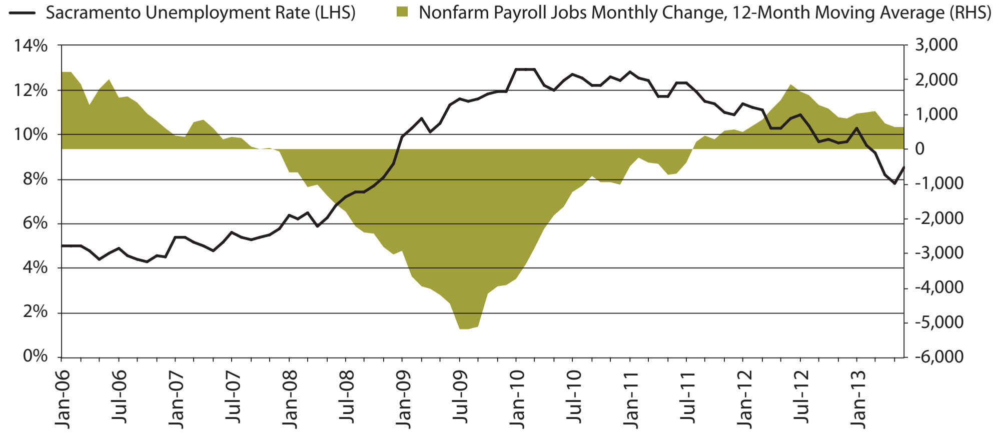
Our initial 2013 forecast expected the unemployment rate of the Sacramento region to fluctuate between 10.5% and 9%, as positive overall job growth would be partially offset by individuals re-entering the labor force. Through the first half of 2013, the drop in this unemployment rate down to 8.5% has moderately exceeded our initial expectations: The Sacramento area has added approximately 25,000 jobs since our January 2013 release (see Figure 1), the largest six-month increase in jobs since March 2000. This compares to an unemployment rate of 8.8% for California and 7.8% for the nation (unadjusted figures). Despite this job growth, the local region has regained only about 37% of the 110,000 nonfarm, payroll jobs lost during the recession, while the U.S. has already regained about 67% of jobs lost.

Looking closer at this sharp drop in the unemployment rate, we must note that only half of the total net jobs added locally since November 2012 were payroll jobs. The other half of the jobs added during the first half of the year were from an increase in non-payroll workers – individuals who were either self-employed, unpaid family workers, household domestic workers, workers on strike, or farm workers. While this growth in non-payroll workers is positive for the region, we believe more traditional payroll job growth would have a larger impact on the broader economy. Over the next year, we expect job growth to keep shifting gradually from the non-payroll workforce to payroll jobs as the economy improves, albeit at a slow yet steady pace.

Unemployment to Remain Near Current Levels for the Remainder of 2013

In light of the recent pickup in job growth, we are revising our initial 2013 estimate for the regional unemployment rate downward to a range of 9% to 7.5% for the next 12 months. There are still a considerable number of individuals on the sidelines waiting to re-enter the labor force. We continue to expect the labor force participation rate to increase as these

Figure 1
Unemployment Rate Drops Despite Only Modest Payroll Job Growth



Data Source: California Employment Development Department

> *"On the whole, we believe the Sacramento region should benefit from continued improvements in the national economy."*

individuals start to look for work again as the economy improves; however, demographic factors such as the large number of baby boomers retiring and leaving the workforce are likely to partially offset this rise in participation rate. Payroll jobs should continue to grow at the modest pace of about 1.1%. This rate of growth is markedly slower than the nation's rate of 1.6% and the 2% long-term job growth rate in the region, but we expect non-payroll job growth to slow from its rapid pace over the last year. As people re-enter the workforce and growth in the non-payroll sector slows, it is likely that the unemployment rate ticks back up over the next few months prior to resuming its downward trend in late 2013 and into early 2014.

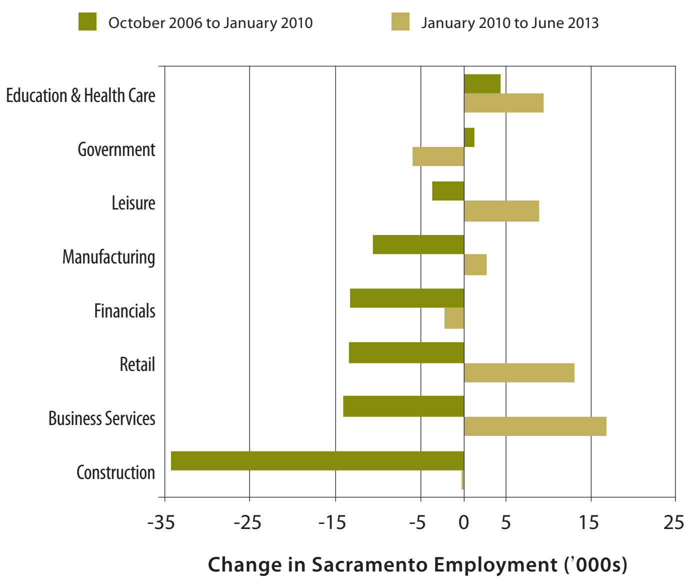
On the whole, we believe the Sacramento region should benefit from continued improvements in the national economy. Economic data from around the country – including home-builder confidence, industrial production, and consumer credit – suggest the broader economy is heading in the right direction and that the housing recovery should be sustainable. The Federal Reserve also increasingly believes there is less negative risk for the national labor market and that inflation expectations remain modest.

Leisure and Business Services Add Back Losses, Construction Slow to Recover

As of June 2013, the leisure and business services sectors have added a greater number of jobs from January 2010 to 2013 than they lost from October 2006 to January 2010, the peak of unemployment (see Figure 2). Education and health care continue to provide a stable level of positive growth. We expect retail to regain jobs lost during the recession in one to two years, and we have started to see moderate job growth in the manufacturing sector; however, we continue to experience headwinds in the government, financial activities, and construction sectors. Construction jobs have not taken off as quickly as we initially thought for the first part of 2013, but a pickup in the number of construction jobs is expected for the coming summer months and into fall as seasonal trends take hold and building continues to recover.

Housing is a key aspect of the local economy as this can drive construction, financial and business services, and

Figure 2
Sectors Are Beginning to Recover Jobs Post-recession



Data Source: California Employment Development Department

promote consumer confidence. Year-over-year increases in the Freddie Mac Home Price Index are approaching levels last witnessed just prior to the recession. We attribute this rapid price increase primarily to a higher proportion of investor cash buyers and tight inventory levels, which have helped pricing bounce off of multi-year lows. Nevertheless, Sacramento home prices remain well below peak levels and are still very affordable compared with other California metropolitan areas. As economic conditions continue to improve, the rate of household formation should rebound, lending further support to the current housing recovery. That said, we will be closely monitoring recent declines in mortgage refinance activity and increasing inventories as potential headwinds for housing prices in the coming year.

As expected, the local economic recovery is gaining more solid footing each year but continues to progress at a modest pace. With housing activity and pricing picking up and government spending on the path to stabilizing, we believe the downside risks have diminished; but a full recovery of jobs lost will continue to be several years off.

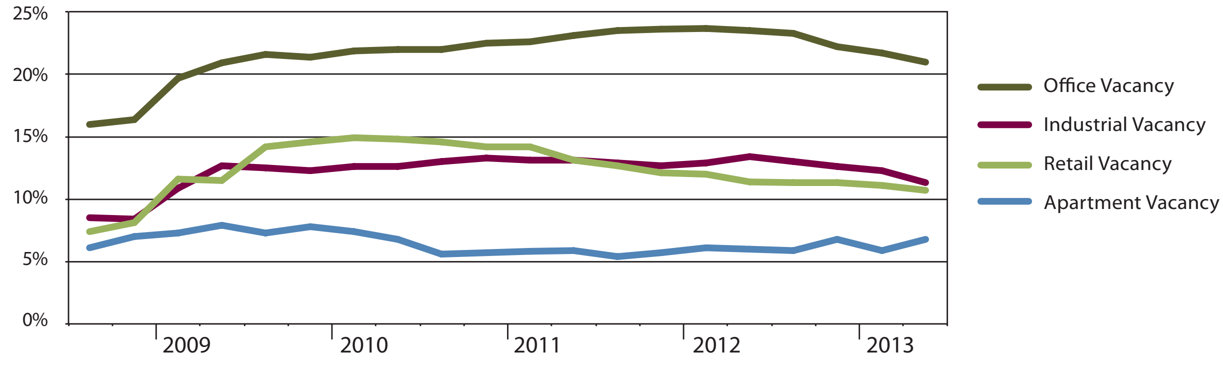
UPDATE

Real Estate Trends *in the* Sacramento Region

Commercial Leasing

- **Office Market** – The office market continues to improve gradually, posting its sixth consecutive quarter of positive net absorption. The vacancy rate, although still highly elevated, dropped 70 basis points to 21% in the second quarter of 2013, the lowest level since the second quarter of 2009. Average asking lease rates were down slightly at $1.65 per square foot, and have now declined for two consecutive quarters after holding steady in 2012. The stubbornly slow climb from the doldrums should continue in uneventful fashion during the balance of the year.
- **Retail Market** – Net absorption was positive for the eighth consecutive quarter, which dropped the vacancy rate below 11% for the first time since 2008. Rent growth is occurring at strong "A" centers, while it remains largely flat at "B" and "C" centers. The trend of discount, dollar stores, and grocery retailers expanding in the market continued during the first half of the year, eating up a majority of vacant mid-box space. Moving into the second half, we anticipate more demand for space at "B" centers as options at "A" locations become scarce.
- **Industrial Market** – We saw the highest quarterly absorption since the third quarter of 2005 occur during the second quarter of 2013 (2,419,739 sq. ft. of net absorption in the first half of 2013). The vacancy rate has now fallen 130 basis points since the end of 2012. The majority of lease transactions were less than 100,000 square feet. While the imminent closure of the 1.6 million sq. ft. Campbell's soup facility will affect absorption numbers later this year, the trend and sentiment continues to be very positive.
- **Multi-Housing** – The apartment rental market remains healthy, with occupancy hovering in the 93%-95% range and average asking rents up 1.25% quarter-over-quarter at the close of the second quarter. More landlords are beginning to invest significant capital in renovations after many years of deferment, with most receiving $75 to $200 more in rent per unit per month. These "value-add" executions will continue during the second half of the year.

Figure 1
Sacramento MSA Vacancy Trends



Source: CBRE, Inc.

> *"The median sales price for the Sacramento region increased even more than anticipated at the beginning of the year."*

Investments

- New capital continues to flow into our region from other coastal markets in search of higher yields and less competition.
- Capitalization rates across commercial properties have trended down slightly. Cap rates for stabilized retail and industrial properties are between 7% and 9%. Stabilized office properties are seeing cap rates between 8% and 10%, reflecting this sector's longer-term recovery cycle.
- Transaction volume is down significantly across all property types through the first half of 2013. However, Broker Opinion of Value requests are up, suggesting sales volume will pick up during the second half of the year.
- With the recent sale of an industrial portfolio owned by the JB Company to Westcore/DRA Advisors at the end of the fourth quarter of 2012, there is a belief that more institutional money will flow into the Sacramento region. However, given Sacramento's lagging economy, many institutions remain cautious about entering the market.

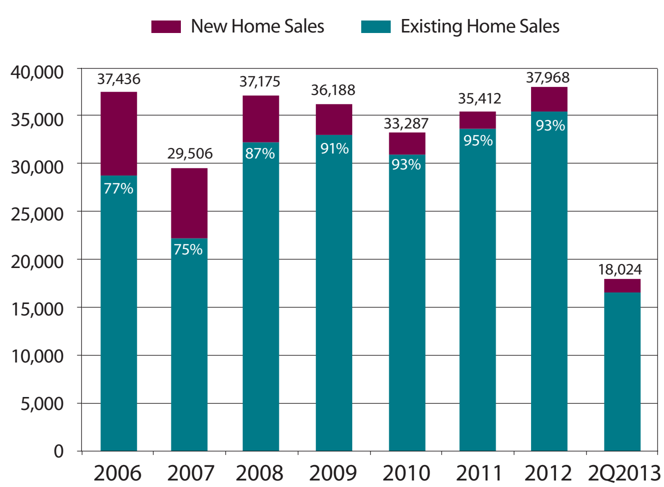
Land

- The regional residential land market continues to be red hot. Fueled by a lack of housing inventory, rising home prices, pent-up demand, and historically low interest rates, public and private home builders are aggressively acquiring finished and tentative map lots.
- Nearly every available finished lot subdivision or easily developable tentative mapped subdivision has multiple offers. Builders are paying double what they would have paid for lots in 2012. Anxious to lock up lot inventory for 2014 and 2015, home builders are chasing up prices. In Roseville, Rocklin, and Elk Grove, approved standard-sized tentative mapped lots are trading at over $70,000 per lot.

Residential

- The median sales price for the Sacramento region increased even more than anticipated at the beginning of the year. The median price for all homes for the second quarter of 2013 was $259,000, which is a 19% increase from the fourth quarter of 2012 ($217,000) and a whopping 35% year-over-year increase ($192,000 in the second quarter of 2012). This equates to 2003 pricing for the region, though it still represents a 38% decline from the peak in 2005. Pricing on a per-square-foot basis is also up significantly (38%) year-over-year during the first half of 2013, with Sacramento County leading the way (39%) and El Dorado County registering the lowest increase in price per square foot, with "only" 26% year-over-year growth.
- While the overall selling activity in the region stayed essentially flat year-over-year, sales of new homes increased nearly 40%, with almost 1,500 new homes sold in the first half of 2013 vs. 1,074 in the first half of 2012. On the other hand, sales of existing homes actually declined year-over-year, with 15,151 homes sold in the first half of 2013 vs. almost 16,000 in the same period a year ago. This shows that the low inventory of existing homes continues to push prices up.
- Another reason home prices have increased as quickly as they have is that the percentage of REO sales continues to decline, with these sales accounting for less than 9% of all homes sold in the second quarter of 2013, a huge decline from the 32% share a year ago. Not surprisingly, sales of homes priced below $200,000 declined year-over-year by as much as 37%, while sales of homes in higher price ranges increased significantly.

Figure 2 – Residential
New Home Sales vs. Existing Home Sales | Sacramento MSA



Source: MDA DataQuick

UPDATE

2013 Sacramento Banking Industry

Mid-Year Update

In January, the *Sacramento Business Review* (SBR) banking industry analysts predicted that the Sacramento Region Banks[1] would continue to have trouble growing their "top-line" net interest income unless loan demand from creditworthy borrowers increased materially. Though many pundits at the time were forecasting a significant ramp-up in borrowing, the SBR team was not as optimistic given the empirical "deleveraging" data from the aftermath of prior financial crises.

As Table 1 illustrates, loan growth has not picked up substantially since the January 2013 SBR was published. In fact, for the local banks in aggregate, total loans have actually declined during the past six months.

The forecast for more subdued loan growth, coupled with a relatively narrow spread between longer-term interest rates (at which banks lend) and shorter-term deposit rates, formed the basis for the SBR banking team's call for weaker top-line net interest income growth. This call has proved correct thus far in 2013, as net interest income for the local banks and all banks nationwide has actually declined year-over-year and during the past six months (Table 2).

Table 1
Loan Growth – Sacramento Region Banks & All Banks Nationwide

	Percentage of Total Loans		Loan Growth (Past 6 Months)		Year/Year Loan Growth	
	Sacramento Region Banks	All Banks Nationwide	Sacramento Region Banks	All Banks Nationwide	Sacramento Region Banks	All Banks Nationwide
Commercial Real Estate	43.5%	14.0%	2.9%	1.3%	5.0%	1.4%
Residential	26.3%	24.5%	-3.3%	-0.7%	0.1%	1.0%
Commercial & Industrial	11.3%	20.0%	-0.8%	5.4%	4.9%	11.6%
Multifamily Residential	3.9%	3.1%	7.4%	3.9%	16.4%	7.2%
Construction Loans	3.0%	2.6%	-11.6%	-4.2%	-9.4%	-11.7%
Other	12.0%	35.8%	-3.6%	0.0%	4.0%	2.5%
Total	**100.0%**	**100.0%**	**-0.3%**	**1.1%**	**3.4%**	**3.3%**

Data Source: FDIC

"Fortunately for the banks, a healthier economy has enabled most to increase their profits by continuing to pare down provisions for loan losses."

Fortunately for the banks, a healthier economy has enabled most to increase their profits by continuing to pare down provisions for loan losses. The SBR banking team thought this would be the case when it stated in the January article that, "Declining provisions have helped the banks increase their net profits in recent years. We expect more of the same during 2013."

This prediction has largely come to fruition. Despite the weaker top-lines, lower loss provisions have enabled most banks to grow their bottom lines (Table 3).

However, considering the finite zero bound for loan loss provisions on the income statement (i.e., loss provisions cannot fall below zero), many locally based banks will likely feel increasing pressure to grow their bottom lines toward the end of the year. Without better loan demand, it is difficult to foresee organic sources of net income growth when one looks out over the next 6-12 months. Thus, the SBR banking analysts continue to believe that merger-and-acquisition (M&A) activity among local banks is inevitable.

Table 2
Net Interest Income Growth

	Past Six Months[1]	Year/Year[2]
Sacramento Region Banks	-2.6%	-3.0%
All Banks Nationwide	-1.0%	-2.0%

1) Figures represent the change in net interest income for the six months ending March 31, 2013, and the six months ending September 30, 2012.

2) Figures represent the change in net interest income for the six months ending March 31, 2013, and the six months ending March 31, 2012.

Data Source: FDIC

Although the team has stuck with this prediction for more than two years despite the lack of M&A activity among the Sacramento Region Banks, the culmination of two mergers involving banks with local operations may reflect the start of a trend. In particular, Central Valley Community Bank early this year announced the acquisition of Visalia Community Bank. Then, in March, PremierWest of Oregon agreed to be acquired by AmericanWest Bank. Furthermore, on one local bank's recent quarterly conference call, an institutional shareholder peppered the management team with questions about why the bank had yet to merge with another institution. This event indicated that the SBR banking analysts may not be the only ones thinking that M&A activity is long overdue.

ENDNOTES

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, 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.

Table 3
Select Income Statement Items for the Sacramento Region Banks in Aggregate ($ in 000s)

	Six Months Ending 3/31/13	Six Months Ending 9/30/12	% Change	Six Months Ending 3/31/12	% Change
Net Interest Income	$216,123	$221,822	-2.6%	$222,880	-3.0%
Provisions for Loan Losses	$10,983	$15,807	-30.5%	$24,023	-54.3%
Pretax Income	$80,858	$78,195	3.4%	$71,815	12.6%

Data Source: FDIC

UPDATE

The Small Business Economy

Small Business Confidence Index Optimism at Record High

The local small business community continues to be optimistic across all our measures: economic outlook, local supportiveness, credit accessibility, future revenue, and likelihood of new hires for the next six months. All measures are now at record highs since our Small Business Confidence Index (SBCI) was introduced in 2011. Confidence in the near-term economic outlook increased to 0.88 – another 20% increase since last January. Both credit accessibility and likelihood of new hires, while strong, have leveled off for the last two terms.

SBA Lending Increases But Remains Tight

During the first eight months of FY 2012-2013, the total dollar amount of SBA loans approved in the Sacramento MSA increased by approximately 3.5% from the previous year. Sacramento County, the largest county in the region, saw a decline in SBA lending by 3.1%. However, the rest of the counties gained between 4% and 26%. Overall, the SBA loan volume is still below both the pre-recession level as well as the 2011 peak level.

Manufacturing Sector Cools Off

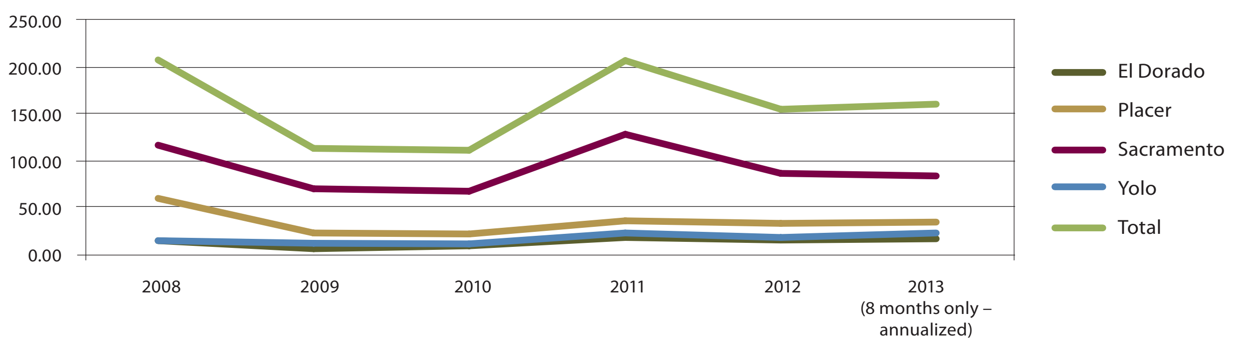
Small and Medium Enterprises (SMEs) in the manufacturing sector continue to hold high hopes for near-term prospects but are more cautious this time than they were six months ago. The confidence in the general economic outlook is at a record high of 0.9 compared to a bottom low of '0.02' last summer; the future revenue prospects have also continued to improve since January. The measures of local supportiveness, credit accessibility and likelihood of new hires, however, declined after dramatic improvements in the January survey – reversing perhaps some of the exuberance exhibited earlier. Overall, the manufacturing sector is still much more optimistic than it was one year ago. The service sector continues to enjoy high confidence across all measures. Other sectors also continue to have high hopes for the economic outlook, but feel less enthusiastic about the local supportiveness, credit accessibility, future revenues, and likelihood of new hires.

SMEs See a Better, But Softer, Business Outlook

Sacramento SMEs are optimistic regarding the future prospects, and this appears to be consistent with overall improvements in the national economy. However, the level of optimism has been softened by tighter credit accessibility in the region. SMEs still face headwinds from a series of tough regulations and changes such as new tax and health care laws. Small businesses have prepared somewhat for this by transforming themselves into more efficient business entities throughout the recessionary period. We expect limited job creation by SMEs in spite of the heightened business and revenue prospects. While Sacramento SMEs will continue to make progress, the speed of any progress will be slow.

"SMEs in the manufacturing sector continue to hold high hopes for near-term prospects but are more cautious this time than they were six months ago."

Figure 1
Total Dollar Amount of SBA Loans Approved in Sacramento MSA (in Millions)



Data Source: U.S. Small Business Administration

Figure 2
Small Business Confidence Index Trends: January 2012 – July 2013

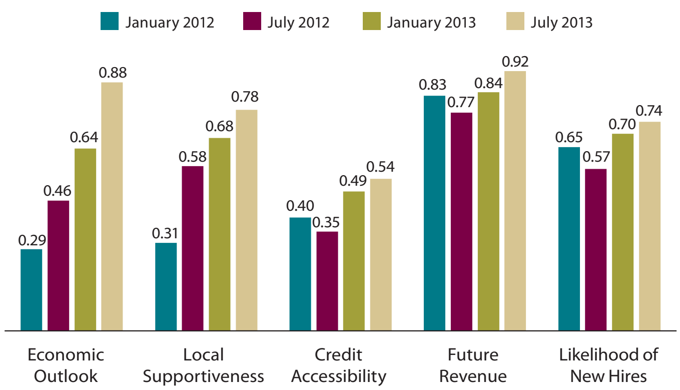


Figure 4
SBCI Trends in the Service Sector

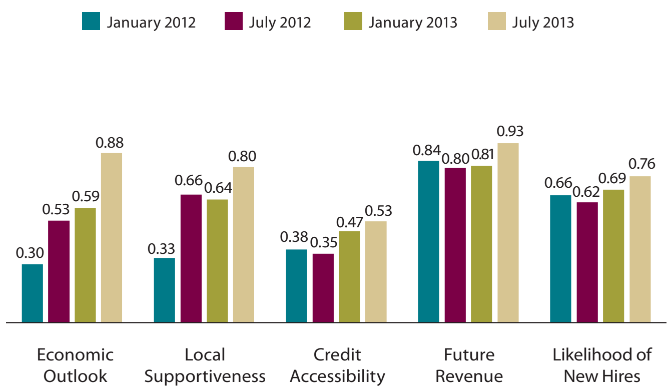


Figure 3
SBCI Trends in the Manufacturing Sector

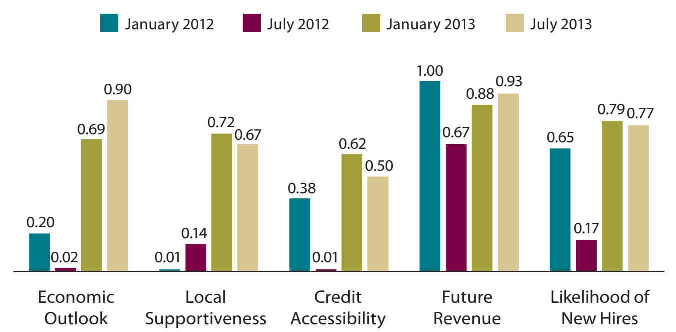
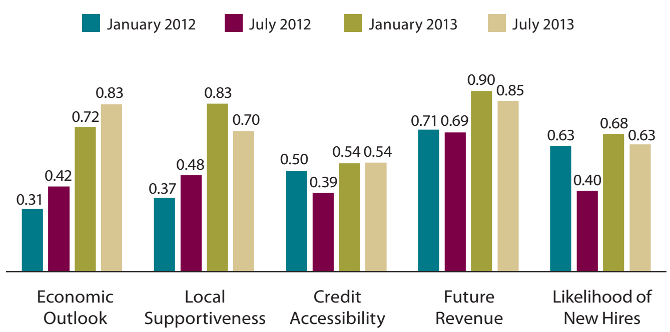


Figure 5
SBCI Trends in the Others Sector



Data Source: U.S. Small Business Administration

UPDATE

2013 Capital Markets *Outlook*

Market	January Outlook	Updated Comment
Economy	Recovery continues	On track, Europe crisis = old news; emerging markets are new wild card
Global Growth	Moderate	Slow as expected, emerging economies stumbling
U.S. Growth	Moderate	Still weak, but still positive and getting stronger
Inflation	Subdued	Inflation nil in the developed world, problematic in emerging
Stocks	Moderately bullish	Equities still look good to us, even at these levels
Regions	International	Did we say that? U.S. should still lead the way in 2013
Sectors	U.S. financials, energy	Financials rocking, Energy, not so much
Bonds	Lean bearish	Is this finally the tipping point? Little value in bondland
Regions	Euro-periphery, Emerging markets	Did we say that, too? Liquidity now compounding the issue
Sectors	US non-government	Still favor credit risk over interest rate risk
Commodities	Trading range	Slowing China + strong dollar = tough sledding ahead
Sectors	Oil, Gold	Oil holding up well, Gold at a critical support point

Our base case for 2013 was that the reduction in systematic risk would lead to a supportive environment for equities, even though global growth would remain subdued due to excessive debt levels. To a large extent, this scenario has manifested itself over the past six months, though not entirely in a manner that we expected. A recap of the January predictions as well as current comment is listed at right.

Global Review

Each time we present our semi-annual update, it seems there is vernacular du jour that dominates the popular headlines. At the time of this writing, the term "taper," coined by Chairman Ben Bernanke in reference to the Fed scaling back its purchases of U.S. debt securities, is all the rage. Not to be outdone by America's central bank, the SBR team has come up with our own term to summarize the current state of world markets: trifurcated. Indeed in observing the investment returns during the first half of 2013, our team has been surprised at the widening trajectory between the world's major economic regions:

- **United States** – Still the one. America has healed many of its structural deficiencies since the financial crisis five years ago. Housing has bottomed and is now a tailwind for the U.S. economy. Advances in U.S. oil and gas production have materially strengthened America's competitive advantage. Manufacturing is growing, and there are steady gains in job creation. To be sure, concerns and questions remain: Will the rise in mortgage rates stymie the housing recovery? When will credit growth (ex-student loan debt) return to a normal level? How sustainable is the U.S. consumer? Our view is that the

"Though U.S. markets are already up strongly this year, we believe the fundamentals within the U.S. economy should provide a sustainable advantage for American stocks of all capitalizations."

U.S. recovery is legitimate, and the broad data give us confidence that America should remain the relative winner over the coming years.

- **Europe** – Painful. Slow. Progress. It's been slightly over a year since Mario Draghi's now-famous "whatever it takes" speech assured the world that the Euro was not (yet, at least) going the way of the Dodo. The banking crisis of 2011-2012 is now but a speck in the rear view mirror; and while EU leaders are still a long way off from forming an inevitably necessary fiscal union, they are marginally closer. The ECB has taken more than a few pages from the Fed's playbook and has kept monetary policy exceedingly loose, with some success: In the periphery, deposit flows are returning, and labor costs as well as deficits are declining. Of course, credit growth is anemic, and many Euro nations continue to be mired in recession. Europe's story remains simple: Systematic risk has receded, but it has not yet been replaced by structural reform that will enable significant economic growth.

- **Emerging Markets** – Tarnished dragon? For the past decade, EMs have been the key drivers of global growth. While their nominal GDP numbers are still significantly higher than those of the developed world, closer inspection of many leading economic indicators reveal a more difficult path ahead. Tight labor markets and rising wages combined with excessive credit growth have created a tinderbox for a potential inflationary fire that could very easily ignite, leaving central bankers with little flexibility. Fluctuations in EM currency levels have exacerbated the issue as reduced liquidity has put a short-term squeeze on asset prices. Regardless, our view is that though EM returns have been meager this year, they are attractively valued from a long-term perspective.

Equity Markets

By far, equities remain our preferred asset class. Though U.S. markets are already up strongly this year, we believe the fundamentals within the U.S. economy should provide a sustainable advantage for American stocks of all capitalizations. From a positioning standpoint, we would overweight U.S. stocks and neutral-weight international and emerging equities, with a tilt towards consumer-sensitive stocks. Economic data should improve in the second half, and we expect stronger growth to offset any negative effects from rising interest rates. Aside from a few specific events this year, volatility has continued to trend lower; and we would not be surprised to see it pick up in the back half of 2013.

Credit Markets

Though bond markets were walloped in the second quarter with fears of Fed tapering and record foreign selling, we believe further large near-term increases in yields are unlikely. While there are structural headwinds facing bonds over the next several years, our view is that the recent sell-off may be a little overdone. Our expectation is for central banks to remain highly accommodative until global growth is significantly stronger. We are much more partial to developed market credit risk (corporate, high yield) over interest rate risk in this environment and believe emerging debt will remain under pressure for some time.

Commodity Markets

Commodity markets have been caught between a rock (slowing Chinese demand) and a hard place (stronger U.S. dollar) since 2011. Is there any relief in sight? Unfortunately, evidence is mounting that the commodity bull cycle may be nearing its end, until 1) sustainable Chinese demand resumes and 2) developed market inflation (and inflation expectations) picks up to a much stronger degree. Both conditions appear distant at this point. We remain comfortable with our call on oil, but clearly gold has been disappointing. Gold is on the ropes: It has fallen through short-term support levels and is now at a critical juncture – we are getting close to throwing in the towel.

Sacramento Business Review Financial Conditions Index • July 2013

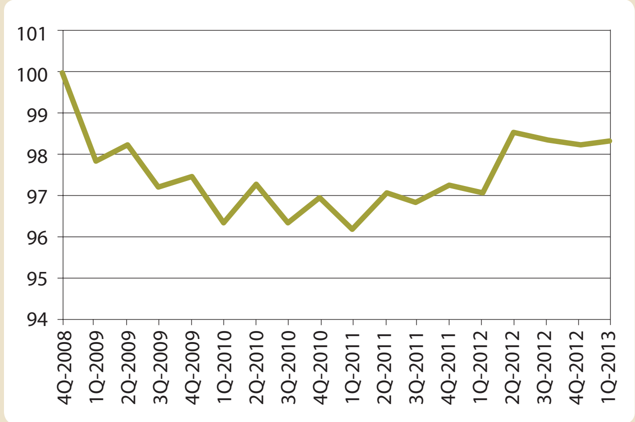
SBR Index Flat Over the Last 6 Months, Expecting Improvements in Employment and Real Estate to Move the Index Higher

Our proprietary SBR index continues to show the region's health has improved from trough levels. Though relatively flat for the first half of 2013, we expect the burgeoning improvement in real estate prices and stabilization of local and state government employment levels to move future readings higher. Below is a brief description of each component of the index:

- **Employment** – the change in total private and government sector employment levels
- **Real estate** – quarterly median home sales prices and quarterly total home sales
- **Small business** – average growth in credit extension from regional SBA data
- **Banking** – gross credit extension from the 14 local banks[1] in the surrounding six counties[2]
- **Capital markets** – share price levels of the 10 largest local publicly traded employers[3]

CHART DATA SOURCES:

Employment Development Department
MDA DataQuick
Federal Deposit Insurance Corporation
Sacramento Business Journal Book of Lists
Dow Jones
U.S. Small Business Administration



NOTES:

1 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, River City Bank, River Valley Community Bank, Sierra Vista Bank, and Sutter Community Bank.

2 El Dorado, Placer, Sacramento, Sutter, Yolo, and Yuba.

3 Intel Corp., AT&T California, Hewlett-Packard, Target, Wells Fargo & Co., Safeway, Pacific Gas & Electric, Union Pacific Railroad, Franklin Templeton, and DST Output.

SOURCES:

Cornerstone Macro, *In Depth Analysis: U.S. Energy Renaissance*, May 22, 2013
Cornerstone Macro, *In Depth Analysis: EM New Normal*, June 17, 2013
Ned Davis Research, *Europe Strategy*, June 17, 2013
Ned Davis Research, *Global Strategy*, July 3, 2013
International Strategy & Investment Group, *Portfolio Strategy Report*, June 11, 2013
Wells Fargo Private Bank, *2013 Global Equity Market Outlook*, July, 2013
Ned Davis Research, *The Future of Gold and the Commodity Bull*, June 2, 2013

Thank You

Authors

Seung Bach, PhD, Associate Professor, Sacramento State, College of Business Administration

Jason Bell, CFA, Senior Vice President and Senior Investment Strategist, Wells Fargo Private Bank

Nuriddin Ikromov, PhD, Assistant Professor, Sacramento State, College of Business Administration

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

Brian M. Leu, CFA, CAIA, Investment Officer, CalPERS

Hao Lin, PhD, CFA, Associate Professor, Sacramento State, College of Business Administration

Lan Liu, PhD, CFA, Assistant Professor, Sacramento State, College of Business Administration

Joe Niehaus, Financial Institution Specialist, U.S. Government

Marc Ross, CFA, Real Estate Investment Broker, CBRE, Inc.

Yang Sun, PhD, Assistant Professor, Sacramento State, College of Business Administration

Sudhir K. Thakur, PhD, Associate Professor, Sacramento State, College of Business Administration

Sanjay Varshney, PhD, CFA, Dean, Sacramento State, College of Business Administration

Anna V. Vygodina, PhD, Associate Professor, Sacramento State, College of Business Administration

Supporting Sponsors

Wells Fargo — The Private Bank

Sacramento State — College of Business Administration

CFA Society Sacramento

SMUD™

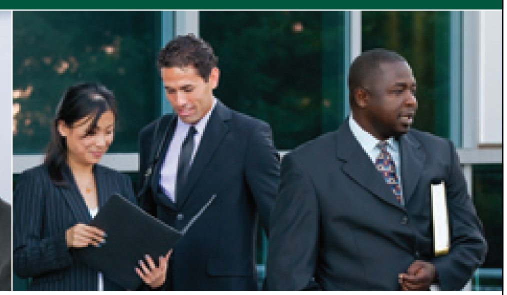
CBRE

weintraub tobin — weintraub tobin chediak coleman grodin law corporation

SACRAMENTO STATE
COLLEGE OF BUSINESS ADMINISTRATION

INSTITUTE *for* BUSINESS RESEARCH & CONSULTING



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 the private sector, not-for-profit sector, and the government/public sector.

Delivering success, growth, and profits to Sacramento business and government – one client at a time.

Type of Assistance:

- Business Valuation, Incorporation, Financing
- Financial Planning and Forecasting
- Economic Impact Studies
- Business Process Improvement
- Strategic Planning
- Market Planning, Survey, and Research
- Business and Product Development
- Market Analysis and Pricing
- Competitive and Feasibility Analyses
- Tax and Estate Planning
- Leadership Training and Development
- Succession Planning
- Improving Employee Productivity
- Enhancing Return on Investment (ROI)

For more information about the IBRC and its consulting services, please call **(916) 278-6578**, email **IBRC@csus.edu** or visit **www.cba.csus.edu**.

CFA Society Sacramento

Global Network • Local Presence

Founded in 1991, the CFA Society Sacramento operates as a member society of CFA Institute. Our membership consists of more than 180 regional investment professionals and academics who work in both the private and public sectors in a broad range of capacities. More information may be found at ***www.cfass.org***.

CFA Charter is The Gold Standard

First awarded in 1963, the Chartered Financial Analyst (CFA) charter has become known as the gold standard of professional credentials within the global investment community. Investors recognize the CFA designation as the definitive standard for measuring competence and integrity in the fields of portfolio management and investment analysis.

About CFA Institute

With more than 96,000 members in 133 countries and territories, CFA Institute is the global association for investment professionals. It administers the CFA curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.

CFA Institute is a respected advocate worldwide for full and fair disclosure of financial information by public issuers to investors; ethical conduct by investment professionals that protects the clients' best interests; investment performance standards; and the highest level of investment knowledge and competence. More information may be found at ***www.cfainstitute.org***.

A Member Society of

CFA Institute

GAF 0830-13 6/13 8.5x11