Regional Analysis

Recession Looming for Texas Economy

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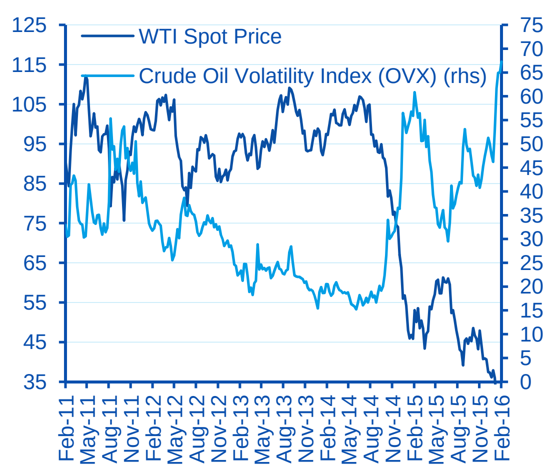
- **Further declines in oil prices and manufacturing weakness push Texas into recession**
- **Global headwinds and dollar strength limit upside in 2016**
- **New oil price paradigm implies "U-shaped" recovery for Texas**

After teetering on the brink of recession for the past six quarters, it appears that the drop in oil prices that began at the outset of 2016 is now supporting a forecast of recession for Texas in 1H16. In fact, in our previous assessment, we highlighted that Texas would be at risk of recession if WTI spot prices trended below $30 /bbl and if there continued to be pressures on the manufacturing sector and exports from a strong dollar.[1] Now, as we edge closer to the end of 1Q16, oil prices have fallen an additional 44%, while the dollar has continued to appreciate to its highest level in 11 years in real terms. Moreover, a resilient U.S. economy is unlikely to materialize and help offset deteriorating investment, weak employment growth, tightening credit conditions, rising interest rates and risk premiums, and mounting uncertainty.

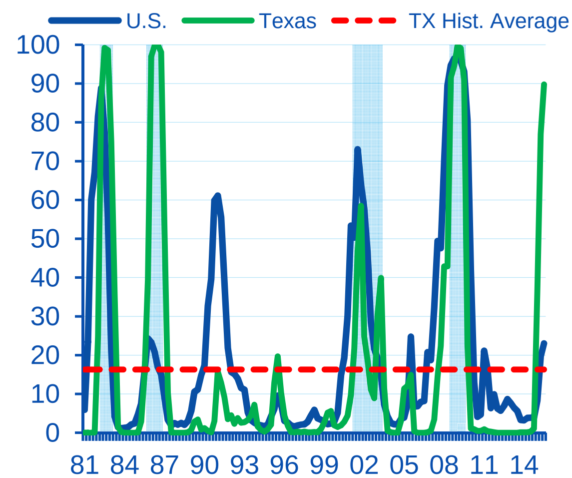
Taken together, these factors suggest that the probability of a Texas recession is 90%. Moreover, based on the trend in the probability of recession, it is likely that Texas is currently entering a recessionary environment. As a result, our baseline scenario is for Texas to be in recession in 2016, with the economy contracting 0.3%. In addition, given our expectation for a more languid recovery in oil prices, Texas will likely follow a "U-shaped" recovery path, failing to recover to potential by 2019.

Chart 1
WTI Spot Prices and OVX ($/bbl, Index)



Source: BBVA Research & Haver Analytics

Chart 2
Texas Recession Probability (%) [2]



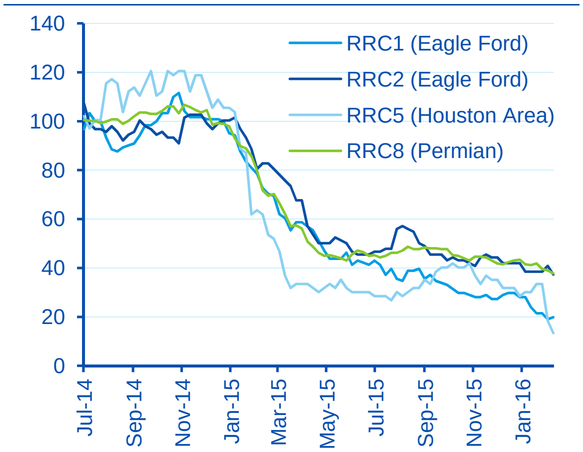
Source: BBVA Research

1 https://www.bbvaresearch.com/wp-content/uploads/2015/12/151204_US_TexasWatch.pdf

2 Results are based on a state-level Probit. Recessions are defined as two consecutive quarters of negative employment growth. Explanatory factors include U.S. risk of recession, state business bankruptcies, state-level output gap, unemployment insurance claims and oil prices.

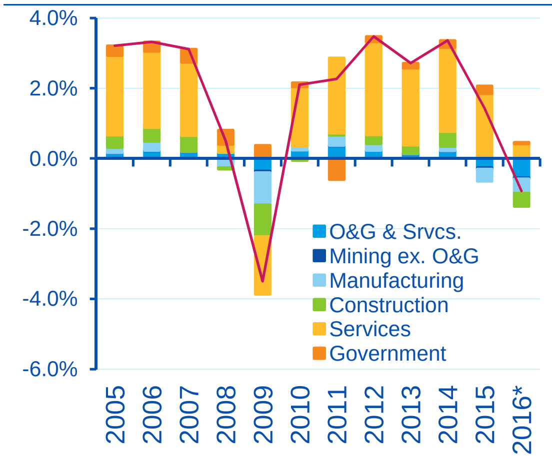
To date, there have been few surprises in terms of correction in the mining sector. In total, 35K jobs have been lost, which is about a third of the losses projected throughout this commodity cycle. Similarly, rig counts, which serve as a rough proxy for oil & gas (O&G) sector activity, have declined by 62% and 63%, respectively, in the Texas districts that cover the Eagle Ford and Permian Basins. Reduced activity and investment have led to rising unemployment insurance claims and unemployment rate albeit at a much slower pace that originally projected. The lagging response to prices and activity is likely a function of outflows from the labor force and delays in production cuts that were targeted at maintaining operations in the face of tightening credit conditions. However, short-term measures, taken to survive what was once thought to be a short price-cycle, will be insufficient and costly, as prices are now expected to trend around $30/bbl throughout 2016, with a slow recovery to $60/bbl by 2019.[3]

Chart 3
Texas Rail Road District Active Rig Counts (Index: July-2014=100)



Source: BBVA Research & Haver Analytics

Chart 4
Texas Employment Growth (%, % contribution)



Source: BBVA Research

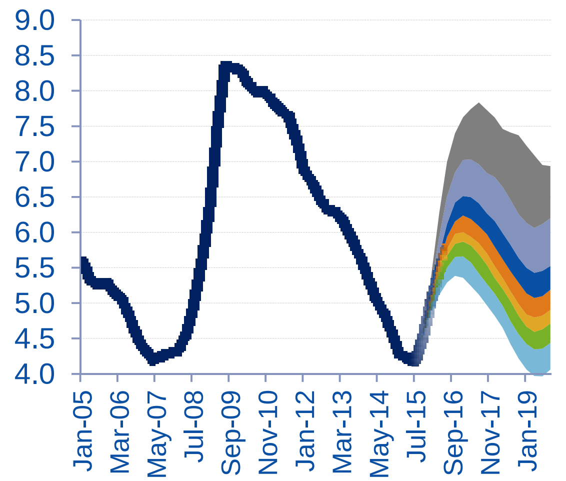
Despite the fact that hydraulic fracturing is more labor-dependent than conventional exploration activity, it continues to rely heavily on manufactured capital goods. As a result, reduced drilling activity likely explains ~30% of the declines in the manufacturing sector (-4.4%). In addition, in our baseline the dollar continues to appreciate throughout 2016, suggesting that the non-oil impact on the manufacturing sector will continue to weigh on employment and growth. In fact, we now expect there to be an additional 4.2% correction in manufacturing sector employment due to effects of weaker demand from major trading partners and the strength of the dollar. In value-added terms, the impact will be larger. In terms of second-round effects from the O&G sector, our baseline now assumes an additional 1.6% decline in employment in manufacturing employment. Together these shocks explain nearly as much of the decline in 2016 activity as the slowdown in O&G sector (Chart 4). Although strong growth in healthcare services, information, transportation and hospitality will help to ease headwinds in goods-producing sectors, after incorporating the third-round effects, we expect overall employment growth to decline 0.2% to 2.0% in 2016, with growth returning in 2Q17.

In response to the negative employment growth, unemployment rates are likely to edge up, eroding the historically strong credit quality Texas has enjoyed in the post-crisis period. In previous cycles, unemployment rates and delinquencies have moved in tandem, meaning that a one percentage point increase in the

[3] https://www.bbvaresearch.com/wp-content/uploads/2016/02/160212_US_OilPricesOutlook.pdf

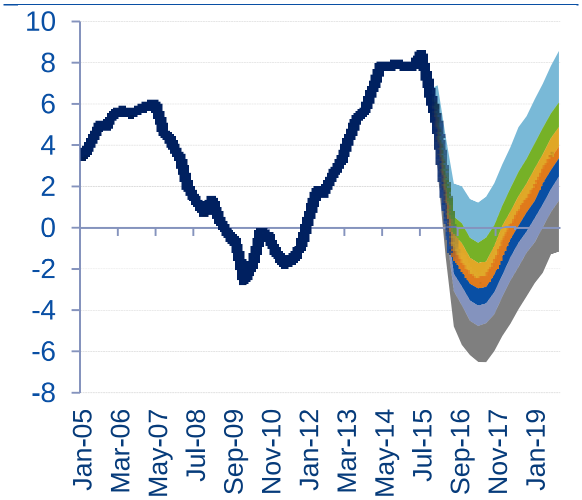
unemployment rate will result in a one percentage point rise in consumer credit balances 90+ days past due. Commercial and industrial (C&I) credit is also exposed given the nature of this cycle (commodities and manufacturing). In fact, according to the Senior Loan Officer Survey, C&I lending conditions have tightened, reflecting the ongoing reassessment of idiosyncratic risks to banks' O&G portfolios. The fact that housing market in Texas was largely insulated from the last crisis does not foretell the current environment, as conditions have already started to deteriorate in some of the most exposed markets. Our expectation is for prices to trend negatively beginning in 2H16. There are also significant downside risks to our housing outlook, such as an overly ambitious Fed tightening cycle that would further erode affordability and lower the willingness of banks to lend; this scenario could imply price declines of greater than 6% in 2017.

Chart 5
Texas Unemployment Rate (%)



Source: BBVA Research

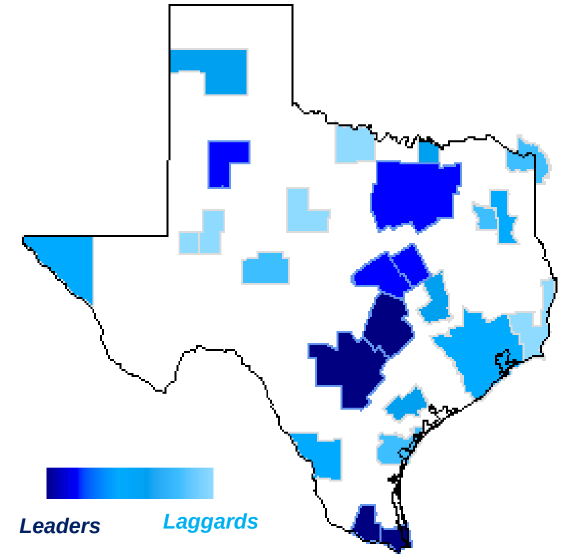
Chart 6
Texas Home Prices (year-over-year %)



Source: BBVA Research

Although risks are tilted to the downside for the state, the commodity-driven nature of this cycle implies that there will be decoupling amongst major cities (Metropolitan Statistical Areas-MSAs). In fact, in 2016, our forecasts for GDP growth range from -11.3% (Midland) to 4.2% (Austin). For those cities that have the greatest exposure to O&G, the outlook is consistently negative, with GDP contracting in 2016. The largest contraction in GDP is expected in Midland, Odessa and Wichita Falls, which lack the diversity of other major MSAs– O&G employment concentrations are 34, 24 and 7 times larger than the U.S. average, respectively. For the often-cited capital of the energy industry—Houston—O&G employment is similarly more concentrated than the U.S. average. However, as a share of the overall labor market, O&G and support services only account for 4.0% of all private sector employees, which underlies the forecast for a mild recession, with growth contracting 0.7% in 2016. In San Antonio, Dallas-Fort Worth and Austin, which in total account for 45% of the state's economy, our baseline is for positive growth in 2016. Although positive, growth will be significantly slower than during the post-crisis period. Meanwhile, in Texas border cities that tend to ebb and flow without respect to U.S. and Texas cycles, slower growth in Latin America and significant gains in the dollar relative to most Latin American currencies will likely create additional headwinds for the border region. In spite of this, our baseline is for McAllen and Brownsville to grow positively in 2016.

Chart 7
2016 MSA GDP Growth (%)



Source: BBVA Research

Chart 8
2016 MSA GDP Growth & O&G Location Quotient

	'16	Location Quotient
Austin-Round Rock	4.2%	1.4
Brownsville-Harlingen	2.1%	2.0
San Antonio	2.1%	2.8
McAllen-Edinburg	2.0%	3.3
Waco	1.7%	0.7
Killeen-Temple	1.6%	1.6
Dallas-Fort Worth	1.5%	2.1
Lubbock	1.3%	4.3
College Station-Bryan	1.2%	4.8
Sherman-Denison	1.0%	1.6
Victoria	-0.2%	15.0
Amarillo	-0.4%	2.8
Houston	-0.7%	7.2
El Paso	-0.7%	1.5
Laredo	-1.1%	13.3
Longview	-1.3%	13.5
San Angelo	-2.3%	16.6
Texarkana	-2.3%	-
Tyler	-2.4%	4.5
Corpus Christi	-3.1%	10.6
Beaumont-Port Arthur	-3.2%	3.0
Abilene	-3.3%	4.2
Wichita Falls	-4.3%	6.5
Odessa	-7.3%	23.7
Midland	-11.3%	34.1

Source: BBVA Research

Bottom Line

Although the Texas economy is far more diversified, less susceptible to financial shocks and more aligned with the U.S. economy, the current oil price environment and weakening manufacturing sector suggest recession in Texas is all but a forgone conclusion (90% probability). Moreover, the new crude oil paradigm supports a shallower exit from current price-levels to a lower long-run price implying Texas will follow a “U-shaped” recovery path. Nevertheless, impacts throughout the state will not be uniform, suggesting decoupling of growth amongst oil-producers and consumers. Stronger U.S. growth, a more resilient Latin America, softer landing in China, or less volatile financial conditions could have offset headwinds in the O&G sector, and supported positive growth in 2016. However, conditions have deteriorated and the risk balance has tilted to the downside, suggesting little upside for Texas in 2016, and the potential for more acute impacts. Broader risks to the state’s future include large population outflows, weaker trade links between its major partners, global contagion and failure to craft policies that will position Texas to be a global leader in the 21st century. Maybe this time Texas can fulfill its promise to capitalize on one more oil boom and not gamble it away.