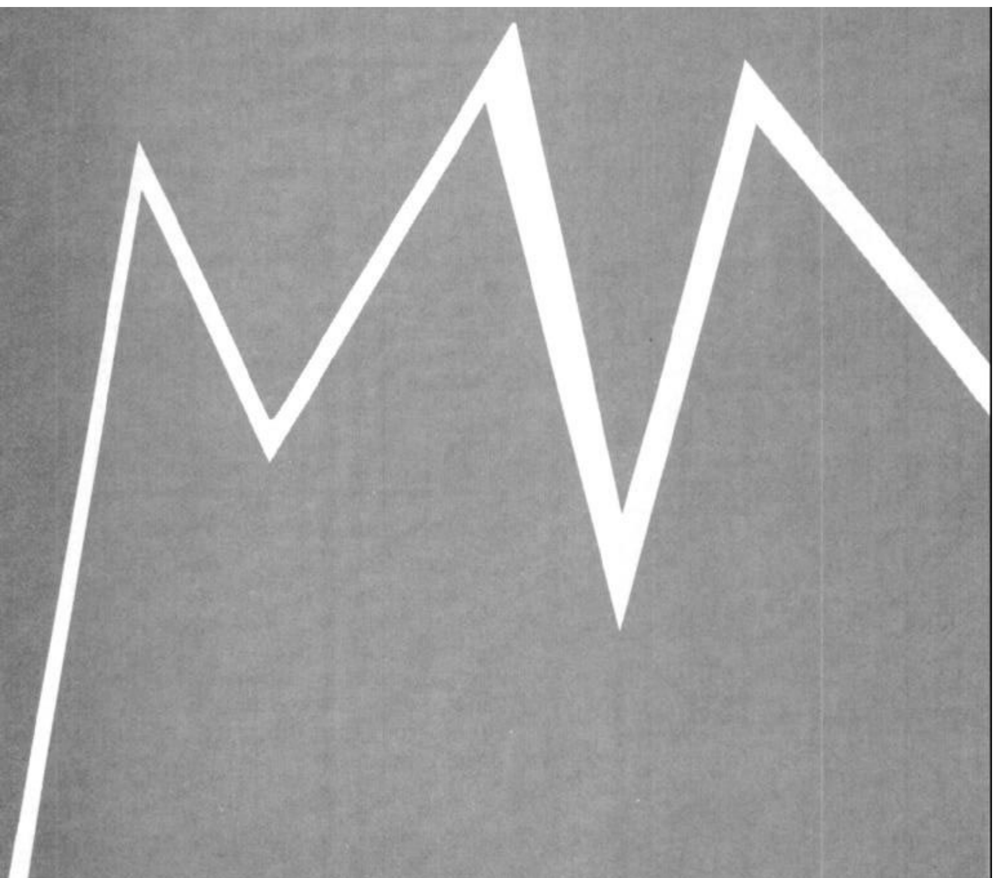
Expect Some Growth Flattening This Year, Economists Forecast

Residential and commercial construction predictions show slowing in 1989, Cahner's research finds, but pockets of opportunity exist.



Fears of a construction recession next year are exaggerated, the 1989 Outlook for the Economy by Cahners Economics predicts, forecasting only a modest cyclical downturn in a U.S. economy where manufacturing is "healthier than it has been in years."

"There is as much room for optimism as pessimism in the outlook for the economy," according to James Haughey, vice president and director of Cahners Economic Research. "Existing U.S. industrial capacity, operating at its highest level in a decade, is strained. Investment in new plant and equipment continues to grow at a double-digit pace."

While pointing to the federal budget and trade deficits as 'dark clouds on the horizon,' Haughey said U.S. exports are growing at a far faster rate than imports. "Exports accounted for about half our GNP growth in 1988. The general outlook for the industrialized world economy in 1989—the major consumers of U.S. exports—is good. The dollar should remain stable at roughly current levels, easing less than 3 percent against an index of 16 major currencies.

Wade Deficit Could Shrink by Early Nineties

"If free trade and monetary conditions remain stable, the U.S. could begin to work off the large trade deficits as soon as the early 90's," Haughey said.

Cahners Economics predicts that the economies of Japan and Western Europe will grow faster than the U.S. next year, with real GNP expanding 3.75 percent in Japan and 3 percent in Germany vs. an average of 2.5 percent for the 24 OECD countries and 2 percent in the U.S.

"This represents a decline from 3.9 percent in the U.S. in 1988," Haughey said, "a considerable slowing of growth—but not a recession. The impact will be moderated by a real decline in imports and continued strong employment as fewer Americans enter the labor market."

Soft Landing for Economy

Interest rates and inflationary pressures will rise during the first two quarters of the year, according to the Cahners study, but the trend will be short-term. "Both short and long term interest rates will peak early in the year, and then decline through the remainder of 1989," Haughey said. "By the end of next year, mortgage rates will ease a full point to an average of 9.9 percent," he added.

The Cahners Economic Outlook also points to rising import costs and increasing efficiency in key manufacturing sectors as sources of strength in the economy. Following are the key forecasts for the construction industry's commercial and residential sectors.

FORECAST/89

BUILDING & CONSTRUCTION

Residential Construction

Growth in new residential construction will be essentially flat in 1989, as housing starts reach a total of 1.46 million units for the year. Single-family housing will provide all of this year's growth, as starts rise by 1.7 percent over 1988 levels to 1.1 million units in 1989. In contrast, the overbuilt multifamily market will weaken further, falling 4.3 percent to 375,000 units-its lowest level in seven years.

Last year provided a bumpy year for the housing market. With inflation and interest rates on the rise, housing starts declined by nearly 10 percent—matching its downturn in 1987.

However, market conditions are expected to improve this year. Although higher mortgage rates will get housing off to a slow start, they will moderate in the spring and summer months, giving a boost to construction activity. Mortgage rates are expected to ease down to 9.9 percent by the end of 1989, nearly a full percentage point below their year-earlier level.

Home prices are also expected to moderate. The weaker economy will curb the trade-up market's appetite for bigger and better houses. This trend has helped to push up the average sales price of a new home by a rapid 9 percent annual rate since 1982, making homeowner-ship more difficult to obtain for 'first-time buyers. This year, however, home prices are expected to decline, sliding from an average $138,700 in 1988 to $137,000 in 1989.

Underlying the flat level of housing starts this year is a shift in regional construction activity. Although the Northeast has provided much of the growth in housing construction since 1982, growth this year will be concentrated in the Midwest and West.

The Northeast remains a stronghold for residential remodeling, but limited availability of land on which to build will keep home prices high and dampen new construction.

Home prices are also relatively high in the Midwest and the Pacific portion of the West, but the recovery in manufacturing should translate into the construction of more homes in both regions this year.

By 1989, the worst of the South's housing slump should be over. Starts have fallen by nearly 10 percent per year since 1983 but are expected to hold steady this year. Stronger worldwide economic growth has given a boost to this region's long-depressed energy and other resource-based economies. Relatively low housing costs and substantial increases in population ensure this recovery will continue throughout the remainder of the decade.

Building and Construction Outlook
(Billions of $)

	Actual	Annual % Change	
	1987	1988	1989
Housing Starts (1)	1620	−9.9	−0.1
Single-Family (1)	1146	−6.8	+1.4
Multi-Family (1)	474	−17.5	−4.3
Residential Remodeling (2)	94.1	+5.6	+4.4
Nonres. Construction (2)	117.2	+3.8	−1.1
Commercial (2)	62.8	+1.3	−2.7
Industrial (2)	13.7	−1.5	−3.5
Institutional (2)	40.6	+9.5	+2.0
Nonres. Reconstruction (2)	—	+5.8	+3.8
Nonbuilding (2)	86.9	−0.1	−4.9
Construction Equip. (2)	5.8	+13.3	−11.2

(1) Thousands of units; (2) Billions of $.

Nonresidential Construction

Nonresidential construction spending is expected to fall by 1.1 percent in 1989, to a total of $120.3 billion. The overbuilt commercial construction market, which includes offices, retail stores, and hotels and motels, will account for the majority of the slowdown.

Commercial vacancy rates are still too high to sustain a recovery in spending levels. The 1984-85 boom in commercial building left a glut of available space. Furthermore, the 1986 Tax Act eliminated the very incentives that had supported this boom, namely passive loss deductions, tax-exempt industrial revenue bonds, and long depreciation periods.

Commercial Construction Spending

	Actual	Annual % Change	
	1987	1988	1989
Office ($ bil)	26.4	+5.9	−2.0
Retail ($ bil)	29.0	−0.3	−3.5
Hotels & Motels ($ bil)	7.4	−8.9	−2.5
Total ($ bil)	62.8	+1.3	−2.7

After a brief upturn in 1988, office construction spending is expected to resume its downturn this year. According to Coldwell Banker, office vacancy rates continue to hover near 20 percent nationwide and are as high as 30 percent in parts of Texas, Florida, and Mid-New Jersey. Nevertheless, the slowdown in office building over the next two years will be much less severe than the 1986-87 downturn.

Retail construction spending is also expected to be sluggish in the coming year. Following the initial upsurge in homebuilding, demand for retail space skyrocketed in 1984 and 1985; spending rose by nearly 40 percent per year. Housing has been in a downturn for two years, however, and consumer spending has also been slow, limiting the need for new retail space. Until these factors improve, retail building will continue to weaken.

The weakest commercial construction sector this year will be hotels and motels. This market enjoyed the fastest growth of any commercial sector over the past decade, but must now pay the price for years of overbuilding. In 1988, spending plummeted to its lowest level in five years. The slower economy this year will cut into business travel, prompting another slowdown in hotel construction spending.

Industrial construction spending continued to slide last year, despite record levels of plant and equipment spending by manufacturers. Years of corporate downsizing, investment in labor-saving equipment, and productivity gains will continue to limit the growth in new industrial building relative to previous expansions.

Unlike the industrial sector, institutional construction expenditures are driven mainly by public building. While spending growth has been exceptionally strong in recent years, it will flatten in 1989 as deficit conscious Washington reins in government spending.

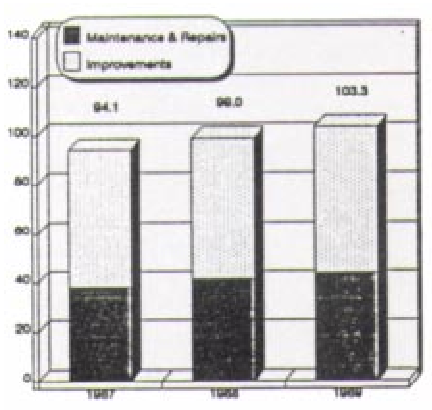
Home Remodeling

Where homebuilding is weak this year, remodeling is expected to pick up the slack. By the end of 1989, total remodeling expenditures are expected to cross the $100 billion threshold for the first time ever.

Maintenance and repairs will provide most of the growth in remodeling this year. As higher interest rates increase the cost of financing big remodeling projects, small maintenance and repair jobs, which the consumer can more readily do himself, are expected to gain in popularity.

A contractor is still needed, however, for the typically larger-scale home improvement projects, which include additions, alterations, and major replacements. To finance these projects, consumers can readily tap into the rapidly expanding home equity loan market, where interest rates are generally much lower than those on unsecured consumer loans.

Residential Remodeling Expenditures
(Billions of $)

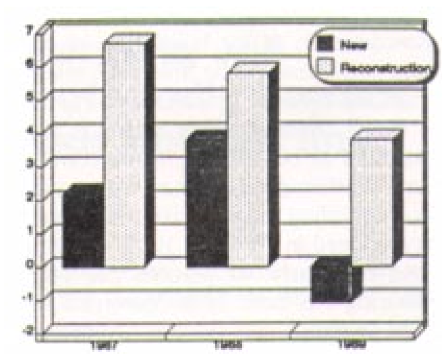


In terms of volume, six of the top ten metropolitan areas for residential remodeling activity are in older cities along the Atlantic Coast, primarily in the Northeast. However, the Los Angeles-Long Beach area continues to lead the nation in both residential remodeling and new construction.

Nonresidential Reconstruction

Nonresidential reconstruction will continue to be a bright spot in the otherwise stagnant non-residential construction market. With slowing growth in the economy and declining levels of new construction, more attention will be given to the existing building stock. Expect non-residential construction spending to expand by 4 percent per year over the next two years, while new construction remains flat.

Nonresidential New Construction and Reconstruction
(Annual % Change)



The reconstruction market enjoyed substantial growth even before the slowdown in new construction began in 1986; reconstruction averaged annual growth of 11.2 percent from 1981 to 1985. Last year, the value of permits for reconstruction work rose nearly 9 percent, while new construction spending increased by only 3.8 percent.

The need for reconstruction work continues to grow. According to a Department of Energy survey, 35.5 percent of the 3.9 million commercial structures existing in 1983 were built before 1946 and another 42.2 percent were constructed between 1947 and 1970.

As in previous years, nonresidential reconstruction activity will be concentrated in the older cities of the Northeast and Midwest regions. The decline in manufacturing jobs and corresponding increase in high-tech employment has meant that the building stock has had to be altered to its new uses. California, with its rapidly expanding population and increasing trade with the Pacific Rim, is also a center for reconstruction activity.

Construction Machinery

Shipments of construction machinery rose 13.3 percent to nearly $6.6 billion in 1988. The outlook for the construction machinery industry is not as bright, however, particularly because demand will not be as strong as in the recent past. Cahners Economics expects machinery shipments to total just $6.0 billion by the end of 1989.

Domestic construction machinery manufacturers will continue to enjoy the low value of the dollar relative to many key foreign currencies. In 1988, machinery exports were 35 percent higher than the year before. Increasing exports helped boost shipments of construction equipment 13.2 percent for the year, as compared to 1987. Over the next year, foreign demand should further boost export shipments, and domestic manufacturers will enjoy less severe import competition.

In 1988, the construction machinery industry benefitted from strong domestic demand in the heavy construction and material production markets. Manufacturers orders for construction machinery increased over 22 percent last year to the highest level since the beginning of the decade, indicating that, in the short-term, machinery sales will continue at a healthy pace.

However, the outlook for the machinery end-markets is not as bright. An overall slowdown in economic growth will dampen activity in the materials producing industries, while federal belt-tightening will cause a cut back in heavy construction.

Towards the end of this year, the equipment industry will begin to feel the effects of this dampened demand. In addition, relatively high interest rates will probably result in the postponement of many new equipment ourchases until 1990.

Heavy Construction: Public Non-building

After five years of rapid growth, spending on public works construction flattened in 1988 to $50 billion. Federally funded construction projects face further cut backs in 1989 as government spending tightens. Public non-building construction includes work on highways and bridges, water and sewer systems, military facilities, conservation and development projects, and airport facilities.

The new administration in Washington is faced with the task of reducing the federal budget deficit. Without a general tax increase, this will require an across the board freeze in federal funding. Yet, over the past several years, Congress has issued an increasing number of mandates binding requirements on the condition of the public works systems which require funds to pay for them.

Ultimately, the result is likely to be a combination of greater state and local government responsibility for funding infrastructure projects, more private sector involvement, and higher user taxes. In the meantime, however, public works construction spending will taper off; in 1989, spending should fall 4.4 percent to nearly $48 billion.

Heavy Construction: Private Non-building

Spending on private nonbuilding construction is expected to remain sluggish, dropping 5.7 percent to $35 billion in 1989. Most of this decline stems from a drop off in construction of telephone and telegraph facilities, following a three-year spending boom. Construction spending on other utilities, including petroleum pipelines, and electric and gas lines is improving slightly, but will also have a slow year in 1989.