



REGIONAL HIGHLIGHTS

First Quarter 2004

Economic Activity Advances in First Quarter; Regional Employment to Pick Up as Year Progresses

Business activity in the region increased in the first quarter, but employment did not improve. The manufacturing sector posted further gains and consumer spending rose. Housing remained robust, although commercial real estate markets are still slack. Employment in the three states of the region did not increase in the first quarter, but employment agencies and college placement offices have seen increased interest by firms anticipating hiring in the spring. The Philadelphia Fed is forecasting a pickup in employment in the three states during the year and a decline in unemployment rates.

Manufacturing Stays on an Upward Trend

The region's manufacturing sector continued to expand output in the first quarter. Manufacturing firms participating in the Philadelphia Fed's *Business Outlook Survey* have reported advances in activity for each of the past 10 months (Chart 1). The survey's general activity index reached 38.8 in January, the highest reading in more than 10 years. Although the index eased somewhat in February and March, it continued to signal solid growth in manufacturing activity. The area's manufacturers are still seeing increased demand for their products, as the number of firms reporting gains in shipments and new orders exceeds the number of firms reporting declines (Chart 2).

Manufacturers participating in the survey continued to extend working hours in the first quarter, marking the third consecutive quarter in which hours rose. They expect to continue boosting hours and adding workers for at least the next two quarters. Three-fourths of the manufacturing firms participating in the March survey indicated that they had had job openings in the first quarter, and three-fourths anticipate having job openings in the next two quarters as well. The increase in hours, along with increased employment at the industrial plants covered by the survey, reflects growing production rates. As output at area plants expands, the need for capital equipment increases. In January, the capital spending plans index from the survey rose to the level typical of economic expansions, and it has remained around that level (Chart 3).

Area manufacturers reported rising prices for industrial commodities and energy products in the first quarter. In March the price indexes from the *Business Outlook Survey* reached their highest levels since the mid-1990s. Survey participants noted higher prices for gasoline and natural gas and sharp increases in steel prices. Prices also rose for many metals and for lumber and building

products. Local manufacturers' reports on prices are consistent with developments on the world's commodities markets, where there have been large increases in prices for oil and gas, metals, and some agricultural products.

Area manufacturers expect continued increases in activity during the next six months. Although the number of firms predicting gains declined somewhat during the first quarter, more expect improvement than decline. Around half of the firms polled in the March survey forecast that business will rise further, as opposed to around one in 10 who expect business to slow.

Consumer Spending Rises

Retailers in the region generally reported that sales moved up in the first quarter compared with the same period a year ago. This year-over-year increase was helped by the unusually low sales in February of last year. In February 2003 sales were greatly reduced when snowstorms forced store closings. Weather also helped propel a moderate rise in retail sales of general merchandise during this year's first quarter. A brief spell of cold weather in late January helped stores move out winter apparel, and warming temperatures

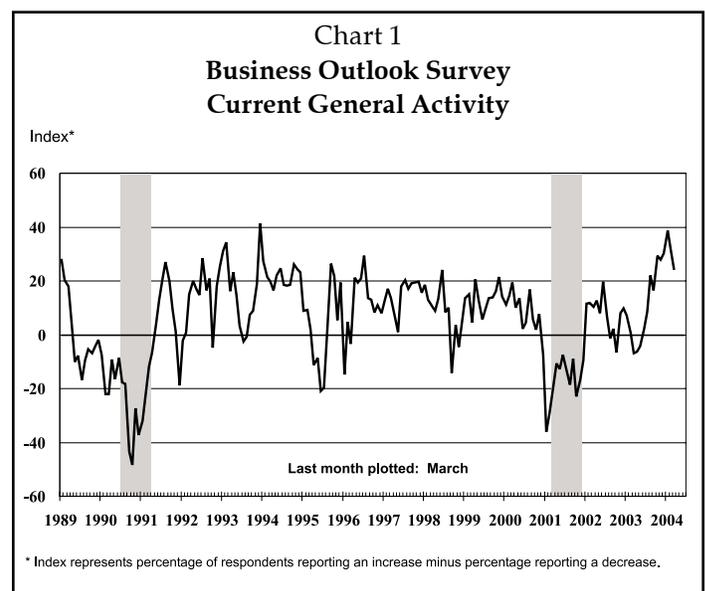
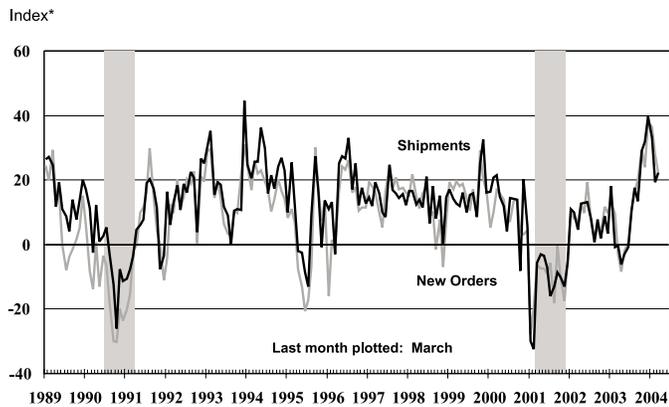
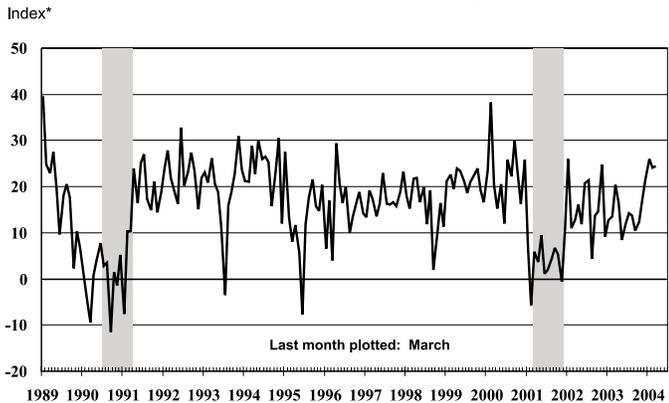


Chart 2
Business Outlook Survey
Current New Orders and Shipments



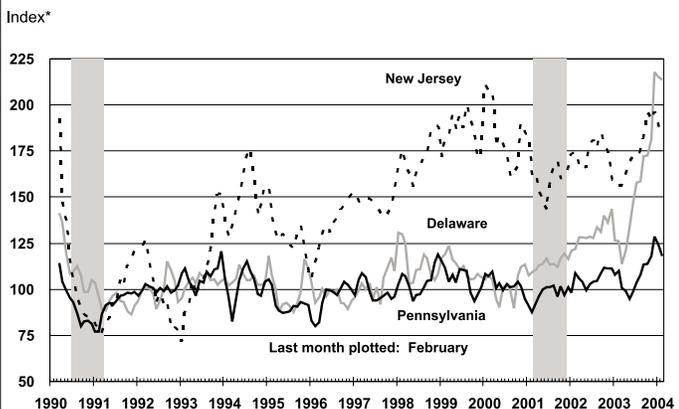
* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.

Chart 3
Business Outlook Survey
Future Capital Spending



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

Chart 4
Total Housing Permits



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

later in February boosted sales of spring clothing. Also, there was a gain in sales of Valentine's Day merchandise this year versus last year.

Retailers expect sales for the spring season to be moderately above the same period last year. Consumer electronics remain popular, and new spring apparel is selling well. However, measures of consumer confidence in the nation and the Middle Atlantic region edged down during the first quarter, and area merchants also observed cautious buying behavior. Shoppers are still being selective and resisting impulse buying. Although retail sales in the region appear to be as strong as or better than sales nationally, some national chains that are retrenching have closed stores in the region despite their local profitability.

Auto sales in the region were a bit higher during the first quarter of 2004 than in the first quarter of last year. As was the case with general merchandise, favorable weather conditions this year compared to last underpinned a year-to-year gain in auto sales. New model introductions also boosted sales, and manufacturers' sales and leasing promotions helped move cars and light trucks off dealers' lots.

Residential Real Estate Markets Are Active

Residential real estate activity continues to be brisk in the region, as it is throughout the nation. Residential real estate agents and homebuilders generally reported that sales rose in late February and in March, after a series of winter storms passed through the region earlier in the quarter. The storms apparently also interrupted home construction; residential building permits declined slightly in each of the states in the region in February (Chart 4). Nevertheless, permit issuance in each of the states is currently at a high level following strong increases during 2003.

Homebuilders and real estate agents reported continuing price appreciation for both new and existing houses during the first quarter. Price appreciation picked up in the fourth quarter of 2003 in the region as it did in the nation. The latest data (fourth quarter 2003) from the Office of Federal Housing Enterprise Oversight (OFHEO) indicated year-over-year price increases for existing houses of 12 percent in New Jersey, 10 percent in Delaware, and just above 8 percent in Pennsylvania (Chart 5). These increases rank New Jersey sixth, Delaware 12th, and Pennsylvania 20th among the 50 states and the District of Columbia. Some metropolitan areas in New Jersey had very rapid price appreciation in 2003. Existing house prices increased 16 percent in the Atlantic-Cape May area and 15 percent in the Monmouth-Ocean area, ranking these places ninth and 15th, respectively, among the 220 areas around the country tracked by OFHEO. These areas were among the few of the top 20 that are not in California or Florida, where house price appreciation has been particularly strong in recent years.

House prices began their current rise around 1999. Among the three states in the region, the increase since then has been greatest in New Jersey (Chart 6). The lack of growth in homebuilding in New Jersey in the period since 1999 might be leading more buyers to look for an existing house in the state, putting more upward pressure on their prices than in Pennsylvania and Delaware, where homebuilding has increased.

Real estate agents expect the pace of existing house sales to continue near its current rate through most of this year. Builders have mixed views: some expect slight declines and others expect slight increases in sales this year. Shortages of land for develop-

ment continue to constrain builders' ability to meet demand in some parts of the three-state region.

Commercial Real Estate Remains Soft

Commercial real estate firms in the Third District reported little change in market conditions in the past few months. The overall office vacancy rate rose slightly in suburban markets but was steady in the Philadelphia central business district. For suburban markets as a whole, the vacancy rate was estimated at around 20 percent as 2004 began, with a great deal of variation from location to location. The vacancy rate in the Philadelphia central business district remained at around 12 percent. In Delaware, the office vacancy rate was approximately 17 percent in central Wilmington and around 15 percent in the suburbs. Throughout the region, effective rental rates have continued to decline. Many lease renewals are being negotiated, and tenants have tended to sign for shorter terms and less space than they had done previously. As a result of shorter leases, as well as the capacity of many firms to expand within their currently leased space, vacancy rates are expected to decline only gradually during 2004.

Construction of a new office building in Philadelphia, the Cira Centre (727,000 square feet), was announced at the end of last year. The building is scheduled to be completed in the fourth quarter of 2005. The addition of this space to Philadelphia's office market has raised concern among some building owners that a recovery in the downtown vacancy rate will be slow unless employment picks up strongly in the central business district.

Industrial building vacancy rates have been nearly steady, although rents have edged down. However, there have been recent signs that demand for industrial space is firming. Industrial space is an important part of the commercial real estate markets in the Lehigh Valley, southern New Jersey, and south-central Pennsylvania. The interstate highways and Pennsylvania and New Jersey turnpikes in these areas make them attractive locations for distribution facilities in particular, and leasing activity for these types of building in the region appears to be turning up.

Employment Slips

In the first two months of this year employment in the region edged down as a result of declines in Pennsylvania and Delaware. Employment in New Jersey was flat (see Table 1 on page 4). This year's rebenchmarking of employment data revealed that employment has been weaker than initially reported in the nation and in Pennsylvania and New Jersey, but stronger in Delaware. (Rebenchmarking is an annual revision by the Bureau of Labor Statistics of its employment survey to take into account a more accurate, but less frequent, employment measure based on data collected as part of the unemployment insurance program.) The rebenchmarking data indicate that since the recession ended in November 2001, employment in New Jersey and Delaware decreased, then regained all or most of the lost ground, while employment in Pennsylvania declined more than in the nation and has not yet recovered (Chart 7).

Some Improvement Ahead

The outlook for the region's economy is modestly positive. Manufacturers forecast increases in shipments and orders during the next six months. Retailers anticipate a moderate increase in sales in the spring compared with a year ago. Residential real estate activity

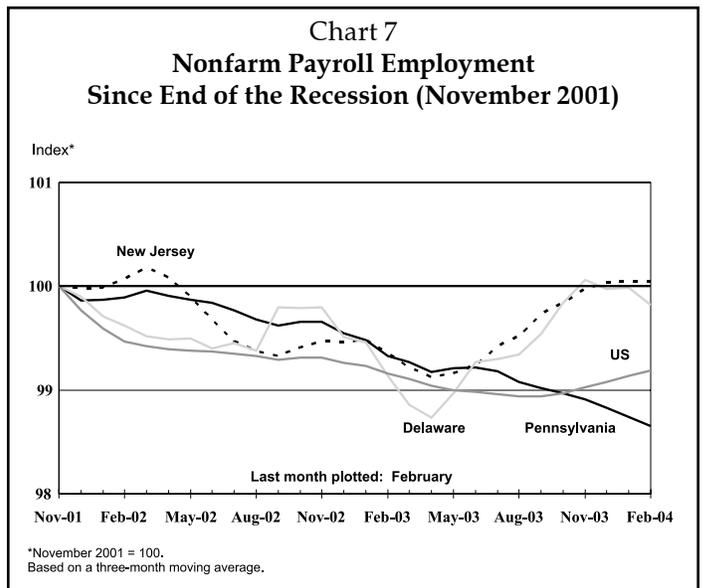
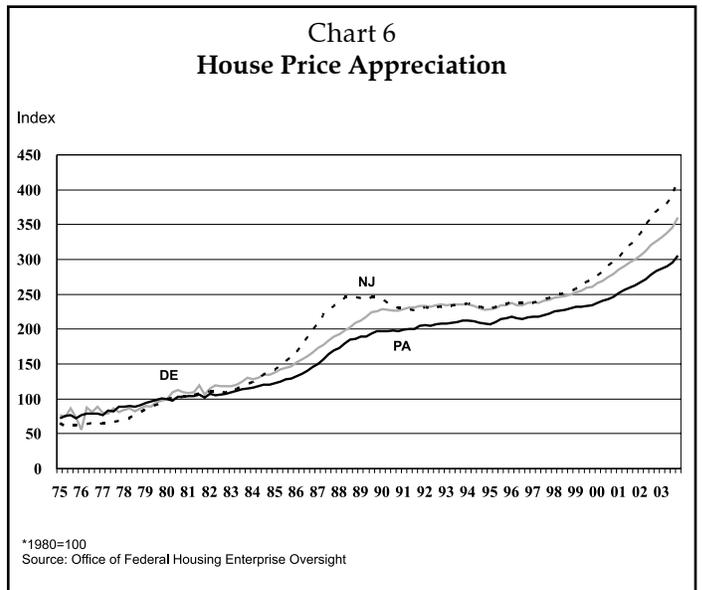
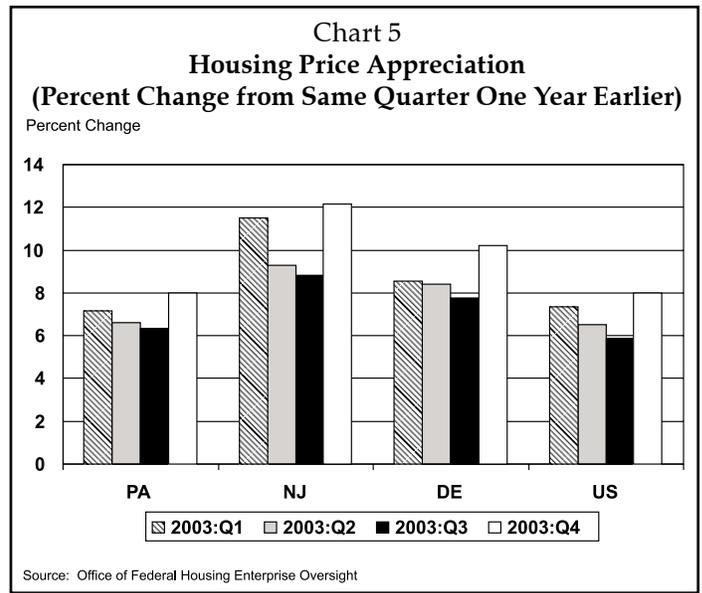


Table 1
Unemployment Rates and Employment Growth*
Seasonally Adjusted

| | 2002 | 2003 | | | | 2004 |
|---------------------------|------|------|------|------|------|------|
| | IV | I | II | III | IV | I** |
| 3-STATE TOTAL | | | | | | |
| Unemployment Rate | 5.8 | 5.9 | 5.7 | 5.6 | 5.4 | 5.2 |
| Payroll Employment Growth | 0.0 | -0.3 | 0.0 | 0.1 | 0.0 | -0.1 |
| PENNSYLVANIA | | | | | | |
| Unemployment Rate | 5.8 | 5.9 | 5.7 | 5.5 | 5.3 | 5.2 |
| Payroll Employment Growth | -0.1 | -0.3 | 0.0 | -0.2 | -0.2 | -0.2 |
| NEW JERSEY | | | | | | |
| Unemployment Rate | 6.0 | 6.0 | 5.9 | 5.9 | 5.6 | 5.5 |
| Payroll Employment Growth | 0.1 | -0.2 | 0.0 | 0.5 | 0.3 | 0.0 |
| DELAWARE | | | | | | |
| Unemployment Rate | 4.2 | 4.3 | 4.3 | 4.5 | 4.4 | 3.4 |
| Payroll Employment Growth | -0.3 | -0.7 | 0.4 | 0.3 | 0.4 | -0.2 |
| UNITED STATES | | | | | | |
| Unemployment Rate | 5.9 | 5.8 | 6.1 | 6.1 | 5.9 | 5.6 |
| Payroll Employment Growth | 0.0 | -0.2 | -0.1 | 0.0 | 0.1 | 0.1 |

* Percent change from previous quarter.

** All numbers reflect two months of data.

appears likely to continue at a brisk and steady pace. Area employers might be poised to begin adding to payrolls as business activity continues to move up. Employment agencies and placement offices at educational institutions in the region have noted increased interest in hiring among firms from inside and outside the region. The Philadelphia Fed is forecasting increases in employment in each of the three states during the year of 1.1 percent to 1.5 percent, which would be the best annual gains since 2000 (see Table 2).

Timothy Schiller
Senior Economic Analyst

Shannon Mail
Research Associate

Table 2
Regional Forecast

| | Forecasted | | | Actual | | |
|--------------------|-------------------|-----|-----|-------------------|-----|-----|
| | 2003:IV - 2004:IV | | | 2002:IV - 2003:IV | | |
| | PA | NJ | DE | PA | NJ | DE |
| Employment | 1.1 | 1.5 | 1.3 | -0.7 | 0.6 | 0.5 |
| Unemployment Rate* | 5.0 | 5.2 | 3.7 | 5.3 | 5.6 | 4.4 |

* Unemployment rate forecasts represent the expected unemployment rate in 2004:IV, while the actual unemployment rate represents 2003:IV.