2022 US Construction Outlook: Non-residential set to boom as housing cools

US homebuilding will likely cool next year as high prices and rising borrowing costs increasingly hurt affordability. But the next 18 months should see a major reversal of fortunes for non-residential construction, which has been hit hard by the pandemic and is set to benefit from a major wave of government spending

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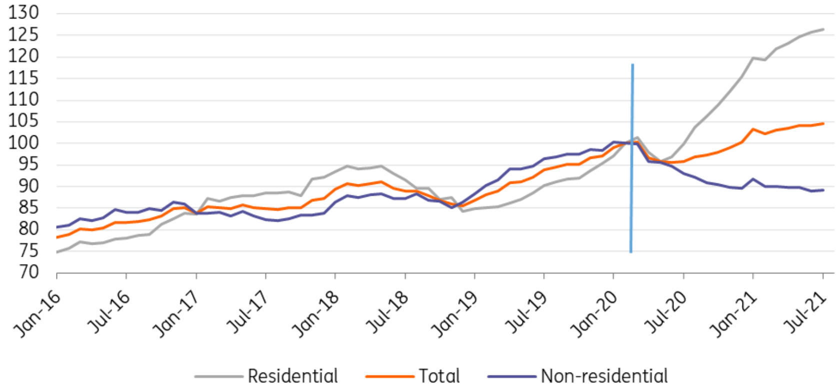
US Construction: Residential boom offsets the gloom

The pandemic hit the construction sector hard, but plunging borrowing costs and the prospect of working from home stimulated a subsequent housing boom that has offset weakness in the non-residential sector. Now though, there is growing evidence that the surge in buying is over with a tougher environment facing home builders

A short sharp shock

As the pandemic-induced shutdowns spread across the country last March and April, we saw spending drop 5% across both residential and non-residential construction with employment plunging by 1.1mn in the sector as a whole. This was equivalent to 14.6% of construction workers losing their jobs. With working from home not an option, it was one of the first sectors allowed to return to the workplace and employment swiftly recovered given the robust order backlog. Government and Federal Reserve stimulus quickly stabilised sentiment, but the relative performance of residential and non-residential construction soon markedly diverged.

Nominal construction spending by sector, February 2020 = 100



Source: Macrobond, ING

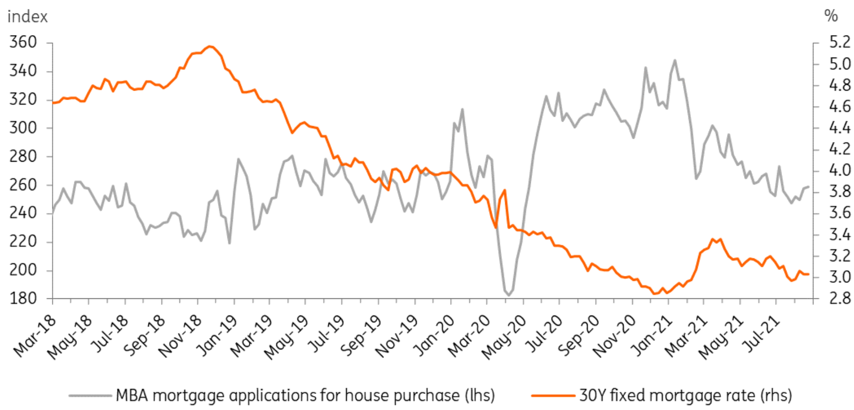
Residential rallied on mortgage rate plunge

Aggressive interest rate cuts and quantitative easing from the Federal Reserve drove down Treasury yields, which dragged mortgage costs lower, too. With equity markets having swiftly recovered their losses, consumer confidence among those who kept their jobs rebounded and this triggered a wave of interest in home buying.

The economic pain from Covid containment measures was especially acute in leisure, hospitality and retail with these three sectors accounting for half of the more than 22 milion jobs lost between February and April. These sectors tend to be lower paid with employees less likely to be homeowners or potential home buyers. Higher skilled workers and employees who weren't public facing were better able to switch to home working and were much more likely to keep their jobs.

Consequently, mortgage applications for home purchases soared to levels last seen before the Global Financial Crisis with the US property market experiencing a wave of buying, particularly in the suburbs as workers decamped from the major cities.

Mortgage applications for home purchase & borrowing costs

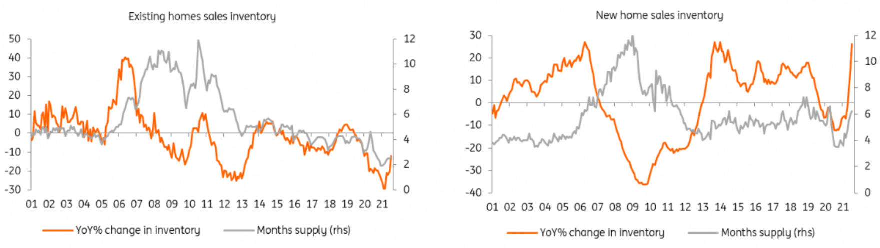


Source: Macrobond, ING

Health concerns and the prospect of a prolonged period away from the office was key, with the purchase of second homes also a major driver of activity. According to online real estate brokerage

Redfin, the demand for second homes grew at double the rate of that for primary homes. The relative affordability of property was underscored by the fact in 2Q 2020, mortgage debt service costs fell below 4% of personal disposable income for the first time ever.

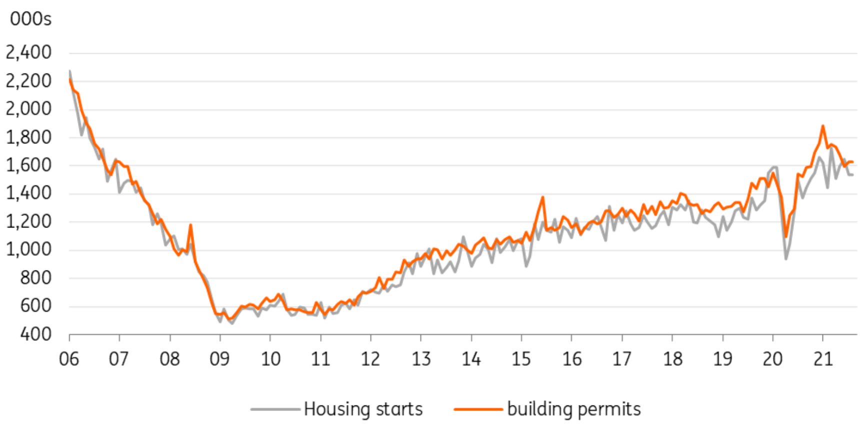
Housing inventory for sale



Source: Macrobond, ING

With inventory levels at historically low levels for both existing and new homes, prices soon started to rise and the profitability of new home building increased. This stimulated a huge residential construction boom with building permits, which had slumped from an annualised level of 1.55mn in January 2020 to 1.094mn in April, surging 72% to 1.883mn in January 2021. This is the highest level since 2006 with housing starts performing similarly.

Housing starts and building permits

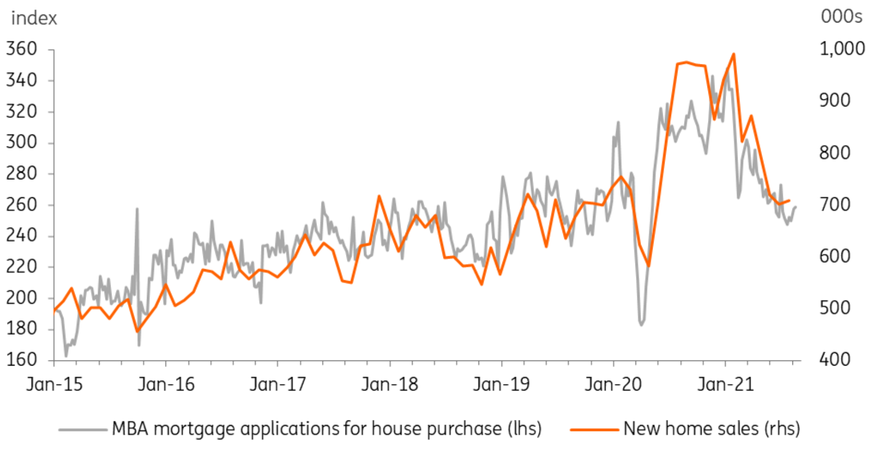


Source: Macrobond, ING

Residential outlook: Housing demand past the peak

Mortgage applications for home purchases have already slowed markedly despite mortgage rates remaining below 3% for a fixed 30Y mortgage. This clearly suggests waning demand. This softening in activity is partly because of people returning to the big cities as companies call workers back to the office, but also because housing affordability is deteriorating.

Nationally, the S&P Case Shiller house price index is up nearly 19% year-on-year with the median price of a new home pegged at $361,800 and an existing home costing $363,300. This is already reflected in consumer confidence with a marked decline in home buying intentions mirroring the decline in mortgage applications.



Source: Macrobond, ING

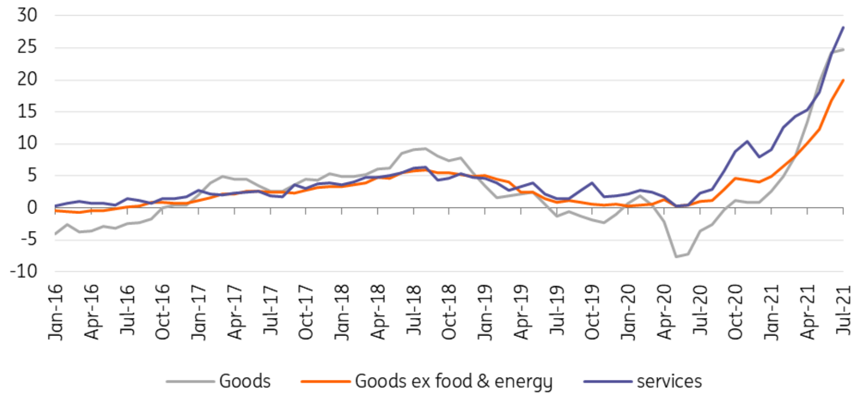
On the positive side, employment is rising strongly and we expect it to fully recover to pre-pandemic levels by mid-2022 while there is growing evidence of wage pressures amid labour market shortages. This should keep overall household income growth firm and provide solid foundations for demand, but with demand and supply moving into better balance, price appreciation is likely to moderate.

Homebuilder sentiment on the wane

The latest sentiment reading from the National Association of Home Builders fell to a 13-month low, with potential buyer traffic clearly slowing. Nonetheless, homebuilders remain positive about the outlook, with the expected future sales component unchanged. We are more cautious and believe that housing activity is returning to its pre-Covid trend. With new home sales and mortgage applications clearly having slowed, we feel residential construction will decline, too.

Given our general economic outlook of strong growth and more persistent inflation pressures, we expect the Federal Reserve to soon announce a tapering of its $120bn per month QE asset purchases that are currently split $40bn per month for agency mortgage-backed securities and $80bn for Treasury securities. We also expect to see the Federal Reserve start to raise interest rates from late 2022. A less stimulative monetary policy backdrop combined with elevated government borrowing, we believe, will push the Treasury yield curve higher with the 10Y Treasury yield set to test 2% over the next six to nine months from the current level of 1.3%. This will inevitably push mortgage borrowing costs higher, with mortgage rates set to rise by 70-90bp over the same period, further hurting home buying affordability.

Construction input costs (PPI YoY%)



Source: Macrobond, ING

Home building set to slow

Another issue for homebuilders is rising commodity prices, supply constraints and a lack of workers to fill required roles. This has resulted in significant cost increases for the construction sector and delayed projects while creating uncertainty about the outlook for profits.

Given this squeeze, amid evidence of falling demand, we expect housing starts to decline to a 1.3-1.4mn annualised range by the end of this year, having peaked at 1.725 mn in March. We believe it will remain broadly within that band for the next couple of years, which is a more pessimistic assessment than the latest Bloomberg consensus figures of 1.57mn for 2022 and 1.548mn for 2023.

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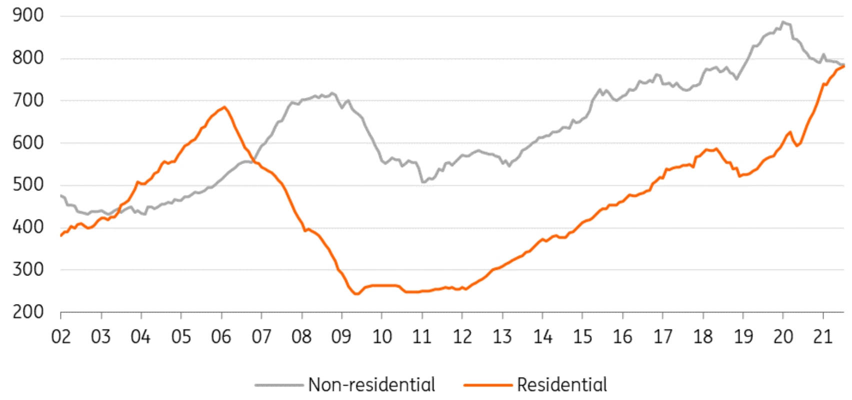
US Construction: Biden's billions to boost non-residential spending in 2022

While residential construction was the post pandemic winner through 2020 and 2021, non-residential construction will lead the charge in 2022 as a reopened economy and fiscal infrastructure spending splurge will support the outlook

Non-residential's torrid 2020

Non-residential construction has had a very different pandemic to residential construction. With workers staying away from offices, towns and cities emptied. Footfall in commercial districts dropped sharply and commuting stopped. Hotel demand collapsed, schools were deserted and recreation activities were scaled back. Given uncertainty over how long this situation would last, plans for repair, renovation and new construction were delayed or cancelled and as legacy building work ceased it wasn't replaced with new projects.

Total construction spending (USD bn)



Source: Macrobond, ING

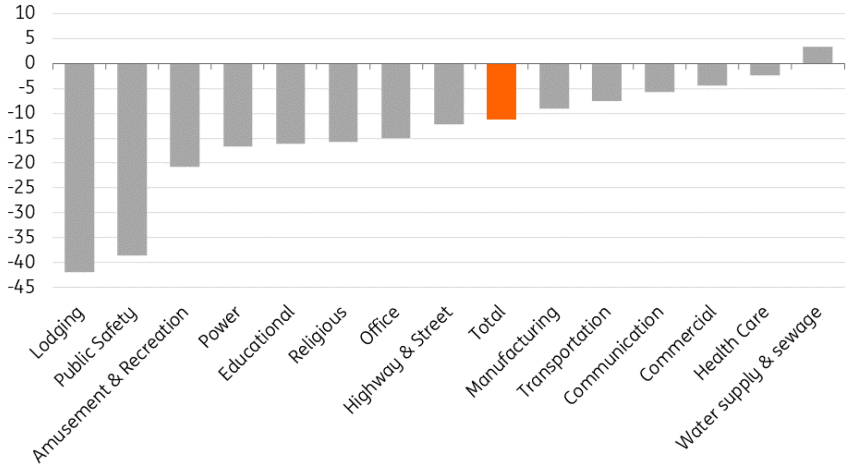
2022 looking better already

While non-residential construction is up 25% on its pre-pandemic highs, non-residential construction is down 11.1% from its January 2020 peak. Lodging (hotels), public safety and recreation are the hardest hit sub-sectors. Only water supply and sewage spending has increased since the start of the pandemic.

However, we are hopeful that 2022 will be a much better year. Already there are tentative signs of stabilisation in non-residential construction activity and as more people return to the office, cities are likely to get busier again, with bars, restaurants and hotels also seeing increased demand. With tourism and leisure returning - US borders are yet to reopen to European, Chinese, Indian and Brazilian tourists and business people, which will give another substantial uplift - non-residential construction should see a significant acceleration.

Given the scale of the rebound in demand in the US economy, with GDP levels now above pre-pandemic levels and the economy expected to expand by around 6% this year and 4% next, there is going to be a major backlog of repair work and deferred projects will be reinstated. The prospect of major government infrastructure investment will further fuel growth.

Non-residential construction spending change versus peak (% change)



Source: Macrobond, ING

Covid resurgence dents office return

Many companies started ordering staff back to their offices earlier this year and people movement in major US cities has certainly picked up. JLL reported that in the second quarter "gross leasing activity rose by 28.7% over the quarter to 34.7 million square feet in Q2, the first time that it has surpassed 30 million square feet since the onset of COVID-19. Despite this increase, this is still 41.6% below the pre-pandemic quarterly average, underscoring the road to recovery for office leasing fundamentals".

Unfortunately, the resurgence of Covid through the Delta variant has put this movement on hold and makes it increasingly likely that we will see an ongoing drift lower in non-residential construction, particularly for new offices, in the months ahead until there is clarity on the way forward.

But signs of stabilisation elsewhere

The latest Federal Reserve's Beige Book suggested that regions around the US are experiencing slightly different rates of performance. For example, the environment in Manhattan was described as "moribund" but the Cleveland Federal Reserve bank said that in its region "activity within the industrial sector remained strong and demand for office spaces experienced notable increases in activity". Both the Richmond and St. Louis Federal Reserve regions are experiencing strong industrial real estate activity, while in the Texas region it was described as "exceptionally strong". The San Francisco region noted "demand for industrial, warehouse, and distribution spaces remained robust".

Moreover, assuming the efficacy of vaccinations holds and the latest Covid wave subsides swiftly (Covid rates seemingly peaking out in some of the key hotspots, such as Missouri, Arkansas, Florida and Texas) we are upbeat on the prospects for non-residential construction.

Office construction to underperform

Compositionally, office construction is likely to remain subdued, but this accounts for only 10% of US non-residential construction spending. Working from home has undoubtedly been a success with technology certainly meeting and, in most cases, beating expectations. We are unlikely to go back to the way things were with everyone in the office at all times. Instead, some form of hybrid model is most likely. This will limit the need for additional office space with firms more likely seeking to sub-let unutilised floors. Emergency back-up sites will also no longer be required with working from home available.

This could also hamper any recovery in the commercial sector, particularly in major cities. While footfall in office areas will increase, it won't return to pre-Covid levels quickly so neither will demand for food outlets, bars, restaurant and business hotels. Indeed, business travel in general is unlikely to make a full recovery with video conferencing a much cheaper option, compounding the issue for major commercial centres.

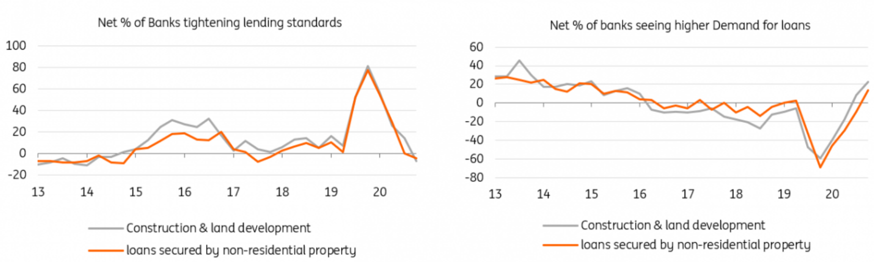
That said, given the effective mothballing of numerous entertainment venues, hotels, bars and restaurants over the past 18 months, there is clearly scope for significant refurbishment work, which will benefit the construction sector.

Moreover, with online shopping set to hold onto much of the gains made as a proportion of total spending, demand for logistics centres and warehousing looks set to continue growing. There is also likely to be more demand for recreational areas outside of the major cities given households will likely spend less time commuting to work and more time in their local areas. We would also imagine a strong pipeline of work required for educational buildings as students return.

Financing looks supportive

Financing conditions do not seem to be a barrier to growth. The Federal Reserve's Senior Loan Officer Survey shows that commercial banks have relaxed lending standards to levels not seen for six years while demand for new loans has rebounded sharply, suggesting appetite for investment has returned.

Federal Reserve's Senior loans Officer Survey points to a positive lending outlook



Source: Macrobond, ING

Biden's billions boost the outlook

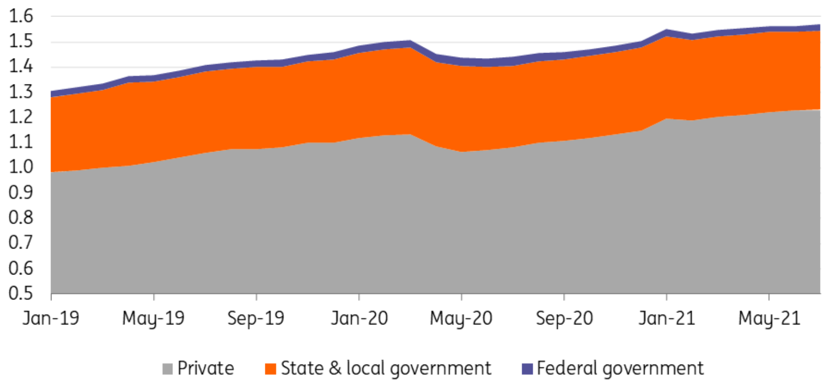
Then we have to acknowledge the anticipated support from the bi-partisan Infrastructure Investment and Jobs Act, which provides for an extra $550bn of infrastructure spending for the next five years over and above the $450bn already approved by Congress. This will also require additional workers, with President Biden stating that the intention of this plan is also to "create good-paying, union jobs".

This is not guaranteed at this point with only the Senate having voted in favour. The legislation still needs to be approved by the Democrat-controlled House of Representatives, which is looking to delay a vote. Progressives within the Democrat party have threatened to vote down the bill unless it is linked to a separate $3.5tn social security bill that will increase taxes on the wealthy and corporates to help fund spending increases and an expansion of healthcare and social benefits.

The social spending bill will also need to be approved by the Senate, which is unlikely to get the 60 votes required given the Democrats wafer thin majority in the upper house and Republicans hostility to such an increase in government spending and taxes. This means the Democrats are likely going to have to go down the route of using the budget reconciliations process to get the plan approved by a simple majority, but even this is not necessarily guaranteed to work given differing positions of individual Democrat Senators.

While we strongly suspect both bills will eventually be approved, it means it could take a few more months for it to be finalised, meaning the money for the infrastructure spending won't come before 2022.

Construction spending by sector



Source: Macrobond, ING

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US Construction Outlook: 2022 the year of consolidation and rebalancing

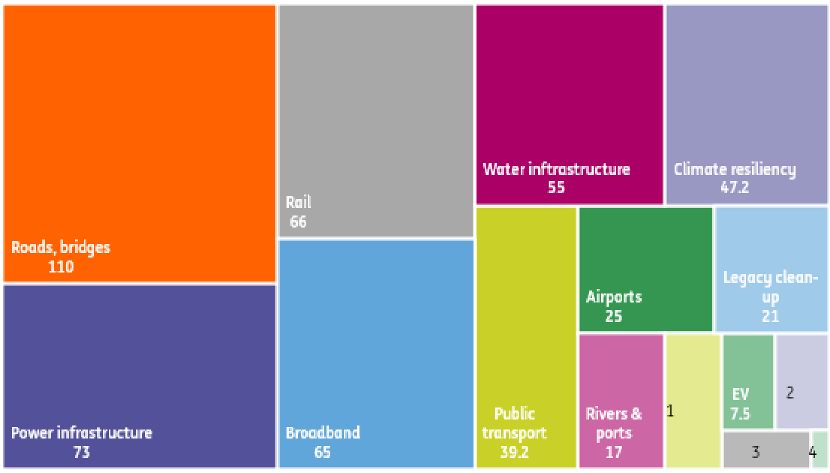
Residential construction will fall, but private non-residential construction is set to rebound as economic reopening drives the need for remodelling and rebuilding. Government infrastructure investment will add an extra layer of spending that can mitigate the headwinds from housing and leave overall spending down 0.5% in 2022 after 2021's 7% gain

$550bn over five years for transport, power, broadband and water

We have already outlined that we think residential construction spending will fall as the cooling housing boom translates into less home building. We also think that private non-residential construction will partially offset that as more and more people return to the cities, and delayed projects are restarted, with a strong economy adding to the incentives to put money to work.

An additional key swing factor will be the government's new infrastructure spending plan that will see an extra $550bn being spent on everything from road improvements to broadband upgrades, to power network improvements and the replacement of water pipes.

Where Biden's Billions are going (USD bn)



1 Safety (11)
2 Bus & ferries (7.5)
3 Water storage (5)
4 Revitalisation (1)

Source: Infrastructure Investment and Jobs Act, ING

1 Transport

A fifth of the $550bn will be focused on repairing and building new roads and bridges. While this is well short of the $786 billion backlog of investment needs, as estimated by the American Society of Civil Engineers, it is still a substantial amount of money. We also must acknowledge not all of the money will be going on construction, with new buses, ferries and electric vehicle technology all set to receive a portion. The full breakdown is as follows:

- $110bn on road, bridges and major projects - repair and rebuilding of bridges with a "focus on climate mitigation, resilience, equity, and safety for all users, including cyclists and pedestrians". $40bn focused on bridges with $16bn for major projects "that are too large or complex for traditional funding programs but will deliver significant economic benefits to communities".
- $66bn for rail repair and Amtrak service expansion – eliminate maintenance backlog, modernising fleets and expanding services
- $39.2bn for public transit – modernise transit fleet of 24,000 buses and expand services.
- $25bn for airports, $17bn for ports - address repair and maintenance backlogs, reduce congestion and emissions near ports and airports, and drive electrification and other low-carbon technologies.
- $11bn for transportation safety including money to reduce crashes and fatalities and money for replacement of cast iron and bare steel gas pipelines under roads.
- $7.5bn for electric vehicle infrastructure – create a network of EV chargers to encourage adoption of EV vehicles to address climate issues.
- $7.5bn for zero and low-emission buses and ferries.
- $1bn for revitalisation of communities - the programme will fund planning, design, demolition, and reconstruction of street grids, parks, or other infrastructure.

2 Energy and sustainability

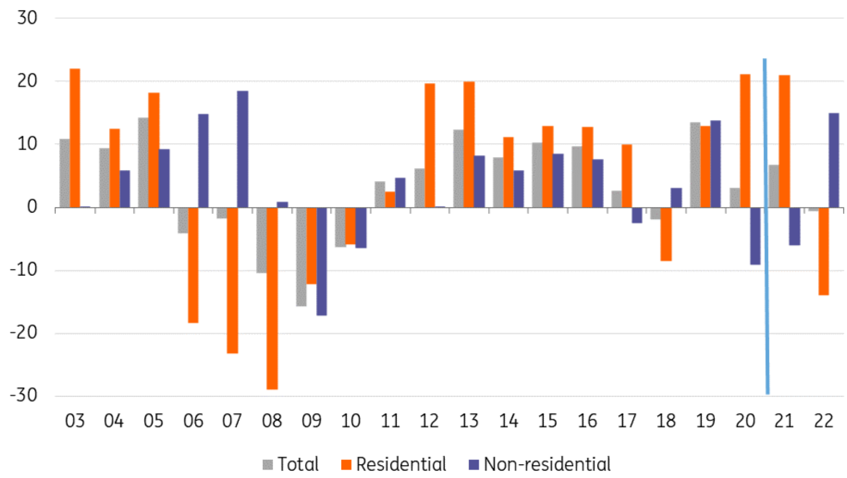
- $73bn for clean energy / power infrastructure - including building thousands of miles of new, resilient transmission lines to facilitate the expansion of renewable energy. Creation of a new Grid Deployment Authority, investing in research and development for advanced transmission and electricity distribution technologies, and promotes smart grid technologies that deliver flexibility and resilience.
- $65bn to boost broadband availability for rural and low income households - ensure every American has access to reliable high-speed internet.
- $55bn for water infrastructure - including elimination of lead pipes to ensure drinking water is safe.
- $47.2bn for climate resiliency – making infrastructure more resilient to the impacts of climate change and cyber-attacks. This includes funds to protect against droughts, floods and wildfires, in addition to a major investment in weatherisation.
- $5bn for Western water storage.
- $21bn for environmental remediation - addressing legacy pollution. The bill includes funds to clean up Superfund and brownfield sites, reclaim abandoned mine land and cap orphaned gas wells.

What it might mean

The additional $550bn is worth around 2.5% of GDP, but assuming it is spread out evenly over five years it is equivalent to around 0.5ppt of GDP per year. However, as a proportion of US construction spending it is equivalent to a 7% boost each year for the next five years, overwhelmingly focused on the non-residential sector. Remember this is on top of the extra $450bn of spending already approved, but we also need to acknowledge that not all is "pure" construction so the actual boost will be a little less.

With government impetus behind greener initiatives with a focus on sustainability, this could incentivise more private sector investment in these areas.

Nominal construction GDP (YoY% with ING forecasts)



Source: Macrobond, ING

2022: Consolidation and rebalancing

The second half of 2020 and first half of 2021 was a fantastic period for residential construction, but with clear evidence that the stimulus-fuelled wave of home buying is waning we expect a drift lower in output over the next 18 months. Higher borrowing costs and high prices mean affordability issues will slow demand, and with costs having risen substantially, we expect construction activity to gradually decline.

It is the opposite story for non-residential where shutdowns and uncertainty led to a steep decline in new business. The next 18 months should see a major reversal of fortunes as reopened leisure, entertainment, travel and hospitality sectors are updated and refurbished, with new businesses developing to take advantage of strong consumer demand.

The corporate sector has largely put things on hold since Covid hit and we see significant growth opportunities for the non-residential construction sector outside of offices and commercial space in major commercial areas. With a significant wave of government infrastructure funding hitting the economy, this should propel the US non-residential construction sector for the coming five years.

Putting this all together we expect total construction spending to increase by 7% in 2021, but suspect that the decline in residential spending of potentially 14% (after two consecutive annual rises in excess of 20%) will more than offset the recovery in non-residential spending next year. For 2022, we expect overall construction spending to fall by around 0.5%.

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