Texas Housing: A Boom with No Bubble?

By D’Ann M. Petersen

America’s red-hot housing market has recently started to cool. U.S. single-family home sales are below last year’s, residential construction activity has slowed, and rapid price escalation has waned in many parts of the country.

Not so in Texas. Housing activity remains strong in the state, with new construction and overall sales running ahead of last year’s records. In addition, home-price increases in major metros show signs of picking up speed.

Why is the state bucking the national trend? What metros are the strongest? Will Texas’ housing demand continue upward? How vulnerable is Texas to slowing sales and falling prices? In answering these questions, it’s helpful to examine the factors that led to the state’s housing boom and the risks on the horizon.

In essence, Texas’ housing market has been driven by economic fundamentals—affordability, new residents and economic growth. Although demand remains strong, the state hasn’t seen price increases as large as those stirring fears of housing bubbles in many parts of the country. As a result, the risk of a sudden collapse of the Texas housing market is low.

Thriving Through the Downturn

Texas’ housing market has been on an upswing. Both new construction and existing home sales have set records each of the past five years (Chart 1). The housing market even flourished during the technology bust of 2001–03, which brought other segments of the construction industry to a standstill.1 Housing demand was especially strong in 2005, when new construction and existing home sales both jumped more than 10 percent from the previous year.

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Chart 1

Texas Housing on the Upswing

Index, 1990 = 100

SOURCES: Census Bureau; Texas A&M Real Estate Center; Federal Reserve Bank of Dallas.
 According to the Beige Book, Texas sales of both new and existing homes in the first few years of the decade were driven largely by first-time homebuyers.

sales was 7.5 percent, putting the state third behind California’s 8.5 percent and Florida’s 7.7 percent.

So far in 2006, the Texas housing industry appears to be holding its own, in sharp contrast to signs of waning demand elsewhere in the country. Through March, single-family permits continued to rise in Texas, while they declined at the national level (Chart 2). Anecdotal evidence confirms Texas’ strength. According to the Dallas Fed’s Beige Book, an anecdotal report on Texas economic conditions, builders reported that new-home sales and traffic continued rising in first quarter 2006.

Driving Texas’ Housing Boom

In the early years of this decade, falling mortgage rates fueled housing demand in both Texas and the U.S. The national average for a 30-year fixed-rate loan fell from over 8 percent in mid-2000 to under 6 percent in 2003. At the same time, lenders offered new types of mortgages that made it easier and less expensive to buy a home. These include interest-only loans and mortgages with low initial payments that rise later in the term. With stock market gains tepid, real estate became an attractive investment nationwide.

According to the Beige Book, Texas sales of both new and existing homes in the first few years of the decade were driven largely by first-time homebuyers. With mortgage rates low, it became almost as cheap to buy a home as it did to rent. After dipping to 63.4 percent in 2002, the Texas home-ownership rate rose to 65.5 percent in 2004, allowing the state to gain

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Source: Census Bureau.
ground on the national rate (Chart 3).

Even as mortgage rates edged up in 2005, a rebounding Texas economy helped stoke the fires of homebuilding and buying. Employment rose 3.1 percent last year, Texas’ best showing since 2000. Every major metro and sector contributed to the gains—a change from the previous year. Austin led the state in job growth as its high-tech sector began to revive, and San Antonio was close behind. Houston’s economy expanded rapidly, fueled by demand for oil-related services. Dallas, the hardest-hit metro during the downturn, made great strides in 2005, almost doubling its rate of job growth. And Texas’ border metros prospered as a strong peso boosted retail sales and Mexico’s expanding maquiladora sector led to job gains on the Texas side.

The strengthening Texas economy and the state’s cost-of-living advantages attracted new residents and businesses, which added to already strong housing demand. Domestic migration to Texas rose from 36,923 in 2004 to 51,067 in 2005. At the same time, California, Massachusetts, New Jersey, New York and other states with elevated home prices lost some population to out-migration.

The characteristics of Texas homebuyers have begun to shift. First-time buyer demand, which had carried the market for several years, ebbed in 2005, and Beige Book contacts reported a pickup in relocation and move-up buyers. The price distribution of existing-home sales changed between 2001 and 2005, reflecting increased demand for pricier homes by families with prior home ownership and less demand for the inexpensive houses favored by first-time buyers (Chart 4).

**Prices Slow to Rise**

 Barely a day passes without media comment on the U.S. housing-price boom and the possibility of an impending bust. And with good reason. From 2001 to 2005, the average U.S. median sales price for a single-family home surged 40 percent to $219,000. By year-end 2005, the National Association of Home Builders–Wells Fargo Housing Opportunity Index, which measures the share of homes within reach of median-income families, fell to 2.3 percent in the Los Angeles area, 5.7 percent in New York City and 13.7 percent in the Miami area.

Texas didn’t participate in the housing-price boom. Its median home price was $136,300 in 2005, up a modest 14 percent from 2001. As prices at the national level rose, Texas’ relative affordability increased. The Housing Opportunity Index stood at roughly 60 percent in the Dallas, Houston and Austin areas, well above the nation’s 41 percent.

The key reason Texas didn’t experience the huge price gains of California, Florida and other states is ample supply. Texas has a low population density, with plenty of open land around its major metros. Moreover, barriers to construction are relatively few. The Texas market presents a marked contrast to such areas as the Pacific Coast, where tight supplies of vacant land and tougher zoning make building difficult. In Texas, the ready availability of land and low entry costs attract homebuilders, creating a competitive marketplace that helps keep a lid on price increases.

With the Texas economy sluggish and high-tech industries languishing through 2003 and into 2004, housing demand got a boost from low mortgage rates, but not enough to strain home supply. Existing home inventories rose from 4.3 months of

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**Chart 3**

**Home-Ownership Rate Up in Texas**

<table>
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<tr>
<th>Year</th>
<th>Home ownership rate (percent)</th>
<th>Mortgage rate (percent)</th>
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<td>2005</td>
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**Chart 4**

**Price Distribution of Homes Sold in Texas Changes**

- **2001**
  - Under 40K: 5
  - 40–69K: 12
  - 70–99K: 17
  - 100–139K: 28
  - 140–199K: 23
  - 200–399K: 12
  - 400K and over: 2

- **2005**
  - Under 40K: 10
  - 40–69K: 15
  - 70–99K: 20
  - 100–139K: 30
  - 140–199K: 25
  - 200–399K: 18
  - 400K and over: 5

*Source: Texas A&M Real Estate Center.*
sales in mid-2000 to 6.2 in early 2004, while new homes were being added to the housing stock.

As the economy improved dramatically in 2005, new and existing-home sales picked up because of faster job growth, move-up buyers, and migrants from the West Coast and other regions. As demand ran ahead of supply, existing-home inventories began shrinking, retreating to a four-year low of 4.8 months by early 2006 (Chart 5).

Texas’ existing-home prices remained relatively flat from mid-2001 through 2004—a time when U.S. prices were soaring. Yet, over the six months ending in March 2006, the state’s median existing-home price, adjusted for inflation, rose slightly, while the national average fell (Chart 6).

Signs of scattered price increases are showing up in the new-home market as well. Although data are limited, homebuilders say they’re raising prices where local economies are growing rapidly, including El Paso, Austin and San Antonio. Rising construction costs may also contribute to upward pressure on prices. Texas homebuilders cite higher energy prices and shortages of material and labor, partly due to hurricane rebuilding efforts. Despite increased construction activity, builders say overall inventories remain at reasonable levels, although the stock of unsold homes has risen for the lower-priced homes favored by first-time buyers.

**Texas-Sized Bubble?**

The risk of a housing price correction appears much smaller in Texas than in other areas of the U.S. While prices are high relative to per capita income in California, Florida, New York and even the nation as a whole, the price-to-income ratio remains flat in Texas, suggesting houses are more affordable here (Chart 7). The PMI Mortgage Insurance Co.’s U.S. Market Risk Index—a measure of vulnerability to future price declines—ranks Texas’ five major metros in the bottom 15, far below cities on the East and West coasts. San Diego, Santa Ana and Riverside, Calif.; Nassau–Suffolk, N.Y.; and Boston fill the index’s top five spots.

Despite its recent strength, the housing market in Texas faces several challenges. Long-term mortgage rates have moved up, making buying more expensive and dampening the first-time market. Further increases could dull demand in other price ranges as well. As rates rise, consumers who purchased homes with adjustable-rate mortgages are beginning to see higher monthly payments. Families unable to afford the higher payments could lose their homes to foreclosure, adding to inventories and slowing price increases.

Moreover, higher costs may lessen
homebuilders’ zeal. Construction materials are becoming more expensive, and the hurricane rebuilding now getting under way may mean shortages and still higher prices. Elevated energy prices, while good for Texas overall, could add to the cost of building and maintaining a home.

Additionally, the labor market may get tighter. Workers are migrating to hurricane-damaged areas, and it is unclear how immigration reform will affect access to workers. (Undocumented workers make up 14 percent of all those employed in construction occupations, according to the Pew Hispanic Center.)

Despite the challenges, the housing market should fare better in Texas than in many other parts of the country. While many business contacts’ year-end 2005 forecasts predicted lower starts and sales this year, demand has yet to slacken much. Last year’s strong homebuilding and homebuying activity continued through the first quarter of 2006. Beige Book contacts in the housing industry are positive in their outlooks, especially with the recent pickup in job growth and anecdotal reports of growing in-migration. Even if rising mortgage rates subdue Texas home demand in 2006, the state’s housing industry can still look forward to one of its best years on record.

Texas’ strengthening economy and cost advantages over other parts of the country appear to be bolstering housing demand in the Lone Star State. Over the long term, strong housing fundamentals are likely to persist. Compared with the nation as a whole, the state offers a faster-growing, younger and more diverse population. It also has a central location and warm weather. All these factors portend a rising rate of home ownership in coming years.

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Notes
The author thanks Anna Berman for research assistance and David Brown of Metrostudy for sharing housing data and other useful information. Keith R. Phillips provided helpful comments.

4 A new federal rule that allows a tax-free capital gain of $500,000 when selling a house may have contributed to increased out-of-state investment in Texas housing.