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sacramento BUSINESS REVIEW

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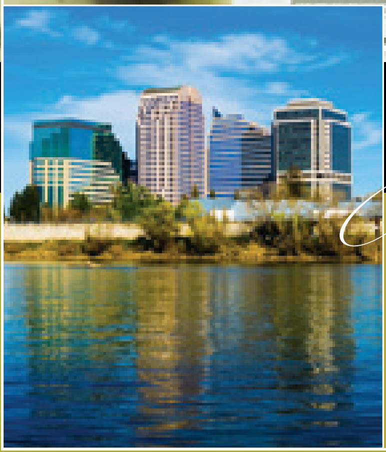
Emerging Trends in Sacramento's Economy



Your Best Guide to Sacramento's Economy

2014 Economic Forecast

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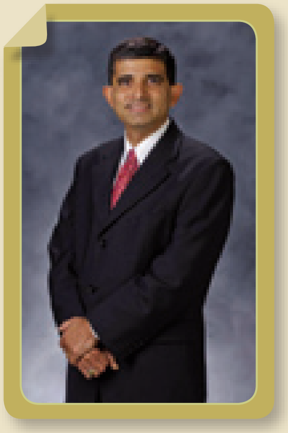
Message from the Dean



Dear Friends,

I am pleased to share the 11th edition of the *Sacramento Business Review* – the most comprehensive, precise, and intellectually sophisticated analysis of the regional economy. For six years now, our team has accurately forecast the economic and business climate and has provided thoughtful predictions. With 14 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.

This same time last 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.**

Overall, 2014 promises to bring better news and a stronger economy. Our **Small Business Confidence Index** shows record high optimism for the next year fueled by better access to credit. Our **SBR Index** confirms sustained stability and predicts continued improving conditions for the region. While challenges remain in the job market and real estate, there will continue to be a slow but steady decline in the local unemployment rate, and Sacramento's housing market will stabilize. While private and institutional capital from outside the region contributed to strong sales in both commercial and residential properties, the financial and construction sectors are facing challenges from rising interest rates and flattening housing prices. We expect the global recovery to accelerate in the coming year, with developed economies doing better than emerging markets. Merger and acquisition activity in the banking industry is inevitable. A steepening yield curve together with modest credit growth will make our banks stronger. Overall we are optimistic about 2014 and look forward to continued stability and sustained recovery.

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
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Contents 2014 Economic Forecast

- The local unemployment rate continues its slow but steady decline, and payroll job growth shows a modest, positive trend.
- A large number of nonpayroll jobs added and a declining labor force provide headwinds for a faster recovery.
- Leisure, retail, manufacturing, education and health care sectors are leading Sacramento's job recovery.
- Financial and construction sectors are facing challenges due to rising interest rates and flattening housing prices.

- Vacancy rates dropped slightly across all property types, though they still remain elevated, particularly for office properties.
- Due to high vacancies and the tenants' strong bargaining positions, rental rates remained flat (industrial properties) or declined slightly (office and retail properties).
- Attracted by relatively high capitalization rates, private and institutional capital from outside the region contributed to strong sales activity for both commercial and residential properties.
- Sacramento's housing market showed signs of improvement during 2013 with increases in home prices and sales volume.

- More than five years after the financial crisis, loan growth in the Sacramento region[1] is showing nascent signs of materializing, thanks to higher real estate prices and improved borrower confidence.
- The key question is whether the recent loan growth marks the beginning of a new re-leveraging cycle or whether it is simply a shorter-term phenomenon based on lag effects from the decline in longer-term interest rates prior to May 2013.
- If the loan growth is the result of re-leveraging in a healthier economy, the Sacramento Region Banks[2] should fare well in 2014, especially since a steeper yield curve[3] would provide the opportunity for higher net interest margins[4].
- Though more optimistic about the industry's prospects relative to prior years, the *Sacramento Business Review* banking team believes credit growth in the region will be modest at best during 2014 since post-crisis deleveraging typically lasts longer than five years.
- Despite the fact that merger-and-acquisition (M&A) activity still has not occurred locally, the team continues to believe M&A involving smaller players is inevitable.

- Our Small Business Confidence Index sets a record high of optimism for 2014 fueled by better access to credit.
- Lending by the SBA continues to expand and improve, and the manufacturing sector finds new hopes as SMEs become more optimistic about future prospects.
- The regulatory landscape is clearer for 2014 relative to last year, with the clouds of uncertainty dissipating as SMEs plan ahead.
- The market for small businesses in the region has seen vast improvements in the number of businesses listed, median sales prices, and the quality of businesses sold.

- The global economic recovery should accelerate this year, with developed economies faring better than emerging ones.
- In 2014, we expect U.S. equity markets to rise 5%-10%, 10-year Treasury rates to increase 0.25% to 0.5% and the U.S. dollar to strengthen.
- We believe China will significantly undershoot its stated growth target of 7.5%, keeping pressure on commodity prices.
- The SBR Financial Conditions Index confirms the regional recovery is on track.

SACRAMENTO'S LABOR MARKET & REGIONAL ECONOMY

page 6

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

2 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.

3 The yield curve measures the relationship between interest rates and maturities for U.S. Treasuries. A steeper yield curve means a greater differential between longer-term and shorter-term rates.

4 The net interest margin is the difference between a bank's interest income and interest expense, measured as a percentage of its average earning assets.

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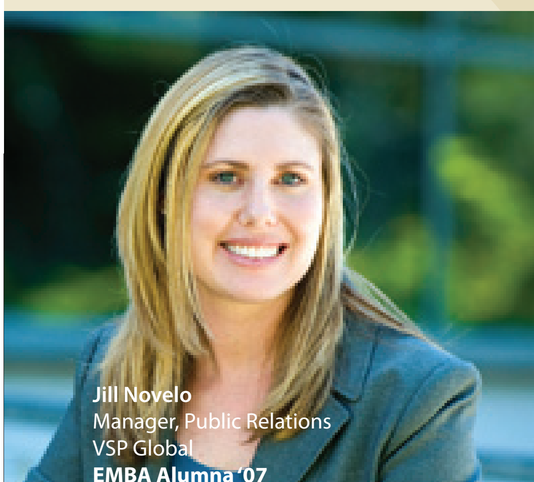

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Sacramento's Labor Market & Regional Economy: *2014 Outlook*

Key Points

- **The local unemployment rate continues its slow but steady decline, and payroll job growth shows a modest, positive trend.**
- **A large number of nonpayroll jobs added and a declining labor force provide headwinds for a faster recovery.**
- **Leisure, retail, manufacturing, education and health care sectors are leading Sacramento's job recovery.**
- **Financial and construction sectors are facing challenges due to rising interest rates and flattening housing prices.**

Are we there yet?

It has been about six years since the onset of the "Great Recession," and things do seem to be improving. However, we can't help but notice how the recovery for the Sacramento area seems to resemble a very long car ride where we find ourselves asking if we have arrived when we still have a distance to go.

On the national level, GDP growth spiked up in the third quarter to 4.1%, consumer confidence took an upward turn in December to a level 17% better than the year earlier, and the national unemployment rate fell to 6.5% (unadjusted). Political uncertainty has been significantly reduced with Congress agreeing to a budget deal that should provide funding through 2015, but capital markets are still well aware of the looming debt ceiling debate, which is likely to rekindle sometime in February 2014.

Overall, things look promising for 2014, and the Sacramento area should continue to see slow and steady job growth. Additionally, prospects of a new downtown arena and state government surpluses provide additional support suggesting future growth should be sustainable. Obstacles to growth include the shrinking of the labor force and the impact of the Fed's taper and the potential for rising interest rates. California budget deficits appear to be a thing of the past, and the Legislative Analyst's Office is projecting billions in additional revenues that should allow the state to end the 2014 fiscal year with a $1.1 billion reserve.

For 2014, we expect to see the Sacramento region's unemployment rate fluctuate between 7% and 8.5%, with payroll job growth in the range of 1% to 2%. For the early part of the year, positive job growth may be offset by individuals who once again start looking for work and re-enter the labor force.

Unemployment Rate Continues Slow But Steady Decline, Payroll Job Growth Shows Modest, Positive Trend

As of the latest reading (November 2013), the Sacramento metropolitan area's unemployment rate has improved to 8.0%, down from 9.6% a year ago. This compares to 8.3% for California and 6.6% for the United States (unadjusted). The fact that Sacramento lags the national economy in recovery is due largely to the housing crash that precipitated the recent recession. Housing is typically the sector that drives regional economic rebounds, but not so this time. While most other recoveries have been paced by resurgence in construction, this last downturn was caused by overbuilding and it will take longer to correct. As a result, every year of this recovery seems to look pretty much like the year before. The housing bust associated with the recession has also dampened another factor that drove strong growth in the past: population inflows. Rapid population growth fueled the economic growth in the Sacramento region prior to the recession but not during the recovery. In 2014, population growth is expected to continue to be moderate without faster job growth to attract more people to the Sacramento area.

On the other hand, although the local labor force did continue a slight decline, the bulk of the improvement in the unemployment rate is attributable to the 12,400 payroll jobs added during the year. The nonfarm, payroll job growth rate of 1.5% continues a three-year trend of positive job growth, and provides further support that the local economy has found stable footing.

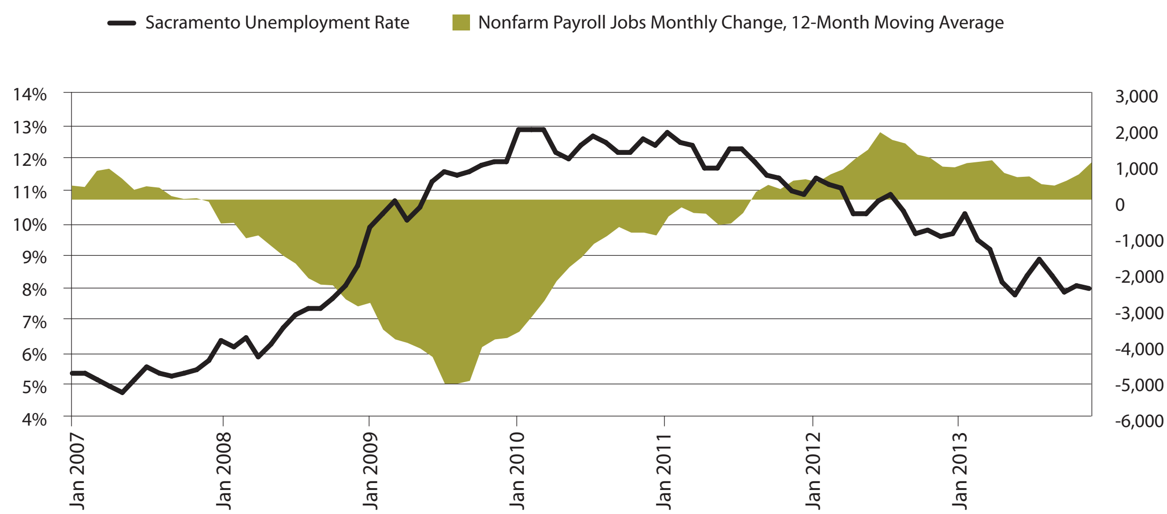
Headwinds of Job Quality and a Declining Labor Force Remain

The number of discouraged workers and others who have fallen out of the labor force remains well above pre-recession norms, and for this reason, we estimate the percentage of underutilized labor, aka underemployment rate, for the region to be in the neighborhood of 16%. This figure is approximately double the rate of unemployment and is in line with the rates of 18% for California and 13% for the country. The positive trends we see for 2014 may very well spark a modest re-entrance to the labor force for these "discouraged" individuals, but this re-entrance will likely put upward pressure on the unemployment rate in the near term. However, the labor force has been undergoing significant demographic shifts that lead many to believe it will steadily decline over the long term. The baby boomers contributed greatly to a strong and robust labor force during their prime working years, but as they age, they are likely to retire and leave the labor force in large numbers, just as they entered it. Additionally, the younger portion of the labor force, individuals age 16 to 24, are not expected to enter the labor force until much later as many will stay in school, seeking the skills necessary to remain competitive in today's knowledge-based, service economy.

> *"One noticeable trend that began along with the crisis is the significant increase in nonpayroll jobs represented by those who are self-employed, unpaid family workers, household workers, seasonal farm workers, or workers on strike."*

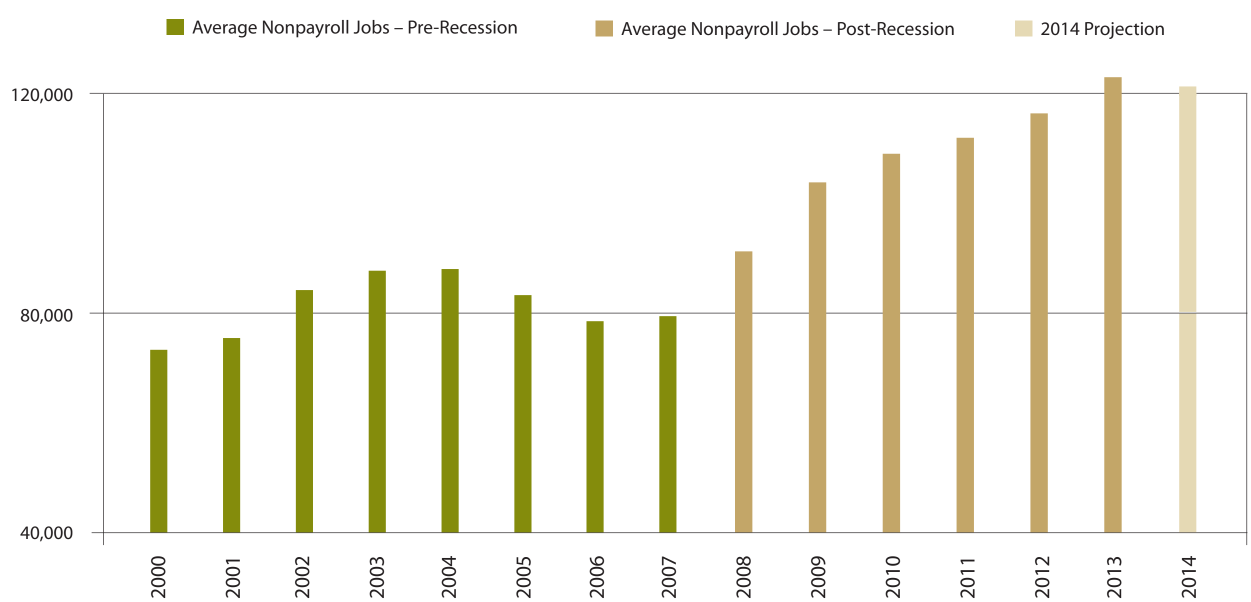
One noticeable trend that began along with the crisis is the significant increase in nonpayroll jobs represented by those who are self-employed, unpaid family workers, household workers, seasonal farm workers, or workers on strike. These individuals are considered part of the employed labor force, but growth for this sector does not carry the same economic impact to the region as the payroll sector. Figure 2 shows how this part of the employed labor force has significantly increased since 2008. However, we expect this portion of the employed labor force to contract during the next couple of years, leading to a more healthy, sustainable recovery.

Figure 1
Sacramento Unemployment Rate and Nonfarm Payroll Jobs



Data Source: California Employment Development Department

Figure 2
Sacramento's Nonpayroll Jobs: Pre- and Post-Recession



Data Source: California Employment Development Department

Leisure, Retail, Health Care and Education, and Manufacturing Expected to Lead the Way in 2014

Although the holiday sales spike allowed for the continuation of a four-year trend of positive growth for retail jobs, leisure was the strongest sector for 2013 and accounted for more than 40% of all payroll jobs added locally during the year. Within the leisure sector, food services and full-service restaurants provided most of the gains. We expect to see another strong year for leisure as Sacramento appears to have attracted significant development dollars, and the increased activity should keep this sector buzzing.

We expect the education and health care sector to continue to be the workhorses that they have been up to, during, and after the crisis. We expect another 3% to 4% growth for this sector, with the bulk of the jobs coming from health care. With the aging population, in-home health care and associated services are expected to drive significant growth. Education should benefit from increased government revenues and budget provisions requiring additional spending on education.

The manufacturing sector has been slowly and steadily adding jobs since the beginning of 2011, and the latest reading for 2013 (November) showed the sector added 1,100 jobs for the year, almost 9% of total nonfarm jobs added. We think this sector will continue to do well, given the re-emergence of "Made in America" and the attractiveness of domestic manufacturing costs relative to those abroad.

Table 1
Sector-by-Sector 2014 Growth Outlook for Sacramento Labor Market

Key Sectors	% of Local Economy	Expected Average % Change Y/Y	Change vs. Last Forecast	Comments
Government	26.6%	flat to +1%	–	Budget surpluses are now a reality thanks to revenues related to recovering property values and capital gains. Agencies should have more flexibility when it comes to hiring.
Business Services	13.6%	flat to +1%	↓	Corporate spending should be more stable with less uncertainty in the economy, and Sacramento continues to provide a nice geographical alternative to technology companies looking to be near Silicon Valley.
Education and Health Care	13.1%	+3% to +4%	↑	More care will be needed for the aging population, and the expansion of services into areas such as home health care should continue to provide for some of the strongest growth in the local economy.
Retail	11.8%	+2% to +3%	–	Consumer confidence spiked at the end of 2013, and people should feel more confident to spend with rejuvenated retirement accounts and more value in their homes.
Leisure	10.2%	+3% to +4%	↑	Similar to retail, more confidence means more willingness of consumers to spend. Potential developments in downtown Sacramento should also contribute to strong growth for this sector in the long run.
Financials	5.6%	-1% to -2%	↓	Financials began another downward slide for the second half of 2013. This decline is most likely related to the cooling housing market, which had seen some of the highest increases in home prices since before the recession.
Construction	4.2%	flat to +1%	↓	As real estate stabilizes, construction should follow suit, but during the second half of 2013 we saw just how fickle the real estate markets can be in a rising interest rate environment. However, large development projects planned for downtown and South Sacramento may make this sector a wild card for hiring in the second half of 2014.
Manufacturing	4.2%	+2% to +3%	↑	Manufacturing costs have been increasing globally making domestic manufacturing more attractive. With more cash and less uncertainty, companies appear ready to invest capital.

↑ = We expect **higher** employment growth in 2014 vs. our 2013 forecast.
↓ = We expect **lower** employment growth in 2014 vs. our 2013 forecast.

Financials and Construction Face Rising Interest Rates and Flattening Home Prices

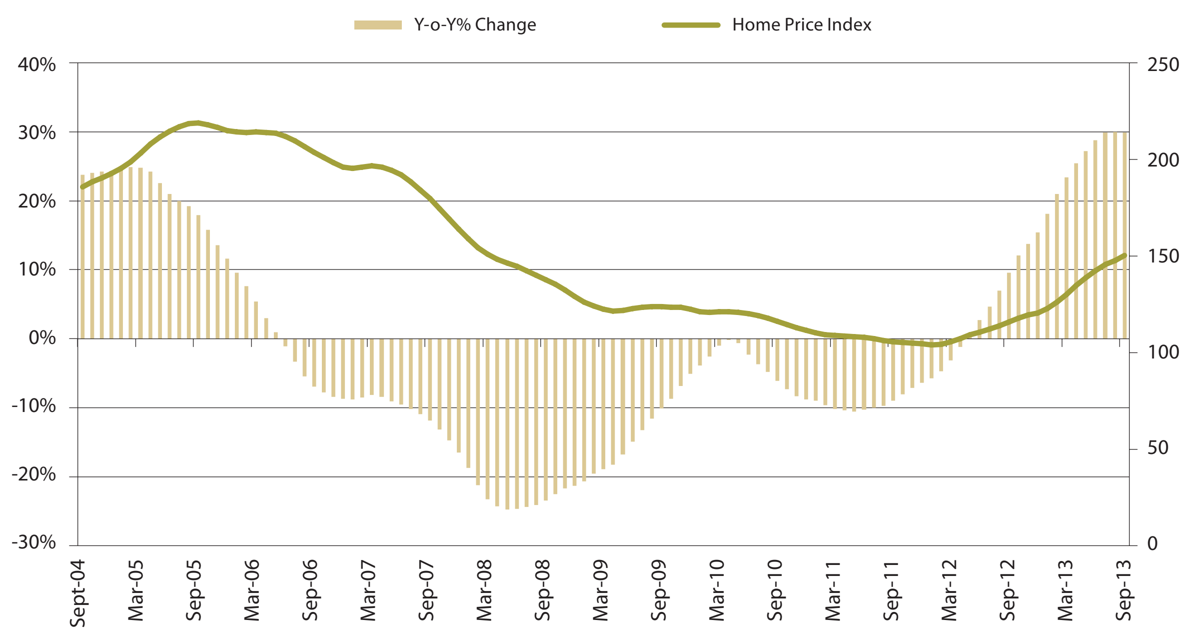
Just as we started to expect residential real estate development to flare back up, long-term interest rates began a sharp upward move beginning in May and were fueled throughout the year by speculation that the Federal Reserve would start to taper its bond buying program. Housing permits for new construction dropped significantly toward the end of the year, and the rapid increase in home prices began to plateau (Figure 3).

Every year of this recovery has been better than the previous year with more jobs added, but it's still a long road to regain the jobs lost during the recession. The Sacramento region still has some 70,000 payroll jobs to regain to get back to the prior employment peak. Construction lost the greatest percentage of jobs, and as of summer 2013, this sector has regained only some 4,000 (or less than 10%) of the 42,000 construction jobs lost.

"As we are having a slow but steady recovery, be patient and have a positive attitude, Sacramentans."

Essentially, this year's job growth projection looks just like a year ago this time. And we'll probably be saying the same thing for the next two to three years. As 2013 was better than 2012, so will 2014 be better than 2013 – but not by much. As we are having a slow but steady recovery, be patient and have a positive attitude, Sacramentans.

Figure 3
Home Price Index for Sacramento



Source: Freddie Mac

SOURCES: Sacramento Metropolitan Statistical Area monthly employment data published by the California Employment Development Department, U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, Federal Reserve, The Conference Board, California Legislative Analyst's Office, Bloomberg, and Freddie Mac. As of our publishing date, the most recent monthly unemployment rate reading for Sacramento was for November 2013. The Sacramento Arden-Arcade Roseville Metropolitan Statistical Area (MSA) is made up of the counties of Sacramento, El Dorado, Yolo, and Placer. Since our analysis explicitly accounts for seasonality throughout the year, the employment figures in this article are "unadjusted" figures.

Real Estate Trends *in the* Sacramento Region

The past year was another positive one for Sacramento's real estate markets. On the commercial side, businesses moved into more space than they vacated in 2013. Vacancy rates dropped slightly for office, retail, and industrial properties, although vacancy still remains elevated, particularly for office properties. On the other hand, lease rates either remained flat or declined slightly. There was relatively little new construction, and almost no speculative construction. These indicators show that the commercial real estate market will remain in recovery mode during 2014, with further modest reductions in vacancy rates and improving lease rates. On the residential side, both prices and sales volume increased significantly, thanks to low mortgage rates and the improving job market. The year 2014 will likely see modest gains in home prices and robust home sales.

Key Points

- **Vacancy rates dropped slightly across all property types, though they still remain elevated, particularly for office properties.**
- **Due to high vacancies and the tenants' strong bargaining positions, rental rates remained flat (industrial properties) or declined slightly (office and retail properties).**
- **Attracted by relatively high capitalization rates, private and institutional capital from outside the region contributed to strong sales activity for both commercial and residential properties.**
- **Sacramento's housing market showed signs of improvement during 2013 with increases in home prices and sales volume.**

> *"After nine consecutive quarters with positive net absorption, the Sacramento retail market experienced almost 30,000 SF of negative net absorption in the fourth quarter of 2013."*

Office

The Sacramento office market recorded its seventh consecutive positive net absorption in the third quarter of 2013. The total for the first three quarters was 770,000 SF, which is four times greater than the same period in 2012. Most of the leasing activity occurred in the higher-quality buildings within the downtown, Highway 50 corridor, Folsom, and Roseville submarkets. Several significant lease transactions were signed by the State of California, with the Department of Housing and Community Development moving into 101,337 SF of space at 2020 El Camino Ave., and the California Health Benefit Exchange signing a lease for 66,179 SF in Rancho Cordova.

For the first time in years, a speculative project was completed – 400 Sunrise Ave. in Roseville. Only one other project – the Civic Plaza Building in downtown Roseville – is currently under construction.

Thanks to a relatively healthy leasing activity, the vacancy rate fell to 20.7% from 23% a year ago. While this is a major improvement, vacancy remains substantially higher than the 13%-15% "equilibrium" vacancy rate, and average asking lease rates actually declined in 2013, to $1.67 per SF per month.

2014 Outlook: The year 2014 will not be a very exciting one for the office market, which will experience a year similar to 2013. While the vacancy rate and absorption will continue to improve, vacancy will remain high, and lease rates will be flat or increase slightly. The office market remains oversupplied, which makes rent increases and new construction difficult. As regional unemployment remains high, tenants will remain conservative in making long-term commitments. The planned Entertainment and Sports Complex will likely provide stability to downtown Sacramento, although its effect will not be fully felt in 2014. Due to the current oversupply of office space, new speculative construction is unlikely.

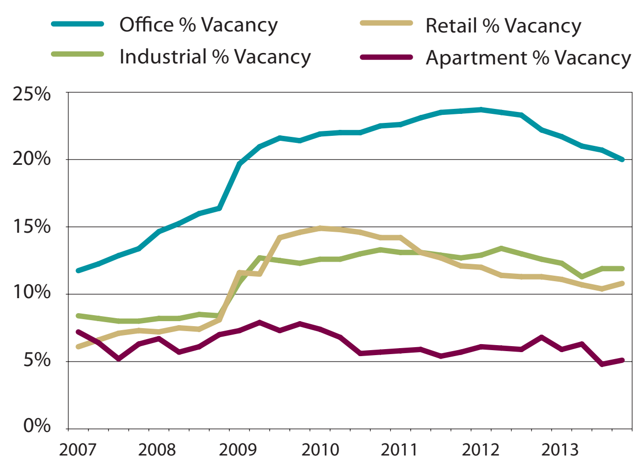
Retail

After nine consecutive quarters with positive net absorption, the Sacramento retail market experienced almost 30,000 SF of negative net absorption in the fourth quarter of 2013. This was largely due to several closures, notably the Fresh and Easy Neighborhood Market and Blockbuster locations. Despite the negative net absorption in the fourth quarter, the market achieved positive net absorption of 589,000 SF for the year 2013. National tenants continued to expand into the Sacramento market, with CarMaxx, Hobby Lobby, Walmart and Walmart Neighborhood Market, Fresh Market, and Stein Mart all signing new leases in the past year. The two biggest lease transactions were both for 60,000 SF of space, with Hobby Lobby moving into Marketplace 99 in Elk Grove, and Burlington Coat Factory moving into Promenade at Sacramento Gateway.

While the construction of retail properties continued to stay well below historical averages in 2013, more than 350,000 SF of new space was added during the past year. The most recent addition is the completion in the fourth quarter of the 25,000 SF T.J.Maxx in the Second Street Crossing Center in Davis.

The vacancy rate declined 0.5% year-over-year, from 11.3% at the end of 2012 to 10.8% at the end of 2013. However, this rate remains higher than the "equilibrium" vacancy rate of 9%-10%, which may be why lease rates slightly declined year-over-year. The average asking lease rate was $1.44 per SF per month at the end of 2013, compared to $1.51 per SF at the end of 2012.

Figure 1
Sacramento MSA Vacancy Trends



Source: CBRE, Inc.

2014 Outlook: Expect continued steady absorption, decline in vacancy rates, and stable asking lease rates. National tenants will continue to expand into the Sacramento region. As lease rates are starting to push $3.00 per SF per month for high-quality Class A centers, some new construction projects will break ground in 2013. The most obvious areas for new construction are dense infill locations with pent-up demand for Class A retail space. Lower-quality Class C shopping centers will likely see flat lease rates and little reduction in vacancy rates.

Industrial

Despite several major tenants moving out of the region, including Campbell Soup vacating 1.3 million SF in South Sacramento, E&E Trading vacating 300,000 SF in Woodland, and Xyratex vacating 170,000 SF in West Sacramento, the Sacramento region industrial market achieved nearly 2 million SF of positive net absorption. Although Campbell Soup's move resulted in a negative net absorption in the third quarter of 2013, the market experienced positive net absorption in every other quarter. Much of this absorption was due to small to mid-sized leases (10,000 – 45,000 SF) being signed, notably in the West Sacramento submarket, where 25% of that size range was absorbed.

New construction in 2013 was due to user-specific buildings. The biggest projects that broke ground were: FedEx (198,750 SF in Roseville), Tomra (60,000 SF in West Sacramento), and Shinmei (25,000 SF in West Sacramento). There was no speculative construction of industrial property.

Positive net absorption, combined with little new construction, resulted in a lower vacancy rate. The overall vacancy rate for industrial properties decreased to 11.9% in the fourth quarter of 2013, and is expected to decline gradually over the next year as well. The lease rates remained relatively stable, and the average asking lease rate was $0.42 per SF per month.

2014 Outlook: Expect continued steady absorption, a decline in vacancy rates, and a slight increase in asking lease rates. The industrial sector will continue to be the brightest spot in real estate in 2013, with increased investment from private and institutional investors arriving from outside the region in search of stabilized and value-add properties. The region will likely see increases in pricing and lower capitalization rates for industrial properties. Steady positive net absorption will lead to lower vacancy rates and rising lease rates, which may make speculative new construction feasible in 2014.

Investments

Sales activity was up dramatically across all property types in 2013, with stabilized and value-add properties offering higher returns than alternative asset categories. Mispriced assets or properties with issues such as functional or economic obsolescence were common. Sacramento is not considered to be one of the more glamorous destinations for private and institutional investors, which is why they initially favored other markets with more robust job growth and rent increase potential. However, as the Central Valley was thought to have weathered the worst of the recession and with the California state government's fiscal troubles easing, investors started to look at the lower-cost Sacramento region favorably. Distressed homes were bought in bulk in 2013 by private equity funds such as Blackstone. These private equity firms are no longer actively buying properties in Sacramento, nor are they expected to sell their assets in large quantities in the immediate future.

2014 Outlook: Sales activity will continue to increase for all property types. The recovery of the real estate market will progress with continued economic growth and job creation. New home construction will help make the recovery tangible to the average consumer. Capitalization rates will likely stay constant.

Residential

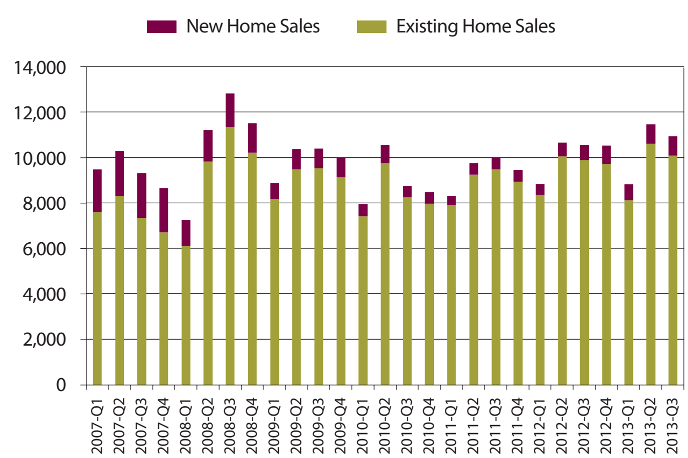
As the U.S. and California regional economy gravitates toward stabilization, Sacramento's housing market showed signs of a turnaround during 2013, as both home prices and sales volume increased several notches. The Sacramento region depicted stability in the median sale price during most of 2011, averaging approximately $214,167 for the following year and a half. The median sale price then increased to $275,000 in the third quarter of 2013. This represents a 32.8% increase year-over-year, though it remains 34% off its 2005 peak. Given these trends, part of the price increase can be attributed to the kinds of homes sold: Luxury homes were sold in large numbers during the past holiday season. The price per square foot for single family homes in the Sacramento MSA region increased by 9%, with the largest increases observed in Sacramento and Yolo counties (9.7% and 8.7%, respectively). Existing home sales in the Sacramento region picked up pace (12%) during the first three quarters of 2013 relative to the same period during 2012, and all home sales increased from 28,260 to 28,780 during the last three quarters of 2013.

During the past decade, new home sales have been on the decline, reaching a low of 393 during the first quarter of 2011. Subsequently, new home sales have picked up, and during the past year have shown a quarterly rate of growth of 6.2%. This growth prompted several home builders in the region – such as New Home Company, Taylor Morrison, Meritage Homes, and Lennar – to sell single family homes of varying square footage. The median sales price has been rising for several months during the past year but seems to have flattened around $245,000 for Sacramento County during July 2013. The announcement by the Federal Reserve Bank of tapering off of the bond buying program implied a slow and steady rise of interest rates, fuelling an expectation amongst buyers of an eventual increase in mortgage rates. Low inventory levels added to cost escalations as well. These factors caused a surge of holiday sales. Home buyers seem to have accepted the prevailing interest rate and home prices as the optimal mix for a bargain price. Most of the new home sales have taken place in Sacramento County followed by Placer, Yolo and El Dorado counties.

Foreclosure activity in the Sacramento region dropped by 63% during November 2013 relative to the same period last year. This is corroborated by the fact that notices of default, which is nonpayment of mortgage payments for three months, declined from an absolute number of 3,965 to 1,575 by the third quarter of 2013. This trend can be explained by rising home values and a strengthening job market as key drivers of the local economy. Further, the proportion of REOs (Real Estate Owned by lenders), which represented a little more than 40% of all sales during 2011, dropped to 28% and 12% during 2012 and 2013, respectively (ending with 7.2% during the third quarter of 2013).

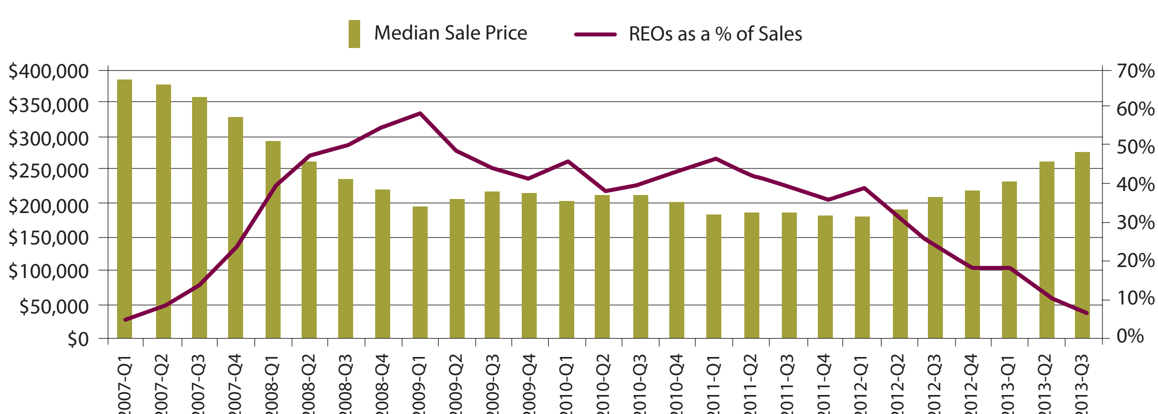
2014 Outlook: As the national and regional economy becomes more resilient and the labor market improves, the demand for owner-occupied homes will continue to rise in the range of 5%-7%, particularly with the consumer expectation that the Federal Reserve Bank will taper off the bond buying program, escalating interest and mortgage rates. With inventory shortages, it is anticipated that home prices and sales activity would increase modestly during 2014, assuming there is no set back in employment growth.

Figure 3
New Home Sales vs. Existing Home Sales | Sacramento MSA



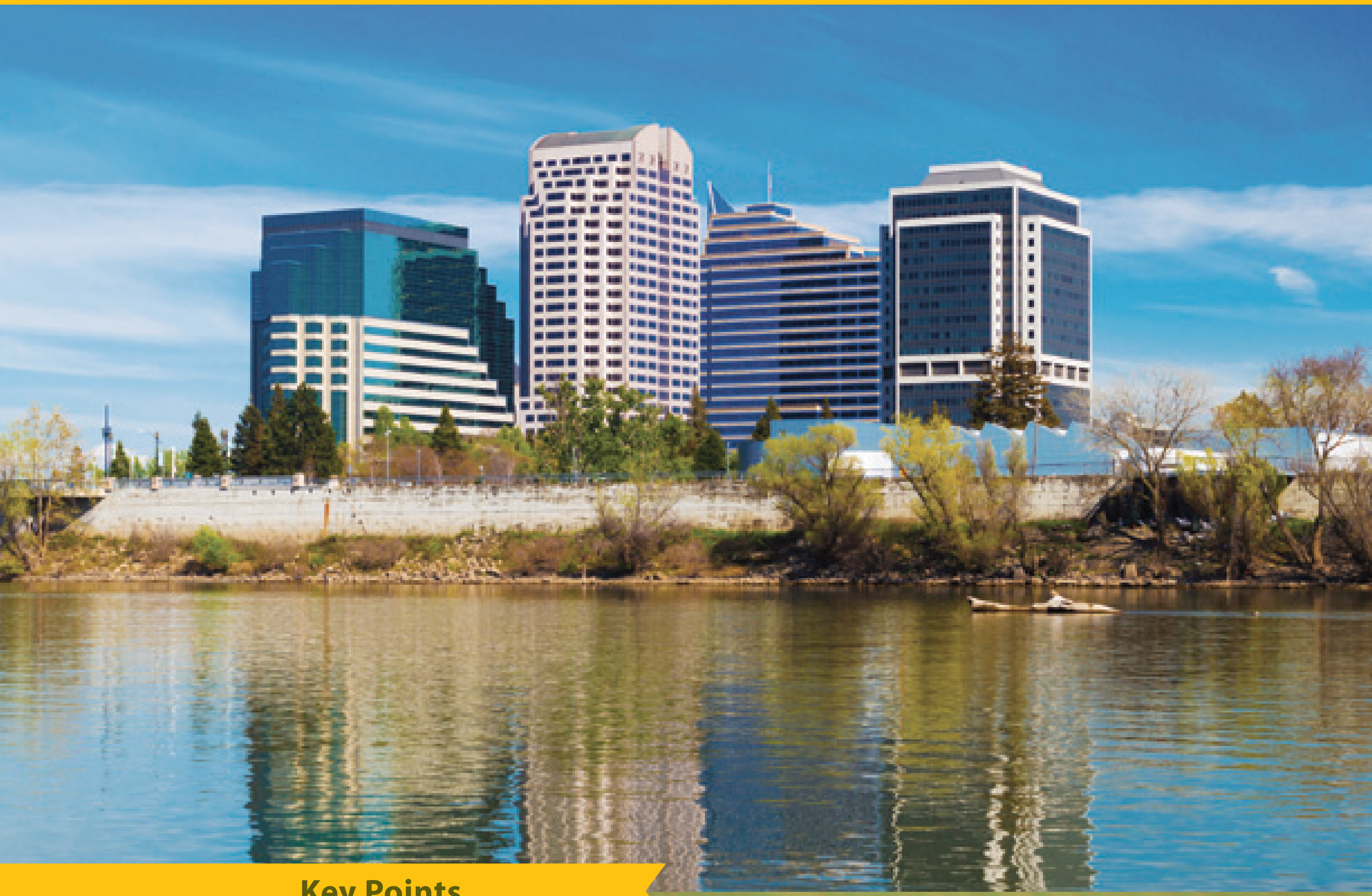
Source: DataQuick

Figure 2
Median Sale Price (All Homes) | Sacramento MSA



Source: DataQuick

2014 Sacramento Banking Industry Forecast



Key Points

- More than five years after the financial crisis, loan growth in the Sacramento region[1] is showing nascent signs of materializing, thanks to higher real estate prices and improved borrower confidence.

- The key question is whether the recent loan growth marks the beginning of a new re-leveraging cycle or whether it is simply a shorter-term phenomenon based on lag effects from the decline in longer-term interest rates prior to May 2013.

- If the loan growth is the result of re-leveraging in a healthier economy, the Sacramento Region Banks[2] should fare well in 2014, especially since a steeper yield curve[3] would provide the opportunity for higher net interest margins[4].

- Though more optimistic about the industry's prospects relative to prior years, the *Sacramento Business Review* banking team believes credit growth in the region will be modest at best during 2014 since post-crisis deleveraging typically lasts longer than five years.

- Despite the fact that merger-and-acquisition (M&A) activity still has not occurred locally, the team continues to believe M&A involving smaller players is inevitable.

In January 2013, the *Sacramento Business Review* (SBR) banking industry analysts predicted that loan growth in the region would remain fairly constrained. During the ensuing two quarters, this forecast proved prescient, as the aggregate loan balance for the Sacramento Region Banks stayed virtually unchanged. However, in the past six months, thanks to higher real estate prices and improved borrower confidence, loan growth started to accelerate (Figure 1).

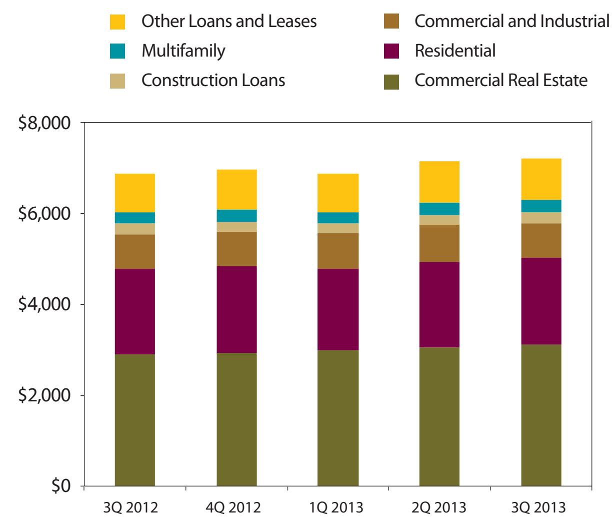
A New "Re-Leveraging" Cycle?

The key question is whether this recent acceleration in loan growth marks the beginning of a new re-leveraging cycle, where pent-up demand from borrowers with healthier balance sheets results in solid credit expansion.

One could make a compelling case that a new long-term credit cycle is in its nascent stages, because the economy is in much better shape (relative to where it has been in the five years since the financial crisis). Real estate and financial asset prices have improved substantially, banks have had time to address problem loans and are eager to lend, more people are employed, and consumer confidence has risen. Moreover, debt service ratios are at early 1980s levels (Figure 2), from which a massive 25-year leveraging cycle started. And after reviewing the recent performance of banking stocks both locally and nationwide, it appears that most investors believe a new credit cycle has begun. In particular,

"One could make a compelling case that a new long-term credit cycle is in its nascent stages."

Figure 1
Sacramento Region Banks
Aggregate Loan Balances – Past 12 Months



$ in millions	3Q 2012	4Q 2012	1Q 2013	2Q 2013	3Q 2013	Year/Year % Change Since 9/30/12	Annualized % Change Since 3/31/13
Commercial Real Estate	$2,902.1	$2,942.4	$2,986.3	$3,046.6	$3,113.0	7.3%	8.5%
Residential	1,867.1	1,887.3	1,805.5	1,883.9	1,900.7	1.8%	10.5%
Commercial and Industrial	783.8	760.0	777.3	817.9	779.7	-0.5%	0.6%
Construction Loans	234.0	225.0	206.9	219.2	218.5	-6.6%	11.2%
Multifamily	246.2	261.3	264.5	280.8	288.7	17.3%	18.3%
Other Loans and Leases	855.3	901.7	824.3	898.4	919.1	7.5%	23.0%
Total	**$6,888.5**	**$6,977.8**	**$6,864.7**	**$7,146.7**	**$7,219.8**	**4.8%**	**10.3%**

Data Source: FDIC

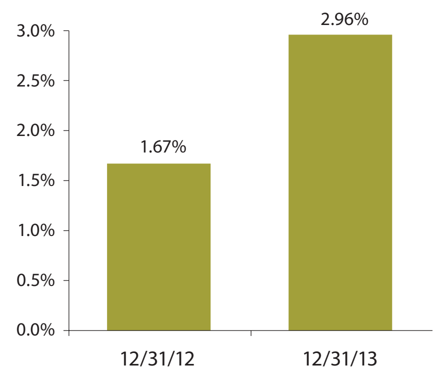
the KBW Regional Banking Index increased close to 50% last year, while the SBR Bank Index grew by nearly 20% during the same time frame (Table 2).

If the Sacramento region is embarking on a new re-leveraging cycle, such a development would benefit the local banks, because higher loan volumes would enable these banks to grow their top-line net interest income. Furthermore, with a steeper yield curve since the Federal Reserve's May 2013 "tapering" discussion, the banks have the opportunity to increase their net interest margins (Figure 3).

The SBR banking analysts believe that top-line net interest income growth will be imperative if the local banks are to increase their bottom lines materially. As the team noted in last year's report, the banks have still been able to grow their net profits in recent years despite a lack of loan growth because of substantial declines in loan-loss provisions due to a healthier economic backdrop. However, the team expressed concerns that only so much juice can be squeezed from the lemon of lower loss provisions. Specifically, the Sacramento Region Banks' aggregate year-to-date (through September 30) loss provisions declined from $26.1 million in 2012 to $5.3 million in 2013, boosting

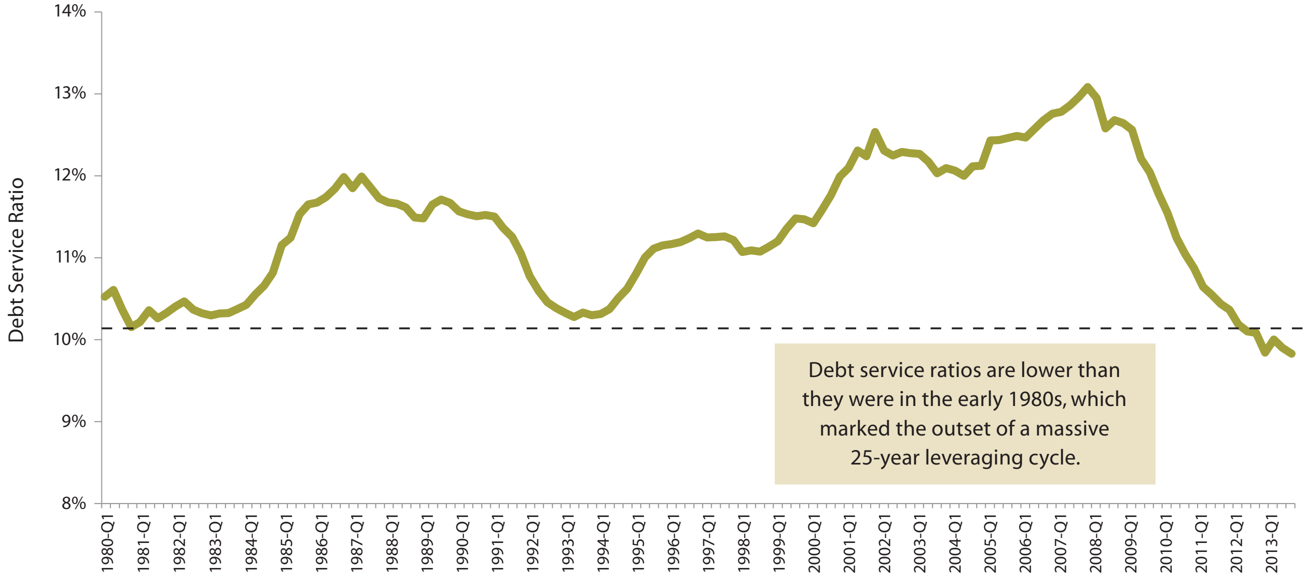
"The SBR banking analysts believe that top-line net interest income growth will be imperative if the local banks are to increase their bottom lines materially."

Figure 3
Differential Between 10-Year U.S. Treasury and Fed Funds Overnight Rate



A greater differential between longer-term interest rates (at which banks lend) and shorter-term rates (at which banks pay depositors) provides banks with the opportunity to increase their net interest margins.

Figure 2
U.S. Debt Service Ratio: 1980-Present



Data Source: Federal Reserve

aggregate pre-tax income by roughly $21 million. Even with no loss provisions this year, the maximum increase to the aggregate bottom line from lower provisions is only $5 million. Therefore, the local banks will need to improve their top lines in order to also grow their bottom-line profits substantially.

A Short-Lived Phenomenon?

Although many are convinced that a new long-term credit cycle has begun both nationally and locally, the SBR banking team remains somewhat skeptical for several reasons. First, we have discussed in previous reports how empirical data from prior financial crises indicates that borrowers typically deleverage (i.e., reduce their debt levels) for six to seven years following the crisis. Since we are a little more than five years removed from the 2008 financial crisis, there may still be a few innings left in the current post-crisis deleveraging period.

Second, the team would argue that the recent pick-up in loan volumes may be more attributable to the lag effects from the decline in longer-term interest rates prior to May 2013. As Figure 4 illustrates, longer-term rates fell by nearly 200 basis points between early 2011 and May 2013, thanks largely to the Federal Reserve's Operation Twist program. During this period, prices of various types of real estate, against which most local banks lend, increased materially.

With longer-term interest rates having retraced much of their declines since early 2013, the SBR banking team believes these higher rates are likely to create a headwind to the robust credit growth scenario many are forecasting for the upcoming year. That said, given the healthier economic backdrop, the team remains optimistic that loan growth locally will remain positive this year (just more modest than what many are expecting).

Still Sticking With the M&A Call

For the past three years, the SBR banking analysts have expected to see a pickup in merger-and-acquisition (M&A) activity among local banks. These predictions were based upon two main factors: 1) continued difficulty generating top-line net interest income growth due to weak loan demand, and 2) the diminishing tailwinds from lower loan-loss provisions.

Through the end of 2013, no M&A transactions involving the local banks have taken place. Should the new long-term credit cycle scenario described earlier start to unfold, it is likely that 2014 would mark yet another year of no M&A activity, because the local banks would have enough operating leverage to materially grow their bottom lines.

However, given the analysts' forecast for more subdued loan growth, coupled with the banks' inability to pare loss provisions much further, the SBR team remains steadfast in its belief that local bank M&A activity is a matter of when, and not if, it will occur. The leading M&A candidates continue to be the smaller banks, and these players are likely either to merge with other banks of similar size or to be purchased by mid-sized regional financial institutions.

Figure 4
10-Year U.S. Treasury | January 2011 – December 2013

Publicly Traded Local Bank Stock Ratings

Within the six-county Sacramento region, 13 locally based banks are publicly traded on the OTC Bulletin Board. In Table 1, we present our recommendations for each. Readers should note that all of these stocks have very low liquidity, so investors should consider market impact[5] when trading shares.

Table 1
Stock Ratings for Publicly Traded Sacramento Region Banks | Dec. 31, 2013

Bank	Ticker	Stock Price	Market Cap ($ in millions)	2013 Total Return	Price / Tangible Book Value[1]	TCE Ratio[2]	NPAs[3] as a % of Total Assets	Return on Equity[4]	Bankrate.com Rating[5]
OUTPERFORM									
River City Bank	RCBC	$100.00	$122.0	42.6%	1.0x	10.5%	0.8%	8.37%	4
Community Business Bank	CBBC	$8.90	19.1	45.4%	1.0x	11.5%	1.9%	5.07%	5
Sierra Vista Bank	SVBA	$2.53	9.6	63.2%	0.9x	12.2%	2.4%	5.69%	3
Sutter Community Bank	SUTB	$5.75	5.5	-4.2%	0.6x	13.5%	7.9%	3.02%	2
MARKET PERFORM									
Farmers & Merchants Bank	FMCB	$417.00	$324.4	6.0%	1.5x	10.7%	0.4%	11.50%	4
American River Bank	AMRB	$9.45	82.7	36.8%	1.1x	12.4%	2.5%	3.56%	4
First Northern Bank of Dixon	FNRN	$7.20	68.2	38.5%	1.1x	7.0%	1.3%	6.94%	4
Bank of Sacramento	GSCB	$15.20	39.7	-4.4%	1.2x	7.3%	0.7%	7.53%	4
River Valley Community Bank	RVVY	$17.00	29.2	13.3%	1.5x	13.2%	0.0%	6.69%	5
Community 1st Bank	CFBN	$4.00	21.8	33.3%	1.2x	7.4%	1.3%	5.26%	4
Folsom Lake Bank	FOLB	$7.10	11.4	4.3%	0.9x	9.6%	6.0%	6.85%	3
UNDERPERFORM									
Tri Counties Bank	TCBK	$28.37	$456.1	71.9%	2.1x	8.4%	3.9%	11.15%	4
North Valley Bancorp	NOVB	$18.91	129.3	32.8%	1.5x	9.8%	2.3%	4.90%	3
				Peer Group Average:	**1.2x**				

1) Price to Tangible Book Value (TBV) ratios use market prices as of 12/31/13 and TBVs as of 9/30/13. TBV is determined by subtracting Preferred Stock and Intangible Assets from Total Equity Capital.

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

3) Nonperforming Assets (NPAs) used in this calculation include noncurrent loans, restructured loans, and other real estate owned.

4) Return on Equity figures are for the first nine months of 2013 and are annualized.

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

Data Source: FDIC

The authors do not own shares of any of the banks listed in Table 1. The Sacramento Business Review cannot guarantee any of the forecasts made in this article.

2013 Local Bank Stock Performance Review

Despite logging a solid 19.3% total return last year, the SBR Bank Index's* 2013 return lagged that of the benchmark KBW Regional Bank Index by a fairly wide margin. As in previous periods, those basing their trading strategies on the SBR bank stock ratings last year would have fared reasonably well. For example, the three banks rated as Outperform in January 2013 (Community Business Bank, River City Bank, and American River Bank) generated returns of 45%, 43%, and 37%, respectively.

We would be remiss if we neglected to mention some of our erroneous calls, which included TriCounties Bank (up 72% as the lone member of the Underperform list) and Sierra Vista Bank and First Northern Bank (both up more than 35% while rated just Market Perform).

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

Table 2
2013 Local Bank Stock Performance Review

Bank	2013 Total Return	January 2013 Rating
Tri Counties Bank	71.9%	Underperform
Sierra Vista Bank	63.2%	Market Perform
Community Business Bank	45.4%	Outperform
River City Bank	42.6%	Outperform
First Northern Bank of Dixon	38.5%	Market Perform
American River Bank	36.8%	Outperform
Community 1st Bank	33.3%	Market Perform
North Valley Bancorp	32.8%	Market Perform
River Valley Community Bank	13.3%	Market Perform
Farmers & Merchants Bank	6.0%	Market Perform
Folsom Lake Bank	4.3%	Market Perform
Sutter Community Bank	-4.2%	Market Perform
Bank of Sacramento	-4.4%	Market Perform
SBR Bank Index	**19.3%**	
KBW Regional Bank Index	**47.5%**	

Endnotes

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

2 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.

3 The yield curve measures the relationship between interest rates and maturities for U.S. Treasuries. A steeper yield curve means a greater differential between longer-term and shorter-term rates.

4 The net interest margin is the difference between a bank's interest income and interest expense, measured as a percentage of its average earning assets.

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

The Small Business *Economy*

Key Points

- Our Small Business Confidence Index sets a record high of optimism for 2014 fueled by better access to credit.
- Lending by the SBA continues to expand and improve, and the manufacturing sector finds new hopes as SMEs become more optimistic about future prospects.
- The regulatory landscape is clearer for 2014 relative to last year, with the clouds of uncertainty dissipating as SMEs plan ahead.
- The market for small businesses in the region has seen vast improvements in the number of businesses listed, median sales prices, and the quality of businesses sold.

Small Business Confidence at a Record High

The small business community (Small and Medium Enterprises – SMEs) in Sacramento continues to be optimistic about its business prospects: Our Small Business Confidence Index (SBCI) set a record high for 2013-2014, after setting the previous record high in our mid-year forecast update in 2013. Except for the measure of expected future revenues, which remains at the previous record high level, all other measures of small business confidence (economic outlook, local supportiveness, credit accessibility, and likelihood of new hires) are improved for the coming year.

Credit Accessibility Fuels Greater Optimism

The most significant improvement in small business confidence comes in credit accessibility, which increased another 41% from the previous record high set last year. The current credit accessibility index is also twice as high as that from July 2012. The easier availability of small business financing has helped fuel market optimism. As the economy in Sacramento has improved, access to credit has improved as well resulting from a healthier capital market and banking sector. For more than five years, tight credit conditions took their toll on the small business community.

Expanded SBA Lending Provides Support

During FY 2012-2013, the total dollar volume of SBA loans approved in the Sacramento MSA increased by 17.4% from the previous year – approximately 14.0% higher than our mid-year forecast of 3.5%. Sacramento County, the largest county in the region, recorded an increase of 18.7% in SBA lending. Placer County, which is the second largest county in terms of the size of SBA lending, saw the largest percentage increase of 33%. Except for El Dorado County, all counties have experienced expanded SBA lending activities. However, the SBA loan volume remains lower than those of both the pre-recession era and the 2011 peak level, even though the gap is by far the smallest in the past five years.

"The most significant improvement in small business confidence comes in credit accessibility, which increased another 41% from the previous record high set last year."

Manufacturing Sector Resumes High Hopes

SMEs in the manufacturing sector renewed high hopes in almost all aspects of confidence in the economy. Measures of the economic outlook reached their highest confidence levels, indicating a prosperous economic outlook for the near future. The manufacturing sector in the Sacramento region has experienced downward pressure during the past few years as high quality manufacturing jobs were lost from both the region and the state. A manufacturing renaissance appears to be underway as job growth has returned and the employment outlook has improved. The regions appears well positioned for greater manufacturing activity with high affordability, plentiful land, inexpensive labor, and good access to transportation corridors.

Future Revenue Prospects Remain Less Certain

Sacramento SMEs have been cautiously optimistic about their future prospects during the past two years, with tight credit accessibility being the major concern. Weak credit accessibility has resulted in lower than usual enthusiasm about future business prospects. The overall confidence is dampened somewhat by expectations regarding the revenue outlook that remains less certain. SMEs still face headwinds from a series of regulations and newly enforced laws, such as new tax and health care laws. SMEs are experiencing the same pressures faced by the larger corporations in increasing their top-line sales, even though aggressive cost-cutting and more streamlined cost

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

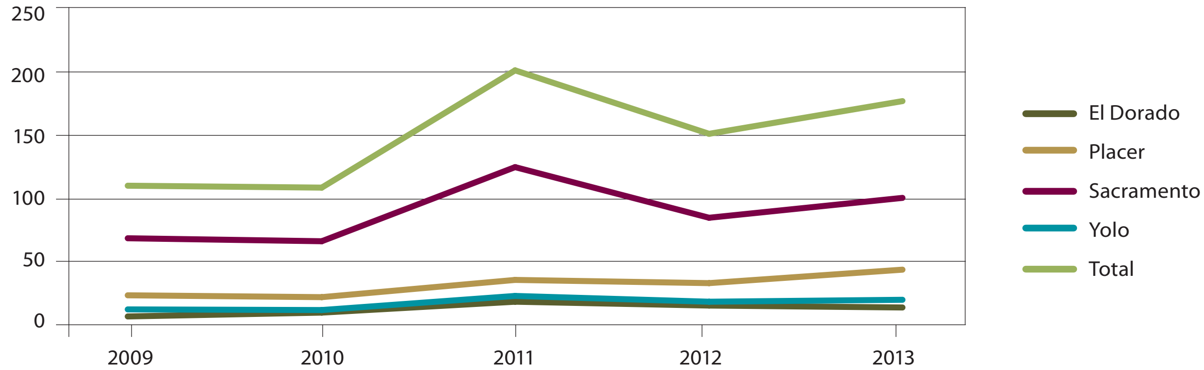


Figure 2
Small Business Confidence Index Trends:
July 2012 – January 2014

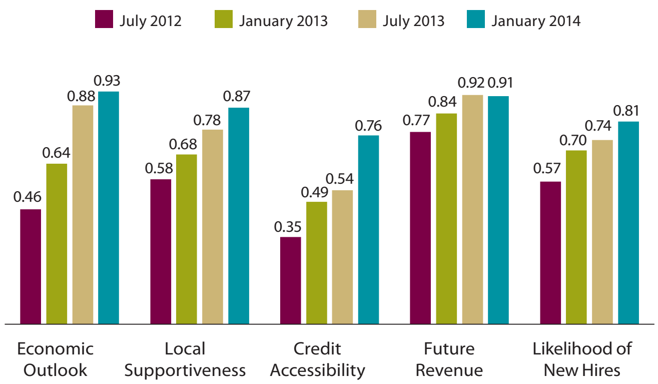


Figure 3
SBCI Trends in the Manufacturing Sector
July 2012 – January 2014

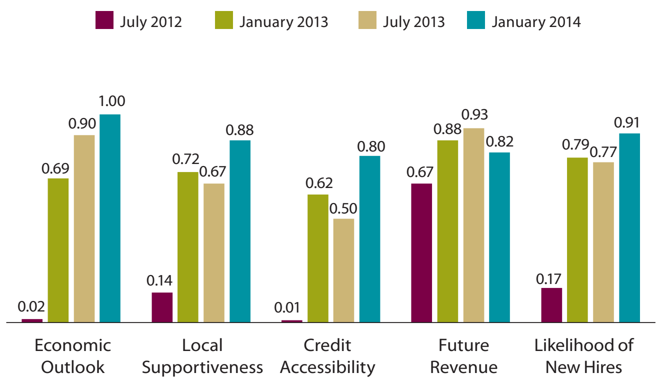


Figure 4
SBCI Trends in the Service Sector
July 2012 – January 2014

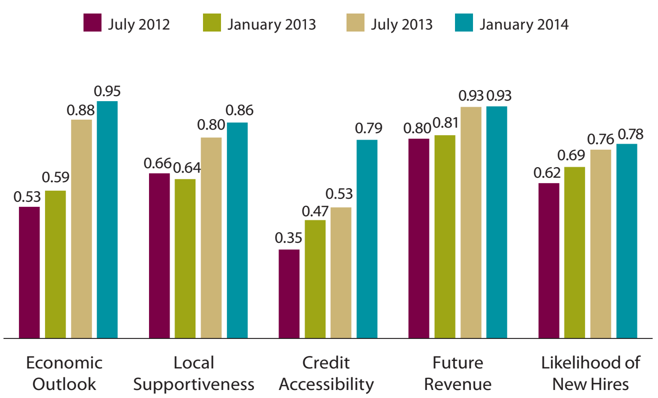
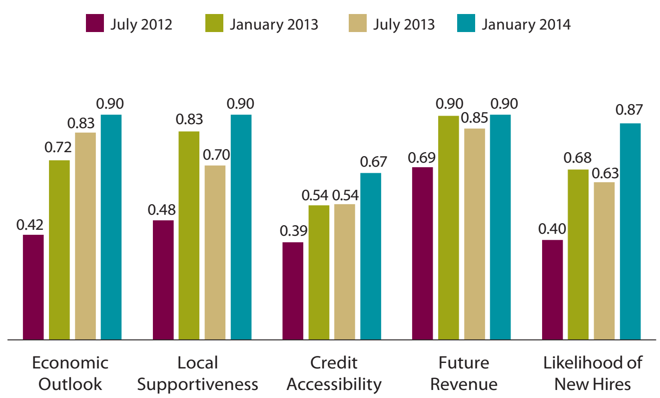


Figure 5
SBCI Trends in the Others Sector
July 2012 – January 2014



Data Source (Figures 1-5): U.S. Small Business Administration structures have allowed them to benefit from increased bottom line earnings. As the economy chugs along, pricing pressure remains problematic for many industries and firms that are unable to charge higher for better products. With improved credit accessibility and greatly improved economic outlook, we are cautiously optimistic regarding increased job creation by SMEs in the near future with a healthier small business sector in 2014.

Small Business Transactions Pick Up: More Activities and Better Quality Sales

The market for small businesses in the Sacramento region has picked up its activities in 2013 compared to recent years, according to the data compiled by BizBuySell, a San Francisco-based online marketplace for small business sales.

1. Increased Activities

Number of businesses listed for sale and closed transactions – show healthy increases from the bottom of the recession. The increased small business sales activity indicates increased confidence in the economy and success of small businesses.

- The number of small businesses listed for sale peaked in 2008-Q2 (243) and bottomed in 2010-Q3 (112). Since then, the number of listings has been steadily increasing. The third quarter of 2013 saw a total of 173 listings, which represents a 54% increase from the bottom.
- The number of actual completed sales transactions showed a similar pattern. The number of businesses changing hands bottomed in 2010-Q4 with three transactions, and then increased more than fourfold to 13 in 2013-Q3.

2. Increased Quality of Sold Businesses

Median closed sales price – has been mostly treading similar levels in the past five years, with an emerging pattern of increase since 2012-Q3. The median sales price has more than quadrupled from 2012-Q3 ($57,000) to 2013-Q3 ($239,000).

Median revenue from closed sales – exhibited some fluctuations but has also been on an increasing trend. The lowest median revenue from sold businesses was $99,500 in 2012-Q3, while in 2013-Q3 the median revenue increased 140% to $239,000.

Median cash flow from closed sales – exhibited patterns similar to those for the median revenue. The 2013-Q3 median cash flow from a sold business increased 92% from that in 2012-Q3.

Figure 6
Numbers of Listing vs. Actual Sales (Quarterly)

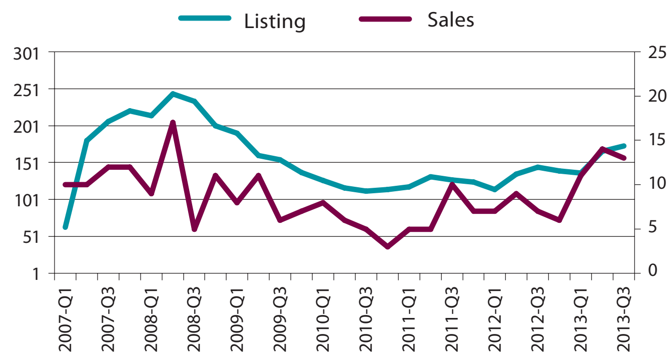


Figure 7
Median Closed Sales Price (Quarterly)

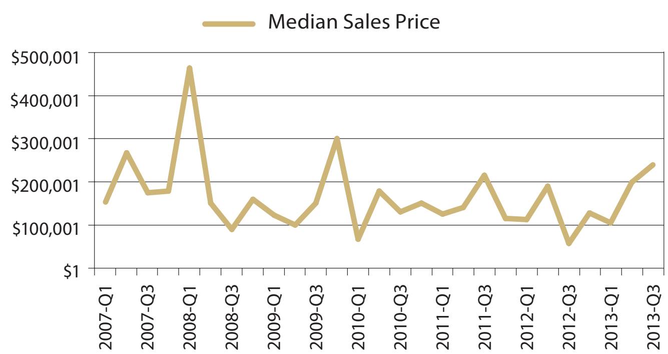


Figure 8
Median Revenue of Closed Sales (Quarterly)

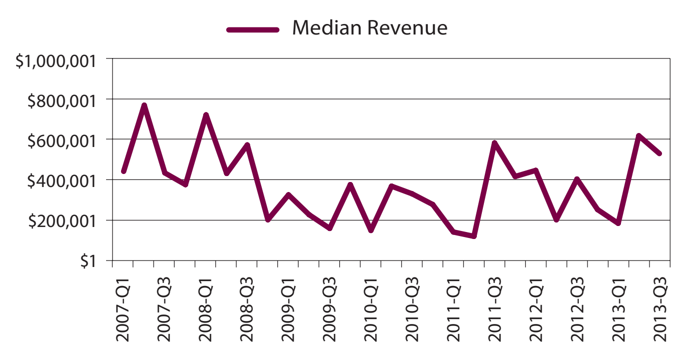
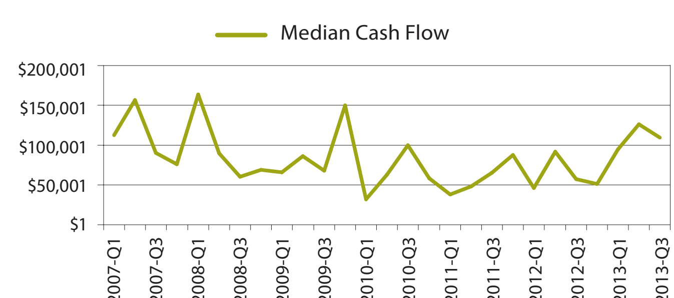


Figure 9
Median Cash Flow of Closed Sales (Quarterly)



Data Source (Figures 6-9): BizBuySell

2014 Capital Markets *Outlook*

Key Points

- **The global economic recovery should accelerate this year, with developed economies faring better than emerging ones.**
- **In 2014, we expect U.S. equity markets to rise 5%-10%, 10-year Treasury rates to increase 0.25% to 0.5% and the U.S. dollar to strengthen.**
- **We believe China will significantly undershoot its stated growth target of 7.5%, keeping pressure on commodity prices.**
- **The SBR Financial Conditions Index confirms the regional recovery is on track.**

> *"2014 finds us with an optimistic view – we expect an acceleration of the global economic recovery."*

Last year was a generally good year in the capital markets: Abating systemic risk as well as reduced policy uncertainty allowed developed equity markets to provide investors with one of strongest calendar year returns on record. U.S., U.K. and European central bankers deftly continued to support their burgeoning economic recoveries though highly accommodative policies. Through a well-executed communication plan, the Fed convinced investors that their largess would not end prematurely, which allowed for the start of an orderly rise in U.S. interest rates.

However, the past year was not an easy one in many emerging markets. Constrained by high inflation and flare-ups in their short-term funding markets, Chinese authorities were limited in their ability to offset slowing economic growth. Reduced Chinese growth contributed to lower commodity demand, dampening prices, which in turn adversely impacted many other commodity export-driven economies. Ultimately the emerging markets experienced subpar equity and bond market returns on the year.

2014 finds us with an optimistic view – we expect an acceleration of the global economic recovery, though it will manifest itself in a desynchronized fashion with developed markets (DM) outpacing their emerging market (EM) counterparts. We present our summary outlook on the right.

Market	Viewpoint	Comments
Economy	↑	2014 stronger GDP growth than 2013, policy risk still elevated
Global Growth	↑	US + Eurozone + Emerging all contribute to growth in 2014
U.S. Growth	↑	Less fiscal drag + more confidence = more consumption
Eurozone	↔	Stronger core - weak periphery = modest expansion
Emerging	↑	Slowing growth + Fed tapering = obstacles
Global Inflation	↔	Low wage growth + low commodity demand = tame inflation
Stocks	↑	Reduced uncertainty + steady earnings = equity tailwinds
Regions	Developed > Emerging	DM = low inflation, stronger growth, easier fiscal policy
Sectors	Consumer	EM = high inflation, weaker growth, tighter fiscal policy
Bonds	↓	Fed tapering = official end of 30-year bond bull market
Regions	Eurozone	Low inflation + slow growth = accommodative ECB
Sectors	Corp/Floating Rate	Remains more attractive than government debt
Commodities	↓	Lower demand + high inventories + strong dollar = headwinds
Sectors	Oil	Global growth + supply/demand balance = stable prices

Macro Themes

This year, the SBR team is taking a slightly different approach to our forecast. Rather than providing our traditional outlook for each of the major asset classes, we have chosen to highlight three key themes that we believe will have the most significant impact on the global capital markets in 2014. While these will not be the only determinants of this year's market behavior, we view these as the most instrumental. Incidentally, two of these themes are U.S.-centric and only one comes from beyond American borders.

Fed Tightening – In our view, the transition in U.S. monetary policy presents one of the most interesting and influential forces we will witness this year. Treasury rates act as price setting mechanisms well beyond their space, and the implications of a directional change are enormous. For the past 30 years, declining interest rates lowered the real cost of credit/capital and generally supported prices for domestic equities, bonds, real estate, and commodities. This trend also weakened the U.S. dollar, inviting inflation from abroad, in the form of higher import and commodity prices.

We now are at an inflection point – the Fed is openly communicating its longer-term intent to allow interest rates to rise to higher levels during the coming years. This is a positive development: The U.S. economy has healed to a point where the current amount of monetary accommodation is no longer necessary. The devil, however, is in the details. How, when, and what degree of confidence the markets have in the Fed's communications and actions will carry massive influence this year. We believe the Fed will take its time as it embarks on a slow removal of stimulus and seek confirmation from the labor, housing, and capital markets prior to taking action.

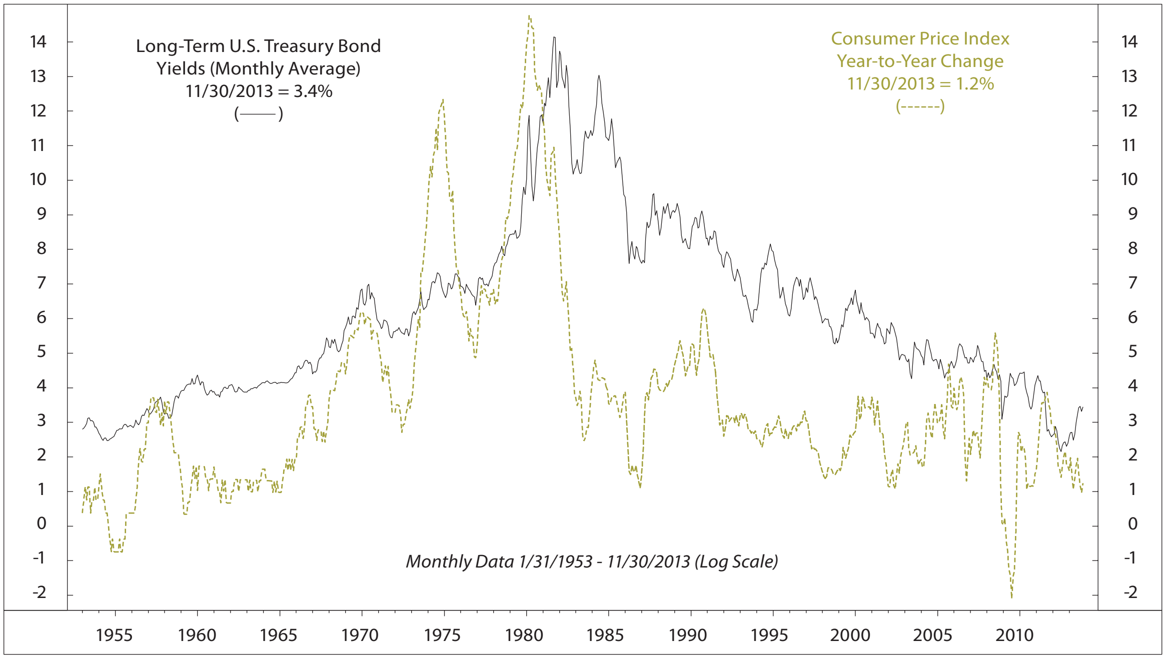
Rising interest rates do not necessarily mean the demise of equity, bond, and real estate prices. Though Fed tightening will be a minor headwind, we think the equity markets finish 5%-10% higher in 2014 due to rising earnings and stable margins. Bond yields will rise, perhaps 0.25% to 0.5%, to a level that equates more closely to the long-term real growth rate of the economy, adjusted for inflation. Rising yields will put minor pressure on bond prices this year and slow, but not cease, the growth in real estate prices.

The dollar should strengthen relative to other currencies, putting further pressure on commodity prices and keeping inflation tame in the U.S. The losers from the stronger U.S. dollar will be the emerging economies as relatively more attractive domestic interest rates will see the repatriation of dollars formerly invested abroad. The unwinding of the so-called "carry-trade" will likely decrease many emerging economies' short-term liquidity and may prove to be a source of volatility in the capital markets this year.

China's Slowing Economy – For years, China's seemingly unstoppable growth fueled fears of an inevitably permanent change in the global balance of economic power, shifting from the West to the East. While China has since grown to become the world's second-largest economy, a number of disturbing signs have emerged that bring its economic model's sustainability into serious question.

We believe that China will significantly undershoot its stated growth target of 7.5% in 2014 as it continues to face mounting structural headwinds. Years of excessive credit growth and an over-reliance on government spending have now come back to haunt the Middle Kingdom as overcapacity, persistent inflation, and a growing concern of a real estate bubble have caused Chinese authorities to tighten their economic policies in an effort to slow their growth.

Figure 1
Treasury Bond Yields vs. CPI (Year-to-Year Change)



Source: Ned Davis Research

Though the U.S. recovery will help boost demand for some Chinese exports, it will likely not be enough to offset the considerable factors weighing on China's broader economy. The trade-weighted yuan is near all-time highs, which has reduced Chinese export competiveness. Not surprisingly, manufacturing growth stalled in the second half of 2013, growing less than 1% despite a broader global recovery. Yields on 10-year government debt have climbed to their highest levels in nearly a decade, suppressing loan growth while a spike in short-term funding markets has added further pressures to the Chinese banking system.

Challenges exist beyond monetary policies as well: Growth in luxury spending has plummeted from 30% to 2% in the past two years as the government has cracked down on political corruption. Pollution has reached hazardous levels in many cities across the country, creating significant public pressure for remediation and demands for reduced industrial output. Lastly, long-term demographics now appear daunting as the effects of China's one-child policy have started to manifest – the working-age population is forecast to start declining by 2015, further reducing per capita GDP.

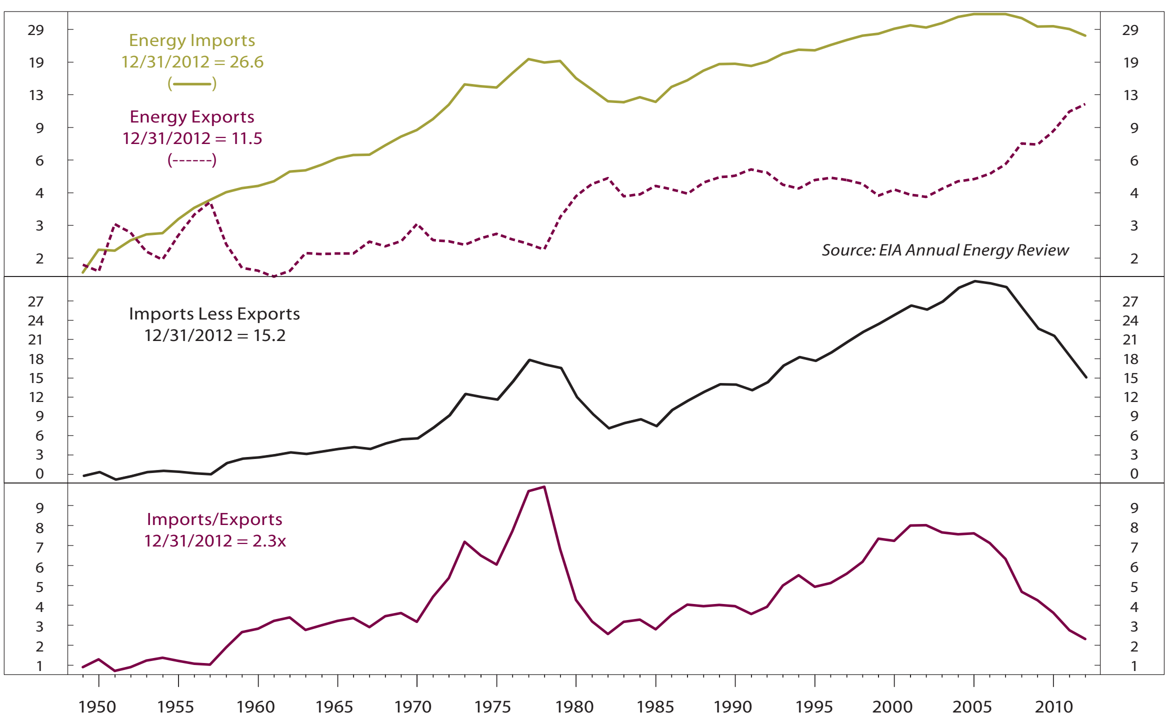
The implications of a slowing and less-competitive China for the global investment markets are wide ranging and should ultimately favor many developed economies over many emerging ones. Lower Chinese growth implies reduced commodity demand, which depresses growth in commodity-exporting economies – such as Brazil, Indonesia, and Chile. Conversely, reduced commodity demand implies lower inflation for commodity-importing economies, such as the U.S., Europe and Japan – which supports consumption and manufacturing. We expect this trend to continue during the coming years as the transition of China's economy is likely to advance slowly.

Saudi America? – For the past decade, the aggregate wealth transfer from petroleum importers to exporters has approximated $1 trillion dollars per year. However, in the past eight years, advances in U.S. energy extraction techniques have significantly increased the domestic supply of consumable fuels, which has allowed America to close its petroleum trade gap. Though the reality of American energy independence may still be a long way off, the evidence is mounting that it may indeed become an attainable goal, and thus create a major ripple effect in the capital markets.

The expanding global recovery is stoking the worlds' appetite for fuel, and petroleum demand is expected to grow modestly in 2014. Supply dynamics, however, are changing dramatically. Global oil production is declining

Figure 2
U.S. Energy Imports and Exports

Yearly Data 12/31/1949 – 12/31/2012 (Log Scale)



Source: Ned Davis Research

among 70% of the world's producers, with production growth in the U.S. and Africa primarily offsetting the supply gap. Multinational energy companies have been attracted by the relatively lower production costs and risks associated with extraction in more stable countries. As a result, investment spending has grown 19% annually from 2010 to 1013 in North America compared to 11% annually in other non-OPEC and 3% annually in OPEC nations.

America consumes about as much natural gas and coal as it produces, however it still relies on imported petroleum products to meet its daily needs. The rate of domestic production is encouraging: The percent of imported petroleum to total U.S. demand is estimated to fall from approximately 30% to less than 10% by the end of this decade. In our view, the trend of the decline is more important than the absolute amount of imports. Higher U.S. petroleum production implies better trade balances, lower national debt and deficits, a stronger dollar, lower inflation, and ultimately, greater national wealth and influence. If the long-term energy forecasts prove accurate, this may be the most significant trend in a generation.

Sacramento Business Review Financial Conditions Index • January 2014

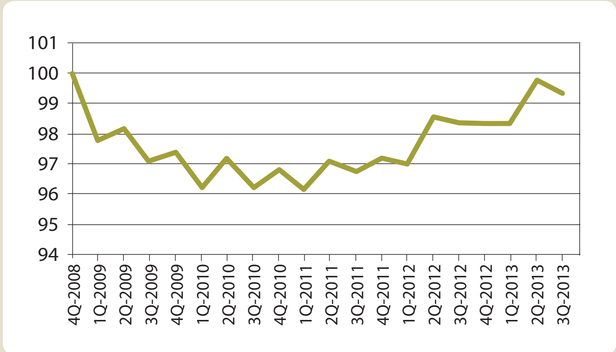
Our proprietary SBR Index incorporates portions from all of the areas of our SBR team's research. This unique combination of local employment, real estate, small business financing activity, banking, and capital market performance data illustrates the general economic conditions that influence the Sacramento region. 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 sale 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]

Our latest reading of our proprietary SBR Financial Conditions Index confirms that the regional recovery remains on track. Our data show that the Sacramento region experienced stable private sector employment, improved housing metrics as well as an increased demand for credit, both in volume and size of loans. Public sector employment declined slightly, which may indicate seasonal trends.

SOURCES:

Cornerstone Macro, Market Outlook 2014, January 6, 2014
International Strategy and Investment, Portfolio Strategy Report, January 6, 2014
Cornerstone Macro, Economic Research, December 31, 2013
Ned Davis Research, 2014 Fixed Income Outlook, December 9, 2013
Wells Fargo Private Bank, Asset Allocation Strategy, December 2013
International Strategy and Investment, Energy Research, November 20, 2013
Ned Davis Research, Commodity Corner, June 13, 2013



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.

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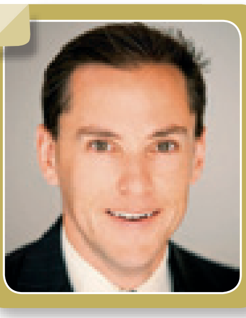

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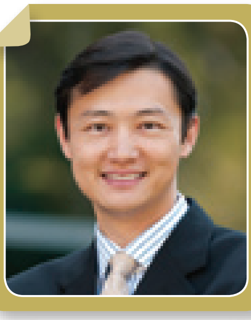

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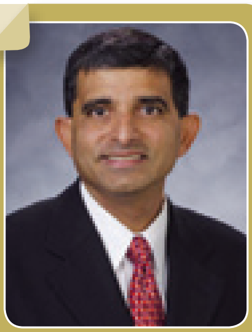

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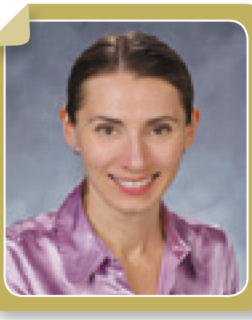

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