Washington Economy Watch

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The Stephen S. Fuller Institute
for Research on the Washington Region's Economic Future
Schar School of Policy and Government
George Mason University

The Washington Economy Watch is a monthly report issued by The Stephen S. Fuller Institute that is intended to inform its readers regarding the current and near-term performance of the Washington region's economy. The Leading and Coincident Indices were first reported in February 1991 and have been calculated each month since that first release and reflect an underlying data base that dates from 1978 covering five complete business cycles in addition to the current cycle that began in mid-2009.

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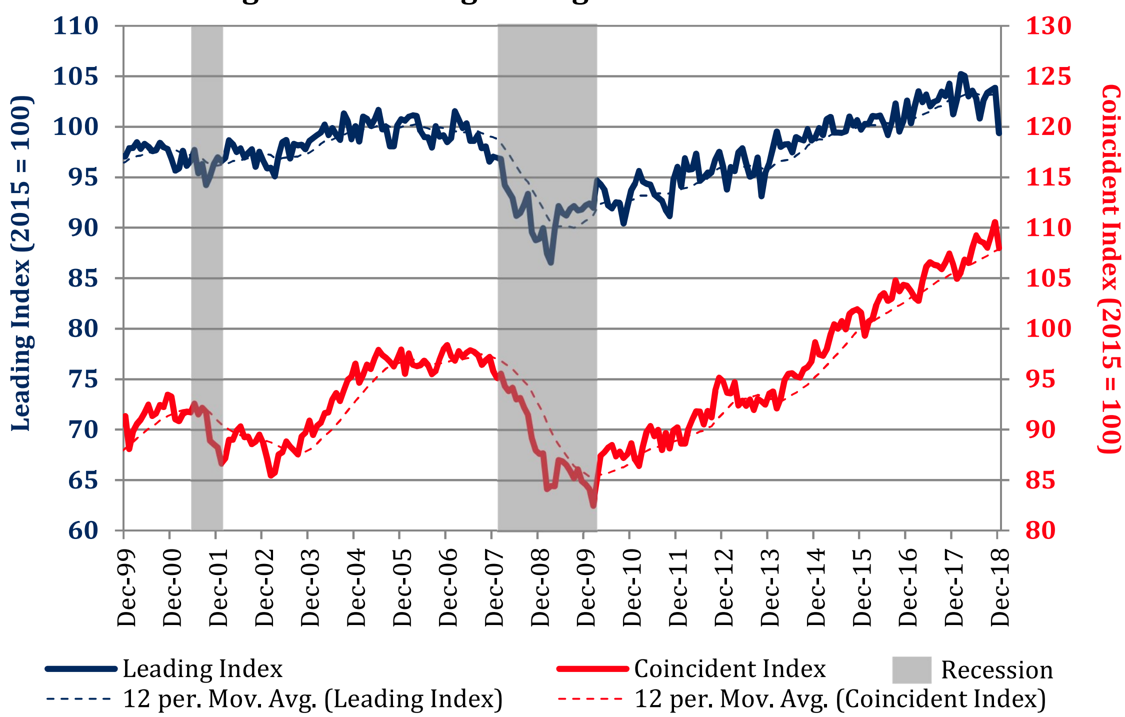
The Partial-Federal Shutdown Diminishes an Otherwise Strong Economic Performance in 2018

For the year, the performances of the Washington region's Coincident and Leading Indices in 2018 pointed to continuing but possibly slower future growth. The Coincident Index continued to exhibit solid gains, but on a month-to-month basis, it experienced four monthly declines since mid-year. Over the same period, the Leading Index experienced five decreases on a monthly over-the-year basis. With the partial-federal shutdown beginning December 22nd, both Indices reported lower than normal performances in December. Even excluding December's sharp decline, this trend clearly raises questions concerning the economy's growth trajectory in 2019. Looking forward, a slowing U.S. economy in 2019, increasing global economic uncertainty, and the unexpectedly long partial-federal shutdown may result in the Washington region's economy underperforming its growth potential in 2019.

Figure 1. Washington Region Economic Indices



Source: The Stephen S. Fuller Institute at the Schar School, GMU

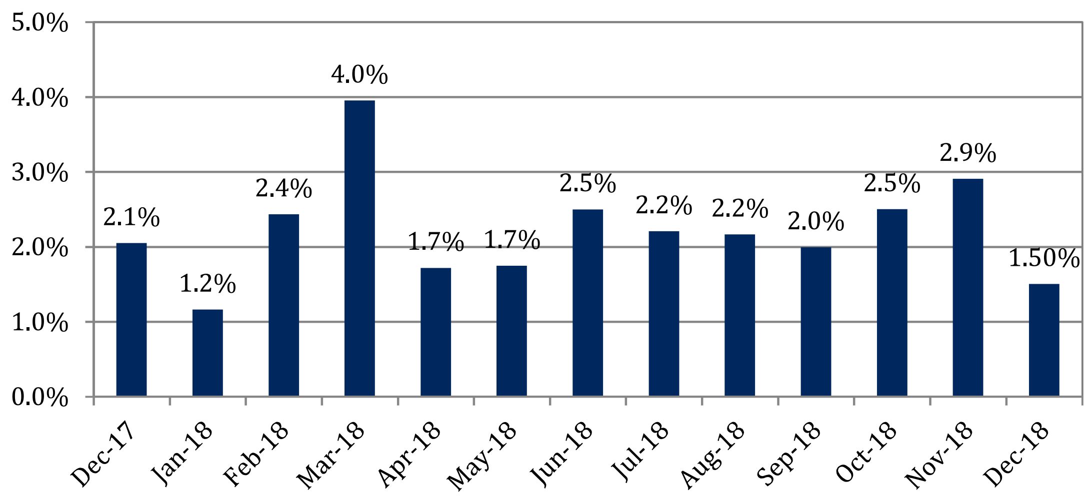
The **Washington Coincident Index**, which represents the current state of the metropolitan area economy, declined sharply in December, on a month-to-month basis, losing 2.35 percent after having increase in both October and November. For the full year, on a month-to-month basis, the Coincident Index decreased six times suggesting that growth rates may have peaked in 2018. The Index's sharp decline in December from its previous month's value can be attributed in part to the partial-federal shutdown that began on the 22nd.

On a monthly over-the-year basis, December's Coincident Index registered an increase of 1.50 percent from December 2017 extending its upward trend to 57 consecutive months, dating from April 2014. The Index's December performance was diminished by both the partial-federal shutdown and weaker nondurable goods sales that followed a national pattern with holiday sales peaking in November.

In December, three of the Index's components were positive on a monthly over-the-year basis:

- *Wage and salary employment* in the Washington region increased 1.6% between December 2017 and December 2018;
- *Consumer confidence (in the present)* extended its positive trend increasing 8.2% from December 2017; and,
- *Non-durable goods retail sales* were up 0.9% from December 2017 gaining for a 22th consecutive month on a monthly over-the-year basis; while,
- *Domestic passenger volume at Reagan National and Dulles Airports* decreased 0.9% from December 2017.

Figure 2. Washington Coincident Index, Monthly Over-the-Year Changes



Source: The Stephen S. Fuller Institute at the Schar School, GMU

The **Washington Leading Index**, which is designed to forecast the performance of the metropolitan area economy six to eight months in advance, decline sharply in December decreasing 1.86 percent. This is the Leading Index's fifth and largest decrease in six months on a monthly over-the-year basis reflecting a slowing pattern in the region's economic growth. However, the early effects of the partial-federal shutdown contributed to lowering December's performance even further. These are seen in a dramatic increase in initial claims for unemployment insurance and weaker gains in consumer confidence. While durable goods sales were positive in December, they were weaker than normal.

In December, two of the Leading Index's four components contributed to its decline:

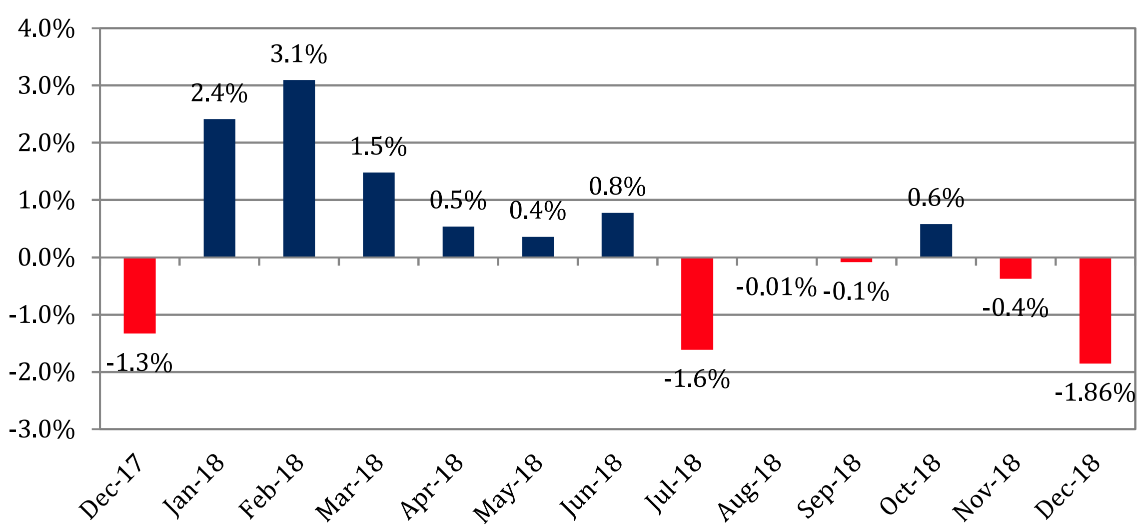
- *Total residential building permits* decreased 0.8% in December and now has declined each month since mid-year; and,

- *Initial claims for unemployment insurance* increased 94.6%, worsening for a seventh consecutive month, but this tripling of November's performance is clearly attributed to a surge in new unemployment claims resulting from the partial-federal shutdown; while,

- *Consumer expectations (consumer confidence six months hence)* increased only 1.0% from its December 2017 level and was likely impacted by the partial-federal shutdown; and,

- *Durable goods retail sales* increased just 1.0% between December 2017 and December 2018 and, while extending its long-term positive trend, this performance was weaker than normal for December.

Figure 3. Washington Leading Index, Monthly Over-the-Year Changes



Source: The Stephen S. Fuller Institute at the Schar School, GMU

Current Performance

The Washington region's economy has sustained its expansion (recovery) from the negative impacts of the Sequester for 57 consecutive months; that is, the Washington region's Coincident Index, which is designed to measure the region's current economic performance, has increased each month since April 2014 through December 2018, in spite of its below-normal performance in December attributed to the partial-federal shutdown. Job growth is the most widely cited measure of the economy's performance and the Washington region continues to add significant numbers of new jobs. The estimated 52,100 jobs gained for 2018 exceeds beginning-of-the-year expectations by almost 10 percent.

While this year's job numbers will be revised and new monthly counts released in mid-March, the preliminary jobs numbers provide several clues to the type of economic growth the region is experienced in 2018. Three sectors—professional & business services, education & health services, and leisure & hospitality services—substantially outperformed their historic job growth patterns. Together, while these three sectors accounted for 46.5 percent of the region's total jobs they generated 63.9 percent of the year's net job increase.

The government sector—federal and state & local—continued to experience a mixed performance in 2018. Federal jobs decreased by 5,700 from 2017 while local and state governments added 7,200 jobs.

All of the region's other sectors added jobs in 2018 but only construction, with 5,300 new jobs, and transportation and utilities, with 3,300 new jobs, grew faster than their percentage share of the region's total employment base, thereby increasing their share of all jobs in the Washington region. The employment shares of the region's other six sectors—retail trade, other services, financial activities, information services, wholesale trade and manufacturing—declined in 2018.

These job changes in 2018, and in each year since 2010 when federal employment was at its peak, reveal the emergence of a new economic structure underpinning the Washington region's economy with federal spending and dependent employment becoming a smaller but still important share of the region's economic base while non-federally dependent businesses and activities are becoming a larger share and growing source of economic growth going forward. Where federal spending had generated almost 40 percent of the region's economic activity in 2010, it now accounts for approximately 31 percent with this percentage continuing to decline towards 25 percent by the end of the next decade.

This transformation has cost the region's economy over the past, as measured by slower growth rates, but could likely position the region's economy for faster-than-GDP-trend growth in the future. The combination of a stable federal government sector with all of its interdependencies within the regional economy and a growing non-federally dependent economic base—think Amazon's HQ2—feeding off the region's assets, many of which tie back to its being the nation's capital and an important global information and business center, should position it for above-trend growth going forward.

Near-Term Outlook

The 2019 forecast for U.S. economy has been revised downwards several times since November. In February, IHS Markit lowered its forecast for 2019 to 2.4 percent (from 2.5% in January, down from 2.7% in November) while the Federal Reserve Board's and IMF's forecasts are for 2.3 percent growth. From the beginning, 2019's economic growth rate was expected to be below the 2018 rate of 2.9 percent, reflecting the diminishing fiscal stimulus, higher interest rates, weaker international trade due to higher tariffs, and weaker economic growth in China and Europe, the impacts of Brexit on Great Britain and its major trading partners, among the other headwinds impacting this year's economic growth.

What was not factored into these forecasts was a 35-day partial-federal shutdown. At the national level, the impact of this shutdown will show up in slower first quarter GDP growth (1.6%) that will be largely off-set by faster 2nd quarter GDP growth (2.5%) reflecting the increased spending by federal workers once they are compensated for their lost wages from the first quarter. In total, GDP growth for the year has been lower by 0.1 percentage points, from 2.5 to 2.4 percent.

For the Washington metropolitan economy, this impact could be larger than for the national economy, as federal spending is a larger part of the region's GRP, especially for federal procurement spending, than it is of GDP. However, these short-term losses should not cause any permanent damage to the economy's future performance. Still, there are, other factors are in flux and should and these will be closely monitored in the coming months.

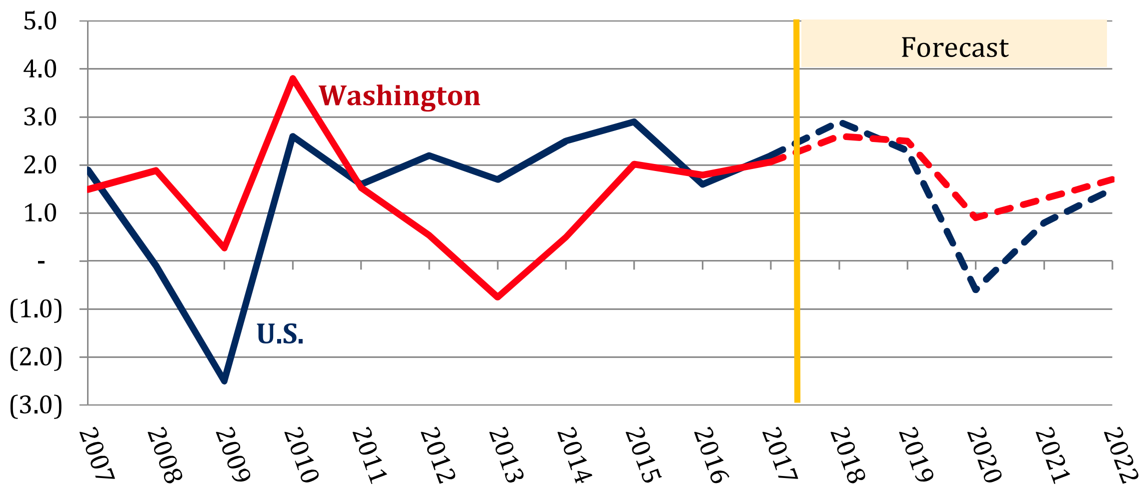
One of these—interest rates—may have been taken out of play by the Federal Reserve Board when following its January 30th meeting it was announced that the Fed would take a pause in its regular interest rate increases and monitor the economy's performance to determine whether future increases would be needed. Since December 2015, the Fed had raised its Federal Funds Rate nine times to keep the economy from overheating and to manage inflation within its target 2.0-2.5 percent target range. Early forecasts for 2018 had built in at least three one-quarter point interest rate increases and up to three rate increases into the 2019 forecasts and one last increase into the 2020 forecast with the Federal Funds Rate peaking at 3.4 percent; the current Federal Funds rate is 2.4 percent. Now, this calculation has changed. The likelihood of further interest increases has been reduced to possibly only one increase this year in July 2019 and one more in March 2020 with the Federal Funds Rate's final upper range approaching only 3.0 percent.

One important consequence of this pull back in the Fed's interest rate increases has already been experienced in the half-point decline in 30-year fixed home mortgage rates since mid-year when they were flirting with 5 percent. Rather than peaking at 5.4 percent, 30-year fixed mortgage rates are now expected to settle near 5.0 percent by 2021. Other interest rates are projected to rise less than had been expected under the Fed's previous interest rate target. This moderation in interest rate increases will translate across the equity markets' future performances and likely stimulate increased business investment; clearly, lower interest rates will have a palliative impact on the broader economy and help to support its continuing, above-trend performance in 2019.

More strategically, this shift in Federal Reserve Bank policy may help the U.S. economy extend the current business cycle well beyond earlier expectations. The current expansion is already the second longest in history, having now almost completed its 119th month. By July, it will be the longest business cycle in history as it completes its 10th year—the 2008-2009 recession officially ended and the current expansion began mid-2009.

There had been growing debate concerning how long this business cycle would continue. And, before the Fed's recent pause in its interest rate increases, there had been growing numbers of forecasters willing to hedge on this cycle's future. The consensus of these pessimists was that a short and shallow recession could occur during the first three quarters of 2020 with GDP registering a 0.6 percent decline for all of 2020 with a new business cycle starting in the fourth quarter of 2020. In this scenario, GDP was projected to grow 1.0 percent in 2021 and 1.9 percent in 2022, as shown in Figure 4.

Figure 4: What Would A Potential Recession in 2020 Look Like?

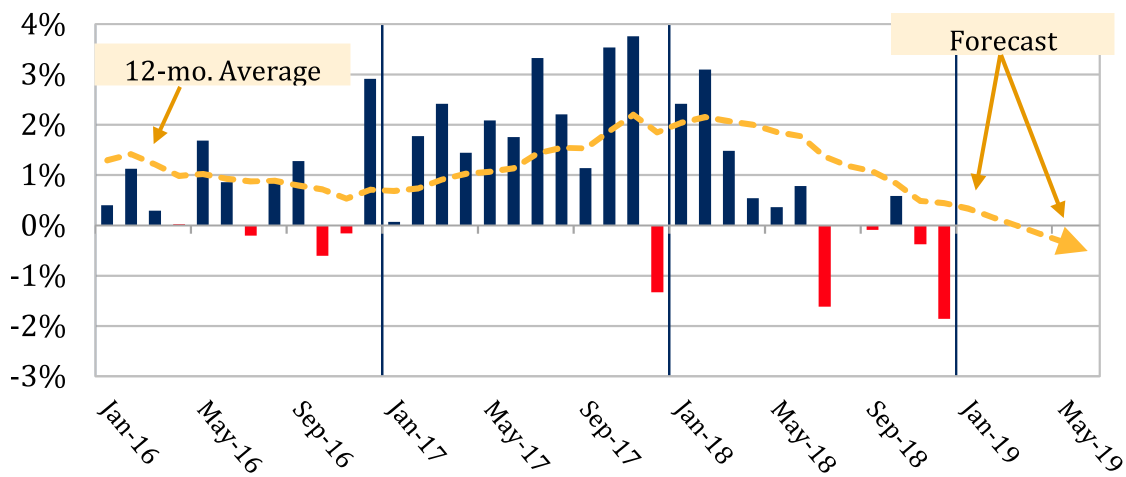


Sources: U.S. Bureau of Economic Analysis; IHS Markit (January 2019); The Stephen S. Fuller Institute at the Schar School, GMU

The consequences of this short recession would be confined largely to 2020 and early 2021 but would be felt broadly across the economy with unemployment rising, housing starts dropping, and the equity markets pulling back. While all of these effects would be relatively small compared to the previous recession and the recovery would be much faster, if this scenario played out it would end history's longest business cycle at 126 months.

Even though this scenario's probably has been lowered by the Federal Reserve Board's new interest rate management policy, it remains possible and its effects on the Washington region's economy is worth noting. Still, beyond the global and national threats hanging over the Washington region's economy, there appears to be an accumulation of performance issues possibly dragging the region's economy lower over the coming year as tracked by the Washington Leading Index (Figure 5).

Figure 5. Washington Region Leading Index
Monthly Over-the-Year Percent Change



Source: The Stephen S. Fuller Institute at the Schar School, GMU

Even discounting December's performance, due to the effects of the partial-federal shutdown, the slowing trajectory of the Leading Index was already clear. And, December's Index would likely have been negative even in the absence of the partial-federal shutdown. Since last year's first quarter, several of the Leading Index's indicators have turned negative or, equally important, their rates of increase had moderated. Compared to their performances during 2017, the residential building industry has experienced decreasing activity; this is both a regional and national trend. Additionally, consumer expectations have been volatile and may have peaked in 2018. And, initial claims for unemployment insurance continue to rise contrary to expectations in a full-employment economy; this could be a positive trend if the workforce is actually expanding as a result of former workers re-entering the labor market. Finally, consumer spending has slowed, especially for big-ticket items. All of these trends need to be monitored as this year's economy seeks a new equilibrium following its strong performance last year.

Washington Area Economic Indicators
Current and Previous Months

Economic Indicator	Estimates			Percent Change	
	Dec-18 Prelim.	Nov-18 Final	Dec-17 Final	Nov-18 to Dec-18	Dec-17 to Dec-18
Washington Area Business Cycle Indicators					
Coincident Index (2015 = 100)	108.0	110.6	106.4	-2.35%	1.50%
Leading Index (2015 = 100)	99.4	103.9	101.2	-4.35%	-1.86%
Washington Area Coincident Index Components					
Total Wage & Salary Employment ('000)[a]	3,363.8	3,360.4	3,310.2	0.10%	1.62%
Consumer Confidence (South Atlantic)[a]	161.3	180.5	149.1	-10.64%	8.18%
Domestic Airport Passengers ('000)[b]	2,220.8	2,377.6	2,242.0	-6.59%	-0.95%
Nondurable Goods Retail Sales ($000,000)[c]	3,146.0	3,336.7	3,118.1	-5.71%	0.89%
Washington Area Leading Index Components					
Total Residential Building Permits[a]	1,097.2	2,213.0	1,106.0	-50.42%	-0.79%
Consumer Expectations (South Atlantic)[a]	104.3	123.0	103.3	-15.20%	0.97%
Initial Unemployment Claims[b]	2,900.4	2,282.8	1,490.5	27.06%	94.59%
Durable Goods Retail Sales ($000,000)[c]	3,761.8	3,972.1	3,722.8	-5.30%	1.05%
Washington Area Labor Force[a]					
Total Labor Force ('000)	3,398.1	3,401.0	3,374.0	-0.09%	0.71%
Employed Labor Force ('000)	3,301.0	3,298.1	3,262.1	0.09%	1.19%
Unemployed Labor Force ('000)	97.1	102.9	111.9	-5.69%	-13.26%
Unemployment Rate	2.9%	3.0%	3.3%	--	--
Washington Area Wage and Salary Employment[a]					
Total ('000)	3,360.3	3,349.0	3,306.2	0.34%	1.64%
Construction ('000)	168.9	168.5	159.6	0.24%	5.83%
Manufacturing ('000)	56.2	56.0	55.1	0.36%	2.00%
Transportation & Public Utilities ('000)	71.9	69.9	67.8	2.86%	6.05%
Wholesale & Retail Trade ('000)	350.0	344.6	346.8	1.57%	0.92%
Services ('000)	2,000.9	2,001.1	1,968.7	-0.01%	1.64%
Total Government ('000)	712.4	708.9	708.2	0.49%	0.59%
Federal Government ('000)	359.9	360.9	365.9	-0.28%	-1.64%

[a]Unadjusted data

[b]Seasonally adjusted data

[c]Seasonally adjusted constant (1996) dollars