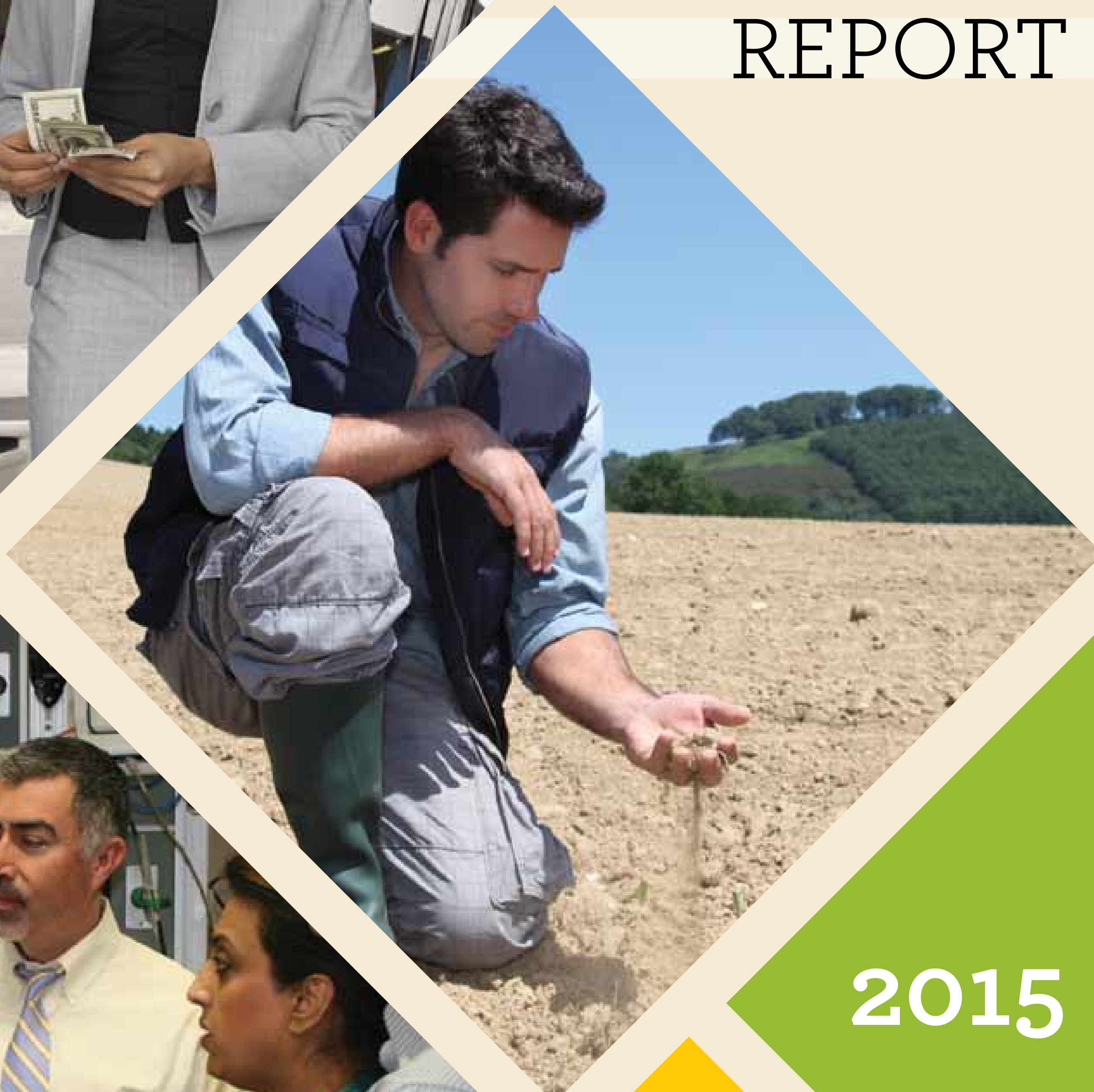
San Joaquin Valley Business Forecast Report



2015

Midyear Update

Volume IV • Issue 2

Table of Contents

California State University | Stanislaus

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San Joaquin Valley

Business

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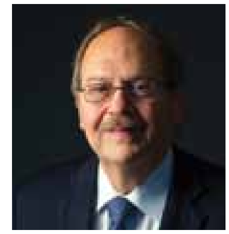

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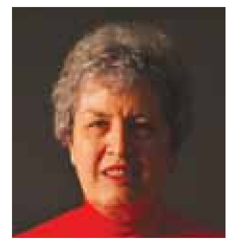

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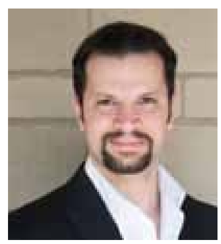

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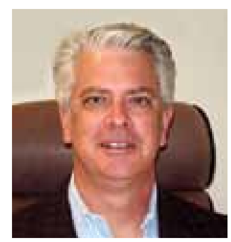

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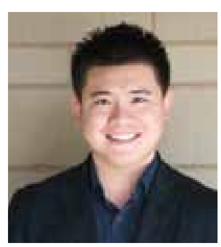

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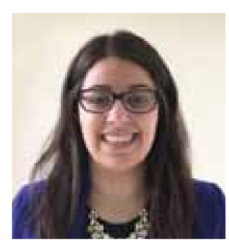


Monica Teicheira

From a structural point of view, the San Joaquin Valley's natural rate of unemployment, approximately twice the national rate, stands at 12.2 percent as of the first quarter of 2015. The lowest unemployment rate in the ten- year interval from 2004 to 2014 was a seasonal dip at 7.32 percent in October 2006. The September, 2014 unemployment rate for the San Joaquin Valley was 9.96 percent -- quite close to the minimum historical rate. Currently, the twelve month average unemployment rate in the Valley is 11.70 percent bringing it below the natural rate of 12.2 percent. Given these numbers, the Valley's current unemployment rate is, if not at par, slightly lower than the natural rate of unemployment based on the past ten years. This above average performance in drought conditions is a testament to the resilience of the Valley economy and the growing importance of its ongoing diversification.

The annual inflation rate has continued to surprise consumers, investors and alike by remaining lower than anticipated for another year…

Employment numbers rose in all seven counties with the exception of Madera County which had a slight decline. Employment in Merced County continued to grow the fastest followed by San Joaquin County. Stanislaus County employment grew about the same rate as the overall Valley employment growth of 1.26 percent. Total employment grew at a decreasing rate than in previous years reflecting the ongoing effect of the drought, particularly in the southern part of the Valley.

Construction and leisure and hospitality services were the fastest growing categories of employment. The most surprising development was in information employment. For the first time since the recession, information employment began posting two to three percent annual growth, significantly above the negative ten year benchmark rate, and is projected to grow even further, thus ending its categorization as a suffering sector in the Valley. The same however, cannot be concluded for the financial activities employment sector which worsened albeit at a slower pace. After several years of marginal improvement, manufacturing employment declined slightly continuing its sluggish performance. Wholesale employment fell to the fifth fastest growing category, while retail employment continued to post stronger performance than wholesale employment. Total Valley employment managed to post another year of growth above the ten-year benchmark rate although closer to the ten-year rate than in previous years. Given these trends, next year might very well be a year during which yearly growth falls below the ten-year benchmark rate particularly if drought conditions persist.

Following the double-digit increases in the past few years, the average yearly change in home prices began displaying more balanced growth. Housing permits now point to steady state growth in the construction sector. Despite a temporary blip when several national banks ramped up repossessions early in the second half of 2014, foreclosures declined to a rate closer to the levels that existed in pre-recession years.

Valley businesses and consumers benefited from the relatively low prices of imported goods because of the dollar's continued appreciation against other currencies. Continuous appreciation in the U.S. dollar, however, has become a worry for national equity markets and has put a drag on the growth of retirement portfolios. Long-term interest rates, despite upward pressures, are likely to remain low for another six months, with little impact on equity markets which increasingly exhibit sensitivity to changes in interest rates.

The annual inflation rate has continued to surprise consumers, investors and alike by remaining lower than the anticipated for another year, in part because of the overproduction of oil to the degree that producers were running out of spaces to store. Literally, there were no cost push factors in place to increase the inflation rate. There was some upward movement in average weekly wages slightly above inflation, which continued to stay at modest rates.

As long-term interest rates remain low, the positive impact on Valley net loans and leases are expected to continue into 2016 and 2017. Bank deposits are projected to grow for another year at about the same rate as the ten-year benchmark rate. Non-farm sectors will continue to partially mitigate the effect of drought conditions on farm-related sectors. The negative indirect effects of the drought have not yet begun to significantly take their toll on non-farm related sectors. >>>

This year's biannual report provides an update to the November, 2014 report and analyzes past, current and future trends in the San Joaquin Valley using time series data spanning from January, 2001, to March, 2015. Forecast updates are generated for the two-year ahead period beginning from July, 2015, and ending in June, 2017.

The report's aim is to forecast a range rather than a point in order to provide a more realistic assessment of likely future values to serve as a guide for informed decision making. The actual numbers are expected to fall within the upper and lower forecast bands. The yearly average figure is for the past twelve months and includes, when available, the preliminary figures for April.

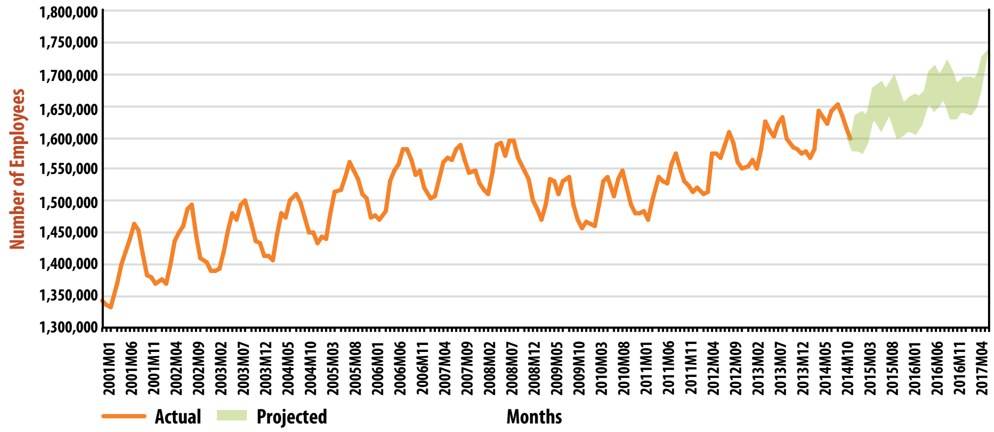
The remainder of this report is structured as follows: San Joaquin Valley labor market conditions are analyzed in Section B; Section C provides an assessment of the region's real estate market; Section D reports wages, prices and inflation; and Section E provides an analysis of banking and capital market conditions in the Valley. >>>

Eagle-Shawmut Mine appeared last year due to the drought conditions and low water level. This mine last operated in the 1940's and 50's. The foundation appears from time to time as the water becomes lower. It hasn't appeared since 1992. Photo courtesy of Don Pedro Recreation Agency.

In previous years, the unemployment rate for the Valley kept declining but stayed above the ten-year historical average. Beginning from the first quarter of 2015 however, the Valley unemployment rate fell below the average historical rate which serves as a proxy for the natural rate of unemployment. Given the ongoing drought, the Valley's below-average unemployment rate points to the importance of an increasingly diversified economy. This year again, non-farm related sectors partially picked up the slack resulting from relatively weaker farm related employment posting an overall unemployment rate of 11.70 percent, about one point less than the natural rate based on the past ten years.

Given the ongoing drought, the Valley's below-average unemployment rate points to the importance of having an increasingly diversified economy.

Total Employment



The Great Recession, however, left a lasting impact on the Valley economy. If the recession had not occurred and the Valley economy had grown at the same pace as before the recession, about 120,000 more people would be employed today. >>>

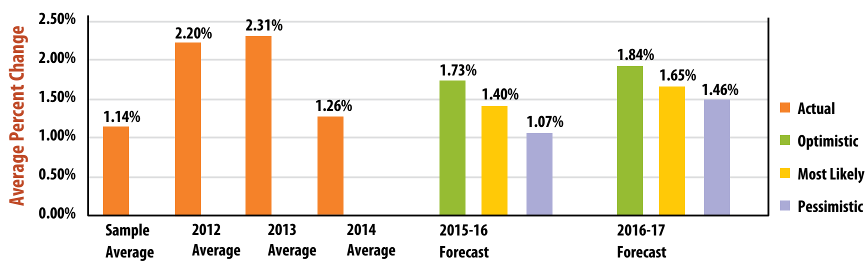
As of the first quarter of 2015, employment in Merced and Fresno counties had the fastest growth while Madera was the only county in which employment declined. The most surprising development was in Valley information employment that began posting above two percent growth in the last couple of months. Considering that, the ten-year benchmark growth rate for information employment is -2.03 percent, the growth in this employment category was quite significant. Skilled workers in information employment are now more likely to find jobs in this category than a few years back. County unemployment rates were slightly below each county's four-year historical averages for all counties including Stanislaus and Tulare. Madera County's unemployment rate was at par with the ten-year historical average. When compared with the Valley-wide historical average, all counties except Merced and Tulare had unemployment rates below the Valley historical average.

When compared with the Valley-wide historical average, all counties except Merced and Tulare had unemployment rates below the Valley historical average.

Construction, leisure and hospitality services employment were the two top performing categories of employment in the Valley. Given the promising performance in information employment, the only category of employment posting continued negative growth remained financial activities employment. However, in this category too, the decline took place at a slower pace than in previous years. >>>

Total Employment:

Historical vs. Projected Average Yearly Growth



Consumer confidence has been growing at an increasing rate since the first quarter of 2014. The Conference Board's Consumer Confidence Index has now passed 100 points. The last time the series had a reading above 100 points was before the recession in 2007. The low price of oil and the low consumer price index with inflation remaining at modest levels have propelled consumer confidence to new highs. Consumer confidence is likely to stay on this path until long term interest rates once again rise. >>>

In the years since the recession ended, employment growth in the Valley has continued to remain significantly above the labor force growth but the latter, although remaining positive, kept falling. Recently however, labor

... labor force growth began increasing together with employment growth.

force growth began increasing together with employment growth. Such a pattern is indicative of returning influx of labor to the Valley, a familiar pattern that was observed during pre-recession years. The two series are projected to intersect each other in the coming years, as labor force begins to grow faster than employment. >>>

Employment growth, both in the State and the Valley, were almost identical after the recession. However, beginning from the first quarter of 2014, an anomaly occurred whereby state employment began to grow faster than Valley employment. Further, the almost non-existent discrepancy between the two began to widen in favor of the state. Historically, in the past thirteen years, this has almost never happened. The employment growth in the Valley should normally be above the state. Ongoing drought conditions were the most likely underlying cause for this unusual pattern, which is projected to reverse once the drought conditions cease. >>>

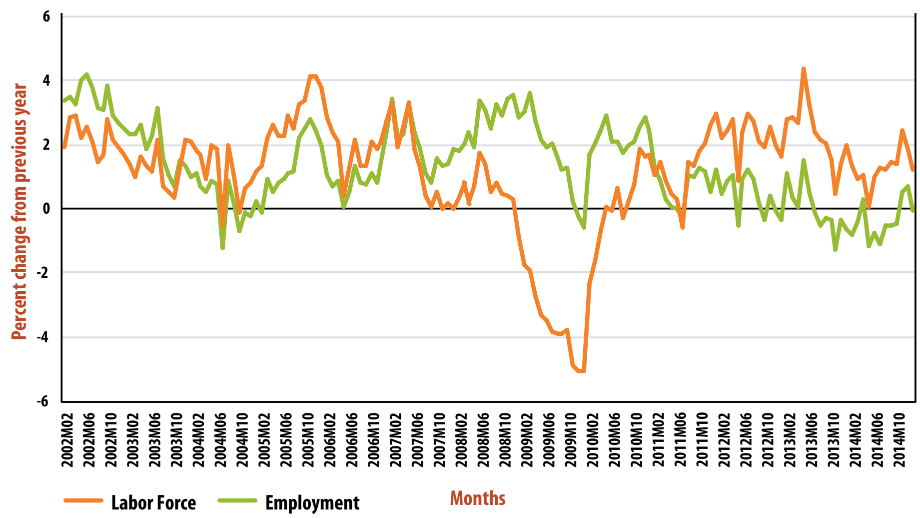
Real gross domestic product (GDP) is projected to post a 2.8 percent average yearly growth in the next two years, about the same

...too much appreciation in the dollar will undoubtedly curb real GDP growth.

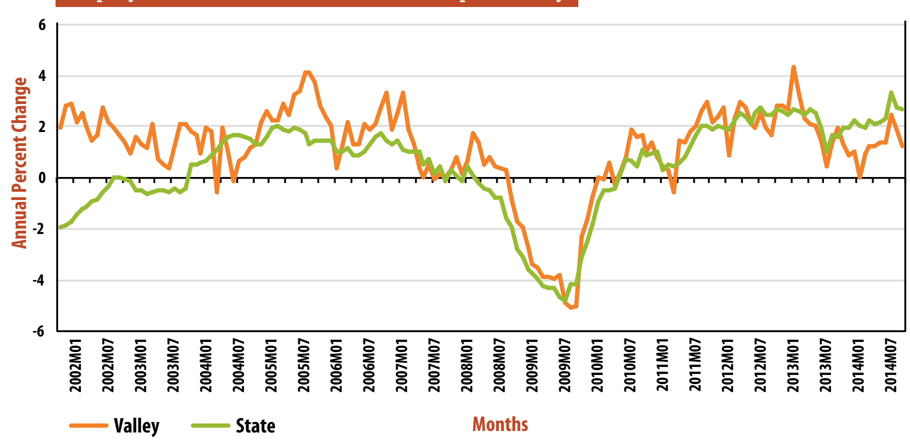
rate as the average historical growth in the nation. Easy monetary policy in Europe caused the dollar to appreciate against the Euro, putting further pressure on the trade deficit. As a leakage

Consumer Confidence Index

Labor Force vs. Employment Growth



Employment Growth: State vs. San Joaquin Valley



from the overall economy, too much appreciation in the dollar will undoubtedly curb real GDP growth. However, an appreciating dollar will help Valley consumers purchase imported goods at relatively lower prices. The dollar's appreciation will also help those businesses that sell imported goods but will hurt the Valley's exports of agricultural goods. >>>

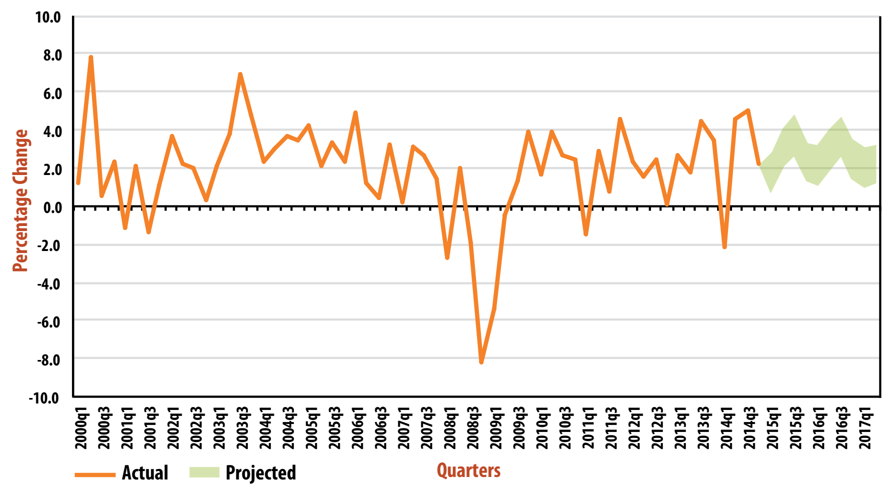
Education and health services employment has now exceeded 185,000 in the Valley. The pace of growth in this series is projected to pick up in the next two years due to increased demand for health care from new enrollments due to the Affordable Care Act and computerization of health care records. Education and health care employment increased the fastest in Fresno and Kings counties, above 5 percent per year, while the average for the whole Valley was 1.4 percent. Growth in Stanislaus and Tulare counties was slightly above average at 1.7 percent per year. In Bakersfield and Madera counties, employment in this category fell slightly from a year ago. >>>

Projections point to an average yearly growth of 3.05 percent in education and health care services employment, of which about 60 percent is private. Higher growth rate projections are attributed to the new influx of labor that the Valley is experiencing for the first time since the beginning of the recession. As labor force growth begins to increase, demand for health care and education will inevitably increase in the Valley. >>>

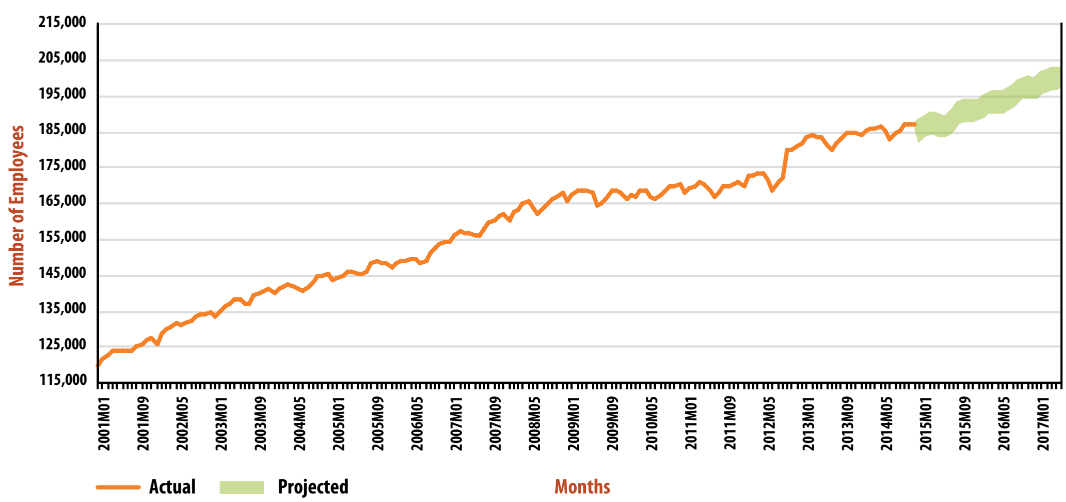
Higher growth rate projections are attributed to the new influx of labor that the Valley is experiencing…

There was little change in manufacturing employment from the previous year. Mostly a farm-related category of employment, manufacturing employment's stagnant activity in the Valley mainly reflected the ongoing drought conditions. However, nationwide manufacturing employment growth has not been very significant either. The fastest growth in

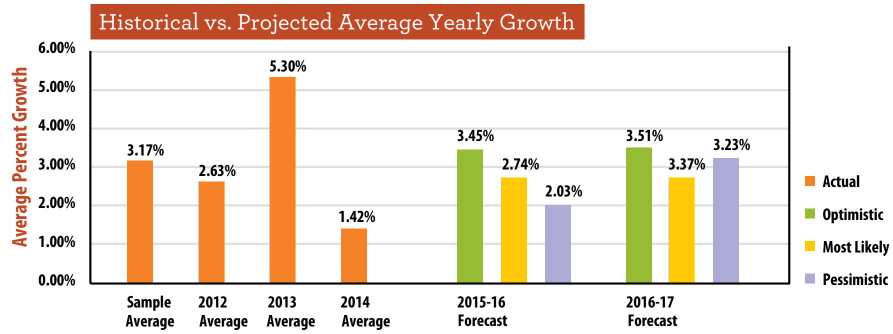
U.S. Real GDP Annual Growth



Education and Health Services Employment



Education and Health Services Employment: Historical vs. Projected Average Yearly Growth



this category of employment took place in Madera and Merced counties, while there was almost no change from the previous year in Tulare and Stanislaus counties. Manufacturing employment declined most in Fresno and Kings counties. >>>

In the next two years, federal money coming into to Valley to build the high-speed rail as well as state money to repair the Hetch Hetchy water system infrastructure is projected to have a positive impact on manufacturing employment growth. Employment in this category is projected to increase at an average yearly rate of 0.60 percent, thus switching from negative to positive growth territory. Worsening of drought conditions, however, will hamper any improvement in manufacturing employment. >>>

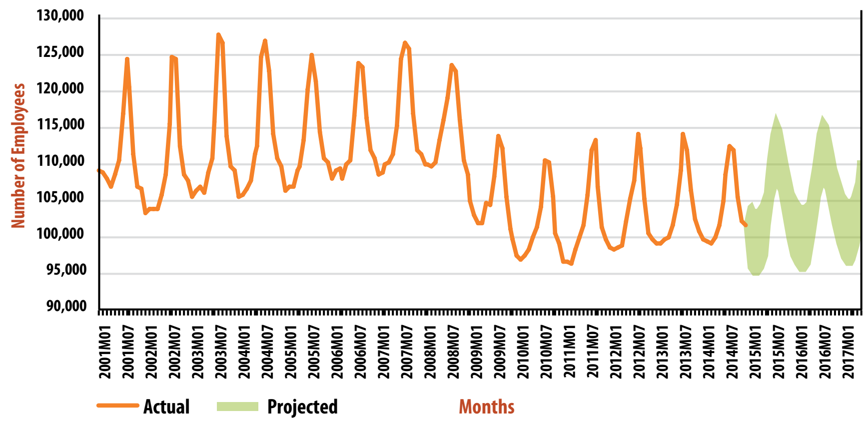
Worsening of drought conditions, however, will hamper any improvement in manufacturing employment.

The Purchasing Managers Index (PMI) dipped below 55 points in January, 2015, indicating some slowdown in manufacturing activity nationwide. National trends combined with drought conditions have not made the picture brighter in the Valley. A strong dollar made imports cheaper and curbed demand from abroad for local manufactured and other goods. The U.S. dollar's continuous appreciation against other currencies creates a substitution effect for cheaper imported goods and away from domestically manufactured goods. A value above 50, however, in the ISM Purchasing Managers Index, still points to an expansion -- but at a slower pace. >>>

National trends combined with drought conditions have not made the picture brighter in the Valley.

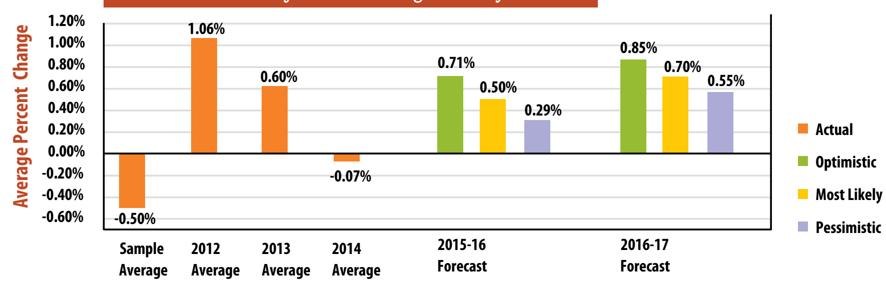
As the dollar continued to gain value against the Euro and other currencies, new export orders declined to the extent that further appreciation in the dollar became a major worry for investors and began to have a negative effect on the national equity markets and the overall economy. Most recently, reaching a peak in December, 2014, the

Manufacturing Employment



Manufacturing Employment:

Historical vs. Projected Average Yearly Growth



Purchasing Managers Index

dollar finally began showing signs of depreciation. The appreciation in the domestic currency was a major cause for the ISM's New Export Orders Index to register the lowest value since February of 2013. Further appreciation in the dollar, therefore, will be a major negative influence on exports from the Valley and the nation. >>>

Leisure and hospitality services employment was the second best performing employment category after construction employment in the Valley. By the end of 2017, employment in this category is projected to reach 120,000 for the entire Valley. Employment in this category grew most in Kings, Tulare, and San Joaquin counties, respectively. In Stanislaus County, growth in this sector comprised half the Valley's growth rate of 4.05 percent. Madera was the only county to post a decline in employment when compared to the year before. >>>

Several factors contributed to above average performance of leisure and hospitality services employment. These were unemployment rates falling below average historical rates in both the

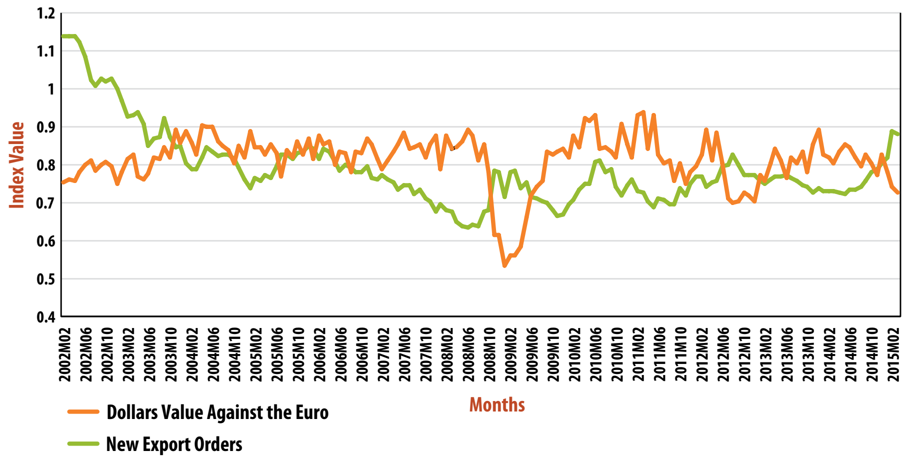
…consumers facing cheaper gas prices than prior years…

Valley and the nation, consumers facing cheaper gas prices than prior years, low rates of inflation, and marginal upward movements in average weekly wages that have begun to take place in the past six months.

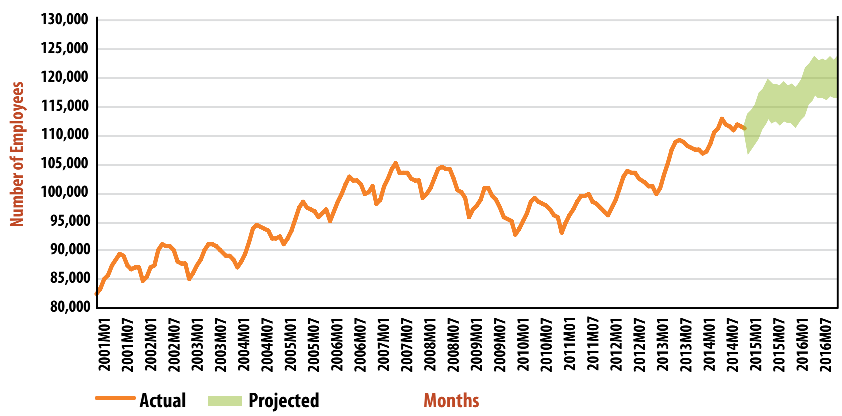
Projections point to a 3.72 percent average yearly growth in leisure and hospitality services employment in 2016 and 2017. Considering that the ten-year benchmark rate is 1.93 percent, some mean reversion to rates generally below four percent is expected to occur in the coming years. >>>

Trade, transportation and utilities employment was another category of employment that displayed strong performance. The top three performers in this employment category were Kern, Fresno, and Stanislaus counties, in which average yearly growth exceeded three percent, beating the Valley's average growth in this sector. Merced County's

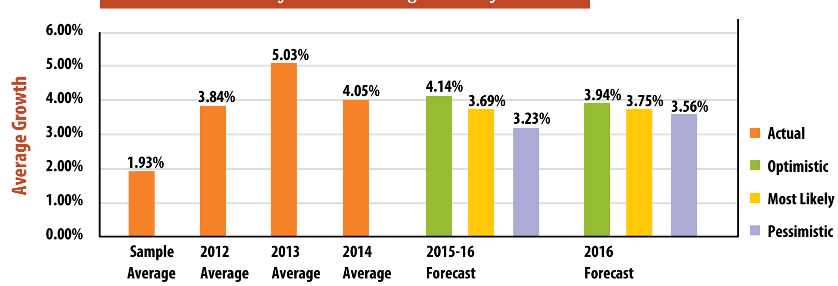
Exchange Rate vs. New Export Orders



Leisure and Hospitality Services Employment



Leisure and Hospitality Services Employment:
Historical vs. Projected Average Yearly Growth



negative average yearly rate of -4.27 in this category put it significantly below the Valley ten-year benchmark rate of a positive 2.74 percent. >>>

Trade, transportation and utilities employment appeared little affected by the ongoing drought and, despite some temporary decreases, still posted average yearly growth of 2.74 percent in 2015 first quarter, which was about twice the ten-year benchmark rate of 1.50

Trade, transportation and utilities employment was another category of employment that displayed strong performance.

percent. Projections point to strong growth in this sector relative to other sectors at an average yearly rate of 3.51 percent in 2016 and 2017, reaching employment of 270,000 for the entire Valley by the first quarter of 2017. >>>

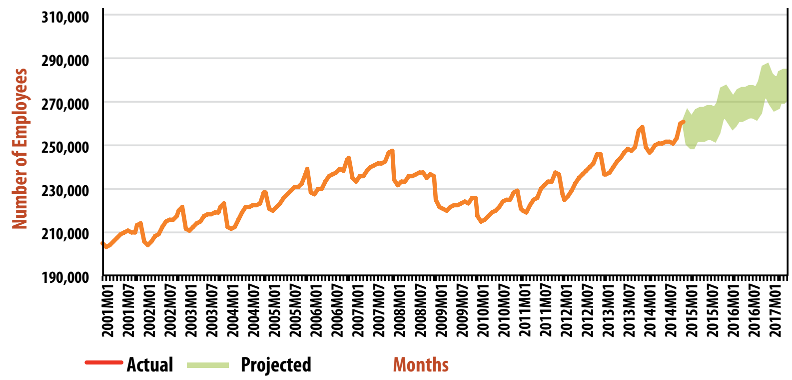
Given the fourth strong performance of retail trade employment in the Valley, seasonal peaks in this series are projected to reach 170,000 by the first quarter of 2017. Employment in retail trade grew faster than wholesale employment, pointing to structural changes in the Valley's employment composition. Employment in this category grew most in Kern and Fresno counties

Retail trade employment was one of those categories of employment that mitigated to some degree the negative impact of drought on farm-related categories

at rates close to four percent, followed by Tulare and Stanislaus counties at about two percent per year as of the first quarter of 2015. >>>

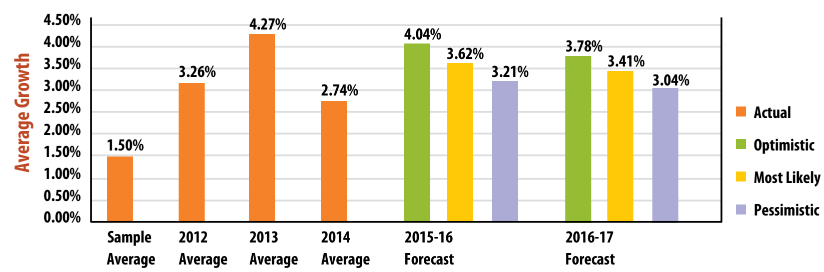
Retail trade employment was one of those categories of employment that mitigated to some degree the negative impact of drought on farm- related categories of employment relative to the Valley's total employment. Projections point to 2.8 percent average yearly growth in retail trade employment during 2016 and 2017. >>>

Trade, Transportation and Utilities Employment

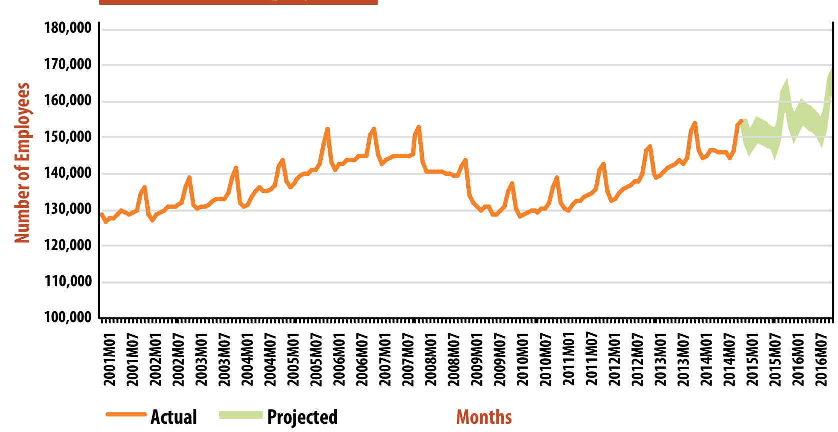


Trade, Transportation, and Utilities Employment:

Historical vs. Projected Average Yearly Growth

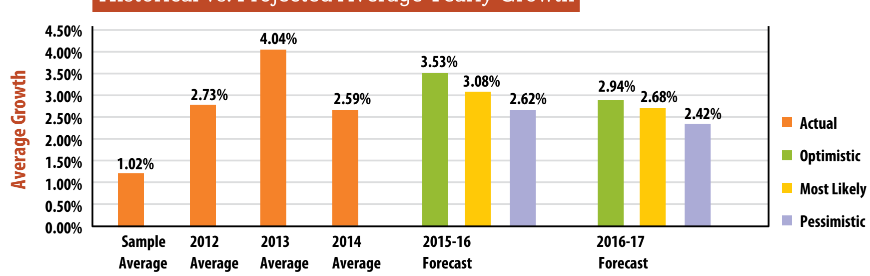


Retail Trade Employment



Retail Trade Employment:

Historical vs. Projected Average Yearly Growth



Wholesale trade employment continued to be negatively affected by the ongoing drought. Growth in this category of employment was weaker than in the retail trade employment category. Growth in wholesale trade employment is now at par with the ten-year benchmark rate. Fresno, San Joaquin and Stanislaus counties were the top three performers in wholesale trade employment. Tulare was the only county that posted a yearly decline. >>>

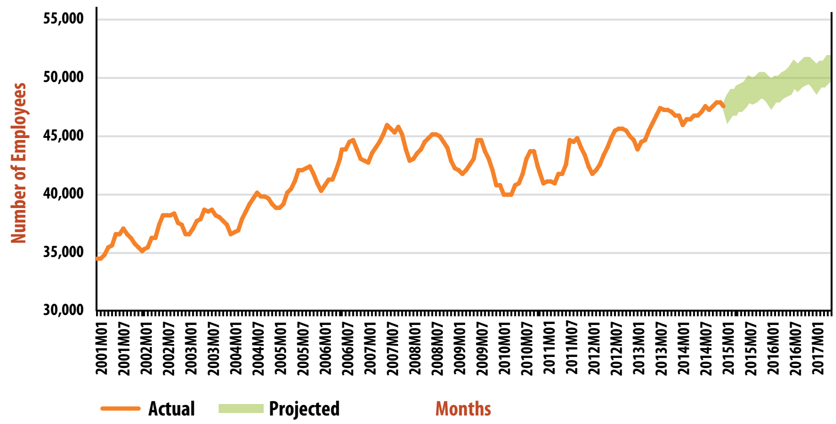
The long-term trend in wholesale trade employment became increasingly flat after drought conditions began in the Valley. Seasonal peaks each year displayed a decreasing pattern consistent with this flattening trend. Compared to its own past dynamics, projections now point to relatively low growth in this category of employment at an average yearly rate of 2.69 percent in 2016 and 2017. Current trends and worsening drought conditions not yet reflected in incoming data will most likely bring growth below the ten-year benchmark rate of 2.18 percent. >>>

…information employment began to recover in the first quarter of 2015 and is now exhibiting a well-defined turning point that is more likely to be permanent…

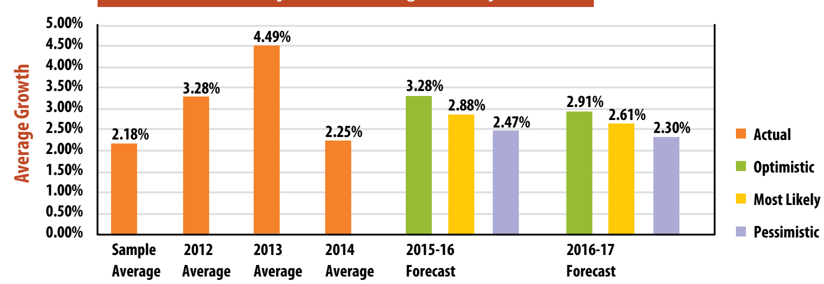
In line with past projections, information employment began to recover in the first quarter of 2015 and is now exhibiting a well-defined turning point that is more likely to be permanent than the turning points displayed in previous years. The most surprising development in this category is the two to three percent yearly growth rate posted for the series in the past few months. Skilled workers in the Valley are now more likely to find jobs in this category than in the past few years. San Joaquin and Fresno counties had the fastest growth in information employment followed by Kern, Merced and Madera counties. >>>

The average yearly growth in information employment switched from negative to positive territory posting growth of 0.93 percent in 2014. The new trend is the steepest since the end of the recession. Relative to its ten-year benchmark growth

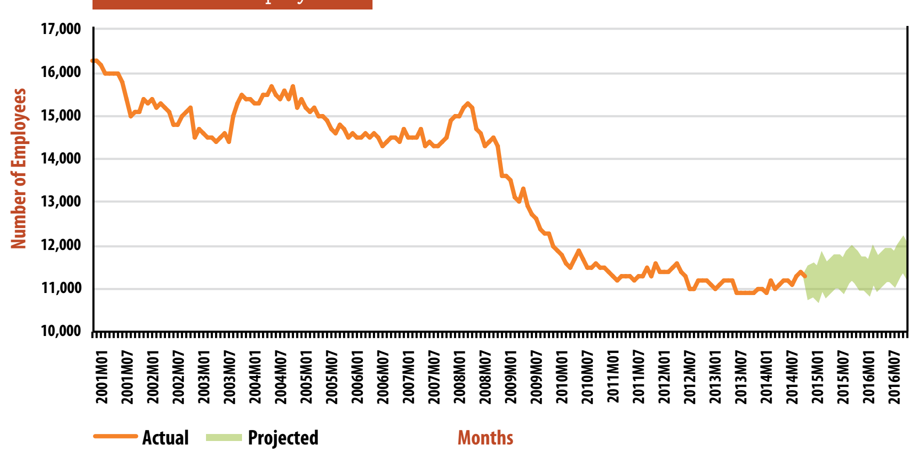
Wholesale Trade Employment



Wholesale Trade Employment:
Historical vs. Projected Average Yearly Growth



Information Employment



of -2.03 percent, the improvement in 2014 was quite significant. Projections point to 1.57 average yearly growth in information employment during next two years. >>>

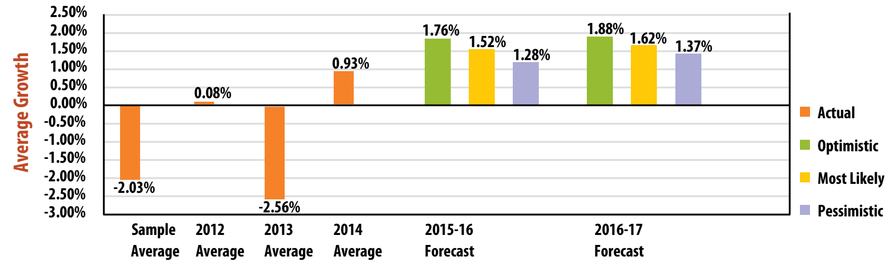
Construction continued to be the Valley's top performing employment category with employment levels projected to reach 47,500 by the first quarter of 2017. Construction employment has been displaying balanced growth for the post-recession years with an almost linear long-term growth pattern since 2011. This contrasts with the observed exponential growth of construction employment just before the recession. >>>

Construction employment has been displaying balanced growth for the post-recession years . . .

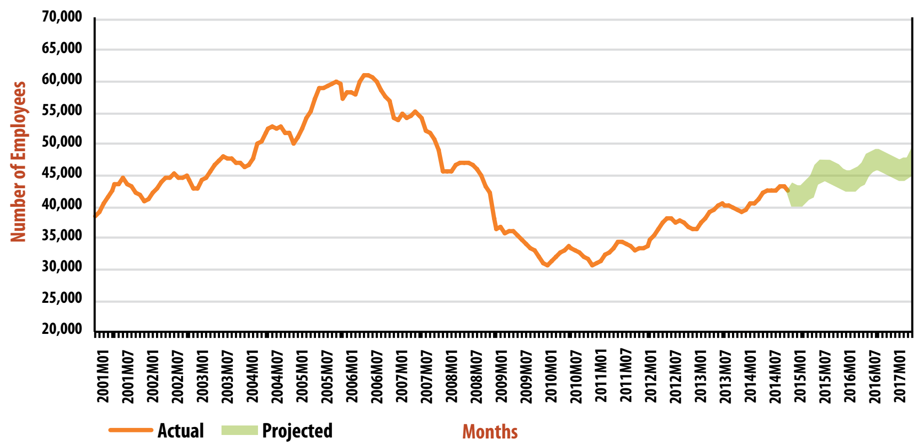
Despite being the category with the fastest growth, construction employment has been increasing at a decreasing rate since 2012, at average yearly rates of 10.9, 7.13 and 6.88 percent, respectively. This trend is projected to continue, particularly given the widespread expectation of interest rate hikes by the Federal Reserve. At the moment, low inflation and disappointing statistics from sectors like manufacturing are keeping the Federal Reserve dovish but many expect interest rate increases to come sooner rather than later. Projections point to an average yearly growth of 4.90 percent in 2016 and 2017. >>>

There was overall 1.25 percent growth in Valley government employment.

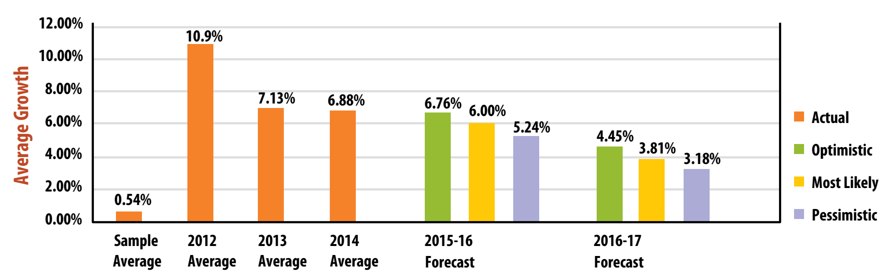
Information Employment:
Historical vs. Projected Average Yearly Growth



Construction Employment



Construction Employment:
Historical vs. Projected Average Yearly Growth



Seasonal peaks in government employment in the Valley are projected to reach 270,000 by the first quarter of 2017. Employment in this category grew most in San Joaquin, Stanislaus, and Fresno counties at rates above the Valley average. Government employment, however, declined in Kings, Madera and Tulare counties. In Merced and Kern counties, employment in this category did not change much from the previous year. There was overall 1.25 percent growth in Valley government employment. >>>

After posting several consecutive years of decline, government employment began to increase at rates much higher than the ten-year benchmark rate to catch up with a recovering economy. The overall labor force influx to the Valley will inevitably require more government workers. Projections point to growth in the upcoming months similar to 2014, at an average yearly rate of 1.75 percent in 2016 and 2017.>>>

There was no improvement in financial activities employment from the previous year. It continued as an employment category failing to improve after the recession ended. Projections show that financial activities employment is not likely to improve significantly in the next two years. The series will continue to oscillate between employment levels of 41,000 and 43,000. >>>

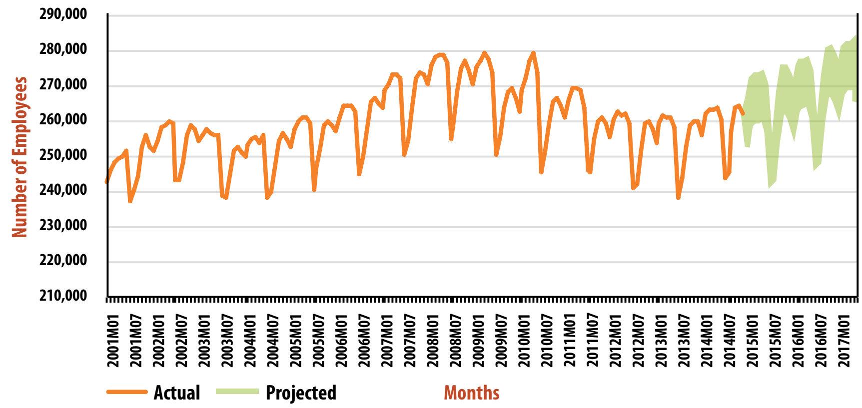
Financial activities and employment declined but at a slower pace than before. Projections point to marginal changes in this category of employment. The 2016 growth rate is expected to be small but positive at 0.15 percent. Thus the model predicts a turning point in the series as the growth rate moves from negative to positive territory. The average yearly growth in 2017 is projected to be higher, but still small at 0.28 percent. >>>

The Valley's overall unemployment rate fell below the average historical rate for the first time since the recession. Using the historical rate based on the past ten years as a proxy for the natural rate of employment, one can infer from the new data that the Valley's economy is

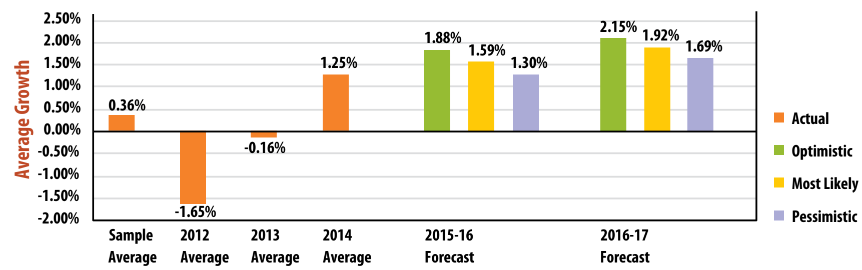
Considering that such a relatively strong performance has taken place in the midst of drought illustrates the benefits of the Valley developing an increasingly diversified economy.

now operating slightly below the natural rate of unemployment. Considering that such a relatively strong performance has taken place in the midst of drought illustrates the benefits of the Valley developing an increasingly diversified economy. The data shows that non-farm sectors to some degree mitigated the negative effects of drought on farm-related sectors. All counties posted an increase in employment levels, with the exception of Madera where there was a slight decline. The categories of employment that remained flat were financial activities and manufacturing employment. Other categories posted significant increases from the previous year. >>>

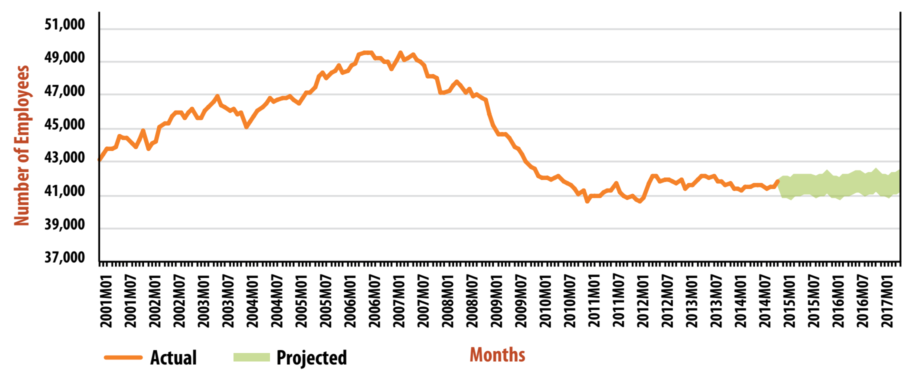
Government Employment



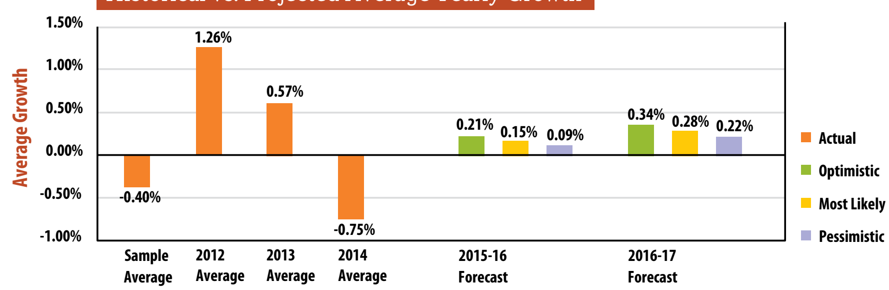
Government Employment:
Historical vs. Projected Average Yearly Growth



Financial Activities Employment



Financial Activities Employment
Historical vs. Projected Average Yearly Growth



The data for the regional housing indicators are from the U.S. Census Bureau and the Bureau of Labor Statistics. The numbers available belong to the eight metropolitan statistical areas (MSAs) in the San Joaquin Valley which include Bakersfield-Delano, Fresno, Hanford-Corcoran, Madera-Chowchilla, Merced, Modesto, Stockton, and Visalia-Porterville. >>>

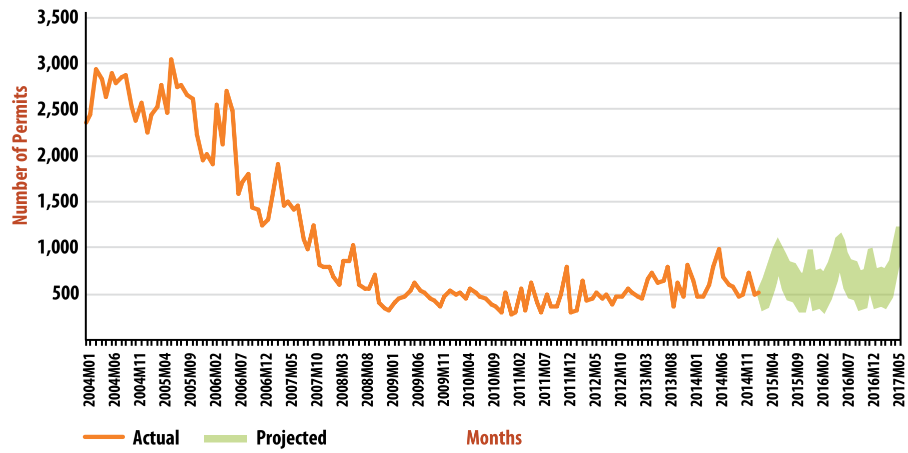
Fresno and Stockton MSAs issued the most housing permits from the third quarter of 2014 to the first quarter of 2015, while Hanford-Corcoran and Merced issued the fewest. Single-family building permits continued to increase in the first quarter of 2015, however at rates more in line with values historically seen in the series. Because the past year reported phenomenal growth rebounding from all-time lows, the subsequent year's growth rates appear much lower as housing permit growth began showing signs of approaching more sustainable rates. >>>

Projections point to further fluctuations in the growth of housing permits in the next few months

Projections point to further fluctuations in the growth of housing permits in the next few months until the series dynamics achieves the new steady state growth rate. Projections for 2016 and 2017 point to average yearly growth rates of 6.68 and 4.11 percent, respectively. The lower growth projected for 2017 is attributed to the anticipation of higher long-term interest rates. >>>

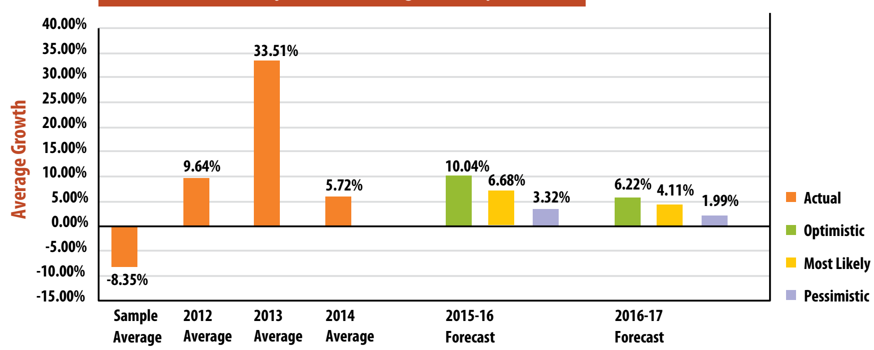
Foreclosures starts have continued to decline now to the levels much earlier than the Great Recession. As predicted in prior year reports, the new values for the series are now coming in parallel to the horizontal axis. This newly-forming flat trend is likely to continue for some time unless interest rates begin to rise in a series of quick upward movements in a pattern similar to pre-recession years. The slight uptick in the latter part of the series is due to banks stepping up remaining foreclosures repossessions in the latter part of 2014. >>>

Single-Family Building Permits

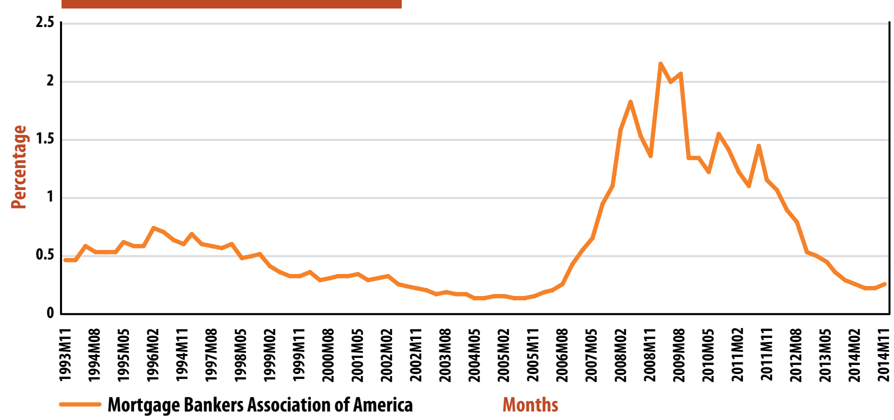


Single-Family Building Permits:

Historical vs. Projected Average Yearly Growth



Foreclosure Starts in California



Thirty-year rates continued to fall well below 4 percent in the last quarter of 2014, extending into the first quarter of 2015. Factors such as low inflation and disappointing manufacturing data in the first quarter of 2015 contributed to the Federal Reserve's decision to keep interest rates low. Low rates are likely to continue, unless inflation rates begin to move significantly upward. Low interest rates have helped the Valley and national economy expand further in 2015, bringing rates of unemployment below the long term historical average.

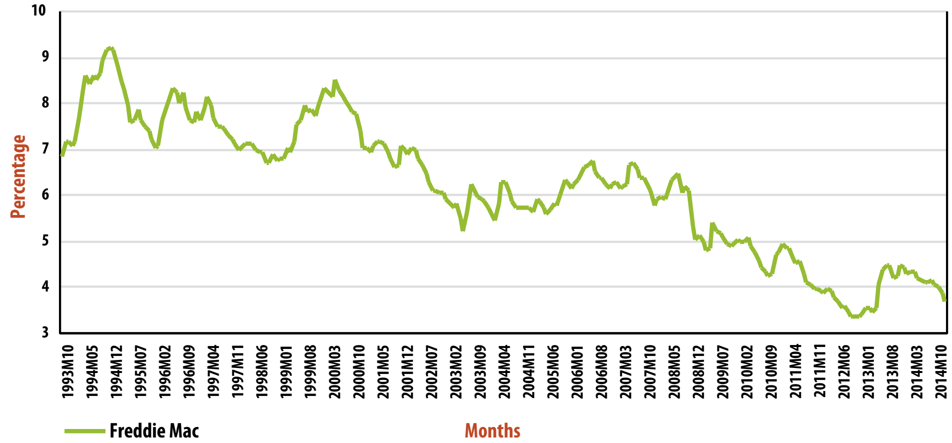
Last year's report successfully predicted a turning point in the yearly change in housing prices. However, the decline in growth actually occurred faster than the lower bound projections. The reversion to the mean rates consistent with the long-term growth of the series over the past ten-year period will continue into 2016 and 2017. A much anticipated increase in interest rates might curb housing demand in the latter part of 2016

Several newly-developing trends are likely to keep demand for housing vibrant in the Valley despite the expectation of higher interest rates by 2016.

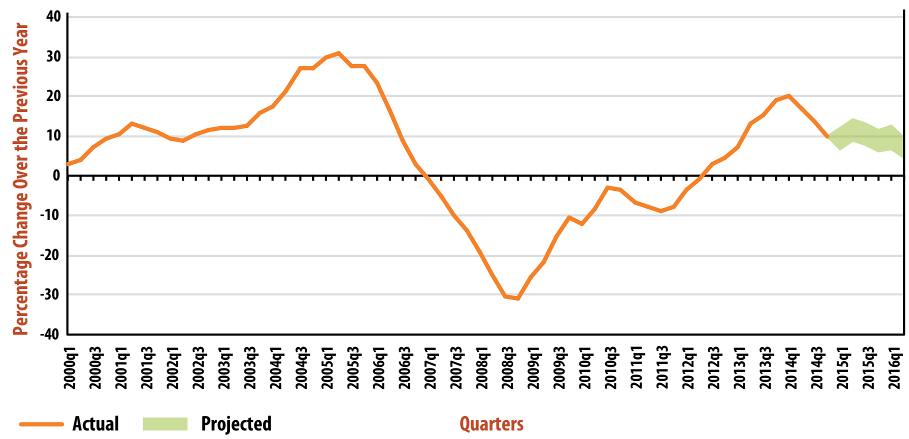
and 2017, further dampening appreciation in home values in the medium term. >>>

Home values appreciated most in Merced County by 21.3 percent in 2014 followed by 20.6 percent in Stanislaus County and by 18.2 percent San Joaquin County. Projections point to Valley home values declining to single-digit average yearly increases in the next two years. In 2016, projections point to an average yearly increase of 9.0 percent and about half that rate at 5.39 percent in 2017 but in line with the series' ten-year benchmark growth rate of 4.55 percent. >>>

30-Year Fixed Rate

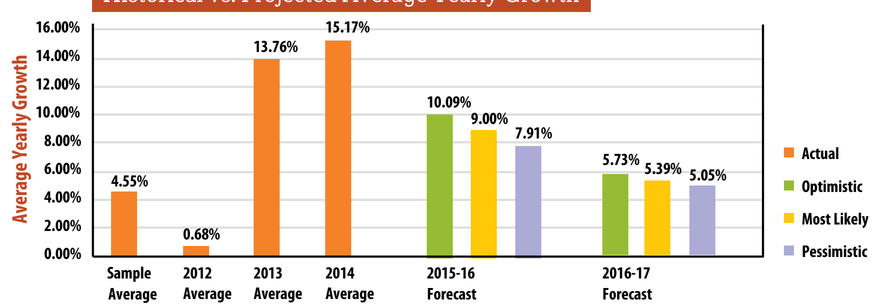


Yearly Percentage Change in Housing Prices



Yearly Growth in Housing Prices:

Historical vs. Projected Average Yearly Growth



Several newly-developing trends are likely to keep demand for housing vibrant in the Valley despite the expectation of higher interest rates by 2016. The re-emerging influx of labor to the Valley

The re-emerging influx of labor to the Valley is one important positive factor on the demand for housing and price appreciation.

is one important positive factor on the demand for housing and price appreciation. Relatively cheaper gas prices decreasing the cost of commuting from the Valley is another. The continuing fall in unemployment rates below historical averages in the Valley is yet another factor. Those newly employed are likely to qualify for home loans in the coming years, helping to maintain the ongoing demand for housing. >>>

New residential housing developments in California's San Joaquin Valley are pushing against the foothills of the Sierra Nevada Range.

The annual rate of inflation fell due mainly to the low price of oil. The increase in aggregate supply outpaced the increase in aggregate demand nationwide, causing the inflation rate to post a negative reading of -0.2 percent. Cheaper price of gasoline meant an average consumer had a little more money to spend for other goods. While there was a small deflation nationwide, prices grew by 0.7 percent in this region, pointing to a reverse situation where demand grew slightly more than supply. Inflation is likely to remain low for some time to come as long as price of oil remains low, and the U.S. dollar keeps appreciating against other major currencies, which further increases the purchasing power of domestic currency. >>>

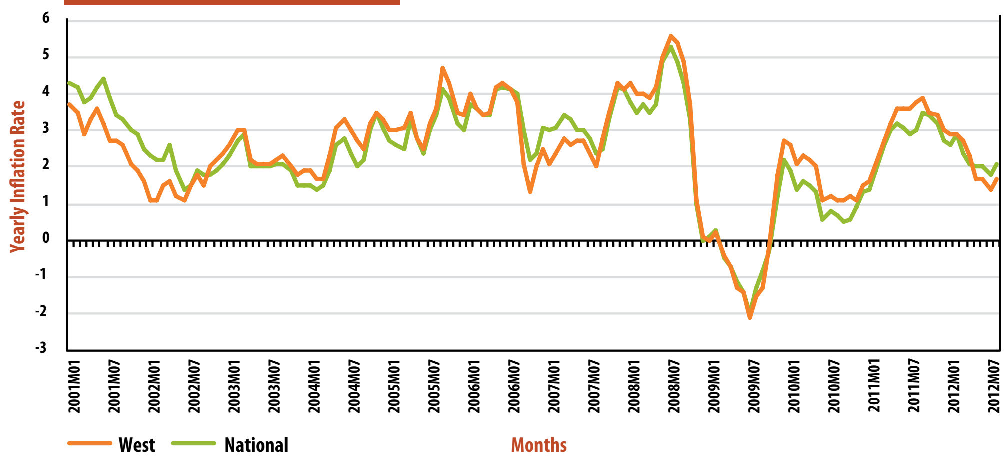
Cheaper price of gasoline meant an average consumer had a little more money to spend for other goods.

A negative reading of the inflation rate in February, 2015 was an important factor for the Federal Reserve to remain dovish in the first half of 2015. Disappointing manufacturing activity was another reason. Although very low, inflation continued to rise faster in the Western region than nationwide and stayed positive at 0.7 percent annually, above deflationary trends. >>>

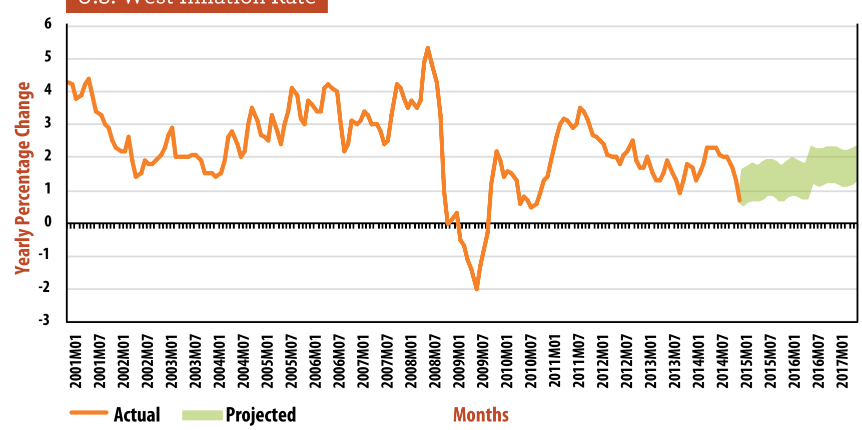
As the price of oil continues to remain low, cost push factors will not be present to move the inflation rate upwards. Therefore, despite low interest rates, inflation will remain low. The dollar's appreciation, however, did prevent inflation from rising by reducing the prices of imported goods. Prices are not likely to rise in the West due to the price of oil continuing to remain relatively low. Projections point to rates below the long term rate of 2.3 percent. >>>

Prices are not likely to rise in the West due to the price of oil continuing to remain relatively low.

Inflation Rate: The U.S. vs West

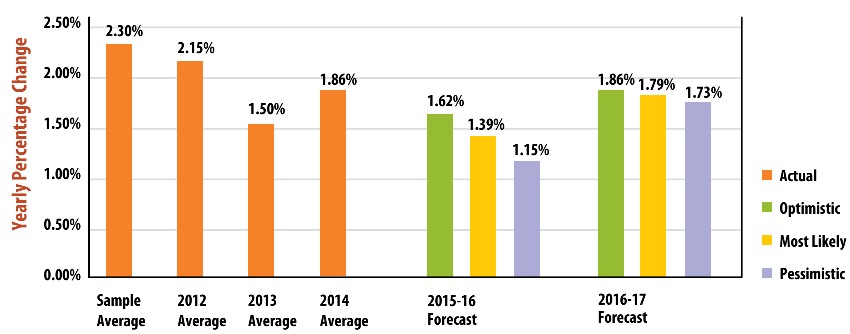


U.S. West Inflation Rate



U.S. West Inflation Rate:

Historical vs. Projected Average Yearly Growth



The 2014 yearly rate of inflation was 1.86 percent below the long term rate. If an interest rate hike occurs in the latter part of 2015, inflation will likely remain modest in the next two years. Projections point to a yearly inflation rate of 1.39 percent in 2016 and 1.73 percent in 2017. Higher inflation projection in 2017 is, however, attributed to the expectation of oil prices rising from all-time lows. >>>

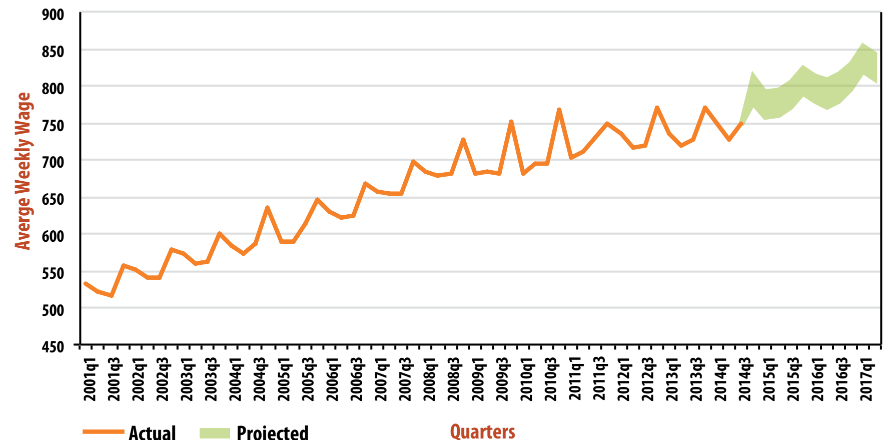
Nominal wages kept increasing at a slow pace, but because inflation remained low, the increase in nominal wages was a bit higher than the inflation rate. The February 2015 reading for the yearly inflation rate was only 0.7 percent. Projections therefore point to further increases in purchasing power of an average consumer in the Valley as long as inflation rates continue to remain modest. >>>

In 2014, for the first time since the end of the recession, average wages raised faster than the inflation rate. The average yearly increase in inflation was 1.91 percent, while the average yearly increase in weekly wages was 2.55 percent in 2014. There was a net gain in purchasing power for the first time since the end of the recession. Projections point to continuation of this trend at an average rate of 2.78 and 2.91 percent in 2016 and 2017, respectively. >>>

In 2014, for the first time since the end of the recession, average wages raised faster than the inflation rate.

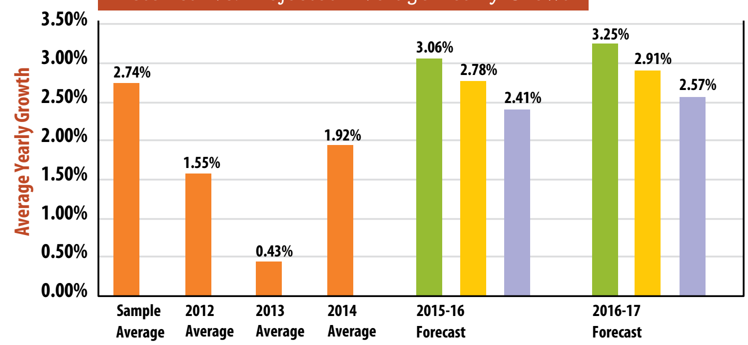
Since the recession, Valley residents have had to spend more out of their pocket to be able to afford the same bundle of goods than a year before. This loss in purchasing power was mainly caused by wage growth lagging behind inflation. However, a look at the newly forming picture shows that this may no longer be the case. A comparison of average weekly wage growth with yearly inflation reveals that inflation will most likely remain below wage growth for several months to come. The Valley operating slightly below the natural rate of unemployment will put further upward pressure on wages due to the tightening labor market. >>>

Quarterly Average Weekly Wages



Weekly Wage Growth:

Historical vs. Projected Average Yearly Growth



Yearly Wage Growth vs. Inflation

Bank deposits grew steadily year over year. For the first time since the recession however, Valley bank deposit growth was at par with the ten-year benchmark rate of 7.0 percent per year, reaching a new high in 2015. The incremental growth of about 2.0 percent from 2013 to 2014 was quite significant, pointing to further financial growth in the Valley. >>>

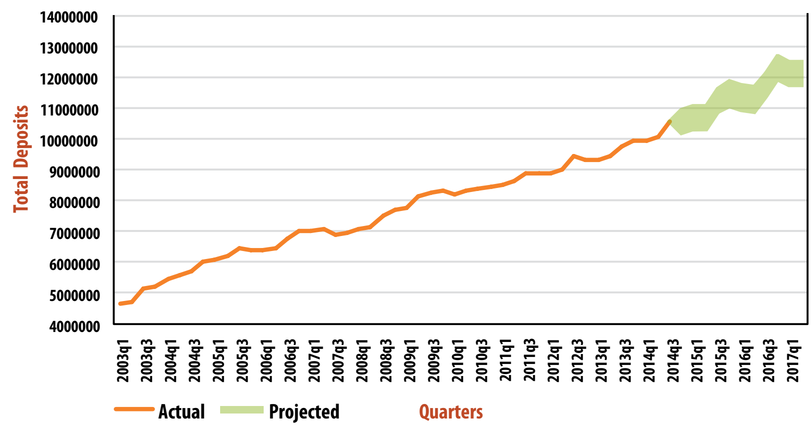
Projections point to growth at about the same rate as the ten-year benchmark rate due to the expectation of higher interest rates in 2016 and the resulting impact on the overall economy. Another factor dampening growth in total bank deposits in the coming months is the ongoing drought. Valley bank deposits projections point to 6.65 percent growth in 2016 and 6.47 percent in 2017. >>>

Bank assets in nonaccrual are settling to a new low after the recession. This new low appears to be at a higher level, indicating that banks are writing off a significantly higher portion of their assets than before the recession began. Assets in nonaccrual are not likely to decline any further to the pre-recession levels in the medium term, particularly if interest rates begin to rise in 2016. >>>

While Valley assets in default 30 to 89 days have increased in the last quarter of 2014, assets in default 90-plus days continued to decline. This increase in assets in default 30 to 89 occurred at the same time when interest rates rose above 4 percent, which was also in the same quarter of 2014. However, assets in default 30 to 89 days are likely to decline, together with assets in default 90-plus days, because interest rates fell in the first quarter of 2015 from 4.34 percent to 3.60 percent.

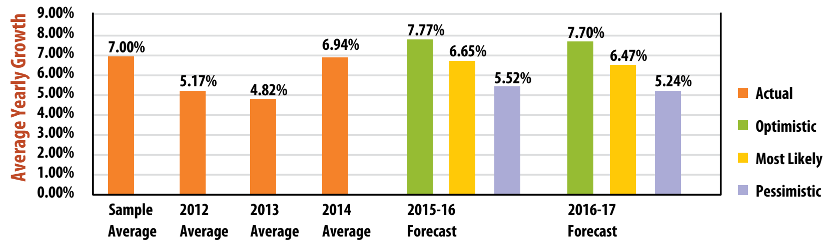
Bank assets in nonaccrual are settling to a new low after the recession.

Total Bank Deposits (in $ Thousands)

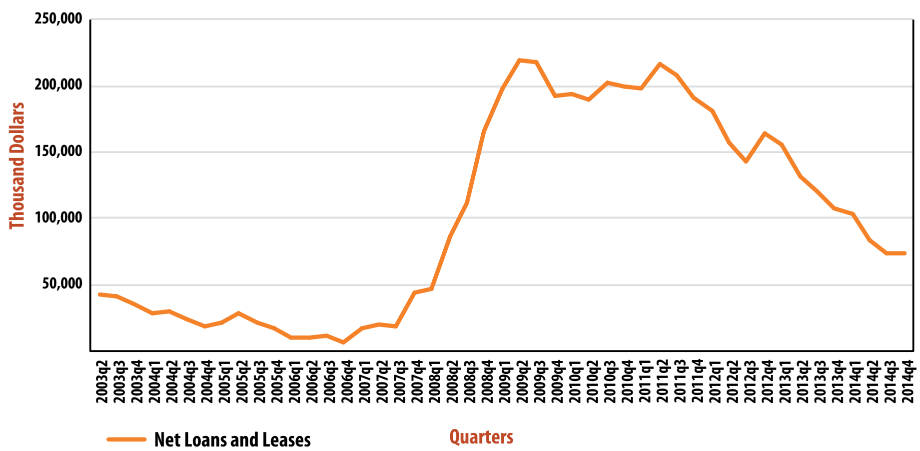


Total Deposits:

Historical vs. Projected Average Yearly Growth



Assets in Nonaccrual



Unlike assets in nonaccruals, both assets in default 30 to 89 days and assets in default 90-plus days have declined all the way down to the levels that existed in 2003. >>>

When 30-year interest rates rose as high as 4.34 percent in the last quarter of 2014, Valley net loans and leases registered a dip. However,

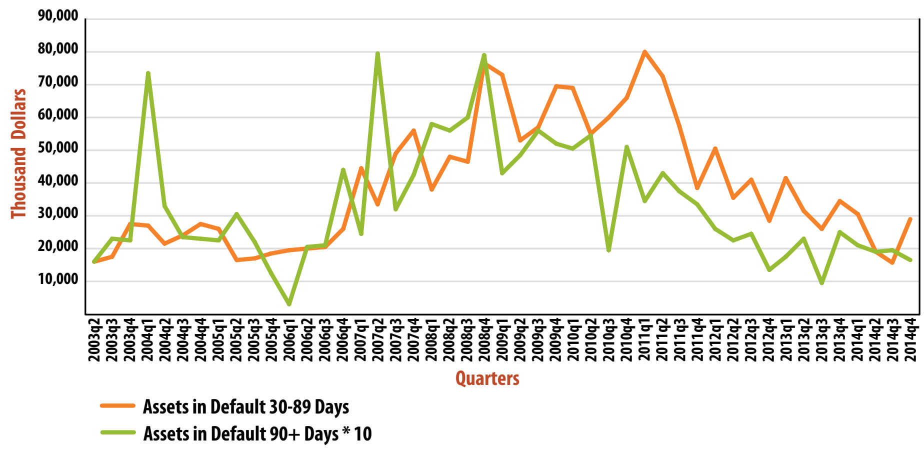
...declines in long-term interest rates brought net loans and leases up in line with the newly forming trend following the end of the recession.

subsequent declines in long-term interest rates brought net loans and leases up in line with the newly forming trend following the end of the recession. >>>

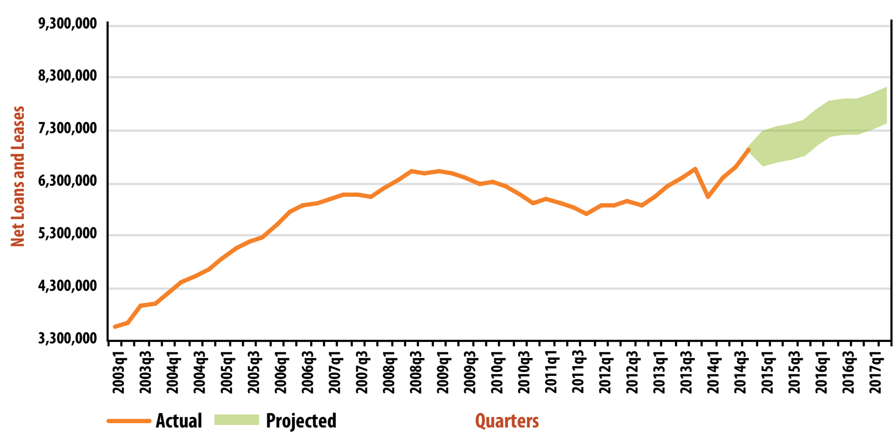
Net loans and leases are now back to the levels that have existed pre-recession and are projected to rise further, but at a slower pace than 2013 when the yearly increase was at 7.13 percent. Yearly growth in Valley net loans and leases is expected to be higher than 2.77 percent in 2014 but, closer to the ten-year benchmark rate of 5.24 percent. >>>

The Federal Reserve is expected to raise interest rates in 2016. A series of interest rate hikes would lower the rate of increase in net loans and leases. Projections point to an average yearly increase of 5.88 percent in 2016 followed by a slower 4.79 percent in 2017. >>>

Assets in Default 30 + Days

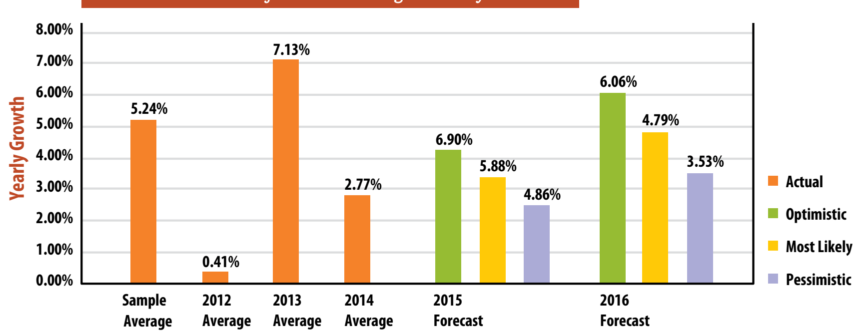


Net Loans and Leases (in $ Thousands)



Net Loans and Leases:

Historical vs. Projected Average Yearly Growth



For the first time since the recession, the Valley's unemployment rate fell slightly below the ten-year historical average. In previous years, employment had increased but unemployment had stayed above this structural rate. Interestingly, the rate of unemployment fell below the natural rate at a time when the Valley has been going through serious drought conditions. The non-farm-related sectors mitigated to a certain degree the negative effect of drought on farm-related sectors.

The fastest growing categories of employment were construction and leisure and hospitality services employment. Information employment registered very significant two to three percent growth, although the ten-year benchmark rate had a negative growth reading. Manufacturing and financial services employment posted a slight yearly decline from the year before.

...despite serious drought conditions, the Valley economy performed slightly above par and will continue to do so in the coming months.

Merced County had the fastest pace of growth in employment, while Stanislaus County grew about the same rate as the Valley overall, and Madera County employment posted a slight yearly decline. Projections point to growth above the ten-year benchmark rate for the entire Valley, but a worsening drought may very well bring forecasts closer to the pessimistic outcome.

Yearly growth rates in home values fell back to steady-state single-digit rates approaching closer to the representative rates observed in the past ten years. This reversion back to the ten-year benchmark rates is projected to continue into 2016 and 2017. Housing permits in the Valley also displayed a similar pattern after bouncing back from all-time lows.

Inflation remained low in 2014 and is likely to remain that way in the coming months. Low oil prices and a strong dollar were contributing factors keeping inflation below two percent. Average weekly wages increased slightly more than inflation, causing a slight increase in the purchasing power of Valley consumers. Projections point to further incremental gains in average weekly wages.

Net loans and leases dipped in the first quarter of 2014 when thirty-year interest rates reached a level above four percent. However, subsequent declines in rates in the following quarters brought Valley net loans and leases back to the post-recession trends. Projections point to increases in net loans and leases at about the same rate as the ten-year benchmark rate. Total bank deposits had the fastest pace of increase since the recessionary years. However, anticipation of interest rate hikes in 2016 will mean slightly lower increases in Valley total deposits in the coming two-year period.

In all, despite serious drought conditions, the Valley economy performed slightly above par and will continue to do so in the coming months. Non-farm related sectors will continue to partially mitigate, albeit to a lesser degree, the negative impact of drought on the farm-related sectors. >>>

Workers in a Kern County vineyard.

Forecast Accuracy Table

	Error	Accuracy	Turning Point
Total Employment	-0.30%	99.70%	Yes
Real GDP Growth	9.95%	90.05%	Yes
Construction	0.11%	99.89%	Yes
Education & Health	1.02%	98.98%	Yes
Government	0.48%	9.52%	Yes
Financial Services	1.46%	98.54%	No
Information	-0.84%	99.16%	Yes
Leisure & Hospitality	-0.53%	99.47%	Yes
Manufacturing	0.59%	99.41%	Yes
Retail Trade	2.26%	97.74%	Yes
Trade, Transportation & Utilities	1.44%	98.56%	Yes
Wholesale Trade	-1.71%	98.29%	Yes
Inflation	0.78%	99.22%	No
Quarterly Average Wage	2.98%	97.02%	Yes
Housing Permits	36.00%	64.00%	Yes
Change in Housing Price	0.38%	99.62%	Yes
Total Bank Deposits	-0.88%	99.12%	Yes
Net Loan/Leases	2.48%	97.52%	Yes
Overall	3.56%	96.44%	

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