

May 2011

- In April, the Texas unemployment rate fell to 8% - a full percentage point lower than the national jobless rate.
- Texas factory activity strengthened in May (in contrast to the nation as a whole).
- In April, home sales in Texas increased by 4% versus the previous month, compared to a small decline nationwide.
- During the first four months of 2011, Texas exports grew by 25% versus only 19% nationwide.

Executive summary

The U.S. economy hit a soft spot in May as factory activity slowed sharply compared to the month before. As a result, there's a growing concern that the overall economy, which was pulled out of recession by a manufacturing rebound, may be slowing. The data, however, is unclear due to industrial deceleration attributed to supply chain disruptions in Japan. Despite this, U.S. manufacturing is in much better shape compared to the worst months of the recession. Sales to inventory ratios remain well below 2009 levels, which testifies to continued strength in demand. Capacity utilization is 10 percentage points higher than two years ago – an impressive comeback compared to prior recessions.

In contrast to the U.S. as a whole, business activity in Texas is expanding at an accelerated rate. For example, the latest survey by the Federal Reserve singles out Dallas as the only regional economy where economic recovery has recently gained momentum. A strong and growing energy sector, improving demand for services and a gradual revival in construction and real estate activity, are adding to the resilience of the local economy. The Texas Manufacturing Outlook Survey highlighted faster growth in May, with the employment index remaining positive for the seventh straight month on continued hiring by Texas factories. This casts Texas in a far more favorable light versus other big national manufacturing centers, where key measures of business activity deteriorated in May.

In April, the Texas unemployment rate fell to 8% - a full percentage point lower than the national jobless rate. The Lone Star State is leading the nation in terms of the number of new jobs created over the last twelve months, with most gains coming from the private sector. In fact, the private sector will continue to drive the job market recovery as budget cuts and a withdrawal of federal funds lead to government hiring freezes. Government employment is starting to level off in Texas, having remained on a steady uptrend during this downturn.

Fortunately, Texas is creating private jobs twice as fast as the nation as a whole. A booming mining industry, and more resilient hiring in construction, can partly explain this trend. Indeed, the downturn in construction was shorter and less severe in Texas. As a result, the local construction industry bottomed out at relatively higher employment and activity levels. Equally important, more service-providing jobs are being created in Texas thanks to increasing employment in trade, education and healthcare, as well as solid demand for business and professional services.

In terms of monetary policy, the Federal Reserve is becoming increasingly concerned with inflation, which hit a 30-month high in April. We believe a transitory surge in energy prices is mostly to blame for this. Overall, inflation expectations remain well anchored as productivity growth continues to surpass wage increases. This means consumer prices will stabilize once the impact of the surge in commodity prices fades away. Certainly, a fresh round of monetary easing through an extension of Treasury securities purchases now looks unlikely. The inconclusive results of the second round of quantitative easing has made the Fed much more cautious about stoking public anxiety over its ability to maintain price stability. Still, in light of the recent weak employment data, the Fed is likely to stick to its close-to-zero interest rate policy for the foreseeable future.

On that count, despite record low mortgage rates, the dire state of the housing market continues to impede any extended recovery. While most housing metrics are distinctly healthier in Texas, the state shares a similar underlying weakness with other parts of the country - the unwillingness of debt-laden consumers to resume borrowing. This points to an extended and gradual housing recovery as mortgage debt flows remain at current depressed levels.

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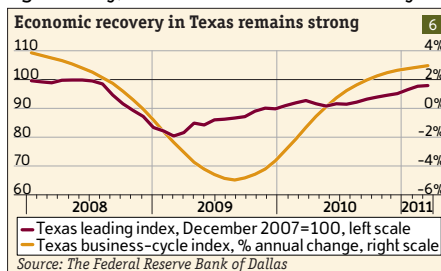
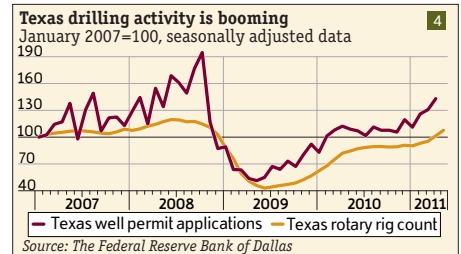
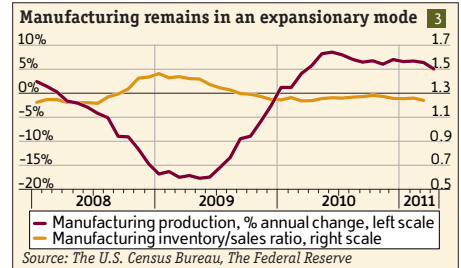
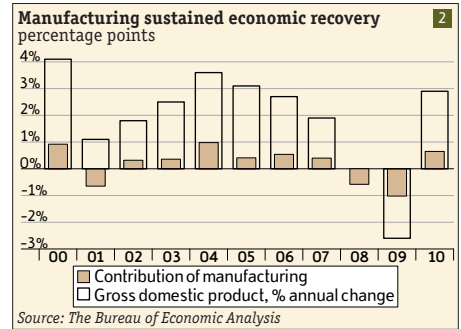
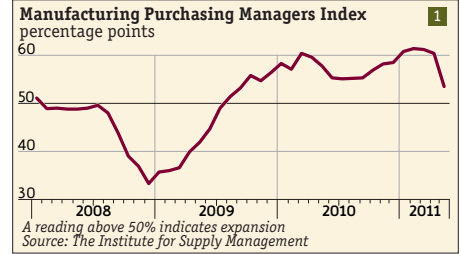
Economic output

The U.S. economy hit a soft spot in May as manufacturing saw a sharp drop in business activity (see chart 1). Although U.S. factory activity has been expanding for the past 22 months, slower growth in manufacturing may spell trouble for the overall economic recovery. Indeed, last year manufacturing helped pull the economy out of recession, contributing over a fifth to GDP growth (see chart 2). Having said that, we believe much of the recent deceleration was due to one-off factors, such as rising commodity prices, a streak of bad weather in the central and southern United States, and the global supply disruption caused by the March earthquake and tsunami in Japan. Policy tightening in emerging markets has contributed to slower growth as well. Indeed, the JPMorgan Global Manufacturing PMI – a barometer of world manufacturing activity, fell for the third straight month in May to its lowest level since September 2010.

On a positive note, U.S. manufacturing is in much better shape compared to the worst months of the Great Recession. Sales to inventory ratios remain well below 2009 levels (see chart 3), indicating continued strength in demand. And capacity utilization in manufacturing at 75% is 10 percentage points higher than two years ago – an impressive comeback compared to past recessions.¹ Having said that, during the 2007 recession, output losses in manufacturing far exceeded previous production declines – the peak to trough drop in factory output was 20% versus roughly 4% during the 2001 and 1990 downturns. As a result, a breakneck manufacturing rebound (which started in July 2009, see chart 3) may have overstretched U.S. factories due to the recession inflicted losses of skills and a disruption of local supply chains. Thus, as global manufacturing supply chains started to sputter this past spring, U.S. companies may have experienced far more serious consequences. Indeed, the latest release of the Beige Book by the Federal Reserve indicates a shortage of parts affecting high-tech firms and carmakers. This means an uptick in factory activity during the second half of 2011 may follow as the impact of these problems fades away while policy tightening in developing economies eases on reduced fears of inflation.

In contrast to the nation as a whole, business activity in Texas appears to be expanding at an accelerated pace. In particular, June's Beige Book singled out Dallas as the only regional economy where economic recovery has recently gained momentum. A strong and growing energy sector (see chart 4), improving demand for services, and a gradual revival in construction and real estate activity, are contributing to the resilience of the local economy. Meanwhile, high-tech manufacturers continue to report robust overseas demand, and the petrochemical industry is benefiting from tight supply and higher prices. The Texas Manufacturing Outlook Survey points to faster growth in May, with the employment index remaining positive for the seventh straight month on continued hiring by Texas factories (see chart 5).

This casts Texas in a far more favorable light versus other big national manufacturing centers. Indeed, the Empire State Manufacturing Survey, the Fifth District Survey of Manufacturing Activity, and a monthly survey of manufacturers in the Third Federal Reserve District², indicate that their local manufacturing activity stalled in May as current activity metrics fell sharply compared to the prior month. Meanwhile, the Texas Leading and Business Cycle Indices continue to point to a robust economic expansion (see chart 6). While rising energy



¹For example, two years after the end of the 1990 and 2001 downturns, capacity utilization in manufacturing was just about 3% higher versus its recession bottom.
Source: The Federal Reserve.

²Source: The Federal Reserve Bank of New York, The Federal Reserve Bank of Richmond and The Federal Reserve Bank of Philadelphia, respectively.

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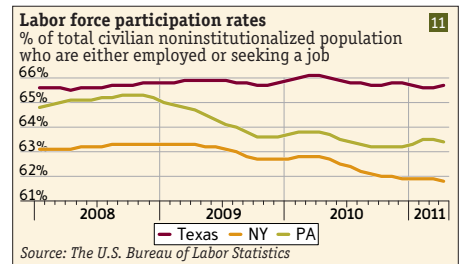
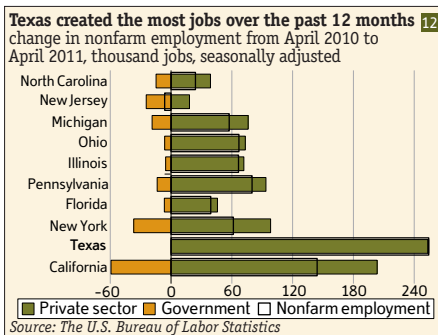
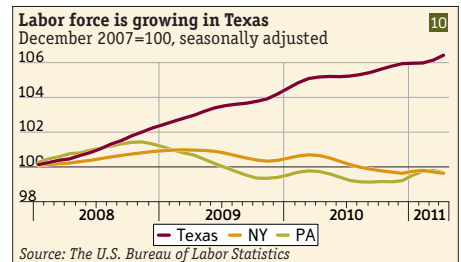
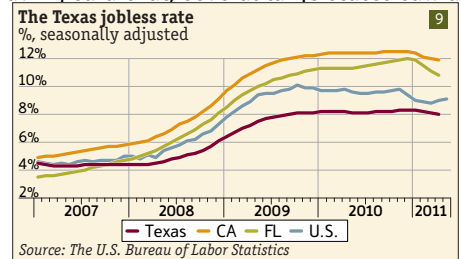
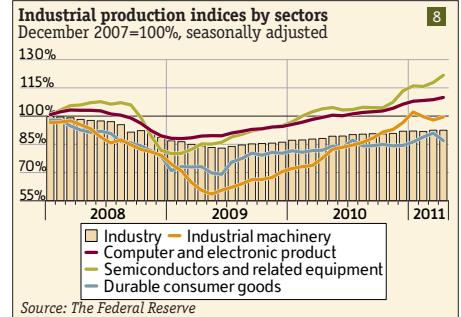
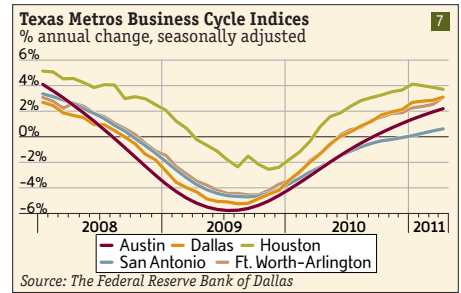
prices are an important part of the Texas success story, there is a broader recovery pattern that extends beyond the regional mining sector (see chart 7). In particular, Austin and Dallas are benefitting from global demand for high-tech goods and semiconductors. For example, according to the Semiconductor Industry Association, in April, worldwide sales of semiconductors were about 4% higher than a year ago. In fact, the national output of computers and industrial machinery (one of the staple exports of Texas) has bounced back more quickly compared to the production of durable consumer goods (see chart 8), partly thanks to the return of foreign demand. This means the slow recovery in consumer spending will remain a relatively smaller drag on Texas, which last year accounted for over a fifth of the national overseas shipments of industrial machinery and computers.

Lastly, Texas has firmly established itself as one of the top destinations for business investment, thanks to low taxes and a friendly business environment. For example, Texas was recently ranked the top state by Site Selection magazine in terms of the number of new investment projects in 2010.³ Meanwhile, Chief Executive Magazine named Texas the best state for business for the seventh straight year. The Lone Star State, which reclaimed the first spot in the CNBC Top States for Business 2010, remains a frontrunner this year as well. As U.S. regional economies continue to experience a visible divergence in economic fortunes, local factors will play an increasingly decisive role in companies' investment choices. Thus a better business climate in Texas will provide a lasting basis for economic development in the region.

Employment

In April, the Texas unemployment rate fell to 8% from 8.1% in March – and was a full percentage point lower than the national jobless rate. A comparison with other large states is even more encouraging for Texas – for example, the unemployment rates in California and Florida are 4 percentage points and 3 percentage points higher than Texas (see chart 9). Having said that, several large states saw a bigger drop in jobless rates compared to Texas (in April 2010, the Texas unemployment rate was just 0.2 percentage point higher than in April 2011). For example, the unemployment rate in New York and Pennsylvania stood at 7.9% and 7.5%, respectively, in April 2011, versus 8.7% and 8.8% a year ago. However, in contrast to Texas, the total labor force in NY and PA remained roughly unchanged compared to the beginning of the recession in December 2007 (see chart 10). This is partly due to faster population growth in Texas. More importantly, a healthier job market appears to be driving more people to look for jobs in Texas (see chart 11). As a result, a faster drop in unemployment rates may not be a sign of a stronger local labor market. In fact, both NY and PA still employ 2.2% fewer workers than at the pre-crisis employment peak; Texas has only 0.8% fewer jobs, having regained 3.4% of jobs since the end of 2009.

On that count, the Lone Star State is leading the nation in terms of the number of new jobs created over the last twelve months, with most gains coming from the private sector (see chart 12). In April, Texas nonfarm employment grew by 2.5% (in annual terms) versus only 0.7% nationwide (see chart 13). The local private sector has added 3% more jobs since April 2010 versus only 1.6% nationwide. In particular, employment in the mining industry was up by 16%, while construction and manufacturing continued to post solid job gains – up by 4.1% and 1.3%, respectively. Hiring remained strong in service-providing sectors as well - 2.4% more jobs were created in trade, transportation and utilities, 4.6% in professional and businesses

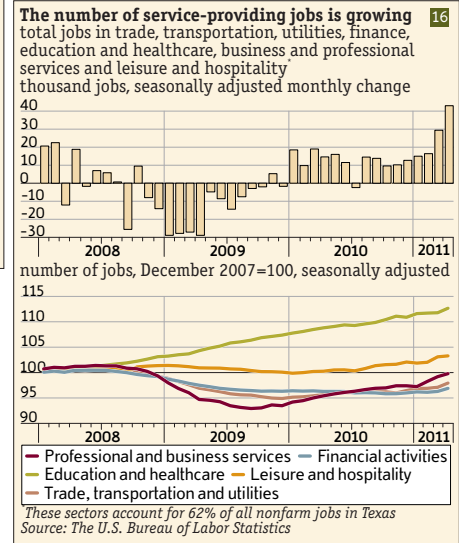
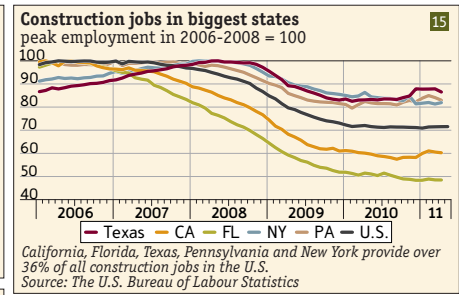
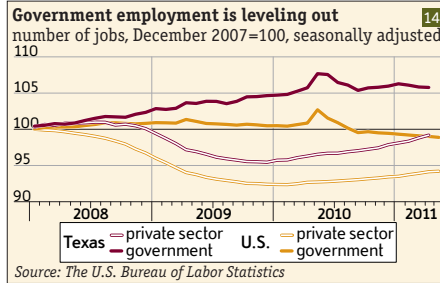
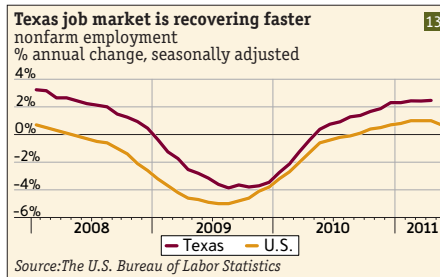


³Source: Site Selection magazine, March 2011.

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services, 3.6% in education and healthcare, and 3% in leisure and hospitality. More than that, at 34,000 jobs, the monthly gain in private employment in April was the second largest in 2011 – not far below 40,000 new jobs created in March.

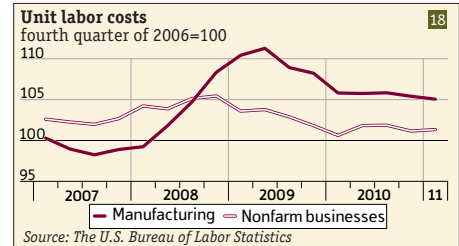
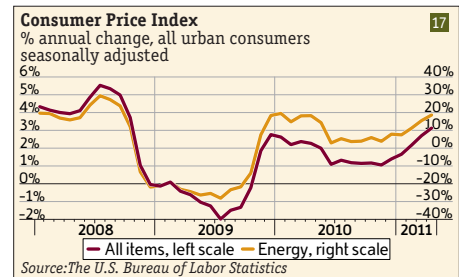
Going forward, the private sector will drive any job market recovery as budget cuts and a withdrawal of federal stimulus cause hiring freezes at the state and federal government level. Indeed, government employment in Texas, which remained on a steady uptrend during the recession, has recently leveled out due to job cuts in the state government (see chart 14). Meanwhile, the Texas private sector continues to add new jobs partly thanks to the booming mining industry and more resilient hiring in construction. In fact, Texas had 4.1% more jobs in construction than in April 2010 – the second fastest annual job growth after Oklahoma. More than that, the downturn in construction was shorter and less severe in Texas than in many other large states, which have been losing construction jobs for over 5 years (see chart 15). This means the Texas construction industry bottomed out at relatively higher employment and activity levels compared to other states. As a result, construction-related manufacturing⁴ suffered less in Texas compared to, for example, California and Florida, which in April 2011 had 16% and 27% fewer manufacturing jobs than at the beginning of 2006 (Texas had only 10% fewer jobs in manufacturing).⁵ Lastly, more service-providing jobs are being created in Texas thanks to increasing employment in trade, education and healthcare, as well as solid demand for business and professional services (see chart 16).



Monetary Policy and Asset Prices

The Federal Reserve is finalizing its second round of quantitative easing by completing the \$600 billion purchase of Treasury securities by the end of June. A further easing of monetary conditions through a third round of large-scale asset purchases looks unlikely. However, in light of the recent weak employment data, the Fed will continue to maintain an accommodative monetary policy by keeping the federal funds rate close to zero.

Recently, the Fed has become increasingly concerned about inflation, which, at an annual rate of 3.1%, hit a 30-month high in April (see chart 17). We believe a transitory surge in energy prices is mostly to blame for this, since labor costs have remained stable (see chart 18) as labor productivity has grown faster than wages, helping to keep inflation expectations firmly anchored. This means consumer prices will stabilize once the impact of the surge in commodity prices fades away. Still, a lackluster job market recovery is an indication that an ultra-loose monetary policy has failed to kick-start the U.S. economy. Although there is no doubt this policy was instrumental in restoring stability to the financial sector, growing domestic and international anxiety over its impact on inflation and asset prices means a fresh program of quantitative easing is highly unlikely.



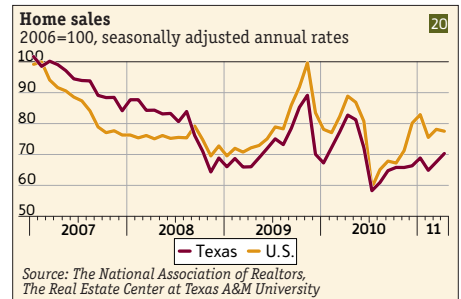
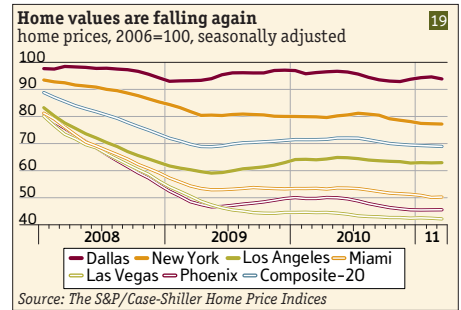
⁴According to the U.S. Bureau of Economic Analysis, the U.S. construction industry consumes about 7% of all manufacturing output.

⁵That said, a relationship between the number of jobs in construction and manufacturing is less strong in Texas than in other large states pointing to the state's weaker reliance on the local homebuilders. For example, the correlation between the employment in manufacturing and construction is close to 100% in California and Florida and is only 81% in Texas (100% correlation indicates perfect relationship between the employment in two sectors).

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Notwithstanding record low mortgage rates, the housing market remains beset by a glut of foreclosed homes, which drags down home values (see chart 19). According to The S&P/Case-Shiller Home Price Indices, home prices in the U.S. hit a fresh low in March, with the composite index shedding nearly a third since December 2006. Nevada, Arizona and California – states that experienced the deepest collapse in their housing markets, continue to lead the nation in terms of foreclosure rates. According to RealtyTrac’s April data, 1 in 97 homes was in foreclosure in Nevada, 1 in 205 in Arizona, and 1 in 240 in California. Meanwhile, the proportion of homeowners who owe more to the bank than the market value of their home remains stubbornly high – 22.7 nationwide in the first quarter of 2011 – just a notch below 23.1% at the end of 2010.⁶ Nearly two thirds of all homes are in negative equity in Nevada, 50% in Arizona, 46% in Florida, and 31% in California. This dire state of the housing market restricts labor mobility, further weakening home values.

That said, most housing metrics are distinctly healthier in Texas. The foreclosure rate is 1 in 1106 versus 1 in 593 nationwide, and only 10% of all homes in Texas carry negative equity. As a result, housing activity in Texas appears to be bucking the national trend – in April, seasonally adjusted home sales in Texas grew by about 4% versus the previous month (compared to a 0.8% drop for the nation as a whole). Above all, a stronger local economy, faster population growth, and an affordable cost of living⁷, add stability to the Texas real estate market. Yet, however well Texas rivals other large states, it shares a similar underlying weakness with them – an unwillingness of debt-laden consumers to resume borrowing. Indeed, two years after the recovery started, home sales in Texas are still 30% off their pre-crisis highs (see chart 20), which points to an extended and gradual recovery as mortgage debt flows remain at current depressed levels.⁸



Foreign Trade

During the first four months of 2011, Texas exports grew by 25% versus only 19% nationwide. Higher commodity prices⁹ are driving exports of mineral fuels (up by 60%) and agricultural products (exports of cereals and cotton jumped by 146% and 180%, respectively). Having said that, mineral fuels represent just 21% of exports from Texas. Industrial machinery, computers and electronics are 30% of Texas exports, which will help sustain export revenues if crude oil prices sputter. Exports of these products are supported by booming investment and consumer demand in developing economies. Indeed, geographical diversification of the Texas export markets is paying off well. Although NAFTA countries remain the primary trading partners (exports to Canada and Mexico increased by 22% and 24%, respectively), Texas exports to developing countries (about 65% of all exports versus just 41% for the nation as a whole) grew faster – up by 27%. Exports to China and Brazil – the third and fourth largest export markets for Texas grew by 22% and 46%, respectively. And thriving Latin American economies are catching up as well – between January-April, exports to Chile, Peru and Argentina increased by 40%, 43% and 64%, respectively, following strong double digit growth in 2010. All told, an ongoing shift toward higher consumption in the developing world looks certain to sustain solid overseas demand for manufacturing, mining and agriculture in Texas. This will help offset the lingering weakness of the U.S. consumer.

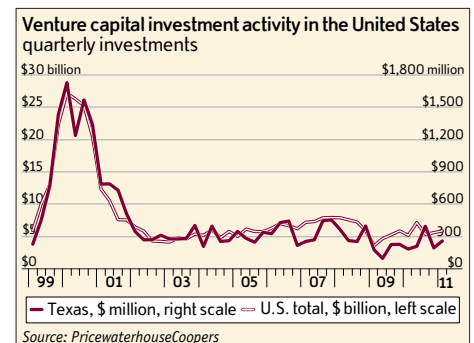
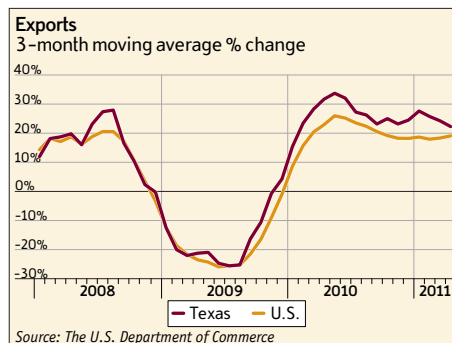
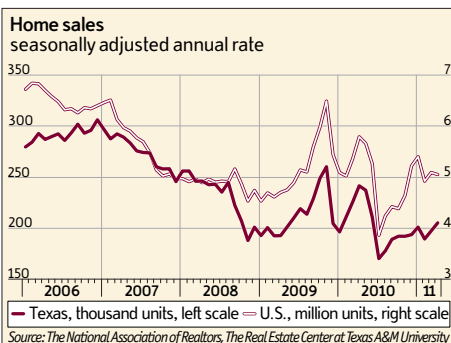
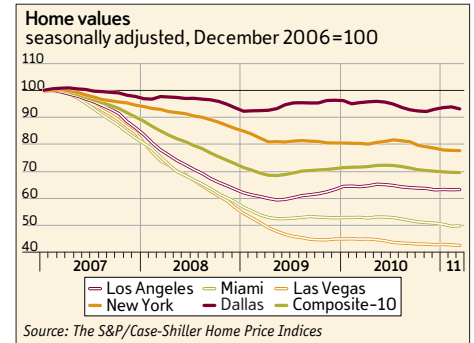
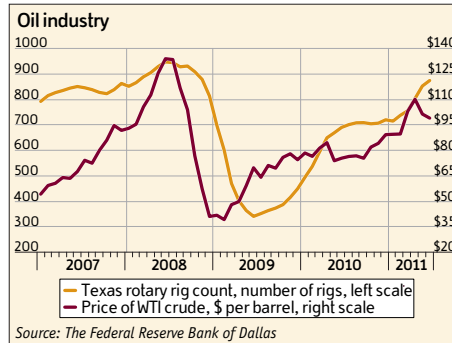
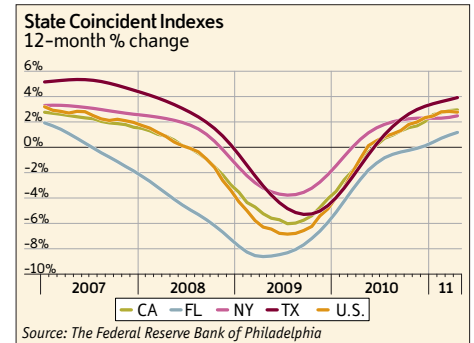
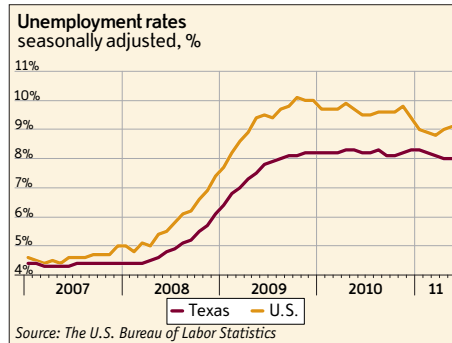
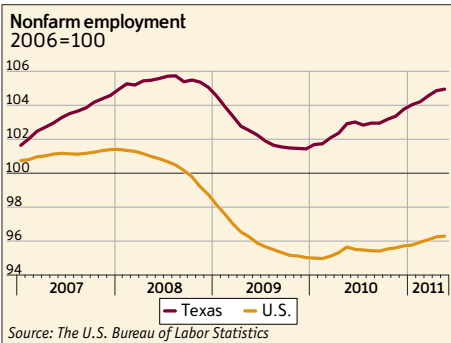
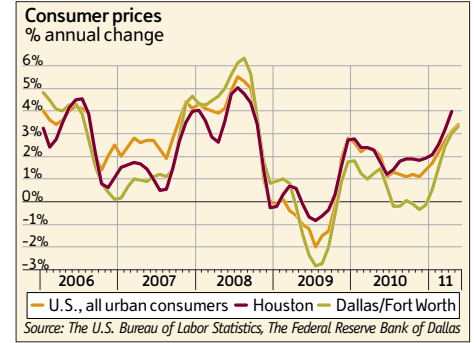
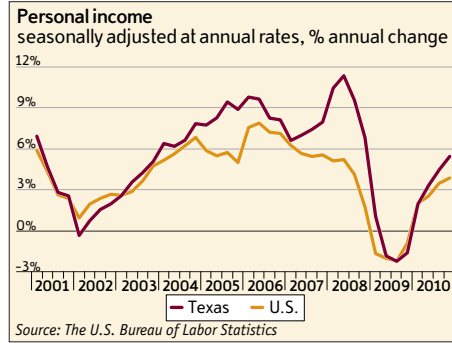
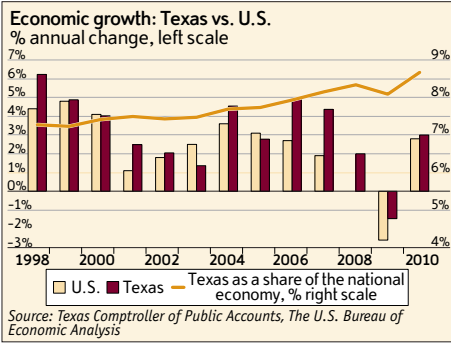
⁶Source: CoreLogic, Negative Equity Report Q1 2011.

⁷According to the ACCRA Cost of Living Index, in the first quarter of 2011, 5 Texas cities were among the 10 least expensive towns nationwide out of 312 urban areas surveyed. The same report placed Houston as the second least expensive metro out of the 40 largest U.S. cities. In particular, Houston is 2.4 times less expensive than New York, 1.6 times less than Washington D.C., and 1.5 times less than Boston and Los Angeles.

⁸According to the Federal Reserve, in January-March 2011, home mortgage debt fell for the 12th consecutive quarter.

⁹Louisiana and New York, where exports grew by 52% and 33%, respectively, are also enjoying a commodity-driven export boom thanks to higher energy and food prices (in the case of Louisiana) and more expensive precious metals (in the case of New York).

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