



REGIONAL HIGHLIGHTS

Third Quarter 2005

Business Activity Moves Up Slowly; Employment Growth Continues

Business activity in the tri-state region (Pennsylvania, New Jersey, and Delaware) continued to expand in the third quarter, but the pace of growth appeared to ease as the quarter ended. Manufacturing growth stalled in September but picked up again in early October. Sales of general merchandise rose slowly during the quarter. Auto sales declined in September, after running at a strong rate during the summer. Residential building activity increased, but there are signs that demand for homes is peaking. Commercial real estate market conditions have been steady. Employment in the three states of the region remained on the rise. The Philadelphia Fed is forecasting continued job growth in each of the three states but little change in each state's unemployment rate.

Manufacturing Advance Slows

Growth in manufacturing activity in the region stalled as the third quarter came to a close but showed signs of picking up as the fourth quarter began. Manufacturers participating in the Philadelphia Fed's monthly *Business Outlook Survey* reported improving conditions during July and August, then a leveling off of overall business activity in September, and finally positive movement again in October (Chart 1). On balance, new orders rose at area manufacturers in October after being flat in September (Chart 2). Shipments from area manufacturing plants have increased, on balance, but order backlogs have been steady. The slowdown in September might be at least partially attributable to the hurricanes that struck the Gulf Coast that month. Some area manufacturers reported that, as a result of the hurricanes, they had had difficulty obtaining needed materials and that their operations were hampered by transportation delays.

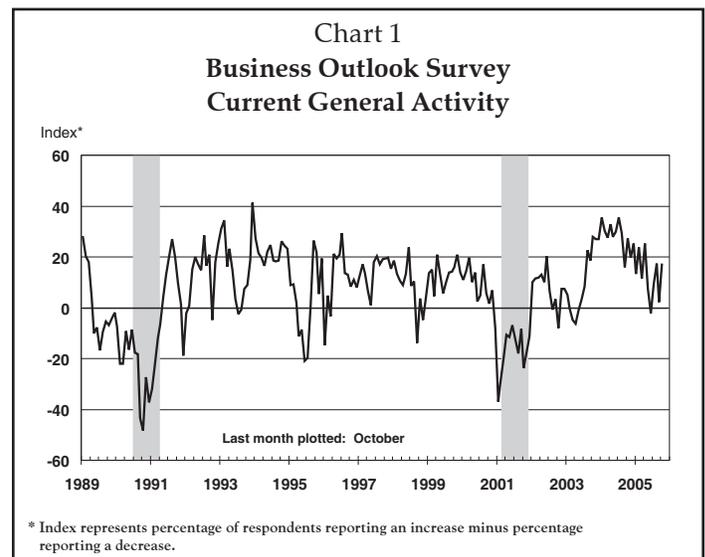
In the wake of rising energy prices, firms participating in our *Business Outlook Survey* reported sharp increases in prices paid for inputs to their manufacturing processes in recent months (Chart 3). In addition to the increase in the cost of fuels, firms reported rising prices for a variety of metals and petroleum-based inputs. Some firms have raised prices for the goods they make, but most have not.

Looking ahead, more manufacturers in the region expect business to improve than to decline during the next six months (Chart 4).

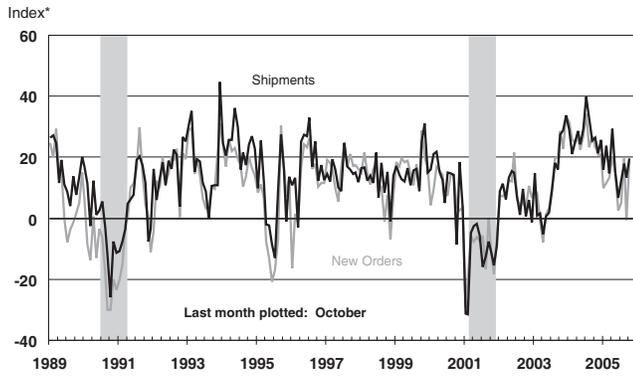
On balance, area manufacturers forecast increases in new orders and shipments but expect order backlogs to be level. More than half of the firms participating in the survey anticipate additional increases in the prices of the goods they purchase. About half of them plan to raise prices for the products they make, and about half expect to hold their own prices steady.

Retail Sales Edge Up

Retail sales of general merchandise at stores in the region increased slowly in the third quarter. Unseasonably warm weather during August and September reduced store traffic and held back sales of fall apparel. Sales growth has been strong for stores that specialize in luxury goods, and discount stores have had some gains, but sales at many stores that carry mid-priced merchandise have barely exceeded sales in the same quarter last year. As the quarter came to an end, many stores saw further drops in customer traffic. Merchants attribute this to the increase in gasoline prices that occurred during the summer. They say consumers are reduc-

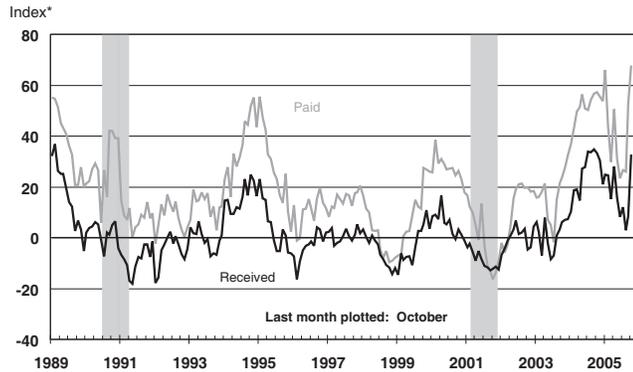


**Chart 2
Business Outlook Survey
Current New Orders and Shipments**



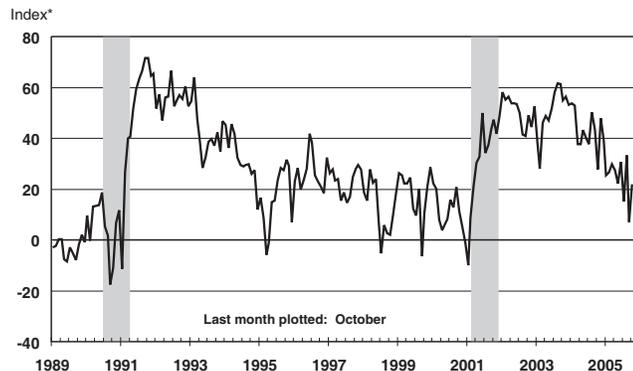
* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.

**Chart 3
Business Outlook Survey
Current Prices**



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

**Chart 4
Business Outlook Survey
Future General Activity**



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

ing discretionary spending as well as cutting back on auto usage, including shopping trips.

Retailers expect sales growth to be slow through the rest of the year. National measures of consumer confidence have fallen lately, and merchants in the region believe the important end-of-year shopping season will be challenging. Some are already bracing for slow sales by limiting orders for winter merchandise. In addition to a difficult sales environment, retailers are facing higher costs. Like their customers, retailers—as well as other business firms—are facing higher costs for motor fuels and are anticipating higher costs for heating this winter. As a result, they are looking for ways to reduce energy usage as well as ways to trim other operating expenses.

Auto sales in the region followed the national pattern in the third quarter. Sales were generally strong at the beginning of the quarter but fell off sharply as inventories of 2005 models were depleted and manufacturers ended their discount programs. It appears that sales of 2006 models are off to a slow start.

Residential Building Increases; House-Price Appreciation Continues

Residential building was on the increase in the region during the third quarter, as it was in the nation. On a seasonally adjusted basis, the number of housing permits issued in the three states as a whole rose in July and August (latest available data). Permit issuance has increased in Pennsylvania and New Jersey and has been roughly steady in Delaware (Chart 5).

Sales of existing homes continue to run at a brisk pace in the region, although homes for sale seem to be on the market longer than earlier in the year. Some real estate agents believe this may be due to sellers setting unrealistically high prices. Nevertheless, the inventory of homes for sale remains low. Demand for new homes continues to be strong, and home builders have large backlogs of homes to be built. Demand for construction materials, equipment, and labor has increased sharply as the areas of the country devastated by the recent hurricanes begin rebuilding. Consequently, some temporary shortages, as well as higher costs for materials and labor, are expected locally and throughout the nation.

The Office of Federal Housing Enterprise Oversight (OFHEO) reported a continuing high rate of price increases for existing houses in the three states and throughout the country during the second quarter (latest available data). The rate of price appreciation remains historically high in the nation as well as in the region. Price appreciation has been more rapid in New Jersey and Delaware than in the nation, and in Pennsylvania it has been on par with the nation (Chart 6). In the second quarter, the year-over-year increase was 18 percent in New Jersey, 17 percent in Delaware, and 13 percent in Pennsylvania. The national increase was 13 percent. New Jersey ranked ninth in house-price appreciation among the 50 states and the District of Columbia, Delaware ranked 11th, and Pennsylvania ranked 19th.

Commercial Real Estate Markets Steady; Construction Advances

Commercial real estate firms reported that vacancy rates in the region's office markets have been roughly steady in the past few months. Rental rates have also been about steady, although in some local markets landlords have reduced concessions. Leasing activity has been fairly strong, and there has been a slight increase in build-

to-suit construction in some areas. Some tightening in the region's office markets is anticipated during the rest of the year, although the scheduled completion of the Cira Centre in Philadelphia at the end of the year is expected to prevent a substantial decrease in the city's vacancy rate. Industrial building vacancy rates have been nearly flat in recent months, and rents have shown little change. Demand for industrial space is expected to grow about in line with the overall economic expansion in the region during the rest of the year.

Nonresidential construction activity continued to advance in the third quarter. Construction of industrial buildings has been on the rise, especially warehouses and distribution facilities in eastern Pennsylvania and southern New Jersey. Public-sector construction, such as educational facilities and roads and bridges, has also contributed to the strength of building activity.

Employment Gains

Employment has been growing in the region as a whole (see Table 1 on page 4). In the three months through September employment increased in Pennsylvania and New Jersey but was unchanged in Delaware. In Pennsylvania there were gains in all of the major industry supersectors defined by the U.S. Bureau of Labor Statistics* except manufacturing and information services. Among the major industry supersectors in Pennsylvania, the largest percentage increase was in leisure and hospitality services. In New Jersey, also, there were increases in all supersectors except manufacturing and information services. The greatest gain among the state's major industries was in construction. In Delaware, there were declines in most supersectors but increases in manufacturing, information services, leisure and hospitality services, and government employment. Those gains offset the declines in other supersectors, keeping employment steady in the state during the third quarter.

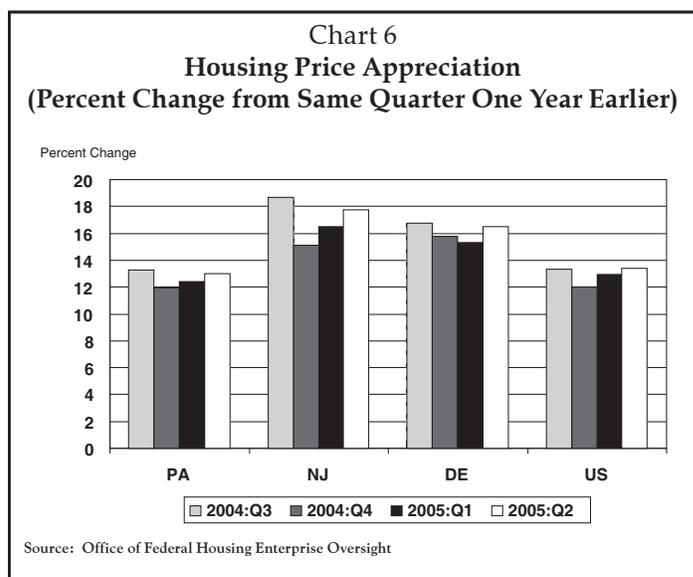
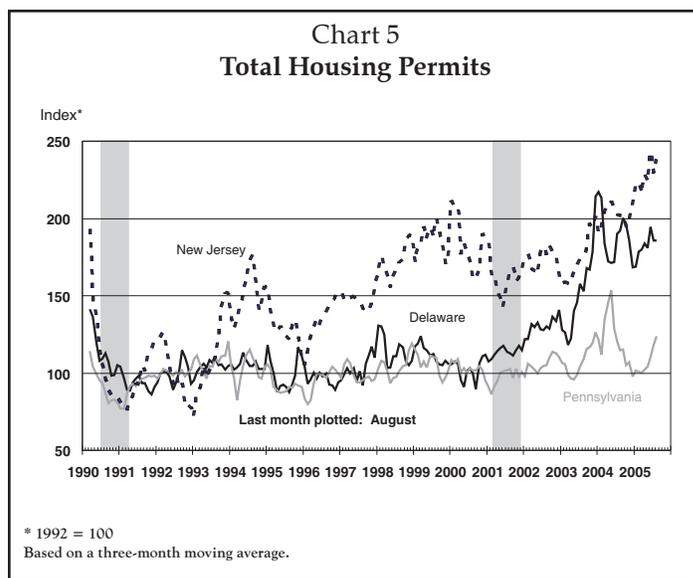
The unemployment rate in the three states as a whole has shown little change in recent months. Pennsylvania's unemployment rate has declined since mid-summer, New Jersey's rate has edged up, and Delaware's rate has been steady. The unemployment rate in each state was below the national rate in September.

Moderate Growth Is Forecast

The consensus view of the region's business community is that economic conditions will improve modestly through the winter. Manufacturers look for a pickup in business during the next two quarters. Retailers expect sales to rise during the fourth quarter, but most look for only moderate gains as consumers remain cautious. Auto dealers do not expect the sales rate to improve substantially this fall, and they believe sales next year could be lower than this year. Commercial real estate agents expect a tightening in the region's office markets during the rest of the year. Residential real estate agents and homebuilders generally believe sales will continue to be strong, but some anticipate an easing in the sales rate as the year comes to a close.

The employment outlook is positive, as comments from employers throughout the region indicate that more plan to increase

* 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.



than reduce staffing levels in the fourth quarter. On balance, area firms expect to hire at about the same rate in the fourth quarter as they did in the third quarter. The Philadelphia Fed is forecasting increases in employment in each of the three states from the second quarter of 2005 to the second quarter of 2006. Growth is projected to be 1.2 percent in Pennsylvania, 1.6 percent in New Jersey, and 1.5 percent in Delaware. Compared with the previous four quarters, this represents a steady pace of job growth for Pennsylvania, somewhat faster growth for New Jersey, and slower growth for Delaware (see Table 2).

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Table 1
Unemployment Rates and Employment Growth
Seasonally Adjusted

	Monthly*									Annual	
	Jan 2005	Feb 2005	Mar 2005	Apr 2005	May 2005	Jun 2005	Jul 2005	Aug 2005	Sep 2005	2005 YTD**	Last 12 Months
3-STATE TOTAL											
Unemployment Rate	4.6	4.9	4.9	4.6	4.4	4.6	4.7	4.6	4.6	4.7	4.8
Payroll Employment Growth	1.3	1.0	0.9	1.3	1.5	1.6	1.0	0.9	1.0	1.2	1.3
PENNSYLVANIA											
Unemployment Rate	5.1	5.3	5.4	4.9	4.8	5.0	5.1	5.0	4.8	5.0	5.2
Payroll Employment Growth	1.1	0.8	1.0	1.2	1.7	1.7	1.0	1.1	1.2	1.3	1.3
NEW JERSEY											
Unemployment Rate	3.9	4.4	4.3	4.2	3.9	4.0	4.1	4.2	4.3	4.1	4.2
Payroll Employment Growth	1.3	0.9	0.6	1.7	1.5	1.9	0.8	0.6	0.9	1.1	1.2
DELAWARE											
Unemployment Rate	4.3	4.1	3.9	3.9	4.1	4.1	4.1	4.0	4.1	4.1	4.1
Payroll Employment Growth	4.8	5.4	3.3	-0.5	-0.1	-0.8	1.6	-0.1	0.0	0.8	1.4
UNITED STATES											
Unemployment Rate	5.2	5.4	5.2	5.2	5.1	5.0	5.0	4.9	5.1	5.1	5.2
Payroll Employment Growth	1.2	1.8	1.7	2.2	1.6	1.8	1.7	2.0	1.4	1.6	1.6

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

** Growth rates for 2005 year to date (YTD) are annualized.

Table 2
Regional Forecast

	Forecast 2005:II - 2006:II			Actual 2004:II - 2005:II		
	PA	NJ	DE	PA	NJ	DE
Employment	1.2	1.6	1.5	1.1	1.4	2.1
Unemployment Rate*	5.0	3.8	3.8	4.9	4.0	4.0

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