



REAL ESTATE CENTER

News Release

2010 Outlook

A preview of the New Year from our most quoted researcher

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Entering the second decade of the new century immediate economic prospects range from blurred to completely unclear. The just-ended “Bubble Decade” generated enormous increases in prosperity, wealth and asset values only to subsequently experience an unprecedented free fall. Economically and financially, we went from bubble expansion to bust contraction. The prospects for the overall economy and for housing in 2010 are basically the same – the free fall may be over, but significant recovery remains elusive.

In its effort to counteract the financial and economic devastation, the federal government poured trillions of dollars into the U.S. economic and financial systems and today single-handedly supports most major economic activities. Of critical importance to housing, the Federal Reserve (the Fed) continues to buy FNMA, FHLMC and GNMA bonds and securities thereby providing virtually all of the liquidity to the residential mortgage market. Extension of the home purchase tax credit for first-time buyers and expansion of the credit to include repeat buyers may boost short-term demand for home purchases, at least until the credits expire April 30. The long-term consequences of the government’s unprecedented levels of economic stimulus will be significant not only fiscally but potentially throughout major sectors of society.

Although most business economists, especially on Wall Street, proclaim the recession to be over, this assessment may be premature. Statistically, the gross domestic product (GDP) turned positive for 3Q2009 (even after a downward first revision and an expected further downward revision yet to come) and is expected to stay positive in 4Q2009. But almost all of the positive increase derived from government stimulus (the “cash for clunkers” program and the first-time buyer housing tax credit, for example), not from enhanced private market activity.

During the coming year, the overall economy and the housing market may garner headlines announcing recovery and revival of the markets. These pronouncements will stem from the basic arithmetic of comparing tepid 2010 performance levels to relatively low 2009 levels – hence, small-to-no declines and possibly even small increases.

As is the case with the overall economy, it may still be too soon to say categorically that the housing market has bottomed. It remains to be seen whether the market can sustain itself without massive federal involvement – particularly the tax credit program, continued low interest rates and especially the Fed’s underpinning of the secondary mortgage market. Foreclosures continue to flood some local markets and show no evidence of letting up. Ultimately, the health of the housing market depends on general economic recovery, especially job growth. If there is a “jobless” recovery, as most economists expect, the housing sector may have bottomed, but recovery may be a much slower proposition.

The collapse of the new home market has had a significant impact on the overall U.S. economy. Total housing starts fell around 74 percent to around 550,000 units from their 2.1 million unit peak in 2006. New home sales declined 22 percent in 2009 from 2008 and around 75 percent from the nearly 1.3 million peak units in 2005. More than one million residential construction jobs disappeared between 2006 and 2009. The decline in housing’s share of the overall economy during the past two years resulted in a point or more of overall GDP decline.

The national passion and public policy for homeownership have been challenged. It is apparent that not everyone is in an economic position to own a home. This fundamental change in societal attitude coupled with revised government policies toward homeownership may bring forth substantially altered levels of housing market activity. Total sales and construction volumes during the coming years, as well as prices, will be even more directly tied to growth in household formation, employment and income, three areas of real challenge for 2010.

How does 2010 shape up, and what should be expected?

The year 2010 most likely will be a year of “damage control,” not expansion. The principal variable will be what the federal government does and how the private sector responds. A “double-dip” recession is certainly possible as the private market attempts to pick up the federal government’s role in key areas of the economy.

Whether or not the recession officially ended sometime in 2009 or lingers into 2010, it appears that the economy will stay relatively flat for most, if not all, of the coming year. The bottom may last for a while before experiencing significant recovery. Companies, especially medium and small corporations, must start making profits before they start rehiring. This might happen by the third or fourth quarter but probably not to any really important degree. The best result for 2010 may be an end of job losses. It may take into 2011 before significant increases in employment occur.

While 2009 depended on extraordinary government stimulus spending to generate a positive GDP for the last two quarters of the year, 2010 may not have that luxury. Record deficits, taxpayer questioning of bailouts, fears about long-term consequences and mid-term elections may substantially reduce or eliminate the political will and the fiscal ability of the federal government to pump more money into the system. State and local governments are financially strapped to meet existing obligations. Expect them to continue to look to Washington for help, not to provide any real stimulus.

Interest rates should remain low as the Fed keeps the cost of capital down to stimulate the financial and capital markets and other interest-rate sensitive activities, such as housing and

business capital spending. The financial system as a whole faces a significant reckoning of near valueless assets held on the collective balance sheets, regardless of all the accounting tricks employed to delay the problem. These assets include commercial real estate loans and land development loans acquired during the boom years. The FDIC is bracing for a number of bank failures during 2010. Credit will remain extremely difficult to obtain for any new real estate developments.

Housing should do fairly well for the first quarter, but after that, it will be a question of how well the market can sustain itself without federal government support. The extended and expanded tax credit for home purchases will draw demand forward from later in the year. Private investors will replace the Fed in supporting the secondary mortgage market but not at the same cost. Mortgage interest rates will be under considerable upward pressure during the second half of the year to provide sufficient yield to attract necessary funding. Home sales volume for both new and existing homes will be about the same as 2009 at best, despite historically low interest rates, significantly lower home prices and the tax credits. Foreclosures will plague areas that continue to lose jobs, where home prices continue to fall and as the wave of option-ARM and Alt-A loan resets hits – primarily the areas where the price bubble was strongest.

Texas' housing markets may fare relatively better than many other markets so long as job losses abate sometime during the year and home prices do not fall extensively. While Texas and the state's major urban areas experienced employment decline throughout 2009, job losses may stabilize in 2010. Sales and prices of existing homes in Texas should remain close to 2009 levels. New construction could pick up slightly during the first part of the year as builders offer new homes for the tax credit, but the overall new home market will not see significant recovery until 2011 or even later.

The commercial real estate (CRE) market could level out during 2010 as values stabilize to reflect new realities in occupancies, rents and market capitalization rates. Overall CRE values have declined by almost half from their peak, and the banks with major CRE exposure will be forced to carry problem loans and rollovers into 2011 or face failure. It may take several years before any substantive new commercial development occurs, similar to the late 1980s and early 1990s.

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