- **The jobless rate in Texas stood at 8.2% with 32,000 new jobs added in June.**
- **The Texas Manufacturing Outlook Survey points to an uptick in factory activity in July.**
- **Texas housing recovery remains ahead of the national trend.**
- **In the first half of 2011, exports from Texas grew by 24%.**
- **Texas Governor Rick Perry declared he's running for US President.**

Executive summary

The latest economic data paints a much less favorable outlook for the world economy. Fragile consumer and business confidence, fiscal uncertainty, European sovereign debt troubles, and policy tightening in emerging markets are exerting a toll on global economic recovery. Although, slower global growth is creating headwinds for the Texas economy, the state continues to buck the national trend in several areas, most notably jobs and factory activity, for various reasons.

First, manufacturing in Texas is less exposed to weak U.S. consumer demand due to closer ties to overseas markets. In January-June, exports from Texas grew faster than the U.S. as a whole, and accounted for close to 17% of all U.S. exports. Although a large portion of this gain was due to higher commodity prices, Texas exports of high-end manufactured goods exhibited a solid uptrend as well. This testifies to the well-diversified and balanced makeup of the Texas economy. In addition, a more pronounced focus on business equipment and industrial chemicals, as well as a greater reliance on booming emerging markets, partly shielded Texas manufacturers from the recent dip in U.S. consumer spending. As a result, in July, the Houston Purchasing Managers Index was 6% above its 2010 average, while the national metric for factory activity fell to its lowest level in nearly two years.

Second, the Texas Manufacturing Outlook Survey points to an uptick in factory activity, partly thanks to a booming energy sector. The Texas rotary rig count and well permit applications are close to record highs. Meanwhile, local high-tech manufacturers are benefiting from strong demand for corporate data centers and enterprise software services. Robust global sales of semiconductors bode well for Texas' growing semiconductor industry.

Third, U.S. construction activity lingers at record lows with no evidence yet of a housing correction. This sector is particularly weak in Florida, California, Nevada, and Arizona. The picture in Texas, however, is different, due to less severe overbuilding at the onset of the financial crisis. Texas was the only large state that had more housing permits in the first half of 2011 than a year ago. As a result, most of the country's housing activity is now concentrated in Texas. Indeed, Texas currently issues about 16% of all housing permits in the nation (up from just 10% in 2005).

These factors have helped keep the Texas labor market on a relatively stronger footing. In June, the Texas jobless rate (8.2%) was well below the national average. In addition, the unemployment rate in Texas remains more or less unchanged due to a growing labor force refilling the pool of unemployed workers. Meanwhile, the labor force in Florida and California has barely grown over the last three years (despite increasing populations), with jobless resident's becoming increasingly disillusioned about finding new jobs in these states. By contrast, better job prospects in Texas have kept labor force participation rates at about the same level as the beginning of the economic downturn. As a result, the Texas labor force has broadly increased in line with population growth.

Lastly, the Texas private sector is creating jobs at a faster pace than the nation as a whole. Over the past 12 months, Texas has added over 240,000 new private sector jobs (thanks to solid gains in mining, construction, manufacturing and service-providing industries). As a result, Texas has already recovered 87% of the almost 400,000 private sector jobs lost during the 2007 recession. Meanwhile, the nation as a whole is still short by three quarters of the 8.8 million private jobs destroyed during the economic downturn. In addition, unlike the nation as a whole, all major sectors of the Texas economy either have already recovered lost jobs or are in a more advanced job recovery phase. This picture does not change much even when adjusted for the shorter duration of the peak-to-trough private employment cycle in Texas. We believe this broadening of the labor market recovery in Texas will help sustain stronger job growth in the state well into the future.

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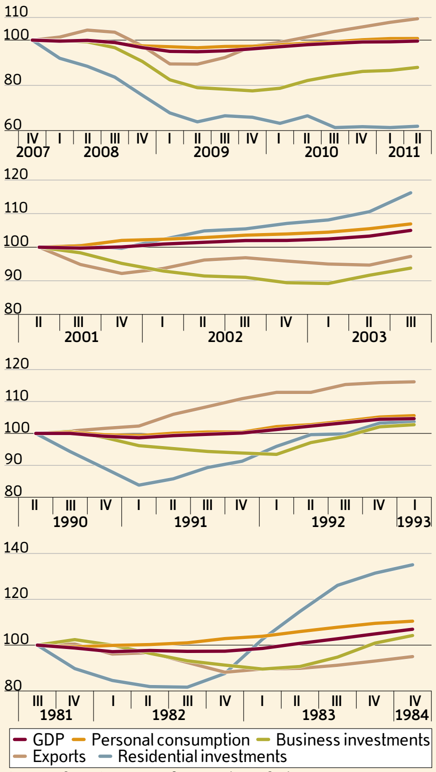
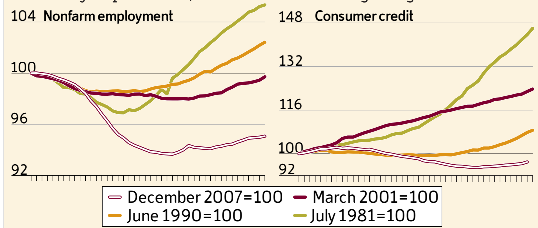
Economic growth during the last four recessions 1
business cycle peak = 100



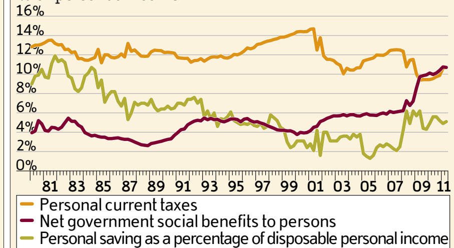
Source: The U.S. Bureau of Economic Analysis

Nonfarm employment and consumer credit 2
business cycle peak = 100, 44 months after the beginning of the downturn



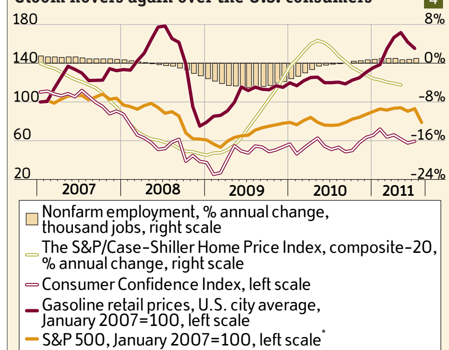
Source: The Federal Reserve, The U.S. Bureau of Labor Statistics

Taxes and social benefits 3
% of personal income



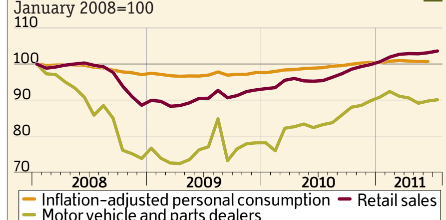
Source: The U.S. Bureau of Economic Analysis

Gloom hovers again over the U.S. consumers 4



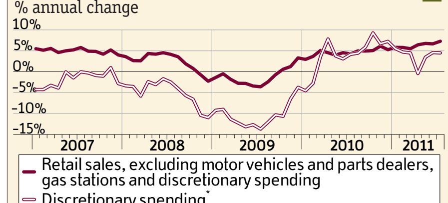
**As of August 19th, 2011.*
Source: The Conference Board, The Federal Reserve Bank of St. Louise, The U.S. Bureau of Labor Statistics, The U.S. Energy Information Administration

Retail sales are stalling 5
January 2008=100



The U.S. Bureau of Economic Analysis, The U.S. Census Bureau

Consumers are wary of loosening their purse strings 6
% annual change



**Spending on furniture & home furnishing stores, building materials, garden eq. & supply dealers, sporting goods, hobby, book & music stores and electronics & appliance stores – about a quarter of all retail sales net of car and gas sales.*
Source: The U.S. Census Bureau

Economic output

Although Texas continues to buck the national trend on several scores, most notably on jobs and factory activity, slower U.S. and global growth is creating a headwind for the local economy. This report ponders the latest national economic data and the question of whether Texas remains more resilient to re-emerging economic risks.

Fragile consumer and business confidence, fiscal uncertainties, European sovereign debt troubles, and policy tightening in emerging markets are all exerting a toll on the U.S. economic recovery. The Bureau of Economic Analysis puts second quarter GDP growth at a frustratingly slow 1.3% annual rate - a rather sluggish pace that will not significantly reduce the jobless rate. Although this recovery is now two years old, output is just approaching pre-crisis levels. This is in stark contrast to the previous three downturns, when it took a year (at most) for the economy to bounce back to pre-recession levels (see chart 1).

Chart 1 also shows that past recoveries have been driven by a sustained rebound in consumer spending, supported by new jobs and/or increasing consumer borrowing. By contrast, the latest downturn has left much deeper scars in the job market, and has pushed households into a significant deleveraging cycle (see chart 2). In addition, inflation-adjusted personal disposable income, which is a good gauge of personal spending, is a mere 2.5% higher compared to its pre-crisis level three years ago.[1]

It is worth adding that payroll tax cuts and social benefits (for example, unemployment insurance) have been propping up consumer income during the latest downturn, even though much of these tax cuts are being saved rather than spent (see chart 3). This means the expiry of a payroll-tax credit and extended jobless benefits at the end of this year are likely to create an additional drag on personal consumption.

Low consumer confidence is also an issue for the struggling U.S. economy. Higher fuel prices and sinking home values have been battering consumers since the beginning of 2011 (see chart 4). Indeed, retail sales slowed in the second quarter of 2011 (see chart 5) pointing to a shift in outlook by the American consumer. Arguably a part of this deceleration may be attributed to lagging car sales and supply disruptions from Japan[2] – in the second quarter of 2011, retail sales of motor vehicles and parts fell by 1.8% versus the quarter before. Thus, a gradual return to normalcy in the automobile industry, and a recent fall off in gas prices, should provide a modest boost to retail sales later this year. However, overall discretionary spending shows signs of softness as increased economic uncertainty makes consumers reluctant to shop (see chart 6). Although shoppers are still in a more upbeat mood compared to the depths of the financial crisis, the latest gyrations in the stock market, and a slow-moving labor market, risk triggering a fresh wave of consumer pessimism.

[1] Three years after the 2001, 1990 and 1981, inflation-adjusted personal disposable income was 8%, 7% and 14% higher, respectively, versus pre-recession highs.
[2] According to Autodata, unlike the three largest U.S. car makers, Honda and Toyota continued to report lower sales in July versus a year ago.

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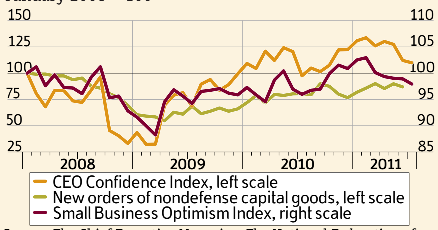
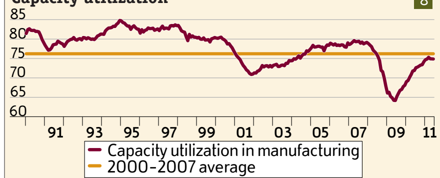
Businesses are putting expansion plans on hold 7
January 2008 = 100



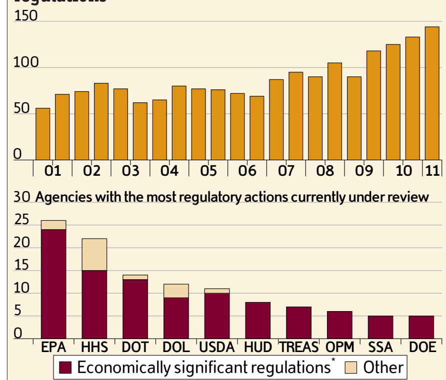
Source: The Chief Executive Magazine, The National Federation of Independent Business, The U.S. Census Bureau

Capacity utilization 8



Source: The Federal Reserve

The number of pending economically significant regulations 9



*Regulations costing $100 million or more every year.
EPA - U.S. Environmental Protection Agency
HHS - U.S. Department of Health and Human Services
DOT - U.S. Department of Transportation
DOL - U.S. Department of Labor
USDA - U.S. Department of Agriculture
HUD - U.S. Department of Housing and Urban Development
TREAS - U.S. Department of the Treasury
OPM - U.S. Office of Personnel Management
SSA - U.S. Social Security Administration
DOE - U.S. Department of Energy
Source: The Heritage Foundation, The Office of Information and Regulatory Affairs

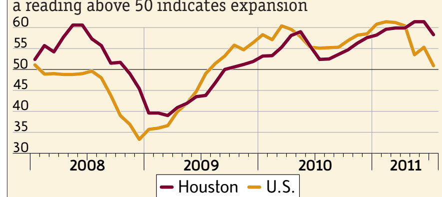
Meanwhile, despite robust corporate earnings and record liquidity, business confidence remains shaky (see chart 7). As a result, business investment is recovering at a slower pace compared to previous cycles. A deeper drop in capacity utilization versus prior recessions, which has reduced the need for capital expenditure during this recovery, may partly explain this trend. In fact, U.S. manufacturing capacity utilization is still below its pre-crisis trend level (see chart 8).

Additionally, businesses may be reluctant to hire and expand their operations because of tax and regulatory uncertainty, as well as concerns about the fiscal outlook. According to the Heritage Foundation, companies are becoming increasingly challenged by growing red tape (see chart 9) due to the overhaul of financial regulations and healthcare reform.

Rising economic uncertainty is prompting companies to put hiring plans on hold or even consider job cuts[3] as business activity weakens (see chart 10). Indeed, weaker factory activity is usually a harbinger of slower job growth in manufacturing (see chart 11).

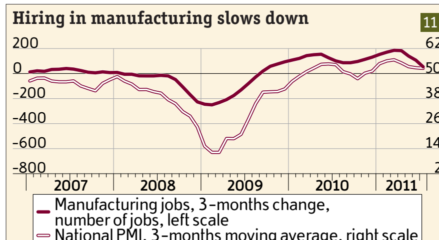
Despite the somewhat bleak national picture, manufacturing in Texas remains less exposed to weak consumer demand thanks to a stronger link to overseas markets. In January-June, exports from Texas grew by about 24% versus 18% nationwide[4], and accounted for close to 17% of all U.S. exports. Although a large portion of this gain was due to soaring crude oil, cereals and cotton prices, Texas exports of high-end manufactured goods (such as industrial machinery, transportation equipment, electronics and chemicals) remain on a solid uptrend. This testifies to the well-diversified and balanced makeup of the Texas economy. For instance, exports of crude oil, cereals and cotton account for just 26% of all exports in Texas (versus 70% of all exports for Louisiana - another big commodity exporter). In addition, a more pronounced focus on industrial machinery, computers and chemicals, as well as a greater reliance on booming emerging markets (Texas ships over 65% of its exports to the developing world versus just 41% nationwide) partly shields Texas manufacturers from the recent dip in U.S. consumer spending. As a result, the latest deterioration in economic outlook for the country as a whole has had a somewhat milder impact on Texas - at 58.3 the Houston Purchasing Managers Index is 6% above its 2010 average. Meanwhile, in July the U.S. PMI fell to its lowest level in nearly two years.

Factory activity is slowing 10
Purchasing Managers Index (PMI)
a reading above 50 indicates expansion



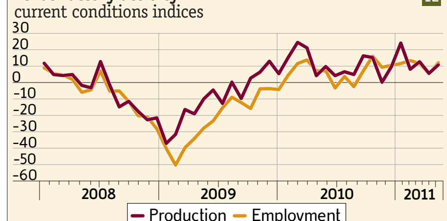
Source: The Institute for Supply Management

Hiring in manufacturing slows down 11



Source: The U.S. Bureau of Labor Statistics, The Institute for Supply Management

Texas factory activity 12
current conditions indices



Source: The Federal Reserve Bank of Dallas

The July Texas Manufacturing Outlook Survey points to an uptick in factory activity, with production and employment more than double June's reading (see chart 12). Meanwhile, manufacturing activity continued to slow in New York, Kansas and Richmond and increased slightly in Philadelphia, albeit following a contraction the month before.[5] A booming energy sector can partly explain this better performance of the Texas economy – in July, the Texas rotary rig count and well permit applications were 27% higher than a year ago. Texas high-tech manufacturers are also benefiting from the robust demand for corporate data centers and enterprise software services. Indeed, leading U.S. suppliers of IT equipment and services, for example Cisco, HP, Dell and IBM, are reporting solid gains in the second quarter thanks to growing demand for information technology services in enterprise, storage and

[3]According to the latest study by the Chief Executive Magazine, about two thirds of all surveyed CEOs plan to freeze or downsize their workforce.
[4]Exports from California, the second largest U.S. exporting state, grew by just 13%.
[5]Source: District Federal Reserve Banks' surveys of manufacturing activity.

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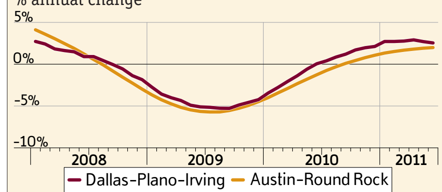
networking segments. Meanwhile, according to the Semiconductor Industry Association, global sales of semiconductors were up by 3.7% in the first half of 2011. This helps the economies of both Dallas and Austin (see chart 13). Indeed, Texas has a large and growing semiconductor industry with leading semiconductor producers, including Texas Instruments, STMicroelectronics and Samsung, all having operating facilities in the state.

Metro Business Cycle Indices 13
% annual change



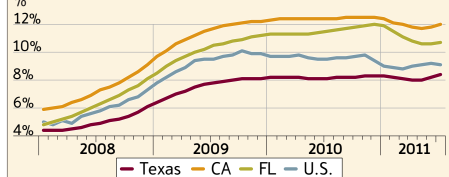
Source: The Federal Reserve Bank of Dallas

Throughout the U.S., construction activity lingers at record lows with no sign of a housing correction in sight. According to the U.S. Census Bureau, during the first half of 2011, the number of newly issued building permits was almost 4 times lower than its peak in 2005. The number of issued housing permits in Florida, California, Nevada, and Arizona is almost 7, 5, 6, and 8 times lower, respectively, than at the highpoint of the construction boom. The picture is markedly different in Texas where the number of newly issued housing permits is only 2 times less than six years ago. Texas was the only large state (excluding New York, which issues 4 times less housing permits compared to Texas) that had more housing permits in the first half of 2011 (up by 1.1% thanks to a 74% jump in new permits for multi-unit buildings) than a year ago.[6] As a result, Texas currently issues about 16% of all housing permits in the nation (or more than Californian and Florida combined) – up from just 10% in 2005, when Texas was only the third largest state (after Florida and California) by number of new housing permits.

Employment

In June, Texas created 32,000 new jobs thanks to increasing employment in both the private and public sector (up by 19,700 and 27,300 jobs, respectively). Meanwhile, only 46,000 jobs were created nationwide as private sector job gains were offset by job cuts in state and local government. As a result, at 8.2% the Texas jobless rate remains well below the national average (see chart 14). In addition, the average duration of unemployment is shorter in Texas[7], which points to a healthier job market.

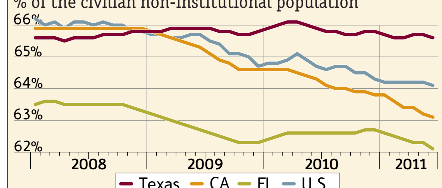
Texas jobless rate 14
%



Source: The U.S. Bureau of Labor Statistics

It is worth noting that bigger jobless rate declines in California and Florida since the beginning of 2011 should not be misread as an indication of a faster labor market turnaround in these states compared to Texas. The unemployment rate in Texas remains more or less unchanged since the beginning of the economic recovery due to a growing labor force that has been consistently refilling the pool of unemployed workers. Indeed, labor force participation rate has remained relatively stable in Texas (see chart 15), meaning the labor force has increased in line with population growth. Since January 2008, the labor force in Texas grew by 6.3% on 6.4% population growth. During the same period, the population of Florida and California increased by 3.1% and 4.1%, respectively; however, the labor force shrank by 0.2% in California and grew by just 0.8% in Florida.

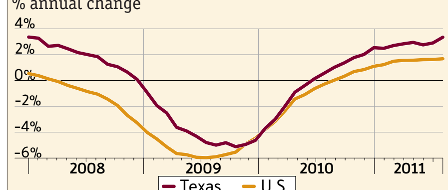
Labor force participation rates 15
% of the civilian non-institutional population



Source: The U.S. Bureau of Labor Statistics

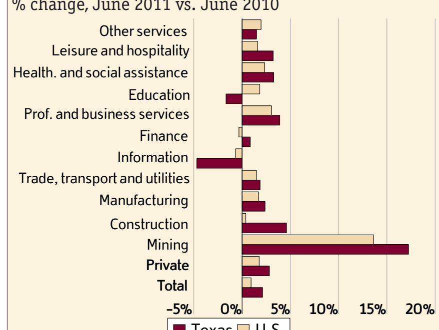
The Texas private sector is creating jobs at a faster pace than the nation as a whole (see chart 16). Over the last 12 months, Texas has added over 240,000 new private sector jobs, thanks to solid gains in goods-producing industries (mining, construction and manufacturing) and a healthy uptick in hiring in service-providing sectors (professional and business services, trade, transportation, finance and leisure, and hospitality) (see chart 17). As a result, Texas has already recovered 87% of the 400,000 private sector jobs lost during the 2007 recession. Meanwhile, the nation as a whole is still short three quarters of the 8.8 million private jobs destroyed during the economic downturn (see chart 18.a). Chart 18.a also shows that unlike the nation as a whole, nearly all major sectors of the Texas economy either have already recovered lost jobs or are in a more advanced job recovery phase. This picture does not change much even if adjusted for the shorter duration of the peak-to-trough private employment cycle in Texas (from July 2008 to December 2009 versus December 2007 to February 2010 nationwide). Indeed, Texas has already regained 72% of all private sector jobs lost since July 2008 (see chart 18.b) and is just 1.5% off the previous peak private

Private sector jobs 16
% annual change



Source:The U.S. Bureau of Labor Statistics

Texas outperforms the nation in job creation 17
% change, June 2011 vs. June 2010

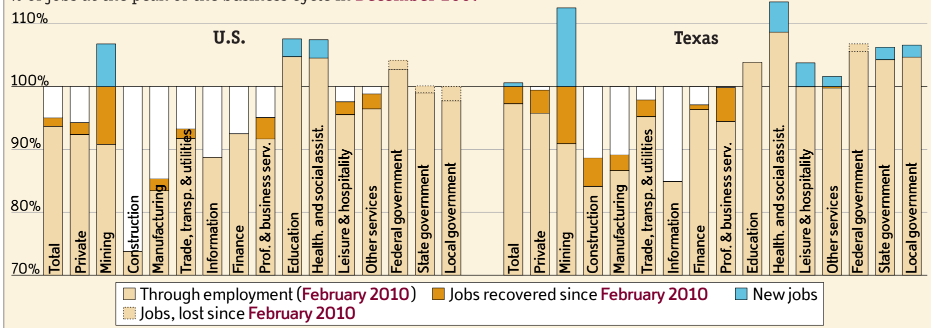


Source: The U.S. Bureau of Labor Statistics

[6]Nationwide, the number of construction permits fell by 6% versus the first half of 2010.

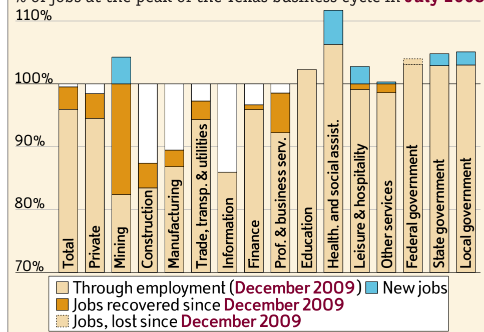
[7]In 2009 (the latest available data, provided by the U.S. Bureau of labor Statistics), the average (and median) duration of unemployment in Texas was 19.9 (11.8) weeks versus 26.5 (17.1) weeks in California or 27.5 (18.8) weeks in Florida.

Job market recovery is stronger in Texas 18.a
% of jobs at the peak of the business cycle in **December 2007**



Source: The U.S. Bureau of Labor Statistics

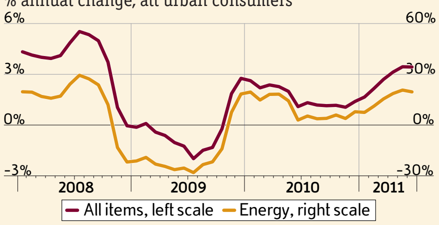
Job market recovery is stronger in Texas 18.b
% of jobs at the peak of the Texas business cycle in **July 2008**



Source: The U.S. Bureau of Labor Statistics

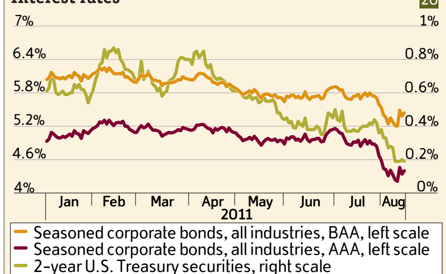
sector employment (the number of private sector jobs in the U.S. is still 5.7% lower than in December 2007). We believe this broad labor market recovery in Texas should help sustain a stronger job picture well into the future.

Consumer prices 19
% annual change, all urban consumers



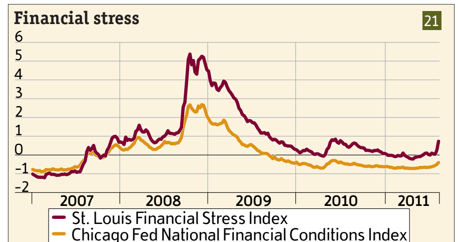
Source:The U.S. Bureau of Labor Statistics

Interest rates 20



Source: The Federal Reserve

Financial stress 21



A positive value indicates that financial stress is above the long-run average.
Source: The Federal Reserve Bank of Chicago, The Federal Reserve of St. Louis

Monetary Policy and Asset Prices

The Fed felt compelled to calm investors by pledging to keep interest rates at exceptionally low levels for the next two years. Although this decision implies the Fed anticipates a slower pace of economic recovery, it also reflects subsiding inflationary risk. Indeed, consumer prices dropped by 0.2% in June – the first monthly decline in a year (see chart 19).

Home values in the large metros 22
Q2 2011

	% of U.S. average	% annual change
U.S.	100%	-2.8%
Boston-Cambridge-Quincy, MA-NH	207%	-1.4%
Dallas-Fort Worth-Arlington, TX	**88%**	**12.5%**
Houston-Baytown-Sugar Land, TX	**91%**	**0.4%**
Austin-Round Rock, TX	**116%**	**1.4%**
Las Vegas-Paradise, NV	73%	-11.3%
New York-Northern New Jersey-Long Island, NY-NJ-PA	224%	-2.3%
San Francisco-Oakland-Fremont, CA	300%	-6.4%
San Antonio, TX	**89%**	**2.8%**
Phoenix-Mesa-Scottsdale, AZ	73%	-12.9%
Los Angeles-Long Beach-Santa Ana, CA	170%	-4.3%
Miami-Fort Lauderdale-Miami Beach, FL	108%	-13.0%

Source: The National Association of Realtors

One concern is that the latest gyrations in equity and bond markets may drive up interest rates for U.S. consumers and businesses. However, there is little evidence either the government or corporate sector currently face prohibitively high interest rates (see chart 20). The corporate sector is flush with cash, while the financial industry, although facing a stricter regulatory environment, is nowhere near the stress levels experienced during the global financial crisis (see chart 21). Still, renewed worries of a double-dip recession may be the precursor for the next round of uantitative easing. Having said that, we believe the likelihood of a new round of Treasury securities purchases by the Fed remains low. The previous two rounds of quantitative easing failed to revive the sickest parts of the U.S. economy – i.e. the residential housing market. Despite record low mortgage rates, existing home sales fell in June for the third straight month[8], while home values have yet to reach a bottom[9]. Indeed, uncertain job prospects discourage households from taking on more debt, while falling property prices and negative equity are adding to consumer pain and are restricting labor mobility. The ongoing household deleveraging implies that only a faster turnaround in the labor market will help put the housing recovery back on track. The Texas experience lends some support to this claim – according to the National Association of Realtors, existing home sales in Texas were up by 7% in the second quarter of 2011 versus the prior quarter (nationwide, home sales dropped by 5.4%). Home prices are also firmer in Texas (see chart 22).

[8] Source: The National Association of Realtors.
[9] The composite-20 S&P/Case-Shiller Home Price Index has been posting annual losses since October 2010.

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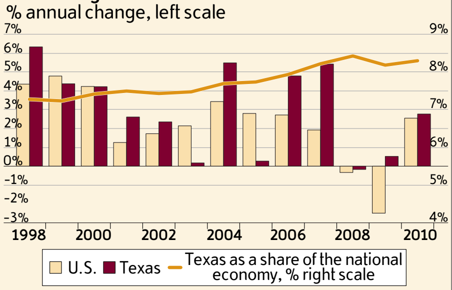
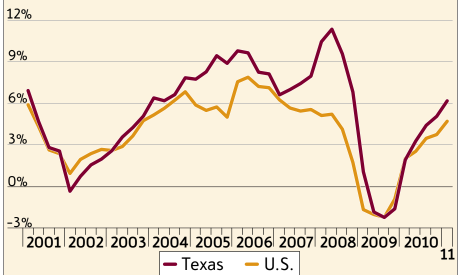
Economic growth: Texas vs. U.S.
% annual change, left scale



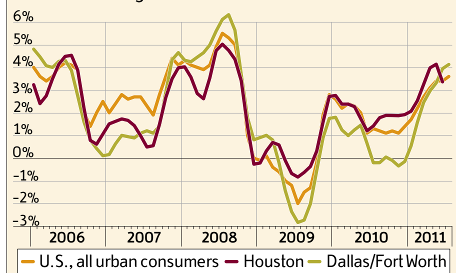
Source: *The U.S. Bureau of Economic Analysis*

Personal income
seasonally adjusted at annual rates, % annual change



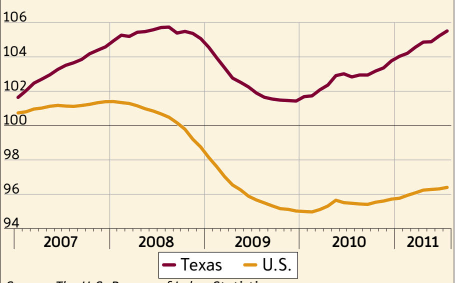
Source: *The U.S. Bureau of Labor Statistics*

Consumer prices
% annual change



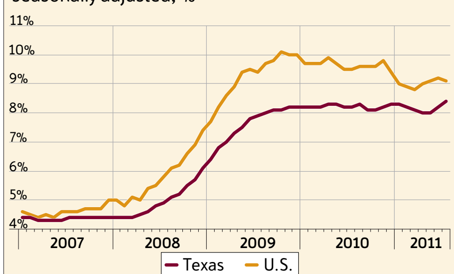
Source: *The U.S. Bureau of Labor Statistics, The Federal Reserve Bank of Dallas*

Nonfarm employment
2006=100



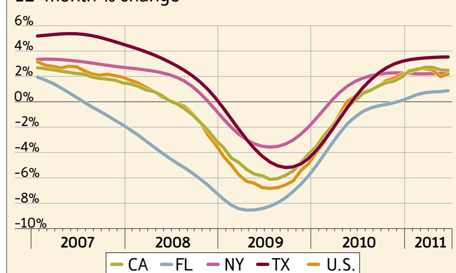
Source: *The U.S. Bureau of Labor Statistics*

Unemployment rates
seasonally adjusted, %



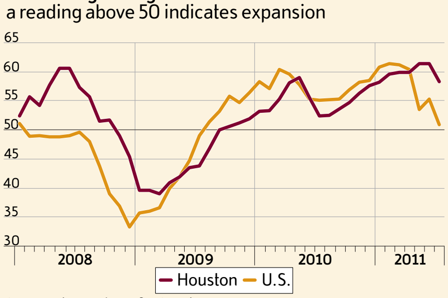
Source: *The U.S. Bureau of Labor Statistics*

State Coincident Indexes
12-month % change



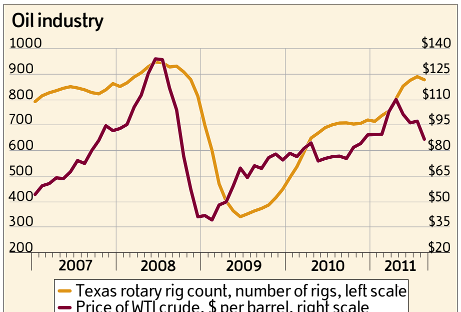
Source: *The Federal Reserve Bank of Philadelphia*

Purchasing Managers Index
a reading above 50 indicates expansion



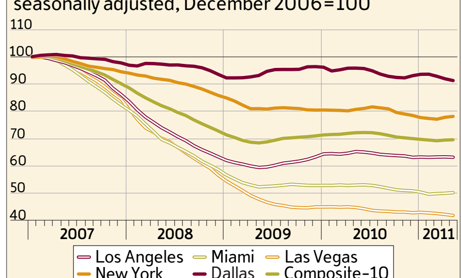
Source: *The Institute for Supply Management*

Oil industry



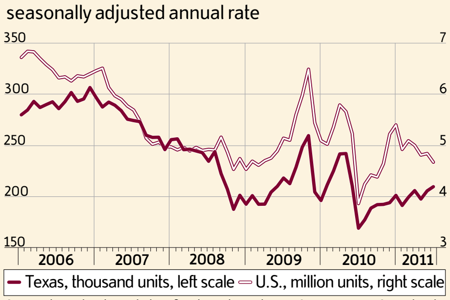
Source: *The Federal Reserve Bank of Dallas*

Home values
seasonally adjusted, December 2006=100



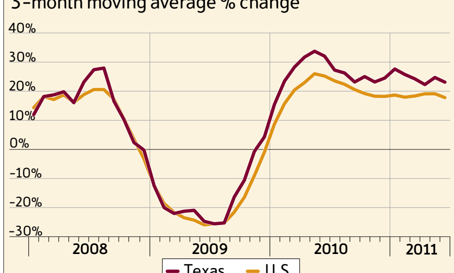
Source: *The S&P/Case-Shiller Home Price Indices*

Home sales
seasonally adjusted annual rate



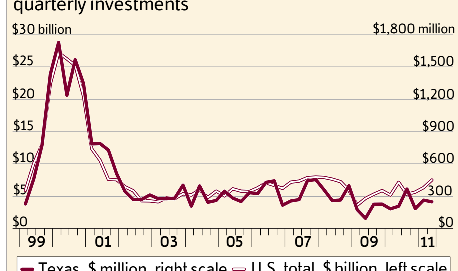
Source: *The National Association of Realtors, The Real Estate Center at Texas A&M University*

Exports
3-month moving average % change



Source: *The U.S. Department of Commerce*

Venture capital investment activity in the United States
quarterly investments



Source: *PricewaterhouseCoopers*

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