

Economics Group

Special Commentary

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Virginia 2019 Economic Outlook

Virginia’s Economy Begins the New Year with Strong Momentum

Virginia’s economy finally caught some breaks this past year, as tax reform and the bipartisan spending deal significantly lessened the headwinds facing the large portion of the Commonwealth’s economy tied to the federal government. Real GDP growth ramped up to a 2.6% pace from the middle of 2017 to the middle of 2018, which is the latest data available. Lower tax rates helped fuel growth in consumer spending and the leisure & hospitality sector. Capital spending and job growth also received a boost, befitting from both lower tax rates and increased government spending, particularly on defense. Nonfarm employment ramped up to a 2.0% pace, while the unemployment rate fell to just 2.8%. The pace of corporate relocations and expansions also improved, with huge capital investment announcements made by Micron Technology in Manassas and Facebook near Richmond. In addition, Amazon chose Crystal City as its primary location for its ‘second headquarters’.

Virginia’s economy finally caught some breaks this past year.

The influx of big tech investment in Northern Virginia and Richmond is certainly welcomed and should help further diversify the region away from its historic dependence on federal and state government. Northern Virginia’s economy has feasted but often struggled with its preponderance of federal government contractors. The concentration of large, specialized contractors has brought a highly skilled workforce to the region and also helped drive important investment in education infrastructure. The relative abundance of highly skilled workers has become a key competitive advantage and helped attract a number of new employers. Richmond is seeing similar success, as its economy has increasingly become closely tied to the more rapidly growing northern portion of the state. Economic development has also picked up in many other parts of the state, including Hampton Roads, Southside, the I-81 corridor and Southwest Virginia.

Figure 1

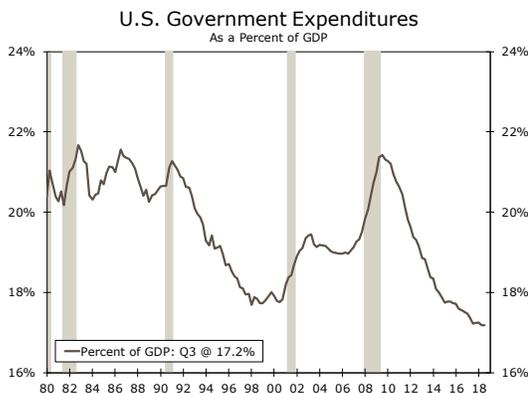


Figure 2



Source: U.S. Department of Commerce and Wells Fargo Securities

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Economic growth accelerated this year.

Growth Finally Ramps Up

Virginia’s recovery from the Great Recession proved agonizingly sluggish, as pressure to contain the federal budget deficit resulted in severe constraints on federal spending. The impact fell hardest on Virginia’s Washington D.C. suburbs and the Hampton Roads area, which is home to a massive contingent of military personnel and much of the nation’s military shipbuilding. Conditions took a turn for the better in 2018, as sequestration was eased and the bipartisan spending agreement boosted federal spending. With the weight of sequestration lifted, economic growth accelerated this past year, with real GDP growth rising 2.6%, the fastest pace since 2010. This marked a significant acceleration from the prior years, when Virginia’s real GDP growth averaged a mere 1.1% pace between 2010 and 2017. The state’s economy has expanded at a slower rate than the nation for seven consecutive years but nearly closed the gap in 2018.

While the Tax Cuts and Jobs Act and the bipartisan budget deal provided a much needed boost to Virginia’s economy this past year, the start of the new year brought a stark reminder of the need to diversify the Commonwealth’s economic base. The partial government shutdown lingered for a record 35 days, which inflicted hardship on furloughed government workers and federal contractors. While the shutdown has been settled, rapidly expanding federal deficits and the deteriorating fiscal situation may impair the ability—or political feasibility—of the federal government to maintain spending increases. We expect government spending to expand 2.2% in 2019 before growth moderates to 1.0% in 2020.

Virginia is making progress at diversifying its economy. Government spending accounted for 18% of Virginia’s GDP in 2017, down from 22% in 1997. Still, including indirect activities such as contractors and consultants, the government’s share of the economy rises to an estimated 30%. The bulk of that is in Northern Virginia and the Hampton Roads area, home to the largest concentration of military facilities in the nation. Much of the economy’s recent growth, however, has come from professional & business services, which now comprises over 20% of the economy and consistently ranks as the largest creator of new jobs. This past year saw a notable increase in corporate expansions and those announcements had a much broader geographic reach than in prior years.

Northern Virginia is a growing hub for technology businesses.

Amazon’s long-awaited decision to locate part of its ‘second headquarters’ in Crystal City validates the Commonwealth’s strong attributes in attracting leading edge technology firms. Northern Virginia is one of the primary hubs of the Internet and is home to numerous data centers and corporate headquarters, including General Dynamics, Northrop Grumman, DXC Technology and Verisign. With its highly acclaimed universities, intensive internet infrastructure and huge pipeline of government contracts, Northern Virginia is home to one of the richest tech ecosystems outside of Silicon Valley. In addition to the Amazon announcement, Micron Technology announced a \$3 billion, 1,100-employee expansion of its Manassas microchip plant. In addition, Appian, KPMG and IDEMIA each announced major investments in their Northern Virginia operations.

Figure 3

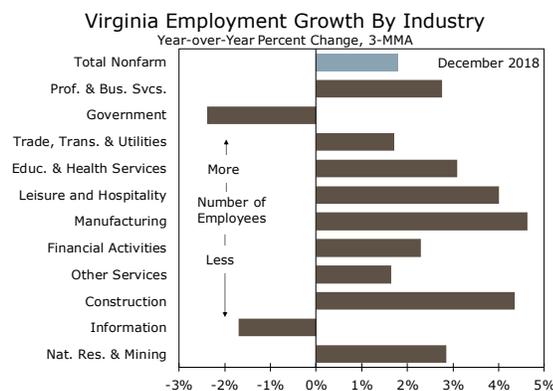
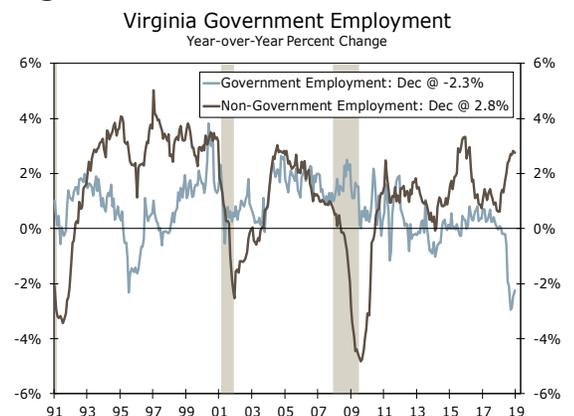


Figure 4



Source: U.S. Department of Labor and Wells Fargo Securities

While Northern Virginia has certainly been the recipient of much of the tech sector's growth in Virginia, other parts of the Commonwealth are also thriving. The past two years have seen economic growth broaden to include most of the state. 2017 marked the first year since 2006 that every major metro area in the state expanded—a feat repeated this past year. Perceptions about Virginia's business climate have also improved, as Virginia received a top-five ranking from CNBC for the best state business climate in 2018, after falling out of the top ten in 2015 and 2016. The improved sentiment is apparent in the recent rush of corporate relocations and expansions, headlined by Amazon and Micron's substantial investment in Manassas. Other notable projects include a \$55 million investment by Global Technical Solutions in Virginia Beach, and a \$275 million projects by Cascades, Inc., which is opening a lightweight recycled paperboard plant in Hanover County, outside of Richmond.

Other parts of the Commonwealth outside of Northern Virginia are also seeing success.

Richmond has seen a great deal of success in economic development in recent years. In addition to the Cascades, Inc. announcement, Facebook announced a \$1 billion expansion of its data center complex in White Oak Technology Park. The expansion follows a \$750 million investment announced last year and boosts plans for the project to include five buildings and more than 2.5 million square feet of space. The project should support 1,500 construction jobs and employ at least 200 workers after it is completed in late 2020 or 2021. Richmond continues to see quite a bit of activity in its tech sector. Science Applications International Corporation (SAIC) announced it will create 75 jobs and retain another 400 positions after it assumes part of the state's IT services contract. Other notable developments include expansions by IT services provider CGI and ramen noodle maker Maruchan. The region's healthcare sector is another key growth driver, with expansions at Virginia Commonwealth University and Bon Secours hospitals. Richmond's economy has added 11,100 jobs over the past year, as payrolls have expanded 1.6% over the past year. The metro area's unemployment rate has fallen 0.9 percentage points to just 3.0%.

The Hampton Roads region is having to learn to roll with the punches. Years of tight federal budgets cast a shadow on the local economy, making it difficult for the region to attract new investment. More recently, Norfolk Southern, the region's largest publicly traded company, announced it would relocate its headquarters to Atlanta, where it has long had a major presence. Throughout these travails, however, the Hampton Roads economy has persevered. While job growth has lagged the nation, the region has moved forward with important infrastructure improvements, including expanding container capacity at the Port of Virginia. This past year has seen a bit of a rebound. Nonfarm employment has risen 1.8% over the past year and the metropolitan area's unemployment rate has fallen 0.8 percentage points over the past year to 3.2%. The region's economy is falling back on its longstanding mainstays: the military, shipbuilding, higher education, healthcare and tourism. Fortunately, the Navy's shipbuilding budget has been increased and the local shipyards have lots of work ahead of them as they build a new class of submarines and aircraft carriers.

Virginia's economic recovery not only strengthened this past year but also broadened to include more parts of the Commonwealth. Every region of the state has seen conditions improve over the past two years, with job growth strengthening, unemployment falling and populations stabilizing. Many of Virginia's smaller markets and rural areas are seeing an influx of investment. Some of the more notable projects include WestRock, which is investing \$248 million in its massive Covington plant, and Press Glass, which is investing \$44 million to establish a 280,000-square foot manufacturing plant near Martinsville. Press Glass, which is Europe's largest independent flat glass maker, will create 212 jobs at the Henry County plant. Other projects in Virginia's Southside include Essel Propack, which announced late last year that they would invest \$31 million to expand its Danville plant and create 45 new jobs.

Many of Virginia's smaller markets and rural areas are seeing an influx of investment.

Southwest Virginia has also landed a number of major projects. Speyside Bourbon Cooperage announced they will invest \$26 million to open a bourbon barrel cooperage in Smyth County and invest \$9 million in neighboring Washington County to build a new stave mill to supply the Smyth County cooperage. The two projects will employ 125 workers in Smyth County and 35 workers in Washington County. And in Lee County, which is the westernmost county of in the Commonwealth, England Furniture announced they would open a 32,000-square foot plant to produce upholstered furniture, creating 79 jobs.

A highly trained and well-educated workforce is a key competitive advantage.

Payroll Growth Accelerates

Nonfarm employment growth across the state exceeded the national rate at the end of 2018, for the first time since 2016. Payrolls expanded at a 2.0% clip to end the year, despite an increasingly tight labor market. The unemployment rate has fallen to a mere 2.8%, raising some concerns of labor shortages, particularly in the high-skilled industries driving much of the growth in the state. With employers such as Amazon hungry for top talent, training and maintaining a highly educated workforce remains a top priority. Thirty eight percent of Virginia’s population holds a bachelor’s degree, the sixth highest level of educational attainment of any state. Recognizing this as a key competitive advantage, the state and Virginia Tech recently announced they would jointly fund a new \$1 billion campus focused on computer science and innovation just one mile from Amazon’s future location. The Virginia Tech Innovation Campus was the centerpiece of a series of educational incentives meant to lure Amazon. George Mason University will also open an Institute for Digital Innovation at its existing Arlington Campus. Recently passed legislation mandates the adoption of computer science learning standards for students in elementary schools across the state. In addition, the Amazon deal included \$25 million for technical education in the state’s public schools. The hope is that the presence of a highly trained workforce and a stronger pipeline for new skilled workers will become an even more potent competitive advantage.

Figure 5

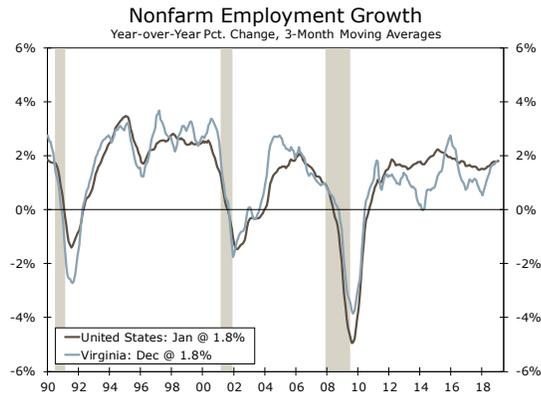
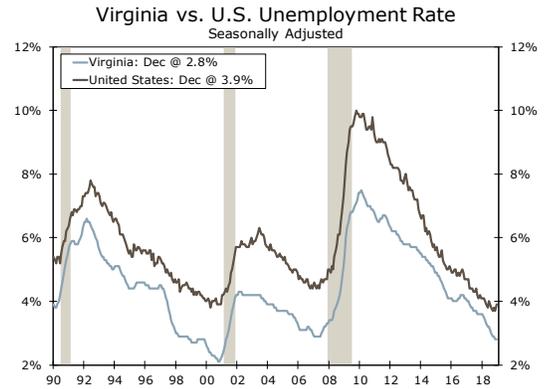


Figure 6



Source: U.S. Department of Labor and Wells Fargo Securities

In contrast to professional & business services, government payrolls are continuing to shrink. Government employment in the state peaked on an absolute basis in May 2010 at 719,000, but as a percent of total nonfarm employment it peaked in May 1992. If the historical 20.7% share reached in the early 1990s had been maintained to today, government employment in the state would be 133,000 jobs higher than it currently is. Of the 77,000 jobs added over the past year, professional & business services accounted for 26.8%, and an identical share of the 416,000 jobs added since 2010. Leisure & hospitality has also been strong, contributing 79,000 new jobs since 2010 and 18,000 over the past year.

Manufacturing has picked up dramatically over the past year, which helps explain part of the improvement in Virginia’s smaller towns and rural areas. From 2010 to 2017 the sector added an average of only 360 jobs per year, but it has added 11,700 jobs over the past year, or 15.2% of total payroll growth. Stronger job growth has helped stabilize many areas that had been rocked by years of sluggish job growth and population losses. Improved economic conditions have also led to increased investment. While Virginia’s rural areas have missed out on most of the mega-deals that landed in Northern Virginia and Richmond, the low cost of doing business coupled with significant investments in job training is helping attract businesses into all corners of the state

Virginia’s unemployment rate fell sharply this past year and the gap with the U.S. rate widened considerably. The lower unemployment rate reflects both stronger job growth, particularly in rural areas, and sluggish labor force growth, reflecting the state’s older and more slowly growing population.

Manufacturing has picked up dramatically over the past year.

Demographic Headwinds & The Housing Market

Demographics remain challenging for Virginia. Net domestic migration has been negative for five consecutive years, and overall population growth has slowed to only around 50,000 new residents per year. Much of the weakness is concentrated in the state's rural regions and in the Hampton Roads area, where population growth has slowed to essentially zero. Virginia still benefits from robust international in-migration, particularly to Northern Virginia. This influx of immigrants has helped boost the state's supply of skilled and unskilled workers. Northern Virginia's tech sector has been a magnet for skilled immigrants, many of which have advanced degrees.

Demographics remain challenging for Virginia.

Despite the influx of new residents, Virginia's labor force is a weak spot, as participation was hit hard by the Great Recession and has yet to recover. Labor force participation has fallen to 65.2%, down from around 70% in the summer of 2008 and an earlier peak of 71.5% in 1992. Labor force participation varies significantly across the state, with rates above 80% in Arlington County, Alexandria and Loudoun County, reflective of the strong gains in the professional & business services sector that is so prevalent in Northern Virginia. Other regions, where agriculture, coal mining and certain types of manufacturing are more prevalent, such as Southwestern Virginia, are home to several counties with labor force participation rates below 40%. Opioid addiction may be weighing on labor force participation in many of these regions, but longer term secular forces, such as the aging of the state's population, are also at play. Virginia's prime working-age population, defined as ages 25-54, has been either flat or declined the past four years. Much of this represents a steadily aging population. The median age has climbed from 35.8 in 2000 to 38.2 in 2017.

Figure 7

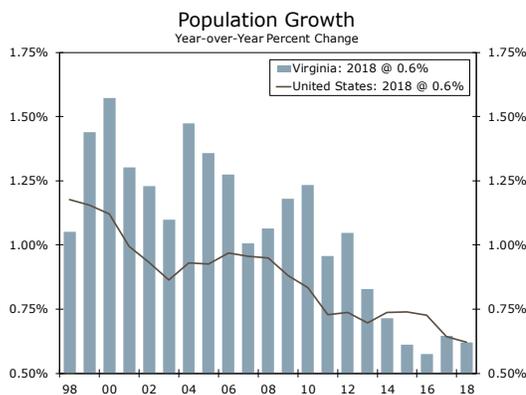
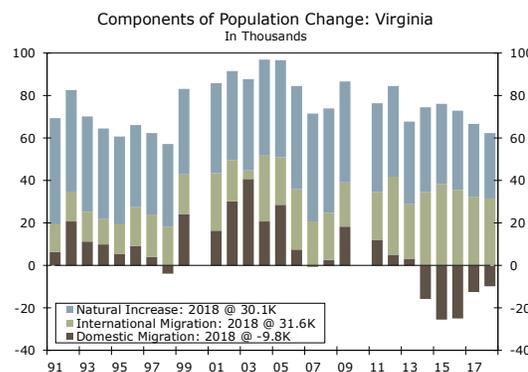


Figure 8



Source: U.S. Department of Commerce and Wells Fargo Securities

Slower population growth and caution by lenders, developers and homebuilders following the housing bust have led to a slow recovery in homebuilding. Single-family construction remains more than 50% below its prior peak, but it is also significantly below its longer run average. Any further pickup in homebuilding in the Commonwealth will likely be moderate. Despite limited new supply, home price appreciation has been fairly modest, not breaching 4% on a year-over-year basis since March 2014, and lagging the national rate every month since 2012.

Any further pickup in homebuilding in the Commonwealth will likely be moderate.

Some of the weakness in single-family construction has been due to persistently strong demand for apartments, particularly in urban areas where creative jobs are clustering. Apartment construction statewide has modestly improved, with some pockets of strength in the major metro areas. Apartments in the District of Columbia do not show up in the Virginia data, however, and that market has been exceptionally strong. Even before the announcement of Amazon's move into Crystal City, only New York City and Dallas had seen more new units completed this cycle. Amazon's plan to hire 25,000, with an average salary of \$150,000, should provide another boost to this market, which has faced periodic concerns about too much supply during the past decade.

Figure 9

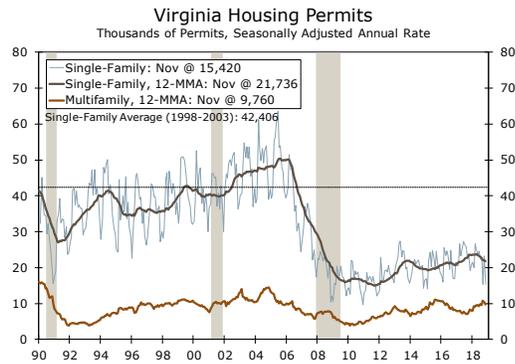
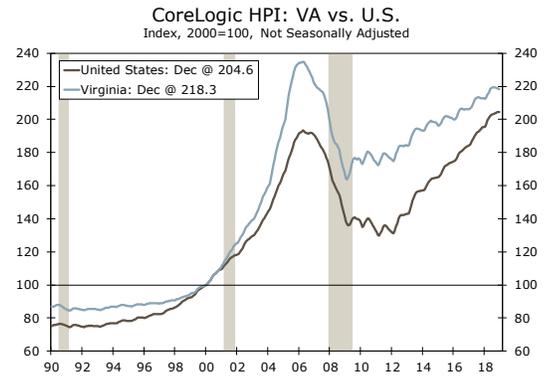


Figure 10



Source: U.S. Department of Commerce, CoreLogic, Inc. and Wells Fargo Securities

Summary & Outlook

After regaining its footing, Virginia's economy likely endured a bit of a setback at the start of this year, as the partial shutdown of the federal government created hardship for thousands of federal workers and federal contractors. With paychecks on hold, economic activity likely slowed a bit in January. Fortunately the government shutdown impacted only part of the government and occurred at a seasonally slow period for tourism. Moreover, Amazon's decision to not go forward with putting half of its 'second headquarters' in Long Island City means that it is likely to have an even larger impact in Northern Virginia, and that impact is likely to occur sooner and ramp up faster than originally planned.

Virginia has avoided many of the squabbles that took place in New York because incentives have long been used to enhance and reshape the Commonwealth's economy. Much of the incentives are also aimed at workforce training, and the skills that Virginians gain from such training will make the state more attractive for future expansions by Amazon and other firms.

Education and training are playing a major role in driving growth in other parts of the state as well. Richmond's highly educated workforce and the revitalization of its downtown have lured a growing list of technology firms. The VA Bio+Tech Park, located next to the VCU medical school, is a flagship initiative with over 70 companies and research labs, and should continue to attract top health and tech professionals. The revival of the downtown area and several neighboring submarkets has also lifted the Richmond apartment market, with demand frequently exceeding supply.

The Hampton Roads area property market has been relatively flat, as sluggish population growth caps the demand for new apartments. Nevertheless, the sheer magnitude of the various military installations provides a floor, in the form of a constant supply of young renters, subject to fluctuations based on increases or decreases in defense spending. The U.S. Navy base in Norfolk is the largest naval base in the world, and the military installations in the Hampton Roads area employ over 150,000 people. Volume through the Port of Virginia reached record highs early this year, benefitting the sizable maritime industries. The Newport News Shipyards have seen an upswing in new orders and employment. Changes in the way ships are designed and built are leading to some transitions with the Shipyard's employment base but the net impact is positive.

We look for employment growth to roughly keep pace with the U.S. this year, with nonfarm employment rising 1.2% and the unemployment rate leveling off at just below 3%. The large government and military presence in Virginia provides a great deal of stability to the state's employment base, which keeps its unemployment rate low but also tends to weigh on growth. Housing and commercial construction should see modest gains this year, with the strongest growth occurring in Northern Virginia and Richmond. We expect the entire state to once again share in Virginia's growth, although some of the recent gains in the state's rural areas might be at risk if a trade deal is not reached with China and tariffs rise substantially. The persistence of large deficits remains a long-term risk for the state but fiscal policy is unlikely to reverse its course in a significant way before the 2020 elections.

2019 should be a relatively good year for Virginia.

Virginia Economic Outlook

	Actual							Forecast		
	2012	2013	2014	2015	2016	2017	2018	2019	2020	
Real Gross Domestic Product by State, \$ Millions	444,950	446,560	445,527	454,156	455,232	463,564	475,715	487,135	498,100	
Annual Rate	0.8%	0.4%	-0.2%	1.9%	0.2%	1.8%	2.6%	2.4%	2.3%	
Nominal Personal Income, \$ Millions	404,772	402,065	420,236	440,824	448,684	466,743	484,480	505,800	529,100	
Nominal Personal Income, Percent Change	4.8%	-0.7%	4.5%	4.9%	1.8%	4.0%	3.8%	4.4%	4.6%	
Real Median Household Income, \$	69,132	69,467	68,567	63,618	67,880	71,293	73,788	76,592	79,426	
Population, Thousands	8,185	8,253	8,312	8,363	8,411	8,465	8,518	8,573	8,628	
Change in thousands	85	68	59	51	48	54	52	55	55	
Percent Change	1.0%	0.8%	0.7%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%	
Nonfarm Employment, Thousands	3,736	3,762	3,783	3,859	3,914	3,951	4,005	4,055	4,100	
Change in thousands	43	26	21	76	55	37	54	50.0	45.0	
Unemployment Rate, Annual Average	1.2%	0.7%	0.6%	2.0%	1.4%	0.9%	1.4%	1.2%	1.1%	
Total Housing Permits	26,666	31,367	28,762	30,033	31,067	33,417	32,100	32,710	34,000	
Single-Family Permits	17,674	20,927	19,134	20,594	21,314	23,266	21,600	22,000	23,200	
Multi-Family Permits	8,992	10,440	9,628	9,439	9,753	10,151	10,500	10,710	10,800	
FHFA Home Price Index, Percent Change	-0.2%	1.6%	2.6%	2.9%	2.8%	3.7%	4.4%	4.5%	4.5%	

Sources: National Association of Realtors, Federal Housing Finance Authority, U.S. Department of Commerce, U.S. Department of Labor, Moody's Analytics & Wells Fargo Securities
Forecast as of: February 21, 2019

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