JULY 2015

UPDATE

sacramento BUSINESS REVIEW

Emerging Trends in Sacramento's Economy

Volume 7 Issue 2 » sacbusinessreview.com

Real Estate Trends Mid-Year Update
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2015 Mid-Year Update

Your Best Guide to Sacramento's Economy

CFA Society Sacramento

SACRAMENTO STATE
COLLEGE OF BUSINESS ADMINISTRATION

JULY
2015

Message From the Director

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

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Founded in 1991, the CFA Society 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.

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

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Dear Friends,

I am pleased to share the 14th edition of the *Sacramento Business Review* – the most comprehensive, precise, and intellectually sophisticated analysis of the regional economy. For more than seven years, our team has accurately forecasted 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) is now the most credible source of independent thinking, insights, and research not found elsewhere in the region.

I am both pleased and grateful for 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.

The greater Sacramento region continues to experience positive job growth with an impressive decline in the unemployment rates, much like the rest of the United States. While we are likely to reach full job recovery to pre-recession levels in the next year , we continue to face challenges from lower labor participation rates and from job growth at the low end of the wage distribution, with no significant major private sector corporate relocations to the region. This is in sharp contrast to Reno, NV which continues to attract high quality jobs with a growing presence of high-technology companies spillover from the Bay Area (Amazon, Apple, Google, Microsoft, Swift, TESLA, just to name a few). Our loss has been Reno's gain due to its extremely attractive affordability and pro-business environment. We also look anemic when compared to the red hot labor market in the Bay Area, and also compared to the State of California which saw its best employment report last month since 2012 (California created more jobs than the next three ranking states of Texas, Florida and North Carolina combined).

The positive psychology and momentum through the new arena construction has already created more economic activity from downtown to midtown with significant impact on property values and vacancy rates. Housing has been a bright spot with the construction sector coming back strong, much like elsewhere in the State. All real estate property types and sectors have shown strength and we expect them to continue growing modestly. We predicted and continue to see more consolidation in the banking industry and the stronger construction sector is helping there as well. With major negative news coming out of China and other emerging markets, we have seen a pause and tempered expectations for the rest of the year. Our Small Business Confidence Index declined – reflecting concerns regarding future revenues and profitability. Headwinds due to global pressures will likely influence FOMC decisions which in turn will have some local impacts. We expect Sacramento to continue along the path of modest growth.

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 **sacbusinessreview.com**.

Warm regards,

Sanjay Varshney

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- Most economic sectors in the region experienced positive job growth over the last year.
- The Sacramento region is very close to full job recovery.
- We need stronger consumer confidence and more full-time jobs to help sustain economic growth.
- We expect the Sacramento region's unemployment rate to stabilize in the 5-6% range with moderate job growth over next year.
- National and international market developments may bring headwinds for the region's economic growth.

Real Estate 10

- All property sectors remain strong and are improving; investment properties are in short supply with significant investor demand.
- Speculative construction of Industrial and Retail properties has returned and is on the horizon for other property types.
- The Entertainment and Sports Complex (Golden 1 Center) is spurring significant new investment dollars in the downtown core from investors outside the region.
- Going forward, increased employment will improve all sectors of the real estate market.
- The median sale price for all single-family homes increased by 7% during the second quarter of 2015 ($320,000) relative to the fourth quarter of 2014 ($298,000).

Banking Industry 14

- During the first six months of 2015, loan growth has been stronger than forecast. Led by commercial real estate, including robust construction loan growth, loans for the Sacramento Region Banks[1] increased at an 11.4% annualized pace.
- Despite narrower spreads between shorter- and longer-term interest rates, the local banks collectively improved their net interest income at a 7.2% annualized rate through June 30.
- The SBR banking team's long-standing prediction of more merger-and-acquisition activity among local banks proved prescient with the recent acquisition of Sutter Community Bank by Visalia's Suncrest Bank.

Small Business.................................. 16

- Total dollar volume of SBA loans approved in Sacramento MSA increased by 2% over last year.
- Small Business Confidence Index, overall, declined from previous levels with the exception of the Manufacturing Sector.
- Small business sales increased to unprecedented high levels in the first two quarters of 2015 with much improved quality of closed sales.

Capital Markets 20

- After steady first half increase, U.S. stocks saw an official correction in August as China's economic woes rocked financial markets globally.
- With both emerging and developed economies abroad plagued by weak growth, commodity prices have struggled to find a bottom with oil prices leading the way.
- However, the slide in oil prices appear to be driven more by supply side decisions and stronger dollar rather than weak demand.
- All eyes will be on the FOMC meetings in September and December as the Fed considers whether or not to raise rates for the first time in almost a decade.

Sponsors 22

1 The Sacramento Region Banks include American River Bank, 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, Redding Bank of Commerce, River City Bank, River Valley Community Bank, Sierra Vista Bank, Sutter Community Bank, and Tri Counties Bank.

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Chase Armer is a co-owner of Planned Solutions, Inc., a Sacramento-based financial planning and investment advisory firm, where he currently acts as a financial planner and is a member of the Planned Solutions Investment Management Committee. Chase holds several professional designations including Certified Financial Planner Practitioner, Chartered Financial Analyst, and Enrolled Agent. Chase has a degree in economics from California State University, Sacramento, a masters in taxation from William Howard Taft University, and a certificate in personal financial planning from UC Davis Extension. Chase is a past president of the Financial Planning Association of Northern California and currently teaches the Fundamentals of Personal Finance and Investments classes at UC Davis Extension.

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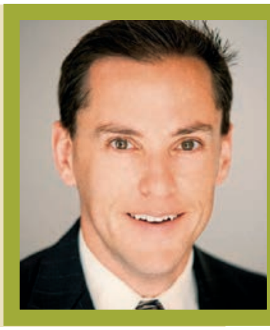

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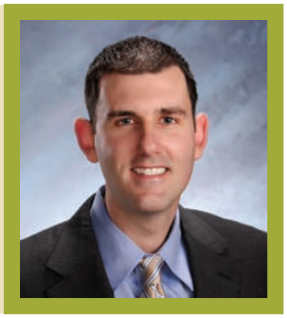

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UPDATE

Sacramento's Labor Market & Regional Economy

2015 Mid-Year Update

We are close to a full job recovery

The Sacramento labor market is now in its fifth year of recovery following the Great Recession. While the region has reported an average annual increase of 2.8% in nonfarm jobs during the recovery, it has yet to recover all of the 110,000 jobs lost between 2007 and 2011. However, the good news is that we are now very close to achieving a new high. It is likely that we will again see the 2007 peak level of employment in the second half of 2015 and be able to claim a full job recovery for the Sacramento Region in 2016 as we predicted in previous issues.

The number of nonfarm jobs in the region increased by 2.2% year-over-year to a total of nearly 920,000. This is less than one percent below the previous high watermark set in June 2007. One more year of nonfarm job growth at or above the historical trend would result in a new all-time high.

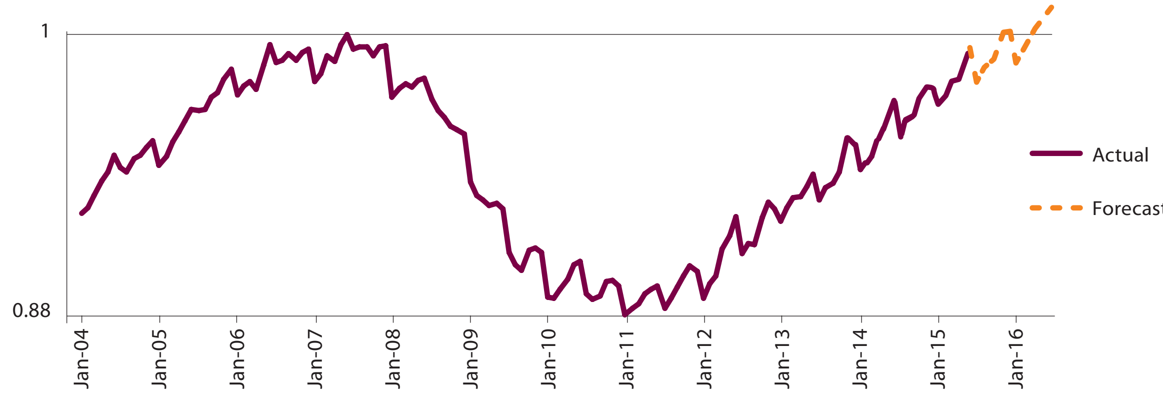
Nearly All Major Economic Sectors Experienced a Positive Job Growth Over the Last Year

- The government sector, the region's largest employer accounting for a quarter of all nonfarm jobs, continues to report a growth rate that lags that of the region as a whole. As the state's revenue stabilizes, the sector's job growth rate has been stable at around 1% per year over the last three years, that is in-line with our predictions for this sector over the last three years. Meanwhile, we have also seen a steady 2-4% year-over-year increase in professional & business services, which has just surpassed health care to become the region's second largest employment sector. This rate of growth is in-line with the region's overall job growth rate over the last three years. On the other hand, the health care sector, now the region's third largest employer and the job growth leader over the last few years, reported a slowing rate of job growth over the past year. The number of health care sector jobs in the region has increased by over 30% from 2007 and by nearly 90% since 2000.

- The leisure and hospitality sector exhibited a well-above-the-average growth rate over the past year. The total number of jobs in this sector increased 6.7% year-over-year, more than twice the rate of increase for the region as a whole. The relatively smaller education sector also added another 800 jobs, or 6.2%, over the last year. The retail industry has experienced a 4.5% increase over the past 12 months; however, we expect to see this growth rate go back to the 2-3% range as consumers remain cautious.

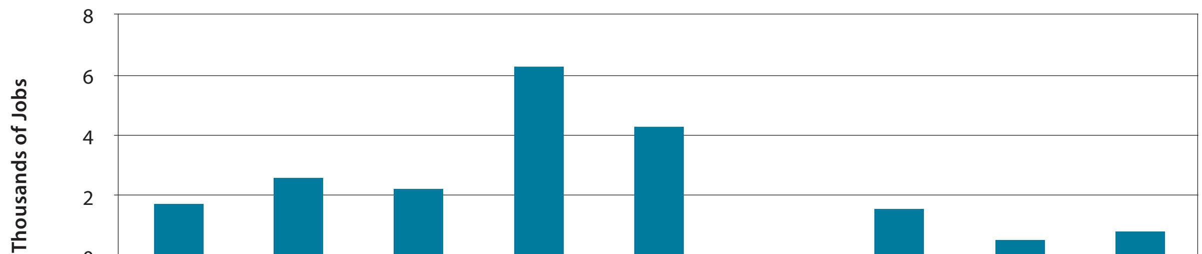
- The real estate market is stabilizing and builders are in the game again. As a result, the construction sector, one of the hardest hit areas during the recession, has

Figure 1
Sacramento Job Recovery » Sacramento Total Nonfarm Jobs (Ratio to 2007 Peak Level)



Data Source: EDD

Figure 2
Sacramento Job Market Changes: 2014 - 2015



	Government	Professional & Business Services	Health Care	Leisure & Hospitality	Retail	Finance	Construction	Manufacturing	Education
Thousand of Jobs	1.7	2.6	2.2	6.3	4.3	0	1.6	0.5	0.8
Percent Change	0.7%	2.1%	1.8%	6.7%	4.5%	0.0%	3.4%	1.4%	6.2%

Data Source: NEED

shown signs of recovery over the past year. In total, construction jobs have increased 3.4% year-over-year that is above the average rate of growth for the region. However, the total number of construction jobs is still about 27% below its prerecession level. Development projects in the Sacramento region will likely help this sector continue its job recovery.

The government, professional services, and health care sectors account for nearly half of the regions total jobs. Therefore, continued growth in these areas will be needed to maintain the labor market recovery in the Sacramento region. However, other segments of the labor market, such as construction, which has been fueled by the increase in housing related activity, as well as the leisure, retail, and education industries, which have recently reported strong employment gains, may also be strong contributors to the region's economic recovery.

National and International Economic Environments May Bring Headwinds for the Region's Economic Growth

As the world is facing greater market volatility and geopolitical uncertainties, the US continues to report stronger economic growth than its peers that has resulted in an increase in the value of the U.S. dollar. A stronger dollar weakens U.S. exports. As a result, the U.S. economy was estimated to grow just 0.6% in 1Q2015 and 2.3% in 2Q2015, well below the figures in 2014. The fed is also in a challenging position as they succeeded in stimulating the economy – now reversing course will breed uncertainty. Raising interest rates is a signal of the U.S. getting back to a more normal economy, but this may bring a chocking of economic growth and a market shock, and may send the value of the dollar even higher. We also need a stronger consumer confidence and more full-time jobs to help sustain the economic growth. Overall, our economic forecast for the year to come is moderately positive and we expect the Sacramento region's unemployment rate to stabilize in the 5-6% range.

UPDATE

Real Estate Trends in the Sacramento Region

Retail

Retail is back in Sacramento with vacancy rates down to pre-recession levels. The first half of the year saw approximately 350,000 square feet of new construction and about 600,000 square feet of positive absorption. About 60% of the absorption in the second quarter came from 10 properties and about a third of the absorption came from discount stores, grocers and furniture stores. Vacancy in power centers and anchored centers is in significant decline. Rates in key submarkets for smaller space are climbing, with some newer centers commanding around $4.00 per square foot per month. Older unanchored strip centers still struggle to attract credit tenants, but rents in these centers are stabilizing and beginning to climb. With Golden 1 Center under construction downtown, there are several food, entertainment and other retail venues poised to benefit from the opening next year. Retail throughout downtown continues to be vibrant, further elevating the profile of the area.

Industrial

The Industrial sector remains consistent and stable. Vacancy has dropped steadily for the last 4 years, ending last quarter at 10.2% overall. This can be partially attributed to the fact that the Industrial sector did not overbuild in the last downturn. With that, there is over 1 million square feet of new industrial space that has either recently been completed or is under construction - most of which is speculative and over half of which was or will be pre-leased upon completion. There has been a flight to quality with Class A buildings seeing good rent appreciation. Older buildings have not seen as appreciable of an increase in rates, although with supply getting tighter, we expect modest increases here as well. A great deal of the leasing activity has been a result of tenants consolidating, expanding or seeking more suitable facilities such as the Macy's 400,000 square foot expansion into the old Campbell's site and the recent announcement of Nor Cal Beverages consolidation of 3 facilities into a new 474,000 square foot building in Southport. With that, the Industrial sector posted over 1.1 million square feet of positive absorption at mid-year. As the market reaches equilibrium, expect more speculative construction in the next 12 months.

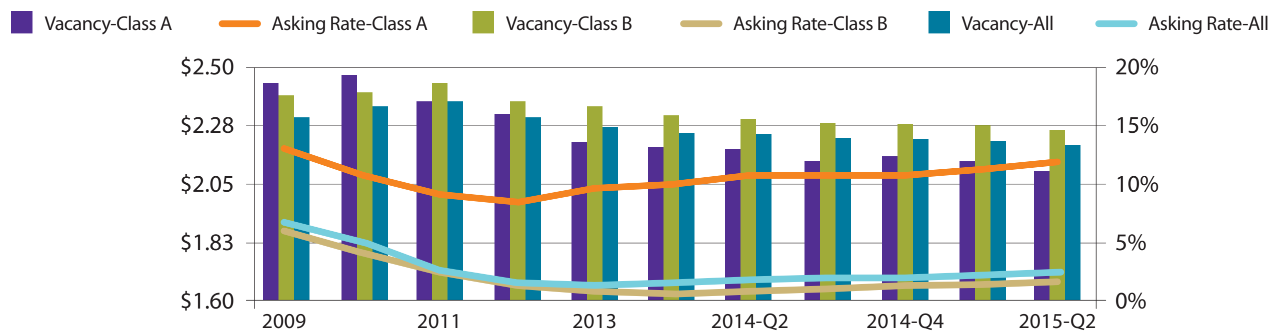
Office

Of all of the product types, Office suffered the most in the last downturn, however we have seen significant improvement with vacancy easing by over 50 basis points in the first half of this year to 13.4%. Rates on Class A properties are climbing, particularly in the downtown submarket, as many Landlords and investors see an improving landscape with construction of the new Entertainment and Sports Complex scheduled to be completed by the fall of 2016. Key suburban markets such as Roseville and Folsom are also seeing gains while other submarkets are still recovering from the last recession. Net absorption at mid-year is approximately 300,000 square feet which has shown generally positive momentum for the last 3 years. New speculative construction has been considered by some developers but nothing is likely to break ground until vacancy drops and the market can support the increased rents needed to justify new construction.

User/Investor Sales

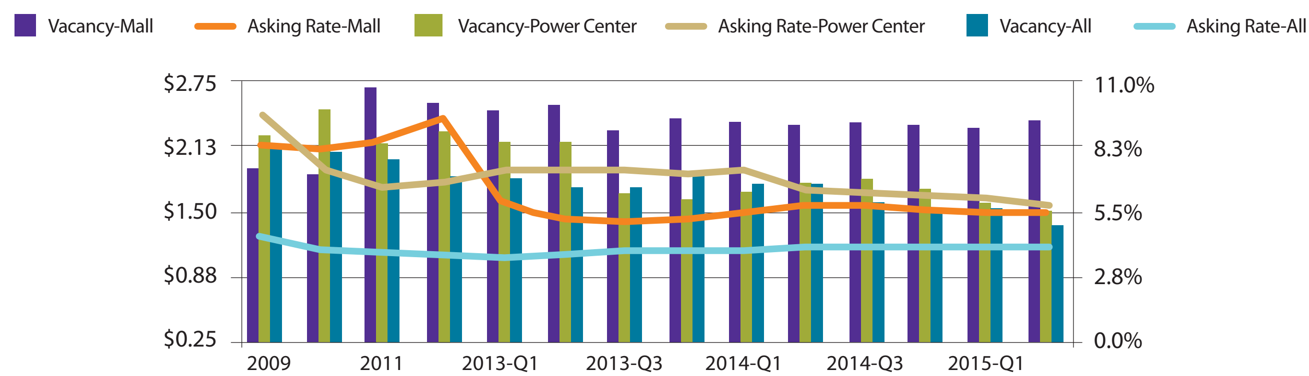
Investor activity from outside of the area continues to swell as several investors being squeezed out of other core markets are chasing yields in the Sacramento area. The downtown renaissance has aided in this additional activity as well with several recent purchases of downtown properties by investors who are new to the region.

Figure 1
Office Lease Rate vs. Vacancy Rate



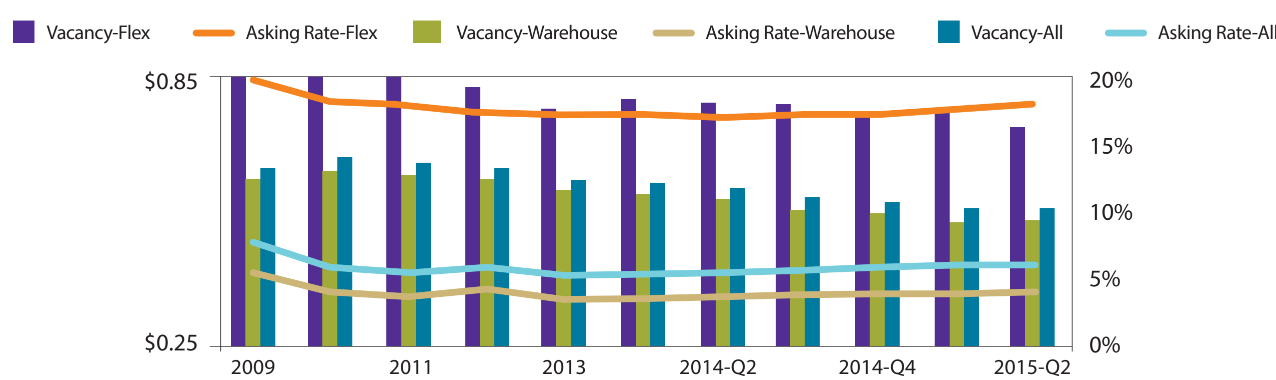
Data Source: CoStar

Figure 2
Retail Lease Rate vs. Vacancy Rate



Data Source: CoStar

Figure 3
Industrial Lease Rate vs. Vacancy Rate



Data Source: CoStar

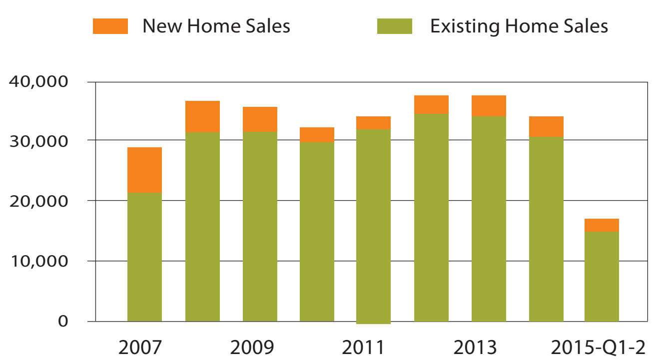
Residential

The median sale price for all houses in the Sacramento region increased modestly during the second quarter of 2015 relative to the fourth quarter of 2014. The median sale price in June 2015 was $320,000, which is approximately a 7% increase from both the fourth quarter of 2014 and year-over-year ($298,000). Notably, the magnitude of this increase was approximately half of the rise from 2013 to 2014. The first half of the year provides further evidence that the Sacramento housing market has "cooled off" since the 26% price increase in 2013. Despite these recent gains, the current median price remains 23% below its 2005 peak. The median sale price per square foot in the Sacramento MSA for single family residences increased by 6% year-over-year, to $186. In particular, the largest year-over-year increases in price per square foot were Yolo County (10.5%), followed by Sacramento County (7.6%), Placer County (3.7 %), and El Dorado County (2.8%).

The trend of increased selling activity of new homes continued in the first six months of 2015, as sales of new homes increased by 25% year-over-year (Q2 2014-Q2 2015). Further, sales of existing single-family residences increased by 15% during Q2 2014-Q2 2015. Sales of all homes (condominiums, existing, and new homes) in the Sacramento MSA increased by 15.6% in the first two quarters of 2015 compared to the same period in 2014. Overall, 18,363 homes were sold in the first half of 2015, compared to 16,293 in the same period of 2014. Geographically, sales activity in all four counties in the region increased by at least 7%, with a 24% increase in the Placer County.

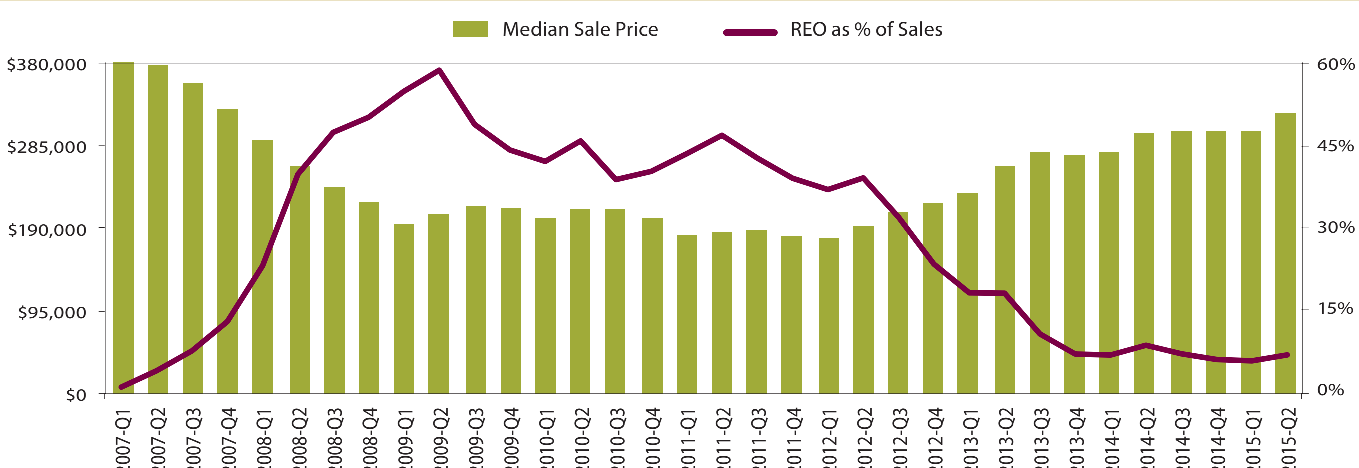
The modest rise in median house prices can be explained by the continued decline in distressed sales and the slight increase in the proportion of higher-priced homes. The real estate owned by banks (REO) represented an average of 5.8% of all sales in the first two quarters of 2015, down from 7.0% in 2014, and 11% in 2013. The proportion of homes sold for more than $400,000 increased slightly in all four counties in the Sacramento region, while the proportion of homes below $400,000 declined. Overall, in the Sacramento MSA the proportion of homes in the $400,000 – 600,000 range increased from 26% to 29%, while the percentage of homes below $200,000 declined from 23% to 20%.

Figure 5
Residential New Home Sales vs. Existing Home Sales
Sacramento MSA



Data Source: CoreLogic

Figure 4
Median Sales Price (All Homes) vs. REO as a % of Sales: Sacramento MSA

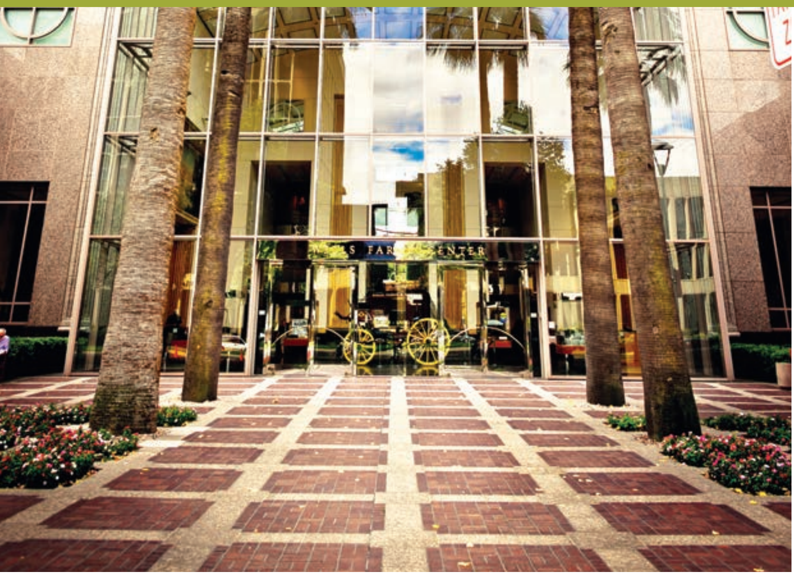


Data Source: CoreLogic

UPDATE

2015 Sacramento Banking Industry Forecast

Mid-Year Update



In January 2015, the Sacramento Business Review (SBR) banking industry analysts predicted that the solid pace of loan growth would be sustained throughout the year. Specifically, the team expected net new loans to increase at a high-single-digit rate, as healthier borrowers continued to re-leverage in a relatively healthy economy.

Through the first six months of 2015, loan growth has turned out even stronger than forecast. Led by commercial real estate, including robust construction loan growth, loans for the Sacramento Region Banks increased at an 11.4% annualized pace (Table 1).

The analysts also noted that the narrower spread between shorter- and longer-term interest rates would act as a drag on top-line net interest income. The team predicted that the Sacramento Region Banks[1] should be able to collectively increase their top lines at a 5-7% rate. Thus far, this forecast has proved rather prescient, as banks improved their net interest income at a 7.2% annualized rate through June 30 (Table 2).

Table 1
Sacramento Region Banks » Loan Growth by Category
(through June 30, 2015)

% of Total	Category	% Change Since 6/30/14	% Change Since 12/31/14*
43.8%	Commercial Real Estate	17.7%	18.5%
22.6%	Residential	0.3%	1.4%
10.4%	Commercial & Industrial	6.1%	14.2%
4.6%	Multifamily Residential	16.2%	8.7%
4.1%	Construction Loans	14.0%	26.2%
14.5%	Other Loans & Leases	17.6%	2.8%
100.0%	**Total**	**11.8%**	**11.4%**

** Figures showing the 2015 year-to-date changes are annualized.*

Data Source: FDIC

Table 2
Sacramento Region Banks
Aggregate Income Statement » ($s in Millions)

	Last 12 Months 12/31/2014	Last 12 Months 6/30/2015	Annualized % Change
Interest Income	$466.7	$483.3	7.1%
Interest Expense	(23.5)	(24.2)	5.3%
Net Interest Income	$443.1	$459.1	7.2%
Provisions for Loan Losses*	1.2	3.5	400.5%
Noninterest Income	91.6	92.8	2.6%
Noninterest Expense	(354.1)	(360.0)	3.4%
Pretax Income	$181.8	$195.4	15.0%

** There were no net Provisions for Loan Losses during the periods presented. The positive figures denote reversals of prior loss provisions.*

Data Source: FDIC

More Merger & Acquisition Activity Occurs

Since 2011, the SBR banking team has predicted that Sacramento would begin to see a pick-up in merger-and-acquisition (M&A) activity among local banks. For three years, the lack of transactions led the analysts to begin questioning their assumptions. Starting in early 2014, however, the team's prediction finally started coming to fruition. After North Valley Bank and Bank of Sacramento were acquired last year, Sutter Community Bank recently announced that it was being purchased by Visalia's Suncrest Bank in a $9.4 million all-stock deal.

Year-to-Date Bank Stock Performance Review

Given solid top- and bottom-line growth this year, the SBR Bank Index increased 3.4% through August 31 (Table 3). This return exceeded the benchmark KBW Regional Bank Index's 1.7% gain during the same time period.

Those basing their trading strategies on the SBR bank stock ratings this year would have fared well. For example, Community Business Bank and Folsom Lake Bank, two of the four banks rated Outperform in January 2015, have been two of the three best performing local bank stocks this year, generating returns of 25.7% and 15.8%, respectively. Moreover, Tri Counties Bank and Sierra Vista Bank, the two stocks rated Underperform, were two of the three worst performing local bank stocks through August.

The team would be remiss if it neglected to mention some of its erroneous calls, which included Sutter Community Bank (which was acquired and was the best performing local bank stock, up 60.7% as a member of the Market Perform list) and River Valley Community Bank (down 15.5% while rated Market Perform).

Table 3
Year-to-Date Stock Performance
(through August 31, 2015)

Bank	2015 YTD Return	January 2015 Rating
Sutter Community Bank	60.7%	Market Perform
Community Business Bank	25.7%	Outperform
Folsom Lake Bank	15.8%	Outperform
Community 1st Bank	14.6%	Market Perform
Farmers & Merchants Bank	11.1%	Market Perform
American River Bank	7.2%	Outperform
River City Bank	5.5%	Market Perform
First Northern Bank of Dixon	2.9%	Outperform
Tri Counties Bank	-2.9%	Underperform
River Valley Community Bank	-15.5%	Market Perform
Sierra Vista Bank	-17.8%	Underperform
SBR Bank Index	**3.4%**	
KBW Regional Bank Index	**1.7%**	

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).

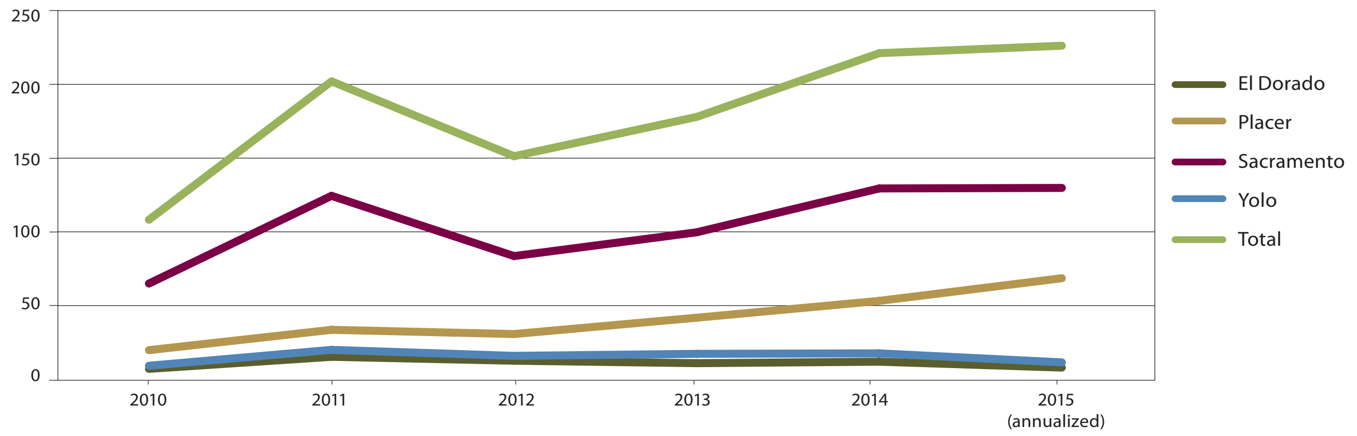
Endnote

1 The Sacramento Region Banks include American River Bank, 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, Redding Bank of Commerce, River City Bank, River Valley Community Bank, Sierra Vista Bank, Sutter Community Bank, and Tri Counties Bank.

The Small Business Economy

The total dollar volume of SBA loans increased by 2% over the last year. While lending activity in Sacramento County, the largest among all adjoining counties, managed to stay flat, Placer County (second largest) had a 28% increase. The two smaller counties - El Dorado and Yolo each experienced a 30% decline. SBA lending has clearly slowed down compared to the previous years since 2012, but the good news is that the trend remains positive and upward. What we are seeing in the Sacramento region is consistent with slowdown in growth nationally.

Figure 1
Total Dollar Amount of SBA Loans Approved in Sacramento MSA - July 2015 (in Millions)



Data Source: U.S. Small Business Administration

Overall, our Small Business Confidence Index declined slightly across the board compared to last year when the measure hit record levels of optimism. The most notable negative changes occurred in the measures of Credit Accessibility and Likelihood of New Hires, whereby each dropped by approximately 9%.

Among the three sectors, the Manufacturing Sector was the only sector that did not experience a decline in its Confidence Index levels. Confidence levels for manufacturing improved in most measures – most notably, 10% increase in Credit Accessibility and 11% increase in Likelihood of New Hires.

Among the three sectors, the Manufacturing Sector was the only sector that did not experience a decline in its Confidence Index levels.

The other two sectors – service and other - showed lower confidence levels across all measures. The most striking drop of confidence was in the "Other" sector's outlook on Credit Accessibility (40% drop).

Most small businesses have pulled back expectations regarding business prospects for the next few months. With market uncertainty and volatility, pressure on energy and commodity prices, speculation on federal interest rate moves, and Chinese currency devaluation, small businesses are cautiously adjusting and updating their outlook for the future.

Figure 2
Small Business Confidence Index Trends: January 2014 – July 2015

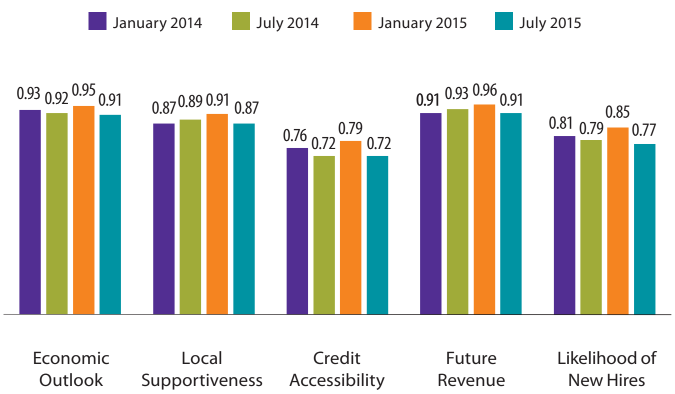


Figure 3
SBCI Trends in the Manufacturing Sector

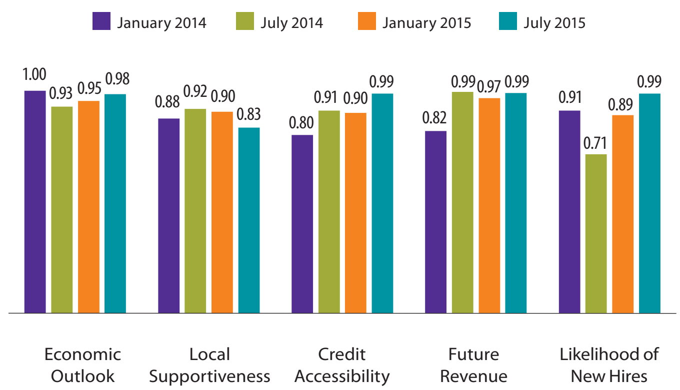


Figure 4
SBCI Trends in the Service Sector

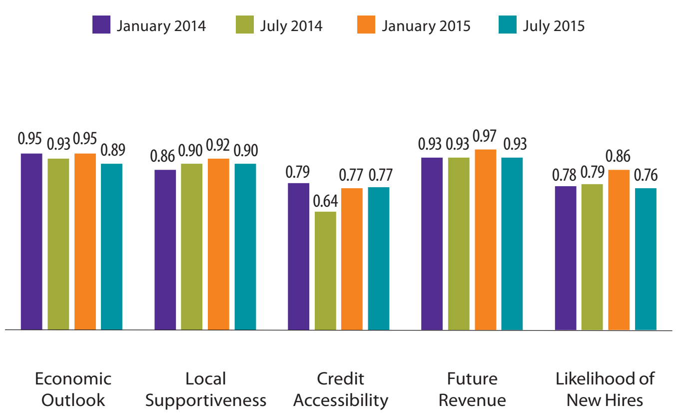
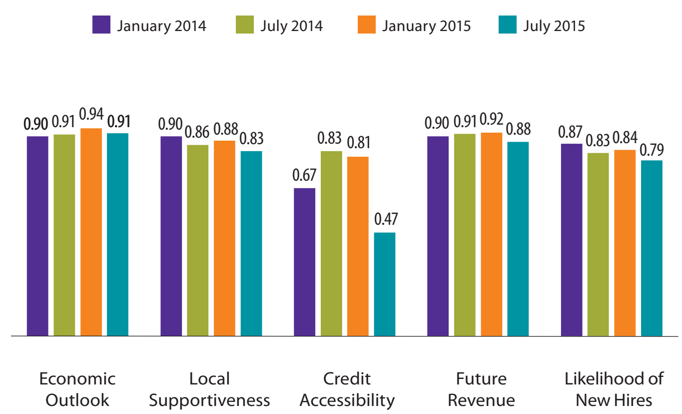


Figure 5
SBCI Trends in Others Sector



Data Source (Figures 2-5): U.S. Small Business Administration

The Small Business Economy

The number of businesses listed for sale in the Sacramento region spiked to 275 in the first quarter of 2015, and then declined in the second quarter to 252, for a total of 527. These numbers are 46% higher from the same period in 2014, and higher than those from any other quarter since 2007.

The median "closed sales price" in Q2 improved over 4.5 times to $775,000 from the 2014 quarterly average of $170,000. This was largely due to a one-time sale of three major businesses (educational services and freight/moving/delivery) that commanded closing prices close to $1.5 million. As a result, both median revenue and cash flow of closed sales were also skewed upward.

Small Business Sales

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

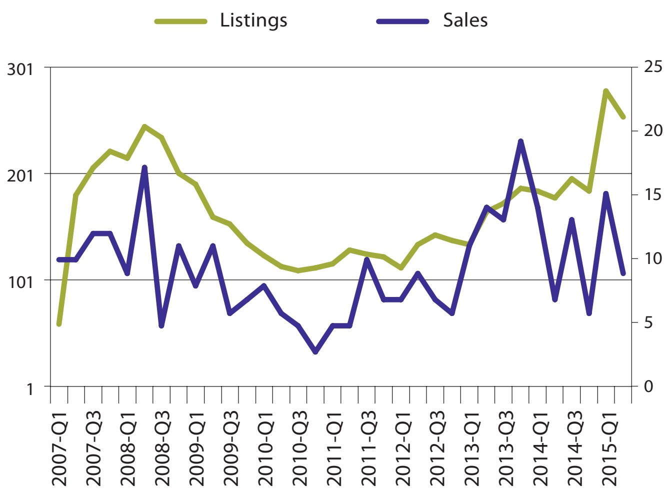


Figure 7
Median Closed Sales Price (Quarterly)

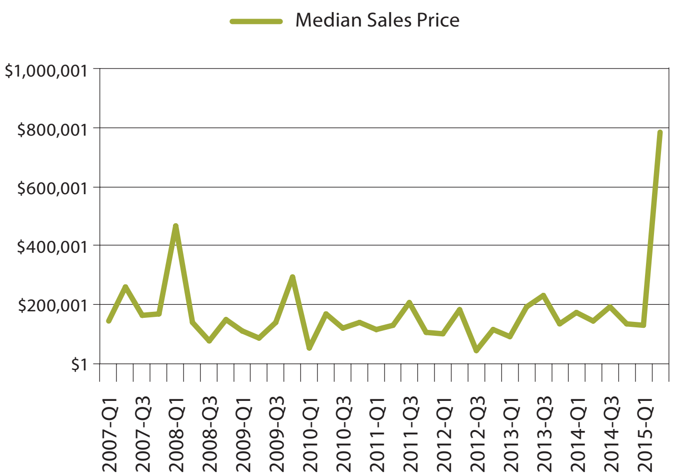


Figure 8
Median Revenue of Closed Sales (Quarterly)

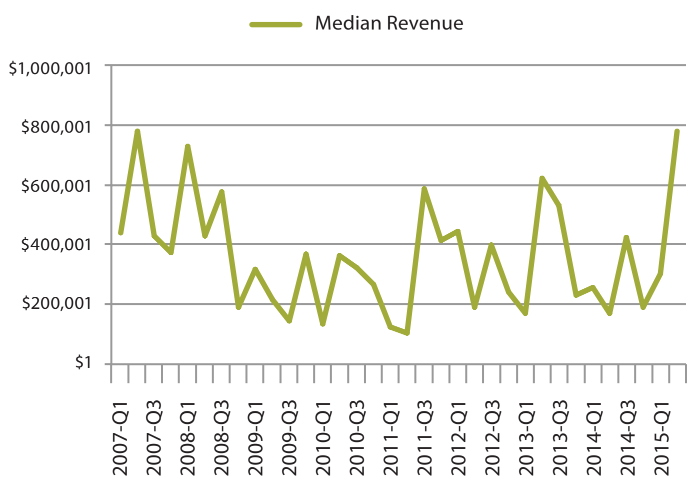
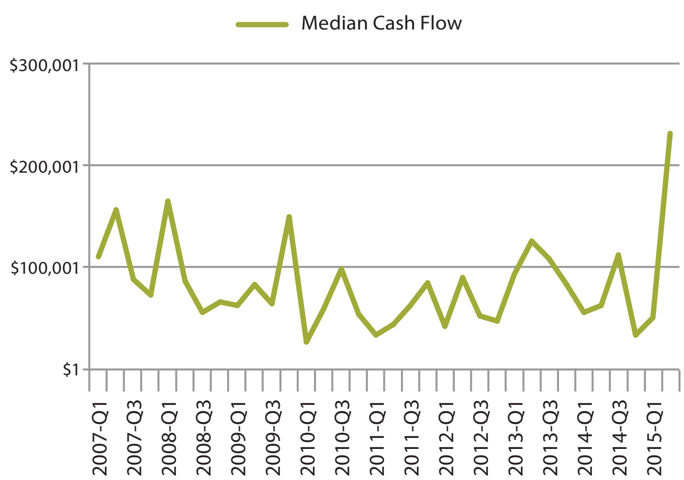


Figure 9
Median Cash Flow of Closed Sales (Quarterly)



Data Source (Figures 6-9): BizBuySell

UPDATE

2015 Capital Markets *Outlook*

It has been a bumpy ride

For the first part of 2015, domestic capital markets have been heavily influenced by mixed U.S. economic data and weakness in capital markets abroad. While every little bit of positive, domestic economic news seems to put upward pressure on interest rates, this upward momentum has often been reversed by other troublesome news concerning the Greek debt crisis or the fragile Chinese economy, and an eventual flight of capital back to the "safe haven" of the U.S. ensues.

Although the Greek debt crisis provided for quite a dramatic dialogue between Eurozone and Greek leaders, it appears that Greece's creditors will have their demands satisfied, at least for now. Greek Parliament continues to pass legislation necessary to enact the financial reforms that will allow Greece's massive debt load to be repaid, but it is one massive debt load in consideration and it is going to take quite a bit of sustainable commitment financially on behalf of the Greek people to work their way back to a healthy economy.

Market	January Prediction	Comment/Update
Economy	↗	Positive momentum building into the second half of the year should help offset the weak growth seen in first half of 2015
Global Growth	↔	U.S. continues to buoy developed economies; global growth headwinds should begin to subside for the remainder of the year and into 2016
U.S. Growth	↗	Persistent 200k+ payroll numbers show continued strength, but still need to see wage growth
Eurozone	↔	With the situation in Greece largely under control and the abatement of deflation fears, Eurozone on track towards positive growth
Emerging	↔	Lack of demand from China bleeding over into price levels of EM economies
Global Inflation	↔	Deflationary pressures have troughed; however, inflation expected to remain low into 2016
Stocks	↗	U.S. focused markets reporting good earnings while companies with foreign exposure are feeling the negative impact of the strong dollar on their bottom line
Regions	U.S. > Rest of World	Weak returns for both U.S. and Developed Markets to turn positive, albeit modestly by year end.
Sectors	Consumer	Consumer confidence volatile due to mixed data and failure to see wage growth
Bonds	↔	Expect curve to flatten as we approach Fed rate decision
Regions	Eurozone	With focus turned away from Greece, ECB able to concentrate on monetary policy
Sectors	Corp/Floating Rate	Brief widening of spreads due to the Greek debt crisis, spreads should revert to tightening for the later part of the year
Commodities	↘	With economic growth showing signs of a slow comeback abroad, commodity prices may have reached a bottom
Sectors	Agriculture	Beef prices remain elevated, but may reverse course due to improving herd conditions as we head into 2016

The wild ride that has been the Chinese economy of late has also given global capital markets much grief. From 2014 into 2015, the Chinese stock market managed to triple in market capitalization from approximately $3.5 trillion to $10 trillion, all within only one year! As the Chinese economy continued to slow into 2015 and earnings came in at underwhelming levels, the margin fueled stock bubble started to show signs of an inevitable burst, and Chinese policy makers have been trying to assist in a gentle pop ever since. The Chinese government initially encouraged more purchases on margin to support prices and followed those actions with a devaluation of the Yuan by an explicit adjustment to the Yuan/Dollar target.

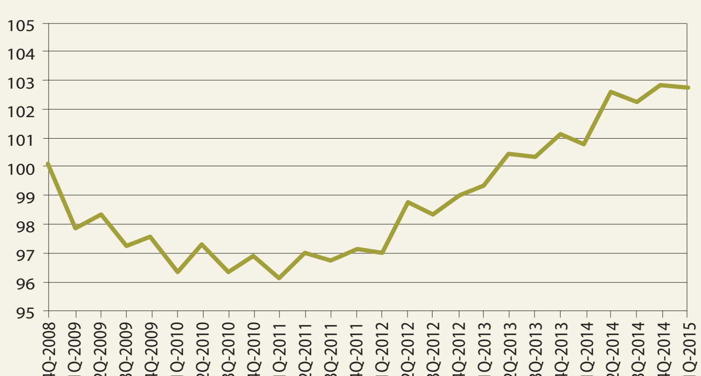
What does this all mean for U.S. markets and the Fed?

In our initial 2015 forecast, we called for a Fed move in the later part of the year, and we still believe this to be true; however, the volatile economic data and geopolitical debates abroad are not making things easy on the Fed. While the economic news here in the U.S. has trended positive, the Fed will still have to justify an interest rate hike under an assumption of inflation yet to come, and face the potential of a flattening yield curve due to dollar strength stemming from the troubles in China and Europe. Although this environment is not ideal for the Fed, we do believe a rate hike is necessary to encourage capital investment. With low interest rates comes cheap capital and we have had cheap capital for quite a while now under relatively positive economic prospects. This cheap capital has allowed companies and investors to squeeze just about every little bit of meaningful return out of investable projects, and now, there are not really that many investable projects left that can provide adequate returns. This may be why we have not seen much in terms of wage growth, because the returns that could be realized on projects that have not been undertaken do not justify an investment in labor. So, companies and investors have only been willing to add inputs at these low costs that will still allow for some return under current conditions. An increase in interest rates will inherently lead to more expensive capital that requires a higher level of investment on the part of investors. This increased level of investment should result in more expensive labor, higher wages, and capital in order to achieve returns at the higher hurdle rate, or the higher cost of capital.

Another hurdle the Fed will face is the impact of its decisions on the yield curve in light of current events. With the weakness abroad causing capital to flow to the U.S., resulting in downward pressure on the longer end and the expectation of a Fed rate hike putting upward pressure on the shorter end, we are most likely headed into a flat yield curve environment. A flat yield curve is tough on banks who need steepness in the curve in order to borrow at shorter, cheap rates and lend at longer, more lucrative rates. When banks have to deal with a flat yield curve, their margins tend to shrink along with their ability to grow capital through retained earnings. The inability to grow capital restricts a bank's ability to grow assets and thus has a direct impact on how much a bank can lend. One way to continue to grow for a bank is to leverage more, but as we have seen, additional leverage is often not healthy for the economy and may be more difficult to attain under new Basel III capital rules. So, if banks do in fact face a flat yield curve and are not able to grow their balance sheets due to poor capital accretion rates, banks will have to cut back on lending and thereby restrict credit to an economy that desperate needs it to continue growing its way out of the recession. These economic conundrums are what we hope all the smart people of the Fed will be able to address as they meet throughout the remainder of the year to discuss just how to get us out of this low rate, low return environment.

Sacramento Business Review Financial Conditions Index

Our latest reading of our proprietary SBR Financial Conditions Index shows a slight contraction for the first part of the year; however, this small downward blip is in line with seasonality that we typically seed during our midyear update. Lower home sales figures reported in the first quarter of the year tend to weigh on the index during our update, but the higher home sales figures typically seen in the summer months offset these declines as we report our annual forecast at the beginning of the year.



Thank You

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* *Data from 2013 EIA Form 826 at www.eia.gov/electricity/data/eia861/*

** *Weighted average using 2012 EIA 861 data and average rates from CMRG Survey dated April 2014.*

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