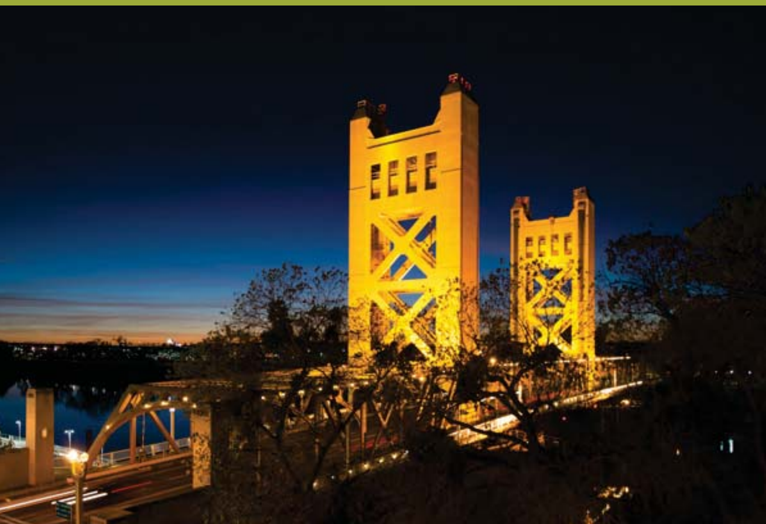
UPDATE

2017 Banking & Capital Markets Mid-Year Update



To provide a more concise, yet informative update for the local banking industry and capital markets, the SBR team felt it best to combine the two sections for the 2017 mid-year update and future editions. Much of the central bank policy decisions and actions that we typically discuss in the Capital Markets section have unquestionable ramifications for the local banking sector, and many of the broader capital markets themes such as macroeconomic expectations and stock market valuations directly impact the local banking sector's customer base and its behavior regarding demand for loan and deposit products. We hope you enjoy the new format, and as always, please feel free to contact us with any feedback.

Banking Industry Forecast

In the January 2017 issue, the SBR team predicted a slowdown in the pace of loan growth for the Sacramento Region. And indeed, annualized Q1 2017 loan growth figures came in lower than that of Q1 2016 across almost every category. The projected annualized loan growth rate for 2017 is 5.3% for banks, down from 13.2% in 2016, and 14.6% for credit unions, a decline from 24.7% in 2016.

But a closer look suggests that we might, yet again, see aggressive growth similar to that in 2016. Both in 2016 and 2017 banks and credit unions demonstrated similar modest annualized loan growth projections after the 1st quarter, but loan growth picked up pace throughout 2016. See Tables 1 & 2 for details.

Table 1
Bank Loan Growth by Category

Segment	Q1 of 2016 Growth	Q1 of 2016 Annualized Growth	2016 Annual Growth	Q1 of 2017 Growth	Q1 of 2017 Annualized Growth
Commercial Real Estate	2.1%	8.6%	17.3%	3.8%	16.0%
Residential	-0.3%	-1.1%	1.1%	0.9%	3.7%
Commercial & Industrial	-0.4%	-1.5%	8.9%	-1.2%	-4.6%
Multi-family Residential	8.7%	39.5%	54.3%	1.9%	7.9%
Construction	6.5%	28.6%	14.1%	-2.1%	-8.1%
Other	-3.1%	22.28%	6.9%	-3.8%	-14.5%
Total	**1.1%**	**4.4%**	**13.2%**	**1.3%**	**5.3%**

Data Source: FDIC

Table 2
Credit Union Loan Growth by Category

Segment	Q1 of 2016 Growth	Q1 of 2016 Annualized Growth	2016 Annual Growth	Q1 of 2017 Growth	Q1 of 2017 Annualized Growth
Auto	4.96%	21.37%	32.9%	5.1%	22.1%
Residential/ RE Lines of Credit	2.5%	10.39%	17.8%	2.2%	9.2%
Credit Card/ Unsecured	-0.3%	-1.19%	14.2%	-1.1%	-4.3%
Other	5.16%	22.28%	23.9%	5.4%	23.5%
Total	**3.47%**	**14.6%**	**24.7%**	**3.5%**	**14.6%**

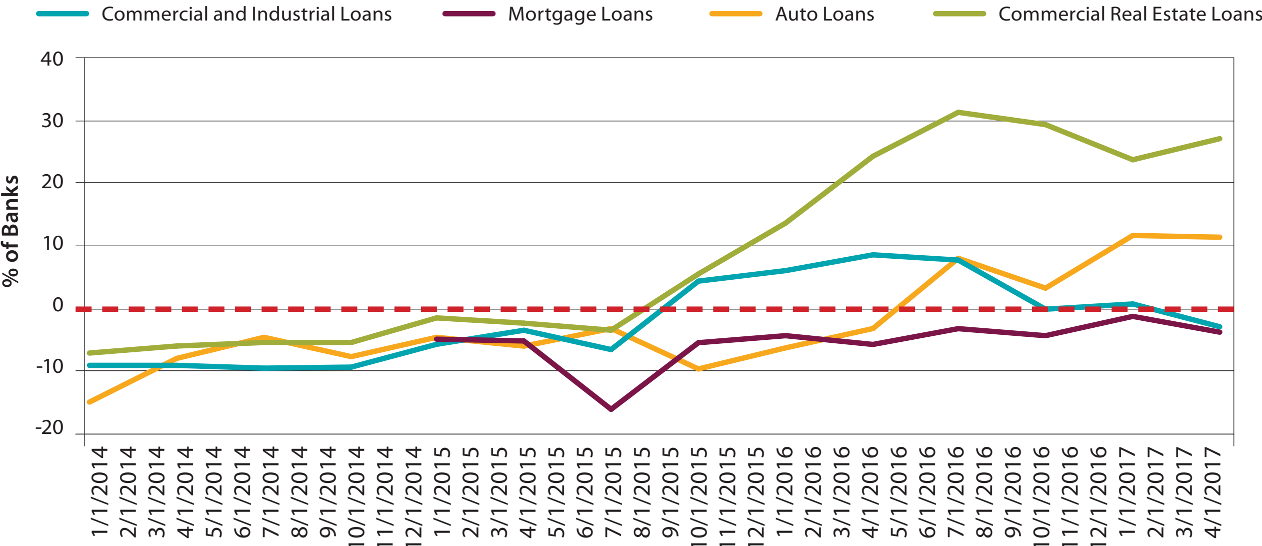
Data Source: NCUA

Current year loan growth patterns for local banks and credit unions appear to be consistent with the SBR's Regional Consumer Sentiment Survey results. The SBR Consumer Sentiment Survey indicates that self-reported patterns of credit usage and plans for acquisition during this time period are fairly consistent with the previous one. Consistent loan growth in the region backs up the self-reported consumer intentions. Nevertheless, the SBR team still believes that Sacramento region bank and credit union loan growth will slow in 2017. The Federal Reserve's Senior Loan Officer Survey points to an increased number of banks tightening standards for (1) commercial real estate loans, the largest loan category for Sacramento region banks at 47.2% of all bank loans, and (2) auto loans, the largest loan category for Sacramento region credit unions at 51.4% of all credit union loans. The Senior Loan Officer Survey points to more relaxed standards for commercial and industrial loans, which affect 9.3% of Sacramento region bank loans. Mortgage related loans show a slight relaxation of standards within a longer-term pattern of tighter standards. See Figure 1 for details. Putting these trends together, the SBR team believes that the net results of the loan standards practices will assert itself in a slower loan growth rate for 2017 as compared to 2016.

Nevertheless, the SBR team still believes that Sacramento region bank and credit union loan growth will slow in 2017.

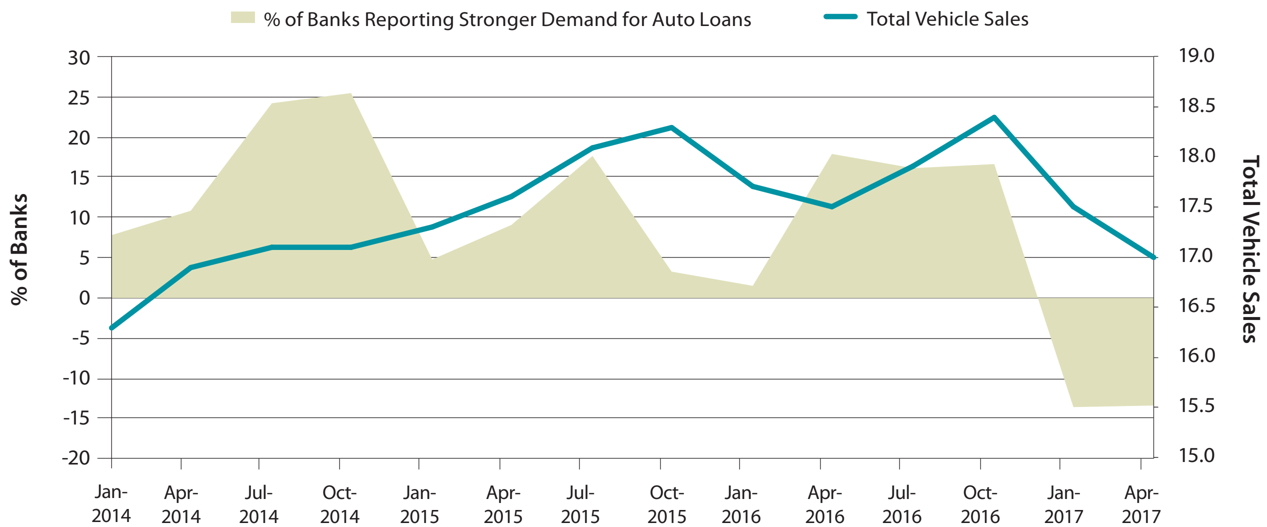
Revisiting our auto loan forecast, the SBR team has predicted a slowdown in auto loan growth for this year. National auto sales are lower compared to the same time last year. Banks nationwide report a substantial

Figure 1
Net Percentage of Banks Tightening Standards for Loan Categories



Data Source: FRED Senior Loan Officer Survey

Figure 2
National Bank Reported Demand for Auto Loans vs. National Auto Units Sales



Data Source: FRED Senior Loan Officer Survey

drop in demand for auto loans as well. See Figure 2 for details. Sacramento region credit unions have outpaced national trends for auto loans over the previous 5 years, which seems to be continuing into 2017: 1st quarter auto loans have not shown a slowdown as compared to the 1st quarter of 2016, but rather a slight uptick (see Table 2). The good news is that auto loan delinquency rates remain low for the region (see Table 3).

Table 3
Sacramento Region Credit Unions » 60+ Day Auto Loan Delinquencies » December 2015 – March 2017

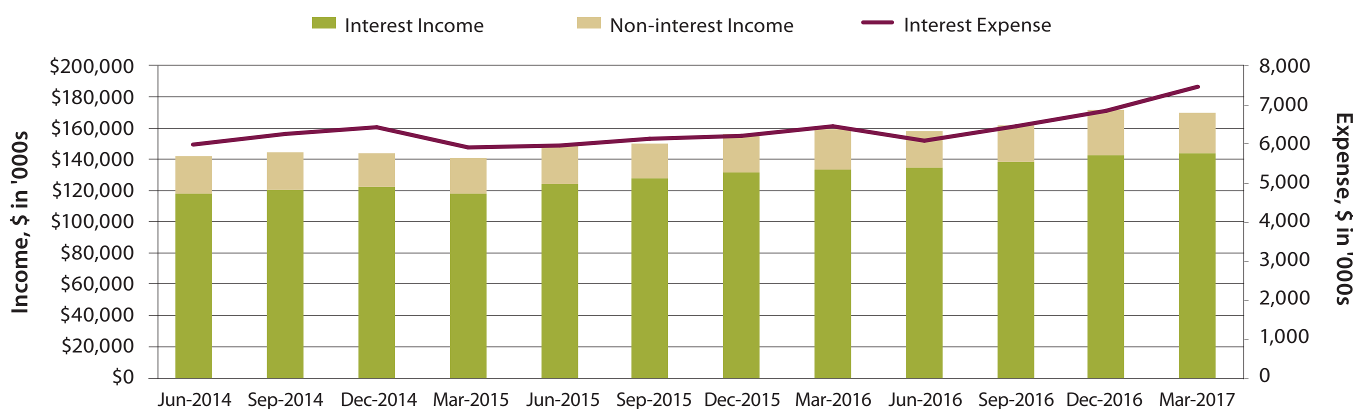
Segment	Dec-15	Mar-16	Jun-16	Sept-16	Dec-16	Mar-17
New	0.31%	0.23%	0.24%	0.30%	0.33%	0.27%
Used	0.53%	0.37%	0.37%	0.47%	0.56%	0.41%

Data Source: NCUA

The SBR's Regional Consumer Sentiment Survey results show that respondents are expecting an improvement in their financial situation and, at the same time, have concerns about an increase in inflation. Coupled with recent and expected Fed interest rates hikes, local consumers might be choosing to make their auto purchases sooner rather than later, causing the local auto loan growth rate to persist above the national trend; however, the SBR team believes that the region will still see a slowdown in the rate of auto loan growth by year end.

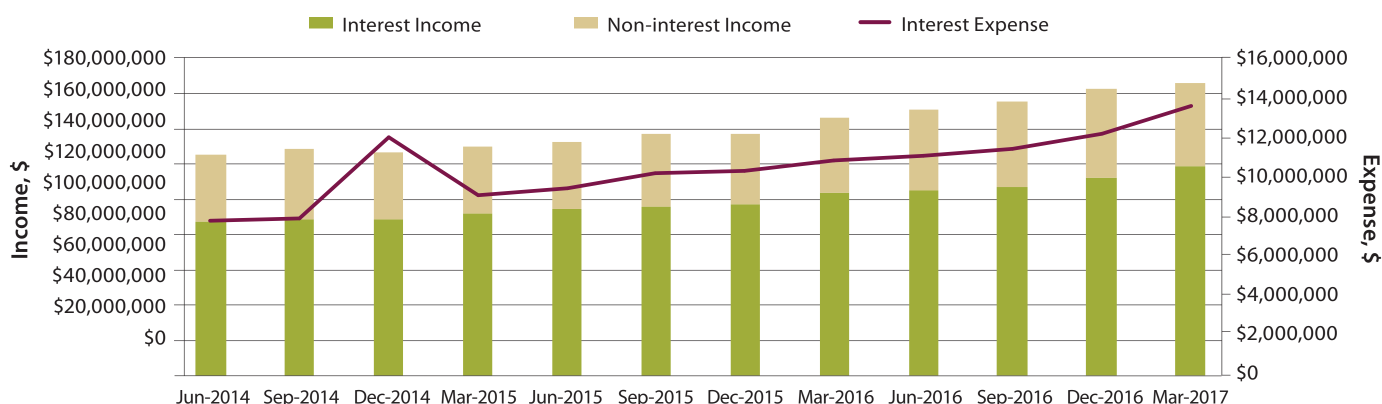
In spite of Federal Reserve interest rate hikes leading to higher short term rates, longer term rates continue to be depressed by geopolitical uncertainty and waning inflation expectations. A flattening yield curve is not necessarily a sign of an economic slowdown, but it is an unwelcome trend for the banks' profits. Banks' main source of income is interest from loans that earn the long-term rates, but banks have to pay short-term rates on the deposits, which are their main source of funds. We can already see the higher short-term interest rates working their way into Sacramento region banks' and credit unions' financial statements, where interest expenses have been rising faster than interest income (see Figures 3 and 4). Credit Unions seem to have a slightly better cushion in the form of noninterest income, but all financial institutions will have to keep their loans growing in order to maintain healthy bottom lines.

Figure 3
Sacramento Region Bank Income vs. Interest Expense, $ in '000



Data Source: FDIC

Figure 4
Sacramento Region Credit Union Income vs. Interest Expense, $



Data Source: NCUA

Capital Markets

In our January 2017 forecast, we sounded a word of caution that cyclical economic stress factors may start to materialize sometime in 2018, and we do not think anything has derailed that sentiment for now. The Federal Reserve Open Market Committee (FOMC) has raised interest rates by 0.5% since our January 2017 release and the broader economy appears to have handled the rising rates fairly well. However, there is still a significant amount of debt, both government and corporate, that will eventually have to be refinanced at higher interest rates, and the result of this refinancing cycle has yet to be seen.

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We have updated Figure 5 with the most recently available data, and one of the key factors we spoke to in our previous issues appears to be coming to fruition. The relatively recent increase in interest rates has spurred companies to invest in capital projects. After having squeezed out all of the returns possible from the capital investment that immediately followed the crisis, companies are now likely investing in more advanced and innovative technologies to achieve higher returns given the increasing cost of capital. If these capital investments are successful, then the current expansionary period may have more room to go; however, if interest rates increase too rapidly, companies will have a hard time keeping pace with the higher interest costs and may have to cut costs elsewhere in the organization, such as personnel, to keep financial statements in check.

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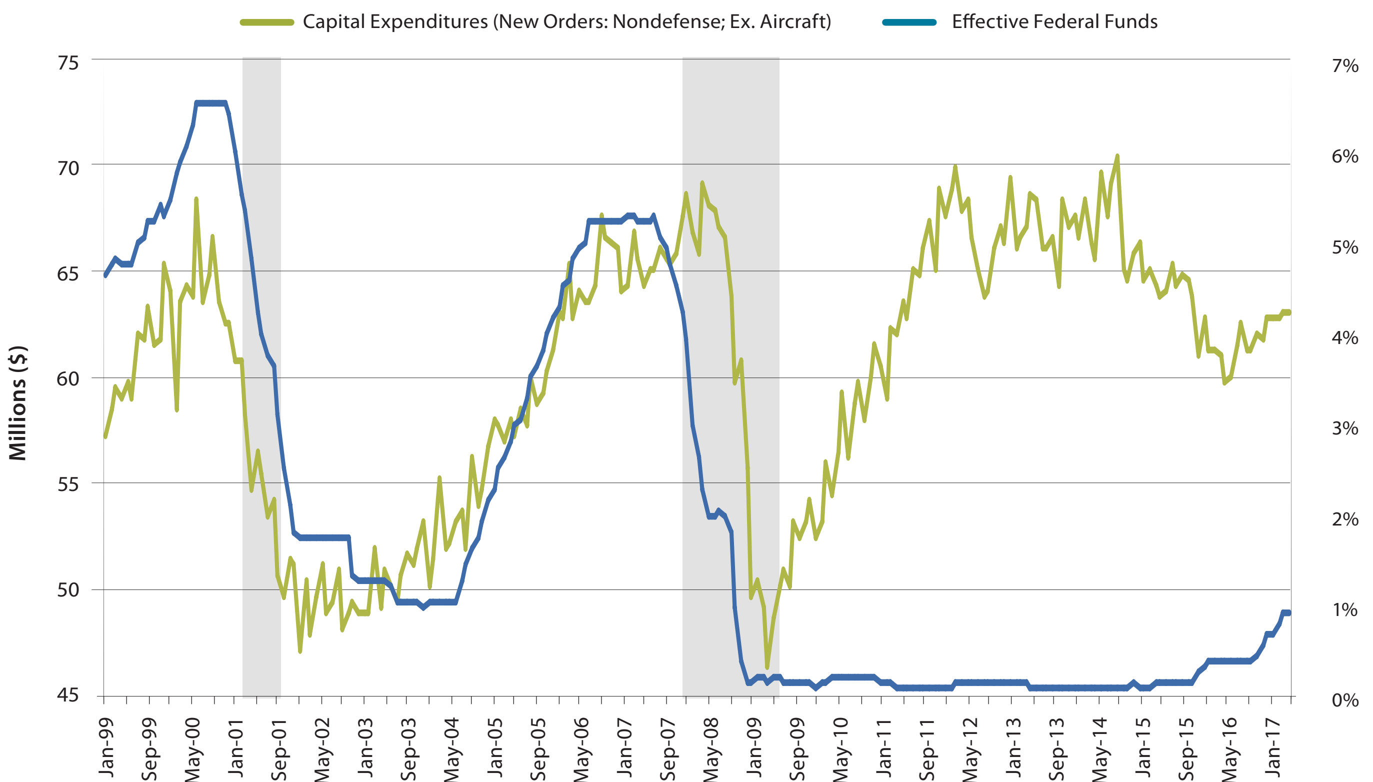
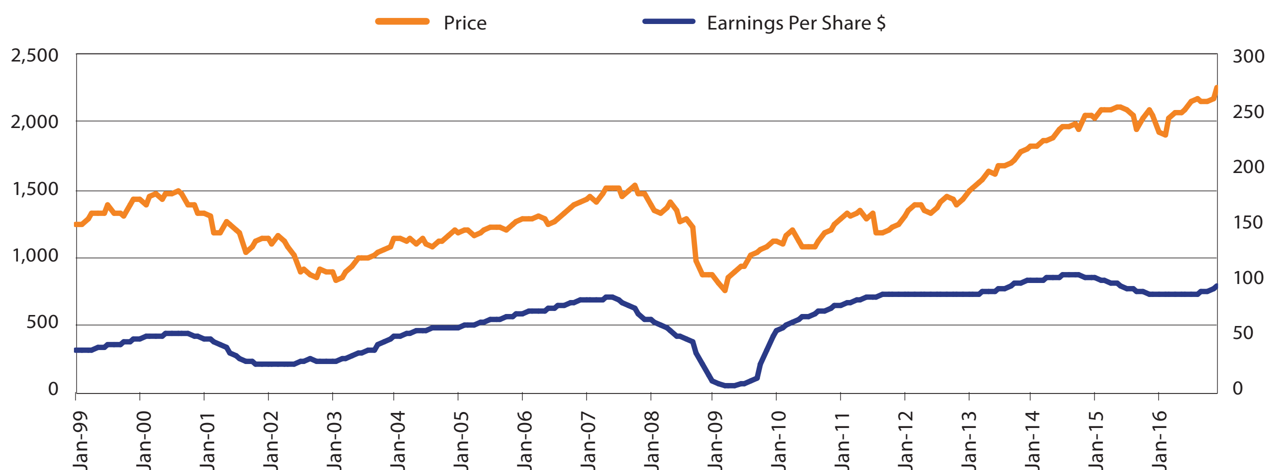
We have also updated Figure 6 with the most recently available data, and not surprisingly, the gap between the price that people are willing to pay for corporate earnings and the actual earnings themselves is at its widest in recent memory. The longer term, cyclically adjusted price-to-earnings ratio (a.k.a. the Schiller P/E) ended July just above 30 and is approaching levels not seen since the Great Depression and tech bubble. It is difficult to see the outstanding business prospects that justify such an outlier of a ratio. What are markets factoring

Figure 5
Interest Rates and Capital Investment



Data Source: U.S. Bureau of the Census

Figure 6
S&P 500 Index and Earnings Per Share



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

in that suggest expected corporate earnings are worth such a high price? Unfortunately, we believe that these high prices have much more to do with central bank stimulus over the last decade than they do with fundamental corporate prospects.

Year to date, the S&P 500 has returned just over 10%, besting our low to mid-single-digit return forecast at the beginning of the year; however, there are just too many looming risks such as North Korea, or the ensuing debt ceiling debate for us to alter our forecast and we reaffirm our projections at the beginning of the year. Annualized Q2 2017 GDP growth of 2.6% is right in line with our 2017 year-end forecast of 2.5%, and longer term Treasuries are yielding less than where they began the year. However, the Federal Reserve's plan to reduce its balance sheet by not reinvesting a portion of its monthly cash flows should put upward pressure on longer term rates once in place. And thus, we will hold fast to our prediction for a quarter-to-half-point increase in longer-term Treasuries by year-end.

Sacramento Business Review Financial Conditions Index

Our proprietary SBR Financial Conditions Index has continued along an expansionary trend. The Q1 2017 downtick was mainly due to seasonal factors for both employment and the housing market. We expect the overall upward trend to continue throughout the remainder of 2017.