Fifth District Economic Expansion Strengthened in 2014

Introduction

In most markets and across most sectors, economic activity in the Fifth Federal Reserve District picked up in 2014. Although the government sector continued to be a drag on the economy, particularly in the northern part of the District, private sector firms were generally optimistic about current and future demand. Growth in the housing sector slowed—and residential construction remained something of a disappointment for many in the housing industry—but commercial real estate activity picked up across most segments. Labor markets showed clear signs of tightening, although wage growth remained spotty. Of course, the strength of economic activity varied by region. Areas such as Asheville, N.C., and Charleston, S.C., continued to expand across economic sectors, while coal mining areas in southwest Virginia and West Virginia, and areas more dependent on federal government spending, lagged.

Labor Markets

Fifth District labor markets generally tightened in 2014, with reports of hiring across a number of industries. Overall, employment in the Fifth District grew 1.8 percent in the year, as the District added 245,000 net new jobs, although this still fell short of the national 2.3 percent employment growth. There were also sizable differences among jurisdictions. The District of Columbia, Maryland, and Virginia all grew more slowly than the United States (1.1 percent, 1.5 percent, and 1.0 percent, respectively) while growth in North Carolina and South Carolina exceeded that of the nation (2.7 percent and 2.5 percent, respectively). Employment in West Virginia actually contracted by 0.1 percent in 2014. Nonetheless, by the end of 2014, all states in the Fifth District exceeded their pre-recession (December 2007) employment level.

The professional and business services industry is extremely important in the Fifth District economy. It accounts for 15.4 percent of District employment, exceeded only by the government sector and the trade, transportation, and utilities industry that account for 19 percent and 17.3 percent of employment, respectively. Professional and business services firms contributed almost 30 percent of the net job gains in 2014. (The remainder of the gains spanned industries.) The professional and business services industry also played a large role in North and South Carolina's employment expansion in 2014. In North Carolina, just over 30 percent of the 110,200 net jobs gained in the year were in professional and business services—a 6.0 percent expansion in that industry. In South Carolina, professional and business services accounted for a little more than 23 percent of the 49,000 net jobs gained in the year—a 4.5 percent increase. Meanwhile, although the professional and business services industry comprises a higher share of employment in Virginia than in any other state in the Fifth District, the industry in Virginia grew only 0.6 percent in 2014. In Maryland, the industry grew only 2.1 percent. Why the slow growth in professional and business services employment in the northern part of the District? This is primarily related to retrenchment and overall uncertainty in federal government contracting, which is discussed in more detail below.

The unemployment rate in the Fifth District fell from 6.2 percent in December 2013 to 5.5 percent in December 2014—ending the year just slightly below the national 5.6 percent rate. Although the unemployment rate in the District is declining, the labor force participation rate has also been falling and, by the end of the year, was at its lowest recorded rate of 62.0 percent. Unemployment rates mostly declined across the District in the year: D.C. fell to 7.7 percent, Maryland fell to 5.5 percent, North Carolina fell to 5.4 percent, South Carolina rose to 6.6 percent, Virginia fell to 4.8 percent, and West Virginia fell to 5.9 percent.

There continued to be reports of hiring in a variety of industries, although more among hourly and lower-skilled workers. Contacts across the District also described turnover among lower-skilled employees throughout the year. Reports of difficulty finding workers with the appropriate soft and hard skills continued, with a particular need for workers in information technology, engineering, skilled manufacturing, distribution and warehousing, trucking, construction, management, and, in some areas, hospitality and recreation. There were very few reports of rising wages, although upward pressure on wages intensified in certain areas and among certain professions.

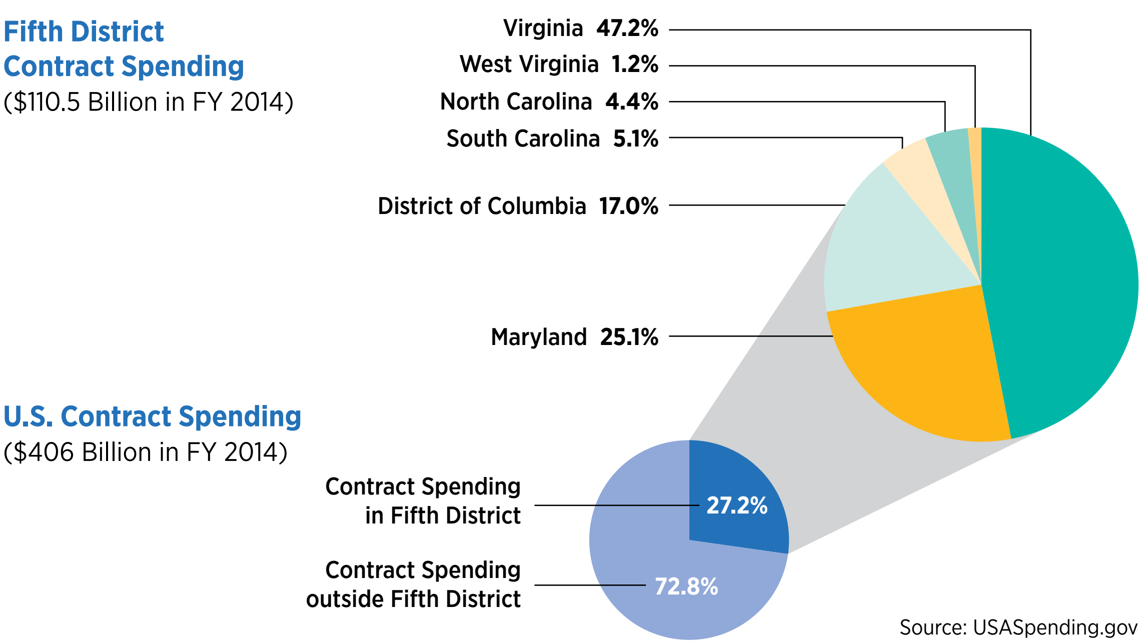
Government Contracting

The Fifth District as a whole accounted for over $110.5 billion federal contract dollars in fiscal year 2014, or 27.2 percent of the national total. Within that, 47.2 percent went to Virginia and 25.1 percent to Maryland. In fact, in fiscal year 2014, Virginia had the largest share of federal contract dollars of any state in the union and Maryland had the fourth-largest share. Contract spending has been declining, however. In the Fifth District, contract spending in fiscal year 2014 was 9.2 percent below its peak in 2010, with spending in D.C. 11.8 percent below its peak in 2010 and spending in Virginia 13.3 percent below its peak in 2011. (Spending in Maryland has remained more constant.)

Business Conditions

The District manufacturing sector expanded more consistently in 2014 than in recent years. Winter weather slowed activity in the first few months of the year, with storms causing shipment delays and plant closures that resulted in lost wages, hours, and production. But the spring brought the improvement that manufacturers

Federal Contract Spending in the Fifth District



Source: USASpending.gov

anticipated. The Federal Reserve Bank of Richmond maintains a composite manufacturing index based on the Bank's *Fifth District Survey of Manufacturing Activity*. It is a diffusion index, meaning that a positive reading indicates that the share of firms reporting expansion exceeds the share of firms reporting contraction. This index was above zero for all but two months (February and March) of 2014. The index was particularly strong in the autumn months with the reading of 20 in October among the highest in the index's history. The composite index was driven up by reports of increases in shipments, in the volume of new orders, and in the number of employees. Although there were scattered negative reports throughout the year, business activity—particularly in the second half of the year—was positive for manufacturing industries as diverse as furniture, electrical components, textiles, food, automotive, chemicals, packaging materials, electrical products, machinery, and medical equipment. Only manufacturing related to defense was consistently downbeat, although in many months construction related to residential building was not as strong as hoped or expected.

Port activity continued to be strong, particularly in the ports of Charleston, S.C., and Norfolk, Va., spurred by expanded manufacturing activity in those regions. Import growth continued to outpace export growth. In general, exports and imports of forest products, grains, soybeans, and heavy machinery/autos grew robustly, while there was some reduced growth in activity related to residential building and coal exports were weak. Domestically, the coal industry suffered further in 2014, both from the low prices of natural gas that enticed companies—particularly utilities—toward gas and away from coal, and from the pressure that power companies are experiencing from impending environmental regulation.

Retail activity had a strong year in 2014, according to the retail revenues index generated from the Bank's *Fifth District Survey of Service Sector Activity*. The index, which tends to be volatile, was above zero in all but one month (June) of 2014, and in May the index hit its highest reading (49) in its more than 20-year history. Reports on retail activity were strong in areas such as cars (used and new), furniture, hardware, discount sales, sporting goods, groceries, and equipment. However, the strength of retail activity varied by region of the District and all retailers expressed continued concern about the effect of the expansion in online sales on brick and mortar stores.

Reports on the non-retail service sector were also generally positive, but in a way that was more consistent with the past few years. Although the non-retail revenues diffusion index never fell below zero in 2014, it did have three months (January, February, and April) at zero and a few more months close to zero. Anecdotes from District services firms were generally positive, particularly after the harsh winter weather at the beginning of the year passed. Tourist activity was reportedly strong throughout the year and throughout the District.

Real Estate

The housing market recovery in the Fifth District continued, but generally slowed, in 2014. According to the CoreLogic Information Solutions house price index, house price growth in the District decelerated, but home values still appreciated 1.6 percent in 2014, continuing the year-over-year house price growth in the District that has persisted since February 2012. As it has for almost three years now, price growth in the nation as a whole—while also slowing—exceeded that in the District; in 2014, house prices in the United States grew 5.0 percent. At the jurisdiction level, only Maryland reported a year-over-year house price decline (0.5 percent) in December 2014. Contacts across the District also reported moderate growth in housing, with mild increases in sales, prices, and foot traffic and generally declining inventory levels. The number (and share) of mortgages in delinquency and in foreclosure also continued to decline in 2014, as it has been doing quite steadily, across states, for the past few years.

Across the housing industry, there were reports that growth in 2014 was positive but not up to expectations for the year. This was particularly true for builders. There was some new construction, but on the whole, residential construction activity remained slow. Nonetheless, activity in residential permit levels, while volatile, continued to trend upward. The total number of new housing units permitted in 2014 was 0.8 percent above the number in 2013. Most of the growth came from permits for multifamily buildings: The number of single-family home permits issued was 0.2 percent below the number issued in 2013.

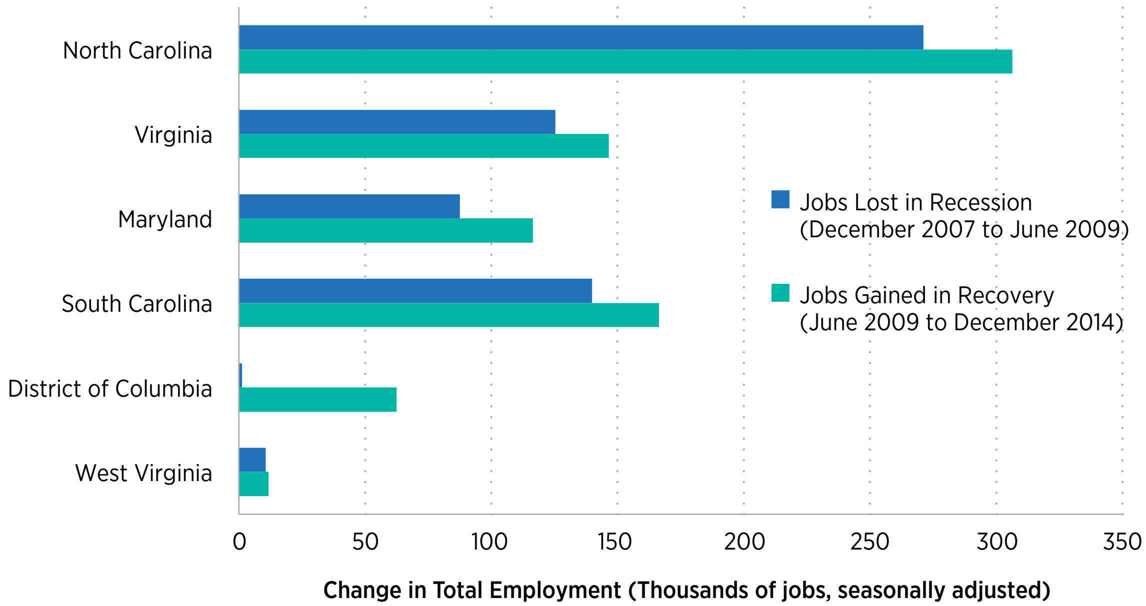
Although residential growth slowed throughout the year, commercial activity seemed to pick up. Contacts reported increased sales and leasing, with particular strength in office (primarily Class A office space), industrial, and certain retail space. In retail, expansion in free-standing space and grocery-anchored space appeared to be the most robust. The multifamily market also remained active throughout the year. In most markets, commercial Realtors noted stable rental rates, declining vacancy rates, increased absorption, and decreased concessions.

Banking Conditions

Fifth District banking conditions improved during 2014; however, banks continued to face a challenging environment due to compressed net interest margins resulting from a low interest rate environment. In spite of these challenges, banks still managed to increase profitability while improving asset quality and maintaining strong capital ratios.

Overall, balance sheets expanded modestly at Fifth District banks as evidenced by median asset and loan growth of 3.6 and 5.3 percent, respectively. Asset growth primarily occurred by way of increases to cash, securities, and loans. Commercial and industrial real estate lending continued to be the largest contributors to District loan growth. Loan growth in these sectors was primarily driven by large- and medium-sized banks. Small community banks continued to focus on residential mortgage lending as large banks slowed lending in this category after a wave of refinance

Job Losses and Gains in the Fifth District



Source: Bureau of Labor Statistics/Haver

Better Understanding Our Local Economies


PHOTO: LARRY CAIN

Twice a year, leaders of the Federal Reserve Bank of Richmond hold regional forums in communities across the Fifth District to learn more about the local economies. The forums also help Bank leaders learn more about emerging issues within the District through the exchange of information, knowledge, and perspectives, which helps inform the Bank's research, policy analysis, and decision-making. In the photo, Matthew Martin (left), Charlotte regional executive and senior vice president of Outreach, discusses issues at the regional forum in Asheville, N.C., with Jon Wehrli, a plant manager at Eaton Electrical. To view a brief video about the 2014 regional forums, please go to https://youtu.be/E9CweyKDRcU.

activity in previous years. Despite historically high levels, median annual nonperforming loan balances declined by 27 percent during the year. Improvements in asset quality allowed provision levels to fall to their lowest in over a decade, contributing to increased earnings. A majority of District banks, 54 percent, reported improved year-over-year earnings and the percent of banks reporting positive returns increased to 92.6 percent at the end of 2014 from 87.3 percent at the end of 2013. Capital levels continued to hold strong in the District as evidenced by increased risk-based capital ratios. Increases in surplus and undivided profits led to improved equity capital at 81 percent of Fifth District banks.

Liquidity remained solid for Fifth District banks as core deposits continued to be the primary source of funding. Despite two years of declining liquid asset ratios, tepid loan growth and new liquidity coverage ratio requirements at large banks bolstered liquid asset levels. Additionally, while Fifth District banks continued to expand their deposit bases, principally in interest-bearing deposits and reduced reliance on non-core funding, bank-funding strategies may shift given an eventual change in the interest rate environment.

Conclusion

On the whole, 2014 was a year of continued economic recovery and progress in the Fifth Federal Reserve District. Although residential real estate growth slowed, other sectors picked up, with increased business investment, expanding commercial real estate activity, and tightening labor markets. Government continued to be a drag on activity, but some of the economic uncertainty appeared to lift from private firms in most sectors of the economy and in most regions of the Fifth District.

Economic (nonbanking) data accurate as of March 20, 2015.