



REGIONAL HIGHLIGHTS

Third Quarter 2006

Economic Activity Increases, But Housing Slowdown Continues

Economic activity in the tri-state region (Pennsylvania, New Jersey, and Delaware) continued to expand in the third quarter, although the rate of growth was not as strong as in the second quarter. Manufacturing activity in the region stalled at the end of the third quarter. Growth in business at many of the region's service-sector firms slowed. On the positive side, retail sales of general merchandise picked up in the back-to-school shopping period, giving many area retailers good year-over-year increases. Auto sales, however, have not shown any sign of significant improvement. Demand for housing continued to wane. Sales of both new and existing homes remained on a downward trend. Despite the evidence of a slowing in economic growth in the region, employment in the three states increased.

Manufacturing Growth Stalls

Manufacturing activity in the region slowed as the third quarter ended. Manufacturers participating in the Philadelphia Fed's monthly *Business Outlook Survey* reported that the modest expansion in the first two quarters of 2006 faded in the third quarter, leaving the sector with little or no growth in September and October (Chart 1). As the third quarter ended, demand was holding up for area manufacturers of chemicals, metal products, and industrial materials but was falling for makers of apparel, petroleum products, and plastic and rubber products.

Manufacturers in the region expect business to turn up during the next six months (Chart 2). However, construction products and other housing-related goods are an important segment of regional manufacturing, so the slowdown in construction that is now evident could limit any rebound in regional manufacturing activity. Another dampening factor is the decline in auto production, especially at domestic manufacturers, which is being felt by parts suppliers in the region.

Retail Sales Strengthen

Retail sales of general merchandise in the region rose in the third quarter, roughly in line with the national increase. Stores specializing in luxury items posted stronger annual gains through the summer than those selling low-priced goods. But in the back-to-school shopping period the pace of sales picked up among most lines of merchandise and types of stores, resulting in year-over-year increases among many retailers that exceeded their expectations. Widespread promotional efforts at area stores helped increase sales, and a decline in the price of gasoline in September gave a boost to shoppers' buying power. Looking ahead, area retailers are uncertain whether the recent pace of growth will continue. They say consumer confidence is fragile and that shoppers' willingness to spend will depend crucially on the course of gasoline prices and the stability of housing values.

Auto sales in the region remained sluggish in

the third quarter, as they did throughout the country. Domestic manufacturers' incentives helped support the sales rate early in the summer, but the positive effect of incentives appeared to ebb as the third quarter came to a close. Sales of light trucks waned during the quarter as consumers' interest shifted toward cars, especially the more fuel-efficient models. However, the recent decline in gasoline prices appeared to spark renewed interest in light trucks. Nevertheless, the overall vehicle sales rate has not improved, and auto dealers in the region do not anticipate a rise in total vehicle sales in the near future.

Service-Sector Expansion Eases

Service-sector firms in the region posted increases in activity in the third quarter, but for many firms growth has slowed recently. In particular, business services firms have experienced slower growth in work done for existing clients and a slower pace of new client acquisition. Information technology firms have had steady gains in activity in the past few months, but their business has not been increasing at a robust rate.

Housing Markets Soften Further

The pace of residential building in the region continued to slacken during the summer. Although there was an increase in Pennsylvania, it was offset by declines in New Jersey and Delaware. As a result, total permit issuance in the three states of the region fell in August to its lowest level in three years (Chart 3). Nationally, there was an increase in permit issuance from July to August, but the trend since the beginning of the year has been downward.

Sales of existing homes declined over the summer. In each of the states, existing home sales have been falling since peak levels reached in 2004 (in New Jersey) or 2005 (in Pennsylvania and Delaware). Nationally, existing home sales have been falling since a peak reached in 2005. As home sales have declined, the inventory of existing homes for sale and the time they are on the market have increased.

The Office of Federal Housing Enterprise Oversight (OFHEO) reported a sharp slowdown in the rate of price appreciation for existing houses in the three states and the nation during the second quarter of this year (latest available data). In the nation and in each of the three states, quarterly price appreciation fell from above 2 percent in the first quarter to below 1 percent in the second quarter (Chart 4). This deceleration of house-price appreciation is not unprecedented. In fact, the OFHEO index for the nation and for each of the three states in the region recorded several quarter-to-quarter drops in house prices in the 1990s. Comparing the second quarter of this year to the second quarter of last year, price appreciation was over 10 percent nationally and greater than that in each of the states of the region (Chart 5). However, for the nation as well as the states, year-over-year appreciation is expected to slow appreciably going forward.

Demand for Commercial Real Estate Is Steady

Commercial real estate markets remained firm in the third quarter. Vacancy rates in the region's office markets have continued to fall in the past few months (Chart 6). Rents have risen and landlord concessions have declined. Much of the increase in leased space has come from expansion at firms already well established in the region. Demand for industrial space in the region continued to grow, and supply has been limited as older buildings have been taken off the market for conversion to non-industrial uses. A large portion of the new industrial construction is taking place in the Philadelphia suburbs (both in Pennsylvania and New Jersey), in the Lehigh Valley, and along the region's interstate highways. The steady rise in demand for office and industrial space has stimulated the construction of office and industrial buildings on both a speculative and build-to-suit basis. Speculative construction is estimated to be greater now than at any time in the past several years. The region's commercial real estate markets are expected to tighten further if the economy continues to expand, but increases in leased space are not expected to be as strong in the future as they were earlier in the year.

Employment Gains

Employment has been growing in the region as a whole (Table 1). In the three months ending in August (latest data), employment increased in Pennsylvania and Delaware but declined in New Jersey. The strength of employment has varied by industry in recent months, as it did in the first half of the year. For the three months that ended in August, Pennsylvania had gains in construction, trade-transportation-utilities, information services, finance, professional and business services, educational and health services, leisure and hospitality, and other services (mainly personal services). There were declines in manufacturing and government. In New Jersey, there were gains in professional and business services, educational and health services, leisure and hospitality, and other services. There were declines in construction, manufacturing, trade-transportation-utilities, information services, finance, and government. In Delaware, there were increases in construction, manufacturing, information services, other services, and government. There were declines in trade-transportation-utilities, finance, professional and business services, educational and health services, and leisure and hospitality.

In the past 12 months, total employment growth in the region has been slower than in the nation. Over that period, the region had slower growth than the nation in the sectors that gained most at the national level – construction, financial activities, and professional and business services – and greater losses in the sector that declined nationwide – information services. Manufacturing employment has been virtually flat in the nation in the 12 months that ended in August, a break from the downward trend that followed the end of the 1990s expansion, but manufacturing employment has continued to decline in the three states of the region. Three service sectors – health and education, leisure and hospitality, and other services – had stronger growth in the past 12 months in the region than they did nationally.

The unemployment rate in the three states as a whole has edged up in recent months. From May to August (latest data), unemployment rose in Pennsylvania and New Jersey but fell in Delaware. The August unemployment rates in Pennsylvania and New Jersey were above the national rate. The rate in Delaware remained well below the national rate.

Modest Growth Is Forecast for the Region

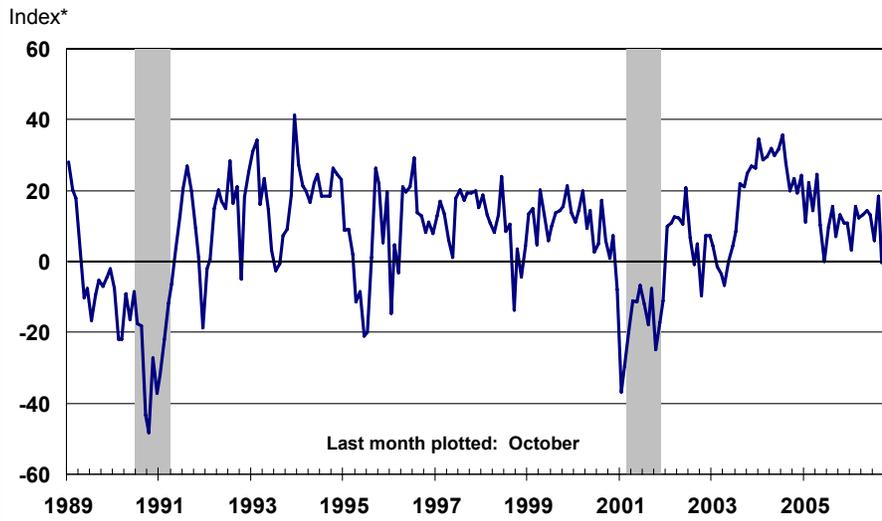
Third District business firms expect economic activity in the region to continue to expand, but many anticipate slower growth in the months ahead than in the past few months. Manufacturers expect some improvement in demand for their products. Retailers forecast modest growth in sales; however, auto dealers do not expect sales to pick up. Service-sector firms expect business to continue to increase slowly. Home builders and real estate agents expect home sales and construction to slow further. Demand for office and industrial space is expected to remain firm, although the rate at which new space is occupied is expected to be slower in the fourth quarter than earlier in the year.

Employment should remain on an upward trend. Employers throughout the region indicate that they plan to add to payrolls in the fourth quarter at around the same rate 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 2006 to the second quarter of 2007. Growth is projected to be 0.9 percent in Pennsylvania and New Jersey, and 1.1 percent in Delaware. This represents a steady pace of job growth compared with the previous four quarters for Pennsylvania and New Jersey but slower growth for Delaware (Table 2).

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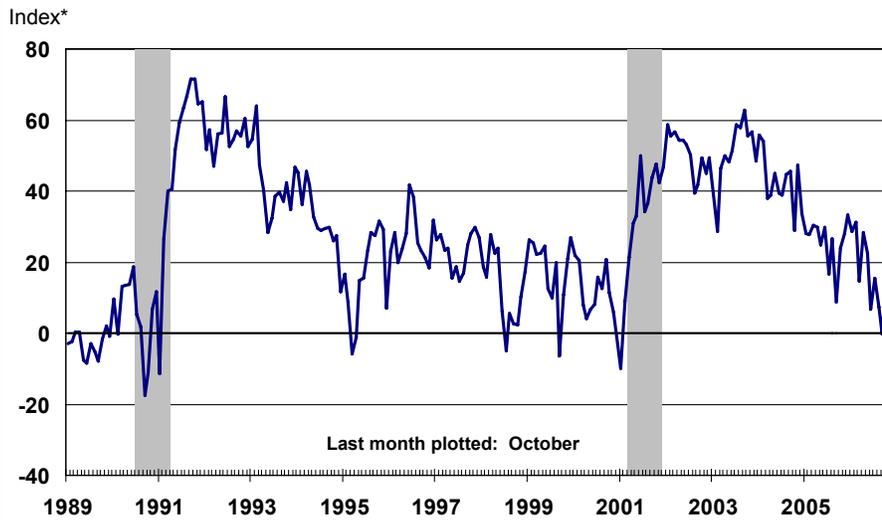
Kristy Buzard
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Chart 1
Business Outlook Survey
Current General Activity



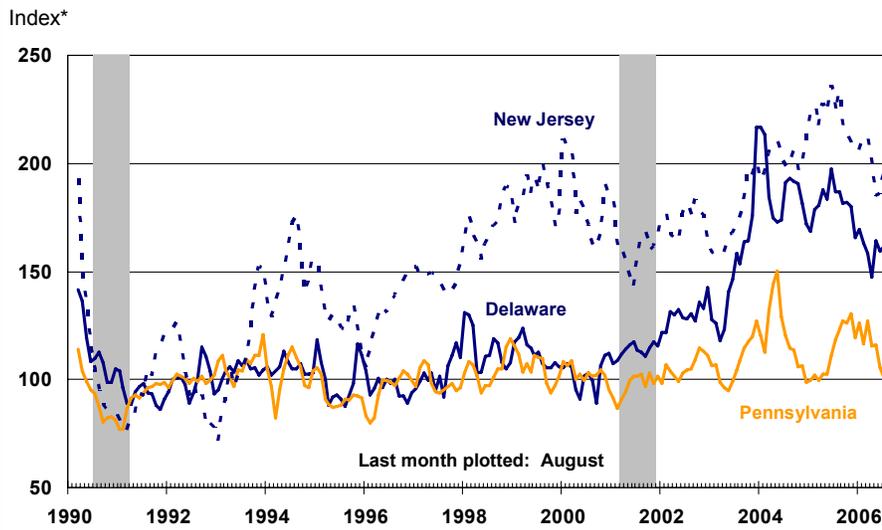
* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.

Chart 2
Business Outlook Survey
Future General Activity



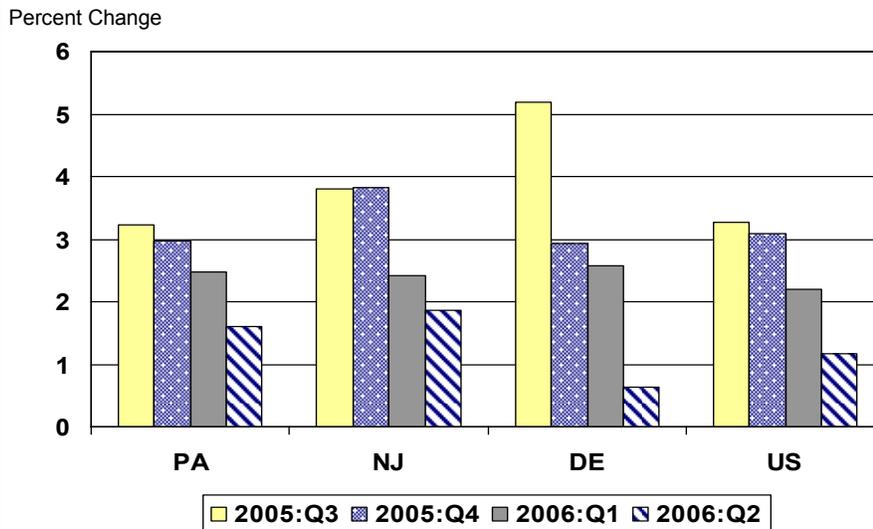
* Index represents percentage of respondents reporting an increase minus percentage reporting a decrease.

**Chart 3
Total Housing Permits**



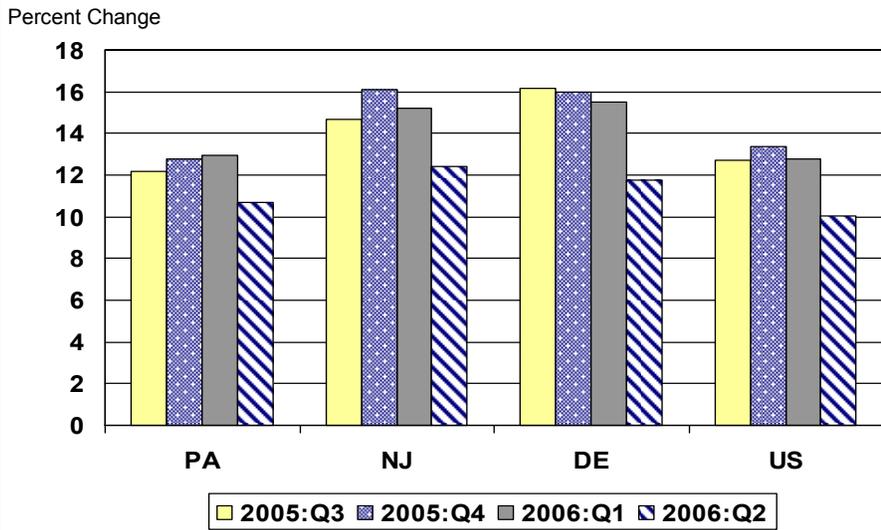
*1992=100
Based on a three-month moving average.

**Chart 4
Housing Price Appreciation
(Percent Change from One Quarter Earlier)**



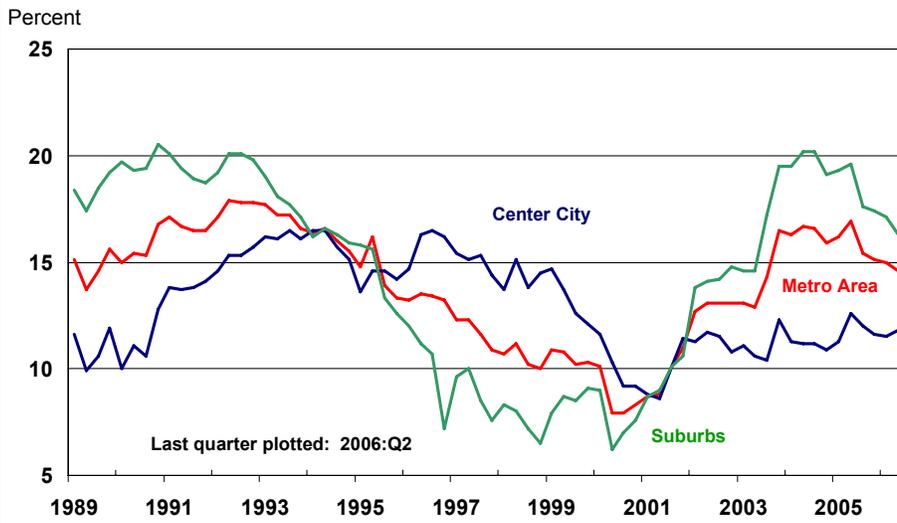
Source: Office of Federal Housing Enterprise Oversight

Chart 5
Housing Price Appreciation
(Percent Change from Same Quarter One Year Earlier)



Source: Office of Federal Housing Enterprise Oversight

Chart 6
Office Vacancy Rates
Philadelphia Area



Source: Average of estimates by area real estate firms.

**Table 1
Unemployment Rates and Employment Growth
Seasonally Adjusted**

	Monthly*									Annual	
	Dec 2005	Jan 2006	Feb 2006	Mar 2006	Apr 2006	May 2006	Jun 2006	Jul 2006	Aug 2006	2006 YTD**	Last 12 Months
3-State Total											
Unemployment Rate	4.6	4.4	4.6	4.5	4.9	4.8	4.7	4.9	5.0	4.7	4.7
Payroll Employment Growth	1.1	1.2	0.9	0.4	0.7	0.7	1.0	0.7	0.5	0.6	0.8
Pennsylvania											
Unemployment Rate	4.7	4.3	4.5	4.5	4.7	4.8	4.7	4.8	4.9	4.7	4.7
Payroll Employment Growth	1.4	1.6	1.3	0.2	0.2	0.1	0.7	0.9	0.8	0.6	0.8
New Jersey											
Unemployment Rate	4.6	4.5	4.7	4.5	5.1	5.0	4.9	5.1	5.3	4.9	4.8
Payroll Employment Growth	0.5	0.5	0.4	0.4	1.2	1.6	1.5	0.6	-0.1	0.6	0.7
Delaware											
Unemployment Rate	4.6	3.9	4.0	3.6	3.7	3.8	3.7	3.8	3.7	3.8	4.0
Payroll Employment Growth	1.9	2.6	0.0	2.1	2.7	0.6	-0.7	-1.2	1.6	1.1	1.5
United States											
Unemployment Rate	4.9	4.7	4.8	4.7	4.7	4.6	4.6	4.8	4.7	4.7	4.8
Payroll Employment Growth	1.6	2.0	1.5	1.6	1.5	1.2	1.0	1.1	1.1	1.3	1.3

*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**

	Forecasted 2006:II - 2007:II			Actual 2005:II - 2006:II		
	PA	NJ	DE	PA	NJ	DE
Employment	0.9	0.9	1.1	0.9	0.9	1.5
Unemployment Rate *	5.1	5.4	4.0	4.7	5.0	3.7

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