SAN JOAQUIN VALLEY

BUSINESS FORECAST REPORT

2015 | Volume V • Issue 1

CALIFORNIA STATE UNIVERSITY
Stanislaus

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Volume V, Issue 1

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We wish to thank Foster Farms for generously providing the endowment for this project.

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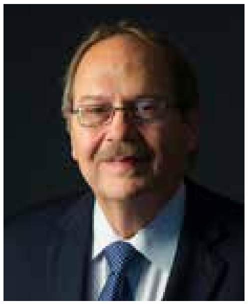

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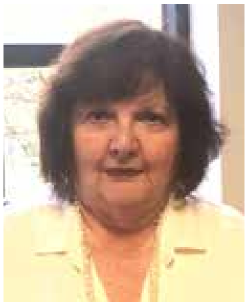

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Executive Summary

The San Joaquin Valley's economy has adapted exceptionally well to the drought.

Total employment in the San Joaquin Valley in 2015 grew by 1.95 percent, higher than the 14-year average rate of 1.19 percent, and exceeding the 1.71 percent growth of 2014. Projections point to 1.67 percent annual total employment growth in 2016 and 2017.

Unlike previous years, employment grew in all counties at varying speeds. Fresno County's employment growth was the fastest in 2015, followed by Merced, San Joaquin and Tulare counties. Stanislaus and Kings counties grew at speeds close to the Valley average, while employment growth in Madera and Kern counties was much slower relative to the historic average and to their neighbors.

The drought has underscored the essential need to increase water storage capacity in the Valley. But even as storage systems have threated to go dry, above-average employment growth has been the rule in all previous drought years. Individual counties – Madera, for example – reported employment declines in some drought years. Had there been no drought, employment levels in the Valley undoubtedly would have grown faster.

"In all, economic growth in 2015 further demonstrated the Valley's adaptability to the four-year drought."

As overall employment gained, the sectors that previously paced the growth no longer led the charge. For the first time since the recession, construction was no longer the Valley's leading category of employment growth, falling from 4.65 percent in 2014 to 3.08 percent in 2015. Trade, transportation and utilities employment registered 5.01 percent growth to outpace all sectors. Financial activities employment, a suffering area of growth since the recession, rebounded in 2015. The Valley's manufacturing employment outperformed state and national averages. Incoming actual values for 2015 mostly fell between the optimistic and most likely projections, providing ample evidence that the forecasts tended to be more realistic than optimistic in nature.

The increase in Valley home prices remained above the long-run average, but was not as strong as in recent years, and projections point to a further decline in growth in 2016 and 2017. A similar pattern is expected for single-family housing permits. One area to watch is the 30-year Freddie Mac interest rate, which would be expected to increase should the Federal Reserve follow through with its anticipated interest rate hike in 2016.

The continued appreciation of the U.S. dollar deepened the trade deficit and hurt Valley exports. While consumers benefitted from the lower prices for imported goods, the stronger dollar made Valley exports less competitive in international markets.

The yearly inflation rate of 1.0 percent was heavily influenced by the absence of cost (push) factors and weak demand (pull) factors, combined with the low price of gasoline and other fuels. The low rate also deterred the Federal Reserve from raising interest rates, given the Fed's mission to achieve and maintain price stability.

With the labor market tightening relative to recent years, average weekly wages trended upward and are expected to continue on that path in the next two years, outpacing inflation. The tighter labor market also led to an increase in attrition and job turnover.

Vibrant retail activity, combined with the growth in total employment, resulted in a growth in the Valley's total bank deposits. Accruals maintained their lowest levels in eight years, while foreclosure starts were minimal relative to recession years. Increases in net loans and leases kept pace with the boost in bank deposits and were at the highest levels since the end of the recession.

In all, economic growth in 2015 further demonstrated the Valley's adaptability to the four-year drought. Aside from the risks emanating from the dollar's appreciation and other associated elements of the external account, as well as the political risks in the Middle East, Russia and China, projections point to further growth in 2016 and 2017.

Introduction

This report assesses the past, current and future business trends in the San Joaquin Valley relative to the state and the nation. Time series data spans from January 2001 to August 2015. Two-year medium-term forecasts span from September 2015 to December 2017. The yearly average figure for 2015 is from the first eight months of the year including preliminary values for August, whereas the figure for 2014 is from the full 12 months.

The remainder of this report is structured as follows: Section B provides a discussion of San Joaquin Valley labor market conditions; Section C reports the region's real estate market; Section D reports prices and inflation; and Section E reports banking and capital market indicators.

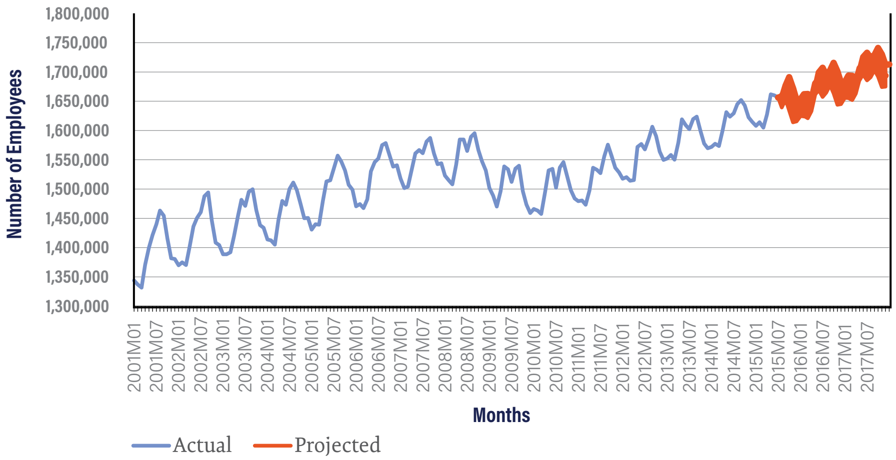
Employment Indicators

Valley total employment, despite the drought's four-year impact, posted higher growth numbers in 2015 than 2014. Unlike 2014, employment numbers grew in all counties, albeit at varying intensities. Fastest growth occurred in Fresno County, with employment growing 2.90 percent in 2015, followed by 2.33 percent growth in Merced County. San Joaquin, Stanislaus, Kings and Tulare counties grew at rates close to the Valley average, while Madera and Kern counties posted the least yearly growth. ▶

As predicted in previous reports, Valley total employment exceeded 1.65 million in 2015, and is on route to reaching 1.70 million by the first half of 2017. Oceans limit California's westward growth. The only direction California can grow is eastward. Thus, regions such as the San Joaquin Valley are situated at an advantageous position, offering abundant land, labor and capital. However, future expansion in these regions means finding ways to store more water to sustain both agriculture and urban growth. Without finding sustainable ways to store more water to meet increasing demand, the Valley's economic development would be more difficult. ▶

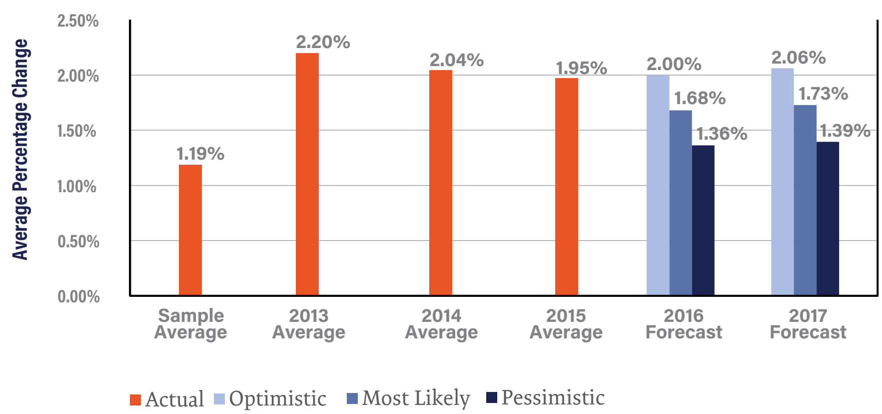
Construction employment had recorded the fastest growth in employment year-after-year since the end of the recession, but this dynamic changed in 2015, when trade, transportation and utilities employment surpassed construction as the fastest category of employment in the Valley. Unlike previous years, construction employment posted the fourth-fastest growth. Financial activities employment halted its decline since the end of the recession and posted growth in 2015. Manufacturing employment growth in the Valley performed better than the state and national averages in the same category. Retail trade employment posted another year of strong growth relative to the wholesale trade employment.

Total Employment



As of the third quarter of 2015, Stanislaus County had the lowest unemployment rate in the Valley at 8.5 percent, followed by Fresno and San Joaquin counties at 8.9 percent and 9.1 percent, respectively. Tulare County had the highest unemployment at 12.0 percent. The Valley's average rate of unemployment during the same quarter was 10.07 percent, significantly down from the previous years.

Total Employment:
Historical vs. Projected Average Yearly Growth



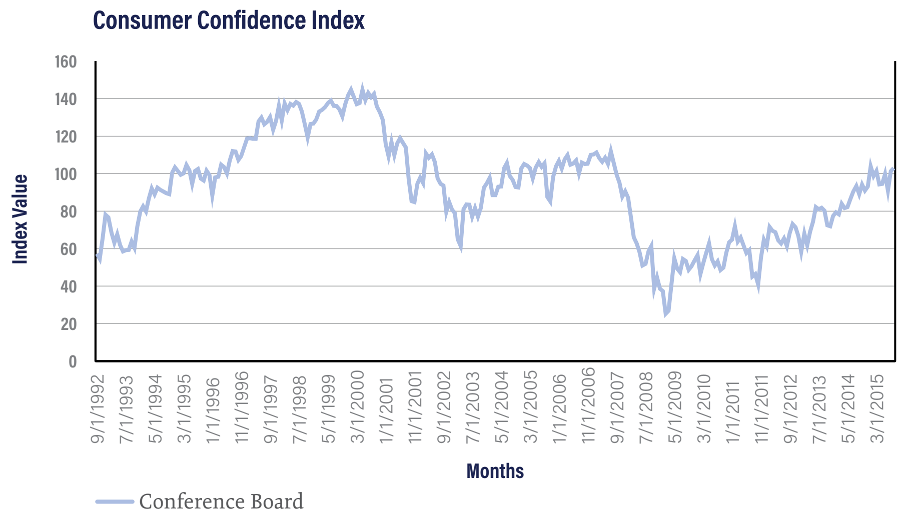
In 2015, Valley total employment grew 1.95 percent. Considering the series' sample benchmark growth is 1.19 percent, 2015 employment growth was quite significant when factoring the drought's negative impact. Projections point to 1.68 percent average yearly growth in 2016 and 1.73 percent in 2017.

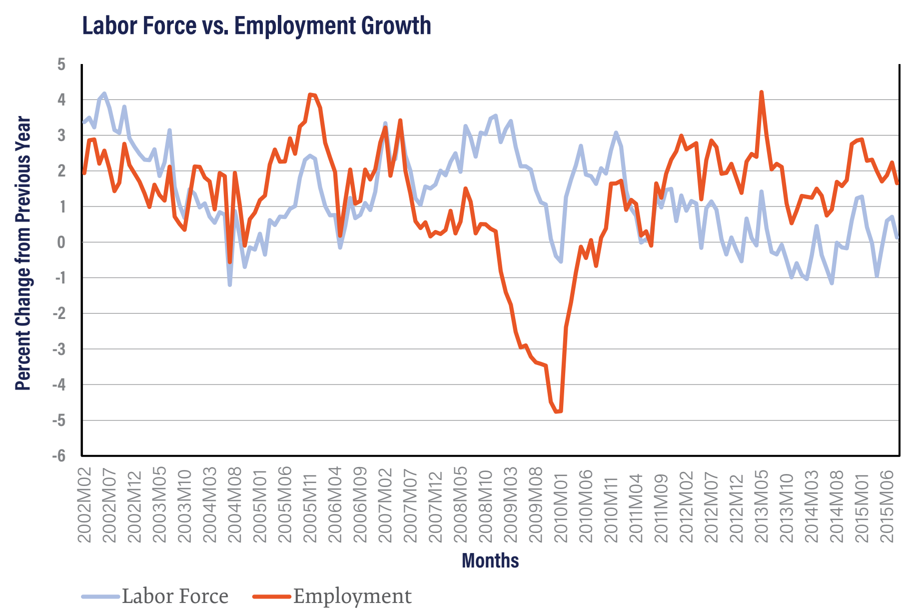
After rising above 80 points in 2014, consumer confidence kept its increasing pattern until the first quarter of 2015, after which the series exhibited a flat pattern, then fell to 91 points in July from 103.8 in January. The incoming index following July, however, showed that consumer confidence was poised to increase further as the index posted 101.3 and 103 for August and September, respectively. ▶

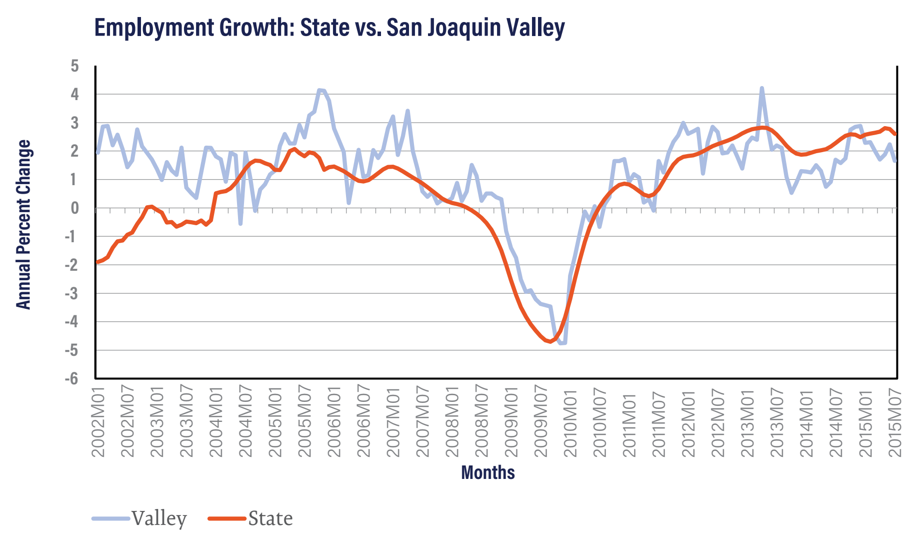
The Valley's employment continued to grow faster than the labor force. Faster employment growth puts upward pressure on wages and salaries. From a structural standpoint, in areas like the Valley, labor force growth normally would exceed employment growth. However, since 2011, the discrepancy between employment and labor force growth has seemed to stay constant. With demand for labor growing faster than supply, the price of labor would increase. This indeed is the case for the Valley economy as upward wage pressures build up. Average weekly wages have increased more than the inflation rate, allowing the Valley consumers to enjoy more purchasing power. ▶

> **"Average weekly wages have increased more than the inflation rate, allowing the Valley consumers to enjoy more purchasing power."**

In the fourth quarter of 2014, the Valley's employment growth briefly exceeded that of the state, as would be expected from a regional economy that has plenty of room for growth. This was the first time since the second half of 2013 that the Valley's employment growth exceeded the state's employment growth. The drought certainly had a role to play in forming such an unusual pattern. In the next two years, however, labor force growth should exceed employment growth in the Valley consistent with the structural pattern observed in the past during expansionary phases of the business cycle. ▶

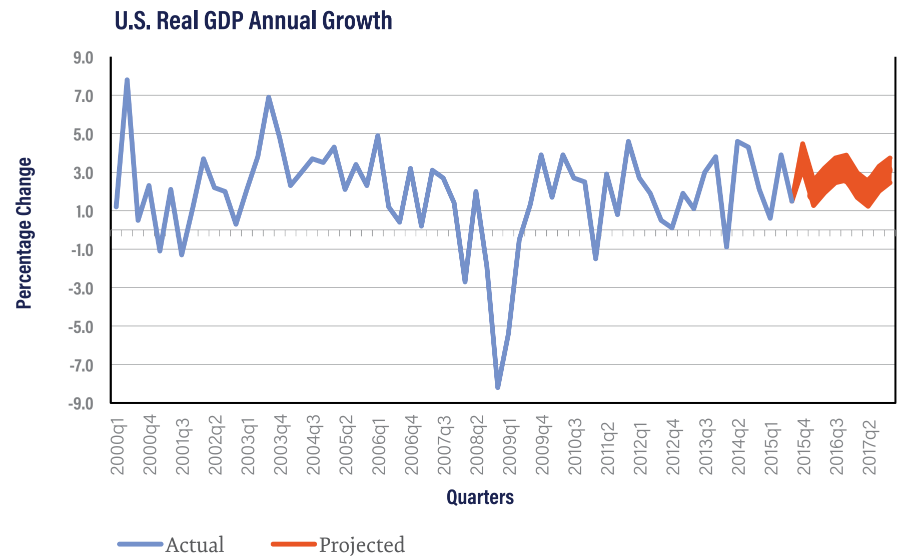






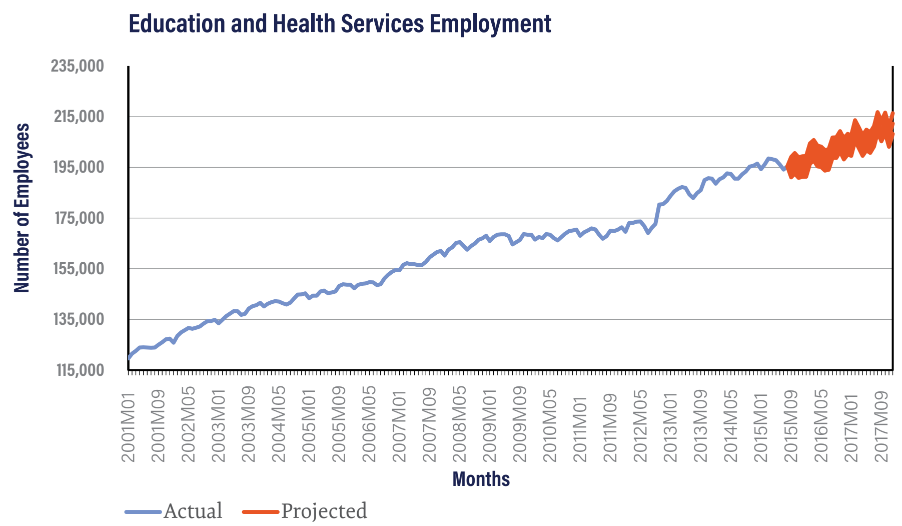
Employment Indicators

When the very long-run business cycles had begun to reverse, capital flew from emerging markets back to the United States. As a consequence, emerging markets began to suffer. The continuously appreciating dollar had a negative impact on the international competitiveness of domestically produced goods. As a result, the worsening trade balance took a greater bite of the U.S. gross domestic product, lowering real economic growth ▶ forecasts. A struggling manufacturing sector also had an impact on the real economic growth forecasts. Nationwide, the industrial production index began to decline during the first quarter of 2015. Projections for 2016 and 2017 now point to 2.56 percent average annual growth in real economic growth.

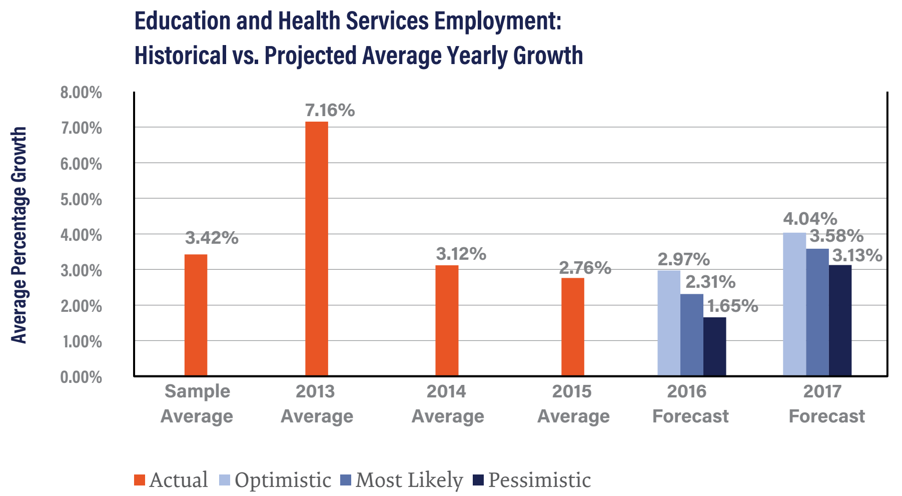


“The continuously appreciating dollar had a negative impact on the international competitiveness of domestically produced goods.”

Education and health services employment ▶ in the Valley exceeded 195,000 in 2015 despite the slowdown in growth over the previous years. It took only two and a half years to gain 20,000 jobs in the sector – the fastest such increment growth observed since 2001. Projections show that it will take only two years for the next 20,000 increment increase, an even faster rate of growth than the one observed from July 2012 to January 2015. Employment growth in education and health services in the Valley has been quite robust, even increasing, albeit at a slower rate, during the recessionary years.



The sample benchmark growth rate ▶ of the Valley's education and health care services employment is 3.42 percent. Employment growth in 2015 was less than the benchmark rate, increasing at an average yearly rate of 2.76 percent. Yearly growth in

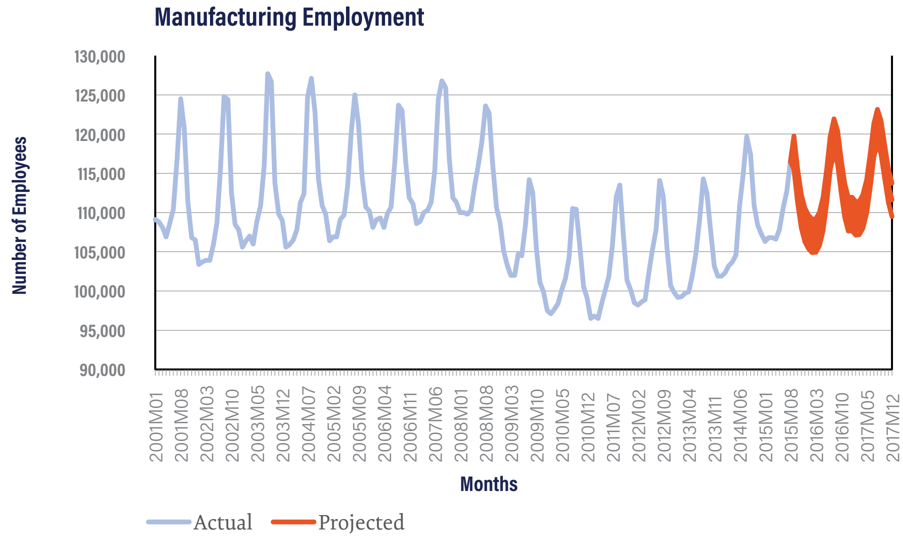


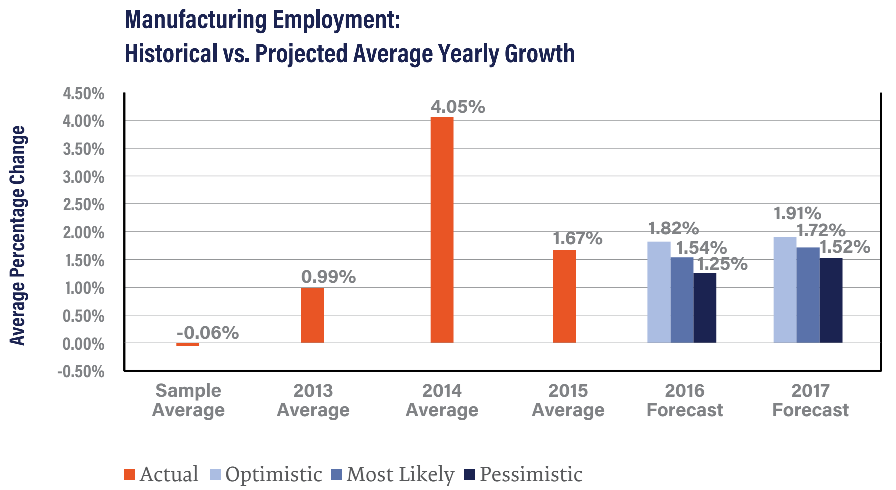
education and health services employment in the next two years is projected to hover around 2.94 percent.

The trend line formed post-recession began to steepen as new numbers arrived in 2015. Valley manufacturing employment ▶ performed better than the nationwide trends, posting 1.67 percent yearly growth, significantly better than the sample benchmark average of -0.06 percent. Distribution centers in Patterson and elsewhere contributed to the Valley's manufacturing activity in 2015. Manufacturing employment had exceeded 120,000 before the recession. Projections show that employment in this category will reach the same numbers by the third quarter of 2017.

The 10-year benchmark growth ▶ in manufacturing employment will switch from negative to positive territory in 2016. Distribution centers such as Amazon, serving as a magnet, will continue to attract others to relocate in the Valley. Manufacturing companies increasingly are becoming aware of the Valley's cheap labor and abundant land when considering relocating in the Valley. Projections point to 1.54 percent average yearly growth in 2016 and 1.72 percent in 2017.

Weakness in nationwide manufacturing can be depicted from the Institute of Supply Management's purchasing managers index. After reaching 60 points in July 2014, well above 50 points, the required minimum level for economic expansion, the index began to decline steadily. As of August 2015, the index stood at 51.1 points. Any further decline in the index would correspond to contraction in the national economy. National manufacturing employment grew 1.4 percent in 2015. Statewide, growth in this category of employment was only 0.31 percent. The Valley performed better than the state and national average in manufacturing activity. ▶



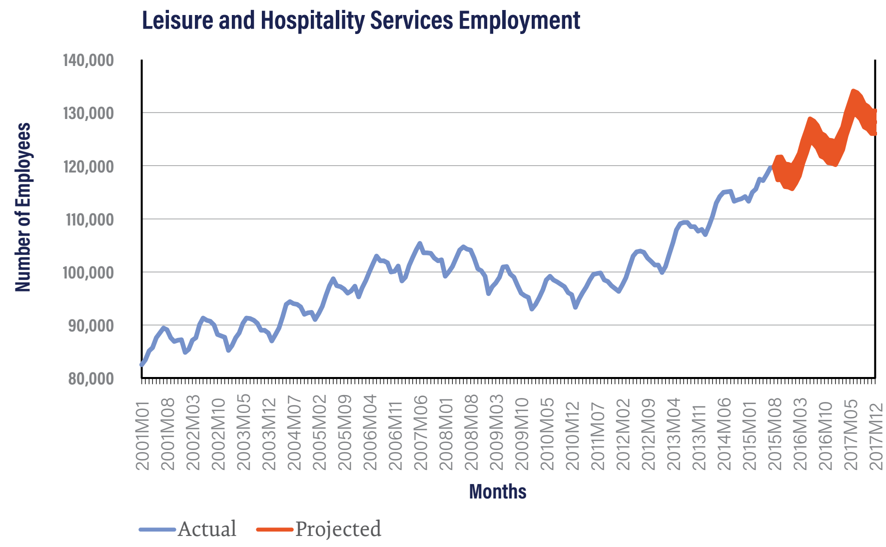


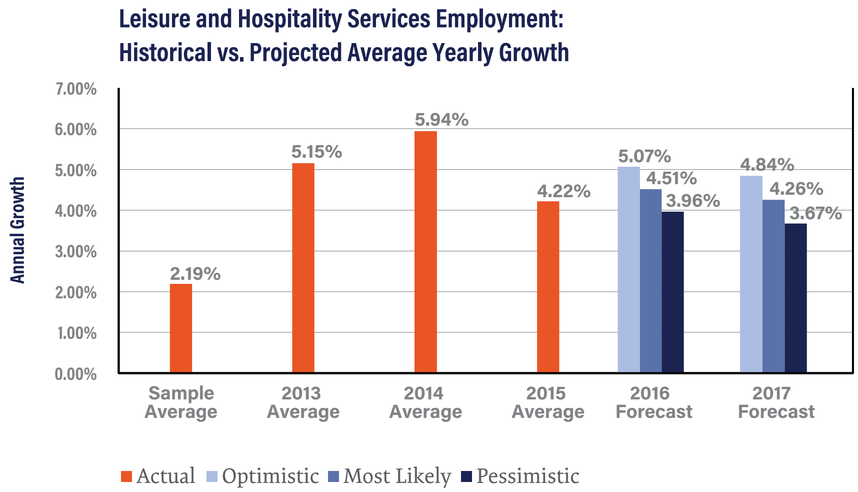
Employment Indicators

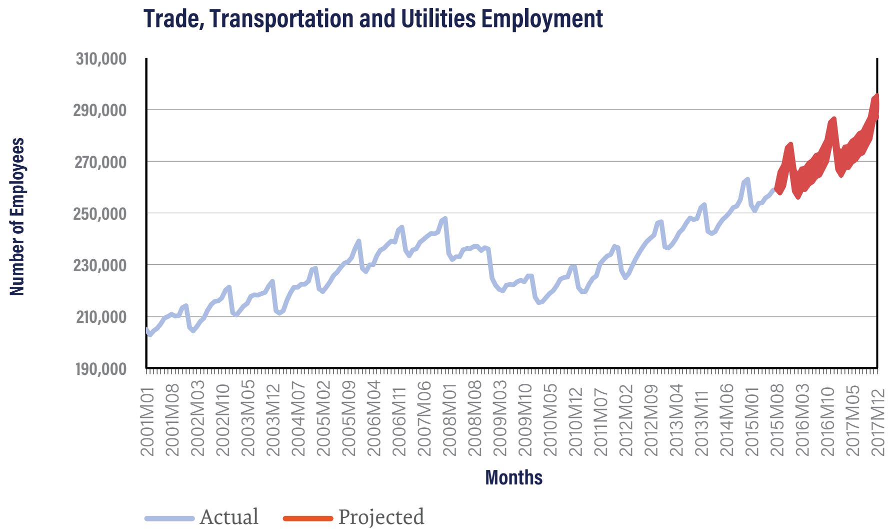
Leisure and hospitality services employment in the Valley reached 120,000 in 2015 and is projected to reach 130,000 by the second half of 2017. The trend that has formed post-recession is now the steepest since 2001. ▶ Leisure and hospitality services employment was the second-fastest-growing category of employment in 2015, surpassing construction employment, which had led all categories of employment since the end of recession. Leisure and hospitality services employment's 4.22 percent growth in 2015, although less than 2014, still was high enough to exceed all other categories of employment except trade, transportation and utilities.

The fastest growth in leisure and hospitality services employment occurred in 2014 at 5.94 percent, while the 2015 growth ▶ was at 4.22 percent. Growth in previous years was significantly greater than the series' sample benchmark growth of 2.19 percent, underscoring robust employment in this sector. Such strong performance year-after-year classifies the leisure and hospitality services employment as another category of employment in which the Valley now maintains a competitive advantage. Projections in this category of employment point to an annual average growth of 4.51 percent in 2016 and 4.26 percent in 2017, about the same pace as in 2015.

Trade, transportation and utilities employment climbed from being the third-best-performing category of employment in 2014 to the fastest-growing category in 2015. Employment growth continued to display a steeper trend post-recession. Trade, transportation and utilities is one category of employment in which the Valley has a competitive edge. The year 2015 was exceptional for this category of employment, growing at three times the series' sample benchmark rate of 1.55 percent. ▶







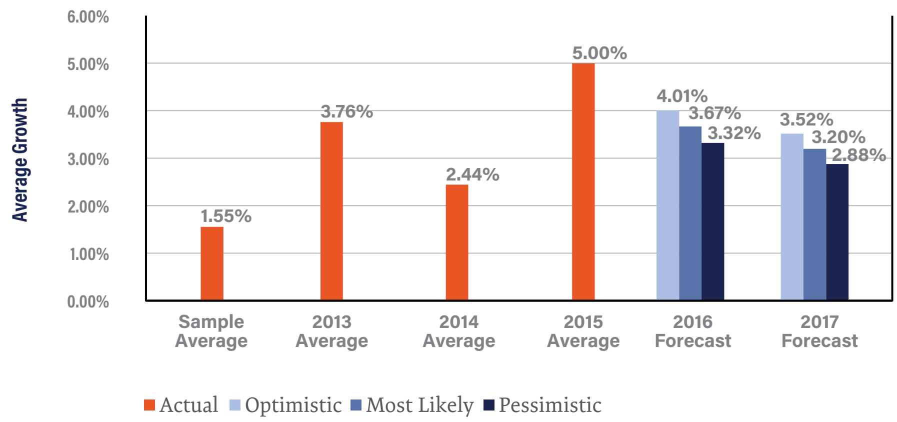
Projections point to slightly slower growth in the next two years, more in line with the structural growth rate. However, strong growth in this category of employment will continue into 2016 and 2017. Trade, transportation and utilities employment is projected to grow at 3.67 percent in 2016 and 3.20 percent in 2017 as other costs associated with this sector, such as the price of oil, begin to rise. ▶

Retail trade employment continued to perform strongly in 2015. Each year, growth in this sector was more than the sample benchmark growth rate of 1.55 percent. This was not an exception in 2015. In fact, growth in retail activity is visible to the eye in almost every city in the Valley. The post-recession trend continues to remain steeper than what prevailed before the recession. Employment in this category likely will reach 160,000 by the first half of 2017. ▶

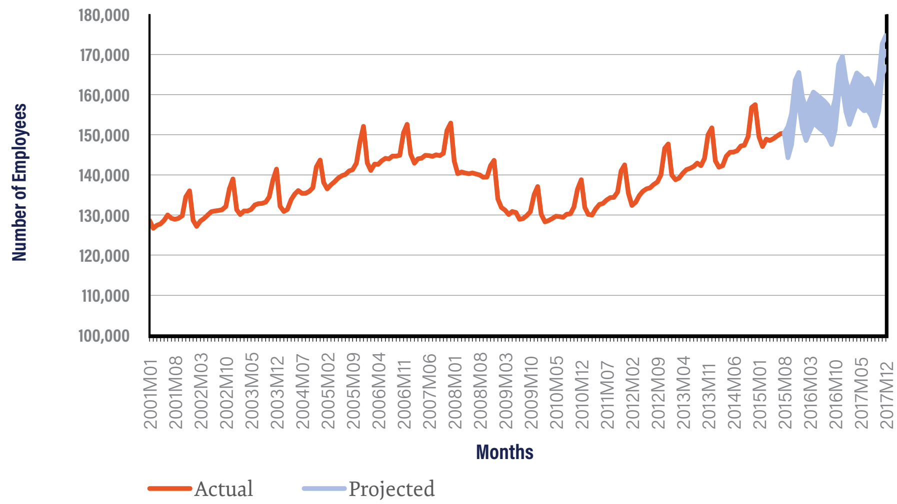
> **"...growth in retail activity is visible to the eye in almost every city in the Valley."**

Retail trade employment grew slightly faster in 2015 than 2014. In the coming two years, average annual growth in this category will continue to remain above 3.0 percent. The diversity of retail establishments also is widening, permitting Valley consumers to enjoy greater choices than before. The Valley now faces increased competition among retail establishments, which benefits consumers in the form of lower prices and higher quality. Projections point to growth of 3.33 percent in 2016 and 3.04 percent in 2017. ▶

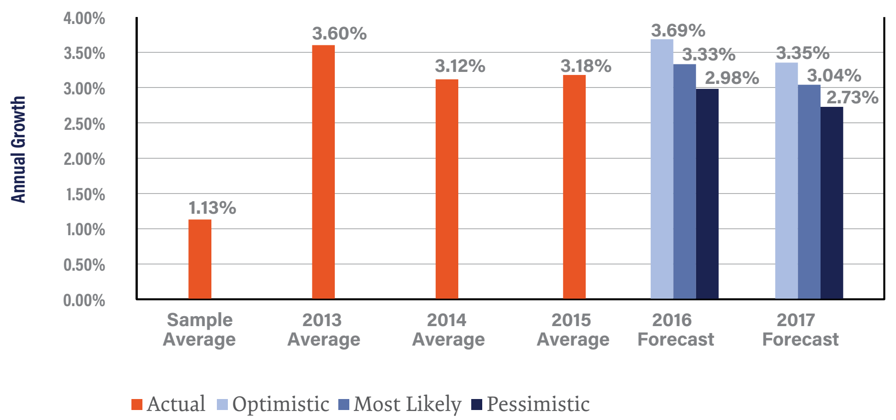
Trade, Transportation and Utilities Employment: Historical vs. Projected Average Yearly Growth



Retail Trade Employment



Retail Trade Employment: Historical vs. Projected Average Yearly Growth



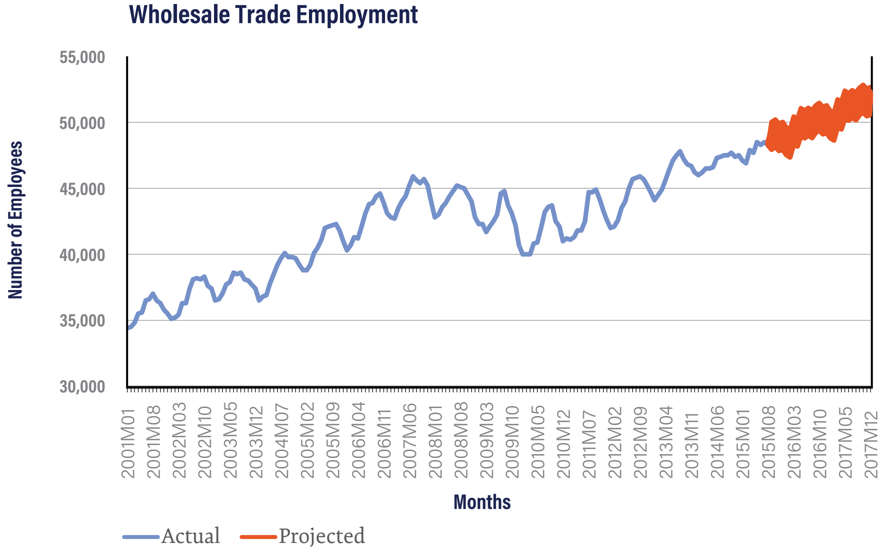
Employment Indicators

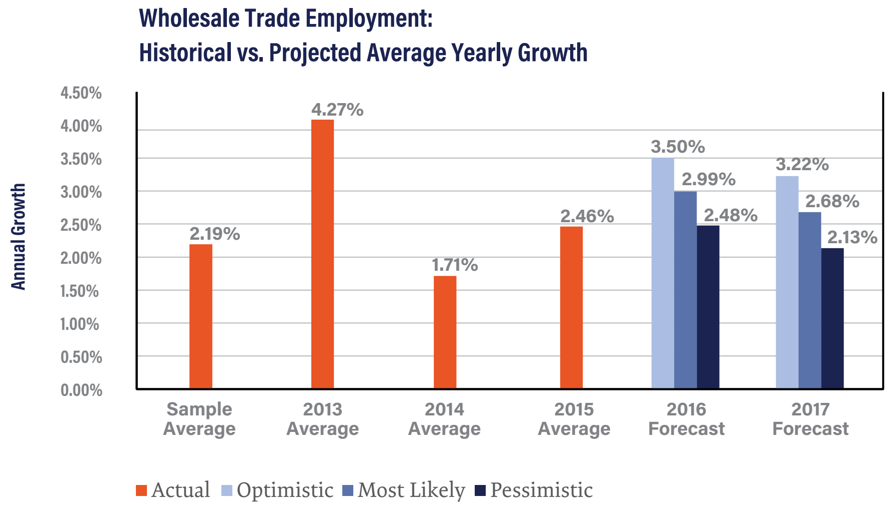
Wholesale trade employment was the fifth-fastest-growing category of employment in 2015. Employment in this category is projected to reach 50,000 by the first quarter of 2017. Wholesale trade employment grew less than retail trade employment in 2015. From a structural standpoint, however, wholesale trade employment normally grows faster than the retail trade employment. Because of the negative impact of drought, the picture was reversed. Farm-related wholesale trade employment performed less than retail trade employment.

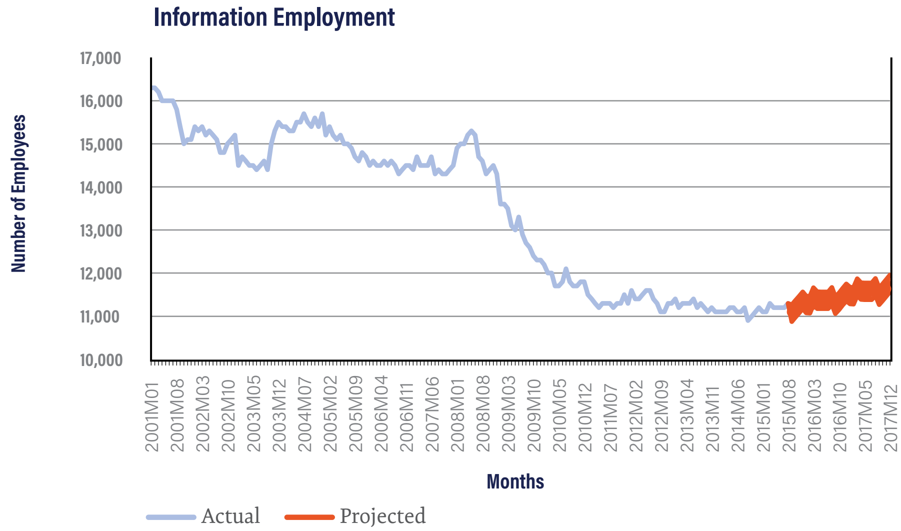
> **Wholesale trade employment grew less than retail trade employment in 2015.**

At 2.46 percent, wholesale trade employment grew faster in 2015 than the previous year, during which the average yearly growth was only 1.71 percent. The fastest growth in the last three years occurred in 2013, when the series posted a 4.27 percent average yearly growth. The growth in 2015 however, was slightly above the series' sample average yearly growth rate of 2.19 percent. Given these oscillations, wholesale trade employment is projected to grow at a yearly average rate of 2.99 percent in 2016 and 2.68 in 2017.

As predicted in previous reports, growth in information employment switched from negative to positive territory in 2015. The turning point that occurred in the third quarter of 2014 now appears to be permanent. Information employment most likely will reach 11,500 in the Valley by the third quarter of 2016 as back-to-back declines of previous years are replaced by improvements in this category. The hyperbolic pattern that has existed in the past is now replaced by steepening trend following the fourth quarter of 2014.





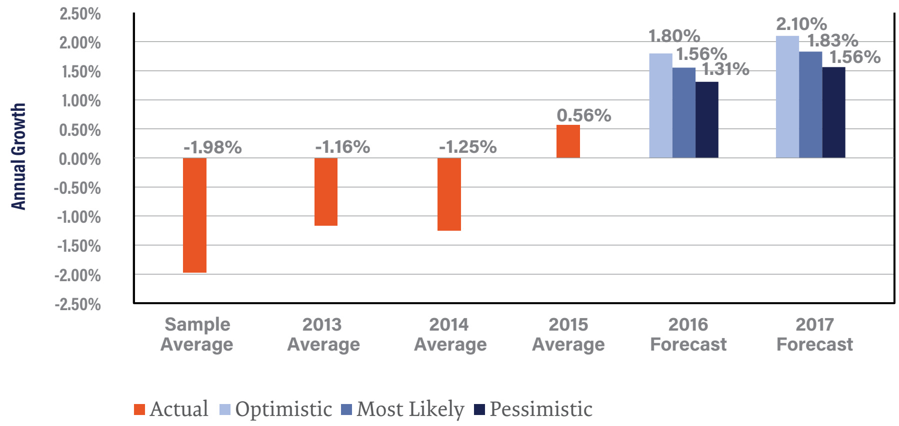


When compared with the sample benchmark growth rate of -1.98 percent, the 0.56 percent growth registered in 2015 appears to be quite significant. Further, the two previous years also posted significant declines at -1.16 percent and -1.25 percent, respectively. Information employment ▶ had been continuously declining since 2008, with the exception of 2015. To observe such a turning point becoming now permanent is encouraging for future growth. Given this turn of events in information employment, projections point to more significant growth at 1.56 percent in 2016 and 1.83 percent in 2017.

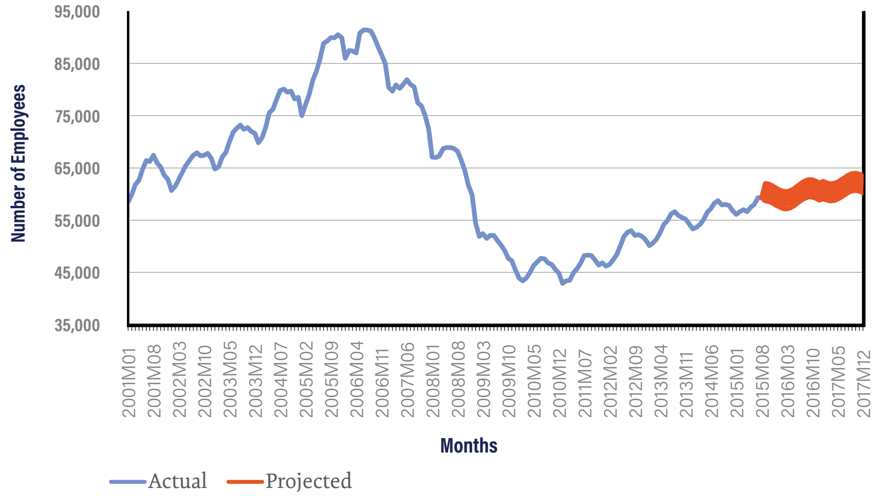
Until 2015, construction employment ▶ was the fastest-growing category of employment in the Valley. Construction employment, however, fell from 4.65percent growth in 2014 to 3.08 percent in 2015. When compared with post-recession activity, the Valley's overall construction employment growth is now displaying much more subtle growth. Noteworthy is the dispersion in growth by county. Kern County reported a -3.68 percent decline in construction employment, while Tulare and San Joaquin Counties reported 16.50 and 10.46 percent average yearly growth, respectively. Nationwide, construction employment increased 4.39 percent in 2015. The increase in construction employment statewide was 6.73 percent.

An active rental market and limited supply puts upward pressure on rents. At the same time, higher demand for rentals means ▶ demand for buying homes is relatively low. Projections point to 2.83 percent average yearly increase in construction employment during 2016 and 2.21 percent during 2017.

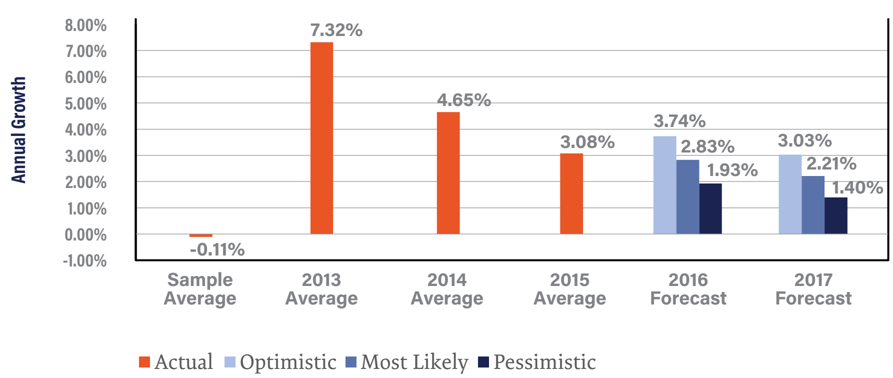
Information Employment:
Historical vs. Projected Average Yearly Growth



Construction Employment



Construction Employment:
Historical vs. Projected Average Yearly Growth

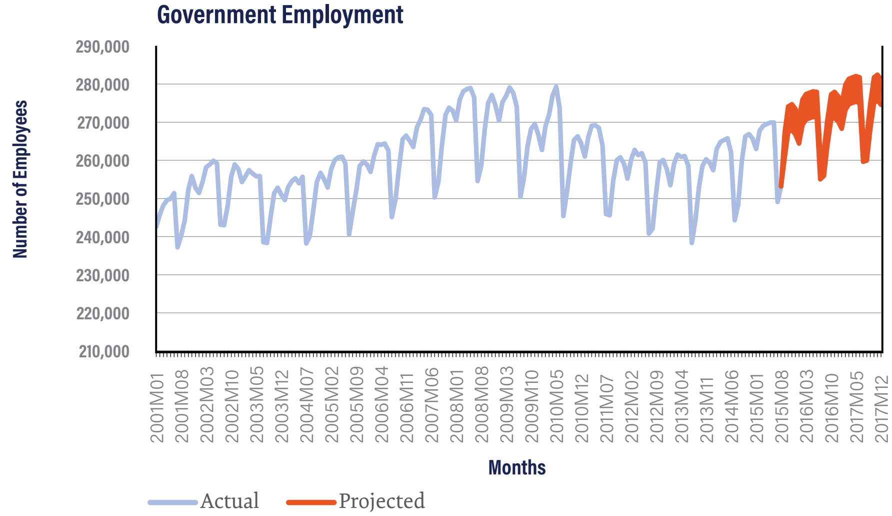


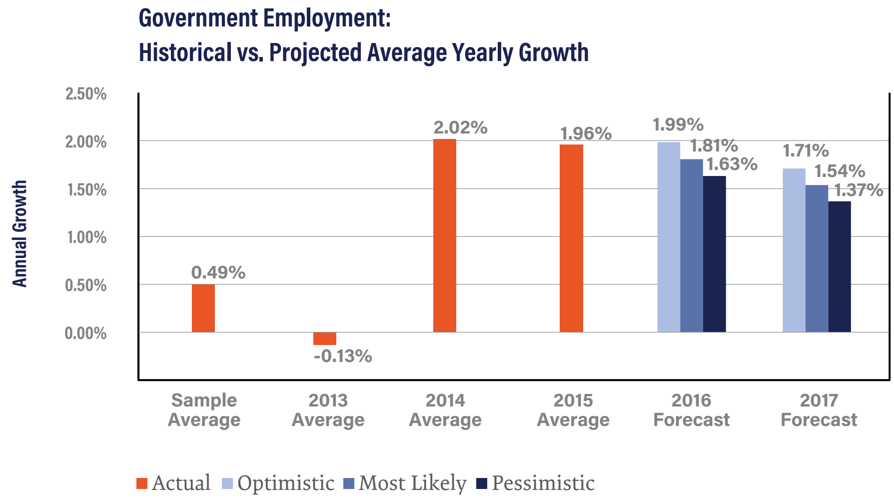
Employment Indicators

Government employment grew in 2015 at about the same rate as the previous year. Employment in this category is projected to reach pre-recession levels by the second half of 2017, totaling 280,000 for the Valley. As such, government employment carves up a larger chunk of total employment at about 17.1 percent. Thus, government employment and spending is one of the main drivers of the Valley economy. ▶

> **"...government employment and spending is one of the main drivers of the Valley economy."**

The post-recession trend in government employment is almost identical to the trend that prevailed before the recession. Although many categories of employment completely recovered after the recession, exceeding employment levels that existed before the recession, this is not the case for government employment, which in the Valley is deficient by about 20,000. Government employment is projected to grow 1.81 percent in 2016 and 1.54 percent in 2017. ▶



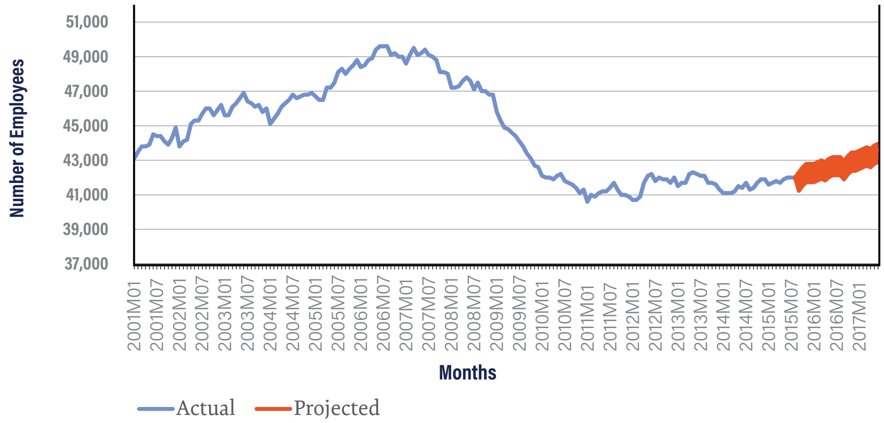


The decline in financial activities employment came to a halt in 2015 when the series posted a 1.30 percent average yearly growth. When compared with previous years, 2015 growth was quite significant. Financial activities employment was the only category of employment that continued to suffer since the end of the recession. Given the growth in 2015, employment in this category does not appear to be suffering any longer. The turning point that has formed in 2015 seems to be permanent. Employment in this category most likely will reach 43,000 by the first quarter of 2017. ▶

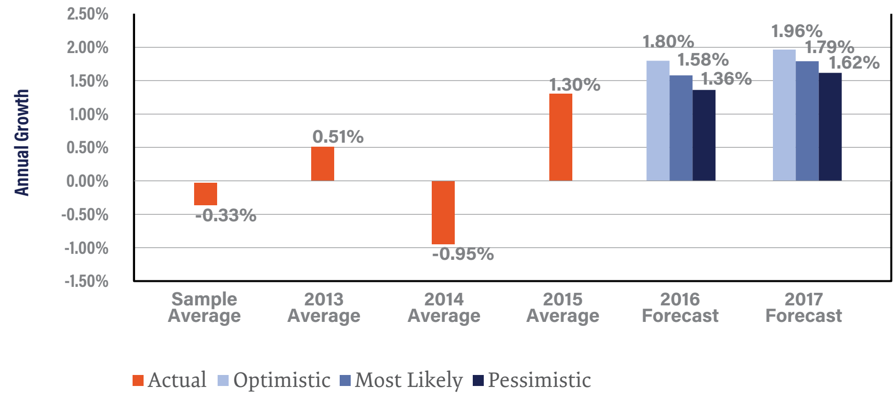
The sample benchmark yearly growth rate of the series still remains negative at -0.33 percent. In 2013, financial activities employment grew at a very trivial rate of 0.51 percent, then in 2014 posted a decline at -0.95 percent. When compared with these rates, the 1.30 percent growth in 2015 was noteworthy. Projections point to faster growth in financial activities employment at an average rate of 1.58 percent in 2016 and 1.79 percent in 2017. ▶

Valley total employment grew faster in 2015 than the previous year. Unlike 2014, all counties grew, but at varying speeds. Fresno County employment grew the fastest. Merced County no longer led employment growth in the Valley, posting the second-fastest growth. Madera and Kern counties grew the least. Stanislaus and San Joaquin counties grew at about the Valley average. Construction no longer was the leading category of employment in 2015, being surpassed by leisure and hospitality services. Construction fell from the first to the fourth spot among all other categories of employment growth. Financial activities employment was the only category of employment that had continued to suffer since the end of the recession, but it posted significant growth in 2015, therefore ending the classification as a suffering category of employment. All categories of employment grew in 2015.

Financial Activities Employment



Financial Activities Employment: Historical vs. Projected Average Yearly Growth



Housing Sector

The Valley aggregate for single-family building permits is composed of the eight Metropolitan Statistical Areas (MSAs) of the San Joaquin Valley: Bakersfield-Delano, Fresno, Hanford-Corcoran, Madera-Chowchilla, Merced, Modesto, Stockton and Visalia-Porterville.

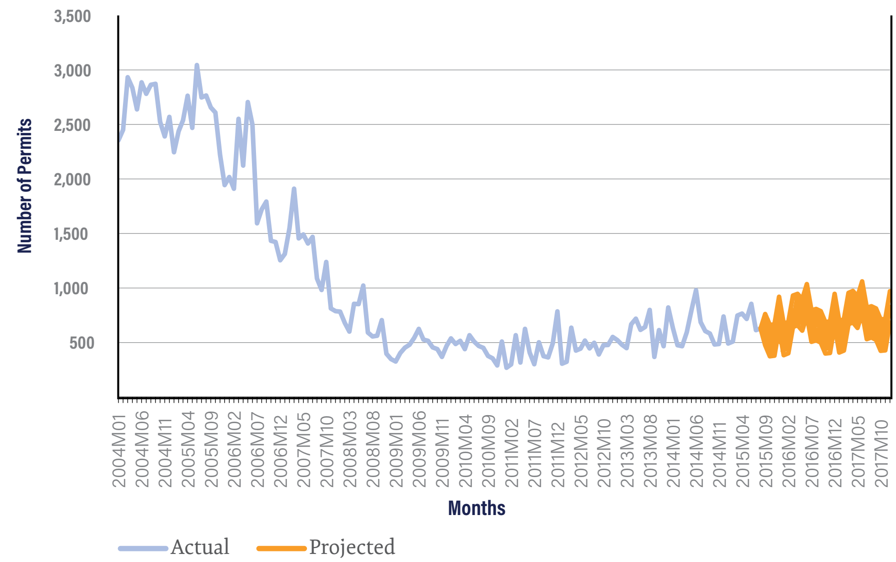
Fresno led the Valley with the most housing permits issued in 2015, totaling 1,414, followed by Bakersfield-Delano and Stockton at 1,114 and 974 newly issued housing permits, respectively. Hanford-Corcoran had almost no housing permits issued, while Modesto and Merced had only 31 and 50 newly issued permits, respectively, by August 2015. Valley-wide, single-family building permits stayed mostly above 500 per month. There were 4,543 Valley permits issued by August 2015.

At 5.66 percent in 2015, the growth in housing permits was almost identical to the 5.78 percent increase in 2014. These single-digit rates reflect sustainable growth, as opposed to the 33.51 percent spike in 2013. Because interest rates are expected to increase in the near term, growth in Valley housing permits is projected to be lower than the previous two years. Projections point to 5.25 percent and 3.87 percent growth in 2016 and 2017, respectively.

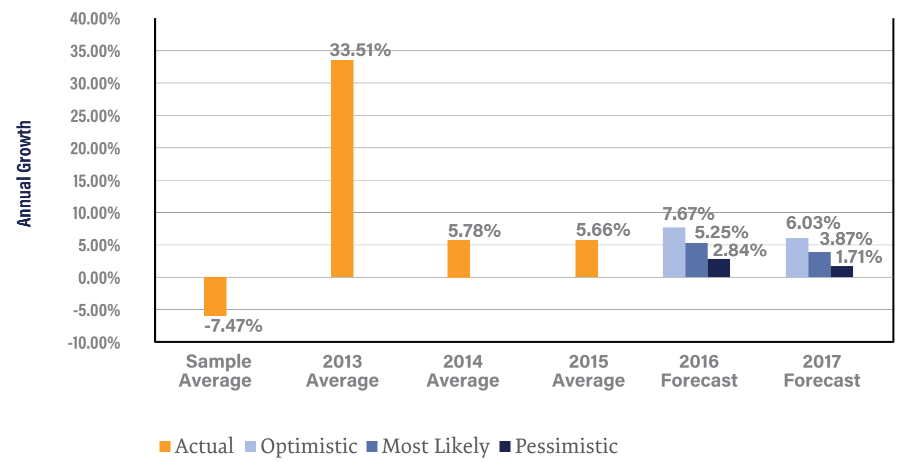
Foreclosure starts are at their lowest occurrence since 2005. The increase that occurred in the fourth quarter of 2014 turned out to be only temporary, as foreclosure starts in the following quarters continued to decline in response to the drop in long-term interest rates. Low interest rates that have continued to prevail since the end of the recession have caused foreclosure starts to decline year-over-year. Given the expected increases in interest rates, however, foreclosure starts are expected to rise only slightly from their new lows, not to reach the exceptional levels of the recession years.

The Freddie Mac 30-year fixed rate fell below 4.0 percent in the summer of 2014 and stayed low until the end of the second quarter of 2015. In the summer of 2015 the market's expectation of a hike in interest rates negatively affected U.S. stock markets, which

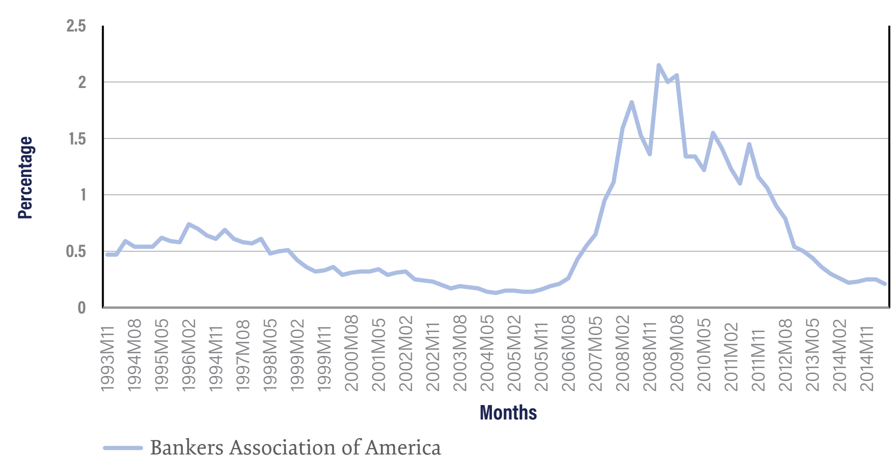
Single Family Building Permits



Single Family Building Permits: Historical vs. Projected Average Yearly Growth



Foreclosure Starts in California



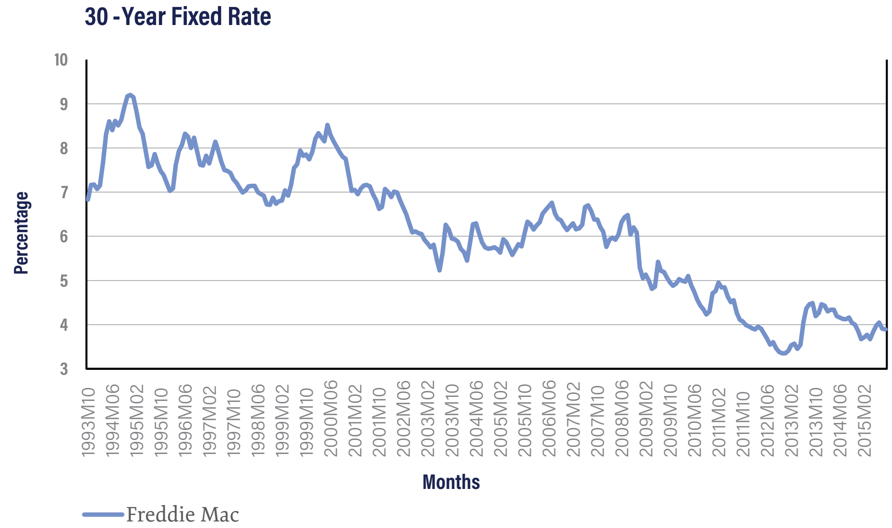
August 2015 as those worries were coupled with concerns about a recession hitting China and other emerging markets. ▶

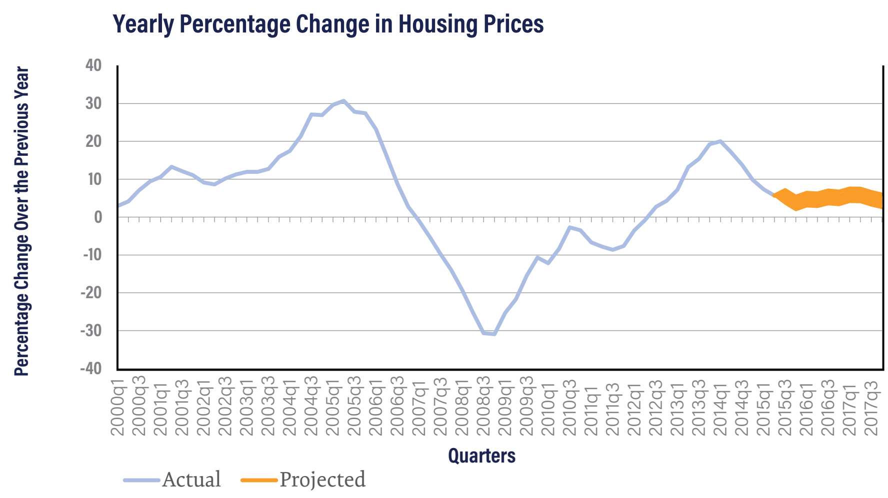
The Federal Reserve's ultimate objective is price stability. Maintaining stable prices minimizes business uncertainty and as a result investors can look to the future and make investment plans. This, in turn, creates a positive business environment that leads to maximization of economic growth.

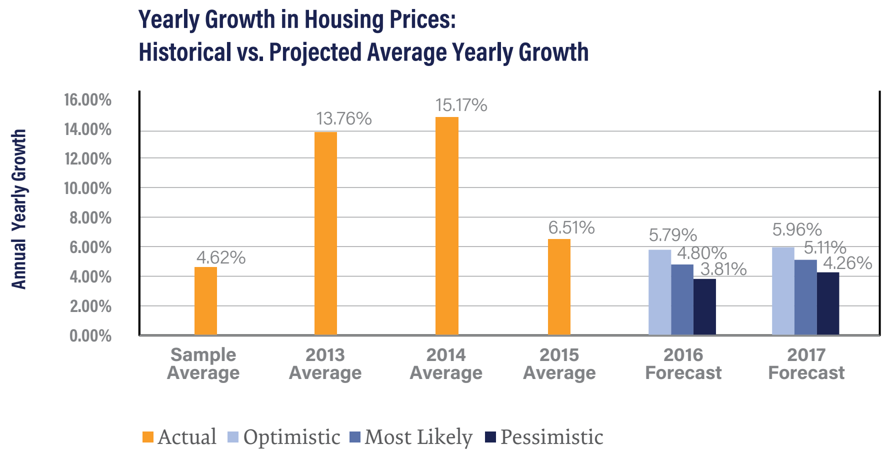
Given that inflation remains very low at the moment, modest economic growth and the added worries of deflation combine to dissuade the Federal Reserve from increasing interest rates in the next couple of months. However, upward pressures may mount in the first half of 2016, when new data on inflation may alter the Federal Reserve's decision to keep interest rates low.

Home prices continued to increase in 2015, ▶ but at rates lower than 2014. Valley home prices appreciated 6.51 percent in 2015, less than half the rate of the appreciation in 2014, which was at 15.17 percent. This growth in housing prices was in line with our prediction of slower but more sustainable growth in Valley home values to take place over the next couple of years. Home values gained the most in Stanislaus County at 8.78 percent in 2015, followed by Merced County at 7.57 percent and San Joaquin County at 7.17 percent. All counties posted greater than 5.0 percent growth in 2015.

The long-term benchmark rate of appreciation for Valley homes stands at an average yearly rate of 4.62 percent. Growth in housing prices approached this rate when the series posted a 6.51 percent gain during the first eight months of 2015. Such a pattern in housing prices is likely to continue into 2016 and 2017, settling to a steady rate consistent with the benchmark growth rate more representative of what the growth in this series will be like in the long term. Valley home values are projected to grow at an average yearly rate of 4.80 and 5.11 percent in 2016 and 2017, respectively, as interest rates slowly begin to rise in the forecast interval and housing prices adjust accordingly. ▶







Inflation and Prices

Inflation continued to stay at very low rates in 2015, which was the main reason the Federal Reserve delayed the decision to raise interest rates. Cost-push factors on inflation were not all present due to the low price of oil. Demand-pull factors also were absent in 2015, further keeping inflation from increasing.

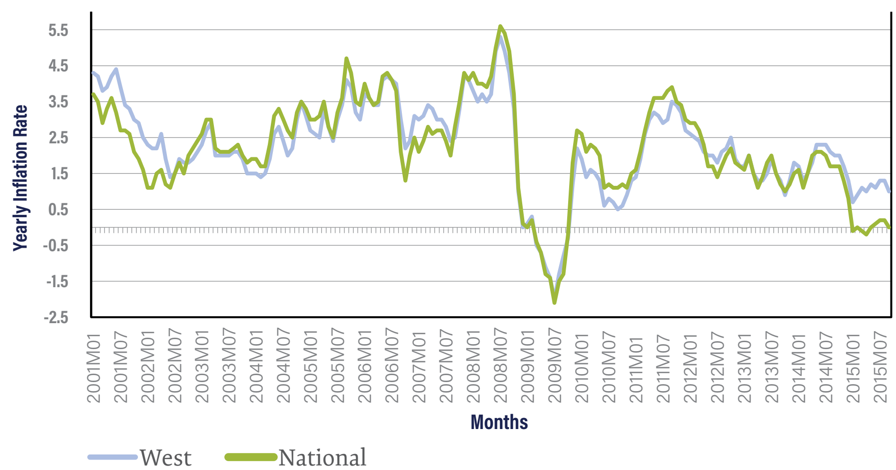
Noteworthy is the increase in inflation in the West Coast relative to the national average. The discrepancy was the widest since 2001. During 2015, inflation rates in the West stayed above 1.0 percent, while nationwide they were near zero. Such a pattern provides strong evidence that the aggregate demand is expanding much faster in California than the rest of the nation.

The lowest increase in the overall level of prices since the first quarter of 2013 was registered in 2015. Given the low price of oil that has continued to prevail for some time, the benchmark inflation over the entire sample has dropped to 2.24 percent. Yearly inflation rates since 2013 all registered below this long-term inflation rate, creating deflationary fears. However, the price of oil is expected to rise in the latter part of 2016.

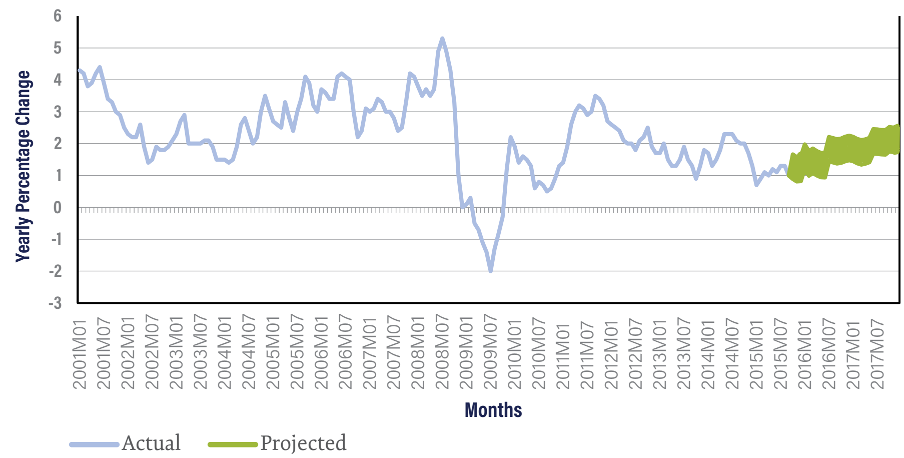
> **Noteworthy is the increase in inflation in the West Coast relative to the national average.**

Appreciation in the domestic currency also partially has an affect on inflation rates remaining low, as imported goods become cheaper to purchase by Valley consumers. Because appreciation has a negative effect on Valley exports, appreciation in the dollar also takes away the impact of demand-pull factors on inflation. Projections point to an average annual increase in overall level of prices on the West Coast of 1.61 percent in 2016 and 1.95 percent in 2017.

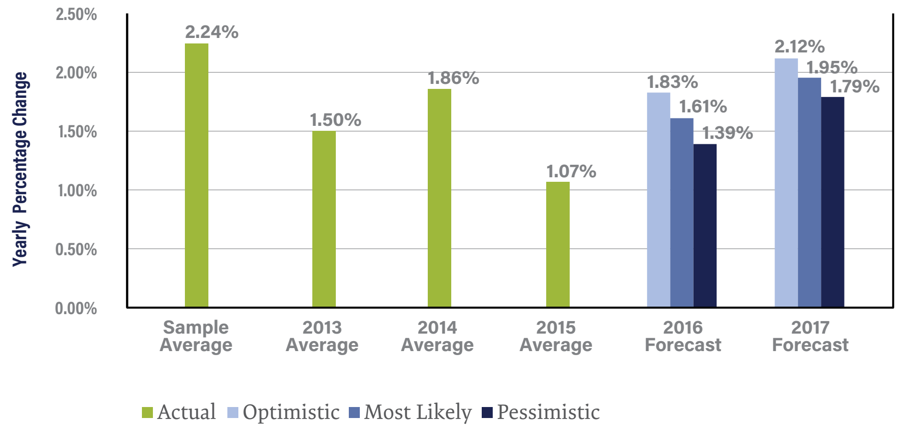
Inflation Rate: Nationwide vs. West



U.S. West Inflation Rate



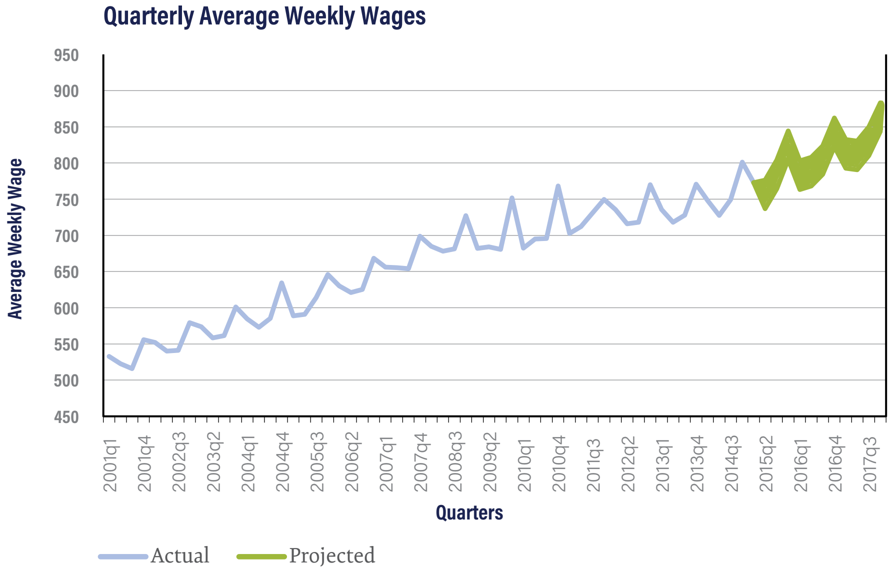
U.S. West Inflation Rate: Historical vs. Projected Average Yearly Growth

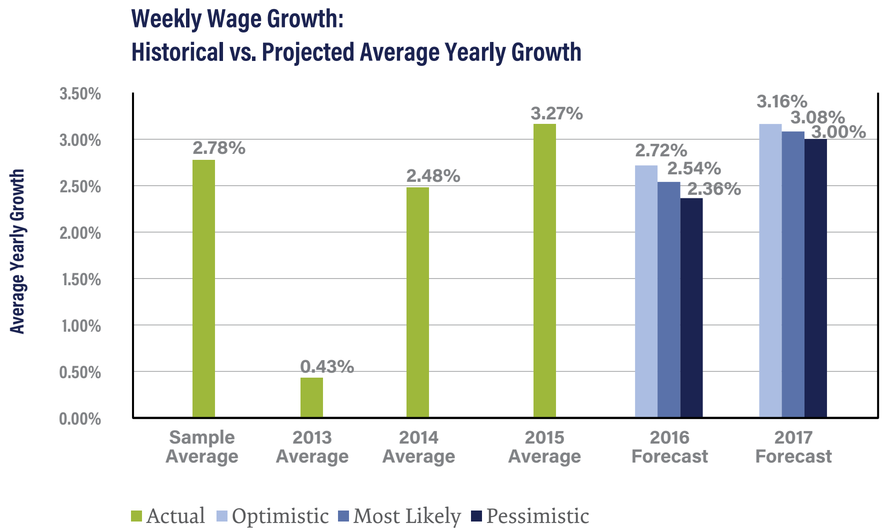


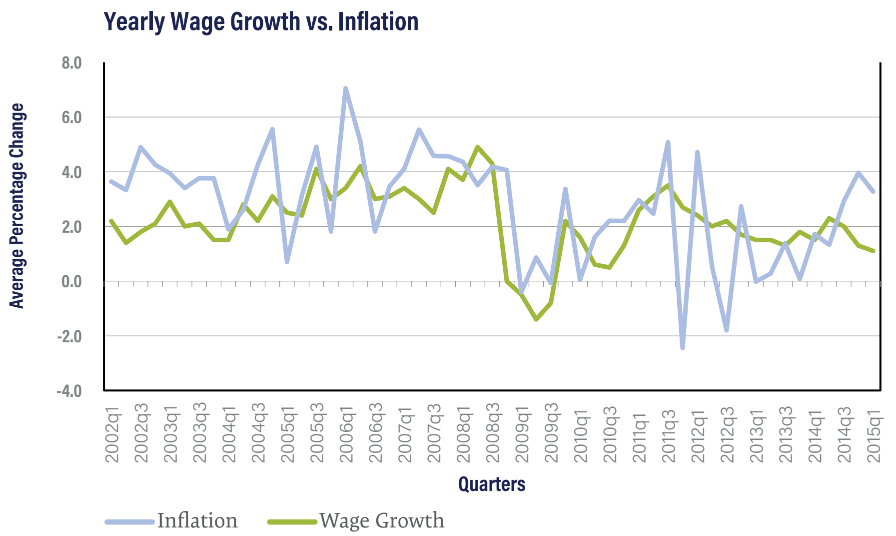
Nominal average weekly wages ▶ in the Valley grew faster than the rate of inflation in 2014 and 2015. As real wages rose, Valley consumers were able to afford more bundles of goods than they did before, and in proportion to the increase in real wages and salaries. Low inflation also helped maintain purchasing power. Because employment growth exceeds labor force growth in the Valley, labor markets have tightened further in 2015, putting upward pressure on wages and salaries. Average weekly wages will continue to rise slightly above the inflation rate in 2016 and 2017.

The discrepancy between average weekly wage growth and the inflation rate turned in favor of wages in 2014. In 2015, this discrepancy widened when the average yearly rate of inflation turned out to be lower than 2014. The Valley's average weekly wages are likely to increase further in the following two years, staying above the inflation rate. Average weekly wages are projected to increase 2.54 percent in 2016 and 3.08 percent in 2017. ▶

Following the second quarter of 2014, average weekly wages began to grow faster and the average yearly inflation rate began to fall. The difference was at a maximum in the fourth quarter of 2014, when average weekly wages posted 3.95 percent yearly growth. The yearly inflation rate registered 1.3 percent, causing real wages to go up by 2.65 percent. The increase in real wages was the highest registered in the past seven years. In 2015, wages grew at a slightly slower rate and inflation continued to fall. Due to the absence of cost-push factors and tightening labor markets, such a pattern in favor of wages likely will continue in the coming months. ▶







Banking and Capital Markets

Above-average employment growth in the Valley, combined with rising real wages, increased total bank deposits quite significantly in 2015 relative to the previous years. Increasing retail trade activity also was consistent with the Valley's increase in total bank deposits. ▶

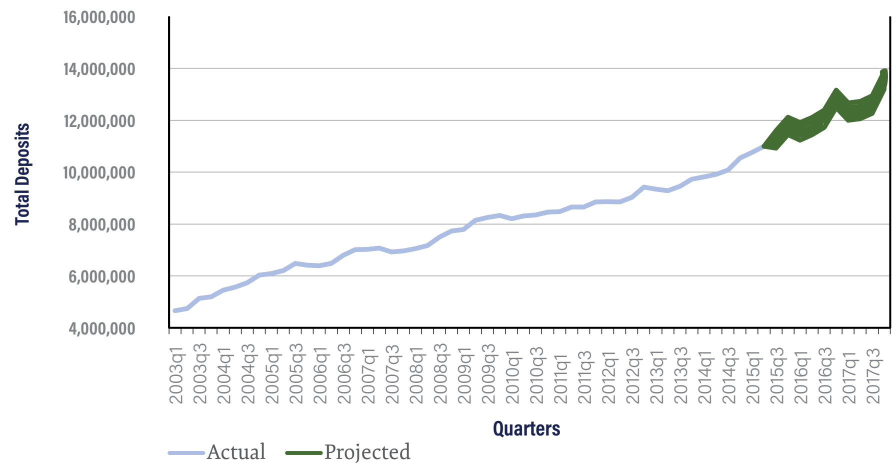
The Valley's total bank deposits in 2015 registered twice the growth rate observed in 2014, at an average annual growth of 10.29 percent in 2015 and 5.41 percent in 2014. Strong growth in the Valley's total bank deposits is expected to continue in the coming two-year period. The increase in financial activities employment in 2015 likely was the result of increased demand for jobs in this category caused by significant increases in total bank deposits and net loans and leases in 2015 relative to previous years. Valley total bank deposits are projected to grow at an average annual rate of 7.62 percent in 2016 and 5.48 percent in 2017. ▶

"Strong growth in the Valley's total bank deposits is expected to continue in the coming two-year period."

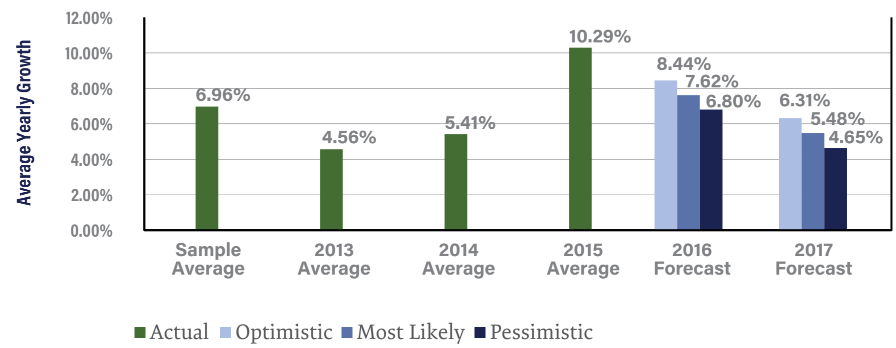
In 2015, bank assets in nonaccrual continued to fall despite significantly higher net loans and leases in the Valley. The small blip in nonaccruals was due to a temporary increase in interest rates during the same time interval, which corresponded to the fourth quarter of 2014 and first quarter of 2015, reflecting the lagged response of defaults to an increase in interest rates. Nonaccruals have returned to the levels that existed in 2007. ▶

In response to the increase in 30-year interest rates during the fourth quarter of 2014, assets in default 30 to 89 days spiked temporarily. Naturally, assets in default 90-plus days responded with a longer lag to the rise in long-term interest rates during the same period.

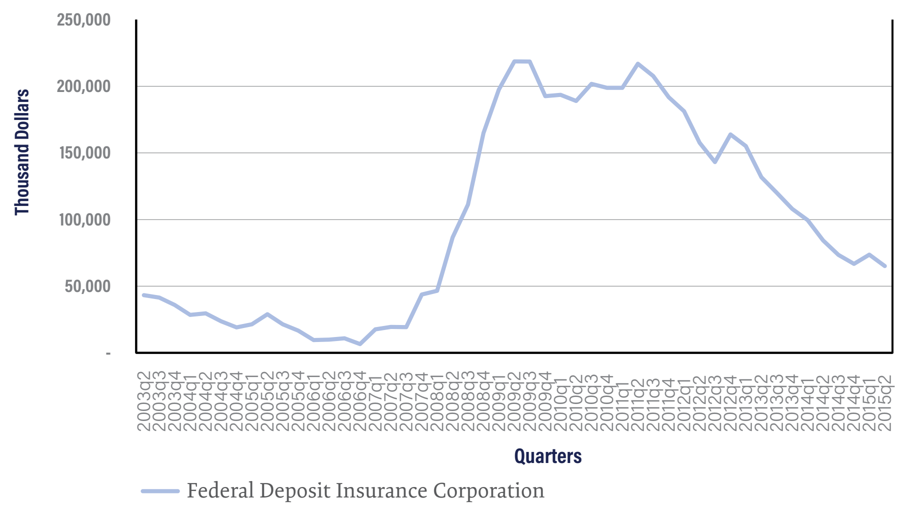
Total Bank Deposits (in $ Thousands)



Total Deposits: Historical vs. Projected Average Yearly Growth



Assets in Nonaccrual



following the drop in the 30-year rates in the following quarters.

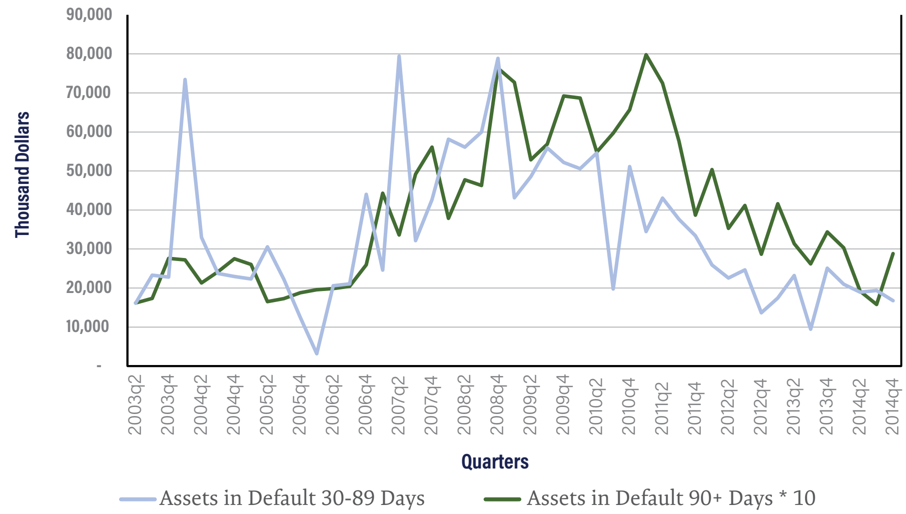
Valley net loans and leases exhibited ▶ exceptional growth together with total bank deposits in 2015. Strong growth in two categories by community banks is indicative of bank deposits being increasingly channeled into loans and leases in the Valley. Further, the pattern observed in these two series is consistent with the view that the funds deposited in the Valley appear to be staying in the Valley, as they should. An outflow of these funds otherwise would jeopardize the Valley's economic growth.

Valley net loans and leases increased 10.14 percent in 2014. Yearly growth in net loans and leases was even higher in 2015 at 16.35 percent. However, average growth over the long run for the Valley in this category stands at 6.36 percent. Projections point to growth more in line with the long-run average rate, at 11.38 percent in 2016 and 8.87 percent in 2017. ▶

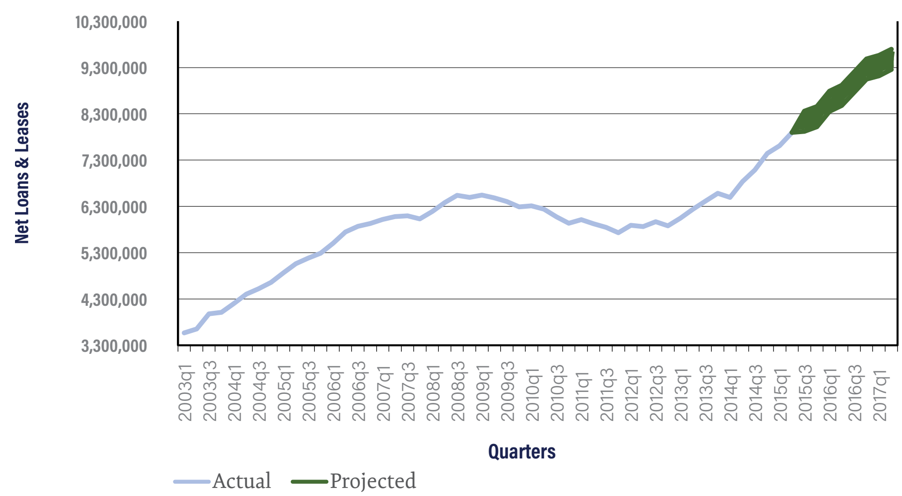
As the Federal Reserve begins to increase interest rates in 2016, nonaccruals along with assets in default are expected increase a bit. Valley bank profits are expected to rise following the increase in interest rates. Total bank deposits and net loans and leases are projected to post yearly growth at above long-run average rates. ▶

"Valley bank profits are expected to rise following the increase in interest rates."

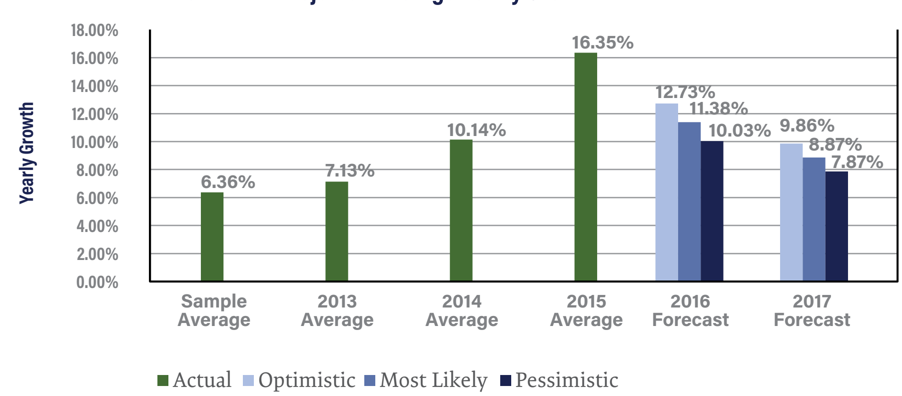
Assets in Default 30 + Days



Net Loans & Leases (in $ Thousands)



Net Loans & Leases:
Historical vs. Projected Average Yearly Growth



Concluding Remarks

Valley total employment grew at a higher rate in 2015 than the previous year. Despite drought, total employment grew significantly above average. Unlike 2014, all counties posted employment growth in 2015. Employment in Fresno and Merced counties grew the fastest. Madera County employment also grew in 2015, but it was quite small compared with other counties.

Dynamics in employment growth changed in 2015. The growth in construction employment was the fourth fastest. Trade, transportation and utilities employment grew the fastest, followed by leisure and hospitality services employment and retail trade employment. Financial activities employment improved significantly from the year before. Manufacturing employment grew above national and state growth rates. Unlike previous years, 2015 was a year in which all categories of employment improved from the previous year.

> **Unlike 2014, all counties posted employment growth in 2015.**

Housing prices increased further, but at a slower rate than previous years and more in line with the long-run average growth rate of the series. Projections point to growth in housing values in single digits, about the same rate as the long-run average rate in the next two years. Housing permits also began to increase at rates more consistent with the 10-year benchmark rates, thus exhibiting more balanced growth.

In 2015, inflation rates nationwide were near zero, but on the West Coast the rise in the average level of prices was about 1.2 percent. Average weekly wages posted a significant increase above the inflation rate in 2015, consistent with tightening labor markets. Average weekly wages are projected to increase faster than the inflation rate in the next two years.

Valley bank deposits and net loans and leases posted exceptional growth in 2015. Nonaccruals in 2015 declined to the levels that existed in 2007 despite a temporary blip in the first quarter of 2015, resulting from an increase in 30-year rates from the previous quarter that proved to be only temporary. However, as the Federal Reserve begins to increase interest rates in 2016, nonaccruals and accruals past due are expected to increase, depending on the extent of the increase in interest rates. Nevertheless, 2015 was a strong year for the financial sector, whereby despite the strong increases in net loans and leases accruals kept on decreasing further.

Overall, the Valley economy adapted exceptionally well to the four-year drought and displayed above-average performance. The projections point to the prevalence of similar upbeat economic dynamics in the two-year forecasting interval.

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Stanislaus