Fifth District Economic Report

Fifth District Economy Grew Moderately in 2016

Anecdotal reports and economic data on the Fifth District in 2016 revealed a regional economy that continued to grow throughout the year. Employment rose at a moderate pace with more robust growth coming out of North and South Carolina. Wage growth picked up overall, including, according to survey responses, for starting wages across a number of firms. Services firms generally reported expanding activity throughout the year, while manufacturers began the year with less universally positive reports and ended the year on somewhat more optimistic notes. Real estate markets continued to improve in 2016, but real estate professionals expressed concerns about regulatory delays and shortages of buildable lots and skilled workers.

Labor Markets

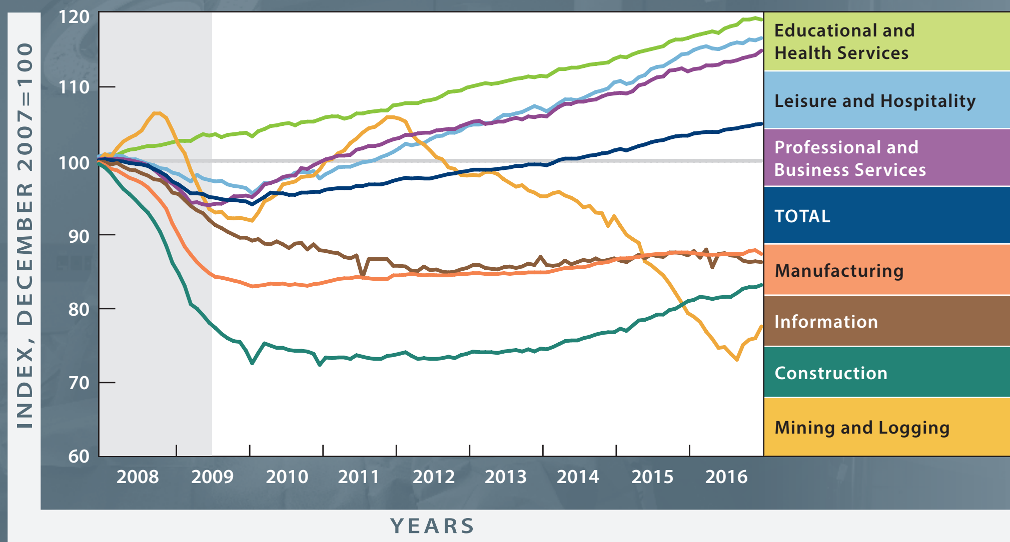
Labor market conditions continued to tighten over the course of 2016. Payroll employment expanded 1.4 percent in the Fifth District as employers added 201,800 jobs. Among the District's jurisdictions, North Carolina posted the largest year-over-year growth rate in December of 2.2 percent, followed by South Carolina's 1.8 percent. The Carolinas were the only Fifth District states to outpace the national rate of 1.6 percent. Employment grew in the other Fifth District jurisdictions except for West Virginia, which reported a 0.8 percent decline as the state continued to shed a large number of jobs from the mining and logging sector.

In the District overall, the most jobs were added over the year to education and health services (50,200 jobs) followed by trade, transportation, and utilities (35,200 jobs) and professional and business services (35,000 jobs). The only industry to lose jobs in 2016 was information, which shed 3,100 jobs (1.3 percent); information is the smallest industry in the District, and employment in the sector has generally been declining or flat since 2000.

Although construction employment grew in 2016 and has been growing at a healthy pace since the beginning of 2014, total employment in the industry has not returned to its prerecession level. (See Figure 1.) In fact, in December 2016 the industry's total employment stood at 82.9 percent of the level reported in December 2007. Similarly, employment in the manufacturing and information industries has yet to return to prerecession levels. Employment in mining and logging had returned to its prerecession levels, but the industry began to shed jobs again in 2012 and is now below its December 2007 level. Employment in mining has fluctuated, primarily in response to changes in coal and natural gas markets.

Despite the fact that a few industries still have not returned to their prerecession employment levels, employment in the District as a whole exceeded its December 2007 level in April 2014 and has remained above that level. Moreover, the professional and business services and leisure and hospitality industries surpassed their prerecession marks in 2011.

Figure 1: Fifth District Employment Growth by Industry



SOURCE: Current Employment Statistics, Bureau of Labor Statistics
NOTES: Gray area indicates the recession. Industries that closely followed the overall growth trend (the total line) have been omitted from this graph. They are: trade, transportation, and utilities; financial activities; and other services. Government employment growth also is not shown because it was essentially flat.

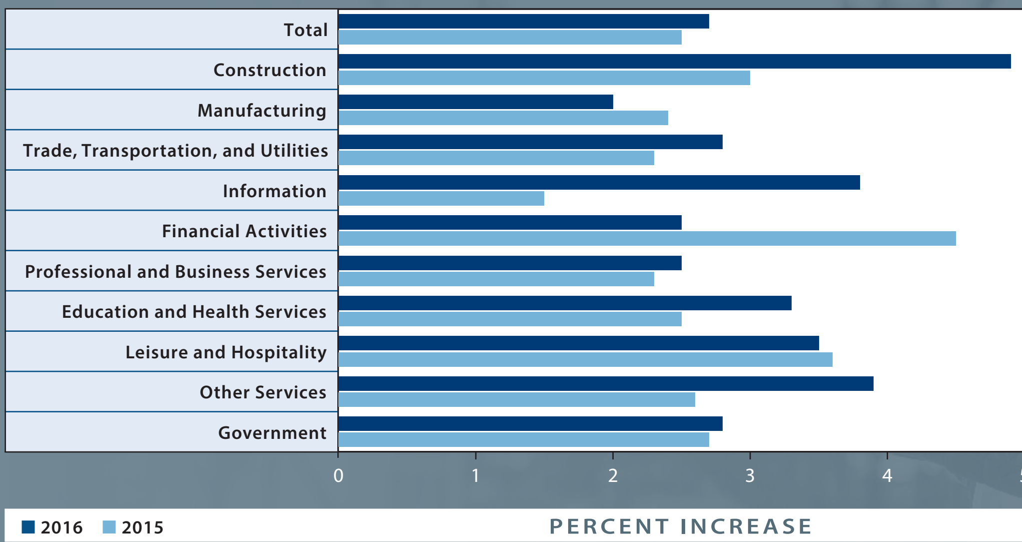
The education and health services industry and the government sector were the only two categories that did not decline either during or since the recession.

In 2016, the unemployment rate in the Fifth District declined from 5.0 percent in December 2015 to 4.6 percent in December 2016—the lowest rate since early 2008. All of that 2016 improvement came in the first half of the year; the rate has remained at 4.6 percent since June. At the jurisdiction level, unemployment rates declined in every state except Virginia, where the 4.1 percent rate in December 2016 matched the rate reported in December of the previous year. The greatest improvement came from South Carolina, where the jobless rate declined 1.2 percentage points to end the year at 4.3 percent.

Anecdotes throughout the Fifth District indicated that as the labor market tightened in 2016, employers increasingly struggled to find skilled workers. In particular, there were consistent reports of challenges in finding tradespeople, construction workers, hospitality workers, and IT professionals. Anecdotal information also suggested that the tight labor market might be driving up starting wages. According to a survey of employers conducted by the Federal Reserve Bank of Richmond in May 2016, more than 60 percent of respondents said they were raising starting wages. The same result was obtained when the survey was repeated in November 2016. Furthermore, the number of respondents who reported raising wages for "most" jobs (as opposed to "some" jobs) was higher in November than in May.

Data on wage growth from the Bureau of Labor Statistics supported the anecdotal information. Using the most recent data from the bureau's Quarterly Census of Employment and Wages, Figure 2 shows that Fifth District wage growth over the trailing four quarters through September 2016 slightly outpaced the same four quarters of the prior year. Additionally,

Figure 2: Year-over-Year Wage Growth in the Fifth District



SOURCE: Richmond Fed calculations using Quarterly Census of Employment and Wages, Bureau of Labor Statistics
NOTES: Calculations are based on nominal average wages from the trailing four quarters through September of 2014, 2015, and 2016. Calculations for manufacturing and construction do not include data from the District of Columbia. For the trailing four months ending September 30, 2016, the District of Columbia accounted for 2.1 percent of construction employment and 0.1 percent of manufacturing employment in the Fifth District.

the largest wage growth came from the construction industry (4.9 percent), which was also the industry with the most persistent reports of difficulties in finding workers. Wage growth accelerated in most other industries as well, with the most notable deceleration coming in the financial services industry.

Business Conditions

Manufacturing activity was mixed in 2016, but it ended on a generally optimistic note. The Richmond Fed 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. As was the case last year, the index fluctuated between positive and negative readings throughout the year; however, 2016 ended with two consecutive months of positive index values and included more comments expressing optimism.

Throughout the year, anecdotal reports indicated that some segments of manufacturing were more consistently positive. For example, manufacturers of automobiles, auto parts, and aerospace products reported growth, fairly robust at times, for most of the year. Conversely, some manufacturers continued to be adversely affected by sluggish global demand and declining commodity prices.

According to the *Federal Reserve Bank of Richmond Service Sector Survey*, conditions were generally upbeat for services firms throughout the year. The revenues index for nonretail service firms was positive in every month except February. For 2016, the average index reading was six, a survey measure that indicated a slow and steady expansion for services firms.

Anecdotally, tourism and hospitality services generally experienced robust growth as contacts reported rising demand at hotels and restaurants.

Retail firms experienced a somewhat more varied business climate in 2016. According to the Richmond Fed survey, the revenues index for retail services remained above zero for the majority of the year but experienced a few months of negative values, including a sharp decline in August. Throughout the year, brick-and-mortar retailers commented on the challenges of competing with online retailers and reported unreliable foot traffic.

The surveys' measures of employment and wages were generally consistent with labor market data from other sources. Throughout the year, most manufacturers reported more employees, with a notable exception in September, when the index fell steeply into negative territory. The index for manufacturing wages has been positive since early 2010, but the average index value has trended higher in recent years. In 2016, the average index value was sixteen compared with thirteen in 2015—both up from nine in 2010.

Similarly, in the service sector, the index for number of employees remained above zero for all of 2016, and the average index value rose slightly compared to the prior year. As was the case with the revenues index, the nonretail services subsector followed the overall trend while the retail subsector was more volatile, with four months of negative employment index values. Average wages, on the other hand, mirrored the manufacturing industry, with persistently positive index readings in 2016 that were just slightly higher than in 2015 and considerably higher than 2010 through 2014. Furthermore, this trend was consistent among both retail and nonretail services.

Real Estate

Fifth District housing markets continued to improve in 2016, but they lagged national averages in some metrics. According to CoreLogic Information Solutions, District house prices grew 4.1 percent on a year-over-year basis, a rate that lagged the national average of 6.3 percent. The sharpest increase in the District was in South Carolina, where home prices rose 5.9 percent, while West Virginia reported the lowest house-price growth of 2.6 percent. Real estate agents throughout the District also reported rising prices and home sales throughout the year, but results varied by region and price level. In some cases, low inventory levels simultaneously reined in sales growth and spurred on new construction.

On balance, residential construction continued to accelerate in 2016 but was somewhat constrained by the availability of lots and a tight market for construction workers. Again, reports varied by location, with some reports of lot shortages driving up lot prices and, in at least one case, contributing to an increase in multifamily leasing and rents. Jurisdictions across the Fifth District issued a combined 138,900 residential building permits in 2016, which was a 1.3 percent increase over the previous year. About 27 percent of those permits were for multifamily units, down slightly from the 31 percent share of total units in 2015. Growth in single-family housing starts was more robust at 4.0 percent.

Commercial real estate (CRE) activity generally expanded throughout 2016. Grocery-anchored retail centers, hotels, health care facilities, and schools were, anecdotally, some of the faster-growing segments. Demand for construction in the retail segment also picked up; however, the square footage of a typical project was smaller than in the past. Office and industrial leasing also rose on the whole, but there were some reports of supply constraints, particularly among the highest quality, Class-A properties.

Banking Conditions

Amid industry consolidation and earnings pressures from the continued low interest rate environment in 2016, Fifth District banks experienced steady loan growth, particularly in the CRE sector, and overall improvement in credit-quality indicators.

Although 94 percent of Fifth District banks were profitable in 2016, earnings remained under pressure, contributing to the industry's consolidation, mostly among smaller banks. The District's overall bank population declined by 8 percent, double the national consolidation rate. This trend helped some District banks improve earnings by achieving economies of scale. The District's median return on average assets (ROAA) of 0.73 percent improved slightly from a year ago with about half of District banks reporting an increasing ROAA. However, the District's median ROAA continued to lag the nation's by 0.20 percentage points due, in part, to higher than average overhead and personnel expense. Earnings improvements were mostly attributable to higher noninterest income and declining overhead costs related to greater efficiency gains at mid- and large-sized banks. While interest rates have risen, rate increases have yet to augment Fifth District margins, which remained compressed due to competition and the low-rate environment.

Balance sheets expanded, with median loan growth of 7.3 percent outpacing the national median of 5.8 percent. The fastest-growing segments were in CRE categories, namely non-owner-occupied CRE, and construction, land, and development. CRE loan growth led to higher CRE loan concentrations, a continuing trend in the District, and weighed on capital ratios.

Credit quality indicators improved, on average, with the Fifth District's level of nonperforming loans declining, but nonperforming loans remained above prerecession levels and 0.25 percentage points higher than the national average. While overall loan delinquencies improved, some District banks' provision expenses ticked up from the previous year.

Conclusion

Overall, 2016 was a year of continued economic expansion in the Fifth District. Employment expanded and wage growth accelerated slightly. However, the tightening labor market may have made it more difficult for businesses to find appropriately skilled employees. In some industries, such as construction, these difficulties could have constrained growth. Residential and commercial construction activity did pick up, though, as house prices rose and new home inventories continued to dwindle. Meanwhile, both manufacturers and services firms across the District reported positive developments in 2016 and were optimistic about the near future.