Texas Economic Update

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- **The U.S. economy is starting to recover, although unemployment will remain high for some time.**
- **Labor market flexibility means Texas will recoup lost jobs faster.**
- **Healthier pre-crisis housing activity is shielding Texas from the distress experienced by many other states.**
- **Despite, falling demand for chemical and petroleum products, Texas exports fare relatively well compared to other large exporting states.**
- **A business friendly environment continues to underpin the relatively stronger prospects for economic recovery in Texas.**

Economy

The U.S. economy is gradually transitioning into recovery mode as labor and real estate markets stabilize, despite continuing weak employment and housing statistics. At the same time, there is a growing sense that the U.S. is facing a jobless recovery that could keep unemployment high for many years to come.[1] We expect a slow revival of consumer spending due to soft labor markets denting consumer confidence (see chart 1). Notwithstanding some recent evidence of an economic rebound, the U.S. economy has been shedding jobs, even though the pace of job destruction has decelerated (see chart 2). This suggests labor markets look increasingly likely to lag behind any output led recovery.

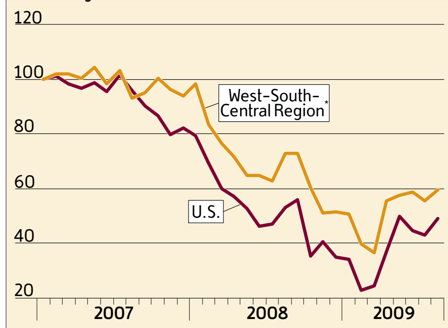
Obviously, job creation is essential to put consumer spending back on a solid footing. Recent economic data suggests that, while job markets are tight, the outlook for U.S. consumers is slowly improving. In particular, in the second quarter of 2009, households' net worth posted the first quarterly gain (up by 4% or $2 trillion) since the third quarter of 2007.[2] Equally important, U.S. industrial output and capacity utilization have been increasing since May. In addition, the housing correction appears to be bottoming out as new home sales pick up and real estate prices stabilize. All of this adds strength to retail sales, which grew by 2.7% in August versus the previous month - the highest monthly gain in three years. A narrower measure of retail sales, which excludes all auto[3] and gasoline purchases, advanced by 0.6% as consumers spent more on discretionary items, such as electronics, clothing and sporting goods. This may imply that consumer confidence is gradually returning. Of course, the strength of any regional economic rebound will depend on the depth of the labor market contraction in each individual state.

Employment

In Texas , seasonally adjusted nonfarm employment fell by 0.6% in August, having posted the first monthly gain in 2009 the month before. On the upside, the annual decline in nonagricultural jobs was only 2.8%, compared to 4.9% in California, 4.8% in Florida or 4.3% in the U.S overall. (see chart 3). Despite this, the unemployment rate in Texas increased to 8% in August due to job losses and a growing labor force.[4]

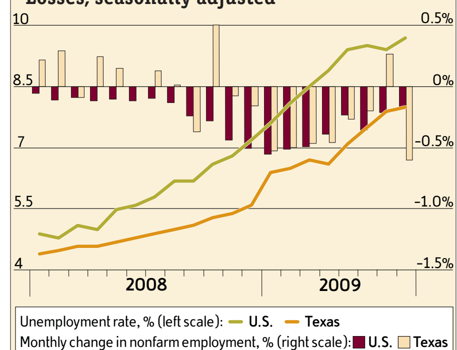
Indeed, in August, Texas recorded the largest job losses since the onset of the current recession. Seasonally adjusted employment fell by 62,200. Jobs losses were primarily concentrated in construction, mining, manufacturing, and the leisure & hospi-

Consumer Confidence Index January 2007=100 1



*Includes Arkansas, Louisiana, Oklahoma, Texas
Source: Texas Comptroller of Public Accounts, The Conference Board

Monthly Unemployment Rate and Job Losses, seasonally adjusted 2



Source: The U.S. Bureau of Labor Statistics

Nonfarm Employment in August, seasonally adjusted 3

	August 2009 vs			State's share of all U.S. jobs
	July 2009	August 2008		
		%	thousand jobs	
California	-0.1%	-4.9%	-741	10.8%
Texas	-0.6%	-2.8%	-296	7.9%
New York	0.0%	-2.1%	-188	6.6%
Florida	-0.3%	-4.8%	-373	5.6%
Illinois	-0.3%	-5.1%	-306	4.3%
Pennsylvania	-0.2%	-3.3%	-192	4.3%
Ohio	-0.6%	-5.1%	-272	3.9%
New Jersey	0.0%	-3.0%	-121	3.0%
North Carolina	0.2%	-5.2%	-214	3.0%
Georgia	-0.9%	-6.0%	-244	2.9%
Michigan	-1.1%	-7.9%	-330	2.9%
Virginia	-0.1%	-3.0%	-115	2.8%
Massachusetts	0.0%	-3.2%	-106	2.4%
US	**-0.2%**	**-4.3%**	**-5 830**	

Source: The U.S. Bureau of Labor Statistics

[1] See: "How Will Unemployment Fare Following the Recession?", Economic Review: The Third Quarter 2009, Federal Reserve Bank of Kansas City.
[2] Households' net worth fell by 12.3% from the second quarter of 2008 to the second quarter of 2009. Source: Flow of Funds Accounts of the U.S.
[3] More than a half of this increase was due to higher sales of motor vehicles (up by nearly 12% in August), boosted by the $3 billion Cash for Clunkers program. Source: The U.S. Census Bureau.
[4] The Texas civilian labor force grew by 2.5% over the past 12 months, while the U.S. civilian labor force stood mostly flat, marginally declining by 0.2%. Source: The Texas Workforce Commission.

tality sectors, which continued to adjust to a weaker real estate market and lower oil prices (see chart 4).

Notwithstanding a recent uptick in residential housing permits, the value of contracts for nonresidential construction in Texas continues to contract - down by 51% versus August 2008 (see chart 5). This trend deepens job losses in the nonresidential construction sector.

Meanwhile, most of the August losses of manufacturing jobs came from the producers of non-durable goods, on the back of falling output of petroleum products and chemicals as global demand for these products remains weak. Government employment declined by 11,100 in August - the largest drop in over a decade, as the federal government and the U.S. Postal Service (USPS) cut jobs. The decline in federal government jobs is partly due to the reduction of temporary workers hired during the initial preparation for the 2010 Census. At the same time, the U.S. Postal Service is likely to continue reducing its workforce in an effort to cut costs and close or consolidate post offices.[5]

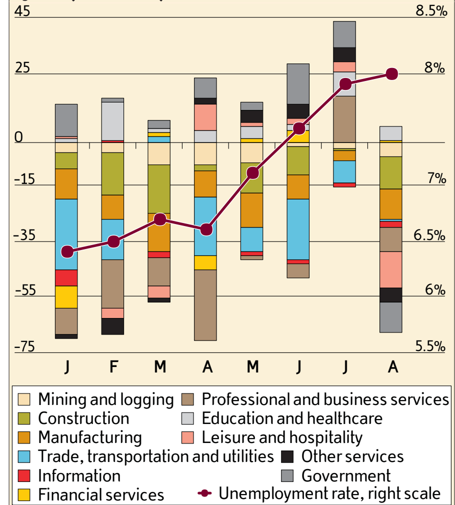
On a positive note, the unemployment rate in Texas is 1.7 percentage points below the 9.7% national average. Furthermore, the Texas economy fares well compared to other large states (for example, in August, the unemployment rates in California, New York, and Florida grew to 12.2%, 9% and 10.7%, respectively). This implies that the Texas labor market is likely to emerge relatively stronger from the current recession. Indeed, Texas provides about 8% of all U.S. nonfarm jobs, while the state's share in the total number of unemployed is only 6.5%. Meanwhile, California is home to about 11% of all U.S. nonfarm jobs and over 15% of all unemployed workers. Michigan has only 3% of all U.S. jobs, yet 5% of all U.S. unemployed reside there.[6] These data points offer additional support to the notion that jobs in Texas have been more resilient during the recent economic slowdown.

Residential housing activity

In August, existing-home sales nationwide decreased by 2.7% (versus the prior month) to a seasonally adjusted annual rate of 5.1 million units. More positively, home sales were 3.4% above last year's level. Combined with a moderation in the decline of property values, this data suggests a gradual stabilization of the housing market. Still, it appears that most of the activity is being driven by depressed home values, as homebuyers take advantage of greater housing affordability (see chart 6).

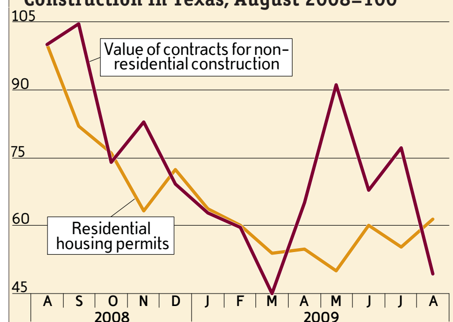
That said, the volume of home sales in the large Texas metro areas remains on a downtrend. According to the data of the Real Estate Center at Texas A&M University, in August, the volume of Texas residential home sales declined by about 15% on the back of only a 3.7% drop in average home prices and a 11.6% decline in sales activity. In particular, the value of home sales in Dallas and Houston (which jointly account for over half of all residential housing activity in Texas) dropped by 17% and 16%, respectively(compared to August 2008). Meanwhile, median house prices in both cities held up pretty well, marginally increasing by 1.4% and 0.5% respectively.

Job Losses in Texas in 2009, thousands jobs (left scale) 4



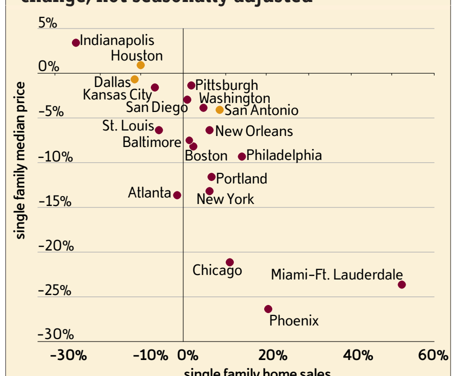
Source: The U.S. Bureau of Labor Statistics

Residential and Nonresidential Construction in Texas, August 2008=100 5



Source: The Federal Reserve Bank of Dallas, Texas Comptroller of Public Accounts

Single Family Home Sales and Median Price in August 2009, 12 months % change, not seasonally adjusted 6



Source: The National Association of Realtors

[5]The U.S. Postal Service has recently announced plans to cut 30,000 jobs as it is planning to close up to 10% of its offices. However, the restructuring of the USPS remains highly controversial due to the strong political opposition to shutting postal facilities. Indeed, at the end of September, the U.S. House of Representatives passed a temporary spending bill which secures funding for the U.S. government operations largely at current levels. This bill allows the USPS to cover a budget shortfall by reducing its retirement payments by $4 billion.

[6]In most of the U.S. states the difference between a state's share in total U.S. jobs and a state's share in the national total of unemployed workers does not exceed half a percentage point.

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Foreign trade

This year's 50% drop in crude oil prices continues to eat into Texas export revenues. Indeed, during the first seven month of 2009, exports fell by over 23% to $88.8 billion on the back of low sales of petroleum products and chemicals. On the upside, the weaker U.S. dollar appears to be driving higher demand from Mexico - Texas's largest trading partner (see chart 7).[7] Additionally, between January and July, exports of industrial machinery and computers to Mexico (about one fifth of all exports to Mexico) grew by 2.6% compared to the first seven month of 2008. However, over the same time period, exports of Texas mineral fuels and petroleum products (about 15% of all exports in 2008) fell by over 30%.

Texas will continue earning lower export revenues this year. However, the performance of the state's exporters is likely to remain stronger relative to other large exporting states. The share of Texas exports to developing countries, where growth momentum has been recovering earlier than in the developed economies, exceeds 60% (see chart 8). This means that a faster rebound in foreign demand from emerging markets is likely to add strength to the Texas economy.

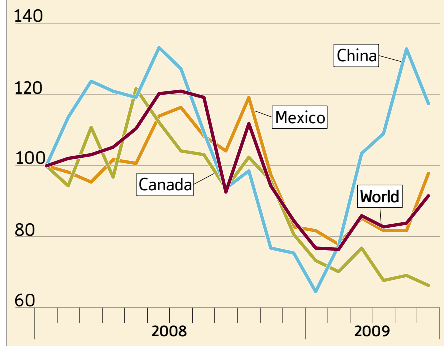
Texas is on track for a faster recovery

Several recent economic reports place Texas among the most likely places in the U.S. to quickly regain the jobs lost during the current downturn. For example, IHS Global Insight forecast that Austin-Round Rock and San Antonio metro areas will return to pre-recession job levels next year.[8] Dallas and Houston are expected to recoup lost jobs by 2011. While recession-driven job losses in Dallas and Houston will stay at 3.3% and 2.4% respectively, this compares to 6.8% in Los Angeles, 3.8% in New York, 3.9% in Boston, 5.8% in San Francisco and 4.6% on average in all other U.S. metro areas. Equally important, according to the latest MetroMonitor, published by the Brookings Institution, the six largest Texas metro areas[9] are among the 20 best performing metro areas in the U.S., with Austin, Dallas, El Paso and Houston occupying the first, forth, sixth and ninth positions, respectively.

All told, Texas appears to be weathering the current economic downturn relatively well. The state's coincident index, which is a proxy for output growth, registered a slower and shallower correction compared to the seven largest comparable U.S. regional economies (see chart 9). The big question is whether this divergence of the Texas economy from the rest of the U.S. reflects a stronger resilience to the current downturn or if it is merely a lagged response to the crisis. The answer depends on the degree of the state's exposure to housing and commodity price cycles as well as on it's capacity to create new jobs. Notwithstanding Texas' higher vulnerability to oil price fluctuations, we believe healthier fundamentals underpinning the state's broader economy appear to be supporting a comparably milder adjustment. This explains the lower employment and output losses in Texas versus other U.S. states.

Obviously, oil and gas accounts for a relatively larger share of the Texas economy compared to the rest of the U.S. This means last year's record high energy prices helped to delay economic slowdown in Texas. At the same time, a relatively rapid expansion of the mining sector left Texas more exposed to sharp fluctuations in global

Monthly Volume of Exports from Texas, January 2008=100 7



Canada, Mexico and China absorb nearly a half of all exports from Texas
Source: U.S. Census Bureau

Five Largest Exporting U.S. States, exports composition in 2008 and % change in January-July 2009 8

	% of the U.S. total	% of exports to developing countries	% of machinery and electronics in exports	% change Jan-Jul 2009 vs Jan-Jul 2008
Texas	**14.8%**	**61.0%**	**35.6%**	**-23.3%**
California	11.1%	36.9%	36.4%	-23.1%
New York	6.1%	19.6%	20.6%	-35.2%
Washington	5.1%	34.5%	6.8%	-34.0%
Florida	4.2%	62.8%	38.0%	-14.9%
U.S.		36.9%	28.1%	-24.8%

Source: U.S. Census Bureau

State Coincident Indexes*, July 2009 9

	Average monthly change in 2009	vs July 2008	January 2007 = 100	State's share in the U.S. GDP
California	-0.6%	-5.1%	95.8	13.0%
Texas	-0.3%	-2.3%	103.4	8.6%
New York	-0.8%	-9.3%	90.4	8.1%
Florida	-0.5%	-5.9%	90.4	5.3%
Illinois	-0.8%	-7.1%	92.6	4.5%
Pennsylvania	-1.2%	-11.3%	88.1	3.9%
New Jersey	-0.4%	-4.2%	96.8	3.4%
Ohio	-0.9%	-9.4%	89.9	3.3%
U.S.	**-0.3%**	**-3.4%**	**98.6**	

* The trend for each state's index is set to the trend of its gross domestic product (GDP), so long-term growth in the state's index matches long-term growth in its GDP.
These 8 states produce a half of the entire U.S. output.
Source: The Federal Reserve Bank of Philadelphia

[7] Mexico accounted for nearly a third of all Texas exports in 2008.
[8] According to this forecast, of the 363 U.S. metros only McAllen, Texas, will add jobs this year. Meanwhile, strong employment gains in the majority of metro areas will not be observed until 2011.
[9] Austin-Round Rock, Dallas-Fort Worth-Arlington, El Paso, Houston-Sugar Land-Baytown, McAllen-Edinburg-Mission and San Antonio, which account for about 80% of the entire Texas economy.

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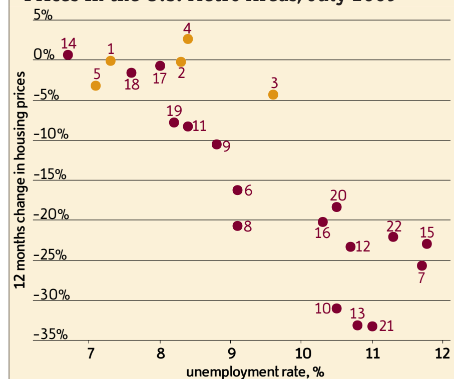
oil prices. During the past three years, employment in Texas mining grew on average by about 12% a year (or four times faster than the total number of nonagricultural jobs). This made mining jobs particularly susceptible to redundancy cuts as weak global demand for oil drove down energy prices. As a result, during the first eight month of 2009, employment in the Texas mining industry decreased by over 15% (compared to only a 3% loss of all nonfarm jobs)[10]. Offsetting this is the fact that, at present, the mining industry provides less than 2% of all nonfarm jobs in Texas. This means the impact of the mining sector contraction on the broader Texas economy is relatively muted. Therefore, although the oil and gas sector added an extra layer of resilience to the Texas economy when oil price surged, its current weaker performance should not pose a serious threat to economic recovery.

Additionally, Texas metro areas are fairly well-diversified, both in terms of their industrial mix and their reliance on domestic and foreign demand.[11] Despite obvious dissimilarities[12], these metro economies share similar traits that have shielded their local labor markets from sizable employment losses. In particular, the Texas metro areas entered the current downturn with relatively smaller construction, financial, professional and business service industries, which were the areas of the national economy most hit by the current recession. Additionally, "recession-proof" sectors such as education, healthcare and government, where jobs remained stable or grew, are relatively well represented in Texas. This has helped protect jobs and is likely to support faster recovery for the Texas economy going forward.

The major Texas metro areas appear mostly immune to the ongoing housing correction, largely thanks to the healthier shape of the state's real estate market prior to this crisis.[13] As a result, housing prices, which are at the heart of the current U.S. recession, either stayed flat or suffered only a mild adjustment in Texas. This factor supports our view on the relative strength of the Texas economy, as weak labor markets usually create significant downward pressures on home values (see chart 10).

Finally, Texas consistently ranks high in many national business climate surveys. The state's pro-business environment adds to the underlying strength of the local economy by supporting its capacity to create new jobs (see chart 11). More than that, easy entry of new businesses boosts innovation and competition, while keeping a tight lid on labor costs. For example, during 2001-2008, output per worker in Texas manufacturing grew by over 70%, while average weekly earnings for production workers in manufacturing inched

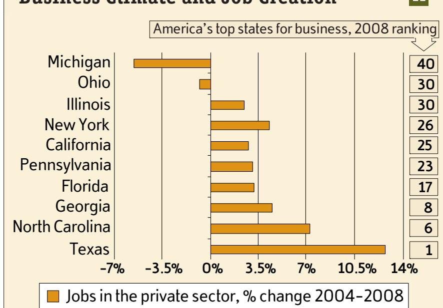
Unemployment Rates and Housing Prices in the U.S. Metro Areas, July 2009 10



1 Austin-Round Rock, TX
2 Dallas-Fort Worth-Arlington, TX
3 El Paso, TX
4 Houston-Sugar Land-Baytown, TX
5 San Antonio, TX
6 New York-Northern New Jersey-Long Island, NY-NJ-PA
7 Los Angeles-Long Beach-Santa Ana, CA
8 Chicago-Naperville-Joliet, IL-IN-WI
9 Philadelphia-Camden-Wilmington, PA-NJ-DE-MD
10 San Francisco-Oakland-Fremont, CA
11 Boston-Cambridge-Quincy, MA-NH
12 Atlanta-Sandy Springs-Marietta, GA
13 Miami-Fort Lauderdale-Pompano Beach, FL
14 Little Rock-North Little Rock-Conway, AR
15 Sacramento-Arden-Arcade-Roseville, CA
16 San Diego-Carlsbad-San Marcos, CA
17 Denver-Aurora, CO
18 Bridgeport-Stamford-Norwalk, CT
19 Hartford-West Hartford-East Hartford, CT
20 Jacksonville, FL
21 Orlando-Kissimmee, FL
22 Tampa-St. Petersburg-Clearwater, FL

Source: The U.S. Bureau of Labor Statistic, The National Association of Realtors

Business Climate and Job Creation 11



These 10 states provide over a half of all jobs in the U.S. private sector.
Source: CNBC Ranking of the U.S. states, The U.S. Bureau of Labor Statistics

[10]It appears that layoffs in the Texas mining industry have made a relatively large impact on the to labor market in Texas. Indeed, about 14% of all Texas nonfarm jobs lost over the last 12 months were in the mining industry, compared to only 1.4% nationwide.

[11]Houston, Austin, McAllen and El Paso's share of exports in their gross metropolitan product exceeds the national average, which means these economies tend to be less exposed to weakness in domestic consumption.

[12]For example, the information communication and technology (ITC) industry represents about 13% of the Austin-Round Rock metro area and less than 2% of the El Paso economy.

[13]More elastic housing supply in Texas, partially thanks to flexible land-use zoning codes, helped prevent pre-crisis housing price run-ups observed in many other states. Indeed, in 2007, the median house price in major large Texas cities was 20-40% below the national average; while home values in New York, Los Ageless, San Francisco and San Diego were 2-4 times above the national average. This divergence cannot be attributed to a difference in economic fundamentals alone. For example, while per capita personal income in the Houston metro area was only 14% below the level in the New York metro area, home values in New York exceeded home prices in Houston by more than 3 times.

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up by less than 3%. Productivity growth was smaller in all other large manufacturing states, while their workers' earnings grew considerably faster than in Texas (see chart 12).

The above factors all highlight Texas' strong competitive advantage versus other states, and reinforce our belief in the resilience of the state's economy to sustain output and employment growth as the U.S. economy begins to come out of recession.

Output per Worker in Manufacturing, % change during 2001-2008 12

	% of the U.S. total*	Output per worker	Average weekly earnings	Number of jobs
California	13%	52%	17%	-20%
Texas	9%	72%	3%	-10%
Ohio	5%	33%	14%	-22%
North Carolina	5%	52%	24%	-27%
Illinois	4%	33%	12%	-19%
New York	4%	52%	14%	-25%
Pennsylvania	4%	18%	12%	-22%
Indiana	4%	32%	13%	-15%
U.S.		**43%**	**22%**	**-18%**

* State's manufacturing as a percentage of the U.S. total.
These states account for over 47% of all U.S. manufacturing and employ about 44% of all workers in manufacturing.
Source: The U.S. Bureau of Labor Statistics, Bureau of Economic Analysis, The Bleyzer Foundation.

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