

Red-Hot Texas Economic Growth Likely to Cool

August 10, 2018

The regional economy is about as hot as the Texas summer. Texas job growth was a blistering 3.6 percent (annualized) in the first half of 2018. The Dallas Fed's Texas Business Outlook Surveys provide further evidence of continued widespread and solid growth. Labor market tightness continues, leading to mounting wage pressures, and trade frictions are increasing price inflation.

However, after red-hot gains the first half of the year, expansion in the regional economy will likely cool in the second half due to a historically tight labor market and a slowing in export growth. Additionally, growth in Houston, which makes up 25 percent of state employment, will likely moderate as Hurricane Harvey-induced activity dissipates in the second half of the year. Despite the softening, Texas payroll expansion is expected to remain above its long-term average.

Job Growth Remains Strong, Placing Texas in the No. 1 Spot

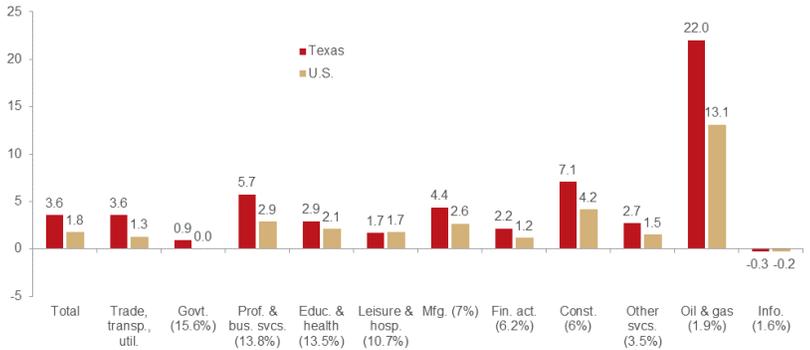
Texas employment grew an annualized 2.8 percent in June, down from 3.7 percent in May. Nevertheless, the pace of job creation was nearly as rapid in the second quarter (3.5 percent) as the first (3.6 percent). Texas payrolls have expanded at a 3.6 percent annualized rate (217,600 jobs) in the first half of the year, ranking No. 1 in the country, up from 9th place in 2017.

Texas employment is expanding at twice the nation's rate so far this year, with the state's lead over the U.S. in job growth extending to most major sectors (Chart 1). The difference is the largest in the goods sector, where Texas is growing 4.3 percentage points faster than the U.S. Among the private service industries, the state's two largest sectors—trade, transportation and utilities and professional and business services—boast the highest job growth premiums relative to the U.S.

Business Activity Expands Broadly

Beyond employment growth, the Texas Business Outlook Surveys (TBOS) also signal broad-based strength in the state's economy. The three-month moving average of the Texas Manufacturing Outlook Survey (TMOS) headline production index ticked up in July to its highest level since March 2006. The three-month moving averages of the Texas Service Sector Outlook Survey (TSSOS) and the Texas Retail Outlook Survey (TROS) headline indexes also edged up last month and remained above postrecession averages (January 2010–December 2017), indicating solid growth.

Chart 1
Job Growth in Texas Exceeding U.S. in Most Major Sectors
Percent change year to date*



*Seasonally adjusted, annualized rate.
NOTES: Year to date refers to June 2018/December 2017 for Texas and July 2018/December 2017 for the U.S. Figures in parentheses refer to share of state employment in June 2018.
SOURCES: Bureau of Labor Statistics; Texas Workforce Commission; seasonal and other adjustments by the Federal Reserve Bank of Dallas.

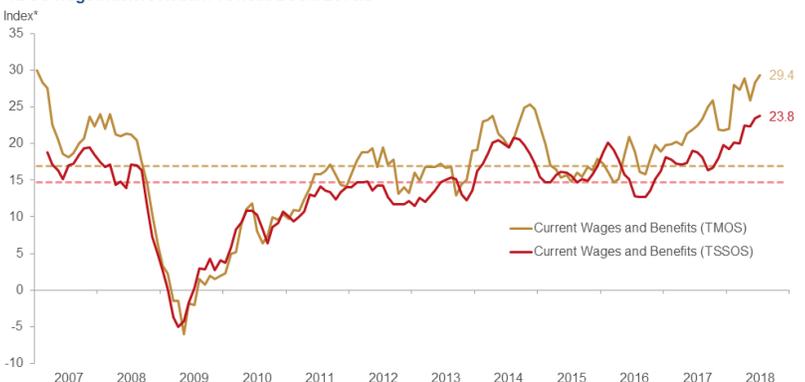
Chart 2
Texas Leading Index Dips



NOTE: Data are through June 2018. Shaded area indicates U.S. recession.
SOURCES: Conference Board; Federal Reserve Bank of Dallas.

*Estimated June value.
SOURCE: Federal Reserve Bank of Dallas.

Chart 3
TBOS Wage Indexes Reach Previous Boom Levels



*Three-month moving average, seasonally adjusted.
NOTES: Data are through July 2018. Dashed lines are postrecession averages (January 2010–December 2017).
SOURCES: Federal Reserve Bank of Dallas Texas Manufacturing Outlook Survey (TMOS) and Texas Service Sector Outlook Survey (TSSOS).

Texas Leading Index Dips

Although job growth and business activity remained robust in the second quarter, the Texas leading index slipped 1.2 percent, resulting in a downward revision to the 2018 job forecast for the state (*Chart 2*). The surge in the Texas trade-weighted value of the dollar and the decline in help-wanted advertising were the most significant drags on the index in the second quarter. The Dallas Fed's 2018 Texas job growth forecast now stands at 3.0 percent, down from 3.3 percent in June, suggesting that growth may cool in the second half of the year.

Tight Labor Market Pressures Wages

The Texas unemployment rate dipped to 4.0 percent in June and is only 0.1 percentage points higher than its all-time low of 3.9 percent in November 2017. Reports of worker shortages are rife across industries and skill sets. Even broader measures of unemployment are below their prerecession averages, indicating that slack in the labor market has been largely absorbed. This suggests that pressure on employers to attract workers may spur further wage increases.

TBOS data provide evidence of elevated and escalating wage pressures across the manufacturing and services sectors (*Chart 3*). The three-month moving averages of the wages and benefits indexes for both the services and retail surveys hit all-time highs in the 11-year history of the surveys in July; the three-month moving average of the TMOS wages and benefits index reached its highest point since January 2007.

Future expectations of wage growth ratcheted up in July. The three-month moving averages of the TMOS and TSSOS six-months-ahead wages and benefits indexes reached their highest point since 2004 and 2007, respectively, and the TROS equivalent hit a new record high.

Inflationary Pressures Elevated, Particularly in Manufacturing

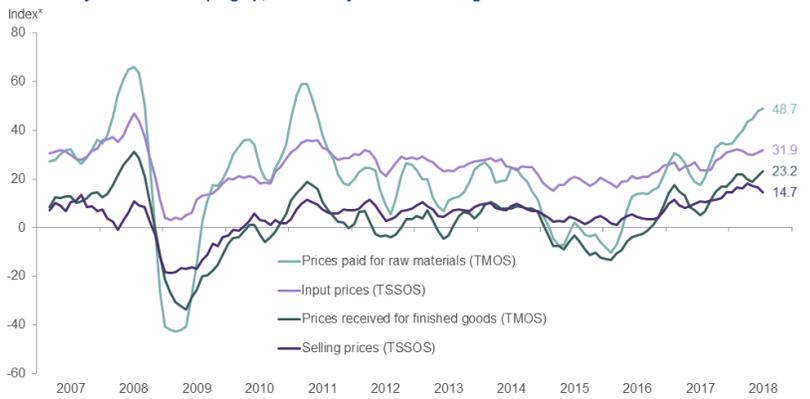
Firms responding to TBOS report that like wages pressures, prices are ramping up (*Chart 4*). The three-month moving average of the TMOS finished goods price index rose to its highest point since 2008, and the TSSOS selling prices index remained well above its postrecession average, suggesting upward pressure on prices.

Manufacturers' input costs have increased at a much faster rate in recent months partly due to the new tariffs, while their ability to pass these higher costs on to customers remains limited, thus widening the gap between the TMOS finished goods and raw materials price indexes shown in *Chart 4*. The three-month moving average of the TSSOS input price index edged up in July, suggesting inflationary pressures on service firms as well.

Manufacturers Suffer Greater Loss of Pricing Power

Responses to the June TBOS special questions suggest that manufacturers' pricing power has suffered from long-term trends, such as technological change and globalization, while service firms have seen less of an erosion (*Chart 5*). A larger share of service firms (24.1 percent) versus manufacturers (20.5 percent) reported an increase in pricing power due to these long-term trends over the past five years. Conversely, a higher percentage of manufacturers

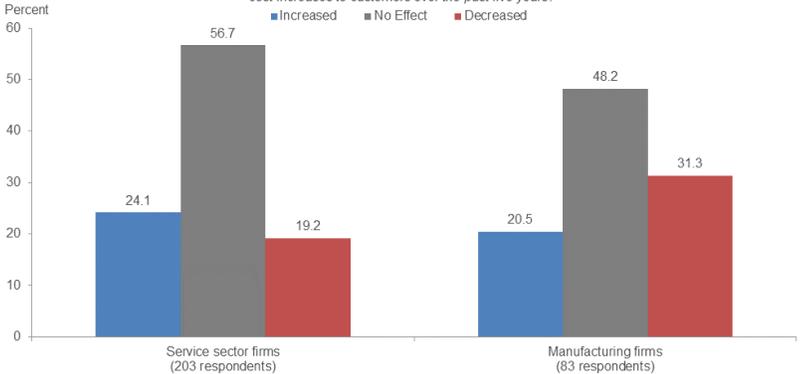
Chart 4
Inflationary Pressures Ramping Up, Particularly in Manufacturing



*Three-month moving average, seasonally adjusted.
NOTE: Data are through July 2018.
SOURCES: Federal Reserve Bank of Dallas Texas Manufacturing Outlook Survey (TMOS) and Texas Service Sector Outlook Survey (TSSOS).

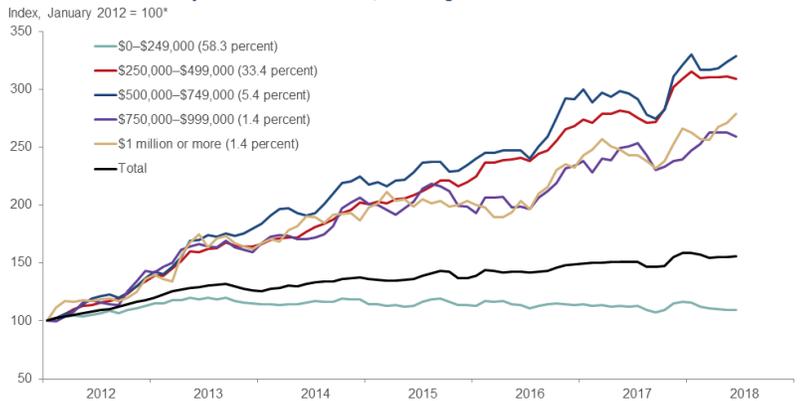
Chart 5
More Manufacturers Lose Pricing Power Relative to Service Firms

On net, how have long-term trends in your industry, such as technological change and globalization, affected your firm's ability to pass on cost increases to customers over the past five years?



NOTE: Data were collected June 12-20, 2018.
SOURCES: Federal Reserve Bank of Dallas Texas Manufacturing Outlook Survey (TMOS) and Texas Service Sector Outlook Survey (TSSOS).

Chart 6
Texas Sales of Moderately Priced Homes Level Off, Softening Growth in Overall Sales



*Three-month moving average, seasonally adjusted.
NOTES: Data are through June 2018. Numbers in parentheses refer to percent of total home sales in 2017.
SOURCES: Multiple Listing Service, Real Estate Center at Texas A&M University; adjustments by Federal Reserve Bank of Dallas.

(31.3 percent) said their pricing power had been diminished by these trends compared with service firms (19.2 percent) noting a decline.

Home Sales Nearly Flat Due to Slowing Activity in Moderate Price Points

Texas existing-home sales appear to have plateaued at elevated levels in recent months, with the number of homes sold in June 4.3 percent below the December 2017 record. In the first half of the year, total existing-home sales are up 2.8 percent compared with the same period last year.

A closer look at the data reveals that the softening is partly a result of slowing in sales of mid-priced homes (\$250,000-\$499,000), which made up 33.4 percent of 2017 sales (*Chart 6*). Tight inventory at the low- to mid-price points and declining

affordability (due to higher prices and mortgage rates) are likely impacting sales.

Exports at Record Highs but Trade Frictions Weigh on Sentiment and Outlooks

Texas exports rose for the fifth straight month in June. Total state exports expanded 14.8 percent in the first half of 2018 compared with the same period a year ago—more than twice the nation’s 5.2 percent increase. An expanding global economy and higher oil prices are boosting exports, although recent trade frictions and uncertainty surrounding North American Free Trade Agreement talks are significant headwinds for future growth.

Numerous business contacts across a wide range of industries are expressing concern about the impact of the ongoing trade disputes on future growth and prices. While future expectations among TBOS respondents remain fairly optimistic, we are seeing uncertainty in outlooks increase as trade tensions escalate (*Chart 7*).

—Laila Assanie and Stephanie Gullo

About the Authors

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Chart 7
Company Outlooks Remain Optimistic But Uncertainty Rises in July
Company outlook index*



*Three-month moving average, seasonally adjusted.
NOTES: Data are through July 2018. Lines are company outlook while bars are uncertainty regarding the outlook.
SOURCE: Federal Reserve Bank of Dallas Texas Manufacturing Outlook Survey (TMOS) and Texas Service Sector Outlook Survey (TSSOS).