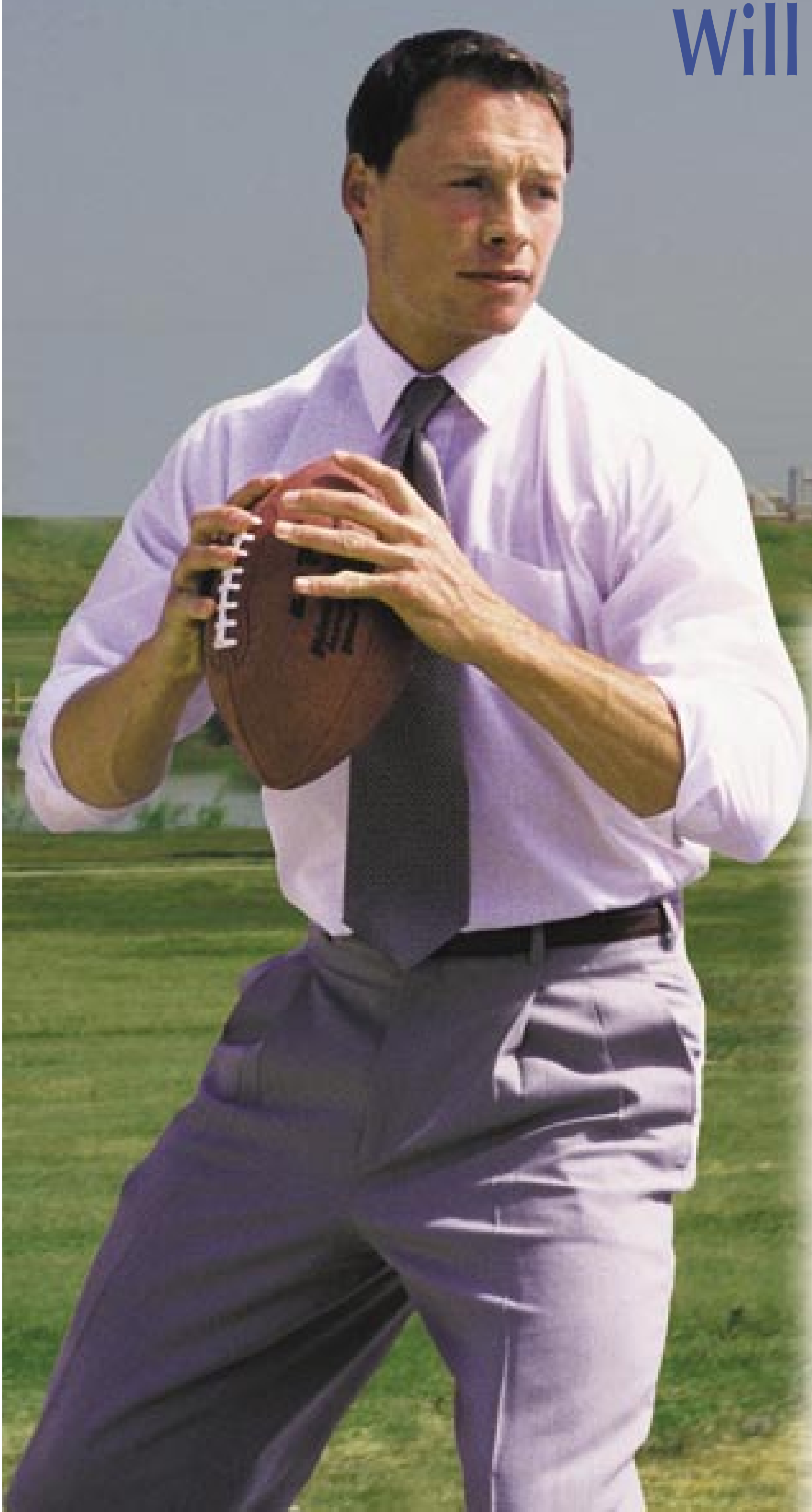
A Reprint from *Tierra Grande*

Third and Long

Will Business Suit Up for Recovery Game?



By Research Staff

For years, the Texas housing market has been setting records without much help from the economy. Though falling employment did not stall the market, the recent pickup in job creation definitely has instilled new life in the housing boom. Land markets have been even more resilient than the housing market, and now commercial markets are starting to recover.

Despite more economic support for real estate markets, a number of serious problems remain. The staying power of the economic recovery is suspect. It is almost a foregone conclusion that interest rates will climb this year. The housing market and consumer spending have been the mainstays of the recovery, but how long can this continue?

Consumers Under Pressure

The reelection of the president probably will have little impact on the Texas economy. However, with elections behind them, look for Congress and the Texas Legislature to hunt vigorously for new sources of revenue.

For an economic recovery to be sustained, business capital spending will need to take the ball from consumers, who have been carrying it.

Consumers will be pressured as this recovery matures. Wage gains are expected to be modest, as most of the higher cost of labor will go to providing benefits such as medical insurance. Even without an outbreak of inflation as measured by the Consumer Price Index, consumers will be hit with higher energy prices and rising state and local taxes.

Several key factors will influence the economy's performance in 2005.

- **Oil prices.** If prices fall, the economy will benefit.
- **School financing.** Without reforms, property taxes will continue to rise.
- **High-tech industries.** Even a modest recovery could help local economies stabilize.
- **China and other emerging economies.** Many U.S. companies are banking on entry into these growing markets. Texas ports could benefit from increased trade and from repercussions from last year's dock strikes in California.
- **Offshoring of services.** While loss of jobs has been modest so far, calls for protectionist measures will probably continue unless the offshoring trend turns around.

Employment Finally Growing

By mid-2004, Texas nonfarm employment was growing at an annual rate of 1.1 percent (total employment was up 1.5 percent). While that is not a boom, it is much better than the shrinkage of the previous two years. Employment numbers picked up as 2004 dawned, reflecting a similar but slightly more vigorous rally in employment nationwide. Unfortunately, the growth rate stalled at midyear (the Texas index of leading indicators was trending downward as well), and at the time this was written, it was unclear whether the economy was headed for long-term recovery or sinking back toward recession.

Sectors leading the pack in job growth were education and health services (up 3 percent) and professional and business services (up 2 percent). Each industry employs more than one million Texans. The education and health services sector benefits from the aging population, and the professional and business services sector benefits from the trend toward outsourcing. The manufacturing sector and the information industry were the laggards, each losing employees at a rate exceeding 1 percent.

Texas Workforce Commission projections indicate manufacturing will add jobs during the decade but at a rate much slower than any of the service industries. This trend could be seen as a lost legacy or as an indication of a modernizing economy based on skilled service provision. The move away from manufacturing and toward service sector jobs has been going on for some time.

Establishing an economic base of high-quality service providers could set the stage for solid growth for the long term. Demand for health and business services is expected to be strong and steady for years. However, some problems threaten the recovery in the near and midterm.

Energy prices and supply. Texas no longer produces enough oil to benefit from higher prices. Rising costs are a big threat to the state's economic health. The current price run-up looks like a spike that will moderate when supply restrictions are resolved. Sustained strong demand from developing countries could prolong high prices and renew efforts to find new sources but will act as a drag on economic recovery.

Efforts to roll back globalization. Although the idea of stopping the outsourcing of jobs overseas has political appeal, any effort to do so could stifle international trade and lead to the loss of many more jobs. With an international border and a major port, Texas is especially vulnerable.

Reduction in government stimulus. The federal government is using every strategy at its command to get the economy back on a growth path. Monetary policy has created the lowest interest rates in decades while income tax cuts and government spending are pouring money into the economy.

However, all this stimulus runs the risk of igniting inflation and creating crushing debt for future generations. Therefore, as the economy recovers there is pressure to discontinue or scale back these measures. The gamble is that the recovery will sustain itself without stimulus, but that is not always the case.

Prospect of moderately higher interest rates. Inexpensive financing costs have stimulated consumer and business spending for the past several years. As rates

Fastest Growing Economies
(Sept. 2003–Sept. 2004)

Rank	MSA	Employment Change (percent)
1	Laredo	5.5
2	Texarkana	4.0
3	Victoria	3.8
4	San Angelo	3.5
5	McAllen	3.4
6	College Station-Bryan	3.2
7	Tyler	2.9
8	Brazoria	2.5
9	El Paso	2.3
10	San Antonio	2.3

Source: U.S. Department of Labor

Figure 1.
Change in Leading Texas Economic Indicators Index and Employment Growth

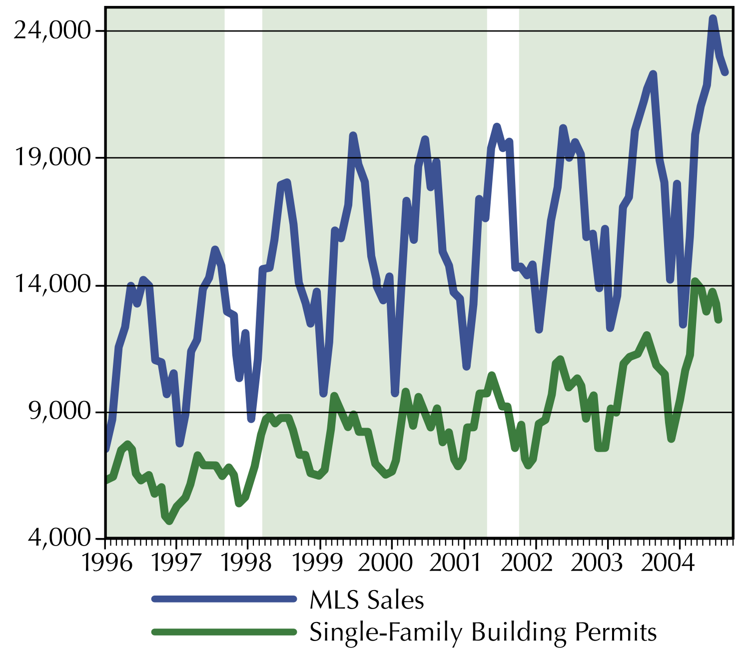
Sources: Texas Comptroller's Office and U.S. Department of Labor, Bureau of Labor Statistics rise, opportunities to lower debt costs disappear. While interest rates are not expected to rise to market-stifling levels, the fact that they probably will no longer go down means the end of this "income" source.

The most probable economic outcome will be continued recovery at a modest pace, with job growth in the 1 to 2 percent range. The recession was mild by historical standards, and this traditionally does not make for a strong recovery.

Slow labor demand might not be the only cause of modest growth in employment. Age distribution changes in the Texas population may be lessening the importance of job creation. During the 1990s, the percentage of Texans aged 18 to 24 fell from 11.2 to 10.5. These are the prime household formation years, and this group is the source of most new jobseekers.

The 44-to-64 age group, mostly people at the height of their earning power, increased from 17.2 to 20.2 percent of the population. Continuation of these population trends would mean more people retiring in coming years and fewer entering the job market.

Figure 2. Texas Housing Market



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

Housing Market Steps Up Pace

Declining job numbers usually do not make fertile ground for home sales. But the past few years have been home sales record breakers, with each year setting a new level for sales within the state's Multiple Listing Services.

With low down payment loans readily available and interest rates so low, many people have found they could buy a home with a lower monthly outlay than they would pay in rent. Consequently, the market has been largely impervious to the employment drop.

Last year, the research staff's review attached significance to the fact that home sales, which are always highly seasonal, were breaking records not by hitting new highs in peak months but by not falling so much in off months. The thought was that the trend might indicate a turn in the cycle. However, with job creation back, housing markets are once again climbing to higher highs. There appears to be no end to this boom.

Given the Federal Reserve's announced plan to raise the federal funds rate, a steady increase in mortgage interest rates is anticipated. As of mid-2004, rates were fairly subdued. They did jump more than 1 percentage point in spring 2004 but subsequently gave much of that gain back, throwing the predicted scenario of higher rates into doubt. The lack of inflationary expectations, questions about the strength of economic recovery and the activities of bond speculators kept long-term interest rates down, but that is not expected to last.

Nothing Lasts Forever

Home sales in 2004 are estimated to set another record, largely because interest rates have not risen appreciably. However, a continuation of low interest rates could indicate the economic recovery has failed, and that would not be good news for housing markets. Sales depend on a supply of willing and able buyers, and for that supply to be adequate there must be jobs to attract new people to the state and to allow current residents the income necessary to form households.

The recent housing uptrend has thrived largely by drawing buyers from rental and manufactured housing. Low interest rates, liberalized qualifying criteria and low cash down payment requirements have been instrumental in expanding the demand for homes.

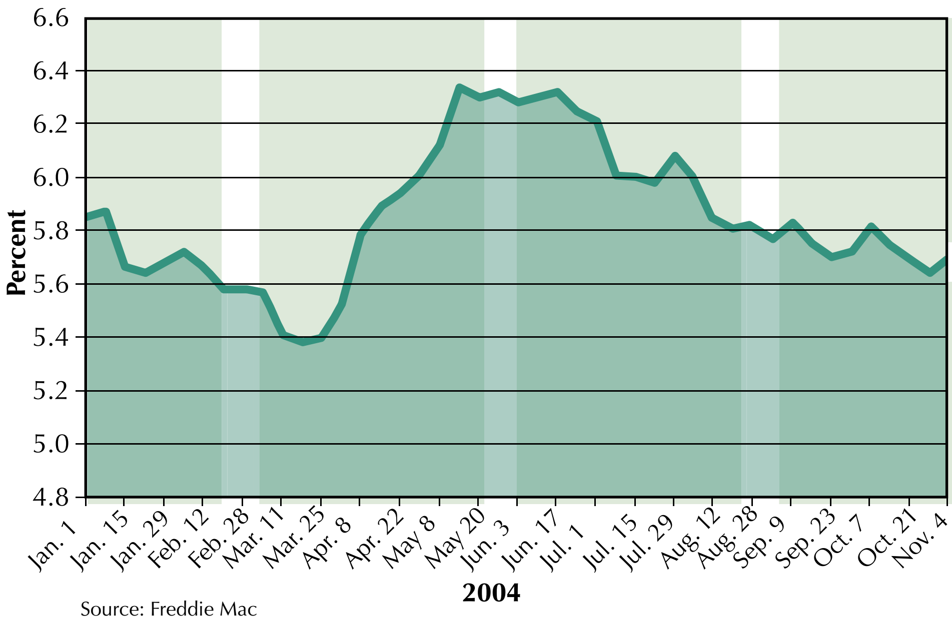
Sales at the low end of the price distribution trigger a chain of sales as existing homeowners move up to larger and more luxurious living quarters. That multiplier effect could be sidelined if home builders target the entry-level market, which they often do when the demand for homeownership is strong. New home construction is growing at a rapid clip and threatens to steal market share from existing units.

Unless the recovery seriously heats up, it will be difficult to continue raising the bar on home sales. Interest rates will be higher, and the supply of renters who wish to buy their first homes is not likely to expand. But considering that the number of homes sold through Texas MLSs in 2004 was twice that of 1992 (and more than three times the dollar volume), a moderate decline should not be too disappointing. Even with some pullback, the housing market should continue to be robust.

Here are some things that bear watching in 2005:

- **Loans.** The continued willingness of lenders to make low down payment and subprime loans is probably more important than what interest rates do. A flare-up of delinquencies and foreclosures might scare lenders away from thesehigher risk loans. Texas delinquency rates have risen but are far below the highs of the 1980s. The level of delinquencies is not unexpected considering the soft economy.
- **Fed policy.** Mortgage rates will rise as the Fed tightens monetary policy, but any increase will be moderate if the Fed manages to quell inflation expectations.
- **Inventories.** Housing market inventories are no longer as tight as they were a few years ago. Current inventories

Figure 3. Interest Rates on Fixed-Rate Mortgages



Source: Freddie Mac

equal around six months of sales, indicating a balance between buyers and sellers. Higher inventory levels could soften sales price gains significantly and possibly even lead to lower prices.

- **Hazard insurance.** With investment markets improving and the mold problem apparently under control, property insurance rates should recede. The ability of insurers to use credit (FICO) scores to ration policies and the growing level of competition among providers are issues.

Worst Over for Commercial Markets

As Texas companies have begun to hire more employees, demand for office and industrial space has improved. Retail stores are doing more business, and there are more people to house. Consequently, commercial property markets are recovering from a slump.

In this regard, Texas is following a national trend that positions most types of property in the early recovery stage of the real estate cycle. Sales of investment-grade properties are rising even as interest rates rise, often giving the advantage to institutional investors paying all cash. Investor optimism is improving and is reflected in falling capitalization rates.

While office properties benefit directly from employment gains, the office market recovery has been the weakest compared with other property types. Based on investment returns, most markets bottomed in mid-2002.

Office vacancy rates in Dallas, Austin and Houston remain among the highest in the country but have been easing of late. Growth in business services shows promise for eventually absorbing most of the vacant space. Dallas' recovery has been stalled a bit by significant space on the market and the number of new office projects. The threat caused by telecommuting seems to have receded, but the impact of foreign outsourcing is unclear.

Recovery in the retail property market is more advanced, having bottomed out in late 2001. Retail sales benefit from housing sales, as people buy furnishings for their new homes. New subdivisions often justify expansion of grocery stores and other outlets into new territories.

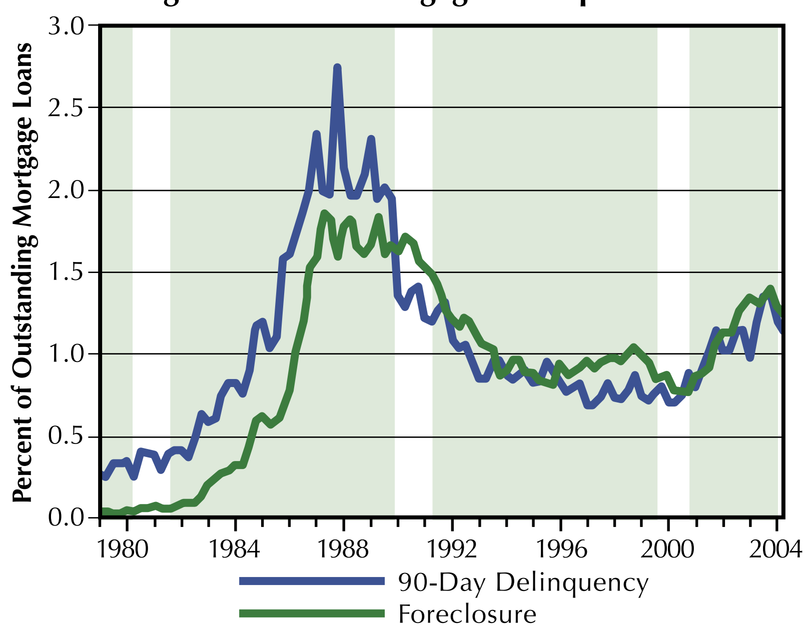
Border towns appear to be benefiting from an improved economy in Mexico, stimulating cross-border shopping. Improved trade boosts industrial properties, particularly warehouse and distribution facilities.

Despite the pervasive appeal of buying a home, rental apartment markets are likewise experiencing a mild recovery. Investment returns are back in positive territory, thanks primarily to stabilized property values. Rents remain soft, but capitalization rates are down from previous years. The long-term outlook for rental housing is favorable given the current low level of construction (except in some markets, such as Houston) and prospects that higher interest rates will limit the loss of tenants to homeownership.

Developments that could contribute to stronger property markets include:

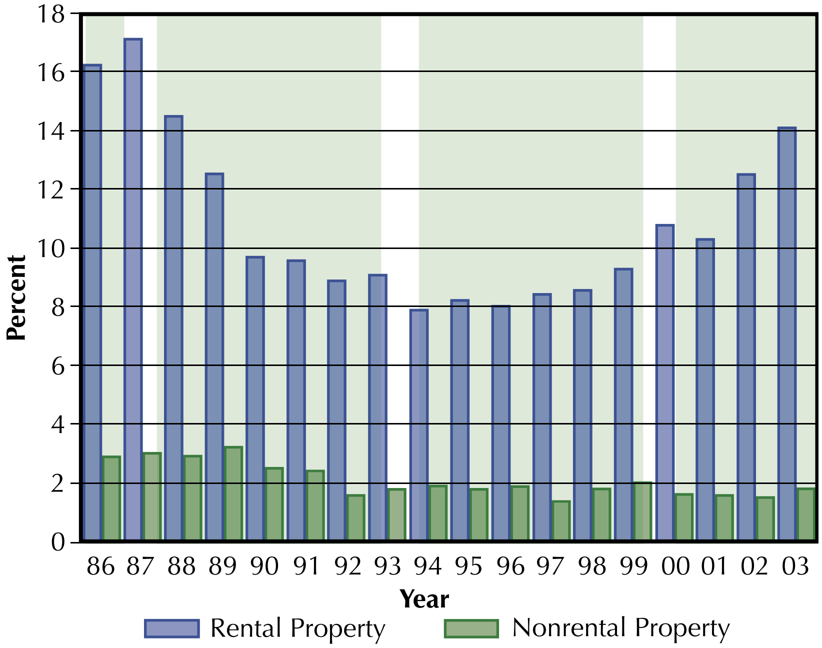
- a pickup in employment growth,
- recovering some jobs previously outsourced,
- a limited increase in interest rates and a decline in gasoline prices stimulating consumer spending and
- a slowing in home sales reflecting a return to renting as the low-cost housing option.

Figure 4. Texas Mortgage Delinquencies



Source: Mortgage Bankers Association

Figure 5. Texas Housing Vacancy Rates



Source: U.S. Census Bureau

Land Markets — Investment of Choice?

Rural land sales soared in 2003, and preliminary data indicate they were almost as strong in 2004. Average tract size on parcels sold continued to be well below the historical average. Recreation remains a prime motivation for these purchases. The search for a safe investment in a world of security concerns and limited expected returns on alternative investment assets could also be responsible.

Sales are spreading out from urban areas, indicating that most of the good tracts in convenient locations have been taken. Prices, adjusted for inflation, have been on a strong upward trend line since 1993, a run comparable to the land price boom of the early 1980s. Prospects are that this market dynamic will continue as long as a feeling of insecurity prevails and the stock market continues to deliver mediocre returns.

The year ahead promises to be another active and interesting year for Texas real estate markets.

Hottest Housing Markets 2004 (Estimated)

Rank	Market Area	MLS Sales per 1,000 People
1	Austin	16.3
2	Tyler	16.0
3	Houston	14.7
4	Abilene	14.5
5	Wichita Falls	14.3
6	Dallas	14.0
7	Amarillo	13.6
8	College Station-Bryan	13.5
9	San Angelo	13.2
10	Odessa-Midland	12.7

Source: Real Estate Center at Texas A&M University

Tightest Housing Markets (Oct. 2004)

Rank	Market Area	Months of MLS Inventory
1	Wichita Falls	4.5
2	Lubbock	4.6
3	Abilene	4.7
3	Odessa-Midland	4.7
3	Corpus Christi	4.7
6	Amarillo	4.9
7	Killeen-Fort Hood	5.0
8	Victoria	5.3
9	San Antonio	5.6
10	San Angelo	6.0

Source: Real Estate Center at Texas A&M University

Hot Home Building Markets (12-Month Total Through September 2004)

Rank	MSA	Single-Family Permits per 1,000 People
1	Brazoria	12.3
2	Galveston	11.5
3	McAllen	10.6
4	Austin	9.7
5	Houston	8.5
6	Brownsville-Harlingen	8.1
7	Fort Worth	8.1
8	Dallas	7.7
9	Laredo	7.3
10	San Antonio	6.8

Source: U.S. Census Bureau

Highest Home Appreciation Rates (Annual as of Third Quarter 2004)

Rank	MSA	Percentage Change in Market Value
1	Texarkana	9.4
2	Odessa	7.6
3	Tyler	7.1
4	El Paso	7.0
5	Corpus Christi	6.9
6	Abilene	6.6
7	San Angelo	6.5
8	Longview	6.5
9	San Antonio	6.2
10	Killeen-Temple	6.0

Source: Office of Federal Housing Enterprise Oversight

Housing Needs Projection

Are Texas homebuilders in danger of overshooting or falling short of the demand for new homes in the next several years? Here is the Center's projection of how many housing units need to be produced each year to accommodate the state's population in 2010. The 2010 population projection is based on continuation of the growth rate from 2000 to 2003. Housing needs are projected on the following assumptions:

- homeownership rate will continue to increase,
- household size will be mostly unchanged for owner-occupied homes,
- household size will increase somewhat for rental housing and
- vacancy rates will fall slightly.

Actual and Projected Housing, 2004–2010
(Numbers expressed in average number of housing units per year.)

	1990–2000 (Actual)	2000–2003 (Actual)	2004–2010 (Projected Need)
Population added per year	387,000	388,000	405,000
Single-family completions per year	111,900	186,400	101,500
Multifamily completions per year	29,000	38,800	39,000
Manufactured home placements per year	26,100	19,700	14,400

Source: Real Estate Center at Texas A&M University

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