January 2014

- **The jobless rate in Texas dropped to 6.1% in November – the best reading in over five years.**
- **Texas factory activity ended 2013 on solid footing, expanding for the eighth straight month in December.**
- **Business activity in Houston continued to expand.**
- **Housing demand stabilized in December.**

Executive summary

Stronger household spending on durable goods and continued improvement of business activity in residential and commercial construction helped pushed third quarter GDP growth to 4.1% - its best reading since the last quarter of 2011. At the same time, government spending saw its first gain in a year on growing spending by local and state governments, which advanced at the fastest pace in four years.

Meanwhile, an ongoing turnaround in automobile industry is boosting national factory activity, as new orders of manufacturing goods strengthened in December to their highest level since April 2010 on growing consumer demand. Indeed, car sales stood above 15 million units for over a year, hitting their best reading since mid-2007 in November 2013. Consumers continue to increase borrowing thanks to the resumption of new issuance of securities backed by car loans. Having said that, tighter financial conditions on expectations of falling asset purchases by the Fed may have slowed the growth of the non-manufacturing sectors and, in particular, have somewhat dented business activity in construction during the final quarter of 2013.

On the upside, the economic policy risks seem to be easing as the year-end budget agreement helped soften the negative impact of federal budget cuts on overall economic activity. Consumer and business sentiment are gradually bouncing back, which bodes well for household and investment spending. On that note, December was the fourth straight month of rising retail sales, while new orders of capital goods (excluding aircraft) in November approached record highs seen earlier in 2013.

In Texas, regional factory activity continued to expand in December on a brighter economic outlook, steady jobs gains, growing exports, and improving business activity in the mining industry. In December, the Texas rig count stood at its strongest level in over year, contributing to a healthy expansion of the Houston metro economy. Meanwhile, exports of industrial machinery saw the fastest growth since the start of the economic downturn, largely thanks to increasing overseas shipments of computers. This adds strength to the metro economies of Dallas and Austin, which are home to high-tech manufacturing clusters.

Lastly, a stronger rebound of the regional economy versus the nation as a whole is helping to sustain a faster pace of hiring in the private sector. The Texas jobless rate has been below 7% since mid-2012, dropping to 6.1% in November – its best reading in five years. Meanwhile, the national unemployment rate dropped below 7% only in the last month of 2013, mostly on account of declining labor force participation. In Texas, the labor force participation rate is two percentage points higher than in the nation as whole, which shows the steady expansion of the regional economy. The sharp drop of the labor force participation rates nationwide, and in states like Nevada and Arizona, points to the continuing struggles of the national economy, as job creation continues to be slow and many previous jobs lost (particularly in construction and manufacturing) are unlikely to return. Texas remains one of the few bright spots in the country that is experiencing significant economic growth and true job creation.

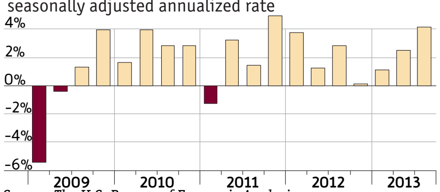
Above all, 2013 was the fourth straight year of post-recession jobs gain in Texas, which proceeded at a consistently higher rate compared to the national trend. While the U.S. is still short about 1.4 million private jobs compared to the start of the recession, private businesses in Texas have already created nearly 6% more jobs than at the employment peak of the previous business cycle. In particular, solid growth of hiring activity in mining and a healthier rebound of the regional construction industry supported a much faster recovery of goods-producing jobs in Texas versus the nation as a whole. Indeed, Texas goods producing sectors have already recovered about 80% of all jobs lost during the recession compared to only a quarter nationwide. Additionally, over the past three years the annual gains in service providing sectors averaged 3.3% in Texas versus only 2% nationwide. As a result, private sector employment in those industries is already 10% higher compared to its previous peak, versus a gain of only 3% nationwide. This is important because since 2010, job growth in private service-providing sectors consistently contributed 2.7% percentage points on average to the overall expansion rate of private employment in Texas. Thus, as hiring activity in mining, construction and manufacturing slows, job gains in service-providing industries will be crucial to maintaining 3% annual private employment growth in Texas.

On that note, a recent uptrend in new job creation in trade, transportation and utilities, and business and professional services industries, does imply that the jobs market recovery is becoming more self-sustained thanks to improving regional consumer and business activity. At the same time, hiring in healthcare and education, and leisure and hospitality industries softened somewhat in the second half of 2013. However, slower employment growth in the healthcare industry was mostly due to uncertainty about healthcare reform. In the future, an aging population and increasing healthcare spending should continue to support steady growth of employment in that industry. And the biggest Texas metros are emerging as the most dynamic hotel markets in the U.S., which will contribute to employment gains in the local leisure and hospitality industry.

Economic output

The national economy grew faster in the second half of 2013; third quarter GDP growth stood at a 4.1% seasonally adjusted annual rate, its best reading since the last quarter of 2011 (see chart 1). In particular, consumer spending grew by 2%, driven by stronger household demand for durable goods – up by nearly 8%. Residential and commercial real estate investments continued to advance at double-digit rates, although decelerating somewhat from the quarter before. Meanwhile, government spending saw its first gain in a year on growing spending by local and state governments, which advanced by 1.7%, its fastest growth in four years. Having said that, the accumulation of private inventories contributed over 40% to overall third quarter GDP growth, which may imply that inventories' impact on economic growth may retreat somewhat in coming quarters.

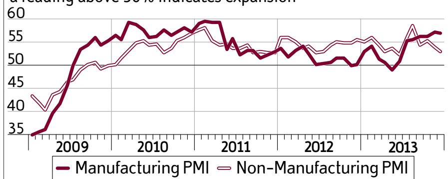
1. GDP growth
seasonally adjusted annualized rate



Source: The U.S. Bureau of Economic Analysis

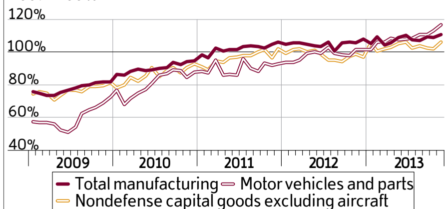
Meanwhile, readings on national factory activity do imply that U.S. manufacturing strengthened at the end of 2013 (see chart 2), as the new orders index hit its highest level since April 2010. The continued turnaround of the automobile industry on booming consumer demand helps explain a solid uptick of new orders in manufacturing during the final months of 2013 (see chart 3). Car sales stood above 15 million units for over a year, hitting their best reading since mid-2007 in November

2. The national factory activity ended 2013 on a strong note
PMI - Purchasing Managers Indices,
a reading above 50% indicates expansion



Source: The Institute for Supply Management

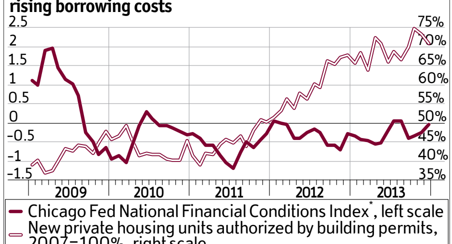
3. New factory orders
2007=100%



Source: The U.S. Census Bureau

2013. This demand for durable goods is being supported, among other things, by increasing credit flows to U.S. households due to the resumption of new issuance of asset-backed securities. According to the Securities Industry and Financial Markets Association, in the last quarter of 2013, 16% more securities backed by auto loans and credit cards were issued compared to the same quarter a year ago, although the pace of growth slowed somewhat on worries over higher borrowing costs. Having said that, tighter financial conditions have exerted a bigger impact

4. Construction activity grew cooler on concerns over rising borrowing costs

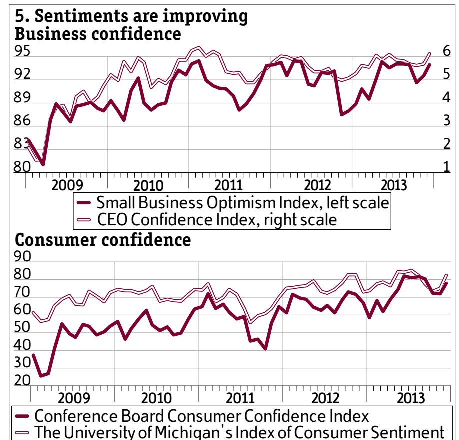


**The National Financial Conditions Index (NFCI) measures risk, liquidity and leverage in money markets and debt and equity markets as well as in the traditional and "shadow" banking systems. Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average.*
Source: The U.S. Census Bureau,
The Federal Reserve Bank of St. Louise

on the homebuilding industry (see chart 4), which slowed the growth of the non-manufacturing sector. Indeed, the issuance of new mortgage-backed securities in the fourth quarter of 2013 was a third lower versus the same quarter a year ago. This drop in funding for new mortgages was one of the factors that kept home sales on a steady downtrend over the final three months of 2013.

On the upside, December's budget agreement helped temporarily ease economic policy uncertainties and softened the impact of federal budget cuts on overall economic activity. Consumer and business sentiment appear to be slowly bouncing back (see chart 5), which bodes well for the household and investment spending.

5. Sentiments are improving



Source: The Conference Board, Haver Analytics, Chief Executive Magazine, The National Federation of Independent Business

Indeed, December was the fourth straight month of rising retail sales, while in November new orders of capital goods (excluding aircraft) approached their record highs seen earlier in 2013.

A brighter economic outlook, steady job gains, continued growth of exports and a pickup in business activity in the mining industry on higher energy prices are sustaining economic activity in

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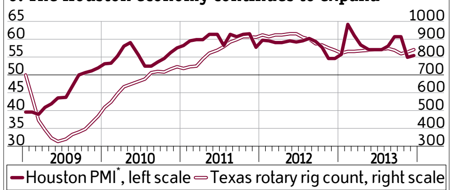
6. The Houston economy continues to expand



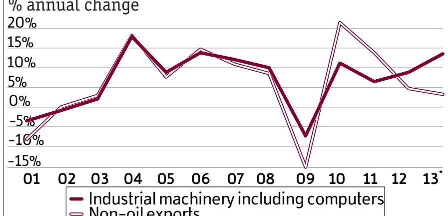
*PMI – Purchasing Managers Index,
a reading above 50 indicates expansion
Source: Institute for Supply Management, Baker Hughes

7. Texas Factory activity grew in December
Manufacturing Activity Indices,
The Texas Manufacturing Outlook Survey

Source: The Federal Reserve Bank of Dallas

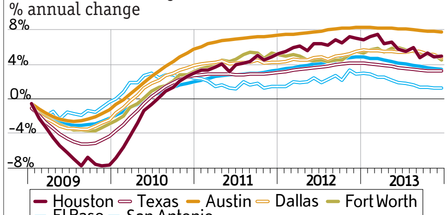
Texas. In December, the Texas rig count stood at its strongest level in over a year (see chart 6), which helps sustain the growth of factory output statewide (see chart 7) and is contributing to the strong expansion of the Houston metro economy. Meanwhile, exports of industrial machinery saw the fastest growth since the start of the economic downturn (see chart 8), largely thanks to increasing overseas shipments of computers. This is strengthening the metro economies of Dallas and Austin, which are home to high-tech manufacturing clusters. The regional economy appears to be moving toward a more moderate pace of expansion (see chart 9) as the growth momentum

8. Texas non-oil exports
% annual change



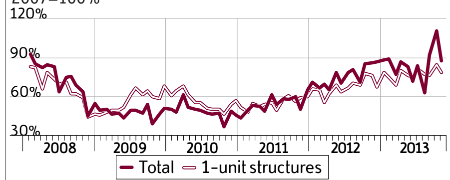
*January-November
Industrial machinery accounts for over a quarter of all non-oil exports
Source: The U.S. Department of Commerce

9. Metro Business Cycle Indices
% annual change



Source: The Federal Reserve Bank of Dallas

10. Private residential buildings authorized by building permits in Texas
2007=100%



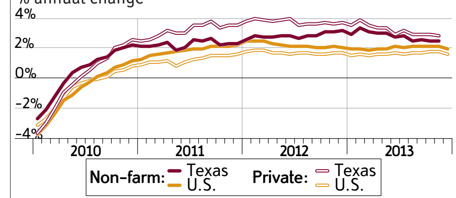
Source: The Federal Reserve Bank of St Louise

in the energy industry cools down. Homebuilding activity in Texas seems to be decelerating (see chart 10) as well, similar to the nation as a whole, as higher mortgage rates are eating into the regional demand for housing. This may limit future employment gains in the construction industry. On the upside, robust demand for office, retail and industrial space in Texas on big employment gains in the energy, manufacturing and sectors providing business and professional services will help partly offset weaker activity in residential construction. Indeed, according to CBRE Commercial Real Estate Services, in the third quarter of 2013 office occupancy rates dropped the most in Dallas compared to other big metros nationwide, while the largest amount of new office space among all major markets nationally was delivered in Houston. Colliers International, a global provider of commercial and residential real estate services, estimates that at the start of the last quarter of 2013, over 10 million square feet of new office development was under construction in Houston as major business, including large energy companies, intend to acquire new office buildings to accommodate growth. Thus, falling inventory and increasing demand for commercial real estate in Texas should help sustain a rebound of the regional construction industry.

Employment

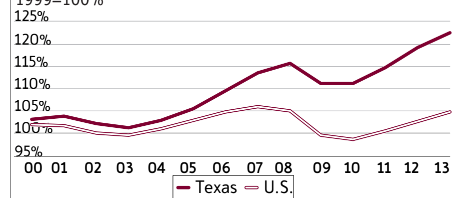
2013 was the fourth straight year of post-recession job gains in Texas, which proceeded at a consistently higher pace versus the nation as a whole. Thus, in November, the annual rate of job creation stood at 2.5% compared to only 1.7% nationwide as the private sector in Texas was adding jobs a full percentage point faster compared to the U.S. average

11. Job gains in Texas and the U.S.
% annual change



Source: The U.S. Bureau of Labor Statistics

12. Private sector employment
1999=100%



Source: The U.S. Bureau of Labor Statistics

(see chart 11). In fact, nationwide, there are still about 1.4 million fewer private jobs compared to the start of the recession five years ago, while in Texas the private sector now provides nearly 6% more jobs versus the employment peak of the previous business cycle (see chart 12). More specifically, about half of nearly 9 million jobs lost nationwide in 2008-2009 were in goods-producing sectors (mining, construction and manufacturing). This almost equal split of the private sector job losses between the goods producing and service-providing industries was observed in Texas as well – about 270 thousand jobs out of 480 thousand lost during the economic downturn were in mining, construction and manufacturing. Yet a solid pick-up of hiring activity in mining and a healthier rebound of the regional construction industry supported a much faster recovery of the goods-producing jobs in Texas versus the nation as a whole. Indeed, Texas goods producing sectors have already recovered about 80% of all jobs lost during the recession compared to only a quarter nationwide. Although most of these regained jobs were in mining, Texas factory and construction jobs recovered faster as well – about 40% of all lost construction jobs and over half of all jobs lost in manufacturing have been already recouped in Texas versus only 16% and 25%, respectively, for the nation as a whole (see chart 13).

Meanwhile, speedier recovery of jobs in

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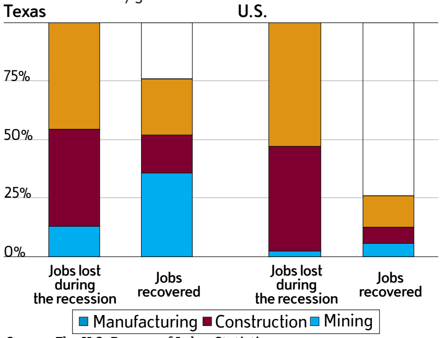
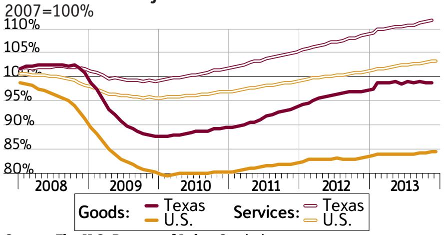
13. Jobs recovery in goods producing industries
% of total losses/gains



Source: The U.S. Bureau of Labor Statistics

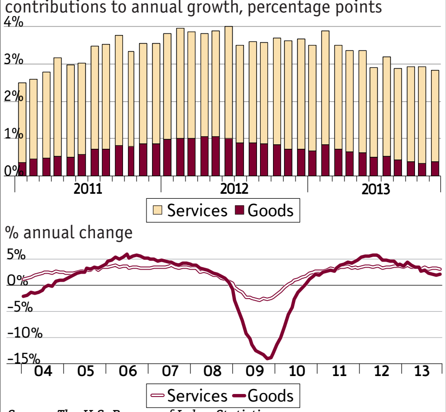
14. Private sector jobs
2007=100%



Source: The U.S. Bureau of Labor Statistics

mining, construction and manufacturing helped support stronger growth of employment in Texas private service-providing industries. In particular, over the past three years the annual gains in service providing sectors averaged 3.3% in Texas versus only 2% nationwide. As a result, private sector employment in those industries is already 10% higher compared to its previous peak versus a gain of only 3% nationwide (see chart 14). This is important, because since 2010, job growth in the private service-providing sectors consistently contributed 2.7% percentage points on average to the overall expansion rate of private employment in Texas (see chart

15. Private-sector jobs in Texas
contributions to annual growth, percentage points

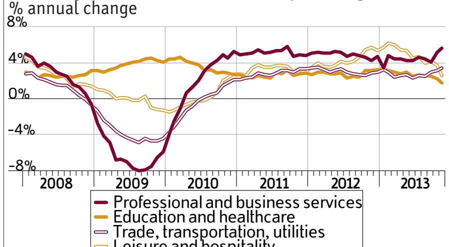


Source: The U.S. Bureau of Labor Statistics

15). Thus, as hiring activity in mining, construction and manufacturing slows (see chart 15, lower panel), continued growth of jobs in service-providing industries will be crucial to maintain 3% annual private employment growth in the Lone Star State.

On that note, a recent uptrend in new job creation in trade, transportation and utilities, and business and professional services industries, which provide 30% and 20%, respectively, of all private services jobs in Texas, does imply that the jobs market recovery is becoming more self-sustained thanks to improving regional consumer and business activity. Meanwhile, hiring activity in healthcare and education, and leisure and hospitality industries (which jointly account for over a third of all private services jobs in Texas) softened somewhat, following the explosive growth experienced during the earlier recovery phases (see chart 16). Having said that, a slower employment growth in the healthcare industry in 2013 was a national trend due to uncertainty over healthcare reform. Still, an aging population and increasing healthcare spending should continue to support steady growth of employment in that industry – according to December's projections from the U.S. Bureau of Labor Statistics, nearly half of all occupations where employment is expected to increase the most within the next decade, will be in healthcare and related industries. Lastly, Texas' biggest metros remain the most dynamic lodging markets in the U.S. The STR, a provider of hotel data, places Houston and Dallas among the top 10 cities nationwide by the number of rooms under construction. This will no doubt contribute to future employment

16. Job growth in the Texas service-providing industries
% annual change



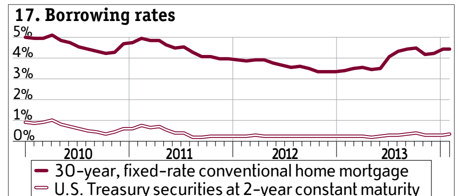
Source: The U.S. Bureau of Labor Statistics

gains in the local leisure and hospitality industry

A stronger rebound in private sector employment in Texas helps explain why the regional jobless rate has been below 7% since mid-2012, dropping to 6.1% in November – its best reading in five years. Meanwhile, December 2013 was the first month when the national unemployment rate fell below 7% since November 2008. However, the labor force participation rate, which measures the share of the working age populations either employed or looking for a job, is two percentage points higher in Texas versus the nation as whole. This means that falling unemployment in Texas reflects an actual expansion of the regional economy rather than the exit of people from the labor force.

Monetary Policy and Asset Prices

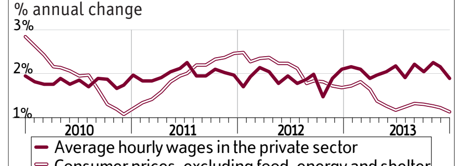
17. Borrowing rates



Source: The Federal Reserve

January was the first month the Federal Reserve started to scale back its quantitative easing program, reducing the monthly volume of asset purchases by $10 billion. As a result, borrowing costs remained elevated on expectations of tighter monetary policy (see chart 17). Still, the Federal Reserve is likely to keep a lid on interest rates as low inflation and slow growth of wages (see chart 18) from continued weakness of the labor market recovery point to the virtual absence of serious risks to price stability in the immediate future. This should sustain the recovery of the residential construction industry, as housing demand remains rather fragile

18. Consumer inflation
% annual change



Source: The U.S. Bureau of Labor Statistics

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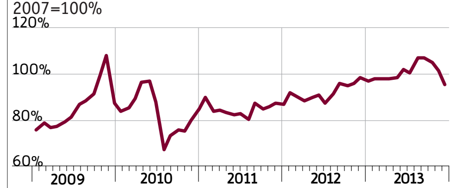
– following three consecutive years of gains, existing home sales stumbled during the second half of 2013 (see chart 19) as costlier mortgages may have put off potential buyers. On the upside, home prices continued to post solid gains – for example, according to the S&P/Case-Shiller Home Price Indices, home values in Dallas rose to a record high in October 2013, surpassing their 2007 peak by 5%. This, coupled with tight housing inventory, will provide an additional boost to the employment and activity in the regional and national homebuilding industries.

19. Existing home sales



Source: The National Association of Realtors

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