THE CONNECTICUT
ECONOMIC DIGEST

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JUNE 2013

IN THIS ISSUE...

In April...

Nonfarm Employment

Connecticut	1,649,300
Change over month	+0.38%
Change over year	+0.7%
United States	135,474,000
Change over month	+0.12%
Change over year	+1.6%

Unemployment Rate

Connecticut	8.0%
United States	7.5%

Consumer Price Index

United States	232.531
Change over year	+1.1%

Turning Point, Inflection Point, or More of the Same? The Outlook to 2014Q4

By Daniel W. Kennedy, Ph.D., Senior Economist

As of 2013Q1, Connecticut has been in recovery for 12 quarters, or three years. This recovery followed the first collapse of housing and credit bubbles since the 1920's, and the first systemic banking panic since the 1930's. In addition, after the financial system bailout in late 2008 and passage of the stimulus package in early 2009, austerity has won the day, in both in the U.S. and Europe. Consequently, this cycle, including the current recovery, has behaved differently than even other Post Cold War cycles which have been much weaker than other Post World War II Era recoveries.

The behavior of Connecticut's current recovery has been one of successively declining rates of growth in Non-Farm Employment over each four-quarter segment of the first 12 quarters of economic recovery, from 2010Q1 to 2013Q1, the last period of available data at the time of writing. Connecticut came out of the gate strongly the first four quarters of recovery, adding 25,500 new jobs between 2010Q1 and 2011Q1, a growth-rate of 1.60%, which surpassed the U.S. growth-rate of less than 1%. Then, in the second four-quarter segment (2011Q1-2012Q1) of the current recovery, Connecticut's job-growth rate fell to 1.26%, and below that of the U.S. Over the last four quarters to 2013Q1, the State's job-growth rate fell to a flat 0.26%. The 2013 Benchmark did show that Connecticut did a little better measured on a fourth-quarter basis (2011Q4-2012Q4): adding 10,800 jobs, which is a 0.67% growth-rate. Nevertheless, the strong growth of the first four quarters has, so far, not returned.

CURRENT STATE OF THE ECONOMY: Spring 2013

So, just where are we in the Spring of 2013? Is the recovery picking up: an Inflection Point? Are we heading toward recession: a Turning Point? Or, is this a continuation of the "fits-and-starts" pattern of this recovery: bursts of strong growth followed by weakening growth, which is then followed by another burst of growth?

According to the Economic Cycle Research Institute (ECRI), the U.S. Economy went into recession at the end of 2012. Their evidence is the advance GDP number for 2013Q1,[1] which shows the continued deceleration of the Year-to-Year (YTY) growth-rate in Nominal GDP, indicating recession.[2] And, U.S. Personal Income (PI) growth slowed to 0.2% in March compared to February's 1.1% growth. Clearly, the end of the Payroll Tax Holiday, as part of the "Fiscal Cliff" deal and the Budget Sequester that went into effect on March 1, 2013, are pulling spending out of the economy and therefore exerting drags on economic growth.

On the other hand, the U.S. Economy added a higher than expected 165,000 jobs in April,[3] and employment gains for February and March were revised upward. In addition, by the first week of May, U.S. Initial Claims for Unemployment Insurance (UI)

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unexpectedly fell to a five-year low.[4] These signals from the labor market indicate that the economy may be at an inflection point, and transitioning from a weak-and-halting to a stronger recovery. The key to the answer lies in what is actually happening in the housing market.

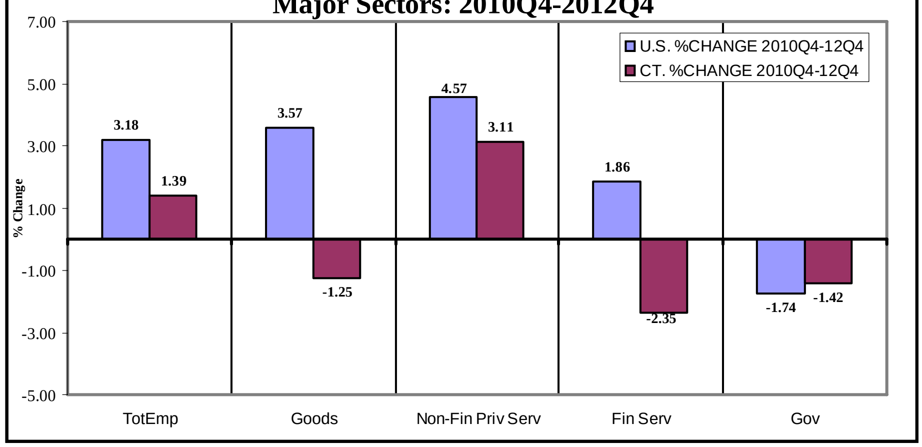
HOUSING: The Key

If the apparent turnaround in the U.S. housing market is sustained, it would represent an inflection point at which the U.S. and Connecticut economies would transition from a weak-and-halting, to a stronger recovery. Though housing has always been a critical part of the business cycle, due to the inflating and subsequent popping of the housing asset-bubble, it has played a particularly critical role over the current cycle. If in fact the housing market is now recovering, would it represent a critical turning point in this cycle, and, if so, is Connecticut's housing market participating in the recovery?

In their report for the fourth quarter of 2012, Prudential Connecticut Reality stated that "Closed sales of single family homes have risen 16.0% over last year and sales of condominium homes are up 9.2%."[5] However, the report did caution that the index for median prices had not yet turned positive. Further evidence comes from the House Price Index produced by the Center for Real Estate and Urban Economic Studies (CREUES) at the University of Connecticut for Connecticut and its Metro Areas. A Four-Quarter Moving Average (4QMA) of the Upper-, Middle-, and Lower-Tier single-home price indices suggests that the 4QMA for all three tiers' prices turned up in 2012Q4.

However, even if housing is turning around, the latest research indicates that it might not serve as the spending platform that it has in previous Post World War II recoveries. This diminished role for housing equity as a driver of consumer spending is a result of the residual damage done by the bursting of the housing bubble. Case, Quigley, and Shiller (2012),[6] in an update of their 2000 study of the effects of housing and financial wealth on consumer spending, found that their new research reinforced, and even strengthened, their original conclusions that changes in housing wealth have a much bigger impact on consumer spending. This is particularly critical for the current recovery because unlike the previous expansion/bubble (2001 to 2007), homeowners are not using their properties as ATM machines to boost spending and they are increasingly paying down the principal and shortening the maturities of their mortgages. In fact, "*Cash-In*" refinancings outnumbered *"Cash-Out"* by more than two-to-one in the fourth quarter, according to Freddie Mac.[7] In addition, the Wealth Effect is much smaller, according to recent

GRAPH 1: %Ch in U.S. and CT Total Employment and Major Sectors: 2010Q4-2012Q4



SOURCE: CTDOL-Research and Author's calculations research by Sufi (2013).[8] Because of the residual effects of the housing bubble-bust, each dollar increase in housing wealth may yield as little as an extra cent in spending, compared to the 3-to-5-cent estimate by economists prior to the recession.[9]

THE BASE PERIOD: Current Recovery (2010Q4-2012Q4)

This section now turns to framing the base period for the 2012Q4-2014Q4 forecasts. Since the forecast period is the eight quarters between 2012Q4 and 2014Q4, the base period is the preceding eight-quarter period: 2010Q4 to 2012Q4. The discussion now turns to the performance of Connecticut's labor markets over the base period for the current forecast which covers most of the current recovery: 2010Q4 to 2012Q4.

Graph 1 presents the growth-rates in Total Non-Farm (NF) jobs and by four major sectors of the economy for the U.S. and Connecticut over the 2010Q4-2012Q4 current recovery/base period. The left-most bars represent the growth-rates in Total Non-Farm Employment. As a consequence of the above noted waning of Connecticut's strong-job growth in the first four quarters of this recovery for the entire eight-quarter period (2010Q4-2012Q4), Connecticut's NF jobs grew by only 1.39% compared to U.S. NF Employment, which grew by 3.18%. A clue to what drove this outcome is found in the bars for the four major sectors. While the U.S. had positive growth in three of the four major sectors, Connecticut's NF Employment *declined* in three of the four major sectors. It should be noted that Connecticut's Financial Services may not have declined as steeply as it appears. NAICS-code reclassifications distorted some of the job-growth numbers. However, that is not the case for the Goods Producing and Government sectors. While the U.S. Goods Producing Sector grew by 3.57%, Connecticut's Goods-Sector jobs contracted by 1.25%. For the U.S., Construction and Manufacturing both added jobs as a result of increased activity in housing and the auto-industry renaissance. Also, U.S. Transport Equipment jobs grew by 9.44%, between 2010Q4 and 2012Q4, while Connecticut's Transport Equipment jobs contracted by 0.98%, reflecting concentrations in aircraft and shipbuilding as opposed to motor vehicle production, and the effects of the $2.190 billion in projected cuts in Total Defense Department (DOD) purchases in Connecticut for 2012.[10] Connecticut did have big percentage gains in Wood Products (+20.24%) and Primary Metals (+13.17%). Overall, there is a low correlation between U.S. and Connecticut growth-rates in Durable Goods jobs over the 2010Q4-2012Q4 recovery/base period. Connecticut had significant job-losses in Non-Durable Goods, and the correlation with U.S. job-growth rates is negative. Connecticut's Construction Sector added 1,296 jobs over the base period, driven largely by Residential Building Construction and Specialty Trades in 2010 and 2011 (although, both industries began shedding jobs in 2012). Thus, it is Manufacturing that accounts for Connecticut's negative job growth in the Goods Production Sector over the base period.

Connecticut's job-decline in Government Employment (-1.42) was not as steep as that for the U.S. (-1.74%). Nationally, 61% of the Government jobs lost between 2010Q4 and 2012Q4 were in Local Government. However, for Connecticut, 97% of the 3,000 lost Government jobs were in Local Government. The significant presence of the tribal nations and the lack of county government may account for Connecticut's higher relative contribution of Local Government to Total Government job losses. Nationally, Local Government job-losses were largely concentrated in Local Education, which accounted for 49% of Government job losses.

Even though Private, Non-Financial Services was Connecticut's only major sector to add jobs between 2010Q4 and 2012Q4, the U.S. still grew more strongly (+4.57%) compared to Connecticut (+3.11%). Connecticut Private, Non-Financial Services added 32,086 jobs over the 2010Q4-2012Q4 base period. Nearly 8,000 jobs, or one-quarter of those added, were in the demographic/trend-driven growth in Health Care and Social Assistance (HCSA). Another 21%, or 6,782 added jobs came from Accommodation and Food Services, especially the Food Services and Drinking Places Industry Sub-Sector, which follows the national trend. Between December 2010 and December 2012, employment in the U.S. Food Services and Drinking Places Sub-Sector grew by 6.79%, and sales increased by 15.44%.[11] Over this same period, employment in Connecticut's Food and Drinking Sub-Sector grew by 6.26%. Although, the correlation between job growth-rates in Connecticut's Retail and Food and Drinking sectors and their U.S. counterparts over the base period, is positive and very high, highest for Consumer Durables, Connecticut's sectors are growing at slightly slower rates, compared to the U.S.

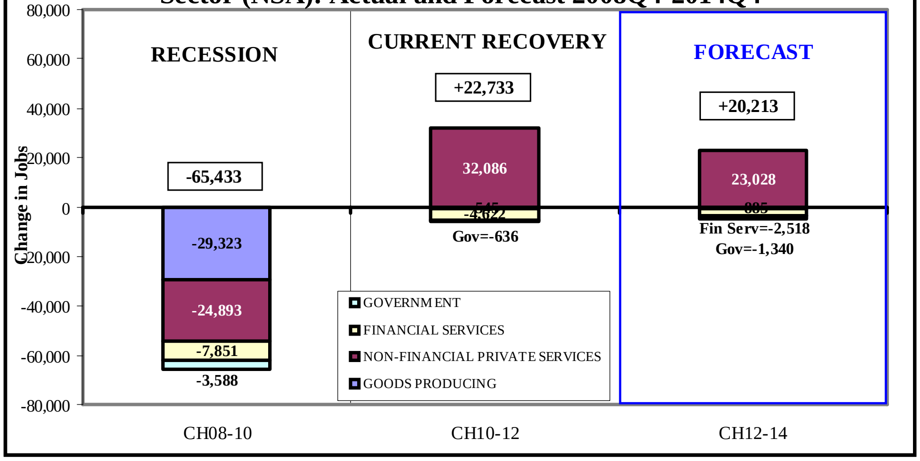
Administrative, Support, and Waste Management (Admin-Support) contributed 5,228 jobs, or 16.29%, to the growth in Private Non-Financial Services. Accounting for a large share of the growth in Admin-Support is Employment Services, which accounted for nearly 39% of all Admin-Support job-growth between December 2010 and December 2012. This follows the national trend in which the use of temporary workers has been on the rise for the last couple of decades. Currently, temps account for 1.97% of the labor force, close to the record of 2.03% set in April 2000.[12]

THE OUTLOOK FOR 2012-2014:
4th Qtr-to-4th Qtr Forecasts

The outlook for the forecast horizon 2012Q4 to 2014Q4 assumes that the Sequester (discussed below) will be a drag on the U.S. and Connecticut economies in 2013. It is expected that there will be a modest rebound in growth in 2014.

Graph 2 presents the eight-quarter changes (CH) in total Connecticut Employment, and the contribution of the four major sectors to the change in jobs for the

GRAPH 2: Eight-Qtr Changes in CT. NF Emp by Major Sector (NSA): Actual and Forecast 2008Q4-2014Q4



SOURCE: CTDOL-Research and Author's calculations

2008Q4-10Q4 Recession Period, the 2010Q4-12Q4 Current Recovery/ Base Period, and the 2012Q4-14Q4 Forecast Horizon. Over the 2008Q4-2010Q4 Recession Period, 80% of Connecticut's job losses were in the Goods Producing and Non-Financial Private Services sectors. The only sector making a positive contribution to job-growth over the Recovery/Base Period is Non-Financial Private Services. The remaining three major sectors all subtracted jobs between 2010Q4 and 2012Q4. This pattern is expected to continue over the forecast period. The forecast projects that Non-Financial Services will once again be the only major sector to add jobs between 2012Q4 and 2014Q4. However, this major sector is expected to add a more modest 23,028 jobs over the 2012Q4-2014Q4 Forecast Period compared to the 32,086 jobs added over the 2010Q4-2012Q4 Base Period. Overall, Connecticut's Total job-growth is expected to slow from a 1.39% growth-rate (+22,733 jobs) over the 2010Q4-2012Q4 Base Period to a more modest 1.22% growth-rate (+20,213 jobs) between 2012Q4 and 2014Q4. This is largely due to an expected slowdown in growth in 2013, followed by a modest rebound in job-growth in 2014.

Continuing the Base-Period trend, the principle driver of growth in the Private Non-Financial Services major sector is expected to be the demographic/trend-driven HCSA Sector. HCSA is expected to add 8,160 jobs between 2012Q4 and 2014Q4, and account for 35.44% of all the jobs added by the Non-Financial Private Services major sector. Admin-Support, driven by the continued, extensive use of temporary workers, is projected to add 3,887 jobs and account for 16.88% of the growth in Non-Financial Private Services. And, continuing a pattern that began with the current recovery driven by its Food Services and Drinking Places Sub-Sector, Accommodation and Food Services is expected to add 3,714 jobs over the forecast period and account for 16.13% of the job-growth in Private Non-Financial Services. Finally, Retail Trade and Professional and Technical Services together are projected to account for 17% of the new jobs in the Private Non-Financial Services major sector.

As for the Current Recovery/ Base Period, the principle drags on job-growth over the forecast period are expected to be the Goods Producing, Financial Services, and Government major sectors. As over the current recovery, the Manufacturing Sector is expected to decline, especially in Non-Durable Goods over the forecast period. This will be off-set by continued growth in Construction (although a principle driver, Residential Building Construction, began shedding jobs again in 2012). The net result will be the continued modest decline in Goods Producing jobs. Credit Intermediation and Insurance are expected to continue to lose jobs over the forecast horizon. However, Credit Intermediation losses should be mitigated somewhat as it was partly driven by reclassifications within the NAICS coding system. Securities, Commodities and Brokers had large losses in 2012, which should subside somewhat. The net result: the Financial Sector is expected to shed another 2,518 jobs between 2012Q4 and 2014Q4. Finally, the pattern of Government job-losses is expected to continue into the forecast period. Not only will Federal budget issues, including the Sequester, continue the reduction in Government Employment, not only Federal, but especially in Local Government Employment, both nationally and at the State level, and in particular, with Connecticut's budget situation, local aid to cities and towns may be cut with the new fiscal year's budget. The net result: the forecast expects Government job-losses to double to 1,340 over the 2012Q4-2014Q4 Forecast Period, compared to the base period.

RISKS TO THE FORECAST

This section briefly reviews the Positive and Negative risks to the forecast. The risks to the forecast posed by the Sequester are discussed separately below. The biggest Positive Risk to the forecast is housing. If the recovery has traction and provides a bigger boost to spending than anticipated, then the forecast will be too pessimistic.

There are several Negative Risks to the forecast. Of course, if the ECRI is correct, then we are already in another recession. With the cumulative effects of the Sequester and the end of Payroll Tax Holiday, the forecast could very well be overly optimistic. And, with two of Connecticut's three biggest export destinations in the crisis-plagued EU (France and Germany), demand for the State's merchandise exports could be flat, at best.

SEQUESTER AND THE FORECAST

Finally, a significant risk to the forecast is the Sequester, which was part of the *Budget Control Act of 2011* and resulted in cuts in both, Defense and Non-Defense spending going into effect on March 1, 2013. The Fiscal Cliff deal reduced the level of the FY2013 Sequester to about $85 billion, with estimated reductions of about $42.7 billion each for both Defense and Non-Defense spending. According to a study by Fuller (2012),[13] the hit to Connecticut from the Sequester would be relatively significant. The State would account for 2% of total cuts nationally, while only accounting for 1.23% of all U.S. Non-Farm jobs in 2012. This would be driven by Defense job cuts where the State would account for 3.32% of defense-related job-cuts in FY 2013. However, for long-term more strategic oriented programs, Connecticut will be minimally impacted according to the State's Office of Military Affairs. For instance, the Navy's contract with General Dynamics for Ohio-class replacement subs will be little affected by Sequestration.[14] However, the State may feel a short-term impact from the cuts particularly over the 2012-14 Forecast Horizon.[15] Over the longer run, Connecticut's more strategic position in the defense procurement program should put it in a relatively better position compared to other states. ■

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GENERAL ECONOMIC INDICATORS

(Seasonally adjusted)	1Q 2013	1Q 2012	CHANGE NO.	CHANGE %	4Q 2012
General Drift Indicator (1986=100)*					
Leading	NA	NA	NA	NA	NA
Coincident	NA	NA	NA	NA	NA
Farmington Bank Business Barometer (1992=100)**	125.0	124.3	0.7	0.6	125.4
Philadelphia Fed's Coincident Index (July 1992=100)***	**APR**	**APR**			**MAR**
(Seasonally adjusted)	**2013**	**2012**			**2013**
Connecticut	156.91	152.91	4.00	2.6	156.49
United States	153.47	149.39	4.08	2.7	153.14

*Sources: *The Connecticut Economy, University of Connecticut **Farmington Bank ***Federal Reserve Bank of Philadelphia*

The Connecticut Economy's **General Drift Indicators** are composite measures of the four-quarter change in three coincident (Connecticut Manufacturing Production Index, nonfarm employment, and real personal income) and four leading (housing permits, manufacturing average weekly hours, Hartford help-wanted advertising, and initial unemployment claims) economic variables, and are indexed so 1986 = 100.

The **Farmington Bank Business Barometer** is a measure of overall economic growth in the state of Connecticut that is derived from non-manufacturing employment, real disposable personal income, and manufacturing production.

The **Philadelphia Fed's Coincident Index** summarizes current economic condition by using four coincident variables: nonfarm payroll employment, average hours worked in manufacturing, the unemployment rate, and wage and salary disbursements deflated by the consumer price index (U.S. city average).