Texas Economic Update

SigmaBleyzer

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

February 2011

- **In January, Texas created 44,100 new nonfarm jobs - a fourth consecutive monthly gain. The Texas jobless rate stood unchanged at 8.3% versus 9% nationwide.**
- **The Houston Purchasing Managers Index touched a new high in February, hitting its highest reading since June 2008.**
- **In January, existing home sales posted their first annual gain both in Texas and nationwide.**
- **The U.S. Purchasing Managers Index increased in February to its highest level since May 2004.**

Executive summary

Texas factory activity bounced back in February, with the production index, a key metric for state manufacturing, increasing from a flat reading the month before. Other indices of manufacturing activity – from employment to capital expenditures – improved as well, pointing to a resumption of growth.

This trend mirrors continued recovery in national and global manufacturing during the first two months of 2011. For example, the U.S. Purchasing Managers Index indicates that national manufacturing grew in February for the 19th straight month, while the broader economy expanded for the 21st consecutive month. The Houston Purchasing Managers Index reached a new high in February as well, increasing to its best reading since June 2008. Increasing crude prices continue to support the metro economy, while robust overseas demand and a weaker dollar continue to propel the economy forward in Texas. In fact, in January, exports from Texas reached a new monthly record, increasing by over 35% versus a year ago.

In addition, consumers are starting to feel more upbeat about the future course of the overall economy. Improving confidence bodes well for consumer spending, which is still the largest component of U.S. GDP. Returning consumer demand for durable goods brightens the outlook for U.S. retailers and manufacturers. Indeed, business sales have recently been outpacing inventory rebuilding – a trend that should sustain output gains over the coming quarters.

The Texas private sector continues to add jobs at a faster rate than most other large states. As a result, in January, the Texas jobless rate stood unchanged at 8.3% versus a 9% unemployment rate nationwide. This stronger performance of the Texas labor market is supported by a fast rebound in private sector hiring in large Texas metros.

Home sales in Texas, and nationwide, are improving, albeit at a glacial pace. While low interest rates (and prices) boost housing affordability, distressed properties continue to drive down home values. The risk of a deeper price adjustment remains high. Above all, the housing market is still struggling to clear as homeowners, beset by negative equity mortgages, struggle to move to places were more jobs are available. Despite this, home values continue to be more stable in Texas. Only 10% of homes in Texas are in a negative equity position (versus 23% nationwide), which makes the local housing market more stable compared to other, harder hit states.

Lastly, several factors continue to create headwinds for an overall U.S. economic recovery. First, increasing food and fuel prices are eating into consumer buying power. Second, fiscal tightening at the state and federal level is weighing on any growth momentum. Meanwhile, key metrics for construction activity linger well below their pre-crisis levels, and the housing recovery is still failing to gain traction. Finally, the world economy is increasingly unstable as higher global food prices warrant policy tightening in large emerging economies. Finally, recent events in the Middle East and the tragedy in Japan add a considerable degree of uncertainty to the global economic outlook.

Despite the above, we continue to believe the present external environment remains favorable to Texas. As a commodity producer, the state will benefit from the upward movement in global energy and agricultural prices. In addition, Texas is less exposed to a potential economic slowdown in China and India, as Canada and Latin America continue to be the major export markets. Solid growth prospects for those economies will continue to help sustain economic activity in Texas over the near term.

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Where Opportunities Emerge.

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Economic output

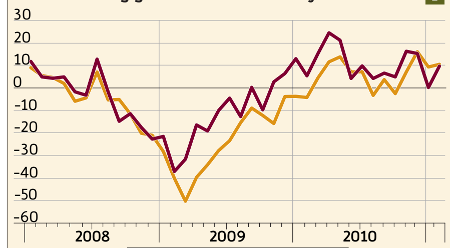
Texas factory activity bounced back in February, with the production index, a key metric of state manufacturing, increasing to 10 from a flat reading the month before (see chart 1). Other indices of manufacturing activity – from employment to capital expenditures – also improved, pointing to a resumption of growth. This trend mirrors a continued recovery in national and global manufacturing for the first two months of 2011. Indeed, the U.S. Purchasing Managers Index increased to 61.4 in February – its highest level since May 2004. This indicates that U.S. factory activity expanded in February for the 19th straight month, while the broader economy grew for the 21st consecutive month. Meanwhile, the JPM Global Manufacturing PMI, a barometer of global manufacturing activity, returned to its strongest reading in over six years, last time reached in April 2010 (see chart 2).

The Houston Purchasing Managers Index touched a new high in February, increasing to 59.6 – its best reading since June 2008 (see chart 3). A number of factors support this continued strong performance. First, increasing crude oil prices continue to support the regional economy. According to Baker Hughes, in February the Texas rotary rig count was 1.5% higher than a month ago, and up by 36% versus February 2010. Second, robust overseas demand, and a weaker dollar, continue to boost demand for Texas exports. In fact, according to the U.S. Department of Commerce, more than a quarter of all manufacturing jobs in Texas depend on exports. This share is even higher for more technologically advanced manufacturing industries, such as computer and electronics manufacturing (47%), transportation equipment manufacturing (41%) and machinery manufacturing (31%).[1] These export jobs support better paying and more competitive parts of the Texas economy, something that is instrumental for long-term economic growth.

High energy prices and strong exports are supporting continued economic recovery in all of the large Texas metros (see chart 4). A gradual rebound in airline traffic is helping the local economy as well. For example, in January 2011, passenger and cargo traffic for the Houston Airport System was up by 3.5% and 7%, respectively, versus the same month a year ago. This follows a 2.1% growth in passenger traffic and a 15.2% increase in cargo traffic in 2010.[2] Air transportation in Texas accounts for a larger share of the state's economy and private sector jobs compared to the nation as a whole.[3] In addition, this industry pays higher wages – over 40% more than the average pay in the private sector.[4] All of this contributes to stronger economic growth in Texas. In addition, population growth and an increasing share of international trade will support a steady improvement in airline traffic for the foreseeable future.

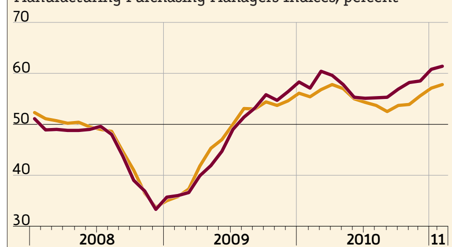
The U.S. economic recovery is showing signs of becoming self-sustaining, as improving consumer confidence supports gains in personal consumption. According to the Conference Board, the Consumer Confidence Index jumped to 70.4 in February – its highest level in two years. Equally important, consumers are more upbeat about the future course of the economy, compared to a more cautious consumer outlook a year ago. This partly reflects an improving labor market and a rebuilding of personal wealth.[5] In addition, falling credit

Manufacturing grew faster in February 1



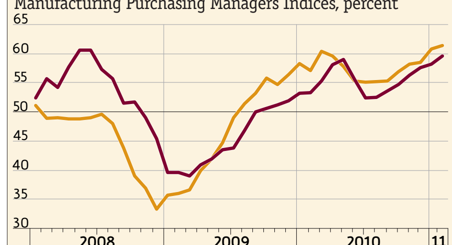
Source: The Federal Reserve Bank of Dallas

Global manufacturing activity is strengthening 2
Manufacturing Purchasing Managers Indices, percent*



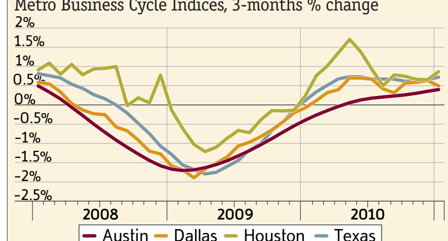
**A reading above 50% indicates expansion*
Source: The Institute for Supply Management

Manufacturing in Houston expands for the 18th straight month 3
Manufacturing Purchasing Managers Indices, percent*



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

Texas metro economies continue to grow 4
Metro Business Cycle Indices, 3-months % change



Source: The Federal Reserve Bank of Dallas

[1]Source: The Office of Trade and Industry Information, 2008 data.
[2]Last year, Dallas/Fort Worth Airport System reported a 1.5% gain in passenger traffic and an 11% growth in cargo traffic.
[3]The air transportation industry represents about 0.7% of the Texas economy and provides a similar share of all private jobs versus only 0.4% nationwide. Source: Texas Workforce Commission, The U.S. Bureau of Labor Statistic, The Bureau of Economic Analysis.
[4]In the third quarter of 2010, average weekly earnings in air transportation stood at $1,270 versus only $879 for the Texas private sector as a whole. Source: Texas Workforce Commission.
[5]According to the Federal Reserve, at the end of 2010, household net worth was up by $8.1 trillion compared to the recession trough in the first quarter of 2009.

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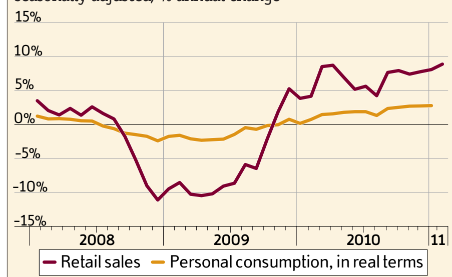
default rates signal the improving financial condition of the U.S. consumer. In fact, according to the S&P/Experian Consumer Credit Default Index, a broad metric of changes in consumer credit defaults, consumer defaults were down across a broad range of credit in February. The composite default index is now 42% lower compared to February 2010. Dallas, which is one of the five largest metros monitored by S&P/Experian, saw the biggest improvement – its consumer credit default rate declined to just 1.78% (compared to 2.54% nationwide).

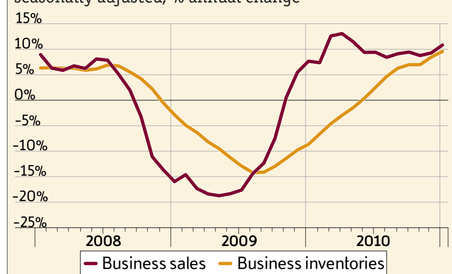
Pent-up demand for durable goods boosts retail sales 5
seasonally adjusted, % annual change



*Personal consumption also includes spending on services – about 2/3 of total personal consumption
Source: The U.S. Census Bureau, The Bureau of Economic Analysis

All this bodes well for consumer spending, which is still the largest component of U.S. GDP. Indeed, in February, U.S. retail sales posted their eighth consecutive monthly gain, increasing by nearly 9% versus a year ago (see chart 5). In addition, stronger consumer demand also improves the outlook for retailers and manufacturers of consumer products. In fact, the growth of business sales continues to outpace the rate at which companies are rebuilding their stocks (see chart 6). As a result, the inventory to sales ratio fell to its lowest reading on record (1.23) in January. Inventory accumulation will continue to support output as producers cope with a strong return of consumer demand for durable goods.

Business inventories and sales are recovering 6
seasonally adjusted, % annual change



Source: The U.S. Census Bureau

Despite the recent good economic news, several factors are creating headwinds for a strong U.S. recovery. First, higher commodity prices are rekindling inflationary fears. In particular, increasing food and fuel prices are eating into consumer buying power. In fact, according to the University of Michigan, the mid-March reading of consumer sentiment declined on surging gasoline prices. That said, the U.S. economy is better prepared for higher energy costs thanks to an energy efficiency drive prompted by the 2008 jump in crude oil prices. In addition, according to the March press release of the Federal Open Market Committee, the elevated unemployment rate continues to keep underlying inflation at a relatively low level, with the recent increases in commodity prices judged to be transitory. This means inflation, albeit an increasing threat, is unlikely to seriously dent near-term recovery prospects.

Second, fiscal tightening at both the state and federal level, and continued weakness in residential housing, are restraining growth momentum. On a positive note, a reduction of the budget deficit, which is likely to have a negative impact on growth in the short-term, will help eliminate many taxation related policy risks. A credible strategy to return to more sustainable budget levels will boost overall business confidence. Meanwhile, key metrics for construction activity linger well below their pre-crisis levels, as the housing recovery fails to gain traction. In February, the number of privately-owned housing units authorized by building permits was 8% lower than the month before, and 20% below its level in February 2010. Privately-owned housing starts fell by 22.5% in February, following a strong rebound in January. February's 480,000 new units (at a seasonally adjusted annual rate) was the second lowest reading on record after a similar drop in construction activity in April 2009.

Third, the global economic recovery is becoming increasingly unstable as higher prices for food and energy prompt policy tightening in large emerging economies, and, most importantly, in China. This means global demand is likely to slow this year, which may exert a toll on U.S. exports. In addition, the economic and social costs of Japan's terrifying natural disaster risks derailing any recovery in the world's third largest economy. At present, it's too early to assess the overall impact of this tragedy. However, the events in Japan add a considerable degree of uncertainty to the world's economic outlook. Japan plays a key role in the global supply chain, especially in the manufacturing of automobiles and high-tech products. As a result, a short-term supply disruption of components may affect manufacturing output globally. Still, the direct impact on U.S. exports of slower economic growth in Japan (or a fall in Japan's output) is likely to be relatively small. Although Japan is the fourth largest overseas market for the U.S., it accounts for just 5% of all U.S. exports (and for less than 2% of Texas exports).

On balance, we continue to believe the present macroeconomic environment remains favorable to Texas. As a commodity producer, the state will benefit from upward movements in global energy and agricultural prices. Texas is less exposed to any economic slowdown in China, as Canada and Latin America continue to be its major export markets. Solid growth prospects for these economies will continue to sustain economic activity in Texas, at least for the foreseeable future.

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Employment

In January, the Texas jobless rate stood unchanged at 8.3% versus a 9% unemployment rate nationwide. Furthermore, the Texas labor market continues to outperform other large states (see chart 7). In particular, in January, Texas created 44,100 new nonfarm jobs – the fourth consecutive monthly gain. As a result, the state had 2.5% more jobs than in January 2010, compared to only 0.8% employment growth in the U.S. as a whole. The Texas private sector added jobs at an even faster rate – up by 2.7% versus January 2010 (nationwide, the number of private sector jobs increased by only 1.2%). All sectors but leisure and hospitality reported monthly job gains in January. Most of the new jobs came from the service-providing sectors of the Texas economy, with trade, transportation and utilities adding 15,800 new jobs (mostly thanks to strong hiring in the retail sector). Education and healthcare saw 7,600 more jobs in January, while the government hired 5,500 new workers.

Compared to the nation as a whole, Texas still enjoys a faster recovery in construction, mining, professional and business services, and education and healthcare jobs. For example, Texas employed 5.9% more construction workers in January versus a year ago, while nationwide the number of construction jobs remained 0.4% lower than a year ago. The overall U.S. construction industry has been through a major downsizing, losing nearly 30% of all jobs since employment in construction peaked four years ago. Contrary to this, Texas, which experienced a shorter and less severe downturn in construction, has only 12% fewer construction jobs compared to the peak two years ago. The Texas mining industry had 14.4% more jobs than in January 2010. Lastly, professional and business services, and education and health care, employed 3.6% and 3.5% more workers, respectively (nationwide, employment in these sectors grew by only 2.6% and 2.1%).

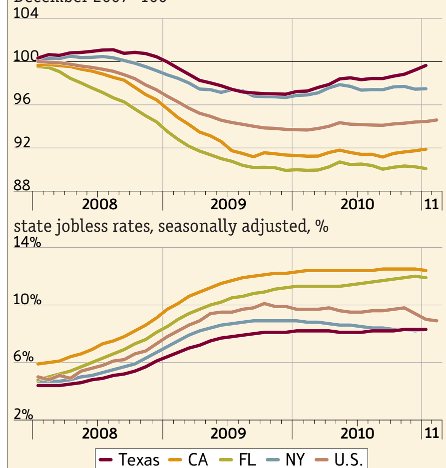
This strong performance of the Texas labor market is supported by a fast rebound in private sector hiring within the large Texas metros. Indeed, in January, private sector employment in Dallas and Houston was 2.3% higher than a year ago. Meanwhile, it grew by only 1.7% in New York, 0.9% in Los Angeles and Boston, and 0.3% in Miami (see chart 8).

Monetary Policy and Asset Prices

The latest statement from the Federal Open Market Committee confirms the Federal Reserve's intention to stick to its original plan to purchase $600 billion of longer-term Treasury securities by the end of the second quarter of 2011. It appears the Fed believes employment gains still remain modest enough to warrant any policy tightening. Meanwhile, consumer prices grew by only 1.7% in January, mostly due to increasing food and energy prices (see chart 9), whose impact on underlying inflation is likely to dissipate over the coming year.

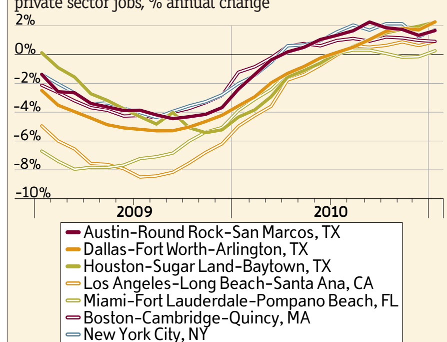
Home sales are improving, albeit at a glacial pace. While low interest rates (and prices) boost housing affordability, distressed properties continue to drive down home values, which adds stress to the housing market.[6] For example, according to the National Association of Realtors, in January existing home sales posted their first annual gain since mid-2010 (see chart 10). At the same time, the national median existing-home price was 3.7% lower than in January 2010. The risk of deeper price adjustments remains high. Above all, severe rigidities in the housing market (for example, a high share of homes in negative equity and the increasing shadow housing inventory[7]) restrict labor mobility as homeowners struggle

Employment is recovering faster in Texas 7
nonfarm employment, seasonally adjusted, December 2007=100



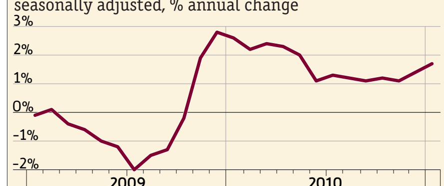
Source: The U.S. Bureau of Labor Statistics

Large metros are creating more private jobs in Texas 8
private sector jobs, % annual change



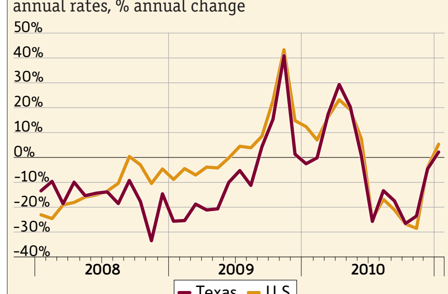
Source: The U.S. Bureau of Labor Statistics

Consumer Price Index for all urban consumers 9
seasonally adjusted, % annual change



Source: The U.S. Bureau of Labor Statistics

Home sales are gradually recovering 10
existing home sales, seasonally adjusted annual rates, % annual change



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

[6] For example, according to CoreLogic, in January the national single family home price fell by 5.7% versus a year ago. Excluding distressed sales, this decline shrinks to only 1.6%.
[7] For example, homes eligible for foreclosure but have not yet been repossessed and put up for sale.

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to sell properties and move to cities where more jobs are available.

Against this backdrop, home values in Texas continue to hold. According to the Real Estate Center at Texas A&M University, in January median home prices were 1.6% higher than a year ago, as home values in Dallas and Austin grew by more than 6%. At the same time, housing prices fell in Houston by about 4%. Only 10% of homes are in negative equity in Texas (versus 23% nationwide)[8] which makes the local housing market more flexible compared to harder hit states.

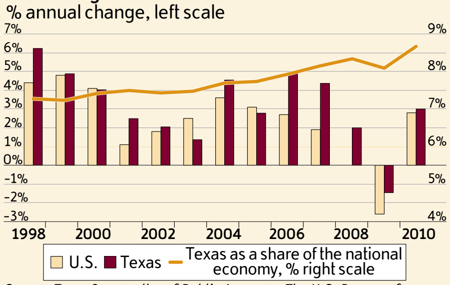
Foreign Trade

The value of goods exported from Texas reached a monthly record in January, increasing to $19.5 billion or up by over 35% compared to a year ago. Texas exports to Canada and Mexico (about 44% of all exports) jumped 48% and 34%, respectively. Exports to Latin America, excluding Mexico, (over 16% of all exports) advanced by 65% thanks to strong demand for Texas products in Brazil. Exports to developing countries, which account for nearly 2/3rds of all Texas exports, increased by 38%. Lastly, shipments of Texas products to OECD countries bounced by 54%. This came as a result of stronger energy prices – exports of mineral fuels from Texas more than doubled amounting to $4.4 billion – a new monthly record. Exports of industrial machinery, and computers and electronics, posted solid gains as well - up by 14.5% and 18%, respectively. Over 2/3rds of these products went to developing economies, mostly to Mexico, as solid economic growth in the region unleashed demand for durable consumer and investment goods.

[8]Source: CoreLogic, Q4 2010.

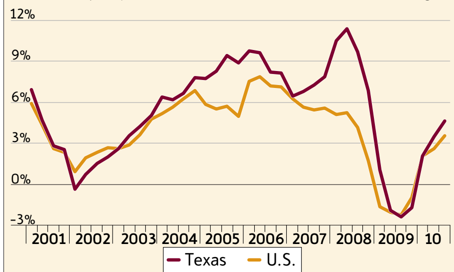
February 2011

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



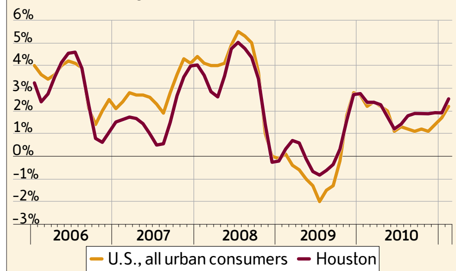
Source: Texas Comptroller of Public Accounts, The U.S. Bureau of Economic Analysis

Personal income
seasonally adjusted at annual rates, % annual change



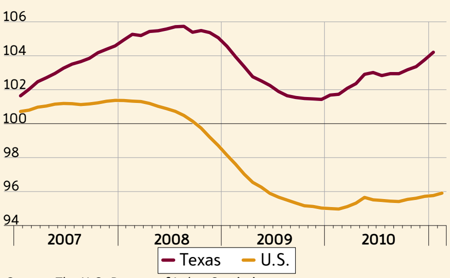
Source: The U.S. Bureau of Labor Statistics

Consumer prices
% annual change



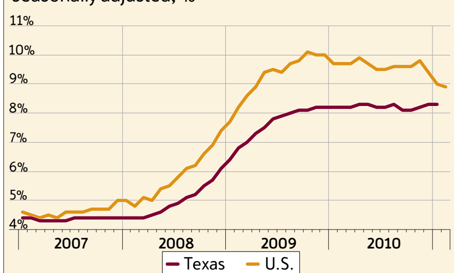
Source: The U.S. Bureau of Labor Statistics, The Federal Reserve Bank of Dallas

Nonfarm employment
2006=100



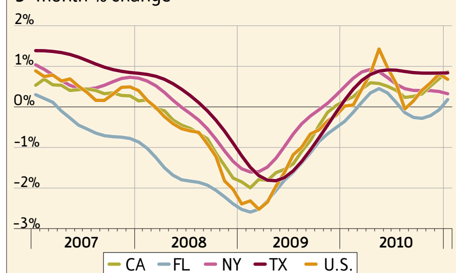
Source: The U.S. Bureau of Labor Statistics

Unemployment rates
seasonally adjusted, %



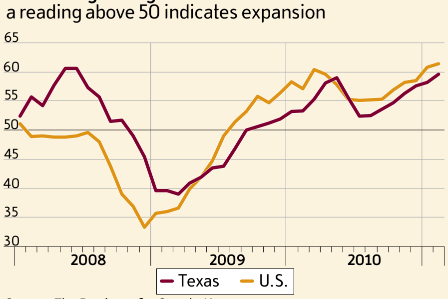
Source: The U.S. Bureau of Labor Statistics

State Coincident Indexes
3-month % change



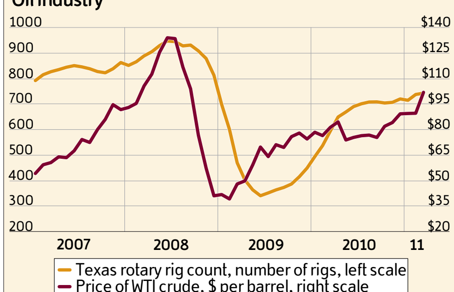
Source: The Federal Reserve Bank of Philadelphia

Purchasing Managers Index
a reading above 50 indicates expansion



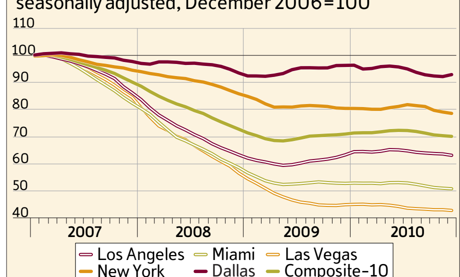
Source: The Institute for Supply Management

Oil industry



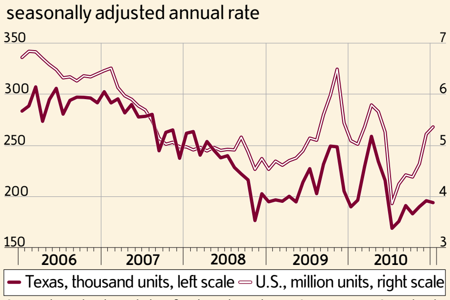
Source: The Federal Reserve Bank of Dallas

Home values
seasonally adjusted, December 2006=100



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

Home sales
seasonally adjusted annual rate

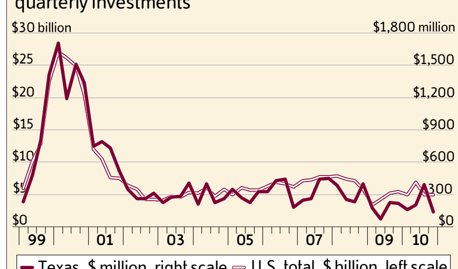


Source: The National Association of Realtors, The Real Estate Center at Texas A&M University

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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