Washington Economy Watch

Year-End Performance Review and Outlook

December 2022

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 six complete business cycles in addition to the Post-COVID 19 cycle that began in May 2020.

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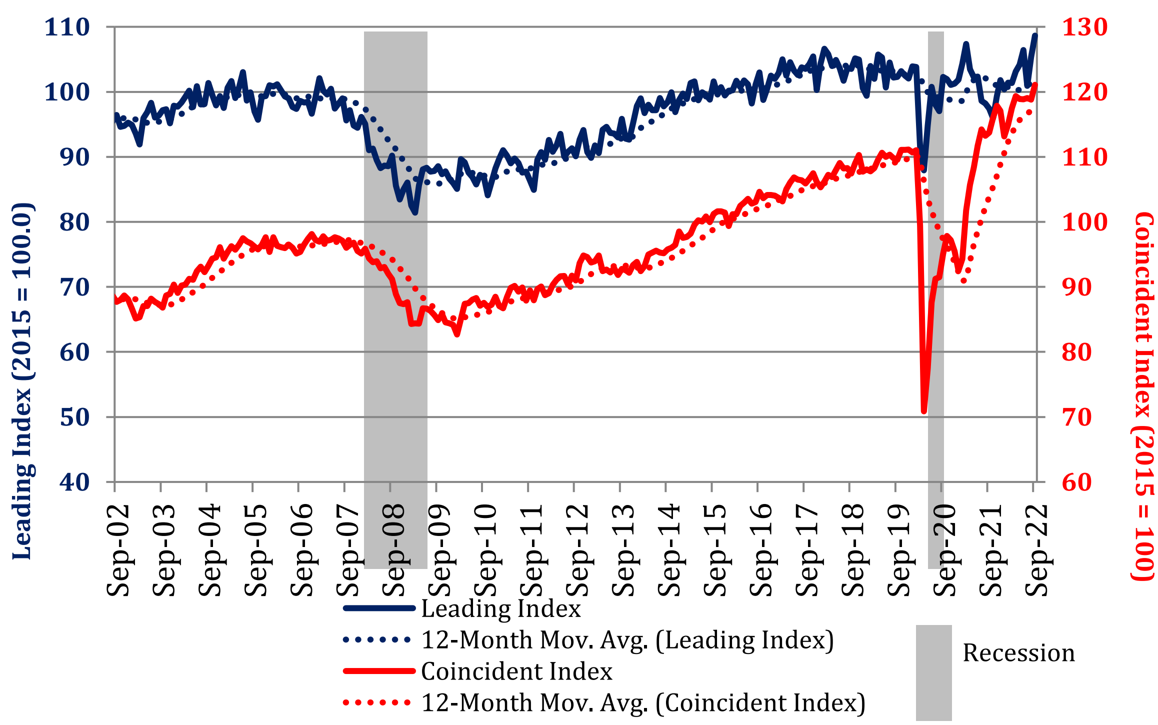
Washington Area Economy Still Recovering from Pandemic, New Challenges Lie Ahead

Throughout 2022 the national economy has struggled with inflationary pressures, a tight labor market, and rapidly rising interest rates, all of which will shape its performance during 2023. The Washington area economy has faced these same macro conditions, as seen in its 2022 performance. The Washington Area Coincident Index experienced a steady deceleration starting in February; it increased more slowly on a monthly over-the-year basis for seven consecutive months through July. However, it has accelerated in both August and September.

Washington DC, Area Economic Indices



Source: Stephen S. Fuller Institute

This pattern was predicted by the Washington Area's Leading Index, which declined, between August 2021 through April 2021, for nine months (including a small gain in December). Since then, it has accelerated each month registering its largest monthly over-the-year gain in more than a year in September. In normal times, this positive trend in the Leading Index would be forecasting a strong performance for the fourth quarter of 2022 and the first quarter of 2023. However, these are not normal times.

The **Washington Coincident Index**, which represents the current state of the metropolitan area economy, increased in September gaining 1.9 percent from its August value with all four of its components registering gains. For the four months prior to September, the Coincident Index has been relatively unchanged, on a month-to-month basis. On a monthly over-the-year basis, the Coincident Index continued to track higher extending its positive trajectory to a nineteenth month. While this trajectory has moderated since February, registering its smallest gain in July, it increased its growth rate in both August and September. Still, the component gains reported in September largely reflect the economy's recovery from losses experienced during the pandemic and not to the economy's post-recovery expansion.

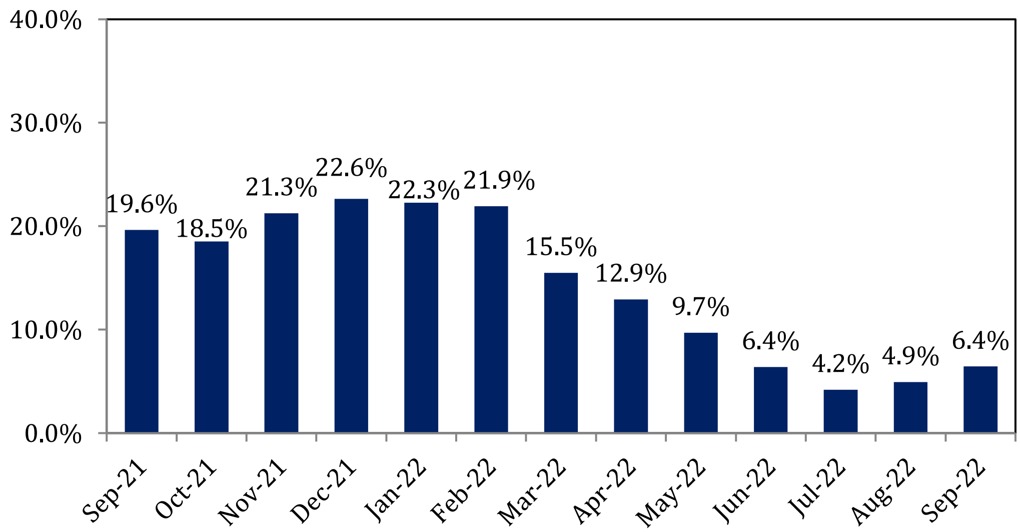
- *Wage and salary employment* growth in the Washington area increased 2.6% between September 2021 and September 2022 although September's job total remained below its pre-recession level;

- *Consumer confidence (in the present)* reversed a four-month decline, gaining 6.2% in September; and,

- *Domestic passenger volume at Reagan National and Dulles Airports* continued its recovery from the pandemic although it continued to lag its pre-recession volume at both airports; while,

- *Non-durable goods retail sales* declined in September on a monthly over-the-year basis extending its downward trend to a seventh month.

Washington Coincident Index, Monthly Over-the-Year Changes



Source: Stephen S. Fuller Institute

The **Washington Leading Index**, which is designed to forecast the performance of the metropolitan area economy six to eight months in advance, registered its fifth consecutive monthly over-the-year gain in September and its strongest gain since April 2021. Following its initial recovery in 2020, the Leading Index turned negative for a period spanning eight months from September 2021 through April 2022 reflecting the economy's struggle to recover to its post-recession levels. While the Leading Index has registered accelerating monthly over-the-year gains each month since April, these gains say more about the weak state of the economy in 2021 than the strength of the economy in 2022. The two components driving its gains in September—total residential building permits and initial unemployment claims—are pointing in worrisome directions and neither will be sustained if the economy encounters the headwinds of a national recession in 2023.

- *Total residential building permits* continued to grow despite a slowdown in new home sales and a broad-based weakening of the residential housing market due to rapidly rising home mortgage interest rates that are expected to increase further as the Federal Reserve Board raises its rates several more times into the first quarter of 2023; and,

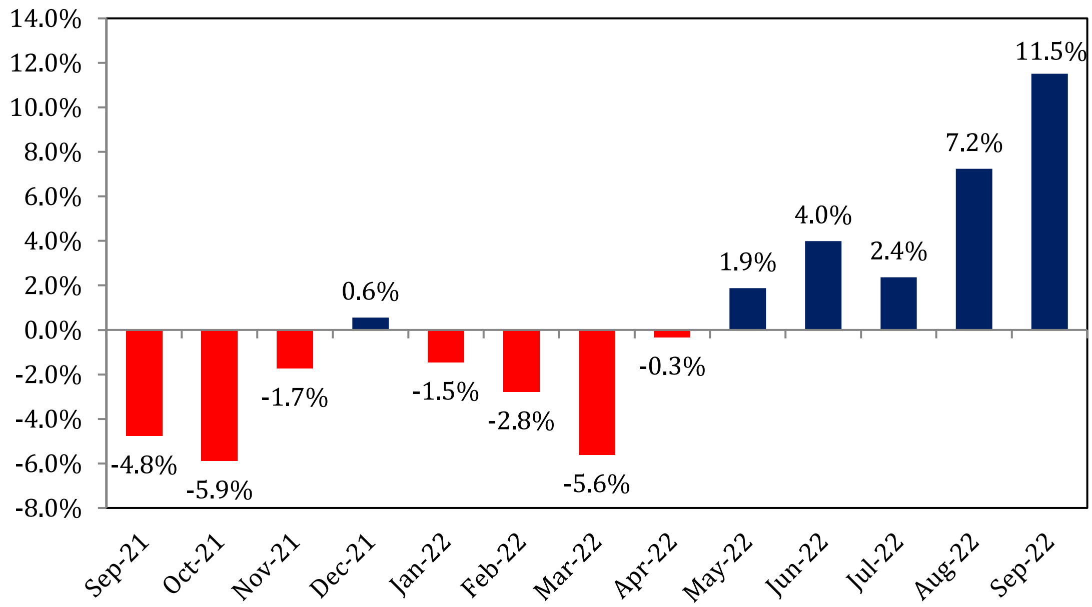
- *Initial claims for unemployment insurance* decreased (improved) for the sixth consecutive month reflecting a continuing tightening of the area's labor market and pointing to rising labor costs fueling further inflationary pressures across all sectors of the economy; while,

- *Consumer expectations (consumer confidence six months hence)* declined for the eighth consecutive month underscoring consumers' economic uncertainty as inflation has become their primary concern shaping their future spending patterns; and,

- *Durable goods retail sales* decreased in September on a monthly over-the-year-basis continuing its downward trend for the year; it has been negative in 10 of the 12 months since September of 2021 reflecting consumers reducing their purchases of automobiles, furniture and appliances, products often purchased on time, as interest rates and economic uncertainty have both increased since the beginning of the year.

While the both the Coincident and Leading Indices appear to be pointing in positive directions and the gains achieved by the Washington area's economy during 2022 will complete its recovery, at least numerically, from the losses experienced during and associated with the COVID-19 recession in 2020, the underlying data behind these Indices may be telling a different story. The Washington area economy that has emerged through three-quarters of 2022 and that will provide the foundation for its performance in 2023, continues to struggle to regain its competitive edge and, as a consequence, its growth rate has lagged many other major metropolitan areas in recent years. An examination of the Washington area's readiness for the economic turbulence that is likely to occur in 2023 reveals long-term challenges that is likely to magnify its short-term vulnerability going forward.

Washington Leading Index, Monthly Over-the-Year Changes

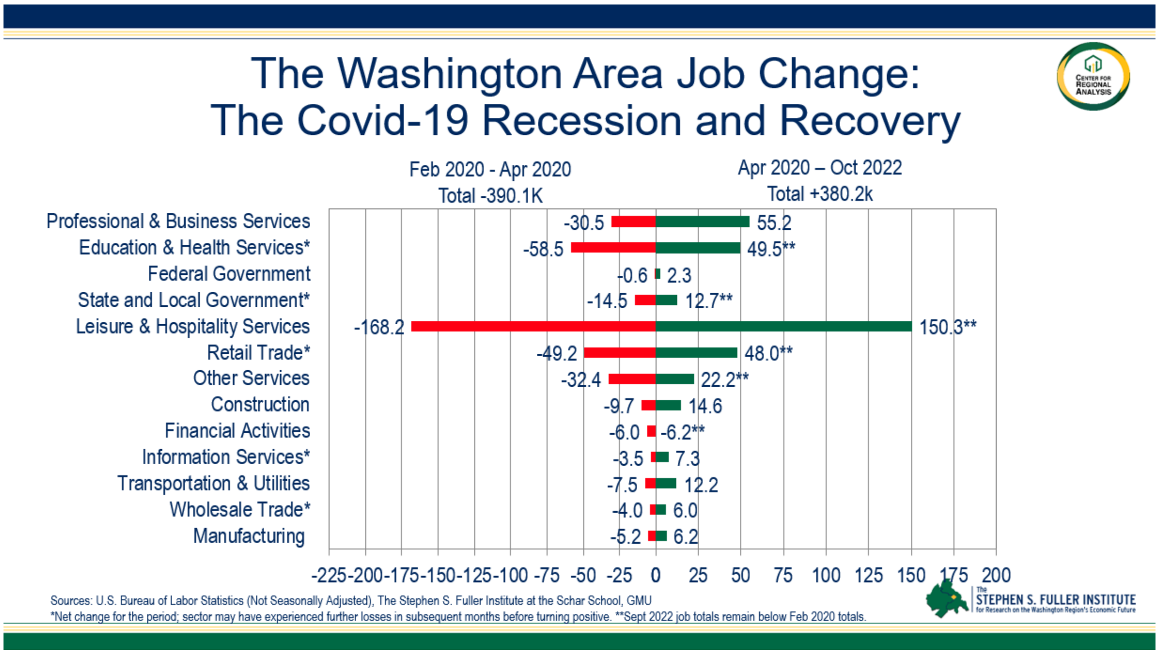


Source: Stephen S. Fuller Institute

Current Performance

The Washington area economy is not the same economy that it was pre-pandemic. In fact, the area's economy was struggling pre-pandemic with slower growth rates post-Sequester that may have contributed to the rapidity and magnitude of losses experienced during the COVID-19 recession. During this short recession, the Washington area lost a total of 390,100 jobs, in just two months and, as of October 2022, it had regained 380,200 jobs. The vulnerability of the area's economy can be seen in the large job losses experienced by Leisure and Hospitality Services, Education and Health Services, Retail Trade, Other Services, and State and Local Government sectors; an 11.6 percent decline in two months. And, April 2020 was not the low point for many of these sectors; some did not turn around until June or July. At its worst, job losses for the Washington area totaled 428,000 jobs in July, a total loss of 12.8 percent.

One sector, the area's strongest and most important to generating future economic growth—Professional and Business Services—also the Washington area's largest sector with more than 800,000 jobs, experienced a small decline followed by a quick and strong recovery. In contrast, the government sectors—federal and state and local—that has been the mainstay of the area's economy since the beginning did little to protect it from the COVID-19 recession. The federal sector, while not losing many jobs, did not provide any counter-cyclical support as had occurred historically during down times in the national economy, and the magnitude of its rebound has not materially affected the economy's performance. And, the state and local government sector, despite these governments running budget surpluses in 2020 and 2021, is not back to pre-recession employment levels.



While it is expected that the Washington area will have regained its re-recession job base by year's end, this employment base will continue to be vulnerable to cyclical changes at the national level. Additionally, labor shortages, numerically and qualitatively, could continue to dampen the area's economic growth potentials during and after the anticipated slowdown during the first half of 2023.

Near-Term Outlook

The optimistic forecast for the national economy in 2023 is for a "soft landing" as the Federal Reserve Board's seven interest rate increases during 2022, and the one or two more expected during the first quarter of 2023, slow the national economy while bringing inflation steadily lower towards the annual goal of 2.0-2.5 percent by 2025. Because of these interest rate increases the cost of consumption has increased—money is more expensive—with consumers reducing their purchases of goods that generally involve loans or use of credit.

These consequences have already shown up in the monthly economic statistics. New housing sales have declined and prices on resales have softened in response to higher mortgage rates and new auto sales are down in response to higher financing costs and declining consumer expectations. Employment figures for the Financial Activities sector will drop substantially due to lower demand for mortgage origination services and continuing consolidation of regional retail banking. Declining consumer confidence may also reduce retail sales more broadly beyond the price effects that are beginning to drag sales lower in face of decline effective buying power as inflation has driven price increases higher than increases in wages in 2022.

The prospects for a “soft landing” are at best 50/50 with the more likely scenario being that the Fed’s interest rate increases will result in a short and shallow recession as has occurred in eight of the last nine Federal Reserve Board rate-hike cycles. Whether a “soft landing” or a recession, multiple segments of the economy will contract as a result and the economic pain will be measurable. The housing sector is already in recession. Manufacturing, while not a large sector in the Washington area is reporting early signs of slowing down at the national level; the most recent ISM Manufacturing Index dropped below 50, singling a contraction, with new orders, hiring, and prices declining in November.

This decline in manufacturing has been mirrored by an increase in spending for services in November with sales activity increasing between October and November at the highest rate since early 2021. This shift in consumer spending from “big ticket” items, often involving financing and sensitive to changes in interest rates, to consumer services provides further evidence of an economy shifting to a slower growth mode with a weaker outlook as services typically employ a less skilled and lower wage workforce and involve more discretionary purchases that can be discontinued quickly as the economy changes. Retailers are also reporting layoffs, and as other sectors move beyond the holiday sales period, unemployment can be expected to increase across multiple sectors. Currently the 3.7% unemployment rate nationally is expected to increase to 5% over the coming year with wage growth moderating helping to ease inflationary pressures.

The signs of an economic slowdown are already evident at the national level and the uneven performance of the Washington area’s economy during 2022 suggests that its ability to respond to these slowing national economic conditions may have been compromised. Furthermore, its declining competitive position relative to its peer metropolitan areas has reduced its attractiveness to younger workers to make long-term commitments to the Washington area as a good place to live and work over the length of their careers.

During previous national recessions positive net domestic migration (workers from elsewhere in the nation) has moderated the recession’s impacts on the Washington area and positioned it for a more rapid recovery than its peers. Since the Sequester in 2013, and its related local economic contraction, the Washington area has experienced net negative domestic migration, more people moving elsewhere in the nation from the Washington area than moving to the Washington area from elsewhere in the nation. This loss of largely younger workers has weakened the area economy’s ability to outperform its peers during hard times as well as good times. Consequently, the Washington area economy may more closely track the national economy’s performance in 2023 with both the magnitude and duration of any downturn and subsequent recovery following the national pattern more closely than in earlier times.

Washington Area Economic Indicators
Current and Previous Months

Economic Indicator	Estimates			Percent Change	
	Sep-22 Prelim.	Aug-22 Final	Sep-21 Final	Aug-22 to Sep-22	Sep-21 to Sep-22
Washington Area Business Cycle Indicators					
Coincident Index (2015 = 100)	121.1	118.8	113.8	1.90%	6.44%
Leading Index (2015 = 100)	108.6	105.3	97.4	3.14%	11.51%
Washington Area Coincident Index Components					
Total Wage & Salary Employment ('000)[a]	3,315.2	3,304.8	3,232.1	0.31%	2.57%
Consumer Confidence (South Atlantic)[a]	158.8	149.3	149.5	6.36%	6.22%
Domestic Airport Passengers ('000)[b]	2,373.9	2,189.4	1,639.0	8.43%	44.84%
Nondurable Goods Retail Sales ($000,000)[c]	4,232.9	4,142.2	4,276.1	2.19%	-1.01%
Washington Area Leading Index Components					
Total Residential Building Permits[a]	3,631.0	3,375.0	2,341.0	7.59%	55.10%
Consumer Expectations (South Atlantic)[a]	78.6	76.4	92.4	2.88%	-14.94%
Initial Unemployment Claims[b]	901.9	1,384.1	21,879.4	-34.84%	-95.88%
Durable Goods Retail Sales ($000,000)[c]	3,937.1	3,807.9	4,043.7	3.39%	-2.64%
Wahington Area Labor Forcea					
Total Labor Force ('000)	3,359.7	3,382.9	3,344.0	-0.68%	0.47%
Employed Labor Force ('000)	3,256.7	3,259.1	3,196.1	-0.07%	1.90%
Unemployed Labor Force ('000)	103.0	123.8	147.9	-16.79%	-30.35%
Unemployment Rate	3.1%	3.7%	4.4%	--	--
Washington Area Wage and Salary Employmenta					
Total ('000)	3,315.2	3,304.8	3,232.1	0.31%	2.57%
Construction ('000)	166.8	164.3	161.2	1.52%	3.47%
Manufacturing ('000)	56.6	56.6	54.9	0.00%	3.10%
Transportation & Public Utilities ('000)	79.9	80.1	73.8	-0.25%	8.27%
Wholesale & Retail Trade ('000)	326.5	328.2	316.8	-0.52%	3.06%
Services ('000)	1,973.4	1,978.9	1,912.2	-0.28%	3.20%
Total Government ('000)	712.0	696.7	713.2	2.20%	-0.17%
Federal Government ('000)	367.2	368.4	377.5	-0.33%	-2.73%

[a]Unadjusted data

[b]Seasonally adjusted data

[c]Seasonally adjusted constant (1996) dollars