Armchair Economics

Perspectives from an economic everyman

Houston's Next Boom

February 2016

No one is taking the word "cycle" out of the dictionary any time soon.

A year ago, many experts were projecting that Houston's energy industry would be in a turnaround by late 2015. As we know, that didn't happen. Whether optimistic or pessimistic, today's prognostications for Houston's economic wellbeing are mostly focused on its oil and gas related industries. But by stepping back to view the greater landscape, one can find seeds of a new economic forest sprouting where you might not expect it—outside of the burning oil patch.

What's happening now in oil and gas is starting to look more and more like the malaise of the 1980s rather than the shorter-term, V-shaped dips and spikes we've seen since. One thing is for sure: no other oil and gas boom since the 1980s has come with the enormous in-your-face real estate development activity we see today in Houston.

What happens to revenues for oil companies when the price of oil falls from $110 to $30? Can you imagine taking a cut in salary from $110,000 to $30,000?

What oil companies spend is what trickles down to their service and supply companies, and not just the ones that directly support the industry. As a banker friend of mine suggested a year ago, "In Houston, even the orthodontist is in the oilfield services business."

Let's hope Mr. Orthodontist didn't borrow a bunch of money to buy or build a new house or a fancy, new office. As the financially experienced know, leverage (debt) cuts both ways. Borrowed money is your friend in a growth market, but your enemy in a contraction. It is difficult to pay off loans when cash flows are contracting. It is impossible when your income gets cut by 70%.

A few days ago at breakfast, an old friend and I walked through a back of the napkin analysis of the wealth that has been lost in Houston over the last eighteen months. I'm close enough to the investment markets to have some thoughts on where wealth has evaporated. My friend, who works for a very large wealth manager, has a perspective that is even better informed.

I suggested the amount of wealth lost in Houston over the last eighteen months is likely between $100B and $200B. My friend thought that range was way too low. No matter the exact number, it's pretty big, and unfortunately still growing.

Values for office buildings, apartments and residential homes have only just begun to fall. Office and apartment vacancies are rising, causing rents to fall. Falling rents mean falling asset values. And as oil patch and regional industry jobs and compensation contracts so will demand for homes, eroding their values.

Amid all this carnage, there are some silver linings.

Houston's healthcare community has continued to invest in facilities. A few billion dollars of development is still forthcoming in the Texas Medical Center as well as throughout the region, as

medical development follows the area's recent residential real estate expansion fueled by immigration growth.

There are also a few billion left to spend expanding our hydrocarbon transportation and processing facilities. The recent increase in oil and gas production means a need for more transportation and processing assets. Although these actual assets may not be in Houston, the investment capital behind them is, as are many of the professionals designing and managing their construction and operations.

With the recent expansions of both the Port of Houston and the Panama Canal, there is still growth in port industrial development. The one real estate market in greater Houston that has, to date, held up well is the industrial/warehouse sector.

With healthcare, energy infrastructure construction and the port of Houston, there seems worthwhile wind in the sails of Houston's economy. But these regional industries have their own economic limitations, and none directly represents the area's next boom.

Cleveland, Ohio and Rochester, Minnesota are home to world-renown healthcare facilities, yet neither region is an envied center of economic growth. And as we all know, healthcare inflation is double to triple general inflation, making it difficult to expect perpetual investment and economic growth in this sector. Healthcare costs are already at painful levels for everyone.

In a couple of years, all those hydrocarbon transportation and processing expansions will be complete, reducing that investment and its resultant regional economic waterfall. If you're not growing oil and gas production, you don't need more assets to transport and process it. And if we're reducing oil and gas production, then we may have even overbuilt transportation and processing assets.

The port is certainly a great strategic asset, but the majority of its historical trade has been energy related: oil, refined products, oilfield equipment and the materials to make it. The port expansion allows Houston the ability to handle more Twenty Foot Equivalent Unit (TEU) vessels, the ships that haul those container boxes around the world. But Houston has great competition in that market.

Annual Houston TEU volume (1.9MM in 2014) pales compared to 2014 rates from Los Angeles (8.3MM), Long Beach (6.8MM), and New York/New Jersey (5.8MM). In TEU traffic, Houston even trails Seattle, Savannah, Oakland and Norfolk. More ominous still is the recent and significant drop in global trade. The Baltic Dry Index, a measure of global shipping activity, is currently at a five-year low. As we are becoming more aware, global growth today is struggling to meet expectations.

When taking in all these perspectives, it can seem improbable that another boom is coming to Houston. But it is.

The seeds of Houston's next boom have already been planted. The current bust itself increases the fertility that will feed that next boom. Every forest fire creates fertile ground for the next forest.

What will this next boom be? How can it happen?

This next boom will come as Houston gains a greater share of domestic and global manufacturing activity.

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The region is already well established in the manufacturing and fabrication of all manner of items that serve the energy and other infrastructure industries. But a new form of manufacturing growth looks to be right around the corner.

Evidence of this next era can be seen in the four-million-square-foot facility Daikin is building in northwest Houston to make air conditioners. You can make a whole lot of air conditioners in a four million square feet facility. If Houston is a competitive market in which to make air conditioners, then it should also be competitive in refrigerators, stoves, ovens, washing machines, dryers and all manner of other appliances. Manufacturer of specialized infrastructure equipment plus greater manufacturer of consumer and commercial goods—this is Houston's future.

This next boom is being made possible by several of Houston's historic economic advantages: affordable and widely available land, hard working and reasonably priced labor, a plethora of creative engineers, center of the country location, access to the world via the Gulf of Mexico and our supportive regional government. And the amazing transformation of Houston into the most socially and ethnically diverse city in the country adds to its entrepreneurial spirit, ingenuity and global interconnectivity.

Interestingly, the oil and gas gold rush bust will actually fuel and aid the manufacturing boom by making many enterprise input costs cheaper…real estate, labor, electricity, transportation and intermediate raw materials from our hydrocarbon processing industry.

Looking around the country, you will not find an infrastructure as capable, a resource base as rich or a workforce as motivated as you see in Houston. Even across the world, few can compete. As Houston puts out the fires of the gold rush bust, the next boom could start to reveal itself even before the smoke begins to clear. With the right political and economic leadership, Houston could become the center of a new, dynamic American Industrial Renaissance.

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