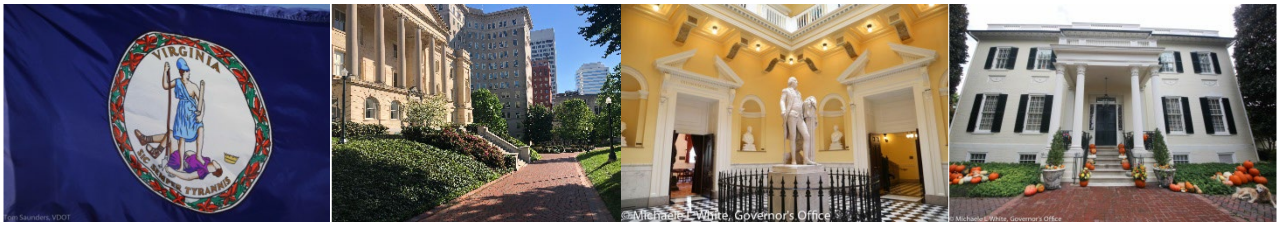
ECONOMIC FORECAST



The US Economy - Review of FY 2025

The Fiscal Year (FY) 2025 outlook was shaped by lingering economic uncertainty as pandemic induced inflationary concerns evolved into anxieties around rising unemployment, softening consumer spending, higher debt delinquencies, and an uncertain presidential election. Nonetheless, as inflation moderated and the labor market appeared stable, expectations about entering a recession diminished by late 2024—monetary policy had turned toward supporting growth, and the Governor’s Advisory Council on Revenue Estimates adopted a “slow growth” expectation for FY25. Despite early concerns, FY25 ultimately exceeded expectations.

Economic output proved stronger than forecasted, with real GDP rising 2.3 percent rather than the anticipated 1.4 percent. A first-quarter decline driven by tariff-related import surges and reduced government spending was more than offset by a strong rebound in the second quarter. Consumer spending also outpaced forecasts, growing 2.8 percent, though momentum softened later in the year as labor market conditions cooled and tariffs raised costs. Employment remained a stabilizing force through much of the year, with the average unemployment rate at 4.1 percent, outperforming projections even as job growth slowed compared to prior years.

Labor market performance in FY25 was mixed—cooling from its post-pandemic highs but still resilient by historical standards. Monthly job gains averaged 127,000, down from the stronger pace of the immediate post-pandemic years, with much of the slowdown occurring in the second half of the fiscal year amid uncertainty around tariffs, tax policy, and federal funding. Job growth was uneven across industries: Education and Healthcare, State and Local Government, and Leisure and Hospitality led gains, while Manufacturing and Professional and Business Services saw the largest declines. Hiring levels slipped and layoffs rose modestly, returning the vacancy/unemployment ratio to roughly 2017 levels as the labor market continued normalizing.

Inflation improved during FY25 with the Consumer Price Index growing 2.7 percent on average, significantly lower than in recent years as energy prices fell and supply chains normalized, particularly for vehicles. Shelter inflation slowed but continued to rise. In response to easing inflation and softer labor conditions, the Federal Reserve shifted to monetary easing, implementing three rate cuts in FY25 and continuing reductions into early FY26 to support economic growth.

Baseline US Forecast

In the baseline economic outlook, policy uncertainty subsides, and consumers and businesses adapt, clearing the way for continued economic growth. This and other headwinds should cause moderate economic growth amid a low fire/low hire labor market. In terms of annual growth rates, we expect real GDP to grow 2.5 percent in FY26 and 2.3 percent in FY27.

Key Assumptions and Risks in the Baseline Scenario

• Modest economic growth over the next two fiscal years as employment growth remains marginal.

• Hiring is soft in the near-term and layoffs remain low, resulting in slow employment growth over the forecast horizon. U.S. job growth is 0.5 percent to 0.8 percent in fiscal years 2026-2028. Professional and Business Services, Construction, and Manufacturing are expected to continue their stagnation.

• In addition to the 25-basis point reductions in September and October, the Federal Reserve will reduce the federal funds rate by another 25 basis points at its December meeting and subsequently reduce the rate by 25 basis points in the first, third, and fourth quarters of 2026.

• The effective tariff rate settles around 15 percent, less of the increase falls on the consumer, the price increases are transitory, and consumers are largely able to adapt. Core PCE inflation rises to above 3 percent through the end of FY26 before gradually easing to close to 2 percent in FY28.

• An increase in layoffs in the "low hire" labor market, higher than expected tariffs, or the Federal Reserve backing off rate cuts could undermine consumer spending and growth.

The Virginia Economy

Review of FY 2025

Employment in Virginia during FY25 grew by 1.4 percent, exceeding the forecasted growth of 1.2 percent. Employment faced its first monthly net negative changes since 2022 with net -2,800 jobs in the second-half of the fiscal year after being net 41,200 during the first half. Although net positive 38,400 jobs for the fiscal year, this is a slower pace than that of FY24 (+62,500) and FY23 (+109,200). Looking forward to the coming year, there is reason for optimism in a relatively strong Virginia economy—recent local sales tax receipts are above historic growth rates. The impact of federal job cuts has been modest with reduced yet positive withholding payments, and there is $140 billion in capital projects supporting 70,000 jobs through 2028 in the investment pipeline.

Baseline VA Forecast

The Virginia baseline forecast follows our national modest growth scenario. This is driven by national trends playing out within our state as the labor market remains sluggish but maintains a reasonable unemployment rate, while consumer and business spending keeps its momentum in face of changing conditions.

- Real GSP is expected to grow at 1.0 percent in FY26 compared to the actual growth of 2.5 percent in FY25. It is projected to then slowly rise to 1.5 percent in FY27.
- Wages and salaries are expected to slow slightly in FY26 and FY27 at 4.5 and 4.6 percent after Virginia posted an unexpected 5.0 percent wage growth in FY25. Total personal income expects to follow the same trend as wages and salaries with 4.7 and 5.0 percent growth in FY26 and FY27.
- The unemployment rate is projected to rise from 3.1 as experienced in FY25 to 3.6 percent in FY26 and FY27. Employment in Construction is projected to lead the way with 4.7 growth in FY26, followed by a drop off to 0.1 percent the following year. After continuing to decline by a forecasted -0.1 percent in FY26, Professional and Business Services employment is expected to rebound to a 1.8 percent growth in FY27.
- Total nonfarm employment will grow by 0.6 and 0.7 percent year-over-year in FY26 and FY27, respectively.