March 2015 Valentyn Povroznyuk, Edilberto L. Segura

- **In February, U.S. industrial production recovered somewhat, following two consecutive months of decline.**
- **Exceptionally cold temperatures in February raised demand for heating at the national level, leading to an increase in utilities and industrial output.**
- **National exports continued to decline in February, but at a decelerated pace.**
- **The Texas economy in general followed the same growth patterns as the national economy during the reporting month.**
- **Agricultural conditions improved in Texas thanks to heavy rains.**
- **The Texas rig count dropped sharply in February and continued to fall in March.**
- **In February, improvements in labor conditions decelerated both in Texas and at the national level.**
- **Gasoline prices increased for the first time in seven months and drove CPI upwards.**
- **Housing market growth was limited due to low inventory in the U.S. in general and especially in Texas.**

Executive Summary

In February, the U.S. economy posted moderate economic growth, with improvements in several sectors compared to the previous month. Despite some worsening in the assessment of current business conditions, consumer confidence also improved in general. The construction sector also experienced a reversal of trend in February, after a decline a month before. On the negative side, US exports further contracted.

Industrial output recovered in February, though at a slow pace. Data from the Federal Reserve System showed only a marginal monthly increase in industrial production, although it was better than the performance in the previous month (which showed a decline of 0.3% mom, according to revised data). This progress in industrial activity was confirmed by the assessments of the Institute for Supply Management, which showed that both manufacturing and nonmanufacturing sectors continued to expand in February. Most of the industries from both sectors reported growth in demand for their products.

In February, improvements were also observed in consumer confidence. The Conference Board Consumer Confidence Index grew by 2.5 bp to 101.3 bp thanks to a more optimistic short-term outlook for employment and income.

In February, the construction sector also recovered after a one-month decline in January. Construction expenditures stopped their falling trend and remained flat in February as a decline in public construction expenditures was almost fully compensated for by growth of expenditures in the private sector. On a year-to-year basis, total construction expenditures remained positive, even though growth slightly decelerated. At the same time, building permits saw more pronounced positive developments in February observing good growth in both monthly and year-over-year terms.

U.S. exports continued to decline in February. However, the pace of decline almost halved to 1.6% mom. Once again, exports of goods were almost fully responsible for the decline, as exports of services remained virtually unchanged. In order to stop or at least to slow the decline, authorities have to solve the West Coast port labor issue, which is one of the main reasons for the decline in exports and both manufacturing and nonmanufacturing activity in the country.

In February, the Texas economy followed the same development patterns as the national economy. In particular, factory activity remained flat for the second month in a row as assessment of current business conditions deteriorated and both new orders and shipment indexes observed their lowest values since 2009. Just as with US manufacturing activity, the short-term outlook for business conditions also improved in Texas. The non-manufacturing sector performed better both in terms of output and assessment of both current and future business conditions. Construction posted much better performance in February compared to January thanks to a sharp increase in the value of contracts for non-residential construction and in building permits for multi-family houses. Agriculture benefited from weather conditions as rains improved moisture and pasture conditions over most of state's territory. On the negative side, there was continued deterioration in the oil extraction sector caused by the dynamics of world oil prices.

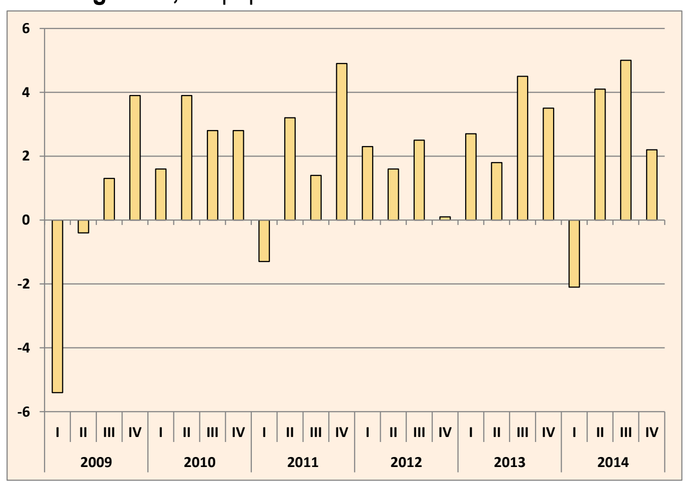
Labor conditions continued to improve at both the national and Texas level in February. Unlike previous months, Texas was not among the leaders in job creation but posted an increase in employment of 0.2% mom, similar to the average for the country. At the same time, the year-over-year growth of employment remained higher in Texas compared to the national average. Similar developments were observed in unemployment. Almost identical monthly progress for the country in general and for Texas, while the Lone Star state showed better performance in year-over-year terms. Slower monthly growth in employment compared to January was the result of negative developments in manufacturing and other major industries. Five Texas metros observed declines in employment, including the Dallas-Fort Worth-Arlington metro. As for unemployment, it remains on the downward trend both nationally and in Texas.

The Federal Reserve did not introduce any changes to its monetary policy in February as it felt that employment conditions were still outside their optimum level, while inflation was significantly below the medium-term target. In fact, many CPI components, and especially the energy index, caused a reversal of the trend in CPI dynamics in monthly terms. Gasoline prices increased for the first time since June 2014, but the impact of their previous monthly decreases kept CPI dynamics in negative territory in year-over-year terms in February. Low inventories continued to restrain sales growth in the housing market as insufficient supply led to higher prices. In some areas, housing prices increased to almost unsustainable levels. The problem of low inventories remained especially problematic in Texas as its housing inventory was around 30% lower than the national average.

Economic Growth

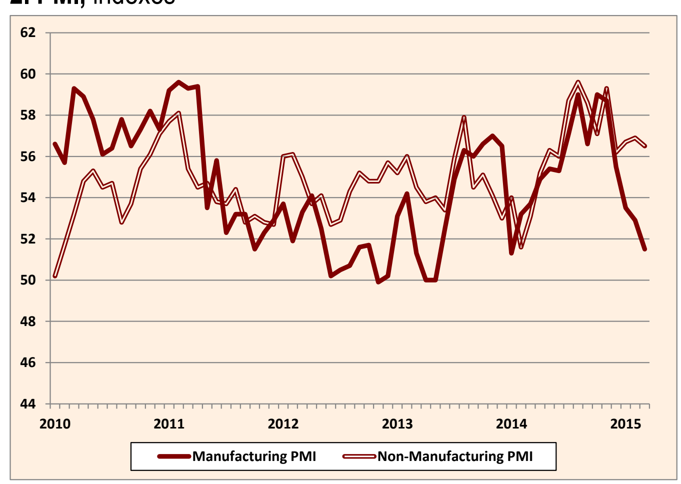
New data led to a revision of industrial output in January and showed just a small increase in February. Based on the latest data, the Board of Governors of the Federal Reserve System revised its industrial production and capacity utilization data. In particular, industrial production growth was revised downwards from 0.2% mom to -0.3% mom for January 2015. Preliminary data for February showed some improvements in industrial production on the back of positive dynamics in utilities, while performance of manufacturing remained sluggish and the decline in mining further accelerated. Uncommonly cold temperatures drove up demand for heating in February. As a result, utilities posted a 7.3% mom increase during the month. This growth compensated for a 0.2% mom decline in manufacturing and a 2.5% mom decline in mining. Most of the decline in manufacturing was attributed to a decrease in production of durable goods by 0.6% mom. The sharpest decline was registered in the motor vehicles and parts industry at 3.0% mom. Production of nondurables posted a 0.2% mom increase as growth in textile and product mills, petroleum and coal products, and in chemicals offset losses in other major industries. Since manufacturing posted monthly declines for three consecutive months, its year-over-year growth decelerated to 3.4%. On a year-to-year basis, the growth of mining remained above 5% yoy despite the acceleration of the monthly decline in February. Finally, the year-over-year dynamics of utilities returned to positive territory. Overall, industrial production grew by 3.5% yoy in February. The Institute for Supply

1. GDP growth, % qoq at annual rates



Source: The U.S. Bureau of Economic Analysis

2. PMI, indexes



Source: Institute for Supply Management

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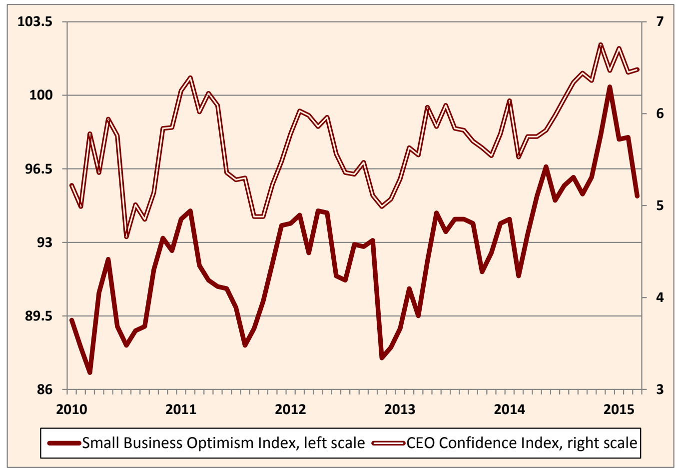
Management (ISM) published its own data on developments in manufacturing and nonmanufacturing sectors. According to this data, both sectors posted increases.

The PMI index posted a 0.6 percentage point decline to 52.9% in February. This means that the manufacturing sector continued to expand but at a slower pace. Twelve manufacturing industries out of 18 reported growth during the month under review. As for the NMI index, which estimates the developments in the nonmanufacturing sector, it also remained above 50% in February and even expanded by 0.2 percentage points to 56.9%. Fourteen nonmanufacturing industries reported growth in February. The ISM also reported that business expressed concerns about further dynamics of fuel costs and the impact of the West Coast port labor issues on the continuity of supply in both manufacturing and nonmanufacturing sectors.

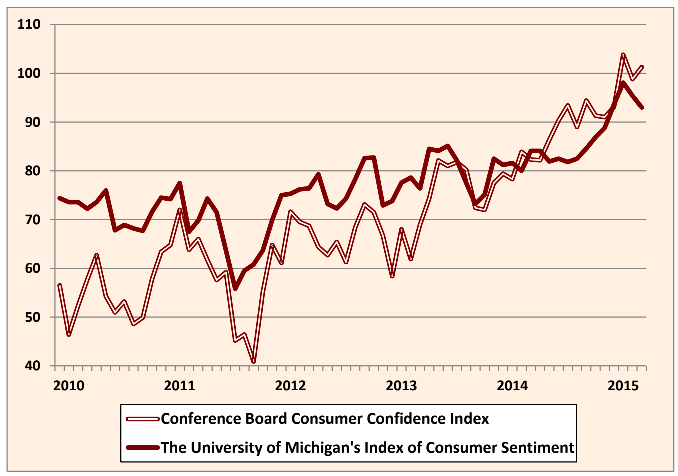
3. Business confidence, indexes



Source: Chief Executive, National Federation of Independent Business

In March, the improved short-term outlook for both employment and income prospects led to an improvement in the Conference Board Consumer Confidence Index despite less optimistic assessments of current economic conditions. The Consumer Confidence Index increased to 101.3 in March from 98.8 in February (revised data). This was the result of significant growth in the Expectations index from 90.0 to 96.0, which reflected more upbeat assessments of business conditions over the next six months especially in the labor market. In particular, the number of people expecting more jobs in the months ahead grew from 13.8% to 15.5%, while the number of those expecting fewer jobs dropped 1.3 percentage points to 13.5%.

4. Consumer confidence, indexes



Source: Conference Board, The University of Michigan

After a sluggish performance in January, the construction sector saw some positive developments in February. Total construction expenditures grew by 3.2% yoy. In February, private construction expenditures grew faster in year-over-year terms (3.6% in February versus 2.0% in January). On a month-to-month basis, seasonally adjusted annualized construction expenditures remained almost unchanged in February, with increases in total private construction expenditures almost fully offset by declines in total public construction expenditures. The private sector slightly shifted its focus from residential construction to non-residential construction. As a result, total construction expenditures were almost equally divided between the two subsectors (50.1% versus 49.9% in favor of residential construction). Within the non-residential construction sector, significant increases in manufacturing construction expenditures (by 6.8% mom to $69.141 billion) were offset by declines in power construction expenditures (by 2.9% mom to $79.332 billion). In public construction, the decline in total public construction expenditures was attributed solely to declines in contraction in nonresidential construction mostly due to declines in power generation sector construction. Construction permits saw improvements in terms of both their number and values in February. The growth in the number of permits was significantly higher than growth in their values, both on monthly and year-over-year terms. A 10.7% mom increase in the number of permits helped to recover the year-over-year growth to 9.8% yoy, which is above the 7.3% yoy observed in December. Growth in the value of building permits was 4.2 percentage points lower compared to that of the number of permits at 6.5% mom, which may be related to some shift in construction towards buildings with 5 and more units, construction of which is cheaper due to lower unit costs. Valuation of building permits grew by 7.6% yoy, which is also lower than growth of the number of permits.

The downward trend in US exports continued in February 2015. Total exports decreased by 1.6% mom to $186.1 billion, which is an improvement over the 2.9% mom decline in January. Similar to January, the decrease in exports was almost fully attributed to lower exports of goods. Exports of goods dropped $2.9 billion ($5.9 billion in January) due to decreases in exports of capital goods and of industrial supplies and materials. The sharpest declines within exports of capital goods were registered in exports of civilian aircraft at $0.6 billion and in exports of semiconductors at $0.3 billion. As for industrial supplies and materials, the sharpest decline was registered in exports of nonmonetary gold at $0.5 billion. Exports of services remained almost unchanged at $60.6 billion in February as increases in exports of other business services and in travel almost fully offset the declines in exports of transport and financial services. Continued West Coast port labor issues remained one of the reasons (if not the main one) prolonging the downward trend in exports. In case the existing dispute with the International Longshore and Warehouse Union will grow into a full-scale strike of port workers, the country may face a slowdown in GDP growth of up to 1%.

The Texas economy grew at a moderate pace in February. Most manufacturing industries reported that demand was either flat or posted slight increases. Food and metal manufacturers indicated strong growth in demand for their products. But in general, manufacturing activity remained almost flat for the second consecutive month in February. The Texas Manufacturing Outlook Survey showed that the production index, which is a key measure of state manufacturing conditions, remained around zero just like in the previous month. But of some concern was the further decline in the new orders index to -12.2 and in the shipment index to -3.3, which are the lowest levels observed for these indexes since 2009. Perception of the current business conditions deteriorated in February, posting declines in all related indexes. On the positive side, however, were the improvements in assessments of future business conditions. Service sector activity improved in February as the Texas Service Sector Outlook Survey showed increases in all indexes, which nevertheless remained below their 2014 high averages. Similar to service sector activity, consumer confidence improved in Texas in February. Furthermore, it improved more significantly compared to the national level. The Conference Board Consumer Confidence Index posted a 4.8 bp increase to 126.2 bp, which was 24.9 bp higher than the value of Index for U.S. in general. Construction in Texas rebounded after a decline in January and posted good growth in both residential and nonresidential sectors. The number of building permits grew by 14.2% mom in February as growth in the number of permits on construction of multi-family houses offset most of the decline registered in January. At the same time, the value of contracts for non-residential building construction more than quadrupled to $5.4 billion in both monthly and year-over-year terms in February. Soil moisture and pasture conditions improved over most of the Texas territory, but significant part of the state is still suffering from severe drought, especially in the North. At the same time, wet field conditions caused planting delays in some areas of South and East Texas. Low cotton prices induced farmers to shift to sorghum, while cattle prices increased seasonally and promise high incomes to breeders. The rig count and demand for oilfield services declined in Texas, with losses concentrated in the Permian Basin and Eagle Ford areas. In particular, the rig count contracted sharply by 22.5% mom to 599 in February and further declined in March (to 465 as of March 17). Outlook remains negative for the year with expectations of 30-40% contraction in capital expenditures.

Employment

The national labor market continued to improve in February 2015. According to the Bureau of Labor Statistics, 36 states observed increases in nonfarm payroll employment and 13 saw decreases. This ensured a 0.2% month-to-month growth in employment in seasonally adjusted terms. The total number of new jobs created amounted to 295,000 in February, more than a quarter of which were generated by just three states: California (29,400), Georgia (25,400), and New York (20,200). Among the economic sectors, food and drinking services generated the highest number of new jobs at 59,000. At the same time, employment in mining entered negative territory as the number of new jobs declined by 9,000 in February. The unemployment situation improved over the reporting month. After a 3.3% mom increase in January, the number of unemployed fell by 3.1% mom in February. This translated into a 0.2 percentage point mom decline in the seasonally adjusted unemployment rate to 5.5%. The

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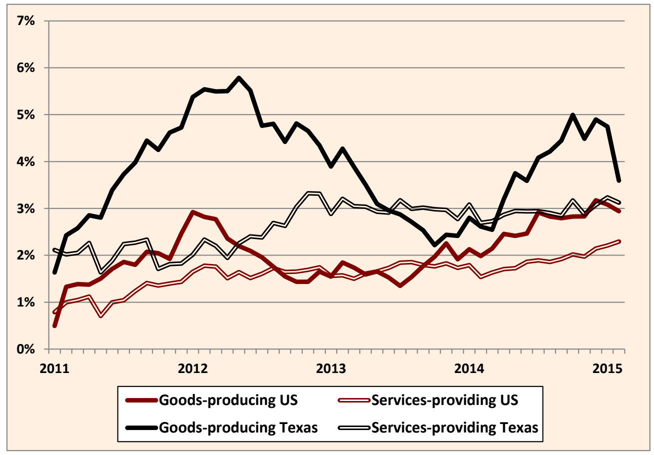
year-over-year decline in the unemployment rate accelerated to 1.2 percentage points from 0.9 percentage points observed in January.

A fast expansion of the trade, transportation and utilities sector further fueled growth of employment in Texas. In particular, this sector added 16,300 jobs in February, which is the largest increase in more than 20 years. Texas as a whole ensured a net gain of 7,100 nonagricultural jobs or 0.2% during the reporting month. Nevertheless, this is significantly below the average of around 34,000 jobs added monthly in 2014 and the lowest increase since February 2011. The February employment increase in Texas was due to positive developments in five of 11 major industries of the state. In addition to trade, transportation and utilities, new jobs were added in leisure and hospitality, construction, other services, and financial activities. Five other industries posted declines in employment, while education and health services observed no changes in employment in February. The sharpest decline in employment was registered in manufacturing with 9,500 jobs lost, which was mostly attributed to the decline in employment in manufacturing of durable goods (8,600 jobs). Despite significant deceleration in monthly growth of employment, the year-over-year growth of the indicator sustained little change in February, inching down by 0.3 percentage points to 3.2% yoy. At the same time, seasonally adjusted unemployment remained on a downward trend, inching down by 0.1 percentage points to 4.3%. The number of unemployed decreased by 3.3% mom or by 19,334 persons.

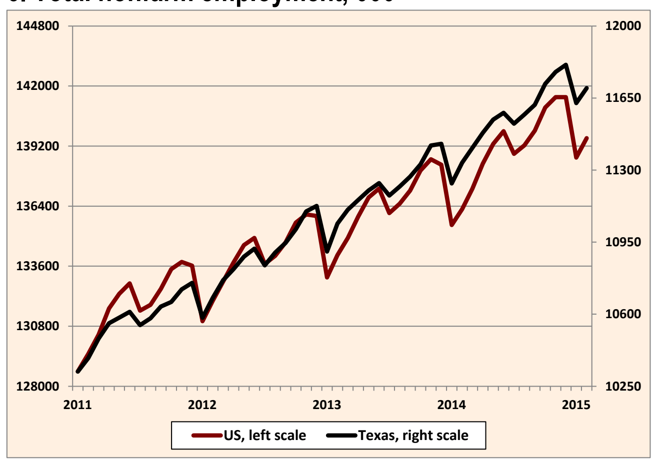
Texas metros observed both positive and negative developments in the labor market in February. In particular, five metros observed monthly declines in employment, including Dallas-Fort Worth-Arlington. However, the decline in the number of employed in the Dallas metro was insignificant at 0.05%. The sharpest monthly decline in employment was registered in Wichita Falls at 0.48%. Because of this decline, Wichita Falls joined El Paso and Amarillo as the only metros observing declines in employment in year-over-year terms. In terms of unemployment, just two metros saw growth in the number of unemployed – Midland and Odessa. However, Midland still observed the lowest unemployment rate in Texas at 2.8% and also remained the leader in growth of employment with a 7.25% yoy increase in February.

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



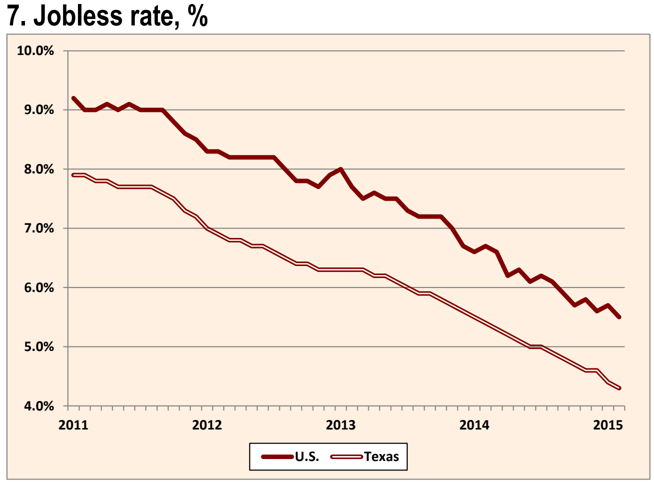
Source: Bureau of Labor Statistics

6. Total nonfarm employment, 000



Source: Bureau of Labor Statistics

7. Jobless rate, %



Source: Bureau of Labor Statistics

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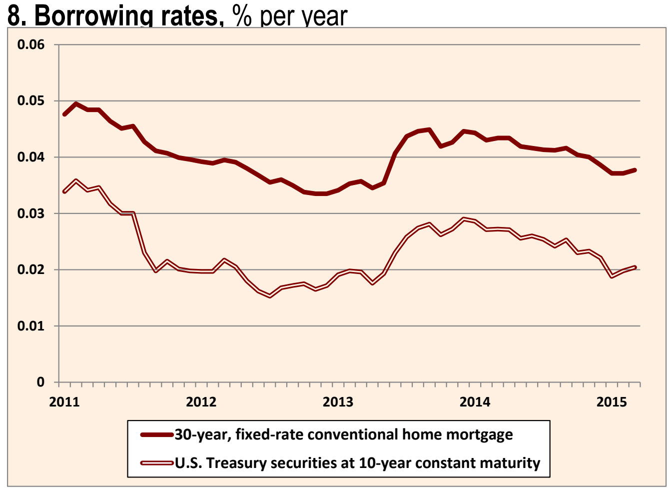
Monetary Policy and Asset Prices

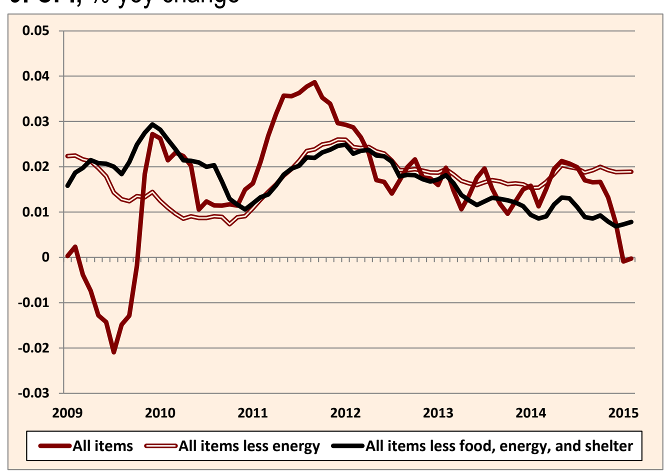
Even though recent data indicated that economic growth has improved somewhat in the U.S., the Federal Reserve reaffirmed its views that the current low target range for the federal funds rate of 0-0.25% remains appropriate. The decision was made based on the dynamics of the labor market and inflation. In particular, labor market conditions are still below optimum levels, despite recent improvements. At the same time, declines in energy prices lower consumer inflation further below the long-run objective of the Federal Open Market Committee (FOMC). The FOMC still expects inflation to rise gradually toward a 2% level in the medium term. During its March 18th meeting, FOMC also stated that it is unlikely that the target range for the federal funds rate will be raised in April. Furthermore, the Committee currently anticipates that economic conditions may warrant temporarily keeping the target federal funds rate below its longer run optimal level, even after employment and inflation are near the mandate-consistent levels.

8. Borrowing rates, % per year



Source: Federal Reserve System

9. CPI, % yoy change



Source: Bureau of Labor Statistics

The dynamics of most major price indexes led to a reversal of the negative trend in the overall CPI index in February. In fact, the overall CPI index increased by 0.2% mom, following three consecutive months of decline. Contributions to growth were made by all CPI components except for energy services and medical care services. The largest contribution to CPI growth was made by the energy index, which grew by 1.0% mom in February on the back of a 2.4% mom increase in the gasoline index, which was the first growth since June 2014. The food index posted a 0.2% mom growth in February as the index for food at home remained almost unchanged and major grocery store food group indexes were split, with three increases and three declines. The overall CPI less food and energy index also increased by 0.2% mom in February. Compared to February 2014, the all items CPI remained unchanged as increases in the food index and in the index of all items less food and energy were compensated for by the decline in the energy index. The food index grew by 3.0% yoy thanks to almost identical increases in food at home and food away from home indexes. The mentioned increase was almost twice as high as the increase in all items less food and energy index. The energy index posted an 18.8% yoy decline in February as prices of energy commodities dropped by almost one-third over the period due to dynamics of world oil prices.

The low housing inventory level once again had a decisive negative impact on housing sales at the national level in February. Insufficient supply hampered prospective buyers in several areas of the U.S. and led to growth in prices to almost unsustainable levels. As a result, despite some improvements in sales, the market in general showed some signs of stagnation. Existing-home sales posted a 1.2% mom increase to a seasonally adjusted annual rate of 4.88 million. As a result, the year-over-year growth in sales accelerated to 4.7%, marking the fifth consecutive month sales were above year-over-year totals. At the same time, the median existing-home price grew almost twice as high at 7.5% yoy to $202,600 for all housing types, which is the 36th consecutive month of increases in prices and the largest increase over the last twelve months. As for inventory, its total level grew by 1.6% compared to January. But 1.89 million existing homes available for sale is still 0.5% below the level observed in February 2014. In terms of months of supply, unsold inventory remained unchanged compared to January at 4.6 months at the current sales pace. Following a seasonal trend, Texas existing-home sales increased to 17,739 actual sales in February. However, this amount was still almost one percent lower compared to that observed in February 2014. The median existing-home price in Texas was not only below the national level at $186,900 but also grew a bit slower at 7.35% yoy, making Texas more attractive for housing purchases compared to the national average. At the same time, development of the housing market in Texas is constrained by supply problems as the inventory level of 3.1 months in February was significantly below the national average and the lowest in the history of observations.

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