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Construction National Outlook – December 2013

One byproduct of the federal government shutdown was that the avalanche of economic data that is released weekly was also shut down. Even without weekly jobs claims, unemployment estimates, labor and manufacturing numbers, businesses can be fairly certain that the state of the U. S. economy hasn't changed much. In fact, what little data was unearthed only confirmed the continuation of the long slow recovery. Five years removed from the panic of the financial crisis, it is no longer accurate to talk about recovery as much as a protracted period of negligible growth.

As has been the case since the recession ended, economic growth prospects depend on an accelerating pace of hiring. People with jobs shop at stores and buy houses. Job creation has been averaging a healthy number throughout 2013, nearly 200,000 jobs monthly. While that rate outpaces the labor supply growth, unemployment will decline slowly until hiring picks up further. Most economists see the current growth rate resulting in another 12 to 18 months before unemployment dips below the desired 6.5 percent.

The most recent employment numbers from the Department of Labor give reason for concern, especially since the hiring trend continues to slow. While no single culprit seems to emerge, the combined impact of the social security tax increase, sequestration cuts and the government's budget battle appear to be taking a toll on employers.

The job data released on October 22 showed 148,000 new jobs created in September, causing a drop in unemployment to 7.2 percent, the lowest level since December 2008. Unemployment at the same point in 2012 was 8.1 percent. The labor force participation rate remained low however, at 63.2 percent, a 35-year low. Average hourly earnings for private sector employees rose by 0.1 percent while average weekly hours also rose last month by 0.1 percent.

For business owners, there are several flies in the ointment at the moment. The compromise that ended the federal shutdown did nothing to resolve the main issues and the possibility still exists that a future solution will lead to additional federal government layoffs or a tighter government budget. Neither bode well for businesses that rely on the federal government for sales. In 2013, procurement by the government and its contractors makes up a significant portion of GDP. A protracted shutdown, while unlikely, will also result in greater problems for the economy.

The more troubling piece in the chess match between Democrats and Republicans is the Patient Protection and Affordable Care Act (ACA), more commonly known as Obamacare. Regardless of what may come of Republican efforts to de-fund the legislation or repeal it altogether, the impact of the ACA moved from the political to reality on October 1. Even those businesses that were preparing for the initiation of ACA have discovered that implementing the legislation is inordinately complicated. Moreover, technical problems with registration and documentation have shown that the government's systems for ACA are unprepared for the influx of patients and doctors. The net effect on business is more uncertainty. Perhaps the most damaging side effect of the implementation of Obamacare – aside from the increased costs – is the dramatic increase in administrative activity associated with it. Businesses that may have hired to achieve growth are finding that additional staff is needed to comply with the ACA regulations. And the jury is still out as to how much the additional health care costs will trim bottom lines.

From a macroeconomic vantage point, the government's mishandling of the budget and debt creates more pressure on the global economy. The protracted recession in Europe has been a splash of cold water for the emerging economies, most of which have seen growth slow by half of the pace of the mid-2000's. An increase in the uncertainty about the American economy will add to the headwinds facing global markets.

Still, with a number of potential problems looming, the outlook for the national construction environment is improving. Construction starts and put-in-place in 2013 is on pace to be six to eight percent higher than the volume in 2012. Housing starts through the first three-quarters of the year remain on pace to top 900,000 units, even though single-family volume will likely be no higher than that of 2008, which was the first year of the housing crisis. Total housing units started in 2013 will be up roughly 14 percent. A similar rate of growth should occur in 2014 if the conditions in single-family housing continue to improve.

One of the construction industry's more respected consultants, FMI, predicted that construction put-in-place will grow by seven percent to $977 billion in 2014 in its Q3-2013 Construction Outlook. FMI reduced its 2013 forecast slightly to $909.6 billion, down four billion from the second quarter Outlook. FMI offers preliminary forecasts for half-dozen market segments:

- Residential Construction - The growth is expected to taper off to 12 percent in 2014. Total predicted residential spending is $379.6 billion, compared with the $338.2 billion for 2013.

- Commercial Construction - The forecast calls for a 5 percent increase in 2014. Although retail sales as of June 2013 were up 5.7 percent over the previous year, new bricks and mortar retail space along with commercial other construction growth will remain slow to recover.

- Healthcare - Affordable Care Act implementation is creating instability for healthcare providers. Although the healthcare construction forecast slipped since last year, construction is still expected to grow six percent in 2014 to $44 billion.

- Educational - Gradual increases in residential construction and tax revenues will help bring this market back in many areas of the country; however, reduced government spending at all levels will limit growth in 2014 to four percent.

- Manufacturing - The resurgence of the automotive industry is a big boost to manufacturing as is the exploration for shale oil and gas. However, manufacturing construction is expected to drop two percent by year-end 2013 before returning to 4 percent growth in 2014.

- Highway and Street - Passage of MAP-21 calls for nearly $38 billion for the fiscal year 2014 for the Federal-Aid Highway Program. This is a major contributor to the forecast of nearly $80 billion for 2014.

What has created a strong growth environment for construction against the backdrop of a slow growth economy? While there is stronger demand for space in most market segments and regional markets, the lack of new construction in response to the recession left supply short in most categories. As unemployment climbed throughout 2009, the fundamentals for real estate deteriorated. Owner-occupied office and industrial construction suffered as layoffs occurred; vacancy rates for commercial properties climbed and values plunged. The trough for real estate was reached throughout 2010 for the various types of properties and additions to inventory were unnecessary. Between the oversupply and the limited availability of credit, new construction for non-residential projects remained well below normal levels well into 2011. Now, new construction is desperately needed for even modest improvements in the economy.

Through the third quarter of 2013, vacancy rates for most U. S. markets have steadily – albeit slowly – fallen. According to Newmark Grubb Knight Frank, the overall office vacancy rate dipped to 15 percent; retail vacancies fell to 6.8 percent and the industrial vacancy rate dropped to 7.8 percent. Apartment occupancy climbed slightly to 95.8 percent. As would be expected, rents for all property types increased slightly between the second and third quarters and more robustly compared to third quarter 2012. The improved fundamentals also led to brisker sales. According to Avison Young's Fall 2013 Commercial Real Estate Investment Review, sales of commercial properties were up 28 percent.

As the data above from CoStar shows, higher rents and improved investment interest have had a beneficial impact on property values. CoStar's Value-Weighted Composite Index of commercial properties is up over 45 percent from the trough in late 2010. The liquidity indicators CoStar tracks have also steadily improved this year. The average time on the market has improved by 28 days and the sales-to-asking price has gone from 85 to 88 percent.

Construction activity for the first nine months of 2013 suggests that the positive absorption of space across most categories is pushing starts higher.

The shutdown of the Commerce Department delayed the release of final third quarter data but estimates are that construction starts overall topped $900 billion, a level that is roughly five percent higher than in the same period of 2012. McGraw-Hill Construction released its data for the first three-fourths of 2013 on October 16. Although the reporting service seems to track less than half the volume reported by the government, McGraw-Hill showed $379.3 billion in total construction. That represented a two percent increase over 2012, but the company noted that the total of all activity excluding electric utilities was up 11 percent.

Robert A. Murray, vice president of economic affairs for McGraw-Hill Construction observed, "…The September gain for nonresidential building reflected the manufacturing plant category posting a strong increase, commercial building staying close to its recently improved pace, and several institutional structure types rising from previously weak levels. After the downward trend that's been underway from 2009 through the first half of 2013, the institutional building sector may now be starting to stabilize, which is necessary for total nonresidential building to register growth. At the same time, the recent Congressional impasse over federal appropriations for fiscal 2014 and raising the debt ceiling only adds to the sense of uncertainty, which hampers renewed expansion for nonresidential building going forward."

Higher non-residential construction in 2013 and 2014 will re-balance the supply and demand that was skewed by the under-building of 2009-2011. The outcome of the current battle over debt limits, budget priorities and healthcare reform will have an influence on how robust the U. S. economy looks to the rest of the world in 2015. Assuming that Washington's deadlock doesn't create an economic 'black swan' event, the business climate will have to support more construction because of renewed growth in 2015. Between now and then are 15 months and mid-term elections. Those elections may hold the key to how well the economy will be humming.

Percentage change	From 30 days	From 90 days	From 1 year	From trough
Value-Weighted U.S. Composite Index	0.1%	3.1%	9.0%	45.2%
Equal-Weighted U.S. Composite Index	2.1%	8.2%	13.6%	17.6%
U.S. Investment Grade Index	1.4%	6.0%	17.6%	30.4%
U.S. General Commercial Index	2.3%	8.5%	12.7%	16.0%
Monthly Liquidity Indicators	**30 days earlier**	**90 days earlier**	**1 year earlier**	**4 years earlier**
Days on Market	418	420	424	443
Sale Price-to-Asking Price Ratio	88.0%	87.7%	87.3%	85.5%
Withdrawal Rate	40.8%	42.3%	42.1%	45.1%

Commercial property values and liquidity has steadily improved over the past four years. Source: CoStar