September saw another bout of market volatility, with European leaders failing to find a quick and credible solution to the problems in Greece. The threat of a contagion to larger EU economies is putting serious pressure on the viability of certain European banks. Meanwhile, fiscal austerity in advanced economies in general, and in the U.S. in particular, is creating a drag on global growth. These fiscal worries not only depress demand, but also exacerbate uncertainty over the future of taxes and spending due to sharp political disagreements on how to fix systemic debt problems. Fresh data on economic growth in China, and manufacturing activity in the Eurozone, appears to confirm investors’ concern that a global economic slowdown may be taking hold.

On a more positive note, U.S. factory activity improved slightly in September, with the national Manufacturing Purchasing Managers Index inching up to 51.6%. Meanwhile, a string of stronger-than-expected data, including September readings on jobs and retail sales, is prompting many analysts to upgrade their U.S. economic growth forecasts. Despite this, U.S. manufacturing is growing much slower compared to the initial phases of the recovery. In fact, better manufacturing figures in September and stronger retail sales may be mostly attributed to increasing car sales as supply disruptions in the automobile industry continue to ease. More importantly, the high jobless rate, anemic growth in earnings and consumer deleveraging continue to sap strength from personal consumption. Overall, economic pessimism is still eroding consumer confidence, which dropped again in October.

Texas, which relies more on commodities, exports and producers of business equipment, continues to do better than the nation as a whole. Statewide factory activity is still growing faster compared to other big manufacturing states. For instance, in September, the production index of the Texas Manufacturing Outlook Survey registered a return to solid growth following flat output the month before.

The Texas jobless rate remains unchanged from August, at 8.5%, and is still lower than the national rate of 9.1%.
September saw another bout of market volatility — the S&P 500 index lost over 7%, while the MCSI World and Emerging Market indices shed 9% and 13%, respectively. Meanwhile, the CBOE VIX Index\(^1\) points to much less certainty over future movements of equity prices. This has prompted a renewed flight to safety, pushing Treasury yields to new lows and driving down the value of the dollar. Behind this market activity, a number of important considerations are keeping investors nervous about future prospects for the world economy.

First is the sovereign debt crisis in Europe. The failure of European leaders to draw a quick and credible solution to the problems in Greece is battering the shares of European banks. This suspense is raising the threat of a contagion to the larger EU economies. The IMF believes that as much as $300 billion may be needed to buttress Euro zone lenders if the debt crisis engulfs Spain and Italy – a tall order for cash-strapped European governments. Meanwhile, higher funding costs and thin capital bases risk compelling European banks to scale back lending, which will sap the energy from an already weak European economy. The recent downgrades of Italy’s sovereign debt rating by Moody’s and Standard & Poor’s testify to the fragility of any regional recovery.

Second, the dire state of public finances in the advanced economies, and in the U.S. in particular, is creating a serious drag on global growth. The IMF now expects the world economy to expand by just 4% in 2011 and 2012 compared to over 5% in 2010. These fiscal worries not only depress demand but also create uncertainty over the future of taxes and spending, due to sharp political disagreements about how to fix our debt problems. Indeed, politics and the question of government ‘interference’ is taking center stage in the U.S. economy, and is likely to make private business uneasy well into next year’s presidential election. In September, the CEO Confidence Index fell to its weakest level in a year\(^2\), while the Small Business Optimism Index remained close to its lowest reading since the beginning of the economic recovery\(^3\).

Lastly, fresh data confirms investors’ concern that a global economic slowdown is taking hold. In particular, in the third quarter of 2011, the Chinese economy grew at the slowest pace in over two years. Meanwhile, global manufacturing activity, tracked by JPMorgan’s Global Manufacturing PMI, points to the weakest production gains in 27 months, on output declines in the Eurozone and Japan and a sharp deceleration in India.

Despite the difficult global economic environment, U.S. factory activity improved slightly in September, with the national Manufacturing PMI\(^4\) inching up to 51.6%. Still, this reading implies that manufacturing is growing much slower compared to the initial phases of the recovery in late 2009, and a brief period of strong growth at the beginning of 2011 (see chart 1). In fact, better manufacturing figures in September may be solely attributed to stronger car sales (see chart 2) helped by a return of the auto industry to more normal conditions following supply chain disruptions in late spring. Indeed, the national car industry, which experienced a radical transformation over the past several years, is still producing well below its precrisis output levels, which look increasingly likely to become the new normal. Producers of building materials will likely share a similar fate (see chart 3). A broader look at U.S. industrial production shows why. In particular, the production of consumer goods has barely returned to its level a decade ago, and is well below its precrisis level if items such as cars, high-tech products and energy are excluded. Meanwhile, business equipment output is recovering much faster, thanks in part to a strong rebound in the manufacturing of computers, semiconductors and electronic products (see chart 4).

Several factors stand behind the current weakness in consumer demand: an elevated jobless rate, the slow growth of earnings (see...
chart 5), higher prices, and less government support are pushing down personal income and, thus, private consumption (see chart 6). In addition, consumers are relying much less on debt (see chart 7) and are saving a much bigger portion of their income than before the crisis. Economic pessimism, which still dominates consumer confidence, has reduced households’ appetite for new borrowing. On the supply side, the credit crunch has brought the growth of asset-backed securities (ABS) to a halt (see chart 8), drastically reducing the funding of new credit. On that count, the securitization market is unlikely to return to levels seen before the market’s collapse any time soon. Liquidity support provided by the Federal Reserve through its Term Asset-Backed Securities Loan Facility (TALF), which helped normalize the ABS market at the height of the crisis, was closed to new loans in 2010. Meanwhile, the Dodd-Frank Financial Reform Act has created tougher rules for credit card issuance and ABS offerings, which is likely to curb the securitization market as well. Thus, even if household deleveraging eases, regulatory and structural changes are creating a more challenging consumer credit environment, which limits the upside potential of a consumer-led recovery.

Weak performance by consumer-related industries may help explain why Texas, which relies more on commodities, business equipment and exports, is still doing better than the US as a whole. For instance, Houston, a huge petrochemical hub, has not seen the same slowdown in manufacturing as the country overall (see chart 9), thanks partly to a robust rebound in mining and oil related industries. In particular, in September, the Texas rig count and well permit applications were 24% and 42% higher, respectively, versus a year ago. And although statewide factory activity has recently weakened, it is still growing compared to other big manufacturing states (see chart 10). In fact, in September, the Texas Manufacturing Outlook Survey production index rose from 1.1 to 5.9, pointing to a solid pickup in growth (following flat output the month before). More importantly, hours worked and certain key employment indices increased to their highest readings since mid-Spring, suggesting a strong environment for factory jobs in Texas.

High global commodity prices are currently adding to the resilience of the Texas economy. For example, in January-August, exports of mineral fuels and oil (over a fifth of all Texas exports) grew by nearly 60%, pushing the overall growth of exports to 23% versus 18% for overall U.S. overseas shipments. In addition, an increasing price differential between Brent and WTI contracts, due to tightness in the European crude oil market (see chart 11), helps cushion Texas from current Eurozone economic woes. During the first eight months of 2011, Texas exports to the Euro area (about 8% of all exports in 2010 versus 14% nationwide) grew by 48% (compared to just 15% for all states) as exports of mineral fuels tripled. Despite this, Texas’ reliance on the export markets of developed economies is smaller than the nation’s as a whole – about 65% of the state’s exports are shipped to developing nations versus...
just 41% nationwide. Thus, Texas exporters are less exposed to a slowdown in the more developed economies of the world.

Obviously, Texas large metros, especially those with fewer ties to the energy industry, are not immune to economic slowdown. For example, the Texas Metro Business Cycle Indexes, which track employment and retail trade in the biggest cities, currently imply that business activity is losing steam in the Dallas-Ft. Worth-Arlington region (see chart 12). The make-up of the Dallas-Ft. Worth metro economy may help explain this trend. Both Dallas and Houston metros are roughly of the same size in terms of economic output and share a similar future – private sector activities account for over 92% of their economies versus 88% statewide.6 Yet private services-providing industries constitute about 70% of the Dallas economy versus just 56% in Houston, meaning the Dallas metro economy is more sensitive to consumer demand. Indeed, trade, financial activities and real estate operations represent a bigger part of the Dallas economy – over one fifth compared to just 13% in Houston. As a result, a still sluggish recovery in consumer spending, and the real estate sector, is exerting a bigger toll on the Dallas economy.

Employment

In September, the Texas jobless rate stood unchanged from August at 8.5% (which is still lower than the national rate of 9.1%) (see chart 13). September saw a healthy uptick in the number of new jobs created by the private sector in Texas, which helped offset the third straight month of job cuts by the government (see chart 14). As a result, over the last twelve months, private-sector employment in Texas grew by 282,200 jobs, or by 3.3%, versus a much slower 1.7% annual growth rate nationwide. The number of the private sector jobs in Texas is now just 0.7% lower than at its pre-recession peak, while the private sector nationwide is still short 5.4% of the jobs it had at the end of 2007.

Several factors help explain why the private sector in Texas is creating jobs faster than other states. Above all, the biggest Texas metros saw a stronger turnaround in private sector employment (see chart 15). This is important, because the share of private sector jobs in big metro cities tends to be larger than for smaller towns.7 Thus, Texas is better positioned to gain from the private sector led recovery thanks to more robust job growth in its biggest metros. More stable housing markets and a smaller exposure to the real estate bubble in Texas prior to the economic downturn is also a factor contributing to this greater economic resilience. Having said that, a slowdown in construction is making for a tougher jobs environment in smaller cities. Indeed, these cities are less diversified and face tighter fiscal conditions as local government tax revenues shrink due to falling property values. In addition, state budget shortfalls are pressing local governments to cut even more jobs. This may present a challenge for Texas - in September, the state had 2.4% fewer jobs in local government than a year ago (versus a decline of just 1.5% nationwide).

A second positive job trend in Texas is that local private industries appear to be recovering much stronger than comparable sectors nationwide. The goods-producing part of the state economy is leading the way, thanks to high oil prices and the return of foreign demand. In September, annual job growth in mining, construction and manufacturing stood at 18.4%, 6.3% and 2.3%, respectively, versus 11%, 0.7% and 1.7% for the nation as whole. Equally important, Texas had 1.9% more jobs in financial services than a year ago (versus a decline of 0.2% in the U.S.) and over 5% more jobs in professional and business services (up by only 3.4% nationwide). In addition, service-providing industries that rely more on consumer demand are creating jobs at a faster rate in Texas than in the U.S. For example, employment in education and health services, trade, transportation and utilities and leisure and hospitality grew by 2.7%, 2.2% and 2.1%, respectively, versus 2.3%, 1.3% and 0.9%, respectively.

\(^6\)Source: The U.S. Bureau of Economic Analysis

\(^7\)According to the data of the U.S. Bureau of Labor Statistics, the share of private jobs in total employment is about 5% larger in cities, where total nonfarm jobs exceed 500,000.
Monetary Policy and Asset Prices

Relatively stable home values in Texas provide yet more evidence of a stronger local economy (see chart 16). According to the National Association of Realtors and the Real Estate Center at the Texas A&M University, both national and Texas existing home sales registered their third consecutive annual gain in September (although the level of activity is still less than three quarters of what it was before the crisis).

![Home prices in large metros chart](chart16)

<table>
<thead>
<tr>
<th>Price</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Atlanta</td>
<td>-15.7%</td>
</tr>
<tr>
<td>Baltimore</td>
<td>-4.1%</td>
</tr>
<tr>
<td>Boston</td>
<td>-1.5%</td>
</tr>
<tr>
<td>Cincinnati</td>
<td>-5.7%</td>
</tr>
<tr>
<td>Dallas–Fort Worth</td>
<td>0.1%</td>
</tr>
<tr>
<td>Houston</td>
<td>0.9%</td>
</tr>
<tr>
<td>Indianapolis</td>
<td>6.1%</td>
</tr>
<tr>
<td>Kansas City</td>
<td>-7.1%</td>
</tr>
<tr>
<td>Miami–Fl. Lauderdale</td>
<td>-11.8%</td>
</tr>
<tr>
<td>Minneapolis–St. Paul</td>
<td>-7.1%</td>
</tr>
<tr>
<td>New Orleans</td>
<td>4.6%</td>
</tr>
<tr>
<td>New York–Northern New Jersey–Long Island</td>
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</tr>
<tr>
<td>Philadelphia</td>
<td>-5.6%</td>
</tr>
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<td>-6.1%</td>
</tr>
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<td>Portland</td>
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<tr>
<td>San Antonio</td>
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<td>San Diego</td>
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</tr>
<tr>
<td>St. Louis</td>
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<td>Washington, DC</td>
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</tr>
<tr>
<td>U.S.</td>
<td>-3.9%</td>
</tr>
</tbody>
</table>

Economic growth: Texas vs. U.S.
% annual change, left scale

Source: The U.S. Bureau of Economic Analysis

Personal income
seasonally adjusted at annual rates, % annual change

Source: The U.S. Bureau of Labor Statistics

Consumer prices
% annual change


Nonfarm employment
2006=100

Source: The U.S. Bureau of Labor Statistics

Unemployment rates
seasonally adjusted, %

Source: The U.S. Bureau of Labor Statistics

State Coincident Indexes
12-month % change

Source: The Federal Reserve Bank of Philadelphia

Purchasing Managers Index
a reading above 50 indicates expansion

Source: The Institute for Supply Management

Oil industry
Texas rotary rig count, number of rigs, left scale
Price of WTI crude, $ per barrel, right scale

Source: The Federal Reserve Bank of Dallas

Home values
seasonally adjusted, December 2006=100

Source: The S&P/Case-Shiller Home Price Indices

Home sales
seasonally adjusted annual rate

Source: The U.S. Department of Commerce

Exports
3-month moving average % change

Source: The U.S. Department of Commerce

Venture capital investment activity in the United States
quarterly investments

Source: PricewaterhouseCoopers

Where Opportunities Emerge.