Stanislaus State

SAN JOAQUIN VALLEY

BUSINESS FORECAST REPORT

2017 | Volume VII | Issue 1

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SAN JOAQUIN VALLEY BUSINESS FORECAST REPORT 2017

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Volume VII, Issue 1

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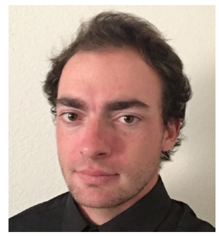

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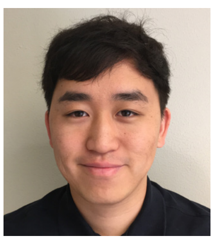

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Executive Summary

In line with predictions made in previous San Joaquin Valley Business Forecast Reports, total employment growth continues to slow. Since the slowing of growth is coming at a more significant rate than in previous years, the Valley economy is displaying signs of plateauing.

With a growth rate of only 0.52 percent in 2017, another year of drop in growth in 2018 could result in a decrease in total employment for the first time since the Great Recession. Much-awaited tax reform and the recent dovish stance of the Federal Reserve following several rate hikes are a few of the factors that may play a role in maintaining employment growth in the Valley.

Relative to recent years, the Valley's total employment grew at a significantly slower pace in 2017. The drought years weakened economic conditions, and new regulations as well as the impacts of immigration reform and the Federal Reserve rate hikes combined to slow growth in 2017.

Much is happening politically that will affect the future course of the economy, including tax reform if it generates the intended result of stimulating the economy without increasing the budget deficit. Other factors may include a significant revision of latest employment numbers from the Bureau of Labor Statistics, a higher rate of inflation that may cause the Federal Reserve to implement additional rate hikes and further escalation of tensions in Asia and the Middle East.

Total employment growth in the Valley is slowing down at a faster rate than that of California, and the decline in both are higher than the gradual slow-down in nationwide total employment. The slow-down is a potential concern if it continues, but the much-anticipated tax reform, along with a dovish stance of the Federal Reserve create an expectation of slightly faster growth in 2018 and 2019 than in 2017.

For the first time since the Great Recession, the yearly rate of employment growth, 0.52 percent, was smaller than the long-term benchmark growth of 1.17 percent. Also for the first time since recession, Stanislaus County paced the Valley with a 1.94 percent growth rate, while other Valley counties stalled or posted slight declines. Madera registered the second-fastest growth at 1.15 percent, beating historical outperformers in growth such as Fresno (0.93 percent) and San Joaquin counties (0.38 percent). Total employment declined in Kern by 0.60 percent and in Kings by 1.19 percent. Merced and Tulare posted very small yearly growth numbers at 0.51 and 0.64 percent, respectively.

Construction employment displayed the fastest growth at 6.38 percent, followed by education and health services employment at 3.99 percent and government employment at 2.01 percent. At 1.83 percent yearly growth, retail trade employment dropped from the first to the fourth place in 2017, tied with trade, transportation and utilities employment. Wholesale trade employment grew 1.55 percent, financial activities employment rose 1.4 percent in 2017, and leisure and hospitality services employment struggled to increase only 0.28 percent. The most significant drop was in information employment, which declined 4.47 percent.

The Valley's average home price grew by 7.82 percent in 2017, more than a point higher than the 2016 rate of 6.56 percent. The growth rate should slow in the coming months. At the same time, long-term interest rates continued to increase in 2017, helping to deflate any bubble in the housing market caused by rising home prices. After several years of double-digit growth in the number of home building permits issued, 2017 saw the number of permits rise by 0.52 percent. However, it's important to note that roughly the same number of permits were issued in 2017 as in 2016.

With the retreat in the price of oil, cost-push factors dissipated in 2017, bringing the yearly rate of inflation back to the long-term rate. The rate of inflation, however, was higher than the growth in weekly wages in 2017, causing a drop in the purchasing power of the Valley consumer. Labor force growth continued to remain below employment growth in the Valley, displaying dynamics not consistent with the Valley's structural pattern.

Despite rising 30-year rates, foreclosure filings continued to fall in 2017. Valley net loans and leases continued to grow together with bank deposits, but at a slower rate than in 2016. The growth in net loans and leases, however, was much less than total deposits. After several years of continuous drop, assets in default 30-89 days, 90-plus days and non-accruals began displaying a flat trend in 2017.

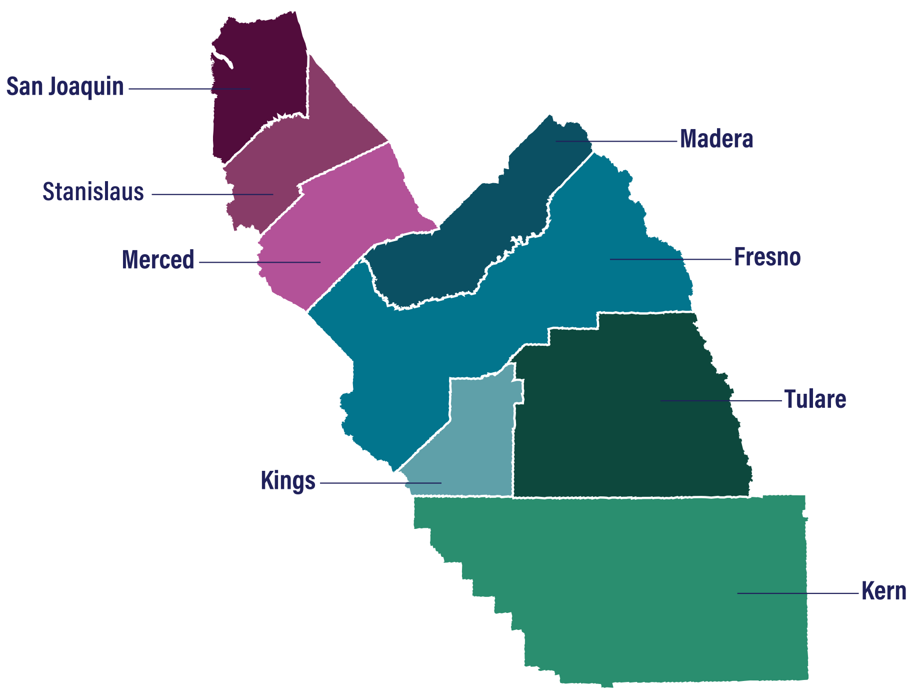
Introduction

This report, now in its eighth year, has benefitted greatly from its chosen broad focus on the San Joaquin Valley. Each edition has garnered increasing attention from private and government constituencies from throughout the Valley, appearing in more than 100 times in popular media outlets and this attention would not have occurred had the report maintained a single-county focus.

The long-term data in this report spans January 2001 through October 2017. The medium-term forecasts span from November 2017 to December 2019. The yearly averages reported in this year's edition are from the first ten months of 2017, whereas the data from 2016 and 2015 are from the entire twelve months.

The remainder of this report is organized as follows: First we provide a discussion of San Joaquin Valley labor market conditions, followed by an examination of the Valley's real estate market. We then cover prices and inflation and finish with a look at banking and capital market indicators.

San Joaquin Valley

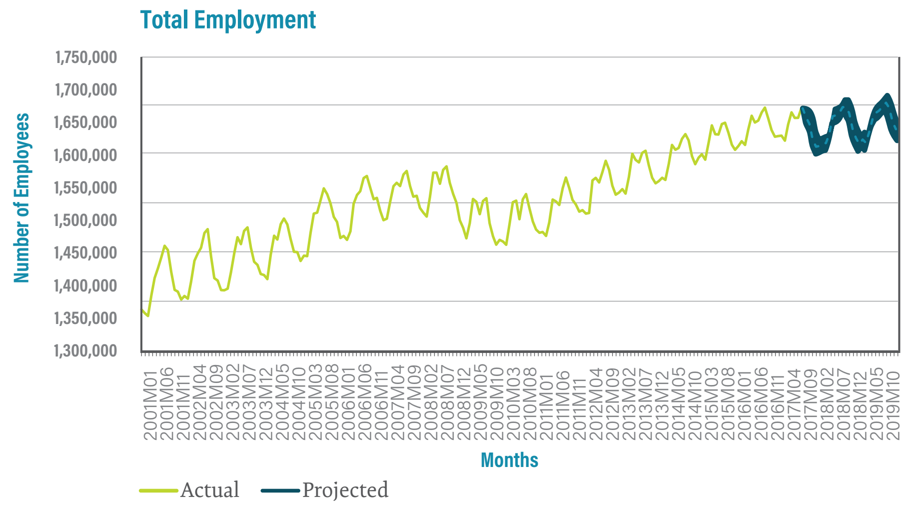


Employment Indicators

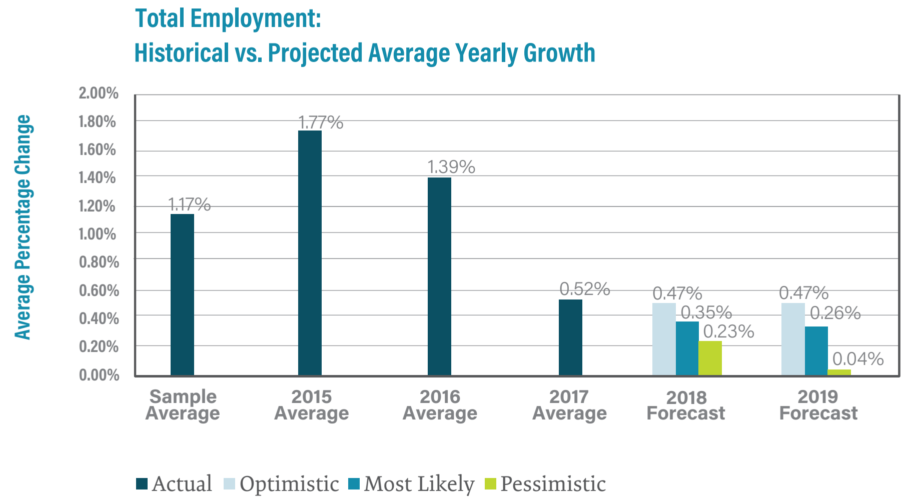
Relative to recent years, the Valley's total employment grew at a significantly slower pace in 2017. The drought years weakened economic conditions, and newer regulations — such as those requiring lower cow emissions and higher overtime pay to farm workers — as well as the dual impacts of immigration reform and the Federal Reserve rate hikes combined with other factors to slow growth in 2017. Both agricultural and non-farm employment contributed to the slowdown in employment growth.

With a 1.94 percent average yearly rate of increase, Stanislaus County posted the Valley's fastest employment growth in 2017, followed by Madera at 1.15 percent. Past years saw San Joaquin and Fresno counties leading growth, but San Joaquin employment grew at only 0.38 percent, while Fresno grew 0.93 percent. Total employment declined in Kern County by 0.60 percent, while Kings County had a faster decline of 1.19 percent. Tulare County's total employment grew by 0.64 percent, roughly the same pace as the Valley average. This was also true for Merced County total employment, which grew at 0.51 percent.

After several years of relatively poor performance, the construction employment sector took back the lead in the Valley in 2017. Education and health services employment came in second, followed by government and manufacturing employment, which continued its recovery and switched from negative to positive growth in the long-term benchmark. When interest rates are hiked, retail trade employment is generally the first sector to get hit, and such was the case in 2017. Following the rate hikes, retail trade sector employment in the Valley fell to fourth place at nearly an identical rate as trade, transportation and utilities employment. Leisure and hospitality services employment came in fifth at 0.28 percent. Financial activities employment was another sector that picked up some speed in 2017, but still placed in sixth in terms of speed of growth. Information employment continued to decline, dropping 4.47 percent.



Valley total employment grew 0.52 percent in 2017, less than half the Valley's typical growth rate of 1.17 percent. When the recessionary years are excluded from the data, this benchmark rate increases to 1.72 percent, serving to make the employment picture in 2017 slightly worse by perspective. The growth rate at 0.52 percent is showing signs of plateauing, which is a flag of concern for the Valley. Another year of decline at the same intensity in the Valley's growth rate may very well bring a decline in total employment for the first time since the Great Recession. Much-expected tax reform and the dovish stance of the Federal Reserve after several rate hikes may play a role to keep employment growing in the Valley. Projections point to a yearly average growth of 0.35 percent in 2018 and 0.26 percent in 2019.

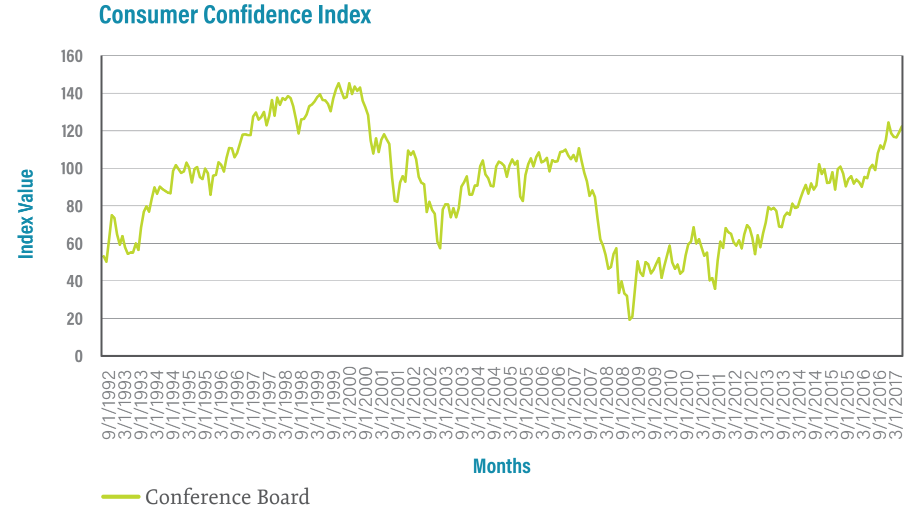


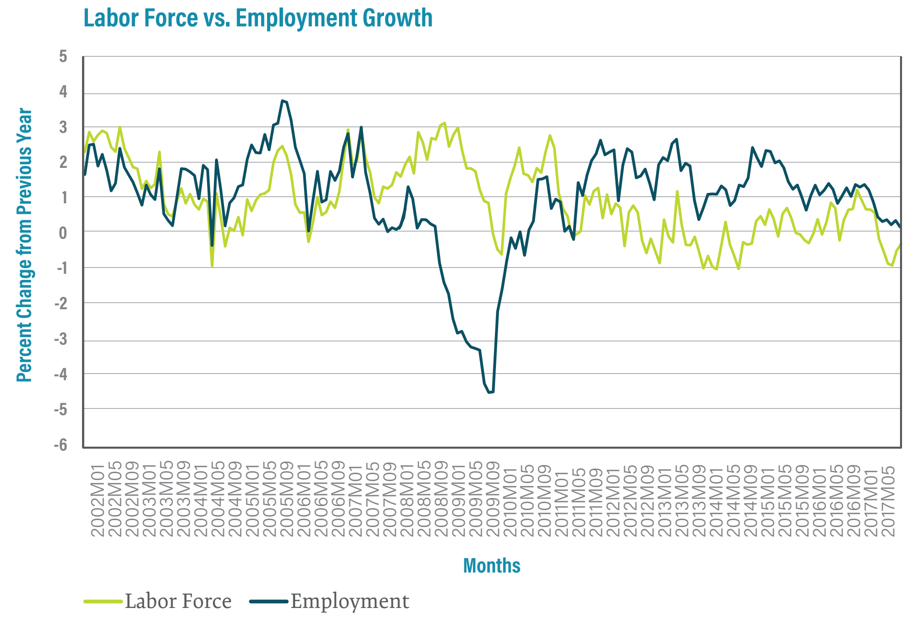
Interestingly, in an environment of Federal Reserve rate hikes, the Consumer Confidence Index continued to increase in 2017. The last time such high consumer confidence numbers were observed was as early as 2000, which indicated consumers' ability to foresee their short-term consumption patterns. However, there was a slight decline in the third quarter of 2017, perhaps signaling — as an important leading indicator — that consumption expenditures would begin to change in the coming months, particularly since retail trade and leisure and hospitality services employment growth is showing the first signs of a slowdown.

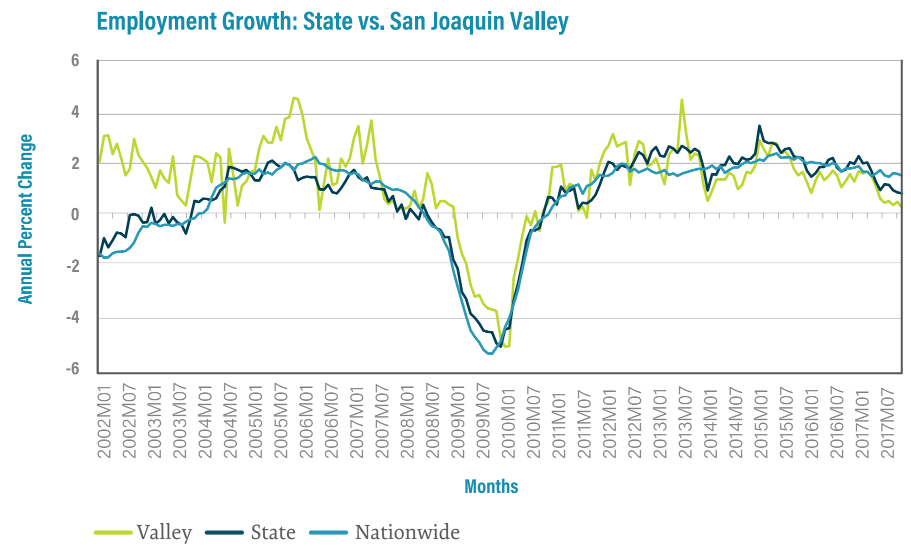
For the first time since 2011, labor force growth caught up with employment growth in the Valley, but the pattern that did not continue through 2017 as both displayed a falling pattern. Labor force growth slowed down at a faster rate and became negative in 2017, which corresponded to shrinkage in labor force numbers.

The abnormal dynamics can be seen from comparing employment growth of the Valley and the state with the national figures. The Valley's total employment together with that of the state is slowing down at a much faster rate than nationwide. Further, the Valley's slowdown in growth is faster than the state. A continuation of this trend would mean the Valley would be one of the first regions in the nation to report a worsening unemployment rate after several years of improvement.

The current unemployment rate in the Valley is at an all-time low, which is indicative of at or above full employment. Employment is not expected to decrease further in the coming months, consistent with naturally occurring business cycles. However, these rates could be impacted by several factors, most notably federal tax reform and its intent of stimulating the economy without increasing the budget deficit.







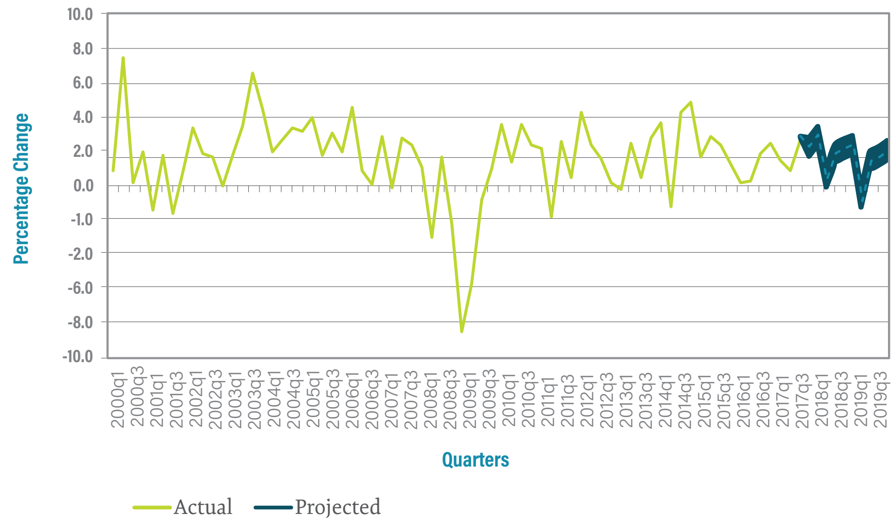
Employment Indicators

Real gross domestic product (RGDP) grew 1.2 percent in the first quarter of 2017, followed by 3.0 percent growth in the second quarter. The depreciation in the U.S. dollar may bring back worries of inflation but it also helps improve the country's current account position. The Federal Reserve's balance sheet reduction should help keep inflation in check. New consensus projections point to 1.95 percent average yearly real economic growth in 2018 and 2019.

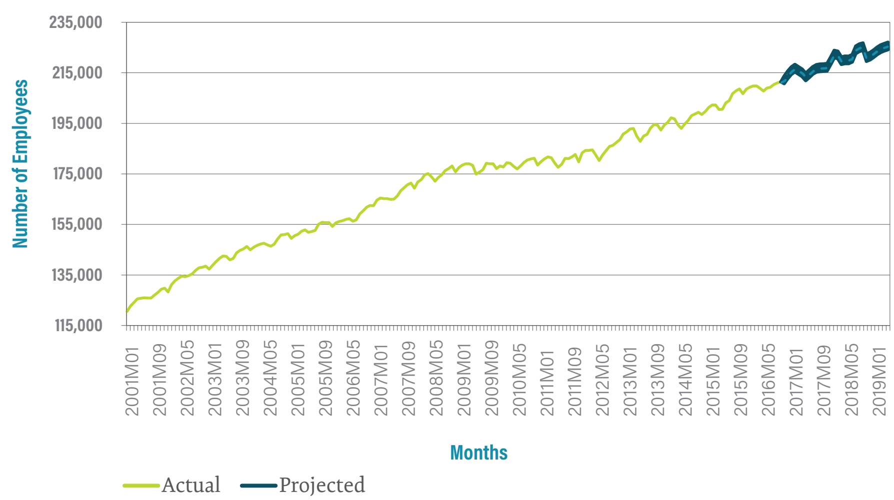
Education and health services employment was the second-fastest growing category of employment in the Valley. Generally resilient to cyclical patterns and recessions, it may be telling of a further slowdown since the sector has tended to show the Valley's second-fastest growth in recent years. During the recessionary years, education and health services employment often came in as one of the strongest categories of employment in the Valley. Employment in this category is projected to exceed 215,000 by the second half of 2018.

The Valley's education and health services employment generally is immune to cyclical patterns and now stands at 3.41 percent, continuing gradual year-by-year growth. Employment growth of 3.99 percent in this sector in 2016 again exceeded the benchmark rate of 3.41 percent. The mean long-term reversion that projected toward the benchmark did not occur in 2017. Projections point to an average yearly growth of 3.04 percent in this sector in 2017 and 2.70 percent in 2018.

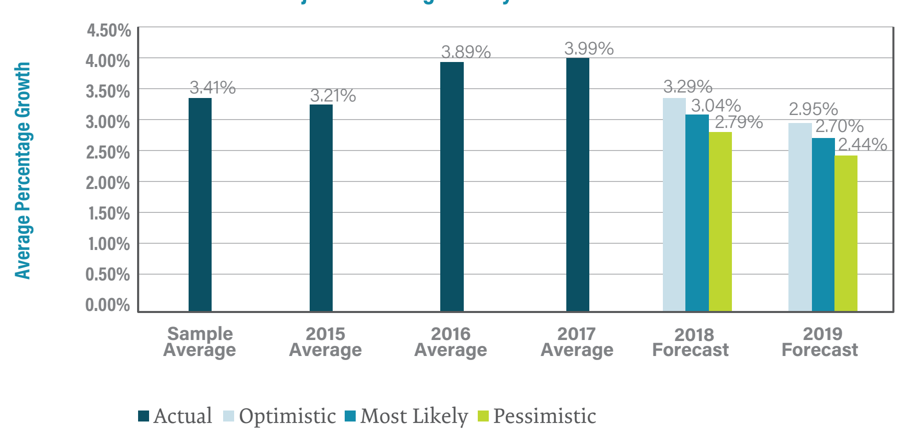
U.S. Real GDP Annual Growth



Education and Health Services Employment



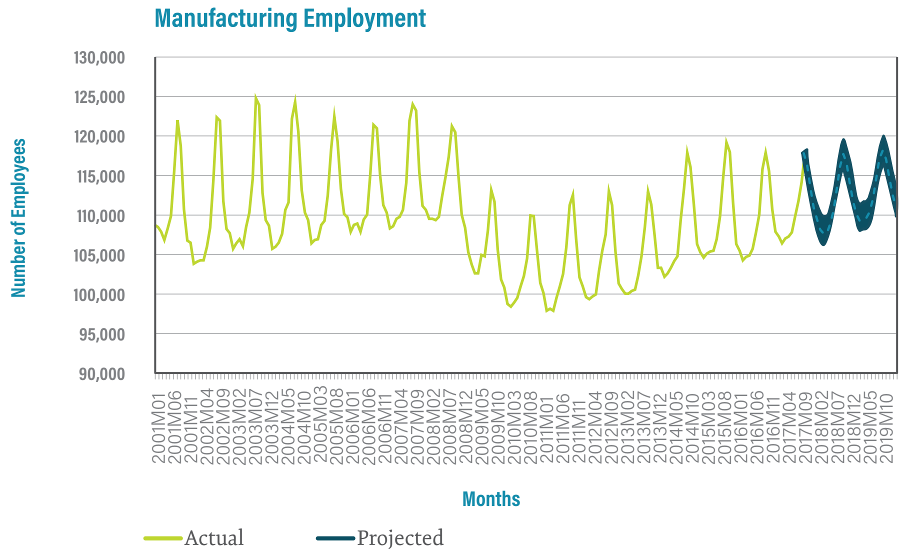
Education and Health Services Employment: Historical vs. Projected Average Yearly Growth

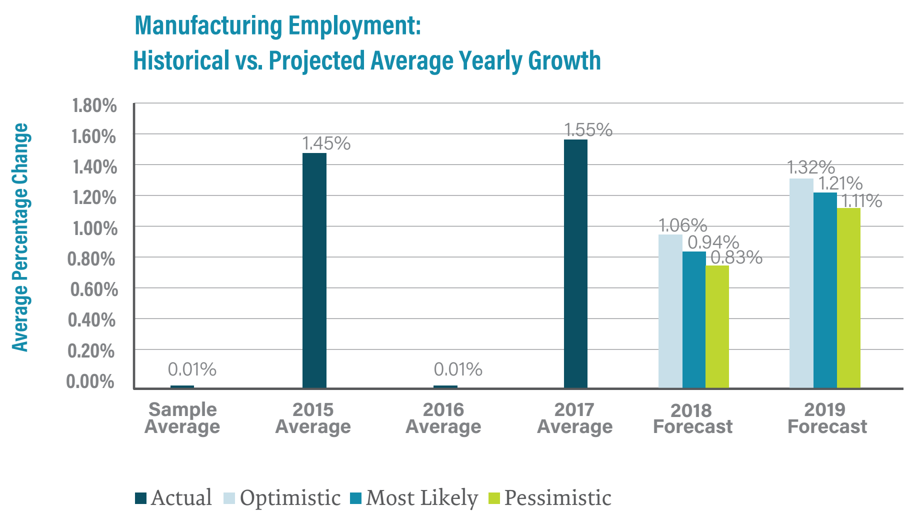


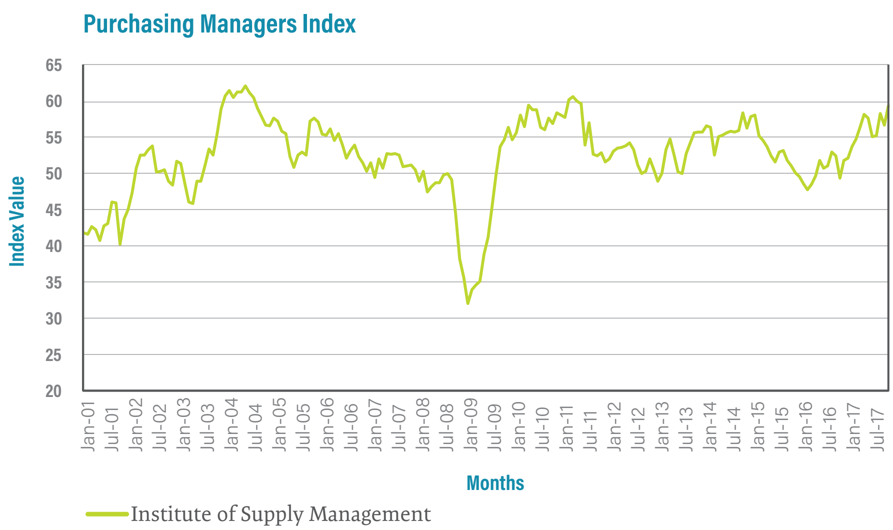
The long-term benchmark growth rate in manufacturing employment switched from negative to positive territory in 2017. After stagnant growth in 2016, employment in this category registered 1.55 percent growth, well above the benchmark rate of 0.01 percent. The increase in manufacturing employment also occurred during the year when growth in other categories fell. The fastest growth in manufacturing employment occurred in the cities of Merced and Hanford, at 6.32 and 5.70 percent, respectively. Employment levels are now back to the levels that existed in 2008. The Valley's manufacturing employment continued to grow faster than the nation and state both in 2016 and 2017.

Two counties reported declines in manufacturing employment: Fresno (-0.29 percent) and Stanislaus (-0.01 percent.) Manufacturing employment in the Valley is projected to exceed 115,000 by the second half of 2018. Decisions by major corporations to relocate distribution sites to the I-5 corridor appeared to pay off for the operations of companies such as Amazon. Projections point to slower growth in 2017 and 2018 at an average yearly growth of 1.07 percent.

The Institute of Supply Management's purchasing managers index continued to increase in 2017. Its value of 58.8 in August was the highest of the last seven years. Such a pattern is indicative of expansion in manufacturing activity relative to previous years at the national level. Nationwide, manufacturing employment had shrunk by -0.19 percent in 2016, but 2017 brought a nationwide increase in manufacturing employment of 0.41 percent. That trend did not hold in California, where manufacturing employment decreased at a yearly average rate of 0.61 percent. At the same time, Valley manufacturing employment posted 1.55 percent growth, more than three times the national rate. This relative strength in employment dynamics again indicates the Valley's emerging potential in manufacturing activity at a time when slowing in other categories occurred.







Employment Indicators

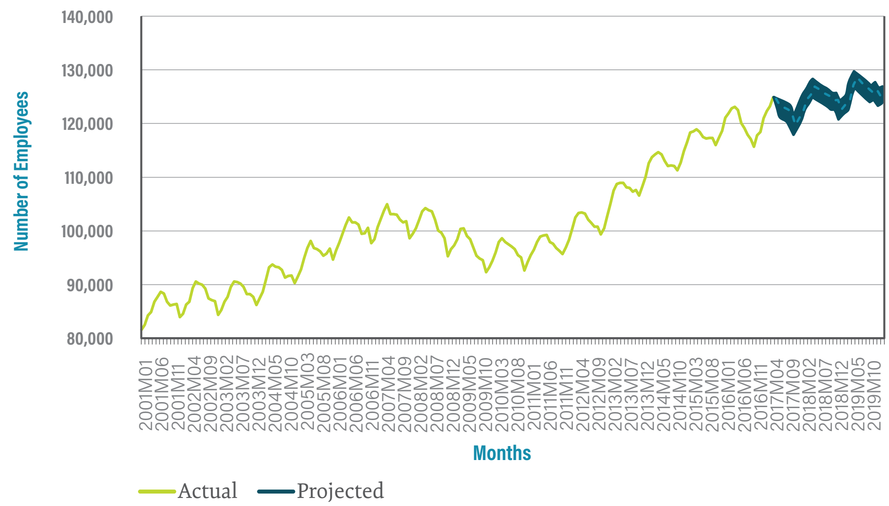
The Valley's leisure and hospitality services employment, which posted strong performance during previous years, posted very small growth of 0.28 percent in 2017 Just like retail trade, leisure and hospitality services generally is one of the first ▶ categories to be negatively affected by the increase in interest rates. Employment in this category exceeded 120,000, and at this slower pace is projected to reach 130,000 by the second half of 2019. Leisure and hospitality services employment dropped from the second-fastest growing category of employment to second from last in 2017.

"...THE STAGNANT GROWTH DYNAMICS WERE THE LOWEST RECORDED SINCE THE END OF THE GREAT RECESSION."

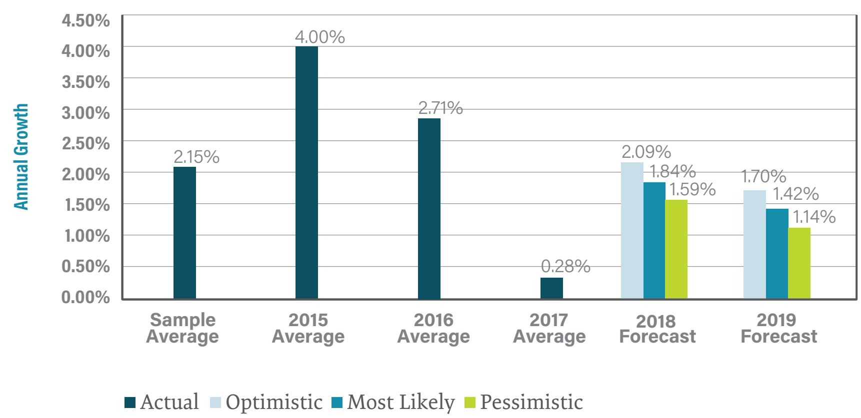
Undoubtedly, higher credit card interest rates resulting from the past rate hikes had a role to play in the significantly lower growth numbers observed during 2017. Further, the stagnant growth dynamics were the lowest ▶ recorded since the end of the Great Recession. The long-term benchmark growth rate in leisure and hospitality services employment now stands lower than 2016 at 2.15 percent. Employment in this category is projected to grow at an annual average rate of 1.84 percent in 2018 and 1.42 percent in 2019, coming back from relatively low numbers reported in 2017 and due to the dovish stance of the Federal Reserve.

In an environment of slowing employment growth, 2017 was another year during which trade, transportation and utilities employment displayed a relatively strong performance. Employment in this category grew fourth-fastest in 2017 at 1.82 percent, or roughly the same rate as the long-term benchmark rate of 1.72 percent. Employment levels in this category are projected to reach 290,000 by the first half of 2019. ▶

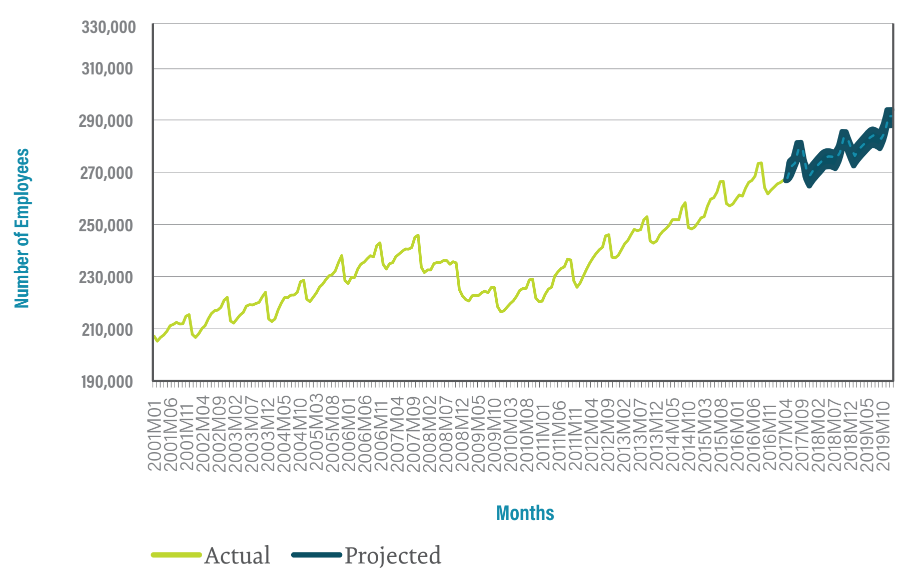
Leisure and Hospitality Services Employment



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



Trade, Transportation and Utilities Employment

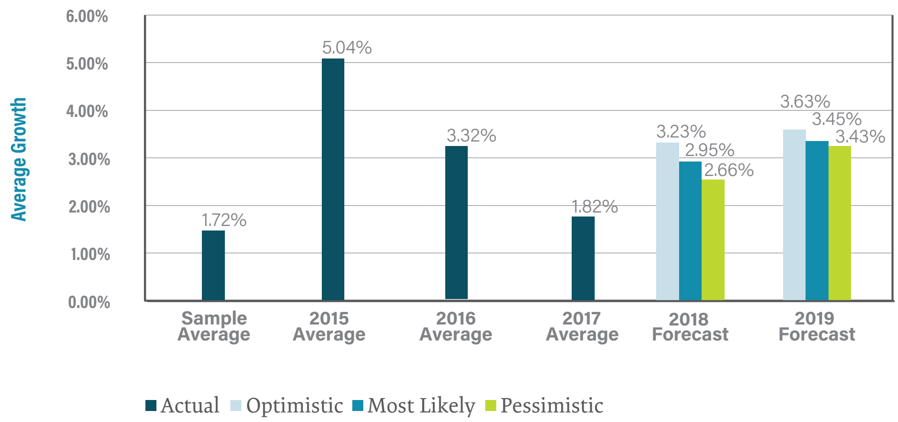


Among Metropolitan Statistical Areas (MSAs) Madera registered the fastest growth in trade, transportation and utilities employment in 2017, at an average yearly rate of 3.21 percent. Fresno and Modesto tied for second place, each growing at 2.63 percent. Above-average growth rates in this category of employment will likely continue in the coming months close to the long-term benchmark rate. The Valley's growth in trade, transportation and utilities employment at 1.82 percent was also well above the growth rate at the national and state level at 0.63 percent and 1.13 percent, respectively. Projections point to growth in this employment category to oscillate around an average yearly rate of 3.20 percent in 2018 and 2019.

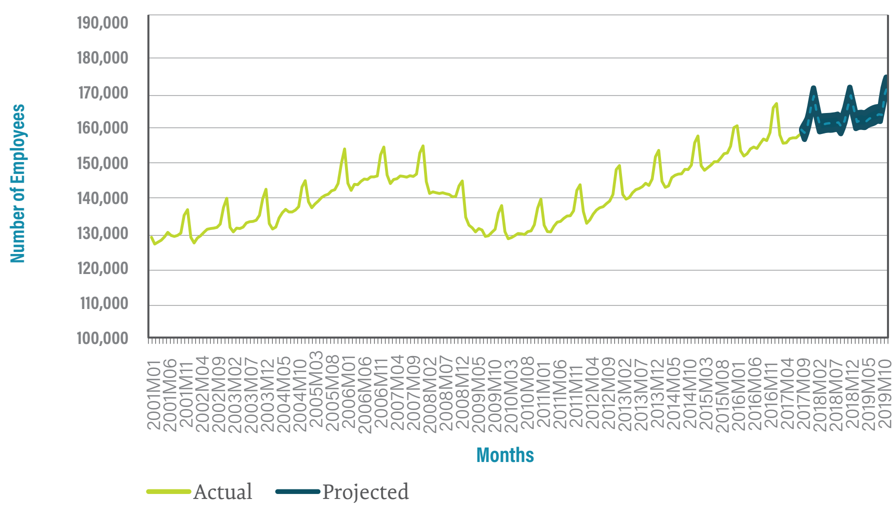
Retail trade fell from the fastest-growing category of employment in 2016 to the fourth fastest in 2017. The retail trade sector is generally the first to get impacted by the increase in interest rates, followed by wholesale trade. At this slower pace of 1.82 percent, employment in this category is projected to reach 170,000 by the second half of 2019. The Federal Reserve's change in stance toward a dovish policy following the last interest rate hike in 2017 should help retail trade employment from declining significantly, but it will grow at slower rates in the coming months.

An increase in the rate of inflation was another factor that put a dent in the purchasing power of the Valley consumer in 2017. The yearly rate of increase in weekly wages fell behind the yearly inflation rate, causing consumers to afford fewer bundles of goods than before. A depreciating dollar increased the domestic price of imported goods, making them less affordable in 2017. Projections in retail trade employment now point to growth of 1.57 percent in 2018 and 1.05 percent in 2019.

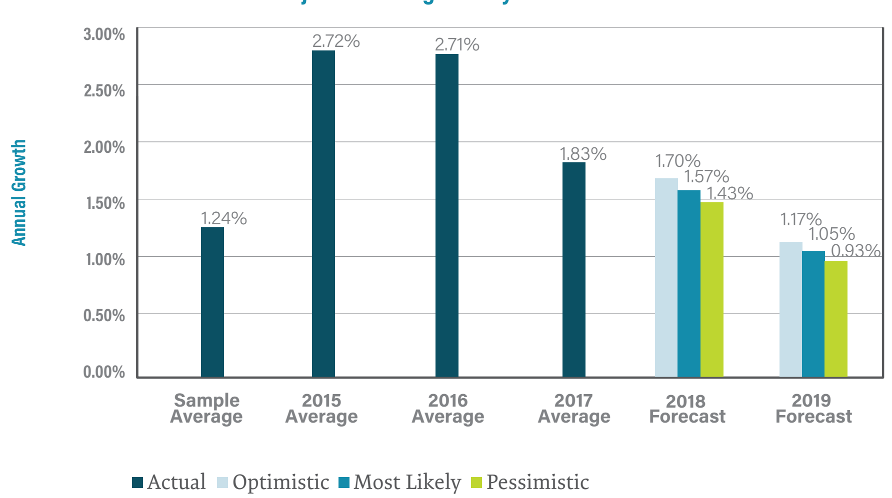
Trade, Transportation and Utilities Employment: Historical vs. Projected Average Yearly Growth



Retail Trade Employment



Retail Trade Employment: Historical vs. Projected Average Yearly Growth



Employment Indicators

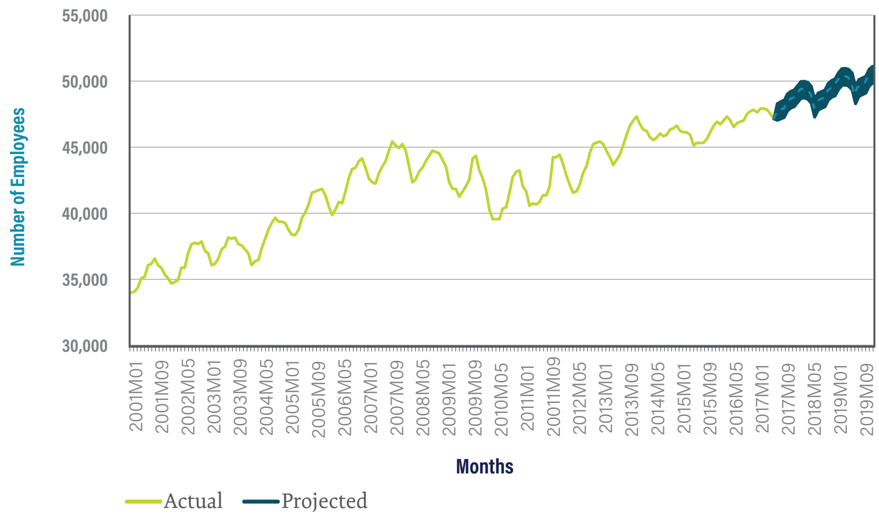
The recovery of wholesale trade employment after the recessionary years was interrupted by the drought years. Obvious seasonal variations no longer were as visible during and after the drought years, clearly pointing to an entirely different type of dynamics that began in the second half of 2014. For wholesale trade employment, 2017 was another year during which employment grew less than retail trade employment. However, the discrepancy between the two was much smaller in 2017 than 2016. Structurally, wholesale trade employment should grow faster than retail trade employment.

Wholesale trade employment in the Valley grew by 1.73 percent in 2017, still slower than the long-term benchmark growth rate of 2.01 percent. Employment levels in wholesale trade employment will likely reach 50,000 by the second half of 2019. Modesto was the fastest-growing MSA at 6.45 percent, followed by Fresno at 5.51 percent. Projections point to growth at a yearly average rate of 1.39 percent in 2018 and 1.16 percent in 2019.

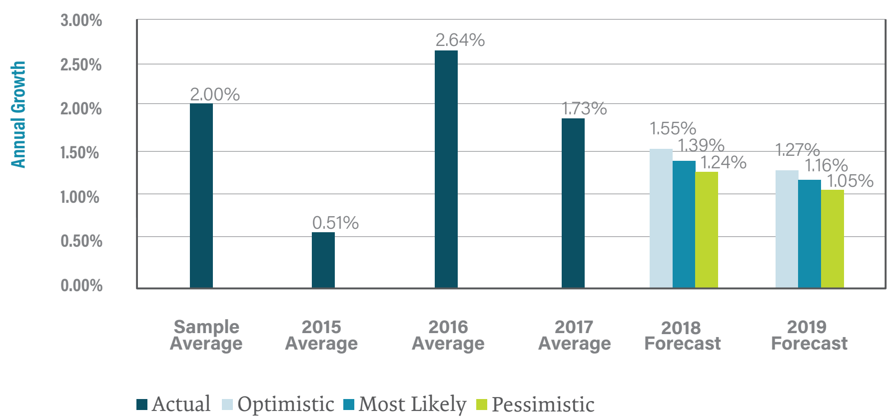
50,000 WHOLESALE TRADE EMPLOYMENT BY 2019

Information services employment continued to worsen in 2017 and remains as one of the categories that continued to suffer after the end of the recessionary years. Given the prevailing dynamics of a slowdown in the Valley in economic activity, any improvement in this category is not expected soon. At best, the series will likely oscillate around an employment level of 10,000.

Wholesale Trade Employment



Wholesale Trade Employment: Historical vs. Projected Average Yearly Growth



Information Employment

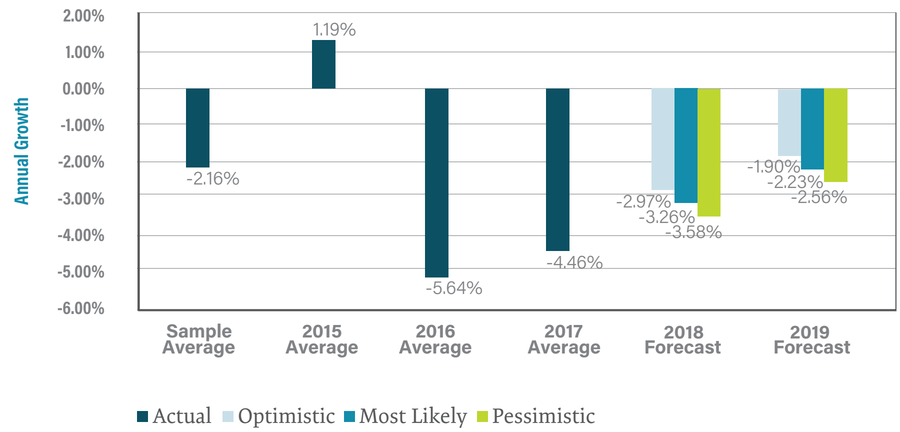
Given the revised numbers from the Bureau of Labor Statistics (BLS) pointing to information employment worsening in 2017 to -4.46 percent, brings the long-term benchmark growth rate further down to -2.16 percent. A negative growth rate basically corresponds to fewer jobs being available in this category than in the previous year. In light of the reversing dynamics, projections point to a yearly average decline of 3.26 percent in 2018 and 2.23 percent in 2019. ▶

"A NEGATIVE GROWTH RATE BASICALLY CORRESPONDS TO FEWER JOBS BEING AVAILABLE IN THIS CATEGORY THAN IN THE PREVIOUS YEAR."

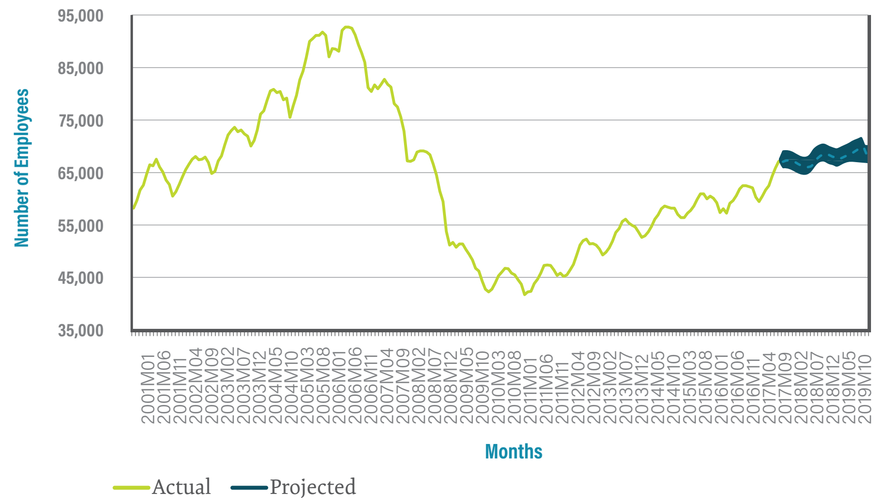
In terms of average yearly growth, the 6.38 percent in 2017 was even higher than 5.26 percent in 2014 for construction employment. The pick-up in speed was also evident from housing permits issued in 2016, which served as a leading indicator for construction activity. Employment in this category is projected to reach 70,000 by the second half of 2019. The discrepancy in growth rates by metropolitan statistical areas however also continued in 2017 as it did in 2016. ▶

Of all the Valley's MSAs, Merced had the fastest growth in construction employment of 13.72 percent in 2017, followed by Stockton and Visalia at 12.20 and 11.06 percent, respectively. Hanford, at 7.46 percent, and Modesto, at 7.39 percent, posted nearly identical growth rates. Bakersfield reported a small decline of 0.47 percent in 2017. In line with a cooling economy, projections point to a 4.14 percent average yearly increase in 2018 and 2.21 percent in 2019. ▶

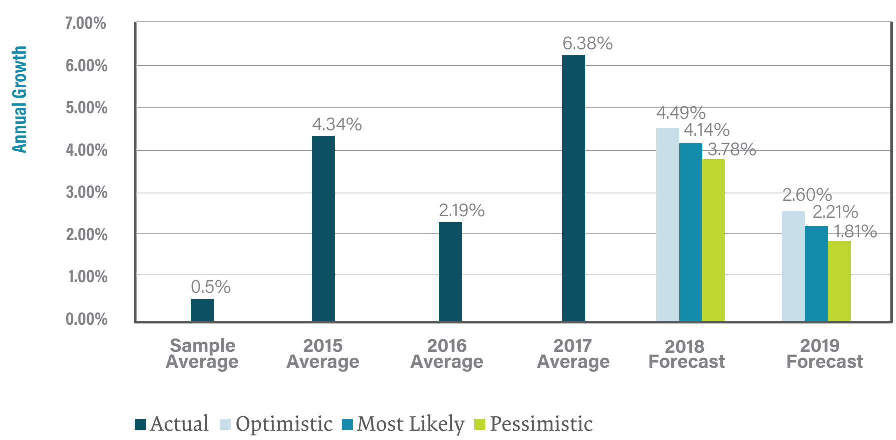
Information Employment: Historical vs. Projected Average Yearly Growth



Construction Employment



Construction Employment: Historical vs. Projected Average Yearly Growth



Employment Indicators

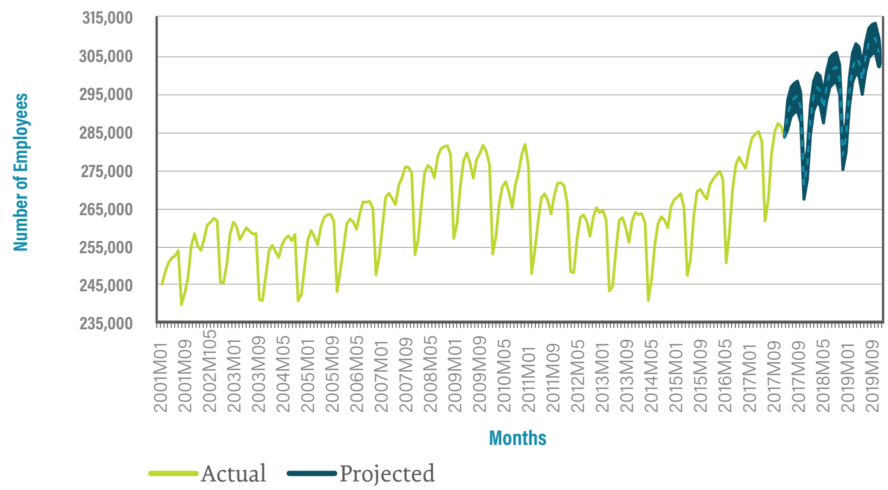
Consistent with general indicators, government employment grew slower at a 2.01 percent average yearly rate in 2017. At this slower pace, employment in this category is projected to reach 295,000 by the second half of 2018. Government employment constitutes one-fifth of the total employment in the Valley and is a main economic driver, improving educational attainment and reducing crime in the region. ▶

"RECOVERY IN GOVERNMENT EMPLOYMENT NORMALLY OCCURS WITH A LAG FOLLOWING THE GENERAL TREND IN A REGIONAL ECONOMY."

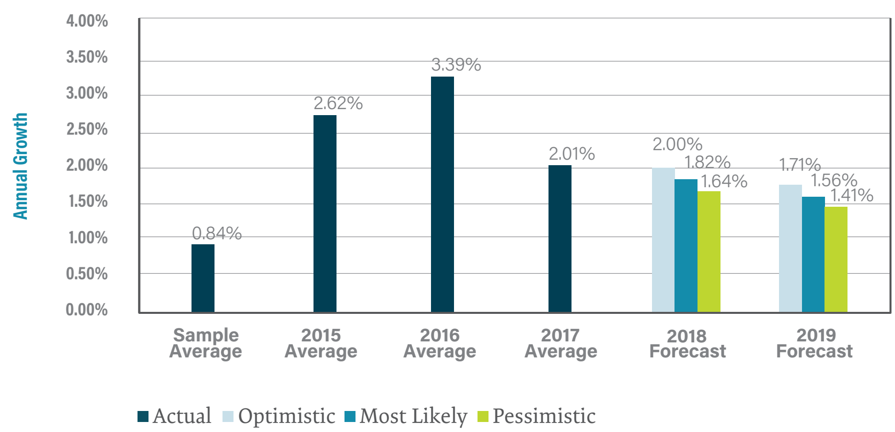
Recovery in government employment normally occurs with a lag following the general trend in a regional economy. Therefore, yearly growth in government employment will likely remain above the long-term benchmark growth of 0.84 percent for several months. Government employment is projected to grow slower but remain above this ▶ benchmark rate, hitting 1.82 percent in 2018 and 1.56 percent in 2019.

Following the rate hikes in 2016 and 2017, bank profitability increased, as did Valley financial activities employment, which grew by 1.40 percent in 2017 — a rate significantly above the negative benchmark decline of 0.17 percent. The turning point observed during the latter part of 2016 is now a permanent trend, pointing to steady increases in this category of employment. At this pace, financial activities employment is projected to exceed 44,000 by the first half of 2019. ▶

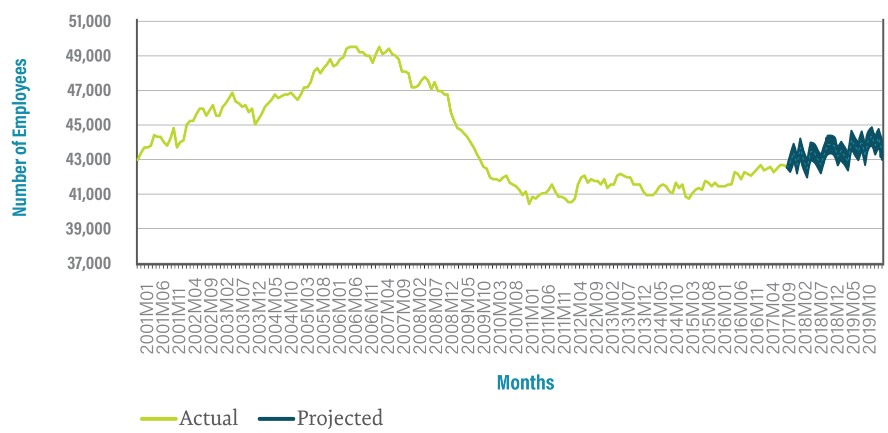
Government Employment



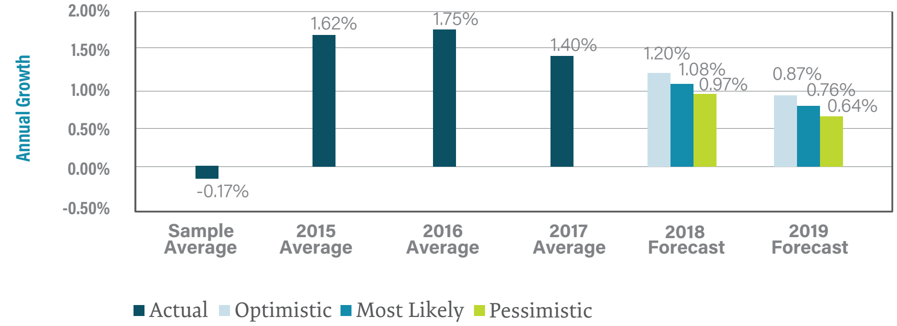
Government Employment: Historical vs. Projected Average Yearly Growth



Financial Activities Employment



Financial Activities Employment:
Historical vs. Projected Average Yearly Growth



The slowing economy will likely dampen growth a little in financial activities employment. The series long-term benchmark rate is projected to switch from negative to positive territory in 2018. The housing market refinancing activity before rates increased any further and the ensuing housing bubble also played a role in adding employees to the finance field. Projections point to slower growth, at an average yearly rate of 1.08 percent in 2018 and 0.76 percent in 2019.

"VALLEY TOTAL EMPLOYMENT GREW AT A MUCH SLOWER PACE IN 2017 THAN 2016, SHOWING CLEAR SIGNS OF PLATEAUING."

Valley total employment grew at a much slower pace in 2017 than 2016, showing clear signs of plateauing. The growth in total employment was 0.52 percent in 2017, in contrast with 1.39 percent in 2016, falling for the first time below the long-term benchmark growth of 1.17 percent. Stanislaus and Madera counties posted the fastest growth in 2017 while Kern and Kings counties reported declines in the number of employed individuals. Construction employment took back the lead in employment growth. Retail trade fell from the fastest growing category to the fourth fastest in 2017. Factors such as higher interest rates, new immigration environment, weakened economic conditions from past years of drought and newer farm regulations were some of the factors that contributed to the significant slowdown in employment growth.

Housing Sector

The eight MSAs that make up the San Joaquin Valley include Bakersfield-Delano, Fresno, Hanford-Corcoran, Madera-Chowchilla, Merced, Modesto, Stockton and Visalia-Porterville. Housing indicators reflect the aggregated indicators belonging to these MSAs.

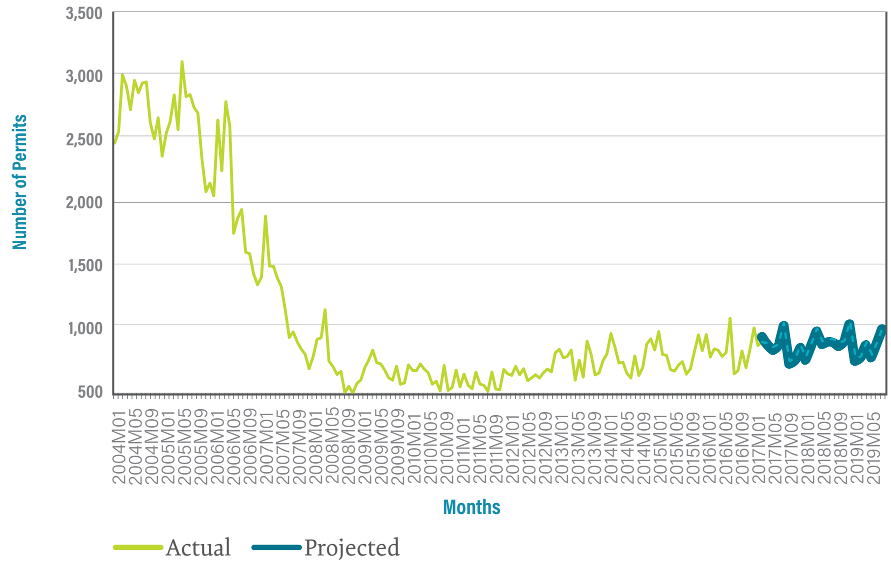
Housing permits issued in 2017 declined by 0.32 percent due to the large increase in the issued permits from the year before that corresponded to 13.08 percent. There were, however, about the same number of permits issued in 2016 and 2017. For example, during the same period, 805 permits were issued in 2017 as compared to 713 in 2016. The total number of permits issued was 4,612 in 2017 versus 4,672 in 2016, for the first eight months of each year.

Bakersfield issued the most housing permits in 2017, totaling 1,319, followed by 1,145 permits in Fresno and 1,006 in Stockton. A change in the Federal Reserve policy toward a dovish stance following the last rate hike in 2017 will likely keep the housing market active in the coming months. However, items in the proposed tax reform that remove the ability to write-off taxes and mortgage insurance premiums potentially acts as a disincentive for home buyers in the Valley. An economy showing signs of entering into a cooling-off period is another worry. Projections point to 6.94 and 5.58 percent growth in 2018 and 2019, respectively.

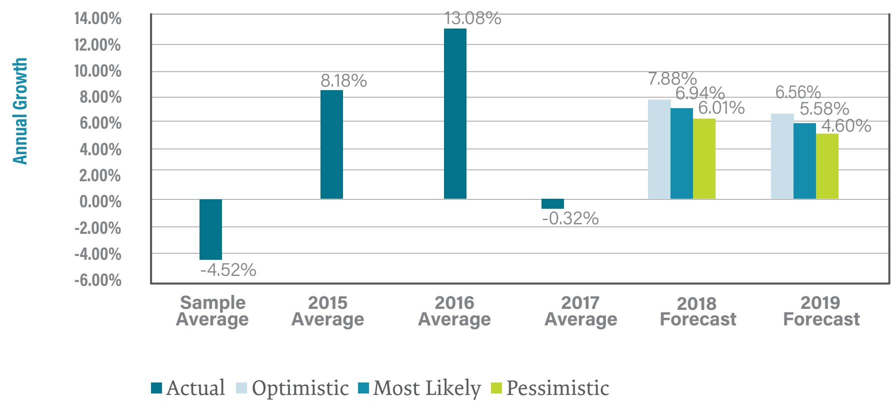
Foreclosure starts in California continued to fall in 2017, despite the rate hikes. However, much of the rate hikes were not yet reflected in long-term interest rates, keeping refinancing activity alive. Home owners were also rushing despite the rate hikes to refinance before interest rates began to increase further. The dovish Federal Reserve after the last rate hike also contributed to declining foreclosure starts. If total employment begins to decline in the Valley, resulting from entering the contractionary phase of business cycles, continuous declines in employment levels may initiate a rising trend in foreclosure starts, which would pose a risk to the regional economy.

Following a series of rate hikes, the Freddie Mac 30-year fixed rate began to increase, gradually reaching 4.2 percent in the first quarter of 2017. However, the Federal Reserve's change in stance prevented further increases in the long-term rates. In the third quarter of

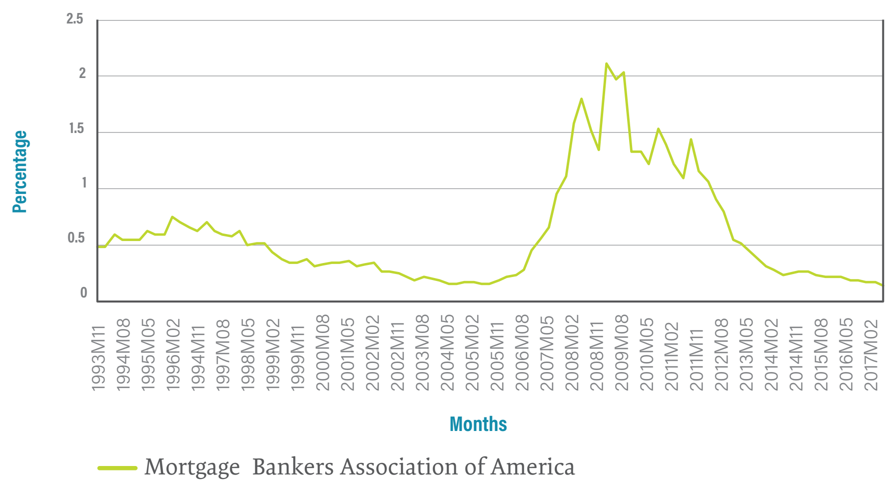
Single-Family Building Permits



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



Foreclosure Starts in California

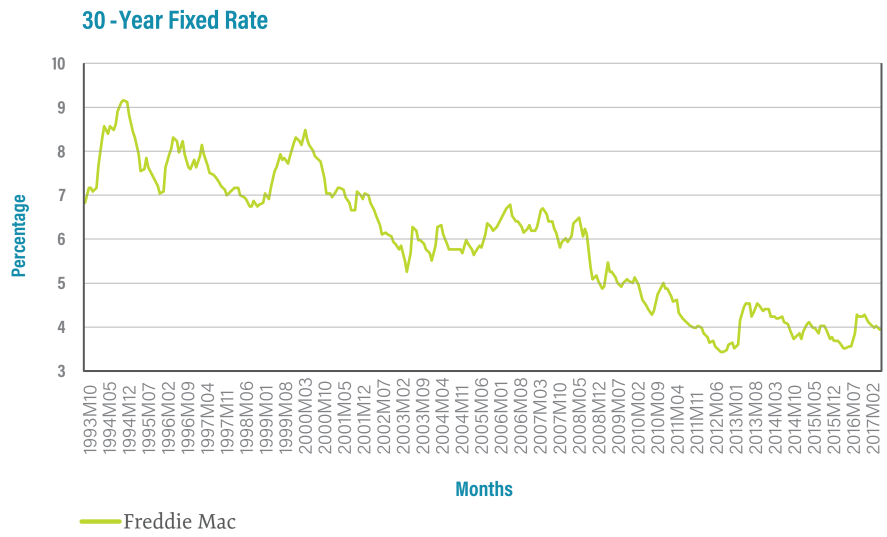


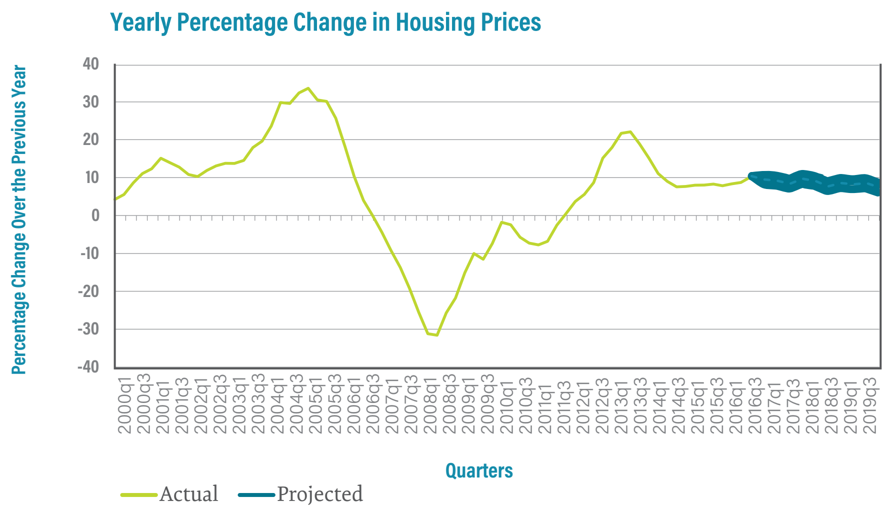
2017, the 30-year fixed rate stood lower at 3.88 percent. At these relatively still lower rates, refinancing and home buying remained active in 2017.

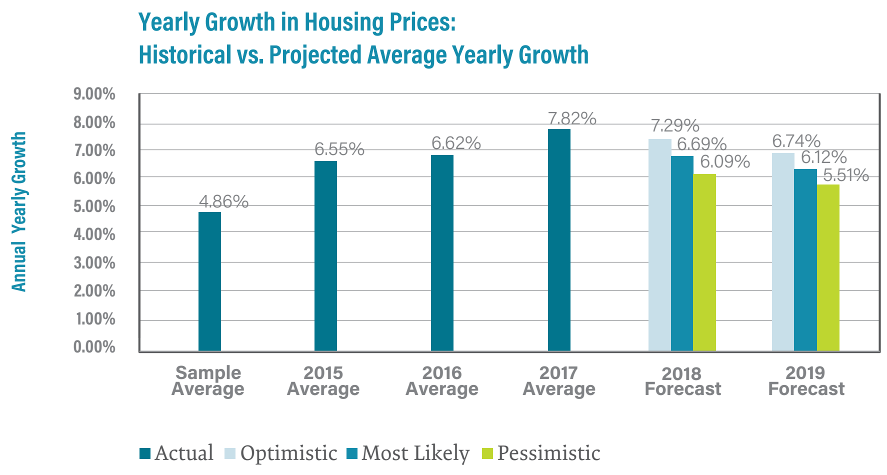
Home values continued to rise, but at a more gradual pace than previous years. Long-term interest rates that continue to remain below 4 percent also contributed to the strong demand in 2017. Rate hikes helped keep the bubble from inflating further to some degree, but the rise in inflation countered, putting added pressure on home values. The supply of new homes built was not keeping up with higher demand. With construction activity picking up in 2017, there may be a slight downward pressure on home values.

Home prices continued to increase in the Valley in 2017 as interest rates did not increase further. The average home price increased at a yearly rate of 7.82 percent in 2017, faster than the 6.62 percent rate in 2016. The speed of growth in both years was higher than the long-term benchmark growth rate of 4.86 percent. If the rate of inflation becomes a continuous worry for the Federal Reserve to act, further rate hikes may very well dampen the speed of appreciation in home values. Tax reform that eliminates writing off interest expenses and mortgage insurance premiums can also play a role in bringing to some degree the demand for housing down.

Home values increased the fastest in the Stockton and Madera MSAs at 9.97 and 9.10 percent, respectively, in 2017. Modesto and Merced saw an increase of 8.84 and 8.45 percent, while Bakersfield and Visalia had the slowest increases, at 4.27 and 6.54 percent. The benchmark rate inched higher to 4.86 percent in 2017. Given that more housing permits are being issued than before, the supply of new housing is expected to pick up slightly in the Valley. A cooling economy and a slower rate of increase in total employment should also dampen to some extent the appreciation in home values in the coming months. Projections now point to slower growth in single-family home prices at an average yearly rate of 6.69 percent in 2018 and 6.12 percent in 2019.







Inflation and Prices

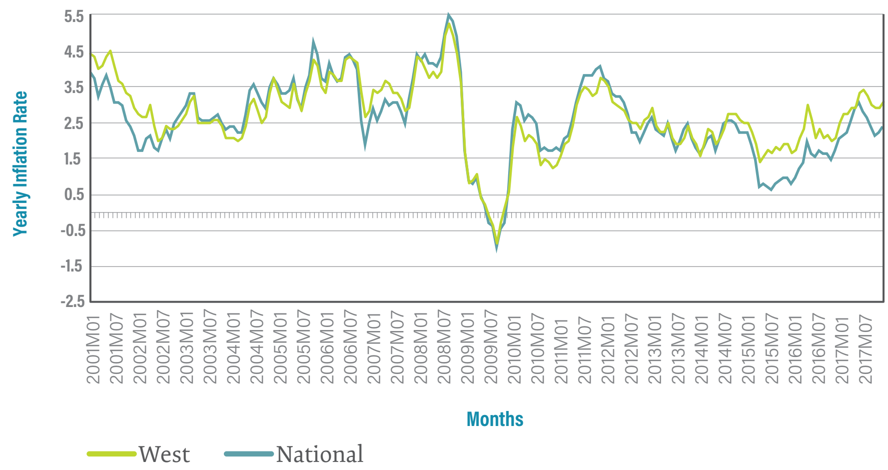
The price of gasoline increased in 2017, only to retreat in the coming weeks. The initial increase in the price of oil placed cost-push pressures on the rate of inflation in 2017. Another contributing factor was a depreciating dollar, keeping the price of imported goods relatively high and thus decreasing purchasing power, causing the Valley consumer to afford a smaller bundle of goods than before. The yearly rate of inflation climbed up to 3.1 percent in the first quarter of 2017. ▶

3.1% "THE YEARLY RATE OF INFLATION CLIMBED UP TO 3.1 PERCENT IN THE FIRST QUARTER OF 2017."

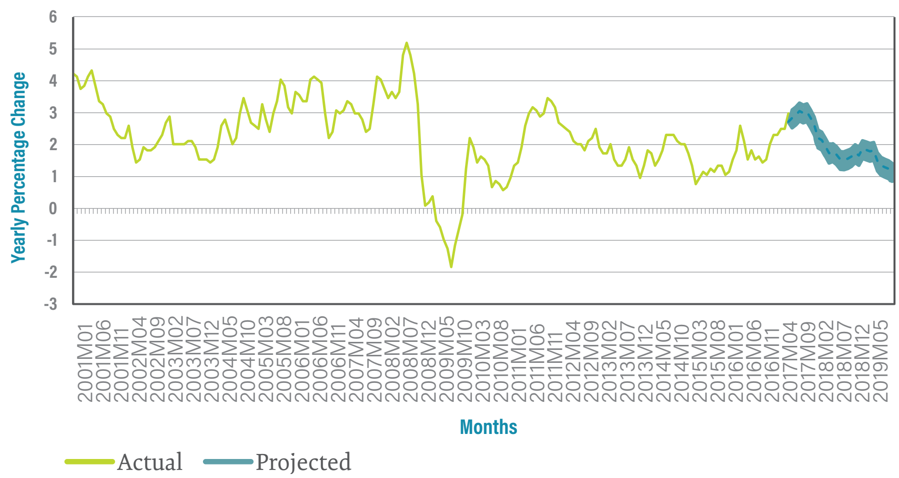
In the third quarter of 2017, the rate of inflation retreated to 2.73 percent, still hovering above the long-term benchmark rate of 2.23 percent. Overall price levels on the West Coast continued to rise faster than the national average by about one percentage point since the first quarter of 2017. Higher price increases in the West are indicative of aggregate demand continuing to expand faster than at the national level. The retreat in the price of oil was the main factor that brought inflation down by half a point in the latter part of 2017. ▶

The rate of inflation has been gradually increasing from a low value of 1.01 percent in the first quarter of 2015. The agreement by several oil exporters to curtail output did not hold, preventing the oil prices from sustaining prices above $50 a barrel. Inflation is projected to come back down to the mean value, due to the recent the pull back in the oil price, balance sheet reduction on the part of the Federal Reserve and signs of a cooling economy. ▶

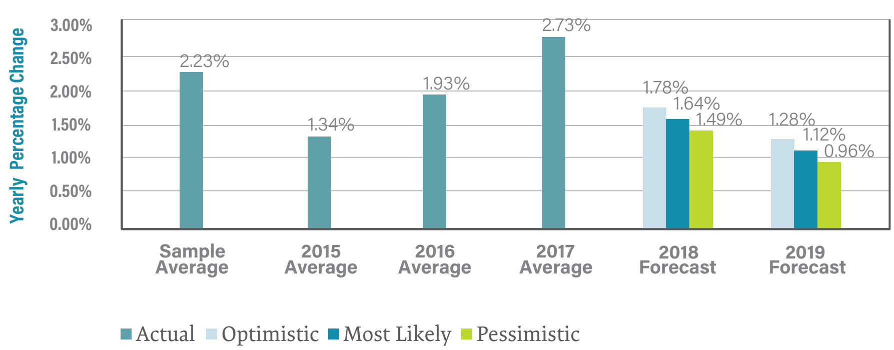
Inflation Rate: Nationwide vs. West



U.S. West Inflation Rate



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



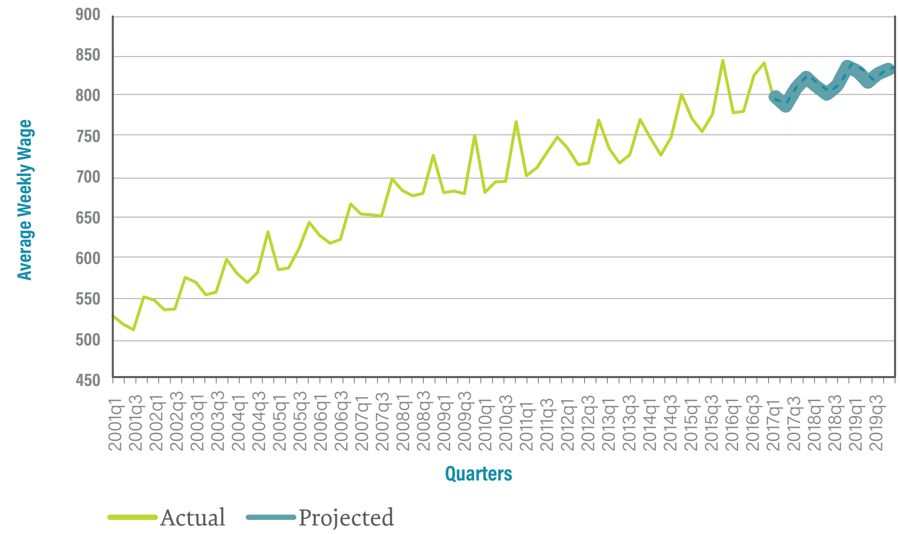
The average rate of inflation in 2017 was 2.73 percent. For the first time since the recessionary years, prices rose more than the long-term benchmark rate of 2.23 percent. On a year-by-year basis, the rate of inflation has been going up earlier, since 2014, with wide oscillations from one month to the other. Projections point to a 1.64 percent increase in the average yearly inflation rate in 2018, and in line with a slowing economy, the average price level is projected to increase 1.12 percent in 2019.

Nominal average weekly wages are expected to reach $850 by the end of 2019. Weekly wages had grown faster than the inflation rate in 2014 and 2015, but in 2016 real wages stayed constant as the weekly wage growth was roughly the same as the yearly inflation rate. In 2017 however, the average yearly increase in weekly wages was 1.69 percent, under the benchmark rate of 2.88 percent for the first time since 2015.

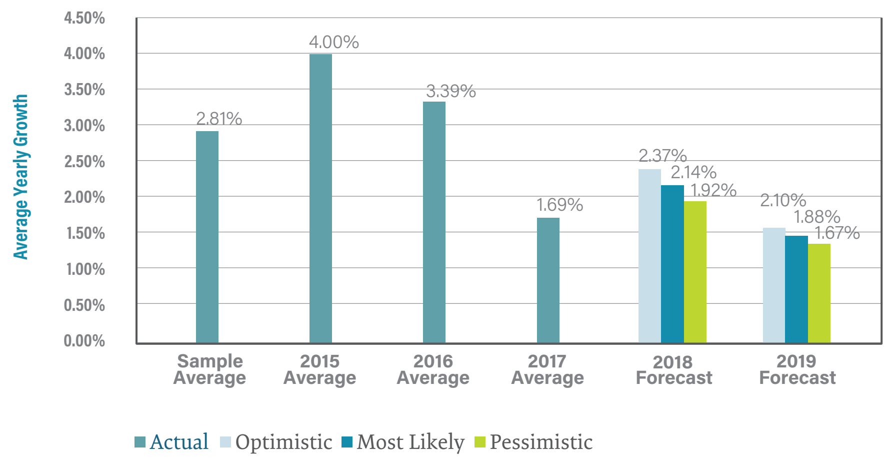
WEEKLY WAGES INCREASED BY 1.69 PERCENT IN 2017

As weekly wages increased by 1.69 percent in 2017, inflation rose 2.73 percent, which corresponded to a loss in the purchasing power of Valley consumers by 0.96 percent. Most notable increases in weekly wages occurred in Tulare and Merced counties at 7.80 and 7.61 percent, respectively, more than twice the yearly inflation. Average weekly wages are projected to increase at a yearly average rate of 2.14 in 2018 followed by 1.88 percent in 2019. Both projections should stay below the benchmark rate of 2.81 percent.

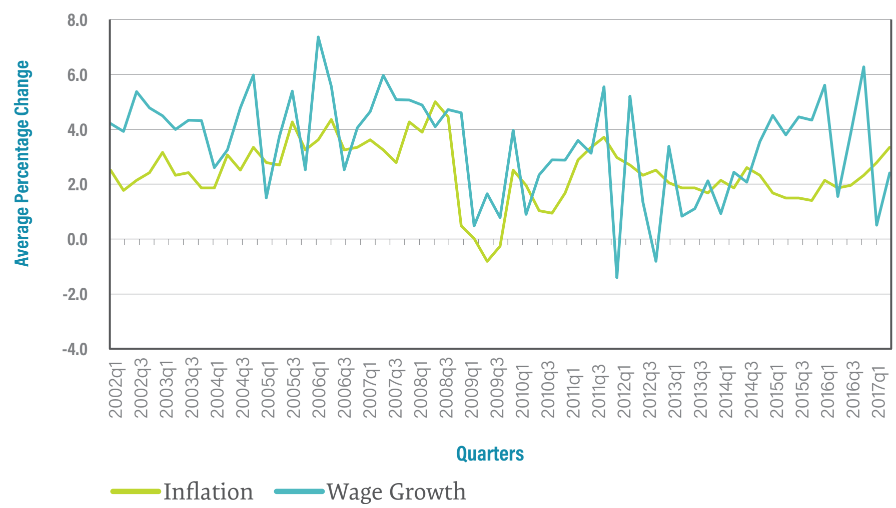
Quarterly Average Weekly Wages



Weekly Wage Growth: Historical vs. Projected Average Yearly Growth



Yearly Wage Growth vs. Inflation



Banking and Capital Markets

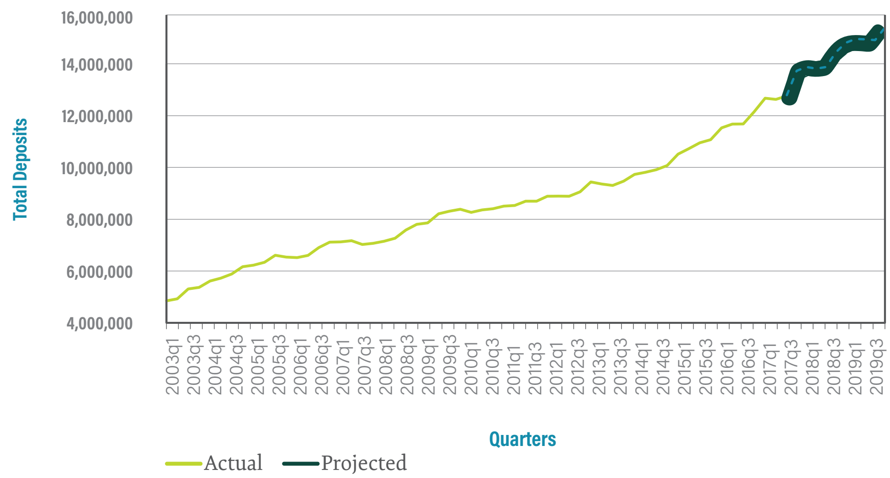
In line with slowing economic growth in the Valley, total bank deposits increased less in 2017 than 2016. The average yearly rate of growth in total bank deposits was 8.97 percent, still higher than the benchmark growth rate of 7.31 percent, pulling the overall average up slightly. As in the previous year, the dynamics observed in total bank deposits was consistent with the dynamics in total employment, both growing at rate slower than 2016.

> "ONE EXCEPTION MAY BE THE POSITIVE EFFECT THAT WOULD COME FROM THE TAX REFORM PUTTING MORE MONEY IN THE HANDS OF SMALL BUSINESSES."

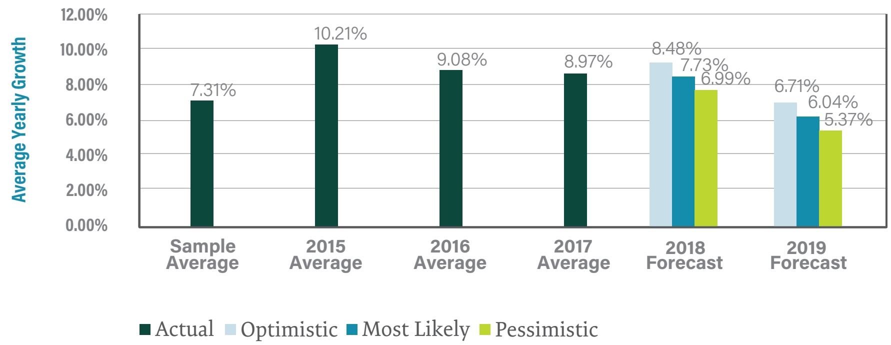
Valley total bank deposits are likely to increase at an even-slower pace in the coming months. One exception may be the positive effect that would come from the tax reform putting more money in the hands of small businesses. If the rate of inflation increases to a point for the Federal Reserve to act by implementing further rate hikes, halting the dovish stance, Valley deposits may see a marginal positive effect. The Valley's total bank deposits are projected to grow at an average annual rate of 7.73 percent in 2018 and 6.04 percent in 2019.

Bank assets in nonaccruals no longer declined as in previous years, following the rate hikes in 2017 and earlier. A flat or slightly increasing pattern in nonaccruals likely will be observed in the coming months, consistent with a slowing economy. The pattern observed in nonaccruals continued to be consistent with the pattern observed in bank assets past due 30-to-89 days and 90-days-plus.

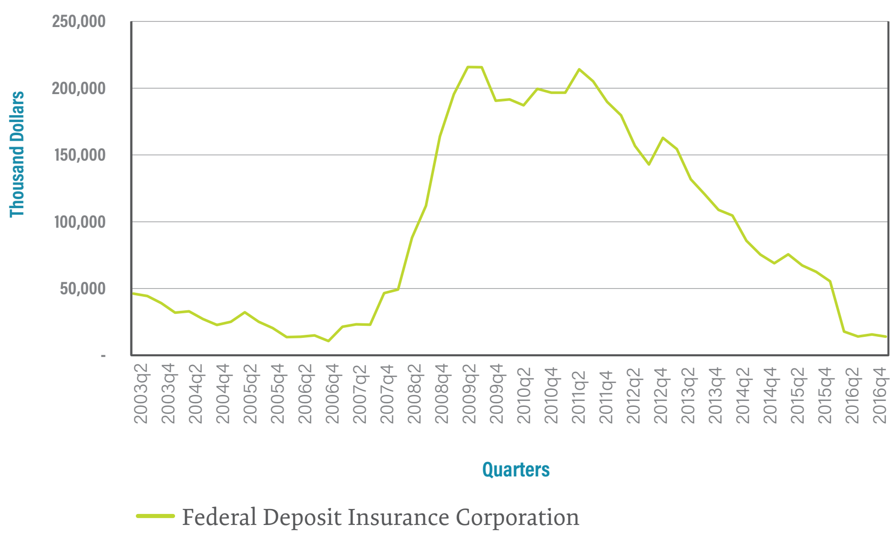
Total Bank Deposits (in $ Thousands)



Total Bank Deposits: Historical vs. Projected Average Yearly Growth



Assets in Nonaccrual

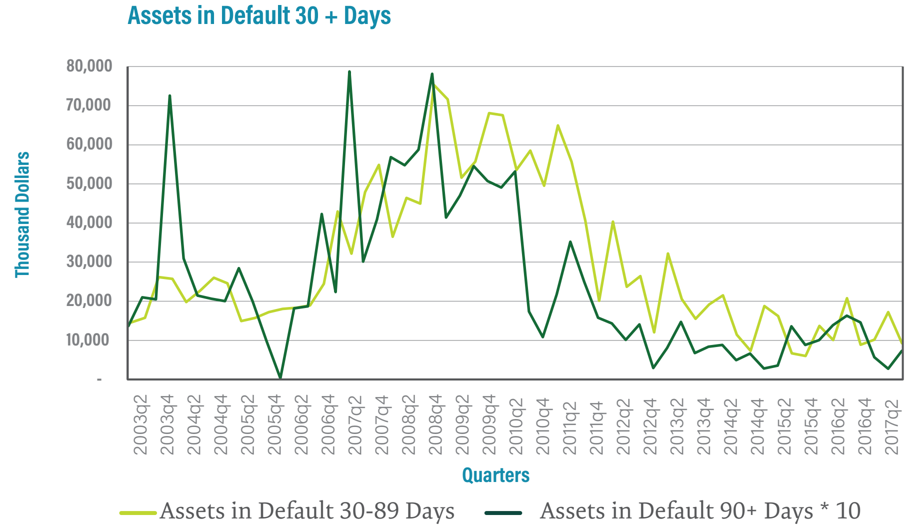


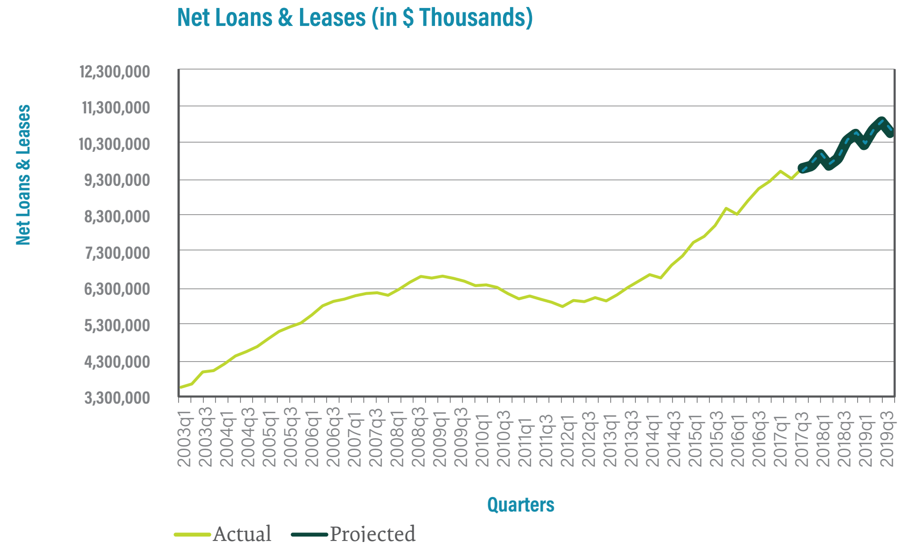
Bank assets past due include residential and non-residential items, such as credit card debt and auto loans. Bank assets past due 30-to-89 days and 90-days-plus continued to display a flat pattern in 2017. The decline in both indicators ended in 2014 and has remained flat. As in nonaccruals, bank assets due 30-to-89 days and 90-plus-days are expected to increase slightly in the following months if the slowing of the Valley economy worsens.

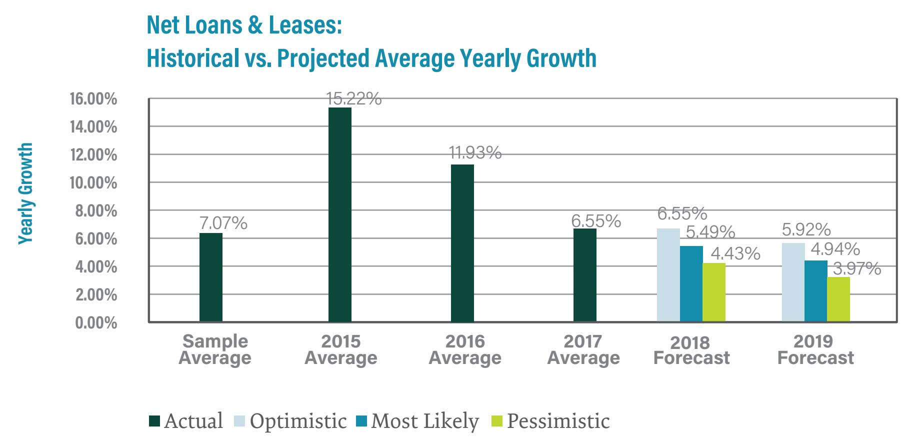
Although total deposits and net loans and leases in the Valley both increased in 2017, the increase in net loans and leases was much slower than total bank deposits, which was also unlike the pattern observed in previous years. Total bank deposits increased by 8.97 percent, versus a 6.55 percent increase in net loans and leases. Both indicators grew at a slower speed in 2017 than in 2016. Rate hikes undoubtedly contributed to a less-than-typical increase in net loans and leases.

Growth in net loans and leases was 11.93 percent in 2016, compared to 6.55 percent in 2017, corresponding to a net decrease in growth of 5.38 percent. 2017 was the first year since the recession during which net loans and leases grew at a slower pace than total deposits. Also, 2017 was a year in which growth in net loans and leases was less than the series long-term benchmark growth rate of 7.07 percent. With higher borrowing costs and a slowing growth in the Valley economy, the net loans and leases series is expected to grow at a slower speed in the coming months. Projections point to a yearly average growth of 5.49 percent in 2018 and 4.94 percent in 2019.

30-year interest rates reached 4.2 percent in 2017, only to fall back a little to 3.88 percent by the third quarter of 2017. Further, the rate of growth in Valley total employment slowed significantly in 2017. Such a pattern will likely change the dynamics governing the financial sector. As in 2016, bank profitability is expected to rise in 2017 but at the same time — due to higher cost of borrowing — slower growth will occur in sectors such as retail trade and leisure and hospitality services employment.







Concluding Remarks

Weakened economic conditions from years of Valley drought were evident in slowing total employment growth numbers in the Valley. As was the case in the past two years, total employment grew at a slower speed in 2017 than 2016. In the non-farm sector, retail trade and leisure and hospitality services employment were the first categories to get hit by rising interest rates.

Construction employment grew the fastest in the Valley, taking back the lead from retail trade employment, which fell to the fourth place together with trade, transportation and utilities employment. Education and health services employment grew the second fastest, followed by government employment. Manufacturing employment continued to grow relatively significantly in 2017 — above the national pace — and at a time when state manufacturing employment declined. Not all counties and categories of employment grew in 2017, displaying divergent economic activity. Kings and Kern counties reported declines in employment levels while others reported employment gain in 2017, but at a slower pace.

Home values increased at a faster pace in 2017 than in 2016. Rate hikes helped alleviate some of the pressure but there is still a bubble in the housing market that is due for some correction.

Projections point to slow growth in housing prices in the coming months. A faster pace of growth in construction employment means the supply of new homes being built will increase, which is also evident in the number housing permits being issued, a leading indicator in the housing market. The dovish stance of the Federal Reserve after the last rate hike in 2017 will likely keep demand high but less than the levels when interest rates were low.

"A FASTER PACE OF GROWTH IN CONSTRUCTION EMPLOYMENT MEANS THE SUPPLY OF NEW HOMES BEING BUILT WILL INCREASE..."

Inflation in the West continued to increase at a faster rate than the national average. Given the retreat in the price of oil below $50 a barrel, after a short episode of increase in 2017, inflation rates are likely to revert back to the long-term mean of 2.23 percent a year. Average weekly wages grew less than the rate of inflation in 2017, corresponding to loss in the purchasing power of the Valley consumer. The depreciating dollar also meant consumers found themselves paying more for the same bundle of imported goods.

Valley total bank deposits and net loans and leases grew less in 2017 than in previous years, displaying consistent dynamics with other Valley indicators. The growth rate in total bank deposits was higher than the long-term benchmark rate, but for the first time this was not the case for net loans and leases in the Valley, which grew less than the long-term benchmark rate. Although the rate hikes are likely to increase bank profitability, slowing economic activity might more than offset those gains.

Overall, the Valley economy is likely to continue growing more slowly than in previous years. The growth may very well be negative if the Federal Reserve decides to act on inflation concerns, particularly facing continuing headwinds such as new farm worker overtime pay, lingering effects of drought years, new immigration environment, regulations on cow emissions and future rate hikes.

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