Texas factory activity strengthened in June.
The Texas jobless rate held steady in May at 6.9% compared to 8.2% nationwide.
Texas was named America’s Top State for Business by CNBC.

Executive summary

The sovereign debt crisis in Europe continues to rattle the global economy and international financial markets. Although an agreement to give more help to European banks has restored a modicum of calm, substantial policy uncertainties continue to unnerve investors as the fate of the Euro increasingly depends on whether a closer banking and fiscal union will be set up in Europe. Yet the risk of a contagion from the euro zone weakness via trade and financial channels still pales in comparison to the impact of fiscal tightening in the U.S. set to take effect next year. The so-called fiscal cliff – a combination of higher taxes and spending cuts – may, according to the Congressional Budget Office, tip the economy back into recession in the first half of 2013.

As fiscal risks build, the private sector remains rather reluctant to invest in new businesses and hire more workers. Indeed, national business surveys indicate that taxes and an increasingly onerous regulatory environment are the overriding concern for many investors. As a result, factories and shops are slashing orders, which dampens national economic activity – in June, U.S. manufacturing witnessed its weakest performance in three years. Meanwhile, consumers, battered by the sluggish jobs market, are feeling less confident as well. After all, higher economic uncertainty may be urging households to save more and cut nonessential spending – in June, retail sales fell for the third straight month.

All that being said, consumer and investor reluctance to spend reinforced by polarizing and dysfunctional politics and a crippling regulatory burden is not indicative of a strong economic recovery. The likelihood of reaching a political compromise to restore the medium-term sustainability of public finances remains rather low. This means that economic recovery is likely to proceed at a relatively sluggish pace and will remain hostage to the political gridlock in Washington.

Meanwhile, Texas continues to show an enviable degree of resilience to national economic woes. In June, regional factory activity surged to its highest level in 2012 as new orders bounced back. This trend comes in sharp contrast to all other major regional manufacturing surveys, which saw a slowdown in factory activity. In addition, unlike the nation as a whole, manufacturing in Houston remained in expansion mode.

The Texas economy continues to outperform the nation as whole because of its size, economic diversity and its business-friendly regulatory environment. Indeed, a diverse industrial structure allows for more growth opportunities and helps shield the state from economic slowdown in construction and finance. For example, the energy industry continues to underpin the regional economy – in June, the Texas rotary rig count stood well above last year’s level thanks to growing production of shale oil and gas. Meanwhile, overseas markets are becoming an increasingly important factor of Texas’s economic strength, counterbalancing the slow pace of recovery of domestic consumption.

In addition, friendlier zoning regulations and more available land make Texas better equipped to benefit from a shift in housing demand and residential investments to multiunit apartment complexes. Indeed, increasing issuance of multiunit housing permits, a gauge of future construction activity, may represent a strengthening outlook for multi-family apartment buildings on growing demand for rentals. This trend reflects a change in attitudes toward housing, as living in smaller and more affordable apartments, which are closer to work and mass transit, is becoming an increasingly appealing option. Tight access to credit and falling home ownership rates are driving demand for rentals as well. Set against faster population growth, a surge in multiunit home building appears to be even more pronounced in Texas – in January-May 2012, one in five permits for multiunit homes issued nationwide was granted in Texas versus about one in eight five years ago.

Lastly, Texas continues to hold a particularly strong appeal for private investors – the latest CNBC survey named Texas as America’s Top State for Business. This means that the state not only offers some of the most promising economic opportunities in the nation but also supports a business-friendly environment that drives the private sector to invest in them.

The strength of the Texas labor market confirms that the local private sector is in better shape than the nation as a whole. Private sector employment in Texas is increasing faster than in the U.S., while the unemployment rate does not exceed 7%. In fact, during the first five months of 2012, the Texas private sector added over 124 thousand new jobs or nearly 8% more than a year ago. Meanwhile, the nation as a whole reported 14% fewer new private sector jobs compared to the first five months of 2011. As a result, roughly one in seven new jobs created so far this year came from Texas.
Economic output

The global economy continues to sputter as the sovereign debt crisis hangs over the euro area. Although, a recent decision by the EU leaders to provide more help to the struggling European banks has restored a modicum of calm to global financial markets, substantial policy uncertainties continue to unnerve investors. Above all, the fate of the euro depends on the success of the European governments in establishing a closer banking and fiscal union. This, however, may lead to tighter bank credit and additional cuts to public spending. As domestic demand stumbles, economic activity in Europe, which is already in a precariously fragile state, will be weakened even more, dragging down the entire global economy. In fact, the latest data on global factory activity singles out the Eurozone as a major source of declining manufacturing activity worldwide. In particular, the Eurozone generates about one in seven dollars earned by Chinese exporters. However, as exports to crisis hit Europe came to a halt (in January-May, Chinese exports to the euro area dropped by 2.7%), factory activity in China began to slip – in June, manufacturing activity in China shrank at its fastest pace in seven months.

Yet the contagion of the euro zone troubles via the trade channel and increasing risk aversion is just one of the several factors threatening job creation and economic recovery in the US. A much bigger issue is approaching tax hikes and spending cuts set to take effect next year. The so-called fiscal cliff – a combination of major tax and spending measures (including the expiration of the Bush tax cuts and the AMT relief, the onset of $1.2 trillion in automatic spending cuts, and a reduction in Medicare spending) is estimated to remove about $500 billion from the U.S. economy in 2013 alone. As a result, the Congressional Budget Office believes that this could tip the economy back into recession in the first half of next year, while annual GDP growth could stay as low as 0.5% in 2013.

Thus, as worries over the future course of fiscal policy build, the private sector is becoming more reluctant to commit to expansionary capital spending and hiring plans. Indeed, national surveys of CEOs and small businesses indicate that a very cautious attitude to investments and jobs still prevails, as business confidence remains weak (see chart 1). Meanwhile, taxes and an increasingly onerous regulatory environment are still the overriding concerns for many investors. All of these uncertainties are forcing companies to trim their order of new goods, which damps national factory activity. In fact, in June, U.S. manufacturing witnessed its weakest performance in three years as new orders of U.S. goods both at home and abroad slumped (see chart 2) hinting at further moderation in factory activity ahead. A sluggish growth of new orders of durable goods (see chart 3) is yet another sign that businesses may be growing less enthusiastic about the strength of economic recovery. Lastly, in June, economic activity in services and construction grew at the slowest rate in over two years (see chart 4) as problems in the manufacturing sector are starting to seep into the broader economy.

Consumers, battered by the lackluster jobs market, are feeling less confident about spending as well – retail sales are growing much slower than a year ago – excluding food services, retail sales grew by 5.4% in the first half of this year versus 8.3% during the same six months of 2011. Indeed, economic uncertainties may be urging households to save more (see chart 5) as well as cut back on nonessential purchases – in June, retail sales fell for the third straight month (see chart 6). In particular, anticipations of higher taxes and cuts in social benefits (at present, over one in ten dollars of personal income comes from the government, see chart 7) will be weakened even more, dragging down the entire global economy. In fact, the latest data on global factory activity singles out the Eurozone as a major source of declining manufacturing activity worldwide. In particular, the Eurozone generates about one in seven dollars earned by Chinese exporters. However, as exports to crisis hit Europe came to a halt (in January-May, Chinese exports to the euro area dropped by 2.7%), factory activity in China began to slip – in June, manufacturing activity in China shrank at its fastest pace in seven months.

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7) may be driving consumers away from shopping malls. Meanwhile, consumer deleveraging continues – over the past four years, mortgage debt outstanding shrank by nearly $900 billion due to foreclosures, distressed sales, loan modifications and debt repayments. Still, household debt remains well above personal after-tax income (see chart 8). In addition, several other metrics of households’ economic security suggest that both deleveraging and soft consumer spending may persist. For example, although households’ net worth has recovered by $11.6 trillion since the onset of the economic recovery, it is still $4.6 trillion lower than at the end of 2007. Inflation adjusted median household income is trending down, while fewer employment-sponsored benefits imply that consumers must chip in to offset the difference (see chart 9).

All that being said, consumer and investor reluctance to spend combined with a polarizing and dysfunctional political environment and a crippling regulatory burden does not bode well for an ongoing economic recovery. The likelihood of reaching a political compromise to restore the medium-term sustainability of public finances remains rather low. This means that economic recovery is likely to proceed at a relatively sluggish pace and will remain hostage to the political gridlock in Washington.

Meanwhile, Texas continues to show an enviable degree of resilience to national economic woes. Indeed, according to the Texas Manufacturing Outlook Survey, regional factory activity surged in June to its highest level in 2012, thanks, in particular, to returning demand as new orders rebounded (see chart 10). This trend is in sharp contrast to all other major regional manufacturing surveys, which saw a slowdown in factory activity in June. Meanwhile, unlike the nation as a whole, manufacturing in Houston remained in expansionary mode (see chart 11). The energy sector is still a key growth factor underpinning the regional economy. Indeed, despite a sharp drop in crude oil prices in June (see chart 12), the Texas rotary rig count remains well above last year’s level, partly thanks to expanding production of shale oil and gas.

Second, Texas’ exporters continue to outperform the rest of the nation (see chart 13). During January-May, exports from Texas grew by 7.5% versus 6.7% in the rest of the U.S. Having said that, an economic slowdown in China and Brazil (the third and fourth largest trading partners of Texas, respectively) is starting to affect local manufacturers – in January-May, exports to China fell by 9% and by 3.4% to Brazil.4 On the up side, Texas exports to the euro zone represent just 9% of the state’s total versus 13% nationwide. More than that, mineral fuels account for over a third of these exports. Thus, while exports from California and New York (the second and third largest exporting states in the U.S.) to the euro area dropped on flagging demand for industrial goods, exports from Texas grew by over 10%. In addition, Texas continues to rely more on markets in emerging economies compared to the nation as whole. For example, nearly 17% of all of the state’s exports go to Latin America (excluding Mexico) versus 11% nationwide. Thus, Texas is better positioned to capture growth opportunities in more dynamic developing nations – in January-May, its exports

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4Still, Texas ships just about 8% of all its exports of goods to China and Brazil. In addition, exports to China fell mostly due to lower cotton prices – cotton represents over 11% of all Texas exports to China.
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to Latin America were up by 18%, growing three times faster than the state’s exports to OECD economies. Lastly, growing foreign demand for knowledge-intensive services (for example, professional and business services and education and healthcare) adds strength to the Texas economy as well. Although state-level data on foreign trade in services is not available, national statistics show that these trade flows tend to be less volatile (compared to foreign trade in goods, see chart 14) in downturns, which may help protect Texas from weaknesses in other parts of the economy. In fact, the composition of jobs in Texas service-providing industries indicates that this segment of the local economy may indeed greatly benefit from strong overseas sales. For instance, architecture and engineering occupations represent only 1.2% of all private jobs nationwide compared to 1.6% in Texas and 2.8% in Houston metro alone. Overseas markets are becoming an increasingly important factor of Texas’s economic resiliency (see chart 15) and help offset the slow pace of recovery of domestic consumption.

Two other factors are sustaining a stronger economic rebound in Texas. First, compared to the nation as a whole, home building in Texas suffered less in the recession and is recovering faster (see chart 16). Equally important, an increasing number of housing permits, a gauge of future construction activity, points to a strengthening outlook for multi-family apartment units on growing demand for rentals (see chart 17). This trend may reflect a change in attitudes toward housing, as living in smaller and more affordable apartments, which are closer to work and mass transit, is becoming an increasingly appealing option to more households. Tight access to credit and falling home ownership due to bank foreclosures are driving demand for rentals as well (see chart 18). In addition, faster population growth in Texas is supporting stronger demand for housing in general and for rentals in particular. Thus, with friendlier zoning regulations and more available land, Texas appears to be better equipped to benefit from this shift in housing demand and growing investments into multiunit apartment complexes – in January-May 2012, one in five permits for multiunit homes issued nationwide was granted in Texas versus about one in eight at the peak of the housing bubble.

Lastly, the Lone Star State continues to hold a particularly strong appeal for private investors – the latest CNBC survey named Texas as America’s Top State for Business. This triumph follows an earlier recognition of Texas by Chief Executive Magazine as the Best State in which to do business – this top spot has been easily clinched by Texas for the eighth successive time. This means that more private companies will be drawn to Texas to set up new and expand existing business. And this higher level of private investments will underpin economic growth and job creation in Texas.

Employment

The Texas labor market provides even more proof that the local private sector is outperforming the nation as a whole. Indeed, the number of private sector jobs in Texas continues to grow faster than nationwide, while the jobless rate remains below 7% (see chart 19). During the first five months of 2012, the Texas private sector added over 124,000 new jobs, or nearly 8% more than a year ago. Meanwhile, the nation as a whole reported 14% fewer new private sector jobs compared to the first five months a year ago; as a result, roughly one in seven new jobs created so far this year was in Texas.

3Just 13% of all Texas exports go to the OECD versus a fifth nationwide. 34 members of the OECD club of advanced economies represent about two thirds of the world economy.
Equally important, May was the second strongest month in terms of private sector hiring – Texas created 15,000 new private jobs. This helped keep the jobless rate steady, offsetting the impact of a growing workforce, increasing the labor force participation rate and government layoffs in May (public sector employment fell by 2,800 jobs). On that note, falling employment in local governments is a drag on the labor markets both in Texas and nationwide (see chart 20). Having said that, thanks to growing employment in private industries, Texas already has more jobs than at the peak of the previous business cycle. First, the state’s goods-producing industries shed fewer jobs during recession compared to the nation as a whole and have been hiring new workers at a faster pace. Since the beginning of the year, Texas saw a 3.7% gain in construction jobs versus a 0.7% decline nationwide. Yet the underlying strength of the local service-providing sector remains the main driving factor of the labor market recovery in Texas. For example, Texas employment in trade, transportation and utilities, professional and business services, and leisure and hospitality – industries providing over a half of all private jobs both in Texas and nationwide – has already surpassed its previous highs. Meanwhile, nationwide there are still 1.4 million fewer jobs in trade, transportation and utilities and 203,000 fewer jobs in business and professional services than five years ago.

Monetary Policy and Asset Prices

Falling energy prices helped push consumer inflation to its lowest level in over a year (see chart 21). Meanwhile, core inflation (which ignores more volatile prices of foods and energy) looks set to hover close to 2%, implying that weak consumer demand continues to curtail producers’ pricing power. This is a sign of a rather moderate economic recovery and may give the Fed the green light to go ahead with looser monetary policy. In fact, the Fed has already prolonged its program to support low levels of long-term interest rates (via the extension of the average maturity of its holdings of securities) through the rest of the year. June’s weak national jobs report may even prompt the Fed to follow other major central banks (for example, the Bank of England and the central bank of China) in implementing a fresh round of quantitative easing to revive the weak economic recovery.

Looser monetary policy and, consequently, low interest rates are still necessary to support a fragile turnaround in the housing markets as job creation continues to stumble. In fact, recent figures on home sales and prices (especially from Texas) point to an encouraging upward trend (see chart 22). This is important, because stronger real estate markets will not only sustain job growth in construction and manufacturing but will also help put household finances on the mend. Since homes are the largest asset on most households’ balance sheets, increasing house prices boost consumers’ wealth and lessen the risk of future defaults on home mortgages. For example, in its latest negative equity report, CoreLogic notes that during the first quarter of 2012, over 700,000 households regained positive equity positions as higher home prices lifted property values above their outstanding balances on mortgages.

Footnote:

6Freddie Mac reports that the national average commitment rate for a 30-year, conventional, fixed-rate mortgage was down to a record low 3.8% in May, from 3.91% the month before and 4.64% a year ago.

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