OBSERVATION

TD Economics

May 27, 2015

CANADA'S NON-RESIDENTIAL CONSTRUCTION OUTLOOK:

Weakness in Oil Patch Will Conceal Pockets of Solid Growth

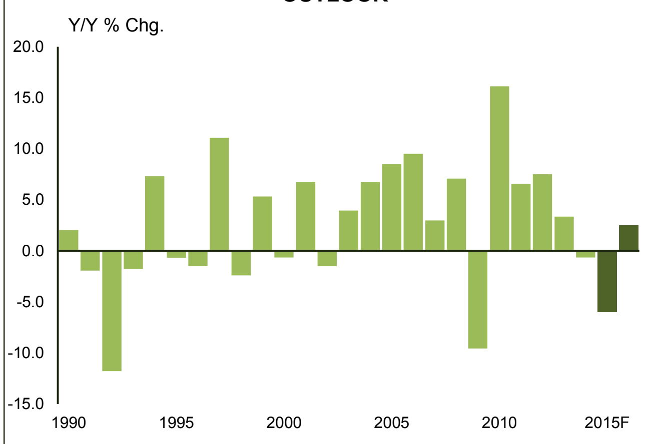
Highlights

- Canada's non-residential construction sector is expected to take a big hit this year, as the massive decline in oil prices weighs on investment in the oil patch. Indeed, engineering construction – which accounts for over 70% of total non-residential construction – will contract significantly in 2015, before recording a modest increase next year.
- The weakness in oil-related investment will conceal some pockets of solid growth. In particular, spending in the industrial and institutional building sectors are poised to outperform over the next two years, providing some offset to the declines in engineering construction. Commercial building, however, has likely peaked and is expected to be flat to down over the forecast horizon.
- Given the energy-related weakness, oil-rich provinces are expected to bear the brunt of the decline in non-residential construction. Meanwhile, Ontario and Quebec will benefit from an uptick in economic activity in the U.S., while large-scale projects in Manitoba and Nova Scotia will put these provinces at the top of the leaderboard for non-residential construction growth in 2015-16.

The non-residential construction sector – comprised of engineering construction and institutional, commercial and industrial building construction – has been a significant contributor to Canada's economy in recent years. It accounts for about 7% of economic activity and has pulled beyond its weight in terms of contribution to jobs and standard of living gains. While many had been bracing for a natural cyclical slowdown in non-residential construction spending, the plunge in crude oil prices since mid-2014 has raised fears of a deeper and more protracted bear market akin to what occurred in Canada in the 1990s.

We anticipate that the actual path of non-residential construction activity will fall somewhere in the middle of these expectations. Overall real (after-inflation) activity appears set to contract by 6% in 2015, and increase by a modest 2.5% in 2016. While oil prices have been showing signs of turning the corner, and we expect a continued but uneven recovery going forward, a great deal of downside risk remains. Moreover, the level of prices will stay low relative to the norms seen in recent years and there will likely be a lag of more than a year before these stronger price conditions feed through meaningfully to new capital spending in the oil patch. In the meantime, the softness in major oil-related work will conceal good growth opportunities across some regions and industries. Indeed, industrial building and government-related infrastructure are two areas where spending is expected to remain strong.

CHART 1: NON-RESIDENTIAL CONSTRUCTION OUTLOOK



Source: Haver Analytics; Forecast by TD Economics as at May 2015

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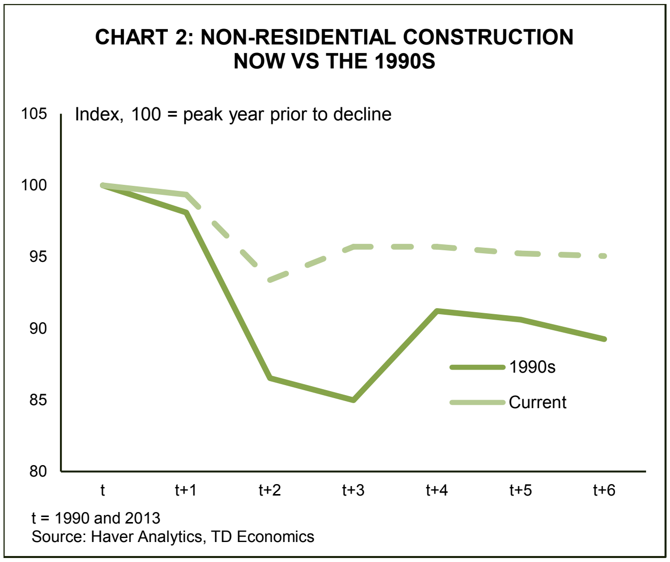


A quick look back in the rear view mirror

The 1990s stands out as the toughest period for the sector in recent memory, with investment in non-residential structures plunging 15% during the 1990-93 period led by significant declines in commercial and industrial construction activity. Investment remained subdued for another three years as interest rates were pushed up sharply and governments moved to curtail deficits, partly through cuts on infrastructure outlays. This prolonged period of weakness sowed the seeds for the latest 10-year bull period that began in 2003. Indeed, while much of the spotlight has been cast on the housing sector since the early 2000s, the non-residential sector was not far behind in terms of robust growth.

Over the 2000-2014 period, growth has been reasonably broad based across non-residential areas, with commercial construction rising 63%, and institutional construction up 44% over the 2000-2014 period. Industrial construction joined the party after the recession, rising 23% since 2009. But the biggest driver of growth in the sector has been the 135% jump in engineering construction, led by the development of the oilsands and offshore petroleum, as well as mining infrastructure. In fact, engineering projects accounted for 37% of total construction and just over 70% of all non-residential construction in 2014, up from 60% in 2000 (See Chart 3). For details on what type of construction is included in each of these subsectors, see Box 1 on page 3.

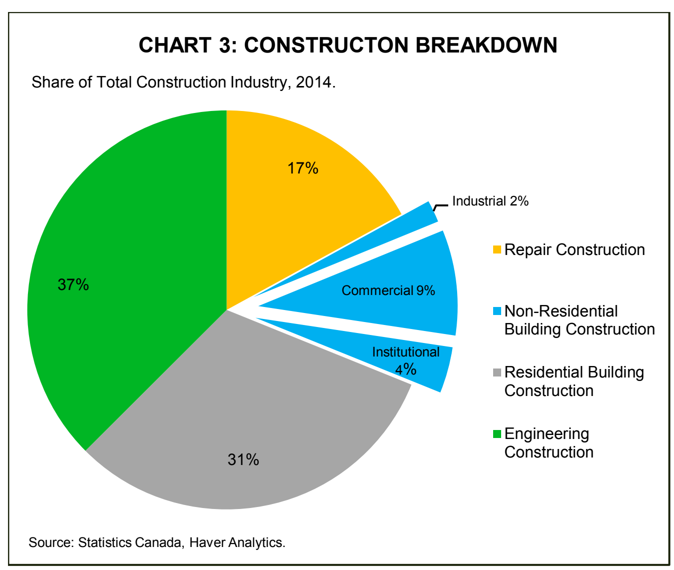
The construction sector as a whole (including residential) accounted for about a fifth of overall job growth since 2008. This excludes indirect benefits. Indeed, Statistics Canada's 2010 Input-Output National Multiplier Tables suggest that every job created in the construction sector supports about 0.6-1 jobs related to the construction sector, depending on the type of construction. For example, non-residential building construction jobs could support jobs in the cement industry. Hence, the sector has been a key support for the Canadian economy in recent years.

Expectations fade alongside oil price plunge

With the resource sector leaving such an indelible imprint on the overall fortunes of the non-residential construction sector, the fall from grace of commodity prices over the past year – particularly oil – has delivered an enormous setback. Going forward, many supportive factors will remain in place – including a persistently low interest rate environment, and a relatively low overall government debt burden – unlike the case back in the 1990s. Still, so much will depend on the near-term direction of resource markets. Unfortunately, the upside for most commodity prices is limited in the near term, as many markets are dealing with abundant supplies.

Consider the oil market, Canada's most important resource industry, and key contributor to construction activity. In 2014, the oil and gas sector accounted for about half of engineering construction and nearly a fifth of total construction including housing. The WTI benchmark lost about 55% of its value between mid-2014 and the first quarter of this year, driven by the massive glut that was built in the market as production growth far outpaced demand growth. While crude oil prices seem to have turned the corner in recent weeks, prices remain vulnerable to bouts of downward pressure. Even with a gradual recovery, oil prices are still expected to be relatively low next year, with the WTI benchmark averaging US$70 per barrel.

The low price environment over the last few months



Box 1: Non-Residential Construction Breakdown

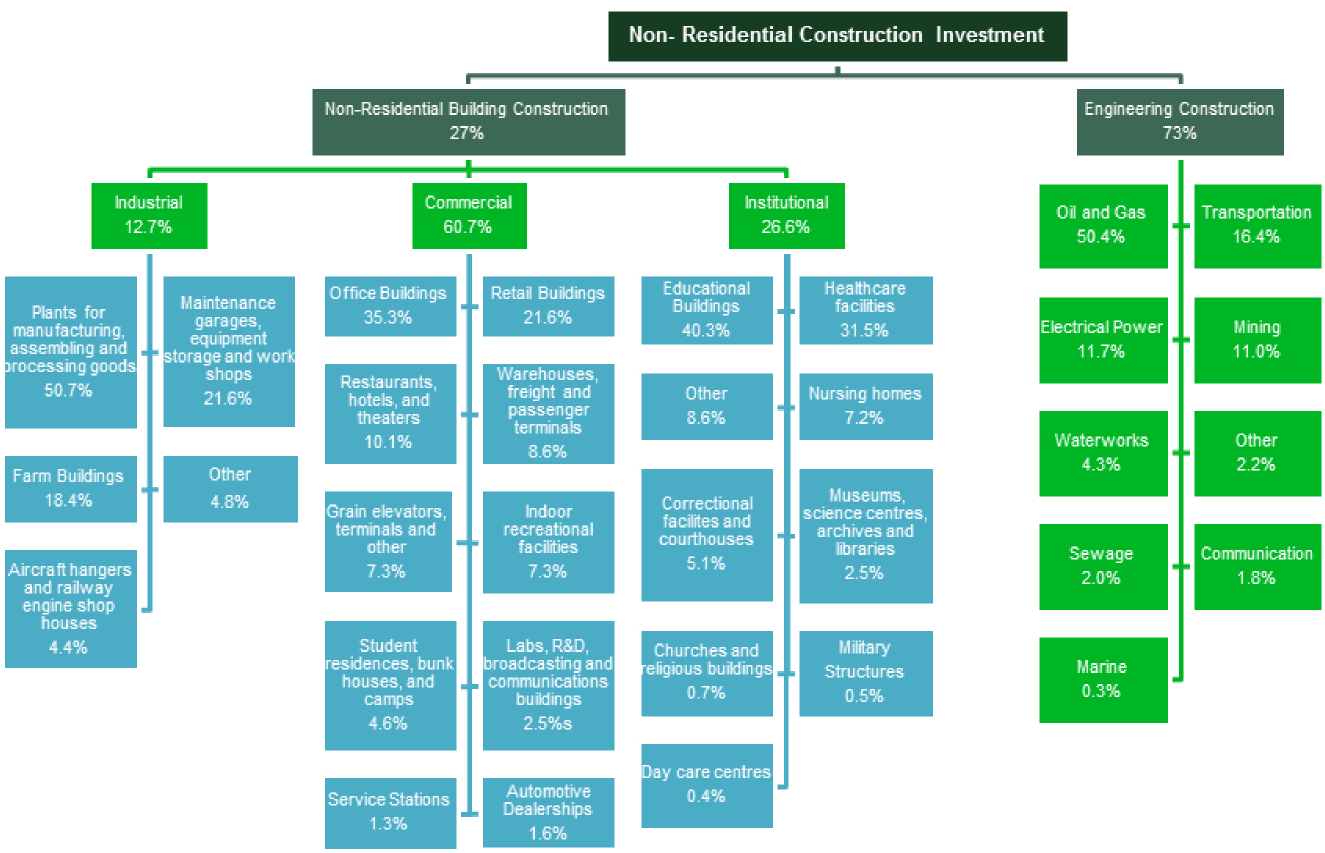
Non-residential construction investment is made up of two key components: engineering construction and non-residential building construction. The development of the oilsands, offshore petroleum and other mining and related infrastructure has shifted the composition of business capital towards engineering construction. In fact, engineering is by far the primary driver of non-residential construction activity, accounting for 73%.

Engineering construction is comprised of eight sub-sectors, with oil and gas—including refineries, pipelines, storage tanks, etc.—accounting for about half of total engineering construction activity. Transportation engineering, including roads, bridges, railways, runways, etc.— is a distant second with a share of 16%.

Non-residential building construction can be broken out into three distinct subsectors: industrial, commercial and institutional (ICI). The commercial sector is the largest of the three, and is driven primarily by office buildings and retail space. Entertainment and hospitality spaces are also part of the commercial sector.

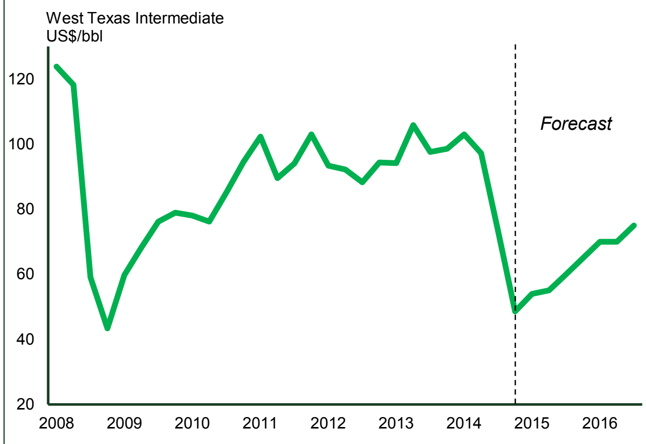
The industrial sector is the smallest, with roughly half of all construction driven by the manufacturing sector. Institutional building construction is in the middle of the pack, with education and healthcare facilities accounting for almost three quarters of construction in the subsector. For a full list of components that make up each subsector, please see Exhibit 1.

Exhibit 1: Non-Residential Construction Components



Source: Statistics Canada. TD Economics.

CHART 4: OIL PRICE FORECAST



Source: Bloomberg, Haver Analytics. Forecasts by TD Securities as at May 2015.

– and subdued outlook for prices going forward – has led producers to slash investment plans. In fact, capital expenditures in Canada's oil patch are on track to fall by 30% this year. This certainly doesn't bode well for engineering construction given that it accounts for such a large share of that market. With expectations for spending in 2015 in the doldrums, perhaps the bigger question surrounds investment intentions for next year. Investment decisions rely less on current prices and more on expectations for future prices. Our forecast puts prices higher than this year; however, on a level basis, they are still on the low side when it comes to the returns needed to make new large scale projects profitable. As such, we suspect that investment in the oil patch will pick up only modestly in 2016.

Input costs sliding alongside oil

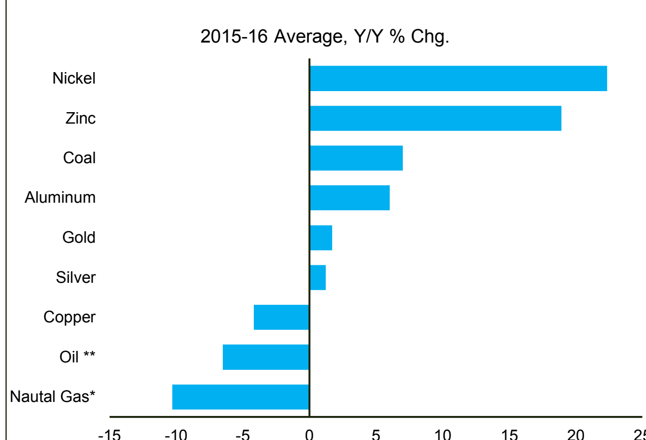
One benefit from lower oil prices is that they have helped to drive input costs lower in recent months, as evidenced by the drop in the industrial product prices index, as well as some oil company earnings reports. However, any inputs that are imported have become more expensive as the Canadian dollar has also weakened, providing some offset. Still, we suspect cost pressures will ease further going forward, particularly on the wage front. Job losses have already begun to show up in the energy sector, with more likely in the pipeline. As the pool of available construction workers grows, loosening the labour market within the sector, downward pressure on wages should follow suit. As such, we expect construction wage growth to flatten out in the coming months.

Non-oil resources a mixed bag

Lower costs will benefit non-oil resource and other segments as well, particularly on the labour side, as reduced oil activity will increase the pool of workers available to work in other industries. That said, investment elsewhere within the resource sector is likely to be relatively flat this year after declining in 2014. In particular, following strong growth in recent years, investment in the potash industry is expected to decline, as big projects have largely been completed.

Lower prices of other commodities, a slower growing China, and a great deal of uncertainty surrounding growth in the rest of the world are expected to hold back spending in non-energy resource sectors in the near term. Rhetoric from non-energy mining companies is that they will be cautious about new investments until they get a better sense of when conditions will improve. However, most are more optimistic about 2016-17. In particular, nickel and zinc prices are expected to shoot up over the next 18 months, which should bode well for investment in these resources. Indeed, the Dumont nickel project in Quebec is already underway. There are also two diamond projects that will continue as planned, one in Quebec (Renard) and one in the Northwest Territories (Gahcho Kue). With natural gas prices under pressure in recent years and limited upside over the foreseeable future, there has been some push for liquefied natural gas (LNG) terminals to be built in order to broaden Canada's consumer base. While several LNG proposals in British Columbia have been tabled, the government has committed to have three in operation by 2020. Hence, this is one area that could see some growth in construction activity in the coming years.

CHART 5: COMMODITY PRICE FORECAST



Source: *Henry Hub, **West Texas Intermediate Cushing. Forecast by TD Securities at May 2015.

Commercial building has peaked

While there will be some opportunities in the commercial building sector, the market in general appears to have peaked. Office job growth has slowed to a 1-2% rate over the last couple of years, down from 3-4% prior to the recession. Moreover, job creation is likely to be lackluster due in part to an expected shift toward the more highly productive export sector. At the same time, firms are using their space more efficiently as they try to rein in spending. According to CBRE, office vacancy rates are on the rise, reaching 11.1% in the first quarter of this year – the highest rate seen since 2005. As a result, rental rates have begun to fall, although they remain elevated relative to historical levels. The rise in vacancy rates has been slightly more pronounced in Western Canada, which has been influenced by the turn in fortunes in the resource sector. Going forward, new office supply, particularly in downtown markets including Toronto, Montreal and Vancouver, combined with a cooling in office demand growth in Canada, should keep vacancy rates elevated over the next couple of years.

On the retail side, the upside for demand is limited. Consumer spending growth has slowed from a pace of 4-5% prior to the recession to about 2-3% amid high indebtedness – a trend that is likely to continue over the forecast horizon. Moreover, the recent weakness in the Canadian dollar has squeezed retail margins as the cost of imported goods has risen. An increase in foreign companies setting up shop in Canada in recent years has led to increased competition, resulting in a lot of consolidation and turnover in the sector. The exit of Target from the Canadian market has increased available retail space, although some has already been absorbed by other retailers. As well, the shift to online shopping has stepped up competition for in-store demand. Some firms are using their stores to facilitate online shopping and some items are limited to in store sales only. This differs from the U.S. where retailers have had to build facilities to meet their online demand. While there will always be a need for actual bricks and mortar in the sector, there likely won't be too much need for expansion.

For the commercial sector as a whole, building permits slipped into negative territory in 2014, and continued to fall through the first quarter of this year. As such, growth in the sector will be limited going forward. All told, commercial building construction is expected to cool over the next couple of years. However, the extent of the cool down will be limited as low interest rates and the ongoing shift to city cores should continue to encourage demand. Overall, we expect commercial construction to be flat to down over the next 18-24 months.

CHART 6: OFFICE VACANCY RATES

Source: CBRE

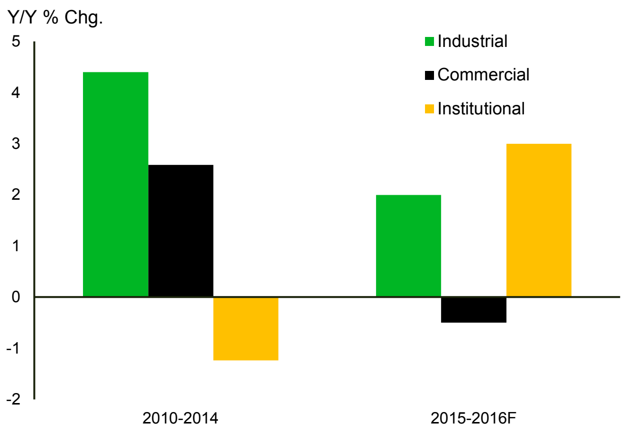
Industrial sector poised for growth

Weakness in commercial and resource-related development over the next few years will conceal some good growth opportunities in other sectors of the economy which will support non-residential construction. Opportunities will flow in part from a combination of low interest rates, a weaker Canadian dollar, and the boost from low oil prices to activity in non-oil-producing regions and sectors of the economy.

Industrial building construction shot up in the second half of last year, and growth prospects for the next two years remain bright. Rising U.S. demand and a weak Canadian dollar will certainly bode well for domestic manufacturers. Given the competitive manufacturing environment globally, Canadian producers will likely have to retool and reinvest in their operations, as well as improve the efficiency of their space. What's more, capacity constraints across various manufacturing industries should prompt producers to increase capital spending in the wake of rising activity. In particular, the machinery and plastics and rubber manufacturing sectors have seen a rise in capacity utilization, and have healthy near-term economic growth prospects. Moreover, given that new industrial projects have been design-built to suit buyer needs, there is more upside potential relative to the commercial sector.

Building permits for industrial units were positive in the fourth quarter last year and shot up in the first quarter of 2015, suggesting that there is more construction in the pipeline. As such, we expect industrial construction to grow by roughly 3% over the next couple of years.

CHART 7: ICI OUTLOOK



Source: Haver Analytics. Forecast byt TD Economics at May 2015.

Government-related spending to outperform

Continued strength in government infrastructure spending will not only provide some offsetting support within the engineering construction component – given that billions of dollars have been targeted towards transit infrastructure – but also feed into opportunities in institutional building construction.

Indeed, despite deficits, infrastructure spending has remained a priority with roughly $40 billion per year earmarked for capital spending across provincial governments in 2015 and 2016. Municipal spending will also add favourably to the investment tally. Ontario has committed $130 billion over 10 years in public infrastructure spending (including transportation), making it the province's largest infrastructure investment in history, while the Quebec government has allocated nearly $90 billion over a 10 year period to infrastructure projects. Even in Alberta, where the government will move to tackle a large $7 billion budget gap, infrastructure spending is likely to remain a priority, although the newly-elected NDP government's first budget will shed some more light on their intentions once released. All told, capital spending plans supporting transportation and institutional investment are set to grow over the next few years from their already lofty levels.

Overall, we expect institutional building construction to bounce back strongly, following a weak performance in recent years. Building permits shot up by a dramatic 26% last year, suggesting that the sector is poised for growth going forward. Much of the growth in permits stemmed from schools and healthcare, which account for the majority of construction in the sector. Overall, we expect this sector to outperform over the forecast horizon, although growth will still remain in a modest 3-4% range.

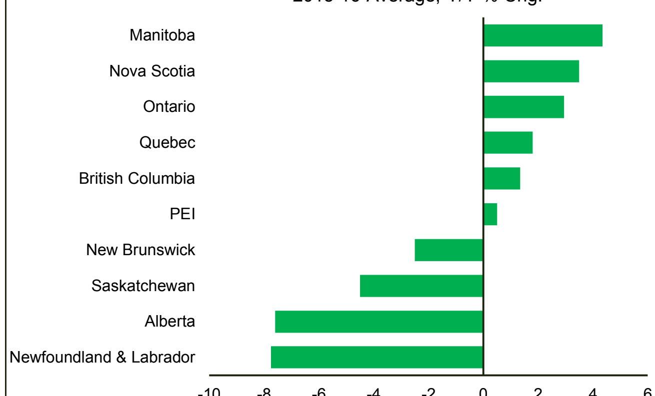
Non-energy regions to outperform

There is much divergence in the outlook for non-residential building and engineering construction across provinces. Oil-producing regions will be hit hardest due to the lack of investment in engineering construction expected this year. Hence, Newfoundland and Labrador, Alberta and Saskatchewan are all likely to record significant declines in non-residential construction activity over the forecast horizon, despite ongoing investment in transit, healthcare and education infrastructure providing some offset. For Newfoundland and Labrador, while investment is expected to contract considerably over the next two years, the decline in spending is projected to be concentrated in 2016 as a number of projects are winding down. That said, given that the province is coming off a multi-year period of robust spending growth, the level of investment should remain elevated.

On the other end of the spectrum, Manitoba is expected outperform, as the government has maintained the 5-year infrastructure plan that is targeted towards transportation, municipal infrastructure and flood protection, which is expected provide a decent boost to economic growth. Nova Scotia is also among the top performers, with several large scale projects giving non-res investment a lift. These include the development of the Halifax shipyard in preparation of the military shipbuilding project, a number of commercial developments, as well as activity tied to the Macdonald Bridge. In addition to the infrastructure program set out in

CHART 8: REGIONAL BREAKDOWN OF NON-RESIDENTIAL CONSTRUCTION GROWTH

2015-16 Average, Y/Y % Chg.



Source: Haver Analytics. Forecast by TD Economics at May 2015.

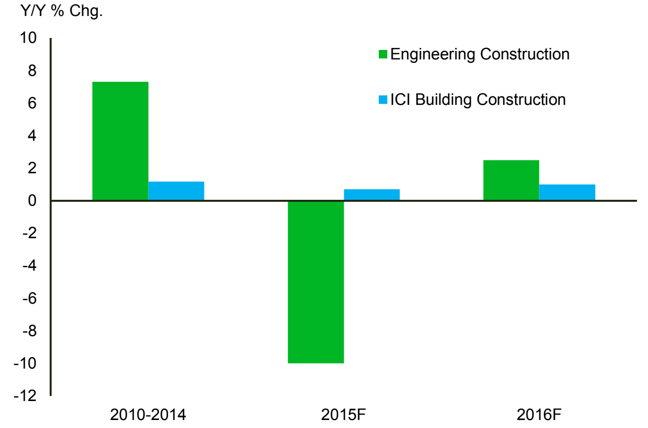
the budget, construction in Ontario should also get a lift from an increase in industrial construction as manufacturers begin to bump up against full capacity and need to expand.

Bottom line

Overall, the near-term outlook for the non-residential construction sector is quite mixed, with massive declines from the energy sector – and to a lesser extent, the commercial sector – only partially offset by ongoing investment in transportation, industrial and institutional construction. The bulk of the impact from lower resource sector investment will be felt this year, with overall non-residential construction expected to record a modest rebound in 2016.

Further out, upside potential for growth in the overall non-residential pie is somewhat limited, given the multi-year boom that just occurred, and the fact that interest rates are likely to normalize, albeit gradually over time. Still, Canada's long term fundamentals remain reasonably healthy. Indeed, governments across the country – even those with elevated debt levels – remain committed to capital spending plans. As well, demographics will support ongoing infrastructure investment, and plans to expand trade ties should lead to increased demand for Canadian-made products, and thus space to make these goods. Moreover, while emerging markets are currently struggling, we believe that they will remain a key source of commodity demand over the longer haul. These solid underlying forces will help to work against any downward cyclical pressures.

CHART 9: NON-RESIDENTAL CONSTRUCTION OUTLOOK



Source: Haver Analytics. Forecast by TD Ecomonics at May 2015.

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