February 2015 Valentyn Povroznyuk, Edilberto L. Segura

- **The Bureau of Economic Analysis revised GDP growth in Q4 2014 downwards to 2.2% but left estimates for 2014 as a whole unchanged.**
- **Consumer expectations of business conditions in the short-term significantly deteriorated at the national level in February.**
- **Construction returned to a decline at both the national and Texas level in January.**
- **The Texas economy still grew faster than the national economy but experienced problems in several important sectors, including oil and gas extraction.**
- **The energy index dropped 9.7% mom causing all items CPI to decline by 0.7% mom.**
- **The housing market experienced some cooling due to low inventories.**

Executive Summary

The U.S. economy sustained mixed developments in January 2015. On the positive side was the return to growth of industrial output on the back of manufacturing and utilities. On the negative side was sluggish performance of construction and continued decline in exports. Furthermore, real GDP growth of Q4 2014 was revised downwards by the Bureau of Economic Analysis. The previously reported growth of 2.6% was lowered to 2.2%. As a result, consumers became less confident in the improvement of current and future economic conditions, which was reflected by contraction of the respective indexes.

Industrial output posted just a marginal increase in January. Output of utilities not only recovered from the decline caused by adverse weather conditions in December 2014 but also posted a 2.3% mom increase. This increase compensated for the negative contribution of mining, which returned to a decrease after one month of growth. Both the PMI and NMI indexes remained above 50, marking the continuation of the upward trend in both the manufacturing and non-manufacturing industries. However, the decline of the PMI index indicates further deceleration of growth in manufacturing.

As data from the Conference Board shows, consumer expectations sustained negative developments in February. Assessments of current business conditions worsened but remained positive as the Present Situation Index stood above 100 at 110.2. In contrast, assessments of future business conditions significantly worsened as the Expectations Index contracted from 97.0 to 87.2.

Improvements in national construction observed in December 2014 did not last, as the sector's dynamics returned to negative territory in January 2015. Both construction expenditures and the number of construction permits decreased. Decrease of the latter, however, was much sharper at 16.3% mom, which raises concerns about existing home inventory in the near future.

The downward trend in total U.S. exports continued at an accelerated rate in January. Similar to previous periods, most of the decrease in total exports was attributed to exports of goods. Industrial supplies and materials were the main driver of the decline as this merchandise category accounted for around one third of the decrease in exports of goods calculated on the Census basis. Exports of services posted just minor negative changes.

The Texas economy continued to grow faster than the economy of the U.S. in general in January. However, Texas experienced difficulties in several major sectors during the month that may lead to a significant slowdown in growth in the near future. Factory output remained almost unchanged compared to December 2014 and expectations concerning further development of the sector were not optimistic. At the same time, the service sector of the state observed significant deceleration in growth. Difficulties were also observed in construction, while a continued decline in oil prices led to a curtailing of extraction as the average number of active rigs decreased by 7.5% mom in January.

The Texas labor market grew faster than the national labor market in January. It saw improvement in both employment and unemployment, while the U.S. labor market observed some deterioration in terms of unemployment. Texas added 20,100 jobs during the month ensuring a 3.5% yoy increase in employment, while national employment expanded by 2.3% yoy in January adding 257,000 new jobs. At the same time, the U.S. unemployment rate inched up to 5.7%, while the unemployment rate in Texas saw the 49th consecutive month of decline to 4.4% despite 3,300 lost jobs in the oil and gas extraction sector. There were no significant changes in the labor markets of Texas metros. Midland remained the leader in terms of both new job creation and lowering the unemployment rate. Houston and Dallas made progress in job creation as they posted employment growth rates above the Texas average.

Monetary policy parameters were left unchanged in January. The Federal Reserve admitted that labor market conditions were close to the optimum level determined by its mandate, while decelerated inflation is an obstacle to policy normalization. CPI further declined against the backdrop of a continued downward trend in oil prices. The energy index posted its sharpest decline over the last seven months at 9.7% mom. The housing market observed some cooling due to low inventory at both the national and Texas level. However, the situation in Texas is more difficult as inventories remained at the lowest level since 1990. A sharp decline in monthly existing home sales in Texas led to a decline in the median existing home price below the national median price, which continued to increase.

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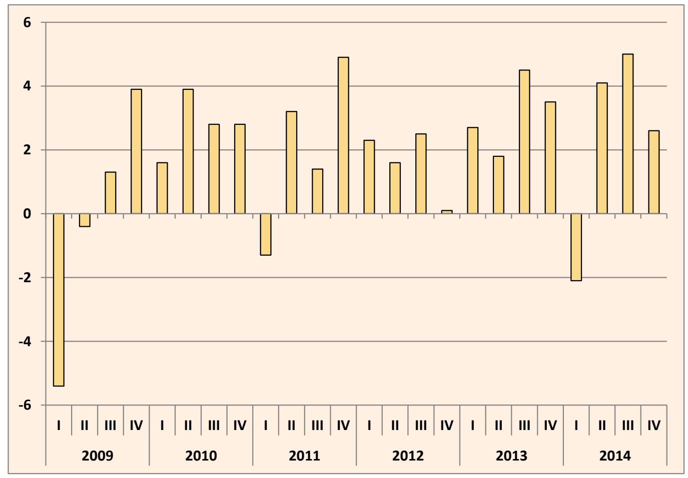
Economic Growth

The second estimate showed that real GDP growth decelerated even more in Q4 2014 than was announced previously. More complete source data used in production of the second estimate led to a 0.4 downward revision in real GDP growth to 2.2% from the preceding period (2.6% growth according to the estimate). According to the Bureau of Economic Analysis, the mentioned changes in the estimate reflected a downward revision to private inventory investment and an upward revision to imports, which were partially compensated for by an upward revision to nonresidential fixed investment and to state and local government spending.

Industrial production returned to growth in January after one month of decline in December 2014. Among the factors favoring the increase was recovery of growth in utilities. After a one-month decline in December 2014, utilities posted a quite strong monthly growth of 2.3%, which fully offset the 1.0% mom decline in mining. Manufacturing inched up by 0.2% mom, which is identical to the monthly growth of industrial output as a whole. Production of durable goods was the main driver of the total manufacturing increase thanks to 0.4% mom growth. All major durable goods industries expanded, except for transport and furniture related ones. Primary metals and computer and electronic production posted increases above 1.0% mom. Year-over-year, the industrial output index increased by 4.8%. Among the major sectors, mining expanded most at 8.5% yoy. Manufacturing grew by 5.6% yoy, while utilities were the only sector that declined (at 6.6% yoy). Institute for Supply Management (ISM) data showed expansion of manufacturing in January 2015, but with further deceleration. The PMI index posted a 1.6 percentage point decrease to 53.5%. The ISM reported that 14 out of 18 manufacturing industries observed growth, while only two declined. Unlike the PMI index, the NMI index posted a minor increase of 0.2 percentage points to 56.7%, marking acceleration of growth in the non-manufacturing industries in January. At the same time, the number of industries observing growth was identical to the number of industries observing contraction.

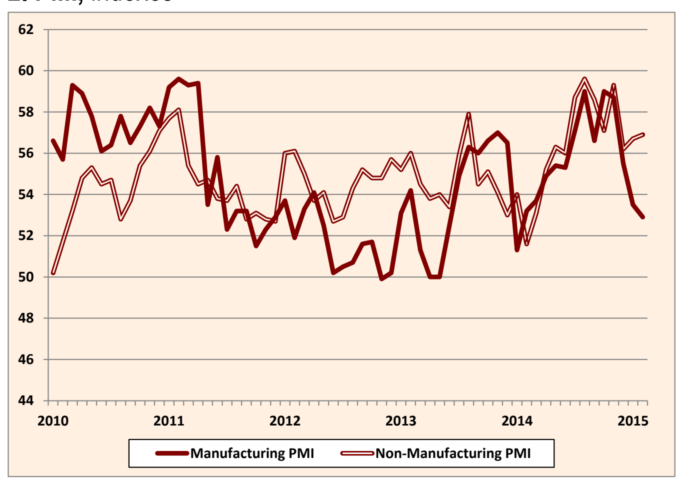
Consumer expectations experienced negative changes in February, especially in relation to the future developments in the economy. The Conference Board Consumer Confidence Index contracted to 96.4 from 103.8 in January. Assessment of current conditions

1. GDP growth, % qoq at annual rates



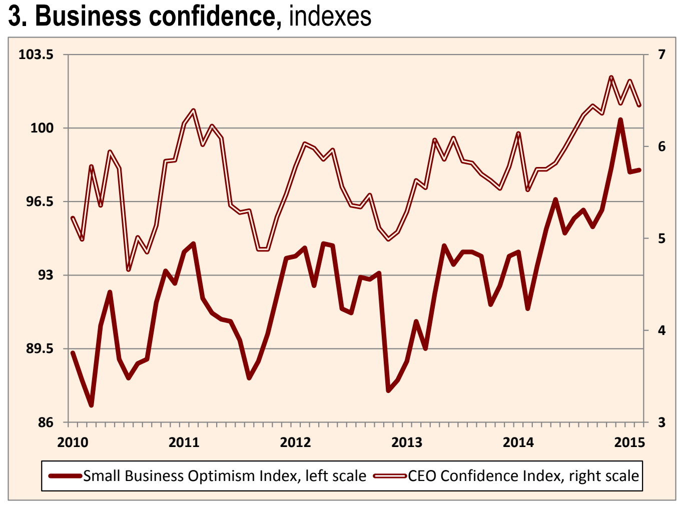
Source: The U.S. Bureau of Economic Analysis

2. PMI, indexes



Source: Institute for Supply Management

3. Business confidence, indexes



Source: Chief Executive, National Federation of Independent Business

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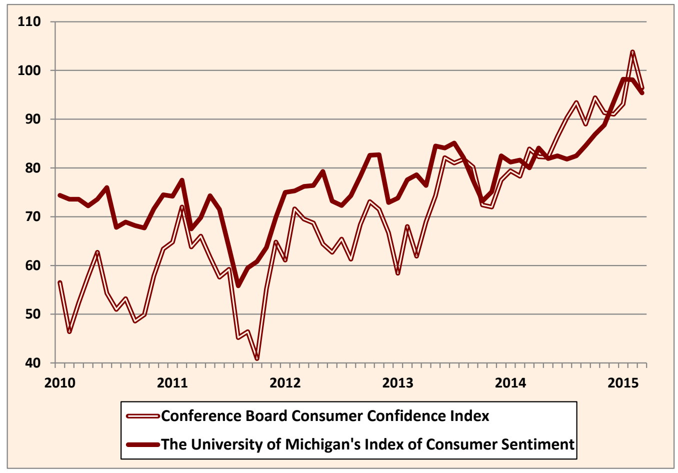
remained positive as the Present Situation Index stood at 110.2 (declined by 3.7 from January). The number of people assessing current business conditions as good decreased from 28.2% to 26.0%, while the number of those assessing business conditions as bad also decreased but insignificantly from 17.3% to 17.0%. Consumers' optimism concerning the short-term outlook significantly deteriorated as the share of people believing in improvement of business conditions decreased by 2.8 percentage points to 16.1% and the share of those expecting business conditions to worsen inched up by 0.5 percentage points to 8.7%. This led to a contraction of the Expectations Index from 97.0 in January to 87.2.

4. Consumer confidence, indexes



Source: Conference Board, The University of Michigan

In contrast to December 2014, both construction expenditures and construction permits posted declines at the national level in January 2015. Total construction expenditures decreased by 1.1% mom due to negative developments in private and public construction. Nonresidential construction expenditures posted sharper declines, while residential construction expenditures even increased in the private sector (by 0.6%). In year-over-year terms, the dynamics of total construction expenditures remained positive, thanks to growth in both private and public sectors. At the same time, growth in the public sector was more significant (3.8% yoy against 0.4% yoy). The decline in private residential construction expenditures almost fully offset the increase in the nonresidential sector, while the public sector posted increases in both residential and nonresidential construction expenditures. Statistics on construction permits also show curtailing of activities in the construction sector at the national level in January. The number of construction permits dropped 16.3% mom. As a result, year-over-year growth in the number of permits decelerated to 4.2% yoy from 7.3% yoy observed in December 2014.

Exports again posted a decline in January 2015. Furthermore, the pace of decline significantly accelerated. Total exports saw a 2.9% mom decline to USD 189.4 billion over the month. 98% of the decrease was attributed to exports of goods. Exports of goods calculated on a Census basis contracted by USD 5.9 billion in January. The sharpest decline of USD 2.2 billion was observed for industrial supplies and materials, half of which was related to supplies of fuel oil and other petroleum products. Since the net balance of payments increased by USD 0.4 billion, the total decline in exports of goods totaled USD 5.5 billion. Exports of services inched down by just USD 0.1 billion to USD 60.7 billion. In particular, increases in travel and in other business services offset most of the declines in transport, financial services, and in maintenance and repair services.

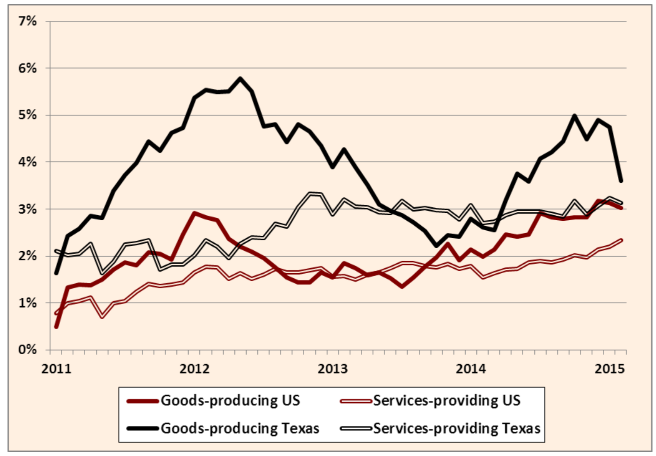
The Texas economy expanded faster compared to the national level in January 2015. At the same time, several sectors revealed problems that may lead to a slowdown in growth later in 2015. In particular, Texas factory activity was flat in January as the production index came in at 0.7. This means that output was essentially unchanged from December 2014. The shipments index contracted from 20.8 to 6, while the new order index registered the first negative reading since April 2013. Declines in indexes related to future business conditions reflect expectations of further worsening of factory activity in Texas. The Texas service sector also experienced difficulties in January. It expanded but at a significantly decelerated rate. The revenue index almost halved from 22.2 to 12.1, which is the lowest level since February 2014. Just as in the case of factory activity, expectations regarding future business conditions in the sector were less optimistic in January. The future general business activity, for example, dropped from 16.9 to 6.1. In contrast, consumer confidence strengthened in the Lone Star state as surveys conducted in February showed a 0.3% mom increase in the consumer confidence index to 117.0. As for the construction industry, it also posted sluggish performance in January. The total number of construction permits contracted by 26.1% mom due to a more than two-fold decline in the number of permits for multi-family houses, which was slightly offset by the growth of permits for single-family houses. The value of contracts for non-residential building construction also saw a decline but at lower rate of 18.8% mom. From a year-over-year perspective, both the number of construction permits and the value of non-residential building construction contracts posted declines of 5.8% and 50%, respectively. The continued decline of oil prices led to further rig count contraction in Texas. According to Baker Hughes, Texas averaged 773 active rigs in January, which is a 7.5% mom decrease. If the downward trend of oil prices continues, Texas economic growth may fall below the national average level in 2015 due to the high role of the extraction industry in the state's economy.

Employment

The U.S. labor market continued to gradually improve in January 2015. Total nonfarm payroll employment grew for the 51st consecutive month adding 257,000 jobs. This ensured the same year-over-year growth as observed in December 2014 at 2.3%. Retail trade, construction, and health care were the leaders in job creation, adding 46,000, 39,000, and 38,000 new jobs, respectively. Furthermore, the increase in employment in construction was significantly higher than the average over the previous 12 months of 28,000 new jobs. At the same time, such major industries as mining and logging, wholesale trade, transportation and warehousing, information and government observed few changes in employment in January. The seasonally adjusted unemployment rate inched up by 0.1 percentage points to 5.7% in January due to a 3.3% mom increase in the number of unemployed to 8.979 million individuals. In year-over-year terms, the number of unemployed declined by 12.5% yoy compared to the average decline of 16.1% yoy in 2014.

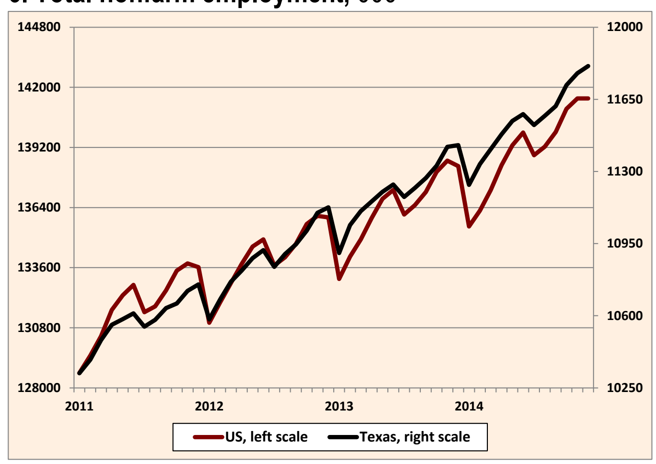
The Texas job market began 2015 similar to the national job market. Its positive momentum in job growth continued in January. The Lone Star state added 20,100 new jobs compared to December 2014 which is a 0.2% mom increase. The mentioned monthly increase was ensured by growth of employment in nine of 11 major industries. Trade, transportation and utilities saw the largest increase in employment with 10,900 new jobs, followed by professional and business services (4,800 jobs added) and information (3,600). At the same time, the oil and gas extraction industry made a negative contribution to employment growth in January. Data shows that the industry dropped 3,300 jobs during the month, which may not be the last monthly decrease given the dynamics of oil prices. Compared to January 2014, total nonfarm payroll employment grew by 392,900 jobs, which is a 3.5% increase. Goods producing

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



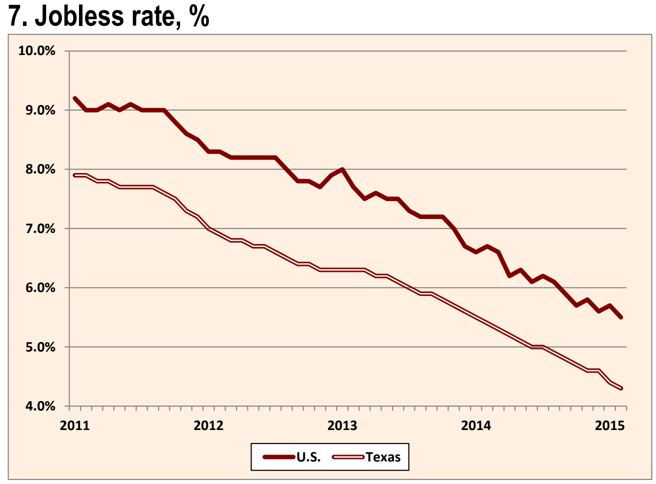
Source: Bureau of Labor Statistics

6. Total nonfarm employment, 000



Source: Bureau of Labor Statistics

7. Jobless rate, %



Source: Bureau of Labor Statistics

industries performed better from this perspective, ensuring a 4.8% yoy increase compared to a 3.2% yoy increase in the service-providing sector. Growth could be even higher if not for weak employment growth in manufacturing. In contrast to the national level, the Texas seasonally adjusted unemployment rate continued to decline in January 2015. It inched down by 0.2 percentage points to 4.4%, which marked the 49th month of the downward trend for the indicator and 96th consecutive month of being below the national unemployment rate.

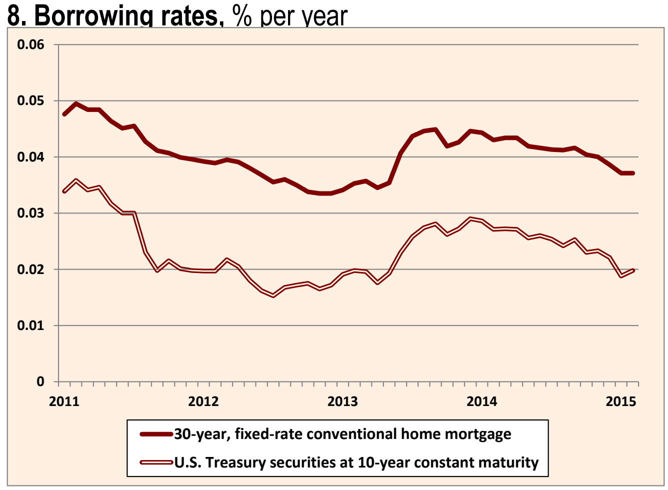
At the Texas metro level, there were few changes in labor market dynamics in January 2015. Midland was still the best in terms of both employment growth and the unemployment rate. Growth of employment in this metropolitan area accelerated to 7.6% yoy, while second best Odessa was quite close with a 7.12% yoy increase. On the other hand, the Midland unemployment rate increased by 0.4 percentage points to 2.6% yoy in January 2015. Both Wichita Falls and Abilene managed to reverse the trend of decline in employment. Employment in Wichita Falls was flat (same as in Amarillo), while Abilene saw an almost 1% yoy increase in the indicator. The only metro area posting a decline in employment was El Paso (0.4% yoy). In January, performance of both Houston and Dallas was close to the state's average in terms of the unemployment rate but slightly above the average in terms of the employment growth.

Monetary Policy and Asset Prices

Observing progress in the major economic indicators in January 2015, the Federal Open Market Committee (FOMC) decided to continue the current stance of the monetary policy without any changes. In its Monetary Policy Report, the Committee stated that the current target range for the federal funds rate of 0-0.25% should be maintained further even though labor market conditions are quite close to the optimum level determined by the current FOMC mandate. The reason for this is inflation, which remains below the 2% long-run goal. At the same time, FOMC continued to plan for the eventual normalization of monetary policy as a part of prudent planning. This includes intentions to reduce securities holdings in a gradual and predictable manner mainly through ceasing to reinvest repayments of principal on securities held in the System Open Market Account. In order for the policy normalization process to go smoothly, the FOMC has continued its practice of testing the operational readiness of its policy tools.

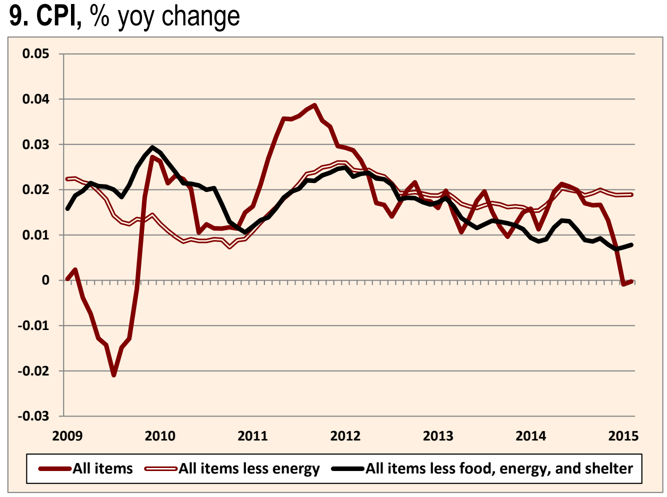
In January 2015, the dynamics of world oil prices was once again the major factor affecting CPI developments. The all items CPI declined by 0.7% mom, which is the largest decline since December 2014. At the same time, it would have increased by 0.1% mom had the energy been unchanged. The energy index itself posted the seventh consecutive monthly decline and the sharpest one since November 2008. The major reason of the 9.7% decline was an 18.7% drop in gasoline prices. All other components of the energy index also posted declines, except for the electricity index, which grew by 0.9% in January and was the only index posting increases over the last

8. Borrowing rates, % per year



Source: Federal Reserve System

9. CPI, % yoy change



Source: Bureau of Labor Statistics

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12 months. The food index remained unchanged in January 2015 after 12 months of increases in 2014. At the same time, the shelter index continued an upward trend, increasing by 0.3% mom. The continued trend of monthly CPI declines was finally reflected in annual dynamics of CPI in January. The all items CPI inched down 0.1% yoy, which was the first year-over-year decline since October 2009. The impact of energy prices on total consumer inflation was even more significant than in monthly terms as all items less energy index increased by 1.9% yoy in January 2015.

A low inventory level was the main issue of some cooling in the housing market in January 2015. At the national level, total existing-home sales fell by 4.9% mom to a seasonally adjusted annual rate of 4.82 million. This is the lowest rate since April 2014, when sales were at 4.75 million. At the same time, despite the mentioned monthly decline, existing home sales increased year-over-year by 3.2%. Total housing inventory remained subdued despite a 0.5% mom increase to 1.87 million existing homes available for sale. In other words, current inventories ensure a 4.7-month supply at the current sales pace, which is an improvement over 4.4 months observed in December 2014. On the other hand, home prices continued their upward trend in year-over-year terms despite the mentioned monthly decline in existing-home sales. The economy in general and the labor market in particular continued to improve, which makes demand for housing stronger. The median existing-home price grew for the 35th consecutive month in January, by 6.2% yoy to USD 199,600. The Texas housing market followed the tendencies observed at the national level in terms of existing home sales, but had significant differences in terms of inventories and prices. In particular, despite a monthly decline, existing home sales posted a 3.4% yoy increase to 15,757 actual sales. At the same time, inventories of existing homes available for sale remained unchanged at a record low level of 3.1 months of supply. As for the median existing home price, it posted a quite sharp monthly decline of 6.6% to USD 179.100. The reason for this may be a sharper monthly decline in sales compared to the previous year.

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