

December 2009

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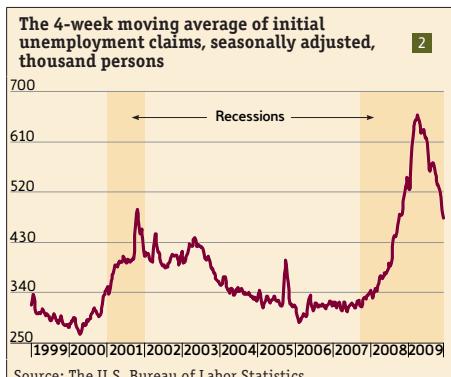
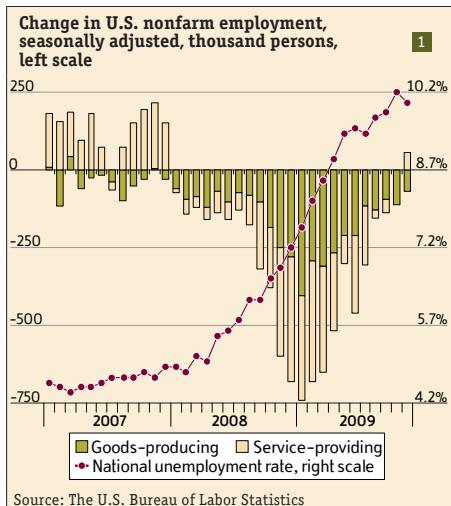
- The U.S. economic recovery may be gathering speed, supported by inventory rebuilding and growing retail sales and exports.
- In November, the unemployment rate in Texas fell to 8%. Texas added 70,000 new jobs in October and November.
- In November, home sales in Texas increased by 36% compared to November 2008 - the third consecutive annual gain in 2009.
- In October, exports from Texas grew by 8% compared to the month before as shipments to Asia and Latin America increased on the back of improving economic conditions in these regions.
- According to the 2009 Milken Institute Best-Performing Cities Index, four out of the top five large and top five small U.S. metros are in Texas.

Economy

We are starting to see evidence that recent improvements in the U.S. economy may be finally reaching the labor market. November's data showed a significantly slower pace of job losses, with nonfarm payrolls falling by only 11,000 - the smallest decline in two years (see chart 1). In addition, in December, the 4-week moving average of seasonally adjusted initial unemployment claims dropped to its lowest level since September 2008 (see chart 2). This implies that companies may be reluctant to cut jobs as the economy emerges from its recent downturn. In addition, a sharp reduction of inventories (see chart 3) is supporting production as demand returns. In fact, in November, average weekly work hours grew both in goods-producing and service-providing sectors of the U.S. economy¹, a clear sign of improving economic activity. According to the Institute of Supply Management (ISM), inventories continued to decline in November and new orders remained on the uptrend both in the manufacturing and non-manufacturing sectors.² These trends add momentum to future output and employment gains.

In November, the Conference Board Consumer Confidence Index inched up to 49.5 on the back of improving short-term expectations. In essence, concerns over job security may be easing, which supports a brighter outlook for consumer spending. In addition, consumers are benefiting from improving non-wage incomes. In October, personal interest and dividend income (about 15% of personal income) grew by 0.3% versus September, following 12 consecutive months of decline. Proprietors' income, another 9% of personal income, has been growing since April, which may imply that recession pressures on small business owners are receding. And, in November, retail sales were up by 1.3% versus October - the second consecutive monthly gain. Retail sales, excluding auto purchases, have been growing since July. More than that, in November, retail sales and non-auto sales registered their first annual gain in 2009.

Turning to Texas, there are more and more signs that the local economy is stabilizing. November's Texas Manufacturing Outlook Survey, published by the Dallas Fed, reported a positive production index for the first time since July 2008. Other manufacturing indices (such as capacity utilization, inventories, new orders and the average workweek) also point to a gradual pickup in demand. In November, ISM's Houston Purchasing Managers Index grew to 51.2%. This means that manufacturing in Texas has been in recovery mode for the last three months. Indeed, cautious optimism is present in the latest Dallas Beige Book where most businesses reported stable conditions. The Dallas Fed Texas Leading Index has been growing since June, supported by stronger energy prices, a weaker dollar, lower initial unemployment claims and increasing weekly work hours in manufacturing. Lastly, in October and November Texas added 70,000 new jobs, following two consecutive months of job cuts.



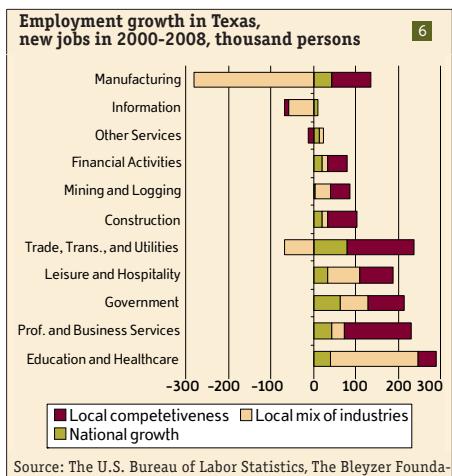
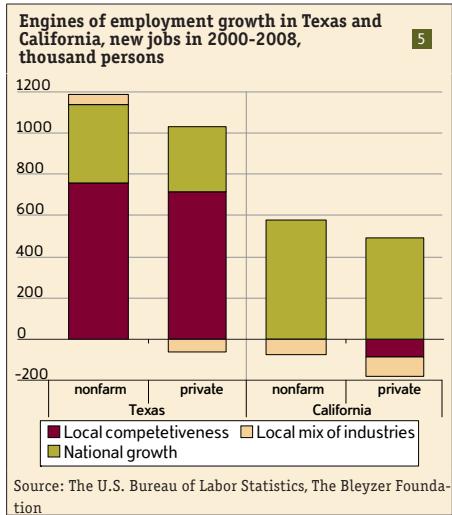
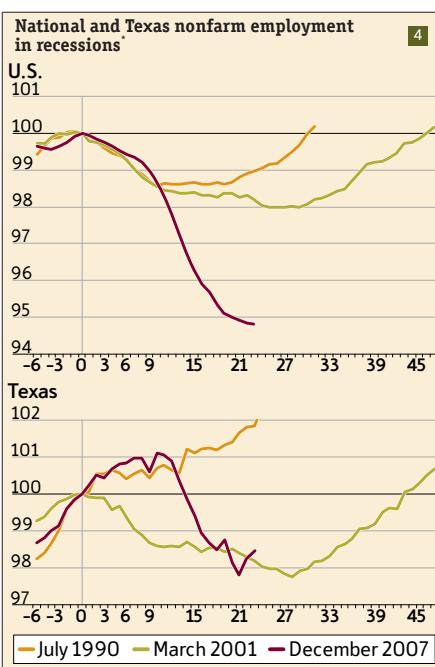
¹Source: The Federal Reserve System.

²According to the U.S. Department of Commerce, in October, new orders for manufacturing goods increased by 0.6% compared to the month before - the sixth monthly gain in the last seven months. Shipments of manufacturing goods were up by 0.8%, while inventories decreased by 0.1% - the tenth consecutive monthly decline.

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Employment

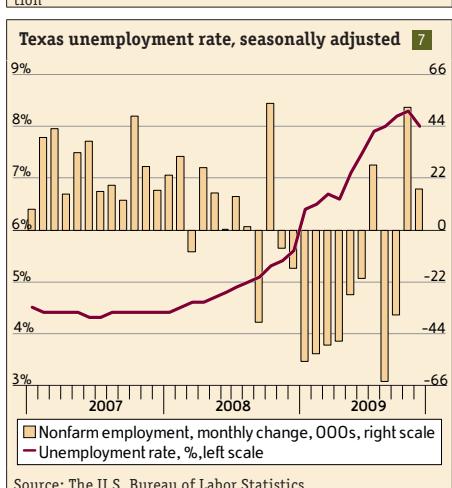
We believe a stronger national recovery will add momentum to employment growth in Texas. Indeed, during the last downturn, Texas returned to its pre-recession employment level faster than the U.S. economy as a whole (see chart 4). The state's capacity to create jobs is supported by the growing willingness of business and people to relocate to Texas. This means jobs lost in other states are increasingly likely to be moved to Texas, as companies aggressively look for sustainable cost reduction strategies. Indeed, according to our "shift - share" analysis, 760,000 jobs (or nearly 2/3rd of the 1.2 million new nonfarm jobs created in Texas during 2000-2008) can be attributed to better competitiveness of the local economy.³ Meanwhile, over the same eight years, nonfarm employment in California grew by only 505,000 - and only due to growth of the U.S. economy (see chart 5). More than that, California lost nearly 90,000 jobs as its private sector became less competitive, while the improving business climate helped Texas add over 700,000 private jobs.



According to the employment projections published by the U.S. Bureau of Labor Statistics in November, service providing industries will remain the main source of new employment in the US, creating nearly 15 million jobs by 2018. Professional and business services, healthcare, and education are anticipated to show the highest rate of job gains. These projections bode well for Texas, which has an employment mix and other structural advantages that favor job creation in these particular industries (see chart 6).

In November, the unemployment rate in Texas fell to 8%, following two consecutive months of job gains (see chart 7). The state's unemployment rate remains 2 percentage points below the 10% national rate and is lower than the unemployment rate in most other large states: for example, Pennsylvania (8.5%), New York (8.6%), Massachusetts (8.8%), Florida (11.5%), and California (12.3%). Compared to November 2008, Texas lost about 272,000 jobs or 2.55% of its nonfarm payroll - the second smallest percentage loss among the 10 largest states.⁴

In November, 7 out of 11 industries added jobs in Texas, including business and professional services, government, financial activities, leisure and hospitality, healthcare, and education. The pace of job losses slowed in construction, while mining added a re-



³Shift-share analysis of non-farm employment provides strong evidence of Texas' competitive advantage. This statistical tool is applied to separate local growth factors from national growth factors. For example, when analyzing local employment dynamics, shift-share analysis can be used to break the employment change into three components: (1) growth driven by the expanding national economy, (2) growth related to the mix of faster or slower than average growing industries, and (3) growth attributable to the competitive nature of the local economy.

⁴These 10 states also include California (-4.2%), New York (-2.4%), Florida (-3.7%), Illinois (-4.3%), Pennsylvania (-2.9%), Ohio (-3.7%), North Carolina (-3.8%), New Jersey (-2.6%), and Georgia (-4.7%), and account for over 55% of all U.S. nonfarm employment.

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cord high 5,100 new jobs in November. The unemployment rate in the five largest Texas metro areas remains below the national average (see chart 8). More than that, in October, the Texas civilian labor force grew at the fastest pace versus all other states⁵. Indeed, according to the 2009 Milken Institute Best-Performing Cities Index, which measures how well cities sustain and support jobs and economic growth, four out of the top five large and top five small U.S. metros are in Texas.

Texas' employment outlook remains favorable as the data increasingly points to improving national and global economic conditions. A stabilization of energy prices (the WTI Cushing spot price nearly doubled since the beginning of the year) helps the local economy as well. On the downside, jobs in construction and manufacturing may take longer to recover as commercial and residential real estate markets, albeit gradually improving, are still weak. Nevertheless, solid gains in service providing industries will continue to offset job losses in goods producing sectors of the Texas economy.

Residential housing activity

Notwithstanding a 10% monthly drop in home sales in November, there are signs that the residential real estate market is stabilizing in Texas. According to the Real Estate Center at Texas A&M University, home sales have been posting annual gains since August, increasing by 36% versus November 2008. In addition, average home prices grew by nearly 3% in November - the first annual increase since July 2008. Meanwhile, the housing supply continues to dwindle with months of housing inventory falling to 6.7 months (see chart 9).

Compared to other U.S. states, the Texas housing market continues to fare well. According to the S&P/Case-Shiller Home Price Index, in September the annual decline of home values in Dallas was only 1.2% versus 9.4% nationwide. Indeed, home values in Texas lost only 5% from their peak levels in 2007, while home prices in the largest U.S. metros sustained considerably larger losses from their peaks in the second quarter of 2006.⁶

Finally, mortgage lenders are defaulting less frequently in Texas, adding strength to local housing markets. According to the Texas Comptroller of Public Accounts, in November 2009, only one in 780 mortgages were in foreclosure in Texas, compared to substantially higher foreclosure rates in Nevada (one in 119), Florida (one in 165) and California (one in 180). This trend is supported by more resilient labor markets as well as a healthier subprime segment of the housing sector (see chart 10). In particular, the average balance on subprime loans in Texas is only \$97,000 compared to \$318,000 in California.⁷ The share of subprime loans obtained with little or no verification of the borrowers' income and assets exceeds 40% for owner-occupied homes in Nevada, California, New York and New Jersey. In Texas, such loans account for less than 30%. Furthermore, nearly 44% of all subprime loans in Texas were originated for the purchase of a property - the highest percentage among all states. In contrast, over 60% of all subprime loans in California, Arizona and Florida were originated as

⁵According to the Bureau of Labor Statistics, in October, the Texas civilian labor force increased to 12.07 million persons or by 2.2% versus October 2008.

⁶For example: Las Vegas (-56%), Phoenix (-53%), San-Francisco (-40%), Miami (-46%), New York (-19%) or Seattle (-15%).

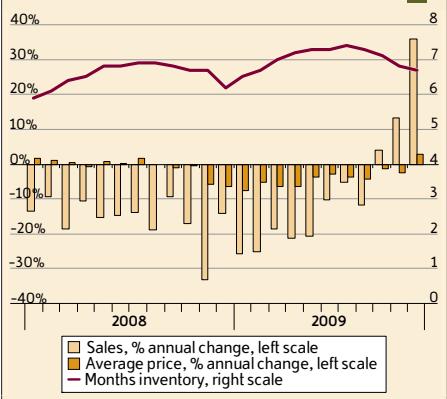
⁷Source: The Federal Reserve Bank of New York, Nonprime Mortgage Conditions in the United States.

Unemployment in the five largest metros of Texas and California, October 2009

	% of state's labor force	annual change of the labor force	unempl. rate, %
CALIFORNIA			
Los Angeles-Long Beach-Santa Ana	35.6%	-1.8%	11.9
San Francisco-Oakland-Fremont	12.3%	-1.2%	10.6
Riverside-San Bernardino-Ontario	9.7%	-0.8%	14.6
San Diego-Carlsbad-San Marcos	8.5%	-1.3%	10.5
Sacramento-Arden-Arcade-Roseville	5.7%	-1.7%	12.3
TEXAS			
Dallas-Fort Worth-Arlington	26.7%	2.2%	8.3
Houston-Sugar Land-Baytown	23.6%	1.2%	8.5
San Antonio	8.1%	2.2%	7
Austin-Round Rock	7.5%	3.3%	7.2
El Paso	2.6%	2.9%	9.5

Source: The U.S. Bureau of Labor Statistics

Texas home sales



Source: The Real Estate Center at Texas A&M University

Owner-occupied homes in foreclosure, October 2009

	Subprime	Alt-A	Bankruptcy rate*
Arizona	14.3%	10.0%	4.7
California	15.3%	12.0%	5.2
Florida	30.4%	28.3%	4.9
Illinois	15.7%	13.5%	5.4
Massachusetts	14.0%	10.1%	3.0
North Carolina	6.3%	3.9%	2.9
North Dakota	8.3%	2.6%	2.5
New Jersey	23.7%	17.1%	3.9
Nevada	17.1%	14.1%	10.5
New York	18.0%	13.0%	2.8
Texas	5.2%	2.0%	2.1
U.S.	13.6%	11.4%	4.5

* Total Chapter 7 and Chapter 13 bankruptcy filings per thousand population.

Source: The Federal Reserve Bank of New York, The Administrative Office of the U.S. Courts

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cash-out refinancing, which means that a fraction of those loans was used to finance other spending. All this means that households in Texas are experiencing less financial stress due to sounder borrowing practices.

Foreign trade

Between January-October, Texas exports stood at \$132.6 billion (19.6% lower than a year ago). Essentially, lower global commodity prices remain a drag on Texas export of industrial and agricultural commodities.⁸ That being said, exports of industrial machinery and computers (the largest component of Texas exports) fell by only 12%, while exports of aircraft equipment grew by 30%. We expect Texas to continue to benefit from its diverse and broad base of manufacturing industries as foreign demand for industrial products returns. Furthermore, the accelerating recovery in developing economies adds strength to the outlook for Texas exporters (see chart 11). In particular, exports to Mexico, China, Singapore and Korea (which jointly account for over 45% of all exports from Texas) declined by only 12%, while exports to Canada (about 1/5th of all exports) dropped by over 30%. On the upside, a rebound of the global economy supports higher energy prices and encourages demand for manufacturing goods. This bodes well for Texas thanks to the geographical orientation and product composition of the state's exports.⁹



⁸For example, Texas exports of mineral fuels, iron and steel and cereals were down by 21.6%, 16.3% and 59.7% respectively.

⁹Over 60% of all exports from Texas goes to developing economies, while industrial and electric machinery, computers, vehicles and aircraft account for about 45% of exports.