- **Texas factory activity posted its third straight monthly gain in October.**
- **In September, the Houston Purchasing Managers Index exceeded 60 for the first time since March.**
- **The Texas jobless rate fell to 6.4% in August, remaining below the 7.2% national average.**

Executive summary

Manufacturing and construction continued to sustain moderate expansion of national business activity. However, growth-restraining fiscal policies are threatening the national economic recovery. In particular, heightened uncertainties over government spending and borrowing costs emerged as a serious blow to consumer and business confidence in October.

Despite the unfavorable political climate, national manufacturing remained relatively strong – in October, factory activity posted its best reading since 2011 thanks to growing exports and automobile sales. In particular, new orders of durable goods saw a monthly gain of 3.2% in September, mostly boosted by stronger exports of civilian aircraft. Car sales stayed above the 15 million annual rate in September and October as growing consumer credit, low inflation and improving personal income are sustaining household spending on durable goods. In fact, consumer spending (less automobiles) grew stronger in September, driven by growing sales of furniture and electronics, building materials as well as health care and personal care products, which points to an increasing willingness of households to spend beyond the necessities.

Turning to Texas, the Lone Start State's factory activity saw its third consecutive monthly gain in October, reaching its highest level since July. At the same time, jobs growth in manufacturing and services persisted at a healthy pace, indicating positive economic conditions in the broader regional economy. This economic resiliency can be attributed to the dynamic growth of the state's major metro economies, which have already expanded by over 10% compared to the start of the economic crisis five years ago. For instance, factory activity in Houston continued to strengthen in September, with the Houston Purchasing Managers Index exceeding 60 for the first time since March. Improving construction spending as well as a competitive chemical industry (boosted by shale gas production) is adding to the metro's growth momentum. Meanwhile, Austin is benefiting from the returning demand for semiconductors and electronics, which may partly explain why the city's jobless rate remains a full percentage point below the statewide average.

Having said all of the above, the Texas jobs market appears to be moving at a slower pace the private sector added just 2.4 thousand new jobs as in August compared to nearly 31 thousand the month before. This may come as a result of Texas being in a more advanced recovery phase versus the nation as a whole – the Texas economy already employs 6% more workers in its private industries than during the peak of the previous business cycle. Meanwhile the nation as a whole has barely reached its pre-crisis private sector employment. Stalled hiring by the government sector is exerting a toll on the broader regional economy of Texas. More importantly, the employment growth in mining and manufacturing, where new jobs have a relatively higher direct and indirect impact on regional business activity, is settling down. And this contributes to the overall deceleration of the broader jobs market in Texas. Lastly, the booming regional economy is slowly making Texas a relatively more expensive place to relocate. As a result, improving job prospects in other states may be shifting the balance in favor of alternative destinations for job seekers from other states.

Finally, uncertainty over the timing of monetary policy tightening has been a key factor driving long-term borrowing costs. In fact, home sales weakened in September as increasing mortgage rates and more expensive homes deterred potential homebuyers. Still, tight housing supply has been putting upward pressure on home prices, which may partly balance the downside of higher borrowing costs and slower jobs growth. Tight supply may play an even a bigger role in sustaining the local construction industry in Texas. After all, residential properties in Dallas are already selling at prices exceeding precrisis levels, which is a clear sign of a healthy turnaround of the regional real estate sector.

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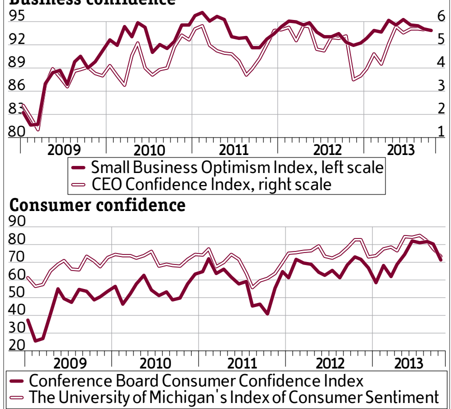
Economic output

Growing business activity in manufacturing and construction continued to support the U.S. economic recovery. However, heightened policy uncertainties were a major blow to consumer and business confidence at the start of the last quarter of 2013 (see chart 1). In particular, a partial

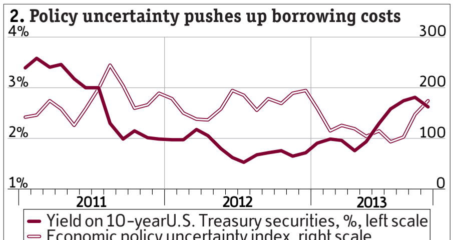
1. Businesses' and consumers' mood dims with policy uncertainty



Source: The Conference Board, Haver Analytics, Chief Executive Magazine, The National Federation of Independent Business

shutdown of the federal government, which lasted for over two weeks, and an eventual eleventh-hour deal to raise the federal debt limit, was partly responsible for a jump in borrowing costs (see chart 2). Additionally, growing concerns over the imminent monetary tightening by the Federal Reserve and increasing mortgage rates emerged as a real threat to the still fragile rebound of national demand for housing.

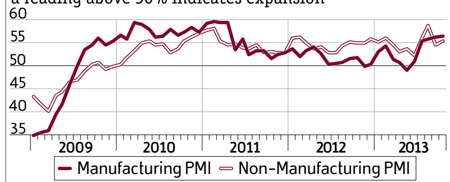
2. Policy uncertainty pushes up borrowing costs



Source: The Federal Reserve, Economic Policy Uncertainty Index

Meanwhile, the U.S. economy began October on a rather upbeat note – factory activity posted its best reading since earlier 2011 (see chart 3) on improving exports and continued strength of automobile sales. New orders of durable goods saw a monthly gain of

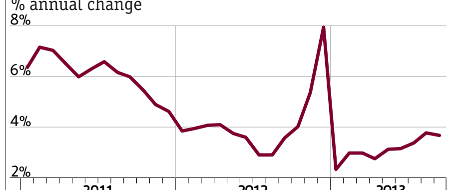
3. National factory activity zooms ahead
PMI - Purchasing Managers Indices,
a reading above 50% indicates expansion



Source: The Institute for Supply Management

3.2% in September, mostly thanks to the booming aviation industry on growing exports of civilian aircraft. Meanwhile, car sales stayed above the 15 million annual rate in September and October, easing somewhat from over 16 million vehicles in August. Expanding consumer credit (which recorded an annual growth rate of 5.4% in August versus 4.1% in July) mostly due to increasing nonrevolving credit, including car loans, may partly explain resilient household spending on durable consumer goods. In fact, while overall retail sales were held back by a 2.4% monthly drop in car sales, consumer spending excluding car sales grew stronger, advancing by 0.4% in September compared to August. This, in particular, was driven by growing sales of furniture and electronics, building materials, as well as health care and personal care products, which points to an increasing willingness of households to spend beyond the necessities. Consumer prices have barely grown in recent months thanks to relatively stable energy prices, which boosts consumers' buying power. Personal income, which has been growing at an accelerating pace since April (see chart 4) thanks to the steady gain of private sector jobs, has added strength to consumer spending as well.

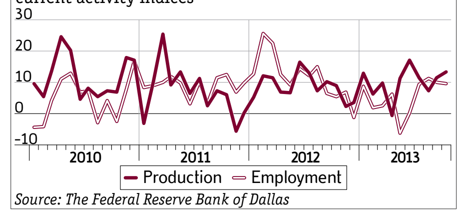
4. Personal income grew faster
% annual change



Source: The U.S. Bureau of Economic Analysis

Turning to Texas, the Lone Start State's factory activity saw its third consecutive monthly gain in October, reaching the highest level since July (see chart 5).

5. Texas factory activity strengthens
current activity indices



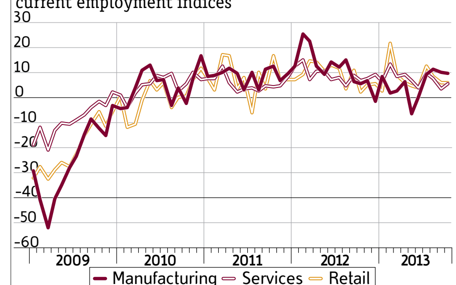
Source: The Federal Reserve Bank of Dallas

Business activity in services and retail trade continued to expand as well, yet at a somewhat slower rate (see chart 6). More importantly, job growth in manufacturing and services persisted at a healthy pace (see chart 7) indicating positive economic conditions in the

6. Business activity in service providing industries remains on an uptrend
current activity indices

Source: The Federal Reserve Bank of Dallas

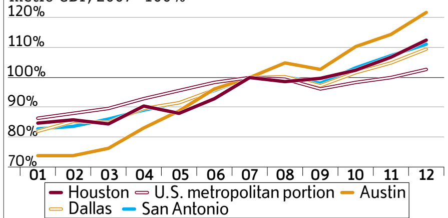
7. Texas manufacturing and services continue to create jobs
current employment indices



Source: The Federal Reserve Bank of Dallas

broader regional economy. Above all, this economic resiliency can be attributed to the dynamic growth of the state's major metro economies. Indeed, recently released data revealed that last year Houston and Dallas were the second and third fastest growing metros out of the ten biggest U.S. cities. And compared to other large metros, where economic activity has barely started to bounce back, Texas metros have already expanded by over 10% versus the start of the economic crisis five years ago (see chart 8). More than that, this trend reflects a successful transformation of Texas into a well-diversified economic powerhouse. For instance, if ten years ago Houston was the 9th largest metro economy nationwide, it jumped to the 4th place in 2012, while the share of the mining industry in the metro economy remained on a downtrend.

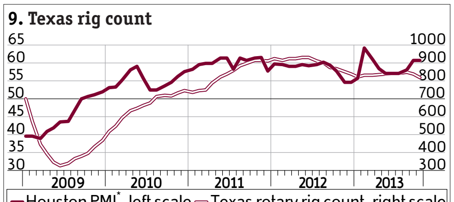
8. Texas metro economies
metro GDP, 2007=100%



Source: The U.S. Bureau of Economic Analysis

Despite somewhat weaker growth in the energy sector (see chart 9), factory activity in Houston continued to expand in September with the Houston Purchasing Managers Index exceeding 60 for the first time since March. Improving homebuilding activity and nonresidential construction spending are sustaining the growth momentum of the metro economy. According to the Greater Houston Partnership, the total value of construction permits issued by the city of Houston was 11% higher in September compared to the month before. Meanwhile, extensive trade links with other large national regional economies and international markets help Houston enjoy the benefits of national and global economic growth. A recent study by the Brookings Institution ranked Houston 4th out of 100 largest metros by the total volume of trade (both domestic and international). Over half of this is advanced industrial products, such as chemicals, machinery and transportation equipment. In fact, thanks to its competitive chemical industry (which was boosted by rapidly expanding shale gas extraction), Houston has the largest trade surplus in advanced industrial commodities of all the other metros.

9. Texas rig count



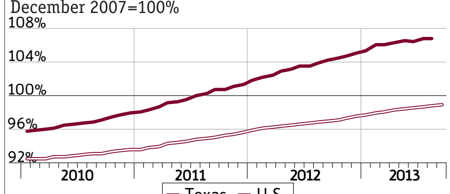
**PMI – Purchasing Managers Index, a reading above 50 indicates expansion*
Source: Institute for Supply Management, Baker Hughes

Trade helps explain the economic strength of other large Texas metros as well. In particular, Austin has a $20 billion trade surplus in computers and electronics (or over a fifth of its total economic output), which, despite the city's 42nd rank by trade volume, places this metro at the 8th position by the size of the trade surplus. As national and global manufacturing continues to improve, higher demand for semiconductors and electronics will help sustain business activity in Austin. In fact, according to the Semiconductor Industry Association, global semiconductor sales posted their sixth straight monthly gain in August thanks to a healthy rebound of demand. Thus, Austin's booming high-tech industry may partly explain why the city's jobless rate remains a full percentage point below the statewide average.

Employment

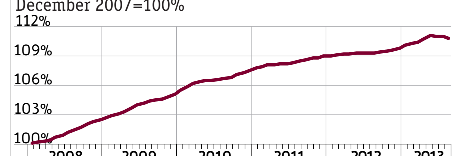
In August, the Texas seasonally adjusted jobless rate fell to 6.4%, remaining well below the 7.2% national unemployment rate. The labor market recovery in Texas appears to have moved at a slower pace as in August as the private sector added just 2.4 thousand new jobs compared to nearly 31 thousand the month before. This may be a result of the Texas labor market being in a more advanced recovery phase than the nation as a whole – after all, Texas already employs 6% more workers in its private industries than during its pre-crisis peak, while the nation as a whole has barely reached it pre-crisis private sector employment level (see chart 10). Weak hiring in federal and (more importantly) local governments due to budget cuts and increased fiscal policy uncertainties is also a factor. And as employment gains settle down in sectors where new jobs have a relatively higher impact on regional business activity (for example, mining and high-tech manufacturing), overall jobs growth tends to decelerate as the labor market recovery shifts to industries where each new job, directly or indirectly, supports a smaller number of workers in other sectors. Indeed, the annual growth rate of mining jobs in Texas has recently slowed to nearly a third of its level in 2011-2012, which obviously contributed to the overall slowdown of the broader regional jobs market. Lastly, strong economic growth over the past several years has started to make Texas a more expensive place to relocate than it used to be. For instance, according to the C2ER Inter-City Cost of Living Index, in the second quarter of this year the average costs of living in Houston and Dallas stood at 97.5% and 96.4% of the national level versus 87.7% and 91.2%, respectively, in 2007. Although Texas' largest cities are still more affordable compared to other U.S. metros, these higher living costs and improved job prospects in other states may be shifting the balance in favor of alternative destinations for people considering a reallocation to Texas for employment reasons. In fact, a recent downtrend in the labor force in Texas (see chart 11) may reflect this slowing inflow of new workers into the Lone Star State.

10. Private sector jobs
December 2007=100%



Source: The U.S. Bureau of Labor Statistics

11. Labor force in Texas
December 2007=100%

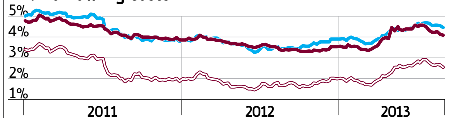


Source: The U.S. Bureau of Labor Statistics

Monetary Policy and Asset Prices

Uncertainty over when the Federal Reserve will begin to reduce its purchases of Treasury securities continued to unnerve financial markets. These monetary policy risks, coupled with ongoing political stalemate over the federal budget and debt, have been a key factor behind a sharp increase in long-term borrowing costs, both for the government and the private sector (see

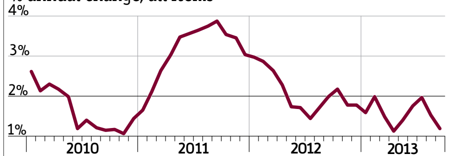
12. Borrowing costs



Source: The Federal Reserve

13. Consumer prices

% annual change, all items

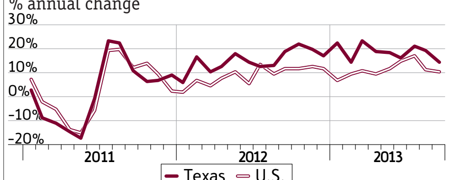


Source: The U.S. Bureau of Labor Statistics

chart 12). However, persistently low inflation (see chart 13), the slow pace of economic expansion as well as growth restraining fiscal policy still make it unlikely that the Fed will start tightening monetary conditions in the near future. Indeed, the latest policy meeting of the Federal Reserve ended with no change to its bond-buying program. As result, borrowing costs have been moving downward as the Fed reconfirmed its commitment to keep interest rates low if national unemployment level continues to exceed 6.5%. Importantly, the Fed has admitted that the housing market recovery grew weaker due to higher mortgage rates. Existing home sales continued to slow in September (see chart 14) as higher interest rates

14. Existing home sales

% annual change

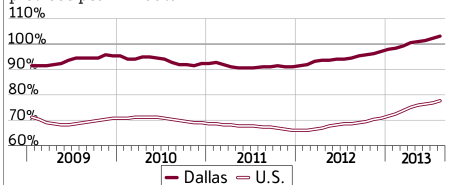


Source: The National Association of Realtors, The Texas A&M University Real Estate Center

and more expensive homes deterred homebuyers. At the same time, tight housing inventory (3.9-month supply in Texas and 5-month supply nationwide) has been putting upward pressure on housing prices – according to Standard & Poor's, the home price index for the 20 U.S. metros saw its sixth consecutive double-digit annual gain in August. Thus, the downside of higher borrowing costs and slower jobs growth may be partly offset by the tightness of housing supply, which may sustain the rebound of home-building activity. Moreover, since the residential construction industry suffered less in Texas during the recent economic downturn, returning demand for housing and limited supply is likely to provide a bigger boost to the local construction industry versus the nation as a whole. After all, residential properties in Dallas are already selling at prices exceeding precrisis levels (see chart 15), a clear sign of a healthier turnaround of the regional real estate sector.

15. S&P Home Price Index

previous peak = 100%*



**According to the S&P, home values in Dallas peaked in April 2007, while the overall index for 20 U.S. cities hit its precrisis peak value a year earlier*

Source: S&P

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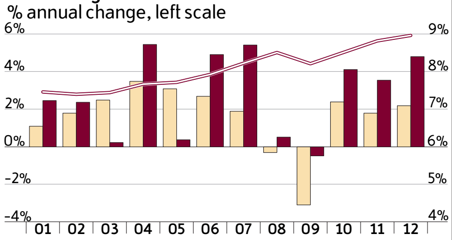
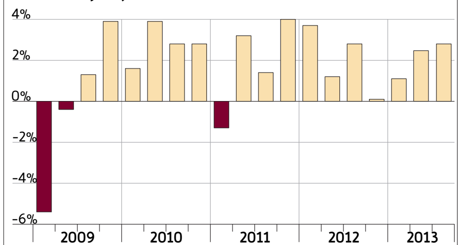
October 2013

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



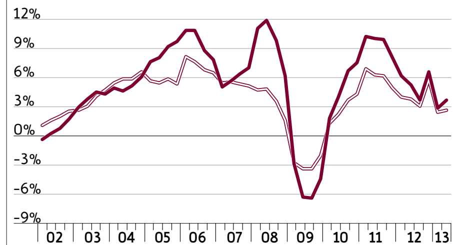
Source: The U.S. Bureau of Economic Analysis

U.S. quarterly GDP
% change from preceding period
seasonally adjusted at annual rates



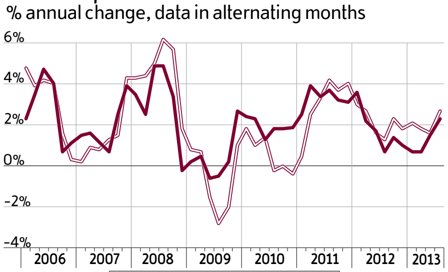
Source: The U.S. Bureau of Economic Analysis

Personal income
seasonally adjusted at annual rates, % annual change



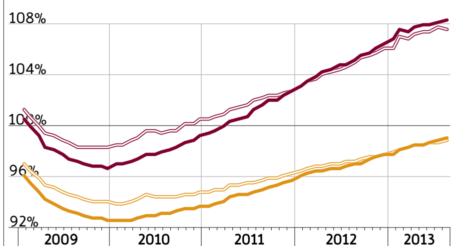
Source: The U.S. Bureau of Labor Statistics

Consumer prices
% annual change, data in alternating months



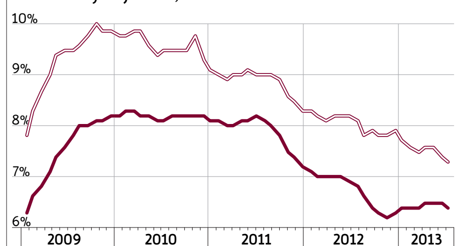
Source: The U.S. Bureau of Labor Statistics

Nonfarm employment
2007=100%



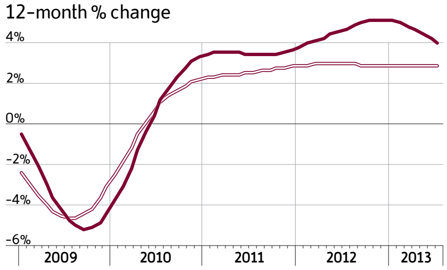
Source: The U.S. Bureau of Labor Statistics

Unemployment rates
seasonally adjusted, %



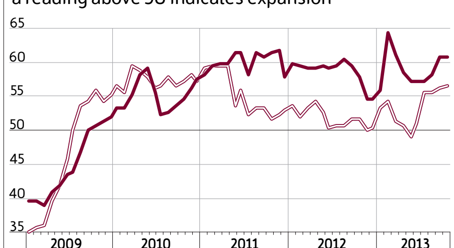
Source: The U.S. Bureau of Labor Statistics

State Coincident Indexes
12-month % change



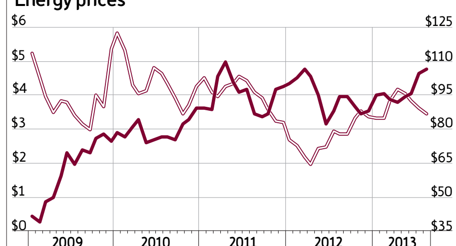
Source: The Federal Reserve Bank of Philadelphia

Purchasing Managers Index
a reading above 50 indicates expansion



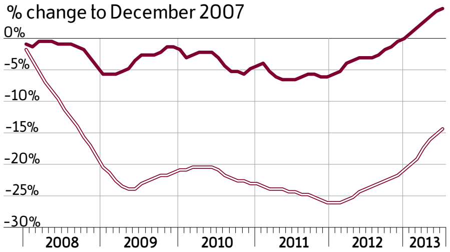
Source: The Institute for Supply Management

Energy prices



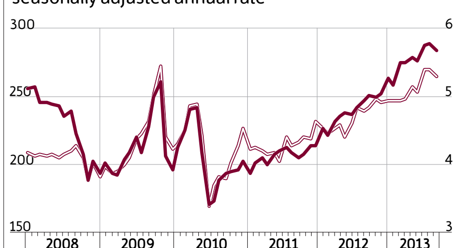
Source: The U.S. Energy Information Administration

Home values
% change to December 2007



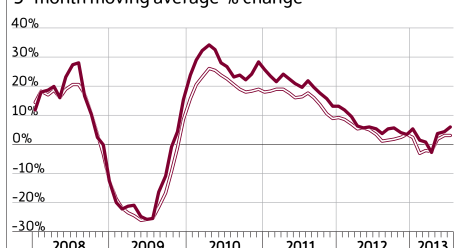
Source: The S&P/Case-Shiller Home Price Indices

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

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