ECONOMIC FORECAST | EMERGING TRENDS IN SACRAMENTO'S ECONOMY

UPDATE

# sacramento BUSINESS REVIEW

MID-YEAR 2018

Volume 10 Issue 2 » sacbusinessreview.com

## Mid-Year Update

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

CELEBRATING 10 YEARS 10 YEARS

MID-YEAR 2018

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 & 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 20th edition of the *Sacramento Business Review* – the most comprehensive, precise, and intellectually sophisticated analysis of the regional economy. For over TEN years, our team has provided thoughtful predictions that have accurately forecasted the area's economic and business climate. With Sacramento's very best financial analysts and researchers combining their skills and talents, the Sacramento Business Review is the most credible source of independent thinking, insights, and research on our economy in the region. 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.

We are now celebrating the longest economic expansion in U.S. history – a bull market that has extended itself with strong synchronized global growth. The U.S. real economic growth rate of 4.1% last quarter exceeded the unemployment rate of 3.9% – a situation not seen in almost 25 years! Sacramento enjoyed a booming labor market that slashed the unemployment rate to a record low of 3.3%, well below the national and statewide averages, and an impressive decline from the all-time high of 13.5%. This is the best job growth we have seen in decades – nationally, there were 6.7 million jobs available and only 6.1 eligible workers available to fill those jobs.

Small businesses remain optimistic about future hiring and access to credit. Consumer sentiment remains high but is less optimistic and less positive than national averages. The real estate market continues to exhibit strength with declining vacancies, increasing rents, and rising median home prices. Banks stayed strong while credit unions experienced weakness in loan growth likely due to a flattening yield curve. Our Financial Conditions Index is now at its PEAK. Can Sacramento sustain this level of economic performance?

The U.S. economy is in its final leg of robustness with tremendous tailwinds coming from tax reform, spectacular corporate earnings, low inflation, record business and consumer confidence, and improved personal incomes. Our region enjoys many of the same tailwinds, and the R word is not on the horizon.

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,

Sanjay Varshney

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CELEBRATING 10 YEARS 10 YEARS



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Chase Armer is a co-owner of Planned Solutions, Inc., a Sacramento-based financial planning and investment advisory firm, where he is a financial planner and a member of the Planned Solutions Investment Management Committee. Chase holds several professional designations including Certified Financial Planner Practitioner, Chartered Financial Analyst, and Enrolled Agent. Chase has a degree in economics from California State University, Sacramento, a master's in taxation from William Howard Taft University, a certificate in personal financial planning from UC Davis Extension, and a doctorate in business administration from William Howard Taft University. He is a past president of the Financial Planning Association of Northern California.

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Sadaf Ashtari is an Assistant Professor of Information Systems and Business Analytics in the College of Business Administration at California State University, Sacramento. She earned her PhD in technology and professional service management from Eastern Michigan University and holds master's and bachelor's degrees in management information systems from Azad University (Science and Research Branch), Tehran, Iran. She has studied the impact of IT applications in health care and the role of organizational and social factors on the effectiveness of electronic health records. Her research interests include applications of information systems in chronic disease prevention and management, and business intelligence in the health care industry.

## Will Austin

Will Austin is a Senior Analyst at Cushman & Wakefield, where he assists in the disposition, acquisition and leasing of office, industrial and retail commercial real estate throughout Northern California and Northern Nevada. He holds bachelor's and master's degrees in sociology from Trinity College and California State University, Fullerton, respectively. He attends UC Davis, pursuing an MBA.

## Seung Bach, PhD

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

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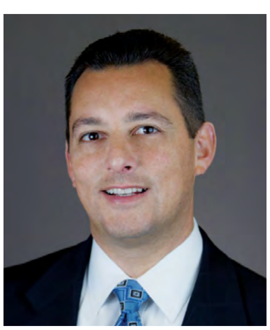
Jessica Bagger is a Management Professor at California State University, Sacramento, and Associated Faculty at the University of Gothenburg in Sweden. She received her PhD in management at the University of Arizona. Dr. Bagger's scientific research relates to factors impacting employee well-being and performance, including HR systems, leadership, and organizational culture.

## Jason Bell, CFA

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

## Jesse Catlin, PhD

Jesse Catlin is an Assistant Professor of Marketing at California State University, Sacramento. He holds a PhD in management with an emphasis in marketing from the University of California, Irvine, and holds master's and bachelor's degrees in economics from California State University, Sacramento. His research interests include consumer behavior and decision-making. Prior to his academic career, he worked as a consultant on projects related to market research and economic development.



## Matt Cologna

Matt Cologna graduated with a degree in business from California State University, Sacramento, and has been active in commercial real estate for the past 21 years in Sacramento. His experience includes owner/user and investment sales, logistics, landlord and tenant representation, land assemblage, build to suits, and developer relations. He has represented clients on a local, regional, and national basis. He is involved with the Cushman & Wakefield Global Supply Chain Solutions Group offering additional insight into current and future needs of occupiers in the market. Matt has completed over 17 million square feet of deals with a value exceeding $620 million.

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John Frisch has been active in commercial real estate brokerage for 37 years in the Sacramento region. During his career, he has been involved in over 1,000 lease, sale and build-to-suit transactions totaling over 10 million square feet. John also is an active volunteer with several non-profit organizations in the region, including the Salvation Army, the Los Rios Community College Foundation, the Sacramento Metro Chamber of Commerce and The Rotary Club of Sacramento. John lives in Arden Park with his wife, Maggie.

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Nick Hladek works as a Quantitative Modeler at Golden 1 Credit Union, where he assists in the development and implementation of quantitative models. Prior to his time at Golden 1 Credit Union, Nick worked as a Senior Research Analyst at the Greater Sacramento Economic Council. He holds both a bachelor's degree and master's degree in economics from California State University, Sacramento.

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

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Joe Niehaus is the Treasurer for SAFE Credit Union, where he is responsible for managing interest rate and liquidity risks as well as developing and maintaining pricing methodologies across all product lines. Joe has worked as a bank examiner for both the public and private sectors and served five years as an Electronic Intelligence Analyst with the U.S. Navy. Joe earned an MBA from the University of Nebraska, Lincoln, and a BS in business administration from California State University, Sacramento. He holds the Chartered Financial Analyst designation and is President of the CFA Society Sacramento.

## Yang Sun, PhD

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

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# KEY POINTS

## LABOR MARKETS & REGIONAL ECONOMY

- Sacramento employment continues to trend upward supporting economic growth in the region.
- Low unemployment and slow labor force growth may cause the employment growth rate to slow in the future.
- The region's labor market needs to rebalance to favor higher paying jobs in order to continue to support the pace of economic and household income growth.

## SBR/SAFE CREDIT UNION CONSUMER SENTIMENT SURVEY

- Consumer sentiment remains positive. At both the regional and national levels, overall index scores were higher in June 2018 compared to January 2018.
- Since our January release, local sentiment has increased at a slower rate than national sentiment.
- Compared to national data, regional consumer sentiment remains less optimistic overall and less positive about current economic conditions.
- Though positive in absolute terms, there has been some slight tapering in expectations for personal financial outlook and regional business conditions.

## SMALL BUSINESS ECONOMY

- Total SBA lending increased with growth in Placer and Yolo counties offsetting a decline in Sacramento County.
- Small Business Confidence Index respondents continue to reflect increasing optimism and feel credit conditions are easing, which is leading to increased hiring expectations.
- Business listing activity remains high, though it registered a slight downtick. Average Selling Prices of subject companies increased, though it is difficult to discern the exact cause.

## REAL ESTATE

- Market fundamentals are strong across all product types with growth expected throughout 2019.
- Industrial market reached record low vacancy (4.4%) and is now seeing speculative construction of large block buildings to meet new user needs.
- Office sector leasing activity exceeded 2.5 million square feet (msf), on pace to exceed 5.0 msf for the first time since 2009.

## CAPITAL MARKETS & BANKING FORECAST

- Financial markets saw a market correction followed by modest growth – our team still believes that we will see a 2018 total return within range of our initial expectation of 10%.
- The U.S. economy remains strong with key indicators suggesting continued expansion.
- Low long-term rates will help to keep real estate loan production going but are not such a welcome sign for the banks.
- Sacramento Region Banks saw first-quarter loan growth in line with past years, though Sacramento Region Credit Unions fell short.

## HUMAN CAPITAL INDEX

- HR managers report that generational challenges are still felt – conflicts over leisure time and views on technology dominate.
- Continued lack of focus on diversity and inclusion.
- No changes in anticipated resignations, training or development efforts, compensation changes, or benefits/perquisites.
- Slight movement for headcount – respondents indicate no active recruiting efforts and headcount is expected to remain at current levels.
- HR managers report pressure to reduce cost and challenging productivity and profit targets.
- Largest differences from the January issue are reported in focus on creativity and innovation efforts.

# SPECIAL THANKS

**Jeff Bingel**
**Nidia Goitia**
**Jasmine Graham**
**Melissa Sheldon**
Sacramento State, College of Business Administration
Office of the Dean Staff

SACRAMENTO STATE

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MID-YEAR UPDATE

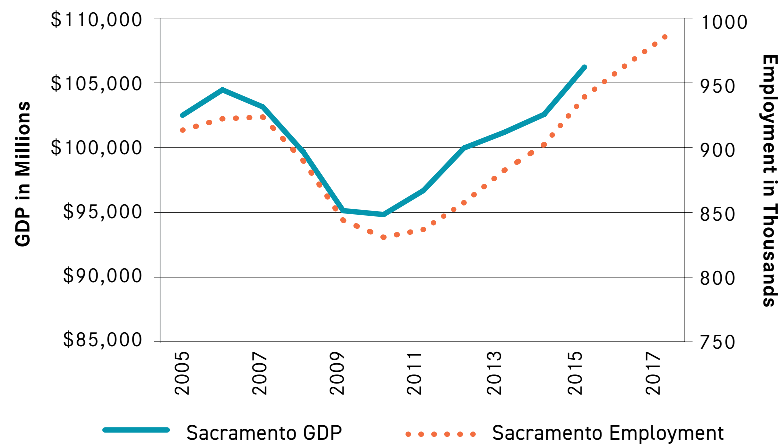
# Labor Markets & *Regional Economy*

Consistent with the improving national economy, the Sacramento regional economy remains firmly in expansion. Total employment, which is highly correlated with total economic output, continues to set new highs leading us to believe that growth will remain strong over the short term.

However, the current strength of our labor market does not look nearly as sustainable over the long term. Regional labor force growth and job growth have stalled in recent months – an indication that we are nearing full employment. This raises the question: If most of those who want a job have a job and few new participants are entering the labor market, how can employment growth continue to fuel the economic expansion in the Sacramento region over the intermediate to long term?

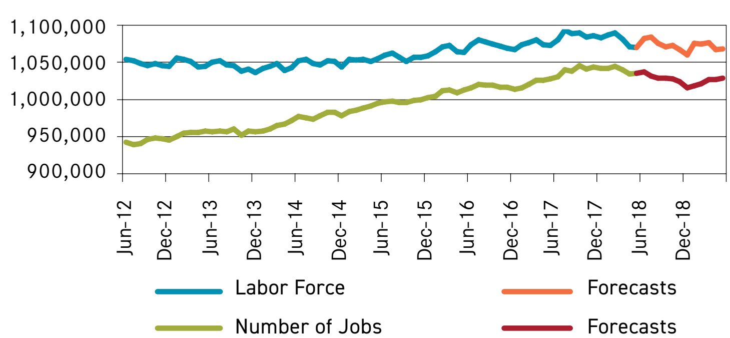
While the Sacramento region unemployment rate reached a record low of 3.3%, we note that both the labor force and the number of nonfarm jobs in the region have decreased by over 1% in 2Q18 compared to the previous quarter. We expect to see another 0.5% loss in both the labor force and the number of jobs over the next 12 months, all while the unemployment rate remains low. Although the risk of recession is very low in the short term, we expect the current growth rate to slow in coming quarters.

**Sacramento Employment and Economic Output**



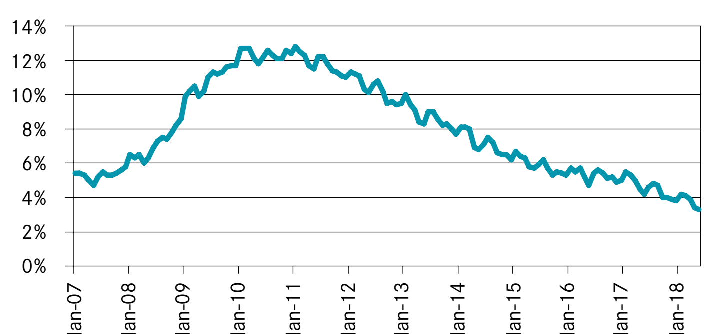

Source: Economagic.com

**Sacramento Labor Market Forcasts**




Data Source: California EDD

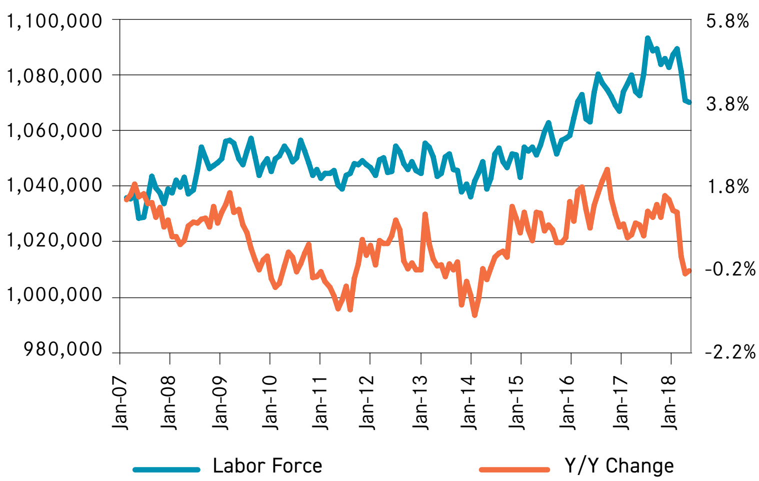
**Sacramento Unemployment Rate**




Data Source: California EDD

SACRAMENTO REGION has above average growth in the number of construction and health care jobs

### Sacramento Area Labor Force

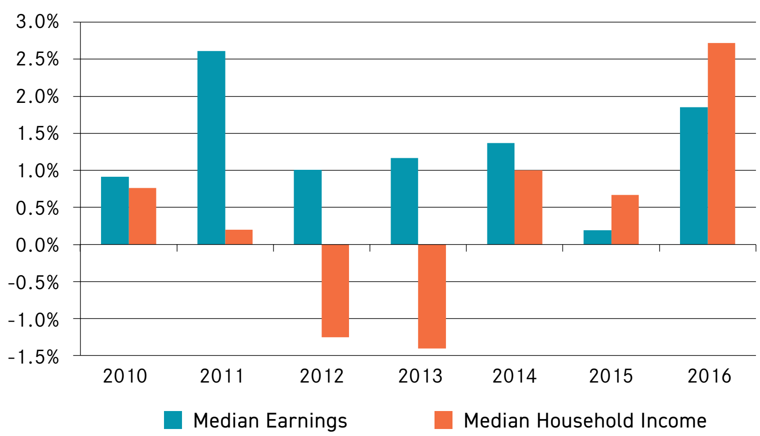



Data Source: California EDD

| Growth Rate | Construction | Health Care | Leisure & Hospitality | Professional & Business Services | Total |
|---|---|---|---|---|---|
| 1 Year | 4.99% | 4.55% | 1.35% | 0.16% | 2.35% |
| 3 Years | 24.00% | 14.36% | 11.71% | 8.79% | 7.94% |
| 5 Years | 41.93% | 22.90% | 18.26% | 15.53% | 13.40% |

Source: Economagic.com

### Median Earnings and Household Income




Source: U.S. Census Bureau

We maintain that the solution lies in the region's ability to rebalance its economy in favor of higher paying jobs. For example, the Sacramento region has reported above-average growth in the number of construction and health care jobs while the growth rate for leisure, hospitality, and professional and businesses services (which includes many lower wage jobs) may have finally started to wane.

The California Employment Development Department has predicted that over the next five to 10 years occupations with the highest potential growth rates in the Sacramento region are construction and services related, whereas the Bay Area expects to see the most growth in higher-wage industries such as health care and technology.

Sustainable economic growth in the region will require an improvement in wages and household income to increase the purchasing power of Sacramento workers and households. Recent data show that the rate of change in median employment income and median household income has improved marginally, but this trend will become an important driver for continued economic expansion in the Sacramento region.

In sum, no recession in sight but the rapid growth has slowed. Potential headwinds include financial market corrections and disruptions from international trade. A heathy, continuous economic expansion calls for a master plan to create higher paying jobs, improve the business competitiveness of the region, balance financials, and increase local household incomes.

MID-YEAR UPDATE

# SBR/SAFE CREDIT Consumer Sentiment *Survey*

For the mid-year update, the Sacramento Business Review, 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.

> **CONSUMER SENTIMENT REMAINS POSITIVE at both the regional and national levels**

## Regional vs. National Sentiment

The SBR team once again compared regional sentiment with national sentiment measures; the results are 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.

(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.

(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.

Across all indices, consumer sentiment increased at both the regional and national levels. However, the national sentiment has grown more than regional sentiment. The largest increase both regionally and nationally was for consumer perceptions of current economic conditions. The smallest increase at both levels was for consumer expectations of future economic conditions. (See Table 1)

**Table 1**
**Regional vs. National**

| | Regional Index Score | | National Index Score | |
|---|---|---|---|---|
| | Mid-year Update | Change Since January 2018 | Mid-year Update | Change Since January 2018 |
| Index of Consumer Sentiment | 93.3 | +0.6 | 98.2 | +2.3 |
| Index of Current Economic Conditions | 98.9 | +1.2 | 116.5 | +2.7 |
| Index of Consumer Expectations | 89.7 | +0.3 | 86.3 | +2 |

Notes: National data obtained from the University of Michigan Consumer Sentiment Survey June 2018 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.


**49%** of regional respondents reported having a **MORTGAGE THIS YEAR**

> *While consumer sentiment remains strong overall, local consumer sentiment continues to lag behind national levels and we have seen some tapering.*

## 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 consistent with those in our last report. (See Figures 1 and 2)

## Summary

While consumer sentiment remains strong overall, local consumer sentiment continues to lag behind national levels and we have seen some tapering. It is unclear whether this is the start of a downward trend. It will be important to keep an eye on factors such as inflation and stagnant incomes.

**Figure 1**
**Type of Credit Held**

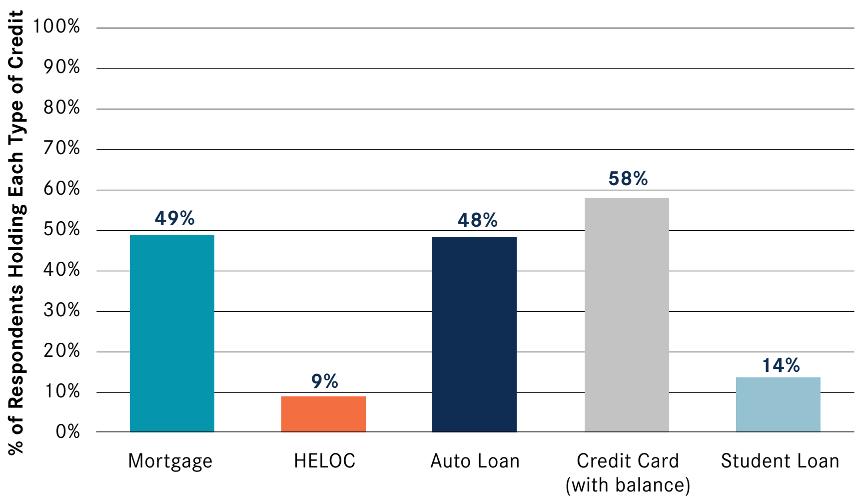
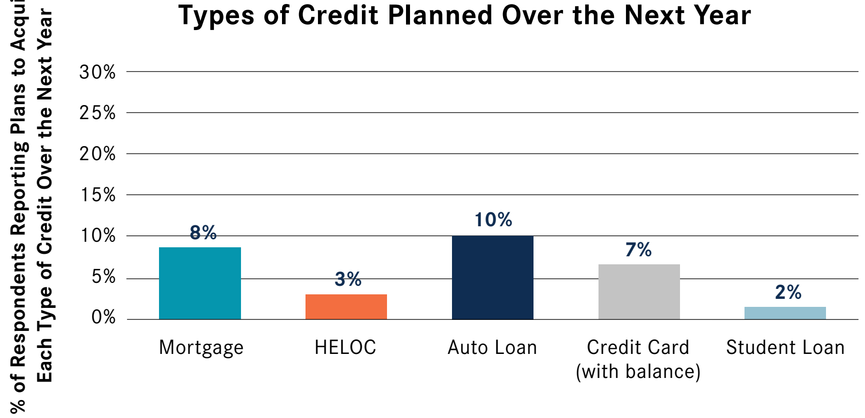



**Figure 2**
**Types of Credit Planned Over the Next Year**




CONSUMER SENTIMENT

MID-YEAR UPDATE

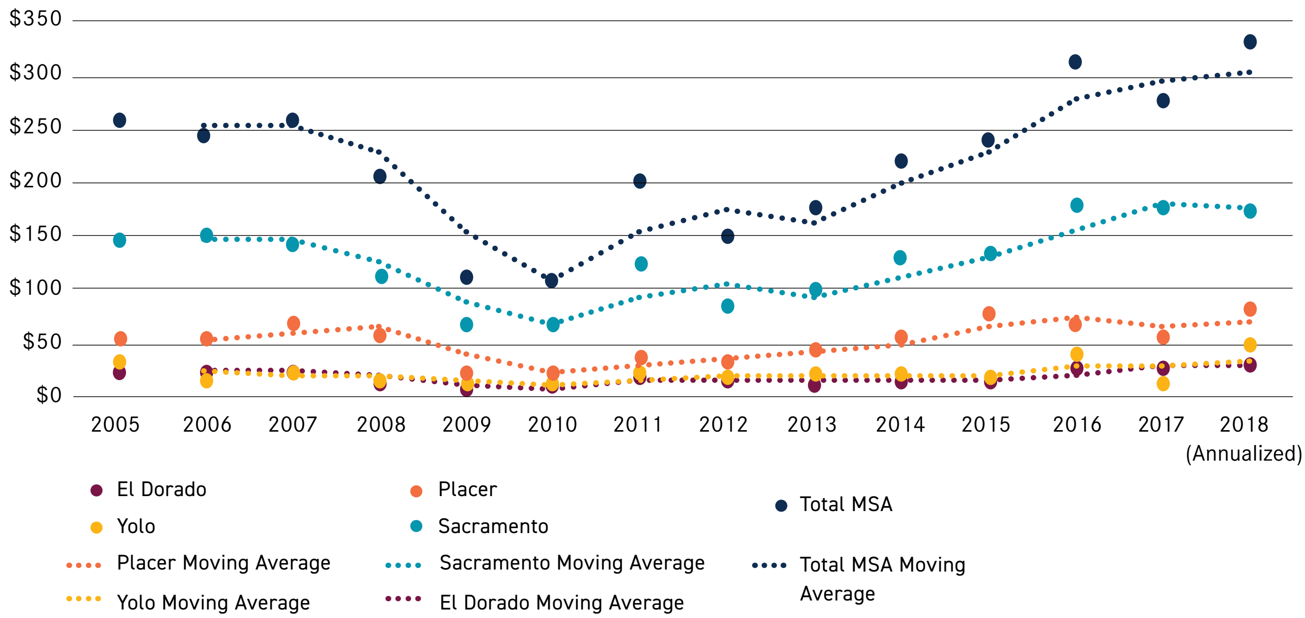
# The Small Business *Economy*

Our mid-year survey of the Small Business Economy shows that credit conditions seem to be improving as total regional SBA lending registered an uptick. Both Placer and Yolo counties increased, acting as an offset to a slight decline in Sacramento County.

Local business confidence conditions remain strong with a higher aggregate reading in overall sentiment and a stable and optimistic outlook for local economic conditions. While January's respondents indicated credit accessibility was waning, those feelings appear to have been transitory as conditions seem to have improved. Importantly, there is a marked increase in likelihood to hire across all sectors, reflective of the continued strength in the job market.

**TOTAL SBA LENDING INCREASED with growth in Placer and Yolo offsetting a decline in Sacramento**

**Total SBA Loan Approvals by County**
(in millions, 2-year moving average)




Moving Average is average of two previous data points.

*While January's respondents indicated Credit Accessibility was waning, those feelings appear to have been transitory as conditions seem to have improved.*

**SBCI Respondents Continue to reflect**

**INCREASING OPTIMISM**

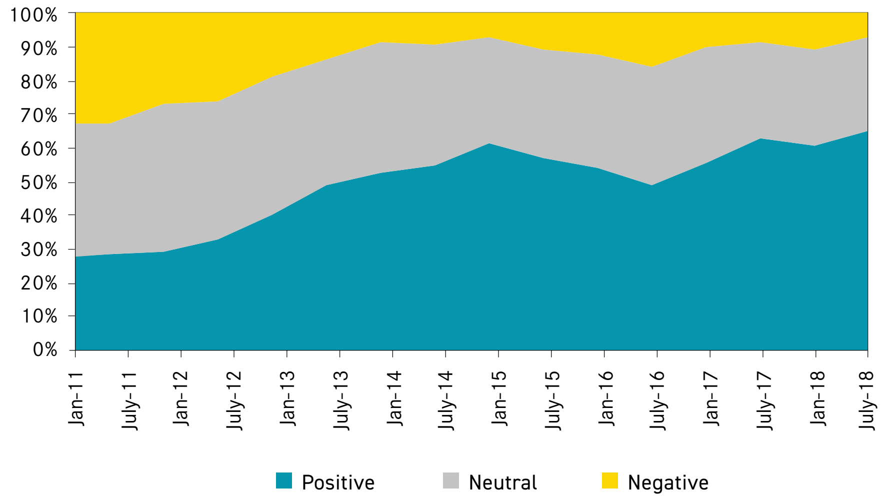
**INCREASED OPTIMISM**

**is leading to**

**INCREASED HIRING EXPECTATIONS**

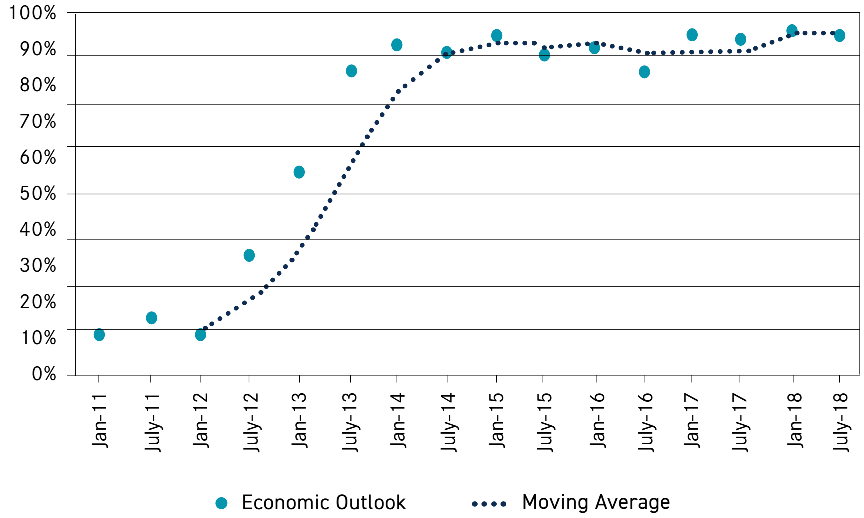
**SBCI Overall Sentiment Responses**

January 2011 – July 2018




**SBCI Total Economic Outlook**

(18-month moving average)



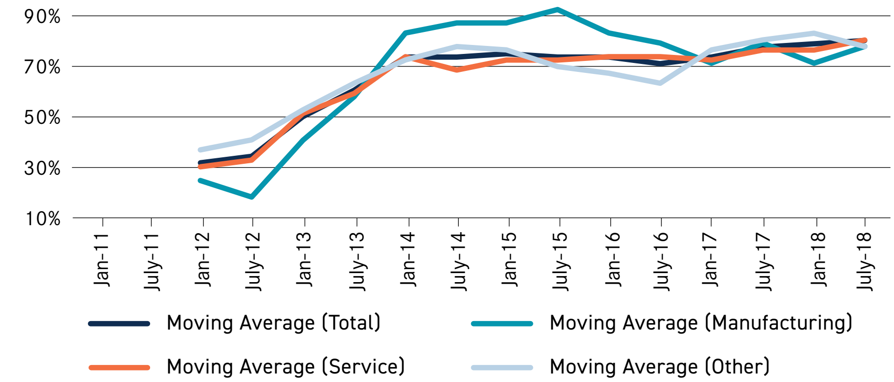

Moving Average is average of three previous data points.

# The Small Business *Economy*

RESPONDENTS FEEL **MORE SUPPORTED BY BANKS**

**SBCI Credit Accessibility by Sector**

(18-month moving average)

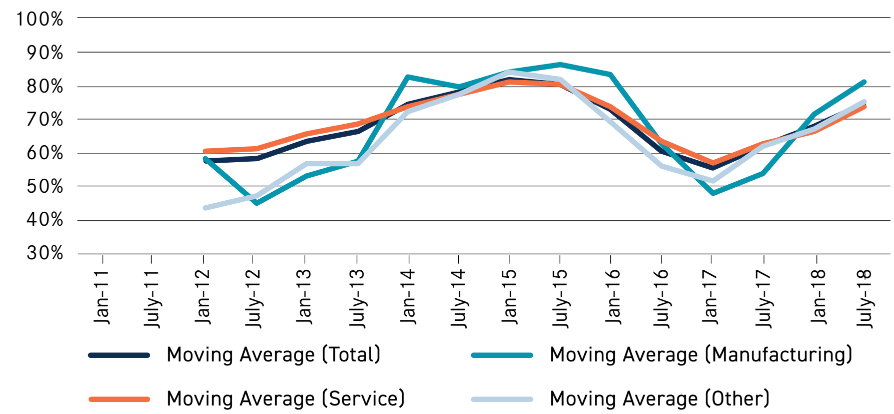



Moving Average is average of three previous data points.

RESPONDENTS EXPRESS **OPTIMISTIC HIRING EXPECTATIONS**

**SBCI Likelihood to Hire by Sector**

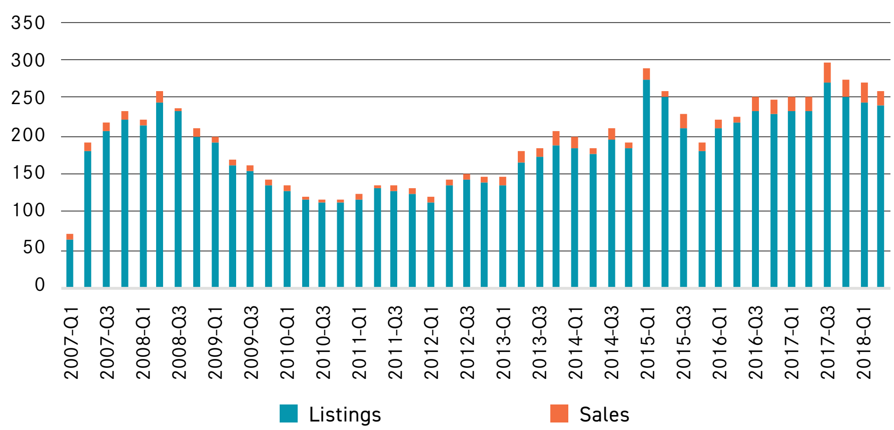
(18-month moving average)




Moving Average is average of three previous data points.

Business listing and sales activity remains high, though it registered a slight decline with our latest reading. Encouragingly, average selling prices were higher even as median revenues and cash flows of the subject companies remained somewhat stable. Given the lumpy nature of the data, it is difficult to discern if this is reflective of increasing multiples, sector-specific or simply noise. That said, higher ASPs would be consistent with other increased asset valuations given the strength of the economy.

**Listings vs. Closed Sales**

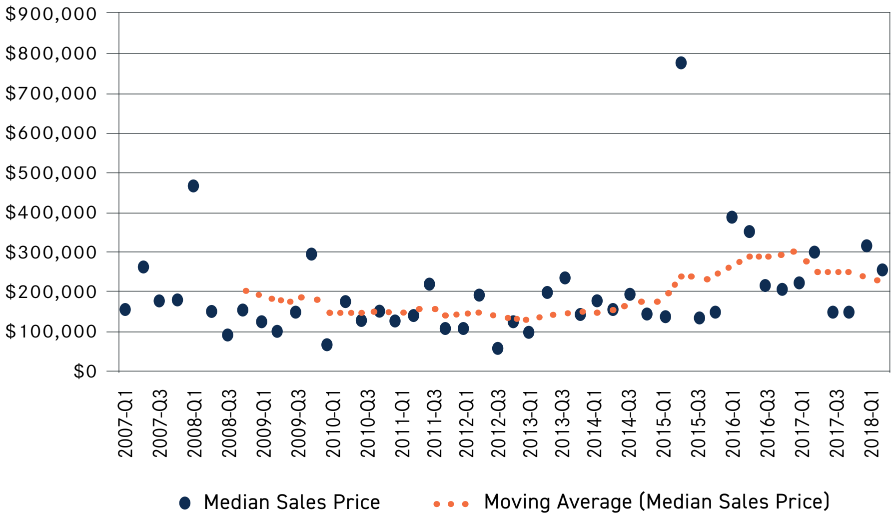



Data Source: BizBuySell

MEDIAN TRANSACTED SALES PRICES CLEARED THE $200,000 THRESHOLD

*Average selling prices were higher even as median revenues and cash flows of the subject companies remained somewhat stable.*

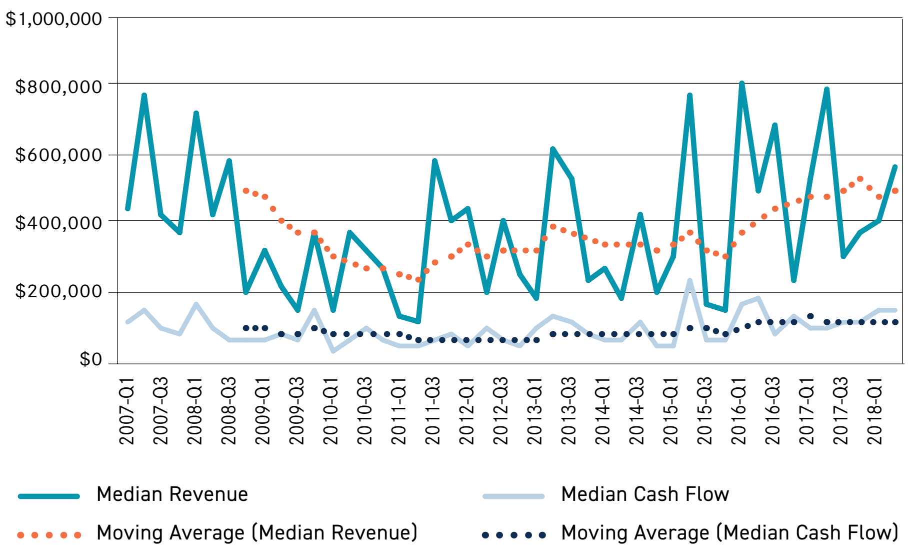
**Median Transacted Sales Price**
(2-year moving average)




Moving Average is average of eight previous data points.

Data Source: BizBuySell

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




Moving Average is average of eight previous data points.

Data Source: BizBuySell

# Real Estate

Sacramento currently enjoys strong market fundamentals across all product types. Vacancy rates for industrial, office and retail all rest below 10.0% and are falling. The market is well positioned for the future as the tenant base continues to diversify and out-of-market companies increasingly look to Sacramento as a strong option for future operations.

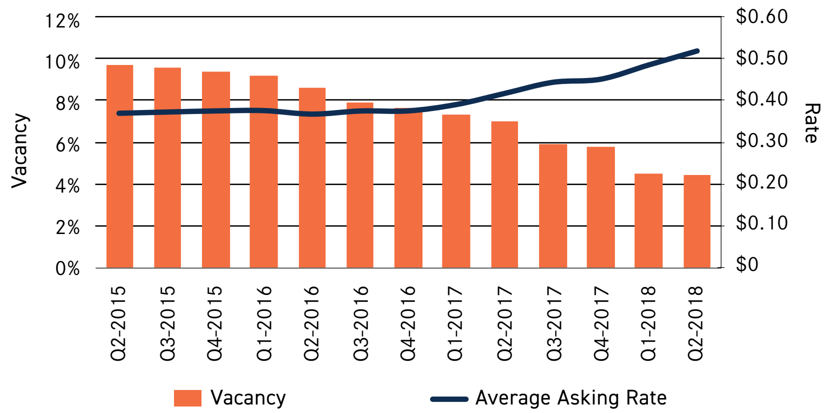
## Industrial

- Leasing activity is very strong to start 2018, reaching 4.8 msf through the end of Q2.
- Asking rates surpassed $0.52 per square foot for the first time ever.
- Record low vacancy (4.4%) and increased demand from high cube tenants is accelerating construction activity. Two completions over 300k sf: McKesson at 7701 Foothills Blvd., Roseville & Veritiv at 3510 Carlin Drive, West Sacramento.
- Market becoming Institutionally owned: Blackstone's recent acquisitions, NorthPoint's new construction in West Sacramento.

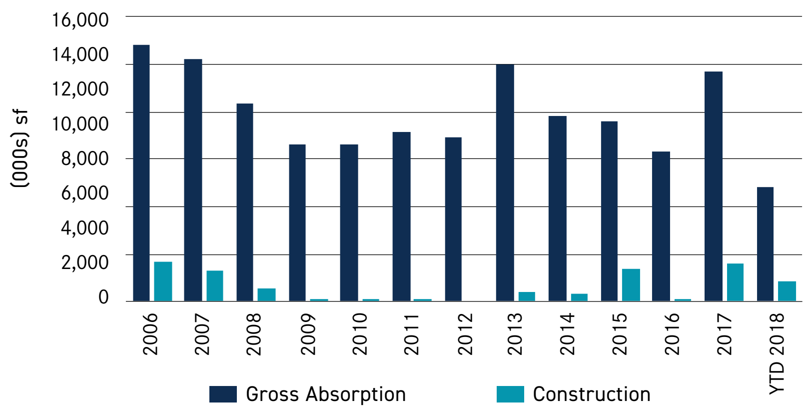
## Office

- Strong rent growth across the market, asking rates are up 5.7% year-over-year, the highest since Q1 2010.
- Leasing activity exceeded 1.3 msf during the quarter, the fifth consecutive quarter above 1.0 msf.
- Tenant demand is changing with more interest from tech companies looking to vacate the Bay Area, currently 11% of active tenants

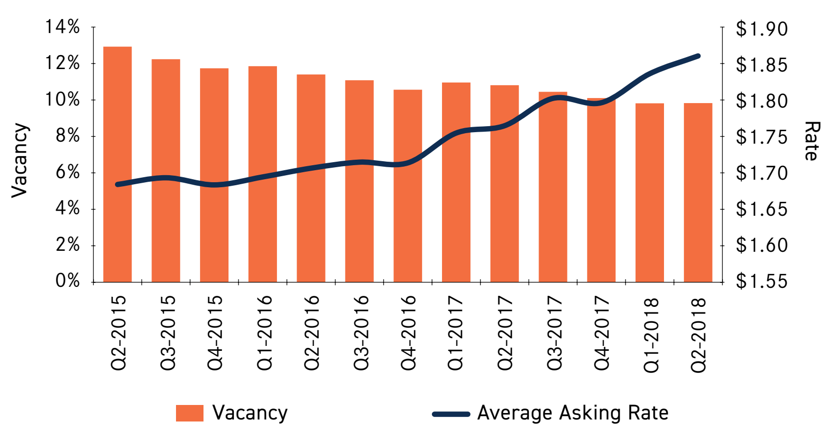
**INDUSTRIAL**
**Vacancy and Average Asking Rates | Q2 2015–Q2 2018**




**INDUSTRIAL**
**Gross Absorption and Construction | 2006–2018**




**OFFICE**
**Vacancy and Average Asking Rates | Q2 2015–Q2 2018**



in the market, up from 1.3% in 2016, and co-working companies now entering the market.

- Reinvestment in the urban core has spurred Central Business District growth, especially for class A space (rents are up 9.8% YOY) and investors are active as well. 555 Capitol Ave., 520 Capitol Ave., 400 Capitol Ave., 621 Capitol Ave. have all sold since the arena location was announced in 2014.
- Speculative construction is still another 2-3 years out. Developers are no longer willing to build and then hope lease rates justify construction costs.

## Retail

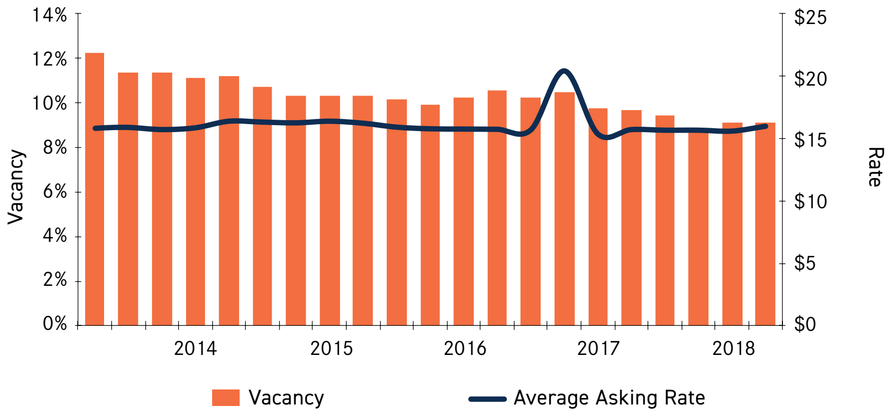
- Demand is strong and property values are high in submarkets with good demographics (high income and strong density) but space is very slow to lease in submarkets with subpar demographics.
- Corporate closures continue to hamper retail market fundamentals. More indicative of changes in the retail market rather than a poor local retail market.
- Landlords looking to backfill with experience-based retailers that are less susceptible to online competition (gyms, sports complexes, escape rooms, etc).

*Reinvestment in the urban core has spurred Central Business District growth, especially for class A space (rents are up 9.8% YOY) and investors are active as well.*

**OFFICE**
**Office Demand Becoming More Balanced**

| | 2016 | 2017 | 2018 |
|---|---|---|---|
| **Professional Services** | 65.4% | 41.8% | 27.3% |
| **Health/Life Sciences** | 16.6% | 18.0% | 13.6% |
| **Government/Non-Profit** | 9.8% | 28.7% | 19.6% |
| **Technology** | 1.3% | 7.6% | 11.0% |
| **Consumer Products & Services** | 0.9% | 0.9% | 7.9% |
| **Undisclosed** | 6.0% | 3.0% | 20.6% |

**RETAIL**
**Vacancy & Average Asking Rates | Q2 2013–Q2 2018**



# Real Estate

## SINGLE FAMILY HOUSING

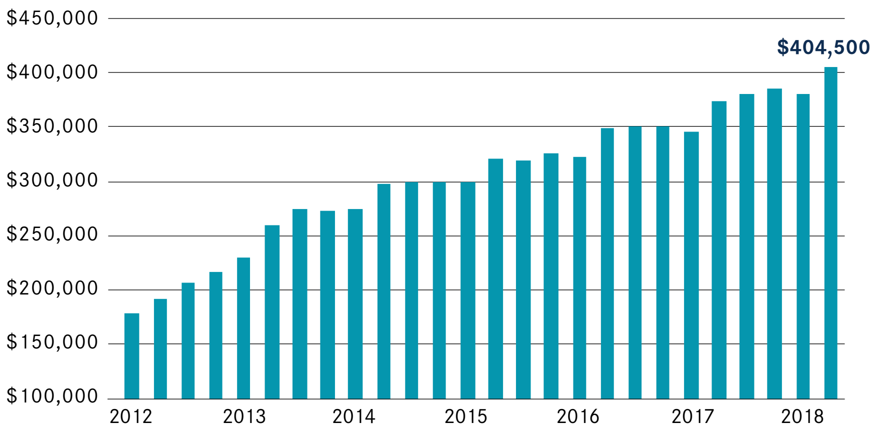
**Home values have risen by 226% since the beginning of 2012**

**Starter homes (under $400k) make up 51.2% of all home sales in 2018**

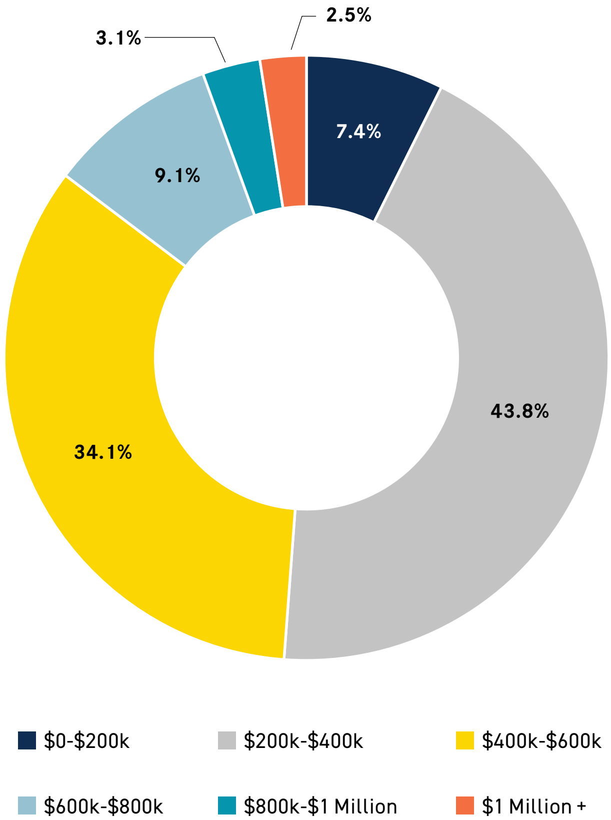
### Single Family Housing

- The median sale price for homes in the Sacramento Metropolitan Statistical Area reached $404,500, the highest point since Q2 2005 and up 8.2% YOY.
- Homes between $200 and $400k are the most popular price segment accounting for 43.8% of sales YTD. The middle two price segments, 200-400k and 400-600k account for 77.9%.
- Due to high construction and land costs, builders are not building starter homes of 1,200-1,600 sf. Without the new supply, home prices for those units are rising faster than the rest of the market.

**SINGLE FAMILY HOUSING**
**Median Home Prices: 2012 - 2018**




**SINGLE FAMILY HOUSING**
**Home Sales by Price: YTD 2018**



# Capital Markets & Banking *Forecast*

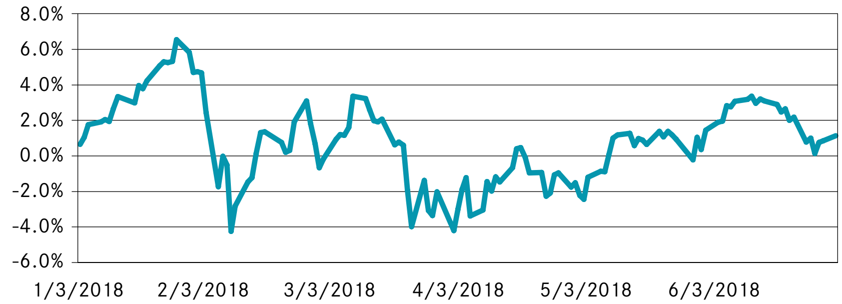
MID-YEAR UPDATE

At the start of 2018, the SBR team predicted that economic growth would continue throughout the year, albeit at a more moderate pace. U.S. stock market participants were of a more optimistic mindset though, with the S&P 500 Index increasing by a hefty 7.5% on the tailwind of tax cuts and prospects of robust fiscal spending. However, in early February we saw the market correct as it stared down multiple Fed interest rate increases, higher wages, and speculations of more rapid inflation growth. The correction amounted to a 10.8% decline in the S&P 500 from its 2018 peak at the end of January. At the start of the third quarter, markets had recovered about half of the losses that resulted from the correction with the S&P 500 providing a quite modest year-to-date return of only 1.2%. However, this rather paltry U.S. stock market return has outperformed most global markets as we alluded to in our January release.

Although volatility has called into question just where the S&P 500 will be at the end of the year, our team still believes that we will see a 2018 total return within range of our initial expectation of 10%. The U.S. economy remains strong with key indicators suggesting continued expansion:

- The unemployment rate and jobless claims continue a downward trend and are currently at levels not seen since the late 1960s.
- Weekly earnings are the highest since the 1980s.

**S&P 500 Cumulative Returns**
**01/01/2018 – 06/30/2018**




- Consumer confidence continues to trend upward.
- U.S. Real GDP for the 1st quarter grew 0.49% (vs. 0.31% 1st quarter growth of 2017).
- U.S. inflation remains within in a healthy range at 1.19% over first six months of 2018 (2.39% annualized which is in-line with Fed objectives).

For 2018, we predicted the best performing sectors would be consumer discretionary, information technology, and materials. After the first six months of the year, we can report partial success in that we have gone two for three. Consumer discretionary and information technology have indeed provided the highest year-to-date sector returns of 9.9% and 9.0%, respectively. However, our prediction has been dogged by the materials sector, which has produced the second-worst year-to-date loss of 5.1%, only outdone by consumer staples, which has brought up the rear with a loss of 8.2%. We maintain that the materials sector stands a good chance of recovery after new tariffs on imports take full effect.

On the fixed income front, U.S. obligations have outperformed those of Europe as we suggested they would in our initial 2018 forecast. Short-term U.S. rates have continued to rise with the 2-year UST hitting 2.6% at the start of the third quarter, but long-term rates have remained nearly flat; the 10-year UST hovered around 2.9%. Over the first six months of the year we have seen the spread between the 2- and 10-year USTs hit a high of 78 basis points in February before beginning a steady downward trend to 30 basis points at the beginning of July.

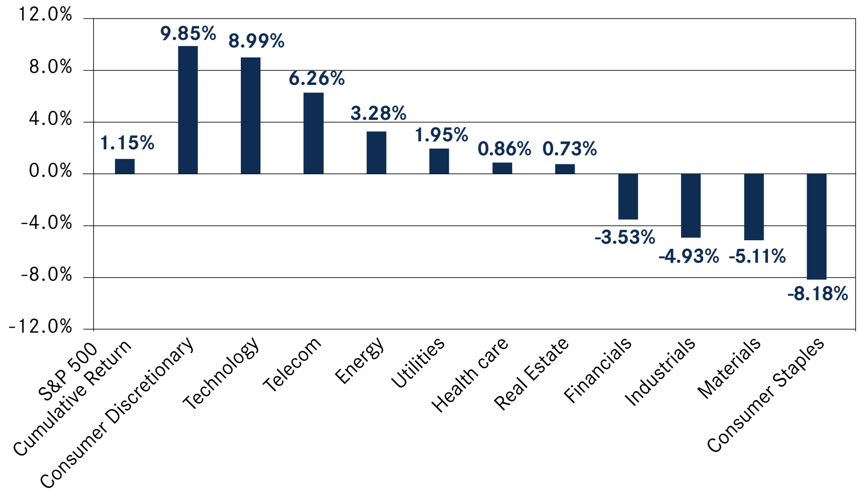
FIXED INCOME
U.S. OBLIGATIONS HAVE OUTPERFORMED
those of Europe

Low long-term rates will help to keep real estate loan production going but are not such a welcome sign for the banks, as net-interest margins will compress as the curve continues to flatten. The central banks of Europe and Japan are likely to start raising their respective short-term interest rates in the second half of 2018, which could potentially lead to higher rates here in the U.S. as global investors repatriate funds due to the higher rates for their respective domestic economy. However, we still expect U.S. markets to continue offering better relative yields and foresee the yield curve flattening further through the end of the year as the Federal Reserve continues along its path of rate normalization.

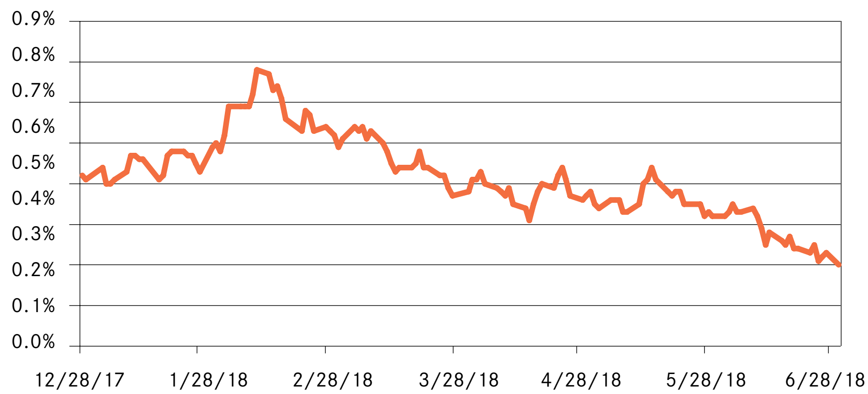
## Regional Banking Trends

Sacramento Region Banks saw first-quarter loan growth in line with the initial quarters of the previous two years (1.4% vs. 1.3% and 1.1%). We have seen a noticeable increase in multi-family residential loans, though single-family residential loan growth did not experience similar uptick.

**Sector Performance | S&P 500 Sector ETFs Returns**
**01/01/2018 – 06/30/2018**




**10-Year to 2-Year Spread**




**Loan Growth by Category | Sacramento Region Banks | March 2018**

| % of Total | Category | Q1 of 2016 Growth | 2016 Annual Growth | Q1 of 2017 Growth | 2017 Annual Growth | Q1 of 2018 Growth |
|---|---|---|---|---|---|---|
| 48.6% | Commercial Real Estate | 2.1% | 17.3% | 3.8% | 9.1% | 3.0% |
| 19.0% | Residential | -0.3% | 1.1% | 0.9% | 5.0% | 0.7% |
| 9.2% | Commercial & Industrial | -0.4% | 8.9% | -1.2% | 4.4% | -1.1% |
| 6.7% | Multi-family Residential | 8.7% | 54.3% | 1.9% | 0.9% | 5.6% |
| 3.7% | Construction Loans | 6.5% | 14.1% | -2.1% | -16.7% | -0.8% |
| 12.9% | Other | -3.1% | 6.9% | -3.8% | 1.8% | -2.8% |
| **100.0%** | **Total** | **1.1%** | **13.2%** | **1.3%** | **5.1%** | **1.4%** |

Data Source: FDIC

# Capital Markets & Banking *Forecast*

In line with our expectations, Sacramento Region Credit Unions fell short for total loan growth during the first quarter as compared to the previous two years (1.3% vs. 3.5% for 2016 and 2017). The main contributor to the lower levels of growth was the auto loan sector. Auto loans had been growing as a proportion of total credit union loans in the region over the past few years, but growth has slowed to just 1.8% during the 1st quarter of 2018 (as compared to 5.0% and 5.1% growth during the 1st quarters of the previous two years). We believe the slowdown to be due to the need for institutions to increase rates on shorter-term assets, such as auto loans, to keep pace with the rising short-term yields as discussed above. As loan growth continues to slow, margins will likely compress as local institutions have to pay more to keep the funding they already have with fewer options for reinvestment on the asset side of the balance sheet.

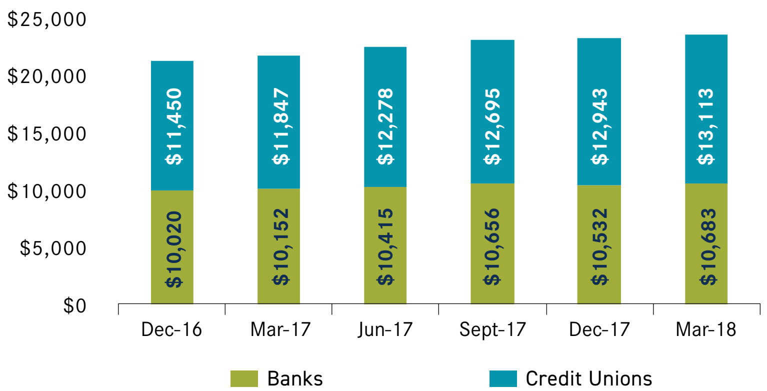
*Sacramento Region Credit Unions fell short for total loan growth during the first quarter as compared to the previous two years.*

**Loan Growth by Category | Sacramento Region Credit Unions | March 2018**

| % of Total | Category | Q1 of 2016 Growth | 2016 Annual Growth | Q1 of 2017 Growth | 2017 Annual Growth | Q1 of 2018 Growth |
|---|---|---|---|---|---|---|
| 53.8% | Auto Loans | 5.0% | 32.9% | 5.1% | 19.6% | 1.8% |
| 37.0% | Residential/RE Lines of Credit | 2.5% | 17.8% | 2.2% | 7.1% | 1.9% |
| 7.6% | Credit Card/Unsecured | -0.3% | 14.2% | -1.1% | 6.9% | -3.8% |
| 1.6% | Other | 5.2% | 23.9% | 5.4% | -9.0% | -2.1% |
| **100.0%** | **Total** | **3.5%** | **24.7%** | **3.5%** | **13.0%** | **1.3%** |

Data Source: NCUA

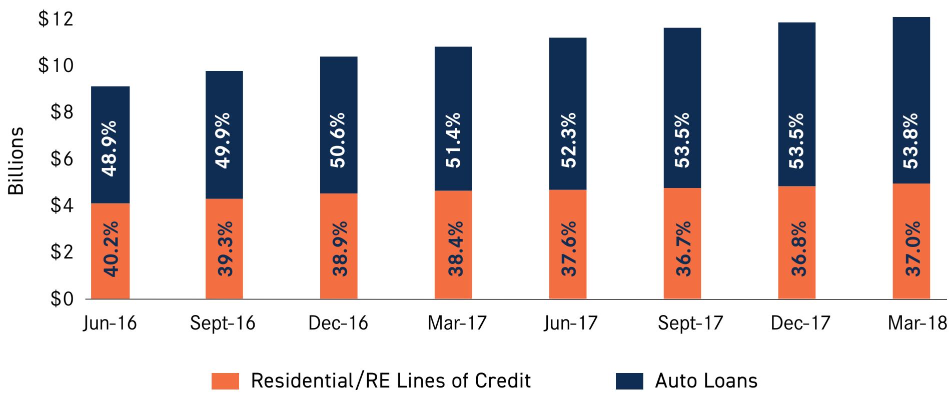
**Aggregate Loans | Sacramento Region Banks & Credit Unions**
**December 2016 – March 2018**




Data Source: FDIC & NCUA

SLOWING LOAN GROWTH ATTRIBUTED TO RISING SHORT-TERM YIELDS

**RE vs. Auto Loans | Sacramento Region Credit Unions**
**December 2016 – March 2018**




Data Source: NCUA

Margins likely to compress

AS LOCAL INSTITUTIONS PAY MORE TO MAINTAIN FUNDING

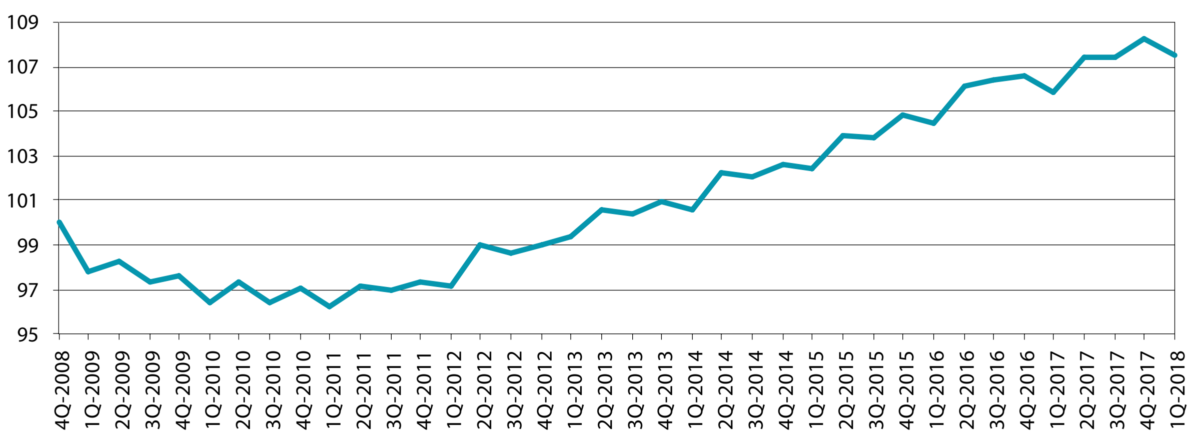
CAPITAL MARKETS & BANKING

**60+ Day Auto Loan Delinquencies | Sacramento Region Credit Unions**
**December 2016 – March 2018**

| Segment | December 2016 | March 2017 | June 2017 | September 2017 | December 2017 | March 2018 |
|---|---|---|---|---|---|---|
| New | 0.33% | 0.27% | 0.25% | 0.27% | 0.31% | 0.26% |
| Used | 0.56% | 0.41% | 0.40% | 0.42% | 0.48% | 0.40% |

Data Source: NCUA

## SBR Financial Conditions Index



MID-YEAR UPDATE

# Human Capital Index

## Current Trends – Generational Challenges and Inclusion Efforts

HR managers are evenly split in reporting generational challenges in their organizations, with 48.86% reporting that no challenges exist. Several HR managers report that the older generations are resistant to new technologies and industry and current trends, while "the younger generation has a hard time listening to instruction from the more experienced generation. The younger generation often have a lot of great ideas. However, many of those ideas have been tested before and there is a reason they have not gone through implementation." In addition, organizations see that Millennials (ages 18 – 38) place a priority on personal life and leisure to a greater extent than did earlier generations. As this finding has been supported by other scientific literature, a fair conclusion is that organizations need to find ways to adapt both formal structures as well as informal practices to be able to attract and retain this recently trained and educated group of employees.

The previously reported lack of focus on diversity and inclusion locally is continuing. Even though many Bay Area companies are vigorously making strides to increase diversity and create inclusive cultures, we are not seeing that same focus here in Sacramento. HR managers report that they themselves view these efforts as slightly higher priorities than do organizational top- and middle-management, who are not seen as placing priorities on either gender or racial diversity.

**Generational Challenges**

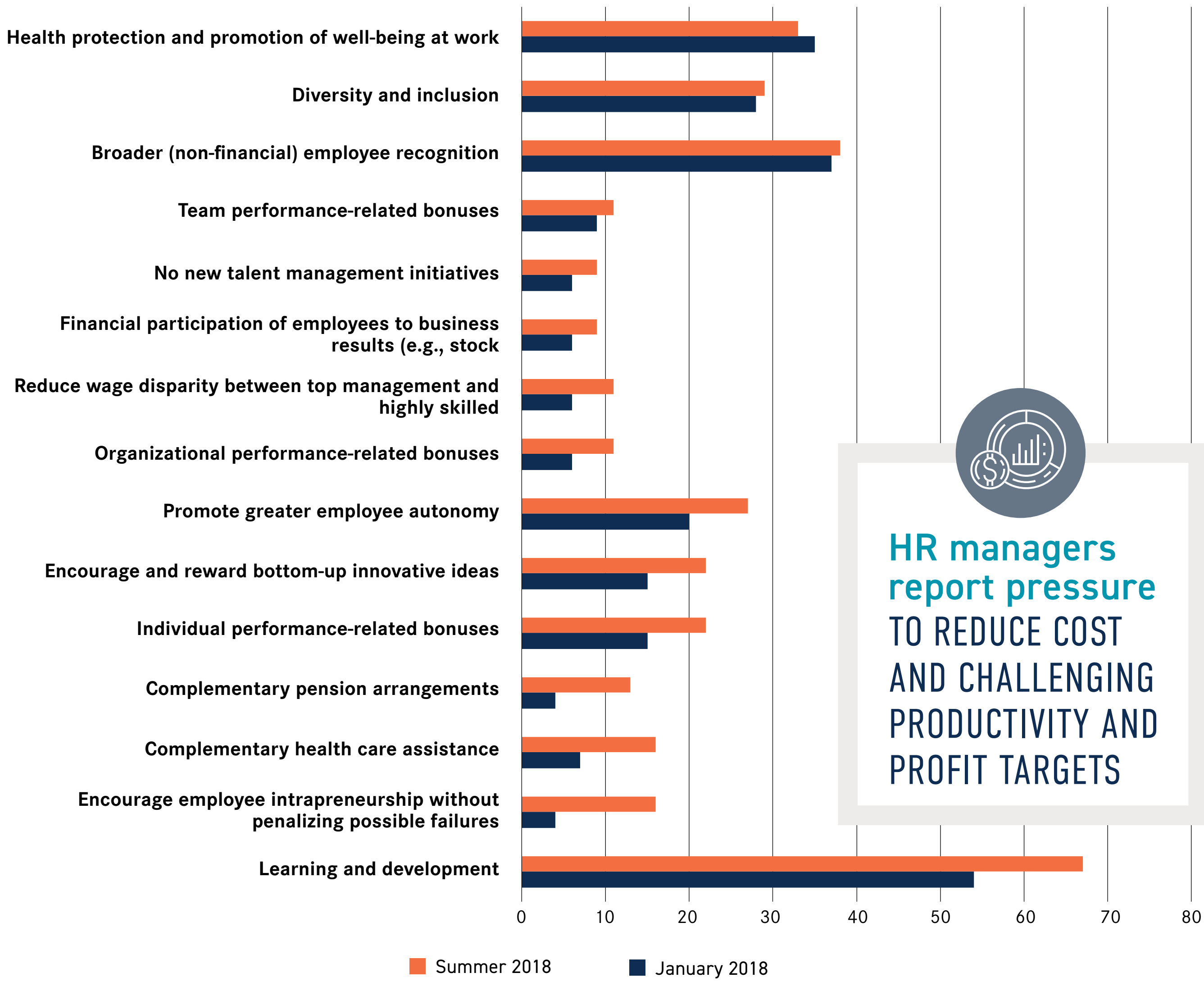

## Human Capital Forecast and Talent Management Initiatives – Q3 and Q4

No significant changes from the January 2018 report are expected for anticipated resignations, training or development efforts, compensation changes, or benefits/perquisites. Slight movement was seen for headcount, where a marginally larger portion of respondents indicated that they are not actively recruiting and expect headcount to remain at current levels. Interestingly, the second area of miniscule movement was diversity and inclusion efforts where slightly more positive reports are noted – a somewhat larger portion of respondents anticipate increased efforts in the diversity and inclusion domain. This seems to conflict with the data reported above. A possible interpretation may be that while diversity and inclusion efforts are not be seen as a current organizational priority, organizations are still seeing the value of accepting everyone into the company culture, and as such, resources are devoted to those efforts.

**LARGEST DIFFERENCES**
from the January issue are reported in focus on
**creativity and innovation efforts**

Continuing the trend from Q1 and Q2, we see a sustained focus on learning and development, perhaps to offset the skills gap reported in the local labor market. The largest differences from the January issue are reported in the creative and innovative space, where both "encouraging intrapreneurship without penalizing any failures" and "encourage and reward bottom up ideas" are taking off. Relatedly, allowing employee autonomy is also seeing a boost in efforts. Complementary benefits (pension and health care) are also in focus.


**Planned Talent Management Initiatives, Q3 and Q4**




**HR managers report pressure** TO REDUCE COST AND CHALLENGING PRODUCTIVITY AND PROFIT TARGETS

## Human Capital – Largest Pressures

Cost reductions and challenging productivity and profit targets are the highest reported pressures on talent management. Second strongest pressures are the skills gap (where job candidates are available but don't have the desired skills) and a talent shortage (where job candidates are simply not available). Divided third place goes to a needed change in company culture to ensure effectively meeting company goals, and expansions into new markets. Last on the list of pressures are increased market competition, market volatility and fear of a recession, organizational restructuring and downsizing.

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