Texas Economy Feels National Pinch

By Laila Assanie and Raghav Virmani

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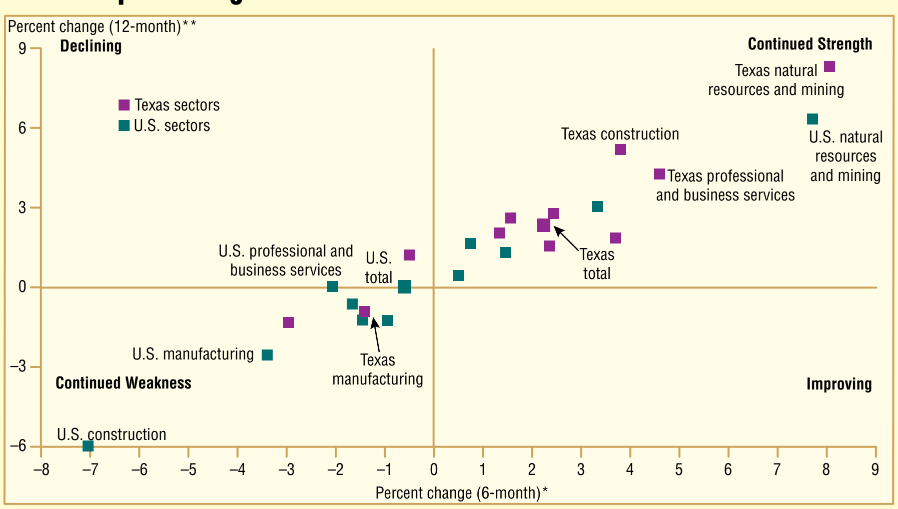
Texas entered 2008 with its economy on the wane, largely because of the drags from the nation's slowing business activity. During the first half of the year, more signs of weakness have emerged in Texas and the U.S., but the state is still doing better than the nation.

Through June, Texas had created 118,200 jobs—a 2.3 percent annualized gain. The pace looks good compared with the nation's 0.6 percent decline, but it doesn't measure up to Texas' 37-year average employment growth rate of 2.8 percent.

In areas where the U.S. has been hurt in the past year, Texas has either weathered the storm by adding jobs or tempered the blow by not losing as many jobs as the nation (*Chart 1*). For instance, Texas increased its construction employment 5.2 percent in the 12 months prior to June 2008 and 3.8 percent so far this year.[1] The number of U.S. construction jobs contracted 6 percent from June 2007 to June 2008 and 7.1 percent so far this year.

Chart 1
Texas Outperforming U.S. Across Sectors



* June 2008/December 2007 annualized. ** June 2008/June 2007.
SOURCES: Bureau of Labor Statistics; Texas Workforce Commission; seasonal and other adjustments by Federal Reserve Bank of Dallas.

Helped somewhat by a weak dollar and strong exports, Texas has shed manufacturing jobs at a 1.4 percent rate so far this year, a much slower pace than the nation's 3.4 percent decline.

Texas is likely to continue doing better than the U.S. A recent Manpower survey indicates that business sentiment is more upbeat in Texas. The company found that 31 percent of Texas firms planned to hire in third quarter 2008, compared with 26 percent of national employers. Only 6 percent of state companies expected to reduce their payrolls, while 10 percent nationwide intended to cut back.

Texas' unemployment rate stands at 4.4 percent, close to a 30-year low. The Dallas Fed Beige Book—an anecdotal survey of current economic conditions—suggests that Texas labor markets are relatively tight, particularly for professionals in energy, information technology and engineering services.

Signs of Weakness

Over the past year or so, a series of storms has broken out over the U.S. economy—skyrocketing food and energy prices, the bursting of the housing bubble and turmoil in financial markets. All these forces are rippling through Texas' economy, some for good, others for ill.

The state, for example, is home to some of the world's largest airlines. A doubling of jet fuel prices in the past year has hurt not only legacy carriers that already suffer from high costs, but also the low-cost carriers whose bold fuel-hedging practices had until recently insulated them from oil shocks. Industry leaders call this period the worst crisis faced by airlines since the Sept. 11, 2001, terrorist attacks.

Dallas–Fort Worth-based American Airlines lost $612 million in the first six months of 2008, excluding second-quarter write-downs related to jobs and capacity cuts. Houston-based Continental Airlines lost $110 million, excluding one-time gains from sale of aircraft and stake in a Latin American airliner. Both companies are cutting payrolls and capacity.

American said it would reduce its capacity 11 to 12 percent after the peak summer travel season and eliminate nearly 7,000 jobs. It has decided to ground 30 of its least-fuel-efficient MD-80 aircraft, all of its A300 fleet, 37 regional jets and its entire turboprop fleet.

Continental announced it would cut 6.5 percent of its workforce (3,000 jobs) and reduce capacity 11 percent. The company also said it would retire its entire 737-300 fleet by next year and ground 20 of its 737-500 aircraft.

Dallas' Southwest Airlines continues to fare better than the two other Texas-based airlines. It has used hedging to offset high jet fuel prices. As oil prices have risen, however, even Southwest has begun to feel the heat. Its profit of $164 million (excluding special items) in the first half of the year was off 28 percent from year-ago levels. The airline has decided to slow its expansion rather than take drastic steps to reduce capacity or trim its workforce.

Activity in the Lone Star State's manufacturing sector has been soft as well. The Dallas Fed's Texas Manufacturing Outlook Survey, which gauges the overall health of state manufacturing, has been sluggish since late 2007. Earlier, the weakness was limited to housing-related manufacturers, but high gasoline prices have slowed activity in Texas' auto manufacturing sector, and two large auto manufacturers are idling their Texas-based SUV and truck plants. (See Noteworthy on state auto manufacturers, page 14.)

Texas' housing industry has been flagging, although it remains in better shape than the nation's.[2] The state's home building and sales activity has been trending down since late 2006. In June alone, starts were off 34 percent and existing home sales fell 15 percent from year-earlier levels.

Many prospective homebuyers are awaiting news of a turnaround or are encountering difficulties obtaining mortgages. Faltering demand and rising foreclosures have pushed home inventories to just over the equilibrium level of six months, but Texas home prices are about even with last year—a contrast to the nation's big declines.

Financial market woes, a fallout from the weakening housing sector, have begun to take their toll on the commercial real estate sector. Office vacancy rates, which had been coming down steadily since mid-2004, have started to edge up, reflecting both a slower pace of job growth and downbeat business sentiment. At 21.4 percent, Dallas' office vacancy rate is second highest among U.S. cities. Austin's rate is about 16 percent, while Houston's is relatively low—around 12 percent—because of a booming energy sector.

Investment in office real estate across major Texas metros has declined sharply. Through May, sales activity is off significantly from last year's levels (*Chart 2*). For instance, sales of Austin office properties through May were merely 2 percent of the total 2007 transactional volume, while comparable numbers were 16 percent in Dallas, 14 percent in San Antonio and 13 percent in Houston.

Nonresidential building activity, which includes office, retail and industrial space, has fallen off as well, and contract values were down 15.6 percent in June compared with year-ago levels. The current contraction in commercial construction is nearly as pronounced in Texas as in the nation, where the decline has been 18.3 percent.

The pullback in commercial real estate activity stems from two factors. First, construction costs are rising, a direct result of soaring fuel, steel and other raw material prices.

Second, financial restraints are increasing. Business contacts indicate that private money is difficult to come by, especially for large projects, many of which have gone

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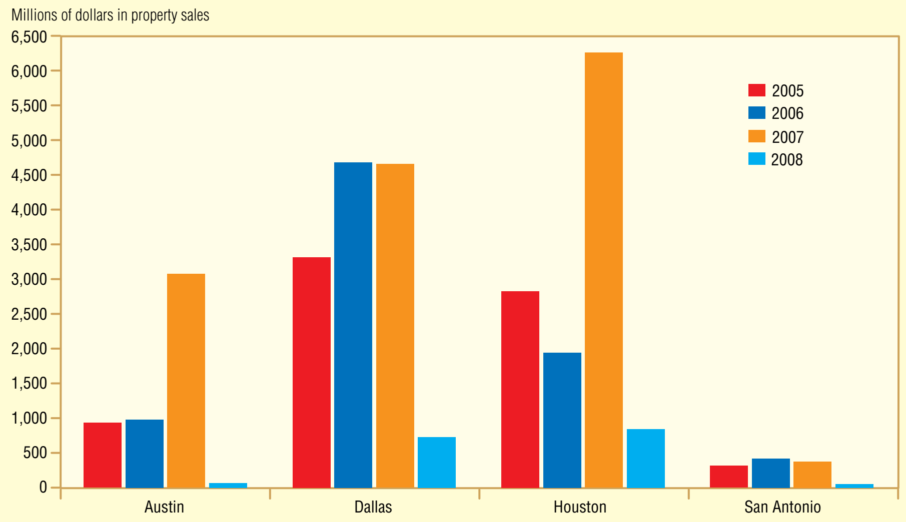
Chart 2

Investment in Texas Major Metro Office Markets Plummets



NOTE: 2008 data include transactions closed through May.

SOURCE: Real Capital Analytics.

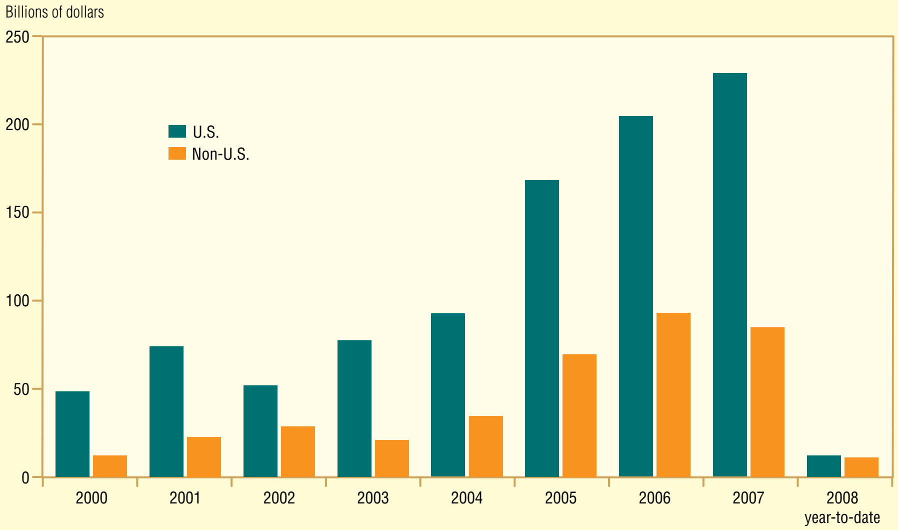
over budget. Perhaps more important, activity has been hindered by a lack of liquidity in the commercial-mortgage-backed securities (CMBS) market (*Chart 3*).

Securitized mortgages, which make up nearly a fourth of the commercial loan market, had fueled a significant share of the growth in mortgage originations in recent years.[3] With securitization activity coming to a screeching halt this year—a direct result of the subprime meltdown that began in mid-2007—financing large deals in particular has become increasingly difficult. Beige Book contacts tell us that only a handful of deals are being finalized in a lending environment characterized by little liquidity and more rigorous underwriting standards.

Although traditional financiers such as commercial banks and life insurance firms have picked up some of the slack, their ability to fill the void is limited. This suggests that, without a turnaround in the CMBS market, there may be further softening in new commercial construction projects in coming months.

Texas commercial markets remain attractive both in terms of relative price and future growth because of the state's business-friendly climate, its low cost of living and a young labor force.

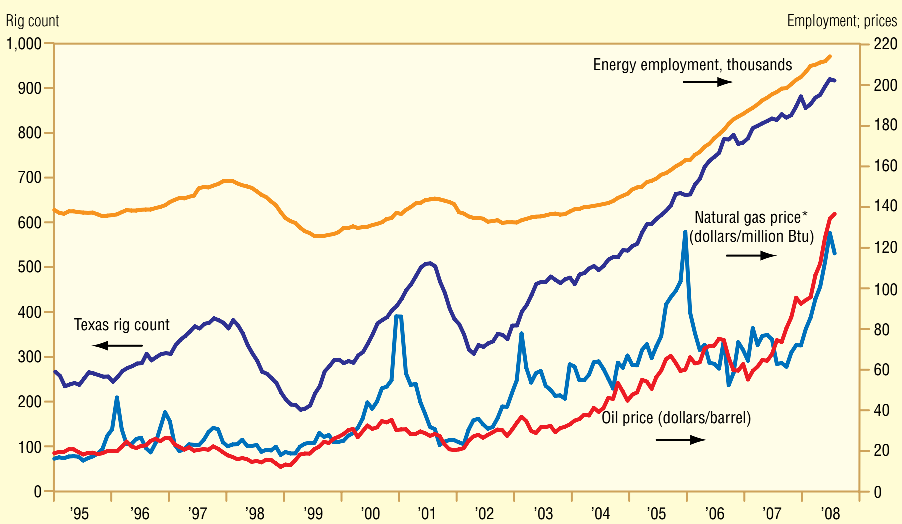
Chart 3
Commercial-Mortgage-Backed Securities Market Dries Up



NOTE: 2008 data are through July 24.

SOURCE: Commercial Mortgage Alert.

Chart 4
Soaring Prices Energize Texas Activity



*Multiplied by 10

NOTE: 2008 data are through July, except employment, which is through June.

SOURCES: Bureau of Labor Statistics; Texas Workforce Commission; Federal Reserve Bank of Dallas; *Wall Street Journal*; Baker Hughes International.

On the Upside

Despite the troubles in airlines, real estate and elsewhere, Texas still looks better than the rest of the country. The factors behind the relatively buoyant performance start with the energy industry, which has long been one of the state's primary economic drivers. This year has been no different.

With oil prices high, Texas' energy employment has continued to reap the immediate benefits, growing 8.1 percent in the first half of the year, after posting a 9.6 percent growth rate in 2007 (*Chart 4*). Texas now employs nearly one of every two workers in the U.S. oil and gas extraction industry.[4]

Although Texas oil production has remained flat because of a lack of reserves, natural gas output has picked up strongly in recent years. Buoyed by drilling activity in the immense Barnett Shale reserve, Texas natural gas production increased more than 16 percent in 2007.

The strength continued this year, with production in the first five months rising 12 percent annualized (*Chart 5*). Today, Texas produces nearly a third of all U.S. natural gas, up from about a fourth in 2004.

Another bright spot has been trade. Texas exports surged 7.6 percent in the first five months of 2008, aided by a falling dollar, a strong energy industry and a record year for agriculture.

While breakdowns of industry- and country-level data aren't available on a monthly basis, first quarter 2008 data show that sales to Europe were 13.3 percent higher than a year ago—likely the result of a euro that strengthened by more than 10 percent in 2007 alone. Anecdotal reports from the Texas business community suggest that there has been a surge of soybean and corn exports to Europe, possibly to aid the production of biofuels. The higher price of oil relative to natural gas has made chemical production competitive in the U.S., fueling European demand for U.S. exports.

Sales to Latin America (excluding Mexico) were up a robust 23.7 percent in first quarter 2008 compared with year-ago levels, driven primarily by a doubling of petroleum products exports and a 50 percent gain in chemical sales. Latin American currencies have strengthened, boosting the region's purchasing power for U.S. goods and services. The Brazilian, Chilean and Colombian currencies have all shown double-digit gains from first quarter 2007 to first quarter 2008 against the U.S. dollar, helping spur Texas exports (*Chart 6*).

Despite a surge in metal and agricultural exports to China, overall exports to the Asian giant grew 4.6 percent between first quarter 2007 and first quarter 2008, the slowest pace since second quarter 2005. China's demand for infrastructure-related raw materials and staple grains ahead of the Summer Olympics increased its purchases of Texas products. A managed float of the Chinese yuan against the dollar, however, hasn't strengthened the currency enough to create the kind of price breaks that help American goods in Europe and Latin America.

Medical services continue to expand swiftly, with employment rising 1.8 percent (8,600 jobs) through June 2008, following a 3.8 percent increase (34,400 jobs) in 2007. The growth is due in part to demand created by the state's strong population growth rate—2.1 percent in 2007, or twice the nation's rate.[5] Health care jobs now account for about 9 percent of Texas' total employment, up from 7.8 percent in 2001.

After receding through most of 2007, inflation-adjusted investment in Texas health care facilities has increased more than 25 percent in the first half of 2008, compared with the same period a year ago. For example, Houston is adding a $220 million, 490,000-square-foot children's hospital, creating a 700,000-square-foot one-stop medical facility and spending $75 million to expand The Woman's Hospital of Texas by 145,000 square feet and 250 employees. (For information on El Paso's health care expansion, see Spotlight, page 15.)

Additional impetus is coming from the military's expanding presence in Texas. Fort Sam Houston, outside San Antonio, has received hundreds of millions of dollars to expand and develop new medical training facilities. New projects are also planned for Fort Hood in Killeen.

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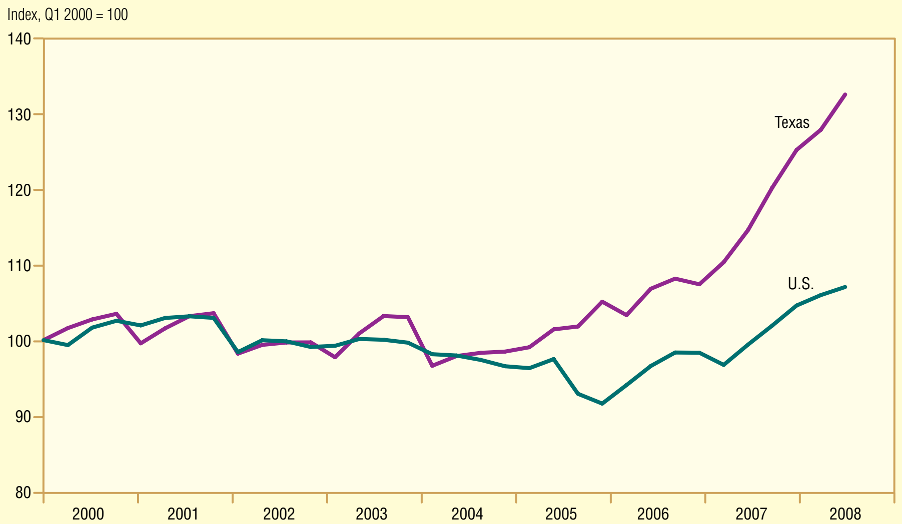
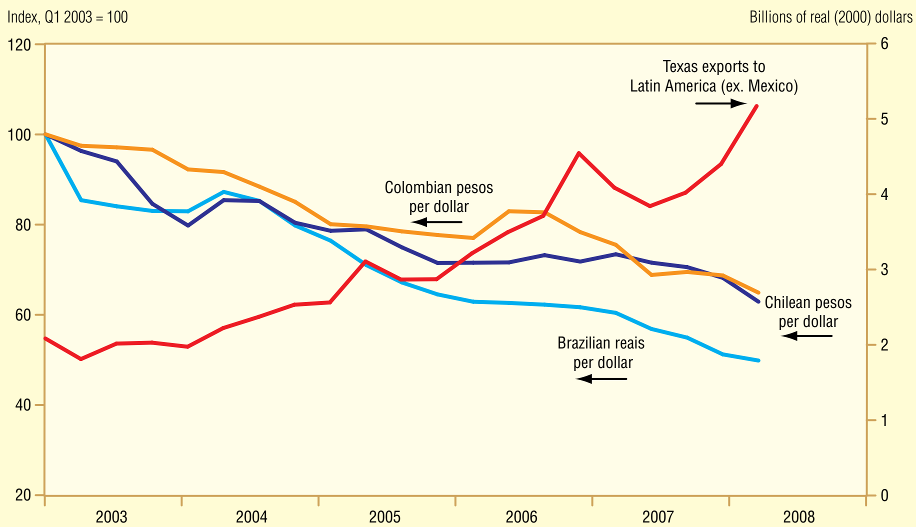
Chart 5
Texas Natural Gas Production Tees Off



NOTE: Second quarter 2008 production has been estimated using the average of April and May data.

SOURCE: Energy Information Administration.

Chart 6
Texas Exports Surge as Dollar Weakens in Latin America



NOTE: Data are through first quarter 2008.

SOURCES: *Wall Street Journal*; WISERTrade; seasonal and other adjustments by Federal Reserve Bank of Dallas.

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What's in Store?

In the second half of 2008, the Texas economy is expected to continue to outperform the nation, although the pace of growth may subside further.

The Conference Board's Consumer Expectations Index for the Southwest region—dominated by Texas—has dipped alarmingly since late 2007. Today, the index for the Southwest is at the lowest level since its inception in January 1981. This plunge in consumer sentiment is worrisome because it suggests that Texans are feeling the pinch of a slowing economy and high commodity prices and may cut back on discretionary expenditures in the near term. If they do, retail sales may soften.

The state's unemployment rate remains low, but the uptick in initial as well as continuing jobless claims suggests softening of Texas labor markets in coming months. Growth in temporary employment, a reliable leading indicator of statewide employment, has slowed since late last year to under 1 percent, also suggesting that overall employment may slow further in the latter half of 2008.[6]

The current mix of strengths and weaknesses coupled with the slowdown at the national level has increased uncertainty about the health of the Texas economy. Movements in the Dallas Fed's Texas Leading Index over the past several months point to employment growth between 1.5 percent and 2 percent this year, well below the state's long-term average.

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Notes

[1] Year-to-date employment data are through June 2008. Employment data are subject to revision. Employment growth rates are annualized.

[2] For details on Texas housing markets, see "Texas Finds Cover from U.S. Economic Storm" by Fiona Sigalla and "Hot Housing Market Catching Cold in Texas" by D'Ann Petersen, Federal Reserve Bank of Dallas *Southwest Economy*, January/February 2008.

[3] Data are from Commercial Mortgage Securities Association's Compendium of Statistics and Flow of Funds Accounts data from the Federal Reserve Board of Governors.

[4] We define energy employment as the sum of oil and gas extraction and support activities for mining.

[5] The Census Bureau estimates that in 2007 eight of the top 50 fastest growing metros were located in Texas.

[6] Econometric testing done at the Dallas Fed suggests that it takes about five months for overall employment to fully arrive at the level suggested by temporary employment.

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