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## Construction National Outlook – January/February 2011

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Just two years removed from the ‘black swan’ crash of the financial markets that exposed a deep global recession, the national economy seems to be on its firmest footing since the winter of 2007-2008. Many questions still remain about the duration and vigor of the recovery, but several respected observers have released outlooks for 2011 that show at least guarded optimism. Couple with recent economic data, these forecasts all point to the passing of the bottom of the market.

In its *2010 Construction Outlook* report, released on Oct. 29, McGraw-Hill Construction estimates that construction starts nationwide will show a decline of 2 percent in 2010, followed by an increase of 8 percent in 2011. That forecast is in line with forecasts made earlier in the month by Reed Construction Data, the American Institute of Architects and the Associated General Contractors of America. Having four concurring forecasts is absolutely no surety of a better market, but the tight range of the expected growth – from a low of 3 percent to a high of 8 percent – suggests that all are drawing similar conclusion from the myriad of data.

McGraw-Hill’s estimate follows declines of 24 percent in 2009, 13 percent in 2008 and 7 percent in 2007. Commercial construction, which is expected to pull back by 17 percent from 2009 levels, had the sharpest decline of any market sector and was significant enough to drag down growth in all other sectors. “2010 was another year of double-digit declines for commercial construction,” said Robert A. Murray, MHC vice president of economic affairs. “The declines slowed compared to 2009, and commercial construction looks to be on the uptick in 2011.” The *Outlook* report forecasts a 16 percent increase in commercial building starts in 2011.

Looking to 2011, the report predicts that growth will mainly driven by single-family housing (+27 percent) and multi-family housing (+24 percent) starts. Other expected growth areas in 2011 include manufacturing buildings (+9 percent) and health care facilities (+9 percent). McGraw-Hill foresees declines in highways, bridges and other transportation construction, largely due to the weak fiscal condition of states and the end of stimulus spending.

Urban Land Institute (ULI) and PwC US released their *Emerging Trends in Real Estate® 2011*, which showed that investors and commercial professionals expressing guarded optimism about the real estate market for the first time in three years.

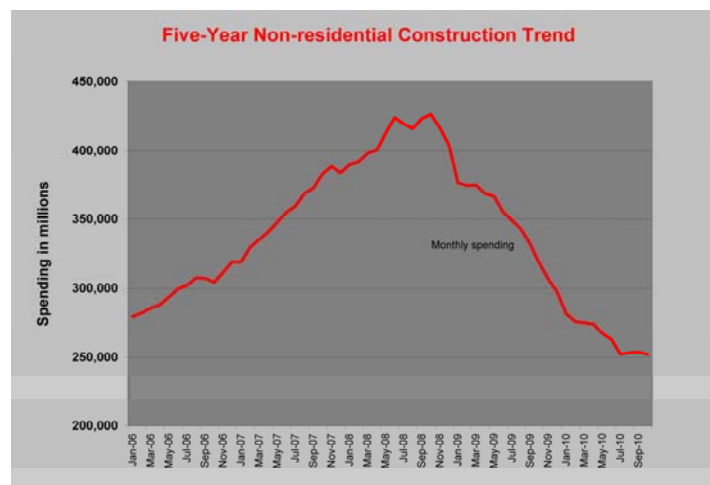
Survey respondents indicate a lowering of performance expectations, anticipating high single digit returns for core properties and mid-teen returns for higher risk investments. Even with sidelined capital at historically high levels market conditions won’t allow the higher leverage, and therefore higher risk, necessary to command higher returns across the board. The survey respondents believe that lenders with strengthening balance sheets will finally step up foreclosure activity and dispositions of properties during 2011 and 2012, helping values reset 30-40% below 2007 peaks.

The pent-up demand for capital investment is expected to increase the gap between desirable properties and run-of-the-mill assets. Offices, apartments, industrial and retail properties in good locations, with high occupancy and strong cash flow will attract a disproportionate share of attention, while risk aversion will remain high enough to keep marginal performing properties unwanted.

The report predicts debt markets thawing further in 2011 as banks continue to strengthen balance sheets, take their losses and step up lending, resulting in higher transaction volumes. But borrowers should expect similar dynamics in underwriting as in investing. As lenders get back into the commercial real estate game they will seek leased-up, cash flowing buildings and shun those with vacancy or rental rate issues.

ULI foresees 2011 as the year that cash comes off the sidelines. "Real estate market participants continue to see a gulf between buyers and sellers, however, there is an expectation that the 'bid-ask' spread will begin to close in 2011 as selling sentiment improves dramatically from last year's all time survey lows and buyers temper expectations for giant discounts," said ULI Senior Resident Fellow for Real Estate Finance Stephen Blank. "Investors with cash could have excellent opportunities to seize market bottom plays by recapitalizing cash-starved owners or buying foreclosed assets."

The rebounding dynamics of the commercial real estate market seem to be reflected in the data for new construction. The Commerce Department reported non-residential starts for its most recent month – October 2010 – and the data showed virtually flat volume for the fourth consecutive month. Starts were a seasonally-adjusted \$252.2 billion in October, which was within 6 one-thousandths of a percent of the starts from July through October. After a precipitous decline of almost 50 percent from the October 2008 high, the leveling off suggests a bottom in contracting, and interestingly matches the same four-month start volume of mid-year 2005. Non-residential construction climbed steadily from that point until the peak in 2008.



*Non-residential starts from July-October show a bottom to the two-year decline.  
Source: Bureau of Census.*

A more general indicator of economic health, The Conference Board reported a 1.1 percent rise in its November index of leading economic indicators. Nine of the 10 component indicators included in the index rose in November, with the largest positive contribution coming from the index of supplier deliveries. Building permits were the only negative contributor.

Other positive contributions in November came from: the interest-rate spread, average weekly initial claims for unemployment insurance, the real money supply, stock prices, the index of consumer expectations, average weekly manufacturing hours, manufacturers' new orders for consumer goods and materials, and manufacturers' new orders for nondefense capital goods. The Conference Board's report sees November's indicators as evidence of a broadening of the economic recovery.

Also, the Federal Reserve Bank's *Beige Book* reports improving business conditions in 10 of its 12 districts during the fourth quarter. Slight to modest improvement was reported in Boston, Cleveland (which covers western PA), Atlanta, Dallas and San Francisco, while New York, Richmond, Chicago, Minneapolis and Kansas City reported stronger improvement. Most districts reported an improvement in commercial or infrastructure construction and marginal improvements in real estate fundamental. All of the districts reported continued weakness in housing markets, with no prospect for significant improvements in 2011 until excess inventories could be burned off.

The two factors most significantly impacting the national housing market are the high unemployment and high inventory of unsold homes, which keeps values depressed.

Data on employment is still mixed but the fourth quarter included several positive surprises about hiring. Private payrolls continue to expand and jobless claims fall. A survey of 18,000 employers showed that 9 percent more (seasonally adjusted) intended to hire in the first quarter of 2011 than to lay off. This represents a big improvement over the 5 to 6 percent net gain of the past four quarters.

On the housing inventory front, the data is less optimistic. Prices for housing continue to show modest improvement month-over-month but intermittent monthly declines still plague the industry, an indication that inventory is not on a steady declining trend. New home construction for 2010 remained below 600,000 units for the third straight year, a level that is less than half that of the new household formation rate. With that level of supply constriction and record low mortgage rates the stage should be set for an explosive recovery in housing, yet nothing seems to be less likely than that for 2011.

As 2010 closes there is little or no data to give clarity to the foreclosure situation. High levels of foreclosures have been ongoing since the sub-prime mortgage market imploded in mid-2007, yet the number of problem mortgages that have been worked through is yet unknown. The foreclosure 'mini-crisis' of early fall, which doesn't seem to have unearthed evidence of unwarranted foreclosures, put a temporary drag on foreclosure proceedings and further clouded the picture. Without some solid data on what remains in the foreclosure pipeline, buyers will have reluctance to enter the market for fear that another significant drop in values is to come.

The prospect of an economic recovery without a recovery in the housing market seems counterintuitive, but evidence is growing that such a recovery is underway. Uncoupling a robust housing market from economic prosperity seems almost un-American, especially since history shows that improvements in an individual's economic status usually translates into an improvement in his or her housing status. As of today, however, there is still little data to indicate just how many borrowers improved their housing status without improved finances during the past boom. Until that piece of the puzzle is found, the future of the housing market remains unclear.

What is clear is that the economy is improving to a greater degree than the housing market. And of the two possibilities – a recovering general economy or a recovering housing market – only the former seems likely in 2011.