

# Economics

## Construction Forecasters Predict Building Downturn Accelerating in 2002 *Weakness in commercial and industrial sectors more than offsets stable institutional market*



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Typically, the construction sector is a harbinger for the rest of the economy. Being a cyclical industry, construction grows rapidly when the economy begins to expand, and declines when the economy begins to weaken. However, key segments of the construction industry have held up well in recent months, even as we recently learned that the economy has been in recession since the beginning of the second quarter of this year.

Since the typical post-World War II recession has lasted less than a year, the fact that we're now over eight months into this recession is cause for optimism. In the past three months, however, the economic downturn has broadened and deepened. While originally restricted to the manufacturing sector—particularly technology-sensitive manufacturing—the consumer sector is now feeling the fallout. Consumer confidence figures have dropped since September, and the unemployment rate has been rocketing upward.

The slowdown has been substantial enough that virtually every region in the country has been affected. A recent survey of regional economic conditions by the Federal Reserve Board concluded that economic activity remains soft in most regions, with additional signs of slowing in recent weeks that outweigh signs of recovery in a few districts.

While construction activity has fared well (all things considered) as the economy has weakened, now it looks as though the rest of the economy is beginning to drag down the construction sector. The monthly AIA Work-on-the-Boards surveys indicate that billings at U.S. architecture firms have declined 7 of the first 10 months of the year, with the decline deepening since the September 11 terrorist attacks. Equally troubling is that inquiries for new projects have modestly declined over this same period, indicating that the slowdown in design work seems destined to continue into next year.

The recent Federal Reserve Board regional survey indicated that residential markets have stabilized in most regions, while nonresidential activity has stagnated. Leasing activity in the commercial real-estate sector weakened further across all reporting districts. Increasing vacancy rates and softening rental rates were widely reported.

### Forecasters anticipating a weaker 2002

According to estimates from the AIA Consensus Construction Forecast Panel, nonresidential construction activity will be off about 3% this year, after adjusting for the effects of inflation. The commercial construction sector is expected to be off more than twice that amount, topped off by a double-digit decline in hotel construction. Construction of industrial facilities is expected to drop by just about the overall nonresidential average, while institutional construction should increase this year by 3%-4%. Construction of education facilities is expected to increase by 7%-8% this year, maintaining its position as the bright light in the generally dim nonresidential construction picture.

Our forecast panel is predicting that next year virtually all sectors will ratchet down a notch or two. Building types that are weak this year in general are expected to be weaker in 2002. Sectors that are healthy this year are expected to be less so next year. Every member of the AIA forecast panel is predicting a decline in nonresidential construction activity next year. Overall, the decline is projected to reach almost 7%, according to the panel.

### Commercial buildings bear brunt of downturn

As is typically the case when the economy weakens, the commercial market has been the first nonresidential sector to feel the effects. All of our forecast panelists expect office building—the single biggest slice of the commercial construction pie—to decline this year. Of greater concern, though, is that all of the panelists are calling for further declines next year, with most feeling that the dip will be in the double-digit range.

Office vacancy rates in downtown metropolitan areas have climbed to 10.4% for the third quarter of this year according to CB Richard Ellis, up from 8.3% in the second quarter and up from 6.2% in the third quarter of 2000 when rates were near their low for this cycle. Suburban office vacancies have climbed even further; up to 13.0% nationally from 11.5% in the second quarter and 8.6% a year ago.

Net absorption of office space has been negative for three straight quarters, even though office construction was increasing at a brisk pace through the first half of the year. With office employment declining in recent months—and no reversal of this trend on the horizon—construction levels will need to slow

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to bring office space back in line with the realities of the current economic downturn.

The retail construction outlook, while also expected to decline this year and next, is not expected to drop as far as office construction. Building in this sector has been more restrained in recent years than in other commercial sectors. Also, retail activity continues to remain at fairly healthy levels in spite of a national recession. Total retail sales have increased about 3% through the first 10 months of this year compared to the same period in 2000, in excess of overall inflation in the economy. Consumer confidence, while taking a hit in September, has begun to stabilize in recent months at levels far in excess of the lows of the 1990-1991 recession, indicating that consumer spending levels will hold up in the months ahead.

Hotel construction levels are expected to decline more than the other commercial sectors. The dramatic falloff in air travel, prompting the cancellation of numerous conventions and other events, has pushed down hotel occupancy rates. F.W. Dodge reports that the greatest declines have come from larger hotels with higher room rates.

### **Industrial slowdown continuing**

The industrial sector of the economy has been declining for well over a year. Recent figures indicate that the downturn has not yet begun to slow, so it is likely that the manufacturing recession will continue well into 2002. However, low interest rates have made investment in new plant and equipment an attractive option, so the slowdown in industrial construction is not as great as it otherwise might have been.

With an industrial recovery still likely to be a few quarters away, and with a slowdown emerging in key foreign markets, manufacturers are likely to be hesitant to add new industrial facilities. All members of our forecast panel are predicting a decline in industrial construction next year, with two feeling that it will fall at a double-digit rate.

### **Institutional construction looks to avoid a downturn**

The national economic slowdown is beginning to be felt by

many states and localities as well as the federal government, which in turn is causing publicly funded institutional projects to be delayed or cancelled. In spite of this concern, the outlook for the institutional building categories remains generally optimistic.

Education construction has been one of the few anchors of nonresidential construction over the past year, and it is expected to continue to play this role moving forward. F.W. Dodge identifies four major reasons for a favorable outlook for the education sector. The first is rising enrollments at elementary and secondary schools, which are at record levels for the sixth straight year. Rising enrollments have strained existing capacity levels, with about a quarter of public schools currently overcrowded, some to the degree that they have been forced to use portable classrooms or other temporary space. Second, many schools are in poor condition. The average age of school facilities is in excess of 40 years. Upgrading will continue to be a strong market segment.

Third is the abundance of funding for school projects as a decade-long economic expansion has helped to fill the coffers of state and local governments. With low interest rates that encourage bond issuances, municipal governments can leverage these revenues into substantial capital programs. Finally, even if new projects begin to ease a bit, the strong market in recent years has created a backlog that needs to be worked off. For these reasons, educational facilities is the only major construction sector expected to expand this year and next.

Much like the design industry, the health-care sector has been concentrating in recent years with increased mergers and acquisitions. Much of this trend is the result of the federal government's desire to slow the growth of Medicare costs. While successful, demographic trends point to continued growth in health-care spending. Health-care currently accounts for more than 13% of expenditures in our economy, and the federal government expects it to approach 16% by the end of the decade. Underlying growth in the industry will continue to push up construction expenditures. Public construction is expected to ease next year due to declining construction spending for postal facilities and scaled-back funding for prison facilities.

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AIA CONSENSUS CONSTRUCTION FORECAST PANEL—SECOND HALF, 2000														
	F.W. Dodge Bob Murray 781-860-6623 Contract Awards (billions of 1996\$)		Cahners Economics Daryl Delano 508-746-7180 Spending Pu-In-Place (billions of 1996\$)		NAHB Stanley Duobinis 202-266-8237 Spending Pu-In-Place (billions of 1996\$) (private structures only)		Portland Cement Assoc. Bill Toal 847-966-6200 Spending Pu-In-Place (billions of 1996\$) (private structures only)		Economy.com Mark Zandi 610-696-8700 Spending Pu-In-Place (billions of 1996\$) (private structures only)		FMI Tim Aylor 919-785-9267 Spending Pu-In-Place (billions of 1996\$)		Consensus	
	Actual 2000 \$	Forecast 2001 2002 % change	Actual 2000 \$	Forecast 2001 2002 % change	Actual 2000 \$	Forecast 2001 2002 % change	Actual 2000 \$	Forecast 2001 2002 % change	Actual 2000 \$	Forecast 2001 2002 % change	Actual 2000 \$	Forecast 2001 2002 % change	Actual 2000 \$	Forecast 2001 2002 % change
Nonres. Total	162.1	-9.0 -3.3	250.0	1.2 -4.4	179.5	-4.0 -11.5	179.7	-5.3 -10.1	179.5	-3.9 -8.9	243.7	2.4 -2.2	-3.1 -6.7	
Commercial Total	79.3	-15.5 -7.3	114.2	-5.8 -10.0	114.1	-5.5 -14.0	114.2	-7.4 -13.0	114.0	-5.5 -10.1	105.1	-4.4 -5.5	-7.4 -10.0	
• Office	31.3	-17.6 -5.8	47.6	-4.1 -9.8	47.4	-6.5 -21.4	47.6	-9.7 -11.6	47.4	-4.6 -10.6	48.0	-3.5 -9.3	-7.7 -11.4	
• Retail	19.9	-11.1 -8.5	*52.5	*5.0 *-8.7	*52.6	*-1.9 *-7.9	*52.5	*-3.8 *-12.9	*52.6	*-3.8 *-11.5	34.5	-2.3 -1.8	-4.6 -8.5	
• Hotel	6.9	-15.9 -10.3	14.0	-14.7 -15.9	14.0	-14.3 -13.3	14.0	-12.9 -18.0	14.0	-15.0 -2.5	13.0	-10.0 -3.4	-13.8 -10.6	
Industrial Total	8.7	-11.5 -1.3	27.4	-1.9 -8.0	27.4	-2.6 -16.1	27.4	-5.1 -11.9	27.4	-0.4 -7.0	20.8	1.4 -0.9	-3.3 -7.5	
Institutional Total	74.0	-1.8 0.4	108.5	9.4 1.4	*38.1	*-0.5 *1.6	n/a	n/a	n/a	n/a	65.0	*7.1 *1.0	3.5 1.1	
• Health	11.9	-7.6 2.7	15.9	1.0 5.7	n/a	n/a	*12.5	*3.2 *0.8	n/a	n/a	15.3	-3.9 -0.7	-1.8 2.1	
• Education	33.4	3.9 2.3	46.9	10.7 5.3	n/a	n/a	*9.7	*4.1 *1.0	n/a	n/a	46.1	11.3 1.4	7.5 2.5	
• Public	6.6	-1.5 -4.6	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-1.5 -4.6	

(\* includes other commercial buildings) (° private construction only) (° includes public industrial) (\*\* includes health, educational, religious buildings)