The Hampton Roads Economy

BACK TO EARTH: THE REGIONAL ECONOMY SLOWS DOWN

During 2007, the Hampton Roads economy has grown at an after-inflation rate of 2.6 percent. This rate is significantly below the average growth rate of 3.4 percent for our region's economy over the past 40 years and even further below the 3.7 percent average annual increase since 2001. Despite meager growth relative to Hampton Roads' own historical average, the region's economy nevertheless may outperform that of the nation and be on par with that of the Commonwealth of Virginia in 2007.

Much of the lackluster performance of the regional economy can be attributed to the national economic situation. Rising interest rates, the poor performance of the U.S. automobile industry, a slowdown in home construction and decelerating defense spending are the primary villains. But local issues were far more important, such as the deceleration of military spending in the region.

Our focus here is upon several of these important local issues that are affecting our region's economic growth and well-being. Starting with a general overview of economic activity over the past few years, we will delve into the reasons why economic growth has slowed in Hampton Roads. We'll then investigate potential shocks to the regional economy and finally, pay particular attention to the area's potentially volatile housing market.

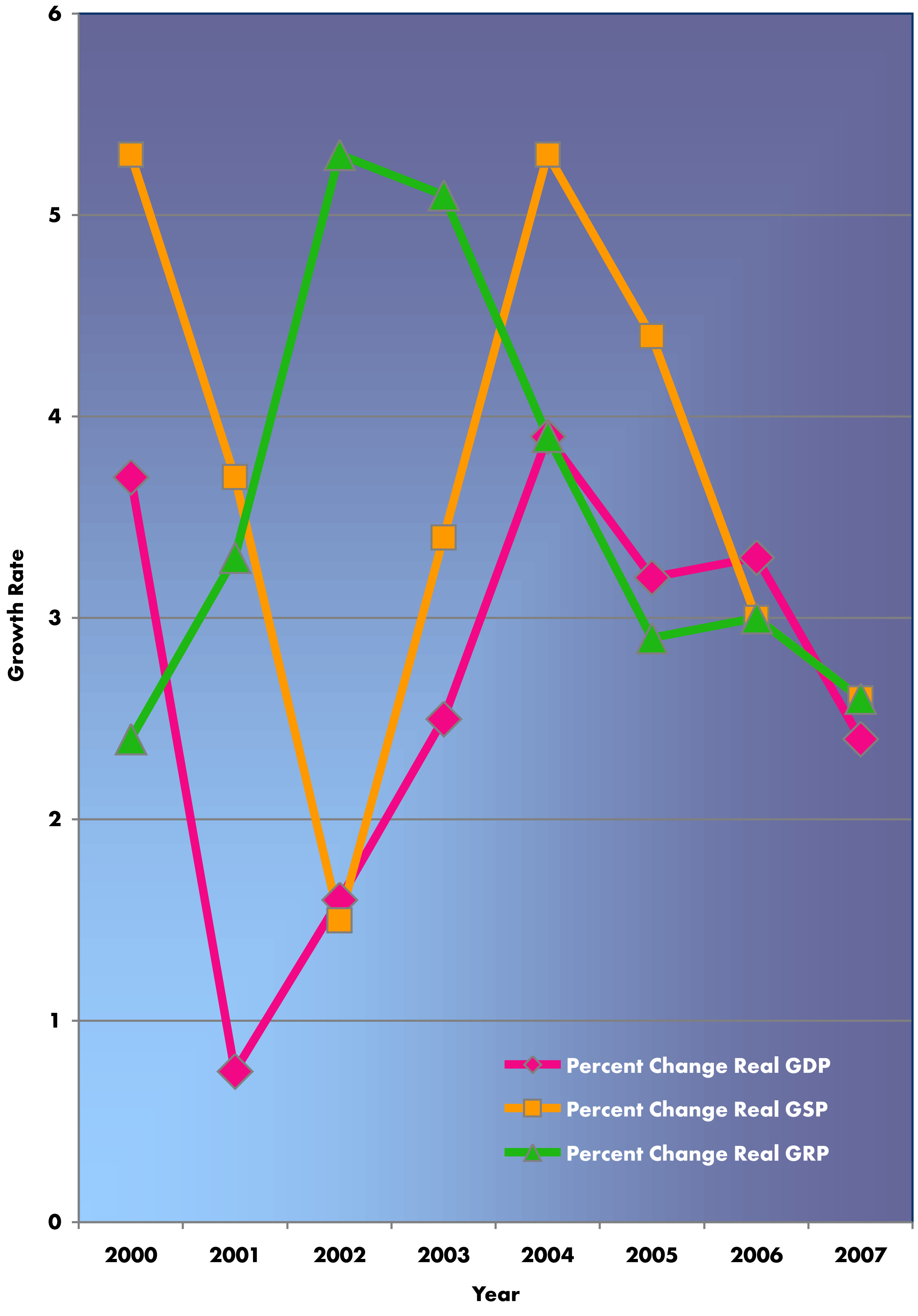
An Economic Roller Coaster

As one can see in Graph 1, the path of the region's economic growth since 2000 has resembled a roller coaster ride. The rate peaked in 2002 as the Hampton Roads economy grew at roughly 4 percent more than the nation and Virginia. Dramatic increases in defense spending in the region, both for personnel and for equipment and supplies, were the primary source of this surge. The unusually strong growth experienced in 2002 and 2003 had not been seen in Hampton Roads since the Reagan defense buildup of the mid-1980s. Note that these growth rates are "after inflation" and therefore represent real economic growth, not merely rising prices.

However, things have changed. In 2007, economic growth in Hampton Roads has decelerated to its lowest level since 2000 and now roughly approximates that of the nation and Virginia. A portion of this decline (statistically speaking) was due to the release in May 2007 of revised personal income data for Hampton Roads. These new figures actually reduced previously reported growth rates. For example, the 3.2 percent rate in 2006 was scaled back to 3 percent.

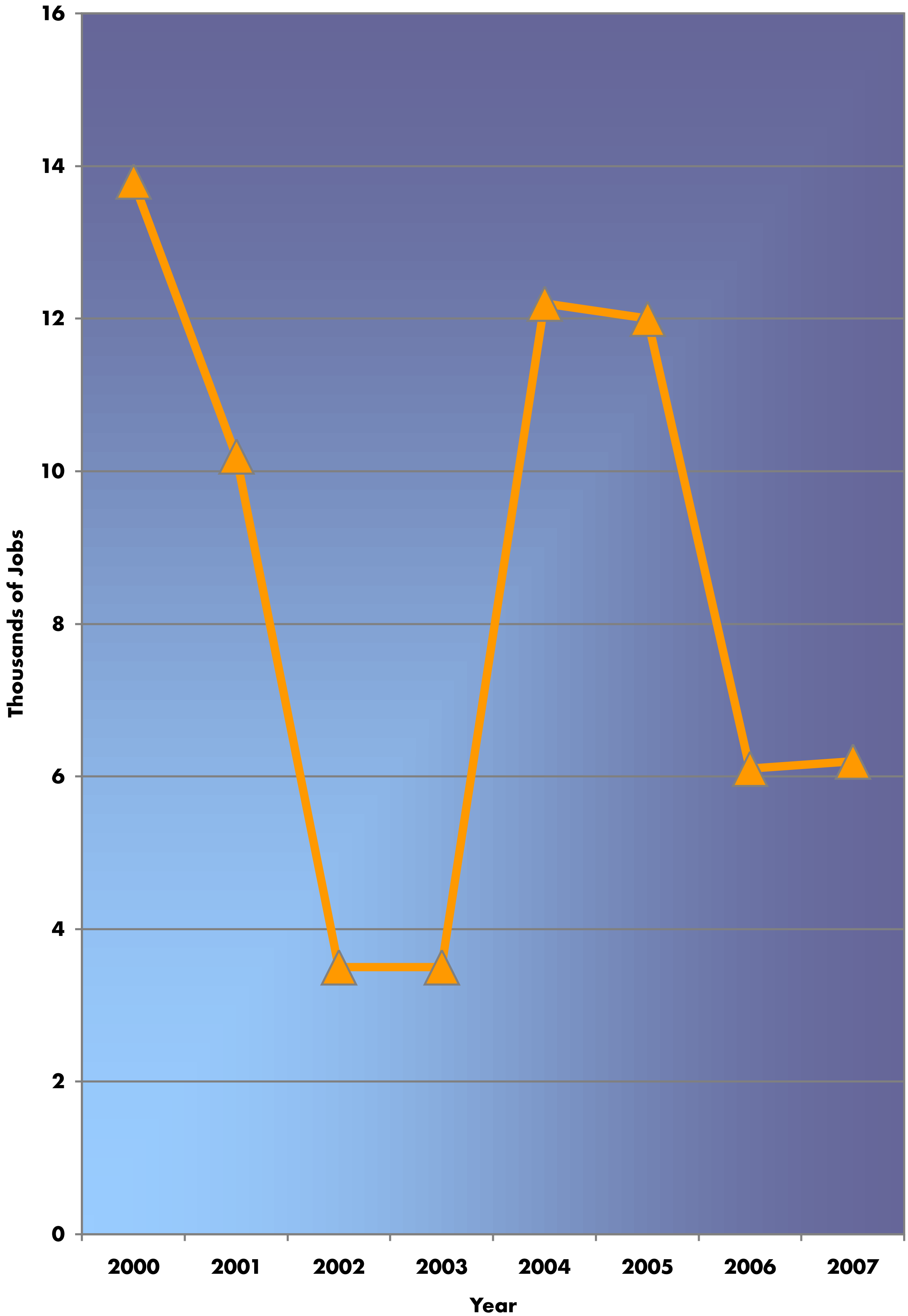
Between 2000 and 2007, approximately 66,000 jobs were created in Hampton Roads. Graph 2 shows that this magnificent annual job creation lagged the region's economic growth by about one year. This is consistent with the national experience. Employers often attempt to "make do" with existing employees when the demand for their products increases; only when they come to believe this increase is permanent do they add significant numbers of workers.

GRAPH 1
RATE OF GROWTH OF GDP (U.S.), GSP (VIRGINIA) AND GRP (HAMPTON ROADS)



Source: Old Dominion University Economic Forecasting Project

GRAPH 2
HAMPTON ROADS ANNUAL JOB CREATION
(2000-2007)



Source: Old Dominion University Economic Forecasting Project

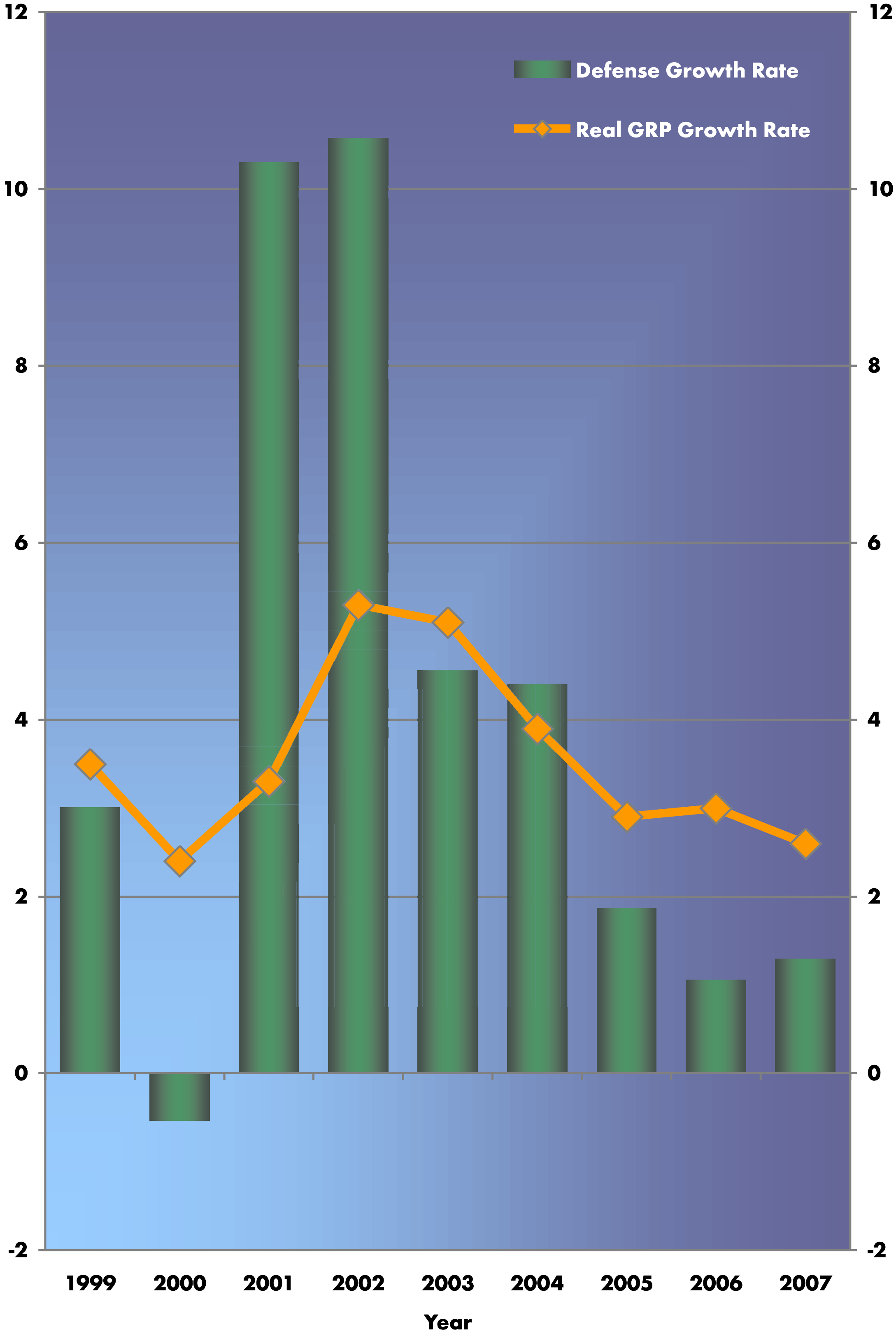
Why Has the Region's Economic Growth Slowed?

It has long been true that our regional economy's health is disproportionately influenced by defense spending. Graph 3 depicts the close relationship between the region's price-adjusted gross regional product (GRP) growth rate and the price-adjusted growth rate of defense spending in Hampton Roads. **The surge in defense spending in the region in the first half of this decade accounted for roughly three of every four dollars of increase in our GRP from 2001 through 2005.** Hence, it is the slowing of the growth rate in defense spending that has played the primary role in the slowing of output in Hampton Roads.

Compensation of military personnel accounts for approximately 60 percent of defense spending in Hampton Roads. In 2002 and 2003, reflecting the needs of a voluntary military force, a major effort was initiated to enhance personnel retention through bonuses, increased housing allowances and higher base pay. This effort stimulated nearly every part of the regional economy, but played itself out by 2006. Graph 4 illustrates this dynamic, but also demonstrates the deceleration of military compensation increases in recent years. This has moderated regional economic growth.

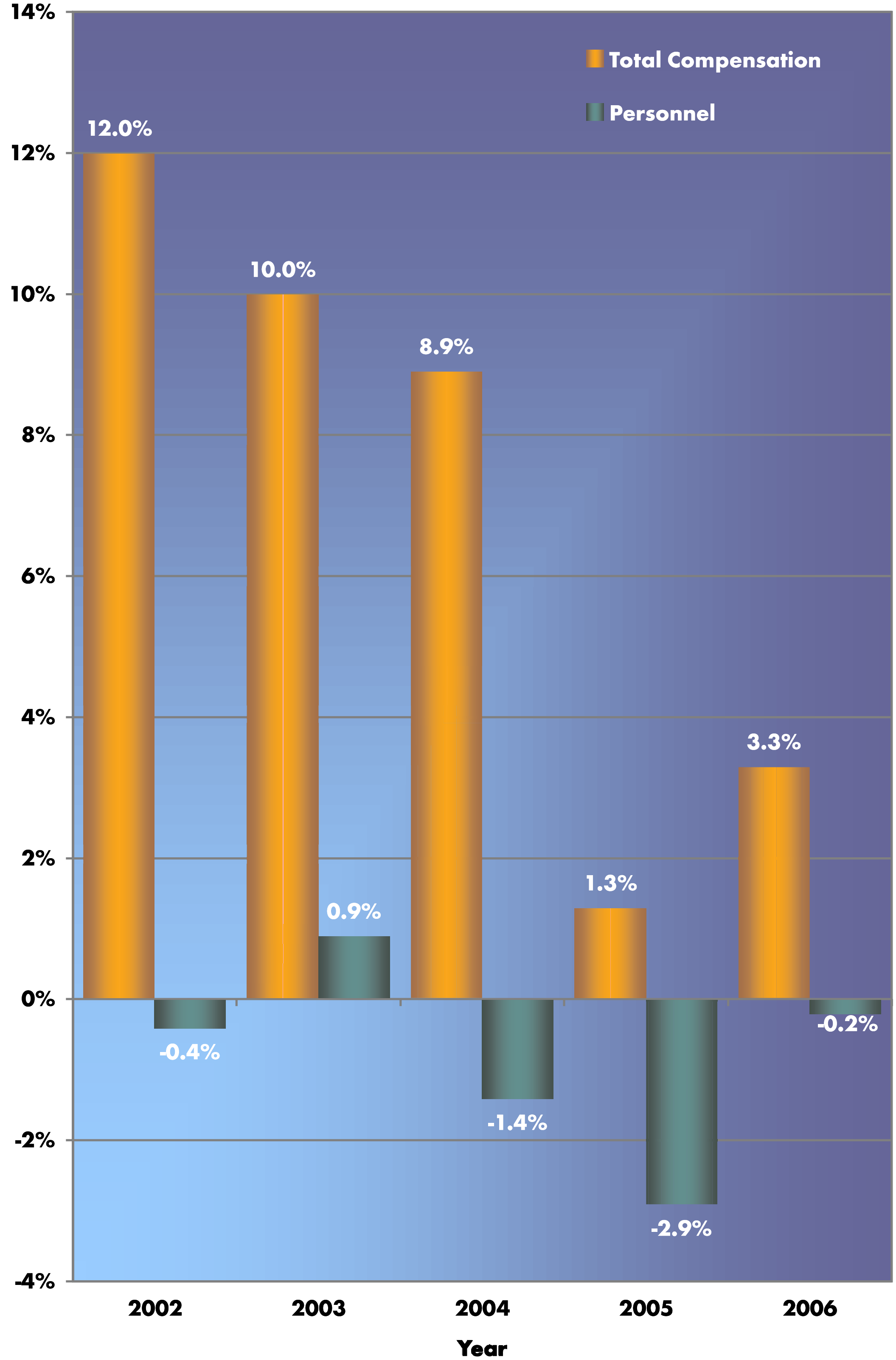
The Old Dominion University Economic Forecasting Project estimates that total compensation of regional military personnel rose by an estimated 41.3 percent between 2001 and 2006, while that of nonmilitary Hampton Roads workers increased by an estimated 22.6 percent during the same period. Total compensation rose by roughly $2.6 billion from 2001 to 2006 despite the fact that the number of military personnel in the region declined by 4,500 during the same period.

GRAPH 3
ESTIMATED PRICE-ADJUSTED GROWTH RATE OF DEFENSE SPENDING IN HAMPTON ROADS AND GRP GROWTH RATE



Source: Old Dominion University Economic Forecasting Project

GRAPH 4
ESTIMATED ANNUAL GROWTH RATE OF HAMPTON ROADS MILITARY PERSONNEL AND TOTAL COMPENSATION (2002-2006)



Sources: U.S. Department of Commerce and Old Dominion University Economic Forecasting Project

Civilian Job Growth in Hampton Roads

Between 2002 and 2006, 36,000 civilian jobs were created in Hampton Roads. Job growth patterns in the region's industrial subsectors are displayed in Graph 5. Health and education accounted for about one third of the new jobs in the region over the period. Leisure and hospitality was responsible for another one quarter of the region's job growth so that these two sectors were responsible for nearly 60 percent of civilian job growth in Hampton Roads over the five-year period.

Two other job developments are notable. First, professional, technical and scientific employment expanded by 2,300 jobs. This is modest in the overall scheme of things, but is important because it reflects a variety of influences – the modeling and simulation expansion centered in Suffolk, expanding research activities at Old Dominion University and increased research and medical activity at Eastern Virginia Medical School. The jobs generated by these activities tend to be the clean, high-paying positions that economic development personnel crave. They represent hope for the future in terms of rising per capita incomes and regional living standards.

The second development, the continuing decline in manufacturing jobs in the region, reflects national trends. Nevertheless, given the increasing levels of manufacturing output in the region, this implies that manufacturing in Hampton Roads is becoming increasingly efficient. This is a good omen for the future.

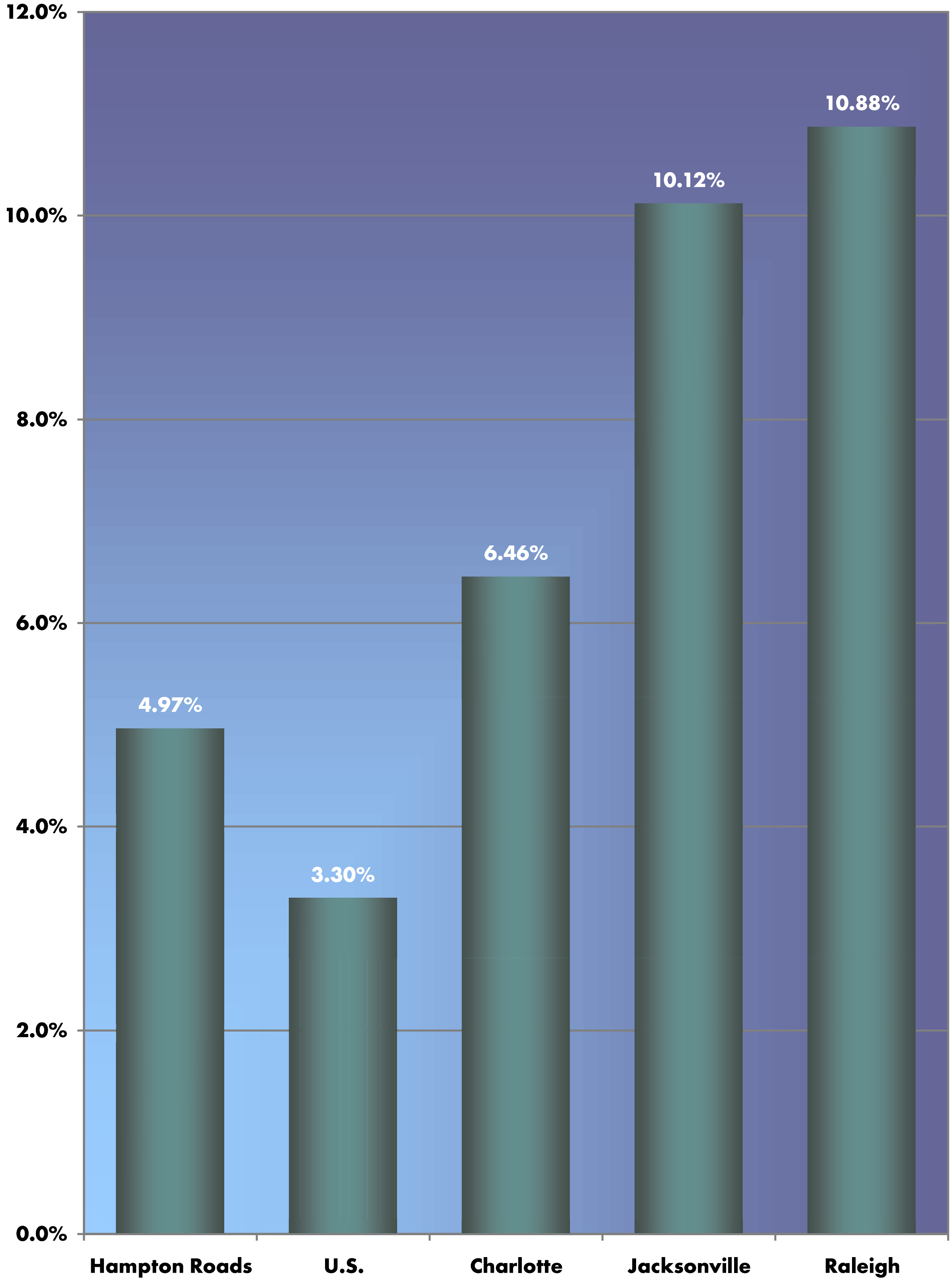
Overall, between 2001 and 2006, civilian job growth in Hampton Roads exceeded the national average, though it lagged several other comparable metropolitan areas in the Southeast. Graph 6 displays these data.

Even though job growth in our region has not been outstanding when compared to other Southeastern metropolitan areas, Graph 7 reveals that personal income in Hampton Roads increased nicely between 2001 and 2006. This reflects higher-wage jobs (an excellent development for the region) and the beneficent effect of the military compensation increases. However, it should also be noted that this trend slowed noticeably between 2003 and 2006.

GRAPH 5
HAMPTON ROADS CIVILIAN JOB GROWTH (THOUSANDS OF JOBS)
(2002-2006)

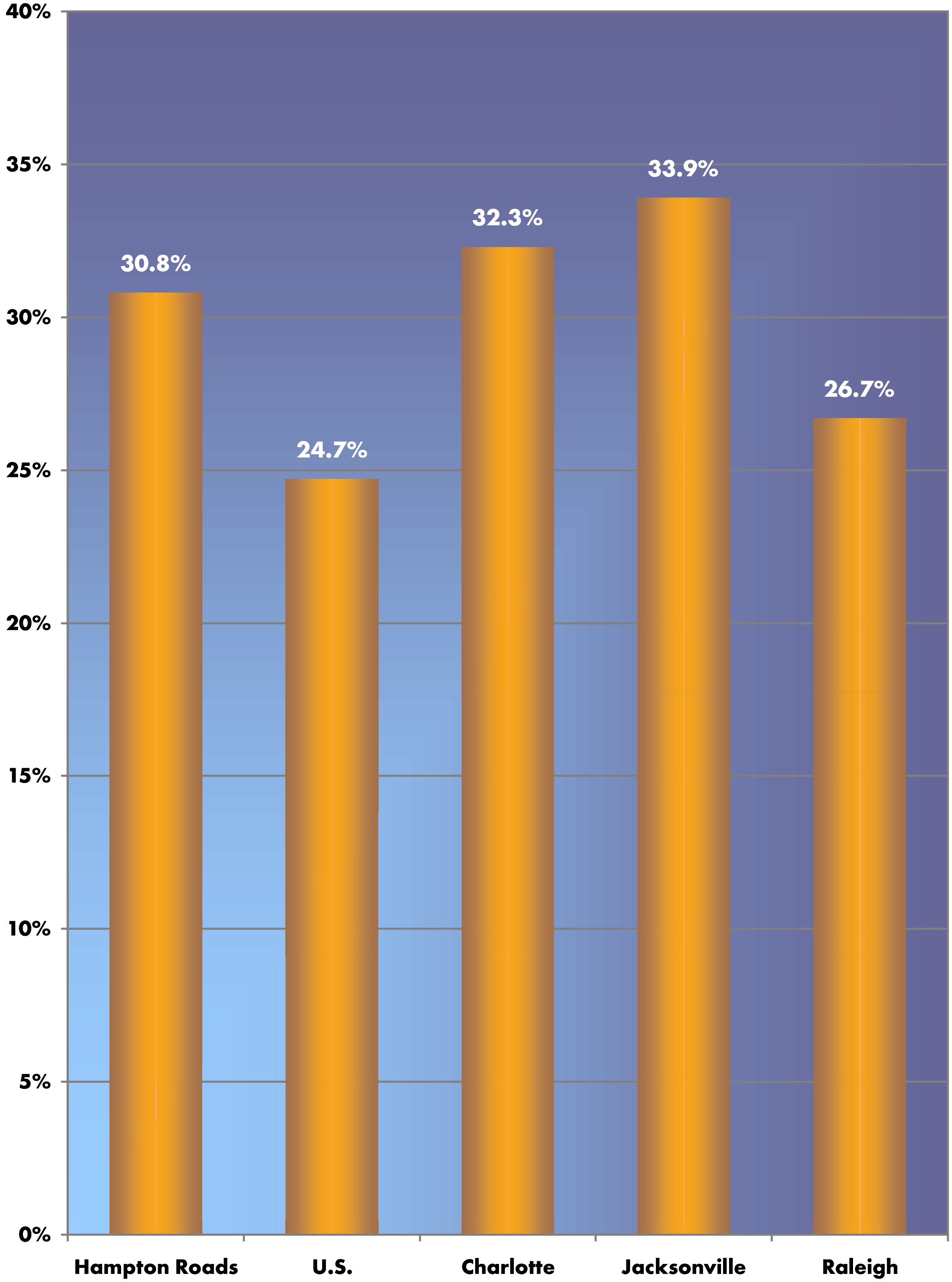
Sources: U.S. Department of Labor and Old Dominion University Economic Forecasting Project

GRAPH 6
ANNUAL CIVILIAN EMPLOYMENT GROWTH RATE IN SELECTED MSA'S
(2001-2006)



Sources: U.S. Department of Labor and Old Dominion University Economic Forecasting Project

GRAPH 7
ESTIMATED PERSONAL INCOME GROWTH RATE IN SELECTED MSA'S
(2001-2006)



Sources: U.S. Department of Labor and Old Dominion University Economic Forecasting Project

Potential External Economic Shocks to Hampton Roads: Ford, BRAC and Jamestown

Spending that flows into the Hampton Roads economy from outside the region stimulates additional economic activity rather than simply reshuffling existing expenditures. Injections of outside spending create an economic ripple effect larger than the original stimulus.

Relatively large increases or decreases in spending that originate outside the region often are referred to as "shocks," because they literally alter the course of the economy. In another chapter in this report, we detail the rather substantial positive economic shock attached to the spending of those who come to the region to compete in and watch the AAU Junior Olympic Games. More than 90 percent of the people who attend the games come from outside Hampton Roads and therefore truly add new spending to the region's economy.

In 2007, there were three important external economic shocks — two negative and one positive — to the region: (1) the Ford Norfolk Assembly Plant closing; (2) BRAC; and (3) the Jamestown 400th anniversary celebration.

Ford Motor Co. completed the planned closing of its truck assembly plant in September 2007. Also in September, the implementation of the Base Realignment and Closing Commission (BRAC) decisions began and will continue through 2012. We addressed the anticipated long-term effects of the Ford plant closing and the BRAC decisions on the region's economy in detail in the 2006 State of the Region report, but have summarized those effects here again in Table 1.

We estimate that closing the Ford plant will reduce the region's 2007 GRP growth rate by only about .1 percent, much less than many individuals would have guessed. On the other hand, the impact of BRAC (a 1.2 percent decrease in GRP between 2008 and 2013) will be substantially larger than that of the Ford plant closing, though it will not have a major effect upon us in 2008.

Taken together, the assembly plant closing and BRAC ultimately will reduce GRP by 1.52 percent annually and eliminate 15,479 jobs after the economic ripple effect has played out.

Much time and effort went into the captivating Jamestown celebration. However, the celebration's economic footprint was relatively small. Displayed in Table 2 are estimates of the event's ability to draw people from outside Hampton Roads. Hotel revenue increased by approximately $2.8 million, a welcome addition, but this was only a tiny proportion of the region's annual hotel revenues of $700 million.

TABLE 1
ESTIMATED FORD PLANT AND BRAC LONG-TERM ECONOMIC OUTCOME (2007 DOLLARS)

	GRP Loss	Job Loss	Jobs as a Percent of MSA Total*	Percent GRP Loss
Ford Plant	$0.6 Billion	6,380	0.63%	0.8%
BRAC	$0.9 Billion	9,099	0.90%	1.2%
Total	$1.5 Billion	15,479	1.52%	2.0%

Source: Old Dominion University Economic Forecasting Project
*Civilian and military employment combined

TABLE 2
2007 JAMESTOWN CELEBRATION ESTIMATED EFFECT ON HOTEL REVENUE AND OCCUPANCY IN HAMPTON ROADS

Room Nights	33,500
Hotel Revenue	$2.8 Million
Percentage Increase in Hotel Revenue	0.42%

Source: Old Dominion University Economic Forecasting Project

Regional Housing Markets

National Association of Realtors data indicate that appreciation in the median price of a single-family home nationally was 12.1 percent in 2005, but only 1.4 percent in 2006. In Hampton Roads, however, single-family home prices appreciated by 21 percent in 2005 and another 19.4 percent in 2006. Hence, there has been some economic disconnect between the Hampton Roads real estate market and national markets. Typically, Hampton Roads markets have lagged the nation by six months to one year.

Lagged relationship or not, the region is not immune to national influences. Preliminary data for 2007 suggest that single-family home prices have not increased this year, and may even have declined in certain categories (condominiums).

NEW HOUSING PERMITS IN HAMPTON ROADS

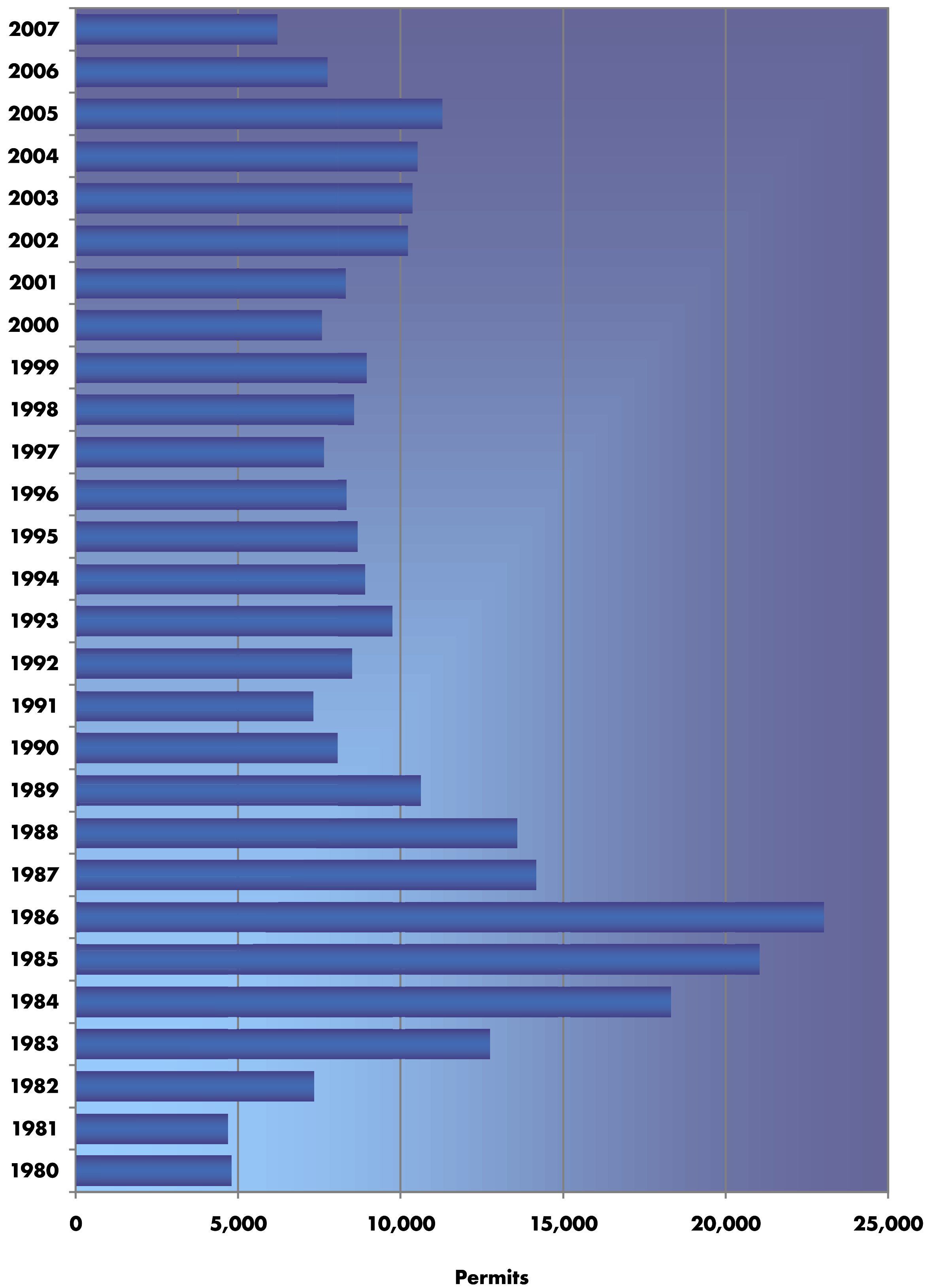
According to the National Association of Realtors, new housing starts nationally declined by 30.6 percent between first-quarter 2006 and first-quarter 2007. The best evidence that residential housing markets have cooled off in Hampton Roads as well is contained in Graph 8, which reports that new housing permits in our region fell by 20 percent during the same time period and 45 percent over two years.

Still, as one can see in Graph 8, this decline was modest compared to that experienced by the region in the late 1980s and early 1990s when new housing permits dropped from about 23,000 to about 6,500 in the space of five years. The good news in 2007 is that builders and developers have been much more cautious in the past few years than they were in the 1980s when, as one builder puts it, "Some of us went nuts and paid for it later."

Despite this caution, as Graph 9 demonstrates, the inventory of unsold residential homes in the region has increased continuously since 2003. Houses now take longer to sell. Graph 10 shows that the typical home being sold in 2007 was on the market for almost 70 days, more than double the time in 2005.

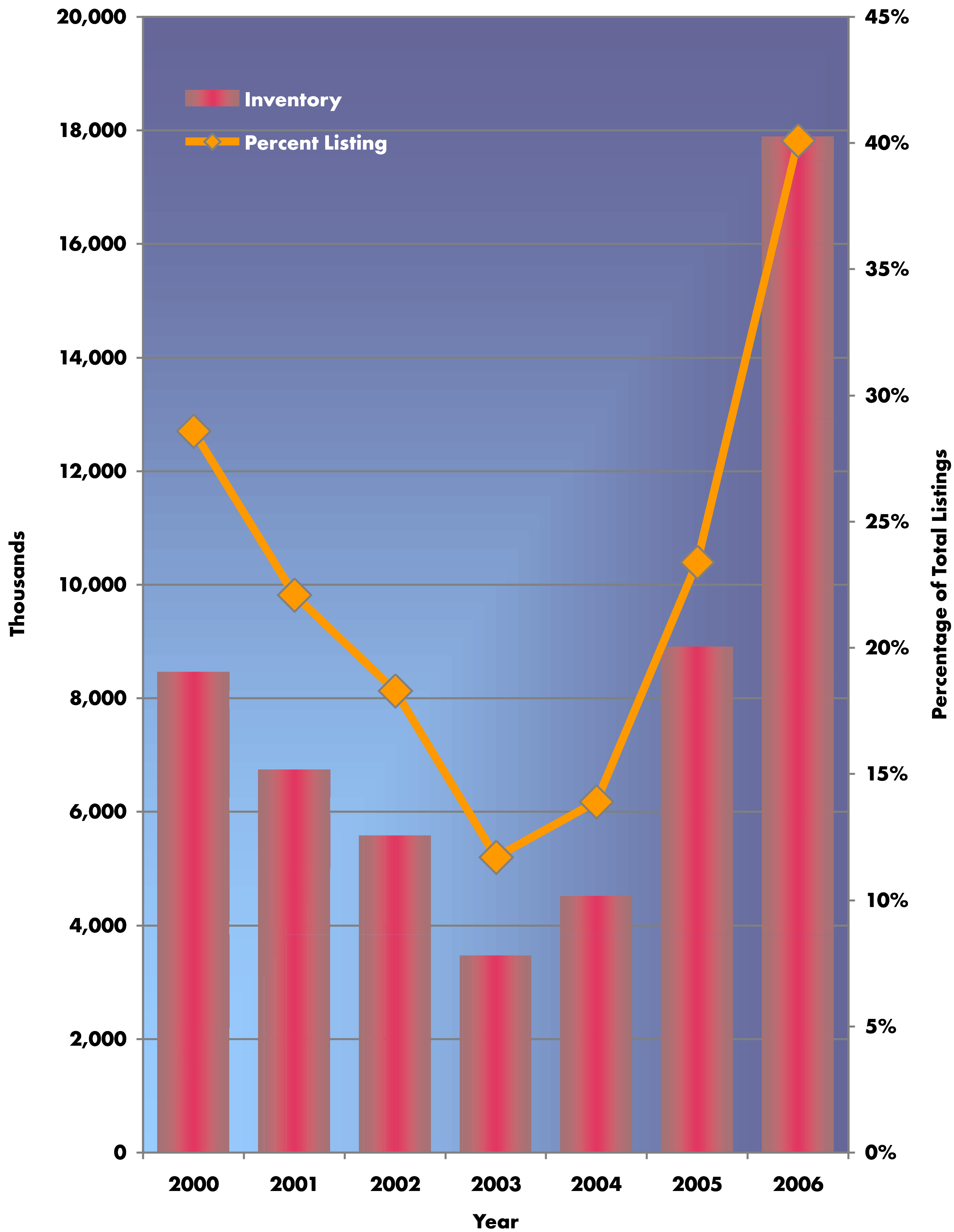
Graph 11 divides the region's new housing permits into two parts: (1) single-family, detached homes and (2) condominiums. One can see that the fall in permits for condominiums has been more severe than that for single-family, detached homes. **If there is a portion of the regional housing market where adjustments to new demand and supply realities are likely to be most difficult, then it is the condominium market.** Substantial amounts of new inventory are still under construction and have yet to hit the market. Some investors who purchased condominium units with the intent of "flipping" them, that is, reselling them for a quick profit, now will find they cannot make a sale without significant price reductions. If they do not wish to offer such reductions, then they will have to make significant concessions on items such as closing costs, or become landlords and rent their units.

GRAPH 8
NEW HOUSING PERMITS IN HAMPTON ROADS



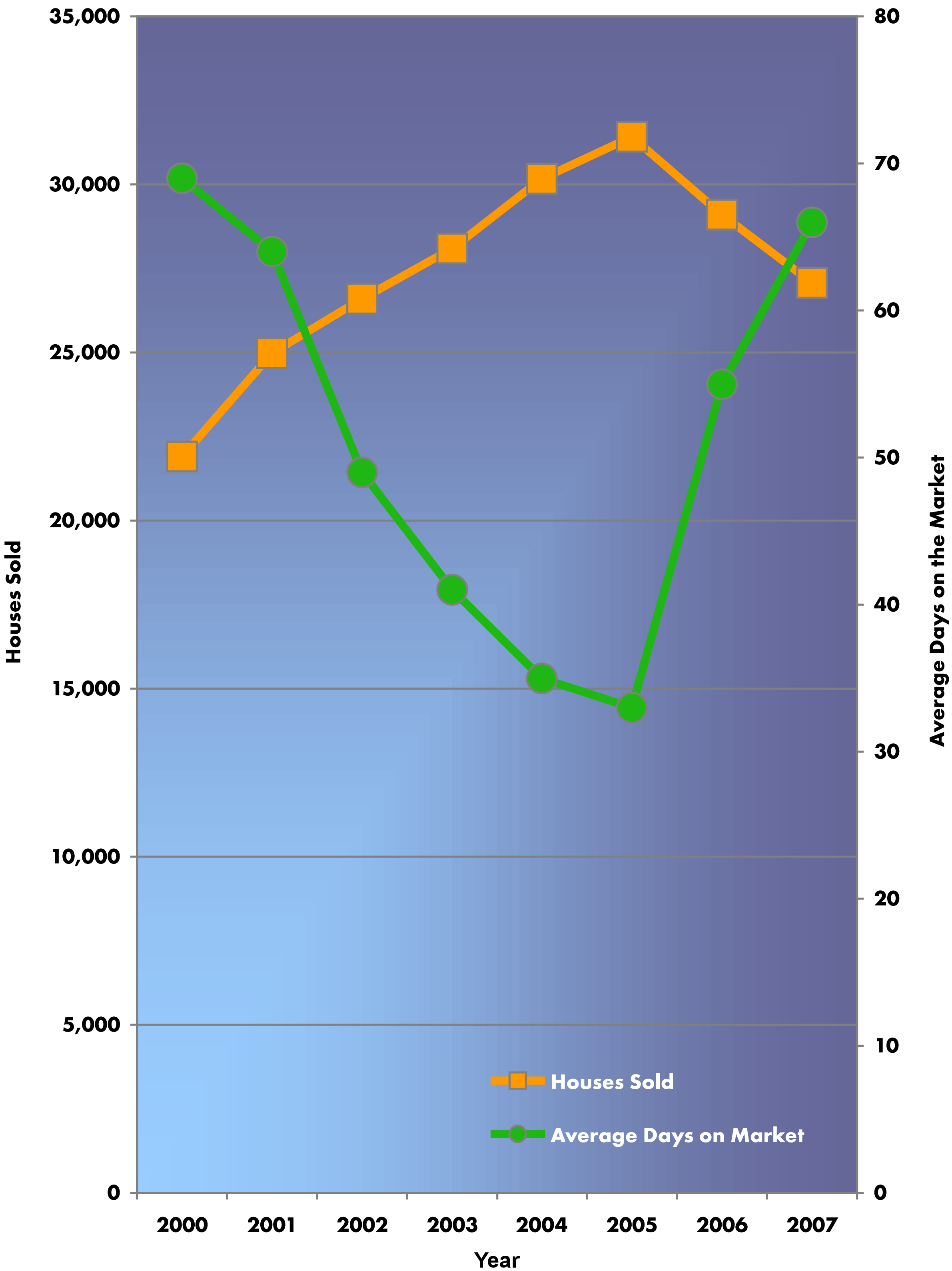
Sources: U.S. Census Bureau and Old Dominion University Economic Forecasting Project

GRAPH 9
HAMPTON ROADS INVENTORY OF UNSOLD RESIDENTIAL HOUSES



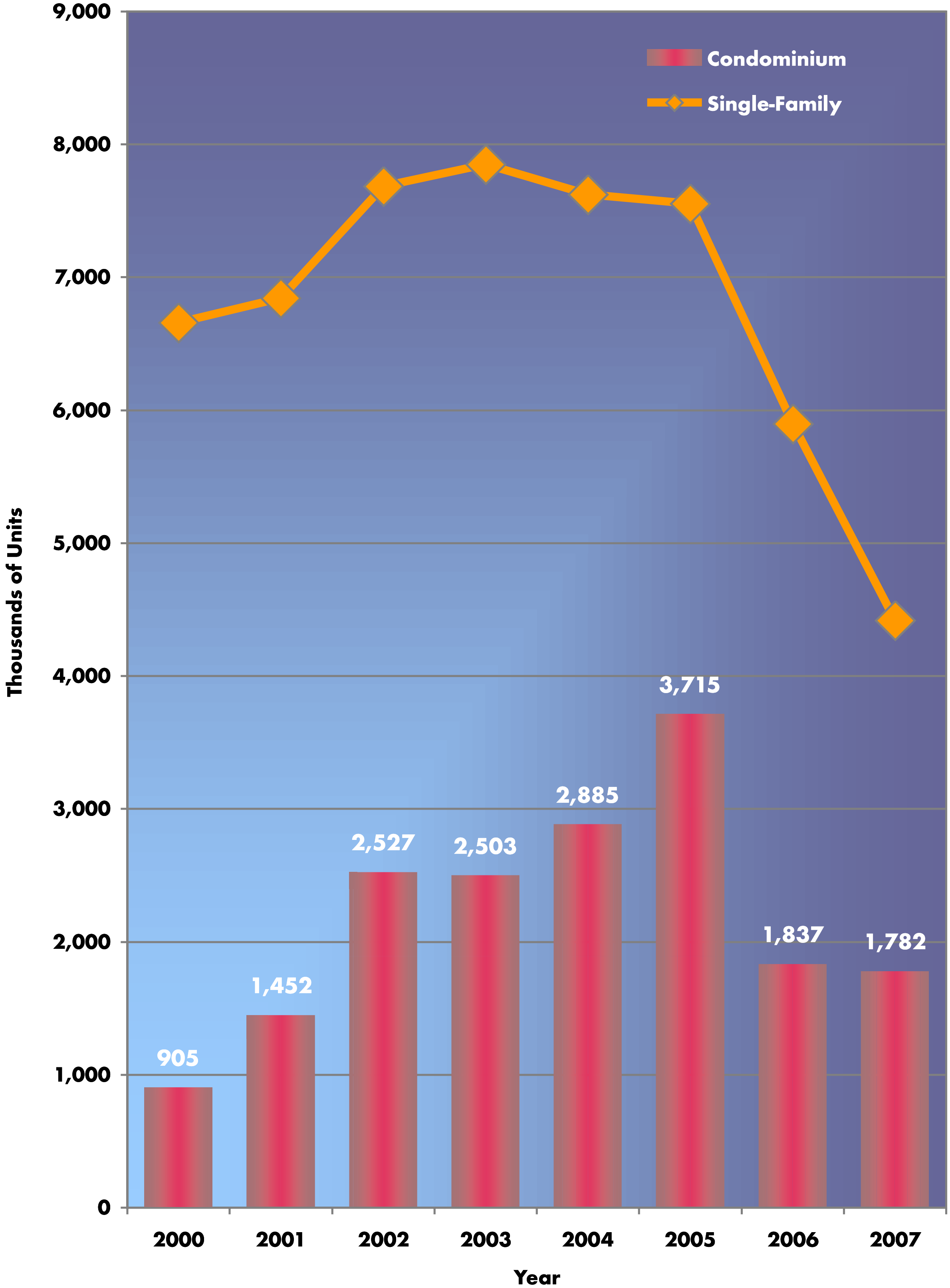
Sources: Real Estate Information Network Inc. and Old Dominion University Economic Forecasting Project

GRAPH 10
HAMPTON ROADS *EXISTING* HOUSING SALES AND AVERAGE NUMBER OF DAYS ON THE MARKET
(2000-2007)



Sources: Virginia Association of Realtors and Old Dominion University Economic Forecasting Project

GRAPH 11
DETACHED SINGLE-FAMILY HOUSES AND CONDOMINIUM BUILDING PERMITS IN HAMPTON ROADS
(2000-2007)



Sources: U.S. Census Bureau and Old Dominion University Economic Forecasting Project

RENTING VERSUS OWNING

Based upon individual circumstances, every household must choose either to rent or to own. **Over the past few years, it has become relatively more attractive for households to rent rather than to own in Hampton Roads.** Table 3 reveals that when we compare the principal and interest payments for the ownership of the median-priced, single-family home (assuming no down payment and excluding taxes) to the price of renting a comparable unit, we find that it now is about 25 percent more expensive to own a three-bedroom house than to rent it. Between 2003 and 2006, the ratio of owner cost to rental cost rose from .77 to 1.25, a 62 percent increase.

The declining attractiveness of ownership relative to renting reversed the relationship that held true in the first few years of this decade. Between 2000 and 2003, the ratio of owner monthly principal and interest payments to renter monthly payments fell significantly. Consequently, many renters opted to own, sometimes with the help of sub-prime mortgages (a subject we treat below). This inflow of former renters supplied tinder for the hot housing market of the first years of this decade. Still, the owner versus renter cost ratio has been rising since 2003 and by 2006 was 65 percent higher. Relatively speaking, renting in Hampton Roads has become much more attractive than it was early in this decade.

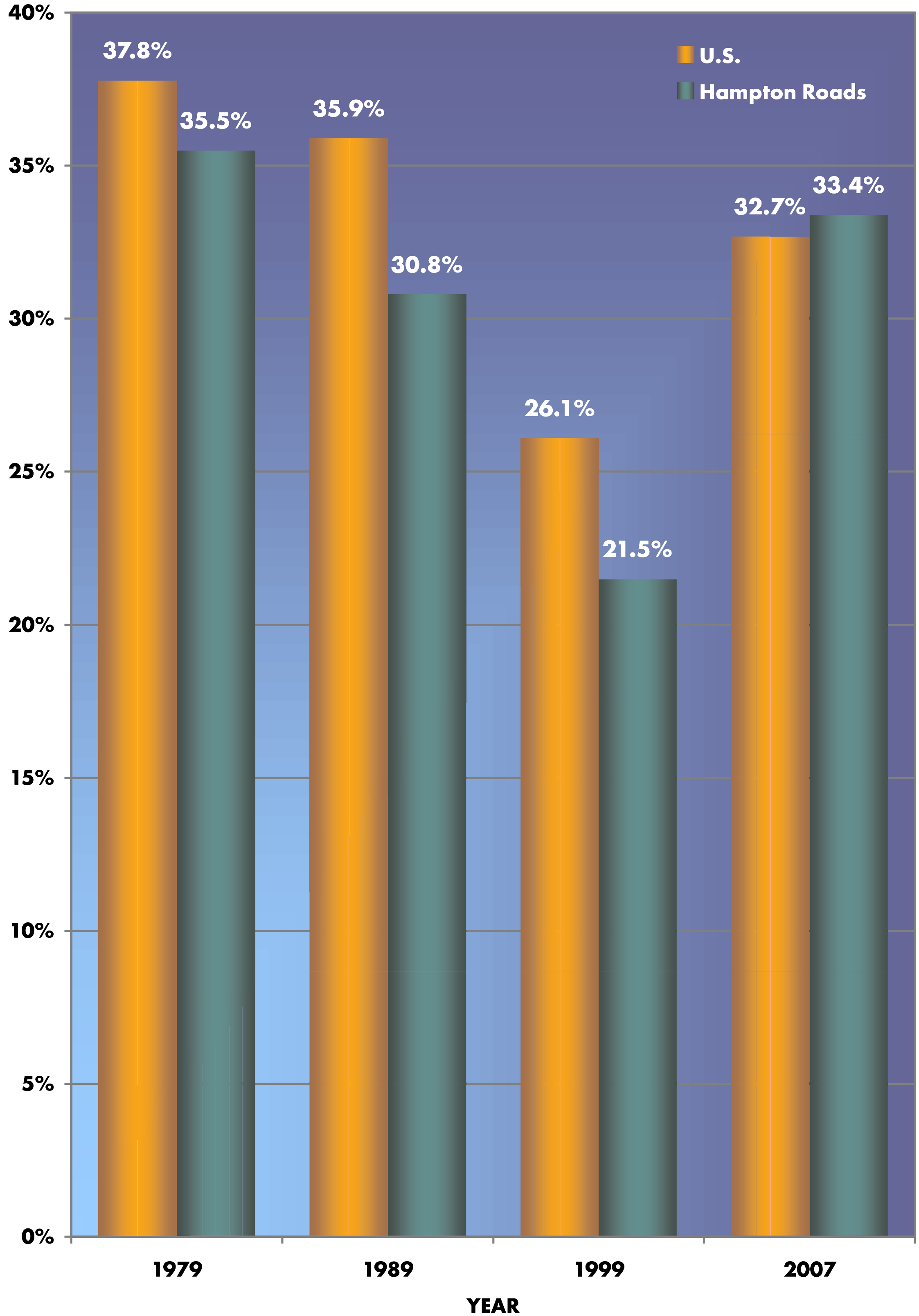
The reduced attractiveness of home ownership also is reflected in Graph 12, which divulges that the principal and interest payments associated with a median home purchase rose from 21.5 percent of median household income in 1999 to 33.4 percent in 2007. Pragmatically, this means that a typical mortgage in Hampton Roads today requires about one third of median household income, whereas the same mortgage required only a bit more than one fifth of median household income in 1999. For the first time in three decades, housing in Hampton Roads is slightly less affordable than in the nation as a whole.

TABLE 3
ESTIMATED HOUSE RENTAL AND PRINCIPAL AND INTEREST FOR A HOUSE PAYMENT IN HAMPTON ROADS (2000-2006)

	Median Monthly Rent for a Three-Bedroom House	P&I Monthly for a Median House	Ratio of Monthly P&I to Rent
2000	$ 882	$ 854	0.97
2001	911	809	0.89
2002	1,037	827	0.80
2003	1,044	809	0.77
2004	1,087	1,065	0.98
2005	1,118	1,341	1.20
2006	1,164	1,457	1.25

Source: H.U.D. and the Old Dominion University Economic Forecasting Project

GRAPH 12
MEDIAN HOUSE PURCHASE BORROWING COSTS AS A PERCENTAGE OF MEDIAN HOUSEHOLD INCOME IN HAMPTON ROADS AND THE U.S. (1979-2007)



Source: Old Dominion University Economic Forecasting Project

THE SUB-PRIME MORTGAGE PROBLEM

Sub-prime mortgages are those granted by financial institutions to borrowers who have lower credit scores (for example, a FICO score below 620). Such borrowers are perceived to be risky and often pay higher mortgage rates as a result. Nationally, there has been great concern that the increase in the proportion of sub-prime mortgages being granted will result in delinquencies and foreclosures as borrowers find themselves unable to service their mortgages. According to the Federal Reserve Bank of Chicago, more than 20 percent of all mortgages granted recently have been sub-prime, up from only 1.4 percent in 1994.

Fortunately, as Table 4 discloses, the exposure of Hampton Roads to sub-prime mortgages has been limited (10.33 percent of all mortgages in December 2006). Further, our regional sub-prime borrowers are less likely than those nationally to be delinquent in their mortgage payments (7.02 percent versus 15.75 percent). Even so, sub-prime delinquency rates in Hampton Roads almost doubled between December 2005 and December 2006.

Meanwhile, the delinquency rate for all mortgages (regular and sub-prime) rose from 1.67 percent to 2.34 percent in the region between fourth-quarter 2005 and first-quarter 2007. Table 5 depicts this change, but also discloses that the overall delinquency rate in Hampton Roads is well below both the national rate and the rates of comparable metropolitan areas in the Southeast. **Hampton Roads is not one of the regions most at risk because of delinquent mortgages.**

TABLE 4
SUB-PRIME MORTGAGE PROPORTIONS
(DECEMBER 2006, SELECTED MSA'S)

MSA	Percent Sub-prime Mortgages Dec. 2006	Percent Delinquent Sub-prime Dec. 2006	Percent Delinquent Sub-prime Dec. 2005
Hampton Roads	10.33%	7.02%	4.13%
Richmond-Petersburg	22.28	10.70	6.46
Danville (Va.)	16.83	11.85	6.39
Jacksonville	16.15	10.77	8.21
Charlotte	12.55	13.50	11.91
Orlando	16.16	7.64	3.88
Atlanta	12.36	17.81	13.62

Sources: Wall Street Journal, First American Loan Performance and U.S. Census Bureau

TABLE 5
MORTGAGE DELINQUENCY RATE
(FOURTH-QUARTER 2005 AND FIRST-QUARTER 2007, SELECTED MSA'S)

MSA	Percent Delinquent All Mortgages 2007 Q1	Percent Delinquent All Mortgages 2005 Q4	Percent Change (2005 Q4-2007 Q1)
Hampton Roads	2.34%	1.67%	.67%
Richmond-Petersburg	2.59	1.99	.6
U.S.	2.87	2.03	.84
Jacksonville	3.09	2.33	.76
Charlotte	3.39	3.06	.34
Orlando	3.54	1.83	1.72
Atlanta	4.07	3.45	.62

Sources: Wall Street Journal and Equifax/Moody's Economy.com

HOUSING DEMAND AND SUPPLY

Ultimately, housing prices are determined by demand and supply influences, just like automobiles, pizzas, or any other good or service. On the demand side of the market, several competing factors are likely to pull the demand for home ownership in opposite directions. On the positive side, as outlined above, the region's income and output are expected to increase. In addition, according to the latest employment prognostication of the Old Dominion University Economic Forecasting Project, employment in Hampton Roads, an important predictor of housing demand, is expected to increase by about 1 percent in 2007, not far from its average rate of increase since 2000 (see www.odu.edu/forecasting). Further, housing prices relative to household incomes in Hampton Roads are still close to the national average.

Against this, as we have seen, it has become relatively cheaper for households to rent than to own in Hampton Roads. And, the percentage of households in our region that already own their home approaches 75 percent, well above the national average. These factors will work to diminish housing demand.

On the supply side, there also are countervailing influences to take into account. First, there is an existing inventory of unsold homes and condominiums in Hampton Roads that clearly is larger than it was three years ago during the height of the housing boom. It will take some time for the region to work through this unsold inventory and, in the case of condominiums, this process might be lengthy because large segments of new inventory currently are under construction, but not yet completed. The bottom line is that we have yet to work through the large number of new housing permits that were issued between 2002 and 2005.

Second, however, regional housing markets are not as maladjusted now on the supply side as they were in the 1980s when the number of new housing permits being issued annually in the region was five times that for 2007. The housing market adjustment process in the late 1980s was painful and drove some builders and developers out of business. Price decreases were not uncommon and seller concessions (closing costs paid, interest rate buy-downs, extras added to homes without charge and the like) were frequent. In 2007, however, because builders and developers have been more conservative, levels of unsold and unoccupied housing in the region are lower, at least as compared to the 1980s. **Further, despite the tremendous upsurge in housing prices that has occurred in Hampton Roads over the past few years, until 2000, housing costs in the region actually were below those that fundamental economic magnitudes (incomes, interest rates and the like) predicted. The result is that while housing prices are 10 percent to 20 percent above what fundamental economic magnitudes predict, currently this is not a housing market that appears to exhibit a price bubble that will rapidly deflate if punctured.**

That said, one would have to be quite an optimist to predict rising housing prices in the Hampton Roads area during the next year or two. More likely, prices will stagnate and seller concessions will become widespread if sellers resist lowering their prices. Several additional words of caution are merited, however. Factors well beyond the control of Hampton Roads could cause this situation to deteriorate quickly. Some combination of rising prices and interest rates, a national economic recession, an interruption in the nation's oil supply and a major decline in the value of the American dollar could cause severe damage to housing markets. If so, then based upon past history, it might be three to five years before regional housing markets recover and prices resume their climb. In our view, there is at least a one in four chance that this scenario will occur.

Summing It Up

Since 2004, Hampton Roads' economic growth rate has fallen below its historic average. This trend is likely to continue in 2007, although the region probably will outperform the national and state economies, something it has not done since 2003.

The relatively sluggish economic conditions within the region are largely due to the declining rate of growth in defense spending. These declines have not been sufficiently offset by growth in the nondefense sectors of the region's economy. The civilian employment growth rate in Hampton Roads was roughly 25 percent below that of the nation from 2003 to 2006 and significantly below that of comparable Southern metropolitan areas. On the bright side, despite relatively modest employment growth, our income growth has kept pace with that of the nation. This reflects both higher-wage jobs and increased military compensation.

The lingering effects of the Ford plant closing, combined with full implementation of the BRAC decisions, are likely to exert a drag on the region's economic growth rate over the next few years. Hence, absent any other significant negative economic shocks, we are in for several years of modest economic performance.

The story will be much the same in housing. The housing price boom is over and housing prices already are stagnating in response to increasing amounts of unsold inventory. Seller concessions will assume increasing importance and will cushion any downward trend in housing prices. **The major threat to our housing markets is not what is occurring here in Hampton Roads, but instead, national and international economic events.** A disruption in the nation's oil supply is only one of many adverse scenarios that would negatively influence both the region's economy and its housing markets.