THE Neal Spelce AUSTIN LETTER

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Dear Client:

During the 2003 and 2004, **the Texas economy will gradually improve – probably at a 3.5% this year and 4.2% next year**. **With Texas' central Sunbelt location**, **relatively low costs**, **and sustained migration into the state**, **Texas should outperform the US by nearly a half percentage point through 2005**.

This is the outlook from the economists at the Texas State Comptroller's office. They maintain the economic expansion that is now underway will be "**more gradual than is typical after economic downturns**, given the depth of the national and international slump and the characteristics of the markets."

The economists say **Texas**' **silver lining is productivity growth**. The reason: productivity of Texas workers has increased at a faster rate than the loss of jobs in Texas. As a result, Texas avoided joining the nation in recession, but just barely.

Let's take a look at some key findings by the State Comptroller's staff as they look ahead. **Manufacturing employment should rebound in Texas**, **but not quickly**. What will help the bounce-back is that energy prices will drop, since the war with Iraq did not disrupt oil supplies.

Over the next two years, the fastest rates of growth in retail sales are expected in general merchandise – largely **warehouse and discount** – stores and miscellaneous/ novelty retailers, including bookstores, drug stores, liquor stores and Internet mail order.

The services industry is expected to come back in 2003, largely in response to renewed growth in **business services** and continued relative strength in **health services**. The **fastest growth rates in government will be at the federal level** for a change, related in large part to security measures.

Construction will continue to fall during 2003, with its upturn in 2004. But overall, the Comptroller's economists believe **unemployment in Texas has topped out**. You'll remember Texas peaked at a very low 3.9% unemployment in December 2000, then soared upward precipitously to a high of 6.3% in the spring of 2002. The state has now stabilized and Austin's unemployment rate is getting lower by the month so far during 2003, touching 5.3% in April.

The Mortgage Bankers Association now forecasts that $3.02 trillion in loans will be written this year, up from $2.48 trillion last year and 2003 will post a new record for homes sold. What's this?

This quote comes straight from page 102 of the 6/16/03 issue of *FORTUNE* magazine. This isn't all. A hedge fund head was quoted as predicting "a speculative rise in home prices and a speculative move in housing stocks." **Doug Kass** went on to say "The homebuilders are going to be the market leaders on the upside in 2003 and 2004."

He was talking in general, national terms – not singling out Austin or any other local market. But obviously, with Texas economic rebound leading the nation (see previous story), and with Austin one of the top markets in the state, this forecast has strong implications for us. And it has to do with what has helped housing stay strong during the downturn – **low interest rates**.

> Here's the logic. Because the **Fed is unlikely to raise rates soon**, financial institutions see little risk in owning mortgage debt. As a result, the average rate on a 30-year mortgage has fallen to a new all-time low of 5.3%, **pulling the country into yet another mortgage boom**.
>
> The low rates mean more folks will continue re-financing mortgages. In fact, the Mortgage Bankers Association's **re-fi index is back near all-time highs**. If this occurs, the good economic news is not limited to the housing industry. The Fed reckons that homeowners extracted some $54.5 billion in cash from their homes during the re-fi boom of 1998 and early 1999, and about 18% of that money went for consumer goods.
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> Today people may be more nervous about using their homes as piggy banks, so fewer borrowers are likely to opt to take extra case when they refinance. But those who *do* re-fi are more likely to **put the money into fixing up the house** and, of course, those dollars are circulated through the local economy.

Since all this is based on incredibly low interest rates, what's the best guess for the immediate future? Well, *FORTUNE* puts it this way: "…**the Fed hinted that it doesn't plan to pull the trigger by raising rates until it sees the whites of inflation's eyes**. That probably won't happen until well after the economy is growing briskly again." The key word here is "briskly." And we haven't seen a single forecast, anywhere, calling for a "brisk" recovery.

By the way, the purpose of the magazine analysis was to suggest that if you didn't get in on the real estate boom by buying an "investment" house (that, in some cases, has doubled in value in about five years), you still have a chance to make a few bucks. **It suggests buying housing related stocks** like Home Depot (HD), **or stock in national homebuilders** like Toll Brothers (TOL), building in the Austin area, and Beazer Homes (BZH), concentrating in the northeast and Mid-Atlantic. But, if you do invest, it recommends you watch your position closely.

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Are Austin's relatively high home prices likely to decline in the next few months? **Probably**, **according to a leading Texas Real Estate data center**.

The Real Estate Center at TexasA&M reported this week that Austin, at the current sales pace, had **7.1 months of existing home inventory** on the market – up from last April's 5.3 months. The Center's research economist, **Jack Harris**, says on average six months of inventory is the point at which prices stay the same, and **more than six months of inventory tends to lower prices**. Home sales are down 9% so far this year, according to Multiple Listing Service data. The median sale price in Austin is $155,400, compared to the state average of $124,800.

Make no mistake about it, ***if*** **the Texas Legislature ends up drawing new Texas Congressional boundaries**, **Austin Congressman Lloyd Doggett's district will be sliced and diced to favor Republicans**. **Doggett is in the GOP crosshairs**.

As of our deadline, Governor **Rick Perry** had not indicated when/if he will call a special session this summer. But he could make his decision known soon, and the inside betting is he will **call a session to start somewhere around the Fourth of July** – unless the governor decides to go to France to watch Texan **Lance Armstrong** try to win the Tour de France again (which would give the cancer survior five victories back-to-back).

Democrat Doggett, who has been one of the most vocal critics of Republicans since his first day in Congress, will almost certainly have his Travis County district diced so drastically **he will have a hard time being re-elected** – even though Doggett has a huge campaign war chest. Doggett is not the only target. There are other Democrats the GOP want out of office – such as **Martin Frost** from Dallas.

Who might surface to challenge Doggett if his new district contains a huge GOP majority? **State Representative Jack Stick**, **the freshman who has gotten a spate of recent publicity**, is being mentioned.

Have you seen the ads touting Ford Motor Company's 100 years in business? **Well**, **while those ads are running**, **a car manufacturer that just located a plant in San Antonio has displaced Ford as the world's #2 automaker**.

This is quite a blow for the venerable Michigan manufacturer. But Japan's **Toyota passed Ford in global unit sales during the first quarter this year**. Ford has been second only to General Motors for your entire lifetime (if you were born after 1931). You might be old enough to remember when Ford had a plant in Texas and every car that rolled off its assembly line had a bumper sticker on it that said "**Made in Texas by Texans**." Wonder if Toyota will do that.

Something is definitely going on in Austin. After topping *Forbes* magazine's annual list of Best Places for Business and Careers last month, *Forbes* is now reporting Austin has edged out much larger metros like Denver, Boston and New York as the nation's best city for singles.

Different criteria were used by the magazine for the two separate designations, which makes the two # 1 rankings even more impressive. For the "singles" designation, *Forbes* wrote, "The Texas capital can thank its **terrific job market**, **its low cost of living and an environment that draws the young, unattached and artistic in droves**." It used six different yardsticks for singles to compare the nation's major metros: nightlife, culture, job growth, number of other singles, cost of living alone and coolness (hmmm, how do you define "coolness"?).

These are fun designations. But in the 5th annual Best Place for Business and Careers listings, *Forbes* changed the way it compiles its rankings to reflect the changed economic times.

> Still keeping a careful eye on income and job growth, *Forbes* this year turned to Economy.com's cost-of-doing business index, which includes the **price of labor**, **energy**, **taxes and office space**. *Forbes* also looked closely at the qualifications of the available pool of labor, taking into account each area's concentration of **college graduates and PhDs**. And, for the first time, *Forbes* rankings characterized the attractiveness of an area by looking at crime rates, housing costs and net migration.

Here's how the **business rankings** stacked up: #**1**, **Austin** … #2, Boise, ID … #3 Raleigh-Durham … #4, Atlanta … #5, Madison … #6, Provo, UT … #7, Omaha … #8, Des Moines … #9, Dallas and #10, Washington, DC-Northern VA.

For the **singles category**, here's how *Forbes* rated them: #**1**, **Austin** … #2, Denver-Boulder … #3, Boston … #4, Washington-Baltimore … #5, Atlanta … #6, San Francisco-Oakland … #7, Los Angeles … #8, New York … #9, Raleigh-Durham and #10, Dallas-Fort Worth.

Noting two candidates for president were campaigning in Austin this week, **Dr. Louis Overholster** observed that, "in America, anybody can become president and I suppose that's the risk they take!"

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Sincerely

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