December 2015

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- **Real GDP grew by 2.0% qoq in Q3 according to the third estimate of the Bureau of Economic Analysis.**
- **Industrial output growth entered negative territory in year-over-year terms in November due to continued sluggish monthly performance.**
- **In December, consumer confidence strengthened at the national level after several months of softening.**
- **Construction followed similar trends in the US in general and in Texas in November.**
- **Factory activity further improved in Texas in November.**
- **The decline in the Texas rig count decelerated.**
- **Texas unemployment continued to grow in November, while national unemployment remained unchanged. Employment, in contrast, grew at both the national and Texas levels.**
- **The Federal Reserve raised the policy rate for the first time in almost a decade on December 16th.**
- **Consumer prices remained flat in November, leaving over-year inflation significantly below the medium-term target of 2.0%.**

Executive Summary

Both national and Texas economies posted modest growth in November. The revised (third) estimate of national real GDP growth showed no significant changes over the previous estimate. The country's GDP increased by 2.0% qoq in Q3.

National industrial output declined further in November and the decline accelerated. The monthly decline was the result of continued contraction in output of mining and utilities, while manufacturing output remained unchanged. Growth in output of nondurables was offset by declines in output of durables and other manufacturing industries. Sluggish monthly dynamics of industrial output led to a reverse of its upwards trend in year-over-year terms.

Consumer confidence improved at the national level in November after three consecutive months of softening. Furthermore, improvements were attributed to better perceptions of both the current situation in the economy and of the short-term outlook. More prominent progress was reported in the assessment of labor conditions.

Negative developments in construction put in place and in building permits led to a reverse of the upward trend in US construction in November. Public construction posted a sharper monthly decline than private construction. The dynamics of nonresidential construction was the key in the reported decline. But negative developments in private nonresidential construction were partially offset by growth in residential construction. The pace of year-over-year growth in total construction put in place remained high despite some deceleration. Building permits posted opposite dynamics in monthly and year-over-year terms. High over-year growth under quite high monthly declines in both the number and value of building permits became possible thanks to a favorable statistical base effect.

The decline in national exports decelerated in November. At the same time, declines were observed in both exports of goods and exports of services. This is common for exports of goods for most months of the last year, while exports of services declined, although insignificantly, for the first time in quite a long time.

Modest growth of the Texas economy continued in November. The manufacturing and service sectors both promoted growth, but construction was one of the factors hindering growth. Despite improvements in factory activities and further growth in services, consumer confidence continued to soften in the state in December. The Texas construction industry in general followed the same trends observed at the national level, observing negative developments in both residential and nonresidential components. Continued decline in world oil prices led to a further decline in the Texas rig count, but the pace of the decline decelerated.

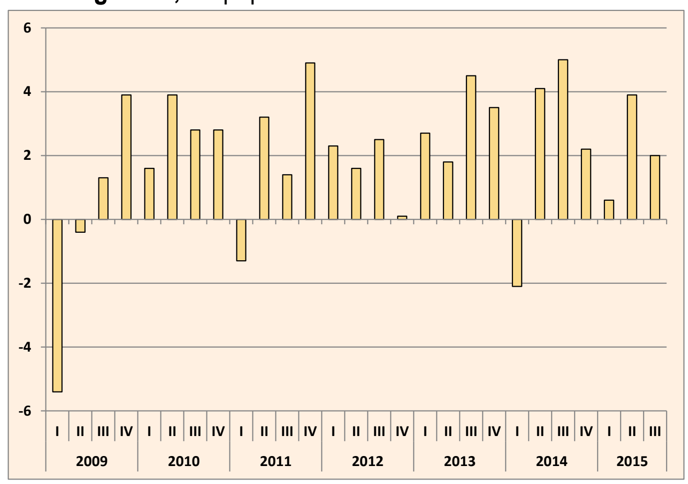
Labor conditions continued to improve at the national level but saw mixed developments in Texas. In particular, national employment expanded under no significant changes in the number of unemployed and the unemployment level. At the same time, Texas reported growth in both the number of employed and unemployed. Mining observed a decline in employment at both Texas and national level due to negative dynamics of oil prices. The year-over-year growth of employment decelerated in the US in general, same as in Texas. The Texas metros saw improvements in terms of both employment and unemployment. Almost all the metros observed monthly growth in employment, while the number of metros observing growth in unemployment significantly decreased. However, declines in several metros that are highly dependent on oil and gas extraction caused the overall increase in the number of unemployment in the state.

In line with expectations of many experts, the Federal Reserve finally raised the policy rate at the meeting of the Federal Open Market Committee on December 16th. The rate range was increased by 0.25 percentage points to 0.25%-0.5% even though inflation continued to be lower than expected. Consumer prices stayed unchanged in monthly terms in November. The decline in price indexes for food and energy fully offset the minor increase in the index of prices for the rest of goods and services. The housing market faced further cooling at both the national and Texas level. Sales fell because of weaker demand due to new regulations in the market. At the same time, inventory also fell because of slow progress in residential construction limiting supply. This also conditioned continued growth of housing prices.

Economic Growth

The third GDP estimate published by the Bureau of Economic Analysis on December 22nd has just minor adjustments compared to the second estimate. Real GDP growth was reported at 2.0% qoq (2.1% qoq in the previous estimate). The largest contribution to growth was made by private consumption expenditures, which expanded by 3.0% qoq. Gross private domestic investments declined by 0.7% qoq (0.3% qoq in the previous estimate). Foreign trade indicators sustained minor negative adjustments as growth of exports was revised downwards by 0.2 percentage points to 0.7% qoq and growth of imports was revised upwards identically to 2.3% qoq. Dynamics of government consumption expenditures and gross investment remained almost unchanged at 1.8% qoq (0.1 percentage point higher than in the previous estimate).

1. GDP growth, % qoq at annual rates



Source: The U.S. Bureau of Economic Analysis

In November, the national industrial output posted decline for the third month in a row. Furthermore, the decline accelerated. Total industrial output index edged down by 0.6% mom, which is 0.2 percentage points faster than upwardly revised 0.4% mom in October. The decline was attributed to declines in mining and utilities, while manufacturing remained flat. In particular, output of nondurable goods gained 0.5% mom, which was offset by a 0.2% mom decline in durables and 1.7% mom decline in the index for other manufacturing industries. Most nondurable goods industries posted increases with the largest gain in food, beverage, and tobacco products. Production of nonmetallic mineral products posted the largest increase among durable goods industries. However, many other durables industries posted significant monthly declines. In particular, losses of one percent or more were reported by primary metals, electrical equipment, appliances, and components, and by motor vehicles and parts. The decline in mining more than halved from downwardly revised 2.4% mom in October to 1.1% mom. At the same time, utilities sustained negative developments in their dynamics. Their decline accelerated by 1.5 percentage points to 4.3% mom. The year-over-year dynamics of the national industrial output reversed the trend in November. The 0.3% yoy growth observed in October turned into a 1.2% yoy decline. All the industrial output major components sustained negative developments. Growth of manufacturing halved to 0.9% yoy compared to October. At the same time both mining and utilities observed acceleration in decline. The former dropped 8.2% yoy (6.9% yoy in October), while the latter decreased by 7.6% yoy (1.2% yoy in October).

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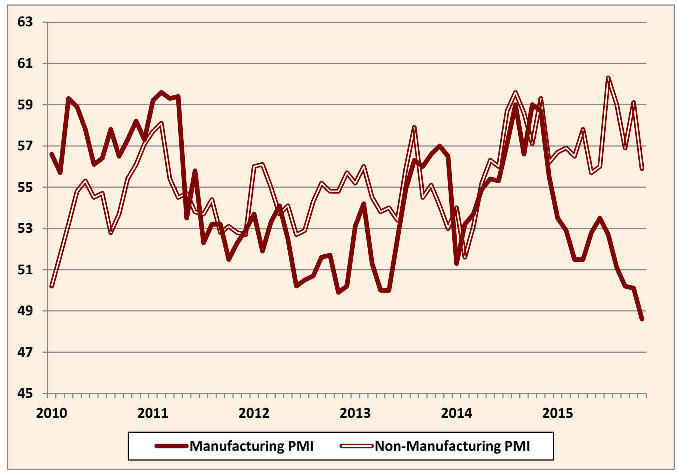
The Institute for Supply Management reported further deterioration in both manufacturing and non-manufacturing sectors at the national level. The 34-month upward trend in manufacturing activity ended as the PMI index dropped below 50% to 48.6%. Such important indexes as the new orders index and production index both posted significant declines of around 4 percentage points to 48.9% and 49.2% respectively. Actually, just three of eleven manufacturing indexes remained marginally above 50% in November. Of 18 manufacturing industries only five reported growth. These were printing and related support activities, nonmetallic mineral products, miscellaneous manufacturing, food, beverage, and tobacco products, and transportation equipment. Ten industries reported declines, including machinery, primary metals, petroleum and coal products, electrical equipment, appliances and components, fabricated metal products, and chemical products. A strong dollar, decreasing world oil prices, and the downturn in China and Europe were mentioned as the main reasons for decline. The PMI reading above 43.1% generally indicates an expansion of the national economy. In particular, the average PMI of 51.7% for January-November 2015 corresponds to a 2.7% increase in real GDP on an annualized basis. As for the non-manufacturing sector, it continued to expand in November. The NMI index dropped 3.2 percentage points to 55.9%, which means some deceleration in growth. Similarly to manufacturing sector, the new orders index and production index of non-manufacturing sector posted significant declines by around 5 percentage points. However, since they remained significantly above 50%, this just means slower growth. Twelve non-manufacturing industries reported growth in November, while six others reported contraction. In addition to mining, declines were reported in the following industries: arts, entertainment, and recreation; wholesale trade; utilities; agriculture, forestry, fishing, and hunting; and other services.

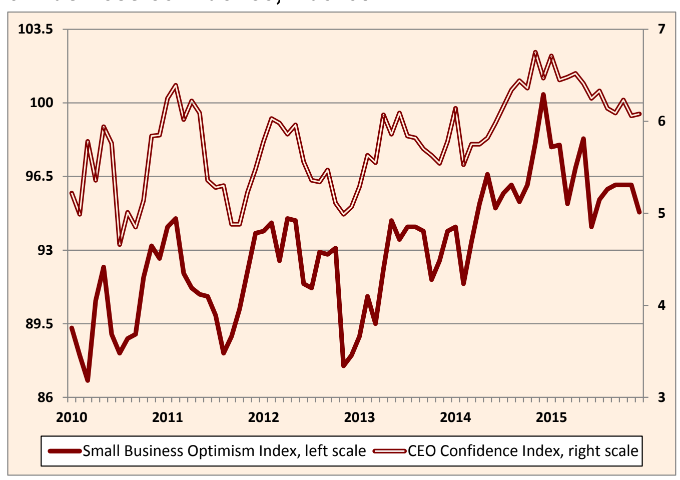
Consumer confidence strengthened in December after a couple of months of softening. The Conference Board Consumer Confidence Index expanded to 96.5 from an upwardly revised 92.6 in November. Consumers' assessment of the current state of the economy remained positive as the present situation index increased by 4.4 bps to 115.3. In particular, consumers were more positive about the labor market as the

2. PMI, indexes



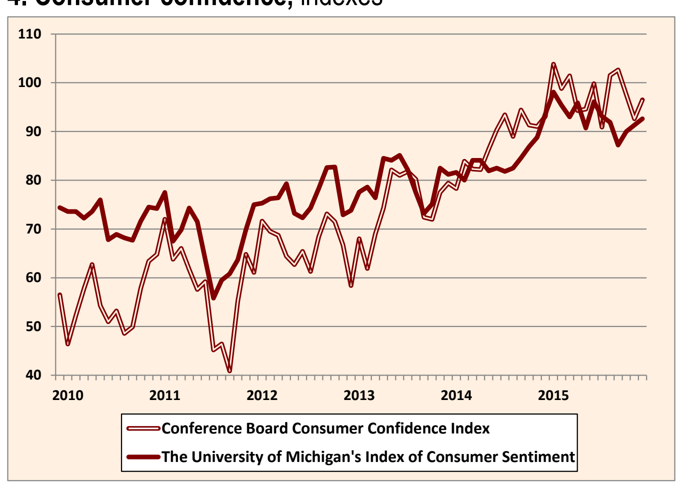
Source: Institute for Supply Management

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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number of respondents claiming jobs are "plentiful" increased and the number of those claiming jogs are "hard to get" decreased. Appraisal of current business conditions was rather mixed. As for short-term outlook, the situation improved as the expectations index grew by 4.5 bps to 83.9. On the other hand, consumers expect little change in both business conditions and the labor market. In particular, optimism about the short-term outlook for business conditions sustained minor softening, while outlook for the labor market was more optimistic.

The US construction reversed the trend in November. The value of construction put in place decreased by 0.4% mom due to declines in both private and public segment. At the same time, public construction posted a sharper decline of 1.0% mom compared to just a 0.2% mom decline in private construction. Nonresidential construction contracted in both private and public segments (by 0.7% mom and 1.2% mom respectively) but the decline in private segments was partially offset by further moderate growth of residential construction. At the same time, the pace of growth in private residential construction continued to decelerate and reached 0.3% mom (1.0% mom in October). In year-over-year terms, growth in construction remained high but decelerated by 1.0 percentage point to 10.7%. Residential construction still significantly outpaced the nonresidential one in growth. Gap between growth of private and public segments of construction narrowed in November. This happened because of both deceleration in private construction (by 1.8 percentage points to 12.5% yoy) and some acceleration in public construction (by 0.6 percentage points to 6.2% yoy). Building permits posted declines in terms of both the number and valuation in November. In particular, the unadjusted data shows that the number of building permits dropped 8.3% mom due to sharp decrease in the number of permits for single-unit houses, which was slightly compensated for by growth in the number of permits for multi-unit houses. As for valuation of building permits, it dropped 7.4% mom in November. The year-over-year developments in building permits were positive during the month. The number of permits returned to growth thanks to favorable statistical base effect posting a 23.8% yoy growth, while their valuation growth accelerated to 26.7% yoy.

National exports continued to decline but at a decelerated pace in November. Total exports dropped 0.9% mom to USD 182.2 billion. Declines were observed in both exports of goods and exports of services. Exports of goods decreased by 1.13 mom or by USD 1.4 billion to USD 122.2 billion. The net balance of payments adjustments of USD 0.5 billion partially offset the decline in exports of goods on a census basis of USD 1.9 billion. The mentioned decline was almost identically distributed between consumer goods, industrial supplies and materials, and other goods. Exports of services posted just a minor decline of USD 0.1 billion to USD 60.0 billion. This decline was generated by transport services and government goods and services which dropped USD 0.1 billion each. Other business services, which include research and development services, professional and management services, and technical, trade-related, and other services, increased by USD 0.1 billion.

In November, modest economic growth continued in Texas. Factory activity expanded for the second consecutive month. The production index inched up by 0.4 basis points to 5.2. Some other indexes of current manufacturing activity also posted increases, but demand measures remained negative despite some progress. In particular, the new orders index improved, moving upwards by 6 basis points but remained negative at -1.6. Furthermore, the growth rate of orders index marked the 13th month of being negative and remained relatively unchanged at 7.3. Perceptions of broader business conditions were mixed, while expectations regarding future business conditions strengthened.

The service sector activity continued its growth in Texas in November. The key measure of service sector conditions (revenue index) slightly recovered from the decline in previous month and reached 10.3 adding 2.7 basis points. Perceptions of broader economic conditions remained optimistic. Expectations regarding future business conditions in general softened a bit but indexes of future revenues and employment reflected more optimism.

Contrary to the national level, consumer confidence further softened in Texas in December. As the Conference Board reported, the Consumer Confidence Index decreased by 7.3 basis points from upwardly revised 105.7 to 98.4.

Texas construction followed similar trends to national construction in November. Judging by the contract value of nonresidential building construction, the nonresidential construction slowed down as value of contracts decreased

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by USD 0.6 billion to USD 1.9 billion. The number of building permits declined by 10.5% mom as the number of building permits for single-unit houses dropped one-fifth in one month. Furthermore, the number of permits for 2-to-4-unit houses decreased by more than 60%. The number of permits for houses with 5 and more units, on the contrary, grew by 6.7% mom. Valuation of building permits decreased almost identically to their number (by 10.6% mom). Similarly to the national level, the year-over-year growth in the number of building permits jumped from 8.8% in October to 26.6% on the back of statistical base effect, while growth in valuation of permits accelerated accordingly from 8.5% to 24.8%.

Texas exports declined again in October. Lower oil prices, sluggish global demand, and a strong dollar caused a 3.8% mom export drop to a level 6.6% lower than in October 2014.

The Texas rig count dropped for the third month in a row in November but the pace of decline decelerated significantly. The rig count lost 2.9% mom to 339 during the month, which accelerated its over-year decline by 1.3 percentage points to 62.5%.

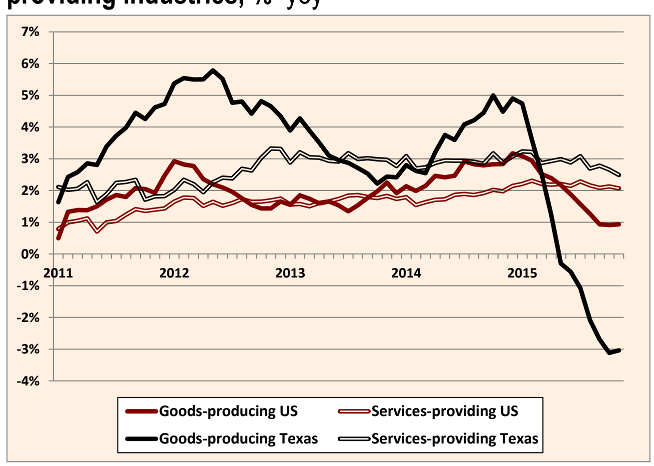
Continued rainfall provided good soil moisture for the spring planting season in November. Texas crop production was above the five-year averages for most crops. At the same time, crop prices were generally low. Furthermore, damage from too much rain forced some producers (cotton producers, for example) to provide further discounts. Therefore, financial results of agricultural producers sustain additional stress. Cattle prices also continued to decline to the level well below the year-ago levels but remained strong historically.

Employment

Non-manufacturing industries pushed national employment upwards in November, while unemployment sustained no significant changes. Total nonfarm payroll employment expanded by 252,000 jobs or 0.2% mom. This is significantly below the upwardly revised 307,000 jobs observed in October but still above the monthly average of the previous 12 months of 238,000 new positions. Construction generated the highest gain of 48,000 jobs (0.7% mom). It was followed by food services and drinking places and retail trade, which, however, were significantly behind with their 31,400 (0.3% mom) and 32,000 (0.2 mom) jobs respectively. Quite high gains were also reported by professional and technical services and health care. Employment in mining continued to decline (by 11,000 jobs or 1.5% mom) with most losses concentrated in mining support activities. However, mining was not the only industry observing contraction in employment. Information industry saw a 0.3% mom decline in employment, which is 9,000 positions. Manufacturing reported no significant changes in employment for one more month. Similarly, little changes in employment were observed in several other sectors, including wholesale trade, financial activities, and government. Despite significant monthly gain in employment, its over-year growth slightly decelerated to 1.9%. As the number of unemployed persons remained essentially unchanged at 7.9 million, the unemployment rate remained flat at 5.0% in November.

Texas employment also increased similarly to national level employment in November. At the same time, Texas unemployment also continued to expand. Employers expanded their payrolls with addition of 16,300 nonfarm jobs (growth of 0.1% mom), which is marginally below the average over the 12-month period of 16,800. For the first time in many months goods-producing industries generated more new jobs than service-providing (10,700 against 5,600). At the same time, most of the total employment gain was achieved just by two industries. These are construction and professional and business service industry. The former

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



Source: Bureau of Labor Statistics

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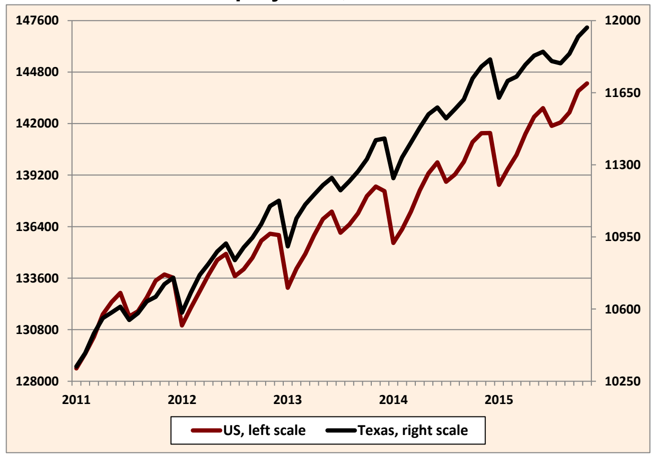
generated 9,000 (1.3% mom) new jobs, while the latter added 5,500 positions (0.3% mom). Both industries expanded their employment for the fourth consecutive month. Continued decline of the world oil prices led to further decline in employment of mining. The industry saw the fourth consecutive monthly decline of 0.7% mom or 2,100 jobs in November. Manufacturing, similarly to the national level, reported no significant changes in employment. The over-year growth of employment decelerated to 1.5% in November. The number of unemployed people grew by 5% mom in November which around 28,500 people. Such significant increase obviously led to further growth of the unemployment rate to 4.6.

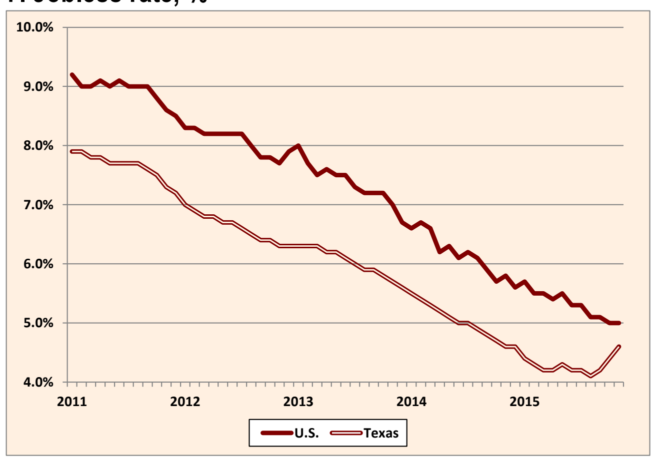
6. Total nonfarm employment, 000



Source: Bureau of Labor Statistics

Texas metros saw improvements in terms of both employment and unemployment in November. As seasonally unadjusted data shows, all the Texas metros except for Amarillo and San Angelo posted monthly growth in employment. For most of the metros that was just minor growth not exceeding 0.3% mom. The largest growth was reported by Laredo at 1.1% mom. As for Amarillo and San Angelo, their employment remained flat. The year-over-year employment dynamics, however, did not change much as most of the metros observed decline in employment. The number of metros reporting growth in unemployment significantly reduced in November. Moreover, almost a half of Texas metros reported zero growth in the number of unemployed and five other metros reported declines. The sharpest decline in the number of unemployed was observed in Texarkana at 3.2% mom, while the fastest growth was reported by McAllen-Edinburg-Mission at 9.0% mom. Most of the metros observing growth in unemployment are those in which oil and gas extraction is the leading industry. Amarillo remained as the metro with the lowest unemployment rate at 3.2%, while McAllen-Edinburg-Mission still had the highest unemployment rate at 8%.

7. Jobless rate, %



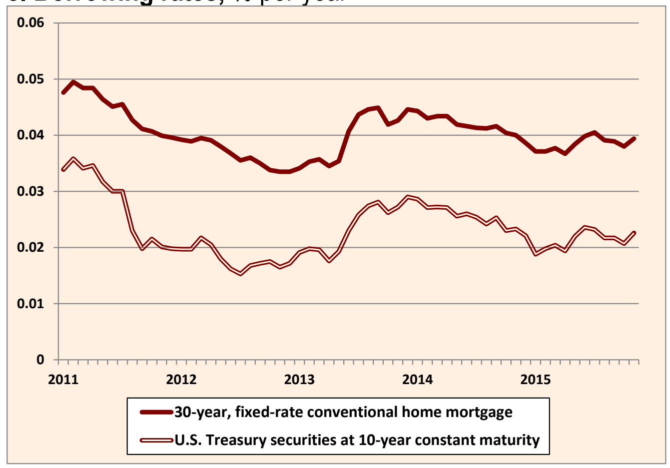
Source: Bureau of Labor Statistics

Monetary Policy and Asset Prices

The Federal Reserve raised the policy rate for the first time in nearly a decade. The Federal Open Market Committee made a decision on the increase of the policy rate by 0.25 percentage points to 0.25%-0.5% at its meeting on December 16th. The Committee claimed that it expects the economic activity to continue expanding at a moderate pace after this gradual adjustment in policy rate. Similarly, the Committee expects further strengthening of labor market indicators. The stance of monetary policy remains accommodative after the increase, which means it will support a return of inflation to around 2% and further improvement of labor market conditions. At the same time, growth of the policy rate is not good news for the government as its borrowing costs will increase. The government's annual interest payments barely increased in recent years despite a substantial growth of the federal debt. The reason for this was low interest rate. Now, as the Federal Reserve raised the rates the payments will grow too. Furthermore, mortgage rates and returns on safe investments are also likely to increase. On the one hand, the Federal Reserve has only indirect influence over the long-term debt rates. On the other hand, most experts expect long-term rates to rise gradually in coming years basing on historical data. This, in turn, will lead to increasing cost of homes and cars.

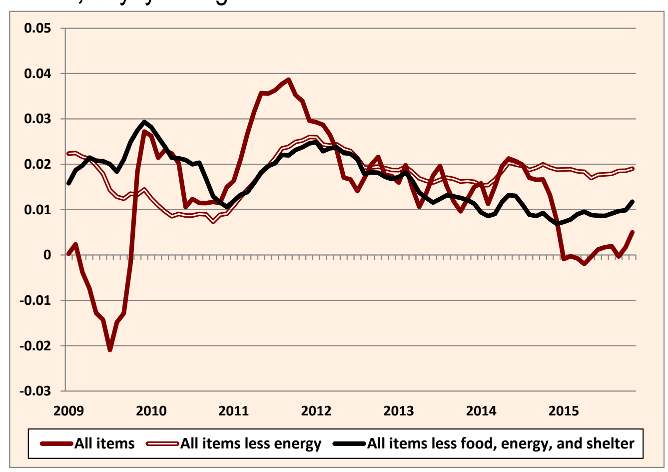
Consumer prices remained flat in November. Deflation in food and energy prices fully offset a minor growth in prices of all items less food and energy. In particular, changes in food index components were mixed, but a 0.3% mom decline in the food at home price index (as every major grocery store food group index except fruits and vegetables declined) prevailed over a 0.2% mom increase in the food away from home index. The overall food index posted a 0.1% mom decline, its first decline since March. The continued decline in world oil prices caused further decrease in energy prices. Prices of energy commodities dropped 2.4% mom on the back of identical decrease of gasoline prices and less sharp decrease in fuel oil prices. Prices of energy services remained almost unchanged as decrease in utility gas service prices more than offset a minor increase in electricity prices. A 0.2% mom growth of all items less food and energy index was attributed to growth in prices of services with the highest growth in prices of transportation services (0.6% mom). As for commodities less food and energy commodities, their prices inched down by 0.2% mom in November. Year-over-year consumer inflation slightly accelerated in November. The all items index grew 0.3 percentage points faster at 0.5% yoy. This was the result of slower decline in energy prices (at 14.7% yoy which is 2.4 percentage points slower compared to the previous month), which compensated for slower growth of food index (at 1.3% yoy). All items less food and energy index remained almost unchanged again at 2.0% yoy.

8. Borrowing rates, % per year



Source: Federal Reserve System

9. CPI, % yoy change



Source: Bureau of Labor Statistics

Cooling of the housing market continued at both the national and Texas level in November. National existing-home sales suffered the most significant drop in pace since April 2014. Total existing-home sales saw a 10.5% mom decline to seasonally adjusted annual rate of 4.76 million from downwardly revised 5.32 million in October. This monthly drop negatively impacted the over-year dynamics of the national existing-home sales as their growth rate decelerated by 7.7 percentage points to -3.8% yoy. To some extent sluggish performance in November was the result of an apparent rise in closing timeframes because the new Know Before You Owe rule. This may have pushed some transactions into December. At the same time, sparse inventory and affordability issues also made a significant contribution to the sales decline. The median existing-home price further expanded. It grew by 6.3% yoy to USD 220,300. At the same time, total housing inventory declined again to 2.04 million existing homes available for sale (by 3.3% mom). The over-year decline, however, more than halved to 1.9% compared to that observed in October (4.5% yoy). Since existing-home sales posted a sharper decline than total inventory, the unsold inventory expanded again reaching 5.1-month supply at the current sales pace. Similarly to the US in general, Texas also observed decline in major housing market indicators. In particular, actual existing-home sales dropped 19.4% mom. However, this decline is actually in line with a seasonal trend observed over the last couple

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of years. Furthermore, this decline is smaller than that observed in November 2014 at 21.6% mom. Year-over-year existing-home sales decline decelerated by 0.3 percentage points to 1.8%. Housing supply continued to decline in November despite lower sales. Unsold inventory inched down from 3.5 to 3.4 months of supply under current sales pace. At the same time, the situation may improve soon as employment in construction increased for a couple of months and the increase was fueled by new jobs in residential construction. Median existing-home prices continued to expand, but slower than in the previous month at 4.8% yoy.

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