



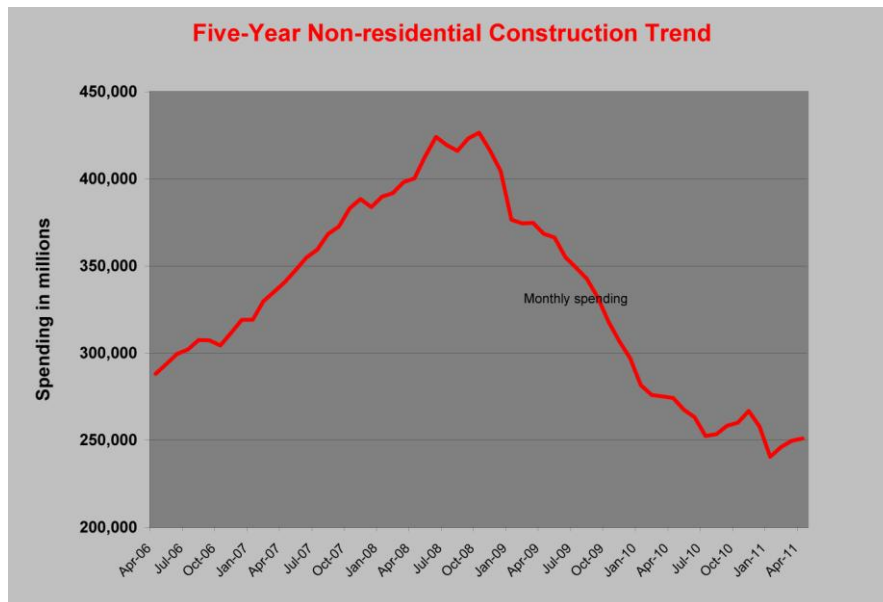
Construction National Outlook: July 2011

The Federal Open Market Committee's release of its opinion on the status of the U. S. economy seemed to confirm widely-held opinions that the modest recovery from the 2007-2009 recession had slowed. The FOMC's official release affirmed the committee members' belief that a long-term recovery was underway – and that the recent slowdown in activity was due to temporary spikes in energy and food prices and the supply chain disruptions caused by the Japanese earthquake – but the Committee's downward revision of its GDP growth again and Chairman Ben Bernanke's tepid press conference only added to the sense of uncertainty that consumers and businesses are feeling.

Like any other business cycle, the current one is not going to proceed in a straight line towards prosperity or recession. What is critical to the success of the private sector taking hold of the economic recovery – the next stage that needs to occur – is confidence from both consumers and businesses that growth will continue. Uncertainty will cause consumers to spend less as a hedge against a double dip and make business owners delay plans for investment until a sustainable growth path looks inevitable.

Dampened consumer spending impacts two-thirds of the GDP and will impact the construction plans of retailers, hospitality, recreational and durable goods suppliers. Nervous consumers don't buy new cars this year, don't take vacations and they spend less at the mall. Nervous business owners tell architects to put their plans in the drawer rather than risk expanding into another recession.

It's unfortunate that this period of uncertainty and nervousness comes on the heels of increased spending on non-residential construction in April and May, according to the Department of Commerce, McGraw-Hill Construction and Reed Construction Data. Non-residential spending, as tracked by the government, has turned up since spring and appears to be bouncing back off the bottom (see chart below). Reed tracked commercial starts higher again in May and April, finally reaching a level that is above the first five months of 2010. McGraw-Hill Construction reported that construction was slightly down in May. They reported that contracting had grown briskly in February, followed by two flat months and was up year-over-year modestly. If caution becomes the dominant response in the summer, however, it's likely these gains will be eroded or erased at least temporarily in the coming quarter.



Behind the caution are events with a Ground Hog Day feel to them. Like last summer, worries about the ability of smaller European countries to maintain their debt payments has shaken stock and bond markets and forced the value of the Euro to fall. Little has changed in the economies of Greece, Ireland, Spain, etc. and the response of the EU in 2010 – which was to bail out in exchange for austerity plans – managed to kick the problem down the road a year or so but the global economy is still dealing with the same fundamentals without a plan for permanently removing the debt.

During the week of June 20 the financial markets got to replay the Greek crisis, absorb the stop gap plan, relax for 24 hours and then start anew with Italy. The reality of the debt ratios in the PIIGS countries is that some form of forgiveness from their bondholders – which include stronger nations and banks – will have to occur in order for their balance sheets to eventually recover. Absent the debt forgiveness, defaults are fairly certain.

It's important to remember that this isn't a European problem anymore than Lehman Brothers' collapse was an American problem. U. S. banks and investors are among those who hold the bonds or derivatives that are under water. A scenario that involves creditors digging in their heels on European debtors will produce defaults and stands a good chance of triggering another freeze of the financial markets. The more likely scenario is for a small default to put a scare into markets before an orchestrated write-down of some portion of the debts is negotiated. That scenario is likely to occur over more than one year.

Again, like last year the significance of the Eurozone problems to the American construction market is in its unsettling effect. Historical investment patterns suggest that the robust increase in business spending on software and technology in 2010 would lead to better than usual investment in buildings in 2011 and 2012. So far, the pattern is holding but the magnitude of the investment recovery is lower than expected. Business owners appear ready to build again (witness the Architectural

Billings Index steady climb from mid-year 2010) but the confidence in the economy hasn't released that pent-up demand yet (witness the cooling of the ABI in April/May).

Pulling back from the macroeconomic picture, there are increasing signs of demand for new construction and some events that will help spur confidence.

To the latter point is the easing of the price of gasoline and diesel fuel. Pump prices have fallen roughly 15 cents per gallon at the end of June. On June 23, the International Energy Agency agreed to release 60 million barrels of oil to replace the supply from Libya that has been constrained due to the six-month-old conflict there. This produced an immediate drop in oil prices of \$5 per barrel although another month will need to pass before understanding the actual impact on inventories. It's more likely that a change in driving habits by American motorists would impact inventories sooner.

Another trend that should build confidence – and spur construction – is the significant increase in state and local tax revenues. The Rockefeller Institute of Government reported on a compilation of data from 46 states that showed collections from major tax sources increased by 9.1 percent in nominal terms in the first quarter of 2011 compared to the same quarter of 2010. That represented the third consecutive quarter of increasing strength in revenues. Tax collections now have been rising for five straight quarters, although revenues were still 3.1 percent lower in early 2011 than in the same period three years ago.

This reversal of fortunes isn't eliminating the huge deficits in hard hit states like California or New Jersey, but it is easing pressure to make drastic cuts in consumer-sensitive areas like education and road maintenance. The better revenue stream should also lessen pressures to raise local taxes, a further relief to consumers. And of course, the most direct impact will be if the rising tax receipts permit more construction than was planned.

Two niche categories that are under supply and demand pressure right now are warehouse/distribution and student housing space. The Census Bureau reported that manufacturer and trade inventories rose 9.7 percent from the first quarter of 2010. Including the rising inventories from the online and catalog sellers, inventory levels are 14 percent higher than last year. At the same time construction of new space was roughly 3 million square feet in the first quarter. During most quarters of the last decade, developers added 40 million square feet or more to the building stock.

Demand for student housing is coming from favorable demographics, with more than three million high school students joining the college ranks annually between now and the 2018-2019 school year. Since the financial crisis there has been concern that the economic disruption would slow the number of college students, yet three years hence the opposite appears to be true. With much lower numbers of beds added to the supply during the recession, colleges and universities are now scrambling to catch up to deal with student demands for the remainder of the decade. And with higher ed balance sheets still somewhat distressed, the need for beds has spurred the third-party developer model again.

The private residential segment of the industry remains stuck at a pace that is well below the household formation rate, even with household formations slowing significantly during the past three years. New construction needs to remain slow to bring supply down and that at least appears to be working.

While not good news for homebuilders and those that supply that market, the greatly reduced levels of units started has shortened the number of months' supply of new homes from 9.2 in May of 2010 to 6.2 in May 2011. On June 23 the Department of Housing announced that the inventory of new homes available for sale had fallen to 166,000 units, while sales of new homes had fallen to less than 27,000. At the peak of the housing bubble in 2005 more than 100,000 new homes were being sold. The current inventory levels are expected to remain low throughout the remainder of 2011.

Offsetting the better supply/demand relationship in new homes was a decline in existing home sales in May. The National Association of Realtors reported on June 21 that May's existing home sales were 4.81 million units, some 3.8 percent below April's pace. That data followed a May report on foreclosures by Lender Processing Services that showed the delinquency rate for homes had fallen 18.3 percent from a year ago but that the number of homes in pre-sale foreclosure had risen 12 percent to 2,164,000. Rather than a trend towards the end of the glut of foreclosures the explanation for the decline in delinquent mortgages may still be linked to the foreclosure processing errors discovered in major mortgage lenders last fall.

While housing economists seem to be in consensus that sales will improve in the second half of the year, the upbeat scenarios rely on a continued decline in the price of gasoline and food, meaningful improvement in new hiring, a real and sustained drop in foreclosures and a return of consumer confidence to the levels seen last fall and winter. It seems certain that some improved economic news will help the housing market in 2011 but that all four of these factors will not be improving until 2013.