

Regional Update: Modest Expansion Ongoing

On balance, the view from regional data and intelligence shared by our business contacts indicated that the southeastern economy continued to expand at a modest pace during the third quarter of 2013. Real estate, tourism, energy, and autos are components of the regional economy that continue to do very well, and manufacturing and employment are growing at a slow rate.

Home growth continues

Residential real estate has been recovering at a solid pace across the district as home sales, prices, and new construction continued to grow. According to the Atlanta Fed's regional housing survey, half of the responding brokers said that sales were up significantly in June compared with a year ago, and more than half of homebuilders reported sales were up slightly (see chart 1). The outlook for home sales and construction growth over the next several months remained positive, as more brokers and builders expect sales to increase over the next three months compared with a year ago.

However, in some markets, contacts have questioned the durability of the recovery in the sector. These contacts expressed concern that the rebound in home prices is driven mainly by constrained supply and that demand alone may not be vigorous enough to sustain future growth. Still-limited credit availability for many developers and smaller builders has been noted as one of the main factors slowing supply growth. Both builders and brokers in our regional housing survey continued to report generally sustained declines in home inventories (see chart 2).

Manufacturing sector expands

Manufacturing activity in the district has also been strengthening. The Southeastern Purchasing Managers Index, produced by Kennesaw State University, indicated expansion in the manufacturing sector, with growth in new orders and production accelerating (see chart 3). A number of our manufacturing contacts, especially larger companies and those in the auto sector, reported higher demand for their products.

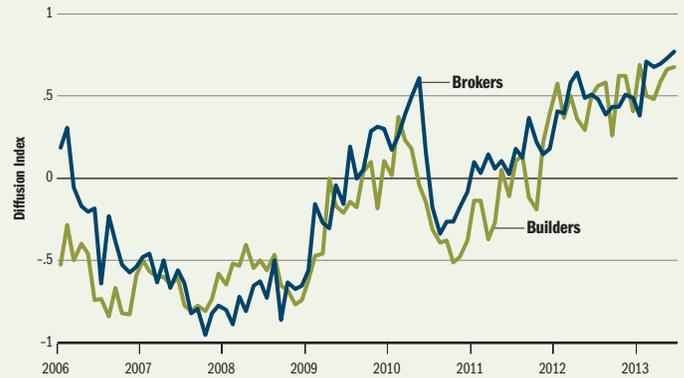
Activity in the energy sector remained robust, with substantial capital investment expected across the Gulf Coast. Significant capital investment is also being made in the utility sector, as coal-fired plants are being replaced with natural gas and nuclear generation.

Sequestration's effects limited

Contacts across the Southeast reported that the impact of sequestration on the private sector to date has been limited mainly to organizations that depend on federal funding or government contracts (see "On the Ground" on page 18). However, concerns about the potential negative effects of sequestration on the broader economy appear to have increased among some of Atlanta Fed contacts as they saw a pickup in furloughs in July.

Chart 1

June 2013 Southeast Home Sales versus a Year Earlier



Source: Atlanta Fed business contact poll

Chart 2

June 2013 Southeast Home Inventory versus a Year Earlier



Source: Atlanta Fed business contact poll

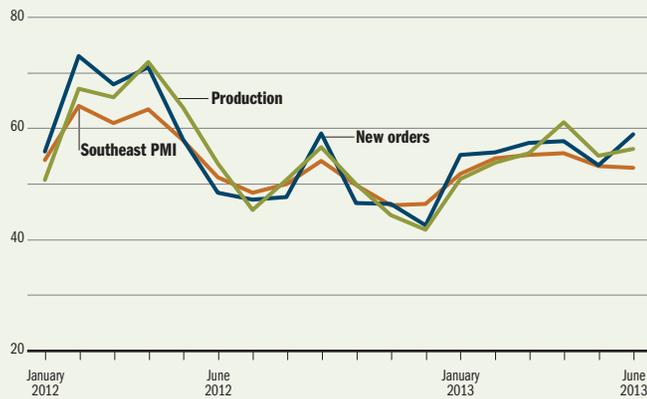
Hiring plans remain subdued

No major shifts in hiring plans have been detected. Payroll growth has slowed somewhat in the district over the past few months, with payrolls increasing by 10,100 in May and 14,600 in June compared with the average gains of 33,400 for the first four months of the year. However, the June payroll number was held back by a 15,700 decline in government jobs in Tennessee.

The unemployment rate in the district held at 7.6 percent in June, the same as the national rate. However, some southeastern states (Georgia, Mississippi, and Tennessee) still have unemployment rates significantly higher than the national rate.

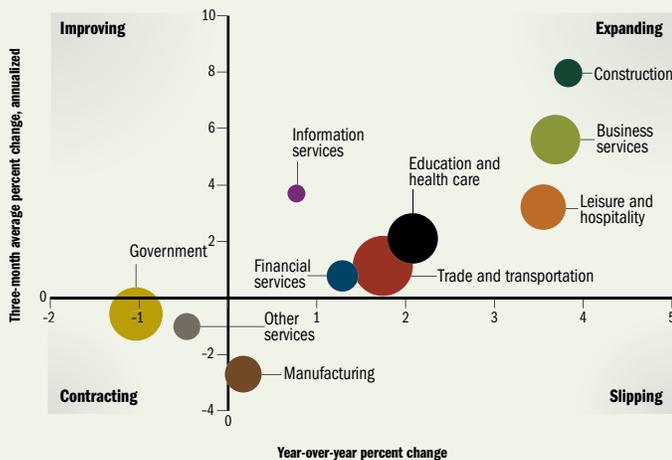
Looking at major industries, construction employment in the district had the strongest momentum in June amid the ongoing

Chart 3
Southeast Purchasing Managers Index



Note: A reading above 50 indicates an expansion in the region's manufacturing sector. A reading below 50 indicates a contraction.
Source: Kennesaw State University Econometric Center

Chart 4
Sixth District Employment Momentum by Industry



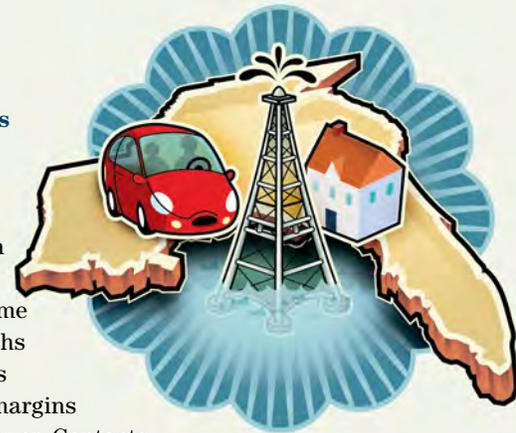
Note: Data are through June 2013.
Source: Atlanta Fed calculations

recovery in the real estate sector. On the opposite side of the hiring spectrum, government payrolls continued to decline, and the government sector remained the laggard among major industries in terms of employment momentum (see chart 4).

In terms of labor supply, contacts continued to report difficulty finding qualified workers for certain high-skilled positions in information technology, engineering, and accounting, as well as for some low-skilled jobs. Our business contacts reported an increase in firms hiring talent away from competitors.

Input prices and wages

According to our July business inflation expectations survey, costs were up 1.8 percent from a year ago and are expected to grow at the same pace in the next 12 months (see chart 5). Businesses continued to note tight margins and very little pricing power. Contacts that recently saw their input costs decline due to the moderation in some commodity prices do not intend to pass on lower costs to their customers, preferring to hold onto higher margins. Wage pressures remain low, except for the industries where workers are in short supply, such as IT and construction. Wage increases in the 2 percent to 3 percent range are still standard, with the distribution of increases weighted toward workers whose skills are in high demand.

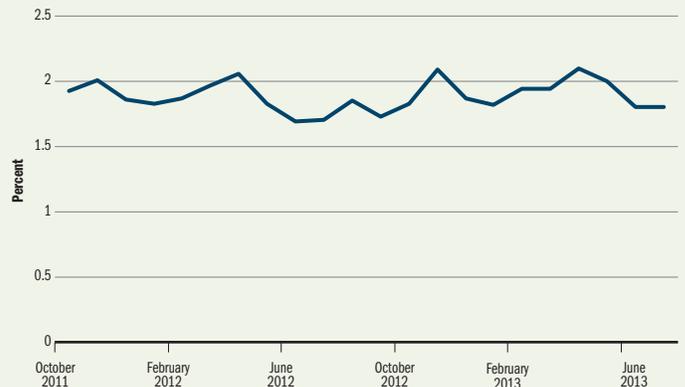


Investment and capital

Companies continued to invest in automation to improve efficiencies and reduce costs. Also, there have been reports that manufacturers that practiced the “fix it when it breaks” approach during the downturn and recent recovery are now engaging in regular maintenance again. However, reports of major capital expansions are still rare with the exception of firms and suppliers in the energy and automotive sectors.

Most businesses that the Atlanta Fed contacted are not changing their borrowing decisions in response to the recent rise in interest rates. However, some reports indicate that

Chart 5
Firms' Year-Ahead Unit Cost Expectations



Note: Data are through July 2013.
Source: Atlanta Fed Business Inflation Expectations (BIE) Survey

companies have begun engaging more actively in interest-rate hedging and have been increasingly asking for longer-term, fixed loan rates.

Near-term business expectations

The outlook among our business contacts across the Southeast remained optimistic. Most industries continued to grow, and the majority of contacts expect overall activity to be sustained at current or higher rates over the next three to six months (see chart 6).

This growth is expected to be driven by a combination of company-specific factors—such as the introduction of new product lines and service enhancements—and overall improvement in economic conditions as the real estate market continues to recover, credit availability increases, and consumer sentiment improves.

It bears watching whether the optimism expressed in Atlanta Fed polls and conversations with business leaders will translate into additional economic activity and a possible exit from this “steady-as-we-go” period. ■

On the Ground: An Interview with the Atlanta Fed’s Regional Executives

How is sequestration affecting business in your region?

Tom Cunningham, regional executive at the Atlanta Fed: The effects of sequestration depend on location. If you are in a locality that is dominated by a business or governmental entity that has been directly affected by the sequestration, you could be feeling some serious pain. If that isn’t the case, you aren’t.

The lack of a dramatic effect on the national economy is the result of a cumulative lack of effect on local economies. But the cuts to spending are real and cause real disruption wherever the spending has dried up. Research funding, for example, has taken a big hit. Institutions that depend on federal funding for research are scaling back, which can have serious consequences on portions of some universities, but it is often hard to see, given the large amount of churning among projects that would occur anyway. The aggregate numbers will look weaker, but whole departments are not shutting down.

The same holds true in areas of heavy government contracting. Specific

projects get defunded, and aggregate numbers look weak. If your job depends on that particular area that is no longer supported, you have a problem. But again, on a larger level, it is often difficult to identify the specific consequence of the sequestration from the everyday noise of the overall economy. One of the idiosyncratic cases where the consequence was clear was in air traffic control. Many Georgia towers were going to be closed, but the ensuing uproar from the general aviation population led to a reconsideration of the funding process, and the towers remain open.

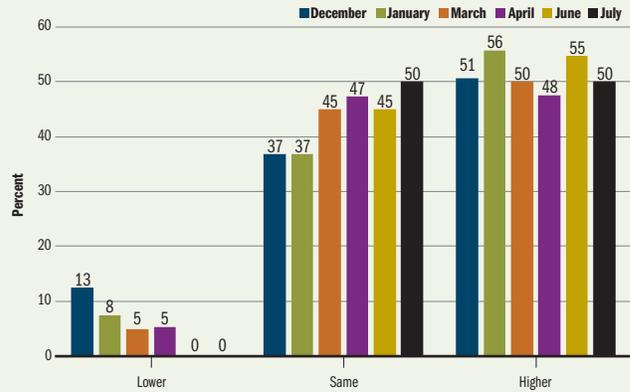
Lesley McClure, regional executive at the Birmingham Branch of the Atlanta Fed: This is a really interesting question. Although many businesses aren’t seeing any impact from sequestration, where it matters, it matters a lot. What I mean by that is that in some parts of the state, the impact appears to be negligible. I’ve spoken with contacts in construction and manufacturing, and sequestration isn’t on their radar at all. Yet Alabama is about seventh on a list of states hardest hit by

Department of Defense civilian-worker furloughs. More than 15,000 workers will be taking furlough days in Huntsville, 3,000 in Anniston, and several thousand more in Dothan and Montgomery.

Earlier this year, the measurable impact was muted as individuals and businesses really hoped there would be a resolution. But as the reality of sequestration sinks in, the effects are showing on the bottom line. I’ve already heard from a retail contact that traffic in his Huntsville store is down by a third. The trickle-down effect goes beyond reduced consumer spending for those directly furloughed; it includes job losses in companies providing services to defense and aerospace installations such as janitorial, groundskeeping, and food service contractors.

And the impact is not limited to defense and aerospace. The president of the University of Alabama-Birmingham said that cutbacks are costing the university \$15 million annually in research dollars. So far they have not cut jobs, but it’s not clear how long that can continue.

Chart 6
Firms’ Outlook for Near-Term Growth



Note: Respondents supplied their outlook for growth during the next three to six months compared with their current rate. Percentages may not total 100 as a result of rounding. Source: Poll of Atlanta Fed directors

Because of the geographic- and sector-specific nature of the impact of the cuts, it's hard to generalize, but there is no doubt that thousands of Alabamians are being personally affected and businesses are holding back to see if any relief may be forthcoming.

Chris Oakley, regional executive at the Jacksonville Branch: Surprisingly, to date there has been little impact from sequestration on most of the businesses I talk with. As a matter of fact, when I ask about the sequester, contacts will often react with an, "Oh yeah, that did happen, didn't it?" Some even go so far as to add that given their worries about the nation's fiscal situation, any spending reductions are welcome, though most indicate they would have preferred a more thought-out and strategic approach.

I recognize, however, that there are enterprises—especially those that provide support to the military—directly affected and whose expectations for this year have been radically changed. Further, certain areas in this part of Florida are more likely to be affected because of the concentration of military operations and support. And related to that, many of the Department of Defense furloughs are only just beginning, so it's too soon to tell how individuals and economic measures like consumer spending will be affected.

Our contacts in South Florida reported no noticeable impact of the sequestration to date.

Lee Jones, regional executive at the Nashville Branch: Based on what we are hearing from our branch directors and REIN contacts, the impact of sequestration on private businesses in Tennessee up to now has been confined primarily to organizations that depend on federal funding or government contracts. Interestingly, within this somewhat limited group, the impact of sequestration as well as the responses to deal with it have been quite varied. The vast majority of contacts reported that private business

has yet to experience any real, noticeable impact from the sequestration.

Essentially, there are three geographic areas in the region that depend heavily on federal government funding. These are Clarksville, home of Fort Campbell and the Army's 101st Airborne Division; the Department of Energy's Oak Ridge National Laboratory (ORNL) complex in East Tennessee; and Arnold Engineering Development Corporation (AEDC) in middle Tennessee at Arnold Air Force Base in Tullahoma.

Branch Director Kathleen Calligan is president of the region's Better Business Bureau and spends a good deal of her time working with businesses and military personnel in the Clarksville area. She reports that private business/consumer activity in the market has not declined over the past six months. Similar sentiments were also reported for the areas surrounding the ORNL and AEDC facilities, where initially there were great concerns over the sequestration. In Oak Ridge's case, one of the branch's contacts had assumed that the cuts were forthcoming and had already experienced almost 5 percent in staffing reductions during the past two years. More recently, contacts indicate that federal and contractor staff have since taken additional cost-saving measures such as cutting back on travel and training, delaying non-essential procurements, and eliminating performance awards for staff. The result has been that many entities have avoided furloughs and layoffs that have occurred in a number of government agencies elsewhere. We have heard similar stories of minimal impact with respect to the AEDC complex in Tullahoma.

This is not to imply that the sequester and federal spending cuts have not had serious effects, most particularly in the health care sector. Many hospitals and academic medical centers have been dealing with sequester-related and other federal funding reductions in reimbursements for Medicare and Medicaid, along with declining support for research through the National Institutes of Health.

For example, Vanderbilt University Medical Center in Nashville recently announced it is targeting \$250 million in budget savings and by some estimates close to a 1,000-staff reduction during two years to plug the shortfalls in revenue resulting from the sequester.

Our two East Tennessee directors—Jenny Banner of Knoxville and Billy Carroll in Pigeon Forge—reported some sporadic effects of sequestration. These included the National Park Service's closing three campgrounds and a couple of other recreational amenities in the Smoky Mountains, and layoffs/furloughs and other cutbacks in federal public defenders' offices and the IRS service center. Also, the University of Tennessee's College of Business expects an 80 percent reduction in enrollment from military personal in its executive education programs.

But overall, a vast majority of our contacts reported seeing little to no impact from the sequester's spending reductions. As one East Tennessee contact put it, the main sequestration impact he noticed was the traditional fighter jet flyover at the Bristol Motor Speedway.

Adrienne Slack, regional executive at the New Orleans Branch: Initially, sequestration was barely noticeable in the New Orleans zone. However, as projected, the implementation of various cost-saving measures began revealing themselves in various sectors of the economy. Companies engaged in routine maintenance work for government agencies recently noted a 10 percent reduction in that portion of their business. Many government agency services reduced the days of the week and hours of the day they are available to the public. The reduction in capacity is also evident in the IT and petrochemical industries through delays in permitting processes. While the effects are now palpable, the reports are not widespread. As the year progresses, we will continue to monitor the zone for planned furlough implementations and reduced service capacity. ■

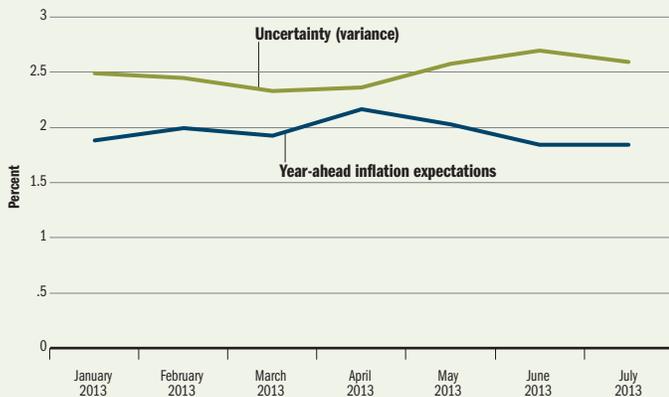
Business Inflation Expectations Survey

Year-ahead inflation expectations were 1.8 percent in June and July and have remained relatively flat since January, hovering around the Federal Reserve's 2 percent target (see chart 1). Long-term inflation expectations (measured quarterly) fell to 2.8 percent in July from 2.9 percent in April (see chart 2). Firms reported continued improvement in sales levels and profit margins in June, a trend that began in April. However, respondents reported a decline in sales levels in July (see chart 3). Firms reported rising year-over-year unit costs, from 1.7 percent in June to 1.8 percent, on average, in July.

Assessing the sales gap

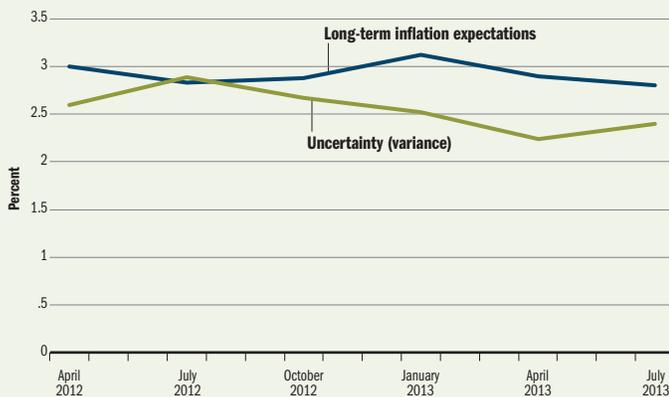
On average (weighted by industry share of gross domestic product, or GDP), respondents indicated in June that unit sales are approxi-

Chart 1
Year-Ahead Inflation Expectations and Uncertainty



Source: Atlanta Fed Business Inflation Expectations (BIE) Survey

Chart 2
Long-Term Inflation Expectations and Uncertainty



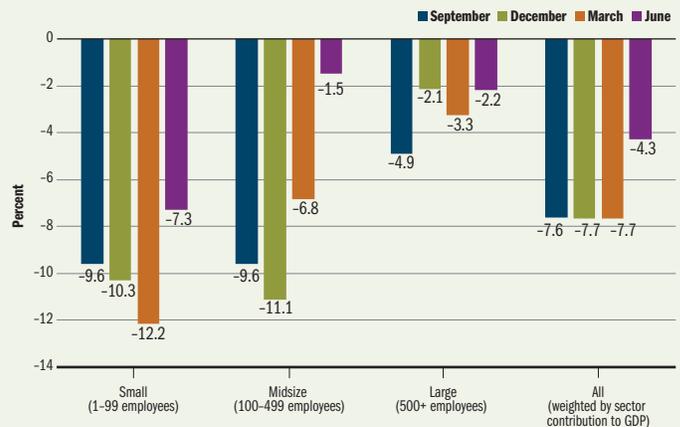
Source: Atlanta Fed Business Inflation Expectations (BIE) Survey

Chart 3
Sales Levels and Margins



Note: A reading in the diffusion index greater than zero indicates better-than-normal activity.
Source: Atlanta Fed Business Inflation Expectations (BIE) Survey

Chart 4
Percentage of Firms Above/Below Normal Sales Levels



Source: Atlanta Fed Business Inflation Expectations (BIE) Survey

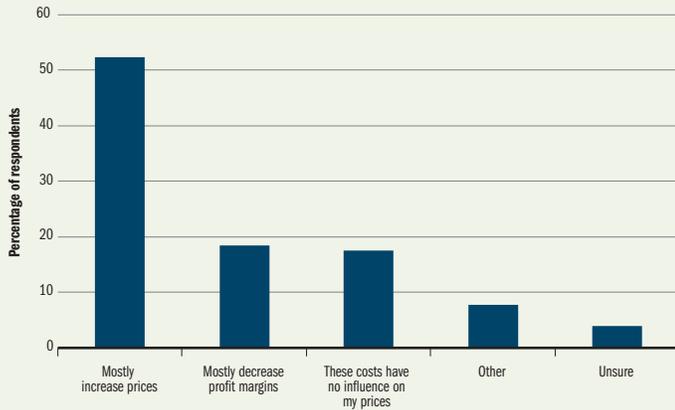
mately 4.3 percent below normal, a notable improvement from the March measure of 7.7 percent below normal. The improvement was shared among firms of all sizes, with small firms seeing the largest improvement (see chart 4). Midsize firms noted a considerable narrowing of their sales gap (from 6.8 percent below normal in March to 1.5 percent below normal in June). Large firms remained fairly stable, with an average gap of around 2.2 percent below normal.

Special questions

In June, the Atlanta Fed asked survey participants to assign likelihoods to various price change scenarios over the coming year. Respondents' mean expectation (weighted by industry share of

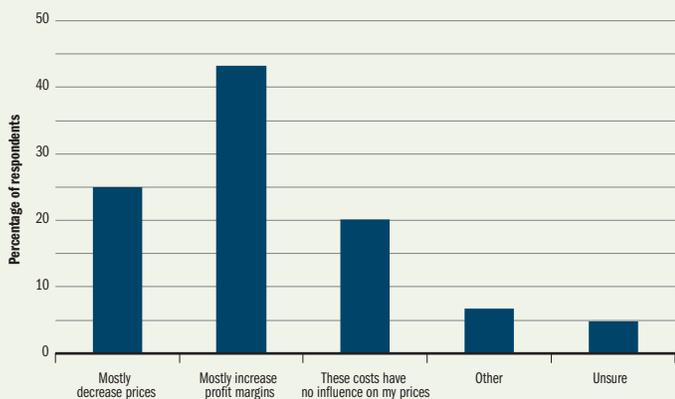
Data Corner: Regional PMI Update

Chart 5
Firms' Responses to Increased Materials Cost



Source: Atlanta Fed Business Inflation Expectations (BIE) Survey

Chart 6
Firms' Responses to Decreased Materials Cost



Source: Atlanta Fed Business Inflation Expectations (BIE) Survey

GDP) for the change in the average price of their products and/or services over the year ahead was under 2 percent.

The July question focused on commodity cost pressures. Half our panel was asked how they would respond to “a 10 percent increase in raw materials costs” and the other half how they would respond to “a 10 percent decrease in raw materials costs.” Of those who received the cost-increase question, 52 percent said they would “mostly increase prices” in response (chart 5). Of those who received the cost-decrease question, 43 percent said they would “mostly increase profit margins” in response (chart 6). ■

The region’s manufacturing index indicated continued expansion in the manufacturing sector heading into the third quarter. The Purchasing Managers Index (PMI) for July came in at 50.2 points, marking the seventh consecutive month of expansion. The Southeast’s overall index fell 2.7 points last month, down from 52.9 in June. Manufacturing activity continues to expand, albeit slowly.

Although growth in Southeast manufacturing has shown signs of recent deceleration, manufacturing has picked up speed in the nation as a whole. The latest Institute of Supply Management’s (ISM) manufacturing index rose 4.5 points in July to 55.4—a marked improvement over the 51.5 averaged in the first half of the year. (The Southeast PMI is not a subset of the national ISM index.)

The Atlanta Fed’s research department uses the Southeast PMI to track manufacturing in the region. The survey is produced by the

Southeast Purchasing Managers Index



Note: Data are through July 2013. A reading above 50 indicates expansion. A reading below 50 indicates contraction.
Source: Kennesaw State University Econometric Center

Econometric Center at Kennesaw State University. It tracks current market conditions for manufacturing in Alabama, Georgia, Florida, Louisiana, Mississippi, and Tennessee. This PMI is based on a survey of representatives from manufacturing companies in those states and analyzes trends concerning new orders, production, employment, supplier delivery time, and inventory. A reading above 50 means that manufacturing activity is expanding, and a reading below 50 means that activity is contracting.

Although still in expanding territory, the PMI ticked down for the third consecutive month since posting a reading of 55.5 in April. July’s decline is the result of sharp decreases in new orders and production. New orders fell 11.8 points to 47.2, and production dropped 10 points to 46.2. Also contributing to July’s decrease was lower hiring activity, which fell 1.5 points to 54.7.

Survey respondents also offered their outlook over the next three to six months: 34 percent expect production to be higher over that time frame, and 21 percent expect less production. Though that percentage shows slight improvement, the subdued responses during the last three months imply a restrained outlook for the manufacturing sector for the remainder of 2013. ■