September 2017

CONSTRUCTION
NATIONAL OUTLOOK

As summer winds down, two events may hold the key to how smoothly the U.S. economy performs into 2018. The impact of the devastating Hurricane Harvey, which hit Houston starting August 25, will last years and is going to be difficult to judge for months. Both the cleanup and reconstruction will require enormous resources. The second looming event, which may end up related to the hurricane relief funding, is the potential battle over the U.S. debt ceiling. Treasury Secretary Mnuchin has indicated that the ceiling must be lifted earlier than the original September 29 deadline. The battle over the debt ceiling could become contentious, possibly resulting in a shutdown of the federal government.

Legislators and the president seem to warm to the idea of attaching aid to Harvey's victims to the debt ceiling solution, a deal that would make it difficult for Democrats and conservative Republicans to oppose. Regardless of how the politics play out, a solution that keeps the government functioning without interruption is desirable for business. That's especially true in a climate in which business is thriving.

> "(A) government shutdown would be incredibly damaging to the economy. We do not believe this is likely to happen, but the increasing animosity between the administration and key Senate leaders does not instill confidence," offered JLL Chief Economist Ryan Severino in his August 30 report. "Congress will need to act quickly when it returns from summer recess in order to pass funding for the government before it runs out of money. In addition, Congress needs to raise the debt ceiling before the government defaults on its obligations. Both houses of Congress are jointly in session for only 12 days in September, which leaves a very thin margin for error. It would be unfortunate if political issues tanked the economy at a time when the data looks optimistic."

Evidence of a solid overall economy has been plentiful during the dog days of summer.

The second revision of U.S. gross domestic product (GDP) showed a more robust economy in the second quarter. The 3.0 percent rate of growth surprised most economists. Consumer spending and better-than-expected business investment drove the economy higher than the 2.5 to 2.7 percent consensus forecast. The improved second quarter boosted confidence in the forecast of two percent or higher GDP expansion for all of 2017.

US manufacturing companies continue to show more strength. While the high-flying US dollar remains a stubborn obstacle to exporting, other factors influencing manufacturing are improving. Low energy costs in the US are a significant input advantage for makers of energy-intensive products; and, key global markets have seen improvement in their economies. This is especially true in Europe where, after a decade of declining or flat GDP, most nations are seeing growth again. Japan's economy, the world's third-largest, saw a surprising one percent jump in its second quarter output. In another pleasant surprise, China's economy grew by 6.9 percent in the second quarter, bouncing back from several quarters of slowing growth. Among emerging economies, only India saw GDP growth slow. Of major concern in that fast-growing market is the rapidly rising level of non-performing loans, which approached ten percent in 2016.

The September 1 jobs numbers came in slightly lower than expected, with employers adding 156,000 non-farm jobs in August. Economists forecasted gains of 176,000, which is in line with the eight-month average of 177,000 new jobs for 2017. Although the August numbers were mildly disappointing, the unexpectedly strong gains in manufacturing jobs (up 36,000) and construction (up 28,000) were indicators that the economy's foundations remain strong. Unemployment rose 10 basis points to 4.4 percent.

Wage growth in August was also somewhat disappointing (up only 0.1 percent) but the year-over-year wage gain of 2.5 percent was in line with the current trend. The tightening labor market, while creating upward wage pressure, is being offset by lower productivity gains (2.2 percent) and sluggish core inflation.

The gap between wage growth and inflation is showing up in consumer confidence and spending. The two leading measures of consumer confidence remained strong in their latest readings.

On August 29, the Conference Board reported that its index of U.S. consumer confidence rose to 122.9 in August from a revised 120.0 in July. That's a strong rebound from surveys in late spring, although those levels were high compared to historical norms. The University of Michigan's Consumer Sentiment Index fell slightly in July to 93.4, a level that was still higher than the 90 reading of July 2016. Michigan's survey results peaked above 98 in December of 2016 and January 2017, as consumers seemed to respond to the economic optimism of the Trump election. Consumer sentiment has moderated since but is also at elevated levels. Echoing the confidence surveys, consumer spending – which makes up about 70 percent of GDP – increased by 0.3 percent in July, following a 0.2 percent increase in June. Lower-than-expected consumer inflation tempered the spending growth.

In the face of this market strength, it's easy to understand Severino's concerns. The economy took a hit in August 2011, when Congressional intransigence about the debt ceiling led to Moody's downgrading of the U.S. coveted AAA credit rating, and again in 2013, when the government shut down for 17 days during an attempt to tie the debt ceiling to a repeal of the Affordable Care Act. In both cases, GDP growth was constrained by nearly a point.

Assuming the government does not get in the way of the economy, the outlook for construction remains solid for the remainder of 2017. Economists evaluating the first half of 2017 have softened their forecast for the full year somewhat, but are still expecting growth that is unusual for this stage in the business cycle.

Several trends that are influencing the near-term forecast are the poor public construction funding environment, the low inventory of new residential construction lots, the growing vacancy rate in multi-family, and the unexpectedly better global economy. The specter of rising interest rates is having little impact on development at this point and, in fact, the historically low rate environment is still supportive for both private borrowing and public bond issuance.

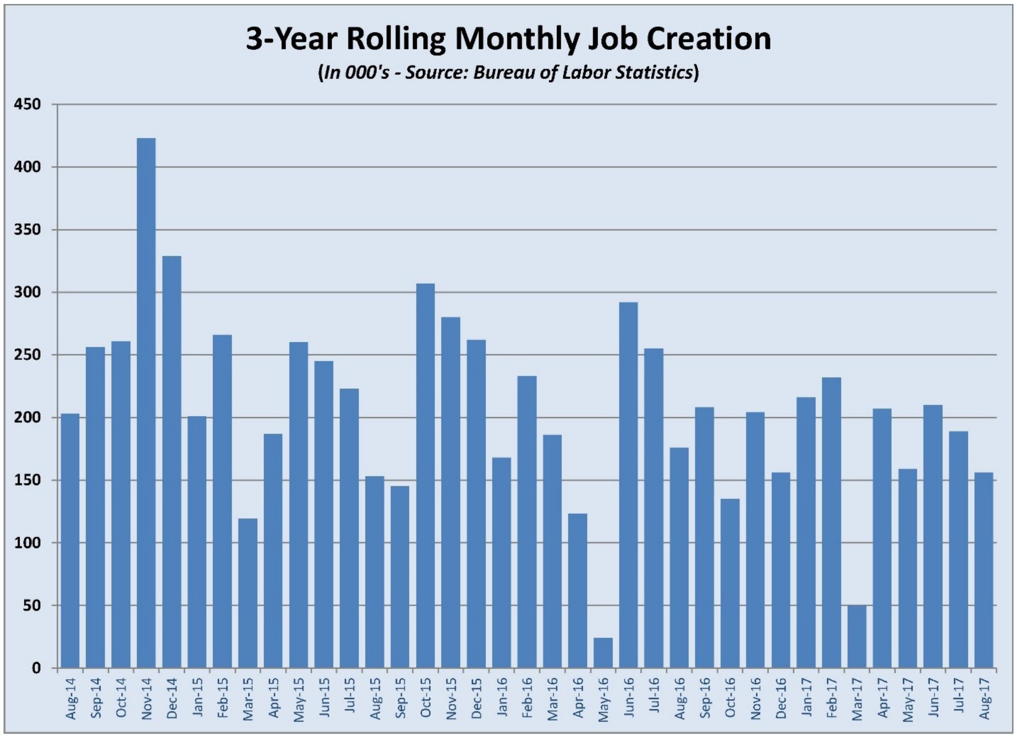
One of the more reliable indicators of future construction remains solidly positive. The July Architectural Billings Index (ABI) from the American Institute of Architects (AIA) was 51.9. While that was down from June's 54.2 reading, the ABI hasn't been in the red (i.e. below 50) since January. Other scores, however, were up from the previous month. The projects inquiry index increased by 0.9 from 58.6 to 59.5 and the design contracts index increased from 53.7 to 56.4. A similar trend occurred last year, followed by a dip in August that continued into the fall. That short-term decline in billings did not translate into a slowdown in construction thus far in 2017.

AIA’s Chief Economist Kermit Baker reported that the mid-year report from the seven-member AIA Consensus Forecast panel had nonetheless lowered its growth forecast for non-residential construction in 2017 to 3.8 percent. The panel also reduced its original forecast of 4.9 percent growth in 2018 to 3.6 percent. Citing slowdowns in the institutional and industrial sectors as the main factors driving the slight decline, Baker said that the lower forecast did not reflect concerns that the overall economy was slowing.

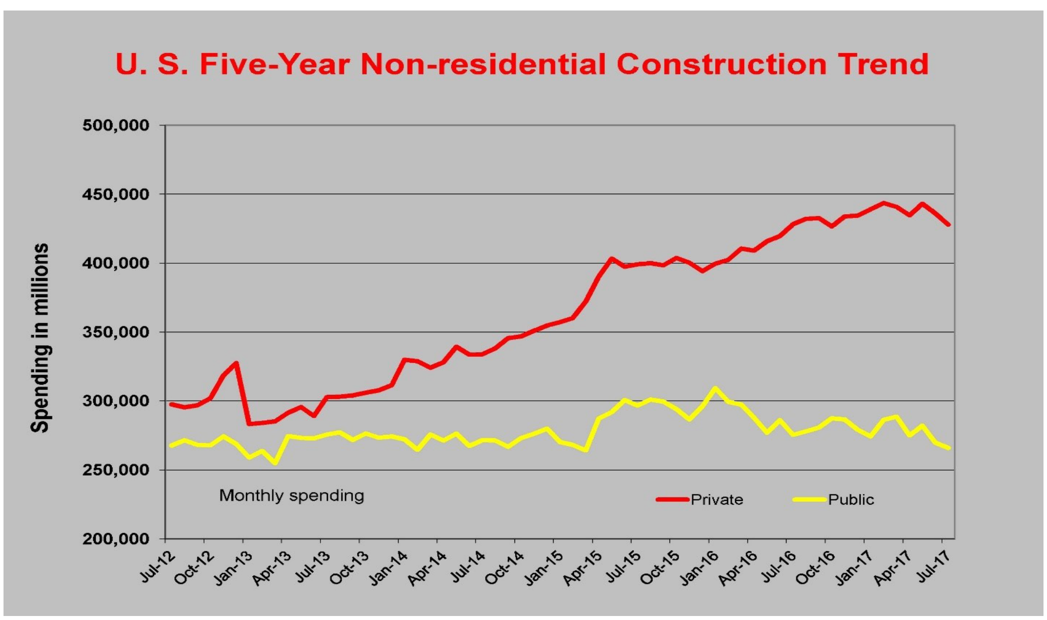
The Census Bureau’s estimate of construction spending in July showed somewhat slower year-over-year growth than the AIA Consensus forecast, with the $1.21 trillion annual rate coming in 1.8 percent higher than July 2016. For the year-to-date, however, construction was up 4.7 percent at $691.2 billion. July’s figures illustrated the disparity between public and private spending on construction. Including residential construction (which is primarily private), private investment in construction totaled $945.5 billion. Non-residential construction was $428 billion in July, 1.9 percent below June’s spending level.

Residential construction activity continues to reflect the two dominant trends: limited lot inventory and slower apartment demand. The August 19 report from the Census Bureau on new home construction found single-family starts in July at 860,000 units, a 0.5 percent decline from June but an increase of 10.9 percent from July 2016. Building permit activity was 13 percent from July 2016. New multi-family starts – defined by starts of five or more units – were off dramatically from the year before, falling 35.2 percent to 287,000 units. Permits for new multi-family projects remained higher, at 377,000 units, but the disparity between permits and starts suggests that many of the apartments that have been permitted will not start.

July’s activity reflects the structural issues facing the housing market. After half a decade of boom, the apartment market is cooling off. Occupancy levels have fallen slightly, although to roughly 95 percent, and rent growth has slowed. Recent home buying activity from Millennial generation occupants suggests that vacancy levels will increase. Lenders have become warier about multi-family, likely keeping more projects in the pipeline than in recent years. For single-family homes, the lack of acquisition, development and construction (AD&C) loans since the financial crisis has created a lot shortage. The National Association of Realtors reports that the unsold inventory of homes fell to 4.2 months’ supply in July, as inventories fell nine percent year-over-year to 1.92 million existing homes for sale. Such short supply of existing homes should be a boost to new construction but the pressures on development and AD&C lending remain.



(job creation history) While August's hiring report was slightly below expectations the monthly average of 177,000 jobs created is running above forecasts for 2017.



(nonres five-year) Non-residential construction remains near cyclical highs but spending has slowed during the middle of 2017. Source: U.S. Census Bureau.