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SLOWING BUT GROWING

U.S., Texas Economies Strong Despite Challenges

By Center Research Staff

The U.S. economy continued to expand at a robust pace in 2006 despite numerous obstacles: Katrina's aftermath, Federal Reserve rate hikes, rising oil prices, the war on terrorism, outsourcing, galloping globalization and corporate corruption.

Real gross domestic product (GDP) increased at an annual rate of 5.6 percent in the first quarter, 2.6 percent in the second quarter, and 2.2 percent in third quarter 2006, according to the Bureau of Economic Analysis. The job growth rate was much smaller than output growth rate because of increased factor productivity.

U.S. total nonfarm employment increased by 1.5 percent from September 2005 to September 2006, according to the Bureau of Labor Statistics. Over the same period, productivity in the U.S. business sector rose by 1.5 percent.

Economies Cooling, Still Growing

After 16 rate hikes since May 2004, the Fed decided in August 2006 to keep its target for the federal funds rate unchanged at 5.25 percent. The Fed's decision was based on the expectation that the gradual cooling of the U.S. economy would contain inflation pressures in 2006 and 2007. According to the Survey of Professional Forecasters compiled by the Federal Reserve Bank of St. Louis, the U.S. economy was expected to grow 3.4 percent in 2006.

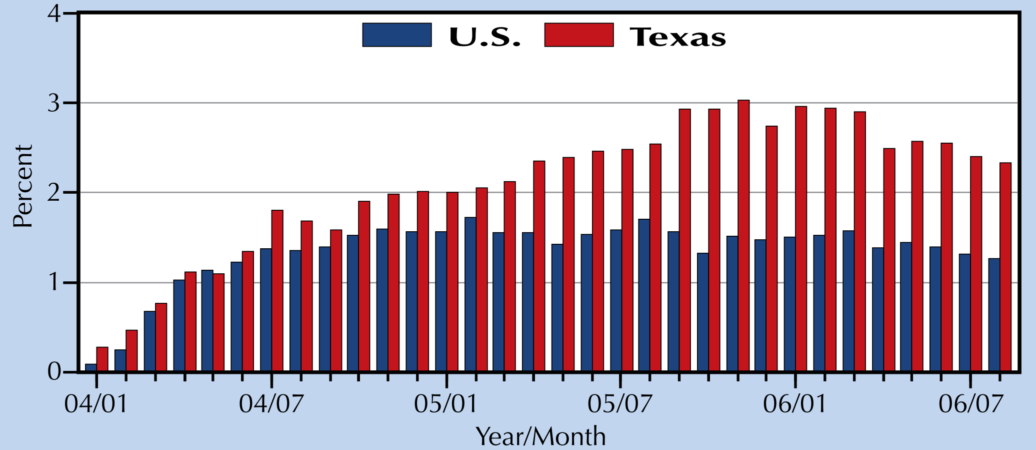
Expectations of lower interest rates, lower energy prices, a continued strong economic growth rate and corporate profits are influencing the stock market. More than six years after its peak of 11,750.28 in January 2000, the stock market set a new record in October 2006.

In 2006, the Texas economy posted higher growth rates of both output and income, coupled with strong job gains. The state accounted for 7.4 percent of total U.S. personal income in second quarter 2006 and ranked second in total income growth rate after Nevada. Since June 2004, Texas total nonfarm employment growth has been outpacing the United States, and from October 2005 to October 2006 it rose 2.2 percent compared with 1.4 percent for the United States (Figure 1).

Texas Business Strong

The higher-than-national-average growth rate was the result of favorable business conditions in Texas. The state ranked second on *Forbes'* list of best states for doing business. The growing importance of Texas to the U.S. economy is reflected in the

Figure 1. Nonfarm Employment Growth Rates, United States and Texas, 2004–06

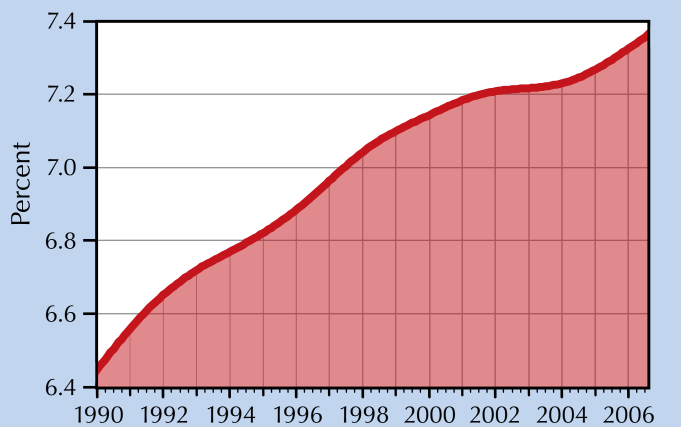


Source: Texas Workforce Commission

percentage of U.S. nonfarm employment accounted for by the state — 6.5 percent in July 1990, 7.2 percent in July 2001 and 7.4 percent in July 2006 (Figure 2).

Texas is a major player in international trade and has ranked first in export revenue since 2002, exporting computer and electronic products, chemicals, petroleum products, machinery and transportation equipment. Recipients include Canada, Mexico, Asia and Pacific Rim countries.

Figure 2. Texas Nonfarm Employment as Percentage of U.S. Nonfarm Employment



Source: Texas Workforce Commission

Laredo, McAllen-Edinburg-Mission, and Midland had the highest employment growth rates among 26 Texas metro areas for most of 2006. Employment growth rates in Austin–Round Rock, Houston–Sugar Land–Baytown, and Dallas-Plano-Irving have been higher than the state average. Midland, Amarillo and Austin–Round Rock had the lowest unemployment rates.

The Texas economy is cooling, as is the nation's, but it is expected to maintain its current growth pace in 2007, about 1 percent above the national average. Employment growth of more than 2 percent should make the 2007 job outlook the best since the beginning of the millennium. The bulk of jobs are expected to be created in professional and business services, education and health services, financial services, trade, leisure and hospitality, and construction. The government sector is expected to gain more jobs despite a recent slowdown.

Commercial Market Overview

The Lone Star State was on every commercial real estate investor's short list in 2006 because of its continued economic strength. Texas has become increasingly successful at luring businesses from other parts of the country, thus boosting two factors critical to the success of commercial real estate markets: job growth and population growth. This bodes well for the state in 2007, as investors should continue to add Texas real estate assets to their portfolios.

Office markets improved statewide during 2006, with positive absorption and rent growth almost across the board. With the torrid pace of construction cost increases finally beginning to slow, potential for oversupply in some markets is a concern. Austin's barriers to new development should give it the strongest income growth in 2007; other cities' rates should continue to improve at a slower pace.

In the retail market, the big question is whether consumers will kick their spending habits. Recent history shows that spending is a hard habit for consumers to break, and tax laws still favor spending over saving. Texas retail developers will continue to pour in new supply with a vengeance through 2007, with attractive new space in convenient locations pulling many desirable tenants away from older centers.

The apartment market has improved steadily, with concessions largely disappearing in Texas cities. However, a substantial amount of product is in the pipeline for 2007. Luckily, the echo boomers (children of the baby boomers) are increasing the pool of potential renters. This group has taken a shine to amenities and will demand more of them than their parents did.

The global economy continues to affect industrial property development in Texas. With the run-up in fuel prices and the manufacturing shift to Asia, the warehouse-distribution sector is becoming more dependent on transportation considerations. Port cities such as Houston are the big beneficiaries, but "inland ports" such as Alliance also will benefit as intermodal rail terminals handle more freight.

Look for more Asian trade to funnel through Texas via Mexico in 2007, providing an alternative U.S. route around the busy West Coast ports.

Commercial real estate investors now realize that the days of falling cap rates and easy appreciation gains are over. Commercial properties will have to show improved operating performance in the coming months to justify heady purchase prices.

Higher utilities, insurance costs and property taxes continue to drive expenses through the roof, raising the bar for adequate income attainment in 2007. Even so, those in Texas commercial real estate will enjoy a better economic environment than most other states.

Housing Overview

Nationally, the housing market has come down from the lofty peaks of record sales and new home construction figures of the past three years. National statistics continue to be dominated by the same East and West Coast states that experienced the greatest boom during that time. Now, however, home sales, new construction and home prices are increasing at significantly lower rates. In California, Florida, Oregon and Virginia, they are even declining.

Texas' housing market during the first half of 2006, on the other hand, continued to forge ahead of 2005 levels in all major categories. While some local markets may experience a slight decline during the second half of 2006, final totals should show major housing market statistics to be ahead of 2005.

Sales: Down Nationally, Robust in Texas

Through second quarter 2006, total existing-home sales nationally were down by about 7 percent; September 2006 sales were 14.2 percent below September 2005. The National Association of Realtors (NAR) reported 7.3 months inventory of existing homes for sale in September 2006 compared to 4.6 months a year earlier.

In Texas, sales reported through the state's Multiple Listing Services (MLS) continued strong. On a cumulative basis, sales through August 2006 were 8.1 percent ahead of 2005, and year-end total sales were projected to be about 8.5 percent greater.

Total reported sales show just how robust the transactions market has been for the past several years. Total 2000–05 Texas MLS sales of 1,309,922 equaled the 1990–99 total. Texas averaged 109,102 sales annually from 1990 to 1994 and 152,207 from 1995 to 1999.

Between 2000 and 2004, total Texas residential sales jumped to a reported 1,043,661, an average of 208,732 per year. In 2005, residential sales totaled 266,506. Some 288,500 are estimated to occur in 2006.

Construction: Signs of Slowing?

Single-family home construction in Texas continues at a healthy pace, unlike the national trend, but there are signs of slowing. Nationally, new home starts were down 27.4 percent in October 2006 compared with October 2005. New home sales were down more than 20 percent for the same period. The National Association of Home Builders reported a 6.5-month inventory of unsold new homes.

Single-family residential permits have increased by 10 percent annually for the past two years, and 2006 permits were running somewhat ahead of the 2005 pace.

Construction costs also are increasing across the state, having an impact on many homebuying decisions. Labor and materials costs are higher than in previous years, in part because of lumber shortages and the added pressure of Hurricane Katrina costs. Land and land development costs are rising, too. This trend most certainly will continue, especially as Texas land markets continue to spur rapid price increases.

Overbuilding and excess inventory of new homes are principal concerns in some local markets. Trends in the new home market so far are favorable, but if sales and demand fall even slightly, local builders could face a substantially longer marketing period. Already, some builders are offering incentives to enhance sales.

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Home Price Appreciation: U.S. Down, Texas Up

For the first time since April 1995, the national median price of a home fell on a year-over-year basis in August 2006. The median-priced home (all types) reported by NAR in August 2006 was $225,000, down 1.7 percent from a year earlier. During the same year, the median price of a single-family dwelling also fell by 1.7 percent to $227,500. Contrary to the national trend, the August-to-August median price of a home in Texas increased 4.8 percent to $145,900.

***NATIONALLY, HOME SALES** came down off the record-breaking mountain of the past three years. In Texas, however, builders continued to build and people continued to buy. Increasing construction costs and land development costs may slow things down in 2007.*

TEXAS' MULTIFAMILY MARKET *improved in 2006, but with new units coming online in 2007, property owners will be looking to baby boomers' kids to expand the pool of potential renters. Amenities of all kinds will attract this group.*

The Office of Federal Housing Enterprise Oversight reported a 10.1 percent annual rate of increase in home prices for second quarter 2006, but the 1.2 percent quarterly increase was the lowest since fourth quarter 1999. Meanwhile, Texas home prices increased by a 6.45 percent annual rate, and the quarterly rise was a solid 1.93 percent.

Foreclosures: Texas Among Leading States

After falling slightly in 2005, the number of Texas residential foreclosures was expected to be among the highest in the nation in 2006. Ohio, Michigan, Indiana and Illinois had foreclosure numbers comparable to Texas thanks primarily to the failing automotive industry and resulting layoffs in those states. After numbering 25,649 in 2005, final Texas foreclosures are projected to be around 32,000 for 2006.

One sign of weakness in the housing market is residential mortgage delinquency rates, which are higher in Texas than nationally. Mortgage loans 90 days past due have ratcheted up in Texas to nearly 2 percent. Federal Housing Administration loans — loans up to $200,000 that have smaller down payments and are available to lower-income households — have an even higher 90-days-past-due percentage (4.3 percent).

Home Financing, Interest Rates: Peaked for Now?

The Federal Home Loan Mortgage Corporation's mortgage interest rate should see modest changes in either direction for most of 2007, barring any unforeseen economic crisis or a change in the Fed's stance on rate increases and inflation. Fed funds rate increases over the past two years have been incorporated into the mortgage market, and fluctuations now appear to be more a function of national and international capital market activity.

A potentially significant effect in the residential marketplace may result from the high volume of adjustable rate mortgages (ARMs) resetting in late 2006, 2007 and 2008. The rate adjustment process may prove a hard hit for subprime borrowers and others who purchased homes with well-below-market introductory rates. The impact of ARMs is already reflected in the fact that nearly 50 percent of recent new loan applications are to refinance existing ARMs.

Housing Affordability: Texas Remains a Bargain

Homeownership remains significantly more affordable in Texas than in the nation as a whole. Second-quarter 2006 data indicate an affordability index of 1.50 for Texas compared with 1.06 for the nation. This means that a Texas family earning the median household income has 150 percent of the income required to qualify to purchase the median-priced home. Nationally, a family earning the U.S. median income has 106 percent of the income required to purchase a median-priced home. Both rates have declined over the past several years.

Texas' relative affordability is further underscored by comparing the national median home price of $227,500 with the state's median price of $146,200 (36 percent less).

Housing affordability is becoming a major economic development factor, especially in California, Florida and New England. Local and state development officials in the high-priced East Coast and West Coast states report difficulty in attracting business relocations and retaining companies already there. The high cost of housing — specifically, the lack of affordable housing for working households — is a key factor.

What to Expect in 2007

- A general economic slowdown will affect overall employment and real estate demand.
- Inflation worries will cause the Fed to reinstitute rate increases.
- Capital will flow back to the stock and bond markets and out of the real estate market, making financing more expensive and less available.
- Overbuilding will occur in many local housing markets already showing signs of too much construction and excess inventory.

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