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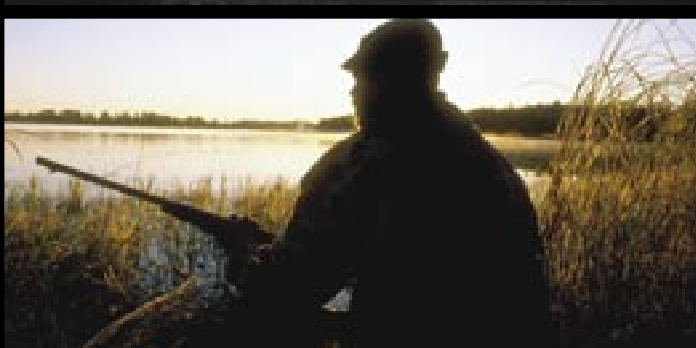
A Reprint from *Tierra Grande*

recovery rolls slowly on

By Research Staff



There are times when economists are hard-pressed to explain what is happening with the nation's economy. Now is one of those times. Officially, the economy is in recovery and has been for over a year. But few are going back to work. Signs of business pickup are tentative. The federal government is pushing as hard as it can to force life into the recovery. And the housing market is booming, seemingly oblivious to the stagnation surrounding it.

The economy is sending mixed signals. During third quarter 2003, gross domestic product, the most widely cited measure of the economy, grew at a 7.2 percent rate. Yet for the year, the nation lost 400,000 jobs. On the positive side, these figures show that productivity is increasing. More is being produced by fewer workers. This is great for people who want to retire. The down side is that a lot of young people are looking for jobs that are not being created.

The enigma may in part derive from the trend many U.S. companies are following of transferring work to employees and subcontractors in other countries. Even white-collar jobs like computer programming are leaving the United States as employers shave costs.

Another factor may be the shift of jobs from the formal sector, which is covered in the government's nonfarm employment data, to the informal sector, which is covered in the much smaller household survey also conducted by the Bureau of Labor Statistics. The latter has been growing at a rate of about 1 percent per year, no doubt because permanent employees are being replaced by temporary workers and the self-employed. This is not unusual at the start of a recovery. So the sun may still rise tomorrow.

Although Texas employment growth trailed national trends for much of 2003, by September it had produced 33,000 new jobs for the year while almost a half-million jobs disappeared nationwide. Growth was concentrated in a few sectors, some of which are not basic producers — that is, industries or services that bring in money from outside the state's economy. Government depends on tax revenues, and taxes represent a burden on the local economy, except for the portion of activities funded by the federal government. To a significant extent, education and health services also depend on government funding. Construction can only be sustained by continuous growth in other parts of the economy. The financial services sector has benefited from low interest rates, a phenomenon that will not continue indefinitely. As these sectors revert to the mean, other industries need to step up.

Texas Industries Ranked by Employment Growth Rate
October 2002 to October 2003

Rank	Industry	October 2003	October 2002	Change: Absolute	Change: Percent
1	Education & Health Services	1,140,000	1,102,900	37,100	3.4
2	Construction	583,600	568,400	15,200	2.7
3	Government	1,689,300	1,659,500	29,800	1.8
4	Financial Activities	588,000	582,800	5,200	0.9
4	Leisure & Hospitality	848,900	841,000	7,900	0.9
6	Other Services	357,400	355,300	2,100	0.6
7	Professional & Business Services	1,056,800	1,058,900	–2,100	–0.2
8	Trade	1,570,800	1,575,000	–4,200	–0.3
9	Natural Resources & Mining	143,000	145,800	–2,800	–1.9
10	Transportation, Warehousing, Utilities	377,200	390,400	–13,200	–3.4
11	Manufacturing	906,400	939,800	–33,400	–3.6
12	Information	231,300	242,500	–11,200	–4.6

Sources: U.S. Bureau of Labor Statistics and Real Estate Center at Texas A&M University

Fastest Growing Metropolitan Areas Based on Nonfarm Employment Growth Rate
October 2002 to October 2003

Rank	Metro Area	Growth Rate (Percent)
1	McAllen-Edinburg-Mission	3.3
2	Bryan-College Station	1.8
3	San Antonio	1.4
4	Waco	1.1
5	Austin-San Marcos	0.7
6	Beaumont-Port Arthur	0.6
	Texas	**0.3**
7	Brownsville-Harlingen	0.3
8	Killeen-Temple	0.2
9	Corpus Christi	0.0
9	El Paso	0.0
9	Laredo	0.0
9	Lubbock	0.0

Source: U.S. Bureau of Labor Statistics

Most of the fastest growing local economies benefited from government spending. Growing school systems and tighter border patrols in the Valley are fueled by state and federal money. Other fast-growing areas are homes to major universities, which are enjoying a strong demand for higher education. All areas of the state are experiencing increasing demand for health care.

The long slump in employment contrasts with the recovery following the 1990 recession. At that time, it took 33 months for employment to regain its prerecession level. Thirty months after the onset of the 2001 recession, national employment was still down 2 percent.

What will it take to turn growth into more jobs? First, consumers must keep buying. More importantly, employers must feel confident enough about the future to expand their businesses and hire more employees.

There are encouraging signs. Indicators of small business outlook compiled by the National Federation of Independent Business bottomed out in March of last year and are on the rebound. The Texas Index of Leading Indicators, a product of the Dallas Federal Reserve Bank, has shown some improvement since 2003's low point. Likewise, the Texas Stock Index (Texas Comptroller of Public Accounts) has ridden the rally in stocks to a better than 20 percent gain from its low in March 2003. And corporate profits are exceeding levels last seen in 1998.

This recovery may seem odd because a fundamental shift is occurring. The U.S. economy is being transformed from one based on manufacturing to one grounded in information and management. It is moving to the next stage of economic development.

Earlier in its history, the United States moved from growing things to making things. Now it seems that manufacturing is increasingly being done in developing parts of the world, leaving more skilled and high-tech jobs here at home. If true, this means that most of the manufacturing jobs lost will never return, even in the best of economic times. If educational and trade institutions and employers provide the training necessary to update worker skills, the bottom line should be better jobs for the American workforce.

One of the bright spots in the recent economy has been the continuation of low interest rates. Rates often spike just before a recession and during early recovery but not this time. They have dipped to lows not seen in decades. Housing and consumer spending have benefited.

Several factors are keeping rates at bay. Federal Reserve policy is to keep rates low to stimulate growth and fight off deflation. Deflation is the opposite of inflation and is characterized by widely and persistently declining prices. While this action primarily affects short-term rates, it also reduces the base on which long-term rates are built.

When the stock market was performing poorly, investment moved into the bond markets, creating a glut of funds and depressing yields. Today, most mortgage money comes from the bond markets through the securitized pools of Freddie Mac and Fannie Mae. The most important factor for long-term interest rates is inflation expectations. Currently, there seems to be more concern in the markets about deflation than inflation, resulting in low inflation premiums.

Given these fundamentals, interest rates are likely to go up. With the federal funds rate, the primary monitor of Fed policy, at 1 percent, the Fed has almost run out of room to apply more stimulation. The base for interest rates will not be declining much further and may be raised should the economy show more strength. For the first time in four years, 2003 stock markets finished with a gain. Investors chasing higher returns and those trying to rebalance their portfolios are redirecting their money from bonds toward stocks and stock mutual funds, putting upward pressure on interest rates.

The absence of inflation is enigmatic, given the Fed's aggressive monetary policy in recent years. The broad money supply (dubbed "M2") has grown by about 8 percent in the last year, while consumer prices have advanced less than 2 percent. The answer to this monetary puzzle is that the velocity of money (the rate at which the money supply turns over) has been slowing dramatically since its peak in 1997.

The slowing velocity is evidenced in a 15 percent decline in loans to business since mid-2001. Lending activity boosts velocity. After a significant surge, money velocity is now near its long-run trend line, meaning it is likely to stabilize. This means that a Fed effort to keep interest rates low will create higher inflation rates. Eventually, rising inflation expectations will affect long-term interest rates. The results could be significant but probably will be modest, resulting in mortgage interest rates close to those of the mid-'90s.

Economic keys to watch in 2004 include:

- *Performance of the national economy.* If the recovery remains on track, there should be significant improvement in the job market. However, interest rates will rise on growing demand for goods and services.
- *Federal Reserve policy.* If inflation rates rise, will the Fed begin to raise interest rates?
- *Business optimism.* The trend of rising profits and the feeling that the worst is over needs to continue for employers to create new and permanent jobs. A persistent flow of good news and an end to the corporate scandals and other shocks that have rippled the economy in the last few years are critical.

The last four years have produced record-breaking home sales numbers in Texas multiple listing service (MLS) areas. A look at Figure 1 shows that growth in sales occurred because of increased activity during "off seasons." The past year was different — off-season sales did not follow the pattern, making it seem likely that overall 2003 sales would be lower. However, for the first time, peak season sales topped 20,000 homes per month. The market jumped to yet another new record (projected to exceed 210,000 for the year).

Encouraged by the growth in existing sales, builders have continued building. Accordingly, builders' confidence in future demand is polling at high levels. Single-family building permits statewide in 2002 were at a level equal to 61 percent of total MLS sales. Compare that with 1990, when they equaled only 38 percent of sales.

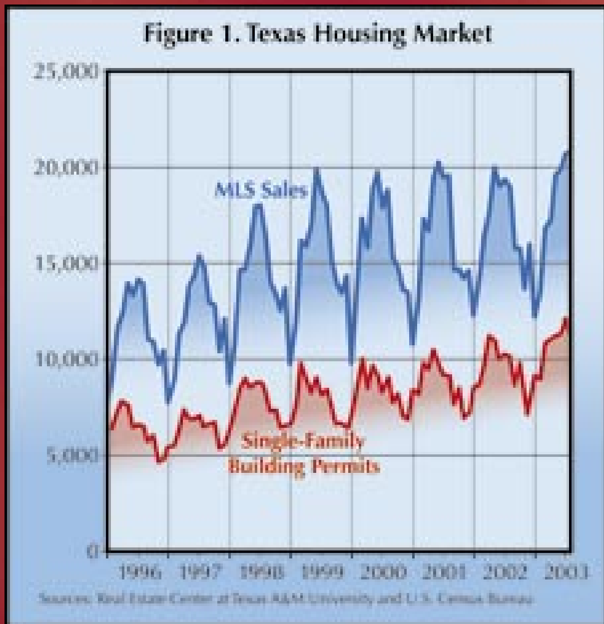


Figure 1. Texas Housing Market

Sources: Real Estate Center at Texas A&M University and U.S. Census Bureau

Figure 2. Texas Housing Vacancy Rates

Source: U.S. Census Bureau

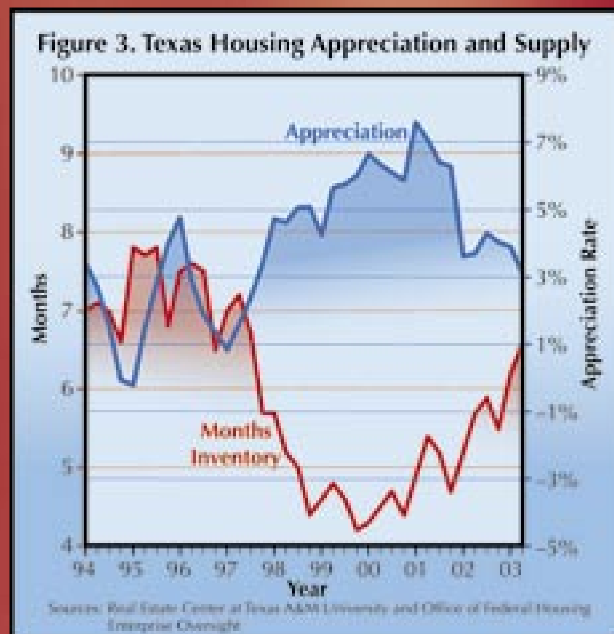


Figure 3. Texas Housing Appreciation and Supply

Sources: Real Estate Center at Texas A&M University and Office of Federal Housing Enterprise Oversight

Fastest Growing Cities (2001–2002)

Rank	MSA	Population Change (Percent)
1	Austin	1.7
2	Laredo	1.5
3	Dallas	1.4
4	McAllen	1.4
5	Brownsville	1.1
6	Fort Worth	1.1
7	Brazoria	1.0
8	Houston	0.9
9	Bryan–College Station	0.8
10	Galveston	0.8

Source: State Data Center at Texas A&M University

The factors that caused home sales to skyrocket the past few years are still at work. Buyers consider a home to be one of the few lucrative investments around today. The rise in peak sales probably was the result of a midyear dip in interest rates that took them below already historical lows. Even rising rates will stimulate sales for a while, as buyers anticipating steadily increasing rates scramble to take advantage of the last "low" rates.

Good times are not the rule in all parts of the housing market. Home sales are stealing some of the prime target market for rental housing. Texas rental vacancy rates are at their highest levels since 1989.

Manufactured housing sales are suffering. Sales of new units have fallen steadily despite the apparent surge in demand for homes. With so many middle-income households able to afford site-built homes, the manufactured home market was left to those with poor credit ratings and little cash. The industry is struggling to work through the excess inventory of repossessed homes competing with new production.

Remember all the talk about a real estate "bubble"? The fear was that prices had risen to such heights that a terrible crash was in store, similar to the rise and fall of the NASDAQ. Well, that bubble never materialized in the Texas market. Home appreciation rates have slowed since the peak in early 2001. Homes are now increasing in value by a modest 3 percent per year, not far above the official inflation rate. Rising inventory — both in MLS listings and new construction

Hottest Housing Markets (Projected 2003)

Rank	MSA	MLS Sales per 1,000 People
1	Austin	14.7
2	Houston	14.0
3	Dallas	13.3
4	Bryan–College Station	13.0
5	Wichita Falls	12.8
6	Amarillo	12.7
7	Abilene	12.6
8	Odessa–Midland	12.2
9	Lubbock	12.1
10	San Angelo	11.9

Source: Real Estate Center at Texas A&M University

Hot Home Building Markets (September 2002 through August 2003)

Rank	MSA	Housing Permits per 1,000 People
1	Bryan–College Station	13.3
2	Galveston	12.4
3	Brazoria	12.1
4	McAllen	11.8
5	Houston	11.3
6	Dallas	9.9
7	Fort Worth	9.3
8	Laredo	9.1
9	Brownsville	8.8
10	Lubbock	8.7

Source: U.S. Census Bureau

Highest Home Appreciation Rates Annual as of June 2003

Rank	MSA	Percentage Change in Market Value
1	Longview	5.68
2	Waco	5.58
3	Sherman–Denison	5.22
4	El Paso	4.90
5	San Antonio	4.85
6	Laredo	4.79
7	Wichita Falls	4.75
8	McAllen	4.65
9	Bryan–College Station	4.38
10	Killeen–Temple	4.27

Source: Office of Federal Housing Enterprise Oversight

Tightest Housing Markets (Projected 2003)

Rank	MSA	Months of MLS Inventory
1	Lubbock	3.1
2	Wichita Falls	4.7
3	Corpus Christi	5.0
4	Odessa–Midland	5.2
5	San Angelo	5.4
6	San Antonio	5.8
7	Abilene	5.9
8	Fort Worth	6.0
9	Houston	6.2
10	Victoria	6.2

Source: Real Estate Center at Texas A&M University

— almost always slows the growth rate of prices. As a result, markets today are more balanced between sellers and buyers.

Can the housing market continue its stellar performance? Three key factors will determine the answer.

Persistence of a "jobless" recovery. There has never been an employment recession that failed to slow housing sales. In fact, periods of slow employment growth tend to impact the market even when they are not serious enough to be recessions. Yet so far, the housing market has suffered no ill effects from the recent recession, suggesting that a sales slump is yet to come. Sales could weaken just as employment starts to recover.

Rise in mortgage interest rates. Reasons for expected rate increases were discussed in the previous section. The rate rise will be modest, in all probability, but could be enough to eliminate some potential homebuyers. However, if Freddie Mac's accounting problems deepen or spread to other mortgage conduits, the effect could be more significant.

Shrinkage of the entry-level market. The cost of homeowners insurance soared in recent years. The state has ordered companies to roll back rates, but that is only part of the issue. Because the cost of insurance is tied to a person's credit rating, rising premiums could have the most impact on the segment of the market dependent on subprime loans. In addition, the higher risk subprime and first-time homebuyer loan markets could shrink severely as lenders try to stem rising risk. In mid-2003, the 90-day delinquency rate for FHA loans (12.6 percent) was higher than that for subprime loans. Active housing markets kept foreclosure rates relatively low (slightly over 1 percent at mid-2003) but this could change if the market slows.

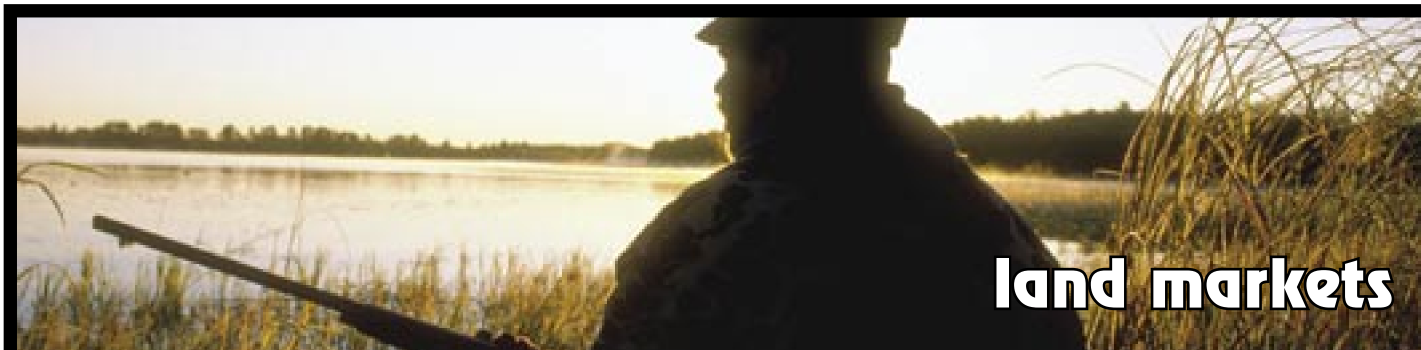
housing needs forecast

Texas is projected to gain more than three million new residents between 2000 and 2010. Based on this projected growth and changes in basic housing conditions (homeownership rates, vacancies, persons per home and others), the Center projects that building activity will continue at a strong pace through the rest of the decade. Single-family construction should slow a bit from recent years, but multifamily construction will approach the level set in 1998.

Projected Need for New Texas Housing Units, 2002–2009

Projected 2000-2009	Single-family	Multifamily	Manufactured
Units needed:			
For new households	699,357	323,368	87,852
Net new vacancies	8,034	18,120	30,580
To replace lost units	271,045	118,243	114,895
Total new units	978,436	459,731	233,327
New units built from 2000–2002	343,610	113,256	64,896
Projected new units from 2003–2009	634,826	346,475	168,431
Annual average	90,689	49,496	24,062
Annual average 1990–1999	72,202	29,239	26,094

Sources: U.S. Census Bureau and Real Estate Center at Texas A&M University



land markets

Texas rural land prices rose sharply in the first half of 2003 and show no sign of turning down. The strong performance relied on a combination of recreational buyers and investors. Low interest rates and meager returns on alternative investments prompted the latter group to see rural land as a good place to park wealth.

Recreational buyers, consisting mostly of buyers seeking a place to hunt wildlife, have fanned out into areas of the Panhandle and West Texas. Those areas have been shielded from the price pressures at work in the Hill Country and South Texas.

Buyers are having more difficulty finding suitable properties at affordable prices in those traditionally popular spots. Buyers have begun to migrate to a corridor from Abilene to Amarillo and are ferreting out suitable properties in prairie areas passed over by hunters in the past (see "Where the Deer and the Antelope Pay," page 12).

Some cities' efforts to control land development through "smart growth" schemes apparently are driving developers farther out into the countryside. This spread of new housing developments further supports land values. Although decline in these market pressures can be expected, it should not occur overnight. The boom in rural land could go on for some time.

Unlike the homeownership market, commercial markets have fully reflected the economic difficulties of the past few years. Low interest rates do not necessarily aid these markets, but the lack of new employees (meaning little need for new space), reduced consumer spending and fewer new households hurt demand.

It appears that most property sectors in Texas' large cities are at the bottom of the cycle. Some are showing signs of recovery as negative employment growth rates lessen.

Office markets. Some of the state's hardest hit industries are those that need office space. Through mid-2003, employment in the telecommunications sector had shrunk 9 percent; accounting, 5 percent; and computer systems design, 8 percent. Surplus space has softened rental rates and reduced the value of existing buildings. Most markets are at the bottom of their cycle (the exception appears to be El Paso), with some signs of slight improvement. Recovery awaits a turnaround in employment trends.

Retail markets. Stores and shopping centers have not been hit as hard by the recession. Retail employment is flat rather than shrinking, and many markets are showing positive gains for property values.

Apartment markets. As mentioned previously, high demand for homes and easy access to mortgage financing have decreased the natural market for apartments. However, numbers suggest that many areas have begun a tentative recovery. Any pullback in the subprime and affordable lending markets would assist this recovery, as more households would rent apartments rather than buy homes.

The last few years have been exhilarating for much of the real estate community, owing to historically high demand for both existing and new site-built homes. But the weak economy is readily apparent in most commercial property sectors. Rental and manufactured housing industries are suffering through hard times, partially because of the great appeal of homeownership.

How long will this situation last? Most experts are surprised it has endured this long, but at the same time are reluctant to predict its imminent demise.

In times like these, the best approach may be to "make hay while the sun shines," as the saying goes, but not expect the sun to shine forever. Depending on which sector of the industry you are in, that prospect can be reason for caution or for hope.

For more information, contact info@recenter. tamu.edu.

Office Markets

Area	Estimated Cycle Phase	Turning Point	Price Change (Percent)	Rent Change (Percent)	Legg Mason Phase*
Austin	Recession	3rd qtr. 2000	–4	–19	Recession
Dallas	Recession	4th qtr. 2000	–4	–7	Recession
El Paso	Oversupply	2nd qtr. 2002	–3	–8	N/A
Houston	Recession	2nd qtr. 1998	–2	–8	Recession
San Antonio	Recession	1st qtr. 1999	–1	–5	Recession

Retail Market

Area	Estimated Cycle Phase	Turning Point	Price Change (Percent)	Rent Change (Percent)	Legg Mason Phase*
Austin	Recovery	2nd qtr. 2002	+3	0	Recession
Dallas	Recovery	4th qtr. 2001	+6	–4	Recession
El Paso	Recovery	2nd qtr. 2001	+1	–1	N/A
Houston	Recovery	1st qtr. 2002	+7	–1	Recovery
San Antonio	Recovery	2nd qtr. 2001	+2	0	Recovery

Apartment Markets

Area	Estimated Cycle Phase	Turning Point	Price Change (Percent)	Rent Change (Percent)	Legg Mason Phase*
Austin	Recovery	4th qtr. 2000	0	–7	Recovery
Dallas	Recession	2nd qtr. 1995	–6	–5	Recession
El Paso	Recovery	2nd qtr. 2001	–1	–2	N/A
Houston	Recovery	3rd qtr. 2002	+4	–1	Recession
San Antonio	Recession	1st qtr. 1999	0	–2	Recovery

*Legg Mason Wood Walker defines markets according to phases in an idealized property market cycle. "Recovery" starts when occupancies begin to rise after a period of decline. "Expansion" occurs when construction activity begins while occupancies continue to rise. "Oversupply" represents the peak in the market when new supply causes occupancy levels to decline. "Recession" sets in when oversupply causes rental rates to decline.

Sources: Data © 2003 by National Real Estate Index, www.realestateindex.com; Legg Mason Wood Walker, Inc.; and Real Estate Center at Texas A&M University

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