THE Neal Spelce AUSTIN LETTER

www.AustinLetter.com

P.O. Box 1905 / Austin, Texas 78767-1905 / 512-498-9495 / Fax 512-327-1976 / e-mail News@AustinLetter.com

Volume 24, Number 21

August 23, 2002

Dear Client:

When you talk about affordability of Austin area homes, it's not just price you talk about. After all, very few people pay cash for a house. Most buyers ask a simple question: can we afford the monthly mortgage payment? That's why the lowest mortgage interest rates in more than 30 years have kept residential real estate a hot commodity.

On the average, **home prices in the Austin area rose over the past year**. But, mortgage interest rates kept going down to where, now, the average 30-year fixed-rate mortgage is 6.22%. This is the lowest level since Freddie Mac, the mortgage company, began its nationwide survey in April 1971. A year ago at this time, 30-year mortgages averaged 7%.

By the way, the average for 15-year fixed rate mortgages dipped from 5.69% the previous week to 5.63%, also setting a record low. **This drop in mortgage interest rates, in effect, has wiped out much of the effect of higher home prices**, according to the Real Estate Center at TexasA&M University.

The Real Estate Center tracks these trends regularly as it compiles the Texas Housing Affordability Index. The THAI takes into account a number of factors to come up with an affordability index for each major market in the state – including **average incomes**, **home prices** based on current sales closed through the Multiple Listing Service, and **interest rates**. Obviously if interest rates are very high (thereby increasing monthly mortgage payments), fewer families can afford to buy a home.

So where does the Austin market rank on the most recent THAI scale of affordability, given the low interest rates, rising home prices and, in many cases, diminishing incomes due to the downturn? In plain English, the THAI index shows **the median household income in Austin is 20% *more* than the minimum income needed to buy a median-priced home**. In other words, low interest rates are keeping Austin homes affordable.

Bear in mind, we're talking "averages" and "medians" here. **The Austin market for million dollar homes is still in the dumper** – even though low interest rates apply to mansions as well as to starter homes. Also, prices for the sprawling, hilltop castles have dropped because of low demand. But, the *other* factor – income – plays a major role here. There are fewer millionaires and high salaries in Austin now, and that hammers the market for mansions.

How long will mortgage interest rates stay near this record low level? The answer to that question is one of the keys to the strength of the Austin economy.

If you've been tracking what Federal Reserve Chairman **Alan Greenspan** has been saying (a big job – considering his mumbo-jumbo, arcane economic language!), you'll remember he has **credited the strong housing market with cushioning the economic downturn**. Also, he's pointed out that rising home prices have, in some cases, offset stock market losses. You'll recall we've written quite extensively over the past few months about home values outperforming stock market investments.

All this has provided buyers with the confidence to invest in homes, and this confidence shows no sign of abating. In fact, Freddie Mac chief economist **Frank Nothaft** was quoted this week as saying the Fed's acknowledgement last week of weakness in the economy is likely to **keep mortgage rates near record lows for the rest of the year**. This is good news for the Austin economy and better news for the Austin area's residential real estate market.

Other points made by Greenspan in his appearance before Congress last week also included one factor that is particularly true of the Austin area (which is predicted by economist **Ray Perryman** to be the fastest growing metro area in Texas for years to come). Greenspan noted that **population growth is fueling the strong housing market**. **Nowhere is that more true than here in the Austin area**. These strong increases in newly formed households keep the demand solid for homes, albeit at a slower pace than during the go-go days.

What about the cost of other capital? Are you going to be paying Austin banks more to borrow money anytime soon?

Based on the best information we've been able to get for you, **the rate you're being charged for borrowed money is not going to ratchet up very quickly this year or next**. The reason being the Federal Reserve is frankly more concerned about the economic recovery than it is about inflation. You'll remember, in the not-too-distant past, interest rates were used by the Fed as the biggest tool to fight inflation. That bugaboo hasn't been with us for some time.

As a result, the best estimates are that interest rate increases will come slowly over the next year or so. In fact, one prediction we trust is calling for the **current prime interest rate of 4.75% to increase by only one percentage point by the end of 2003**. And, with the Fed's penchant of taking baby steps each time it moves, the prime interest rate will likely inch up slowly, rather than take a big leap at any given interval, during the next 16 months.

This stable cost of capital will be a welcome constant as the Austin area grows its way slowly out of the downturn.

As Dell goes, so goes Austin. Well, not exactly. But, there is no single company that impacts the Austin area economy greater than the largest private employer in the area. So, how is Dell doing since it lost $104 million in the 2nd quarter last year?

Very well. And, we're not just talking earnings and revenue, though they are quite impressive. For instance, **Dell *earned* $501 million** in the 2nd quarter this year, compared to last year's $104 million loss. That's not all. **Dell's revenue of, get this!, $8.46 billion** grew 11% — topping Wall Street expectations and Dell's own forecasts.

This is all the more significant when you remember the hand wringing that went on last year as **Dell laid off thousands of its employees when the downturn hit**. You may also remember we told you at the time that, despite the personal difficulties suffered by those who were laid off, this would make Dell a much stronger company.

More importantly, was Dell's take-no-prisoners competitive strategy, which we chronicled for you. Because of Dell's strong cash position, and its' manufacturing advantage, the Round Rock-based company **ramped up its advertising**, **slashed prices**, and **stole market share from its competitors** that were retrenching. Aggressive, wise move.

However, that's all in the past. How is Dell staying ahead of the game? The ever-confident Dell is moving into new markets. We're not talking solely about its recent announcement that **it will start selling its own printers and handheld organizers**. That's a very visible part of what Dell is getting ready to do. But, frankly, handheld devices will probably only account for about 1% of the company's revenue.

What should really make the difference is the fact that, in addition to Dell's dominance in its original business – the personal computer – it has started selling **more complex servers**, **more advanced storage devices** and **network switches**. Those items are not as visible to the public, nor as sexy, but they will have a huge impact on Dell's bottom line.

This move will solidify Dell's strategy of building relationships with corporations. By making these complex servers and storage devices, then selling them to companies and, importantly, maintaining them, **Dell is treading into territory where IBM and Hewlett-Packard have long been the big dogs on the block**.

What Dell is doing is ideal for difficult economic times. Its long-admired manufacturing system is a model of a **lean, turn-on-a-dime process**. **Dell is nimble**, **not lumbering**. While making high tech history, Dell has actually stuck to good old US manufacturing roots emphasizing low-cost manufacturing and distribution. This has pushed Dell, which was not even on the FORTUNE *Global* 500 list until 1997, to #131 today. Not bad, not bad at all.

With Labor Day just around the corner, the partisan political rhetoric will soon reach a decibel level found only on East Sixth Street on Saturday night after a UTAustin football victory. So, before we're drowned out, let's take a moment to look ahead to where Texas stands to gain in a non-partisan way on a political battlefield.

Texans have long held positions of power, on both sides of the aisle in Congress. In most cases, where the interests of The Lone Star State have been at stake, Texas Democrats and Republicans in Congress have put partisanship on hold and **joined for the common good** of the state. And, because of the leadership positions held by Texans, the state has fared quite well.

There will be some shakeups in the leadership of the USHouse of Representatives after the November elections, and when presidential politicking picks up soon thereafter. You already know the GOP leader in the House, Republican **Dick Armey**, is not seeking re-election. But, that very powerful position will more than likely be filled by another Texan – **Tom DeLay**.

On the Democratic side of the aisle, Texas stands to gain because of the presidential ambitions of Democratic leader **Dick Gephardt**. The betting is Gephardt will step down to focus on his run for the White House and, if so, his likely replacement is Texan **Martin Frost**.

So, Texas could really be in a stronger position in the USHouse with a Republican and a Democrat solidly entrenched in the leadership of their respective party. However, Texas stands to lose some stroke in the USSenate, when the powerful **Phil Gramm** steps down in January. Because of the seniority system in the Senate, it will be a while before either Democrat **Ron Kirk** or Republican **John Cornyn** can move into a position of power. This just means that Texas' remaining USSenator **Kay Bailey Hutchison**, who has made strong strides toward leadership in that elite deliberative body, may have to step up her leadership role a bit.

Dr. Louis Overholster has reached the age where – if it weren't for stumbling – he wouldn't get any exercise at all!

NEAL SPELCE AUSTIN LETTER (ISSN 1071-0612) is published weekly, except last two weeks of the year, for $150 (plus tax) per year or $249 (plus tax) for two years. To subscribe, call 512-498-9495. Periodical Postage Paid at Austin, TX 78767 by Austin Letter, Inc., 1407 Wild Cat Hollow, Austin, TX 78746. POSTMASTER: Send address changes to: Neal Spelce Austin Letter, P.O. Box 1905, Austin, TX 78767-1905.

Sincerely

Neal Spelce

Editor/Publisher