SigmaBleyzer

Texas Economic Update

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

January 2011

- **The U.S. economy grew by 2.9% in 2010.**
- **The Texas Manufacturing Survey production index was flat in January 2011.**
- **In December 2010, the state's jobless rate was at 8.3% versus 9.4% nationwide. Last year, Texas added 2.7% new private jobs versus only 1% nationwide.**
- **Recommended state budget cuts for 2012-2013 may be as much as 16% in Texas.**

Executive summary

Factory activity was flat in January as the Texas Manufacturing Survey production index settled at zero. However, other indicators, including capacity utilization, shipments and new orders, remained in positive territory and continue to point towards growth. The employment index was above zero for the third straight month, indicating continued improvement in the Texas labor market. Finally, all future activity indices registered far better readings than at the beginning of 2010 as Texas businesses continue their upbeat mood.

Economic activity appears to be recovering in the largest Texas metros. For example, the Houston Purchasing Managers Index rose in December, as the local economy shrugged off its mid-year slowdown. The Dallas, Austin and San Antonio metros also appear to be turning the corner. Indeed, the outlook remains bright as favorable economic trends persist. In particular, increasing crude oil prices add support to the state's mining and chemical industries. Unlike crude oil prices, natural gas prices are still where they were during the economic downturn. This makes the chemical industry, one of the key components of the state's manufacturing base, more competitive versus its peers in Europe and Asia.

At the national level, recent indicators of economic activity have been comforting. U.S. economic recovery accelerated in the last quarter of 2010. In January, economic activity in the manufacturing sector grew for the 18th consecutive month and the broader economy expanded for the 20th straight month. In particular, the Manufacturing Purchasing Managers Index hit its highest reading in six years on strong new orders, growing exports and continued stockbuilding. The service-providing part of the economy remains in an expansionary mode as well. This stronger economic growth bodes well for Texas manufacturers, who will gain from the recovery in total business spending. In addition, the Texas housing market suffered less compared to other worse-hit states and homebuilders remain more confident about the Texas housing industry, which should benefit from relatively stable market conditions in 2011.

A milder downturn in construction is one of the reasons why Texas has a lower unemployment rate than the nation as a whole. In December, the state's jobless rate was at 8.3% versus 9.4% nationwide. All major Texas industries posted job gains in 2010, with most new jobs coming from service-providing sectors. This compares exceptionally well with the nation as a whole, which continued to lose construction jobs and achieved more modest results in manufacturing and services. In fact, faster job growth in Texas reflects aggressive 'insourcing' by the U.S. corporate sector, which increasingly finds Texas a great place to do business.

Lastly, Texas was not immune to the recession-driven decline of tax collections faced by many other states. As a result, sizable budgetary reductions are on the agenda. While the state has a big rainy day fund, and the Texas political system usually leans towards fiscal and social conservatism, clearly hard decisions lie ahead for the Governor and Texas legislature.

Investor Relations: Marc Sharpe

Where Opportunities Emerge.

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Economic output

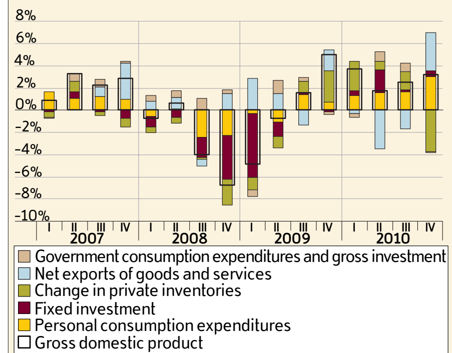
The U.S. economic recovery accelerated in the last quarter of 2010, with GDP expanding at an annualized rate of 3.2% versus 2.6% the quarter before. In particular, robust demand from domestic and foreign consumers continued to support the national economy. However, a major drag came from inventories, which subtracted 3.7 percentage points from GDP growth (see chart 1). Still, this also coincides with a sharp fall in imports, which declined at an annualized rate of 13.6% in the last quarter of 2010. Indeed, companies appear to have sped up inventory restocking, which tends to be relatively import-intensive, prior to the holiday season, and thus may have felt less pressure to increase stocks in the last quarter. This means current year inventory restocking may add less to economic growth as it will be partly offset by increasing imports.

Recent economic activity indicators have been quite comforting. In particular, in January, economic activity in the U.S. manufacturing sector grew for the 18th consecutive month (and the broader economy expanded for the 20th straight month).[1] The Manufacturing Purchasing Managers Index (PMI) hit its highest reading in six years on strong new orders, growing exports and continued stockbuilding. The service-providing part of the economy grew faster in January as well, with non-manufacturing PMI indicating expansion for the 18th consecutive month. A similar trend was observed for the Houston economy, which signals continued momentum into 2011. The Houston PMI rose to 57.6% in December (see chart 2), as the local economy shrugged off a mid-year slowdown. This means the Houston economy has been in an expansionary mode for the last 16 months.

According to the Texas Manufacturing Activity Survey, factory activity stood flat in January as the production index fell to zero (see chart 3). Still, other indicators (such as capacity utilization, shipments and new orders) remained positive, which points to growth, albeit at a slower rate. Equally important, the employment index was in positive territory for the third straight month, indicating continued improvement in the Texas labor market. Finally, all future activity indices improved in January, registering far better readings than at the beginning of 2010 (see chart 4). Texas businesses are clearly in a more upbeat mood, which should support continued economic recovery in 2011.

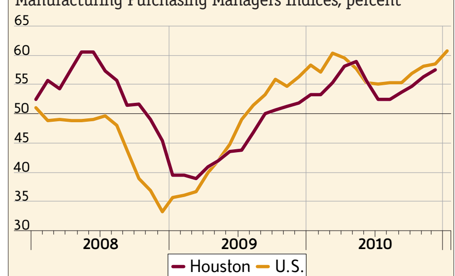
Improving economic activity in the biggest metros helped push the Texas Leading Index back to where it was in September 2008 – up by 8% compared to 2009 (see chart 5). At the end of 2010, the Houston Business-Cycle Index hit its highest level on record. Dallas, Austin and San Antonio are also turning the corner (see chart 6). Indeed, the economic trends that helped Texas pull out of the recession in 2010 appear to be carrying the state forward this year as well. First, the energy sector, boosted by surging crude oil prices, continues

Contributions to GDP growth 1
percentage points, seasonally adjusted annualized rates



Source: The Bureau of Economic Analysis

Texas manufacturing remains on an uptrend 2
Manufacturing Purchasing Managers Indices, percent*

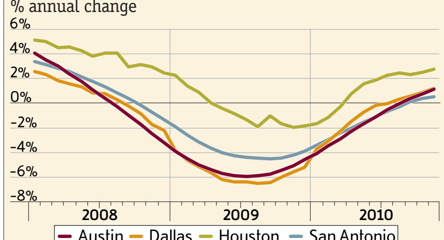


**A reading above 50% indicates expansion*
Source: The Institute for Supply Management, Greater Houston Partnership

Factory activity held steady in January 3

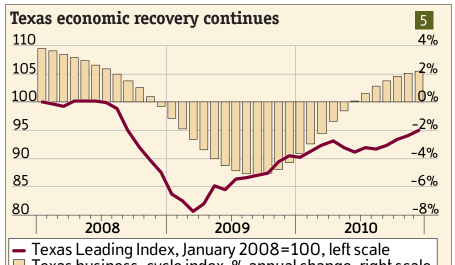
Source: The Federal Reserve Bank of Dallas

Metro Business-Cycle Indices 6
% annual change



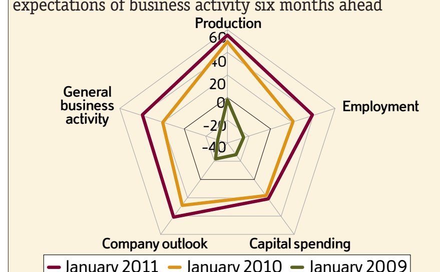
These four metros represent about 80% of the Texas economy.
Source: The Federal Reserve Bank of Dallas

Texas economic recovery continues 5



Source: The Federal Reserve Bank of Dallas

Business expectations are improving 4
expectations of business activity six months ahead



Source: The Federal Reserve Bank of Dallas

[1]Source: January 2011 Manufacturing ISM Report On Business

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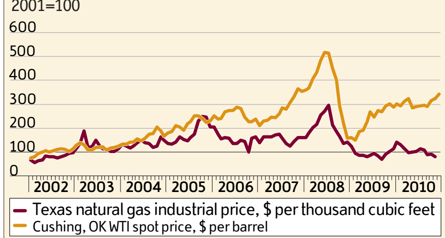
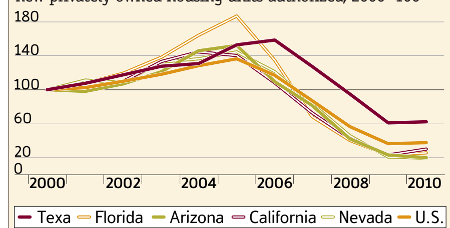
to support the state's mining and chemical industries. The mining industry accounts for a relatively large chunk of the Texas economy – about 2% of total nonfarm employment and over 7.5% of output. Thanks to robust demand for energy from emerging markets, as well as continued improvements in the U.S. economy (which is the world largest consumer of crude oil), the outlook for the Texas mining industry remains favorable. In addition, dearer petroleum prices bode well for the state's chemical industry, which uses natural gas as a feedstock.[2] Unlike crude oil prices, natural gas prices are still where they were during the economic downturn (see chart 7). This makes Texas' chemical industry more competitive versus its peers in Europe and Asia. According to the American Chemistry Council, every chemical industry job creates 5.3 more jobs in Texas, while the average wage in the chemical industry is nearly 50% higher than the average wage in manufacturing. In December, the Texas rig count was 60% higher than a year ago.

Petroleum and natural gas prices continue to diverge 7
2001=100



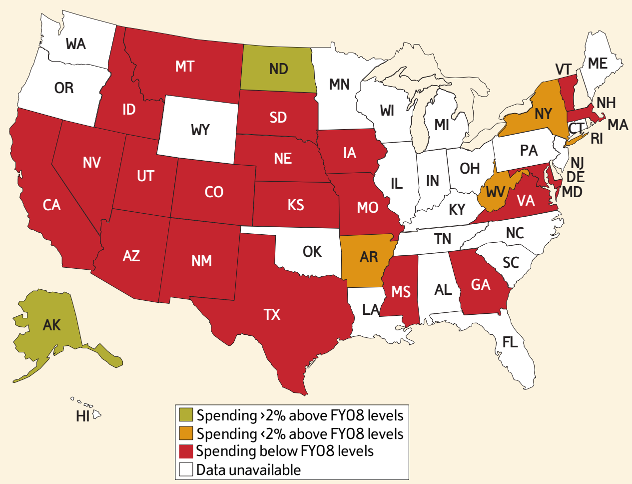
Source: The U.S. Energy Information Administration

Housing market continues to struggle 8
new privately owned housing units authorized, 2000=100



Source: The U.S. Census Bureau

State governments are cutting spending 9
proposed fiscal year 2012 spending versus 2008 levels



Source: Center on Budget and Policy Priorities

Texas enjoys strong overseas demand for capital goods, with Latin America and Asia emerging as important export markets for the state. The large Texas metros, including Austin, Dallas and Houston, have already established themselves as diverse manufacturing hubs producing a wide range of products – from computers and high tech equipment to industrial machinery. These metro economies will continue to benefit from increasing global investment in infrastructure and mining. In addition, a gradual recovery of business spending in the U.S. bodes well for Texas manufacturers. According to the Census Bureau, shipments of computers and machinery were up by 18.5% and 8.1% in 2010. This trend is likely to persist this year, as businesses continue to invest in productivity boosting technology.

The Texas housing market suffered less compared to other, worse-hit states. For example, despite the first time home buyer credit, last year many states issued just a fraction of the number of building permits authorized at the peak of the housing bubble in 2005. Indeed, residential housing activity in the Sand States (California, Florida, Arizona, and Nevada) is just a fifth or a quarter of what it was ten years ago. Meanwhile, residential housing activity fell by only about 40% in Texas (see chart 8). This means homebuilders remain more confident about the Texas housing industry, which should remain relatively stable in 2011.

Lastly, state governments are facing spending cuts as tax collections remain below pre-recession levels. Over the past few years, many states introduced cuts to major public services, including health care, services to the elderly and disabled, and education. However, as Recovery Act funds are expected to be mostly depleted by fiscal year 2012[3], more cuts to state budgets are increasingly likely (see chart 9). At the same time, demographic and economic pressures will persist, which continues to add to the cost of public service provision. In addition, U.S. public pension funds have accumulated substantial unfunded liabilities, which may force states to pursue even deeper spending cuts[4]. This fiscal tightening risks exerting a considerable toll on the pace of economic recovery.

[2]According to the U.S. Energy Information Administration, Texas accounts for about 15% of all natural gas consumed in the U.S. At the same time, it accounts for about a fifth of the nationwide industrial consumption of natural gas.

[3]According to the Center on Budget and Policy Priorities, in FY2012 states will receive only $6 billion in federal aid - down from $59 billion in FY2011 and $68 billion in FY2010.

[4]For example, according to the former chairman of New Jersey's pension fund, this shortfall for the top 25 public pension funds may amount to $2.5 trillion.

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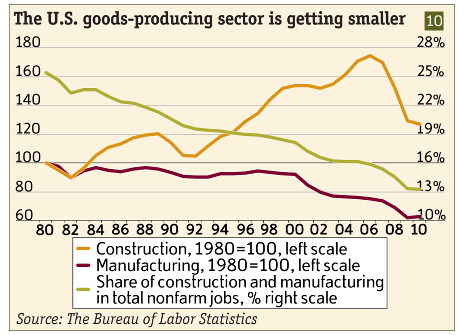
Employment



Three years following the beginning of the Great Recession, the U.S. economy is again producing as much as it did before the economic downturn. Indeed, in 2010, real GDP was up by 2.8% versus 2009 and 0.1% higher than in 2007.The return of GDP to its 2007 level is supported by consumer demand, exports and government spending, which offset a sharp drop in business and residential investments. Despite this, the economy created just above 1.3 million private-sector jobs last year. This means private businesses still employ more than 7 million fewer workers than at the end of 2007. More than that, nearly 90% of all new private-sector jobs were created in service-providing industries. This points to an asymmetric recovery in the U.S. economy. Indeed, during 2008 and 2009, service-providing and goods-producing industries lost over 4 million jobs each. However, job growth was much slower in goods-producing sectors (up by only 0.8% in 2010 versus 1.4% private-sector job growth in the service-providing part of the economy) as construction continued to lose jobs for the fourth consecutive year.

In fact, the decline in goods-producing jobs has been a secular trend for over two decades, as the share of construction and manufacturing in total employment continues to fall (to 13% by the end 2010 - see chart 10). While job losses in manufacturing reflect outsourcing and an erosion of international competitiveness, construction jobs were particularly hard hit in the aftermath of the U.S. housing bubble. Indeed, many construction jobs are performed by small businesses subcontracted by large homebuilders. Many of these small construction firms have failed to survive as credit conditions tightened. In addition, the employment situation in the construction industry is likely to improve only gradually because of the sluggish recovery of the housing sector as well as limited transferability of skills in construction to other industries.

The milder downturn in construction in Texas is one of the reasons why the state has a lower unemployment rate than the nation as a whole. In December, the Texas jobless rate was at 8.3% versus 9.4% nationwide. Last year, Texas created over 230,000 new nonfarm jobs – up by 2.3% thanks to 2.7% private-sector job growth (versus only 1.1% nationwide). Equally important, all major industries, with the exception of information and trade, posted job gains in 2010. Most new jobs came from service-providing industries: employment in professional and business services was up by 5.2%, education and healthcare was up by 3.4%, and leisure and hospitality was up by 3.4%. Mining, construction and manufacturing reported job growth as well – up by 14.8%, 5.8% and 3.4%, respectively. This compares exceptionally well with national employment trends. For example, the nation as whole lost 2.8% of its constructions jobs in 2010. Meanwhile, employment in U.S. manufacturing grew by only 1%, while professional and business services employed only 2.5% more workers than at the end of 2009.

Texas remains well positioned to gain from the current economic recovery, which is still mostly driven by cost-cutting, exports of manufacturing goods and resilient emerging market economies. In particular, Texas manufacturing is enjoying a global rebound from the demand for capital goods, while its mining industry is benefiting from higher commodity prices, boosted by increasing consumption in the developing world. Faster job growth in Texas business and professional service industries (a key insourcing sector that includes legal, consulting, engineering, and other commercial services) indicates strong future growth for the state. Indeed, job growth in professional and business services (both in Texas and nationwide) is a feature of this economic recovery as businesses slash costs by relying more on subcontractors rather than in-house employees. This means that Texas will continue to benefit from this ongoing efficiency drive in the U.S. corporate sector.

Monetary policy and asset prices

According to the Federal Reserve, a sluggish labor market recovery remains the major constraint to future economic growth. This means the Fed will likely stick to its commitment to purchase $600 billion of longer-term Treasury securities by the end of the second quarter of 2011. With modest inflationary risk being factored in, the federal funds rate will therefore be maintained at exceptionally low levels. Indeed, consumer prices are rising at their lowest pace on record – up by only 1.4% in December (see chart 11). However, a rapid recovery in global commodity prices is starting to add to inflationary expectations. For example, the latest manufacturing and non-manufacturing purchasing managers' surveys[5] point to increasing price pressures. That said, the impact of commodity prices on

[5]Source: The Institute for Supply Management

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inflation is likely to remain transitory as wage pressures are virtually nonexistent, while the output gap (the difference between what the economy can produce and the current output level) is not narrowing.[6] Workers' bargaining power for higher salaries is still weak and companies are still reluctant to boost hiring.

Although consumer credit grew each month last quarter, it was still 1.6% lower than in 2009, and 6.6% below its peak in mid 2008 (see chart 12). Furthermore, at its peak, about 25% of total consumer credit was held in pools of securitized assets. Because securitization markets remain under stress, consumer credit is unlikely to return to pre-crisis levels anytime soon. In 2010, the personal saving rate stood close to 6% of disposable income for the second year in a row. This means consumers are still reluctant to borrow, while they continue to repay their debts. Similar concerns are prevalent in the mortgage market as tight credit and low demand exert a toll on home sales. Although home sales improved both nationwide and in Texas in the last month of 2010 (see chart 13), they have continued to drop in annual terms for over 4 years. In particular, existing home sales in Texas fell by 4.8% in 2010 following an 8% drop the year before. However, because distressed properties in Texas represent a lower share of total sales versus the U.S. as a whole[7], home values have held up relatively well. If the national median existing home price was 1% lower in December 2010 than a year ago, it grew by 4.2% in Texas (see chart 14). Stronger economic growth is likely to support a modest recovery of home sales and residential housing activity in 2011. Indeed, the National Association of Realtors expects U.S. home sales to increase by about 8% to 5.2 million units. Better economic performance and faster population growth are likely to sustain an even stronger rebound in Texas.

Fiscal Policy and Public Debt

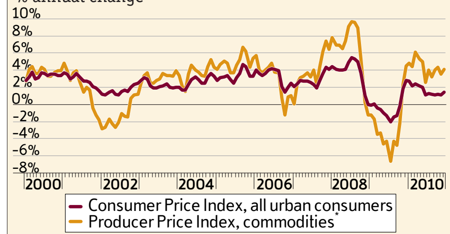
A recession-driven decline in sales and property values has caused sharp state budget revenue shortfalls across the U.S., and Texas is no exception. According to the Texas Controller of Public Accounts, total tax collections fell by 6.1% in fiscal 2010. In particular, sales tax collections (which account for over 55% of state tax revenues) declined by 6.6%, while franchise tax collections (another 11% of all tax revenues) fell by 9.3%. On a positive note, tax revenues are expected to improve in fiscal 2011 thanks to increasing sales and business revenues. However, total tax collection for 2010-11 will still be 9.4% lower than in 2008-09. As a result, according to the Center on Budget and Policy Priorities, in fiscal year 2012 Texas may face a 31.5% budget shortfall (as a percent of the fiscal year 2011 budget).

While Texas has a large rainy day fund, which is projected to total $9.4 in fiscal year 2013, the state also faces increasing public service provision costs due to demographic trends and growing funding needs in public education and healthcare. For example, according to the latest U.S. Census Bureau data, per pupil funding in Texas is the 9th lowest in the nation (or 19% lower than the U.S. average). However, according to the U.S. Department of Education, the share of school-age children in Texas is higher than nationwide. Furthermore, this group of children increased by about 10% over the past 10 years in Texas, while it fell slightly for the nation as whole. As a result, the state may have to increase its spending on education (about 56% of the general revenue-dedicated funds for 2012-2013) to maintain and improve its educational standards.

[6]For example, the Congressional Budget Office expects inflation to remain very low this year and next and stay below 2% in 2013-2016 because of the large amount of unused economic resources.

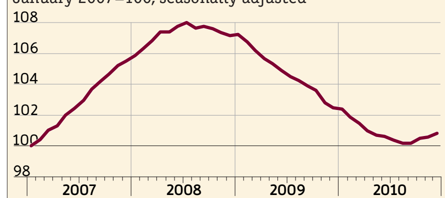
[7]According to CoreLogic, only a fifth of home sales in Texas involve distressed properties, compared to over 40% in Florida and California. Furthermore, only 11% of homes in Texas carry negative equity versus over 22% nationwide.

Commodity prices are rising again 11
% annual change



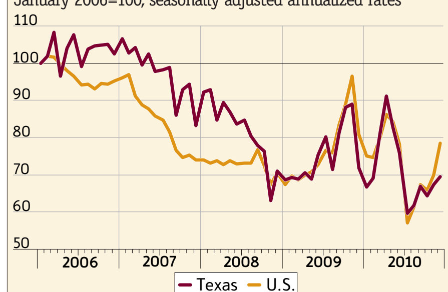
*The selling prices received by domestic producers for their output.
Source: Bureau of Labor Statistics

Consumer credit outstanding 12
January 2007=100, seasonally adjusted



Source: Federal Reserve

Home sales are improving but still at record low levels 13
January 2006=100, seasonally adjusted annualized rates

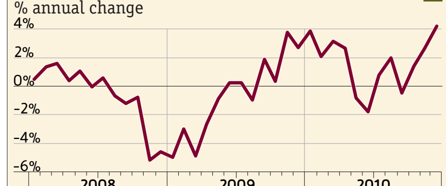


Source: National Association of Realtors, The Real Estate Center at Texas A&M University

Home sales are improving but still at record low levels 13
January 2006=100, seasonally adjusted annualized rates

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

Medium home price in Texas 14
% annual change



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The Texas Legislative Budget Board has submitted its budget proposals to the 82nd Texas Legislature with a proposed budgetary reduction for all funds of over 16.6% for 2012-2013 (see chart 15). This includes a 10.4% reduction in general revenue funds – the spending portion of the budget over which the Legislature has direct control. In particular, general fund spending on public and higher education is to be cut by 9% and 15.6%, respectively. If adopted, the measures are expected to balance the state budget for 2012-2013.

Proposed budget cuts in Texas 15
% change, 2012-13 biennial vs. 2010-11 biennial

General Government	-23.8%
Health and Human Services	-24.6%
Agencies of Education	-11.5%
Public Education	-13.1%
Higher Education	-7.6%
The Judiciary	-10.3%
Public Safety and Criminal Justice	-12.7%
Natural Resources	-15.8%
Business and Economic Development	-14.3%
Regulatory	-14.0%
General Provisions	NA
The Legislature	-10.0%
Total, all functions	**-16.6%**

The Texas Legislative Budget Board

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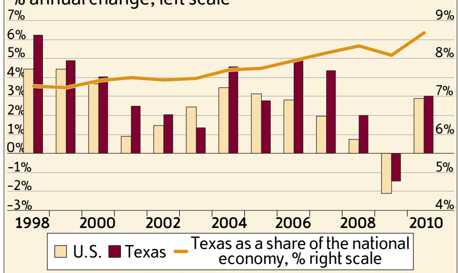
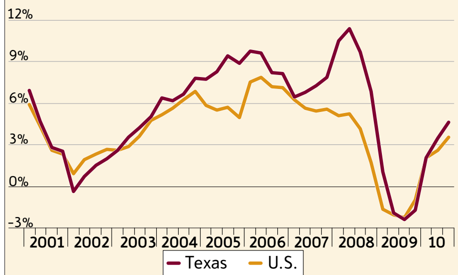
Economic growth: Texas vs. U.S.
% annual change, left scale



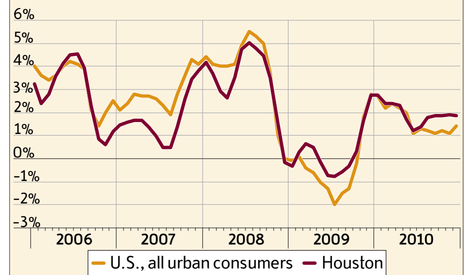
Source: Texas Comptroller of Public Accounts, The U.S. Bureau of Economic Analysis

Personal income
seasonally adjusted at annual rates, % annual change



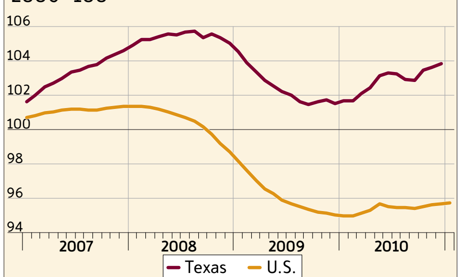
Source: The U.S. Bureau of Labor Statistics

Consumer prices
% annual change



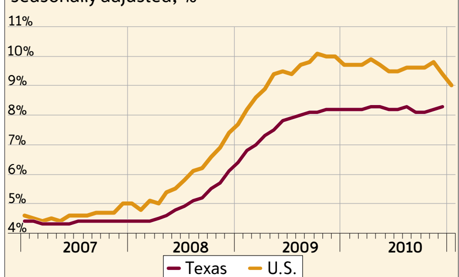
Source: The U.S. Bureau of Labor Statistics, The Federal Reserve Bank of Dallas

Nonfarm employment
2006=100



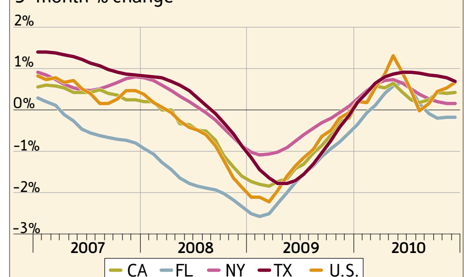
Source: The U.S. Bureau of Labor Statistics

Unemployment rates
seasonally adjusted, %



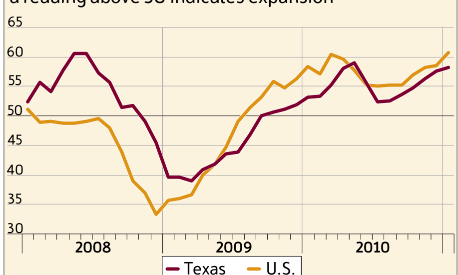
Source: The U.S. Bureau of Labor Statistics

State Coincident Indexes
3-month % change



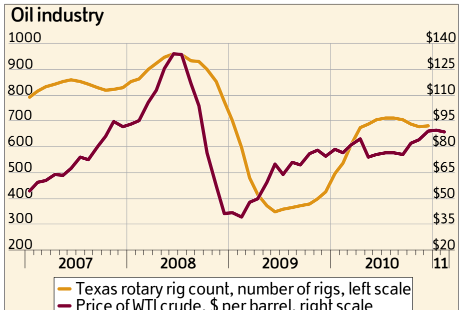
Source: The Federal Reserve Bank of Philadelphia

Purchasing Managers Index
a reading above 50 indicates expansion



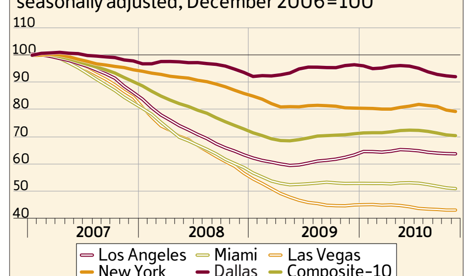
Source: The Institute for Supply Management

Oil industry



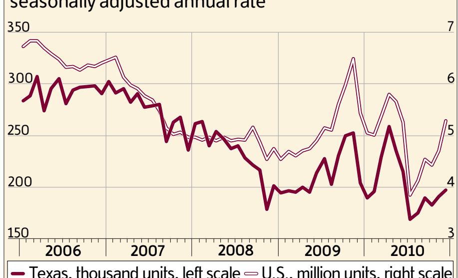
Source: The Federal Reserve Bank of Dallas

Home values
seasonally adjusted, December 2006=100



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

Home sales
seasonally adjusted annual rate

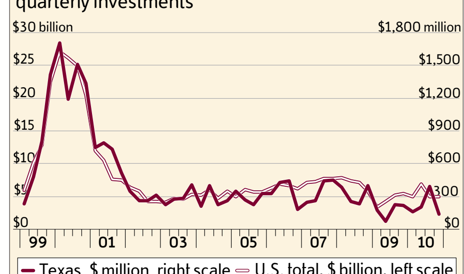


Source: The National Association of Realtors, The Real Estate Center at Texas A&M University

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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