

July 2010

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- The Texas Manufacturing Outlook Survey points to a return to growth in July.
- The Texas housing markets continue to suffer the aftershocks of the homebuyer tax credit with June's home sales down by 3.5% vs. May.
- In June, Texas saw the sixth consecutive month of job gains and the unemployment rate fell to 8.2%.
- In the first half of 2010, Texas exports were up by nearly 30% on robust demand from developing countries.

Executive Summary

Stronger exports of manufacturing goods and a rebound in the energy sector continue to support the Texas economy. Indeed, the Texas Manufacturing Outlook Survey, released by the Federal Reserve Bank of Dallas, indicates that Texas manufacturing returned to growth in July following a drop in output the month before. And July was the fifth straight month of job gains in Texas manufacturing.

That said, June's Houston Purchasing Managers Index was pulled down by heightened uncertainties over the near-term economic outlook. This trend is broadly consistent with slow economic activity at the national and metro levels. The recovery may be losing momentum on weakened residential construction, modest gains in the job market, and worries over future economic policies, which all negatively impacts consumer and investor sentiment.

In June, the Texas Leading Index edged down for the second consecutive month, although it was still 7% higher than a year ago. This means Texas may grow slower in the second half of 2010, as resumed worries over the health of the global economy lead to higher volatility of exchange rates and commodity prices, and wider swings in global demand.

The national economy slowed in the second quarter with inventory restocking contributing less to economic recovery. Consumption, which is still important for sustainable growth, remains weak on sluggish

growth of incomes, tighter credit conditions, and continuing deleveraging in the private sector. And this time, consumers' contribution to economic growth is unlikely to be on par with previous recoveries. An export-led recovery requires keeping labor costs under control, which usually results in slower employment and income growth, a combination rarely supportive of a strong rebound in personal consumption. Furthermore, increasing dependence on exports will widen disparities across U.S. regional economies. Indeed, competitive labor costs and a strong export base bode well for a faster return to self-sustained growth in Texas than in most other large states.

In June, Texas saw the sixth consecutive month of job gains; while the State's unemployment rate fell to 8.2%, 1.3 percentage points lower than the national unemployment rate. This strong performance of labor market is largely due to resilience of the biggest Texas metros, where unemployment rates remain below 9%.

Finally, Texas exporters are benefiting from stronger demand for energy and manufacturing goods in rapidly growing emerging markets. After all, emerging and developing countries are expected to grow nearly three times faster than advanced economies both this year and next. Significant growth in energy consumption will also take place in these countries. Both factors should boost Texas' manufacturing sector thanks to increasing overseas shipments of high-tech goods and petrochemical products.

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Economic Output

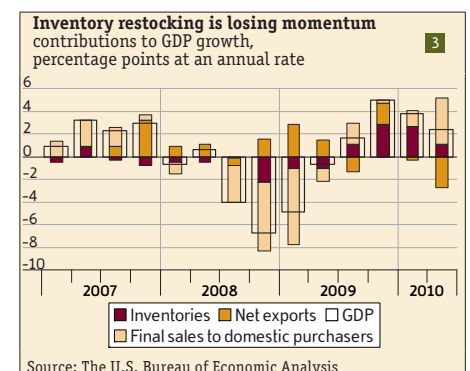
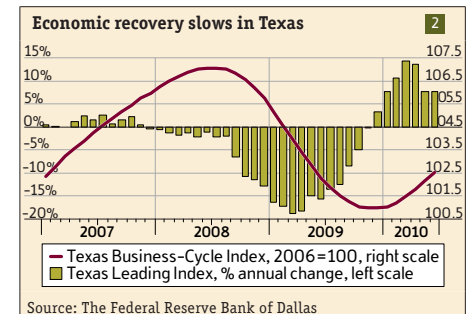
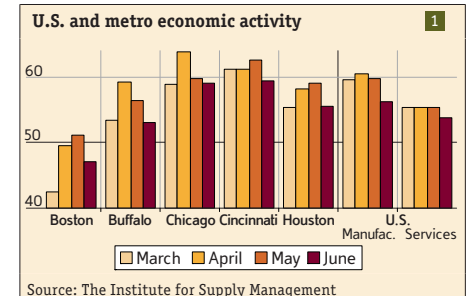
A favorable outlook for export orders of durable goods, and a robust turnaround in the energy sector, continue to support economic recovery in Texas. In June, Texas industrial production was up by 3.4% versus a year ago (on a 1.5% increase in manufacturing of durable goods and a 12.4% growth in the mining industry). That said, the Houston Purchasing Managers Index edged down in June indicating slower growth. Still, this trend is broadly consistent with the national measures of economic activity as well as readings on economic performance of the major U.S. metro areas. The recovery is slowing on weakened residential construction (after the expiration of the home-buyer tax credit) and increased uncertainties over future economic policies. Ban on deepwater drilling in the Gulf of Mexico has clearly dampened economic growth in Houston as evidenced by the fact that the metro economy started to decelerate only in June - a month later than slower growth was registered nationwide (see chart 1).

On the upside, July's data on the U.S. Manufacturing and Non-Manufacturing PMI points to improving export demand for goods and services, which is a positive sign for the Texas economy. The Texas Manufacturing Outlook Survey, released by the Federal Reserve Bank of Dallas, hints at a resumption of growth in Texas manufacturing, with July being the fifth straight month of job gains.

Lastly, the Texas Leading Index, calculated by the Federal Reserve Bank of Dallas, was 7.6% higher in June versus the same month a year ago. Readings on the Texas Business Cycle Index (which show that Texas entered this recession in the second half of 2008 six months later than the national economy) imply that the regional economy has been growing for the last three quarters (see chart 2). However, the leading index has been on a downtrend since April, which means that Texas is likely to grow more slowly in the second half of 2010. Essentially, this trend reflects recent uncertainties over near-term economic growth in the U.S. and worldwide. Indeed, as global investors remain hyper-sensitive to new risks, fresh economic data that fails to confirm expectations triggers higher volatility of commodity prices, and wide swings in sentiment, which hurts global demand. In fact, high global risk aversion was a decisive factor behind June's strengthening of the U.S. dollar. Although this may weigh down the near-term economic performance of Texas, the state is better geared towards an export-led recovery once current anxiety over the health of the global economy subsides. This means the prospects of returning to self-sustained growth are still brighter in Texas than in most other large states.

In line with what we are seeing at the state level, the second quarter U.S. GDP figures from the Bureau of Economic Analysis point to a similar moderation in the U.S. economic recovery. The overall economy grew at an annual rate of 2.4%, down from 3.7% the quarter before. Inventory restocking appears to be losing momentum (see chart 3) on heightened uncertainties about the resilience of U.S. consumers and signs of a slowing world economy. On the other hand, business spending added 1.5 percentage points to GDP growth as both investments into structures and equipment and software grew in the second quarter (at annual rates of 5.2% and 21.9%, respectively). In fact, during the second quarter of 2010, companies invested in equipment and software at the fastest pace since the first quarter of 1998.

Growth in investments usually follows an uptick in consumption, as business expands production to meet higher demand. This time, however, weak personal consumption is not driving future investments. Companies are improving business processes to use their existing workforce more productively. These investments add to the global competitiveness of the U.S. corporate sector, which should benefit



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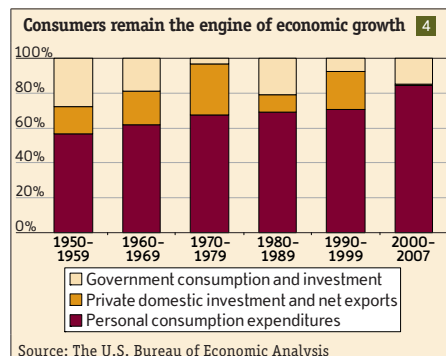
from an export-led economic recovery. The negative implication of all this, of course, is that the private sector has been creating fewer jobs thanks to stronger productivity gains.

That said, consumption - the biggest component of the U.S. economy - still remains important for sustainable growth. The share of personal consumption widened to about 70% of GDP and its contribution to economic growth increased to 85% in 2000-2007 from about 64% in 1950-1989 (see chart 4). And all three previous U.S. recessions ended only after a rebound in consumer demand (see chart 5). Importantly, an export-led recovery may not lift national GDP growth to the levels necessary to absorb a growing workforce and a large pool of unemployed workers. After all, the export boom in the early 90s went together with a slow rebound in private consumption and private sector employment. Indeed, stronger consumption was supported by higher incomes and low savings rates (savings rates fell following the July 1981 recession) rather than growing exports. However, a shift toward an export-driven economy must be sustained by competitive labor costs, which means that real wages should either remain stable or decline. Germany is a textbook case of an advanced economy that relies on exports for economic growth (see chart 6). Yet, because of slower growth of wages, personal per capita consumption in Germany grew by only 50% in real terms during the 1995-2007 period, while it jumped by 70% in the U.S.

Equally important, households' access to credit is a vital driver of consumer spending. Following the 1981 and 2001 downturns, consumer credit continued to grow, supporting personal consumption. It remained flat in the early 90s and fell sharply during this recession (by over 6% between December 2007 and June 2010), despite the current unprecedented monetary easing. Of course, the most recent consumption boom was driven by the rapid buildup of household debt (see chart 7 on next page). This trend can hardly be sustained on tighter credit conditions and continuing private sector deleveraging.

As a result, this time, consumers' contribution to economic growth is unlikely to be on par with previous recoveries. In July, the Conference Board registered a second consecutive drop in consumer confidence - to the lowest level since February. This means consumer spending on durable goods as well as purchases of homes will be weak due to fewer new jobs in the private sector. Businesses are likely to continue to invest into productivity-improving technologies to maintain a competitive edge in overseas markets. Keeping labor costs under control, however, usually results in slower employment and income growth - a combination rarely supportive of a strong rebound in personal consumption.

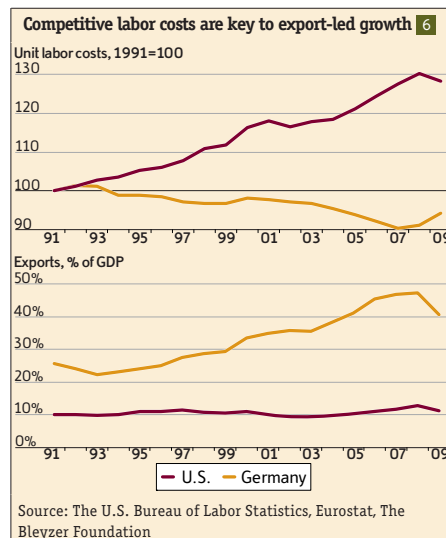
All this implies that a prolonged recovery of private consumption, and increasing dependence on exports, will widen disparities across U.S. regional economies. In particular, states where too much leverage created excess capacity in industries relying on domestic demand (especially in real estate, finance, construction and durable consumer goods manufacturing) may end up with a fragile economic rebound. States with lower labor costs, stable housing markets, a strong export base and specialization in commodities (such as agricultural products and energy) will see a faster recovery of output and employment. Finally, the economic outlook is sunnier for the states that can compete effectively for the growing demand from developing countries. After all, robust performance of emerging economies, partially supported with large public infra-



The current recession is a "totally different animal" 5
% change, 10 quarters after the beginning of the recession

	Jul 81	Jul 90	Mar 01	Dec 07
GDP	6.9%	4.4%	3.6%	-1.1%
Personal consumption	10.4%	5.1%	6.3%	-0.9%
Private investment	14.6%	0.9%	-8.3%	-15.3%
Exports	-5.0%	15.9%	-9.6%	2.1%
Imports	33.0%	9.1%	1.3%	-4.6%
Government expenditures	6.6%	2.0%	10.9%	4.6%
Consumer credit	22.0%	1.7%	17.7%	-6.0%
Private sector employment	2.2%	-1.4%	-3.1%	-6.8%
Real disposable income	8.9%	0.1%	6.9%	2.9%
absolute change, percentage points				
Savings rate, % of disposable income	-2.4	-1.0	0.0	4.1
Private nonfinancial sector debt, % of GDP	2.0	-8.0	11.0	0.0
Public debt, % of GDP	2.0	6.5	2.3	22.6

Source: The U.S. Bureau of Economic Analysis, The Federal Reserve System, National Bureau of Economic Analysis, The Bleyzer Foundation



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structure projects, boosts global demand for energy, productivity improving technologies (industrial machinery and computers) and sophisticated engineering and technical services. We believe Texas leads the nation in many of the areas necessary for this export-led recovery. For example, Texas' largest metros offer competitive labor costs, while their share of exports is relatively greater than in other U.S. metros (see chart 8).

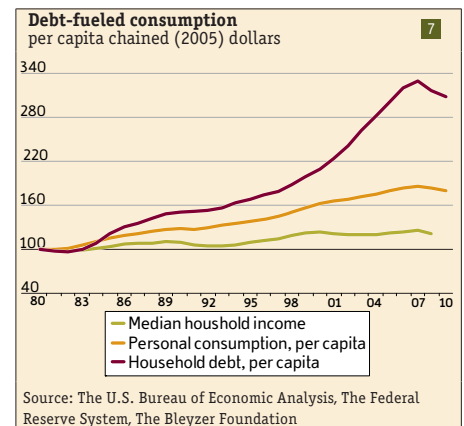
Employment

In June, Texas saw the sixth consecutive month of job gains, with nonfarm employment increasing by 14,000 jobs (see chart 9). This puts total job gains in 2010 close to 180,000 (up by 1.7% since the beginning of the year). Meanwhile, the unemployment rate fell to 8.2%, and was 1.3 percentage points lower than the U.S. unemployment rate of 9.5%. Twelve month employment growth in Texas stood at 1.1% versus a decline of 0.2% nationwide. More than that, during this recession, the annual declines in Texas nonfarm employment continued for a period of 16 straight months, or 8 months shorter than in the U.S. And the biggest percentage loss of jobs stood at 3.9% (in August 2009) versus 4.9% nationwide.

Private sector jobs are recovering faster in Texas as well. In June, private sector employment (not seasonally adjusted) grew by 0.4% - its first annual increase in 17 months; meanwhile, the U.S. private sector continued to employ fewer workers than a year ago. This testifies to the overall strength of the Texas economy. Indeed, since the beginning of this recession in December 2007, to June 2010, the U.S. unemployment rate rose by 4.5 percentage points, while the national workforce remained virtually unchanged. Meanwhile, Texas' labor force expanded by nearly 6%, while the State's unemployment rate increased by only 3.8 percentage points. This means the Texas economy outperformed the national economy because it grew faster to provide jobs for people entering the workforce.

This strength in the labor force was largely echoed throughout the largest Texas metros. According to the Texas Workforce Commission, the unemployment rate in the four biggest Texas metros (Austin-Round Rock-San Marcos, Dallas-Fort Worth-Arlington, Houston-Sugar Land-Baytown and San Antonio-New Braunfels), which provide roughly two thirds of all jobs in the State, was still below 9% in June 2010. Meanwhile, 128 U.S. metros still have an unemployment rate of at least 10%. Labor market conditions remain especially dire in such recession-hit states as California, Florida, Michigan and Nevada. Only three Texas metros ended the first half of this year with unemployment rates higher than 10%, yet these metros account for just 5% of all jobs in the State.

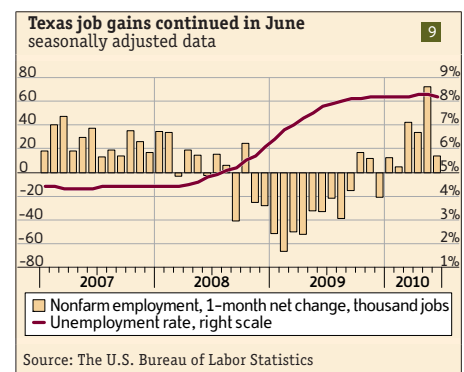
Because of their economic size and generally faster growth rates, large metros are key to the economic performance of U.S. regional economies. Indeed, according to the latest available data on GDP by metropolitan area, the 32 biggest U.S. metros (with GDP exceeding \$90 billion each and an aggregate size of about 62% of all 366 U.S. metros) grew on average by 19% from 2001 to 2008, compared to 17.4% for the entire U.S. metropolitan population. During the same 7 years, the metro economies of Dallas and Houston registered even bigger gains, expanding by 23.7% and 22.3%, respectively. Healthier labor markets in these two metros should support stronger recovery of the Texas economy versus other U.S. regions where employment conditions are weaker.



Exports support large Texas metros

	Exports, % of metro economy	Unit labor costs
Houston-Sugar Land-Baytown, TX	19.8%	97.1
Austin-Round Rock, TX	9.2%	93.0
Los Angeles-Long Beach-Santa Ana, CA	8.4%	93.4
Boston-Cambridge-Quincy, MA-NH	7.7%	109.1
New York-Northern New Jersey-Long Island, NY-NJ-PA	7.5%	96.7
Chicago-Naperville-Joliet, IL-IN-WI	6.8%	104.6
San Francisco-Oakland-Fremont, CA	6.6%	99.3
Philadelphia-Camden-Wilmington, PA-NJ-DE-MD	6.5%	99.7
San Antonio, TX	6.2%	97.4
Dallas-Fort Worth-Arlington, TX	5.9%	90.5
Atlanta-Sandy Springs-Marietta, GA	5.3%	97.7
Washington-Arlington-Alexandria, DC-VA-MD-WV	2.5%	102.1

Source: The U.S. Bureau of Economic Analysis, The U.S. Census Bureau, The Bleyzer Foundation



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Housing Market

Both the Texas and national housing markets continue to suffer the aftershocks of the homebuyer tax credit expiration, although it appears the effect of the tax credit boost to housing demand was still present in the June data. Indeed, according to the Real Estate Center at Texas A&M University, home sales in Texas fell by only 3.5% compared to May on somewhat weaker sales in Dallas (down by 4.3%), Houston (down by 1.2%), Austin (down by 1.7%) and San Antonio (down by 2.5%). At the same time, the National Association of Realtors estimates that nationwide existing home sales dropped in June for the second straight month by about 5% and were 7.3% lower than this year's high in April. We expect home sales to post even deeper declines in the second half of 2010, when the impact of the tax credit fades away. On the upside, home prices continued to strengthen across many metro areas, which may point to more stable demand conditions. In addition, record low mortgage rates triggered a pickup in refinancing activity. At the same time, the pool of homeowners who can qualify for refinancing remains narrow as many houses in distressed markets have negative equity. This may partially explain why lower interest rates are still failing to bring a meaningful turnaround in home-buying activity.

We believe the national housing market is likely to experience only a modest recovery in the next few years. After all, high unemployment rates and sluggish private sector job growth depress housing demand. And the market is still plagued by many structural distortions that were at the heart of the recent housing bust. In particular, the housing sector, which always enjoyed implicit public support, finds itself even more deeply wedded to the government. For example, Fannie Mae and Freddie Mac, two government sponsored enterprises that were placed in conservatorship in 2008, following huge losses on household mortgages, continue to own or guarantee over half of all outstanding mortgages in the U.S. Following the exodus of private investors, these firms remain the main source of liquidity in mortgage financing. Fannie Mae, which reported a \$12.7 billion net loss in the first half of 2010, is the biggest issuer of mortgage-related securities with a market share of 39% in the first half of 2010. A lack of clear strategy for an orderly withdrawal of government support for the housing market is clearly discouraging private investors from taking a more active role in mortgage financing activity.

Exports

In the first half of 2010, exports of goods from Texas increased by nearly 30% versus the first half of 2009 to \$97 billion, which amounts to 16% of all U.S. exports. In particular, Texas exports to Mexico, Canada, China, Korea, Brazil and Singapore (roughly 60% of all exports) grew by 35.6%, 35%, 19.7%, 39.7%, 45.7% and 38.47%, respectively. Meanwhile, exports to the Euro area (7.7% of all exports) fell by 1.7%. In fact, the State's reliance on developing overseas markets, where economic growth is stronger than in advanced economies, is significantly boosting export revenues. Indeed, exports to developing countries, which account for 64% of all exports, jumped by 34%, while Texas exports to the OECD member states (11% of all exports) inched up by a paltry 1.2%. More than that, Texas exports to OECD countries excluding Turkey fell by 1.3%.

Obviously, Texas exporters are benefiting from stronger energy prices, as exports of mineral fuels jumped by 64%. However this increase was entirely driven by stronger demand from developing economies (up by 116%), while exports of mineral fuels to OECD plunged by 47%. In fact, the U.S. Energy Information Administration forecasts that the growth in world energy consumption in 2010 and 2011 will come almost exclusively from emerging Asia and other developing countries. This will sustain relatively high world energy prices, which will support Texas' petrochemical industry. Furthermore, the International Monetary Fund expects emerging and developing economies to grow nearly three times faster than advanced economies both this year and next. As a result, global demand for high-tech machinery and equipment, which are vital for economic development, will remain robust. All of this bodes well for Texas, whose exports of machinery, equipment and computers already grew by roughly 18% in the first half of 2010, on stronger demand from emerging Asia and Latin America.

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