

January 2010

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Executive Summary

Economic data continues to suggest a bottoming out of the current recession in Texas. Indeed, manufacturing in the Houston area is starting to recover, with the Houston Purchasing Managers Index returning to positive levels in the last quarter of 2009. Additionally, the latest Dallas Beige Book confirms improving demand in high-tech manufacturing and retail. Demand conditions appear to have stabilized in other sectors as well, providing a more optimistic outlook for the Texas economy.

The Texas Leading Index of Economic Activities, released by the Dallas Fed, has been posting gains since June 2009. These gains have been mostly driven by higher oil prices and a slower pace of job losses. Meanwhile, Texas Metro Business Cycle Indices indicate that many metro economies are already turning the corner, while recession pressures in other metros are receding. And, according to the Brookings Institution, three Texas metros had already bounced back to their pre-recession output levels by the third quarter of 2009.

Despite an improving outlook for output growth, unemployment is still a challenge. In December, Texas lost about 24,000 jobs as difficulties persisted in trade, transportation, leisure and hospitality, and professional & business services. In spite of these losses, the Texas unemployment rate is nearly 2 percentage points below the national average. In fact, our estimates show that last year Texas lost 16% fewer jobs than it would have if it had a similar industry mix to other comparable large U.S. states. We believe a favorable industry mix, and the greater resilience of the Texas economy, will support a relatively faster return to pre-recession economic activity and employment levels than the U.S. as a whole.

Housing activity in Texas remains well below its pre-recession level, despite the implementation of the

first-time buyer tax credit program. According to the Real Estate Center at Texas A&M University, existing home sales fell by 8% in 2009. Residential housing permits more than halved, while the construction sector continued to shed jobs, accounting for about 40% of all non-farm jobs lost in 2009.

Still, residential housing activity does show some signs of revival in the largest Texas metros, and the inventory of unsold previously-owned homes has been shrinking since January 2009. According to the National Association of Realtors, home prices and sales grew in Dallas, Houston and San Antonio in December 2009. The Dallas component of the S&P/Case-Shiller Home Price Index fell by less than 5% from its peak in early 2007, compared to a 28% drop in the national indices. This means Texas metros are still the least affected by falling home prices. However, we expect that the overall housing market recovery will be slow due to tight credit and weak labor markets. That said, faster population and economic growth in Texas should support an earlier housing turnaround. Indeed, in 2009, nearly 40% of all single family housing permits issued in the 20 largest U.S. metros were in Houston, Dallas, Austin and San Antonio.

Growing demand for high-tech manufacturing and higher oil prices helped Texas remain the largest exporting state in the U.S. for the 8th consecutive year. In the first 11 months of 2009, exports from Texas fell by only 18%, compared to a 21% decline nationwide. As a result, the Texas share of total U.S. exports grew from 12% in 1999 to over 15% in 2009. Meanwhile, California's share (the second largest U.S. exporting state) fell from 14% to about 11%. This resilience of Texas exporters should help keep the state's economy on more sustainable footing as the U.S. economic recovery becomes increasingly dependent on the strength of foreign demand.

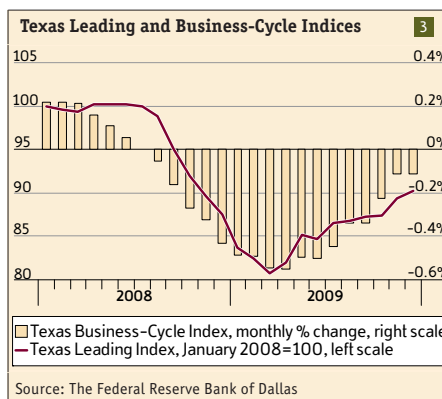
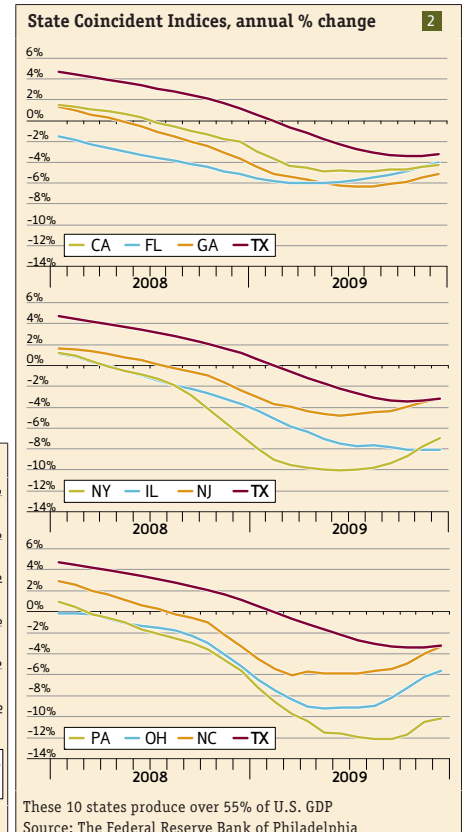
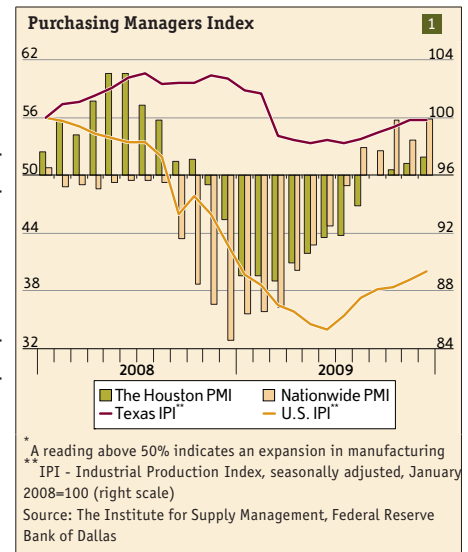
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Economic Growth

The Houston Purchasing Managers Index approached 52% in December - its highest level in 16 months (see chart 1). This index was in positive territory throughout the last quarter of 2009, which means Texas manufacturing is gradually turning the corner - helped by returning foreign demand and inventory restocking. The latest Dallas Fed Texas Manufacturing Outlook Survey confirms that manufacturing continued to expand in January 2010. Business activity and company outlook indices reached their highest levels since mid-2007. At the same time, employment data remains mixed. In particular, the Future Employment Index has been increasing since July 2009, indicating that companies may start hiring more workers in 2010. However, the Current Employment Index is still negative, albeit improving since the beginning of 2009, implying that a slow labor market recovery may be under way. While the pace of job cuts has decelerated and weekly hours worked in manufacturing have increased, businesses are still cautious to hire more workers, which means employment will generally continue to trail output growth.

In January, the Federal Open Market Committee acknowledged that U.S. economic activity continues to strengthen. The Philadelphia Fed's State Coincident Indices, which allow for a cross-state comparison of current economic conditions, point to a bottoming out of the economic downturn in the largest U.S. states (see chart 2). According to these indices, Texas entered the recession later and experienced a relatively milder economic correction versus other major regional U.S. economies. Additionally, the Texas Leading Index of Economic Activities and Texas Business-Cycle Index show signs of an economic turnaround (see chart 3). In particular, crude oil prices nearly doubled in 2009, adding strength to the Texas energy sector. In December, well permit applications and the rotary rig count in Texas grew by 113% and 45%, respectively, after hitting 8-year lows in mid-2009.

Lastly, according to Texas Metro Business Cycle Indices, economic activity in Dallas and Ft. Worth-Arlington began to grow in the last quarter of 2009. The Brookings Institution ranks Austin as the strongest metro area out of America's 100 largest metropolitan economies. Dallas, El Paso, Houston and San Antonio are all among the 20 best performing metros. This economic resilience is evidenced by relatively modest output and employment declines and strong house prices.¹

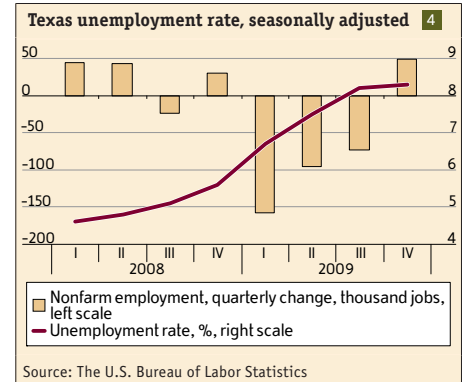


¹According to Brookings' estimates, in the third quarter of 2009, just 5 out of the 100 largest U.S. metros returned to their pre-crisis output levels. Three of these five metro areas are in Texas: Austin, San Antonio and McAllen.

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Employment

In December, Texas lost 24,000 jobs due to continued layoffs in the construction, trade & transportation, and leisure & hospitality sectors. As a result, the unemployment rate inched up to 8.3%, which is still well below the 10% unemployment rate nationwide. Despite job losses in December, Texas still managed to add nearly 50,000 new jobs in the last quarter of 2009 (see chart 4) as the hiring of new workers resumed in mining, and in financial, professional and business services. At the same time, education, healthcare and the government sector continued to post solid job gains. In manufacturing and trade & transportation, the pace of job losses has eased. Both sectors shed about 3,000 jobs each in the last quarter of 2009, or ten times less than in the first quarter of 2009.



The Texas labor market continues to fare relatively well compared to other large U.S. states. In 2009, Texas lost 276,000 jobs or 2.6% versus 3.1% nationwide (see chart 5). Texas still boasts the lowest unemployment rate among the 10 largest states, even though its labor force grew by 2% in 2009.²

	2008-2009 empl. change		Peak employment		Un. rate, Dec. 2009	Labor force, % change 2008-2009
	th. jobs	%	date	% change by Dec. 2009		
California	-579.4	-3.9%	Jul-07	-6.9%	12.4%	-1.8%
Florida	-232.4	-3.1%	Mar-07	-9.0%	11.8%	-1.7%
Georgia	-173.9	-4.3%	Sep-07	-7.6%	10.3%	-3.7%
Illinois	-237.3	-4.1%	Jan-08	-6.4%	11.1%	-0.5%
New Jersey	-90.1	-2.3%	Jan-08	-4.4%	10.1%	0.4%
New York	-168.6	-1.9%	Jul-08	-3.3%	9.0%	-0.7%
North Carolina	-124.2	-3.1%	Feb-08	-6.0%	11.2%	-1.2%
Ohio	-184.9	-3.5%	Jun-07	-6.5%	10.9%	-1.3%
Pennsylvania	-150.3	-2.6%	Jan-08	-3.8%	8.9%	-2.0%
Texas	-276	-2.6%	Oct-08	-2.8%	8.3%	2.0%
U.S.	-4164	-3.1%	Dec-07	-5.2%	10.0%	-1.0%

Source: The U.S. Bureau of Labor Statistics

Texas employment conditions started to deteriorate much later compared to other large states, which is another reason to be optimistic about the state's employment outlook. A recent downturn in mass layoffs and initial claims for unemployment insurance (both in Texas and nationwide) implies that labor markets are nearing a turning point. This means peak-to-trough employment losses are likely to remain relatively smaller in Texas compared to other large states. Moreover, this 'head start' over other states with substantially larger employment declines will help Texas recoup lost jobs faster as economic recovery gains momentum.

	2007-2009			2008-2009		
	CA	TX	FL	CA	TX	FL
Number of jobs lost	-1041.3	-182.5	-607.6	-579.4	-276.0	-232.4
Number of jobs that could have been lost if the state's labor market were identical to the U.S.*	-796.2	-552.4	-416.8	-454.0	-327.7	-233.6
A difference between the number of jobs that could have been lost if the state's labor market were identical to the U.S. and the actual number of jobs lost	-245.1	369.9	-190.8	-125.4	51.7	1.2
Unemployment rate if the state's labor market were identical to the U.S.**	11.0%	11.3%	9.8%	11.7%	8.7%	11.8%
State unemployment rate in December 2009	12.4%	8.3%	11.8%	12.4%	8.3%	11.8%

* Calculated by multiplying each state's employment level at the beginning of the period by the rate at which the U.S. employment declined during that period.
 ** Calculated by adding the number in the third row of this table to the state's pool of unemployed workers at the end of 2009.
 Source: The U.S. Bureau of Labor Statistics, The Bleyzer Foundation

Interestingly, if Texas had been losing jobs at the same rate as the overall U.S. economy, its non-farm employment would have declined by 52,000 more in 2009 than it actually did. And, if Texas had experienced a recession of the same magnitude and duration as the overall USA, its unemployment rate would have exceeded 10% by the end of 2009 (see chart 6). Instead, the more favorable mix of recession-proof industries - such as education, healthcare and government - has shielded the Texas labor market from the recession pressures experienced by many other states.

²By widening the pool of unemployed workers, this higher labor force growth may have added up to a percentage point to the Texas unemployment rate in 2009.

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Housing Market

Tight access to credit and difficult employment conditions have taken their toll on residential housing activity in Texas. According to the Real Estate Center at Texas A&M University, in 2009 existing home sales fell by 8.4% following a 15% drop the year before. A tax credit for first-time homebuyers, which was extended in November 2009, may have added some strength to demand for housing in the last quarter of 2009 (see chart 7). However, as homeowners rush to take advantage of low mortgage rates and the tax credit, we expect demand for new homes to slump when these incentives expire. A sustainable housing recovery relies on employment growth and a resumption of mortgage lending, both of which are currently in their nascent stages.

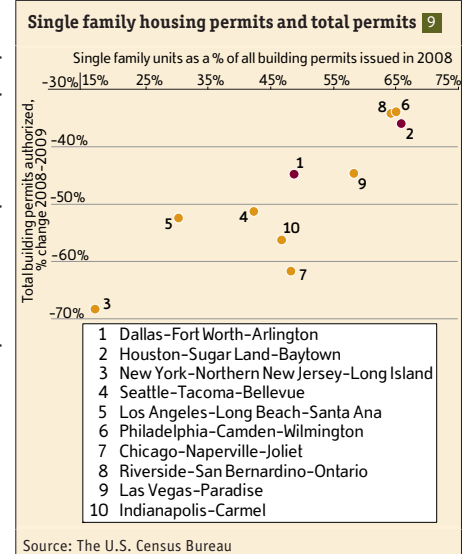
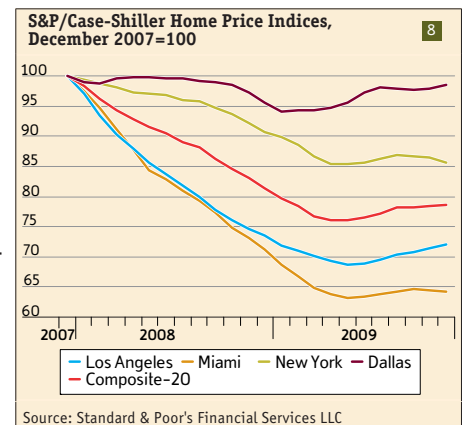
Despite weak home sales, the S&P/Case-Shiller Composite-20 Home Price Index has been posting monthly gains since June 2009 (see chart 8). Home prices in some large U.S. metros registered modest gains in 2009, while the Composite-20 index fell by only 1.3% during in the first 11 months of 2009 (compared to an 18.6% drop the year before). Having said that, it is important to note that this index is still nearly 30% below its 2006 level.

Since home prices remain considerably below their pre-crisis levels, in 2010 more and more homeowners may end up with mortgages exceeding the value of their homes. This, in addition to a slow recovery in labor markets, may keep foreclosure rates high, restricting price gains in the housing market. Indeed, according to RealtyTrac, about 2.8 million properties were in foreclosure in 2009 - a 21% increase over the prior year. The top 20 metro foreclosure rates were in states which suffered the largest declines of home values - California (9 metros), Florida (8 metros), Nevada (2 metros) and Arizona (1 metro)

Fortunately, the housing situation in Texas is far less grim. Home prices stayed mostly flat and, according to First American CoreLogic, only 11% of Texas homeowners with mortgages were in a negative equity position in the third quarter of 2009. This compares to 65% in Nevada, 48% in Arizona, 45% in Florida, 35% in California and 23% nationwide. Additionally, Texas has one of the fastest population growth rates in the U.S., which should sustain long-term demand for housing in this part of the country.³ Indeed, Texas is emerging as one of the most active residential housing markets nationwide. According to the U.S. Census Bureau, about 27% of all new privately owned housing units authorized in the 20 largest US metros in 2008 and 2009 were located in Dallas and Houston.⁴ Furthermore, over the last two years, Dallas and Houston accounted for 30% of all single family building permits issued in the 20 largest U.S. metros. Indeed, lower land costs and better land availability in Texas favor single family housing development. This has helped the state to benefit from the relatively stronger demand for single family dwellings (see chart 9).

	Home sales, units			Av. price
	2009 vs. 2008	Q4 2009 vs. Q4 2008	Dec. 2009 vs. Dec. 2008	Dec. 2009 vs. Dec. 2008
Texas	-8.4%	16.6%	1.1%	5.6%
Austin	-7.0%	31.4%	7.3%	5.0%
Dallas	-10.4%	12.9%	1.6%	2.4%
Houston	-8.0%	14.5%	-1.0%	13.3%
San Antonio	-3.7%	24.3%	6.5%	1.3%

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



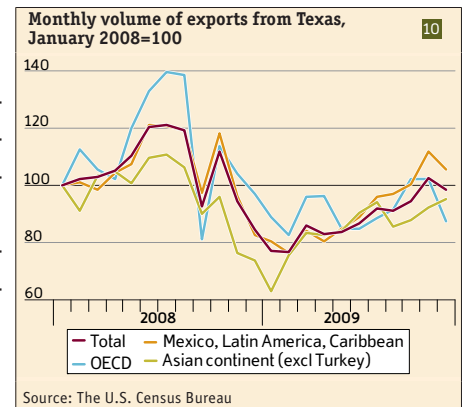
³According to the latest estimates of the U.S. Census Bureau, thanks to net domestic migration and high birth rates, Texas leads the nation in terms of net population gains for the fourth consecutive year.

⁴New York's share fell from 18% in 2008 to 9.4% in 2009.

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Foreign Trade

A resumption of foreign demand for manufacturing goods, and higher oil prices, helped support Texas exports in 2009. During the first 11 months of the year, Texas exports fell by only 17.7% versus a 21% decline nationwide. Furthermore, among the 10 largest exporting states, only Florida posted a smaller decline in exports (about 15%). This can mostly be attributed to a doubling in exports of precious metals to Switzerland as gold prices soared. Obviously, this one-off gain in Florida does not represent a sustainable improvement in manufacturing competitiveness. By contrast, Texas has a wide range of manufacturing products, exported to a broad number of fast growing developing countries (see chart 10).



Private Equity Investments - 2009 summary

Last year, approximately \$3 billion was invested in Texas-based companies by private equity and venture capital funds - a 47% drop from 2008 levels (see chart 11). This reflects tightness in financial markets and a high degree of risk aversion. In 2009, energy companies, mostly located in Dallas and Houston, were the principle targets of private equity firms investing in Texas (see chart 12). Still, the state's potential for private equity investment remains high. Indeed, while the Texas economy is smaller than California's economy by only one third, in 2009 the total amount of private equity investment in California was more than 6 times that in Texas. We believe a gradual return of investors' appetite for risk and a better performing local economy should help revive private equity activity in Texas in 2010, particular in the distressed, mid-market buyout space.

