



National Outlook: Does Good News/Bad News Mean a Construction Recession Bottom Is In Sight?

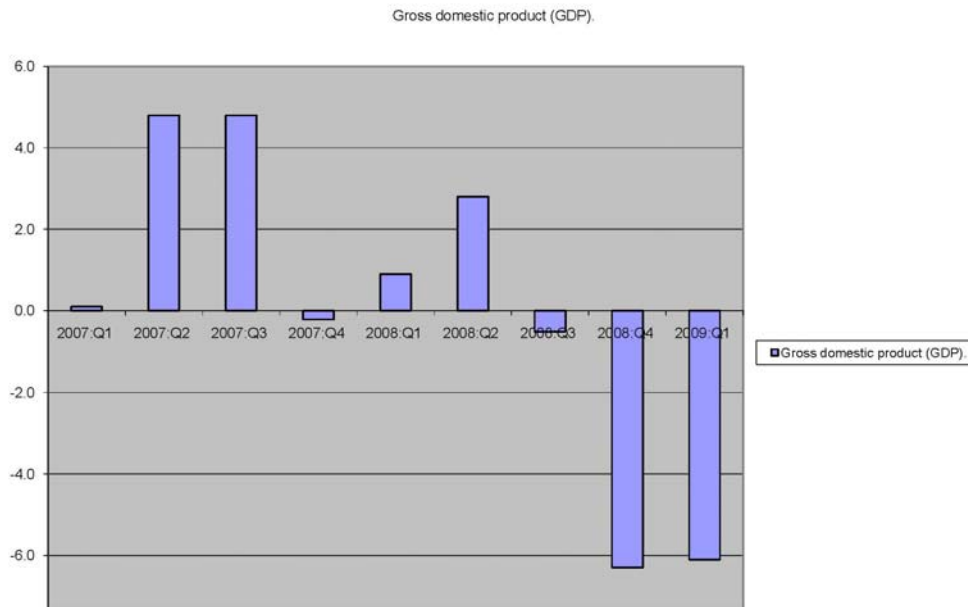
Getting a handle on how the national economy is going to effect construction and real estate for the remainder of 2009 has become less difficult since the second quarter played out. That doesn't mean that forecasts (this one included) still won't miss the mark, but the course of the macro economy finally seems to have some definition, which mean the course of the construction market will be more predictable hereafter.

May's economic numbers offer the most recent total picture we have to judge the health of the overall economy, but virtually all indicators are that the worst results of the recession have occurred and that either stability or recovery will mark the third quarter.

To highlight a few of the indicators that have turned positive (or less negative), we can look first at the Conference Board's Leading Economic Index (LEI), a measurement of ten indicators (including building permits) which tend to predict future economic direction. The LEI turned sharply positive after March, and is up 1.2 percent for the past six months, the first such six-month climb in two years. Another key positive trend is home sales, which have been slightly positive for both new and existing homes since January. While not a big upward move, the positive trend, accompanied by low housing starts, is beginning to erode the excess inventory of unsold houses. Further good news on housing was that the first two national builders to report quarterly earnings, KB Homes and Lennar, touted significant increases in orders in May.

The Commerce Department reported that durable-goods orders rose 1.8% in May, contrary to analysts' expectations for a slight retreat. A gauge of capital spending in the report also jumped, and orders for non-defense capital goods excluding aircraft rose by 4.8%, after decreasing 2.9% in April. It was the largest increase since 8.2% in September 2004.

Some early mid-year indicators are also showing more stability, if not growth, in the business sector. The service sectors of the U.S. economy contracted at a slower pace in June, the Institute for Supply Management reported July 6. The ISM nonmanufacturing index rose to 47.0% from 44.0% in May. The decline was better than expected. Economists were looking the index to rise to 46.0%. Anthony Nieves, chair of the ISM services survey, said the report was "encouraging." The business activity index rose to 49.8% in June from 42.4% in the previous month. New orders rose to 48.6% from 44.4%. The employment index rose to 43.4% from 39.0%. Inflation pressures picked up. The price index rose to 53.7% from 46.9% in the previous month.



The Department of Commerce amended its first quarter loss in gross domestic product, validating that a recession had created two consecutive quarters of decline.

For consumers, there is a mixed bag of indicators that effect construction. The best news is that the pace of unemployment seems to have slowed significantly. The number of initial claims dropped by several hundred thousand in May. Continued slowing in layoffs would back up the LEI's trend showing recovery. Perhaps the firming employment picture is borne out in the reversal of the decline in consumer spending since January, however the level of spending is still below \$10 billion monthly, and well below the spending levels of 2007.

The most difficult indicator to use as a gauge is the savings rate. On the good news side of the ledger is that personal savings has spiked in the last three quarters, currently at around seven percent. This reversal in trend was needed to provide consumers the opportunity to reduce their debt burden, so that a healthier economy could return. The bad news is that personal savings has spiked in the last three quarters, meaning that consumers are paying off past purchases instead of making new ones. And that is not good for the nation's retailers.

One of the bellwethers of future construction is retail. Second to increased housing starts, it is always a good indicator when retail chains begin to grow their capital expenditures in anticipation of a recovery, much like the stock market anticipates recovery. The size of the investment in a new store represents a sufficient risk on the part of the retailer that they tend to research the market conditions thoroughly, and consequently, increased retail capital spending always predicts increased construction spending in general.

The current retail climate is improving, at least in terms of earnings, but that is a result of reduced costs rather than better sales.

"We're looking at difficult conditions until at least spring of 2010," says Brooks Brothers president Diane Hamilton. "I think we'll see things begin to eke out small increases, maybe one or two percent, in comparable stores sales throughout 2010, but beyond that it's hard to see much more than three or four percent growth. Most retailers are down 25% from last year, so it will take a while to recover at three to four percent."

Construction of retail space began to tail off more than a year ago, and as is cyclically normal, activity in other non-residential sectors is now following a downward trend.

The latest data from the two national construction services, Reed Construction Data and McGraw-Hill Construction, show upbeat May numbers in counterbalance to pretty dismal year-to-date performance. For the first five months Reed shows a decline in total nonresidential starts of 6.1%, and while May was up from April, the volume in May was 20% lower than May 2008.

"The May starts increase partly offsets an unusually weak April but does not signal that starts have moved to a rising trend," says Reed chief economist Jim Haughey. "Expect a mix of monthly gains and losses for the balance of the year, with the average level of starts not significantly different from May." Haughey noted that credit problems will continue to plague commercial contracting and that state deficits will dampen public works construction that is not supported by the stimulus.

McGraw-Hill's data showed a jump in starts of 7% in May, but an even more severe decline year-to-date, with 38% lower start volume than the first five months of 2008.

"May's strengthening was lead by a substantial increase for public works," stated Robert A. Murray, vice president of economic affairs for McGraw-Hill Construction. "Meanwhile housing stayed flat and nonresidential building resumed its downward trend after the brief upturn reported in April. For nonresidential building, there's been the occasional display of resilience by such institutional structure types as healthcare facilities and public buildings, but the downward trend for the commercial structure types is still very much underway."

Both firms reported gains in non-building construction in the range of 1-2%. While that is almost negligible in terms of all construction spending, it's worth noting that the non-building sector would likely be down between two and ten percent without the American Recovery and Reinvestment Act (ARRA), since almost all state and municipal owners are looking to fill budget deficits with lower spending on all fronts. More noteworthy is that the stimulus related spending is entering the marketplace much quicker than anticipated, meaning that the salutary effects that are expected on employment will be felt sooner than expected.

PERCENTAGE CHANGES IN COSTS	May 2009 compared to		
	1 mo.	3 mo.	1 yr.
Consumer, Producer & Construction Prices			
Consumer price index (CPI-U)	0.3	0.8	-1.3
Producer price index (PPI) for finished goods	0.5	0.4	-5.0
PPI for construction	0.6	-0.4	-5.3
Costs by Construction Types			
Highway and street construction	2.1	0.9	-10.8
Nonresidential buildings	0.6	-0.3	-5.9
New warehouse construction	-0.4	-0.8	5.7
New school construction	0.0	0.4	11.5
New office construction	0.3	-0.5	6.4
Multi-unit residential	0.2	-0.7	-3.8
Single-unit residential	0.1	-0.9	-1.0
Costs for Specific Construction Inputs			
#2 diesel fuel	4.4	14.6	-58.1
Asphalt paving mixtures and blocks	3.5	-1.5	11.7
Concrete products	-0.1	-1.3	2.1
Brick and structural clay tile	-0.6	-1.2	-0.5
Plastic construction products	-0.1	-0.5	1.7
Gypsum products	-2.4	-2.5	4.2
Lumber and plywood	-0.9	-3.4	-13.8
Architectural coatings	0.0	0.1	12.4
Steel mill products	-2.7	-9.5	-33.8
Copper and brass mill shapes	0.8	21.4	-25.1
Aluminum mill shapes	1.4	-2.2	-23.7
Fabricated structural metal	-1.6	-3.6	-8.1
Prefabricated metal buildings	-0.7	-6.5	-7.1
Crude petroleum (domestic production)	18.6	68.5	-55.1
Cement	0.0	0.9	0.5
Iron and steel scrap	18.8	-3.8	-62.0
Copper ore	18.4	36.0	-43.0
Source Bureau of Labor Statistics			
Compiled by Ken Simonson, Chief Economist AGC			

Bureau of Labor Statistics data from June 1 shows a significant drop in construction costs since mid-2008 and more stability in prices for 2009.

One other impact that ARRA is having sooner than was hoped for is in stabilizing a troubled sector of the financial markets that has made public construction difficult since fall, the municipal bond market. As the markets melted in fall 2008, so few bidders existed for municipal bonds that yields skyrocketed, making public construction less affordable.

Part of ARRA, the Build America Bonds program offers a 35% rebate from the Federal government to issuers on their interest payments. The rebate is meant to bridge the gap between the lower rates that could be offered tax free, and the higher taxable rate that would be attractive to investors. This means that public authorities can offer higher rates on their debt than they typically would be able to afford, and so take their offerings into the taxable bond market.

For taxable bond investors, the attraction is diversification as municipal bonds, which offer relatively low risk, are an area that they rarely have exposure to.

The figures show how Build America Bonds are having the desired impact. Through the end of May, the number of new issues in the tax-free market has dropped 17% compared to the year-ago period, according to The Bond Buyer. In the same period, the number of taxable issues has risen 32%. The numbers are even more dramatic for May alone, as the Build America Bonds program really started to take effect. Compared to May 2008, tax-free issues fell 40% while taxable issues were up 56%.

The growth in bond-funded public construction will help with schools, parks and public transportation, while the non-building construction market will be aided directly by infusions from ARRA, in some states (like PA) increasing investment in infrastructure by 100% year over year. For the remainder of the construction industry, however, the rest of 2009 will likely be a period of further soft conditions while demand is rebuilt and oversupply is absorbed.

While the market struggles with much lower construction volumes to meet diminished demand, the one factor in the construction industry that is demonstrating some much needed stability is the price of building materials and products.

Although energy costs rose again sharply during the mid-second quarter, the increase paled in comparison to the 100% jump in the first half of 2008, and by the Independence Day weekend prices were cooling again. The increased cost of energy and fuel has sparked some jumps in pricing for steel, asphalt and transportation (which puts pressure on all manufactured products), but the sagging demand for building materials overall has kept prices well below mid-2008 levels. Until there is a significant change in supply/demand dynamics for construction, which won't happen this year, expect the cost of construction to remain more predictable than in several years.