The Barron Report

January 17, 2022

2022 Forecast for Construction and Real Estate

"Understanding and monitoring these and more variables will help us remain firm in our plans, but flexible in our execution."

Once giving a lecture to MBA students, I was asked what the biggest challenge was in owning my own business.

My response: ***"Predictions!"***

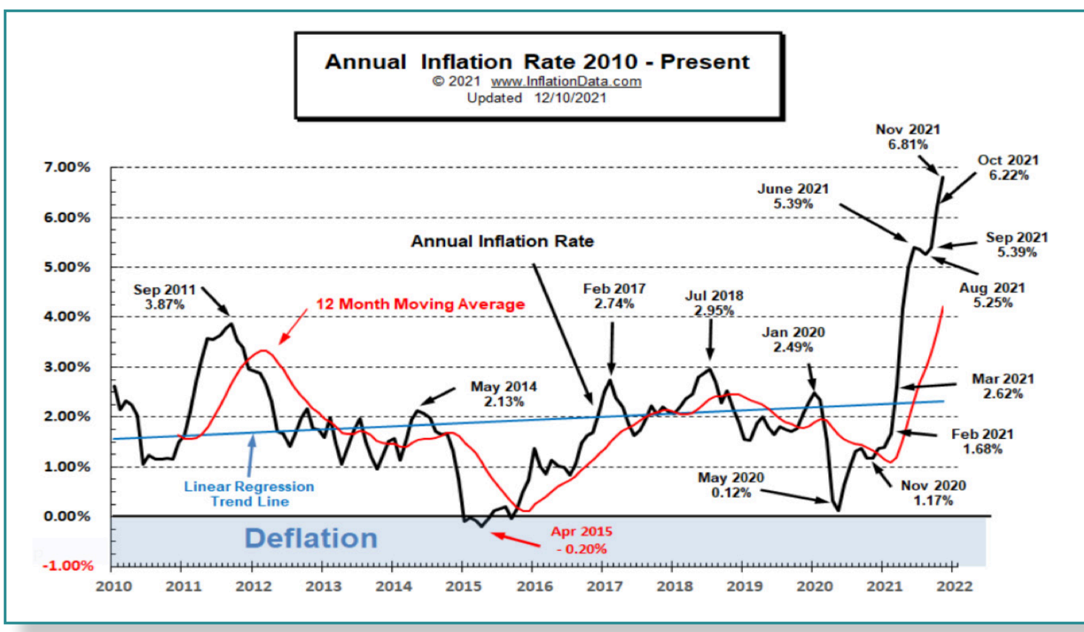
However daunting, predicting what's ahead is especially important as we all develop strategic business plans. For our Barron companies, the first step to properly plan for all our business silos is to educate ourselves by compiling and analyzing all available data and trends.

I'd like to share some information I've gathered I believe will be critical in formulating ideas and strategies to create and preserve value in the coming construction and real estate development markets.

The necessary disclaimer, of course, is we are in volatile times: increasing inflation, Covid-induced supply-chain and labor constriction, unstable geo-political disturbance. Understanding and monitoring these and more variables will help us remain **firm in our plans, but flexible in our execution.**

Inflation: An Unvoted "Tax"

Our prediction analysis begins with a quick graph of the most recent indices of inflationary figures:



As indicated, the most recent trailing inflation figures are topping 6.8% and by all calculations, have trailed higher as 2021 came to a close.

Inflation is something like this:

"If I serve a cup of black coffee and then start pouring clear hot water in your coffee to dilute it, and if your objective in drinking the coffee is the caffeine it contains, then you're going to have to drink a lot more coffee to get the same amount of caffeine.

As we have more money printed and injected into the monetary system for circulation, the result is a fall in its value and a rise in prices.

The same thing happens with our money. As we have more money printed and injected into the monetary system for circulation, the result is a fall in its value and a rise in prices".

To place this into perspective, if you are fortunate enough to have $1,000,000 parked in cash or cash equivalent vehicles (CD's, Bonds, Treasuries), and if the present figures remain static (7%), $1,000,000 today will be worth $932,000 this time next year. This is actually a staggering loss of purchasing power, **the WORST in 40 years!**

$1,000,000 in 2021 cash will be worth only $932,000 by end of 2022 if inflation continues at its current pace.

When Congress votes to inject more money (pump priming), into the monetary system for circulation without the willingness of the people to be taxed, inflation naturally occurs because we still have the need for the same amount of caffeine.

Inflation is a tax – we don't vote for it, but in the end, we all pay for it.

Trends and Predictions for 2022

Lumber

Trading in lumber in 2021 was similar to the volatility we saw in trading crypto currencies. Despite the extreme ups- and-downs for prices, lumber ended last year with a gain of nearly 32%. Lumber futures climbed to a record $1,670 per 1,000 BF on May 7, 2021, then promptly bottomed on August 20 to $448/1,000 BF. They again rebounded to end the year around $1,100/1,000 BF. Presently, spot prices have trended up to around $1,280/1,000 BF as of this writing.

As you can see from the chart below, the expectation is lumber to be trading from $1,017/1000 BF to $1,427 during 2022.

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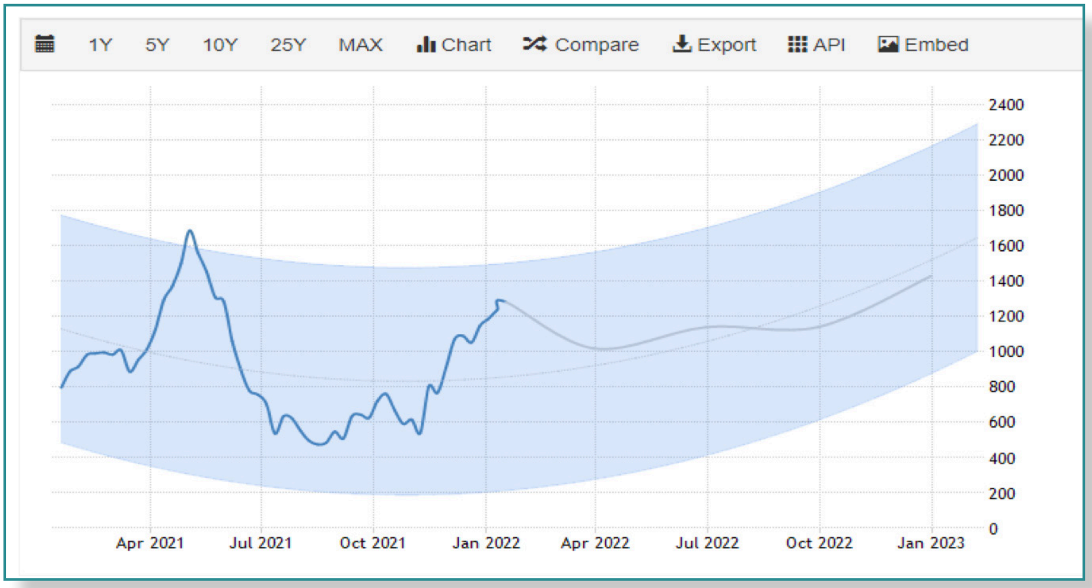

Simply stated, there will be some reduction in BF price through the first quarter of 2022 then a gradual rise, stabilizing around the $1,400/1,000 BF price.

Structural Steel

Fabricated Structural Iron and Metal Bar Joists, the material most specified for commercial projects outside of lumber and concrete saw a wild ride through 2021. As indicated by the chart below, Structural Steel took a 25-30% increase year-over-year. Although certainly impacted by supply-chain logistics with much of the raw material coming from China, demand also contributed to the increase as well as the Pandemic related impact to production to fill the demand. Non-Residential construction is not expected to stay at the same pace in 2022 as 2021 so demand will wane slightly, but it will take through 2022 for prices to stabilize given the supply chain issues will play catch-up. Don't anticipate delay to see if the prices will constrict. You may be waiting a very long time.

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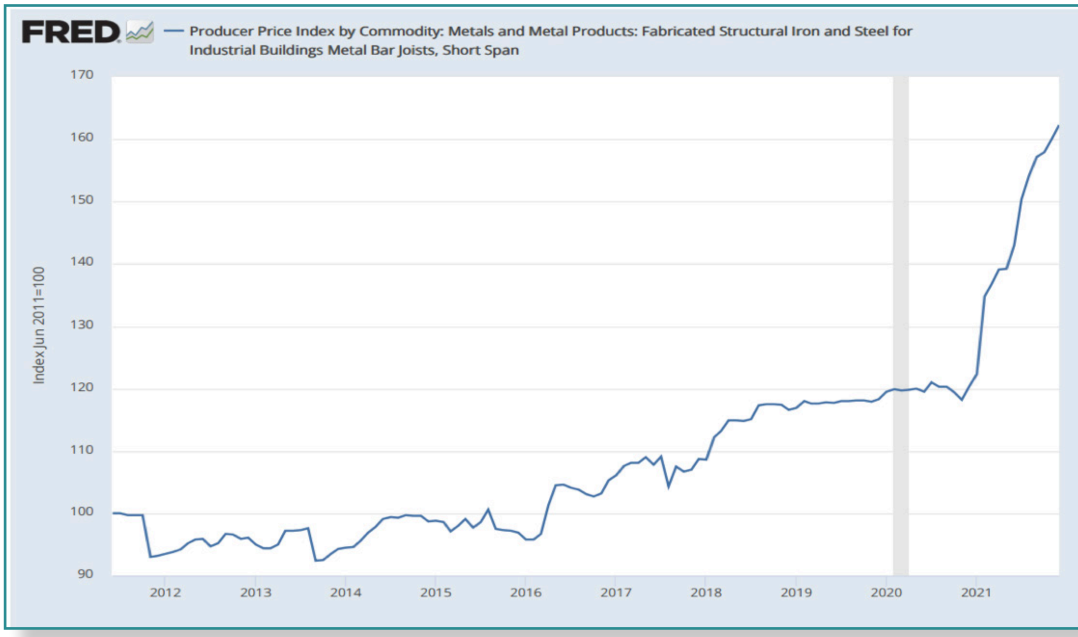


Shipping

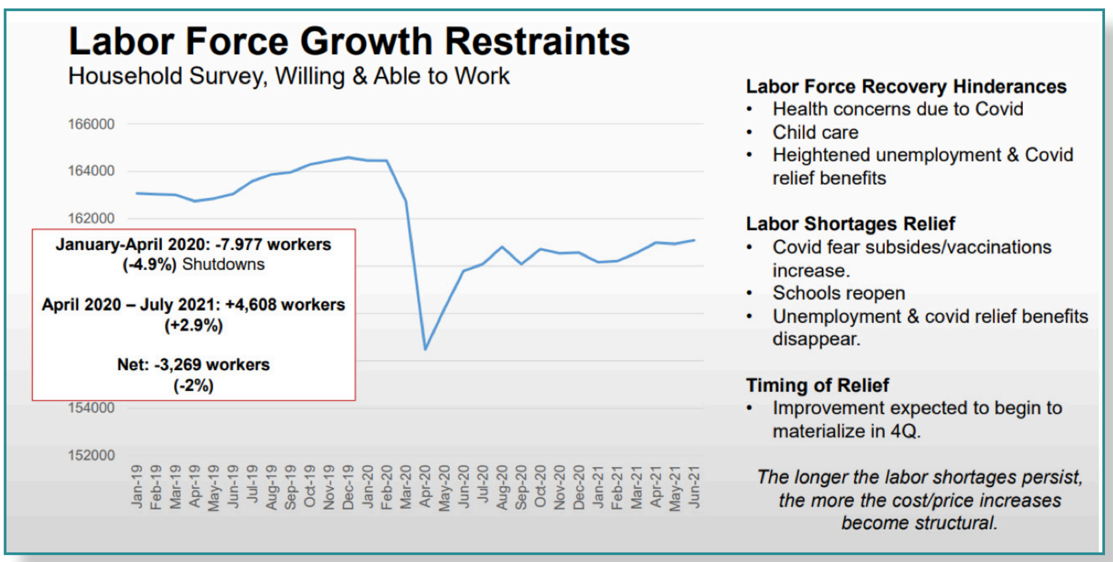
Unless you have been hiding under a rock, the negative effects of supply have been felt at every level. Most Americans have come to use the word "supply chain" naturally and understand it means **delay!** According to the Drewry World Container Index (WCI), "The global supply chain is a fragile system consisting of numerous links that need to function properly for the whole system to work. The COVID-19 pandemic proved to be a disruption of such proportions to either bring to halt whole industries and supply chains, or severely reduce their efficiency. Container shipping, with its complexity and transcontinental nature, was especially affected by the COVID-19 pandemic. Various events, such as port closures due to outbreaks, port congestions, shortages of labor, as well as lack of new shipping containers, have made the business difficult and unpredictable. Moreover, shipping costs from Asia to the United States has increased by about 40% in 2021 compared to YOY 2020. This is staggering considering the exports stayed roughly the same. Carriers have not been able to fully utilize their capacity (their round-trip balance), to meet the demand which has driven the freight rates to record levels."

“...a survey of Port Managers expects port strains to continue well into 2022 and persist until the second half of next year.”

This disparity from import to export (trade imbalance), along with the challenges of labor at ports has actually allowed freight carriers to increase their profit margins by 8.5% from 2020 due to cargo being held off-shore for extended periods. Freight from Asia to Los Angeles alone has increased 9 times YOY for a 40’ Container from $1,633 to an average of $9,800. These additional profits have allowed some carriers to increase their carrying capacity by buying new containers and ships, but it takes 18 months to build a container ship so these effects won’t be abated until 2023. The result is that any imported goods will continue to see a disruption in supply-chain until this disparity can be righted. Schedules will continue to feel the affect of items being delayed and the cost of these goods will carry the added burden of increased shipping costs until supply catches up with demand. According to the WCI, a survey of Port Managers expects port strains to continue well into 2022 and persist until the second half of 2023. This disruption will continue to affect delivery, which pushes out schedules, which translates to increased cost to complete prices.

Labor

“Able but unwilling to work” emerged as the dubious mystery trend of 2021. Some science can be applied to this mystery according to following graph by the U.S. Chamber of Commerce:



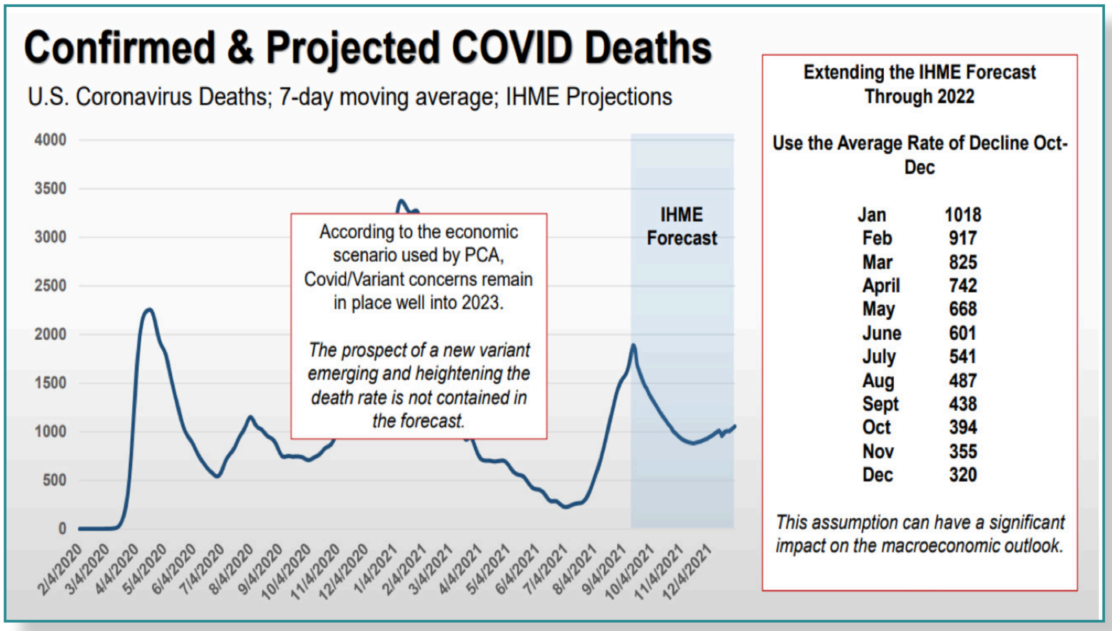
“Able but unwilling to work” emerged as the dubious mystery trend of 2021.

Labor markets remain tight for many reasons but will start to unwind in the second and third quarter of 2022, given another variant doesn’t disrupt global economics as Omicron did in 2021.

According to the U.S. Chamber of Commerce, the hindrances of going back to work have mostly been tied to:

1. Health Concerns
2. Child Care Concerns
3. Covid Relief Benefits (Financial Cushion for many)
4. School Closures

According to the IHME (Institute for Health Metrics and Evaluation), the extended forecast through 2022 shows a continual decline in COVID related deaths through December of 2022 as shown by the following graph (without of course the invasion of a new variant):



“... the Labor market will begin to stabilize after the second quarter of 2022 as we approach the Spring months.”

With increased pressure of structural inflation (currently at over 7%), eroding purchasing power for families, the stimulus of COVID-19 relief disappearing and the renewed security of external child-care and re-opening of schools, the Labor market will begin to stabilize after the second quarter of 2022 as we approach the Spring months. This of course will take time as the able-but-unwilling will start to return to the workforce.

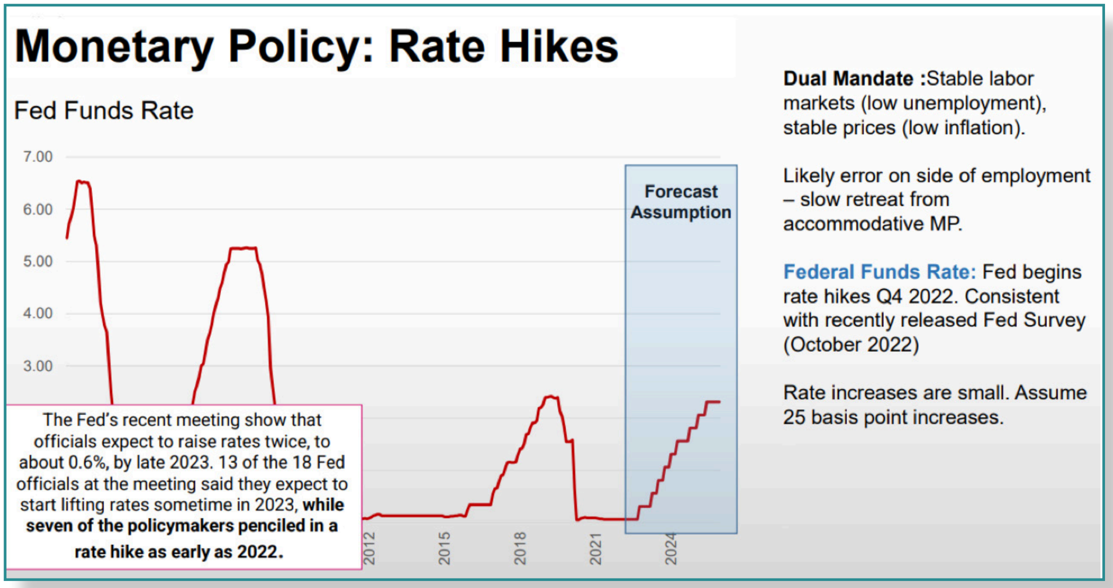
Inflation, Interest Rates and Real Estate Development

For those of us in the business of Construction and Real Estate Development, Investors say that our sector is a primary hedge against inflation because it tends to rise with inflation. For those that are starting developments in the first two quarters of 2022, the majority of future costs are tied to those items that are adjusted for inflation such as Portland cement, lumber and structural steel. On one hand, real estate is certainly a great hedge historically against inflation, but it is important to also adequately predict the impact of the future development cost that will ultimately drive the final cost and subsequent cost to lease and occupy to achieve the expected ROI. When developing with this in mind, it stands to reason that lease rates will have to rise to accommodate the cost of goods to produce the same product and achieve the same desired return, we still need the same amount of caffene!

Additionally, there will be pressure on the Feds to raise rates to cool inflation, which will ultimately increase the cost of funds to service the debt. Although the incremental increase will be slow, expect several rate hikes by the Fed in 2022 and beyond which will increase slightly the cost of borrowing funds and increase the cost to produce materials.

According to generally held beliefs by most economists, rates will inch up through 2024 to continue to cool inflation. The following graph by Ed Sullivan, Chief Economist of Portland Cement Manufacturers, shows the anticipated rate hikes:

"Millennials are ending their leases, moving out and buying houses in larger numbers."



Although these rate hikes will be slow, banks will undoubtedly tighten lending requirements during the adjustment period and will be more resistant to lengthen terms due to their own risk adjusted forecasts to maintain profitability.

Commercial leases will be more prone to include either CPI adjustments or solid percentage bumps to mitigate the erosion of the ROI over the term. Expect commercial construction to feel the adjustment and softness will start to occur from the fourth quarter of 2022 through 2024.

The residential development market will fare much better given that housing demand still out strips supply, according to most economists. Buyers will continue to absorb the thin supply through 2024. According to Forbes, the Millennials are leading this charge. "Millennials are ending their leases, moving out and buying houses in larger numbers. In fact, they make up the fastest-growing segment of buyers today, according to recent National Association of Realtors report. Particularly those in their late 20's to 30's are pushing this segment along the most. A Pew Research study found that household income rates of this group were two to four times higher than that of other age groups".

Although land-to-home developments will remain robust, expect development and construction costs to rise through 2022 because of inflation pressure on materials, the increased borrowing costs and the labor lag for those able-but-unwilling to move back into the workforce.

In Summary

- Inflation has risen north of 6.8% through 11/2021 and will trend higher into 2022
- With static inflation in 2022, $1,000,000 in cash equivalents today will be worth $932,000 this time next year and erode purchasing power
- Real Estate as well as real assets are a historical hedge against inflation since their intrinsic value floats with inflation
- Hard development costs will increase more in 2022 as will labor costs as inflation remains static, supply-chain logistics struggles to meet demand and able-but-unwilling work force is slow to enter the workforce
- Lumber prices will stabilize but remain at or near first quarter 2022 figures
- Structural Steel prices will remain stable during 2022 but at their present 30% increase over early 2021
- The Fed will incrementally raise rates .025 per quarter over the course of 2022 and taper their repurchasing of bonds
- Commercial Income properties will insist on more CPI or equivelant adjusted rates as the erosion of inflation reduces the purchasing power of static leases
- Single Family housing starts will remain static through 2023-2024 as Millennials continue to move into home ownership in the suburbs but not at the same pace as 2019-2020
- Land-to-home developments will continue to be aggressive but will see infrastructure and development costs increase through 2022 due to inflationary price increases and the labor shortage affects development costs

I hope that sharing this information and analysis helps us all be better equipped to plan for and stay nimble in the coming year. I'd love to hear your thoughts and any additional input. Email me at greg@barronstark.com.

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Greg Barron is the CEO of The Barron Companies, Inc. of Fort Worth, Texas. The Barron Companies has interests in Engineering, Construction, Real Estate Development and Commercial Facility Services. His companies operate in sixteen states and three offices. Greg is a graduate of Harvard Business School and The University of Texas-Arlington. He has served on Advisory and Public Boards in sectors including Banking, Construction and Secondary Education.