SigmaBleyzer

Texas Economic Update

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

November 2011

- **In October, the Texas jobless rate moved down to 8.4%.**
- **The Houston Purchasing Managers Index jumped to 61.3%.**
- **Texas factory activity weakened in November on slowing global demand.**
- **Texas claimed the top spot in the 2011 business climate ranking by Site Selection magazine.**

Executive summary

European economic woes continue to send ripples through global financial markets. Above all, significant exposure of EU lenders to crisis-hit sovereigns is starting to drain liquidity from the real economy. An agreement by the world's leading central banks to supply cheaper dollar loans has helped ease the threat of the euro crisis turning into a global financial panic, for now. However, it falls short of resolving the underlying sovereign solvency problems that exist in Europe.

We are starting to see economic data from different corners of the world that suggest the problems in Europe are putting a considerable drag on global economic growth. For example, manufacturing in France and Germany has quickly weakened as demand has slumped. In addition, factory activity in China contracted for the first time since February 2009, while economic growth slowed sharply in other big emerging markets, such as India and Brazil.

Despite this, the American economy appears to be faring slightly better, thanks to a healthier banking sector, a solid uptick in personal consumption, and improving manufacturing activity. In fact, continued growth of retail sales, record high Black Friday spending, and a jump in car sales to a two-year high suggest the resilience of the U.S. consumer is still in tact. Expansion of private sector payroll and recently falling joblessness has helped keep US consumers in a relatively upbeat mood. In November, consumer confidence rebounded by about one third from the month before.

The CEO Confidence Index and the Index of Small Business Optimism moved up in October, as corporations continue to report healthy earnings. Still, the failure of the congressional "supercommittee" to reach an agreement and the continued standoff in Washington over fiscal policy is clouding the economic outlook. The latest data on new orders of durable goods, along with flat business inventories, indicates that businesses continue to tread very carefully with regard to any expansion plans.

Like to US as a whole, Texas is benefiting from stronger consumer spending. Regional surveys of service and retail sectors registered a solid upturn in business activity in November. In addition, the energy sector remains an important factor, driving economic growth in Texas (and in the Houston metro, in particular). However, Texas factory activity weakened in November. While this is broadly consistent with the national picture of a slowing manufacturing recovery, the Texas manufacturing sector, which relies more on overseas markets, seems to be starting to feel the impact of the slowing global economy.

On the upside, Texas' friendly business climate is attracting an increasing number of companies to the State, along with the associated jobs and investment capital. Indeed, in November, Site Selection magazine named Texas the best place for business and industry. In October, the Texas jobless rate moved down to 8.4%, keeping it below the national unemployment rate for almost five years now. Other labor market indicators paint a relatively healthier jobs situation in Texas as well. For example, the jobless rate is falling despite rapid growth in the state's workforce (and stable labor force participation rates). Nationwide, most of the latest drop in the unemployment rate can be traced to a shrinking labor force rather than an acceleration of job creation. In fact, in October, private sector employment in Texas came within a whisker of its pre-recession peak, while there were still 5% fewer private jobs in the U.S as a whole.

Lastly, although residential housing activity, both in Texas and nationwide, remains substantially below its pre-crisis levels, property prices continue to hold steady in Texas. This is important, because weak home prices lead to greater foreclosure risk, which expands the pool of distressed properties. In addition, foreclosure paperwork and processing problems, as well as uncertainty over new regulations, are delaying any housing market correction in those states that suffered most from the bursting of the housing bubble. Thus, thanks to less severe foreclosure activity in Texas, the state is likely to see a much quicker turnaround in its residential housing market in both the short and long term.

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Where Opportunities Emerge

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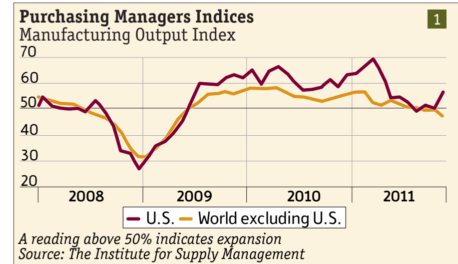
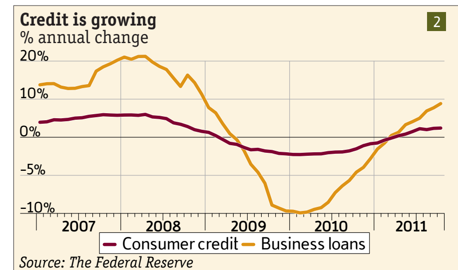
Economic output

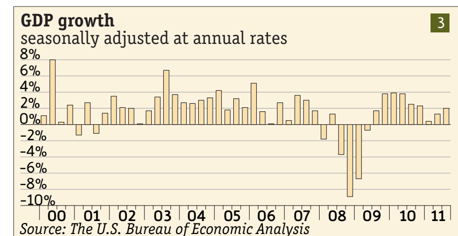
Sovereign debt worries continue to send ripples through global financial markets. With no credible solution to the European debt problem in sight, the euro crisis is engulfing bigger EU economies such as Italy and Spain. Even Germany is not immune to market panic – its recent bond auction failed to place about 40% of the issuance. Meanwhile, the congressional "supercommittee" failed to agree on a plan to reduce the U.S. budget deficit, which threatens America's triple-A rating. In fact, Fitch has just placed a "negative" outlook on the U.S. credit score, warning that the absence of a credible solution may trigger a downgrade.

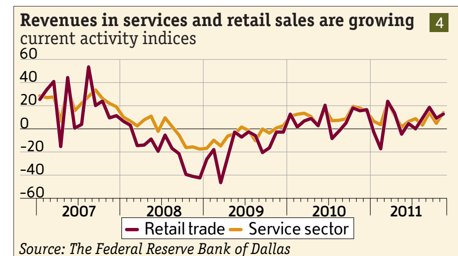


Above all, the significant exposure of EU banks to sovereign debt elevates the possibility of a fresh credit squeeze in the Eurozone. And fiscal tightening may amplify its impact on the real economy. Indeed, manufacturing in France and Germany has already weakened due to a slump in demand. Worldwide, factory activity has stalled; in November, the JPMorgan Global Manufacturing PMI dipped below 50%, lingering at this level for the fourth straight month. Manufacturing activity in China contracted for the first time since February 2009, as Chinese exports to crisis-hit Europe (about a quarter of all exports from China goes to the EU) have sharply decelerated. All of this indicates the persistence of a slow and fragile economic recovery taking hold as the new global trend.



Struggling to cope with a bleaker economic outlook and a worsening euro crisis, the world's biggest central banks joined forces to supply more liquidity to global financial markets. On the last day of November, the Federal Reserve, in a coordinated move with five other central banks, including the Bank of England and the European Central Bank (ECB), agreed to provide cheaper dollar funding to international banks, lowering the pricing of U.S. dollar liquidity swap arrangements by 50 basis points. This will allow the ECB to supply cheaper dollar loans to European commercial banks, which are becoming increasingly dependent on the central bank as a source of short-term liquidity. Indeed, American money market funds, which are an important source of dollar liquidity for European banks, have recently been cutting their exposure to Europe. According to the latest data by Fitch, the 10 biggest U.S. funds reduced their short-term lending to European banks to the lowest level in five years. On that count, a coordinated action by the leading central banks is yet another sign of how challenging it has become for European lenders to access private funding markets. Tight liquidity in the European banking system is a symptom of the underlying sovereign solvency problems that are threatening the health of many European lenders. Indeed, the one-year yield on German government notes fell below zero for the first time on record, in a sign that investors are still prepared to pay a premium for the safety of German debt versus the debt of other European governments.





The American economy appears to be faring slightly better. In November, U.S. factory activity bounced back, while manufacturing in other countries continued to weaken (see chart 1). U.S. banks have core capital ratios of 9% of assets, hold nearly $1.5 trillion in reserves at the FED, and have minimal exposure to crisis-hit Europe. As result, credit continues to flow to U.S. households and companies (see chart 2), supporting business investment and personal consumption.

As a result, in the third quarter of 2011, U.S. economic growth hit 2% (see chart 3), thanks to a 2.3% increase in personal consumption and a 15.6% growth in business spending on equipment and software. The growth in business spending is encouraging, although consumer spending remains the major component in any U.S. economic recovery – with over 80% of GDP growth coming from personal consumption. Recovering car sales in September were a big part of the stronger spending picture.

The continued growth of retail sales (up by 0.5% in October following a 1.1% gain in September), record Black Friday consumer purchases (up by 16% from a year ago) and a jump in car sales to a two-year high in November point to the surprising resilience of the American consumer.[1] In particular, according to the Conference Board, November's reading on consumer confidence rebounded by about one third versus October. Expansion of private sector payroll, albeit at a relatively slow pace, has helped keep consumers in a relatively upbeat mood. Indeed, in November, the national jobless rate fell to its lowest level since March 2009. Meanwhile, in January-November of 2011, over 1.7 million new private sector jobs were created – 70% more than during the same eleven months of 2010.

[1]Source: The U.S. Census Bureau, The National Retail Federation, Autodata

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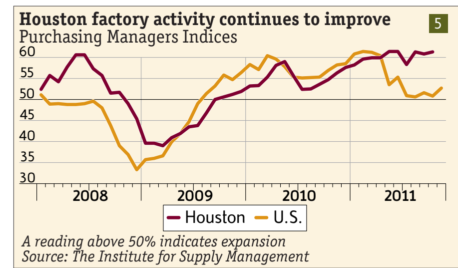
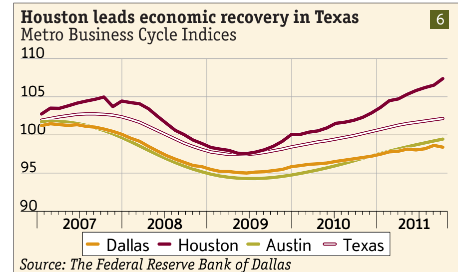
US business conditions seem to be getting better, with the CEO Confidence Index, published by Chief Executive Magazine, recovering in November back to its summer levels. A similar positive trend was registered by the monthly survey of small business, with the Index of Small Business Optimism inching up slightly in October.[2] Several factors stand behind this recent uptick in business optimism. First, corporations continue to report healthy earnings – according to CNBC, over two thirds of the S&P 500 companies that have reported their Q3 earnings beat expectations. And with profits at a record high 7% of GDP, and balance sheets recording over $2 trillion in liquid assets, US nonfinancial businesses are well positioned to invest and create more jobs. ,





Similar to the nation as a whole, Texas is benefiting from an uptick in consumer spending. In particular, surveys of the service and retail sectors by the Federal Reserve Bank of Dallas point to a solid upturn in business activity in November (see chart 4). This is important, because, unlike manufacturing and mining, service-providing industries are more sensitive to local conditions. Thus, their strength reflects improving performance of the regional economy. Clearly, with the WTI oil price above $100 per barrel, the energy sector remains an important factor driving economic growth in Texas (and in the Houston metro area in particular). Texas well permit applications and the rig count are 20% and 25% higher, respectively, than a year ago, which helps sustain manufacturing activity in Houston (see chart 5). More than that, the energy sector is creating high paying jobs (e.g., petrochemical engineers), which are supporting jobs in other sectors of the local economy. Not surprisingly, the size and vigor of the Houston metro economy (nearly a third of the state's total) has helped pull Texas out of the recent recession (see chart 6).

That being said, Texas factory activity did weaken in November, with the Texas Manufacturing Outlook Survey registering lower output and softer labor market conditions (see chart 7). These results are broadly consistent with similar surveys by the Federal Reserve Banks of Philadelphia, Richmond, New York, and Kansas, which paint a national picture of a slowing manufacturing recovery. Clearly, worries over the strength of the global economy, the European debt crisis, and domestic political uncertainty are making companies uneasy about their business outlook. Still, several local factors appear to be behind the recent divergence between Texas and national surveys, which generally tend to move in tandem (see chart 8).

First, Texas manufacturing relies more on overseas markets compared to other states, which makes local companies more sensitive to slowing global demand. While Texas exporters have a relatively small direct exposure to the European Union – Texas exports to the EU-27 account for just 10.5% of all exports versus over 18% nationwide – weaker economic growth in Europe is transmitted to Texas through its other trading partners, for whom the Eurozone is a big customer. For example, exports of industrial machinery, computers, semiconductors, and electronic components – over a third of all exports from Texas – grew by just 8% during the first three quarters of 2011 (versus much stronger growth a year ago). Falling exports of advanced electronic components (e.g., processors and controllers, semiconductors and electronic circuits) to such countries as South Korea, Singapore, Taiwan, and Mexico, which are experiencing a rapid deterioration of external demand, is of particular worry for Texas' high-tech industry. In fact, Texas Instruments, the second biggest U.S. chipmaker, cut its sales projections in October due to weak global demand for components. Meanwhile, according to the Washington-based Semiconductor Industry Association, worldwide semiconductor sales were flat in October due to falling demand in Europe.

Second, Texas was less exposed to supply disruptions in the global auto industry following the earthquake in Japan. Thus, the state benefitted less from the strong rebound in car production in the second half of 2011. Indeed, according to the U.S. Bureau of Economic Analysis, motor vehicles and parts manufacturing accounts for just above 5% of all durable goods manufacturing in Texas, versus 9% nationwide. Meanwhile, the share of petrochemicals, computer and electronic products manufacturing, machinery and industrial supplies in total Texas factory output tends to be higher than in the U.S. Yet, according to the Federal Reserve, growth in those sectors has recently slowed, which helps explain a recent weakening in factory activity in Texas.

Cleary, Texas manufacturing is starting to feel the impact of the slowing global economy. Of course, a booming energy industry continues

[2]Source: The National Federation of Independent Business

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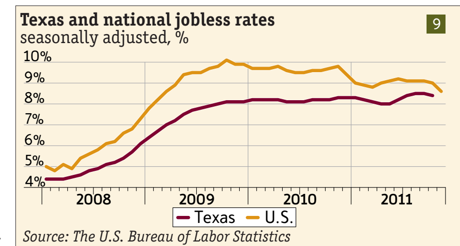
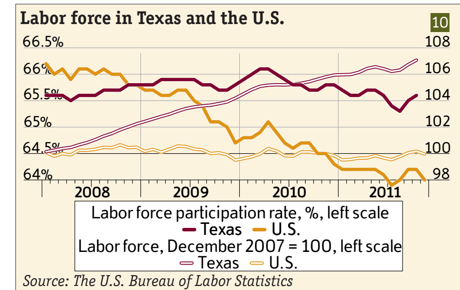
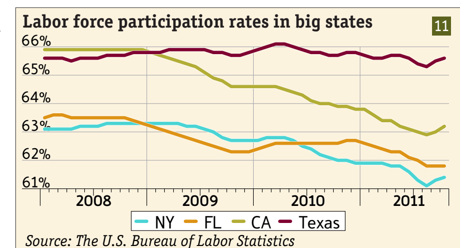
to add resilience to the regional economy. Furthermore, the friendly business climate in Texas is attracting an increasing number of companies to the state. For example, Texas leads the nation in corporate expansions and reallocations. In November, Site Selection magazine put Texas in the top spot for number of new plants in 2010. These new and expanding companies are bringing jobs and investments to Texas.



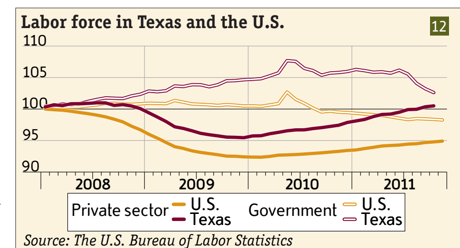
Employment

In October, the Texas jobless rate moved down to 8.4%, remaining well below the national unemployment rate for almost five years now (see chart 9). Although the gap between Texas and the U.S. unemployment rate has been recently narrowing, other labor market indicators point to a much healthier jobs situation in Texas. For example, the Texas labor force participation rate, which is a good indicator of how actively people are seeking employment, remained at about the same level as at the start of the recession. Nationwide, it dropped by 2 percentage points as jobseekers in many recession-hit states became disillusioned with their employment prospects.[3] Add to this a faster growing (and younger) population, and the Texas labor force jumped by more than 7% since December 2007 (see chart 10). Thus, most of the latest drops in the national unemployment rate can be traced to a shrinking labor force, rather than an acceleration in job creation. A glance at some of the biggest U.S. regional labor markets shows the scale of the problem (see chart 11). Although a recent uptrend in labor force participation rates may imply improving labor market conditions, following sluggish economic growth in the first half of 2011, a flat or falling labor force in such states as California and Florida will be a substantial drag on these regional economies going forward.



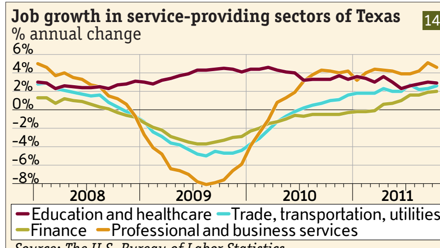


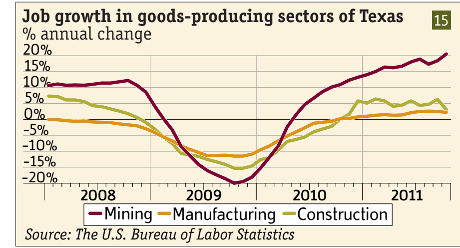
In October Texas had 2.2% more jobs than a year ago (versus just 1.2% job growth nationwide). Although Texas is losing public sector jobs faster than the nation as a whole – down by 2.9% in Texas versus just 1.3% nationwide, the private sector is creating jobs much faster. Thus, from October 2010 to October 2011, Texas created 3.4% more jobs in the private sector compared to an increase of just 1.7% nationwide. As a result, in October, the private sector in Texas employed just 0.5% fewer workers compared to the pre-recession peak - while there were still 5.2% fewer private jobs in the U.S (see chart 12).



Budget cuts continue to affect jobs at the local government level in Texas, which provides over two thirds of all government jobs and nearly 12% of all nonfarm jobs in Texas (see chart 13). Funding cuts in primary and secondary education are of particular concern, because government education services account for 66% of total local government employment in Texas. According to the Center on Budget and Policy Priorities, inflation adjusted spending per pupil was cut by over 10% in Texas – the third fastest reduction nationwide. As a result, in October, Texas had 4% fewer jobs in local government education services versus a year ago.

Private service-providing sectors are doing better thanks to solid gains in education and healthcare jobs, although the pace of job growth may be starting to decelerate (see chart 14). Employment in mining continues to expand at double digit rates thanks to increasing activity in shale-gas exploration and deep water drilling. Meanwhile, job growth in construction is disappearing and it is decelerating in manufacturing (see chart 15) - both sectors still have over 10% fewer jobs than at the end of 2007. Still, construction and manufacturing in Texas are performing much better than in other states – nationwide, employment in those two sectors was 26% and 14% lower, respectively, versus four years ago.





[3]Demographic forces are also push the participation rate down as the baby-boom generation is starting to move into retirement.

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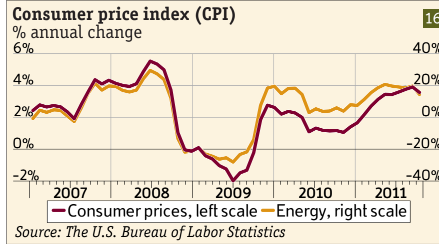
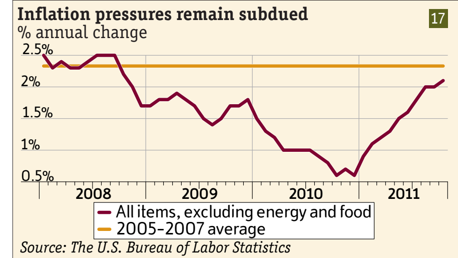
Monetary Policy and Asset Prices

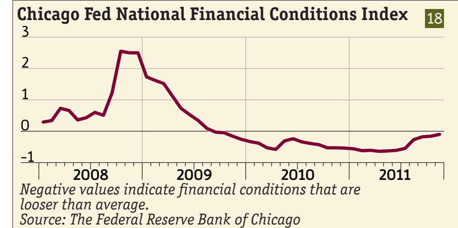
Cheaper energy prices led to lower consumer prices in October, with CPI growing by just 3.6% versus a year ago (see chart 16). Meanwhile, the growth of consumer prices, excluding more volatile fuel and foods prices, remained stable at a 2% annual rate compared to its rapid ascent in the first half of 2011 (see chart 17). This means that, despite rather loose monetary conditions (see chart 18), price inflation remains subdued.



Source: The U.S. Bureau of Labor Statistics

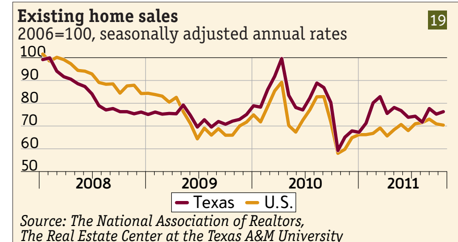


Source: The U.S. Bureau of Labor Statistics



Negative values indicate financial conditions that are looser than average.
Source: The Federal Reserve Bank of Chicago

Despite low interest rates, residential housing activity both in Texas and nationwide is substantially below its pre-crisis levels (see chart 19). Falling property prices (Texas is still an exception, see chart 20) continue to hold back any housing recovery. Weak home prices are increasing the pool of distressed property entering the market, which hurts sales and construction. For example, according to CoreLogic, at the end of the third quarter of 2011, over 10.7 million, or 22%, of all borrowers with a mortgage, owed more to banks than the value of their homes. Near negative-equity homes (i.e. properties whose value exceeds the mortgage by less than 5%) put another 2.4 million borrowers at risk of default. More than that, 45% of all borrowers have loan-to-value (LTV) ratios that exceed 80%. Nearly 70% of these borrowers are paying interest rate of 5% or more – well above the current average 30-year fixed mortgage rate of 4%. Thus, because of above average LTV ratios, many risky borrowers find it difficult to refinance at today's low interest rates.



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

Obviously, this comes as a result of the past unsustainable housing boom and the resulting collapse of home prices - Nevada, Arizona and Florida have the highest share of negative equity mortgages. Meanwhile, Texas, which saw a much milder adjustment in its housing market, continues to have one of the lowest shares of mortgages with negative and near-negative equity (9.5% and 4.9%, respectively). In addition, an average LTV ratio in Texas is just 67.5%, compared to 69.8% nationwide. This means that borrowers in Texas face lower foreclosure risk – according to RealtyTrac, in October, foreclosure filings remained on a downtrend in Texas versus a 7% increase nationwide (see chart 21). As a result, in October, the foreclosure rate in Texas was only one in 988 mortgages, compared to 1 in 259 in Arizona, 1 in 180 in Nevada, 1 in 268 in Florida, and 1 in 563 nationwide.

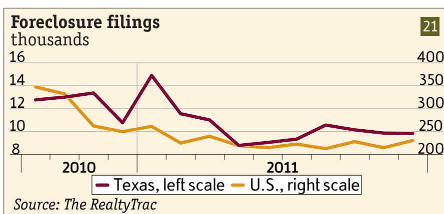
Home prices held steady in Texas 20

% change October 2011 vs. October 2010

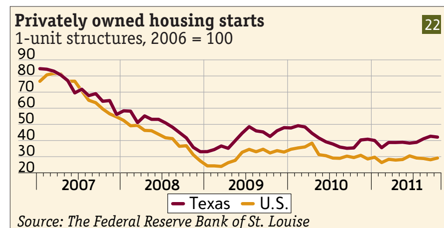
	Price	Sales
Atlanta	-20.1%	33.4%
Baltimore	-8.2%	5.2%
Boston	-11.3%	10.1%
Cincinnati	-12.0%	28.9%
Dallas-Fort Worth	**-0.8%**	**13.9%**
Houston	**0.6%**	**9.1%**
Indianapolis	-0.9%	10.8%
Kansas City	-6.6%	12.9%
Miami-Ft. Lauderdale	-14.7%	34.6%
Minneapolis-St. Paul	-11.0%	33.4%
New Orleans	-7.0%	27.0%
New York-Northern New Jersey-Long Island	-7.1%	-0.8%
Philadelphia	-7.3%	15.1%
Phoenix	-7.7%	17.3%
Portland	-5.0%	12.3%
San Antonio	**3.6%**	**5.6%**
San Diego	-7.1%	1.7%
St. Louis	-0.8%	7.8%
Washington, DC	-6.1%	4.1%
U.S.	**-3.4%**	**12.3%**

Source: The National Association of Realtors

While a significant housing recovery is still years ahead, healthier fundamentals imply resilience in the Texas residential construction industry (see chart 22). And because of less severe foreclosure activity in Texas, the state is likely to see a much quicker turnaround in its residential housing market.



Source: The RealtyTrac



Source: The Federal Reserve Bank of St. Louise

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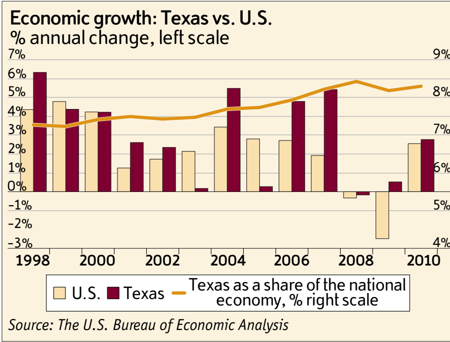

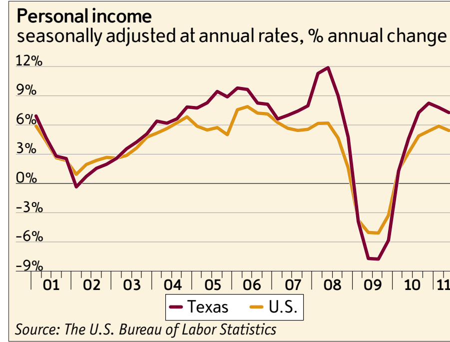

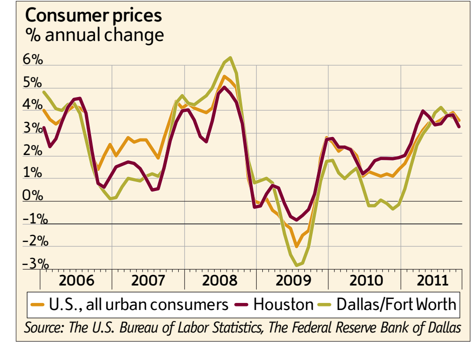

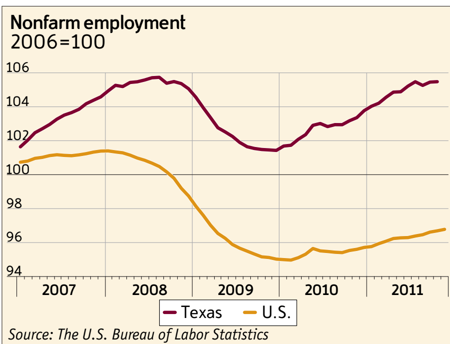

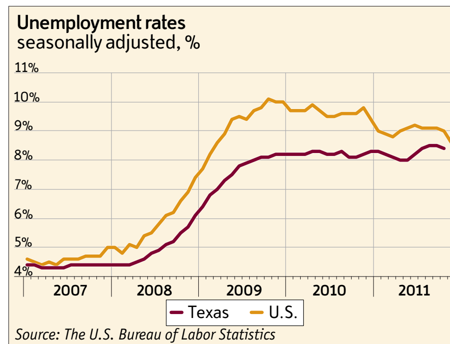

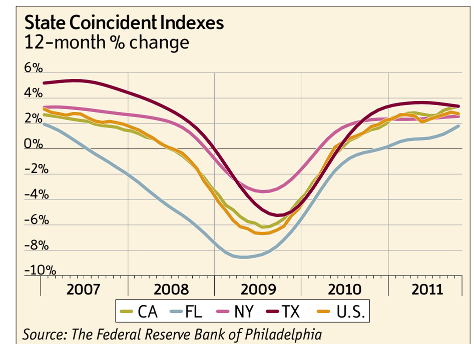

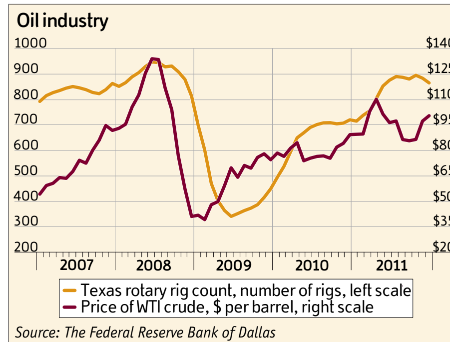

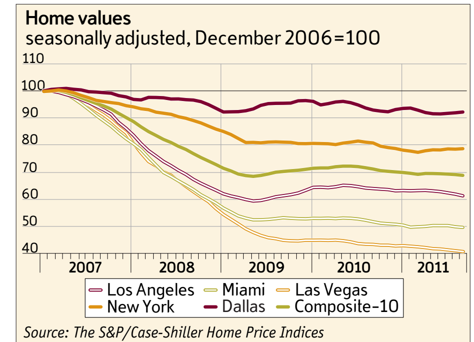

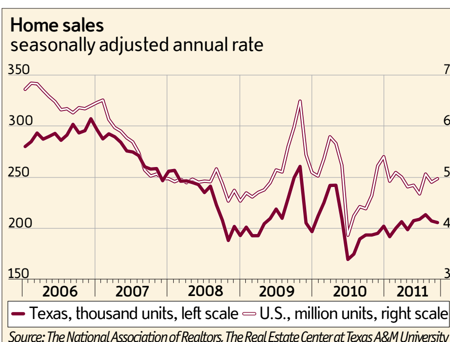

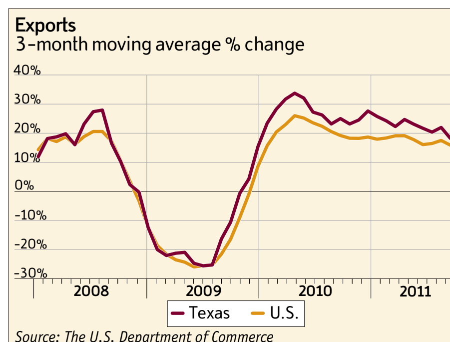

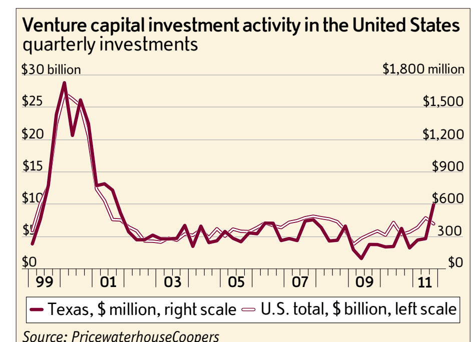

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