



What's in store for 2008?

The outlook for the residential real estate market.

by Mark Dotzour and Jim Gaines

It's common knowledge that economists were put on earth to make the weatherman look good. Even so, the Federal Reserve rarely admits just how challenging economic forecasts are. But in a meeting last December, they acknowledged that "the situation is quite fluid and the economic outlook is unusually uncertain." In plain English, this means, *We really don't have any idea where the economy is headed in the next six months.*

The national picture

Actually, we think the Fed knows exactly where the economy is heading, and it's not pretty. First, consumers are running out of gas. Not only are mortgage delinquencies increasing, but so are bankruptcy filings. Housing has always been a leading economic indicator. When home building declines dramatically like it has, it has frequently resulted in a recession. Second, there are still too many homes being built. Third, prices are falling dramatically in many areas of the country now.

When prices fall, buyer psychology changes. REALTORS® describe this phenomenon as "buyers sitting on the fence." And when buyers sit on the fence, sales volume drops. Ultimately, buyers get off the fence for two reasons: They think that prices are likely to start rising again, or they think that mortgage rates may begin to go up. Neither of those two events is likely to happen in 2008 at the national level.

So what's next for the U.S.?

Expect the federal government to intervene heavily in the U.S. economy. The Federal Reserve is likely to cut interest rates several times in the early part of the year. Also, look for more revisions in the mortgage lending arena. The sub-prime and Alt-A lending market needs to be restructured, so some of these borrowers can stay in their homes. Look for changes in FHA, FannieMae, and FreddieMac that will ramp up the volume of loans they originate. Expect the unexpected in 2008, because we are clearly in uncharted territory.

Texas: Where we've been and where we're going

The recent housing cycle in Texas peaked in 2006, but the falloff has not been as rapid or as deep as in other states. Total sales volume declined, and homebuilders face an excess of unsold new homes. Nevertheless, home prices continued to climb and the months' inventory of unsold homes remained within the general guidelines of a "good" market.

The outlook for 2008 is for further reduction in sales volume and construction activity, with slower, but still positive, price gains. Barring any unforeseen calamities, the overall housing market in Texas should be much stronger than most other areas of the country.

Four major conditions will influence the Texas housing market for the rest of the decade:

1. General economic conditions. A major risk to the real estate market in 2008 is the prospect of a general economic recession. So far, employment and income trends in Texas favorably support housing demand.
2. Uncertainty in the capital and mortgage market. The period of “easy credit, easy terms” that fueled the recent housing cycle is over, but mortgage credit for qualified buyers (i.e., those with documentable jobs and income and savings for a downpayment) is available and at historically attractive interest rates. The banks, investment funds, and other capital market institutions are reeling over the lasting effects and default rates. Foreclosures will remain historically high throughout the year and may not decline until well into 2009.
3. Demographic trends. Texas continues to lead the nation in numerical population growth and immigration. Growth over the next several decades will help keep the state’s housing market moving forward despite short-term disruptions.
4. Housing affordability. The median home price in Texas is about two-thirds of the national median home price, which makes Texas the most affordable high-growth state in the United States. The price of housing will be one of the strongest magnets for population and business growth in the state during the next 25 to 30 years.

Home sales activity

Total reported sales in 2007 declined a little more than 5%. Sales volume in 2008 will probably fall another 5%, as buyers have to meet stricter mortgage underwriting criteria, marginal, subprime buyers are excluded from the market, and the psychological impact of a national housing decline influences many to “wait and see.”

The inventory of unsold homes increased from around 5 months to 5.6 months in 2007, indicating a general trend toward a buyer’s market from a seller’s market. Buyers should find bargains in 2008, especially in unsold new homes as builders move to reduce inventories.

Home prices

The statewide average and median home prices in 2008 will probably grow slower than the long-term rate of increase but significantly better than the overall national experience. Home prices nationally fell about 2% in 2007 and may decline further in 2008. Expect the average Texas home price to go from around \$193,000 to about \$200,000, a 3.6% increase, and the median price to go from about \$147,000 to \$150,000, a 2% increase. Home-price increases will be constrained by sales of excess new-home inventory at lower prices and the number of foreclosed homes that will enter the market. Both conditions will influence not only the specific homes sold but also the surrounding neighborhoods.

Construction

New-home construction in 2007 fell dramatically as potential buyers who were dependent on easy credit disappeared. The number of single-family permits exploded from mid-2004 through mid-2006. Since mid-2006, the number of permits issued has fallen significantly. Texas single-family permits fell around 28% in 2007. Expect permits to fall another 10% or so in 2008. Total permits in 2008 should be around the same level as recorded in 2000, reflecting a major correction to the previous overbuilding.

Overall outlook

The Texas housing market will slow down further in 2008 from the 2006 peak but will still be strong relative to most other states. The Texas market is not immune from national economic conditions, from forces in the mortgage and credit markets, or from overbuilding in the past, but sustained job and population growth will keep demand strong. It may well take two or three years before the national market

completely rebounds from the excesses of the recent housing cycle. The longer-term outlook, however, is most favorable. Population growth, affordable housing, available and affordable labor, and an attractive business climate will fuel future market increases and expansion.

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