

Regional Economic Activity Expands in 2018

Overall, the economy of the Fifth Federal Reserve District expanded in 2018, and by some measures, economic growth picked up compared with the past several years. Labor markets continued to tighten, as evidenced by expanding payrolls and widespread declines in unemployment rates that coincided with strong survey measures of wage growth in the Fifth District. Business conditions generally improved in 2018, with strong activity coming from a wide variety of industries; however, there were new or increasing headwinds from labor shortages, rising input costs, and the trade environment. There were also a few short-term disruptions during the year, such as severe weather events and a partial federal government shutdown. Residential housing markets continued to strengthen but at a slightly slower pace than in recent years, while commercial real estate activity remained strong and was largely on pace with 2017 growth.

Labor Markets

Overall, labor market conditions improved during the year. Total payroll employment in the Fifth District grew 1.3 percent from December 2017 to December 2018, but it lagged the national rate of 1.8 percent. Among jurisdictions in the Fifth District, year-over-year employment growth was weakest in the District of Columbia and in Virginia, at rates of 0.6 percent and 0.8 percent, respectively. Maryland and North Carolina came in slightly higher at 1.1 percent and 1.3 percent, respectively, while the strongest growth occurred in West Virginia (2.2 percent) and South Carolina (2.6 percent).

In the Fifth District as a whole, the most jobs were added in the professional business services industry, followed by education and health services and leisure

and hospitality. In terms of percentage increase, the strongest growth of 3.2 percent occurred in the natural resources, mining, and construction sector, which was partially driven by considerable growth in construction employment in West Virginia. The information services industry, which is primarily print publications and other media, was the only industry in the Fifth District to contract in 2018, declining 0.4 percent (1,000 jobs) from December 2017 to December 2018.

By the end of the year, the unemployment rate in the Fifth District rested at 3.8 percent, which was just below the national rate of 3.9 percent. Virginia's unemployment rate remained the lowest in the Fifth District at 2.8 percent in December 2018, while the highest rates in December of 5.4 percent and 5.1 percent were reported in the District of Columbia and in West Virginia, respectively.

Although D.C. had the highest rate, counties that are part of its surrounding metropolitan area had some of the lowest rates in the Fifth District. In fact, the lowest rate among all counties was in Arlington, Virginia, which had 1.7 percent unemployment in December. Meanwhile, some of the highest unemployment rates occurred in West Virginia counties, particularly around the middle of the state, where an unemployment rate of 12.4 percent was reported in Calhoun County. The only other county in the Fifth District to report an unemployment rate above 10 percent was Worcester County on the Eastern Shore of Maryland. (See Figure 1.)

Compared with December 2017, jobless rates declined in every Fifth District jurisdiction, with the largest improvement occurring in South Carolina, where the rate fell 0.8 percentage points to 3.2 percent. At the local level, unemployment rates declined in all but eight counties of the Fifth District.

Moreover, county unemployment rates were lower in December 2018 than they were just prior to the Great Recession in the vast majority (82 percent) of Fifth District counties. However, by the end of 2018, no county had yet reached a historic low.

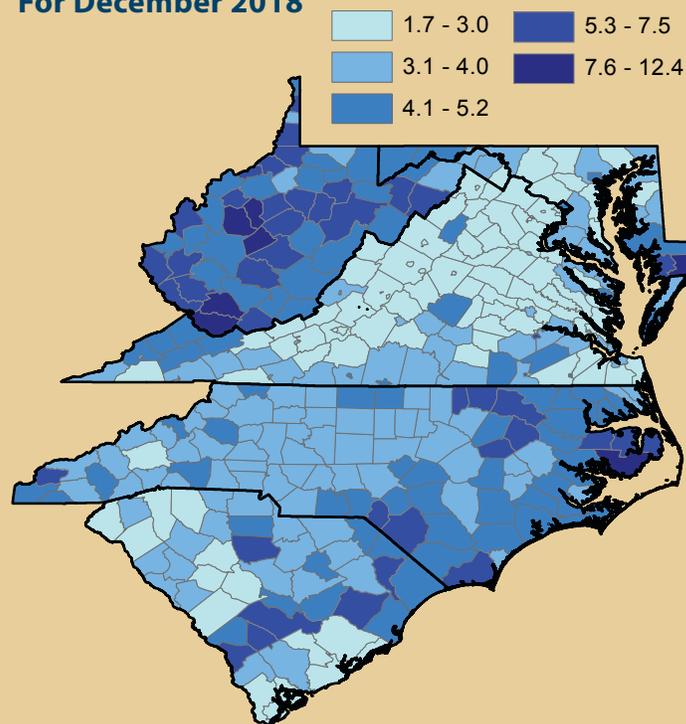
The tightening of labor markets also was evidenced by anecdotes from across the Fifth District. Throughout the year, a wide variety of firms indicated that finding and retaining workers was becoming increasingly difficult. A few firms, primarily in construction, even said that the labor shortage was constraining their growth. Many businesses increased starting wages to attract new hires and were giving existing employees raises to keep them from leaving, as turnover was also reportedly up. In addition to wage increases, there were many comments about enhanced nonwage incentives to attract and keep staff, such as signing bonuses, employee referral awards, and increased vacation time.

The Federal Reserve Bank of Richmond's survey data also indicated solid employment growth and rising wages in 2018. The Bank conducts monthly surveys of business conditions in the manufacturing and service sectors of the Fifth District. Among other questions, both surveys ask about changes in employment and wages. The Bank aggregates responses to these questions and creates diffusion indices in which positive values indicate that the share of firms reporting improvement exceeds the share of firms reporting decline.

The indices for manufacturing and service sector employment remained positive throughout the year, with the manufacturing index hitting a record high in August. In the last few months of the year, however, both readings declined slightly but remained in expansionary territory. Meanwhile, the survey indices for wages were well above zero and generally increased over the course of the year, reaching record highs in November 2018. (See Figure 2.)

The November survey also included a series of special questions on employment and wages, which showed that many businesses intended to increase employment in the near future and were using some

FIGURE 1: Unemployment Rates by County For December 2018



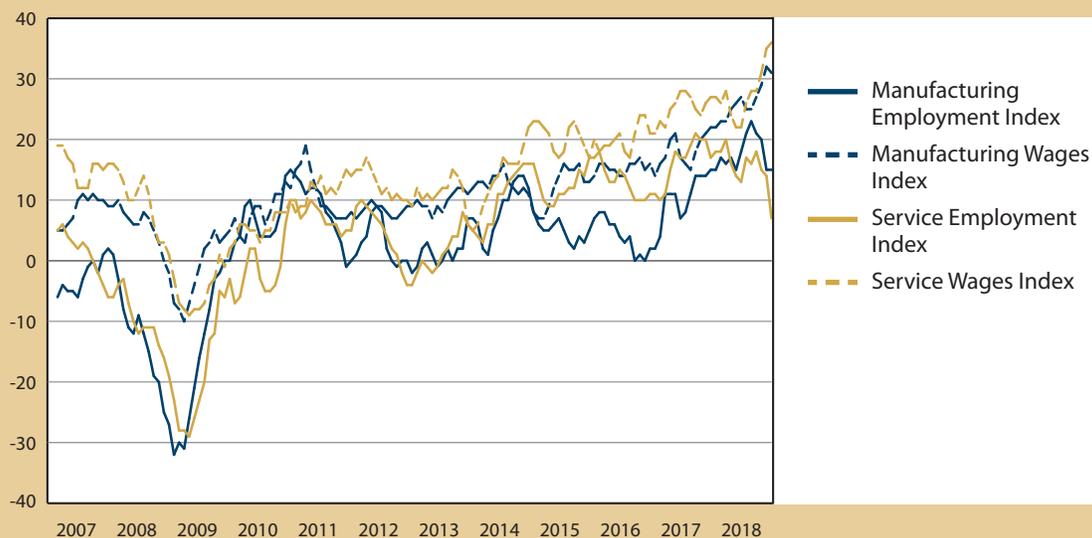
SOURCE: U.S. Bureau of Labor Statistics, 2018

combination of higher wages, sign-on bonuses, and enhanced benefits to attract candidates. And although a majority of businesses reported challenges in attracting and retaining workers with the necessary skills, only a small portion of firms expected those challenges to become a considerable restraint on growth in 2019.

Business Conditions

Manufacturing activity generally expanded in 2018, according to the Bank's survey of business conditions in the sector. The composite diffusion index for Fifth District manufacturing activity spent the majority of the year at elevated levels and hit a record high in September. In the last few months of the year, however, the index declined and dipped below zero in December—the first negative reading in more than two years. The December low was driven by a drop in new orders, with many comments indicating that the expected increases to tariffs on January 1, 2019, had a negative impact on business.

FIGURE 2: Fifth District Survey Measures of Employment and Wages



SOURCE: Richmond Fed Regional Surveys of Manufacturing and Service Sector Activity

NOTES: Survey responses are represented by diffusion indices. In each index, values equal the percentage of responding firms reporting an increase minus the percentage reporting a decrease. Values are expressed in three-month moving averages.

Overall, anecdotes from manufacturing contacts were positive across a diverse set of industries. Throughout the year, many firms reported strong growth, with some expressing plans to increase capacity through hiring, equipment investment, and/or plant expansions. At the same time, manufacturers also expressed concerns over staffing challenges, finding enough trucks to move goods, and rising raw materials costs. They attributed some of the rising materials costs to new or increased tariffs, such as those for steel and aluminum. A majority of manufacturing contacts said they were unable to fully pass these costs along to customers. Nonetheless, manufacturers were generally optimistic about their growth prospects for 2019.

In the service sector, overall business activity expanded in 2018, according to the Bank's survey measures. The index for revenues in the sector was fairly strong for most of the year, with notable exceptions in October and November, when the measure fell to negative one and negative five, respectively. Many of the comments in the surveys during those periods indicated that adverse weather, including hurricanes Florence and Michael, as well as

new and increasing tariffs, had some negative effects on business.

Within the service sector, some of the strongest reports of growth in 2018 came from the transportation industry. Port activity was robust throughout the year with some record-setting volumes reported. Some of the import growth toward the end of the year was partially attributed to firms frontloading goods purchases ahead of expected tariff increases. Trucking demand was also strong in 2018, with reports of tight capacity and a shortage of drivers, which led to some increased demand for rail services. Positive reports also were given by firms ranging from engineering, law, and information technology to defense contracting, education, and hospitality. Most services firms expected growth to persist into 2019, but there were concerns about the pace of growth slowing in the near future.

Real Estate

On the whole, Fifth District housing markets grew moderately in 2018, with many metrics and comments echoing those from the past several years. House prices, according to CoreLogic Information Solutions,

grew 3.3 percent on a year-over-year basis in the Fifth District, but trailed the national rate of 4.7 percent. Home prices rose most quickly in North and South Carolina at rates of 4.4 percent and 4.1 percent, respectively. Meanwhile, prices grew most slowly in Maryland (2.1 percent) and D.C. (2.3 percent). Anecdotes from residential real estate contacts broadly suggested that inventory levels remained low, with many homes both selling quickly and with multiple offers.

New home construction generally expanded throughout the year but at a somewhat slower pace than in 2017. As was the case in 2017, growth reportedly was constrained by a lack of available lots, labor shortages, and rising raw materials costs. Raw materials cost increases were exacerbated in the beginning of 2018 due to tariffs on Canadian lumber and on imported steel and aluminum. In terms of building permits, Fifth District jurisdictions issued a combined 114,022 single-family building permits in 2018, which was an increase of just 1 percent over 2017 and the slowest pace of growth reported since 2014.

Reports on the commercial real estate (CRE) sector were, on balance, more upbeat than residential reports. Although there were similar comments about difficulty finding workers and rising raw materials costs, CRE contacts generally reported solid to robust growth in 2018 across retail, industrial, office, warehousing, and multifamily subsectors. The robust growth in multifamily construction was evidenced by 7 percent growth in new building permits for structures with five or more housing units, which was about on pace with the 6.9 percent growth reported in the previous year.

Banking Conditions

Banking conditions continued to improve in 2018. Assets grew steadily through mergers and organic loan growth, and credit quality remained strong throughout the year. Rising interest rates drove record profits in 2018, but greater competition for deposits may hinder margin growth in the future if rates continue to increase.

Interest rates have started to rise in recent years, and Fifth District banks began seeing increases in net interest margins in 2018. Higher interest income and lower income taxes drove earnings to ten-year highs throughout the year. As of the fourth quarter, median return on average assets was 0.92 percent and 1.1 percent for banks in the Fifth District and nation, respectively.

During the year, median assets at Fifth District banks grew 4.3 percent, outpacing national median growth of 3.2 percent. Loans also grew steadily over the year in the Fifth District and nation, with median annual growth of 5.8 percent and 5.4 percent, respectively. In the Fifth District, particularly strong growth was observed in commercial and industrial portfolios (10 percent) and in non-owner-occupied commercial real estate portfolios (8.9 percent). The largest balance sheet concentration at Fifth District banks remained in commercial real estate, but those levels fell during the year.

Net loan losses and median nonperforming loan rates remained low and decreased in 2018, both at the Fifth District and national levels; however, nonperforming loan levels in the Fifth District remained about 0.19 percentage points higher than the national average. Though credit-quality indicators are improving generally, as competition for loans and deposits heats up, banks may face pressure to loosen underwriting standards and rely more heavily on volatile funding sources to achieve higher earnings.

Conclusion

On the whole, the Fifth District economy strengthened in 2018. Payroll employment expanded, most local unemployment rates ended the year below prerecession lows, and wage increases were reported across a broad spectrum of industries. Overall, business activity picked up, with considerable growth reported across industries, most notably in transportation. The general outlook among Fifth District firms is for continued, although perhaps more subdued, growth in 2019. ■