

A Reprint from *Tierra Grande*

HOUSING'S PERFECT STORM

BY JAMES P. GAINES

Most residential real estate prognosticators, including the Real Estate Center staff, project a fairly optimistic outlook for residential real estate in 2006. Those who venture such guesses estimate that while the national market may slow in sales and rates of appreciation, no major disruptions will cause concern.

- Home builders continue the high level of residential construction?
- Interest rate increases, general economic slowdown or both cause investors, first-time buyers and move-ups to decline, leading to reduced housing sales activity and slower appreciation?
- Lenders reduce or stop offering attractive, nontraditional mortgage loans with high loan-to-value ratios and below-market introductory rates to qualify purchasers?

None of these gloomy conditions are projected to occur individually, much less all at the same time. As things are today, the housing market could probably continue more or less on its current path if any one or even two of these events occurred. But should all these events happen at the same time, the housing market could be in for a shock. The combination could produce housing's "perfect storm."

Economic Slowdown or Shallow Recession

Expectations for 2006 are for continuation of a fairly robust overall economy with moderate-to-good job growth and sustained business productivity. Corporate profits are up; the stock market closed up for 2005, and small businesses' prospects are positive. For now, there are no heavy clouds suggesting an economic slowdown or recession, but there may be a few wisps on the horizon.

During the first week of January 2006, the yield curve turned upside-down (that is, the rate on ten-year treasuries was lower

than the rate for one-year treasuries, Figure 1). This condition often precedes an economic slowdown or recession.

The differences so far have been small — just a few basis points. But observers continue to monitor the Federal Reserve interest rate and monetary policies looking for fundamental changes in trends. Energy prices continue to cause concerns, not only for the price of gasoline at the pump but also for heating oil and diesel, all of which affect home, business and transportation costs.

Other possible clouds on the horizon include the loss of manufacturing jobs announced by several major industrial giants, including General Motors and Ford. Manufacturing as well as professional service jobs are being "offshored" by U.S. companies to take advantage of labor cost differentials in other countries.

What these factors portend for the near term is unclear, but the economy is expected to evolve from an information-based economy successfully. One-fourth of the workers today are in occupations that were not even listed by the Census Bureau in 1967. New ideas, new products and entirely new businesses will form the foundation of the economy for the longer term.

Higher Interest Rates

The biggest single influence on the housing market for the past three years has been historically low mortgage interest rates that have prevailed not only in the United States but around the globe as well. Low rates encouraged people who

were renters to become homeowners and enabled existing homeowners to sell and move up to higher-priced, larger housing with more amenities. The low rates allowed homeowners to refinance their properties, thereby converting home equity into tax-free, disposable capital, and made acquiring a second or vacation home a practical alternative. Lower rates attracted vast quantities of capital, both debt and equity, to the housing sector.

All of these activities contributed significantly to the overall economy and to the housing boom. The question is, what will happen to the housing market as mortgage interest rates rise from their historically low point? And how high will rates have to go before a significant impact is felt?

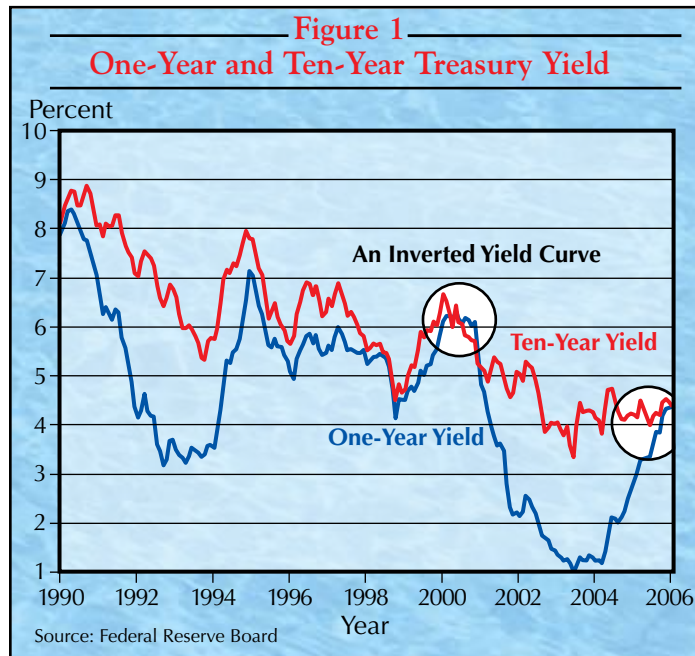
Most projections for mortgage interest rates this year anticipate the 30-year fixed rate to stay below 7 percent. The Federal Reserve is expected to discontinue its regular increases in short-term rates during the year as inflation fears stabilize. Although the U.S. savings rate remains effectively zero, foreign savings and investment in U.S. debt remain sufficient to keep rates from increasing much more. If these expectations hold, mortgage rates should continue to be attractive to the market.

A small increase in the rate will primarily affect buyers at the margins of the different housing price levels. A 7 percent rate is still well below what the housing market bore throughout the 1990s and considerably lower than prevailing rates in the 1980s (Figure 2).

New Home Construction

Home prices in Texas have not experienced the high rates of appreciation seen in other areas primarily because home building has kept pace with demand to keep the housing supply in relative balance. Affordable, developable land continues to be available with minimum interference or added costs from local regulatory controls.

Residential construction costs have not escalated beyond normal increases in labor and material costs. And while much of the new construction has been middle- to high-price housing, housing transactions at each price level have been adequately active, all the way down to entry-level housing. If



that investor-rental home sales account for about 23 percent of the market, and vacation or second homes equal about 13 percent (Figure 3).

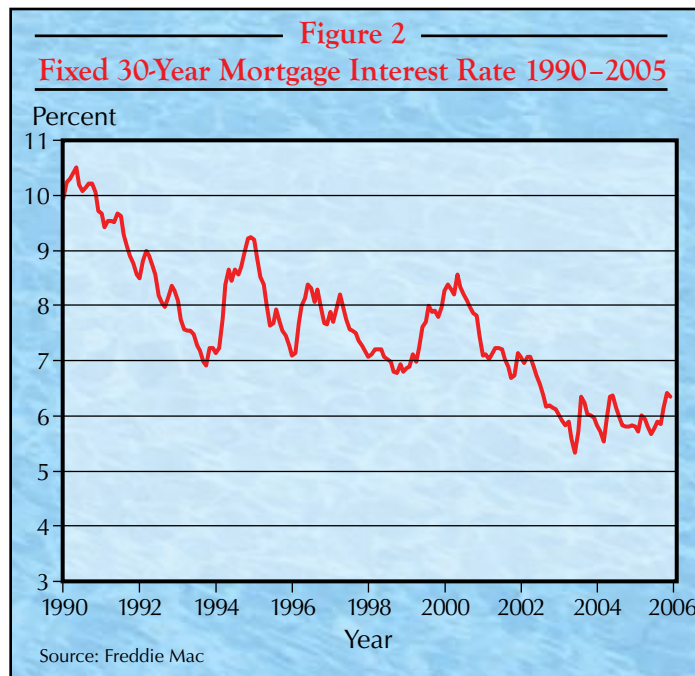
A significant number of out-of-state investors have come to Texas to buy homes, either to hold and sell or rent and sell. Demand from this source can increase prices and decrease inventory stock and time on the market. So far, the level of investor demand has had little to no major influence on either prices or inventory except for a few specific areas or developments.

demand for housing within any price level along the overall chain is weak, the market's ability to expand is constrained.

Texas residential construction had two of its best years in 2004 and 2005. Home builders report planning new construction for 2006 at about the same level as 2005, in spite of slightly higher interest rates. Annual permits for new, single-family dwellings statewide increased approximately 11 percent in 2005 over 2004 levels.

Changes in Investor, Buyer Activity

Current National Association of Realtors (NAR) data indicate



Little hard data are available to measure the consequences of outside investors on Texas' housing market. Estimated impacts are based on anecdotal reports by agents and builders in specific market locales such as El Paso, Austin and the Dallas suburbs, where as much as 25 percent of sales are to investors. Several builders are refusing to sell new homes to investors to prevent their developments from becoming rental communities.

Vacation home sales are mostly second-home purchases.

A great many of these nationally are condominiums in resort areas bought by purchasers who live in other states. Investor-rental and vacation/second-home sales reflect the growing interest in buying houses for investment, to take advantage of the housing boom and lack of attractive yields from the stock and commodities markets. Second-home investment has been significant in the Hill Country, Texas resort areas and along the coast from South Padre Island all the way to Texas City.

Galveston, for example, is experiencing a significant condo boom.

Primary home sales reflect a healthy number of first-time homebuyers leaving the rental market plus move-up buyers and transfers moving from one place to another — in other words, the “normal” homebuying market. Some former renters are fulfilling long-standing desires to own their own homes, while others are making economic choices to acquire equal or better housing at equal or lower monthly costs.

Some buyers are new households just entering the housing market. Evidence of the activity level can be seen in the increase in homeownership rates nationally and in local markets. The national homeownership rate exceeded 69 percent in 2005, up from 66 percent in 2000. In the southern region, the homeownership rate is greater than 70 percent.

Interest rates and easy credit (easier qualifying and lower down payment requirements) provide opportunities to existing homeowners to sell their current properties and buy bigger, better or more expensive homes. Cashing in on built-up equity provides large down payments, spendable income or both. Lower interest rates allow buyers to qualify for higher-priced homes, even if income has not increased a great deal.

Because the refinancing crush has worked its way through the market, the consumption spending that derived from homeowners monetizing their home equity is expected to disappear. However, a growing number of homebuyers who used adjustable rate financing during the past several years are electing to refinance to fixed-rate loans before their adjustments kick in at higher rates.

Credit Terms, Qualifying, Underwriting Changes

In December 2005, the principal financial oversight agencies (Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration) posted joint proposed guidance measures for “nontraditional mortgage products.” These measures are under review for public comments and

suggestions before becoming official guidelines. This effort is targeting mortgage loans including “interest only” and “payment option” adjustable-rate mortgages (negative amortization loans), especially those combined with simultaneous second liens or reduced documentation for evaluating an applicant’s creditworthiness.

Concern focuses on the level of risk lenders carry on these loans and the fact that the loans are being extended to sub-prime borrowers — those who might not be financially qualified and may not understand their potential obligations.

The guidance document specifies that institutions providing these kinds of loan products may be subject to criticism, corrective measures and higher capital and loan-loss reserves. It seems clear that mortgage lenders may change their lending practices and loan-approval standards.

High-risk mortgage loans are most prevalent in California and other “hot” housing markets where housing prices greatly exceed local area incomes. They have not been widespread in Texas. In fact, many Texas lenders report that they either do not offer the products or discourage borrowers from using them.

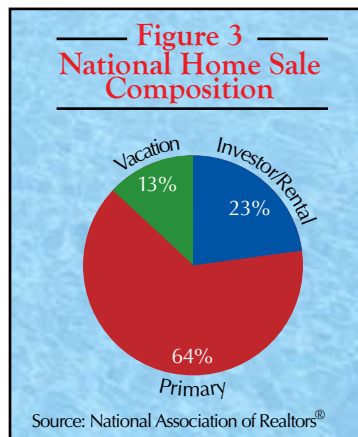
Nevertheless, changes in mortgage credit underwriting and qualifying procedures may tighten during the coming year. So-called “low doc” and “no doc” loans with high loan-to-value ratios can be expected to become harder to qualify for and more limited in availability. Loan under-

writing changes in Texas will primarily affect marginal buyers: people trying to buy higher-priced houses than they can really afford or entry-level, first-time buyers coming into the market with weak credit records or little capital for down payments.

The Texas housing market is expected to perform this year more or less the same as it did in 2005. A “perfect storm” scenario is highly unlikely. Texas continues to enjoy sustained job growth and general economic prosperity. Income is increasing and many businesses look at the state as a land of opportunity for relocation, expansion and development.

But sometimes, it’s hard to resist wondering, “what if ...”

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Home as Investment — Then and Now

Ten years ago a family making \$70,000 bought a home for \$175,000 (2.5 times annual income) with a 7.5 percent, 30-year fixed rate mortgage and a \$35,000 down payment (20 percent). Current balance on the loan is \$121,513.

Today, they sell the house for \$245,000 (average 4 percent per year increase over ten years) with a net price after costs-of-

sale of \$225,400. The net gain on the sale is \$103,887 (\$225,400-\$121,513).

The family’s current income is \$85,000 (average 2.15 percent per year increase). The interest rate on a 5/1 ARM loan is 5.77 percent.

The family could qualify for a loan of roughly \$300,000. Using all of the gain from the sale of their home for a

down payment, the family could buy a \$403,887 home — that is, a new home nearly 2.4 times the value of the home they bought ten years earlier.

As an alternative, they could save, invest or spend \$50,000 from the sale of the original home, using the rest of the gain (\$53,887) as a 15 percent down payment on a home valued up to \$353,887.



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