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THE U.S. CONSTRUCTION INDUSTRY 2009 & 2010, THE LEAN YEARS

The bursting of the housing bubble was greeted with shock, as surprising as it was immense. In truth there should not have been shock at all. Rather, as with all “bubbles,” the shock should have been that the bubble lasted so long and was inflated so far.

In its Fourth Quarter 2007 Quarterly Construction Cost Report, Rider Levett Bucknall included the following poignant quote:

“Real estate markets are among the most unstable and cyclical assets markets, exhibiting large amplitude cycles of 10-20 years. Real constitutes a large fraction of the total wealth in any economy, generates a significant fraction of banking activity and debt, and strongly affects the job market. Consequently, real estate booms are often accompanied by periods of intense speculation involving expansion of credit and banking activity, stimulating the local and even national economy. When the bubble bursts the resulting bad loans, defaults, and unemployment can throw an entire region into recession or even depression.”

John D. Sturman, Business Dynamics, Irwin McGraw Hill, 2000 Page 698.

What has taken commentators breath away is how far the housing industry has sunk since its peak in 2006, the extent of the carnage that has overtaken the financial markets and the toll that this has in turn taken on the broader economy.

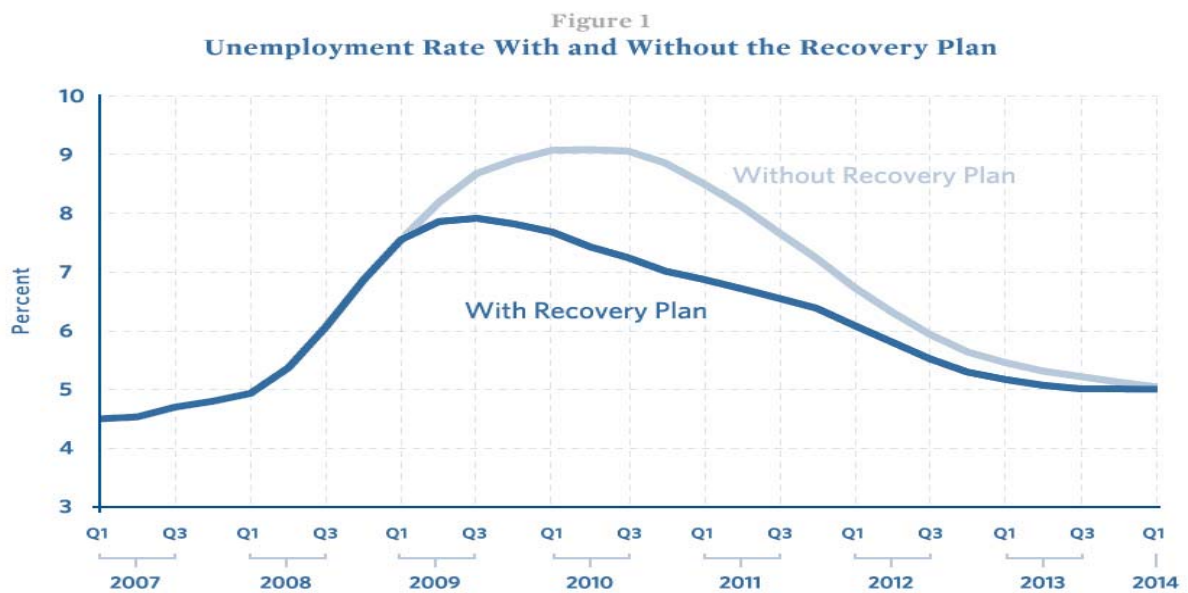
US Housing Starts



The U.S. Bureau of Labor Statistics reported in February 2009 that “Construction lost 111,000 jobs in January [2009]. Employment in the industry has fallen by about 1 million since peaking in January 2007.”

The question that everyone wants answered is, when will the industry begin to recover?

A clue to this can be found in the projections produced by President Obama’s Council of Economic Advisors in support of the recently enacted *American Recovery and Reinvestment Act* (“ARRA”), more commonly known as the “Stimulus Package.”



Source: Council of Economic Advisors

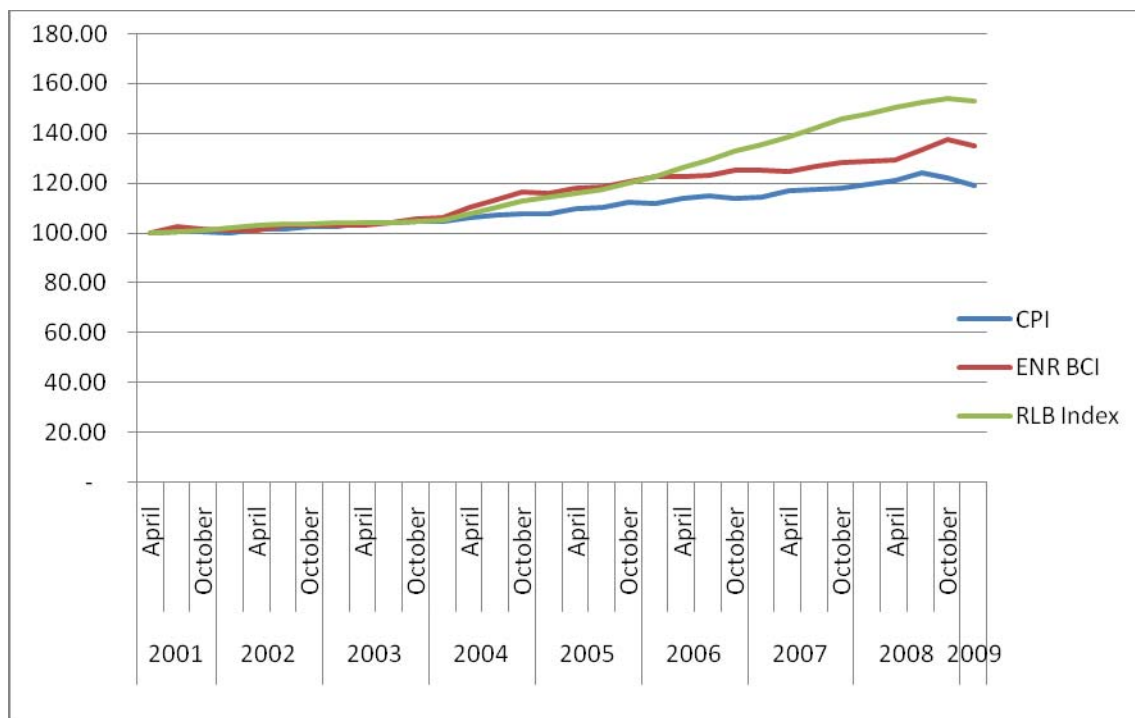
The table above hints that, even with the passage of ARRA, unemployment will only begin to decrease around the Third Quarter 2009 but that it is not expected to reduce to even the Fourth Quarter 2008 level until the Fourth Quarter 2010 and only by the end of 2012 will we see a 5 percent unemployment rate again.

The same Council of Economic Advisors predicted that ARRA would either create, or prevent the loss of, some 678,000 construction jobs, but this is against the 1.0 million construction jobs lost by January 2009 and is not the same as saying that there will not be further erosion of construction employment.

The misery for those involved in the construction industry is unlikely to end soon. With the exception of certain government projects pushed forward using ARRA funds, the rest of the industry is likely to suffer decreasing workload well into 2010.

The effects of reduced commodity and oil prices will interact with the reducing volume of work to put significant downward pressure on construction prices.

Rider Levett Bucknall has made a study of the relationship between the underlying rate of inflation in the broader economy, the rate of inflation in construction labor and materials and the rate of inflation in bid prices.



Sources: Bureau of Labor Statistics, Engineering new Record, Rider Levett Bucknall

The graph above shows that through April 2004 general inflation (as measured by the Bureau of Labor Statistic's Consumer Price Index), construction labor and material price inflation (as measured by Engineering News Record's Building Cost Index) and bid price inflation (as measured by Rider Levett Bucknall's National Construction Cost Index) all tracked with each other. Then, suddenly, in April 2004, driven at first by an upward leap in the price of steel, and later by a boom in commodity prices and workload volumes, the graph lines separated. By October 2008, the relative cost of construction labor and materials had gained a premium of 7.3 percent over general consumer prices while the total bid price for construction had gained a 14.2 percent premium over the increase in construction labor and materials – a combined cumulative premium of 22.5 percent over CPI.

In the medium term construction bid prices tend to increase at a rate not significantly different to the economy's underlying rate of inflation as measured by the CPI. So, it is reasonable to believe that, over the next 24 months, much of the premium of bid price over CPI will evaporate. This is not to say that construction prices will fall by 22 percent – there will continue to be inflation in the general economy and the price of oil and base metals remains volatile so it is not possible to convincingly determine how these factors will feed into construction prices.

In summary, it is my view that construction volumes will continue to decrease in the short term (probably through 2010), construction unemployment will continue to increase and there will be downward pressure on bid prices between 10 percent and 20 percent (depending on locale and market segment). For contractors and consultants 2009 and 2010 will be lean years.

For anyone thinking about constructing a building, 2009 and 2010 will be a great time to get work started!

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