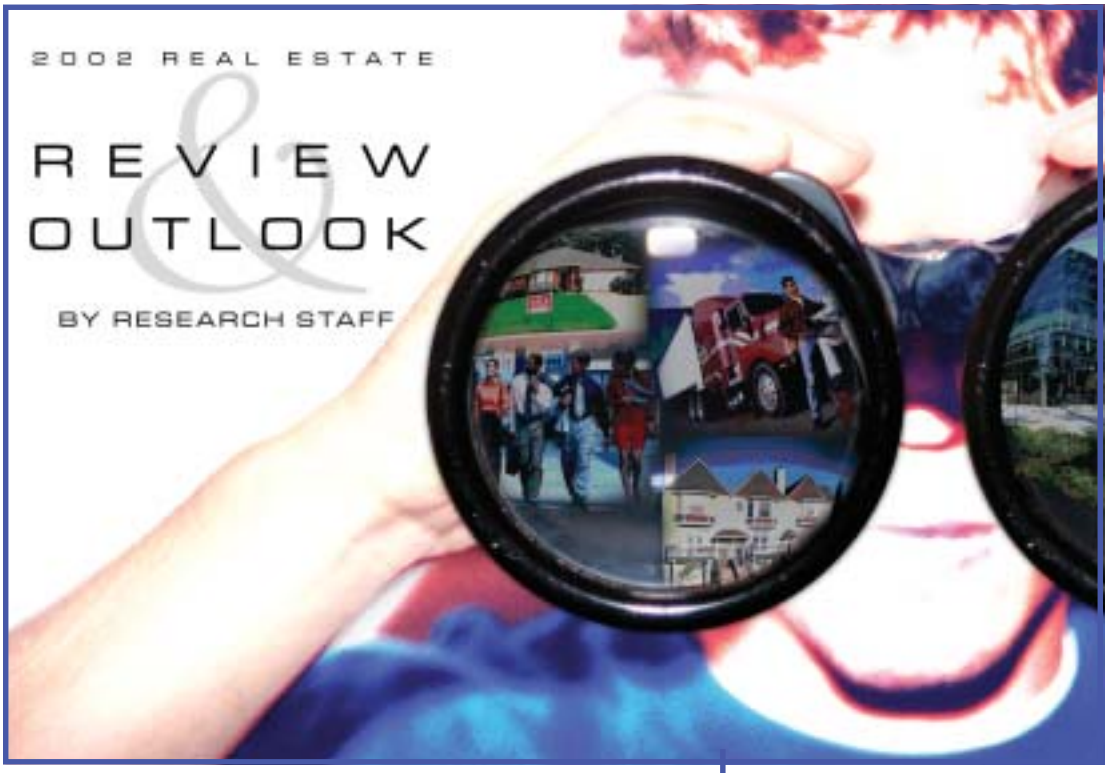
A Reprint from *Tierra Grande*, the Real Estate Center Journal

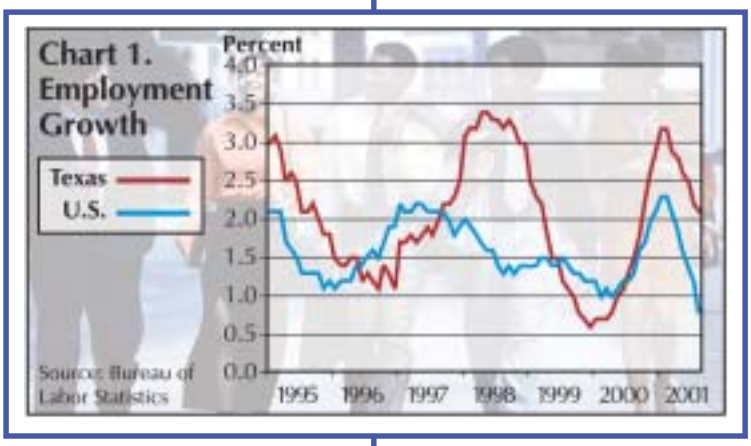


A disputed election. Terrorism. Tumbling stock markets. Recession. Recent times have provided an extraordinary stream of unsettling events. Such uncertainty has contributed to the fall of consumer confidence. Yet real estate markets, the housing market in particular, have held up surprisingly well. Will the industry continue to live a charmed life and escape major disruption?

Economy Pauses

In last year's spring forecast, the Texas Comptroller of Public Accounts projected employment growth in 2002 (2.4 percent) as only slightly lower than that for 2001 (2.5 percent). Of course, that was before the tragic events of last September and the resulting jolt to the national economy, as well as the revelation that the economy had been in recession since March. Consequently, the forecast may be too optimistic.

Even if employment grows this year, that does not rule out the possibility of a few negative quarters. Employment growth was 3.2 percent in January 2001 but only 2.1 percent by August. By the end of the year, growth may have ground to a halt. A better than 2 percent growth rate in 2002 may be achieved if a near standstill in the first half is followed by a vigorous recovery in the summer. Such growth would mean a short recession.



Texas employment has been growing at a rate about 1 percentage point more than the national rate (Chart 1). So, despite a contraction nationwide, the state may escape that fate. Texas has had only one year in the last 20 (1986) in which employment declined. If employment continues to decline, it may simply be a scaling back of the rapid growth in early 2001. Such growth surges are difficult to maintain even in buoyant economies.

Like the national economy, Texas should be positively affected by the federal tax rebates and interest rate cuts by the Federal Reserve Bank (Fed). The Fed is also increasing the supply of money at a rapid pace to re-ignite the economy. Increased defense spending should be stimulating as well. It will take some time for increased demand to absorb excess inventories and boost corporate profits needed for the creation of new jobs. Expect renewed growth in the latter half of 2002. However, the strength of the recovery could be dampened should the Fed need to raise interest rates.

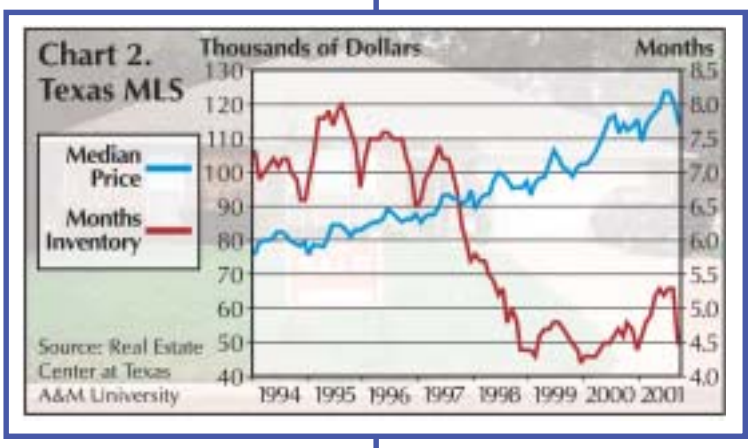
Before the Sept. 11 terrorist attacks, some questioned whether the U.S. economy would lapse into recession. A strong retail and homebuying sector was keeping the economy on a slightly positive path. The traditional manufacturing economic base was clearly in retreat. But consumers were badly shaken by events and retail sales dropped substantially. The Conference Board's Consumer Confidence Index last September dropped to its lowest level in ten years.

The attacks caused considerable damage to the U.S. economy. The people lost cannot be replaced, and the resources destroyed will be costly to replace. Security measures put in place to prevent future attacks will create inefficiencies. Some industries, such as the travel industry, will have difficulty dispelling fear among their customers. The global war on terrorism will not be cheap, so taxes may have to be raised once the economy is strong enough to support them.

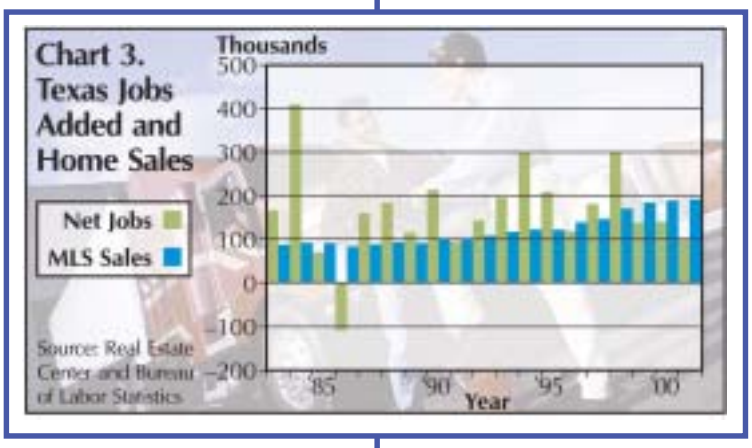
Some fear that the slowdown will drag out over several years because the growth phase was so long — beginning approximately in 1991. Long periods of no growth are caused by excesses during the preceding expansion. Often expansion is based on government spending rather than productivity gains. For example, prosperity in the 1960s was built on massive government spending on the War on Poverty and the Vietnam War. The result was runaway inflation in the 1970s and volatile interest rates.

In contrast, the 1990s were remarkable for government spending restraint and the Fed's commitment to a low-inflation policy. And unlike in the early 1980s, energy prices have been under control with market forces dampening price swings. Interestingly, the sense of unity engendered by the Sept. 11 attacks forged a consensus among political groups to rejuvenate the economy in defiance of the terrorists. In this way, the tragedy may have provided a catalyst to economic growth. So even with the additional problems caused by terrorists' actions, economic stagnation promises to be relatively short.

Texas is in a much better economic position than during the turbulent 1970s and 1980s. The state's economy is more diversified. In 2001, the majority of new jobs were created in the services sector, which has shown consistent growth. The impact of energy prices is hedged by the fact that Texas now is as much a consumer of oil as it is a producer. The decline in manufacturing employment may not be as bad as forecast; it was showing some moderation near the end of 2001. Mexico, which has an economic impact on a large part of the state, is committed to freer trade and a market-based economy.



On the other hand, industries with unexpectedly strong growth in 2001 may not be as fortunate this year. Mining sector employment got a boost from the oil and gas price spike early in 2001. Likewise, the construction sector benefited from the surprisingly strong demand for new homes. Both sectors are expected to slow or shrink during 2002. Real estate employment is expected to decline modestly. In the recent past, this decline has been based on higher productivity, leaving those in the business with higher incomes. This year, it may reflect lower demand, depending on how big a hit the housing market takes.



Unless there are big surprises, look for a slow first half in 2002, with a decent recovery later in the year. However, construction and real estate will be under pressure much of the year.

Resilient Housing Markets

A remarkable three-year period for Texas housing markets ended in 2001. More homes sold through Texas Multiple Listing Services (MLS) during each of those years than in any year since the Center began compiling statistics in 1979. Some increase is expected as the population keeps getting larger, giving the markets a larger base from which to draw. In the past three years, a combination of strong economic growth (including the creation of many high-paying jobs in the high-tech, medical and business services sectors), low interest rates and easy credit created an ideal environment for home sales.

It now looks like that period of booming markets is over. A slower, more cautious economy will mean fewer new households relocating to the state and reduced confidence among move-up and first-time buyers. To the extent that entry-level jobs become hard to come by, many would-be first-time buyers will lack the financial base to enter the market.

Home sales could be more adversely affected if an economic slump leads to disruption in the mortgage market. Those who qualified under the eased standards applied to low down payment, affordable housing programs are especially vulnerable. The proliferation of these loan programs is one reason homeownership rates climbed in recent years.

Indiscriminate credit extension and aggressive marketing already have wreaked havoc on manufactured housing markets. High default rates have driven several lenders out of the subprime loan market (subprime loans are high interest rate loans for borrowers with poor credit ratings).

If defaults, already at elevated levels for FHA-insured mortgages, get out of hand and lead to extensive foreclosures, interest rates could rise and qualifying standards may tighten. In a worst-case scenario, the favorable credit conditions that expanded the housing market would be reversed. Higher foreclosure rates could lead to higher inventories of homes for sale in the lower price ranges.

Even if defaults and foreclosures do not get out of hand, look for interest rates to rise by the end of 2002. The drop in rates last year was foreshadowed by inversion of the yield curve in late 2000. An inverted yield curve occurs when short-term interest rates exceed long-term rates, indicating that financial markets expect lower interest rates, generally accompanied by recession, in the near future. The spread between the shortest- and longest-term treasury securities was almost 3 percentage points last September, the widest gap in years. Market analysts are anticipating higher rates, which could come as soon as the effect of the Fed's rate-cutting runs its course.

Strong sales numbers of recent years have been accompanied by rising property values. According to the repeat sales price index compiled by the Office of Federal Housing Enterprise Oversight, Texas homes improved in value by 7.7 percent in 2000 and 7.4 percent halfway through 2001. The main reason for such high rates of appreciation is short supply. Many MLS inventories fell to less than a three-month supply in 2001 (Chart 2).

Expect prices to soften in 2002 even if sales remain strong. There will be more supply for buyers to choose from and sellers will be more accommodating. Inventories of existing homes began rising in the second half of 2001. Single-family building permits have hit levels equaling or exceeding the early 1980s boom. While it may not be a buyers' market exactly, the sellers' market of recent years is probably over. It has been over for some time for the highest-priced homes.

The big question is how far activity will decline. To see how markets have reacted in the recent past, see Chart 3, which compares economic growth (reflected in net jobs added) and home sales for each year since the early 1980s.

The only time during this period that a war was being waged was in 1990 — the Gulf War. Sales were up that year, and it was a strong year for the economy as well. When the economy slumped in 1991, sales slipped a bit. However, values were up that year as mortgage rates tumbled.

Texas has experienced a net loss in jobs only one year: 1986. That was the year of the great oil bust. Home sales fell by more than 7 percent, and property values fell by more than 5 percent. Consider that mortgage rates — around 10 percent — were much higher than they are today, and prices had been soaring in previous years. If the current market suffers a comparable drop, sales volume would still be higher than any year prior to 1999.

The economy and housing market are in many ways much stronger than they were in the mid-1980s. Though the tech manufacturing bubble has burst, it is not as important to the state's economy as oil was then. Home prices are elevated because of a shortage of inventory and low interest rates, not because of inflationary expectations. Mortgage lenders have their problems, but they are not as vulnerable fundamentally as they were in the 1980s. Consequently, the contraction in sales should be milder. The key is how the mortgage market fares. If defaults build, credit will be tighter, and many first-time buyers may be shut out of the market. This would result in a much larger decline.

Slower economic growth will mean slower population growth and fewer new housing units needed in the near future. The latest Housing Needs Projection (see Statewide Housing Needs Assessment) indicates less home building in the next several years than during recent years. The pace should be comparable to that of the mid-1990s. Also look for some scaling back on multifamily production and shipments of manufactured homes.

Hottest Housing Markets

Rank	MSA	MLS Sales Per 1,000 Population*
1	Austin	13.2
2	Dallas	12.8
3	Houston	12.1
4	San Angelo	11.0
5	Odessa-Midland	10.9
6	Fort Worth	10.7
7	Tyler	10.6
8	Abilene	10.5
9	Wichita Falls	10.4
10	Lubbock	10.3

*projected from September year-to-date figures
Source: Real Estate Center at Texas A&M University

Commercial Markets Mixed

Income-producing property markets have been signaling the end of economic expansion for some time. According to a nationwide analysis published by Legg Mason Wood Walker, Inc., all commercial property sectors were in overbuilt situations by mid-2001. That assessment came prior to the terrorist attacks that caused property markets to retreat further.

Legg Mason analyst Glenn Mueller has developed methodologies that allow specific property markets to be evaluated according to their position on the classic real estate market cycle (see Real Estate Market Cycles). In the oversupply phase, a market is struggling to absorb a surge of new supply. Normally, these markets would proceed to the recession phase, which is characterized by falling rents and lack of construction activity.

Texas market cycle conditions vary by location and property type. In general, apartment markets are faring better than other types of property. However, multifamily construction has been on a downward trend since mid-1999, largely reflecting the decline in real estate investment trust (REIT) (companies that invest in real estate using funds raised in the stock market) market activity (Chart 4). Rents in most markets, except Austin, have been flat for more than a year. However, Legg Mason considers apartments in most Texas cities a better bet than other types of commercial property.

Austin, last year's star performer, has been tarnished by the high-tech bust and will have a hard time maintaining the rent and price premiums it currently enjoys. According to Legg Mason's analysis, the industrial and retail markets are in oversupply, and the office and apartment markets have advanced to the recession phase.

Houston's markets are nearing their peaks, but some opportunities may remain. The office market is the big story with

Fastest Growing Local Economies

Rank	MSA	Employment Growth Rate (percentage)*
1	Laredo	3.6
2	Dallas	3.3
3	McAllen-Edinburg-Mission	2.9
4	Brownsville	2.8
5	Houston	2.7
6	Fort Worth	2.6
7	Brazoria	2.6
8	Odessa-Midland	2.5
9	Lubbock	2.1
10	Texarkana	1.8

*August 2000 to August 2001
Source: Texas Workforce Commission

Fastest Growing Home Prices

Rank	MLS Area	Annual Percent Change in Median Price*
1	Bryan-College Station	18
2	McAllen-Edinburg-Mission	16
3	Lufkin	15
4	Garland	12
5	Sherman-Denison	12
6	Arlington	11
7	Irving	11
8	Fort Bend	9
9	Fort Worth	9
10	Houston	8

*September 2000 to September 2001
Source: Real Estate Center at Texas A&M University

rents exceeding $25 per square foot and valuations more than $150 per square foot. This market is supposedly near the end of its expansion phase, but there is not a lot of new supply in the pipeline. Therefore, an overbuilt situation may be avoided.

The Dallas-Fort Worth office market is at the other end of the scale. Although valuations remain high, prospects for the market were the lowest in the nation according to the National Real Estate Index Market Score survey. The industrial and retail markets have entered the overbuilt phase. Apartments offer some promise as rents and valuations are still rising.

San Antonio offers more opportunities for contrarian-minded investors. The apartment market is in recovery, meaning that there may be bargains for those with a long-term strategy. Retail is well into the oversupply phase and other sectors are holding near the peaks of their cycles.

All nonresidential sectors of real estate markets depend on economic growth. Even apartment markets need a level of prosperity to attract potential tenants into their market areas. As the economy slows, expect occupancy and rental rates to slip and construction and transaction activity to slacken. Apartments may get a temporary boost from those who might have purchased homes in a stronger economy.

Rural land markets follow the economy as closely as other real estate markets. Sales activity has slackened across the state. The one factor that had been driving much of the rural land market — recreational sales — appears to have taken a temporary hiatus.

What Industry Professionals Can Expect

Texas real estate markets are being and will continue to be influenced by the current economic lull. This phase is expected to be a pause in the market, however, not a crash.

Housing markets are entering a downward phase from an extremely high level of activity. While this will make it more difficult for sellers, it will help buyers and may even allow sales professionals to devote more time to each transaction. Selling a home will require more effort, so demand for professional assistance should strengthen. This may prove a real test of the Internet and other new ways of gaining market exposure.

For investors, this is a time for selective acquisition and long-term thinking. Those with attractive property presented in a professional manner will prevail.

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

Statewide Housing Needs Assessment

	Single-family units	Multifamily units	Manufactured homes
Housing stock			
1990	4,602,751	1,783,454	622,794
2000	5,200,500	2,049,700	907,500
2005 (est.)	5,506,800	2,147,100	1,039,200
Housing units produced 1990–2000	830,804	325,008	350,621
Annual average	75,528	29,546	31,875
Total housing needed 2001–2004	259,634	78,747	112,507
Housing needed per year 2001–2004 annual average	64,909	19,687	28,127

The Housing Needs Assessment is an estimate of future housing needs based on population projections prepared by the Texas State Data Center. Housing stock for 2000 is estimated based on 1990 and 2000 Census of Housing and building permit data. The stock for 2005 and production for 2000–2004 are estimated based on projections of population and characteristics of the housing stock. Among the key assumptions are:

2005 population: nearly 22.4 million (more than 20.8 million in 2000)
2005 homeownership rate: 64 percent (63.8 in 2000)
2005 average household size: 2.745 (2.74 in 2000)
2005 single-family vacancy rate: 3 percent (3.7 in 2000)
2005 multifamily vacancy rate: 8.5 percent (9.1 in 2000)

Real Estate Market Cycles

Because it is difficult to forecast future demand for commercial real estate space and because it takes a long time to bring new space onto the market, real estate markets tend to be highly cyclical. Surges in demand caused by economic expansion often cause space shortages in a market area, while a waning of demand may occur as new space comes on the market. Cycles generally have four distinct phases:

- Expansion — Rising demand and occupancies with a high level of construction.
- Oversupply — Rising vacancies as construction continues; rental rates grow at a slower rate.
- Recession — Demand and rental rates fall; vacancies rise but construction continues.
- Recovery — Construction stops as excess capacity is absorbed; decline in rents slows.

Identifying a local market's current phase is important to investors as market dynamics affect the success of the investment.

Markets tend to progress from one phase to the other, though not at uniform pace. Some markets can go backwards in the cycle or may skip a phase. In general, however, knowing which phase a market is in helps predict what the next phase will be.

LOWRY MAYS COLLEGE & GRADUATE SCHOOL OF BUSINESS

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031
800-244-2144 orders only

Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year.