JANUARY 2022 ECONOMIC FORECAST | EMERGING TRENDS IN SACRAMENTO'S ECONOMY

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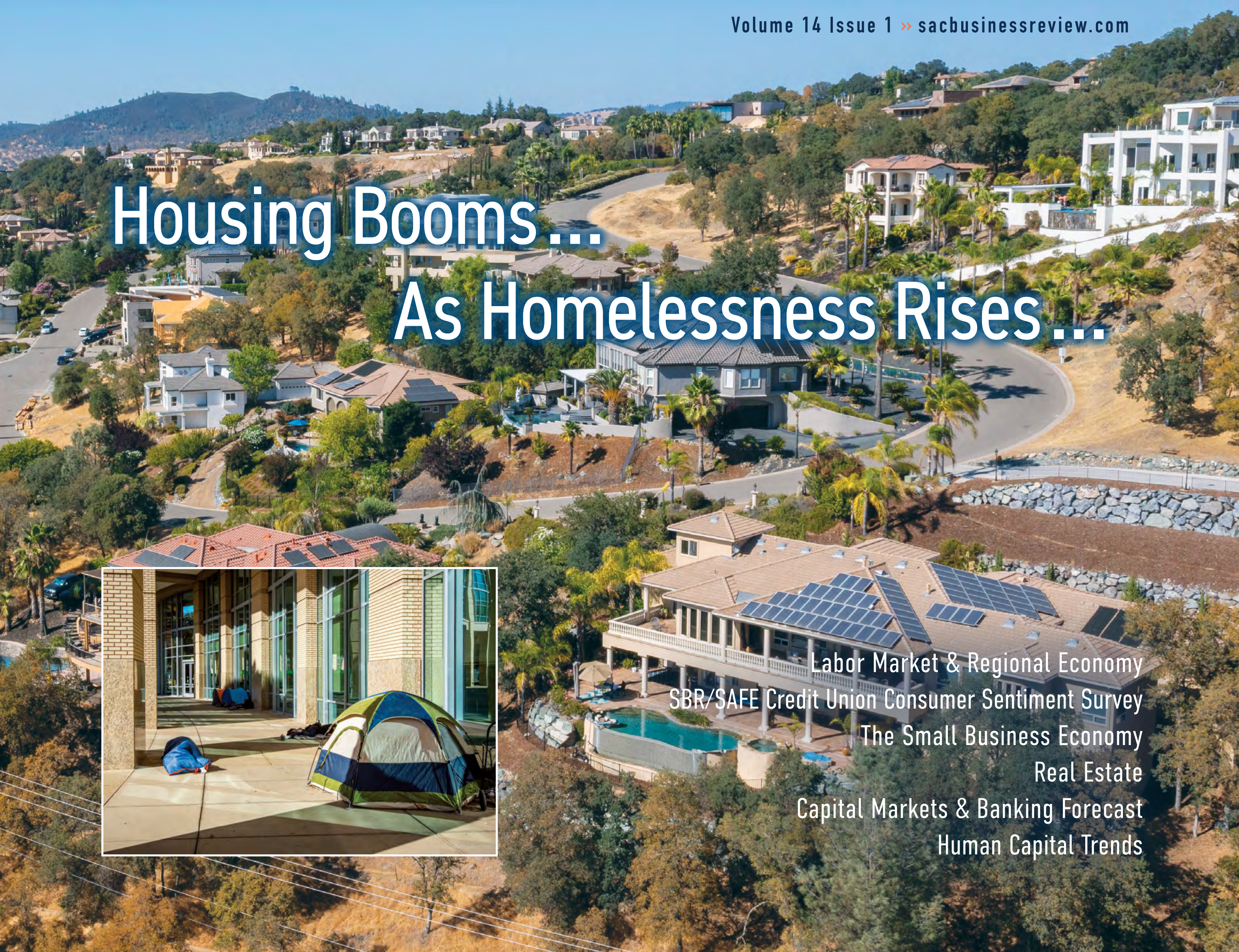

Housing Booms...

As Homelessness Rises...

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

JANUARY
2022

sacramento
BUSINESS
REVIEW

MISSION

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

LABOR MARKETS & REGIONAL ECONOMY

SBR/SAFE CREDIT UNION CONSUMER SENTIMENT SURVEY

THE SMALL BUSINESS ECONOMY

REAL ESTATE

CAPITAL MARKETS & BANKING

HUMAN CAPITAL TRENDS

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MESSAGE FROM THE CHIEF ECONOMIST

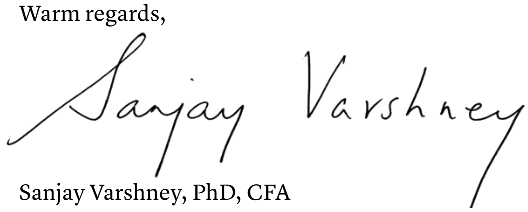
Dear Friends,

2021 ended on a positive note in several ways despite the continued challenges from the pandemic — such as lower than desired vaccination rates and the threats of new variants such as Omicron, as well as increasingly polarized thinking on many important issues. Both the U.S. economy as well as our local region exhibited a resilient and sharp recovery. The stock market hit new highs, capping three years of back-to-back double-digit gains. While many of us moved closer to normalcy, many also continued to struggle as they were not as fortunate.

2022 brings caution, concerns, and declining optimism. Our Consumer Sentiment Index has hit a new all-time low. Rampant inflation with the highest recorded price increases in 39 years threatens to severely disrupt economic progress. Confidence is receding as the Federal Reserve announced accelerated tapering and possibly three interest rate hikes. (I personally predict the Fed will back off from this due to a globally troubled economy.) Trust in the government and its policies have also declined. The biggest story in Sacramento — the booming housing market — will likely continue its ascent (but very gradually; with a cooling off due to continuing challenges of low supply and supply chain disruptions). The labor market will be further challenged by the skills gap; increasing quit rates; the changing profile of the sectors and jobs distribution in the region; and the absence of significant progress on new job creation. Homelessness and other challenges confront the region in ways that do not inspire confidence in our leadership. All of this tempers our outlook for the coming year: While I look forward to continued economic progress, my expectations are dampened.

Cheers to 2022!

Warm regards,



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FEATURES

KEY POINTS

LABOR MARKETS & REGIONAL ECONOMY

- The Region's employment has recovered from the pandemic low but remains 1.4% below its pre-pandemic level. The local unemployment rate has also exhibited a strong improvement to get below 5% for the first time since the pandemic.
- The pandemic has changed the employment distribution across a number of labor market sectors and subsectors that favor goods producing and distribution industries.
- Average weekly earnings have increased 4.3% over the past year but have failed to keep pace with inflation.

SBR/SAFE CREDIT UNION CONSUMER SENTIMENT SURVEY

- Regional sentiment has plummeted to its lowest level since the inception of our survey.
- National sentiment is also down substantially but overall remains at or above regional sentiment levels.
- Consumer expectations for inflation have increased over the past year and most expect that their income will not keep pace with prices over the next year.
- Consumer sentiment continues to vary substantially by household income, with a notable drop in sentiment in some of the higher income categories.
- Consumers generally indicate stable or slight declines in plans to acquire credit, with the exception being a large drop in plans to acquire student loans.

SMALL BUSINESS ECONOMY

- The SBCI survey for the Greater Sacramento Region showed a 4% decrease in Overall Sentiment relative to the 2021 mid-year update. These results are virtually equal to the 5-year pre-pandemic average. Positive drivers to the Index were Access to Credit and Future Revenue prospects. There is a difference in Hiring responses between sectors, with Manufacturing reporting a higher likelihood to hire than the Service or Other Sectors.
- Lending activity in El Dorado County and Sacramento County are on pace to finish at the highest level ever, and Placer County has doubled its loan volume from 2020. Yolo County had a 20% deceleration.
- Business transactions in the region have recovered from their lows, but have yet to reach their pre-pandemic levels. Listings and Sales are higher than the mid-year update; however, revenue and cash flow metrics slowed down from the mid-year update as has been seasonally observed over the years.

REAL ESTATE

- **Residential:** Lack of housing throughout the region poses a significant hurdle to growth in 2022. While development is underway, it is unclear whether it will arrive in time to allow Sacramento to fully benefit from the significant migration over the past two years.
- **Office Market:** There are initial signs of recovery with an increase in lease activity in the second half of 2021 and sublease space is beginning to plateau. A small but pertinent part of this growth is coming from outside the area as firms are beginning to consider Sacramento as their workforce relocates here. The Omicron variant could slow positive momentum in early 2022 but with growth occurring later in the year.
- **Industrial Market:** Construction and rent growth are the biggest headlines in the industrial sector with high construction costs helping to drive lease rate increases.
- **Retail:** While the market still has a long recovery ahead of it, there are reasons for optimism. Specifically, migration from the Bay Area and increasing leasing activity and tenant types shift towards outdoor focused activities.

CAPITAL MARKETS & BANKING FORECAST

- Equity markets finished the year up markedly as valuations expanded to historic levels, and economic fundamentals have remained strong; however, inflation looms as an emerging risk to the economy and valuations
- We see 2022 as bringing a sooner-than-expected Fed action on rates and likely below average equity market returns.
- Regional bank and credit union performance rebounded in 2021 as credit losses failed to materialize and overall loan growth remained positive. The new year likely brings additional opportunities as Fed action pushes yields higher thereby improving loan and investment opportunities.
- Our proprietary SBR Financial Conditions Index shows favorable economic trends for the region since the bottom of the pandemic recession and through the first 9 months of 2021.

HUMAN CAPITAL TRENDS

- Employers report engagement is down, and burnout is present.
- The ongoing skills abyss is forcing employers to look out of state, reorganize their organizations, and increase training and development efforts.
- Pressure on cost reduction has formally been surpassed by the talent shortage and skills gap for the first time.
- Resignations are expected to further increase.
- Focus in Q1 and Q2 will be on recruitment/selection, retention, pandemic recovery, and improving communication with employees.


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

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Will Austin is the Director of Market Analytics At CoStar Group, specializing in Sacramento and the Central Valley. He analyzes market fundamentals for office, industrial, retail, and multifamily commercial real estate throughout Northern California for a variety of platforms. He holds bachelor's and master's degrees in sociology from Trinity College and California State University, Fullerton, respectively and an MBA from UC Davis.

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

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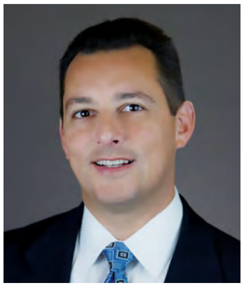

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Matt Cologna graduated with a degree in business from California State University, Sacramento, and has been active in commercial real estate in Sacramento for the past 21 years. His experience includes owner/user and investment sales, logistics, landlord 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 in the Sacramento Region for 39 years. 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 is also 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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Nick Hladek works as a Quantitative Modeler at Golden 1 Credit Union, where he assists in the development and implementation of quantitative models. Prior to his time at Golden 1 Credit Union, Nick worked as a Senior Research Analyst at the Greater Sacramento Economic Council. He holds both a bachelor's degree and master's degree in economics from California State University, Sacramento.

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Tristan Hopkins is a co-founder and Managing Partner of Elm Grove Partners, a private investment firm based in Sacramento, organized to acquire and operate companies in the lower-middle market. He also serves as President of ArcherHall, a company that provides digital forensics and e-discovery services to law firms, government agencies, and corporations. Tristan received a BS in Economics and Mathematics, *cum laude*, from Duke University. He also holds the Chartered Financial Analyst (CFA®) designation and serves on the Board of Directors of the CFA Society of Sacramento.

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Joe Niehaus is the Vice President of Finance for Golden 1 Credit Union, where he is responsible for managing the treasury, profitability, and financial analytics functions. Previously, Joe was the Treasurer for SAFE Credit Union, and he has also worked as a bank examiner for both the public and private sectors. Prior to his corporate experience, Joe served five years in the U.S. Navy as an Electronic Warfare Operator and attained the rank of Second Class Petty Officer. Joe earned an MBA from the University of Nebraska, Lincoln, and a BS in business administration from California State University, Sacramento. He holds the Chartered Financial Analyst designation and is Past President of the CFA Society Sacramento.

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Lisa Stanley has spent the past 20 years as a commercial real estate broker in the Sacramento Region, providing strategic advisory services in leasing, purchasing and selling commercial real estate. Lisa's area of expertise includes office buildings and specialty use properties such as mixed use, educational properties, medical office buildings and land. She has done extensive work with non-profit organizations and government agencies and is experienced in the nuances of ground up development and major renovation projects. Lisa has completed 700+ lease and sale transactions worth over $630 million. She is a 5-time nominee for ACRE's Office Broker of the Year Award. In 2020, she was recognized as a CREW Women of Influence Award Honoree for Outstanding Women in Real Estate.

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SCAN ME

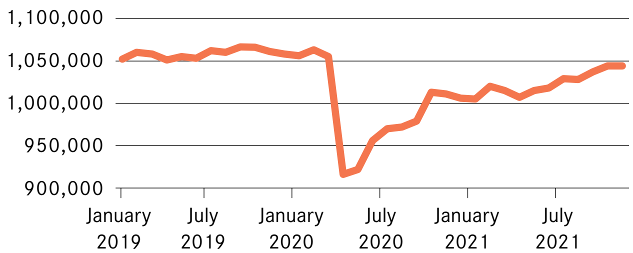
Labor Markets
& Regional Economy

While viral variants continue to bring uncertainties, we expect the overall local labor market and regional economy to fully recover from the pandemic in 2022.

The Sacramento Region's labor market continues to recover from the COVID pandemic. As of November 2021, local non-farm employment has rebounded nearly 15% from the pandemic low and is only 1.4% below the pre-pandemic level, resulting in an unemployment rate of 4.7%. While viral variants continue to bring uncertainties, we expect the overall local labor market and regional economy to fully recover from the pandemic in 2022.

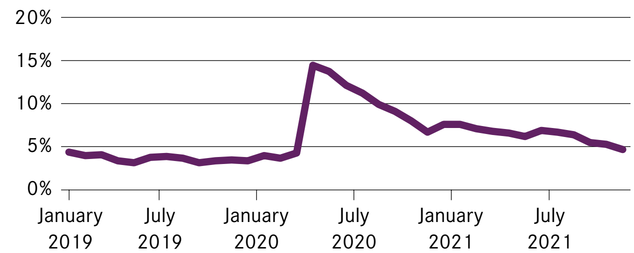
However, the labor market recovery has been uneven with some sectors outperforming others. Construction jobs benefited from societal changes and archived a 25% increase in jobs from the pandemic low and a

Figure 1
Sacramento Region Employment



Data Source: BLS and CA EDD

Figure 2
Sacramento Unemployment Rate (%)



Data Source: BLS and CA EDD

SERVICE SECTORS WERE HIT HARD BY JOB LOSSES.

10.2% gain over the last 12 months, making construction jobs 11% higher than the pre-pandemic level. On the other hand, over the last 12 months, the local Financial Activities sector reported no gain, which keeps its employment only on par with pre-pandemic level. Although the local Leisure and Hospitality sector has rebounded 54.6% from the pandemic low, it achieved only a 6% gain over the last 12 months and is still nearly 20% below the pre-pandemic employment level. Table 1 shows the uneven job recovery across major economic sectors in the Sacramento Region.

Digging deeper into the sub-sectors of the local labor market, areas such as Retail Trade, which declined sharply during the pandemic due to economic restrictions, have rebounded. Jobs in logistics industries such as Transportation and Warehousing have experienced an all-time high recently. Meanwhile, jobs requiring person-to-person contacts, such as those in Real Estate, Rental, and Leasing as well as Nursing and Residential Care Facilities, remain near their employment lows, showing little recovery over the past 18 months. Employment at restaurants and other eating venues has recovered significantly but remains well

Table 1 • Local Labor Market Recovery by Economic Sectors

Local Sector	Current Jobs (in '000s)	12-mo % change	% change vs. pre-pandemic	% change vs. pandemic low
Total Nonfarm	1,012.6	3.3	-1.4	12.6
Construction	78.6	10.2	11.0	25.0
Trade, Transportation, and Utilities	168.6	1.2	5.6	20.9
Manufacturing	37.7	7.7	1.1	11.2
Financial Activities	53.0	0.0	0.0	4.7
Professional and Business Services	137.1	2.7	-0.4	8.9
Government	241.3	2.0	-0.4	6.7
Education and Health Services	164.5	1.6	-3.7	6.4
Information Services	10.1	4.1	-10.6	6.3
Leisure and Hospitality	86.9	6.0	-19.7	54.6

Data Source: BLS

Figure 3
Retail Trade Jobs ('000s)

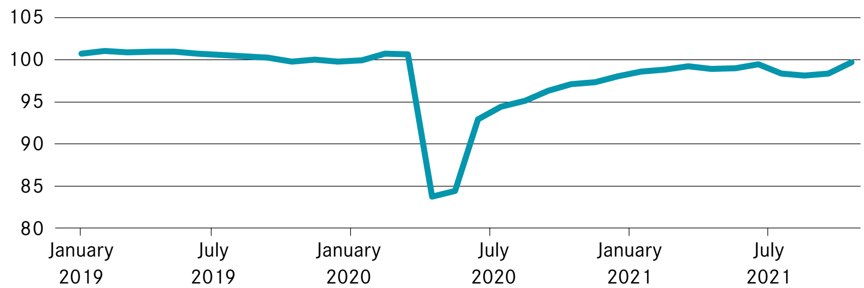


Figure 4
Real Estate, Rental, and Leasing Jobs ('000s)

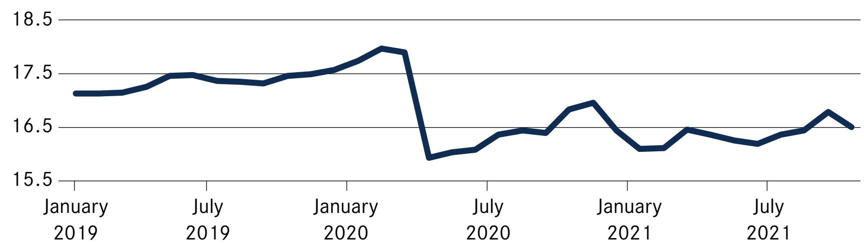


Figure 5
Restaurants and Other Eating Venues Jobs ('000s)

Data Source (Figures 3-5): St. Louis Federal Reserve

Labor Markets *& Regional Economy*

EARNINGS INCREASE FAILS TO KEEP PACE WITH INFLATION.

below its pre-pandemic level. Many construction related subsectors, such as Foundation, Structure, and Building Exterior Contractors, have not only recovered but have gone on to set a new all-time employment high. Overall, the change in the job distribution across sectors has benefited goods producing and distribution industries such as Construction, Manufacturing, and Trade, Transportation and Utilities. Service sectors that could involve close human contact are still struggling to get back to their pre-pandemic normal.

The labor market recovery has also added to the wage pressures that have been building in recent years. Average weekly earnings in the Sacramento Region have increased 4.3% over the past year. However, inflation has also surged, causing real earnings to decrease nearly 3% over the past 12-months. As a result, despite the increase in earnings, the buying power of those earnings have decreased.

Figure 6
Transportation, Warehousing, and Utilities Jobs ('000s)

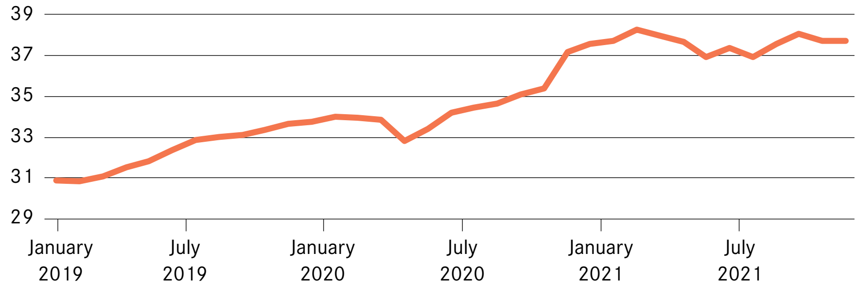


Figure 7
Nursing and Residential Care Facilities Jobs ('000s)

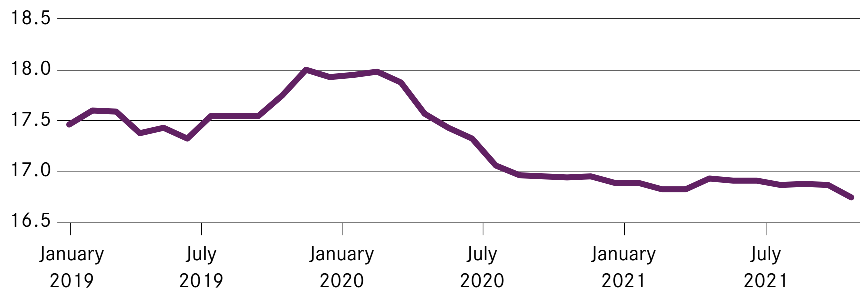
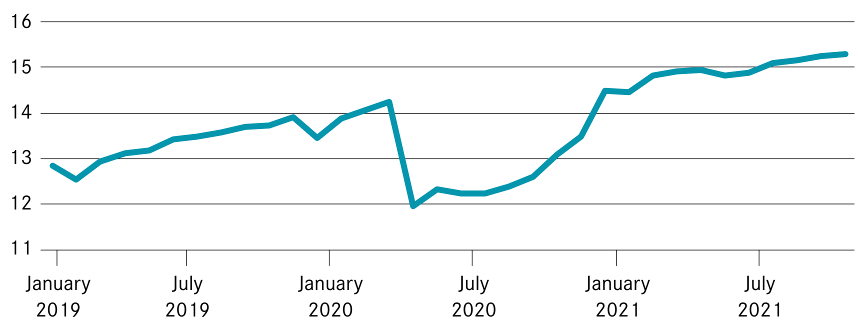


Figure 8
Foundation, Structure, and Building Exterior Contractors Jobs ('000s)



Data Source (Figures 6-8): St. Louis Federal Reserve

Table 2 • Earnings Increase vs. Inflation

	Average Weekly Earnings	Consumer Price Index	Difference
1 Year	+4.3%	+7.1%	-2.8%
3 Year Average	+4.3%	+3.3%	+1.0%
5 Year Average	+3.0%	+2.9%	+0.1%

Source: St. Louis Federal Reserve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Consumer Sentiment *Survey*

For the 2022 annual release, the Sacramento Business Review (SBR), in partnership with SAFE Credit Union, conducted another round of our regional consumer sentiment survey. The survey included measures of personal and regional economic conditions, expectations regarding prices and income, as well as purchasing and credit utilization.

Regional vs. National Sentiment

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

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

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

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

In general, we see a clear pessimism taking hold at both the regional and national levels. After a slight rebound in the middle of 2021, regional consumer sentiment has plunged to its lowest level since the inception of our survey. Compared to the mid-year 2021 data, we observed double-digit declines in the overall index of consumer sentiment and both of the subcomponents (index of current economic conditions and the index of consumer expectations). This suggests bearish sentiment in terms of perception of the current economic situation and that to come over the next year (see Table 1). Nationally, consumer sentiment experienced even larger declines, but remains roughly at or slightly above regional sentiment in absolute terms (see Table 1).

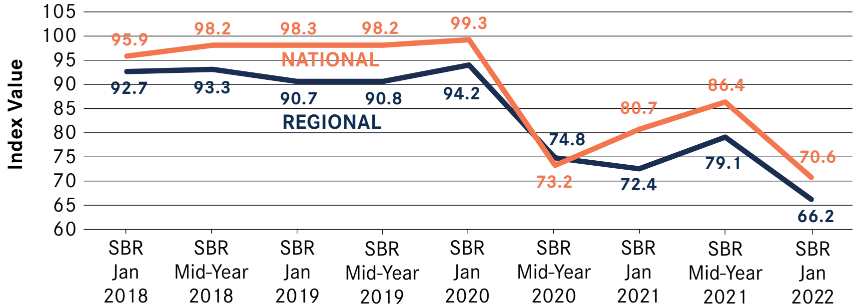
Table 1 · Regional vs. National

	Regional Index Score			National Index Score		
	Annual Release 2022	Change Since Mid-Year 2021	Change Since January 2021	Annual Release 2022	Change Since Mid-Year 2021	Change Since January 2021
Index of Consumer Sentiment	66.2	-12.9	-6.2	70.6	-15.8	-10.1
Index of Current Economic Conditions	61.8	-14.0	-11.1	74.2	-16.4	-15.8
Index of Consumer Expectations	69.0	-12.3	-3.1	68.3	-15.5	-6.3

Notes: National data obtained from the University of Michigan Consumer Sentiment Survey December 2021 Final Data, available at: https://data.sca.isr.umich.edu/. Indices calculated using the methods specified at: https://data.sca.isr.umich.edu/fetchdoc.php?docid=24770.

REGIONAL AND NATIONAL SENTIMENT ARE AT THE LOWEST LEVELS SINCE THE START OF OUR SURVEY.

Figure 1
Regional and National Consumer Sentiment



Notes: National data obtained from the University of Michigan Consumer Sentiment Survey, available at: https://data.sca.isr.umich.edu/. Indices calculated using the methods specified at: https://data.sca.isr.umich.edu/fetchdoc.php?docid=24770.

Figure 2
Expectations for Prices (Inflation) Over the Next Year (% of Responses)

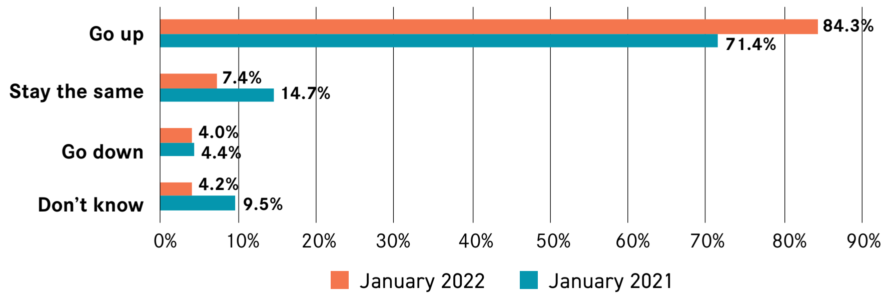
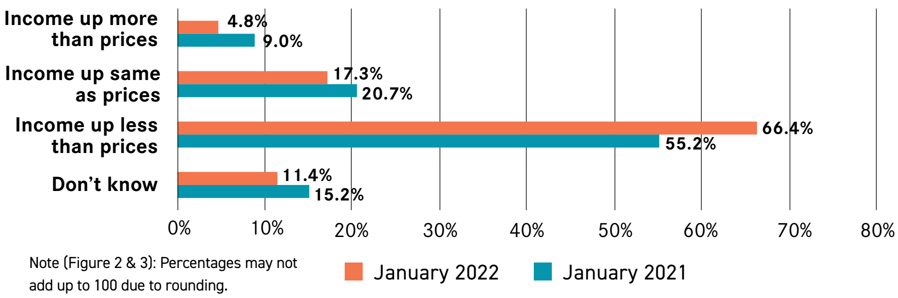


Figure 3
Expectations for Income Relative to Prices (Inflation) Next Year (% of Responses)



Note (Figure 2 & 3): Percentages may not add up to 100 due to rounding.

Inflation and Income

Amid growing discussion in the popular media about inflation, our survey also asked participants about expectations for prices and their perceptions of how their income would compare to price changes over the next year. The vast majority of respondents expected prices to increase over the next year, which represents nearly a 13 percentage point increase from just a year ago (see Figure 2). Additionally, nearly two-thirds of respondents expect that their income will fail to keep pace with price increases over the next year (see Figure 3). For both questions, we see that consumers in the region are more concerned about inflation than just a year ago. Additionally, the portion of respondents choosing "Don't know" to these questions is down compared to a year ago, reflecting less uncertainty in regional consumers' minds about these issues.

AT THE REGIONAL LEVEL PESSIMISM IS REFLECTED UNANIMOUSLY ACROSS HOUSEHOLD INCOME LEVELS.

Overall, we see marked pessimism among regional and national consumers heading into 2022.

Regional Consumer Sentiment and Household Income

The data continue to suggest that consumer sentiment varies in the region by household income level. Sentiment is down across all income levels and is at its lowest point in every category since the inception of our survey. Of particular note is the plunge in sentiment among the highest household income category ($250,000+), which is down markedly from a year ago and is now lower than several of the other income categories.

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. While we didn't see a large change in patterns of credit held, we do see some tapering in plans for credit acquisition, particularly for student loans (see Figure 5).

Figure 4
Index of Consumer Sentiment By Household Income Level

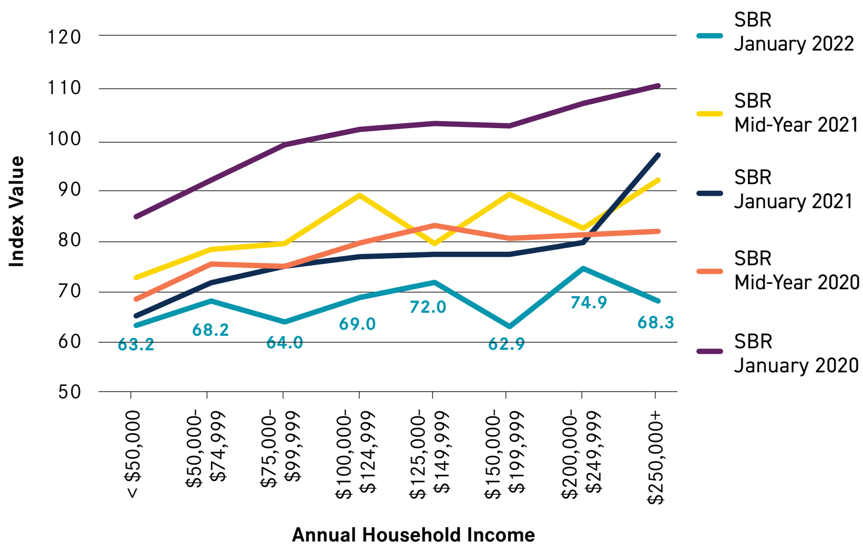
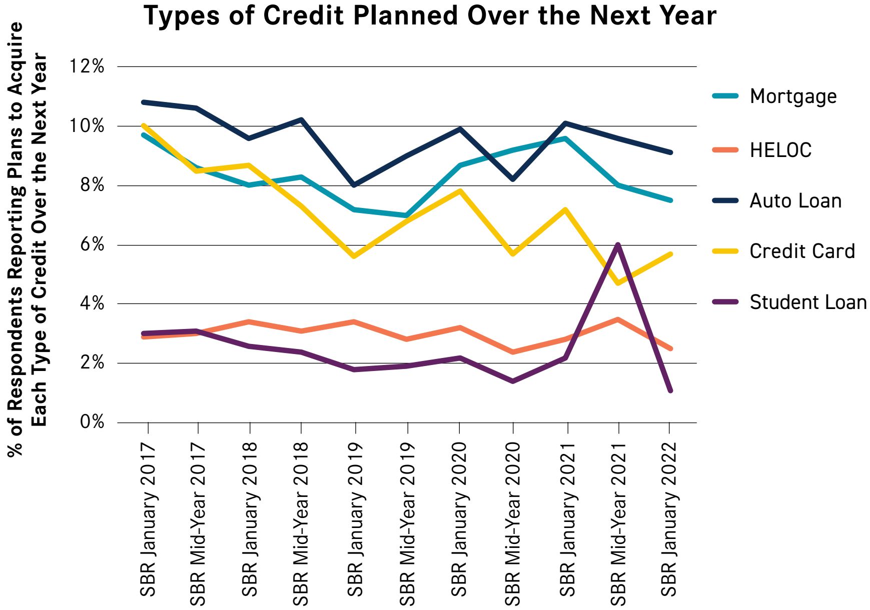


Figure 5
Types of Credit Planned Over the Next Year



Summary

Overall, we see marked pessimism among regional (and national) consumers heading into 2022. And, at the regional level, this pessimism is reflected unanimously across household income levels. We also see a substantial increase in inflation-related concerns and most do not expect their income to keep pace with anticipated inflation. These results suggest substantial headwinds as we move into 2022 with a potentially overheated economy along with pandemic-related concerns and the Omicron variant.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The Small Business *Economy*

The health of the Small Business Economy is vital to the economic success of a community. Each year, the *Sacramento Business Review* (SBR) team conducts an annual assessment to measure how different areas of Small Business are doing. This review includes analyzing our proprietary Small Business Confidence Index (SBCI), reviewing regional loan trends in El Dorado, Placer, Sacramento, and Yolo Counties, and evaluating business transaction trends.

The Overall Sentiment of the SBCI survey for the Greater Sacramento Region had a 4% decrease relative to the 2021 mid-year update. These results are virtually equal to the 5-year pre-pandemic average. The main positive drivers were Access to Credit and an optimistic view on Future Revenue prospects. The weakest components were the Economic Outlook and the Likelihood of New Hires. A divergence between the New Hires reading can also be observed. In the Likelihood of New Hires datapoint, the Service Sector indicated a 12% drop compared to the mid-year update, whereas the Manufacturing and Other Sectors reported positive readings relative to the mid-year and January 2021 update.

The overall sentiment of the last 18 months is plateauing. Additional progress is needed, especially in the Economic Outlook, Local Supportiveness, and in New Hires. A silver lining in the recovery is that Access to Credit appears abundant to local businesses. In fact, the loan volume in 2021 was more than 40% higher vs. 2020, and it is the highest volume observed in 15 years. However, if higher interest

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

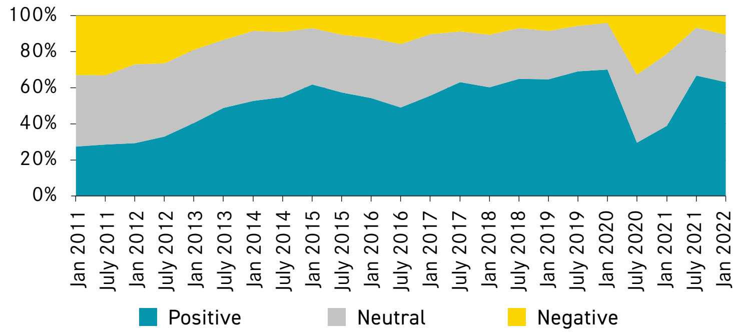


Figure 2 • SBCI Total: Credit Access
(18-month Moving Average)

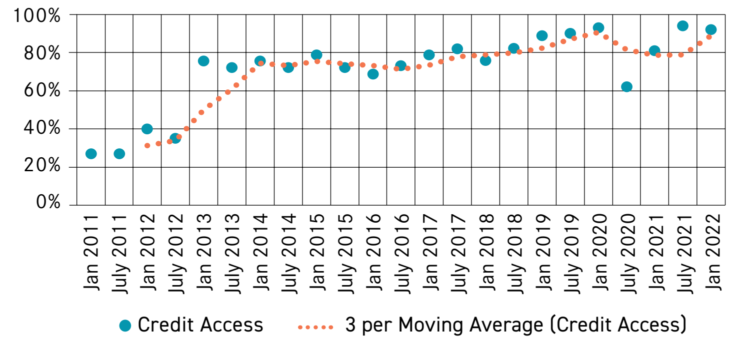
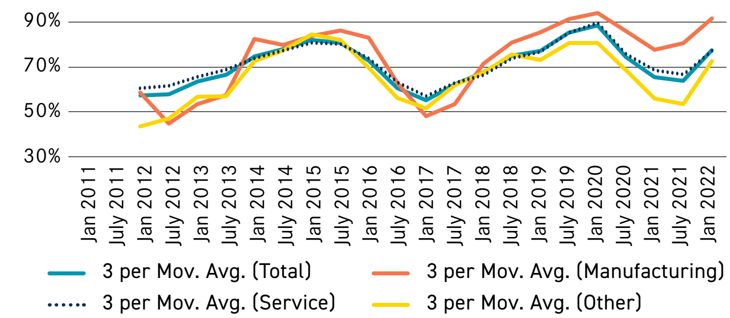


Figure 3 • SBCI Likelihood to Hire by Sector
(18-month Moving Average)

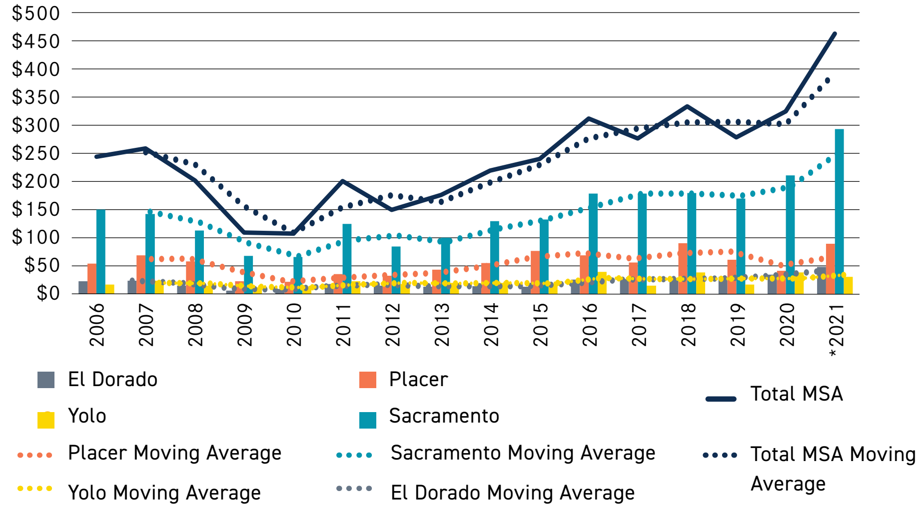


rates materialize next year, the positive boost received can quickly disappear as business credit dries up or business loan affordability is reduced. The prospect for a positive Future Revenue Outlook remains strong, which gives hope that the Small Business Economy will continue to push forward.

Lending data provided by the Small Business Administration (SBA) shows that the loan volume recorded this round was over 40% higher than 2020. It is also the highest in 15 years. The loan volume in Placer County more than doubled, while both Sacramento and El Dorado County increased more than 35%. Loan activity in Yolo County decreased 20%. For example, lending activity in El Dorado County and in Sacramento County are on pace to finish at their highest levels in 15 years. All four counties recorded higher volumes than their 5-year pre-pandemic average. A deeper look at the loan volume data shows that SBA loans peaked around August 2021, followed by a slowdown which has been observed both in 2020 and 2021.

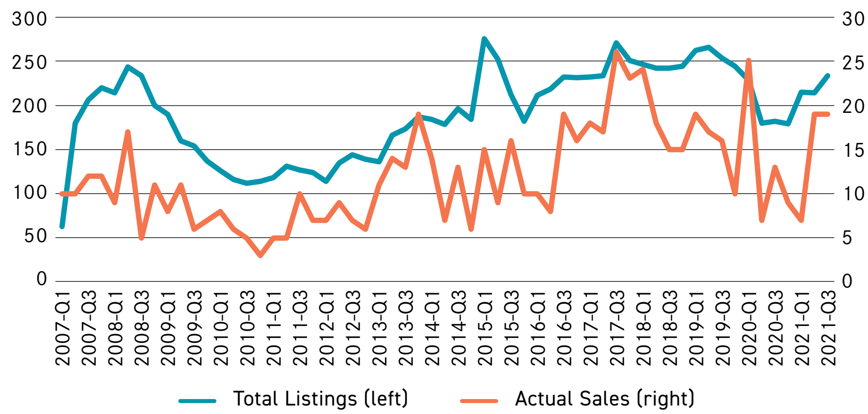
Business listings are 6% lower than their 2-year pre-pandemic moving average in this report, and transactions are 13% higher than their 2-year pre-pandemic moving average. Both listings and sales have yet to recover to their pre-pandemic levels. While listings and sales are higher than the beginning of 2021, the transaction metrics are soft. The Revenue and Cash Flow Multiples of transactions decreased 35% and 13% versus the 1-year Moving Average. This is consistent with the seasonal pattern observed over the last few years. Median Sales Price for closed deals reflected a 16% premium over Median Asking Price in the last reported quarter. The Median Sales Price is 30% higher than 12 months ago.

Figure 4 • Total SBA Loan Approvals By County
(in millions, 2-Year Moving Average)



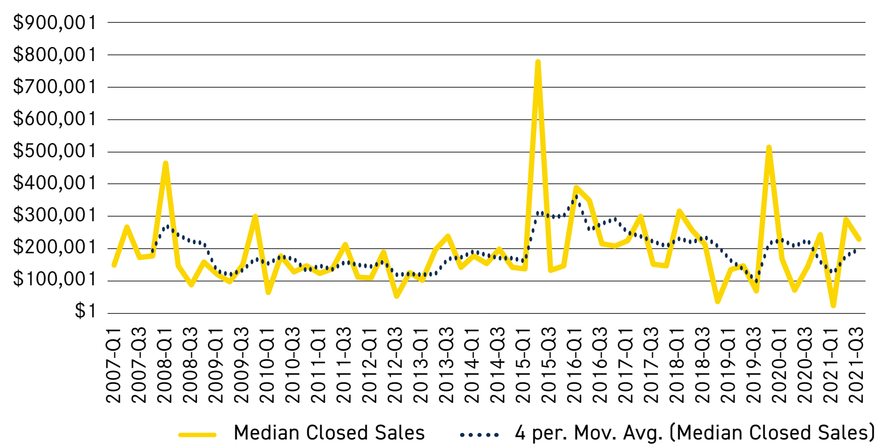
Moving Average is average of two previous data points. *FY: October 2020 through September 2021

Figure 5 • Number of Listings vs. Actual Sales (Quarterly)



Data Source: BizBuySell

Figure 6 • Median Closed Sales Price (Quarterly)
(1-year Moving Average)



Data Source: BizBuySell

Real Estate

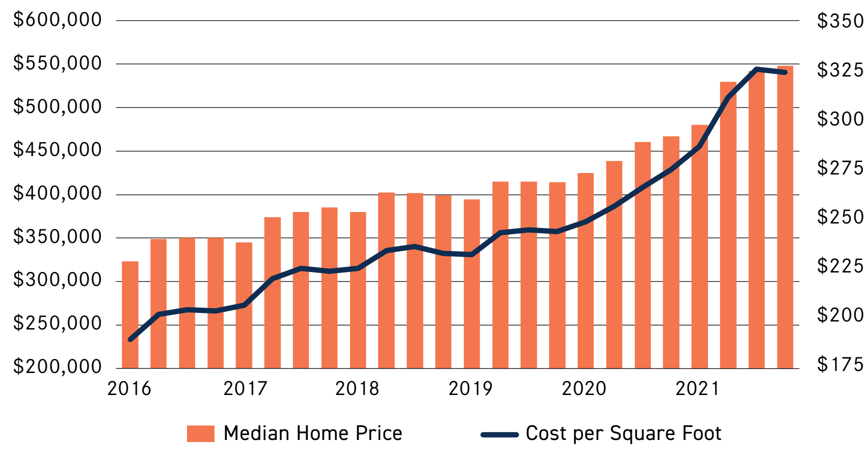
Residential

Sacramento's residential real estate has experienced a significant pricing boom over the past year. A lack of supply on the market coupled with an increase in new residents coming to the area has created a significant supply-demand imbalance and driven pricing up significantly.

As of the end of 2021, the median single-family home has increased in price by more than 17% year-over-year and has consistently surpassed 10% year-over-year growth every quarter since mid-2020. Additionally, sales in excess of $1 million exceed 15% of all market transactions, a first for the area. With that said, data as of mid-fourth quarter indicates that growth on a per square foot basis may be starting to plateau. However, that could be due to seasonal lulls in sales.

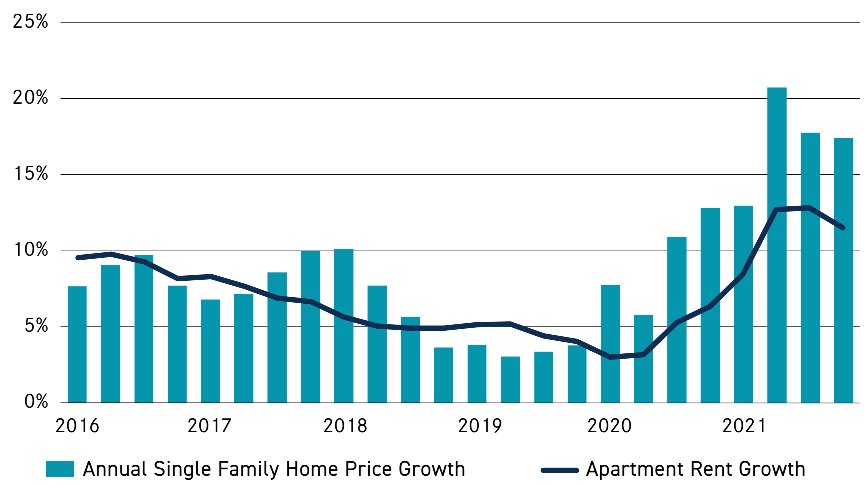
Local renters are not fairing much better. Apartment rents are up nearly 12% year-over-year and have been accelerating until recently. Rent control, which pertains only to properties within Sacramento city limits and only to tenants renewing in their current apartment, will likely not help much in the coming year. The calculation of 5% plus the consumer price index, came to 9% in 2021 and

Figure 1
Median Home Prices & Cost Per Square Foot • 2016 - 2021



Source: DQ News

Figure 2
Median Home Prices & Rental Growth • 2016 - 2021



Source: DQ News & CoStar

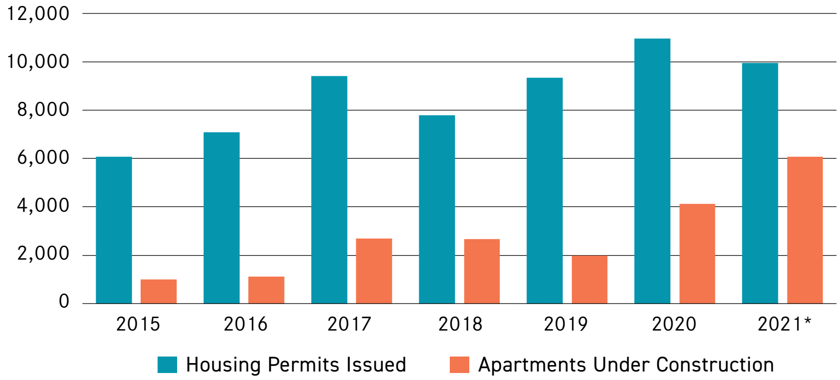
APARTMENT RENTS ARE UP NEARLY 12% YEAR-OVER-YEAR.

with inflation at a thirty-year high that figure will likely increase for 2022. While growth in housing prices surpasses rental increases, the lack of housing throughout the Sacramento area is an increasingly severe problem.

Developers are moving to meet increased demand, but construction takes time and is increasingly costly. As of the end of October nearly 10,000 housing permits were issued during the year and marks the second consecutive year in which Sacramento surpassed that figure and has not been topped since 2006. Additionally, more than 6,000 new apartments are underway, most of which are located in or immediately surrounding the Downtown area. Even with the flood of new inventory it may not be enough to meet demand with four out of every ten renters still coming from outside Sacramento.

Sacramento's biggest real estate challenge comes from the residential sector. Lack of supply coupled with increasing demand from outside the market has put significant upward pressure on pricing with little indication of that changing in the near term. While there is significant development in the area, finding the desired equilibrium that allows the region to grow without oversupplying the market is a difficult task. However, for the short-term, construction will continue in high quantities for both the single family and apartment sectors.

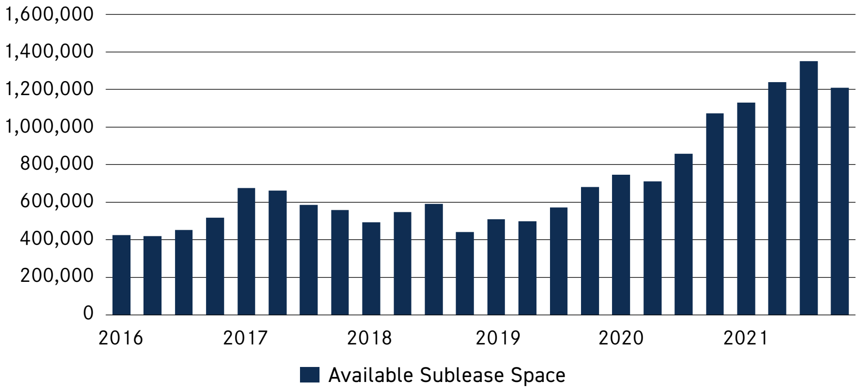
Figure 3
Housing Permits Issued & Apartments Under Construction



Source: Fred Economic Data & CoStar

*Housing Permit Data Through October 2021

Figure 4
Office Available Sublease Space • 2016 - 2021



Source: CoStar

Office

While the impact of COVID-19 on the local office market was significant, the second half of 2021 saw some significant signs of stabilization. Companies seem eager to return to the office and the influx of new residents is changing the local talent pool. The largest unknown, however, is the Omicron variant and its impact on firms' willingness to fully return to the office in the near term. With nearly two years to determine their real estate needs and work from home policies, the new variant is unlikely to have the same effect as previously given the availability of vaccines and therapeutics. While it could slow momentum moving into the beginning on the year, activity should accelerate thereafter ending with a much improved 2022.

Sublease space, which had been increasing since mid-2019 has leveled off. Many of the companies that put sublease space on the market have already done so, with fewer new sublease offerings expected in 2022. Nationally, the areas hit hardest by this trend tended to be predominantly urban with dense populations, and with a high concentration of tech tenants. Sacramento is primarily a suburban office market with a smaller tech footprint and less volatile leasing market.

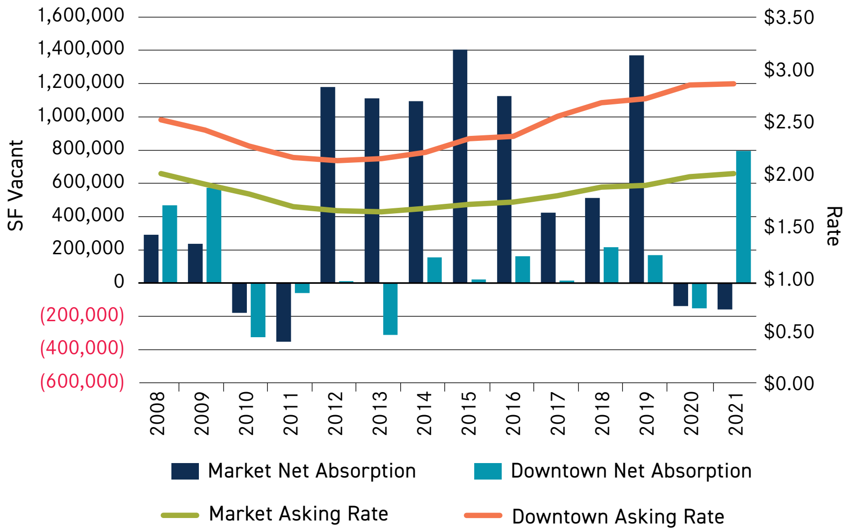
There are early signs that more companies are considering opening offices in Sacramento, even if they start off as very small. For example, Penumbra recently expanded its Roseville operation and now occupies approximately 250,000 square feet, while JOINN Biologics purchased a 20,000 square foot building in North Natomas to use as a laboratory.

New activity has helped to push leasing volume in excess of 1 million square feet in the fourth quarter and annual numbers to 3.6 million square feet, up 21% over 2020. This activity is not yet reflected in the vacancy rate which is up 100 basis points since the end of 2020 to just above 10%.

Rents are up slightly over the last year, just over 1% but that figure is likely to increase in the year to come, if leasing activity remains close to fourth quarter levels. Across the market, net absorption figures are lagging, but downtown is positive, driven by the completion and occupancy of two state office buildings. That activity has left large blocks or vacancy in nearby buildings that may have to be repositioned in the coming quarters.

Despite the hardship of the last few years, the office market could be positioned for recovery in the coming year.

Figure 5
Office Market Activity • 2008 - 2021



Source: CoStar

Despite the hardship of the last few years, the office market could be positioned for recovery in the coming year. A lack of development during the prior economic cycle means that Sacramento is not oversupplied. With leasing activity increasing and companies from outside the area now considering Sacramento, 2022 could look much different than the past two years.

INDUSTRIAL MARKET:
HIGH CONSTRUCTION COSTS
HELPING TO DRIVE LEASE RATE INCREASES.

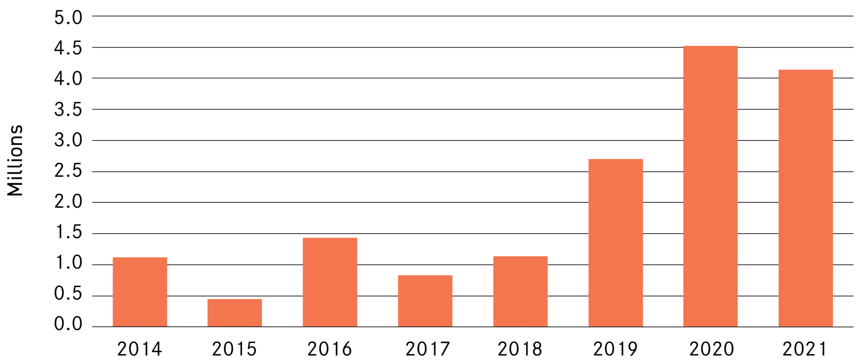
Industrial

The industrial market has been the best performing commercial sector throughout the pandemic. Construction has struggled to keep up with demand with many new projects leased prior to completion. Such fervent activity has prompted developers to buy up land around Metro Air Park with plans for additional expansion over the next few years. Northpointe (350 AC) and Harsh Investments (19 AC) have each purchased land to develop independently. Activity is not limited to Natomas, additional development is planned in Elk Grove, Rancho Cordova, and Roseville. Near record construction will introduce some much-needed supply to the market, as the vacancy rate is at an all-time low of 2.2%.

The other major market theme in the industrial sector is rent growth. Year-over-year rents are up 9.7%, slightly below the record figures set back in early 2018 and could continue their upward trend in 2022. The rapid growth is driven primarily by two factors: first, a lack of supply in the market. Record low vacancy is giving owners more leverage during lease negotiations, which they are using to test the limits of the market. Second, rising construction costs are greatly affecting the pro forma lease rates required for new construction to pencil. Construction materials, specifically, have been very difficult to source, increasing prices for existing inventory. This is an issue across the nation, with some markets reporting in excess of 50 million square feet underway.

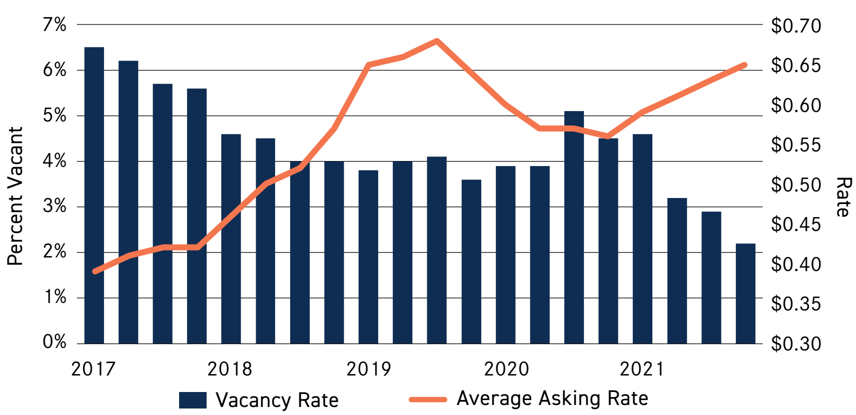
The industrial market continues to fire on all cylinders with little reason to expect change in the near to medium term. Interestingly, Sacramento has yet to mirror the rest of the state when it comes to property values. Cap rates in Sacramento are significantly higher than competing markets, pointing to a possible increase in investment activity in the coming year.

Figure 6
Industrial Under Construction • 2014 - 2021 (SF)



Source: CoStar

Figure 7
Industrial Vacancy & Average Asking Lease Rate • 2017 - 2021

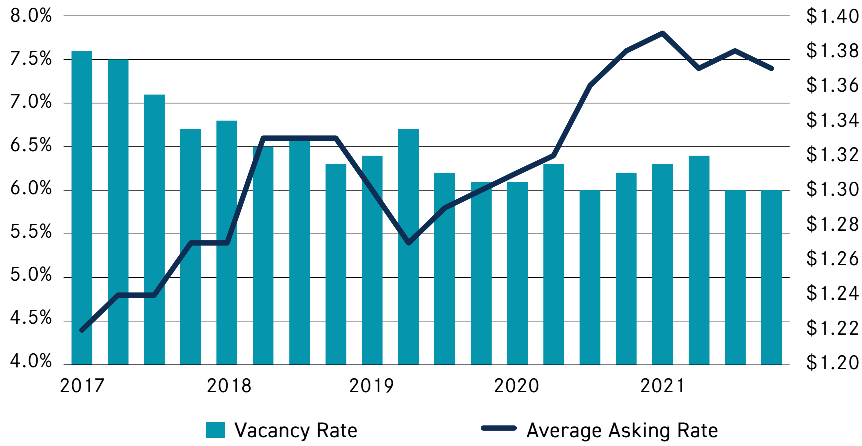


Source: CoStar

REAL ESTATE

THE RETAIL VACANCY RATE FELL TO 6.8%, AFTER INCREASING IN FOUR OF THE PAST FIVE QUARTERS.

Figure 8
Retail Vacancy & Average Asking Lease Rate • 2017 - 2021



Source: CoStar

Retail

The pandemic had the most profound effect on the retail sector, but as we conclude 2021, it too is giving reasons for optimism. A number of large leases have led to a strong net absorption figure to end the year. Most notably, Sportsman's Warehouse took occupancy of more than 40,000 square feet in Elk Grove. This is one of ten move-ins of 15,000 square feet or more in the fourth quarter alone. As a result, the vacancy rate fell to 6.8%, after increasing in four of the past five quarters.

The retail market may be the commercial area that benefits the most from the Bay Area migration to the region. An increasing population that has a favorable income compared to the local average will improve local demographics, making the region more attractive to potential retailers. The region has worked for many years to shake its sleepy government town image, and there are early indications of positive changes ahead.

One area that is lagging behind is investment sales. Typically, investors are avoiding this product class with a couple of exceptions: first, grocery anchored centers are still desirable in the market. Second, recently constructed, triple net leased small buildings are commanding a high price per square foot. Any other product on the market moves very slowly and often trades at a discount with potential buyers remaining cautious.

Capital Markets & Banking *Forecast*

UNEMPLOYMENT HAS DROPPED AND JOB OPENINGS ARE AT ALL TIME HIGHS.

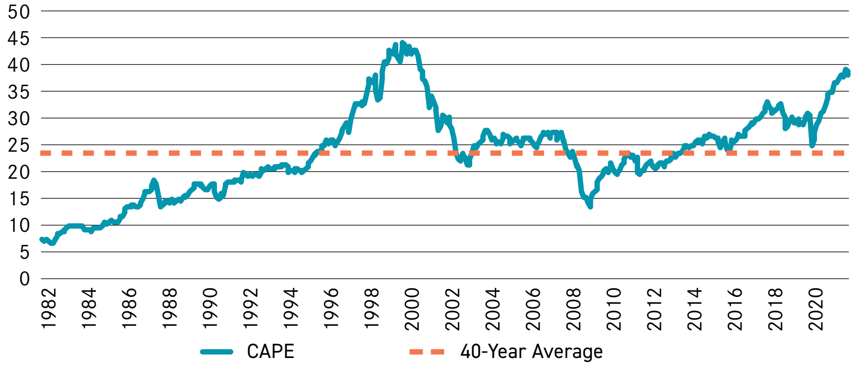
In our mid-year update, we compared Equity markets to a roller coaster – that metaphor seems particularly apt in the second half of 2021 as the Equity markets seemed to be on the approach to the top of a significant drop. In our January 2021 report and again in our mid-year update, we predicted Equity returns for 2021 would be in the mid-teens. Full-year returns look to be finishing the year just above that, up more than 25%, and up over 70% since the COVID correction lows in March 2020. Each minor pullback has been met with significant "buy the dip" investor behavior, leading to resumption of the market's upward trajectory. Aggregate valuations, as measured by Cyclically Adjusted Price-to-Earnings (CAPE), have reached levels not seen outside the "Dot-Com" bubble.

From a sector level, Energy was the strongest in 2021, driven by underlying commodity prices. Communication Services was the only negative sector, mostly due to increased competition among the largest US wireless providers, which weighed on subscriber value and earnings.

Overall, the economy has continued its recovery from the pullback in 2020 and appears to have the foundation of a strong multi-year run.

Overall, the economy has continued its recovery from the pullback in 2020 and appears to have the foundation of a strong multi-year run. Corporate profits were exceptionally strong, IPOs were the strongest on record with over 1,000 new issues for the first time, and domestic investment posted elevated numbers. Unemployment has continued to drop, falling to 4.2% in November, and job openings are at all-time highs, though labor participation remains lower than pre-pandemic levels.

Figure 1 • Equity Valuations are Approaching Historic Levels



The only fly in the ointment is the recent increase in inflation as CPI numbers elevated to levels not seen for nearly 40 years. Prices have been increasing across the board as housing, food, and energy have all seen double digit increases. Years of accommodative monetary policies mixed with the substantial fiscal stimulus brought in to stabilize the U.S. economy from a COVID-driven recession, as well as myriad supply-chain challenges, have created a looming specter for 2022. In addition, the strong employment market is likely to generate wage pressure and the create the potential for a wage-price cycle.

Despite these concerns, equity market volatility, as measured by the VIX, has been on a downward trajectory for most of the year, and only seen a small uptick toward year end with the recent emergence of the COVID-19 Omicron variant. Despite the increase in cases and potential risk of shutdowns, absolute market levels reacted with indifference.

After another strong year of performance, the SBR team sees significant risks in the equity markets, potentially looking forward to a below average (0-10%) — or even negative — year. Corporate earnings growth was extremely strong in 2021, with record margins despite cost pressures, and are most likely to return to normal levels in 2022. In addition, inflation is likely to force the Fed to end its asset purchasing earlier than previously expected and begin raising rates to keep economic activity from overheating. Rate increases will have a muting affect on equity returns. Conversely, if the Fed declines to act, or acts more slowly, investors seeking inflation protection may push equity returns even higher. In fixed income markets, we see the 10-year treasury yield moving up as 2022 progresses, likely finishing between 1.75% and 2.25%.

Figure 2 • IPO Acceleration Driven by SPACs

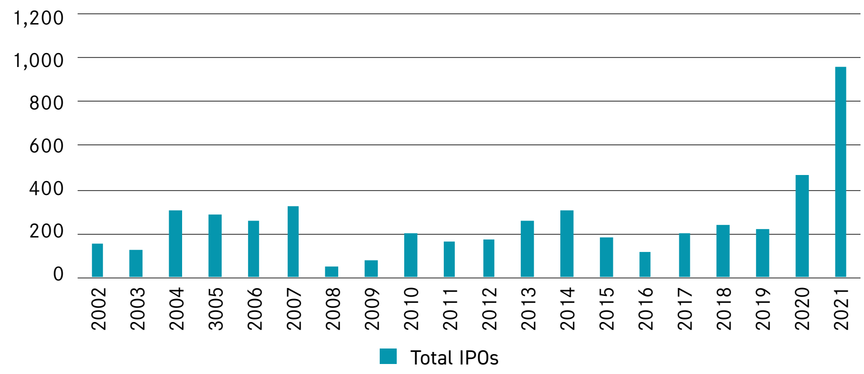


Figure 3 • Rising Inflation Looms Over Markets

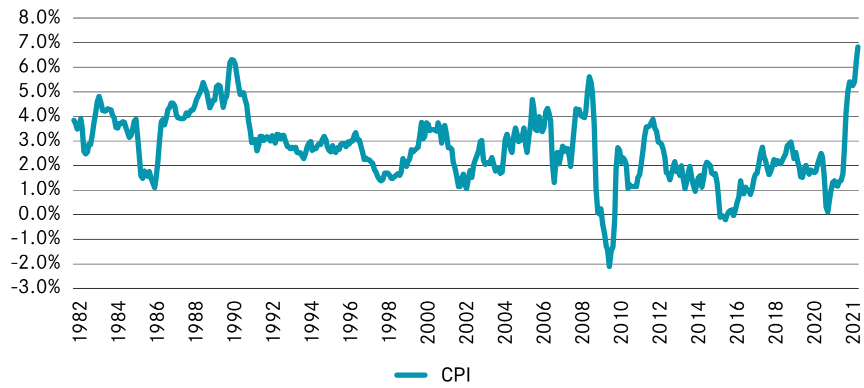
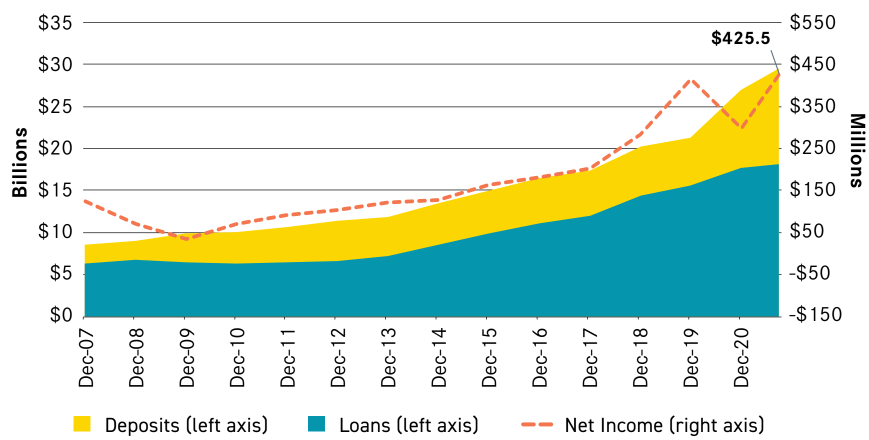


Figure 4 • Loan, Deposit, and Net Income Trends – Region Banks



Regional Financial Institution Performance

Regional banks and credit unions somehow staved off what many thought would be unprecedented levels of credit defaults in 2020 and have performed well in 2021. Asset growth slowed from 23% to 12% for the region's banks and from 24% to 11% for the region's credit unions for 2020 and 2021 year-to-date through September. However, the excess liquidity brought about by asset growth at these levels remained a challenge with limited loan and investment options in the historically low interest rate environment. We project the region's financial institutions (FIs) will end the year with net income levels at or above the dollar highs observed over the last business cycle.

Capital Markets & Banking *Forecast*

The economic environment ahead remains uncertain due to the persistent pandemic situation; however, higher interest rates inspired by a more hawkish Federal Reserve bodes well for financial institutions' performance both regionally and nationally. The following charts highlight net interest income (interest income less interest expense) for regional banks and credit unions over the last business cycle, and it is clear that rising interest rates allow regional FIs to lend and invest at the higher rates while holding back deposit costs to expand net interest margins. Ultimately, this net interest margin expansion should make its way to FI bottom lines. Inflation risk should not be underestimated, however, as it has the potential to impact everything from labor costs (higher operating expense) to borrower affordability (fewer loans).

For 2022, asset growth will continue to slow, and loan growth should continue along in the mid-single digits range for both regional banks and credit unions. Regional FIs should perform relatively well in the coming year as long as their commercial and consumer customers and members can withstand higher prices and the impact of any additional COVID protocols taken to address the current Omicron surge.

Figure 5 • Loan, Deposit, and Net Income Trends – Region Credit Unions

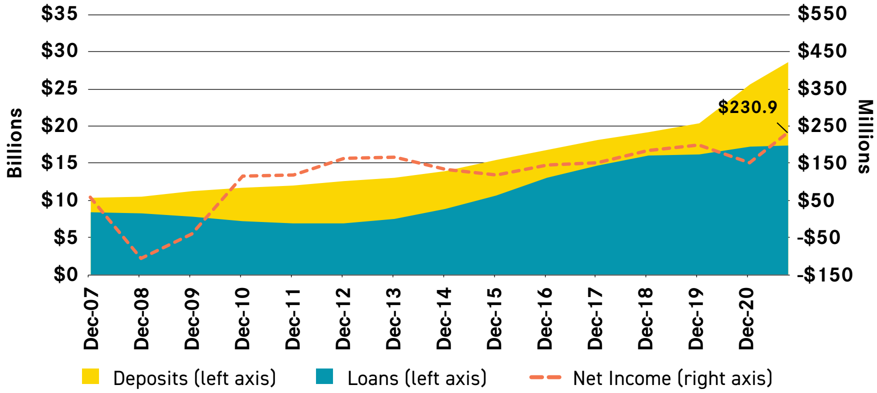
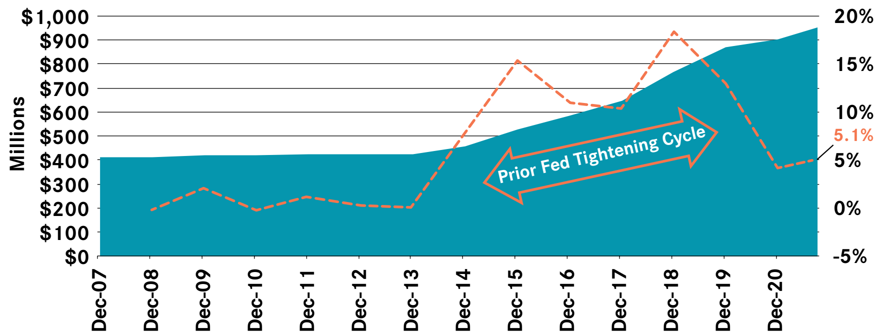
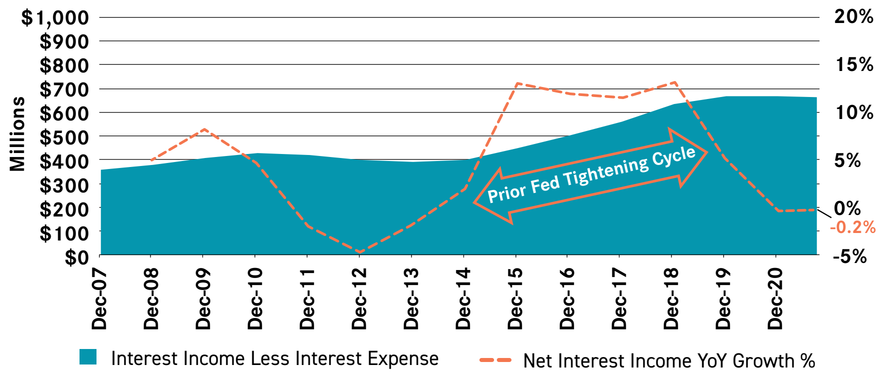


Figure 6 • Net Interest Income – Region Banks

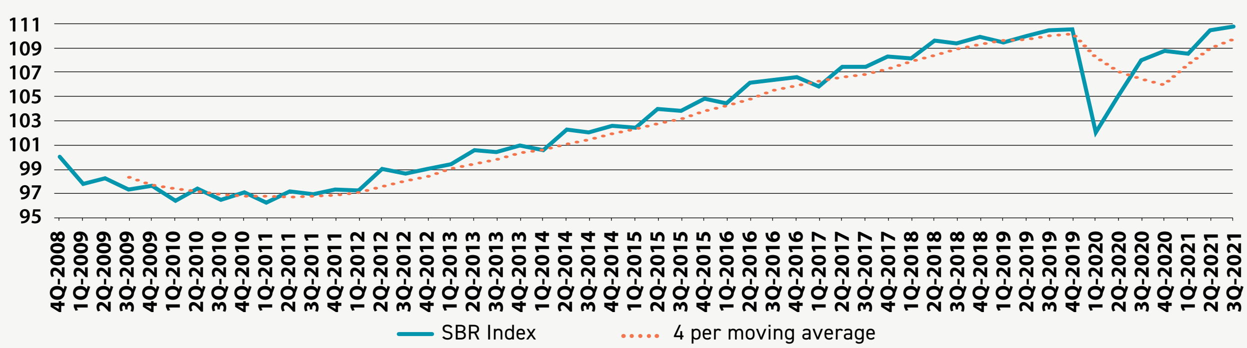


Net Interest Income – Credit Unions



Sacramento Business Review Financial Conditions Index (with 2-year moving average)

Our proprietary Financial Conditions Index for the region's economy shows continued recovery and expansion as of Q3 2021 relative to the pre-pandemic peak.



Human Capital Trends

Figure 1 • Resignations

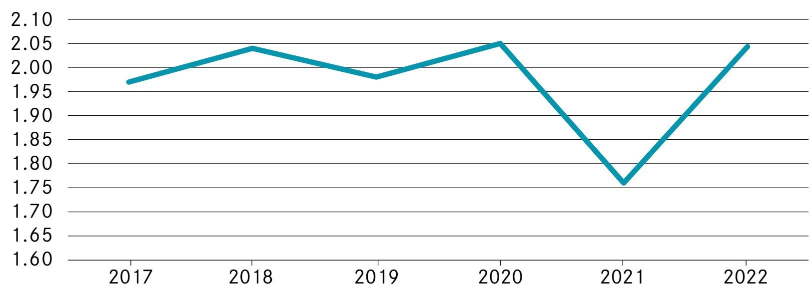


Figure 2 • Headcount

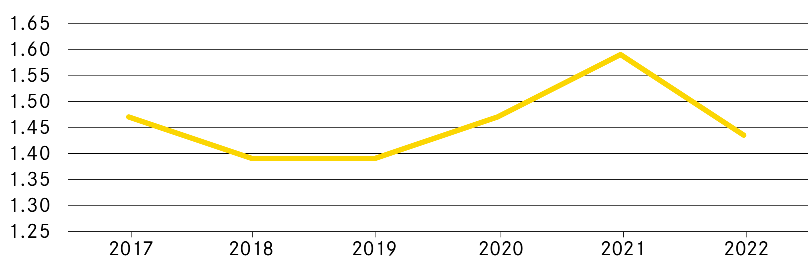
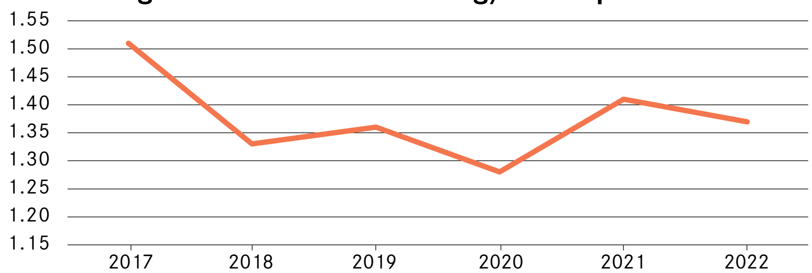


Figure 3 • Need for Training/Development



Our human capital indices are illustrated in Figures 1-6. Movements in the graphs may appear slight but since responses are on a three-point scale, even small movements illustrate real impact. Upward movements indicate movement in the desired direction, and downward movements indicate decline.

Sacramento is – as expected – trending with the nation and reporting forecasted increases in resignations (Fig. 1). Conversely and as expected for headcount – layoffs are decreasing and recruiting efforts are underway (Fig. 2). In the last few years we have also reported a heavy focus on training and development (T&D), with last year pausing these efforts. Current numbers again show us an expanded need in this arena (Fig. 3). Perhaps the 2018-19 focus on T&D, which might have resulted in more of a stable skills level last year, is now offset by the Great Resignation, forcing organizations to again invest in their current workforce.

Pressure on cost reduction has formally been surpassed by the talent shortage and skills gap for the first time.

Compensation is leveling off after a boost last year (Fig. 4), and it looks like organizations are once more finding themselves behind in providing optional benefits and perquisites at appropriate levels (Fig. 5). Racial justice and diversity efforts are slipping even further down, showing that our local organizations are not meeting their goals in this domain (Fig. 6), in stark contrast to the import placed on this in the Bay Area and nationally.

Pressure on cost reduction was the factor exerting the greatest burden on the organization in 2019, 2020, and 2021 (Fig. 7) – but coming up, we see the talent shortage and skills gap both surpassing the pressure on reducing costs. This tell us that local organizations are facing a dearth of job candidates, and as the open-ended comments told us (below), local companies are truly suffering in this area. Pandemic recovery – a new entry in our survey last year – moved up from number 8 to be ranked 5th in priority this year, also again beating the strategic priority of racial justice.

Figure 4 • Meeting Compensation Goals

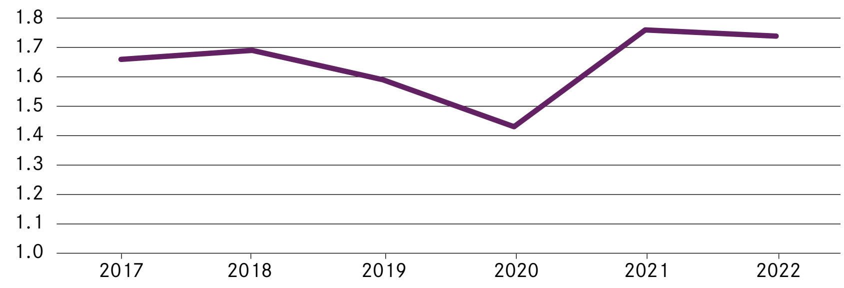


Figure 5 • Meeting Goals for Optional Benefits

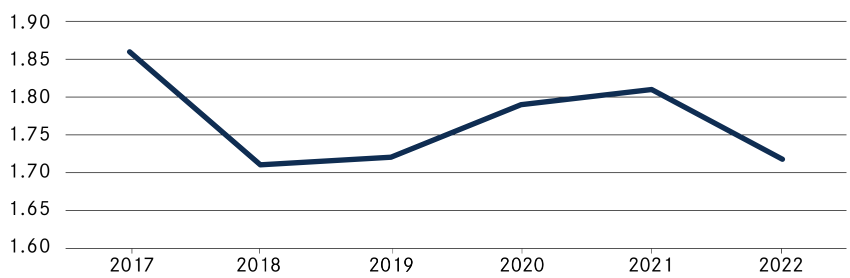


Figure 6 • Meeting Goals for Diversity

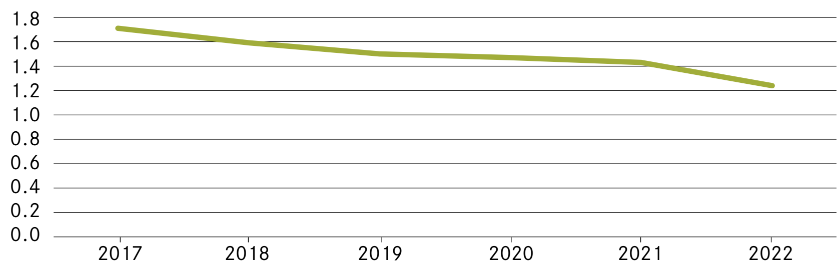
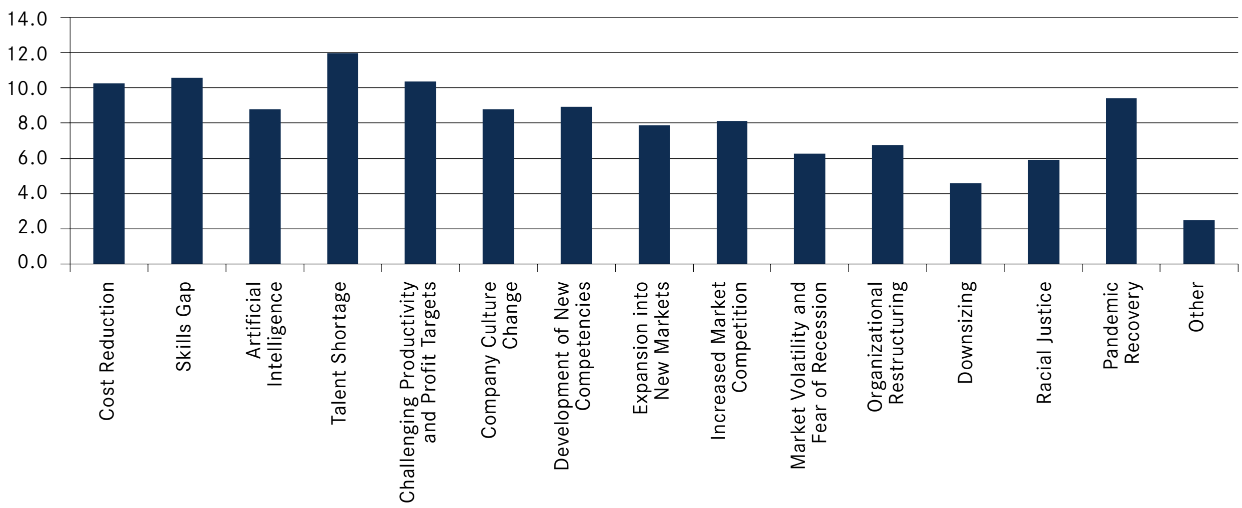


Figure 7 • Most Significant Pressures Expected 2022



Human Capital Trends

Open-ended answers regarding current challenges really gave only one answer – there isn't a workforce, and the workforce that is left is struggling. Survey responses pointed to severe understaffing and lack of available talent in the labor market. Respondents said their challenges are "lack of experienced candidates available," and "retention of key talent especially in highly competitive technical roles." This abyss is causing organizations to look for new hires out of state, redesign their current organizations, promote individual contributors into management roles, and shift workloads among current employees. There is no surprise then that we also received reports of employee burnout and feelings of being overworked. This has resulted in reduced morale and reports of managers not being understanding, including reports of hostile work environments. Employers, conversely, are reporting that they are seeing "lack of follow through" from their employees and challenges with team culture and work ethic. All in all, it seems like our local organizations are truly hurting.

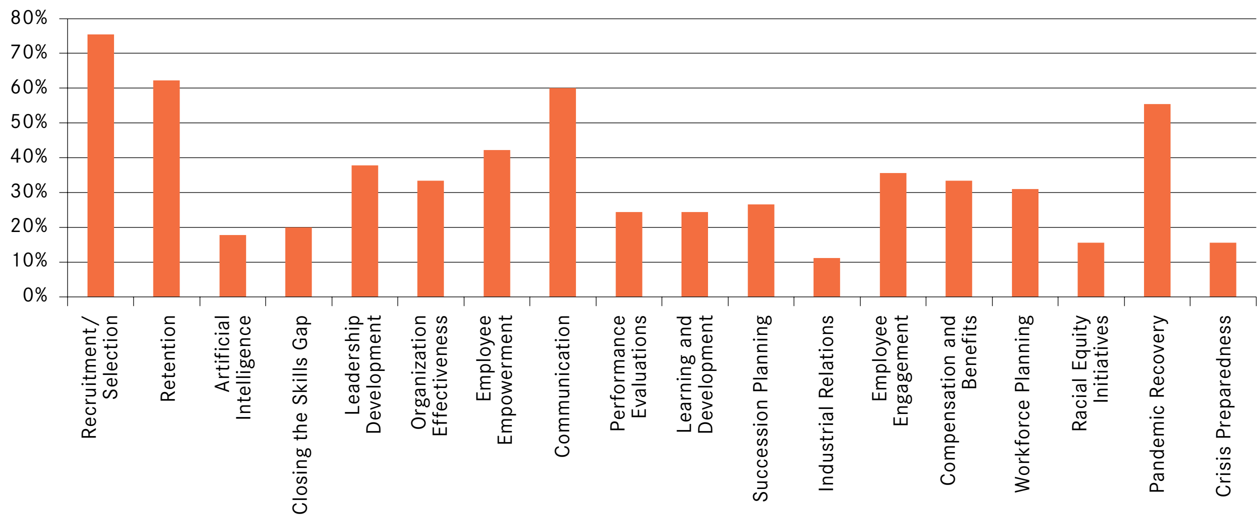
Also tracking with national reports, and as reported in our Summer 2021 issue, local Sacramento employees want to keep the flexibility that the pandemic brought and are requesting telework for part of the time. Perhaps some of these requests stem from the overwork and burnout employees are experiencing. Related workforce challenges include the training and development needed to address the skills gap. This requires employee buy-in and commitment, which is at an all-time low. So getting existing employees trained is also a difficulty. Related concerns encompass how to handle COVID-19 vaccination mandates and "the fine line between employers that are flexible with the mandates and those that are not." Furthermore, and as reported in the Summer 2021 issue, motivating staff and engaging the workforce is reported to be very difficult right now. Managers also disclose facing challenges with their relationships with employees as well as managing in a virtual environment. Lack of support from leadership is also reported.

Top HRM activities expected to have the greatest impact on business performance in Q1 and Q2 (Fig. 8) include recruitment/selection, retention, pandemic recovery, and improving communication with employees.

In sum, the pandemic effects are still impacting local workforces, and we are seeing gloomier reports for 2022 than we have in the earlier pandemic times.

> *Sacramento employers are in for a rough 2022 - Employees are burned out, engagement is low, and leadership is struggling to be supportive.*

Figure 8 • HRM Activities Expected to Have Greatest Impact on Business Performance

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