**Executive summary**

The national economy remained in slow-growth mode in the first half of the year, as the contribution of the housing market recovery and an uptick in exports only partly offset weaker gains of private consumption and investment spending. In addition, economic policies have been less conducive to economic growth due to the fiscal drag of higher taxes and growing borrowing costs. Despite the eleventh straight quarterly gain of residential investment and the strongest reading on exports since the third quarter of 2011, second quarter GDP growth stood at just 1.7% as household consumption grew by only 1.8%. Meanwhile, higher taxes have been a drag on the overall economic recovery for the third consecutive quarter, while the impact of the federal budget sequestration seems to be receding. Lastly, private inventories added to GDP growth for the second straight quarter as better than anticipated exports and consumer spending on durable goods may have prompted companies to continue rebuild inventories.

Consumers appear to be in a spending mood - retail sales saw the second straight monthly gain in June as higher household income and borrowing added to consumers’ buying power. Consumer credit saw an 8.3% annual gain in May as credit card use reached its highest level since October 2010. Higher credit is also driving car sales – in June and July, automobile sales were close to the 16 million units last seen at the end of 2007. Thus, partly thanks to strong demand for durable goods, national factory activity returned to growth in June following a month of contraction, while July saw the strongest reading since mid-2011. Business activity in services and construction is also growing faster.

The steady growth of business spending is sustaining national factory activity as well. In June, new orders of durable goods recorded their third consecutive monthly gain thanks to growing orders of transportation equipment and, in particular, booming new orders for commercial aircraft. Orders of investment goods were up in June for the fourth consecutive month, increasing by over 7% - their strongest annual gain since the beginning of 2012. Improvements in the national economy (in addition to an uptick in homebuilding, continued expansion of the energy sector and growing exports) also contribute to economic recovery in Texas. Indeed, the Lone Star State’s business activity grew stronger at the end of the first half of 2013, registering in June its best reading since March 2011.

Importantly, there are signs that Texas may see stronger economic recovery in the second half of 2013. In particular, factory activity continued to expand in July, while the jobs picture in manufacturing improved due to higher labor demand. Business activity in services and retail sectors grew at a faster pace as well. Above all, high and increasing energy prices are propping up drilling activity and oil and gas service businesses, which bodes especially well for Houston – the biggest metro economy in Texas. Meanwhile, growing demand for semiconductors helps to drive economic activity in the high-tech manufacturing clusters of Austin and Dallas. Lastly, the global economy seems to be stabilizing, which should drive foreign demand for Texas exports.

Although the second half of this year may bring stronger employment and economic growth to Texas, the local jobs market did not see its usual strong growth in June. The Texas jobless rate held steady at 6.5% while job creation in the private sector slowed to just 2.1 thousand; the regional labor force posted its first month-over-months decrease in nearly a year. As a result, the second quarter of 2013 saw the smallest quarterly gain in private-sector jobs since the third quarter of 2010. Essentially, since the last quarter of 2012, the economic environment was less favorable for job creation in goods-producing industries. Because mining, construction and manufacturing played a key role in the overall labor market improvement in Texas – one in five new private jobs created since 2010 in Texas was in goods producing sectors versus just about 14% nationwide – slower jobs growth in goods producing sectors are set to cool the pace of the overall labor market recovery. This trend is likely to be reinforced by the increasing reliance of Texas on hiring in private service-providing industries, which tend to expand in line with overall economic activity. Thus, it is possible that private employment will continue to grow more slowly in the near term.

Still, the unemployment rate in Texas has been below 7% for the past twelve months and is a full percentage point below the national level, all while undergoing a population increase and huge influx of labor from other regions. In fact, unlike the nation as a whole, Texas already has nearly 6% more private sector jobs compared to the peak private employment reached during the previous business cycle.
The national economic recovery proceeded at a moderate pace, supported by an improving housing market, growing consumer spending, stronger foreign demand and an uptick in capital outlays by private businesses. In particular, the 1.7% annualized GDP growth in the second quarter of 2013 (see chart 1) was driven by a 1.8% increase of household consumption, the eleventh straight quarterly gain of residential investments, growing nonresidential investments as well as a 5.4% jump in exports – the strongest reading since the third quarter of 2011. Lastly, private inventories added to GDP growth for the second straight quarter as companies, perhaps surprised by stronger than anticipated exports and resilient consumer spending on durable goods, continued to increase inventories.

Despite higher taxes and only a modest rebound of the jobs market, consumers appear to remain in a spending mood – households’ consumption of durable goods grew by 6.5% in the second quarter versus 5.8% the quarter before. Meanwhile, retail sales saw the second straight monthly gain in June (up by 0.6% versus the month before) as increasing household income and borrowing added to consumers’ buying power. In June, personal income was 3.1% higher than a year ago, while consumer credit registered a more significant 8.3% annual gain in May as credit card use reached its highest level since October 2010 (in May, revolving credit, which includes credit card loans, jumped by 9.3% - its fastest annual rate of growth in a year). As worries over economic conditions seem to be subsiding (see chart 2), consumers appear to have once again stepped up borrowing. In fact, a resumption of bank lending to households (partly sustained by the revival of the asset-backed securities issuance) was an important driver of car sales – in June and July, automobile sales were close to the 16 million units last seen at the end of 2007. This helps support the national factory activity: according to the Institute for Supply Management, U.S. factory output returned to growth in June following a month of contraction, while July saw the strongest reading since mid-2011. Business activity in services and construction is growing faster as well – in July, the Non-Manufacturing PMI returned to levels previously observed at the start of the year (see chart 3).

Improving confidence is sustaining the growth of business spending as well. For instance, in June new orders of durable goods recorded their third consecutive monthly gain thanks to growing orders of transportation equipment and, in particular, booming new orders for commercial aircraft. As a result, new orders of durable goods have surpassed their previous high mark for the first time since the start of the recession in 2008. Meanwhile, orders of nondefense capital goods excluding aircraft (a good gauge of the overall willingness of companies to invest) were up in June for the fourth consecutive month, increasing by 7.2% versus the same month a year ago – their strongest annual gain since the beginning of 2012.

Turning to Texas, the Lone Star State’s business activity grew stronger at the end of the first half of 2013. Indeed, following its best reading since March 2011, Texas factory output continued to expand in July, while the jobs picture in manufacturing improved on growing labor demand with the current employment index rising to its highest level in nearly 12 months (see chart 5). Business activity in services and retail sectors grew at a faster pace in July as well. After all, an improving real estate industry, the continued strength of the residential construction industry is a big reason for optimism. However, the brisk housing market recovery, which stretches back to the end of 2011, may have stalled somewhat at the end of the first half of 2013 as growing borrowing costs raised concerns over the sustainability of the housing demand in the future. Still, the current level of private residential construction remains much stronger than a year ago, regaining over 40% of what was lost during the crisis (see chart 4). As a result, the share of residential investments in GDP exceeded 3% for the first time since the end of 2008, meaning that as the housing recovery continues, it will be contributing more to overall economic expansion.
energy sector and an uptick in exports are sustaining economic recovery in Texas. In particular, high and increasing energy prices are propelling up drilling activity and oil and gas service businesses, which bodes especially well for the Houston metro economy (see chart 6). In addition, returning demand for semiconductors (according to the Semiconductor Industry Association, in the second quarter of 2013 global semiconductor sales posted the biggest quarterly gain in three years) is a boon for the high-tech manufacturing clusters in Austin and Dallas.

Employment
The labor market recovery took a pause in June, as the Texas jobless rate held steady at 6.5% while the private sector added only 2.1 thousand new jobs. Meanwhile, the regional labor force, having grown by close to 30,000 per month on average during the previous five months of the year, dropped by about 4 thousand in June – the first month-over-month decrease in nearly a year. Importantly, the unemployment rate in Texas stood below 7% for the past twelve months and is a full percentage point lower than the national jobless rate (see chart 7). In fact, the jobs picture in Texas has been steadily improving despite the massive expansion of the regional workforce since the start of the 2007 economic downturn (see chart 8). This means that Texas private industries have been expanding their payrolls at a rate that was sufficient both to recoup jobs lost during the recession and provide jobs for the new entrants to the labor market. After all, unlike the nation as a whole, Texas already has nearly 6% more private sector jobs compared to the peak private employment reached during the previous business cycle (see chart 9).

Although employment growth in Texas continues to outperform other large states and the nation as whole (see chart 10), the second quarter of 2013 saw the smallest quarterly gain in private sector jobs (about 47,000 jobs, or nearly twice as low as a year ago) in the Lone Star State since the third quarter of 2010. In particular, the goods-producing sectors, which include mining, construction and manufacturing, posted the first quarterly jobs loss (about 3 thousand jobs) since the start of the labor market rebound in 2010. This is important, because, as we emphasized in the previous issues of this report, a strong recovery in local mining, construction and factory jobs played a key role in the overall labor market improvement in Texas – one in five new private jobs created since the start of the recovery in Texas was in goods-producing sectors (with mining accounting for roughly a half) versus just about 14% nationwide. However, since the last quarter of 2012, the economic environment was less favorable for jobs creation in goods-producing industries (see chart 11). In particular, slower growth of energy prices and the number of jobs in mining already at an all-time high made additional rapid gains of employment in mining less feasible. Meanwhile, slower growth of the global economy cooled foreign demand for Texas exports, limiting jobs growth in manufacturing. Lastly, having experienced a solid pick up at the start of the year, hiring in the construction industry has recently cooled, perhaps hit by increasing concerns over the sustainability of the rebound of the housing market.
federal levels may be partly responsible for the slowing jobs growth in service providing sectors. On the upside, a recent stabilization of public sector employment may help ease this impact on the Texas economy (see chart 13). Still, as jobs growth in Texas becomes increasingly driven by hiring in private service-providing industries (which tend to expand in line with the overall economic activity), private employment may continue to grow slower in the near future.

Monetary Policy and Asset Prices

Worries over the impact of tighter monetary policy on economic recovery and borrowing costs have been upsetting investors since the end of May when the Federal Reserve signaled a likely tapering of its bond buying program as economic data gets better. However, minimal GDP growth and below 2% core inflation (see chart 14) led the Federal Reserve to reiterate its goal of keeping interest rates close to zero as long as the national jobless rate stays above 6.5% (in July, the U.S. unemployment rate was at 7.4%). After all, a jump in borrowing costs (see chart 15) may have already started to cool demand for housing both in Texas and nationwide. Although existing home sales remain well above the bottom reached during the recession, recent figures point to slowing growth (see chart 16). Still, low housing inventory are helping keep home values on an uptrend (see chart 17), which adds to consumer optimism and helps restore household wealth. In addition, home prices in Texas appear to be moving on a more sustainable trajectory, supported by continued expansion of the regional economy. Indeed, a recent recovery of the national price index was largely driven by strong gains in the worst-hit states, such as California, Arizona and Nevada. However, higher borrowing costs may make residential properties less attractive to investors whose demand for distressed homes was a big reason for the recent surge of housing prices in many metros with the biggest drops in home values. This leaves cities with the biggest recent jumps in house prices more vulnerable to downward price corrections in the future.