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- **National GDP growth slightly decelerated to 3.9% qoq in Q3.**
- **Retail trade and food services in the U.S. reverted to growth thanks to a rebound in sales of motor vehicles and parts.**
- **The Texas rig count grew by 9.1% yoy in November despite a continued decline in oil prices.**
- **Growth of national employment reached a ten-year high at 2.6%.**
- **The Texas jobless rate fell below 5.0% for the first time since mid-2008.**
- **The Federal Reserve continued its asset purchase program in October.**

Executive Summary

The national economy continued to grow in October 2014. However, some signs of weakness were still in place. The real sector of the country in general performed well despite some slowdown of growth in services and contraction in non-defense capital goods orders. The employment market remained on an upward trend. At the same time, the Texas economy continued to outperform the national economy with respect to most economic indicators.

Even though industrial activity and business conditions in the services sector remained on an upward trend, some negative developments were observed. In particular, GDP growth decelerated in the third quarter and may continue to decelerate, as shown by future output indicators such as the Non-Manufacturing Index, business confidence, and core capital goods orders. The Non-Manufacturing Index experienced deceleration in growth losing 1.5 percentage points (pp). At the same time, business confidence indices experienced similar developments. Core capital goods orders dropped 1.3% month-over-month (mom) for the second month in a row.

Consumer confidence, in contrast, remained around peak levels in October, fueled by growth in the jobs market. This led to improvements in personal consumption expenditures. In particular, retail trade and food services returned to growth in October thanks to better performance of motor vehicles sales among others.

The construction sector posted improvements in all major indicators over the reporting month. But the number of construction permits increased at a rate two times lower compared to September, while total construction expenditures reversed the trend, increasing by 1.1% mom.

Similar to the previous month, Texas economic performance was significantly better than the nationwide economy. The Texas construction industry performed the best. In January-October 2014, growth of the number of issued building permits was 12.6%. Thanks to this, the share of Texas in total building permits issued in the U.S. over the mentioned period grew to 15.8%. Factory activity, similarly to the trend observed for the U.S. in general, grew at a decelerated rate. At the same time, unlike the U.S. services sector, the Texas service sector observed significant improvements. A continuing decline in oil prices seems to have had little effect on Texas mining, as the rig count rig continued to grow in October.

Employment conditions in the U.S. and in Texas remained positive in October. The major employment indicators for the U.S. posted the best performance over the last six years. In particular, the jobless rate reached 5.5%. This is the lowest level since May 2008. However, Texas still managed to outperform the national economy in both employment and unemployment levels. Furthermore, the state set a record for total nonfarm jobs added in year-over-year terms for the third month in a row with 421,000 new jobs.

Monetary policy will continue to support further economic growth, but could affect inflation expectations. Continuation of the asset purchase program, though without its flow-based component, will accelerate inflation over the long term. Nationwide inflation is expected to fluctuate around 2% in the short run, despite an on-going decline in oil prices. At the same time, inflation indicators in Texas continued to deviate upwards from the nationwide ones. The Texas CPI was significantly higher and grew faster from the previous month in October.

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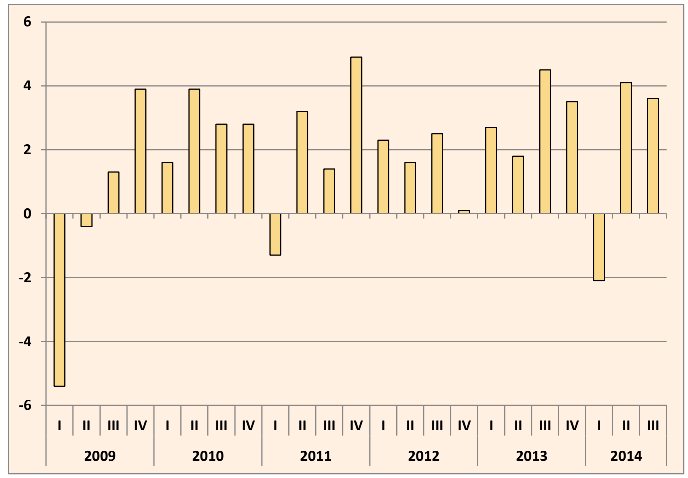
Economic Growth

Economic growth in the U.S. slightly decelerated in the third quarter of the year, but continued its upward trend for the 65th consecutive month. According to estimates from the Bureau of Economic Analysis, the annualized growth of real GDP in the third quarter was 3.9% quarter-over-quarter (qoq) compared to 4.6% qoq growth in the previous quarter (see chart 1). The increase in GDP was driven by 2.2% growth in personal consumption expenditures, a 7.1% increase in nonresidential private domestic investment (the third highest over the last 11 quarters), reasonable growth in exports accompanied by a tiny decline in imports, and boosting national defense expenditures.

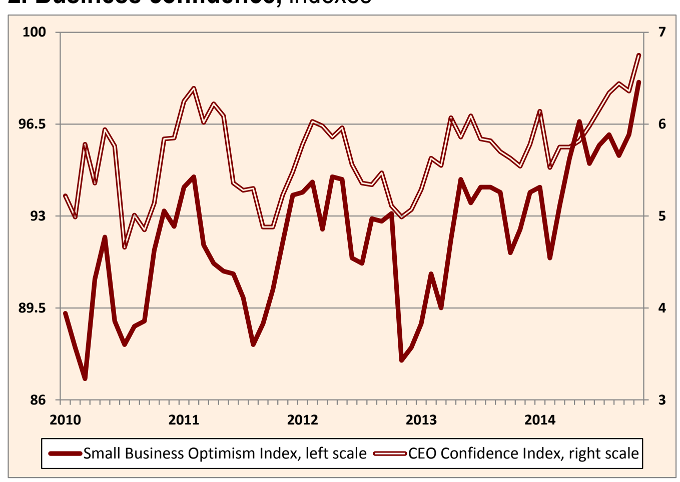
1. GDP growth, % qoq at annual rates



Source: The U.S. Bureau of Economic Analysis

The nation's industrial output remained almost unchanged in October compared to September, resulting in 4.0% growth in year-over-year terms. Mining remained the major contributor to growth despite a slowdown in October. Manufacturing also posted good growth (17th month in a row) over the October 2013 level, while utilities saw a decline. Manufacturing performance showed improvements in all output indicators, except for the backlog of orders and exports, which saw a deceleration in growth. The Purchasing Managers Index (PMI) registered 59%, one of the highest levels in the last five years, indicating strong expansion. This index increased by 2.4 pp over the level observed in September. In fact, 16 manufacturing industries out of 18 achieved growth in October, while only the petroleum & coal products industry reported a contraction. At the same time, business activity in the non-manufacturing sector remained on an upward though slower trend in all of its indicators except for employment. The Non-Manufacturing Index lost 1.5 percentage points, but remained on an increasing trend for the 57th consecutive month. Favorable business conditions were the main reason for growth in the majority of the 16 expanding non-manufacturing industries in October. However, a leveling off from the high previous months' growth was observed. Business confidence remained on an upward trend but experienced some uneven developments over the last couple of months (see chart 2). On the negative side, in October non-defense capital goods orders excluding aircraft (a proxy for business spending on equipment plants) declined for the second consecutive month. This decline was 1.3% mom, which was the same as in September. Since good growth of business spending on equipment was among the main factors of economic growth in the third quarter, the decline in October is a sign that the national economy lost some momentum at the beginning of Q4.

2. Business confidence, indexes



Source: Chief Executive, National Federation of Independent Business

Continued growth in the jobs market in October helped maintain consumer confidence around peak index levels for the last four years (see chart 3), stimulating consumer expenditures. Growth of personal consumption expenditures remained unchanged at 2.4% yoy in Q3, but remained at a rate comparable to that achieved in Q2. Expenditures on goods remained the major driver of growth thanks to an 8.7% growth in spending on durable goods. Personal expenditures on services also grew at a good pace of 1.8%. As a result, in October, personal consumption expenditures improved

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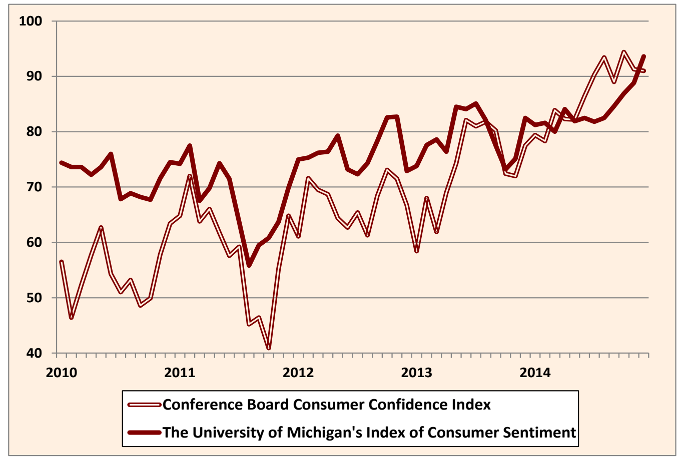
compared to September's flat growth, posting growth equal to the average monthly growth in Q3. The October improvement was most pronounced in retail trade and food services, which grew by 0.3% mom compared to a decline of 0.3% in the previous month. This reversal of the trend was caused to a large extent by a rebound in sales of motor vehicles and parts from -1.2% mom in September to 0.5% mom in October. In contrast, sales of petroleum products continued to decline, leading to decreasing oil prices. Overall, retail trade and food services observed good growth of 4.0% yoy over the first ten months of the year.

3. Consumer confidence, indexes



Source: Conference Board, The University of Michigan

The country's construction industry continued to recover, observing growth in all major output indicators in October. In particular, the number of construction permits grew by 4.2% yoy, which though half of September's rate was still one of the highest over the year. Total construction expenditures recovered from a decline in September and posted a 1.1% mom increase thanks to growth in both residential and nonresidential construction, with the former posting higher growth. Generally, there was a differentiation between the private and public sectors in construction activities in October. The private sector increased expenditures on residential construction, while leaving expenditures on nonresidential construction virtually unchanged. On the other hand, the public sector spent more on nonresidential construction and lowered spending on residential. The number of new manufactured homes' shipments for the 10-month period of 2014 was almost identical to the total number of shipments in 2012, and was 6.6% higher than the number of shipments in January-October 2013.

Nationwide exports grew at a decelerated rate in the third quarter of the year as compared to the previous quarter, following the seasonal trend observed in the last couple of years. At the same time, deceleration in export growth was more significant compared to the respective quarter of the previous years. The annualized growth of exports to the previous quarter amounted to 4.9% in Q3 2014, which was more than a twofold deceleration. This deceleration was the result of lackluster performance of exports in the month of September. According to data of the U.S. Census Bureau and the U.S. Bureau of Economic Analysis, exports dropped 1.4% mom in September, which was the first decline in exports since March 2014. Exports of goods contributed more to the total decline, decreasing by 1.9% mom in September. Despite this deceleration in goods exports, during the first 10 months of the year, exports remained on an upward trend thanks to growth in exports of services.

Regarding the Texas economy, many indicators signal that the Texas economy is still growing at a pace faster than the national economy. Significantly faster growth was observed in job creation, sales tax collection and in building permits. In particular, the number of building permits issued in Texas grew by 12.6% yoy in January-October 2014. As a result, the share of Texas in the total number of issued permits in the US expanded by 0.8 percentage points to 15.8%. Factory activity in Texas also grew again in November, though at decelerated rate. However, all manufacturing activity indicators posted significant declines, signaling a less optimistic outlook for business conditions. In contrast to manufacturing, the Texas service sector observed significant improvements in November as most of the indicators showed decent growth. Furthermore, the agricultural sector is having a very good year. Easing drought conditions for the last couple of months positively influenced crop production, which led to a decline in grain prices. In particular, the price of corn is on a downward trend for most of the year. This price decline favored cattle producers and also taking into account increasing cattle prices, boosted their profitability. Good performance of agriculture may boost exports at the beginning of 2015. In the meantime, Quarterly Texas reported a 3.3% increase in exports in Q3 2014 on the back of sharp growth in exports to Asia and Latin America (excluding Mexico). Growth could be even higher if not for a 5.3% decline in exports to other states in the EU and flat exports to Mexico. Despite decreasing oil prices, the Texas rig count grew from 899 in October to 904 in November, which is a 9.1% yoy increase.

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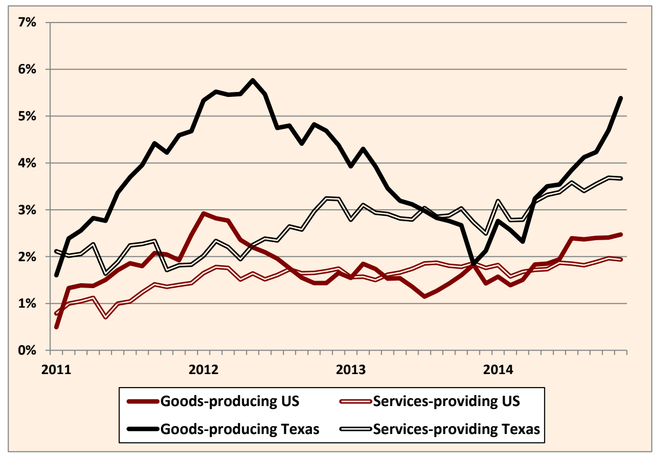
Employment

In October 2014, the US labor market continued to improve in terms of both unemployment and employment. The nationwide unemployment rate reached 5.5%, a low since May 2008; the total number of unemployed dropped by 19.4% yoy, which is the largest decline over the last decade. At the same time, growth in total national employment reached 2.6% yoy, which is also the highest level of growth over the last ten years.

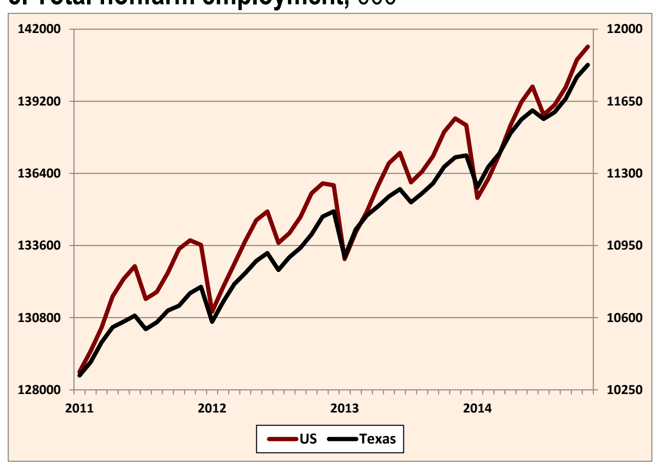
Texas posted even better performance in October. The number of seasonally unadjusted jobless declined below 5.0% for the first time since June 2008 thanks to a 19.9% yoy drop in the total number of unemployed. Growth in Texas' employment was also higher compared to the national level, being equal to 3.3% yoy. Furthermore, Texas was the second best in the country in month-over-month increases in nonfarm payroll employment with 35,200 new jobs. This allowed Texas to set a record for total nonfarm jobs added in year-over-year terms for the third consecutive month (421,900 jobs). The goods-producing industry again observed higher growth rates of employment compared to the service-providing industry, both nationwide and in Texas. At the same time, performance of Texas was better than average over the country for both industries (see chart 4). Mining was the leader in employment growth among the major production sectors, raising the nationwide number of employed to the maximum level over the last 20 years and the number of employed in Texas to a new record of 325,100 people (see chart 5).

4. Jobs growth in private goods-producing and service providing industries, % yoy



Source: Bureau of Labor Statistics

5. Total nonfarm employment, 000



Source: Bureau of Labor Statistics

The labor market indicators in Texas' metropolitan areas were also positive in October. Most of the metros observed positive changes in both unemployment and employment, while the leaders of the labor market of the state (Dallas and Houston) posted almost identical performance. In particular, the unemployment rate decreased by 1.3 percentage points to 4.8% in Houston in twelve months, compared to 1.1 percentage points decline to 5.0% in Dallas. Both metros created 10,800 jobs in October, which was a 3.7% yoy increase in employment for Dallas and a comparable 3.8% yoy increase of the indicator for Houston.

Monetary Policy and Asset Prices

Following the recently released news on employment, inflation, and economic recovery, the Federal Reserve introduced some measures to tighten monetary policy. In its October meeting the Federal Open Market Committee (FOMC) decided to continue its Asset Purchase Program, but to modestly reduce the pace of the asset purchases. The Committee also decided to conclude the flow-based component of the asset purchase program at the end of October. However the market did not react to these decisions, as the cost of borrowing was not increased. Moreover, some interest rates even declined slightly (see chart 6). The implication of this decision is that the remaining components of the Asset Purchase Program should continue to maintain accommodative financial conditions in order to support economic recovery.

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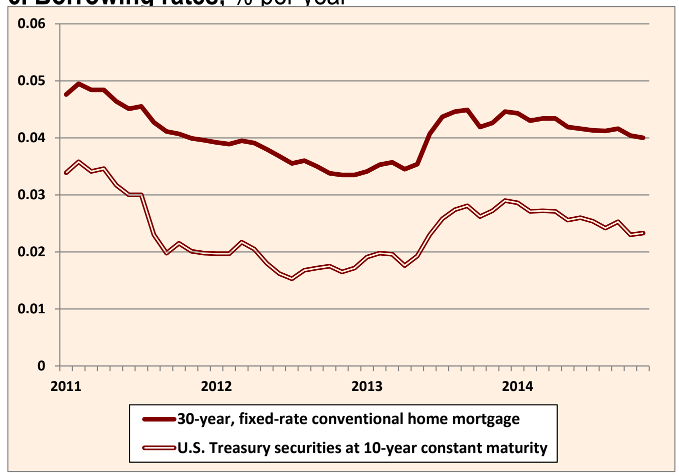
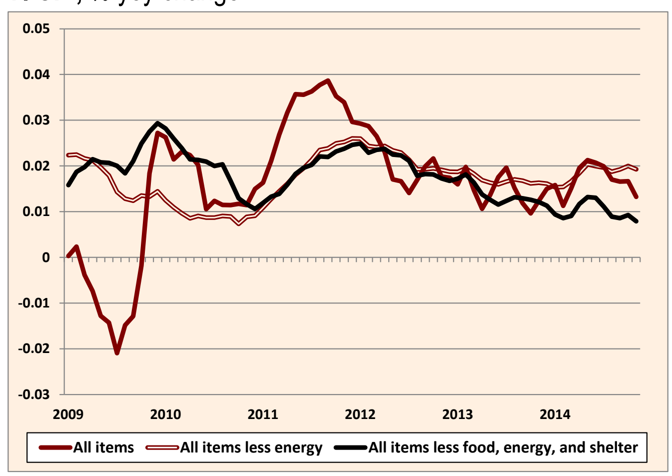
The ongoing drop in oil prices affected inflation in October 2014. The CPI for all urban consumers remained unchanged in monthly terms for all items. However, the CPI calculated for all items but energy posted a 0.2% mom increase. In year-over-year terms, the effect is more significant. The CPI for all items posted a 1.7% yoy increase in October, while the CPI for all items less energy grew by 2.0% yoy. The above-mentioned effect was observed in Texas too. The data for the Houston-Galveston-Brazoria area (updated for even-numbered months) shows that CPI for all items posted a 3.4% yoy increase in October compared to a 3.6% yoy increase of CPI for all items less energy. On the other hand, the difference between the two CPIs was more significant in September 2014, when CPI for all items grew by 2.6% yoy, while CPI for all items less energy increased by 3.1% yoy (see chart 7). On a negative note, the level of inflation in Texas was higher and grew faster compared to the national level. The FOMC doubts that inflation will run persistently below 2 percent. The Committee mentioned in its press release that the likelihood of that happening is now lower than at the beginning of the year.

6. Borrowing rates, % per year



Source: Federal Reserve System

7. CPI, % yoy change



Source: Bureau of Labor Statistics

Despite the fact that recovery of the housing sector remains slow, it is showing some signs of marginal acceleration. Positive developments on the job market and the lowest interest rate level since last summer were the main factors supporting growth in nationwide existing-home sales. In October, total existing-home sales grew by 1.5% mom from 5.18 million observed in September. The resulting 5.26 million of existing-home sales represents the highest number of sales since September 2013 and marks the first year-over-year growth since last October (2.5%). Positive dynamics in the job market for the last half-year as well as the lowest mortgage rates over the last 15 months provide a good basis for solid demand for housing by the end of the year. (see figure). The only factor that may restrict growth is the uneven dynamics of housing inventory. On the one hand, unsold inventory posted a 5.2% yoy increase in October. At the same time, total housing inventory was at the lowest level since March, falling 2.6% mom. Therefore, the supply of housing needs to grow steadily in order to support the existing trend on the market.

The Texas housing market grew much faster in October, which is in line with the development trend of the market. Better performance of the job market in Texas translates to better housing affordability and higher demand for housing. This also leads to higher pressure on housing inventory and housing prices. In October, growth of existing-home sales increased more than two fold compared to that in September, but continuation of the trend remains doubtful. Housing inventory decreased to a low since last November. Texas needs faster growth in housing starts to catch up with increasing demand. Otherwise, demand growth will be leveled via increased housing prices as is now already happening. The average sales prices of existing homes in Texas were already 13.5% higher than the nationwide prices in October 2014. At the same time, housing prices also grew 2.19 percentage points faster in Texas than they did nationwide.

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