JANUARY 2020 ECONOMIC FORECAST | EMERGING TRENDS IN SACRAMENTO'S ECONOMY

sacramento BUSINESS REVIEW

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Sacramento Boom: Rising into the next decade

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

JANUARY 2020

sacramento **BUSINESS REVIEW**

MISSION

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

LABOR MARKET & REGIONAL ECONOMY

SBR/SAFE CREDIT UNION CONSUMER SENTIMENT SURVEY

SMALL BUSINESS

REAL ESTATE

CAPITAL MARKETS & BANKING

HUMAN CAPITAL TRENDS

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MESSAGE FROM THE CHIEF ECONOMIST

Dear Friends,

I am pleased to share the 23rd edition of the *Sacramento Business Review* – the most comprehensive, precise, and intellectually sophisticated analysis of the regional economy. For over 12 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.

December 2018 was the worst on record since 1931, but the U.S. stock market came roaring back in 2019 to produce the best returns in years, driving the S&P 500 and Nasdaq up 29% and 35% respectively. Driven by a significant wealth boost from financial markets to include even gold and real estate; a robust economy; Federal Reserve rate cuts (after rising for 11 straight years); Brexit certainty; China Phase 1 deal; and a technology sector on fire — 2019, by all measures, was a spectacular year.

Thankfully, the U.S. economy grew at a faster pace than anticipated and appeared much more robust than the rest of the world. Not even a slowdown in China, or an inverted yield curve, or global trade tensions, or the historic impeachment of Donald Trump could dampen the enthusiasm and confidence of both consumers and businesses. The 2019 economic and market performance defies the skeptics and puts an exclamation point to mark the end of the last decade.

The new decade begins with the usual circus that accompanies an election year. The Sacramento economy remains strong with no signs of any impending recession. While job growth has slowed, we continue to enjoy the best labor market in over 50 years with the unemployment rate at a record low of 3%. We expect the commercial real estate market to remain strong, and residential market stable. A widening skills gap and talent shortage will confound businesses and employers. Loan growth will cause further slowdown for local banks and small businesses. Recent MLS announcements will breathe more years of expansion into our construction sector, which is already vibrant.

Our 12th anniversary milestone demonstrates 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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Although the unemployment rate reached a record low of 3%, the rate of improvement in the region's labor market slowed in recent months. This decrease in the pace of job gains — and the recent decline in the labor force — could foreshadow a more challenging economic climate for the region.

14 SBR/SAFE CREDIT UNION CONSUMER SENTIMENT SURVEY

Consumer sentiment has reached its highest point since the inception of our survey. Notably, the survey indicates that consumers in the Sacramento region are more optimistic about future economic conditions than consumers in the nation as a whole. Our survey also saw an increase in the number of people planning to acquire mortgages, auto loans, and credit cards, which could be a boost to consumer spending in the region.

18 SMALL BUSINESS ECONOMY

Small business sentiment saw a slight uptick since our mid-year report, with an expectation for continued growth. However, Sacramento continued to experience less growth than El Dorado and Placer. Our Small Business Confidence Index (SBCI) Total Economic Outlook hit an all-time high and surpassed the 18 month moving average. Recent transactions are generally for smaller deals with lower valuations than in prior years.

22 REAL ESTATE

The region's real estate market is thriving, with office vacancy rates at an all time low. The lease rates in the industrial market have stabilized; however, most rates remain below replacement cost. In the retail market, landlords are favoring tenants who are insulated from online competition, but the long-term viability of experiential tenants has not yet been established. The single-family housing market continues to see growth, but shows signs of deceleration.

26 CAPITAL MARKETS & BANKING FORECAST

Regional financial institutions had a great year in 2019, but 2020 looks to be much more challenging with slowing loan growth and buoyant funding costs. Although recessionary pressures continue to build, economic indicators point to a relatively stable year. 2019 was a banner year for the equities market, and 2020 is likely to continue the upward trend, albeit with a single-digit positive return.

32 HUMAN CAPITAL TRENDS

Organizations are expecting continuing large numbers of voluntary resignations. The skills gap and a talent shortage remain key issues for local companies. Accordingly, the top priorities for companies in 2020 include: improving employee engagement and satisfaction; building a leadership pipeline for the future; improving talent management; and succession planning.

36 SPECIAL THANKS

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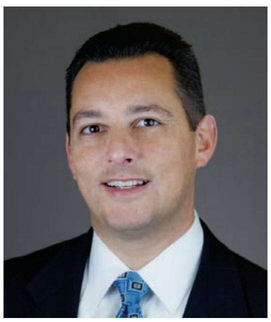

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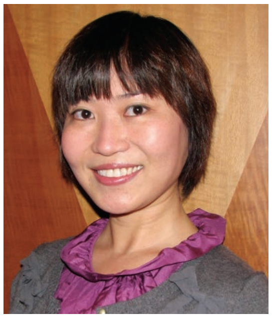

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Labor Markets
& Regional Economy

IN SEPTEMBER 2019
THE REGION'S UNEMPLOYMENT RATE
HIT A RECORD LOW OF 3.0%

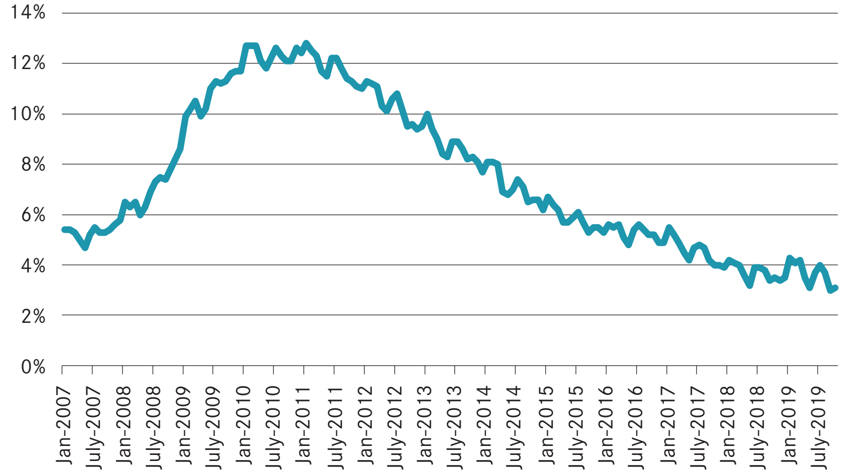
KEY POINTS

- Local unemployment rate reached all time low at 3%.
- Labor force had declined by 20K in the first half of 2019 and employment growth rate has slowed dramatically in last six months.
- Construction, manufacturing and health care have been largest sectors for job growth over the last 12 months.
- We expect the economy to remain healthy in 2020.

The Sacramento Region labor market continues to post strong results. In September 2019, the region's unemployment rate hit a record low of 3.0% after eight consecutive years of job growth.

However, the rate of improvement in the region's labor market has slowed, if not stalled, in recent months. The average year-over-year growth rate over the past six months has hovered at just 0.2%, a sharp decline from the nearly 3% growth rate from the previous 12 months. This is no doubt partly due to the decrease in the labor force that we have raised concerns about in the past. In 2Q19, the region lost approximately 2.6% of its labor force; while approximately 2.3% of the jobs in the region were also lost. In 3Q19, the loss of employment was partially regained at a pace faster than the labor force came back. As a result, the local unemployment rate remains strong in 2019. However, according to the U.S. Bureau of Labor Statistics, the State of California's Labor Underutilization Rate is higher than the national average. This indicates a high degree of underemployment in California; that is, a significant portion of the jobs counted towards employment is part time. Given that the Sacramento Region economic growth rate is highly correlated with its employment growth rate, the decrease in the pace of job gains and the recent decline in the labor force could foreshadow a more challenging economic climate for the region.

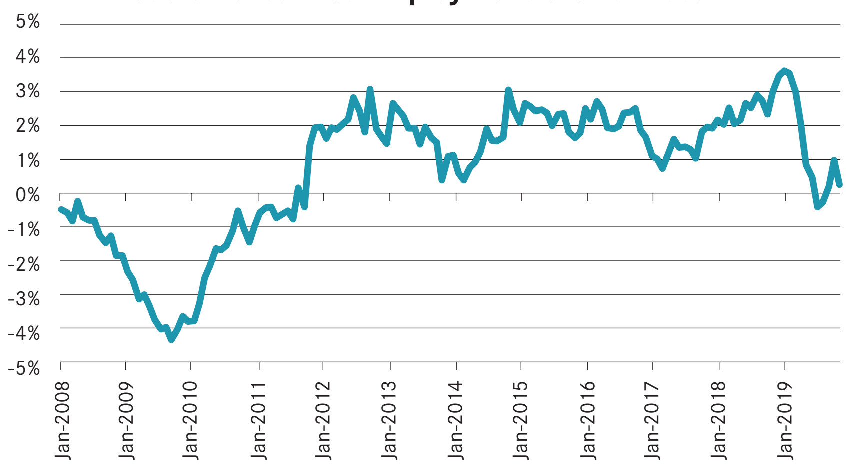
Figure 1
Sacramento Unemployment Rate



Source: Economagic.com

The average year-over-year growth rate over the past six months has hovered at just 0.2%, a sharp decline from the nearly 3% growth rate from the previous 12 months.

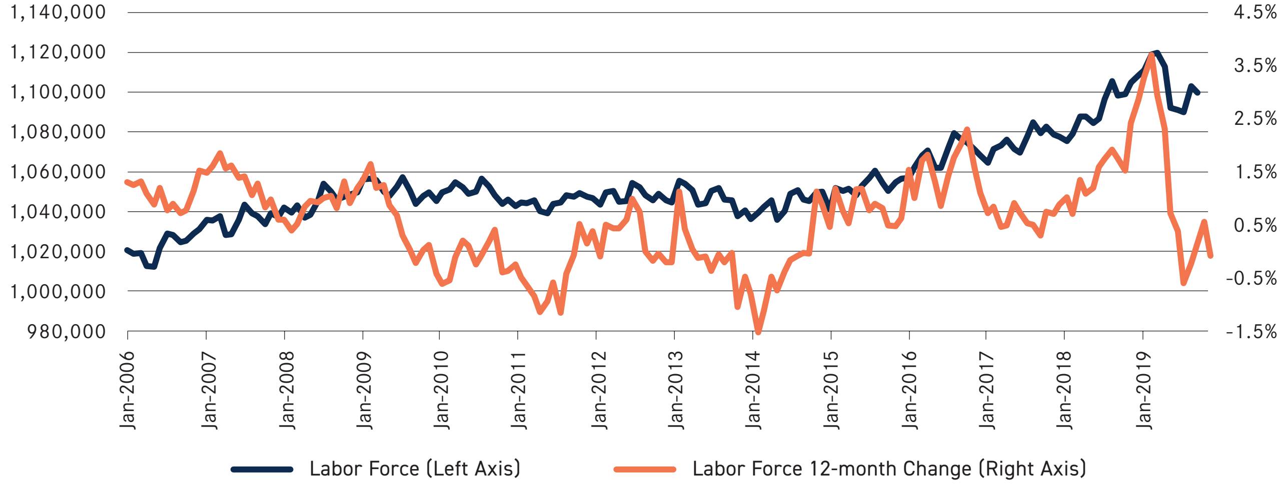
Figure 2
Sacramento Area Employment Growth Rate



Source: Economagic.com

Labor Markets & *Regional Economy*

Figure 3
Sacramento Labor Force



The distribution of jobs among the major labor market sectors has returned to pre-recession levels.

The distribution of jobs among the major labor market sectors has returned to pre-recession levels. Most notably, construction jobs now represent 6.90% of the region's jobs, close to the 7.2% level before the recession and financial crisis. The total number of people employed in construction are also at pre-crisis levels. Meanwhile, the region's employment dynamics have shifted in favor of health care, leisure and entertainment, and professional services jobs while shifting away from finance, government, and information jobs. This gives some indication as to how the recession, and the economic recovery that followed, has reshaped the economy of the region.

Table 1
Change in Labor Sector Allocation as a Percentage of the Total Local Jobs

Sector	2007-2019
Health Care	3.8%
Professional & Business Services	1.2%
Leisure & Hospitality	1.1%
Education	-0.1%
Construction	-0.3%
Manufacturing	-0.7%
Trade, Transportation, & Utilities	-0.7%
Information	-1.0%
Financial Activities	-1.2%
Government	-2.5%

Data Source: Economagic.com

Table 2
12-month Percent Change

Sector	Weight	12-month % Change, 3Q18-3Q19
Construction	6.9%	7.0%
Manufacturing	3.7%	4.4%
Health Care	15.0%	4.2%
Education	1.2%	3.1%
Financial Activities	5.4%	2.2%
Trade, Transportation, & Utilities	15.8%	1.2%
Professional & Business Services	13.6%	1.2%
Leisure and Hospitality	10.3%	0.5%
Government	23.0%	-0.9%
Information	1.1%	-4.9%

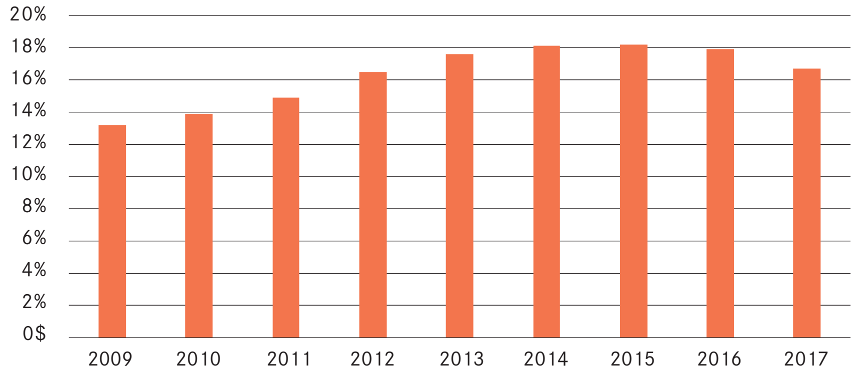
Data Source: Economagic.com

It should be noted that not everyone in the Sacramento Region has benefited from the post-financial crisis recovery. The poverty rate in the region remains elevated despite some recent improvement. In addition, homelessness continues to be a challenge in the region as the number of homeless people is more than double the level from before the financial crisis. While it is generally believed that the increased homelessness arises from a number of societal factors such as mental illness, drug addiction and alcohol usage, a study by a group of UC Berkeley researchers suggests that simple economic factors such as the high housing price and the unavailability of low cost rental housing explain a large portion of homelessness in California.[1] A recent Sacramento State report[2] shows a similar result – when asked, 45% of the homeless said Sacramento needs more affordable housing. In addition, 48% of homeless youth wanted job training. Homelessness is a multifaceted problem with no single solution and there is still a lot of work to be done to bring about a full economic recovery that benefits everyone on the economic spectrum.

Overall, we expect the economy to stay healthy in 2020 while a few risk factors remain, including continued trade talks, which could be extended to countries other than China, Fed moves, election year hesitation, and potential budget and debt-ceiling deadlocks.

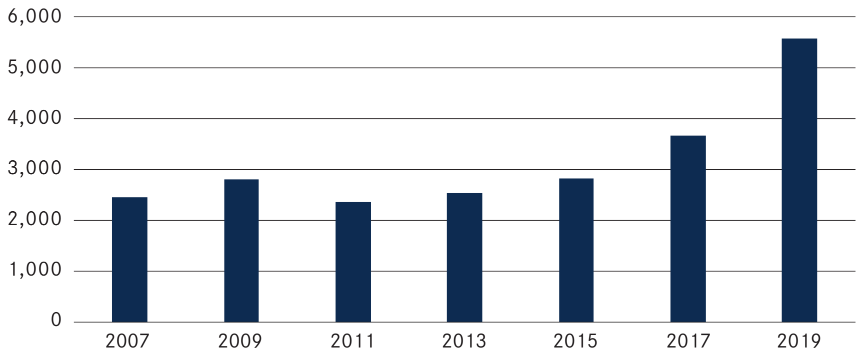
45% of the homeless said Sacramento needs more affordable housing. In addition, 48% of homeless youth wanted job training.

Figure 4
Sacramento Region Poverty Rate



Source: U.S. Census Bureau

Figure 5
Sacramento Homeless Count



Source: Point-in-Time Homeless Count

Endnotes

1 Quigley, J.M., Raphael, S., & Smolensky, E. (2001). *Homeless in America, Homeless in California*, The Review of Economics and Statistics 2001 83:1, 37-51.

2 Baiocchi, A., Curry, S., Williams, S., Argüello, T., Price Wolf, J., & Morris, J. (2019). *Homelessness in Sacramento County: Results from the 2019 Point-in-Time Count.* Sacramento, CA: Institute for Social Research and Sacramento Steps Forward.

Consumer Sentiment *Survey*

KEY POINTS

- Overall, regional consumer sentiment is at its highest level since the inception of the SBR/SAFE Credit Union Consumer Sentiment Survey.
- Significant increases in consumer sentiment observed over the past year at both the regional and national levels.
- Consumer sentiment is highly correlated with household income. Respondents with higher household income reported significantly higher consumer sentiment when compared with respondents at lower household income levels.
- Types of credit held remain fairly constant with previous releases, with a slight rebound in plans to acquire mortgages, auto loans, and credit cards.

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

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 Surveys of Consumers 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.

THE INDEX OF CONSUMER EXPECTATIONS IN THE REGION IS HIGHER THAN THE NATIONAL INDEX

(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.

Both national and regional sentiment are up compared to last year (see Figure 1). After experiencing a drop in our past two releases, regional consumer sentiment has rebounded to its highest point since the inception of our survey (see Figure 1). All three indices for the region are up over 3 points since our mid-year update. (see Figures 1-3). In particular, the index of consumer expectations, which measures expectations about future economic conditions in the region, is once again higher than the national index of consumer expectations (see Figure 3).

Figure 1
Index of Consumer Sentiment[1]

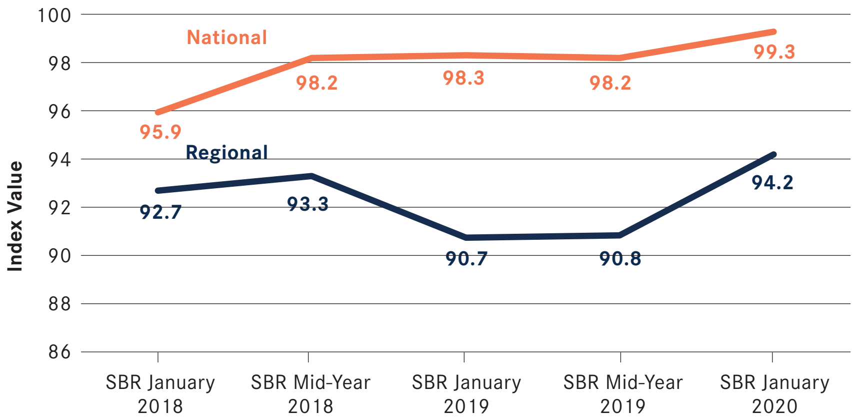


Figure 2
Index of Current Economic Conditions[1]

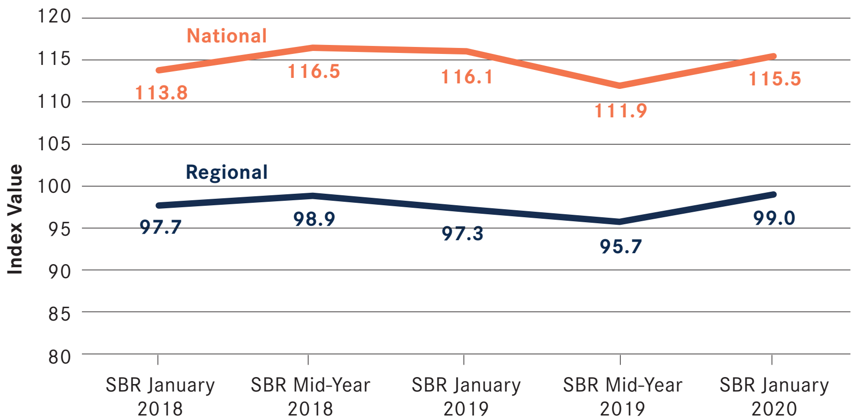
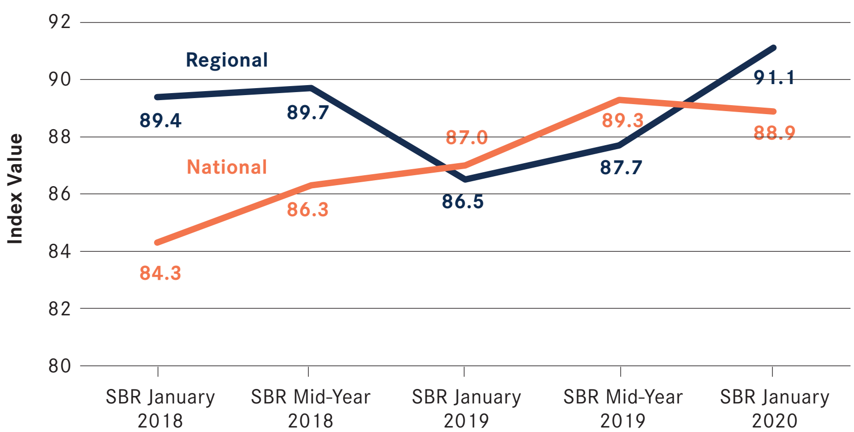


Figure 3
Index of Consumer Expectations[1]



REGIONAL CONSUMER SENTIMENT IS AT ITS HIGHEST LEVEL SINCE THE INCEPTION OF OUR SURVEY

REGIONAL CONSUMER SENTIMENT VARIES CONSIDERABLY BY HOUSEHOLD INCOME LEVEL

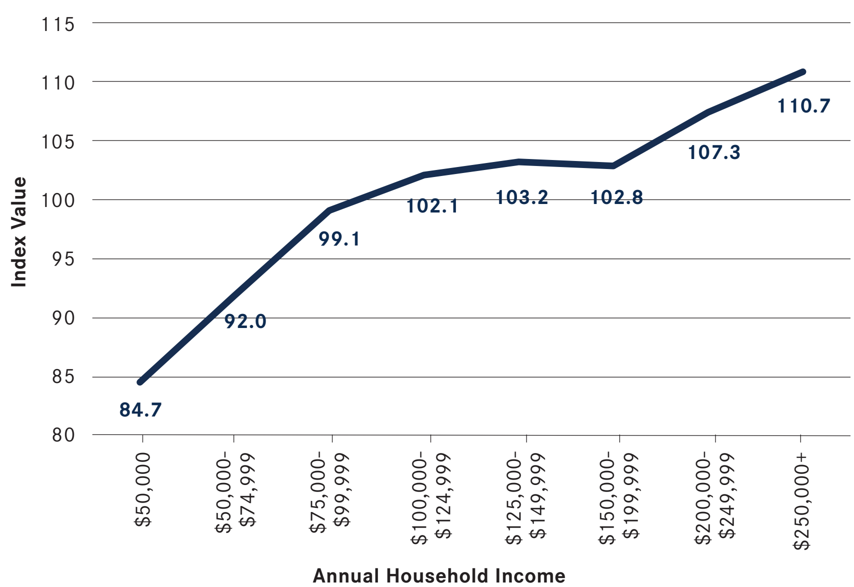
REGIONAL CREDIT ACQUISITION PLANS HAVE MOSTLY REBOUNDED TO 2017 LEVELS

Regional Consumer Sentiment and Household Income

The data suggest that consumer sentiment varies considerably by household income level. Overall regional consumer sentiment is substantially higher among respondents with higher levels of household income compared to those at lower household income levels (See Figure 4). Higher income household respondents express more positive perceptions of current economic conditions and are also more optimistic about future economic conditions. Thus, while overall regional consumer sentiment is higher, there is substantial variation among consumers of differing household income levels.

> *Higher income household respondents express more positive perceptions of current economic conditions and are also more optimistic about future economic conditions.*

Figure 4
Index of Consumer Sentiment By Household Income Level
SBR January 2020



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 5). The patterns of credit held are generally consistent with previous releases. Whereas last year we saw a slight dip in the percentage of respondents planning to acquire mortgages, auto loans, and credit cards, the current data suggest that these figures have mostly rebounded to 2017 levels (See Figure 6). This suggests the possibility that consumer spending could remain strong as consumers in the region seek access to these forms of funding.

Figure 5
Types of Credit Held

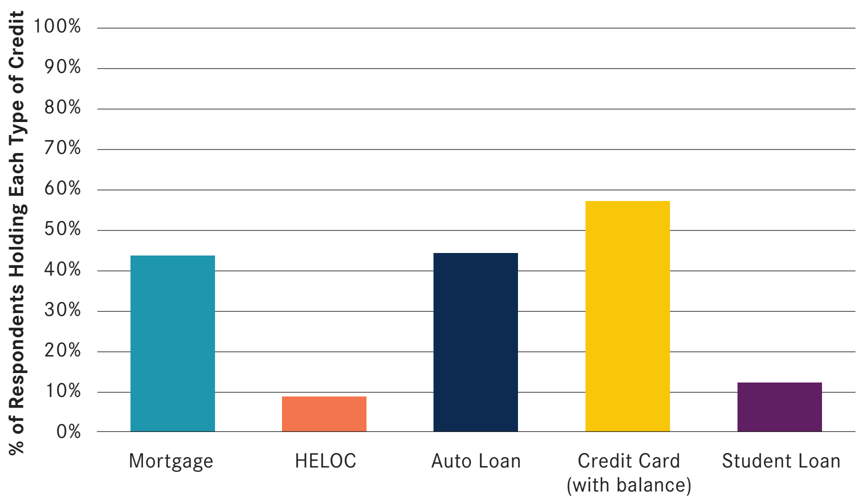
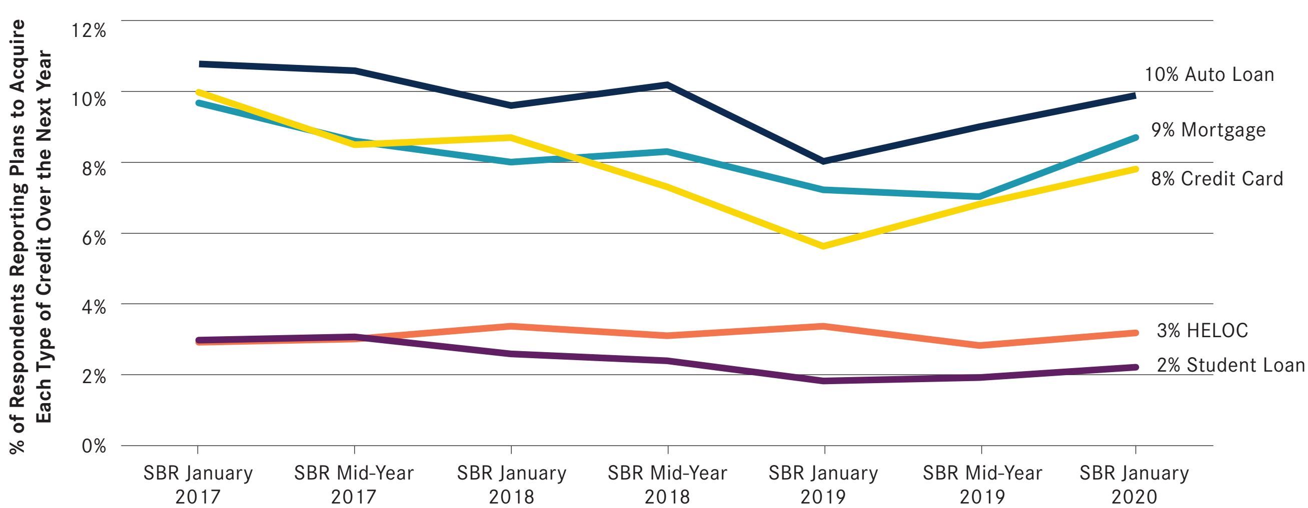
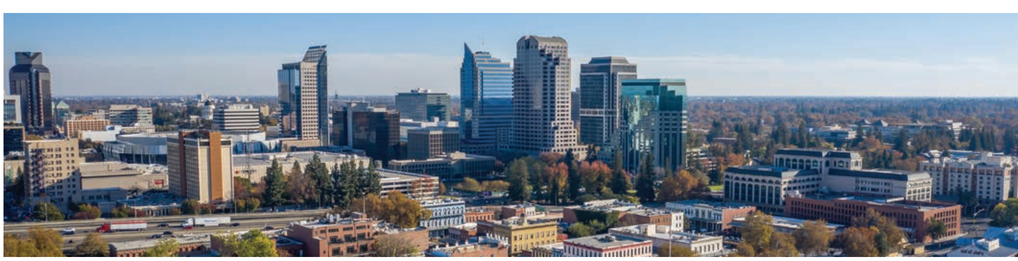


Figure 6
Types of Credit Planned Over the Next Year



Endnote

1 National data obtained from the University of Michigan Surveys of Consumers, 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

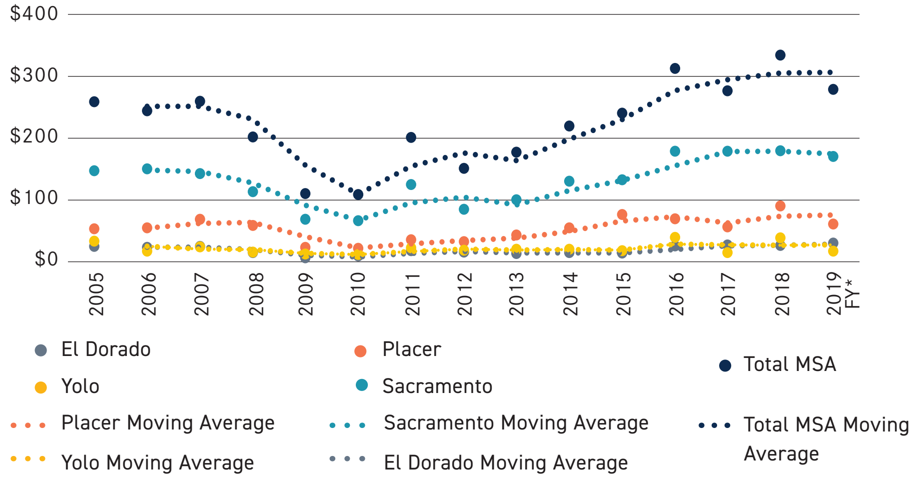
- SBA lending activity in 2019 was good, but loan approvals fell below the two-year moving average, primarily due to a slowdown reflected in Sacramento County.
- Overall business sentiment is optimistic across the different sectors surveyed. There is an expectation for continued growth, albeit at a slower pace.
- Business transaction activity measured by volume of listing and closed sales continues to show positive year-over-year growth. However, excluding a tough Q4 2018, the most recent transactions are on smaller deals with lower valuations relative to prior years.

Welcome to 2020! Lending activity wrapped up last year with good numbers despite results coming in slightly below the two-year moving average. As we enter a new decade, the total dollar volume of SBA loans in the Sacramento Metropolitan Statistical Area grew 158% over approximately the last ten years. Over the last three years, however, growth is virtually unchanged at 0.3% annualized due to the decline in Sacramento County practically muting the growth seen in other counties. Looking ahead, there is an expectation for continued growth, albeit at a slower pace. With the largest proportion of SBA loans, Sacramento County needs to pull its own weight to help support the growth in the region.

Respondents in the latest reading of our Small Business Confidence Index (SBCI) showed strong optimism despite global uncertainty. Overall business sentiment improved year-over-year across all areas of our SBCI survey. Compared to mid-year results, sentiment improved in most areas reflecting continued positive momentum for the near future. It is important to note, however, that the neutral reading marginally increased from the mid-year update.

STEADY LONG-RUN GROWTH FOR SACRAMENTO MSA DESPITE FALLING BELOW 2-YEAR MOVING AVERAGE

Figure 1
Total SBA Loan Approvals by County
(in millions, 2-Year Moving Average)



Moving Average is average of two previous data points. *FY: October 2018 through September 2019

ROBUST GROWTH FROM EL DORADO AND PLACER, BUT A DECLINE IN SACRAMENTO COUNTY SUPPRESSED IT

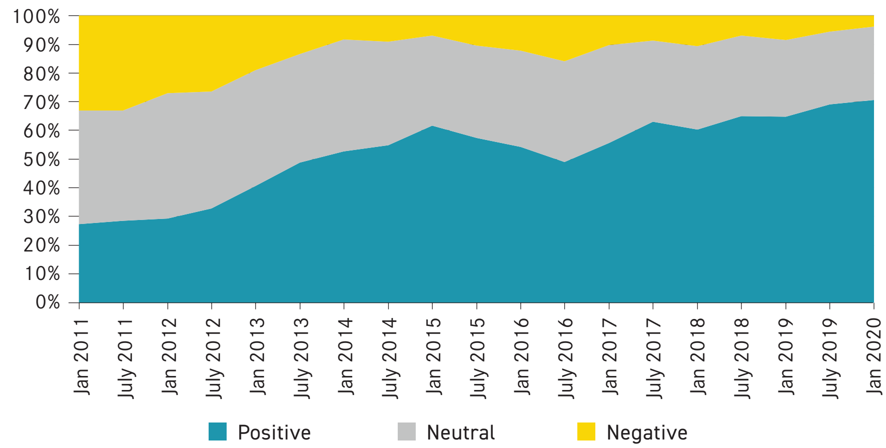
Table 1
SBA Loan Growth Rate by County

County	Share of 2019 Loan Volume	Loan Volume 2017-2019 Compound Annual Growth Rate	Loan Volume 2010-2019* Compound Annual Growth Rate	Loan Volume 2010-2019* Percent Change
El Dorado	11%	4.1%	12.6%	226.7%
Placer	22%	2.8%	10.9%	181.3%
Sacramento	61%	-1.5%	10.0%	158.4%
Yolo	6%	4.8%	4.2%	50.3%
Total MSA	**100%**	**0.3%**	**9.9%**	**157.5%**

*October 2018 to September 2019

BUSINESS SENTIMENT CONTINUES TO BE POSITIVE

Figure 2
SBCI Overall Sentiment Responses
January 2011 – January 2020



SMALL BUSINESS

The Small Business *Economy*

The SBCI Total Economic Outlook results hit an all-time high and surpassed its 18-month moving average.

Coupled with strong lending activity, credit accessibility continues an upward trend in all sectors surveyed.

Results came in strong for new hiring prospects, local business conditions, and the future economic outlook.

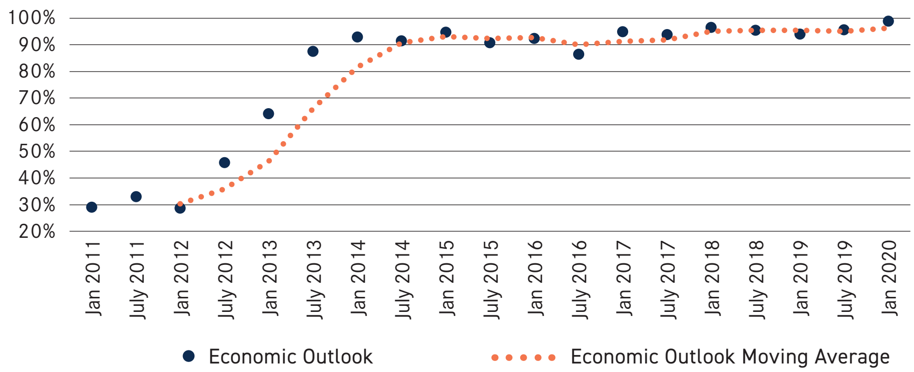
RESPONDENTS ARE OPTIMISTIC ABOUT FUTURE ECONOMIC OUTLOOK

CREDIT ACCESSIBILITY CONTINUES ITS UPWARD TREND

SMALL BUSINESS CONTINUING TO HIRE

Figure 3

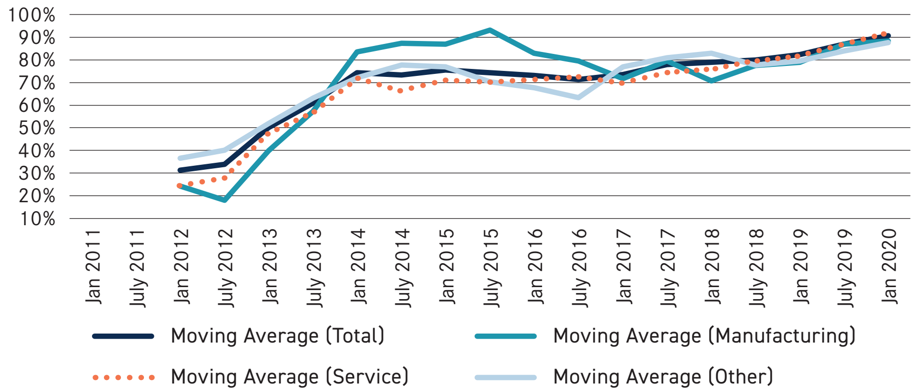
SBCI Total Economic Outlook (18-month moving average)



Moving Average is average of three previous data points.

Figure 4

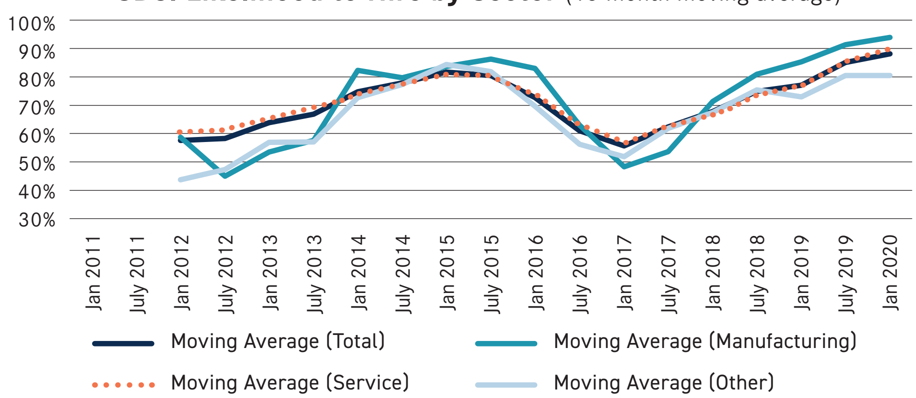
SBCI Credit Accessibility by Sector (18-month moving average)



Moving Average is average of three previous data points.

Figure 5

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

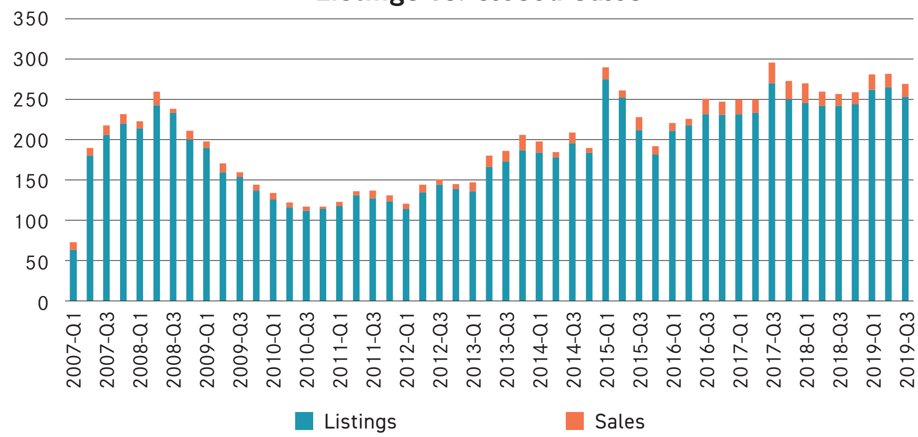


Moving Average is average of three previous data points.

Business transactions in the region continue to show positive signs year-over-year. When looked at more closely, the storyline remains largely the same; the most recent transactions are on smaller deals with lower valuations. If we exclude a difficult Q4 2018, median revenue and median cash flow of subject companies is the lowest since Q2 2011 and Q1 2015, respectively. This piece of data alone does not signal a trend, but it shows less attractive business transaction metrics versus prior years. While the positive results in the SBCI Index are optimistic, a slight dip in lending activity from its two-year moving average and smaller deals with lower valuations may be trying to tell us that a slower pace of growth lies ahead.

BUSINESS TRANSACTION ACTIVITY GROWS YEAR-OVER-YEAR

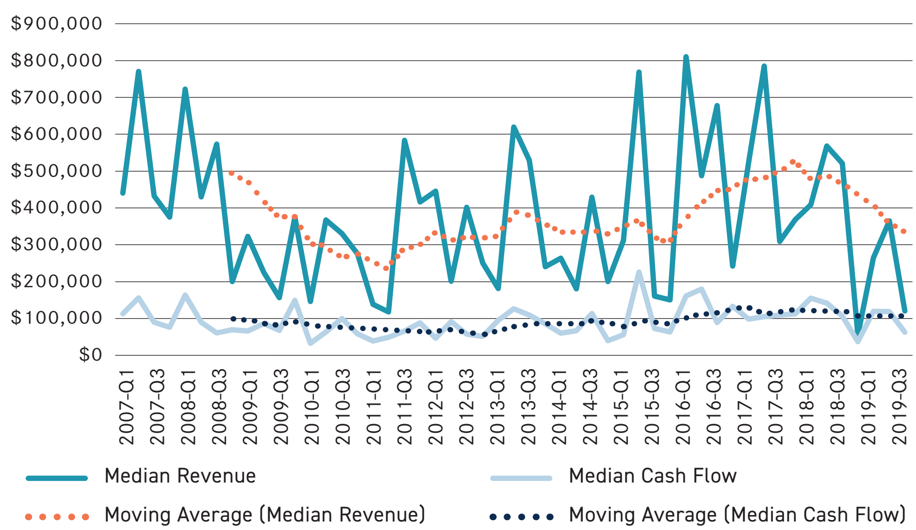
Figure 6
Listings vs. Closed Sales



Data Source: BizBuySell

BOTH MEDIAN REVENUE AND MEDIAN CASH FLOW DECLINED

Figure 7
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:** Vacancy rate continues to hit all time low with the market seeing a very few large blocks of space and little speculative construction on the horizon.
- **Industrial Market:** Lease rates have stabilized, and the market finds its new, low vacancy equilibrium. However, rates remain below replacement cost for all product except high-cube distribution centers like those being built at Metro Air Park.
- **Retail:** Retail fundamentals continue to be driven by construction, and class A centers are seeing strong demand due to strong demographics. Tenants continue to look to add experiential elements resulting in food halls, virtual reality arcades and the like.
- **Single Family:** Property value growth has slowed since 2018, increasing by 3.5% year-over-year, likely due to the increase of new construction throughout the region.

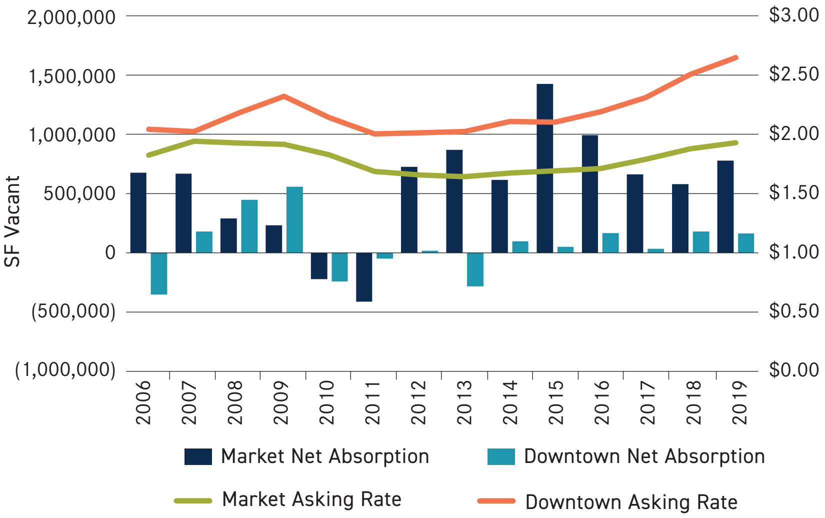
Office

The office market remains hot and finished 2019 strong, recording more than 777,000 square feet of net absorption and a decline in vacancy of 120 basis points year-over-year to 8.6%. Demand remains strong with 2.1 million square feet of tenants currently seeking office space in the Sacramento Region. Construction remains a significant market trend but is bringing little new available product to the market as only 90,000 square feet of the 2.5 million square feet is available.

High levels of demand have also led to an increase in lease rates and property values. Downtown remains a prime destination for tenants, and asking lease rates for Class A properties eclipsed $3.25 per square foot per month on a full service gross basis, for the first time. More of the same is expected for the balance of the year as the market will continue to tighten pushing lease rates up further.

THE SACRAMENTO OFFICE MARKET REMAINS STRONG WITH HIGH DEMANDS, AND INCREASING RATES AND PROPERTY VALUES

Figure 1
Office Market Activity 2006-2019



Industrial

Growth in the industrial market slowed during the year as the market inched closer to full occupancy. Net absorption remained strong, reaching 686,000 square feet for the year with vacancy resting at 4.3%, slightly above the record low of 4.2% set in the first quarter of 2019. Lease rates fell during the quarter, ending the year at $0.60 per square foot per month on a triple net basis. This was partially due to a lack of quality space on the market and partially due to the market finding its new, low-vacancy equilibrium.

New speculative construction has been limited to large, high-cube distribution buildings with more expected to break ground in early 2020. Businesses seeking smaller space have few options in the market and fewer still in the pipeline, combined with the slowdown in lease rate growth makes speculative construction of small or divisible speculative buildings less likely in the near term.

Figure 2
Industrial Asking Rate & Vacancy Rate Q1-2016 to Q4-2019

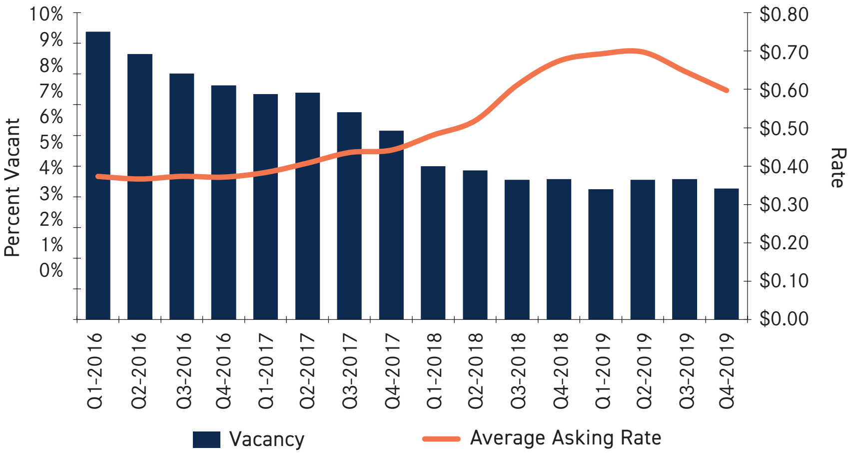
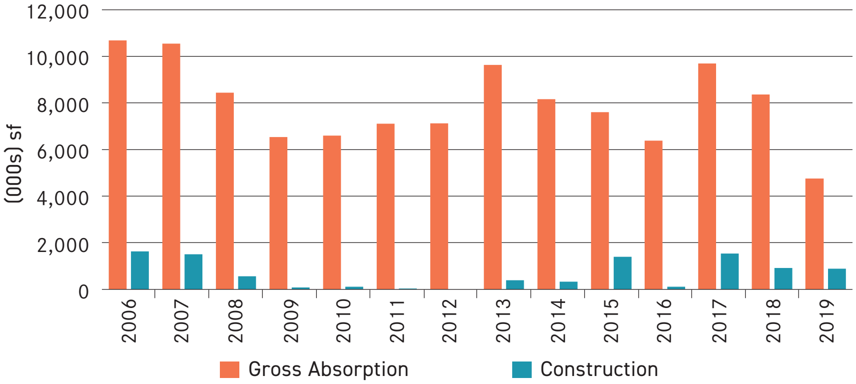


Figure 3
Gross Absorption & Construction 2006-2019



Real Estate

Retail

The Sacramento retail market was stable throughout much of the year. Net absorption totaled 442,000 square feet for the year, while the vacancy rate has been flat, hovering between 6.6% and 6.9%. Landlords continue to prefer tenants that are insulated from online competition, but it is unclear as to whether experiential tenants like escape rooms, ax-throwing bars or indoor trampoline parks have a large enough market niche to be viable long-term.

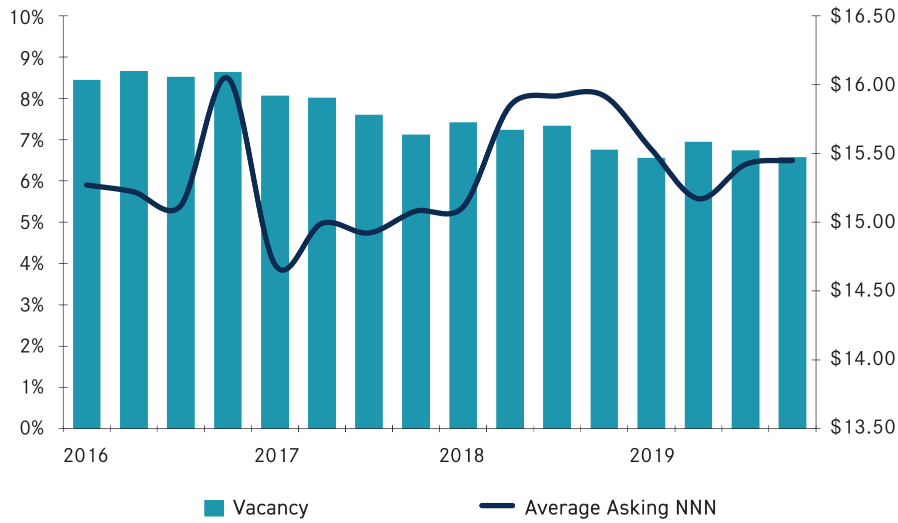
Retail construction is active totaling 195,000 square feet, but developers remain selective with the projects they undertake. A large amount of new retail will be mixed use in the urban core, associated with either new office or multi-family projects. New shopping centers are largely relegated to the suburbs with a strong anchor tenant needed for construction to begin.

Single Family

The single-family housing market continues to see growth but there are signs of deceleration. Sale prices on a per square foot basis across the Sacramento Region increased by 3% year-over-year, compared to 6% in 2018. This is in part due to increased construction of single-family homes effectively capping home values at or very near their replacement cost. With that said, home prices are far from outrageous with sales below

Retail construction is active totaling 195,000 square feet, but developers remain selective with the projects they undertake.

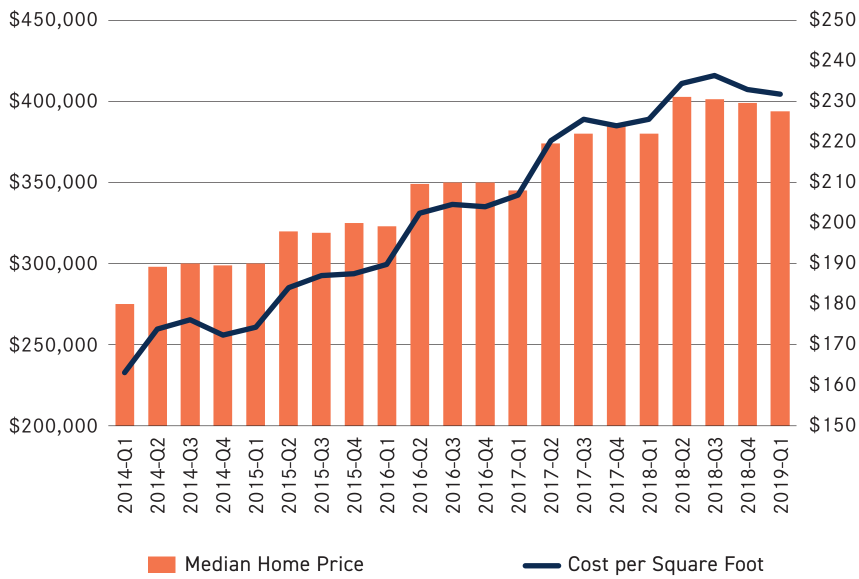
Figure 4
Vacancy & Average Asking Rates 2016-2019



THE SACRAMENTO RETAIL MARKET WAS STABLE THROUGHOUT THE YEAR

THE SINGLE-FAMILY HOUSING MARKET CONTINUES TO SEE GROWTH

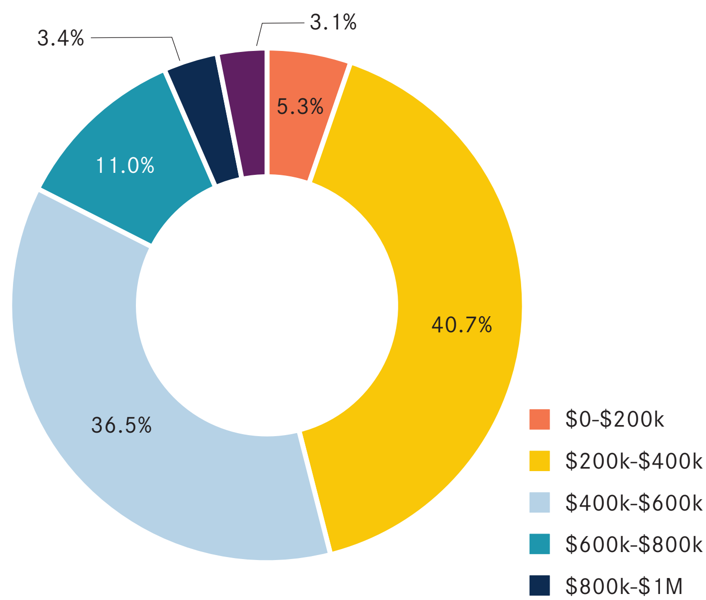
Figure 5
Median Home Prices & Cost Per Square Foot 2014 - 2019



the $600,000 threshold accounting for 83% of all home sales in the region, furthering the region's value proposition to new residents by offering a high quality of living at a relatively reasonable cost.

83% OF ALL HOME SALES ARE BELOW THE $600K THRESHOLD

Figure 6
Home Sales by Price: YTD 2019



*2019 data includes January 1 through October 31

Capital Markets & Banking *Forecast*

Trade policy disputes between the world's largest economies have been key contributors to a widespread disruption in global economic activity that has adversely impacted most developed economies.

KEY POINTS

- The Fed did an about face in 2019, easing on rates with three cuts and aggressively stepping into short-term funding markets to keep the liquidity flowing; monetary policy makes us think they got it right and plan to hold the line on rates in 2020.
- Although U.S. economic performance left a lot to be desired in 2019, U.S. equities soared with a return of almost 30% for the year; with such a lofty starting point, emerging market and other developed market equities appear to be the better play in 2020.
- Regional financial institutions had a great year in 2019 from an income perspective, but 2020 looks to be much more challenging with slowing loan growth and buoyant funding costs.

Economic Outlook

At the beginning of 2019, the SBR team suggested that a recession would not materialize over the course of the year. As such, U.S. economic performance trended positive with recession indications remaining in-check. However, growth has remained heavily dependent on a strong, confident consumer, and broader trends point to a continued slowing of economic activity. Trade policy disputes between the world's largest economies have been key contributors to a widespread disruption in global economic activity that has adversely impacted most developed economies. The team also thought that interest rates would move higher as the Fed worked to keep the U.S. economy from overheating, but as it turned out, rates moved lower with the Fed aggressively stepping in to keep growth on a positive trajectory.

In 2020, recessionary pressures will continue to build, but economic indicators point to a relatively stable year. U.S. GDP growth for 2018 was at 2.5%, 2019 is expected to finish at about 2.3%, and 2020 growth is likely to show signs of slowing down to slightly below 2%. Global GDP has slowed from 3.7% in 2018 to a little over 3% in 2019 and is likely to stay at a similar level in 2020.

THE FED TOOK SWIFT ACTION IN 2019 TO STEADY MARKETS, BUT WILL ITS MONETARY POLICY BE AS EFFECTIVE IN 2020?

THE REGIONAL ECONOMY CONTINUED TO EXPAND IN 2019; 2020 GROWTH APPEARS TO BE SLOWING

Table 1

Market	Forecast	Comment
Economy		
Global Growth	→	Hangover effect of 2019 trade disputes to impact global growth in first half of 2020; growth to remain muted but positive.
U.S. Growth	↙	U.S. economic growth slowing, but GDP to remain positive in 2% range; recessionary pressures building, however.
Eurozone	↗	ECB committed to doing what it can to get Eurozone growth going again; with such a weak 2019, outperformance in 2020 should be achievable.
Emerging	↗	Emerging markets are essentially coming out of a multi-year restructuring and should regain favor in 2020.
Global Inflation	→	Global inflation to remain in-check with the central banks of developed market economies at the ready to adjust policy as necessary.
Stocks		
Regions	Rest of World > U.S.	Blockbuster equity performance in U.S. will be hard to beat in 2020; rest of world markets have much better return potential; emerging markets with greatest return prospects.
Sectors	Utilities, Industrials	More defensive sectors and those with longer term, more steady revenue streams.
Bonds		
Regions	U.S. > Rest of World	Fed to remain on hold for 2020, and U.S. yields to remain favorable along with safest option should turbulence hit markets.
Sectors	Rest of World Investment Grade	IG credit in developed markets abroad to make a comeback along with more positive economic prospects relative to 2019.
Commodities		
Sectors	Base Metals	With some supply disruptions in the copper market and with rest of world developed economies gaining a little bit of steam in 2020, base metals like copper and nickel have upside potential.

Capital Markets & Banking *Forecast*

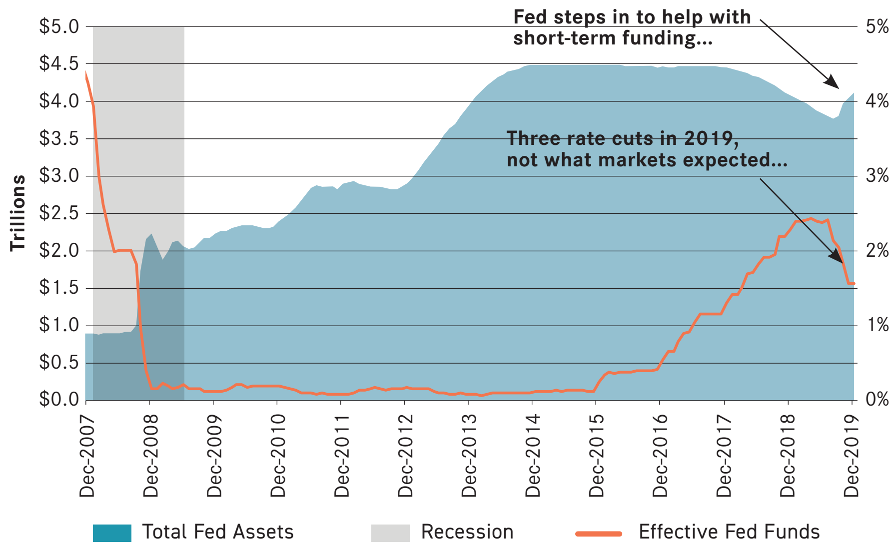
The Fed to the Rescue

Even with the U.S. unemployment rate remaining at or below 4.0% for all of 2019 and inflation ranging between 1.5% and 2.0%, just below the target rate of 2.0%, the Fed felt it necessary to implement three rate cuts in the second half of 2019. Global disruption due to trade policy was cited as the main threat to U.S. economic output. Going into the fourth quarter, the Fed also had to step in with overnight liquidity to help quell unexpected volatility in short-term funding markets.

What do Market Cash Flows Suggest for 2020?

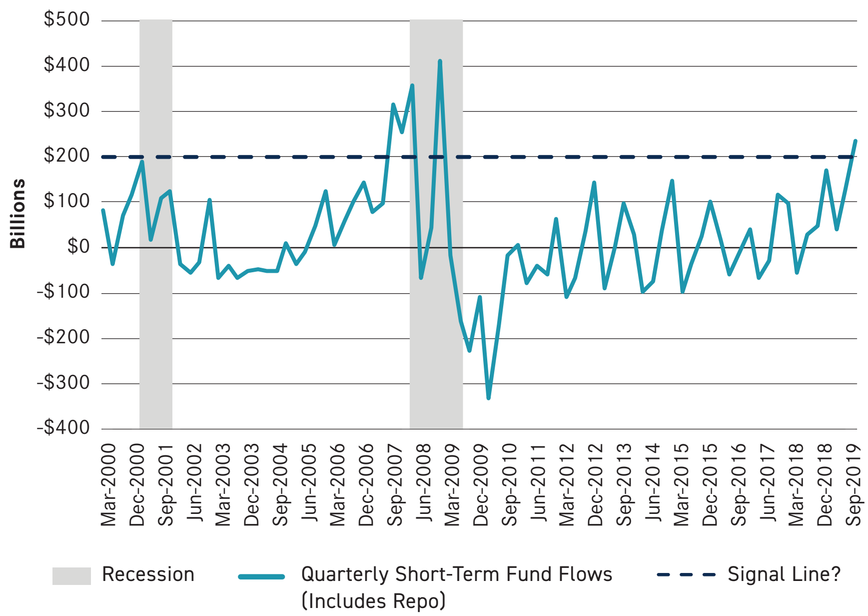
Short-term fund flows into money market type instruments, including repurchase agreements (repos), have historically signaled that companies are experiencing difficulty managing short-term liquidity or that credit losses are impacting underlying asset values in collateralized funding transactions. While we have not seen these types of systemic concerns come to the surface, the fact that the Fed has taken action, signals that things are not in perfect working order. Part of the issue is related to U.S. Government spending and the Treasury Department's need to drum up funding by issuing bills and notes. The Fed has committed to coming into the short-term funding markets as necessary to keep the Fed Funds rate within its target range, but for how long and to what extent does a "free market" require this type of intervention?

Figure 1
Fed Assets & Effective Fed Funds Rate



Source: Federal Reserve Bank of St. Louis

Figure 2
Are Short-Term Fund Flows Signaling Recession?



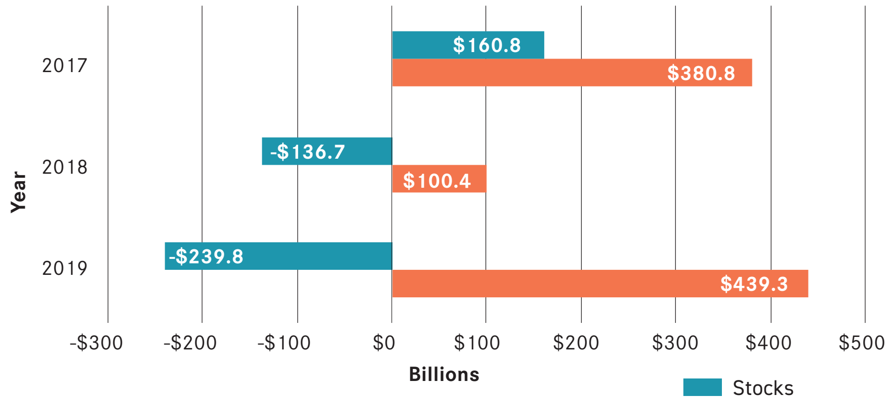
Source: Federal Reserve Bank of St. Louis

Longer term fund flows are also signaling that markets are preparing for some turbulence over the next year. Cumulative flows for 2019 show over $439 billion of cash flowing into more conservative bond funds, while $240 billion flowed out of more risky stock funds.

Interest Rates to Remain Low with a Tempered Fed

Interest rates are likely to remain low in 2020 with the possibility of a slight uptick in the long-term rates, but the curve will stay relatively flat. With an estimated $12 to $14 trillion of negative-yielding debt worldwide, longer-term U.S. bonds will remain an attractive option for investors, and this relative attractiveness will limit the uptick in the longer part of the yield curve. Short-term rates are likely to remain unchanged next year as the Fed has signaled that it feels comfortable with the current implementation of monetary policy. One of the most looked-to recession indicators, the spread between the 2- and 10-year U.S. Treasury Notes, has widened relative to the slight inversion observed toward the middle of 2019, thereby signaling that a recession may not be as imminent as once thought. This widening, however, has a lot to do with the reversal of monetary policy implemented by the Fed in the second half of the year. Only time will tell if the Fed correctly assessed the appropriate response to keep the U.S. economy on track in light of significant global pressures on growth.

Figure 3
Long-Term Mutual Fund and ETF Flows



Source: Investment Company Institute

Figure 4
10-Year vs. 2-Year Treasury Rate

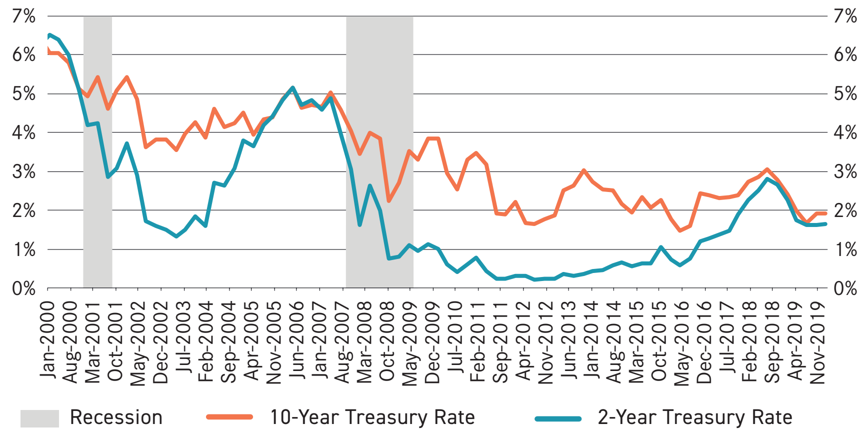
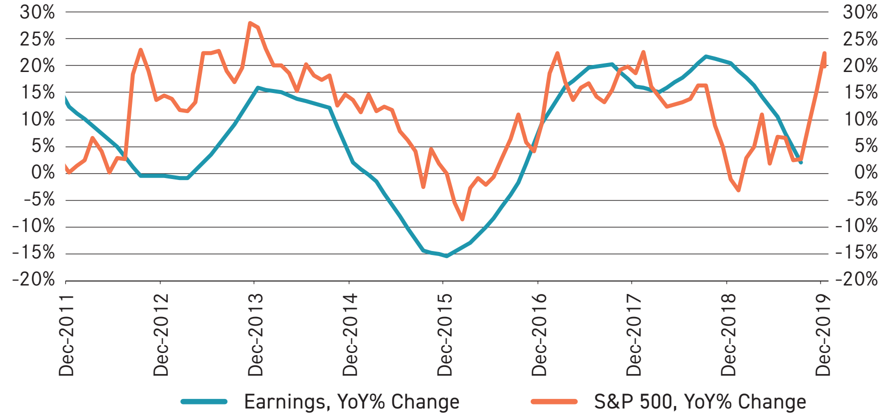


Figure 5
Earnings vs. S&P 500



Source (Figures 4 & 5): Federal Reserve Bank of St. Louis

CAPITAL MARKETS & BANKING

Capital Markets & Banking *Forecast*

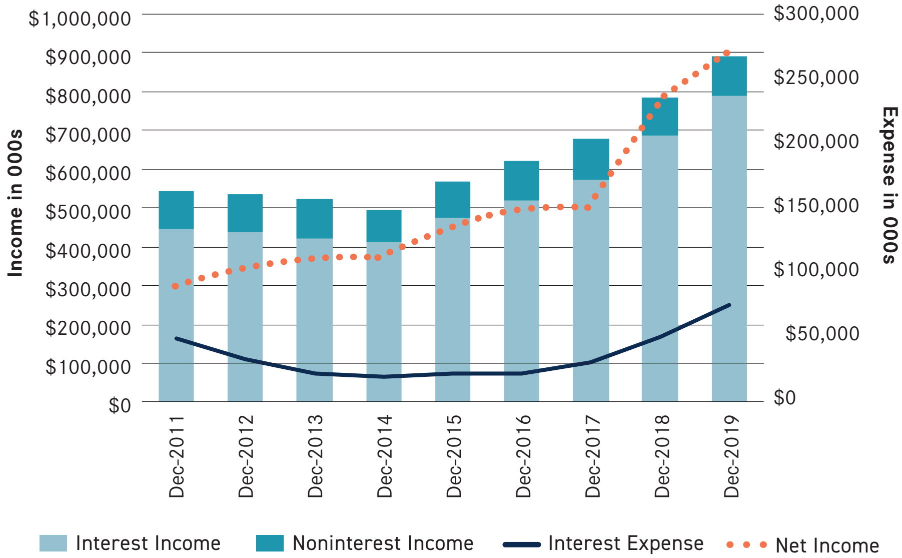
Equities Boom to Record Highs Leading to Lofty Starting Point for 2020

Corporate earnings ended the Q3 2019 at only a 2% annual growth rate, while the S&P 500 Index continued to rise throughout the second half of the year and ended 2019 with almost a 30% return. Given this high watermark and the trend for stock market returns to follow the corporate earnings pattern, we expect U.S. stock markets to slow in 2020, albeit still eking out a low, single-digit positive return for the year. With that said, positive equity returns will be hard to achieve if trade tensions persist or if geo-political factors such as further destabilization in North Korea or the Middle East spook markets and send capital seeking safe haven assets.

Regional Banking Outlook

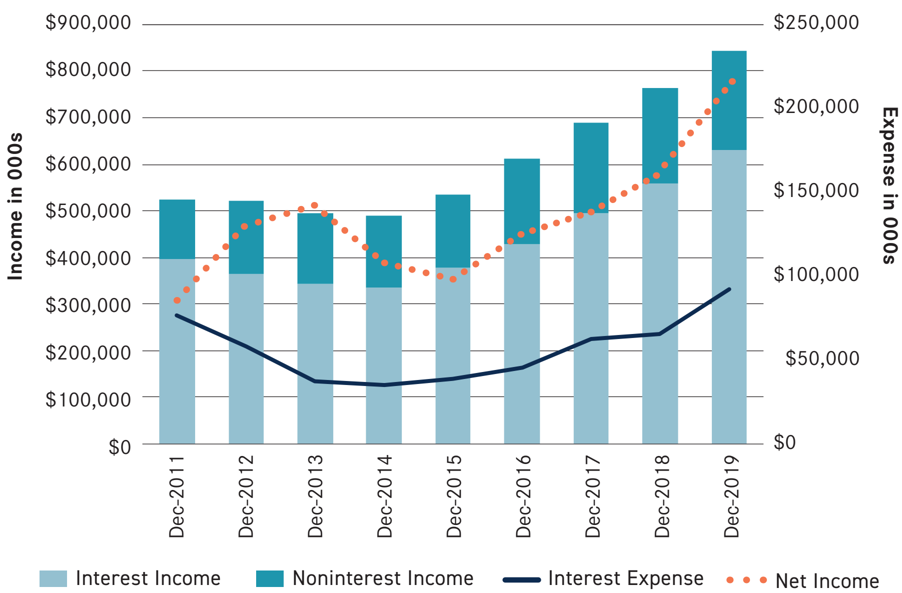
Sacramento Region financial institutions performed well in 2019 with higher yielding assets, originating in the last couple of years, buoying interest income. Additionally, interest expense increased at a much slower rate than initially projected thanks, in large part, to the accommodative Fed policy discussed previously.

Figure 6
Income Statements for Sacramento Region Banks (in Aggregate)
$s in 000s



Data Source: FDIC

Figure 7
Income Statements for Sacramento Region Credit Unions (in Aggregate)
$s in 000s



Data Source: NCUA

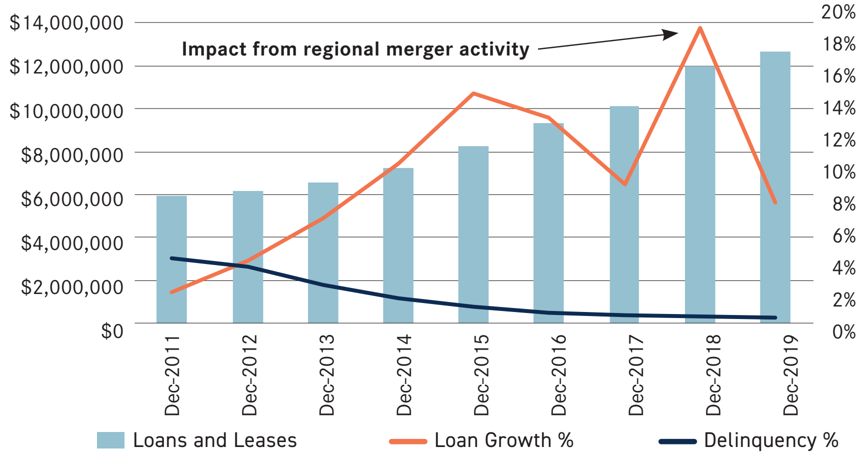
Regional Lending Trends Show Slowing Growth

In line with the SBR team's initial expectations for 2019, both banks and credit unions continued to see slowing loan growth as institutions managed liquidity and carefully evaluated credit standards in the latter stages of the cycle. We expect the 2020 loan growth to follow similar patterns with mid-single digit growth for the region's banks and low-to-mid single digit growth for regional credit unions.

Merger and acquisition activity continues to become more and more relevant for the region's financial institutions, and we anticipate the consolidation trend to continue. Ever-increasing regulatory and compliance costs continue to make it difficult for smaller institutions to achieve the necessary scale to overcome these costs. In times of slowing loan growth and margin compression, which we expect to see in 2020, scale achieved through consolidation can become even more valuable.

Figure 8

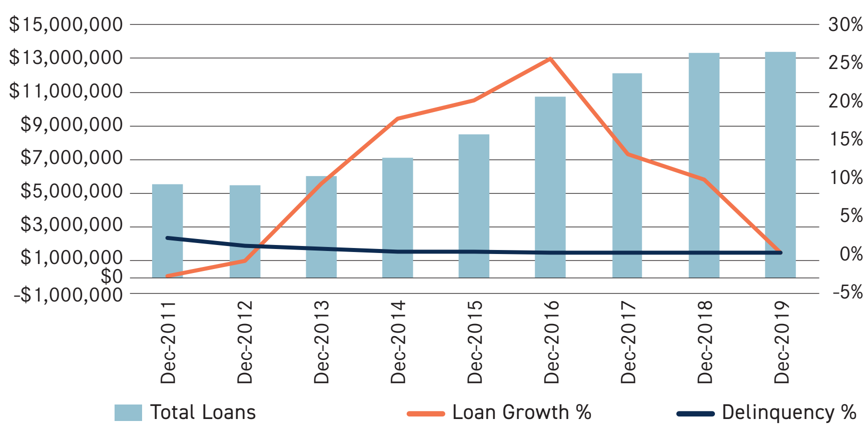
Bank Lending Trends (in Aggregate) $s in 000s



Data Source: FDIC

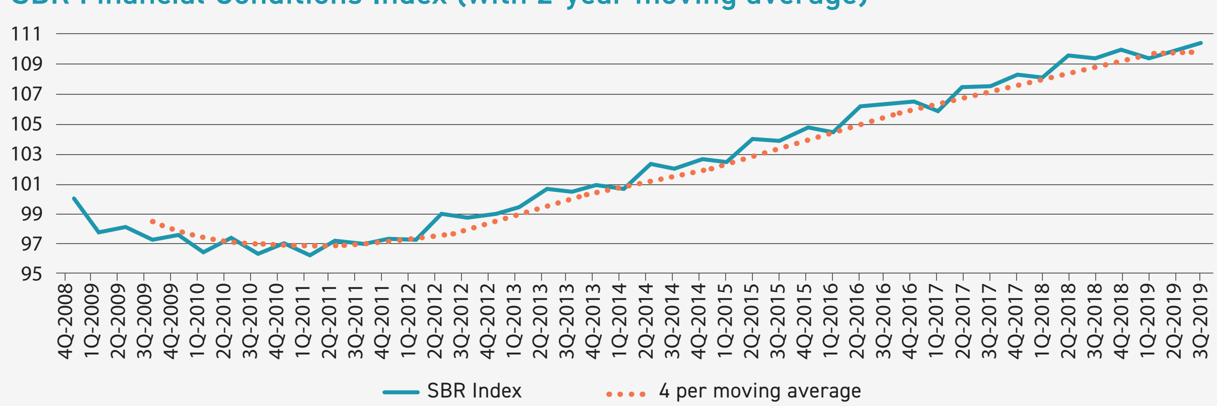
Figure 9

Credit Union Lending Trends (in Aggregate) $s in 000s



Data Source: NCUA

SBR Financial Conditions Index (with 2-year moving average)



Human Capital Trends

In partnership with the Sacramento Area Human Resource Association, we annually monitor several key human capital areas to track emerging regional trends. Figures 1-5 illustrate all years of data to date. Even though movements may appear slight, please keep in mind that the response scales are on a short three-point scale. In general, positive numbers indicate movement in the desired direction, and negative numbers indicate decline.

KEY POINTS

- Skills gap is at its widest margin since 2017; voluntary turnover expected to increase.
- Cost reduction, managing persistent talent shortage, and skills gap expected to have most significant impact on local organizations.
- Improving employee engagement, talent development, and succession planning are top priorities for area HR managers in 2020.
- Artificial Intelligence ranks toward the bottom in our region.

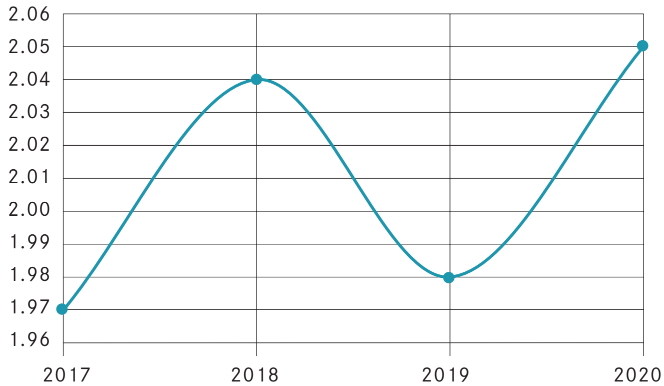
ORGANIZATIONS PLAN TO MAINTAIN CURRENT LEVELS OF DIVERSITY AND INCLUSION EFFORTS

Organizations are expecting greater numbers of voluntary resignations in the upcoming year compared to the previous year (Figure 1). In the last couple of years, we have also reported a heavy focus on training and development, and that trend is not slowing down. Current numbers indicate an even greater need for training and development than prior years (Figure 2). In 2017, our data noted that most organizations reported that sufficient knowledge and skills were available. We are now seeing the lowest number on record for 2020 as more organizations see a need for increased training and development.

Similarly, we are seeing the lowest number to date indicating that organizations are not meeting their compensation goals (Fig. 3). Organizations are reporting a need to increase compensation across all levels in the organization. The highest number reported to date was for 2018, when organizations indicated they were maintaining current compensation levels. Related to compensation, projected 2020 numbers for optional benefits and perquisites show that organizations are slightly more stabilized than prior years, showing an intent to maintain current levels (Figure 4).

THE TALENT SHORTAGE AND SKILLS GAP HAVE NOT IMPROVED - MIGHT WORSEN WITH GREATER NUMBERS OF VOLUNTARY RESIGNATIONS

Figure 1
Expected Resignations



Finally, the upcoming year shows that organizations plan to maintain current levels of diversity (age, gender, race) and inclusion efforts compared to prior years, when they were closer to not meeting these goals and were anticipating greater efforts in these directions (Figure 5).

Figure 2
Meeting Training/Development Goals

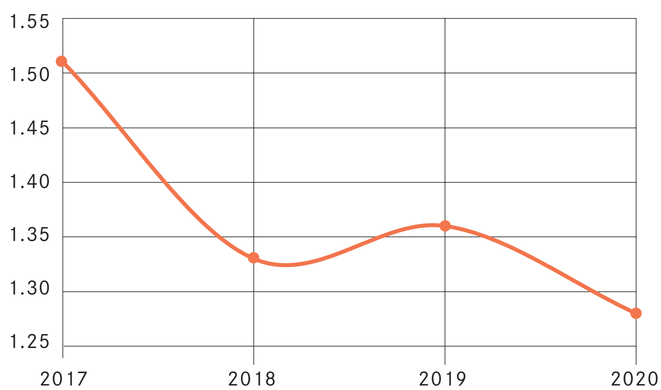


Figure 3
Meeting Compensation Goals

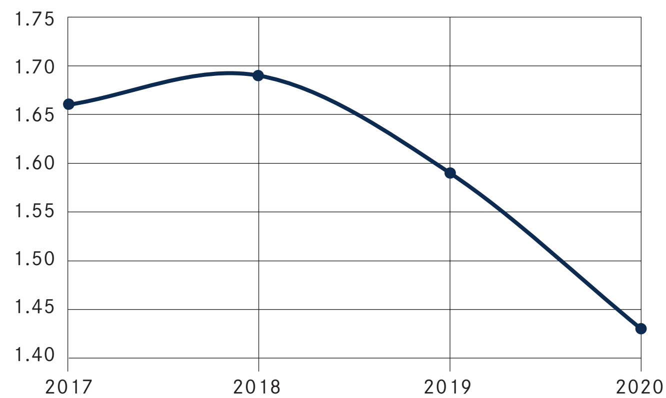


Figure 4
Meeting Goals for Optional Benefits

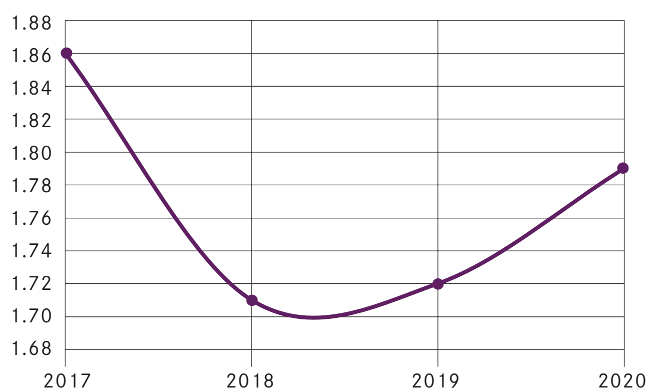
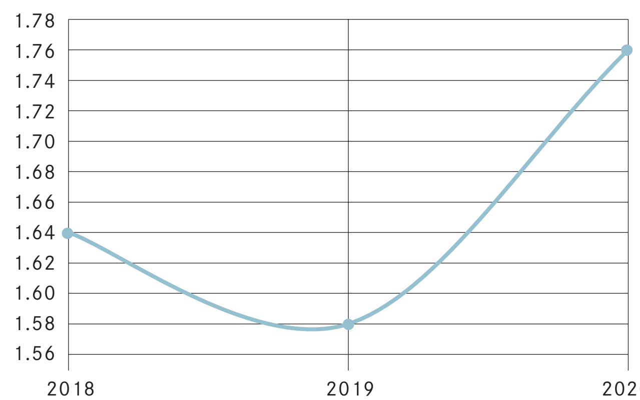


Figure 5
Meeting Goals for Diversity



Human Capital Trends

Among the factors expected to exert the greatest influence on local organizations (Table 1), pressure on cost reduction retains its top ranking from last year. Unsurprisingly, the talent shortage and skills gap fill out our top three, with the two challenges switching places this year – organizations report that not having enough job candidates to fill positions is the more pressing concern. Addressing the challenge of a skills gap, in fourth place (up from fifth) is a reported focus on developing new competencies. This year, challenging productivity and profit targets is ranked fifth. Essentially, the top 5 concerns describe a workforce lacking both in numbers as well as in job skills preparation, along with tight budgets. Artificial Intelligence (machine learning and new technologies) is not yet realizing a top spot, and market volatility, fear of a recession, and downsizing are all low probability events – these factors retain the same ranks as last year.

In the open-ended answers, several comments included concerns with cybersecurity awareness (as well as technology in general), the political landscape, and government initiatives (including compliance changes for wage and hour laws). A recurring concern is knowledge transfer, as the average employee in many sectors – including government – is approaching retirement age.

Table 1
Factors Expected to Exert the Most Influence in 2020

Factors	Rank
Pressure on cost reduction	1
Talent shortage (job candidates are not available)	2
Skills gap (job candidates available but don't have desired skills)	3
Development of new competencies	4
Challenging productivity and profit targets	5
Change in company culture	6
Organizational restructuring	7
Expansion of operations in new markets	8
Artificial Intelligence	9
Market volatility and fear of recession	9
Increased market competition	10
Downsizing	11

Table 2
Top Priorities for HRM in 2020

Priority	Rank
Improve employee engagement and satisfaction	1
Build a pipeline of leaders for the future	2
Improve talent management at every level of the organization	3
Succession planning	3
Workforce planning to better anticipate business needs	4
Better measuring employee performance	5
Reduce the skills gap	6
Increased rewards for employee performance	7
Improve assessment of what HR does and how it adds value to the business	8
Prepare the organization to face possible recession	9
Artificial Intelligence	10
Implement an integrated HR system throughout the organization	11

PRESSURE ON COST REDUCTION TOWERS OVER ALL OTHER EXPECTED INFLUENCES ON BUSINESSES

The upcoming focus for HRM (Table 2) includes improving employee engagement and satisfaction, as well as ensuring that the leadership bench has sufficient depth. Leadership development is also the highest ranked activity when asked about greatest impact on business performance (Table 3). Recruitment and selection, along with retention, ranks second as an activity with the greatest impact which reflects HRM efforts to address the continued talent shortage. Artificial Intelligence (machine learning as well as new technologies) ends up towards the bottom both on the HRM top priorities as well as on the HRM activities with the greatest expected impact on business performance in the upcoming year.

Overall, we are seeing continuations of prior years' trends, albeit with slightly stronger indications of a weaker workforce in terms of numbers and preparation, which ultimately may lead to lower levels of performance and productivity. Organizations are also showing great efforts to ensure that management is well prepared to run the organizations. AI is not on the radar locally, and preparation for recession has not yet made it onto organizational to-do lists.

Overall, we are seeing continuations of prior years' trends, albeit with slightly stronger indications of a weaker workforce in terms of numbers and preparation, which ultimately may lead to lower levels of performance and productivity.

Table 3
HRM Activities with Greatest Impact on Business Performance in 2020

HRM Activities	Rank
Leadership development	1
Recruitment and selection	2
Retention	2
Learning and development plans	3
Succession planning	4
Organizational effectiveness	5
Workforce planning	5
Employee communication	6
Performance evaluations and rewards	6
Employee empowerment	7
Compensation and benefits policy	7
Evaluation of employee engagement/satisfaction	8
Closing the skills gap	9
Artificial Intelligence	10
Industrial relations	11

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