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- The U.S. economic recovery is gaining momentum.
- The pace of job losses is slowing in Texas.
- Home sales in Texas grew by 4.6% in September compared to last year.
- Texas was ranked second by Site Selection Magazine in its 2009 Top State's Business Climate Rankings. In addition, 8 out of the 50 best places to launch a small business in the U.S. are located in Texas.
- Texas remains the largest exporting state in the U.S., supported by broad product and geographical diversification of its exports.

Economy

There is more evidence of economic recovery in the U.S. The Consumer Confidence Index is almost twice as high as in February 2009, and is 9 points above its level in October 2008. The housing market appears to be turning a corner and stronger equity prices are restoring household wealth. Retail and housing inventories are shrinking, which means that supply cuts have been outpacing demand declines. In another sign that the housing recovery may be under way, in September, the Case/Shiller Home Price Index posted the fourth consecutive monthly gain since 2006.

In September, seasonally adjusted shipments and new orders of durable goods grew by 0.8% and 1%, respectively, versus August, as businesses rebuilt their inventory.¹ This may help improve capacity utilization in manufacturing and hold off any further job losses. Indeed, in October, seasonally adjusted capacity utilization in the U.S. manufacturing grew to 67.6%, its highest level in 2009.²

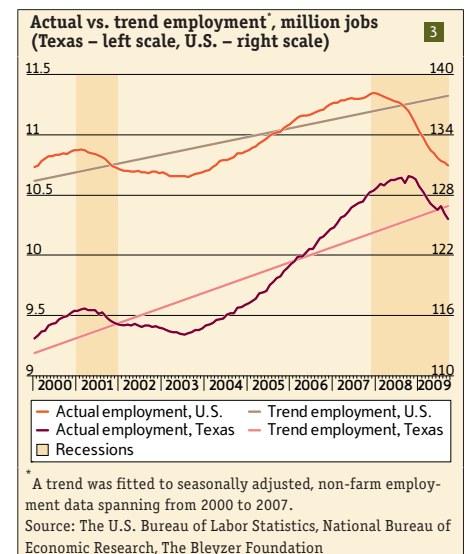
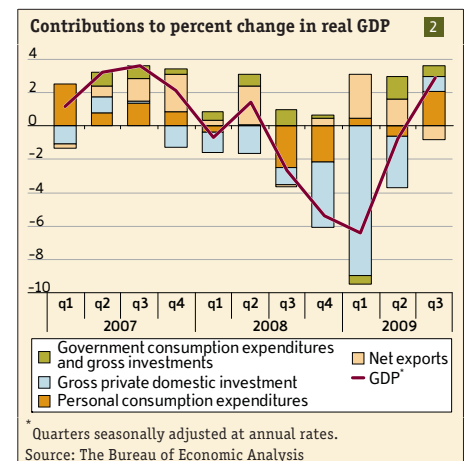
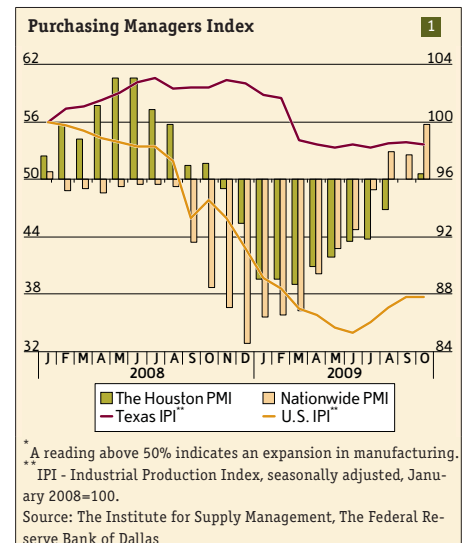
The Purchasing Managers Index (PMI), issued by the Institute for Supply Management (ISM), indicates that U.S. manufacturing grew for the third consecutive month in October. Texas manufacturing is on the mend as well. The Houston PMI rose to 50.6% from 50% in September, which ended ten consecutive months in negative territory (see chart 1).

In October, the ISM Non-Manufacturing Index stood at 50.6%, which means that the non-manufacturing sector has been expanding for two consecutive months for the first time since August 2008.

As private consumption and residential investment bounce back, economic growth appears to be returning. Estimates by the Bureau of Economic Analysis place third quarter GDP growth at an annual rate of 2.8%. Personal consumption, which grew at an annual rate of 2.9% - a record high since the first quarter of 2007 - contributed nearly 3/4th to overall GDP growth (see chart 2). Meanwhile, gross private domestic investment increased at an annual rate of 8.4%, contributing to growth for the first time since the third quarter of 2007. In the third quarter of 2009, residential investments surged by an annual rate of 20% - their first gain since the last quarter of 2005. As a result, about 45% of GDP growth in the third quarter of 2009 was brought by residential investment and consumer spending on motor vehicles.

There are signs that this recovery reflects healthy business cycle dynamics. Indeed, exports remain on an uptrend (helped by the recent weakening of the U.S. dollar), and firms have increased spending on equipment and machinery. Inventories in trade and construction are declining - a trend that may contribute to growth in the medium-term.

Although labor markets have been slow to regain firm footing, this is a typical trend during any downturn, as employment usually lags behind output recovery. Neverthe-



¹Source: The U.S. Census Bureau.

²Source: The Federal Reserve Bank of Dallas.

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less, several risks to the nascent economic rebound are still present. Above all, rising joblessness and tight access to credit will delay the return of consumer spending to prior levels.

Employment

U.S. non-farm employment is nearly 5% below its trend level. Despite this, we believe the Texas labor market will recover faster due to higher trend employment growth and a stronger labor market versus the U.S. labor market overall (see chart 3). Specifically, Texas annual trend employment growth is about 1.3% or twice as high as the U.S. average. Meanwhile, in Texas, employment is only 1.1% below its long-term trend.

We believe the job creation capacity of Texas is stronger than other large states for the following reasons:

First, the state's demographics support faster population growth and, therefore, higher long-term trend employment growth. An accelerated population growth is due to large inflows of domestic and international migrants and higher fertility rates due to a younger and more diverse population.³ From 2000 to 2008, the population of Texas increased by over 16% - the second fastest growth rate among the 10 largest U.S. states (after Georgia). Faster population growth creates stronger demand for services - a sector that remains the main source of jobs and growth in the U.S. economy (see chart 4).

Second, Texas has an extremely competitive and diverse economy. The state was ranked second by Site Selection Magazine in its 2009 Top State's Business Climate Rankings.⁴ This makes it an appealing destination for U.S. and international businesses. Indeed, Texas is home to the largest number of companies on the Fortune 500 list - 67 companies have headquarters in the state. Additionally, Texas has a favorable environment for small businesses, with 8 out of the 50 best places to launch a small business in the U.S. located in Texas (including Houston and Austin as the 4th and 8th top large metros for small businesses).⁵

Third, Texas public finances remain in relatively healthy shape compared to other large U.S. states. According to the Center on Budget and Policy Priorities, falling revenues have opened mid-year budget shortfalls in 26 states, including California, Florida, New York, Arizona and Massachusetts. The latest Pew Center report lists California, Arizona, Rhode Island, Michigan, Oregon, Nevada, Florida, New Jersey, Illinois and Wisconsin as 10 states in fiscal peril. According to the U.S. Census Bureau, during the first two quarters of 2009 the total tax revenues of Texas fell by only 11% compared to 15% in California and New Jersey, 20% in New York, and 14.5% nationwide. This smaller deterioration in fiscal revenues allows Texas to avoid raising taxes, which helps preserve competitive advantages within the Texas business tax climate. More than that, the state is experiencing less pressure to roll back its business and employment support programs.

All told, a favorable combination of supportive state government, attractive living conditions and competitive business costs creates stronger long-term fundamentals for the Texas economy and its labor market.

In September, the Texas seasonally adjusted unemployment rate inched up to 8.2% from 8% a month ago, which is well below the national unemployment rate of 9.8%. The state



	September 2009 vs. September 2008		Composition of the Texas nonfarm employment, % of total	
	Texas	U.S.	2008	2009
Total nonfarm	-2.9%	-4.2%		
	thousand jobs			
Education and health services	58.7	2.0%	12.3%	13.2%
Other services*	9.4	-2.5%	3.4%	3.6%
Government	46.1	-0.4%	16.8%	17.7%
Financial activities	-0.3	-5.1%	6.1%	6.3%
Leisure and hospitality	-3.7	-2.0%	9.4%	9.7%
Trade, transport, and utilities	-106.2	-4.5%	20.2%	19.8%
Prof., and business services	-76.7	-6.0%	12.6%	12.2%
Information	-13.5	-5.4%	2.0%	2.0%
Manufacturing	-90	-11.9%	8.7%	8.1%
Mining and logging	-31.5	-11.2%	2.2%	2.0%
Construction	-96	-15.5%	6.3%	5.6%

* Includes repair and maintenance, personal and laundry services, religious, civic and professional organizations.
Source: The U.S. Bureau of Labor Statistics

³According to the U.S. Census Bureau, only 10% of Texans are older than 65 years, compared to 17% in Florida, 13% in New York, 11% in California or 13% nationwide. The median age of the Texas population grew by only about 10 months from 2000 to 2008 to 33.2 years compared to 36.8 years for the U.S. (or up by over 17 months from 2000 to 2008).

⁴Texas is second in terms of the number of new or expanded corporate facility projects in 2008. According to this ranking, Houston and Dallas are the first and the second metros with population over 1 million.

⁵Source: Fortune Small Business magazine and the Kauffman Foundation, the 2009 list of the 50 best metro areas for small business startups, October 2009.

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lost only 44,700 jobs in September (30% less than in August). As a result, Texas nonfarm employment shrank by just 2.9% over the last 12 months (versus 4.2% nationwide). About half of all monthly job losses were in business and professional services, and transportation, trade and utilities.

There are signs the Texas employment situation is gradually stabilizing. First, the mining sector added jobs for the first time in 2009 (2,100 jobs in September). Second, in September, average weekly initial unemployment insurance claims fell to 20,400 compared to about 27,600 in the first quarter of 2009. Third, 3 out of 11 economic sectors in Texas (which account for 35% of all nonfarm employment) added jobs in the last 12 months, compared to only one nationwide (see chart 5). If finance, leisure and hospitality are added to those three sectors, then during the last 12 months, five industries (or over half of all nonfarm employment) added about 110,000 jobs, compared to a loss of over 530,000 jobs in the same sectors nationwide. This is evidence of the resilience of the services industry in Texas. Indeed, stronger performance of a large group of service sectors in Texas has been partially offsetting negative dynamics in manufacturing, construction, trade, professional and business services (which generally follow overall U.S. employment trends).

In September, 117 of 372 U.S. metropolitan areas had an unemployment rate of over 10%, compared to only 10 metros a year ago. During the last 12 months, the unemployment rate surpassed the 10% level in only 3 out of 25 Texas metros (compared to 22 of 26 in California, 11 of 13 in Florida, and 13 of 14 in Michigan) (see chart 6). In some states, over half of all those unemployed reside in the largest metro area. This reflects the scale of the distortion in some local economies, be it in construction, for example, in Las Vegas (NV) and Phoenix (AZ), or in automobile manufacturing in Detroit (MI).

Residential housing activity

According to the Real Estate Center at Texas A&M University, in September home sales grew by 4.6% compared to a year ago, helped by the 30% increase in home sales in Houston (see chart 7). In addition, several other indicators point toward improving fundamentals in the Texas housing market. First, in September, the number of months necessary to sell off listed homes fell in most Texas residential markets. The number of months of housing supply in Austin, Dallas and Houston remains well below the U.S. average⁶. Second, home values in Texas fell by only 0.9% compared to a 6.5% price reduction nationwide.⁷ Third, in October mortgage foreclosures in Texas decreased by over 10% versus September, compared to only a 3.3% decline nationwide.⁸ This means that the forces driving foreclosure activity (such as negative equity, employment losses and the quality of sub-prime loans) are weakening faster in Texas. Lastly, Texas remains a top destination for migrants lured by its diverse and dynamic economy and low cost of living.⁹ As a result, faster population growth should prop up the regional housing market.

Metropolitan Statistical Area	unempl. rate	unemployed, % of the state's total	Sep. 2009 vs. Sep. 2008, % change	
			empl.	civilian labor force
Denver-Aurora-Broomfield	7.1%	53.3%	-5.0%	-2.9%
San Antonio	7.1%	7.0%	-0.2%	2.2%
Austin-Round Rock	7.2%	6.5%	0.8%	3.6%
Minneapolis-St. Paul-Bloomington	7.3%	64.2%	-2.6%	-0.6%
Baltimore-Towson	7.6%	50.1%	-4.7%	-1.8%
Pittsburgh	7.6%	17.3%	-4.0%	-1.2%
Dallas-Fort Worth-Arlington	8.3%	27.1%	-0.8%	2.6%
Cleveland-Elyria-Mentor	8.3%	15.4%	-3.9%	-1.9%
Houston-Sugar Land-Baytown	8.5%	24.2%	-1.9%	1.7%
Phoenix-Mesa-Scottsdale	8.6%	62.3%	-4.0%	-0.8%
Boston-Cambridge-Quincy	8.8%	69.0%	-3.5%	0.2%
Philadelphia-Camden-Wilmington	8.8%	49.1%	-4.4%	-1.0%
Kansas City	8.9%	33.7%	-1.3%	1.7%
Seattle-Tacoma-Bellevue	9.1%	55.5%	-1.5%	3.0%
Cincinnati-Middletown	9.2%	17.9%	-5.3%	-2.0%
St. Louis	9.9%	50.9%	-4.1%	-0.7%
Chicago-Naperville-Joliet	10.0%	72.2%	-4.7%	-0.6%
New York City	10.2%	48.1%	-3.3%	1.2%
San Diego-Carlsbad-San Marcos	10.2%	7.3%	-4.8%	-0.7%
San Francisco-Oakland-Fremont	10.4%	10.7%	-5.3%	-0.6%
Atlanta-Sandy Springs-Marietta	10.5%	57.7%	-6.9%	-3.0%
Portland-Vancouver-Beaverton	10.9%	60.2%	-5.6%	-0.1%
Miami-Fort Lauderdale	10.9%	30.1%	-4.4%	0.3%
Orlando-Kissimmee	11.5%	12.4%	-6.2%	-0.9%
Tampa-St. Petersburg-Clearwater	11.7%	14.9%	-5.9%	-1.2%
Sacramento-Arden-Arcade-Roseville	11.8%	5.7%	-5.4%	-0.7%
Los Angeles-Long Beach-Santa Ana	11.9%	35.4%	-5.7%	-1.1%
Las Vegas-Paradise	13.9%	73.9%	-5.7%	1.1%
Riverside-San Bernardino-Ontario	14.2%	11.5%	-6.2%	-0.7%
Detroit-Warren-Livonia	17.3%	50.7%	-9.5%	-0.3%

Source: The U.S. Bureau of Labor Statistics

	Sep. 2009 vs. Sep. 2008, % change		months of supply, Sep. 2009
	average price	sales	
Austin	-1.2%	7.9%	6.4
Beaumont	-8.6%	75.9%	8.9
Dallas	-1.1%	-6.6%	6.3
El Paso	-5.1%	8.0%	8.7
Fort Worth	-2.1%	-12.9%	6.7
Houston	-2.0%	30.7%	6.5
Lubbock	-4.6%	0.4%	5.5
McAllen	-11.9%	1.7%	13.9
San Antonio	-1.3%	-3.1%	8.1
Texas	-0.9%	4.6%	7.1

Source: Real Estate Center at Texas A&M University

⁶7.8 months. Source: The National Association of Realtors.

⁷As reported by the National Association of Realtors. In September, the S&P/Case-Shiller Home Price Index was 9.4% below its level a year ago.

⁸Source: RealtyTrac.

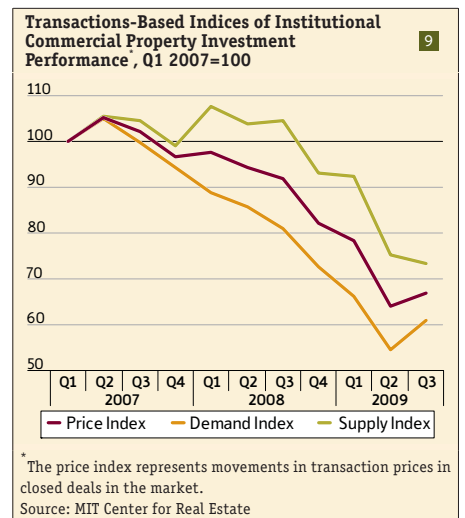
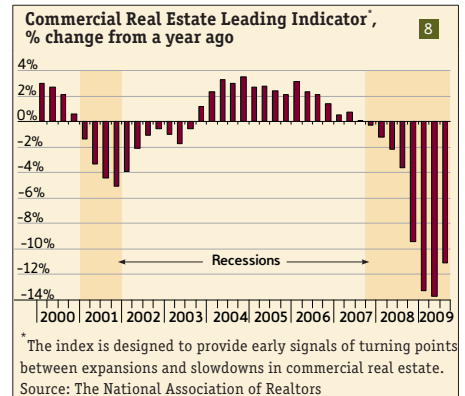
⁹Indeed, according to the Center for an Urban Future, it costs 60%, 38% and 21% less in Houston to enjoy a similar standard of living as in Manhattan, Los Angeles and Chicago, respectively.

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The U.S. commercial real estate market appears to be stabilizing as well. The quarterly decline of the National Association of Realtors Commercial Real Estate Leading Indicator has been moderating, which, judging from the last recession, may imply that this market will hit bottom in the second half of 2009 (see chart 8). In addition, in the third quarter of 2009 the Transactions-Based Commercial Property Price Index posted the first quarterly gain in two years as demand conditions improved (see chart 9).¹⁰

On the downside, declining rents and vacancies increase delinquencies on the commercial real estate loans (see chart 10). Weak commercial mortgage-backed securities (CMBS) activity adds to the industry's woes. According to the Commercial Mortgage Securities Association (CMSA), U.S. CMBS issuance fell by 85% during the first three quarters of 2009 to just \$1.8 billion (compared to \$197 billion in the first three quarters of 2007).¹¹ This lack of liquidity elevates CMBS delinquency rates, which, according to the latest reports by Moody's and Fitch, rose to about 4% in October.

Banks with excessive loan concentration in commercial real estate remain particularly vulnerable. To their credit, Texas commercial banks have a relatively smaller exposure to this sector (see chart 11). This, in addition to stronger residential housing market in the state, supports better asset quality and profitability of Texas-based mortgage institutions.



FDIC state profiles, second quarter 2009						
	TX	NY	NV	CA	AZ	FL
Loan Concentrations (median % of Total Risk-Based Capital)						
Commercial Real Estate	187.4	162.9	269.5	391.4	407.6	411.1
Construction & Development	41.9	14.8	85.6	53.3	106.1	91.8
Multifamily Residential Real Estate	2.4	11.2	1.1	16.9	8.1	16.8
Nonresidential Real Estate	124.2	116.3	170.8	258.4	239.3	257.9
Residential Real Estate	104.9	207.5	42.8	53	90.4	150.8
Consumer	43.8	4.2	6.7	4.1	5.4	7.6
Agriculture	30.9	0	0	0	0	1.1
Asset Quality						
Past-Due and Nonaccrual Loans / Total Loans (median %)	1.79	2.4	9.07	3.74	6.67	6.58
Percent of commercial banks with earning gains	44.75	38.46	20	27.46	27.27	18.18

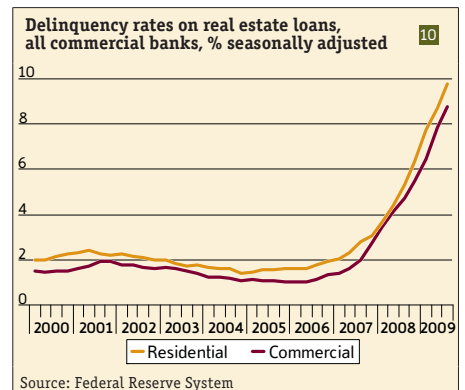
Source: Federal Deposit Insurance Corporation

Foreign trade

A weaker U.S. dollar and strong growth in developing economies is supporting demand for U.S. exports (see chart 12). Texas remains the largest exporting U.S. state. In January-August, exports from Texas stood at \$102.6 billion or 35% more than exports from the second largest U.S. exporter - California. This implies that an ongoing resurgence of foreign demand will have a stronger impact on Texas versus other large U.S. states.

A greater role of exports benefits the Texas economy for several reasons. First, the state exports over 60% of its goods to developing countries, where demand is likely to remain resilient as foreign governments are switching from export-oriented to consumer driven growth. In fact, U.S. states with a higher share of exports to developing countries in 2008 tended to report smaller declines in exports in 2009 (see chart 13).

Louisiana is an obvious outlier to this pattern, which brings us to the second important point - product diversification of exports. In 2008, oil seeds, grains and cereals accounted for about 29% of all exports from Louisiana, while mineral fuels stood for another



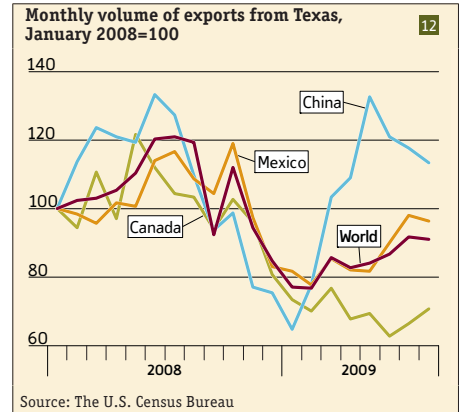
¹⁰Source: The Center for Real Estate, Massachusetts Institute of Technology. In addition, by mid-November, the Bloomberg REIT Office Property Index, which measures the performance of 14 real estate investment trusts, more than doubled compared to its bottom in March 2009, gaining over 40% over the last 12 months.

¹¹According to the CMSA, there was no new U.S. CMBS issuance in the last two quarters of 2008 and the first quarter of 2009. The FED Term Asset-Backed Securities Lending Facility program (TALF) was slow to unfreeze the CMBS market. The first commercial-mortgage deal under TALF was completed only in mid November.

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26%. Meanwhile, exports of industrial machinery and computers were only 3.5% of all exports. Texas relies much less on exporting commodities, such as agricultural products and mineral fuels, whose prices fell sharply following the global economic slowdown.¹² In January-August 2008, the state's exports of industrial machinery and computers (20% of all exports in 2008) fell by only 14% (versus a 31% fall in exports of mineral fuels), which shielded the state's export revenues from falling oil prices. A resumption of growth in Latin America (which buys over 45% of all Texas exports) will bolster demand for Texas manufacturing products. In fact, Texas exports of industrial machinery and computers to Mexico grew by 2.6% during the first eight months of this year.

Lastly, according to the U.S. Department of Commerce, exports support nearly one in four jobs in Texas manufacturing, while jobs linked to export-oriented manufacturing account for about 7% of total private sector employment. This means that a faster recovery of exports, relative to domestic demand, will continue to help buoy the Texas labor market and economy.



¹²In 2008, exports of oil seeds, grains and cereals were only 2% of total exports from Texas, while exports of mineral fuels accounted for less than 15%.