As the economy continues to struggle, the North American construction industry remains one of its strongest sectors, reported presenters at Reed Construction Data’s North American Construction Forecast conference, held Oct. 16 at the National Press Club in Washington, D.C. Reed Construction Data’s annual North American Construction Forecast conference features leading experts, economists and analysts from the United States, Canada and Mexico who discuss conditions affecting building activity and opportunity throughout the NAFTA region. Speakers provide a sector-by-sector analysis, along with economic indicators for the construction industry and its many related businesses.

Ken Simonson, chief economist of Associated General Contractors, expects the next several months to be very uneven for construction. Any construction related to consumer activity should remain strong, and business-related construction will pick up gradually in 2003 if the economy continues to strengthen; however, government-funded projects are likely to diminish once current jobs are completed.

Simonson reported that there are two key indicators of construction industry health: employment and value put in place. He says both factors are relatively flat in construction nationally. Supporting this view, the Census Bureau reported that nationwide construction that was put in place for the first eight months of 2002 was virtually unchanged from the same period of 2001. The seasonally adjusted figures for August, $830 billion, were just 0.4 percent below the total for July. From August 2001 to August 2002, public construction rose by 8 percent. Private nonresidential buildings fell by almost 19 percent.

In addition to Simonson’s forecast, other construction industry analysts and economists presented forecasts on the individual
sectors of the construction industry as well as the outlook for Canada and Mexico. Following are excerpts.

Commercial Real Estate Outlook

Ray Owens, vice president and senior economist for the Federal Reserve Bank, said net absorption, which had been negative at about 30 million square feet, is now working its way back. Improvement is being seen in class “A” space. Looking at recent absorption rates versus total supply, Owens also noted that there is a 13-year supply of sublet space on the market. The amount being absorbed currently is quite low and rising, and the amount available is being capped somewhat by a sharp decline in construction, so that ratio is likely to flip in a favorable correction quite soon. Vacancy rates are moving up, but are still several percent below what was seen during the early 1990s. Owens says that even with a sluggish economic recovery, prospects for improvement in the commercial market appear in place for 2003.

In the late 1990s information technology companies were the single largest absorbers of office space. The growing technology work force led some firms to contract for more space than they initially needed. Between 1998 and 2000, approximately 20 million square feet of office space was constructed. Of that, high-tech companies occupied 11.5 million square feet. By the end of 2000, the year that began with a boom ended with a whimper, according to Owens.

It began in March of 2000 with sharp corrections in the stock market. It appeared that those corrections weren’t going to be sharply reversed—it looked like the market had peaked and was in the process of adjusting. This changed the attitudes in the economy. Venture capitalists started to look closely at projects they were investing in and technology tenants in commercial buildings began to realize that without prospects for growth on the horizon, further funding would be in shorter supply. Many began to adjust their space needs. As a result, vacancy rates began to rise. As was the case in 2001, there was a large supply of space for a rapidly diminishing demand. As a result, total amount of space available rose from about 110 million square feet at the onset of the recession to about 60 million square feet—a significant decline.

The good news is that net absorption, which had been negative at about 30 million square-feet, is now working its way back. One of the signs of improvement is a decrease in class “A” space, which is the best quality commercial space.

“Overall absorption rates are climbing toward net zero, but class “A” is moving back into positive territory,” said Owens. “This is a sign that there is some improvement in store for the sector and that the bottom, in terms of net absorption, may be close to an end.”

Regarding the absorption rates versus total supply mentioned earlier, there is a 13-year supply of sublet space on the market. For example, if current sublet space were a hypothetical 1.3 million square feet in a market and the current absorption rate was only 0.1 million (100,000) square feet annually, then it would take 13 years to absorb all of that space. But if the absorption rate improves next year to 0.65 million (650,000) square feet, then it would only take 2 years to absorb the volume. The amount being absorbed currently is quite low and rising. The amount available is being capped somewhat by a sharp decline in construction so that ratio is likely to flip in a favorable correction in the near future.

During the recent recession, the commercial real estate market deteriorated less sharply compared to steeper deterioration experienced during the previous 1990-1991 recession. Vacancy rates are also moving up, but they are still several percent below what was seen during the early 1990s.

“Even with a sluggish economic recovery, prospects for improvement in the commercial market appear in place,” said Owens. “We’re seeing improvement in absorption of class “A” space and construction adjusted rather promptly. In turn there’s still some coming on line, but not nearly the amount we saw a decade ago.” Further downdrifts in the conditions of the sector can be expect-
ed, but there are conditions in place that appear to suggest the bottom may be near and may be reached as soon as the first half of 2003. It appears conditions may improve during the year. Whether it’s early in the year or late in the year depends on how uncertainties currently facing the economy are resolved.

Residential Construction Outlook

David Seiders, chief economist for the National Association of Home Builders, reported the housing sector has done extremely well in a tough economic environment. He said the best bet is funds rate stability through third quarter 2003. Long-term mortgage rates are currently at 6 percent, which is the lowest since the mid-1960s. Seiders said he is forecasting rates to continue to average that in fourth quarter 2002 and then rise gradually in 2003 and 2004.

Last year’s residential forecast contained a great deal of uncertainty and caution due to the events of September 11. No one knew what the impact would be on consumer and business attitudes. But looking back to fourth quarter of last year, GDP and housing numbers, sales and starts came through the entire episode in very good condition.

The coming year is again looking positive for the housing market. Seiders doesn’t believe the economy will slip back into a second stage of recession. He explained that there were many components in the economy that were still weak, but others had healed to some degree and are moving along and will show fairly solid performance going forward.

“Consumers have been the real bulwark, because spending has been very well maintained,” said Seiders. “Housing has done quite well—it didn’t give way in the recession. It is imperative that we have growth out of other sectors of the economy, such as corporate and capital investments. These and other nonresidential sectors will have to kick in at the first half of 2003,” he said.

What’s key to the overall outlook of the economy is home price increases, equity generation and consumer extraction of equi-
ty, which is supporting consumer spending. A number of factors have impacted both the housing sector and economy this year including the Enron issue, fear of terrorism and the Iraq situation. All of these visible events have had an impact on the stock market as well. But the shock absorber has been the interest rate and housing values. The best bet is funds rate stability through third quarter 2003. Fixed rate 30-year mortgage rates are currently at 6 percent, which is the lowest since the mid-1960s. Seiders said he is forecasting rates to continue to average 6 percent in fourth quarter 2002 and then rise gradually in 2003 and 2004. Adjustable rate mortgages are priced incredibly low as well, but most consumers are opting for fixed rate at these levels.

One of the reasons the housing markets have done so well through the recession has been because of excellent inventory balance throughout. Unlike other expansion periods, homebuilders didn’t overbuild the market so they wouldn’t be left with heavy inventory if the economy were to give way. But don’t look to housing to be a growth engine because it’s moving sideways. The multifamily housing sector is experiencing a mild setback due to the strength of single-family homes. With the recession last year and weak job market the first half of this year, many have moved from rent to own. This is good for single-family home sales and production starts, but it is opening up vacancies in rental housing stock, now roughly 10 percent per unit. The most recent vacancy rate for rental properties is about 9 percent nationally, but a little over 10 percent in a few regions of the U.S. This will take a modest toll on production numbers going forward.

“We’re counting on economic recovery and resurgence of job growth to help fill those vacancies,” said Seiders. “I have a little vulnerability about our housing forecast, primarily the multifamily piece because single-family sales are strong.” Residential remodeling is doing very well according to Seiders. He says the economy is looking at “freight train momentum” both this year and in 2003. Remodeling is a large piece of construction activity. So large in fact, that it’s 28 percent and growing at a rate of 9 percent so far this year. The equity generation and extraction of it all support this market. It’s a conservative forecast, but shows ongoing modest growth.

Canadian Outlook

Roger Grant, vice president of Reed Construction Data, said the Canadian housing market is at a 10-year high with close to 200,000 starts, which is well above a more sustainable rate of 160,000. The forecast for housing construction in 2003 anticipates a moderate decline of about 10 percent to 173,000 starts. In the nonresidential sectors, institutional and engineering have been relatively stable, while the commercial and industrial sectors suffer from a high office vacancy rate of 12 percent. Based on a forecast of general strength in the Canadian economy, Grant expects all nonresidential sectors to make a comeback in 2003.

The strength in the Canadian economy is reflected in some, but not all, sectors of the construction market. While housing is remarkably strong, nonresidential building is off, lead by the commercial sector, with engineering work relatively stable. Underlying these trends are strong economic indicators—pent-up demand for automobiles and housing and exceptional growth in employment. Auto sales year to date are up more than 10 percent over prior year. The housing market is at a 10-year high with close to 200,000 starts, well above a more sustainable rate of 160,000. More than 385,000 jobs have been added through August, well ahead of average year growth of 200,000. These trends combined with low mortgage rates and rental vacancy rates close to 1 percent, have pushed the housing starts number up in 2002 and will help maintain it at high levels in 2003 when the rate is expected to settle back slightly more than
10 percent to 173,000 starts. The housing market is experiencing strength in a number of provinces, including Quebec, Ontario and Alberta, owing to inter-provincial migration.

In the nonresidential sectors commercial activity is suffering from dramatic declines in office building construction, down 65 percent year over year with vacancy rates over 12 percent. According to Grant, starts are coming back in 2003 at a fairly high growth rate, but still well below what levels have been in the last several years. Retail and warehouse construction follows a similar trend, without as significant a decline. The hotel and motel market has been relatively more consistent over the last few years and is expected to continue going this trend with growth in casino and resort construction. Industrial starts, based on high capacity utilization rates in manufacturing, follow similar trends as the commercial sector.

A different picture is presented by the strength and stability in the institutional and engineering sectors. Medical and educational starts are holding at high levels and are forecasted to remain strong. Upcoming/recently started hospitals represent $5.2 billion in 2002 vs. $4.4 billion in 2001 with schools at $2.8 billion in 2002 vs. $2.3 billion in 2001. The cultural sector is also providing many new construction projects. Overall institutional starts are at a 25-year high. Engineering construction, driven by oil prices approaching $30 (U.S. dollars) per barrel and demand for power generation, has held up well and is forecast to continue slightly above recent levels.

Looking across the provinces, Ontario, a significant source of spending in construction overall, is particularly strong in the residential and institutional areas. Quebec’s strength is bolstered by government spending on institutional and engineering work while Alberta is strong as a result of energy projects and residential migration in support of that work.

In summary, while commercial and industrial building in Canada is at historical lows, housing, institutional and engineering
have held up well in 2002. Looking ahead to 2003, the trend line for all but housing is pointed upward. Based on the strength of the Canadian economy, the overall outlook for Canadian construction looks solid for 2003 barring any significant downward changes in the U.S. or world economies.

**Mexican Outlook**

The Mexican economy is expected to grow at a 4 percent rate in 2003 fueling construction market growth of over 5 percent in 2003, according to Grant. Inflation rates are declining and are projected to be under 5 percent this year and moving below 4 percent next year. Deficits are also declining indicating an overall stable economy. Grant reported that more than 50 percent of the total construction value in Mexico is in housing. With an increase in U.S. funds becoming available for economy housing mortgages, economy housing is projected to grow steadily in 2003 with other sectors of construction expected to see growth as well, though at lower rates.

The Mexican economy bottomed out in GDP growth in 2001 has improved slightly in 2002 and is expected to lead the three NAFTA countries in GDP growth in 2003. The free trade agreements Mexico has in place in the Americas and with Europe are having an impact on manufacturing. The stability of the political situation is a factor as well, evidenced by declining inflation rates, projected to be under 5 percent this year and moving to below 4 percent next year. Deficits are also declining and while Mexico now has a two-party system, which is impacting the administration’s ability to make promised reforms that could help fund institutional and engineering projects, the overall economy is stable and growing with construction spending projected to grow at more rapid rates.

Economy housing is moving up 8-12 percent over a two-year period and is projected to grow steadily in 2003. Helping this trend is an increase in U.S. funds becoming available for economy housing mortgages, and there’s a similar trend in luxury and average housing.

In the nonresidential sector, the office vacancy rate for 2002 in Mexico City is 15.4 percent, holding down office construction. A 70-year ban on the construction of casinos may soon be lifted, which will create opportunity in resort areas. There is also a shortage of school space, especially at the secondary level. Tax reforms are needed to help the current administration do more to fund these demands. Still, after increasing about 5 percent this year, there is more growth projected for this sector into 2003, approximately doubling the value of tracked projects to meet the demands for the education and healthcare infrastructure.

Industrial construction is also projected to grow this year at about 8 percent in tracked projects moving to 11 percent for 2003 on the strength of trade driven manufacturing. Government control has a significant impact on spending in the engineering sector. Pemex, the state oil and gas company, provides 37 percent of federal government revenues. While there is a move to privatize the generation of electricity, currently only 4 percent is privately generated. Reforms proposed by the current administration aimed at opening up the energy sector are being stalled by the opposing party.

In 2000, construction spending was up 6.9 percent over 1999, but fell in 2001 as the Mexican economy contracted during that period. Construction growth has returned in 2002 and is expected to grow by more than 5 percent, leading the growth of 4 percent forecast for the overall economy in Mexico for 2003. Overall, Mexican construction spending is growing and will continue to do well in the coming year barring any further U.S. or worldwide economic slowdowns impacting Mexico’s trade-driven economy.

**Retail/Industrial/Office Construction Outlook**

Glenn Mueller, managing director, Real Estate Investment Strategy, Legg Mason, Inc. and professor at the Johns Hopkins University Real Estate Institute, believes there will be stable but modest demand growth going forward. Supply is slowing down, creating market equilibrium, which is good for the economy. We will return to a growth phase in late 2003.

**Major Projects and Trends: A Panel Discussion**

Hugh Hardy, FAIA, founding partner, Hardy Holzman Pfeiffer Associated, cited growth in restoration of historical areas of the city and many individuals and groups are beginning to use community structures as entertainment outlets.

Henry Mann, chairman/CEO, Perkins and will, said the higher education market looks good specifically in the area of teaching labs and academic research labs. In addition, with the many aging urban school systems that exists, there is plenty of opportunity in replacement construction projects across the country.
Leo A. Daly, III, chairman/CEO, Leo A. Daly noted that there are three basic areas where construction is going to pick up in 2003: aviation, federal government and healthcare. Particularly, in aviation, he indicated that once the federal government completes its study on air security measures, the industry must change its approach to construction in this arena.

Scott Simpson, co-chairman, The Design Futures Council and director/partner, Stubbins Associates, said speed of delivery from design to build is a growing trend in the industry. He sees upcoming growth in academic medical centers and biotech markets.

Rod Kruse, Partner, Herbert, Lewis, Kruse and Blunck, observed that in the Midwest market there is growth in single-family homes, sports arenas and municipal libraries.

William Geuerin, deputy chief architect, U.S. General Services Administration, said there was growth in courthouse construction due to capacity issues. With homeland security becoming a concern, there is a significant border station construction program coming up for GSA in 2003.

The NACF conference was moderated by Jim Cramer, chairman, Greenway Consulting and editor, DesignIntelligence.

About Reed Construction Data
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