JANUARY
2016

sacramento BUSINESS REVIEW

Emerging Trends in Sacramento's Economy

Volume 8 Issue 1 » sacbusinessreview.com

Real Estate Trends in the Sacramento Region page 12

photo credit: Sacramento Kings / Sara Molina

2016 Economic Forecast

Your Best Guide to Sacramento's Economy

Labor Market Forecast » Real Estate » Banking Industry »
Small Business » Capital Markets »
NEW! Human Resources/Leadership

JANUARY
2016

sacramento BUSINESS REVIEW

sacbusinessreview.com

MISSION

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

LABOR MARKET FORECAST

REAL ESTATE

BANKING INDUSTRY

SMALL BUSINESS

CAPITAL MARKETS

NEW! HUMAN RESOURCES/ LEADERSHIP

Follow us on twitter

https://twitter.com/SacReview

@SacReview

CONTACT

Sanjay Varshney, PhD, CFA, Chief Economist,
Sacramento Business Review
(916) 799-6527 » *sbvarshney@yahoo.com*
sacbusinessreview.com

EDITORS
Jason Bell, CFA
Jonathan E. Lederer, CFA
Sanjay Varshney, PhD, CFA

GRAPHIC DESIGN
Carrie Dennis Design

PHOTOGRAPHY
Dee and Kris Photography
istockphoto.com
Sacramento Kings / Sara Molina

PROOFREADING
JMT Communications Management

Message from the Chief Economist

Dear Friends,

I am pleased to share the 15th edition of the *Sacramento Business Review* – the most comprehensive, precise, and intellectually sophisticated analysis of the regional economy. For eight years, 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) is now the most credible source of independent thinking, insights, and research not found elsewhere in the region.

For the first time, in addition to our **Small Business Confidence Index** and comprehensive **Financial Conditions Index**, we are introducing the **new HR Barometer** and fresh new coverage of **credit unions** that have a substantial presence in the region. We find that Sacramento women are under-represented at the highest levels of the workforce, but minorities are underrepresented at every level. We also find that credit unions have grown their aggregate loan books faster than the local commercial banks, thanks in large part to auto loans, which have nearly doubled since 2012.

The greater Sacramento region has lagged both the nation and the state in its recovery for both speed and job growth. We predict a modest, yet-lackluster, 2016 that will see stabilizing employment in the face of deteriorating job mix. Last month, the region finally reached full job recovery to pre-recession levels. While our comprehensive **Financial Conditions Index** suggests economic health stronger than pre-recession levels, 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 company 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 with the red-hot labor market in the Bay Area, and also compared with the State of California, which saw a great 2015 for both the gross state product and job growth.

The positive psychology and momentum from the new arena construction has already created more economic activity from downtown to midtown with significant impact on property values and vacancy rates. All real estate property types and sectors will continue to grow modestly in strength with supply limited and demand rising. We predicted and continue to see more consolidation in the banking industry and predict a double-digit year for loan growth. 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 significantly for both likelihood of new hires and credit accessibility as we predict a soft 2016 due to global headwinds, given the election year anxiety and changes to both the economic/political backdrop and regulatory climate.

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 our analysts do this work entirely as a public service to the region.

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

Sanjay Varshney, PhD, CFA
Chief Economist, SBR » Professor of Finance, California State University, Sacramento »
Vice President/Investment Strategy Specialist for California/Nevada, Wells Fargo Private Bank – Wealth Management Group » **(916) 799-6527** » ***sbvarshney@yahoo.com*** » ***sacbusinessreview.com***

Contents

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

2 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.

Authors

Chase Armer, CFA

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 master's 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.

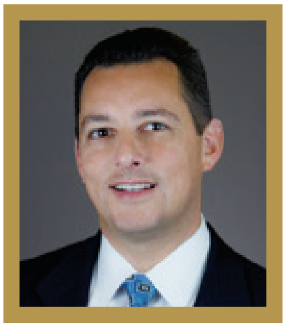
Seung Bach, PhD

Seung Bach is Professor of Entrepreneurship and Strategic Management in the College of Business Administration, and he currently serves as the faculty director of the Center for Entrepreneurship at California State University, Sacramento. He earned his PhD in business administration at the University of Tennessee, Knoxville, and his MBA at the George Washington University, Washington, D.C. His expertise is in the areas of new venture creation, small business management, entrepreneurial transitions, innovation and corporate entrepreneurship, and global management and strategy.

Jason Bell, CFA

Jason Bell is a Senior Vice President and Senior Investment Strategist for Wells Fargo Private Bank, where he manages funds for a select group of clients. He is a member of Wells Fargo's Global Strategies team and previously led the bank's Domestic Equity Sector Strategy team. During the past several years, Jason has served as a senior volunteer leader and advisor to the Board at CFA Institute. He holds the Chartered Financial Analyst designation and a business degree from the University of the Pacific, as well as an MBA from the University of California, Davis.

Matt Cologna



Matt Cologna graduated with a degree in Business from California State University, Sacramento, and has been active in commercial real estate for the past 20 years in Sacramento. His experience includes owner/user and investment sales, logistics, landlord and tenant representation, land assemblage, build to suits, and developer relations. He has represented clients on a local, regional, and national basis. He is involved with the Cushman & Wakefield Global Supply Chain Solutions Group offering additional insight into current and future needs of occupiers in the market. Matt has completed over 12 million square feet of deals with a value exceeding $411 million.

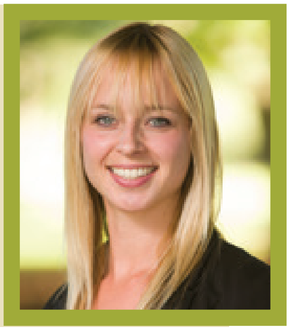
Nuriddin Ikromov, PhD

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

Authors

Jessica Kriegel, EdD

Jessica Kriegel works as an Organizational Development Consultant for Oracle Corporation, where she acts as an adviser and strategist in matters of organizational development, change management and talent development. She is also CEO of Ingage, Inc., an organization development consulting firm. In 2013 she completed her doctoral degree in Educational Leadership and Management with a specialization in Human Resources Development from Drexel University. Jessica also recently joined Fulcrum Property as its Chief Revenue Officer.



Jonathan E. Lederer, CFA

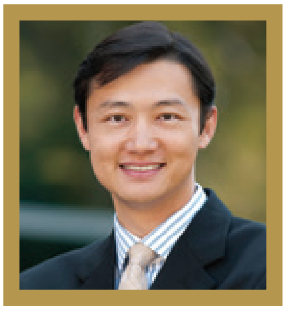
Jonathan Lederer is a Vice President and Senior Investment Strategist for Wells Fargo Private Bank. He graduated with his MBA from the University of Michigan's Ross School of Business and received his BA from the University of California, Berkeley. Jonathan has held the Chartered Financial Analyst designation since 2003 and is currently President of the CFA Society Sacramento.

Brian M. Leu, CFA, CAIA

Brian Leu is the Head of Global Equity Trading at CalPERS, overseeing the trading activities of the internally managed equity and derivatives portfolio. Prior to joining CalPERS, he worked at Roseville-based DCA Partners supporting the firm's investment banking business and private equity investments. Previously, Brian was a member of the Equity Research team at Deutsche Bank Securities and an investment analyst at a long-short hedge fund in New York City. Brian earned his MBA from the New York University Stern School of Business and an economics degree from Duke University and also holds the Chartered Financial Analyst and the Chartered Alternative Investment Analyst designations. He is also a past president of the CFA Society Sacramento.

Hao Lin, PhD, CFA

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



Lan Liu, PhD, CFA

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

Authors

Joe Niehaus, CFA

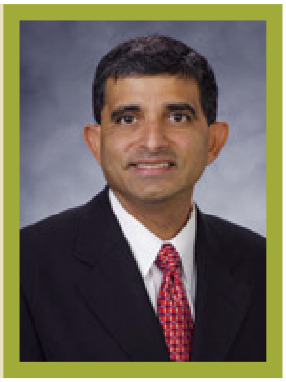
Joe Niehaus is Vice President and Senior Treasury Financial Analyst for Rabobank, N.A., where he manages the bank's agency mortgage-backed securities portfolio and collaborates on asset/liability management. Joe has worked as a bank examiner for both the public and private sectors, and he also served five years as an Electronic Intelligence Analyst with the U.S. Navy. Joe holds a BS in business administration from California State University, Sacramento, and an MBA from the University of Nebraska, Lincoln. He also holds the Chartered Financial Analyst designation and serves on the Board of Directors of the CFA Society Sacramento.

Yang Sun, PhD

Yang Sun is an Associate Professor of Supply Chain Management and Quantitative Methods in the College of Business Administration at California State University, Sacramento. In addition to his PhD in industrial engineering from Arizona State University, he has a Six-Sigma Black Belt. He also received an engineering degree from Tsinghua University in Beijing, China. He has research and teaching interests in the areas of global supply chain management, operations strategy, Lean and Six Sigma, managerial economics, operations research, and big data, and is a recipient of the university's Outstanding Scholarly and Creative Activities Award as well as Outstanding Teaching Award.

Sanjay Varshney, PhD, CFA

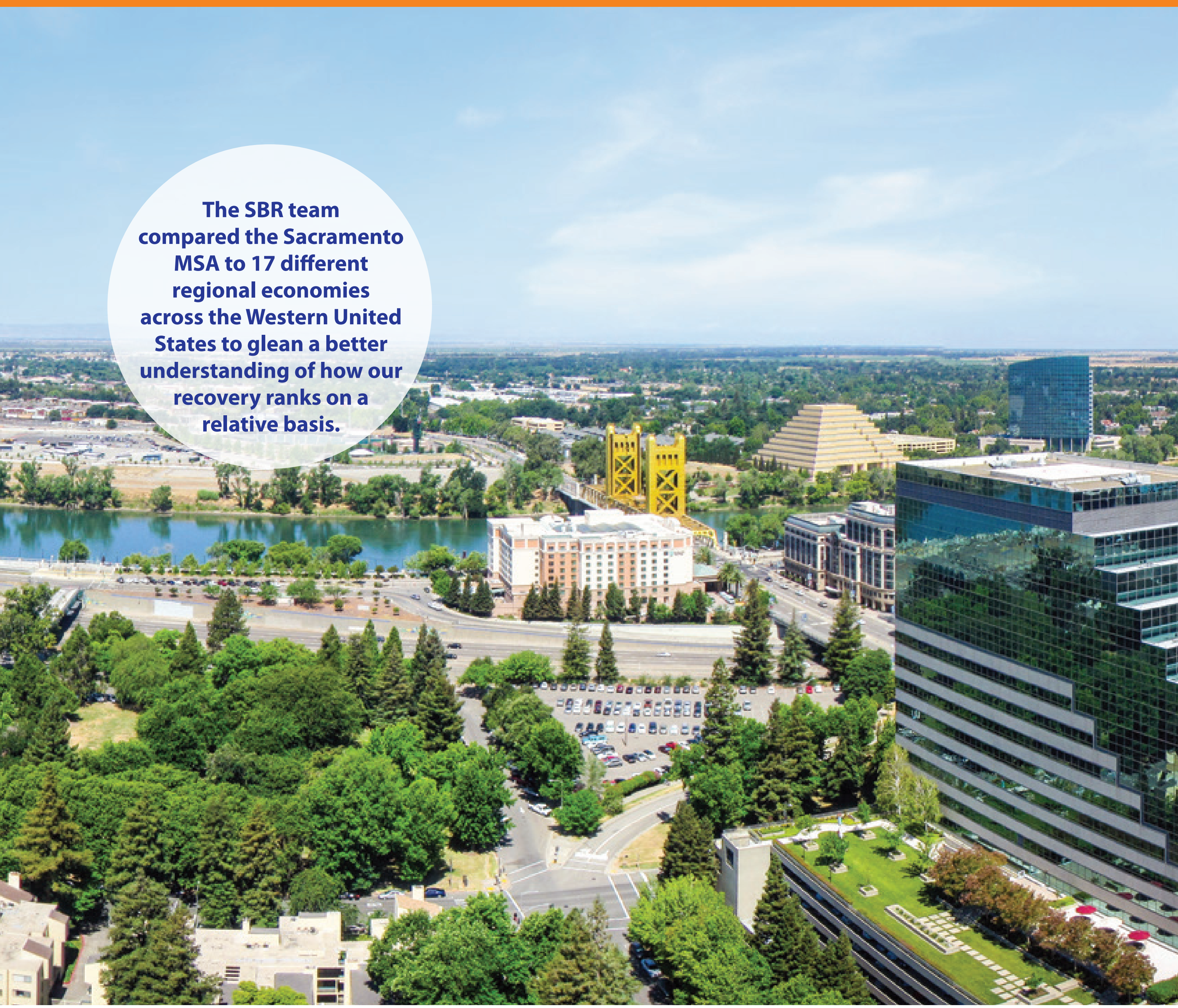
Sanjay Varshney is Professor of Finance at California State University, Sacramento, and Vice President/Investment Strategy Specialist for California and Nevada at Wells Fargo Private Bank – Wealth Management Group. He recently served as the Vice President for Economic and Regional Partnerships and Dean of the College of Business Administration at California State University, Sacramento, for 10 years. He earned an undergraduate degree in accounting and financial management from Bombay University, a master's degree in economics from the University of Cincinnati, and a PhD in finance from Louisiana State University. He also holds the Chartered Financial Analyst designation. Dr. Varshney serves as the Chief Economist for the *Sacramento Business Review*.



Anna V. Vygodina, PhD

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

Sacramento's Labor Market & Regional Economy



The SBR team compared the Sacramento MSA to 17 different regional economies across the Western United States to glean a better understanding of how our recovery ranks on a relative basis.

2016 Outlook

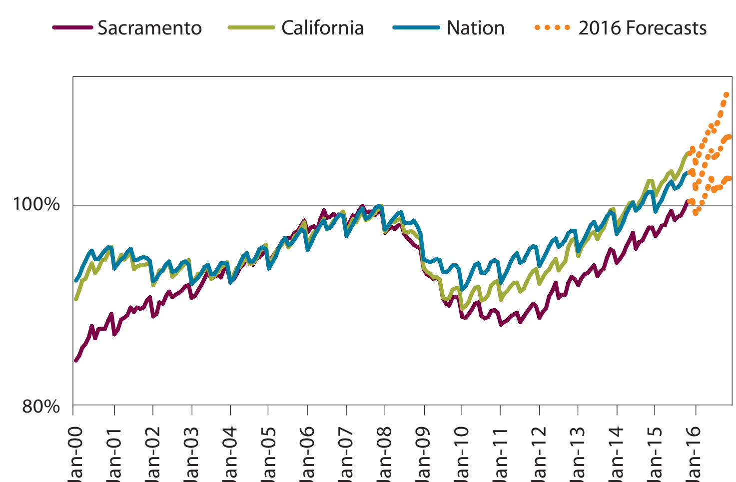
Key Points

- Headline employment numbers belie a fragile recovery.
- Sacramento lags peers on recovery speed and labor force growth.
- The regional job mix has shifted down the value chain.
- Labor market indicators imply few catalysts for near-term economic growth.
- We expect moderate job growth and unemployment to stabilize in 2016.

Sacramento's labor market recovery is similar to that of many regional economies around the United States – the headline employment numbers are full of optimism, but the underlying fundamentals tell a more sobering story.

The good news is that the Sacramento region has finally recovered all of the jobs that were lost during the great recession. The bad news is that the job recovery has occurred in sectors that are traditionally filled by unskilled and lower-wage labor. This is not new news, the SBR team has illustrated the challenges facing Sacramento for a number of years now, and the data we present here highlights some of the issues that continue to impede our local economy.

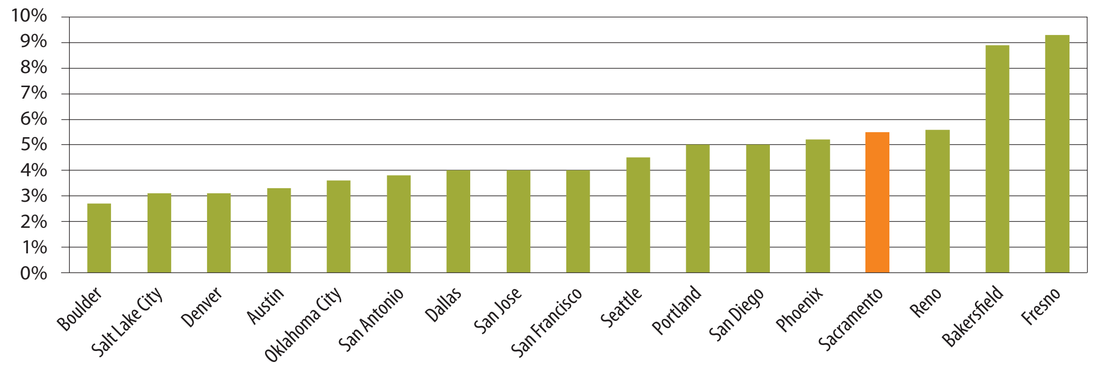
Figure 1
Total Nonfarm Jobs Relative to the Pre-Recession Peak



Source: California EDD, BLS

The SBR team compared the Sacramento MSA to 17 different regional economies across the Western United States to glean a better understanding of how our recovery ranks on a relative basis. Unfortunately, and perhaps not surprisingly, our region ranks near the bottom in almost every category. While we are somewhat pleased that we have again achieved near-full employment, it is worth noting that our unemployment level is the fourth highest amongst our 17 regional peers.

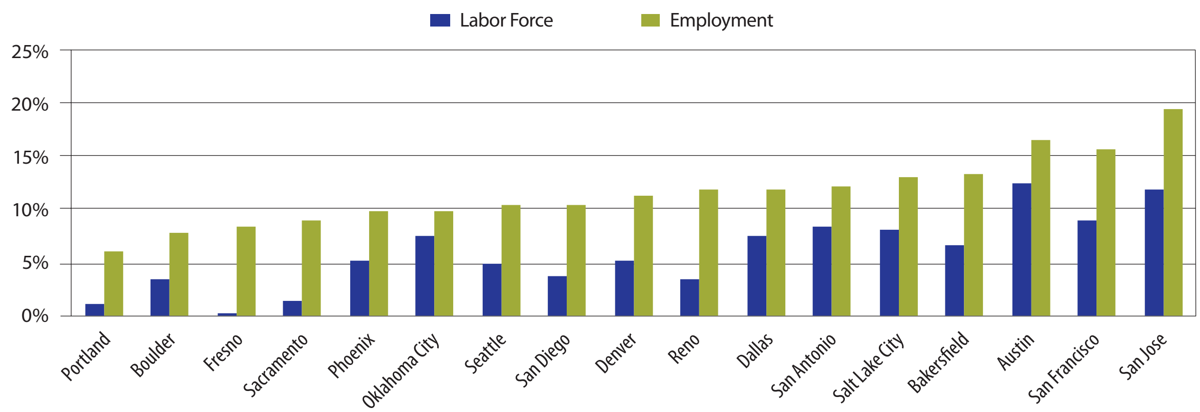
Figure 2
Unemployment Rates in Western U.S. Metropolitan Areas | Regional Unemployment Still Relatively High



Source: Economagic.com

An important component to accurately assess the health of a regional labor market is to understand the rate and sources of job creation. Again, Sacramento's labor force growth has been stagnant over the past five years as net job creation has been negligible.

Figure 3
Trailing Five-Year Labor Force and Employment Changes | Sacramento Labor Force Growth Near Zero

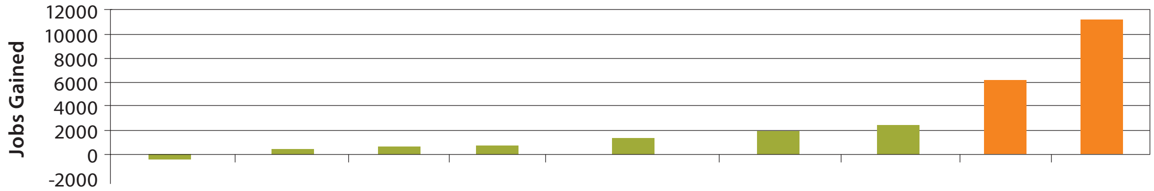


Source: Economagic.com

It is no secret that Sacramento has a dearth of large employers. While our small business sector is a critical and powerful force in our regional economy, it is still important that we bolster and diversify the employer base in the area. Perhaps our greatest area of concern is presented in Figure 4 – the sources of our region's job growth have moved from the segments that are traditionally associated with skilled labor and higher wages, such as manufacturing, healthcare and finance, to segments that are less so, such as retail and leisure.

Therefore, it should be of no surprise that our average hourly earnings growth (AHE) continues to remain near the bottom of our peer group. This is somewhat concerning as it is a measure of future economic growth. Reno, which has seen a tremendous amount of economic activity lately, exhibits the highest AHE amongst the peer group.

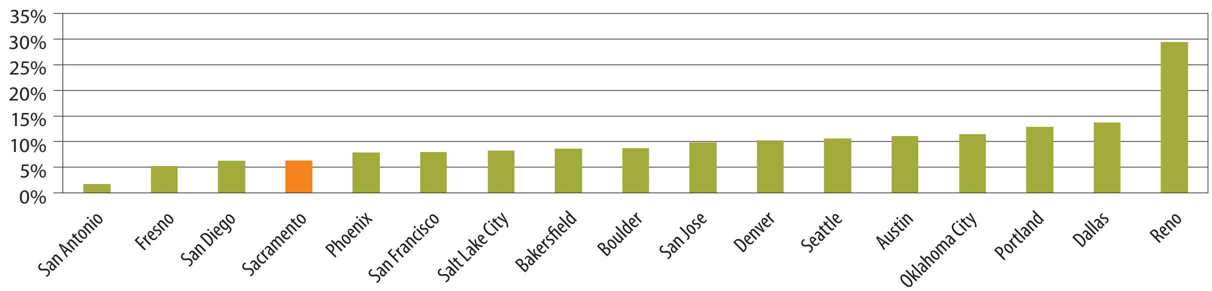
Figure 4
Year-over-Year Labor Sector Changes | Regional Job Growth Unbalanced



	Manufacturing	Healthcare	Finance	Education	Professional Services	Construction	Government	Retail	Leisure
Change in Jobs	-200	300	700	700	1400	2000	2400	6100	11200
Percent Change	-0.6%	0.2%	1.4%	0.5%	1.2%	4.3%	1.0%	4.1%	12.3%

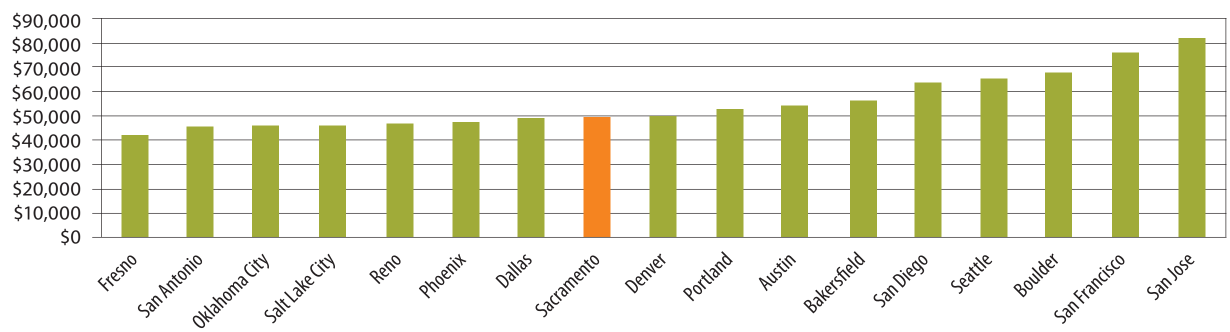
Source: California EDD

Figure 5
Five-Year Average Hourly Earnings (AHE) Growth | Tepid Sacramento AHE Growth



Sacramento does rank reasonably well when it comes to household income. At first glance, it would appear to be a benefit that the median household income is near the middle of the peer group. However, when taken in context of low job creation, low AHE growth and a regional job mix that is moving downstream, we are left with the conclusion that our median household income is simply a by-product of being located in a higher-cost state where the labor force is more expensive to employ.

Figure 6
Median Household Incomes (2013)



Source (Figures 5 & 6): Economagic.com

Summing it all up, we believe that despite the job recovery, underlying labor market conditions have not changed all that much and in our opinion have deteriorated slightly. Sacramento still has many well-known, desirable attributes that should be able to attract a broader employer base, but until that happens, we expect more of the same in 2016.

Real Estate Trends *in the* Sacramento Region

photo credit: Sacramento Kings

Key Points

- Improved commercial real estate fundamentals continue across all property types, with vacancy declining and rates stabilizing or increasing, particularly in retail and multi-family.
- Investor demand is high and supply is limited. Out-of-town investors continue to scout the Sacramento region to invest.
- Construction and investment in the downtown urban core will continue to remain strong in 2016 with new retailers entering the region and housing sales remaining strong.
- Rents on single family homes are up 10.4% year-over-year, compared with 5.7% nationally. Multi-family rates continue to climb as well. The percentage of single family homes rented versus owned dropped by approximately 0.6%. The median house price increased by 8% in 2015, but there are signs that the housing markets started to cool off in the second half of the year.

Growth in Sacramento is still occurring across all property types, particularly retail and multi-family. The last two years have seen modest, yet continual, growth and absorption. No significant change in any of the product types is expected in the coming year.

The opening of Golden 1 Center in the fall of 2016 will certainly be one of the most significant events in recent Sacramento history. This is not only due to the arena itself, but also because of the related mixed-use project known as Downtown Commons, which will include approximately 630,000 square feet of retail, 50 luxury residential units, a 250-key hotel, and 250,000 square feet of office space within the Central Business District (CBD).

In addition, the 200 acre Railyards project just north of the CBD, the largest undeveloped urban land property in the country, should begin development in 2016. The Railyards is expected to include a hospital, soccer arena, retail amenities, and multi-family housing once completed.

Office

2015 Review:

The office market has trailed in the recovery behind all other product types, but has seen significant improvements in vacancy over the last three years and, finally, some stabilization and growth. Vacancy at year-end 2015 was 12.7%, down 1.4% from year-end 2014. Net absorption, the total gain in leased space, came in around 1,140,000 square feet for 2015, which was a significant increase from 2014.

Given the exorbitant vacancy rates just a few years ago, the region has seen very little new office construction – in fact, the completion of five separate projects in 2016 will result in just over 300,000 square feet of new office space, all of which is pre-leased.

Meanwhile, asking rents gradually increased across the suburban submarkets and significantly increased in the CBD. Full-service rents ranged from around $1.75 per square foot per month in the Highway 50 Corridor to as much as $3.25 per square foot per month in the CBD. Despite this growth, rents remain lower than in the Bay Area, which can work to Sacramento's advantage as more tenants are priced out of San Francisco and Oakland, yet want to stay in a northern California urban environment.

A great deal of excitement will stay in the downtown and midtown core as more development surrounds the new Golden 1 Center.

While most of the office leasing transactions over the past few months have remained in the small to mid-sized range, health care groups accounted for some of the largest leasing transactions of 2015. The state government and financial services sectors were also active in absorbing new space. The majority of sales transactions over the past six months were properties under 50,000 square feet.

2016 Preview:

A great deal of excitement will stay in the downtown and midtown core as more development surrounds the new Golden 1 Center. While current rents do not justify new construction, dropping vacancy rates and rising rents indicate a promising outlook for future development. Following in the footsteps of San Francisco's SOMA, repurposed space in the downtown and midtown area will also remain in high demand. However, as space in the downtown market continues to compress, look for some companies to pull up stakes and search for more affordable space, and free parking, in suburban markets. Expect modest increases in rent across the board and more significant rent increases in downtown and midtown.

Retail

2015 Review:

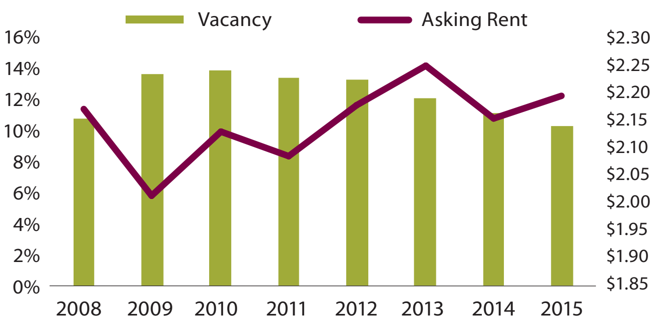
2015 marked the third consecutive year of steady declines in vacancy, ending the year at 10.3% vacant. Over 710,000 square feet of positive absorption was recorded for the year, with the majority of the absorption coming from about a dozen projects. Completed shopping center projects in 2015 accounted for the addition of 279,000 square feet, compared with 2014 construction of approximately 489,000 square feet. Add to that all the freestanding retail buildings constructed and the total square footage built in 2015 climbs significantly. Rates in Class A centers in key submarkets continued to climb while older, unanchored strip centers struggled to attract credit tenants or see much rent appreciation. With Golden 1 Center under construction downtown, several food and entertainment concepts new to the region have been announced, including Punch Bowl Social, Pour Society, and Sauced.

2016 Preview:

2016 will be very similar to last year. Geographically key suburban markets will continue to flourish. The downtown and midtown retail core will continue to see a major transformation, but it will take significant additional housing options for the dream to be fully realized.

Sacramento, which has trailed behind the rest of the nation in the overall economic recovery, has a small window of opportunity to benefit from national credit tenants who are poised for growth and seeking more affordable rates than found elsewhere in the country. Sacramento's improving overall economy and value compared with other markets provide a good justification for retailers to consider the region.

Figure 1
RETAIL | Vacancy & Average Asking Rate (NNN)



However, nationally and locally we expect store closures in 2016 to reach their highest level since the recession. Retailers will continue to rightsize their brick-and-mortar footprints as they shift increasingly towards omni-channel. "Life cycle" closures will be up; some weaker chains already on the edge will pass the point of no return. Surging merger activity will mean redundancies and consolidation for many chains. Given the already tight margins, restaurants will be a sector to watch closely as the high rate of restaurant growth and saturation will force the weakest players out of the market.

Industrial

2015 Review:

In 2015, the Sacramento industrial market continued to show remarkable perseverance and reasonable gains. Net absorption for 2015 posted at approximately 1.9 million square feet, representing an over 35% decrease from 2014. Gross leasing activity was about 7.2 million square feet, down approximately 500,000 square feet from 2014. Some of this reduction in activity can be attributed to the limited supply of Class A product and functional spaces in the size ranges needed by tenants in the market.

Vacancy dropped by 50 basis points, from 10.5% at year-end 2014 to 10% at year-end 2015. Given that the industrial sector did not overbuild in the last cycle, it has been fortunate to have a steady decline in vacancy for the last 4 years. However, besides retail and multi-family, industrial was the only other product type that saw any significant new construction in 2015. The industrial sector delivered close to 1.4 million square feet of space in 2015, much of which was leased by the time of completion.

2015 continued the trend of tenants in the market expanding, contracting, or consolidating to more functional space better suited for their needs. These moves have left several larger and some older less desirable spaces available in the market.

Industrial investment sales were also hot this year. A couple transactions to note include the sale of 1100 Tinker Road in Rocklin, primarily leased to Volkswagen for almost $82 per square foot, and the 250,000 square foot distribution center leased to Core-Mark International in West Sacramento for almost $100 per square foot. These represent record high prices for investment sales in Sacramento's industrial market.

2016 Preview:
Look for a lot of the same in the industrial market in 2016. Expect moderate new construction and moderate rent growth. There are several larger blocks of Class A and B space that need to be absorbed to have a meaningful impact on vacancy. There will be good velocity of small space leasing.

There is a very limited supply of smaller buildings for sale and significant demand. The price buyers will pay, however, is not in equilibrium with replacement costs yet.

Investor Sales

Historically, Sacramento has been a "no go" market for investors from out of town, REITs, or institutional capital. That dynamic has changed, however, as investors in core markets, such as the Bay Area, are getting squeezed on pricing and have turned their eye to Sacramento to obtain a better yield and lower price per square foot. This, coupled with the development in downtown, is getting Sacramento recognized as a viable alternative for investment. 1031 Exchange buyers have also returned to the market.

The median house price in the Sacramento region rose 8% year-over-year to $323,000.

These buyers are all having a significant impact on cap rates, pricing, and supply to the point that many of the local investors are finding it difficult to identify any value priced real estate. REO (Real Estate Owned by Lenders) properties, which were also in plentiful supply 3-5 years ago, are almost non-existent today, further eroding the supply of value add properties.

Look for this trend to continue in 2016. Supply of good quality properties at a reasonable price will be the biggest challenge.

Residential

The residential real estate market in the Sacramento region continued the trend of modest improvement in 2015, with slight increases in median prices and sales activity, and a decline in distress sales. However, although both construction and sales of new homes have increased, these indicators remain well below historical averages. Furthermore, despite a year-over-year increase in median prices, there are signs that the Sacramento housing market cooled off in the second half of 2015.

The median house price in the Sacramento region rose 8% year-over-year to $323,000. However, prices were essentially flat over the last three quarters, and remain 23% below the 2005 peak. The price per square foot for single family homes in the Sacramento MSA increased by 9%, with the largest increase observed in Sacramento County (11%), and the lowest increase in Placer County (5.6%). In a sign of a cooling housing market, median prices in all four counties in the region either remained flat or declined slightly in the last three months of 2015.

The sales volume of all types of homes (new homes, resale homes, and condominiums) in the Sacramento MSA increased by 14% year-over-year. While it was encouraging that new home sales increased by 21% to more than 3,700 units sold, this total is still less than half of the 14 year average of 7,800 properties sold. The number of properties priced below $200,000 declined by 13%. Actual sales of properties in all other ranges increased.

In a sign of a robust housing market, foreclosure activity in the Sacramento MSA continued to decline in 2015. REO sales, which represented a little more than 41% of all home sales during 2011, dropped to only 4% in the fourth quarter of 2015, down from 7% in 2013, and 6% in 2014.

Real Estate Trends in the Sacramento Region

2016 Preview:

The January 2015 issue of *Sacramento Business Review* predicted that house prices would rise by 6-7% in 2015. While this prediction turned out to be correct, the outlook for 2016 is not as optimistic. Given the expected changes in employment, income levels, and interest rates, house prices are not expected to increase significantly. Supply of new housing will increase somewhat compared with 2015. Building permits for new housing are on pace to exceed 6,200 units for 2015, compared with the average of fewer than 4,000 units for the previous three years. Thus, it would be unsurprising if house prices declined in 2016, especially if mortgage interest rates increase substantially.

DATA SOURCES (ATTRIBUTION FOR DATA USAGE):

Cushman & Wakefield
CoStar
Data Quick
Real Property Management and Rent Range
Census Bureau

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

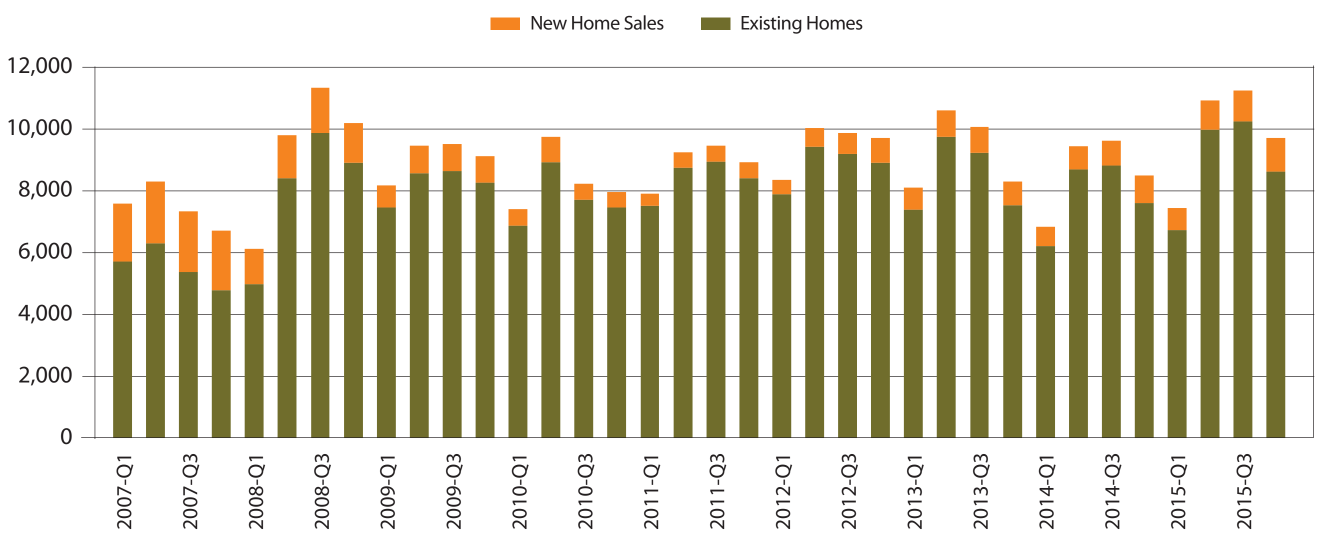
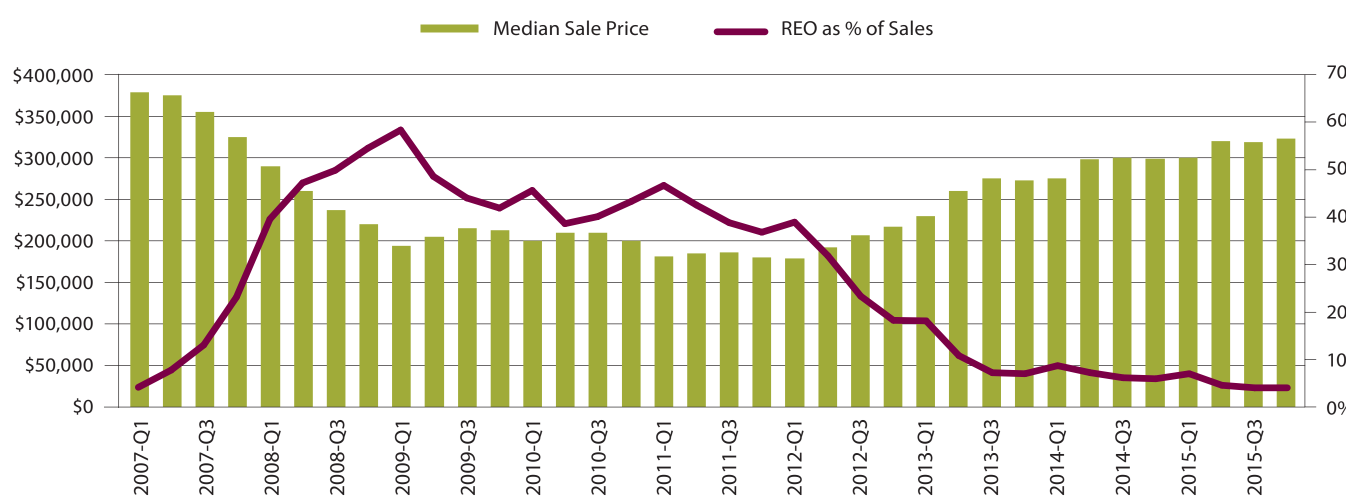
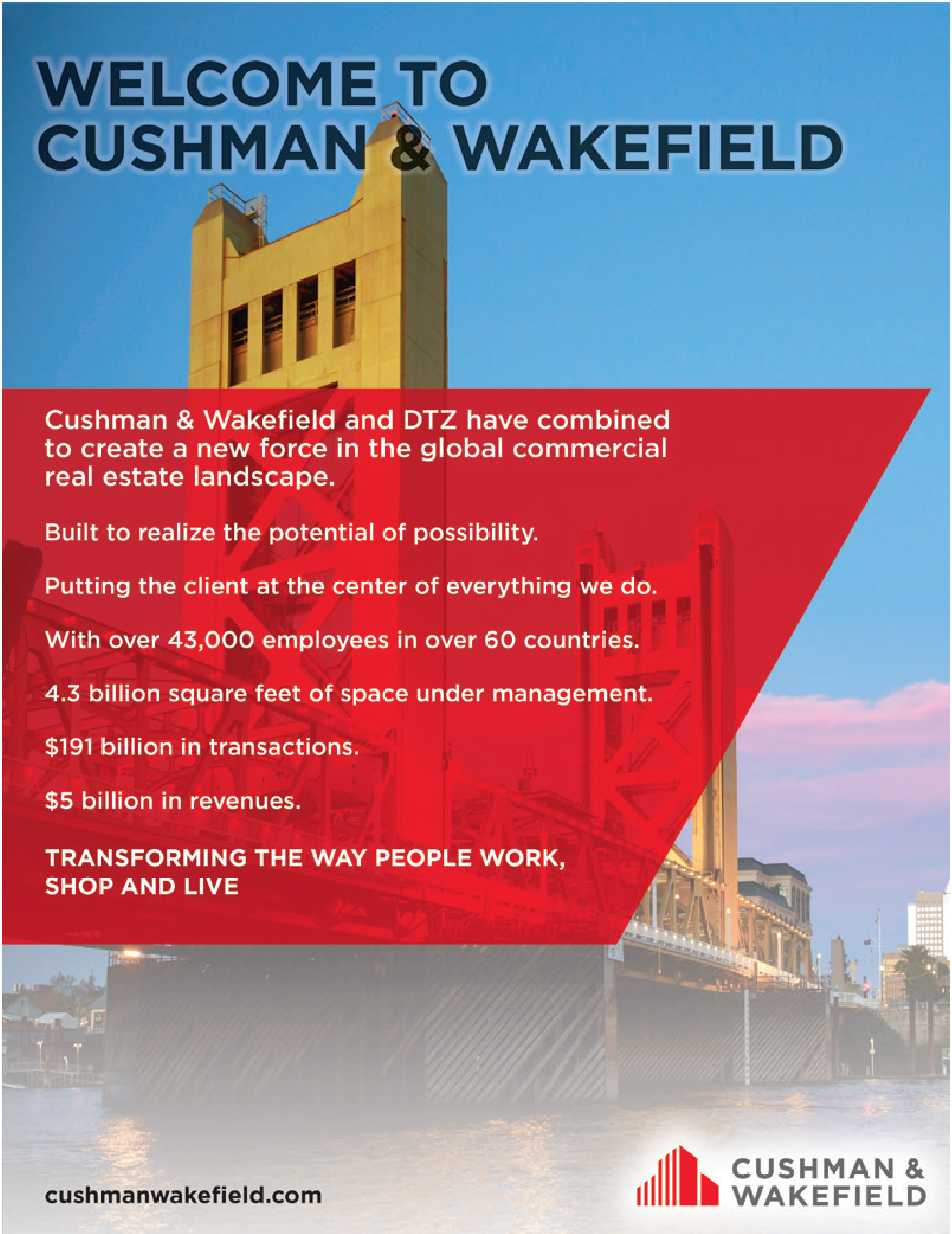


Figure 3
Median Sales Price (All Homes) vs. REO Share of Sales | Sacramento MSA



Data Source (Figure 1 and 2): Data Quick


WELCOME TO CUSHMAN & WAKEFIELD
Cushman & Wakefield and DTZ have combined to create a new force in the global commercial real estate landscape.
Built to realize the potential of possibility.
Putting the client at the center of everything we do.
With over 43,000 employees in over 60 countries.
4.3 billion square feet of space under management.
$191 billion in transactions.
$5 billion in revenues.
TRANSFORMING THE WAY PEOPLE WORK, SHOP AND LIVE
cushmanwakefield.com
CUSHMAN & WAKEFIELD

2016 Sacramento Banking Industry Forecast

We added local credit unions with more than $100 million in assets to the list of financial institutions we track to assess credit trends in the region.

Key Points

- We expect loan volumes in the Sacramento region[1] to grow at a low double-digit rate (10-12%) in 2016.
- Top-line net interest income is likely to increase at a slightly slower pace given lower projected net interest margins[2] due to a flatter yield curve (relative to one year ago).
- We added local credit unions with more than $100 million in assets to the list of financial institutions we track to assess credit trends in the region.
- Local credit union loan portfolios consist primarily of auto loans (47%) and residential real estate loans (42%), while 44% of local commercial bank loans are tied to commercial real estate.
- During the past five years, regionally based credit unions have grown their aggregate loan books faster than the local commercial banks, thanks in large part to auto loans, which have nearly doubled since 2012.

Last January, the SBR banking industry analysts predicted that the Sacramento Region Banks[3] would achieve high-single-digit loan growth during 2015. In hindsight, this forecast appears too conservative. Analyzing the available loan data through September 30 (Table 1), one can see how strong commercial real estate (CRE) loan growth has pushed aggregate loans for the local banks up by 14.5% (annualized) through the first nine months of the year.

Heading into 2016, the team expects this trend to continue. Historically low interest rates, coupled with a strong CRE market, should help the Sacramento Region Banks grow their loan books around 10% this year. Top-line net interest income is likely to increase at a slightly slower pace given lower projected net interest margins due to the flatter yield curve (relative to one year ago).

Forming a More Perfect Union

Since the inception of the SBR's banking industry section, the team has focused its analysis almost exclusively on the local commercial banks. In an effort to gain a more complete understanding of the region's credit trends, the SBR has decided to also include local credit unions starting this year. Along with analyzing the Sacramento Region Banks, the team will evaluate the Sacramento Region Credit Unions, which comprise credit unions with more than $100 million in total assets based in the six-county region. Using data from the National Credit Union Administration (NCUA), the team found seven credit unions that fit these criteria (Table 2).

Table 1
Loan Growth by Category | Sacramento Region Banks
January – September 2015

% of Total	Category	% Change Since 12/31/14*
44.1%	Commercial Real Estate	20.4%
21.9%	Residential	3.4%
10.0%	Commercial & Industrial	10.5%
4.8%	Multi-family Residential	18.2%
4.6%	Construction Loans	47.5%
14.6%	Other	8.7%
100.0%	**Total**	**14.5%**

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

Data Source: FDIC

Table 2
Sacramento Region Credit Unions

Credit Union	Headquarters	Assets ($s in MMs)	Members
The Golden 1	Sacramento	$9,508.2	743,736
SAFE Credit Union	Folsom	$2,295.5	190,384
Schools Financial	Sacramento	$1,591.0	123,578
Sierra Central	Yuba City	$772.1	61,570
Sacramento Credit Union	Sacramento	$396.1	24,573
First U.S. Community	Sacramento	$332.7	24,885
Heritage Community	Sacramento	$197.1	13,796

Data Source: NCUA

Table 3
Total Deposits ($s in 000s) in the Sacramento Region
June 30, 2015

Institution	Deposits
Wells Fargo Bank	$10,660,302
The Golden 1 Credit Union	8,099,296
U.S. Bank	7,736,338
Bank of America	7,387,577
Rabobank	3,359,034
JPMorgan Chase	3,327,549
Union Bank	2,071,524
SAFE Credit Union	1,954,878
Citibank	1,672,282
Bank of the West	1,423,093
Schools Financial Credit Union	1,397,494
Umpqua Bank	1,233,539
El Dorado Savings Bank	1,064,981
River City Bank	1,002,984
Sierra Central Credit Union	661,846
Five Star Bank	613,687
First Northern Bank of Dixon	607,599
AmericanWest Bank	588,800
Tri Counties Bank	498,346
Comerica Bank	482,444
Sacramento Credit Union	338,879
American River Bank	335,926
California Bank & Trust	326,327
First U.S. Community Credit Union	293,217
Farmers & Merchants Bank of Central CA	281,590
Compass Bank	272,295
Westamerica Bank	230,887
Redding Bank of Commerce	225,879
First Bank	215,445
Community 1st Bank	207,090
First-Citizens Bank & Trust Company	198,746
River Valley Community Bank	191,639
The Merchants National Bank of Sacramento	180,909
Heritage Community Credit Union	177,355
Folsom Lake Bank	129,846
Mechanics Bank	127,335
Sierra Vista Bank	122,867
Community Business Bank	118,868
Golden Pacific Bank	113,172
East West Bank	106,665
Beal Bank USA	90,118
Bank of Feather River	62,993
Cathay Bank	59,152
Sutter Community Bank	58,587

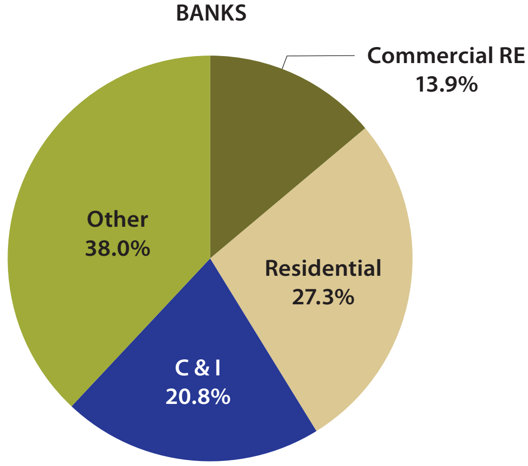
Data Source: FDIC

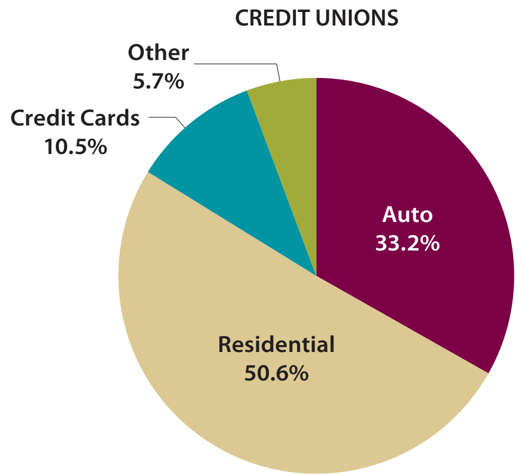
Looking at deposits in the region, these credit unions are significant players. For example, as of June 30, 2015, the Golden 1 Credit Union had the second-largest deposit base behind only Wells Fargo (Table 3).

Different Loan Segmentations

In terms of loans, commercial banks and credit unions differ with respect to their portfolios. Given that credit unions primarily serve individual customers, a large proportion of their loans consists of residential mortgages and lines of credit. Figure 1 shows that more than half of all credit union loans nationwide are tied to residential real estate, compared with 27.3% for all banks in the United States.

Figure 1
Loan Percentages by Segment
U.S. Banks & Credit Unions



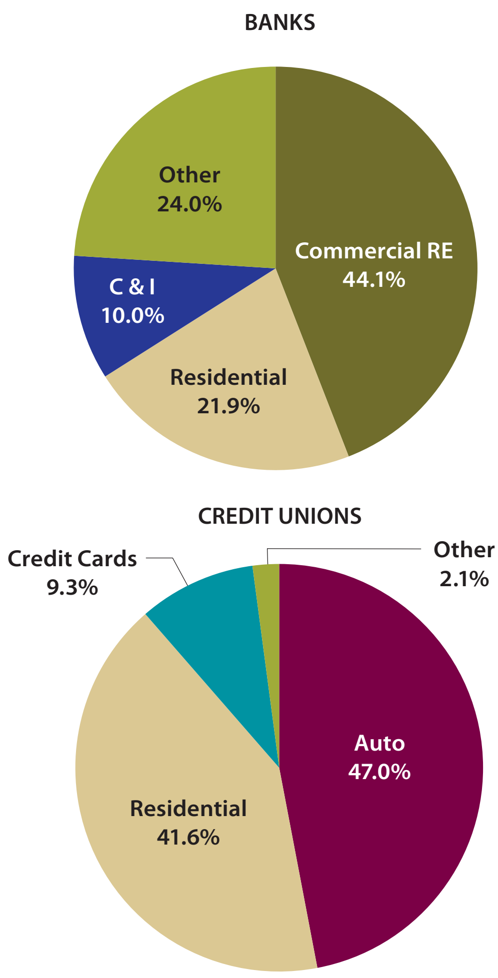


Data Sources: FDIC & NCUA

Auto loans make up one-third of credit union loans nationally. For commercial banks in the United States, 20.8% of all loans are commercial and industrial (C&I) loans, while nearly 15% are tied to commercial real estate.

Locally, the loan breakdowns differ from those nationwide. Given the Sacramento region's emphasis on real estate, CRE loans for the local banks make up more than three times the proportion of all banks nationally (44.1% versus 13.9%). At the same time, due to the region's smaller corporate base, C&I loans for the Sacramento banks make up just 10% of their loan portfolios, compared with 20% for all banks across the United States.

Figure 2
Loan Percentages by Segment
Sacramento Region Banks & Credit Unions



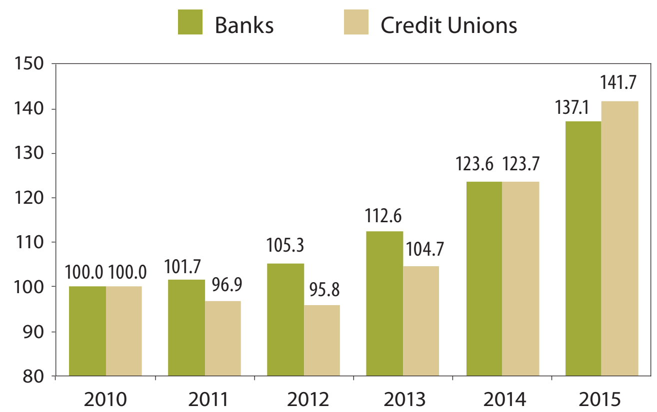
Data Sources: FDIC & NCUA

For the local credit unions, roughly half of their loans are auto loans (versus 33% nationally). And though the proportion of Sacramento credit union residential loans/lines of credit (41.6%) is nearly twice that of the local banks (21.9%), it is notably less than the 50.6% share for all credit unions nationwide.

Auto Loans "Driving" Credit Union Growth

Since 2010, the Sacramento Credit Unions have grown their loan books faster than the local banks (Figure 3). This higher pace is mainly due to auto loans, as the local credit unions have nearly doubled their aggregate auto loan balances since the end of 2012.

Figure 3
Aggregate Loan Growth (Indexed to 100)
Sacramento Region Banks & Credit Unions | 4Q 2010- 3Q 2015



Data Sources: FDIC & NCUA

Table 4
Loan Growth by Category | Sacramento Region Credit Unions
January – September 2015

% of Total	Category	% Change Since 12/31/14*
47.0%	Auto Loans	21.4%
41.6%	Residential/RE Lines of Credit	17.3%
9.3%	Credit Card/Unsecured	19.9%
2.1%	Other	14.7%
100.0%	**Total**	**19.4%**

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

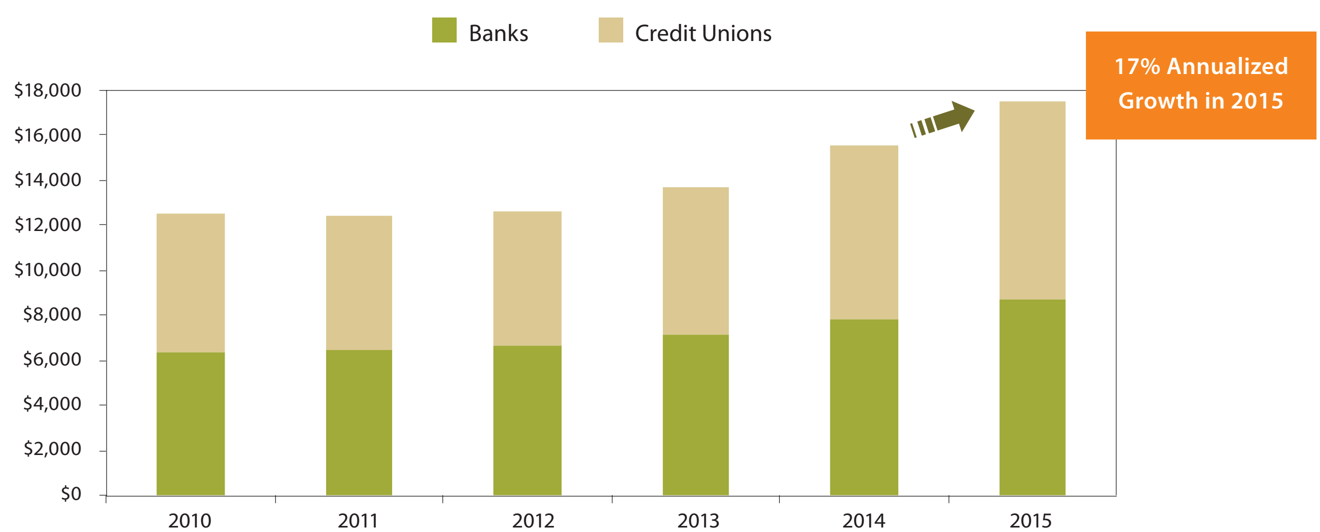
Data Source: NCUA

2016 Sacramento
Banking Industry Forecast

Combining the local bank and credit union data, total loans in the region grew at a 17% annual rate for the first nine months of 2015 (Figure 4). Looking ahead to 2016, the team expects total credit growth to slow modestly to a low double-digit pace (10-12%). This still-healthy credit backdrop should support economic growth through much of the year.

Looking ahead to 2016, the team expects total credit growth to slow modestly to a low double-digit pace (10-12%).

Figure 4
Aggregate Loans | Sacramento Region Banks & Credit Unions | 4Q 2010- 3Q 2015



Data Sources: FDIC & NCUA

Endnotes

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

2 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.

3 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.

The total dollar volume of SBA loans approved in the Sacramento MSA increased by 10% providing continued support and credit accessibility to small businesses.

Sacramento » 19th and L Streets

The Small Business Economy

Key Points

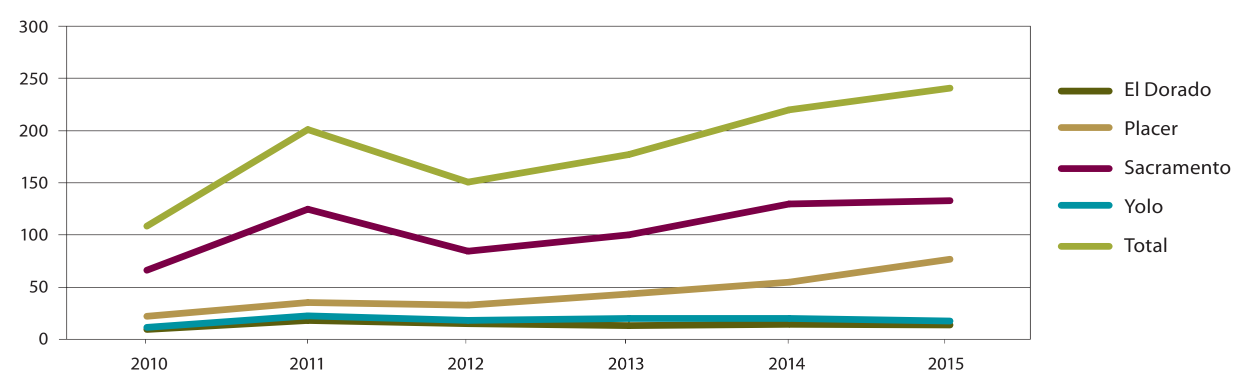
- The total dollar volume of SBA loans approved in the Sacramento MSA increased by 10% providing continued support and credit accessibility to small businesses.
- Overall, our Small Business Confidence Index sustained slightly improved levels of confidence in economic outlook, local supportiveness, and future revenue, but experienced significant declines in likelihood for new hires and credit accessibility.
- Small business sales activities slowed down in 2015-Q3, even though the trend has been improving since 2010.
- The overall softness in small business sales and optimism is consistent with reports from the National Federation of Independent Business, given the macro conditions and uncertainty in the economy and markets.
- Our Small Business Confidence Index predicts a soft 2016 given the election year anxiety and changes to both the economic/political backdrop, and regulatory climate.

The small business sector in the Greater Sacramento Region is showing increased caution as our most recent Small Business Confidence Index, SBA lending activity, and small business sales data are yielding mixed results and sending mixed messages. The good news is: SBA lending increased by approximately 10%. The bad news is: The market for small business sales has seen a major softening, and two key components of our Small Business Confidence Index, credit accessibility and likelihood of new hires, declined significantly.

The total dollar volume of SBA loans in the fiscal year 2015 increased by 10% over last year. This overall increase was driven primarily by significantly higher lending activities from two counties: Placer (39% increase), and Sacramento (2% increase). However, both the other counties, El Dorado and Yolo, experienced significant drops of 7% and 12% respectively. While Sacramento County drives almost two-thirds of the MSA economy, with Placer County being the next largest, the decline in lending in the two smaller counties may not represent a significant threat to overall SBA lending in the region.

Even though SBA lending has increased in recent years, the 2015 total loan amount for the Sacramento MSA is still 7% below the pre-crisis high of 2007. On the positive side, it is 20% higher than the first post-crisis spike in 2011. One county in particular, Placer, however, has surpassed its 2007 level for the first time. Its 2015 loan volume totaled $76.62 million, which is 11% higher than its pre-recession peak volume of $68.76 million in 2007. SBA lending in Placer has grown 116% since its lowest trough level in 2010.

Figure 1
Total Dollar Amount of SBA Loans Approved in the Sacramento MSA – January 2016 (in Millions)



Data Source: U.S. Small Business Administration

The Small Business Economy

Overall, our SBR Small Business Confidence Index improved slightly compared to measures from last year in the areas of economic outlook, local supportiveness and future revenue. Measures of credit accessibility and likelihood of new hires continue to drop, with a significant 28% decline in the latter. Our measure of Likelihood of New Hires (at 0.56) is approximately the same as in 2011 when our index was first created. In other words, this measure is at its lowest in the past five years.

Among the three sectors that we follow closely - manufacturing, service, and others, small businesses in the manufacturing and the others sectors expressed serious concerns regarding near-term prospects. Confidence in the manufacturing sector declined by 39% in credit accessibility, and by 38% in likelihood of new hires. The others sector saw a 42% decline in likelihood of new hires, even though its credit accessibility measure, unlike the other sectors, is actually 62% higher than last July. The service sector declined by 12% in credit accessibility and by 23% in likelihood of new hires.

The number of small businesses listed for sale in the Sacramento region in 2015-Q3 decreased noticeably from the heightened sales in the first two quarters of the year, but was still better than the sales in any given quarter of 2014. We have seen the listing activities steadily improve since 2010 when the quarterly average was only 117. The

Figure 2
Small Business Confidence Index Trends: July 2014 – January 2016

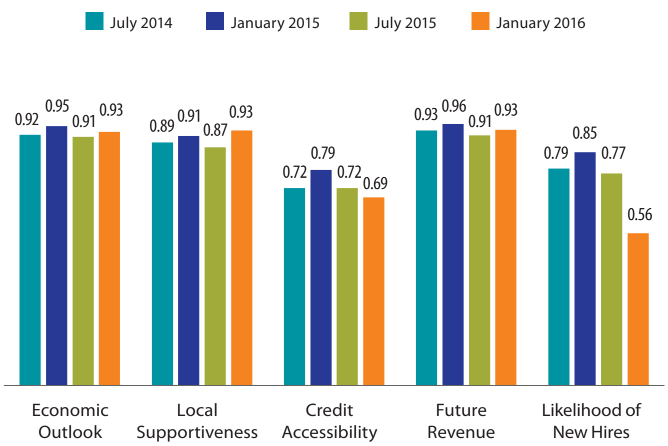


Figure 3
SBCI Trends in the Manufacturing Sector

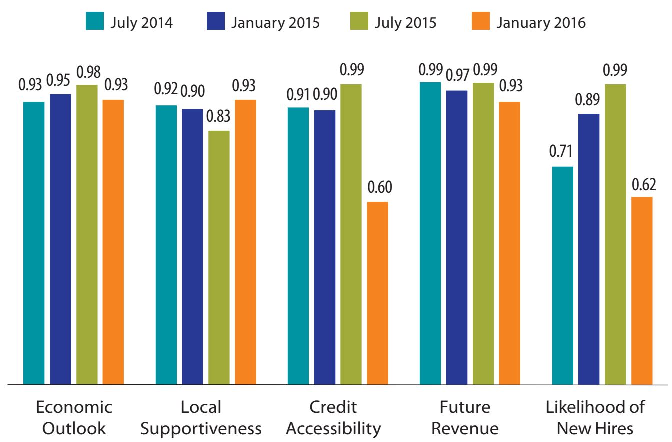


Figure 4
SBCI Trends in the Service Sector

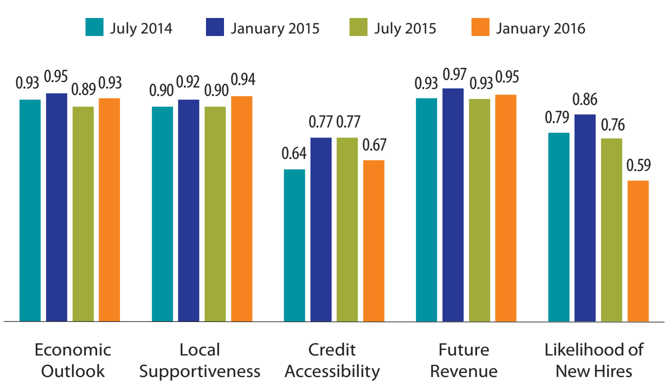
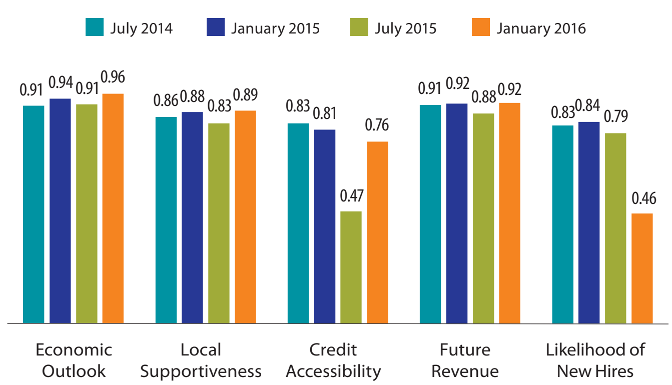


Figure 5
SBCI Trends in Others Sector



Data Source (Figures 2-5): U.S. Small Business Administration actual number of completed sales transactions in Q3 went up to 16 from 9 in Q2, making the percentage of sales to numbers listed double from 4% to 8%.

The median closed sales price in Q3 improved slightly to $135k, after a one-time aberration when three one-time major sales of services businesses caused a significant increase in the median sales price in Q2. However, median revenue of closed sales dipped almost 50% to $160k compared with $311k in Q1; the median cash flow of closed sales improved by 31% to $72k compared with $55k in Q1.

Small Business Sales

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

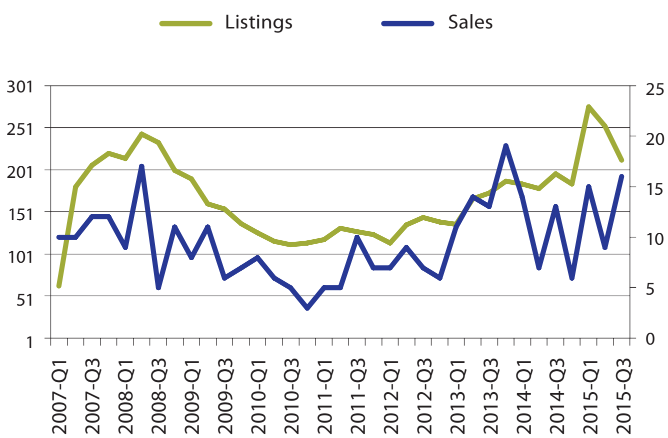


Figure 7
Median Closed Sales Price (Quarterly)

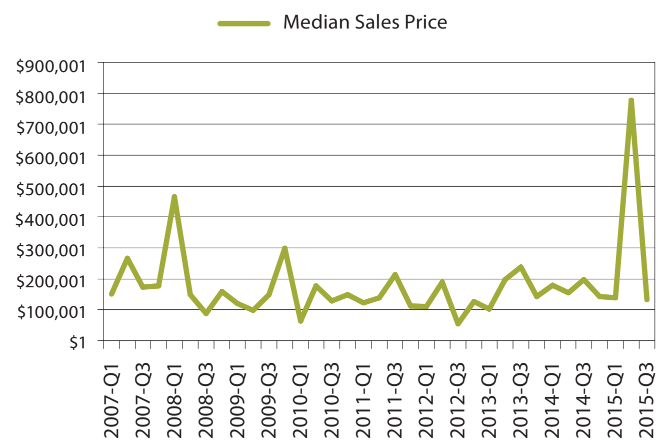


Figure 8
Median Revenue of Closed Sales (Quarterly)

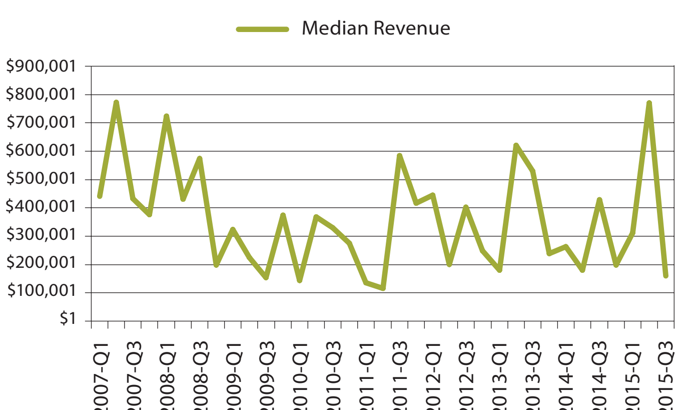
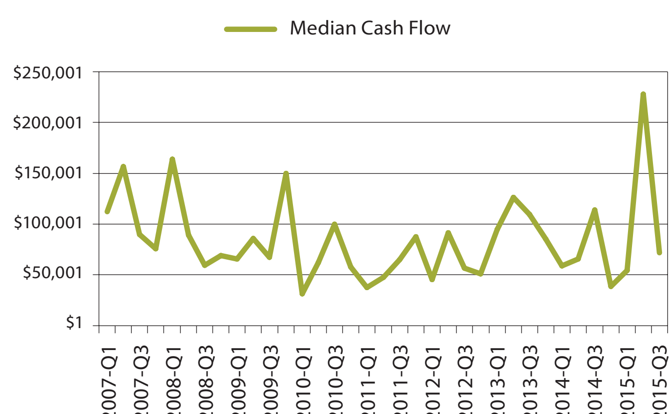


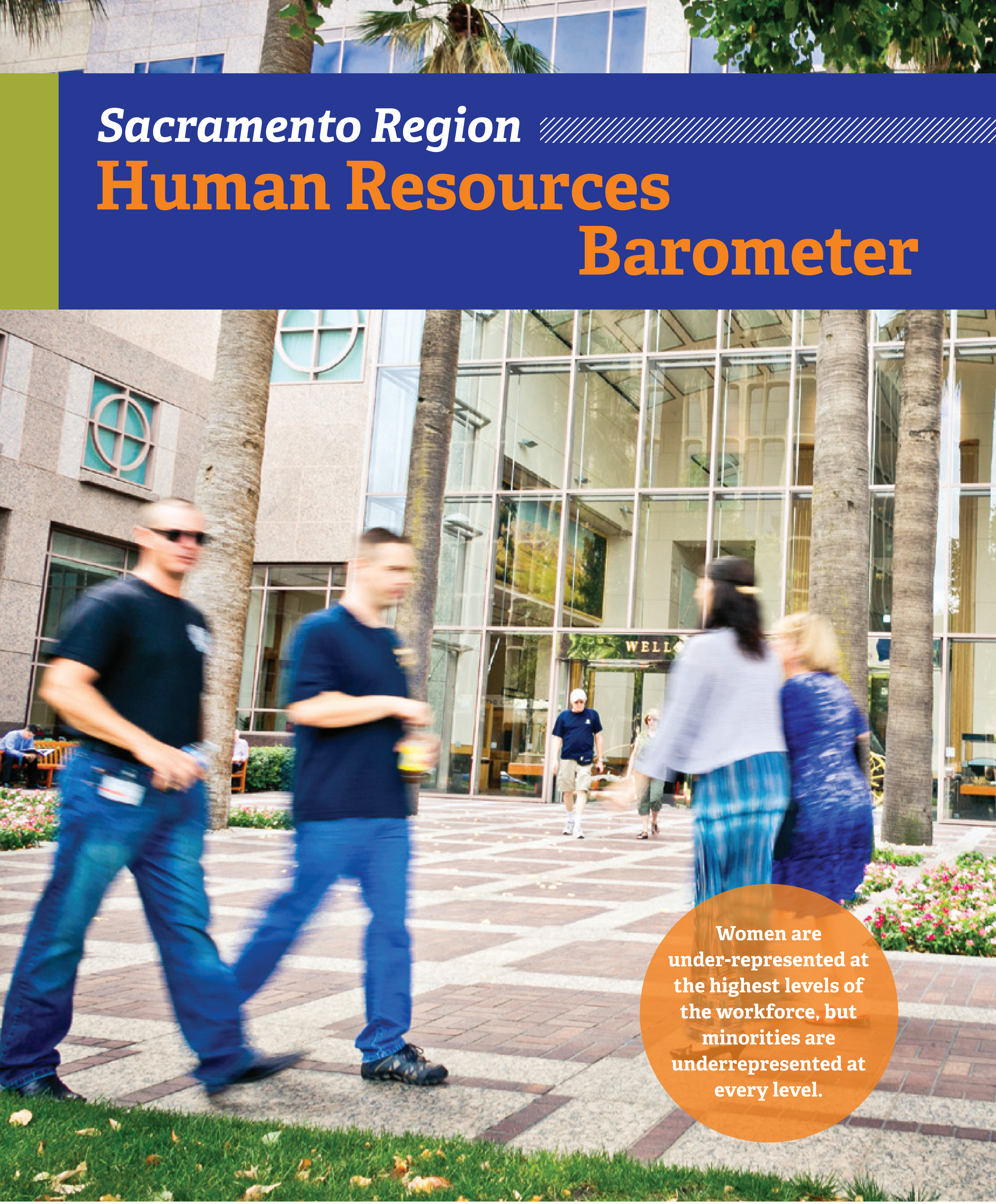
Figure 9
Median Cash Flow of Closed Sales (Quarterly)



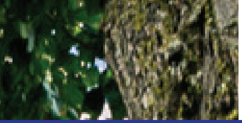
Data Source (Figures 6-9): BizBuySell

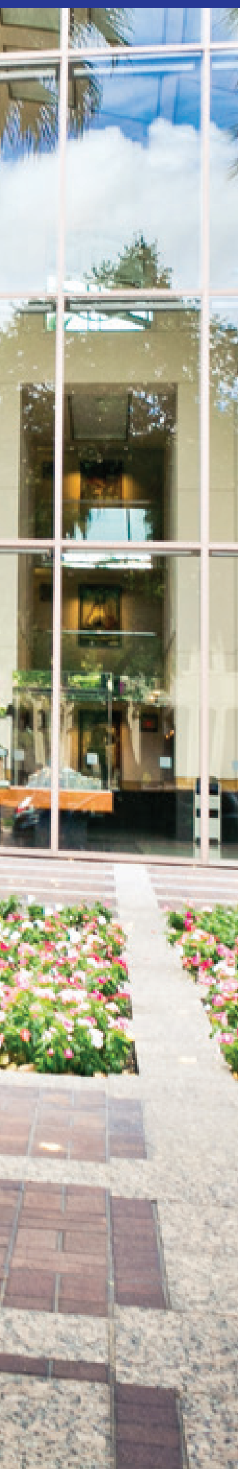
Sacramento Region

Human Resources Barometer



Women are under-represented at the highest levels of the workforce, but minorities are underrepresented at every level.





Key Points

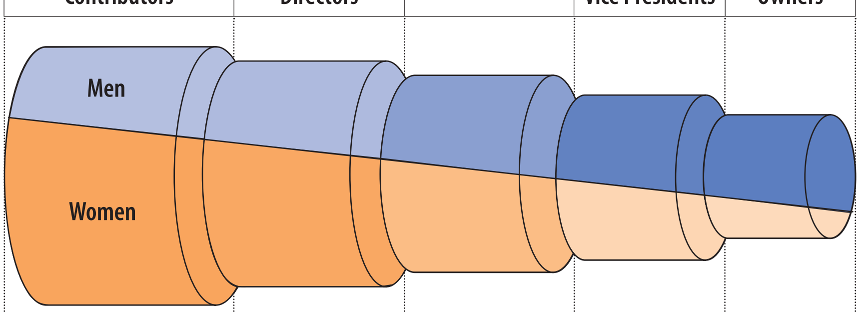
- **Gender and Racial Equity:** Women are under-represented at the highest levels of the workforce, but minorities are underrepresented at every level.
- **Compensation and Engagement:** Only 34% of women and 55% of men believe that better performance will result in better compensation.
- **Perks and Benefits:** Companies were most likely to offer perks such as an onsite gym and reduced schedules, but participation rates were highest for discounted products and executive training.
- **Recruitment:** Referrals were the most common form of recruitment and accounted for 45% of hires.
- **Generational Issues:** More than half of the respondents said that generational differences were not an issue at their organization.

For the first time, the Sacramento Business Review (SBR) in partnership with Forum MW, has conducted an analysis of human resources in the Sacramento region. Over 270 individuals from over 100 organizations were surveyed during the month of December, 2015. Key areas of analysis include gender equity, racial diversity, employee engagement, compensation and benefits, recruitment methods, and generational issues.

Gender Equity

Women are significantly under-represented at the top management level. Striking trends were found in gender representation in the workforce by job level (Table 1). The difference in gender equity by job level is statistically significant: the higher the job level the less women were represented. Only 26% of individuals at the C-suite/owner level were women, whereas 70% of individual contributors were women.

Table 1
Gender Representation in the Workforce by Job Level



	Individual Contributors	Managers/ Directors	Vice Presidents	Senior Vice Presidents	C-suite & Owners
Men	30%	33%	50%	71%	74%
Women	70%	67%	50%	29%	26%

Leadership ambition alone cannot explain the disparity in gender representation. Survey respondents were also asked about their ambition to become a top executive (Table 2). Women desired the top job at a rate of 60% whereas men were at 69% (a statistically significant difference). While leadership ambition between men and women was different by 9%, actual representation in the workforce was different by 48%.

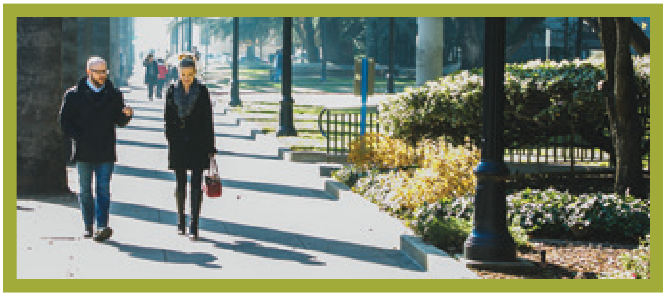


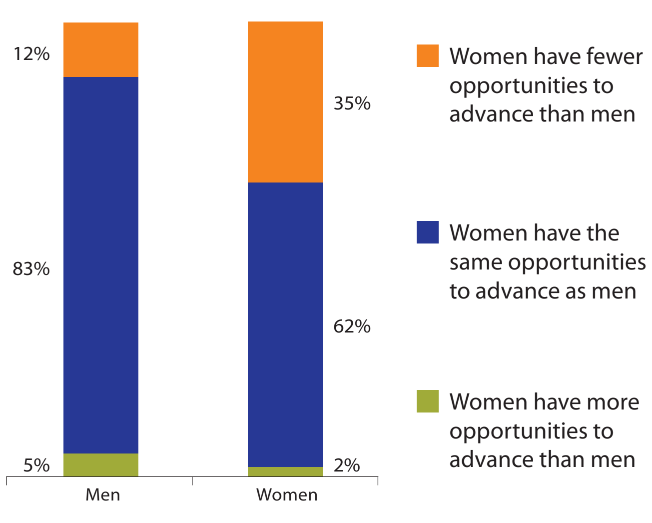
Table 2
Leadership Ambition by Job Level and Gender

	Entry-Level	Managers	Total
Men who wish to be a top executive	42%	59%	69%
Women who wish to be a top executive	32%	56%	60%

Women believe the system favors men. Women were three times more likely to believe that the workforce is skewed in favor of men (Table 3). Only 12% of men said women have fewer opportunities to advance than men, whereas 35% of women so believed. When asked about this perceived uneven playing field, women were 7 times more likely to say their gender inhibited their success in the past, and 10 times more likely to say their gender would likely inhibit their success in the future.

Women were three times more likely to believe that the workforce is skewed in favor of men.

Table 3
Perceived Impact of Gender on Opportunity



Comparing Gender Equity in the USA to the Sacramento Region

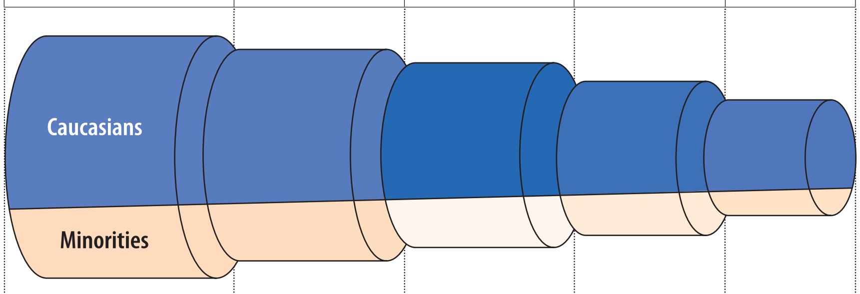
In 2015, McKinsey and Company partnered with Lean In to conduct a nationwide study of the state of women in corporate America. Similar trends were found on a national level as in our business review. However, a lower percentage of women appeared at the highest job levels in the national survey than in our SBR survey (17% of the C-suite in the national survey were women as compared with 26% in Sacramento). One other notable difference was in commitment to gender diversity. CEOs from the national survey were more likely to prioritize gender diversity than CEOs in Sacramento (74% nationally vs. 38% in Sacramento).

Racial Diversity

Minorities are under-represented at every job level. The same metrics used to analyze gender equity in the workforce were applied to racial diversity. The results for minority employees were bleak. While minorities make up 55% of the population in Sacramento[1], they were severely underrepresented at every job level (Table 4).

Leadership ambition was not different between caucasians and minorities.

Table 4
Racial Representation in the Workforce by Job Level

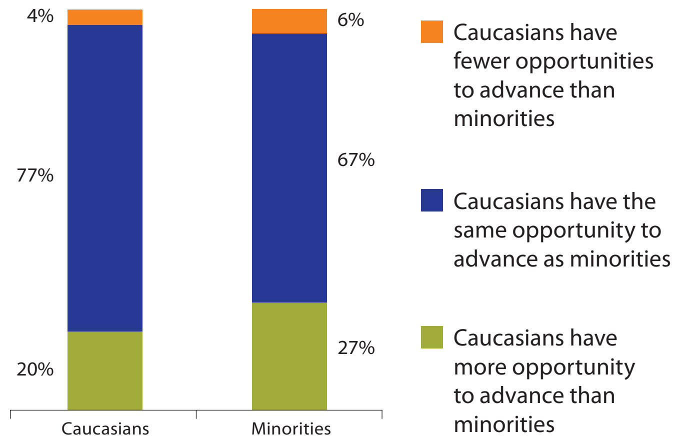


	Individual Contributors	Managers/ Directors	Vice Presidents	Senior Vice Presidents	C-suite & Owners
Caucasians	75%	76%	94%	86%	80%
Minorities	25%	24%	6%	14%	20%

Table 5
Leadership Ambition by Job Level and Race

	Entry-Level	Managers	Total
Caucasians who wish to be a top executive	35%	50%	60%
Minorities who wish to be a top executive	35%	65%	60%

Table 6
Perceived Impact of Race on Opportunity



Leadership ambition was not different between caucasians and minorities. Both caucasians and minorities had leadership ambition at a rate of 60% (Table 5).

Despite the fact that minorities are under-represented in the workforce at all levels, the perceived impact of race on opportunities for advancement is low (Table 6). Minorities were only slightly more likely to believe that the workforce is skewed in favor of caucasians. In fact, minorities were more likely than caucasians to say that caucasians had fewer opportunities to advance than minorities.

Employee Engagement

Employee engagement concerns employee connection and commitment to their organization.[2] Job satisfaction is a key driver, and in our study 75% of employees expressed satisfaction with their role (Table 7). In addition, 72% of respondents felt proud to work for their organization, and 64% would recommend their organization to friends. The lowest rated drivers of employee engagement centered on training and compensation. Only 44% of employees felt they received the training required to do their job effectively. Likewise, only 44% of employees felt that future compensation would match future performance.

These engagement drivers were also analyzed by gender, race, generation, and job level. Only two dimensions were different to a statically significant degree: compensation by gender and job satisfaction by job level. (Table 8).

Table 7
Key Drivers of Employee Engagement

Table 8
Statistically Significant Differences in Employee Engagement by Gender and Job Level

	All	Men	Women	Entry Level	Managers	Owners
The better my performance, the better my compensation	44%	55%	34%	31%	39%	64%
I am satisfied with my role	75%	77%	70%	61%	72%	90%

Benefits

Survey respondents were asked to identify perks and benefits offered by their organizations, as well as their participation in those programs (Table 9 on following page). Onsite gym facilities and reduced schedules were the most widely offered, however participation was highest in executive training and discounted products. Subsidized childcare was only available at 4% of organizations surveyed and only used by 1% of participants.

Recruitment

Referrals were the most common method of recruitment among survey respondents (Table 10 on following page). Other recruitment methods included networking events (such as red carpet events for women), external recruiters, temporary agencies, and social media. Social media sites included LinkedIn and Craigslist. Zero respondents were recruited via Facebook or Twitter.

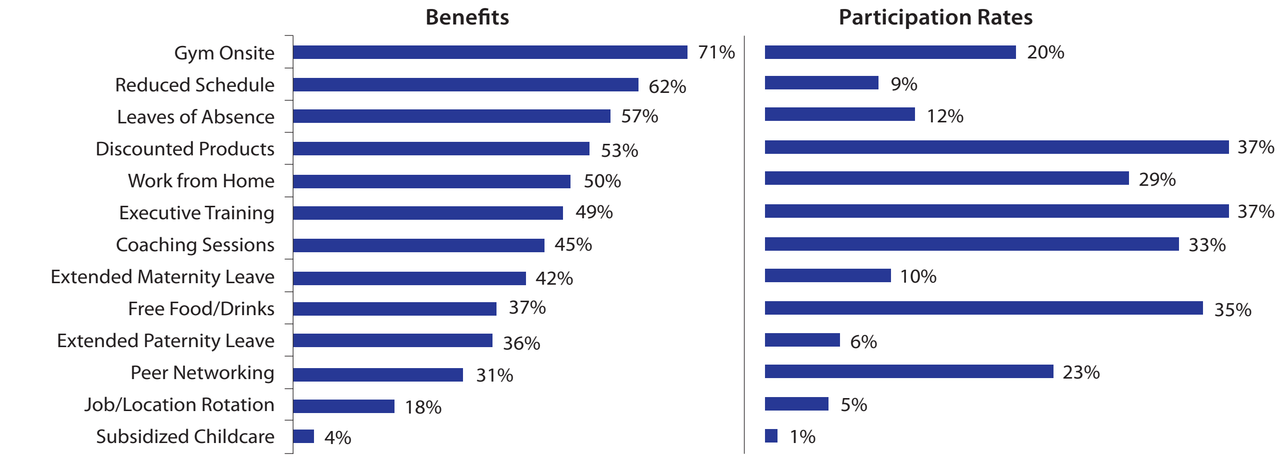
Compensation

Survey participants felt more positively about their benefits than their compensation (Table 11 on following page). More than three-quarters of respondents felt their benefits were either "Very Good" or "Good." However, only 56% of respondents felt the same about their pay.

Endnotes

1 United States Census Bureau, 2015
2 Society for Human Resources Management, 2013.

Table 9
Benefits and Participation Rates



When asked to identify other high-impact benefits offered by their organization, participants wrote in:

- 401K Matching
- Paid Parking
- Gym Membership
- Annual Bonuses
- Tuition Reimbursement
- Community Involvement
- Flexible Work Hours
- Relaxed Dress Code
- 4-Day Work Week
- Fuel Discounts
- 7.5 Hour Work Day
- Chair Massage
- Auto Care
- Cool Work Space
- Special Gifts

Table 10
Recruitment Methods

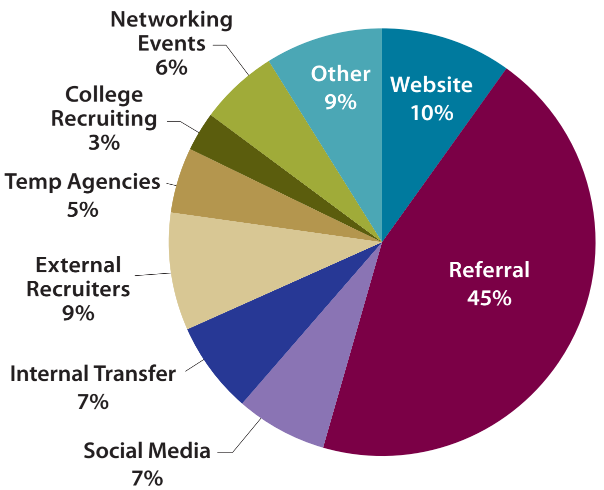
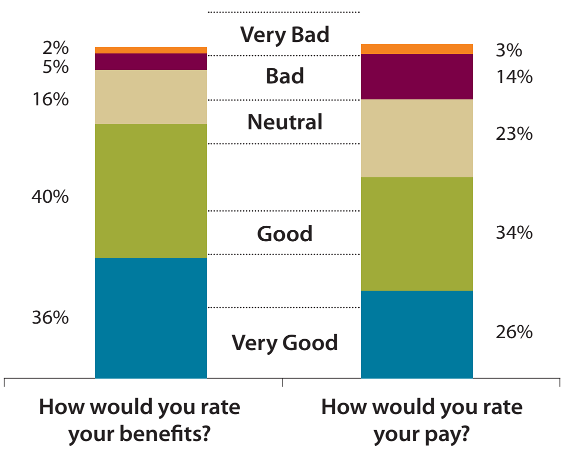


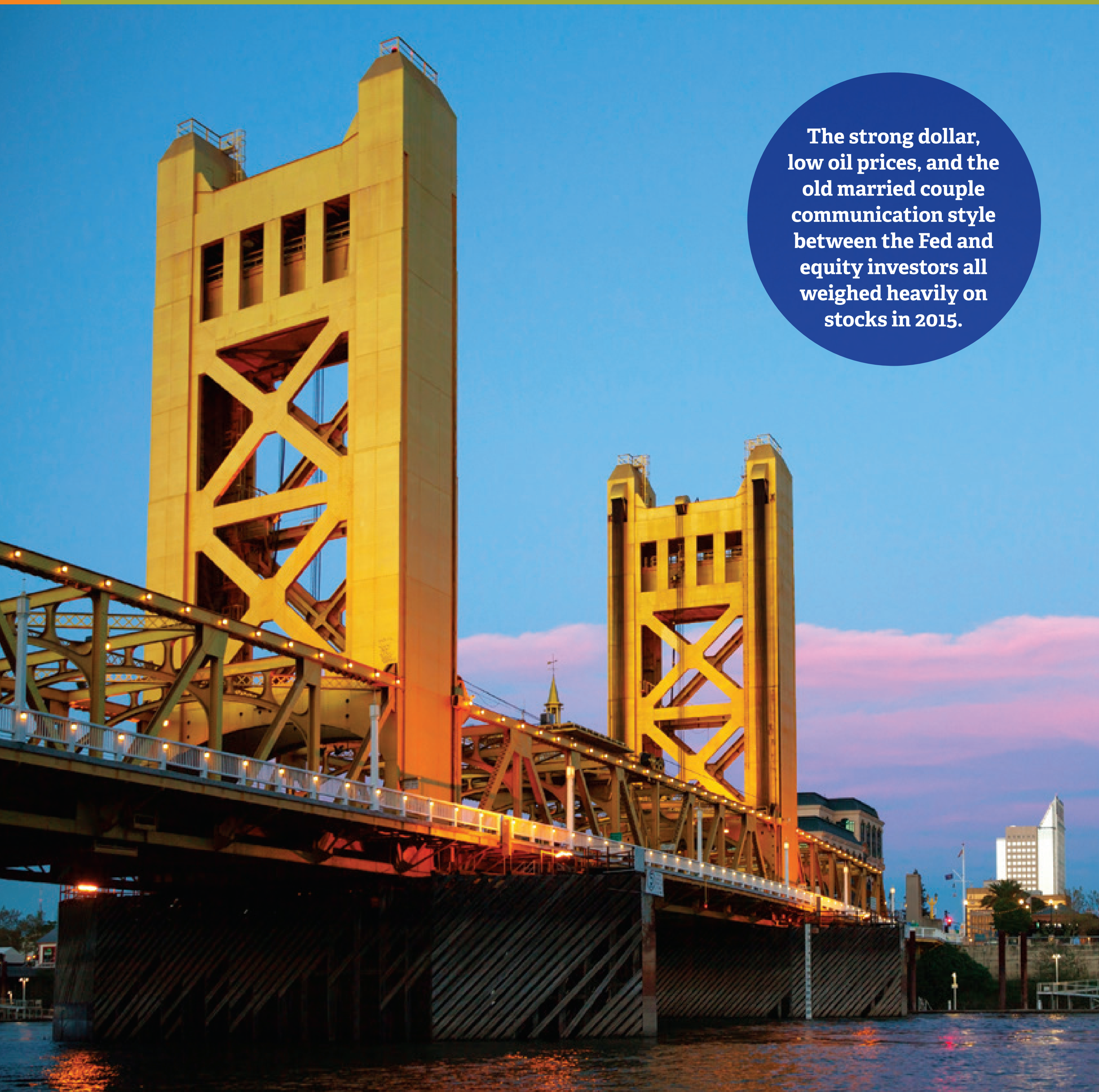
Table 11
How would you rate your pay and benefits?



Generational Issues

Generational difficulties were much less in evidence than might be assumed from popular literature on the subject. More than half of the respondents claimed that generational differences were not an issue at their organization. Surprisingly, the older the respondent, the less likely they were to report generational issues as being a problem. All data points (gender equity, racial diversity, employee engagement, benefits, recruitment methods, and pay) were analyzed through a generational lens, and no differences in opinions were found with one exception: Millennial women were more likely to believe their gender would likely inhibit their success in the future (15%) than Generation X (5%) and Baby Boomers (3%). This is likely less of a generational issue and more a product of the amount of time left in their career given their age.

2016 Capital Markets *Outlook*



The strong dollar, low oil prices, and the old married couple communication style between the Fed and equity investors all weighed heavily on stocks in 2015.

Key Points

- With stubborn worldwide deflationary pressures, 2016 will look a lot like 2015 with the U.S. experiencing modest expansion while the rest of the world resorts to whatever is necessary to hold the line on price levels.
- With wage and inflation expectations continuing to suggest little upward momentum, and sluggish global growth, it is difficult to understand why the Fed would estimate four rate hikes for 2016.
- 2016 will likely see decoupling of monetary policy, oil-dependent sovereigns, and geopolitical destabilization as the three biggest risks to global financial markets.
- Locally, the economy seems to be doing quite well. With increases in employment, home sales, and lending, the SBR Financial Conditions Index reached new heights during the second half of 2015.

One of our SBR co-authors put it best when he analogized the 2015 investment landscape to that of a minefield: investors had to tread lightly throughout 2015 and most are thankful to have made it to the other side (end of the year) without any major explosions. Unfortunately for those investors who bet heavily on either high yield bonds or oil and its producers, "the other side" may be further out of reach for the time being. Those of us who made it through the minefield still intact have come to realize that more tip-toeing will be needed to make it through 2016.

Tepid Growth Abroad for 2016

On the global macro-economic front, weakness was persistent throughout the year with central bankers consistently trying to prevent any rapid economic slide while weighing the costs and benefits of further stimulus and currency devaluations. Monetary policy meetings for developed economies were routinely expected to result in additional stimulus, and when they didn't, or when markets viewed the stimulus as not enough, volatile days ensued. Even with the unprecedented easing we saw in 2015, economies abroad failed to show any signs that the stimulus was working, and our optimism for global growth drivers in 2015 has now materialized into wishful thinking. Global growth estimates for 2015 and 2016 have been trending more toward the 3% to 3.5% range, well below the 4%+ level of growth seen after the turn of the century.

2016 Capital Markets *Outlook*

Market	Forecast	Comment
Economy	↔	Another year of modest outperformance by the U.S. relative to other developed and emerging economies
Global Growth	↔	Global growth headwinds persist into 2016; difficult to see near-term relief given deflationary pressures
U.S. Growth	↗	Modest domestic growth expected; however, global economy to drag on positive U.S. trends
Eurozone	↔	Stabilization of sovereign exit threats should provide for harmonized focus on growth drivers
Emerging	↔	EM economies will continue to struggle with lack of demand from developed economies; those economies with dollar-denominated debt to struggle more
Global Inflation	↔	With only modest wage growth in the U.S. and persistently low oil and commodity prices abroad, inflation catalyst nowhere to be seen
Stocks	↗	Domestically focused small and medium-cap companies to outperform multinationals and large cap
Regions	U.S. > Rest of World	Not a lot has changed in a year, more of the same expected in 2016 with the U.S. leading other developed economies; Eurozone most promising rebound story
Sectors	Consumer Discretionary	U.S. consumer sentiment remains at elevated levels not seen since 2006 - 2007
Bonds	↘	Longer term bonds to outperform short term as we see the yield curve flatten further into 2016
Regions	Eurozone	Economy with the most financial flexibility and upside potential
Sectors	U.S. Corp ex Energy	While energy company debt may have the most upside, U.S. corporates should see tighter spreads with the continuation of positive domestic economic trends
Commodities	↔	Difficult to imagine commodities going lower; persistent weak global growth to keep deflationary threats alive
Sectors	Agriculture	Chinese meat demand + low beef supply = best relative space in commodities sector

Table 1
Top-Down World Economic Outlook

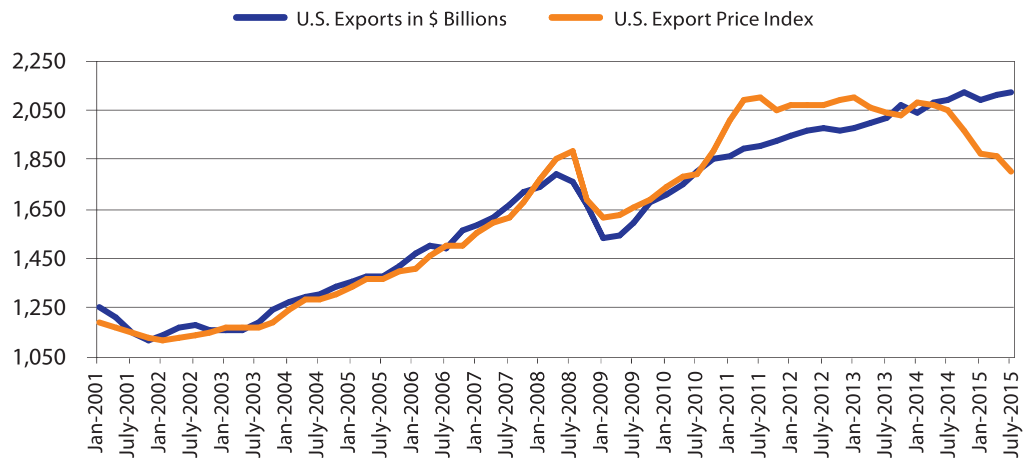
Global Indicator and Range	Implied 2016 Growth Rate
OECD Plus Non Member Economics Composite Leading Indicator (between 98.7 and 100.0)	3.07%
JP Morgan Global Manufacturing & Services PMI (between 50.0 and 55.0)	3.65%
Breadth of Manufacturing PMIs – % Above 50 (between 40 and 70)	3.61%
Global Recession Probability Model (between 50 and 90)	3.10%
World Industrial Production Year-to Year % Change (between 0 and 3.7)	3.47%
World Trade Volume Year to Year % Change (between 0.5 and 5.0%)	3.17%
Global Central Bank Interest Rate (between 1.71 and 2.28)	3.60%
Average of Global Indicators	**3.38%**

Data Source: Ned Davis Research Group, Global Focus, December 14, 2015

Dollar Strength

With more easing expected abroad for 2016, we expect U.S. dollar strength to be a prominent theme for the year. As we mentioned last year, the stronger dollar initially leads to increased exports, but domestic companies selling goods abroad must eventually reduce price and/or volume in order to keep trading partners coming back for more. As can be seen in the chart on the following page, exporters have been able to maintain dollar volumes; however, it has come at the cost of shrinking margins via cheaper prices. With slimmer margins for U.S. multinationals and those companies with heavy exposure abroad, room for higher wages and additional hiring will be hard to justify. The full ramifications of this impact still do not appear to have made their way through the U.S. economy just yet. On the brighter side, if you have an exotic vacation idea that you have been debating for some time, chances are your trip hasn't been this cheap in a long time!

Figure 1
U.S. Export Volume and Prices



Data Sources: U.S. Bureaus of Economic Analysis and Labor Statistics data retrieved from FRED, Federal Reserve Bank of St. Louis

Domestic Expectations

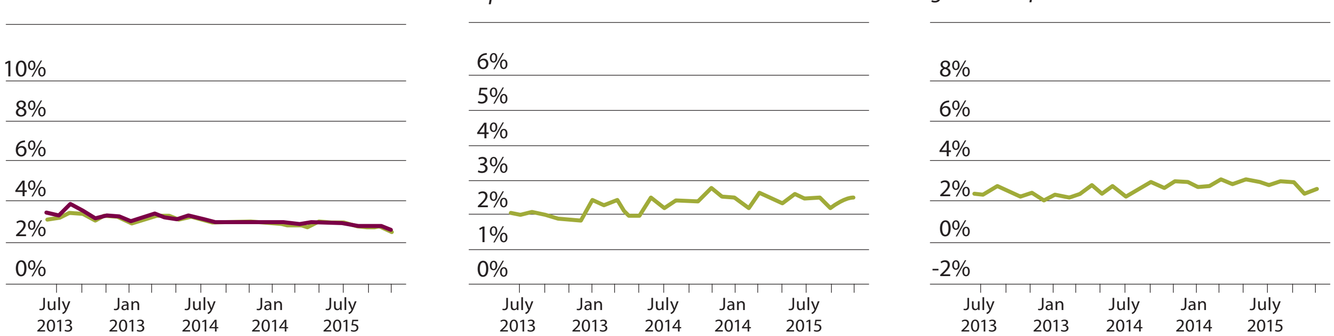
The ability of companies to pay higher wages in light of the stronger dollar doesn't seem very feasible. Supporting this notion are the three charts below that show expectations of inflation, wages and household income. While the earnings and household income expectations have bumped positive as of late, the levels at which those bumps come show why inflation expectations have not shown any sign of upward momentum. Given depressed commodity and energy prices, the only real potential catalyst for inflation appears to be wage growth; however, people don't seem to expect much wage or income growth in the year ahead. All this boils down to little impetus for growth in 2016. We expect developed economies, particularly the U.S., to perform better than emerging economies, albeit modestly better.

Figure 2
Survey of Consumer Expectations – December 2015

Inflation
Inflation expectations

Labor Market
One-year ahead earnings growth expectations

Household Finance
One-year ahead household income growth expectations

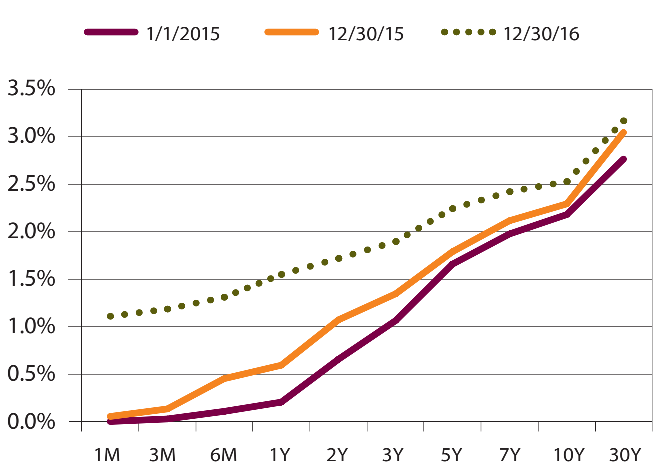


Data Source: https://www.newyorkfed.org/microeconomics/sceindex

The Fed Moved, Now What?

As we and many other market participants expected, the Fed finally raised interest rates by a quarter of a percent at its December 2015 meeting. While the rate hike may constitute a sign of confidence by the Fed that the U.S. economy is strong enough to withstand normalization, this move is counter to that of other developed economies abroad, thereby exacerbating the strong dollar theme discussed above. Additionally, with long-term inflation expectations remaining low, the long end of the curve has not really moved much, but the short end responded appropriately to the hike, and thus, we have a flattening of the yield curve as we discussed in our 2015 forecast. Interestingly, markets expect the U.S. Treasury curve to flatten even more over the coming year as can be seen by the dotted line in the chart below. This degree of flatness may be attributed to the decoupling of monetary policies between the U.S. and other developed economies abroad as the central bankers of each attempt to do what they think is best for their respective economy.

Figure 3
Treasury Curve – Past, Present and Future?



Data Source: Bloomberg

The Three Biggest Risks Ahead

Decoupling of monetary policy, oil dependency, and geopolitical destabilization

As outlined previously, the central banks of the U.S. and the rest of the world have parted ways when it comes to what they feel is necessary to keep their respective economies on the path to prosperity. For the U.S. this likely means a stronger dollar and for the rest of the world it means weaker currencies. Weaker currencies can help to make a country's goods more attractive to its trading partners, but with both developed and emerging economies abroad struggling with growth, a weaker currency may not help in this case. Worse, countries such as China, whose state-owned enterprises carry substantial amounts of U.S. dollar-denominated debt, will have trouble finding the necessary demand to obtain the additional production in terms of local currency to pay off their dollar-denominated debts.

The central banks of the U.S. and the rest of the world have parted ways when it comes to what they feel is necessary to keep their respective economies on the path to prosperity.

This problem also plagues many of the world's oil producing countries that were accustomed to taking on dollar debt since they receive dollars for the oil they put to market. Brazil's sovereign debt has now been downgraded to "junk" status largely due to the massive decline in revenues the country receives related to oil production. Venezuela has avoided default so far, but the cash-strapped country's financial condition continues to deteriorate as it has resorted to selling gold reserves in order to make debt payments.

The last major risk to markets is geopolitical events such as the recent conflict between Saudi Arabia and Iran or more terrorist attacks by ISIS. On the first business day of the new year markets began to react to the news of the deteriorating relations between Saudi Arabia and Iran, but the impact of this news was quickly overshadowed by further currency devaluations in China along with a steep 7% slide in Chinese equities.

Tying It All Together

So what does this all mean for the 2016 investment landscape? As we alluded to last year, companies that rely heavily on foreign trade and large U.S. multinationals will perform less favorably than those companies with domestic exposure in the small to medium cap space. Companies who use energy and other commodities as major raw inputs should continue to benefit from low prices as long as their main markets reside here in the U.S.

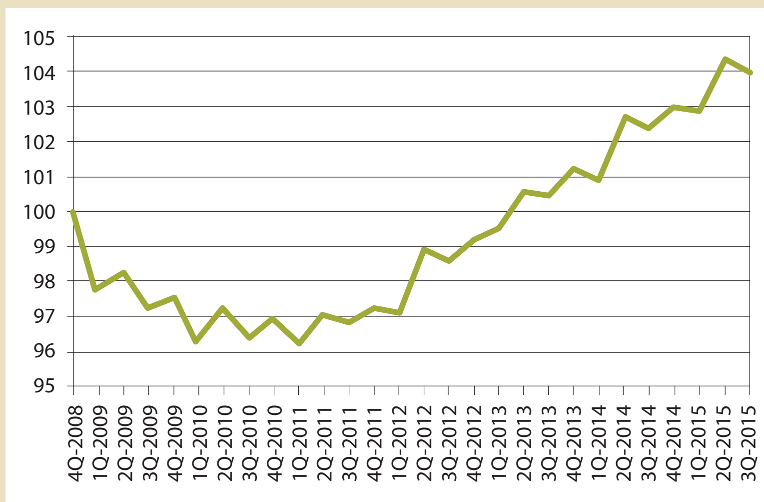
Given the low inflation expectations and weak growth abroad, we don't expect longer term treasuries to finish the year a whole lot higher than where they began, perhaps another quarter point to half point higher. We definitely missed our 2015 performance estimate for U.S. stocks as the S&P 500 ended the year right about where it started.

The strong dollar, low oil prices, and the old married couple communication style between the Fed and equity investors all weighed heavily on stocks in 2015. Given that many of the same headwinds appear before us in 2016, we have reduced our return expectations down from a year ago to the low to mid-single digits range. As we move forward through 2016, keep an eye out for those land mines as any one of them could easily roil the fragile global economy and cause serious trouble for the ever more correlated financial markets.

Sacramento Business Review Financial Conditions Index

Positive Trends Continue for the Local Economy

On a more positive note, our latest reading of our proprietary SBR Financial Conditions Index shows that the local economy continues to expand. Key index components such as local employment and home sales activity have shown steady upward trends over the last year. Local lending is on the rise as well, helping to fund business investment and commercial real estate activity.



SOURCES:

Bloomberg

Ned Davis Research, Equities, 2016 U.S. Outlook: Unfinished Business, December 4, 2015

Ned Davis Research, Economics, 2016 Global Economic Outlook – Where's the Upside, December 14, 2015

Ned Davis Research, Fixed Income, 2016 U.S. Fixed Income Outlook, December 10, 2015

Rabobank Economic Research, Outlook 2016: Global Economy, November 16, 2015

Rabobank Economic Research, Outlook 2016: Financial Markets, November 16, 2015

Thank You

Authors

Chase Armer, CFA, Co-owner, Planned Solutions, Inc.

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

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

Matt Cologna, Senior Director, Cushman & Wakefield

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

Jessica Kriegel, EdD, Organizational Development Consultant for Oracle Corporation

Jonathan E. Lederer, CFA, Vice President and Senior Investment Strategist, Wells Fargo Private Bank

Brian M. Leu, CFA, CAIA, Head of Global Equity Trading, CalPERS

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

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

Joe Niehaus, CFA, Vice President and Senior Treasury Financial Analyst, Rabobank, N.A.

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

Sanjay Varshney, PhD, CFA, Professor, Sacramento State, College of Business Administration, and Vice President/ Investment Strategy Specialist for California and Nevada at Wells Fargo Private Bank – Wealth Management Group

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

Publication Sponsors

at&t

CA Intern NETWORK

capital public radio
Licensed to SACRAMENTO STATE

CFA Society Sacramento

CUSHMAN & WAKEFIELD

FORUM MW

WELLS FARGO

SACRAMENTO BUSINESS JOURNAL

SACRAMENTO STATE

SMUD

VSP Global

WELLS FARGO The Private Bank

SACRAMENTO STATE · COLLEGE OF BUSINESS ADMINISTRATION

Take the Next Step to Advance Your Career

We offer graduate programs with convenient access for the working professional.

Chelsea Minor
Director of Public Relations & Public Affairs
Raley's Family of Fine Stores
EMBA Alumna '15

GRADUATE PROGRAMS

MBA for Executives (15-month, weekend program)

MS Accountancy (18-month, online program)

MBA (on campus, weeknight program)

IMBA on-campus (one-year, full-time, and day-time program)

- Only 5% of business schools worldwide are AACSB-accredited; we are one of them
- Endorsed by the local business community
- Alumni network of 40,000+

SACRAMENTO STATE
COLLEGE OF BUSINESS ADMINISTRATION

cba.csus.edu/graduate

Redefine the Possible

AACSB ACCREDITED