



National Outlook: Construction Industry

January 2009

As expected, the last 60 days of 2008 revealed one dismal economic report after another in reflection of the stunning crash of the stock markets in early October and the breakdown in the credit markets. If there's a positive to derive from all the bad news (and this is definitely a reach), it is that the negative reaction by consumers and businesses was swift and decisive, which may hasten the beginning of recovery. But in the meantime, the national economy and construction markets will experience contraction.

From among the litany of gloomy data several key areas of the construction economy are in very different positions from the beginning of 2008, and bear watching. The most telling of these are the status of the housing market, commercial construction and architectural billings.

On the residential front the Mortgage Bankers Association (MBA) issued its expectations for the coming year:

- Total existing home sales for 2008 will decline about 12 percent from 2007 to 4.96 million units. Sales will pick up about three percent in 2009.
- New home sales will decline about 36 percent from 2007 to 500,000 units. We expect sales to decline another 12 percent in 2009.
- Median home prices for new and existing homes are expected to continue their decline this year, falling about 7-8 percent. Prices should decline more modestly in 2009.
- Total mortgage production will be down 22 percent \$1.81 trillion in 2008.

While all other economic activity slumped at the end of November, the MBA announced that the drop in mortgage rates had created a tsunami of loan applications in the week following Thanksgiving, rising 112.1% over the previous week.

December 9 the National Association of Realtors (NAR) reported October's existing home sales fell .7% compared to September, and only 1% compared to October 2007, not as steeply as economists had feared, and a much smaller decline than most other indicators in October. The October data also showed declines across all regions, an indication that the financial crisis was keeping prospective buyers on the sidelines, and NAR economist Lawrence Yun estimated that 45% of the existing home sales were foreclosures.

Yun called on the incoming administration to consider mortgage assistance as part of any stimulus package, suggesting that \$50 billion should be used to buy down interest rates to allow buyers to qualify and troubled mortgage holders to refinance at affordable levels.

The Center for Economic and Policy Research (CEPR) issued a radical solution in its December report on housing values: let the prices fall completely. The report, "The Key to Stabilizing House Prices: Bring Them Down," notes that prices are still dramatically out of line in 'bubble' markets and calls for Fannie Mae and Freddie Mac to restrict the buying of mortgages in these areas. This would lead to fewer loans being issued in these markets and prices would quickly adjust to normal levels. The fact that real house prices exploded by 80 percent from 1996 to 2006 while rents increased by only 4 percent over the same time period points to a degree of speculation and the fact that prices still have further to fall before the bubble deflates.

For those faced with foreclosure due in part to falling home prices, CEPR suggests the best solution is one that amends the rules on foreclose to give homeowners the right to rent their home at the market rate, keeping families in their houses and giving bankers an incentive to renegotiate terms by making foreclosure an even less attractive option.

While virtually all residential market indicators are somewhat negative, the last six months of 2008 saw several upticks in home sales, a much smaller decline in sales after the stock market crash, another double-digit decline in new home construction, and falling mortgage interest rates. Together these factors all seem to indicate a bottom to the housing decline has been reached. Economists expect that values will decline only slightly in 2009, and most expect to see buyers coming back to the market by mid-year. Of course, most felt that the housing recovery would begin in 2008 as well. Whether 2009 marks an increase in home buying or simply a prolonged bottom, there is no evidence that demand and supply will align so that new home construction will start recovering anew until 2010.

Like virtually all real estate business cycles, this one has seen the downturn in housing precipitate a significant downturn in retail construction. Already slow for more than a year, retail store construction has become extremely targeted, with retailers adding stores only in markets that have been resistant to the recession so far (and those are few and far between). Major projects have been deferred or abandoned, and most that had already begun have seen significant dropoffs in pre-leasing, and significant withdrawals from previously committed lessees.

Although another indicator of slow retail construction probably isn't necessary, the attendance at the International Council of Shopping Centers (ICSC) 2008 CenterBuild shows how deep the chill has gone. Held in Phoenix, the show normally attracts 2,500 attendees, yet only 1,500 paid to attend the 2008 conference, and only around 1,000 of those showed up.

This sector, however battered now, bears the closest scrutiny in 2009, particularly if the housing market begins to show life. In a typical cycle, retail activity will pick up six to twelve months after housing begins recovery. If the stimulus package and foreclosure relief begins to help consumers out of the doldrums during the first quarter, renewed planning of shopping centers and stores will begin by the end of 2009, with the start of a new retail construction cycle for openings in the summer of 2010. Should the relaxation of credit be limited to housing, or if consumers limit themselves once housing recovers, the slump in retail construction will continue into 2011.

Other sectors of the commercial construction market are also in a tailspin at year's end. Hotel and office vacancy rates were up significantly. A deteriorating economy and high fuel costs had already negatively impacted the hospitality industry this past summer, and the rapid decline in the financial markets deepened the slowdown in business travel that normally occurs in the fourth quarter, as corporate managers pare back to meet budgets.

Office construction has been declining slightly throughout 2008, as the loss of almost two million jobs has eroded demand. The accelerating pace of layoffs and shutdowns in fourth quarter 2008 will keep demand soft, with a worsening outlook for white-collar job creation for 2009. Also threatened by the poor jobs outlook are the manufacturing and warehousing markets, both of which had been positive for new construction through mid-2008.

Reinforcing the lean outlook for commercial construction is the steadily declining Architectural Billing Index, conducted monthly by the American Institute of Architects. The ABI measures billings in comparison to the previous month, simply tracking respondents' increase or decline so that a reading of 50 is neutral. The October ABI showed the index at 36.2, down from a positive 53 in October 2007. Unlike previous surveys, the AIA now finds that even members with strong institutional practices were seeing declining billings.

As 2009 begins the Federal government will give the reins to Barack Obama, and his administration has indicated during the transition that it intends to stimulate the economy through infrastructure spending, and through continued programs aimed at freeing up credit. While these efforts may support heavy and highway construction, most economists don't see more available credit having the same impact.

"The massive intervention by the Treasury and Federal Reserve in the credit markets should unlock bank lending and bond markets in the next few weeks. But the availability of credit is no guarantee that borrowers will rush to take out loans again," offered Ken Simonson, Chief Economist for Associated General Contractors. "For 2009, I predict nonresidential spending will drop by 3 to 9 percent; materials costs will be down 1 to 5 percent, depending on the project; and labor costs will rise 3 to 4.5 percent."

Simonson also voiced concern over the financial health of the individual states, as many are now struggling to meet balanced budget demands. His concern is that an Obama stimulus may not lead to new infrastructure construction levels so much as replacing construction that had been cut back.

National publisher McGraw-Hill Construction's outlook anticipated declines affecting nearly every type of construction this year and next. McGraw-Hill reported that office construction is set to decline by 18 percent, and store construction by 15 percent in 2009, after declines in office construction of 17 percent, and store construction by as much as 30 percent in 2008. The company's Vice President of Economic Affairs Robert Murray presented a similar forecast for the other commercial categories, anticipating declines in hotel construction of 19 percent, in manufacturing of 10 percent and a 16 percent drop in warehouses.

McGraw-Hill also forecasts public works spending declining 5 percent in 2009, with much of the decline driven by state revenue shortfalls. Federal funding, however, could help make up the difference. "There is potential for substantial funding as part of a second stimulus bill," Murray said. "We'll find out in the next couple of weeks."