



Construction National Outlook – November 2010

September and October data may finally be showing that the way to a construction recovery is visible. One of the easy parts of forecasting construction is that there are some obvious indicators that begin to turn about six months before that construction that follows. The hard part is that often these indicators give little 'head fakes' for a month or two before falling back or going higher, depending on where the business cycle is. September could yet prove to be such a head fake, but the indicators have some weight.

One indicator that isn't showing a head fake or a positive signal is unemployment. No matter what becomes of the economy over the course of the winter, the employment picture remains stubbornly negative. It is important to remember that 20 million people out of work will be a drag on the economy and 9.6% unemployment could, in fact derail a recovery in 2011.

But while the global economy may still have room for further stagnation from high unemployment, the construction economy seems poised to recover even without an improved jobs picture.

The economic indicators that are trumping some of the more gloomy macroeconomic signals are related to consumer confidence, business investment and finance. Consumer confidence is at best a dicey indicator, and in September and October surveys of confidence often showed sagging results. It's important to remember that consumer confidence as surveyed is highly susceptible to a bad news cycle or some event that professional investors may deem negative and then digest and ignore a few days later.

The European debt crisis of earlier this year was one of those events that spooked markets for a while, until investors determined that measures would be taken to avoid a widening crisis and discounted the problem (of course investors discounted the mortgage crisis in 2007 too). Most consumers can't truly grasp the European sovereign debt problem but they heard it was causing the stock market to fall and saw the balances in their 401-K fall 10% or more during the following couple of months and therefore, Greek debt begets weaker consumer confidence.

At this point the better consumer confidence indicator is how consumers are using their pocketbooks. The Commerce Department reported that consumer spending rose .6% in September, following an upwardly adjusted .7% increase in spending in August. International Council of Shopping Centers (ICSC) reported that consumer spending at chain stores had risen 2.6% in September. These increases are particularly interesting because they bridge a period between back-to-school spending and the holiday season.

At an October ICSC Pittsburgh Alliance program in Cranberry, retail veteran Steve Schuler expressed a theory about the reasons behind the re-emerging consumer. Schuler is a principal at DowntownWorks LLC, a Washington DC-based retail consulting firm.

“My experience is that the American consumer will respond to an economic crisis by cutting back spending and worry and get their house in order but will only deprive themselves for so long,” he says. “Right now it seems the consumer has decided that depriving themselves for two years is enough and retailers who know their customers are doing well. The Class A malls are packed and smart retailers are seeing good traffic again.”

Schuler pointed specifically at the Baby Boomers as a demographic that seems to be recovering its appetite for consumption, reminding the attendees that Boomers weren't like their parents. “They buy clothing that makes them feel cool, because the clothes are new not because they need another shirt or whatever, and they think they are going to drive their Corvette until they are 90.”

Another intriguing aspect of the consumer mentality is that it transfers directly to work. Business spending decisions are made by people who don't change their behavior all that much when they go to work. A quarterly survey of 73 corporate economists released in September by the National Association for Business Economics (NABE) showed that industry demand, profits, costs, employment and capital spending all strengthened compared to results in the July 2010 survey. Of the 50 respondents to a question about plans for spending on structures, 12 said they expect their firms to increase spending over the next 12 months, while 11 expect a decrease. It was the first net positive response to the question in over two years.

For the past year businesses have been consuming more as well, driving inventory replacement up and setting the stage for positive decisions about construction projects in 2011, according to Dr. Kermit Baker, chief economist for the American Institute of Architects (AIA).



Baker was part of a webcast on October 21, titled "After the Fall" that addressed when the rebound would begin. He keyed in on the historical pattern of construction spending that followed business investment in the years after a recession ended. Baker found that the correlation between the two was extremely close and had accurately foretold how the recovery unfolded in each of the past four recessions, going back to 1973.

"Business investment in equipment and software in the first year after a recession represent smaller expenditures that can be expensed rather than large investments like structures," he explained. "The two are generally related. If there is weak spending, like in 2001, then the investment in structures is weak the following year. Now who knows how this cycle will go but the spending this year had been very positive. If the traditional pattern holds we could see a much stronger recovery than expected next year." Growth in spending in 2010 was 16%, greater than that following all but the 1980-1982 recession.

Business Investment in Equipment & Software Indicates Future Investment in Structures

U. S. Dept. of Commerce data for annual growth in inflation-adjusted dollars

Recession Period	Year 1: Business Invest. in Equip. and Software*	Year 2: Business Invest. in Structures**
1973-1975	6.0%	4.8%
1981-1982	23.1%	14.1%
1990-1991	7.3%	-0.2%
2001	-1.8%	-1.7%
2008-2009	16.0%	???
Average – past 4 cycles	8.7%	4.3%

* Annual growth rate in first year after recession

** Annual growth rate in second year after recession

Source: Kermit Baker, AIA chief economist

The AIA was also the source of another positive and reliable indicator, the Architectural Billing Index (ABI), which passed the 50 mark in September. The ABI is the result of a simple yes/no survey of member firms that asks if billings were better or worse than the previous month. Any reading over 50 means that more firms responded affirmatively than negatively. September marked the fourth consecutive month of increases, following a dip in May, and the eighth month of increased ABI in the past nine. The ABI reading of 56.3 for inquiries also marked an extended period of positive readings dating back through the entire year.

"Firms are seeing recovery that is fairly broad-based and is especially good in commercial buildings," Baker explained. "It looks like on the commercial/industrial side we're looking at a real recovery."

AGC of America's chief economist Ken Simonson agreed with Baker about the prospects for non-residential construction in 2011, predicting an increase of less than five percent for that sector of the market, and an overall increase in contracting of between three and seven percent. Simonson expressed more concern about the impact of state and municipal finances and felt the mid-term elections would yield results that were less hopeful for a solution than the current political balance.

"State and local pension fund shortfalls have moved to the forefront in most places and government is going to be forced to deal with the funding," he says. "Almost all local government is struggling with reduced revenues for operations and pension fund contributions will be a higher priority than construction spending for most municipal and state governments."

Simonson also expressed concern that the next transportation authorization, if passed, would not be the remedy most states are seeking, predicting that the federal portion would require more state matching funds rather than less. "I think heavy and highway construction will be extremely challenged over the next few years."

The Reed Construction Data forecast for 2011 takes into account four threats to U. S. recovery. Reed economist Dr. James Haughey is concerned that government pension obligations, slower Chinese growth and demand, higher taxes to pay for the Obama administration's ballooning deficit and European Union defaults could deal a serious blow to restored growth in the U. S. His conclusion, though, is that any impact from these structural problems will be blunted or deferred for the future. Reed's forecast is for total construction spending to expand 5.3% next year and 11.4% in 2012. This will bring spending by the end of 2012 up to 87% of the spring 2007 peak level.

One segment of the market that is overdue for recovery is not likely to see much better conditions in 2011. The housing construction market remains mired in a downturn that has yet to see the stars align for growth. A key element to the recovery of the housing market is a sustained rebound in home prices. And while home prices continued to inch higher again in September, additional pressures on a continued rise mounted.

Bank repossession of homes passed 100,000 for the first time in September, according to industry research firm RealtyTrac. A record total of 102,134 bank repossessions were reported for the month. The RealtyTrac U.S. Foreclosure Market Report for the third quarter of 2010 shows that foreclosure filings — default notices, scheduled auctions and bank repossessions — were reported on 930,437 properties in the third quarter, a 4% increase from the previous quarter and a 1% decrease from the third quarter of 2009. This figure is one out of every 139 homes in the US.

Potential homebuyers have been showing increased traffic through the summer months but the concerns about a glut of foreclosure properties have been compounded by the federal inquiries into foreclosure procedures of the national banks. Few observers expect the federal and state investigations to yield any inappropriate foreclosures but the proceedings will add uncertainty to the market, possibly casting enough doubt on a buyer's ability to determine clear title to further suppress demand in an already tough environment.

The volume of new home construction in 2010 will likely end up below 750,000 new units. If so, it will mark the third consecutive year of new home starts at a level that is half the new household formation rate. This kind of demand suppression should be creating an explosive recovery, but other factors besides under built supply will keep new construction growth in single digits for 2011.

Next year is likely to be a rare market: a jobless recovery with little new housing construction.