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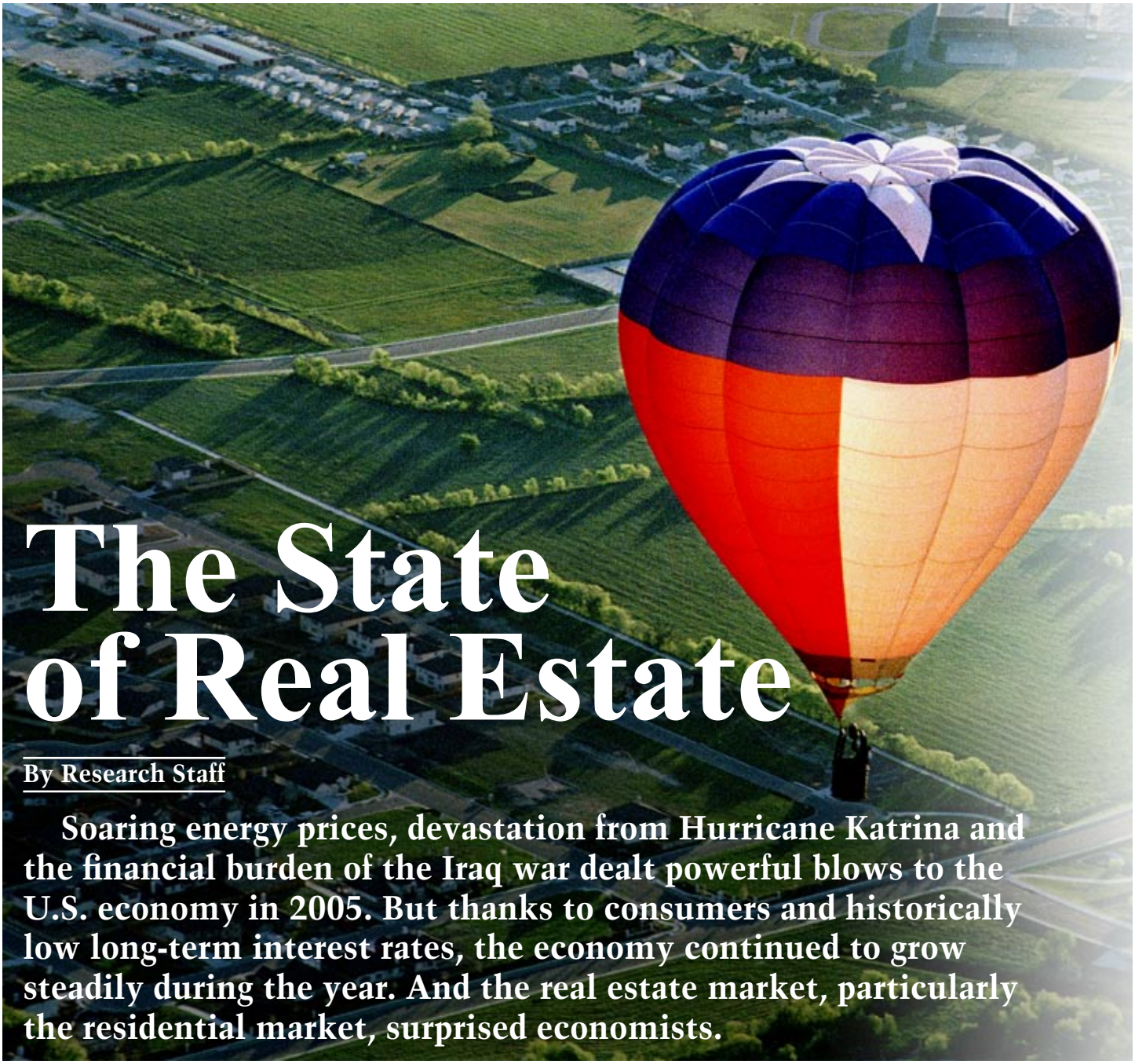


The State of Real Estate

By Research Staff

Soaring energy prices, devastation from Hurricane Katrina and the financial burden of the Iraq war dealt powerful blows to the U.S. economy in 2005. But thanks to consumers and historically low long-term interest rates, the economy continued to grow steadily during the year. And the real estate market, particularly the residential market, surprised economists.

Real gross domestic product (GDP) increased at an annual rate of 3.8 percent in the third quarter of 2005, up from 3.3 percent the previous quarter. According to a Federal Reserve Bank of Philadelphia survey of 53 professional forecasters, the economy was poised to show stronger growth rates in both the output and employment markets in the second half of 2005 than it showed in the first six months. Forecasters have revised their expected annual growth rate of real U.S. GDP in 2006 from 3.3 percent to 3.4 percent.

The U.S. economy also experienced a steady labor market recovery in 2005. In the year ending in October, the economy added more than 1.9 million jobs, a 1.4 percent growth rate. Forecasters expect 175,400 jobs to be added each month in 2006.

The nation's seasonally adjusted unemployment rate fell from 5.5 percent in October 2004 to 5.0 percent in October 2005. According to the Fed's survey of professional forecasters, the unemployment rate is expected to fall to 4.9 percent in 2006.

Expecting stronger growth rates in the economy and concerned about price pressure, the Fed raised its influential fed funds rate six times in 2005 from 2.5 percent in February to 4.0 percent in November. While the rate hike raised short-term interest rates (prime rates on bank loans and rates on credit cards), so far long-term interest rates have not been significantly influenced by higher fed funds rates.

Rates on 30-year mortgages rose from 5.81 percent in December 2004 to 6.36 percent in November 2005. Long-term

interest rates, including mortgage rates, are determined in global financial markets by long-term inflationary expectations and are expected to remain at their current levels as long as financial markets are confident that monetary authorities can contain inflation in the long run. According to the Mortgage Bankers Association of America, the rate on 30-year fixed-rate mortgages is expected to inch up to 6.6 percent in 2006.

Because of historically low inflation and interest rates, energy price hikes are not expected to hurt the national economy nearly as much as in the turbulent 1970s and 1980s.

The Texas Economy

Texas total personal income rose at an annualized rate of 6.9 percent from the first to the second quarter of 2005 compared with 6.3 percent for the United States, and the state ranked 12th among all states in terms of personal income growth. Total personal income is closely related to total output, and a higher-than-national-average growth rate of personal income means the state's economy is growing strongly.

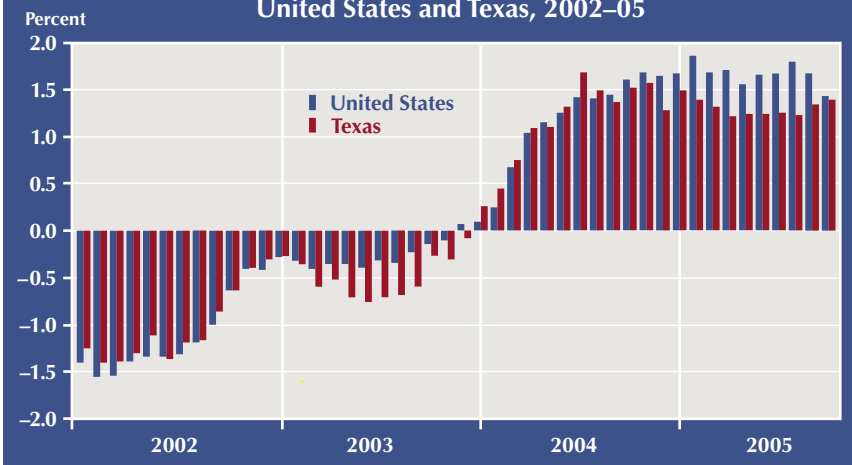
The state's nonfarm employment rose from more than 9.54 million in October 2004 to more than 9.67 million in October 2005, adding 69,000 more jobs over the prerecession peak in December 2001. The state's labor market recovery was lagging the nation's until September 2005. But the recovery gap, defined as the difference between the employment growth rates for Texas and the United States, narrowed from 0.6 percent in August 2005 to 0.1 in October 2005 (Figure 1).

The Austin-Round Rock metro area posted an employment growth rate of 2.0 percent from October 2004 to October 2005, making it the fastest growing local economy among the five major Texas metro areas. Meanwhile, employment in the Houston-Baytown-Sugar Land metro area rose 1.8 percent; San Antonio's nonfarm employment grew 1.7 percent, and the Dallas-Plano-Irving metro area and Fort Worth-Arlington metro area both posted annualized employment growth rates of 1.1 percent.

The state's seasonally adjusted unemployment rate fell from 6 percent in October 2004 to 5.2 percent in October 2005, a four-year low.

The impact of Hurricane Katrina on the Texas economy is not yet clear. The adverse effects of the hurricane on the Louisiana economy are expected to indirectly impact the Texas economy through regional economic transactions. But the adverse impact is expected to be insignificant considering that Texas' economic output is more than $884 billion — close to that of Canada.

Figure 1. Nonfarm Employment Growth Rates United States and Texas, 2002–05



Sources: Bureau of Labor Statistics and Texas Workforce Commission

As for the 2006 outlook, the state's economy is expected to grow faster in both the output market and the labor market than it did in 2005, but growth is expected to be slower than the national rate.

Residential Market

The past three years have seen a global housing boom in prices, sales volumes and construction. General economic expansion, job growth, population expansion, low interest rates and easy credit have fueled record housing sales and price increases. Nationally, the median house price rose nearly 33 percent between 2002 and 2005 and jumped 13.4 percent in the past year, according to the Office of Federal Housing Enterprise Oversight (OFHEO).

The number of homes sold through Multiple Listing Services (MLS) as reported by the National Association of Realtors (NAR) increased from more than 5.63 million in 2002 to more than 6.78 million in 2004 and to an annualized level of nearly 7.3 million by August 2005. That means approximately 1.6 million (28.4 percent) more houses will change hands in 2005 than in 2002.

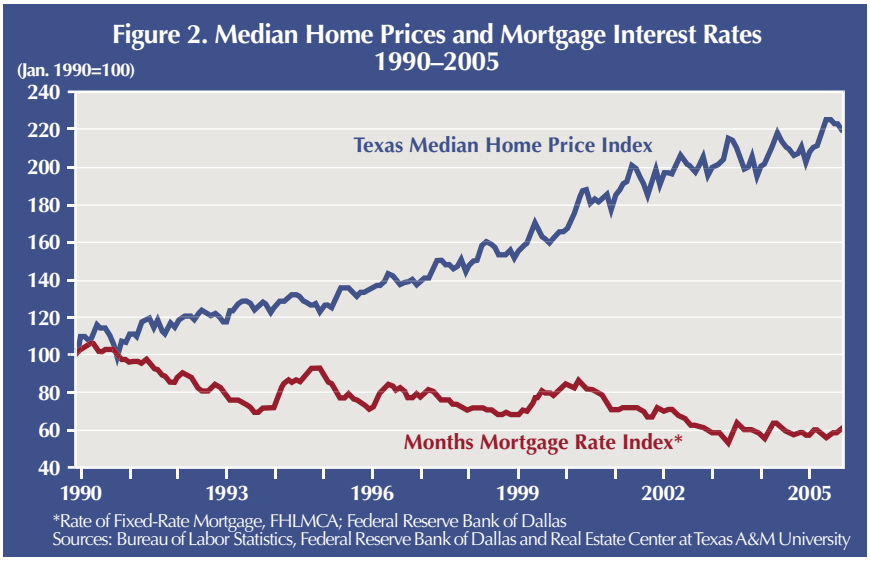


Figure 2. Median Home Prices and Mortgage Interest Rates 1990–2005

*Rate of Fixed-Rate Mortgage, FHLMCA; Federal Reserve Bank of Dallas
Sources: Bureau of Labor Statistics, Federal Reserve Bank of Dallas and Real Estate Center at Texas A&M University

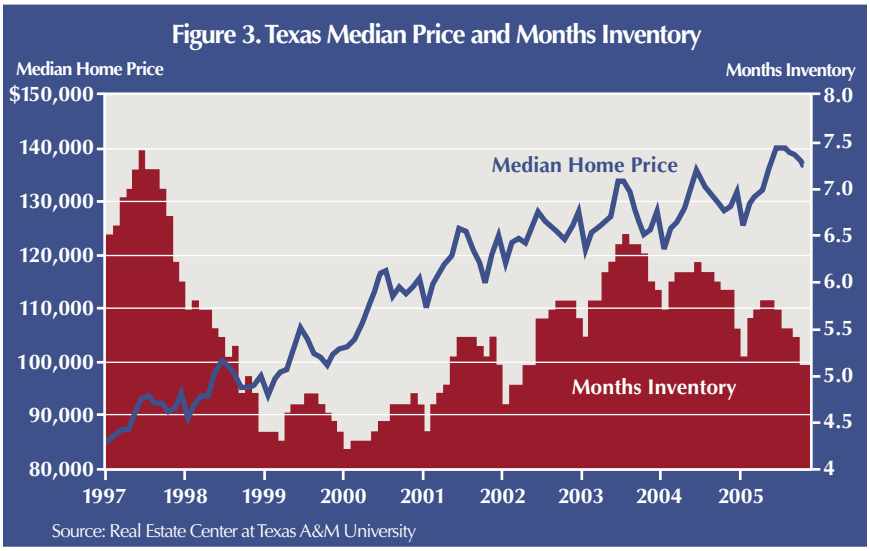


Figure 3. Texas Median Price and Months Inventory

Source: Real Estate Center at Texas A&M University

Similarly, single-family construction expanded more than 25 percent, from nearly 1.36 million units in 2002 to an estimated 1.71 million units in 2005. Increases in Texas sales and prices occurred despite negative job growth in 2002 and 2003 and modest personal income increases. The key drivers of the national and Texas housing booms have been low interest rates and aggressive home loan financing.

Mortgage interest rates stayed at all-time lows throughout 2004 and 2005 despite the Fed's regular rate increases. Lenders, spurred by massive amounts of capital funneled into the real estate finance market, adopted aggressive marketing techniques and relaxed loan underwriting requirements, making loans plentiful and easy to obtain (Figure 2).

The rapid escalation in home prices nationally has been deemed by many to be a housing price "bubble" that could suddenly burst, causing home prices to collapse. Some observers express concern that Texas' housing sector also reflects a housing bubble that could suddenly and dramatically burst, leaving Texas homeowners and the market reeling. But the data do not support either of these bubble scenarios.

There are signs that the market surge may not be as strong as before, but a healthy housing market should continue in 2006. The national housing bubble, to the extent there is one, appears to be localized to several states and to specific local metropolitan markets on the East and West Coasts that experienced more than 25 percent per year home price appreciation in 2004 and 2005.

Several factors indicate that while Texas' housing market is doing well by historical standards, it is not experiencing a price bubble. Texas' home prices have appreciated at rates significantly lower than the national rate of increase. During the first half of 2005, Texas ranked last out of the 50 states and Washington, D.C., in the rate of home price appreciation reported by OFHEO. Texas' 4.7 percent appreciation rate was less than half of the 13.4 percent national appreciation rate.

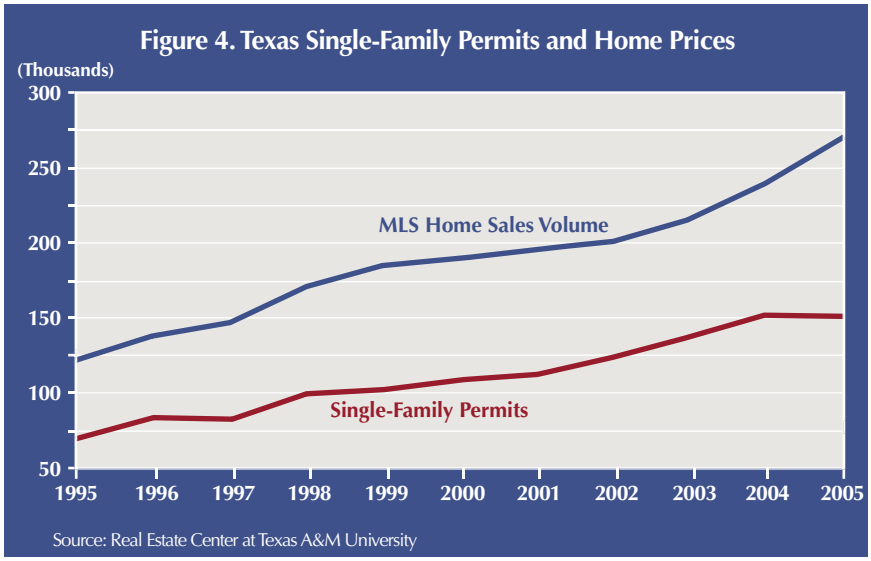


Figure 4. Texas Single-Family Permits and Home Prices

Source: Real Estate Center at Texas A&M University

Texas' 2005 rate of home price increase was virtually equal to its 15-year average rate of 4.4 percent. MLS data indicate that the state's 2005 appreciation rate will be around 4.3 percent. Home price increases are consistent with general employment and personal income gains statewide.

Although up somewhat from 2000 to 2004 levels, the 2005 median-price-to-median-family-income ratio remained relatively consistent at about 2.5. Nationally, the median-price-to-median-family-income ratio runs more than 3.6. The 2005 estimated 5.6-month inventory of homes for sale in Texas was only slightly less than the six-month inventory of available houses generally considered to reflect a balanced market (Figure 3).

Residential construction in the state maintained a reasonable level of stability between supply and demand. New single-family residential permits in 2005 are expected to be down slightly from the record level of permits issued in 2004 (Figure 4).

Texas has an active, record-setting housing market, but prices are increasing at a significantly slower rate than in the rest of the country. Between September 2002 and September 2005, Texas' median-priced home increased from $124,200 to an estimated $138,200, a modest 11.3 percent.

The average price of a Texas home increased from $152,500 in September 2002 to $176,800 by September 2005, or 15.9 percent. The state's MLS residential sales volume increased from more than 200,800 in 2002 to an estimated 2005 level of about 268,940, a 34 percent increase over the three-year period (Figure 5).

Hottest Housing Markets Projected 2005

Rank	MSA	MLS Sales per 1,000 People
1	Collin County	20.4
2	Montgomery County	18.1
3	Dallas	17.6
4	Austin	15.5
5	Houston	15.4
6	Tyler	15.1
7	Denton County	13.2
8	San Angelo	12.5
9	Midland-Odessa	12.1
10	Amarillo	11.4

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

Hottest Home Building Markets Projected 2005

Rank	MSA	Single-Family Permits per 1,000 People
1	Austin	12.2
2	McAllen	11.5
3	San Antonio	10.3
4	Houston	10.3
5	Dallas	8.6
6	Bryan–College Station	7.9
7	Texas	7.6
8	Laredo	7.5
9	Brownsville–Harlingen	7.0
10	Killeen–Fort Hood	6.9

Source: Real Estate Center at Texas A&M University

Hottest Appreciation in Median-Price Home Projected 2005

Rank	MSA	Percent
1	Port Arthur	25.1
2	Galveston	16.8
3	El Paso	15.9
4	Wichita Falls	13.5
5	Abilene	11.6
6	Midland–Odessa	11.4
7	Montgomery County	10.6
8	Amarillo	10.3
9	San Antonio	8.3
10	Killeen–Temple–Belton	8.0

Source: Real Estate Center at Texas A&M University

Market Changes to Come

Significant alterations in the financial markets, loan underwriting practices or the general economy could depress the housing market during 2006. Changes in mortgage interest rates, financing terms and underwriting criteria in the coming year could slow both the Texas and the national housing boom. In 2006, the Federal Reserve is expected to continue its pattern of raising the fed funds rate as it continues to focus on general inflation. Mortgage interest rates are expected to continue to increase.

More significant short-term impacts on the housing market may result from changes in mortgage loan underwriting regulations that affect not only direct government loan programs but mortgages eligible for purchase by federal organizations. To date, various federal actions have been limited to revised loan underwriting guidelines and other nonbinding suggestions. However, the various oversight organizations consistently point out that if real estate financial markets become exposed to higher loan risk levels, defaults and foreclosures, then regulatory changes and stricter loan underwriting requirements may result.

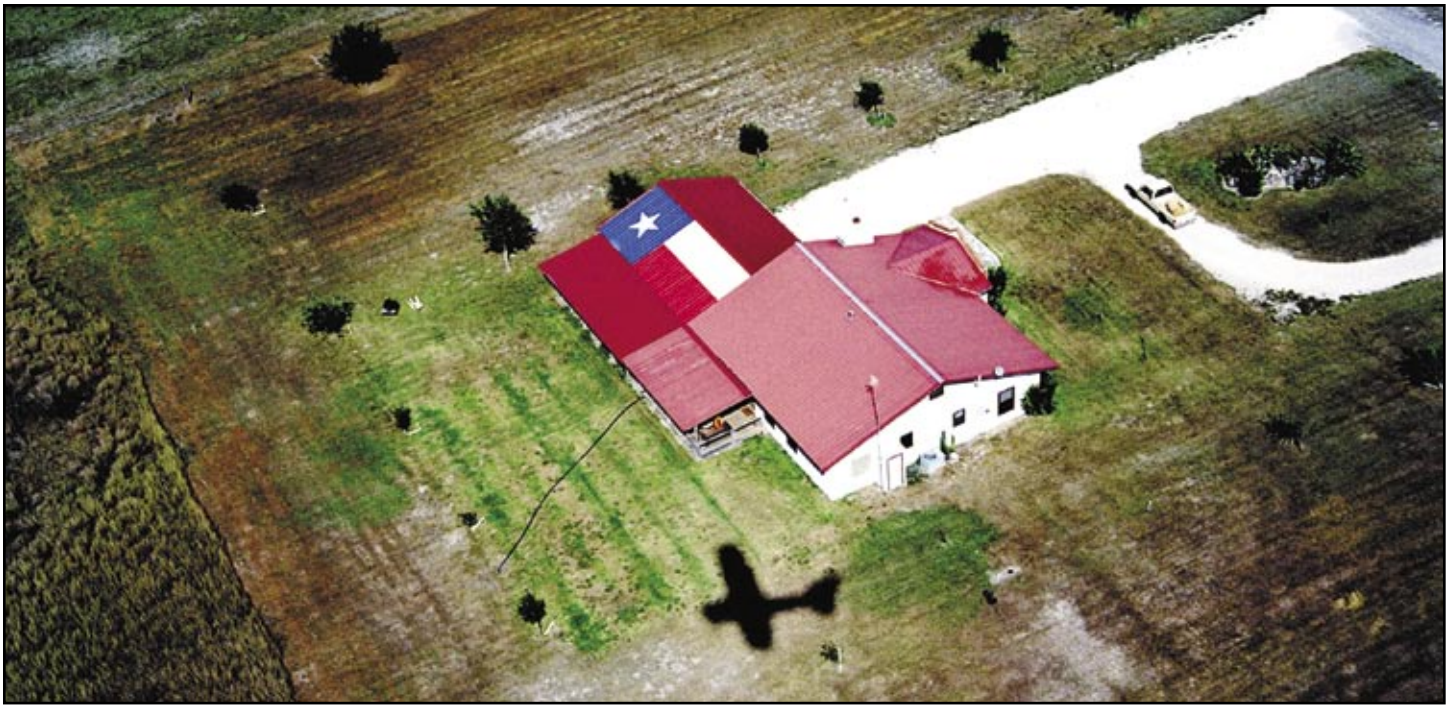
A general economic slowdown at the national level, the state level or both could dampen the housing boom. Most of the increases in the housing market have paralleled employment gains, personal income gains and population growth in the major markets. Texas' employment growth has been relatively steady but unspectacular and continues to lag national employment growth. Personal income levels also continue to expand but more slowly than the national rate.

The economic outlook for 2006 generally indicates higher mortgage interest rates and no significant increases in employment or personal income levels. New home construction may fall slightly from 2004's record level but only if small-to-modest cost increases occur. There is no reason to anticipate a housing shortage that would drive prices up or an oversupply that would depress the market. Builders and developers should be concerned if their unsold inventories begin to grow as home loans become more expensive and harder to obtain.

Overall, Texas' housing market continues to offer highly affordable homes without excessive price inflation. Price increases, sales and construction levels in 2006 will probably be equal to or slightly less than the 2005 rate. Mortgage market conditions and general economic growth will determine the market for the remainder of the decade.

Texas Commercial Market Overview

Texans will remember 2005 as the year when "mixed-use" projects finally received widespread attention. Mixed-use momentum had been building for several years, and skyrocketing fuel prices only made such projects more attractive. Look for more Texas cities to embrace developments that use different combinations of retail, residential, office and even hotel space, saving Texans considerable transportation time and money.



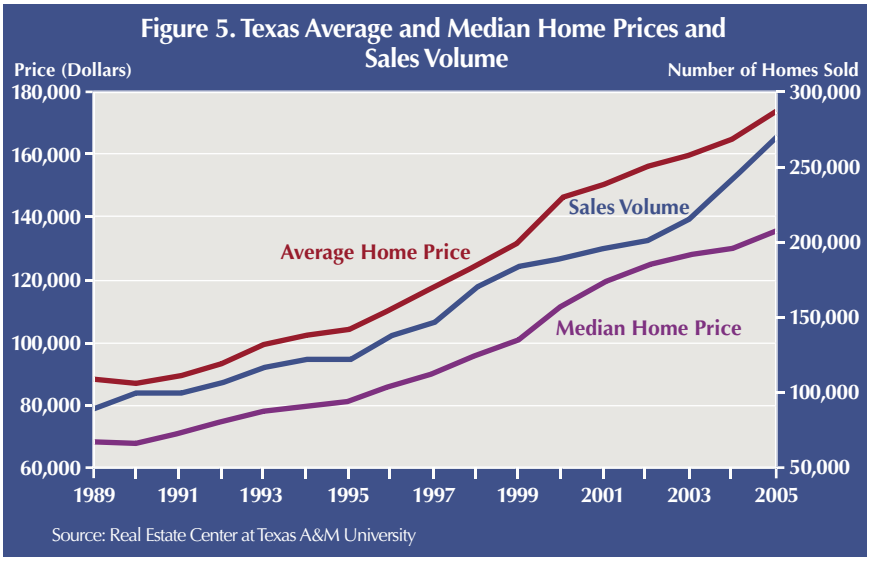
Investors paid record prices for trophy office properties in Austin and Houston in the early stages of what can only be described as a tepid market recovery. The bet is that ever-increasing construction costs will temper any explosion in new office development during the coming year. That bet might actually be worth taking outside the Dallas and Houston markets. Growth in business service jobs should work in the office market's favor this year.

Retail developers have been steadily weeding out the weak sisters, efficiently producing a steady stream of big boxes, restaurants and shopping centers. Retail properties have been the darling of commercial real estate for several years now, thanks to the public's willingness to keep on spending. Positive job growth and a strong housing market should continue to bolster the state's retail sales, even as considerable new development begins to temper the sector's overall performance.

The state's apartment markets got a boost from the influx of those displaced by Hurricane Katrina. Houston, which hosted the largest number of evacuees, needed the boost worse than other markets after several years of overbuilding. Other cities, such as Austin, with limited new multifamily construction should see impressive returns from apartment properties in the coming year.

Excepting the Houston warehouse market, double-digit vacancy rates continue in the state's industrial sector. With the steady increase in global trade benefiting Texas, warehouse-distribution space looks to outperform the flex-service center sector during the next 12 months. Much of the service center space was brought online as a response to tight office markets. Until the office market shows significant improvement, flex space markets may remain mediocre.

Cap rates continue to compress, especially in the office market. A sea of money has pushed up the price of high-quality properties while driving down returns. Although the Fed has been steadily increasing short-term interest rates, the effect on long-term rates has been negligible. Global competition continues to keep wage inflation in check, and this environment should bode well for commercial investors' cost of capital in the coming year. All in all, commercial real estate markets should continue their recovery in 2006.



Texas Land Market Outlook

The state's land markets continue to reflect strong demand from recreational buyers and investors, but farmers and ranchers also continue to participate in buying activity. Expectations of anemic returns on alternative investments have undoubtedly contributed to thriving land markets.

Prices for rural land posted another strong move up in the first half of 2005 compared with price levels in the first half of 2004. The weighted median price of Texas rural land rose 11 percent from the 2004 median of $1,238 per acre to

$1,379 per acre. From the Piney Woods to the Hill Country to the North Central Plains, regional markets posted substantial increases in price per acre.

Markets in the Lubbock, Texarkana, Lake Texoma and Kerrville areas posted especially strong results. Market pressures pushed up prices in most regions.

The volume of sales dropped from 4,711 in 2004 to 3,367 in 2005. This decline confirms anecdotal reports of a scarcity of property for sale. Investors seem poised to further spur the market in 2006.

The typical size of property sold in 2005 dropped to 102 from 108 acres in the first-half 2004.

Investment demand continues to drive markets around in the larger metro areas throughout Texas. Recent activity could indicate increasing investor interest in land.

Recreational demand continues to dominate land markets throughout the state. Agents continue to report a shortage of good land for sale in most areas. The land that is available does not stay on the market long. One market observer commented that if property owners bring him land, he can sell it.

The Road Ahead

Without question, 2005 was a trying year for the country. The strength and resilience of the U.S. economy was put to the test. But every punch to the economy created opportunities to make the national economy stronger and more robust.

Higher energy prices meant more investment opportunities in alternative energy resources. And the debris caused by Hurricanes Katrina, Rita and Wilma will be cleared. Gulf Coast cities and communities will be rebuilt, revitalizing this important part of the national economy.

For more information, visit the Center's website, recenter.tamu.edu.

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Tierra Grande (ISSN 1070-0234) 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. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin. Photography/Illustrations: E. Joseph Deering, pp. 1, 2, 5.