August 2014

- **Texas factory activity improved in June.**
- **The Texas jobless rate remained at 5.1% in June versus 6.1% nationwide.**
- **CNBC named Texas the second best state for business.**
- **The Texas economy is about 20% bigger than at the start of the recession; the national economy grew by just 5% from 2007 to 2013.**

Executive summary

The national economic recovery strengthened in the second quarter of this year; business activity in manufacturing and services increased well above their levels at the start of the year. As a clear sign of a more self-sustaining economic expansion, consumer and business confidence are hovering at their highest readings since the start of the recession. Recent solid job gains are prompting businesses and households to spend more. In June, retail sales were up by 4.5% versus the same month a year ago as car sales hit nearly 17 million units. Meanwhile, orders of durable goods in manufacturing remained above prerecession levels in May, thanks to improved business spending on capital goods

Turning to Texas, regional factory activity improved in June following somewhat slower growth the month before. The energy industry continued to expand, contributing to the strength of the Houston metro economy. Service-providing industries remained positive as well, indicating a broad based economic expansion in the Lone Star State. Meanwhile, Texas homebuilding activity is approaching its precrisis levels, whereas nationwide the number of newly issued building permits is still a third below where it was seven years ago. Having said that, the construction industry continued to decelerate in June. Higher borrowing costs and dearer homes may have dented housing demand. However, a different factor may be at play in Texas; the rapid growth of multi-unit residential construction has created shortages of construction lots and construction workers, which is slowing further gains in the regional homebuilding industry.

Lastly, Texas continues to maintain its leading position as one of the most business-friendly states in the nation. A recent study of the Small Business Friendliness by Thumbtack in partnership with the Kauffman Foundation assigned an A+ to the business climate in the Lone Star State. According to CNBC, Texas has been either the first best or the second best location for doing business over the past decade. Thus, it comes as no surprise that the regional economy is now a fifth bigger compared to the start of the recession in 2007. Nationwide, GDP grew by less than 5% over the past six years.

In June, the nation added 288 thousand new jobs and the jobless rate dropped to 6.1%, its lowest reading since September 2008. The unemployment rate in Texas remained at 5.1%. However, this recent drop in the national jobless rate may not paint a complete picture of the health of the U.S. labor market. The U.S. labor force has declined over the past twelve months, and the labor force participation rate remained at a record low level of 62.8%. In June, the labor force participation rate in Texas was just marginally below its level a year ago. Demographic trends aside, this difference between the labor market outcomes in Texas and the U.S. may be a result of the structural change experienced by many big regional labor markets due to a slow economic recovery. Unlike Texas, a shrinking labor force may present a big challenge for those regional economies in the future.

Similar to the nation as a whole, the first six months of this year ended with the biggest number of new jobs created in Texas since the start of the economic recovery. At the same time, June saw the weakest gain of private sector employment in the second quarter of 2014. On that note, slower creation of new jobs in mining and manufacturing, as well as job cuts in construction and several key service sectors, contributed to the overall moderation of job creation in Texas. On the upside, employment in all major regional industries remains above its level a year ago. With the exception of construction, mining and information, all private industries in Texas have already exceeded their previous peak employment levels.

Improving labor market conditions sparked investors' concern that the Federal Reserve might start tightening monetary policy sooner than anticipated. In July, the Fed continued to scale back its asset purchase program, reducing the total amount by another $10 billion Recent employment gains and sluggish expansion of national output are depressing productivity growth, which usually stokes inflationary pressures. Consumer prices have already been creeping upward since the start of the year, and core consumer inflation came within a whisker of the Fed's implicit inflation target of 2%. This means that the likelihood of further monetary tightening and consequently – higher borrowing costs –remains relatively high. On the upside, the labor market recovery appears to be putting the housing market on more sustainable footing. Thus, in June nationwide sales of existing homes surpassed 5 million units for the first time since October 2013, while housing demand in Texas may have already bounced back to where it was before the start of the housing crisis.

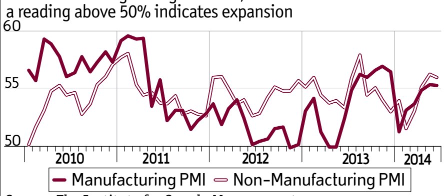
Investor Relations: Joshua Ballard
(E) jballard@sigmableyzer.com

Chief Economist Edilberto L. Segura
Editor Rina Bleyzer O'Malley

August 2014

Economic output

1. Business in manufacturing and services activity remains strong
PMI – Purchasing Managers Index,
a reading above 50% indicates expansion

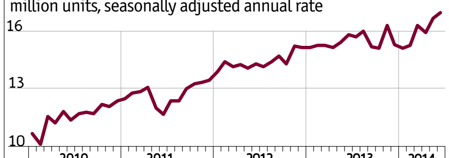


Source: The Institute for Supply Management

The national economy grew stronger in the second quarter of 2014. Despite the fact that readings on business activity in manufacturing and services edged down somewhat in June, they remained well above where they were at the start of the year (see chart 1). Meanwhile, consumer and business confidence continued to hover at their highest levels since the start of the recession, which is a clear sign that the ongoing economic expansion is becoming more self-sustaining. After all, recent solid job gains are boosting household consumption, which is prompting businesses to expand production and increase capital spending. For instance, in June retail sales were up by 4.5% versus the same month a year ago thanks to strong car sales. Indeed, car sales hit nearly 17 million units in June (see chart 2) – their best reading since the start of 2006. Increasing consumer borrowing can partly explain this trend – in May, nonrevolving consumer credit (which mostly includes car loans) grew at a seasonally adjusted annual rate of 9.3%. More importantly, new jobs in the private sector are adding to consumers' buying power – in May, total wages and salaries paid by the private businesses were up by 4.3% versus the same month a year ago, which helped push personal income by 3.5% versus May 2013.

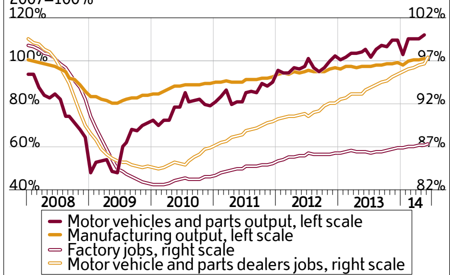
A revival of the U.S. automobile industry is powering a recovery in factory employment and manufacturing activity

2. Automobile sales
million units, seasonally adjusted annual rate



Source: The Federal Reserve Bank of St. Louise

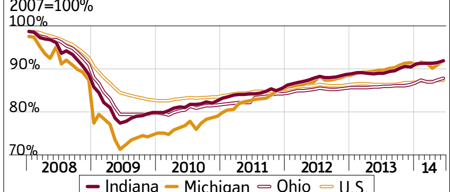
3. Manufacturing production and factory jobs
2007=100%



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

(see chart 3). And since automakers indirectly support many other jobs, for example, employment at motor vehicle and parts dealers, the industry has a big impact on the overall economy; according to the Alliance of Automobile Manufacturers, there are about 5 million jobs in auto manufacturers, suppliers, dealers, and aftermarket and repair services or 4% of the total private sector employment. This impact is particularly clear in the states where carmakers account for a big chunk of overall employment. Thus, manufacturing employment in Michigan, Indiana and Ohio – states that provide about a third of the U.S. auto jobs – seems to be recovering faster versus the nation as a whole (see chart 4).

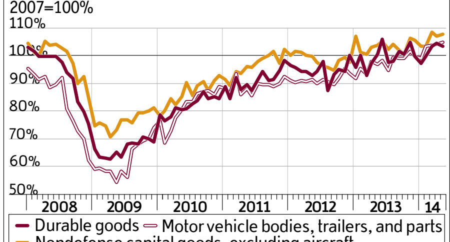
4. Manufacturing jobs in car making states
2007=100%



Source: The U.S. Bureau of Labor Statistics

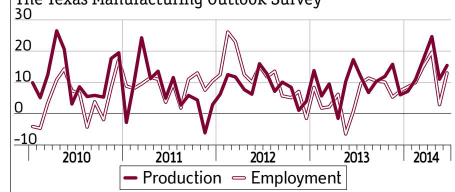
Meanwhile, orders of durable goods in manufacturing remained above precrisis levels in May, thanks to improving business spending on capital goods (see chart 5). In particular, new orders of construction and industrial machinery

5. New orders of durable goods
2007=100%



Source: The U.S. Census Bureau

6. Texas factory strengthened in June
Manufacturing Activity Indices,
The Texas Manufacturing Outlook Survey

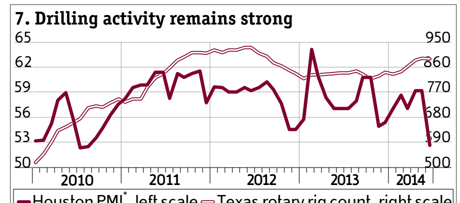


Source: The Federal Reserve Bank of Dallas

were 13% and 29% higher, respectively, than in May 2013. This higher demand for industrial equipment bodes well for Texas; machinery manufacturing accounts for about 9% of the total factory output in the Lone Star State versus just above 7% nationwide. Lastly, improving demand for semiconductors (according to the Semiconductor Industry Association, May global semiconductor sales rose by 2% versus the same month of 2013 on an 11% gain in America) is boosting business activity in Texas' high technology hubs, such as Austin and Dallas.

Texas factory activity strengthened in June following somewhat slower growth the month before, while a jump in hiring activity points to increasing manufacturing jobs (see chart 6). Meanwhile, the energy industry continued to expand; in June, the Texas rotary rig count remained at its highest level in nearly two years (see chart 7). At the same time, a drop in the Texas Purchasing Managers Index to 52.7 may be partly attributed to falling production in the Texas refining industry. Indeed, power outages and refinery maintenance reduced the utilization of refinery operable capacity in the Gulf Coast to about 84% in the first half of June versus nearly 90% on average during the first five months of 2014. This means that a return of refinery output to more normal levels should contribute to the metro economic expansion in the coming months.

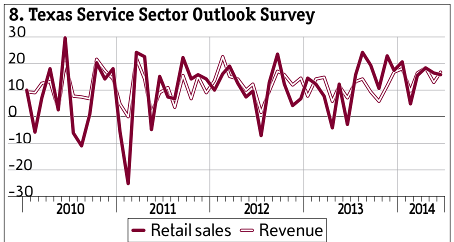
7. Drilling activity remains strong



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

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 6213111 Fax: +1 (713) 6214666
Email: sbleyzer@sigmableyzer.com

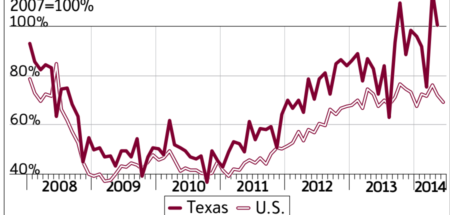
8. Texas Service Sector Outlook Survey



Source: The Federal Reserve Bank of Dallas

Texas manufacturing aside, the regional service-providing industries remain in a positive mood as well – current indices for revenue and retail trade point to improving business activity in the service sector in June (see chart 8). In addition, the Texas homebuilding activity is approaching its precrisis levels, whereas nationwide the number of newly issued building permits is still a third below where it was seven years ago (see chart 9). Having said that, higher borrowing

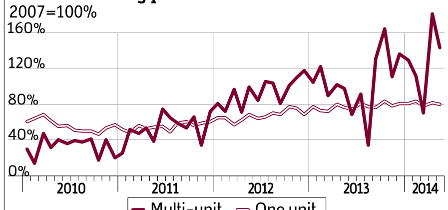
9. New housing units authorized by building permits
2007=100%



Source: The Federal Reserve Bank of St. Louise

costs may be beginning to put pressure on the U.S. construction industry; June saw the third consecutive monthly drop of housing starts to their lowest level in nine months. In particular, this 9.2% monthly drop was triggered by a nearly 50% reduction of the monthly housing starts of homes with more than one unit in the South region (which includes Texas and Florida). This, however, may be partly attributed to the rapid expansion of the multi-unit residential housing sector (see chart 10), which may have led to a shortage of construction lots and construction workers. For example, in January-May 2014, the monthly

10. New building permits in Texas
2007=100%

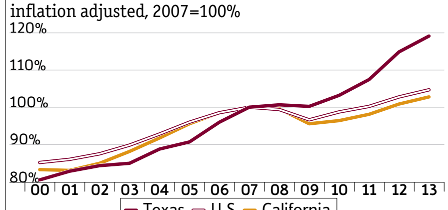


Source: The Federal Reserve Bank of St. Louise

number of new construction permits for multi-unit structures in Dallas and Houston was 90% and 38% higher on average than a year ago as well as 83% and 19% higher than during the first five months of 2007. These trends stand in sharp contrast to the nation as a whole, as the average monthly number of new building permits with more than one unit issued nationwide was just 9% higher in the first five months of this year compared to the same period a year ago, and still 4% below the same five months of 2007.

Lastly, Texas continues to maintain its leading position as one of the most business-friendly and regulation-lite states in the nation. For example, a recent study of Small Business Friendliness by Thumbtack and the Kauffman Foundation assigned an A+ to the quality of the business climate in the Lone Star State. The same high grade was earned by just three other states – Idaho, Virginia and Utah. Meanwhile, other big states, such as California, New York and Florida got an F, a D+ and a C+, respectively. In addition, according to CNBC, Texas is the second best state (after Georgia) for business in 2014. According to the CNBC study, Texas has been either the first or the second best location for doing business over the past decade. Thus, it comes as no surprise that the regional economy has been expanding at a faster pace versus the nation as a whole. According to recently released data on the state-level GDP, the economy of Texas is now about 20% larger compared to the start of the recession in 2007. Nationwide, the economy grew by less than 5% over the past six years (see chart 11).

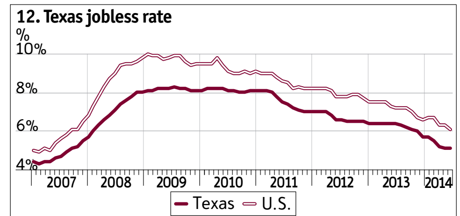
11. State Gross Product
inflation adjusted, 2007=100%



Source: The U.S. Bureau of Economic Analysis

Employment

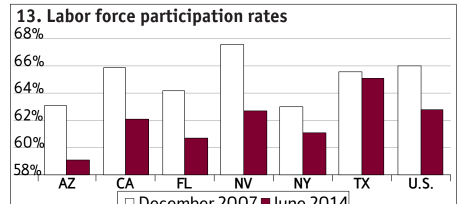
12. Texas jobless rate



Source: The U.S. Bureau of Labor Statistics

National nonfarm employment increased by 288 thousand jobs in June, which puts the total number of new jobs created in the first half of 2014 at nearly 1.4 million or 13% higher than a year ago. During the second quarter alone, over 800 thousand new jobs were created – up by 35% versus the same quarter of 2013. As a result, the national jobless rate dropped to 6.1%, its lowest reading since September 2008. Meanwhile, the unemployment rate in Texas remained at 5.1% (see chart 12). Having said that, a recent drop in the national jobless rate may not paint a complete picture of the health of the U.S. labor market. Unlike Texas, where the regional labor force grew by 1.3% during the last twelve months, the U.S. labor force declined slightly compared to June 2013. The national labor force participation rate remained at a record low level of 62.8%. In June, the labor force participation rate in Texas was just marginally below its level a year ago. Demographic trends, such as an aging population and retiring baby boomers, only partly explain this divergence between Texas and other states. A protracted and slow economic recovery may have done irreversible damage to many big regional labor markets (especially those that excessively relied on the construction and financial industries). Indeed, the labor force participation rates are currently much lower in states such as Arizona, Nevada and Florida than at the end of 2007 (see chart 13). For those states, as well as for

13. Labor force participation rates



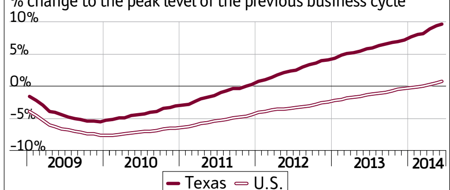
Source: Source: The U.S. Bureau of Labor Statistics

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 6213111 Fax: +1 (713) 6214666
Email: sbleyzer@sigmableyzer.com

the nation as a whole, a shrinking labor force may represent a large challenge to a sustainable economic expansion in the future.

Similar to the nation as a whole, the first half of this year ended with the biggest number of new jobs created in Texas since the start of the economic recovery. In particular, in January-June, about 225 thousand new jobs were added in Texas – up by almost 50% compared to the same two quarters a year ago. More importantly, Texas had 3.6% more private sector jobs in June 2014 than in June 2013, whereas nationwide private sector employment was up by only 2.1%. Thus, there are already nearly 10% more private sector jobs in the Lone Star State compared to the peak employment level of the previous business cycle. For the nation as a whole this gain is just approaching 1% (see chart 14).

14. Private sector jobs
% change to the peak level of the previous business cycle

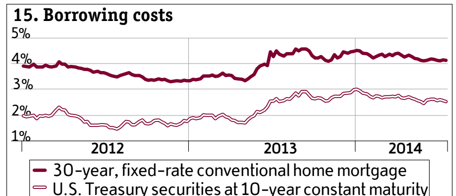


Source: The U.S. Bureau of Labor Statistics

Turning back to Texas, June saw the weakest gain in private sector employment in the second quarter of 2014 – private payroll grew by just about 13 thousand jobs versus 57 thousand jobs on average in April and May. Texas lost jobs in goods producing industries as slower creation of new jobs in mining and manufacturing was not enough to offset layoffs in the construction industry. Meanwhile, job creation in service providing sectors decelerated to just 15 thousand in June from over 40 thousand a month in the previous two months. This was mainly driven by virtually no job growth in healthcare and a sharp slowdown of hiring in trade. In addition, several service industries lost jobs in June, contributing to the overall moderation of job creation in Texas. In particular, the information sector, leisure and hospitality and other service industries reported big job cuts in June from the month before. On the upside, employment in all major industries remains above its level a year ago. Moreover, with the exception of construction, mining and information, all private industries of Texas have already exceeded their peak employment levels of the previous business cycle. However, even considering that Texas still has to regain lost construction and factory jobs, the state's labor market is performing considerably better than the nation as a whole. Thus, Texas has about 7% and 6% fewer jobs in construction and manufacturing than seven years ago compared to losses of 22% in construction and 13.5% in factory jobs nationwide.

Monetary Policy and Asset Prices

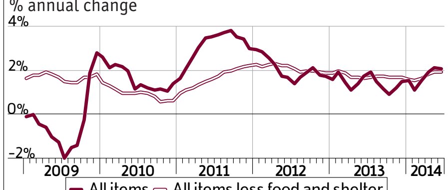
15. Borrowing costs



Source: The Federal Reserve

Improving labor market conditions sparked investors' concern that the Federal Reserve might start tightening its monetary policy sooner than anticipated. The Fed continued to scale back its asset purchase program – by another $10 billion in July – which kept borrowing costs a full percentage point above last year's level (see chart 15). Recent strong employment gains and sluggish expansion of the national output (in the first quarter of 2014, the U.S. economy shrank at an annual rate of 2.9%) imply that productivity growth is slowing, but is still stoking inflationary pressures. Indeed, consumer prices have been creeping upward since the start of the year (see chart 16), although they have recently stabilized thanks to slower growth of the cost of food and

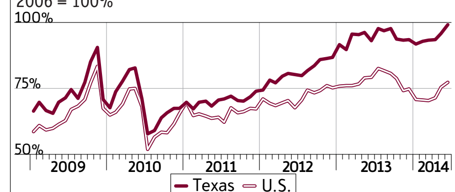
16. Consumer prices
% annual change



Source: The U.S. Bureau of Labor Statistics

moderation of the growth of service prices. Having said that, the growth rate of the core consumer price index, which ignores changes of more volatile prices of food and energy, came within a whisker of the Fed's implicit inflation target of 2%. Thus, the likelihood of further monetary tightening remains relatively high. On the upside, the housing market appears to be shrugging off the impact of higher borrowing costs and dearer homes as stronger labor markets are putting the housing recovery on a more sustainable footing (see chart 17). According to the National Association of Realtors, sales of existing homes surpassed 5 million units in June for the first time since October 2013, while data from the Real Estate Center at the Texas A&M University indicates that the regional housing activity may have already bounced back to where it was before the housing crisis.

17. Existing home sales
2006 = 100%



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

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 6213111 Fax: +1 (713) 6214666
Email: sbleyzer@sigmableyzer.com