MID-YEAR 2022 ECONOMIC FORECAST | EMERGING TRENDS IN SACRAMENTO'S ECONOMY

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MID-YEAR 2022

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Is Sacramento ready for the next major downturn or recession?

CAPITAL SOUTHEAST CONNECTOR

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MID-YEAR
2022

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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

THE SMALL BUSINESS ECONOMY

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MESSAGE FROM THE CHIEF ECONOMIST

What does a bad hangover feel like!

While I was pessimistic — with dampened expectations about the year before it started — the reality has been more disappointing and negative. In January, we predicted 2022 would bring caution, concerns, declining investor optimism, rampant inflation, low consumer and business confidence, and loss of confidence in the government. We also predicted that the housing market in Sacramento would continue its ascent but would start cooling off.

The U.S. economy shrank in both first and second quarters, the bond market had its worst first half ever recorded in history, while the stock market saw the third worst. All the froth, optimism, and excesses were squeezed out just like lemons, leaving us with a sour and acidic lemon juice to digest.

The free liquidity in excess of $10 trillion pumped into the economy that made us giddy in 2020 and 2021, has now abruptly become the reason behind what has now begun to feel like a nasty hangover. The party is over! We need to end putting more free money on the table — but just in recent months — more stimulus and loan forgiveness has been approved by Congress. A recession seems inevitable as the Federal Reserve struggles to rein in inflation by raising rates.

Unfortunately, I am not convinced Sacramento is ready for the next major downturn or recession. While we rejoice in population growth and migration from the Bay area that has sent the housing market to the moon, job creation has not kept pace, homelessness and crime are on the rise, and we have no new large private sector companies to hang our hats on. While the government jobs appear stable, how long before we go from surplus to deficit mode like in the past?

Warm regards,

Sanjay Varshney

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FEATURES

"Mobility is key to prosperity. The Connector provides greater workforce mobility, greater mobility for goods and services and new mobility for active recreation. When you couple that with the direct economic benefit of the jobs created and the materials purchased in order to construct it, there is no denying the Connector is a significant economic driver for our region."
– Pat Hume, Elk Grove Councilmember and JPA Board of Directors

Capital SouthEast Connector

CAPITAL | SOUTHEAST CONNECTOR
Connecting Communities

The Capital SouthEast Connector (Connector) is an innovative, 34-mile multimodal solution to the transportation challenges of South Sacramento County.

Project Overview

South Sacramento County lacks sufficient connectivity and multi-modal facilities to accommodate the community needs and its growing economy. Existing roadways are in poor condition and often flood during severe storm events. The facilities lack bicycle and pedestrian accommodations to provide for non-motorized travel. There are limited roadway connections from east to west causing motorists to use the already congested freeways for travel.

The Connector replaces existing two-lane rural roads with a four-lane modern expressway including a separated Class I multi-use path. The redesigned roadway provides capacity for a growing population, active transportation opportunities, access to employment centers, addresses climate resiliencies, deploys innovative technology, and provides for improved quality of life.

Economic Benefits

The Capital SouthEast Connector is more than a regional multimodal roadway facility. Economists agree that the Connector provides significant economic development benefits to the region.

The Connector JPA prepared an economic study in 2022 to determine the direct and indirect benefits of the Connector construction. This study finds that a $552.5 million investment in construction by the Connector JPA would create a substantial gross economic impact. The incremental economic impact to the region between 2021 and 2040 would produce $1.1 billion of economic output and create 7,347 new full-time jobs. The Connector would also generate $43.1 million in new indirect business taxes. Creating new well-paying jobs will provide a tremendous lift to the region's economy.

Key Benefits

- $585.7 million in travel time savings benefits to commuters
- $37.3 million in residual investment value of Connector construction
- $19.5 million in safety benefits from avoided collisions
- $17.2 million in avoided pavement rehabilitation costs
- $6.8 million in increased walking and biking benefits for the community
- $6.3 million in reduced vehicle emissions benefits for the region
- $3.5 million in savings from reduced truck miles traveled and operating costs

"Our population has doubled between 1980 and 2020 — my lifetime. To accommodate that growth in population, we must continue to make investments that expand the capacity of all infrastructure: adding a new airport terminal, raising Folsom Dam, and building new roadways are all important investments to grow our economy."
– Derek Minnema, Executive Director, Capital SouthEast Connector JPA

Key Benefits

- Replaces 2-lane rural roads with 4-lane expressway
- Adds a separated Class I multi-use path along the corridor
- Establishes an efficient and reliable freight corridor in the region
- Addresses regional climate resiliency and environmental stewardship issues
- Deploys innovative smart technologies to manage and improve traffic flow
- Reduces vehicle miles traveled and travel times for commuters
- Provides new interregional route Connecting I-5 to SR 99 to SR 16 to US 50
- Enhances safety by constructing medians, improved intersections, separated Class I multi-use path, buffered bike lanes, and removing obstructions from the clear recovery zone
- Reduces vehicle miles traveled and greenhouse gas emissions, provides resiliency by correcting persistent roadway flooding issues, avoids impacts on underserved communities, and supports habitat conservation
- Provides multimodal connectivity to affordable and workforce housing, job centers, healthcare, and recreational facilities and removes barriers to opportunity
- Improves traffic operations to job centers, supports regional jobs creation, and supports truck throughput and operations from aggregate mines
- Improves affordable transportation choices for underserved communities with the accessibility of bicycle and pedestrian facilities and access to bus transit
- Implements a "fix it first, fix it right" approach to replace failing pavement
- Extensive support from local, state, and federal elected officials, labor unions, business groups, agencies, and residents
- Constructs a smart corridor with emerging technologies

Key Supporters

U.S. Senator Alex Padilla
U.S. Representative Ami Bera
CA Assemblymember Ken Cooley
Sacramento County Sheriff Jim Cooper

"In recent years, the Greater Sacramento Area struggled a lot in attracting new industries, business, and jobs. Transport infrastructure is a well proven driver of economic development and vibrancy. For instance, construction of Highway 65 was a huge positive impact on communities of Lincoln and Roseville as well as the whole Placer County. This Project will be a historic chance to increase long-term economic competitiveness and attractiveness of Project area communities as well as Sacramento and El Dorado counties as a whole. The investment of $600 million has a tremendous payoff potential that is worth billions of dollars in the long run. The new local taxes on production and imports could be beneficial to the jurisdictions as they seek to make their local communities more economically vibrant. A spirit of entrepreneurship, cooperation, and investment, together with a vision of the long-term benefits will lead the project area to a new level of competitiveness and prosperity as a region."
– Sanjay Varshney, PhD, CFA

KEY POINTS

LABOR MARKETS & REGIONAL ECONOMY

- The Sacramento Region's labor market has made a full recovery to the pre-pandemic level, with all major labor market segments in the region adding jobs over the past 12 months.
- The local unemployment rate has yet to make a full recovery, as the region's population and labor force has increased faster than jobs over the past two years.
- A normalized 3.60% increase in weekly wages is falling short of price increases induced by inflation.

SBR/SAFE CREDIT UNION CONSUMER SENTIMENT SURVEY

- Regional and national consumer sentiment are down since our annual release in January 2022.
- National sentiment declined more than regional sentiment during this period, but regional sentiment remains below national sentiment overall.
- Regional consumers indicate inflationary and related economic concerns and plan to reduce spending on major purchases.

SMALL BUSINESS ECONOMY

- Relative to the 2021 mid-year update, the results in every category point lower; however, they do reflect a better environment than the bottom of 2020. All five categories — Economic Outlook, Business Conditions, Credit Access, New Hires, and Future Revenue Outlook came in below their 18-month moving averages. Responses for the Economic Outlook and for Local Business Conditions came in the weakest, dropping 31% and 25%, respectively.
- It appears that total loan volume activity is on pace to come in 30% below last year's total volume. Over the past three years, Sacramento County has averaged 61% of this volume, but this year it is on track to drop to 56%. The difference is being captured by Placer County with the share increasing from 19% to 24%. While the total loan volume may be on track to decrease significantly, one should bear in mind that this is compared to the all-time high registered in 2021.
- The number of business listings and transactions are higher compared to 2021. Transaction metrics were also higher year-over-year, with Revenue and Cash Flow metrics increasing 4% and 19%, respectively. While business transactions data portray a view of what already happened, the general takeaway is that it appears this data peaked sometime at the end of 2021 and the numbers coming in are the remnants of a very strong 2021.

REAL ESTATE

- **Residential Market:** The market still lacks housing inventory despite the highest development totals in more than a decade. Prices continue to grow despite rising interest rates, but growth in that area will likely slow in coming periods.
- **Office Market:** Office leasing activity has increased over the past 6 months; however, many companies are "right-sizing" to accommodate new hybrid work models, which is resulting in increasing vacancy, primarily in Class B and Class C product.
- **Industrial Market**: Market remains in good standing with new inventory leasing quickly, although the rate at which leases sign could slow, with Amazon pulling back in Sacramento and across the county. Sales activity could also slow as interest rates exceed cap rates, making returns on new investments hard to realize.
- **Retail Market:** Recovery has been much stronger than was initially feared. There has been demand for some of Sacramento's larger spaces, with discount retailers and fitness users as some of the most active.

CAPITAL MARKETS & BANKING FORECAST

- The Federal Reserve kept interest rates too low for too long, and asset purchasing programs (quantitative easing) were ongoing as late as the first quarter of 2022. These actions, combined with the unprecedented fiscal stimulus in the COVID relief bills, ignited inflation to levels not seen in 40 years. The Consumer Price Index (CPI) increased 9.1% in June and the Producer Price Index (PPI) increased 11.3%.
- Although the exceptionally strong labor markets have been a bright spot for the U.S., with unemployment remaining near historic lows, we believe this market is likely to soften. While labor markets have been tight, wage growth has not kept pace with inflation.
- Equity markets entered bear status in May. Investors fled to safety, with value and defensive outperforming growth and cyclical. Driven by underlying commodity prices, energy continued to perform well, while Technology stocks experienced the most significant selloff. The SBR team believes equity markets have already experienced the bulk of the pain, and we project positive single digit returns for the second half of 2022.
- Regional financial institutions are likely to end the year with relatively good performance. The key market risks posed by the Fed's actions — along with looming credit risks — are not likely to materially impact earnings statements until 2023. If the Fed can bring inflation down while keeping unemployment low, 2023 and beyond may turn out quite rosy. The SBR team expects more credit and market risk to materialize as we head into the second half of 2022 and early 2023.

HUMAN CAPITAL TRENDS

- With an expectation for a more normal talent management landscape in 2022, there is a sense of disappointment across organizations.
- The talent market continues to face unprecedented worker shortages as turnover is still growing in the Sacramento region.
- Sacramento organizations are increasing hiring for Summer and Fall, predicting job growth and setting organizations up for churn.
- As workers are adapting to post pandemic work expectations, burnout is increasing.
- Fairness and equity will become significant issues as parts of the workforce are able to negotiate work-from-home and related benefits, while other workers do not have such access.
- Worker performance is decreasing as employees are "quitting in place."

TOURISM & HOSPITALITY

- A good post-COVID recovery in the Sacramento hotel industry — especially in the second half of 2021 — is now slowing down and reversing course in 2022.
- Natomas demonstrates the best growth in occupancy rates compared to other zones, including downtown.
- Average daily rates for rooms, sharply declined during COVID, recovered nicely in the second half of 2021, but declined again in the first quarter of 2022.

HEALTHCARE

- Sacramento's healthcare industry, though battered by the pandemic, is a bedrock of the region and maintains tremendous growth potential and investment opportunity.
- The healthcare sector continues to be the strongest sector of the labor market, attracting national and international talent.
- The trifecta of education, innovation, and enterprise offered in the region's healthcare sector must collaborate to combat American's general dissatisfaction with the nation's healthcare system, unprecedented healthcare-worker burnout, nursing shortages, and increasing financial challenges within healthcare.
- The region's health systems have planned significant growth in hospital and medical centers over the next 5-10 years; increased capital costs may delay expansion or renovations unless innovative solutions are created through independent breakthroughs and/or community-wide business collaboration.
- The median hospital across the nation is experiencing significant operating losses according to industry watchers Fitch and Kaufman Hall.

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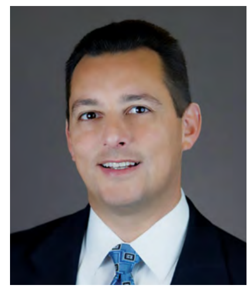

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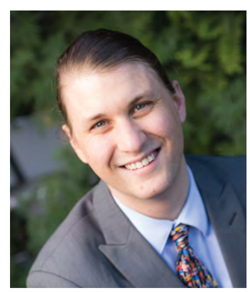

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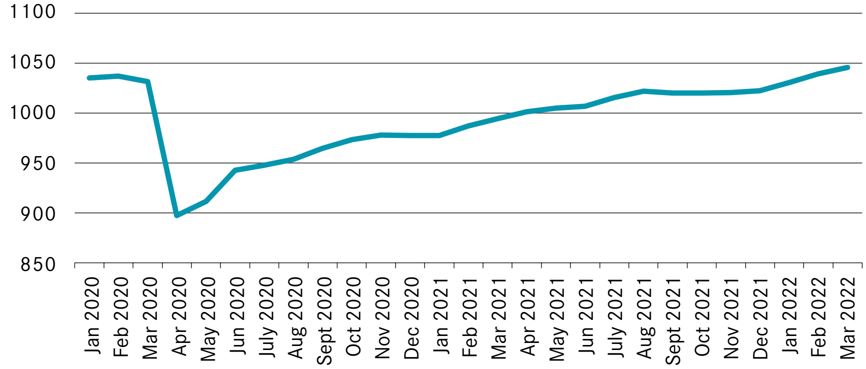
We're improving our local air quality, creating a clean energy economy and helping the planet. By 2030, we'll eliminate all carbon emissions from our power supply, so all of the customers we serve will live in a Clean PowerCity℠. As we change the future for the better, our commitment to deliver safe, reliable and affordable energy won't waver - as your community-owned, not-for-profit electric service for nearly 75 years.
Join the charge
CleanPowerCity.org
SMUD®

Labor Markets
& Regional Economy

The Sacramento Region's labor market has officially made a full recovery following the pandemic induced recession in early 2020. Regional employment is currently 1.045 million, which is 8,000 more jobs; a 0.85% increase than the previous peak in February 2020. However, the unemployment rate has yet to make a full recovery, as the region's population and labor force has increased faster than jobs over the past two years. The Sacramento Region's unemployment rate currently sits at 4.0%, which is still elevated from the previous cycle low of 3.2% in September 2019.

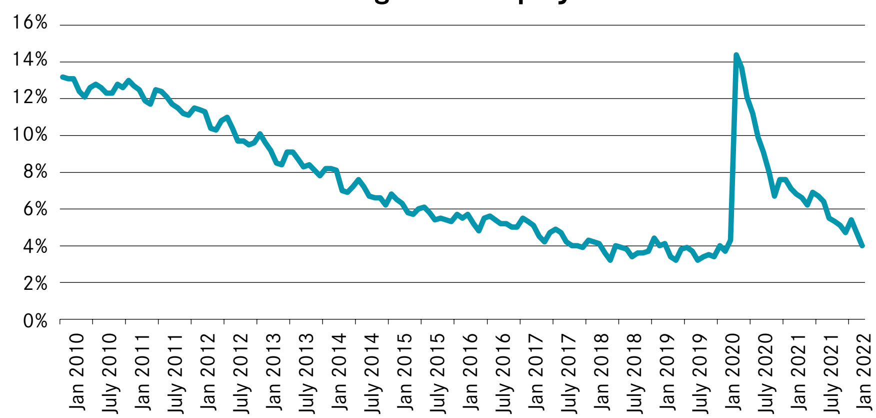
The Region's labor market recovery has been broad, with all nine of the major labor market segments adding jobs over the past 12 months. Major contributors to the recent job boom have been leisure and hospitality and construction, whereas financial activities and government have lagged. However, several segments of the labor market have yet to make a full recovery from their pre-COVID highs,

Figure 1
Sacramento Region Employment



Data Source: St. Louis Federal Reserve

Figure 2
Sacramento Region Unemployment Rate



Data Source: St. Louis Federal Reserve

MID-YEAR UPDATE

The Region's labor market recovery has been broad, with all nine of the major labor market segments adding jobs over the past 12 months.

with leisure and hospitality jobs down 8.7% and finance jobs down 1.5% from February 2020.

The wage data seems to show mixed results. Average hourly earnings increased sharply in 2021, but have declined slightly in 2022. Meanwhile, the average number of hours worked per week have continued to decline from a peak of 35.1 to 33.1 hours, a 5.7% decrease.

Over the past year, average hourly earnings have increased by 7.04%, but this was partially offset by a 3.22% decrease in the average weekly hours worked, resulting in a 3.60% increase in average weekly earnings. With inflation running over 9%, a 3.60% increase in weekly wages is falling well short of price increases. The question is: Are employees choosing to work fewer hours as their hourly compensation increases or are employers limiting hours due to supply chain issues, uncertain demand for goods and services, recessionary fears, or other reasons?

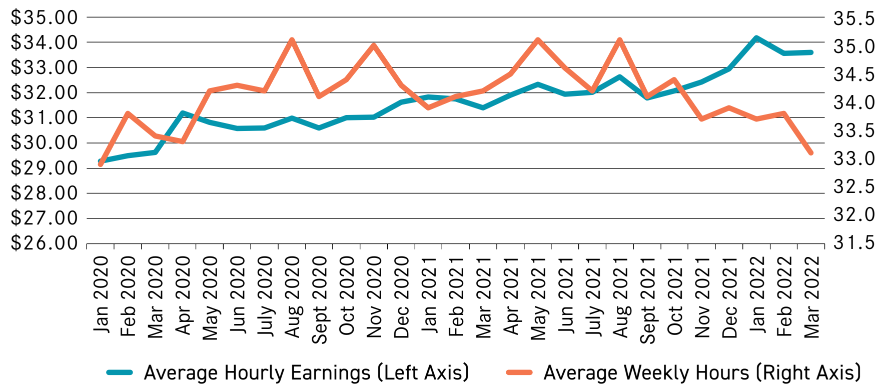
3.60% INCREASE IN WEEKLY WAGES IS FALLING SHORT OF PRICE INCREASES.

Table 1
Local Labor Market Change by Economic Sectors

Sector	Jobs (in thousands)	% change (Mar 2021 – Mar 2022)
Total Nonfarm	**1045.8**	**+5.2%**
Leisure and Hospitality	102.0	+20.9%
Education	12.5	+6.9%
Construction	78.9	+6.3%
Trade, Transportation, and Utilities	171.2	+4.4%
Professional and Business Services	141.8	+3.7%
Healthcare	161.3	+3.5%
Manufacturing	38.4	+3.4%
Government	242.9	+2.8%
Financial Activities	52.2	+1.3%

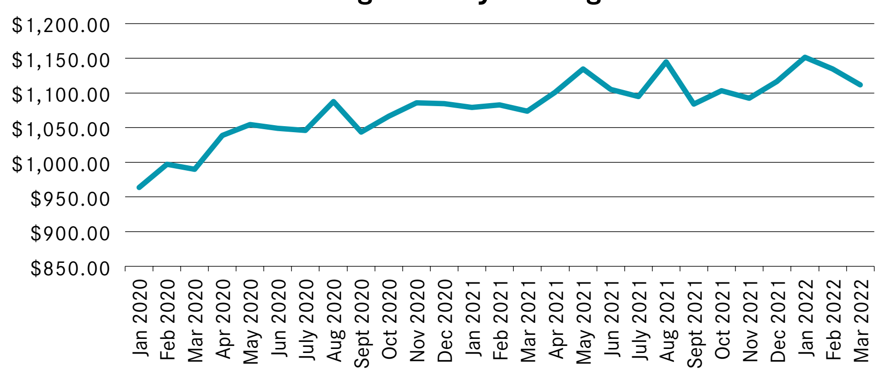
Data Source: St. Louis Federal Reserve

Figure 3
Hourly Earnings and Hours Worked



Data Source: St. Louis Federal Reserve

Figure 4
Average Weekly Earnings



Data Source: St. Louis Federal Reserve

LABOR MARKETS

SAFE CREDIT UNION

MID-YEAR UPDATE

Consumer Sentiment *Survey*

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

Regional 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.

(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.

Table 1 · Regional vs. National

	Regional Index Score		National Index Score	
	Mid-Year Update	Change Since January 2022	Mid-Year Update	Change Since January 2022
Index of Consumer Sentiment	57.2	**-9.0**	58.4	**-12.2**
Index of Current Economic Conditions	52.3	**-9.5**	63.3	**-10.9**
Index of Consumer Expectations	60.4	**-8.6**	55.2	**-13.1**

Notes: National data obtained from the University of Michigan Consumer Sentiment Survey May 2022. Final 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.

Overall, national consumer sentiment dropped substantially (12.2 points) since our annual release (58.4 mid-year 2022 vs. 70.6 January 2022). This includes lower perceptions about current economic conditions and a more pessimistic outlook for the future. At the regional level, consumer sentiment has also fallen substantially, decreasing 9 points to 57.2 from 66.2. (See Table 1 and Figure 1) This marks the lowest reading since the inception of our regional survey. Regional perceptions of current economic conditions are well below national levels whereas regional expectations for the future are more optimistic than national. A more negative outlook on current conditions could be a reflection of inflationary pressures that are exacerbated in the regional economy. For example, local gas prices remain among the highest in the country, and the region has seen marked increases in residential housing prices and rental rates over the past year.

REGIONAL & NATIONAL CONSUMER SENTIMENT ARE DOWN SINCE OUR ANNUAL RELEASE.

> *Over the next year, 80% of regional respondents expect prices to increase, with 65% expecting that their income will lag behind these price increases.*

Purchasing and Credit

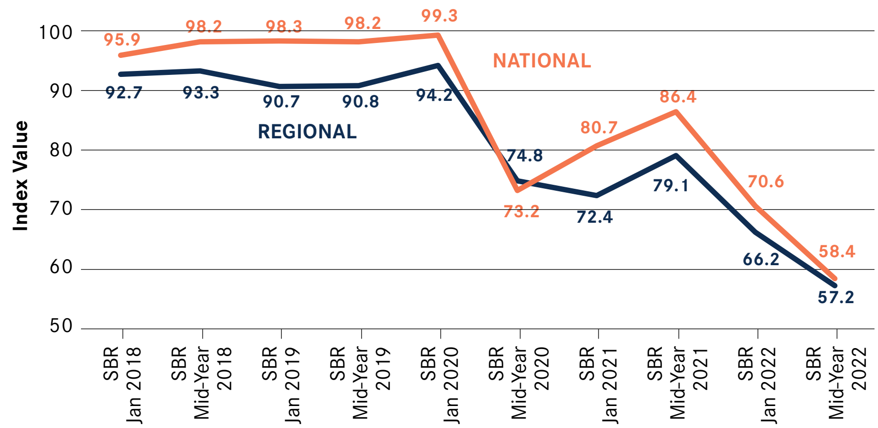
Inflationary and related economic concerns continue to weigh heavily on regional consumers' minds. Over the next year, 80% of regional respondents expect prices to increase, with 65% expecting that their income will lag behind these price increases.

The data also suggest a slowdown in consumer spending. Asked if they plan to purchase a major household item in the next six months (e.g., furniture, television, refrigerator, etc.), only 17% reported an intention to do so. Regional consumers also expressed lower intentions to acquire mortgages and auto loans with slight upticks in plans to acquire credit cards and student loans. (See Figure 2)

Summary

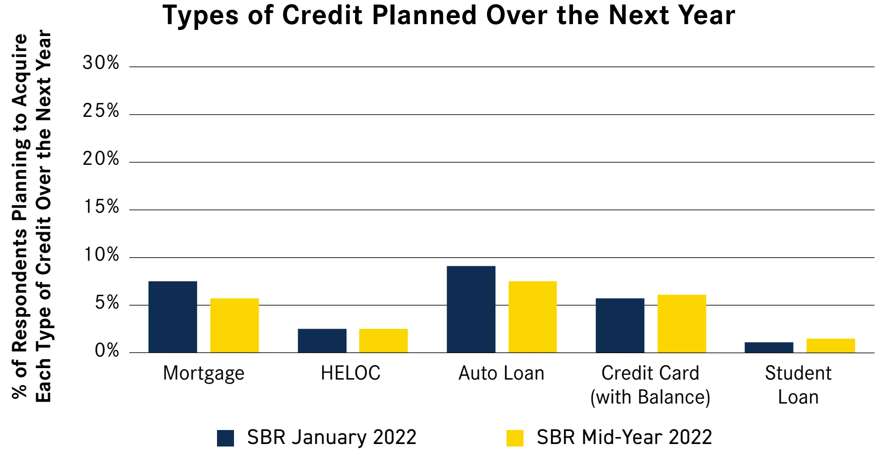
Regional and national consumer sentiment continues the plunge seen in our annual release. Consumers clearly perceive inflationary and other economic threats and indicate plans to reduce spending over the next year.

Figure 1
Regional and National Consumer Sentiment



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

Figure 2
Types of Credit Planned Over the Next Year



The Small Business *Economy*

The Small Business Economy of the Greater Sacramento region has seen better days. As usual, the Sacramento Business Review (SBR) team conducted its mid-year checkup, which includes evaluating the results of the Small Business Confidence Index (SBCI) to gauge business sentiment, analyzing loan trends in the region, and reviewing the business transaction results of our local economy. Relative to the 2021 mid-year update, the results in every category point lower; however, they do reflect a better environment than the bottom of 2020.

Starting with the results of our proprietary index ("SBCI"), the responses displayed a meaningful drop in overall sentiment across all categories. The two weakest compared to a year ago were views of the Economic Outlook and Local Business Conditions, which dropped 31% and 25%, respectively. Additionally, respondents indicated a weaker Credit Access environment, with the responses dropping 20% relative to the beginning of the year. As the SBR team indicated at its annual 2022 update, higher interest rates have now materialized and the positive boost received in 2021 is quickly disappearing as business credit dries up and affordability is negatively impacted.

While results for Business Conditions have dropped 25% in the last year, it is noteworthy to point out that this is still 70% higher than the bottom marked in July 2020. This is reflected across all categories where, despite robust double-digit improvement relative to the 2020 lows, the conditions have a long way to go before enjoying the highs of a 5-year pre-pandemic average. All five categories — Economic Outlook, Business Conditions, Credit Access, New Hires, and Future Revenue Outlook came in below their 18-month moving averages.

Figure 1 • Overall Sentiment
(January 2011 - July 2022)

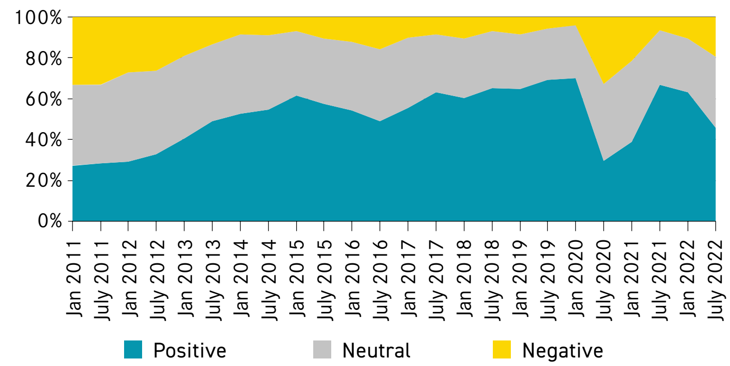


Figure 2 • SBCI Total: Local Business Conditions
(18-month Moving Average)

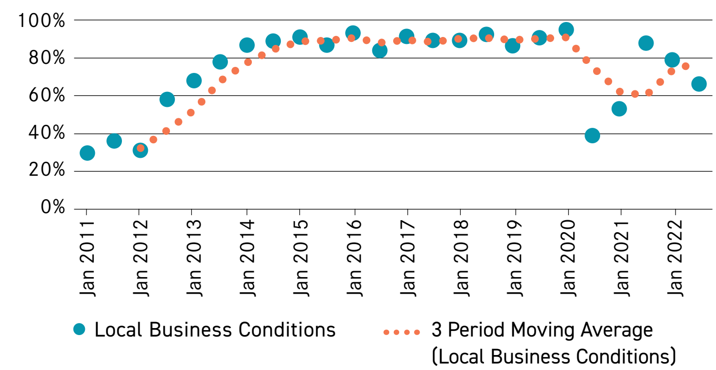
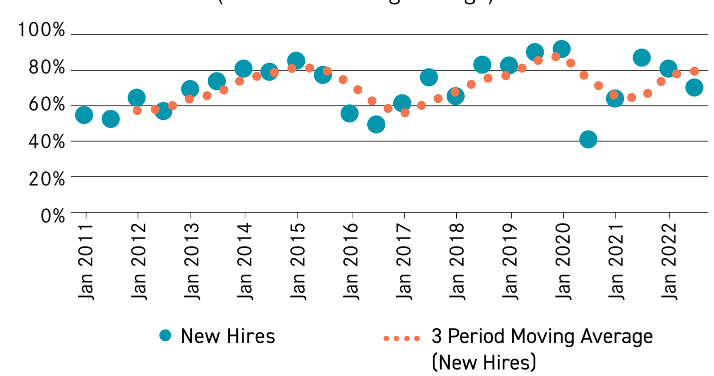


Figure 3 • SBCI Total: New Hires
(18-month Moving Average)



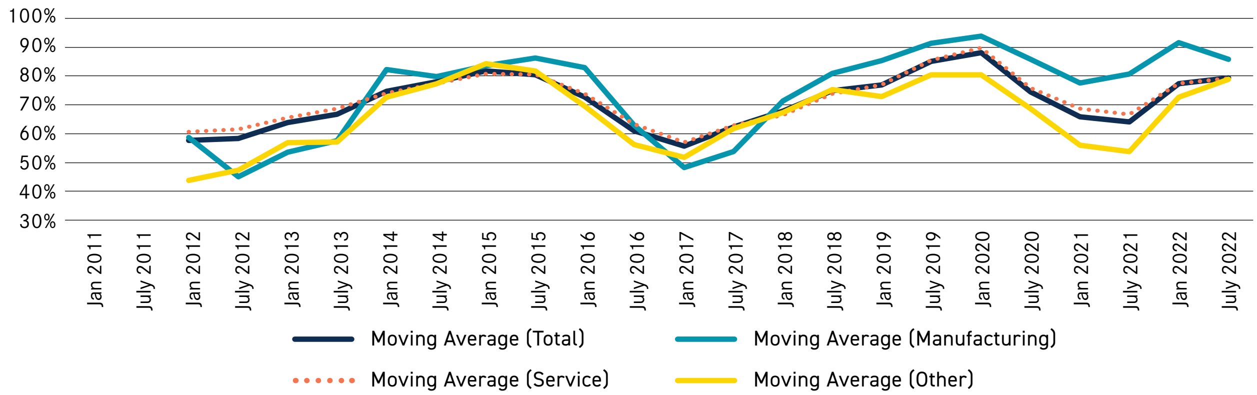
Source for all SBCI: DCA Capital and Sacramento Business Journal

Lending activity data provided by the Small Business Administration shows that loan volumes are on pace to come in 30% below last year's total volume.

Lending activity data provided by the Small Business Administration shows that loan volumes are on pace to come in 30% below last year's total volume. The loan volume share of Sacramento County comprises 56% of the total in the region, which is below the 3-year average of 63%. Placer County picked up the difference by increasing to 24% of the total loan volume, compared to only 19% last year. Yolo County increased slightly from 7% to 9%. Finally, El Dorado County remained unchanged, marking 10% of the total loan volume in the region. If the results were wrapped up right now, the total loan volume would be 14% higher than the 5-year pre-pandemic average of $288.3 million. While it appears that the second half of the year might be slower given conditions have changed dramatically over the past 6 months, it is important to note that the comparisons are to the all-time high of 2021. Combining this data with the SBCI results, credit access across sectors came in 19% lower relative to the 2022 annual update.

Figure 4 • SBCI Likelihood to Hire by Sector

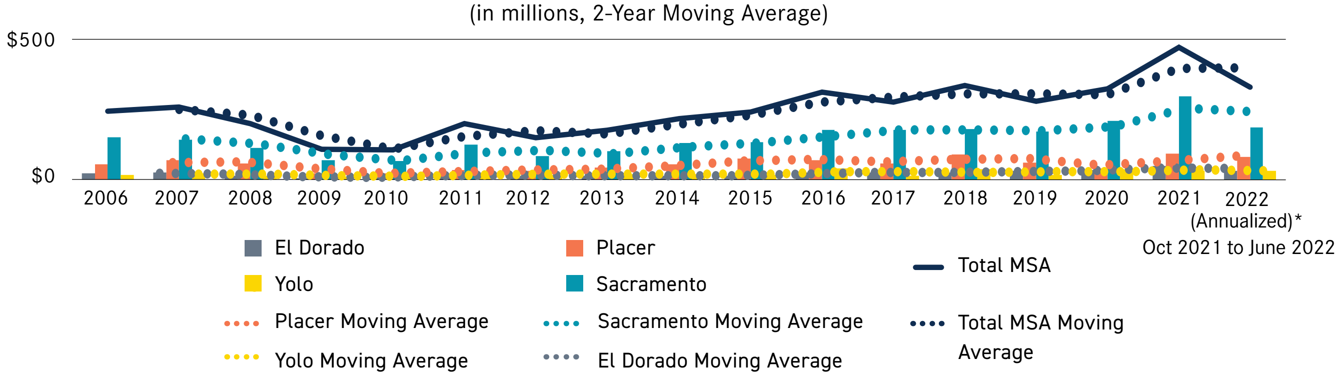
(18-month Moving Average)



Moving Average is average of three previous data points.

Figure 5 • Total SBA Loan Approvals By County

(in millions, 2-Year Moving Average)



Moving Average is average of two previous data points.

SMALL BUSINESS

RESULTS ACROSS SECTORS WERE 19% LOWER COMPARED TO THE BEGINNING OF THE YEAR.

LISTINGS REMAIN STEADY, AND MORE SALES ARE OCCURING COMPARED TO 2021.

Compared to 2021, there are 25% more business listings and 33% more transactions year-to-date. At first glance, it appears there is a deceleration in sale transactions, but these numbers are higher than the overall 2021 transactions. Additionally, the reported transaction metrics are higher compared to 2021. Year-over-year, the average Revenue and Cash Flow metrics of sold businesses were 4% and 19% higher, respectively. Median Sales Price for closed deals reflected a 43% premium over Median Asking Price in the last twelve months. Business transactions tend to be a lagging indicator given various factors such as the time it takes to close deals and historical past data in the reports. Nonetheless it appears that the data overall depicts a similar peak reached sometime at the end of 2021.

Figure 6 • SBCI Credit Accessibility by Sector

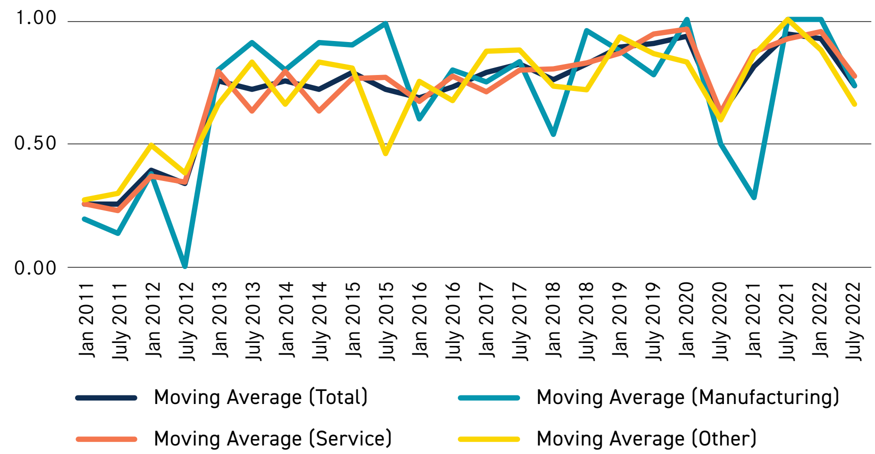
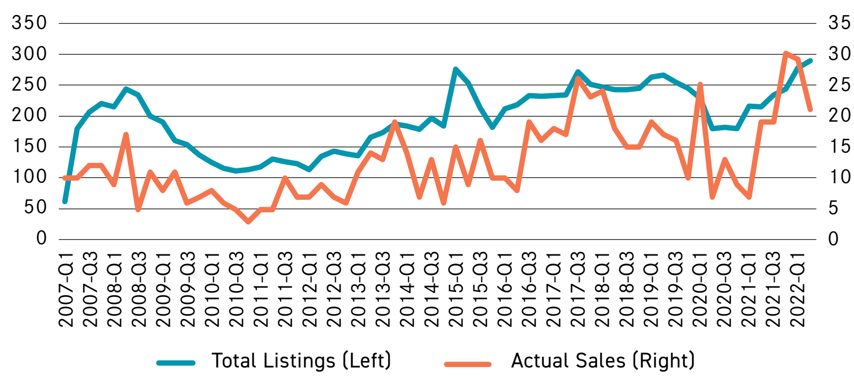


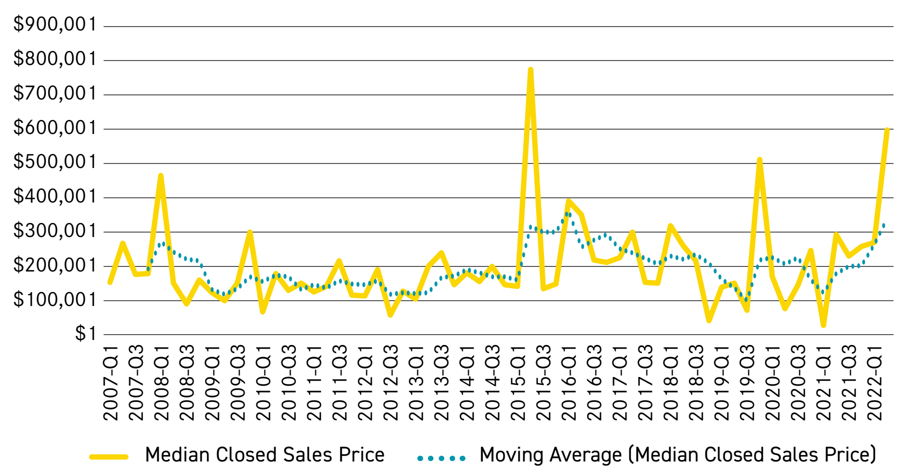
Figure 7 • Number of Listings vs. Actual Sales (Quarterly)



Data Source: BizBuySell

Figure 8 • Median Closed Sales Price (Quarterly)

(1-year Moving Average)



Data Source: BizBuySell

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According to the Bureau and labor statistics, over 4 million healthcare jobs will be added through 2026, making it **the fastest-growing professional field**. Additionally, the employment of medical and health services managers is **projected to grow 32%** from 2019 to 2029, much faster than the average for all occupations.

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SCAN ME

Real Estate

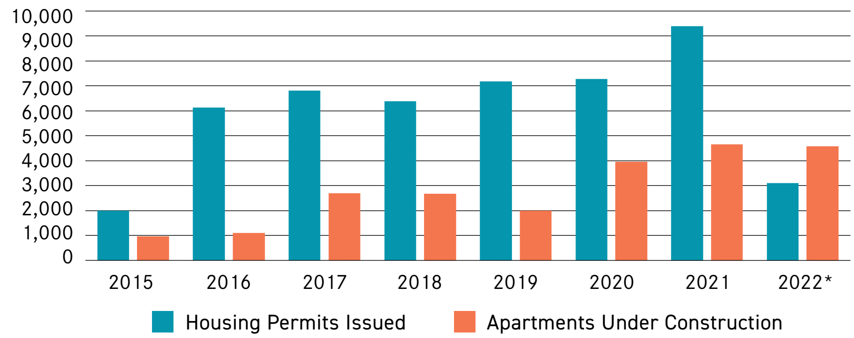
Residential

Sacramento's residential real estate sector still has a supply shortage after years of increasing construction. Both multifamily and single-family development are nearing a combined all-time high with more than 14,000 new homes underway in 2021. All this construction comes on the heels of strong pricing growth in both apartment rents and single-family home values.

The median home price in Sacramento stretched to $605,000 at the midpoint of 2022, having increased by more than 40% since the first quarter of 2020. For comparison, in the two-year period between 2018 and 2020, the median home price grew by 12% — a strong figure — but nowhere near the growth seen in more recent quarters.

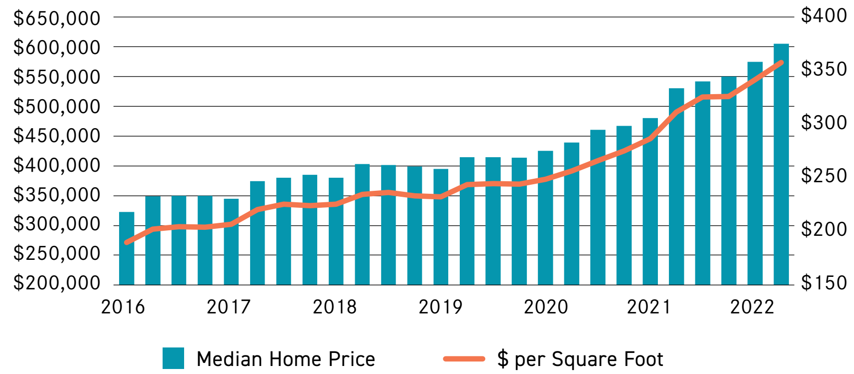
Sacramento renters are witnessing slowing in rental cost growth. The average asking rent has settled at $1,770 per month, up 6% over the past year. For comparison, at the mid-point last year, rents were up by 13%, one of the highest increases in the nation. Some areas, like Roseville and Folsom, recorded annual growth of more than 20%. These same areas, one year later, are seeing rent growth around 3%, but they still command a 23% premium over the market average.

Figure 1
Housing Permits Issued & Apartments Under Construction



Source: CoreLogic

Figure 2
Median Home Prices & Cost Per Square Foot: 2016 - 2022



Source: CoreLogic

> *The median home price in Sacramento stretched to $605,000 at the midpoint of 2022, having increased by more than 40% since the first quarter of 2020.*

There are possible headwinds facing the residential sector. Although it is difficult to categorize the market as 'affordable' with another record high for the median home price — there is evidence that the rate of migration to the region is slowing. Additionally, rising interest rates limit buying power. These two factors could combine for a pricing correction over the next year or two.

Market availability is far from alarming levels, currently on par with activity seen in early 2017 and below record highs seen in 2010 and 2011.

Office

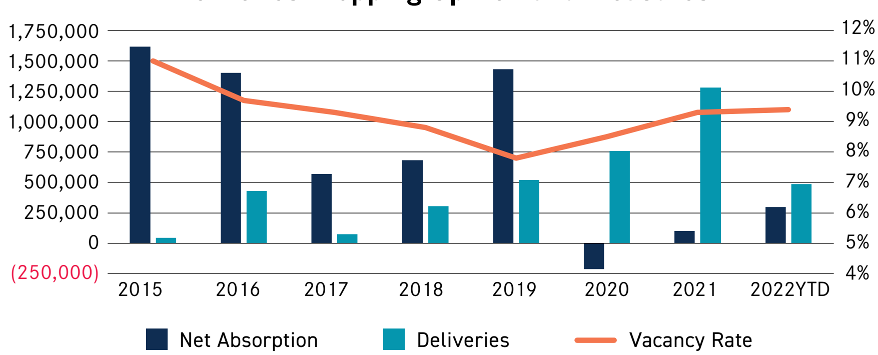
With employees and employers becoming accustomed to the ebb and flow of the pandemic, long-term return-to-office strategies are finally being determined and implemented. Employers remain mindful of talent retention, while focusing on space efficiencies and improving office space to create a work culture and environment employees want to return to. Class A and creative office space is seeing increasing activity, while Class C and under-improved space will likely remain dormant for the foreseeable future. As companies downsize their footprint to reduce their real estate costs, availability is increasing. Despite this trend, market availability is far from alarming levels, currently on par with activity seen in early 2017 and below record highs seen in 2010 and 2011.

One potential headwind in addition to pandemic-related supply increases, is that the region's largest occupier, the State of California, plans to shift occupancy to state-owned real estate. The sequencing plan, put together by the Department of General Services, calls for the construction of a number of new office buildings in Downtown. The first of these locations, the Natural Resources Building, was completed in October of 2021 and houses a number of state agencies. Three government buildings have been completed in the past 12 months, bringing a total of 1.7 million square feet to the market. While the new inventory will be occupied, sizeable holes in privately held properties will be left, causing a net increase in vacancy and some downward pressure on rents.

There is some optimism surrounding the office market. During the prior economic cycle, Sacramento was at a competitive disadvantage with a lack of large blocks of available space in the market. While there have been an increasing number of announcements regarding new small- to mid-sized firms occupying new space in the capital region, some existing companies have announced sizeable expansions of current facilities. Some of the most notable are Thermogensis in Rancho Cordova, which committed to an additional 30,000 square feet to expand their gene therapy business and Penumbra, which will lease an additional 50,000 square feet in Placer County.

Despite the hardship of the last few years, the office market is showing some signs of recovery, albeit slowly. New residents from the Bay Area have improved the local

Figure 3
Deliveries Propping Up Demand Measures

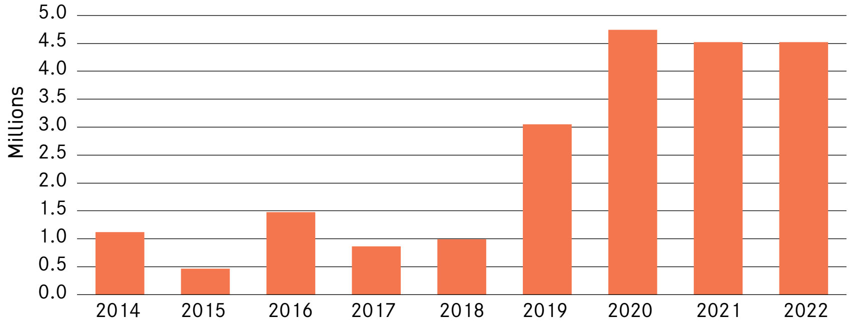


Source: CoStar

REAL ESTATE

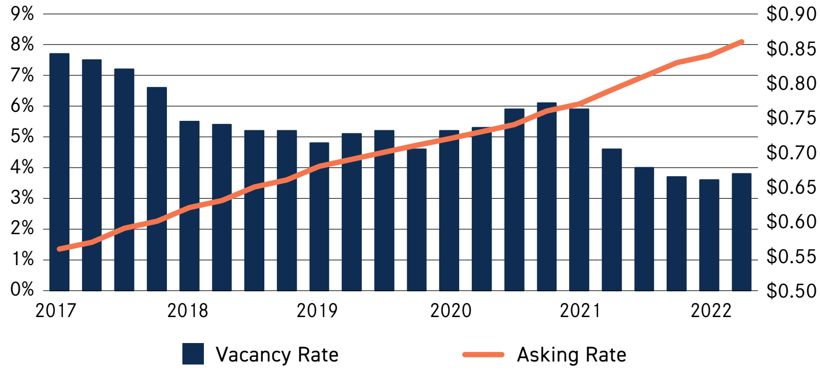
talent pool and bring promise of new employers, retailers, housing developments, and eventually, office space absorption. Property owners considering improving or re-purposing functionally obsolete or tired real estate despite high construction costs will easily prevail over conservative investors not mindful of quality product with amenities. Sacramento tenancy includes a large proportion of defensive labor sectors, like government and medical users, which have helped buoy the market when it turned in the past; however, new industries and private sector employers are the key to a bright future.

Figure 4
Industrial Under Construction: 2014 - 2022 (SF)



Source: CoStar

Figure 5
Vacancy & Asking Lease Rate: 2017 - 2022



Source: CoStar

Industrial

The industrial market remains one of the strongest sectors in Sacramento. The vacancy rate is below 4%, despite high levels of construction over the past few years and another 5 million square feet is currently underway. Demand has been particularly high for these new buildings, as most of the market's existing inventory is old and functionally obsolete for modern eCommerce and third-party logistics users. Development is spread throughout much of the region but the most concentrated area remains Metro Air Park which has so far delivered 9 buildings for a total of 5.7 million square feet. Another 36 properties are planned or under construction, which would bring another 12 million square feet to the area.

Recently the market has been heavily reliant on eCommerce firms to occupy much of this new inventory. Amazon has been responsible for more than a third of leases on new construction by square footage since 2017. With the announcement that Amazon would be subleasing approximately 10 million square feet across the country, they are unlikely to occupy any of this next wave of development. With that said, the eCommerce giant is far from the only tenant seeking space in Sacramento, as both food users and third-party logistics firms have been very active in the region. While Amazon's absence may slow the rate at which new spaces are occupied, it should not slacken the demand for such inventory.

The market vacancy rate has been below 6% since the start of 2018. Such a long stretch of time with very limited supply has put significant upward pressure on asking rates throughout the market. Over the past year, lease rates are up by nearly 9%, and they have cumulatively grown by 50% over the past five years. Further rent growth is expected in the coming months as construction costs remain elevated, especially for raw materials and, as mentioned, available inventory remains difficult to source.

The industrial market continues much of the velocity from prior years. However, it is worth keeping an eye on investment activity going forward as rising interest rates paired with near record low cap rates could slow trades in the coming quarters. With that said, property values themselves are not expected to decrease as cash flows will keep pace on the back of increasing asking rates.

Retail

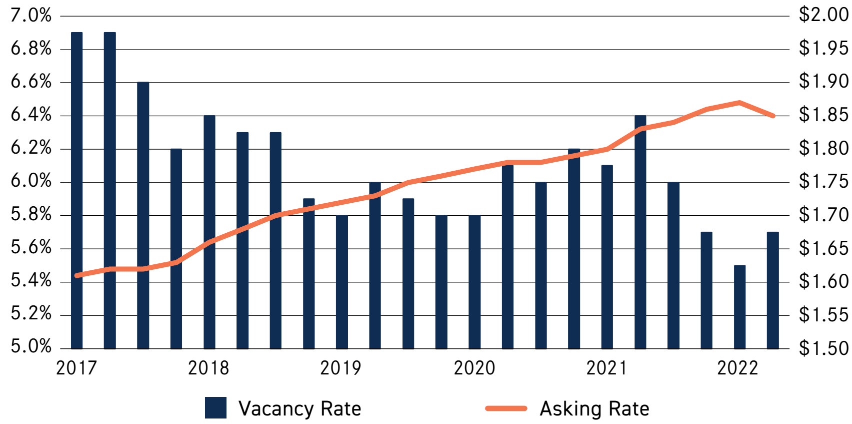
The retail sector is showing signs of improvement through the first half of 2022. Leasing activity is trending upwards, which is an optimistic sign for a sector battling economic shutdowns for much of the past two years. As a result, the vacancy rate is below 6% and has been largely flat over the past 12 months. This activity, combined with a low level of construction across the market, puts the retail sector on much firmer footing than was expected a year ago.

The region's large spaces have been one area of focus for retailers. So far this year, 18 spaces of 10,000 square feet or more have leased with fitness users the most active tenant type. Restaurants have been active as well. A swell of second-generation restaurant space entered the market during the lockdown, and with restrictions in the rearview mirror, new locations are opening. Finally, discount retailers have been growing rapidly. Companies like Falling Prices, Ross Dress for Less and Marshalls have all signed deals since the start of the year.

The stronger than expected rebound is largely a function of an increasing population. The region has worked for many years to shake its sleepy government town image, and there are early indications that positive changes are taking shape.

Capital markets, however, may remain slow. There is limited buyer demand for less than prime retail real estate. Combined with the rising cost of capital, this will likely cause a disconnect between buyers and sellers on pricing. Cap rates are expected to rise, as lease rate growth is far too low to consider purchasing properties with negative leverage.

Figure 6
Vacancy & Average Asking Lease Rate: 2017 - 2022



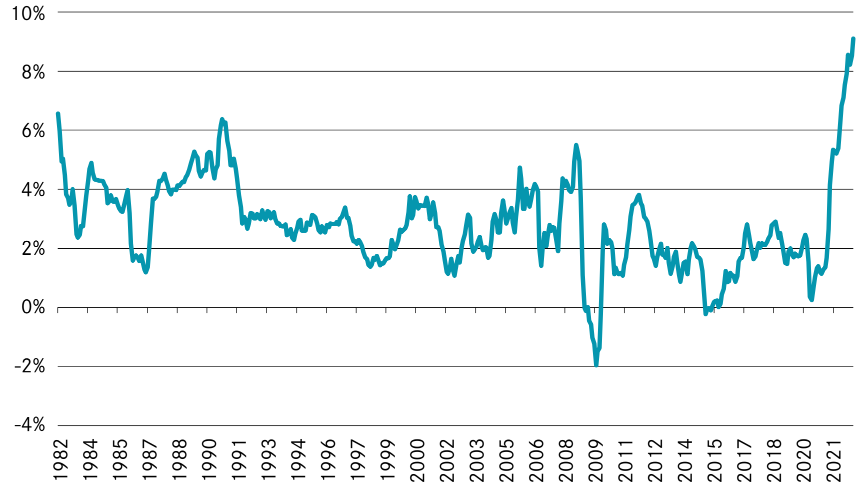
Source: CoStar

Capital Markets & Banking *Forecast*

INFLATION RISES TO LEVELS NOT SEEN IN 40 YEARS

As we pointed out in the previous update, equity markets began the year priced to perfection, attaining valuation levels that were stretched to a point where any stumble could cause a meaningful sell off. We did not realize how right we were. We also highlighted inflation as a major risk, but we, along with most others, vastly underestimated the impact that it would have this year. In hindsight, it is obvious the Federal Reserve erred in viewing inflationary pressures as "transitory". Interest rates were kept too low for too long, and asset purchasing programs (quantitative easing) were ongoing as late as the first quarter of 2022. These actions, combined with the unprecedented fiscal stimulus in the COVID relief bills, have ignited inflation to levels not seen in 40 years, with the Consumer Price Index (CPI) rising 9.1% in June and the Producer Price Index (PPI) increasing 11.3%.

Figure 1
Consumer Price Index (CPI)
Year-Over-Year Change, Monthly, Since July 1982



INFLATION IS DRIVEN BY ENERGY, BUT PRESENT ACROSS GOODS

These policy mistakes have been exacerbated by global supply chain issues, still fragile from COVID. Delays in production and logistics perpetuate an environment of high uncertainty and combine with inflation to create a self-reinforcing cycle. Thrown into this scenario, the Russian invasion of Ukraine has significantly disrupted commodities markets worldwide as well as causing immeasurable human suffering.

One anomaly, and bright spot for the U.S., has been the exceptionally strong labor markets; with unemployment remaining near historic lows. However, we believe this market is more likely to soften, rather than carrying the economy to positive growth. Also noteworthy is that while labor markets have been tight, wage growth has not kept pace with inflation. While we do not have Sacramento-specific inflation data, it is likely our region has experienced higher relative inflation in gasoline prices and shelter as compared to other parts of the country.

In this environment, equity markets have seen a substantial sell-off, reaching bear market status in May. Asset class performance generally followed "flight-to-safety"rules, with value and defensive outperforming growth and cyclical. Small- and Mid-Cap companies performed in line with Large. From a sector perspective, Energy continued to perform well, driven by underlying commodity prices, while Technology stocks experienced the most significant selloff. Globally, commodity-oriented markets such as Brazil performed better, but nearly every international equity index is down year-to-date.

Figure 2
Consumer Price Index (CPI) Select Component Baskets, Year-Over-Year Change, Monthly, Since July 2012

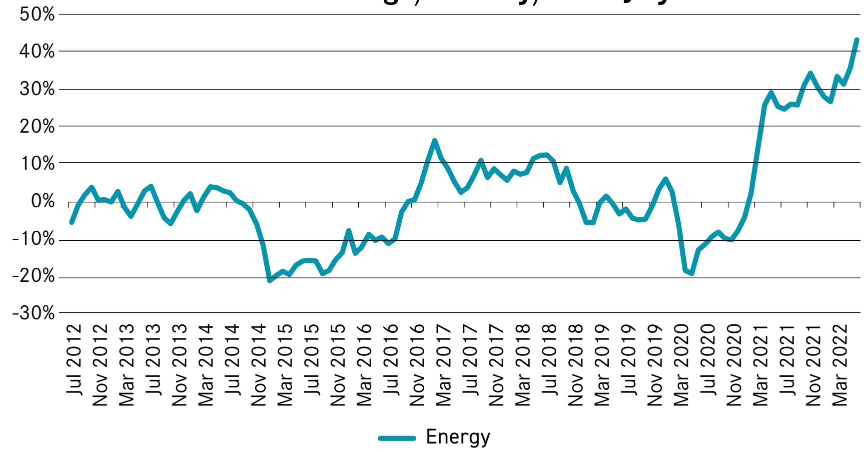


Figure 3
Consumer Price Index (CPI) Select Component Baskets, Year-Over-Year Change, Monthly, Since July 2012

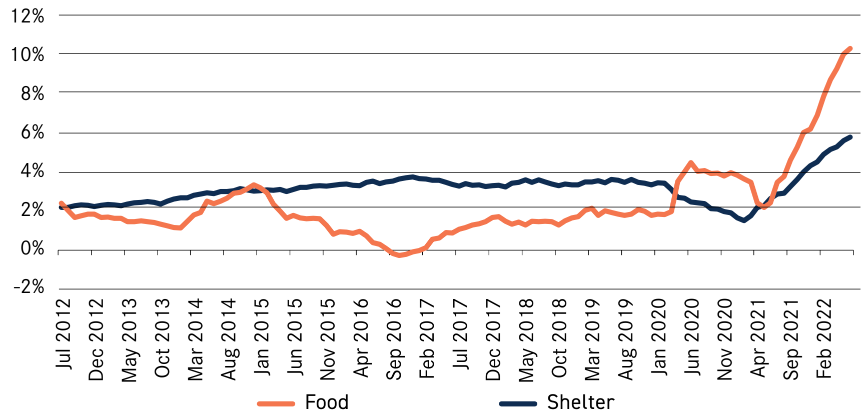


Table 1 · Returns

Index	Year-to-Date	2021
S&P 500	-19.97%	28.68%
S&P 400 (Mid-Cap)	-19.55%	24.73%
S&P Small-Cap 600	-18.97%	26.74%
Russell 1000 Growth	-28.07%	27.59%
Russell 1000 Value	-12.87%	25.12%
MSCI World	-20.28%	22.38%

Source: S&P, Russell, and MSCI. As of June 30, 2022.

Capital Markets & Banking *Forecast*

As we head into the second half of 2022, there are major risks to aggregate economic activity. The first quarter surprised with a negative GDP, and many indicators point to negative GDP in the second quarter as well, raising the question of whether a recession has already begun.

The impact of inflation, combined with supply chain disruptions, contribute to an environment of uncertainty and elevated risk, which is likely to compress corporate margins and slow fixed investment. In addition, the higher fuel and energy costs are likely to be a drag on growth. Consumers, which comprise over 70% of the US economy, will be challenged as inflation erodes purchasing power, leading to diminishing savings and higher utilization of credit for household expenses.

In corporate markets, one area to watch is collateralized loan obligations (CLOs). These instruments are backed by non-investment grade leveraged loans. A leveraged loan is a type of loan that is extended to companies with substantial borrowing needs and higher credit risk. Typically, the underlying instruments are floating, and thus borrowing costs will increase with a rise in market rates. This has the potential to squeeze the corporate borrowers, potentially introducing the risk of widespread defaults.

Equity Market Outlook

While uncertainty is high and economic outlook murky, the SBR team believes equity markets have already experienced the bulk of the pain. Returns will be volatile and low, but we are projecting positive single digit returns for the second half of 2022. Fixed income markets look to remain challenged as the Fed will continue to ratchet up rates. We see the 10-year treasury yield likely finishing between 3.50% and 4.00%.

Regional Financial Institution Performance Update

What a difference six months makes! At the end of 2021, futures markets thought the Federal Reserve Open Market Committee (FOMC) — the body that decides what to do with short-term interest rates — might have increased rates a couple of times to achieve a fed funds rate between 0.25% and 0.50%. However, as discussed previously, markets would come to find out that transitory inflation can have several different meanings (everything is transitory in the long-run), and the U.S. economy would see the highest levels of inflation in nearly 40 years. This once in a

Figure 4
9-Quarter Loan, Deposit, and Net Income Trends for Regional Banks

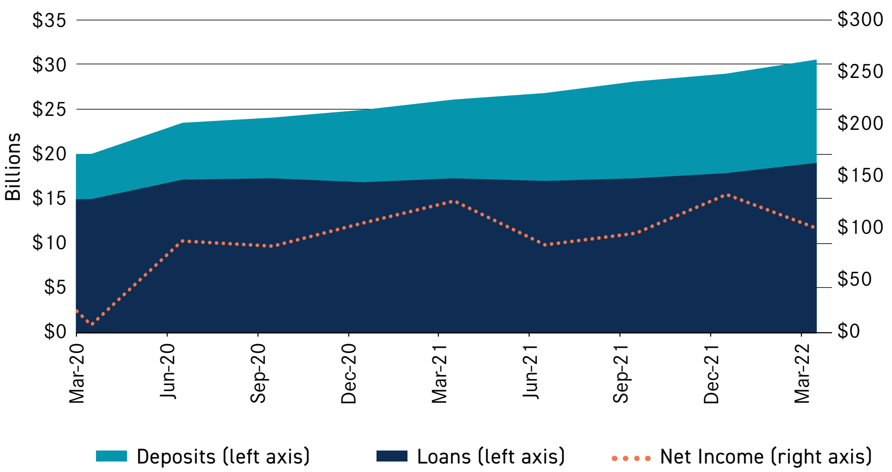
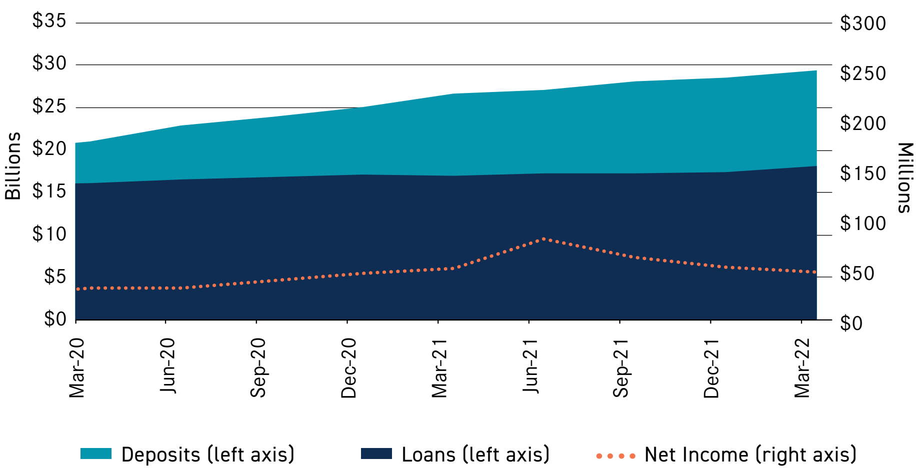


Figure 5
9-Quarter Loan, Deposit, and Net Income Trends for Regional Credit Unions



generation increase in price levels had the FOMC scrambling to raise short term interest rates fast enough to bring prices back down, and we remain in the midst of an uncertain, inflationary economic environment. As of June 2022, the target range for fed funds was 1.50% to 1.75% (six 0.25% rate hikes since the beginning of 2022), with futures markets now expecting another seven 0.25% hikes to come by the end of the year, resulting in a target range of 3.25% to 3.50%.

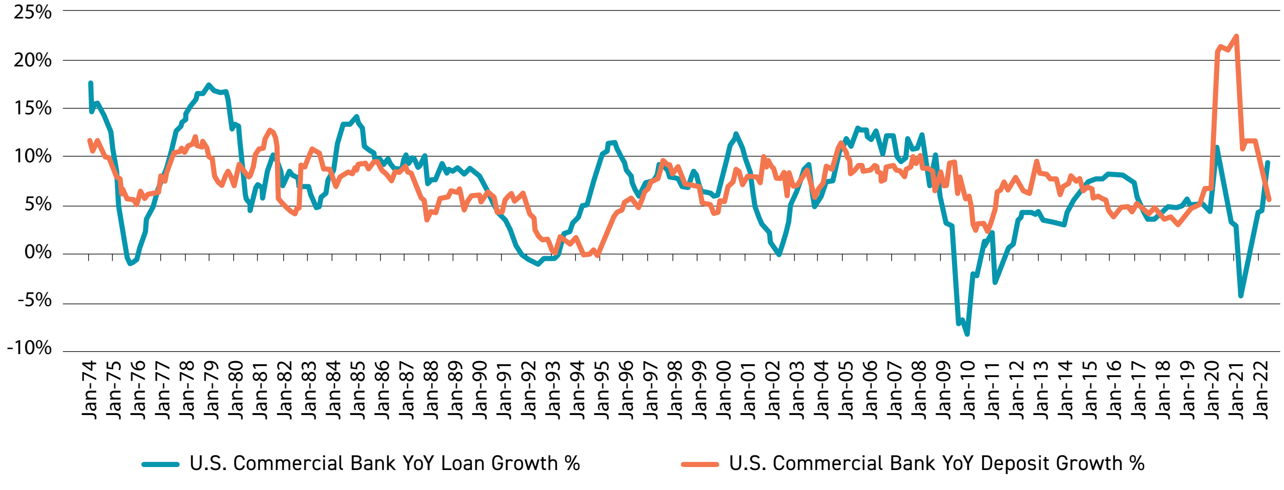
The rapid increase in the fed funds rate was likely a welcome change for most regional financial institutions, as the yield earned on excess liquidity built up over the past couple of years (i.e., short-term cash and floating rate securities) has increased accordingly, thereby helping to expand net interest margins. The latest deposit financial data available as of this writing is Q1 2022, so the impact of the rapid fed funds rate hikes is not quite baked into the numbers.

One trend that the SBR team is watching closely is the pace of growth for loans and deposits as the Fed does what it can to slow the economy (i.e., reversal of stimulus), while consumers and business face higher and higher prices for goods and services. At the national level, long-term loan and deposit growth trends on a year-over-year percentage basis clearly show just how much of an impact the pandemic and related monetary and fiscal measures had on financial institution balance sheets.

We see similar trends when homing in on recent quarterly data for regional banks and credit unions. One of the most prevalent risks facing financial institutions at this point in the

One trend that the SBR team is watching closely is the pace of growth for loans and deposits as the Fed does what it can to slow the economy (i.e., reversal of stimulus), while consumers and business face higher and higher prices for goods and services.

Figure 6
Implications from U.S. Commercial Bank Loan and Deposit Growth Trends



cycle is access to liquidity at reasonable rates. Should deposits, the cheapest form of liquidity, fail to grow fast enough to fund loan growth, financial institutions will either have to pay up for the cash needed to fund loans or slow the amount of lending overall. This is not something financial institutions want to do when loan rates are much higher relative to where they have been over the last cycle. Net interest margins are still likely to expand, but the rate of expansion may be hampered by a Fed that removes too much liquidity too fast in the effort to stem inflation.

Regional Financial Institution Outlook

Regional financial institutions should end the year with relatively good performance as the key market risks posed by the Fed's actions — along with looming credit risks — are not likely to materially impact earnings statements until 2023. If the Fed is able to bring inflation back down while keeping unemployment low, then 2023 and beyond may turn out quite rosy as the domestic economy outruns the aftereffects of the pandemic fiscal and monetary policy actions. However, economies are cyclical, and the SBR team expects more credit and market risk to materialize as we head into the second half of 2022 and early 2023.

Figure 7
Regional Banks: QoQ Loan and Deposit Growth Rates

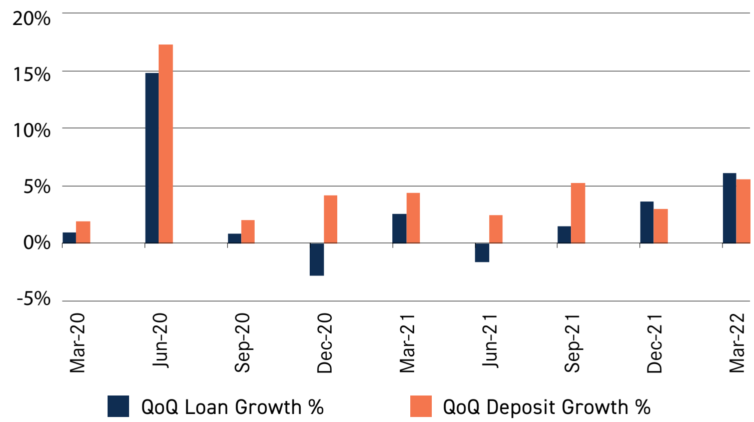
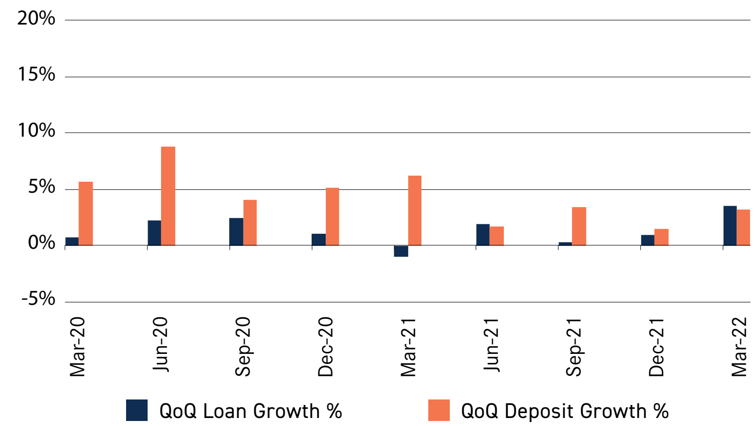


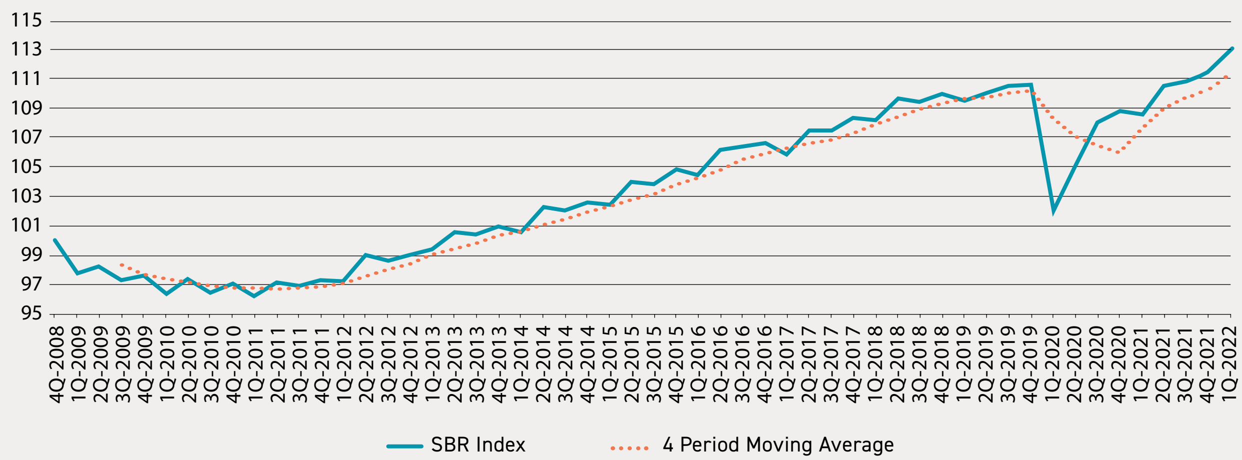
Figure 8
Regional Credit Unions: QoQ Loan and Deposit Growth Rates



Sacramento Business Review

Financial Conditions Index (with 2-year moving average)

Our proprietary Financial Conditions Index for the region's economy shows continued recovery and expansion as of Q1 2022 relative to the pre-pandemic peak.



Human Capital Trends

The continuing focus on skills gaps and talent management challenges is starting to sound like a broken record. In response, organizations are working on upskilling and reskilling, while many positions stay open for months before being filled. Employees report a great need for further training and development, as organizations are not fully prepared to meet those needs. Coupled with the lack of training, most workers tell us their employers are failing to support them in finding fulfillment and growth, causing them to quit in place or to leave the organization.

MANY POSITIONS STAY OPEN FOR MONTHS BEFORE BEING FILLED.

Organizations are working through the most effective policies for work-from-home arrangements and are simultaneously facing fairness and equity issues as parts of the workforce negotiates work-from-home and related benefits, while other workers do not have such access.

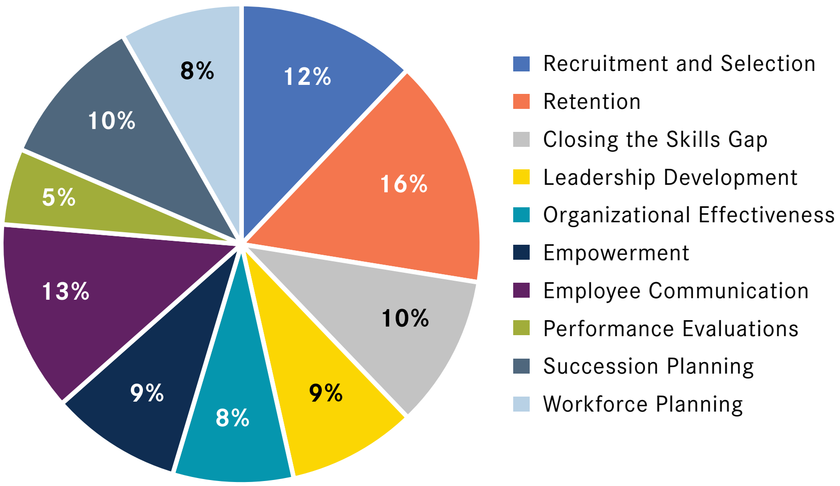
EMPLOYEE COMMUNICATION REMAINS A TOP AREA OF FOCUS FOR EMPLOYERS.

The talent management landscape in the Sacramento Region is still more of a tearjerker than a fairytale, as employers navigate worker shortages, burnout, renegotiation of work-from-home arrangements, and creating and implementing effective training and development programs.

The talent management landscape in the Sacramento Region is still more of a tearjerker than a fairytale, as employers navigate worker shortages, burnout, renegotiation of work-from-home arrangements, and creating and implementing effective training and development programs.

We also asked HR and managers about workforce and human capital initiative KPIs predicted to impact business performance in Q3/Q4. Regarding human capital initiatives with the greatest expected business impact, retention is on everyone's mind. Looking to close out a more successful 2022, the highest priorities after retention are hiring, training and development, and succession and talent planning, with efforts focused on building fully and competently staffed organizations. Employee communication is still claiming a top spot as we continue to navigate uncharted waters (Figure 1).

Figure 1
Areas of Focus Q3 and Q4



Regarding human capital initiatives with the greatest expected business impact, retention is on everyone's mind.

HUMAN CAPITAL TRENDS

NEW SECTION

Healthcare *Industry Conditions*

Sacramento: Reimagining the Future of Healthcare

The American Healthcare Industry — a $4.1 trillion giant — is undergoing an existential transition. In 2020, medical care was brought to its knees by a 0.125 micron virus. The resulting paradigm shift — from treating individuals' diseases to preventing population destruction — became the immediate priority overnight.

As capital of the state with the world's fifth largest economy, Sacramento has all the elements to lead the future of healthcare. Policy for the state is written here. And just as in climate policy, minimum wage, and privacy law — wherever California goes — the rest of the nation will soon heed, if not follow.

Change is imminent. The U.S. healthcare system as it stands today is hopelessly overburdened, financially untenable, poorly distributed, and — worst of all — viewed by the people as inadequate to meet their needs.[1] America delivers among the highest costs for medical care in the world, while failing to deliver better outcomes.[2]

Hospitals, particularly not-for-profit hospitals, are facing a harsh outlook: Largely maintaining fiscal strength in the first year of the pandemic due to government subsidies through the CARES Act and/or reorganization, the cushion of governmental protection has waned. Through 2021, staffing shortages and supply chain disruptions increased labor and capital costs significantly, while patient volumes were still recovering. The impact of these trends, combined with the rising interest rates of an inflationary 2022 economy, has ushered in six straight months of negative margins for hospitals across the nation.[3, 4]

How will Sacramento play a role in the future of healthcare? By all indications, the region is poised to collaboratively — and competitively — create new and better ways to teach, deliver, and pay for healthcare. Sacramento is positioned to model the way for the rest of the nation's communities through forward-thinking medical education, conscientious expansion of care services, and facilities that focus on equitable delivery and judicious payment strategies.

Sacramento's healthcare market has proven itself unique in its ability to flourish with four large, established healthcare systems that dominate the region's hospital market and labor force. In addition, the region adds excitement and innovation through an up-and-coming university medical center for education and care delivery, a competitive medical insurance marketplace, a robust FQHC landscape, and countless biotechnology and medical device companies. The economic forecast for the Sacramento region is significantly impacted by these healthcare sector players.

The region's ruling healthcare systems have all carefully planned reconstruction or even complete rebuilding of aging infrastructure to coincide with the state's 2030 seismic requirements. Even more noteworthy is the commitment from some to literally build the future — by creating education, research, and care delivery institutions that will tap the most forward-thinking aspirations in the health sciences. Although a loss of approximately 10,000 jobs was estimated for the local healthcare industry due to the pandemic, in the long run, jobs in this sector are projected to increase along with these regional expansions, attracting high level professionals in a very competitive market. (Figure 1)

As shown in Figure 2, the four large healthcare systems in the region (UC Davis Health, Kaiser Permanente, Sutter Health and CommonSpirit [Dignity] Health) all have laid out plans to build new hospitals or expand their capacities in the very near future. UC Davis Medical Center is augmenting its already world-class reputation through Aggie Square, an institution dedicated to biotechnology research and innovation, the *California Tower* expansion of their Sacramento medical campus, and a planned *Folsom Center for Health* in Folsom Ranch. A relative newcomer, California Northstate University (CNU), has received approval to build a medical center, teaching hospital, and living campus in a portion of the former Sleep Train Arena grounds. The proposed *CNU Medical Center Campus at Innovation Park* is capitalizing on a new generation of medical professionals whose focus is on holistic health and wellness, both within their work and within their community.

The Sacramento region is extraordinarily poised to create remarkable efficiencies and outcomes in a post-COVID world by virtue of the talent, resources, and momentum already present in the region. Led by Sacramento's healthcare sector, innovative technologies including AI, precision medicine, population health, and virtual medicine are becoming the national standard for modern healthcare systems' delivery.

All of Sacramento's newly created and proposed expansions for healthcare delivery will have one very important requirement in common: They will have to find new and better ways to teach, deliver, and pay for healthcare in an environment that is undergoing unparalleled transformation and challenge.

The Sacramento region is extraordinarily poised to create remarkable efficiencies and outcomes in a post-COVID world by virtue of the talent, resources, and momentum already present in the region.

Figure 1
Sacramento Metropolitan Area Healthcare Jobs

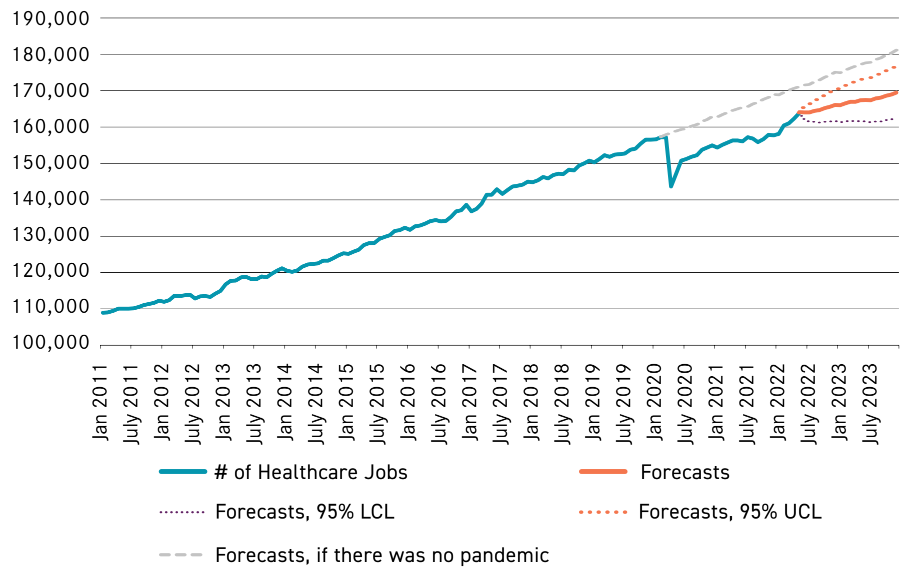
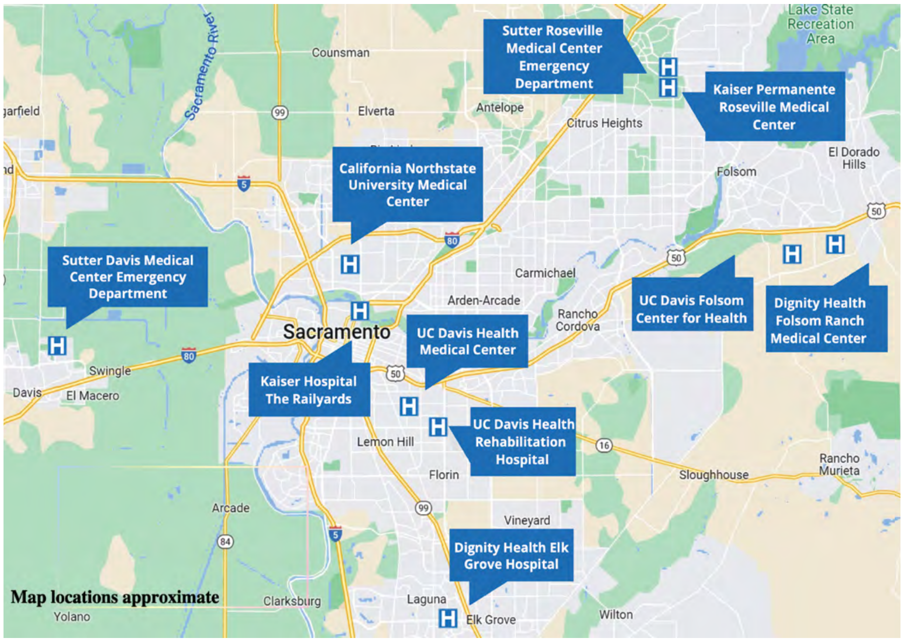


Figure 2
New and Proposed Hospital Expansions in Sacramento Region



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HEALTHCARE

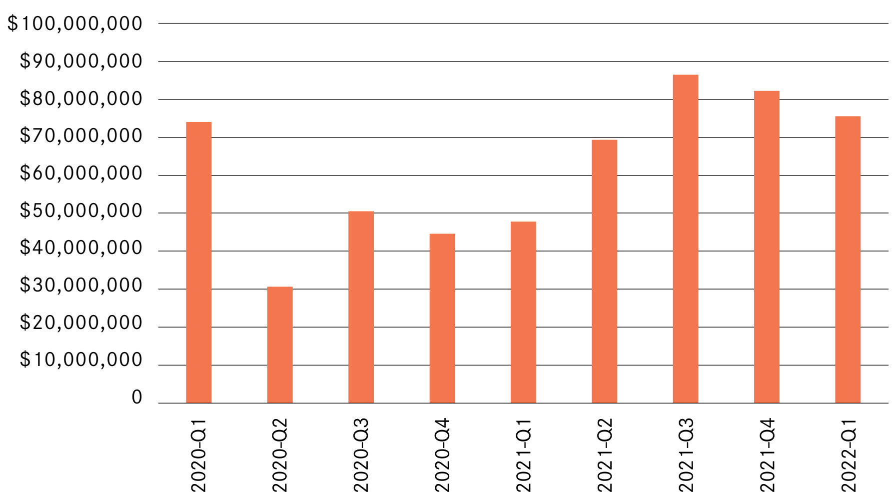
NEW SECTION

Tourism & Hospitality

Sacramento Hotel Revenues Declining

Sacramento hotels continue to struggle in 2022 after a steady rise in revenue in 2021 and peaking in the third quarter. The total revenue is measured for four hotel zones outlined by Sacramento Convention & Visitors Bureau (Downtown, Point West, Natomas, and Outlying hotels). While recovery back to pre-COVID levels has been good, in the first quarter of 2022, hotels faced a decline of 8% over the previous quarter ($75.6 vs $82.2M).

Figure 1
Total Revenue From Hotel Stays in Sacramento



Source: Visit Sacramento

> *Sacramento Downtown (Zone 1) occupancy rates in 2022 Q1 (62.6%) were higher than 2021 Q1 (44.4%), and almost the same as in 2020 Q1 (61.6%).*

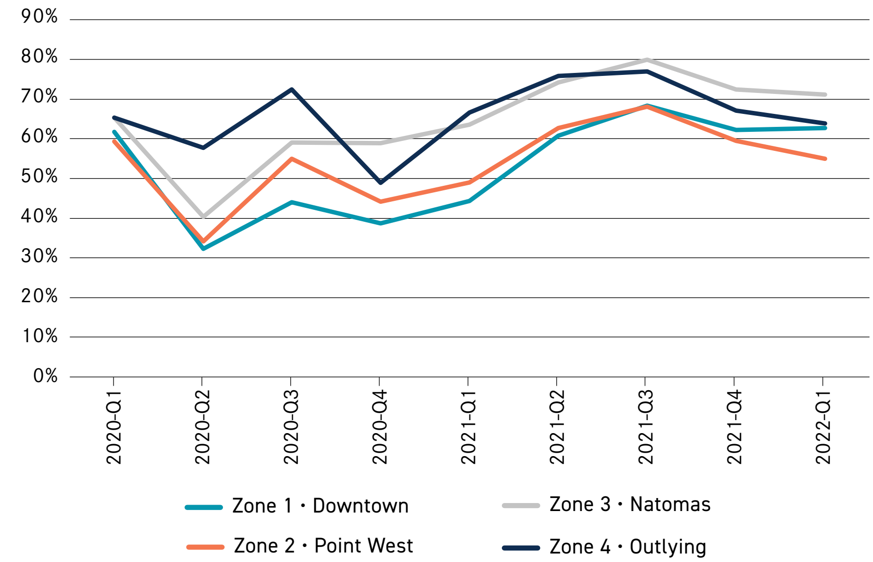
Geographic Segmentation of Sacramento Hotels

Of the 4 geographic segments, only Natomas occupancy rates in 2022 Q1 achieved a substantially higher level than in pre-COVID 2020 Q1 (71.0% vs 65.2%). Sacramento Downtown (Zone 1) occupancy rates in 2022 Q1 (62.6%) were higher than 2021 Q1 (44.4%), and almost the same as in 2020 Q1 (61.6%). Point West and outlying hotel occupancy rates were lower than in pre-COVID 2020 Q1 (54.9% vs 59.3% and 63.9% vs 65.4% respectively).

Pricing Trends

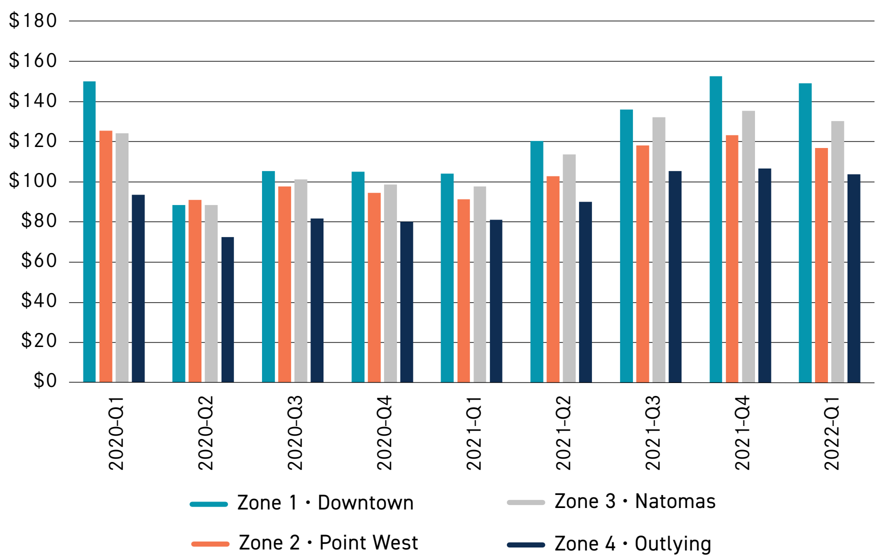
Average daily room rates charged by Sacramento hotels declined sharply during COVID, recovered nicely in 2021, but declined again in 2022 Q1. Downtown and Point West average daily rates 2022 Q1 remained even lower than in pre-COVID 2020 Q1 ($149.00 vs $150.20 and $116.85 vs $125.42 respectively), while Natomas and Outlying hotel rates were somewhat higher ($130.17 vs $124.29 and $103.75 vs $93.54 respectively).

Figure 2
Hotel Occupancy Rates



Source: Visit Sacramento

Figure 3
Average Daily Rate in Sacramento Hotels



Source: Visit Sacramento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