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Economics Group

Special Commentary

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Texas Economic Outlook: December 2018

Texas Will Remain Central to National Economic Growth in 2019

Texas will continue to play a central role in the U.S. economy.

The Texas economy continues to play a central role in the national economic expansion that is now approaching a record 10 years. Nationally, real GDP growth has remained robust and will likely end the year at around 2.9%. We anticipate some moderation in 2019. Growth will remain solid, however, and Texas will continue to benefit from many of the same factors expected to drive national economic growth next year.

Nationally, capital investment in the energy and tech sectors continues to drive overall business investment, and Texas stands to benefit more than virtually any other state given the outsized proportion of these businesses located in the state. This past year will likely be remembered as the year the United States became a net exporter of oil, primarily as a result of surging production in West Texas. This trend will continue in 2019 despite recent commodity price headwinds. Moreover, as tech investment continues to disperse beyond Silicon Valley, Texas will continue to cement its status as one of the world's largest and fastest growing tech hubs.

Strong consumer spending, underpinned by a sturdy labor market and rising wages, has spurred the need for robust supply chains and transportation linkages. The state's central geography will remain a key advantage and continue to attract major transportation and logistics operators looking to reach wide swathes of the nation's consumer base. Additionally, while trade uncertainty was a substantial headwind for most of the year, preliminary agreements with Mexico and Canada will potentially unleash investment in export-related industries and regions of the state. Furthermore, the bi-partisan budget agreement should benefit the state's many military installations, and defense contractors should also reap the positive benefits of increased defense spending.

Figure 1

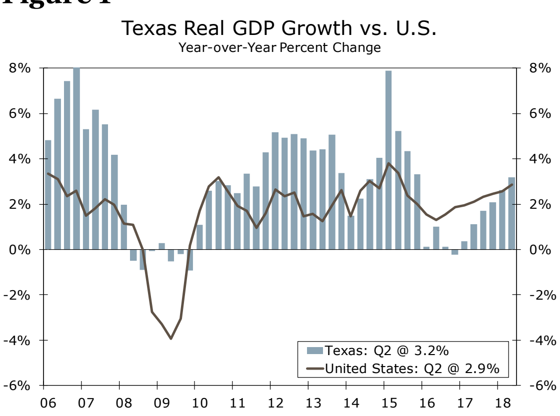
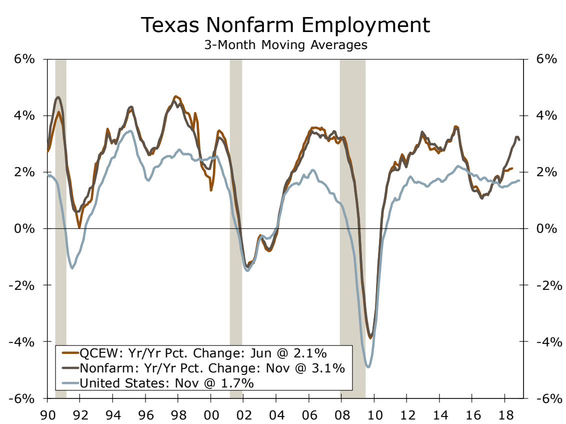


Figure 2



Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.

The Texas Economy Is Poised for Growth

The Texas economy continues to build momentum following a brief pause resulting from the mid-decade slide in oil prices. Real GDP grew 3.2% on a year-over-year basis in the second quarter and has steadily accelerated in each of the past six quarters. Moreover, at 6.1%, the state registered the fastest annualized quarterly pace of real GDP growth in the nation. This is not an aberration. Between 2010 and 2017, Texas ranked as the 4th fastest growing state in the country in terms of real GDP growth, even while registering essentially no growth in 2015. The ability of the state's economy to continue to expand is especially impressive given the sheer magnitude of the Texas economy. Texas has the second-largest economy in the nation and recently surpassed Canada to become the 10th largest economy in the world.

Despite lower oil prices, the energy industry will continue to be a source of strength.

The energy industry has been a major source of strength for much of the year, a trend that will continue over the next several years despite recent oil price volatility. Production has leaped well ahead of existing capacity. Pipeline congestion in the booming Permian Region has led to substantial discounting, which has led to some scaling back of exploration and production. Several pipeline projects are currently underway, however, and many are expected to come into service in 2019 and 2020. This should provide operators some near-term relief and allow wells to be competed. The existing pipeline of midstream and downstream projects will likely continue to move forward, even though oil prices have fallen sharply. Fewer new projects, however, are likely to be started.

Slowing global economic growth has also applied downward pressure on other commodity prices. Advances in technologies and innovations used for drilling, however, have allowed domestic producers to become much more efficient, and many are boosting output much faster than they are adding employees. The increased efficiency should help Texas better endure future price swings. The United States' growing status as an energy exporter has also created a more balanced global market, with U.S. shale producers assuming the role of swing producer from Saudi Arabia, which will likely limit the dramatic price swings seen earlier in the decade. The development of energy infrastructure along the Gulf Coast should also help minimize productions swings, although the industry is always likely to be subject to pressures from the global economy.

Nonfarm employment in Texas has strengthened considerably over the past year, thanks to firmer oil prices earlier this year, an expanding transportation and logistics sector and a booming tech industry. Payrolls have now increased 2.9% year-over-year, which equates to 365,400 net new jobs over the past 12 months, more than any other state. Employers expanded their payrolls by just 14,000 jobs in November, the smallest gain of the year. However, the state has added close to an average of 32,000 jobs per month, well ahead of the average in 2017. In contrast to last year, employment growth through has also been extraordinarily consistent so far this year, with little month-to-month volatility.

Figure 3

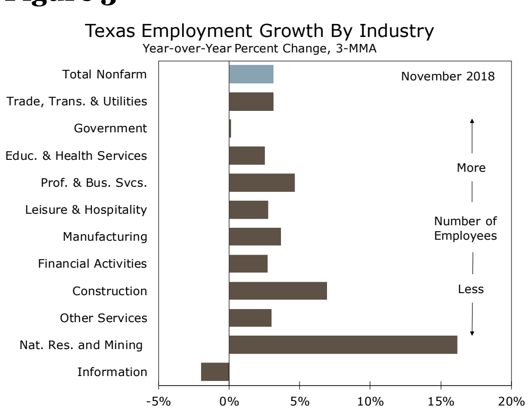
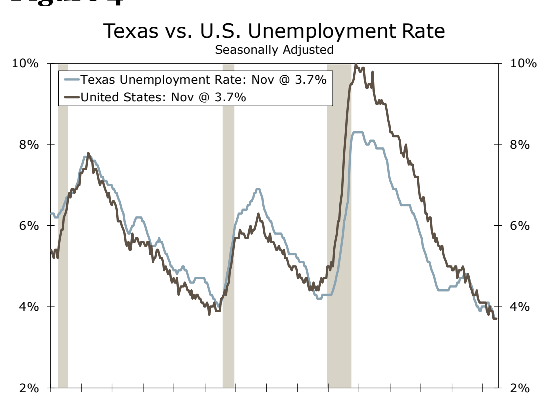


Figure 4



Source: U.S. Department of Labor and Wells Fargo Securities

While employment growth in Texas remains solid, the initial monthly estimates may be slightly overstating employment growth. The Quarterly Census of Employment and Wage (QCEW), a more complete account of payrolls that lags the monthly survey data by six months, shows year-over-year employment growth was 0.7 percentage points slower through June, equating to 85,774 fewer net new jobs being created than originally reported. Houston and Dallas saw slower employment growth than the initial estimates showed. Several sectors, which are notoriously difficult to fully capture in the monthly surveys, may still be suffering from post-hurricane volatility, which may explain the large downward adjustment. Hiring within the construction industry and at hotels, bars and restaurants and retailers was shown to be somewhat weaker. On the bright side, job growth appears to have been somewhat stronger in San Antonio, Fort Worth and McAllen. The Midland and Odessa MSAs, which are closely tied to the booming Permian Basin, have seen employment surge even faster than had been initially reported. Job growth in the tech industry has also been stronger than initial estimates.

Employment growth in the Lone Star State will remain solid in 2019.

Given the incredibly strong and broad-based nature of recent employment gains, we expect the strong pace of hiring to continue into next year, although some moderation is likely given the slightly slower pace of hiring registered in the QCEW and overall slower national growth. Employers will also continue to have a difficult time finding qualified workers. After drifting higher following the 2015 oil bust, the unemployment rate recently hit a new series-low of 3.7% and Dallas, Austin and San Antonio all boast even lower unemployment rates. A scarcity of skilled workers is especially acute in the oil-producing region of Midland where the unemployment rate is among the lowest in the country, at just 2.1%. The unemployment rate has remained low despite an expanding labor force, which has kept pace with robust household employment growth seen throughout the state.

Figure 5

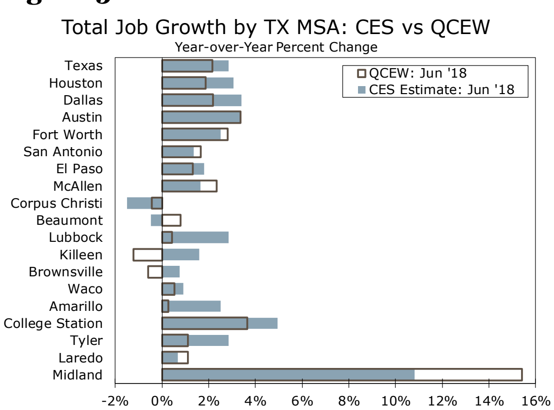
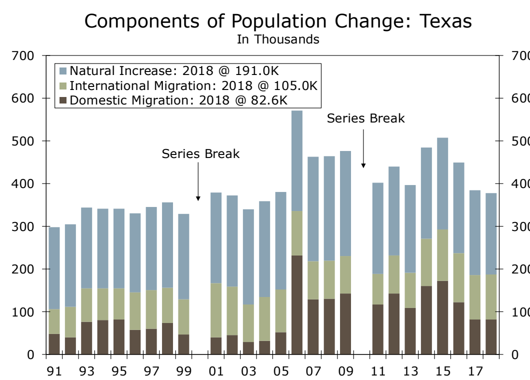


Figure 6



Source: U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Securities

Affordability is the primary driver behind the influx of businesses and residents to the state.

The Texas population grew 1.3% in 2018, a pace slightly slower than 2017. Even at that 'slower' pace, however, population growth was more than double the rate seen in the rest of the country and the 379,128 residents added this past year was easily the largest absolute increase of any state. The modest slowdown was a result of overall fewer births and more deaths. The number of state-to-state movers remained subdued by historical standards, adding roughly 82,600 in 2018. That gain marks a substantial slowing from recent years. Net migration from other states totaled roughly 122,000 persons in 2016 but has slowed considerably this past two years and is currently running at the slowest pace since 2005. The recent slowing reflects a slow-down in general of state-to-state migration, as economic conditions have improved in other parts of the country and many homeowners are reluctant to give up their current low mortgage rates. The slowdown also likely reflects some residual effects from the energy downturn, as Houston, Midland and Odessa all saw net declines in 2017, which is the latest data available at the MSA level. Dallas, Austin, and San Antonio, the state's major job centers, saw much less of a drop-off. The state also saw an uptick in international migration in 2018. Tighter immigration controls, however, will likely lead to a pullback from increases in the foreign born population in coming years. That being said, we expect overall population growth to strengthen in coming years as demographics in Texas tend to skew younger, which generally translates to more births and fewer deaths. Domestic migration will also likely pick back up as the differential between growth in Texas and the rest of the country widens again.

Affordability is central to Texas' growth prospects and continues to fuel the rapid in-migration from more expensive areas such as California and New York. The median home price in the state remains considerably lower than the rest of the country. Relatively low land costs and an entitlement process that works more closely with builders and developers help keep supply and demand more in line than in many other parts of the country and keep home prices within reach of a wider proportion of the population. More recently, prices statewide have begun to ease alongside higher mortgage rates and slower sales. Dallas home value appreciation has moderated from a 6.9% yearly pace in January to 5.7% in September. Houston and Austin have seen prices moderate as well.

A slight downshift in price appreciation may be a blessing in disguise as home prices in many of the state's booming metros have seen significant appreciation over the past several years, despite robust gains in residential construction. Dallas and Houston remain the nation's top markets for single-family homebuilding, together accounting for roughly 9% of all single-family building permits. Compared to the torrent seen this past year, Dallas has seen considerable moderation. Residential construction in Houston continues to gain momentum, however, following the aftershocks of Hurricane Harvey and the 2015 oil rout. Throughout Texas, apartment development has lost some steam relative to the early part of the cycle but remains at relatively healthy levels in many markets, notably in Austin. Austin's burgeoning tech sector has boosted job and population growth and pushed apartment vacancies to the lowest level since 2015, which has reignited rent increases despite an incredible amount of new supply delivered over the past five years. Apple's recent announcement of a $1 billion investment in a new campus in Austin will bring 5,000 new jobs and provide a further boost to housing demand.

Figure 7

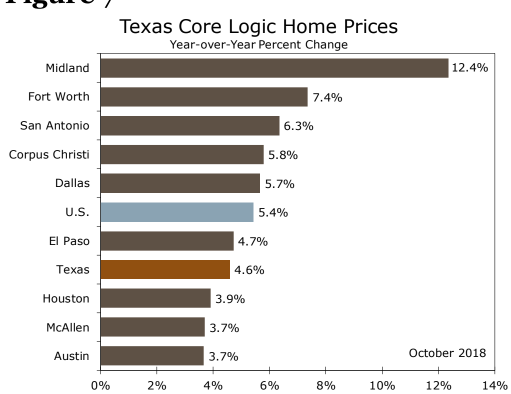
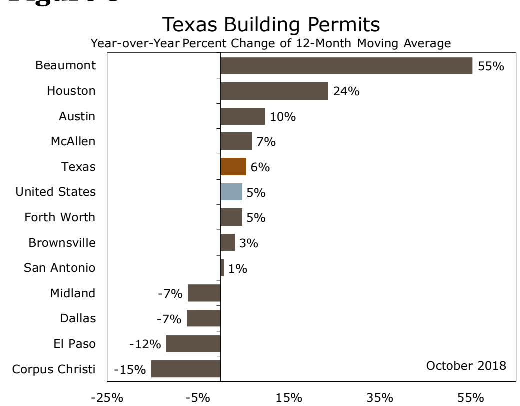


Figure 8



Source: CoreLogic, Inc., U.S. Department of Commerce and Wells Fargo Securities

Employment and population growth are running well ahead of the rest of the nation and giving Texas strong momentum going into 2019.

Commercial real estate in Texas stands to benefit from the same factors driving overall economic growth. Employment growth will likely moderate somewhat next year, which will be a headwind for office demand. On the other hand, Texas will continue to attract scores of new businesses looking to benefit from lower costs for its employees and a friendly regulatory environment, which should continue to provide a boost to the office markets throughout the state. The need for efficient supply chains, facilitated by modern warehouses and distribution centers, will remain a top priority for retailers. Texas stands to greatly benefit from this long running shift, given the state's central geography and status as a logistics hub. International trade will also continue to be a major driver of industrial properties. The preliminary agreement with Mexico and Canada left most of the legacy NAFTA agreement intact and should unleash investment in areas with significant cross-border processing hubs and transportation linkages such as El Paso and McAllen.

Tax reform will likely also be a boon to commercial real estate in Texas. Newly established "opportunity zones" provide preferential tax treatment to investments in distressed communities. Texas has designated 628 census tracts as opportunity zones, roughly 23% of which are located within the Houston metro area. Dallas, Austin and San Antonio also contain a large number of these census tracts, but the vast majority of Texas opportunity zones can be found outside of the major metros in more rural areas which have seen little commercial development during the current cycle. The net effect of this new provision will likely be to draw significantly more capital into the Texas commercial real estate industry in 2019, which will significantly boost commercial development and boost property valuations.

Summary & Outlook

Texas has strong momentum heading into 2019. Employment growth has been resilient and payrolls are expanding at a pace well ahead of the rest of the nation. Job gains have also been extraordinarily broad based. The state is home to Dallas, Houston and Austin, three of the fastest growing metros in the country. Moreover, every major industry and every region has contributed to growth. We look for employment growth to moderate slightly in 2019 off the robust pace seen so far this year.

Booming oil production in West Texas is behind much of the success Texas has seen this year. The energy sector also represents the greatest risk going into 2019. Amid capacity constraints and lower global economic growth, oil prices have fallen hard recently, which diminished the prospect of Texas repeating the stellar growth seen this past year. Texas weathered the last oil-related downturn unusually well and the rebound in output seen the past few years did not generate anywhere near as many jobs as the boom in the early part of the decade did. As a result, any decline in exploration and production will likely produce fewer ripples in the labor market.

The headwind of lower oil prices will likely be outweighed by stronger tailwinds outside of the energy sector. The transportation and logistics sector is a key asset to the state economy and will continue to be bolstered by strong consumer spending and rapid ecommerce inspired supply chain expansions. The renegotiated NAFTA agreement should also propel local industrial markets. We expect real GDP to grow 3.3% for the year in 2018, and strengthen further to a 3.6% rate in 2019.

Affordability is one of the state's top advantages. Texas remains a magnet for companies fleeing other high-cost parts of the country, and the tide of relocations keeps on coming. Homebuilding has lost a bit of its momentum, as affordability challenges have reached parts of Texas. On an overall basis, however, Texas is still one of the nation's largest markets for new single-family construction. Home sales and prices have moderated recently, but some additional slowdown is expected in 2019 given higher mortgage rates. Even with a few more challenges, Texas will continue to rank among the nation's fastest growing economies in 2019, and population, employment and income growth should all easily outpace the nation.

Texas Economic Outlook

	Actual						Forecast		
	2012	2013	2014	2015	2016	2017	2018	2019	2020
Real Gross Domestic Product by State, $ Millions	1,411,379	1,472,104	1,512,351	1,590,409	1,594,408	1,615,555	1,669,605	1,729,127	1,784,671
Annual Rate	5.0%	4.3%	2.7%	5.2%	0.3%	1.3%	3.3%	3.6%	3.2%
Nominal Personal Income, $ Millions	1,133,801	1,160,362	1,250,850	1,282,380	1,287,687	1,340,568	1,409,273	1,478,826	1,549,002
Nominal Personal Income, Percent Change	7.2%	2.3%	7.8%	2.5%	0.4%	4.1%	5.1%	4.9%	4.7%
Real Median Household Income, $	55,542	54,183	55,839	58,432	59,396	59,295	61,580	63,551	65,330
Population, Thousands	26,090	26,489	26,977	27,487	27,937	28,323	28,702	29,158	29,648
Change in thousands	443	400	488	510	451	385	379	456	490
Percent Change	1.7%	1.5%	1.8%	1.9%	1.6%	1.4%	1.4%	1.6%	1.7%
Nonfarm Employment, Thousands	10,914	11,241	11,594	11,866	12,012	12,225	12,549	12,843	13,108
Change in thousands	310	327	353	272	146	213	323.1	294.3	265.3
Percent Change	2.9%	3.0%	3.1%	2.3%	1.2%	1.8%	2.6%	2.3%	2.1%
Unemployment Rate, Annual Average	6.7%	6.3%	5.1%	4.4%	4.6%	4.3%	3.9%	3.7%	3.6%
Total Housing Permits	133,297	146,372	166,054	173,990	162,323	169,885	180,922	190,289	196,221
Single-Family Permits	78,809	89,872	98,736	104,096	106,101	114,094	123,841	132,318	139,612
Multi-Family Permits	54,488	56,500	67,318	69,894	56,222	55,791	57,081	57,971	56,609
FHFA Home Price Index, Percent Change	1.5%	4.5%	7.2%	7.4%	7.6%	8.0%	7.6%	7.1%	6.5%

Sources: National Association of Realtors, Federal Housing Finance Authority, U.S. Department of Commerce, U.S. Department of Labor, Moody's Analytics & Wells Fargo Securities
Forecast as of: December 21, 2018

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