



# Texas Two-Step

## Looking Back, Moving Forward

By Research Staff

**T**he mild recession is ending, and now the economy should be getting back on track," announces the ever-optimistic television economist. Comments such as these raise a number of questions.

If there was a recession, why did the housing market hit record sales volume? Will recovery mean even higher levels of sales? If the economy is recovering, why is employment growth still negative (Figure 1)?

Despite the fact that housing markets have been flourishing during the economic slowdown, a strong economy is important to the vigor of the real estate markets. Growth means an expanding population, increased business activity and the resulting need for homes and commercial space. It means higher income and the confidence to make financial commitments. The research staff of the Center offers this review of economic trends, and highlights the developments likely to affect the real estate industry this year.

### Looking for Signs of Recovery

Based on employment figures, Texas and the nation fell into recession (meaning that fewer people were employed) in late 2001 and had not yet recovered by September 2002. By fall 2002, the decline in job growth was slowing, suggesting that the worst had passed, and the economy was building a foundation for renewed growth.

For the past several years, the Texas economy consistently outperformed the U.S. economy. When U.S. job growth was positive, job growth in Texas grew faster than the national rate. When national job growth was negative, Texas' job growth rate declined at a slower rate. However, that changed in summer 2002 when, compared with the U.S. rate, the rate of job loss in Texas was higher in July, August and September. This may signal a slow recovery for the state's economy.

Gazing into the economic crystal ball crafted from the lessons of market cycles past reveals a cloudy picture of the year ahead. The most likely scenario for 2003 is a slow recovery that when plotted on a graph looks more like a wide "U" rather than the sharp "V" that most of us would like to see. Some sectors of the economy will continue to shrink and consolidate. Even this modest expectation could be jeopardized by several key developments.

**War.** Where will President Bush take the war on terrorism? Will there be an invasion of Iraq? The economy may get a boost from military spending, but the cost of security measures and reduced spending from fear of terrorism will have a greater effect.

Expectations are that a war will be short, and any associated oil price spike will be temporary. But there is a risk the war will drag on, causing a sustained increase in the cost of oil. That would result in a slowing of industrial production and

would end the current era of low inflation. Some feel that uncertainty over whether the United States will invade Iraq is stalling the recovery, and the economy will begin moving once the invasion question is answered.

**Shortfall in state revenues.** Owing to a drop in consumer spending, state tax revenue will not meet expectations, resulting in budget cutbacks and, possibly, tax increases. Scaling back spending means that certain programs may lose federal matching funds.

A legislature hunting for ways to raise revenue is always a threat. Local governments are not exempt from the shortfall and have fewer options for boosting revenue. Texas property taxes are already high relative to many states, and increases will have implications for housing affordability.

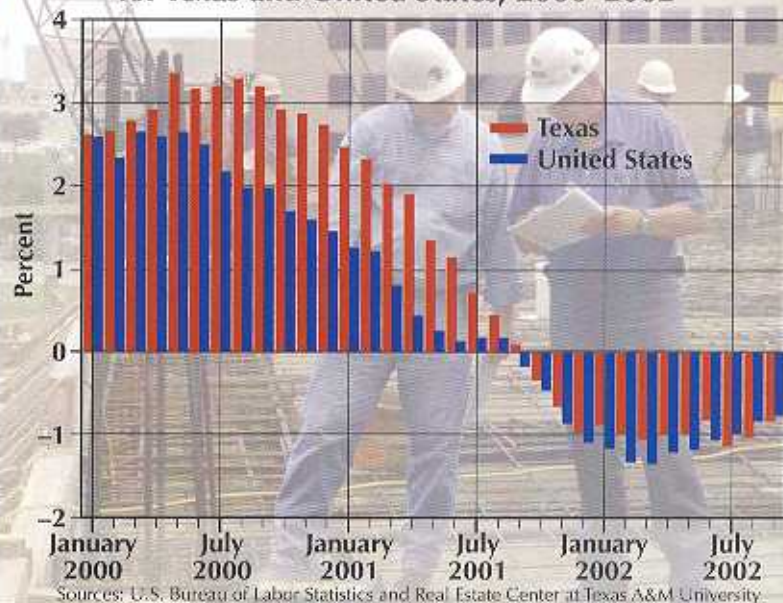
**Mexico's economy.** Texans can never be oblivious to their southern neighbors. Texas border cities are probably more affected by the Mexican economy than by that of the United States. Hopes for a more prosperous future were kindled when Mexico elected President Vicente Fox, but time has shown that problems are more entrenched than many thought. Further, Mexico has new worries, including the possible loss of manufacturing jobs to China and an impending tax on foreign firms operating in the country.

**Interest rates.** Low mortgage interest rates have been a major stimulus to the housing market. Refinancing allows homeowners to lower their monthly payments and take equity out of their homes, thus stimulating consumer spending. If rates rise, the refinancing boom will end, and some would-be homebuyers will be priced out of the market.

**The Federal Reserve.** When the Fed was cutting rates, many expected the economy to rally, but not much happened. The Fed is not likely to cut beyond its half-percentage point cut last November, given its bias against the threat of inflation. If the recovery picks up, it may even begin to raise rates.

**Small business growth.** The bulk of new employment is produced by small, independent firms. Texas ranks third on a

**Figure 1. Nonfarm Employment Growth Rates for Texas and United States, 2000–2002**



list of best places to start a business compiled by Microsoft's bCentral website. The ranking considers taxes, business costs, crime rates, labor laws and government restrictions. The state was fourth on a similar ranking conducted by the Small Business Survival Committee. Whether or not Texas can maintain these favorable rankings is a key question.

### Slowly Leaking Bubble

**H**ousing booms do not last. This may come as a shock to licensees who entered the real estate business in the last few years. On the other hand, fears of a replay of the 1980s debacle are unfounded, as sales could scale back significantly and still be at historically high levels.

The estimated 190,000 sales through the state's reporting Multiple Listing Services in 2002 represent a 50 percent increase in sales over the mid-1990s. During the worst years of the 1980s, total sales fell by only 15 percent in any one year.

Despite talk of housing "bubbles," there is little speculative premium to be wrung out of housing prices. Mortgage interest rates could rise one or two percentage points and homes would still remain affordable. Even if the economic recovery is not vigorous, it should prevent the type of market collapse induced by the oil industry's downfall in the 1980s.

Sales figures are highly seasonal, but comparing peaks shows a significant slowdown in 2002. The year began at record pace but ran into trouble during the summer. Note, however, that the last few years were boosted by increases in the off-season months rather than higher sales during the summer. The end of that pattern could signal a slow winding down of sales to a more sustainable level somewhat lower than the most recent peak.

Building shows no signs of slowing and may not, even if sales decline. Builders have been hampered by shortages of various supplies (concrete, dry wall) and are responding to perceived backlogs in demand.

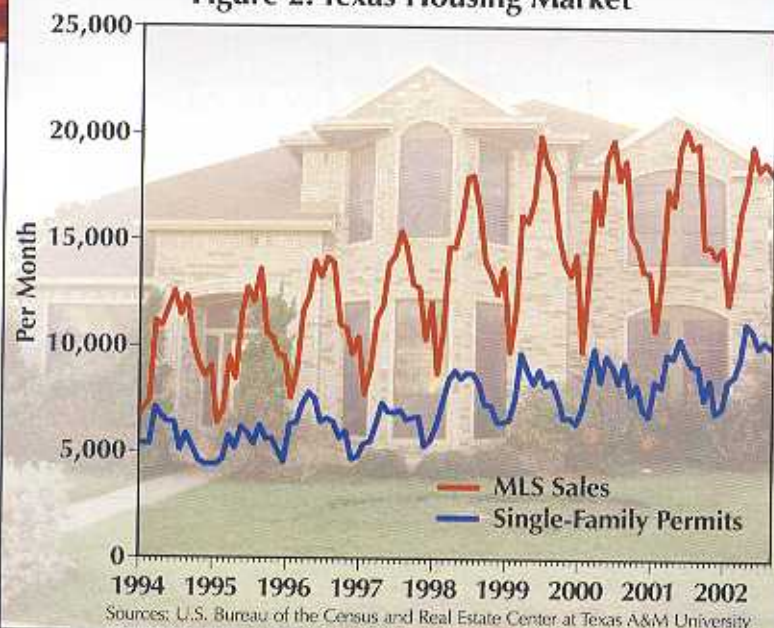
The possibility of a price bubble — or, more accurately, a price "spike" — became apparent in mid-2000 (Figure 3). At one point, the median price of homes rose almost 14 percent

**Ten Fastest Growing Economies in Texas, Based on Growth Rate of Nonfarm Employment August 2001–August 2002**

Rank	Metro Area	Growth Rate (percent)
1	McAllen-Edinburg-Mission	3.5
2	Laredo	2.6
3	Tyler	1.1
4	Brazoria	0.8
5	Lubbock	0.7
5	San Angelo	0.7
7	Killeen-Temple	0.1
8	Corpus Christi	-0.1
8	Houston	-0.1
10	Brownsville-Harlingen	-0.2
10	Austin-San Marcos	-0.2
10	Odessa-Midland	-0.2

Source: Texas Workforce Commission

Figure 2. Texas Housing Market



above the same-month-last-year amount. Since then, however, price increases have fallen to the 3 percent range or slightly more than the rate of inflation.

Bubbles usually do not fizzle out; they burst in a rapid decline in prices. The brief price run-up looks more like a classic sellers' market — steady demand combined with lower supply. The markets have corrected for this imbalance. Since mid-2001, inventories have increased. MLSs now have a six-month supply of active listings.

Much of the media's concern about price bubbles centers on affordability. News coverage may imply that housing prices should advance in line with household incomes, and lately they have been rising much faster. In some areas, prices have increased two to three times faster than income. The implication is that prices eventually will fall into alignment with income. Falling interest rates have deflected the impact of price increases on buyers. As long as rates stay low, prices do not seem so out of line.

Many factors point to slower market activity. Consider these developments.

Increase in Median Home Prices and Median Household Incomes 1998 to 2002 (Second Quarter)

Metro Area	Price Change (percent)	Income Growth (percent)
Houston	36.2	18.1
Austin	33.8	16.0
Bryan-College Station	31.8	9.5
Dallas	23.1	10.7
San Antonio	21.3	3.4
Lubbock	18.7	8.4
Tyler	18.3	10.6
El Paso	16.4	8.6
Amarillo	14.2	10.2
Wichita Falls	12.8	7.1

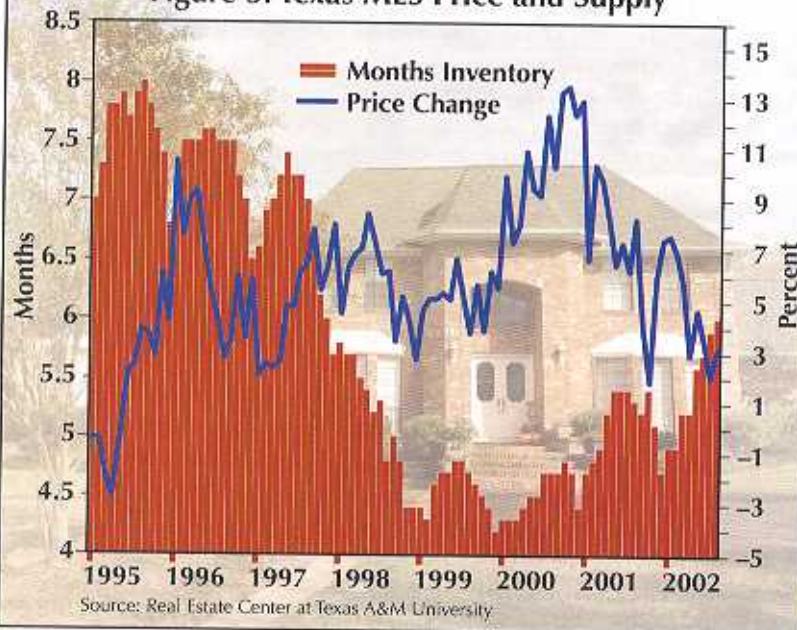
Source: Real Estate Center at Texas A&M University

**Probability of rising mortgage interest rates.** Though it is unlikely the Federal Reserve Board will cut the federal funds rate further, that is not why interest rates most likely have bottomed. Rates are low because of how much money flowed from the stock market into bond markets, sending all interest rates downward. If stocks become more attractive, that flow will reverse.

**Slow economic recovery, especially in employment.** Job creation is critical to attracting new residents and giving renters the confidence to become homeowners. And these two groups are essential to maintaining repeat sales. If interest rates rise, homeowners will no longer be able to effectively derive income from refinancing their homes.

**Some retrenchment among providers of low down payment mortgage loans.** Making it easy for first-time buyers to make the transition to homeownership is key

Figure 3. Texas MLS Price and Supply



to expanding the market. However, the rising risk level represented by these loans is showing up in higher delinquency and foreclosure rates.

Some have raised alarms over what they view as the highest delinquency rates in a decade, though the Mortgage Bankers Association of America considers the rates consistent with current unemployment levels. Loan performance should improve with the economy, but if this does not occur, mortgage credit may become tighter.

The mortgage industry can draw lessons from recent experiences of manufactured housing lenders. Defaults and foreclosures have caused major disruption in the new manufactured home market, forcing lenders and home suppliers out of the market.

**Eroding affordability.** Home prices have risen, and the overall cost of owning a home also has escalated to an unusual degree. As prices rise, so do property taxes, a problem that is compounded by the relatively high Texas property tax rates.

### SOUNDS OF NAIL GUNS

and power saws filled the air as builders did their best to supply eager throngs of Texans with new homes. Sales slowed as the year progressed, but low-interest mortgage loans kept overall sales at record highs.



The cost of homeowners insurance is a growing concern. Large casualty losses combined with negative investment returns are pressuring insurance companies to raise rates dramatically. Lenders consider taxes and insurance when qualifying borrowers for mortgage loans. Therefore, fewer buyers will be able to buy homes, even if they are willing to pay the higher costs.

**Insurance availability.** In some cases, insurance may not be available even at a much higher cost. The state's major insurers have either stopped or restricted the writing of new homeowners policies. Some have refused to renew existing policies if the policyholder has a history of claims.

**A** poll by the Texas Association of Realtors shows almost all responding agents think that getting insurance is harder now than in the past. Because mortgage lenders require insurance coverage as a condition for making loans, a shortage of insurance could severely cripple the housing market.

It is highly unlikely that home sales could continue at the level of the last few years. However, with only a mild rise in interest rates, no major increase in foreclosures and a resolution of the insurance situation, the market can settle into a sales level that can be sustained for years.

The outlook for new construction is more restrictive. If the State Data Center's forecast for slower population growth is right, look for single-family production to decline from the record output of recent years.

### Investment Property: Waiting for Turnaround

**G**iven the state of the economy, it is no surprise that commercial markets are at a low ebb. According to the market cycle analysis reported by Legg Mason Wood Walker, Inc., most property markets across the country are either in the late stages of recession or early recovery. That translates to occupancies and rents well below equilibrium. Look for renewed vigor only after the economy has begun to expand, and the need for more space becomes apparent.

**Office markets.** These markets reflect the economy fairly closely. Nationwide, the vacancy rate is 16 percent. High-tech dominated localities have been especially hard hit. Austin and Dallas recorded sharp increases in vacancies and now exceed 20 percent. Any uptick in demand will only serve to reduce the pressure from a stream of new stock poised to come online in the next several years.

It will take a return to positive employment growth to help these markets. Small business creates about 70 percent of all new jobs, so those properties that can serve the needs of small companies and start-ups should be in the best position for recovery.

A few years ago, much was made of the trend toward telecommuting and its impact on demand for office space. However, telecommuting does not appear to be a factor in today's

weakened demand. Companies simply do not need as much space to handle their reduced business. When growth returns and companies begin to invest, employ and expand, demand for office space will rise.

The availability and cost of commercial property insurance is one problem that could delay market recovery. With insurance companies hypersensitive to risk and looking to raise revenues, expansion may come with a higher price tag.

**Apartment markets.** Rental housing is not as dependent on a good

Major Texas Office Markets

Area	Rent per Square Foot	Trend	Occupancy (percent)	Prognosis	Cycle Phase*
Austin	\$25	Down	83	Down	Late recession
Dallas	\$20	Down	86	Flat	Late recession
Fort Worth	\$17	Down	84	Flat	Late recession
Houston	\$20	Slightly down	85	Flat	Late recession
San Antonio	\$17	Flat	83	Up	Late recession

\*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: Reis; Legg Mason Wood Walker, Inc.

### Major Texas Apartment Markets

Area	Rent per Month	Trend	Occupancy (percent)	Prognosis	Cycle Phase*
Austin	\$800	Flat	91	Flat	Late recession
Dallas	\$740	Flat	92	Flat	Mid recession
Fort Worth	\$650	Flat	94	Flat	Mid recession
Houston	\$650	Flat	94	Flat	Mid oversupply
San Antonio	\$600	Up	94	Up	Late oversupply

### Major Texas Retail Markets

Area	Rent per Square Foot	Trend	Occupancy (percent)	Prognosis	Cycle Phase*
Austin	\$16	Flat	94	Down	Early recovery
Dallas	\$14	Up	92	Down	Late oversupply
Fort Worth	\$13	Flat	90	Flat	Late oversupply
Houston	\$14	Flat	88	Flat	Mid recovery
San Antonio	\$13	Up	89	Down	Late oversupply

### Major Texas Industrial Markets

Area	Rent per Square Foot	Trend	Occupancy (percent)	Prognosis	Cycle Phase*
Austin	\$3.60	Down	84	Down	Late recession
Dallas	\$3.80	Down	88	Flat	Late recession
Fort Worth	\$3.90	Down	88	Down	Late recession
Houston	\$3.70	Flat	89	Down	Early recovery
San Antonio	\$4.30	Up	82	Down	Early 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: Reis; Legg Mason Wood Walker, Inc.

economy as other property types. Texas apartment markets have not performed that badly during the recession. Many of the factors that have aided home sales, however, have worked against apartments.

Low mortgage interest rates and easy loan qualifying have allowed many renters to become homeowners. The popularity of manufactured homes also has eroded demand for apartments. These factors will reverse if interest rates rise significantly.

Unlike single-family permits, apartment building permits have dwindled over the last several years. Permits issued in late 2002 were at about 65 percent of 1998's peak rate. This allowed landlords to raise rents or maintain rent levels despite a reduction in demand.

Lower construction levels also reflect lack of demand for multifamily properties. Individual investors appear more comfortable with single-family homes, and real estate investment trusts (REITs) have reduced acquisitions over the last several years. Though REITs are once again attracting funds, they have not started buying properties in great numbers.

The housing needs projection indicates multifamily production will remain steady for the next several years. Although not expected to return to peak levels, the predicted pace of production is substantially higher than the 1990s average.

**Retail markets.** Consumers have long been the hope for turning the economy around and largely delivered until the

mid-2002 slump. Retail properties have performed well, and are relative latecomers to the experience of falling rents and occupancy. This could be a problem for the sector, with many markets oversupplied with space.

Retail thrives on both population and income growth, so demand will be soft for a while. Look for some retrenchment before the market begins to grow again.

**Industrial markets.** Uncertainty over whether the economy will begin a new growth phase has placed company expansion plans on hold. On average, the economy has more production capacity than it can use, so additions will occur only if existing facilities are not the right type or in the right location to serve the needs of existing firms.

Research and development space used heavily in the technology sectors of industry has been especially hard hit. Tech was notorious for its overexpansion during the last economic boom. Accordingly, industrial markets

will probably be the last to recover.

### Other Issues to Ponder

**Homeowners insurance.** The risk of being a homeowner must have risen enormously over the past year, judging from the increase in premiums for homeowners hazard and liability insurance.

The need to decrease the disparity between premium revenue and claim costs, a problem exacerbated by low earnings on stockpiled funds, has made insurance companies sensitive to their exposure to new claims. Consequently, they are reluctant to write new policies or continue coverage for long-time customers with any potential for claims.

Unofficial reports indicate that insurance availability problems are delaying closings and may be discouraging sales. However, the problems have not shown up in the data as yet. What is apparent is the impact on affordability. One estimate is that the average homeowner's premium has increased 38 percent in 2002. Values for the Texas Housing Affordability Index, which compares the cost of buying a home to resident incomes, have fallen to levels last seen in 1990, despite much lower mortgage interest rates.

**Manufactured housing.** Factory-built units are a major source of affordable housing in Texas. Financing problems put that role in jeopardy. By mid-2002, shipments of new units were down 50 percent from year 2000 levels. This was at a time when production of new site-built homes was rising. The



**Ten Most Active Home Building Markets  
Based on 2002 Single-Family Permits Issued**

Rank	MSA	Permits per 1,000 Persons
1	Brazoria County	16.6
2	Galveston	15.6
3	McAllen	15.5
4	Fort Worth	11.7
5	Laredo	11.5
6	Brownsville	11.1
7	Dallas	10.6
8	Houston	10.1
9	Bryan-College Station	9.5
10	San Antonio	8.5

Source: Real Estate Center at Texas A&M University

**Ten Most Active Sales Markets  
Based on 2002 MLS Sales**

Rank	MSA	Sales per 1,000 Persons
1	Austin	14.6
2	Houston	13.2
3	Dallas	12.9
4	Wichita Falls	12.4
5	Tyler	12.0
6	Lubbock	11.9
7	Bryan-College Station	11.6
8	Abilene	11.3
9	Odessa-Midland	11.2
10	San Angelo	10.9

Source: Real Estate Center at Texas A&M University

**Ten Highest Price Increases  
Based on 2002 MLS Sales Price Annual Increase**

Rank	MSA	Median Price	Percent Increase
1	San Antonio	\$105,900	7
2	Fort Worth	95,200	6
3	Houston	128,900	6
4	Lubbock	87,300	5
5	Victoria	87,600	4
6	Austin	156,200	3
7	Killeen	79,100	3
8	Wichita Falls	76,500	3
9	Dallas	144,900	2
10	Sherman-Denison	85,200	2

Source: Real Estate Center at Texas A&M University

industry is struggling with a large number of repossessed units on the market that attract buyers away from new manufactured homes.

Aggressive buyer qualifying put many in homes they could not afford. This is a nationwide problem, but passage of HB 1869 in the 2001 legislature gave Texas suppliers a new set of issues.

The law mandates mortgage financing for homes placed on land owned by the homeowner. The conditions attached to the restriction apparently have sown confusion among providers of nonmortgage manufactured housing loans and have made it difficult to arrange financing, even in cases where the restrictions do not apply. The Texas Manufactured Housing Association will work for reform of the law during the 2003 legislative session, with the aim of restoring consumer choice while retaining consumer protection measures.

**Water supplies.** This perennial problem is coming to a head around the fast-growing Hill Country-San Antonio area. Regulating authorities in the Edwards Aquifer control area are

**OFFICE AND INDUSTRIAL** markets were hit hard during the recession and are waiting for employment growth to feed business expansion.



slowing the issuance of well permits. In a related move with implications for growth, authorities reportedly will seek more regulation of subdivisions by county governments in the 2003 legislature.

**Clean Water Act.** The Texas Commission on Environmental Quality will submit a plan for regulating total maximum daily load for water pollution emissions to the Environmental Protection Agency. Such acts often spur lawsuits from environmental groups interested in slowing development.

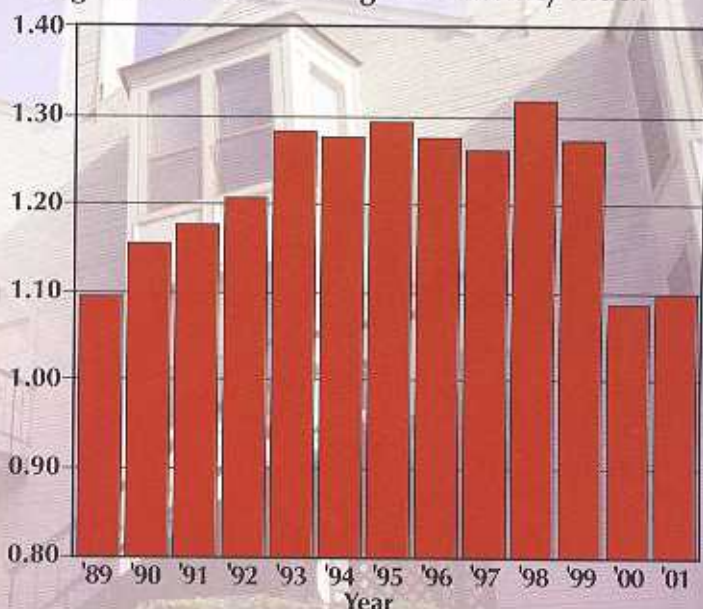
**Clean Air Act.** The federal government can cut off funding for new highway projects if cities fail to attain specified levels of air quality. Dallas-Fort Worth and Houston are already under mandate to develop plans for attaining these standards.

There is a good chance that Beaumont-Port Arthur, Austin, San Antonio, Tyler and Longview will have to develop attainment plans as a result of the 2004 assessment. El Paso is struggling to maintain a new standard for ozone. The choice is tighter restrictions on industry and automobile emissions or loss of support for new highways. Either has growth implications.

**Rural decay.** Rural areas and small Texas towns are not only losing population, they are losing the key middle-class segment necessary to maintain a viable local economy.

Affluent retirees are in evidence on ranches and country estates. Although low-income jobs can be found in rural areas, there are dwindling opportunities for professional employment in the countryside. As a result, though Texas is a large state, most of the population lives in and around metropolitan areas.

Figure 4. Texas Housing Affordability Index\*



\*The THAI is the ratio of median household income to the income required to buy the median-priced home using currently available mortgage financing. Standard financing is a 30-year loan covering 80 percent of the cost of the home. A THAI of 1.00 indicates that the median household income is just enough to qualify for a loan sufficiently large to purchase the median-priced home.

Source: Real Estate Center at Texas A&M University

**Education.** State officials have concentrated on equalizing access to education, but improving the quality of public education, especially in light of Texas' large and growing immigrant population, is critical. Failing to do so will hamper the economic progress of the state's population and limit the number of Texans who can afford homeownership. ♦

For more information, contact [info@recenter.tamu.edu](mailto:info@recenter.tamu.edu).

## Housing Needs Forecast

The State Data Center projects an additional 1.5 million people will be living in Texas by 2005. Using that projection and additional data from the 2000 Census, the Real Estate Center projects new housing units needed in Texas.

### Projected 2005

**Population:** 22.5 million

**Persons per unit:**

- single-family owned: 2.89
- single-family rented: 3.1
- apartments: 2.2

**Homeownership rate:** 64 percent

**Vacancy rate:**

- single-family: 7 percent
- multifamily: 10 percent
- manufactured homes: 20 percent

Housing Stock		
	2000	Projected 2005
Single-family	5,420,910	5,759,400
Multifamily	1,970,701	2,137,700
Manufactured homes	765,965	831,900

New Construction			
	Annual average 1990-2000	2001	Projected annual 2002-2004
Single-family	75,528	111,915	63,700
Multifamily	29,546	38,427	35,300
Manufactured homes	26,287	21,254	15,100

Source: Real Estate Center at Texas A&M University