



Beyond Estimation Q3 Market Update

November 21, 2011

Market Watch

- *Early signs of stable growth.*

SINCE 2006, VERMEULENS has been reporting on the state and direction of the construction market. Our guiding philosophy in forecasting is that the inflation targets of the Federal Reserve and Canada's Central Bank will propel monetary policy and subsequently construction prices. This approach led to the successful forecast of a future drop in prices during the 2007 and 2008 price peaks. Previous recessions have been analyzed and have framed our positions on both the size and extent of the price drop-off we have seen in the most recent recession. Looking ahead we see a bumpy road for recovery and therefore buying opportunities for owners.

As the money supply and credit growth stabilizes, rescue packages from central banks will continue or wind down as conditions permit. As financial markets recover to pre-recession levels, institutional buyers will be able to plan for construction in the near to medium term.

See Vermeulens blog <http://vermeulens.posterous.com/> for more discussion on this and other topics.

- *Selling prices have remained flat through Q3 2011*

What Does This Mean For Construction

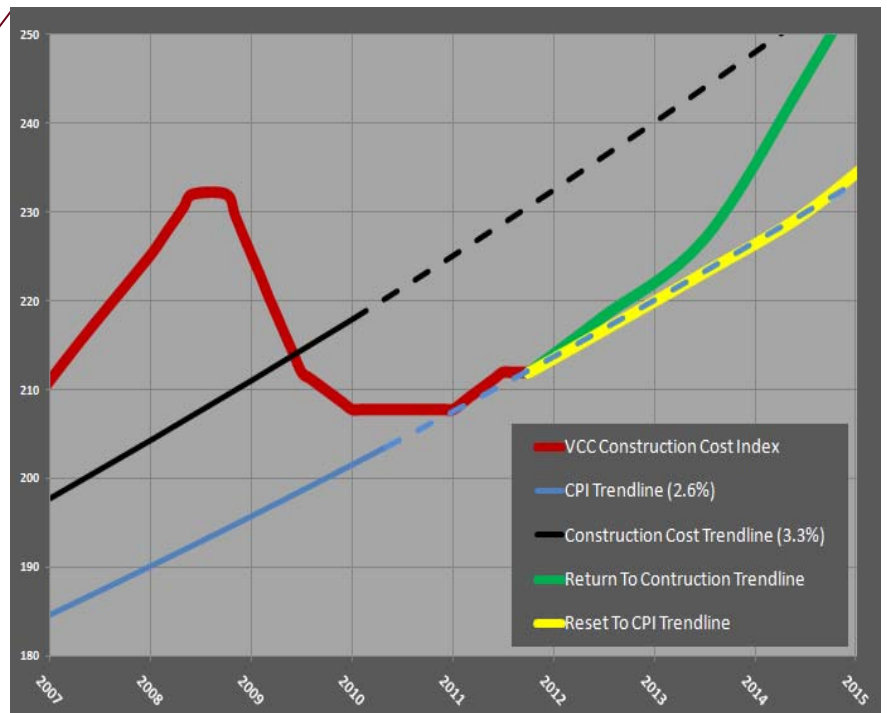
FOLLOWING THE GLOBAL RECESSION construction selling prices for institutional projects fell by 14% from their peak in 2008. In some cases we experienced extremely competitive bidding and 'bids at cost' increasing this reduction to as much as 25%. During the first half of 2011 Vermeulens observed an average selling price increase of 2%. However, pricing levels have remained stable through the third quarter of 2011.

- *The end of QE2 and uncertainty at home and abroad have moderated growth.*

Key Indicators

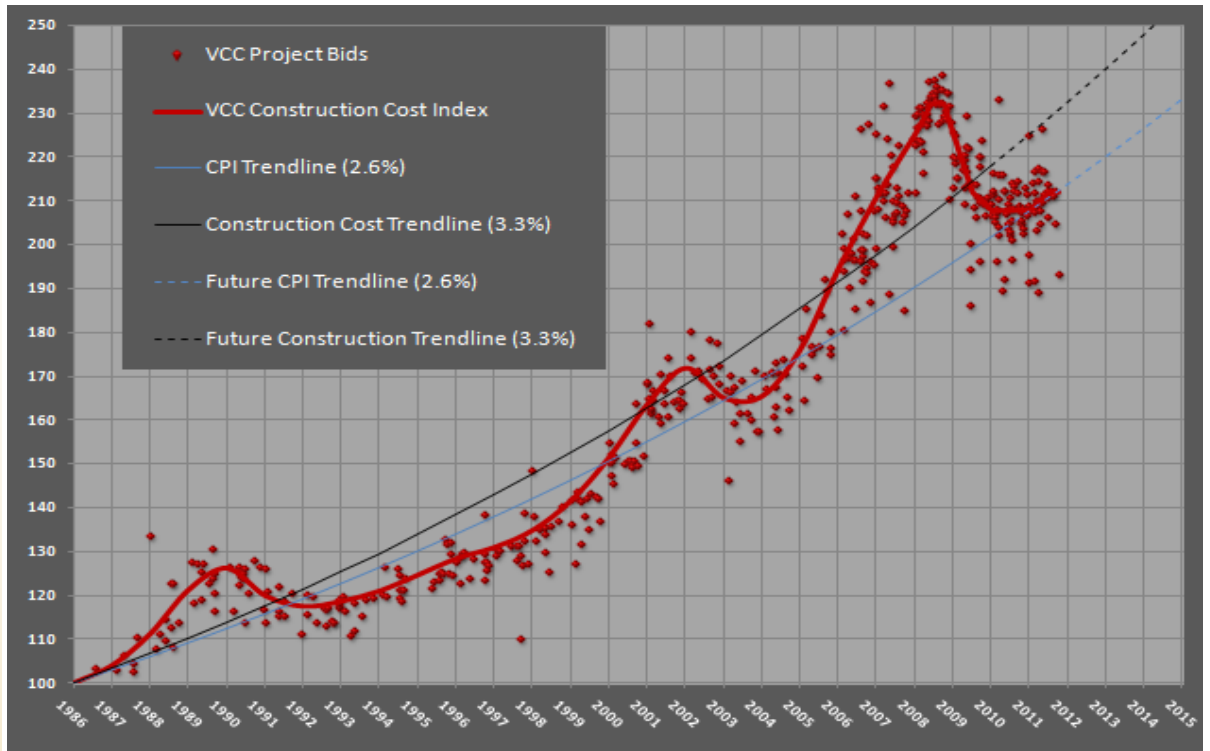
THE TABLE BELOW AND LEFT looks at several of the key economic indicators that drive construction volume and subsequently construction costs. On balance, current indicators support stable construction costs. Consequently, continuing slow growth indicates that institutional costs will follow the "Reset To CPI Trendline" scenario (depicted in the chart below and to the right) and that buying opportunities for owners will persist for some time. Due to recent monetary policy, nominal and real interest rates as well as financial and real estate assets will support an uptick in activity. Likely changes to fiscal policy will work against this.

Indicator		Current	Forecast
CPI Inflation	Very Low	↑	↔
ICI Demand	Low Stable	↓	↔
Nom Interest Rates	Very Low	↔	↔
Real Interest Rates	Turn from high	↔	↔
Gov Spending	Turning	↔	↓
Gov Deficits	Turning Very Neg	↓	↓
Financial Assets	Improving	↔	↔
Real Estate Assets	Low Stable	↓	↔
Construction Prices	Low Stable	↔	↑
Construction Employ	Low	↔	↑



Vermeulens Construction Cost Index

- *Construction Selling Prices have leveled off in the third Quarter of 2011*



FOR THE PAST 25 YEARS construction costs have trended to a 3.3% annually compounded escalation rate. In 2008 construction costs reached a peak and adjusted rapidly downward then stabilized for two years. Similarly, costs peaked in 1990, and 2001. From the peak in 2008 to the bottom in 2010, construction costs fell by 14%. The rate of escalation seen in construction costs are indirectly tied to the Federal Reserves goal of 2 - 3% annual inflation and the monetary policy used to achieve this goal. For the past 20 years, construction costs have escalated approximately 15% faster than CPI due to lower inflation achieved in other sectors of the economy and the reduction in real interest rates.

Based on the balance of indicators in the previous graph we see this environment ending. The chart above illustrates bid prices ('Vermeulens Project Bids') for institutional projects relative to the Vermeulens Cost Index and the 3.3% construction trend line (1986=100) and the 2.6% CPI trend line. The balance of current factors will result in establishing a new lower trend line such as in the 1990's.

For more on this see Vermeulens blog
<http://vermeulens.posterous.com>

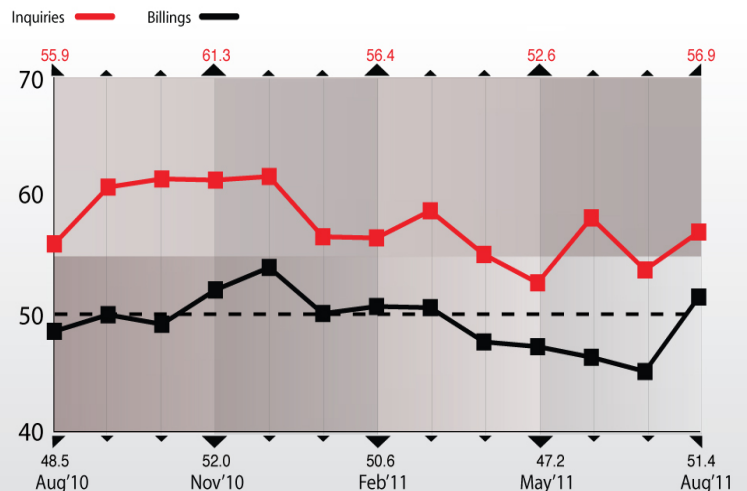
AIA Billings

- *Architectural Billings report growth in August.*

A BILLING INDEX VALUE OF 51.4 in August indicates the first sign of increased architecture activity since the first quarter of 2011. In addition, an Inquires Index of 56.9 concludes 12 consecutive months of decreasing inquiries. With slower than expected GDP and jobs growth there remains a substantial amount of uncertainty which is holding back new construction projects. In general there is a 12 to 24 month lag between an increase in AIA billings and increased construction starts due to length of the design cycle.

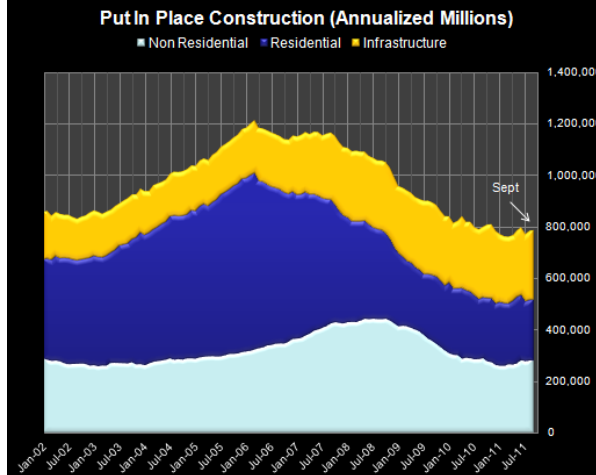
Architecture Firms Report an Unexpected Increase in Firm Billings in August

billings and inquiries scores over the past year
 index: 50 = no change from previous period



Market Indicators

- Construction volume has decreased by 38% from their peak



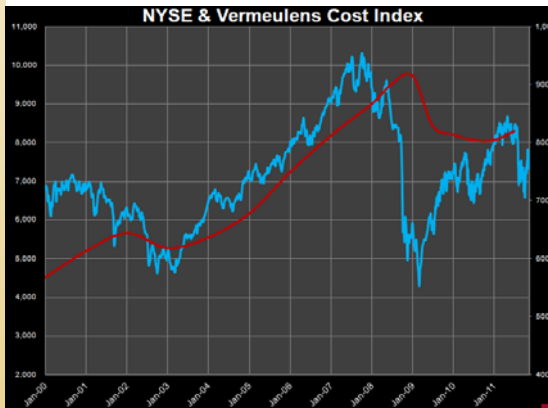
<http://www.census.gov/const/www/c30index.html>

CONSTRUCTION VOLUME IS THE NUMBER ONE DRIVER OF CONSTRUCTION COSTS. As volumes increase and hence contractor bidding opportunities and backlogs grow, the margins included in a bid will grow. Put In Place Volume peaked in March 2006 (along with residential construction) and continued on its 5 year decline to its bottom in March 2011 (down 37%). All this despite the 300+ billion in construction spending injected through federal stimulus funding. When examining Put In Place construction it is important to note that these figures typically lag construction starts by 12 to 24 months. Therefore, reduced spending in 2011 is a result of reduced starts in 2009 and 2010. **Residential** volume appears to have bottomed and is currently 1% higher than its recent bottom in July 2011. Put In Place Residential Construction is currently 35% of the value seen in March 2006. Existing home inventories have begun to decline and are now at 8.5 months which is well below the value of 12.5 months seen last July. According to McGraw Hill, current construction levels are about 1/3 of what is required historically to satisfy long term household formation. During the depression and second world war residential construction ran below long term averages. As incomes supported renewed consumption after the war residential volumes boomed. Using this as a model, employment and income growth will need to re-establish themselves before a real recovery in this sector.

Non Residential construction volume (excluding infrastructure) peaked in October 2008 and has declined by 41%. Although it can mostly be attributed to several large scale projects, Non-Residential construction has increased 8% from its bottom. Along with cues from the continued increases in the AIA Billings Index, the Non-Residential sector may have stabilized.

Infrastructure spending peaked in August 2009 and fell by 12% to its bottom in Feb 2010. Infrastructure spending has now rebounded by 6% from the February bottom. New fiscal policy will be an important driver in this sector.

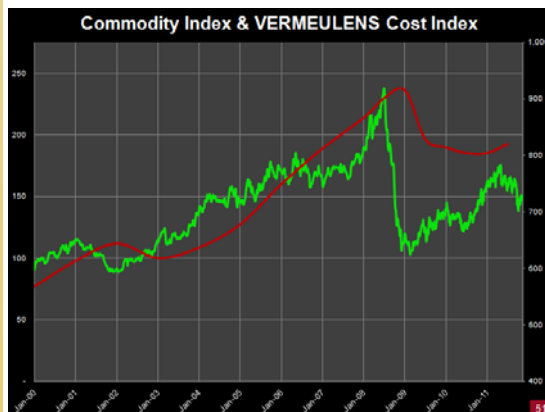
- Market uncertainty may be stalling further growth



THE NYSE IS A STRONG PREDICTOR of construction costs. The reason for the correlation is that improving equity markets provide capital and investment spending. From the peak in November 2007 the equity markets fell by 58% to their bottom in March 2009. Since that time equity markets increased by 92% but have since fallen off another 15%. Markets have been moving 'sideways' throughout 2011 due to uncertainty with debt levels, default concerns and minimal growth in the jobs market. If markets return to growth this will lead to increased construction volume and consequently support for construction prices.

<http://finance.yahoo.com/q/hp?s=%5ENYA>

- Commodities have appreciated by 45% and are approaching a supply/demand equilibrium.

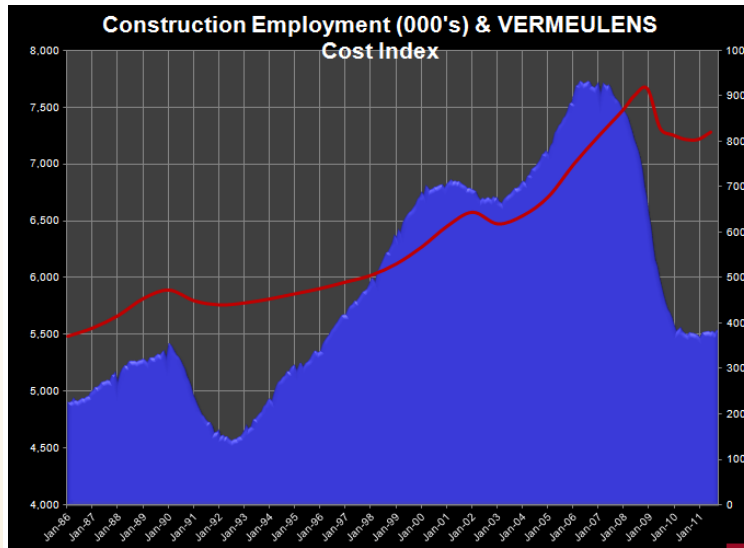


COMMODITY PRICES are an indicator but not necessarily a predictor of construction prices. These prices can lag or lead construction volumes in the North American market depending on world demand. The story on commodities will continue to be dictated by Asian demand, supply streams created by strong price levels and regulatory responses to energy supply and security issues. The energy story is particularly important as energy underpins all economic activity. Technical advances and peak oil will continue to do a dance for some time until significant "unconventional" supplies and efficiency reductions to demand come on stream.

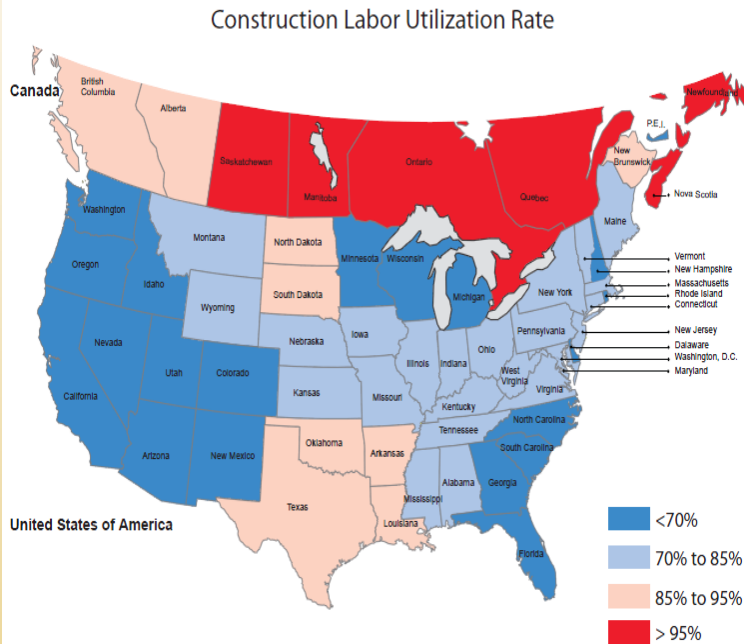
<http://finance.yahoo.com/q/hp?s=%5EDJCI>

Labor Market

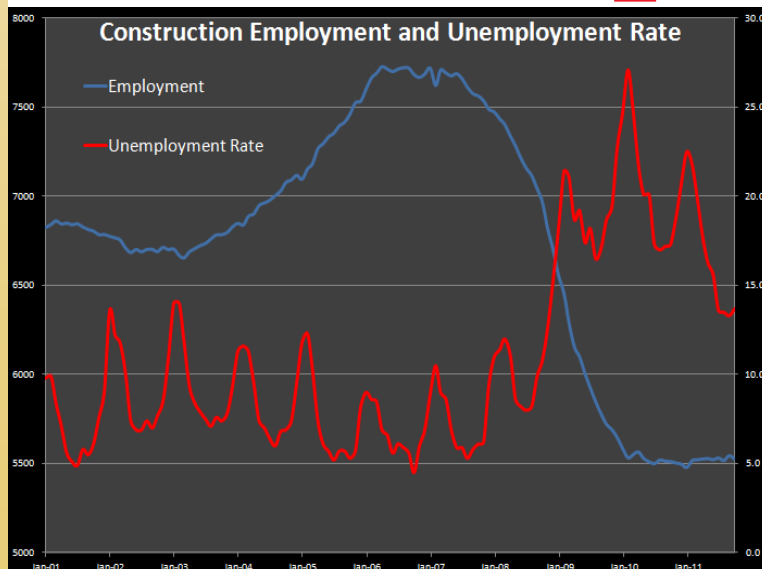
- Construction employment has fallen by 29% or 2.3M workers



US bureau of labor statistics Series Id: CES2000000001



- There will be enough labor capacity to support non-inflationary growth for some time.



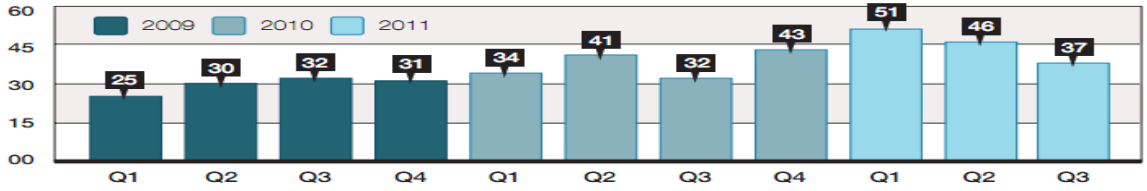
CONSTRUCTION EMPLOYMENT PEAKED understandably at the same time as construction put in place (March 2006). However, the sharp downward decline in employment did not occur until approximately 12 months later. From the peak, construction employment has fallen by 29% or by 2.3M workers. With such substantial layoffs the remaining workers are generally the most experienced and productive resulting in improved productivity and consequently lower costs to suppliers. Improved productivity has offset annual labor wage increases. As we move back towards increased construction volume there is substantial capacity for the market to grow without labor shortages. However, the non-inflationary level of employment will reset to a lower amount as workers will leave the construction labor market. CONSTRUCTION LABOR UTILIZATION RATE (Chart Left) is calculated by taking the ratio of current construction employment to the peak construction employment. Generally, a utilization rate of greater than 85% will begin to put upward pressure on construction labor costs. As you can see from the chart on the left, the majority of U.S. states are well below their peak levels of employment. However, it is important to note that several states are entering the “warm” zones which may begin to put upward pressure on labor rates. CONSTRUCTION UNEMPLOYMENT (bottom chart) in the US has been on its seasonal downward swing however the winter months will turn this trend around to increased rates. Expect the labor force to continue to shrink. This should bring unemployment into the 10-15% band in the next 12 to 24 months. Unemployment seasonally fluctuating between 5% - 10% will tend to put upward pressure on labor costs. (2004-2007) A range of 15% - 25% will put downward pressure on labor rates (2008-Current). A range of 10% - 15% is considered stable. Most regions are still in the downward pressure range however as seen with unemployment rates and the labor utilization charts we have been moving to the intermediate zone.

Confidence Index

ENR'S CICI (CONSTRUCTION INDUSTRY CONFIDENCE INDEX) continues to decline and is now at a level of 37, down 9 from Q2. The index measures executive sentiment. It is obvious that sentiment has improved since 2009 however the recent decline is of concern. Only 9% of the survey respondents feel that the economy is improving and 52% believe that it is declining.

- 52% of respondents feel the market is declining. An increase from 27% in Q2.

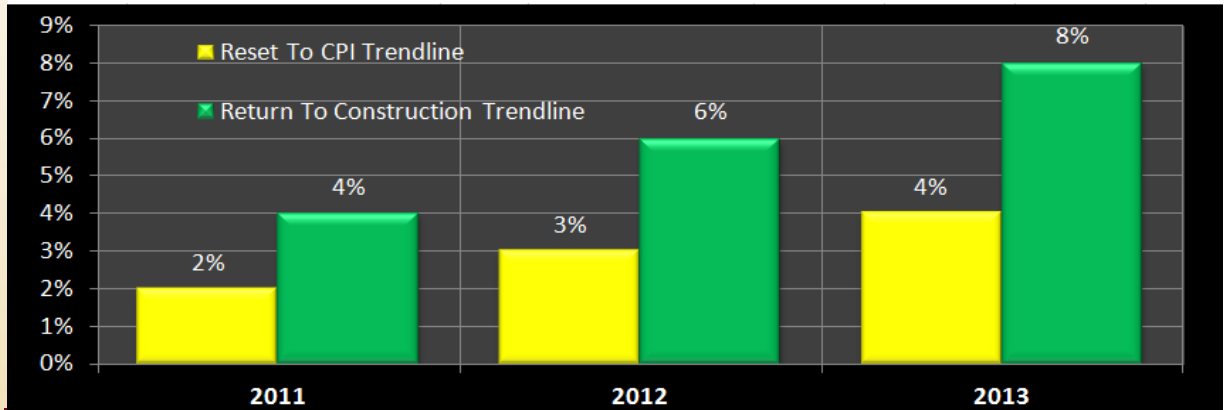
Quarterly Cost Report Confidence Index



SOURCE: MCGRAW-HILL CONSTRUCTION ANALYTICS / ENR.

Forecast

Construction prices are firming and have begun to increase. With the current labor market capacity and continued lows in construction volume being put in place it is Vermeulens' opinion that construction cost will escalate closer to the CPI Trend Line rather than the historic Construction Trend Line for the medium term.



- 2011: 2%-4%
- 2012: 3%-6%
- 2013: 4%-8%

Vermeulens Update

NEW OFFICE! -CALIFORNIA



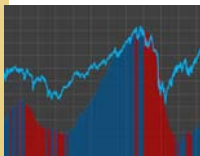
Vermeulens is proud to announce the opening of our NEW LOCATION in California. Our new office is managed by Richard Vermeulen and is located at:

Howard Hughes Center
6080 Center Drive, 6th Floor
Los Angeles, CA 90045

VERMEULENS BLOG

Go to <http://vermeulens.posterous.com> for more wide-ranging analysis of current economic trends and issues. Blog's since our last edition: Debt Ceiling

RECONCILIATION TRACKER



Stay in tune with the market and have Vermeulens present the latest construction economics live in your office while earning an AIA credit. Please contact Marisol Serrao to schedule a date: mserrao@vermeulens.com 617-273-8430

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