



REGIONAL HIGHLIGHTS

First Quarter 2006

Business Activity Increases; Employment Growth Continues

Economic activity in the tri-state region (Pennsylvania, New Jersey, and Delaware) continued to expand in the first quarter. Manufacturing increased, building on the gains of the fourth quarter of last year. Retail sales of general merchandise rose slowly during the quarter. Healthy sales growth in January was followed by sluggish growth in February and March. However, sales growth is expected to pick up with warmer spring weather. Auto sales were up a bit from the fourth quarter of last year. Residential building activity eased, and demand for existing homes moderated. Commercial real estate markets continued to firm as the amount of space leased increased and rents rose. Employment in the three states of the region increased, although growth rates varied among the three states. The Philadelphia Fed is forecasting continued job growth in each of the three states, and a slight improvement in the region's overall unemployment rate.

Manufacturing Activity Increases

Manufacturing activity in the region increased in the first quarter. Manufacturers participating in the Philadelphia Fed's monthly *Business Outlook Survey* reported a strengthening of conditions in the first three months of 2006, continuing the pace of improvement observed in the last quarter of 2005 (Chart 1). On balance, manufacturers in the region posted increases in new orders and shipments during the first quarter of 2006 (Chart 2). Among the District's major manufacturing sectors, business improved for producers of industrial and construction materials, lumber, metals, and electrical equipment but was about steady in other sectors.

Firms participating in our *Business Outlook Survey* reported fewer instances of price increases in the first quarter of 2006 than in the fourth quarter of 2005. Although many respondents noted that they continue to face high prices for energy and raw materials, the costs of those inputs do not seem to be rising as rapidly as they did last fall. Similarly, survey participants' expectations of further price increases have moderated somewhat.

Looking ahead, more manufacturers in the region expect business to improve than to decline during the next six months (Chart 3). Business spending for plant and equipment will be a key factor in maintaining the current national economic expansion if residen-

tial construction eases, as is widely expected. Our manufacturing survey indicates that in our region some growth in business capital expenditures is likely. Area manufacturers' plans call for stepped-up capital spending during the next six months (Chart 4). The largest increases are being planned by producers of metals, industrial materials, machinery, and electrical equipment. The increase in capital spending indicated by our regional manufacturing survey parallels manufacturers' intentions nationally, as reported in a survey recently conducted by the National Association of Manufacturers.

Retail Sales Increase Slowly

Retail sales of general merchandise got a boost in January from the redemption of gift cards purchased for Christmas and from warm weather that increased store traffic. A return to more normal winter temperatures in February helped sales of winter apparel but otherwise had a negative effect on sales, as consumers delayed shopping for spring merchandise. A continuation of cold temperatures into March and the later date of Easter this year also tended to delay demand for spring merchandise. Merchants expect sales to pick up in April

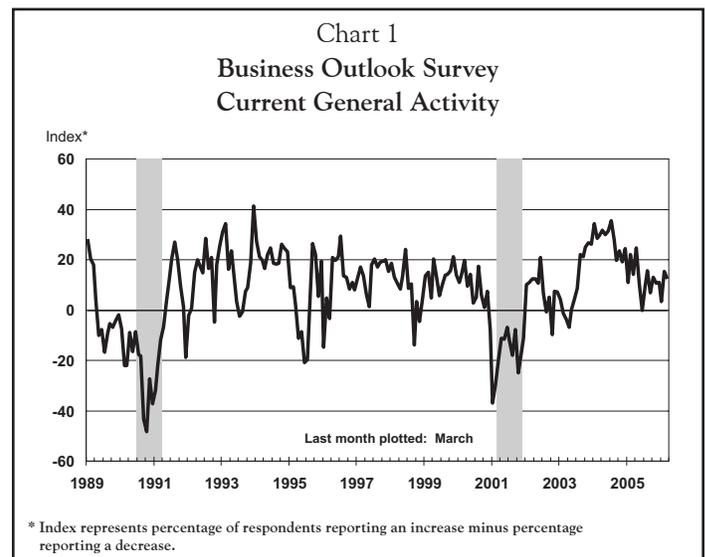
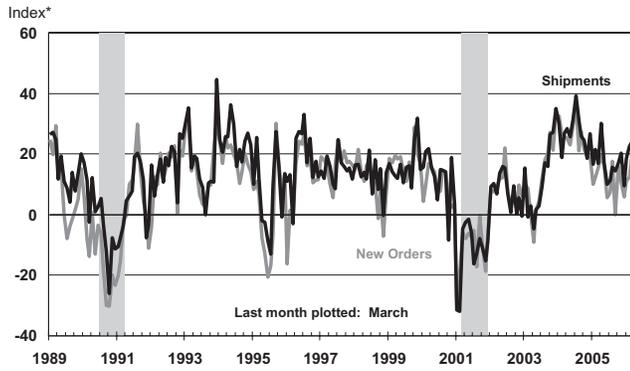
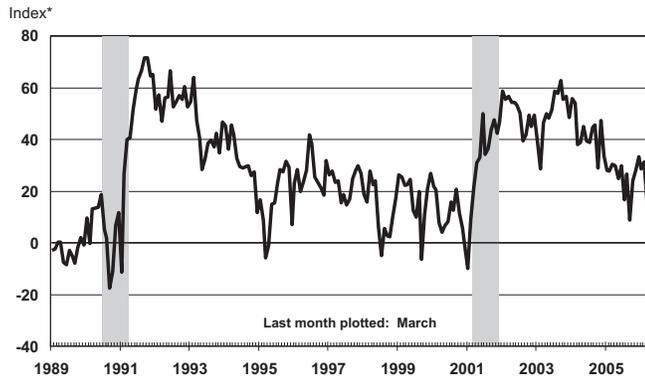


Chart 2
Business Outlook Survey
Current New Orders and Shipments



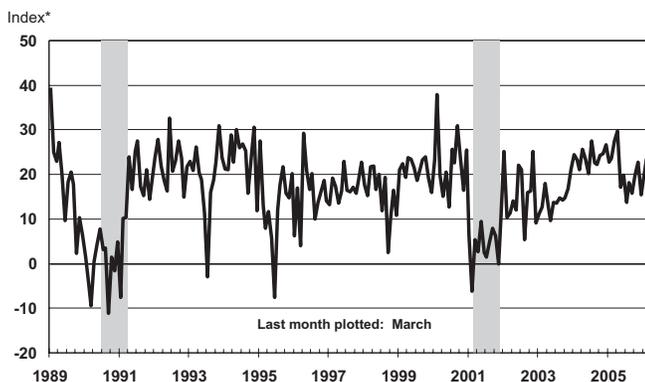
* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.

Chart 3
Business Outlook Survey
Future General Activity



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

Chart 4
Business Outlook Survey
Future Capital Expenditures



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

as warmer weather takes hold and spring school breaks encourage consumers to shop for summer fashions. Warmer weather will also boost sales of home and garden merchandise, and stores selling these lines of goods have noted early and stronger demand for these items this year than in 2005.

Auto sales in the region were somewhat higher in the first quarter of this year than in the fourth quarter of last year. However, the pace of sales was uneven during the quarter, and the longer-term trend appears to be toward slower sales for 2006 as a whole compared with 2005. Foreign models continued to have better year-to-year sales comparisons than domestic models, and sales of smaller, car-based sport-utility vehicles have been rising, while sales of larger models have weakened.

Residential Building Eases

Residential building in the region slowed further in the early months of 2006, as the decline in home building that began in mid-2005 continued. On a seasonally adjusted basis, the number of housing permits issued in the three states as a whole declined in February (latest available data), as it did in the nation. The three-month moving average in total permits—to smooth monthly volatility—reflects drops in Pennsylvania and Delaware and virtually steady permit issuance in New Jersey (Chart 5).

Sales of existing homes in the region have also been slowing. The downward trend in sales noticed in the fourth quarter of 2005 continued into the first quarter of this year. Although there was an increase in sales nationally in February attributable to warm weather, sales in the region did not strengthen appreciably. So far this year the inventory of existing homes for sale has been rising both nationally and locally, and the average amount of time homes are on the market has been increasing, suggesting that the downward trend in sales will continue.

The Office of Federal Housing Enterprise Oversight (OFHEO) reported a steady rate of price increases for existing houses in the three states and throughout the country during the fourth quarter of last year (latest available data). Price appreciation was more rapid in New Jersey and Delaware than in the nation in the fourth quarter, as it was throughout 2005; in Pennsylvania it remained near the national rate (Chart 6). In the fourth quarter, the year-over-year increase was 16 percent in New Jersey and Delaware and 12 percent in Pennsylvania. The national increase was 13 percent. New Jersey ranked 12th in house-price appreciation among the 50 states and the District of Columbia, Delaware ranked 13th, and Pennsylvania ranked 21st. During 2005 the three states slipped somewhat in ranking relative to other states. Homebuilders and real estate agents in the region expect price appreciation to slow significantly this year. Recent signs that a growing proportion of existing houses are selling for less than the asking price and that new home price increases are fading indicate that slower price appreciation is probably setting in.

Commercial Real Estate Markets Are Firming

Demand for commercial real estate continued to increase in the region as 2006 began. Vacancy rates in the region's office markets have declined in the past few months, and rents have generally edged up. Demand for space in newer buildings is stronger than that for older buildings. Owners of older buildings have been upgrading and renovating their properties to remain competitive as

prospective tenants search for the most up-to-date features. Further gradual tightening of the region's office markets is expected this year. However, the supply of office space in the region will increase during 2006 as buildings under construction are completed and a large number of leases in existing buildings expire. The increased supply could limit the rise in rental rates unless demand picks up as well. Demand for industrial space in the region has been growing, especially along major roadways, with significant increases in leasing and purchasing and rising rental rates.

Employment Growth Continues

Employment has been growing in the region as a whole (see Table 1 on page 4). In the three months ending in February (latest data) employment increased in each of the states. In Pennsylvania there were gains in all of the major industry supersectors defined by the U.S. Bureau of Labor Statistics except manufacturing, information services, and financial activities.* In New Jersey, there were gains in all supersectors except manufacturing, trade-transportation-utilities, information services, and professional and business services. In Delaware, there were increases in all supersectors except professional and business services, leisure and hospitality, and other services (mainly personal services).

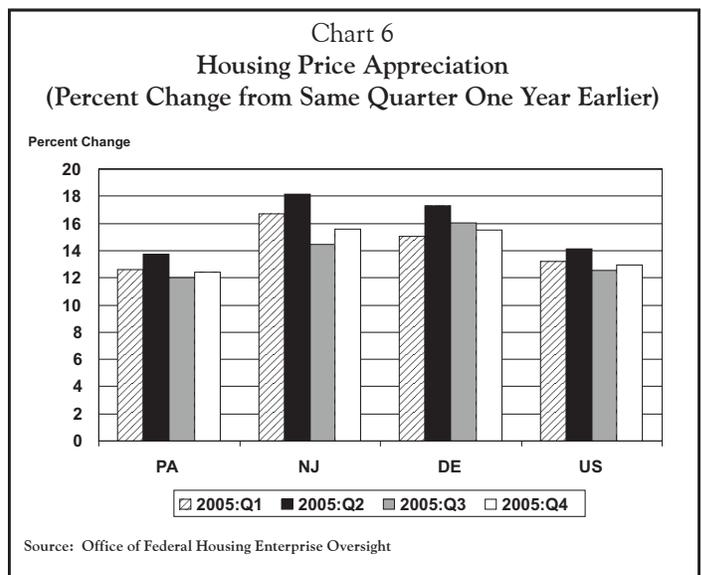
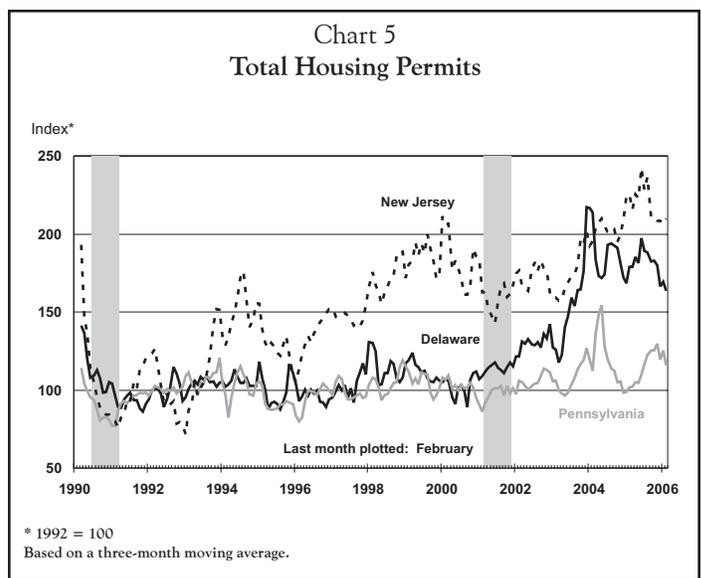
In the past 12 months, total employment growth in Delaware has exceeded national growth, but growth in Pennsylvania and New Jersey has lagged behind the nation. Over that period, Pennsylvania and New Jersey have had greater declines in manufacturing than the nation, and they have had declines in information services employment, in contrast to a slight gain in the nation. In supersectors that have had increases in employment, Pennsylvania and New Jersey have both had slower growth in construction, financial activities, and professional and business services than the nation. Employment growth in education and health services exceeded the national growth rate in Pennsylvania. Employment growth in the leisure and hospitality supersector in New Jersey exceeded the national rate. However, faster growth in those supersectors was more than offset by slow growth and declines in other supersectors in both states, holding total employment growth below the national rate.

The unemployment rate in the three states as a whole, like the national rate, has changed little in recent months. From January to February (latest data) the rate rose in Pennsylvania and Delaware and fell somewhat in New Jersey. The unemployment rate in each of the three states in February was below the national rate, as they have been for most of the past 12 months.

Moderate Growth Is Forecast

The consensus view of the region's business community is that economic conditions will improve modestly in 2006. Manufacturers look for further growth in business during the next two quarters. Retailers expect sales growth to pick up around Easter and gain strength as warm weather returns. However, auto dealers expect sales in 2006 to be below sales in 2005. Commercial real estate agents expect further tightening in the region's office markets during the year, although there is some concern that the amount of

*The supersectors are natural resources, construction, manufacturing, trade-transportation-utilities, information services, finance, professional and business services, education and health services, leisure and hospitality services, other services (mainly repair and personal services), and government.



office space coming onto the market this year could exceed demand. Residential real estate agents and homebuilders generally believe sales will be lower in 2006 than in 2005, and they forecast a slowing in price appreciation.

The employment outlook is positive, as comments from employers throughout the region indicate that they plan to hire at the same rate in the second quarter as they did in the first quarter. The Philadelphia Fed is forecasting increases in employment in each of the three states from the fourth quarter of 2005 to the fourth quarter of 2006. Growth is projected to be 1.2 percent in Pennsylvania and Delaware and 1.1 percent in New Jersey. This represents a steady pace of job growth compared with the previous four quarters for Pennsylvania, slightly faster growth for New Jersey, but slightly slower growth for Delaware (see Table 2).

Timothy Schiller
Senior Economic Analyst

Shannon Mail
Research Associate

Table 1
Unemployment Rates and Employment Growth
Seasonally Adjusted

	Monthly*										Annual		
	Apr 2005	May 2005	Jun 2005	Jul 2005	Aug 2005	Sep 2005	Oct 2005	Nov 2005	Dec 2005	Jan 2006	Feb 2006	2006 YTD**	Last 12 Months
3-State Total													
Unemployment Rate	4.7	4.7	4.7	4.7	4.7	4.6	4.6	4.6	4.6	4.4	4.6	4.5	4.6
Payroll Employment Growth	1.8	1.3	2.1	1.1	0.9	1.3	0.6	1.2	1.1	1.2	1.0	0.8	1.1
Pennsylvania													
Unemployment Rate	5.0	5.0	5.0	4.9	4.9	4.8	4.8	4.7	4.7	4.3	4.5	4.4	4.8
Payroll Employment Growth	1.8	1.2	2.1	1.0	0.8	1.2	0.5	1.1	1.4	1.6	1.5	1.0	1.1
New Jersey													
Unemployment Rate	4.3	4.2	4.3	4.4	4.4	4.4	4.4	4.5	4.6	4.5	4.7	4.6	4.4
Payroll Employment Growth	1.6	1.3	2.3	1.3	1.2	1.2	0.6	1.0	0.5	0.5	0.5	0.3	1.0
Delaware													
Unemployment Rate	4.0	4.1	4.2	4.2	4.2	4.3	4.4	4.5	4.6	3.9	4.0	4.0	4.2
Payroll Employment Growth	3.3	3.0	-0.2	-0.5	0.0	3.7	1.9	4.0	1.9	2.6	0.7	2.5	1.9
United States													
Unemployment Rate	5.1	5.1	5.0	5.0	4.9	5.1	4.9	5.0	4.9	4.7	4.8	4.8	5.0
Payroll Employment Growth	1.9	1.4	1.5	1.6	1.8	1.4	0.8	1.3	1.6	2.0	1.7	1.9	1.5

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

**Growth rates for 2006 Year to Date (YTD) are annualized.

Table 2
Regional Forecast

	Forecast 2005:IV - 2006:IV			Actual 2004:IV - 2005:IV		
	PA	NJ	DE	PA	NJ	DE
Employment	1.2	1.1	1.2	1.2	0.9	1.5
Unemployment Rate *	4.5	4.4	4.4	4.7	4.5	4.5

* Unemployment rate forecasts represent the expected unemployment rate in 2006:IV, while the actual unemployment rate represents 2005:IV.