CONSTRUCTION NATIONAL OUTLOOK

Economic data from August and September painted a picture of a U.S. economy that remains stuck in a slow-growth cycle, but which is strong relative to its primary global partners. Job creation remains solid given the duration of the business cycle; and related data on wage growth and household incomes suggest that U.S. consumers have less to be concerned about today than even two years ago. Activity by business continues to weaken – albeit slightly – as a strong U.S. dollar, political uncertainty and weak global demand are sources of worry.

Labor markets remain the best source of optimism about the economy. Employment grew by 156,000 jobs in September, according to the October 7 report from the Bureau of Labor Statistics. After revisions were made to July and August job creation estimates, the September data meant that the monthly job additions during the third quarter averaged 191,000 – higher than the average of 171,000 for the full year to date.

As important as the jobs gained were the increase in average workers wages, which were up 2.6 percent year-over-year. Labor force participation also improved, with 444,000 more people entering the workforce. The average hours worked also jumped during the quarter. The September report showed a continuation of the upward trend in professional services and healthcare jobs, a possible end to the extended job losses in energy and further declines in manufacturing employment.

The extended decline in manufacturing tends to produce the most headlines and hand-wringing. Output in the U.S. has declined in 13 of the past 17 months. Concerns that the declines are more than cyclical aren't supported by data, however. China surpassed the U.S. as the leading manufacturing economy in 2010 and outpaces American manufacturing by a three-to-two ratio. Output in China is also weaker, with the Caixan Manufacturing PMI rising above 50 (meaning increasing) since July after 16 consecutive months of decline. Slower demand in Russian, China, Brazil and Europe have slowed manufacturing throughout the globe.

Poor economic conditions abroad have further boosted the demand for and value of the U.S. dollar, circumstances that are great for investment in America but challenging for exporting. That's an additional burden on U.S. manufacturers.

Weaker demand for products keeps market pressure on interest rates low. In concert with the Federal Reserve Bank's caution about lifting rates too soon, the lack of inflationary pressure from demand makes it easier for the Fed to stay the course of low rates. Feedback from the most recent meeting of the Federal Open Market Committee (FOMC) suggests that rates will get a minimal bump in December. Members of the Fed remain adamant that the committee's decisions will be driven by data, but the conflicting economic data makes no compelling case in one direction or another; and, ultimately, the low unemployment rate seems to be inconsistent with an environment of near zero interest rates.

While rising rates are often a concern for an economic cycle, the current environment has its own flaws. Low rates are a catalyst for development and construction but they also artificially compress capitalization rates, which lead to overvaluation of properties. Low interest rates also artificially increase demand for stocks and other risky investments, especially those made to boost fixed-income investors. Investments meant to throw off income are typically dependent upon bond yields but those yields are producing insufficient returns in many cases. That pushes demand higher for stocks and other assets not meant for income generation. Such conditions can lead to asset bubbles or sell-offs when rates spike. At the September 21 FOMC meeting, Federal Reserve Bank of Boston President Eric Rosengren voted against waiting further because of concerns about asset inflation. Rosengren commented specifically about commercial real estate when he warned about "potentially increasing financial market imbalances."

On balance, the health of the U.S. economy seems to be supportive of higher interest rates.

In the commercial real estate sector, property values have continued to rise throughout 2016, reaching roughly ten percent above the levels before the Great Recession. Market fundamentals have certainly justified the increase in values, as vacancy rates have fallen and rents increased during the extended slow economic recovery. But there is no question that low interest rates have helped push cap rates down and prices up. Moreover, the shortage of other investments with adequate yield has steered record levels of capital to the commercial real estate market.

Regardless of the direction of rates over the coming 12 to 18 months, the evidence is that those segments with the most potential for overheating – apartments and hotels – are slowing. Likewise, the segments that benefit most directly from a strong labor market – offices, retail and industrial – should see more in rents and occupancy. Nearly all data and forecasts for construction of commercial real estate shows that this sector will outperform the overall industry in 2016.

Construction of multi-family projects has slowed in 2016, according to housing start data released by the Census Bureau on September 20. Starts of apartments slumped 6.9 percent from July to August, bringing the year-to-date activity to slightly above the levels started in 2015; however, permits for multi-family units have fallen by 15 percent compared to the first eight months of 2015. Permits for 256,000 multi-family units were issued through August, versus 251,000 units started. Based upon history, the small variance between permits and starts indicates that little backlog of multi-family projects exists.

The lack of buildable lot inventory continues to hold back single-family construction. Starts for August were down almost six percent from July, to an annualized rate of 1,142,000. Single-family starts were up 0.9 percent over the previous year, however. Permits for single-family homes declined 0.4 percent from July to August and 2.3 percent from August 2015. Completion of single-family homes is expected to reach roughly 750,000 units in 2016. With both slow new construction growth and declining existing home inventory for sale, home prices should appreciate again in 2016 at a faster-than-average clip.

Construction spending held steady at $1.142 trillion in August compared to July but is up nearly 4.9 percent for the first eight months of the year compared to same period in 2015, according to an analysis by the Associated General Contractors of America (AGC). The association expressed concerns that the multi-year expansion in nonresidential construction may be fizzling out without increased investment in highways, sewers and bridges.

"While demand for construction remains robust, it is no longer growing like it was earlier this year," says Ken Simonson, AGC's chief economist. "There is little doubt that new public-sector investments in our aging infrastructure could help reinvigorate demand for construction."

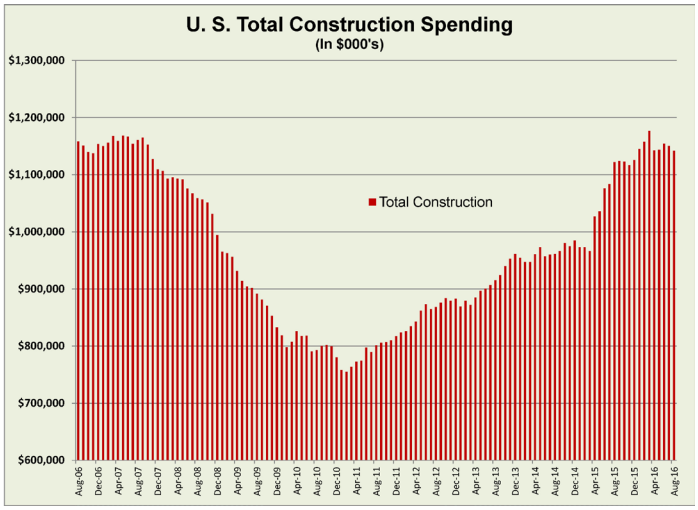
The data for the first eight months of 2016 showed a marked increase in commercial construction – up 6.9 percent – with office construction leading the way at a 28 percent higher pace than in 2015. While construction of multi-family projects is slowing, spending in that category is up 13.9 percent from the previous year. Spending on manufacturing buildings is down 7.4 percent year-over-year and public investment in structures and infrastructure has decline by 8.8 percent. Construction spending on highways and streets within the infrastructure category is off 8.3 percent, accounting for the lion's share of the public spending decline.

The first forecasts for the market in 2017 have begun to roll out. Most see 2017 as a late-cycle year for the construction industry. It's interesting to note that forecasts are tending towards mid-single-digit increases in activity.

American Institute of Architects (AIA) Consensus Construction Forecast Panel - comprised of Dodge, IHS-Global Insight, Moody's Economy.com, FMI, Construction Market Data (now part of ConstructConnect), Associated Builders & Contractors, and Wells Fargo Securities – predicts that construction will grow 5.8 percent this year and 5.6 percent in 2017. Within the panel it is interesting to note that the forecasts from the construction reports are the outliers on the high side, with Dodge predicting 9.3 percent higher activity in 2017 and ConstructConnect looking for an increase of 6.9 percent.

The relatively flat variance between 2016 and 2017 in the consensus forecast should be noted with caution. Late in economic cycles, fewer indicators of growth tend to exist and indications of decline tend not to be observed until recessionary pressures have begun to build. The uncertainty about the political environment in 2017 and beyond may have as much to do with the forecasts as any supply and demand indicators.

U.S. construction activity has recovered to pre-recessions highs. Source: Census Bureau.



The AIA's Consensus Construction Forecast Panel sees construction activity in 2017 growing 5.6 percent.

Forecast	% Change 2016	% Change 2017
Nonresidential Total	5.8	5.6
Commercial Total	11.7	6.5
Office	14.7	7.5
Retail & Other Commercial	7.4	5.2
Hotel	17.9	7.6
Industrial Total	-2.1	2.9
Institutional Total	4.5	5.8
Health	2.3	5
Education	6.5	6.3
Religious	-0.4	1.9
Public Safety	-3.7	3.3
Amusement & Recreation	10	5.7