

NATIONAL OUTLOOK

For both the construction market and overall economy the year 2011 has unfolded in a remarkably similar fashion to the 2010 played out. What is disappointing is that the forecast for 2012 offers more of the same, or at least a similar forecast to the one given for 2011.

The performance of the economy during the twelve months that preceded summer of 2010 saw a recovery from the raw fear and precipitous decline of the winter of 2009. That confidence about a new cycle of expansion was dashed during the summer of 2010 by the fears of another financial crisis triggered by European Union sovereign debt. After a summer and fall of see-sawing economic data and a 15 percent correction in the stock market, the American consumer responded by spending confidently at Christmas 2010 and setting up 2011 as the year the expansion would begin. What followed was a Ground Hog Day of a year, buffeted by some of the same issues (Greek and Italian default, high unemployment, depressed housing market, record levels of hoarded cash), as well as some new issues (debt ceiling debate, presidential electioneering) with the same result.

All of these issues have combined to keep consumers and businesses uncertain about the economy. Uncertainty and high unemployment have kept investment and expansion from moving ahead in 2011. Looking forward to 2012, there are some glimmers of hope that construction will shake out of stagnation but a number of structural problems remain.

While the economic news reporting from national and global media is decidedly negative, the actual economic data is actually not nearly so. In the case of several key indicators the news is actually better. Unemployment is still the biggest drag on confidence and growth but the claims for unemployment are falling and new hiring continues. The overall pace of hiring remains at half what is needed to get back to three or four percent GDP growth but the hidden gem in the employment numbers is that the net hiring is being held down by government cutbacks. Furloughed government workers are still unemployed consumers but private sector hiring is growing. The tradeoff of government employees for private hiring may well be an equation that keeps unemployment from falling much in the coming year but in the long run the shift will benefit the country.

The biggest piece of the economy is consumer spending – making up two-thirds of the gross domestic product. For the past few months, consumer confidence surveys have shown that Americans fear that the economy was slipping back into recession, however, at the same time consumer spending increased every month but June. In the months that followed June, consumers increased their spending by 0.9 percent, 0.2 percent and 0.6 percent respectively.

Factory output and manufacturing capacity utilization continues to grow. The level is still below the 79 percent utilization that was normal during the last boom but the current level is climbing above 76 percent. Likewise spending for new equipment and software is

also rising gradually. Both of these indicators come before an increase in capital spending on buildings.

The Equipment Leasing and Finance Association reports economic activity for the equipment finance industry. Their Monthly Leasing and Finance Index showed overall new business volume for September was \$7.1 billion, up 25 percent from the same period in 2010. Volume was also up 25 percent through nine months compared to last year. Receivables over 30 days decreased to 2.3 percent in September from 2.5 percent in August, and declined by 32.4 percent compared to the same period in 2010.

With data on business conditions becoming somewhat more positive there may be more support for the more positive forecasts by leading construction economists for construction in 2012. Tempering the more upbeat outlooks is the reality that the year-to-date volume for 2011 is lagging the 2011 forecasts by a significant margin.

The two national construction reports, Reed Construction Data and McGraw-Hill Construction have slightly different methodologies for tracking contracting, which leads to varying data. For that reason their monthly data has varied widely, with one often tracking opposite the other. Over the full year, however the trends appear to be similar. In 2011 the most surprising trend has been the rollercoaster-like advances and declines in activity from month-to-month. As an extreme example, both companies reported double-digit declines in September after double digit increases in August. This could, in reality, be a result of poor timing in reporting of data but the up-and-down nature of the data also reflects what would occur in a market that surged and stopped because of uncertainty.

As an interesting confirmation of the uncertainty explanation, the AIA's Architectural Billing Index – a monthly survey of the trend in firm billings – has fallen and risen three times since peaking at 53.9 in December 2010 and fell again at the latest survey in September. The same index of inquiries has advanced and fallen four times in that same period.

McGraw-Hill's Robert Murray sees the up and down as evidence of stagnation, a condition he forecasts continuing in 2012. "For a variety of reasons, this extended plateau is likely to last a while longer. Tight budget conditions at the federal, state, and local levels of government are restraining the amount of construction that's taking place for the institutional building and public works sectors, notwithstanding the occasional upturn such as shown by public works in September," he says. "The slow pace of job creation and widespread uncertainty about the economy are causing developers and lenders to remain hesitant about new commercial projects, and they're also causing potential homebuyers to remain wary about going ahead with home purchases."

AIA's chief economist, Kermit Baker says that his association's *Work on the Boards* survey confirms how developer and lender caution is influencing the architects' work. "The survey showed that 70 percent of the firms had stalled projects at the time and that 62 percent of the firms indicated that financing was the reason for the delay."

Reed's chief U. S. economist, Bernard Markstein sees the roller coaster ride continuing only until early 2012. Markstein believes the recovery in non-residential construction has begun and predicts that the final results for the third and fourth quarters of 2011 will show ten percent growth, followed by a first quarter 2012 that will decline similarly. Reed's forecast for 2012-2014 is for slower but steadier growth in construction, averaging roughly five percent each quarter.

Markstein is unique among forecasters in that he foresees a strong housing recovery – maybe as soon as in 2012 – because of severe constriction of supply.

“Production of new homes is off 35 percent over the past five years,” he explains. “Demand has remained that low as well because household formations have fallen off. Kids have been living at home because of finances and there has been a decline in immigration but these factors have been building a bubble of demand. It will only take confidence to move buyers off the sidelines.”

The National Association of Homebuilders (NAHB) supports that theory. Their data on the historical long-term trend for household formations suggests that two million fewer households have been formed since the recession began in 2008, an amount equal to the higher estimates of the ‘shadow inventory’ of homes that are not on the market but need to be sold because the mortgages can't be met by the owners.

AIA also compiles a consensus of housing forecasts from Fannie Mae, Freddie Mac, Moody's, Zelman & Associates, NAHB and the National Association of Realtors. Kermit Baker reports that these various housing groups see the number of new housing starts staying at or below 50 percent of the normal household formation level until 2013. The consensus estimate for 2011 is for 587,000 new units, the fourth straight year below 750,000. The forecast for 2012 is for 753,000 units – only Moody's sees housing topping 1 million units in 2012 – and 1.076 million units in 2013. With the Census Bureau projecting population growth in America at 31.2 million during this decade, such an anemic start would leave demand for new housing at roughly 13 million units for the last seven years of the decade. Without forecasting a housing recovery, Baker makes a compelling case for the demand for one.

Ken Simonson, AGC's chief economist, is less eager to offer an interpretation of the housing demand. “I've given up forecasting when single family housing will recover,” he says.

Simonson sees one sector of the housing market in the early stages of a boom; that is market rate multi-family apartments. The demographics and the pent up household formation rate bode well for apartments, since it is first-time buyers who are finding it hardest to purchase houses. Just as important is the fact that the financing for multi-family housing is actually favorable at the moment. Demand from investors for apartment projects outstrips the supply of deals at present, making lenders of all sorts anxious to finance the sale or construction of apartments. With housing finance still tightening the supply of renters is growing, while the supply of apartments is not. And attractive

financing products from Fannie Mae, HUD, FHA and even insurance companies offer opportunities for developers to construct apartments with as much as 93 percent loan-to-value deals.

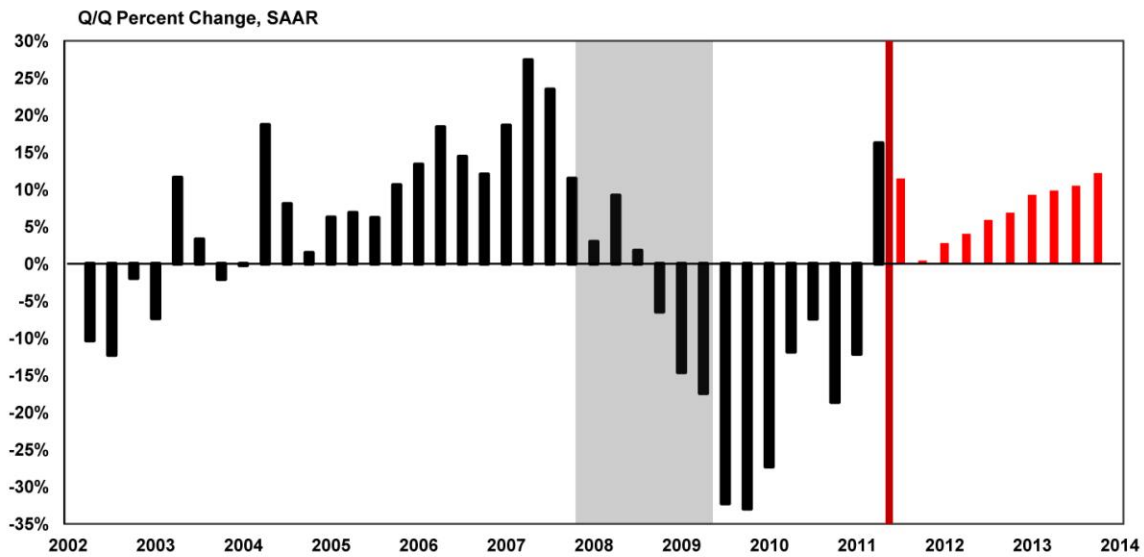
Overall, Simonson does not see a double-dip recession occurring and forecasts that GDP, personal income and job growth will all improve in 2012. He believes the growth rate will be relatively weak however, saying that all three should be “at or below the historical trend line.”

Simonson believes the weakness will continue to hold down construction of offices and retail centers but sees strength in power plants, manufacturing facilities, warehouse/distribution and an increase in hospital construction following a three-year slump. He sees big declines in government-funded construction, predicting that sector will move from propping up the industry during the ARRA program to becoming a drag on construction. Simonson is also not optimistic about government’s response to some of the economy’s biggest problems.

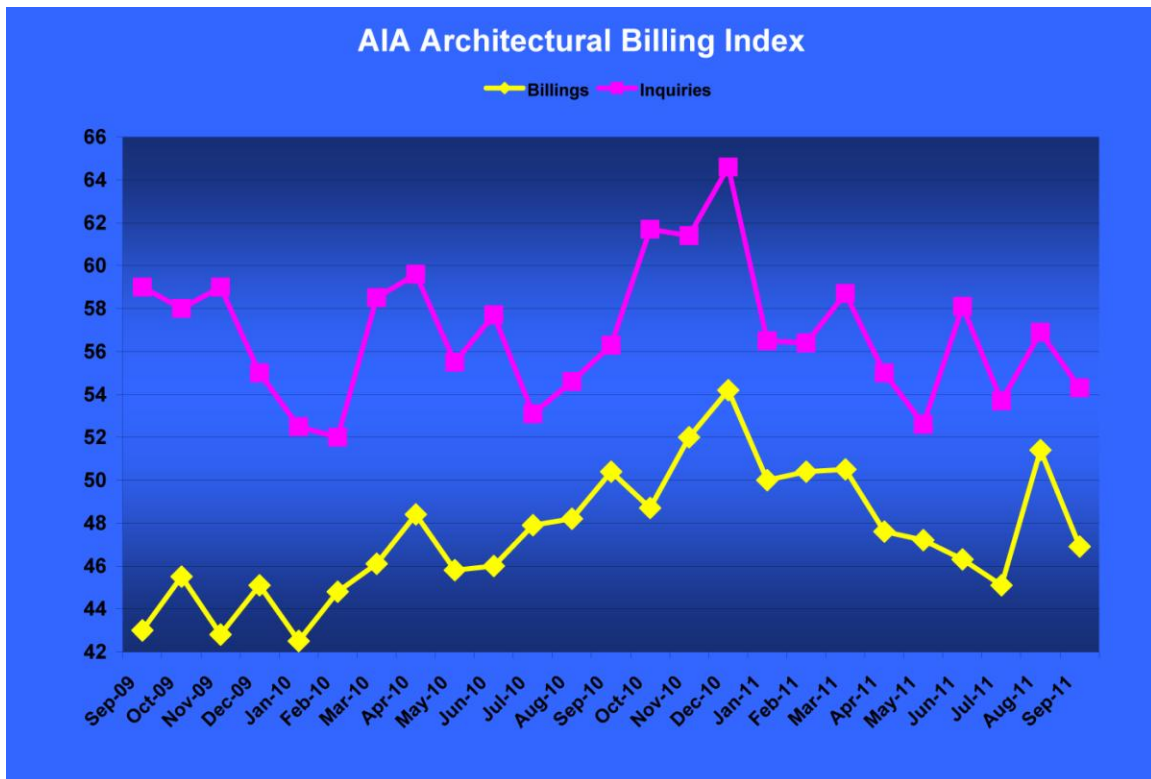
“Without a new federal highway bill or funding increase, infrastructure construction will decline,” he predicts. “Whatever debt ceiling agreement there is should result in even more federal spending cuts; and I think passage of the American Jobs Act [which includes \$50 billion for transportation and \$30 billion for schools] is unlikely.”

Ken Simonson’s forecast for new construction predicts annual increases of between six and ten percent from 2012 to 2016. Those seem like healthy rates of expansion, however the first years of recovery after a recession usually bring about double-digit growth. Moreover, the growth Simonson forecasts also reflects recovery from the record low volumes of new housing construction, which is more of a reflection of the current weakness than of a robust future.

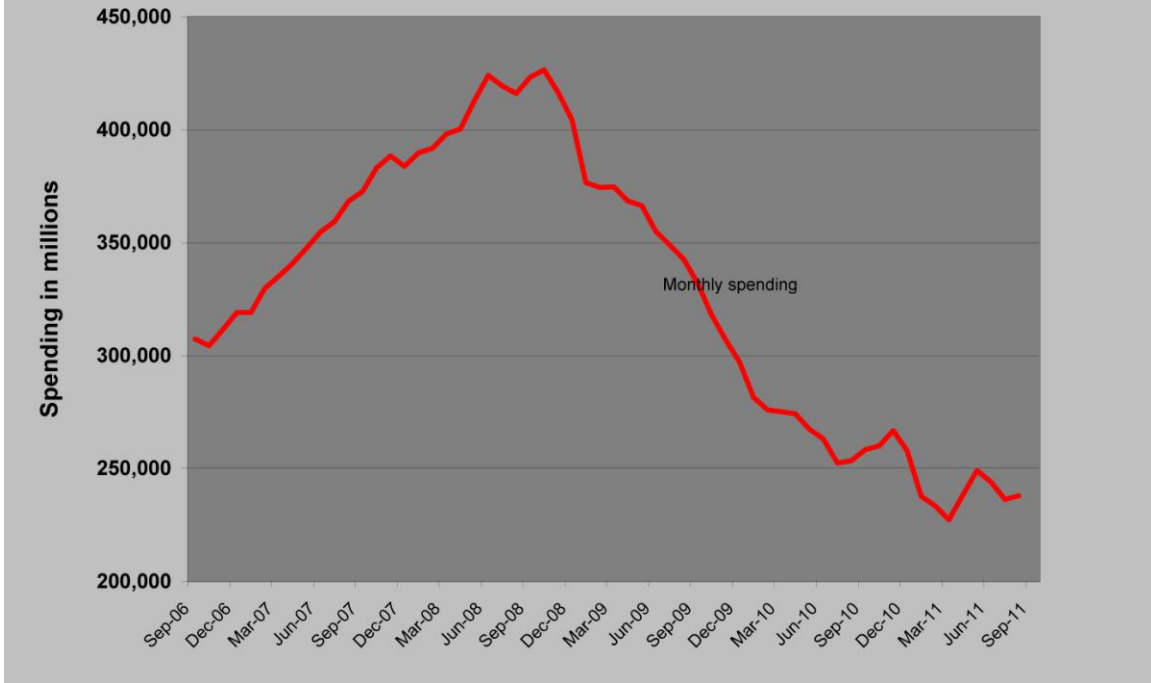
Construction Spending: Nonresidential Building



Reed Construction Data's forecast shows steady long-term growth beginning in mid-2012



Five-Year Non-residential Construction Trend



Private non-residential construction put-in-place (Source Census Bureau)