Texas Economic Update

SigmaBleyzer

THE BLEYZER FOUNDATION

September 2010

- **During the first eight months of 2010, the Texas private sector created 155,000 new jobs.**
- **Texas exports grew by 29% on stronger overseas shipments of durable goods and chemical products.**
- **The Houston Purchasing Managers Index improved by 1.1 percentage points in September, pointing to continued manufacturing recovery in Texas.**
- **On October 12th, the federal government lifted its ban on deepwater drilling.**

Executive summary

Economic recovery appears to be stabilizing in Texas. In particular, manufacturing saw a slight improvement, with the Dallas Fed production index moving back into positive territory. The Houston Purchasing Managers Index grew as well, pointing to continued growth in factory activity. In addition, the federal government has lifted its moratorium on deepwater drilling, which should help the Texas energy industry.

Texas manufacturing, which depends less on the construction industry and household spending on durable goods than other parts of the country, has already returned to its pre-crisis output level. However, total U.S. industrial production is still nearly 7% lower than before the 2007 recession. Manufacturing in Texas was more resilient to the economic downturn thanks to a strong rebound in exports and a resilient petrochemical industry. Indeed, the petrochemical industry, which accounts for a large portion of nondurable goods manufacturing in Texas, held up relatively well thanks to cheap input costs. Meanwhile, the manufacturing of durable goods was supported by the return of overseas demand for capital goods, especially from large emerging economies.

Despite a marginally higher unemployment rate in August, due to continued layoffs of the 2010 Census workers, Texas still has more jobs than a year ago. Total job loss since peak employment in Texas was half that of the U.S. as a whole. Improved hiring by the private sector is central to the labor market recovery. Since the beginning of the year, 155,000 new private sector jobs were added in Texas, mostly thanks to stronger growth in the local private sector compared to the nation as a whole. Equally important, jobs in Texas' professional and business services sector are growing faster than total nonfarm employment. This sector is the top performer in terms of job creation, and pays 25% more on average than other private sector jobs. Clearly, the creation of more high paying jobs in Texas should add to the strength of the overall economic recovery within the state.

That said, high unemployment and weak housing markets remain key threats to U.S. economic recovery overall. This means that the Federal Reserve is increasingly likely to resume buying Treasury securities, especially considering the disappointing September jobs report. Although this new round of quantitative easing is likely to boost growth in the near-term, its impact on long-term macroeconomic performance is less certain. Indeed, thus far, low interest rates have failed to rekindle bank lending. The latest massive foreclosure freezes threaten to undermine bank earnings and halt the nascent recovery in the housing market.

Still, by pumping more liquidity into the market, the Fed should raise inflation expectations, which will prevent the U.S. economy from plunging into a Japan-style slump. And a weaker U.S. dollar, as a response to a prolonged period of low interest rates, should help sustain the export-led recovery.

As the largest exporting state, Texas benefits more from a recovery in exports than the rest of the country. Texas exports are booming on a robust resumption of demand from NAFTA partners, as well as increasing shipments to large emerging economies. The composition of Texas exports, which are dominated by machinery and petrochemical products, helps sustain the economy thanks to a competitive petrochemical industry and increasing overseas demand for capital goods.

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Economic output

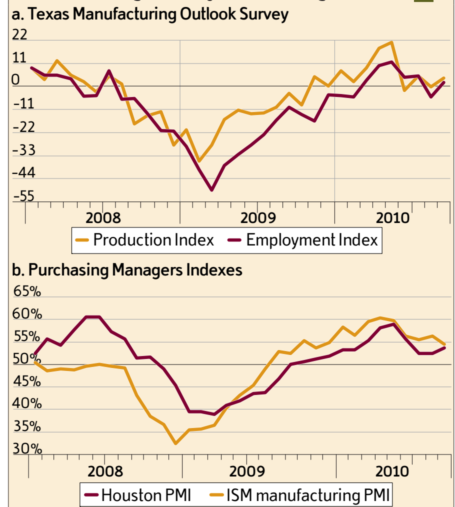
Texas manufacturing saw a slight improvement in September, with the production index, a key measure of state manufacturing conditions, moving back into positive territory (see chart 1a).[1] That said, the overall economic picture was still mixed, with better factory activity indicators in September, but a continued worsening of general business activity. On the upside, business expectations remained upbeat as most indicators relating to economic activity and outlook six months ahead posted solid gains in September versus August.

The Houston Purchasing Managers Index improved by 1.1 percentage points in September, pointing to continued manufacturing recovery in Texas (see chart 1b). In addition, on October 12th, the federal government lifted its ban on deepwater drilling. This should provide a boost to Texas-based drilling contractors as deepwater drilling should resume by the end of this year (provided that new permits are approved). However, compliance with new rules will be more expensive and time-consuming. Indeed, according to the Interior Department, new requirements will increase the cost of a deepwater well by about 2% (or $1.42 million on average). While the lifting of the deepwater moratorium makes the future of the Texas energy industry brighter, its near-term impact is likely to remain muted as companies take time to adjust to the new permitting process.

The nation still faces substantial economic hurdles that are slowing the pace of recovery. High unemployment and weak housing markets continue to undermine consumer confidence (see chart 2). According to the latest CEO Survey by the Business Roundtable, companies are becoming less optimistic about the future growth of sales (which leads to delays in hiring and investment spending). Heightened regulatory risk relating to future taxes and business costs are not helping either. Indeed, notwithstanding the ample liquidity in the financial and non-financial sectors[2], and record low interest rates, the private sector has been very slow to create new jobs. In fact, according to the payroll processor ADP, private employment fell by 39,000 jobs in September on continued layoffs in construction and a resumption of job losses in manufacturing.

Manufacturing and construction suffered particularly hard during the 2007-2009 economic downturn. These two sectors account for roughly one seventh of the U.S. economy and nonfarm employment; however, they have absorbed over half of all job losses since the beginning of the recession. Meanwhile, the inventory cycle, which supported a strong turnaround in U.S. manufacturing at the end of 2009, has been losing steam. Since inventories and sales tend to grow at a relatively similar pace when the economy stabilizes (see chart 3), future production will become more responsive to the strength of domestic demand. This means weak personal consumption (especially consumption of durable goods, see chart 4) will create headwinds for U.S. manufacturing, which is likely to grow more slowly as production adjusts to lower levels of inventories and sales.[3]

Manufacturing recovery is stabilizing 1

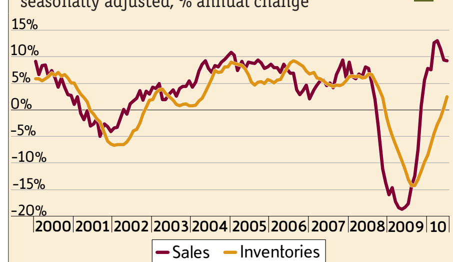


Source: The Federal Reserve Bank of Dallas, The Institute for Supply Management

Consumers remain worried about the economy 2
Consumer Sentiment Index

Source: University of Michigan

Sales and inventories tend to grow in tandem 3
seasonally adjusted, % annual change



Source: The U.S. Census Bureau

[1]Source: The Texas Manufacturing Outlook Survey by the Federal Reserve Bank of Dallas.

[2]According to the Federal Reserve, in the second quarter of 2010, U.S. nonfinancial companies held more than $1.8 trillion in liquid assets or 18% more than a year ago. Meanwhile, commercial banks' reserves at the Federal Reserve stood at nearly $900 billion or 50% more than in the second quarter of 2009.

[3]Inventories may still grow faster than sales for a while thanks to falling real costs of holding inventories. For example, in September, the interest rates on nonfinancial commercial paper (which usually funds current assets such as receivables and inventories) were below 0.25% compared to over 2% two years ago. Meanwhile, prices of finished goods are growing again (up by 1.3% during the first 8 months of this year), which is an additional incentive for producers to hold more inventory.

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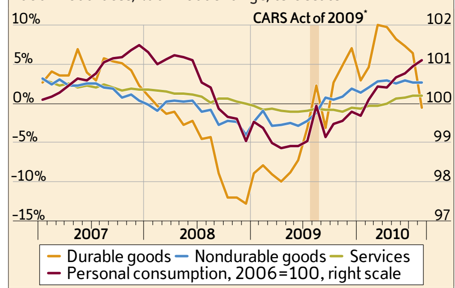
Texas manufacturing, which depends less on the construction industry and household spending on durable goods than other parts of the country, has already returned to pre-crisis output levels. In fact, the contrast between the nation as a whole and Texas in particular is striking - U.S. industrial production is still nearly 7% lower than before the 2007 recession (see chart 5). Meanwhile, manufacturing output in Texas is only 1% below its peak at the end of 2008 as production of durable goods declined by only 2%. U.S. manufacturing, however, is 9% lower compared to the beginning of the crisis, on a 10% decline in the production of durable goods.

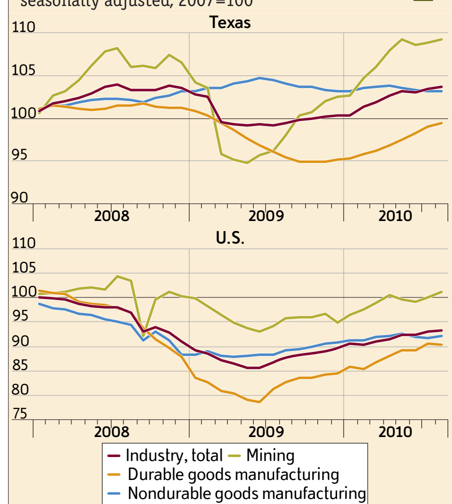
Manufacturing in Texas was more resilient to the latest economic downturn thanks to exports and a strong rebound in energy prices. In particular, the petrochemical industry, which accounts for a large portion of nondurable goods manufacturing, held up relatively well thanks to competitive input costs and relatively high crude oil prices. Manufacturing of durable goods was propped up by the return of overseas demand for capital goods, especially in key Texas export markets such as Mexico and China (see chart 6).

Consumers still shy away from big-ticket items...
chained (2005) dollars, seasonally adjusted at annual rates, % annual change, left scale 4



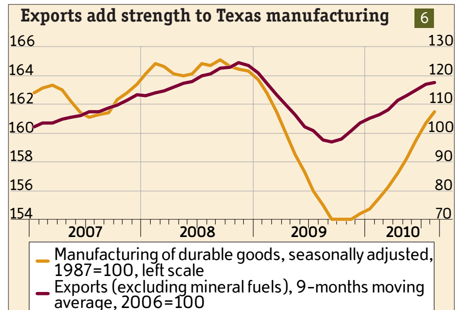
* CARS- Consumer Assistance to Recycle and Save Act (*cash for clunkers program*) authorized credit for trading in old vehicle and purchasing or leasing a new, more fuel-efficient vehicle. The credit amount was either $3,500 or $4,500, depending upon the amount of improved fuel efficiency.
Source: The Bureau of Economic Analysis

Texas manufacturing is more resilient
seasonally adjusted, 2007=100 5



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

Exports add strength to Texas manufacturing 6



Source: The U.S. Census Bureau

Employment

The Texas labor market continues to recover faster than the nation as a whole. Indeed, although nonfarm employment dropped by about 34,000 jobs in August, on continued layoffs of the 2010 Census workers, Texas had 1.3% more jobs than year ago (see chart 7). Because the economic slowdown started later in Texas, total job losses since peak employment (August 2008 in Texas) were only 2.7% compared to 5.5% nationwide. Furthermore, since the end of the 2007 recession (June 2009), Texas employment is up 0.7% while U.S. employment has declined by 0.3%.

Strong hiring by the private sector is central to the labor market recovery in Texas. Since the beginning of 2010, the private sector has created 155,000 new jobs in Texas, up by 1.8%.[4] A shift-share analysis, which identifies the sources of employment growth, implies that nearly 60% (or 92,500 jobs) related to this gain can be attributed to faster recovery by the Texas private sector.[5] Meanwhile, private sector employment is growing less quickly in other large states, for example, in California, Florida, New York and Pennsylvania (see chart 8).

Equally important, job growth in Texas appears to be broad-based with major sectors reporting annual gains since June (see chart 9). Indeed, a relatively larger share of jobs in mining helped delay the economic slowdown in Texas until August 2008. Robust growth in the export of capital goods supported a faster recovery of jobs in manufacturing. Meanwhile, relatively stable housing market conditions in Texas have shielded the state from the sizable job cuts experienced by other large states, which suffered most from the housing crisis. In particular, from December 2007 to August 2010, the construction industry in Nevada, Arizona, Florida, and California lost 53%, 46%, 37%, and 36.5% of all jobs, respectively. During the same period, Texas lost only 15% of all jobs in construction (the nation as whole saw employment in the construction industry fall by a quarter). Furthermore, in Texas, jobs in construction have grown each month since March 2010, which puts employment in this sector

[4]Nationwide, private sector employment grew by only 0.7%.
[5]This shift share analysis splits job gains into three components: (1) overall impact of the U.S. economic recovery on private sector employment, (2) the impact of faster job growth in the national private sector vs. the government, and (3) the impact of faster job growth in the Texas private sector vs. the U.S. private sector. For the January through August period, the U.S. economic recovery contributed about 30% to private sector job gains in Texas.

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2.7% higher than at the end of 2009 (nationwide, employment in construction declined by 1.2%). This is important, because a shrinking construction sector exerts a toll on regional economies by depressing business activities in trade, transportation and manufacturing. Furthermore, the scale of job losses in construction points to the excess capacity accumulated in this industry during the housing boom. This means it will take years for the hardest hit states to recover from the impact of the bursting of the housing bubble.

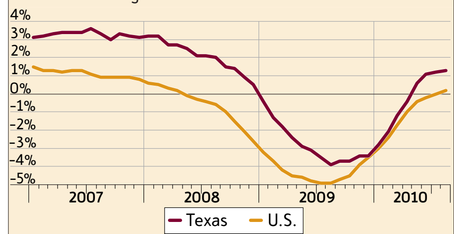
Lastly, high-wage service industries (such as professional and technical services) continue to create new jobs in Texas. In particular, in August, employment in professional and business service industries (about 12% of total nonfarm employment in the state) grew by 3.2% (the fourth consecutive annual gain). Nationwide, this sector has added only 2.1% more jobs over the past twelve months. This faster growth in Texas testifies to strong domestic and international competitiveness in engineering, scientific and technical services. Indeed, the professional and business service industry was the top performer in job growth in Texas and is leading the labor market recovery (see chart 10). In addition, wages in business and professional services are 25% higher on average than wages in the Texas private sector as a whole.[6] The creation of more high paying jobs in Texas should add to the strength of the overall economic recovery in the state.

Monetary policy and asset prices

The Federal Reserve is increasingly likely to resume buying Treasury securities following the disappointing September jobs report, which points to continued weakness in the U.S. economic recovery. The buying targets are expected to be announced following the policy meeting of the Federal Open Market Committee on November 3rd. Although this new round of quantitative easing is likely to boost growth in the near-term, its impact on long-term macroeconomic performance is less assured. Thus, in the short term, by signaling its commitment to support economic recovery, the Fed will boost investor sentiment, which drives up the value of riskier assets. A weaker U.S. dollar, as a response to a prolonged period of low interest rates, should help sustain the export-led recovery. Since a high unemployment rate and substantial excess capacity in the economy make near-term deflation risks more material than the threat of inflation (see chart 11), by pumping more liquidity into the market the Fed should be able to prevent the U.S. economy from plunging into a Japan-style slump.

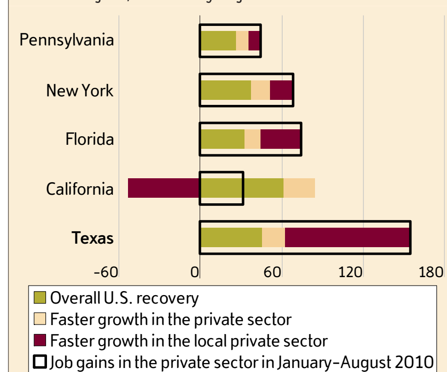
That said, the long-term implications of this quantitative easing are much more uncertain. In-

Texas created 130,000 new jobs from August 2009 to August 2010 7
non-farm employment, seasonally adjusted, % annual change



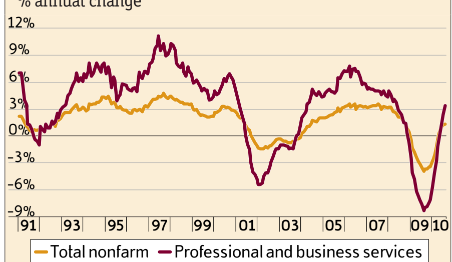
Source: The U.S. Bureau of Labor Statistics

Sources of the private sector job gains in 2010 8
thousand jobs, seasonally adjusted



Source: The U.S. Bureau of labor Statistics, The Bleyzer Foundation

Professional and business services are growing again 10
number of jobs, seasonally adjusted, % annual change



Source: The U.S. Bureau of labor Statistics

Consumer prices may be on a trend toward deflation 11
Consumer Price Index - all urban consumers, % annual change

Source: The U.S. Bureau of labor Statistics

Private sector creates more jobs in Texas 9
employment, seasonally adjusted, % change August 2010 vs. August 2009

	Texas	U.S.
Total nonfarm	**1.3%**	**0.2%**
Private	1.5%	0.3%
Mining and logging	11.8%	9.1%
Construction	-2.8%	-4.4%
Manufacturing	2.2%	-0.1%
Wholesale trade	-1.1%	0.0%
Retail trade	-0.4%	-0.3%
Transportation and utilities	0.6%	-0.3%
Information	-6.4%	-2.2%
Financial activities	0.7%	-1.5%
Professional and business services	3.4%	2.1%
Education	3.3%	1.8%
Healthcare and social assistance	4.4%	2.0%
Leisure and hospitality	1.4%	0.4%
Other services	0.2%	0.1%
Government	0.4%	-0.6%
State government	-1.3%	-0.5%
Local government	0.2%	-1.4%

Source: The U.S. Bureau of Labor Statistics

[6] According to The U.S. Bureau of Labor Statistics, in August 2010, the average weekly wage in professional and business services was $992.3, compared to an average weekly wage in the private sector of $788.2.

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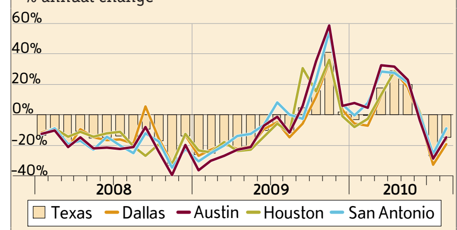
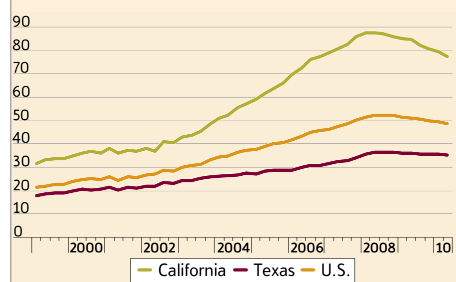
deed, thus far low interest rates have failed to rekindle bank lending. The latest massive foreclosure freezes threaten to undermine bank earnings and halt the nascent recovery in the housing market. Indeed, the question of the Fed's exit strategy remains very much open for debate. More importantly, although the Fed's policy is key to sustaining demand in the near-term, it does little to resolve structural economic problems throughout the U.S. economy. Facing the lack of a credible fiscal consolidation plan and heightened uncertainty about future tax policy, businesses will continue to postpone investment and hiring decisions. Meanwhile, the dysfunctional housing market may remain a big constraint to labor mobility, which elevates structural long-term unemployment.

Indeed, despite record low mortgage rates (4.43% in August compared to 5.19% a year ago, for a 30-year fixed rate mortgage) the latest report on existing home sales still points to a slow and gradual recovery. According to the National Association of Realtors, August existing home sales increased by 7.6% versus July; however, this was 19% below the 5.1 million units sold in August 2009. In Texas, existing home sales grew by 3.2% in August on rising sales in Austin, Dallas and San Antonio.[7] However, sales were down compared to August 2009, although the pace of decline decelerated slightly following a sharp drop of sales after the expiration of the government's first time home buyer credit (see chart 12).

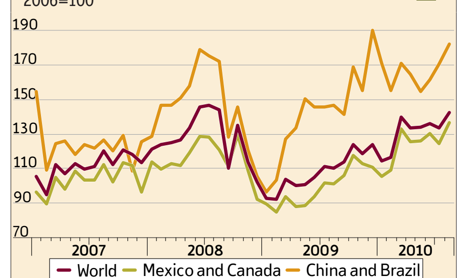
Lastly, the total debt balance per capita remains substantially lower in Texas compared to other states (see chart 13).[8] Furthermore, the ratio of debt to personal income grew from 72% in 2000 to 94% in 2009 in Texas; meanwhile, it nearly doubled in California - from 108.3% to 199%. This means that households in Texas are in a healthier financial position compared to other parts of the country, which should help stabilize the housing market faster.



Existing home sales in Texas
% annual change
Source: The Real Estate Center at Texas A&M University



Total debt balance per capita
thousand $
Source: The Federal Reserve Bank of New York



Texas exports to emerging markets are booming
2006=100
Source: The U.S. Department of Commerce

Foreign trade

During January-August, exports of goods from Texas grew by nearly 29% to $132 billion or 16% of total U.S. exports (versus 15.3% a year ago). An increasing share of national exports implies that the state is benefiting more from the export-led recovery compared to other large exporting US states. Indeed, exports from California, New York, Florida, Washington, and Illinois[9] increased by only 21%, 15%, 17.7%, 3.3%, and 18.3%, respectively, during this period. The data suggests that Texas exports are booming on the back of robust demand from the state's NAFTA partners (Mexico and Canada account for 44% of all exports from Texas) as well as increasing shipments to large emerging economies in Asia and Latin America (see chart 14).

The composition of Texas exports helps explain this stronger rebound in export activity. First, exports of mineral fuels, which represent only 17% of all exports, increased by 58%, on higher energy prices. Second, exports of machinery and transportation equipment (about 43% of all exports) jumped by 22% thanks to increasing overseas demand for capital goods. Finally, exports of chemical products (over one fifth of all exports) grew by nearly one third.

[7] Source: The Real Estate Center at Texas A&M University.
[8] According to the Federal Reserve Bank of New York, mortgages account for only 68% of the total debt balance in Texas compared to 81% in California and 74% nationwide.
[9] These six states (including Texas) generate 45% of all U.S. exports.

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Private equity news

- **G.E.** will buy **Dresser**, a Texas-based privately held energy infrastructure company, for $3 billion. Dresser is majority-owned by funds managed by **Riverstone Holdings** and **First Reserve Corporatio**n.
- **TPG Capital** (formerly known as Texas Pacific Group), a global private investment firm, has formed a new venture, **Petro Harvester Oil & Gas, LLC**, to invest in oil and gas production in North America.
- **New Century Hospice**, a provider of hospice care to patients in nine centers located in Texas, has closed $20M in Series A financing, led by **Scale Venture Partners** and **Petra Capital Partners**. This new financing will be used for an expansion in Texas and neighboring Southern states.
- **IDEV Technologies, Inc.**, a Texas-based developer and provider of minimally invasive medical technologies, has completed a $46m Series D round of financing. Investors included **Piper Jaffray & Co.'s Merchant Banking Fund**, **PJC Capital LLC**, and a strategic global healthcare company.
- The O**nduline Group**, backed by French private equity firms **Astorg Partners** and **Abenex**, has bought **Tallant**, a lightweight roofing company based in Texas.

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Texas Economic Update

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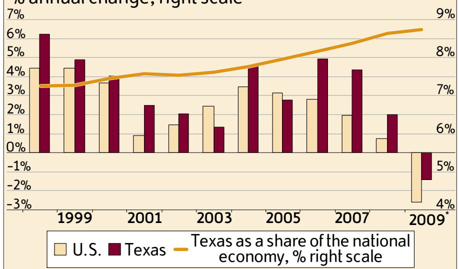
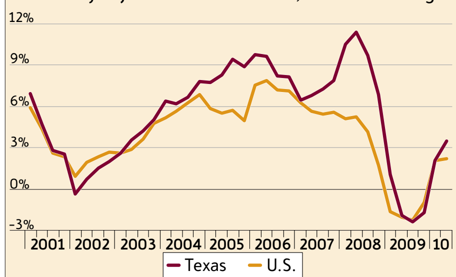
Economic growth: Texas vs. U.S.
% annual change, right scale



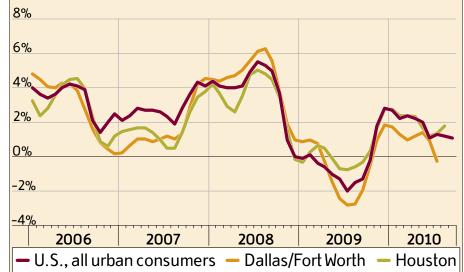
*Estimates by the Texas Controller of Public Accounts
Source: The U.S. Bureau of Economic Analysis, Texas Controller of Public Accounts

Personal income
seasonally adjusted at annual rates, % annual change



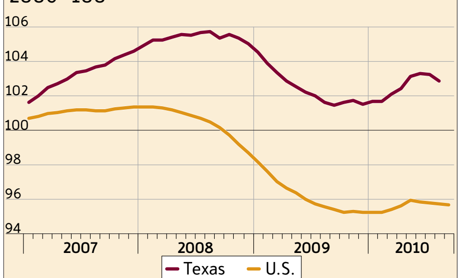
Source: The U.S. Bureau of Labor Statistics

Consumer prices
% annual change



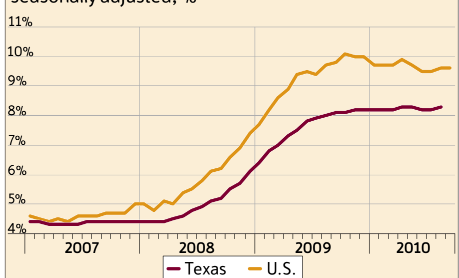
Source: The U.S. Bureau of Labor Statistics, The Federal Reserve Bank of Dallas

Nonfarm employment
2006=100



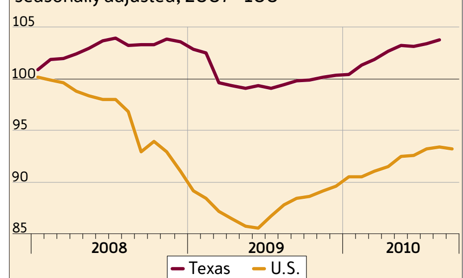
Source: The U.S. Bureau of Labor Statistics

Unemployment rates
seasonally adjusted, %



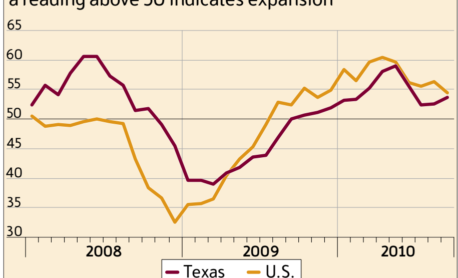
Source: The U.S. Bureau of Labor Statistics

Industrial production
seasonally adjusted, 2007=100



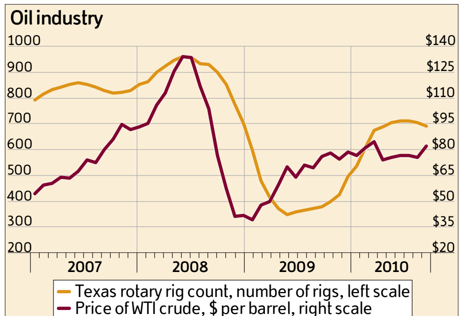
Source: The Federal Reserve, The Federal Reserve Bank of Dallas

Purchasing Managers Index
a reading above 50 indicates expansion



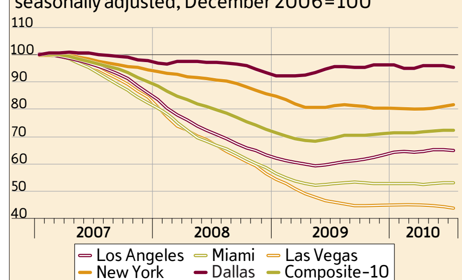
Source: The Institute for Supply Management

Oil industry



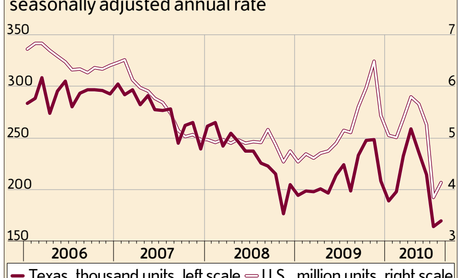
Source: The Federal Reserve Bank of Dallas

Home values
seasonally adjusted, December 2006=100



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

Home sales
seasonally adjusted annual rate

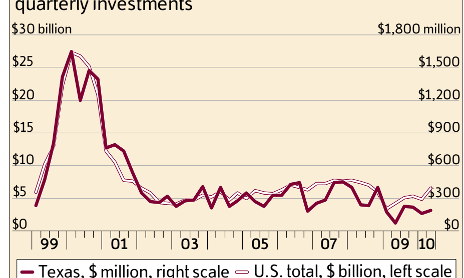


Source: The National Association of Realtors, The Real Estate Center at Texas A&M University

Exports
2006=100

Source: The U.S. Department of Commerce

Venture capital investment activity in the United States
quarterly investments



Source: PricewaterhouseCoopers

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Where Opportunities Emerge