THE Neal Spelce AUSTIN LETTER

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Dear Client:

According to a Texas-based economist, "there are signals that the economy is trying to turn the corner." And he thinks there could be a "pleasant economic surprise" on the horizon.

The chief economist and director of research at the TexasA&M Real Estate Center, **Mark Dotzour**, reports that "**consumer confidence has increased from a year ago and consumer spending has resumed its relentless upward trajectory**." There's more, though.

"**The most important positive indicator is that corporate profits have rebounded**," he pointed out. "In a free-market capitalistic system like America, profits are the key indicator."

"**When profits are *growing*, companies *hire* employees**. When profits flatten, they stop hiring. When profits fall, they start to fire people, and they keep on firing people until profits start to increase again. Clearly," he says, "most businesses have right-sized their firms sufficiently to regain profitability."

Okay. So then, why aren't companies hiring people? Unemployment is still high.

"**The answer is uncertainty**: uncertainty of capital gains and income tax rates; uncertainty about the cost of health care and the possible increase in energy costs due to 'cap and trade'," he noted. "**The prospect of new and increased government regulation makes it hard for business to see clearly in the future**."

Dotzour says businesses can buy insurance against risk, but there is only one way to "insure" against uncertainty and that is to *hoard cash*. **There is now well over a trillion dollars sitting in cash on business balance sheets**, he says. In fact, he points out that businesses have much more capital than the Federal Reserve, the FDIC, Fannie Mae and Freddie Mac — combined.

So, what will it take to get businesses to deploy their capital and start hiring? Because a new cycle of economic expansion will not happen until this occurs.

Dotzour has some answers and some predictions. And you'll see what he says, along with his "pleasant economic surprise," in the next item.

For businesses to start hiring again, the answer lies in business owners seeing the opportunity to make significant profits again.

And that may not occur until next year, according to **Mark Dotzour**, the TexasA&M Real Estate Center's chief economist and director of research. "It is unlikely that the issues of taxes, 'cap and trade,' insurance costs and new regulations will be resolved in 2010," he predicted. "**Hence, expect a sluggish economy through the remainder of the year**."

> "After the elections in November and new Congress members are seated early in 2011, business owners may get a clearer picture of what the future looks like," he said. "**As the uncertainty recedes, the confidence to invest, expand and hire will increase**."

Dotzour went on to point out that many business decisions have been deferred in the past three years. As a result, he said "**there could be a pleasant economic surprise when businesses see the 'all clear' signal**." The reason for the "surprise:" "The *pent up demand* that has been created by several years of postponed purchasing."

> "**A second headwind for economic recovery comes from the government sector** at the state, county and city level, including school districts," he went on. "All over the country, income tax revenues are down. So are sales tax revenues. Property tax revenues from commercial real estate have fallen some, and are likely to fall further in 2011."
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> "In many states residential property taxes have fallen as home prices declined. These declines in revenues are forcing government entities to make difficult decisions regarding spending and hiring. **There is little doubt there will be reductions in employment at all levels of government**, he said.
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> "The private business sector has right-sized their firms to adjust to the current environment. Individual households have increased their savings rate to pay down debt and improve their balance sheets," he observed. "**Government has begun the same process, but has a long way to go yet**."
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> "Small business is crucial at this stage of the game," Dotzour said. "As the government lays people off, it will be essential that small businesses resume hiring. **Otherwise, we will start losing more jobs rather than beginning a new expansionary cycle**."

So, what can you anticipate? "Look for signals from Washington," he suggests. "**Business owners are like racecar drivers**. They have a precision-tuned machine with lots of spare tires and parts. They are just waiting to hear from Washington that the **yellow flag of government intervention has been lifted and it's time to roll back onto the track and resume the race**."

FORTUNE magazine has boiled it down to "Four reasons why Texas beats California in a recession." CNNMoney.com has picked it up as the word is spreading.

In *FORTUNE*'s view, California's problems are not a direct result of "its liberalism and sloth." Here's how their report starts: "Back in 1965, the Mamas & the Papas reached the top of the charts with 'California Deamin',' a song pining for a return to the warm safety of their home state. But these days they'd be better off dreaming about Texas. The reason is that **Texas powered through the global fiscal crisis, while The Golden State's economy is forecast to remain tarnished for some time.**"

"The fact that California remains locked in such a pronounced slump compared to its economically and demographically similar cousin to the southeast has been pounced upon with biblical zeal by conservative commentators who claim the **state's woes are a direct result of its liberalism and sloth**," the article continued.

"**But in truth, California's industrial mix and its history of voter empowerment may have done more than glad-handing liberalism to bring low the nation's largest economy** – one that, in better times, brought the world the Popsicle, the Hula Hoop, the 'slimsuit' swimsuit and the fortune cookie," reported *FORTUNE*. The magazine's four reasons:

Number One: "The chief reason California remains mired in a recession that Texas almost skirted is fairly obvious. **Its major industries were more directly tied to the causes of the recession, resulting in steeper job loss when the recession hit.**" In other words: housing, subprime mortgages, etc.

Number Two: "It pays to be friendly to business owners." *FORTUNE* calls **California "the Venezuela of North America" and praises Texas tax structure, labor union status** (6% of workers in Texas are union vs. 18% in California).

Number Three: **California's focus on progressively taxing income and profits, instead of consumption** has created volatility that increased the pain of the state's budget shortfalls. An audit in 2005 warned California of such problems.

Number Four: **Power of the people can backfire.** Starting with the voter-initiated tax revolt in 1978, *FORTUNE* quoted a *Los Angeles Times* editorial last month that said "California voted itself into its current budget crisis by adopting **ballot measures that demand more from government** while limiting its ability to do its work." *FORTUNE* on Texas: "just about the **only political census for budget cuts needs to come from three politicians sitting around a table**," referring to the Governor, Lieutenant Governor and the Speaker of the House.

Of course Texas has its own economic problems – anticipated **budget shortfall**, **planned state agency cuts**, etc. But most businesses would rather be doing business in Texas.

If you look around, you will see major builders scrambling to buy lots in the Austin area. What's going on here? Is a rebound in the housing market just around the corner?

Could be. According to Mission Mortgage's **Mark Sprague**, it takes about 2½ years to develop lots in the Austin area. "Therefore," he says, "**a builder or developer needs to stay ahead of the market and make an educated guess of where the housing market will be in 2+ years**." But what if they guess wrong?

Sprague trots out some numbers to make his case that **Central Texas "will be facing a shortage, if not a gap, in lots within two years**." He points out there are about 22,000+ vacant lots in the area, but only 10,000-or-so are "desirable" lots. The current absorption rate is 7,000 to 8,000 a year.

In other words, builders are concerned there won't be enough lots to meet the demand. So they are **optioning all the "quality" lots they can secure**. Another factor fueling this frenzy is that financial institutions are not making loans to developers, so the developers can't "create" lots for builders.

"Therefore there are not enough lots coming to the market in the next few years," Sprague says. And "even if they were started today, they would not be 'entitled and finished' in time even at current lower absorption rates." **So one builder paid cash for about 1,200 lots and another bought 455 lots – just in the last few weeks**.

Is this premature? After all, the homebuying market has slowed down after the tax credit expired. Sprague responds that "**the time to purchase in any market is near the bottom. If this isn't it, we are awfully close**." He further predicts that "being proactive in purchasing lots …will make what some call 'premature' a very smart move looked at historically."

Speaking of looking ahead, **Dr. Louis Overholster** is telling friends about the sign he saw on the wall of a local small business: "Due to the problems in the nation today, the light at the end of the tunnel has been turned off. We apologize for the inconvenience!"

Sincerely

Neal Spelce

Editor/Publisher