Fifth District Expansion Continued in 2015

Introduction

Overall, 2015 was a year of economic expansion in the Fifth District. Labor markets tightened in most areas, with the notable exception of West Virginia, where job losses were largely related to the state's energy sector. The tightening labor markets in the rest of the District resulted in firms reporting upward pressure on labor costs and increased difficulty finding qualified workers. An area of the economy with the most pronounced labor challenges was construction, where activity picked up in both residential and commercial real estate. Reports on manufacturing and transportation were a little more mixed across the year; some firms benefited from the lower commodity prices and the appreciating dollar, although export activity declined. Retail and non-retail service sector firms continued to experience improved sales to a generally more confident consumer.

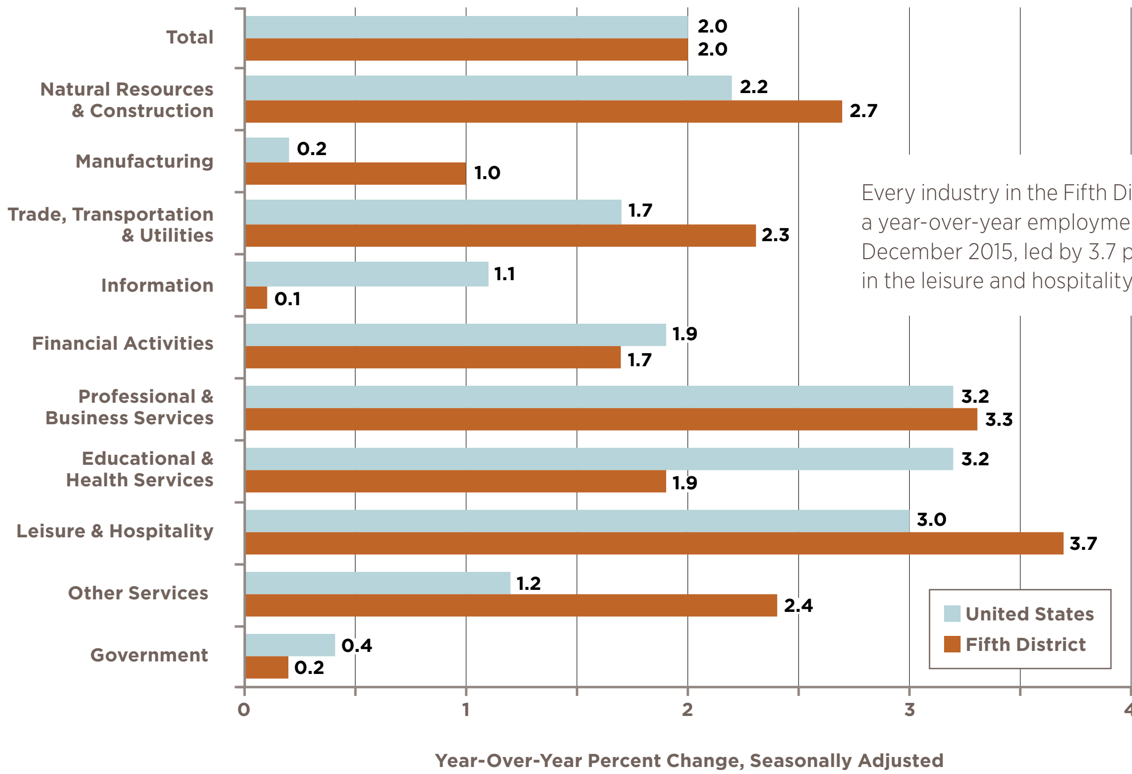
Labor Markets

Labor markets in the Fifth District generally strengthened over the year. Total employment in the District grew 2.0 percent (284,000 jobs) in 2015 as every jurisdiction except West Virginia added jobs. South Carolina reported the largest year-over-year growth in the District of 2.8 percent, which outpaced the national rate of 2.0 percent. Job growth in North Carolina and Virginia met or exceeded the national expansion, while the District of Columbia and Maryland posted slower growth (1.0 percent and 1.6 percent, respectively). In West Virginia, employment declined; the most notable contributor to the 1.3 percent contraction was the natural resource and mining industry, which shed 5,500 jobs (19.1 percent) over the year.

In the District overall, every industry reported a year-over-year employment gain with the most jobs—72,300 (3.3 percent)—added in the professional and business services industry. The professional and business services industry was the largest contributor to the net job gain in North Carolina, South Carolina, and Virginia. In both D.C. and Maryland, the industry was the second-largest contributor behind leisure and hospitality. In West Virginia, the professional and business services industry contracted on a year-over-year basis, as did most industries in that state.

The unemployment rate in the Fifth District declined from 5.6 percent to 5.1 percent in 2015, closely mirroring the improvement in the national rate that declined from 5.6 percent to 5.0 percent over the year. Unemployment rates declined in every District jurisdiction over the year. The largest improvement occurred in South Carolina, where the rate fell 1.1 percentage points to 5.5 percent. The District of Columbia ended 2015 with the highest unemployment rate in the Fifth District, despite decreasing 0.9 percentage point over the year. Meanwhile, the labor force in the District rose steadily over the course of 2015 but grew more slowly than the civilian population and, as a result, the labor force participation rate declined from 62.6 percent to 62.5 percent.

Employment Growth by Industry
Percent Change from 2014



Every industry in the Fifth District reported a year-over-year employment gain in December 2015, led by 3.7 percent growth in the leisure and hospitality industry.

Source: Bureau of Labor Statistics, Haver Analytics

Anecdotes from across the Fifth District indicated a tightening labor market, with certain exceptions such as coal mining in West Virginia. Demand for workers at all skill levels reportedly expanded in 2015, particularly in information technology, manufacturing, and construction. Certain occupations were also cited regularly throughout the year, including: health care workers, engineers, truck drivers, accountants, and hospitality workers. Over the course of the year, the accounts of upward wage pressures increased, particularly for those positions that were in the most demand.

Business Conditions

Reports on manufacturing activity were mixed during 2015. 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. The diffusion index spent most of the year close to zero, although the summer months were a bit stronger. Toward the end of the year, not only did the index indicate slowing activity, but several manufacturers commented that slowing global demand and the appreciating dollar had negatively impacted business activity. That sentiment was not expressed universally, however, as other manufacturers indicated a pickup in activity over the same period, particularly manufacturers of metals, automobiles, and auto parts. Further, in every month of the year, the survey measure of raw materials price growth was lower than in the same month of 2014, which was consistent with persistent reports of low commodity prices from manufacturing contacts. The survey's index for number of employees and the index for wages were consistently positive in 2015.

Data on Fifth District port activity were consistent with the reports of slowing exports of manufactured goods. Export activity out of the Charleston, S.C., port, for example, started the year strong but slowed some in the fall and winter months. In fact, District exports of most goods categories declined from the prior year, with the notable exception of transportation equipment, which includes automobile and aerospace vehicles and parts. The Norfolk, Va., port reported export declines beginning in the spring of 2015 and the Baltimore, Md., port continued to report declining exports. Import activity, on the other hand, grew fairly steadily over the year across Fifth District ports.

According to the *Federal Reserve Bank of Richmond Service Sector Survey*, retail activity strengthened throughout most of the year. The survey index for retail revenues was relatively high by historical standards until the last two months of the year. On the other hand, comments from retailers in the District indicated a continued trend toward online shopping, particularly around the holidays, which negatively affected brick-and-mortar retailers in the District. This trend could be manifesting itself in the softer readings for the November and December shopper traffic index.

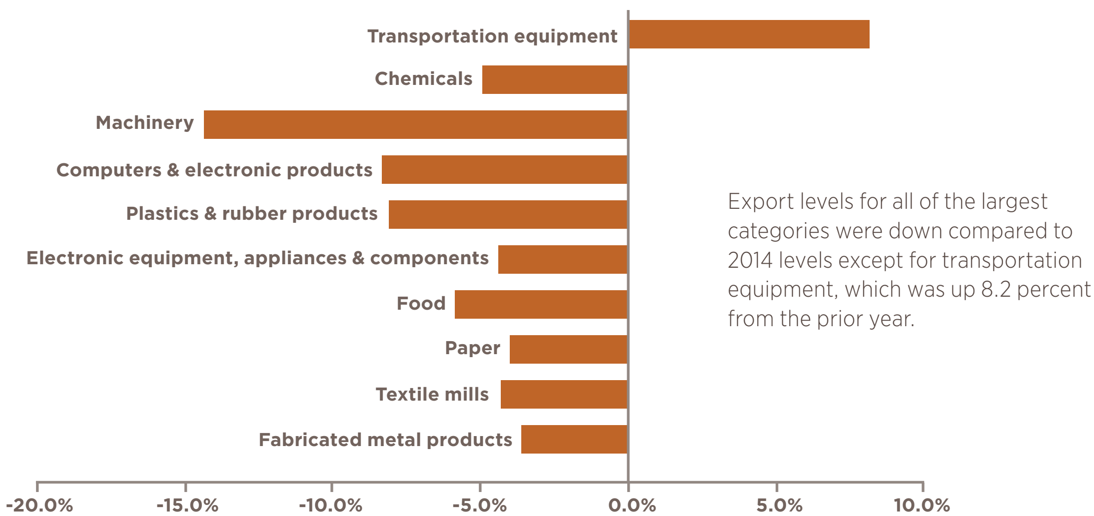
Non-retail services firms reported steady improvements over the year. The survey measure of revenues for those businesses remained above zero throughout the year, with particularly high index values in July and August. Anecdotes from services firms during those months indicated a boost from tourism as well as strength in software, transportation, and temporary employment services. Similar to retail firms, non-retail services experienced a slowdown in the last two months of the year. There were a few comments about sluggish activity in wholesale trade, real estate services and construction, legal services, and tourism.

Like the manufacturing sector, the survey measures of employment and wages also indicated continued improvement in the service sector. The non-retail services employment index maintained a value well above zero for the majority of the year, while the retail index started the year strong, although it dipped below zero a few times in 2015, commonly during the fall months. The indexes for wages were consistently positive throughout the year. Moreover, the retail index for wages hit a 10-year peak in October 2015.

Real Estate

In 2015, Fifth District housing markets continued the slow and steady improvement that has characterized the industry for a few years. According to CoreLogic Information Solutions, District house prices grew 2.8 percent over the course of the year. Home values appreciated in every District jurisdiction except Maryland, with the strongest growth coming from the 6.6 percent price

Ten Largest Fifth District Export Categories in 2015
Percent Change from 2014



Source: The Census Bureau via WISER, Haver Analytics

growth in South Carolina. In the second half of 2015, North Carolina's house price index exceeded its pre-recession high, becoming the second jurisdiction in the Fifth District to do so (D.C. crossed that threshold in January 2013). Reports from real estate agents generally noted rising home sales and prices, reduced days on market, and low inventory levels. One exception was Maryland, where many contacts still reported sluggish activity. Meanwhile, distressed inventory levels shrank as the number of mortgages in foreclosure or with payments more than 90 days late continued to decline in 2015 across the District.

Residential construction activity picked up in 2015 after many years of lagging the improvement in other housing indicators. However, there were reports of constraints on growth such as lot shortages, regulatory delays, and difficulty finding construction workers. Activity in rental markets strengthened as well, with several comments citing continued expansion in multifamily construction. Permitting activity, although volatile, generally supported the anecdotal information. The total number of housing permits issued in 2015 exceeded the prior year by 5.5 percent. Permits for single-family homes, which account for about 70 percent of total permits in the Fifth District, grew 7.1 percent while multifamily permitting grew 2.0 percent.

Commercial real estate activity varied by location but generally expanded in 2015 as well. Particular strength was noted in the construction of multifamily housing, industrial space (particularly data centers and warehouses), hotels, health care facilities, and grocery-anchored retail projects. Reports from the office segment were more mixed, with some mention of high inventory levels and a decreased need for square footage, while other markets reported rising rents and increased absorption. Similarly to residential construction, builders noted increased difficulty finding labor, which drove up costs in some areas.

Banking Conditions

Despite the challenges of adapting to an evolving banking environment, Fifth District banks continued to grow during 2015 while exhibiting stable profitability and improving credit quality.

Though the challenges of a continued low-rate environment and costs associated with technological innovations and new regulatory requirements has inhibited widespread profitability from rebounding back to pre-financial crisis levels, Fifth District earnings over the course of 2015 remained stable with median return on average assets (ROAAs) of 0.70 percent. Despite the low interest rate environment weighing on banks' net interest margins, a little over half of the District banks showed improving ROAAs year over year. Overall, 92.7 percent of Fifth District banks were profitable at year-end 2015. Retained earnings contributed to capital growth, which increased year over year by 4.6 percent.

In response to environmental challenges, some banks across the nation and in the Fifth District chose alternative strategies to boost earnings and growth by adding more risk to the balance sheet and/or engaging in merger and acquisition activity. As of fourth quarter 2015, Fifth District banks grew both organically and through mergers and acquisitions at a median asset growth pace of 4.5 percent. This asset growth consisted mainly of loan growth. Median loan growth in the Fifth District and the nation stood at 5.9 percent and 6.3 percent, respectively. In the District, the commercial and industrial (9.6 percent) and construction and development (8.8 percent) loan segments had the highest median year-over-year growth rates. The District's largest balance sheet concentration, in terms of capital, remained in commercial real estate.

In conjunction with growing loan portfolios, credit quality also improved. Fifth District credit quality indicators improved with banks' median ratio of nonperforming loans as a percentage of total loans at 1.0 percent, declining to their lowest level since 2008, with improvements centered in the real estate sector. Improvements in credit quality allowed provision levels to fall to their lowest in over a decade, with 15 percent of Fifth District banks reporting negative provisions, providing a boost to earnings.

Conclusion

Overall, economic activity in the District strengthened in 2015. Labor markets continued to tighten, retail and non-retail services firms indicated improved activity, and residential and commercial real estate activity—including construction—expanded. As was the case across much of the country, the strongest headwind came in the form of slowing global demand that most notably impacted the manufacturing and transportation sectors. Low energy prices were also a challenge for certain firms in manufacturing and transportation; in the Fifth District, the slowdown in energy-related activity manifested itself primarily through softening economic indicators for West Virginia.

Economic (nonbanking) data accurate as of March 14, 2016.