SigmaBleyzer

Texas Economic Update

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

June 2011

- **U.S. factory activity improved slightly in June on easing supply disruptions in Japan.**
- **According to the Texas Manufacturing Survey, factory activity in Texas continued to expand in June, albeit at a slower pace.**
- **The Texas jobless rate held steady at 8% in May.**
- **Texas seasonally adjusted home sales fell slightly in May.**
- **Texas was ranked second in CNBC's list of the Best States for Business in 2011.**

Executive summary

The second quarter has been marked with renewed fears over the sustainability of growth achieved since the depths of the Great Recession. Although U.S. factory activity improved slightly in June, as global supply disruptions in Japan started to ease, concerns over fiscal policy, as well as a lack of consumer demand, continue to make businesses reluctant to invest their record high cash surpluses.

Consumers remain reluctant to spend due to the lackluster job market and higher prices at the pump and in grocery stores. Indeed, the consumer confidence index slipped in June for the second straight month to its lowest level since October. Continued consumer deleveraging is also not helping - consumer credit outstanding remains at 6% below its pre-crisis peak. Consumer debt is no longer being used to smooth consumption spending as the growth of personal income slows. On the upside, the latest ADP employment report shows a healthy uptick in private sector hiring. However, government data paints a much less favorable picture – in June, over two thirds of private sector job gains were wiped out by employment losses in the public sector. Still, a recent decline in gasoline prices makes a modest pickup in consumption in the second half of this year a potentially positive outcome.

Despite all of this, Texas appears to remain resilient to these emerging economic headwinds for the US economy as a whole. One reason is due to the fact that Texas manufacturing relies less on the automobile industry (and imported parts from Japan), and has a larger share of computer, electronics and petrochemical firms. In fact, according to the Texas Manufacturing Outlook Survey, current trends point to a continued growth in output and employment for Texas in June, following a solid gain the month before. The recovery remains on track in all major Texas metros, thanks to a booming mining industry, an export-driven rebound in manufacturing and increasing business spending on information technology. The rapid rise in mining activity to its pre-crisis peak bodes well for Houston. Meanwhile, Austin and Dallas are enjoying strong demand for high-tech products, software development and information technology services. Lastly, on top of being a well-diversified and open economy, Texas has one of the best business climates in the nation. CNBC ranked Texas the second best state for business in its 2011 Best States for Business survey – Texas has been alternating the top position with Virginia since 2007. This helps attract capital and talent, which ultimately boosts the long-term potential of the state's local economy.

In May, the Texas jobless rate held steady at 8% - well below the unemployment rates of other large states, and 1 percentage point lower than the nation as a whole. Still, monthly job growth slowed sharply as heightened anxiety over fresh threats to economic recovery spread across the U.S. Furthermore, May's job market lull was primarily caused by weaker hiring in service providing sectors, including trade, transportation, healthcare and social assistance. On the upside, information technology saw a monthly gain in jobs for the first time in a year, while job gains in the financial services industry increased for the third straight month. In addition, job creation in professional and business services continued at a steady 4% annual rate – well above the national growth rate of 3%. Meanwhile, the number of government jobs grew for the second straight month in a row. Going forward, we expect hiring in the Texas public sector to weaken as spending cuts start to bite. However, the local private sector has been recovering with more vigor compared to the nation as a whole, which should help sustain the state's lead in job creation.

In June, the Federal Reserve completed its purchases of $600 billion of longer-term Treasury securities, bringing the second round of quantitative easing to an end. Similar to the first round of easing (a $1.25 trillion program to purchase agency mortgage-backed securities), the policy objective of the second round was to lower long-term interest rates and to prop-up a faltering economic recovery. Clearly, the Fed's withdrawal from the Treasury market risks pushing up interest rates on lower demand for overall government debt. Still, at present, worries over the debt crisis in the Euro zone, as well as weak economic data in the U.S., have helped to sustain demand for safer U.S. Treasuries. However, as the Fed scales down its purchases, market volatility is likely to pick up, adding extra uncertainty to the economic outlook. This may strain the already anemic housing market recovery, which, despite low interest rates, continues to languish. While falling foreclosure rates suggest the housing market is gradually starting to heal, without a solid uptick in hiring, a speedy end to the housing correction is still not in sight.

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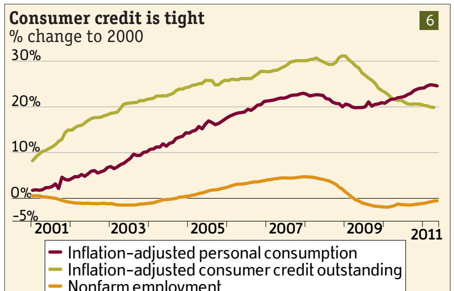
Economic output

U.S. factory activity improved slightly in June as global supply disruptions, triggered by the March earthquake in Japan, started to ease. Indeed, the national Purchasing Managers Index points to a stronger growth in manufacturing, partly thanks to more stable production in the automobile industry (see chart 1). As can be seen from the data, U.S. based Japanese carmakers were badly affected by the shortage of imported vehicle parts and components.[1] For example, in June, U.S. car sales of Toyota and Honda, which jointly account for over a fifth of the national market, fell by over 21% (see chart 2) on low inventories of small cars.[2] On the upside, factories in Japan reported a second straight monthly gain in May following a 15.5% production drop in March.[3] This means U.S. production of cars should recover in the second half of 2010 as imported components become more readily available.

An increase in U.S. factory orders is another sign that the manufacturing recovery is under way. Indeed, according to the U.S. Census Bureau, shipments and new orders of manufactured goods were up in May following a sharp decrease in April. Equally important, new orders of capital goods excluding aircraft and defense, which is a good metric of future business investment, were up by 1.6% in May (after a 0.4% decline in April). In fact, companies' spending on equipment and software has contributed to economic recovery since the second quarter of 2009. This may be a sign that companies are cautiously starting to expand production. Having said that, liquid assets within the corporate sector remain at record high levels (see chart 3) pointing to lingering concerns over the future course of fiscal policy (both at the state and federal level) and the strength of the U.S. economy. Above all, lack of consumer demand is the real reason why businesses are reluctant to part with current record high cash surpluses.

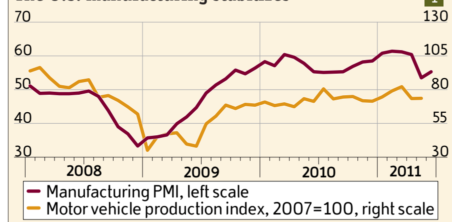
The Conference Board said that the Consumer Confidence Index slipped in June for the second straight month, to its lowest level since October 2010. A lackluster job market recovery, combined with higher prices at the pump and in grocery stores, is weighing on consumers' wiliness to spend. Indeed, a recovery in retail sales appears to be fizzling out on flagging car sales and increasing spending on gas (see chart 4). Higher prices, slower growth in personal income, as well as continued consumer deleveraging (households are saving twice the share of personal income compared to pre-crisis years) are exerting a toll on personal consumption (see chart 5). In addition, consumer credit outstanding, which has been posting monthly gains since October, is only 0.6% higher than a year ago, and is still 6% below its pre-crisis peak. While employment is by far the biggest driver of personal spending, an expansion of consumer borrowing played a big part in sustaining consumption when job creation slowed over the last decade (see chart 6). However, lenders are generating new consumer loans at half the rate of 2006-2007. As households continue to reduce debt, which is a secular trend in the aftermath of the financial crisis, it will take time for consumer credit to resume its role as a tool to smooth out consumption spending. As a result, personal consumption is likely to follow the dynamics of the job market more tightly than in recent history. On the upside, the latest ADP employment report shows a healthy uptick in private sector hiring – in June, nonfarm private businesses added 157,000 new jobs (versus only 38,000 jobs in May). However, June's government data paints a much

Consumer credit is tight 6



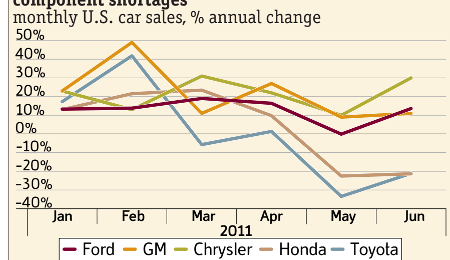
Source: The Federal Reserve, The Bureau of Economic Analysis

The U.S. manufacturing stabilizes 1



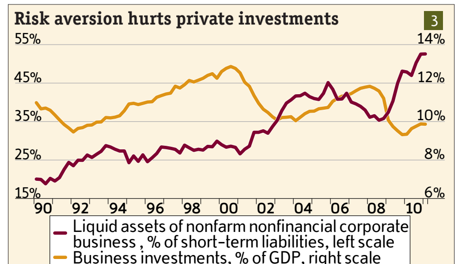
Source: The Institute for Supply Management, The Federal Reserve

Japanese carmakers were hit by component shortages 2



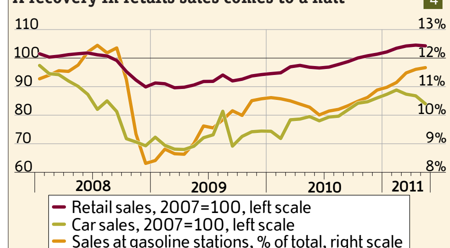
Source: Company reports

Risk aversion hurts private investments 3



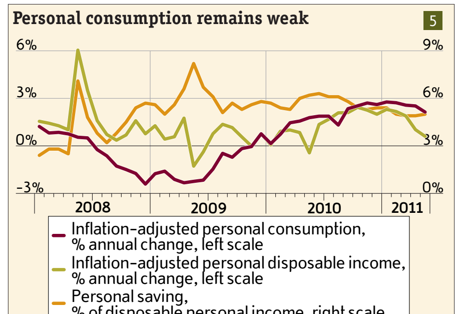
Source: The Federal Reserve, The Bureau of Economic Analysis

A recovery in retails sales comes to a halt 4



Source: The Bureau of Economic Analysis

Personal consumption remains weak 5



Source: The Bureau of Economic Analysis

[1]In 2010, Japan supplied over 17% of all U.S. imports of car parts.
[2]Demand for smaller, fuel efficient cars has been booming on surging gas prices.
[3]Source: The Ministry of Economy, Trade and Industry of Japan.

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less favorable picture – over two thirds of the gain in private sector jobs was wiped out by employment losses in the public sector, thus generating just 18,000 new jobs. Still, with retail gasoline prices down by about 10% from nearly $4 per gallon at the beginning of May, it is reasonable to expect a modest pickup in consumer spending in the second half of 2011.

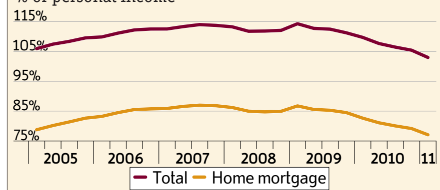
Ongoing deleveraging and a high debt burden continue to be a big drag on the national housing recovery. Households, saddled with mortgages exceeding home values, are cutting their debt obligations. According to the Federal Reserve, in January-March 2011, home mortgage debt shrank for the 12th consecutive quarter and is now $635 billion smaller than at its peak three years ago. As a result, the ratio of household debt to personal income is about 103% or roughly 10 percentage points lower than at the height of the housing boom (see chart 7). Although this helps households' finances through lower debt service costs, it keeps housing activity well below historic levels (see chart 8). In addition, recent demographic trends appear unfavorable to the housing market as well. The household formation rate has slowed in the aftermath of the housing bust (see chart 9) due to both falling immigration and the lack of job opportunities for young people. For example, the U.S. Census Bureau estimates that last year 13.4% of young adults[4] lived at home versus just 10.7% on average in 2000-2005. Of course, the demand for housing is likely to improve as household formation returns to normal levels once jobs for young workers become more available, and there are signs that this corner of the labor market will improve faster than the overall labor picture – from May 2010 to May 2011, the economy created 1.5% more jobs for young adults compared to just 0.4% for all age groups.[5]

The economic recovery in Texas appears to be more resilient to these headwinds. In particular, during the first quarter of 2011, personal incomes in Texas grew by 6.2% (the fourth fastest rate among the 50 U.S. states), exceeding the overall national rate for the fourth straight quarter. This trend is likely to persist thanks to robust private sector hiring and more jobs in higher paying sectors of the economy, such as mining and professional and business services. A faster turnaround in construction, which generates close to 6% of all nonfarm personal earnings in Texas (and 5% nationwide), and a solid uptick in manufacturing (about 10% of all nonfarm personal earnings both in Texas and the U.S.) helps as well (see chart 10).

Texas manufacturing, which relies less on the automobile industry and has a larger share of computer, electronics and petrochemical firms versus the nation as a whole[6], continues to outperform other large regional manufacturing hubs. For example, according to the Texas Manufacturing Outlook Survey, current trends point to an expansion in output and employment in June (see chart 11). Meanwhile, factory activity in other regions of the country was mixed. Manufacturing stabilized in the central Atlantic region and returned to growth in Chicago, while Philadelphia and New York reported weaker business activity.[7]

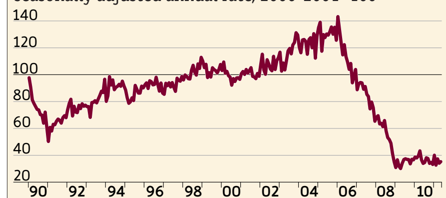
The recovery remains on track in all major Texas metros thanks to the booming mining industry, an export-driven rebound in manufacturing, and increasing business spending on information technology services (see chart 12). In particular, in June, the Texas rotary rig count was 27% higher than a year ago (and just 7.5% below its peak in 2008). The San Antonio economy, which is home to a large Boeing facility, is benefitting from a surge in new orders for civilian aircraft – according to the U.S. Census Bureau, new orders of non-defense aircraft and parts were up by 28% in January-May.[8] Meanwhile, Austin and Dallas are enjoying a solid uptick in demand for high-tech products, software development and

Household debt 7
% of personal income



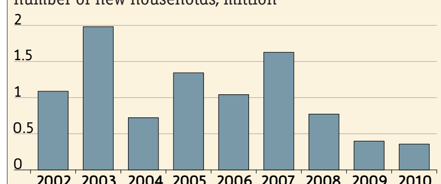
Source: The Federal Reserve, The Bureau of Economic Analysis

Housing activity remains under stress 8
new privately owned housing units started, seasonally adjusted annual rate, 2000-2001=100



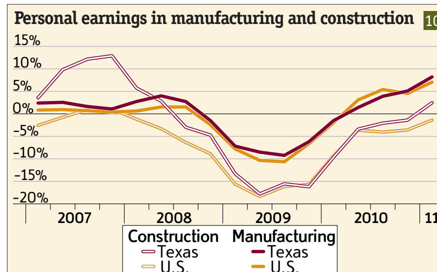
Source: The U.S. Census Bureau

Household formation 9
number of new households, million



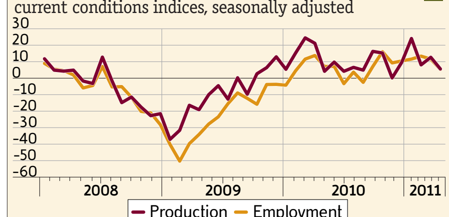
Source: The U.S. Census Bureau

Personal earnings in manufacturing and construction 10



Source: The Bureau of Economic Analysis

Texas factory activity 11
current conditions indices, seasonally adjusted



Source: The Federal Reserve Bank of Dallas

[4]25 to 34 year old. According to the U.S. Census Bureau, the median age at first marriage is 28 years for men and 26 years for women.
[5]Source: The U.S. Labor Bureau, seasonally unadjusted data.
[6]According to the U.S. Bureau of Economic Analysis, car makers generate just 5.5% of the total value added in manufacturing (versus about 9% nationwide). Meanwhile, the share of producers of computers, electronics and petrochemicals products in manufacturing value added is over 80% in Texas compared to just 63% for the U.S. In addition, Texas imports most of its car parts from Mexico, which makes local car makes more resilient to supply disruptions in Japan.
[7]Source: Manufacturing surveys by the regional Federal Reserve Banks.
[8]In June, Gov. Rick Perry signed House Bill 3727, which should make it easier for aircraft producers to operate in Texas.

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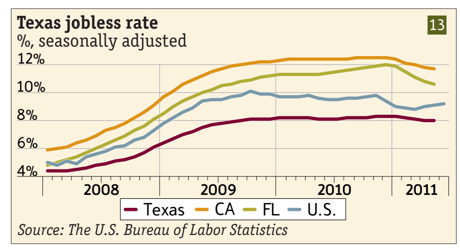
information technology services. In particular, according to the Semiconductor Industry Association, in May, sales of semiconductors in the Americas were 0.9% higher than in April and up by 3.2% versus a year ago. Strong consumer spending on mobile devices (such as tablets, e-readers and smart phones) as well as business spending on industrial processors (due to the application of more sophisticated technology in the energy sector, healthcare and automobile industry) is a boon for chip makers. In addition, according to Gartner, an information technology research and advisory company, businesses are planning to boost spending on business process management. This year, global IT spending is projected to increase by 7% (on a 12% gain in spending on computer hardware and a 10% growth of spending on enterprise software). This bodes well for Texas thanks to its strong position in the national and global IT industry. In fact, Texas-based Dell, which is the second largest vendor of enterprise hardware and services in the U.S.[9], reported record high earnings in the first quarter of this fiscal year on improving business demand for its products and services.

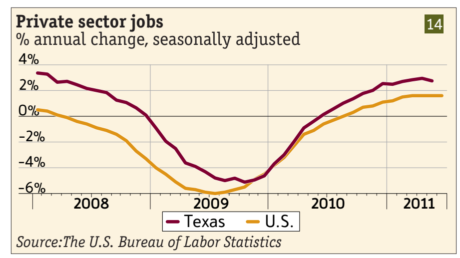
As well as being a well-diversified and open economy, Texas has one of the best business climates in the nation. At the end of June, CNBC ranked Texas the second best state for business in its 2011 list of Best States for Business. In fact, the Lone Star State has managed to preserve its competitive position versus other states since the inception of the CNBC rating five years ago – Texas has been alternating the top position with Virginia since 2007. This helps attract capital and talent, which ultimately adds to the resiliency of the local economy. Indeed, over the last decade, Texas has become the second largest regional economy in the nation and, at present, is nearly two thirds the size of the economy of California (versus just 55% in 2000).

Employment

In May, the Texas jobless rate held steady at 8%, staying well below the unemployment rates of other large states, and 1 percentage point lower than the nation as whole (see chart 13). However, monthly job growth slowed to just 8,800 (from an average 27,500 in the first four months of 2011) as heightened anxiety over fresh threats to economic recovery spread throughout the U.S. Despite this, both construction and manufacturing added jobs in May (versus a decline the month before) posting 4.1% and 1.3% annual gains, respectively (nationwide the number of construction jobs was the same as a year ago). This means that May's job market lull was primarily caused by weaker hiring in service providing sectors. In particular, in May, annual job growth in trade, transportation and utilities slowed to 2% from 2.3% the month before on a sharp reduction of hiring in trade, and new layoffs in transportation. More importantly, employment in health care and social assistance fell by 4,300 (in contrast to continued employment growth in this sector nationwide). Lastly, leisure and hospitality lost jobs, with annual employment growth slowing to 2.3%, albeit still higher than the national rate of 1.6%.



Source: The U.S. Bureau of Labor Statistics



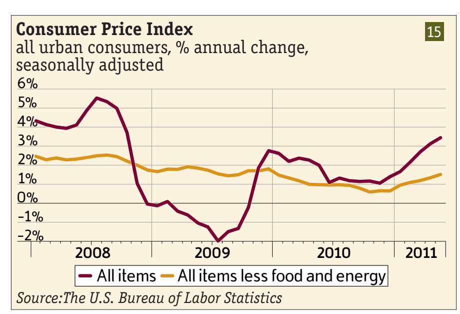
Source: The U.S. Bureau of Labor Statistics

Information Technology saw a monthly gain in jobs for the first time in a year, while job gains in the financial services industry increased for the third straight month. In addition, job creation in professional and business services continued at a steady 4% annual rate – well above the national growth rate of 3%. Meanwhile, the number of government jobs grew for the second straight month in a row thanks to a resumption of hiring by local government (nationwide, May was the seventh consecutive month of government job losses). While we expect hiring in the Texas public sector to weaken as spending cuts start to bite, the Texas private sector has been recovering with more vigor compared to the nation as a whole (see chart 14), which should help sustain the state's lead in job creation.

Monetary Policy and Asset Prices

In June, the Federal Reserve completed its purchase of $600 billion of longer-term Treasury securities, bringing the second round of quantitative easing to an end. At the same time, interest rates have remained exceptionally low as a weak economic recovery and the persistent jobless rate fails to stoke inflationary expectations. Indeed, consumer inflation, excluding more volatile prices of foods and energy, remains well below 2% (see chart 15).

The first round of quantitative easing (a $1.25 trillion program to purchase agency mortgage-backed securities[10]) helped reduce borrowing costs for the private sector to record low levels



Source: The U.S. Bureau of Labor Statistics

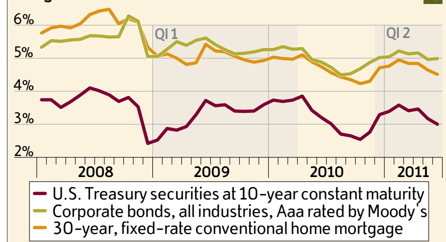
[9] According to the company reports, last year, global sales of hardware and services to businesses generated 53% of total revenues.

[10] MBS issued or guaranteed by the Fannie Mae, Freddie Mac or Ginnie Mae.

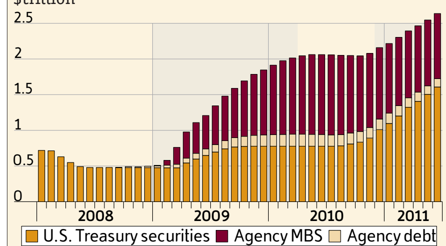
(see chart 16). Meanwhile, the focus of the second round of easing was to lower long-term interest rates and prop-up a faltering economic recovery. Therefore, the Fed's withdrawal from the Treasury market risks driving up interest rates, which will raise borrowing costs for the corporate sector and households.

At present, worries over the debt crisis in the Euro zone have helped to sustain demand for safer U.S. Treasuries. However, as the Fed scales down its demand for overall government debt, market volatility is likely to pick up, adding extra uncertainty to the economic outlook. This may strain the already anemic housing market, which continues to languish despite low interest rates. Indeed, home sales (both in Texas and nationwide) are hovering at historic lows (see chart 17). The continued weak labor market and falling property values risk pushing more homeowners into foreclosure, which will exert additional downward pressure on home prices. In fact, according to CoreLogic, national home values were 7.4 lower in May than a year ago. Excluding distressed sales, home prices inched down by just 0.4%. Distressed sales are pushing home prices down in Texas as well, albeit to a lesser extent thanks to the more stable housing situation. Single family home prices in Texas fell by about 2% in May, but were 4.2% higher if distress sales are excluded. RealtyTrack reported a 2% monthly drop in new foreclosures nationwide (following a 9% decline in April) and a 1.9% gain in foreclosure sales prices. Meanwhile the national foreclosure rate fell to 1 in 605 (from 1 in 400 a year ago). In May, only 1 in every 1,074 housing units received a foreclosure filing in Texas – a much healthier rate compared to 1 in 103 in Nevada, 1 in 259 in California, and 1 in 461 in Florida. While the housing market is gradually starting to heal, without a solid uptick in hiring, a speedy end to the housing correction is not in sight.

Long-term interest rates 16

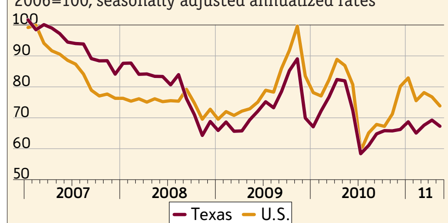


Securities held by Fed
$trillion



QI - quantitative easing
Source: The Federal Reserve

Home sales 17
2006=100, seasonally adjusted annualized rates



Source: The National Association of Realtors, The Real Estate Center at Texas A&M University

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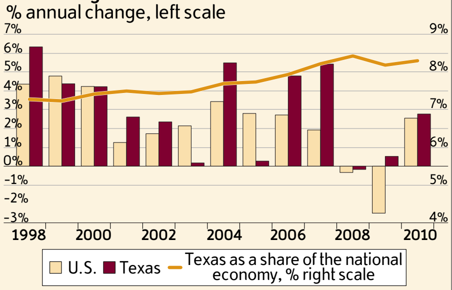
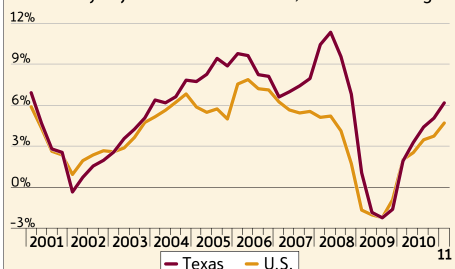
Economic growth: Texas vs. U.S.
% annual change, left scale



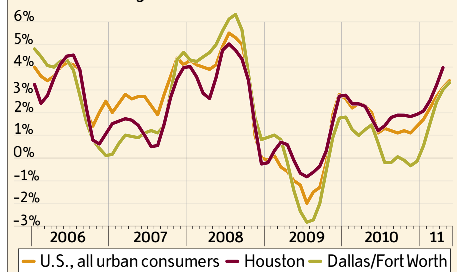
Source: *The U.S. Bureau of Economic Analysis*

Personal income
seasonally adjusted at annual rates, % annual change



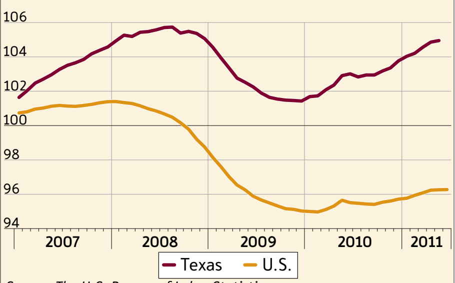
Source: *The U.S. Bureau of Labor Statistics*

Consumer prices
% annual change



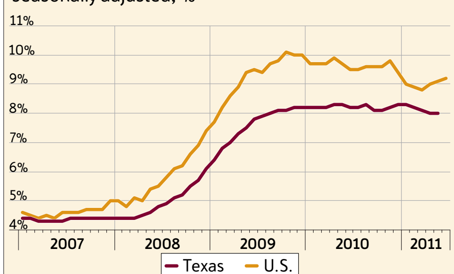
Source: *The U.S. Bureau of Labor Statistics, The Federal Reserve Bank of Dallas*

Nonfarm employment
2006=100



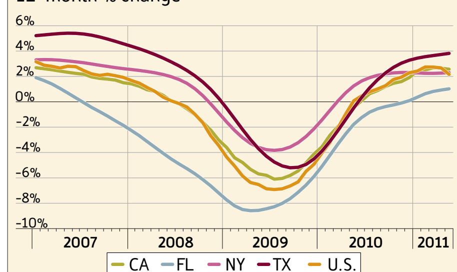
Source: *The U.S. Bureau of Labor Statistics*

Unemployment rates
seasonally adjusted, %



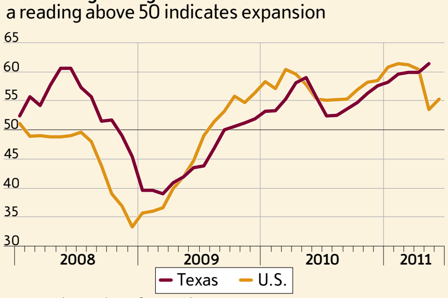
Source: *The U.S. Bureau of Labor Statistics*

State Coincident Indexes
12-month % change



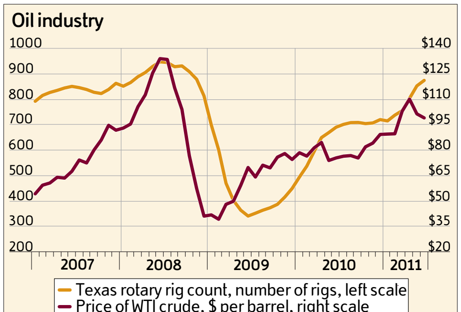
Source: *The Federal Reserve Bank of Philadelphia*

Purchasing Managers Index
a reading above 50 indicates expansion



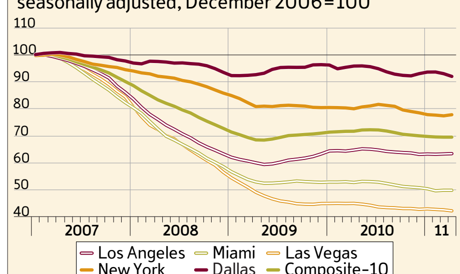
Source: *The Institute for Supply Management*

Oil industry



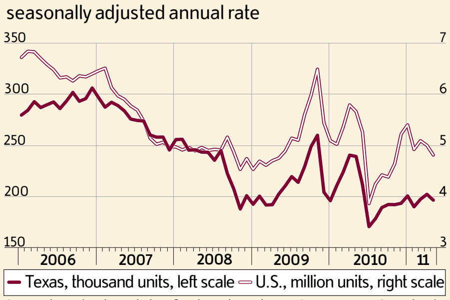
Source: *The Federal Reserve Bank of Dallas*

Home values
seasonally adjusted, December 2006=100



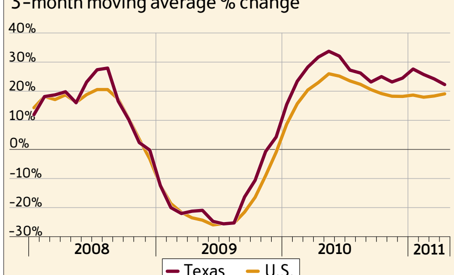
Source: *The S&P/Case-Shiller Home Price Indices*

Home sales
seasonally adjusted annual rate



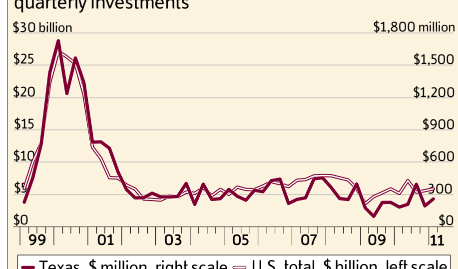
Source: *The National Association of Realtors, The Real Estate Center at Texas A&M University*

Exports
3-month moving average % change



Source: *The U.S. Department of Commerce*

Venture capital investment activity in the United States
quarterly investments



Source: *PricewaterhouseCoopers*

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