- **In March, the Texas jobless rate was at 7% – its lowest level in three years.**
- **The U.S. economy overall increased by 2.2% in the first quarter of 2012.**
- **Texas' share of national construction jobs grew from about 8.5% in 2007 to 10% in 2012.**
- **Texas factory activity grew slower in April, although still outperforming other comparable states.**

Executive summary

Following a strong start to the year, the U.S. economic recovery appears to still be moving forward, albeit in low gear. In particular, during the first quarter, the economy expanded by only 2.2%, compared to 3% at the end of 2011. The factors that generated an initial resurgence in economic activity, most importantly, inventory restocking, appear to be running out of steam. In fact, private inventories generated less than a third of first quarter GDP growth versus 60% in the fourth quarter of 2011. Meanwhile, businesses are still reluctant to invest, with equipment and software spending slowing sharply in the first quarter of 2012.

Fortunately, personal consumption saw a somewhat stronger gain – it increased by nearly a full percentage point faster than at the end of 2011. In particular, improving car sales were a big driver of first quarter growth, producing over 50% of the overall economic expansion. This spending supports national factory activity, which in April grew at its strongest pace in 10 months. However, a reversal of strong gains in business activity in services in March and April may imply consumers are starting to face increasing headwinds. Indeed, higher gas prices and a recent weakening of the national jobs picture will dent consumer confidence, thus, threatening the continuation of any consumer-led recovery. The fact that, despite ultra-loose monetary policy and record low interest rates, inflation continues to trend down and the housing market struggles to improve, points to the rather fragile state of any economic or labor market recovery.

Turning to Texas, local factory activity weakened in April, which mirrors current economic trends in other states, as a robust uptick in economic activity at the start of 2012 is starting to subside. Still, Texas appears to be faring better compared to other regional economies. First, the local mining industry remains an important driver of the regional economy (for example, in April, the Texas rig count was 17% higher than a year ago). Second, a gradual return of demand for advanced manufacturing is benefiting Austin and Dallas (which are strong in semiconductor and high-tech industries). Lastly, the overseas shipments of Texas non-oil exports are growing faster than exports from other states. This growth remains robust across major manufacturing industries as well. Fortunately, Texas' biggest export markets are in the emerging economies, where demand for manufacturing goods is still strong. Meanwhile, the state is less exposed to an economic slowdown in China and the Eurozone since only about 4% of all Texas exports go to China and 9% to the Eurozone, versus 7% and 13% nationwide.

In March, the Texas jobless rate fell for the seventh straight month to 7% – its lowest level in three years. This is entirely thanks to a solid uptick in hiring by the private sector, which already employs 2% more workers than at the start of the recession. In particular, over the past twelve months, over 300,000 more workers were hired by local private businesses – up by 3.5% versus the national growth rate of just 2%. Mining jobs aside, Texas service-providing industries remain the engine of this private job creation. Indeed, local employment trends in trade, professional and business services, the financial industry, education and healthcare as well as leisure and hospitality continue to outshine the nation as a whole.

Meanwhile, the national economy is still 4% below the pre-recession private sector jobs number. The hardest hit states remain saddled with struggling construction sectors. On that count, the resilience of the Texas construction industry is particularly impressive. Five years ago, the number of construction workers in California was about 40% higher than in Texas; Florida employed more people in construction as well. Now, Texas has almost as many construction workers as California, while Florida employs 43% less people in construction. As a result, the share of Texas in national construction jobs grew from about 8.5% in 2007 to 10% in 2012.

All told, March's state employment report painted a somewhat weaker jobs picture – the private sector added just 8,000 new jobs – the smallest gain since May 2011. Above all, this reflects nationwide factors – jobs growth in construction, trade, and leisure and hospitality were supported by unseasonably warm weather at the beginning of 2012. More importantly, employment figures in consumer-related industries softened on worries over the strength of domestic consumer spending. Meanwhile, jobs growth in healthcare may be slowing on uncertainties over the future of healthcare reform. Finally, the Texas mining sector has been adding jobs at a slower pace partly because falling energy prices and the oversupply of natural gas are dampening down new drilling activity. On the upside, March saw the biggest jobs gain in manufacturing since November, while the financial industry continued to add new jobs for the fifth straight month.

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Economic output

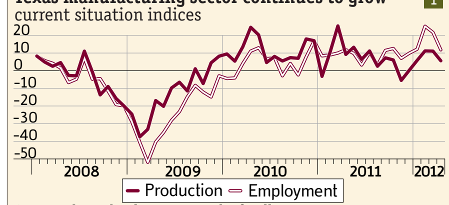
Texas factory activity grew slower in April, following a somewhat stronger performance during the previous two months, when the production index of the Texas Manufacturing Outlook Survey stayed close to its highest level since July 2011 (see chart 1). Broader economic conditions worsened as well, and expectations about future business activity point to a less optimistic outlook. These trends mirror other U.S. regional business surveys[1], which confirmed that an uptick in economic activity in the first quarter of 2012 is starting to subside. On the upside, the latest surveys of Current Economic Conditions by the Federal Reserve[2] paint a broadly positive picture. In particular, there are signs that business activity is getting stronger across most regions and major industries. Meanwhile, the national Purchasing Managers Index rose in April to its highest level in 10 months. The Purchasing Managers Index (PMI) for the Houston area remains well above 50% (see chart 2) indicating solid growth in local manufacturing.

All of the above suggest economic recovery is moving ahead, although the pace of growth is slowing. While improving jobs data boosted consumer sentiment at the beginning of 2012, which supported retail spending and car sales (see chart 3), rising gas price may already be damaging labor markets and lowering consumer optimism (see chart 4). Indeed, national jobs reports for March and April were much weaker than expected, delivering half as many new jobs as in the first two months of this year. Meanwhile, a reversal of strong gains in business activity in services and construction sectors (which account for over 70% of the U.S. economy) in March and April (see chart 5) implies the national economy is starting to face increasing headwinds.

Notwithstanding some recent resilience in overall manufacturing, this sector also appears to be facing strong headwinds. In March, new orders of durable goods fell by 4.2% versus the month before. A significant portion of this decline can be explained by falling orders for non-defense aircraft and parts - in March, they stood at just $8.4 billion, or twice as low as in the previous two months. However, orders of both non-defense capital goods and motor vehicles and parts industries are growing at a much slower annual rate than at the start of the year (see chart 6). This can be partly attributed to slowing inventory restocking. Indeed, if during the first quarter of 2011, sales and inventory in manufacturing increased at an annual rate of over 10% on average, in the first two months of 2012, inventory grew by just above 8%, and sales by 7%. Thus as manufacturers see a slowing in sales (see chart 7), they have less incentive to build up inventory, which depresses new orders of durable goods. Meanwhile, flat new orders of capital goods (down by 0.1% in March versus the month before) imply companies remain cautious about the economic outlook and are slowing investment spending.

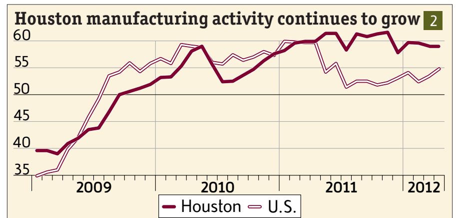
Advance estimates, released by the U.S. Bureau of Economic Analysis at the end of April, put

Texas manufacturing sector continues to grow 1



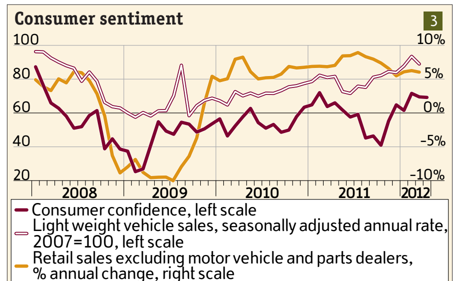
Source: The Federal Reserve Bank of Dallas

Houston manufacturing activity continues to grow 2



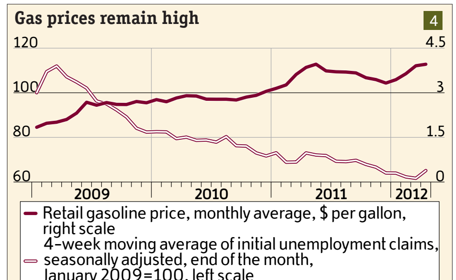
Purchasing Managers Indices, a reading above 50% indicates expansion.
Source: The Institute for Supply Management

Consumer sentiment 3



Source: The U.S. Census Bureau, The Federal Reserve Bank of St. Louise, The Conference Board

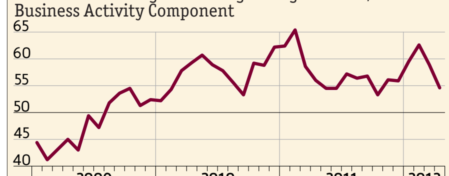
Gas prices remain high 4



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

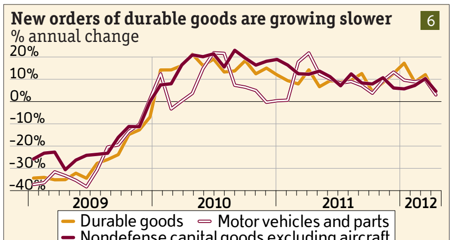
Business activity in the service-providing part of the economy is weakening 5

Nonmanufacturing Purchasing Managers Index, Business Activity Component



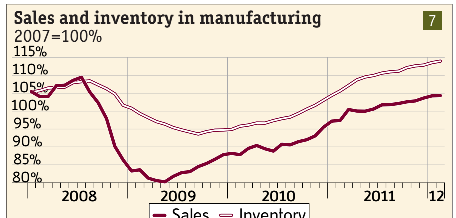
A reading above 50% indicates expansion.
Source: The Institute for Supply Management

New orders of durable goods are growing slower 6



Source: The U.S. Census Bureau

Sales and inventory in manufacturing 7



Source: The U.S. Census Bureau

[1]For example, the March Manufacturing Survey by the Federal Reserve Bank of Kansas City, the monthly survey of manufacturers in New York State conducted by the Federal Reserve Bank of New York, the Survey of Manufacturing Activity by the Federal Reserve Bank of Richmond and the monthly Business Outlook Survey by the Federal Reserve Bank of Philadelphia.

[2]See http://www.federalreserve.gov/fullreport20120411.pdf

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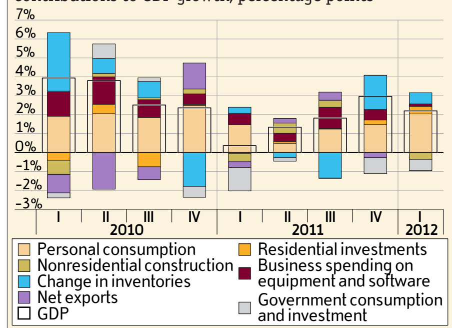
first quarter GDP growth at 2.2% (down from 3% in the last quarter of 2011). It appears that slowing inventory and non-residential fixed investment are the primary drag on economic growth. For example, business spending on equipment and software was up by only 1.7% compared to an increase of 7.5% in the fourth quarter of last year. Meanwhile, inventory investment added just 0.6 percentage points to GDP growth versus 1.8 percentage points at the end of 2011, when the change in private inventories generated 60% of fourth quarter economic growth (see chart 8). At the same time, personal consumption saw a somewhat stronger gain – household spending on goods and services grew by 2.9% in the first quarter versus just 2.1% in the fourth. And improving car sales were a big driver of first quarter growth, contributing over 50% to overall GDP expansion. Lastly, residential investment grew by over 19% - up from 11.6% in the fourth quarter of 2011 thanks to unseasonably warm weather and increasing private residential construction spending (see chart 9).

Although the U.S. economy as a whole is still struggling to expand fast enough to make a dent in the jobless situation, the economic recovery in Texas appears to be better (see chart 10). The local mining industry remains an important driver of the regional economy and, in particular, in Houston (see chart 11). Indeed, despite a recent downtrend in energy prices, in April the Texas rig count remained close to its record level (and was 17% higher than a year ago). Meanwhile, a gradual return in demand for advanced manufacturing is benefiting Austin and Dallas, which are strong semiconductor and high-tech hubs. According to the Semiconductor Industry Association, March saw resumption in growth of semiconductor sales across all major regions, including Europe and Japan, thanks to a supply recovery in Thailand and Japan, as well as an improved outlook for the U.S. auto industry.

Overseas demand for Texas non-oil exports appears to be growing faster than exports of other states (see chart 12). In particular, during the first two months of 2012, Texas non-oil exports increased by over 10% (compared to a 7% and a 3% growth in California and New York, the second and third biggest U.S. exporting states, respectively). In fact, the growth in exports remains robust across many major Texas manufacturing industries. Indeed, during the first two months of 2012, Texas exports of industrial machinery and computers, electronics, vehicles and aircraft (about half of all non-oil exports from Texas, and roughly 45% of all non-oil exports nationwide) increased by 14%, 14.4%, 32.6% and 26.5%, respectively. Meanwhile, nationwide, exports of these products grew slower – up by 14%, 3.3%, 22.6% and 27.7%, respectively. In addition, low natural gas prices are helping the state's chemical industry – exports of organic chemicals from Texas (about a tenth of all non-oil exports in Texas and only 3.2% in the U.S.) increased by 17.7%, or three times faster than for the nation as a whole.

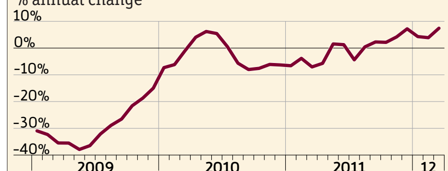
Texas' biggest export markets are in emerging economies, where demand for manufacturing goods is growing faster. On that count, Texas's factories are benefiting from their proximity to Mexico, which buys about 35% of all the state's exports and is an important source of foreign demand for Texas' electronics, computers, vehicles and machinery. Indeed, only three advanced countries (Canada, Netherlands and Japan) are among the top ten export destinations for Texas, and account for just over 14% of all exports from the state. Nationwide, five advanced economies are among the top ten export partners and account for a third of all national exports.[3] Lastly, Texas remains less exposed to an economic slowdown in China, as well as economic problems in the Eurozone, as only about 4% of all Texas exports go to China and 9% to the Eurozone versus 7% and 13% nationwide.[4]

Consumer demand is sustaining economic growth 8
contributions to GDP growth, percentage points



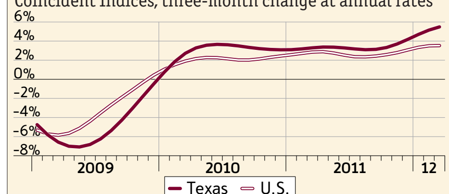
Source: The U.S. Bureau of Economic Analysis

Total private residential construction spending 9
% annual change



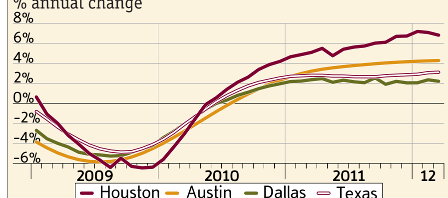
Source: The U.S. Census Bureau

Texas continues to outperform the national economic recovery 10
Coincident Indices, three-month change at annual rates



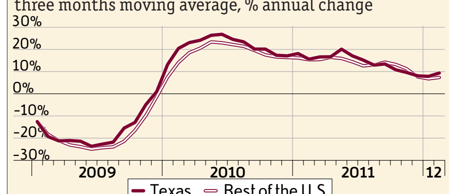
˙The trend for each index is set to the trend of its gross domestic product.
Source: The Federal Reserve Bank of Philadelphia

Metro Business Cycle Indices 11
% annual change



Source: The Federal Reserve Bank of Dallas

Non-oil exports 12
three months moving average, % annual change



Source: The U.S. Department of Commerce

[3]Top ten export countries account for about two thirds of all exports both in Texas and nationwide.

[4]In addition, Texas manufacturers of computers, electronics and industrial machinery rely less on Chinese and European markets. Indeed, Texas exports to the Eurozone and China are mostly chemicals and commodities - mineral oil represents 36% of all Texas exports to the Eurozone, while oil and cotton – 16% of all exports to China. Just 10% of all Texas exports of computers, electronics and machinery go to either the Eurozone or China versus over 17% for the rest of the U.S.

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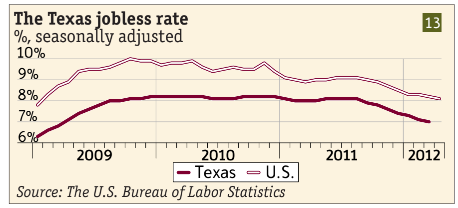
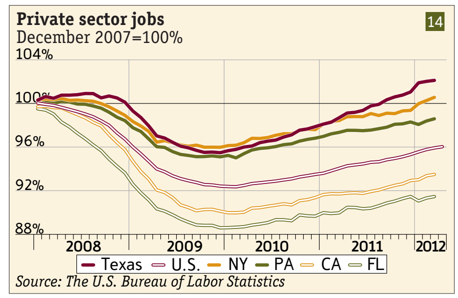
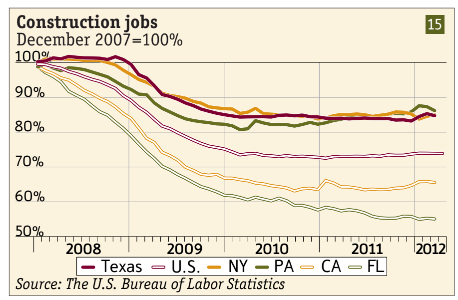
April 2012

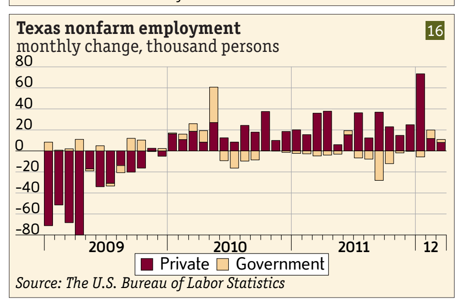
Employment

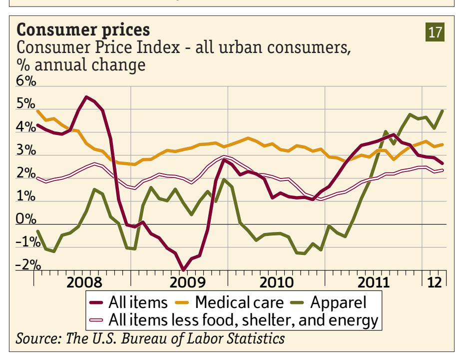
In March, the Texas jobless rate fell for the seventh straight month to 7% – its lowest level in three years (see chart 13). This is almost entirely due to the faster recovery in the private sector, which already employs 2% more workers than in December 2007 (see chart 14). Meanwhile, the nation as a whole is still short 4% of prerecession private jobs as labor market recovery in the large and hardest hit states (for example, Florida and California) fails to gain traction, partly due to a struggling construction industry (see chart 15). On that note, the resilience of the Texas construction industry is particularly impressive. Indeed, five years ago the number of construction workers in California was about 40% higher than in Texas. Florida employed more people in construction as well. Now, Texas has as many construction workers as California, while Florida employs 43% fewer people in construction. As a result, the share of Texas in national construction jobs grew from about 8.5% in 2007 to 10% in 2012.











Texas private industries continue to create new jobs at a faster rate than the nation as a whole. Over the past twelve months, over 300,000 more workers were hired by local private businesses, which amounts to a 3.5% annual growth – well above the national average of just 2%. Mining and logging, where employment grew by 16.1% versus a year ago continues to support labor market recovery in Texas. Meanwhile, in March, manufacturing saw a 2.9% annual job growth compared to 2.1% nationwide. Yet, mining jobs aside, Texas service-providing industries remain the engine of private sector job growth, which testifies to the underlying strength of the regional economy. For example, employment in trade, transportation and utilities was up by 2.6% versus a more modest increase of just 1.3% nationwide. The number of jobs in professional and business services, the second largest job creating sector in the state, increased by 3.9% compared to 3.5% nationwide. The financial industry had 2.6% more jobs in March than a year ago (the nation as a whole recorded a mere 0.5% growth in financial industry jobs). Jobs growth in education and healthcare and leisure and hospitality stood at 3.4% and 4.8% - well above 2.4% and 2.6%, respectively, in the U.S. as a whole. Finally, other service-providing industries hired 3.9% more workers over the last year versus a gain of just 0.5% nationwide. In addition, March was the second consecutive month of growing government employment (chart 16); although sizable public sector job cuts at the end of 2011 left Texas with 3% fewer government jobs in March than a year ago (the nation as a whole had only 1% fewer government jobs).

All that said, March's state employment report painted a bleaker jobs picture in Texas compared to the strong start of the year. In particular, the private sector added just 8,000 new jobs – the smallest gain since May 2011. This trend mostly reflects nationwide factors. For example, in March, employment fell in construction, following solid gains in the previous two months, which were to some extent supported by unseasonably warm weather at the beginning of 2012. Job growth has recently stalled in the leisure and hospitality industry as well, where good weather may have contributed to a surge in hiring in January. More importantly, employment in consumer-related industries, such as retail trade, dropped on worries over the strength of domestic consumer spending. Meanwhile, job growth in healthcare may be slowing due to uncertainties over the future of healthcare reform. Lastly, job creation in Texas mining has been slowing partly due to falling energy prices and the oversupply of natural gas, which is dampening new drilling activity. On the upside, March saw the biggest gain in manufacturing jobs since November, while financial services continued to report higher employment for the fifth straight month.

Monetary Policy and Asset Prices

Slow growth in gasoline prices, and low natural gas prices, which helps keep utility costs from rising, pushed overall consumer inflation in March to its lowest level in a year (see chart 17). Meanwhile, core inflation, which excludes food and energy prices (typically the most volatile components of the Consumer Price Index), stayed at 2.4%. Although the CPI increased slightly from February's reading, this was mostly driven by a seasonal jump in clothing costs due to Easter shopping. This means the impact of higher apparel prices is likely to fade away over the rest of the year. Thus, despite ultra-loose monetary policy, inflation pressures appear to be under control. Indeed, not only does core inflation remain at record low levels, but the jobs market is in a much weaker state compared to past recoveries (see chart 18). That being said, a combination of loose monetary policy and low inflation indicates that businesses are still finding it difficult to pass higher prices to recession-battered and debt-laden consumers.

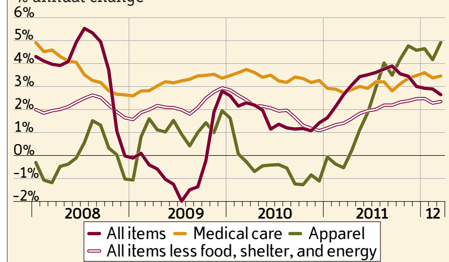
Consumer prices aside, a slow recovery in the housing market is yet another symptom of the continued weakness of the national economy and labor market. Notwithstanding record low borrowing rates, existing home sales are struggling to grow. According to the National Association of Realtors, March was the second straight month of declining existing home sales nationwide (see chart 19). Although existing home sales posted their ninth consecutive annual gain, a typical home has lost a third of its value over the past five years (see chart 20). Meanwhile, the housing picture is noticeably better in Texas - home prices are just 7% below their pre-crisis peak. Since the start of 2012, home values in most Texas metros have outperformed property prices in other big cities, and, in particular, in metros that, similar to Texas, experienced smaller-than-the-national-average price drops during the recession (see chart 21).

Metro home prices in Q1 2012 21
not seasonally adjusted, % change

	vs. 2006	vs. Q1 2011	vs. Q4 2011
Austin-Round Rock	11.2%	2.7%	2.6%
San Antonio	5.8%	0.9%	-0.3%
El Paso	5.6%	2.5%	-1.3%
Houston-Baytown-Sugar Land	2.0%	2.4%	-2.4%
Dallas-Fort Worth-Arlington	-0.9%	3.6%	1.4%
Charleston-North Charleston	-8.9%	5.5%	-3.0%
Denver-Aurora	-9.3%	1.2%	-1.9%
Philadelphia-Camden-Wilmington	-15.9%	-2.8%	-3.7%
Kansas City	-20.2%	-0.7%	-5.3%
New York-Northern New Jersey-Long Island	-22.5%	-3.2%	0.3%
Boston-Cambridge-Quincy	-22.6%	-3.3%	-4.2%
Seattle-Tacoma-Bellevue	-26.5%	-7.6%	-0.8%
Washington-Arlington-Alexandria	-27.7%	5.7%	-0.5%
U.S.	**-28.8%**	**-0.4%**	**-2.8%**
Minneapolis-St. Paul-Bloomington	-36.6%	4.8%	-2.8%
Cleveland-Elyria-Mentor	-36.8%	-2.4%	-17.7%
San Francisco-Oakland-Fremont	-40.5%	-3.7%	-3.1%
Chicago-Naperville-Joliet	-42.5%	1.4%	-4.3%
Atlanta-Sandy Springs-Marietta	-48.9%	-12.0%	-3.1%
Miami-Fort Lauderdale-Miami Beach	-51.0%	9.6%	-1.5%
Phoenix-Mesa-Scottsdale	-51.6%	2.5%	9.3%
Los Angeles-Long Beach-Santa Ana	-51.9%	-4.1%	-5.2%
Las Vegas-Paradise	-61.5%	-4.8%	0.2%

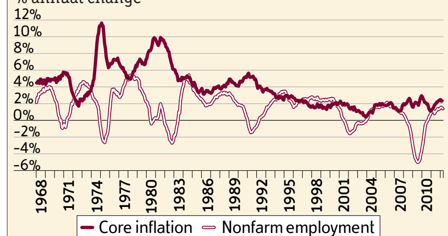
Source: The National Association of Realtors

Consumer prices 17
Consumer Price Index - all urban consumers, % annual change



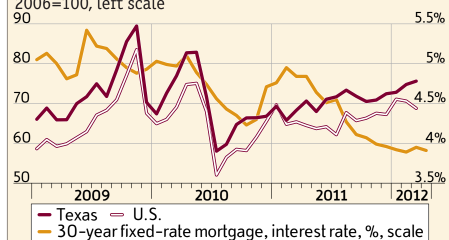
Source: The U.S. Bureau of Labor Statistics

Inflation and employment 18
% annual change



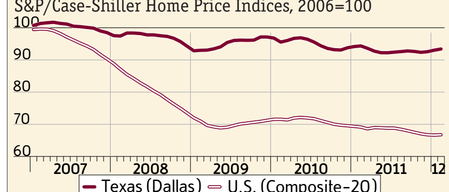
Source: The U.S. Bureau of Labor Statistics

The national housing market remains weak 19
existing home sales, seasonally adjusted annual rate, 2006=100, left scale



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

Home prices 20
S&P/Case-Shiller Home Price Indices, 2006=100



Source: Standard & Poor's

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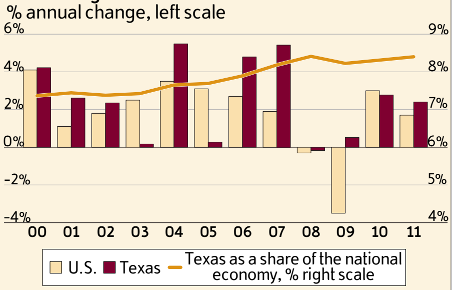
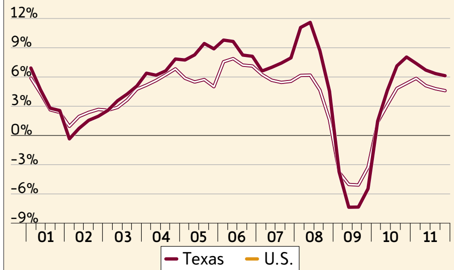
Economic growth: Texas vs. U.S.
% annual change, left scale



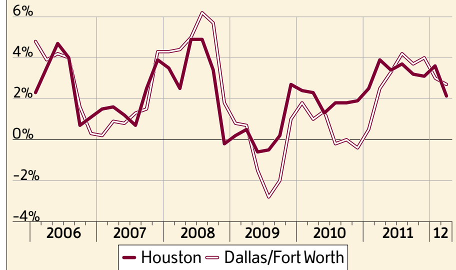
Source: The U.S. Bureau of Economic Analysis

Personal income
seasonally adjusted at annual rates, % annual change



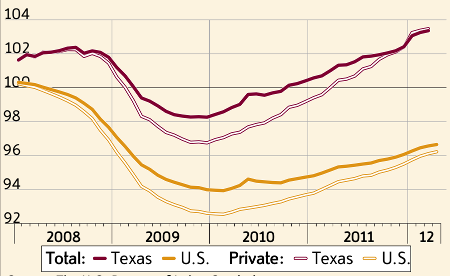
Source: The U.S. Bureau of Labor Statistics

Consumer prices
% annual change, data in alternating months



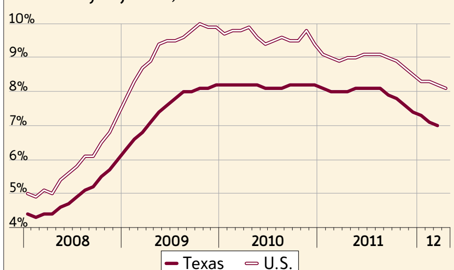
Source: The U.S. Bureau of Labor Statistics

Nonfarm employment
2007=100



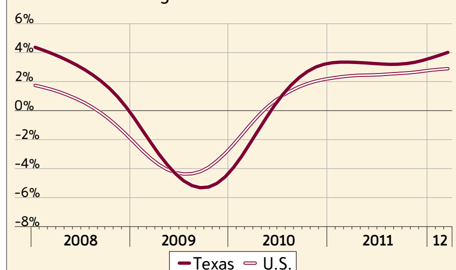
Source: The U.S. Bureau of Labor Statistics

Unemployment rates
seasonally adjusted, %



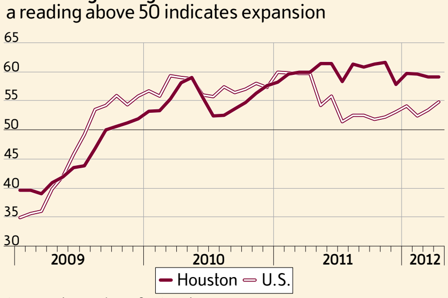
Source: The U.S. Bureau of Labor Statistics

State Coincident Indexes
12-month % change



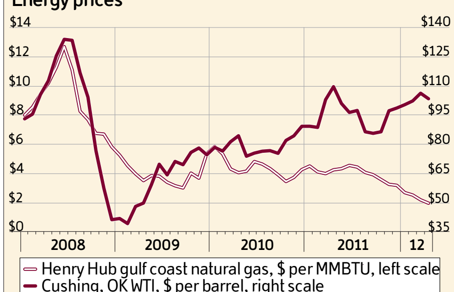
Source: The Federal Reserve Bank of Philadelphia

Purchasing Managers Index
a reading above 50 indicates expansion



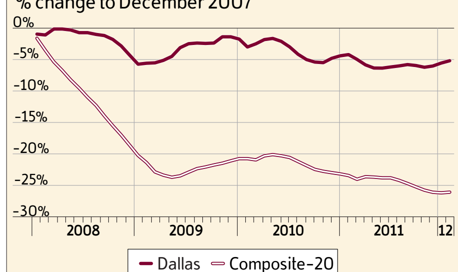
Source: The Institute for Supply Management

Energy prices



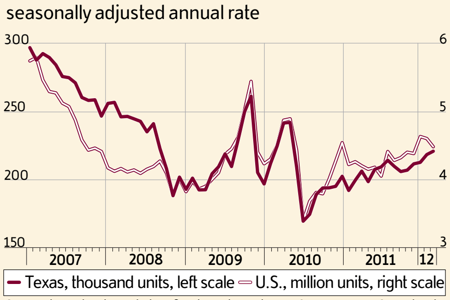
Source: The U.S. Energy Information Administration

Home values
% change to December 2007



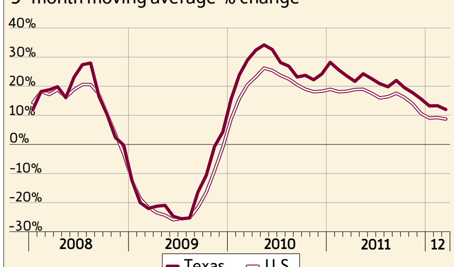
Source: The S&P/Case-Shiller Home Price Indices

Home sales
seasonally adjusted annual rate



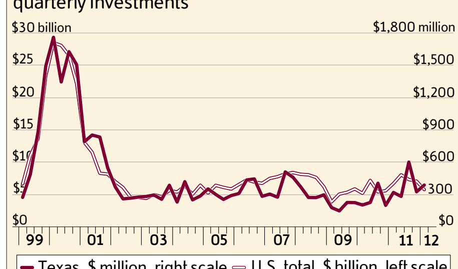
Source: The National Association of Realtors, The Real Estate Center at Texas A&M University

Exports
3-month moving average % change



Source: The U.S. Department of Commerce

Venture capital investment activity in the United States
quarterly investments



Source: PricewaterhouseCoopers

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