

December 2010

- In November, the Texas unemployment rate inched up to 8.2%.
- Despite falling sales, home values in Texas remain stable.
- Texas factory activity continued to strengthen in November.
- During the first 10 months of 2010, Texas exports jumped by 30%.
- According to the latest Census data, the population in Texas has grown by 20% since 2000 (twice as fast as in California). As a result, Texas will add four House seats - the largest gain of any state - increasing its delegation to 36 members in the House of Representatives.

Executive summary

The Houston Purchasing Managers Index increased to 56.3 in November as booming exports and stronger energy prices continued to prop up the Texas economy. Indeed, in October, the Texas Leading Index was 7% higher than a year ago, while the Business Cycle Index registered its 12th consecutive monthly gain. Higher commodity prices, a weaker exchange rate, improving labor market conditions and a robust return from overseas demand have been supporting the local economy in 2010. That said, the big question now is whether these factors, which have been an integral part of the Texas recovery, will continue to sustain economic growth in 2011.

Despite slower expected global growth in 2011, economic recovery in big developing countries will likely continue to steam ahead. As these economies grow, their contribution to global demand increases. As a result, our outlook for commodity prices and the export of manufactured goods remains optimistic, which bodes well for Texas.

However, the outlook for the U.S. economy overall is still uncertain. The national economy is entering 2011 on a much firmer footing compared to a year ago. Furthermore, the tax deal is expected to provide a significant boost to the national economy. Meanwhile, consumer retrenchment is easing and businesses are restocking inventories due to a strong turnaround in sales and more optimistic economic expectations. Indeed, capital spending may pick up as economic recovery takes hold and businesses start to invest their accumulated cash balances.

However, residential investments remain particularly weak compared to previous economic recoveries. In fact, residential housing activity, which has been in a steady downtrend since 2006, lingers well below 2000 levels. Indeed, mortgage financing is still struggling to recover following the exodus of private investors. Meanwhile, the federal government has emerged as the main source of liquidity for the housing market. It is quite likely that an unavoidable downsizing of the government's role in the mortgage finance market will be a harbinger of continued weakness in the U.S. construction industry.

In November, the unemployment rate in Texas inched up to 8.2%, remaining well below the national jobless rate of 9.8%. Thanks to a stable housing market and growing exports, the economic slowdown in Texas has been shorter and milder compared to other large U.S. states. As a result, this year Texas will see a 2% growth in nonfarm jobs compared to less than 1% nationwide. Service industries remain crucial to this labor market recovery. In 2010, the professional and business services industry was the largest contributor to private-sector job growth in Texas. As average earnings in this industry are relatively high, personal income is recovering faster in Texas. This will help Texas to continue to outperform many other U.S. states in 2011.

Lastly, Texas exports to Canada (the state's second largest market) are booming thanks to that country's milder economic downturn and stronger recovery. This, as well as increasing reliance on growing developing markets, will help sustain Texas exports into the future.

December 2010

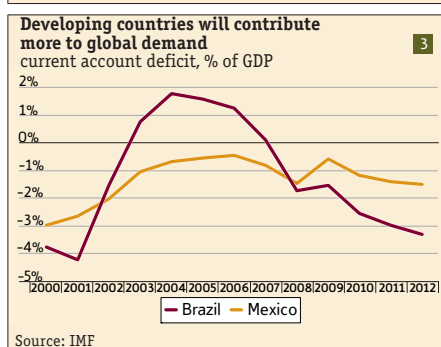
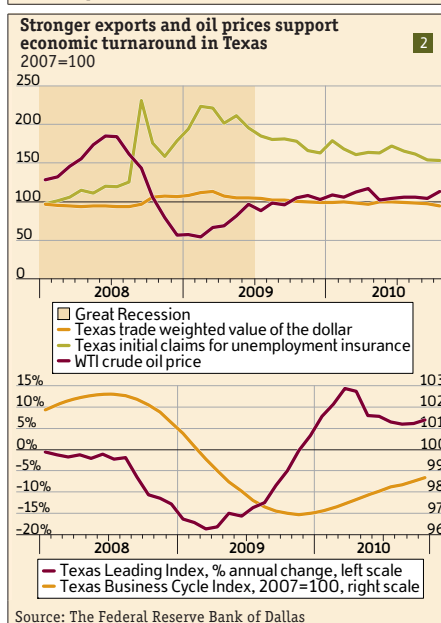
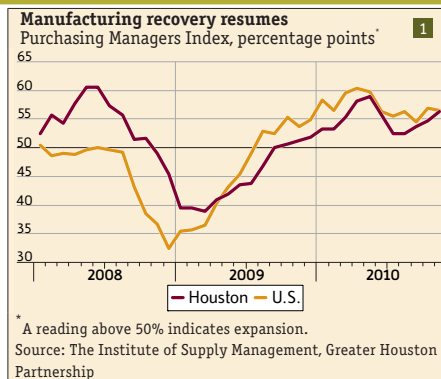
Economic output

The Texas economy continued to strengthen in November, with the Houston Purchasing Managers Index increasing to 56.3 points from 54.7 the month before (see chart 1). Higher energy prices, a weaker exchange rate, improving labor market conditions, and a robust return from overseas demand have been supporting the local economy since the end of the Great Recession (see chart 2). Indeed, in October, the Texas Leading Index was 7% higher than a year ago, while the Business Cycle Index registered its 12th consecutive monthly gain.

That said, the big question now is whether these factors, which were an integral part of the Texas recovery, will continue to sustain economic growth in 2011. We believe the global economy will grow somewhat slower in 2011 due to fiscal tightening in advanced economies (mostly in Europe) and a deceleration of the economic recovery in Japan. In addition, inflation worries in China continue to pressure authorities to further tighten monetary policy there. At the end of December, the People's Bank of China unexpectedly raised its benchmark rate by 25 basis points - the second rate hike in just over two months. More rate increases may follow next year as Beijing tries to cool the economy to tame inflation. This will exert a toll on global growth.

Despite this, our outlook for world trade remains optimistic - global trade is expected to increase at an annual rate of 7%-8% over the next two years.¹ The economic recovery in big developing countries (China, India and Brazil) shows little sign of running out of steam. In fact, the beginning of a new monetary tightening cycle in these emerging economies implies they are growing above their trend rates, which significantly exceed trend growth rates in advanced economies. This stronger economic growth in developing countries will continue to support commodity prices and exports of manufactured goods, which bodes well for Texas.

Additionally, Mexico, Canada, China and Brazil account for over 50% of all exports from Texas. Each of these economies is projected to grow relatively quickly in 2011. For example, GDP growth in Canada will be nearly a full percentage point higher than in the Euro zone or Japan. Meanwhile, the Chinese economy will continue to steam ahead at an average annual pace of around 9% during the next two years. Economic growth in Mexico² and Brazil³ will surpass 4% on average over the next five years. As these economies are getting bigger, their contribution to global demand will increase. In particular, higher consumer income and stronger exchange rates in Latin America should help boost imports. Indeed, the current account deficit as a percentage of GDP is expected to widen both in Mexico and Brazil (see chart 3). This means that demand for foreign goods in these economies will keep growing, which should help support Texas exporters as well. Finally, rising commodity prices are prompting global mining companies to step up investment spending.⁴ This should help Texas thanks to the state's strong base in mining-related services and manufacturing of min-



¹Source: United Nations, World Economic Situation and Prospects 2011 (December 2010); The International Monetary, World Economic Outlook (October 2010); The Organization for Economic Co-operation and Development, The OECD Economic Outlook (December 2010).

²Over a third of all Texas exports go to Mexico.

³In addition, Brazil is expected to ramp up its infrastructure spending over the next several years as it will host the FIFA World Cup in 2014 and the Olympic Games in 2016. This should add to the economic strength of Brazil, which is already the biggest regional economy (accounting for nearly half of the total for Latin America and the Caribbean) and will have a positive economic impact on other regional economies, as well as on Texas.

⁴According to the Financial Times, global investments in mining may total \$120 billion in 2011, exceeding the pre-crisis peak of \$110 billion.

Headquarters

123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 621-3111
E-mail: texas@sigmableyzer.com

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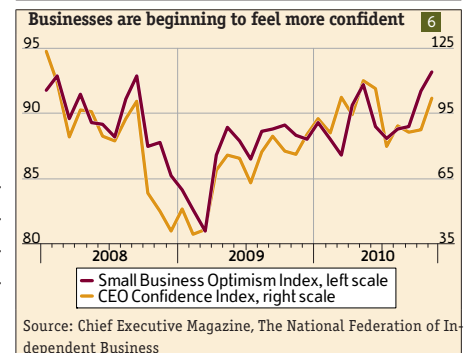
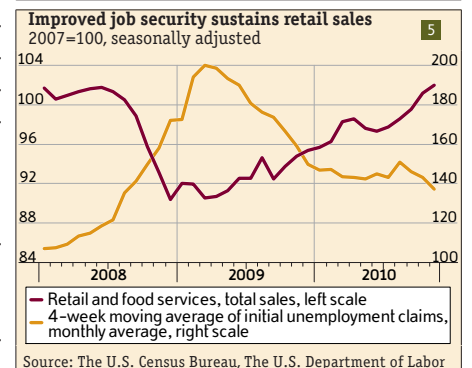
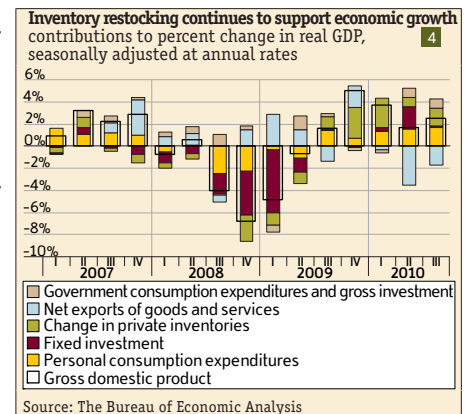
December 2010

ing machinery and equipment.⁵ As a result, global economic conditions should remain favorable for the Texas economy in 2011.

We believe most of the risk to the economic recovery in Texas is rooted in the U.S. economy, whose outlook is still uncertain. On a positive note, the national economy is entering 2011 on a much firmer footing compared to a year ago. Inventory restocking and growing personal consumption have sustained economic recovery since the second quarter of 2009 (see chart 4). In particular, retail sales registered robust gains at year-end, despite a persistently high jobless rate. Several factors may explain this cyclical rebound in consumer spending (see chart 5). First, receding fears over job security are boosting consumer confidence - both the Conference Board Consumer Confidence Index and the University of Michigan Index of Consumer Sentiment have been improving since September. Second, stronger equity markets and stable home values are adding to household wealth. According to the Federal Reserve, in the third quarter of 2010 households' net worth was \$1.7 trillion higher than a year ago. Finally, a combination of tax cuts, higher government spending on social benefits (for example, unemployment insurance) and increasing workers' compensation⁶ lifted personal disposable income, which was 3.3% higher than a year ago, growing by 9.2% versus the third quarter of 2007. All of this makes shoppers more confident and willing to spend.

Business confidence is improving as well - in November, the CEO Confidence Index⁷ jumped by 14% versus the month before. Meanwhile, the Business Roundtable CEO Economic Outlook Index rose to its highest reading since the first quarter of 2006. A more certain outlook for tax policy appears to be driving capital expenditure and hiring.⁸ Small business owners feel more bullish about the economy - in November, the Small Business Optimism Index increased to its highest level in nearly three years (see chart 6). This brighter outlook should make businesses feel more confident about expanding production. Indeed, in recent years, despite a healthy rebound in corporate profits, businesses were slow to resume investments, preferring to hoard liquid assets instead (see chart 7).

That said, while corporate investments usually lag behind economic recoveries, as it takes time for investors to regain confidence, residential investment spending tends to pick up following an economic downturn (see chart 8). This time, however, residential housing investment remains particularly weak compared to previous economic recoveries. In fact, residential housing activity, which has been in a steady downtrend since 2006, still lingers well below 2000 levels (see chart 9). In particular, mortgage financing is still struggling to recover following the collapse in housing prices. Indeed, the two government-sponsored enterprises (GSEs), Freddie Mac and Fannie Mae, are in dire financial condition, and continue to report losses from an increasing number of delinquent loans.⁹ The GSEs remain the main source of liquidity for the U.S. mortgage market. They own or guarantee nearly half of all home loans in the U.S. and are major issuers of any new mortgage-backed securities (MBS). Meanwhile, private-label MBS (originated without government backing) have virtually disappeared from the market (see chart 10). As a re-



⁵For example, Caterpillar Inc., which is the biggest global manufacturer of construction and mining equipment, relocated one of its primary manufacturing facilities to Texas in 2009. The company has recently decided to open an escalator assembly plant in Victoria, Texas.

⁶According to the U.S. Census Bureau, in the third quarter of 2010 total compensation of all civilian employees was 1.9% higher than a year ago. Still, during the past two years, workers compensation grew twice as slow as prior to the Great Recession.

⁷Source: Chief Executive Magazine.

⁸Source: Business Roundtable. Nearly 60% and 45% of all surveyed companies are planning to increase investments and employment, respectively, over the next six months.

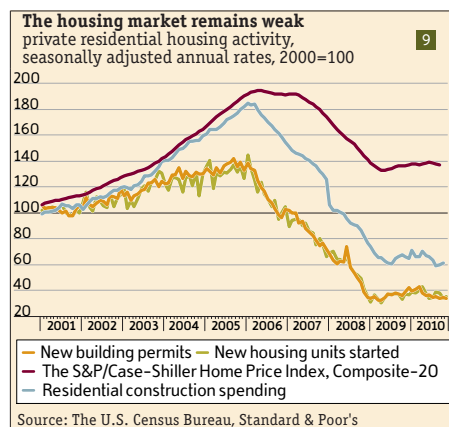
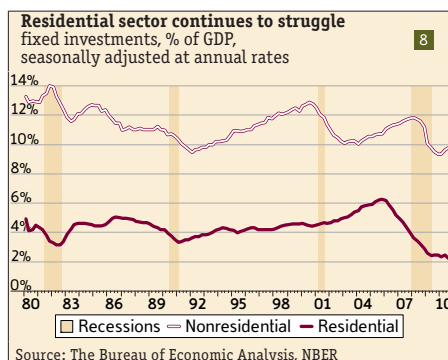
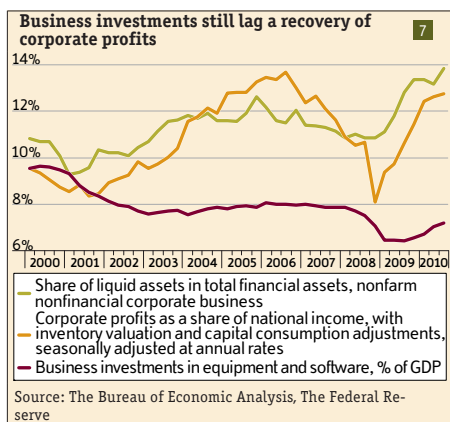
⁹According to the latest quarterly financial statements, Freddie Mac and Fannie Mae recognized net losses of \$13.9 billion and \$14.1 billion, respectively, for the first nine months of 2010.

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 621-3111
E-mail: texas@sigmableyzer.com

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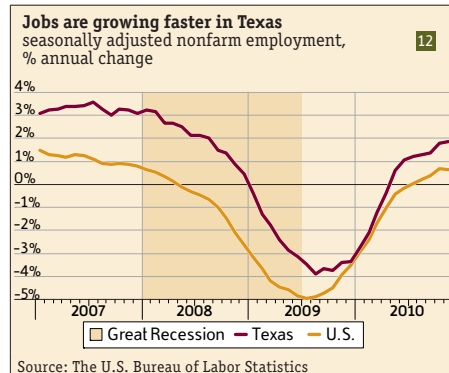
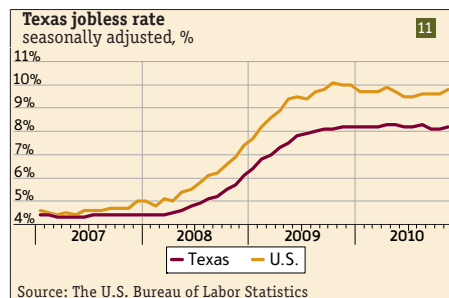
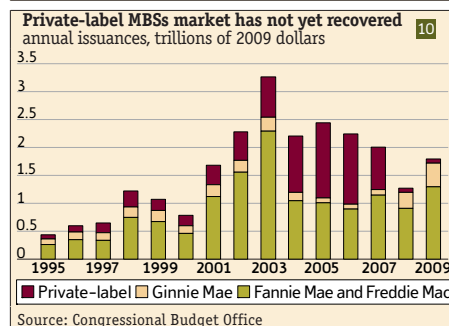
sult, practically all new mortgages originated since the beginning of the Great Recession have been supported by the federal government.¹⁰ We believe the combination of a slow recovery in private financing and an unavoidable downsizing of government support is a harbinger of continued weakness in the U.S. construction industry.

Employment

In November, the unemployment rate in Texas inched up to 8.2%, remaining well below the national jobless rate of 9.8% (see chart 11). Texas entered the economic downturn much later than the U.S. as a whole and its labor market has been recovering faster thanks to strong energy prices and booming exports (see chart 12). As a result, this year Texas will see 2% growth in non-farm jobs versus less than 1% nationwide. Texas will enter 2011 with roughly 2% fewer jobs than it had at the peak of the business cycle (August 2008). Meanwhile, the nation as whole will have nearly 8 million less jobs (or 5.4%) than three years ago.

The relatively strong Texas labor market is supported by private-sector job growth and relatively stable government employment. The number of private-sector jobs in Texas grew by 2.2% versus November 2009 or more than twice as fast as the country as a whole.¹¹ Indeed, the private sector in other large U.S. states is still struggling to resume hiring (see chart 13) due to the fallout from the housing sector and weak domestic demand for durable goods. The housing markets in the worst hit states (such as Arizona, California, Florida and Nevada) are faltering due to high unemployment rates, which further delays economic recovery. On the other hand, a pickup in private-sector hiring and stable home prices support a faster turnaround in the Texas construction sector.

Indeed, the depth of job losses in the U.S. construction sector is unprecedented in America's postwar history. The national construction industry has been losing jobs over the last four years, ending 2010 with only three quarters of pre-recession employment.¹² Job



¹⁰The GSEs' access to long-term debt markets was sustained by the Treasury and Fed purchases of the agency-backed MBS. In particular, from September 2008 to December 2009, the Treasury bought \$220.8 billion of Freddie Mac and Fannie Mae MBS. Meanwhile, from January 2009 to March 2010, the Fed purchased \$1.25 trillion of MBS issued by GSEs. Source: The Federal Housing Finance Agency.

¹¹Texas is one of only four states (excluding the District of Columbia) where private-sector employment grew by more than 2% versus 12 months earlier.

¹²The industry now employs as many workers as at the end of 1996.

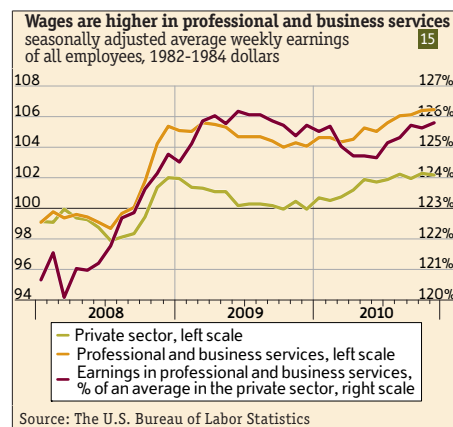
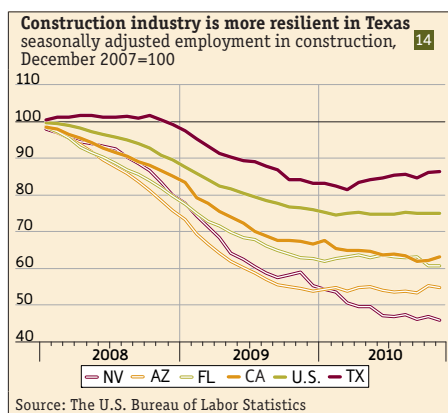
Headquarters

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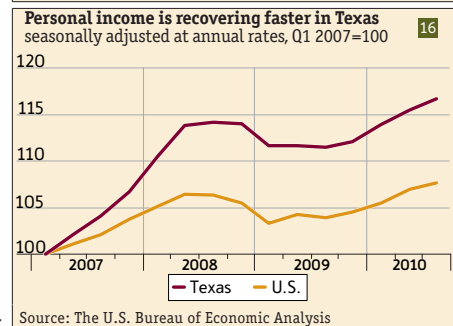
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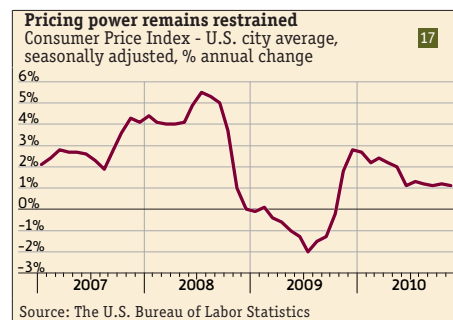
losses in some of the worst hit states exceed 50% (see chart 14). Meanwhile, Texas has bucked this trend, adding 21,000 new construction jobs this past year.

Despite this, it is the service industry that remains crucial for labor market recovery in Texas. In November, Texas private-sector service industries added 121,700 new jobs - up by 1.8% (versus only 1.1% nationwide). Although information, trade, transportation and utilities had fewer jobs compared to a year ago, hiring in other service sectors continued to outpace the national average. In particular, employment in professional and business services (which this year emerged as the largest contributor to private-sector job growth in Texas) increased by 5% (or 61,200 jobs). Education and healthcare added 47,900 jobs - up by 3.5%. For the nation as a whole, job growth in these industries was much slower - at 2.4% and 2.1% respectively. Furthermore, average earnings in professional and business services are higher compared to the private sector as a whole. They tend to grow faster as well (see chart 15). This means personal income should register bigger gains in Texas thanks to more new high-paying jobs. Indeed, in the third quarter of 2010, Texas saw the fourth largest gain in state personal income - up by 4.7% versus the same quarter a year ago (compared to 3.6% growth nationwide).¹³ As a result, personal income in Texas is now 9.4% higher than at the beginning of the Great Recession (the last quarter of 2007); meanwhile, it grew by only 3.8% nationwide (see chart 16).



Monetary policy and asset prices

High unemployment and increased competition from price-conscious consumers continued to restrain pricing power in November. The Consumer Price Index increased by only 0.1% versus October and was up by 1.1% compared to year ago - well below the Fed's implicit target of 2% (see chart 17). This still allows the Fed to proceed with the implementation of the \$600 billion Large-Scale Asset Purchase (LSAP) program announced in November. However, the approval of the tax deal in December (which, among other things, provides a two-year extension for all expiring tax cuts and a new temporary 2% payroll tax cut for employees) represents a shift to fiscal stimulus next year. This means that conditional on economic data, the Fed is unlikely to extend or broaden its LSAP beyond the second half of 2011.



Indeed, the tax deal, which is estimated to add \$374 billion and \$423 billion to the U.S. federal budget deficit in 2011 and 2012,¹⁴ is

¹³In the third quarter of 2010, New Mexico, Iowa and Tennessee were the only states where personal income grew quicker than in Texas.

¹⁴The total net cost is put at \$857.8 billion over the next 10 years. Source: Congressional Budget Office and the Joint Committee on Taxation. Estimated budget effects of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

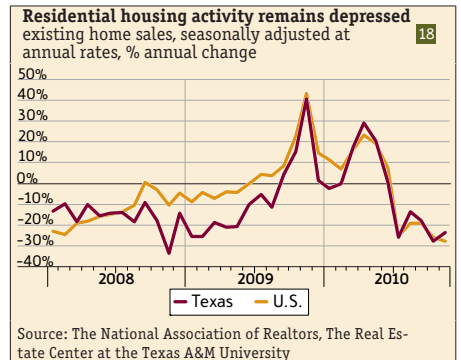
December 2010

expected to provide a significant boost to the national economy.¹⁵ This means the Fed will feel less anxious to engage in more aggressive monetary easing. However, a higher budget deficit heightens investors' worries over the sustainability of U.S. public debt, particularly given the absence of a credible medium-term fiscal consolidation strategy. As a result, this combination of fiscal and monetary policies looks certain to exert upward pressure on interest rates in 2011.

Higher interest rates will hardly help the national housing market. In fact, despite record low interest rates, home sales continued to post double digit losses this year (except for a brief period of growth during the first-time homebuyer tax credit program). In November, existing home sales nationwide were 28% lower than a year ago, and 24% below last year's level in Texas (see chart 18). That said, despite depressed home sales, housing prices in Texas have held up much better than in many other large U.S. metros (see chart 19). As a result, according to CoreLogic, in the third quarter of 2010 only 11% of all Texas homes were in negative equity (versus 22.5% for the U.S. as a whole).

International Trade

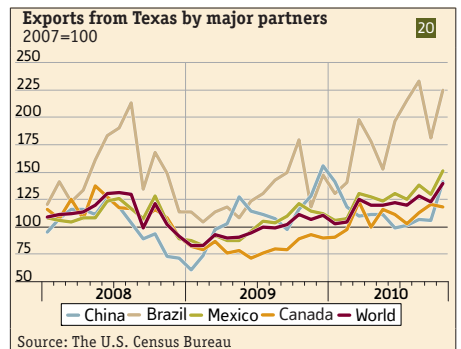
Texas exports continued to post solid gains, increasing by over 27% (to \$168.8 billion) from January to October 2010 (nationwide, exports grew by only 21.5%). In fact, in October, exports from the state surged to the highest level on record (nearly \$20 billion) thanks to higher energy prices as well as booming demand from Mexico, Brazil and China (see chart 20). Texas is benefiting from a solid economic recovery in developing countries, which account for over 64% of its total exports. At the same time, Texas exports to Canada (the state's second largest export market) jumped by nearly 37% thanks to increasing imports of industrial machinery, chemicals, cars and mineral products. Canada has experienced a milder economic downturn and is recovering faster compared to other big developed economies. This, as well as increasing reliance on developing markets, should sustain Texas exports into the future.



Home values in large Texas metros remain strong
% change in Q3 2010 **19**

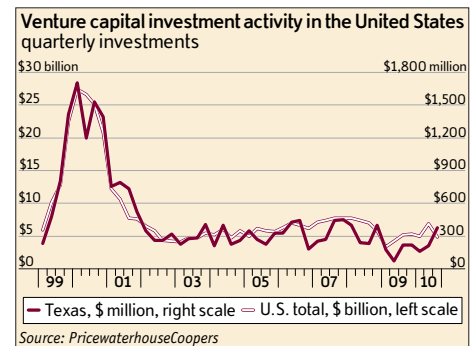
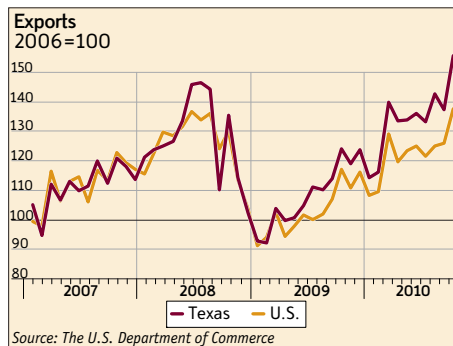
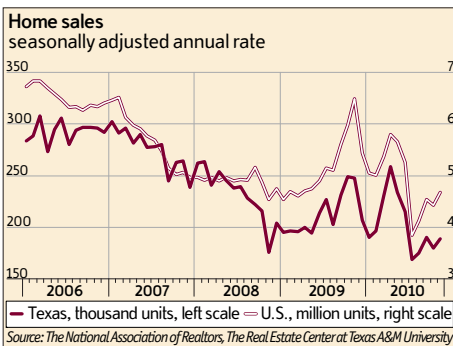
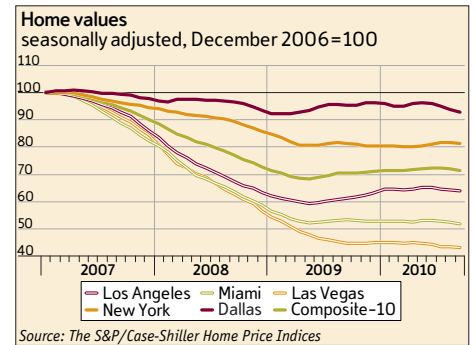
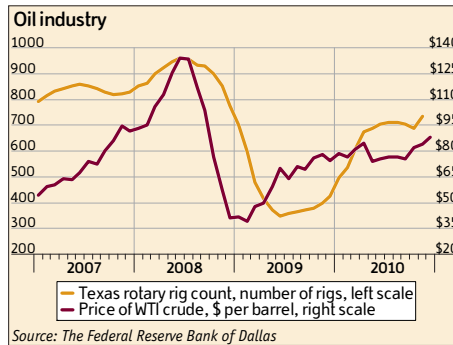
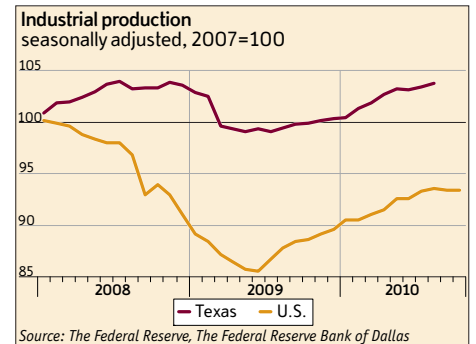
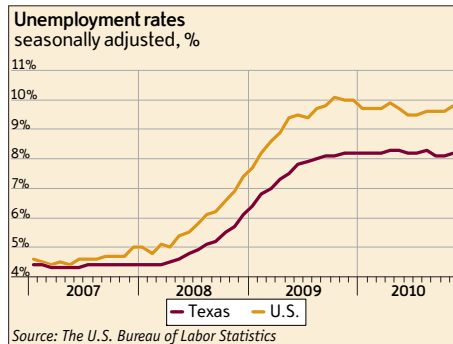
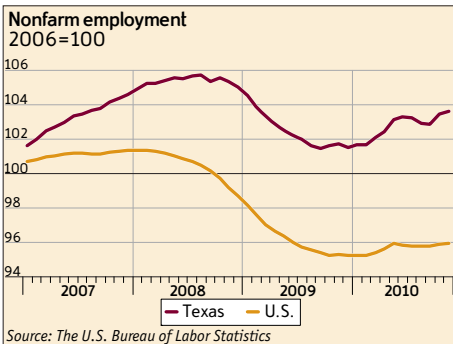
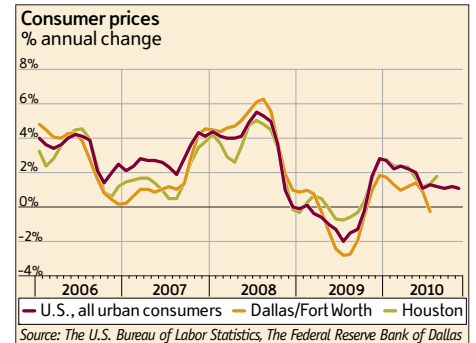
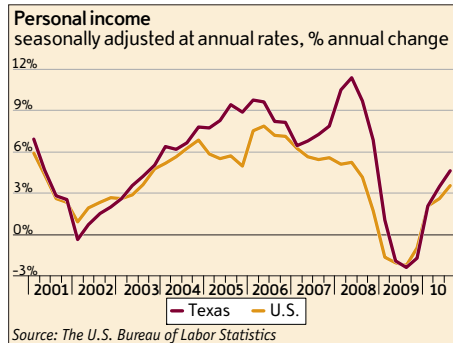
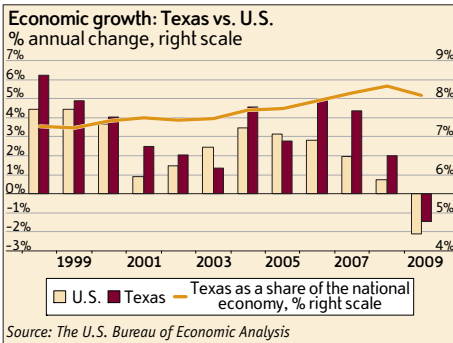
	vs. Q3 2009	vs. 2007
Austin-Round Rock, TX	8.4%	11.6%
Dallas-Fort Worth-Arlington, TX	14.2%	13.7%
El Paso, TX	4.8%	5.5%
Houston-Baytown-Sugar Land, TX	-1.1%	4.2%
San Antonio, TX	3.4%	3.1%
San Francisco-Oakland-Fremont, CA	9.4%	-26.8%
San Diego-Carlsbad-San Marcos, CA	2.5%	-34.2%
Phoenix-Mesa-Scottsdale, AZ	-3.3%	-46.4%
Orlando, FL	-11.0%	-46.2%
New York-Wayne-White Plains, NY-NJ	4.3%	-13.0%
Miami-Fort Lauderdale-Miami Beach, FL	-1.0%	-41.2%
Las Vegas-Paradise, NV	-0.3%	-53.6%
Chicago-Naperville-Joliet, IL	-6.4%	-28.9%
Los Angeles-Long Beach-Santa Ana, CA	1.3%	-41.0%

Source: The National Association of Realtors



¹⁵GDP growth may accelerate to 4%, while the unemployment rate may drop below 9%.

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Houston, TX 77024 USA
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