Texas factory activity continues to expand, albeit at a slower pace than at the beginning of 2010. In particular, construction-related manufacturing is struggling on the back of poor residential and commercial real estate activity. Meanwhile, growing overseas demand continues to support manufacturing of chemicals and high tech products. Still, the Texas Manufacturing Outlook Survey employment index has been drifting sideways since June, as businesses appear to be delaying employment decisions due to considerable economic and policy uncertainty. Indeed, a sluggish labor market recovery is plaguing the economic outlook for the entire U.S. economy, with recent modest gains in employment still insufficient to bring the unemployment rate down.

This persistently high jobless rate is exerting a toll on personal consumption. As a result, consumer and business spending, which historically have driven the U.S. economy out of downturns of similar magnitude, are faring far worse than in past recoveries. This means that exports remain an integral part of any U.S. economic rebound. Furthermore, U.S. economic growth is becoming increasingly dependent on a multiplicity of other factors. In particular, those states that steered away from aggressive mortgage lending, have sound public finances, stronger export bases, and more competitive business environments, are likely to outperform other regional U.S. economies. Judging by the widening gap between unemployment rates in Texas and other parts of the country, Texas is clearly benefitting from a more robust economic model.

A large part of this gap is due to the 'milder' business cycle in Texas versus other large states. In particular, the intensity of the housing market adjustment was much smaller in Texas. Employment in local manufacturing was supported by the relatively higher reliance on exports versus domestic demand. And, a quick recovery of the energy sector added resilience to the Texas labor market. Moreover, the flexibility of many of the biggest metropolitan labor markets in the U.S. is severely constrained by the dire conditions of their local housing markets. Contrary to this, it is easier for the unemployed in Texas to relocate to places where new jobs are created. In fact, the share of negative equity mortgages in Texas is half as high as nationwide, as home values in the state have held up fairly well with lower volumes of distressed properties entering the market. This means the gap between the unemployment rate in Texas versus other states is unlikely to close anytime soon.

The U.S. housing market appears to be stabilizing, on record low mortgage rates and improved housing affordability. That said, the housing sector is still near the lows reached during the downturn, while the overhang of foreclosed homes is dampening any recovery in home prices. This means the Fed will likely continue to try and keep long-term interest rates low. Indeed, with unemployment stuck around 10% and little room for any additional fiscal stimulus, the Fed is likely to stick to its QE2 target by purchasing $600 billion of longer-term Treasury securities by the end of June 2011. This is being done on the premise that, at least in the near term, weak producer pricing power and below-historic-average growth of consumer prices still allows for additional monetary easing without rekindling inflation.

Finally, Texas exporters continue to enjoy a healthy rebound of overseas demand. In particular, Texas is benefiting from its relatively high exports to developing countries in general, and to Latin America (including Mexico) in particular. Fortunately, a relatively smaller share of exports to Europe (versus the nation as whole) reduces exposure to resurfaced worries over the strength of economic growth in the Euro area. That said, China's intentions to curb inflation are exerting downward pressure on commodity prices. On the upside, the relatively good diversification of Texas exports (both in terms of commodities and export destinations) should help mitigate the impact of tighter economic policies in China.
Economic output

Texas factory activity continues to expand, albeit at a slower pace than at the beginning of 2010. According to the Texas Manufacturing Outlook Survey, the production index grew for the second consecutive month in October; however, it was still below its spring level (see chart 1). The data shows construction-related manufacturing struggling on the back of poor residential and commercial real estate activity. Indeed, according to the U.S. Census Bureau, seasonally adjusted annualized spending on private construction was 17% lower in September than a year ago, as spending on residential and nonresidential construction fell by 6% and 25%, respectively. On a positive note, Texas manufacturing is better equipped to catch the rising wave of overseas demand for high-tech products and capital goods. In fact, the share of these industries in Texas manufacturing is higher than nationwide. For example, manufacturing of machinery, computers, electronics and electric equipment account for about one quarter of all manufacturing in Texas compared to 20% in the nation as a whole.

Meanwhile, the Texas Manufacturing Outlook Survey employment index has been drifting sideways since June, as businesses appear to be delaying employment decisions due to considerable economic and policy uncertainty. The latest ADP National Employment Report shows that the private sector created only 43,000 new jobs in October. These modest gains are still insufficient to bring the unemployment rate down. Indeed, despite 151,000 new jobs in October, the U.S. jobless rate stood steady at 9.6%.

This persistent lack of jobs (the U.S. unemployment rate has remained over 9.5% for the last 18 months) is taking a toll on consumer spending. In particular, in the third quarter of 2010, the U.S. economy grew at a seasonally adjusted annualized rate of only 2%, with personal consumption (over 70% of the U.S. economy) faring worse than in previous recoveries. Personal consumption is only 2.4% higher than its level five quarters ago, when the economy bottomed out. Yet five quarters after the previous two downturns (in March 1991 and November 2001), personal consumption was approximately 3.5% higher than at those recession troughs. Moreover, those two business cycles were much milder than the 2007 downturn (the peak-to-trough decline in GDP was only 1.4% in 1991, and less than 0.5% in 2001). This time, the economy shrank by over 4% from the last quarter of 2007 to the second quarter of 2009. A recession of comparable magnitude lasted from July 1981 to November 1982, with GDP declining by about 3%. Personal consumption was 8.4% higher five quarters after that recession ended.

The contribution of personal consumption to economic growth is unlikely to be on par with previous recoveries this time. First, consumer confidence, having recovered a good deal since February 2009, is still well below its pre-crisis levels. At present, this index drifts around the lowest numbers recorded during the previous four recessions. This means consumers remain anxious about the economic outlook and are delaying discretionary spending. Second, consumers are reducing their debts at the fastest pace in over a decade. In particular, in the third quarter of 2010, total consumer indebtedness was $922 billion lower than its peak two years ago. Indeed, between 2000 and 2007, non-mortgage consumer borrowing grew on average by over $200 billion a year; however, it fell by $250 billion during the last seven quarters. Although this large reduction reflects a sharp increase in the volume of charge-offs as well as tighter lending standards, consumers appear to be stuck in deleveraging mode (see chart 2). After all, personal saving as a percentage of disposable personal income nearly tripled from 2% in 2005-2007 to 6% in 2009 and 2010. Recent trends indicate a fundamental shift in consumer behavior as households have become thriftier.

Weak personal consumption and declining residential investment have led to a sharp deceleration in final domestic demand (to 2.5% in the third quarter from 4.3% the quarter before). Government spending slowed as well, on falling spending at the state and local level. On

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1Source: The Federal Reserve Bank of New York, Quarterly Report on Household Debt and Credit.
2The removal of obligations from consumers’ credit reports because of defaults.
3According to the October 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices, a substantial fraction of banks does not see lending standards easing to their precrisis levels in the foreseeable future.
4Excluding exports and change in private inventories.
the upside, inventories continued to prop up growth, adding 1.4 percentage points to third quarter GDP growth, as companies bet on stronger sales during the coming holiday shopping season. However, inventory restocking is nearing its end (with the year-over-year gap in the growth of sales versus inventories gradually closing). And with inventories-to-sales ratios approaching their pre-crisis averages, there’s little room for inventories to contribute much to economic growth in the coming quarters (see chart 3). Furthermore, inventory accumulation by businesses boosted imports (see chart 4), which subtracted 2.6 percentage points from overall economic growth.⁵

Finally, exports continued to support economic recovery for the fifth consecutive quarter. This has several implications for overall economic recovery. First, exports continue to drive a turnaround in U.S. manufacturing, which is recovering faster than the broader economy.⁶ Indeed, the New Export Orders Index jumped by 6 percentage points in October, contributing to stronger economic activity in the manufacturing sector (see chart 5). Second, exports have rebounded by over 15% in real terms since the second quarter of 2009. However, the U.S. economy grew by only 3.5% during the same five quarters. With the share of GDP from exports at just over 12%, it will take time for exports to replace traditional drivers of U.S. economic growth (such as consumer and business spending). This means that while remaining an integral part of the U.S. economic recovery, increasing exports may not be enough to achieve sustainable growth. Therefore, this recovery is likely to be more complex compared to previous downturns. Indeed, while credit-fueled consumption and residential investment supported the U.S. economy in the past, this time economic growth will depend on a multiplicity of factors. In particular, states that steered away from aggressive mortgage lending, have sound public finances, enjoy a strong export base, and have competitive business environments are likely to outperform regional economies with excess capacity in sectors relying on highly-leveraged domestic consumption (for example, retail and construction).

Employment

In September, the unemployment rate in Texas dropped to 8.1% from 8.3% the month before, staying well below the national jobless rate of 9.6% (see chart 6). Furthermore, Texas continues to have the lowest unemployment rate among the ten most populous states (see chart 7). Since the onset of the 2007 downturn, the state has consistently had a lower unemployment rate than the nation. Meanwhile, the gap between the unemployment rate in Texas and California (which has a fairly similar demographic profile)⁷ widened to 4 percentage points in 2010 (see chart 8). This implies that demographics alone have played little role in the U.S.-Texas unemployment gap.

Indeed, a big part of this gap is due to a 'milder' business cycle in Texas versus other large states. In particular, the intensity of the housing market adjustment was much smaller in Texas compared to, for example, California and Florida. Employment in Texas manufacturing was supported by the relatively higher reliance on exports rather than domestic demand. In addition, the quick recovery in the energy sector added resilience to local labor market conditions.

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⁵China’s removal of export tax rebates in July also contributed to a surge in imports in the second and third quarters.

⁶For example, shares of manufacturers gained more this year than the broader indexes. By mid-November, the S&P Machinery Index grew by over 30% compared to only a 7.5% increase of the S&P 500 Index.

⁷The Texas demographic profile is much closer to the demographic profile of California than to national demographics. In particular, both states have younger populations and a relatively similar share of population with Hispanic origin, although the share of Asian population is much higher in California.
The impact of the housing-led recession on employment is most evident in those regional economies that experienced substantial appreciation in home prices prior to 2008. Since December 2007, California, Florida, Nevada and Arizona (states that suffered most from the bursting of the housing bubble) have contributed disproportionately to national unemployment. In particular, over 26% (compared to less than 20% at the beginning of the recession) of all unemployed workers reside in just those four states (see chart 9). Meanwhile, California and Florida account for 17.3% and 9.4% of the 7 million workers who lost their jobs over the last three years. This is in spite of the fact that the share of these states in the U.S. labor force is only 12% and 6%, respectively.

There are good reasons to believe that the gap between the unemployment rate in Texas versus other large states is unlikely to close soon. The flexibility of many key metropolitan labor markets is severely constrained by the dire conditions of their local housing markets. In particular, the share of negative equity mortgages exceeds 30% in many large cities in California, and is even higher in Florida, Nevada and Arizona. Contrary to this, only 11% of all mortgages in Texas are under water - twice as low as the national average. This makes it easier for the unemployed to relocate to places where new jobs are being created.

**Monetary policy and asset prices**

At the beginning of November, the Federal Open Market Committee confirmed its intention to purchase $600 billion of longer-term Treasury securities by the end of June 2011. The Fed, however, acknowledged that it may adjust the size of this program (conditional on the trajectory of the unemployment rate and inflation). However, with U.S. unemployment stuck around 10%, and little room for any extra fiscal stimulus, it’s increasingly likely that the Fed will stick to its original target. This is premised on the belief that the short term risk of higher inflation remains subdued. In October, the Producer Price Index (excluding food and energy), which tracks selling prices received by domestic producers of goods and services, declined by 0.6% versus September. This was the largest monthly drop in over 4 years, implying that producer pricing power is still weak. Meanwhile, in October, consumer prices were only 1.2% higher than a year ago - well below historic averages.

More importantly, lower mortgage rates, as well as improved housing affordability, are starting to unfreeze the housing market. Indeed, there are signs the housing market is gradually stabilizing, albeit at a glacial pace. Nationwide, existing home sales grew for the second consecutive month in September, to 4.53 million units, although they are still 19% lower than a year ago. In Texas, home sales dropped in September on lower sales in key housing markets - Houston, Dallas, San Antonio, and Austin. Yet despite weaker sales, home values remain stable in Texas thanks to a much smaller share of distressed properties in total sales. According to the Texas Association of Realtors, the average price of a single-family home increased by 5.6% in October 2010 versus a year ago. The National Association of Realtors estimates that in the third quarter of 2010, the annual gain in home prices in Austin, San Antonio and Dallas was 8.4%, 3.4% and 14%, respectively.

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8 According to the Housing Price Index calculated by the Federal Housing Finance Agency, home values declined by 40% in Arizona, 37% in California, 39% in Florida and 50% in Nevada during the period from the first quarter of 2007 to the second quarter of 2010.

9 Source: CoreLogic Negative Equity Report, Q2 2010.

10 According to Freddie Mac, the national average rate for a 30-year, conventional, fixed-rate mortgage fell to a record low of 4.35% in September.
Foreign trade

During the first three quarters of 2010, exports from Texas increased by nearly 28% (to $149 billion) on stronger overseas shipments to NAFTA partners (Canada and Mexico), Latin America and Asia. Texas exports continue to be dominated by industrial machinery and computers, mineral fuels, electric equipment and components, and petrochemical products. This product composition appears to favor a stronger rebound of overseas sales compared to states with less diversified exports. In particular, thanks to higher crude oil prices, Texas exports of mineral fuels jumped by 55% (contributing nearly 30% to the overall expansion of exports). Exports of industrial machinery, parts and computers are growing as well, spurred by recovering global manufacturing of durable goods such as consumer electronics and passenger cars. This growth supports foreign demand for high-tech components, including circuit boards and semiconductors. Finally, consumption of white goods is growing in developing countries, which drive overseas demand for Texas petrochemical products, including synthetic chemicals, plastics and rubber.

In addition to the composition of its exports, Texas is also benefiting from increased demand from developing countries in general, and Latin America (including Mexico) in particular. Indeed, in January-September, total U.S. exports grew by only 22% as the share of national exports to Europe (where demand for U.S. products grew much slower compared to other parts of the world) is nearly 10% higher than in Texas. Meanwhile, Texas exports to Latin America (excluding Mexico) jumped by over 50%, and exports to Mexico increased by 31%. As a result, higher exports to Latin American markets contributed nearly two thirds to the overall growth of Texas exports, compared to just above one third nationwide (see chart 10). Lastly, exports to developing countries (over 62% of all exports from Texas) were up by 31%, adding 19 percentage points to the 28% growth of Texas exports. Nationwide, exports to developing countries (about 38% of all U.S. exports) accounted for less than half of the overall 22% growth of exports.

Although the share of Texas exports to Asian countries is almost the same as nationwide (24.5% vs. 29%), the composition of exports to Asia is somewhat different. In particular, exports to South Korea, Singapore, Taiwan, and Japan contributed as much as 65% to a 24% growth of Texas exports to Asia (compared to only a 43% contribution from those four countries nationwide). These countries are all enjoying a strong rebound in manufacturing, which boosts their purchase of high-tech components from Texas. Meanwhile, the contribution of exports to China to the growth of Texas exports was less than one percentage point (or three times smaller than for the nation as a whole). After all, the share of petrochemical products in Texas exports to China is much higher than nationwide. And growing production capacity, both in China and the Middle East, as well as increasing exports of scrap plastics to China, may have slowed Chinese demand for Texas chemicals.

Canada and Mexico still account for over 40% of Texas exports. As both economies appear to be exiting this recession faster than their peers, Texas should continue to enjoy robust overseas demand for its products. More than that, a growing share of Texas exports to developing economies exposes the state to faster economic growth as these economies continue to develop (see chart 11).

E-mail: texas@sigmableyzer.com
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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Private equity news

A Miami-based private equity firm, H.I.G. Capital, has made an investment in San Antonio-based Cardell Cabinetry. Cardell is a leading designer, manufacturer, marketer, and distributor of kitchen and bath cabinetry.

Offers.com, an Austin-based web site featuring coupons, discounts and other promotional deals, has raised $7 million from Susquehanna Growth Equity, a private equity group investing in growth capital and buyout opportunities in financial technology, information services, and software.

Austin Ventures led an $11.5 million seed investment in Silverback Acquisitions, an Austin-based consolidator of subscale enterprise software companies. Austin Ventures has committed a total equity growth-capital investment of up to $50 million to this new venture.

ViroXis Corp., a San Antonio-based life sciences and biotechnology company, received a $2.5 million investment from the Texas Emerging Technology Fund. The capital will be used to advance development and commercialization of anti-viral treatment of skin warts.

Riptano, an Austin-based provider of software, support and training for the open source database management system Apache Cassandra, has closed $2.7 million in Series A financing. The financing was led by Lightspeed Venture Partners with the participation of Sequoia Capital and a private investor.

The CapStreet Group, a Houston-based private equity firm, has closed its third fund with $178 million. The firm will focus on lower-middle market privately-held businesses located in Texas and other states in the Southwestern U.S.
Economic growth: Texas vs. U.S.
% annual change, right scale

Estimates by the Texas Controller of Public Accounts
Source: The U.S. Bureau of Economic Analysis, Texas Controller of Public Accounts

Personal income
seasonally adjusted at annual rates, % annual change

Consumer prices
% annual change

Nonfarm employment
2006=100

Unemployment rates
seasonally adjusted, %

Industrial production
seasonally adjusted, 2007=100

Purchasing Managers Index
a reading above 50 indicates expansion

Oil industry

Home values
seasonally adjusted, December 2006=100

Home sales
seasonally adjusted annual rate

Exports
2006=100

Venture capital investment activity in the United States
quarterly investments

Source:
- The U.S. Bureau of Economic Analysis
- The U.S. Bureau of Labor Statistics
- The Federal Reserve Bank of Dallas
- The Institute for Supply Management
- The U.S. Department of Commerce
- PricewaterhouseCoopers
- The S&P/Case-Shiller Home Price Indices
- The National Association of Realtors
- The Real Estate Center at Texas A&M University
- The U.S. Bureau of Labor Statistics
- The Federal Reserve Bank of Dallas
- The Bureau of Labor Statistics, the Federal Reserve Bank of Dallas
- The Bureau of Economic Analysis, Texas Controller of Public Accounts
- The U.S. Bureau of Economic Analysis
- The Bureau of Labor Statistics
- The Federal Reserve Bank of Dallas
- The U.S. Bureau of Labor Statistics
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