

Economics

After Rocky Year for Construction, Forecasters Anticipate Rebound in 2003 *Commercial/industrial recovery plus continued growth in institutional activity points to improved business conditions*



by Kermit Baker, PhD, Hon. AIA

AIA Chief Economist

Commercial and industrial construction activity is expected to drop sharply this year before recovering next year. The first half of this year should be much weaker than the second half, meaning that for architecture firms, the worst is already behind us. The institutional construction sector, which accounts for almost half of billings at firms, was able to avoid this construction recession completely and is slated to see continued growth next year.

These are key findings from the midyear update from panelists of the AIA Consensus Construction Forecast. Leading construction forecasters provide the AIA with their outlook for the coming year, thereby presenting architecture firms with information to determine likely design opportunities within key construction sectors. Their forecasts for nonresidential construction activity this year have been lowered since the beginning of the year. However, given the consensus of a weak year in 2002, they see a healthy rebound occurring next year.

Economy slowly recovering

Recent economic indicators provide conclusive evidence that the recession ended late last year or sometime early in the first quarter of this year. Our economy grew 5.6% at an annual rate during the first quarter, the best showing since the end of 1999. However, several reasons for the strong growth during the first quarter—most notably spending by the federal government to deal with the aftermath of September 11 and a huge buildup in inventories by our nation's businesses—are unlikely to be repeated in the near future.

Even with the strong showing for the overall economy during the first quarter, several sectors were performing less than optimally. Business investment still is suffering from the effects of depressed corporate earnings. Investment in structures and equipment declined by more than 8% at an annual rate during the first quarter and—more directly to the concern of architects—private investment in nonresidential structures declined by almost 24% during the quarter, the fourth straight quarterly decline in this sector.

Even though the surge in the overall economy is likely to be moderated in the quarters ahead, there are reasons for optimism in the economic outlook. First and foremost is the continuation of low rates of inflation, and the resulting low interest rates and financing costs for construction activity. Con-

sumer price inflation is currently running about 1.5% per year, and has averaged just under 2.5% over the past five years. With low rates of inflation, interest rates have been unusually favorable. The prime bank lending rate is currently 4.75%, its lowest level in over 35 years. Mortgage rates for 30-year fixed-rate mortgages are running around 7%, again very favorable by historical standards.

Strength on residential side provides optimism

Low mortgages have been instrumental in keeping the housing market strong during this recession. While housing is traditionally one of the more volatile sectors in the economy, during this past recession, residential construction activity hardly dipped at all. A relatively strong housing market was one of the key factors keeping the economy from a more serious downturn.

A strong housing market is one reason for the anticipated rebound in commercial construction activity later this year. With homebuilding comes retail, office, and lodging construction opportunities. In spite of the deep slide in these sectors, there are already signals of a turnaround later this year. The AIA Work-on-the-Boards monthly surveys of business conditions at architecture firms provide evidence on an impending upturn in commercial and industrial activity.

Firms participating in this survey that concentrate their practice in the commercial/industrial sector reported falling billings last fall and this past winter. However, starting in March, billings began stabilizing at these firms. Additionally, inquiries for new projects began rising quite dramatically about the same time. As inquiries develop into design projects, and design projects translate into construction projects later this year, construction activity in the commercial/industrial sectors will emerge from its 18-month downturn.

Commercial/industrial markets weak

The brunt for the weakness in the nonresidential sector has been borne by the commercial and industrial activity. Our consensus forecast panel estimates that overall commercial construction activity will decline by low double-digit rates this year, and industrial activity by even more. On the commercial side, office and hotel/motel activity have been particularly weak.

Office vacancy rates have been climbing as a weaker economy has stalled job growth. Additionally, though, many businesses that had leased extra space during the late-1990s economic boom in the anticipation of future growth are now subleasing

some of their excess space. Torto Wheaton Research reports that sublet space currently accounts for over 25% of available office space nationally. Colliers International reports that the first quarter this year was the fifth consecutive quarter where the net absorption of office space (the change in occupied office space) declined. Last year marked the first time in at least two decades that there was a decline in occupied space, according to Torto Wheaton Research. Rising vacancy rates have led to falling rents in many markets, which has reduced the feasibility of many office development projects and thereby discouraged construction.

With the recovery of our economy, the AIA Consensus Construction Forecast Panel expects a rebound in office construction next year. All panelists expect an increase next year, although most expect the gain to be relatively modest.

Retail construction has fared the best of the major commercial/industrial construction sectors in recent quarters. Strong consumer spending has produced solid retail sales figures, which has helped to offset the trend toward consolidation in retail operations. There has been a swing, though, toward discount retailing operations, no doubt a reflection of a weaker economy. Our forecast panel expects retail construction activity to decline about 6% this year, and all of the panelists expect at least a modest recovery in retail construction next year.

The sharpest declines in construction activity have been seen in the manufacturing sector. Since manufacturing has been one

of the weakest sectors of the economy recently—industrial activity has been declining for the past five quarters—it would be expected that the construction of manufacturing facilities would also be soft. However, the magnitude of the downturn has been staggering. The sharp contraction this year comes on top of three straight annual drops, where overall manufacturing construction levels declined by over a third. The consensus is that construction of manufacturing facilities will decline another 18% this year, followed by a 7% increase in 2003.

Institutional construction sector continues to grow

The commercial and industrial construction sectors fell victim to a downturn in the broader economy. Institutional construction, while not completely insulated from business cycles, generally sees more stable levels of activity from year to year. That appears to be the case in this instance: our AIA Consensus Forecast Panel is estimating only very modest growth in institutional construction levels this year, followed by equally modest growth levels next year.

The major building types within the institutional sector—health care and education—are both expected to avoid a downturn this year. However, overall growth rates are expected to be reasonably modest. Next year is expected to see more of the same: relatively stable construction levels in both of these sectors. Public construction, in large part due to losses suffered by the U.S. Postal Service and ensuing construction cutbacks, is expected to see a dip in 2003.

AIA Consensus Construction Forecast Panel—Second Half, 2002

	F.W. Dodge Bob Murray 781-860-6623 Contract Awards (billions of 1996\$)			Reed Business Information Daryl Delano 508-746-7180 Spending Put-In-Place (billions of 1996\$)			NAHB Stanley Duobinis 202-266-8237 Spending Put-In-Place (billions of 1996\$) (private structures only)			DRI/WFEA Patrick Newport 781-860-6774 National Income and Product Accounts (billions of 1996\$)			Portland Cement Assoc. Bill Toal 847-966-6200 Spending Put-In-Place (billions of 1996\$) (private structures only)			Economy.com Mark Zandi 610-696-8700 Spending Put-In-Place (billions of 1996\$) (private structures only)			FMI Tim Aylor 919-785-9267 Spending Put-In-Place (billions of 1996\$)			Consensus	
	Actual 2001 \$	Forecast 2002 % change	Forecast 2003	Actual 2001 \$	Forecast 2002 % change	Forecast 2003	Actual 2001 \$	Forecast 2002 % change	Forecast 2003	Actual 2001 \$	Forecast 2002 % change	Forecast 2003	Actual 2001 \$	Forecast 2002 % change	Forecast 2003	Actual 2001 \$	Forecast 2002 % change	Forecast 2003	Actual 2001 \$	Forecast 2002 % change	Forecast 2003	Forecast 2002 % change	Forecast 2003
Nonres. Total	149.6	-6.2	1.6	251.0	-3.4	5.9	173.8	-11.9	2.3	181.6	-14.5	8.9	173.4	-10.8	5.0	173.8	-13.1	3.1	250.5	-3.3	2.3	-9.0	4.2
Commercial Total	67.0	-13.3	4.6	109.3	-8.6	4.6	109.5	-10.1	5.0	101.5	-16.7	2.4	109.2	-12.7	4.6	109.5	-10.3	4.2	99.2	-7.3	2.5	-11.3	4.0
• Office	25.0	-16.8	3.4	44.8	-13.3	6.6	44.9	-15.3	10.5	52.2	-25.1	0.5	44.8	-16.3	4.5	44.9	-15.8	0.8	46.3	-10.2	2.2	-16.1	4.1
• Retail	18.2	-9.9	3.7	*52.2	*-3.6	*2.9	*52.4	*-4.4	*1.7	*49.3	*-7.5	*3.7	*52.2	*-8.4	*4.6	*52.4	*-3.8	*3.3	34.1	-5.2	4.8	-6.1	3.5
• Hotel	5.8	-15.5	12.2	12.2	-12.9	5.1	12.2	-15.3	0.8	n/a	n/a	n/a	12.2	-18.0	5.0	12.2	-18.2	21.2	11.8	-4.4	-0.3	-14.1	7.3
Industrial Total	7.8	-2.6	10.5	25.9	-10.3	7.1	26.0	-36.9	-9.2	24.6	-29.7	25.4	25.9	-22.8	11.0	26.0	-22.8	1.4	*19.5	*0.0	*0.9	-17.9	6.7
Institutional Total	74.8	-0.3	-1.7	115.8	3.1	6.8	°38.3	°0.0	°0.4	32.5	1.5	-3.9	n/a	n/a	n/a	n/a	n/a	n/a	*71.0	°-0.5	°2.7	0.8	0.8
• Health	11.9	3.4	0.0	16.1	0.6	5.0	n/a	n/a	n/a	14.1	2.8	2.1	°12.7	°2.4	°3.8	n/a	n/a	n/a	14.7	-0.2	1.0	1.8	2.4
• Education	35.5	1.1	-2.5	51.4	6.9	8.6	n/a	n/a	n/a	11.7	4.3	-13.1	°10.5	°10.5	°3.4	n/a	n/a	n/a	52.5	-0.9	3.3	4.4	-0.1
• Public	6.9	-2.9	-6.0	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-2.9	-6.0

* INCLUDES OTHER COMMERCIAL BUILDINGS ° PRIVATE CONSTRUCTION ONLY ° INCLUDES PUBLIC INDUSTRIAL ° INCLUDES HEALTH, EDUCATIONAL, RELIGIOUS BUILDINGS