Executive Summary

Economic development at the national level slowed in December 2014. This was reflected by flat industrial output and further decline in exports. On the other hand, construction and consumer confidence posted increases. Preliminary data showed that GDP growth in Q4 halved compared to Q3 mainly due to lower federal expenditures and an external trade balance. However, annual GDP growth of 2.4% was higher than that in 2013. Moreover, there is a high probability that growth will be revised upwards taking into account manufacturing sector data.

Weather conditions had a negative impact on industrial production in December. Higher than expected outside temperatures significantly lowered demand for heating. As a result, the decline in output of the energy sector almost fully covered growth of other industrial sectors. On the positive side is a 2.2% mom increase in mining after two months of decline. Both the PMI and NMI indexes posted declines but stayed above 50, meaning that manufacturing and non-manufacturing sectors were still expanding.

Consumers were optimistic about both existing present and future market conditions in the short-term in January 2015. Moreover, they were so optimistic that the Conference Board Consumer Confidence Index was at its highest level since August 2007. People were more optimistic about business and labor market conditions and about income growth in the six-month outlook.

After sluggish performance in November, the U.S. construction industry observed growth in both construction permits and expenditures in December. Construction permits posted significantly higher monthly growth recovering from a slump observed a month ago. Both indicators saw good annual growth in 2014.

In December 2014, U.S. exports further decreased. Compared to the previous month, the decline slowed down a bit as exports of services reversed to an upward trend. As a result, growth in exports of services compensated for two-fifths of the decline in exports of goods, which in turn accelerated compared to November. Total exports grew by 2.7% yoy in 2014, despite the negative developments at the end of the year.

Like the U.S. economy in general, the Texas economy saw significant deceleration in growth in December. The major reason for this was the continued decline in world oil prices, which led to a decrease in the rig count and exports. Construction was the only sector posting good growth, especially in the residential building sector. Factory activity, on the other hand, posted sluggish performance in January 2015. Moreover, the dynamics of future business conditions reflected pessimism about the business environment and a significant slowdown in growth.

In December 2014, the labor market saw positive developments at both the national and Texas level and for both employment and unemployment. The annual unemployment rate reached the lowest levels since 2009 for the U.S. and early 2008 for Texas. Continuous improvement in labor market conditions over the year ensured the highest annual growth in employment at 1.9% over the last fourteen years in 2014. The Lone Star State, in turn, saw growth in employment for the 51st consecutive month and the 5th month in a row of the record-breaking annual jobs growth. At the metro level, Midland remained the best performer in both new job creation and lowering of the unemployment rate. Dallas and Houston were among the best metros in terms of job creation in December, but remained an average performer in terms of decreasing the unemployment rate.

The Federal Reserve did not introduce any changes to its monetary policy, despite the fact that inflation fell beyond the forecasted levels due to continued decline in world oil prices. The reason for this is that all the other economic development and labor market indicators are within projections and inflation is expected to return to the projected target level of 2.0% in the medium-term. The housing sector posted growth in existing-home sales at both the national and Texas level, despite low housing inventories. However, sales may significantly decelerate over the next couple of months, especially in Texas, as inventories are at their lowest since 1990. Texas housing inventories are the lowest since 1990.
**Economic Growth**

The advance estimates show that real GDP growth significantly decelerated in the fourth quarter of 2014. Dynamics of GDP reflected a drop in national defense expenditures at the federal level which, accompanied by an upturn in imports and deceleration in exports, surpassed the accelerated growth in personal consumption expenditures. Gross private domestic investment grew at a rate almost identical to that in Q3 thanks to positive changes in private inventories, which compensated for a 5.4 percentage point deceleration in growth of fixed investments to 2.3%. Overall, GDP grew by 2.6% in Q4, which is just half of the growth in the previous quarter. As for the annual real GDP growth, it was 0.2 percentage points higher at 2.4% yoy in 2014. The mentioned increase was ensured mainly by positive contributions from personal consumption expenditures and nonresidential fixed investments. At the same time, the most significant negative contribution to GDP growth was recorded from a decline in federal government spending. There is a high probability that GDP data will be revised upwards, as PMI data shows that GDP growth should be around 4%.

After strong performance in November, industrial production remained almost unchanged in monthly terms in December 2014. This happened due to abnormally warm weather, which led to a decline in the output of utilities caused by reduced demand for heating. Excluding utilities, industrial output grew by 0.7% mom in December on the back of a 0.3% mom increase in manufacturing and a 2.2% mom increase in mining, which followed a two months decline. Much of the increase in mining was ensured by oil and gas extraction. However, continued decline in world oil prices caused a drop in drilling and well-servicing, which limited growth of the sub-sector. Production of primary metals saw the highest increase among durable goods industries at 2.2% mom and was followed by production of computers and electronic products (1.2% mom). At the same time, wood products and motor vehicles and parts recorded the largest declines of nearly 1% mom or more. Most of the nondurable goods industries saw increases with the fastest ones in apparel and leather. Data from the Institute for Supply Management show similar dynamics. Both the PMI and NMI indexes declined but stayed above 50 in December 2014. This
means that manufacturing and non-manufacturing industries continued to expand but at a decelerated rate compared to
November. Manufacturing marked the 19th consecutive month of growth, while the non-manufacturing economy grew
for 59 months in a row.

A more optimistic assessment of both present conditions and short-term outlook significantly strengthened consumer confidence in January 2015. The Conference Board Consumer Confidence Index reached its highest level since August 2007. Its current value of 102.6 is a sharp increase from the upwardly revised 93.1 in December 2014. Positive changes were observed in assessment of both business conditions and labor market conditions. Furthermore, the number of people expecting higher incomes over the next six months also significantly increased. The proportion of such people increased from 16.2% to 20.0%. However, the number of those expecting a decline in incomes also marginally increased from 10.2% to 11.3%.

Data on dynamics of both construction permits and construction expenditures shows a rebound in the construction industry in December. The number of construction permits grew by 17.1% mom after a 26.0% mom decline in November. Even though the number of construction permits was still significantly lower than the level observed in October 2014, it posted a 7.3% yoy increase. Annual increase in the number of construction permits equaled 5% yoy in 2014. This marked further deceleration in annual growth of the number of construction permits observed after the crisis for the first time in 2013. Construction expenditures grew in both monthly and annual terms in December. The monthly increase was not significant at 0.4% mom and was ensured by growth of both residential and non-residential construction at an identical rate. However, the public sector ensured higher monthly growth at 1.1% mom compared to a tiny 0.1% mom increase in private construction. This is a fundamental difference from construction expenditures’ annual development trend. Private construction grew by 7.2% yoy in 2014, which is exactly 4 times faster than growth of public construction.

The downward trend in exports continued in December 2014. The decline decelerated, however, to 0.8% mom from 1.0% mom observed in November. Just as in previous months, the decline was attributed to the decrease in exports of goods totaling USD 2.5 billion to USD 134.3 billion. Exports of services, in contrast, increased by USD 1.0 billion on the back of a rebound in freight and port services and passenger fares, financial services, and in travel. In 2014 as a whole, exports increased by 2.7% yoy to USD 2,345.4 billion, despite the decline in exports at the end of the year. Exports of goods ensured two-thirds of the increase. In particular, exports of capital goods increased by USD 15.8 billion, while exports of consumer goods added USD 10.1 billion. Most of the increase in exports of services was attributed to travel, charges for the use of intellectual property, and financial services.

The Texas economy continued to expand in December, but economic growth decelerated a bit mostly because of a continued decline in oil prices. Oil well permits and rig count saw significant declines in the reporting month, as did exports, which are highly dependent on oil and gas. In particular, the rig count dropped to 872 from 904 observed in November. At the same time, conditions outside the energy sector were more optimistic. Construction industry growth picked up in December in both the residential and non-residential sector. In particular, the number of construction permits jumped by 43.1% mom on the back of 76.3% mom growth in the number of construction permits for multi-family houses. As a result, the total number of construction permits was 26.4% higher in December 2014 compared to December 2013. At the same time, the value of contracts for non-residential building construction grew by 6.7% mom, which is a significant improvement over the 31.8% mom decline observed in November 2014. The Federal Reserve Bank of Dallas reported that factory activity was almost flat in January 2015, as the production index came in at 0.7. This means that output posted just a minor increase. Other indicators also showed sluggish activity in January. In
particular, the capacity utilization index fell to its lowest value in five months. Indexes reflecting future business conditions posted significant declines, meaning that businesses expect their worsening and slower growth. As for agricultural conditions, they posted just a marginal improvement. Harvesting was finished for all crops except cotton. Winter wheat has been planted. However, some areas need more rain to yield, as a large portion of the state remains in drought. Cattle and dairy prices slightly declined, but the former remained around record highs.

**Employment**

The situation in the labor market further improved in December 2014. The number of unemployed dropped 4.2% mom and reached the lowest level since June 2008 at 8,688 thousand people. Thanks to the mentioned monthly developments, the annual decline in the number of unemployed equaled 16.1%, which is the largest decrease over the last 30 years. Thus, the unemployment rate for 2014 showed a 1.2 percentage point decline to 6.2%, which was the lowest rate since 2009. As for employment, it also saw some improvements in December 2014. Such major sectors as manufacturing, construction, and mining posted the highest year-over-year growth of to 1.8%, 5.7%, and 5.5% respectively. This helped accelerate the growth of total nonfarm jobs by 0.2 percentage points compared to November to 2.3% yoy. The total number of nonfarm jobs increased on average by 2,649 thousand jobs in 2014, which is a 1.9% increase to 2013. This is the largest annual increase over the last fourteen years.

A strong business climate and faster growth than the average in the country helped Texas post stronger performance in the labor market compared to the national level in December 2014. The state marked monthly growth in employment for 51 consecutive months gaining 45,700 jobs. Furthermore, creating 457,900 seasonally adjusted total nonfarm jobs compared to December 2013, the Lone Star State registered the fifth straight month of record-breaking annual jobs growth. All the major industries added jobs over the year. At the same time, 11 major industries posted monthly increases in jobs in December. Professional and business services were the leader in job creation with 14,800 jobs. Education and health services were the second best, creating 6,800 and were followed by construction, which generated
5,100 new jobs in December. Mining and logging also managed to significantly expand employment, generating 4,900 new jobs after one month of decline in November. Furthermore, oil and gas extraction added 600 new jobs despite continued decline in oil prices in the world market. Improvements in unemployment were also more significant in Texas compared to the national level. The seasonally unadjusted unemployment level dropped 1.5 percentage points to 4.1% in December 2014, which is the lowest unemployment level since April 2008. The unemployment rate has been at or below the national rate for 96 months in a row in Texas.

There were few changes among the Texas metros in terms of labor market development in December. Midland remained the best performer in terms of both employment growth and the unemployment rate. Employment in Midland grew by 6.0% yoy, while the unemployment rate equaled 2.1%. Both indicators were 0.2 percentage points lower compared to November. Wichita Falls and Abilene once again saw a decline in employment at 0.2% yoy and 0.3% yoy respectively, while McAllen-Edinburg-Mission saw the highest unemployment rate among Texas metros at 7.8%. The largest contributors to total Texas employment, Dallas-Plano-Irving and Houston-Sugar Land-Baytown, were third and fourth in terms of employment growth with 4.9% yoy and 4.3% yoy increases, respectively. At the same time, both metros registered the unemployment rate at 4.1%, which is the same as the average for Texas in general.

Monetary Policy and Asset Prices

Monetary policy did not sustain any changes in December. The Federal Open Market Committee after analysis of economic data made a conclusion that all the major economic indicators except for inflation progressed as forecasted. Economic activity has been expanding at a solid pace. Improvements were observed in employment, household spending, and business fixed investments. Inflation though has declined further below the longer-run objective of the Committee. At the same time, the Committee still expects inflation to rise gradually to the target level of 2% in the medium term, since the labor market improves and the transitory effects of decreasing oil prices and other factors diminish. Based on these observations the Committee decided to keep the federal funds rate unchanged, as it is adequate for current economic conditions in the country.

The continued decline in oil prices has been pushing consumer prices down. In particular, the decline in the gasoline index (all types) accelerated further to 9.4% mom, while the fuel oil index dropped 7.8% mom. The mentioned decreases ensured acceleration of the energy index from 3.8% mom in November to 4.7% mom. The drop in the energy index could be even larger, if not for increases in the natural gas and electricity indexes. In year-over-year terms, the declines in energy indexes were much higher. The gasoline index (all types) dropped 21.0% yoy and the fuel oil index fell by 19.1% yoy, causing the energy index to decrease by 10.6% yoy. At the same time, other more volatile prices continued to increase in December. In particular, the food index inched up by
0.3% mom and the shelter index added 0.2% mom. However, these increases, just like the largest increase in the medical care index since August 2013, were offset by decreases in a large set of other indexes including apparel, airline fares, new and used vehicles, used trucks, etc. Thus, the all items index saw a 0.4% mom decline in December. Annual CPI posted a 0.8% increase in 2014, which is slightly more than half of the increase observed in 2013 (1.5%). Furthermore, this is the second-smallest December-December increase in the last 50 years, lagging behind the growth in 2008 by just 0.1 percentage point.

The housing sector rebounded again at the national level in December despite low inventory conditions. Total existing-home sales grew by 2.4% mom, climbing above a seasonally adjusted annual rate of 5 million. Actually, they equaled 5.04 million compared to a downwardly-revised 4.92 million in November. As for 2014 in general, existing-home sales posted much better performance in the second half of the year, increasing by 8% compared to the January-June 2014 period. The increase in inventory, accelerated economic growth and more attractive prices ensured the mentioned growth in sales. However, this growth was not enough to compensate for the sluggish performance of sales at the beginning of the year. Therefore, total existing-home sales posted a 3.1% yoy decline to 4.93 million from 2013. There are also some concerns about growth of existing-home sales in the nearest future because of the accelerated drop in housing inventory. Total housing inventory declined by 11.1% to 1.85 million existing homes at the national level in December. This is just 4.4 months of supply at the current sales rate. On the other hand, this is still significantly higher than just 3 months of supply in Texas (the lowest level since January 1990, when the data on housing inventory became publicly available). This may be a serious problem in the nearest future, especially in light of the rebound in existing-home sales to the level above 20 thousand of actual sales per month. There were 23,321 actual existing-home sales in December 2014, which is a 23% mom increase. The annual increase in existing-home sales was almost identical to the average in the country at 3.0%.