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National Outlook: The Recession Looms, Right on Time

There's a story that was told about Albert Einstein commuting in New Jersey towards the end of his career. A young conductor noticed the great man searching frantically through his belongings as he approached. Upon reaching Einstein, the conductor assured him that he didn't need to produce a ticket. "We all know who you are, sir, and I'm sure you bought a ticket." As he moved away, the conductor noticed Einstein still looking for his ticket. Doubling back he reassured the scientist, "Dr. Einstein, it's OK, I know who you are." To which Einstein replied, "Young man, I am also certain of whom I am; what I don't know is where I'm going."

Two large uncertainties weigh heavily on the construction economy as the first quarter ended, leaving more questions about the direction of the economy.

Of the two, the more certain is the prospect of a recession. In virtually every measure but the classical two consecutive quarters of declining GDP, the first quarter of 2008 seems to have convinced most consumers and business people that a recession is, or will soon be, happening. Chances are the economy will meet the negative GDP benchmark once we have two quarters of 2008 under our belt. Investment in the stock market is down, the dollar is horribly weak, inflation of some very basic necessities has settled in, and consumer confidence is at an all time low (at least since we've been measuring it).

Housing remains the other uncertain sector influencing the economy, although the uncertainty seems to be whether or not we've hit bottom, rather than whether or not the recovery will start soon. Much like a particularly bad flu virus, the housing slump's symptoms are continuing to ebb and flow as it extends into its third year, with every new day producing recovering and declining symptoms.

Since the housing market is at the center of our current economic woes, let's start with an update on that sector first. There are some quantitative indicators that an end may have been reached in the declining starts. Actual permits or starts may continue to be up and down monthly throughout this year but some key figures are showing that the demand for new housing is building.

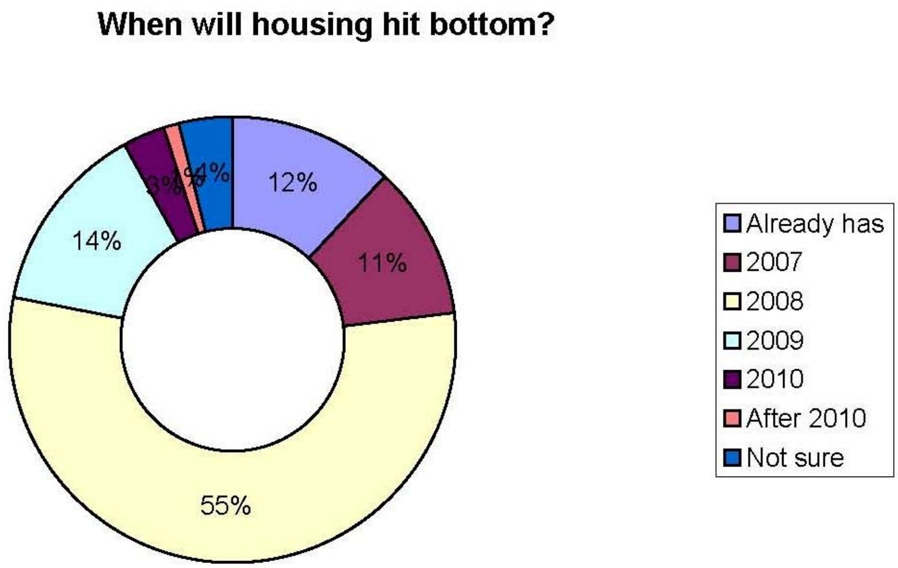
Home sales have begun to pick up again, although home values continue to decline. Sales through February were up slightly, and inventories of homes for sale fell three percent from February 2007, to just over 4 million homes for sale. The inventory levels represented a 9.6-month supply of homes, compare with a 10.2-month supply in January. Home values slipped in February, with the national median price falling to $195,900, down 8.2 percent from a year earlier when the median was $213,500. Even here there is some good news, because the decline is owed mostly to the fact that the steepest declines are occurring in areas with the most expensive homes, causing a greater drag on the median price.

The most optimistic signal from the market is that the source of housing demand, household formations, is lagging behind the pace of new housing. A new household is formed, on average, for every two people. Population grew in the U. S. by 3 million in 2007, but somewhere between 650,000 and 800,000 new households were formed, a pace that is roughly half what would be normal. What is keeping household formation, and the demand for housing, depressed is the uncertain economy. Household formations mostly take place in the young adult demographic, and an unusually high number of young adults are staying in their family homes, or sharing rental property, out of fear of buying at the wrong time. Availability of credit has been limited significantly for this untested group, making mortgages scarcer.

Assuming that the population grows a similar number again in 2008, the reduced housing start activity of one million or so total new units will be roughly one-third what the normal household formation demand should be for two consecutive years.

With a dramatic reduction in lending costs acting as an incentive, and the emergence of more conventional lenders as more of the ‘suckers’ have been cleared out of the mortgage business, market conditions will be ripe for a shift in demand once would-be buyers begin to regain confidence in the overall economy.

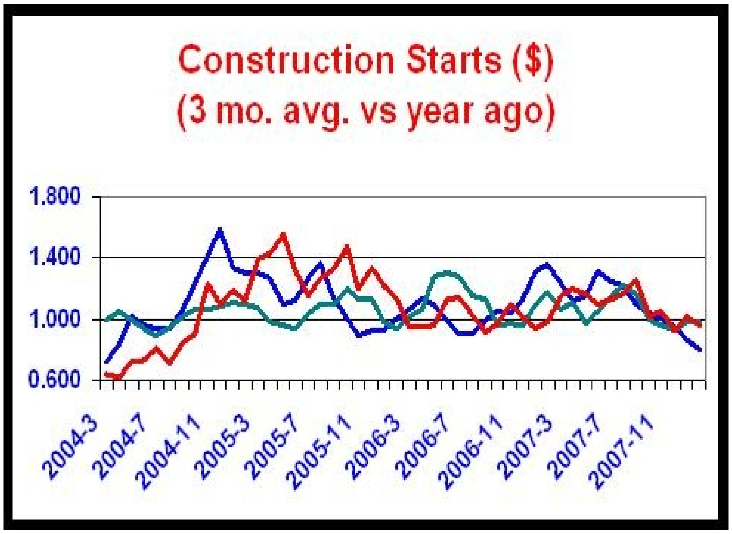
A couple of national builder surveys done recently show that the homebuilders aren’t expecting that shift in demand to occur this year. The chart below shows the results of a survey done by *Professional Builder* magazine. It demonstrates the ambivalence that has grown in the past quarter or so. While 55% believed that the bottom will occur in 2008, another 25% believed that the decline will continue into 2009 or later. This contrasts with the predominant builder sentiment of last summer that the recovery would begin by mid-2008. A survey done in March by the National Association of Homebuilders (NAHB) marked a growing sentiment that there will be a delay between the bottom of the market and recovery. That survey indicated a stabilizing in new housing by mid-year 2008, but no prospect for long-term, sustainable recovery until 2010.



Recessions have deleterious impacts on demand, eroding consumer and business spending, which in turn trims hiring and expansion plans. The reduced demand defers investment in new construction of retail, office and hospitality facilities, further reducing employment. Reduced employment lowers tax revenues and insurance premium payments, which lowers revenues for hospitals and spreads the malaise into healthcare construction. Lower tax revenues trim public building spending. It's an unpleasant litany of cause and effect that is in the middle of playing out as 2008 progresses.

The impact of the recessionary climate on non-residential construction had been limited through 2007, but first quarter data suggests that the tide has turned in those sectors of the market as well. Those factors putting downward pressure on the economy, growing inflation, tightening credit conditions and flagging consumer and business confidence, have slowed the pace of all non-residential construction.

McGraw-Hill Construction has reported that contracting in January-March was 2% lower than the same period in 2007; but adjusted for inflation, that volume shows a much steeper decline in square footage. Reed Construction Data showed a decline of 6.6% for the full first quarter, with non-residential building construction down 5%. Reed's data, shown in the chart below, also indicates that the commercial, institutional and heavy construction subsectors are moving downward together since July of 2007.



Future construction indicators don't offer much inspiration for hope of a short-term decline either.

Architectural/engineering employment fell by 1,500 jobs in March, according to the Bureau of Labor Statistics. Moreover, the three-month hiring totals of 2,100 represent the lowest quarter since 2003. The American Institute of Architects index of architectural billings had slipped to 41.8, down from 58.8 in July 2007. The index indicates rising or falling billings, with an index of 50 representing break-even. Numbers under 50 indicate a falling trend for billings.

The recession and inflation pressures on public construction have reached a critical point as well. Recessionary pressures have reduced the sources or revenue (taxes on sales, fuel consumption, property and wages) at the same time that the inflation in fuel and construction materials has limited the amount of construction being done. This scenario means less construction can be done for the same dollars, and fewer dollars are available to government for paving or bridges or schools.

The first quarter of 2008 didn't have any real bright spots. Whatever hangover exists from the overextension of credit, inflationary monetary policy and overbuilding will have to be endured until the equilibrium of supply and demand is reached. On the darker days, do bear in mind that this part of the cycle is the normal correction that will lead to another round of expansion. The nation is still growing. The question of an expanding construction economy is when it will turn, not if it will.

Notes:
Professional Builder survey of homebuilders shows 80% believe the housing decline will continue through this year or beyond.

Reed Construction Data chart shows a 3-month moving average of contracting dollars in the current market versus the start of recovery in 2004 (Institutional dollars in green, commercial in blue, heavy construction in red)