

March 2011

- **The Texas jobless rate fell to 8.2% in February.**
- **The Texas production index increased to its highest level since April 2010.**
- **In February, consumer prices grew at an annual rate of 2.2% on higher energy costs and more expensive food.**
- **Existing home sales fell in February, both in Texas and the U.S. overall.**
- **Texas lawmakers closed the \$4.3 billion 2011 fiscal deficit.**

Executive summary

Texas factory activity continued to strengthen in March, for the 17th consecutive month. Labor market conditions have been steadily improving as well – with the manufacturing employment index pointing to a fifth straight month of job gains. All other key metrics of manufacturing activity, including company outlook and the perception of the health of the broader economy, remain in positive territory, indicating continued improvement in general business conditions.

In February, the Texas Business Cycle Index improved for the 14th consecutive month, with the energy sector adding continued momentum to the local economy. Mining accounts for a much larger share of private-sector job gains in Texas (compared to the industry's share in total employment), and business activity in mining is likely to stay strong as high energy prices prompt oil companies to step up domestic production. Indeed, six new deep-water drilling permits were approved last month (three off the Texas coast), which means commercial interest in deep-water drilling in the Gulf of Mexico remains high despite stricter safety standards.

A recovery in the automobile industry, and strong overseas demand, are driving economic expansion in many key regional economies in the U.S. In addition, growing consumer spending, driven by pent-up demand for durable goods, is adding strength to the overall national manufacturing story. This is attributable to a gradual stabilization of consumer credit, thanks to 'looser' lending standards. A gradual recovery in personal income is also supporting consumers' buying power as well.

In February, the jobs picture improved in Texas as the

jobless rate fell to 8.2%. At the same time, the number of people either employed or looking for jobs in Texas is trending upwards as more jobseekers move in from other states. In addition, the share of working-age people, who choose to participate in the Texas labor market, is higher compared to the national labor force participation rate. As a result, faster population growth and higher participation rates help explain why the jobless rate is declining slower in Texas, despite a stronger recovery in the state's job market.

Increasing commodity prices are adding to inflationary pressures, as growing concern over input costs is present in all national and regional business outlook surveys. In February, consumer prices grew at an annual rate of 2.2% on higher energy costs and dearer foods. Having said that, food and energy account for less than a fifth of total spending for the average U.S. consumer. Meanwhile, housing costs (over a third of consumer spending) are likely to grow slower than overall inflation thanks to low mortgage rates and more affordable homes. This should partly offset increasing prices for groceries and gasoline.

Lastly, despite record high housing affordability, housing activity remains weak due to tight mortgage lending and an increasing number of distressed properties. In February, national home sales and median existing-home prices were lower than a year ago. That said, in February only 1 in 841 homeowners received foreclosure notices in Texas – a much better reading compared to harder hit states. Meanwhile, median home values grew in Texas thanks to strong house prices in the state's largest metros.

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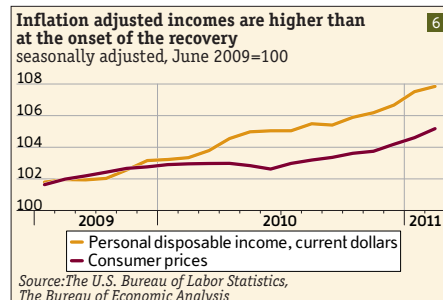
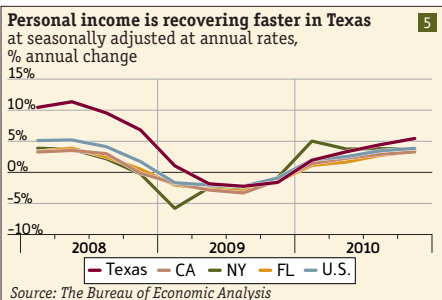
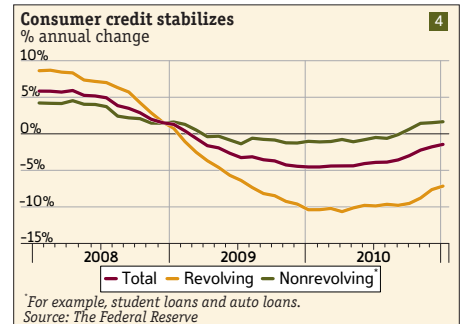
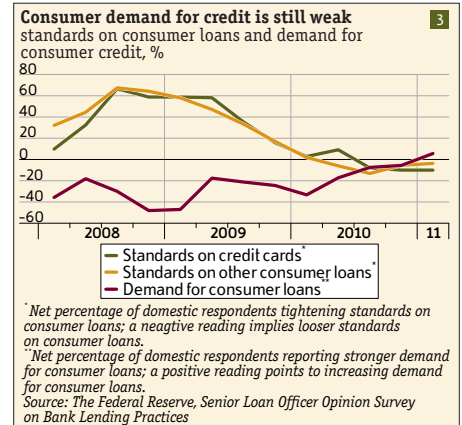
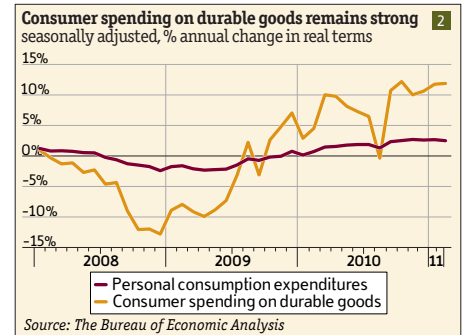
Economic output

According to the latest Texas Manufacturing Outlook Survey, factory activity strengthened in March with the production index increasing to its highest level since April 2010 (see chart 1). This means March was the 17th consecutive month of growth in Texas factory output. Labor market conditions have been steadily improving as well – the employment index points to a fifth straight month of job gains. All other key metrics of manufacturing activity, including company outlook and the perception of the health of the broader economy, remained in positive territory, indicating continued improvement in general business conditions.

Nationwide, key regional surveys point to expanding economic activity and a favorable economic outlook. For example, the Empire State Manufacturing Survey, conducted by the Federal Reserve Bank of New York, registered increasing factory output and employment in March. Meanwhile, March results from the Business Outlook Survey by the Federal Reserve Bank of Philadelphia revealed strengthening demand for manufactured goods and improving labor market conditions. Lastly, reports from Atlanta, Chicago, Kansas City, and San Francisco point to more solid growth in factory activity thanks to increasing spending on high tech products, a recovery in the automotive industry¹, and robust overseas demand (especially from emerging Asia).²

Improving personal consumption, especially on the back of substantial pent-up consumer demand for durable goods (see chart 2), also adds strength to U.S. manufacturing. This may be partly attributed to a gradual stabilization of credit usage thanks to somewhat looser lending standards (see chart 3), which drive demand for consumer loans (see chart 4). A recovery in personal income is also helping to sustain consumer spending. Indeed, according to the latest release of the Bureau of Economic Analysis, last year personal income in the U.S. grew by 3%, on employment gains in the private sector and higher government spending on social transfers, such as unemployment benefits and health insurance. Yet thanks to a better performing labor market, personal income grew faster in Texas (up by 3.8%)³, accelerating at the end of 2010 (see chart 5).

Household income continued to rise in February. Indeed, personal disposable income⁴ grew by 2.7% on an inflation-adjusted basis versus the same month a year ago. Since the beginning of the U.S. economic recovery in the second half of 2009, incomes have grown faster (by about 7.8% from June 2009 to February 2011, see chart 6) than prices (up 5.2% during the same period), which puts the inflation-adjusted gain in income at above 2%.



¹For example, according to Autodata Corp., during the first two months of 2011, sales of cars and light trucks in the U.S. retail market were up by 22.6%, growing in February to a seasonally adjusted annualized rate of 13.4 million. More than that, with sales of imported brand light vehicles down by 7.6%, car sales grew thanks to solid demand for domestically produced vehicles.

²Source: The Federal Reserve Board, The Beige Book Surveys.

³The seventh fastest annual growth of personal income among all U.S. states.

⁴Personal disposable income – after-tax household income available for consumption and saving.

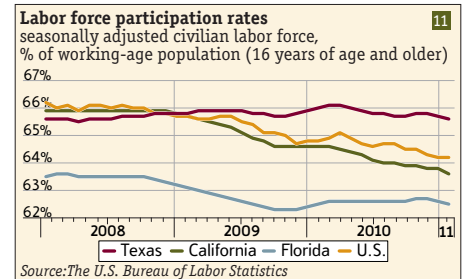
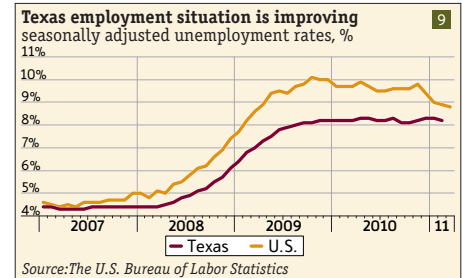
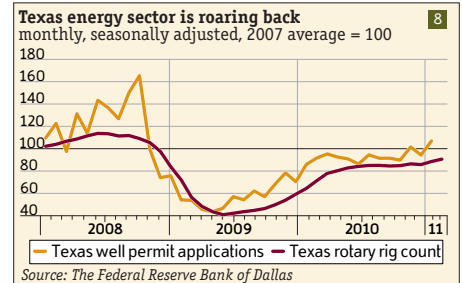
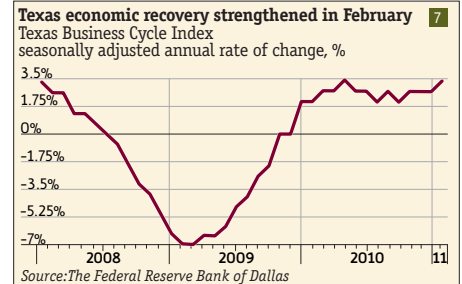
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Despite this, in February, an increase in incomes was not sufficient to make up for higher gas and grocery prices – inflation-adjusted personal income was about 0.1% lower than the month before. In fact, worries over higher inflation are starting to affect consumer confidence. In March, the Conference Board Consumer Confidence Index fell to 63.4 from 72 the month before. Although consumers’ assessment of job market conditions remains mostly unchanged, the short-term outlook was considerably less favorable than in February. Clearly, a stalled housing market recovery and increasing energy prices are exerting a toll on consumer sentiment. For example, according to the U.S. Department of Energy, the pump price for regular gasoline was \$3.60 per gallon in the last week of March - the highest level since September 2008. Still, we believe that a continued recovery in the labor market⁵, and savings from the tax cuts, should help sustain consumer spending, partly offsetting the impact of higher prices.

Turning to Texas, the state’s economic recovery remains strong, with the Texas Business Cycle Index⁶ increasing in February for the 14th consecutive month (see chart 7). Energy is adding momentum to the local economy thanks to increasing activity in the oil and gas industry (see chart 8). The Texas mining industry, which represents just above 2% of all private-sector jobs, is responsible for over 13% of all jobs created since Texas private-sector employment bottomed out at the end of 2009. Business activity in the mining industry is likely to stay strong as high energy prices prompt U.S. oil companies to step up domestic energy production. According to the U.S. Energy Information Administration, last year U.S. production of crude hit the highest mark in five years, while the production of natural gas was at its highest level in more than three decades. In addition, the government is trying to unwind U.S. dependence on energy imports, which further deepens the reliance on domestic sources of oil and gas. This means that more deepwater drilling permits will be issued following a temporary suspension of deep-water drilling in June 2010. Indeed, at the end of March, the Bureau of Ocean Energy Management, Regulation and Enforcement approved a sixth deepwater drilling permit that complies with new safety standards.⁷ All this should support business activity in the energy sector, in which Texas is a key player.

Employment

In February, the employment picture improved in Texas with the jobless rate inching down to 8.2% (see chart 9). That said, the unemployment rate in Texas, which has stayed above 8% for the past 17 months, is still at the same level as a year ago. Meanwhile, nationwide, the jobless rate fell from 9.7% in February 2010 to 8.9% in February 2011. This can largely be attributed to the stalled expansion of the U.S. labor force (see chart 10), as weak employment prospects and a depressed housing market discourage Americans from looking for jobs.⁸ Meanwhile, the number of people either employed or seeking jobs in Texas grew by about 6% since December 2007, as more jobseekers are moving in from other states. Furthermore, not only is the Texas working-age population growing faster than in other large states (up by 1.7% in February versus an annual increase of just 1% in California and Florida), the share of people who are either employed or looking for jobs is higher in Texas (see chart 11). As a



⁵According to the ADP National Employment Report, the private sector created 200,000 new jobs on average each month during the first quarter of 2011. The March report, which registered 201,000 new jobs in the private sector, provides additional evidence that the labor market recovery is gaining traction.

⁶family of Texas Business Cycle Indices, produced by the Federal Reserve Bank of Dallas, measures monthly changes in employment, jobless rates and inflation adjusted wages and retail sales at the state and metro levels.

⁷All six permits were issued in March, including three deepwater permits off the Texas coast. In March, the U.S. administration also approved the first deepwater permit for completely new exploration since the deepwater drilling moratorium was lifted in October 2010.

⁸Indeed, in February the national labor force participation rate (the share of working age population, who are either employed or looking for jobs) fell to its lowest reading (64.2%) since 1982.

Headquarters

123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 6213111 Fax: +1 (713) 6214666
Email: sbleyzer@sigmableyzer.com

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result, this combination of higher population growth and a widening gap between the U.S. and Texas labor force participation rates helps explain why the jobless rate is declining at a slower rate in Texas, despite a stronger recovery in the state's overall job market.

On that note, 22,700 new jobs were added in February thanks to solid job gains in mining and continued hiring in business and professional services. Texas continues to lead the nation in job creation. During the last twelve months, over 250,000 new jobs were created in Texas – the fastest job growth among the 10 most populous U.S. states⁹ (see chart 12).

Private-sector job growth remains robust, with employment increasing by 2.7% versus February 2010. Over the past twelve months, most new jobs came from professional and business services, trade, transportation and utilities, and mining, where annual job-growth continued to surpass national levels. This is important, because sectors where employment is increasing at a faster rate than nationwide (see chart 13) account for roughly 77% of all private jobs in Texas. This means that improving labor market conditions will boost job gains in Texas thanks to stronger performance in sectors where the state already leads the nation. Additionally, unemployment insurance claims are trending down both in Texas and nationwide¹⁰, which eases doubts about the strength of the labor market recovery in 2011.

Monetary Policy and Asset Prices

Increasing commodity prices are adding to inflationary pressures in the U.S. Furthermore, growing concern over input costs is present in all recent national and regional business outlook surveys. According to the U.S. Bureau of Labor Statistics, in February, consumer prices grew at an annual rate of 2.2%, on higher energy costs (the energy cost index jumped by 11% - the fastest growth rate since May 2010) and dearer foods (the 2.3% increase in food prices was the biggest in nearly two years). That said food and energy account for less than a fifth of total spending for an average U.S. consumer.¹¹ Meanwhile, the cost of housing, which absorbs more than a third of all consumer spending, is unlikely to outpace overall inflation, thanks to low mortgage rates and more affordable homes. Indeed, although prices of goods and services, excluding more volatile food and fuel prices, have been on an uptrend for the past three months, they are growing much slower compared to 2008, when surging inflation aggravated economic recovery (see chart 14).

The housing market continues to struggle as existing home sales fell in February, both in Texas and in the U.S. overall (see chart 15). In particular, according to the National Association of Realtors, in February, national home sales were down by nearly 3%, versus the same month a year ago, while the national median existing-home price was 5.2% lower than a year ago. Despite record high housing affordability, housing activity remains weak on tight credit and a high number of distressed properties on the market, which are sold at a discount.¹² As a result, there is a considerable degree of uncertainty over home values, which keeps many potential sellers at bay. Although the number of new foreclosures declined by about 14% from January to February, the average sales price of foreclosed properties registered a monthly drop of 1.7%.¹³ According to RealtyTrack,

1 in 577 U.S. homeowners received a foreclosure filing in February. The foreclosure crisis remains particularly dire in Nevada (1 in 117), Arizona (1 in 178) and California (1 in 239). This high concentration of foreclosed properties depresses values of neighboring homes,

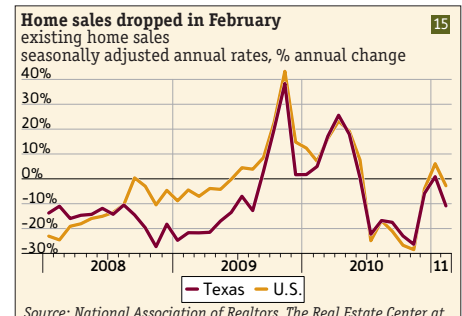
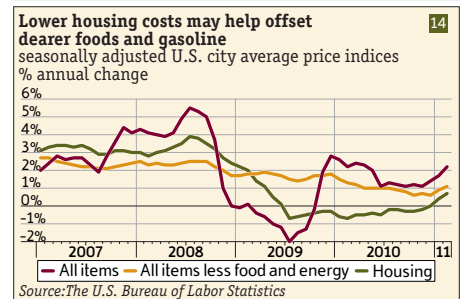
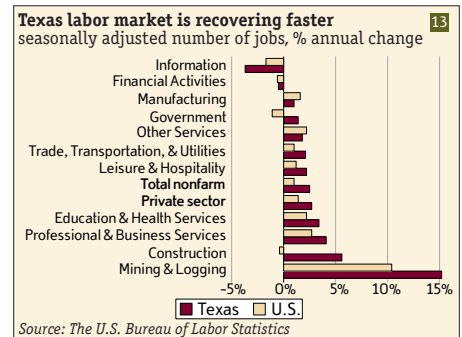
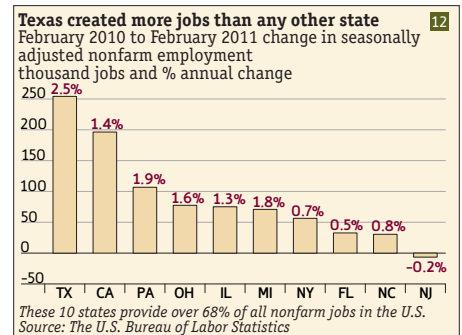
⁹In February, Texas was the third state (after North Dakota and Vermont) in terms of the pace of job creation. Yet the combined number of nonfarm jobs in North Dakota and Vermont is just 6.6% of the total employment in Texas.

¹⁰According to the latest release of the U.S. Department of Labor, an annual drop of the 4-week moving average initial unemployment claims stood at 15% in Texas and 14% nationwide.

¹¹Source: The U.S. Bureau of Labor Statistics, Consumer Expenditures Survey.

¹²According to the National Association of Realtors, the share of distressed homes in total sales grew to 39% in February.

¹³Source: RealtyTrack.



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which takes a toll on solvent homeowners and reduces local government tax revenues. That said, only 1 in 841 homeowners received a foreclosure notice in Texas. Thanks to a more resilient housing market, median home values improved in Texas on increasing housing prices in the biggest metros (see chart 16). All said, continued employment gains should sustain price stability for the Texas housing market. In fact, according to the latest release of the S&P/Case-Shiller Home Price Indices, in January, home values in Dallas posted the second consecutive monthly gain, while home prices continued to weaken for the seventh straight month nationwide.

	Sales	Median price
Austin	-3%	4%
Dallas	-14%	6%
Fort Worth	-19%	-3%
Houston	-2%	4%
San Antonio	-12%	3%
Texas	-10%	3%

Source: The Real Estate Center at Texas A&M University

Fiscal Policy and Public Debt

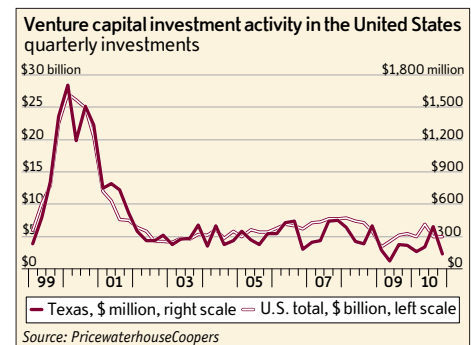
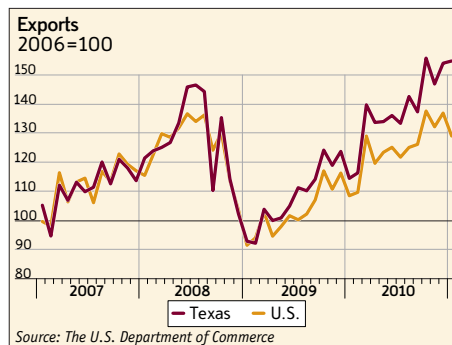
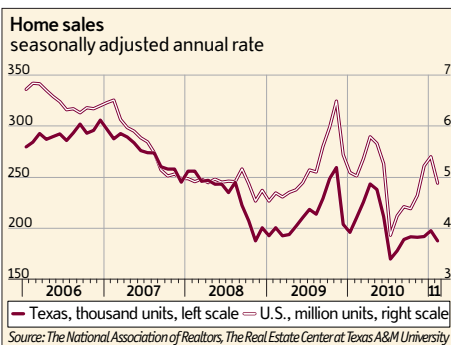
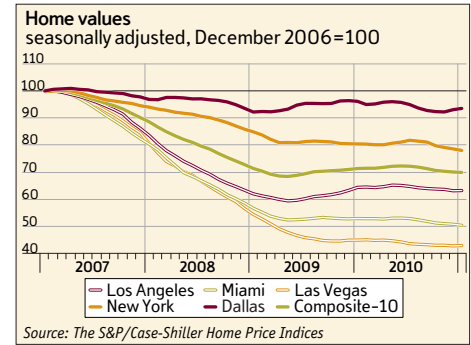
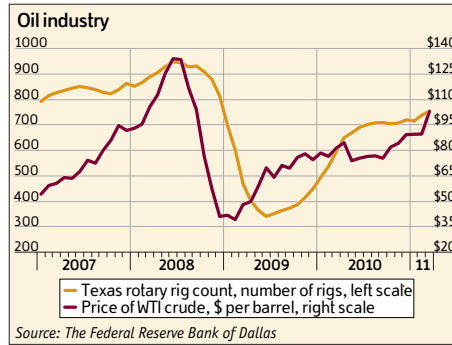
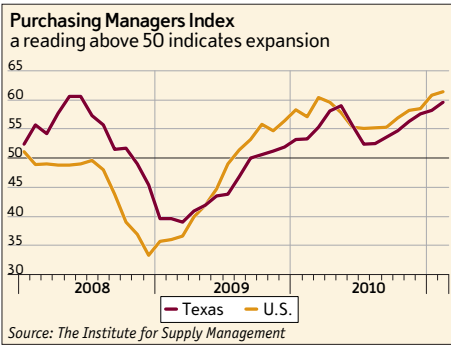
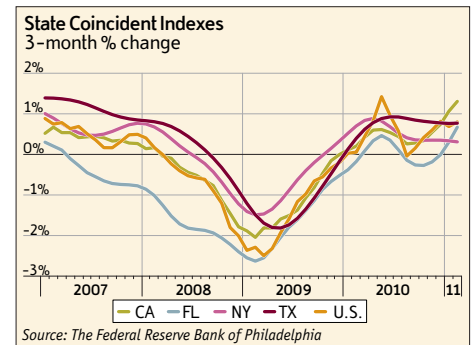
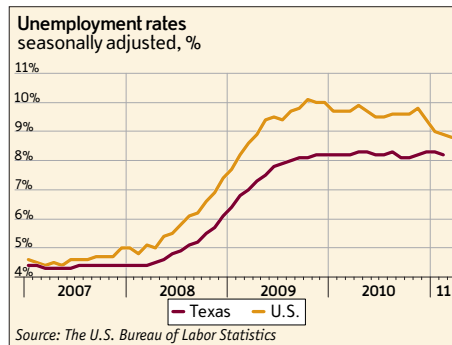
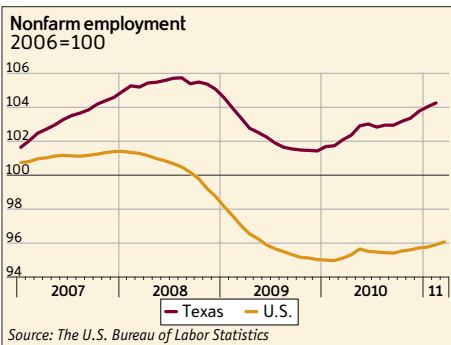
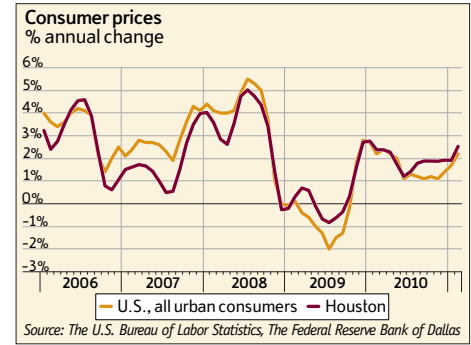
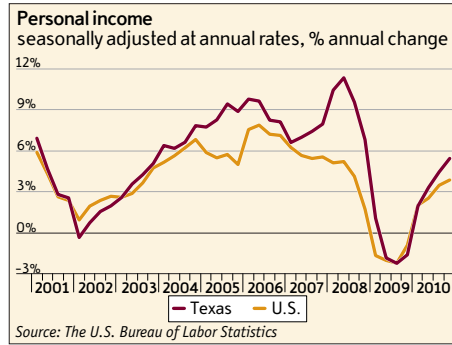
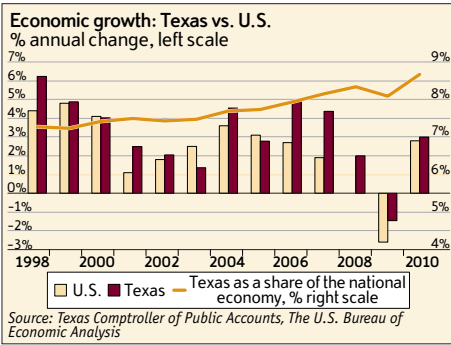
Lastly, the Texas budget gap, which various estimates put at between \$15-\$27 billion for the next two fiscal years, presents a big challenge to the state's economy. In particular, the state needs to close its fiscal deficit and, at the same time, preserve its low-tax, business-friendly model of state government. Growing demand for public services (due to rising population and increasing costs of social and healthcare programs) leaves little room for budget cuts.

At present, the government remains determined to preserve the state's business-friendly environment and solve fiscal problems with a combination of spending cuts and funding from the rainy-day fund. Texas lawmakers have already supported several initiatives that will balance this year's state budget (fiscal gap in 2011 is estimated at about \$4.3 billion) and are discussing ways to narrow the deficit for the next two years. In particular, in March, the Texas House approved a supplemental budget to cover the state's bills for the rest of this fiscal year ending on August 31st, 2011. This bill (House Bill 4) cuts spending for various state agencies by \$1.13 billion. Another bill (House Bill 275) taps the Texas rainy-day fund for just over \$3 billion to cover the rest of the 2011 budget deficit. The size of this fund is estimated to exceed \$9 billion in 2011.¹⁴

Deliberations over the 2012-2013 state budget may prove to be more tricky as more budget cuts are needed to reduce the deficit. Although high crude prices, and economic recovery, should sustain a gradual pickup in fiscal revenue, it may not be sufficient to offset the end of federal stimulus programs and the increasing cost of public services. In addition, according to the Texas Legislative Budget Board's analysis of spending cuts proposed by the House Appropriations Committee, total job losses in the private and public sectors may exceed hundreds of thousands of jobs over the next two years. Meanwhile, expenditure cuts in education and infrastructure risk undermining the state's long-term growth prospects. All said, 2012-2013 is likely to involve a wide range of fiscal solutions, including additional spending cuts, more withdrawals from the rainy-day fund and possibly higher taxes.

¹⁴Source: Texas Legislature Online.

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Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 6213111 Fax: +1 (713) 6214666
Email: sbleyzer@sigmableyzer.com

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