

Growth in Texas Economy Downshifts

February 1, 2019

The Texas economy experienced another downshift in growth over the last two months, although the level of activity remains strong. Job growth decelerated slightly in the fourth quarter, and the Dallas Fed's Texas Business Outlook Surveys (TBOS) suggest a slowing in output growth in December and January.

Expectations have also slumped; the 2019 job growth forecast for Texas is now between 1 and 2 percent, and survey contacts' outlooks have notably deteriorated since November. Headwinds include lower oil prices, a strong dollar, tariffs, higher interest rates, labor constraints and increased uncertainty. Wage and price inflation may also be moderating; survey data point to softer growth in the second half of 2018 and expectations for slower growth in 2019.

Activity Remains Strong, Growth Moderates

Texas added jobs at a moderate 2.5 percent pace in the fourth quarter, slightly slower than the third-quarter growth of 2.7 percent (*Chart 1*). The gap between Texas and U.S. job growth narrowed in the second half of 2018 as U.S. payroll growth increased from 1.5 percent in the third quarter to 2.1 percent in the fourth. Most Texas metros experienced slower growth in the fourth quarter, with the exception of Fort Worth and San Antonio.

While Texas economic activity remains robust, a broad-based deceleration was seen in December and January across the manufacturing, services and retail sectors. The latest data from TBOS show notable declines in the production and revenue indexes (*Chart 2*). While these indexes are roughly in line with their postrecession averages, the recent declines point to slowing output growth from 2018 levels.

Manufacturing Activity Solid but Slowing

The Texas manufacturing sector remains strong, although production growth appears to be moderating for both durables and nondurables. The marked slowdown in manufacturing is not limited to Texas, as the new orders indexes from the four other Federal Reserve Banks' manufacturing surveys also declined (from high levels) in December and January, and the national Manufacturing ISM Report for Business came in weaker than expected at year-end (*Chart 3*).

Less Optimism in Outlooks

The Texas Leading Index declined sharply in November and December, due in large part to lower oil prices and lower stock prices of Texas companies (*Chart 4*). The drop in the leading index coupled with slower employment growth in the fourth quarter resulted in a downward revision to the 2019 Texas employment forecast to a range of 1 to 2 percent, from 2.0 percent in December.

A rather dramatic slowdown in outlooks among TBOS contacts was seen in December and January, lending further support for weaker expected growth this year. Texas business executives are now fairly balanced as to whether their company's six-month outlook has improved or worsened from last month, quite a deterioration from what was seen through November 2018, when far more con-

Chart 1
Texas Employment Growth Slows Slightly in Fourth Quarter

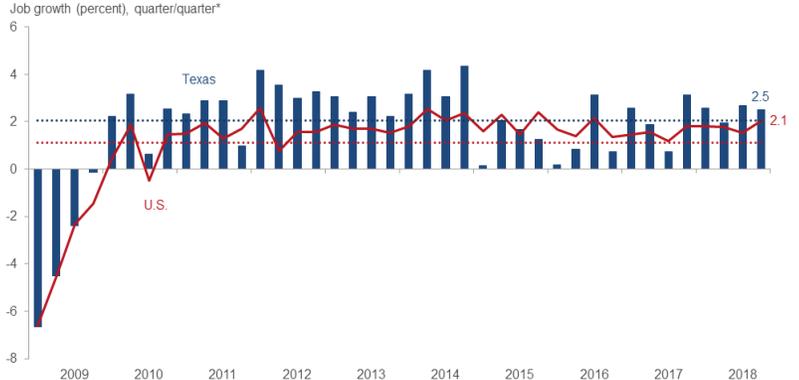


Chart 2
Output Growth Starting Off More Moderate in 2019

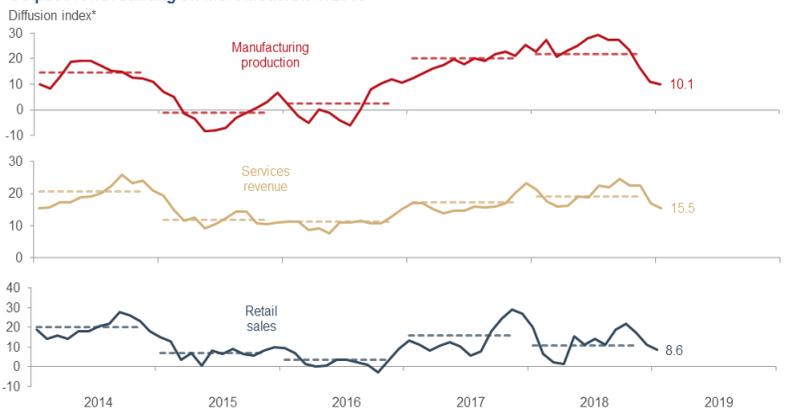
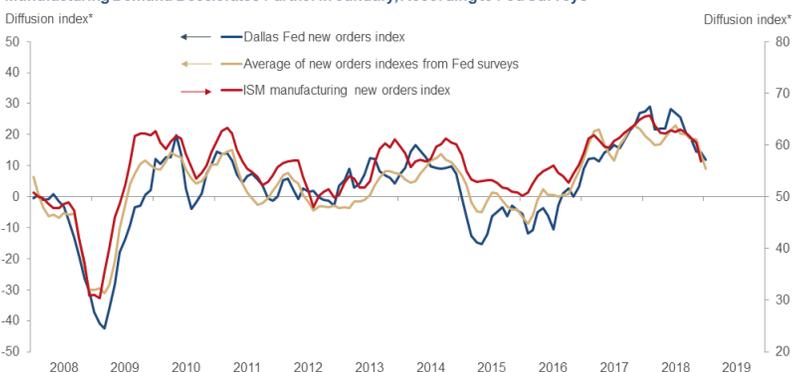


Chart 3
Manufacturing Demand Decelerates Further in January, According to Fed Surveys



tacts noted improved outlooks month to month. Contacts cited declining oil prices, labor constraints, increased stock market volatility and reduced activity in the housing and energy sectors as factors damping outlooks.

Wage and Price Growth Tempers

Texas businesses expect wage and price growth to abate somewhat in 2019 but still remain elevated. Respondents to December TBOS special questions expect wage growth to moderate from 4.5 percent in 2018 to 4.0 percent in 2019 and input price growth to be nearly 1 percentage point lower in 2019, on average (*Table 1*). Businesses expect to raise selling prices by 2.8 percent in 2019, on average, down slightly from 2018 and a distinctly slower pace than the expected rise in labor and nonlabor costs. As with wages, these price expectations are still quite elevated but do suggest that inflationary pressures may have topped out last year.

Texas Businesses Report Narrower Margins

Results from December TBOS Special Questions shed some light on why selling price growth is not keeping pace with wage and other input price increases. While a majority of survey respondents noted passing at least some of their costs on to customers, only 8 percent said they were passing all cost increases through, compared with nearly a quarter of firms who reported not passing on any of their higher costs.

With Texas businesses reporting selling price growth lagging input price growth, it's not surprising that 45 percent of respondents to December's TBOS special questions noted decreased operating margins over the past six months (*Chart 5*). Thirty percent reported increased margins, while almost a quarter noted no change. Margin erosion appears particularly severe in the retail sector, with nearly two-thirds of respondents reporting lower margins versus six months ago. Retail contacts point to internet pricing putting downward pressure on prices, particularly for auto dealers.

Housing Market Indicators Slow

The housing market appears to be slowing from elevated levels in 2018. Texas home sales began to wane in the second half of 2018, and single-family housing permits fell off sharply in October (*Chart 6*). Construction and real estate contacts expect flat housing starts and home sales in 2019 and further deceleration in house price appreciation. Builders report several headwinds to affordability, including elevated land, labor and construction costs.

—Emily Kerr and Benjamin Meier

About the Authors

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Chart 4
Texas Leading Index Drops in November, December

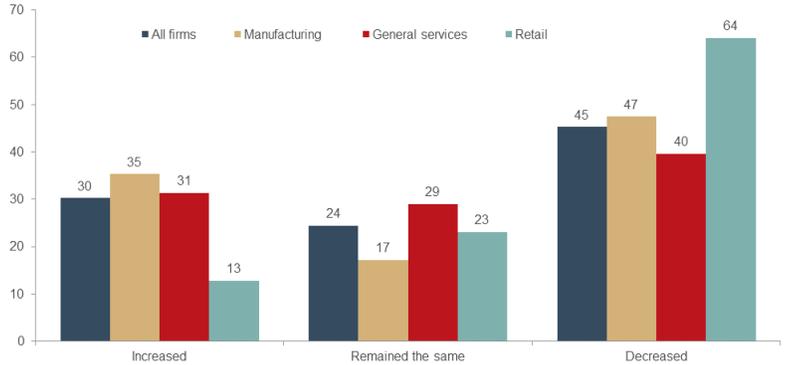
Index, January 1987 = 100



NOTES: Data are through December 2018. Texas trade-weighted value of the dollar is estimated. SOURCE: Federal Reserve Bank of Dallas.

Chart 5
Nearly Half of Businesses Report Decreased Margins over Past Six Months

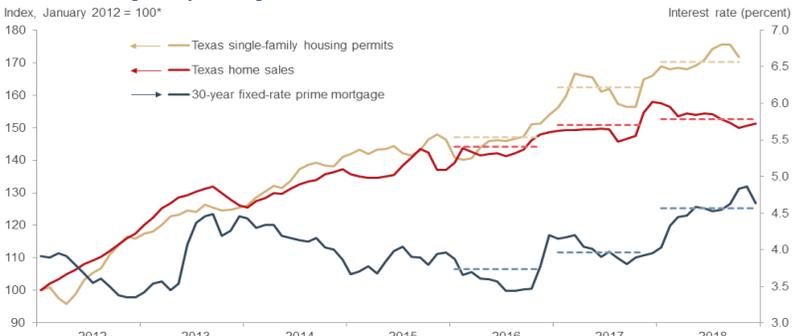
Percent of respondents



NOTES: Respondents were asked, "How has your firm's operating margin (defined as earnings before interest and taxes (EBIT) as a share of total revenue) changed over the past six months?" Data were collected Dec. 18-26, and 311 Texas business executives responded to the question. SOURCE: Federal Reserve Bank of Dallas Texas Business Outlook Surveys.

Chart 6
Growth in Housing Activity Leveling Off

Index, January 2012 = 100*



*Three-month moving average, seasonally adjusted. NOTES: Dashed lines show annual averages. Single-family permits through October 2018. Texas home sales and interest rates are through December 2018. Interest rate is monthly average of closed 30-year, fixed-rate prime mortgages. SOURCES: Multiple Listing Service; Real Estate Center at Texas A&M University; Freddie Mac Primary Mortgage Market Survey; Census Bureau.

Table 1: Texas Firms Report on Annual Percent Changes in Wages and Prices

	2017 (actual)	2018 (actual)	2019 (expected)
Wages	3.8%	4.5%	4.0%
Input prices (excluding wages)	3.1%	4.7%	3.8%
Selling prices	2.3%	3.1%	2.8%

NOTES: Shown are the trimmed means with the lowest and highest 5 percent of responses omitted. 2017 figures were collected in May 2018, and 216 firms responded to this question. 2018 and 2019 figures were collected in December 2018, and 258 firms responded.

SOURCE: Federal Reserve Bank of Dallas Texas Business Outlook Surveys.