



National Outlook: Construction Industry

For an economy that was already running out of steam, the market events of the month between mid-September and mid-October could hardly have been more damaging. The enormous loss of life that resulted from the attacks of September 11, 2001 makes a comparison of the two periods irrelevant; however, the fear that resulted from the potential unwinding of the global banking system caused as much financial damage as the fear that followed the terrorist attacks.

The sell-off that started September 29 on Wall Street was the logical response to that fear, if such a thing is possible. Bailing out is fear taking action. Now the question has shifted from what happens if all these loans go bad, to when we'll know if the bottom has been reached.

This isn't a publication for the stock market, but since stocks are much more a reflection of future sentiment, it is worth taking a moment to describe what the bottom has looked like in past. During the end of the last bear market, in October 2003, bottom came after the Dow had lost a third of its value, down to 8,200, and was surprisingly short-lived. In fact, if you check the daily close and volume for the beginning of the generally accepted start of the last bull run, October 11, 2003, you'll see that the Dow was up nearly 1,000 points within ten days after the bottom. That bottom was tested again a couple more times throughout the winter before the run up to 14,000 began in earnest.

Our current status is that the Dow dropped more than 40% from its high last December, and that it has rebounded about 1,000 points since then, with lots of volatility present to reflect more testing of the downside limits to come. Like 2003 this bottom was reached in the midst of earnings season, which adds even more uncertainty to the mix. From an investor's vantage point, the earmarks of a market bottom are present right now. The reality of the market's next move will depend on whether or not another 'shoe' of bad credit news is yet to drop.

On the credit front, the end of October did bring some early signs that the global governmental response to the problem was easing the fear that had seized up bank-to-bank lending. The premiums being charged over and above LIBOR or the Fed Funds rates were declining, which is an indication that the fear of default was easing. Until those spreads fall back to less than 50 basis points, however, credit markets and construction lending will be susceptible to bad news.

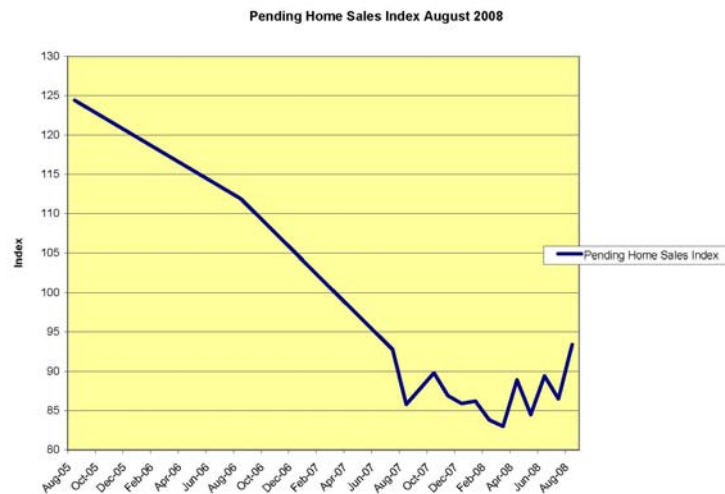
For all the 'once in a lifetime' financial events, the construction cycle actually seems to be playing out as it always has when a boom unwinds. That, of course, is a 'good news, bad news' proposition.

Housing starts fell 6.3% in September to a seasonally adjusted annual rate of 817,000, the lowest since January 1991, according to Commerce Department estimates. Starts of single-family homes tumbled 12% to an annual rate of 544,000, the lowest since February 1982. Building permits, which are less volatile than the starts data, fell 8.3% to 786,000, a 27-year low. Permits for single-family houses fell 3.8% to 532,000, the lowest in 26 years. And housing starts were off 31% in the past year and were down more than 60% from the peak in early 2006. In the past year, permits for single-family homes have dropped 39%, single-family starts have fallen 42%, and single-family completions have sunk 27%.

OK, that doesn't sound like good news, but coupled with sales data from the same period, the extreme conditions indicate that the end of the free fall in housing may have occurred.

Like housing starts, sales of new and existing homes reflected further declines across many metrics of measure. Resale of single family homes and condos fell to annual rates of about 4.9 million units, and inventory levels grew to 10.4 months supply. The median home price continued to fall throughout the summer, falling a cumulative 5.8% since the peak of April 2007. Yet for all this continued negativity, the rate of decline is slowing dramatically, suggesting that the supply/demand balance for housing is approaching equilibrium.

One lesser touted indicator that portends a housing recovery is the Pending Home Sales Index (PHSI). This index measures sales agreements, not closings, and doesn't account for price. During the six months between February and August, the PHSI has risen three times, with slight declines followed by an increase larger than the previous one. As the chart above shows, the PHSI trend looks like buyers may finally be emerging from hibernation. This may only be because the opportunity to buy at distressed prices is too appealing, and an extended recession may dampen recovery, but the indication nevertheless is that the inventory of homes for sale will finally decline. And that is a precursor to appreciating home prices again.



The Pending Home Sales Index is one leading indicator that is trending positive as the fourth quarter begins

Lawrence Yun, Chief Economist for the NAR, explained the August increase as having the potential for marking the bottom of the market, "Given all the focus on the U.S. housing market, mortgage availability appears to be improving despite the turmoil in the stock market and banking stocks. The Treasury, since the takeover, is forcing Fannie and Freddie to be not as overly stringent, including the removal of fee in declining markets. It is a move not to lax standards, but to normal healthy underwriting criteria," he said. "The Treasury clearly and rightly understands that the global economy will not recover without a recovery in the U.S. housing market."

For non-residential construction the activity is, unfortunately, proceeding as it would at this point in the business cycle.

The three major entities which track non-residential construction, the Commerce Department, McGraw-Hill Construction and Reed Construction Data, use slightly different methodologies for reporting, yet all are indicating a slowdown as the third quarter ended.

McGraw-Hill reported contracting volume to be slightly ahead of 2007, but that pace has dropped from the beginning of the year, and the trend is for a year-over-year decline by December. Reed was showing a four percent decline year-to-date, and more ominously, a 14% decline in square footage of new construction compared to 2007. Commerce Department data showed the third straight monthly decline in seasonally-adjusted construction put in place, with the trend towards year-to-year decline by 2009.

The \$700 TARP bill passed by Congress was aimed at banks and homeowners, but the aim of calming the global credit markets could have a positive effect on both commercial construction lending, and more pressingly, on the distress in the municipal bond market. Access to municipal bonds has been severely limited since mid-year. Aside from a large municipal authority issue in Alabama, defaults have not been the problem, but rather the skyrocketing yields of the bonds themselves. This situation was exacerbated as the market sold off in early October because many large hedge funds found that their municipal bond portfolios were the only instruments that could be sold as they were hit with redemptions. Like the panic selling of stocks, the forced selling of muni bonds drove prices sharply downward and yields up, with some bonds bearing interest rates near seven percent. These kinds of rates effectively halted bond issues for many authorities.

Private construction sectors which reflect consumer confidence, like retail stores, have been slowing since 2007, but the likely slowdown in the economy has begun to spill over into the other commercial sectors. The growth of new office and industrial construction has slowed, particularly when construction of energy-related facilities are factored out. A looming recession will reduce investment in new hotels and recreation facilities. And the bright spot of non-residential construction, the institutional market, faces a challenge in raising capital over the next year or so.

When asked about the downstream effect of the credit market problems Associated General Contractors of America (AGC) Chief Economist Ken Simonson summed up the damage to all sectors.

“Public projects and institutions such as hospitals and universities may not have the same credit difficulties (as other markets), but their funds have also taken a hit. Many states are dialing back their forecasts for income and sales tax revenues while increasing their projections for social welfare spending. That combination, along with a requirement that their budget be balanced in a fiscal year that typically ends just nine months from now, means construction projects will be delayed, scaled back or canceled,” he explained. “Institutions that had counted on endowments or pledges from wealthy donors may find their portfolios have shrunk too much to proceed with planned projects. Putting the economic engine back in gear may not be easy.”

It is likely that there will no sector of the construction industry on the upswing when 2008 ends. Because of the causes of the economic woes, there will be a temptation to view this year as extraordinary, but the reality is all economic upheavals are unique and yet, mostly similar. Like in other slowdowns or recessions, the summer of 2008 may eventually be viewed as the time when the piper had to be paid. Looking at similar years, like 1982 or 1991, will yield clues as to how the consumer is likely to react in 2009, and when the new growth will begin.