Fourth Quarter 2006

Economic Activity Increases,
But Housing Market Remains Soft

Overall economic activity in the Third District was up modestly in the fourth quarter of 2006, but manufacturing eased, and retail sales growth slowed as the year came to a close. Manufacturers saw a softening in demand for their products in the final months of 2006. Retail sales of general merchandise rose slightly during the year-end holiday shopping period. Auto sales remained weak. Service-sector activity increased at a nearly steady rate. Demand for housing continued to ease. Housing construction remained on a downward trend during the fourth quarter. Sales of existing homes were mixed around the region, but there was no evidence of a clear rebound. Employment in the three states increased.

Manufacturing Activity Eases
Manufacturing activity in the region edged down in the fourth quarter, although it appeared to turn up as 2007 began. Manufacturers participating in the Philadelphia Fed’s monthly Business Outlook Survey reported softening demand for their products as 2006 came to a close. At year’s end shipments were up for makers of food products, furniture, and machinery in the region, but not for other manufacturing sectors. Increases in orders were noted in only a few sectors, mainly food products and textiles.

After slowing through most of the second half of 2006, manufacturing in the region appears to be poised for improvement this year. Reports from manufacturers in January indicate that they are seeing some moderate increases in overall business activity (Chart 1). They expect the improvement to continue at least through the first half of 2007 (Chart 2). However, the level of unfilled orders continues to decline at industrial plants in the region, suggesting that any increase in manufacturing activity may be modest (Chart 3). Nevertheless, area manufacturers plan to step up capital spending in the first half of 2007, a sign of optimism (Chart 4).

Retail Sales Growth Slows
Growth in retail sales of general merchandise in the region moderated during the fourth quarter. After strong back-to-school sales in the early fall, sales growth eased in the important final quarter of the year. Sales during the 2006 Christmas shopping period barely exceeded the results in 2005. Warm weather during much of

NOTE: This is the last issue of Regional Highlights. Beginning in early 2007 reports on economic developments in the region will be posted to the Federal Reserve Bank of Philadelphia’s website at www.philadelphiafed.org/econ/regdata/. The reports will be posted as regional data become available, enabling more timely analysis.
November and December hampered sales of winter apparel. Without the usual seasonal boost from winter apparel, many clothing and department stores fell short of their planned sales levels for the final quarter of the year. Sales of home improvement items, appliances, and furnishings also weakened. In contrast, consumer electronics sold briskly, although stores selling these items discounted heavily.

Auto sales in the region remained sluggish in the fourth quarter. Year-to-year sales comparisons show that foreign makes continued to fare better than domestic makes. However, if the new domestic models arriving in showrooms this winter prove to be popular, domestic sales could pick up.

Service-Sector Expansion Continues

Service-sector firms in the region generally posted increases in activity in the fourth quarter. Business services firms expanded the work they do for existing client firms, and they gained new clients as well. Information technology firms also gained business. Many of the business and information services firms in the region provide administrative support to a wide range of companies and nonprofit institutions, and they have been expanding their activity as clients outsource more administrative functions. In contrast to the positive trend for business services firms, transportation firms, particularly freight companies, have experienced some slowing in growth.

Freight activity largely depends on overall economic activity, so freight firms in the region and the nation have felt the effect of the slowdown in national economic growth that developed in the second half of 2006.

Residential Real Estate Softens Further

The pace of residential building in the region continued to slacken during the fourth quarter of 2006 (Chart 5). Throughout 2006, the slowdown in housing construction in the region was similar to the national trend, and builders in the region, like builders elsewhere in the country, have yet to see signs of a turnaround. Sales of existing homes were mixed in the region. From the second quarter to the third quarter of 2006 (latest available data), existing home sales — single-family, condominiums, and co-ops — rose in Pennsylvania, fell in New Jersey, and were steady in Delaware. Nationally, there was a decline.

The Office of Federal Housing Enterprise Oversight (OFHEO) reported a further slowdown in the rate of price appreciation for existing houses in the three states and the nation during the third quarter of 2006 (latest available data). In the nation, and in each of the states in the region, the year-to-year rate of price appreciation fell below 10 percent, although all three states in the region had faster appreciation than the national average rate of 7.7 percent (Chart 6). Pennsylvania’s rate of appreciation (8.4 percent) ranked 24th among the 50 states and District of Columbia, New Jersey ranked 19th (9.2 percent), and Delaware ranked 21st (8.9 percent).

Commercial Real Estate Markets Remain Firm

Commercial real estate markets remained firm in the fourth quarter. Vacancy rates in the region’s office markets have continued to decline in the past few months, and rents have risen. The amount of leased space has increased in both the Philadelphia and Wilmington central business districts and in suburban markets throughout the region. The increase in occupancy has resulted in a scarcity of large blocks of available space. There has been an increase in the construction of buildings to accommodate anticipated demand for large blocks of space with up-to-date features, while demand for space in older buildings is falling. Demand for office space and high-tech research and manufacturing facilities is expected to increase in 2007, with much of the demand coming from firms in the financial, health-care, and pharmaceutical industries.

Gains in Employment

Employment has been growing in the region as a whole (see Table 1). In the three months ending in December (latest data), employment in-
creased in each of the three states in the region, although growth in New Jersey continued to be slower than growth in Pennsylvania and Delaware.

For the three months that ended in December, Pennsylvania had gains in construction-natural resources-mining; manufacturing; trade-transportation-utilities; finance, professional and business services; and educational and health services and declines in information services, leisure and hospitality, other services (mainly personal services), and government. In New Jersey, there were gains in information services; finance, professional and business services; educational and health services; leisure and hospitality; and government and declines in manufacturing; trade-transportation-utilities; and other services. Employment in construction-natural resources-mining was unchanged. In Delaware, there were increases in trade-transportation-utilities; professional and business services; educational and health services; leisure and hospitality; and government and declines in manufacturing; trade-transportation-utilities; and other services. Employment in construction-natural resources-mining was unchanged.

The unemployment rates in New Jersey and Delaware have fallen in recent months, but Pennsylvania’s rate has been virtually unchanged. The unemployment rate in New Jersey fell substantially from September to October and continued to fall, although not as steeply, through the fourth quarter. The unemployment rate in Delaware declined moderately from September to December. The rate in Pennsylvania dipped slightly in the first two months of the fourth quarter but rose in December, returning to its level of September. In December the unemployment rates in New Jersey and Delaware were below the national rate, and Pennsylvania’s rate was only slightly above it.

**Growth Is Forecast for the Region**

Third District companies generally expect business activity to continue to expand at a steady rate. Manufacturers anticipate a modest improvement in the first half of 2007. Retailers generally expect a steady, albeit slight, gain in sales, although some believe the growth rate may slow further. Auto dealers do not expect sales to pick up in the near future. Bankers generally anticipate increases in business and consumer lending; as for mortgage lending, some expect an increase, and others do not. Service-sector firms expect steady growth in the months ahead. Residential real estate agents and builders expect further slowing in home sales through the winter. Commercial real estate firms expect demand for office and industrial space to remain strong.

Employment should remain on an upward trend. Employers throughout the region indicate that they plan to add to payrolls in the first quarter of 2007, although firms’ projected rates of hiring may be somewhat lower than they were in 2006. The Philadelphia Fed is forecasting higher employment in each of the three states from the third quarter of 2006 to the third quarter of 2007. Growth is projected to be 0.9 percent in Pennsylvania, 0.6 percent in New Jersey, and 0.9 percent in Delaware. This represents nearly steady job growth compared with the previous four quarters for Pennsylvania and New Jersey, but slower growth for Delaware (see Table 2).

Timothy Schiller
Senior Economic Analyst

Nathan Brownback
Senior Research Assistant
Chart 1
Business Outlook Survey
Current General Activity

Index*

* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.

Chart 2
Business Outlook Survey
Future General Activity

Index*

* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.
Chart 3
Business Outlook Survey
Current Unfilled Orders

Chart 4
Business Outlook Survey
Future Capital Expenditures

* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.
Chart 5
Total Housing Permits

Index*

*1992=100
Based on a three-month moving average.

Chart 6
Housing Price Appreciation
(Percent Change from Same Quarter One Year Earlier)

% Change

Source: Office of Federal Housing Enterprise Oversight
## Table 1
### Unemployment Rates and Employment Growth
#### Seasonally Adjusted

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*Payroll Employment Growth: monthly numbers represent three-month growth at an annualized rate.

## Table 2
### Regional Forecast

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*Unemployment rate forecasts represent the expected unemployment rate in 2007:III, while the actual unemployment rate represents 2006:III.