

June 2015

Valentyn Povroznyuk, Edilberto L. Segura

- **National GDP edged down by 0.2% quarter-over-quarter (qoq) in Q1 2015.**
- **Texas GDP posted 5.2% yoy growth in 2014.**
- **Consumer confidence strengthened in June thanks to more optimistic assessment of future business conditions.**
- **National exports returned to decline after two months of growth.**
- **The decline in the Texas rig count decelerated in May.**
- **Growth in employment accelerated at both the national and Texas levels.**
- **In May, Texas saw an increase in the unemployment rate; however, it remained significantly lower than the national unemployment rate.**
- **A sharp increase in gasoline prices slightly accelerated consumer inflation in May.**

Executive Summary

The US economy continues to expand moderately. Unfortunately, industrial production was not among the sectors promoting growth as it posted a moderate decline once again in May. Consumer confidence further strengthened at the national level and positive developments were also observed in construction. At the same time, US exports posted a decline after two consecutive months of growth.

The third estimate of GDP growth based on the most complete dataset showed that Q1 GDP growth was between the first and second estimates at -0.2% qoq. The main factors of the decline were deterioration in foreign trade and lower government expenditures. Their combined decline was higher than growth in personal consumption expenditures and gross private domestic investments.

National industrial output further declined in May. On the positive side was the fact that the rate of monthly decline more than halved compared to April. Utilities returned to growth but this was not enough to overcome continued decline in mining and a small decline in manufacturing. The fifth month of decline in a row turned year-over-year growth of mining into a decline. At the same time, other industrial output components still posted year-over-year growth in May. Surveys of the Institute for Supply management indicated that the situation with economic activity in manufacturing sectors improved during the reporting month, while major indexes of the non-manufacturing sector posted moderate declines.

Improvements in assessment of both current and future business conditions showed that consumers became more optimistic about the national economy. Furthermore, respondents provided better assessment of the short-term outlook, while improvements in assessment of the current situation were not that significant, especially in relation to the labor market.

US construction posted another monthly increase in May. However, growth of construction significantly decelerated mostly because of slower growth in the nonresidential segment. At the same time, deceleration in growth was not as sharp in private construction. Therefore, the performance of private construction put in place was better than in public construction in May. Building permits posted good growth in terms of both units and valuation during the reporting period.

National exports returned to decline in May. Capital goods, the major driver of increase in exports over two previous months, were to blame for the decline. The USD 2.4 billion decline in capital goods exports was softened by the increase in exports of petroleum products. Exports of services remained almost unchanged again in May.

The Texas economy continued to expand at a moderate pace in May. The growth is driven by the service sector as manufacturing further declined. At the same time, the Texas Manufacturing Outlook Survey showed significant improvements in expectations of respondents related to future business conditions. Unlike in the US in general, construction saw both positive and negative developments in Texas in May. Developments were exactly the opposite of those observed in April. Residential construction declined considering almost a 20% mom decline in both the number and valuation of building permits. At the same time, nonbuilding construction ensured growth in nonresidential construction. Texas exports posted good growth of 4.9% mom, however this was not enough to ensure growth in year-over-year terms.

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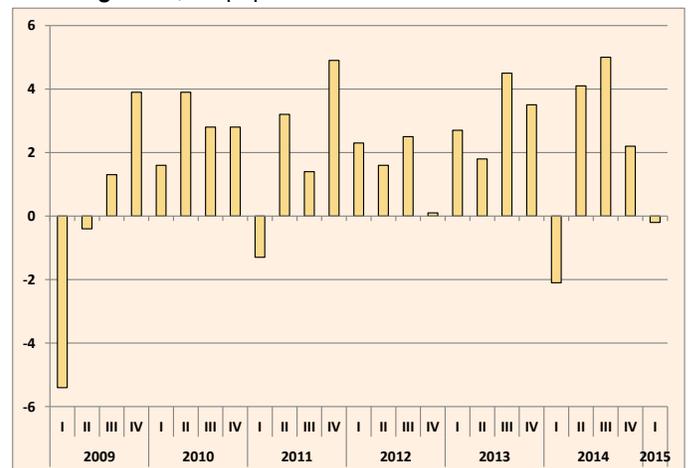
In May, labor market conditions clearly improved at the national level but saw both positive and negative developments in Texas. The number of newly created jobs slightly exceeded the 12-month average in the US. Increases in employment were observed in most of the industries but service-providing industries generally created more jobs than goods-producing ones. The only sector observing decline in employment was mining. Both the number of unemployed and the unemployment rate saw little changes at the national level in May. Employment in Texas followed the national trend, posting good growth in the reporting month. Furthermore, this growth was fueled by expansion of employment in service-providing industries. However, unlike in the US, the number of unemployed increased in Texas in May, which led to a minor growth of the unemployment rate to 4.3%. Around half of Texas metros observed a decline in employment and just one metro saw a decline in the number of unemployed. On the positive side, year-over-year growth in Texas employment remained higher than national growth, while the unemployment rate in Texas is still below the national rate.

The Federal Open Market Committee considered recent developments on the labor market and in prices insufficient to change its monetary policy stance or adjust the policy rate. Therefore, the target range for the federal funds remained unchanged at 0-0.25%. Consumer inflation accelerated moderately again in May, but remained below the long-run target of the Federal Reserve. Oil stabilization led to a rebound in the gasoline price index, while both the food index and all items less food and energy index were flat in May. The housing market saw positive developments in terms of existing-home sales at both the national and Texas levels. At the same time, national unsold housing inventory inched down, while Texas unsold housing inventory remained around historical lows despite edging up during the reporting month.

Economic Growth

The Bureau of Economic Analysis issued the third estimate of GDP growth on June 24th. According to the estimate, GDP decreased by 0.2% qoq at an annual rate in Q1 2015. The reported decline level is an improvement over the 0.7% qoq decline reported in the second estimate but is still below the 0.2% qoq growth reported in the advance estimate. The upwards revision of GDP dynamics was the result of positive adjustments in all the major GDP components but imports. In particular, growth of personal consumption expenditures was revised upwards by 0.3 percentage points compared to the second estimate to 2.1% qoq. Growth of gross private domestic investment is reported at 2.4% qoq, which is a 1.7 percentage point revision compared to the second estimate. The third estimate showed a 5.9% qoq decline in exports compared to the 7.6% qoq decline in the second estimate. Growth in imports was also revised upwards to 7.1% qoq (5.6% qoq in the second estimate). The decline in the government consumption expenditures and gross investments almost halved to 0.6% qoq in the third estimate.

1. GDP growth, % qoq at annual rates



Source: The U.S. Bureau of Economic Analysis

The downward trend in US industrial production continued, but at slower pace in May. According to Federal Reserve data, the total industrial production index inched down by 0.2% mom during the reporting period. This is an improvement over the downwardly revised 0.5% mom decline in April. The major reason for the monthly industrial output decline was negative dynamics in manufacturing, which saw a 0.2% mom decrease in May after two months of growth. Mining posted a decline for the fifth consecutive month (0.3% mom), while utilities returned to growth (0.2% mom) after two months of decline. The mentioned decrease was the result of a 0.7% mom drop in the output of nondurables, which was partially offset by a small increase in the output of durables. Almost all major nondurable goods industries reported declines. The sharpest decline was observed by petroleum and coal products industry (1.6% mom). At the same time, production of motor vehicles and parts posted the highest increase among durable goods industries at 1.7% mom. Developments in other durable goods industries were mixed, but none of them posted either growth or decline above 0.7% mom. The decline in mining was the

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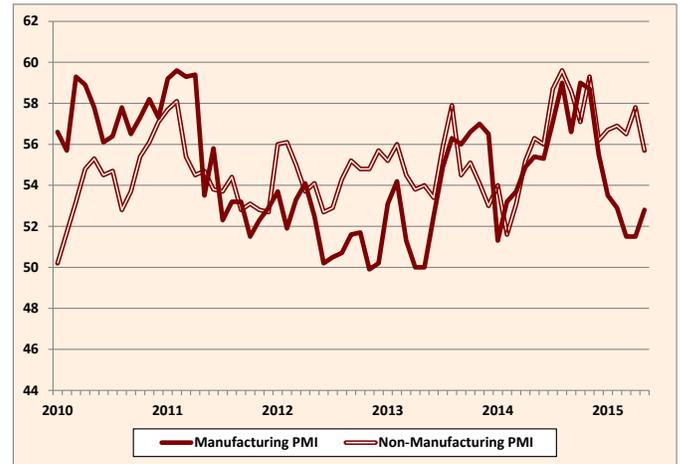
result of a drop in oil and gas well drilling and servicing and in nonmetallic mineral mining. At the same time, it was partially offset by an increase in crude oil extraction. The above mentioned developments led to quite a significant deceleration of industrial output growth in year-over-year terms. Total industrial output growth dropped 0.4 percentage points to 1.4% yoy mainly to much slower growth in manufacturing (1.8% yoy compared to 2.3% yoy in April). Utilities also increased (by 1.3% yoy) in May, while mining posted a minor decline (0.3% yoy).

According to the Institute for Supply Management (ISM), economic activity in the national manufacturing sector expanded in May. The PMI index posted a 1.3 percentage point increase to 52.8% during the month. This marked the 29th consecutive month of economic activity growth in the sector (PMI being above 50%). According to the ISM, 14 of 18 manufacturing industries reported growth in May. Declines were registered in the textile industry and in manufacture of computer and electronic products. Apart from PMI itself, positive developments were observed for indexes such as new orders (up by 2.3 percentage points to 55.8%), employment (back to growth with a 3.4 percentage point increase to 51.7%), and inventories (also back to growth with a 2.0 percentage point increase to 51.5%). At the same time, the production index and export index dropped 1.5 percentage points each to 54.5% and 50%, respectively. Unlike in previous months, the non-manufacturing sector posted slightly

worse performance this year compared to the manufacturing sector in May, according to the ISM. In particular, the NMI index posted a 2.1 percentage point decline compared to its reading in April of 55.7%. This means that growth in economic activity of the sector continued for the 64th consecutive month, but at slower pace. Mining was the only industry reporting contraction among non-manufacturing industries in May.

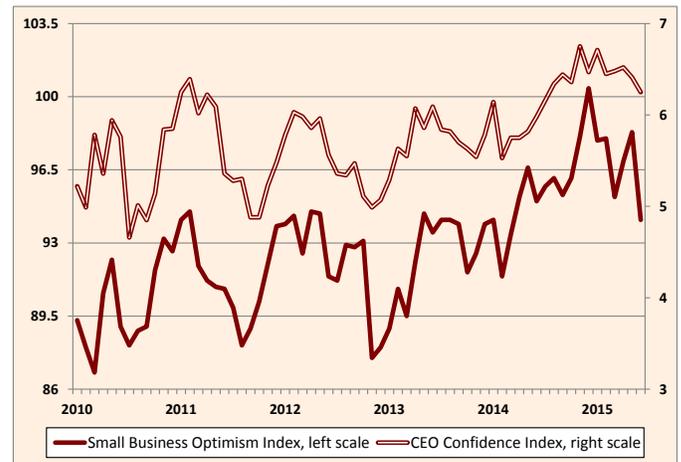
Consumer confidence continued to strengthen in June thanks to improvements in both current business conditions and short-term outlook. As a survey of the Conference Board showed, the Present Situation Index increased from 107.1 in May to 111.6 in June. At the same time, the Expectations Index advanced from 86.2 to 94.6. As a result, the Consumer Confidence Index

2. PMI, indexes



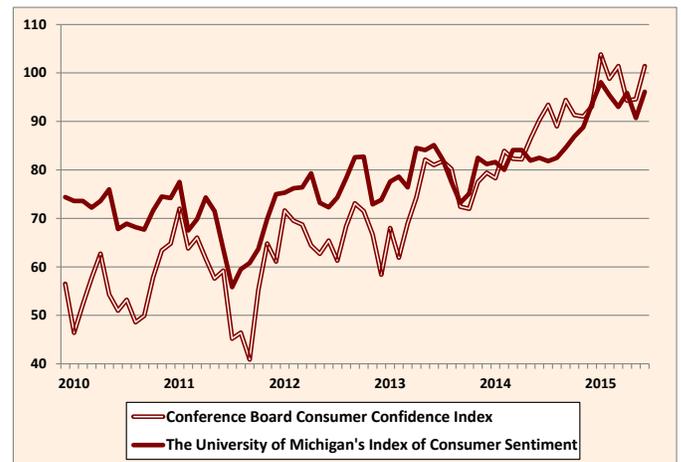
Source: Institute for Supply Management

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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grew by 6.8 bps to 101.4 in June. Consumers were more optimistic about both current business conditions and the current situation in the job market. However, job market assessment observed both an increase in the number of respondents claiming that getting job is easy and a decline in the number of those claiming that jobs are hard to get, while assessment of business conditions saw just growth in the number of people claiming business conditions are good. The number of people claiming business conditions are bad remained virtually unchanged. In relation to the short-term outlook, positive changes were more pronounced as both business conditions and labor market assessments observed growth in the number of respondents with good expectations and decline in the number of people with bad expectations.

As both the value of construction put in place and building permits increased, the national construction sector continued to expand in May. At the same time, there was some deceleration in monthly growth observed. In particular, the growth rate of total construction put in place decreased by almost three times to 0.8% mom as both residential and nonresidential construction grew slower compared to April. Residential construction inched up just by 0.3% mom in May, which is two times lower than a month ago. Growth in nonresidential construction fell from 3.2% mom to 1.1% mom. Contrary to the previous month's developments, private construction grew faster than public construction in May. Growth of total private construction halved to 0.9% mom due to two times slower growth in both residential and nonresidential segments (to 0.3% mom and 1.5% mom, respectively). At the same time, public construction saw 0.7% mom growth, which is almost five times lower than in April. The mentioned deceleration was the result of identical deceleration in the nonresidential segment, which accounts for 98.5% of public construction in the US. As for building permits, they posted monthly growth in terms of both the number and total valuation in May. The total number of issued building permits increased by 6.0% mom thanks to an almost 20% mom increase in the number of building permits on construction of multi-unit houses, which offset a 3.0% decline in the number of building permits on construction of single-unit houses. Total valuation of building permits grew slower (by 3.6% mom) than the number of permits as unit cost of multi-unit houses construction is lower than that of single-unit houses. Despite some deceleration in monthly growth, both construction put in place and building permits did not observe any deceleration in year-over-year growth. Furthermore, building permits experienced acceleration in growth of both the number of permits and their valuation because of the statistical base effect (the number of permits and their valuation decreased in monthly terms in May 2014). Construction put in place grew by 5.9% yoy, while the number of building permits and their valuation increased by 18.4% yoy and 16.3% yoy, respectively.

US exports declined after two months of growth in May. Most of the decline was attributed to lower exports of goods, while exports of services posted a minor increase. Exports of goods saw a 1.2% mom decline (USD 1.6 billion) to USD 127.7 billion. The sharpest decline was observed in capital goods totaling USD 2.4 billion half of which was attributed to exports of civilian aircraft, goods which ensured most of the increase in exports in March and April. Industrial supplies and materials grew by USD 0.8 billion thanks to increases in exports of fuel oil and other petroleum products (by USD 0.5 billion each). Exports of services increased by USD 0.1 billion to USD 60.9 billion in May. Overall, exports amounted to USD 188.6 billion which a 0.8% mom decline. From the beginning of the year, exports of goods and services decreased by USD 26.5 billion or 2.7% yoy.

The Texas economy continued to modestly expand in May. Some economic indicators remained above the national level, but the difference in pace of growth was not as significant as in 2014 (Texas GDP growth was almost 2.5 times faster than GDP growth in the US in general at 5.2% yoy). Business outlook surveys showed that service sector has supported growth, while sluggish performance of manufacturing has had an opposite effect. According to the Texas Manufacturing Outlook Survey, the production index (which is a key measure of state manufacturing conditions) was at its lowest reading of the last six years at -13.5. Perceptions of both current business conditions and labor market indicators continued to deteriorate in May. On the positive side, however, was improvement in expectations concerning future business conditions, as all the correspondent indexes surged by not less than 10 points. Even though the revenue index of the Texas Service Sector Outlook Survey dropped 10.8 points to 3.8, all the other indicators improved in May. Growth in labor market indicators reflected faster employment growth. The general business activity index turned positive, while the company outlook index grew by 2.5 points to 6.9 proving that perceptions of economic conditions improved in services sector in May. Construction observed mixed developments in May. The residential sector saw some curtailing of activities as both the number of permits and their valuation shrank by one-fifth in one month (pace of

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decline for both single- and multi-unit houses was almost identical). In year-over-year terms, the decline was slightly above 20% for both the number of permits and their valuation. At the same time, the five-month moving average of total Texas construction contract values posted a 20.8% mom increase to USD 10.1 billion thanks to non-building construction (mainly power plants, as and communications contracts). Further improvements were observed in foreign trade as exports grew by 4.9% mom, the largest increase since October 2014 thanks to stabilization of energy prices and slight dollar weakening. At the same time, despite this growth, exports remained 2.9% lower compared to the previous year. In May, the Texas rig count further declined, but at a slower pace (from 422 in April to 375).

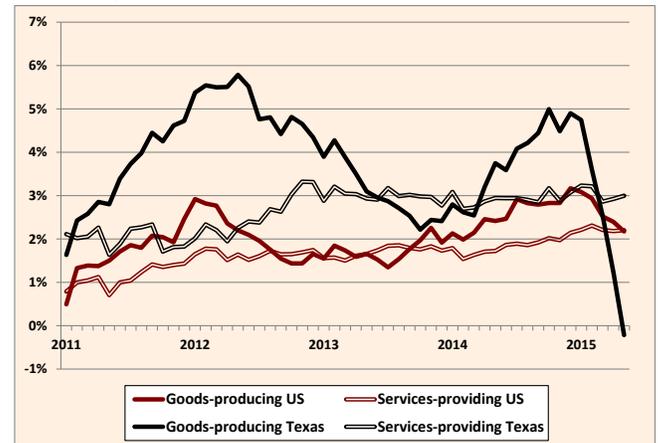
Employment

The national labor market observed further improvements in May. Changes in the number of unemployed were not very significant, leaving the unemployment rate virtually unchanged. At the same time, the number of new jobs exceeded the average for the last twelve months. Total nonfarm employment increased by 0.2% mom or 254,000 jobs (the average monthly increase over the last 12 months was 249,000). Most of industries saw increases in employment. The highest monthly gain in jobs was reported by professional and business services at 74,000 (0.4% mom) which is the highest monthly gain this year. The second best in terms of job creation, after two months of sluggish performance, was leisure and hospitality with 54,000 (0.4% mom) new jobs. Mining was the only sector observing decline in employment. The sector lost 17,000 jobs (a 2.1% mom decline). This is the sharpest decline since May 2009 (16,800 jobs or a 2.5% mom decline). Such important industries as manufacturing, wholesale trade, information, and public sector showed little monthly changes in employment. In year-over-year terms, total nonfarm employment growth remained unchanged for the third consecutive month at 2.2% (employment growth for March was revised downwards by 0.1 percentage points). The number of unemployed and the unemployment rate remained virtually unchanged for the third consecutive month at 8.7 million and 5.5% respectively.

The Texas labor market saw mixed developments in May 2015. On the one hand, growth in employment significantly accelerated but, at the same time, some

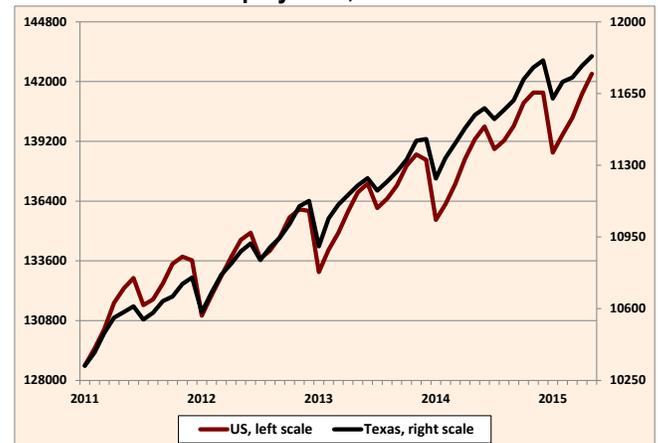
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5. Jobs growth in private goods-producing and service providing industries, % yoy



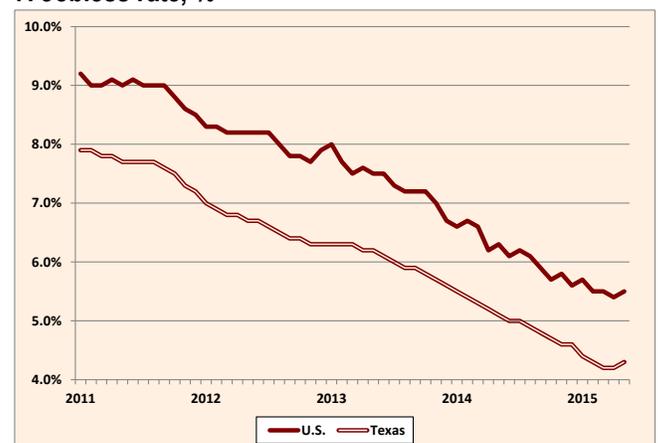
Source: Bureau of Labor Statistics

6. Total nonfarm employment, 000



Source: Bureau of Labor Statistics

7. Jobless rate, %



Source: Bureau of Labor Statistics

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growth was also observed in unemployment. Total nonfarm jobs grew by 33,200 (or 0.3% mom) which is a significant progress over 2,100 in April. Leisure and hospitality industry was the leader in job creation for the second month in a row with 16,000 new jobs (3 times more than downwardly revised 5,400 jobs in April). This 1.3% mom growth was the highest observed in the industry since September 1996. Education and health services industry was the second best in terms of job creation in Texas in May. Employment in the industry grew by 12,500 during the month which is the largest monthly gain in 25 years. In relative terms, employment grew by 0.8% mom. The last time such growth was observed in the industry was in June 2001. Mining again observed the sharpest decline in employment, but the pace of decline decelerated. The sector lost 6,000 jobs compared to 8,500 jobs in April (2.0% mom decline versus 2.8% mom respectively). The mentioned monthly decline in employment accelerated the year-over-year decline to 3.4%. Manufacturing remained the only other sector observing the year-over-year decline in employment in Texas in May. Furthermore, the decline accelerated from 0.8% yoy to 1.8% yoy. As for nonfarm employment in general, its year-over-year growth decelerated for the fourth consecutive month but remained positive at 2.5% in May. The number of unemployed increased by around 0.4% mom to almost 560,000 during the reporting month. This led to a minor increase in the unemployment rate from 4.2% to 4.3%. This was the first increase in the unemployment rate since August 2009. At the same time, the Texas unemployment rate still remained significantly below the national level.

Labor market developments were mostly negative at the metropolitan area level in May. 11 of 25 metros observed monthly decline in employment during the month. Eight other metros generated gains in employment, while three metros saw no changes in the number of employed. The sharpest decline in employment was registered in Abilene at 0.7% mom, while the highest increase was in McAllen-Edinburg-Mission at 1.1% mom. In year-over-year terms, the number of metros observing a decline in employment further expanded from 8 to 10 metros, while Brownsville-Harlingen left the group thanks to positive monthly dynamics in May (0.3% mom growth). Situation with unemployment was even less optimistic as just one metro (already mentioned Brownsville-Harlingen) saw a decline in the number of unemployed and one metro saw the number of unemployed unchanged in May. The largest increase in the number of unemployed was registered in Amarillo at 11.4% mom. The positive thing about unemployment at the metros' level was that it had continued to decline in all the metros except for Midland and Odessa in year-over-year terms. Despite continued negative monthly developments in employment, Midland remained the leader in job creation in Texas. At the same time, Amarillo became the metro with the lowest unemployment rate (in April, as the revised unemployment data shows).

Monetary Policy and Asset Prices

The monetary policy stance and parameters remained unchanged. The Federal Open Market Committee (FOMC) reaffirmed its view that the 0-0.25% target range for the federal funds rate remains appropriate at its latest meeting which took place on June 17th. The Committee has not observed economic developments significant enough to adjust policy rate or other monetary policy parameters. Labor market conditions continued to improve moderately at the national level but still did not reach the optimal level specified by the Committee's mandate. The same is true for inflation, which was still below the Committee's long-run objective.

Consumer inflation accelerated a bit in May. The seasonally adjusted all items index posted a 0.4% mom increase. The acceleration in inflation was mainly the

8. Borrowing rates, % per year



Source: Federal Reserve System

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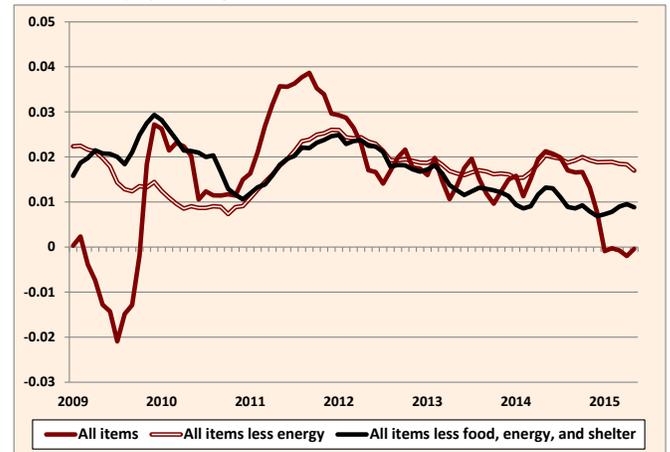
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result of a sharp increase in the gasoline index which grew by 10.4% mom. Growth in fuel oil index was much lower at 0.7% mom, while a 1.2% mom decline in electricity index flat gas index caused the decline in the overall energy services prices. Therefore, the total energy index posted a 4.3% mom growth. The food index remained unchanged for the second consecutive month thanks to food at home index, a decline of which fully offset an increase in the food away from home index. The all items less food and energy index inched up by 0.1% mom which is the lowest increase since December 2014. In year-over-year terms, consumer inflation was zero in May. A 1.6% yoy increase in food index (driven mainly by food away from home prices) together with a 1.7% yoy increase in the all items less food and energy index (fueled by growth in prices of services) fully offset a 16.3% yoy decline in the energy index. The mentioned decline was caused by a 25.0% yoy decline in gasoline index and a 27.6% yoy decline in fuel oil index.

9. CPI, % yoy change



Source: Bureau of Labor Statistics

In May, there were significant improvements in existing-home sales at both the national and Texas level, while unsold inventories were not doing well. According to the National Association of Realtors, the US in general saw a 5.1% mom to a seasonally adjusted annual rate of 5.35 million from upwardly revised 5.09 million in April. This was the result of wider choices of homes as more homeowners listed their homes for sale. However, overall supply of houses remained tight because of fast sales. Therefore, home prices further grew at rates in double digits in many states. As for Texas, existing-home sales increased by 2.2% mom (actual sales by 7.6% mom). At the same time, the median price of sold houses grew significantly faster in Texas (9.6% yoy compared to 7.9% yoy in the US in general). However, the reason is obvious when one takes a look at housing inventory. Despite a moderate increase, unsold housing inventory remained around historical lows at 3.4 months of supply at the current sales pace in Texas. Unsold housing inventory in the US in general declined insignificantly, but still remained 1.5 times higher compared to Texas at 5.1 months of supply.

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