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Emerging Trends in Sacramento's Economy

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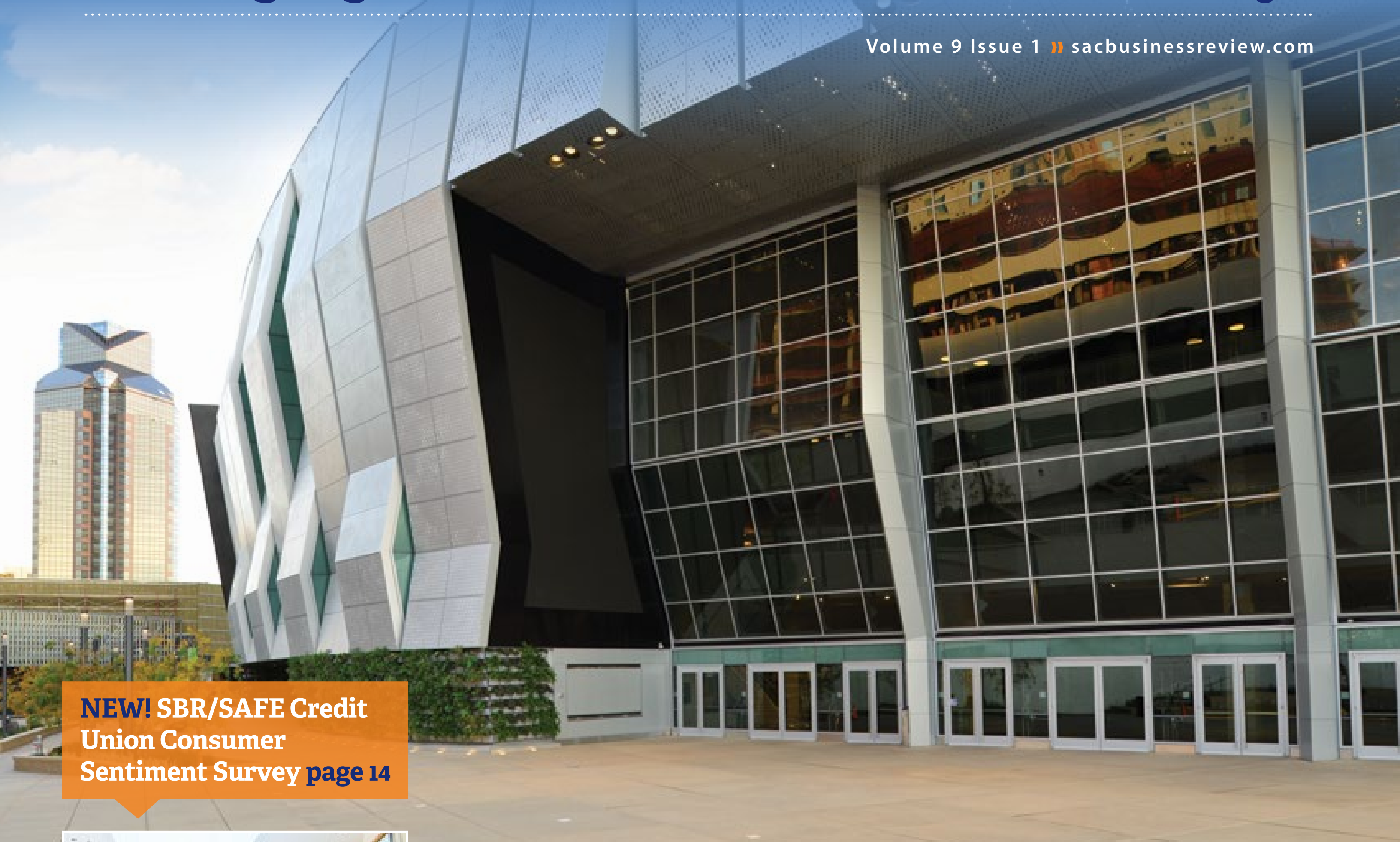
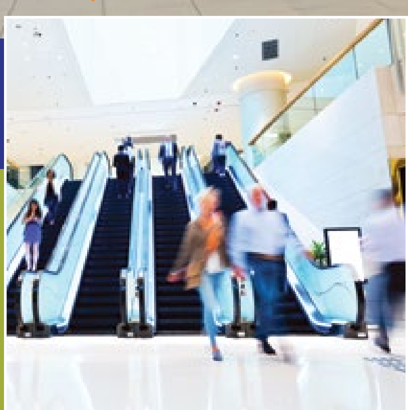


NEW! SBR/SAFE Credit Union Consumer Sentiment Survey page 14



2017 Economic Forecast

Your Best Guide to Sacramento's Economy

Labor Market & Regional Economy » SBR/SAFE Credit Union Consumer Sentiment Survey » Small Business » Real Estate » Banking Industry » Capital Markets » Human Capital Index

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MISSION

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

LABOR MARKET & REGIONAL ECONOMY

NEW! SBR/SAFE CREDIT UNION CONSUMER SENTIMENT SURVEY

SMALL BUSINESS

REAL ESTATE

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Message from the Chief Economist

Dear Friends,

I am pleased to share the 17th edition of the *Sacramento Business Review* – the most comprehensive, precise, and intellectually sophisticated analysis of the regional economy. For nine years, our team has provided thoughtful predictions that have accurately forecast the economic and business climate. With 17 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 on our economy in the region. In this issue we are pleased to introduce the **SBR/SAFE Credit Union Consumer Sentiment Survey**, as well as the **Human Capital Index**.

The greater Sacramento region continues to face a widening income and wage gap relative to the state of California that produced astonishing results for both job growth and economic expansion compared to most states in the country. A lackluster 2016 may bring more of the same in 2017 with health care and construction being the bright spots. Our comprehensive Financial Conditions Index was powered to its highest level with employment gains, home price appreciation and local lending activity providing momentum for sustained growth in 2017.

High investor demand and limited supply are helping improve fundamentals for all real estate property types in commercial real estate, resulting in rising rents, and dropping vacancy rates. Sacramento was ranked number 1 nationally in multi-family rent growth in 2016. Borrowers will face higher interest rates and tighter lending standards, but the banks should benefit from a steepening yield curve. Our Small Business Confidence Index reversed course and stands at a record 18-month level with SBA lending at its highest since 2005. Consumer sentiment is very high in the region, as is optimism regarding both business and economic conditions in the region. Our Human Capital Index shows employee development, satisfaction, and workforce skill development as the highest priorities for Sacramento businesses. We expect the post-election enthusiasm and optimism to help the Sacramento region economy stay stable in 2017. The region desperately needs to do something about developing or attracting higher paid jobs and diversifying the job mix.

I am both pleased and grateful for your overwhelmingly positive response to the publication, as you have embraced it and 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 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

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

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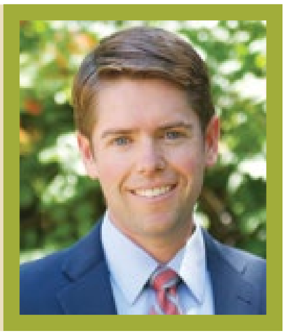

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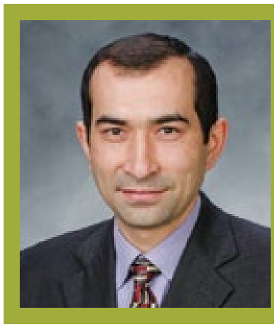

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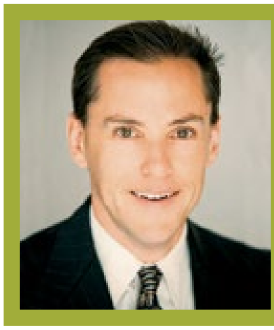

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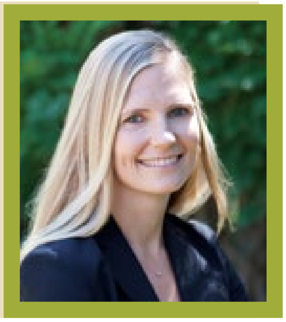

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Sacramento's
Labor Market & Regional Economy

The Sacramento region has recently reported strong labor market and employment growth.

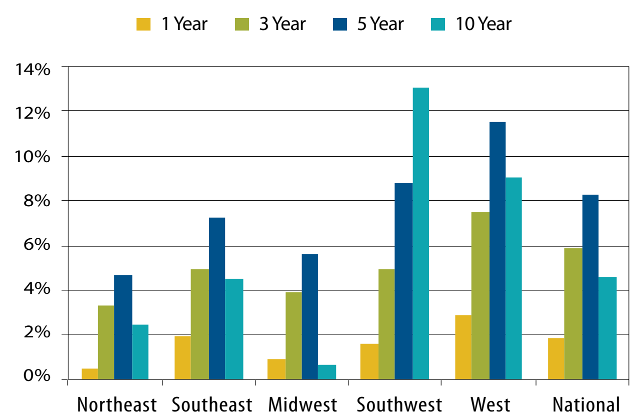
2017 Outlook

Key Points

- **The pace of labor market improvement has slowed in general. However, the Sacramento region has reported above average growth as it continues to play catch-up.**
- **The construction and health care sectors are leading Sacramento labor market growth.**
- **Income inequality is a concern nationally, as well as in California and the Sacramento region.**

The national labor market has continued to improve over the past year. However, the pace of employment has slowed and become more uneven across the five national regions. The western United States has continued to lead in both employment and labor force growth while the northeast and midwest regions have lagged. (Figure 1)

Figure 1
Employment Growth by U.S. Regions



Source: Bureau of Labor Statistics

The Sacramento region has recently reported strong labor market and employment growth. The growth rate has been in line with the state average and outpaced the growth rate for the nation. This could be partially attributable to the fact that the labor market recovery started later in the Sacramento region, and it is now playing catch-up to the nation's post-recession labor market and employment growth. It is also possible that the Sacramento region is riding a wave of strong employment trends affecting California as a whole. Either way, it is worth noting that the Sacramento region has now surpassed the national averages for post-2008 labor market and employment growth. (Figures 2 & 3)

Figure 2
Total Labor Force Growth

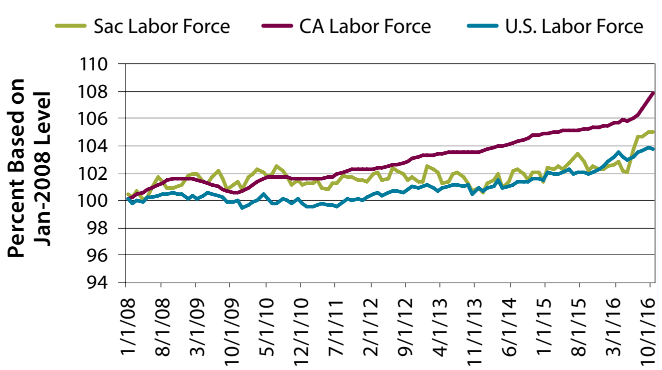
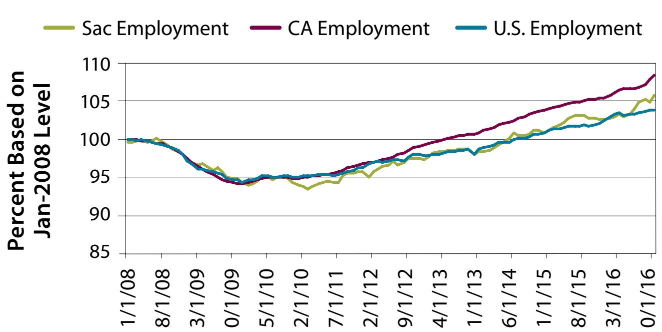


Figure 3
Employment Growth



Source (Figures 2 & 3): Bureau of Labor Statistics

Sacramento's Labor Market & Regional Economy 2017 Outlook

The Sacramento region has ranked near the middle of the nine California regions for employment growth, consistently behind Southern California and the San Francisco Bay Area. However, on a relative performance basis, the Sacramento region has improved from a below-average rank to an above-average rank in the past year. The Sacramento region was led by Sacramento, Placer, and El Dorado counties, which each reported employment growth over 3%, a strong improvement from their sub- 2% growth rate from 2015. (Table 1)

Employment Sectors

In 2016, the Sacramento region's job recovery was led by the construction sector due to continued improvement in new home and commercial building sales. Construction jobs are currently just 6.09% of the region's total employment but accounted for 16% of the increase in the region's jobs over the past five years. However, as we learned during the last recession, the region's labor market tends to be less stable when it is dependent on construction jobs for employment growth as construction jobs can be more cyclical than other subsectors.

Health care jobs have continued to be a bright spot in the region. Health care employment makes up a greater percentage of the Sacramento region's employment than it does for the state as a whole and has been a key driver of employment growth over the past 25 years. Much of the growth over the past five years has come from outpatient care services jobs (24.5%) followed by nursing and residential care jobs (16.9%) and hospitals (8.7%). This may make the possible repeal of the Affordable Care Act an especially large risk for the Sacramento region as it could reduce payments to in patient and out patient health care providers, which have been an important source of employment growth in recent years. (Table 2)

Table 1
Employment Growth by California Regions

	Greater Sacramento[1]	SF Bay Area[2]	Southern California[3]	Central Coast[4]	Southern Border[5]	North Central[6]	Central Sierra[7]	Northern[8]	Central Valley[9]
1 Year	2.90% (4)	3.09% (3)	3.32% (1)	1.68% (7)	2.54% (5)	1.66% (8)	3.26% (2)	2.06% (6)	-1.30% (9)
3 Years	7.98% (3)	9.92% (1)	8.09% (2)	6.36% (6)	6.92% (4)	5.64% (7)	6.71% (5)	4.69% (8)	2.56% (9)
5 Years	10.60% (4)	15.26% (1)	12.42% (2)	10.24% (5)	10.65% (3)	9.96% (6)	6.11% (7)	4.01% (9)	5.45% (8)

1 Sacramento, Yolo, Sutter, Yuba, Placer, & El Dorado counties.
2 Sonoma, Napa, Solano, Marin, Contra Costa, Alameda, Santa Clara, San Benito, San Francisco, San Mateo, and Santa Cruz counties.
3 Ventura, Los Angeles, Orange, San Bernardino, and Riverside counties.
4 Monterey, San Luis Obispo, and Santa Barbara counties.
5 San Diego and Imperial counties.
6 Shasta, Tehama, Glenn, Butte, and Colusa counties.
7 Amador, Calaveras, Alpine, Tuolumne, Mariposa, Mono, and Inyo counties.
8 Mendocino, Lake, Humboldt, Trinity, Del Norte, Siskiyou, Modoc, Lassen, Plumas, Sierra, and Nevada counties.
9 San Joaquin, Stanislaus, Merced, Madera, Fresno, Kings, Tulare, and Kern counties.

Source: Bureau of Labor Statistics

Table 2
Employment Growth by Local Industrial Sectors

	Construction	Manufacturing	Finance	Education	Health Care	Leisure & Hospitality	Government	Trade, Transportation, and Utilities	Professional Services
1 Year	8.63%	2.22%	2.71%	5.83%	3.27%	1.28%	1.70%	-1.42%	2.73%
3 Years	26.14%	6.96%	8.15%	-0.78%	14.31%	8.84%	6.69%	-2.11%	6.14%
5 Years	47.70%	7.58%	13.46%	-0.78%	23.01%	18.95%	11.63%	-12.58%	16.37%
% of Total	6.09%	2.33%	5.58%	1.34%	14.28%	9.97%	25.13%	15.94%	13.08%

Source: Economagic.com

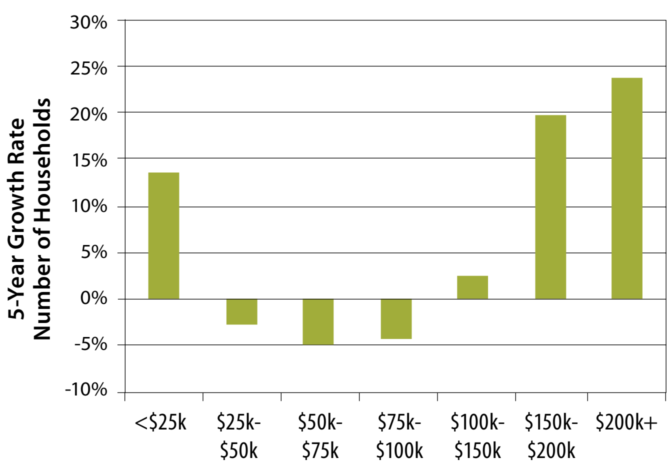
Leisure & hospitality and professional & business services have also exhibited an upward trend in recent years. Both are near their highest level as a percentage of the region's employment since 1990. Meanwhile, manufacturing; finance; trade, transportation, and utilities; and information jobs have continued a long-term decline as a percentage of the region's labor force. In addition, government jobs have slightly declined as a percentage of the region's economy in recent years while a number of other sectors have increased employment at a relatively faster pace.

Incomes

Two other areas of concern for the Sacramento region are the slower pace of income growth and an increase in income inequality. Per capita income in the Sacramento region kept pace with the state up until 2004. Since then, income growth for California as a whole has outpaced that of the region so that per capita income in the Sacramento region is now 87% that of the state wide average (Figure 4). Of added concern is that the region's per capita income declined 1.15% in 2015 while the statewide average increased 5.40%. This may be a sign that while the Sacramento region is posting job growth in-line with that of the state, it is attracting lower-income jobs.

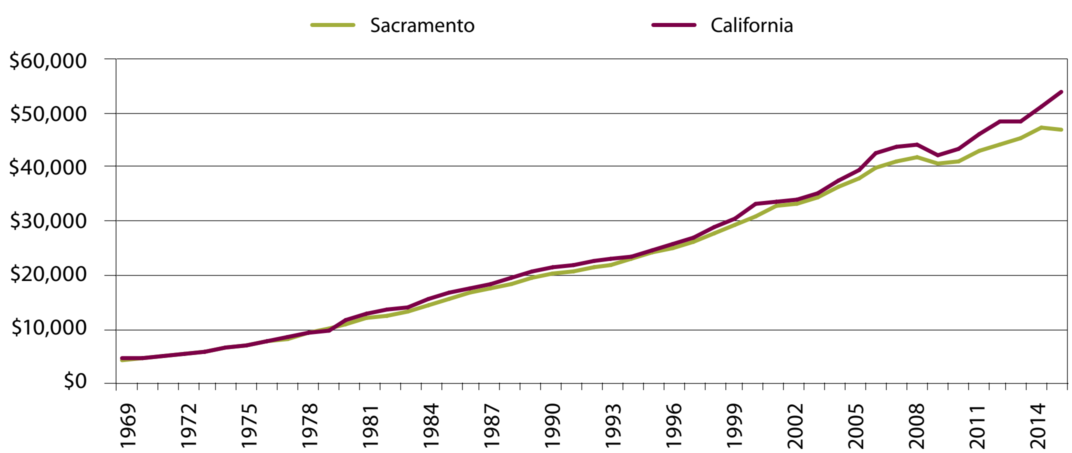
Income inequality has been a national, if not global, problem that has received a lot of press throughout the current economic recovery. Unfortunately, the Sacramento region has been no exception. Over the past five years, the number of households with income less than $25,000 per year increased by 13.6%, while the number of households with income over $100,000 per year increased by an average of 9.6%. The number of households in the middle-income brackets (between $25,000 and $100,000) decreased over that same period (Figure 5). A concern is that income inequality may lead to reduced economic stability in future years as high-income households – with a greater share of income tied to investments, business ownership, or real estate holdings – are often impacted more during recessions.

Figure 5
Sacramento Household Income Growth Distribution



Source: U.S. Census Bureau

Figure 4
Per Capita Income Growth



Source: Economagic.com

SBR/SAFE Credit Union
Consumer Sentiment Survey

iStock by Getty Images

Almost 90% of respondents expect their income to rise or at least stay the same over the next year.

Key Points

- Consumer sentiment in the region is generally positive.
- Almost 90% of respondents expect their income to rise or at least stay the same over the next year. However, many respondents expect that inflation will increase faster than their income during this period.
- The vast majority of respondents expect that regional business conditions will improve (32%) or stay the same over the next year (48%).
- Compared to national data, regional respondents are overall slightly less positive about their personal economic conditions and income expectations, but slightly more positive regarding our economy as a whole.

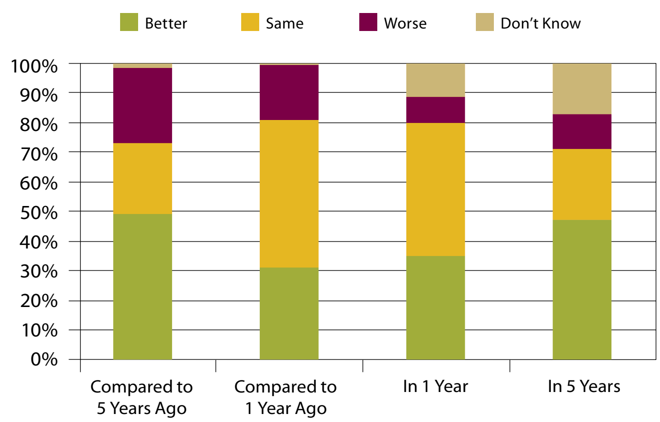
For the first time, the *Sacramento Business Review* (SBR) in partnership with SAFE Credit Union, has conducted a survey of consumer sentiment in the Sacramento region. The survey included measures of personal and regional economic conditions, monthly expenditures, as well as purchasing and credit utilization. The findings indicate that overall consumer sentiment in the Sacramento region is generally positive.

Regional Consumer Sentiment

Respondents indicated that their personal economic situation is generally the same or better than it was in the past. Almost 50% of respondents reported that they are currently financially better off compared to 5 years ago. When compared to 1 year ago, 24% reported being financially better off now, whereas 50% reported being financially the same. (See Figure 1)

Looking to the future, respondents reported positive expectations about their future personal financial prospects. Eighty percent of respondents expect to be the same or better off financially 1 year from now, and 47% expect to be better off 5 years from now. Only 9% expect to be worse off financially 1 year from now. (See Figure 1) Additionally, 32% of respondents expect their household income to increase over the coming year, and another 57% expect household

Figure 1
Personal Economic Conditions



income to remain the same. Of those expecting an increase, the median anticipated increase is 2%. However, over half of respondents (54%) expect prices to increase (i.e., inflation) faster than their income over this period. (See Figure 2)

With respect to the region's economy as a whole, respondents believe economic conditions have improved (31%) or stayed the same (54%) over the past year, and they expect conditions to continue to improve (32%) or stay the same (48%) over the next year. (See Figure 3)

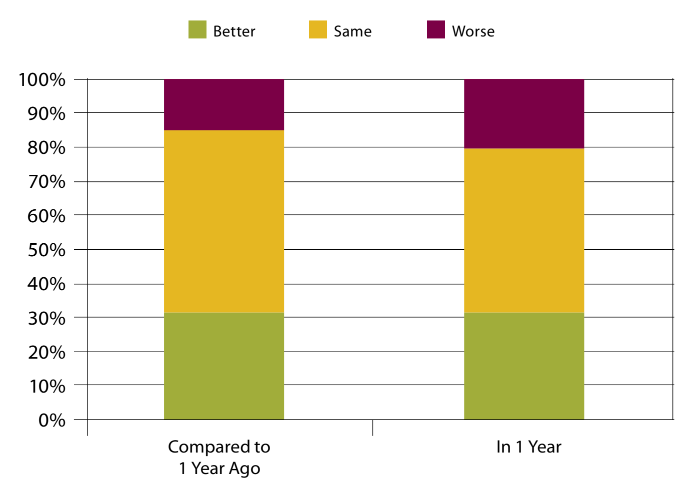
Regional vs. National Sentiment

The SBR team also compared regional sentiment with national sentiment measures. Our survey included questions from the University of Michigan Consumer Sentiment© survey that were adapted to specifically address the Sacramento region. Per the methods used by the University of Michigan survey, responses to these questions were used to create what is called a "relative score". Relative scores above 100 suggest more respondents indicated favorable expectations than unfavorable expectations. Scores below 100 suggest respondents indicated more unfavorable than favorable expectations. These relative scores can then be compared directly across the regional and national samples.

Overall, assessments related to personal income were comparable to or slightly below the national data. Compared

Figure 2
Personal Income Expectations

Figure 3
Regional Economic Conditions



to the national data, regional respondents perceived relatively less improvement in their financial situations over the past 5-year period (relative scores: 123 vs. 129). Their expectations over the next year are comparable to the national data (relative scores: 126 regional and 127 national) and slightly less positive than the national data regarding the next 5 years (relative scores: 135 vs. 144). With respect to personal income, while the regional respondents expect household income to grow over the next year, they expect it do so to a lesser degree than the national data (relative scores: 121 vs. 135). Both the regional and national data suggest many consumers expect prices to increase (i.e., inflation) over the next year. Respondents were pessimistic about real income growth in that both samples expect these price increases to exceed gains in income. This negative belief about real income was stronger at the regional level (relative scores: 56 regional vs. 79 national).

We also compared regional respondents' perceptions of business conditions in the region's economy to the national respondents' perceptions of the U.S. economy overall. Both samples perceived improvement in business conditions during the past year; however, regional respondents were more likely to indicate that current business conditions improved over this time period. Similarly, both samples expect positive improvements over the coming year, with regional respondents being more likely to indicate this favorable belief. (See Table 1 for additional measures and interpretation)

Consumer Expenditures

We also asked consumers to indicate how much they spend each month on various purchase categories such as housing, transportation, food (at home and away), health care, etc. and compared their responses to national data from the Bureau of Labor Statistics Consumer Expenditure Survey. In general, expenditure patterns were comparable at the regional and

Table 1
Regional vs. National[1]

Category	Regional Relative Score	National Relative Score	Comparison	Interpretation
Personal Economic Conditions				
Current Financial Situation Compared to 5 Years Ago	123	129	↓	Region perceives less improvement over past 5 years
Current Financial Situation Compared to 1 Year Ago	113	111	→	Region perceives equivalent improvement over past year
Expected Change in Financial Situation in 1 Year	126	127	→	Region expects equivalent improvement over next year
Expected Change in Financial Situation in 5 Years	135	144	↓	Region expects less improvement over next 5 years
Personal Income Expectations				
Expected Household Income Change Over the Next Year	121	135	↓	Region expects less income growth over the next year
Expected Change in Prices Over the Next Year	174	183	–	Region expects less inflation over the next year
Expected Change in Household Income Relative to Prices	56	79	↓	Region expects less real income growth over the next years
Economic Conditions				
Current Business Conditions Compared to 1 Year Ago	116	112	↑	Region perceives more improvement over past year
Expected Change in Business Conditions in 1 Year	111	103	↑	Region expects better conditions over the next year

national levels. In both samples, housing was the largest expenditure category, with regional respondents indicating that a larger percentage of their monthly expenditures goes towards housing than at the national level (37% vs. 33%). Notably, savings levels were lower at the regional level (2%) than at the national level (8%). (See Figure 4)

Purchasing and Credit

Respondents also completed questions about major purchases and credit utilization. Approximately 29% of respondents reported making a major household purchase during the past 6 months (e.g., furniture, television, major appliances, etc.) and about 28% of respondents anticipate making one during the next 6 months. With respect to credit utilization, we asked consumers to indicate which types of credit they currently hold as well as to report their plans to acquire different types of credit in the next year. Roughly half of respondents hold a mortgage (50%) and/or an auto loan (46%), while 60% of respondents reported having 1 or more credit cards carrying a balance. As for the next year, 10% of respondents plan to seek mortgages, 11% plan to seek auto loans, and 10% plan to obtain credit cards. (See Figure 5)

Endnotes

1 National data from the University of Michigan Consumer Sentiment Survey October 2016 Data. Available at: https://data.sca.isr.umich.edu/
Relative score values calculated as % of favorable responses minus % of unfavorable responses plus 100. Positive or negative comparison indications are provided for regional vs. national score differences exceeding 3 points.

2 National data from BLS 2015 Consumer Expenditure. Available at: https://www.bls.gov/cex/2015/research/allcuprepub.pdf.
Savings calculated from BLS Consumer Expenditure Survey Data by subtracting total expenditures from total income after taxes (converted to a monthly basis). Other category computed by subtracting total reported expenditures in named categories from overall total reported expenditures (includes education, child care, etc.).

Figure 4
Regional and National Expenditures[2]

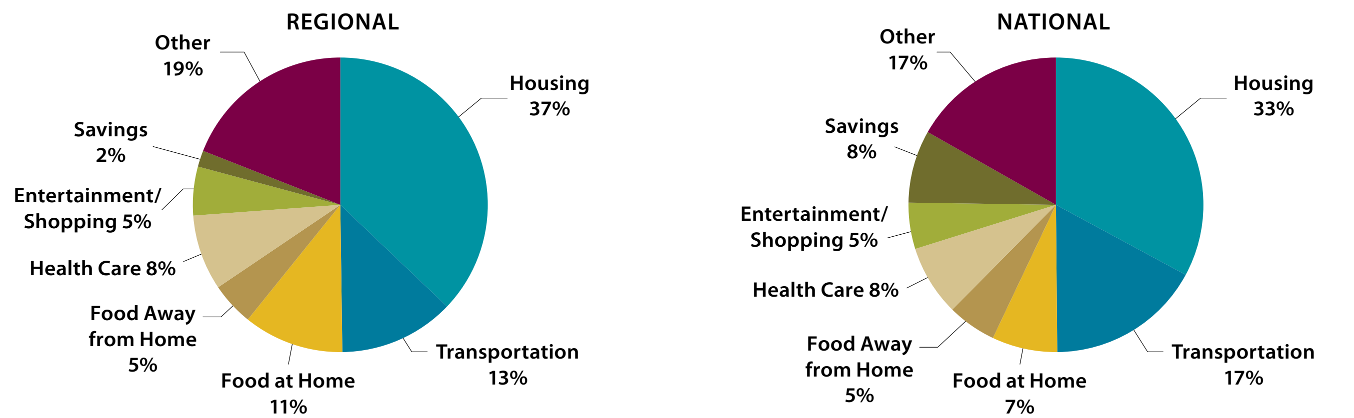
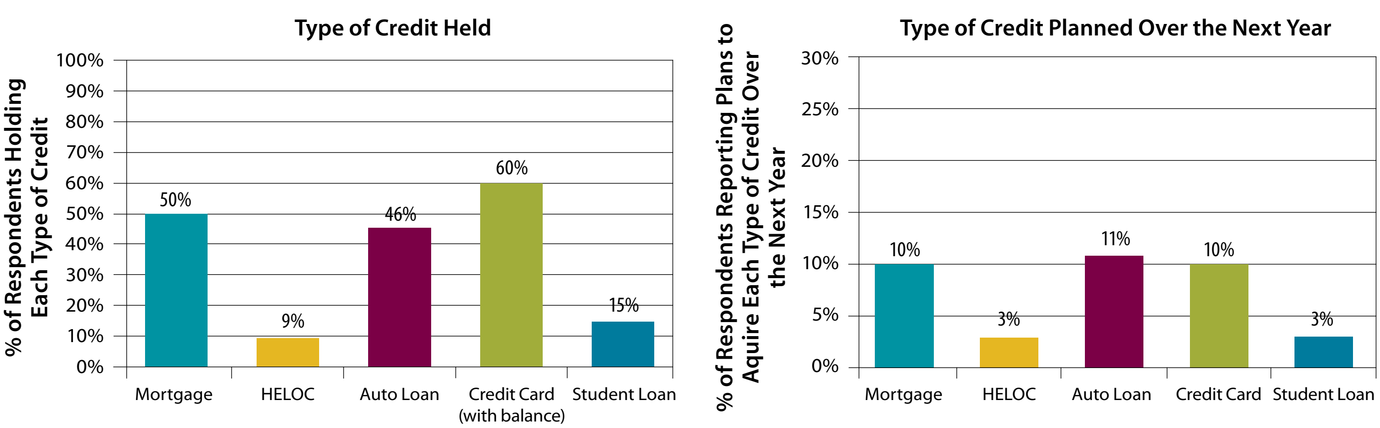


Figure 5
Types of Credit Held and Planned Over the Next Year



THE Small Business Economy

The total dollar volume of SBA loans in 2016 increased by 30% over the previous year.

Key Points

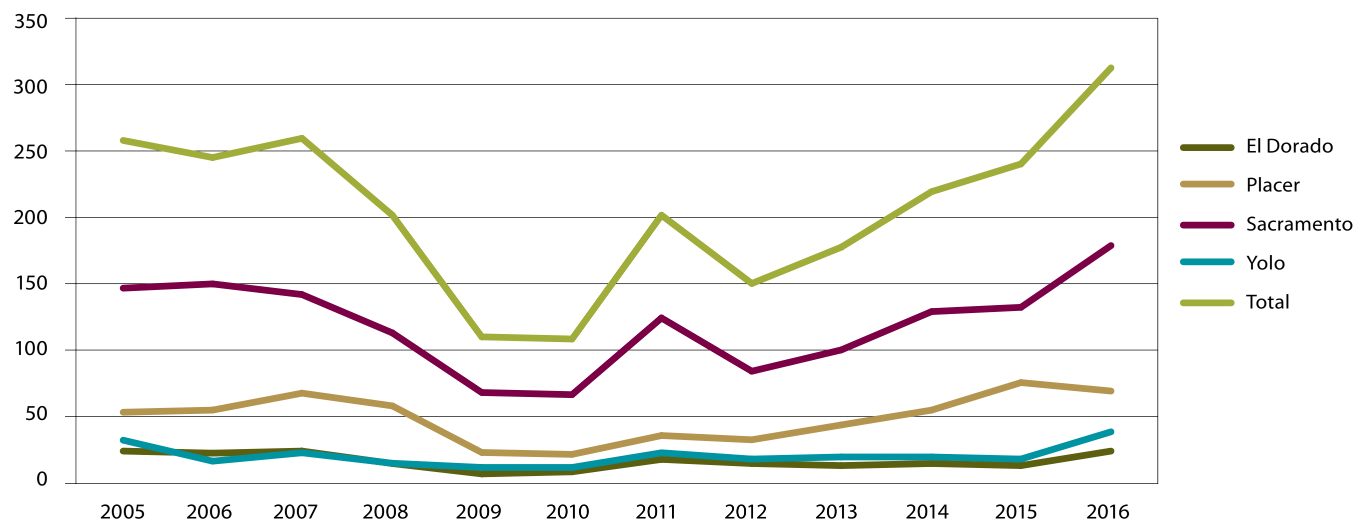
- Total SBA lending for Sacramento MSA reached its highest level since 2005 and stands at 21% higher than the previous peak in 2007.
- Our SBR Small Business Confidence Index improved significantly across the board with all five measures at their 18-month peaks.
- The overall health of the small business sales market appears to be improving as measured by the number of listings and the number of sales, with median revenue and median cash flows of closed sales hitting 10-year records.
- The above is consistent with recent surveys of the National Federation of Independent Business and Wells Fargo's Quarterly Survey of Small Businesses, which find small business optimism at its highest level since 2008.

The total dollar volume of SBA loans in the Sacramento metropolitan statistical area (MSA) 2016 increased by 30% over the previous year to surpass pre-recession levels. Sacramento County, the largest of the four counties in the Sacramento region, saw lending increase by 34%; El Dorado County and Yolo County saw lending increase by 88% and 122% respectively. Placer County, the second-largest county as measured by the SBA loan amount, however, bucked the trend with a 10% decrease. Total SBA lending for the combined four counties totaled $312.34 million in 2016 – its highest level since 2005, and 21% higher than the previous peak of $259.05 million in 2007.

Our SBR Small Business Confidence Index improved significantly across the board with all five measures at their 18-month peaks...

Our SBR Small Business Confidence Index improved significantly across the board with all five measures at their 18-month peaks, with three measures (economic outlook, credit accessibility, and future revenue) at their highest levels in two years. The most notable improvement was on the likelihood of new hires, which increased by 24.3% from the summer reading (which itself was the lowest survey reading since January 2011). However, it remains 27.9% below its peak in January 2015. The economic outlook measure is now at its highest reading ever since we began publishing our survey results in January 2011 – slightly surpassing the previous record high from January 2015.

Figure 1
Total Dollar Amount of SBA Loans Approved in the Sacramento MSA » Overall Since 2005 (in Millions)



Data Source: U.S. Small Business Administration

The above is consistent with recent surveys of the National Federation of Independent Business and Wells Fargo's Quarterly Survey of Small Businesses. Both find that small-business optimism is at its highest level since 2008. Both attribute much of this optimism to the Trump victory and expectations regarding policy changes and significant tax, health care, financial, and other regulatory reform. The small-business economy endured the biggest shock from the Great Recession, and subsequently experienced a very sluggish recovery. While top-line revenues stayed flat or declined, small-business owners tried to control costs, including those from expensive health care and federal/state/local regulations. This meant hiring fewer workers and lesser capital investment in buildings and equipment.

Not surprisingly, the manufacturing sector reported mixed results. With the economic outlook measure unchanged, businesses do have a more optimistic view on future revenue and likelihood of new hires, which saw an 8.9% and 90.9% increases, respectively. However, they have concerns regarding both local supportiveness and credit accessibility. These readings are down by 23.5% and 6.3% respectively. Other than the economic outlook reading, which is closer to its previous peak, the other four measures are still about 22% to 45% below their peak levels in 2011.

Figure 2
Small Business Confidence Index Trends » January 2011 – January 2017

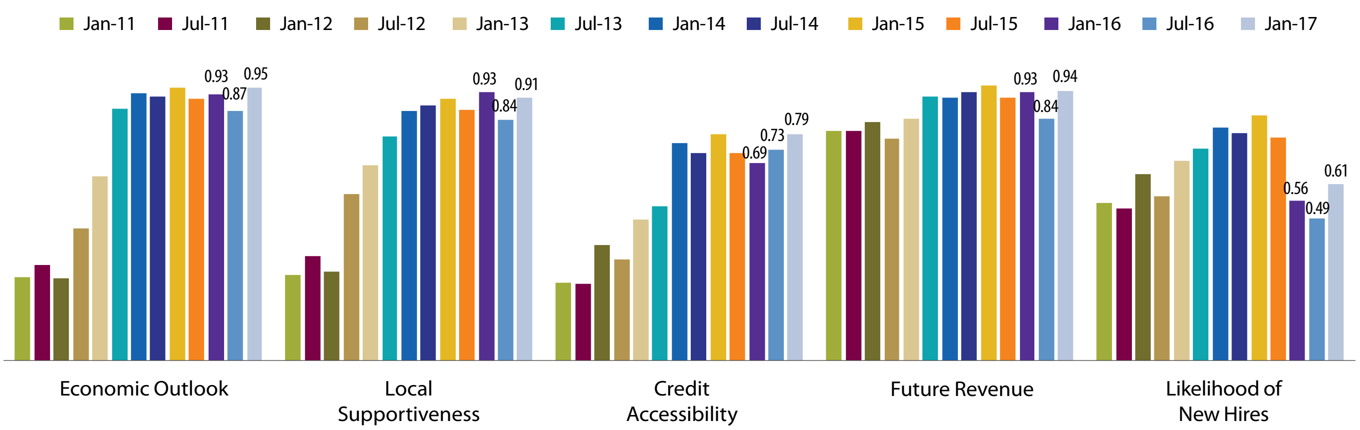
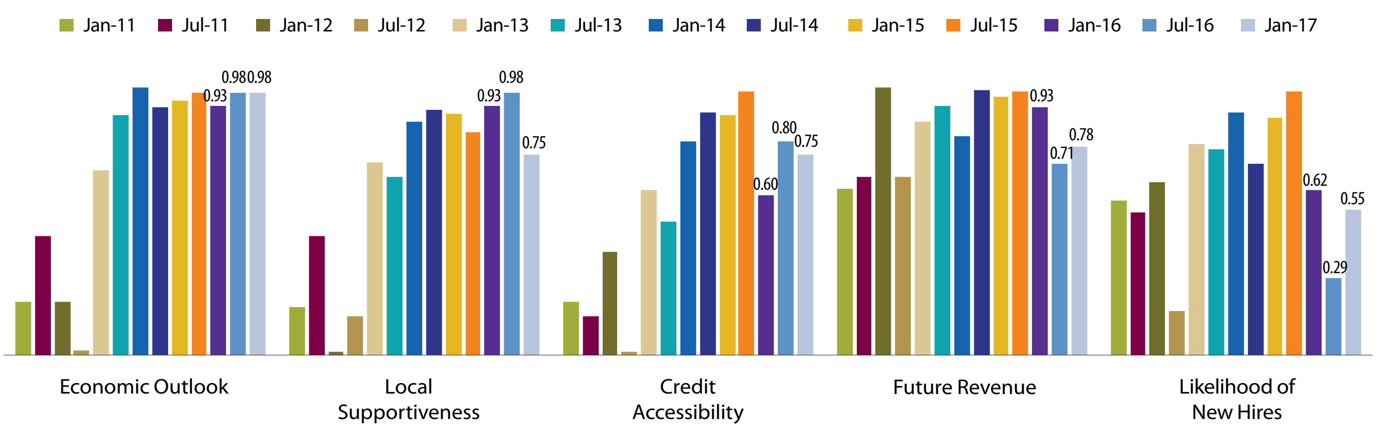


Figure 3
Small Business Confidence Index Trends in the Manufacturing Sector » January 2011 – January 2017



Data Source (Figures 2 & 3): U.S. Small Business Administration

The service sector reported results better than those of the manufacturing sector. All measures saw a good 5% to 10% improvement from six months ago, with the exception of credit accessibility, which had a 7.8% decrease.

The others sector reported the best results among the sectors that we follow closely. All five measures saw a 20% to 30% improvement from six months ago, with the likelihood of new hires increasing by 51.9%. All readings are at their peak levels since January 2011, with the exception of likelihood of new hires, which, despite the recent improvement, is still 24% below its peak in January 2014.

Figure 4
Small Business Confidence Index Trends in the Service Sector » January 2011 – January 2017

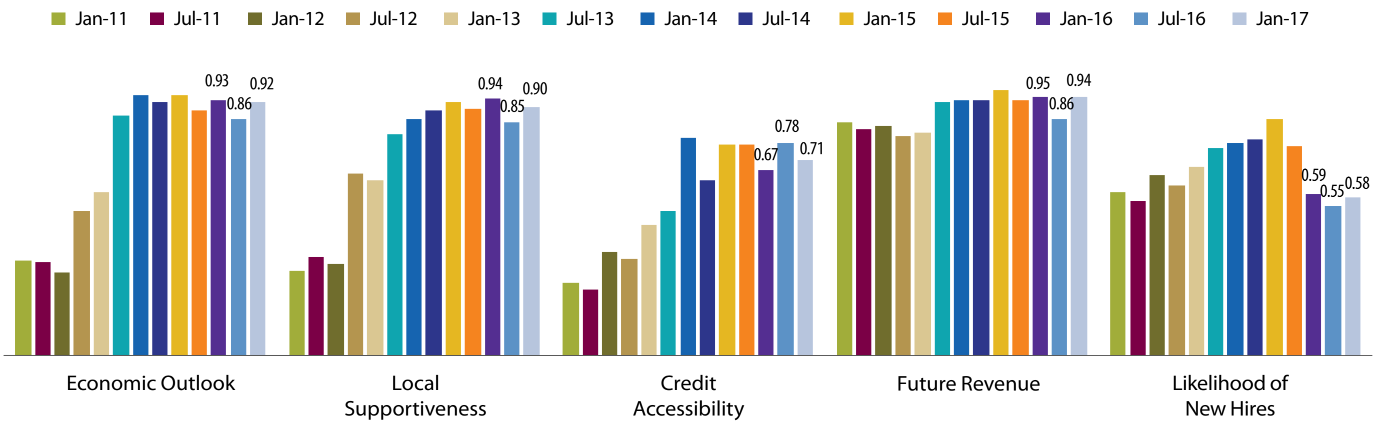
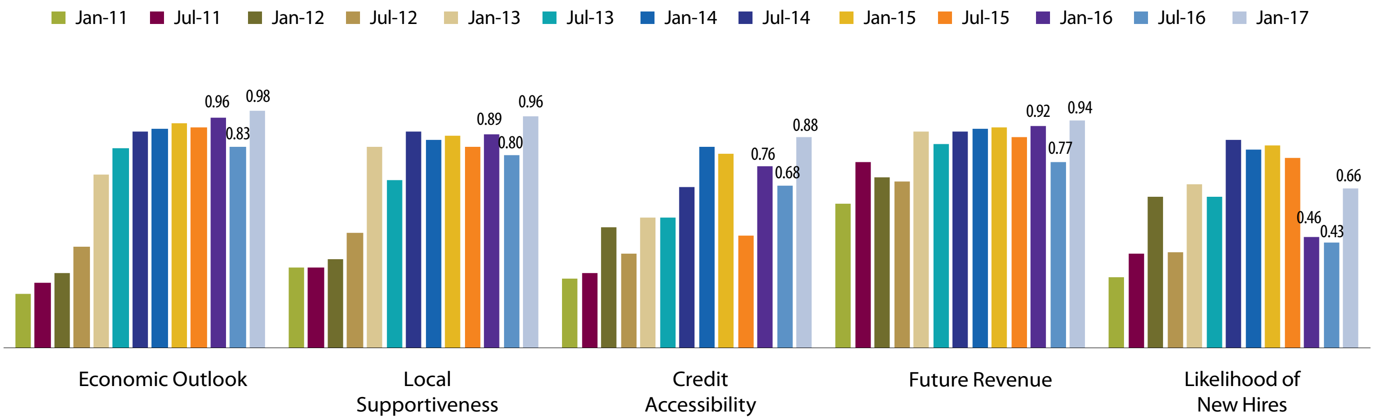


Figure 5
Small Business Confidence Index Trends in the Others Sector » January 2011 – January 2017



Data Source (Figures 4 & 5): U.S. Small Business Administration

THE Small Business Economy

Both the numbers of small businesses listed for sale (listings), and actual sales in the Sacramento region picked up in 2016. Although the number of listings has not come back to its peak level from 2015 yet, it has been on an increasing trend for the last three quarters of the year. The actual sales number in 2016-Q3 was the largest third-quarter reading in the last 10 years. It is also the largest single-quarter actual sales number, tying that from 2013-Q4.

The median closed sales price has been on a declining trend in 2016, even though it remains higher than three of four quarterly readings from 2015. The median revenue of closed sales and median cash flow of closed sales managed to sustain higher levels in 2016, especially when compared to those from the two last quarters in 2015. The average quarterly median revenue of closed sales at $659,147 in 2016 is the highest reading over the last 10 years. The same is true for the average quarterly median cash flow of closed sales, which at $143,995 in 2016, is the highest reading over the last 10 years as well. These results suggest an improvement in overall conditions for small business sales activity, as well as better quality of small businesses that have successfully changed hands in the market.

Small Business Sales

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

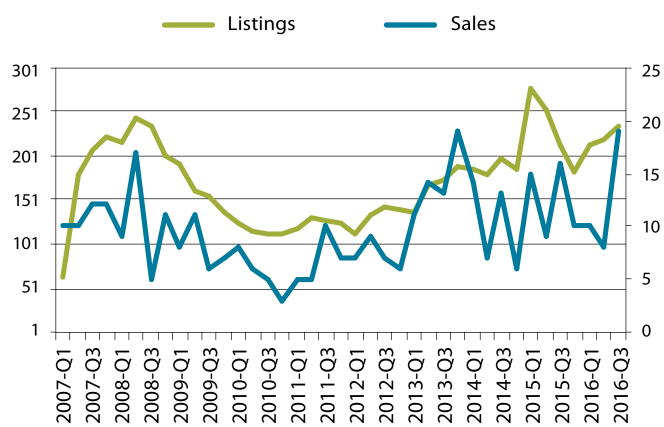


Figure 7
Median Closed Sales Price (Quarterly)

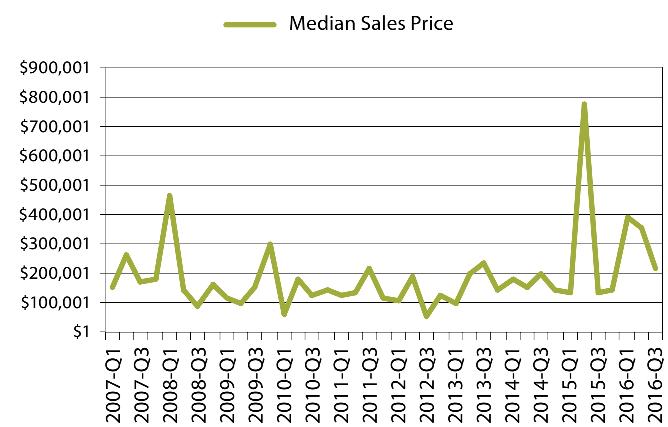


Figure 8
Median Revenue of Closed Sales (Quarterly)

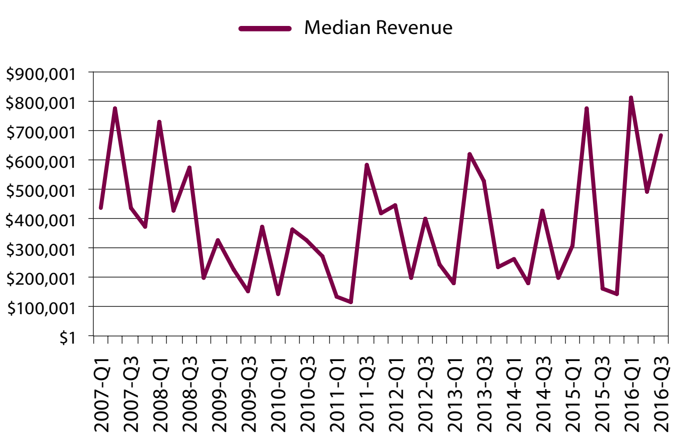
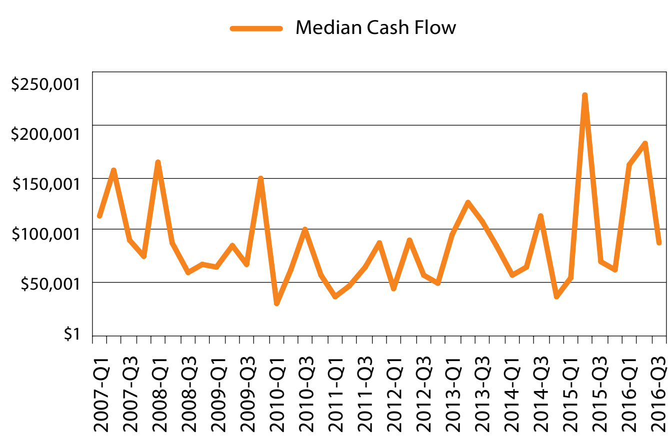


Figure 9
Median Cash Flow of Closed Sales (Quarterly)



Data Source (Figures 6-9): BizBuySell

Real Estate Trends *in the* Sacramento Region

New speculative construction is needed in all property types, but current rents are not high enough to provide an adequate return to developers in most cases.

Key Points

- **Commercial real estate fundamentals continue to improve, with vacancy declining and rental rates increasing in all property sectors.**
- **Investor demand remains high, while supply is limited. Out-of-town investors, unable to achieve adequate yield in core markets, continue to scout the region.**
- **New speculative construction is needed in all property types, but current rents do not provide an adequate return to developers in most cases.**
- **Tightening credit standards – along with regulatory compliance, permits and fees – are key barriers to expansion.**
- **The downtown core will remain strong in 2017 with the completion of several more projects, helping make Sacramento an 18-hour city.**
- **Sacramento was ranked number 1 nationally in multi-family (MF) rent growth in 2016. 2017 MF rent growth will be more moderate.**

E-commerce has found its way to Sacramento with Amazon's announcement of building a new distribution facility in Metro Air Park.

Sacramento is still experiencing moderate and continual growth and absorption across all property types and in many different sectors, with more robust growth in rents and pricing in certain submarkets and property types as further explained below. Our region has benefitted in good part from being one of the last areas in the country to see full recovery, which has kept our community relatively affordable.

The opening of Golden 1 Center has so far delivered on its promises of bringing more people downtown who are contributing to the new and existing businesses in the area. While these transient visits are helping to boost the economy downtown, Sacramento needs more downtown housing to fully realize the dream of becoming an 18-hour city. Several developers have been proposing such projects, and many will likely be realized, but only if rents and sale prices continue to rise. Without the streamlining of regulations and gentrification of certain blocks in the core, however, some projects could falter.

E-commerce has found its way to Sacramento with Amazon's announcement of building a new distribution facility in Metro Air Park (the first building that will go into this industrial park). While some fear that e-commerce will be the death of retail (true in some regards), the reality is that with an omni-channel strategy, industrial and retail sectors are working in harmony; and both are flourishing here in the Sacramento region.

Our efforts to attract more businesses and lease more space will be tied very closely to providing a highly trained workforce and our region's ability to streamline regulations and provide certainty to potential businesses. Our region collectively needs to come together on these issues, which will allow Sacramento to succeed and grow well into the future.

Office

2016 Review:

While the office market had trailed in the recovery behind all other product types, that is no longer an issue, with continued improvements in vacancy and increases in rates. Overall net absorption (the total gain in leased space) was down by about 300,000 SF to 1,125,000 from 2015 to 2016. This absorption resulted in a vacancy rate at the end of 2016 of 11.4% overall, which represents a reduction of 0.9% since the end of 2015, and the lowest vacancy rate since 2005. Some of this reduction in absorption can be attributed to lack of larger blocks of space available in the market, rather than lack of demand.

Even with these gains, however, the region continues to experience limited new office construction. In fact, only about 375,000 SF of new office space was delivered in 2016, of which 125,000 SF was built for the Federal Bureau of Investigation in Roseville, and 110,000 SF was built and half pre-leased to California Correctional Health in Elk Grove.

Meanwhile, asking rents continue to increase across the suburban submarkets and significantly increase in the Central Business District (CBD). The overall class A asking rents for the entire Sacramento area are averaging $2.13 PSF, which remains far below its peak in 2007 of $2.48 PSF. Asking rents in the CBD alone have climbed over $0.07 PSF in the last quarter since the new arena opened to $2.85 PSF. As larger blocks of space are becoming scarce, rates also are climbing at a more precipitous levels in hot submarkets such as South Placer, Natomas and Folsom. Rates along other parts of Highway 50 remain affordable compared to these other markets.

2017 Preview:

The Downtown CBD will remain "King" in 2017 because the "arena effect" of the new Golden 1 Center has the potential of pushing average Class A asking rates to over $3.00 PSF. As rates continue to increase downtown and space availability compresses, look for some companies to pull up stakes and search for more affordable space and free parking in suburban markets. This will continue upward pressure on rents in the suburban markets as well. While current rents still do not justify new speculative construction (although we are getting closer to this potential), dropping vacancy rates and rising rents indicate a promising outlook for future development. Repurposed space in the downtown and midtown areas continues to remain in high demand and will command top rents.

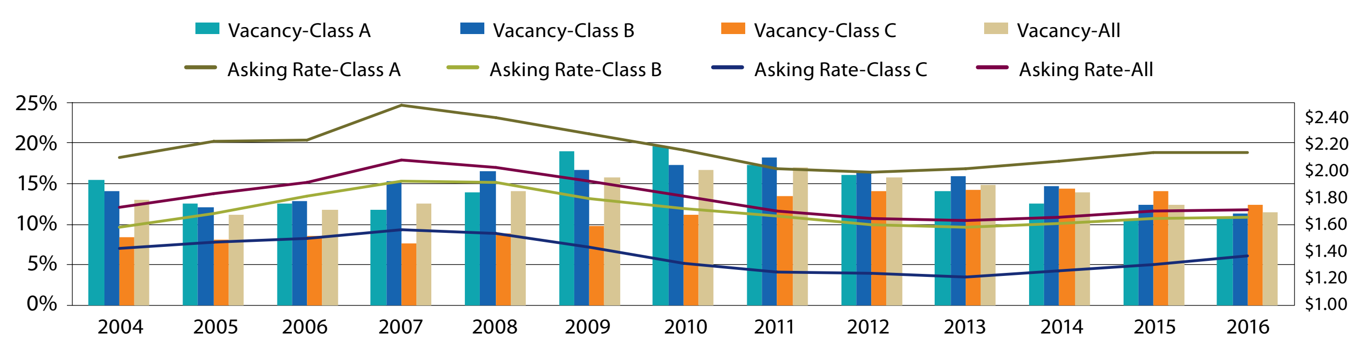
Retail

2016 Review:

As predicted in last year's forecast, 2016 marked the exit of several retailers through bankruptcy, rightsizing or consolidation – arguably the highest level since the recession. These closures (including Sports Authority, Sports Chalet and Kmart) put a damper on net absorption for 2016 although we still ended up in positive territory overall. Many of these vacated locations already have new proposals, leases or concepts in place.

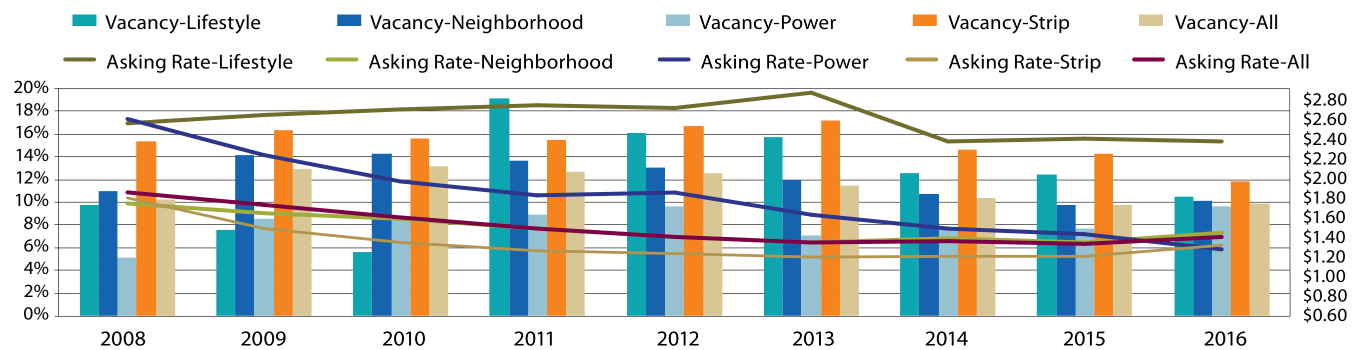
The largest new speculative project under construction is the Delta Shores project off I-5 in the South Sacramento area. Several other projects have been significant remodels or repositioning projects such as the Howe Bout Arden project

Figure 1
Office Lease Rate vs. Vacancy Rate



Data Source: Co star and Cushman & Wakefield

Figure 2
Retail Lease Rate vs. Vacancy Rate



Data Source: Co star and Cushman & Wakefield

coupled with revamped theaters. Virtually all other projects under construction are build to suit or otherwise pre-leased.

New class A space is commanding pre-recession pricing to justify the cost of construction. As a result of the strong lease up of these new centers, tenants are having to look to older product, which is driving rents in these inferior spaces up as well.

Many national retailers are feeling confident about their business expansion plans and want to open new stores or relocate this year. That said, however, the deals still need to "make sense" or they will not deploy.

The opening of Golden 1 Center downtown has driven more transient traffic to the area restaurants and bars, which has been welcome.

2017 Preview:

General fundamentals from 2016 will continue in 2017. Geographically key suburban markets and newer centers will continue to flourish. The downtown and midtown retail core will continue to see a major transformation.

Sacramento continues to be more affordable than many other metro areas, which coupled with our demographics presents a good value proposition to several national credit tenants.

Retailers will continue to right size their brick-and-mortar footprints, and we will continue to see some of the weaker retail chains exit the market. Also look for consolidations as a result of mergers to address redundancy issues. While we do not expect a significant fallout in 2017, it is worth noting that 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 given the already tight margins, increasing wages and other regulations.

Industrial

2016 Review:

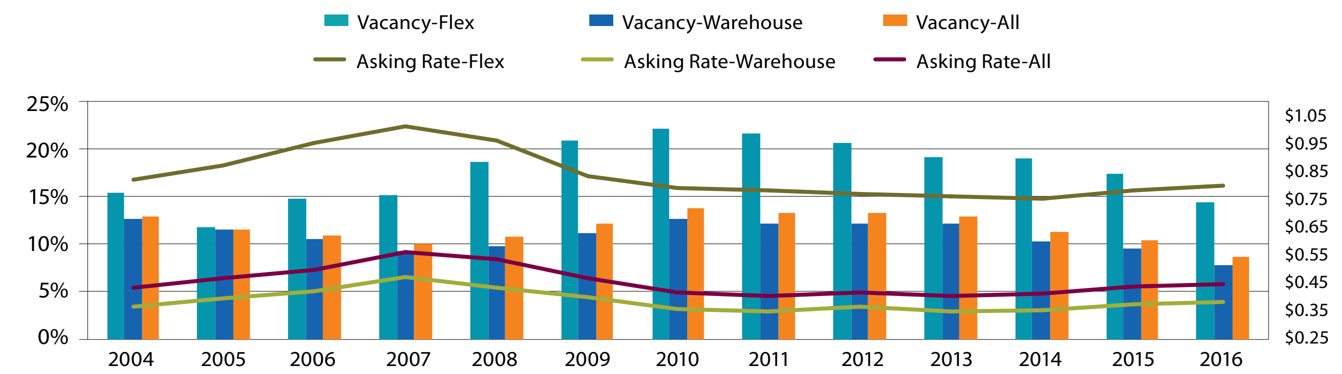
2016 was another remarkable year for the Sacramento Industrial market. Net absorption for warehouse space in 2016 posted at approximately 2,375,000 SF, which is similar to year end 2015. Gross leasing activity was down from 2015 to 2016, which in part can be attributed to the limited supply of available functional product in the size ranges needed by tenants.

Vacancy for warehouse space dropped by over 150 basis points year over year to 8%, signaling the lowest vacancy rate we have seen since 2007 and a steady decline in vacancy over the last five years. At the same time, asking rents have not recovered to pre-recession levels.

There is only one reasonably sized speculative industrial building under construction – 141,000 SF in West Sacramento. All other key properties under construction are build to suit, which includes U.S. Cold Storage for 220,000 SF; Mitsubishi Rayon for 62,254 SF, and the arrival of Amazon for 850,000 SF.

Most activity in the industrial sector this last year has revolved around distribution (including food distribution), service sector and manufacturing. Sacramento has been considered for a handful of large manufacturing sites over

Figure 3
Industrial Lease Rate vs. Vacancy Rate



Data Source: Co star and Cushman & Wakefield

the last year, but has come up short in the end. There is a need for more fully entitled, fully serviced, and well-located industrial land that is permit-ready to really attract new companies.

2017 Preview:
With vacancy down to pre-recession levels, there is nowhere for rents to go but up, by an average of 5-10%, if not more. These rents will approach a level that makes speculative construction viable again in limited submarkets and within certain size ranges. However, the elevated costs of construction, regulation, permits and fees, and tightening credit availability will still limit overall expansion. The very few remaining larger blocks of space in the market are seeing activity, and many should be leased up in 2017. Smaller spaces will continue to see significant rent growth and will be difficult to find.

There also remains 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

Sacramento finally found its place on the list of areas that institutional and out-of-town investors would consider in 2015, and this was further validated in 2016. Investors who were not finding adequate yield in core markets have been finding significantly better value in Sacramento.

Single-tenant properties with credit tenants are securing much higher values than a year ago. Conversely, lower-quality multi-tenant projects are trading significantly below replacement cost, providing investors an opportunity for higher yield and upside.

The biggest issue with investment sales in Sacramento is that demand far outstrips supply. There are far more 1031 Exchange buyers and new cash in the market in 2016 than in previous years and very few options in which to put their dollars.

Some positive news is that there should be a good amount of consumer mortgage-backed securities loans coming due this year which could bring some properties to market if the owners can achieve a reasonable return. Given where we are in the recovery cycle, most properties have regained sufficient value to justify a sale, such as the sale of the trophy Wells Fargo building to Starwood Capital Group for $175 million, or $343 PSF.

Residential

The residential real estate market in the Sacramento region continued the trend of modest improvement in 2016, 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 certain price segments in the "middle" markets that appear to be more stagnant. By sharp comparison, sales in the downtown area have remained strong, and prices continue to appreciate.

The median house price in the Sacramento region was $350,000 at the end of September 2016. This represents an 8% increase from December 2015 and a 10% increase year-over-year. This compares favorably to the 6% increase nationally and 7.7% increase in California. Overall, prices continue to inch up towards their peaks a decade ago, with the current median price 16% below the $418,000 level observed at the end of 2005. The price per square foot for single-family homes in the Sacramento MSA increased by 9% year-over-year, with the largest increase observed in Sacramento County (11%) and the lowest increase in El Dorado County (5.6%). As of September 2016, single-family homes in the region were selling for $205 per square foot.

The sales volume of all types of homes (new homes, resale homes, and condominiums) in the Sacramento MSA increased by 5% year-over-year. This is in stark contrast to the 23% increase observed in 2015. New home sales are on pace for a 20% increase from 2015 to exceed 4,500 projected at the end of 2016. This total is still substantially lower than the 14-year average of 7,630 and the peak of 16,650 in 2003.

Foreclosure activity in the Sacramento MSA continued to decline in 2016. Distress sales kept with the recent downward trend: only 1 in 30 sales were real estate owned by lenders (REO) sales in the third quarter of 2016, as compared to 4 in 10 during the depth of the housing crisis 2011.

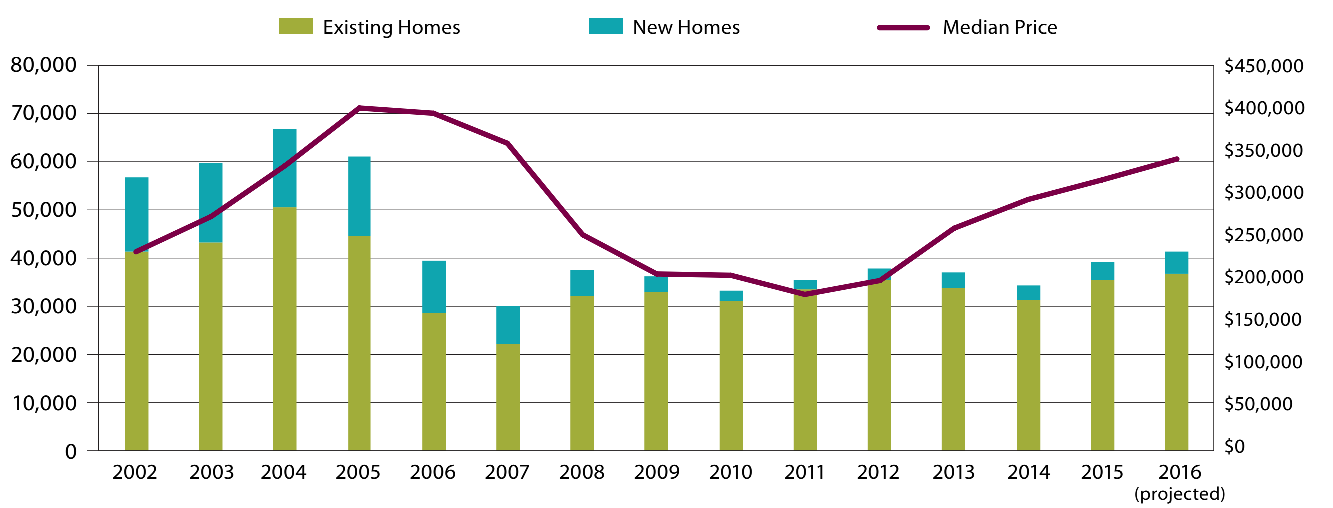
2017 Outlook:

Realtor.com predicts that Sacramento will be one of the top 5 performing housing markets in 2017 based on price and sales gains. The SBR team also feels strongly about Sacramento in 2017 given the limited supply of new housing; but without income growth and more quality jobs, sales prices and rents could be slightly tempered. Supply of new housing should increase compared to 2016. The average interest rate for the 30-year fixed-rate mortgage increased by 90 basis points in the last three months of 2016 resulting in a slight decline in mortgage applications. Further significant increases may have an impact on the available buyers in the entry-level market.

DATA SOURCES (ATTRIBUTION FOR DATA USAGE):

Cushman & Wakefield
CoStar
Data Quick
Real Property Management and Rent Range
Census Bureau
Freddie Mac house price index
Freddie Mac Primary Mortgage Market Survey

Figure 4
New Home Sales, Existing Home Sales, and Median Sale Price (All Homes) » Sacramento MSA



Data Source: CoreLogic

2017 Sacramento Banking Industry Forecast

Credit growth for the local banks and credit unions continued at a torrid pace last year.

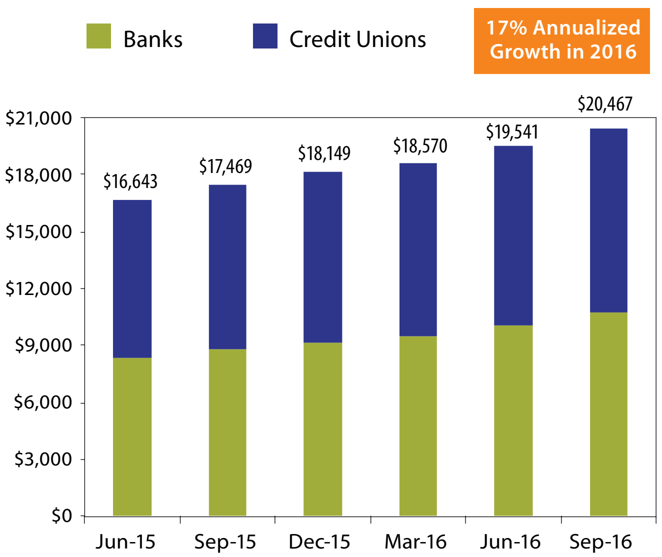
Key Points

- The Sacramento Business Review (SBR) banking team expects loan growth in the Sacramento region[1] to slow modestly relative to last year's robust pace.
- Despite improved confidence survey data since the November election, the rate of borrowing will likely decelerate thanks to higher interest rates and tighter lending conditions.
- The silver lining from these higher interest rates will be opportunities for stronger net interest margins[2] due to the steeper yield curve[3] (relative to mid-2016).
- The team is tracking auto lending at the local credit unions with tighter scrutiny following a parabolic rise in recent years.

Credit growth for the local banks and credit unions continued at a torrid pace last year. Aggregate loans for the Sacramento Region Banks[4] and the Sacramento Credit Unions[5] (combined) increased at a 17% annualized rate through the first nine months of 2016 (Figure 1). These results exceeded the SBR team's 10-12% growth expectations. While the team predicts another year of solid loan growth, it believes the pace will decelerate in 2017 as borrowers grapple with higher interest rates and potential constraints in the auto loan space.

Last year's 10-12% loan growth forecast proved accurate when it came to the local banks. Led by commercial real estate (CRE) and multi-family residential (up 15% and 35%, respectively), aggregate loans for the region's banks increased by 10.8% (annualized) through the first nine months of the year (Table 1).

Figure 1
Aggregate Loans » Sacramento Region Banks & Credit Unions
2Q 2015- 3Q 2016



Data Sources: FDIC & NCUA

The SBR team believes the pace of CRE and multi-family borrowing will decline during the upcoming year.

Table 1
Loan Growth by Category » Sacramento Region Banks
January – September 2016

% of Total	Category	% Change Since 12/31/15*
45.8%	Commercial Real Estate	14.9%
19.9%	Residential	0.6%
9.7%	Commercial & Industrial	7.5%
5.7%	Multi-family Residential	35.4%
5.1%	Construction Loans	20.9%
13.8%	Other	3.6%
100.0%	**Total**	**10.8%**

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

Data Source: FDIC

Heading into 2017, the team expects growth to slow modestly. Despite improved confidence survey data since the November election, the SBR team believes the pace of CRE and multi-family borrowing will decline during the upcoming year. The 100+ basis-point (1.00%) rise in intermediate-term interest rates since last July, coupled with tighter lending conditions, will make it more difficult for local banks to duplicate their robust loan volume growth over the past several years. However, the silver lining from these higher interest rates will be opportunities for stronger net interest margins due to the steeper yield curve (relative to mid-2016).

Though the SBR analysts accurately predicted loan growth for the local banks, they drastically underestimated it for the local credit unions. Table 2 shows that credit union loan volumes increased by more than 23% last year. Once again, auto loans spearheaded the remarkable results. After aggregate auto loans at the region's credit unions rose by an average annual rate of 24% between 2012 and 2015, the SBR team did not expect this pace to actually accelerate in 2016. Yet, this is exactly what occurred, as auto lending locally rose by more than 30%. At the same time, the residential/real estate line-of-credit category improved by 16.2%, with borrowers taking advantage of the drop in mortgage rates during the first half of 2016.

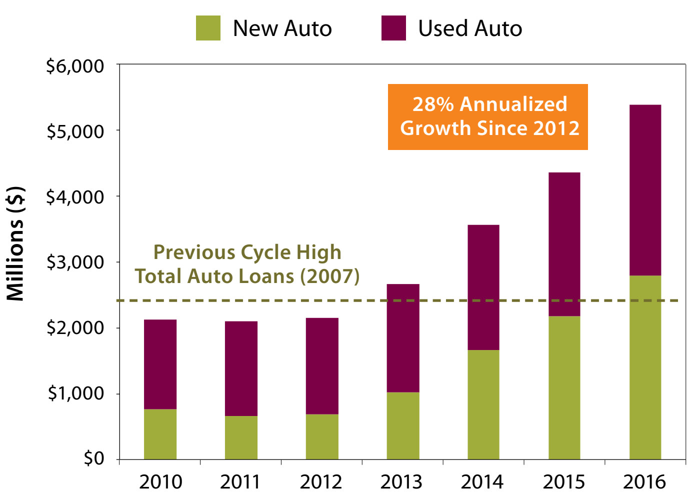
Table 2
Loan Growth by Category » Sacramento Region Credit Unions
January – September 2016

% of Total	Category	% Change Since 12/31/15*
49.9%	Auto Loans	30.9%
39.3%	Residential/RE Lines of Credit	16.2%
8.7%	Credit Card/Unsecured	12.9%
2.1%	Other	29.6%
100.0%	**Total**	**23.1%**

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

Data Source: NCUA

Figure 2
Sacramento Region Credit Unions: Auto Loans » 2010 – 3Q 2016



Data Source: NCUA

How Sustainable Are Auto Lending Growth Rates?

When compiling last year's introductory piece on credit unions, the SBR analysts were astounded at the local auto loan volumes. And data through the third quarter of 2016 have piqued the team's interest further. Specifically, auto loan balances for the Sacramento Credit Unions have increased at a 27.8% rate (compound annual growth rate) since the end of 2012. While vigorous growth is not unprecedented during the early stages of a recovery, the duration and pace of local auto loan growth has been remarkable, especially since the peak-to-trough differential between the prior high (2007) and recession low (2010) was not all that sizable (Figure 2).

The local auto lending trends have generally mirrored those nationwide. In its third quarter *State of the Automotive Finance Market* report, Experian Automotive noted that total U.S. auto loan balances just hit an all-time high. A combination of lengthier loan periods, lower interest rates, and pent-up demand following the Great Recession has "driven" this solid growth.

The national auto research firm Edmunds determined that, as recently as 2002, the average auto loan maturity was 60 months (five years). By 2016, this figure had increased to more than 68 months, as a higher percentage of borrowers are now able to access loans with 6-7 year terms. And since 2007, the average interest rate on new auto loans has dropped by more than 350 basis points (3.50%)[6]. Given these lower interest rates, coupled with longer loan terms, borrowers have been able to cut their monthly payments substantially. This has helped lead to the robust auto lending observed during the past five years.

Experian Automotive also pointed out that credit unions across the country have been taking market share from banks, from auto finance providers, and from the automakers' wholly owned finance subsidiaries. This corresponds with NCUA data, which indicate that U.S. credit unions collectively have increased their auto loan books by more than 12% per year over the past five years. During this same time frame, banks have seen an 8% average annual increase.

Should We Be Concerned?

History shows that periods of excessively high loan growth usually do not end well. On a relative basis, when comparing auto loan growth at the local credit unions during the past five years with U.S. mortgage debt growth in the five years leading up to the housing market collapse, it is a bit disconcerting to notice how the parabolic growth in local auto loans exceeds mortgage growth by a wide margin (Figure 3).

Adding to the concern is data from the Experian Automotive report referenced previously that notes how growth in the subprime auto loan categories during the past year has exceeded that for prime borrowers since mid-2015.

Although some may find the rate of loan growth and the higher proportion of subprime borrowers alarming, the SBR analysts do not see any imminent signs of trouble brewing in the very near future. First, delinquency rates locally remain very low and do not show any nascent indications of rearing their head (Table 3). Second, and perhaps most importantly, interest rates on auto loans have not risen considerably during the past several years. By contrast, in the years leading up to the mortgage collapse, the Federal Reserve raised interest rates by 425 basis points from 1.00% to 5.25%. These tighter financial conditions were a catalyst that ultimately helped bring down the housing market. While the Fed is now talking about raising interest rates three times over the upcoming year, the pace of rate increases has been slow thus far, and further tightenings will likely occur gradually.

Table 3
Sacramento Region Credit Unions
60+ Day Auto Loan Delinquency Rates » 2013 – 3Q 2016

	2013	2014	2015	3Q 2016
New	0.36%	0.30%	0.31%	0.30%
Used	0.56%	0.54%	0.53%	0.47%

Data Source: NCUA

Despite the lack of near-term warning signs, it would stand to reason that auto loan growth has to slow eventually. The SBR team believes the pace will begin to decelerate in 2017. As a result, overall loan growth for the local credit unions should decline relative to last year's stout pace.

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.

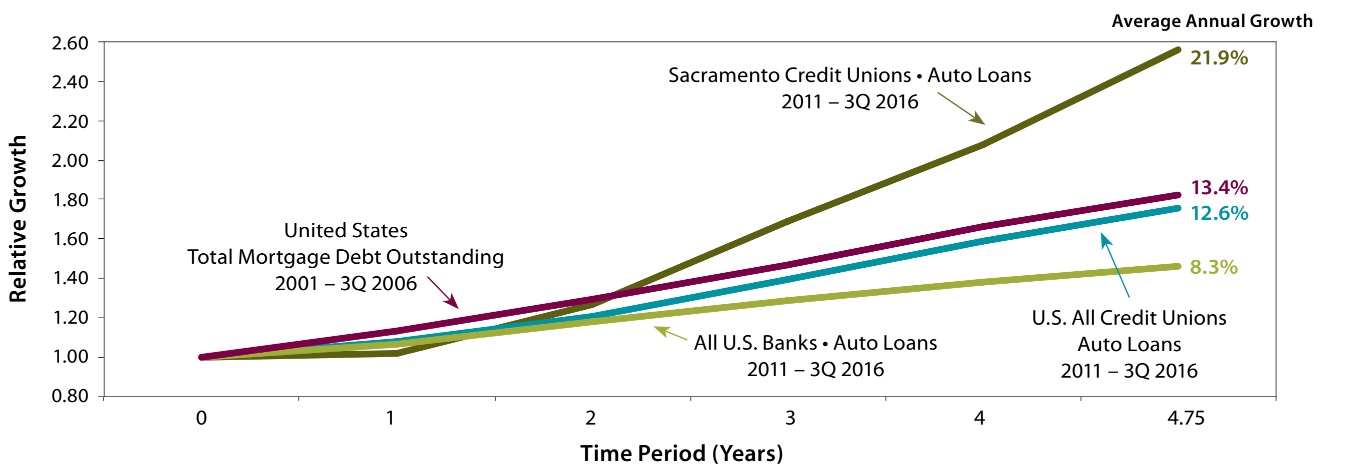
3 The yield curve measures the relationship between interest rates and maturities for U.S. Treasuries. A steeper yield curve means a greater differential between longer-term and shorter-term rates.

4 The 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, and Tri Counties Bank.

5 The Sacramento Credit Unions include The Golden 1, SAFE Credit Union, Schools Financial Credit Union, Sierra Central Credit Union, Sacramento Credit Union, First U.S. Community Credit Union, and Heritage Community Foundation.

6 Source: St. Louis Federal Reserve FRED Database.

Figure 3
Relative Growth » Auto Loans (2010-2016) vs. Mortgage Debt (2001-2006)



Data Source: U.S. Federal Reserve, FDIC & NCUA

2017 Capital Markets *Outlook*

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2017 is likely to be a pivotal year for both domestic markets and markets abroad as the foundation will be laid for either a successful boom or a painful bust.

Key Points

- The Business Cycle: What will it be this time? A mountain of corporate debt is awaiting the next catalyst, whatever it may be.
- Where have all the worthwhile capital projects gone? Capital spending leveled off in 2012 and has yet to recover.
- Corporate debt-to-equity levels look fine, but the devil is in the details. Record-high market valuations may be covering up a more systemic issue. Don't let new equity highs fool you; earnings aren't following suit.

We appear to have hit a fork in the road, and our magical prediction for capital markets in 2017 is that things will either get better or they will get worse. As the bulk of our publication has mostly positive trends to report, we felt it necessary to temper expectations a bit with a reminder that our economy is cyclical and that there are signs beginning to appear that suggest we may be in the latter stages of the expansionary cycle where the odds of both boom and bust become greater.[1] Unfortunately for many, it feels as if we never really got off the ground when trying to escape the prior recession.

In all seriousness, 2017 is likely to be a pivotal year for both domestic markets and markets abroad as the foundation will be laid for either a successful boom or a painful bust. Here in the U.S., an incoming presidential administration will look to enhance American greatness with proposed infrastructure spending and tax code overhauls. Rhetoric regarding this fiscal stimulus has already been more than enough to cause a sharp decline in U.S. Treasuries and a strident Q4 rise in equities. The year-to-date return on the S&P 500 Index as of November 7, (the day before the election) was 4.3%, in line with our 2016 forecast of low-to mid-single digit U.S. equity returns. However, since the election, equity markets have been on a steady up-trend, and 2016 returns climbed into the double digits at just over 10%. On the flip side, bonds have sold off dramatically over the last couple of months with Treasury rates increasing by more than 50 basis points on the longer part of the curve. The feeling is that infrastructure spending combined with tax reforms will be enough to drive inflation upward. This makes sense, although, even if the president and Congress agree on a plan, it will take some time to overcome administrative hurdles and get the ball rolling.

Market	Forecast	Comment
Economy	↔	U.S. to outperform on a relative basis but other developed and emerging economies are making up ground; trade war could complicate things
Global Growth	↗	Global leading economic indicators suggesting modest growth, but large risks such as the Chinese housing market remain a significant threat
U.S. Growth	↗	Another year of modest growth; Headwinds = higher rates and stronger dollar; tailwinds = strong consumer and potential deregulation
Eurozone	↔	Modest growth likely, but Brexit, strong dollar and Eurozone bank fragility could easily destabilize recent positive trends
Emerging	↔	Uncertain U.S. trade policy and sovereign debt concerns to weigh on EM growth
Global Inflation	↗	Global inflation to trend higher, albeit slowly; oil output agreements to help buoy energy prices
Stocks	↗	Sticking with domestically focused small and medium-cap companies to outperform multinationals and large cap
Regions	U.S. > Rest of World	Surprisingly, we feel U.S. markets have least amount of uncertainty; might as well stick with what has worked over the last few years
Sectors	Financials and Energy	Upstream oil and gas now lean and mean after production rout; financials to benefit from steeper yield curve
Bonds	↘	Potential for flatter curve with Fed tightening pushing up short end with global uncertainty keeping longer end in check
Regions	U.S. > Rest of World	European and Japanese rates only have one way to go should they see reflation and moderate growth
Sectors	U.S. Financials	U.S. financials to benefit from steeper curve, but watch out going into 2018; corp. credit deterioration could threaten bank earnings
Commodities	↗	Commodities to continue modest move upward along with inflation
Sectors	Oil & Metals	Cyclical gains following supply corrections and demand pickup

Do we have what it takes to achieve escape velocity or will the economy succumb to fatigue in the final innings of the current cycle?

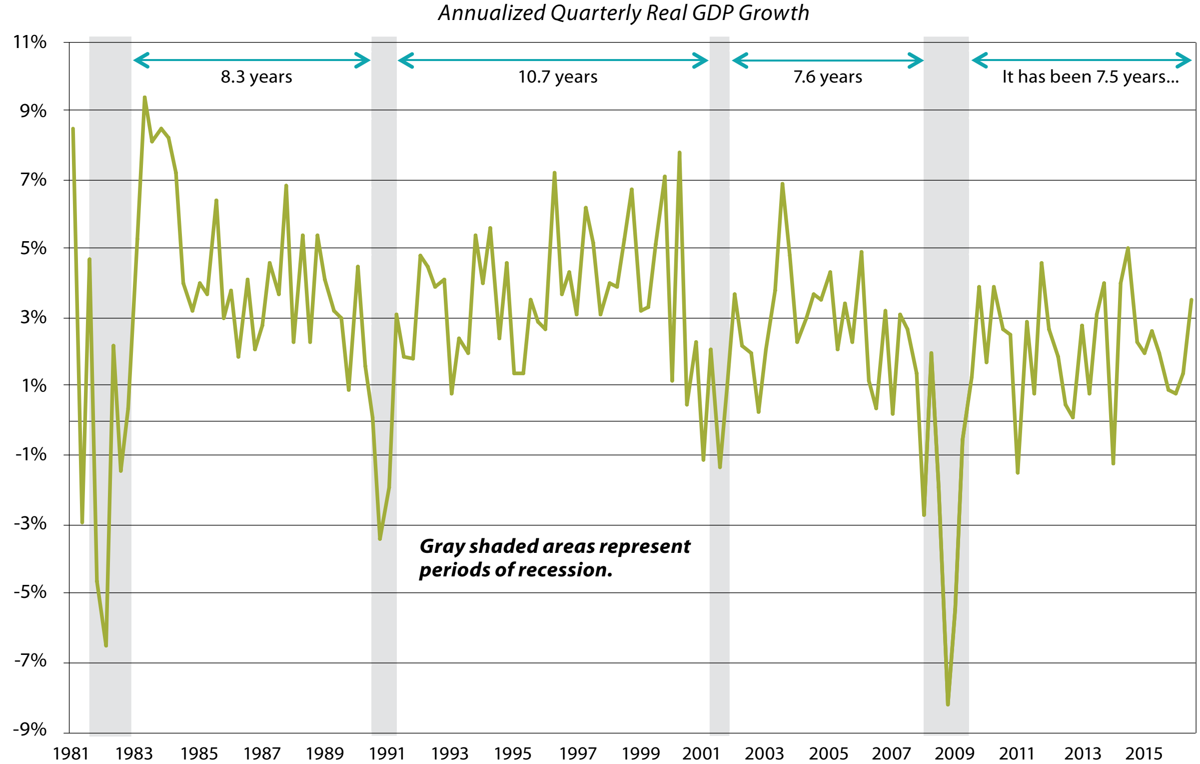
Just because it has been 7.5 years since the last recession does not mean we are bound to have another soon, but the cyclicality of our economy and our financial markets is quite evident in the historical data and difficult to ignore. It is possible that the impact, severity and circumstances of the 2008 recession created a situation in which the distance from trough to peak is longer than we typically see, but signs are beginning to appear that suggest history will repeat itself and that the next downturn may be lurking sometime in 2018. With that said, it is difficult to identify exactly where the future economic stress will rear its ugly head. Rising interest rates on the heels of massive debt issuance in a low-rate environment coupled with record-high equity index levels in the face of mediocre earnings provide us with a cause for concern. Additionally, low productivity levels along with waning capital spending have us wondering where the earnings growth will come from to justify the record-high equity valuations. Perhaps the reforms of the incoming presidential administration will help companies save on taxes and regulatory costs, but it is still hard to see how sovereigns and corporations will deal with the debt monkey on their back, especially if interest expense continues to rise. Ultimately, we think 2017 will still be a year of moderate interest rate increases and positive equity returns, but we also think this may be the year to try to position portfolios to withstand the volatility that typically occurs in the latter part of the cycle.

With such cheap debt capital for so long, did companies simply run out of profitable projects to invest in?

An interesting trend shown in Figure 2 is how low interest rates after the 2008 financial crisis initially provided the boost to capital investment that we typically see following a downturn, but unlike the two prior downturns, rates were kept low for a longer stretch of time than we have ever seen before. Rates were justifiably kept low in response to a persistently high domestic unemployment rate, weak GDP growth, lower than desired inflation levels, and risks presented by developed economies

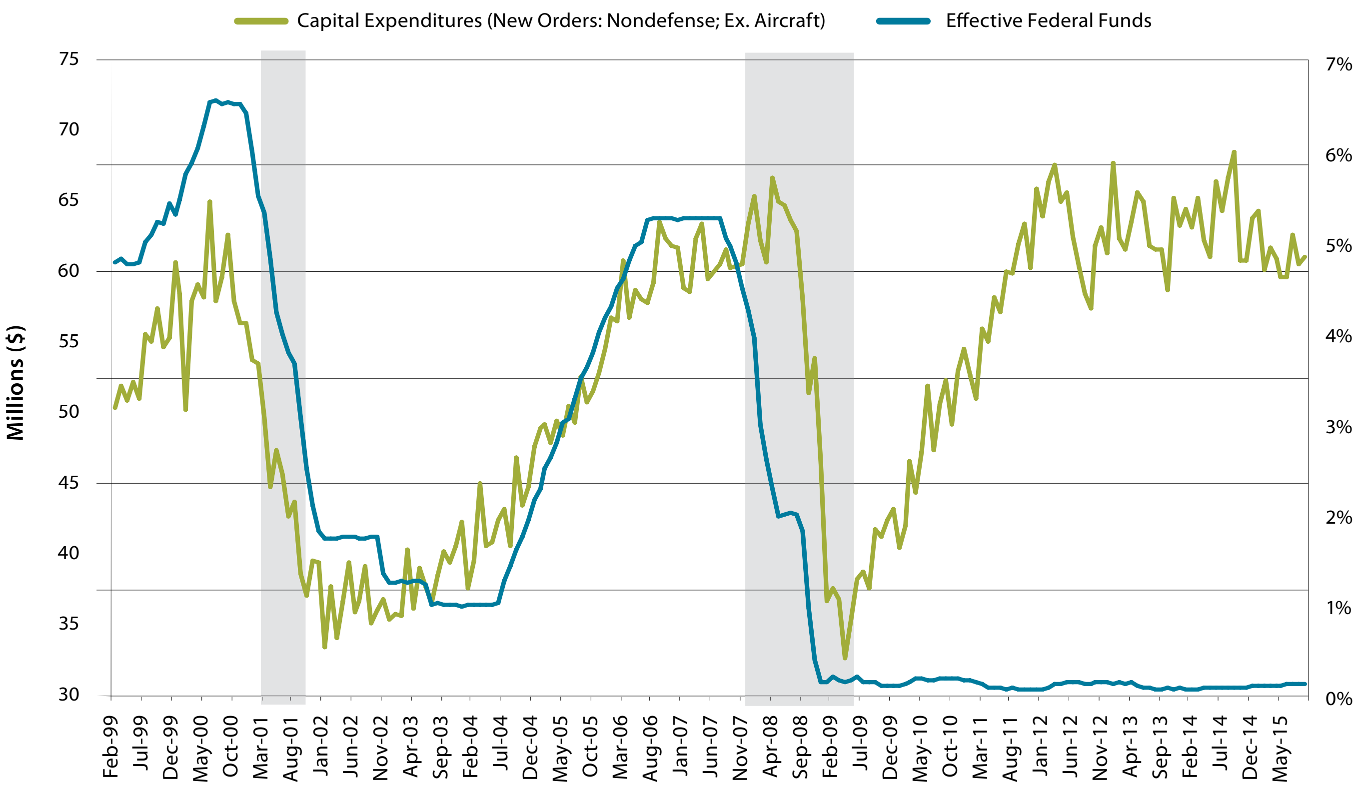
Figure 1
The Business Cycle: Escape Velocity or Are We in Extra Innings?

Annualized Quarterly Real GDP Growth



Data Source: U.S. Bureau of Economic Analysis

Figure 2
Interest Rates and Capital Investment



Data Source: U.S. Bureau of the Census

abroad. However, the corporate investment opportunity set is limited and at some point, companies run out of attractive opportunities in which to invest. Per the data, it appears companies began to have difficulty finding worthwhile projects in 2012.

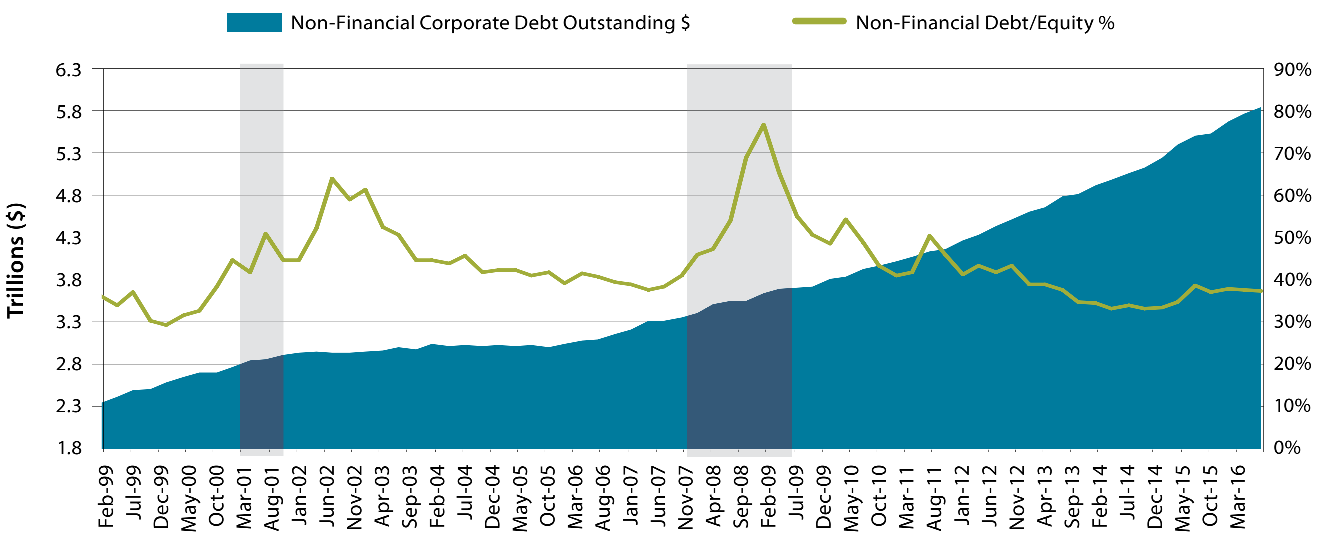
The goal with capital spending is that it will enhance output and efficiency leading to better productivity and more growth. However, average productivity in this expansionary period is less than half of what productivity averaged in the expansionary period that followed the turn of the millennium (1.3% vs. 2.7%, respectively). So, although the unemployment rate has improved dramatically during the current expansionary period, it seems to coincide with inefficient capital investment that fails to take full advantage of the capital and labor inputs.

However, the corporate investment opportunity set is limited and at some point, companies run out of attractive opportunities in which to invest.

So, what's the problem?

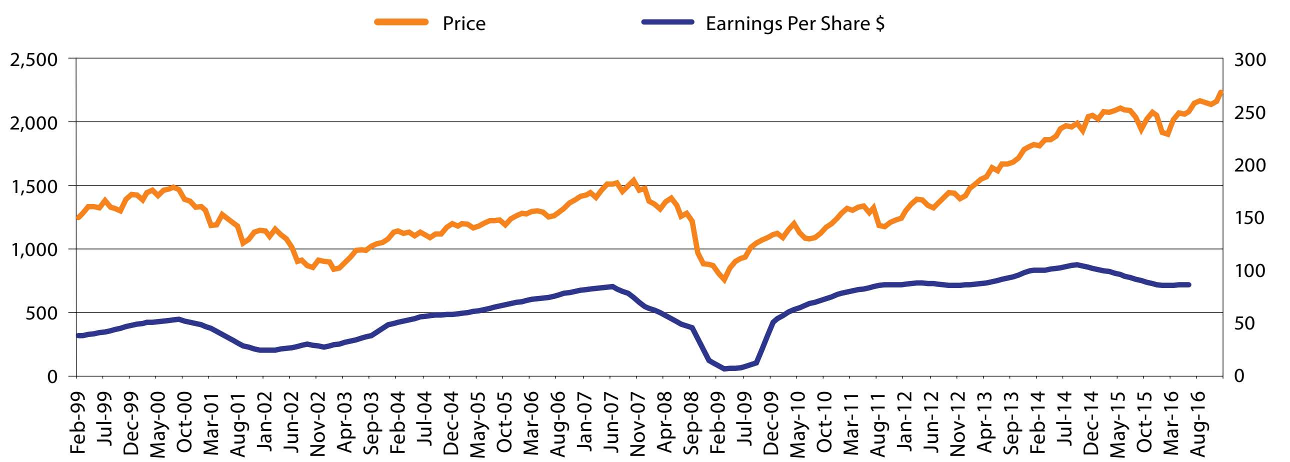
The biggest concern with the waning capital investment and low productivity levels is that they are occurring at a time when both non-financial corporate debt and equity market values are at all-time highs. The chart on the following page shows that at first glance, non-financial corporate debt-to-equity ratios (the green line) appear to be in line with historically healthy levels. However, the dark blue shaded area shows that corporate debt outstanding is at an all-time high of nearly $6 trillion. What happens if there is a sharp market correction and interest rates have gone higher? How would companies fare in refinancing their debt when their debt-to-equity ratios have worsened at a time when interest expense is higher?

Figure 3
The Corporate Debt Burden



Data Source: Board of Governors of the Federal Reserve System (U.S.)

Figure 4
S&P 500 Index and Earnings Per Share



Data Source: http://www.econ.yale.edu/~shiller/data.htm

These debt risks could be mitigated by strong corporate earnings growth that would enable companies to afford higher levels of interest expense, but strong corporate earnings growth is not what we have seen lately. Figure 4 shows the recent run up in the S&P 500 index pitted against the combined earnings per share of the S&P 500 index constituents. While market prices have continued to rise, earnings growth has leveled off, which raises the question, why the continued increase in prices? One indication suggesting the market may be overvalued is the Schiller price-to-earnings (P/E) ratio, which attempts to account for the business cycle by including the current S&P 500 index level in the numerator and a 10-year average of the combined earnings per share for the index constituents in the denominator. The long-term average of the Schiller P/E runs at about 16.7 while the current level is a lofty 27.9.

Faced with these metrics, it is hard to argue that the massive monetary stimulus seen during the current expansionary cycle has not resulted in debt-laden balance sheets and overly inflated market values.

So, what does this all mean for capital markets in 2017?

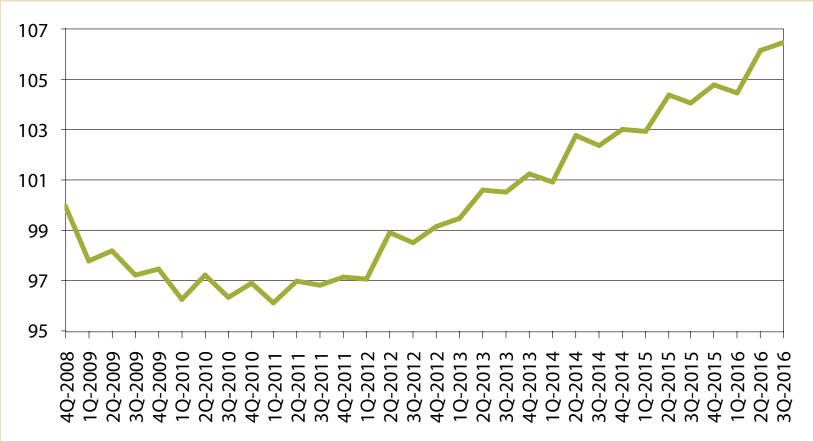
For 2017, we think it is likely that Mr. Market[2] will continue to experience the mania that he has experienced over the last few years as immense monetary stimulus and few worthwhile investment projects have led to debt binges and new highs for stocks. The catalyst to turn Mr. Market's mania into a depression is hard to put a finger on, but we know it is lurking out there somewhere.

Risks from abroad have yet to subside, and continue to pose a significant threat. Although, things have appeared relatively stable in the Eurozone lately, the recent bailout of Italy's third-largest commercial bank, Banca Monte dei Paschi di Siena, along with Deutsche Bank's legal costs and the not so sure footed Greek economy present a multitude of risks to the global economy, not to mention Brexit! In China, banks appear to have underwritten both a housing bubble and a corporate debt bubble. A bursting of either, if not both simultaneously, would most certainly hinder growth and cause negative impacts globally.

Even if the U.S. can avoid the fallout from negative shocks abroad, the foundation upon which our modest growth estimate of 2.5% GDP is expected appears evermore wobbly considering corporate debt levels and less-than-stellar capital spending and productivity. Should the unforeseen, destabilizing catalyst remain dormant for 2017, we project mid-single-digit returns for equities and another quarter- to half-point increase in yields on longer-term Treasuries.

Sacramento Business Review Financial Conditions Index

Similar to U.S. equity indices, the latest reading of our proprietary SBR Financial Conditions Index reached new highs in 2016. Employment gains, home price appreciation and local lending activity continue to power the Index higher. The local economy appears to have a good amount of positive momentum heading into 2017.



Sources:

"U.S. Fixed Income Markets, 2017 Outlook"; J.P. Morgan North America Fixed Income Strategy; November 23, 2016

"Sparkle and Fade, 2017 Global Strategy Outlook"; Morgan Stanley Research; November 27, 2016

"Will Elevated Expectations Be Met in 2017?"; Ned Davis Research Group; December 1, 2016

"Risk and Reward in and Aging Business Cycle, 2017 Annual Economic Outlook"; Economics Group, Wells Fargo Securities; December 8, 2016

Endnotes

1 "Sparkle and Fade, 2017 Global Strategy Outlook"; Morgan Stanley Research; November 27, 2016, page 3

2 Benjamin Graham is famously attributed with likening the stock market to a manic-depressive person named Mr. Market who is willing to buy when prices are high and sell when prices are low.

Sacramento Region

Human Capital Index

Key Points

- The current focus for human capital management in the region is on employee development, i.e., training for necessary work skills and development for future changes.
- Local organizations predict that their most important initiative during the first half of 2017 will be recruiting new talent, although they expect low levels of turnover – an apparent contradiction.
- More than three-quarters of employees view their pay and benefits positively, consistent with the data in our SBR/SAFE Credit Union Consumer Sentiment Survey.
- Seventy-five percent of organizations anticipate championing new or significantly revised human capital initiatives for 2017, including employee recognition in non-financial forms.
- HR departments expect to focus on improving employee engagement and satisfaction.

Talent management is a significant lever to gain competitive advantage. Most organizations within a specific industry generally have access to the same tangible resources, but can differentiate their HR and management systems; i.e., how they manage their employees. In this report, we expand on last year's endeavor by forecasting human capital management trends for organizations in the Sacramento region.

Current Human Capital Trends

Figure 1 shows that, when it comes to talent management, the leading area of emphasis was training for necessary skills and development for future needs.

In second place was a focus on headcount – ensuring sufficient staffing – with compensation coming in a close third. Diversity and inclusion efforts were found at the bottom of the list, with 20% of respondents indicating that no effort was expended in this area at their organizations. While an explanation for this may be that larger organizations have the financial resources to devote to diversity and inclusion efforts, and our region is traditionally known as an area fueled by small and medium-sized businesses, there was no significant correlation between size of organization and emphasis placed on diversity and inclusion efforts.

The human capital survey data reports a positive sentiment related to pay and benefits, with 78% of respondents saying their benefits were either "Very Good" or "Good." When asked about their pay as compared to others doing similar work in other companies, 69% of respondents said they felt "Very Good" or "Good" about their compensation (see Figure 2).

Figure 2
Employee Sentiment Regarding Pay and Benefits

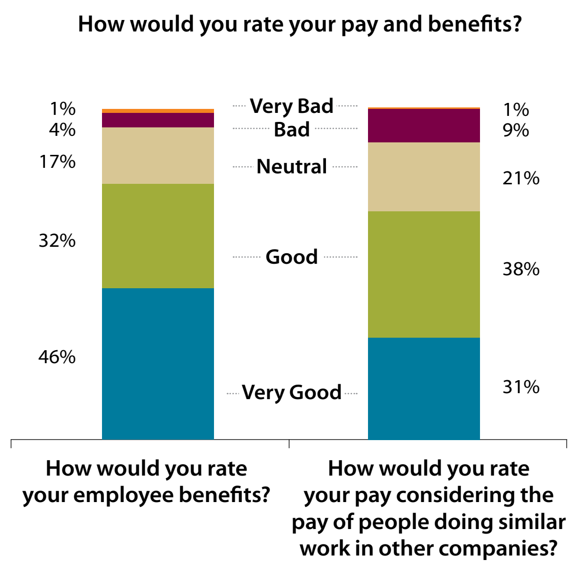


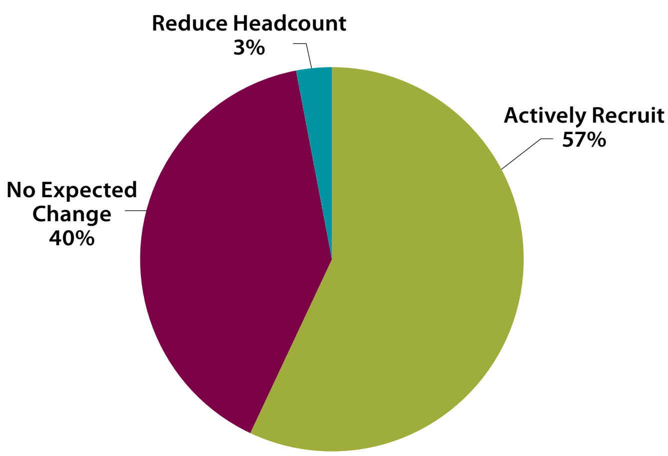
Figure 1
Current Trends in Talent Management Efforts

Human Capital Forecast

The majority of local organizations expect a positive headcount change in 2017 with 57% of organizations indicating active recruiting efforts, mirroring the data in this year's SBE/SAFE Credit Union Consumer Sentiment Survey. This is also reflected at the national level, where the Society for Human Resource Management (SHRM) in its December 2016 report identified an expected net increase in headcount. Regionally, only a handful of respondents indicated their organizations are planning to actively lay people off in 2017 (see Figure 3) with the rest indicating no proactive changes in headcount.

In addition, anticipated turnover – where employees voluntarily leave the organization – is expected to decrease. Respondents indicated that they do not anticipate significant increases in resignations. We noted an apparent contradiction in this data. On the one hand, companies are indicating that a key strategic initiative is to increase headcount. On the other hand, they are placing low emphasis on employee turnover. It is possible that if most companies are attempting to attract new talent, turnover would increase commensurately as employees transition between organizations. Could this indicate that organizations are underestimating employee turnover levels? Alternatively, it is possible that businesses that responded to this survey are expanding as demand for their products and services are increasing.

Figure 3
2017 Expectation for Headcount



Seventy-three percent of respondents indicated that their organizations are championing new or significantly revised human capital initiatives in 2017.

Seventy-three percent of respondents indicated that their organizations are championing new or significantly revised human capital initiatives in 2017. Apart from the major focus on talent development, new or significantly revised initiatives include employee recognition in non-financial forms. This may be due to the acknowledgment that today's employees value benefits such as flexibility or the feeling that they make a difference at work (Willis Towers Watson, 2016). SHRM reports that, nationally, 81% of organizations have some type of employee recognition programs. Locally, we see regional trends align with national data.

Providing evidence for the current creativity and innovation-driven economy, organizations listed three disparate but related human capital initiatives as new or improved for this year: 1) encouraging and rewarding bottom-up ideas, 2) fostering employee entrepreneurship without penalizing possible related failures, and 3) promoting greater autonomy of employees at work. Statistical analysis shows that an organization's size does not impact the trends related to identifying new creativity and innovation initiatives. Capturing employees' novel ideas and thinking is emerging as a crucial effort and competency for entrepreneurial start-ups and small businesses, as well as larger and more well-established organizations.

Regarding the other areas of human capital efforts, organizations predict stability. Neither increases nor decreases were projected for diversity and inclusion efforts, compensation, or optional benefits and perquisites.

Internal Human Resources Forecast

Focusing on the internal HR organization (i.e., HR departments or units), the factors expected to most strongly influence HR policies and practices during 2017 were an acknowledgement of a talent shortage and pressures on cost reduction. This expected talent shortage is also echoed above where the respondents indicated active efforts to recruit new talent. This was followed by challenging productivity and profit targets. The least influential factors were market volatility and fears of recession. The SBR/SAFE Credit Union Consumer Sentiment Survey mimics this data to some extent, with the vast majority of respondents expecting regional business conditions to improve or stay the same in 2017, although the respondents to the human capital survey acknowledged cost reduction pressures and difficult effectiveness and profit goals as factors to watch.

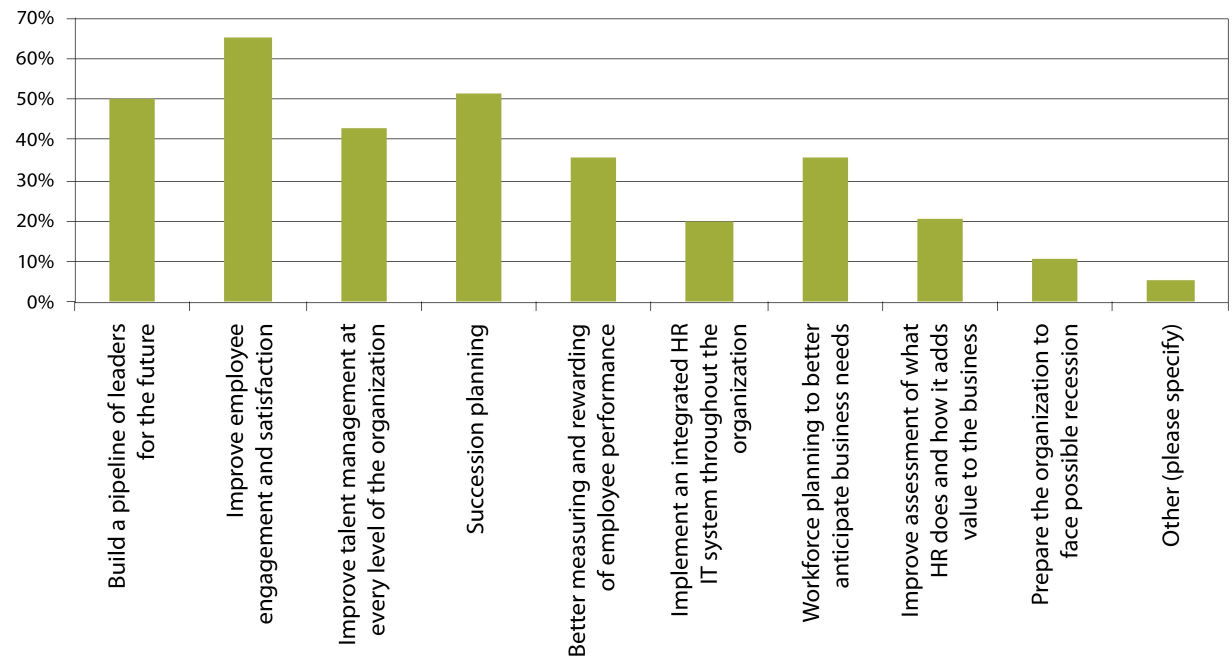
The highest anticipated organizational priority for HR professionals in 2017 is an improvement in employee engagement and satisfaction.

Human Capital Priorities

The highest anticipated organizational priority for HR professionals in 2017 is an improvement in employee engagement and satisfaction (see Figure 4). Low employee engagement has been widely identified on the national level for years, with CEOs citing engagement as a "top global business strategy," and HR units proclaiming that achieving high levels of engagement is their current largest challenge (SHRM).

Following a focus on employee engagement, the second-most-important priority identified for regional HR in 2017 was ensuring sufficient and appropriate top management. This was evident through two human capital priorities: the importance of succession planning and a focus on building a leadership pipeline for the future. Again, a very similar sentiment is echoed at the national level, where a development of a new generation of leaders is identified as the highest priority in the years to come (SHRM).

Figure 4
Anticipated Regional HR Priorities in 2017



Thank You

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