

April 2010

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- The U.S. economy expanded for the third consecutive quarter.
- The Houston Purchasing Managers Index increased for the seventh straight month in March, reaching its highest level since September 2008.
- The March Texas Leading Index was up by 14% compared to its 18-year low a year ago.
- The March unemployment rate in Texas remained unchanged at 8.2%.
- Existing home sales in Texas improved in Q1, with housing prices staying firm.
- Texas was ranked by Chief Executive Magazine as the best state for job growth for the sixth year in a row.

### Executive Summary

In the first quarter of 2010, U.S. GDP grew at an annualized rate of 3.2% (the third straight quarter of economic recovery). While the contribution from inventory rebuilding has been declining, both improving sales and lean inventory will continue to sustain economic growth in 2010. Stronger foreign demand for U.S. goods is also driving improvements in industrial production; while purchasing manager's indices point to continuing expansion in factory activity.

In March, Texas industry posted its first annual gain following twelve consecutive months of falling output. However, the peak-to-trough duration and depth of the decline in industrial activity was still much milder in Texas versus the U.S. as a whole. During this contraction (which stretched for 18 months in the U.S. compared to only 10 months in Texas), U.S. industrial activity declined by approximately 15%, while Texas industrial activity dropped less than 5%. This resilience was due in part to less exposure by Texas manufacturing to durable consumer goods plus a higher reliance on exports. Texas not only exports high technology products and industrial machinery to faster growing emerging markets, but also has a strong competitive advantage in petrochemical manufacturing. Strong demand for chemicals and energy products, combined with competitive local input costs helped shield Texas from output declines in nondurable manufacturing. Additionally, higher oil prices supported a swift rebound in the Texas mining industry.

As has been noted in prior reports, the Texas housing market did not participate in the national boom-and-bust cy-

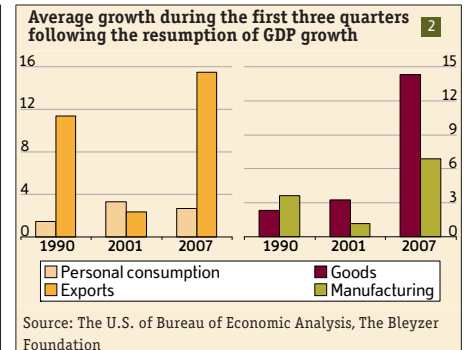
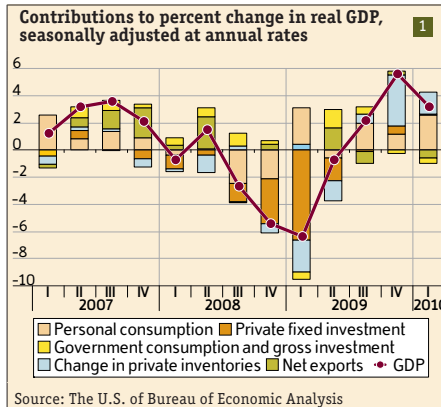
cle. Thus, the combination of a stable housing situation, higher commodity prices, and a diverse economy with significant exposure to faster growing international markets added resilience to the Texas labor market. In March, the unemployment rate in Texas remained unchanged at 8.2%, giving Texas the lowest unemployment rate among the largest U.S. states. Although the state has been steadily adding jobs in mining and manufacturing since the beginning of this year, jobs in retail, construction and business services (sectors that depend more on the strength of domestic economy rather than exports) remain under pressure. On the upside, in April and May, initial and continued unemployment claims declined in Texas, implying that the employment situation in the state is gradually improving.

That said, several downside risks to the Texas economic outlook still remain, including increased volatility of commodity prices, slower growth in emerging markets and fiscal consolidation in developed countries. Despite this, we believe the regional economy remains well positioned to resume strong and sustainable growth. Texas is a well diversified economy with low taxes, a business-friendly regulatory framework, and world class infrastructure. In addition, relative to other large states, Texas has a modest debt burden and can cover its budget shortfall with funding from the \$8 billion Economic Stabilization Fund. A healthier public sector will help Texas to maintain its competitive advantages in the future. Indeed, this year Chief Executive Magazine ranked Texas as the top state for job growth and business development for the sixth consecutive year.

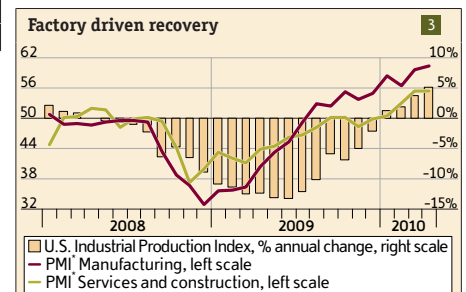
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## Economic Growth

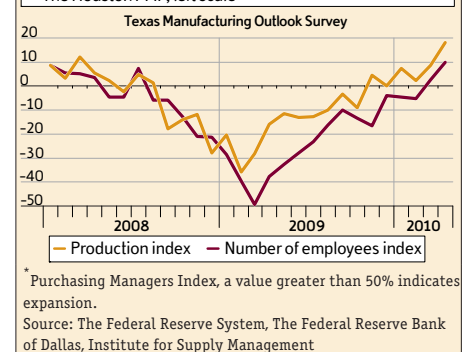
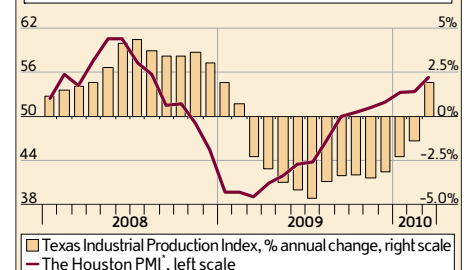
According to estimates by the U.S. Bureau of Economic Analysis, GDP grew at an annualized rate of 3.2% in the first three months of 2010. The economy expanded for the third consecutive quarter, although the rate of inventory replenishment has slowed (see chart 1). That said, the ratio of business inventories to sales, calculated by the U.S. Census Bureau, slipped to a record low of 1.24 in March. This means that businesses continue to add inventories at a slower pace than their sales are recovering. According to the Institute for Supply Management (ISM), April was the 10<sup>th</sup> consecutive month of growth in new orders, while the ISM Customers' Inventories Index indicates that businesses supplied by U.S. factories are running on very lean inventories. Meanwhile, in the first quarter of 2010, the value of manufacturers' shipments and new orders were up by 7.7% and 12.1%, respectively, versus the same quarter a year ago. The data, therefore, implies that returning consumer demand and tight inventory levels will add strength to the economic recovery. Indeed, the economy appears to be driven by a swift turnaround in manufacturing as foreign demand for U.S. goods improves. A comparison of this recent recession with past economic downturns shows that this time, the first three quarters of resumed economic growth has come with a stronger rebound of factory activities and exports (see chart 2).



This factory recovery continued in April as both national and Texas industrial production indices remained on an uptrend (see chart 3). In particular, in March, Texas industry posted its first annual gain following twelve consecutive months of falling output. Meanwhile, it has taken 20 months for total U.S. industry nationwide to start growing again. In fact, the peak-to-trough decline in U.S. industry stretched for 18 months (versus only 10 months in Texas) with output falling by about 15% (versus less than 5% in Texas).



Several factors may explain this shorter duration and milder contraction of industrial activity in Texas. First, the peak-to-trough decline in Texas manufacturing was only 3.1% versus 16% nationwide. This large contraction was principally caused by a 23% drop in the production of durable goods from December 2007 to June 2009, as consumer and business demand collapsed (production of durable consumer goods fell by over 30%, while the automobile industry shrank by 48%). In contrast, Texas durable goods manufacturing declined by roughly 10% due to the fact that Texas has a higher percentage of manufacturing exports compared to the U.S. as a whole. Indeed, according to the U.S. Department of Commerce, exports support the largest share of Texas jobs both in manufacturing and the regional economy compared to other big manufacturing states, such as California, Ohio, Illinois, North Carolina, Pennsylvania and New York.



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In addition, Texas exports high technology products and industrial machinery to faster growing emerging markets, particularly to Latin America and Asia (see chart 4).

The fact that, Texas is the leading crude oil and natural gas producing state in the U.S. gives the state a competitive advantage in petrochemical manufacturing (note: the Houston Ship Channel is the largest petrochemical complex in the U.S.). According to the U.S. Bureau of Economic Analysis, the share of chemical, petroleum and coal products manufacturing in nondurable manufacturing approaches 75% in Texas versus less than 50% in the U.S. as a whole. Strong demand for chemicals and energy products in emerging markets, plus competitive local input costs, helped shield Texas from overall output declines in nondurable manufacturing. In fact, Texas nondurable manufacturing grew by 2.1% and 1.7% in 2008 and 2009, respectively (versus -3% and -5.6% nationwide). Lastly, higher oil prices supported a nearly 10% growth in the Texas mining industry in March 2010 compared to the same month the year before.

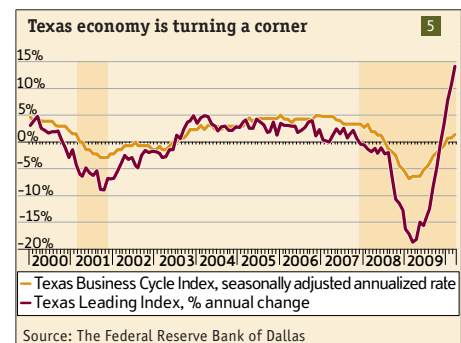
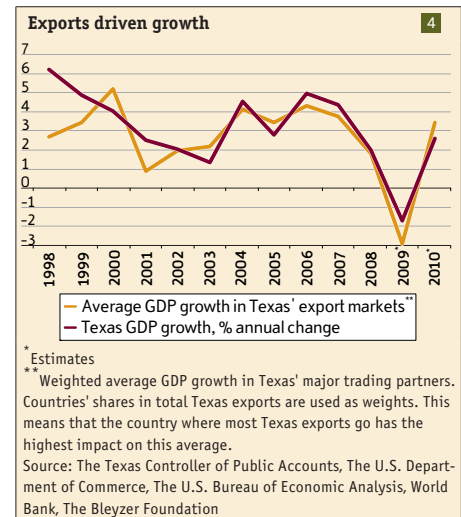
This outperformance by Texas industry supports broad-based improvements in the regional economy. Indeed, the Texas Business Cycle Index, which tracks movements in employment and GDP, has been increasing for the third straight month. Meanwhile, in March, the Texas Leading Index was up 14% compared to its 18-year low in March 2009 (see chart 5).

As noted in previous updates, the Texas housing market missed the boom-and-bust cycle that hit many other large metros in the U.S. Therefore, the wealth locked up in housing was protected from the large declines experienced by residents of California, Florida, Nevada and Arizona, for example. This combination of a stable housing situation, higher commodity prices, and a diverse export-led economy, should sustain employment gains in Texas in 2010. In fact, the latest report by Forbes ranks Austin, San Antonio, Houston and Dallas as the first, second, third and fifth best metros for job growth among large U.S. cities.

That said, several downside risks to the Texas economic outlook still remain. First, uncertainty over the strength of the U.S. and global economic recovery will keep commodity prices volatile. In May alone, WTI crude oil price dropped by over 20%. Second, emerging market growth may slow if local policy-makers raise interest rates on fears of increasing inflation. Lastly, a synchronized withdrawal of fiscal stimuli by many developed economies, which is likely once the economic recovery becomes more solidly entrenched, may pose additional downside risks to the global economy.

Still, Texas remains well positioned to resume strong and sustainable growth in the long-term. Above all, Texas has a large and well diversified economy, low taxes, a business-friendly regulatory framework, with affordable living conditions. All of which will help the state to continue to attract businesses, jobs, and talent. Chief Executive Magazine recently ranked Texas as the top state for job growth and business development for the sixth consecutive year. And, Site Selection Magazine put Texas as the third most competitive state in the nation<sup>1</sup> and the second state by the number of new corporate projects and expansions in 2009.

In terms of fiscal strength, Texas is relatively healthier than most other large U.S. states (which are generally cutting spending to bridge widening budget gaps). According to the Center on Budget Policy and Priorities, the projected FY2010 budget



<sup>1</sup>Virginia and Louisiana are at the first and second place, respectively. However, these two regional economies together are half the size of Texas.

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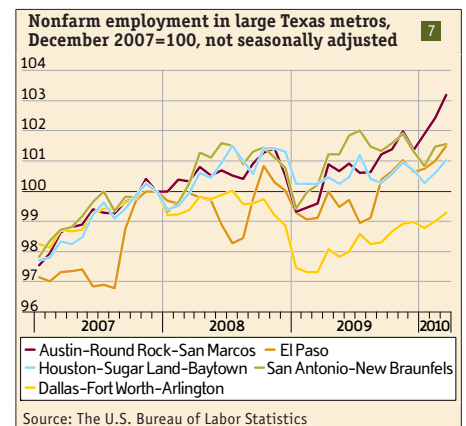
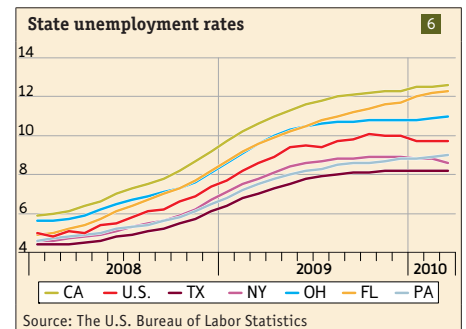
gap in Texas will likely be \$3.5 billion, or roughly 9.5% of the total general fund budget (compared to a 57% budget gap in California, 38% in New York or 23% in Florida).<sup>2</sup> However, Texas has approximately \$8 billion from the Economic Stabilization Fund that can be tapped to avoid disruption of public services. And, the state's total debt burden remains modest. According to the latest reports by the Citizens Budget Commission of New York, the outstanding long-term obligations of the state of Texas are almost five times smaller than the state's recession adjusted revenue capacity. This compares exceptionally well with such states as New York (where debt exceeds revenue capacity), California (where the state's debt is 60% of its revenue capacity) or New Jersey (where debt exceeds revenue capacity by nearly 50%). We believe Texas' relatively healthy public finances will help Texas maintain the state's competitive advantage well into the future.

## Employment

The employment situation is improving both in Texas and in the U.S. In March, the unemployment rate in Texas remained unchanged for the fifth straight month (at 8.2%), while the unemployment rates in other large states continued to move upward. In addition, during this recession Texas has maintained the lowest unemployment rate among the largest U.S. states (see chart 6).

In March, Texas created 8,500 new jobs thanks to increasing employment in mining (up by 6,100 jobs), manufacturing (2,100 jobs), leisure and hospitality (10,300 jobs), and continued job growth in education, health care, and government. Meanwhile, construction, retail trade, and business services lost 22,500 jobs. These employment trends reflect the ongoing economic recovery, which favors commodity producers and export-oriented manufacturing. At the same time, sectors that depend on domestic demand remain under pressure. On the upside, in April and May, initial and continued unemployment claims decreased in Texas, reinforcing the argument that the employment situation in the state is gradually improving.

At the metro level, three out of the 25 metropolitan areas in Texas had unemployment rates higher than 10% in March compared to none a year ago. Still, employment in large Texas cities has been recovering since the beginning of 2010 (see chart 7). This makes Texas metros appear much healthier relative to many large U.S. cities with double-digit unemployment rates (particularly in California, Florida and Ohio).



## Housing Market

The housing market appears to have stabilized, partially due to the home buyer tax credit. According to the Real Estate Center at Texas A&M University, in March, home sales in Texas grew by 16% compared to a year ago, while home values remained firm, posting annual gains of about 5%. Nationwide, increasing housing sales and prices signal an improving residential real estate market overall (see chart 8), which should support construction activity (see chart 9) and an increase in the issuance of housing permits in the U.S. going forward.

Historically low mortgage rates and more affordable house prices should support housing markets as the first-time home buyer tax credit expires. Still, local markets that were hardest hit by the housing bust may face a prolonged recovery as more homeowners fail to service their debt. In fact, according to the Mortgage Bankers Association, in the first quarter of 2010, over 10% of all mortgages were late (up from 9.5% at the end of 2009). Yet, according to RealtyTrac, only one in 730 housing

<sup>2</sup>According to the National Conference of State Legislatures, by 2013, a combined budget gap of the U.S. states may exceed \$531 billion.

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units in Texas was in foreclosure in April (compared to one in 69 in Nevada, one in 181 in Florida, and one in 192 in California). Texas still has the lowest share of subprime loans undergoing foreclosure procedures. According to the Federal Reserve Bank of New York, in February, 5.5% of all owner occupied properties financed with subprime loans were in foreclosure in Texas versus approximately 14% nationwide. Therefore, we believe that, due to better initial conditions, the Texas housing market recovery should become self-sustained faster (relative to other large states) once employment growth strengthens.

### Texas Private Equity News Summary

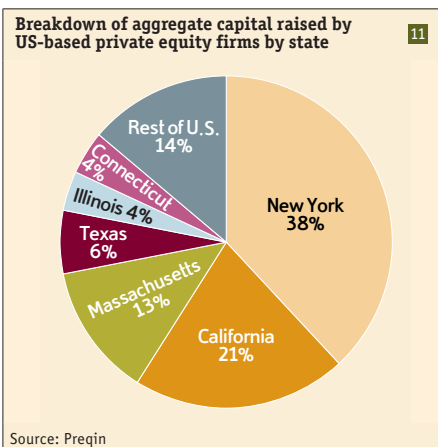
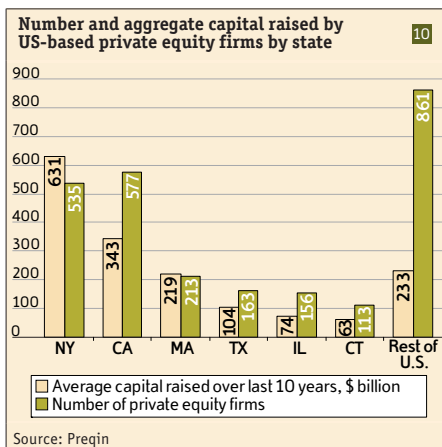
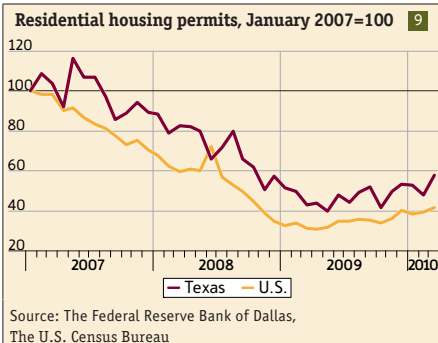
According to a recent study by Preqin, an alternative asset research firm, there are over 2,600 private equity firms headquartered in the US, and over two-thirds of these are located within six states. New York, California, Massachusetts, Texas, Illinois and Connecticut are the biggest states in terms of number of private equity firms and the amount of capital raised by such firms over the last 10 years (see chart 10). Firms primarily based in these six states have raised over \$1.4tn in aggregate capital over the last decade, over 85% of the total funds raised by primarily US-based private equity firms during that period.

With more than 570 firms headquartered in the state, California is home to the largest number of private equity firms in the US and these firms have raised the second-largest amount of capital. New York is the second-most populated state in terms of private equity firms and its 535 firms have raised the largest amount of capital over the last 10 years. The \$630bn raised by private equity firms in New York is equivalent to 38% of the aggregate capital raised by all primarily US-based private equity firms in the last decade (see chart 11). Primarily US-based firms are responsible for raising approximately \$1.7tn over the past 10 years and firms based in either New York or California account for 59% of this, or \$974bn. The state of Massachusetts is home to 213 private equity firms. Texas, Illinois and Connecticut are home to 163, 156 and 113 private equity firms respectively and together have raised funds totaling \$241bn over the last decade.

**Median home prices and existing home sales in March 2010, annual change** 8

	Median price	Home sales
Atlanta	-2.3%	7.0%
Baltimore	-3.5%	18.9%
Boston	13.9%	25.9%
Cincinnati	9.6%	16.0%
Dallas	4.7%	12.6%
Houston	6.0%	11.0%
Indianapolis	9.3%	11.0%
Kansas City	4.4%	11.5%
Miami/Ft. Lauderdale	3.8%	12.9%
Minneapolis	7.1%	6.5%
New Orleans	-1.4%	-2.3%
New York	3.4%	24.5%
Philadelphia	-0.2%	19.6%
Phoenix	13.3%	10.1%
Pittsburgh	13.1%	26.3%
Portland	-2.8%	45.6%
San Antonio	-1.2%	29.7%
St. Louis	19.8%	25.6%
San Diego	20.4%	4.0%
Washington DC	4.0%	12.5%

Source: The National Association of Realtors



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