PCA Portland Cement Association
THE Monitor Flash Report
Breaking Analysis of the Economy, Construction and Cement Industries
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Residential Outlook: Upside Risks?

Overview

Through 2009, cement volumes declined 54 million metric tons (MMT) from peak 2005 levels. Of this, roughly 30 MMT, or 55%, is attributed to the collapse in residential construction activity. The 79% decline in single family starts activity that transpired during 2005-2009 accounts for 87% of the decline in residential cement consumption with the remainder accrued to declines in multifamily starts as well as home repair and improvements.

PCA believes the residential sector's adverse impact on cement consumption has run its course. A saddle point in residential construction activity and cement consumption is expected to characterize the first half of 2010. Tepid increases in residential construction activity are expected to materialize during the latter half of 2010 with more substantive gains expected in 2011 and beyond.

PCA's fall forecast projects a 14.4% increase in housing starts during 2010 compared to extremely depressed 2009 levels. This reflects a 20% increase in single family starts and a 5.7% decline in multifamily starts compared to 2009 levels. These projections lie well below the consensus of construction economists' expectations.

If the consensus is correct, there is the potential of upside risk to our fall projections for housing starts activity and cement consumption. Consensus averages for single and multifamily starts compared against PCA projections imply the potential upside risk of 1.8 MMT in 2010 and 1.5 MMT in 2011.

While PCA's fall forecast may contain upside risk in residential cement consumption, there is reason to believe that the risks are much less than suggested by the consensus estimates. At issue is the timing of the recovery. PCA's continues to believe that several significant hindrances specific to the housing sector will remain in play throughout 2010 leading to a delay and more muted improvement in the residential sector compared to the consensus averages. In our view, it is likely that 2011 will be characterized by a dynamic recovery in residential.

Upside Risks to Cement Outlook

	2010	2011
Total Housing Starts		
PCA	14.4%	48.4%
National Association of Homebuilders	25.6%	49.4%
National Association of Realtors	37.3%	40.0%
Mortgage Bankers Association	33.4%	38.0%
Potential Upside Risk to Cement Consumption (Tons)*	**1,796,000**	**1,541,300**
Single Family Starts		
PCA	20.0%	54.3%
National Association of Homebuilders	37.7%	46.1%
National Association of Realtors	39.9%	35.1%
Mortgage Bankers Association	37.8%	37.9%
Potential Upside Risk to Cement Consumption (Tons)*	**1,760,000**	**1,176,500**
Multi Family Starts		
PCA	-5.7%	21.7%
National Association of Homebuilders	-22.3%	72.4%
National Association of Realtors	25.9%	62.4%
Mortgage Bankers Association	16.5%	38.1%
Potential Upside Risk to Cement Consumption (Tons)*	**36,000**	**364,800**

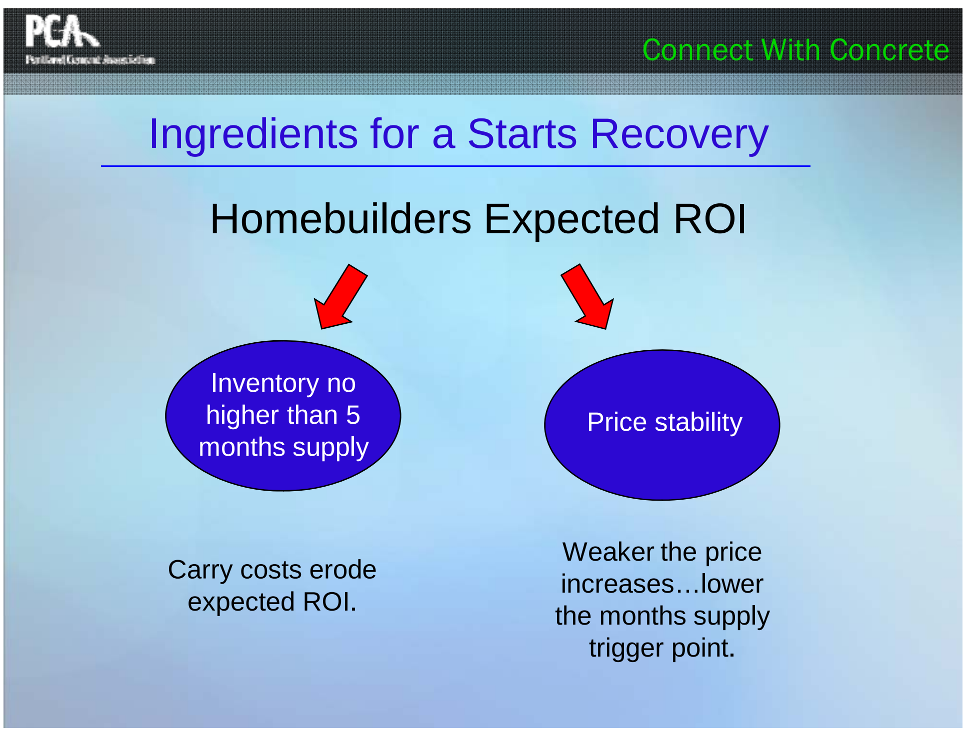
* Compares PCA volume projections against consensus average and applies relevant cement intensity.
Note: PCA forecast performed 10/2009, NAHB 12/2009, NAR 01/2010, MBA 12/2009

Conditions Required for a Broad Based Recovery in Single Family Construction

Homebuilders are unlikely to accelerate construction activity until two critical conditions are met including: (1) low levels in inventory of unsold new homes reflecting no higher than five months supply, and (2) stable or rising home prices. Both conditions are likely to be required to insure an adequate ROI for homebuilders to increase building activity. Lacking either condition a substantive recovery in home building will not materialize.

Unfortunately, the single family housing market is characterized by excess new home inventories. Nationally, new home inventories stand at 235,000 units, or roughly 7.9 months' supply. Assuming five months desired supply implies an 87,000 excess inventory position that must be burned off – roughly one out of every three new homes on the market.

In addition, according to the National Association of Realtors, new home prices stand nearly 24% below October 2005 peak levels. Year-over-year November 2009 prices are down 4.8% compared to 2008 levels. More importantly, however, month-over-month price changes have recorded sporadic small gains/losses during the past six months – suggesting that new home prices may be nearing a turning point. This firming, however, has materialized in the context of federal homebuyer support programs as well as private and public foreclosure moratoriums – neither of these can necessarily be counted on to insure sustained price increases.

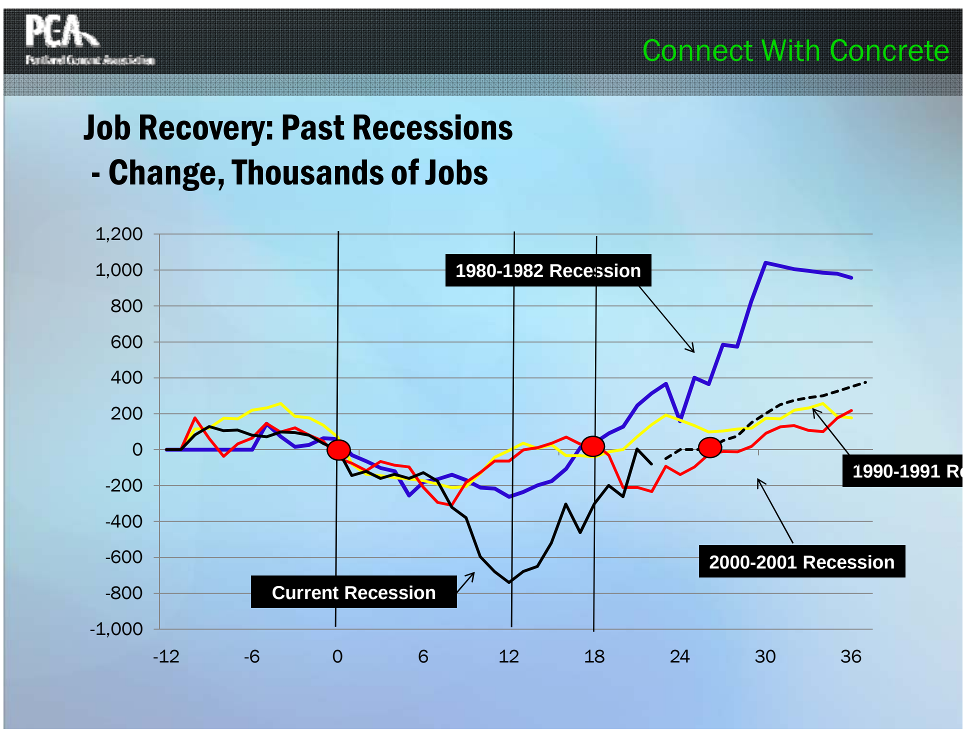


Reasons Why a Delayed Recovery in Single Family May Materialize

At this point in time, neither of the conditions required to drive an increase in single family construction are in place. A reduction in new home inventories and stabilization in new home prices must occur in a near-term environment currently characterized by weak economic growth, high unemployment, likely increases in foreclosure activity, fire sale pricing of bank possessed properties (which acts as a depressant on new home pricing) and the continuation of tight lending standards. Combined, this environment is hostile to any significant near term improvement in the fundamentals leading to an increase in starts activity. Present conditions do not signal an imminent acceleration in single family starts activity. The issue becomes when will future conditions improve to justify acceleration. Consider the following PCA assessments in determining the turning point in single family construction activity.

Point 1. Weak labor markets will hinder a significant and sustained increase in 2010 new home building.

The recovery in the U.S. housing market cannot be sustained without stabilization in labor markets and job creation. Stabilization of labor markets is ***the*** critical ingredient that eventually leads to an improvement in the underlying fundamentals for residential activity including homeowner affordability, foreclosure activity, lending risk and standards as well as willingness to buy. Without a sustained improvement in labor market conditions, it is unlikely that any notable increase in sales activity will materialize.



PCA's expects job losses will stop in the first quarter of 2010, followed by a saddle point quarter characterized by minor monthly losses/gains essentially leaving quarterly job losses at zero. Early in the third quarter, job gains are expected to materialize followed by successive strengthening in labor markets. This period of strengthening yields between 350,000 to 500,000 new jobs created in 2010.

Point 2. Homebuyer tax credits may result in a payback in sales during the second half of 2010 – moderating perceived momentum.

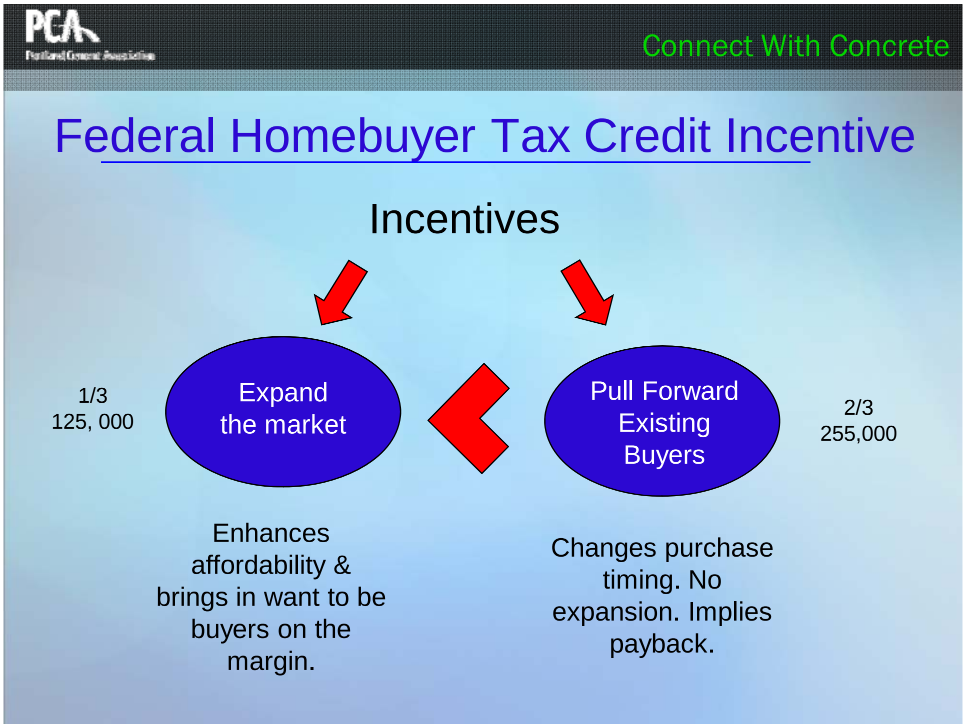
Late 2009 housing data such as the accelerated sales pace and resulting reduction in months' supply of inventory has provided much optimism for the housing industry. No doubt, the economic fundamentals were less adverse in these months than earlier in the year and therefore support a firming in the sales pace. The accelerated sales pace that materialized during the 4^{th} quarter of 2009, however, may owe a substantial amount of credit to the homebuyer tax credit and its originally planned expiration in November. During the three months leading up to the expiration of the program, home sales averaged more than a 5.3 million seasonally adjusted annual rate (SAAR) – roughly 17% higher than the 2009 pace preceding that period. Tax credits work. Tax credits work best when there is an urgency to act before the deal expires.

The lessons learned from the automotive industry and its sales incentive activity (0% financing, etc.) is that they work in two ways to encourage sales. First, they result in sales that never would have materialized without the incentives. Second, they accelerate the sales timing (pull forward) that realistically would have been expected in the months ahead. Typically, the latter had a far larger impact in stimulating period sales. Once the incentives expired and lacking the future buyers (pulled forward), automotive sales typically experienced a lull, referred as the payback period. There is no reason to believe that automotive manufacturer rebates and housing tax credits will have a significantly different impact on consumer spending habits.

NAHB calculates that the 2009 tax credit increased home sales by 200,000 units. The extension and expansion of the homebuyers' tax credit through mid-2010 will again prop-up home sales activity. On this account, NAHB expects the second round of tax credits will increase 2010 sales by roughly 180,000 units. Indeed, the selling pace for homes will probably accelerate by April – three months before the expiration of the new round of tax credits.

The expected payback from the first round will be muted due to extension of tax credits during the first quarter. Sales will again accelerate in the second quarter as the credits are scheduled to expire. Months' supply of inventory will be reduced. Then what? Payback.

All of the improvement in sales and inventory conditions as well as the resulting optimism could be premature. Incentive activity largely works by pulling future sales – not by expanding the market. Pulling forward future buyers could imply moderation or potentially an outright decline in the sales pace after the tax credits expire. Whether the home sales pace moderates or declines depends upon the strength of the policy-free market environment. In our view, at the time of the second round of tax credits expiration, job creation will only have begun and initially at tepid rates. At the minimum, this suggests a second half 2010 pause in sales activity – not a continued acceleration.



Point 3. Foreclosure activity is likely to accelerate during the first half of 2010 - adding to inventories.

During August-November 2009, foreclosure activity showed successive month-over-month improvement. Trial loan modifications, private and public foreclosure moratoriums, home price firming and an improvement in labor market conditions probably played key roles in the improvement in foreclosure activity. In any case, the successive months of foreclosure improvement prompted many to suggest continued and sustained improvement through 2010 – and essentially diminishing this potential adverse impact on housing.

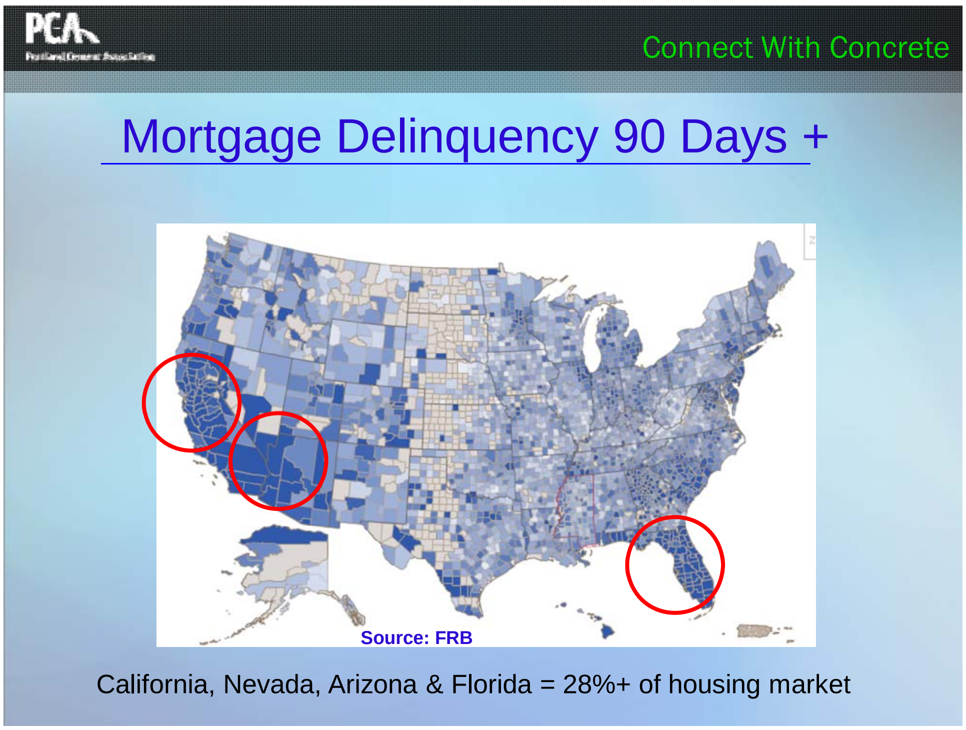
PCA expects foreclosure activity is likely to increase during the first half of 2010. This assessment is based on three key factors including labor market conditions, the end of foreclosure moratoriums work through of bank backlogs, and a continuation of weak home price conditions.

Weak labor markets: Foreclosure activity is highly correlated to employment conditions. When all is totaled, more than 7.5 million jobs are expected to be lost during the recession that began in December 2007. Net job creation is not expected to materialize until the third quarter of 2010. Even then the job gains will be modest. By the fourth quarter more substantive job gains and an overall firming of the labor market will ***begin*** to materialize. Until then, labor market conditions will continue to exert upward pressure on foreclosure rates.

Moratoriums and backlogs: Compared to 2009 levels, private and public foreclosure moratoriums are expected to be greatly reduced or completely eliminated by the second half of 2010. While many foreclosure moratoriums ended mid-2009, huge foreclosure backlogs were generated. Indeed, delays in processing the huge backlog of delinquent loans may be a partial factor in the improvement in foreclosure rates experienced in 2009. A massive supply of delinquent loans continues to loom over the housing market, and many of those delinquencies will end up in the foreclosure process in 2010 and beyond as lenders gradually work their way through the backlog.

Home prices: According to the National Association of Realtors new home prices stand nearly 24% below October 2005 peak levels. In many instances the mortgage value now exceeds the prevailing home value. This phenomenon is referred to as "homeowners being underwater." According to some reports, roughly one quarter of home loans are underwater. People with such loans have less incentive to keep making mortgage payments.

Month-over-month price changes have recorded sporadic small gains/losses during the past six months – suggesting that new home prices may be nearing a turning point. This firming, however, has materialized in the context of federal homebuyer support programs as well as private and public foreclosure moratoriums – neither of these can necessarily be counted upon to insure sustained price increases.



Point 4. Increases in bank possessed properties will hinder an improvement in new home prices.

According to Realty Trac, during 2008 banks took possession of roughly 36% of the 2.3 million homes in the foreclosure process. During 2009, due to moratoriums and resulting processing backlogs, less than 31% of the 2.8 million homes foreclosed ended up in bank possession. This represents roughly 27% of current existing home inventory – up from 22% during 2008. By this measure, bank possessed properties account for 1.5 to 2.0 days supply at current selling rates.

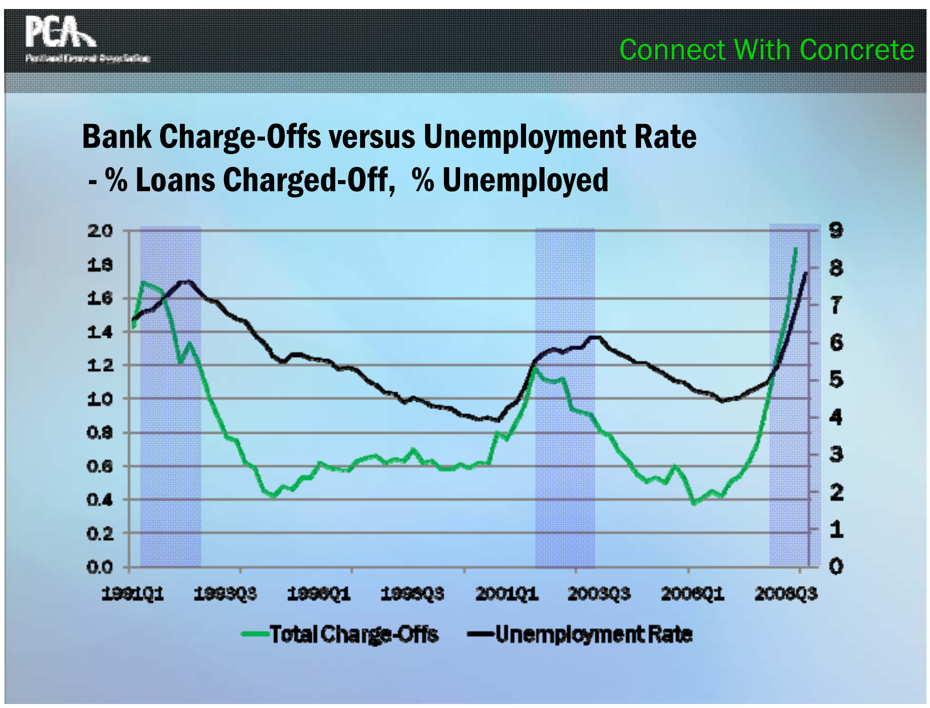
It is likely that the bank possession rate per foreclosure will exceed depressed 2009 levels and probably even 2008 levels. Compared to 2008 levels, the depressed 2009 bank possession rate resulted in

175,000 to 200,000 fewer properties taken by banks. As banks catch up and work through the backlogs generated by moratoriums, the possession rate will increase. PCA expects the rate will range between 36% to 42%. This implies roughly 1.3 million additional homes will be held by banks during 2010, compared to 871,086 in 2009.

Banks are not in the realty business – they are in finance. Banks offer substantial discounts below prevailing market prices to remove the financial liabilities of possessed homes from their books. These homes, some nearly new, compete directly with new homes for the homebuyer – putting downward pressure on new home prices. The potential of increased foreclosure activity and higher bank possession rates during 2010 suggests that the downward price pressures arising from bank possessed properties may accelerate during the first half of 2010.

Point 5. Lending conditions are likely to remain a hindrance during much of 2010.

The subprime crisis and resulting bank charge-offs reduced capital available for lending and restricted access to capital due to bank aversion toward risk. The critical issue facing the economy is not the level of capital available, but rather the access to the capital by business and consumers. It is likely that banks' ***aversion toward risk*** will diminish only after charge-offs for loans show a sustained pattern of decline. Unfortunately, loan charge-offs are expected to accelerate as unemployment increases. PCA expects



an easing in lending standards will begin to materialize roughly six to nine months after labor markets stabilize. Stabilization in the labor markets implies less risk in borrowers' ability to pay back loans, but also should lead to a reduction in loan charge-offs and hence risk aversion. By then job creation should be well underway and home prices stabilized – reducing the actual risk in lending.

Point 6. Trigger points may be delayed – suggesting less upside risk compared to consensus.

There is new optimism regarding housing starts for 2010. Clearly, PCA has pessimistic assessments compared to the cautious optimism of other construction forecasters. Upon review of the structural factors that will bring about a strong recovery in housing (percentage gains), there may be reason to lean against the wind of consensus.

Despite recent data evidence regarding increased sales activity, foreclosure improvement and inventory reduction, the environment for a sustained improvement in single family starts activity, representing the bulk of residential cement consumption, may not be as positive as it seems.

Homebuilders are unlikely to accelerate construction activity until two critical conditions are met including; (1) low levels in inventory of unsold new homes reflecting no higher than five months supply, and (2) stable or rising home prices. Both conditions are likely to be required to insure an adequate ROI for homebuilders to spur an increase in building activity. Lacking either condition a substantive recovery in home building will not materialize.

These conditions may not materialize as quickly as expected. Federal tax credit programs may have artificially inflated the recent improvement in home sales. There is the potential for a significant sales payback during the second half of 2010. Job growth may be slow to materialize and may not be able to shoulder an acceleration in sales during the second half of the year. An easing in lending standards is unlikely to materialize soon and overall financing conditions, including interest rates, may become more adverse as the fed backs out of these financial markets. Combined, these factors are strong concerns that could weigh against a sustained strong increase in sales activity that is required to burn down inventories and firm housing prices.

It is also likely that foreclosure activity may accelerate during 2010. This, combined with increased bank possession rates suggests the potential significant addition to existing inventories. The combined increase in properties for sale and bank possessed discounted properties could forestall home price gains.

Compared to consensus, the potential for slower than expected sales, higher than expected inventories and a weaker than expected pricing environment suggest the potential for a delay in homebuilders reaching the trigger point signal to accelerate single family home building.