SPECIAL REPORT

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THE JERSEY COMEBACK: ELUSIVE SO FAR, BUT NOT OUT OF REACH

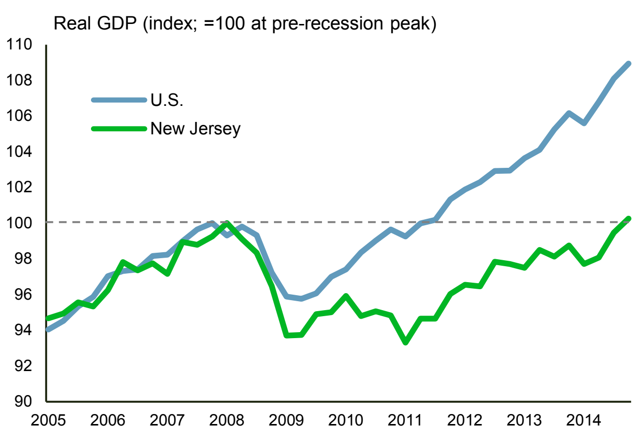
Highlights

- The New Jersey economy has been struggling for several years now with the state lagging behind the nation in most measures including employment and economic activity.
- Part of the divergence is due to broader national and global trends affecting some of New Jersey's core industries, including pharmaceuticals, financial services, and tourism.
- The rest of the underperformance is related to more Jersey-specific factors, with weakness in the housing market and fiscal issues across both state and local governments weighing on the recovery.
- Still, the headlines may be bleaker than reality. Recent payroll growth may be revised up. At the same time, the New Jersey labor market has benefitted from robust job gains in New York City.
- The state economy will accelerate but underperform in the near-term as outstanding issues weigh on growth. But, longer-term prospects remain favorable, provided the state is able to tackle some of its most pressing problems.

The New Jersey economy has been struggling for several years now. The Great Recession hit the state economy harder than the national, but the recovery has been markedly weaker than in the rest of the country. In part, this was due to New Jersey's recession being more of a double-dip, with the downturn in 2010 erasing all the progress made over 2009 (see Chart 1). Garden State's economic divergence to the nation became even more apparent last year. While U.S. payrolls posted the strongest pace of growth since 1999 and surpassed their pre-recession peak, New Jersey's job creation nearly stalled, leaving the state with a 3% payroll deficit which is unlikely to close for several more years.

The striking underperformance of New Jersey's economy and labor market is related to two sets of economic factors. The first set consists of national and global trends that are playing out across several of the state's core sectors. To some extent, the deterioration of these industries in the Garden State can be chalked up to external causes: patent expiration and consolidation in the pharmaceutical industry, regulation and the Eurozone crisis in the case of financial industry, and increased casino competition alongside Sandy-inflicted destruction in the tourism sector. However, not all of Jersey's challenges are a function of external trends. The second set of factors dragging down growth is more Jersey-specific. It consists of the persistent weakness in housing and a slew of structural and

CHART 1: JERSEY RECOVERY LAGGING BEHIND



Source: Bureau of Economic Analysis, TD Economics

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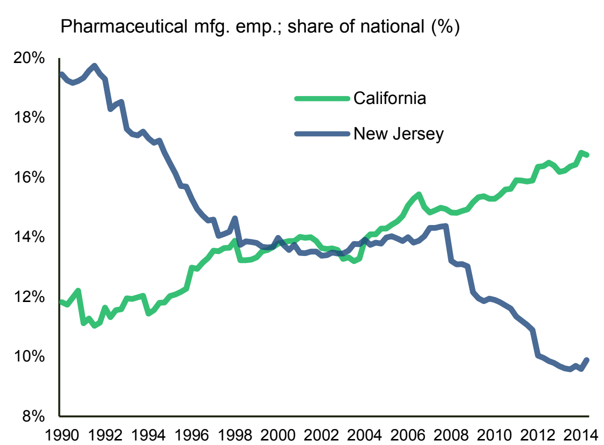
fiscal problems in the public sector. These issues are not a direct by-product of the weakness in the core industries, but are exacerbated by it, looming large over the recovery and keeping construction, real estate, and government hiring subdued.

Economic momentum will improve, but remain in the shadow of the national pace as these issues continue to weigh. Still, longer-term prospects in New Jersey remain favorable. A skilled workforce, excellent educational institutions, proximity to major urban centres, and relatively affordable housing should enable the state to make further inroads in its recovery. But, passively relying on these qualities will not be enough to achieve sustained success, and the state will need to be pro-active in solving some of the overarching problems that haunt its economy.

Pharmaceuticals: The shrinking medicine chest

One of the major headwinds for Garden State's economic momentum has been the shrinking footprint of the pharmaceutical industry. In the early nineties the state was home to 20% of the nation's pharmaceutical manufacturing, and was often referred to as the nation's "medicine chest." But, its share has largely been on a downward trend ever since. The sector has seen some stability in N.J. in the years leading up to the recession, but the flight of "big pharma" with extensive operations in the state's northern and central counties has accelerated since. Many of state's major pharmaceutical companies have scaled down operations or left altogether, leading to a 40% decline in industry payrolls since 2006. Job losses extended to the closely-related scientific R&D industry and medical device manufacturing, with headcounts down by 15% and 8%, respectively.

CHART 2: NEW JERSEY LOOSES LEAD IN PHARMACEUTICAL EMPLOYMENT



Source: BLS (QCEW), TD Economics

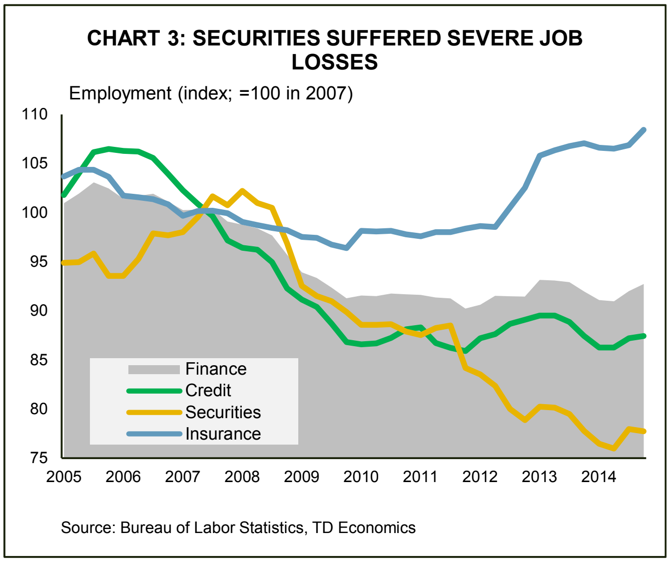
Reasons for this disappointing development are multifold. Restructuring in the pharmaceutical manufacturing industry as a result of the "patent cliff" – expiration of a series of patents for blockbuster prescription drugs – has been one such factor. This has been driving cost-cutting and consolidation within the industry. Partially in response to revenue declines and cost pressures, big pharmaceutical companies have also been increasingly seeking to acquire promising small and medium biotech firms. As a result, they have been turning their attention to the well-established biotech hubs in California, Massachusetts and North Carolina, which with their vibrant start-up cultures, ample pools of venture capital, and world-class research universities, have been on the winning side of the ledger.

As a result, while New Jersey's share of the national pharmaceutical manufacturing employment has fallen to half of what it has been, California's is up by nearly 50% (see Chart 2), and the share has almost doubled in Massachusetts and North Carolina. New Jersey shares some of the same advantages with the above states, namely the highly-educated workforce and an extensive network of colleges and universities. However, other important indicators have been slipping. For example, venture capital investment attracted by New Jersey start-ups has fallen by over 60% since 2007, while Massachusetts posted a 20% increase over the same period of time.

New Jersey has been taking some steps to re-invent itself. In 2012 voters approved a ballot measure which would allow the state to borrow $750 million for science and technology programs at colleges and universities. And, in 2013, lawmakers merged Rutgers University with the University of Medicine and Dentistry of New Jersey in order to spur collaboration. That being said, reviving innovation will not be easy or fast. New Jersey is up against some tough competition from other states – a task made even more challenging given its difficult financial position.

Financials: Insurance increases as securities struggle

The financial services industry has also played a part in the lackluster recovery. The industry is a large part of the New Jersey economy, generating roughly 7% of output, and accounting for one out of every twenty jobs in the state. The industry has been battered by the financial crisis, as the insurance, credit intermediation, and securities business all slowed. The insurance sector, clustered in northern and central counties (Essex, Morris, Union, and Middlesex), has



since bounced back and seen healthy growth – with employment up some 10% from pre-recession levels. The credit intermediation business on the other hand, which is spread more broadly across the state (Burlington and Bergen are largest centers) remains soft, weighed down by a subdued state housing recovery and a slowdown in refinance activity since mid-2013. But, it is the securities industry that has fared the worst in the state (see Chart 3).

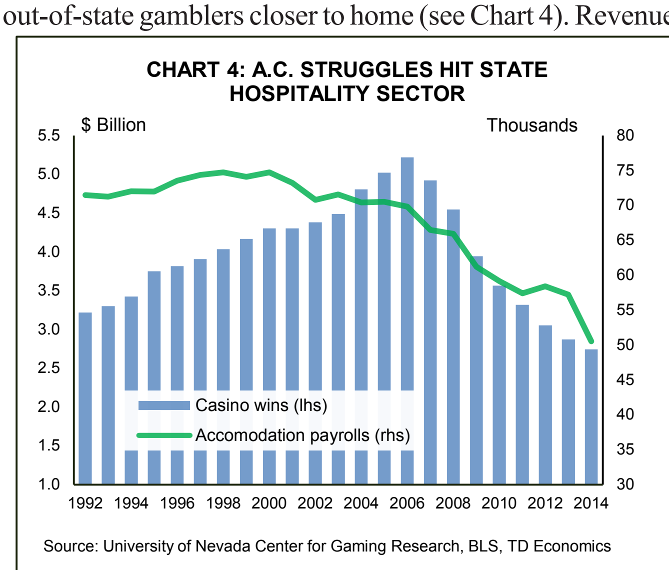
The poor fortunes of the state's securities industry, concentrated in northern Jersey with its epicenter in Hudson County, are an important element of N.J.'s economic underperformance. Output in securities, commodity contracts, and investments remains nearly a quarter below its peak level, single-handedly reducing economic activity in the Garden State by about 1%, or several billion dollars-worth per year. Employment is also about one-quarter below its pre-recession level, leaving N.J. with 13,000 fewer well-paying positions. The securities industry pays some of the highest salaries in the economy, with an average industry salary of nearly $170,000 – almost triple the state mean of $59,000. The loss of these high-paying jobs has had a significant impact on the state economy, depressing spending, housing demand, and state & local finances.

The decline in the securities industry was not limited to New Jersey. Recessionary job losses in this sector were experienced in New York, Connecticut and nationwide. But, while the sector has been rebounding nationally, it declined sharply in New Jersey and across the rest of the tri-state area after 2011. Chief reasons for this are a concentration in and around New York City of large investment houses facing increasing regulation, and an abundance of large European-domiciled institutions, which are scaling down operations in the aftermath of the sovereign debt crisis in Europe. These factors have together led to substantial paring back of activity in the area, with the New Jersey presence faring worse, as many firms consolidated their shrinking operations across the Hudson.

The financial sector in New Jersey is unlikely to bounce back quickly to its pre-recession size. But, there are reasons for hope that the losses in the battered industry may be coming to an end. For one, the insurance sector continues to expand in the state, and is more concentrated in New Jersey than ever before. Secondly, the credit intermediation business should see some growth with falling interest rates and improving labor market spurring refinancing activity and credit demand. Lastly, growth in the state's securities industry should be supported by a skilled labor pool, proximity to Manhattan at a fraction of the cost, as well as an extensive fiber optic communication network. Combined, these should support growth in New Jersey, and Jersey City's Wall Street West in particular, as a key operations support hub.

Leisure & hospitality: Running out of luck

Leisure and hospitality is the most recent of New Jersey's core industries to face challenges. Last year, the sector's payrolls fell by 1.5%, marking the first annual decline outside of a recessionary period. Reasons for the slump are not hard to find, with legacies of Hurricane Sandy and the downturn in Atlantic City casinos contributing to recent misfortunes. Casino revenues decreased sharply during the recession, but the trend began well before its onset as a proliferation of new casinos across the Northeast (Pa., Del., Md.) kept out-of-state gamblers closer to home (see Chart 4). Revenues



continued to slump even as the economic recovery set in, with Atlantic City's slice of the gambling pie shrinking further. After eight years of consecutive declines, casino wins are now nearly half of what they have been at their peak in 2006, and have been eclipsed by Pennsylvania's. With no respite in sight, four of Atlantic City's dozen casinos closed their doors last year.

Despite its small size, Atlantic City remains an important driver of the N.J. tourism industry. The Greater Atlantic City Region remains the primary destination for New Jersey's overnight leisure visitors,[1] accounting for slightly over 40% of all leisure travel, with gambling remaining the most popular activity among state visitors. Moreover, Atlantic City is helping to drive tourism spending for the state, with average daily spending by state visitors nearly 30% higher when Atlantic City visits are included. Other than casinos, visiting family and friends remains the chief reason for state tourists – resulting in lower daily spending.

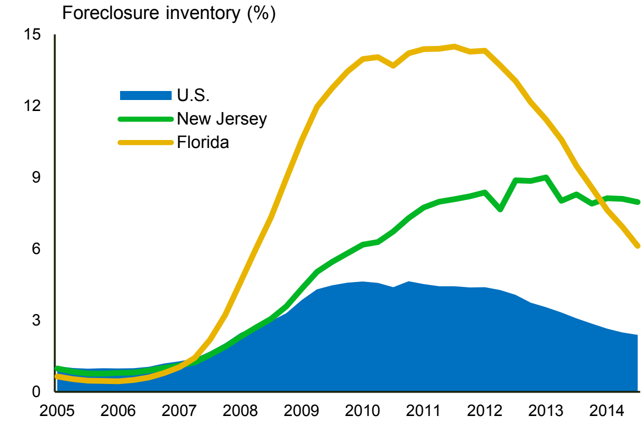
Even though Atlantic City has lost a battle, it has not yet lost the war. Due to its location, the tourism and hospitality industry will always remain a big part of the local economy. Currently, the remaining casinos are profitable, and some have even seen an improvement in their profitability relative to the previous year, benefiting from reduced industry concentration. But, despite decreased local competition, financial performance has deteriorated in three of its medium-sized casinos and future closures are not out of the question. All this suggests that once the dust settles, the sector will likely be considerably smaller and will not contribute to the local economy to the same extent that it has in the past. To fill the void, Atlantic City, and the Shore more broadly, will need to re-invent itself as an attractive destination to visit and live.

Housing: Weighed down by shadow inventory

The fortunes of the New Jersey housing market have also diverged from those of the nation more broadly. On the one hand, home prices in the state declined less during the downturn than they did across the country. On the other hand, when the national home values began to recover, New Jersey's housing market did not follow. After six consecutive years of declines, some upward momentum manifested in 2013, but the gains were limited, and fizzled out this year.

The weakness can largely be traced back to a combination of weak economic growth and a slow judicial foreclosure process. A sluggish labor market recovery has resulted in some of the highest delinquency and foreclosure rates in the nation. At the same time, foreclosure proceedings in New Jersey are often among the most drawn-out in the nation, related to its court-administered process and delays, which prevented a meaningful reduction in the foreclosure inventory (see Chart 5). The substantial overhang of this distressed shadow inventory, which has recently eclipsed Florida's, continues to weigh on the existing housing market. Existing home sales were little changed during 2014, while prices barely appreciated, rising by a very modest 1.2%. As a result, nearly 13% of New Jersey mortgages remain underwater – more than double the rate of neighboring New York and Pennsylvania. No doubt, the negligible price gains have blunted the wealth effect for New Jersey's consumers, which has buoyed spending nationally. Moreover, the depressed activity has also failed to boost payrolls in the real estate sector, in contrast to the national experience.

CHART 5: JERSEY FORECLOSED INVENTORY REMAINS LITTLE IMPROVED

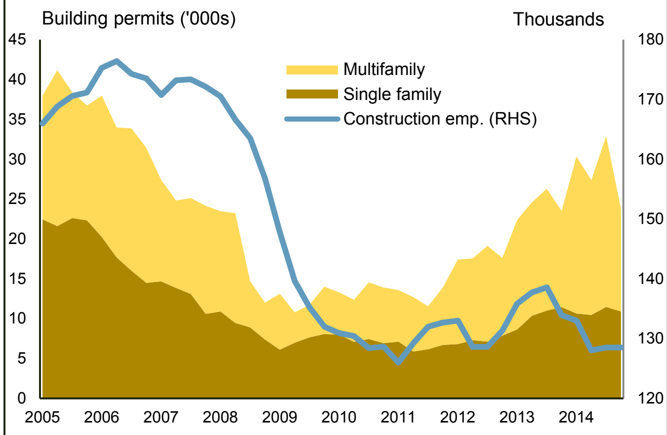


Source: Mortgage Bankers Association, TD Economics

The lack of interest in the resale market has not dampened enthusiasm for new construction. Building permits in New Jersey have recently rebounded to near their mid-2000s levels, significantly higher than the nation's, which remain near half of their pre-downturn pace. But, the rebound in N.J. has been skewed away from the single family segment even more than nationally. Indeed, the recovery in single family construction has been very limited, and much of the boost was related to post-Sandy rebuilding efforts. On the other hand, multifamily construction in the Garden State reached an all-time high in the third quarter of 2014, spurred by rising demand and falling vacancy rates in apartments, especially in northern counties around NYC.

The skew towards multifamily properties may be partly related to the changing preferences of the Millennial gen-

CHART 6: RISING MULTIFAMILY PERMITS HAVE NOT BOOSTED JOBS



Source: Bureau of Labor Statistics, Census Bureau, TD Economics

eration, but is also likely a symptom of restricted credit and weak income growth in the state. Moreover, the upswing in new construction has barely trickled down into the labor market. Despite the rebound in homebuilding, and a temporary lift from Sandy rebuilding efforts, construction payrolls in New Jersey remain near their recessionary trough (see Chart 6). This poor hiring performance is related to the fact that multifamily construction uses less labor per housing unit built, as well as the utilization of spare capacity that was present in the sector following the downturn. As it stands, declines in employment across construction and real estate sectors are not likely to persist, but neither sector will provide much in the way of support for the economy until the single family housing market heals more meaningfully.

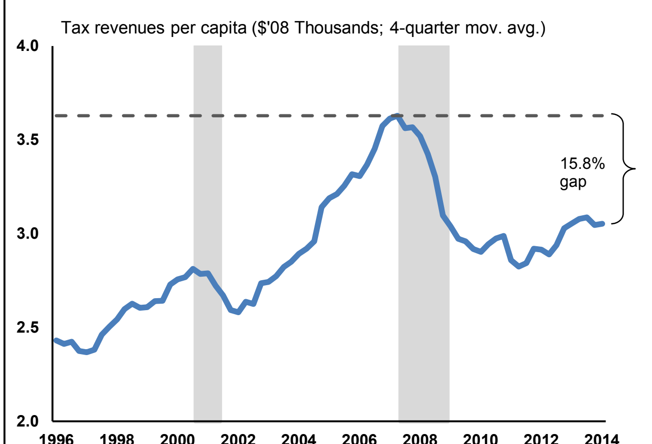
State and local government: Fiscal strains persist

The Garden State's economic ills have not been limited to the private sector. New Jersey government finances have been stuck between a rock and a hard place because of the double whammy on the revenue and expenditure sides of the ledger. On the revenue side, the state's lagging economic performance has undermined the recovery in tax revenues. State tax collections remain 2% below their pre-recession peak, even as aggregate tax collections for all U.S. states now stand 11% above the previous peak. The numbers look even less rosy once they are adjusted for population growth and inflation, with the gap widening to 16% (see Chart 7). In absolute terms, the biggest shortfall remains on the corporate income side, where collections remain 23% below their pre-recession level. However, corporate income taxes account for only 9% of state tax collections, meaning that the bulk of the weakness in the headline number was due to underperformance in sales and personal income taxes, which together account for three-quarters of tax revenues. Troubles in New Jersey's gaming industry is also a net negative for government finances, however the fiscal pain from the recent streak of casino closures will be felt most acutely at the local rather than state level. Casino tax revenues account for less than 1% of the state budget, but comprise roughly 70% of the tax base in Atlantic City.

In addition to the lagging revenue performance, challenges are also looming with New Jersey's large and growing pile of long-term liabilities. Garden State's pension obligations are among the highest in the country and its state pension system continues to be severely underfunded, making it the fourth worst-funded system in the nation. To make matters worse, health care obligations to state employees are also substantial. Already, required pension and health care payments represent 10% of the state budget and are crowding out spending on other priorities including infrastructure investment. In the absence of changes and assuming a 4% growth rate in revenues, pension and health care costs are projected to consume nearly a quarter of the state budget by 2024.[2] To top it off, the state also holds a considerable amount of debt, with per capita state liabilities fourth highest in the U.S. Taken together, these fiscal issues pose a challenge to the state's budgetary balance, and have led to deterioration of the state's credit rating. Over time, they run the risk of discouraging businesses from investing in the state, especially if they continue to crowd out state infrastructure spending.

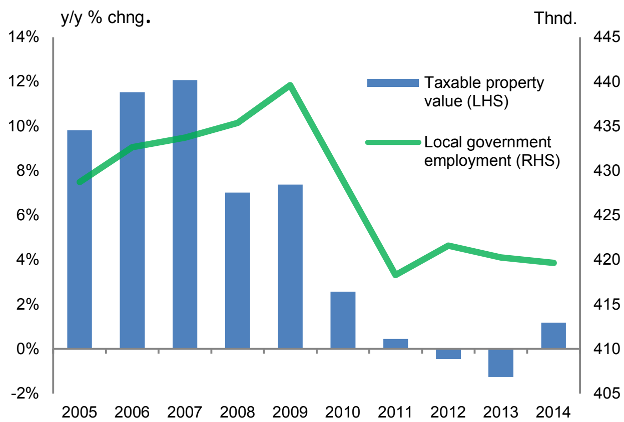
Aside from a handful of cases, New Jersey's local governments face fewer challenges than the state, in part because

CHART 7: MIND THE GAP IN STATE TAX COLLECTIONS



Source: Census Bureau, TD Economics

CHART 8: SLUGGISH HOME PRICE GROWTH WEIGHS ON LOCAL GOVERNMENT PAYROLLS



Source: NJ Department of Community Affairs, BLS, TD Economics

their expenditures were significantly reduced through payroll cuts, which were reduced by 5% in 2010. But, whereas much of the country's municipalities began hiring again, New Jersey local payrolls have remained largely flat – aside from a post-Sandy blip. Much of this is related to a protracted recovery in the housing market, which continues to pressure local government coffers. Property tax revenue, which accounts for 37% of self-generated state & local revenues in New Jersey – second highest share in the nation – remained stagnant for the last four years, with home prices failing to register any meaningful appreciation. As a result, state and local governments remain in a hiring lull, and are unlikely to raise headcount in the near-term (see Chart 8).

Wait, there's a twist: Headlines bleaker than reality

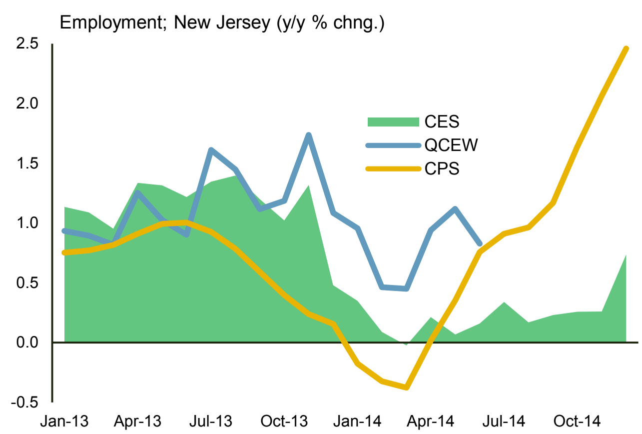
As a result of all the issues outlined above the recovery during 2014 remained largely nonexistent. But, the headline numbers may be painting too bleak a picture of the current economic climate. In particular, the headline job figures, which suggest that nonfarm payroll growth this year was little changed, may be overstating the degree of labor market weakness for two reasons. Firstly, the monthly payroll figures are estimates and are subject to benchmark revisions, which appear slated for an upward adjustment. Secondly, most analysts focus on the establishment employment numbers. But, we suspect this report is underestimating job growth within New Jersey since it does not account for self-employment and, perhaps more importantly, the high degree of out-of-state commuting into New York and Pennsylvania.

The headline payroll numbers, which suggest that a mere 10,000 jobs have been added in 2014 on average, are based on the Current Employment Statistics (CES) survey. This survey is timely, but is based on a sub-sample of establishments. A more fulsome survey, the Quarterly Census of Employment and Wages (QCEW), covers a more extensive set of establishments but is released with a long lag. Still, data through mid-2014 suggests that the hiring momentum was stronger than indicated by the CES data (see Chart 9). The annual benchmark revisions will be released in early-March, with the final tally for 2014 likely closer to 20,000 to 30,000 positions – or more than double the current reading.

Secondly, payroll gains according to the CES survey are also below those from the Current Population Survey (CPS), whose responses are used to generate the state and national unemployment rates. According to the CPS, employment in New Jersey increased by 33,000 during 2014 on average, leading to a 1 percentage point decline in the jobless rate. In fact, based on CPS results, year-over-year employment growth in New Jersey has matched the national pace, with employment as of the last quarter of 2014 up by a whopping 86,000 from a year earlier.

Revisions to the CES data may lead to some convergence with CPS results, but both surveys can still differ substantially for several reasons. Individuals that are self-employed or employed by households are not included in the establishment survey, and a rise in these forms of work would not be captured by the CES. Figures could also be affected by multiple job holders. Since the CES counts jobs and not employees, a worker who had two part-time jobs but switched to a single full-time job would result in a job loss according to the CES count, but would have no impact on the CPS results.

CHART 9: JERSEY PAYROLLS LOOK PRIMED FOR AN UPWARD REVISION



Source: Bureau of Labor Statistics, TD Economic

But, perhaps the most important reason for the divergence between the two employment surveys stems from commuting. New Jersey has the second highest level of out-of-state commuting, with 280,000 people on net working out of state.[3] New York State is the destination for 250,000 of these commuters, with 380,000 leaving New Jersey every morning for the Empire State, and only 130,000 doing the opposite trek across the Hudson. As such, robust job creation in NYC, where payrolls have been outpacing the national gains, is likely contributing to the improving unemployment rate in New Jersey, and its northern and central counties.

Reasons for hope

The New Jersey recovery may look a bit better than the payroll numbers suggest, but there is little doubt that the economy remains sluggish. After expanding by just 1.1% in 2013, growth last year looks to have slowed to about 0.8%. The economy should accelerate to double that pace this year, as stronger U.S. growth helps N.J. firms doing business out of state, while a combination of low gasoline prices and falling borrowing costs amid an improving labor market boost spending. Still, the mid-1% growth that we project for this year will be merely half the national pace.

The subdued outlook is a testament to the outstanding issues that continue to loom over the economy. The worst of the cuts in many of its core industries may be in the past, but their legacies continue to haunt the economy. At the same time, the very weak housing recovery and increasing fiscal pressures will prevent these sectors from providing meaningful support to economic growth.

Still , there are reasons to be hopeful that the New Jersey economy will strengthen over the medium-term. The state has a highly skilled workforce and top notch colleges. It is also uniquely positioned between two major urban centres and lies within a day's drive from 40% of the U.S. population. It has one of the better primary education systems and relatively affordable housing.

These positives have so far been overshadowed by other factors, but they should begin to come through as the weak spots dissipate. In order to get there, the state has much work ahead of it. Getting its fiscal house in order while still investing in infrastructure should be top of mind. The former would relieve some anxiety by businesses investing in the state long term. New Jersey often ranks in the last quintile in business opportunity surveys with high costs of doing business and poor infrastructure figuring most prominently as negatives. The state is also made up of some 565 municipalities, each with significant fixed overhead costs that could be reduced by restructuring or consolidation.[4] The savings could be used to invest in infrastructure, which would both boost demand for housing, as well as lay a foundation for New Jersey as a Mid Atlantic transport/logistics hub of the 21st century. Rehabilitating the housing market is also a key priority, with initiatives to fast-track foreclosures likely being beneficial for the state economy.[5] The state should also support increased partnerships between the universities and the private sector, and nurture venture capital investment in its high-tech industries. New initiatives for research related to health care, biotech, unmanned aircraft, and green energy could enable the state's labor market to better utilize the substantial human capital present in New Jersey and boost its economic growth prospects well into the future.

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5. For an analysis of the potential benefits of fast-tracking foreclosures see "Estimating the Impact of Fast-Tracking Foreclosures in Ohio and Pennsylvania" by Kyle Fee and Thomas J. Fitzpatrick IV. http://www2.clevelandfed.org/research/commentary/2014/2014-03.pdf