



Construction National Outlook: September 2011

After several months of mostly negative news about the economy it is becoming clear that the national construction climate is stuck in neutral for at least the near term. There is some irony in the situation, in that the principle driver in the recovery – improved corporate earnings – remains strong as of the last quarters earning reports. Strong corporations haven't yet become strong hiring machines and the extended period of high unemployment seems to be focusing investors and consumers on the economic news that they mostly ignored during the fourth quarter of 2010 and the first quarter of this year.

The data piles up on both sides of the argument at this point.

On the upside is the strong corporate income and balance sheet picture. Corporate stockpiles of cash are at staggeringly high levels, although it is not being put to use. Financial institutions have mostly healed from the 2008 crisis and their current balance sheets indicate that there is excess liquidity. The latest indicators of credit availability show minor easing in lending conditions and the cost of borrowing appears to be set at record low rates for the foreseeable future. Energy costs have begun to contract. And the recent bad news seems to be a motivation for another round of government spending or intervention, which is likely to include construction.

Weakness in the outlook comes from fears about global finance due to Europe's debt problems and the unknown exposure of U.S. banks to Euro default. Housing sales, prices and starts remain at very soft levels. Foreclosures remain almost one-third of all sales, although the number of new foreclosures has dropped the past few months – perhaps artificially. Federal government inaction and ignorance of the economic impact of their partisan intractability leaves most people skeptical of any positive policy towards the economy. Employment is not improving. Investors are showing diminishing confidence that corporate earnings will continue by moving out of the stock markets in big surges. All of these factors are driving consumer confidence (although not spending yet) down each month.

This bad news/worse news cycle is roughly 90 days old and the experts have begun to move from the "soft patch" theory towards the "potential double dip" theory again. In almost every corner the watch word for the moment is uncertainty.

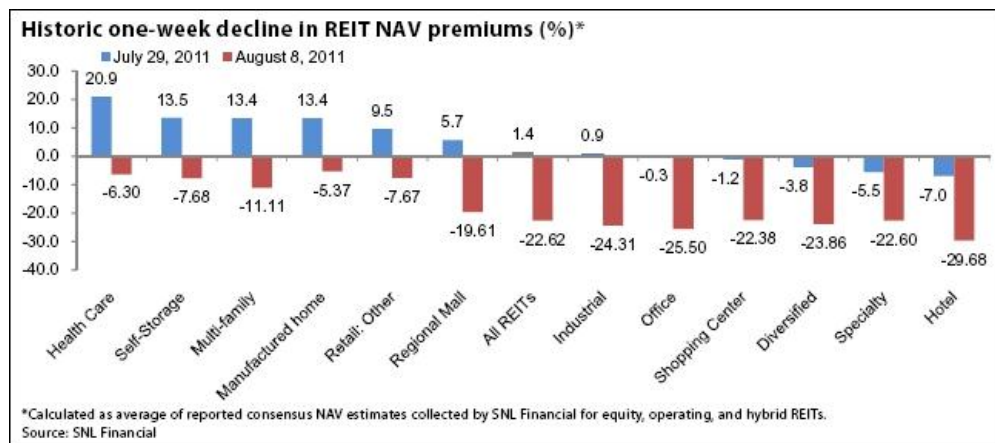
Friday, August 5 was a poster child for the kind of uncertainty that faces business owners. As the business day began the government released its monthly hiring and unemployment data. The news – expected to be gloomy – was the first positive surprise in the employment area in months, with 117,000 new jobs added and unemployment dropping slightly to 9.1 percent. The biggest increases occurred in health care (31,000), retail (26,000) and manufacturing (24,000). Government shed

37,000 jobs, marking the ninth consecutive decline. The Commerce Dept. also revised the June and July jobs added by 56,000.

After 5:00 PM the mood changed as the anticipated downgrade of the U.S. credit rating took place at Standard & Poors. The ratings agency, which chose not to downgrade \$1.7 trillion in residential mortgage debt it had rated AAA in 2007, based its downgrade on the political wrangling surrounding the debt limit deal.

The immediate impact of the downgrade was to unsettle the already unsettled markets, as evidenced by the 600+ point decline in the Dow Jones Industrial Average on August 8. What followed was a week unlike any the markets have experienced since the financial crisis in fall of 2008. Even though the volatility has moderated somewhat in recent weeks, confidence has not been rebuilt.

Of greater concern are the many unintended consequences of the ratings downgrade that can impact the real estate – and by extension construction – business. One glaring example is the dramatic reduction in real estate investment trust (REIT) pricing that occurred in the run up to the debt deal and subsequent downgrade. For all REITs the pricing declined from a 1.4 percent premium to net asset value (NAV) to a 22.6 percent *discount* to NAV. This swing was the largest since the December 2008 collapse and will make real estate trusts less functional as a financial instrument unless the momentum swings back, since such a precipitous decline could signal an end to the recent appreciation in NAV.



In 'normal' conditions the overall price of REIT equities should be very close to the underlying net asset value of the properties contained in the trust's portfolio. In declining markets, informed investors will tend to devalue REIT prices ahead of the realized decline in property values, and in expanding markets – like the U. S. commercial market of July 2001 – the price of REIT's tends to trade at a premium to NAV. During the three cyclical swings that have occurred since REITs were common financial instruments, sudden changes in investor sentiment have triggered extreme changes in pricing to NAV because more uninformed investors are in the market. Because the commercial market is in the early stages of recovery from the last recession it's difficult to judge yet whether or not the reaction to the downgrade was simply emotional trader noise or the first indicator that NAV will be falling again to meet the lower pricing.

As unsettling as the roller coaster of news is for consumers there is no shortage of backtracking from the economists and professionals, many of whom have been generally optimistic about the conditions for commercial real estate and construction in the second half of 2011.

“[A]s for liquidity, if the monumental retreat in financial stocks continues, the ability of institutions to lend will be curtailed,” concludes Jeffrey Rogers, CEO of Integra Realty Resources. “In these times, banks tend to get more conservative in underwriting. This has the effect of reducing liquidity as transaction volume decreases.”

Rogers presented Integra’s analysis of the consequences of the downgrade as a significant negative event for commercial real estate. Specifically IRR sees problems arising with corporate confidence, liquidity and demand from government. Their concerns are:

- Hiring will be curtailed or delayed by companies across the board. Demand for commercial real estate will decrease and stall the economy in the short run.
- Banks may get more risk adverse, erasing the gains of liquidity in the market. This will then decrease the ability of investors to purchase commercial real estate.
- Taxes will increase significantly, either in the form of higher rates and/or deduction rollbacks. This will pare back the gains we have seen in hospitality and resort travel.
- The government will make further reduction in spending, thereby sinking GNP and decreasing the demand for commercial real estate.

Reed Construction Data is a national construction tracking service that had been forecasting a mostly flat or slightly declining market for non-residential construction in 2011. They were the most upbeat of all the construction economists until late August when they revised their official forecast.

U.S. Total Annual Construction Spending						
(in billions)						
	Actual			Forecast		
	2008	2009	2010	2011	2012	2013
New Residential	238.2	141.4	135.8	127.6	136.4	160.5
% change (from previous year)	-34.2%	-40.6%	-4.0%	-6.0%	6.8%	17.7%
Residential Improvements	120.7	119.3	116.8	118.7	129	142.2
% change	-13.9%	-1.1%	-2.1%	1.6%	8.7%	10.2%
Non-residential Building	437.4	379.7	290.9	266.8	275.5	301.6
% change	8.6%	-13.2%	-23.4%	-8.3%	3.3%	9.5%
Non-building	270.9	273.7	269.8	261.3	270.8	289.9
% change	9.3%	1.0%	-1.4%	-3.1%	3.6%	7.0%
Total	1067.2	914.2	813.3	774.5	811.7	894.2
	-7.4%	-14.3%	-11.0%	-4.8%	4.8%	10.2%

Source: U.S. Census Bureau, Department of Commerce.
Forecasts and table: Reed Construction Data.

Reed's chief economist, Bernie Markstein observed in his August 24 blog post, "[We] have reduced our forecast of economic activity, lowering economic growth in second half 2011 from 2.5 percent to 1.8 percent. For the year, GDP will grow 1.7 percent. 2012 GDP is now forecast to increase 1.7 percent as well. We forecast slow improvement in the second half of 2012 into 2013, with 2013 GDP advancing 2.4 percent. We also see a higher risk of recession. We place that risk at 25 percent to 30 percent."

Markstein continued, "The outlook for construction spending remains positive for 2012 and 2013, outperforming GDP growth, though not as strong as before. We project a 4.8 percent decline in 2011, previously forecast as a 4.2 percent decline. The increase in 2012 construction spending has been cut to 4.8 from 10.5 percent."

It's unfortunate that the data does little to point in a clear direction any more than expert opinion. The most recent Census Department data on construction shows that construction put in place for both private and public construction tracking relatively flat from June 2010 to June 2011. Publicly funded construction has dipped roughly ten percent since then, while private non-residential and residential are off about two percent each. The total construction spending is less than two percent off of June 2010 volume, however and June 2011 total of \$772.3 billion represented the fourth straight month of increases of less than \$10 billion. Reviewing the data since the financial crisis reveals that construction volumes have been stuck in a range between \$750 billion and \$800 billion since the recovery in mid-2010.

Even the AIA Architectural Billing Index is giving unclear signals about the potential work in the coming quarters. ABI fell for the fourth straight month again in July to 45.1 after a decline in June to 46.3. A reading below 50 means more architects saw a decline in billings than an increase that month. Perhaps the pattern of responses to inquiries is more instructive of the sentiment. Inquiries jumped significantly from 52.8 to 58.1 in June and then slipped to 53.7 in July. Firms have reported increasing and decreasing levels of inquiries in alternate months since February, suggesting that owners are vacillating about releasing projects during most of this year.

A technical analysis of both ABI and construction spending data also suggests that the overall trend is downward, as the movement within the range of activity has been hitting lower highs and lower lows. Like the stock market, the construction market appears to be looking for catalyst up but with each month that passes fewer owners are willing to act without one.