

4TH QUARTER 2016

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ECONOMIC INDICATORS

DEFINING TECHNICAL EXCELLENCE

EXECUTIVE SUMMARY



A RETURN TO NORMALCY *by: Salim Furth, Ph.D.*

As of the end of 2016, economic growth has been normal for at least a year. With a few exceptions, data indicate an economy operating at or near its “natural” or “potential” level.

The unemployment rate reached a nine-year low of 4.6 percent in November and has not exceeded 5 percent since September 2015. Experience from previous periods of sustained growth indicates that little further improvement can be expected.

Gross domestic product (GDP) is growing at a steady but unimpressive rate. Adjusted for population growth and inflation, GDP grew 0.8 percent from the third quarter of 2015 to the third quarter of 2016.

Private domestic investment grew rapidly from its recession trough but peaked at 17 percent of GDP in early 2015 and has not grown since then. The lack of further growth is both an indicator and a cause of the end of the recovery: Strong growth

in wages and GDP depends on investment. At just 16 percent to 17 percent of GDP, investment is treading water.

Like investment, labor force participation has not reached pre-recession levels. Part of that change is due to the retirement of the baby boomers: People born in 1951 turned 65 in 2016. However, prime-age workers are also less likely to be working or looking for work now than in 2007. Persistently low participation is one of the main challenges facing policymakers in 2017.

Monetary policy is an exception to the prevailing normalcy. Inflation has remained below the Federal Reserve Board’s 2 percent target for years. Consequently, the Fed has left its policy levers in positions that are typical of a recovery and is likely to remain accommodative until inflation reaches 2 percent.

Furth, Ph.D., S. (2017, January 13). *Economic Outlook for 2017*. Retrieved from heritage.org: <http://www.heritage.org/research/reports/2017/01/economic-outlook-for-2017>

PERFORMANCE SUMMARY

INDICATORS	JUNE 2016	JULY 2016	AUGUST 2016	SEPT. 2016	OCTOBER 2016	NOV. 2016	DEC. 2016
ABC Construction Backlog Amount of commercial construction to be performed in coming months	8.6 mo. 1st Qtr. '16			8.6 mo. 2nd Qtr. '16			8.7 mo. 3rd Qtr. '16
AIA Architectural Billing Index 50 or above indicates growth	52.6	51.5	49.7	48.4	50.8	50.6	55.9
FMI Non-Residential Construction Indicator 50 or above indicates growth	61.3 2nd Qtr. '16			57.3 3rd Qtr. '16			56.9 4th Qtr. '16
Core Inflation Rate Target is 2%	2.26%	2.19%	2.32%	2.21%	2.14%	2.11%	2.20%
Gross Domestic Product Healthy rate of growth is 2-3%	1.2% 2nd Qtr '16			3.5% 3rd Qtr '16			1.9% 4th Qtr '16
Housing Starts - Single Family Declining trend indicates slowing economy	778,000	711,000	724,000	783,000	863,000	780,000	817,000
Unemployment Rate	4.9%	4.9%	4.9%	5.0%	4.9%	4.6%	4.7%
Performance Key: Good Average Poor							

Construction Backlog Rebounds in Third Quarter

Construction backlog expanded during the third quarter, led by strong growth in the commercial/institutional sector, according to Associated Builders and Contractors' (ABC) Construction Backlog Indicator (CBI). The increase during the third quarter follows two quarters of decline in backlog—the amount of work under contract but yet to be performed—that led to speculation that growth in the country's nonresidential construction industry was slowing.

"Despite growing concern that certain commercial segments in a handful of major U.S. cities are on the path to overbuilding, commercial construction backlog improved during the summer of 2016," said ABC Chief Economist Anirban Basu. "The ongoing expansion of spending on healthcare has also helped to expand institutional construction volumes.

"However, exports have been sagging in the context of a disappointing global economic recovery and strong dollar," said Basu. "Business investment in the U.S. has been weak, though there have been more recent indications of improvement. This improvement was not fully apparent in third quarter data, and industrial construction backlog declined during the quarter.

"Perhaps the biggest news is that infrastructure-related backlog is on the rise," said Basu. "Despite the passage of a federal highway bill in 2015 and a growing consensus that America's expanding infrastructure deficits must be aggressively countered, infrastructure spending in America has been in decline for much of 2016. According to U.S. Census Bureau data, over the past year public spending has declined in water and sewer categories, the highway and street segment, public safety and in transportation. The rise in backlog suggests that this negative trend will soon turn positive. The outcome of the most recent presidential and congressional elections renders the outlook for near-term infrastructure spending more promising.

Industry Highlights

Commercial/institutional backlog expanded by nearly 4 percent during the second quarter. This is a segment that has been impacted by tightening lending standards for commercial real estate developers. Despite those headwinds, commercial/institutional contractors generally report that backlog remains healthy and stable.

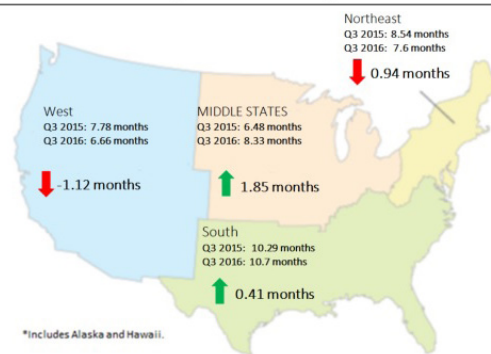
Average backlog in the heavy industrial category fell to 6.6 months during the third quarter, more than offsetting the segment's second quarter gains. Industrial backlog is precisely where it was at the beginning of 2014.

Backlog in the infrastructure category expanded for the first time in 2016 during the third quarter. Despite small setbacks in infrastructure backlog during the first and second quarters, the segment's backlog remains elevated by historic standards. The nation's appetite for stepped-up infrastructure spending appears to have grown, which should translate into rising backlog sometime in the future.

Region	Months of Backlog	% Change	Change from Q2 2016
Northeast	7.6	6.6%	+
South	10.7	-1.0%	-
Middle States	8.3	4.1%	+
West	6.66	-6.9%	-
Industry			
Commercial/Institutional	8.31	3.7%	+
Heavy Industrial	6.60	-11.3%	-
Infrastructure	11.05	2.3%	+
Company Size			
<\$30 Million	7.5	3.4%	+
\$30-\$50 Million	7.79	-14.4%	-
\$50-\$100 Million	9.36	4.2%	+
>\$100 Million	13.72	-2.4%	-



Year-Over-Year CBI Map of Regions and Backlog Months
Third Quarter 2015 v. Third Quarter 2016



FMI Non-Residential Construction Indicator 4th Quarter 2016

The FMI Nonresidential Construction Index slipped just 0.4 points in the fourth quarter to 56.9. In the fourth quarter of 2015, the Index stood at 59.5. While the trend indicates a slower outlook for nonresidential construction, the Index is still solidly in positive territory as it has been since the first quarter of 2012. While most of the economic components of the NRCI slipped lower this quarter, backlogs increased from 10 months to 12 months with expectations that backlog growth will continue in the near term. Looking at markets, the outlook continues to be positive for all markets through the next year, but the three-year outlook is less rosy.

This quarter's current issues responses may help to shed some light on the uneasy long-term outlook for construction markets and the economy. In a two-part question, we asked NRCI panelists to rank a range of items and areas that might affect the economic picture in the next year. The rankings included the top-three most impactful concerns, both for positive and negative potential outcomes. Then, for those who said they examine the impact of external issues, such as global economic matters, consumer behavior and regulatory policy, when they are planning their strategic and business goals, we asked which items normally made it into the planning cycle. For instance, from the survey comments we heard: "We do a lot of senior care work, and the residential housing market affects this work directly. When the cost of homes plummets, seniors postpone entering these facilities, which hurts our business."

Overall, the top-three ranked positive factors included private sector investment activity, specific construction market sector trends, and consumer sentiment and spending decisions. U.S. monetary policy and the results of the elections also ranked as high positives for 2016 expectations. On the other hand, the top-ranking issue on the negative side was the results of the U.S. elections. This was followed by concerns about unemployment rates and U.S. monetary policy.

We received many comments that external issues were not much of a concern for strategic planning; however, many contractors know they need to be mindful of larger societal issues, both domestic and global. They are also keeping a close watch on what may happen in labor, both in terms of immigration laws and availability of U.S. citizens seeking work. While market sector trends, private investment, regulations and consumer activity are the most immediate and measurable concerns in planning, in a world of social upheaval and political change, everything is connected, and the outcomes are difficult to predict.

FMI Corporation. (2016). 2016 Fourth Quarter Report FMI Nonresidential Construction Index.

- Overall Economy: Up**
At 58.5, a gain of just 0.4 points, panelists' view of the overall economy was little changed over last quarter.
- Overall Economy Where Panelists Do Business: Down**
With a drop of just 0.2 points, the NRCI component results for the overall economy where panelists do business is essentially unchanged.
- Panelists' Construction Business: Down**
With a score of 66.7, panelists still view their business as strong, but this is a drop of 4.3 points from the third quarter.
- Nonresidential Building Construction Market Where Panelists Do Business: Down**
The fourth quarter results continue to show that construction executives participating in the NRCI believe their construction markets are somewhat stronger than that of the overall economy; however, the score of 64.6 this quarter was a drop of 2.7 points over last quarter.
- Expected Change in Backlog: Up**
The median current backlog in months went from 10 months last quarter to 12 months for the fourth quarter. The score for expected change in backlog increased from 58.9 to 61.3 this quarter. While this growth trend seems to run counter to other components, it appears to represent continued momentum from the growth of the past year that should last well into 2017.
- Cost of Construction Materials: Lower**
Cost of Labor: Lower
The NRCI components for the cost of materials and labor improved somewhat this quarter; however, both continue to indicate rising costs for construction companies.
- Productivity: Higher**
Even though our component score for productivity improved 1.6 points this quarter to 48.1, the outlook for improving productivity continues to struggle. Along with growing backlogs, this appears to indicate that finding enough skilled labor continues to be a huge challenge.

ABI December 2016: Architecture Firms Report Strong Finish to the Year



The ups and downs of business conditions listed as the top challenge to firm profitability.

Architecture firm billings saw an unexpected surge in December, generating an ABI score of 55.9 for the month. This was far and away the highest monthly growth of the year and brought the average monthly reading for 2016 up to 51.3, almost equaling the 2015 average monthly score of 51.6. Project inquiries and new design contracts both had positive readings but didn't rise at nearly the same pace as billings. That would suggest that firm billings are likely to see more moderate growth moving into 2017.

Boom and bust nature of construction activity listed as top challenge to firm profitability.

In a recent AIA survey of business concerns for 2017, architecture firms placed increasing firm profitability at the top of their list, a concern that also topped their list in 2016. This month, firms were asked to discuss the major challenges that they face in increasing profitability.

At the top of the list is "the ups and downs of business conditions in the industry," which create difficulties for firms in balancing costs and revenues. Fully 20 percent of respondents ranked this as the most important challenge that they face in increasing profitability. The second most common response was "the high cost of running a firm, and the required investments," which put pressure on firm revenue. Other popular responses were "intense competition from other firms" and that "some competing firms have low cost structures, or are willing to accept lower profits." Each of these two responses was mentioned as a key challenge to profitability by about 15 percent of respondents.

Larger firms have a somewhat different set of challenges to increasing their profitability. The top of their list was competition from other firms, mentioned by 30 percent of firms with \$5 million or more in annual revenue. The next most common response was the high cost of running a firm, mentioned by 19 percent of respondents, followed by other firms' lower cost structure or willingness to accept lower profits (18 percent) and their limited ability to negotiate with clients (12 percent).

Hon, K. (2017, January). *ABI December 2016: Architecture Firms Report Strong Finish to the Year*. Retrieved from aia.org: <https://www.aia.org/pages/26736-abi-december-2016-architecture-firms-report->

Key December ABI highlights:

- **Regional averages:** South (53.8), West (48.8), Northeast (54.0), Midwest (54.4)
- **Sector index breakdown:** multi-family residential (50.6), institutional (53.3), commercial / industrial (54.3)
- **Design contracts index:** 51.2

The regional and sector categories are calculated as a 3-month moving average, whereas the national index, design contracts and inquiries are monthly numbers.



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