

JANUARY
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sacramento BUSINESS REVIEW

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Is Sacramento keeping
pace with the
rest of the nation?

CELEBRATING

10
YEARS

10 YEARS

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



sacramento BUSINESS REVIEW

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

CAPITAL MARKETS AND BANKING

HUMAN CAPITAL INDEX

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MESSAGE FROM THE CHIEF ECONOMIST

Dear Friends,

As we celebrate our 10th anniversary, I am pleased to share the 19th edition of the *Sacramento Business Review* – the most comprehensive, precise, and intellectually sophisticated analysis of the regional economy. For TEN years, our team has provided thoughtful predictions that have accurately forecasted the economic and business climate. With 18 of Sacramento's very best financial analysts and researchers combining their skills and talent, the *Sacramento Business Review* is the most credible source of independent thinking, insights, and research on our economy in the region.



Following synchronized global growth that has picked up steam in the United States, Japan, Europe, and emerging Asia, the greater Sacramento region job growth has outpaced that of California – led by the construction, health care, leisure and hospitality, and business services sectors. After touching a high of 13.5% at the worst part of the great recession, the Sacramento region unemployment rate is now below 4% – and below both statewide and national averages. However, the region is not producing enough graduates in industries with the highest job openings, and clearly needs to realign the educational programs offered at universities to ensure we are producing those skills that are highest in demand.

Small business optimism remains high, especially in light of the recent tax reform, even though total Small Business Administration lending declined somewhat. Business sales and listings remain healthy even though sales prices have declined more recently. Consumer sentiment remains high, but is less optimistic and less positive compared to national averages. The real estate market has been strong and will continue to see another good year in 2018 due to mortgage rates remaining in check following the 10-year treasury yield. Vacancy rates will continue to decline, rents continue to increase, and median home prices continue their ascent, although moderately.

2017 was a spectacular year both for the economy and the stock market by any measure, setting records in many ways. Global pick-up in growth, low inflation, consumer and business confidence, recent tax reform, and improving fundamentals will all provide tailwinds for a solid 2018. As we celebrate a great economy, I still want to remind ourselves that the region desperately needs to do something about developing or attracting higher paid jobs and diversifying the job mix to prepare ourselves for the next recession.

Our 10th anniversary milestone represents the success and commitment of our analysts who do this work entirely as a public service to the region. We plan to continue doing this as long as our team continues to enjoy producing the forecast.

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 partner. To download your free copy, please visit sacbusinessreview.com.

Warm regards,

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Consumer confidence is high and unemployment is low. But, consumer defaults are worsening and interest rates are rising. What does this mean for the regional forecast? Our Capital Markets and Banking Forecast offers some encouraging predictions.

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Talent shortages and skills gaps continue to be among the biggest challenges facing the region's employers. While the expectation for 2018 is a slightly more positive headcount, the data suggest renewed recruitment and training efforts may not be enough to close the gap entirely.

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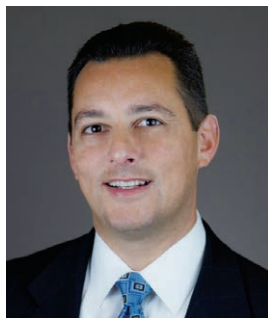
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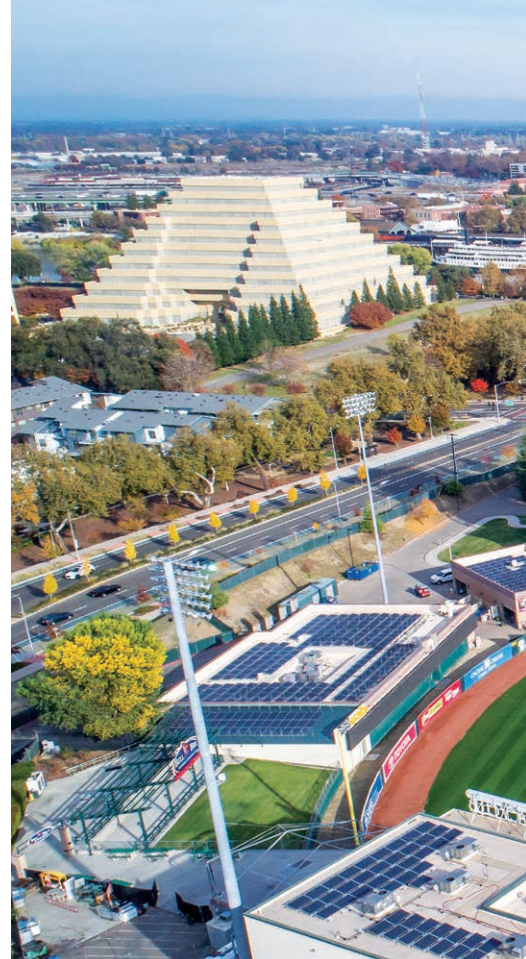
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Labor Markets & *Regional Economy*



KEY POINTS

- The Sacramento region's labor market growth has outpaced the State over the past 1-, 3-, and 5-year periods.
- The construction, health care, leisure and hospitality, and business and professional services sectors have led the region's job growth over the past 5 years.
- The region is not producing enough graduates or skilled labor force in the areas where labor demand is the highest.
- Job openings are especially high in the construction and health care sectors, showing a lack of available workers in the region's fastest-growing sectors.
- Constraints in key sectors, such as construction, may spill over to other related job categories.
- Action needs to be taken to align the region's labor force with the skills in demand in sectors with a high number of job openings.

THE REGION

is not producing enough GRADUATES or SKILLED LABOR FORCE



The Sacramento region continued its strong labor market recovery in 2017. In fact, the Sacramento region reported a 3.23% increase in jobs over the past year, more than doubling the rate of growth for California as a whole. The rate of job growth is important because it is highly correlated with the rate of growth in the region's economy. On average, a 1% increase in employment will lead to a greater than 1% increase in overall economic output.

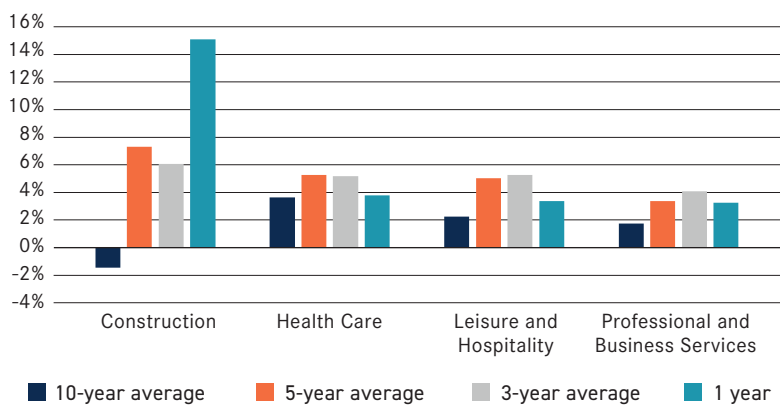
	Sacramento	California
1 Year	3.23%	1.55%
3 Years	8.74%	7.30%
5 Years	14.43%	13.45%
10 Years	6.21%	9.09%



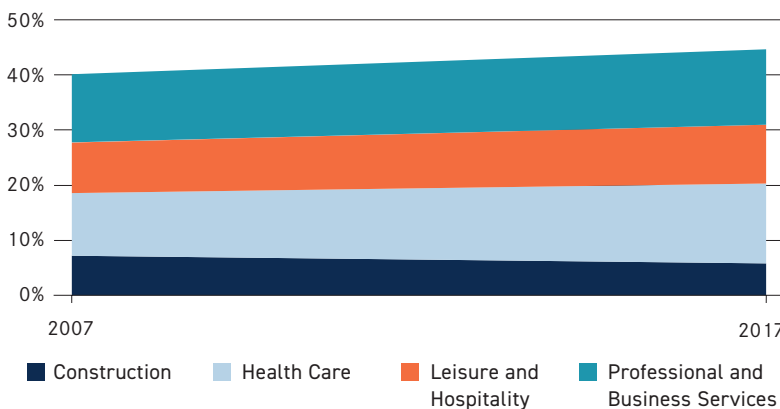
CONSTRUCTION JOBS
report the
highest growth rate

In particular, the region has continued to report strong growth in four key segments of the labor market in the non-government, non-farm sector: construction, health care, leisure and hospitality, and professional and business services. Health care employment has increased from accounting for 1 out of every 9 local jobs 10 years ago to 1 out of every 7 jobs today. Meanwhile, construction jobs have decreased from approximately 1 out of every 14 jobs 10 years ago to just 1 out of every 17 jobs today. However, construction jobs have reported the highest growth rate over the past 1, 3, and 5 years as the construction industry has rebounded from the great recession.

Occupational Annual Growth Rates



Share of Sacramento Labor Market





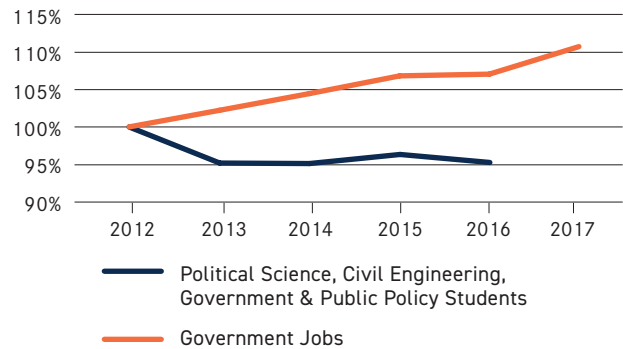
Labor Markets & *Regional Economy*

As we have highlighted in the past, one of the biggest challenges facing the Sacramento region is the skills mismatch between employment training and job growth. While the numbers of construction, health care, and business and professional services jobs has increased, the number of local graduates earning degrees in related fields has not kept pace. In addition, government jobs, which account for approximately 1 in 4 local jobs, have outpaced the number of graduates in related degree programs.

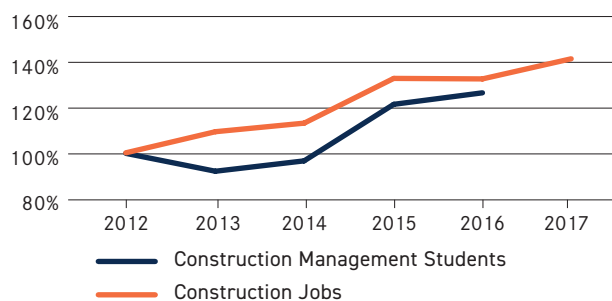
Of course there are other areas where the number of degree candidates is growing more rapidly than the number of available jobs. For example, the region is not creating enough business, engineering, education, or IT related jobs to keep the graduates with related degrees in the region. Instead these graduates must compete for the few jobs

available or relocate to regions such as the San Francisco Bay Area to find employment. This mismatch may represent a significant lost opportunity for the region.

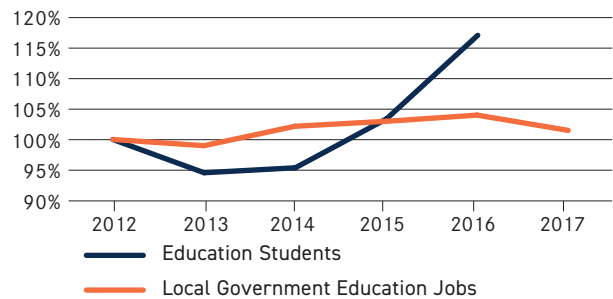
% Change in Degrees and Jobs – Government



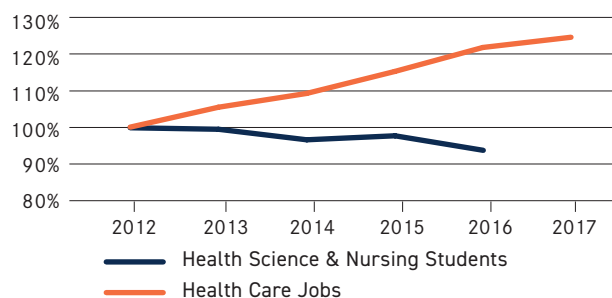
% Change in Degrees and Jobs – Construction



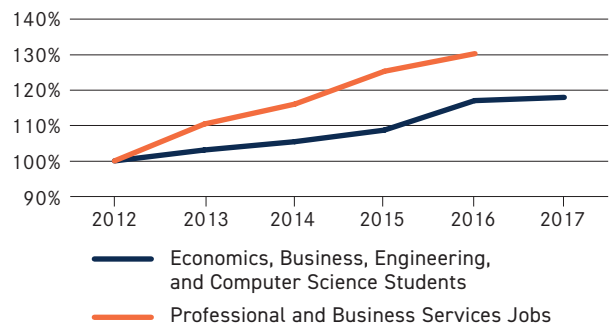
% Change in Degrees and Jobs – Education



% Change in Degrees and Jobs – Health Care



% Change in Degrees and Jobs – Professional & Business Services



In our view, the job recovery in the Sacramento region following the great recession is now complete.

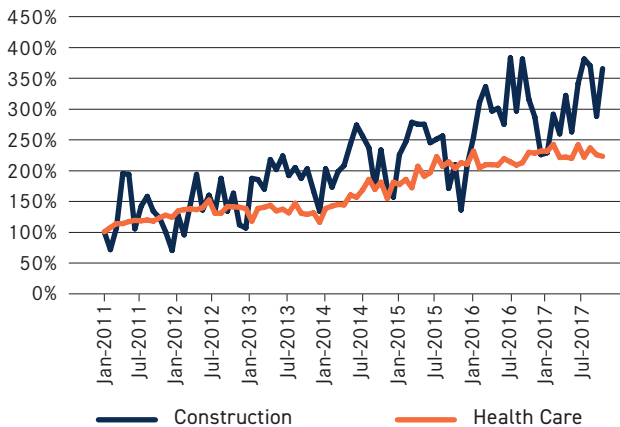


The skills mismatch may be a major inhibitor to the growth of the Sacramento job market. National data shows that job openings in construction and health care industries have increased sharply over the past seven years (Construction = 366% and Health Care = 224%). While similar regional data are not available, evidence suggests that construction and health care job openings are also high in the Sacramento region. For example, a report published by the Employment Development Department (EDD) listed registered nurses and construction laborers among the occupations with the most job openings in the Sacramento region. In addition, many health care and construction occupations top the list of the fastest-growing occupations in the Sacramento region. The availability of labor to fill these occupations may be the

greatest constraint to the Region's labor market growth in the future. According to the EDD, the top 10 fastest-growing occupations in Sacramento have an average median income of \$54,000 and mostly demand vocational education, whereas in Silicon Valley the top 10 fastest growing occupations are mostly technology or health care jobs that require undergraduate and graduate degrees and have an average median income of \$103,000.

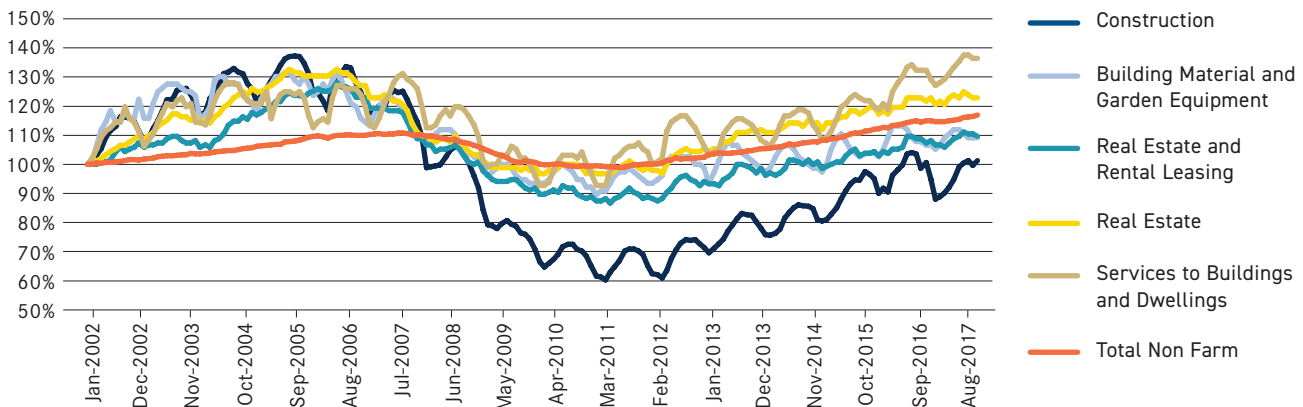
For example, if we drill down to take a more detailed look at the real estate sector, we see that construction jobs have increased at a fast pace in recent years but still lag other job categories related to real estate. Should construction jobs continue to be difficult to fill, it could constrain job growth in these other areas, such as building material and garden equipment, real estate and rental leasing, and real estate sales.

% Change in National Job Openings – Construction & Health Care



In our view, the job recovery in the Sacramento region following the great recession is now complete. Therefore, for the Sacramento region to continue to report strong job growth an effort must be made to match the labor force to the jobs available. An investment in the job skills in demand in the health care, construction, and public sectors may pay big dividends for the region. Conversely, a failure to adapt the labor force to the employment market may lead to a continued increase in job openings and a slow pace of job growth in the region. In 2018 we expect a steady, sustainable but not spectacular growth for Sacramento's job market and regional economy.

Real Estate Related Jobs



SBR/SAFE CREDIT UNION Consumer Sentiment *Survey*

KEY POINTS


- Compared to national data, regional consumer sentiment is less optimistic overall and less positive about current economic conditions.
- Regional respondents, however, are more optimistic than national respondents about expected economic conditions over the next 5 years.
- Although lower than the national data on some measures, consumer sentiment in the region remains positive in absolute terms.
- Expectations for business conditions in the region over the next year remain positive, with more than 3 out of 4 regional respondents predicting conditions will remain the same or improve over the coming year.
- One-third of regional respondents believe their personal economic situation has improved over the past year, with another 1/2 of respondents indicating their personal economic situation has remained the same over the past year.
- Nearly 44% of regional respondents believe their personal economic situation will improve over the next five-year period, with only 14% believing their personal economic situation will be worse in 5 years.

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 vs. National Sentiment

The SBR team once again compared regional sentiment with national sentiment measures with the results shown in Table 1. To measure sentiment, we utilized questions from the University of Michigan Consumer Sentiment® survey that were adapted to specifically address the Sacramento region. Per methods used by the University of Michigan survey, we calculated the following three indices for the region and compared them to the national data.




(1) Index of Consumer Sentiment: An overall measure of how consumers assess their own personal economic prospects and broader regional or national economic conditions.

 Regional respondents were slightly less positive in general about their own economic prospects as well as the Sacramento region's economy compared to the national respondents' perceptions of their own economic prospects and the U.S. economy overall.




Regional respondents are relatively less optimistic now and therefore may look to the future as holding more potential for improvement.


Table 1
Regional vs. National¹

	Regional	National	Regional vs. National Comparison	Interpretation
Index of Consumer Sentiment	92.7	95.9		Overall consumer sentiment is higher nationally than regionally.
Index of Current Economic Conditions	97.7	113.8		Perception of current economic conditions is higher nationally than regionally.
Index of Consumer Expectations	89.4	84.3		Region is more optimistic about economic conditions over the next 5 years.

(2) Index of Current Economic Conditions: A measure of how consumers assess their own personal economic prospects compared to a year ago along with perceptions about the current market for making major household purchases.

 Regional respondents were less likely to report being better off economically than they were a year ago and less enthusiastic about it being a good time to make major household purchases.

(3) Index of Consumer Expectations: A measure of what consumers expect to happen in the future for their own finances and the regional or national economy.

 Regional consumers expressed greater optimism about the local economy's future over the next 5 years than the national respondents did about the U.S. economy over the same period.

There are several plausible reasons that regional respondents are less optimistic about current and overall economic conditions. One could simply be the perception that regional economic conditions have not improved as much as they have nationally in recent years. For example, while median household income has increased in the region over the past 10 years, it has increased at a slower rate than nationally.² Another reason could be the region's political affiliation, which leans Democratic.³ Past national data suggest consumer sentiment is correlated with political affiliation, with lower scores when the respondents' political affiliation differs from the party in office.⁴

Further, it may seem surprising that regional respondents would be less optimistic about current and overall economic conditions, yet more positive about the future. One plausible explanation for this could be that national respondents perceive better economic conditions in the current market and therefore potentially less room for improvement in the future. In contrast, regional respondents are relatively less optimistic now and therefore may look to the future as holding more potential for improvement.

SBR/SAFE CREDIT UNION Consumer Sentiment *Survey*



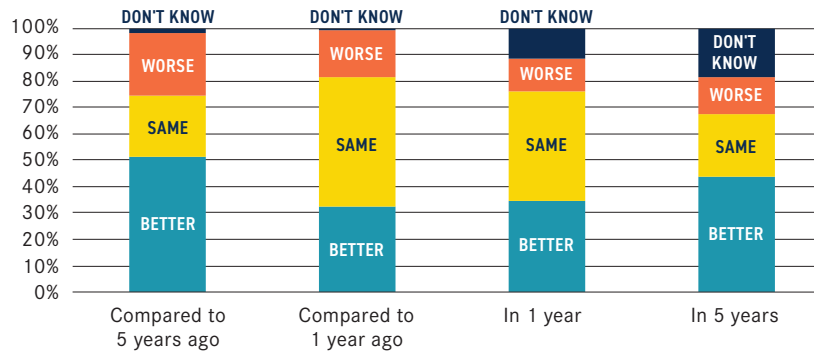
Regional Consumer Sentiment

Still, despite lagging national data on two of the three indices, regional consumer sentiment remains positive in absolute terms. Regional respondents continue to report that their personal economic situation the same or 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). These responses are nearly identical to our 2017 survey results.

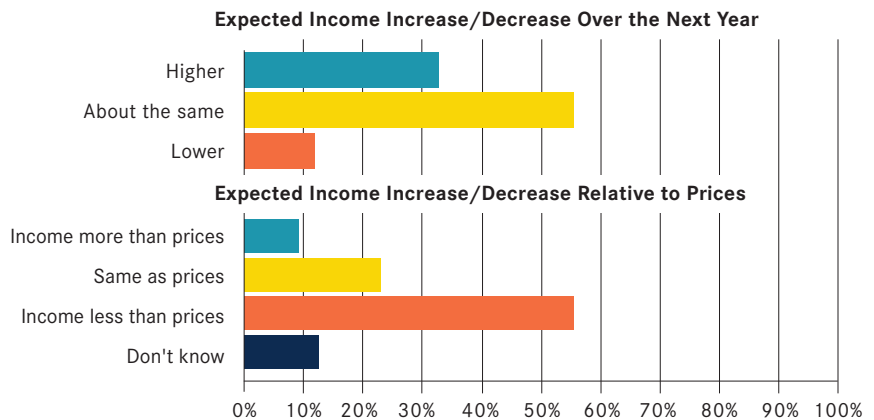
Nearly 33% of regional respondents expect their incomes to increase over the next year, with another 56% expecting their income level to remain the same. However, respondents continue to forecast that any income growth will be outpaced by inflation (See Figure 2).

Respondents' evaluations of regional economic conditions also remain generally positive, with 40% indicating that regional economic conditions have improved over the past year, an increase of 9 percentage points from last year's results. However, compared to last year's results, the number of respondents predicting regional economic conditions will improve over the next year has declined 5 percentage points from 32% to 27% (See Figure 3).

**Figure 1
Personal Economic Conditions**



**Figure 2
Personal Income Expectations**



**Figure 3
Regional Economic Conditions**



58% of regional respondents reported having a **CREDIT CARD BALANCE THIS YEAR**



Purchasing and Credit

We again asked regional respondents about the types of credit they currently hold and their plans to acquire credit in 2018. The patterns of credit usage and plans for acquisition are fairly consistent with those from last year (See Figures 4 and 5).

Endnotes

- ¹ National data obtained from the University of Michigan Consumer Sentiment Survey December 2017 Data, available at: <https://data.sca.isr.umich.edu/>. Indices calculated using the methods specified at: <https://data.sca.isr.umich.edu/fetchdoc.php?docid=24770>
- ² <https://fred.stlouisfed.org/>
- ³ <http://www.sos.ca.gov/elections/report-registration/>
- ⁴ <https://data.sca.isr.umich.edu/fetchdoc.php?docid=59408>

Figure 4
Types of Credit Held

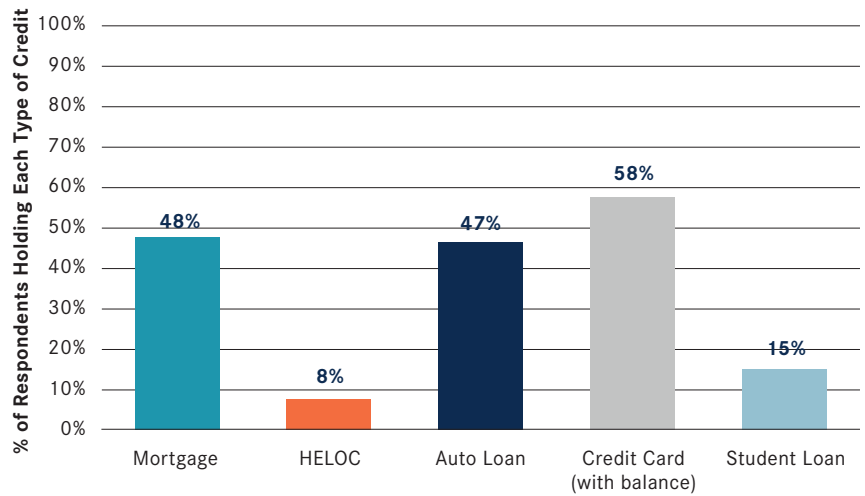
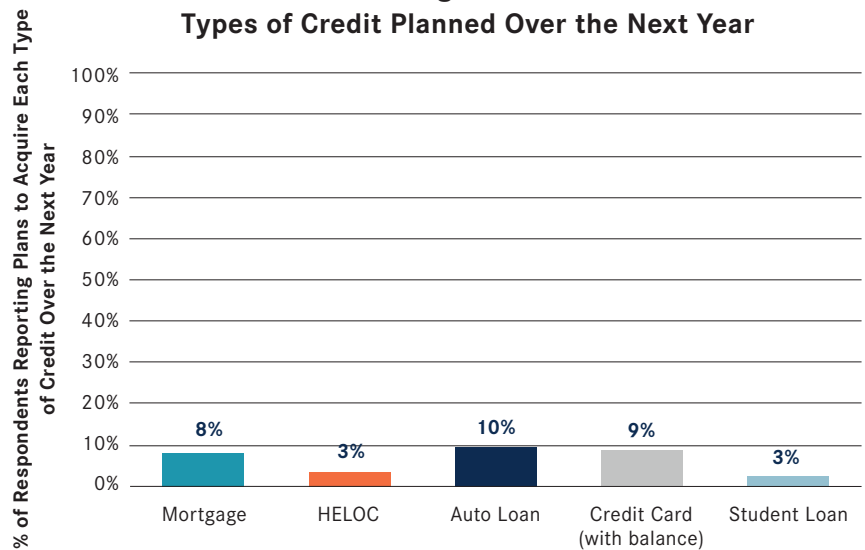


Figure 5
Types of Credit Planned Over the Next Year





The Small Business Economy

KEY POINTS

- Total SBA lending declined slightly on a year-over-year basis, but the overall trend remains positive. Of note, Placer County notched its second year of declining loan volumes.
- SBCI respondents remain very bullish on the local economy, consistent with elevated consumer sentiment. Hiring demand is strong in the manufacturing sector, although perceived credit accessibility appears to be diminishing.
- Business listing and sales activity remains healthy, but average selling prices declined despite higher revenues and stable cash flows of the subject companies.

PLACER COUNTY

second year of declining LOAN VOLUMES

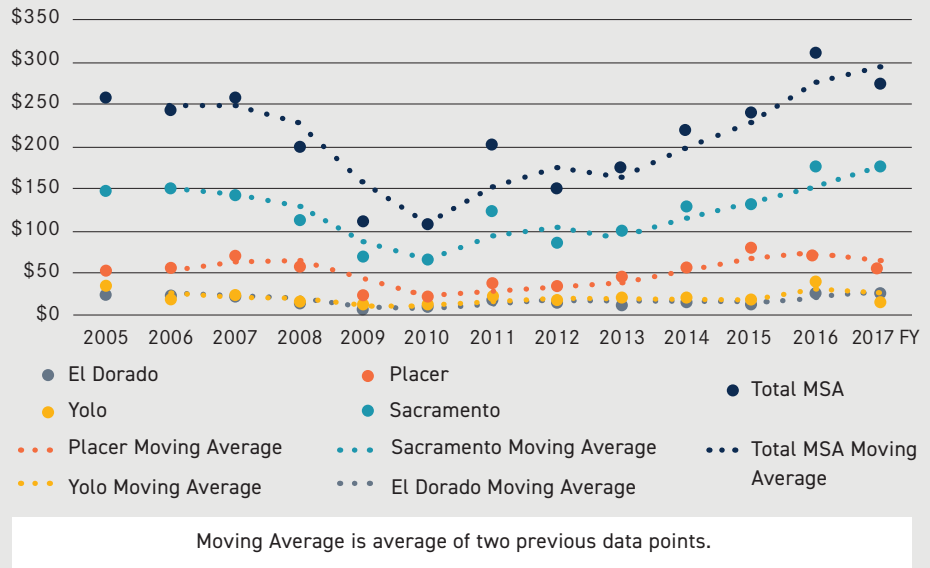


Our semiannual checkup on the small business economy shows that the region remains on a generally positive trend, though late-cycle signs continue to present themselves in various ways. On a year-over-year basis, overall Small Business Administration lending declined, but remains at healthy levels. Lending continues to be dominated by Sacramento County, which registered trend growth this past year. While it's premature for concern, it is notable that Placer County, the second-largest contributor to regional loan volumes, declined for a second year in a row.



Total SBA Loan Approvals By County

(in millions, 2-year moving average)

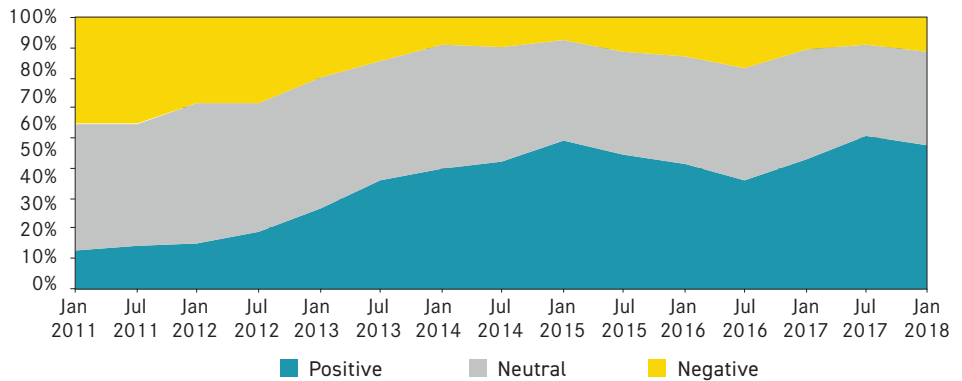


The latest reading of our proprietary Small Business Confidence Index shows that respondents feel positive about the local economy as well as about prospects for future revenue growth.

SMALL BUSINESS

SBCI Overall Sentiment Responses

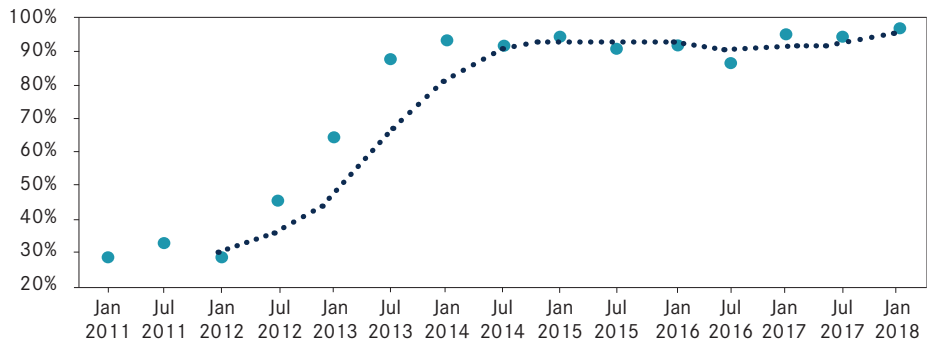
January 2011 – January 2018



The latest reading of our proprietary Small Business Confidence Index (SBCI) shows that respondents feel positive about the local economy as well as about prospects for future revenue growth. These data are also consistent with our proprietary Consumer Confidence Index for 2018. Unfortunately, survey responses indicate that perceived credit accessibility is starting to wane, most noticeably in the manufacturing sector, which is the only area where hiring demand is picking up.

SBCI Total Economic Outlook

(2-year moving average)



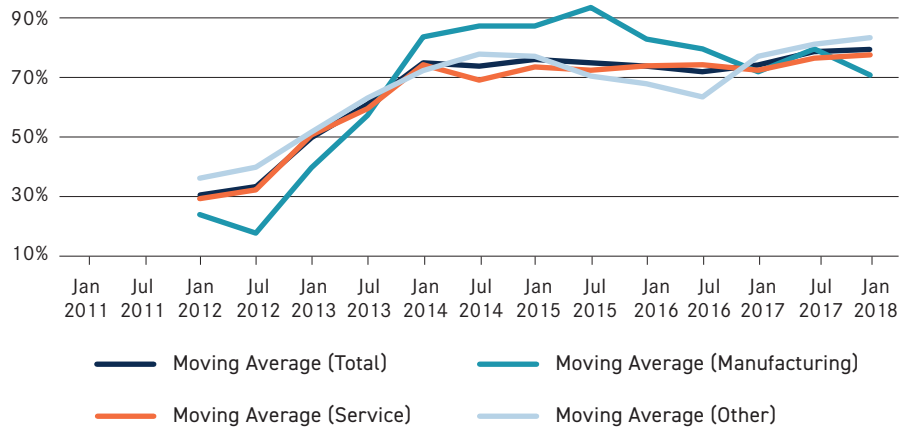


The Small Business Economy

Respondents
Feel
Banks are
Starting to
PULL BACK



SBCI Credit Accessibility by Sector
(18-month moving average)

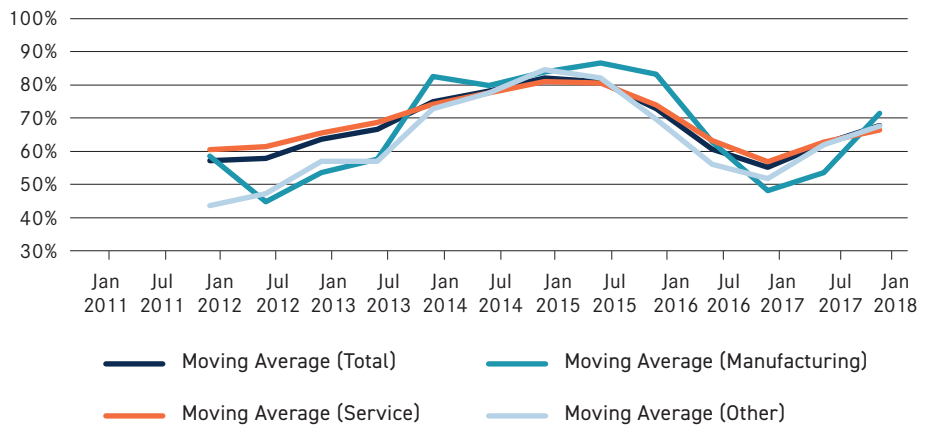


Moving Average is average of three previous data points.

Precisely
When SMALL
Manufacturing
IS HIRING



SBCI Likelihood to Hire by Sector
(18-month moving average)



Moving Average is average of three previous data points.

Business listings and closed sales continue to increase at a strong pace, reflecting a healthy secondary market.

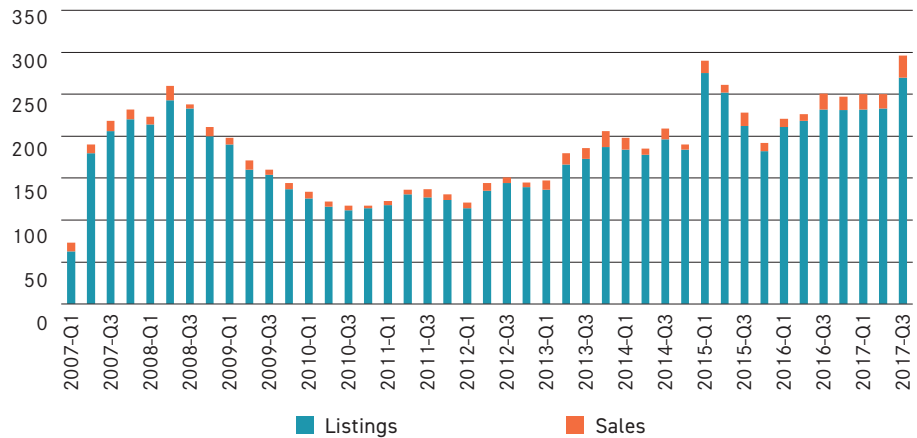


Listing and Sales Activity
REMAIN HEALTHY
 but 2017 Average Sales Prices **DECLINING**



Business listings and closed sales continue to increase at a strong pace, reflecting a healthy secondary market. Though volumes are higher, average selling prices (ASPs) declined on a year-over-year basis. Perplexingly, average selling prices declined while critical financial metrics such as revenue and cash flows remained strong. We doubt aggregate valuations are declining, but the cause of this phenomenon is difficult to determine from one year's readings. We will continue to monitor this activity to see if 2017 was simply an aberration, or the start of a larger trend.

Listings vs. Closed Sales

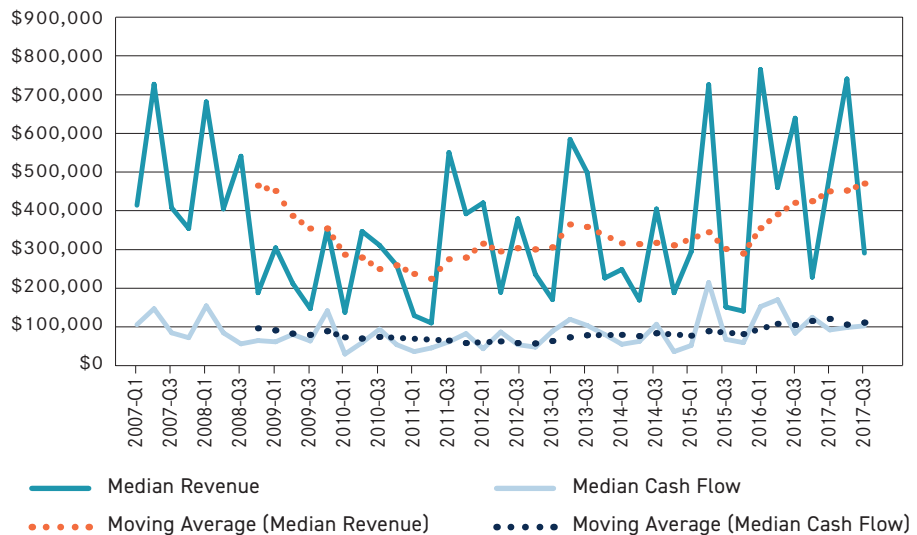


SMALL BUSINESS

Though **MEDIAN REVENUE & CASH FLOWS** of Subject Companies **TRENDING HIGHER**



Median Revenue & Cash Flow of Transactions
 (2-year moving average)



Moving Average is average of eight previous data points.

Real Estate



KEY POINTS

- Vacancy continues to decline and rental rates are increasing in office and industrial properties.
- Class A properties in all property types have seen the most significant increases in rates and the greatest amount of leasing activity, causing a constraint in supply.
- The resultant lack of supply in Class A properties has provided a boost in rental growth for Class B and C properties.
- Investor demand remains high, while supply is limited.
- Speculative construction is still limited in office and industrial, but with continued increases in rent we inch closer to a point where developers can rationalize building.
- A tight labor pool along with regulatory compliance, permits and fees are key barriers to allowing for more speculative construction.
- Median home prices will continue to increase but may be more tempered than last year.

The Sacramento region, which was one of the last areas to recover from the last downturn, has until recently remained relatively affordable. While we are still a bargain compared to the Bay Area, our commercial rental rates across all property types have seen significant increases recently, particularly in industrial properties.

The question for most of the residential and commercial markets relative to construction is: When do we reach the inflection point where rents or sales prices become high enough to justify new speculative construction? A good percentage of new commercial construction has been built with at least a portion pre-leased. In simple terms, every \$10 per square foot in construction costs equates to a developer requiring an additional \$0.06 – 0.07 per square foot per month in rent. With that in mind, rents either need to continue to climb or costs need to come down through regulatory relief or adding adequate labor force.

It is a balancing act and one that our region needs to look at closely if we are going to succeed long term.

Office

Office continues to rebound and is currently experiencing its best performance in a decade. Overall net absorption (the total gain in leased space) for 2017 was approximately 740,000 SF resulting in a vacancy rate at year end of 9.6% overall, which represents a reduction of 0.8% since the end of 2016, and the lowest vacancy rate in 17 years.



OFFICE



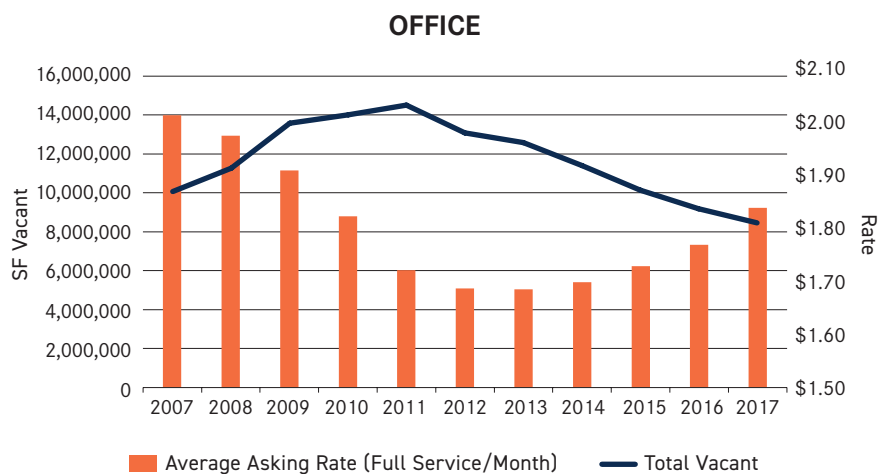
Large blocks of space will
CONTINUE TO SHRINK



MIDTOWN IS “HOT”
among the tech,
entrepreneurial,
start ups & other
business owners



Downtown rents
WILL CONTINUE TO
CLIMB



With such positive news and shrinking of available space, average asking rents continue to increase. The overall Class A asking rents for the entire Sacramento area are averaging \$2.21 PSF, which remains far below its peak in 2007 of \$2.48 PSF.

These gains in rent, however, have not been enough to spur any significant speculative office construction. Of the 650,000 SF of space under construction, 500,000 SF is built to suit (the two largest projects are Adventist Health and a new Kaiser medical office building in Roseville). For significant new speculative construction to take place, there would have to be an approximate 20% increase in rents.

That said, larger blocks of space are becoming scarce with less than 25 Class A buildings having units with a size greater than 20,000 SF.

What to expect in 2018:

- Large blocks of space will continue to shrink.
- Tenants are still trying to get their space-per-employee ratios down, which is driving the need in suburban offices for better parking ratios. This is one reason that some older offices with less than ideal parking are still available.
- Hours of operation for tenants in full-service leases is a topic discussed more often as some companies need the flexibility to operate outside of traditional business hours.





- Companies still want to buy properties to occupy as prices and rates are still relatively attractive, but supply is constrained.
- Midtown is "hot" among the tech, entrepreneurial, start ups and other business owners looking for a "hip" alternative. Rates and prices in this submarket are soaring and supply is limited.
- Speaking of tech companies – there have only been a trickle of new companies moving to the area and options for these companies seeking "edgy" space are limited.
- Health care, government and financial sectors are still the fastest-growing in the area.
- As Downtown rents continue to climb and options become limited some companies will flee to the suburban submarkets.

Nationally there were 36 major retail bankruptcies in 2017, up from 26 in 2016.

Retail

Nationally there were 36 major retail bankruptcies in 2017, up from 26 in 2016. While there may be fewer in 2018, the likelihood is that they may be greater in their impact simply because they may include a few large and iconic retailers and department store chains. The largest

new shopping center to come online last year was Delta Shores in the South Sacramento submarket. Because this project was largely pre-leased, it was a major driver of occupancy growth in Q4 (over 550,000 square feet). Meanwhile, significant remodels and repositioning efforts (such as the Howe bout Arden project) drove activity throughout much of the year. Downtown Commons and the Ice Blocks projects continue to shape the Downtown/Midtown's renaissance, attracting new tenants and concepts that have not been seen in our region before.

What to expect in 2018:

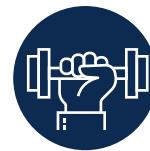
- National level bankruptcies and strategic closures could have some impact to the local retail market.
- Sacramento will largely escape the increasing trend of mall closures; primarily because the region already has gone through a consolidation (10 years ago there were six regional malls in the region, now there are half that).
- Expect frantic M&A activity among retailers and retail REITs; stock values have been hurt for solid operators along with troubled ones and this is creating opportunity for investors looking for values.
- While boosting the amount of tenancy dedicated to food, beverage & entertainment tenants, landlords need to exercise caution – these retailers rely heavily on discretionary spending, which could especially become an issue in the next economic downturn for weaker concepts or players.

- Fitness concepts continue to be in expansion mode, ranging from large-format health clubs to small, niche health concepts (spin, kickboxing, yoga, dance-based, etc.)
- E-commerce will continue to put a strain on physical retail even as more pure play online retailers start to open bricks-and-mortar stores.

RETAIL



National level bankruptcies could impact THE LOCAL RETAIL MARKET



FITNESS CONCEPTS continue to be in expansion mode



E-COMMERCE continues to put strain on physical retail

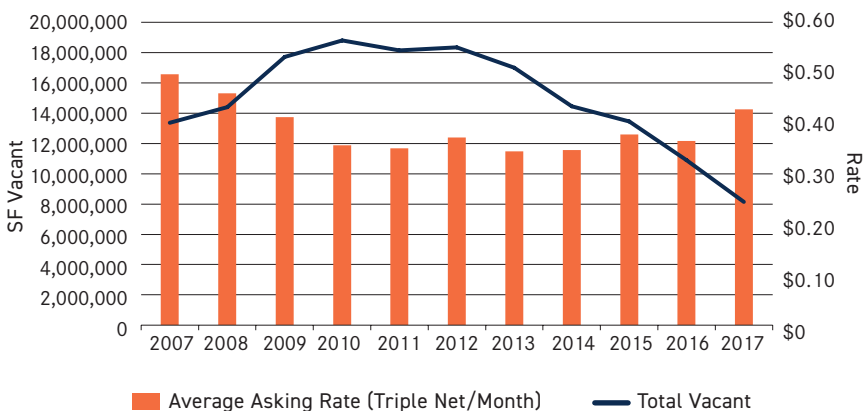
Industrial

Industrial continues to be the asset class outperforming all other property types. Net absorption for warehouse space in 2017 posted a record 4.3 million SF of which 855,000 SF was a result of the new Amazon distribution center near the airport. This absorption rate is 1.4 million SF above the record set in 2006.

As a result, vacancy is at a low of 5.8%, representing a 200 basis point decrease from 4th quarter last year and a 6-year trend of declining vacancy. With legalized marijuana use now allowed, there has been a run on properties in designated areas in the city of Sacramento that have priced many conventional tenants out of the market and further constrained supply. Also, with the sale of 6.5 million SF of industrial buildings from Westcore to Gateway Industrial (Blackstone) there is going to be further pressure to push rents upwards by this institutional ownership with other landlords likely following suit.

Most speculative construction has been limited to Southport Industrial Park where a combination of the basis in the property and incredibly low development fees have allowed building to take place and the developers to achieve an adequate return. There are build-to-suit projects taking place in Southport for Veritiv and Roseville for McKesson as a result of expansion and consolidation (and the lack of ability to find adequate existing property in the market for their needs).

INDUSTRIAL



What to expect in 2018:

- Tenants in Class A properties who negotiated a good deal in the downturn may find that their renewal rates could increase by up to 40% or more. Given limited other available options there may be a trend to renew versus relocate.
- E-commerce and supporting users will continue to expand and flourish in Sacramento.
- With vacancy at record lows and rates climbing to pre-recession levels, expect more speculative construction in 2018 likely exceeding 1 million SF from several well-known local developers.
- Smaller units and buildings with yard are increasingly difficult to find, with multiple offers.
- Marijuana cultivation deals will continue to further constrain available space and drive prices upward.

INDUSTRIAL



E-COMMERCE
will expand and flourish



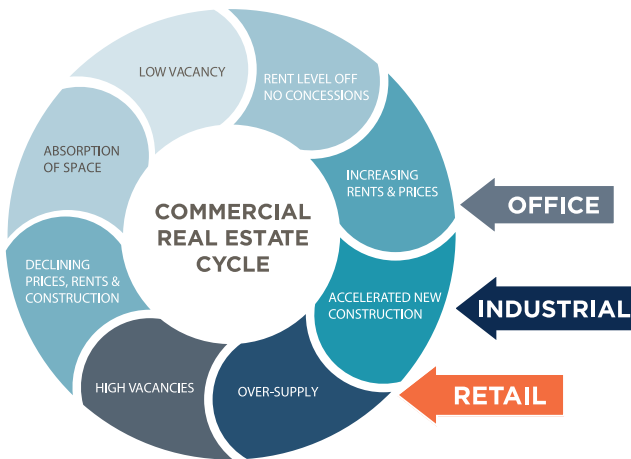
MORE SPECULATIVE CONSTRUCTION in 2018



MARIJUANA CULTIVATION
constrain available space and drive prices upward



	OFFICE		RETAIL		INDUSTRIAL	
	2017	2018 Forecast	2017	2018 Forecast	2017	2018 Forecast
Vacancy	↓	↓	↓	↔	↓	↓
Net Absorption	↓	↑	↑	↔	↑	↔
Avg. Lease Rates	↑	↑	↓	↔	↑	↑
Under Construction	↑	↔	↑	↔	↑	↑



Investor sales

Investment sales remain strong with the biggest issue being an increased amount of capital chasing a decreased supply. Out-of-town investors, unable to achieve adequate yield in core markets, continue to scout the region for Class A product. Conversely, local and regional investors are seeking value opportunities in the area. Virtually all properties are trading at a discount to replacement cost.

Leading the pack in desirability is multi-family with investors scooping up Class A properties at record prices and cap rates for our region. Industrial properties are another desired asset class but one that has limited supply.

Sale/lease-back opportunities seem to be on the rise with companies selling off their assets and leasing back properties to invest their cash in their respective businesses.

Single tenant properties with credit tenants are securing much higher values than a year ago. Multi-tenant projects,

which are still trading below replacement cost, have increased on a price per SF basis, which takes into account the increased rental rates.

Residential

The Sacramento region was one of the top housing markets nationally in both price and rent increases in 2017. While beneficial for homeowners and landlords, it also means that housing became less affordable for both homebuyers and renters.

The median house price in the Sacramento region was \$385,000 at the end of November 2017, representing a 10% increase from December 2016 and only 8% from the pre-recession peak. As of November 2017, the average price per square foot for single family homes in the region was \$225. Total sales volume in the region for 2017 was similar to 2016 at approximately 41,500 homes sold. Homes in the lower price ranges are sold within a couple days compared to homes over \$1 million that in some cases sit for months.

As home prices rise, homebuilders typically increase production of new homes. While new home sales increased 10% in 2017 over 2016 to approximately 5,370 units, this number pales in comparison to the 15,000-unit-per-year average in 2002-2006.

The Sacramento region was one of the top housing markets nationally in both price and rent increases in 2017.



So what is different in this cycle?

- Consumer lending – Loans and credit availability are tighter (The buyer actually needs to qualify legitimately).
- Business lending – Lenders are scrutinizing the viability of new projects more closely.
- Labor force – Availability of construction workers is tight, driving labor costs upward and extending construction schedules.
- Regulatory environment – Although some jurisdictions are attempting to streamline processes to allow for more granny flats, overall the regulatory environment is extending timelines and increasing costs, making many projects not viable and not allowing housing to be created at the pricing levels to match the market needs.
- Cost of construction – As a result of these other factors, the overall cost of construction has gone up.

The result:

- Affordability is becoming a problem. Less than 1 in 10 homes sold in 2017 were under \$200,000, while more than 4 in 10 were above \$400,000, making the prospect of homeownership unrealistic for many lower- and middle-income households. Without wage growth or relief on construction costs, the problem will be exacerbated.

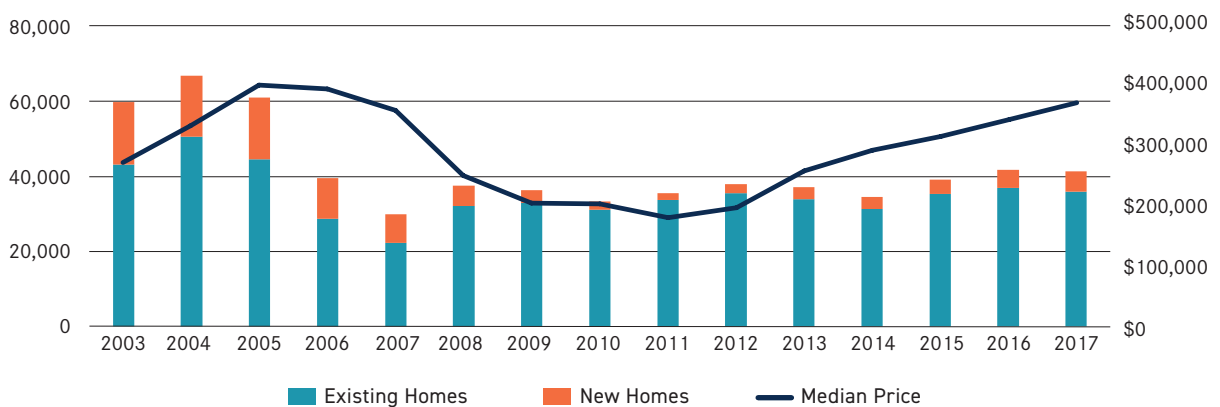
buyers is unlikely to disappear. Second, a “speculative bubble” requires lots of speculation, which we have not observed in this cycle. We expect the demand to remain strong, and the supply to increase only modestly. The combination of these two factors would normally lead us to predict an 8-10% increase in house prices in 2018.

2018 outlook:

Given that Sacramento has joined most of the other major California markets on the list of the hottest housing markets in the United States for 2017 and the fact that the median prices in 2017 are approaching the 2005 peaks, some have started to express concerns about another housing bubble. While we acknowledge the rapid run-up in house prices over the past 2-3 years, we do not believe there is a serious threat. First, the demand from Bay Area

However, the tax legislation that was recently signed into law, which limits the deductibility of both property taxes and mortgage interest, will increase the cost of homeownership, particularly at higher price ranges. Additionally, there is a chance that mortgage interest rates could increase, which would put additional pressure on affordability. With permit issuances up 36% last year, we expect new home sales to rise (assuming that the builders can find labor to get them built). We expect a modest, 3-5% increase in house prices in the Sacramento region this year.

New Home Sales vs. Existing Home Sales vs. Median Sale Price (All Homes) – Sacramento MSA



Capital Markets & Banking

Forecast

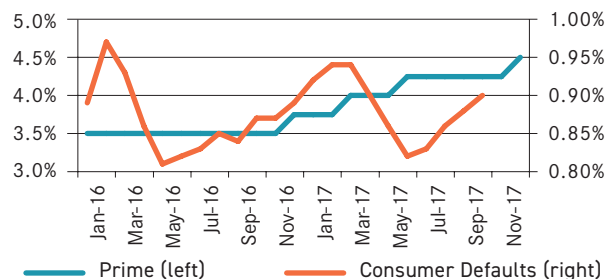


KEY POINTS

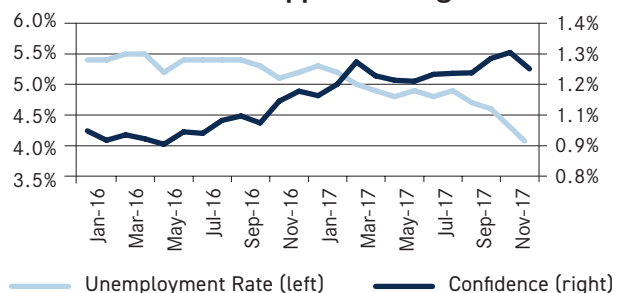
- Cautious optimism continues to be the prevailing theme for capital markets.
- Corporate tax cuts combined with low unemployment and high consumer confidence suggest corporate earnings may live up to the lofty valuations seen in the stock markets.
- The Fed's ability to accurately gauge labor market slack and inflation expectations will be key to future economic growth; monetary policy that is too aggressive could hinder growth in a hurry, but gradual rate hikes still appear to be the most likely course of action.
- Loan growth is still expected for the Sacramento region, albeit at a slower pace relative to 2017; financial institution net-interest-margin improvement will depend largely on how aggressive the aggregate deposit pricing response is to more Fed hikes.
- The SBR Financial Conditions Index shows 2017 was another strong year for Sacramento; positive trends are expected to continue into 2018.

At the start of 2017, the SBR team was faced with two apparent but divergent themes for capital markets: Positive trends such as high consumer confidence and low unemployment suggested an opulent 2017, while worsening consumer default trends coupled with the prospect of rising interest rates signaled that perhaps the credit cycle had run its course. Looking back, it is obvious that the positive trends took hold and helped to make 2017 a prosperous year for many; however, similar trends are apparent once again as we head into 2018.

Rising rates and consumer loan defaults still a concern for 2018



Low unemployment and high consumer confidence support 2018 growth

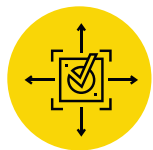




ECONOMY
GLOBAL GROWTH
 is well set to continue
 through 2018



STOCKS
 U.S. markets
 are likely to
 KEEP THE LEAD IN 2018



BONDS
 Long-term rates
 are likely to
 REMAIN IN CHECK

Market	Forecast	Comment
Economy		
Global Growth		Global growth is well set to continue through 2018 with India and China taking the lead.
U.S. Growth		U.S. growth will be sustained through 2018 by capex, low unemployment, higher wages, strong consumer spending. Fed's monetary policy should help to keep economy from overheating.
Eurozone		Modest growth is likely to continue, Eurozone moving towards the height of its economic expansion in 2018, but hard Brexit can still lead to trade disruptions.
Emerging		Strong growth seen in 2017 to continue to be led by India, Brazil, and Russia; China to maintain stable growth.
Global Inflation		Global inflation is likely to stay in healthy range, Japan turning around the deflation cycle.
Stocks		
Regions	U.S. > Rest of World	U.S. markets are likely to keep the lead in 2018, with European growth possibly being already priced in by stock markets, and Chinese markets being under pressure of growth slow down and regulatory restrictions on credit growth and production in areas of overcapacity.
Sectors	Materials, IT, Consumer Discretionary	Global demand will aid the materials sector performance, capex - in productivity improvements for the IT industry, wage growth and strong consumer sentiment will continue driving the consumer discretionary performance.
Bonds		
Regions	U.S. > Rest of World	Long-term rates are likely to remain in check due to central banks of Europe and Japan continuing U.S. example of keeping their rates low to boost local economies. Fed can control short-term rates, but the long-term rates can remain low as European and Japanese investors push the long-term U.S. bond prices higher.
Sectors	U.S. Financials	U.S. financials to benefit from higher rates depending on their ability to keep deposit rates low, but watch out going into 2018; corp. credit deterioration could threaten bank earnings.
Commodities		
Sectors	Oil & Metals	Commodities stand to benefit from the continued global growth, oil prices likely remain flat if OPEC keeps to the production constraints and U.S. shale oil production does not over flood the markets.

CAPITAL MARKETS & BANKING



Capital Markets & Banking *Forecast*

The strong consumer and the prospects and eventual passage of tax reform helped stock markets outperform our low- to mid-single-digit forecast. Key indices logged hefty gains with the Dow and S&P 500 growing by 25% and 19%, respectively, and longer term government bonds ended the year about even with the yield on the U.S. 10-year note down 3 basis points from 2.44% at the start of 2017 to 2.41%.

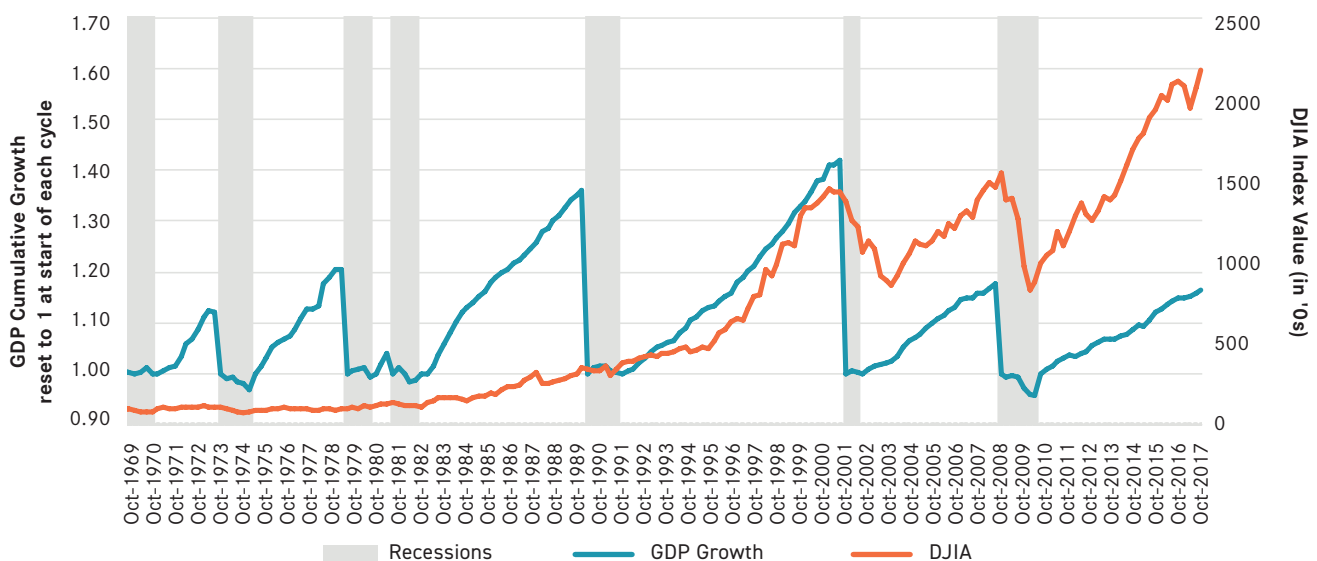
How much longer can it last?

The expansionary cycle that began in 2009 has now completed its 35th quarter of growth, and at this rate, the current cycle will likely be the longest on record with just over a year to go to match the boom we saw in the 1990s.

One of the reasons that the current expansionary cycle may be the longest on record is that growth has been rather tepid relative to past cycles and this lower, more steady, growth has helped the economy to avoid the boom/bust type behavior that typically leads to shorter cycles. Real GDP has grown at a modest 2.1% annual rate, although you would not be able to tell by stock market performance with the annual return on the Dow averaging just over 10%.

Years of Economic Expansion	1971-1973	1975-1979	1982-1989	1991-2000	2001-2007	2009-present
Length of Expansion Cycle, Quarters	11	16	29	39	24	34
Annualized GDP Growth	4.2%	4.8%	4.3%	3.7%	2.7%	2.1%
Annualized DJIA Return	4.5%	3.48%	17.6%	14.7%	5.4%	10.1%

DJIA vs. GDP Growth



Data Source: U.S. Bureau of Economic Analysis, Real Gross Domestic Product, and S&P Dow Jones Indices LLC, Dow Jones Industrial Average retrieved from FRED, Federal Reserve Bank of St. Louis.

Low unemployment, wage growth and a confident consumer should lead to steady GDP growth readings for 2018.

Cumulative stock market growth in the current economic expansion has greatly surpassed GDP growth, and our team once again cautions the investor to watch for overinflated stock prices relative to corporate earnings and GDP growth. We expect stock market returns to land somewhere near their longer term average of 10% in 2018.

Tailwinds to keep it all going

Low unemployment, wage growth and a confident consumer should lead to steady GDP growth readings for 2018. With the recent tax reform, the corporate tax rate has gone from 35% to 21%, which should flow directly to corporate bottom lines. If tax reform does encourage corporate cash repatriation, it will bring additional cheap capital for corporate expansion projects and even higher levels of employment.

**DOMESTIC
MONETARY
POLICY**

**BIGGEST
risk factor for
CAPITAL MARKETS**

Risks that threaten all the fun

No segment of either the domestic economy or the economy abroad appears to be an imminent threat to financial markets. With that said, we do see domestic monetary policy as the biggest risk factor for capital markets, given the Federal Reserve's admitted difficulty in assessing labor market slack and the conundrum with persistently low inflation. Should the labor market end up being tighter than expected, markets would react harshly as they repriced inflation risks and the pace of policy normalization. However, even without wage growth, we are starting to see inflationary pressures build due to the recent uptick in global oil prices. After hitting a 2017 low of \$44 in June, a barrel of Brent crude demanded over \$66 at the start of 2018, a 50% increase for the second half of the year. Other potential risks from abroad include a hard Brexit or North Korean military action, with the main impact of either leading to a disruption in global trade and severely inhibiting the positive momentum gained by global markets over the last year.

Speaking of the Fed

The Fed raised rates three times in 2017, and according to the infamous "Dot Plot" three additional interest rate hikes are in the works for 2018. In October of 2017, the Fed officially started its balance sheet normalization process in order to whittle down the \$4.5 trillion of securities it amassed as part of its quantitative easing efforts. Under the current plan, the Fed will eventually cease reinvestment of \$50 billion per month of both Treasuries and agency mortgage backed securities. While the Fed's rate decisions have caused the short end of the yield curve to move up, the longer end has remained low, largely due to investor demand from abroad. The balance sheet normalization process coupled with improved economic prospects abroad and higher inflation expectations should lead to the longer end of the yield curve moving upward as well.

What do higher interest rates mean for the markets and financial institutions?

With higher rates, we predict a moderate drop in mortgage lending given the reduction in affordability for a region that has already seen significant appreciation in home values. A lower numbers of qualified loan applicants might nudge financial institutions towards demanding less in terms of credit quality (though we do not predict this to become a noticeable issue). For financial institutions, we believe higher rates present a opportunity for higher net interest margins and stronger bottom lines in the coming year, as long as the longer end of the curve starts to increase more rapidly. We expect longer term Treasuries to end 2018 somewhere in the range of 75 basis points higher than where they begin the year, as growth abroad entices investment flows out of the U.S.

Regulatory relief?

The current administration made it clear that they will try to dismantle the Dodd-Frank Act. Deregulation will help banks reduce some of their compliance related costs, but we are not likely to see it in 2018 for a couple of reasons. A comprehensive regulatory package is not likely to pass in the current, polarized political climate. And, any agreed-upon changes that may go into effect will take time to get implemented and are not likely to show up in 2018 bottom lines.



Local financial institution performance

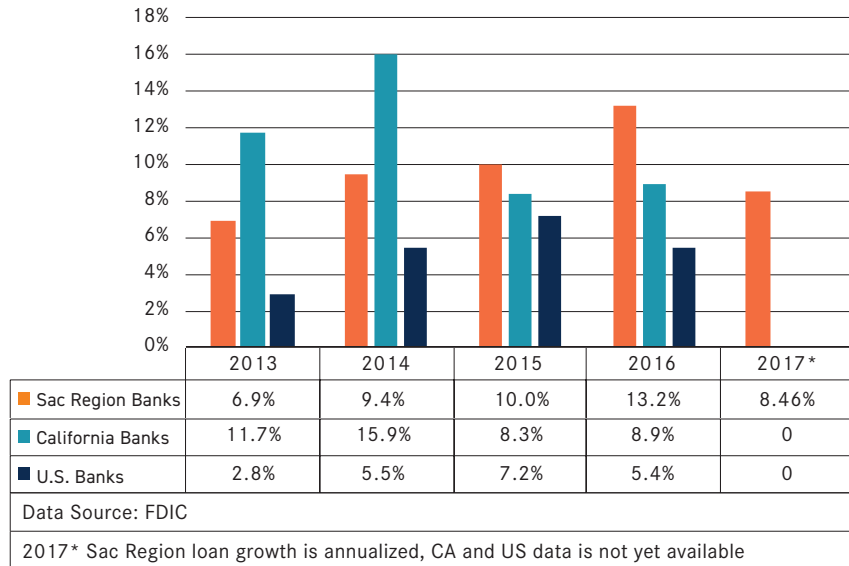
Sacramento region banks and credit unions have fared well compared to aggregate state and national financial institutions and had another year of solid loan growth. Loan growth did slow in 2017, as the SBR team predicted last year. Loan growth for Sacramento banks was down from 13.2% to 8.5% year-over-year, and loan growth for credit unions was down from 24.7% to 14.5%.

Our team believes that positive loan growth will continue into 2018 for the Sacramento region financial institutions, albeit at a slower rate relative to 2017 as higher interest rates lead to reduced demand. Real estate and auto loans dominated the loan market in the region, hence, the SBR team believes that rising interest rates will leave a noticeable negative impact on the region's loan growth.

In the previous issue, we cautioned to watch out for increased delinquencies in over-extended amounts of auto loans. As of now, the auto delinquency rates are still low and in line with previous quarters. Nevertheless, we still expect the delinquencies to continue trending upward.

In spite of the slowdown in loan growth, Sacramento financial institutions had a strong uptick in net income with net interest margins on the rise helping to negate any other

Aggregate Loan Growth | Sacramento Region California & U.S. Banks



Loan Growth by Category | Sacramento Region Banks September 2017

% of Total 2017	Category	Annual % Growth, 2016	YTD Annualized % Growth, 2017
47.5%	Commercial Real Estate	17.3%	12.9%
19.2%	Residential	1.1%	8.9%
9.6%	Commercial & Industrial	8.9%	10.1%
6.4%	Multi-family Residential	54.3%	3.1%
4.3%	Construction Loans	14.1%	-3.3%
13.0%	Other	6.9%	-1.6%
100.0%	Total	13.2%	8.5%

Data Source: FDIC

Loan Growth by Category | Sacramento Region Credit Unions September 2017

% of Total 2017	Category	Annual % Growth, 2016	YTD Annualized % Growth, 2017
53.5%	Auto Loans	32.9%	23.0%
36.7%	Residential/RE Lines of Credit	17.8%	6.4%
8.0%	Credit Card/Unsecured	14.2%	5.8%
1.8%	Other	23.9%	-4.5%
100.0%	Total	24.7%	14.5%

Data Source: NCUA

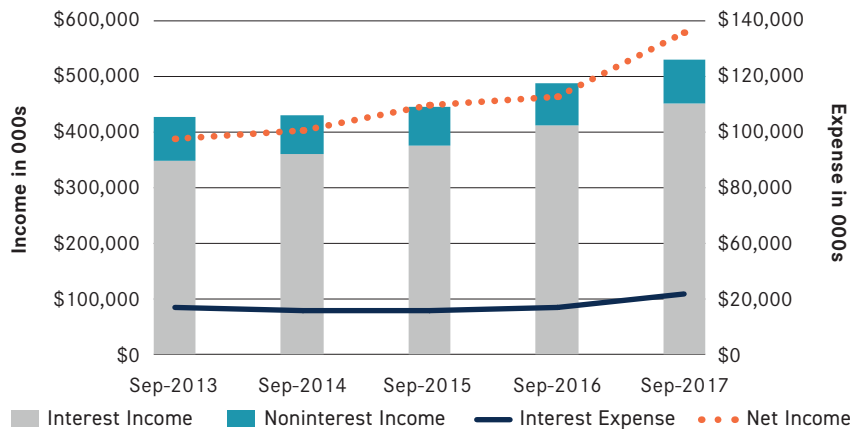
shortfalls. Even though net interest margins are expected to continue to rise in 2018, the SBR team projects that Sacramento region financial institutions net income growth will be low to moderate due to slowing loan growth and an increase in interest expense.

We believe that Sacramento region financial institutions are in a stable position with a number of expected positive environmental changes to keep a steady increase in net incomes (rising interest rates and net interest margins, likely relaxation of some of the post 2008-crisis regulations, and technological innovations that will allow small banks to bypass the need for expensive in-house solutions).

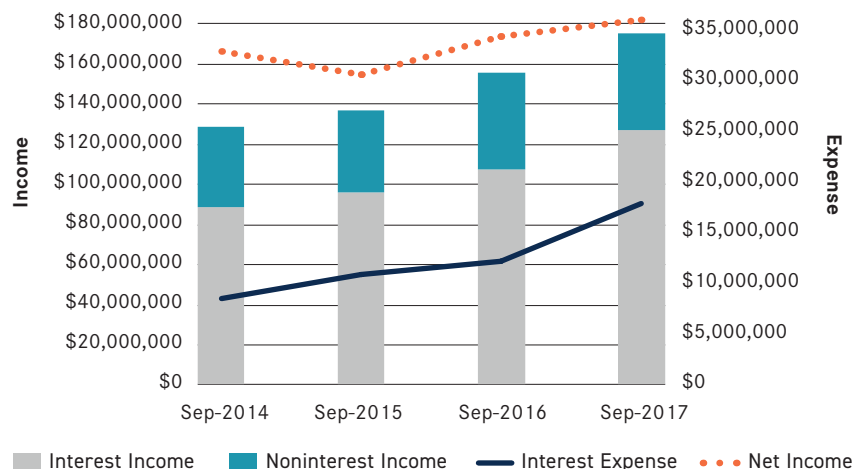
Endnotes

1. "A Cautious Tale for an Optimistic Outlook," 2018 Annual Economic Outlook, Economics Group, Wells Fargo Securities, December 14, 2017
2. "Global Economic Outlook 2018 – 2019," Global Economic Perspective, UBS, November 6, 2017
3. "Stronger for Longer," 2018 Global Macro Outlook, Morgan Stanley, November 26, 2017

Sacramento Region Banks YTD Income vs. Interest Expense (in 000s)

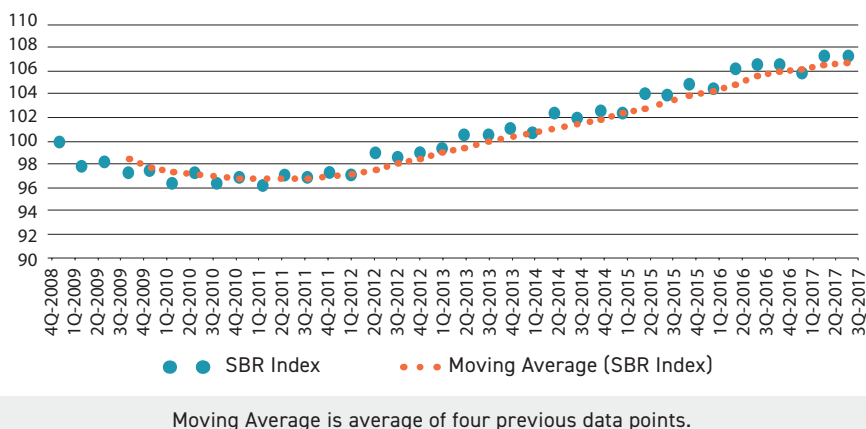


Sacramento Region Credit Unions YTD Income vs. Interest Expense



SBR Financial Conditions Index

The latest reading of our proprietary SBR Financial Conditions Index shows that the regional economic expansion continued throughout 2017. We do not see any major hindrances to this trend for 2018 and expect another year of positive growth.





Human Capital Index

KEY POINTS

- Organizations continue to focus efforts on training for necessary work skills and employee development for future changes.
- Current efforts on diversity and inclusion are still low.
- Focus on compensation has reduced from this time last year.
- The factors exerting the most influence are talent shortages and skills gaps.
- Local organizations predict increasing efforts to actively recruit and to reduce attrition, signaling growth.
- 73% of organizations anticipate championing new or significantly revised human capital initiatives for 2018, including greater autonomy for employees as well as health protection and promotion of well-being at work.
- HR departments expect to focus on talent management at every level.

Current Human Capital Trends

As in the past, the SBR team collected local organizational data for this analysis in partnership with SAHRA (Sacramento Area Human Resource Association) and SEAC (Sacramento Employer Advisory Council). Results indicate that there have been some movements in several human capital areas.

Overall, our local organizations are reporting greater efforts in several areas as compared to last year. The one consistent effort is on compensation, which saw no movement. In rankings, the No. 1 current trend from last year's reporting still holds the top spot – our region's employers are still very much focused on training and development. Ranked second last year was headcount – ensuring sufficient staffing – which currently shares third place with a focus on reducing employee resignations.

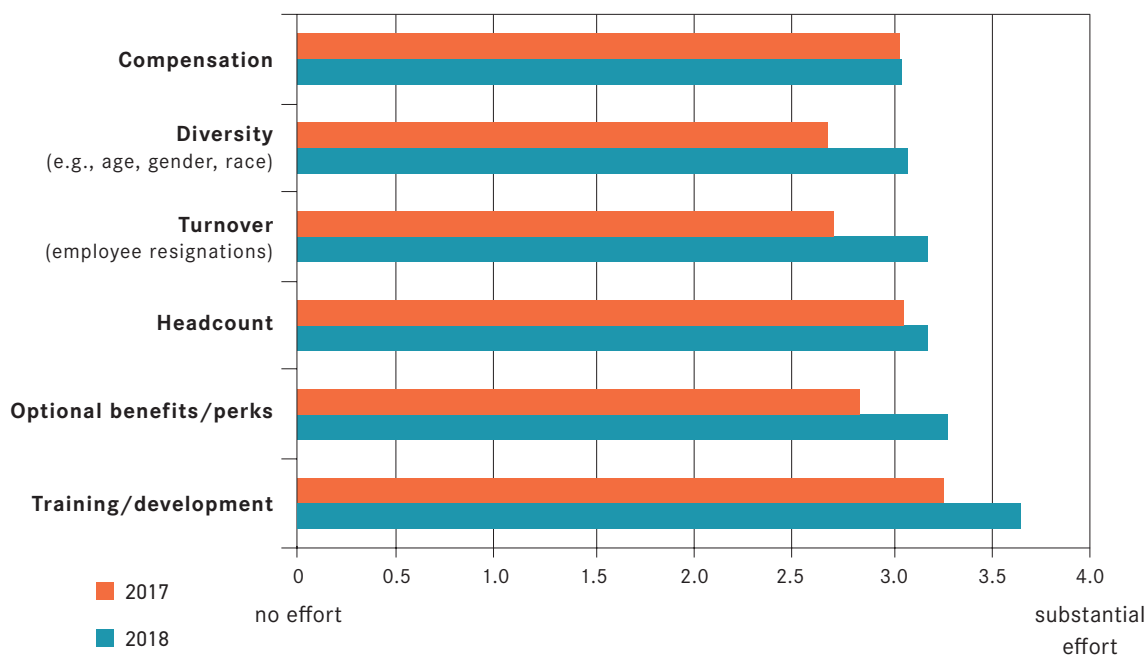
We also see movement towards greater efforts in the areas of less focus. Local organizations report a much-renewed focus on reducing attrition and keeping talent from leaving the organization as well as efforts to actively recruit new hires. This may be

Local organizations report a much-renewed focus on reducing attrition and keeping talent from leaving the organization as well as efforts to actively recruit new hires.



Current Human Capital Trends

Current resource allocation



signaling stability or even growth. Down from second place, compensation ranked last in this year's trends.

In the 2017, issue we reported that diversity and inclusion efforts were last on the list of human capital trends, with 20% of respondents indicating that no effort was expended in this area, bucking the trend of the Bay Area, which has had a significant focus on these issues in the past several months. In light of last year's data, we specifically queried the extent to which gender and diversity are considered

current priorities. Data shows that HR professionals view their top management-C-suite teams, as well as their direct managers, as not placing a great priority on gender diversity, with racial diversity ranking slightly higher. Respondents further indicated that they themselves viewed these efforts as slightly higher priorities than organizational top- and middle-management. Until diversity and inclusion efforts become part of the CEO agenda, moving these efforts forward may prove challenging for our local organizations.



Human Capital Index

Human capital forecast for 2018

Compared to last year's forecast, the expectation for 2018 is slightly more positive for headcount (1.39 in projected 2018 versus 1.47 in projected 2017*). Sixty-two percent of respondents indicate their organizations will actively recruit new employees in the first half of 2018 (only one respondent indicated upcoming layoffs), compared to 57% last year. This data is aligned with a slightly more negative outlook on voluntary turnover (2.04 versus 1.97); respondents report higher expected levels of employee resignations. This could possibly be fueled by the current low unemployment levels, which give workers greater opportunity to move between organizations. Unemployment levels nationally are expected to continue to decline according to the Bureau of Labor Statistics, given expectations for sustaining strong U.S. economic growth in 2018. Increased optimism is reported for a focus on training and development (1.33 versus 1.51), optional perks and benefits (1.71 versus 1.86), and a potentially renewed focus on diversity, including age, gender, and race (1.59 versus 1.71).

A very slight increase in negative outlook on compensation was reported (1.69 versus 1.66). Respondents declared moving more towards maintaining current compensation levels versus increasing compensation levels. Perhaps this can partly be explained by AB 168, a bill which will prohibit employers from asking job candidates about their salary and benefits history. This legislation, aimed at lowering existing and documented gender wage gaps, may in effect reduce individualized compensation due to increased transparency, as organizations are mandated to provide compensation information upon request and avoid tying future compensation to past compensation. Although the negative outlook on compensation is negligent, it goes against the national trend where the projection for U.S. salaries is slightly positive, growing from an increase of 3.1% in 2017 to an increase of 3.2% in 2018 (SHRM).

Similar to last year, as many as 73% of organizations surveyed reported that they will undertake some new or significantly revised talent management and human capital initiatives for 2018. In the top were learning/development, increased non-financial recognition for employees, greater autonomy for employees, and health protection and promotion of well-being at work.

HUMAN CAPITAL FORECAST FOR 2018



The expectation for 2018 is **slightly more positive** for **HEADCOUNT**



A **slightly more negative outlook** on **VOLUNTARY TURNOVER**



Potentially renewed **focus on diversity**, including age, gender, and race



Increased **optimism** for **TRAINING & DEVELOPMENT**



negative outlook on **COMPENSATION**

* On a 1-3 scale; lower numbers indicate positive expectations and higher numbers indicate negative expectations.

THE TOP 2 EXTERNAL PRESSURES ON ORGANIZATIONS



TALENT SHORTAGE
job candidates
NOT AVAILABLE
to fill positions



SKILLS GAP
job candidates **ARE**
AVAILABLE but without
the desired skills

While organizations see the need for different skills, they may not have the internal resources to address skill deficiencies through training and development efforts.

External pressures on organizations

The top two external pressures reported are closely linked, the highest concern being a talent shortage – with the fear that job candidates are simply not available to fill open positions. Second is a reported skills gap, where job candidates are available for hire but without the desired skills. This is in line with national trends showing growing skills gaps. According to the Bureau of Labor Statistics, nationally there are about 6.2 million unfilled jobs, an increase from 5.6 million in a year-over-year comparison. Furthermore, as reported last year, another factor continuing to exert pressure on local organizations is a

focus on cost reduction, being the third most important influence reported, with challenging productivity and profit targets a close fourth.

Human capital priorities

The highest human capital priorities for 2018 are similar to what was expected for 2017, with one large exception – the top spot for the upcoming year was taken by an anticipated improvement of talent management at every level of the organization. Last year's No. 1 – improved employee engagement – moved to second place.

A contrarian perspective was offered in this data on organizational priorities, with workforce planning to better

anticipate business needs outranking projected efforts to reduce the skills gap, which respondents in other places indicated was a large threat. One explanation could be that while organizations see the need for different skills, they may not have the internal resources to address skill deficiencies through training and development efforts. Further, they may not see community partners as providing specific skills needed. In essence, organizations may have a need with no mechanism to address the challenge of filling that need, prompting them to allocate resources to challenges over which they have control.

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The word "build" is written in a large, bold, yellow, cursive-style font with a blue outline. It is positioned in the upper right quadrant of the page, overlapping the background image of buildings and the geometric pattern.

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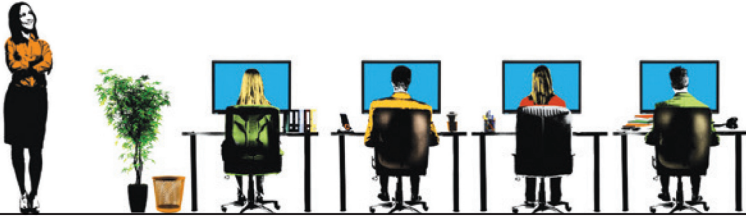
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