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## Construction National Outlook: May 2011

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The data at end of the first quarter reinforced a sense of certainty about what is going on in the sub-segments of the national construction market. Not all of the certainty is necessarily good news, but given how the recession began there is some comfort that can be drawn from a more orderly progression of the trend.

Unfortunately the most certain trend is that construction of new single family homes will remain at depressed levels throughout the remainder of 2011 and likely through 2012. The overextension of home buying credit that precipitated the financial crisis has continued to roil the residential construction and real estate markets even as the financial institutions that survived have been rejuvenated. While the long-feared wave of foreclosed homes has not hit the market, a steady supply of distressed properties and record numbers of foreclosures have kept the residential real estate market with an overhang of unsold homes that shows no sign of burning off in the near future.

There is a bright spot in the residential market, however. In part because the mortgage debacle has limited who can buy a home and in part because the improved employment picture has goosed demand, the supply of vacant apartments has fallen. According to Co-Star Group, the nation's apartment owners saw net absorption of 44,000 units in the first quarter, which was the highest rate of absorption in a decade. New construction of multi-family units fell to 121,000 units in 2009 and 130,000 units in 2010, but Co-Start forecasts growth of 22,500 units in 2011 and 94,600 units in 2012. In addition to the more favorable supply and demand conditions, financing and investor appetite for multi-family projects has improved dramatically since 2009.

First quarter data also suggests that there is an unprecedented disconnect between the recovery and the housing market. Even at the forecasted 2012 levels, the number of new construction units for multi-family residential will still be less than two-thirds of the 340,000 units built on average from 1997 to 2006. With construction of new single-family detached housing falling to less 425,000 units annually, it's clear that the housing market will not lead a construction recovery. At the same time, the extended depression in housing has reduced employment in residential construction from 2.5 percent to 1.6 percent of all jobs. And residential investment – whether in the form of new construction, remodeling or purchase – has fallen to 2.5 percent from the pre-bubble norm of 5 percent. While these may be gloomy numbers the data underscore the reality that the new housing construction market currently has a negligible impact on the overall economy.

Non-residential construction activity is in the midst of recovering, even if the normal cyclical pattern isn't holding. The factors that had been depressing commercial construction – high unemployment, lower consumer spending and a lack of financing – have been easing since the early stages of 2010. And the real estate fundamentals are signaling coming improvement.

Office vacancy rates are still high but have begun to fall, dropping one-tenth of a percent to 17.5 percent in March. Office rents also climbed half a percent in March, the second straight month. Retail vacancies have not yet turned the corner, rising to over nine percent on average in the first quarter for properties in the top 80 markets. Mall vacancies hit their highest level in eleven years and the outlook for strip centers and neighborhood retail is for vacancy rates to top eleven percent this year; however, for top-tier retail centers the tide has turned. Vacancies in such retail centers fell to seven percent.

If there is credence in what some of the national construction economists are observing about the data, the non-residential market should regain its footing in 2011 and begin the next growth cycle in 2012.

One of the leading indicators of future activity is the American Institute of Architects' survey, the Architect Billings Index (ABI). The February ABI showed a slight recovery from January's level, and a 10 percent increase over last February. More importantly, the ABI – which tracks whether member firms have increased or decreased billings over the previous month – remains above 50 percent and extends the upward trend of improving conditions since a year ago. While it is an imprecise forecasting tool, the Index is an accurate way to gauge the overall trend and predict how contracting activity will be in six to nine months.

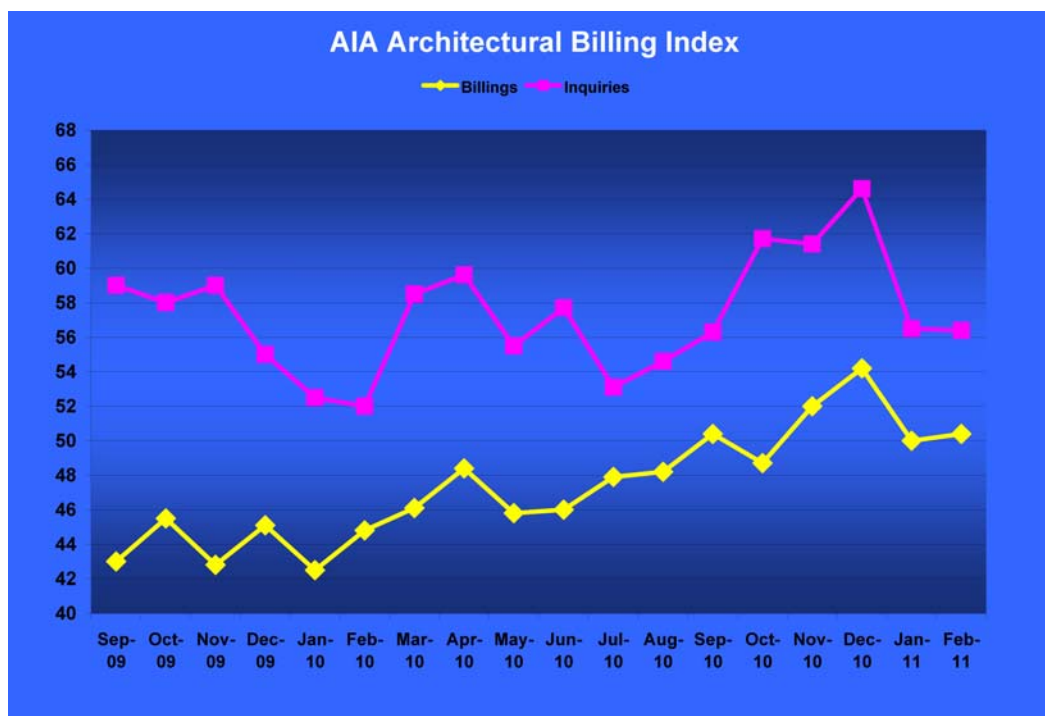
Reed Construction Data's vice president and chief economist, James Haughey, gave his outlook on the remainder of 2011 at a late March webcast with the AGC's Ken Simonson and AIA's Kermit Baker. Haughey projects that non-residential building construction will stabilize in 2011 but still decline 3.7 percent compare to last year. He expects the lingering spending from ARRA to offset the steep state and local cuts in heavy and highway spending, lifting contracting in that sector by 7 percent. Haughey sees the overall non-residential market to increase 2.8 percent in 2011.

Haughey pointed to the falling vacancy rates in commercial properties (although still above normal levels), the slight gains in rental rates, the return of investors to commercial real estate and more projects in the Reed Construction Data pipeline as indicators that the market is turning towards growth again next year. His forecast for 2012 has commercial construction gaining by 13.6 percent, residential expanding by 23.8 percent, heavy and highway by one percent and an overall increase in contracting of 12.5 percent over 2011.

AGC's Simonson sees a similar pattern unfolding for the balance of 2011, although with slightly deeper declines. Like Haughey, Simonson expects the follow through of the stimulus to keep public spending afloat in 2011 with a three percent increase to \$302 billion. Offsetting that gain, however, he projects an eight percent decline in private residential spending to \$246 billion, and a bigger decline of 13 percent to \$244 billion in private non-residential construction.

The Department of Labor's year-end jobs data was another indicator that the construction industry is healing. During 2010, construction jobs were added in 15 states. While that is hardly a hiring frenzy, positive employment occurred in only one state in 2009. In eleven states, employment decline by two percent or less (Pennsylvania was virtually flat with a one-tenth percent decline). Declines of three percent or more were registered in 24 states, but only three saw double-digit declines. The AIA's data on architectural employment in 2010 showed stabilization, according to Kermit Baker; however, the number of architects employed at the end of 2010 was some 75,000 less than in 2006.

If the improving conditions are indicating a predictable pattern of recovery for the non-residential market, however, not all forecasters are seeing it that way. A look at the forecasts for the balance of 2011 from the major construction economists surveyed for the AIA's Consensus Construction Forecast shows some big variances, particularly when comparing opinions on specific sectors. Those variances demonstrate as well as any other measure just how difficult it is to get a handle on where the U. S. economy stands and to gauge how the various global influences will play out.



*The AIA's Architectural Billing Index shows the long-term trend of increasing design activity.*

Among the categories with divergent forecasts are industrial construction – which Reed Construction Data forecasts as declining 5.6 percent while McGraw-Hill Construction predicts a 24.2 percent decline – and hotels – which McGraw-Hill sees declining 17.5 percent and IHS Global Insight forecasts as *increasing* 2.8 percent. IHS Global also goes against the majority in predicting an increase in retail spending of 4.3 percent while FMI forecasts a 7.8 percent decline at the other end of the spectrum. Generally, IHS is the only organization with a positive outlook for 2011.

The most extremely negative outlooks came from McGraw-Hill and FMI, while Reed and Moody's expected more moderate declines that tended toward the mean of the forecasts. Differing data sources accounts for some of the variance but uncertain conditions is the more likely culprit.

As summer approaches some of the economic questions appear to have answers. The federal government and Congress seem to have determined to avoid a shutdown, even if there is no actual budget agreement. The Obama administration has moved towards accepting deeper spending cuts, albeit without abandoning the rhetorical support of the middle class and elderly. State and local governments are facing up to their fiscal imbalances and making cuts that will slow public construction for the first half of the decade. Sovereign debt crises in Europe seem less likely to unwind into defaults. A protracted slump in the housing market isn't keeping recovery from starting.

The big questions left unanswered at the moment mostly center on energy costs. If prices climb, how high will prices go before tamping down consumer spending again? Will rising costs of products and materials derail projects that have been revived this spring? Is the short-term price inflation the first act in an inflation drama that will force borrowing rates up and wreck pro forma performance for commercial projects?

A nascent recovery in commercial construction depends on owners and developers being able to build for what they expect to and demonstrate ample cash flow to financiers of construction. Keeping prices from going further north may be the key to maintaining momentum in the national economy.