Construction Market Decline in First Year of New Millennium Predicted Following Strong Growth in 1999

Editor's Note: CMD Group hosted the North American Construction Forecast and co-hosted FEDCON with the National Institute of Building Sciences, at the National Press Club on Oct. 28, 1999. This article is a summary of speakers' comments made during the conference.

Total construction will increase 3.5 percent in 1999, followed by a 1 percent decline in 2000 due to a drop in residential construction, and then it will begin to rise again in 2001, according to Bill Toal, chief economist for the Portland Cement Association. Toal, speaking at CMD Group's fourth annual North American Construction Forecast on Oct. 28 at the National Press Club, said there are “good days ahead for construction and related industries.”

Toal told attendees that there have been nine economic recoveries since 1945 with an average length of 50 months. “Over time, we are seeing the recoveries become longer and longer,” he said. The current recovery is 103 months, and, if it lasts until February 2000, it
will be the longest recovery ever.

Toal said there are many things that could affect the recovery. “Inflation might heat up, which would cause the Fed—which has already raised rates twice—to raise them again. That could have some effect on lowering residential construction from today’s lofty levels,” he told the audience. Inflation has been running at 2 percent but has started to pick up. Asian basin countries are stabilizing, and petroleum prices have already doubled.

Y2K could also play a role. “We have to keep an eye on how inventories build toward the end of the year,” Toal said. “There are concerns of an inventory cycle lead slowdown as people build inventories at the end of this year and then run them off the first of next year.”

Among potential jolts to the world economy, Toal told the audience to also keep an eye on various sources of turmoil worldwide. “We skated through the Asian basin thing pretty well. We were one of the few countries in the world that was not hit by the problems that happened in Asia.” He noted as another example of significant world events to watch is that many people in Russia may not make it through the winter.

On the other hand, Toal said, many things are going right with the economy. It is the second year in a row we have had a federal budget surplus of approximately $130 billion. State and local governments are also running surpluses. “That gives us the wherewithal for the publics works spending that we think will be coming down the road over the next couple years,” he said.

BALANCED CONSTRUCTION

Another plus is that office and commercial construction is essentially in balance, with vacancy rates running at approximately 9 percent. San Jose, Wilmington, San Francisco, Seattle and Manhattan have the lowest vacancy rates. Oklahoma City, Dallas, Westchester/Mid-Hudson, Ft. Worth/ Arlington and Palm Beach County have the highest rates. According to Toal, even with rising interest rates and a slowing economy, commercial and off-ice construction will maintain levels if not increase further. He added that commercial bank debt leverage portfolios are in very good shape.

Technology also is adding to the strength of the industry. Information processing and equipment has risen from almost nothing in the 1970s to approximately 6 percent of Gross Domestic Product today.

“Technology has helped hold down inflation and has kept our economy growing at a rate we haven’t seen,” Toal said. “It’s one of the reasons we’ve had the longest expansion we’ve ever had. We as economists really don’t know its full impact.”

As for the individual sectors, Toal said most of the weakness in residential will be in the number of first-time homebuyers, which he expects to drop off approximately 8 percent.
Toal said he expects housing starts to continue to trend down from 1.6 million units this year to 1.4 million units in 2000, and then begin rising again. He blames the decline on rising mortgage rates, which have increased from 6.5 percent to 8.0 percent. Vermont, South Carolina, South Dakota, Iowa and Virginia have had the biggest increases in single-family building permits, while North Dakota, Wyoming, Oregon, Washington and Massachusetts have seen the biggest declines.

Toal said nonresidential construction is enjoying a nice recovery from the early 1990s. Office construction is the strongest, up 11.3 percent this year and continuing to rise. Vacancy rates are low. The hotel market is still going strong, up 9.7 percent from last year; however, Toal expects it to weaken in the near future.

Other areas that are seeing increases in construction in 1999 include retail (1.2 percent) and religious (8.5 percent) construction. Industrial (-22.4 percent), educational (-12.2 percent) and hospital (-12.2 percent) construction are seeing declines in 1999. Toal said school construction should improve, as the school age population is on the upturn, which means more new and renovated schools.

Overall, nonresidential construction will see a slight decline of 0.5 percent in 1999, then a 1 percent increase in 2000, before picking up to 3 percent or 4 percent growth, he said.

“Public construction is our savior,” Toal told the audience. It has been rising steadily, increasing 6.0 percent this year and another 5.5 percent next year.

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**RETAIL AND INDUSTRIAL IN GOOD SHAPE**

Retail and industrial real estate will weather a slight dip around the turn of the year and continue on a strong course in 2000, Hugh Kelly, chief economist of Landauer Associates told participants at the conference. The dip resulting from investor anxiety over Y2K, but will be temporary. 2000 will begin much as 1999 did, with a traditionally slow first quarter followed by robust quarters later. Overall, Kelly sees a healthy, if somewhat slower-growth, economy over the next two years.

“We are halfway through the consumption phase of the expansion,” he said, “which should last another one to two years.”

He said the retail sector was particularly good not only in Sunbelt cities from Phoenix to Orlando but also in the core cities of Philadelphia, New York, Boston and Chicago. He thinks the laggards will be Connecticut cities, New Orleans and such Pacific cities as Honolulu, Portland and San Diego, where supply has recently caught up to demand.

About the impact of e-commerce on traditional retail construction Kelly said, “Although retail commerce on the Internet is growing tremendously at about 50 percent per year, and by 2001 the figure will reach $30 billion, this is still less than 1 percent of retail sales nationally. It will not affect retail construction any time soon.”

The hot spots for industrial construction, Kelly believes, will be Seattle, Los Angeles, Northern New Jersey and Denver, with the laggards being Phoenix, Washington, D.C., Orlando and Tampa. Leading the way in industrial construction are food preparation plants
with $43.6 billion in contracts, air pollution abatement systems with $27.1 billion and electric generation plants with $26.9 billion.

Kelly was enthusiastic about real estate because he said the fundamentals are strong: “The U.S. economy is in the sixth year of an extraordinary expansion, which has pushed unemployment to very favorable levels (under 4.5 percent), and is creating prosperity for all classes.”

Kelly then made a statement he believed would astonish his audience: “Over the last six years, interest rates and inflation have not been linked.” He showed a graph to illustrate his point. In 1994-95, interest rates went up, but not the Consumer Price Index. In 1997, the CPI declined, but interest rates did not.

The reasons he ascribes to Alan Greenspan, the chairman of the

Federal Reserve Bank. Kelly believes Greenspan artificially held down interest rates before 1994 in order to help the ailing bank industry recover when inflation was not a threat. In 1997, Kelly believes Greenspan did not lower interest rates although the CPI was declining because he did not want to over-stimulate the economy to the detriment of foreign countries then in trouble.

“The Fed realized it was not just the central banker of the United States but also of the world,” Kelly said. “It adjusted interest rates to accommodate the international economy, not just that of the United States.”

Kelly said that in the 1980s and 1990s, commercial real estate had not kept up with stocks and bonds as an investment. “But now I see the stock market as going flat and real estate as being strong. Over the next 12 months, I see real estate as an asset class beating stocks and bonds.”

Kelly said that although investment into real estate had only amounted to $4 billion in the first quarter of 1999, it bounced back to a record level of $7.5 billion in the second quarter. Of this last amount, $3.9 billion was put into the office buildings, $846 million into retail buildings and $479 million into industrial buildings.

“The strongest region in the quarter was along the Pacific, especially California,” he said. “It has led the nation in retail and industrial building investment for the last two years. Currently, it is the region of preferred investment.
RESIDENTIAL CONSTRUCTION WILL SLOW IN 2000

Robert Barr, a senior economist with the Federal National Mortgage Association, told attendees that following record levels in homes sales and mortgage market activity in 1999, housing activity will slow somewhat in 2000.

Looking at the economy overall, Barr said he expects the strong growth to moderate over the next year. Gross Domestic Product growth may be beginning to slow as well. However, Barr explained, the Federal Reserve is concerned about how much the economy is growing further than its trend growth (2.75 percent), which adds inflationary pressure. The Fed tightened interest rates twice over the summer and was expected to raise them again at its Nov. 16 meeting. Barr said he expects inflation to remain low, with modest increases to only 2 percent to 3 percent over the next two years.

According to Barr, personal spending has powered the recent economic boom. Consumer confidence is strong, but there may be early signs of a slowdown, Barr said. “A lot of consumer spending has been fueled at least in part by the wealth-effect of the stock market,” Barr explained. If the stock market continues to go down or move sideways, it will remove one of the impetuses for continued consumer spending and may also effect remodeling jobs and home purchases.

Barr said productivity growth by U.S. work forces has been heading up toward 2 percent and seems to be growing and stabilizing at a higher rate. Barr portrayed this as a solid sign of long-term strength of the economy. “If it can stay there over a sustained period of time, that would increase our ability to grow our economy,” he said. The major reason for productivity growth seem to be the sharp declines in technology prices, which has lead to the application of technology to many processes, including inventory control processes.

“Household growth remains very strong, rising faster than the population growth as a whole,” he said. People are forming households at a faster rate due to many factors, including the growth in the number of “20-somethings,” strong immigration and a strong economy. If in 2000 job growth continues to trend down and the economy slows, the household formation rate will go back down to at least 1.2 percent.

Residential construction is expected to dip in 2000, as the economy slows and refinance numbers go down, but rebound in 2001, Barr said.

“Higher rates have really choked off the refinance market,” he added. Long-term interest rates have risen, topping 6 percent on the 10-Year Treasury. Thirty-year fixed rate mortgages have gone up as well. A slower economy should allow the rates to fall.”

Barr told the audience to continue to expect new home prices to exceed inflation, but with slower gains in 2000 and 2001. He predicted that home price appreciation should drop to about 4.5 percent next year. It is likely that 1999 will be the fourth consecutive year of record new home sales, but 2000 should see an 8 percent to 10 percent drop in sales, followed by a slight recovery in 2001.


Combined with the slowdown in home sales, the drop in refinance activity will drop mortgage originations below $1 trillion next year to around $940 billion, the fourth-best year ever. This current year’s projected $1.32 trillion will be the second-strongest year in history.

MANY OPPORTUNITIES IN MEXICO

Mexico is continuing to undergo privatization and enjoying a
rebound from its devaluation crisis of five years ago, according to Oscar Vera, an economics consultant who was once the director of macroeconomic analysis for the country’s Ministry of Energy and Mines.

Mexico is in the fourth year of growth, Vera said, and he expects growth to continue at about 4.5 percent per year for next five years. 1999 was an important year for Mexico economically, because during 1999 Mexico reached full recovery from the disastrous devaluation of 1995, without running into any major obstacles to continued real growth.

“If we get this kind of steady growth, then we’ll do well for the next 10 years. Traditionally, we had cycles of growing very fast and collapsing. What we need is steady and undramatic growth.” Trouble would come if the United States growth rate fell below 1.5 percent, which could cause a recession in Mexico due to the fact that 30 percent of its GDP owes to exports.

Vera had the following to point out about Mexico’s strengths. Mexico’s GDP is 15 percent higher than it was before the crisis of 1995. Mexico is the second largest trading partner with the United States, after Canada. And it is looking forward to a free trade agreement with Europe.

Such an agreement “will have a different effect than NAFTA,” Vera said. “We already had good trade with the United States—NAFTA laid the rules for long-term integration. A European agreement will affect not so much trade as it will investment.”

CONSTRUCTION GETTING BETTER

With respect to construction, Vera reported that the level of construction was only now reaching levels of the pre-crisis economy. Another development is that Mexican construction firms have been consolidating since the crisis. In addition, government spending now represents only 15 percent of construction in Mexico, and privatization is continuing at a good pace, thus opening new areas for infrastructure construction. These would be in telephone services, railroads (now fully privatized), commercial ports (fully privatized and with $5 billion in private investment over the last five years), natural gas distribution and electricity generation.

Over the next five years, the number of telephone lines will double, railroad cargo will increase 20 percent, and electricity demand will grow at 6 percent a year and require $15 billion in investments, Vera reported.

Vera pointed out that there is a huge demand for construction materials and supplies in Mexico. He cited as an example cement demand, which has been growing at double-digit rates since 1994.

Along with infrastructure, the fastest growing sector of the economy is housing. It is growing at 6.5 percent a year, fueled by population growth and rising incomes, Vera said. He pointed out that the sector is being helped by the implementation of a better secondary market scheme for mortgages and greater institutional investing.

“The fastest growing region in the country is in central Mexico, which was the hardest hit in the 1995 crisis,” Vera said. “An example is Guadalajara, which has turned around and is developing its own ‘Silicon Valley.’ Mexico City is not growing. Its industries are old and oriented to the domestic, not the export, market. The only opportunities there for construction is in replacement construction.”

Vera predicted that although elections are coming, there would be no significant pump priming by politicians.

It is likely that 1999 will be the fourth consecutive year of record new home sales, but 2000 should see a drop.
“Construction companies that depend on the government will not have such a good year, but overall construction will do fine.”

CANADA IN GOOD SHAPE

Alex Carrick, economist at CanaData (a division of CMD Group), painted a picture of a solid Canadian construction economy. While many indicators are not at record levels, they have been rising, and potential trouble spots are few.

Carrick showed that Canada was in its eighth year of growth. In 1999, he expected the economy to grow at a rate of just under 4 percent. The expected rates for 2000 and 2001 are slightly over 3 percent and slightly under 2 percent respectively.

With graphs and charts, he showed that the Consumer Price Index, which was below 2 percent last year, is likely to be slightly more than 2 percent this year and slightly under 3 percent for the next two years. “Last year the best economy in the world was that of North America, because there was weakness everywhere else. The U.S. Federal Reserve has been trying to keep the North American economy strong, and it has succeeded,” he said.

The threats he sees to the economy of North America are the growing U.S. trade deficit, concerns about U.S. stock prices and the improving economies in the rest of the world. But he did not predict trouble and went on to document Canadian strengths.

The hottest provinces are Ontario and Alberta; British Columbia is slowing down.

Carrick noted that the Canadian chartered banks’ prime rate is under 8 percent, below peaks in the late 1980s and mid-1990s. He pointed out that the Canadian dollar is ticking up relative to the U.S. dollar, but low enough to be showing real bargains finally being recognized in the United States. Consequently, acquisitions by U.S. corporations are accelerating, and he noted as an example the acquisition by Weyerhaeuser of Mac-Bloedel.

Carrick said the hottest provinces were Ontario, because of financial services and automobile manufacturing, and Alberta, because of a strong oil, gas and petrochemical industry. He said British Columbia was slowing down because of low commodity prices and reduced immigration now that the influx of Hong Kong residents had tapered off.

Carrick then examined each segment of the Canadian construction market. He said housing starts should run about 147,000 a year this year, 152,000 next year and 147,500 in 2001. A recent peak year was 240,000 in 1987, and a low was 115,000 in 1995.

Nonresidential building starts in 1999 would run about 93 million square feet, down from 107.5 million square feet last year, and would trend downward over the next two years to 90.5 million...
square feet in 2000 and 87.5 million square feet in 2001. He called the engineering investment sector “strong and growing,” this year running at $36.5 billion and in the next two years reaching $39.9 billion and $41.8 billion.

“Here are some huge projects to watch,” he said, referring to Suncor, Syn-crude, Mobil and Shell near Fort McMurray in Alberta; petrochemical projects in Joffre and Fort Saskatchewan, Alberta; Terra Nova oil off Newfoundland; the Alliance pipeline to Chicago; and Sable Island natural gas going to New England.

About the Author
CMD Group's annual North American Construction Forecast and FEDCON conference presented by CMD Group and the National Institute of Building Sciences, assembles leading economists and analysts in every area of construction—office, retail, industrial, residential, highway and infrastructure—who officer eagerly anticipated forecasts of coming year construction throughout North America and by specific metro region.