Texas Economic Update

SigmaBleyzer

THE BLEYZER FOUNDATION

November 2010

- **The Texas jobless rate stood flat at 8.1% in October.**
- **Texas factory activity continued to strengthen in November.**
- **The Houston Purchasing Managers Index increased to 54.7 in October, indicating that the metro economy has been growing for the last 14 months.**
- **Residential housing activity remained weak, with home sales falling both in Texas and nationwide.**
- **November was the best month for leveraged buyouts (LBOs) since July 2007.**

Executive summary

Texas factory activity continued to strengthen in November, with manufacturing recovery accelerating (following somewhat slower growth at the beginning of the second half of 2010). Businesses have been building up inventories on better outlook for exports and the 2010 holiday shopping season, which has boosted demand for durable products. Indeed, manufacturing activity grew in October for the 14th straight month, supported by a stronger U.S. economy and improving global manufacturing. November readings for world-wide manufacturing activity are also encouraging. Factory activity in emerging Asia and the biggest European economies is recovering to levels last seen in May of this year. This is important, because Texas relies more on overseas demand compared to other parts of the U.S. Therefore, with a high share of capital goods from exports, Texas should see strong demand for its products coming from the rest of the world.

Higher energy prices are also supporting economic recovery in Texas. Notably, the Houston metro economy, which relies heavily on the energy sector, represents around a third of the state's total economy. The outlook for oil exploration and production in Texas remains favorable, as increasing demand for energy in Asia exerts upward pressure on oil prices. Furthermore, higher crude prices help sustain the competitiveness of the Texas petrochemical industry, which uses natural gas as a major input.

That said, sovereign debt worries in Europe are adding to exchange rate and commodity price volatility, which may ultimately impact the Texas economy. The Euro zone buys just above 10% of all Texas exports, with about 40% going to the biggest and more resilient economies of the U.K., Germany and France. Fortunately, the weaker European economies of Ireland, Spain, Portugal, and Greece jointly account for less than 1% of all exports from Texas.

As the economic outlook for the U.S. improves, consumers who pulled back during the economic downturn, appear to be ready to spend again. Indeed, despite high unemployment and a continued accumulation of savings, the latest metrics for consumer spending show healthy gains. For example, in November, retail sales grew for the fourth straight month. Additionally, holiday sales - both brick-and-mortar and online - beat expectations. This is encouraging, suggesting the recovery is gradually taking hold (especially now, when the impact of fiscal stimulus is fading).

The labor market appears to have stabilized, with initial unemployment claims falling to their lowest level since August 2008. The latest ADP National Employment Report registered the highest monthly rate of private-sector job gains in three years. Although this pace of labor market recovery is still too slow to reduce the unemployment rate below 9%, it should help boost consumer sentiment, and ultimately consumption and spending.

In October, the Texas unemployment rate remained unchanged at 8.1%, with the gap between the national and state unemployment rates at 1.5 percentage points. The Texas private sector continued to add jobs at a faster pace compared to other large states, and the country as whole.

Finally, existing home sales, both in Texas and nationwide, continued to trend well below their levels a year ago. A growing supply of distressed residential properties is rekindling downward pressure on prices again. That said, Texas has one of the smallest backlogs of distressed homes in the nation. This lower shadow inventory will help contain home value losses in Texas compared to other, more distressed, parts of the U.S.

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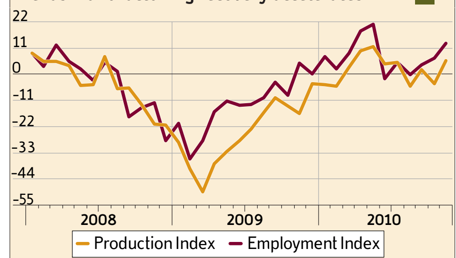
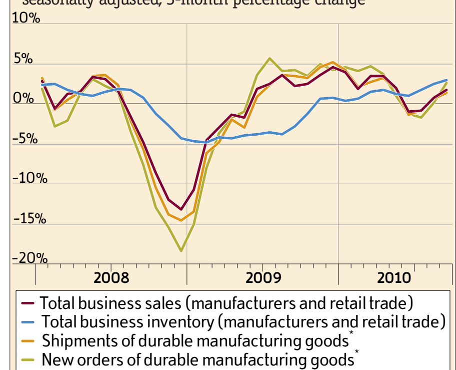
Economic output

Texas manufacturing recovery accelerates 1



Source: The Federal Reserve Bank of Dallas

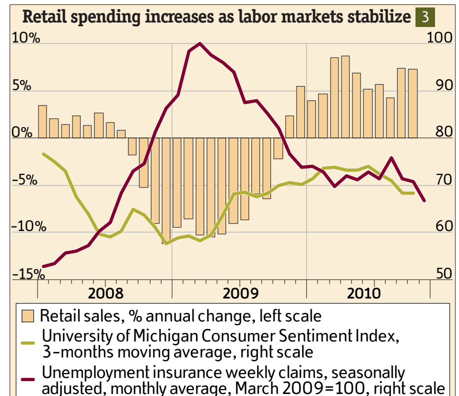
Inventories add strength to economic activity
seasonally adjusted, 3-month percentage change 2



*Excluding defense.

Source: The U.S. Census Bureau

Retail spending increases as labor markets stabilize 3



Source: The U.S. Census Bureau, University of Michigan

According to the Texas Manufacturing Outlook Survey, factory activity continued to strengthen in November. In particular, the production index, which tracks the state's manufacturing output, has been positive for the past three months, bouncing back to levels last seen in May (see chart 1). Other key measures of business conditions in manufacturing (such as capacity utilization and the volume of new orders) are improving. General business activity and company outlook indices were up in November, implying that the regional economy is getting better as well. Equally important, the employment index moved back into positive territory, suggesting that stronger manufacturing activity is supporting the Texas labor market.

The manufacturing recovery appears to be accelerating again following somewhat slower growth at the beginning of the second half of 2010. Indeed, a better outlook for this year's holiday shopping season, as well as stronger exports, are encouraging businesses to build up inventories, which supports sales and shipments of durable goods (see chart 2). In September, total business sales were up by nearly 9% compared to the same month a year ago, while shipments and new orders of durable manufacturing goods, excluding defense, increased by 8.1% and 10.5%, respectively. Business inventories were 6.3% higher than in September 2009 - the fourth consecutive month of annual growth.

However, despite an uptick in business activity, the labor market remains weak, with the U.S. unemployment rate stuck above 9%. Households remain cautious, saving about 6% of their personal disposable income - well above pre-crisis levels. That said, as fears over job security gradually recede, consumers are beginning to shop again. In fact, in October, retail spending rose by 1.2% versus the previous month - the fourth straight monthly gain (and the highest reading since November 2009). Labor market conditions appear to have stabilized with initial unemployment claims sliding to the lowest level since August 2008 (see chart 3). In addition, according to the ADP National Employment Report, the private sector created 93,000 new jobs in November - the highest monthly rate of job gains in three years. Although this growth is still not fast enough to reduce the jobless rate below 9% in 2011, the tenth consecutive month of job gains does imply that the U.S. labor market is starting to show some signs of life. Consumer confidence is modestly improving as well - in November, the Conference Board Consumer Confidence Index rose to 54.1. As the economic outlook improves, consumers who pulled back during the economic downturn appear ready to spend again, which drives retail sales.

Several other measures indicate consumers are willing to spend more this year, as holiday sales and discounts release pent-up demand. For example, in October, the National Restaurant Association's Restaurant Performance Index increased to its highest level since August 2007, thanks to stronger sales and traffic levels. The ICSC-Goldman Sachs retail chain-store sales index reported firm gains in consumer spending during the beginning of the holiday shopping season.[1] Two earlier indicators of holiday spending (Black Friday and Cyber Monday) are encouraging as well. According to the National Association of Realtors, U.S. consumers spent an estimated $45 billion during this year's Thanksgiving weekend - over 9% more than a year ago. U.S. online sales were up by 16% on Cyber Monday (the first working day after Thanksgiving), exceeding $1 billion for the first time.[2] These encouraging economic reports may be the first signs of the recovery taking hold on its own, especially now that the impact of fiscal stimulus is fading.

[1] In November, same-store sales increased by 1.2% versus a month ago.
[2] Source: ComScore Inc.

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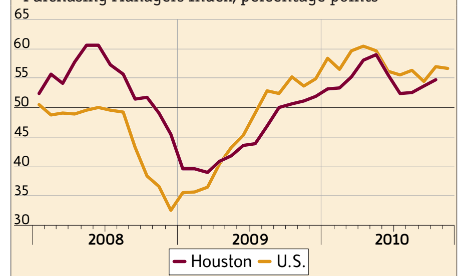
Turning to Texas, manufacturing activity continued to expand in October for the 14th straight month, with the Houston Purchasing Mangers' Index (PMI) increasing to 54.7 (see chart 4). A stronger U.S. economy[3] and continued growth in global manufacturing are supporting this economic turnaround in Texas. Indeed, in November, the JPMorgan Global Manufacturing PMI increased to its highest level since July led by emerging Asia (China and India) and the biggest European economies (Germany, France and the United Kingdom). This is important, because Texas relies more on overseas demand compared to other large states. In addition, capital goods are a big component of Texas exports. This means that accelerating global manufacturing growth should sustain robust foreign demand for Texas products (see chart 5). Furthermore, we believe the renewed sovereign debt risks in the Euro zone are unlikely to exert a significant downward pressure on Texas exporters. The Euro zone buys just over 10% of all Texas exports (with about 40% of exports going to the biggest and more resilient economies of the U.K., Germany and France). Fortunately, Ireland, Spain, Portugal, and Greece jointly account for less than 1% of all exports from Texas.

However, sovereign debt worries in Europe are adding to volatility in exchange rates and commodity prices. This higher volatility will ultimately impact the Texas economy. Indeed, during the last European sovereign debt crisis in May 2010, the Euro weakened against the U.S. dollar, while crude oil prices dropped on fears over the health of the global economy. This may have contributed to a deceleration in the manufacturing recovery in Texas at the beginning of the second half of 2010 (since the state is the largest producer of crude oil in the U.S. and the biggest exporting state). Despite this, crude oil prices remained relatively strong as fresh concerns over public finances in Ireland re-emerged this fall (see chart 6). Although the U.S. dollar strengthened against the Euro, encouraging economic news (particularly from emerging Asia) helped keep oil prices high.

The Houston metro economy, which represents around a third of the Texas economy, is recovering thanks to stronger crude oil prices (see chart 7). According to the latest Energy Outlook by the U.S. Energy Information Administration, WTI spot prices are projected to increase to $89 per barrel by the fourth quarter of 2011. As a result, next year average crude oil prices are expected to settle at around $86 per barrel or 8.9% higher than in 2010. Furthermore, increasing demand for energy in Asia (particularly in China and India, where economic growth this year may approach 9%) will continue to exert upward pressure on prices. As a result, higher crude oil prices should help sustain the competitiveness of the Texas petrochemical industry, which uses natural gas as a major input (see chart 8).

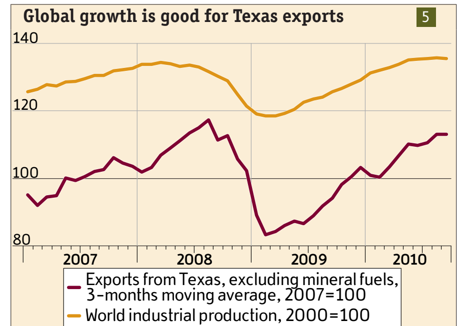
Other sectors of the Texas economy are also performing well. In particular, the Dallas and Houston airport systems report strong growth in freight traffic volumes and improving passenger traffic. Meanwhile, the Port of Houston Authority is registering robust improvements in container tonnage (up by 7% during the first ten months of 2010), ship arrivals (up by 4%) and barge traffic (up by 18%). That said, the construction industry remains distressed, due to the weak residential housing market. According to the U.S. Census Bureau, the number of total residential permits issued in Texas in October was 21% lower than in the previous month, and 5.5% below last year's level. Still, partially thanks to the impact of the first home buyer tax credit, the number of permits issued in Texas during the first 10 months of

Texas manufacturing continues to grow 4
Purchasing Managers Index, percentage points*



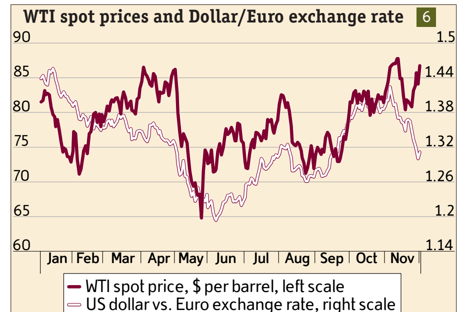
*A reading above 50% indicates expansion.
Source: The Institute of Supply Management, Greater Houston Partnership

Global growth is good for Texas exports 5



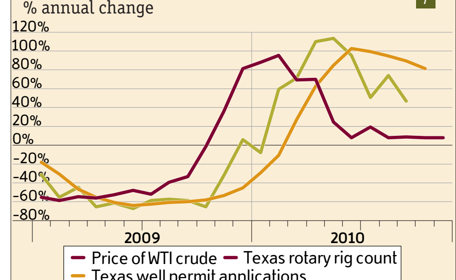
Source: The U.S. Department of Commerce, The CPB Netherlands Bureau for Economic Policy Analysis

WTI spot prices and Dollar/Euro exchange rate 6



Source: The U.S. Energy Information Administration, The European Central Bank

Higher oil prices are good for Texas 7
% annual change



Source: The Federal Reserve Bank of Dallas

[3]The latest Survey of the Current Economic Conditions (the Beige Book) by the Federal Reserve indicated continued improvements across the broader U.S. economy in October.

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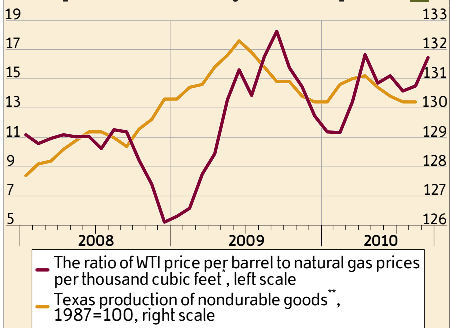
this year was up by almost 2%. At the same time, nationwide the total number of permits grew by about 6% (the number of construction permits issued in California rose by 20.7%). Despite this, the size of the downturn in the residential construction industry in Texas is relatively milder than has been seen nationally. Indeed, 52% fewer permits were issued in Texas in January-October 2010 than three years ago, compared to 58% fewer nationwide and 64% fewer in California (see chart 9). As a result, California, which issued just as many construction permits as Texas in 2005, approved 53% fewer residential construction permits in 2010.

Texas petrochemical industry is more competitive 8

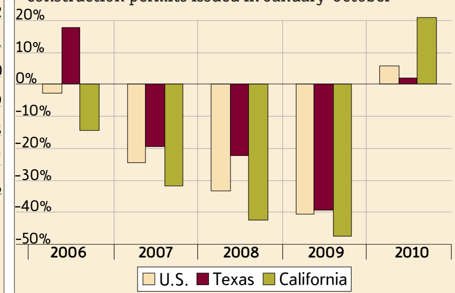


*One thousand cubic feet of natural gas is equivalent to 1.028 million British thermal units (Btu), while one barrel of WTI crude is equal to 5.825 million Btu. As a result, natural gas is usually considered to be more competitive than crude oil if the ratio of oil price per barrel to gas price per thousand cubic feet exceeds 6.

**Manufacturing of petroleum and coal products, chemicals, plastics and rubber products accounts for nearly 80% of total value added in Texas nondurable goods manufacturing.

Source: The Federal Reserve Bank of Dallas, The U.S. Energy Information Administration

Downturn in construction is milder in Texas 9
% annual change in the number of residential construction permits issued in January-October

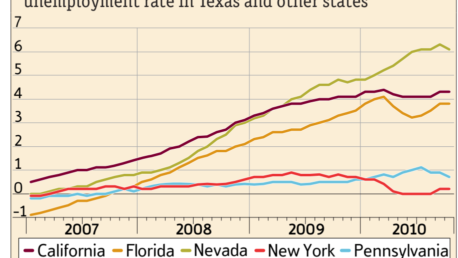


Source: The U.S. Census Bureau

A gap between the Texas and national unemployment rates 10
percentage points

Source: The U.S. Bureau of Labor Statistics

The Texas jobless rate is lower than in other large states 11
percentage points gap between the unemployment rate in Texas and other states



Source: The U.S. Bureau of Labor Statistics

Employment

In October, the Texas unemployment rate remained unchanged at 8.1%, while the gap between the U.S. and Texas unemployment rates stood at 1.5 percentage points (see chart 10). The employment situation in other large states (for example in Florida and California) is improving slower than in Texas, which leaves the gap between jobless rates in Texas and those states close to recession level highs (see chart 11). Indeed, Texas nonfarm employment grew by 1.7% compared to October 2009 - the sixth straight month of annual job gains. Meanwhile, employment in California (the largest U.S. state) continued to fall for the third consecutive year (ending October with 0.2% fewer jobs than a year ago). Over the past twelve months, employment in New York, Florida, Pennsylvania and Ohio was up by only 0.4%, 0.5%, 0.9% and 0.1%, respectively. As a result, nationwide, the total number of nonfarm jobs grew by only 0.6%.

In October, Texas created 47,900 new jobs, thanks mainly to the private sector. In fact, the Texas private sector has been adding jobs each month since the beginning of 2010. As a result, the number of private sector jobs in Texas has increased by 177,300 year to date (or up by 2.1% compared to October 2009). For the U.S. as a whole, the private sector created only 1% more jobs than a year ago as companies in other large states still struggle to step up their hiring. Furthermore, all sectors of the Texas economy added jobs in October compared to the month before. In particular, employment in construction grew by 8,800 jobs (or by 1.6% versus September). As a result, Texas had 12,900 more jobs in construction than a year ago (up by 2.3% vs. September 2009). Nationwide, construction still employed 2.1% fewer workers than a year ago, as construction jobs in New York, California, Florida, and Nevada were down by 0.9%, 7.9%, 3.8%, and 20%, respectively.

Employment in Texas mining and manufacturing posted annual gains of 15.7% and 3.2%, respectively. The U.S. manufacturing sector had only 0.8% more jobs than a year ago, as employment in other big manufacturing states was still smaller than a year ago or grew significantly slower compared to Texas. For example, in October, New York and California had 0.5% and 0.4% fewer manufacturing jobs than in October 2009, while manufacturing employment in Pennsylvania grew by only 0.5%.[4] That said, manufacturing employment in Texas is still 9.5% lower than three years ago. However, California, Pennsylvania and New York have lost roughly 15% of their manufacturing jobs since October 2007. A similar pattern holds for the construction industry. From October 2007 to October 2010, Texas lost 13.5% of jobs

[4] California, Texas, Pennsylvania and New York provide 27% of all manufacturing jobs in the U.S.

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in construction, while employment in this sector declined by 39% in California and 40% in Florida. In the near term, many construction and manufacturing jobs are unlikely to return as demand for housing and durable manufacturing products is likely to remain below pre-recession norms for some time. Contrary to this, Texas construction and manufacturing were more resilient during the downturn, thanks to a smaller exposure to the housing bubble and a greater reliance on exports. This should help support the recent pick up in hiring as the U.S. and global economic recovery gathers momentum.

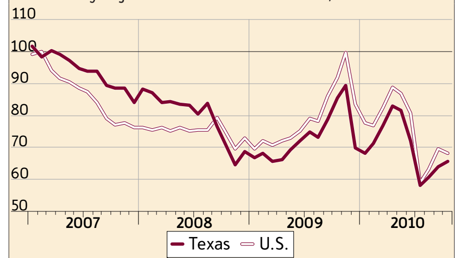
Texas service-producing industries continue to report stronger job gains than in the U.S. as a whole, driven by increasing employment in professional and business services, education and healthcare, and the leisure and hospitality sectors. Indeed, employment in business and professional services grew by 50,600 jobs (up by 4.1% versus October 2009 and only 2.7% lower than three years ago), accounting for nearly half of all new jobs in the service-producing part of the local economy. Nationwide, this sector employed only 2.7% more workers than in October 2009 and 6.7% less compared to October 2007. The number of jobs in the Texas education & healthcare and leisure & hospitality sectors was up by 2.9% and 2.4%, versus a gain of only 2% and 1%, respectively, for the nation as a whole.

Monetary policy and asset prices

In October, existing home sales in the U.S. fell to a seasonally adjusted annual rate of 4.43 million (down by 25.9% compared to a year ago).[5] Seasonally adjusted home sales in Texas were down by 23% versus October 2009. Housing activity is still considerably weaker than in the run-up to the recession (see chart 12). Indeed, although year-to-date existing home sales were down by only about 3% both in the U.S. and Texas, residential housing is still struggling to pick up following the expiration of the home buyer tax credit earlier this year. With distressed homes accounting for over one third of all sales, the downward pressure on housing prices is re-emerging (see chart 13). In fact, according to CoreLogic Home Price Indices, in September, national home prices declined by only 0.7% if distressed properties are excluded. In Texas, prices of homes, excluding distressed sales, were up by 0.5% in September versus a year ago.

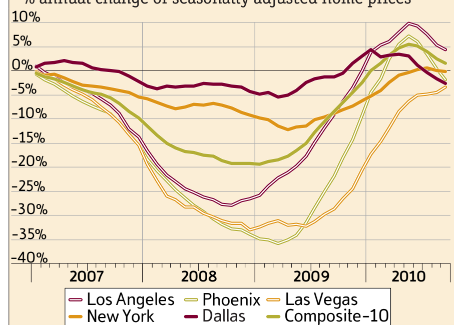
Texas has one of the lowest backlogs of distressed homes in the nation (see chart 14), while the inventory of distressed properties in the biggest Texas metro areas is below the national average (8 months). Furthermore, three Texas metros (Austin, San Antonio and Fort Worth-Arlington) have the lowest inventory of distressed homes among the 50 largest U.S. metros (4.2, 4.7 and 6.3, respectively, compared to 33.5 months in Miami and 21.5 in Los Angeles). This lower shadow inventory of homes in Texas will help contain downward pressure on home prices compared to other, more distressed parts of the U.S.

Home sales in Texas and the U.S. 12
seasonally adjusted at an annualized rate, 2006=100



Source: The National Association of Realtors, The Real Estate Center at the Texas A&M University

Home values are falling again 13
% annual change of seasonally adjusted home prices



Source: S&P/Case-Shiller Home Price Indices

Shadow inventory of homes by states 14
August 2010

	Share of distressed homes in total sales	Negative equity share	Months supply of distressed homes
ND	5.3%	7.5%	1.1
TX	20.0%	11.4%	5.5
PA	13.2%	7.3%	10.3
AZ	53.0%	50.3%	13
DC	11.8%	15.6%	16.6
CA	45.7%	33.1%	16.8
ME	10.2%	8.5%	16.8
NV	59.5%	68.5%	17.8
NY	7.8%	7.1%	17.8
GA	30.7%	28.2%	19.5
FL	41.0%	46.8%	20.8
IL	24.6%	19.9%	23
NJ	13.0%	15.5%	24.1

Source: CoreLogic

[5]Source: The National Association of Relators.

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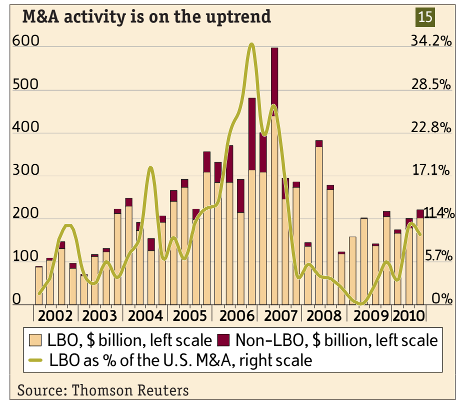
Private equity news



According to Thomson Reuters, November was the best month for leveraged buyouts (LBOs) since July 2007. In particular, there were 76 leveraged buyouts exceeding $21 billion. One of the largest LBOs included the $5.21 billion offer to buy the Dallas based oil and gas producer Exco Resources Inc.

During the first three quarters of 2010, merger and acquisitions (M&A) activity in the US grew by about 22% to US$732 billion - the first annual gain since 2007 (see chart 15). The energy sector dominated the market, accounting for 30% of all M&A activity, and increasing by more than five times compared to 2009. Healthcare and high tech were the second and third biggest industries for M&A deals.

Industry average exit multiples increased to 11.8 from 10.6 a year ago, led by the energy sector (up to 12.1 from 9.6), healthcare (up to 12.9 from 11.0), high tech (up to 12.5 from 10.3) and real estate (up to 19.8 from 14.7). Multiples fell for deals involving companies in consumer staples, retail and telecommunications.

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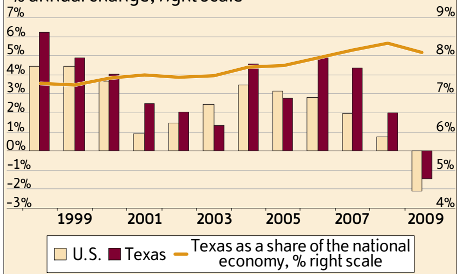
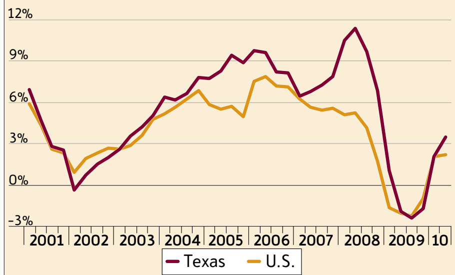
November 2010

Economic growth: Texas vs. U.S.
% annual change, right scale



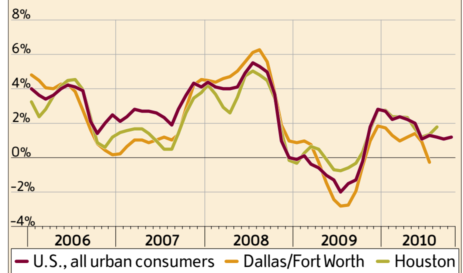
Source: The U.S. Bureau of Economic Analysis

Personal income
seasonally adjusted at annual rates, % annual change



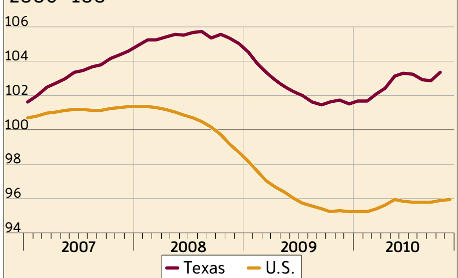
Source: The U.S. Bureau of Labor Statistics

Consumer prices
% annual change



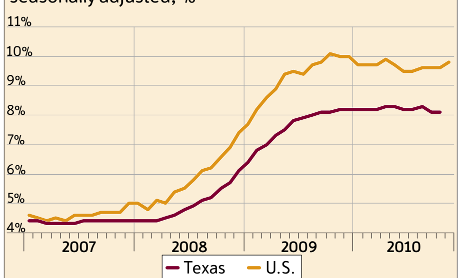
Source: The U.S. Bureau of Labor Statistics, The Federal Reserve Bank of Dallas

Nonfarm employment
2006=100



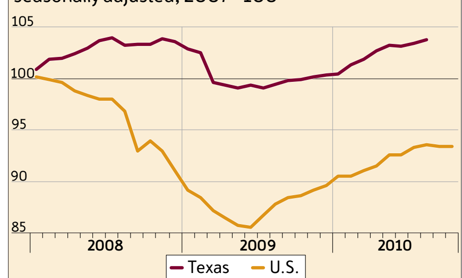
Source: The U.S. Bureau of Labor Statistics

Unemployment rates
seasonally adjusted, %



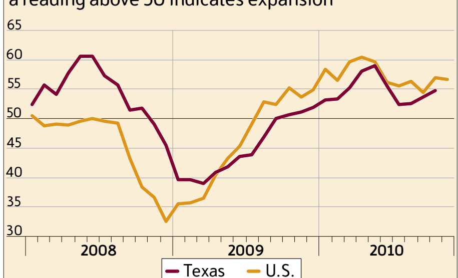
Source: The U.S. Bureau of Labor Statistics

Industrial production
seasonally adjusted, 2007=100



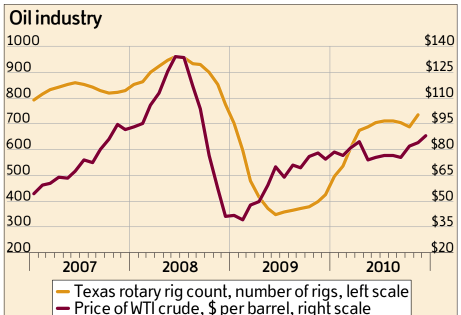
Source: The Federal Reserve, The Federal Reserve Bank of Dallas

Purchasing Managers Index
a reading above 50 indicates expansion



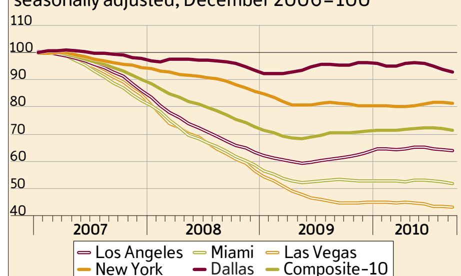
Source: The Institute for Supply Management

Oil industry



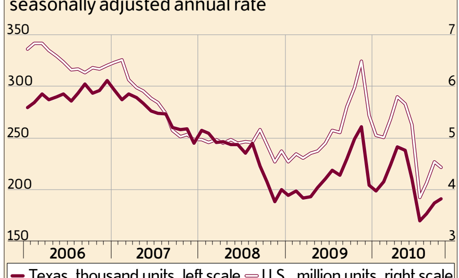
Source: The Federal Reserve Bank of Dallas

Home values
seasonally adjusted, December 2006=100



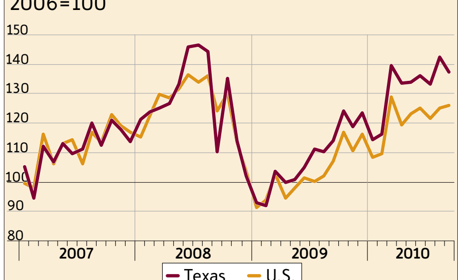
Source: The S&P/Case-Shiller Home Price Indices

Home sales
seasonally adjusted annual rate



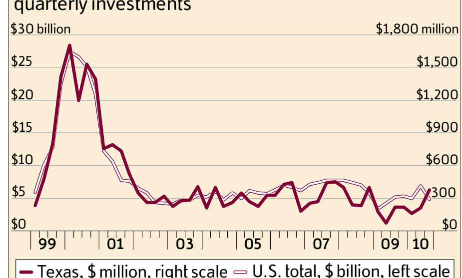
Source: The National Association of Realtors, The Real Estate Center at Texas A&M University

Exports
2006=100



Source: The U.S. Department of Commerce

Venture capital investment activity in the United States
quarterly investments



Source: PricewaterhouseCoopers

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Where Opportunities Emerge