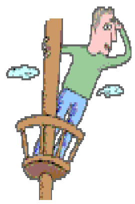

THE NORTH CAROLINA ECONOMIC OUTLOOK

WINTER 2013

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Executive Summary: Moving to a Higher Gear

The economic growth experienced in both the nation and North Carolina in 2013 is forecasted to continue into 2014, at a somewhat accelerated pace. Several factors will support the improvement, including a solid recovery in the housing market, repaired household finances, and an upswing in business hiring.

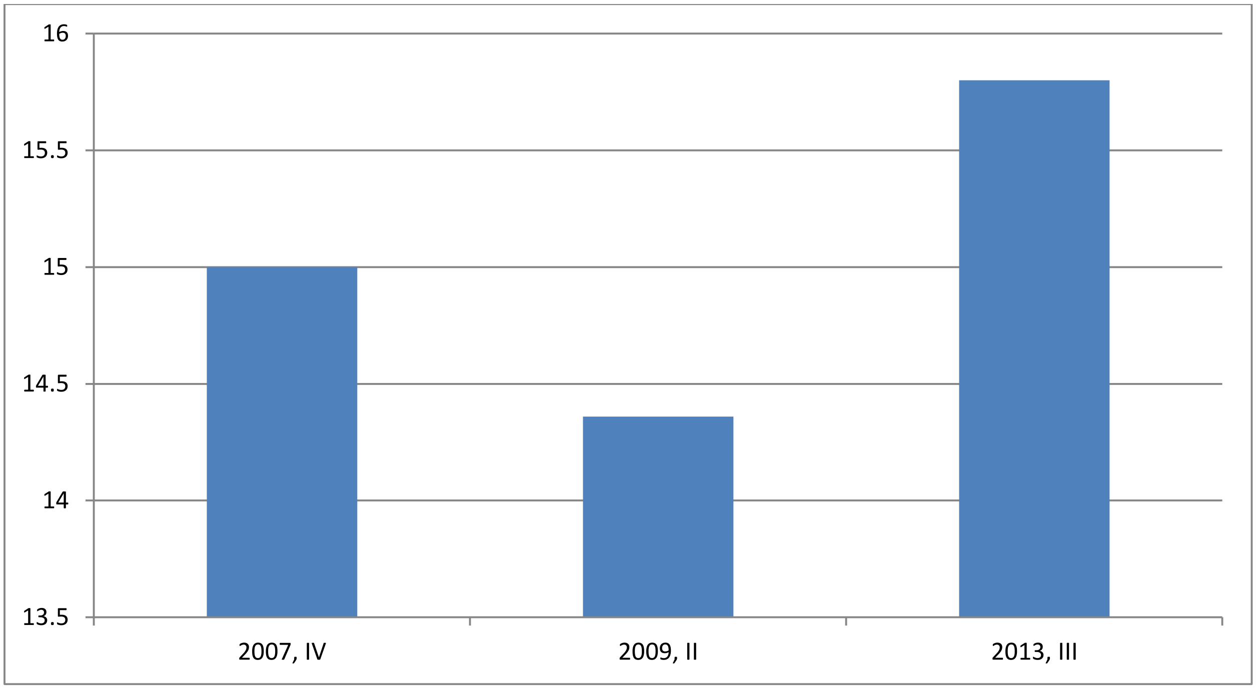
The broadest measure of the national economy – real gross domestic product – is expected to grow by 2.75% in 2014. Between 2.5 and 2.8 million net new jobs will be created nationally, and the national unemployment rate will fall to between 6.0 and 6.5% by year's end. The Federal Reserve, under new chairwoman Janet Yellen, will likely begin to "taper" their stimulative monetary policy, resulting in upward pressure on interest rates and more cautious advances in the financial markets

North Carolina's job growth has been improving in recent years, and this trend will continue in 2014 with the state seeing over 100,000 new net jobs created. Consequently, the state jobless rate will drop to between 6.5 and 7.0% by the end of 2014. Some regions of the state, such as the Triangle and Asheville, will have unemployment rates near 5% by the conclusion of 2014. These regions, plus Charlotte, will enjoy job growth significantly above both the state and national averages.

The Nation: Plodding Progress

It's the same song we've heard since the economic recovery began in mid-1990. The economy is improving, but at a slow rate. The good news is that

Figure1. U.S. Real Gross Domestic Product (2009 $ trillions)



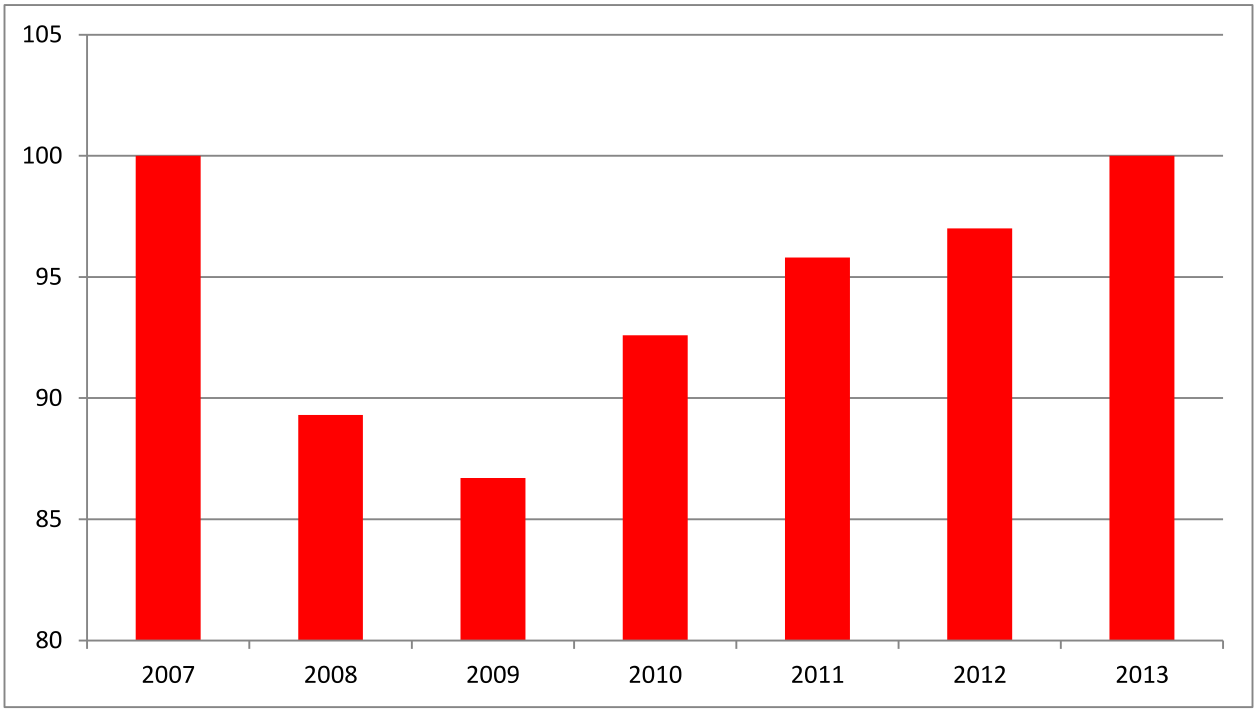
Source: U.S. Department of Commerce.

aggregate economic output (real Gross Domestic Product, Figure 1) is now well about its pre-recession level. The bad news is that the pace of growth has been modest – averaging only 2.4% on an annualized basis through the first three quarters of 2013.

Factory output (industrial production) returned to pre-recessionary levels in 2013 (Figure 2) and has improved twice as fast as total economic output since the bottom of the recession, implying households and businesses are acting on "pent-up demand".

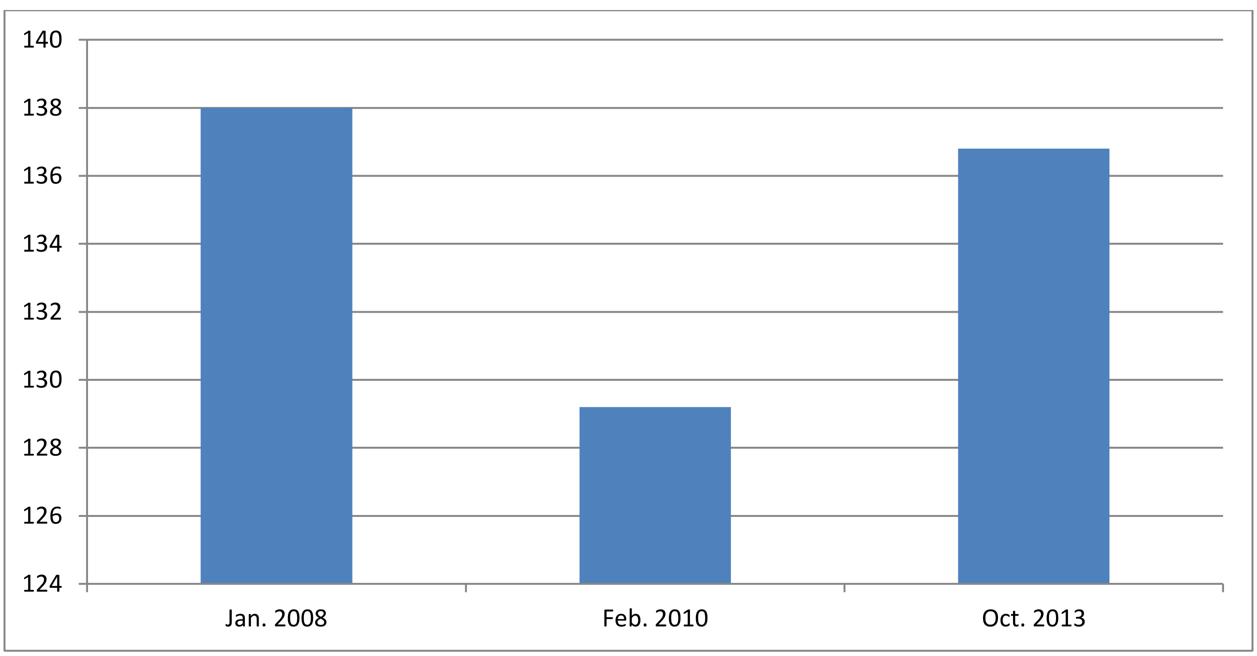
By the third quarter of 2013, payroll employment was at 99% of pre-recessionary levels (Figure 3). Still, due to the growth of the labor force, the

Figure2. Industrial Production (Index)



Source: Board of Governors of the Federal Reserve System. 2013 is for October.

Figure 3. National Employment (millions, estabalishment survey, seasonally-adjusted)

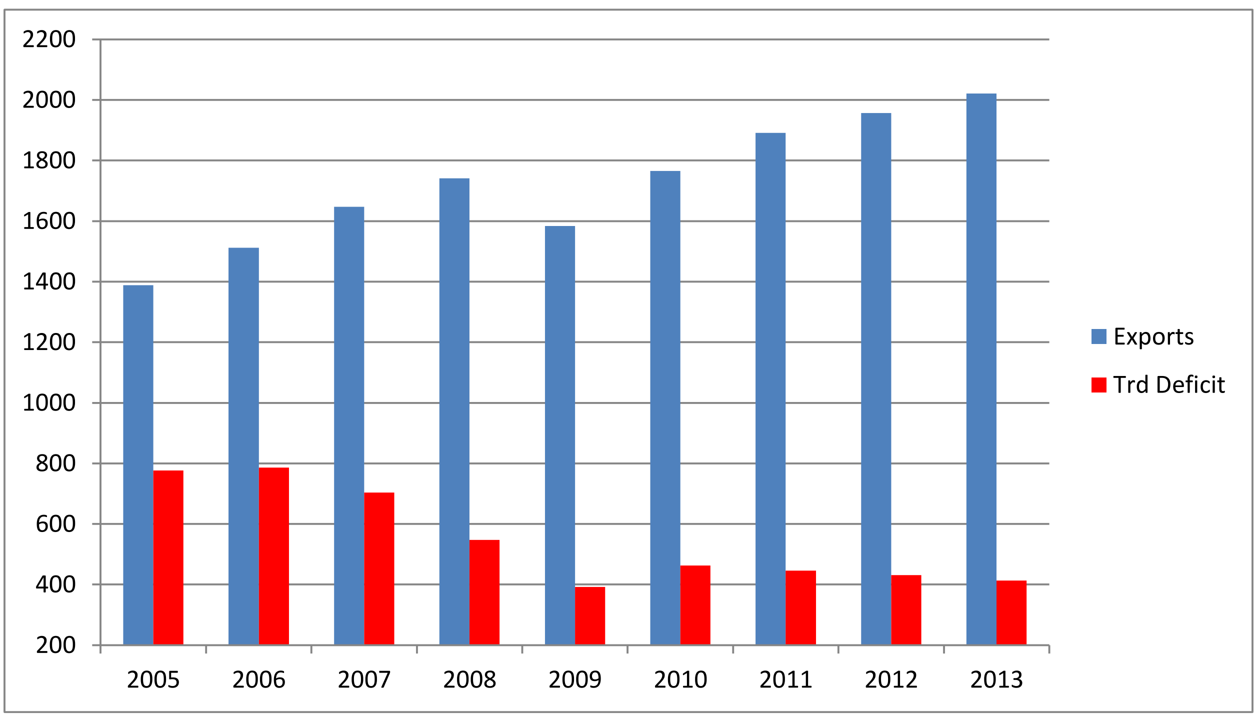


Source: U.S. Commerce Department.

"headline" jobless rate remained above 7% for most of 2013, and the broader unemployment rate (including unemployed workers who have not looked for work and individuals working part-time only because they can't find full-time work) stood above 13%. Unemployment remains the most severe among those jobless for a long period of time (more than 15 weeks). Unemployment among the short-term jobless (those without a job for less than 15 weeks) is almost at pre-recessionary levels. This difference suggests an inadequacy of marketable skills for those without a job for a long period.

Exports continued to be a "good news" item in the economy in 2013, again setting a record level (Figure 4). American producers are benefitting from more competitive labor costs compared to foreign producers and lower energy costs – thanks to increased domestic production. The latter is also a major element in reducing the U.S. trade deficit, which is now approximately one-third its level in 2005.

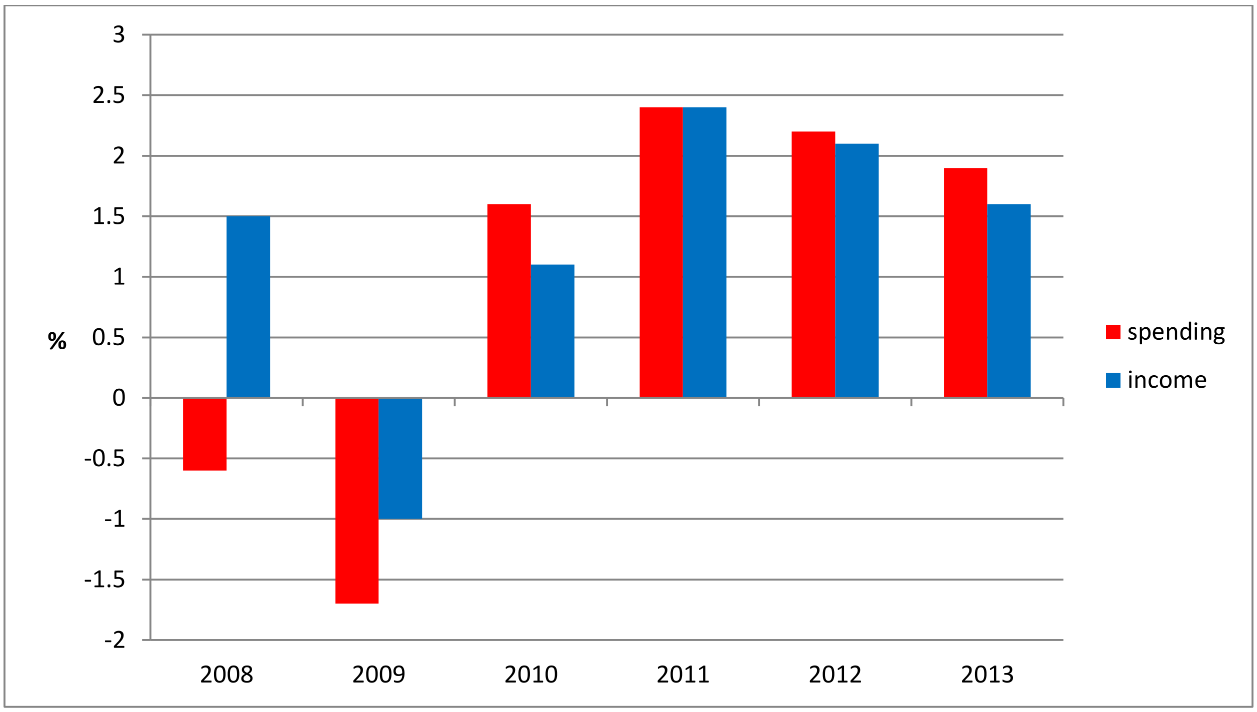
Figure 4. Exports and the Trade Deficit (2009 $ billions)



Source: Board of Governors of the Federal Reserve. 2013 is annualize through the third quarter.

With consumer spending the main driving force in the economy, there is a close link between spending growth and overall economic growth. This linkage continued in 2013, with consumer spending rising modestly at a 1.5% annual rate (Figure 5). There has been a steady decline in the rate of growth in consumer spending since 2011, potentially reflecting several forces – a maturing of the current economic expansion, satisfying of "pent-up" demand, or renewed uncertainty about the strength of the economic recovery.

Figure 5. Trends in Real Consumer Spending and Real Disposable Personal Income

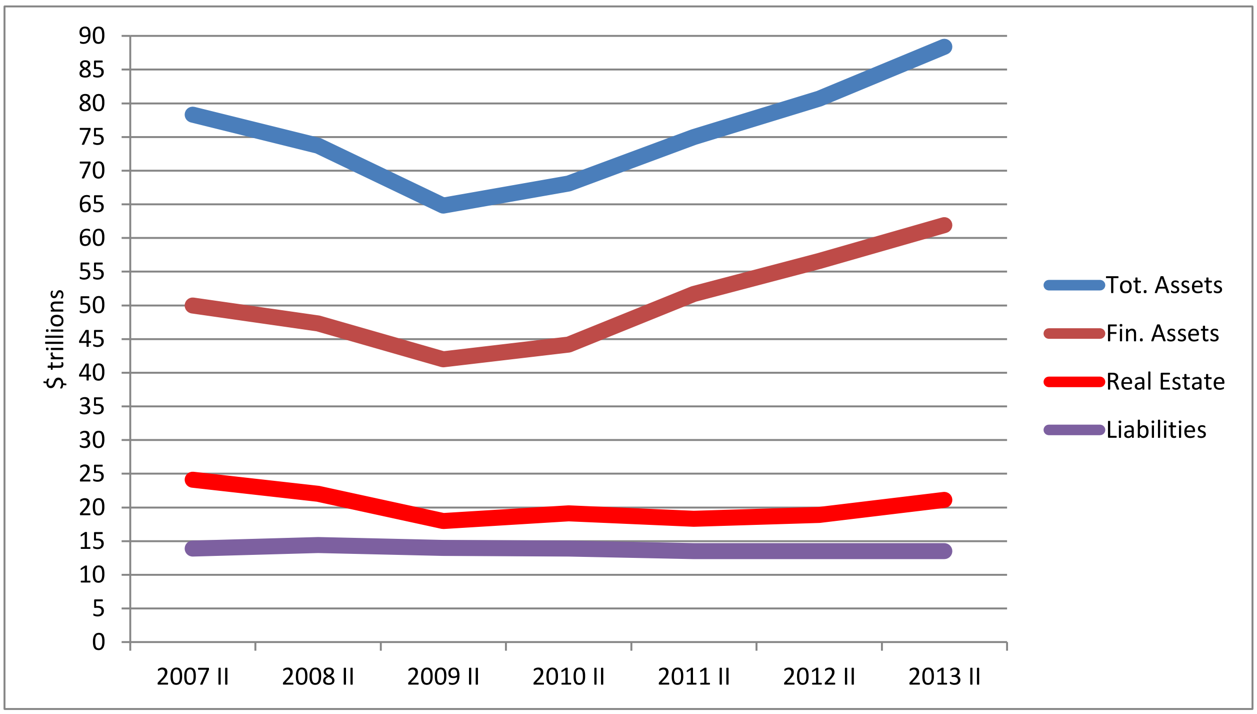


Source: U.S. Department of Commerce. 2013 is 2012 III to 2013 III.

The $16 trillion of household asset value lost during the recession has now been fully recovered (Figure 6). Both total asset values and financial asset values are now above their pre-recessionary levels. Real estate asset values have been improving, but are still below 2007 levels, yet liabilities are also under their recessionary peak.

These trends are important for three reasons.   A recovery of household asset values boosts consumer confidence. Higher household asset values also increase household wealth and generate new consumer spending.   Last, the implied lower liability/asset ratio suggests a greater borrowing capacity for households in the future.   Each of these factors are "bullish" for the economy.

Figure 6. Household Wealth Trends (nominal values)

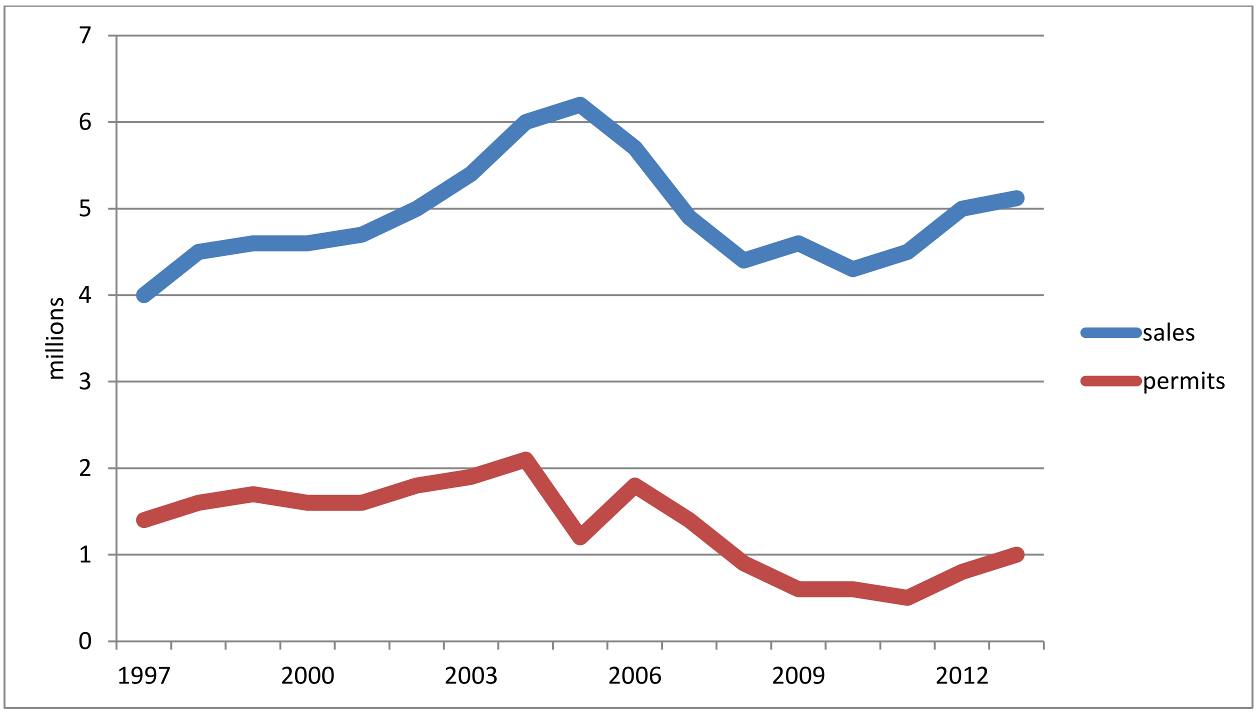


Source: Board of Governors of the Federal Reserve System.

It is now well-known that the 2007-2009 recession was prompted by first an "over-heated" housing market – which created an "investment bubble" in residential real estate – followed by a deflation of that "bubble" in the form of an unprecedented drop in home prices, home sales, and home construction.

Fortunately, the retreat in the housing market appears to have ended. For the second straight year, average housing prices, home sales, and home construction gained in 2013. While home sales and home construction are not back to pre-recessionary levels (Figure 7), those earlier numbers were not sustainable. The gain in home prices has significantly reduced the number of "underwater" homeowners (homeowners having a mortgage value larger than the home's value), repaired the balance sheets of lenders, and increased the confidence of both home buyers and home sellers.

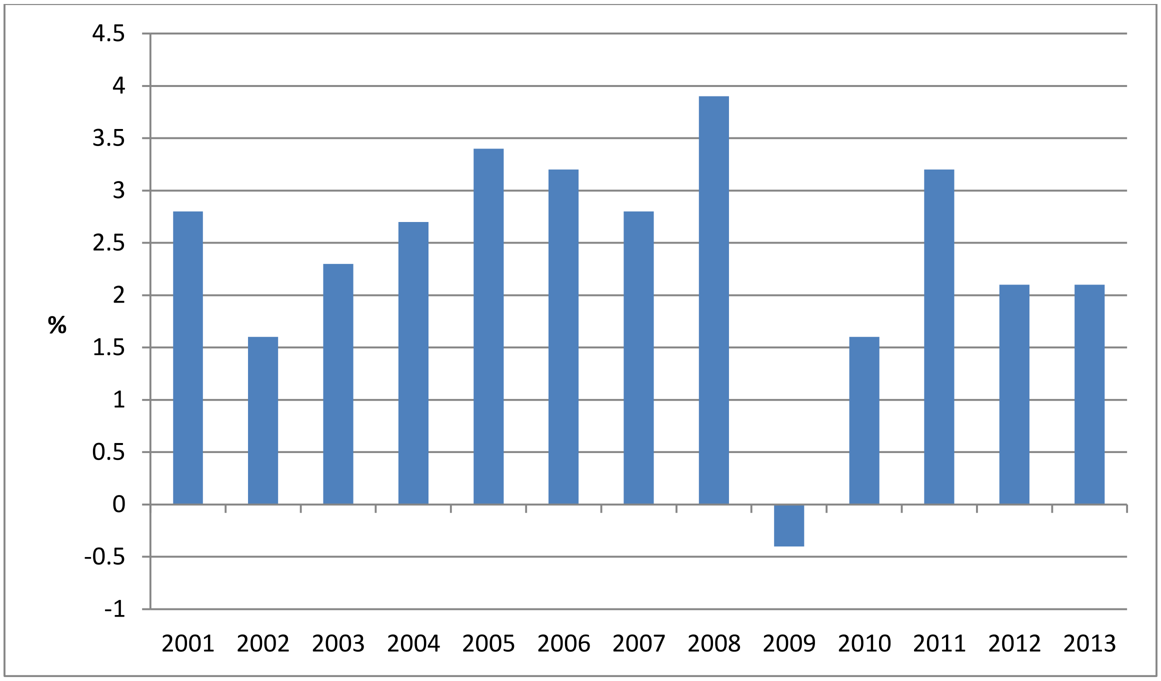
Figure 7. Single-Family Dwelling Unit Sales and Permits



Source: U.S. Census, National Association of Realtors. 2013 values are annual forecasts based on data through August.

The inflation rate continued to be modest in 2013, indicating a rise of 2% during the year in the prices of the average consumer's market basket of goods and services (Figure 8). Forecasts of future inflation rates, derived from econometric models and investment markets, suggest a continuation of this trend. Concerns

Figure 8. Total Inflation Rates at the Retail Level (Consumer Price Index)

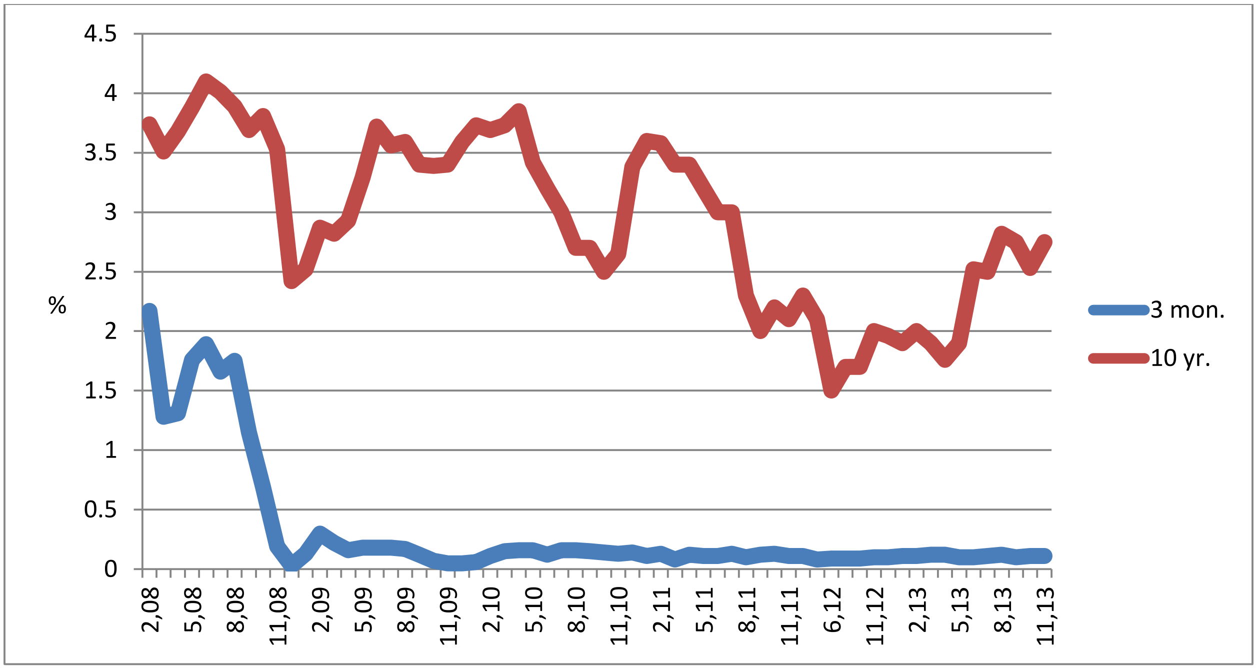


Source: U.S. Department of Commerce. 2013 is annualized based on data through October.

about a spike in inflation resulting from the infusion of liquidity (money) by the Federal Reserve over the past five years are moderated when it is realized that a large portion of these funds are being held by banks as excess reserves.

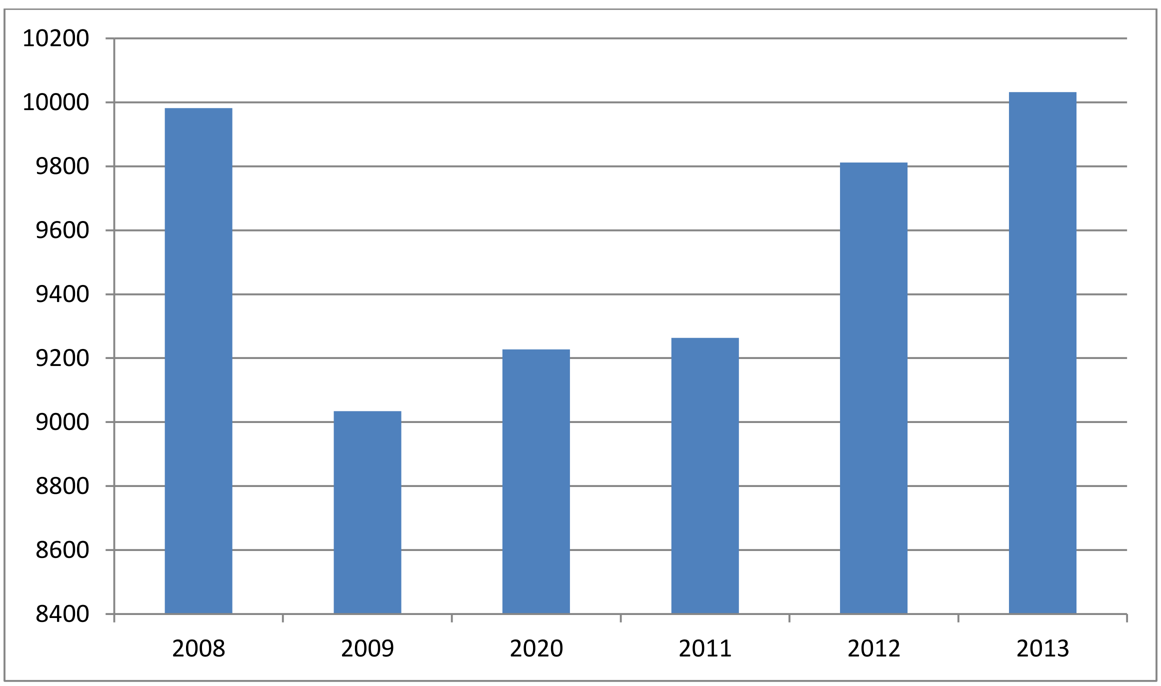
While short-term interest rates continued to hold at near zero levels – compliments of the Federal Reserve - long-term interest rates moved significantly higher in 2013, rising over 100 basis points (Figure 9). Most economists consider the move in long rates a positive sign, indicative of greater borrowing and an improved evaluation of the economic future. Indeed, outstanding bank loans in 2013 moved to levels higher than before the recession (Figure 10). Even with the recent moves, long-term interest rates still remain low by historical standards.

Figure 9. Trends in Short-Term and Long-Term Interest Rates (U.S. Treasury Security rates)



Source: Board of Governors of the Federal Reserve.

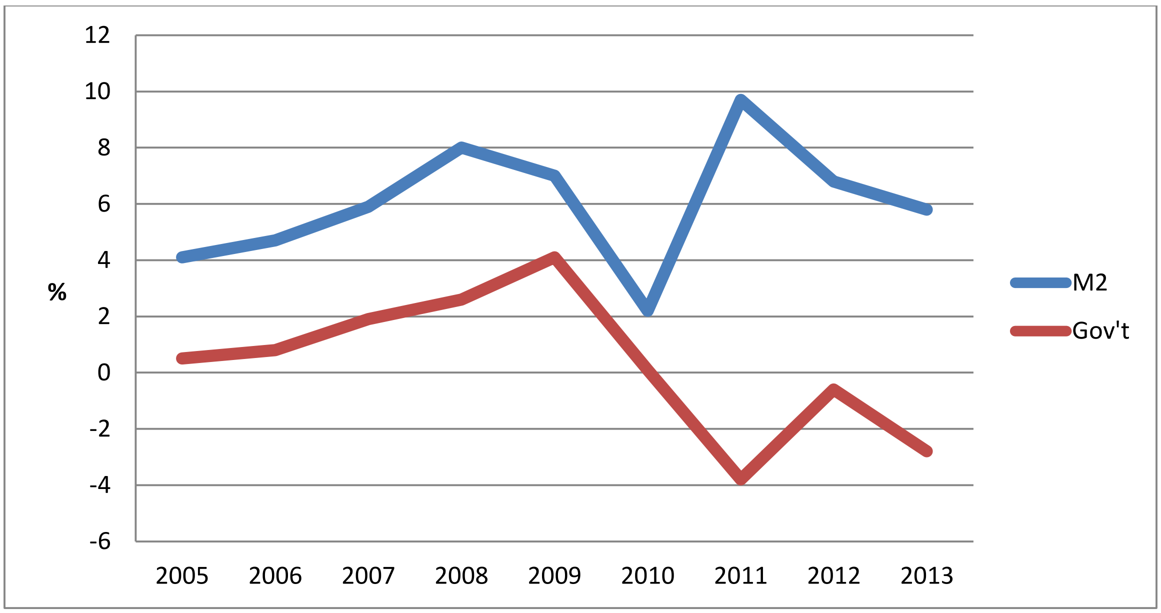
Figure 10. Outstanding Bank Loans (nominal $billions)



Source: Board of Governors of the Federal Reserve System. 2013 is for November.

Both monetary and fiscal policies became less stimulative in 2013. M2 money growth dropped a percentage point from its 2012 level, and government spending for purchases (current and investment) actually contracted during the year (Figure 11). The change in Federal Reserve policy may be a forerunner to its "tapering" of stimulus, ultimately leading to selling some of the holdings in its now very large portfolio.

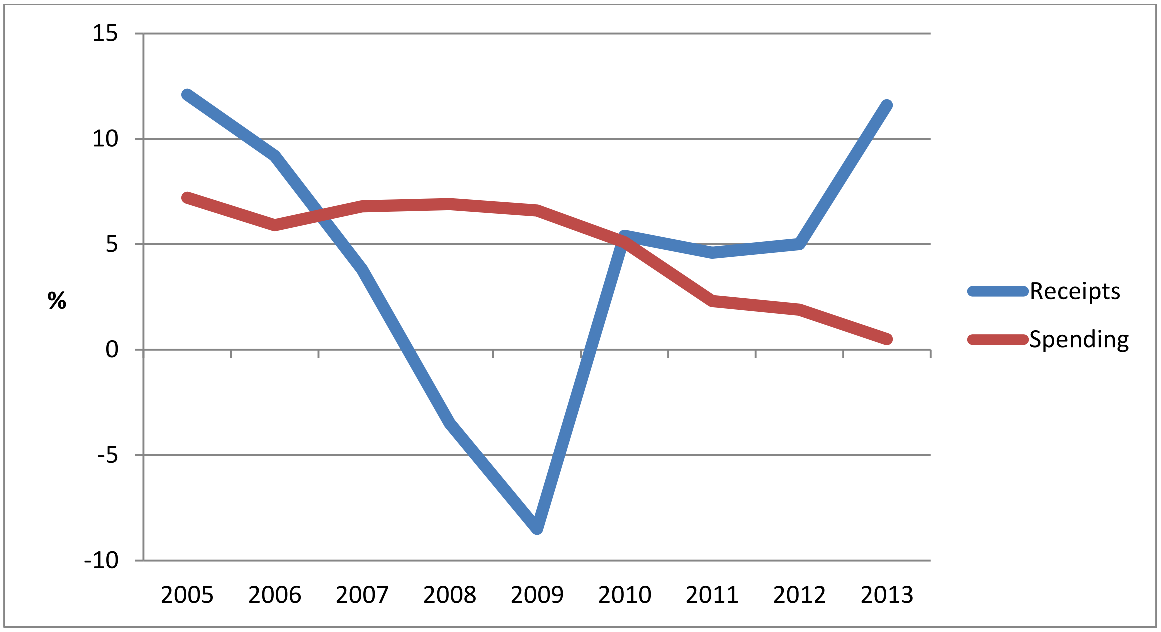
Figure 11. Annual Growth Rates in M2 Monetary Aggregate and in Total Government Consumption and Investment Spending (seasonally-adjusted real $)



Source: Board of Governors of the Federal Reserve System; U.S. Dept. of Commerce; 2013 is October year over year for M2 and third quarter year over year for government spending.

The origins of the fiscal pullback by the federal government can be seen in Figure 12. With the recovery in the economy – particularly in Gross Domestic Product – federal revenues surged in 2013. At the same time, the federal budget sequester caused spending growth to drop to near zero. There is a major debate among economists about whether the "tightening" of fiscal policy has contributed to sluggish economic growth.

Figure 12. Annual Change in Total Government Receipts and Spending (nominal $)



Source: U.S. Dept. of Commerce. 2013 is annualized through the second quarter.

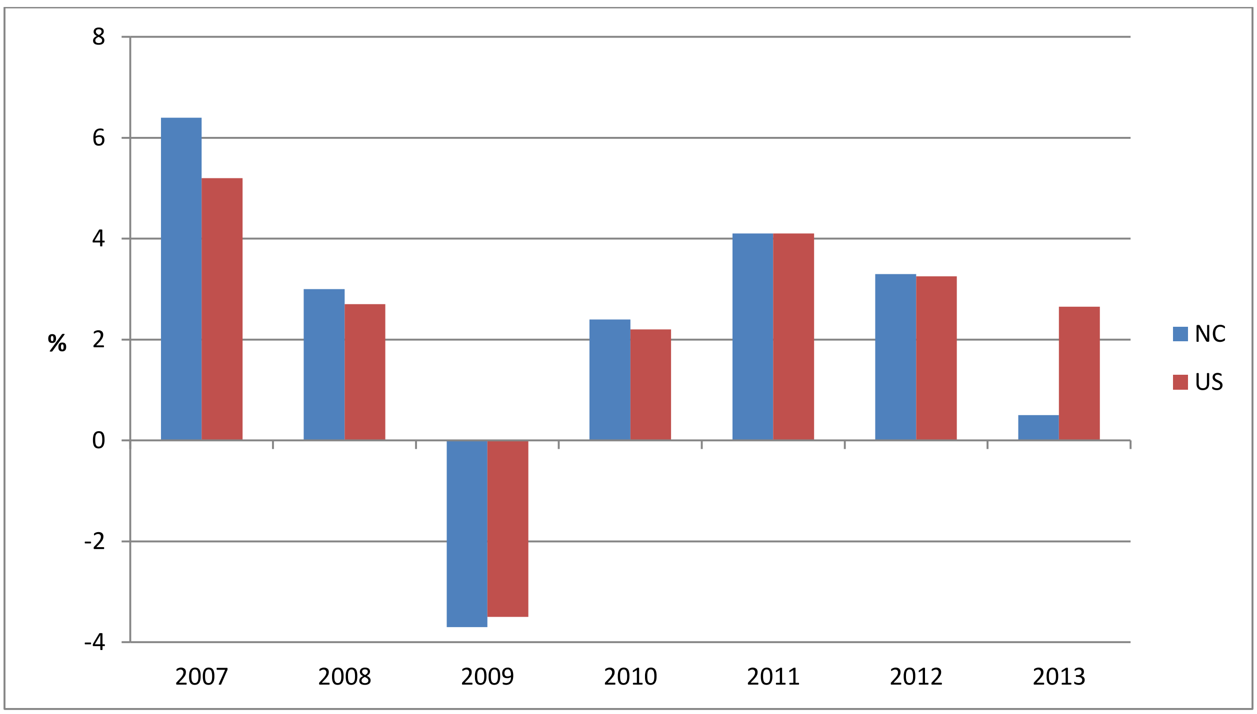
The national economy should enjoy another year of growth in 2014. The growth rate of real Gross Domestic Product should be near **2.75%**. Between **2.5 and 2.8 million payroll jobs** will be added, thereby lowering the national (headline) **unemployment rate to between 6.0% and 6.5% by year's end**. If these numbers occur, the Federal Reserve will likely begin its "tapering" program of increasing short-term interest rates and selling financial investments – such as mortgages – from its portfolio. The challenge will be for the Fed to do this in such a way as to not spike interest rates and curtail economic growth.

The housing recovery will continue, but with price gains moderating. A boost in construction will spur increases in construction jobs, which will be a major aid to improving the employment picture. Still, challenges remain for moving the long-term unemployed to jobs and ensuring that jobless workers obtain the necessary skills for employment.

North Carolina: A Return of Jobs

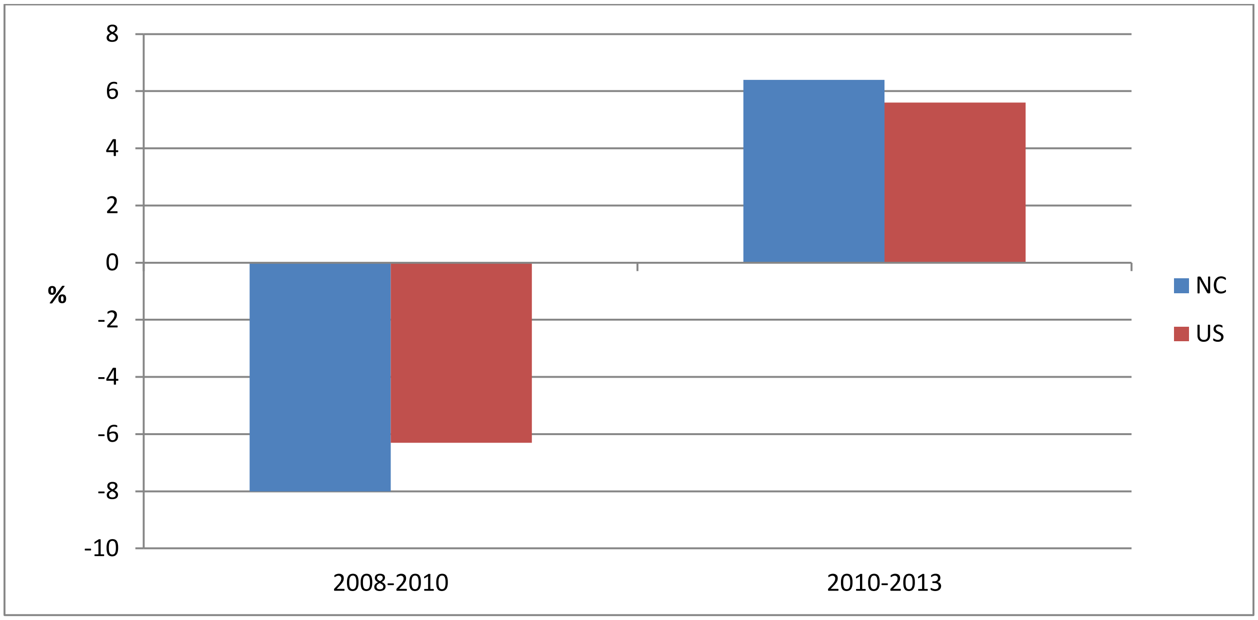
North Carolina's economy outpaced the national economy in 2013. Growth in total labor compensation – a proxy for Gross Domestic Product which is only available for states with a considerable time lag – was significantly stronger for North Carolina than for the nation (Figure 13). The growth in payroll jobs during the year (October 2012 to October 2013) was also greater in the state, at 2% versus 1.7% for the nation. This continues the trend of faster job growth in North Carolina since 2010 (Figure 14).

Figure 13. Annual Change in Total Labor Compensation, U.S and N.C. (nominal $)



Source: U.S. Department of Commerce. 2013 is annualized through the second quarter.

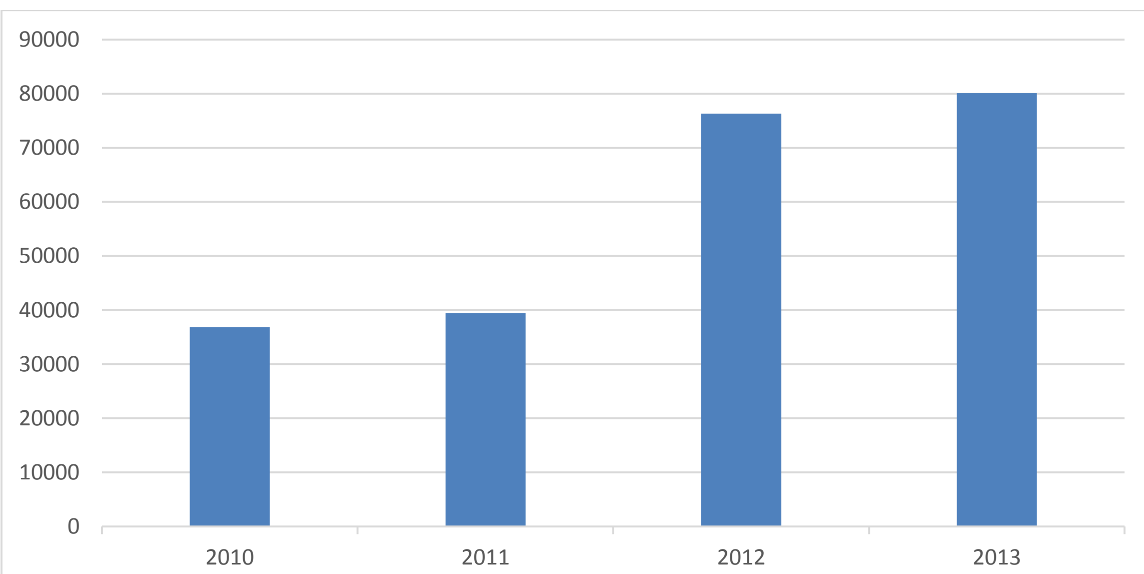
Figure 14. U.S. and N.C. Job Markets During the Recession and Recovery



Source: U.S. Department of Commerce. 2013 is through October.

The state's job growth has also been accelerating (Figure 15), and payroll employment in the state at the end of 2013 (October) was only 3% below the pre-recessionary high. However, close to 70% of the net job growth in both 2013 as

Figure 15. Increases in North Carolina Payroll Employment During the Recovery (#)

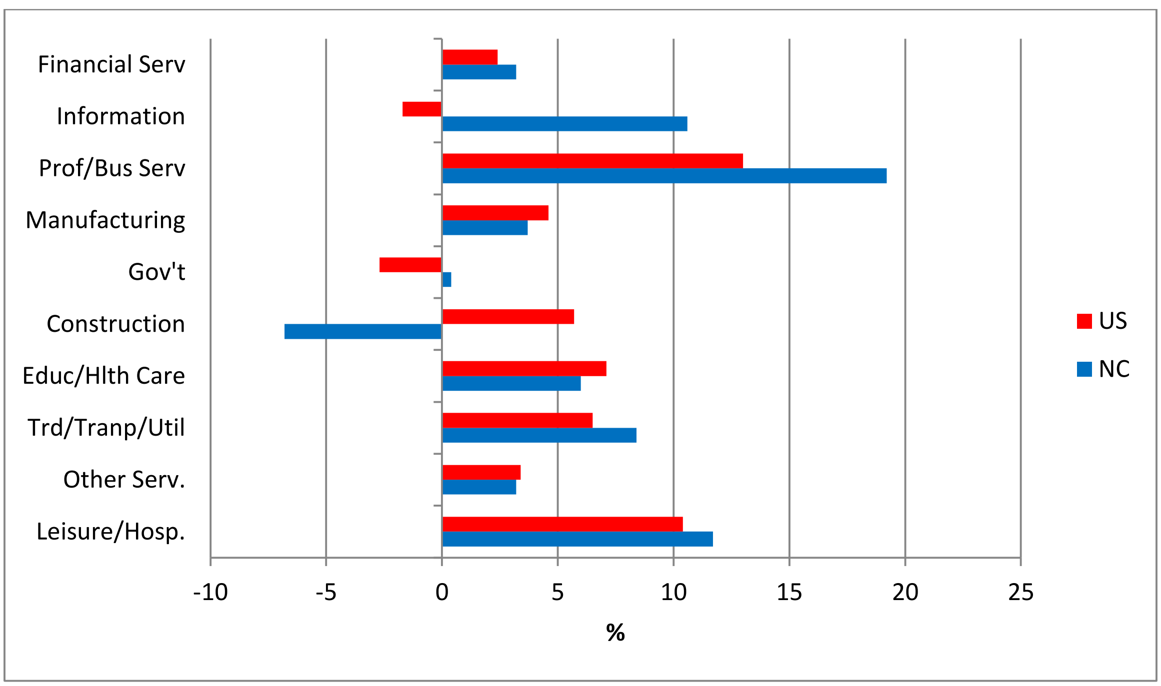


Source: U.S. Department of Commerce; seasonally-adjusted. Years measured from October to October.

well as from 2010 to 2013 has been in the state's three largest metropolitan areas – Charlotte, the Triangle, and the Triad. This is suggestive of the continuing economic divide between metro North Carolina and small town/rural North Carolina.

Figure 16 shows trends in job totals since the start of the job recovery in February 2010 through October 2013 for major economic sectors in the nation and state. North Carolina has had faster gains in financial services, professional/business services, government, trade/transportation/utilities, and leisure/hospitality. The state has recorded slower gains – or losses – than the nation in manufacturing, construction, education/health care, and other services. The difference for construction is startling. If North Carolina's construction sector had added jobs at the same pace as the nation between 2010 and 2013, 10,000 additional jobs would exist in the state. An examination of construction employment within individual markets in North Carolina shows the largest lags in job creation have been in the Triangle and Wilmington markets.

Figure 16. Growth Rates in Employment by Sector, N.C. and U.S., Feb. 2010-October 2013



Source: U.S. Department of Commerce; seasonally-adjusted data.

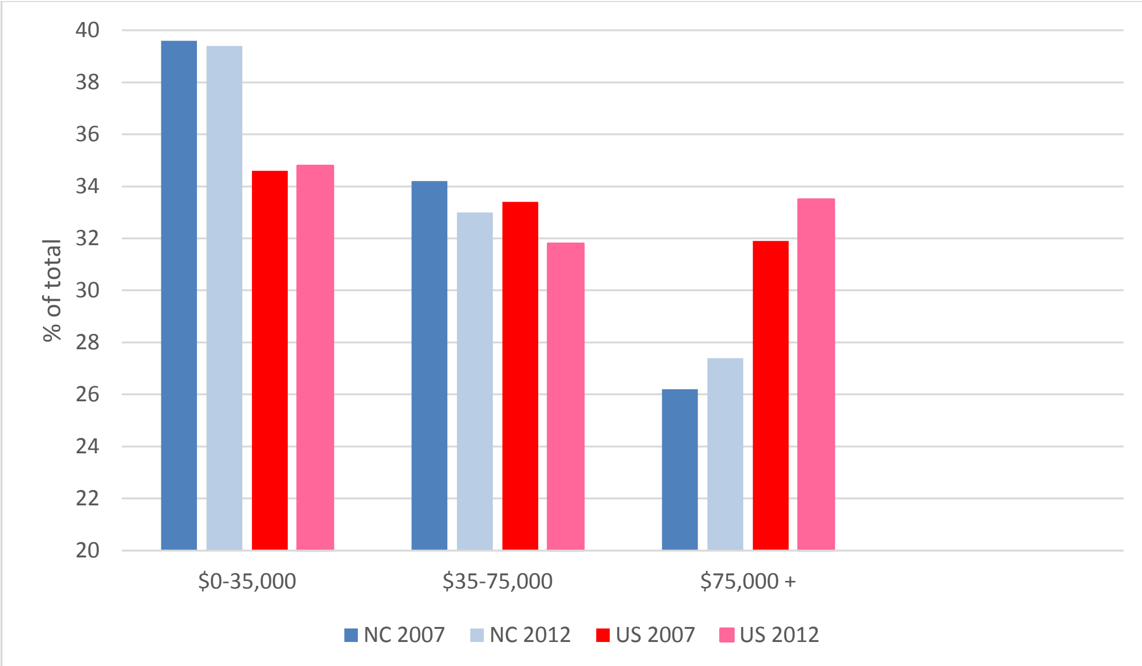
The improvement in the North Carolina job market has resulted in a drop in the state's unemployment rate, which in October 2013 hit 8.0%, 1.4 percentage points lower than in October 2012 (Figure 17). North Carolina's jobless rate generally tracks higher than the national rate during job recessions (see 2001 to 2003 and 2008 to 2010 in Figure 17), but moves closer to the national rate in economic expansions (see 2004 to 2007 in Figure 17). Since 2011, North Carolina's unemployment rate has fallen by 2.2 percentage points, compared to a reduction of 1.6 percentage point for the nation.

There is evidence of a continuing widening of income disparities in both North Carolina and the nation. Figure 18 shows the percentage of households in three income (including government benefits) categories in 2007 and in 2012. For both North Carolina and the nation, there was little change in the percentages for the lowest income category. However for the state and the nation, there was a noticeable decline in the household percentage in the middle income category and a significant increase in the household percentage in the upper income category. These results suggest economic forces are reducing the percentage of middle income households and increasing the "distance" between lower income and upper

Figure 17. North Carolina and U.S. Unemployment Rates

Source: U.S. Department of Commerce; seasonally-adjusted; October for each year.

Figure 18. Distribution of Households by Range of Income + Benefits, 2007 and 2012 (nominal dollars)

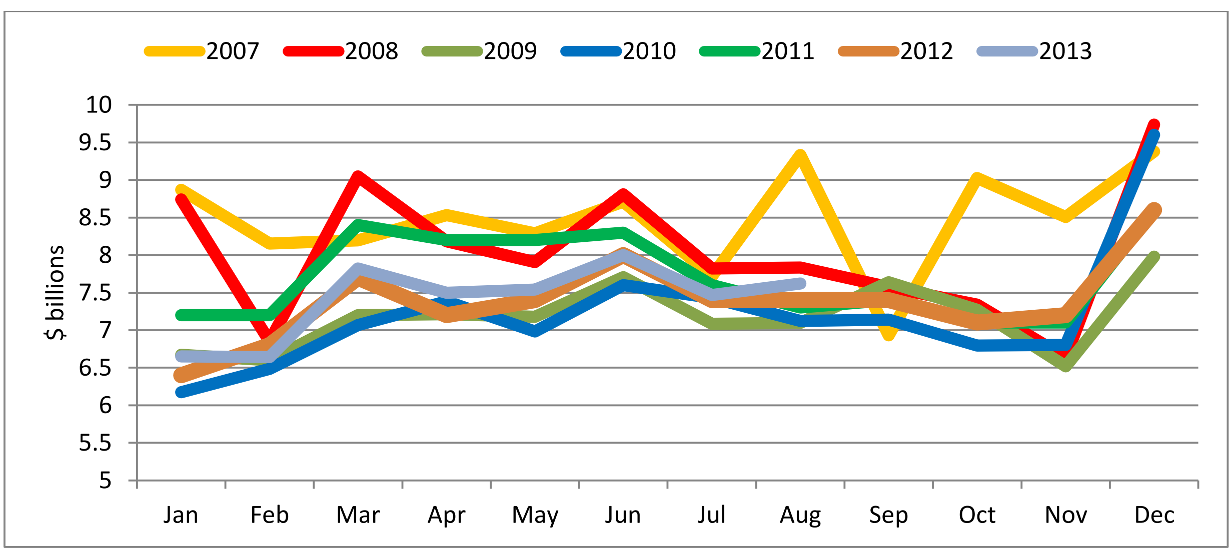


Source: U.S. Census.

income households.

A broad indicator of the North Carolina economy is taxable retail sales. Figure 19 shows 2013 retail sales closely tracking 2012 levels. Retail sales

Figure 19. Trends in North Carolina Retail Sales (real 2005$, not seasonally adjusted)

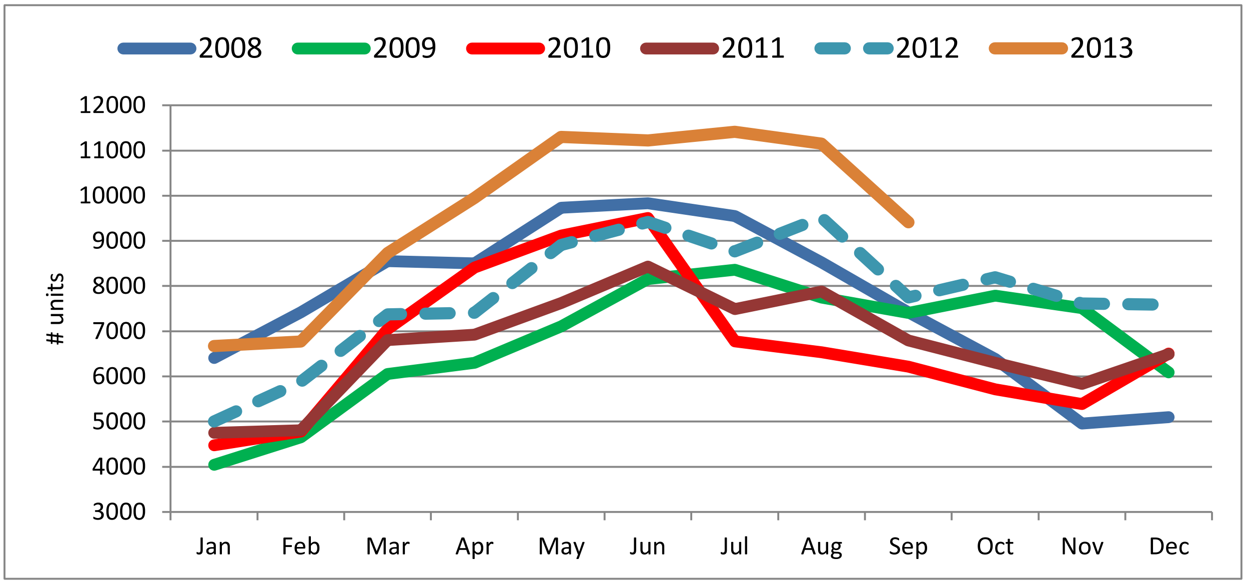


Source: North Carolina Department of Revenue.

in 2013 have also been better than 2009 and 2010 levels but not as robust as sales in the pre-recessionary years of 2007 and 2008. Of course, increases in on-line purchases continue to impact retail sales at traditional outlets.

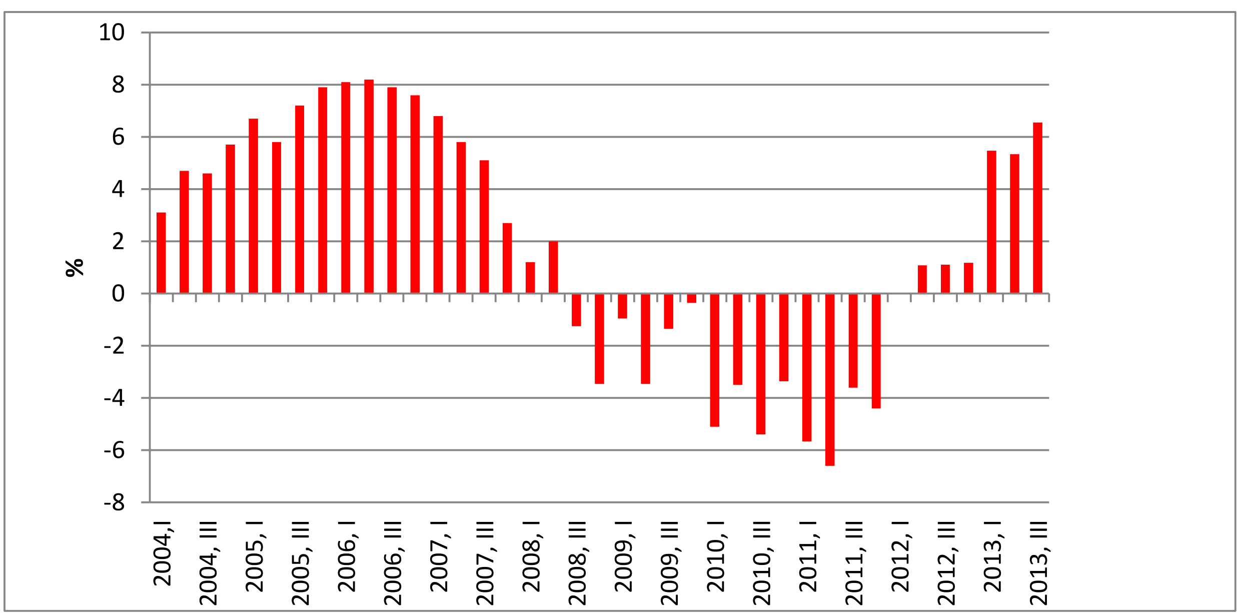
North Carolina existing home sales in 2013 were at their highest level in six years (Figure 20), suggesting the housing market is recovering in the state. Home

Figure 20. North Carolina Existing Home Sales (not seasonally-adjusted)



Source: North Carolina Association of Realtors.

Figure 21. North Carolina Single-Family Dwelling Appreciation Rate (annualized and sea.-adj., quarterly

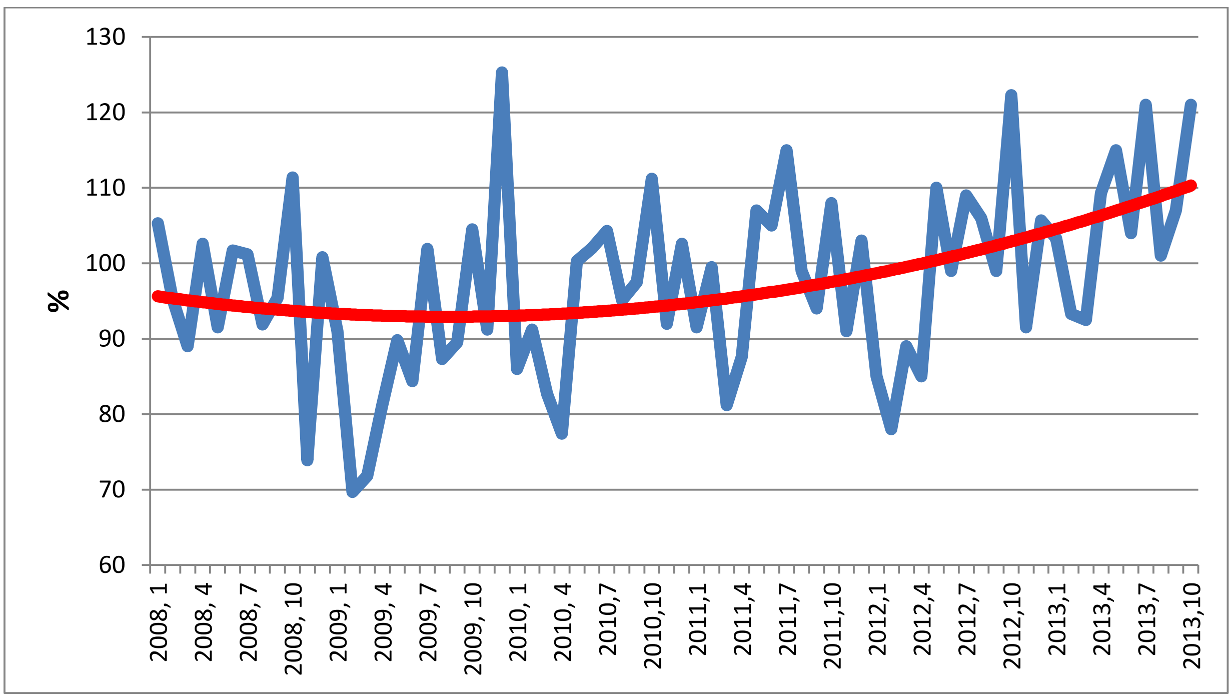


Source: Federal Housing Finance Agency.

prices also gained during the year, with annualized price increases of near 6% (Figure 21). Annual home price gains will likely moderate in the future toward their long-run average of near 3%.

Also reflecting the improvement in the state's economy, state tax revenues trended upward in 2013 (Figure 22). Tax revenues available to the state are now higher than prior to the Great Recession.

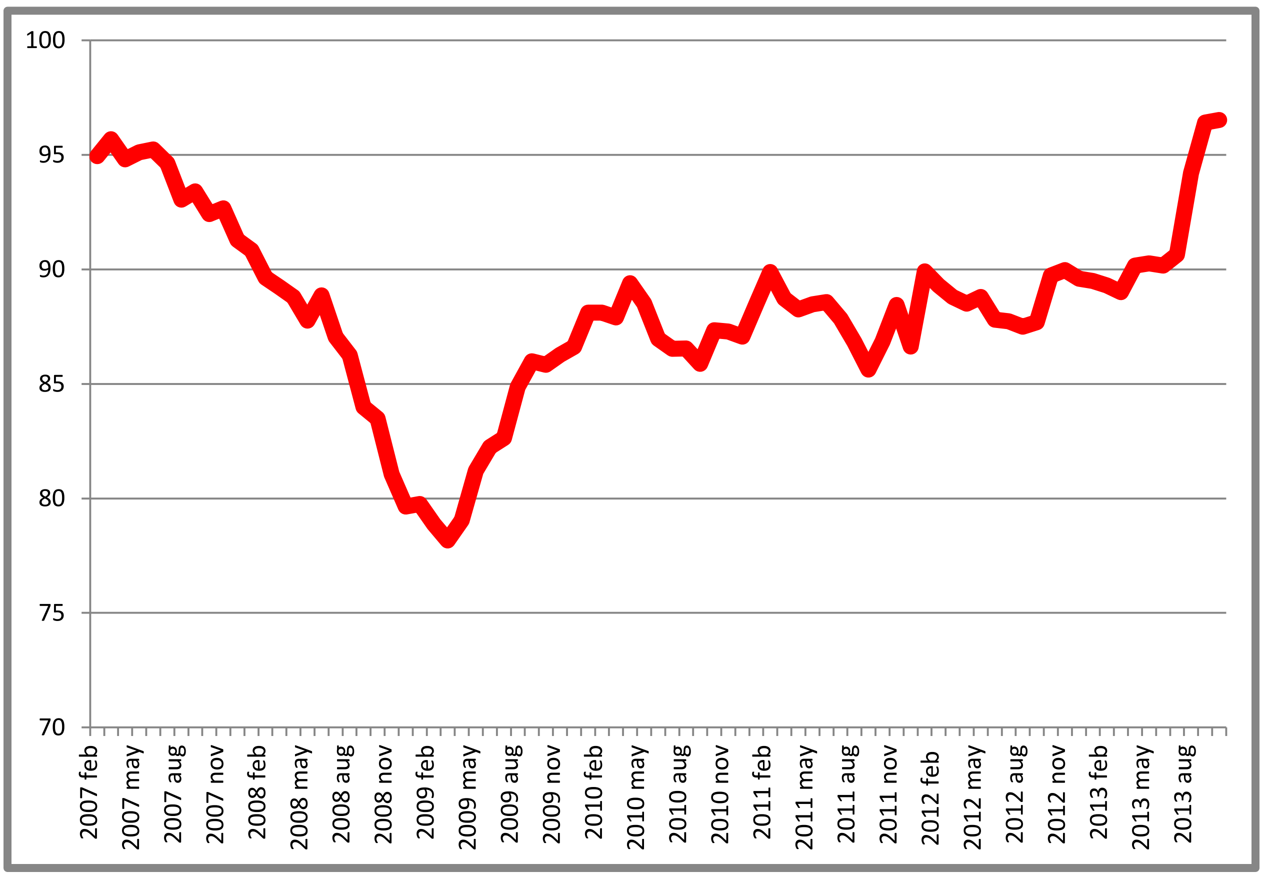
Figure 22. North Carolina State Tax Revenue from Own Sources as a Percentage of Revenue in the Same Month in 2007 (nominal dollar values; trend line in red)



Source: North Carolina Office of the State Controller; author's calculations.

The NCSU Index of North Carolina Leading Economic Indicators (Figure 23) is designed to indicate the path of the state economy four to six months ahead. It is composed of a national leading index, initial North Carolina jobless claims, building permits issued in the state, and average weekly hours worked and average weekly earnings in the state's manufacturing sector. After showing little movement in early and mid-2013, the Index jumped at the end of the year, suggesting an acceleration in the state's economic growth in 2014.

Figure 23. NCSU Index of North Carolina Leading Economic Indicators



Source: Author's calculations.

Looking ahead, North Carolina has now been in an economic expansion for four years, and all signs suggest this growth will continue into 2014. Job growth has steadily been improving. *The North Carolina Economic Outlook* projects ***at least* 100,000 net payroll jobs will be added in the state in 2014, lowering the seasonally-adjusted statewide unemployment rate to between 6.5% and 7.0% at the end of 2014.** Contributing to the state's growth will be its competitive cost structure, location in the southeast, attractive amenities, and the dynamics of its two "racehorse" regions, Charlotte and the Triangle.

But North Carolina will still be challenged by several "headwinds". Although the state has made tremendous progress in improving educational attainment in recent decades, it continues to lag the national average on this measure. The percentage of North Carolina households with a graduate or professional degree is still 15% under the national rate, and the percentage of households without a high school degree is 9% above the national rate (2012 data from the U.S. Census).

Manufacturing in the state still accounts for over 400,000 jobs, but the reduction in jobs – even while production is rising – will continue. Since 1990 manufacturing employment in North Carolina has declined by 45%, but production has still gained with a shift from labor to machinery and technology on the factory floor. This shift may actually accelerate in coming years, creating a challenge for the state to find new employment opportunities for the displaced workers.

Lastly, the shift in the economic composition of North Carolina – from the traditional "big three" of tobacco, textiles, and furniture to new production and service sectors - continues to influence employment opportunities. The shift is largely complete in the metropolitan counties, where the location of universities and a college-educated workforce has made those regions more fluid and dynamic. But the transition has been enormously more problematic in small town/rural counties, where lower levels of educational attainment have made it difficult to attract jobs – particularly high-paying ones.

Regional North Carolina Trends: A State of Many Parts

Regions in North Carolina have typically grown at different rates, and recent experience is no exception. Table 1 shows the job growth rates in the state's metropolitan regions and aggregate rural area for the recent year (October 2012 – October 2013) as well as for the entire period since the jobs recession ended in February 2010.

Table 1. Payroll Employment Growth in North Carolina Metropolitan and Rural Areas, Oct. 2012-Oct. 2013 and Feb. 2010-Oct. 2013 (seasonally-adjusted)

Region (ranked by 2013 Growth Rate)	2013 Growth Rt.	2010-2013 Growth Rt.
Charlotte	3.3%	11.5%
Durham-Chapel Hill	2.8%	7.4%
Asheville	2.6%	6.9%
Raleigh-Cary	2.1%	9.2%
North Carolina	**2.0%**	**6.4%**
U.S.	**1.7%**	**5.6%**
Rural	1.7%	4.7%
Winston-Salem	1.6%	4.1%
Greensboro-High Point	1.6%	3.6%
Burlington	1.2%	6.1%
Jacksonville	1.2%	2.9%
Goldsboro	1.2%	1.4%
Fayetteville	0.8%	1.5%
Wilmington	0.6%	3.9%
Hickory	0.6%	1.6%
Greenville	0.0%	4.2%
Rocky Mount	-1.9%	-3.3%

Source: U.S. Department of Commerce.

The regions can be grouped into three categories. First are the rapidly growing regions of Charlotte, the Triangle (Durham-Chapel Hill and Raleigh-Cary), and Asheville. Each of these areas has outperformed the state and nation in job growth during the past year as well as since the job market began improving. Next are regions that have not performed as well as the state and nation, but which are not far behind. The Triad (Greensboro-High Point and Winston-Salem), Burlington, and – perhaps surprisingly – non-metro, or rural, counties - are in this group. It should be noted that Burlington's longer-run job growth has been much better than its recent job growth – so by longer-run growth Burlington would be in the top category. Last are regions that have significantly under-performed the state and nation on job growth. This group is composed of Jacksonville, Goldsboro, Fayetteville, Wilmington, Hickory, Greenville, and Rocky Mount. With the exception of Hickory, these regions are in eastern North Carolina.

Although Wilmington and Greenville experienced no or slow job growth in 2013, their growth since 2010 is much better – therefore Wilmington and Greenville likely have better growth potential than their counterparts in the category.

Table 2 presents forecasts for unemployment rates for the state's regions at the end of 2013 and the end of 2014. Asheville, Durham-Chapel Hill, and Raleigh-Cary are forecasted to have the lowest unemployment rates over the next year, with each of these regions approaching a jobless rate of 5%. Fayetteville, Rural North Carolina, and Rocky Mount are projected to have the highest rate of joblessness. All regions, however, should see reductions in their unemployment rate.

Table 2. End-of-Year Unemployment Rate Forecasts, % (seasonally-adjusted)

Region (ranked by 2013 Unemploy. Rt.)	**December 2013**	**December 2014**
Asheville	5.8	5.1
Durham-Chapel Hill	6.0	5.3
Raleigh-Cary	6.1	5.2
U.S.	**7.0**	**6.3**
Jacksonville	7.5	7.0
Winston-Salem	7.5	6.9
Burlington	7.6	6.8
Charlotte	7.7	6.6
North Carolina	**7.8**	**6.7**
Wilmington	7.8	6.9
Greenville	7.9	7.4
Goldsboro	7.9	7.3
Greensboro-High Point	8.1	7.3
Hickory	8.6	8.2
Fayetteville	9.1	8.4
Rural	9.6	8.9
Rocky Mount	11.3	10.6

Source: author's forecasts

North Carolina's regions have different economic challenges and futures. The future is most upbeat for the top performing group – especially Charlotte and the Triangle. Growth in those regions will continue to be better than in both the nation and state. In the near term, the focus will turn to challenges of economic growth – congestion, school crowding, open space, water supply, and air quality. The regions will be motivated to deal with these issues in order to maintain their attractiveness to households and businesses.

The Triad and Burlington are transforming their economies to the 21st century, and while not yet as successful as Charlotte and the Triangle, their strong economic fundamentals (road and air transportation, location, trained workforce) mean they will eventually succeed. Agriculture and tourism – both expected to be "growth industries" in coming decades – will be the driving forces of Rural North Carolina.

With the exception of Hickory, the slowest growing regions are all in eastern North Carolina. Among these, Wilmington – with its economic base in the recovering tourism, second-home, and retirement sectors – and Greenville – centered on an expanding East Carolina University – have the best economic outlook. Fayetteville and Jacksonville's futures are clouded by the upcoming downsizing in the military. The other areas in this group are still coping with the transition from the traditional "big three" (tobacco, textiles, and furniture) to the new economy. One positive prospect for eastern North Carolina – particularly along the I-95 corridor – is the forthcoming completion of the Panama Canal. Set to open in 2015, some experts forecast a significant jump in cargo activity and cargo transportation along the U.S. east coast. Additional cargo shipments on I-95 could mean warehousing and servicing opportunities for adjoining counties.