August 2015 Valentyn Povroznyuk, Edilberto L. Segura

- **National real GDP grew by 2.3% quarter-over-quarter (qoq) in Q2 2015.**
- **Average real GDP growth for Q4 2011-Q1 2015 was revised downwards by 0.2% from the previously published 2.2%.**
- **US industrial output returned to monthly growth in June.**
- **The decline in Texas manufacturing activity decelerated in June.**
- **The decline in the Texas rig count significantly decelerated.**
- **The US and Texas reported increases in employment and declines in the unemployment rate in June.**
- **The number of Texas metros facing negative developments in labor market conditions increased.**
- **In June, the national consumer inflation index grew by 0.3% mom.**

Executive Summary

There were no changes in economic growth dynamics in June. Moderate growth continued during the reporting period. At the same times, the economy was growing at faster rates over the last three months compared to Q1 2015 according to advanced estimates of real GDP growth announced by the Bureau of Economic Analysis. The Bureau also published revised estimates of economic growth for 2012-2014. Among June's positive developments were the return to growth of industrial output and further growth in construction, though at a much decelerated growth rate in construction. On the negative side, consumer confidence weakened in July. US exports remained almost unchanged.

Real GDP growth was much faster in Q2 2015 compared to the previous quarter. The advanced estimate showed that quarterly growth accelerated by almost 4 times even compared to the upwardly revised 0.6% qoq increase in Q1. Such acceleration was the result of positive developments in both personal and government expenditures and in foreign trade. Simultaneously with advanced estimates for real GDP growth in Q2, revised estimates were also published for real GDP growth in the previous three years. Negative revisions were reported for 2012 and 2013, while the estimate for GDP growth in 2014 was left unchanged. In general, the average annual real GDP growth rate was downwardly revised for the period from the fourth quarter of 2011 to the first quarter of 2015.

National industrial output posted some modest increase of 0.3% mom in June. Mining and utilities ensured monthly growth in the sector as manufacturing remained flat. Mining reported growth despite negative developments in oil, gas, and coal components. Since monthly growth of total industrial output was not that significant after a couple of months of decline, the year-over-year dynamics of industrial production sustained no significant changes during the reporting month.

Consumers became less optimistic about the economy in July. Perceptions of the current situation declined moderately. On the other hand, short-term outlook saw more significant negative developments as the Expectation Index dropped more than 10 bps. Highly possible that the mentioned worsening of expectations assessment is the result of external factors, as there were no preconditions for such developments inside the country.

In June, US construction saw mostly positive developments, especially related to issuance of building permits. Growth in residential construction ensured a small monthly increase in total construction put in place despite sluggish performance of the nonresidential construction segment, which remained flat. Building permits, on the contrary, saw fast growth in terms of both the number and valuation at both monthly and year-over-year levels in the reporting month.

National exports remained almost unchanged in June. Despite significant contraction in exports of capital goods and of industrial supplies and materials, total exports saw less than a 0.1% mom decline. Half of the USD 0.2 billion decline in exports of goods was offset by growth in exports of services.

Moderate growth continued in Texas despite a further decline in manufacturing activity. The production index declined for the fourth month in a row in June. The decline, however, was slower than in May. The service sector, on the other hand, continued to expand and the pace of the increase almost fully recovered from the deceleration observed a month ago. Texas construction saw improvements in both residential and nonresidential segments. This is reflected by high growth in building permits (from the point of view of both the number of permits and their valuation) and in nonresidential building construction. The Texas rig count continued to decline but at a significantly decelerated pace in June.

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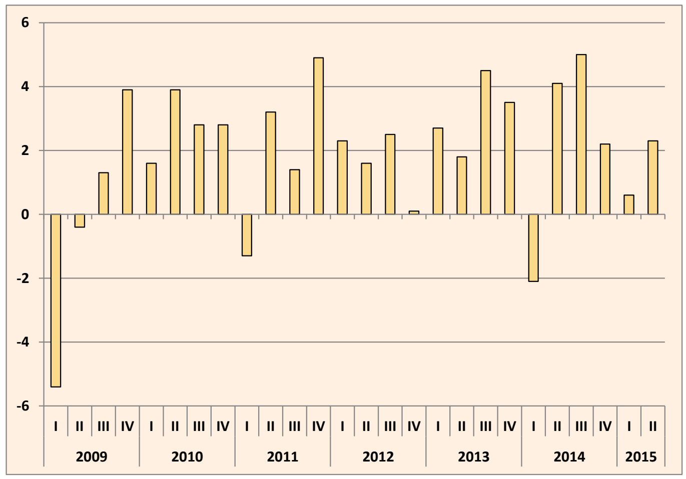
The US in general and Texas both observed positive developments in labor market conditions. In June, improvements were reported for both employment and unemployment. Services-providing industries were among the leaders in job creation, while goods-producing industries were way behind. Some important sectors reported almost no changes in employment at the national level. At the same time, the national level number of unemployment saw a decline in June, which led to a 0.2% drop in the national unemployment rate. Texas generated a significantly smaller amount of new jobs in June compared to May. Among the reasons for this was a decline in manufacturing employment. Unemployment returned to decline in June after one month of growth. Despite general positive developments in labor conditions at the state level in Texas, the situation continued to deteriorate at the metro level. Most metros observed monthly declines in employment.

The major monetary policy parameters were left unchanged at the meeting of the Federal Open Market Committee on July 29th. The Committee reached the conclusion that both labor market conditions and inflation were not consistent with its mandate. Monthly growth of consumer prices remained unchanged in June compared to May. Monthly increases were observed in all major price indexes. The highest growth was reported for energy prices driven by a further increase in gasoline prices. The US in general and Texas both reported positive developments in the housing market in June. Texas improved both existing-home sales and unsold inventories, while the national level housing inventory did not catch growth in housing sales, which led to a small decline in the national unsold housing inventory.

Economic Growth

1. GDP growth, % qoq at annual rates



Source: The U.S. Bureau of Economic Analysis

On July 30th, the Bureau of Economic Analysis published advanced estimates for real GDP growth in Q2 2015 and revised data for real GDP growth for the last three years (series for some indicators were revised back even further). According to the advanced estimate, national GDP grew by 2.3% qoq (seasonally adjusted at an annual rate). At the same time, GDP growth for Q1 2015 was revised upwards to 0.6% qoq. The acceleration in GDP growth in Q2 2015 was the result of an upturn in exports, faster personal consumption expenditures growth, deceleration of imports, and an upturn in government consumption expenditures and gross investments. Growth, however, could have been higher if not for deceleration in gross private domestic investments. Personal consumption expenditures grew by 2.9% qoq from downwardly revised 1.8% qoq in Q1 thanks to faster growth in expenditures on goods, mainly durables. Growth in gross private domestic investments dropped 8.3 percentage points from the upwardly revised 8.6% qoq in Q1 due to negative developments in all components. Exports significantly improved in Q2. Much faster growth in exports of goods triggered acceleration in total exports from -6.0% qoq to 5.3% qoq. Growth in total imports, in turn, almost halved from 7.1% qoq to 3.5% qoq as imports of both goods and services significantly decelerated. Government consumption expenditures and gross investment reversed the downward trend in Q2 (increased by 0.8% qoq compared to upwardly revised decline of 0.1% qoq in Q1). Using newly available and revised source data, same as the improved estimating methodologies, the Bureau of Economic Analysis revised annual real GDP growth downwards by 0.1 percentage points for 2012 and by 0.7% for 2013. Annual growth for 2014 was left unchanged. From the fourth quarter of 2011 to the first quarter of 2015, real GDP advanced at an average annual rate of 2.0% compared to the average rate of 2.2% reported previously for this period.

US industrial production returned to growth in June. A 0.3% mom increase in the total industrial production index was driven by growth of output in mining and utilities as manufacturing output remained flat. The mining index saw a 1.0% mom increase despite the seventh consecutive monthly decline of 3% mom in the index for oil and gas well drilling and servicing, and the third consecutive monthly decline in coal production. Output of utilities grew

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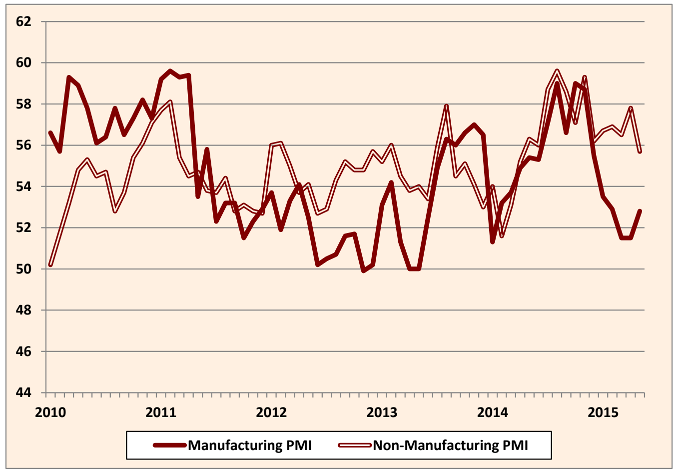
by 1.5% mom in June. As for manufacturing, growth in output of nondurables was offset by a decline in production of durables. Output of nondurables expanded thanks to an advance in production of chemicals and products of 0.7% mom as other major industries reported gains or losses of less than 0.5% mom. Production of durables observed a moderate decline, as a sharp decline in output of the motor vehicles and parts industry and the wood products industry was compensated for by substantial growth of output in computer and electronics industry, production of furniture and related goods, and in miscellaneous manufacturing. The year-over-year dynamics of industrial output sustained almost no changes. The growth rate of manufacturing remained unchanged at 1.8% yoy. At the same time, growth of utilities more than tripled to 4.3% yoy, the decline in mining accelerated from 0.3% yoy in May to 0.8% yoy in June. As a result, the total industrial output index posted a 1.5% yoy increase, which is just 0.1 percentage points higher than a month ago.

Business surveys of the Institute for Supply Management showed expansion of both manufacturing and non-manufacturing activity in the US in June. The PMI index grew by 0.7 percentage points (to 53.5%), which is higher than the 0.3 percentage points for the NMI index but still almost two times lower than expansion in May. Eleven manufacturing industries reported growth with the highest gain in the furniture and related products industry, while just four industries reported contraction. The most significant decline was observed in petroleum and coal products. Other declining industries were primary metals, plastics and rubber products, and machinery. The index for exports reversed the trend to decline (from 50% in May to 49.5% in June) on soft business conditions in Europe and a decline in Asia related to the slowing economy in China. The above-mentioned growth of the NMI index was the result of expanding activities in 15 non-manufacturing industries. At the same time, other services and construction joined mining in the group of industries reporting contraction. All the other non-manufacturing indexes were above 50% indicating growth, except for the imports index, which saw a 5.5 percentage point decline to 48.0%.

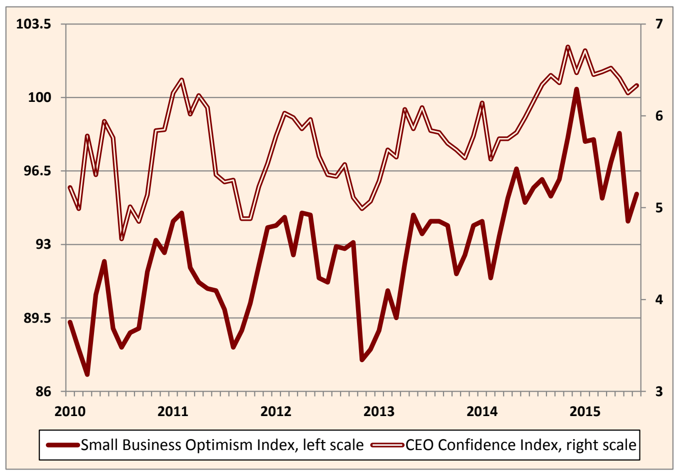
Unlike in previous couple of months, consumer confidence weakened in July. The assessment of the current situation deteriorated moderately as reflected by a decline in the Present Situation Index from the

2. PMI, indexes



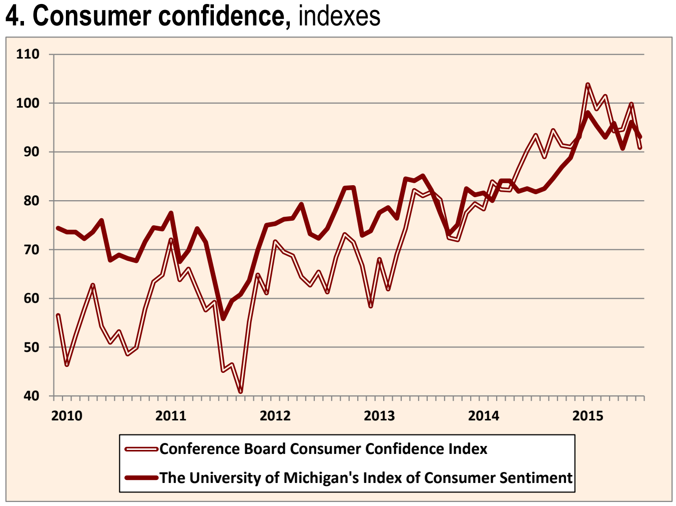
Source: Institute for Supply Management

3. Business confidence, indexes



Source: Chief Executive, National Federation of Independent Business

4. Consumer confidence, indexes



Source: Conference Board, The University of Michigan

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downwardly revised 110.3 in June to 107.4, as both current business conditions and current labor market situation saw moderate declines in consumer optimism. At the same time, the Expectations Index saw a sharp drop to 79.9 from the downwardly revised 92.8 in June due to sharp deterioration in assessment of both business conditions and the labor market. The worsening assessment of the short-term outlook may be the result of the situation in Greece and China, which caused some uncertainty and volatility in financial markets.

National construction continued to grow in June. However, growth in construction put in place further decelerated to almost zero, while growth in building permits significantly accelerated. Total construction remained almost flat in monthly terms in June due to sluggish performance in private nonresidential construction. A 1.3% mom decline in private nonresidential construction put in place fully offset a 1.7% mom growth in public nonresidential construction. Since public residential construction remained too low to have any influence on dynamics of total residential construction, the latter posted the same growth as private residential construction at 0.4% mom. At the same time, nonresidential construction put in place was still almost two times larger in terms of value than residential construction. Therefore, total construction put in place inched up by just 0.1% mom. In year-over-year terms, however, growth in total construction accelerated thanks to a favorable statistical base effect. The overall 12.3% yoy growth was the result of faster growth in private construction (14.0% yoy), especially in the nonresidential segment (15.2% yoy). Growth in building permits was by far more dynamic compared to that in construction put in place in terms of both the number of issued permits and their valuation. The number of issued building permits saw a 20% mom increase on the back of increases in the number of permits for all types of houses. However, the fastest growth was observed in multi-unit houses (31.8% mom). This is why growth in total building permits valuation (17.5% mom) was slower than in number of permits. High monthly growth led to significant acceleration in growth of both number and valuation of building permits in year-over-year terms. The former saw a 40.1% yoy increase, while the latter grew by 34.5% yoy. The reason is the same as that mentioned in the analysis of monthly growth of building permits. The number of permits for multi-unit houses, the unit cost of construction of which is lower than for other types of houses, grew faster (more than doubled in year-over-year terms) than the number of permits for other types of houses (11.3% yoy).

US exports remained almost unchanged in June. Total exports were USD 188.6 billion, which is USD 0.1 billion or less than 0.1% lower than in May. Exports of goods declined by USD 0.2 billion (0.2% mom), which was compensated for by a USD 0.1 billion (0.2% mom) increase in exports of services. The decline in exports of goods on a census basis was driven by a decrease in exports of capital goods (particularly telecommunication equipment) by USD 0.8 billion and industrial supplies and materials (particularly metal shapes) by USD 0.6 billion. More than half of the decline was offset by growth in consumer goods exports by USD 0.8 billion. The net balance of payments adjustment was equal to around USD 0.2 billion. As for exports of services, the USD 0.2 billion decline in exports of transport services was more than compensated for by growth in exports of other services, with the highest gain of USD 0.1 billion in other business services. H1 exports saw a 2.9% yoy decline to USD 33.4 billion.

In June, moderate economic growth continued in Texas, but some important sectors faced further decline. In particular, factory activity declined again, but at a decelerated pace during the month. The production index of the Texas Manufacturing Outlook Survey improved to -6.5 indicating the fourth consecutive month of decline in output. Companies admitted further deterioration in current business conditions. At the same time, worsening of business conditions perception was not as sharp as in previous months. Similarly, labor market indicators showed just moderate declines in employment and working time. On the positive side was further improvement in expectations regarding future business conditions. Contrary to manufacturing, the service sector saw significant improvement in June. The revenue index almost fully recovered from the drop registered in May as it grew by 9.4 bps during the reporting month. Employment growth slowed in the sector. At the same time, perceptions of broader economic conditions further improved, increasing by 3 bps to 4.1. Respondents were also more optimistic about future business activity in the sector as the correspondent index edged up from 10.6 in May to 12.5. Consumer confidence in Texas saw a more significant decline compared to the national level in July. The Conference Board Consumer Confidence Index dropped 15.7 bps to 114.9. Texas construction, in general, followed the same patterns as national level construction, but there were also significant differences in the dynamics of the two in June. Building permits, similar to the national level, registered fast growth in both number and valuation. Furthermore, monthly growth rates for the number and valuation of building

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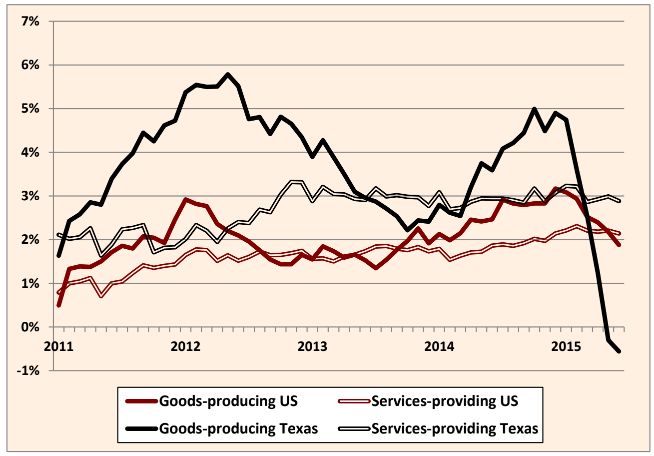
permits were significantly higher than those at the national level (42.3% and 29.2% respectively). In year-over-year terms, however, growth in both the number and valuation of building permits was slower in Texas compared to the national level (35.8% and 25.1% respectively). The reason for significant difference in the growth of the number of building permits and their valuation in monthly and year-over-year terms is the same as that observed at the national level. Growth of the number of permits for multi-unit houses bearing lower unit costs compared to other types of houses grew much faster. As for nonresidential construction, it grew much faster in Texas compared to the national level in monthly terms in June. Nonresidential building construction contracts saw a two-thirds increase to USD 2.5 billion compared to May. On the contrary, in year-over-year terms, nonresidential building construction contracts posted a 44.4% decline. Texas rig count further declined in June. On the positive side, the pace of decline significantly decelerated from 11.1% mom in May to 3.2% mom. The Texas rig count dropped by 59.3% compared to the same month of the previous year.

Employment

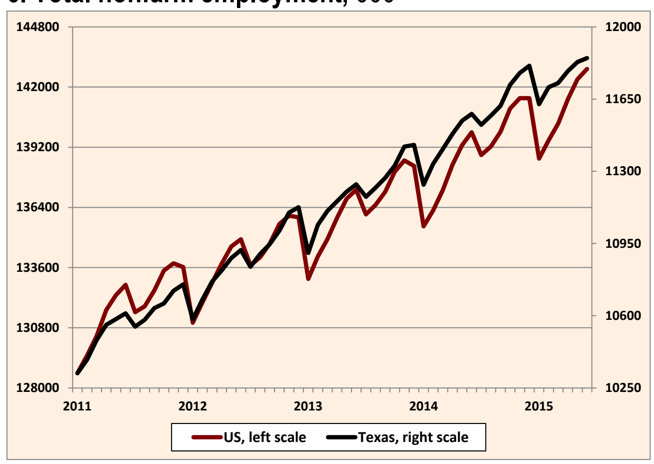
In June, the national labor market saw further improvements in terms of both employment and unemployment. The increase in nonfarm payroll employment of 231,000 was below the 12-month average of 250,000. At the same time, the growth remained almost unchanged in relative terms around 0.2% mom. As it observed for some time, employment in the services sector grew significantly faster than in the goods-producing sector. In particular, the highest monthly gain was observed in professional and business services for the second consecutive month at 69,000 new jobs (0.4% mom). Health care and retail trade followed with 40,200 positions (0.3% mom) and 36,500 positions (0.2% mom) respectively. As for goods-producing industries, they did not perform as well in terms of new job creation in June. Construction and manufacturing observed almost no change in employment at all during the period, while mining saw further decline in employment, though at a much lower pace (4,000 positions or 0.5% mom). In year-over-year terms, total nonfarm employment increased by 2.1%, which is virtually the same as in May. The number of unemployed dropped by 375,000 to 8.3 million people in June, following a quite significant increase a month ago. This led to a 0.2 percentage decline in the national unemployment rate to 5.3%.

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



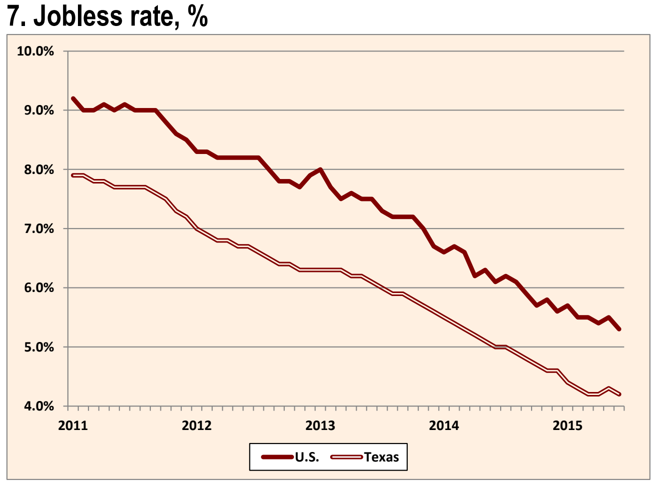
Source: Bureau of Labor Statistics

6. Total nonfarm employment, 000



Source: Bureau of Labor Statistics

7. Jobless rate, %



Source: Bureau of Labor Statistics

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Where Opportunities Emerge.

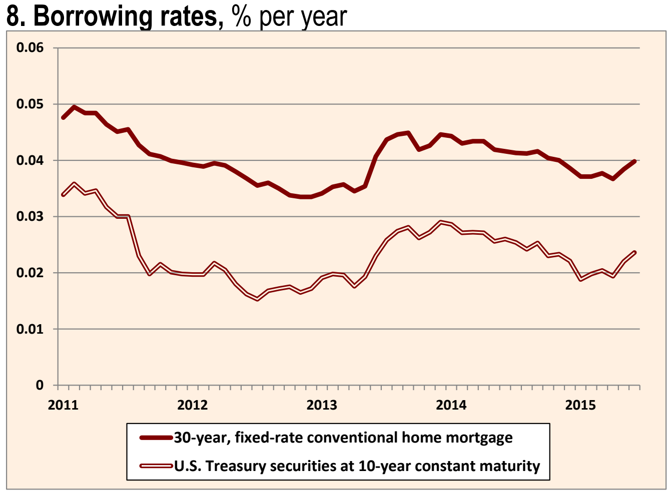
Similar to the national labor market, the Texas labor market saw improvements in both employment and unemployment in June. The state saw the addition of 16,700 nonagricultural jobs (0.1% mom) during the month, which is two times smaller than in May and significantly below the average of 22,500 jobs added per month over the 12-month period. The education and health services industry was the leader in job creation with 10,100 added positions in June (growth of 0.6% mom). Professional and business services followed with 8,300 new jobs (up by 0.5% mom). Mining and logging saw a positive number of added jobs after several months of decline in employment. The sector created 2,700 new positions (a 0.9% mom increase). Manufacturing was the only major sector observing a monthly decline in employment in June, and the decline was quite large at 0.6% mom or 5,400 positions. Changes in other sectors' employment were not that significant. Despite a tiny growth of employment in relative terms, Texas still posted better performance in job creation than the US in general in year-over-year terms. Total nonfarm employment grew by 2.39% yoy during the reporting period. In June, the number of unemployed declined by 2.7% mom to 544,800 people in Texas. As a result, the seasonally adjusted unemployment rate inched back down to 4.2% (its lowest level since July 2007) for the third time this year.

Similar to May, the labor market saw mostly negative developments at the metropolitan area level in Texas in June. The vast majority of metros saw monthly declines in total employment. The two largest metros in terms of employment (Houston and Dallas), however, still created new jobs during the reporting period. The College Station metro saw the sharpest decline in total nonfarm employment at 0.5% mom. Texarkana managed to increase its total nonfarm employment by around 1.0% mom, which is the highest among Texas metros. From a year-over-year perspective, Texas employment also sustained some negative developments. The number of metros observing a decline in total nonfarm employment increased to 12, which is almost half of the state's metros. Wichita Falls reported the sharpest decline at 1.4% yoy. The number of unemployed increased in all the Texas metros, according to non-adjusted data (the only available unemployment data at the metro level). Midland and Odessa posted the worst performance in terms of job creation, as these metros' nonfarm employment decreased also in year-over-year terms (by 9.3% and 19.2% respectively) because of continued monthly declines. The lowest unemployment rate was observed in Amarillo (3.2%), while the highest one was registered in Brownsville-Harlingen (7%).

Monetary Policy and Asset Prices

The Federal Open Market Committee (FOMC) decided to leave the major monetary policy parameters unchanged at its meeting on July 29th. The Committee admitted that the US economy expanded moderately over the last couple of months, which resulted in further improvements in the labor market. At the same times, labor market indicators still did not reach the levels consistent with the Committee's mandate. Inflation was still below the Committee's longer-run objective. However, the FOMC expects inflation to rise gradually toward 2% over the medium term as the transitory effects of earlier declines in energy and import prices dissipate.

8. Borrowing rates, % per year



Source: Federal Reserve System

Consumer prices further increased in June. The all items index posted a 0.3% mom increase, which is almost the same as a month ago. Growth was observed in all the major price indexes but energy prices grew faster than other prices. The food index grew at a rate identical to the all items index thanks to growth in both its components (food at home index increased by 0.4% mom, while food away from home index inched up by 0.2% mom). Growth of gasoline prices by 3.4% mom fueled energy prices growth to 1.7% mom as prices of fuel oil declined by almost 2% mom and prices of energy services saw just minor increases. The

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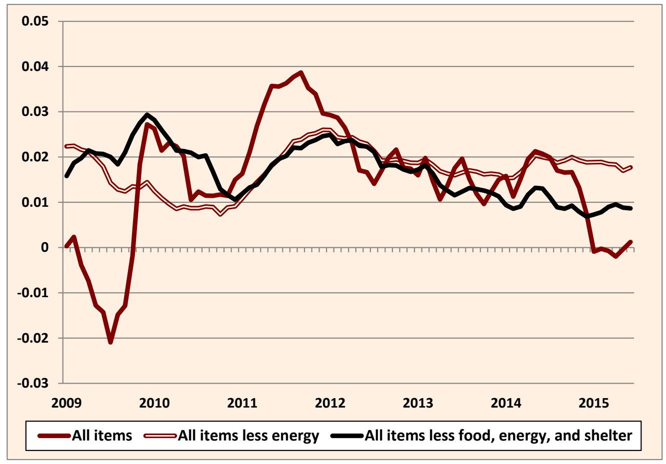
all items less food and energy index increased by 0.2% mom thanks to growth of services prices, as prices of commodities less food and energy commodities declined insignificantly in June. As the effect of the earlier decline in energy prices dissipates, consumer prices returned to growth in year-over-year terms. The all items index edged up by 0.1% yoy, as an identical 1.8% yoy increase in the food index and in the all items less food and energy index more than offset the 15.0% yoy decline in the energy index, 1.3 percentage points lower than in May.

9. CPI, % yoy change



Source: Bureau of Labor Statistics

The housing market posted good performance at both the national and Texas level in June. National existing-home sales reached 5.49 million (seasonally adjusted annual rate), which is a 3.2% mom increase over the downwardly revised 5.32 million in May and the highest level since February 2007 (5.79 million). The mentioned monthly growth was the major factor of acceleration in the year-over-year growth of existing-home sales by 9.6%. Such a high monthly and annual national growth of June sales, as a part of this year's spring buying season, was the result of several factors. On the one hand, higher demand for housing is fueled by steady growth of employment for more than a year. More new jobs and general economic growth provide more households with incentives to buy housing and the necessary financial means. On the other hand, initial mortgage rates increased in spring, which usually induces people to buy now rather than wait until later when borrowing costs could be higher. Sales increased even despite the 40th consecutive monthly growth of the median price for all housing types in June to USD 236,400 (by 6.5% yoy). Total housing inventory also increased during the reporting period, but the growth was much slower than that of sales. Therefore, unsold inventory inched down a bit to a 5.0-month supply. Texas performance in the housing sector was even better in June. The state managed to build up not just existing-home sales against a background of increasing median prices, but also unsold inventory. Actual housing sales grew by 15.6% mom even though the median price gained 2% mom. Unsold inventory, in turn, edged up to a 3.5-month supply. This is not big progress over the 3.4-month supply in May and is significantly lower than the national level, but at the same time this is definitely better than the historical low of 3.1-month supply observed for 3 consecutive months from December 2014.

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