DAKOTA OUTLOOK

DAKOTA INSTITUTE

ISSUE 3

2023 • Q2

DAKOTAINSTITUTE.ORG

Executive Summary

Executive Summary ▌ Jared McEntaffer

The economic roller coaster of 2023 continues. There haven't been too many ups and downs so far in 2023. In fact, we seem to be going up and up and up, the question seems to be whether we reach a peak and then start the long, gentle descent, or if we come crashing down.

The GDP data shows that South Dakota and the nation performed well during the first quarter. South Dakota reversed the trend of three consecutive quarters of negative growth in 2022 and grew by 10.1% annualized in Q1 2023. National GDP, which is reported more quickly than state-level GDP, grew at 2.0% and 2.1% annualized in the first and second quarters. But what could be coming down the pike? Student loan repayment is set to restart in October and we are already seeing increases in credit card and auto loan delinquency rates. Washington seems dead set on a government shutdown, and the economy could be headed for a commercial real-estate tsunami. The growth is here for now, but the level of uncertainty is increasing rapidly.

The macro uncertainty is all the more unwelcome because inflation is moderating, and real incomes are on the rise. South Dakota's real personal income growth during Q1 2023 was 5.1% compared to only 1.2% nationally. In this issue, we also show that several Midwest states have reported strong growth in nonfarm earnings, even after adjusting for inflation. This quarter, we also report some interesting hourly earnings data for South Dakota, which shows how earnings can differ across location and industry sector.

On the housing front, the current issue of the Dakota Outlook provides more evidence that the housing market is in a deep freeze. Building permit activity was down 37% year-over-year in South Dakota and 15.1% nationally during the second quarter. Listing activity has also dried up as high mortgage rates keep buyers and sellers on the sidelines. It seems prices are immune, though, and median listing prices again rose by 7.3% in South Dakota during the second quarter. This issue also reveals a change in our affordability index from the last issue. Realtor.com revised its entire time series of home prices in June 2023. The revisions affected prices as far back as 2016 and resulted in notable changes to our affordability index scores.

Finally, this issue checks in on a labor market that continues to outperform expectations and complicates the lives of central bankers. South Dakota and the nation continue to enjoy record-low unemployment. South Dakota's unemployment rate dipped to 1.9% during the second quarter, while the national unemployment rate rose slightly to 3.6% during the same period. More and more people continued to join the workforce as well. Employment growth was 2.8% at the state level and 2.6% for the nation. The continued strong performance of the labor market will likely be a major reason the FED chooses to raise rates again later this year.

Momentum Holds but Economic Uncertainty Rising

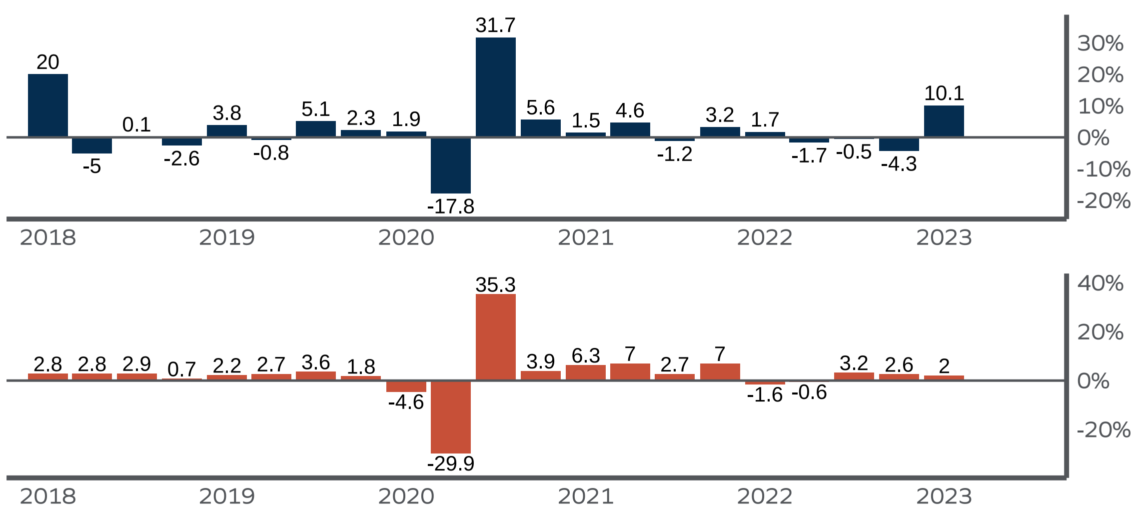
Macroeconomy | Jared McEntaffer

Sometimes I like to think of the macroeconomy as an oceangoing container ship. There's a lot of mass in those ships, a lot of momentum. The largest of these ships are nearly 450 yards long and 180 yards across. They can hold nearly 24,000 twenty-foot-long shipping containers. Their sheer size allows them to survive storms that would sink smaller ships. They tend to move slowly, and you can't exactly parallel park. Once they get moving, though, they don't want to stop.

The US economy is in containership mode right now. The FED has raised rates by 525 basis points (i.e. 5.25%) in the last eighteen months, core inflation has been above 4% for nearly two years, multi-decade highs in mortgage rates and commercial vacancy rates, a worrying slowdown in China, and chaotic energy and commodity prices due to war in Ukraine. A container ship, Mike Mulligan's steam shovel, or whatever other metaphor suits you, the US economy is not slowing down for now.

During our first quarter issue, we reported that growth appeared to be slowing at the national and state levels. Growth had been slowing at the national level for a few quarters. Growth had remained above 2%, but the trend was softening. At the state level, real growth had been negative for the last three quarters, and the state finished the year up only 0.5% over the prior year.

South Dakota and United States Quarterly Real GDP Growth



Source: Dakota Institute, BEA
Note: Growth rates are annualized percent changes from the previous quarter.

The US economy grew at an annualized rate of 2.0% during the first quarter and 2.1% during the second quarter. At the local level, South Dakota posted very strong 10.1% annualized growth in the first quarter due to a strong rebound in the Ag sector, which had a difficult fourth quarter in 2022. South Dakota's second-quarter numbers will almost certainly fall back to earth, but the steady

Macroecomic Summary and Forecast										
	Actual							Forecast		
	2018	2019	2020	2021	2022	2023:Q1	2023:Q2	2023:Q3	2023:Q4	2023
Real GDP Growth (%) [a,b]										
SD	1.1	0.8	1.6	4.5	0.5	10.1				1.2
US	2.9	2.3	-2.8	5.9	2.1	2.0	2.1			2.0
Price Level (% YoY) [a]										
CPI	2.4	1.8	1.2	4.7	8.0	5.8	4.1	3.5	3.1	4.1
Core CPI	2.1	2.2	1.7	3.6	6.1	5.6	5.2	4.6	4.0	4.9
PPI (Final Demand)	2.9	1.7	0.0	7.0	9.5	4.5	1.1	1.0	0.8	1.9
Interest Rates (%) [a,c]										
Fed Funds Target	2.00	2.22	0.53	0.25	1.86	5.00	5.25	5.50	5.50	5.31
Mortgage Rate	4.54	3.94	3.11	2.95	5.34	6.32	6.71	6.90	6.65	6.65
10 Year Treasury	2.91	2.14	0.89	1.45	2.95	3.48	3.81	3.88	3.75	3.73

Source: Dakota Institute, Wells Fargo Economics, BEA

[a] Annual values are averages. [b] Quarterly values are annualized percent changes from the previous period. [c] Quarterly rates are end-of-period values.

employment growth and solid hiring numbers indicate growth will remain positive as long as the Ag sector holds out.

In response to the solid first-quarter growth numbers, we are revising South Dakota's 2023 growth forecast up from 0.8% to 1.2%. We are also revising our national growth forecast up from 1.1% to 2.0%. We are watching out for disruptions in the commercial real-estate sector and potential government shutdowns later this year. Either development would negatively impact growth, though the full effects would not be fully felt until 2024.

The continuing moderation of inflation pressures helps to buoy our growth outlook as well. Overall inflation, as measured by the growth in the CPI, declined rapidly in the second quarter, falling from 5.8% in the first quarter to 4.1% in the second. The FED's actions are clearly having an impact, though we expect broad CPI inflation to remain above 3% through the end of the year. On the other hand, Core inflation (CPI less food and energy) remains stubbornly high and will have a greater impact on FED policy than the broad CPI measure. The Core CPI indicated 5.2% price growth in Q2 2023 compared to one year prior, down from 5.6% in Q1. We expect core inflation to remain above 4.0% throughout the year.

In the battle to tap down inflation, the FED has aggressively raised the Federal Funds target rate since March 2022. There was a pause in June 2023, but the Fed raised its target rate to 5.5% in July 2023. The FED has also clearly messaged its preference for another rate increase before the end of the year. It seems almost certain that there will be another increase at the September meeting. Further increases may follow, but concerns about the commercial real-state sector and government shutdowns may lead the FED to pause again before the end of the year.

Finally, mortgage rates have continued to rise through the second quarter. Average mortgage rates crossed 7.0% again in early August. During the week of August 24th, average rates reached 7.24%, levels not seen since 2001. We are revising our forecast for the year in light of developments over the last quarter. We now forecast rates to hit 6.90% during the third quarter before falling slightly to 6.65% by year's end.

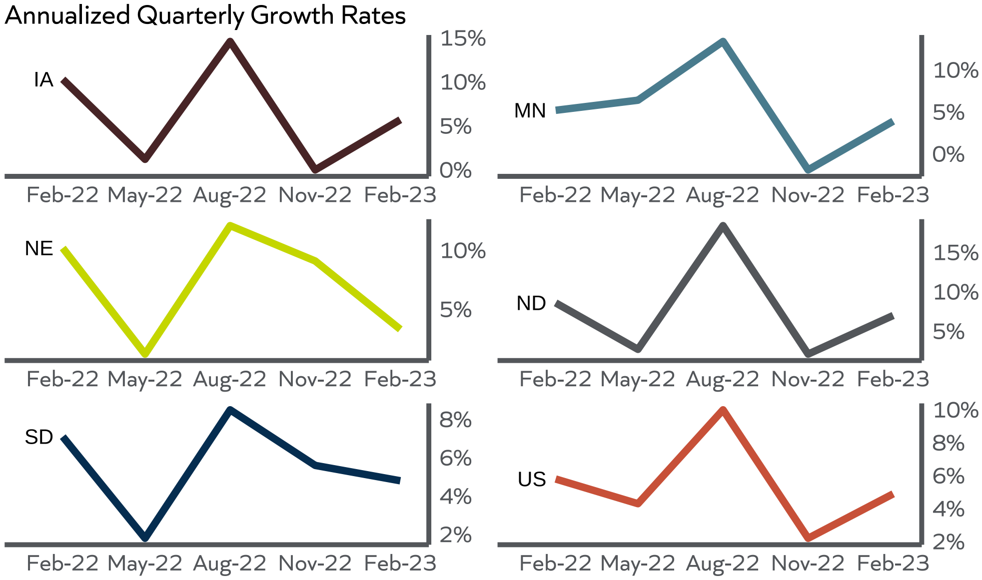
Real Incomes and Hourly Earnings on the Rise

Income & Wages | David Sorenson

South Dakota's personal income growth was strong in the first quarter of 2023, with its 5.1% inflation-adjusted annualized growth rate more than four times the national growth rate. Part of the rapid growth reflected a recovery in farm earnings, which dipped significantly in the final quarter of 2022 before posting a large gain in the first quarter of 2023. Nonfarm earnings grew at about the same pace as the nation in the first quarter, but South Dakota had modest growth in the final quarter of 2022 while the nation experienced a decline of almost two percent. The strong growth in the first quarter led to an increase in per capita income to $65,870 in 2022 dollars, greater than the values in the prior two quarters but still below the state's peak in 2021. South Dakota's per capita personal income remains slightly higher than the U.S. value. Forecasting through the end of 2023 given national real growth of about one percent relative to 2022 personal income, South Dakota income should grow about two percent, with an increase in per capita income of 1.5%.

State and National Nonfarm Earnings Growth

Annualized Quarterly Growth Rates



Source: Dakota Institute, BEA

South Dakota's economic fluctuations are very much in line with the Plains region. Given the large impact of swings in farm earnings, Plains states have more pronounced swings in overall economic growth. The smaller state economies also have more pronounced swings in nonfarm earnings, as shown in Figure 1, which also illustrates a similar pattern of growth and decline in several Plains states. The combined effect of farm and nonfarm performance leaves South Dakota as one of the fastest-growing states when farm earnings increase and modest growth when farm earnings decline or grow only slowly. South Dakota's nonfarm earnings growth consistently ranked in the middle third of states between the first quarters of 2022 and 2023.

Income Summary and Forecast									
	Actual								Forecast
	2019	2020	2021	2022:Q1	2022:Q2	2022:Q3	2022:Q4	2023:Q1	2023
Real Personal Income Growth (%) [a,b]									
SD	5.0	8.5	2.8	0.7	-1.3	0.4	-0.4	5.1	2.1
US	3.2	5.3	2.6	-5.6	-4.3	1.8	0.8	1.2	1.0
Per-Capita Real Income [a,b]									
SD ($)	63,289	68,272	69,654	66,336	65,866	65,650	65,299	65,870	66,196
US ($)	64,372	67,565	69,300	65,806	65,016	65,208	65,246	65,376	65,624
SD (%)	4.1	8.0	1.9	-1.6	-2.8	-1.3	-2.1	3.5	1.5
US (%)	2.7	4.9	2.5	-6.0	-4.7	1.2	0.2	0.8	0.5

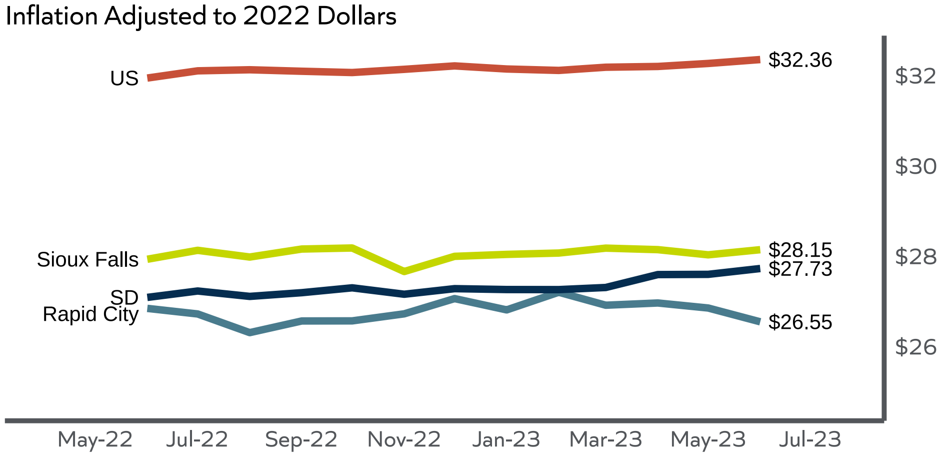
Source: Dakota Institute, Wells Fargo Economics, BEA

[a] Annual values are averages. [b] Quarterly growth rates are annualized percent change from the previous period.

South Dakota's sectors again varied significantly in their growth rates for the most recently reported quarters (fourth quarter 2022 and first quarter 2023). Finance and insurance continued its downward trend, with a pronounced -11.4% decline in the first quarter of 2023. Healthcare posted small declines in both quarters. Retail trade was up in both quarters, with the strongest growth in the fourth quarter of 2022. Manufacturing experienced a sharp increase in the fourth quarter of 2022 followed by a decrease of 7.1% in the first quarter of 2023. Construction declined slightly at the end of 2022 before growing by 13.8% at the beginning of 2023.

Average Hourly Earnings

Inflation Adjusted to 2022 Dollars



Source: Dakota Institute, BLS

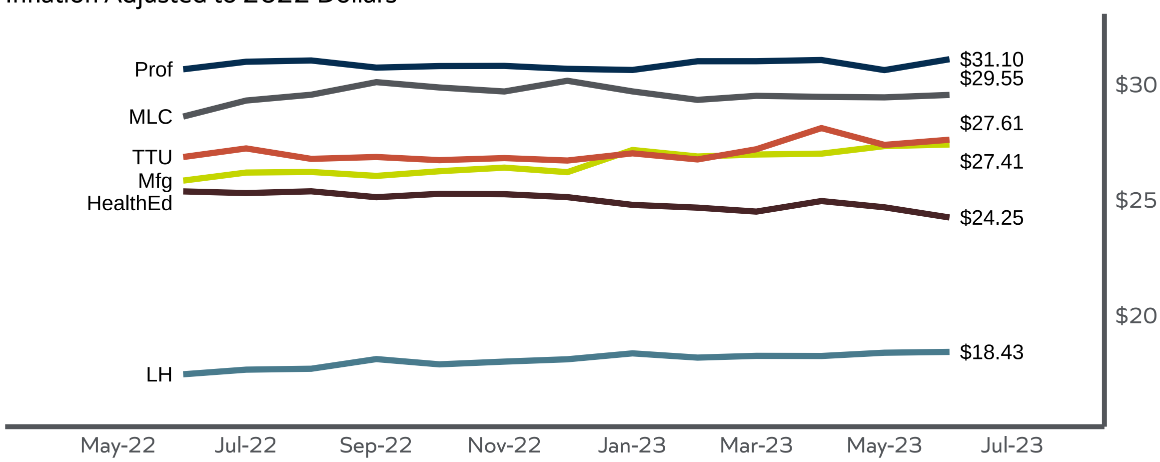
Average Hourly Earnings

Average hourly earnings improved in the first half of 2023 compared to 2022. In addition to nominal hourly earnings increases greater than those in the second half of 2022, a lower inflation rate meant that real earnings were not eroded as badly as they were in 2022. Average hourly earnings for the private sector in South Dakota increased by almost a dollar (from $27.88 to $28.80) between December 2022 and June 2023. After accounting for inflation, the increase was 3.3%, or about fifty cents. The year-over-year inflation-adjusted earnings increase from June 2022 to June 2023 was 2.4%. The year-over-year increase was a full percentage point higher than the national rate, while the December 2022 to June 2023 state rate was almost four times the national average earnings increase.

The Sioux Falls and Rapid City metropolitan areas did not experience the state's level of growth in average hourly earnings. Sioux Falls grew at a slower rate, similar to the nation, while Rapid City continued the decline seen in 2022. Average hourly earnings in the Rapid City metropolitan area fell in actual dollar amounts from December 2022 to June 2023. The nominal drop was compounded by inflation, leading to a decline of almost four percent (annualized). The year-over-year drop was closer to one percent. As of June 2023, average hourly earnings stood at $33.60 in the US, $29.23 in the Sioux Falls metropolitan area, $28.80 for all of South Dakota, and at $27.57 for Rapid City. The monthly trends for the US, South Dakota, Sioux Falls, and Rapid City are shown in Figure 2.

Average Hourly Earnings by Industry Sector

Inflation Adjusted to 2022 Dollars



Source: Dakota Institute, BLS
Note: Industry abbreviations are as follows, Professional and Business Services (Prof), Mining, Logging, and Construction (MLC), Trade, Transportation, and Utilities (TTU), Manufacturing (Mfg), Education and Health Services (HealthEd), Leasure and Hospitality (LH)

Differences in trends were also evident among sectors at the state level. Manufacturing and Transportation, Trade, and Utilities both experienced more than ten percent annualized growth in average hourly earnings between December 2022 and June 2023. Year-over-year growth approached ten percent in Manufacturing and was about six percent in Transportation, Trade, and Utilities. Professional and Business Services and Leisure and Hospitality also saw significant growth, with both experiencing annualized average hourly earnings growth above six percent between December 2022 and June 2023. The Leisure and Hospitality sector year-over-year growth was almost nine percent. Despite the growth, the June 2023 average hourly earnings of $19.13 were still much lower in the sector than in Mining, Logging, and Construction ($30.69), Manufacturing ($28.46), Transportation, Trade, and Utilities ($28.67), Professional and Business Services ($32.29), and Health and Educational Services ($25.18). Health and Educational Services fared worst among the sectors in recent months, with an annualized decline of almost four percent between December 2022 and June 2023. The actual dollar amount of average hourly earnings was lower in June 2023 than it was in June 2022. The monthly trend is shown along with other sectors in Figure 3.

Labor Markets Continue to Run Hot

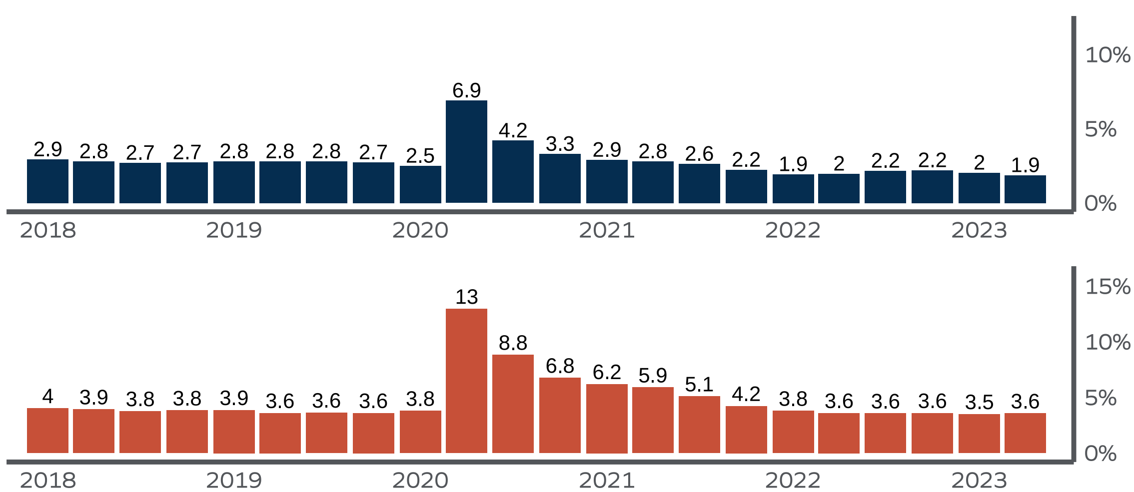
Labor Force ▌ Jared McEntaffer

The labor market outlook continues to defy gravity. In our last issue, we shared how national and state labor markets generally outperformed expectations. We also discussed historic data revisions that indicated labor markets were healthier in the post-pandemic years than originally thought. Looking out today, the story continues to be strong employment growth, low unemployment, and tight labor market conditions.

South Dakota's employment growth has outpaced the US during the first two quarters of 2023, but the gap has narrowed as employment growth slows. We anticipate national employment growth will surpass the states during the second half of the year, with both the state and nation ending the year with an average 2.4% employment growth year-over-year.

Two headwinds at the national level are contributing to slower employment growth. First, the FED has strongly signaled it's not done raising interest rates. Every increase puts more pressure on Aggregate Demand — the sum total of all final demand, which we typically divide between Consumption, Investment, Government Spending, and Net Exports. Higher rates depress spending on houses and cars, for example, and cause businesses to reduce their investment spending on new capital goods. The FED is still looking for a so-called soft landing, but every additional rate hike risks being the one that drives the economy towards the hard landing we'd all rather avoid. Second, the labor market has been hot for two years now. Unemployment has been at multi-decade lows for nearly a year. It's hard to keep posting record employment growth quarter after quarter, even with expansionary monetary policy.

South Dakota and United States Quarterly Unemployment Rate



Source: Dakota Institute, BLS
Note: Quarterly unemployment rates are averages.

On the home front, South Dakota may be somewhat insulated by monetary policy considerations, but we are potentially more constrained by a lack of worker availability. South Dakota's unemployment rate in Q2 was an unhealthy 1.9%, down from a similarly unhealthy 2.0% in Q1. It may seem odd to hear handwringing about low unemployment, but the issues can be real.

Labor markets are constantly trying to solve a highly complex sorting problem. Imagine there are unemployed workers on one side of the room, and on the other are businesses looking to hire. In this scenario, it's easy to see how workers and businesses can find one another. Now imagine the workers are in one building and the businesses are in another all the way across town. Without cell phones and Google Maps, you can see how it might be a bit harder for workers and businesses to find one another. One last metal game. Imagine that workers and businesses are again spread out all over the town. This time, each worker also has a key, and each business has a job offer locked in a safe. The trick now is that you need the right key to unlock the safe and get the job offer. You've probably heard of required experience or minimum qualifications. Now it can be almost impossible to match workers and jobs. No matter how much a worker might want a job, they might not have the right key, i.e. the skills and experience, that a business is looking for. From the other side as well, no matter how much a business advertises a position or how much they are willing to pay, they might not be able to find the right worker.

Labor Force Summary and Forecast

	Actual							Forecast		
	2018	2019	2020	2021	2022	2023:Q1	2023:Q2	2023:Q3	2023:Q4	2023
Employment Growth (% YoY)										
SD	0.9	0.6	-3.3	3.2	2.4	3.6	2.8	2.1	1.1	2.4
US	1.6	1.3	-5.8	2.9	4.3	2.9	2.6	2.4	1.8	2.4
Unemployment Rate										
SD	2.8	2.8	4.2	2.6	2.1	2.0	1.9	2.0	2.0	2.0
US	3.9	3.7	8.1	5.4	3.6	3.5	3.6	3.5	3.6	3.6
SD Labor Market Indicators (1,000s)										
Job Openings	23.3	22.0	19.2	29.7	31.9	30.3	29.8	30.6	30.2	30.2
New Hires	18.1	17.2	17.2	19.1	19.6	20.9	19.8	19.6	19.3	19.9
Job Quits	10.5	10.8	8.8	12.1	12.4	11.8	12.7	12.2	12.0	12.2

Source: Dakota Institute, Wells Fargo Economics, BLS
[a] Annual and Quarterly values are averages.

When a labor market has too few people in the pool of unemployed, it can be challenging to match workers and jobs successfully. One negative outcome is an increase in bad matches that aren't good for either party. Another potential outcome is greater churn in the labor market as workers move around, generally due to higher wage offers. This churn can be great for workers. There can be downsides for businesses, though. Greater churn, instead of employment growth, can feel like a zero-sum game, especially at the community level. Businesses that lose out can face real hardship through lost productivity or shrinking market share. These problems can arise whenever there are too few unemployed workers for the matching and sorting process, and the SD labor market continues to show signs of overheating.

Job openings in the state remain elevated, according to the JOLTS data. During Q2, South Dakota had an average of 29,800 open jobs per month, down slightly from Q1 but almost 50% higher than before the pandemic. A persistent spread between the number of job openings and new hires indicates that the pool of unemployed workers is too low to meet the labor market's needs. Another sign of potential problems is the jump in quits from Q1 to Q2. The rise in voluntary quits could signify churn due to poor matches or employed workers jumping ship for better opportunities.

Housing Demand Remains Strong Despite Increased Borrowing Costs

Housing | Aaron Scholl

Mortgage rates, the ever-powerful forces shaping the dynamics of the US housing market, remain at the forefront of activity as we push into the latter half of 2023. The first half of the year has witnessed the profound impacts of these rates, effectively creating a wedge between aspiring homebuyers and homeowners who locked in historically low rates of 3% or less. This wedge is particularly pronounced across the entire US — marking a significant reversal in the historic housing price growth observed since the onset of the pandemic -– a decline of 3.1% in listing prices from Q2 2022 to Q2 2023, after accounting for inflationary factors.

In contrast, South Dakota's housing market has displayed remarkable resilience, though there are some signs of a slowdown. South Dakota has maintained substantial listing price growth, reflecting an impressive 7.3% increase from Q2 2022 to Q2 2023. This upward trajectory in listing prices, despite a slightly decelerated pace in the new construction market, underscores the distinct nature of South Dakota's housing landscape. Although homebuyers in the state face similar challenges due to rising rates, continued price growth indicates robust buyer demand relative to supply across South Dakota.

Housing Summary and Forecast

	Actual							Forecast		
	2018	2019	2020	2021	2022	2023:Q1	2023:Q2	2023:Q3	2023:Q4	2023
Building Permits (% YoY) [a]										
SD	-13.5	-4.7	48.2	15.6	24.8	-23.3	-37.0	-31.0	9.4	-20.4
US	4.5	3.1	6.1	19.2	-4.9	-20.7	-15.1	-1.0	19.3	-6.2
New Listings (% YoY) [a]										
SD	-0.8	5.1	-8.5	-2.2	-6.5	-22.4	0.2	-1.7	2.1	-5.4
US	0.7	-2.1	-5.1	1.9	-8.8	-17.1	-23.6	-6.9	1.8	-10.5
Median List Prices (% YoY) [a]										
SD	1.9	1.0	1.8	4.0	17.5	10.6	7.3	4.1	2.2	5.9
US	5.3	4.0	6.1	5.8	5.2	1.7	-3.1	-2.1	-0.5	-1.0
Affordability Index [a,b]										
SD	173	184	206	206	131	106	108	107	116	109
US	138	145	159	154	109	96	96	96	105	99

Source: Dakota Institute, Census Bureau, Realtor.com, Freddie Mac, BLS
[a] Annual and quarterly values are averages. [b] Affordability index is calculated using the National Association of Realtors methodology.

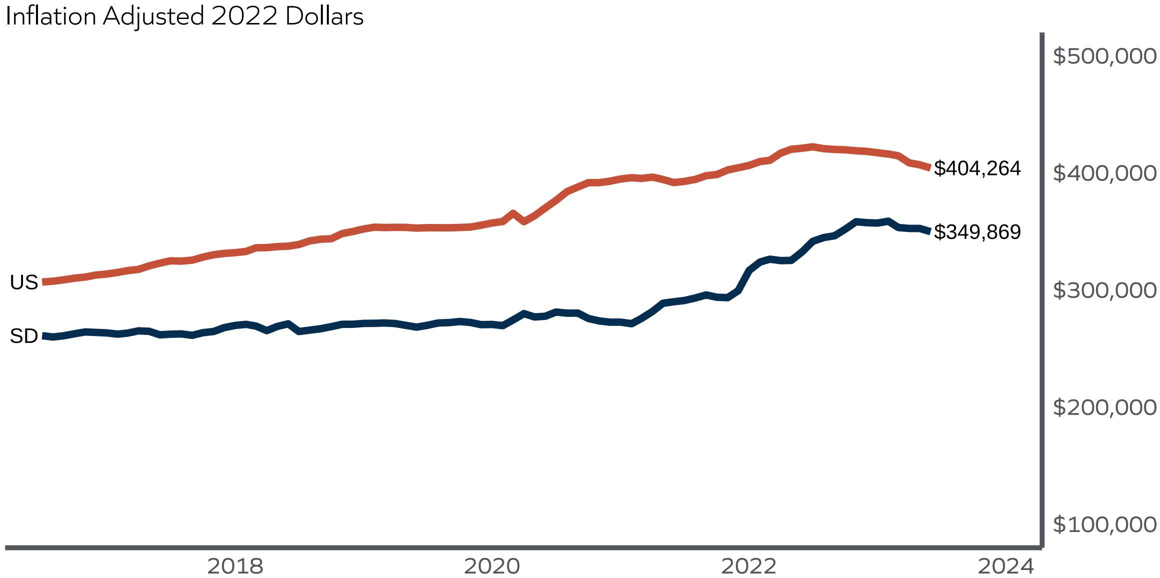
Another crucial gauge of housing demand is the number of building permits issued. Delving into these figures reveals a nuanced picture, where potential buyers increasingly hesitate to opt for new construction in the face of higher prices and borrowing costs. South Dakota has been a standout in this regard, experiencing remarkable growth in building permits since the pandemic's onset. This growth included consecutive years of double-digit expansion, peaking at an impressive 48.2% surge in 2020, followed by substantial year-over-year growth of 24.8% in 2022. However, a closer look at short-term trend indicates a substantial slowdown in permitting activity, with a 23.3% year-over-year decline in Q1 2023 and a 37% year-over-year decline in Q2 2023.

The wider US housing market has also shown similar signs of weakening. Permitting activity began to slow in late 2022 and 2023 has maintained that trend. Permit issuance declined 15.3% from Q2 2022 to Q2 2023.

Shifting focus to the supply side, the last few years have signaled a noticeable slowdown in homeowners' willingness to sell their properties, both at the national and state levels. This trend has contributed further to the elevated prices observed in recent years as supply struggled to keep pace with surging demand. More recently, as the national market slows, the US has seen significant declines in the number of new listings, with a decrease of 17.1% from Q1 2022 to Q1 2023. Conversely, while South Dakota initially saw a substantial reduction in new listings from Q1 2022 to Q1 2023, likely influenced by an extended winter, the state's housing market has displayed some resilience. The supply side rebounded modestly, showing 0.2% growth from Q2 2022 to Q2 2023, in contrast to the continued contraction of 23.6% in the US from Q2 2022 to Q2 2023.

South Dakota and US Median List Prices

Inflation Adjusted 2022 Dollars



Source: Dakota Institute, Realtor.com

Aggregating these data points to the most salient feature of the housing market illustrates the unique situation South Dakota finds itself in. Despite inflationary pressures, economic uncertainty, and rising mortgage rates, South Dakota continues to experience elevated listing prices. In fact, median listing prices in South Dakota have recently grown more than three times faster than at the national level. South Dakota's median list price grew 17.5% compared to the national average of 5.2% from 2021 to 2022. In the most recent data, we see this trend continue. While the US saw modest growth of 1.7% from Q1 2022 to Q1 2023, South Dakota enjoyed 10.7% listing price appreciation over the same period, and a 1.7% decline nationally and 7.3% increase in the state in Q2 2023, even after accounting for inflation factors.

The impact of strong buyer demand, combined with the ongoing upward trajectory of home prices, has amplified the pressing issue of housing affordability in the South Dakota market. Although the state retains relative affordability compared to the national average, the past year has seen a swift deterioration in affordability conditions, effectively excluding marginal homebuyers from the market. Looking ahead to the remainder of 2023, we hold the expectation that mortgage rates will stabilize, leading to an improved affordability landscape for those currently grappling with housing challenges. This anticipated stabilization in housing will translate to decreased moving costs for existing homeowners, an expansion in housing supply, and a likely reduction in persistently high listing prices. This positive outlook aims to mitigate the affordability crisis, ensuring a more accessible and sustainable housing market in South Dakota.