- **In April, the Texas jobless rate fell below 7% for the first time since March 2009.**
- **Texas factory activity grew in May for the sixth straight month.**
- **In 2011, Texas saw the strongest economic growth among the biggest U.S. states.**

Executive summary

Texas factory activity grew in May as both production and hiring in local manufacturing remained in a moderate expansionary mode. Still, the pace of growth has slowed compared to the strong start to the year. On that note, regional trends remain broadly consistent with the rest of the nation as consumers' appetite for shopping cooled somewhat due to a weakened labor market recovery.

It appears that a post-crisis uptick in consumer spending, mostly driven by growing car sales, may be starting to abate. Meanwhile, a closer look at consumer spending shows that discretionary spending as well as housing-related household expenditure is still struggling to reach pre-crisis levels. Some areas of the economy, most notably construction, have yet to regain lost ground. As a result, businesses appear to be accumulating inventories at a slower pace on expectations that an initial surge of pent-up consumer demand, which helped kick-start a manufacturing rebound, is gradually beginning to wane. Indeed, factory orders fell in April for the second straight month. Equally important, orders of capital goods continued to slow, which is a sign of companies putting their investment plans on hold due to a less optimistic economic outlook.

As capital spending and private inventory investments were revised down, first quarter GDP growth was reduced from 2.2% to 1.9%. However, these two components of GDP tend be more volatile through a typical business cycle as they are the most sensitive to changes in economic sentiment. Thus, they should bounce back as the economic outlook brightens again. However, unlike previous episodes of post-recession economic expansions, the U.S. economy is still missing several key growth factors this time.

First, recession-hit state and local governments, which saw a sharp drop in property related tax revenues following the collapse of the housing bubble, are cutting budgets. This comes in sharp contrast to previous recoveries, when state and local governments were not such a large drag on economic expansion. Thus far, politicians have failed to soften the impact of a looming fiscal contraction at the beginning of 2013, which is starting to emerge as a serious risk to the sustainability of U.S. economic growth.

Second, worries over the fate of the troubled Eurozone countries and slowing emerging economies are beginning to slow global economic activity. This means that U.S. exports and corporate profits may weaken, which may be another bump in the road to economic recovery. On the upside, an easing of global inflationary pressures and intensified risks of a second global recession make it much more likely that governments around the world will ease fiscal and monetary policies. In fact, China has just cut its main interest rate for the first time since 2008.

Lastly, the construction industry, which is usually an engine of economic recovery, has barely started to regain lost ground. Although several metrics – such as growing sales, stabile home prices, and falling mortgage delinquency and foreclosure rates – point to an improving housing market, this sector continues to be a serious drag on overall economic activity.

In fact, a more resilient construction industry is one of the factors that has supported a stronger economic recovery in Texas. In particular, since the beginning of the Great Recession, the national construction industry shrank by over 20% versus a 3.2% decline in Texas. Compared to other big states, which had an overextended construction industry, the Lone Star State is already well ahead in terms of the strength of its economic recovery. Indeed, since the end of 2007, Texas GDP grew by over 7% compared to virtually no change nationwide, a nearly 2% drop in California and a 7.5% contraction in Florida. And healthy growth of the private sector is a big part of this success story. Private service-providing industries in Texas expanded by over 10% in 2007-2011 (versus just 1.1% nationwide) due to much faster economic growth in the regional retail trade industry, financial sector, professional and business services, and healthcare.

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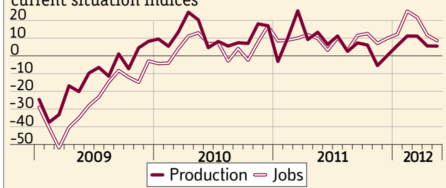
Economic output

May's reading on Texas manufacturing activity points to a steady growth of the state's factory output - both production and employment indexes of the Texas Manufacturing Outlook Survey remained in positive territory. However, the rate of growth has moderated compared to a stronger start to the year (see chart 1). This picture is broadly consistent with manufacturing trends throughout the rest of the nation (see chart 2) as consumers' appetite for shopping cooled thanks to a stalled labor market recovery (see chart 3). Indeed, businesses appear to be adding inventory at a decelerating pace (see chart 4) as pent-up consumer demand, which helped kick-start sales and production at the beginning of the recovery, is gradually beginning to wane.

In fact, the post-crisis uptick in consumer spending was largely due to improving car sales, which helped sustain a strong rebound in factory activity (see chart 5). Nearly 60% of first quarter GDP growth was generated by increasing automobile production. Meanwhile, a closer look at consumer spending on goods shows that discretionary spending (e.g., purchases of electronics and sporting goods), as well as housing related expenditure, is still struggling to reach pre-crisis levels (see chart 6). This means that some areas of the economy, most notably construction, have yet to regain lost ground. Thus, as upturn in the inventory cycle is beginning to fade, the national manufacturing recovery may be starting to face increasing headwinds. For example, factory orders fell in April for the second straight month partly due to slowing demand for capital goods (see chart 7). This, in particular, can be seen as a sign of companies putting their investment plans on hold due to a weakening economic outlook.

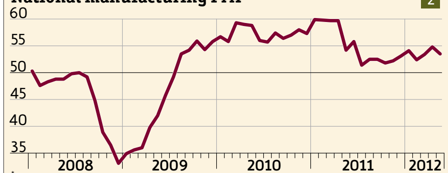
A deceleration in capital spending and private inventory investments was behind the latest revision of first quarter GDP growth from 2.2% to 1.9%. However, this may be a trend of a typical business cycle, as both inventory and equipment investments tend to be more volatile components of the economy (see chart 8). Yet unlike previous episodes of post-recession economic expansions, the U.S. economy is still missing several key growth drivers this time, which curbs the speed and strength of the labor market recovery.

Texas factory activity continues to expand 1
current situation indices



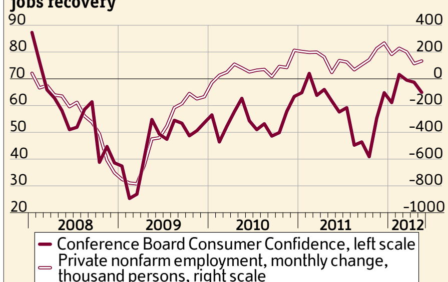
Source: The Federal Reserve Bank of Dallas

National manufacturing PMI* 2

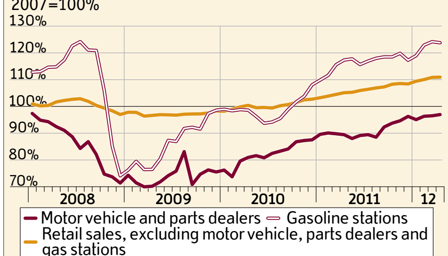


Purchasing Managers Indices, a reading above 50% indicates expansion.
Source: The Institute for Supply Management

Consumer confidence wobbles on a stalled jobs recovery 3

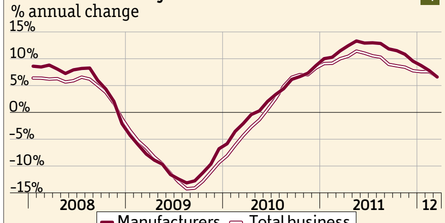


Retail sales
2007=100%



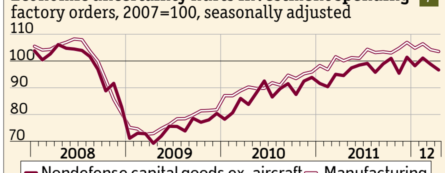
Source: The U.S. Census Bureau, The Federal Reserve Bank of St. Louis, The ADP National Employment Report

Business inventory 4
% annual change



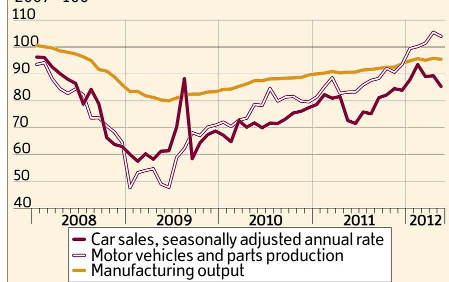
Source: The U.S. Census Bureau

Economic uncertainty hurts investment spending 7
factory orders, 2007=100, seasonally adjusted



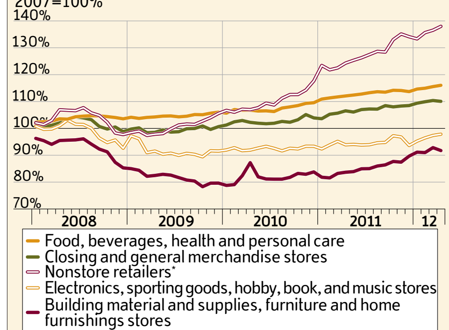
Source: The U.S. Census Bureau

Car sales are starting to cool 5
2007=100



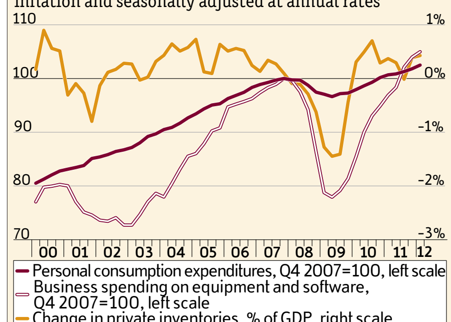
Source: The Federal Reserve, The Federal Reserve Bank of St. Louise

Retail sales, excluding motor vehicles, parts dealers and gas stations 6
2007=100%



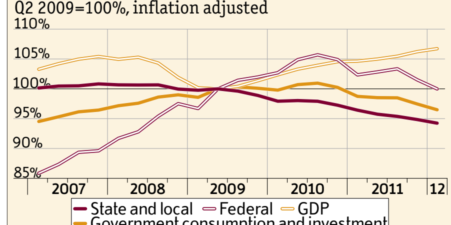
Includes electronic shopping
Source: The U.S. Census Bureau

Business investment and inventory 8
inflation and seasonally adjusted at annual rates



Source: The U.S. Bureau of Economic Analysis

Shrinking local government weighs on economic growth 9
Q2 2009=100%, inflation adjusted



State and local governments account for about 12% of the national economy
Source: The U.S. Bureau of Economic Analysis

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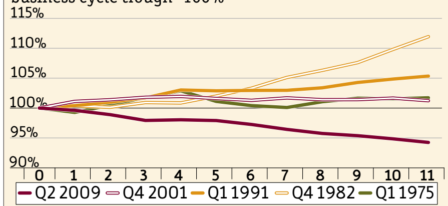
First, although the economy grew by about 7% since the beginning of the recovery (in the third quarter of 2009), government consumption and investments dropped by nearly 4% on budget cuts at the state and local level (see chart 9). This comes in sharp contrast to previous recoveries (see chart 10), when state and local governments were not such a large drag on economic expansions. After all, a collapse in the housing market and high joblessness have hit state and local government tax revenues (see chart 11), as individual income and property taxes account for over half of tax receipts.

Second, worries over the fate of the troubled Eurozone economies are starting to weaken global economic activity. In fact, the latest JPMorgan Global Manufacturing PMI indicates that global factory activity eased to its lowest level in five months, barely staying in expansionary mode on output contraction in the Eurozone and UK. This means that U.S. exports and corporate profits may weaken (see chart 12), which will be another bump in the road to economy recovery. After all, exports of goods and services make up over 13% of the national economy, while U.S. multinational businesses earn a fifth of their profits abroad.

Lastly, although several metrics – such as increasing sales, stabilizing home prices, and falling mortgage delinquency and foreclosure rates – point to an improving housing market, the residential construction industry has barely started to regain lost ground. Indeed, unlike in previous economic expansions, when residential investments were a powerful engine of growth, this time the struggling construction industry continues to be a serious drag on overall economic activity (see chart 13). All of this comes as a result of the unprecedented depth of the housing recession and a sluggish and bumpy recovery (see chart 14). More than that, considering that a big chunk of private funding that fueled the pre-crisis housing bubble is still missing (see chart 15), the residential construction industry is still struggling to play as important a role in the economic recovery as in past recoveries.

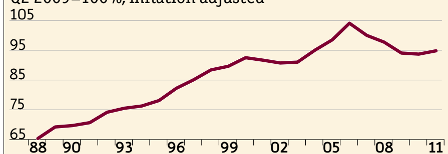
Texas faces similar difficulties to those of the nation as a whole. Yet the latest data on the state GDPs shows that the Texas economy is much better at dealing with these economic difficulties. In 2011, GDP in Texas increased by 3.3% (versus only 1.5% nationwide) – the fourth fastest economic growth in the nation after North Carolina, Oregon and West Virginia. Thanks to faster growth, Texas is now a bigger part of the national economy, having grown by a third in real terms since 2000 compared to a much slower increase of just 17% nationwide (see chart 16). Second, compared to the other four biggest states, which together with Texas account for 40% of the national economy, the Lone Star State is well ahead in terms of the strength of its economic recovery. Indeed, since the end of 2007, Texas GDP grew by over 7%, compared to virtually no change nationwide, a nearly 2% drop in California and a 7.5% contraction in Florida (see chart 17).

State and local governments - 11 quarters following five recent business cycle troughs 10
business cycle trough=100%



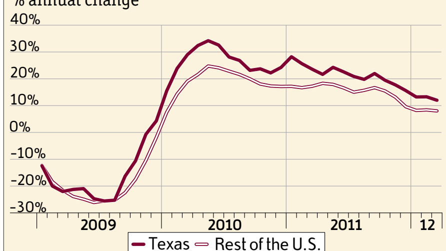
Source: The U.S. Bureau of Economic Analysis

Shrinking local government weighs on economic growth 11
Q2 2009=100%, inflation adjusted

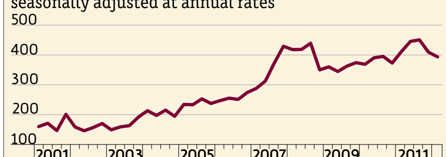


Source: The U.S. Census Bureau, The U.S. Bureau of Economic Analysis

Exports and corporate profits are trending down 12
Exports of goods, three month moving average, % annual change

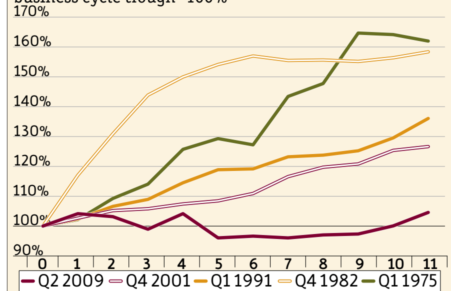


Corporate profits earned abroad, $ billion, seasonally adjusted at annual rates



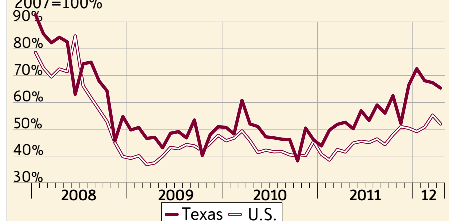
Source: The U.S. Department of Commerce, The U.S. Bureau of Economic Analysis

Residential investments - 11 quarters following five recent business cycle troughs 13
business cycle trough=100%



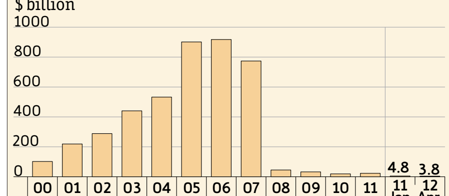
Source: The U.S. Bureau of Economic Analysis

New private housing units authorized by building permits 14
2007=100%



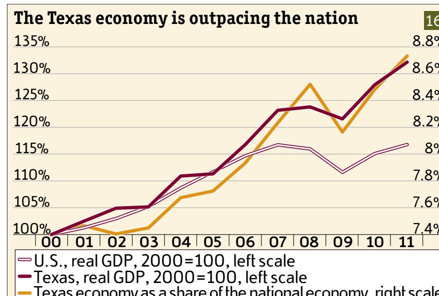
Source: The Federal Reserve Bank of St. Louise

Issuance of non-agency mortgage backed securities 15
$ billion



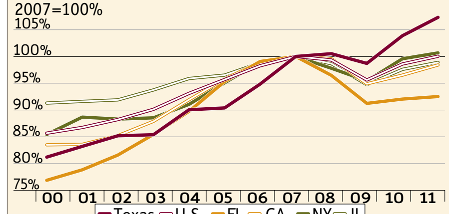
Source: Securities Industry and Financial Markets Association

The Texas economy is outpacing the nation 16



Source: The U.S. Bureau of Economic Analysis

Texas is ahead of other big states in its economic rebound 17
2007=100%



Source: The U.S. Bureau of Economic Analysis

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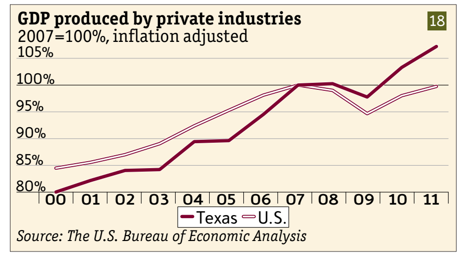
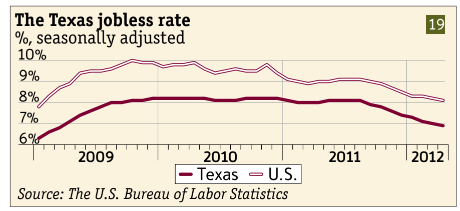
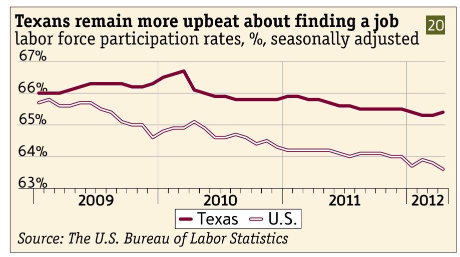
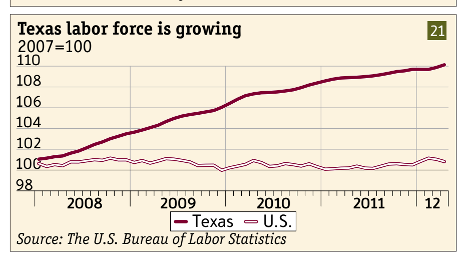


More importantly, the private sector remains the driving force behind the Texas economic rebound (see chart 18). Meanwhile, economic output for the nation a whole was pulled above its pre-crisis level only thanks to growing government spending. Interestingly, the Texas mining industry was not the primary reason for the diverging performance between the national and state economy. Since 2007, output in this sector grew by about 16%, both in Texas and nationwide; although being a much bigger share of the state's economy, mining made a significant contribution to the local economic recovery in Texas, generating over a fifth of total economic growth over the past four years. The biggest difference, however, is in construction and service-providing industries. In particular, since the beginning of the Great Recession, the national construction industry shrank by over a 20% versus a 3.2% decline in Texas. Meanwhile, in 2007-2011, private service-providing industries expanded by over 10% in Texas (compared to just 1.1% nationwide) primarily thanks to double-digit growth of the local retail trade industry, financial sector, professional and business services, and healthcare.

Employment

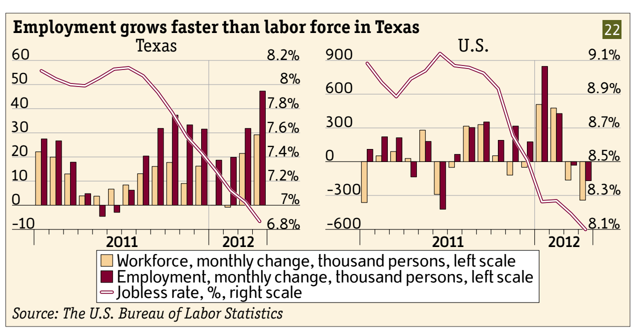






The Texas jobs picture improved in April, with the unemployment rate falling below 7% for the first time since March 2009 (see chart 19). This means that over the past twelve months, the jobless rate in Texas dropped by 1.1 percentage points versus a decline of 0.9 percentage points nationwide (from 9% in April 2011 to 8.1% in April 2012). What's more, since the start of the Great Recession in December 2007, the national labor force participation rate fell by 2.4%, while it remained mostly stable in Texas (see chart 20). Considering that most of the recent drop in the U.S. unemployment rate can be explained by the growing number of discouraged workers leaving the labor force (see chart 21), this divergence between labor force participation rates at the state and national levels is a clear sign of the underlying strength of the Texas economy. Indeed, the Texas jobless rate has been steadily falling since September 2011, precisely because the number of newly created jobs exceeded the growth of the state's labor force (see chart 22). The picture is rather different for the nation as a whole. In fact, the national jobless rate fell in March and April only because the national workforce shrank faster than employment.

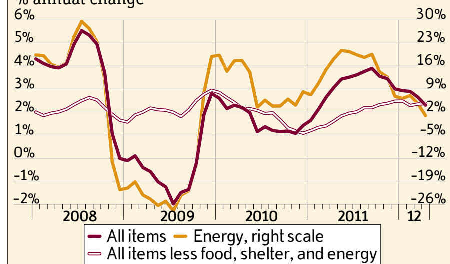
In April, nonfarm employment in Texas gained 13,200 jobs, which adds to an annual gain of over 225,000 new jobs. Private sector employment was up by 3.2% versus April 2011, with service-providing industries generating the strongest gains. Thus, employment in professional and business services, education and healthcare, trade, transportation and utilities, and leisure and hospitality increased by 3%, 3.5%, 2% and 4.1%, respectively, compared to a year ago. Job creation continued at a healthy pace in goods-producing industries as well. Mining and logging employment posted an annual gain of 15%, construction jobs grew by 2.5%, while manufacturing employment stood 3.1% higher than in 2011.



Monetary Policy and Asset Prices

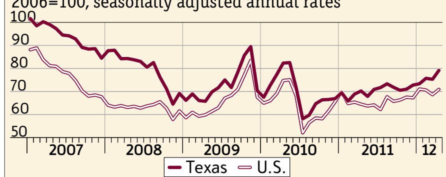
Falling energy prices continue to keep consumer inflation on the downtrend. In April, consumer prices were just 2.3% higher than a year ago – the lowest annual rate of growth in 14 months (see chart 23). This easing of inflationary pressures may prompt the Federal Reserve to consider an additional round of monetary easing following a disappointing jobs report in May. The Fed's latest policy, "Operation Twist" – launched in September 2011 to keep long-term interest rates low, will terminate at the end of June. It seems that this policy helped keep borrowing costs from rising (see chart 24). However, as the housing recovery is just starting to move to firmer footing (see chart 25), monetary policy may need to stay loose to counterbalance emerging domestic and international threats to economic growth.

Consumer prices 23
Consumer Price Index - all urban consumers, % annual change



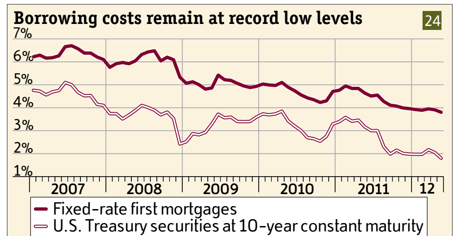
Source: The U.S. Bureau of Labor Statistics

Existing home sales are gradually improving 25
2006=100, seasonally adjusted annual rates



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

Borrowing costs remain at record low levels 24



Source: The Federal Reserve

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