SigmaBleyzer

Texas Economic Update

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

April 2011

- **Texas manufacturing grew for the 18th straight month in April, albeit at a slower pace.**
- **The Houston Purchasing Managers Index advanced in March, for the six consecutive month to its highest level since June 2008.**
- **The Texas jobless rate declined to 8.1% in March, while nonfarm employment grew for the sixth consecutive month.**
- **The U.S. economic recovery decelerated in the first quarter of 2011 with GDP growing by only 1.8%.**

Executive summary

The U.S. economic recovery decelerated in the first quarter of 2011 with GDP growing by only 1.8%. Higher energy prices exerted a toll on personal consumption, and a slower growth in exports was offset by an accelerated expansion of imports. Bad weather in January depressed consumer spending, while the natural disaster in Japan also appears to have negatively impacted manufacturing. Policy tightening in developing economies and weak European demand for U.S. products were also a factor. In addition, sovereign debt in the developed world is reaching levels where risks to fiscal sustainability are too great to ignore. Standard & Poor's has recently put the triple-A rating of the U.S. under review and cut its outlook for Japan, the world's third biggest economy. The cost of issuing government debt in struggling European economies surged to record high levels. The world economic outlook remains uncertain as emerging inflationary and sovereign debt fears weigh down the pace of economic recovery.

That said, U.S. economic growth is still expected to beat other large advanced economies. In addition, business spending on equipment and software increased for the eighth straight quarter. As a result, a stronger recovery and improving capital spending should help the U.S. labor market gain a more solid footing compared to other developed nations. In fact, the Federal Reserve now expects the national jobless rate to range between 8.4% and 8.7%, versus 8.8% to 9% in late January.

Turning to Texas, factory activity stayed in expansionary mode in April, increasing for the 18th straight month. Although production grew somewhat slower compared to March, manufacturers are still hiring new workers as the employment index of the Texas Manufacturing Outlook Survey reached its highest level in four months. The Houston Purchasing Managers Index points to robust growth of the regional economy as well. Lastly, the Texas Business Cycle and Leading Indices are trending upward as the state's economic recovery becomes more solidly entrenched.

Overall, business sentiment is still upbeat as growing consumer and business spending are providing the foundation for sustained economic growth in 2011. Consumers, hit by higher grocery and gas prices, are gradually regaining confidence, pointing to signs of life in the job market. In addition, recent gains in retail sales are relatively widespread, which helps broaden economic recovery. Indeed, more jobs are contributing to consumer buying power and are helping to unlock pent-up demand. As a result, consumers feel more confident to spend on cars, discretionary goods and restaurants.

The continued strength of business sales testifies to the fact that the U.S. economic recovery rests on a fairly solid foundation. Equally important, shipments and new orders of durable goods are posting healthy gains on a rebound in IT and capital spending. This bodes well for Texas, which relies more on business spending compared to other large states. In particular, Texas' large metros, such as Houston, Dallas and Austin, are benefiting from the improved performance of large U.S. companies, which, among other things, fuels demand for professional and business services jobs. Meanwhile, the Texas energy sector is returning to its pre-crisis levels of activity thanks to booming oil prices. This supports the Houston economy thanks to the increasing number of well-paid jobs in the oil and gas industry and strong demand for drilling-related products and services.

The improving labor picture provides additional evidence for the strength of the Texas economy. In March, the jobless rate declined to 8.1% and nonfarm employment grew for the sixth consecutive month. Annual job growth stood at 2.4%, versus only 1% nationwide, as industries that have been adding jobs through the recession (or saw a strong rebound of hiring as the economy bounced back in 2009) performed better in Texas than in other comparable large states.

Finally, the Federal Reserve is continuing to reinvest principal payments from its securities holdings and will complete its second round of quantitative easing soon. The Fed's view on the economy and inflation is now somewhat less optimistic compared to the beginning of the year. At the same time, energy and food prices aside, inflation expectations remain well-anchored due to sluggish national wage and job growth. All of this means the Fed is likely to stick to loose monetary policy for some time to promote employment and support the housing market. Yet despite increasing employment and record high affordability, the housing market is struggling to sustain any growth momentum. Sales and prices are weak as more distressed properties enter the market. Despite this, home values in the major Texas metros remain more stable compared to other large cities. Affordable housing and strong demand add resilience to the Texas housing market and should support its faster turnaround as job creation picks up.

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Where Opportunities Emerge

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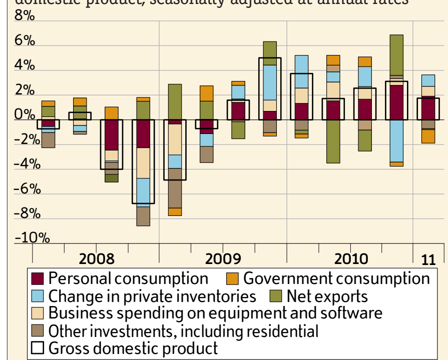
Economic output

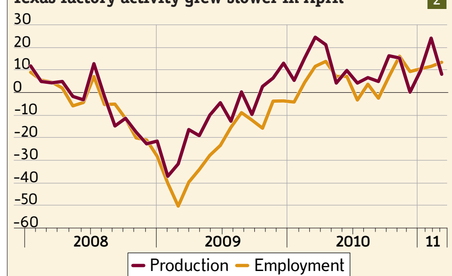
The U.S. economy remains in a slow recovery mode as higher energy prices put pressure on consumer spending. According to advance estimates, in the first quarter of 2011, the national economy grew at an annual seasonally adjusted rate of just 1.8%, down from 3.1% the quarter before (see chart 1). Personal consumption increased by 2.7% - faster than in the first five quarters of the recovery, but well below the 4% growth rate in the last four months of 2010. Meanwhile, a slower growth in overseas demand was offset by an accelerated expansion of imports – net exports subtracted 0.08 percentage points from growth versus a 3.3 percentage point contribution in the last quarter of 2010. Several transitory factors dampened first quarter growth as well. In particular, bad weather conditions in January depressed consumer spending, while the natural disaster in Japan appears to have slowed output expansion in manufacturing. As a result, economic growth should accelerate as the impact of these negative shocks fades away. That said, the economic outlook is still highly uncertain as emerging inflationary and sovereign debt risks weigh on the pace of economic recovery. Policy tightening in developing economies and fiscal consolidation in the European Union may weaken foreign demand for U.S. products. As a result, the Federal Reserve has lowered its projection for full-year GDP growth to 3.1% (from 3.4% in January) and raised the inflation forecast to 2.1%–2.8% (January's projection stood at 1.3%–1.7%). That said, the growth rate is still well above economic projections for other large advanced economies.[1] In addition, business spending on equipment and software has contributed to U.S. economic growth for the eighth straight quarter, with growth accelerating to 11.6% from 7.7% in the last quarter of 2010. Faster economic growth and improved business spending should help the U.S. labor market gain a more solid footing compared to other developed countries. In fact, the Federal Reserve now expects the national jobless rate to range between 8.4% and 8.7%, versus its forecast of 8.8% to 9.0% in late January.

Economic growth slows in the first quarter 1
contributions to percent change in real gross domestic product, seasonally adjusted at annual rates



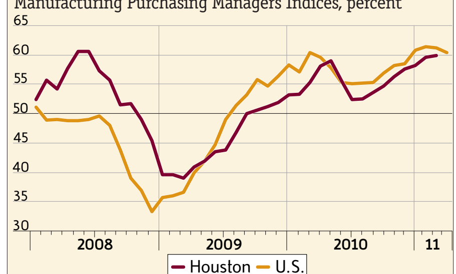
Source: The U.S. Bureau of Economic Analysis

Texas factory activity grew slower in April 2



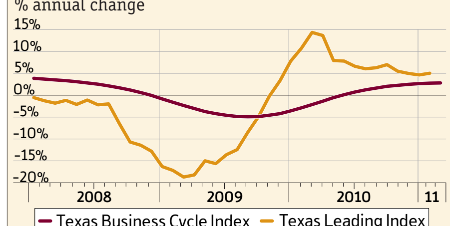
Source: The Federal Reserve Bank of Dallas

Regional manufacturing recovery remains strong 3
Manufacturing Purchasing Managers Indices, percent*



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

Texas economic recovery continues 4
% annual change

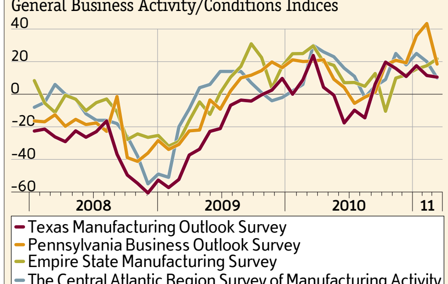


Source: The Federal Reserve Bank of Dallas

Turning to Texas, factory activity remained in expansionary mode in April, increasing for the 18th straight month. Although production grew somewhat slower compared to March, manufacturers are still hiring new workers. The employment index of the Texas Manufacturing Outlook Survey reached its highest level in four months (see chart 2). Purchasing Managers Manufacturing Surveys point to robust growth in the regional economy as well. In March, the Houston Purchasing Managers Index (PMI) advanced for the six consecutive month to its highest level since June 2008. Meanwhile, the national PMI fell slightly, having registered a record 7-year high reading in February (see chart 3). Lastly, the Texas Business Cycle and Leading Indices are trending upward as the state's economic recovery becomes more solidly entrenched (see chart 4).

Notwithstanding slower growth in April, overall business sentiment remains upbeat throughout the large U.S. regional economies (see chart 5). Above all, growing consumer and business spending are contributing to improving economic conditions. In fact, the Conference Board Leading Economic Index increased in March for the ninth straight month, pointing to sustained economic growth in 2011.

Business conditions remain relatively strong 5
General Business Activity/Conditions Indices



Source: The Federal Reserve Bank of Dallas, The Federal Reserve Bank of Philadelphia, The Federal Reserve Bank of New York, The Federal Reserve Bank of Richmond

Consumers, hit by higher grocery and gas prices, are gradually regaining confidence given the signs of life in the job market.[2] The Consumer Confidence Index improved slightly in April thanks to a more favorable assessment of current economic conditions and

[1]According to April's release of the World Economic Outlook (IMF), Japan is expected to grow by just 1.4% in 2011, the United Kingdom by 1.7% and the Euro Area by 1.6%.
[2]Consumer confidence fell sharply in March on rising gasoline prices. Source: The Conference Board.

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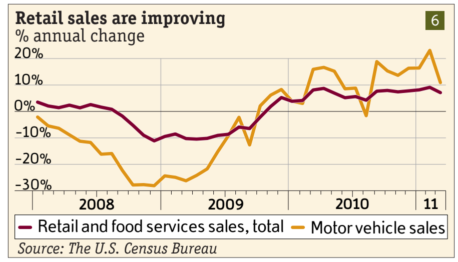
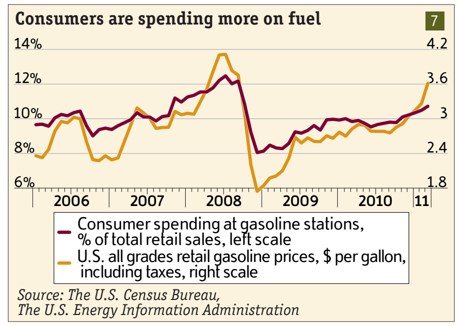
the labor market. March was the sixth straight month of job gains, which is a sign the U.S. economic recovery is shifting into a self-sustaining mode. Indeed, more jobs are contributing to consumer buying power and are helping to unlock pent-up demand. As a result, personal spending, which is the main driver of U.S. economic growth, is on an uptrend as consumers feel safer about spending on cars, discretionary goods and restaurants. For example, retail sales registered their 9th consecutive monthly gain in March and are now 7% higher than a year ago (see chart 6). For the first quarter of 2011, retails sales were 8% higher than a year ago thanks in part to a 16.6% gain in car sales.



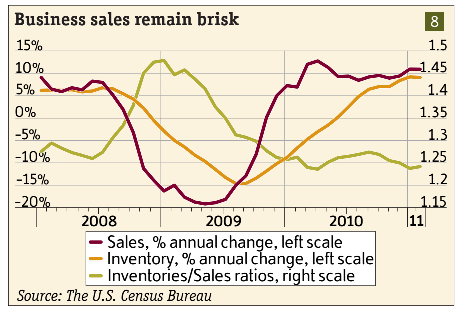
Retail sales are improving 6
Source: The U.S. Census Bureau

Recent gains in retail sales are relatively widespread, which helps broaden economic recovery. First quarter sales of clothing and accessories were up by 4.1%, sales of sporting goods, hobby, book, and music stores grew by 5%, while sales of building materials and supplies advanced by 7.1%. Consumers' appetite for eating out appears to be returning as well – sales at food service and drinking establishments were nearly 5% higher than in the first quarter of 2010. That said, rising gasoline prices are taking a toll on personal expenditures as consumers are spending more to refuel their cars (see chart 7). According to the U.S. Energy Information Administration, at the end of April, average retail gasoline prices were 36% higher than a year ago. While price growth has somewhat moderated in recent weeks, tight global supply will continue to keep energy costs at an elevated level, which will slow the recovery in consumer spending.

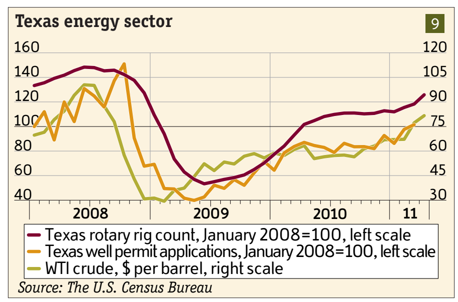


Consumers are spending more on fuel 7
Source: The U.S. Census Bureau, The U.S. Energy Information Administration

The continued strength of business sales testifies to the fact that the U.S. economic recovery is resting on a firm foundation. Business inventory is growing, albeit at a slower pace, which leaves the inventory to sales ratio at record low levels (see chart 8). Equally important, shipments and new orders of durable goods are posting healthy gains as companies step up capital spending. In the first quarter of 2011, shipments of nondefense durable goods were up by 8.7% versus the same quarter a year ago, while new orders grew by 9.6%. Shipments and new orders of nondefense capital goods were up by 8.5% and 14.4%, respectively. Spending on durable goods grew across all major categories, including machinery, computers, motor vehicles, and aircraft. First quarter earnings of Intel and IBM – bellwether companies that can be used as a barometer for business spending – grew well ahead of market expectations, by 25% and 8%, respectively, on a rebound in IT spending.[3] Other major U.S. industrial companies (such as Ford and 3M) are reporting record high first quarter results and are raising their full-year projections. This points to a steady turnaround in economic activity across a wide range of sectors – notably, nearly 70% of all companies that have already reported their first quarter earnings beat market estimates.[4]



Business sales remain brisk 8
Source: The U.S. Census Bureau



Texas energy sector 9
Source: The U.S. Census Bureau

Improving business spending bodes well for major Texas metros, and in particular for Houston and Dallas, which are home to 24 and 12 Fortune 500 corporate headquarters, respectively.[5] A robust turnaround in corporate performance from large U.S. companies fuels demand for professional and business services jobs. However, industry composition matters. For example, New York, with 42 corporate headquarters, created just 2.4% of new jobs in business and professional services from March 2010 to March 2011 due to continued weakness in financial services, while annual jobs gains in professional and business services in Dallas-Irvin and Houston was 7% and 4%, respectively, thanks to more diverse and resilient local economies.[6] Meanwhile, the Austin-Round Rock metro is strong in semiconductor and software and is benefiting from a recovery in IT spending. As a result, in the first quarter of 2011, the Austin and Dallas Metro Business Cycle Indices[7] reported annual gains of 2.1% and 2.7%, respectively.

Lastly, increasing oil and grain prices are boosting the economic fortunes of commodity-producing metro economies. The Texas energy sector is returning to pre-crisis levels of activity, with the rotary rig count and well permit applications posting annual gains of 24% and

[3]Source: Company reports.
[4]As of May 12th, 454 (91%) S&P 500 companies had released their first quarter results. Source: CNBC News.
[5]Source: Fortune Magazine.
[6]Source: The U.S. Bureau of Labor Statistics.
[7]The Metro Business-Cycle Index tracks the health of local Texas economies based on changes in non-farm employment, the jobless rate, inflation-adjusted wages and retail sales. Source: The Federal Reserve Bank of Dallas.

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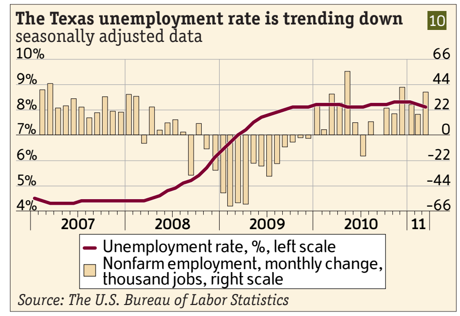
21%, respectively (see chart 9). This supports the Houston economy due to the increasing number of well-paid jobs in the oil and gas industry, and strong demand for drilling-related products and services. Indeed, in March, the Houston Business Cycle Index was 2.4% higher than its previous peak in 2008, having recovered by over 5% from its low at the end of 2009.

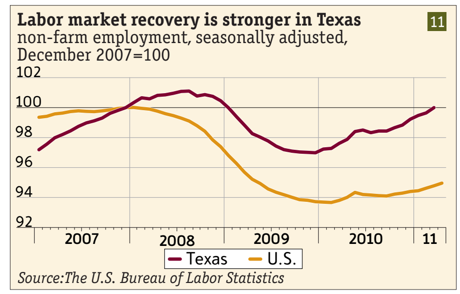
Employment

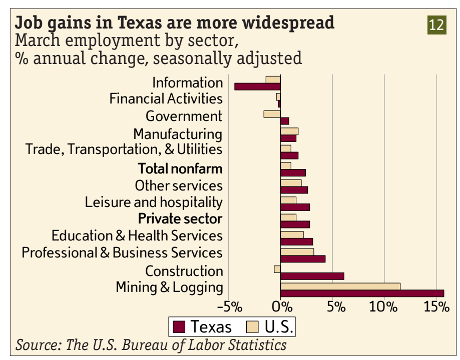
The Texas labor market continued to improve in March. The jobless rate declined to 8.1% and nonfarm employment grew for the sixth consecutive month (see chart 10). Annual job growth stood at 2.4% with over 251,000 more jobs than in March 2010. Indeed, nonfarm employment in Texas has already recovered to its precrisis level; for the nation as a whole it is still 5% lower (or down by over 7 million jobs) versus December 2007 (see chart 11).Peak-to-trough employment losses in Texas (from August 2008 to December 2009) stood at only 4.1% compared to 6.3% nationwide (from January 2008 to February 2010). Furthermore, Texas has created 3.1% more jobs since the state's labor market bottomed out at the end of 2009. Meanwhile, national employment has recovered by only 1.2% from its recession low in early 2010.

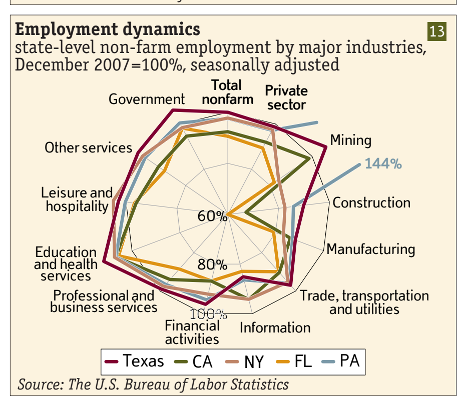
With the exception of information services, all major Texas industries added jobs in March. The largest gain was in business and professional services – where employment grew by 10,800 versus the month before, which translates into an annual growth rate of 4.3% - the fastest among all sectors besides mining. The mining industry created 4,300 new jobs in March and reported a 15.7% annual growth rate. Construction, education and healthcare, and leisure and hospitality saw healthy job growth as well, hiring 6.1%, 3.1% and 2.1% more workers, respectively, over the course of the past 12 months. This compares well with the rest of the country, where the job market recovery is still struggling to gain traction, especially in the hardest hit industries such as construction and finance (see chart 12).

A comparison of Texas with other large U.S. states sheds some light on why the Texas job market has been more resilient during the "Great Recession". First, a collapse of the housing market has had a major impact on states with inflated real estate prices. For example, employment in construction is merely two thirds of what it used to be at the onset of the recession in California and Florida (see chart 13). A similar trend is present in the financial industry. However, Texas experienced a much milder housing market correction. Meanwhile, industries that have been adding jobs through the recession (or saw a strong rebound in hiring as the economy bounced back in 2009) performed better in Texas than in other large states. In particular, job recovery in the private sector was mostly concentrated in professional and business services, education and healthcare, manufacturing, and, in the case of commodity-producing states, in mining. While Texas created more government jobs (up by about 7% from December 2007), which added strength to the regional labor market, its private sector also remained more resilient. In March, the total number of non-government jobs in Texas was only 1% lower than in December 2007, versus a decline of 8% and 10% in Florida and California, respectively. While tighter state budget finances are likely to curb further expansion in government employment, Texas still provides a solid foundation for continued private-sector job growth. It has a growing and relatively young population to support demand for health and education services. Favorable demographics are likely to sustain demand for housing as well, boosting employment in the construction industry. Meanwhile, manufacturing is recovering due to improving foreign demand and a rebound in business spending. Lastly, strong crude oil prices and increasing commercial interest in offshore drilling are set to boost the number of jobs in the mining sector.







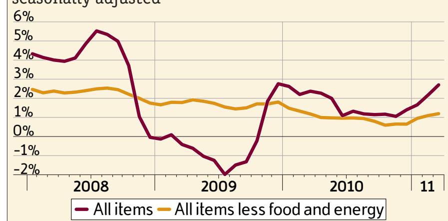


Monetary Policy and Asset Prices

According to the April press release of the Federal Open Market Committee, the Federal Reserve is to continue reinvesting principal payments from its securities holdings and will complete its second round of quantitative easing (which will total $600 billion) by the end of the first half of 2011. While the Federal Reserve's view on the economy was somewhat less favorable compared to the start of the year, long-term inflation figures are still projected to stay within the Fed's target range (the impact of higher commodity and food prices was assessed as 'transitory'), despite an upward revision of the inflation forecast. Indeed, although headline inflation jumped in March to its highest level since October 2008, a less volatile measure of price stability (which excludes energy costs and food prices) remained well within the comfort zone (see chart 14). Market inflation expectations, albeit on the rise, are still below historic averages (see chart 15). This means the Fed is likely to stick to an ultra-loose monetary policy in the foreseeable future to promote employment and support the U.S. housing market.

Having said that, the housing recovery is still struggling to maintain its momentum, despite increasing employment and record high housing affordability[8]. In addition, despite recent modest improvements (for example, 11% more building permits were issued in March than in February, while housing starts posted a 7% monthly gain)[9], sales and prices remain at low levels due to the increasing volume of distressed properties entering the market. According to the National Association of Realtors, distressed homes, which are typically sold at a discount of 20% compared to similar properties, accounted for 40% of all home sales in March - up from 39% in February and 35% a year ago. In addition, national existing home sales were 6.3% lower than in March 2010, while median existing single-family home prices dropped by 5.3%. A similar trend was observed in Texas – home sales were up by about 6% in March versus February, yet they dropped by 12% versus March 2010 (see chart 16). Last year's surge of housing activity due to the first-time home buyer tax credit is distorting housing statistics and, more importantly, points to a lack of strength in housing demand when federal government support is not available. On a positive note, according to the Real Estate Center at Texas A&M University, median home values in Texas stood mostly unchanged compared to a year ago. Furthermore, out of 20 large U.S. metros tracked by the S&P/Case-Shiller Home Price Indices, Dallas was one of the four metros (the other three are Washington D.C., Atlanta and Cleveland) where home prices grew for the third consecutive month in February (the Composite-20 Index fell for the eighth straight month). In February, home values in Dallas were only 7% lower than at the peak of the housing bubble in 2007 (see chart 17). This price dynamic is due to more affordable housing in Texas and more stable demand. Both factors should support a stronger housing recovery as job creation gathers pace.

Consumer Price Index 14
all urban consumers, % annual change, seasonally adjusted

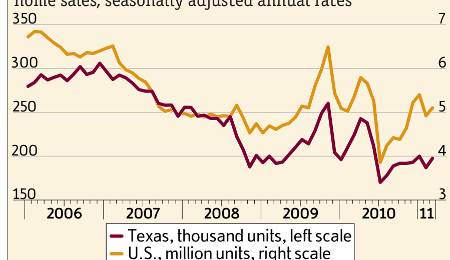


Source: The U.S. Bureau of Labor Statistics

Implied inflation 15
monthly yield spreads between the rates on 10-Year Treasury Securities and 10-Year Inflation Protected Treasury Securities

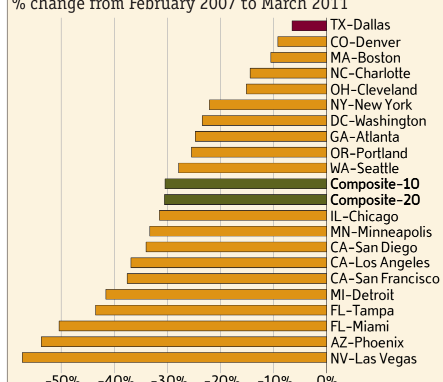
Source: The Federal Reserve Bank of St. Louis

A sluggish recovery of the housing market 16
home sales, seasonally adjusted annual rates



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

Home values held up relatively well in Texas 17
seasonally adjusted home prices, % change from February 2007 to March 2011



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

[8]The National Association of Realtors estimates that the typical monthly mortgage principal and interest payment for the purchase of a median-priced home dropped to only 13% of household income – the lowest level on record.

[9]In March, building permits and housing were still 13% lower than a year ago. Source: The U.S. Census Bureau.

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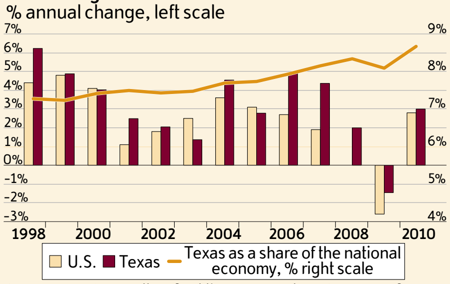
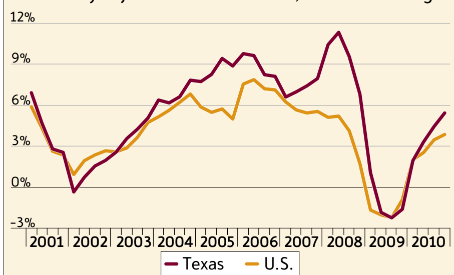
Economic growth: Texas vs. U.S.
% annual change, left scale



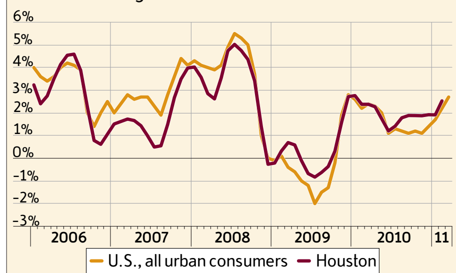
Source: Texas Comptroller of Public Accounts, The U.S. Bureau of Economic Analysis

Personal income
seasonally adjusted at annual rates, % annual change



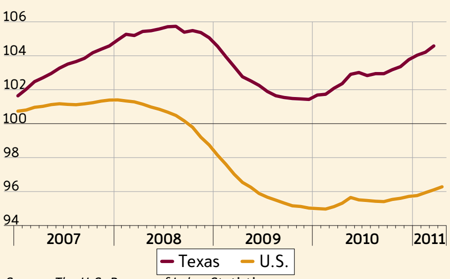
Source: The U.S. Bureau of Labor Statistics

Consumer prices
% annual change



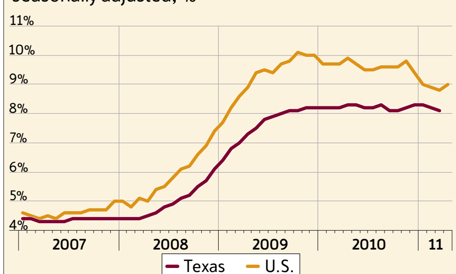
Source: The U.S. Bureau of Labor Statistics, The Federal Reserve Bank of Dallas

Nonfarm employment
2006=100



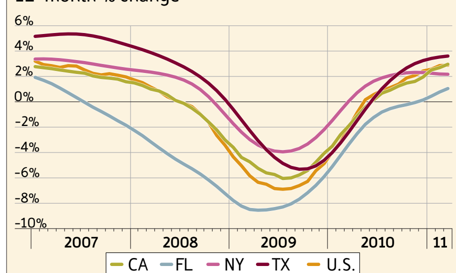
Source: The U.S. Bureau of Labor Statistics

Unemployment rates
seasonally adjusted, %



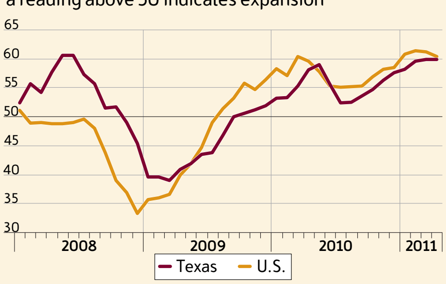
Source: The U.S. Bureau of Labor Statistics

State Coincident Indexes
12-month % change



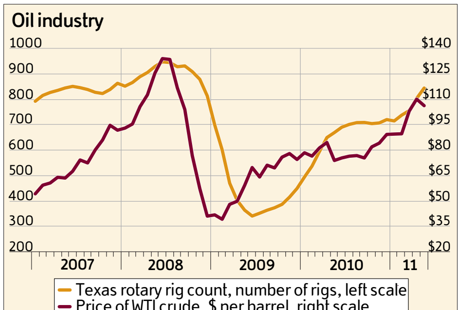
Source: The Federal Reserve Bank of Philadelphia

Purchasing Managers Index
a reading above 50 indicates expansion



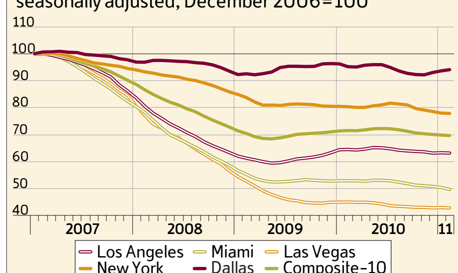
Source: The Institute for Supply Management

Oil industry



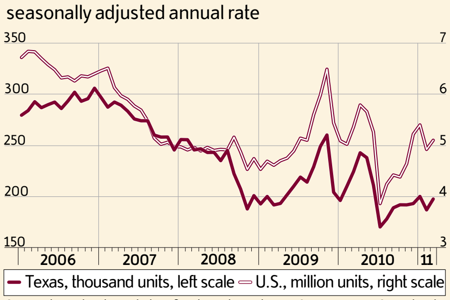
Source: The Federal Reserve Bank of Dallas

Home values
seasonally adjusted, December 2006=100



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

Home sales
seasonally adjusted annual rate

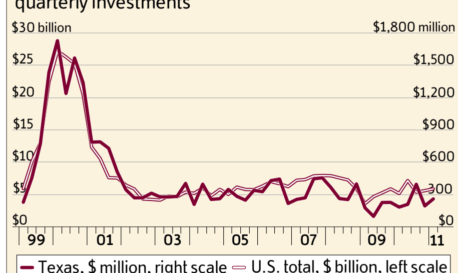


Source: The National Association of Realtors, The Real Estate Center at Texas A&M University

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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