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Houston Business

A Perspective on the Houston Economy

Houston in 1993: Another Weak Year Ahead?

Looking ahead to 1993, the keys to renewed growth in Houston rest with the national economy and energy—both upstream and downstream. The general outlook adds up to a year that should slowly move local employment growth back to the positive side of the ledger.

Since mid-1991, Houston has been stuck in an economic rut, with month-to-month employment statistics that are flat to slightly down. Before this slowdown, Houston enjoyed 4½ years of very strong job growth explained by four key factors: a strong national economy; timely growth at NASA and the Texas Medical Center; strong downstream energy construction, especially in petrochemicals; and a return to stability in the upstream energy sector. Looking ahead to 1993, the keys to renewed growth in Houston rest with the national economy and energy—both upstream and downstream. The general outlook adds up to a year that should slowly move local employment growth back to the positive side of the ledger.

However, a return to Houston's strong job growth of 1987–91 is probably not in the cards for 1993. A gain of 2 percent, or 30,000 employees, in wage and salary jobs is quite possible this year, but a combination of modest national growth and a weak energy outlook leaves us with limited potential to grow much faster. On the downside, weaker than expected energy markets can easily pull local job growth back from positive gains to flat or negative changes. The energy sector will pose the most significant risks to Houston in 1993, especially world oil markets.

THE NATIONAL ECONOMY

The pattern of recession and recovery in the national economy since 1989 is shown in Figure 1. The end of the recession was recently made official by the National Bureau of Economic Research, the final arbiter of such statistics. The recession that began in July 1990 ended in March 1991, with subsequent growth so slow that it took six quarters for gross domestic product (GDP) to return to pre-recession levels. Although a new period of economic expansion has begun, the recession's legacy lives on in the widely expressed view that GDP growth in 1993 will be slow. A *Wall Street Journal* survey of 44 economists, for example, resulted in forecasts of GDP growth that averaged 2.8 percent for the first half of 1993 and 3.2 percent for the second half. These estimates are higher than those that might have been made just weeks ago, as the most recent economic news has turned quite positive. The on-again, off-again recovery seems to be "on" once more and finally secure. Still, many of the ills that brought us this latest round of recession and slow growth—debt, weak job markets, defense cuts—have followed us into 1993.

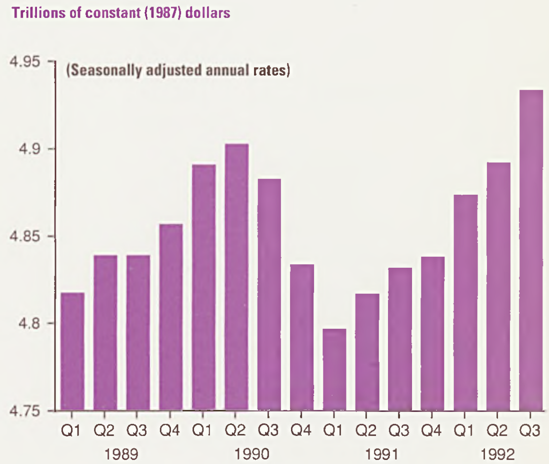
Consumers are likely to remain pessimistic about 1993, and slow consumption spending will slow recovery. There are at least two regular surveys of consumer sentiment, but they can safely be ignored if we know two pieces of data—consumers' job prospects and real disposable income. The anemic pace of recovery, as reflected in jobs and income, has provided small comfort to consumers. The typical recovery experienced since World War II would have brought a 6-percent increase in GDP between the recession's trough and mid-1992, and GDP should have been accompanied by gains in employment and real income of 4.2 percent and 5 percent, respectively. What happened instead was that GDP increased 1.6 percent, and we achieved gains of only 0.2 percent in jobs and 2 percent in real income.

The slow recovery was also influenced by the level of debt carried into the recession by consumers and businesses. The consumer debt situation is now improved but is still out of line with historical standards. Household debt burden, as measured by mortgage and installment debt as a share of disposable personal income, rose from 14 percent to 18 percent over the course of the 1980s. Cautious spending over the past two years has returned it to about 16 percent of disposable income, but further improvement in 1993 is necessary to bring the household debt burden back to the norms of the early 1980s.

Debt problems were not confined to consumers, as balance sheets heavy with debt forced corporate America into a process of "restructuring" during the latest downturn, permanently laying off large numbers of white-collar, middle-management employees. These cost reductions, along with debt refinancing made possible by lower interest rates, improved balance sheets. The benefits of restructuring are apparent in a healthy gain of 2.5 percent in nonfarm business productivity over the past year, and further productivity gains are likely in 1993 as cost efficiencies continue to materialize. Any strong productivity gains, positive as they are for competitiveness, work against job growth. If productivity were to return to high levels this year, GDP growth would have to reach 2.5 percent before job growth could even begin, and the weak outlook for GDP growth leaves the employment picture quite sluggish at best. It takes better than a percentage point of job growth just to absorb new entrants to the labor force, leaving the economy making slow headway against a backlog of 9 million unemployed and 6 million forced into involuntary part-time work.

There are other reasons to see slow national growth ahead. First, the commercial real estate boom of the mid-1980s produced a glut that will not evaporate in 1993 or 1994. The national vacancy rates for both industrial space and office space are at historical highs, and investment in business structures has continued to fall throughout this recovery. Also, government spending will be restrained. The budget deficit at the federal level remains as a significant constraint on any new fiscal package, and cuts in defense spending will be an ongoing drag. Finally, slow growth has moved worldwide, affecting the buying power of

Figure 1
U.S. Gross Domestic Product



SOURCE: U.S. Department of Commerce.

our major trading partners and dampening the prospects for exports. Exports were the engine of growth for the U.S. economy in the 1980s, growing 8.3 percent per year from 1983 to 1991.

ENERGY IN HOUSTON

Energy remains at the heart of the Houston economy. The upstream oil sector—at headquarters facilities, among producers and operators, and at oil service companies and oil machinery producers—still accounts for 80,000 jobs and more than $4 billion per year in wages, salaries and employer-paid benefits. The direct employment figures for downstream energy are less impressive (28,000 in refining and 9,000 in chemicals), but the linkages into local business services, construction and engineering services are more extensive than for the upstream companies. Much of Houston's industrial diversification from upstream oil, and the city's recovery from the oil bust, can be attributed to the resilience and revival of downstream operations in the late 1980s.

The energy outlook for 1993 is not strong. World oil markets continue to weaken over the winter; the bullish news on natural gas prices that followed Hurricane Andrew is shaping up as yet another possible disappointment for gas producers. Downstream margins may improve in 1993 as the U.S. recovery proceeds, but it will be a modest improvement that starts from the present, very weak levels. Further, a lingering global recession may stymie even modest gains, particularly for export-sensitive petrochemicals. Apart from another unforeseen crisis in the Persian Gulf, the best to be expected from Houston's energy sector is stability to modest improvement. However, the risks to stability lie on the downside, particularly from a collapse in the world price of oil.

Oil prices were expected to strengthen over the winter, rising from the $21-per-barrel levels of last fall. Instead, for example, the February futures contract for light, sweet crude fell from $22 per barrel in early October to $19 per barrel by early December. After a modest rally, it fell below $19 per barrel in early January. Why? The answer is simple: continued OPEC overproduction and the inability of OPEC to find production levels that bring supply and demand back into balance. As the global economy weakened in October, OPEC production levels hit 25 million barrels per day, the highest in a decade. Announced cutbacks by Nigeria, Iran and Venezuela produced only transient rallies in oil prices; and the continued global oil glut can only make traders more nervous about 1993, especially while Iraq remains under United Nations embargo and out of world oil markets. The volatile mix of Middle East politics makes it hard for OPEC members to share pain in times of excess oil supplies, and even weaker oil prices offer a real threat to Houston's new year.

Natural gas prices have probably played a larger role in Houston's recent history than oil prices. The war in the Persian Gulf created an oil price spike, and many local oil service and oil machinery companies used the resulting cash flow to build up staff in anticipation of a coming boom in natural gas drilling. The end of the natural gas bubble was widely proclaimed. However, instead of the expected boom, natural gas prices collapsed over the winter of 1991–92; Houston-based energy employment tumbled along with these gas prices.

Then, prices soared last fall as Hurricane Andrew threatened high-volume gas wells in the Gulf of Mexico just as the peak heating season approached. In retrospect, an element of panic was at work as these prices rose very sharply. Spot prices in October were near $2.60 per thousand cubic feet (Mcf). They have since weakened, and the January seasonal peak saw the futures contract close out at just under $2 per Mcf. Prices *have* remained better than in the winter of 1991–92, and conventional gas drilling has improved, especially in the Gulf of Mexico. We find once more, however, analysts talking about a weak start for natural gas prices in 1993; the second half will be better, when natural gas markets finally tighten again. The long-run outlook for natural gas is almost certainly bullish, but natural gas prices in 1993 will probably fail to sharply boost Houston's energy activity.

The domestic drilling outlook for 1993 is much like the outlook for energy prices—slightly improved but with downside risk. The Baker Hughes rig count recently peaked at 935 in mid-December, largely on the strength of Section 29 tax breaks for drilling in tight sands or coal seams. These breaks expired on January 1, and a sharp drop in drilling is expected early this year. The positive news is that the energy plan passed last fall ended the alternative minimum tax for independent producers. It should improve cash flows and is a strong development for drilling over the course of 1993. One survey has already found independents planning to increase domestic drilling this year, despite a continued shift overseas in the drilling plans drawn up by major companies.

The best sign that the U.S. recovery is having a positive effect on Houston is improved consumer confidence, as reflected in retail, auto and new home sales. Poor markets for oil products and chemicals reflect a growing slump in Japan and Europe, hurting local companies as much as domestic recovery helps.

RETAIL AND AUTO SALES

The holiday season in Houston followed national trends and was the best in several years for local retailers. The gains of 8 to 10 percent for 1992 were strong, but the basis for comparison offered by recent years is weak. In 1990, the impending start of a ground war in the Persian Gulf slowed sales, and in 1991, the national recession finally came to Houston with an autumn wave of layoffs by the city's biggest employers.

Houston auto sales finished 1992 with a very strong December and were up 1 percent for the year. Annual results would be much better except for restructured contracts between rental car companies and manufacturers that cut sharply into local fleet sales.

PAPER AND LUMBER

A strong regional market for lumber and other homebuilding products continues. Lumber prices are still rising sharply, driven by rebuilding from Hurricane Andrew and environmental restrictions. Paper markets also continue to strengthen, with year-end demand for boxes weakening seasonally.

UPSTREAM OIL AND NATURAL GAS

Light, sweet crude weakened in recent weeks, as prices moved under $19 per barrel on news of growing inventories. Slow growth in Europe and Japan is offsetting any stimulus from a U.S. recovery.

Natural gas prices have steadily weakened since Hurricane Andrew. February futures have a life-of-contract high of $2.22, but the contract has recently slipped under $1.60. One large producer said he would drill for conventional gas again when the price moves above $2 and stays there, comparing himself to Charlie Brown and gas prices to Lucy with the football.

Drilling has slumped sharply with the new year, as tax credits expired for drilling in coal seams and tight sands. The 1992 Baker Hughes rig count hit a weekly high of 935 in mid-December; already, fewer than 800 rigs are at work. A seasonal decline is normal in January, but some respondents think that, without tax credits, the rig count could again move under 600 this spring and post another all-time low.

DOWNSTREAM OIL AND CHEMICALS

The glut in world oil markets is also apparent in weak product prices. Wholesale gasoline, for example, began 1992 at 61 cents per gallon, rose to 71 cents over the summer, and is now back to 60 cents despite the U.S. recovery. Margins for refineries have improved slightly in recent weeks but not enough to prevent capacity from being shut in temporarily by several companies with operations in Louisiana and Texas.

Chemical producers reported seasonal declines in demand, but, otherwise, demand was stable or improved. Margins have stabilized with the national recovery, but they have not improved much. Global recovery may be needed in this case, as chemical producers account for 10 percent of U.S. exports.

REAL ESTATE

New home starts in Houston jumped 30 percent in December compared to a year earlier, and sales were up 10 percent. Heavy sales over the past three months, combined with thin inventories, were given much of the credit. With no employment growth in 18 months, lower interest rates are driving the market, luring purchasers out of apartments and smaller homes.

In contrast, existing homes have suffered a disappointing and erratic year. Used home sales are down sharply on a year-to-year basis, and we now have the largest inventory of unsold homes since 1988. The price difference between existing homes and new homes has widened all year.

Office markets show continued weakness. Apartments show flat occupancy and rents over the past few months. Retail markets improved slightly late in 1992, and respondents think 1993 will see continued gains.

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