Texas Economic Update

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- **In April, Texas industrial production grew by roughly 3% versus April 2009.**
- **The Houston Purchasing Managers Index increased for the thirteenth straight month to 58.1%.**
- **Texas home sales increased by 12% in April versus the month before (and by over 26% copared to April 2009).**
- **During the first quarter of 2010, exports from Texas jumped by 28% versus the same quarter a year ago.**
- **In April, the unemployment rate in Texas edged up to 8.3% (1.6 percentage points below the national average).**

Executive Summary

Texas factory activity continues to strengthen on growing exports, higher energy prices, and new manufacturing goods orders . In April, Texas industrial production grew for the second straight month in annual terms thanks to continued gains in manufacturing and mining. And the Houston Purchasing Managers Index increased for the thirteenth straight month to its highest level since June 2008.

A survey by the Federal Reserve Bank of Dallas points to continuing gains in Texas manufacturing activity. In particular, in May, both the current and future production indices moved upward; with the current production index increasing for the seventh straight month to its highest reading since March 2007. The current employment index grew for the third consecutive month, which means the share of companies hiring new workers exceeds the share of firms making layoffs. In addition, the inventory rebuilding cycle, and a stronger flow of new orders on growing sales abroad, should continue to support output growth in Texas manufacturing throughout 2010.

Texas remains the largest exporting state in the U.S., with manufacturing that has been somewhat shielded from the domestic, consumer-led recession. As a result, peak-to-April 2010 job losses in manufacturing were much lower in Texas than nationwide. Additionally, small businesses account for a smaller share of construction jobs in Texas versus the U.S. This, and, a stable housing market, helped Texas lose fewer jobs in construction. Additionally, a rising population supports stronger job gains in education and healthcare; while sound public finances help sustain stable employment levels in the state and local governments of Texas. More importantly, thanks to flexible zoning rules and affordable housing, past productivity gains brought more jobs rather than inflated home values in Texas. All of this reinforces the argument of a more mobile and adaptable labor market in Texas, which has helped ease the adjustment during the recent economic downturn.

According to the Real Estate Center at Texas A&M University, in April, Texas home sales posted their third consecutive monthly gain, increasing by 12% versus the month before (or by over 26% against April 2009). Home sales in Dallas, Houston, Austin and San Antonio continued to report solid gains. Although home sales may remain weak due to the expiration of the first-time home buyer tax credit, brighter economic prospects, and an affordable cost of living, support a better outlook for the state's real estate market.

During the first quarter of 2010, total exports from Texas jumped by 28% on stronger exports of chemicals and petroleum products, as well as computers and transportation equipment. This rebound is driven by stronger foreign demand from developing countries and Canada, where growth momentum is expected to stay strong. Lastly, the impact on Texas exporters of sovereign debt problems in the Euro area are likely to be trivial as these countries account for less than 10% of all Texas exports.

Economic Growth

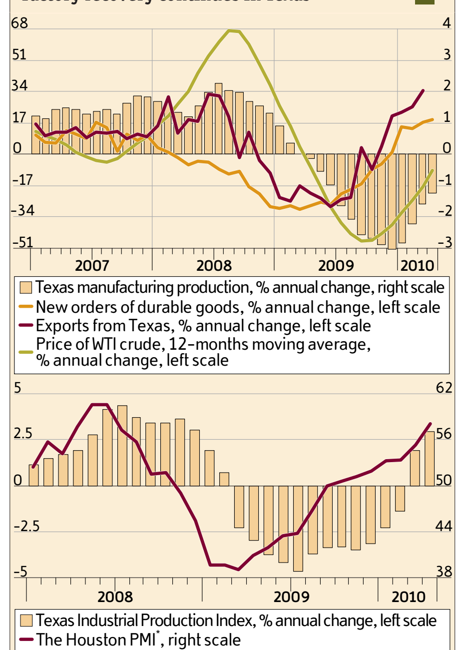
Texas factory activity continues to strengthen on growing exports, higher energy prices, and new orders for manufacturing goods (see chart 1). In April, Texas industrial production grew by roughly 3% versus the same month a year ago thanks to continued gains in manufacturing and mining. The Houston Purchasing Managers Index increased for the thirteenth straight month settling at 58.1% - its highest level since June 2008.

Nationwide, activity expansion in manufacturing continued in May for the tenth consecutive month. The Purchasing Managers Index stood at 59.7, with sixteen out of 18 industries reporting growth. In particular, indices of new orders and new export orders saw an 11th straight month of growth, implying that exports are supporting output recovery in overall U.S. manufacturing. The manufacturing outlook in Texas also remains solid. A survey by the Federal Reserve Bank of Dallas points to continuing gains in Texas factory activity. In particular, in May both the current and future production indices moved upward; with the current production index increasing for the seventh straight month to its highest reading since March 2007. And the current employment index grew for the third consecutive month (see chart 2), which means the share of companies hiring new workers exceeds the share of firms with layoffs. The share of companies with layoffs dropped to 9% from 37% a year ago. Equally important, the share of manufacturers planning to layoff employees in the future fell to about 8% from 35% at the beginning of 2009.

We believe a continuation of the inventory rebuilding cycle and a stronger flow of new orders on growing sales abroad will continue to support output growth in Texas manufacturing throughout 2010. Indeed, according to the U.S. Census Bureau, U.S. manufacturing inventories have been increasing on a monthly basis since the beginning of 2010. Still, for the period between September 2009 and March 2010, the average monthly growth of inventories was only 0.1% versus a roughly 1.3% growth of sales. As a result, the ratio of inventories to sales in manufacturing fell to 1.27 from 1.46 in March 2009. With a better sales outlook, inventories should grow faster in the second half of 2010. This will provide additional support to factory activity in the U.S. In addition, the lagged impact of increasing new orders of durable goods on factory output will also sustain growth momentum in Texas manufacturing (see chart 3).

Lastly, growing manufacturing and exports will contribute to output growth in other sectors of the Texas economy. In particular, during the first three months of 2010, cargo traffic at the Dallas-Fort Worth International Airport and the Houston Airport System grew by about 17%. Meanwhile, according to the Port of Houston Authority, in the first quarter of 2010, the volume of container units was up by 18%. Texas-Mexico railroad and truck crossings increased by 17% and 14%, respectively.[1] In fact, the Bureau of Transportation Statistics reported that in March 2010, Texas led all U.S. states in its surface trade turnover with Mexico, which stood at roughly $10 billion - the largest amount on record. And this adds strength to local Texas

Factory recovery continues in Texas 1

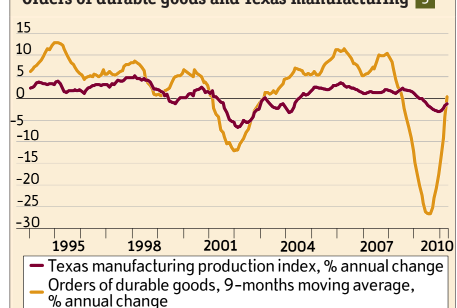


*Purchasing Managers Index, a value greater than 50% indicates expansion.
Source: The Federal Reserve Bank of Dallas, The U.S. Census Bureau, Institute for Supply Management

Output and employment indices in Texas manufacturing, seasonally adjusted 2

Source: The Federal Reserve Bank of Dallas

Orders of durable goods and Texas manufacturing 3



Source: The Federal Reserve Bank of Dallas, The U.S. Census Bureau

[1] Source: The Texas Center for Border Economic and Enterprise Development.

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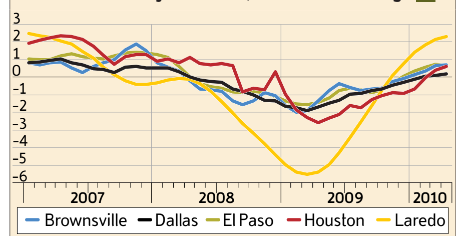
metros, where the economy benefits more from trade and transportation services (see chart 4).

The above data clearly supports a broad economic recovery for the Texas economy. Indeed, the Texas Business-Cycle Index has been posting monthly gains since it bottomed out at the end of 2009 (see chart 5). Meanwhile, in April, the Texas Leading Index grew to its highest level since September 2008, recovering by roughly 15% since March 2009.

Metro Business-Cycle Indices, 3-months % change 4

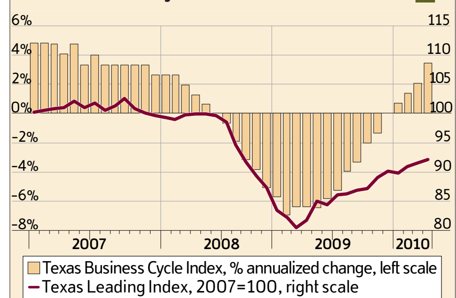


Source: The Federal Reserve Bank of Dallas

Employment

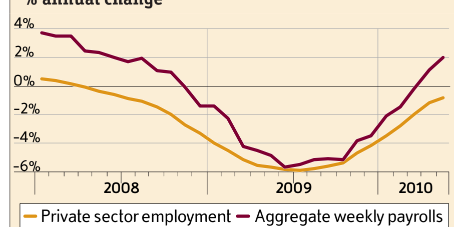
Notwithstanding a strong industrial rebound, May's employment reading revealed rather lackluster growth in private sector jobs. Nationwide, the private sector added only 41,000 jobs, more than 5 times less than the previous month. Several factors may be contributing to this lagged response of employment to output recovery. First, labor input is rising much faster than total employment. Indeed, since the beginning of 2010, private sector weekly hours worked increased by 1.2%, with private sector employment gaining only 0.5%. This means businesses are more likely to respond to higher demand by using existing workers more productively than creating new jobs. On the upside, higher hourly earnings obviously add to wage income for employed workers. In fact, a faster recovery of hours worked and a continued growth in wages contributed to positive annual gains in private sector aggregate payrolls in April and May (see chart 6). These income gains will be spent, which should sustain more jobs and spending in the future.

Economic recovery continues in Texas 5



Source: The Federal Reserve Bank of Dallas

Private sector employment and payrolls, % annual change 6



Source: The U.S. Bureau of Labor Statistics

A relatively stronger recovery in exports versus domestic consumer demand may be the second reason for slower private sector employment growth. The short-term benefits of rising exports are usually captured by existing exporters, while the impact on new exporters is relatively modest.[2] And, according to the U.S. Census Bureau, over two thirds of all U.S. exports are by large firms (with more than 500 workers); 75% of which are in manufacturing. This means the current export recovery is mostly supporting large U.S. exporters. However, large firms have a smaller impact on private sector employment. Indeed, small businesses, which account for half of all private sector jobs in the U.S., are the major source of net job growth - they created about 64% of over 7.2 million new private sector jobs after the 2001 recession (from Q3 2003 to Q4 2007). These firms, however, were more vulnerable to the 2007 downturn. In particular, over 80% of all jobs in construction and real estate were provided by small firms.[3] A high concentration of jobs in the small business sector is also typical for car dealerships, repair and maintenance shops as well as legal services, advertising, accommodation and food services. As a result, a retrenchment in consumer demand and falling residential investments has had a larger impact on the small business sector.

In addition, limited access to bank loans restricts the ability of small businesses to grow. Unlike large companies, small firms lack access to public credit markets. This means these companies rely more on bank credit, especially on loans from local banks. According to May's Oversight Report by the Congressional Oversight Panel, commercial banks have been reducing their loans to small businesses faster than their total loan portfolios. On the upside, recent readings from the loan officer surveys indicate that credit conditions for small businesses are slightly easing compared to the beginning of the credit crunch. And demand for loans by small firms is picking up (see chart 7). In addition, small business sentiment improved markedly in

[2] See: Bernard A. B., Bradford J. J., Redding S. J., and Schott P. K. The Margins of U.S. Trade. NBER Working Paper 14662, January 2009.
[3] Source: The U.S. Small Business Administration.

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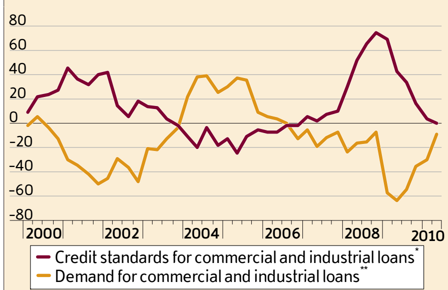
April and May, which should encourage small businesses to increase employment (see chart 8).

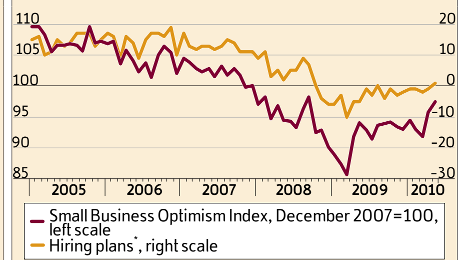
Sustainable job gains in the private sector rely on the healthy growth of small businesses. Thus, local economies with a friendly investment climate for private entrepreneurs have better prospects for employment and economic recovery. Various surveys put Austin and Houston among the top ten places to launch a business.[4] For example, according to the Small Business & Entrepreneurship Council, from 2004 to 2009, Texas moved up from 11th place to 3rd place in the Small Business Survival Index[5]. The Council also ranks Texas as the second best business tax environment for entrepreneurship and small business in 2010. This means that an eventual resumption of job growth in small companies supports a brighter outlook for private sector employment in Texas.

Small business and commercial banks 7



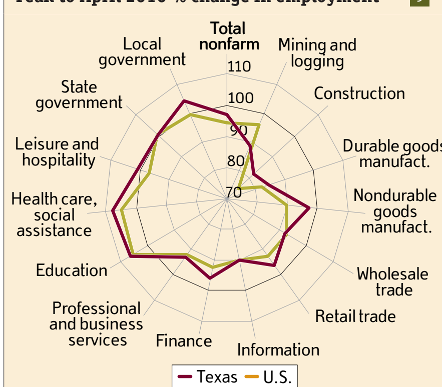
*Difference between respondents reporting tightened credit standards vs. eased credit standards for small firms.
**Difference between respondents reporting stronger loan demand vs. weaker demand from small firms.
Source: The Federal Reserve System Senior Loan Officer Opinion Survey on Bank Lending Practices

Small businesses are more optimistic 8



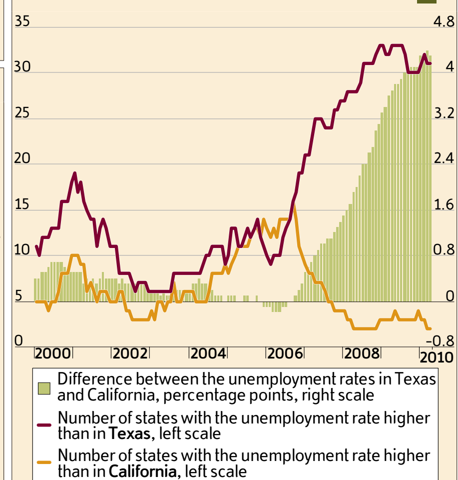
*Difference between respondents planning to increase employment vs. decrease employment in the next three months
Source: The National Federation of Independent Business Owners

Peak to April 2010 % change in employment 9



During this business cycle, U.S. nonfarm employment peaked in December 2007; meanwhile the employment in Texas continued to increase until August 2008.
Source: The U.S. Bureau of Labor Statistics

Texas vs. California 10



Source: The U.S. Bureau of Labor Statistics, The Bleyzer Foundation

On top of that, Texas is the largest exporting state in the U.S., which shielded its manufacturing from the consumer-led recession. As a result, peak-to-April 2010 job losses in manufacturing were much smaller in Texas than nationwide (see chart 9). Small businesses account for a smaller share of construction jobs in Texas versus the U.S.[6] This and, more importantly, a stable housing market helped Texas lose less jobs in construction. On top of that, a rising population supports stronger job gains in education and healthcare. Furthermore, sound public finances help sustain stable employment levels in the state and local governments of Texas.

A comparison of the employment situation in the two largest U.S. regional economies - Texas and California, reveals much greater resilience in the Texas labor market to the current recession. Not only did the gap between unemployment rates in Texas and California widen over 4 percentage points, but also the number of states with higher unemployment rates than Texas increased to over 30. Meanwhile only 2 states have higher unemployment rates than California (see chart 10). All of this points to a more mobile and adaptable labor market in Texas, which helps ease adjustments during economic downturns. Indeed, the state is a large and diverse economy, which benefits from significant exports of manufacturing goods and abundant natural resources. More importantly, thanks to more flexible zoning rules, past productivity gains have brought more jobs, rather than inflated home values, to Texas. And more affordable housing and stable home values in Texas allows for greater labor mobility. Indeed, labor mobility in the U.S. has been declining as, according to the U.S. Census Bureau, about 21% of all unemployed, and 12% of all employed, workers changed residence in 2007 and 2008 (versus 24% and 14.5%

[2]See, CNNMoney's "Best Place to Launch a Small Business", Kiplinger's "10 Best Cities for the Next Decade", Portfolio.com's "Best Places to Launch a New Business" or Entrepreneur's "10 Startup-friendly Cities".
[5]This index ranks the policy environment for entrepreneurship across the nation from the friendliest to the least friendly.
[6]According to the latest data of the U.S. Census Bureau, in 2006 Texas small businesses employed 75% of all workers in construction versus 85% nationwide.

on average in 2000-2006); while roughly 85% of all re-locations were within the same state, compared to only 80% in 2000-2006. However, labor force movement in the South, which includes Texas, remained relatively high - about 15% of all employed and unemployed workers moved to a different location in 2008 compared to 17% in 2000.

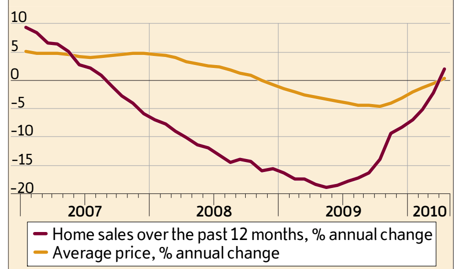
Housing Market

According to the Real Estate Center at Texas A&M University, in April, Texas home sales posted their third consecutive monthly gain, increasing by 12% versus the month before (and by over 26% versus April 2009), as homebuyers took advantage of the expiring tax credit. Twelve month home sales grew for the first time since August 2007 (see chart 11). Home sales in Dallas, Houston, Austin and San Antonio gained 26.6%, 26.6%, 33% and 20.5% in annual terms, respectively. That said, this improvement in residential housing sales may reflect pent up demand, as well as a rush to qualify for the first-time home buyer tax credit. We believe, Texas remains an attractive destination for domestic and international migrants because of its economic prospects and affordable cost of living (see chart 12), and this supports a healthier outlook for the state's real estate market going forward.

Foreign Trade

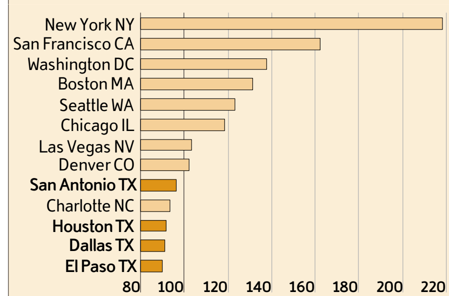
During the first quarter of 2010, exports from Texas jumped by 28%, to $47 billion, on stronger exports of nondurable goods, namely, chemicals, petroleum and coal products (see chart 13). This rebound in exports is driven by stronger foreign demand from developing countries and Canada. This means, the export recovery will continue as growth momentum in China, Mexico and Brazil remains strong. Furthermore, Canada, which is the second largest export market for Texas, is expected to achieve one of the highest GDP growth rates among developed countries in 2010 and 2011 (see chart 14). Lastly, the impact on Texas exporters of the sovereign debt crisis in Europe is likely to be minimal as these countries account for less than 10% of all Texas exports.

Home sales in Texas 11



Source: The Real Estate Center at Texas A&M University

ACCRA Cost of Living Index, Q1 2010, national average=100 12



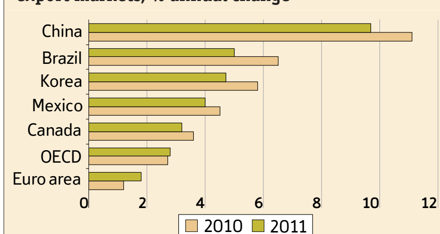
Source: The Council for Community and Economic Research

Exports from Texas to the World, % change Q1 2010 vs. Q1 2009 13

by commodity	
Total	**28.0%**
Manufacturing	26.9%
Durable goods	13.6%
computers and electronics	17.8%
machinery	-0.3%
transportation equipment	33.5%
Non durable goods	50.2%
chemicals	50.1%
petroleum and coal products	71.5%
Non manufacturing	45.6%
crops	71.9%
oil and gas	41.5%
by export market	
Total	**28.0%**
Mexico	30.9%
Canada	25.4%
China	58.5%
Korea	77.3%
Singapore	31.4%
Brazil	41.0%
Euro area	-13.2%

Source: The U.S. Census Bureau

Projected GDP growth in Texas' largest export markets, % annual change 14



Source: OECD, May 2010 Economic Outlook

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