

February 2013

- Texas factory activity strengthened in January.
- Houston's manufacturing sector grew faster during the first month of this year.
- The U.S. economy grew by 2.2% in 2012.

Executive summary

Despite a somewhat downbeat end of the year – with fourth quarter GDP registering only a slight increase of 0.1%, the national economic recovery continued at a moderate pace. Year-end weakness was mostly brought on by falling exports and a reduction in federal defense spending, which shaved more than a percentage point off quarterly economic growth. Meanwhile, consumer and business spending expanded at the end of 2012. Thanks to growing consumer demand for durable goods, personal consumption grew faster than during the previous two quarters. A downtrend in business spending on equipment and software reversed in the last quarter of 2012, as this component of the national economy posted its first double-digit gain since the third quarter of 2011. The housing recovery remained on firm footing, with residential investments adding to economic growth for the seventh straight quarter.

The private sector continued to expand at the start of 2013, albeit slowly. National factory activity improved in January as manufacturing PMI hit its highest level in eight months, largely thanks to improving domestic demand. Business activity in service-providing sectors increased at a slower pace in January, coupled with a moderate expansion in the retail sector. However, the employment component of the Non-manufacturing Purchasing Managers Index jumped to its highest level since February 2006, pointing to improving hiring activity in services and construction.

Still, the fact that business confidence barely budged in January points to a rather fragile economic climate. The uncertain course of federal fiscal policy remains a major factor affecting the national economic outlook. The tax deal, enacted at the start of the year, may have already dented consumers' resolve to spend. Indeed, consumer confidence plunged in January (although, it moved back up a bit in February) and consumer spending on goods grew by just 0.1% versus December. Meanwhile, on top of the long-term budgetary challenges, lawmakers will have to resolve several key policy issues with big near-term implications for budgetary outcomes. The federal government's statutory debt limit, temporarily suspended at the start of February, will take effect on May 19th. This means that fiscal outcomes may remain highly unpredictable.

Turning to Texas, the state's factory activity bounced back in January as the current production index of the Texas Manufacturing Outlook Survey jumped to its highest reading in seven months, marking the best start to the year since the onset of the economic downturn five years ago. Business activity in the service providing sectors continued to grow as well, although at a somewhat slower pace compared to the end of 2012. Importantly, the recovery of the Houston metro remains on track, which adds growth momentum to the overall Texas economy - metro factory activity strengthened in January, despite a deceleration in the energy sector. This may imply that the metro economy, where recovery was initially boosted by the booming energy industry, is shifting toward more broad-based growth thanks, in part, to firmer business activity in the real estate sector.

Texas is a big and well-diversified economy, which means that the individual strengths of its metros are adding to the overall economic resilience of the state. This is reflected in the more dynamic recovery of Texas' metro labor markets compared to other regions of the national economy. For instance, both Austin and Houston are enjoying a solid rebound in private sector jobs, which grew by 7.6% and 4.4% in December 2012 versus four years ago. Houston goods producing sectors are benefiting from the expanding mining industry, as well as a pickup of hiring in construction and manufacturing. A similar trend is observed in Austin and Dallas, although factory jobs are growing faster in Austin thanks to its lead in high-tech manufacturing.

Metro job growth in private service-providing sectors has a distinct regional flavor as well. Dallas, the financial powerhouse of Texas, saw a healthy gain of jobs in the financial industry. A bigger share of high-tech service jobs in Austin is sustaining a solid recovery of employment in professional and business services. Houston, which is home to the world's leading medical center, leads all other big Texas metros in terms of its jobs growth in healthcare. Lastly, Austin, Houston and Dallas created more new jobs in leisure and hospitality. This is important, because increasing employment in that sector helped partly make up for jobs losses in relatively similar service occupations, which may be one of the reasons for the stronger labor market rebound in Texas compared to other states.

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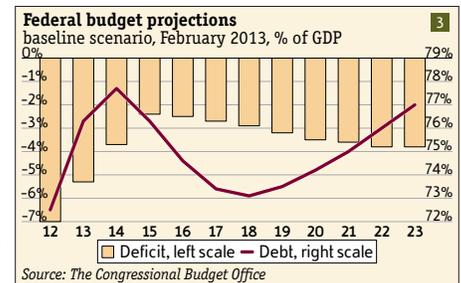
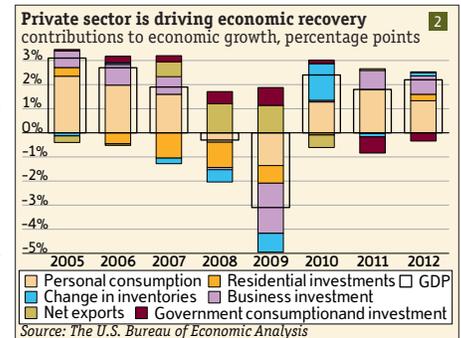
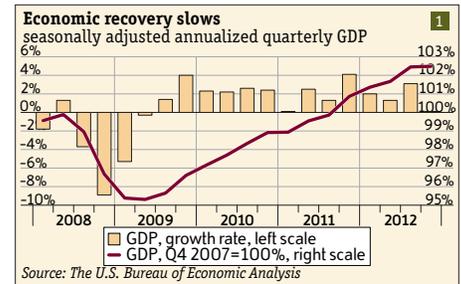
Economic output

The U.S. economy ended 2012 on a down note as economic recovery came to a standstill, with fourth quarter GDP registering a slight increase of only 0.1% - the lowest reading in nearly two years (see chart 1). As foreign demand continued to weaken due to slowing global economy, exports fell for the first time since the first quarter of 2009, declining by 3.9%. A 22% drop in federal defense spending triggered a 6.9% decline in government consumption, which shaved over 1.3 percentage points off quarterly economic growth. Lastly, slower build-up of private inventories, partly on growing worries over the strength of domestic and foreign markets, was a big drag on national output - inventories knocked off 1.6 percentage points from GDP growth in the last quarter of 2012.

Consumers and businesses expanded spending at a quicker pace at the end of 2012. Indeed, thanks to growing consumer demand for durable goods (in particular, surging car sales), personal consumption grew by 2.1% in the fourth quarter of 2012 - faster than during the previous two quarters. Meanwhile, a downtrend in business spending on equipment and software reversed in the last quarter of 2012, as this component of the national economy posted solid growth of 11.3% - the first double-digit gain since the third quarter of 2011. Equally important, as a sign of the continuing housing recovery, residential investments saw their seventh straight quarter of growth, advancing by 17.5% in the final quarter of 2012.

Having said all of the above, government policy on taxes and spending is emerging as a major factor affecting the national economic outlook. First of all, the tax deal enacted at the start of the year may dent consumer spending; the expiration of the two-percentage point payroll-tax cut alone is estimated to reduce the annual income of an average household by about \$1,000. Since the tax deal moved additional revenue side measures to fix the federal budget virtually off the table, debates on stabilizing public debt and the budget deficit will mostly revolve around spending cuts – an area where it has been particularly difficult to reach bipartisan compromise. Meanwhile, the urgency to fix the federal budget was accentuated by the recent Budget Outlook. Despite some improvements over the next several years, the Congressional Budget Office estimates that both the federal budget deficit and public debt (as a percentage of GDP) will resume growing (see chart 3) as an aging population and increasing healthcare costs add to entitlement spending. On top of these long-term budgetary challenges, lawmakers will have to resolve several key policy issues with big near-term implications for budgetary outcomes. The federal government's statutory debt limit (currently at \$16,394 billion and temporarily suspended at the start of February) will take effect on May 19th. The Congressional Research Service estimates that about \$700 billion in additional debt above the current limit could be required to finance the government during this fiscal year. However, because House and Senate legislative actions on budgetary policy are often complicated by disagreements and delays, uncertainties over national fiscal policy are certain to persist, remaining a big deterrent to a stronger private sector recovery in the coming months.

Readings on the national business activity indicate that the private sector continues to grow even in this highly uncertain policy environment. For instance, U.S. factory activity improved in January as manufacturing PMI hit its highest level in eight months (see chart 4). In particular, all major components of manufacturing, including employment, production, new orders and inventories, posted stronger readings during the first month of 2013, pointing to accelerating economic growth. Importantly, this uptick in factory output was registered despite somewhat slower expansion of exports, which means that much of the recent growth can be attributed to domestic factors, such as consumption and business spending. Although business activity in service-providing sectors increased at a slower rate in January, perhaps as a result of more moderate expansion of the retail trade industry, the Non-Manufacturing PMI (NMI) still remained above its 2012 average. More than that, the employment component of the NMI jumped to its highest level since February 2006, which is a sign of increasing hiring activity in services and construction (see chart 5).



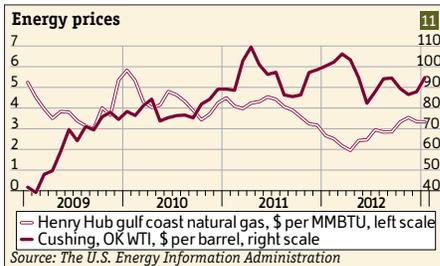
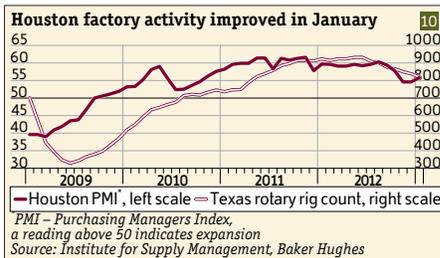
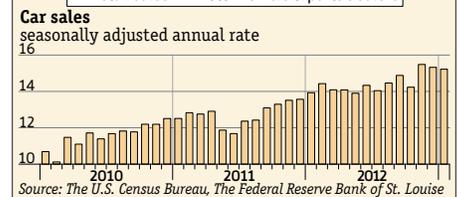
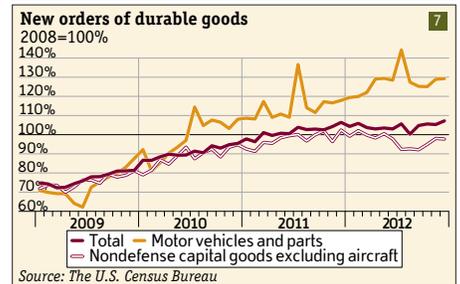
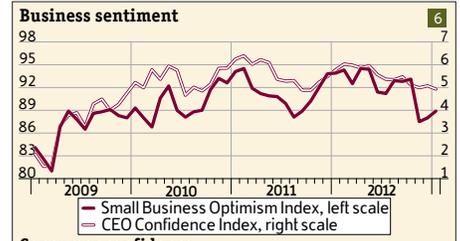
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Still, the fact that business confidence barely budged in January (see chart 6) points to a rather fragile economic climate. Above all, taxes and government regulations are the most important problems for business owners, who continue to delay hiring and investment decisions. On the upside, business spending picked up at the end of 2012 (see chart 7), thanks to recovering spending on capital goods and continued growth in the automobile industry. Meanwhile, higher payroll taxes are starting to bite as retail sales grew slower in January compared to the previous two months. In particular, consumer spending on goods grew by just 0.1% versus December, as car sales appear to be leveling out after having recovered to their pre-crisis levels (see chart 8). Increasing gasoline prices (up by about 48 cents per gallon since the start of the year) may be squeezing consumer spending as well. On the uptrend, an uptrend in consumer confidence does imply that economic conditions are gradually getting better, which should help sustain consumer spending and demand for housing.

Turning to Texas, the state's factory activity bounced back in January—the current production index of the Texas Manufacturing Outlook Survey jumped to its highest reading in seven months, marking the best start to the year since the onset of the economic downturn five years ago (see chart 9). Business activity in service providing sectors continued to grow as well, although at a somewhat slower pace compared to the end of 2012. As a result, hiring in the service sector and retail industry seems to be decelerating; in January, the employment indices of the Texas Service Sector Outlook Survey edged down.

The recovery of the Houston metro remains on track, which adds growth momentum to the overall Texas economy. Indeed, similar to the state's economy as a whole, factory activity in Houston strengthened in January as the Houston Purchasing Managers Index moved up to 55.8 after staying unchanged during the last two months of 2012 (see chart 10). Importantly, this improvement was registered on the back of a deceleration in the energy sector, as oil and natural gas prices remained volatile (see chart 11). This may imply that the metro economy, where recovery was initially boosted by the booming energy industry, is shifting toward more broad-based growth thanks to firmer business activity in the real estate sector as well as growing exports of manufacturing products and services.

In particular, improving economic conditions in the construction industry are a genuine sign of strengthening economic fundamentals, both in Texas and nationwide. For instance, in January, sales of new homes nationwide jumped to their highest level in over four years (see chart 12) thanks to affordable prices and tight supply (the inventory of new homes remained near a record low at 4.1 months). Meanwhile, homebuilding in Texas appears to be bouncing back faster than in the nation as whole. At the end of 2012, the number of new private housing units authorized by building permit for Texas was just about 12% lower compared to the 2007 average, versus a drop of 35% nationwide (see chart 13). Last year, 41% more building permits were issued in Texas (versus 34% growth nationwide) thanks to a rebound of multi-unit residential construction, for which 76% more building



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permits were authorized (compared to an increase of 53% for the nation as whole). As a result, Texas remained the most active residential housing market in the country for the seventh consecutive year (see chart 14).

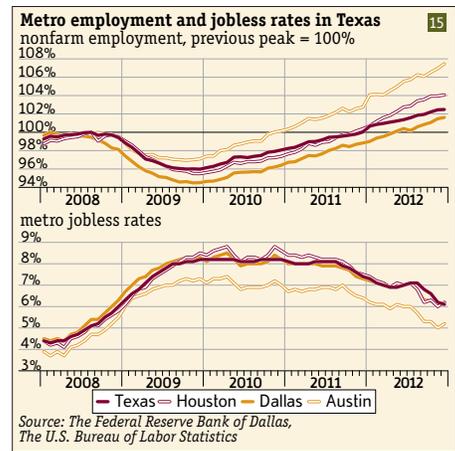
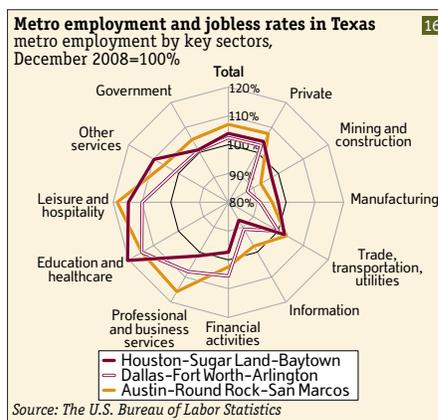
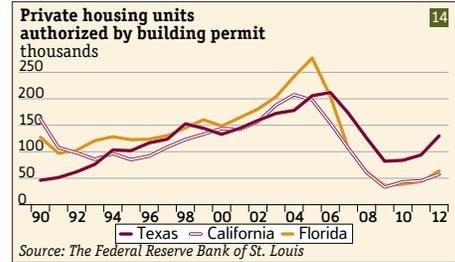
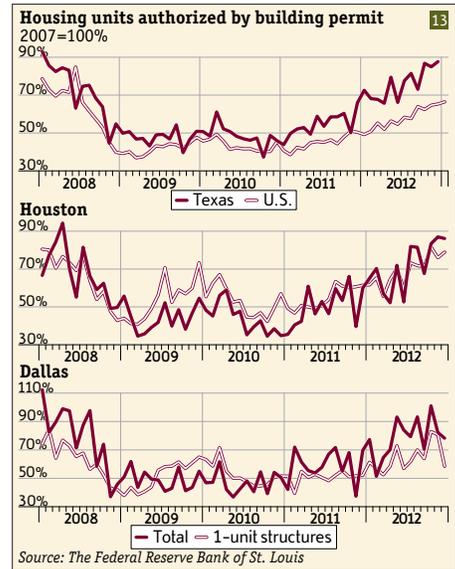
Employment

The economic resiliency of the Houston and Austin metros is reflected in the more dynamic recovery of their labor markets. Last year, nonfarm employment in both metros was 4.1% and 7.5% higher compared to the peak employment of the previous business cycle; meanwhile, the jobless rates in both metros have recently fallen below the state's average (see chart 15). Both Austin and Houston are enjoying a solid recovery of private sector jobs, which in December 2012 grew by 7.6% and 4.4% versus four years ago. In particular, job growth in the Houston's goods-producing sectors (such as mining, construction and manufacturing) was supported by the expanding mining industry, as well as a pickup of hiring in construction and manufacturing. In December 2012, the Houston metro had 10% more construction jobs than a year ago. A similar trend was present in Austin and Dallas, where employment in mining and construction saw an annual gain of 6% and 7.5% at the end of last year. However, because manufacturing in Dallas had a bigger share of companies producing transportation equipment (although mostly in the aerospace industry, which at the beginning of 2012 employed about 24k factory workers in Tarrant County¹, or nearly half of the state's total employment in that sector) and construction supplies, Dallas saw a bigger drop of factory employment compared to Austin and Houston (see chart 16), where manufacturing jobs relied more on relatively recession-proof high-tech sectors (Austin) and petrochemical industries (Houston).

Metro jobs growth in private service-providing sectors has a distinct regional flavor as well. Dallas, the financial powerhouse of Texas, saw a healthy rebound of jobs in the financial industry. An uptick in general business activity fueled job growth in professional and business services in all three of the biggest metros, with a particularly strong rebound in Austin due to the metro's bigger share of jobs in high-tech service-providing sectors, such as computer systems design (about one in four professional and business services jobs in Austin). Dallas, which has roughly the same share of computer systems design jobs as Austin (versus just 16% of all professional and business services jobs in Houston), saw a rebound of professional and business services jobs as well, albeit at a somewhat slower pace versus Austin due to its higher share of jobs in legal services and advertising, where job growth has been more sluggish. Meanwhile, a bigger share of architectural and engineering jobs (over one third of all professional and business services jobs in Houston) led to a sharper decline of professional and business services jobs in Houston during the economic downturn, and, consequently, a more modest recovery versus Dallas and Austin. On the upside, Houston, which is home to the world's leading medical center, leads all other big Texas metros in terms of its jobs growth in education and healthcare. This helped offset the slower growth of employment in professional and business services. Lastly, Austin, Houston and Dallas created more new jobs in leisure and hospitality. This is important, because improving hiring in leisure and hospitality partly made up for jobs losses in relatively similar service occupations (for instance, in retail trade), which may be one of the reasons behind a stronger labor market rebound in Texas than in other states.

Monetary Policy and Asset Prices

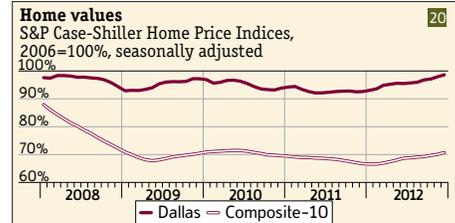
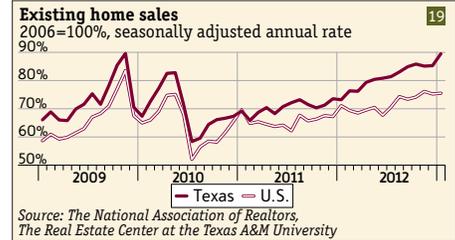
Decelerating growth of consumer prices (see chart 17) and falling interest rates (see chart 18) continue to remain the key feature of the national monetary landscape. After all, the latest congressional testimony, delivered by the Fed



¹Contains Fort Worth (the county seat) and Arlington – the fifth and seventh largest cities in Texas.

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Chairman in late February, painted a picture of a moderate economic recovery and a medium-term inflation outlook of below 2% growth of consumer prices. Thus, the Fed is set to continue implementing its quantitative easing program (monthly purchases of agency mortgage-backed securities and longer-term Treasury debt at a pace of \$40 billion and \$45 billion, respectively) to sustain accommodative financial conditions. There are signs that this monetary policy is contributing to a pickup in bank lending. For example, last year consumer credit registered its biggest gain in five years, expanding by 5.8% thanks to growing automobile loans. More importantly, low mortgage rates are putting the housing market recovery on a sustainable footing – existing homes sales in Texas and nationwide remained on an uptrend in January (see chart 19). Indeed, affordable home values and falling housing inventory (in January, the inventory of unsold homes in Texas fell to 4.3 months – the lowest level in over a decade) are laying the groundwork for stable growth in the future. In fact, home values in major Texas metros have already surpassed their pre-crisis levels (see chart 20), which shows that Texas has seen a more advanced and sustainable housing recovery compared to other recession-hit regions of the U.S. economy.

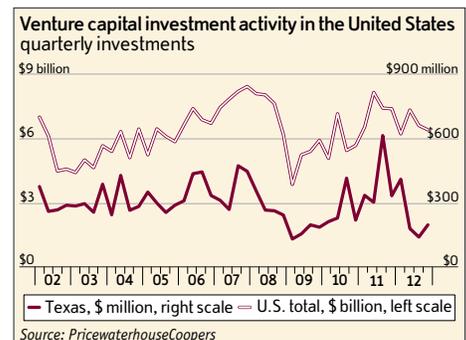
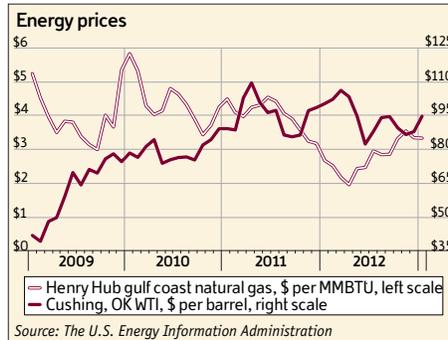
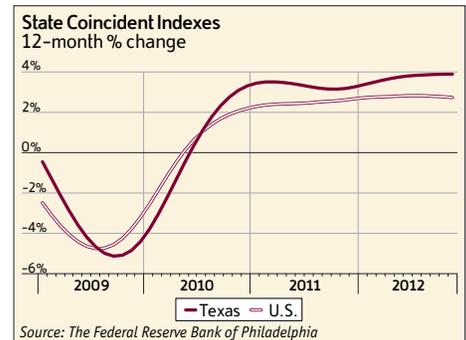
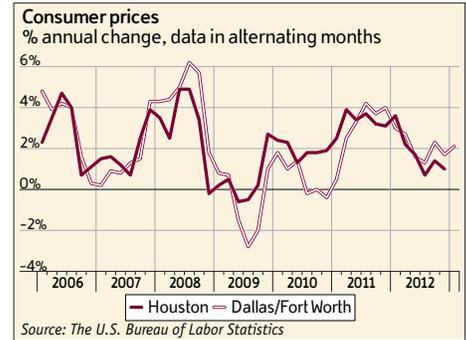
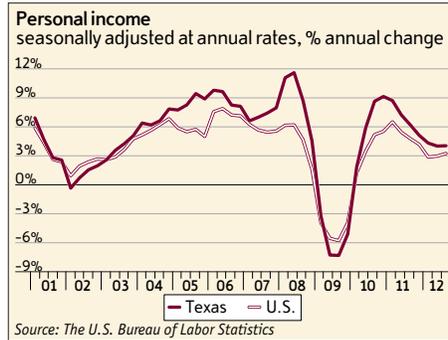
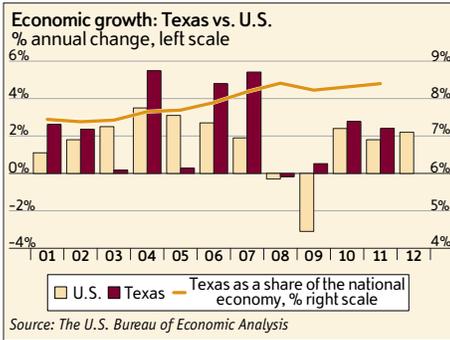


Median sales price of existing single-family homes
% change in 2012

	vs. 2011	vs. 2006
U.S.	6.4%	-20.3%
Austin-Round Rock	6.7%	18.6%
Boston-Cambridge-Quincy	1.4%	-12.7%
Dallas-Fort Worth-Arlington	7.0%	6.6%
Houston-Baytown-Sugar Land	5.8%	10.5%
Las Vegas-Paradise	7.5%	-57.8%
San Antonio	4.6%	12.6%
San Diego-Carlsbad-San Marcos	4.1%	-35.9%
Pensacola-Ferry Pass-Brent	1.0%	-49.3%

Source: The National Association of Realtors, Standard & Poor's

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