State of & Outlook

US Construction 2019/20
Jan/Feb 2020 Report

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I. End of Year Construction Recap

Since our last report we prepared in July 2019, quite many of our views based on our analysis have materialized and the downward pressure has continued in the overall US-Residential and Non-Residential (Commercial) construction markets. Revised numbers by the US Census Bureau were available for September 2019 at the time of writing this report in early December 2019. We established in our prior report that we will only take revised and final data which is published for the previous month by the US Census Bureau in the current October 2019 memorandum.

a. Residential Housing Construction

We are on track for a 12% decline from 2018 in Single -Family Housing Completions at an annual rate of 858,000 units. Let's keep in mind that Residential Construction Inflation now revised at 4% increases the decline in reality to 16%. Interestingly enough, Residential Building Permits inched up 5% over last year which gave the recent builder confidence news a boost which we feel is misguided as Single-Family Housing completions are still trending down considerably over 2018. Recently, there have been more optimistic views going into 2020 for the residential home market from several industry experts and players, but we do not think that tighter inventories of single family homes will spark a housing boom despite the fact that credit standards are expected to loosen in 2020.

Multi-Family has seen higher completions at an annual rate of 354,000 units, which is an increase of 31% over 2018. At the same time, we see Multi-Family Building Permits cooling off as issuance is down 4% compared to last year. However, Builders are still filing higher numbers of Multi-Family Permits (476,000), which is 27 percent higher than what is completed, as trend from owning to renting is ongoing, and builders continue to focus on Multi-Family Developments. We will discuss later some new studies that have been recently published regarding the ongoing shift from owning to renting residential real estate in the US.

b. Non-Residential (Commercial) Construction

Annualized Commercial Construction was flat compared to 2018 at $ 451.5 Billion. Factoring in that Commercial Construction Inflation is still tracking at over 5% the commercial sector likewise is trending down at the same 5+% which is now in its third year of contraction due to the very high inflation associated with Commercial Construction. Most certainly geo-political uncertainties are having a considerable effect on companies being cautious on expanding their real estate footprint.

c. Public Construction

Public Construction is up by 9% over last year at $ 327.2 Billion; after factoring in 5% Construction Inflation, the whole sector is still up by 4%.

II. Outlook into 2020

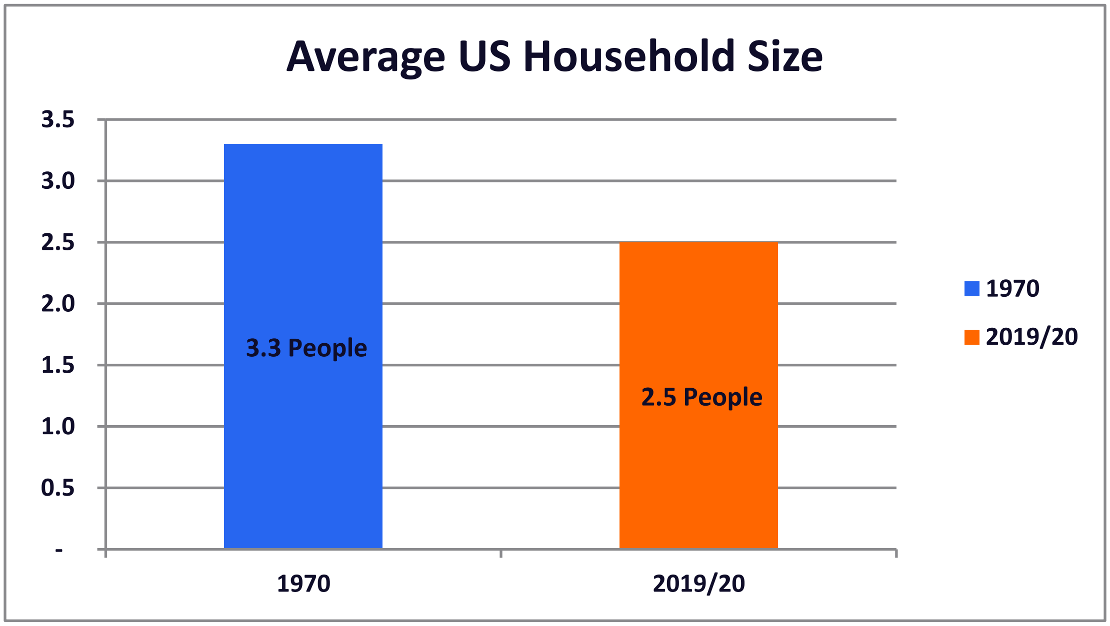
According to all reputable institutions tracking the pace of global economic activity, it remains weak, particularly the manufacturing sector, to levels not seen since the financial crisis starting in 2008. Global growth is now to be expected to be at about 3.5% for 2020, which is mostly coming from the service sectors. The main driver for the slower than anticipated growth rate, especially in manufacturing are the rising trade and geopolitical tensions which have significantly increased uncertainty about the future of the global trading system and international cooperation in general. Monetary easing policies in the developed economies of the world (low interest rate and increase of money supply) have cushioned some of the impact and the continued spectacular rise of service sectors, which have kept unemployment rates low. As the US is upon its next election cycle in 2020, these events are quite contentious and may be more so in modern times negatively affecting economic sentiment. In particular, international trade agreements partially completed and some changing on a weekly and sometimes daily basis maintain an overall sentiment of uncertainty. In the last five months, we have not seen enough fundamentals change in favor for construction markets to improve and get back to normalized growth until at least past the elections of 2020.

III. Long Term Trends

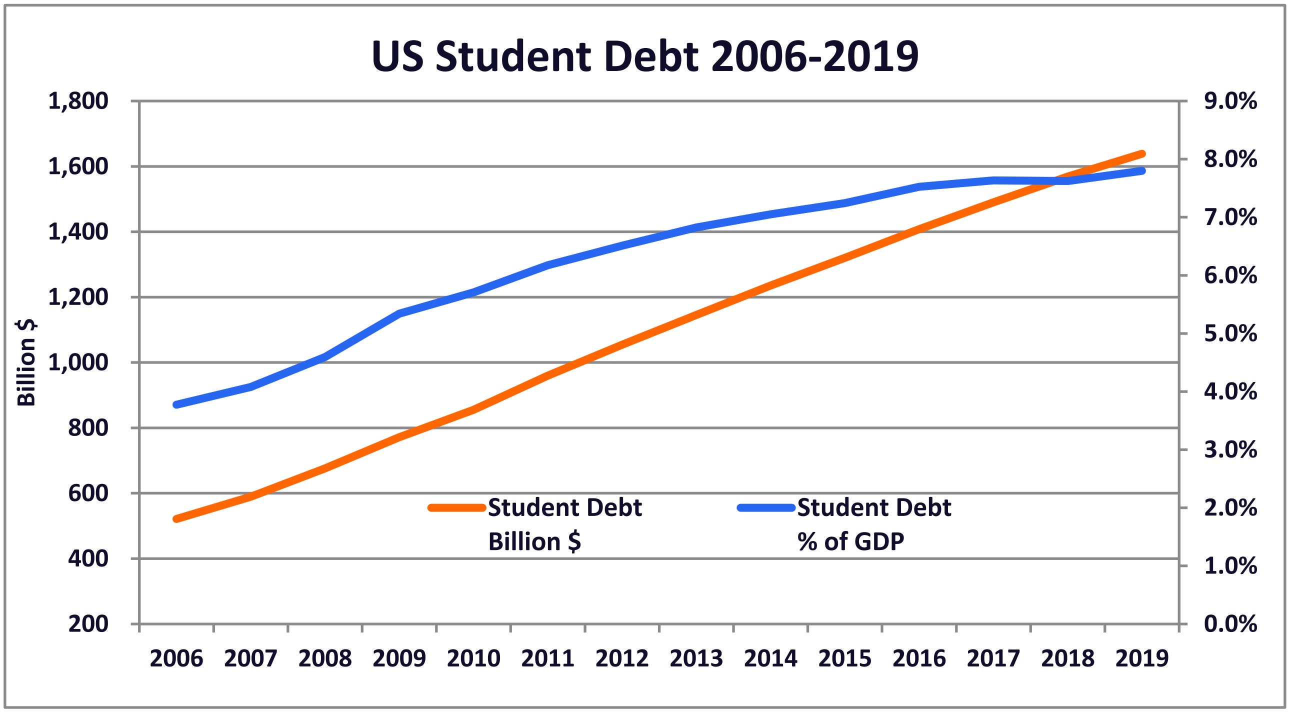
a. Generational Changes affecting Residential Housing

There are several interesting facts about the demographics of the various generations in the US that are either retired, established in the work force or are entering the work force. Zillow, the largest online real estate broker in the US, has just recently published a study conducted in all US residential markets (they have unique insight as they produce significant sales volume in all US regions) which shows the Baby Boomers own more than 30% of all residential real estate in the USA, and possess 57% of the nation's wealth, while only representing 22% of the US population. It is notable to mention that the boomers' wealth is tied to their paid off primary real estate and retirement accounts. Zillow is estimating that between the early 2020's and the late 2030's approximately 1 Million residential properties per year will hit the existing home resale market. If this occurs, which at least in part will, circa 20% more homes will be added to the future supply of existing homes on the market, which stands at a little over 5 Million today. The question is, how much of these homes will eventually be absorbed by Generation X, the Millennials and Generation Z? Of course, some of this excess inventory will be naturally absorbed, but we tend to believe that these dynamics will maintain considerable downward pressure on resale prices as there will be estates sales that will lower prices until their properties will sell and on top of that we are looking roughly at a 15-17 year period.

Homeownership age compared to the 1990's, when first home buyer median age was in the low 30's, has changed to 47 years of age today. From the Boomers to Generation X and the Millennials, the average family size has declined from 3.3 to 2.5 people per household, which quite obviously requires less square feet to be inhabited these days. Generation X who are in their 40's+ today are already owning smaller real estate than their parents, and the general consensus of the Millennials is not wanting to own a home, because they have gotten shell shocked living through the housing collapse of 2008-2011 and have witnessed the immense struggle of their parents. Further, they prefer to live in urban areas where home prices are at historical highs, making renting smaller square feet condos/apartments the only affordable option for most.



Again, we cannot exactly predict the future, but these findings lead to what we call "reasonable assumptions" to make better investment and business decisions. Generation X and the Millennials are not accumulating wealth at the same rate or proportion as the Boomers did due to various factors like the amortization of considerable student debt, which has ballooned from $521 Billion in 2006 (3.8% of US GDP) to $1.6 Trillion (7.8% of GDP in 2019), changes in societal values comparing previous generations to today's, where living in the moment has taken a more predominant focus, compared to the long-term planning of the Boomer generation who were nearly obsessed with retirement planning, which is a good thing to say the least. Early studies suggest that the pendulum will swing back in these matters in Generation Z, as they will see the negative effects of their parents, who will not have the retirement resources as the Boomers did. Based on our research, analysis and resulting conclusions we remain with a very strong opinion and conviction, that after adjusted for inflation US constructions markets will produce flat to slight growth results over the next several years.



b. Economic Cycle

As the US economy remains reasonably strong, mention needs to be made of which sectors are keeping it going. When studying the history of economic growth in the developed world one can clearly see that when a given country's prosperity rises its economy starts to shift and rely more on service sectors, healthcare and pharmaceuticals rather than the more traditional industries that have fueled the previous rise. These will start to maintain or regress and of course technology advancements contribute considerably to that shift as well. The US economy has been no exception to this development and health care, service sectors and pharmaceuticals have become the main drivers of US economic growth and employment, while agriculture and manufacturing are not faring the same. Besides the stable economy, notable economists and financial advisers are getting more increasingly concerned that we are either in or will enter a recessionary cycle over the next two years. Most people view a recession as a terrible glooming event, but reality is, that even if a possible recessionary cycle is upon us, the US economy will still grow, just at a lower rate.

In our last report, we discussed the effects of the “thinning out” of the US middle class as a long-term trend. Because of the Feds intervention and its counterparts overseas, QE monetary policy, and due to the amount of debt outstanding and interest to be repaid, the developed world is pretty much stuck in a low interest environment (some developed countries like Japan or even Switzerland have currently negative interest rates on savings accounts). The Federal reserve has been moderately raising interest rates since the last downturn in 2008-2011 and has been forced to relinquish some of the increases, despite a strong economy. This low interest environment, which is here to stay, has a quite devastating effect on the ever-widening wealth gap in our society and for that matter in the entire developed world. Ray Dalio from Bridge Water Associates (largest and best performing hedge fund in the world) has been quite vocal on how modern capitalism is broken, only benefiting the wealthiest. After the last recession, we have seen an acceleration of wealth amongst the richest unlike ever before in history, and the underlying dynamics are quite interesting and will repeat themselves during and after the next recessionary cycle. As interest rates are lowered or remain low and money supply is increased via QE (Quantitative Easing) through issuance of bills and bonds. These proceeds are being lent by the Fed at the Fed Fund rate to banks, who will lend it at interest to credit worthy borrowers, who in turn use it to fuel their growth (this is a very simplified explanation of a very complex process). As credit worthy individuals and organizations can borrow even more and since there is no significant interest to be gained from traditional more secure financial instruments. Qualified borrowers have no choice but to look for alternatives. The excess cash is then invested in asset classes that will protect against inflation such as well-run companies whether privately held publicly or traded and prime commercial real estate. That inevitably continues to drive valuations of these asset classes up as they are the only investments that will protect against inflation and generate positive cash flow. These asset classes get more cash and in turn will make their franchises and profitability grow. On the other side of the spectrum, which represents most of the developed world’s population, the less credit worthy will be left holding no bag at all, much less an empty bag and the wealth gap continues to widen. These unintended consequences will further lead to more extreme populism in politics no matter the flavor. We are making mere observations here and do not offer any conclusions and neither are we pointing fingers in any direction as these dynamics have been developing over a very long time.

We have made our case before, that the sheer size and velocity of the US economy is being rivaled by no one in the world and that we have by far the best legal framework of any nation today to maintain a more or less healthy economy that will continue to grow for a very long time to come. The construction markets will continue to grow, but with these short and long-term challenges it most-likely will not be as robust for those who have business exposure to US construction and will remain sideways with very moderate growth for the foreseeable future (2-5 years in our estimation) after factoring in construction inflation costs.

IV. In Memoriam

At the time of finishing up this report, a great American has passed away reminding us that the greatest minds and decision makers of our nation had a bipartisan approach with the best interest at heart for the US. They have weighed their very influential decisions against how everybody, no matter the race or class, would be impacted in a beneficial way. Paul Volcker, the former Federal Reserve Chairman (1979-1987) who passed away at the age of 92 on December 8th 2019, is one of our true American heroes! Thanks to his character, incredible financial acumen and best interest at heart for our country, he implemented financial measures that normalized the extremely high inflation environment of the late 70's and early 80's in the US. Due to his impeccable character and track record, he was entrusted in 1987 by the world's financial leadership and respectively involved governments, to make a review of the Holocaust funds hidden in secret Swiss Bank accounts, which eventually led to more than a Billion Dollar settlement with the surviving heirs of the Holocaust. He remains to be the most astute financial leader the US had in modern times. May his life be remembered and serve as a continuing example for our present day political and financial leadership.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