THE Neal Spelce AUSTIN LETTER

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Dear Client:

As you've watched the Austin area's growth over the past couple of years you have no doubt noticed the proliferation of bank branch locations. This has come to a screeching halt.

New bank branches appeared to be popping up like weeds, as financial institutions seemingly tried to one-up each other in the number of different branch locations. And many of them were not cheap either. While some financial institutions leased space, others – like Wachovia – erected expensive, well-designed buildings on prime property. Not anymore.

Look for few, if any, new branches to open. But look for many to close. Due to various bank mergers and acquisitions, what were once *competing* branches are now *duplicate* branches serving the same area. So, one branch will logically close. The total number of banks serving this area is diminishing – as is true nationally. And the number of neighborhood outlets for them will dwindle.

An example of this closing/consolidation exercise occurred just yesterday (1/29/09) when JPMorgan Chase, as a result of its consolidation with Washington Mutual (WaMu), announced it will **close nine Austin area WaMu branches by the end of the first quarter**.

Chase had 62 branch offices in the area; WaMu had 19. The remaining **10 WaMu branches will be converted to Chase branches** – probably by mid-year.

Another reason the pace of bank branch expansions will slow is that **banks are increasingly turning to technology** — offering services via Internet and telephone while automating many functions.

Teller machines are being made more sophisticated. Some banks are even sending check scanners to small business customers. As a result, **some banks are also cutting back bank personnel** as the need for branches is not perceived to be as necessary as in the past. All this means face time with your banker will be even tougher to schedule.

This trend is also an **opportunity for the smaller community banks** in the Austin area – if they play up the personal touch that can come from a smaller financial institution.

Lenders are the lifeblood for so many in the Austin area — especially for homebuyers, homebuilders and developers. What is the latest assessment of the local lending situation?

The head honcho locally of Residential Strategies is **Mark Sprague**. His job is to track what is going on in the **residential real estate and lending businesses** in the Austin area. After his assessment, he cautiously tries to anticipate what is around the corner. So, let's get his take.

> As for *builders*, Sprague points out that **builders continue to downsize** as market demand dictates. He says **layoffs and consolidations are almost "mechanical,"** based on company cash flow. For smaller and independent builders, Sprague says interim lines of credit are their lifelines. But he cautions that, as regulators move in on troubled financial institutions, committed lines of credit may be frozen. He also says very few builders are willing to make commitments on positions in new subdivisions. And that the **only speculative homes on the market now are those stemming from cancellations**.

The cancellations are an interesting phenomenon in this uneasy economy. When you have noticed reports of declining sales in the Austin area, cancellations of contracts-to-buy have been one of the reasons net sales were down in the 4th quarter. As a further result, the **finished home inventory is climbing**.

> Sprague reports that *developers* are finding it very difficult – if not impossible – to move their loans when renewals come due. In fact, he reports that **most developer loans are in technical default** due to a slower takedown of the finished homes.

> As a result, the *lenders* are in somewhat of a box. Lenders are complaining that many **developers are not responsive to the demand for a reduction of the loan principal**. But lenders don't want the problem, they prefer a solution, Sprague says. When a loan is "classified" (moved to a more negative category), it puts further constraints on a lender's capital as it impacts the reserves the lenders must set aside for potential loan losses.

Sprague suggests there may be an **increased amount of lender-owned real estate on the horizon**. But he points out that, to date, in Austin and surrounding regions, this has been limited and this has prevented the erosion of home values throughout the area.

So what does Sprague see in his crystal ball? As you would expect, positives and negatives. Some positives: mortgage rates at historic lows, a wave of refinancing applications are flooding the market, and **Austin housing inventories (new and resale) are in good shape**. Some negatives: he thinks the **spring housing market will be muted** due to very weak consumer confidence, sales will not improve until the prospects for the national economy get better, and Texas builders are adjusting their overhead with the anticipation of a **20% reduction of sales in 2009**. There's a lot to watch here. And we'll keep an eye on it for you.

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Texas can expect a slightly smoother ride through the recession than the rest of the country. And the role of states in the economy is greater, by far, than the federal government.

Last week in San Antonio, the Chief Economist for the US banking arm of one of Spain's financial giants took a hard look from the outside at the Texas economy. And **Nathaniel Karp**, while acknowledging job losses and other signs of slower economic growth in Texas, had some positive comments about the immediate economic future of the Lone Star State.

> **Karp predicted the Texas economy will continue growing** – about 1.2% in 2009, compared to 2% growth in 2008. He pointed to the state's continued **growth in exports** – above the national average – particularly to neighboring Mexico and Canada, and cited an impressive 7% growth rate in exports to China.
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> He said his company's estimates show than **personal income in Texas will increase by 4.8%** in 2009, compared to 2.5% nationwide. And he foresees a **5.6% increase in home sales in Texas this year**, compared to an average *decline* of 12.4% across the country.
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> Karp took into account the economic effects of Hurricane Ike in 2008, but said the **reconstruction efforts aimed at recovering from the hurricane's devastation will help stabilize Texas' job outlook in 2009**. In other words, more jobs will be created as the hardest-hit areas of the state go through the rebuilding process.

He had words of caution, particularly related to the potential effect of lower energy commodity prices and the ripple effect from national economic conditions if the recession is deep and long. On energy, his estimate was that oil will average $46 a barrel in 2009.

A blunt assessment of the role of the states, vis-à-vis the federal government, came from another important economic source. **Van Hoisington** and **Lacy Hunt**, writing in their 4th quarter review and outlook of the economy, pointed out that if transfer payments are excluded from federal government expenditures, the **spending of state and local governments totaled $1.9 trillion in the 3rd quarter – much greater than the $1.1 trillion spent by the federal government**.

> So the total economic health of state and local governments is in reality more important to the national economic wellbeing than the federal government. Hoisington and Hunt, who operate their successful $5 billion investment management company in Austin, also noted that **state and local governments employ 19.8 million workers versus 2.8 million for the federal sector**.

Texans can take pride in the relative strength of Texas. But when other states are suffering it provides a heavy economic drag. Those suffering states must curtail spending, raise taxes, or do both this year – thereby impacting the nation's economy, even as Texas remains steady.

There will be a lot of give-and-take under the State Capitol dome between now and the end of May as Texas legislators wrangle over budget priorities. **But it will be nothing compared to what is going on in other states**.

Be thankful you don't live or work in California, New York or other embattled states. Even if the economic stimulus package now under consideration in Washington finally passes loaded with dollar goodies for states, there will still be a lot of pain inflicted on residents of those states. **There just won't be enough money flowing from Washington to solve all the financial ills of those states**.

Our friends *The Kiplinger Washington Editors* say **California is worst off** – struggling with a $41.5 billion budget gap. This is a whopping one-third of its budget. What is under consideration?

A 2.5% income tax surcharge, **a sales tax increase of three-quarters of a cent**, **higher gas taxes** and a tax on in-state oil production. And this is after a 10% spending cut and possible furloughs of state government workers.

Or you could live and work in New York, **where state leaders are mulling more than 100 new or higher taxes**, including levies on luxury boats, wine and beer, movies, cable and satellite TV and music downloads.

New York state is also considering taxing some services provided by barbershops, beauty salons and spas. It is even weighing an "**obesity tax**" in the form of fees on non-diet sodas.

And all this is occurring when residents of those states are being impacted more than most by the national economic crisis. **Thank your lucky stars you live/work in Texas**.

Dr. **Louis Overholster** notes it used to be that only death and taxes were inevitable. Now, of course, there's shipping and handling as well!

Sincerely

Editor/Publisher