- **Texas factory activity strengthened in May.**
- **In May, the Texas jobless rate stood at 6.5% versus 7.6% nationwide.**
- **Home sales in Texas are at their highest level in over five years.**
- **The U.S. economy grew by 1.8% in the first quarter of 2013.**

Executive summary

Readings on the first quarter GDP growth indicate that the national economy continues to be propped up by resilient private spending and a strong rebound in residential construction. In the first quarter of 2013, household consumption advanced at the fastest rate in nearly two years, while residential investment spending saw its eighth consecutive quarterly gain. At the same time, investment spending remained weak on falling commercial real estate activity.

On the upside, consumer confidence has been hovering close to post-recession highs as growing stock prices and home values help rebuild household wealth. According to the Federal Reserve, households' net worth reached an all-time high of over $70 billion in the first quarter of 2013. A steady creation of new jobs is boosting consumers' purchasing power as well. In May, personal income was about 3.3% higher than a year ago, as private sector employment grew by over 2 million in the past twelve months. This adds to households' buying power and helps sustain private consumption. On that note, retail sales recorded a firm gain in May thanks to broad-based growth across major retail sectors and, in particular, increasing automobile sales. Growing consumer credit and a return of the households' savings rate to lower levels shows consumers' willingness to spend despite rather anemic economic growth.

Businesses appear to be gradually regaining their appetite for spending as well. In May, new orders of durable goods increased by 3.6% following a similar gain the month before thanks to strong new orders of transportation equipment and machinery. New orders of nondefense capital goods excluding aircraft, a key metric of business investment spending, were up in May for the third straight month.

Turning to Texas, factory activity improved sharply in May while business activity in service industries continued to expand. The energy industry is still a big driver of the region's economic activity and is supporting the steady expansion of the Houston metro economy. According to the U.S. Bureau of Economic Analysis, last year mining contributed nearly a fifth to overall economic growth in Texas. The region's economy is now 13.1% larger than at the start of 2008 versus a gain of only 2.5% nationwide. Despite its big contribution to the local economy, the Texas mining industry is only one of the drivers of economic recovery. For instance, compared to North Dakota, where the shale gas boom propelled the share of the mining industry in private sector activities to 11% from just 3.6% in 2007, the Texas mining sector accounts for about the same portion of the state's private economy as at the beginning of the 2007 economic downturn. This points to a sustained and balanced economic recovery in Texas, due to a faster turnaround in the regional construction activity and a robust expansion in private service-providing sectors.

In May, the Texas jobless rate held steady marginally increasing to 6.5% as more people entered the labor force to look for work. On that note, while the labor force has barely grown nationwide since the start of 2013, it has expanded by 1.2% in Texas. This faster growing workforce, with a larger share of the adult population that has a job or is looking for one, shows that Texas continues to offer better job prospects than other states.

In May, Texas created over 17,000 new private sector jobs, which puts the employment gain over the last 12 months at nearly 300,000 private jobs. At a 3.3% annual rate, the Texas private sector continues to add new jobs at faster pace compared to 1.9% national growth. In fact, in May, the private sector employed 5.6% more workers in Texas compared to the previous employment peak in mid-2008. Nationwide, there are still about 2 million (or 1.6%) fewer private jobs compared to the beginning of the economic downturn.

The Texas private sector has recently confronted fresh headwinds, which may cool the pace of hiring. Specifically, a weaker global economy may hold back further job gains in Texas manufacturing, while job growth in mining is starting tapering off on sluggish energy prices. This is important since goods-producing industries are a bigger source of new jobs in Texas than in the U.S. – nearly one in five new private sector jobs created in Texas over the last twelve months was in mining, manufacturing or construction compared to only one in nine nationwide. On the upside, construction jobs are returning to Texas at a much faster pace than the rest of the country – in May 2013, Texas had only 7% fewer jobs in construction than five years ago, while the nation as a whole was still short of over 20%. In addition, as the global economy starts to accelerate, a return of foreign demand and stronger energy prices will boost Texas exporters. This, coupled with a strong housing market, should help Texas maintain its position as the job creation engine of the national economy.

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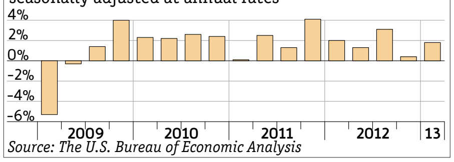
Economic output

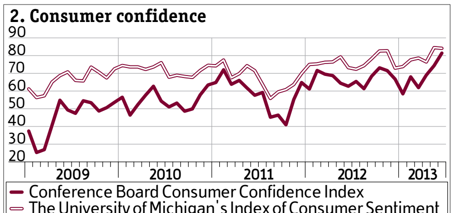
1. Economic growth
seasonally adjusted at annual rates



Source: The U.S. Bureau of Economic Analysis

During the first quarter of 2013, the national economy grew at an annual pace of 1.8% (see chart 1) due to resilient private consumption and a sustained rebound in the residential housing sector. Household consumption advanced by 2.6%, the fastest rate since the first quarter of 2011, while residential investment spending (up by 14%) saw its eighth consecutive quarterly gain. Meanwhile, business spending grew even slower (up by only 0.4%, versus 13.2% the quarter before) as nonresidential construction spending dropped by 8.3%.

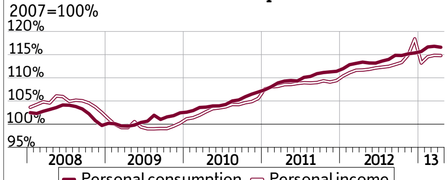
2. Consumer confidence



Source: The Conference Board, Haver Analytics

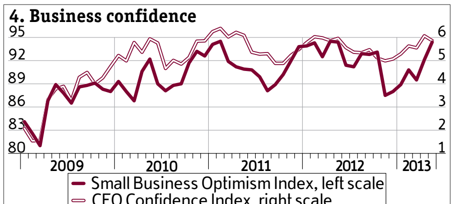
On the upside, consumer confidence has been improving (see chart 2) on growing equity and home values, and increasing income. In June, the Conference Board's Consumer Confidence Index improved to its highest reading in five years. Meanwhile, according to the U.S. Bureau of Economic Analysis, in May personal income was about 3.3% higher than a year ago. This adds to households' buying power and helps sustain private consumption (see chart 3) – the biggest driver of overall economic growth. This more robust recovery in U.S. private consumption is in sharp contrast with the stagnant private demand in crisis-hit Europe. Indeed, while in the first quarter of 2013, inflation-adjusted private consumption in the EU was about 2% lower than at the end of 2007, it grew by about 5% in the U.S. On that note, retail sales saw a gain in May, increasing by 0.6% versus the month before following 0.1% monthly growth in April. Excluding gasoline stations, where sales dropped for the third straight month on falling energy prices, retail sales were up by 0.8% thanks to broad-based gains across major retail sectors. In particular, automobile sales were up by nearly 2%, while sales of building materials and supplies grew by 0.9% to their highest level since 2007, reflecting the strengthening housing market. Spending on discretionary items, such as sporting goods, increased as well. Consumers appear to be more willing to spend, even if it means again expanding credit – the household savings rate is just 2.5% and consumer credit is growing (up by 5.9% in April versus a year ago). In May, car sales recovered by 2.6% compared to the month before (or up by nearly 10% versus the year ago) to over 15 million units at seasonally adjusted annual rates.

3. Personal income and consumption
2007=100%



Source: The U.S. Bureau of Economic Analysis

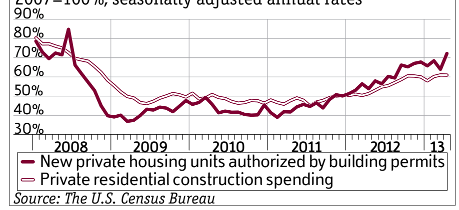
4. Business confidence



Source: Chief Executive Magazine,
The National Federation of Independent Business

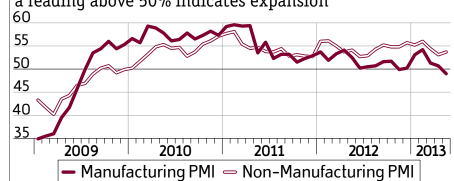
Businesses are growing slightly more confident as well (see chart 4). During the first two months of the second quarter of 2013, the private sector added 23% more jobs compared to the same two months the year before. Meanwhile, companies appear to be gradually increasing spending – in May, new orders of durable goods increased by 3.6% following a similar monthly gain the month before thanks to improving new orders of transportation equipment and machinery. In particular, a stronger residential construction sector (see chart 5) is sustaining demand for building materials and construction machinery and equipment. Equally important, new orders of nondefense capital goods excluding aircraft, a key gauge of business investment spending, were up in May for the third straight month, increasing in the first five months of this year by 2.3% versus January-May 2012.

5. Residential construction is turning the corner
2007=100%, seasonally adjusted annual rates



Source: The U.S. Census Bureau

6. Manufacturing recovery stalled in May
PMI - Purchasing Managers Indices,
a reading above 50% indicates expansion

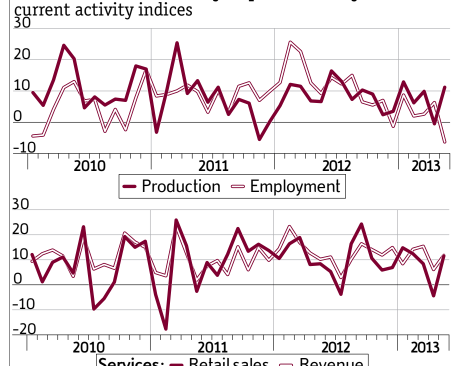


Source: The Institute for Supply Management

May's readings on national factory activity paint a somewhat bleak picture for U.S manufacturing activity. The Purchasing Managers Index (PMI) slipped below 50% (see chart 6), a sign of shrinking business activity. On the upside, business activity in services and construction, as measured by Non-manufacturing PMI, improved in May, while the employment indices of both Manufacturing and Non-manufacturing PMI stood above 50%, pointing to a continued but slowing job creation.

Unlike the nation as a whole, Texas

7. Texas business activity improves in May
current activity indices



Source: The Federal Reserve Bank of Dallas

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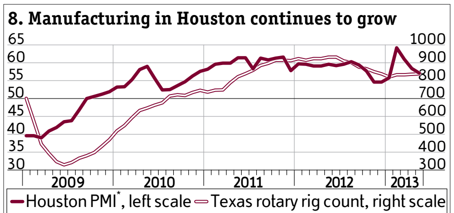
saw strong economic growth in May: according to the Dallas Fed Business Outlook surveys, the Lone Star's factory activity improved sharply, while business activity in service industries remained in expansionary mode (see chart 7). The energy industry remains a big driver of regional economic activity and continues to support a steady expansion in the Houston metro economy (see chart 8).

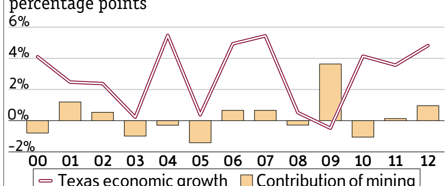
8. Manufacturing in Houston continues to grow



*PMI – Purchasing Managers Index, a reading above 50 indicates expansion
Source: Institute for Supply Management, Baker Hughes

On that note, according to the U.S. Bureau of Economic Analysis, last year mining contributed nearly a fifth to overall economic growth in Texas (see chart 9). As a result, the regional

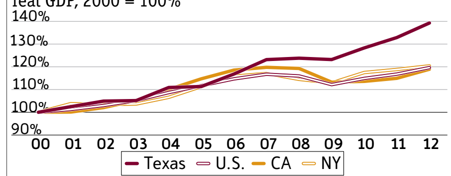
9. Texas economic growth accelerated in 2012
percentage points



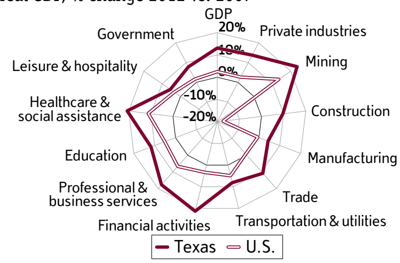
The U.S. Bureau of Economic Analysis

economy is now 13.1% larger than at the start of 2008 versus a gain of only 2.5% nationwide. Furthermore, strengthening economic recovery in Texas compares very well to the sluggish rebound in California and New York – the only other two regions where annual GDP exceeds $1 trillion (see chart 10). More importantly, despite its vital contribution to the local economy, the Texas mining industry was far from the only source of economic recovery. Indeed, compared to North Dakota, where the shale gas boom propelled the share of the mining industry in the private sector activities to 11% from just 3.6% in 2007, the Texas mining sector accounts for about the same portion of the state's private economy

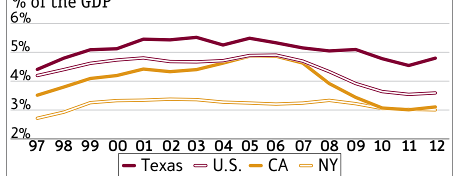
10. Texas economy is 40% bigger than in 2000
real GDP, 2000 = 100%



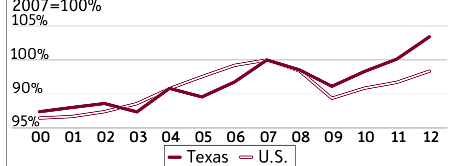
Economic activity by major industries
real GDP, % change 2012 vs. 2007



Construction industry
% of the GDP



Real GDP per capita
2007=100%



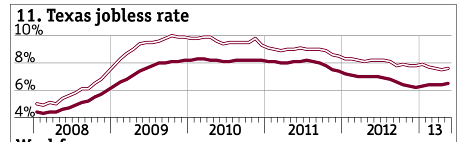
The U.S. Bureau of Economic Analysis

as at the beginning of the 2007 economic downturn. And this points to a sustained and balanced economic recovery in Texas on a faster turnaround in regional construction activity and a robust expansion in private service providing sectors.

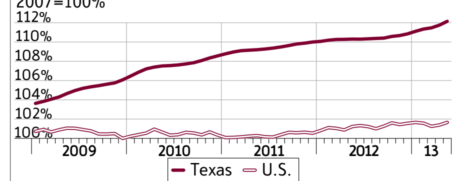
Employment

In May, the Texas jobless rate held steady, marginally increasing to 6.5% as brighter employment prospects encouraged more people to look for work (see chart 11). In fact, while the labor force has barely grown nationwide since the start of 2013, it expanded by 1.2% in Texas. Meanwhile, at 65.3% the Texas labor force participation rate (i.e., the share of the adult population that has a job or is looking for one) is about at the same level as at the end of 2007. For the nation as a whole, the labor force participation rate is nearly 3% percentage points lower than five years ago.

11. Texas jobless rate



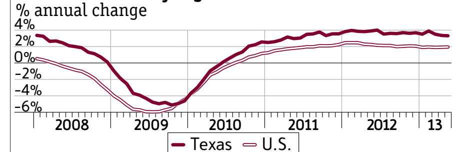
Workforce
2007=100%



Source: The U.S. Bureau of Labor Statistics

In May, Texas created over 17,000 new private sector jobs, which puts the employment gain over the last 12 months at nearly 300,000 private jobs. As a result, the Texas private sector continues to add new jobs at a much faster pace than the nation as a whole (see chart 12). In fact, in May, the private sector employed 5.6% more workers in Texas compared to the previous employment peak in mid-2008. Nationwide, there are still about 2 million (or 1.6%) fewer private jobs compared to the beginning of the economic downturn.

12. Private sector job growth
% annual change



Source: The U.S. Bureau of Labor Statistics

The Texas private sector has recently confronted fresh headwinds, which may slow the pace of hiring. However, the state's labor market looks set to continue to outperform the nation as a whole. A weaker global economy and, consequently, subsiding foreign demand for Texas exports, may hold back further job gains in manufacturing (see chart 13). Meanwhile, job growth in mining, where employment has already reached its highest level in over two decades and is 18% larger than in late-2008, is

13. Exports and factory jobs

Source: The U.S. Bureau of Labor Statistics

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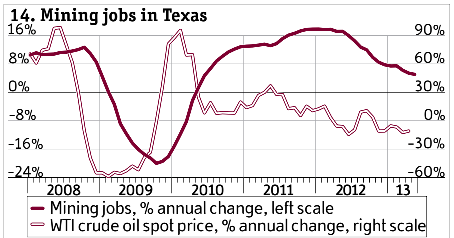
14. Mining jobs in Texas

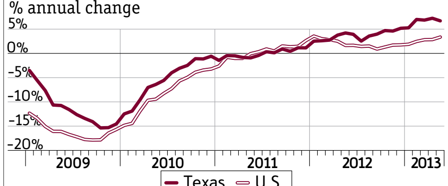


Source: The U.S. Bureau of Labor Statistics

tapering off on falling energy prices (see chart 14). This is important since goods-producing industries are a bigger source of new jobs in Texas versus the U.S. – nearly one in five new private sector jobs created in Texas over the last twelve months was in mining, manufacturing or construction compared to only one in nine nationwide. Thus, a slower growth of employment in those industries may reduce the speed of the overall labor market recovery. On the upside, construction jobs are returning to Texas at a much faster pace than the rest of the country (see chart 15) – in May 2013, Texas had only 7% fewer jobs in construction than five years ago, while the nation as a whole was still short of over 22% construction jobs. In addition, as the global economy starts to accelerate, Texas exporters should benefit from the gradual pickup in energy prices and increasing overseas shipments to developing economies. This, coupled with a reviving housing market, will help Texas maintain its position as the job creation engine of the national economy.

15. Construction jobs

% annual change



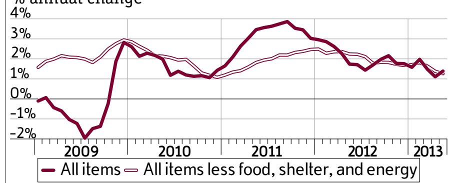
Source: The U.S. Bureau of Labor Statistics

Monetary Policy and Asset Prices

In June, the Federal Reserve hinted that it may start scaling down its $85 billion monthly bond-buying program if the labor market continues to improve. In particular, the Fed now sees fewer downside risks to the economic and expects the jobless rate to fall to about 7% by mid-2014, when the Fed sees no need to extend its asset purchases.

16. Consumer prices

% annual change



Source: The U.S. Bureau of Labor Statistics

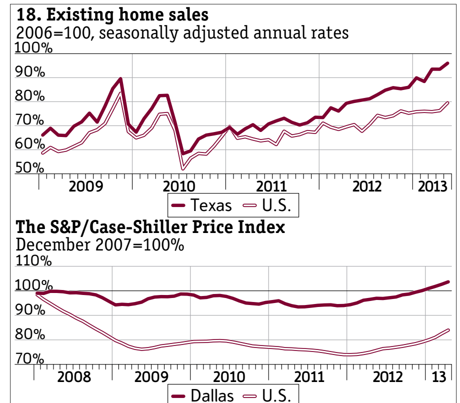
Annual growth of consumer prices is not projected to exceed 2% over the next three years. Indeed, latest readings on inflation indicate that overall price pressures remain contained (see chart 16). This means that if the economy recovers slower than the Fed forecast, the monetary policy may remain loose to keep interest rates at their current record low level without greater risks to price stability.

17. Yield on U.S. Treasury securities at 10-year constant maturity

Source: The Federal Reserve

In fact, borrowing costs appear to be moving up – the yields on Treasury bills increased to their highest level since August 2011 (see chart 17), on expectations of tighter monetary policy in the future. Meanwhile, according to Freddie Mac, by the end of June at 4.46% the average rate for a 30-year fixed mortgage climbed to its highest level since July 2011, exceeding 4% for the first time since March 2012. These higher rates may cool booming demand for housing (see chart 18) and slow the appreciation of home prices, which in April saw their strongest annual gain in over 6 years both in Texas and nationwide. On the upside, low housing inventory (4-month supply in Texas and 5.1-months supply in the U.S. at current sales pace) will help keep housing prices on the uptrend and will continue to support new home construction. Lastly, readings on homeowners' financial conditions are pointing to a sustained improvement in the housing market as well. For instance, according to RealtyTrac, in May, foreclosure activity in the U.S. declined by 28% versus a year ago – just one in every 885 homeowners entered the foreclosure process during the month compared to one in 639 in May 2012. In addition, improving home prices help households rebuild wealth – CoreLogic estimates that about 850 thousand homeowners exited negative equity (i.e., the value of their houses now exceeds their underlying mortgages) in the first quarter of 2013. Thus, due to higher residential property values and stock prices, the Federal Reserve puts the aggregate net worth of all U.S. households at over $70 trillion at the end of the first quarter of 2013, which is $2.3 trillion more versus the previous all-time high recorded more than five years ago.

18. Existing home sales



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

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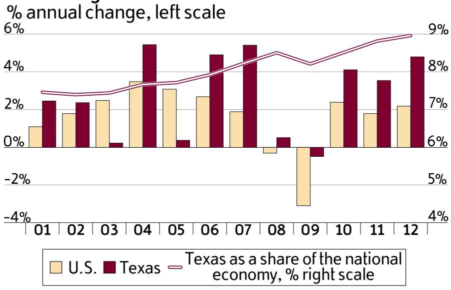
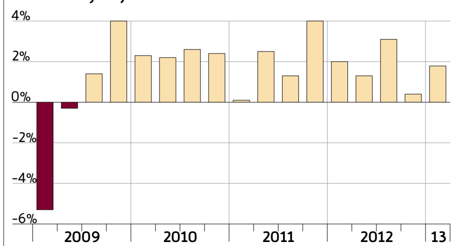
Economic growth: Texas vs. U.S.
% annual change, left scale



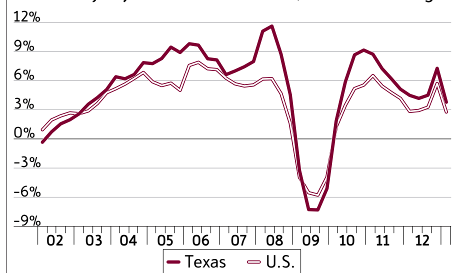
Source: The U.S. Bureau of Economic Analysis

U.S. quarterly GDP
% change from preceding period
seasonally adjusted at annual rates



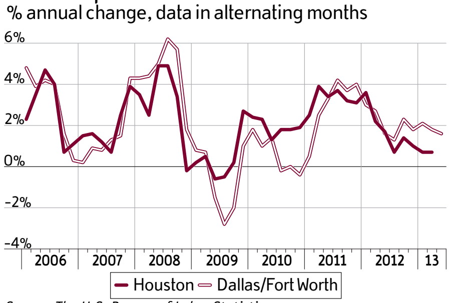
Source: The U.S. Bureau of Economic Analysis

Personal income
seasonally adjusted at annual rates, % annual change



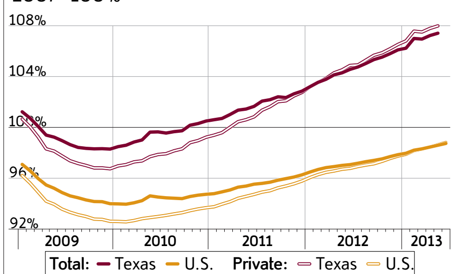
Source: The U.S. Bureau of Labor Statistics

Consumer prices
% annual change, data in alternating months



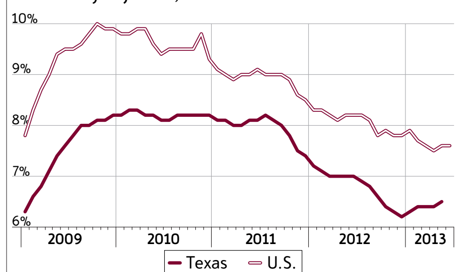
Source: The U.S. Bureau of Labor Statistics

Nonfarm employment
2007=100%



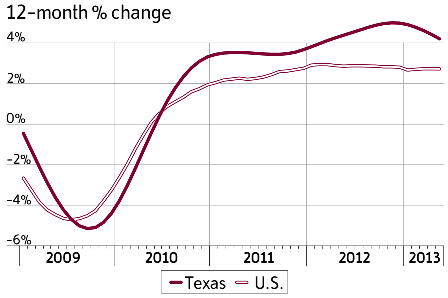
Source: The U.S. Bureau of Labor Statistics

Unemployment rates
seasonally adjusted, %



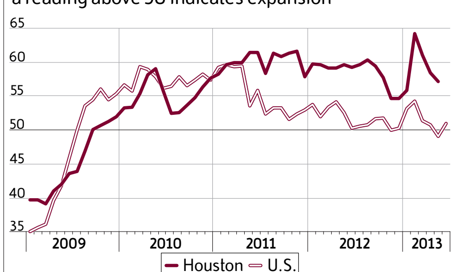
Source: The U.S. Bureau of Labor Statistics

State Coincident Indexes
12-month % change



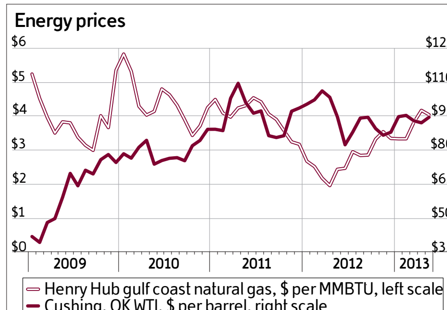
Source: The Federal Reserve Bank of Philadelphia

Purchasing Managers Index
a reading above 50 indicates expansion



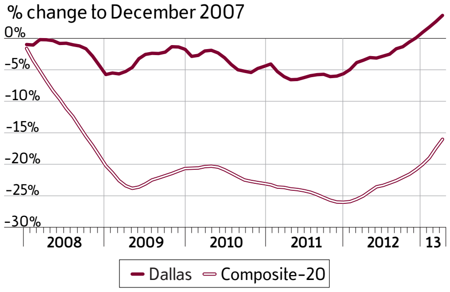
Source: The Institute for Supply Management

Energy prices



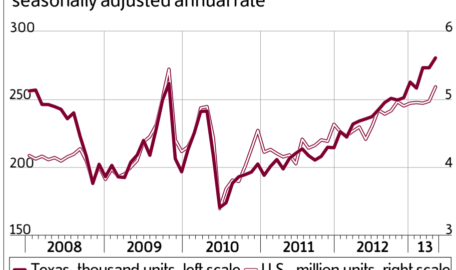
Source: The U.S. Energy Information Administration

Home values
% change to December 2007



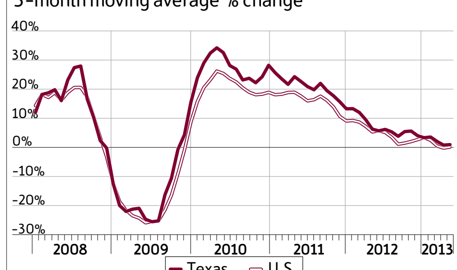
Source: The S&P/Case-Shiller Home Price Indices

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