Texas Facing Economic Headwinds in 2015

By Keith R. Phillips and Christopher Slijk

ABSTRACT: Texas job growth is likely to slow in 2015 from last year's rapid pace as the state economy absorbs the impact of collapsing energy prices that have curtailed oil patch activity.

After expanding strongly in 2014, the Texas economy faces significant economic challenges in 2015. They include a sharp decline in the oil and gas industry, tight labor markets and weakening exports. Texas job growth is projected to slow to between 1 and 2 percent for the year.

State employment grew 3.4 percent last year, according to Federal Reserve Bank of Dallas data. That is well above the previous year's 2.7 percent and more than a full percentage point above the national average of 2.3 percent. Growth in 2014 was broad based, with jobs in most industries picking up significantly over 2013. Employment in oil and gas, professional and business services, construction, and leisure and hospitality led overall growth.

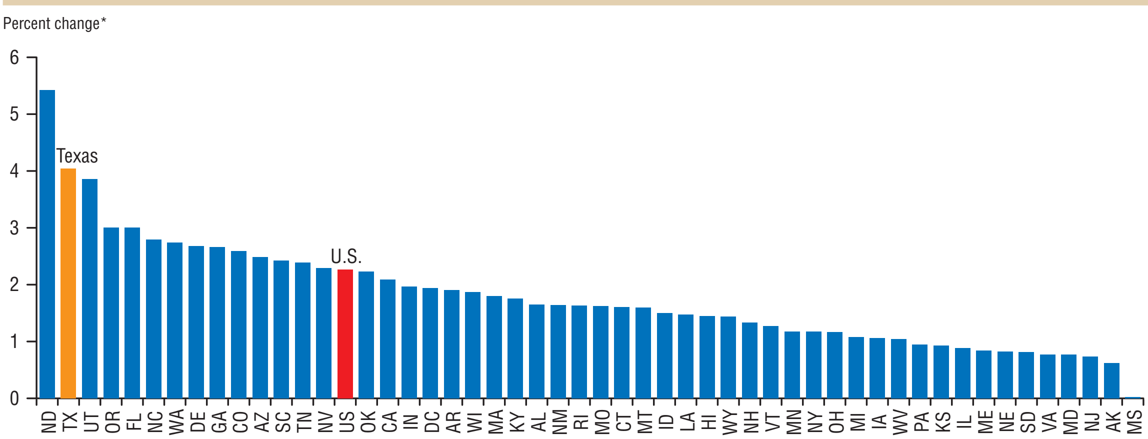
Texas ranked second in job growth in 2014, behind only North Dakota, according to Current Employment Statistics data released by the Bureau of Labor Statistics (*Chart 1*). While oil and gas-producing states led the U.S. in the early years of the recovery, the rankings of these states in recent years have become more dispersed, with Oklahoma and Louisiana falling below the national average. Meanwhile, Sunbelt states hard hit by the housing crisis—such as Florida, Arizona and Nevada—have rebounded and are above the national average.

The Texas unemployment rate fell sharply last year, to 4.6 percent in December 2014 from 5.6 percent a year earlier. The decline occurred despite steady increases in the labor force, which grew 1.3 percent. The unemployment rate at year-end was the lowest since May 2008 and well below the long-term average of 6.1 percent.

Industry contacts noted that labor market tightness grew throughout the year, with firms encountering difficulty finding qualified workers in a broad range of industries and sectors. In the Federal Reserve Bank of Dallas' November 2014 Texas Business Outlook Survey (TBOS), 77.1 percent of manufacturing respondents and 71.9 percent of service sector respondents reported difficulty finding qualified workers.

While many sectors of the Texas

Chart 1 Texas Posts Second-Fastest Job Growth in U.S. in 2014



*December over December, adjusted for seasonality and comparison purposes.
SOURCE: Bureau of Labor Statistics.

economy remain strong, headwinds will likely damp growth in 2015. The energy sector has begun losing significant numbers of jobs following the recent sharp decline in oil prices. This will, over time, ripple through other sectors of the economy, such as truck, pipeline and rail transportation; warehousing; equipment manufacturing; hospitality; construction; and retail.

Although layoffs in the oil and gas sector may ease labor market tightness this year, the skills of oil and gas workers will not match those demanded by such industries as health care. Additionally, laid-off oil patch workers will need time to find jobs and relocate to areas where labor is in short supply. Thus, labor market tightness will likely dissipate somewhat this year, although in many occupations and regions, it will continue restraining job growth. Finally, the recent strength of the Texas value of the dollar is putting downward pressure on Texas exports.

Texas Growth Strong in 2014

Texas growth was on the higher end of the Dallas Fed's 2.5 to 3.5 percent interval forecast for 2014, published a year ago. While a pickup in activity was anticipated, mining and construction jobs in particular accelerated faster than expected. Employment growth was faster than the national average for the 11th consecutive year. Since attaining its prerecession employment peak in late 2011, Texas has added 1.1 million jobs, a 10.2 percent expansion (*Chart 2*). By comparison, the U.S. matched its prerecession employment peak in April 2014; at yearend, the nation was just 1.6 percent (2.3 million jobs) above the previous high.

Job growth increased in most Texas industries in 2014 (*Chart 3*). Oil and gas employment, driven by gains in energy prices through midyear, picked up the most and grew 10 percent last year from 5.4 percent in 2013. Due to gains in both residential and nonresidential building activity, construction employment accelerated from 4.5 percent in 2013 to 7.7 percent last year.

Professional and business services added the largest number of net new jobs, accounting for one-fifth of the total 389,000 jobs gained in 2014. This came in large part from a strong increase at employment agencies, which expanded 6.2 percent. Other notable areas of activity included accounting services and computer systems design.

Job growth in the government sector picked up slightly to 1.2 percent last year. Sector expansion has been light over the past several years compared with the historical average as budget cuts led to cutbacks first at the state and local level and then at the federal level. With less federal fiscal uncertainty in 2014, federal government employment in Texas fell 0.4 percent, compared with a 2.8 percent decline in 2013. Growth among state and local governments remained steady at 1.3 percent in 2014, still well above 0.4 percent nationally.

Fiscal stability also affected private industries that rely on government funding. This was particularly true in private education and in health services, which increased nearly a percentage point to 3.1 percent after several years of lagging activity.

Construction Surge

Construction accelerated significantly in 2014 after moderating in the prior year. Growth was broad based, with healthy expansion in nonresidential and residential construction. Multiple billion-dollar manufacturing plant projects, such as a new Dow Chemical facility in Freeport, Texas, broke ground in the second half of the year, pushing nonresidential contract values to record highs.[1]

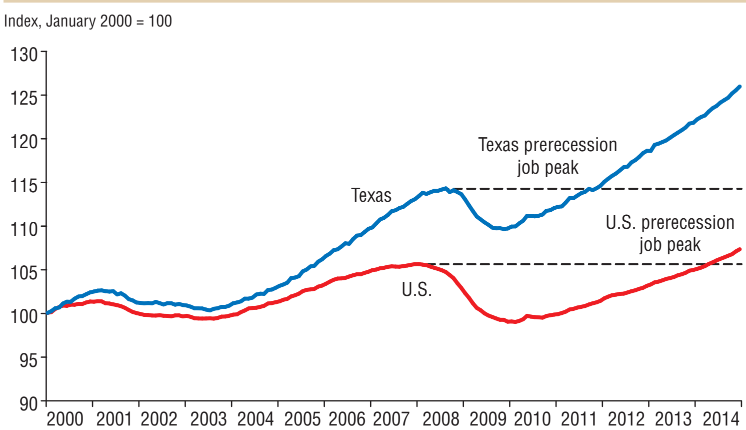
Meanwhile, residential housing construction picked up steadily through the year, with average monthly contract values up 13.4 percent, slightly less robust than the very strong 14.1 percent growth in 2013. Multifamily construction increased 23.6 percent, while single-family home construction rose 11.7 percent. Still, low lot supply, tight lending for land development and higher input costs constrained single-family activity.[2]

The 2015 outlook for construction generally remains positive, although falling energy prices add an element of uncertainty. Continued low mortgage rates and record low existing-home inventories of 3.4 months—well below the standard 6 months considered healthy—means that new building is needed to meet demand. Similarly, a low average office vacancy rate of 14.3 percent across the five largest Texas metros indicates that new construction is likely in areas that are tight on space and won't be hit hard by the weaker energy sector.

Overall construction will moderate in metros such as Houston, where jobs have grown strongly the past several years due to direct and indirect effects of oil and gas industry expansion. The effect will be greater in areas even more heavily dependent on the energy sector, such as Midland–Odessa.

Nevertheless, help-wanted advertising across the state for construction

Chart 2 Texas Jobs Continue to Grow Beyond 2008 Peak



SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

and maintenance workers was up 10.6 percent in the fourth quarter, and as of February, was at all-time highs. A need to ease tight home and office space inventories should buffer the impact of the energy sector declines. In areas less affected by the loss of energy jobs, the inflow of workers from that sector may help the construction sector expand at a faster pace.[3]

Health Care Bounce-Back

Employment in health care and social assistance picked up sharply in 2014 and looks ready to continue growing rapidly in 2015. Sector employment grew at a 2.1 percent annualized rate in first quarter 2014, a weak pace that typified the sector over the past several years and was well below the long-term average of 3.5 percent. However, jobs picked up sharply, particularly at physicians' offices, home health care agencies and hospitals, in the last nine months of 2014.

In second quarter 2014, Medicaid enrollments in Texas began climbing rapidly and grew 13.4 percent last year. This rise, along with the rollout of the Affordable Care Act, likely contributed to a significant increase in demand for health services even though Texas opted out of the federal government's proposed expansion of Medicaid eligibility.

One notable area of growth the past year has been in home health care. This field faced significant weakening in 2013 due to cutbacks in government funding, which were particularly felt in Texas metros along the Mexico border, where up to 10 percent of all employment is in home health care. More stable government spending in 2014 and a higher percentage of people with insurance drove demand for home health aides and enabled employment in the field to bounce back.

Manufacturing activity picked up substantially in 2014 after an anemic 2013. The Dallas Fed's manufacturing barometer, the Texas Manufacturing Outlook Survey (TMOS), indicated robust manufacturing output growth. The TMOS production and volume of new orders indexes reached their highest annual levels since 2006, indicative of a strong pickup in activity relative to the past several years.

Manufacturing employment was predominantly driven by the strength of chemical and construction-related industries (*Chart 4*). Jobs in construction-related manufacturing (wood products, cement and concrete products, architectural and structural metals, and furniture) and chemical production grew more than three times faster than the rest of the manufacturing sector in 2014.

Manufacturing prospects in 2015 look less positive. The business outlook of companies participating in TMOS turned sharply downward the first two months of 2015, dipping into negative territory for the first time since May 2013. Production and new orders data also declined, suggesting that manufacturing output may decelerate in coming months.

There are several reasons for this softening outlook. The oil price decline will likely lead to a significant reduction in demand for oil and gas equipment. Also, the recent rise in the value of the dollar has increased the cost of Texas exports (*Chart 5*). Recent appreciation in the Texas trade-weighted value of the dollar is likely behind some of the 12.8 percent decline in the state's exports from last August through January. Energy price declines—particularly in gasoline and diesel fuel—have also contributed to the falling value of Texas exports.

Energy Sector Boom and Bust

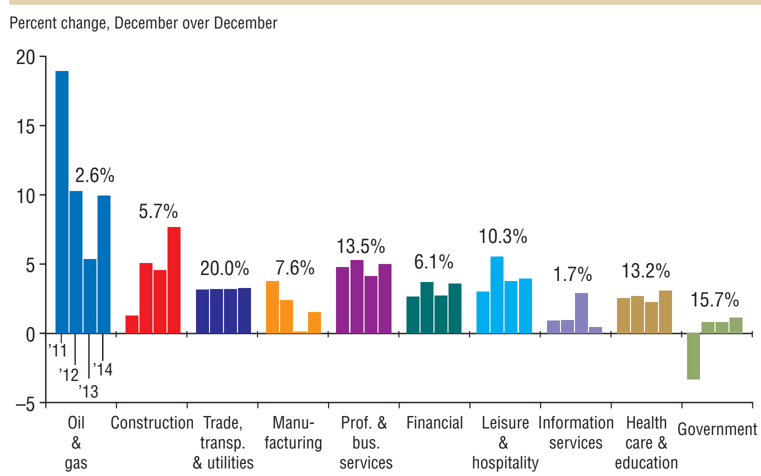
The energy industry accelerated in 2014, thanks in large part to continued expansion in shale drilling. Employment grew 10 percent, and the annual average rig count expanded 5.6 percent. However, weaknesses in this industry will ripple throughout the economy in 2015. (*See "Lower Oil Prices Weaken Prospects for Job, Economic Growth in Texas," p. 10.*)

Over the past several years, the average price of West Texas Intermediate (WTI) crude oil has been relatively stable at around \$95 per barrel. The high prices and success of hydraulic fracturing exploration spurred a flurry of drilling that has expanded state oil production more than 50 percent since year-end 2012.

However, after peaking at \$107 per barrel in June 2014, WTI fell below \$50 in January (*Chart 6*). The initial decline—from the peak to \$80 at the end of October—likely positively influenced the regional economy. Because the break-even point for most oil drilling in the state is below \$80, mining activity changed very little while consumer spending picked up, reflecting households' lower cost of energy.

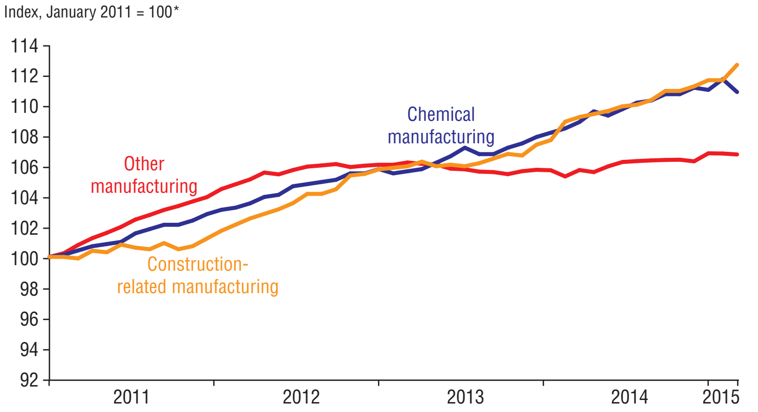
The further decline to between \$45 and \$50 is likely to more greatly affect the oil and gas sector. The rig count is off 41 percent, from a high of 906 in late November to 538 at the beginning of March. Further reductions are expected.

Chart 3 Most Texas Industries Advance in 2014
(Annual job growth by year, 2011–14)



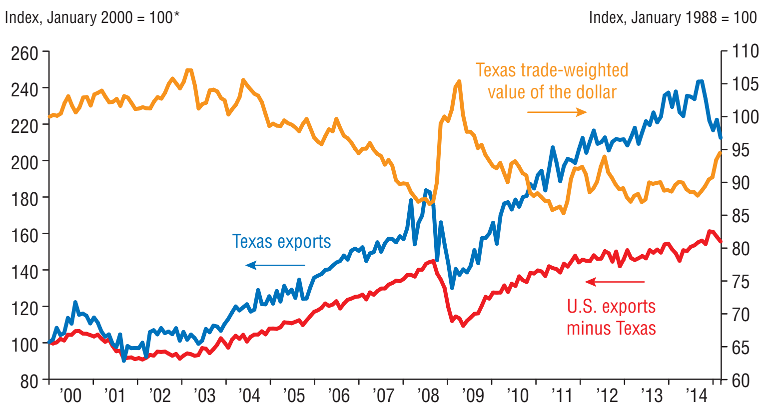
NOTES: Figures above bars represent each industry's share of total nonfarm employment in December 2014. The financial category includes financial services, insurance and real estate.
SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

Chart 4
Chemical, Construction Manufacturing Jobs Surge in 2014



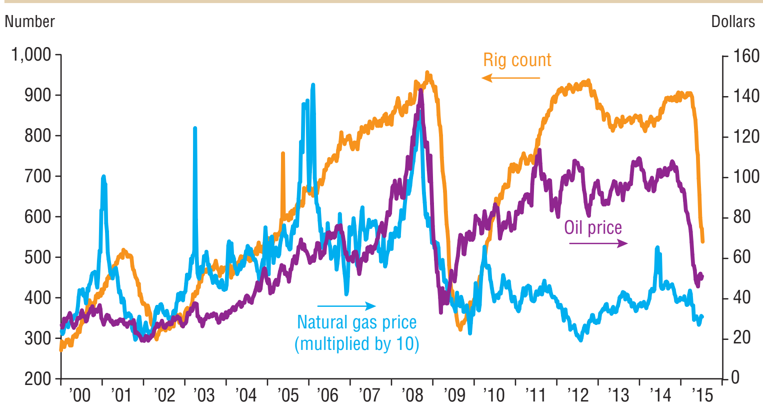
* Seasonally adjusted.
SOURCE: Bureau of Labor Statistics.

Chart 5
Texas Exports Decline Sharply Since August 2014



*Seasonally adjusted; real.
SOURCES: Census Bureau; WISERTrade; Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

Chart 6
Rig Count, Oil Prices Begin Plunge in Last Half of 2014



SOURCES: *Oil and Gas Journal*; Baker Hughes; *Wall Street Journal*.

Large oilfield service companies such as Schlumberger, Halliburton and Baker Hughes recently announced they will lay off thousands of workers over the next several quarters. Layoffs began appearing in January oil and gas employment data, which fell an annualized 5 percent. Natural gas prices, which have been low the past several years, have also recently fallen, further damping drilling activity.

To better understand the effects of this sharp price decline on Texas in 2015, it helps to look at past oil price shocks and job growth in the state relative to the nation (*Chart 7*). By examining Texas' relative job growth (the difference between state and national rates of growth), we factor out broader macro influences that may be affecting both economies, such as interest rates and national consumer spending.

For example, in the late 1990s, a high-tech boom positively influenced growth in Texas and the U.S. When oil prices declined to very low levels in late 1998 and early 1999, Texas job growth fell below that of the nation (although it remained positive). In general, the chart shows a strong relationship between the inflation-adjusted price of oil and the relative growth in Texas jobs, suggesting that Texas employment growth may slip below the national average this year.

Job Growth Likely to Slow

The Texas Leading Index declined sharply in the three months ended in January, a sign of impending weakening in the state's economy. The index incorporates changes in key indicators that have historically led movements in Texas job growth (*Chart 8*). Among them, oil prices, well permits and the Texas value of the dollar had a large negative influence on the change in the index.

In this three-month period, the real (inflation-adjusted) price of WTI crude oil and permits issued to drill oil and gas wells each plunged by more than 50 percent. These are strong indicators that the recent slowdown in drilling activity will continue for the foreseeable future.

The rise in the Texas value of the dollar also was a weakness over this period, making Texas exports to the rest of the world more expensive. This may be pressuring Texas manufacturers, which, as previously noted, have experienced sharp reductions in new orders since October and more recently lowered their outlooks. The negative contributions from broader economic indicators, such as initial claims for unemployment insurance and average weekly hours worked, were more modest.

Other leading indicators have been modestly positive. Lower energy prices are a stimulus for the nation, where energy consumption far outweighs energy production. The price decline is likely an important factor behind the recent rise in the U.S. leading index. A pickup in the national economy increases the demand for goods and services made in Texas.

Despite a decline in the stock prices of energy companies, overall share prices have risen for Texas-based firms—pointing to continued sales and profit growth in the months ahead. And finally, online and print help-wanted advertising increased over the period, suggesting continued demand for workers.

Mixed Outlook for 2015

The Texas economy picked up last year after a more moderate performance in 2013. Broad-based expansion across all major industries, led by energy, construction, business services and health care, pushed Texas job growth to the second-fastest in the nation.

2015 looks to be a year of mixed growth. Low oil prices, though bad for Texas energy producers, benefit consumers in the form of lower gasoline and other prices that free up real disposable income and increase real spending. The U.S. economy is likely to benefit on net, fueling further demand for Texas goods and services. Health care appears poised for further growth as more people become insured. Housing demand remains strong across much of the state, suggesting that construction will continue to grow at a pace similar to that in 2014.

However, low oil prices and a high value of the dollar are risk factors. Energy sector companies will continue experiencing sharp cutbacks in capital expenditures and jobs, with ripple effects across the rest of the economy. International exports likely will continue falling with a strong dollar, putting pressure on manufacturing activity.

Recent declines in the Texas Leading Index suggest slowing growth. This is consistent with weakening projections reported in the Dallas Fed's Texas Business Outlook Surveys. A forecasting model that uses past changes in job growth and the leading index finds that Texas job growth will be 1 to 2 percent—an increase of 117,000 to 235,000 jobs—between December 2014 and December 2015. Last year, job growth nationally was 2.3 percent. If the national figure remains constant or picks up slightly in 2015, there is a good chance that Texas will trail the nation in job growth for the first time in 12 years.

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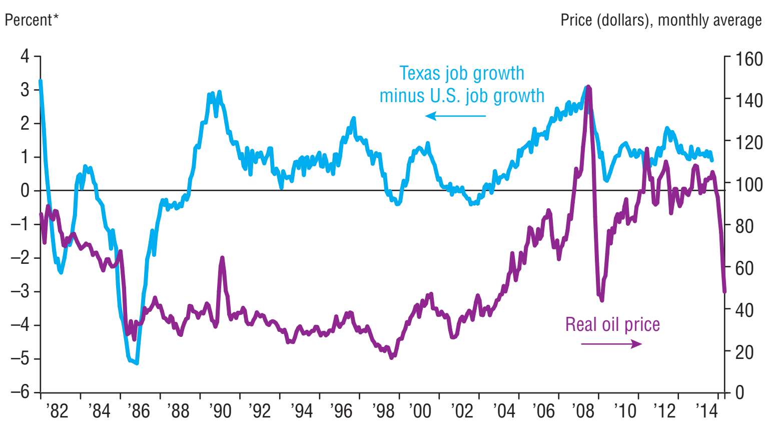
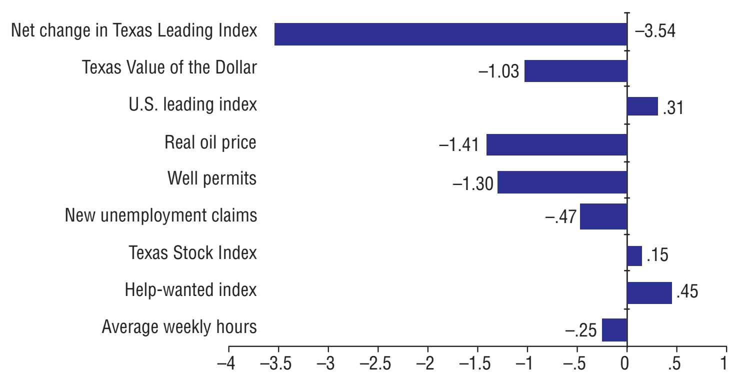
Chart 7 Texas Job Growth Slows Relative to U.S. as Oil Prices Slump



*Difference in Texas and U.S. job growth; 12-month centered moving average.
SOURCES: *Wall Street Journal*; Bureau of Labor Statistics.

Chart 8 Texas Leading Index Components Point to Slowing Growth
(Weighted contribution of components to index change, November 2014–January 2015)



SOURCE: Federal Reserve Bank of Dallas.

Notes

[1] The value of construction contracts, measured by F.W. Dodge, is a measure of the value of construction contracts that are awarded and expected to start within 60 days. Data include new construction, additions and major alterations and exclude repairs and maintenance.

[2] For more information, see "Single-Family Housing Squeeze Eases in Texas; Multifamily Soars," Federal Reserve Bank of Dallas *Southwest Economy*, Fourth Quarter, 2014.

[3] See "Laid Off from Oil Field? Contractors Want You; Construction Industry in Texas Is in Hiring Mode," by David Hendricks, *San Antonio Express News*, Jan. 24, 2015.