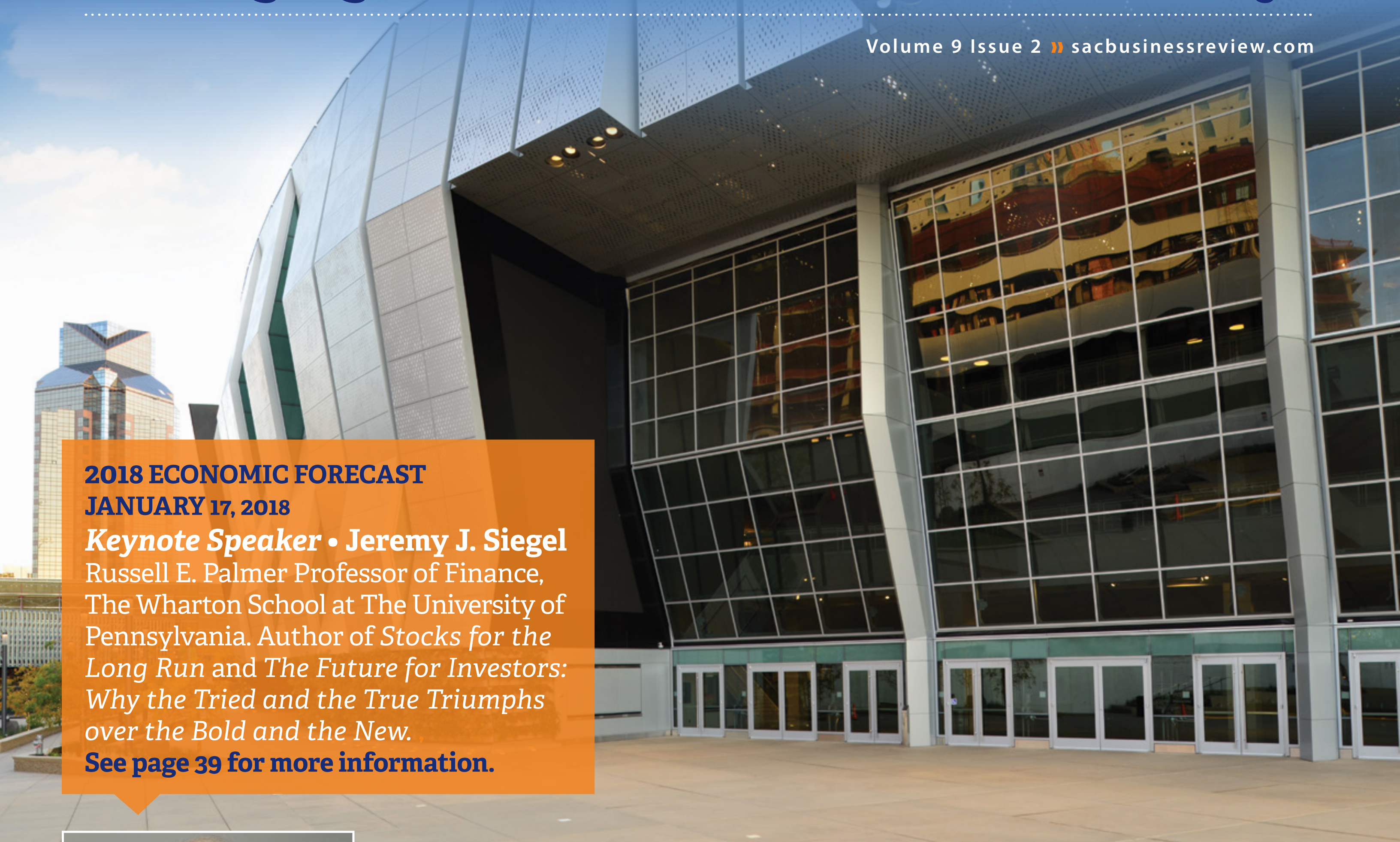
Mid-Year 2017

UPDATE

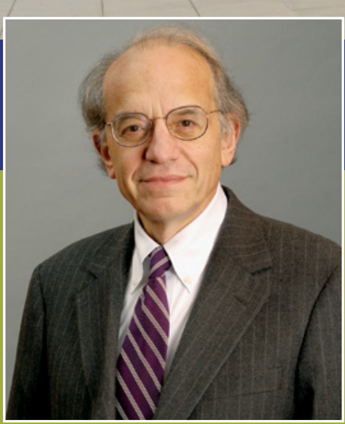
sacramento BUSINESS REVIEW

Emerging Trends in Sacramento's Economy

Volume 9 Issue 2 » sacbusinessreview.com



2018 ECONOMIC FORECAST
JANUARY 17, 2018
***Keynote Speaker* • Jeremy J. Siegel**
Russell E. Palmer Professor of Finance, The Wharton School at The University of Pennsylvania. Author of *Stocks for the Long Run* and *The Future for Investors: Why the Tried and the True Triumphs over the Bold and the New.*
See page 39 for more information.



2017 Mid-Year Update

Your Best Guide to Sacramento's Economy

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

Mid-Year
2017

Message from the Chief Economist

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

LABOR MARKET & REGIONAL ECONOMY

SBR/SAFE CREDIT UNION CONSUMER SENTIMENT SURVEY

SMALL BUSINESS

REAL ESTATE

BANKING & CAPITAL MARKETS

HUMAN CAPITAL INDEX

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Dear Friends,

I am pleased to share the 18th 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 sharp contrast to the global and national economic landscape that continues to improve and pick up steam, the local economy seems to show the first signs of slowing. The labor market in Sacramento has slowed down with goods-producing employment declining, and the construction sector losing jobs for the first time in seven years! Regional credit growth, while still strong, raises concerns about the future with Placer County experiencing its second consecutive yearly decline. We also expect loan growth among banks and credit unions to slow down relative to last year due to tightening credit conditions impacting local commercial real estate, and due to deteriorations in the auto loan segment.

Sacramento faces the fourth fastest aging workforce in the country, causing concern among area employers. Business optimism appears to be fading, regional business sentiment has declined in the first half in contrast to the national sentiment that rose sharply, and regional consumers appear less optimistic about their financial outlook and regional economic conditions when compared to national statistics. These all combined, appear to show the first signs of an economic slowdown, even though nationally and globally we see quite the opposite. To sound like a broken record — 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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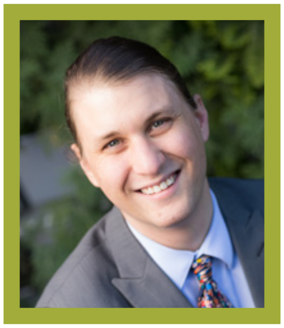

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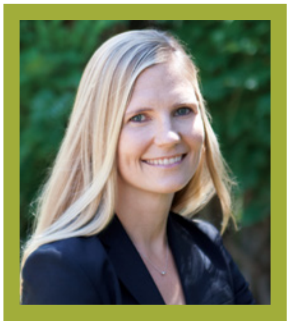

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UPDATE

Sacramento's Labor Market & Regional Economy

2017 Mid-Year Update

The employment growth rate also slowed statewide with California's employment growth rate declining from 3.30% to 1.48%.

Employment has continued to increase in the Sacramento Region but the rate of improvement has slowed. Employment increased just 1.10% over the past 12 months, down from a rate of 3.97% for the prior 12 month period. The employment growth rate also slowed statewide with California's employment growth rate declining from 3.30% to 1.48%. This data is counter to our prediction that Sacramento area employment may catch up to the state's employment recovery. However, seasonal factors may be to blame, especially given the winter storms and flooding that adversely impacted the local economy.

Table 1
Employment Growth

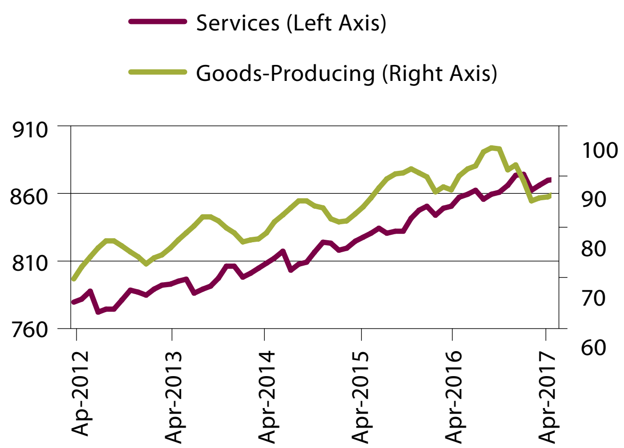
	Sacramento	California	Difference
Past 12 Months	1.10%	1.48%	-0.38%
Prior 12 Months	3.97%	3.30%	+0.67%
3 Year Average	2.62%	2.54%	+0.08%
5 Year Average	2.49%	2.62%	-0.13%

Source: Economagic.com

For example, construction employment, which was a bright spot in 2016, declined by more than 4% over the past 12 months. The decline in construction employment may be due to weather factors as the real estate market remains healthy. Meanwhile, manufacturing employment resumed its long-term decline following a short period of growth between 2011 and 2015.

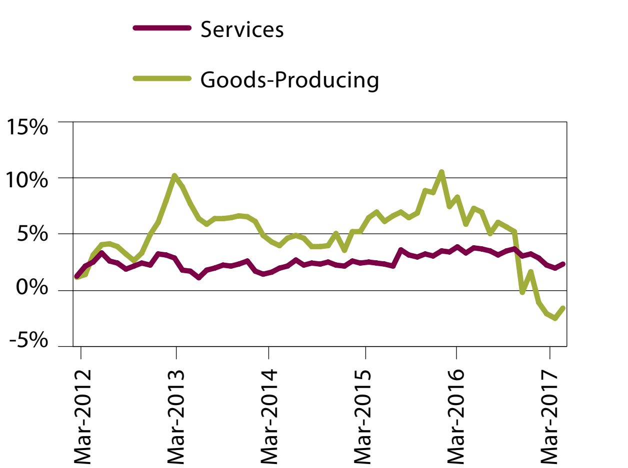
Manufacturing employment is 28% lower than its high from 2000. The decline in construction and manufacturing employment has led to a 3.67% decline in goods-producing employment. This reversed a 5 year trend in which goods-producing employment increased at nearly twice the rate of total area employment. However, the goods-producing economy accounts for less than 10% of total employment in the region.

Figure 1
Goods-Producing and Services Employment



Source: Economagic.com

Figure 2
Percent Change in Good-Producing and Services Employment



Source: Economagic.com

Leisure and hospitality employment increased 3.5% and now represents nearly 11% of the region's employment.

Services employment, which accounts for more than 90% of the region's employment, has continued to grow. Once again the health care sector reported the highest employment growth rate. The recession-resistant health care industry appears to have shrugged off the uncertainty around the repeal of the Affordable Care Act, with health care employment increasing 4.89% over the past 12 months. This represents a sharp increase in the rate of growth of health care jobs. However, as a large percent of California residents are on some type of government-funded health care support, potential cuts in spending in the near future could have a negative effect on Californians and their spending power.

Another service sector employment category that has continued to report strong employment growth is the leisure and hospitality segment. Leisure and hospitality employment increased 3.5% and now represents nearly 11% of the region's employment. Employment in the finance sector also accelerated. While finance represents just 5.5% of Sacramento area jobs, it has been an area of strength in recent years. Not all areas of the service economy reported gains. The information services sector continued its decline, contracting 4.32% over the past 12 months and 15.29% over the past 5 years. Given that technology job growth has been a bright spot for the state, the region's poor performance is disappointing.

Government jobs, which represent nearly one out of every four local jobs, showed little improvement, increasing just 0.42% over the past 12 months. Once again, the Sacramento region's labor market growth has been hampered by its dependence on government jobs.

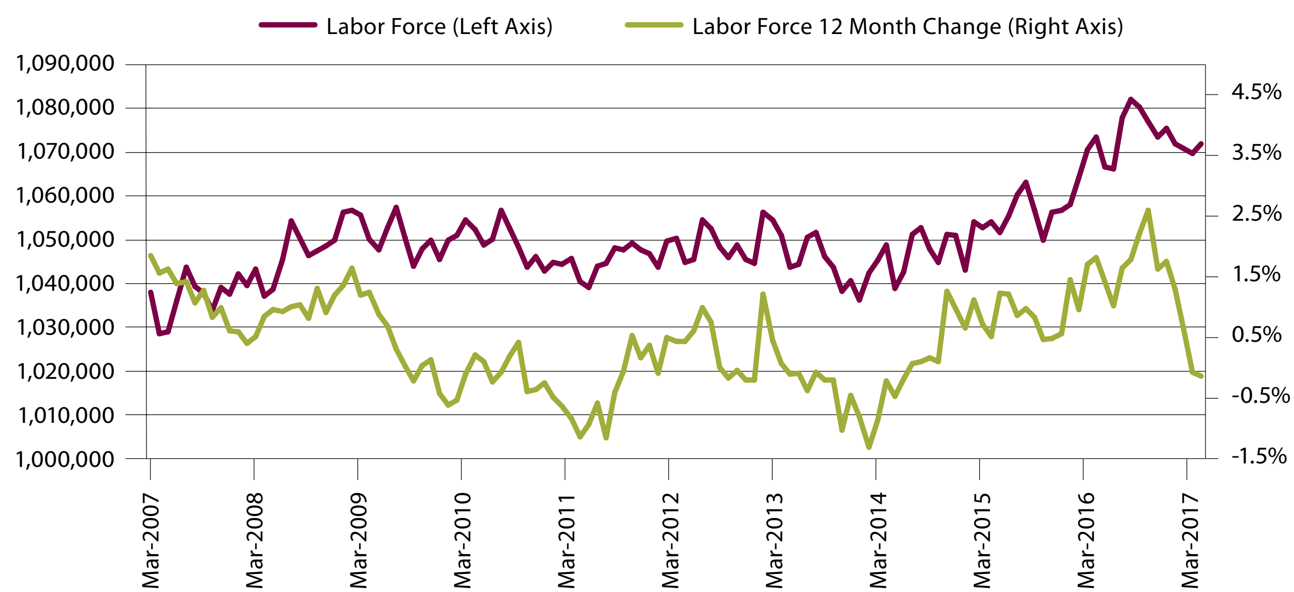
Table 2
Employment Distribution

	Construction	Manufacturing	Finance	Education	Health Care	Leisure & Hospitality	Government	Trade, Transportation, & Utilities	Information	Professional & Business Services	Other Services
Past 12 Months	-4.28%	-3.06%	3.12%	-0.82%	4.89%	3.50%	0.42%	0.80%	-4.32%	1.25%	-2.88%
Past 36 Months	18.43%	0.29%	9.98%	-5.47%	15.58%	12.99%	2.94%	7.32%	-2.92%	9.86%	0.66%
Past 60 Months	44.79%	4.19%	10.90%	-11.03%	23.78%	21.91%	4.94%	10.46%	-15.29%	17.95%	6.29%
% of Total Jobs	5.38%	3.64%	5.53%	1.27%	14.59%	10.83%	24.87%	15.80%	1.39%	13.53%	3.18%

Source: Economagic.com

Going forward, we expect the rate of employment growth in the Sacramento region to remain slow. The region's unemployment rate has declined to just 5%, down from 5.6% a year earlier. This hints that the vast majority of people seeking employment have already found a job. Meanwhile, Sacramento's labor force growth has stagnated likely due to demographic trends, job relocations, and migration. For example, recent job relocations and layoffs by large employers such as Aerojet, Intel, and Hewlett Packard are a negative for the local labor market. However, if weather permits, new residential, retail, and commercial projects starting to fill the real estate landscape will bring jobs and new experiences to the region. Sacramento has a service-based economy and what can drive this economy is the quality of life that brings people here.

Figure 3
Sacramento Area Labor Force



SBR/SAFE Credit Union Consumer Sentiment Survey

UPDATE

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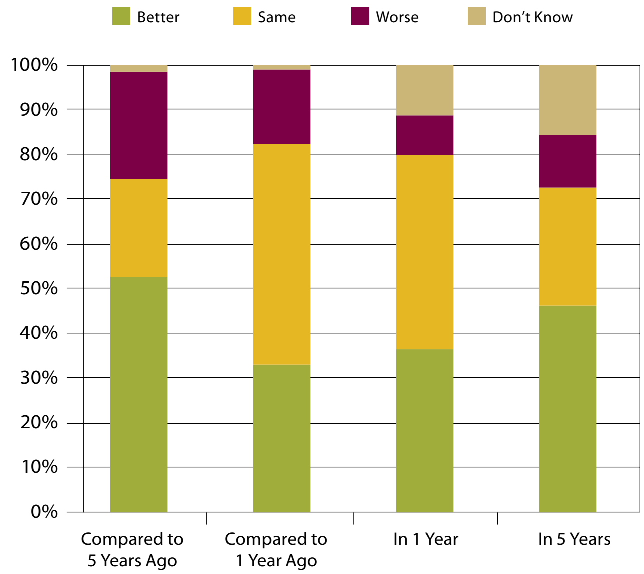
> *Respondents continue to report that their economic situation is better than it was both 1 year and 5 years ago.*

For the mid-year update, the Sacramento Business Review (SBR), in partnership with SAFE Credit Union, conducted another round of our regional consumer sentiment survey. The survey included measures of personal and regional economic conditions along with purchasing and credit utilization.

Regional Consumer Sentiment

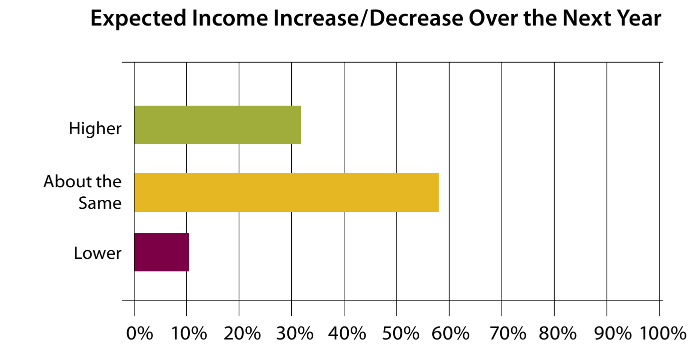
Respondents continue to report that their economic situation is better than it was both 1 year and 5 years ago. They also look positively toward the future with the vast majority expecting their financial prospects to be better or at least the same over the next 1 and 5 year periods. (See Figure 1) This optimism has grown during the first half of 2017. The vast majority of respondents also expect their incomes to rise during this period, though they express lingering concern about inflation outpacing this income growth. (See Figure 2)

Figure 1
Personal Economic Conditions



Expectations for the regional economy also remain generally positive. However, there appears to be some tapering of optimism since our last report, with fewer respondents indicating that they believe regional business conditions will improve during the next year. (See Figure 3)

Figure 2
Personal Income Expectations



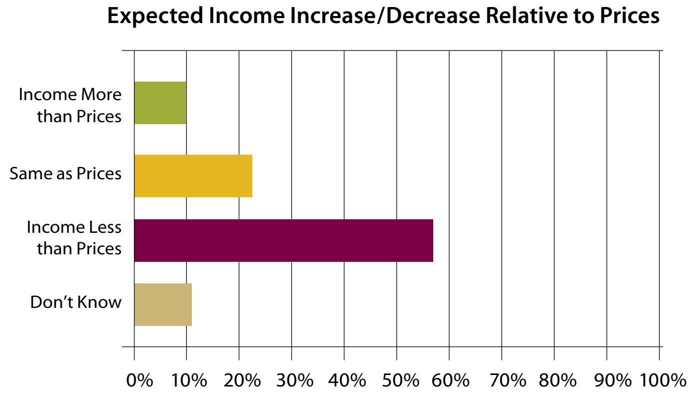
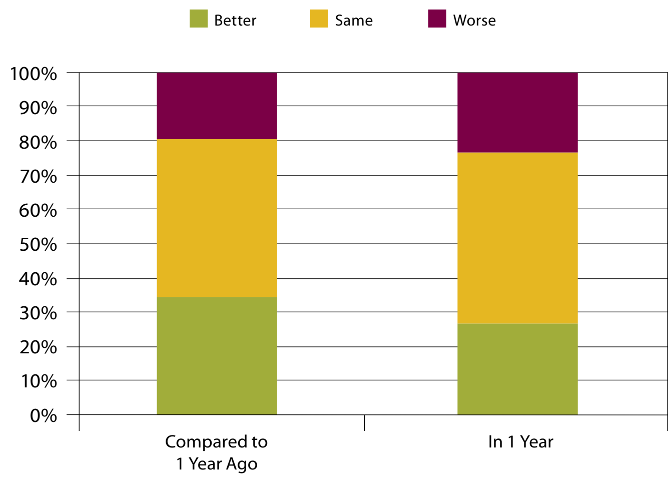


Figure 3
Regional Economic Conditions



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.

Both the national and regional samples expect inflation to increase over the next year. This concern has grown since the beginning of 2017 for regional respondents. Additionally, national respondents are more optimistic than regional respondents when it comes to their income keeping pace with inflation. The first half of the year showed an uptick in the number of national respondents who expect their income to keep pace with or exceed inflation.

We again compared regional respondents' perceptions of the business conditions in the region's economy to the national respondents' perceptions of the U.S. economy overall. Both samples expressed generally positive outlooks; however, there is a notable divergence in the trends for each sample since our last survey. (See Table 1) Regional respondents' expectations about business conditions specifically in our region's economy have fallen 7 points since our last survey, whereas national respondents' expectations for the national economy overall have grown substantially since our last report.

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	129	139	↓	Region perceives less improvement over past 5 years
Current Financial Situation Compared to 1 Year Ago	117	126	↓	Region perceives less improvement over past year
Expected Change in Financial Situation in 1 Year	128	129	→	Region expects equivalent improvement over next year
Expected Change in Financial Situation in 5 Years	134	139	↓	Region expects less improvement over next 5 years
Personal Income Expectations				
Expected Household Income Change Over the Next Year	121	147	↓	Region expects less income growth over the next year
Expected Change in Prices Over the Next Year	15	21	↓	Region expects less inflation over the next year
Expected Change in Household Income Relative to Prices	53	93	↓	Region expects less real income growth over the next years
Regional Economic Conditions				
Current Business Conditions Compared to 1 Year Ago	115	128	↓	Region perceives less improvement over past year
Expected Change in Business Conditions in 1 Year	104	117	↓	Region expects less improvement over next year

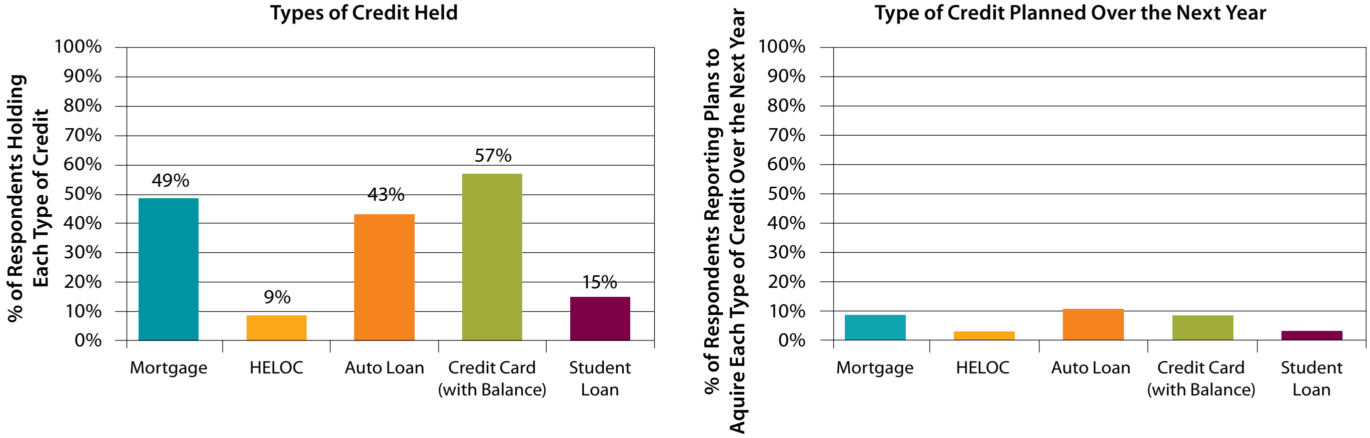
Purchasing and Credit

We again asked regional respondents about the types of credit they currently hold and their plans to acquire credit over the next year. The patterns of credit usage and plans for acquisition are fairly consistent with those in our last report. (See Figure 4)

Endnotes

1 National data obtained from the University of Michigan Consumer Sentiment Survey October 2016 and May 2017 Data. Available at: https://data.sca.isr.umich.edu/
Relative score values calculated as % of favorable responses - % of unfavorable responses plus 100. Positive or negative comparison indications are provided for regional vs. national score differences exceeding 3 points.

Figure 4
Types of Credit Held and Planned Over the Next Year



UPDATE

THE Small Business Economy

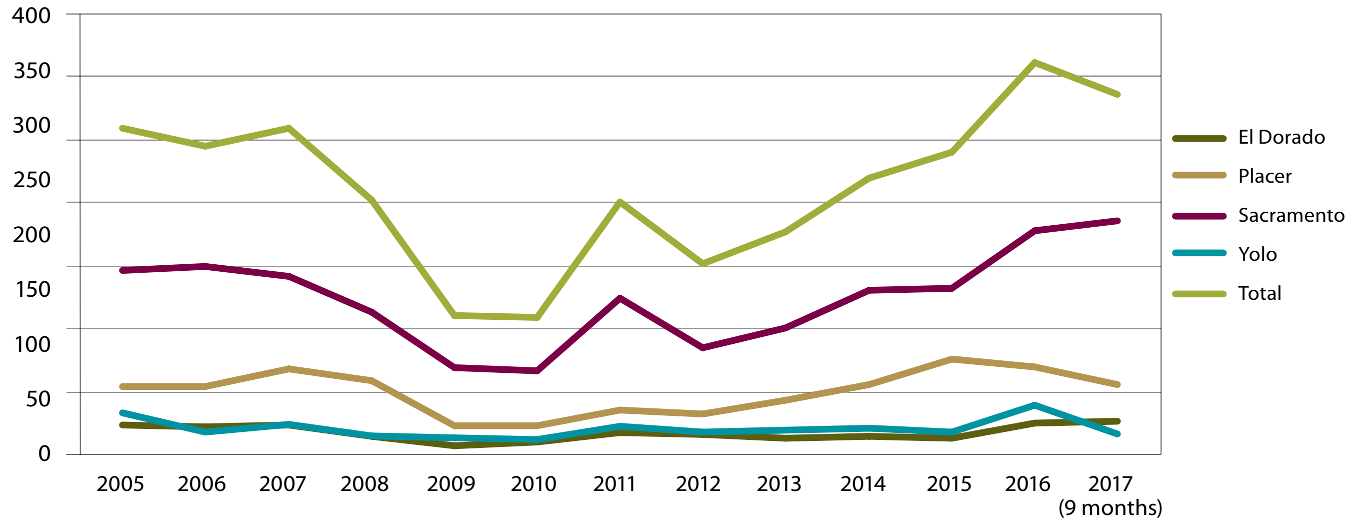
Local Credit Growth Remains Strong, but Uneven by County

Our latest reading of regional lending shows that credit extension remains strong, but lower absolute levels raise questions about future growth rates. In the past six months, the total dollar amount of approvals declined from $312M to $285M, an 8% decrease.

This is not necessarily a cause for concern as the upward trend appears intact and some variance in year to year point estimates is to be expected. That said, we will be monitoring the next two readings very closely to see if this data simply represents a soft patch or portends more difficult conditions ahead.

Sacramento County continued to show strength into 2017, surpassing last year's high. This is especially encouraging as Sacramento County makes up a 65% share of the aggregate. Troublingly, Placer County, the second largest contributor, registered its second decline in a row. El Dorado County held steady while Yolo County regressed back to 2015 levels.

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

Small Businesses Looking to Hire, Manufacturing Leads Local Confidence

Our SBR Small Business Confidence semi-annual survey shows continued high degrees of confidence across the spectrum. Survey respondents indicated that even though local supportiveness was slightly less favorable, they felt broader economic conditions would remain positive. Small business owners continue to believe that credit accessibility is very strong and they had increased expectations for future revenue. Perhaps most importantly, respondents indicated a material increase in their willingness and likelihood to hire.

Manufacturing logged the most dramatic increase when we broke the results down by sector. Readings for future revenue expectations and likelihood to hire increased by 28% and 43% respectively. Given the new presidential

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

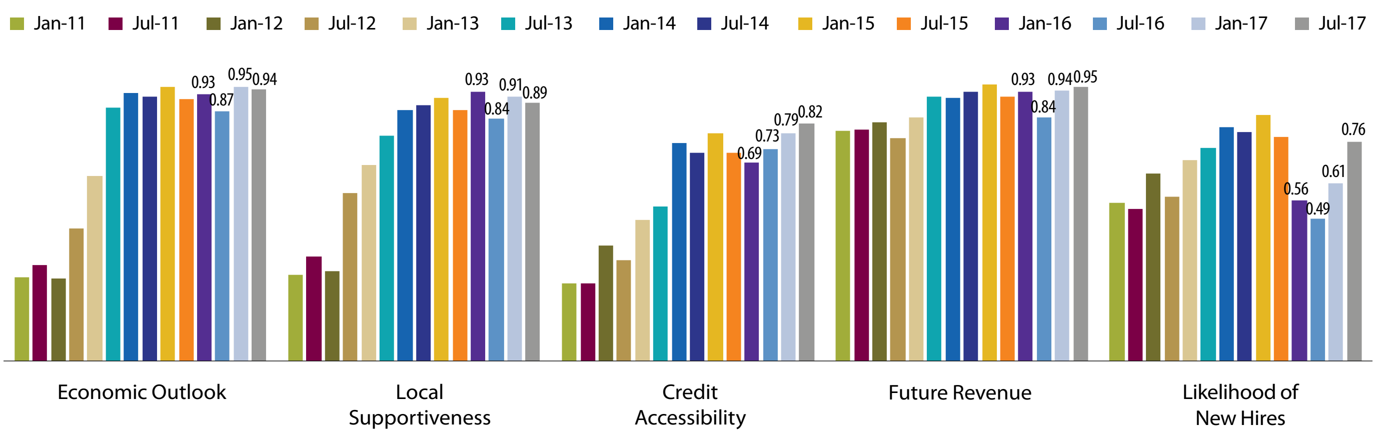
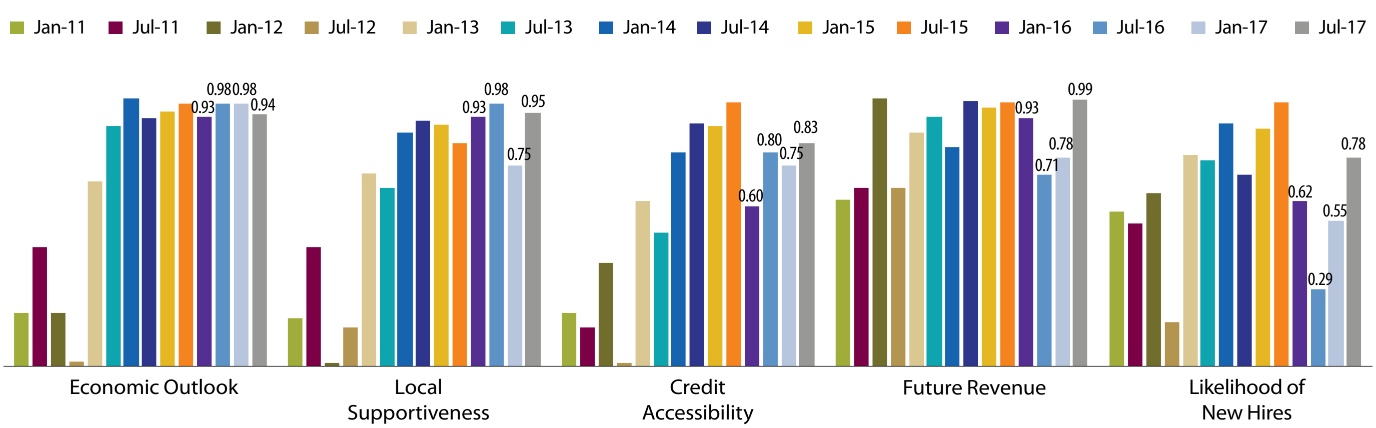


Figure 3
Small Business Confidence Index Trends in the Manufacturing Sector » January 2011 – January 2017



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

administration's "America First" policies and focus on repatriating manufacturing jobs in the U.S., these responses are not overly surprising to us.

Our local job mix continues to shift towards the service sector, so measuring attitudes in this area is very important. Fortunately, respondents feel credit conditions remain positive and they too have logged a material 33% increase in their likelihood to hire.

Respondents in the other sector had no material change in outlook across most categories. On a positive note, their likelihood to hire increased by 15% as well.

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

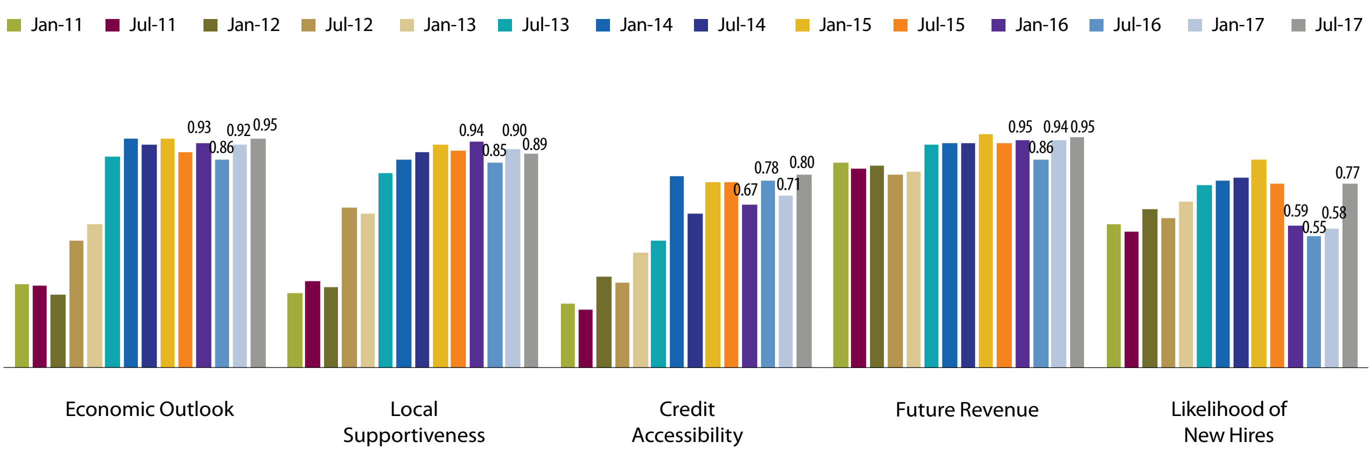
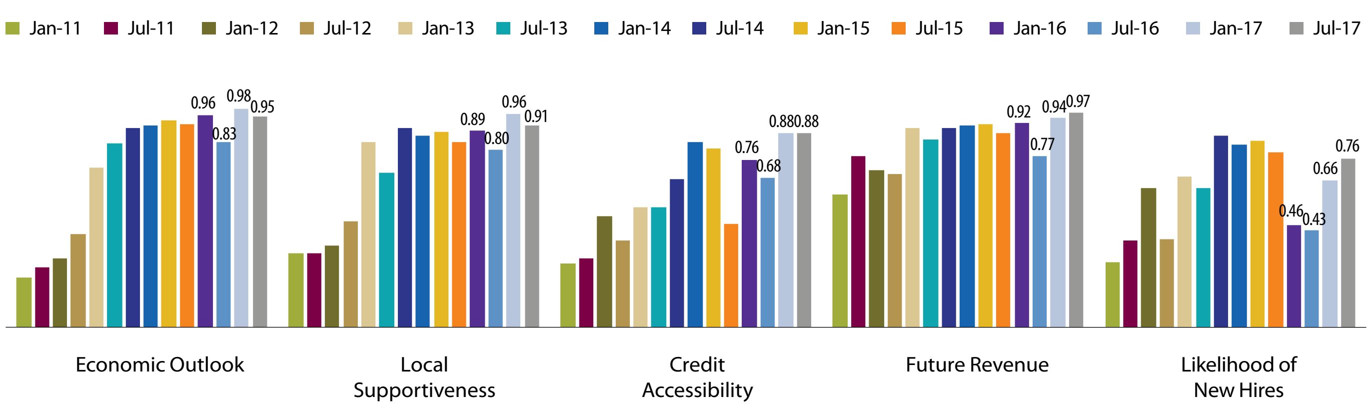


Figure 5
Small Business Confidence Index Trends in the Others Sector » January 2011 – January 2017



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

Small Business Listings and Sales Trend Continues to Modestly Improve

Quarterly readings of small business listings and volume of sales continue to show positive, if unspectacular, trend growth. Notably, median sales prices have increased above $300K for the third time since the Great Recession, which is indicative of a larger proportion of higher quality businesses that are the subject of transactions.

Median revenue and cash flow of the subject companies continue to show trend growth. While the data can admittedly be a bit volatile given the small sample sets, we believe that the metrics support our assertion of improving economic fundamentals and a resulting healthy appetite for business acquisition activity.

Small Business Sales

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

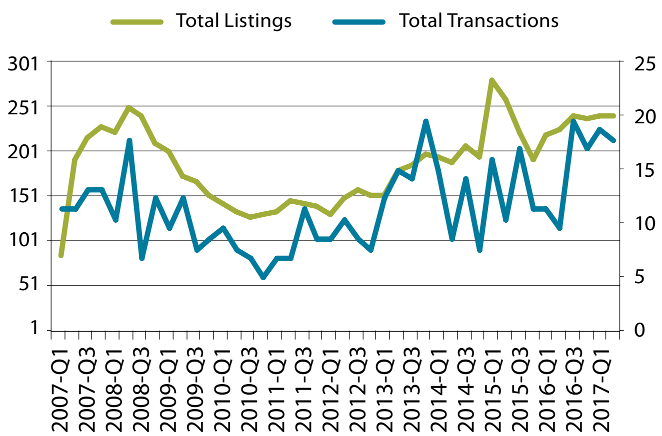


Figure 7
Median Closed Sales Price (Quarterly)

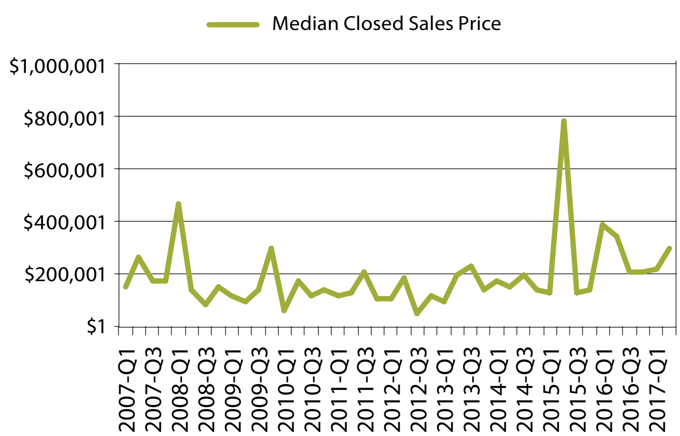


Figure 8
Median Revenue of Closed Sales (Quarterly)

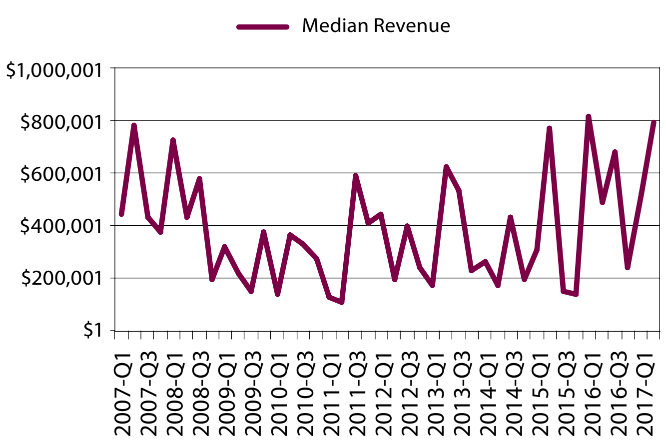
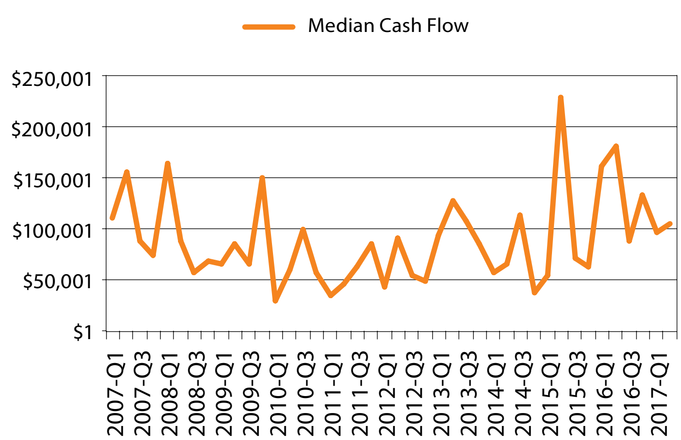


Figure 9
Median Cash Flow of Closed Sales (Quarterly)



Data Source (Figures 6-9): BizBuySell

UPDATE

Real Estate Trends *in the* Sacramento Region

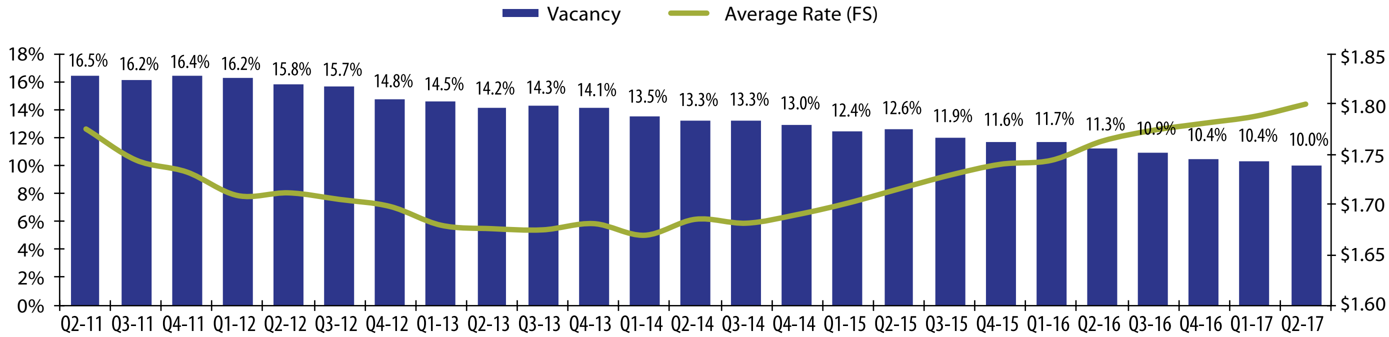
Office

Overall office vacancy in the Sacramento Region decreased by 40 BPS since the previous quarter, and was down by 130 BPS year-over-year (YoY) to 10.0%. Large block space options, particularly in the core Sacramento submarkets, have been growing scarce. With no office projects ready to break ground in the near future, and continuously rising demand, there will be further upward pressure on lease rates. Overall asking rents in the region rose a modest \$0.04 PSF since last year to \$1.80 per-square-foot-per-month (PSF) on a full service gross (FSG) basis. Central Business District Class A average asking rents remained relatively flat, ending Q2-2017 at \$2.86 PSF (FSG). The largest project currently under construction is the build-to-suit (BTS) Adventist Health building located in Roseville, totaling 242k SF and scheduled to deliver in Q3-2018. Second quarter leasing activity was strong, reaching 1.16 MSF and topping that figure from last year by 96k SF. Net absorption was a healthy 290,000 SF for the quarter.

Retail

Although there has been continued pressure from e-commerce, retail is not dead. Grocery, fast casual restaurants, fitness and service oriented sectors have

Figure 1
Office Lease Rates and Vacancy Rates: Sacramento MSA



Data Source: Co star and Cushman & Wakefield

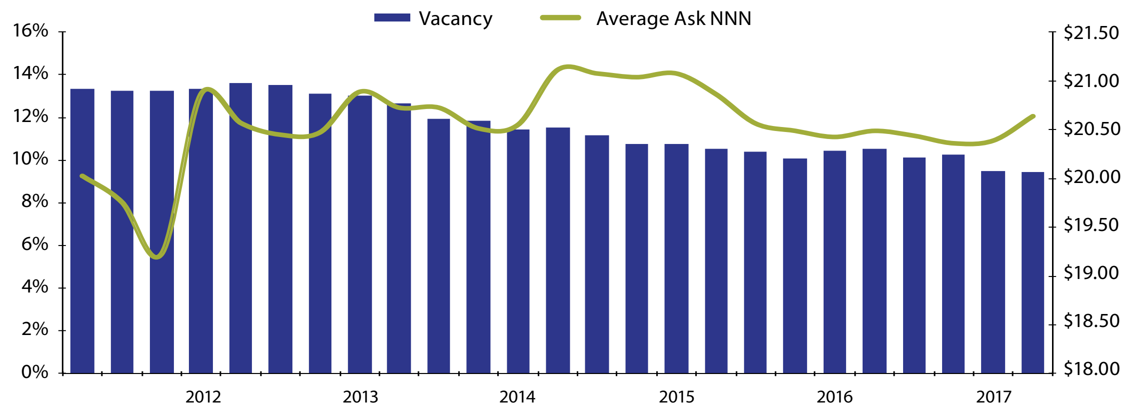
remained the strongest categories in retail, which are predominantly insulated from e-commerce. Demand for Class A retail is strong with vacancy in the 6% range and asking rents in prime submarkets at around $36.00 per square foot per year on a triple-net basis (NNN) and higher for new construction. Overall vacancy has been hovering around 9.4% and is very close to pre-recession levels in 2008 of under 9%. Although leasing activity in the 2nd quarter was slow, this is not an indicator of any lack of demand. There has been a torrential pace of investment activity. Among the numerous retail properties under construction, the most notable in the suburbs is Delta Shores Center (on Beach Lake Rd. at Interstate 5) in the South Sacramento submarket. This new speculative 727,400 SF power center is set to deliver in late 2017, and will add such big box stores as Wal-Mart Super Center and RC Willey Home Furnishings. In Downtown and Midtown, the two key retail projects under construction are Downtown Commons (aka DOCO) and The Ice Blocks. DOCO is situated next door to the Golden 1 Center, and will add 140,000 SF of lifestyle center space, as well as mixed use components like the 20-story Sawyer Hotel, with a delivery date set for the fourth quarter of this year.

Despite the limited amount of available industrial space in Sacramento, the vacancy rate continued to fall in Q2-2017.

Industrial

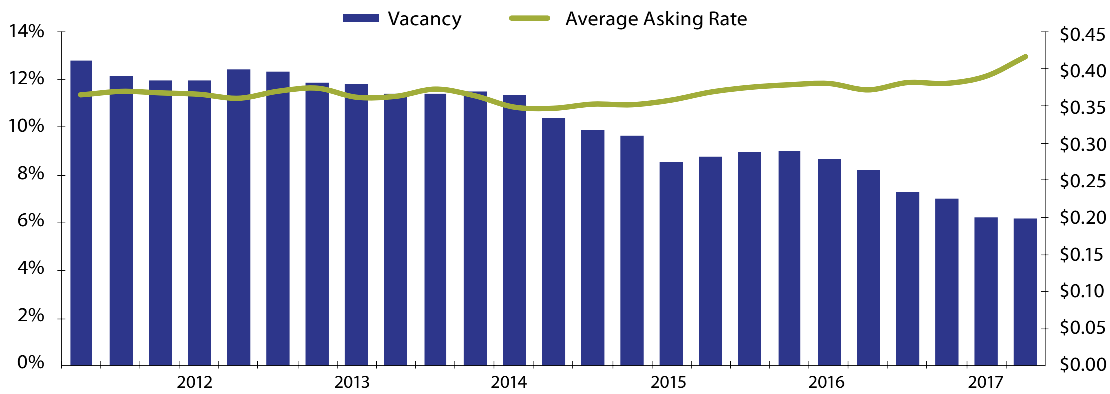
Despite the limited amount of available industrial space in Sacramento, the vacancy rate continued to fall in Q2-2017. Compared to only one year ago, the vacancy rate decreased significantly by 200 BPS to 6.2%. Big block spaces (100k SF or larger) in the region grew scarcer during the quarter,

Figure 2
Retail Lease Rates and Vacancy Rates: Sacramento MSA



Data Source: Co star and Cushman & Wakefield

Figure 3
Industrial Lease Rates and Vacancy Rates: Sacramento MSA



Data Source: Co star and Cushman & Wakefield

with only 25 availabilities or half the amount of big block availabilities that were on the market one year ago. The lack of new development in the region is tightening up supply, which will slow the pace of growth if not addressed. Since their lowest point in the last three years (Q2-2015), asking rents have climbed by just $0.07 PSF on a NNN to $0.42 PSF. This can predominantly be attributed to Class A space being leased up at a faster rate leaving more class B space available where rates have not accelerated as fast. There are some buildings that will vacate this year pushing vacancy up, but the current leasing activity should keep the vacancy rate stable or still in decline. With continued demand we anticipate a shift in pricing in response to the shortage of supply and the potential of realizing more speculative development.

Residential

House prices in the Sacramento region continued the recent trend of robust increases during the first half of 2017. The median sale price for all houses in June 2017 was $374,000, which is an approximately 7% increase both from the fourth quarter of 2016 ($350,000) and from June of last year ($349,000). This makes it the 12th consecutive quarter in which prices increased between 6.8% and 9.7% year-over-year, with an 8% average increase in the last three years. Going back a couple more years, house prices in the Sacramento region have almost doubled since the median price bottomed at $179,000 in late 2011. The five consecutive years of significant appreciation have brought the median house price to within 11% of the 2006 peak. In comparison, the Case-Shiller national home price index increased by 5.6% over the past year.

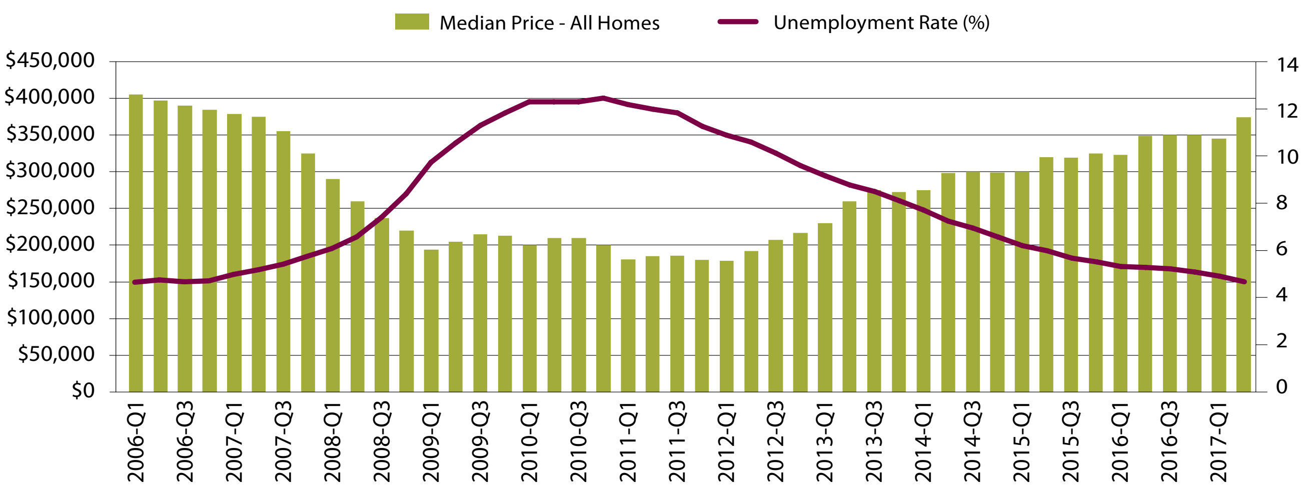
The median price per square foot in the Sacramento MSA for existing single-family residences increased by 9% year-over-year, to $220. Year-over-year changes in price per square foot ranged from 10% in Sacramento County to 5% in Yolo County.

Sales of all homes (condominiums, existing, and new homes) in the Sacramento MSA were essentially the same in the first two quarters of 2017 as in the same period in 2016: slightly under 20,000 units. For perspective, sales increased 14% in 2015 and 6% in 2016. Geographically, Yolo County experienced a 10% increase in sales activity, while El Dorado County saw a 10% decrease.

Just like a year ago, the limited supply of both existing and new housing is the main reason for the robust house price increases. Currently, the average home is on the market for only nine days. The good news is that home construction and sales of new homes continue to trend upward. Sales of new homes increased by 16% year-over-year, from 2,196 in the first half of 2016 to 2,548 in the same period this year. Further, new homes represented 13.9% of all sales in 2017, up from 12.6% in the first two quarters of 2016. However, it is worth noting that both new home inventory and the proportion of new homes in sales both remain far below pre-housing crisis levels. For instance, almost 16,500 new homes were sold in 2005, which represented 28% of all home sales. Other reasons for rising house prices are declining unemployment rates, rising personal incomes, a flood of buyers from the Bay Area, and low mortgage interest rates. In the January issue of SBR, we stated that "significant increases [in mortgage interest rates] may have an impact on the buyers in the entry-level market." This has not materialized, as the average mortgage rate actually declined from 4.2% in January 2017 to 3.9% at the end of June.

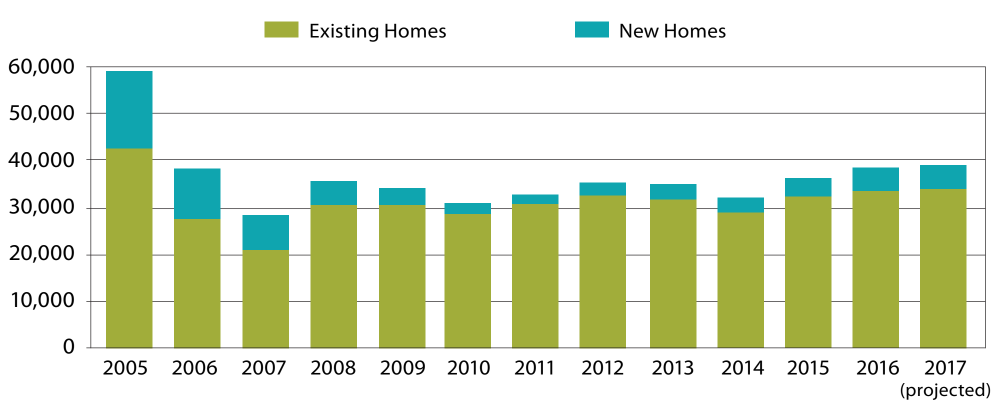
The strength of the housing market is further demonstrated by the continuing decline in distress sales. The real estate owned by banks (REO) represented about 1 out of 40 of all sales in the first two quarters of 2017, while this number was 1 out of 20 even two years ago.

Figure 4
Median Sales Price (All Homes) vs. Unemployment Rate: Sacramento MSA



Data Sources: CoreLogic, Bureau of Labor Statistics

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



Data Source: CoreLogic

UPDATE

2017 Banking & Capital Markets Mid-Year Update

2017 banks and credit unions demonstrated similar modest annualized loan growth projections after the 1st quarter, but loan growth picked up pace throughout 2016. See Tables 1 & 2 for details.

Table 1
Bank Loan Growth by Category

Segment	Q1 of 2016 Growth	Q1 of 2016 Annualized Growth	2016 Annual Growth	Q1 of 2017 Growth	Q1 of 2017 Annualized Growth
Commercial Real Estate	2.1%	8.6%	17.3%	3.8%	16.0%
Residential	-0.3%	-1.1%	1.1%	0.9%	3.7%
Commercial & Industrial	-0.4%	-1.5%	8.9%	-1.2%	-4.6%
Multi-family Residential	8.7%	39.5%	54.3%	1.9%	7.9%
Construction	6.5%	28.6%	14.1%	-2.1%	-8.1%
Other	-3.1%	22.28%	6.9%	-3.8%	-14.5%
Total	**1.1%**	**4.4%**	**13.2%**	**1.3%**	**5.3%**

Data Source: FDIC

Table 2
Credit Union Loan Growth by Category

Segment	Q1 of 2016 Growth	Q1 of 2016 Annualized Growth	2016 Annual Growth	Q1 of 2017 Growth	Q1 of 2017 Annualized Growth
Auto	4.96%	21.37%	32.9%	5.1%	22.1%
Residential/ RE Lines of Credit	2.5%	10.39%	17.8%	2.2%	9.2%
Credit Card/ Unsecured	-0.3%	-1.19%	14.2%	-1.1%	-4.3%
Other	5.16%	22.28%	23.9%	5.4%	23.5%
Total	**3.47%**	**14.6%**	**24.7%**	**3.5%**	**14.6%**

Data Source: NCUA

To provide a more concise, yet informative update for the local banking industry and capital markets, the SBR team felt it best to combine the two sections for the 2017 mid-year update and future editions. Much of the central bank policy decisions and actions that we typically discuss in the Capital Markets section have unquestionable ramifications for the local banking sector, and many of the broader capital markets themes such as macroeconomic expectations and stock market valuations directly impact the local banking sector's customer base and its behavior regarding demand for loan and deposit products. We hope you enjoy the new format, and as always, please feel free to contact us with any feedback.

Banking Industry Forecast

In the January 2017 issue, the SBR team predicted a slowdown in the pace of loan growth for the Sacramento Region. And indeed, annualized Q1 2017 loan growth figures came in lower than that of Q1 2016 across almost every category. The projected annualized loan growth rate for 2017 is 5.3% for banks, down from 13.2% in 2016, and 14.6% for credit unions, a decline from 24.7% in 2016.

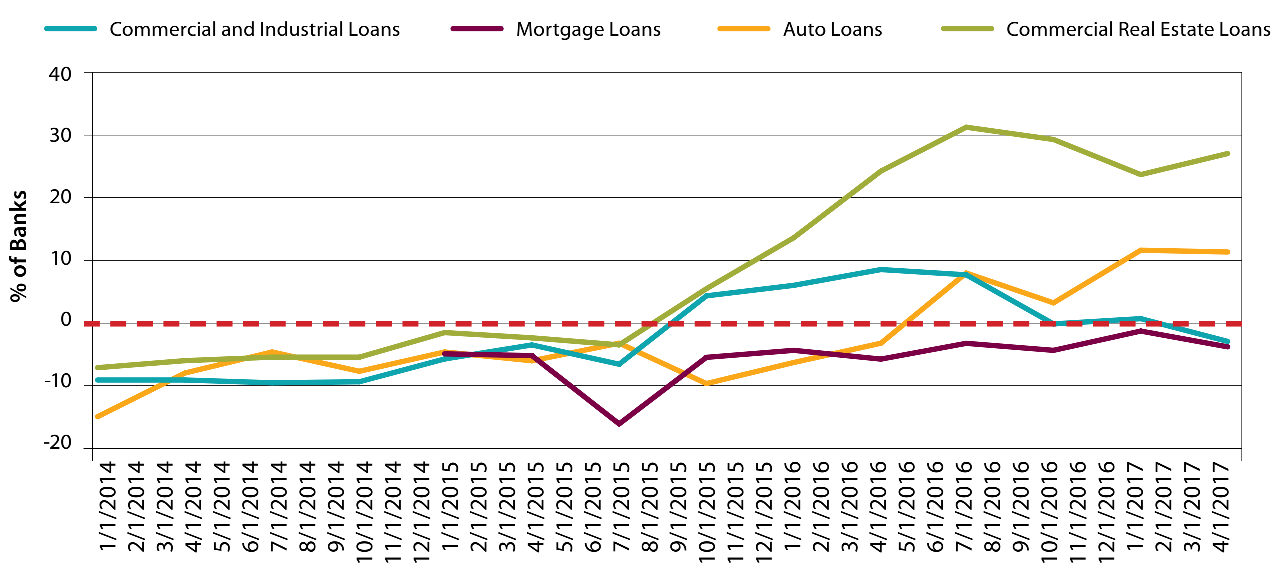
But a closer look suggests that we might, yet again, see aggressive growth similar to that in 2016. Both in 2016 and

Current year loan growth patterns for local banks and credit unions appear to be consistent with the SBR's Regional Consumer Sentiment Survey results. The SBR Consumer Sentiment Survey indicates that self-reported patterns of credit usage and plans for acquisition during this time period are fairly consistent with the previous one. Consistent loan growth in the region backs up the self-reported consumer intentions. Nevertheless, the SBR team still believes that Sacramento region bank and credit union loan growth will slow in 2017. The Federal Reserve's Senior Loan Officer Survey points to an increased number of banks tightening standards for (1) commercial real estate loans, the largest loan category for Sacramento region banks at 47.2% of all bank loans, and (2) auto loans, the largest loan category for Sacramento region credit unions at 51.4% of all credit union loans. The Senior Loan Officer Survey points to more relaxed standards for commercial and industrial loans, which affect 9.3% of Sacramento region bank loans. Mortgage related loans show a slight relaxation of standards within a longer-term pattern of tighter standards. See Figure 1 for details. Putting these trends together, the SBR team believes that the net results of the loan standards practices will assert itself in a slower loan growth rate for 2017 as compared to 2016.

Nevertheless, the SBR team still believes that Sacramento region bank and credit union loan growth will slow in 2017.

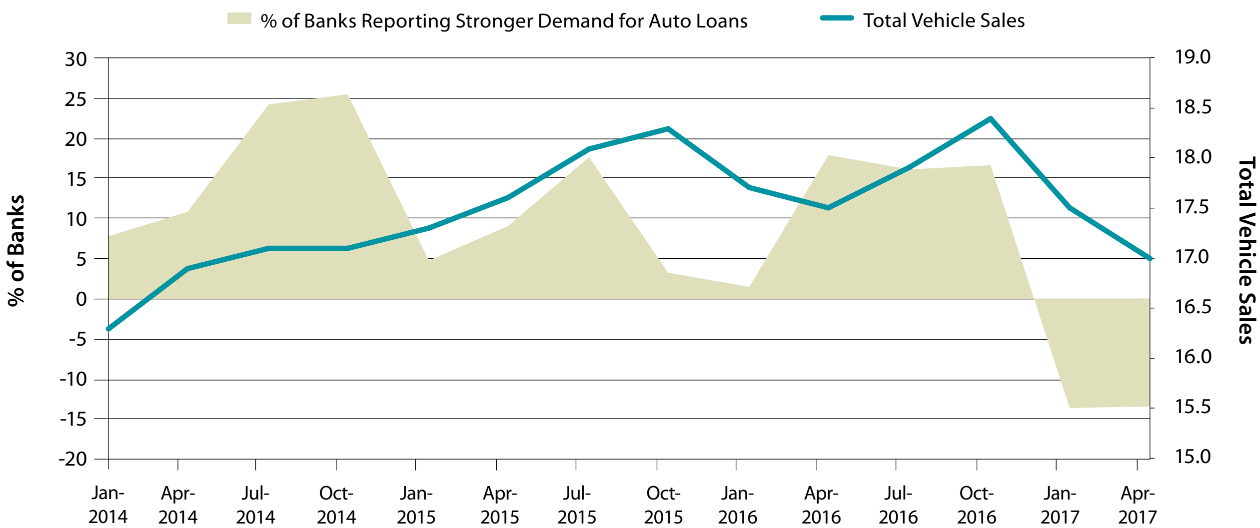
Revisiting our auto loan forecast, the SBR team has predicted a slowdown in auto loan growth for this year. National auto sales are lower compared to the same time last year. Banks nationwide report a substantial

Figure 1
Net Percentage of Banks Tightening Standards for Loan Categories



Data Source: FRED Senior Loan Officer Survey

Figure 2
National Bank Reported Demand for Auto Loans vs. National Auto Units Sales



Data Source: FRED Senior Loan Officer Survey

drop in demand for auto loans as well. See Figure 2 for details. Sacramento region credit unions have outpaced national trends for auto loans over the previous 5 years, which seems to be continuing into 2017: 1st quarter auto loans have not shown a slowdown as compared to the 1st quarter of 2016, but rather a slight uptick (see Table 2). The good news is that auto loan delinquency rates remain low for the region (see Table 3).

The SBR's Regional Consumer Sentiment Survey results show that respondents are expecting an improvement in their financial situation and, at the same time, have concerns about an increase in inflation. Coupled with recent and expected Fed interest rates hikes, local consumers might be choosing to make their auto purchases sooner rather than later, causing the local auto loan growth rate to persist above the national trend; however, the SBR team believes that the region will still see a slowdown in the rate of auto loan growth by year end.

In spite of Federal Reserve interest rate hikes leading to higher short term rates, longer term rates continue to be depressed by geopolitical uncertainty and waning inflation expectations. A flattening yield curve is not necessarily a

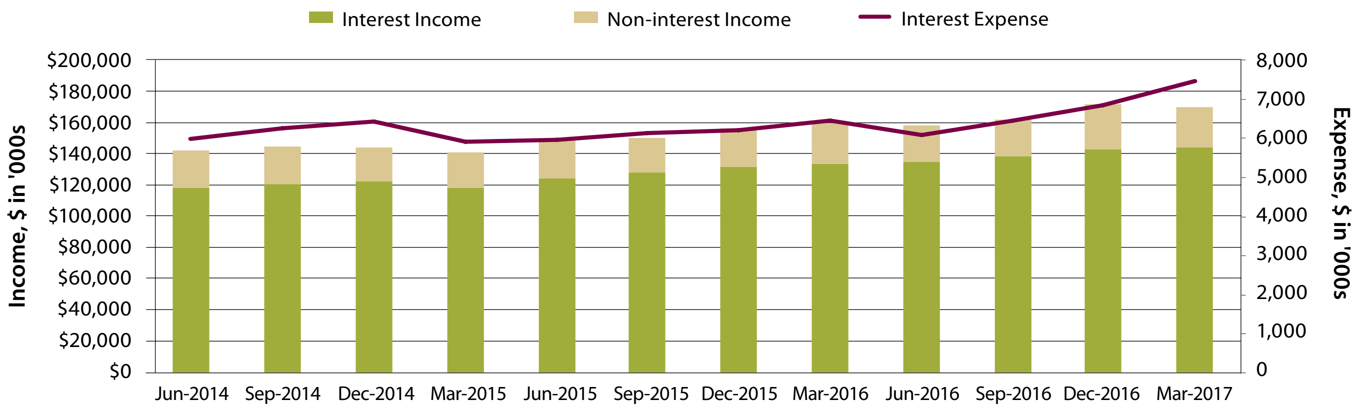
Table 3
Sacramento Region Credit Unions » 60+ Day Auto Loan Delinquencies » December 2015 – March 2017

Segment	Dec-15	Mar-16	Jun-16	Sept-16	Dec-16	Mar-17
New	0.31%	0.23%	0.24%	0.30%	0.33%	0.27%
Used	0.53%	0.37%	0.37%	0.47%	0.56%	0.41%

Data Source: NCUA

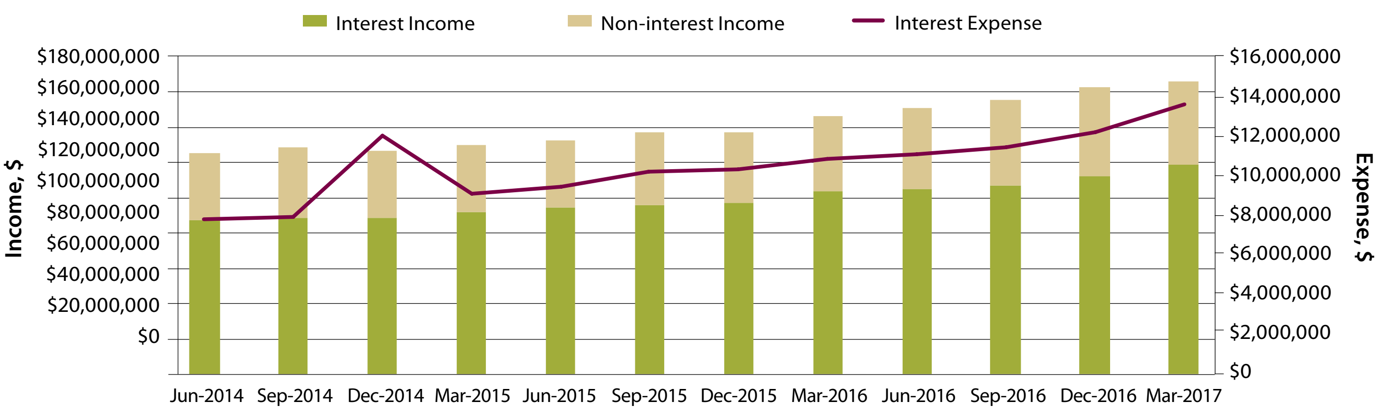
sign of an economic slowdown, but it is an unwelcome trend for the banks' profits. Banks' main source of income is interest from loans that earn the long-term rates, but banks have to pay short-term rates on the deposits, which are their main source of funds. We can already see the higher short-term interest rates working their way into Sacramento region banks' and credit unions' financial statements, where interest expenses have been rising faster than interest income (see Figures 3 and 4). Credit Unions seem to have a slightly better cushion in the form of noninterest income, but all financial institutions will have to keep their loans growing in order to maintain healthy bottom lines.

Figure 3
Sacramento Region Bank Income vs. Interest Expense, $ in '000



Data Source: FDIC

Figure 4
Sacramento Region Credit Union Income vs. Interest Expense, $



Data Source: NCUA

Capital Markets

In our January 2017 forecast, we sounded a word of caution that cyclical economic stress factors may start to materialize sometime in 2018, and we do not think anything has derailed that sentiment for now. The Federal Reserve Open Market Committee (FOMC) has raised interest rates by 0.5% since our January 2017 release and the broader economy appears to have handled the rising rates fairly well. However, there is still a significant amount of debt, both government and corporate, that will eventually have to be refinanced at higher interest rates, and the result of this refinancing cycle has yet to be seen.

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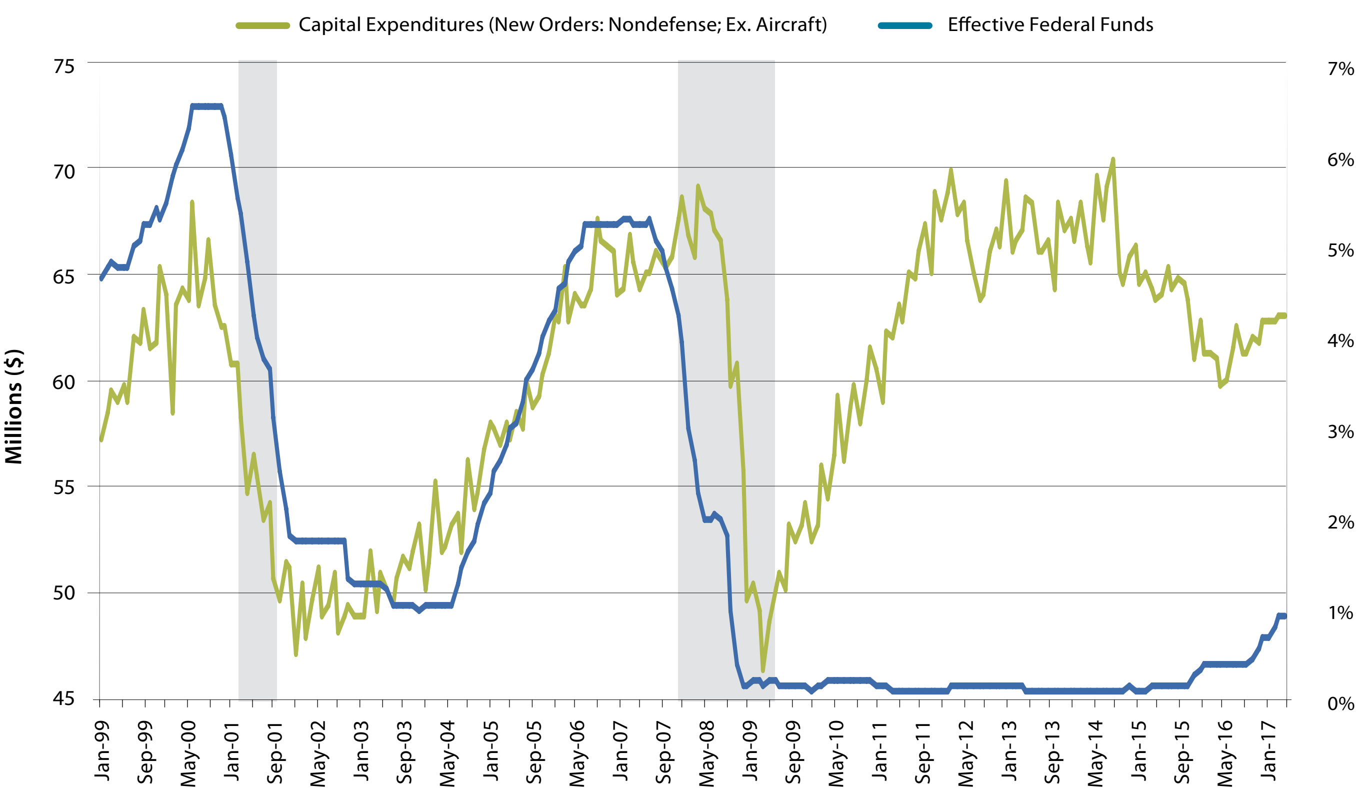
We have updated Figure 5 with the most recently available data, and one of the key factors we spoke to in our previous issues appears to be coming to fruition. The relatively recent increase in interest rates has spurred companies to invest in capital projects. After having squeezed out all of the returns possible from the capital investment that immediately followed the crisis, companies are now likely investing in more advanced and innovative technologies to achieve higher returns given the increasing cost of capital. If these capital investments are successful, then the current expansionary period may have more room to go; however, if interest rates increase too rapidly, companies will have a hard time keeping pace with the higher interest costs and may have to cut costs elsewhere in the organization, such as personnel, to keep financial statements in check.

companies are now likely investing in more advanced and innovative technologies to achieve higher returns given the increasing cost of capital.

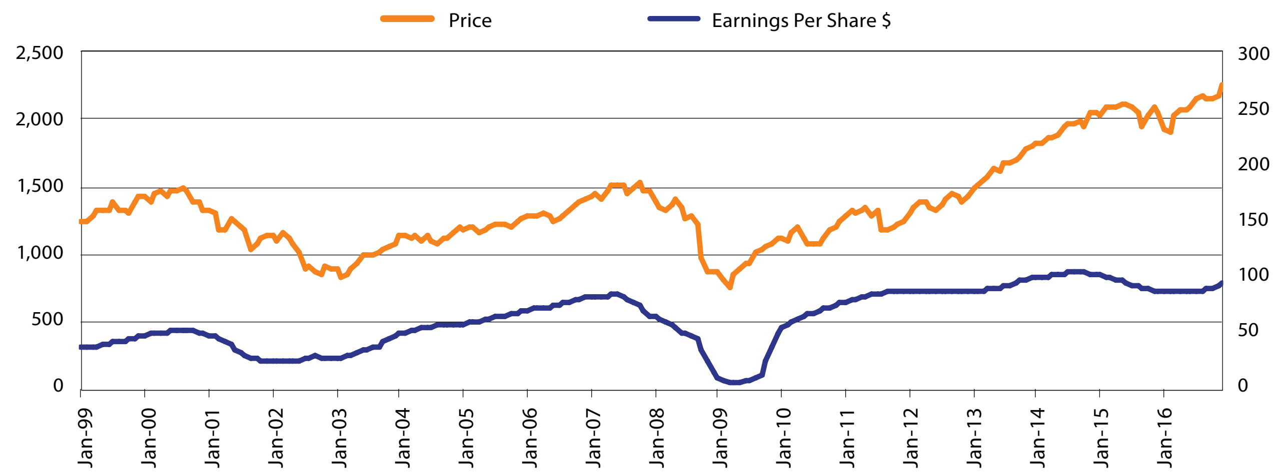
We have also updated Figure 6 with the most recently available data, and not surprisingly, the gap between the price that people are willing to pay for corporate earnings and the actual earnings themselves is at its widest in recent memory. The longer term, cyclically adjusted price-to-earnings ratio (a.k.a. the Schiller P/E) ended July just above 30 and is approaching levels not seen since the Great Depression and tech bubble. It is difficult to see the outstanding business prospects that justify such an outlier of a ratio. What are markets factoring

Figure 5
Interest Rates and Capital Investment



Data Source: U.S. Bureau of the Census

Figure 6
S&P 500 Index and Earnings Per Share



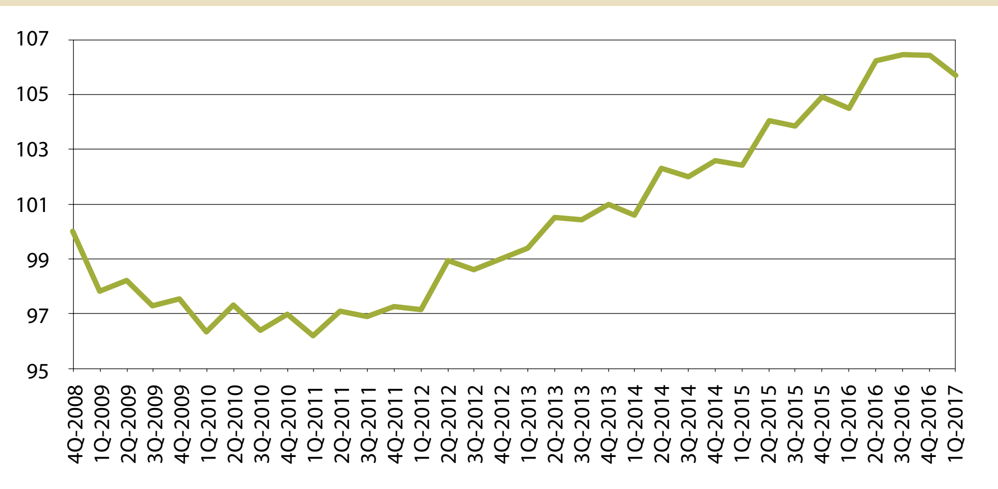
Data Source: http://www.econ.yale.edu/~shiller/data.htm

in that suggest expected corporate earnings are worth such a high price? Unfortunately, we believe that these high prices have much more to do with central bank stimulus over the last decade than they do with fundamental corporate prospects.

Year to date, the S&P 500 has returned just over 10%, besting our low to mid-single-digit return forecast at the beginning of the year; however, there are just too many looming risks such as North Korea, or the ensuing debt ceiling debate for us to alter our forecast and we reaffirm our projections at the beginning of the year. Annualized Q2 2017 GDP growth of 2.6% is right in line with our 2017 year-end forecast of 2.5%, and longer term Treasuries are yielding less than where they began the year. However, the Federal Reserve's plan to reduce its balance sheet by not reinvesting a portion of its monthly cash flows should put upward pressure on longer term rates once in place. And thus, we will hold fast to our prediction for a quarter-to-half-point increase in longer-term Treasuries by year-end.

Sacramento Business Review Financial Conditions Index

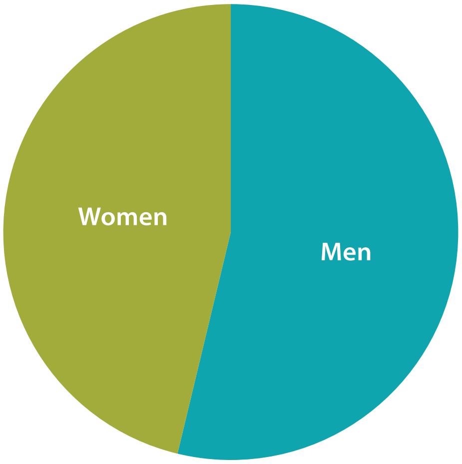
Our proprietary SBR Financial Conditions Index has continued along an expansionary trend. The Q1 2017 downtick was mainly due to seasonal factors for both employment and the housing market. We expect the overall upward trend to continue throughout the remainder of 2017.



UPDATE

Sacramento Region
Human Capital Index

Figure 1
2017 Wage Gap



Diversity

While the January issue reported that survey respondents viewed diversity and inclusion efforts at the bottom of the current human capital list of focus areas, with 20% responding no effort was expanded in this area, this may be about to change. AB 168, currently with the Senate, could indirectly impact organizations' efforts in this area. With this bill, organizations would not be able to ask job applicants for their salary history during the recruitment and selection process. Additionally, organizations would be obligated to disclose their pay scales upon request, reducing the common practice of asking job candidates about their individual salary history. This bill is aimed at reducing the gender wage gap, which still exists locally and throughout the nation. Even though California is doing better than most of its peers throughout the country, a 14-cent gap in wages between full-time employed men and women still exists. It is also worth keeping an eye on Senate Bill 328, which may indirectly counteract some gender diversity efforts. This bill proposes that middle and high schools would not be able to start earlier than 8:30 a.m. Delaying school start time may translate in delaying parents arriving to work, which for those in non-flexible

Even though California is doing better than most of its peers throughout the country, a 14-cent gap in wages between full-time employed men and women still exists.

jobs may mean that they are facing difficulty in maintaining their employment. In reality this may hit women harder than men. Decades of research shows that women still bear the brunt of household chores, and more recent research shows that this holds true even when the man is the lower earner. In same-sex households the partner perceived as more "feminine" is expected to take on an increased share of unpaid work (Quadlin, 2016).

Recruiting and Employment

The January issue reported that 57% of organizations surveyed indicated that they would actively recruit new employees. This is supported by numbers at the national level indicating increasing recruitment efforts. In support of this, unemployment remains low in our region at 4.4% (down from 5.1% in 2016) thanks to an overall increase of 25% jobs across industries (Bureau of Labor Statistics). It is worth noting that this statistic does not reflect that some industries are small with few jobs added (e.g., mining and logging). Furthermore, data reported in the January issue showed organizations indicated increased recruiting while at the same time expecting reduced voluntary turnover, which prompted us to debate whether the organizations were expecting turnover or possibly expanding their operations. Current data would suggest that the former would have been the more accurate prediction.

Jobs in the software field have increased a whopping 46.6% over the past few years (California Employment Development Department) though they make up a fraction of the overall job market locally – only about 6,500 jobs in total. The Sacramento region is bucking the national trend where organizations are predicted to spend more than $650 million on salaries for newly created jobs in artificial intelligence as automation becomes the new normal (Jones, 2017). Large local employers — except Intel Corporation — are absent from that list, with Intel spending roughly 8% of what Amazon spends, 15% of Google's spending, and 25% of Microsoft's spending. Overall the Sacramento region is a small player in this domain and hosts jobs in the field of information in the low teens of thousands and further declining with a 4.3% drop from last year (BLS).

The fastest growing industry locally is personal care and service while the region keeps losing jobs in the construction sector, where we see a decline exceeding 4% since last year, tracking closely with the underbuilding of affordable housing in our region. With currently debated legislation (SB 35) recently passed by the Senate, communities may no longer be able to thwart housing proposals which they deem not aligned with their communities and we may see an uptick in construction and construction-related jobs.

Government is currently approximately 238,000 jobs with a small (0.4%) increase since last year, but facing great loss of talent and knowledge as a majority of government workers are age 50 or older. Anecdotally government agencies have a hard time filling open positions with younger employees who find it difficult to navigate job ads and selection processes, and fear that once hired, the opportunity for creativity and freedom is small. Sacramento has the fourth fastest aging workforce in the nation.

In the January issue we reported that more than 75% of employees view their pay and benefits positively.

Compensation

In the January issue we reported that more than 75% of employees view their pay and benefits positively. It remains to be seen whether this sentiment will hold for our 2018 data collection as 2018 salary predictions remain modest with an increase of about 3.2% nationally, although this is slightly up from 2017 (3.1% increase) and 2016 (3.0% increase). This may be surprising given the resurgence of the global economy and anticipation of an expanding U.S. economy due to expected eased fiscal policies at the national level (SHRM).

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2018 Economic Forecast

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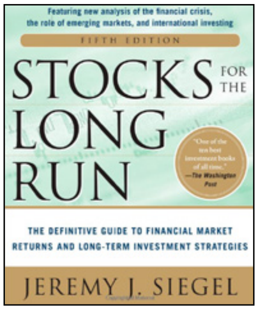
Keynote Speaker: Jeremy J. Siegel
Hosted bar, refreshments, and networking from 5:00 – 7:00 p.m.

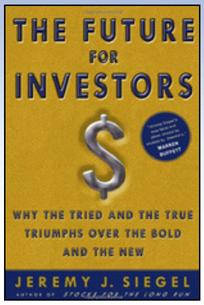
Jeremy J. Siegel

Jeremy J. Siegel is the Russell E. Palmer Professor of Finance at the Wharton School of the University of Pennsylvania. He graduated from Columbia University in 1967, received his Ph.D. in economics from the Massachusetts Institute of Technology in 1971, and spent one year as a National Science Foundation Post-Doctoral Fellow at Harvard University. Professor Siegel taught for four years at the Graduate School of Business of the University of Chicago before joining the Wharton faculty in 1976.

Professor Siegel has written and lectured extensively about the economy and financial markets, has appeared frequently on CNN, CNBC, NPR and other networks. He is a regular columnist for Kiplinger's and has contributed articles to the *Wall Street Journal*, *Barron's*, the *Financial Times* and other national and international news media. Professor Siegel served for 15 years as Head of Economics Training at J.P. Morgan and is currently the Academic Director of the U.S. Securities Industry Institute.



Professor Siegel is the author of numerous professional articles and three books. His best known, *Stocks for the Long Run*, which published its fifth edition in 2014, was named one of the 10 best investment books of all time by the *Washington Post*. His book *The Future for Investors: Why the Tried and the True Triumphs over the Bold and the New* was published by Crown Business in March 2005 and was named one of the best business books published in 2005 by *Business Week*, the *Financial Times* and *Barron's*.



Professor Siegel has received many awards and citations for his research and excellence in teaching. In November 2003 he was presented the Distinguished Leadership Award by the Securities Industry Association, and in May 2005 he was presented the prestigious Nicholas Molodovsky Award by the Chartered Financial Analysts Institute. It is awarded to "those individuals who have made outstanding contributions in investment research of such significance as to change the direction of the profession and to raise it to higher standards of accomplishment."

Other awards include the Roger F. Murray Prize for best paper presented at Q Group Conferences in 2014, the Graham and Dodd Award for the best article published in the *Financial Analysts Journal* in 1993, and the Bernstein Fabozzi/Jacobs Levy Awards for the best article published in the *Journal of Portfolio Management* in 2000.

In 1994 Professor Siegel received the highest teaching rating in a worldwide ranking of business school professors conducted by *Business Week*, and in 2001 *Forbes* named JeremySiegel.com one of the "Best Business School Professor" websites.

Professor Siegel served as Head of Economics Training at J.P. Morgan from 1984 through 1998 and is currently the Academic Director of the U.S. Securities Industry Institute. He currently serves as Senior Investment Strategy Advisor of WisdomTree Investments, Inc., advising the firm on its proprietary stock Indexes.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