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Dear Client:

Looking not only at this New Year, but five years out, the Austin metro area will once again lead Texas' big metros in percentage of population gains, employment and economic output.

To get a handle on future trends that will likely affect you and your business, we're turning at the beginning of 2005 to two trusted sources – one in Texas, the other national (as national developments have more-and-more impact on the Austin area). We'll extrapolate what they forecast and **add our local perspective** for you to use in your planning.

In summary, for the nation, **Kiplinger Forecasts says to look for continued economic growth in 2005** with slower profit gains and mild inflation. High energy prices will continue to have an effect on many sectors of the economy. For Texas, economist **Ray Perryman** predicts there will a moderate population gain from 2004 to 2009, and **state employment will rise almost 2% per year** over the next five years. And the Austin area will lead the way.

First of all, let's break it out for Central Texas. The five-county Austin metro area is expected to see a compound annual *population* growth rate of 2.36% over the next five years. **This is solid — not spectacular, out-of-control – growth and will lead the other major metros.** Perryman predicts the Dallas metro will have a compound annual growth rate of 2.03%, Fort Worth-Arlington, 2.02%, Houston, 1.93%, San Antonio, 1.87% and El Paso, 1.52%, over the next five years. By the way, the state's population will increase by 2.11 million, up from 22.5 million.

The state's *employment* is projected to rise 1.96% per year over the next five years and, again, the **Austin metro will lead the way with a 2.18% compound annual employment growth rate.** The Dallas metro will be close behind at 2.14%. Some of the others: Fort Worth-Arlington, 2.08%, Brownsville-Harlingen-San Benito and Laredo, 2.06%, San Antonio 2.05% and Houston 1.88%.

With this predicted growth, the Austin area is also expected to have the greatest percentage *economic* growth. Perryman predicts Texas will experience 4.15% real gross product growth. **Austin will lead the major metros, as follows: Austin, 4.48%**, Dallas, 4.41%, Fort Worth-Arlington, 4.37%, San Antonio, 4.13%, Houston, 4.03% and El Paso, 3.98%. Remember, when we use the major metros as a comparison, this covers about 85% of the state's population and is predicted to be responsible for more than 89% of the population gain over the next five years.

Austin's economy is at the mercy of such outside factors as interest rates, inflation, energy prices, etc. What can you expect in these and other areas as this New Year unfolds?

Our friends at Kiplinger Forecasts in Washington, DC, are predicting higher *short-term interest rates* will come gradually during 2005. "The Federal Reserve won't continue to boost short-term rates unless it is convinced that economic growth won't be hurt," according to Kiplinger. **"We expect a series of hikes that put the prime in the 6% - 6.5% range by the end of 2005, about a percentage point higher than now."** This will raise the cost of your borrowings and what you pay on your credit card debt.

What about housing? The Austin area's residential real estate sector enjoyed a great 2004, despite less-than-enthusiastic forecasts a year ago. One of the big reasons was that *long-term interest rates* stayed low. Kiplinger predicts long-term rates will move up in 2005. **"Mortgages will be more expensive, but still affordable, with the 30-year fixed rate about 7%, up from 5.7% in late 2004,"** according to Kiplinger. The reason: the yield on 10-year Treasury bonds will be about 5.5% by year-end 2005, compared with 4.5% at year-end 2004.

It's been some time now since rampant *inflation* was a factor. Looks like this will continue. Modest inflation is predicted to continue next year, even dip a little. Kiplinger thinks the Consumer Price Index (CPI) will rise about 2.5%, down from 3.2% in 2004. "There will be exceptions," predicts Kiplinger. **"The costs of energy, health care, education, household repairs and accounting services figure to rise faster than the overall CPI."**

The big surprise last year will carry over into 2005. *High energy costs* are probably not something you budgeted for your business or personal planning at this time in 2004, **but you are going to be hit directly with bigger bills for the fuel you use, and indirectly through surcharges for higher transportation and raw materials costs in 2005.** An example: Kiplinger thinks gasoline prices will average about \$2 a gallon, spiking to \$2.50 if there are supply disruptions, such as "terrorist attacks against oil facilities and civil unrest in major oil-exporting countries such as Nigeria and Venezuela."

Austin's largest private employer, Dell Inc., should do well in the sale of its products in the international market because of the down dollar. The US trade and budget deficits will *keep the dollar weak* against other major currencies this year. Since early 2002, the dollar has fallen nearly 15% against a broad index of the currencies of the largest US trading partners. This makes Dell's products, as well as those sold by other US exporters, "cheaper".

The flip side of the lower dollar is it will cost you more when you travel to foreign countries. Already, the dollar is at its **weakest level ever against the euro** – about \$1.35 to \$1. The weak dollar will help increase travel *to* the US and that, in turn, will aid the turnaround of our tourism and hospitality industry. But high fuel prices will keep airlines struggling to make a profit.

We're being swept up in a sea change shift in US population, and for the most part, this will aid the Austin area's economic dynamism.

This trend has been going on for decades – the population growth in the South and West and a corresponding decline in census in states like New York, Pennsylvania, Ohio, Michigan and Indiana. In fact, it is so pronounced that California, Texas and Florida can expect to add the most people from now to 2010 – nearly 10 million in all. As we pointed out in the first item, Texas economist **Ray Perryman** predicts Texas will gain 2.11 million people in the next five years. And the Austin area will have the greatest percentage increase of the major metros.

However, it's not just the total numbers that will impact how you live and work in this area. **Baby boomers** (the oldest are entering their late 50s and the youngest have just turned 40) will remain the **dominant demographic force**. This means there will soon be a big increase in empty nesters – people age 55 to 64 whose children have left home. In another five years, about one out of nine will be in the group, investing and spending money with the cost of raising children behind them, according to Kiplinger Forecasts.

This also means seniors — those 65 and over – are going to increase in number faster and faster. It's not just the baby boomers growing older. You're living longer now and are more physically active than your parents. As a matter of fact, **average life expectancy in the US is now at a record high of just more than 77 years**. Austin, recognized as a “young” city, will be getting greyer over the years.

Growth in the Austin area is nothing new. In fact, during the 25+ years we've been chronicling the Austin economy in this newsletter, we have pointed out frequently that, since its founding, **the Austin area has doubled in size approximately every 20 years**.

What's happening now is the historical growth, augmented by a sizeable in-migration (from distant shores as well as nearby states), is taking place as part of a national “movement,” and is being bolstered by a **growing, healthy economy with more than its share of good-paying jobs**. This augurs well for upward trends in the Austin area economy for 2005 and beyond.

Everywhere you drive in the Austin metro, it seems there is a new bank sign or a new bank building under construction – many of them within eyesight of others. This trend will continue during 2005, though some bank signage will be replaced by another's.

Financial institutions position themselves for the future and they like what they see in Austin's future. **Look for more banking locations to spring up throughout this year** as the big and small banks jockey for position. Many of the “smalls” are expanding to be more attractive as merger targets at a time the “bigs” are seeking acquisitions. So, there may be more banking *facilities*, but the total number of banking *institutions* may dwindle during 2005 and beyond.

Changing employee trends in the workplace will have an impact on Austin businesses. As you plan for the future, let's look at some changes that may put you ahead of the pack.

The conflict between work and personal life is growing, and finding the right balance will be the key for most companies, reports Kiplinger Forecasts. And, at the heart of all employee concerns is health care – the *increasingly expensive* basic benefit. “Companies that offer **coverage that is least burdensome to workers** have a leg up on the competition in attracting and keeping the best employees,” notes Kiplinger. But, wow, is it costly!

What about the trade-off between vacation time and sick leave? Some companies are choosing to allot an employee's leave days in one big lump, making no distinction as to what is vacation and what is sick leave. (Most of these firms reduce the combined amount of time.) **This plan helps reduce abuse of sick leave and rewards conscientious workers.** Also, some companies are letting employees choose extra paid leave in exchange for less-generous benefits in other areas, such as life insurance policies.

Flexible work schedules are growing more popular – in forms such as flextime, a compressed four-day work week and job sharing. Many Austin companies are encouraging **telecommuting** in this high-tech community. Workers quickly adapt to the technology that gives off-site access to home office databases and communication networks. And it keeps them off the crowded Austin roadways.

All this brings us to the job creation hot button – outsourcing. This is a trend that will continue. Besides service call centers and manufacturing, you can look for sectors such as software design, data processing, medical data review and even architectural, accounting and legal services to continue to expand abroad. Local businesses will outsource services *locally*, such as accounting, payroll, etc. All in all, these trends should expand in Austin in 2005.

The Texas Legislature convenes in Austin this month. As **Dr. Louis Overholster** observed: “Every time the legislators make a joke it's a law and every time they make a law it's a joke!”

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