Texas Economic Update

August 2011

• Texas factory activity expanded slower in August.
• In contrast to the national trend, the Houston Purchasing Managers Index strengthened in August on a booming energy sector and growing exports.
• The Texas jobless rate edged up to 8.5% in August, which is still well below the 9.1% national unemployment rate.
• In an effort to sustain economic recovery, the Fed pledged to lower long-term interest rates.

Executive summary

The U.S. economic recovery has come under renewed stress as concerns over the European sovereign debt crisis and a slowing world economy are weighing on global equity markets. Meanwhile, domestic fiscal issues are undermining consumer and business confidence. Indeed, consumers feel increasingly less optimistic about the economy, while the rising regulatory burden is preventing companies from hiring new workers.

As uncertainty over the future course of economic policies looms, even a healthy rebound of corporate profits appears to add little to businesses’ willingness to invest. In addition, a big reason why investment activity remains weak is that companies are still looking for a definite sign of a self-sustained recovery in consumer spending. Yet, an overhang of consumer and mortgage debt and the stubbornly high jobless rate are raising investor concern over the strength of domestic demand. For example, retail sales stood virtually flat in August as consumers shied away from discretionary spending. Inventories in retail trade are growing slower on expectation of a weaker holiday shopping season. Orders of durable goods, despite some easing of the supply-chain stress in the automobile industry, point to a softer economic outlook as well. All this is just a reminder of how fragile the recovery of the consumer-driven economy is in the aftermath of the deep banking crisis.

The weaker national economy is taking a toll on Texas as well - in August, factory activity grew much slower compared to the first half of the year. On the upside, in sharp contrast to the nationwide trend, the Houston and Austin Purchasing Managers Indexes improved in August, testifying to better resilience of the Texas metro economies.

First, high energy prices are a boon for the Texas energy sector. This, as well as increasing offshore drilling activity, should sustain demand for drilling-related services and equipment, creating high paying jobs in Texas manufacturing and services industries.

Second, exports from Texas are growing faster than nationwide since Texas is better equipped to benefit from the rapid economic recovery in Latin America. And although commodities are a big part of this story, exports of high tech manufacturing goods and petrochemical products are posting solid gains as well. Thus, stronger foreign demand helps partly offset the negative impact of consumer retrenchment in Texas manufacturing.

Finally, over the course of this economic downturn, residential housing activity suffered less in Texas compared to the nation as whole. This may be evidence of a less severe overbuilding in Texas at the peak of the 2005-2006 housing bubble. This means that downward pressures on construction jobs, home values and sales are likely to remain less pronounced in Texas. After all, the fact that both Texas house prices and sales are on an uptrend is a genuine sign of healthier demand for housing and of a stronger local economy.

The U.S. labor market stalled in August as private businesses froze hiring while government payroll cuts gathered speed. In fact, nonfarm employment in Texas fell for the first time since September 2010, as modest job gains in the private sector failed to offset job losses in the government. As a result, the Texas jobless rate increased to the highest level since the start of the recession. This, however, is mostly due to the fact that the job growth in Texas is not keeping up with increases in the workforce, as better job prospects in Texas are attracting jobseekers from the rest of the country.

The disappointing recovery of the national labor market is pushing the Federal Reserves, which has a dual mandate to support maximum employment and price stability, to take a more active stance on boosting credit activity in the private sector. In September, the Fed pledged to lower long-term interest rates by lengthening the average maturity of its holdings of Treasury securities. If anything, this easing will help calm renewed worries over price deflation as the global economic outlook is becoming less optimistic. The policy may help avoid higher real costs of debt for the private sector, which can potentially derail any prospect of economic rebound.

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The national economic recovery came under renewed stress as concerns over Europe’s sovereign debt woes have been weighing on the global economy and equity markets. Meanwhile, domestic fiscal issues are undermining consumer and business confidence. Indeed, compared to the first half of the year, consumers feel much less optimistic about the economic outlook (see chart 1). The Conference Board reported that the Consumer Confidence Index fell to 44.5 in August versus 64.5 on average during the first half of the year. Businesses confidence is in short supply as well. Increasing regulatory uncertainty is preventing companies from hiring new workers. For example, according to the latest poll by Chief Executive Magazine, ambiguity over the new Healthcare Reform provisions and government regulation of business came in as the third and fourth most serious obstacles to hiring. Meanwhile, the National Association of Independent Business places government regulation of business in the U.S. as the second most problematic factor as well. This report ranks America 58 out of 142 countries in terms of the burden of government regulation. Partly due to increasing regulatory costs, the Global Competitiveness Index now ranks the U.S. as the 5th most competitive economy in the world – down from the number one position three years ago. A more worrying trend has been the gradual erosion of U.S. global leadership in innovation and market efficiency – the U.S. standing in market efficiency and innovation dropped to the third and sixth spots, respectively, from the first position at the onset of the global financial crisis. To be fair, the nation still has the best culture of creativity and innovation in the world – American businesses account for over 40% of all R&D spending in OECD countries. The U.S. still beats out many places in the world as the best destination for businesses – last year it received $228 billion in foreign direct investments (FDI) – well above the $106 billion invested in China, the second biggest recipient of FDI. That being said, a less friendly business climate appears to be discouraging U.S. companies from investing – nonfarm businesses are sitting on a record high pile of cash (see chart 2), which makes it harder to maintain a competitive edge against more pro-business countries.

As uncertainty over the future course of economic policies looms, a healthy rebound of corporate profits appears to be adding little to businesses willingness to invest. Indeed, domestic profits as a share of GDP have already surpassed previous peaks, yet the ratio of nonresidential investments to output is still below its precrisis level (see chart 3). A big reason why investment activity remains weak is that companies are still looking for a sure sign of a self-sustained recovery in consumer spending. Yet the overhang of consumer and mortgage debt and a stubbornly high jobless rate is raising investor concern over the strength of domestic demand. Indeed, according to the Census Bureau, retail sales remained virtually flat in August as consumers shied away from discretionary spending. For example, retail clothing sales and restaurant and bar sales fell for the second straight month. General merchandise outlets and furniture, home furnishings and appliances stores reported softer sales as well. In addition, according to the International Council of Shopping Centers, the Leading Indicator of Shopping Center Sales fell in the first week of September, having remained mostly flat in August. Lastly, personal spending on goods and services, a broader measure of consumer demand, is just 2% higher than in 2007 (see chart 4).

Orders of durable goods point to a softer economic outlook as well. Although new orders of durable goods have recently been on an uptrend as supply-chain disruptions in the automobile industry eased, orders of nondefense capital goods slowed, partly due to weaker demand for information technology products (see chart 5). Inventories in retail trade are growing slower as well (see chart 6) on expectation of a weaker holiday shopping season. All this is just a reminder of how fragile the recovery of the consumer-driven economy can be (over 70% of the U.S. economy still rely on personal consumption expenditures) in the aftermath of the deep banking
crisis. Indeed, households, battered by depressed home and equity values, are still cautious to spend, preferring to reinforce their personal finances instead – personal savings as a percentage of disposable personal income jumped from 2.5% on average in 2004-2007 to over 5% in 2008-2011.

The weaker national economy is taking a toll on Texas business activity as well - according to the Texas Manufacturing Outlook Survey, factory activity grew much slower in August compared to the first half of this year (see chart 7). On the upside, in a sharp contrast to the nationwide trend, the Houston and Austin Purchasing Managers Indexes improved in August (see chart 8). This better resilience of Texas metro economies bodes well for the broader nationwide trend, the Houston and Austin Purchasing Managers Indexes improved in August compared to the first half of this year (see chart 7). On the upside, in a sharp contrast to the Texas Manufacturing Outlook Survey, factory activity grew much slower in August compared to the first half of this year (see chart 7). This helps put Texas on relatively healthier footing compared to other large states and the nation as a whole (see chart 10).

Several factors continue to underpin the better performance of the Texas regional economy. First, high energy prices are a boon for the Texas energy sector – in August, the Texas rotary rig count was 25% higher than a year ago, while the number of Texas well permit applications jumped by 32%. This, as well as increasing offshore drilling activity, is sustaining demand for drilling-related services and equipment, creating high paying jobs in Texas manufacturing and services industries.

Second, exports from Texas are growing faster than nationwide – in January-July, the value of Texas exports was 23% higher during the same seven months a year ago; nationwide, exports increased by just 17.6%. Unlike many other states, Texas is better equipped to benefit from the rapid economic recovery in Latin America (thanks to the state’s geographical proximity to the region, tighter economic ties and more competitive manufacturing). For example, Texas exports to Brazil (the state’s fourth largest export market) jumped by 40% versus 21% nationwide. And although commodities, such as mineral fuels, cotton and cereals, are a big part of this story, exports of high tech manufacturing goods from Texas (for example, industrial machinery, electronics, computers and aircraft) are posting solid gains as well. In addition, being the biggest petrochemical hub in the world, Texas continues to lead the nation in exports of petrochemical products. All said, stronger foreign demand partly shields the regional economy from the weakening personal consumption that restrains economic activity in less export-oriented states.

Finally, residential housing activity weakened less in Texas compared to the nation as whole (see chart 11) thanks to more stable and affordable home prices. This may be evidence of less severe overbuilding in Texas at the peak of the 2005-2006 housing bubble. Thus, downward pressures on construction jobs, home values and sales are likely to remain over 5% in 2008-2011.

1The U.S. economic recovery closely mirrors past episodes of international banking crises. In particular, home and equity values decline by about 36% and 56% on average following a big financial crisis. Source: Carmen Reinhart and Kenneth Rogoff, “The Aftermath of Financial Crises” and a recent update of their calculations by the Oregon Office of Economic Analysis.
2Dallas-Ft.Worth-Arlington accounted for another 18% of all new private sector jobs.
3According to Baker Hughes, in August the number of active offshore rigs in Louisiana increased by 85% versus a year ago.
relatively modest in Texas versus other key national housing markets. Indeed, the latest release of the National Association of Realtors singles out Dallas, Houston and San Antonio as several of the few big U.S. metros where both housing prices and sales are on an uptrend. This can be interpreted as a genuine sign of healthier demand for housing in particular, and of a stronger local economy in general.

Employment
The U.S. labor market stalled in August – nonfarm employment remained unchanged, while the unemployment rate was stuck at 9.1% (see chart 12), staying above 9% for the fifth straight month. Meanwhile, nonfarm employment in Texas fell for the first time since September 2010 as modest job gains in the private sector failed to offset government payroll cuts (see chart 13). As a result, the Texas jobless rate increased to 8.5% - it highest level since the start of the recession. This, however, should not be interpreted as a deterioration of the Texas job market picture. The increasing jobless rate in Texas points to the fact that job growth is not keeping up with the increasing workforce (see chart 14). If anything, this may imply that better job prospects in Texas are attracting jobseekers from the rest of the U.S. After all, the Texas private sector has been creating jobs since the beginning of 2010, adding about 400,000 private jobs over the last 20 months, while the number of private jobs in the U.S. is still more than 5% short of its 2007 level (see chart 15). Since the beginning of 2010, all key private industries in Texas increased employment; meanwhile, the U.S. construction and finance sectors employed 5.3% and 3.3% fewer workers, respectively, than in December 2009.

Monetary Policy and Asset Prices
A slow recovery of the national labor market is pushing the Federal Reserve, which has a dual mandate to support maximum employment and price stability, to take a more active stance on boosting credit activity in the private sector. At its September meeting, the Fed pledged to lengthen the average maturity of its holdings of securities by replacing $400 billion worth of short-term Treasury securities (with remaining maturities of 3 years and less) with Treasury securities that have a remaining maturity of 6 to 30 years. The goal of this program, which will be completed by mid-2012, is to ease overall financial conditions by putting downward pressure on long-term interest rates. At present, additional monetary loosening is unlikely to create significant inflationary risks – consumer prices (less food and energy) are still growing below the Fed’s implicit target of 2% (see chart 16). If anything, this easing will help calm renewed worries over price deflation as the global economic outlook is becoming less optimistic. The policy may help avoid higher real costs of debt for the private sector, which can potentially derail any prospect of economic recovery.

That being said, notwithstanding sovereign debt problems in the Euro zone and national fiscal worries, there is still little sign of tighter financial conditions in the U.S. (see chart 17). In fact, market expectations about the Fed’s move may have already helped lower the long-term Treasury interest rates to record low levels. Lastly, this policy shift is not without precedent – in 1961, the Fed and the Treasury conducted a program (dubbed “Operation Twist”) to lower long-term Treasury interest rates. At $8.8 billion, Operation Twist amounted to just 1.7% of GDP versus about 2.7% of GDP of the Fed’s September initiative. A study by the Federal Reserve Bank of San Francisco estimates that Operation Twist managed to lower long-term Treasury yields by about 0.15 percentage points. Under normal conditions, this reduction of long-term rates is equivalent to roughly a 1% cut of the Federal funds rate. Yet, with the Federal funds rate staying virtually at 0%, this policy can hardly be sufficient to bring a significant reduction of the jobless rate.

1Titan Alon and Eric Swanso, “Operation Twist and the Effect of Large-Scale Asset Purchase”.