SigmaBleyzer

Texas Economic Update

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

August 2012

- **U.S. economic growth decelerated to 1.7% in the second quarter of 2012.**
- **Texas factory activity grew at a slower pace in August.**
- **The jobless rate in Texas inched up to 7.1% in July.**

Executive summary

The U.S. economic recovery has been losing speed, with second quarter GDP expanding at its slowest pace since the third quarter of 2011. Most sectors faced softer demand on weakening job growth, faltering foreign demand and elevated national and global economic uncertainties. In particular, despite a slight uptick of business spending, investments grew at the slowest pace in five quarters as spending on commercial real estate failed to gain traction. In addition, declining government spending continued to subtract from economic growth for the seventh quarter in a row. Still, the residential housing sector remains a rare bright spot – it has been contributing to economic growth for the fifth consecutive quarter.

On that count, the improving outlook of the national housing sector is perhaps one of the factors underpinning stronger performance of the U.S. economy relative to other advanced countries. Yet, the travails of the Eurozone public sector offer valuable insight on the economic risks of a disorderly fiscal contraction, which may happen in the U.S. at the start of the next year. The Congressional Budget Office has warned that fiscal tightening may push economy back into recession in 2013.

This economic uncertainty, as well as an increasing regulatory burden, is sapping business confidence. As a result, businesses are delaying hiring and investment decisions – in July, new orders of capital goods fell by over 5% versus a year ago. This means that the ability of U.S. consumers to increase spending will remain central to the strength of the national economic recovery. Yet, recent data indicates that consumer demand may be weakening as well – in August, consumer confidence dropped to its lowest level since November 2011. Higher fuel prices, an anemic jobs market and uncertainties about future tax rates are adding to consumer pessimism. This elevates the risk of a pullback in household spending. Indeed, the deterioration of consumer sentiment in August was primarily driven by weakening expectations of income growth and the availability of jobs in the future.

Increasing concerns over the retrenchment in consumer and investment demand as well as a slowing global economy are already creating headwinds for U.S. businesses. In fact, readings on the strength of national business activity are pointing to a slowing economy. Most importantly, in August, national factory activity declined for the third consecutive month. On the upside, the manufacturing sector in Texas is still in expansionary mode, although the pace of growth is starting to decelerate.

The Texas mining industry, sustained by relatively high energy prices, remains an important factor adding strength to the local economy. However, this industry alone can hardly take full credit for the economic resiliency of the Lone Star State. Indeed, judged against other states where mining accounts for a comparable portion of the local economic activity, Texas is performing noticeably better. On that note, a strong rebound of business activity in Texas service industries, which rely most on local consumer spending, testifies to the underlying strength of the broader economy. And a faster turnaround of the state's jobs market is a crucial driver of this economic resilience.

In July, the jobless rate in Texas stood at only 7.1% compared to 8.3% nationwide, as the local labor market remained well ahead of national trends. In particular, the number of private jobs in Texas has already surpassed its prerecession level, whereas nationwide the private sector still employs 4.3 million fewer workers than at the start of the economic downturn five years ago.

Equally important, the jobs recovery in the largest Texas metros is proceeding at a faster pace than the national average. This is important as, for example, Houston and Dallas provide about half of all private sector jobs and account for over 60% of all new private sector jobs created over the last twelve months. After all, Texas metros are big and well diversified economies and, as a result, have been more resistant to the impact of the financial crisis.

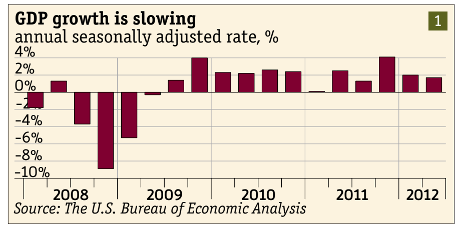
Investor Relations: Joshua Ballard
(E) jballard@sigmableyzer.com

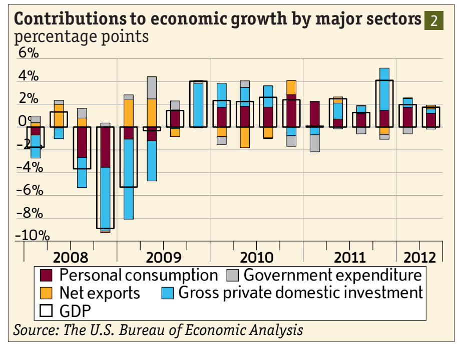
Where Opportunities Emerge

Chief Economist Edilberto L. Segura
Senior Economist Sergiy Kasyanenko
Editor Rina Bleyzer O'Malley

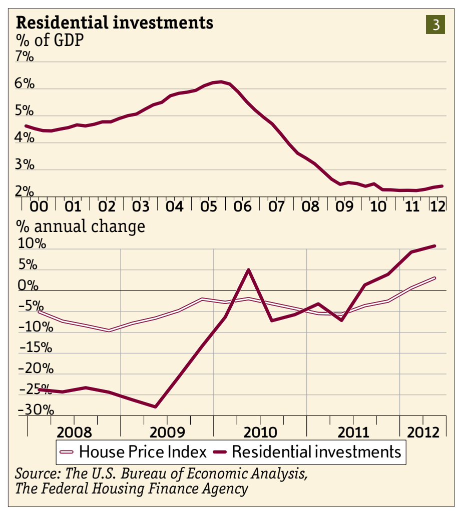
Economic output

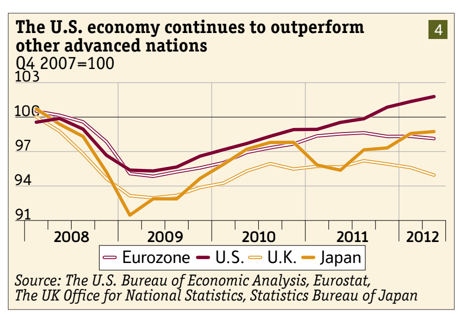
The U.S. economic recovery continued to slow in the second quarter, as the economy expanded at an annual rate of just 1.7% – its weakest pace of growth since the third quarter of 2011 (see chart 1). In particular, most major sectors of the economy saw softer demand in the second quarter. First, consumers, hit by the sluggish jobs market and elevated economic uncertainty, increased spending by only 1.5%. Second, despite a slight uptick of business spending on equipment and software, nonresidential investments expanded at the slowest pace in five quarters as spending on commercial real estate failed to gain traction. Meanwhile, declining government expenditures continued to subtract from economic growth for the seventh straight quarter (see chart 2) as cash-strapped local governments are struggling with budget shortfalls. On the upside, improving investment activity in the housing sector, which is usually a precursor of more solid economic growth, contributed to GDP expansion for the fifth consecutive quarter. As the share of residential investments in GDP is gradually moving up (see chart 3), stronger activity in the residential construction industry will be contributing more to overall economic performance.



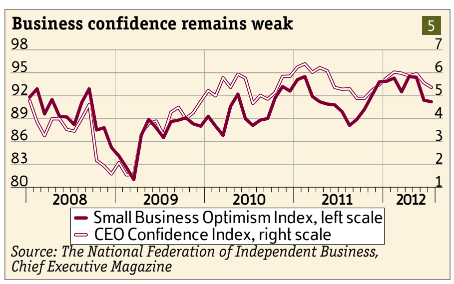


On that note, the improving outlook of the housing sector is a factor that may help sustain stronger performance of the U.S. economy relative to other advanced countries (see chart 4). Having said that, the travails of the Eurozone public sector hold a valuable lesson for the U.S. In particular, sizable fiscal adjustments appear to be dragging down the economies of the crisis-hit European countries. Thus, impending budget cuts, which are due to occur in January 2013 under current law,[1] continue to cloud the medium-term economic outlook. For example, the Congressional Budget Office warns that fiscal tightening may push the economy back into recession in 2013 with GDP shrinking by about 0.5%.[2]

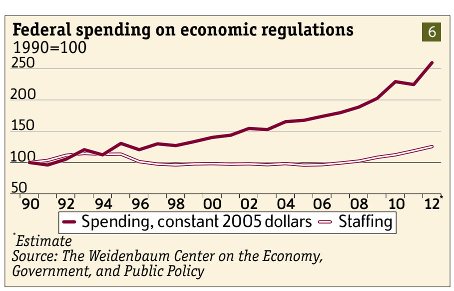




This economic uncertainty, as well as an increasing regulatory burden, is sapping business confidence (see chart 5). Although it is not easy to accurately quantify the economic costs of business regulations, the mere fact that federal spending on regulating economic activities went up by over 44% during the last five years (see chart 6) implies that government policies are adding to the cost of doing business in the U.S. This means that businesses will continue to defer their investment decisions. In fact, a recent drop in new orders of capital goods (see chart 7) may indicate a weakening investment outlook. Although increasing newer orders of cars and aircraft provided a boost to total new orders of durable goods, in July new orders of capital goods fell by 5.5% versus a year ago.



All of the above implies that consumer spending, which still represents over 70% of GDP, will

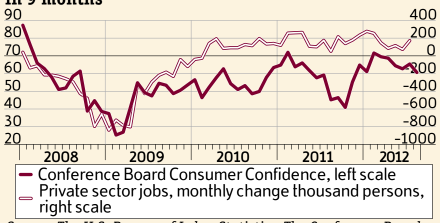


[1]The following are likely to have the most substantial impact on the U.S. economy: expiration of the tax credits and deductions enacted in 2001, 2003 or 2009, including provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010; a reduction in Medicare funding; automatic budget cuts under the Budget Control Act of 2011; expiration of the extended unemployment benefits; and a 2 percentage points reduction in the payroll tax.

[2]Source: The Congressional Budget Office, An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022, August 2012.

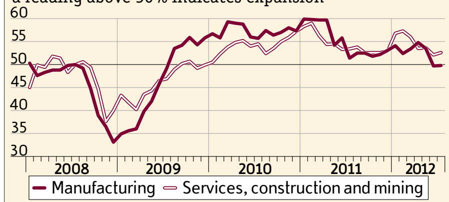
Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 6213111 Fax: +1 (713) 6214666
Email: sbleyzer@sigmableyzer.com

Consumer confidence slips to its lowest level in 9 months 8



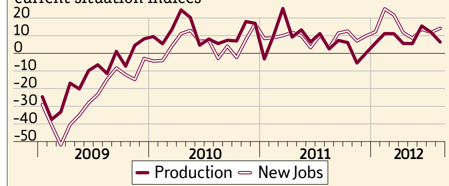
Source: The U.S. Bureau of Labor Statistics, The Conference Board

National business activity 9
Purchasing Managers Indices, a reading above 50% indicates expansion

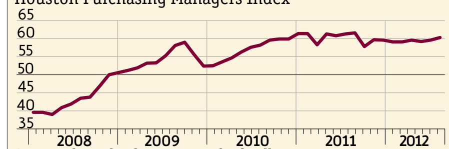


Source: The Institute for Supply Management

Texas factory activity bounces back 10
current situation indices



Houston factory activity remains strong
Houston Purchasing Managers Index



Source: The Federal Reserve Bank of Dallas, The Institute for Supply Management

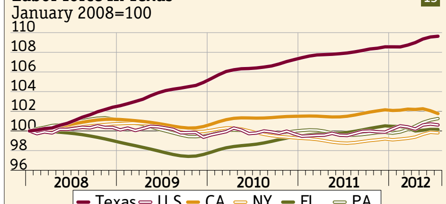
remain central to the strength of the U.S. economic recovery. On that note, July's uptick in consumer confidence looked encouraging. Indeed, retail sales strengthened in July, increasing by 0.8% month-over month in contrast to a 0.7% monthly drop in June. Sales of furniture, building materials and supplies were particularly strong (up by 1.1% and 1%, respectively, in July versus June) indicating that improving home sales may be already supporting a pickup in retail activity. In addition, consumer spending on discretionary items (such as electronics and sporting goods) saw a solid gain as well (up by 0.9% and 1.6%, respectively, compared to June). However, in August consumer confidence dropped to its lowest level since November 2011 (see chart 8). Increasing fuel costs, a weak labor market and policy uncertainties are adding to consumer pessimism, which elevates the risk of a pullback in household spending. In fact, the deterioration of consumer sentiment in August was primarily driven by weakening expectations about income growth and the availability of jobs in the future.

Meanwhile, national surveys on business activity continue to point to a slowing economy. In particular, factory output and business activity in services and construction ticked up in July (see chart 9), although manufacturing activity remained virtually flat for the second straight month. On the upside, factory activity is growing in Texas (see chart 10), although the pace of growth is starting to decelerate. Obviously, the mining sector, sustained by relatively high energy prices (see chart 11), is a factor that adds strength to the local economy. However, the mining industry alone can hardly take full credit for the economic resiliency of the Lone Star State. Indeed, judged against other states where mining accounts for a comparable portion of local economic activity, Texas is performing noticeably better (see chart 12). Indeed, a strong rebound of business activity in Texas service industries in August (see chart 13) testifies to the underlying strength of the broader economy. After all, a faster turnaround in the state's jobs market bodes well for businesses in services and construction, which rely most on local consumer spending.

Employment

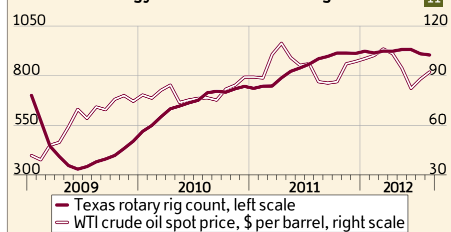
In July, the jobless rate in Texas stood at only 7.1% compared to 8.3% nationwide (see chart 14). Having said that, the unemployment rate in Texas has been edging up for the last three months both because of an increasing labor force and slowing job growth in the private sector. Unlike in other large states and in the nation as a whole, the Texas workforce has not stopped growing since the onset of the 2007 recession. In fact, it has increased by nearly 10% over the past five years compared to less than 1% growth nationwide (see chart 15). As a result, the state's labor market has had to absorb both new entrants as well as regain jobs lost during the economic downturn. Meanwhile, the private sector has been creating jobs at a slower rate on weakening domestic and international

Labor force in Texas 15
January 2008=100



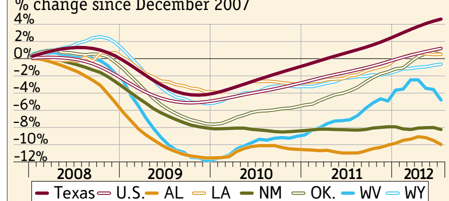
Source: The U.S. Bureau of Labor Statistics

The Texas energy sector remains strong 11



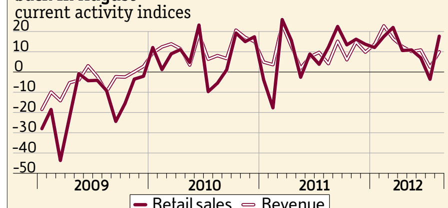
Source: The U.S. Energy Information Administration, Baker Hughes

State Coincidence Indices* 12
% change since December 2007



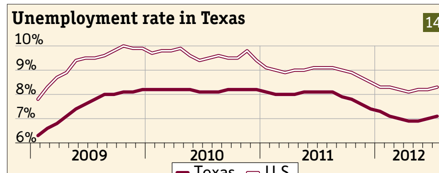
The coincident indexes combine four state-level indicators to summarize current economic conditions in a single statistic. The trend for each state's index is set to the trend of its gross domestic product (GDP), so long-term growth in the state's index matches long-term growth in its GDP.
Source: The Federal Reserve Bank of Philadelphia

Texas service-providing sectors bounced back in August 13
current activity indices



Source: The Federal Reserve Bank of Dallas

Unemployment rate in Texas 14



Source: The U.S. Bureau of Labor Statistics

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 6213111 Fax: +1 (713) 6214666
Email: sbleyzer@sigmableyzer.com

economic prospects (see chart 16).

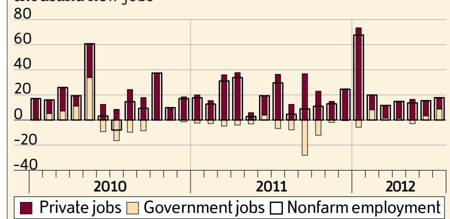
However, notwithstanding the fact that in July the Texas private sector created the smallest number of new jobs since May 2011, the local labor market remains well ahead of national trends. In particular, the number of private jobs in Texas has already surpassed its prerecession peak (see chart 17); meanwhile, nationwide the private sector still employs 4.3 million fewer workers than at the start of the economic downturn five years ago.

The Texas private goods-producing industries (for example, construction and manufacturing) endured smaller job losses and started to recover faster compared to the nation as whole. Meanwhile, thanks to strong hiring in education and healthcare, service-providing businesses in Texas already employ 4% more workers than at the precrisis peak (see chart 18). A closer look at the Texas jobs market indicates that most sectors of the regional economy are in a more advanced recovery stage compared to the national employment picture. In particular, by the end of July 2012, Texas regained over 40% of all manufacturing jobs lost during the recession versus less than a quarter nationwide (see chart 19). Although the recovery of national construction jobs still has to start in earnest, Texas has already recouped 14% of all jobs lost in construction since mid-2008. The jobs recovery in Texas service-providing sectors is even more impressive. Over 90% of all job losses in wholesale and retail trade (providing nearly a fifth of all private jobs in Texas and nationwide) have been regained in Texas versus just a third in the nation as a whole. In addition, compared to the start of economic downturn, Texas already has more jobs in finance and professional and business services (accounting for over 22% of all private sector jobs), whereas the national labor market has recuperated just 14% and 92% of such jobs, respectively.

Lastly, employment growth in the largest Texas metros remains well above the national average (see chart 20). This is important because, although both metro areas provide just about 54% of all private sector jobs, over 60% of all new private sector jobs created in the state over the last year were in Dallas and Houston. True, thanks to a booming energy sector, over a third of all new jobs created over the past twelve months were in Houston. Indeed, one in three new mining jobs created from July 2011 to July 2012 were in Houston. Yet these mining jobs accounted for only 9% of all new private jobs in that metro. Healthcare businesses were the largest creators of new jobs in Houston, accounting for over 20% of the net private sector job gains. More than that, over 50% of all new healthcare jobs in Texas were created in Houston. Meanwhile, about a quarter of all new private sector jobs created over the past year in Dallas were in business and professional services. As a result, private businesses in Dallas created one in three jobs in that industry statewide.

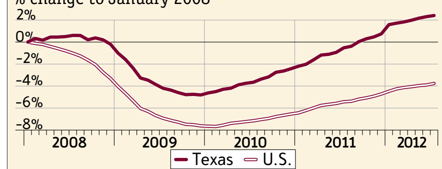
All of this means that Texas metros are big and diversified economies and, as a result, have been more resilient to the impact of the financial crisis. Indeed, according to the U.S. Bureau of Economic Analysis, data on the composition of metro economies shows that prior to the economic downturn, Houston and Dallas economies had a smaller financial activities sector compared to such states as California and Florida.[3] More than that, while the share of Information, Communication, and Technology industries (ICT) does not exceed 5% for

Jobs growth in Texas 16
thousand new jobs



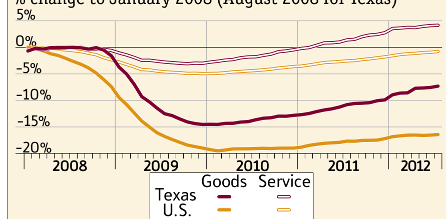
Source: The U.S. Bureau of Labor Statistics

Private sector jobs 17
% change to January 2008



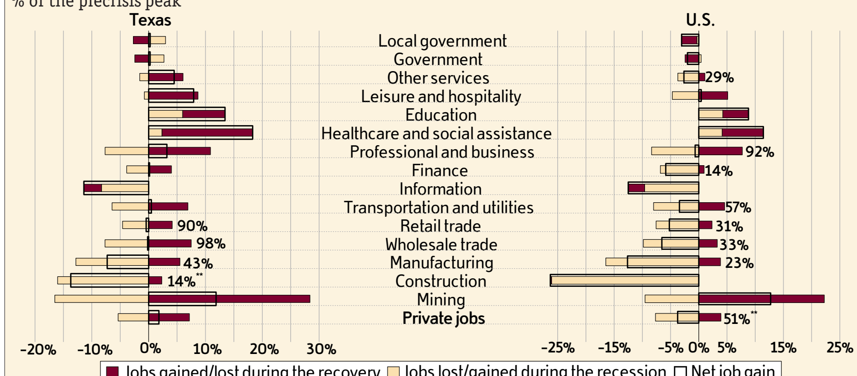
Source: The U.S. Bureau of Labor Statistics

Private sector jobs 18
% change to January 2008 (August 2008 for Texas)



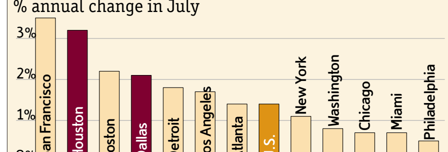
Source: The U.S. Bureau of Labor Statistics

Chart 19. Labor market recovery: Texas vs. U.S. 19
% of the precrisis peak*



Nonfarm employment peaked in August 2008 in Texas (in January 2008 for the national as a whole) and started to grow in December 2009 (in February 2010 in the U.S.).
**Jobs recovered since the start of the labor market recovery as a percentage of jobs lost during the recession.*
Source: The U.S. Bureau of Labor Statistics

Job growth in the largest U.S. metros 20
% annual change in July



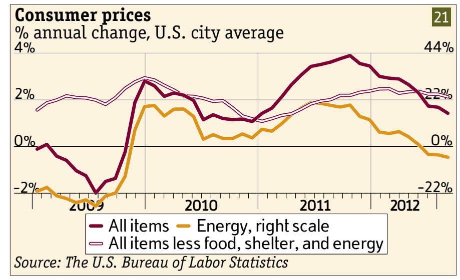
Source: The U.S. Bureau of Labor Statistics

[3] Finance and insurance, real estate, rental, and leasing services represented about 22% of all economic activities in the U.S. metropolitan portion in 2004-2007 versus just 20% in Dallas and 13% in Houston. It was nearly a third in New York and over a quarter of all economic activities in San Francisco, Phoenix, Las Vegas, Miami, San Diego and Los Angeles.

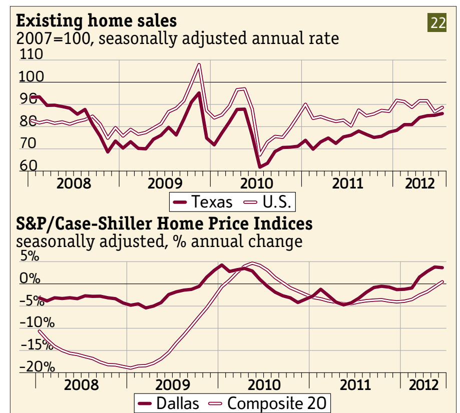
all U.S. metros, it is about 7% and 15% of the total economic activity in Dallas and Austin, respectively. Thus, these Texas metros continue to benefit from the robust demand for ICT products and services.[4]

Monetary Policy and Asset Prices

In July, consumer prices grew by only 1.4% versus the same month a year ago, as lower energy costs helped push the overall inflation rate down (see chart 21). With annual inflation at its lowest level in 19 months, the Federal Reserve may feel more confident to further loosen its monetary policy if the economic situation worsens. Despite record low interest rates , slower economic growth and tighter credit may choke off a nascent recovery in the housing market (see chart 22).



Source: The U.S. Bureau of Labor Statistics



Source: The National Association of Realtors, Standard & Poor's Financial Services LLC, The Real Estate Center at Texas A&M University

[4]According to Gartner, information technology research and advisory company, global IT spending will grow by 3% in 2012 to $3.6 trillion and by 4.4% in 2013.
[5]According to Freddie Mac, the monthly average interest rate on 30-year fixed-rate mortgages stood at just 3.6% in August versus 4.27% in the same month a year ago.

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 6213111 Fax: +1 (713) 6214666
Email: sbleyzer@sigmableyzer.com