Hot Housing Market Catching Cold in Texas

By D'Ann Petersen

The Texas housing market enjoyed a remarkable upswing in the middle of this decade.

Home sales and building accelerated in 2004 as the state's economic engine revved up, generating strong population and employment growth. Historically low interest rates attracted new homebuyers, while the rise in nontraditional mortgages fueled the market's strength as more Texans were able to obtain financing even if they had flawed credit or lacked down payments. The state's homeownership rate reached a record 66 percent in 2006, up from 61.8 percent 10 years earlier.

The nation's housing market began faltering in 2005, but Texas' kept expanding at a feverish pace through spring 2006. Then it began to cool. Buyers turned cautious and builders cut back in response to slower demand. Texas' existing-home sales bucked the national trend through December 2006, but they too started to slip as the new year got under way.

In 2007, national housing ills took a toll on Texas' housing sector. Persistent declines in U.S. sales and home prices spooked many potential Texas homebuyers. In addition, a slowdown in the regional and national economies, along with tighter credit conditions brought about by the subprime fallout, further reduced the pool of willing and able Texas home purchasers. Sales continued edging down, and home construction retrenched further. Homebuilders and manufacturers of residential construction products bore the brunt of the housing downturn and reduced payrolls to cut costs.

The Texas housing industry faces a difficult year in 2008. Many potential homebuyers are unable to get financing or await news of a housing turnaround. While Texas' housing sector is weakening, it remains healthier than the national average, and Texas metro markets are better positioned than many other parts of the country to thrive when housing demand turns the corner.

Homebuilding Takes a Hit

With sales in other parts of the country spiraling downward, large national builders—whose cash flow and balance sheets were hurt by problems elsewhere—at first shifted building to Texas and its robust economy. Permits for single-family home construction surged in late 2005 and early 2006 (*Chart 1*).

As concerns about the national housing market trickled down to Texas, the cooling showed up initially in new-home building. Buyers became more wary. Cancellation rates soared as would-be Texas homebuyers became unable to sell their existing homes elsewhere in the country.

The state was left with an increasing supply of finished homes. New-home inventories in Texas had already begun to edge up above the comfort zone of six months before new-home sales showed signs of cooling in the second half of 2006. That's when builders, responding to lagging demand and rising inventories, pulled back strongly on new-home construction.

As the pace of building slackened, other segments of the market remained on the upswing. Strong job growth of 3.5 percent in 2006—more than double the nation's—extended Texas' existing-home market expansion. Pre-owned-home sales, which account for almost twice the volume of new-home sales, hit a record high in 2006, despite a decline of 8 percent nationally.

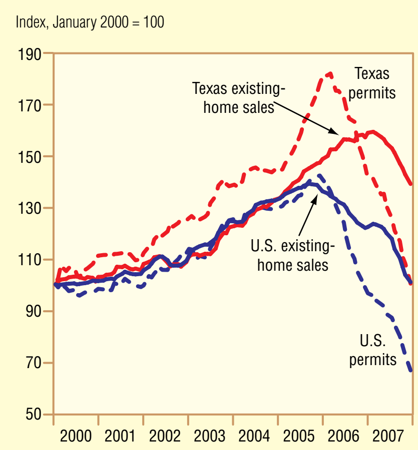
Affordability was a major factor in Texas, where the median home sold for less than 70 percent of the nationwide price. While increased job opportunities, rising incomes, low interest rates and easy credit spurred sales among Texans, residents from other states found Texas homes more attractive as prices skyrocketed in other parts of the country.

Texas owes its housing affordability to ample land supply and relatively few regulations on construction. This allows supply to respond quickly to demand, boosts competition and keeps a lid on price increases in both new and pre-owned markets. During the housing boom, Texas homes appreciated modestly, while prices elsewhere soared out of reach of many Americans (*Chart 2*).[1]

The National Association of Home Builders–Wells Fargo Housing Opportunity Index, which measures the percentage of homes sold at prices an area's median-income household can afford, gave Texas metros high scores in 2006. The index ranged from 52 percent in San Antonio to 67 percent in Fort Worth, compared with a national average of 41 percent. Areas of the country that witnessed rapid appreciation during the boom, including parts of California and Florida, recorded affordability rates in the single digits and teens.

Diminishing affordability contributed to the nation's housing woes.

Chart 1
Texas Housing Market Falters



NOTE: Existing-home sales are five-month moving average; housing permits are six-month moving average.

SOURCES: Census Bureau; National Association of Realtors; Texas A&M Real Estate Center; seasonal and other adjustments by the Federal Reserve Bank of Dallas.

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In 2007, U.S. home sales fell at a record pace, national home inventories ballooned to levels not seen since the mid-1980s, foreclosures shot up and home prices deteriorated throughout the year, especially on the East and West coasts.

Because Texas' housing sector held up relatively well in 2006, industry executives remained hopeful the state would be spared a hard hit in 2007.[2] Most were hoping for a minor dip in building. Those hopes were short-lived, however, as several negative factors converged during the past year, resulting in a statewide housing slump.

Although conditions were better than in the rest of the country, Texas homebuyers turned apprehensive, which dampened demand for both new and existing homes. In addition, more stringent lending standards associated with the subprime mortgage crisis eliminated many potential first-time homebuyers, a market that had spurred much of Texas' sales in prior years. Finally, a slowdown in economic growth both nationally and in Texas further reduced the demand for homes.

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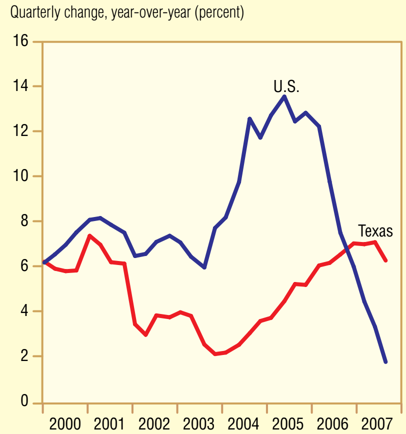
A Closer Look: Metro Markets

Because of their sheer size, the state's major metros make up the lion's share of new-home building and sales—accounting for roughly 80 percent of the state's total.

Chart 2

Texas Home Prices Less Volatile

(OFHEO House Price Index)



SOURCE: Office of Federal Housing Enterprise Oversight; adjusted by the Federal Reserve Bank of Dallas.

Like in the state as a whole, the pace of homebuilding began to edge down in most major metros in 2006 and decelerated further in 2007 (*Chart 3*). Metro existing-home sales held up through 2006 but weakened in 2007, especially in the second half of the year as the credit crunch took hold (*Chart 4*).

While the housing downturn has impacted all major Texas metros, the extent of the fallout is somewhat varied. The cooldown has been most prominently felt in Dallas–Fort Worth. The metroplex more closely resembles the nation than other Texas metros in economic structure. Following the U.S. lead, D–FW job growth slowed to 2.3 percent in 2007, down from a robust 4.3 percent in 2006. Fort Worth's rate of job increase decelerated from 2.7 percent to 2 percent over the same period. While still respectable, the slower rates of job formation mean fewer homebuyers.

Total new-home sales in the metroplex fell 17 percent in 2007, according to Metrostudy, a residential consulting company, and existing-home sales declined 8 percent in Dallas and 5 percent in Fort Worth.[3] Builder inventories of finished homes reached record levels in early 2007. A sharp reduction in construction—with building permits plunging by more than 16,000, or 37 percent—brought inventories down to more comfortable levels by year-end.

In San Antonio, vigorous 2006 job growth, coupled with recognition as one of the country's best places to live, pushed up home sales and expectations of future demand. In 2007, however, the Alamo City's job engine slowed, putting a damper on sales. New-home sales edged down 8.5 percent and existing-home sales dropped 9 percent from the previous year. Builders reacted quickly and pulled the reins on housing construction. As a result, single-family permits fell by 4,511 last year, or 33 percent.

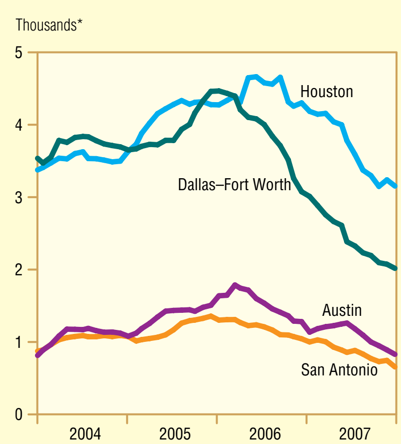
In 2006 and 2007, Houston and Austin led the state's major metros in job growth. Initially, the booming energy sector in Houston and a strengthening high-tech sector in Austin helped cushion the metros from the full impact of national factors that led to homebuyer uncertainty elsewhere. Despite their strong economies, the two metros saw new- and existing-home sales falter in 2007, especially as credit tightened late in the year. Builders cut back on construction; by December, single-family permits had fallen 21 percent in Houston and 30 percent in Austin from 2006 levels.

Texas home prices held up quite well in 2007, despite the weakening housing landscape. U.S. median existing-home prices fell 6.5 percent from December 2006 to December 2007, but Texas metros saw mostly stable home prices, with an overall increase of 1 percent (*Chart 5*). Price appreciation varied by metro, with Austin in the top spot at 8 percent and Dallas prices inching down 2 percent.

Chart 3

Homebuilding Ebbs in Texas Metros

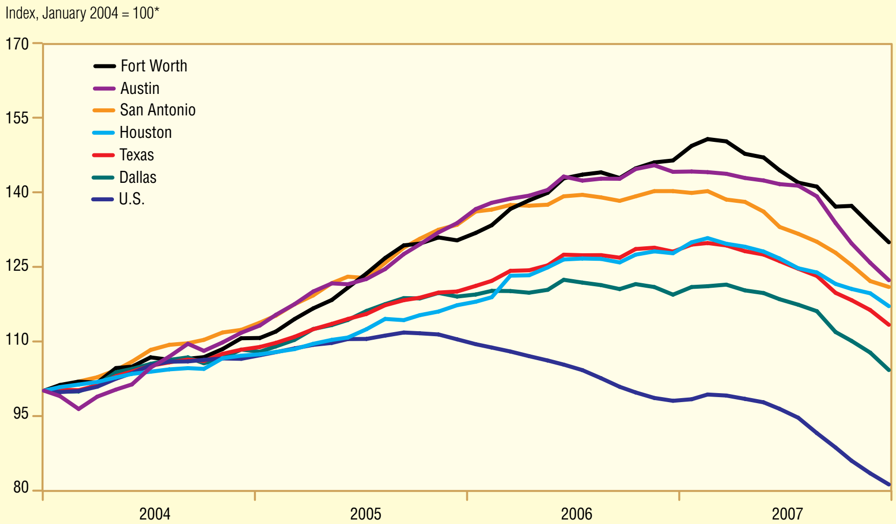
(Monthly single-family permits)



* Five-month moving average.

SOURCE: Census Bureau; seasonal adjustments by the Federal Reserve Bank of Dallas.

Chart 4
Existing-Home Sales Edge Down in Texas, Plunge Nationally



* Six-month moving average.

SOURCES: National Association of Realtors; Texas A&M Real Estate Center; seasonal and other adjustments by the Federal Reserve Bank of Dallas.

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New-home prices aren't readily available at the metro level, but Dallas Fed business contacts say prices have held mostly steady despite aggressive discounting on unsold inventory in some areas.

Down but Not Out

While the Texas housing industry faces some tough challenges in the year ahead, the state has so far managed to avoid the pitfalls of the nationwide housing downturn.

One major concern is the possibility of dramatic increases in foreclosures, which could inflate Texas home inventories and push down prices. So far (through third quarter 2007), foreclosures as a percentage of total loans outstanding have held relatively steady in Texas, while spiking in the U.S. (*Chart 6*). Likewise, Texas' inventory of loans in foreclosure as a share of total loans outstanding is below the national average.

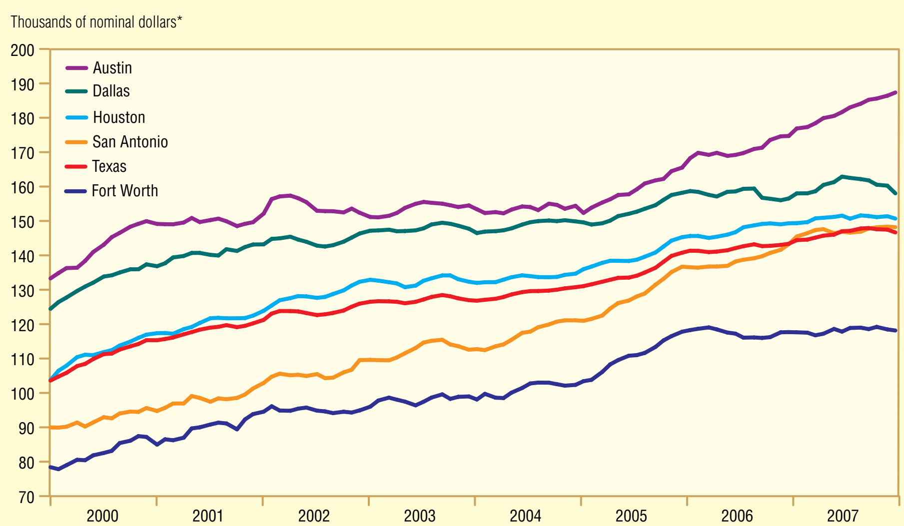
Texas' foreclosure rate remains close to the level recorded during the state's high-tech downturn, when telecom-related layoffs forced many homes back on the market. While the percentage is roughly the same, today's foreclosures are more likely skewed toward higher-cost loans and adjustable rate mortgages (ARMs) often used by first-time homebuyers and those without downpayments or with blemished credit.[4]

As interest rates reset on homes purchased with ARMs, homebuyers drawn in by creative financing may be unable to afford higher monthly payments. Texas' slower housing appreciation affords less opportunity to tap home equity when these homeowners become financially strained.[5] While rising, prime and subprime ARM foreclosures remain a small part of Texas' overall loan pool—0.8 and 3.6 percent, respectively, in the third quarter 2007, well below the U.S. shares of 0.97 and 4.7 percent.

Because of its relative affordability, Texas has a smaller share of jumbo loans—loans above the government's conforming limit of $417,000. While overall credit has tightened for all types of loans, the market for jumbo loans has become especially restrictive recently because it includes a large share of subprime mortgages.[6] In contrast, nonjumbo loans were mostly made up of traditional fixed-rate mortgages (88.1 percent).[7] The smaller percentage of jumbo loans may lessen the impact of the credit squeeze in Texas relative to some more expensive areas of the country.

Other factors should help Texas housing markets avoid the problems other states

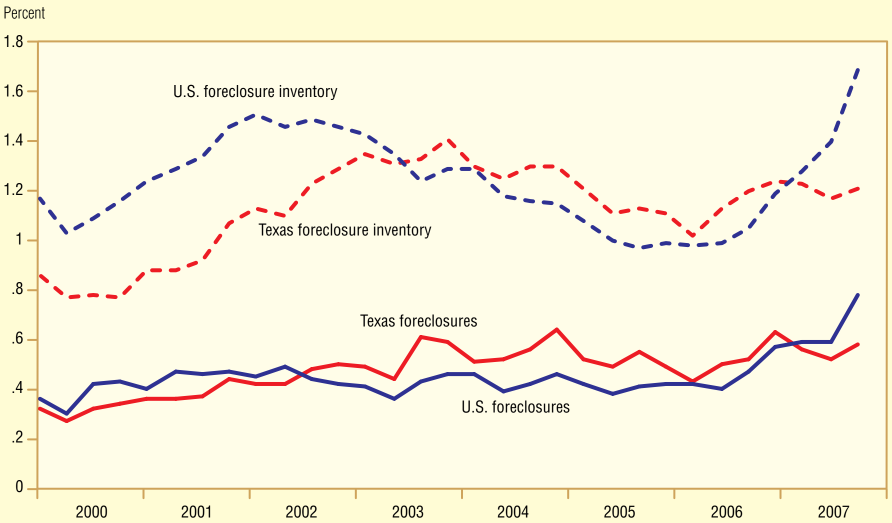
Chart 5
Texas Median Existing-Home Prices Hold Up



* Four-month moving average.

SOURCE: Texas A&M Real Estate Center; seasonal and other adjustments by the Federal Reserve Bank of Dallas.

Chart 6
Texas Foreclosures and Inventories Relatively Steady



NOTE: Foreclosures are number of foreclosures initiated in the quarter as a percentage of total loans. Inventory is total number of loans in the foreclosure process as a percentage of total loans.

SOURCE: Mortgage Bankers Association; seasonally adjusted by the Federal Reserve Bank of Dallas.

are facing. Most notably, Texas home prices continue to hold up fairly well compared with prices at the national level.

Thanks to plenty of land and few building restrictions, Texas didn't join the nation in the run-up in housing values during the boom years. More recently, builder restraint in response to weaker demand has helped keep Texas' new-home inventories in check—near six months' supply in most major metros, compared with more than 10 months at the national level (*Table 1*).[8] While existing-home inventories edged up slightly in 2007—from 5 months' supply to 6.1 months'—they're still well below levels recorded even as recently as the mid-1990s.

Tighter inventories should help buffer Texas markets from the large price declines prevalent in other areas of the country. While some downward movement is possible, the risk of price declines is much smaller in Texas than in other parts of the U.S.

The PMI Mortgage Insurance Co.'s U.S. Market Risk Index—a measure of vulnerability to future price declines—ranks Texas' metros among the 11 least vulnerable in its 50-city survey. In fact, Dallas, Fort Worth and Houston rank among the four lowest for risk of price deterioration.

Most important, while economic growth is expected to continue to slow, Texas is still expected to outpace the national average.

Long-Term Advantages

2008 will be a tough year for the Texas housing industry. While fundamentals are healthier in Texas than in many other parts of the country, housing demand has lost its luster, and it may be some time before buyers feel confident enough to jump back into the market.

A slowing national economy, the recent move toward more stringent lending practices, rising foreclosures and lagging housing prices in other states will continue to negatively impact the housing industry in Texas.

Table 1
Texas Home Inventories Tighter
(Months' supply of single-family homes)

	Existing homes Q4'07	New homes* Q4'07
Austin	4.6	7.3
D–FW		6.8
Dallas	6.5	
Fort Worth	6.3	
Houston	6.6	6.0
San Antonio	6.4	5.6
Texas	6.1	
U.S.	10.0	10.6

*Not seasonally adjusted.

SOURCES: Metrostudy; Census Bureau; National Association of Realtors; Texas A&M Real Estate Center; seasonal and other adjustments by the Federal Reserve Bank of Dallas.

There is a bright side. Texas metro housing markets remain better off than other areas of the country in terms of prices, inventories and foreclosures. Moreover, despite the recent pullback, Texas is still the top state for homebuilding.

In the longer term, Texas' location and cost advantages, fast-growing population and relatively buoyant economy put the state's housing industry in a strong position to respond when demand turns the corner.

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Notes

Thanks to Bill Gilmer for comments and to Mike Nicholson for research assistance. Thanks to Metrostudy for sharing housing data.

[1] The OFHEO home price index is a broad measure of the movement of single-family house prices. It is a weighted, repeat-sales index, meaning that it measures average price changes in repeat sales or refinancings on the same properties. This information is obtained by reviewing repeat mortgage transactions on single-family properties whose mortgages have been purchased or securitized by Fannie Mae or Freddie Mac since January 1975.

[2] Based on the Dallas Fed's Beige Book, a regular survey of current economic conditions.

[3] Calculated as total sales in 2007 versus total sales in 2006.

[4] For more information, see "Neither Boom nor Bust: How Houston's Housing Market Differs from Nation's," by Amber C. McCullagh and Robert W. Gilmer, Federal Reserve Bank of Dallas *Houston Business*, January 2008.

[5] A decline in Gulf Coast foreclosures, including Houston, can be attributed to actions taken by the Department of Housing and Urban Development, which implemented a moratorium on foreclosures in federal disaster areas for properties insured by the Federal Housing Administration from August 31, 2005, through August 31, 2006.

[6] According to the Office of Federal Housing Enterprise Oversight, risky interest-only loans and negatively amortizing ARMs made up nearly two-thirds of the dollar volume of first-lien jumbo loans originated in the U.S. in the first half of 2007 and later securitized, whereas traditional fixed-rate mortgages composed only a quarter of those loans.

[7] "Mortgage Market Note 08-01: Potential Implications of Increasing the Conforming Loan Limit in High Cost Areas," Office of Federal Housing Enterprise Oversight, Jan. 11, 2008.

[8] Inventories are months' supply of single-family homes on the market at the current sales pace.