



The Economy and Construction Review of Recent Indicators -- February 2008

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Broad Picture

The fears of recession have mounted in early 2008, based on a steady flow of downbeat economic news. Last fall the prospects that the U.S. economy would slide into recession were generally estimated to be about 30%, and that figure has since been revised up to 60% or higher. The popular definition of recession is two consecutive quarters of negative GDP growth, although that standard has been broadened on occasion to cover an extended period of weakness, such as in 2001 when GDP declines were reported in the first and third quarters.

At the end of 2007, the U.S. economy effectively stalled. With the January employment report showing a drop in the number of payroll jobs, it's become more likely that the first quarter of 2007 will be one of contraction. Housing continues to exert a drag, consumer spending is slowing, and the full extent of the subprime mortgage meltdown on the financial services sector is still not clear.

At the same time, the Federal Reserve has taken aggressive action to cushion the economy's slowdown, and Congress has passed a fiscal stimulus package. The impact on the economy from these steps will require at least a few months to take hold. Shifts in monetary policy affect the economy with about a nine-month lag, meaning the benefits from the January interest rate cuts may not be discernible until the fall. The stimulus package includes tax rebate checks that will begin to be issued in May, which would help to lift consumer spending towards the end of the second quarter and into the third quarter. The stimulus package also includes incentives for business investment, to encourage the purchase of equipment. However, these efforts towards stimulus are taking place at a time when bank lending standards are tightening substantially.

There's little question that the current year is off to a slow start. January's employment report raised the red flag, meaning the next employment report for February (and January's revision) will be eagerly awaited. Based on the information seen so far, it's now widely believed that GDP growth for first quarter 2008 will be negative. Whether it's followed by another negative quarter depends on a variety of factors, including how effective the monetary and fiscal stimulus turns out to be. Tighter credit conditions will make it more difficult for overall business investment to provide the same support to the economy that took place in 2007, particularly as it relates to groundbreaking for new commercial buildings. For the full year 2008, it's estimated that GDP growth will be in the range of just 1% to 1.5%, compared to last year's 2.2% gain.

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In this environment, the construction industry will see more retrenchment for homebuilding, although not quite as severe as the plunge that took place in 2007. The commercial building categories had shown a strengthening trend in 2006 and 2007, but this will change in 2008 as new construction starts weaken. The institutional building sector at best will stay even with last year, while public works is still expected to register slight growth, given the renewed emphasis on infrastructure maintenance. For 2008, the overall level of construction starts in current dollars will fall another 5% to 8%, after the 10% decline that was reported for 2007.

Recent Indicators

Here's a review of some of the recent indicators affecting the U.S. economy and the construction industry.

Employment. The U.S. economy lost jobs in January, as the U.S. Bureau of Labor Statistics reported that payroll employment dropped by 17,000. This was the first monthly job loss since mid-2003, and covered a range of industry sectors, including manufacturing (down 28,000), construction (down 27,000), and government (down 18,000). The bad news was viewed by some as confirmation that the economy has in fact moved into recession, although it's important to keep in mind that the employment data is subject to revision.

When the employment statistics for December were first issued, payroll jobs grew by a relatively small 18,000; and in the latest release the December gain was upgraded to 82,000. In the August employment release, jobs were initially reported as falling by 4,000; the latest figures show that August jobs grew by 74,000. On the down side, the January data included one of the periodic benchmark revisions by the Bureau of Labor Statistics. As a result, the average monthly job growth was downgraded for both 2006 (175,000 versus the earlier 189,000) and 2007 (95,000 versus the earlier 111,000).

The basic point to be derived from the January employment report is that job growth settled back as 2007 progressed, moving from an average of 107,000 in the first half to 82,000 in the second half. Since the employment data gets revised, it will take another month or so before one can say that payroll jobs did in fact fall in January. Furthermore, a monthly job decline of 17,000 is small by recent historical standards. In the recession year of 2001, payroll jobs fell by an average of 147,000 per month. So, while the January employment pattern is consistent with a sliding economy, it's not yet ironclad confirmation of recession.

Real GDP. The U.S. economy grew just 0.6% in the fourth quarter of 2007, much slower than the 4.9% pace in the third quarter, according to the advance estimate issued by the U.S. Bureau of Economic Analysis. The weak reading for GDP was consistent with the sense that the economy decelerated sharply at the end of 2007. Residential investment plunged 24%, the largest quarterly decline so far since the housing correction began in early 2006. Nonresidential investment for structures climbed 16%, the same pace as the third quarter, but slower than the 26% jump in the second quarter. It's expected that nonresidential investment for structures will rise much more slowly in 2008, following the 2007 pattern for nonresidential building starts.

The GDP reading was also lowered by reduced growth for exports and a weaker buildup of inventories, as firms pulled back in anticipation of sluggish conditions ahead. Significantly, consumer spending (which comprises 70% of GDP) expanded just 2% in the fourth quarter, compared to its 3%

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rise in the prior three months. For all of 2007, the 2.2% expansion for the U.S. economy was down from the 2.9% increase in 2006.

Lending Standards. The January 2008 survey of senior loan officers conducted by the Federal Reserve showed a substantial tightening of lending standards. For commercial and industrial loans to large and medium size firms, 32% of the respondents indicated that they had tightened standards over the past three months.

For commercial real estate loans, the survey results were striking – 80% of the respondents said that they had tightened standards over the past three months, compared to 50% of the respondents in the October survey. The 80% of loan officers that reported tightening is the highest percentage since this survey question was introduced in 1990. As for loan demand, 47% of the respondents reported weaker demand for commercial real estate loans, a larger share than the 35% of respondents in October. The January survey also found that over the past year 55% of the respondents were requiring lower loan-to-value ratios, and 40% said that they had reduced the maximum loan size they were willing to grant. Clearly, the tough financing environment has broadened in scope to now include the commercial building sector.

As for residential loans, the January survey found that lending standards continue to tighten across the home mortgage spectrum – prime, subprime, and nontraditional (including interest-only and Alt-A adjustable rate loans). Lending standards have been tightened for nontraditional and subprime mortgages for at least the past year, with the January survey indicating a very high percentage of respondents reporting tightening for both subprime (72%) and nontraditional (85%). More recently, standards have tightened for prime mortgages as well. After just 14% of the respondents said that they had tightened standards on prime mortgages last August, that percentage moved up to 41% in the October survey and most recently 53% in the January survey.

Inflation. The fourth quarter 2007 GDP report showed a pickup in inflation. The price increase for personal consumption expenditures rose 3.9% in the fourth quarter, and the important core reading (excluding food and energy) was up 2.7%. The Fed's "comfort zone" for this measure is in the 1% to 2% range. The higher inflation was also reflected in the consumer price statistics. For December, the consumer price index was up 4.1% over the same month a year ago, and November and December combined were up 4.2%, compared to the 2.6% increase for the first ten months of the year.

In contrast, the recent producer price indexes for construction materials showed either a slower rate of increase or decline. The composite measure for construction materials grew just 1.6% for full year 2007, following a 6.3% hike in 2007, and the latter half of 2007 saw this measure retreat 0.5%. Price declines in 2007 were reported for gypsum products (down 15%) and lumber and wood products (down 1%), although iron and steel products (up 8%) continued to move upward.

Monetary Policy. The Federal Reserve took aggressive action in January, more concerned with ebbing business conditions than rising inflation. On January 22, the Fed lowered the federal funds rate from 4.25% to 3.5%, an unusual move taken in advance of its scheduled policy meeting. On January 30, at the conclusion of its policy meeting, the Fed lowered the federal funds rate an additional 50 basis points to 3.0%. Since September, the federal funds rate has been reduced by 2.25%. The Fed's statement indicated that "financial markets remain under considerable stress, and credit has tightened further for some businesses and households." By noting that "downside risks to growth remain," the

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Fed set the stage for more interest rate cuts to be implemented at upcoming policy meetings. It's expected that by this spring the federal funds rate will be lowered to at least 2.5%, and quite possibly 2.0%.

And, it's not just short-term interest rates that are retreating. With the financial markets showing greater concern about recession than inflation, long-term interest rates have moved down. By early February, the 30-year fixed mortgage rate was 5.7%, compared to an average of 6.3% for all of 2007.

Stimulus Bill. On February 7 both houses of Congress approved a stimulus package costing \$168 billion over two years. The bill's provisions feature tax rebates of up to \$600 for individuals and up to \$1,200 for couples, plus \$300 per child for taxpayers with children. Payments would phase out for individuals with more than \$75,000 in adjusted gross income, with the income threshold for couples set at \$150,000. The phase-out would reduce the amount of the tax rebate check by \$50 for each \$1,000 above the income threshold, meaning individuals with incomes about \$87,000 and couples with incomes above \$174,000 (and no children) would receive no rebates. The expectation is that rebate checks will be issued starting in May.

To encourage the purchase of new equipment, the stimulus bill allows firms to deduct 50% of the value of new investment expenditures in 2008, for items subject to depreciation over a 20 year period or less. The bill would also allow small businesses to write off the entire cost of new investment expenditures in 2008, up to a ceiling of \$250,000 from the current \$128,000. To provide relief to the housing sector, the bill would allow Fannie Mae and Freddie Mac for a one-year period to purchase loans to as much as 125% of an area's median home price, up to a cap of \$729,750 per loan. The current limit is \$417,000, and a higher cap for "jumbo loans" would be a particular help towards increasing mortgage availability in regions with high housing costs, such as California and the Northeast. The bill would also enable the Federal Housing Administration to insure mortgages as high as \$729,750, up from the current limit of \$367,000.

What will be the impact of the economy? The stimulus bill by itself won't keep the economy from recession, but it will help to moderate the slowdown that's already underway. The boost provided by the tax rebates will help the economy in the third quarter. The boost provided by the business tax incentives has the potential to help the economy during the latter half of 2008. However, as noted above, tighter lending standards will prove to be a major constraint for 2008, dampening investment in general and commercial building in particular.