JANUARY 2019 ECONOMIC FORECAST | EMERGING TRENDS IN SACRAMENTO'S ECONOMY

JANUARY 2019

sacramento BUSINESS REVIEW

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Is Sacramento headed toward a recession?

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

JANUARY 2019

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

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MESSAGE FROM THE CHIEF ECONOMIST

Dear Friends,

As we celebrate our 11th anniversary, I am pleased to share the 21st edition of the *Sacramento Business Review* – the most comprehensive, precise, and intellectually sophisticated analysis of the regional economy. For 11 years, our team has provided thoughtful predictions that have accurately forecasted the economic and business climate. With 17 of Sacramento's very best financial analysts and researchers combining their skills and talent, the *Sacramento Business Review* is the most credible source of independent thinking, insights, and research on our economy in the region.

2018 started on a very positive note with plentiful tailwinds coming from tax reform, rising consumer and business confidence, synchronized global growth, improving labor market conditions, and a strong real estate market. The stock market continued its ascent and hit all-time records with the best summer performance on record. Things changed post October 3, when we saw the worst October on record since 2008, only to be followed by the worst December since 1931, the worst Christmas Eve ever — and no Santa rally. With new data showing a slowdown in global growth, a downshift in the second-largest economy of the world (China), an escalating trade conflict between the U.S. and China, a fourth rate hike by the Federal Reserve, and a partial government shutdown, market confidence came to a crashing halt, and the R word (Recession) became increasingly prominent in all media outlets.

While most do not expect a national or global recession in 2019, we are now increasingly cautious on the local Sacramento economy, which has a history of entering recession before a national recession begins. The greater Sacramento region job growth has slowed (low unemployment is a lagging indicator anyway), with declines in both consumer and business confidence. While the commercial real estate market remains strong, the housing market is exhibiting weakness. With a flattening yield curve and reduced cheap liquidity that will impact local banks, a stagnant labor force, mismatch and disconnect between university graduates' aspirations and what the market really needs, and potential changes to pro-growth policies threaten to push the local economy into a recession sooner than anticipated. Small businesses are expecting more challenging revenue environments and business conditions ahead. The question is whether we are prepared for the next down cycle. As we celebrate a great current economy, I want to remind ourselves that the region desperately needs to do something about developing or attracting higher paid jobs and diversifying the job mix to prepare ourselves for the next recession.

Our 11th anniversary milestone represents the success and commitment of our analysts, who do this work entirely as a public service to the region. We plan to continue doing this as long as our team continues to enjoy producing the forecast.

I invite your feedback. Please do not hesitate to let me know how we may improve future issues or if you wish to be a supporting partner. To download your free copy, please visit **sacbusinessreview.com**.

Warm regards,

Sanjay Varshney

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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.

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Labor Markets
& Regional Economy

KEY POINTS

- The Sacramento economy has been booming, the unemployment rate hit a historic low, and household income has increased.
- The pace of job growth in the region has slowed partially due to stagnant labor force growth, which may slow the pace of economic growth.
- Risks to continued growth include weak job growth in cyclical industries, competition with other counties for construction jobs, and increased labor costs.

The UNEMPLOYMENT RATE has declined BELOW 4% FOR THE FIRST TIME SINCE THE BOOM YEARS of the late 1990s

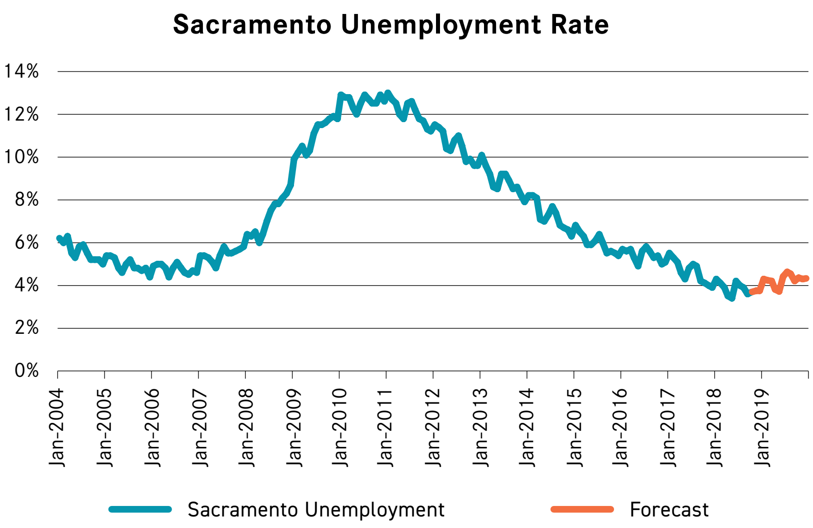
A Rising Tide Lifts All Boats

The labor market is a lagging economic indicator. It has often been compared to looking at the rear-view mirror of a car as it primarily provides a picture of what has happened rather than what is to come and therefore should be taken with a grain of salt. Yet it does provide an indication of the overall economic landscape, which has been very bright.

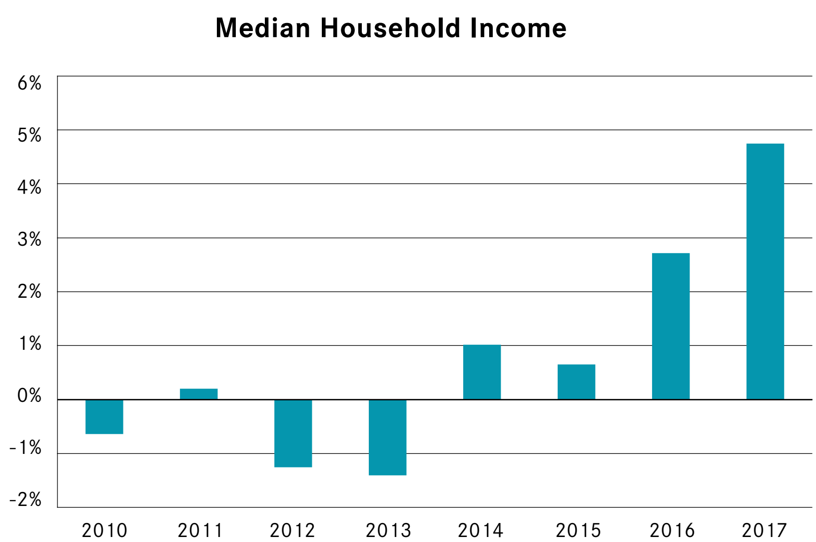
The Sacramento economy has been booming. The Sacramento area unemployment rate has continued its downward trend and recently hit a historic low. The unemployment rate has declined below 4% for the first time since the boom years of the late 1990s, indicating that the good times are here again.

The strong labor market has spilled over into household income data. Household income increased 4.75% in 2017, and all indications show that this trend continued into 2018. Median household income has increased nearly 10% from its cyclical low in 2013. More importantly, the rate of increase has accelerated in recent years.

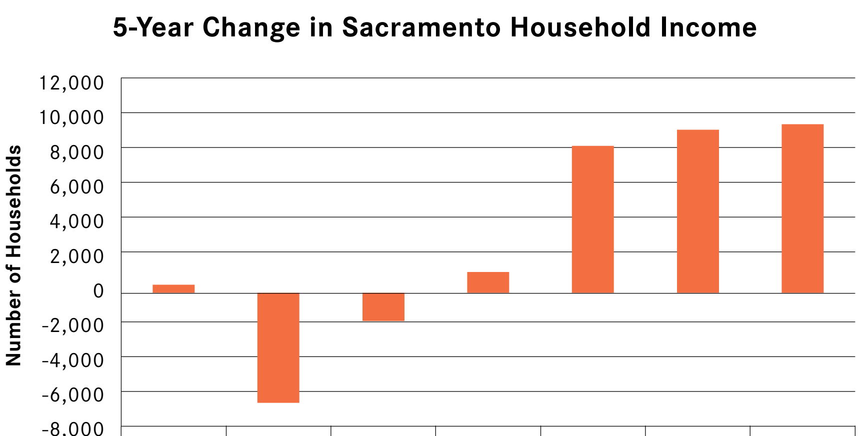
Household income distribution has also improved. The number of households with income of $100,000 or more has increased sharply over the past five years while the number of households with income less than $100,000 has declined. This shows that the rising tide is lifting all boats as households are able to move up the income scale. This is partially fueled by an increase in household earnings from employment, which reported its highest growth rate since the end of the recession.



Data Source: California EDD



Source: Economagic.com



	<$25k	$25-50k	$50-75k	$75-100k	$100-150k	$150-200k	$200k+
5-year	441	-6,574	-1,932	1,142	8,133	9,018	9,326

Source: Economagic.com

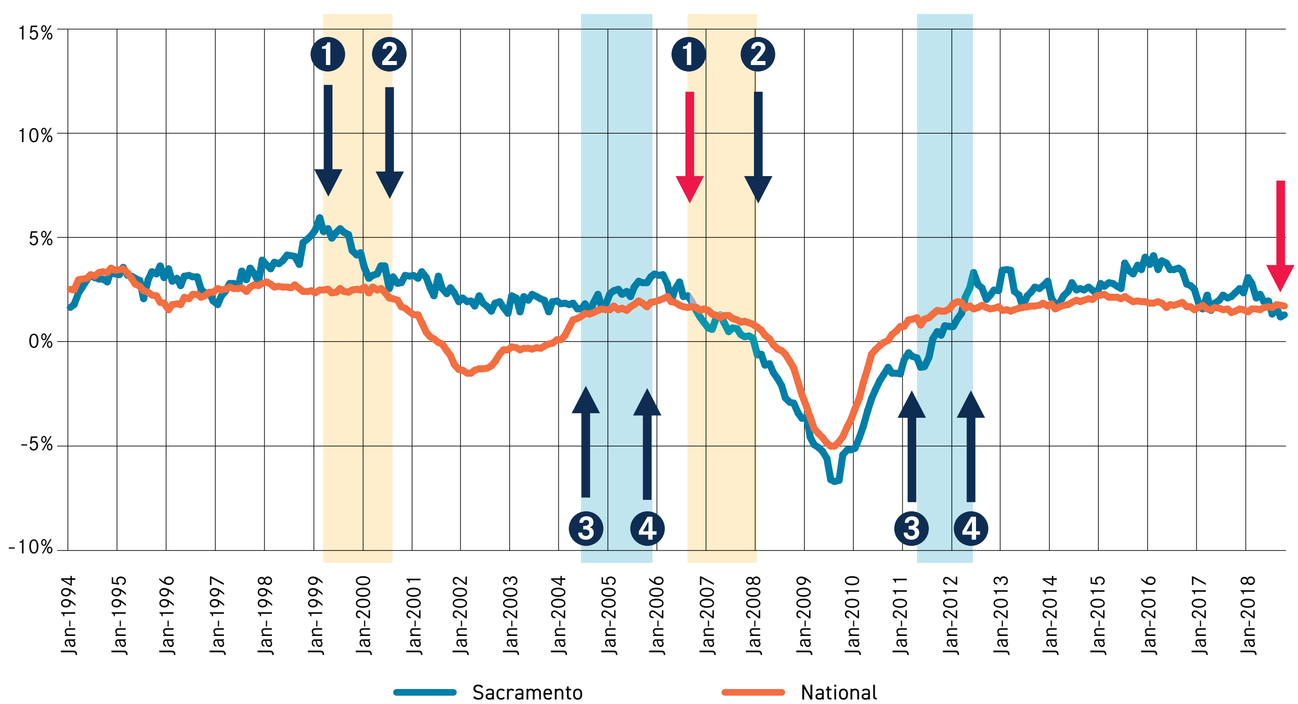
LABOR MARKETS

Labor Markets *& Regional Economy*

> *The rate of increase in the Sacramento area employment growth rate has declined to just 1.33%, the slowest growth since 2011.*

However, looking forward there are reasons for concern. The rate of increase in the Sacramento area employment growth rate has declined to just 1.33%, the slowest growth rate since 2011. This may be partially due to the stagnation in the labor force growth rate as everyone who wants a job may already be employed. We are at full employment and running out of workers. Many companies are converting contractors into payroll employees as the labor force stops growing. Construction employment, which was a bright spot in last year's report, declined in the Sacramento region over the past year despite increasing 3.6% statewide. This is likely a result of construction activity shifting to Sonoma County, where construction employment increased 9.3% over the past year fueled by a 407% increase in the number of building permits authorizing construction spending of $683 million over the past six months. Unfortunately, this trend will likely continue as Sacramento area construction workers will likely be needed in Butte County as well.

Total Nonfarm Jobs, 12-month % Change



1. Sacramento job growth slowed down
2. National job growth slowed down
3. National job market recovered from downturn or recession
4. Sacramento job market recovered from downturn or recession

Data Source: California EDD

TRADE TENSIONS will negatively affect GLOBAL GROWTH, so will a tightened monetary policy

We expect to see a SLOWER GROWTH IN 2019 HERE IN SACRAMENTO

It is noticeable that Sacramento's year-over-year job growth rate has fallen below the national rate in the second half of 2018. Historically Sacramento's job growth significantly declined approximately 1.5 years before the nation's did, while it took approximately 1.5 more years for the local job market to achieve a full recovery after the national recovery. A dropping local job growth rate can be a leading indicator for a coming economic downshift.

Another explanation for the decline in the employment growth rate may be related to concerns about the economy. Over the past year, several sectors that are considered to be less economically sensitive have reported above-average growth while several sectors that are considered to be more economically sensitive have reported a decrease in employment. The weakness in these more cyclical sectors may be a sign of economic weakness to come. Fortunately, Sacramento area employment is more concentrated in defensive sectors than cyclical sectors.

Other headwinds for a continued bullish economy include changing global geopolitical and economic environments and rising interest rates. Trade tensions will negatively affect global growth, so will a tightened monetary policy. Weak employment growth in an already-maxed-out labor market could hinder economic growth as well. While the real estate market has been behaving in a more disciplined way since the great recession, total nonfinancial corporate debt has reached a historic high as many large corporations have leveraged the low interest rates over the last few years. The concerns are reflected in the high volatility over the past year in the stock market. The economy is strong right now, but we expect to see a slower growth in 2019 here in Sacramento and a potential national recession in the following years. Enjoy the warm weather, but winter is coming.

Defensive Sectors		
Sector	One-Year Growth Rate	% of Labor Market
Education	3.94%	1.33%
Health Care	2.31%	14.72%
Government	1.95%	24.71%

Cyclical Sectors		
Sector	One-Year Growth Rate	% of Labor Market
Information	-2.44%	1.21%
Construction	-2.41%	6.12%
Professional Services	-0.46%	13.17%

Source: Economagic.com

Consumer Sentiment *Survey*

KEY POINTS

- Overall, consumer sentiment remains fairly positive but appears to be cooling somewhat.
- While national sentiment has remained steady since our last release, regional sentiment is down for the first time since the inception of our survey.
- Expectations regarding the future of the regional economy have fallen the most over the past year. In contrast, national data for the same period shows increased optimism for the future.
- The data hints at potential slowing of consumer spending in the region. The share of respondents who plan to acquire mortgages, auto loans, or credit cards over the next year is down compared to previous releases.

For our latest release, 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.

Regional vs. National Sentiment

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.

NATIONAL AND REGIONAL SENTIMENT ARE DOWN OR FLAT compared to our mid-year update

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

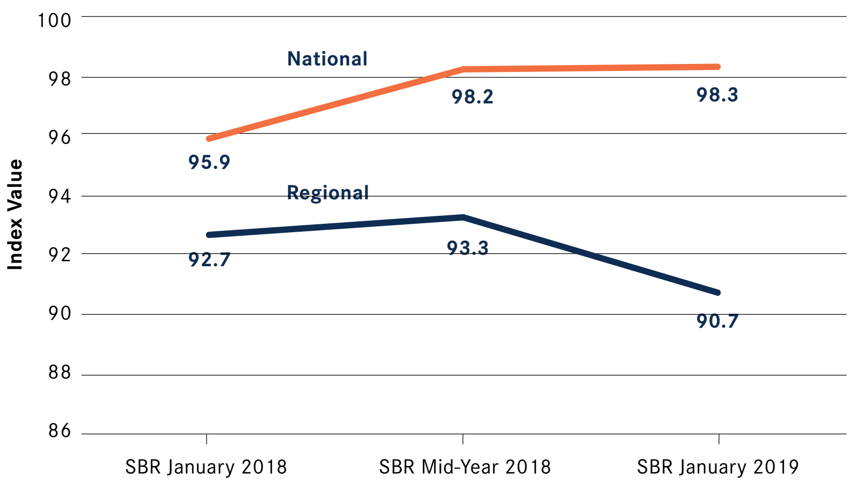
(2) Index of Current Economic Conditions: A measure of how consumers assess their own personal economic prospects compared to a year ago along with perceptions about the current market for making major household purchases.

(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.

For the first time since the inception of our survey, regional consumer sentiment has decreased. In contrast, national sentiment remained fairly consistent compared to our mid-year update. (see Figures 1-3). In particular,

For the first time since the inception of our survey, regional consumer sentiment has decreased.

Figure 1
Index of Consumer Sentiment[1]



SBR/SAFE CREDIT UNION Consumer Sentiment *Survey*

THE SMALLEST REGIONAL CHANGE was the INDEX OF CURRENT ECONOMIC CONDITIONS

INDEX OF CONSUMER EXPECTATIONS in the region IS DOWN OVER 3 POINTS

INDEX OF CONSUMER EXPECTATIONS in the national data continues to TREND UPWARD

the regional index of consumer expectations, which measures expectations about future economic conditions in the region, is down over 3 points compared to the 2018 mid-year update (see Figure 3). The smallest regional change was for the index of current economic conditions, which decreased by 1.6 points since mid-year (see Figure 2). Taken together, this suggests that regional consumers are feeling slightly less positive about their current economic situation and feel that the economic prospects for the region in the coming years are starting to dim even more (see Figures 2 and 3).

Figure 2
Index of Current Economic Conditions[1]

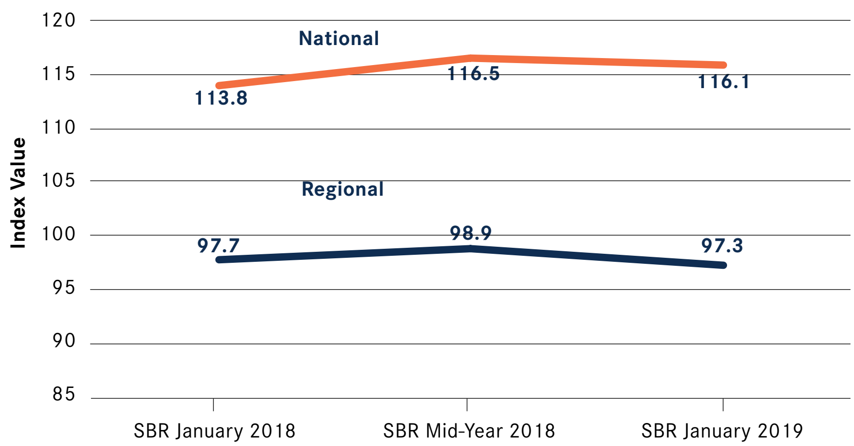
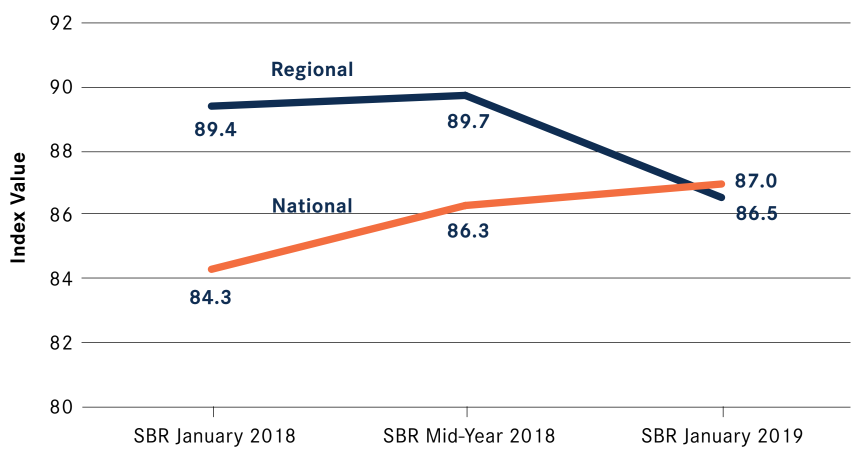


Figure 3
Index of Consumer Expectations[1]

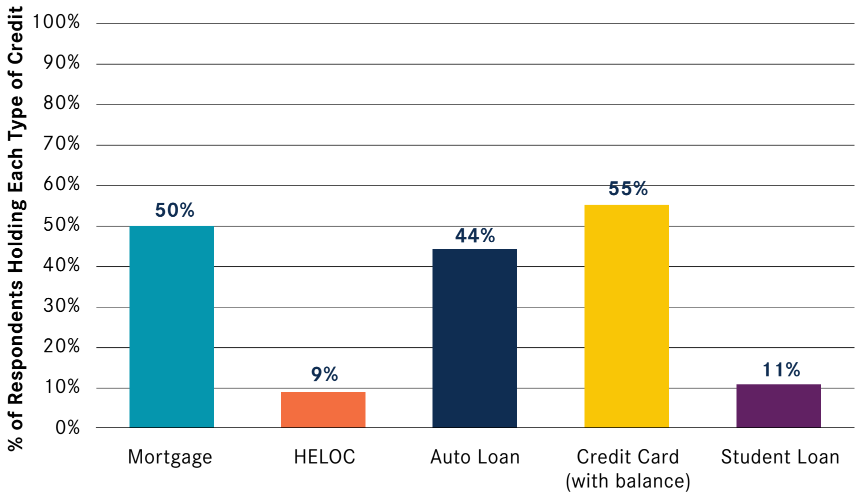


We see downward movement in the share of respondents planning to obtain mortgages, auto loans, and credit cards.

Purchasing and Credit

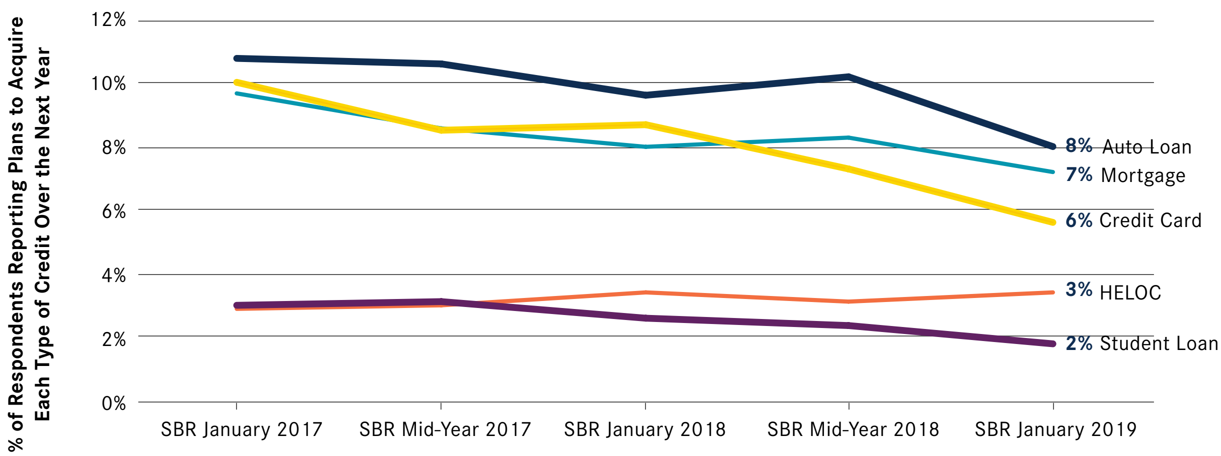
We again asked regional respondents about the types of credit they currently hold and their plans to acquire credit over the next year (See Figure 4). The patterns of credit held are generally consistent with previous releases. However, for credit acquisition planned over the next year, we see downward movement in the share of respondents planning to obtain mortgages, auto loans, and credit cards (See Figure 5). This could suggest the prospect of slowing consumer spending on the horizon if fewer regional consumers seek access to these forms of lending.

Figure 4
Types of Credit Held



CONSUMER SENTIMENT

Figure 5
Types of Credit Planned Over the Next Year



Endnote

[1] 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.

The Small Business *Economy*

KEY POINTS

- SBA lending has surpassed prior peak levels, primarily due to growth in Placer County.
- Latest Small Business Confidence Index survey results indicate a perception of plentiful credit and widespread plans to hire; but respondents expect more challenging revenue environments and business conditions ahead.
- Business transaction activity remains robust, but focused on smaller deals with lower valuations.

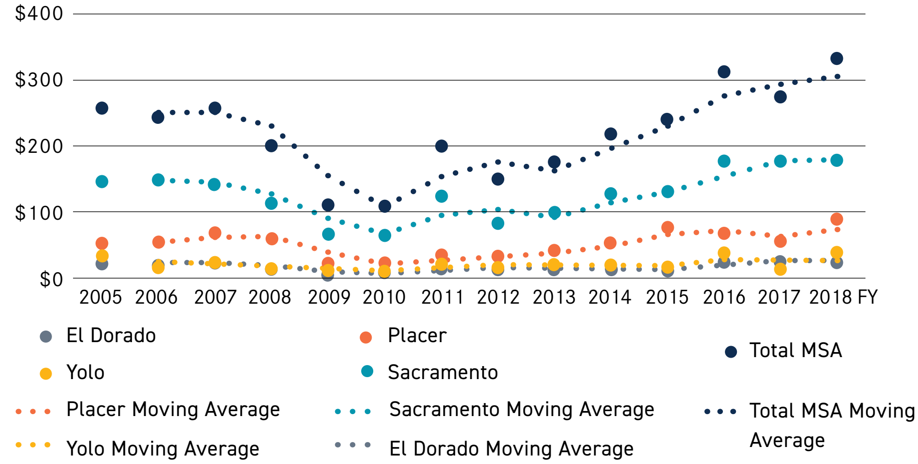
Our latest check into the Small Business Confidence Index survey shows that small business economic conditions remain generally positive. SBA lending rebounded from a dip in 2017, and loan volumes reached an all-time high in 2018. However, reviewing the data from a compound annual growth rate perspective paints a more blasé picture as total Sacramento Metropolitan Statistical Area lending has only grown at an annualized 2.2% rate over the past three years, with Placer County having been the main driver.

Overall business sentiment improved on a year-over-year basis but decreased from our 2018 mid-year survey. Have we reached a peak? One set of data points does not make a trend, but our respondents clearly registered more uncertainty about the economic outlook, prospects for future revenues, and a sense of declining future business conditions. On a positive note, their feedback also indicated that access to credit had strongly improved, and business owners stated a strong likelihood to hire in 2019.

SBA LENDING AT ALL-TIME HIGH...

Total SBA Loan Approvals by County

(in millions, 2-Year Moving Average)



Moving Average is average of two previous data points.

...THANKS TO PLACER COUNTY

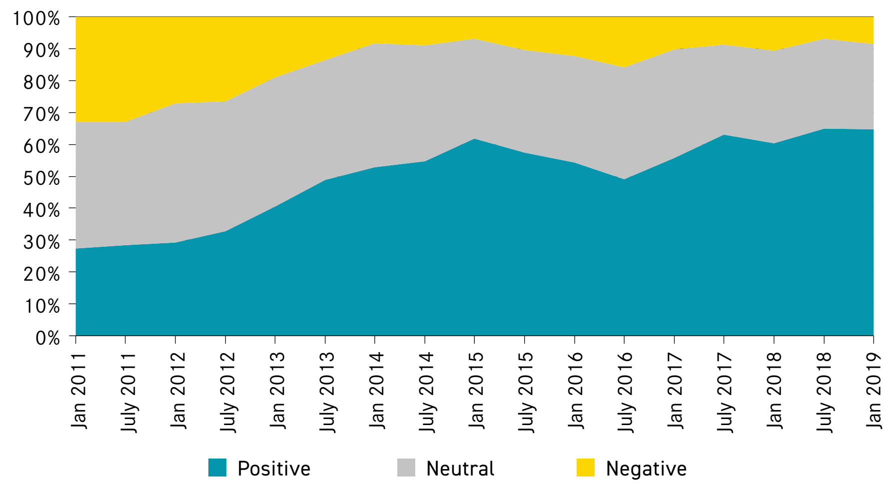
3-Year SBA Loan Growth Rate By County

County	Share of 2018 Loan Volume	2016-2018 Compound Annual Growth Rate
El Dorado	8%	1.1%
Placer	27%	9.1%
Sacramento	54%	0.2%
Yolo	11%	-0.8%
Total MSA	**100%**	**2.2%**

CRACKS FORMING IN SMALL BUSINESS SENTIMENT?

SBCI Overall Sentiment Responses

January 2011 – January 2019

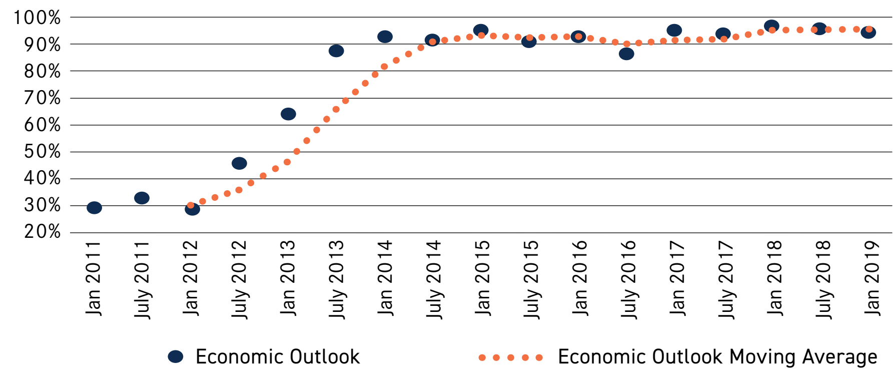


The Small Business *Economy*

ECONOMY OUTLOOK DOWN SEQUENTIALLY

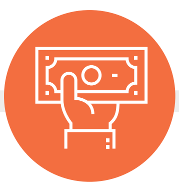
SBCI Total Economic Outlook

(18-month moving average)



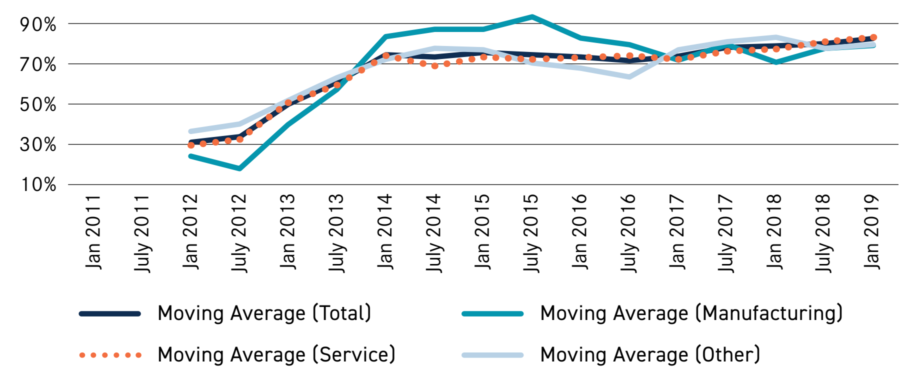
Moving Average is average of three previous data points.

PERCEPTION OF CREDIT ACCESSIBILITY +17% YEAR OVER YEAR



SBCI Credit Accessibility by Sector

(18-month moving average)

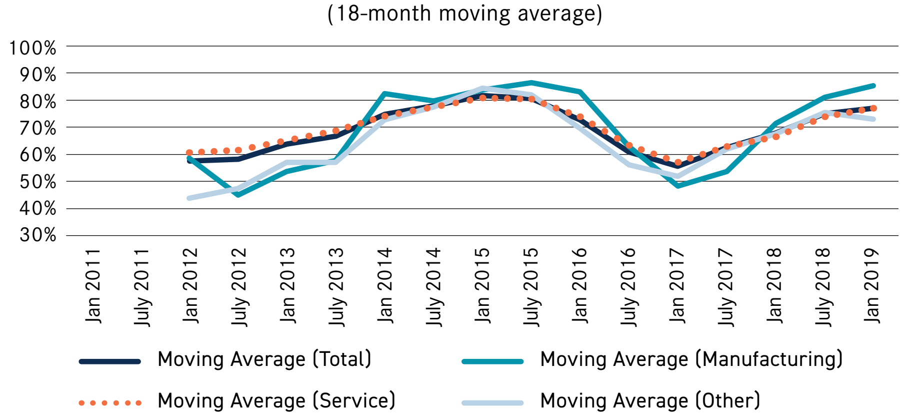


Moving Average is average of three previous data points.

HIRING OUTLOOK STILL STRONG

SBCI Likelihood to Hire by Sector

(18-month moving average)



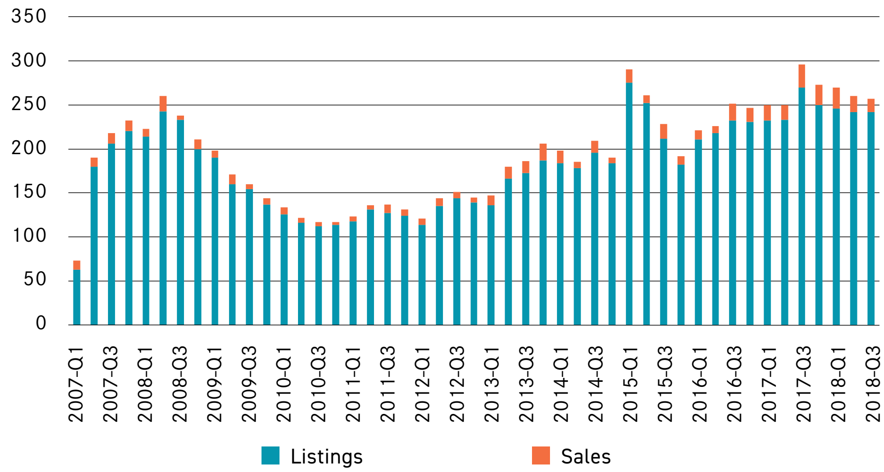
Moving Average is average of three previous data points.

Business transaction activity, measured by volume of listings and closed sales, remains virtually unchanged over the past year. On a troublesome note, subject companies were smaller in both median revenue and cash flow metrics, and multiples paid for their future earnings and cash flow declined for a second year in a row.

Business transaction activity, measured by volume of listings and closed sales, remains virtually unchanged over the past year.

BUSINESS TRANSACTION ACTIVITY STILL ROBUST...

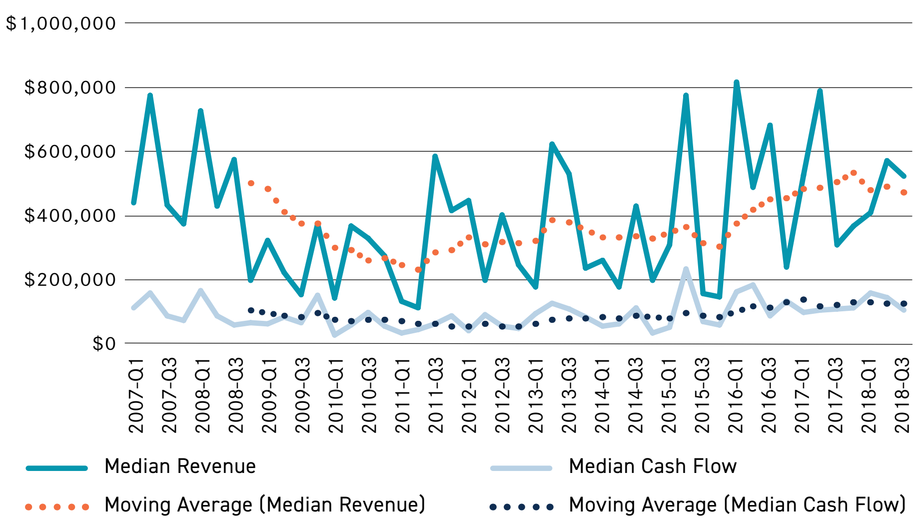
Listings vs. Closed Sales



Data Source: BizBuySell

...but SIZE AND VALUATIONS OF SUBJECT COMPANIES CONTINUING TO DECLINE

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



Moving Average is average of eight previous data points.

Data Source: BizBuySell

Real Estate

KEY POINTS

- **Office Market:** Showed strong performance during 2018 and is well positioned for further growth in the coming year, although availability will likely be an issue long-term.
- **Industrial Market:** Strong lease rate growth was driven by low vacancy. New product is scheduled to come online in early 2019 but is focused on attracting a new tenant base rather than servicing the traditional tenant base.
- **Retail:** Retail fundamentals were largely driven by construction in 2018, and class A centers are seeing strong demand due to strong demographics. Landlords are looking to new, experiential tenants to try to insulate themselves from online competition.
- **Single Family:** Property values continue to grow but the pace has slowed, up 5.3% year-over-year. The market is not over saturated with new supply; developers have curtailed their pace of construction to approximately 8,000 permits this year, down from a 2004 peak of 22,005.

Office

The office market had a strong 2018, recording more than 530,000 square feet of net absorption, resulting in a decline in vacancy of 60 basis points to 9.2%, a new low for the market. Strong market metrics result from increased demand from tenants looking to enter the market. Recently, Centene has broken ground on its new headquarters in Natomas, and Penumbra signed a long-term lease of 160,000 sf in Roseville. Combined, these two tenants are expected to bring approximately 7,500 new jobs to the region.

High levels of demand have also led to an increase in lease rates and property values. No submarket better exemplifies this more than downtown, which has seen asking rates for class A space eclipse $3.00 per square foot per month on a full-service gross basis for the first time. The outlook for 2019 is similar with nearly 1.7 million square feet of tenants actively seeking space and a lack of available Class A throughout the region.

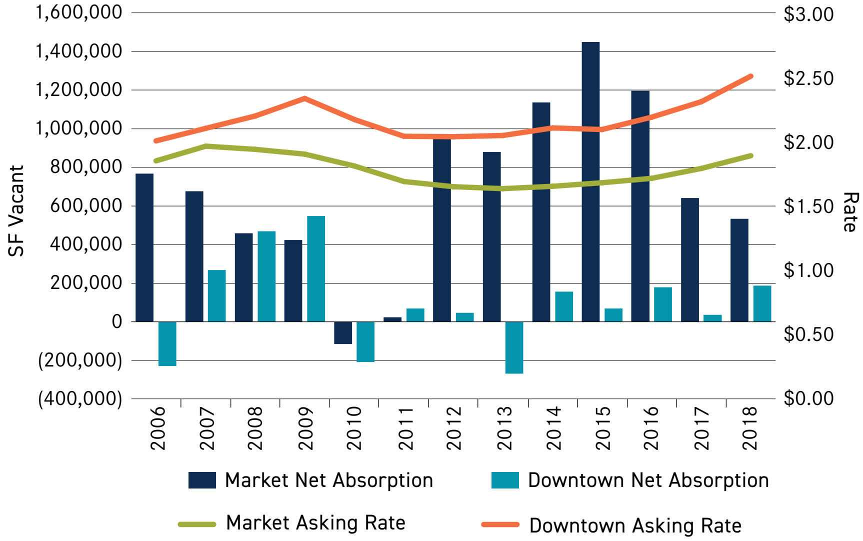
THE INDUSTRIAL MARKET CONTINUES ITS RECORD GROWTH

Industrial

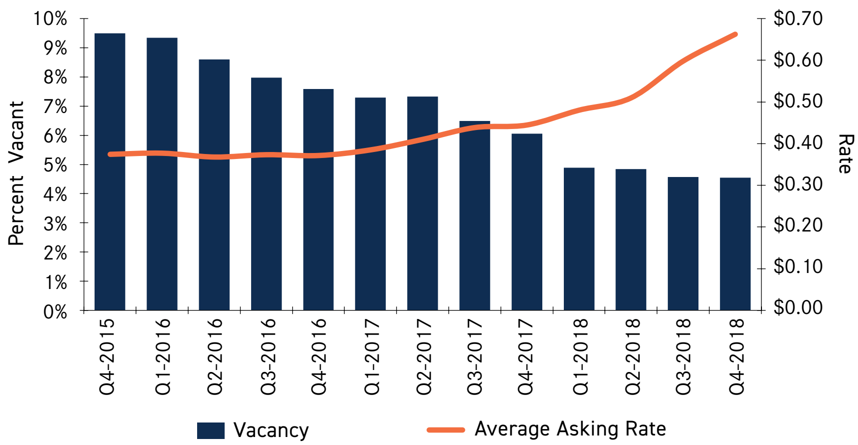
The industrial market continues its record growth. Net absorption reached 2.9 million square feet for the year with vacancy reaching a record low of 4.5%. Marijuana tenants, which were initially responsible for the sharp decrease in vacancy and increase in lease rates, have largely saturated the market, and growth is now sustained by demand from the market's traditional tenant base.

New speculative construction is due to complete in early 2019 and will fill a void in the market for class A high-clear-height distribution buildings. The new developments will serve as a litmus test for the market as developers seek to bring large block distributors to the region. Interestingly, much of the market demand is for tenants looking to occupy 10,000 to 50,000 sf, which has little availability and little in the way of new supply. This may be a hurdle to further market growth as current developers will either be forced to demise the large buildings already under construction, incurring additional costs, or tenants will be forced to remain in their current locations, possibly hindering market growth while real estate costs increase.

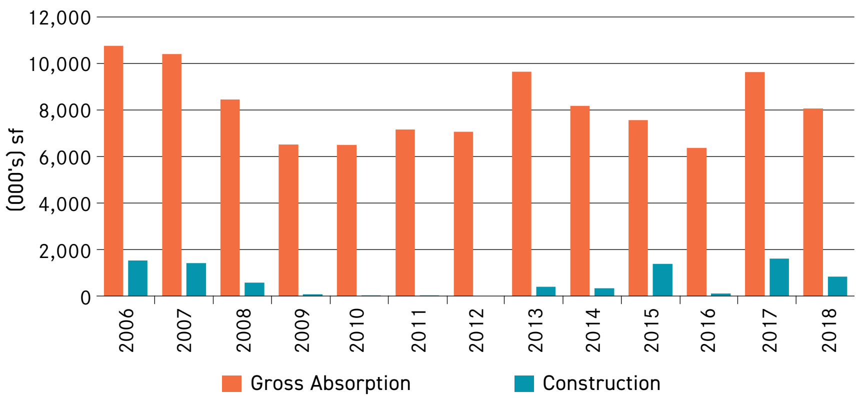
Office Market Activity 2006-2018



Industrial Asking Rate & Vacancy Rate Q4-2015 to Q4-2018



Gross Absorption & Construction 2006-2018



REAL ESTATE

Real Estate

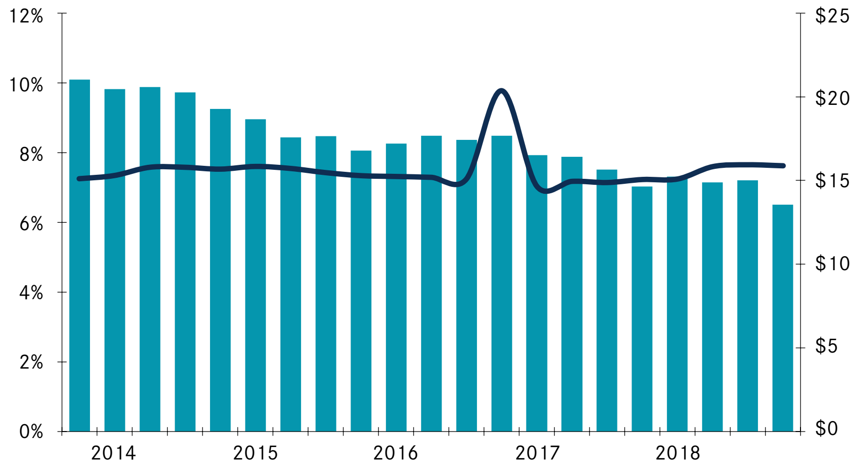
Retail

The Sacramento retail market recorded strong fundamentals during 2018. Construction completions buoyed net absorption figures, which reached nearly 890,000 sf during the year; correspondingly the vacancy rate fell to 6.5%, a year-over-year decrease of 50 basis points. The strong market fundamentals are driven, in part, by a shift in landlord preference regarding tenant type. In the previous economic cycle, goods retailers were highly sought after, but they are currently facing increased competition from online outlets. Now landlords are considering experiential-based retailers — like indoor trampoline parks or escape rooms — to fill vacant space.

Demand is strong for the region's class A shopping centers; however poor demographics change a retail center's prospects dramatically. In some cases, like a former Watt Avenue grocery store, projects are being redeveloped as mini-storage or other non-retail uses. This trend is expected to continue as brick and mortar looks for creative ways to compete with online retail.

Construction completions buoyed net absorption figures, which reached nearly 890,000 sf during the year; correspondingly the vacancy rate fell to 6.5%.

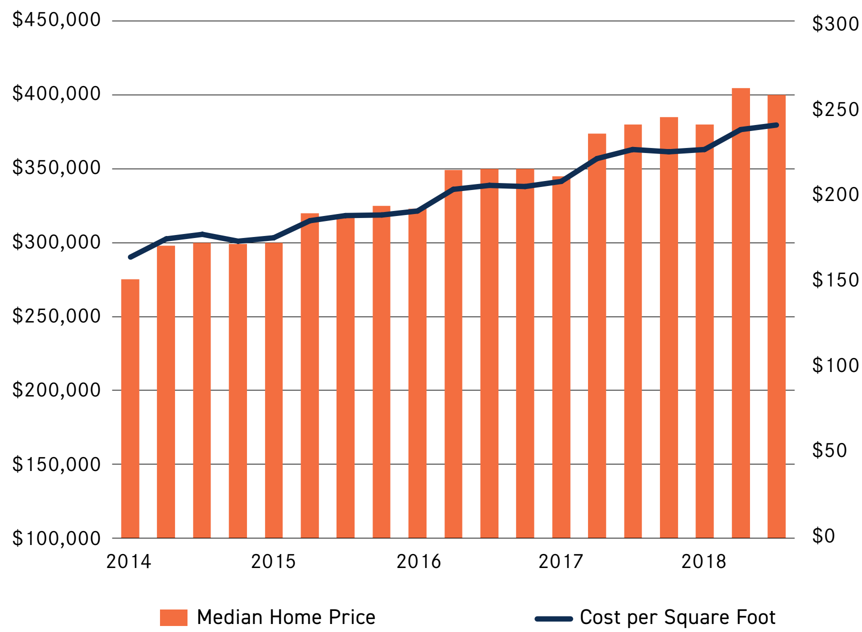
Vacancy & Average Asking Rates 2013-2018



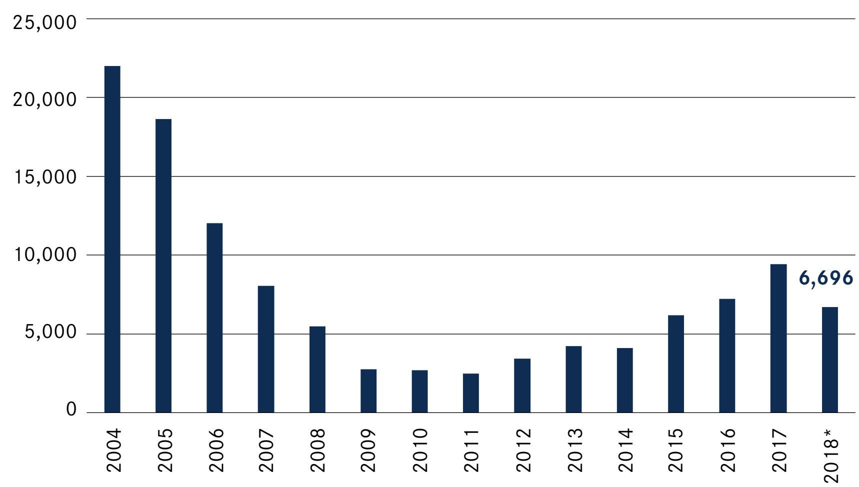
The Sacramento retail market recorded STRONG FUNDAMENTALS DURING 2018

While growth continues there are signs of DECELERATION

Median Home Prices & Cost Per Square Foot 2014 - 2018



Single Family Building Permits Issued by Year



*2018 data includes January 1 through October 31

Single Family

The single-family housing market has seen significant growth over the last few years. While growth continues, there are signs of deceleration. Sale prices on a per-square-foot basis across the Sacramento region increased by 6% year-over-year, compared to 9% growth or more in 2015, 2016, and 2017. Similarly, median home prices saw a slight decrease in the third quarter of 2018, approximately 1.1%; however year-over-year home values are up by 5.3%.

The majority of the region's sales remain below the $600,000 threshold. This puts pressure on developers to keep costs down due to the high cost of land, as a result there has been a lack of starter homes (1,600 sf or less) on the market. With that said, the outlook for single family property values remains positive as developers have learned from the previous recession and are not saturating the market with new supply. Through October 2018, 6,696 single family building permits were pulled and that number is on pace for around 8,000 by the end of the year. This is down from 9,429 last year and well below the 2004 peak of 22,005.

REAL ESTATE

Capital Markets & Banking *Forecast*

KEY POINTS

- Last year, cautious optimism was one of our main themes for 2018; we are still cautiously optimistic for 2019, but with a little more caution and a little less optimism for capital markets and the regional banking sector.
- Confidence on the part of the consumer and the corporation is expected to wane in 2019 as the source of future economic growth beyond 2019 becomes less clear.
- Regional banks and credit unions have performed well, but the dwindling of cheap liquidity and a flatter yield curve present formidable headwinds.

The Fed increased its target range for Fed funds four times for a 1.0% total increase in 2018.

Capital Markets Outlook

Last year we called out domestic monetary policy as the biggest risk factor for capital markets in 2018, and we think this will persist as a key factor right up there with consumer confidence as we head into 2019. The Fed increased its target range for Fed funds four times for a 1.0% total increase in 2018. This was the most rapid increase in short-term rates since the recovery began in 2009. U.S. equity markets coped with the increases for the first three quarters of 2018, but anticipation of several more increases in 2019 gave markets pause in Q4, with stocks reversing more than 8% in gains as of the end of Q3 and heading closer to bear market territory with close to an 8% decline to end the year. While there does not appear to have been any sharp change in fundamentals, higher risk-free rates (discount rates), and the anticipation thereof, coupled with late-cycle preponderance regarding what factors will keep corporate earnings growing as they have over the last couple of years seem to have caused investors to rethink the lofty valuations achieved for stocks at the end of Q3.

U.S. equities are likely to experience higher volatility in the upcoming year, with equity returns for 2019 projected to be in the low to mid-single digits. While monetary policy and consumer confidence are key risks to watch out for domestically, the possibilities of a messy Brexit and a prolonged trade dispute with China also pose threats to both the U.S. and global economies.

POSITIVE GROWTH FOR MOST REGIONS, but at more **MODERATE RATES**

MARKETS ABROAD expected to **OUTPERFORM U.S.**

LOW OIL PRICES to help keep **INFLATION IN CHECK**

Market	Forecast	Comment
Economy		
Global Growth	↗	Global growth will continue through 2019, though at a slower pace. Regional growth is likely to be patchy through the year with concerns of looming recession exacerbating the risks.
U.S. Growth	↗	The U.S. economy has momentum to continue growth through 2019, but it will be at a slower pace. The first signs of the unemployment rate turning the corner, lower consumer confidence, and/or the cost of credit rising are all factors that can stymie growth.
Eurozone	→	Brexit and the Italian budget deal implementation still hold uncertainty for the Eurozone; the Euro is not likely to strengthen until Eurozone internal conflicts are worked out.
Emerging	↗	Emerging markets will maintain growth, though a slowdown in the U.S. will adversely impact emerging markets. China is still expected to lead in economic growth, but an anticipated slowdown in the Chinese economy will ripple through the Asian markets. U.S. China trade tensions remain a risk.
Global Inflation	→	Global inflation is likely to stay in healthy range.
Stocks		
Regions	Rest of World > U.S.	Foreign markets have lagged the US for several years, and now the value proposition is likely to be found abroad in both emerging and developed economies.
Sectors	Consumer Staples, Utilities, Health care	Defensive sectors are likely to be the best bet for 2019. Increased volatility will have a greater effect on other sectors leading to higher uncertainty of positive returns.
Bonds		
Regions	U.S. > Rest of World	The Fed is expected to increase rates two times in 2019, and yields are expected to rise, although the yield curve will remain flat. Central banks of Europe and Japan will keep their rates in check.
Sectors	U.S. Financials	Investment-grade U.S. financials are positioned well relative to the last crisis with higher capital buffers. However, headwinds are aplenty with a flat curve and potential credit concerns.
Commodities		
Sectors	Crude Oil	Oil prices plunged in Q4 of 2018 amid concerns about an economic slowdown, but as anticipated stable (though slower) growth continues; oil prices are likely to have tepid growth through 2019.

Capital Markets & Banking *Forecast*

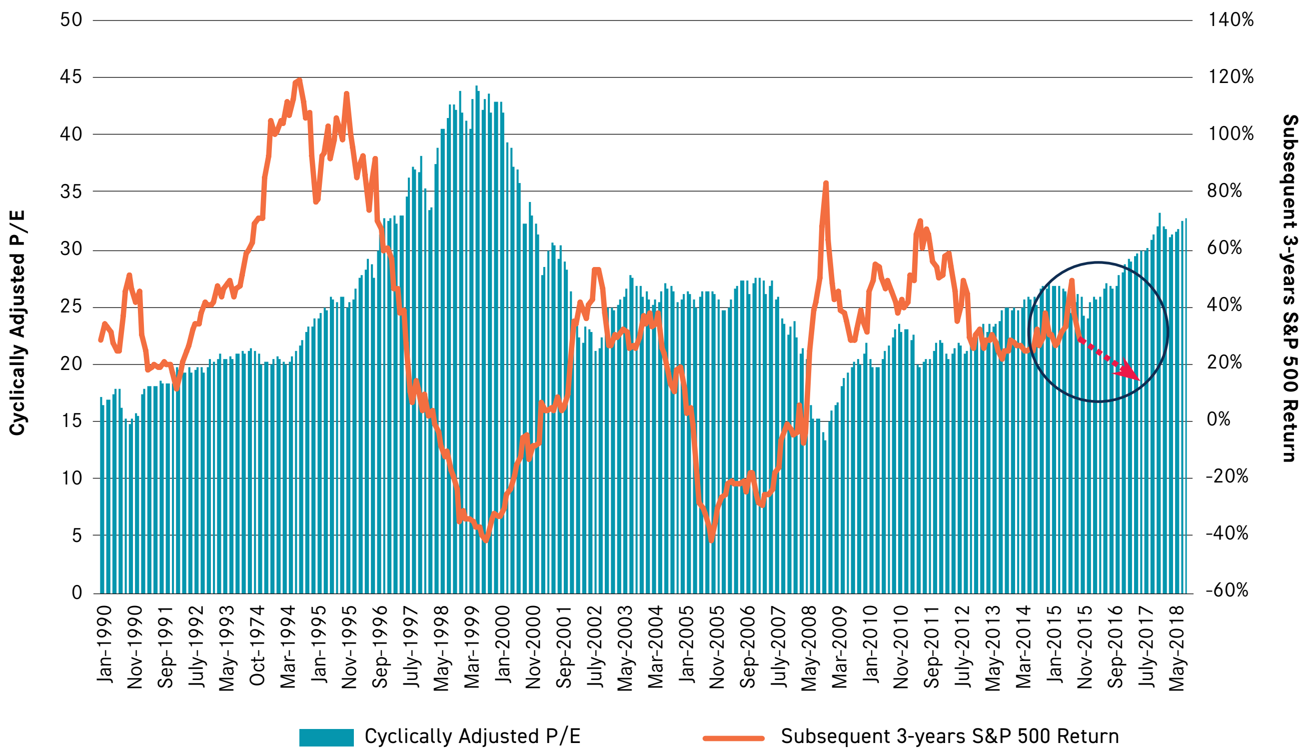
Even after a year of market corrections in 2018, U.S. equity valuations are still relatively high: A decade of low discount rates have contributed to the higher valuations. Historically, high P/E ratios tend to be followed by three to five years of low returns. The current level of P/E ratio suggests a slowdown in the investors' returns (see chart below).

While we do not see a recession taking hold in 2019, the impact of the flattening yield curve on the ability of financial institutions to lend may start to adversely impact growth toward the end of the year and into 2020. As stated in the subsequent regional banking section, banks and credit unions have seen net interest margins expand and net income grow through 2018. However, the flatter curve will ultimately lead to higher interest expense with the higher short end of the curve, while interest income growth will stall as assets are repriced along the stagnant, long-end of the curve. It is this margin compression that has historically impacted the ability of financial institutions to continue providing credit at favorable rates in the later part of the cycle. Thus, when we see a persistent flat curve, or an inverted curve, the anticipation of a recession begins to take hold.

As both companies and consumers find it more difficult to obtain, or refinance, credit on what have been favorable terms for this expansionary cycle, their ability to purchase and invest in the broader economy will become more difficult and ultimately lead to lower levels of economic growth, which could perpetuate a lack of confidence and a further pull-back in spending.

We project longer-term Treasury rates to end 2019 in the range of 3.00% to 3.50%, and for the Fed to push the short-end of the curve higher with two more quarter-point rates hikes.

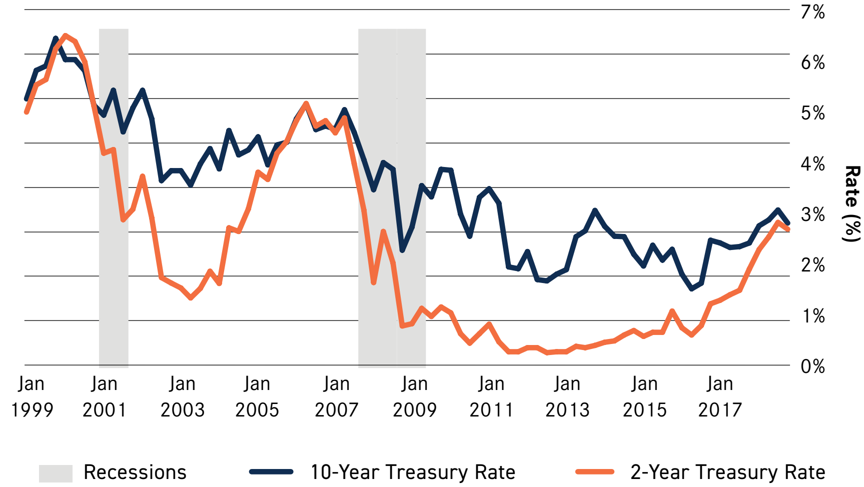
P/E Ratio vs. Subsequent 3-Year Returns (S&P 500)



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

A FLAT OR POTENTIALLY INVERSE YIELD CURVE to squeeze NET INTEREST MARGINS

10-Year vs. 2-Year Treasury Rate



Data Source: Board of Governors of the Federal Reserve System (U.S.), retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/

CAPITAL MARKETS & BANKING

Regional Financial Institution Performance

Overall, regional loan growth in 2018 was in line with our initial projections at the beginning of the year. Sacramento banks and credit unions grew their loan portfolios by approximately 10% on average for the 12 months ended September 30, 2018, which is approximately 4.5% less growth relative to the 12 months ended September 30, 2017. Regional banks appear on pace to end the year with similar growth relative to 2017; however, regional credit unions will finish 2018 with a noticeable slowdown in growth attributable to fewer auto loans.

The SBR team foresees loan growth continuing a general slowing trend throughout 2019 as market rates move higher and companies, consumers, and investors re-evaluate their economic prospects and capacity

Loan Growth by Category | Sacramento Region Banks

% of Total	Category	YoY% Change Sep 2016 - Sep 2017	YoY% Change Sep 2017 - Sep 2018
48.3%	Commercial Real Estate	15.7%	13.3%
18.8%	Residential	7.3%	9.3%
8.8%	Commercial & Industrial	10.8%	1.9%
7.7%	Multi-family Residential	24.6%	33.2%
3.3%	Construction Loans	-2.6%	-15.3%
13.0%	Other	2.8%	12.5%
100%	**Total**	**11.3%**	**11.4%**
Data Source: FDIC			

Loan Growth by Category | Sacramento Region Credit Unions

% of Total	Category	YoY% Change Sep 2016 - Sep 2017	YoY% Change Sep 2017 - Sep 2018
53.3%	Auto Loans	26.5%	9.0%
37.9%	Residential/RE Lines of Credit	10.0%	13.0%
7.3%	Credit Card/Unsecured	8.7%	-0.5%
1.5%	Other	-2.0%	-6.7%
100%	**Total**	**17.9%**	**9.4%**
Data Source: NCUA			

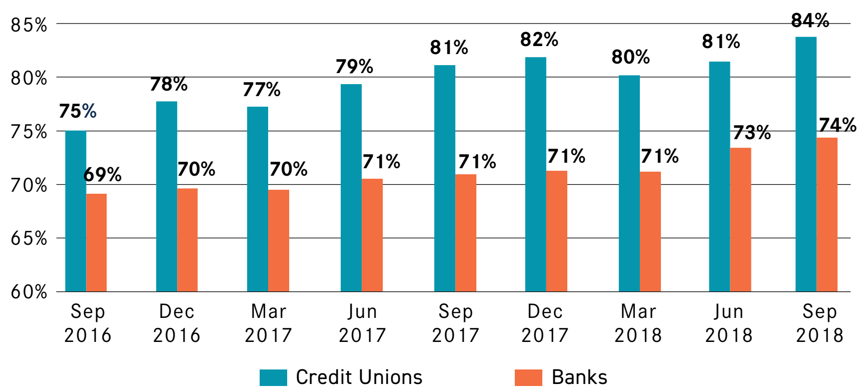
Capital Markets & Banking *Forecast*

for additional debt in light of the re-emergence of market volatility and greater levels of uncertainty in the fourth quarter of 2018 that will likely persist into 2019. Additionally, rising short-term rates have pushed the cost of deposits and wholesale funding higher, reducing further the supply of "cheap" liquidity that provided the fuel for loan portfolio growth in the current expansionary cycle. This trend may be observed in the steadily increasing loans/shares ratios of regional financial institutions that have been growing loans at a faster pace than deposits; however, it is important to note that the increasing loans/shares ratios are occurring while loan growth has been slowing, indicating that deposit growth will be a key objective of local financial institutions in 2019.

Profitability for local financial institutions has continued an upward trend in 2018 as faster loan growth relative to deposit growth helps to propel net interest income higher.

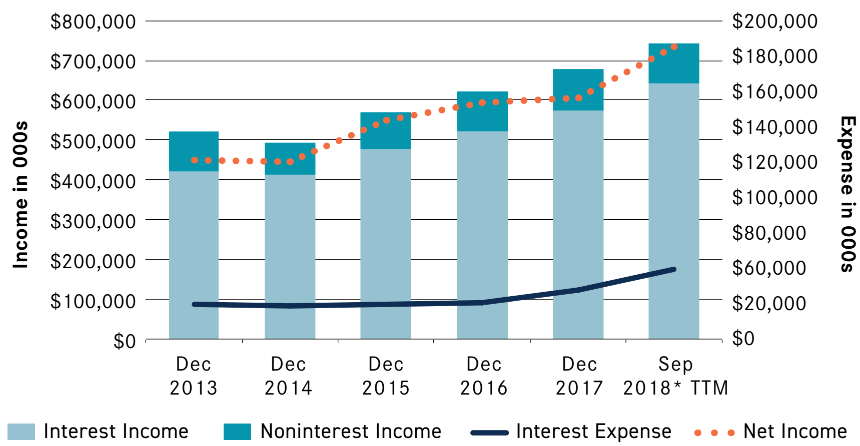
REGIONAL FINANCIAL INSTITUTION profitability in 2018 will be HARD TO MATCH IN 2019

Sacramento Region Financial Institutions - Loans/Deposits



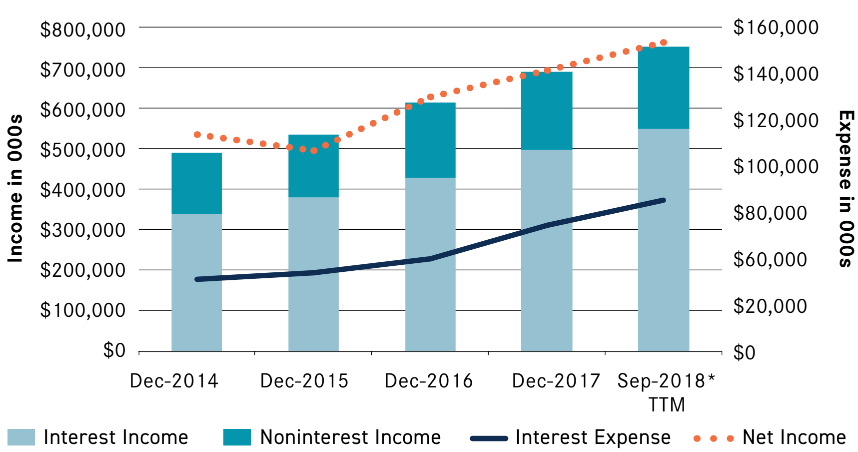
Data Sources: FDIC and NCUA

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



Data Source: FDIC

Sacramento Region Credit Unions YTD Income vs. Interest Expense



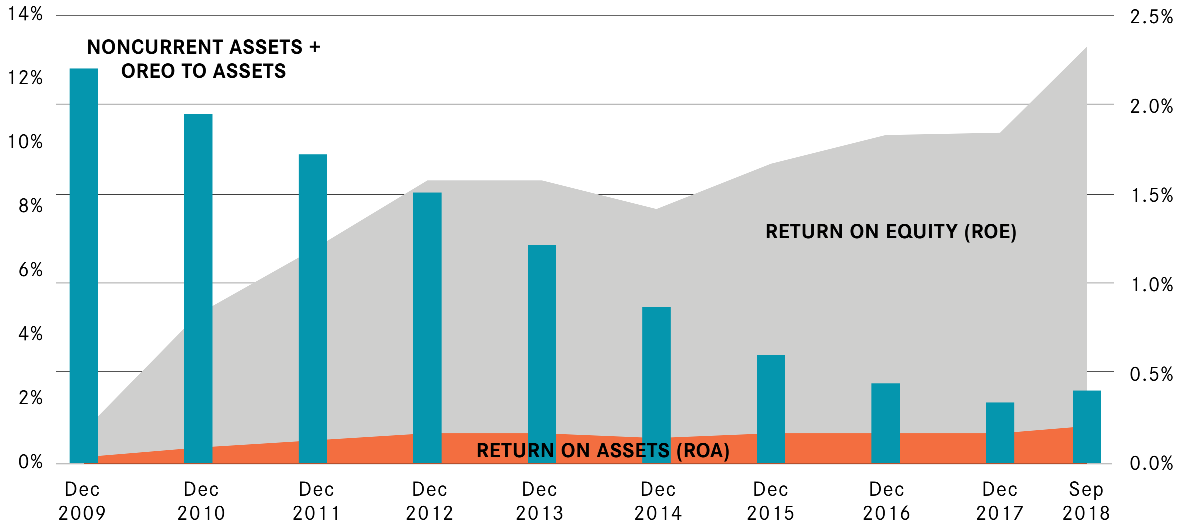
Data Source: NCUA

In addition to the expectation for higher interest expense, local financial institutions will likely face higher credit and operational costs in 2019. Delinquencies remain near their lowest levels of the cycle, but we may see an uptick in delinquency and charge-off rates as loan production and portfolio growth slow and the loss characteristics of the loan production of the last couple of years becomes more defined without the addition of as many new loans without loss history.

Operational costs related to regulatory compliance and increasing labor costs will be a key consideration for local financial institution management in 2019.

Operational costs related to regulatory compliance and increasing labor costs will be a key consideration for local financial institution management in 2019. In particular, the new accounting standard model for which institutions will estimate loan losses, the Current Expected Credit Loss model, will be required for local institutions as early as 2020, with much of the costs to implement and run the model impacting 2019 income statements if they have not already. The more relaxed regulatory approach carried out by the current administration has provided some relief to the banking sector, but it is difficult to imagine Congress agreeing to much more regulatory pull back as the one-party control of Congress becomes a thing of the past in 2019.

Regional Financial Institution Performance this Cycle



	Dec-2009	Dec-2010	Dec-2011	Dec-2012	Dec-2013	Dec-2014	Dec-2015	Dec-2016	Dec-2017	Sep-2018
Return on Equity (ROE)	0.8%	4.2%	5.9%	8.0%	8.0%	7.2%	8.5%	9.3%	9.4%	11.9%
Return on Assets (ROA)	0.12%	0.44%	0.68%	0.89%	0.85%	0.76%	0.88%	0.92%	0.91%	1.14%
Noncurrent Assets + OREO to Assets	2.2%	1.9%	1.7%	1.5%	1.2%	0.8%	0.5%	0.4%	0.3%	0.4%

Data Sources: FDIC and NCUA

Human Capital Index

KEY POINTS

- Employee resignations are expected to slow
- Preparations for artificial intelligence are taking place
- The need for the human resource unit to be increasingly proactive and strategic is evident from trends such as generational challenges, natural disasters, and economic uncertainty

Together with the Sacramento Area Human Resource Association, we track several areas on a year-over-year basis to anticipate upcoming human capital movements. Figure 1 shows the 2018 to 2019 movements, where positive numbers indicate movement in desired direction and negative numbers indicate reductions/shrinkage. We see in essence no movement on optional benefits and perquisites or on headcount. Headcount levels indicate that slightly more organizations are planning to actively recruit versus staying at current levels, with no indications of layoffs. We see a change in anticipated turnover; organizations are expecting fewer voluntary resignations. This is suggestive of a larger workforce locally. Another static area is training and development, where companies are basically keeping the relatively high 2018 levels. Increased efforts are indicated for compensation as well as diversity and inclusion efforts. Finally, as compared to last year, a larger number of organizations report generational differences to be an upcoming challenge.

We see a change in anticipated turnover; organizations are expecting fewer voluntary resignations.

A majority of organizations (70.5%) are reporting that new or significantly revised talent management/HR initiatives are planned for 2019.

Figure 1
Human Capital Index

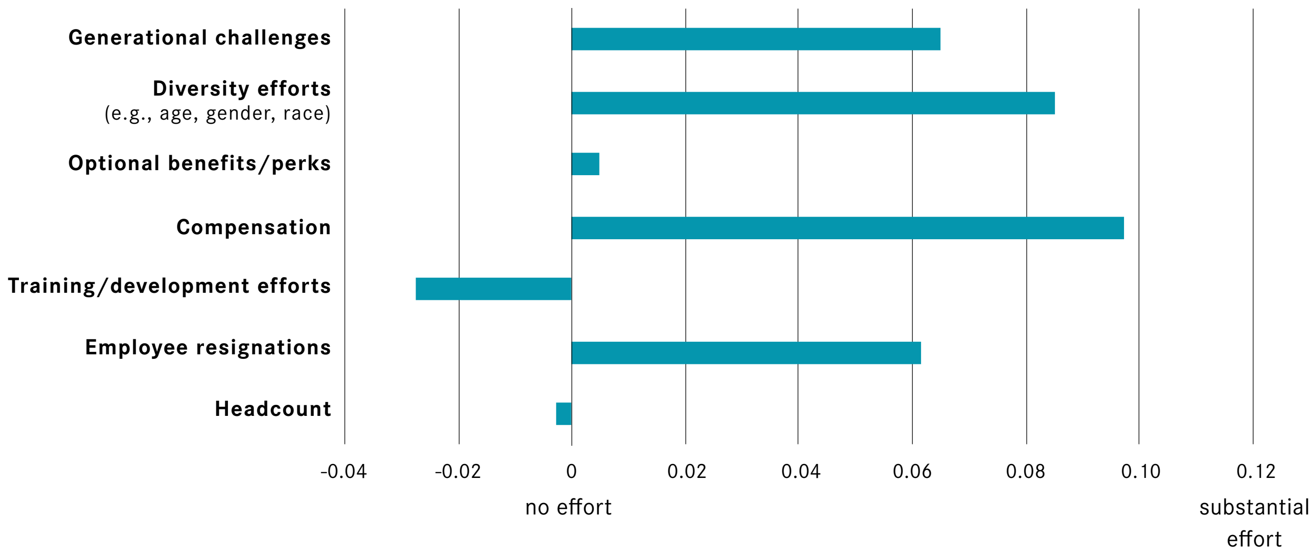
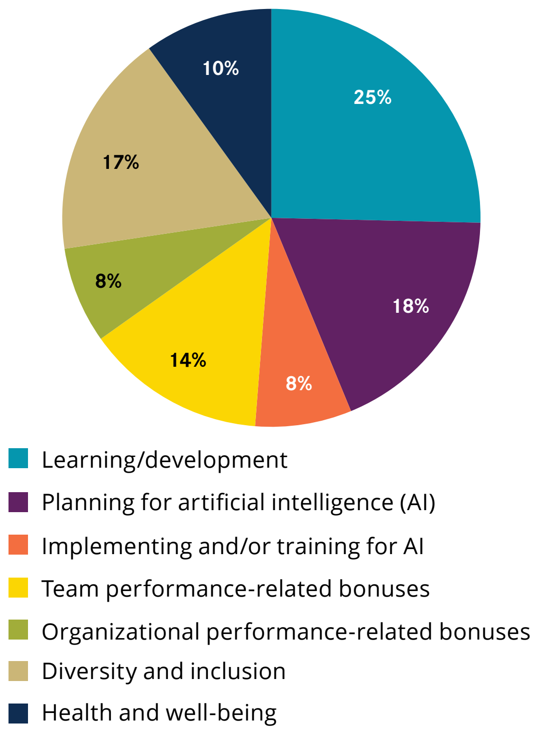


Figure 2
Talent Management Initiatives 2019



A majority of organizations (70.5%) are reporting that new or significantly revised talent management/HR initiatives are planned for 2019, with the top three being learning and development, planning for artificial intelligence (defined as machine learning and new technologies), and diversity and inclusion (Figure 2). Initiatives receiving little or no focus in the upcoming year include broader (non-financial) employee recognition, individual performance-related bonuses, financial participation of employees in business results (e.g., stock options), complementary health care assistance, complementary pension arrangements, reduction in wage disparity between top management and highly skilled talent, encouragement/reward of bottom-up ideas, encouragement of employee entrepreneurship without penalizing possible related failures, and promoting greater autonomy of employees at work. The trends from the planned versus no-go initiatives are that the focus is on collaboration and cooperation that is partly achieved by financially rewarding teams and tying such rewards to the organizational-level results. Focus is also on preparing for new AI and the HR staples of learning/development and diversity/inclusion. No-go initiatives are at the individual level as well as those initiatives focusing on employee-level creativity and innovation (including autonomy).

Human Capital Index

Table 1 lists factors expected to exert the most influence on the overall organization in 2019. The top four factors carried over from 2018, with slight changes in the order. In 2018, talent shortage was deemed the biggest pressure, while this year cost reduction is looming large. Skills gap (job candidates available but without needed skills) and challenging productivity/profit targets are staying at 2nd and 4th ranks respectively. In a separate survey this year, we asked employees about the extent to which they feel prepared for the work they do: 62% reported that they have the education required for their current position and 50% reported feeling prepared for their next promotion/position. This suggests a large need for further training and development to shrink the existing local skills gap. Talent shortage (job candidates not available) is predicted as the third most important factor in 2019. Artificial intelligence is new on shared rank number eight. Downsizing is deemed to be the least threat.

Write-in options included mergers and acquisitions, lack of business acumen in top management, cyber security awareness/training, pace of technological change, and retirement and the need for succession planning, which was mentioned repeatedly. Other points made were concerns regarding large impacts at the societal level, such as impending recession/economic depression, uncertainty of the stock market and trade, and unpredictable factors such as weather changes and natural disasters. These external factors impact business strategy and operations that in turn impact workforce planning

Table 1
Factors Expected to Exert the Most Influence in 2019

Factors	Rank
Pressure on cost reduction	1
Skills gap	2
Talent shortage	3
Challenging productivity and profit targets	4
Development and management of new competencies	5
Change in company culture	6
Expansion of operations in new markets	7
NEW: Artificial intelligence	8
Increased market competition	8
Organizational restructuring	8
Market volatility and fear of recession	9
Downsizing	10

HUMAN CAPITAL FORECAST FOR 2019

TRAINING/ DEVELOPMENT are staying at 2018 LEVELS

DIVERSITY AND INCLUSION EFFORTS are still GROWING

PRESSURE ON COST REDUCTIONS is seen as MOST IMPORTANT FACTOR EXERTING INFLUENCE

37% of workers perceive their organization as caring, something that impacts willingness to go over and beyond simple job descriptions.

and management. Overall, these factors suggest a need for the HR unit to stay strategic and proactive, and to scan the environment for upcoming trends and local/global factors impacting our Sacramento-area businesses.

The surveyed HR professionals reported receiving continued employee requests for telecommuting and flexible schedules, which aligns with the data from the employee survey. When asked about the reason for staying with an employer, 74.25% of workers cited the opportunity for flexibility in scheduling. The next highest reason for staying with the company was "great coworkers" with 55.85% of employees reporting this, something the organization and HR have influence over in the extremely important recruitment and selection processes.

Our data suggests diversity (gender, race, and age) are less of a priority for all levels in the organization (C-suite/top management, middle and line managers, and HR) in the upcoming year than in the past cycle. Identified challenges include ensuring the organization is current on inclusiveness on gender and educating the workforce and leadership on diversity/inclusion and harassment. An opportunity is to revise the training significantly to start anew and to move away from the harassment training that is seen as a simple bureaucratic exercise with little or no value to an initiative promoting better general understanding, awareness, and appreciation. Gender bias tends to be alive and well with respondents reporting on inappropriate work practices such as dismissing women from meetings without due cause and male employees citing the gender of their boss as a reason for not yielding to authority. HR professionals have the responsibility to provide a safe environment for all employees by establishing a strong ethical code of conduct not only for themselves but for the company. HR can make it known throughout the company that such behavior is unacceptable. Only 37% of employees reported perceiving their organization as caring about them.

Managing expectations and reducing conflict across the generations with regards to technology, importance of face time (presence in the office versus delivering results from remote places), and scheduling and vacation preferences are still ever-present. Currently, the millennial generation move with a faster speed and willingness to take risks not always mirrored in the older generations. Finally, several comments related to the alarming lack of succession planning and performance management of more senior employees, as well as apparent age discrimination. This aligns with the employee data where only 34.45% of workers indicated available career opportunities and only 25% have access to coaches/mentors for further development.

Development of the next generation skilled workers and leaders is abysmal, with 34.45% of workers saying they see career opportunities and 25% reporting having access to coaches or mentors.

SPECIAL THANKS

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