Washington Economy Watch

Vol. I, No. I
January 2017

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

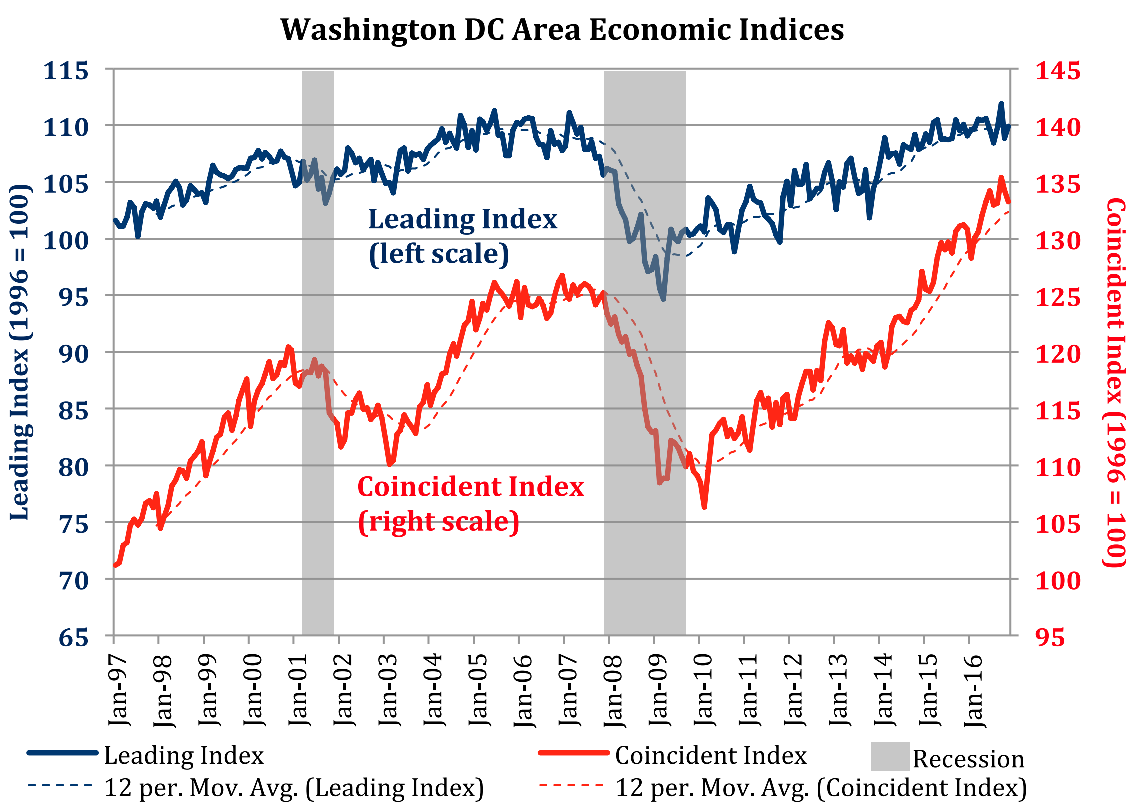
The Washington Economy Watch is a monthly report issued by The Stephen S. Fuller Institute that is intended to inform its readers regarding the current and near-term performance of the Washington region's economy. The Leading and Coincident Indices were first reported in February 1991 and have been calculated 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 2009.

Washington Economy Watch

Vol. I, No. 1 January 2017

The Washington Region's Economy Slows At Year's End Following Strong Year

The Washington Leading Index flattened out during 2016 and is now pointing to a likely peaking of the economy's growth rate in 2017. This moderation of the Leading Index follows a six-year growth trend that began in 2009 at the bottom of the Great Recession and experienced only one interruption during The Sequester in 2014. The Washington region's strong performance in 2016 is mirrored in the performance of the Coincident Index that registered gains throughout the year although it is ending the year with slower gains than it had registered in the second and third quarters. This strong pattern of growth is expected to continue in 2017 with slower growth projected in 2018 and beyond.



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, decreased 0.75 percent in November 2016 to 133.2 from its October value. November's decline in the Index was its second consecutive monthly decrease following a positive growth pattern dating from the beginning of the year. Even with its slowing in November, the Coincident Index was 1.54 percent higher than its November 2015 level extending this positive trend to 32 consecutive months dating back to March 2014. This unbroken string of monthly over-the-year gains in the Coincident Index tracks the Washington region's recovery from the year-long impacts of The Sequester that sharply reduced federal procurement spending during 2013 (down 8.8% from 2012 and 15.5% from their peak in 2010). In November, three of the Index's four components were greater than in November 2015; only Domestic Airport Boardings at Reagan National and Dulles Airports declined from November 2015; passenger traffic was also lower in November 2016 than in the previous month (October 2016) reflecting a long-term negative trend in air passenger travel to the Nation's Capital.

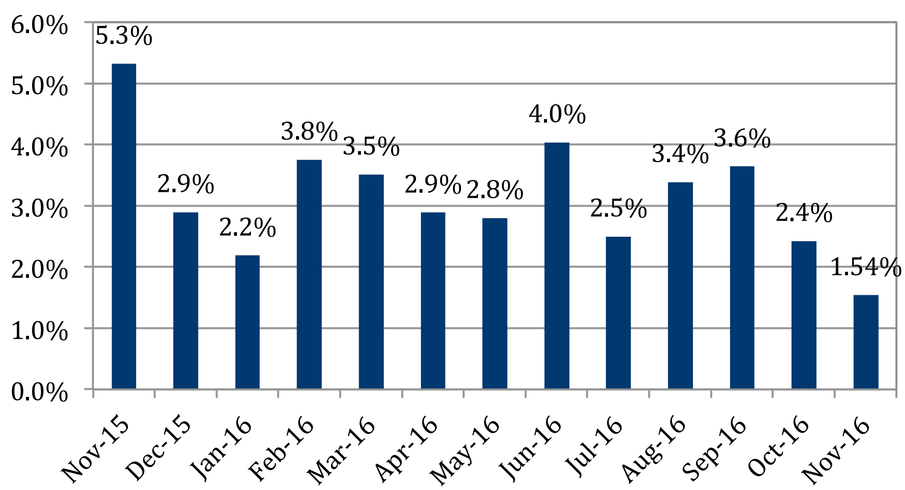
- *Wage and salary employment* continued its better than 2.0 percent annual rate of growth for the year;

- *Consumer confidence (in the present)* continued to track higher than in 2015 gaining on average 2.9 percent for the year;

- *Non-durable goods retail sales* continued to track higher through November averaging 4.6 percent higher for the year; while,

- *Domestic passenger volume at Reagan National and Dulles Airports* declined by 5.8 percent on a monthly over-the-year basis.

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, declined slightly in November 2016 to 109.9, down 0.15 percent from November 2015. This monthly over-the-year decrease in November was the Index's second consecutive decline and the fourth monthly decline for the year (the others occurred in April and July). Still, the Leading Index remains positive for the year with a monthly average gain of 0.5 percent through November. However, its recent decrease may be signaling a future change in the economy's growth rate that will be important to monitor in the coming months. In November, two of the Index's four components contributed to its decline.

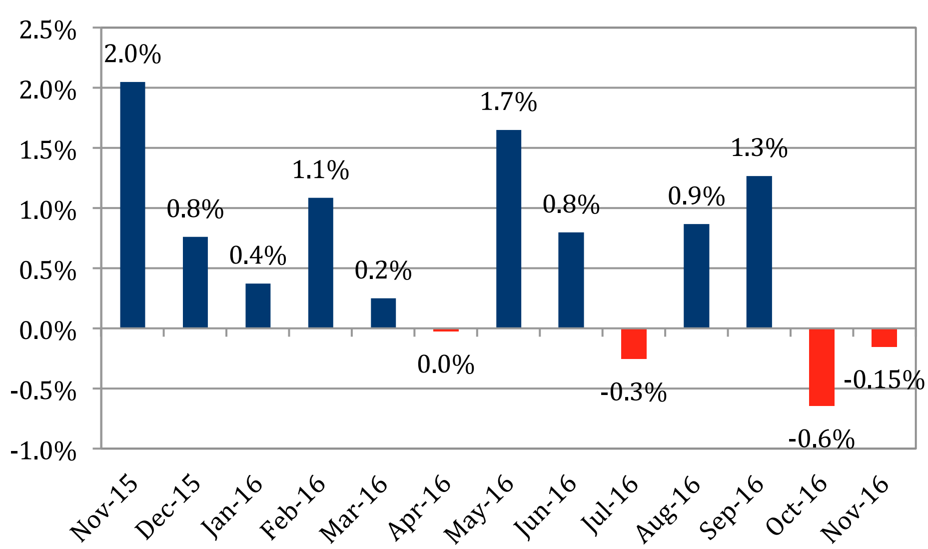
- *Initial claims for unemployment insurance* increased (worsened) following two monthly decreases; initial claims have only increased (worsened) twice in 2016 underscoring the growing tightness of the region's labor market;

- *Durable goods retail sales* increased in November as they have each month in 2016 compared to its same month in 2015 averaging 5.4 percent through eleven months; while,

- *Total residential building permits* declined sharply in November for a second consecutive month, falling 42.0 percent from their November 2015 level, and continued an uneven pattern that has characterized the full recovery dating back to 2011; and,

- *Consumer expectations (consumer confidence six months hence)* continued its upward trend; it was 9.8 percent higher in November 2016 than in November 2015.

Washington Leading Index, Monthly Over-the-Year Changes



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

The Washington region's economy has continued its dual recovery in 2016—from the Great Recession and from the 2013-2014 Sequester—registering its strongest performance since 2007. For the year, the Leading Index exceeded its previous high point (June 2005). The Leading Index's 12-month moving average trend line continued to move higher at the end of 2016 where, in contrast, by the end of 2005 it had already peaked and begun its decline, forecasting the on-set of the Great Recession. The Coincident Index has accelerated for almost three years (32 months) following the Washington area economy's slight contraction in 2013. Over this period, the Coincident Index has gained 11.1 percent and appears to have momentum to continue this trend into 2017.

Current Performance

The strength of the Washington region's economy can be seen in the job growth registered in 2016 and also in the growth in retail sales. Net job growth for 2016 is expected to come in close to 71,000 making it the best year since 2004 (71.4K), at a time when federal spending was booming, and the fourth best year ever for job growth following 1999 and 2000.

The mix of job growth improved in 2016 compared to the early years of the recovery. Where the professional and business services sector accounts for 23 percent of the region's job base, this sector has been generating 28 percent of the new jobs in 2016 with an above-average share of these professional and business services jobs in the scientific and technical services sub-sector. Interestingly, these are the types of jobs that had been supported by federal contracting in the past but now that federal contracting has stabilized at a level about $9.3 billion or 11.4 percent below its 2010 peak, these new professional and business services jobs, and especially the scientific and technical services jobs, appear to be driven by increased sales activity in non-federal markets.

While this faster-than-average growth in professional and business services jobs has been beneficial to the economy's growth, strong job gains in education and health services, retail trade and leisure and hospitality services in 2016 combined to outnumber the job gains in the professional and business services sector. The average salary difference between professional and business services jobs and jobs in the education and health services, retail trade and leisure and hospitality services sectors is more than 50 percent. The net effect of this job mix, even though it is more favorable across all of the sectors in 2016 than it was between 2010 and 2015, is slower growth in and a changing distribution of household income in the region.

This strong job growth in 2016 has continued to put pressure on the region's labor force. Unemployment declined to 3.7 percent in November down from 4.1 percent in November 2015. The continuing low and declining rate of initial claims for unemployment insurance, down (improved) in all but two months in 2016 through

November, suggests that the availability of qualified labor may become an accelerating source of wage inflation and a moderating force on the region's economic growth in 2017.

Strong job growth and a tightening of the labor market has pushed personal earnings higher in 2016 and this has supported growth in local retail sales in spite of several counter forces (and increasing savings rate and growth of on-line shopping that is not included in local sales data). Total retail sales is projected to have totaled $87.2 billion in 2016, an increase of $4.5 billion or 5.4 percent from 2015.

Near-Term Outlook

The forecast for the Washington region's economy is for continuing strong performance in 2017 with the region's gross regional product (GRP) growing faster than in 2016 as well as out-performing the 2017 U.S. GDP growth rate (2.3% in IHS Economics December forecast). The current forecast, absent any adjustments for the Trump Effect, is that the region's fundamentals will support a 3.3 percent GRP increase in 2017 following its 2.9 percent gain in 2016 and 1.3 percent gain in 2015.

Job growth in 2017 will not duplicate the numbers achieved in 2016. As is the normal pattern over the length of an expansion, job growth lags at the beginning as employers have residual, surplus labor on their payrolls but as the expansion gains momentum, increased output requires additional human resource inputs, as well as investments in work space and equipment. Over-investment in anticipation of continued growth of demand is common during the "second quarter" of the expansion setting up the capacity for increasing output without concomitant magnitudes of business investment and hiring over the later stages of the expansion.

The U.S. economy's demand for labor peaked in 2015 with job growth slowing in 2016. In the Washington Region, the Sequester interrupted the growth of its demand for labor in 2013 and 2014 and delayed peak job growth until 2016. Forecasts for continuing job growth in the Washington region point to annual gains of 60,000 in 2017, down from an estimated 71,000 in 2016 with job growth expected to slow annually to the end of the decade.

With the region's economy currently at near full employment and employers having to increase salaries in order to attract new workers (often at lower-than-advertised skills levels), the economy's output levels will also begin to grow more slowly as the full potential of the current economy's capacity is achieved. Increased productivity, resulting from increased business investment in technology, will extend the economy's growth potential but moderating forces (rising energy costs and interest rates, declining pent-up demand, and higher prices across the economy) will likely slow the economy's growth rate beyond 2017.

The Leading Index has flattened its growth trajectory over the past six months and, while it is still expanding, it is pointing to the peaking of Washington region's economic growth in the coming year. The Coincident Index is still strong. With the national economy projected to achieved its strongest performance of the decade in 2017, the Washington region's economy appears poised for its best performance since 2010.

The key indicators to watch to determine the future changes in the current growth patterns include job growth and unemployment, consumer confidence, and retail spending. These economic indicators are the most easily monitored on a monthly basis and will confirm the economy's future direction. Over the course of the coming year, it is expected that these indicators will begin to exhibit slower growth rates. How the Trump Effect will change this forecast will be the subject of future reports.

Then and Now

The first Washington Economic Index was released in February 1991. In the twenty-six years since that date, the Washington Region's economy has weathered two full business cycles and is now well into its third cycle. During those 26 years, the Washington economy has almost doubled in size, with its gross regional product achieving an inflation-adjusted gain of 94 percent. This economic growth generated 1 million net new jobs, a gain of 45 percent, with 39 percent of these being professional and business services jobs. The Leading and Coincident Indices shown on page 1 document the Region's economic growth path over this period.

The Washington Region's Economy, Then and Now
(jobs in thousands)

Indicators	2/1991	1/2017	Change
Leading Index	92.5	109.9	18.8
Coincident Index	89.6	133.2	48.7
Total Employment	2,210.0*	3,212.0	1,002.0
Unemployment	4.6%*	3.7%	- 0.9
Professional Service Jobs	362.8*	754.6	391.8
Federal Government Jobs	355.5*	372.6	17.1

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