OBSERVATION
TD Economics

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THE D.C. METRO ECONOMY IS FINALLY EMERGING FROM THE SHADOW OF BUDGET CUTS

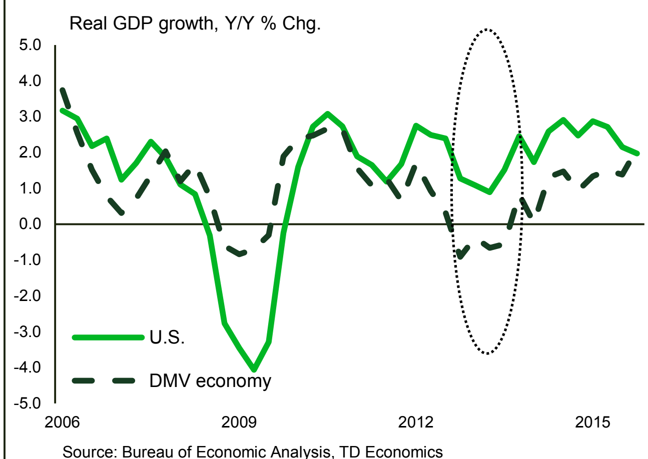
Highlights

- After three years of lackluster performance, resulting from federal spending cuts related to the Budget Control Act of 2011, green shoots have begun to emerge across the Washington D.C. metro economy.
- The economic expansion should increasingly strengthen, supported by a continued rotation of federal contractors towards private sector demand, the region's rising importance as a cybersecurity hub, modest increases in federal spending, and focus on growth priorities by state governments.
- As a result of these developments, the D.C. metro area is already catching up with national growth and should grow by 2.2% this year before accelerating to a more robust 2.5% pace in 2017 – the best consecutive pace of growth in a decade.

It has been more than three years since a set of automatic spending cuts related to the Budget Control Act (BCA) of 2011, known as sequestration, was implemented. It cut federal defense and non-defense discretionary program spending nationally, but its effects were arguably most pronounced across the Washington D.C. metro.[1] The region is among the most exposed to federal funding through both direct government employment as well as procurement spending on government contracts.

Dependence on federal dollars insulated the region during the Great Recession, which was only half as deep in the D.C. metro as it was nationally. However, the region's dependence on federal dollars become a liability once the sequester was implemented (chart 1), with post-sequester peak-to-trough contractions of 1.0% in Virginia and 1.4% each in D.C. and Maryland. The impact of sequestration was most pronounced in the federal government and business services sectors. Civilian employees at the Department of Defense (DoD) were one of the largest groups affected, with roughly 650,000 employees furloughed in the aftermath of sequestration. Similarly, the federal judiciary cut its workforce by 8% and other federal agencies in the D.C. metro faced similar constraints.

CHART 1: DEPENDENCE ON FEDERAL DOLLARS, A DOUBLE-EDGED SWORD FOR GROWTH



Source: Bureau of Economic Analysis, TD Economics
*The DMV economy encompasses the D.C., Maryland, and Virginia economies.

Resultant job losses led to lower income tax revenues, placing a subsequent strain on state and local government coffers. Notably, governments in both Va. and Md. introduced several cost-cutting measures to combat the consequent revenue shortfalls, further impinging on economic growth. The effects of the sequester did not stop there as second order effects manifested in subdued housing market metrics, weaker retail sales, and lower

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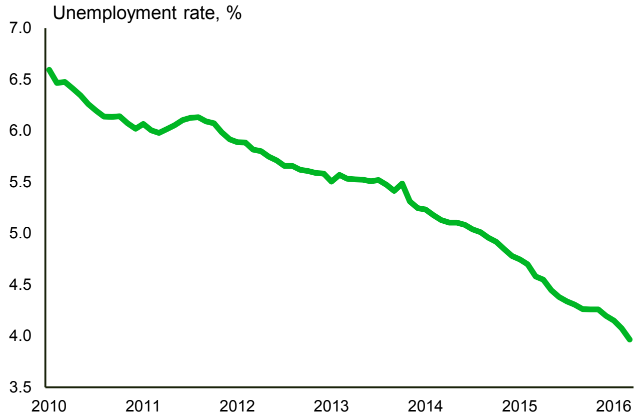
CHART 2: SEQUESTRATION ONLY A MINOR SPEEDBUMP ON THE ROAD TO LOWER UNEMPLOYMENT



Source: Bureau of Labor Statistics, TD Economics

business sentiment. Real estate & leasing payrolls slumped yet again and home prices in Md. and Va. have remained lower for longer, with post-recession recovery well-below the national.

Nonetheless, after years of little to no growth, green shoots have begun emerging across the regional economy. These should turn into increasingly robust economic growth over the medium run. For one, the hard hit professional & business services sector, previously reliant on federal money, is beginning to diversify away from federal contracts, with the high-tech and cybersecurity sectors leading the way in venture capital funding. The regional economy should also find some reprieve by additional federal government funding towards cybersecurity research as well as the lifting of federal government spending caps related to the Bipartisan Budget Act (BBA) of 2015. Lastly, state and local governments are moving from budgets of austerity to ones that increasingly prioritize investment and growth.

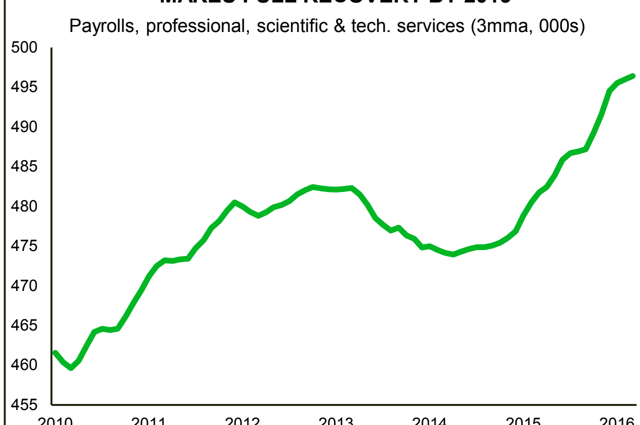
The importance of high-skilled labor

Cuts to federal procurement spending manifested sharply on the metro's professional, scientific, and technical sector. This industry was among the hardest hit at the onset of sequestration, with job losses reaching nearly 10,000 by late 2013 – more than double the declines during the Great Recession. Still, these cuts have come at a relatively opportune time for the industry. The national economy has been rapidly turning to one that's more knowledge-based. As such, many firms in the high-tech services sector that lost federal contracts often found customers in the private sector. Displaced workers from firms that were less successful in transitioning also appear to have found employment relatively quickly given their skillsets were in high demand. As such, while the improvement in the jobless rate slowed during this time, unemployment did not rise as a result (chart 2).

The professional, scientific, and technical sector has since made a full recovery, rising to it's pre-sequester level by early-2015 (chart 3). And payrolls in the sector are showing no signs of slowing. Having added almost 25,000 since the sequester-related trough, jobs in the sector are increasing by a very robust 3.5% y/y clip. This stellar performance will greatly benefit the regional economy, with the well-paying sector accounting for one of six jobs in the D.C. economy – more than double the 6% share nationally (chart 4).

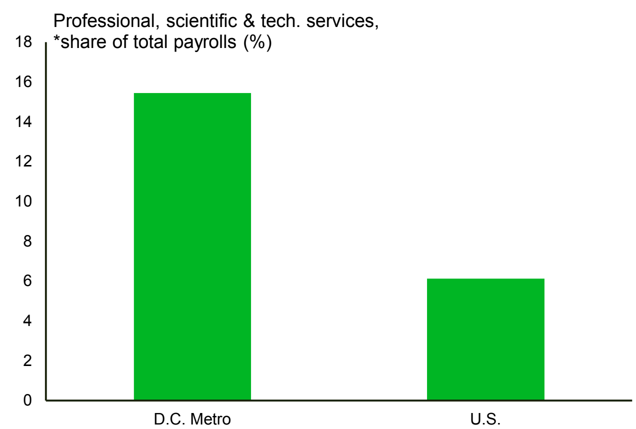
About half of the sectoral gains have been in computer systems & design with many of the jobs in the field of cybersecurity. Many of the local firms previously depended on contracts from nearby Fort Meade and the Pentagon,

CHART 3: HIGHLY EDUCATED WORKFORCE MAKES FULL RECOVERY BY 2015



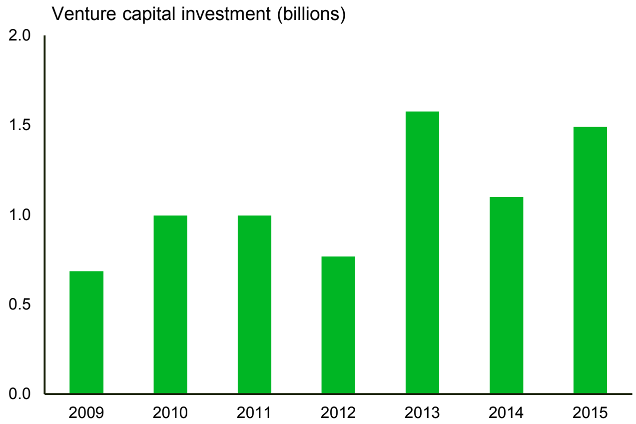
Source: Bureau of Labor Statistics, TD Economics

CHART 4: SIZABLE NUMBER OF HIGH-SKILLED WORKERS IN THE D.C. METRO AREA



Source: Bureau of Labor Statistics, TD Economics
*share is calculated using March 2016 data

CHART 5: VENTURE CAPITALISTS TAKE NOTICE OF CYBER DEVELOPMENTS



Source: PwC/National Venture Captial Association, TD Economics

but cybersecurity firms have diversified away from federal contracts and are increasingly serving firms including Mastercard, BMW, and Adidas among others. Prospects for the industry remain bright given the clustering effects, proximity to key internet backbones, and substantial human capital in this field. Moreover, D.C. area schools are investing substantial resources in their cybersecurity programs which should ensure a continuous stream of skilled graduates in the area. George Mason University in Fairfax, Va. and the University of Maryland, in particular, are ranked among the top schools nationally for cybersecurity programs.

VC firms are taking notice

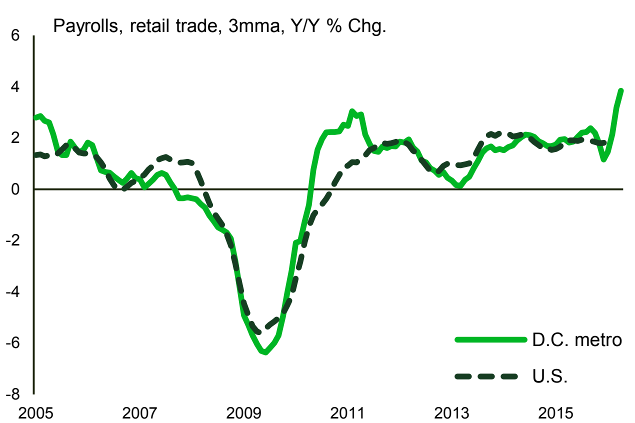
Much of the growth in the cybersecurity industry is dependent on venture capital (VC) funding which has begun to flow to the D.C. metro as it develops into a hub for cybersecurity. Last year, VC investment in the region totaled over $1.4 billion, up nearly 30% from the prior year (chart 5). The average deal size was also up from $5.5 million in 2014 to $8.4 million last year, led by a $250 million deal by cybersecurity firm Tenable Network Security – a record in the cybersecurity space and the region's largest VC deal since the 1999 deal for XM Satellite Radio Holding.

Growing threat from cyber-attacks, which are becoming more frequent and continue to evolve, is motivating more companies to seek assistance from cybersecurity firms. Tenable, for example, has a client list spanning over 20,000 companies nationally, and plans to hire hundreds of new employees over the next five years. The bright prospects for the industry should continue to attract substantial VC investment and help spur economic growth.

Cyber boom helps spur a virtuous cycle of more job creation

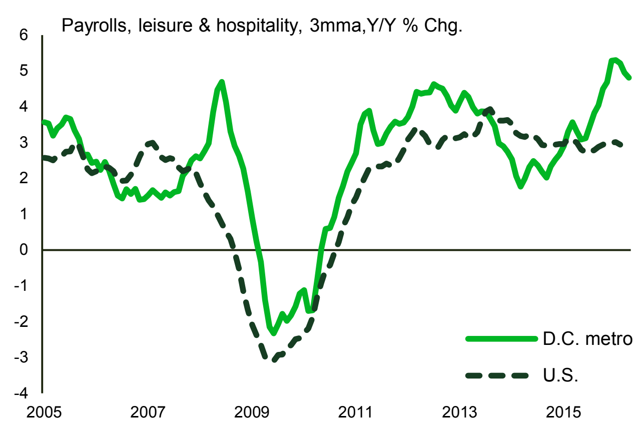
The continuing recovery in the generally well-paying professional, scientific, and technical jobs has led to an acceleration in incomes across the region. This has boosted the appetite for dining out and shopping, increasing demand and hiring amongst retailers, restaurants, and entertainment venues which is helping generate a virtuous cycle of job and income growth. After decelerating sharply, and briefly stalling, in the aftermath of the sequester, hiring in the D.C. metro retail sector is outpacing that of the national and is among the sectors leading regional hiring (chart 6). The leisure & hospitality sector was much less affected by sequestration, with the number of tourists visiting the nation's capital growing by an average of 4.5% y/y in 2013 and 2014 and setting a record 20.2 million visitors in 2014.

CHART 6: STRONG RETAIL HIRING A RESULT OF VIRTUOUS CYCLE...



Source: Bureau of Labor Statistics, TD Economics

CHART 7: ... AND EVEN STRONGER HIRING AT RESTAURANTS AND HOTELS



Source: Bureau of Labor Statistics, TD Economics

Better yet, hiring in this sector has accelerated sharply as of late, driven by increased domestic business and leisure travel (chart 7) – perhaps partly a result of additional activity during an election year.

Housing market metrics still lag behind

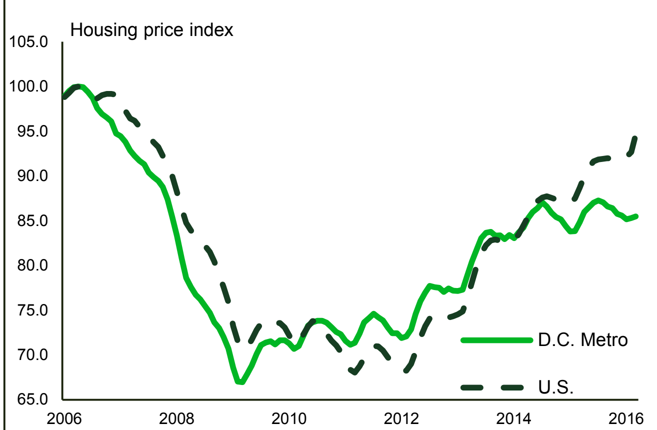
Stronger job and income gains have begun to make their way into discretionary spending, but have been less evident in the housing market. While home prices in the D.C. metro remain more expensive than nationally, past job losses and rising uncertainty related to sequestration has led them to underperform the nation ever since its onset (chart 8). Home prices growth has languished, and slowed well below the national, with prices some 12% below previous peaks – as compared to the 3% posted nationally. Nonetheless, housing market metrics typically lag employment and incomes and recent payroll and permitting data suggest that an improvement is in store for the near-to-medium-term outlook.

Corroborating this notion is the recent rise in real estate and leasing payrolls. After underperforming the national for the much of the post-sequester period, payrolls in this sector are now outperforming suggesting that transaction activity is picking up (chart 9). Encouragingly, homebuilders are also laying out plans for future construction with permit growth at its fastest pace in two years, after a recent soft patch (chart 10).

Federal dollars will also help support cyber sector and help spur regional growth

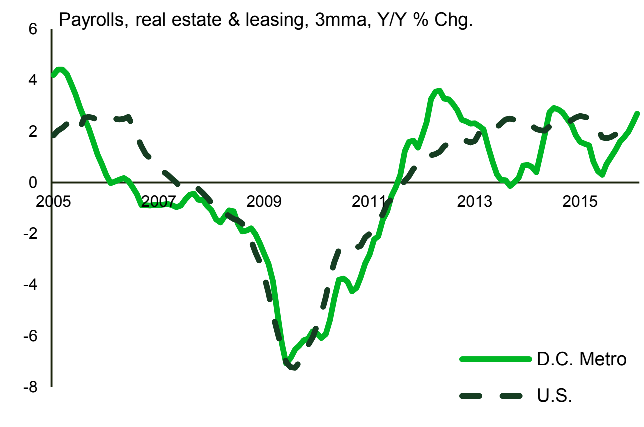
The organic growth that is taking place in the cyber sector and leading to a virtuous cycle of more job creaton will be further strengthened by an increase in federal spending.

CHART 8: SEQUESTRATION PUTS A HALT ON ACCELERATING HOME PRICE GROWTH



Source: Corelogic, TD Economics

CHART 9: HOUSING MARKET METRICS SUGGEST ACTIVITY IS ON THE RISE

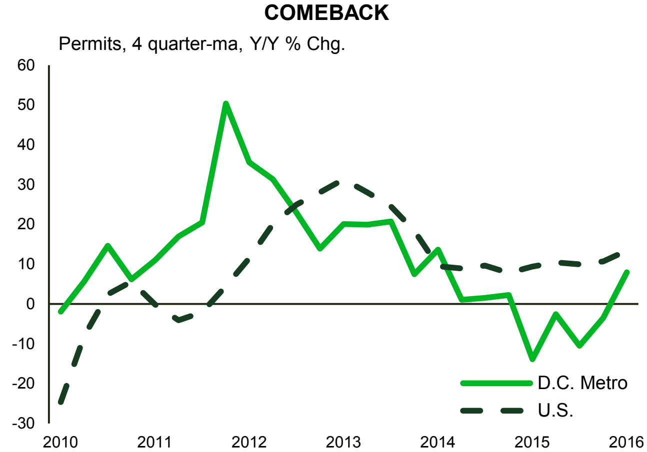


Source: Bureau of Labor Statistics, TD Economics

Though broad-based federal spending will remain constrained over the next decade as many spending caps linger through FY2025, federal money allocated for cybersecurity is rising. The Department of Defense is calling for a 15% increase in spending on cyber-defense operations in the fiscal 2017 budget (totaling $6.7 billion). The required funding will be used to further develop cyber tools and infrastructure and provide offensive cyber options. Moreover, cyberattacks are not only constrained to the private sector, with the Office of Management and Budget reporting a 10% increase in the number of cybersecurity attacks on government networks in 2015 (77,000 in total).

Many of the government institutions that require top-notch security are located in the area, which is home to the FBI and Department of Homeland Security in D.C., the CIA and Pentagon in Virginia, and Central Cyber Command at

CHART 10: PERMITTING ACTIVITY IS MAKING A COMEBACK



Source: U.S. Census Bureau, TD Economics

Fort Meade in Maryland. Since many of these government contracts incorporate proximity requirements requiring that bidders be within a few miles of their government customers, any spending increase by government on these services will benefit local businesses and ultimately improve economic growth prospects for the D.C. metro area.

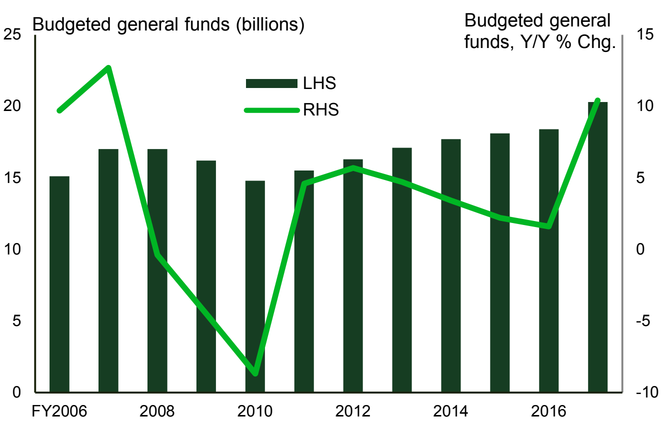
Bipartisan Budget Act to provide further support to the region

The D.C. metro economy also stands to benefit more broadly from the additional federal spending that is set to make its way into the economy as per the BBA of 2015. The omnibus appropriations bill that was passed in Congress in December of 2015 will lift federal government spending caps to the tune of $80 billion. An additional $50 billion in of this has been tacked on to the FY2016 budget, split evenly between defense and nondefense, with an additional $30 billion in spending earmarked for FY2017. Given the outsized number of federal agencies located in the D.C. metro, the higher spending will prove particularly constructive for the regional economy.

State budgets are also investing in economies

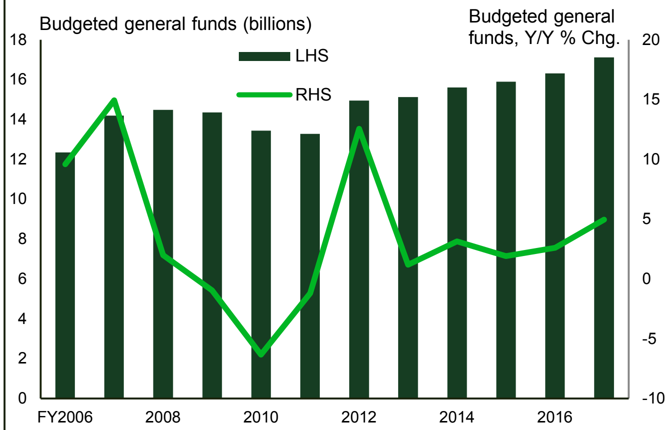
State spending in Maryland and Virginia, while not as hard-hit as during the Great Recession, also declined considerably in the aftermath of the sequester. For budgeting purposes state spending in Virginia is divided into two broad categories (general and non-general funds), while state spending in Maryland is categorized as general, special, or federal funds. The combination of the latter two in Maryland is equivalent to Virginia's non-general funds. Non-general funds are largely derived from federal grants, institutional revenue and transportation revenue, with spending, by law, earmarked for specific purposes. As such, non-general spending levels are not decided by state governments, but instead depend on projected revenues. On the other hand, general fund spending patterns are more discretionary in nature.

CHART 11: VIRGINIA IS MOVING AWAY FROM AUSTERE BUDGETS...



Source: Virginia Department of Planning and Budgeting, TD Economics

CHART 12: ... AS IS MARYLAND. WITH BOTH STATES INVESTING IN ECONOMIES.



Source: Maryland Department of Budget and Management, TD Economics

General funds are derived entirely from individual and corporate income taxes, as well as sales taxes, and can be used at the discretion of the Governor and the General Assembly. These have averaged a mere 3.0% and 2.2% in Virginia and Maryland, respectively (charts 11 and 12), between FY2013 and the current fiscal year ending next month, growing largely in line with inflation and population growth. But, the FY2017 budgets proposed by Governors Terry McAuliffe and Larry Hogan incorporate significantly faster spending growth. General fund spending is set to increase by 10.4% in Virginia and 5.0% in Maryland, suggesting that the relatively austere budgets enacted in the aftermath of the sequester may be giving way to more stimulative ones.

The proposed budgets are recognizing and welcoming the structural change that is currently underway, with Gov. McAuliffe highlighting the idea of a "new Virginia economy". Included in his vision is "the creation of 21st century jobs" consistent with the continued state-support for developing a regional cybersecurity hub and technologies. The proposed budget has included provisions for an additional $500k for the Herndon based MACH37 Cybersecurity Accelerator and $4.8 million for cybersecurity education & training at Virginia Tech and George Mason University. Gov. Hogan's proposed budget also prioritizes investment and economic growth, increasing funding for both education and infrastructure in Maryland.

Bottom line

Though the end of sequestration will be delayed for yet another year to FY2025 as a result of the BBA, the D.C. metro economy appears increasingly well adapted to an environment where robust federal spending growth is no longer a reality. Importantly, the effects of the sequester, which in recent years acted to significantly slow the regional economy, are dissipating. This is happening as the government contractors are increasingly moving towards private sector demand and are increasingly employed in a fast growing cybersecurity industry. Moreover, the sequester itself has been diluted by the BBA, with additional spending earmarked at the federal year this year and next. Lastly, state governments are increasingly turning from relatively austere budgets to those that prioritize the new technologies and education.

All these factors will help the local economy accelerate, supporting continued labor market progress, with strong hiring translating to further income gains. Improving incomes bode well for consumption and housing in the area, helping set in motion strong economic gains over the medium term. All told, after several challenging years the outlook for the region has significantly brightened. At this point, the D.C. metro area is catching up with the national pace. In fact, latest numbers for the fourth quarter of 2015 suggest the metro area has outperformed the nation, with D.C., Maryland and Virginia growing by 3.0%, 2.5% and 2.4%, respectively - all well above the national pace of 1.6%. Moreover, we expect this outperformance to continue with real GDP in the region expected to grow by about 2.2% this year before accelerating to a more robust 2.5% pace in 2017, both well above the near-flat growth registered since the sequester was enacted.

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End Notes:

[i] The Washington metro consists of the District of Columbia, several Maryland counties (Calvert, Charles, Frederick, Montgomery, and Prince George's), as well as counties and independent cities in Virginia (Arlington, Clarke, Culpeper, Fauquier, Fairfax, Loudoun, Rappahannock, Stafford, Warren; Alexandria, Fairfax City + Falls Church, Prince William, Manassas + Manassas Park, Spotsylvania + Fredericksburg) and Jefferson county in West Virginia.