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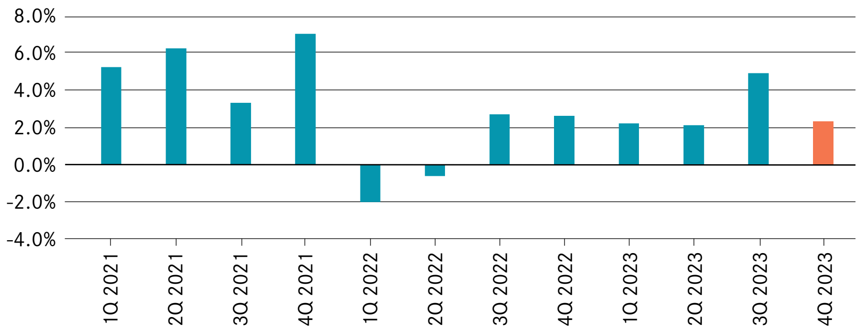
Last year was a year that, in many ways, defied expectations. At this time last year, the consensus view was that — in an effort to tame inflation — the Federal Reserve would raise rates, which would ultimately cause a recession. However, the recession never materialized — unemployment has stayed low, wage growth was low but positive, and consumer spending has remained resilient in the face of head winds.

Driven by macroeconomic factors, equity markets experienced a meaningful rally over the course of the year. On the whole, companies were successful in navigating the difficult environment by cutting costs and managing interest expenses. However, the overwhelming gains were made by a small number of large cap technology companies, dubbed the “Magnificent 7” (Amazon, Apple, Google/Alphabet, Meta/Facebook, Microsoft, Nvidia and Tesla), which now make up nearly 30% of the S&P 500.

...the SBR believes the Fed is unlikely to cut rates without clear evidence that such a move is absolutely necessary, for fear of reigniting inflation.

Figure 1

Real GDP Growth (year-over-year, quarterly)



Source: Bureau of Economic Analysis and Atlanta Fed.

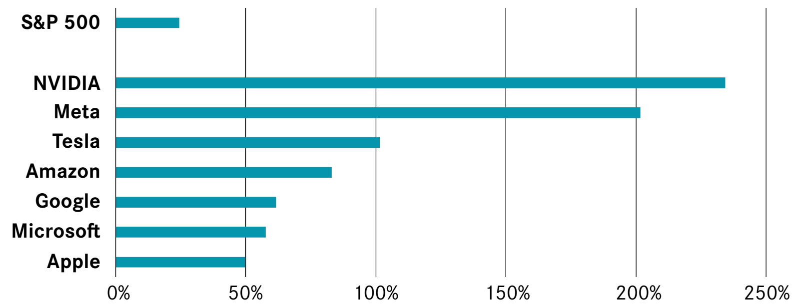
Going forward, fed officials have indicated that rate cuts could be needed to prevent overtightening. Markets have adjusted expectations, which was visible in the late year equity rally as well as rate contracts. Currently, futures contracts are pricing at a benchmark rate of 3.75% - 4.0% for the end of 2024, which would be 150 bps below current levels. However, the SBR believes the Fed is unlikely to cut rates without clear evidence that such a move is absolutely necessary, for fear of reigniting inflation.

While we avoided a recession in 2023, many of the same forces are still in effect, and in assessing the current conditions, it must be concluded that the U.S. economy is still poised for a slowdown. The effects of monetary policy are lagged and starting to appear: 1) lending growth — as we will discuss in the Banking section — has slowed dramatically; 2) commercial real estate is under pressure from both the Remote Work trend and higher rates; and, 3) Credit market deterioration is appearing in both corporate defaults and delinquent consumer credit card balances, which have risen to the early COVID levels.

Our outlook for equity markets is for more modest returns. The S&P 500 currently exhibits above-average valuations on a price-to-earnings basis, although as noted above, this is driven by a small number of large-cap technology companies. When parsed, other areas, including U.S. mid-cap and small-cap, and certain "left-behind" sectors such as Energy and Utilities, as well as global equities, continue to trade at substantial discounts to historical levels. And while elevated, U.S. stock valuations do not seem unreasonable considering current margins, healthy interest coverage, and prospects for improved corporate revenue growth. On the rates front, the SBR team expects the yield curve to flatten over the next twelve months with shorter term rates moving down and longer-term rates remaining near current levels, i.e., ~3.75 to 4.00% on the 10-year UST.

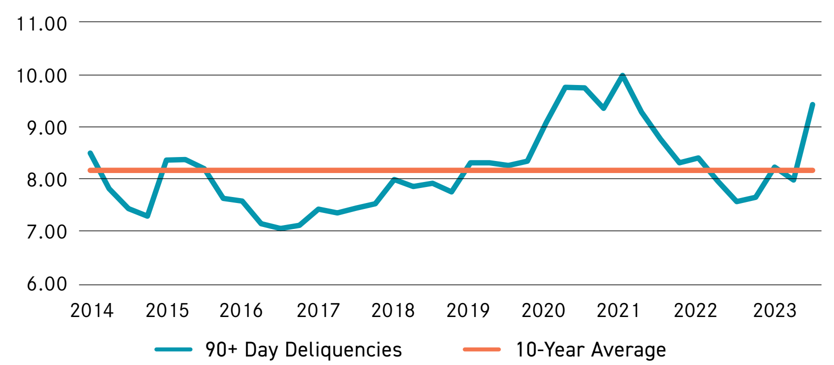
Our outlook for equity markets is for more modest returns.

Figure 2
The "Magnificent 7" - YTD Total Return vs. S&P 500



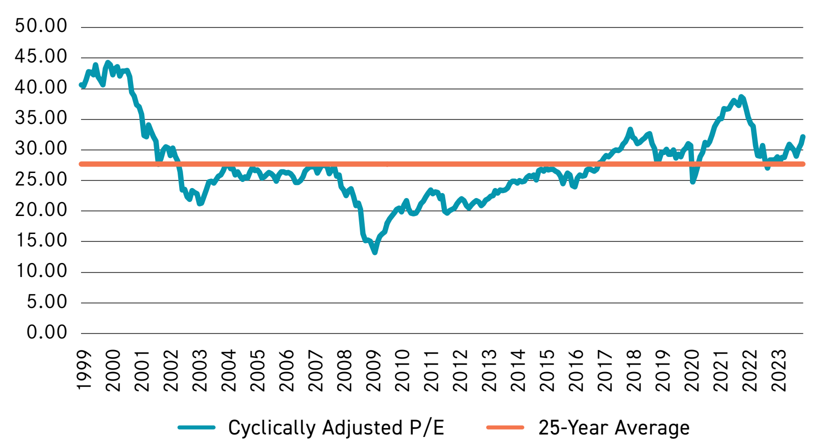
Source: Bloomberg as of 12/22/2023

Figure 3
Credit Card Delinquencies (90+ Days), Last 10 Years



Source: NY Fed

Figure 4
Equity Valuations Compared to Long-term Averages



Source: Robert Shiller

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Regional Banking Update

Regional banks and credit unions went along for one wild ride in 2023, and planning for what may come in 2024 has been fraught with uncertainty not experienced in years. Will rates be higher for longer or will there be swift cuts to stave off a recession? Will there be a commercial real estate charge-off tsunami, an over-extended consumer, or both? These are just some of the questions that regional bank and credit union executives have been grappling with as they finalized budgets going into year-end. How the Fed proceeds in 2024 will be data driven, as Chair Powell routinely reminds us. The key question that remains is, will the Fed land the jumbo jet on the aircraft carrier, or will it be late to the game in tweaking the necessary policy levers?

To assess what may come in the next twelve months, it is best to take a quick look back over the last five years and see how we have arrived at where we are today.

Figure 5
Regional Bank Loan and Deposit Trends

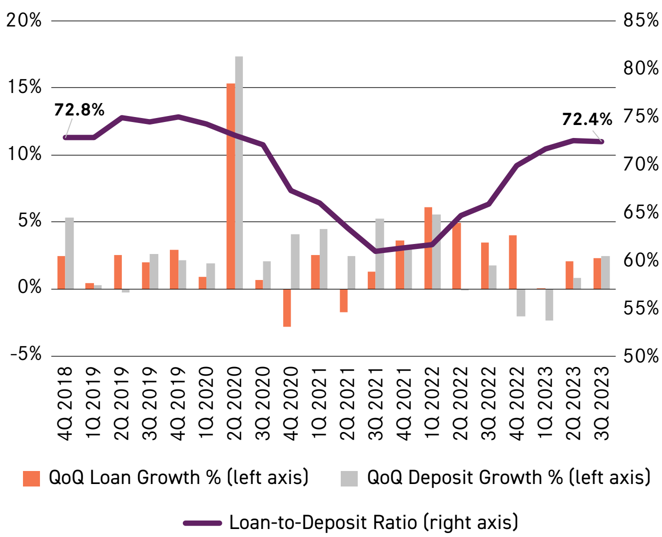


Figure 6
Regional Credit Union Loan and Deposit Trends

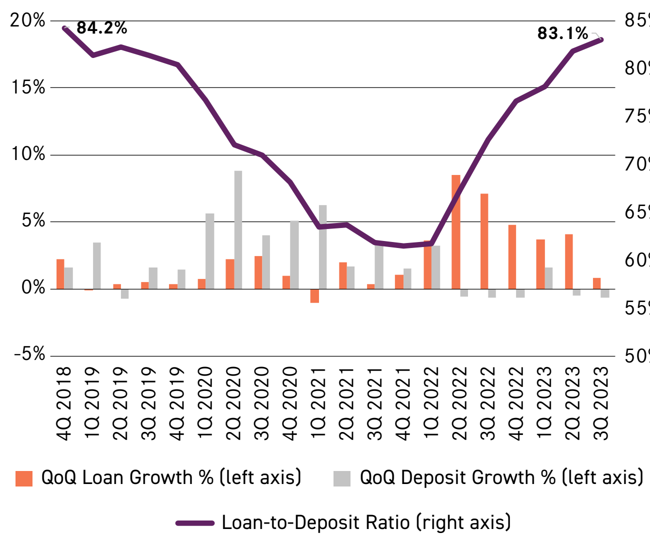


Figure 7
Regional Bank Net Inc. $ and Return on Avg. Assets %

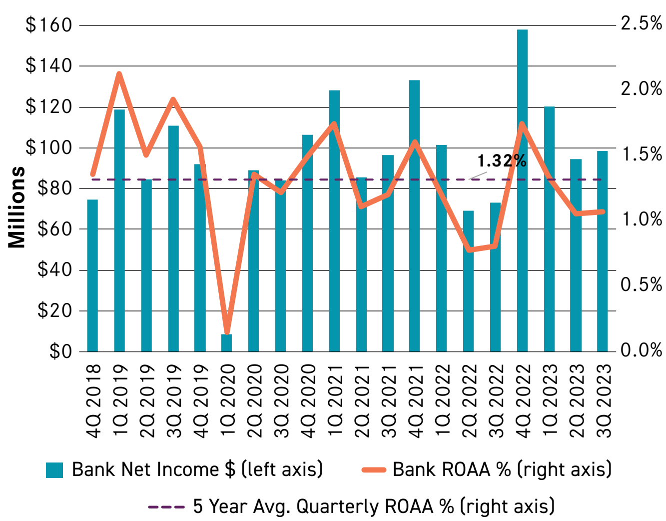
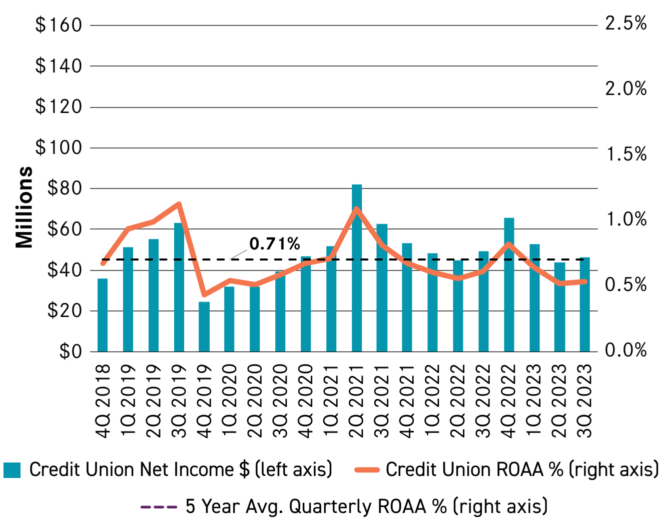


Figure 8
Regional Credit Union Net Inc. $ and Return on Avg. Assets %



Source (Figures 5-8): FDIC, NCUA, S&P Capital IQ

Loan and Deposit Trends

As of September 30, 2023, the Loan-to-Share ratios for regional banks and credit unions were 72.4% and 83.1%, respectively. After both groups bottomed out in the low 60% range amidst the massive monetary and fiscal stimulus brought about by the pandemic, both figures are near the high end of historical ranges. Tepid deposit growth coupled with persistent loan demand has resulted in regional financial institutions relying on cash and investment reserves to help fund cash outflows. Elevated Loan-to-Share ratios are likely to remain for 2024. Attractive money market mutual fund rates, stiff competition from online financial institutions, and the need to keep pace with a significantly higher priced economy will remain key obstacles for deposit growth over the next twelve months. However, a slowing economy and fears of a recession have traditionally resulted in a flight to safety (cash) and incremental deposit growth for regional financial institutions (FIs).

Asset Quality Trends

The direction of the economy over the next twelve months is a key consideration for asset quality trends. While regional banks have benefited from near zero charge-off rates over the last cycle, elevated net charge-offs are expected for 2024, in line with normalization trends and a reversion to a longer run average net charge-off rate of ~0.30%. Similarly, regional credit unions will also experience continued normalization trends for net charge-offs in 2024. The wild card for both regional banks and credit unions is how well the Fed can moderate economic growth through monetary policy. An economy that cools too fast, with its increasing unemployment levels and asset price pressures, will undoubtedly lead to more severe asset quality trends.

Figure 9
Regional Bank Net Charge-Offs: $ and %
(% annualized quarterly rate)

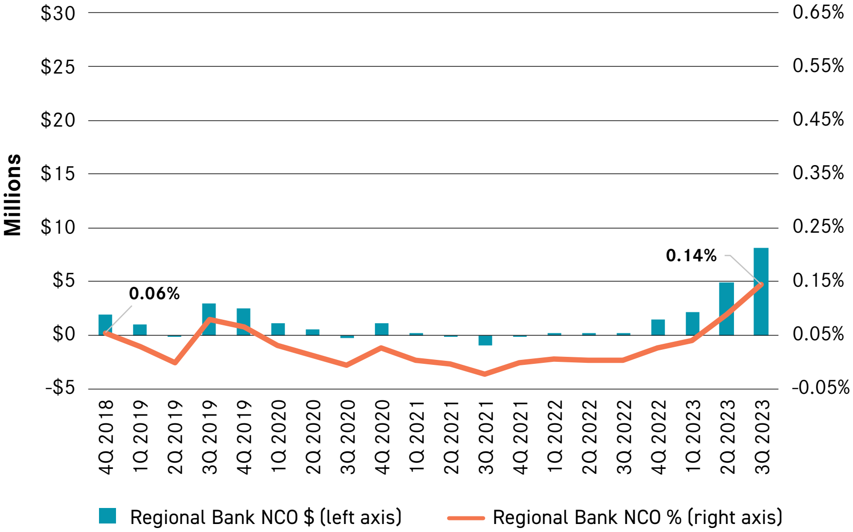
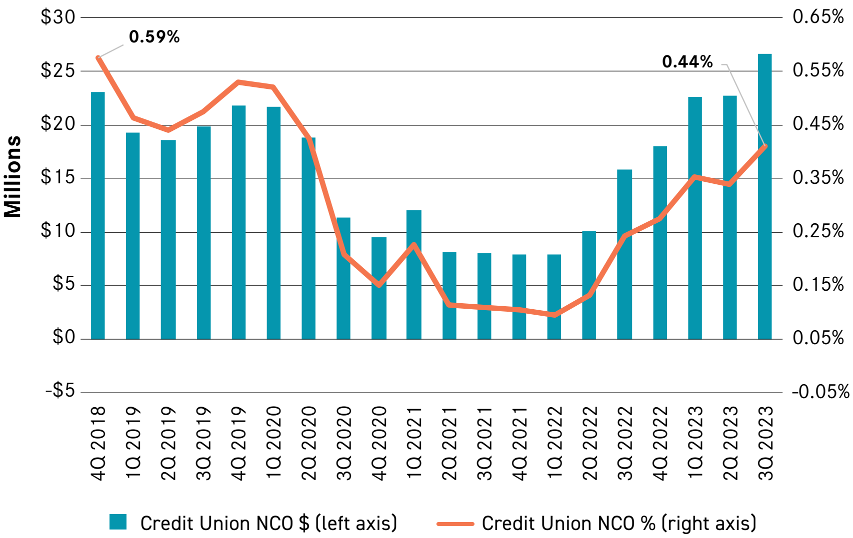


Figure 10
Regional Credit Union Net Charge-Offs: $ and %
(% annualized quarterly rate)



Source (Figures 9 & 10): FDIC, NCUA, S&P Capital IQ

THE WILD CARD FOR BOTH REGIONAL BANKS AND CREDIT UNIONS IS HOW WELL THE FED CAN MODERATE ECONOMIC GROWTH THROUGH MONETARY POLICY.

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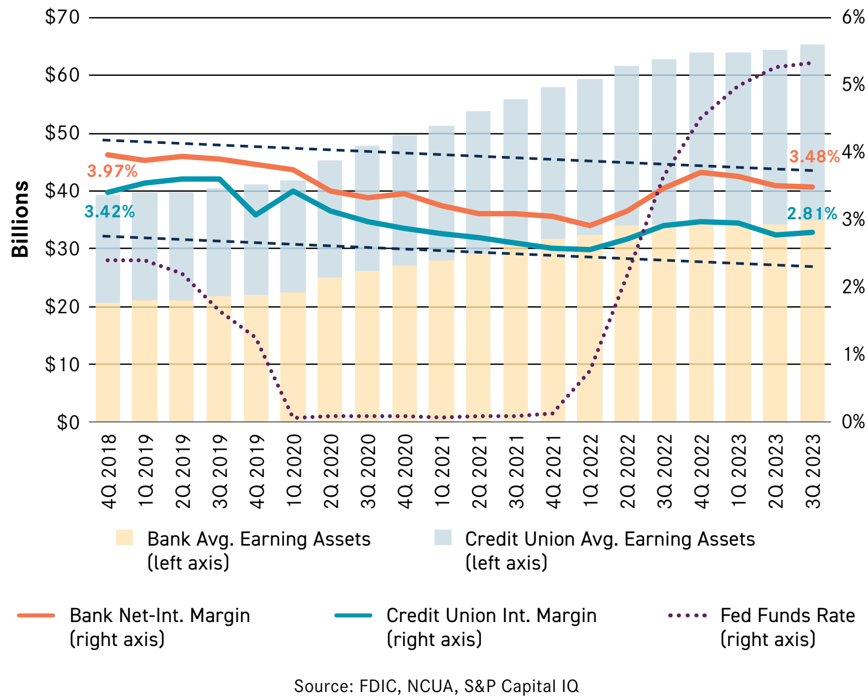
The Bottom Line

The unfavorable liquidity and asset quality trends discussed previously have weighed on regional FIs' bottom line. Quarterly net income levels for 2023 have trended below five-year averages, and these below average trends are expected to continue throughout 2024. Without cheaper funding, i.e., the return of core deposit growth (think lower cost checking and savings accounts), net interest margins, (interest income less interest expense relative to average earning assets), will remain under pressure. With this margin pressure persisting at a time of deteriorating asset quality trends, i.e., increasing net charge-offs, net income levels at or above average will be elusive in 2024.

Figure 11
Regional Bank & Credit Union Margin Pressure



> *...the SBR team anticipates future slowing on the employment and banking fronts to provide additional headwinds in 2024.*

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

Our proprietary SBR Financial Conditions Index shows that the regional economy continued to expand through the third quarter of 2023, with the only drag on the index stemming from a persistent decline in the number of homes sold in the region. However, the SBR team anticipates future slowing on the employment and banking fronts to provide additional headwinds in 2024.