

May 2014

- The Texas jobless rate slipped to 5.2% in April – its lowest level since late 2008.
- In April, private employment jumped by over 68 thousand jobs in Texas – its strongest monthly gain since the start of the economic recovery.
- Texas factory activity improved notably in March and April.
- The Houston metro economy continued to expand in April.

Executive summary

The national economy struggled to grow in the first quarter of 2014, with output decreasing at an annual rate of 1%, as harsh weather conditions in the first few months of the year may have affected business and consumer spending. Meanwhile, higher borrowing costs continued to cool housing demand – falling residential investments brought down overall economic growth for the second straight quarter.

On the upside, economic conditions improved in March and April, with business activity in manufacturing, services and construction posting its best levels in 2014. This can be partly attributed to pent-up demand, as consumer and business spending resumes growth following a lull at the start of the year. In addition, more upbeat business and consumer sentiments indicate that economic growth is on track to accelerate this quarter. The economy continues to slowly create jobs – in the first four months of 2014, payroll employment grew by almost 860 thousand jobs or over 4% more compared to the same four months a year ago. Thus, households are feeling more confident to borrow and spend – in March, consumer credit was up by 6.7% annually, helped significantly by expanding car loans. Lastly, construction activity strengthened in April as a response to tight housing inventory and continued price gains on major regional housing markets. This implies that residential investments may start contributing to economic growth again in the second quarter of 2014.

Turning to Texas, regional economic growth accelerated markedly during the first two months of the spring; factory activity and jobs indices hit their best readings in over two years in April. Output expansion in service and retail sectors is proceeding at a faster pace as well, which is a sign of a continuing broadening of the economic rebound in the Texas.

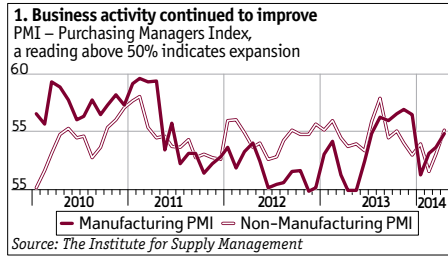
The energy sector remains a key driver of the Texas economy and, in particular, the state's biggest metro – Houston. Indeed, steady growth of crude oil and natural gas prices is sustaining mining activity, which benefits Houston – the world's largest petrochemical hub. The Metro Business Cycle Indices point to a recent uptick in Houston's economic activity as well. Houston – one of the busiest ports in the world, is benefiting

from strengthening global economic growth as well. For instance, during the first quarter of 2014, exports from Texas increased by over 7% compared to only 2.6% for the nation as a whole, driven by booming exports of mineral fuels and solid growth of exports of industrial machinery and computers. On that note, Texas is enjoying a rapid rebound of global semiconductor sales, which hit record high levels in the first quarter of 2014. And it is a boon for the Austin and Dallas metro economies, where some of the world largest semiconductor plants are located.

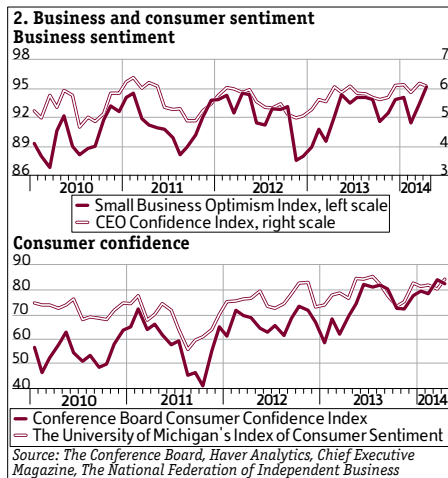
In April, the jobless rate in Texas dropped to 5.2% – its lowest reading in nearly six years – thanks to a record monthly gain of new jobs in private industries. In particular, private employment in Texas jumped by over 68 thousand jobs, 70% of which came from the service providing sector thanks to accelerating jobs growth in business and professional services, trade, transportation and utilities, and education and healthcare. This may imply that the labor market expansion in Texas is gaining momentum as the pace of job growth in the service providing part of the regional economy starts to accelerate. More importantly, this latest uptick in hiring may represent a sustainable uptrend in the regional job market. The annual job growth in private good producing and service providing industries appears to be settling at above 3% – roughly on par with the long-term trend. The Texas labor force participation rate is almost where it was at the start of the recession and is growing. Nationwide, the labor force participation rate shrank again in April, which is a reflection of less favorable demographic trends and a bigger portion of disillusioned workers leaving the workforce nationally. Lastly, the size of the Texas economy, as measured by the real gross state product, expanded by over 15% since 2007 versus a more modest 6% increase nationwide. This means that the regional economy is now capable of sustaining many more private jobs versus the nation as a whole. Indeed, Texas already employs nearly 9% more workers in private industries than six years ago; nationwide, private sector employment has just touched its prerecession level.

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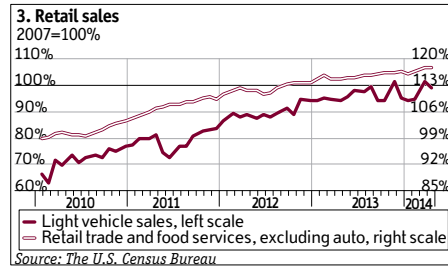
Economic output



The national economy strengthened in March and April, with business activity in manufacturing, services and construction reaching its highest level in 2014 (see chart 1). A portion of this recent uptick in output expansion may be driven by pent-up demand, as consumer and business spending resumes growth following harsh weather conditions at the start of the year. Yet steadily improving business and consumer sentiment (see chart 2) do

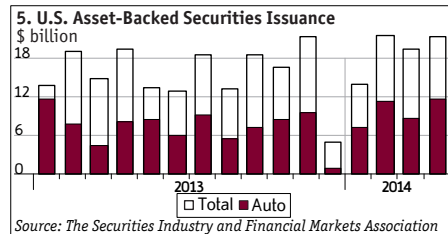


imply that economic growth is on track to accelerate this quarter following a rather anemic 0.1% annualized GDP growth during the first three months of the year. The economy continues to slowly create jobs – in the first four months of this year, payroll employment grew by almost 860 thousand jobs or over 4% more versus the same period a year ago. This makes households and companies more confident to borrow and spend. Consumer spending is growing at a steady pace, thanks in part to the recovery of car sales (see chart 3). Meanwhile, new orders of manufacturing



goods rebounded following a dip at the start of the year, as business capital outlays seem to be gaining momentum (see chart 4).

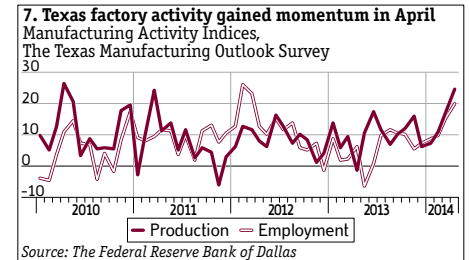
Improving economic prospects and an ongoing recovery of the structured finance markets (see chart 5) are supporting a steady flow of credit to households as well. In March, consumer credit was up by 6.7% annually, helped by expanding car loans. This, together with increasing consumer income (which grew by 3.5% in the first quarter of 2014), is sustaining households' buying



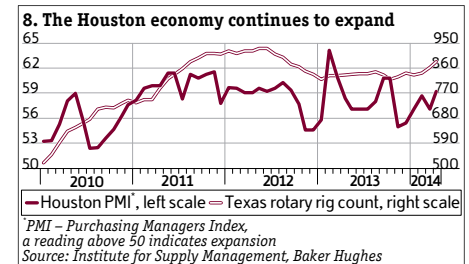
power. At the same time, rising borrowing costs and higher home prices seem to be cooling households' demand for housing – existing home sales stood mostly flat in the first three months of this year. Indeed, according to Freddie Mac, the national average for a 30-year mortgage was at 4.34% in March or nearly a full percentage point higher versus a year ago. Meanwhile, in March home prices saw an annual gain of nearly 8%. Thus, dearer mortgages and pricier homes are affecting housing affordability. On the upside, construction activity strengthened in April (see chart 6), partly



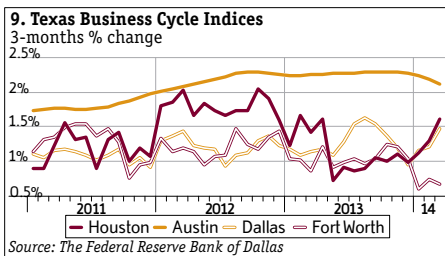
as a response to tight housing inventory and strong price gains on the major regional housing markets. This implies that residential investments may start contributing to economic growth again in the second quarter of 2014, following two consecutive quarterly drops - in the last quarter of 2013 and the first quarter of this year.



Turning to Texas, regional economic growth accelerated markedly during the first two months of this spring – factory activity and manufacturing employment indices hit their best readings in over two years in April (see chart 7). Business activity in service and retail sectors, as measured by the Texas Service Sector Outlook Survey, is growing at a faster pace as well, indicating a continuing broadening of the economic rebound in the state. Still, the energy sector remains a key ingredient of the Texas success story. In particular, steady growth of crude oil and natural gas prices (in April, the WTI crude oil spot price was about 11% higher than a year ago) is fueling growth of the Houston metro economy as mining activity improves (see chart 8). The Metro



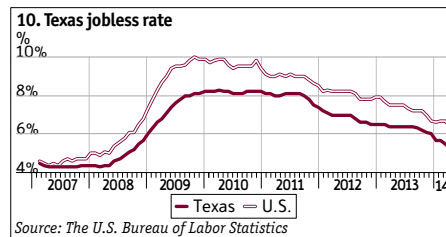
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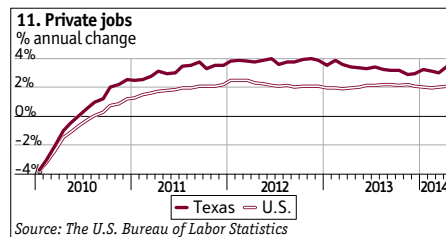
Business Cycle Indices point to a recent uptick in Houston economic activity as well (see chart 9). In addition, Houston – one of the busiest ports in the world – is benefiting from the recovering global economy. Indeed, being the biggest exporting state nationwide, Texas is well positioned to gain from the recent uptick in international business activity. Thus, over the first quarter of 2014, exports from Texas increased by over 7% compared to only 2.6% for the nation as a whole. On that count, this stronger performance of exports was driven by a 28% jump of exports of mineral fuels (about a quarter of all exports). Yet, contrary to the rest of the U.S., Texas exports of industrial machinery and computers (over 17% of all exports) advanced by over 12%; nationwide these exports edged up by just 2.7%. This can be partly attributed to the rapid rebound of global semiconductor sales – according to the Semiconductor Industry Association, the global sales of semiconductors hit record high levels in the first quarter of 2014 thanks to strong growth in the Americas and Asia. This bodes well for Texas, which accounts for nearly two thirds of all computer parts exported from the U.S. And it is a boon for the Austin and Dallas metro economies, where some of the world’s largest semiconductor plants are located. Indeed, Texas exports of industrial machinery and computers to Mexico and Asia are growing at double-digit rates; nationwide, these exports are barely 5% more versus the first quarter of 2013.

Employment

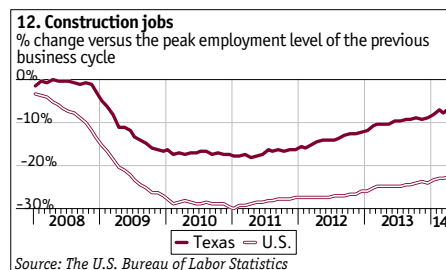
In April, the jobless rate in Texas dropped to 5.2% – its lowest reading since late 2008 – and remained more than a full percentage point lower compared to the national average (see chart 10).



This latest improvement in the Texas job market is a result of an acceleration in private sector hiring; in April, the annual job growth in the private industries was at 3.5% versus 2.1% nationwide (see chart 11). In particular, in April, private employment in Texas jumped by over 68 thousand jobs – the strongest monthly gain since the start of economic recovery. A slight decline in government payroll notwithstanding, most of the major private industries posted solid job gains. Equally important, nearly 47 thousand jobs (or close to 70%) of April’s employment

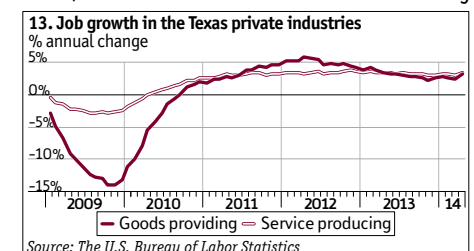


growth came from the service providing sector thanks to 20.1 thousand new jobs in business and professional services, 16.3 thousand new jobs in trade, transportation and utilities, and 8.1 thousand new jobs in education and healthcare. This indicates that the labor market expansion in Texas is gaining momentum as the pace of job growth in the service providing part of the regional economy starts to accelerate. That said, April was a good month for goods producing industries as well, which added 17.3 thousand new jobs on



solid gains in mining, construction and manufacturing. On that note, a much faster rebound of construction jobs in Texas (see chart 12) is a clear sign of the health of the Texas economy. In April, the homebuilding industry in Texas employed just 6.6% fewer workers versus the peak employment level of the previous business cycle. Nationwide, the construction industry was still short of nearly a quarter of the workers employed at the start of the Great Recession. Thus, April was just the second straight month that private sector employment was above its pre-crisis level, although it was by only 0.4%. Meanwhile, Texas already employs nearly 9% more workers in private industries than six years ago.

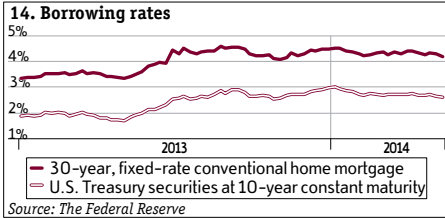
Lastly, there are signs that this recent uptick in hiring may represent a sustainable uptrend for the Texas labor market. First, annual job growth in private good producing and service providing industries is stabilizing at above 3% (see chart 13), which is about on par with the long-term trend. Second, at 65.2% the Texas labor force participation rate is almost where it was at the start of the recession and has been gradually growing since the start of the year. Nationwide, the labor force participation rate continued to shrink in April, dropping to 62.8% in April versus 66% in 2007. This reflects both more favorable demographic trends in Texas (younger and faster growing population) as well as brighter job prospects as fewer discouraged workers are leaving the workforce. After all, the size of the Texas economy, as measured by the real gross state product, expanded by over 15% since 2007 versus a more modest 6% increase nationwide. This means that the regional economy is now capable of sustaining many more private jobs compared to the nation as a whole. Thus, as the U.S. economic recovery



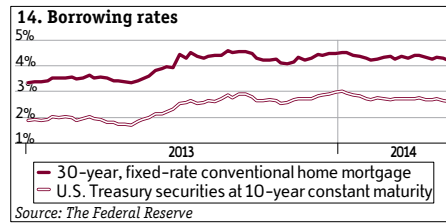
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takes firmer hold in the coming quarters, Texas will continue widening its lead in job creation compared to many other state economies.

Monetary Policy and Asset Prices

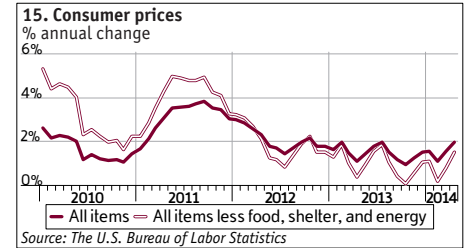


The improving economic climate has prompted the Federal Reserve to scale back its asset buying program by another \$10 billion in April. Starting in May, the Fed is reducing its monthly purchases of agency mortgage-backed securities and longer-term Treasury securities by \$5 billion both to \$20 billion and \$25 billion, respectively. Still, the impact on borrowing costs was relatively muted (see chart 14) considering that this policy decision was anticipated by



investors. Meanwhile, following a lull, consumer inflation has been recently getting somewhat stronger on growing healthcare costs, higher gas prices and dearer housing. Still, the pace of core inflation, which excludes more volatile prices of fuels and foods, remains below the Fed's implicit 2% target (see chart 15), pointing to an unlikely acceleration of the speed of monetary policy tapering.

In fact, the impact of the higher borrowing costs on the housing market – mortgage rates are now a full percentage point above last year's level – may be another factor deterring the Fed from pursuing a less accommodative monetary policy. Dearer mortgages have already cooled housing demand as



fewer potential homebuyers can afford to finance a new home. Home prices appear to be increasing at a slower pace as well (see chart 16). Still, low levels of housing inventory (3.4 months of supply in Texas and 5.2 months nationwide) are helping sustain business activity on the housing market at a relatively healthy level.

