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Construction Data Decidedly Mixed

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Rate of Industry Expansion Softened in Early '16

After several months of disappointing construction spending and employment data, July represented a most welcome bit of good news. Data from prior months had indicated significant softening in nonresidential construction spending growth and diminished hiring. The overall U.S. construction industry shed 27,000 positions during the three-month period ending in June.

As further example of the tenor of prior data releases, nonresidential construction spending shrank 0.6 percent in June, totaling $682 billion on a seasonally adjusted, annualized basis. That meant that nonresidential construction spending had contracted for three consecutive months and was now down on a year-over-year basis.

The data have been somewhat surprising given upbeat anecdotal information coming from contractors in California, Florida, Georgia, South Carolina, and a number of other states. There has also been an expectation that highway and street-related spending would be bolstered by the passage of a 5-year federal highway bill in late 2015, the first federal highway bill to be passed in several years. Instead, by June, year-over-year highway and street spending was down by roughly 6 percent, and overall year-over-year nonresidential construction spending was negative for the first time since July 2013.

Exhibit 1. *Nonresidential Spending, June 2016, Millions of Dollars, Seasonally Adjusted Annual Rate*

Sebsector	June 2016	1-month % Change	12-month % Change
Nonresidential	681,983	-1.00%	-1.10%
Lodging	27,107	0.70%	16.10%
Office	64,443	0.40%	16.20%
Commercial	70,506	-2.20%	7.50%
Health care	40,253	-1.40%	-4.80%
Educational	84,467	-1.00%	-4.30%
Religious	3,961	2.20%	3.70%
Public safety	8,010	0.60%	-8.40%
Amusement and recreation	21,524	0.50%	-0.70%
Transportation	43,614	0.10%	-3.30%
Communication	18,927	-0.30%	-6.00%
Power	97,105	0.20%	3.00%
Highway and street	88,329	-1.40%	-5.90%
Sewage and waste disposal	21,669	-2.60%	-14.50%
Water supply	12,523	3.30%	-14.00%
Conservation and development	8,323	-0.60%	8.30%
Manufacturing	71,221	-4.50%	-10.40%

Source: United States Census Bureau

Joe's View

It's late in the summer, and (I hope) many of you are reading this by the pool or in your golf cart as you steal as many sunny days as you can before the leaves begin to fall. And, if I were with you in that cart or by that pool, and you asked me, "Joe, how's the construction market these days?" I'm not totally sure how I would answer. As you'll see in this quarter's index, it's really up and down. It's certainly not great to see that nonresidential spending has lessened. On the other hand, industrywide unemployment is clocking in at very low 4.5%. Should July's gains continue, the forecast stays sunny. But in case they don't, let's take a minute to consider some potential outcomes.

So, what do we make of constricting markets but falling unemployment? I think the most productive way to assess our data this quarter is as a cautionary sign for what may be to come. First, let's watch those backlogs (as I'm sure you already do). We all know the whipsaw effect cooling markets can have, and we all should be prepared should the situation become critical. Next, I'd say "take care of your people." At Marcum, we always say that our most valuable asset goes home every night. A lower unemployment rate means fewer folks are out of work, but it also often means fewer folks looking for that type of work. It's a real possibility that some people who were a part of the national construction workforce have moved on to other careers in other industries. That potential scarcity of talent means that management may be looking at higher industry wage demands in the immediate future.

Now, having offered a somewhat serious message, let me encourage you to enjoy the rest of your summer, family vacations and however else you choose to celebrate this beautiful time of year. My family and I wish you a great Labor Day holiday and a smooth rentry for those of you with school-age children.

Joseph Natarelli, CPA
National Construction Industry Group Leader, Marcum LLP

Charts

Thankfully, the July data were better and suggested the recovery in nonresidential construction has not completely stalled. The overall construction industry added 14,000 jobs for the month, with the nonresidential segment accounting for an easy majority of those net new positions (11,500). Heavy and civil engineering construction, which largely revolves around roadwork, added 1,900 jobs in July after shedding 8,800 positions from January to June. While July was certainly a bright spot for this year thus far, it did not fully reverse prior month losses.

The nonresidential construction sector's unemployment rate is now down to 4.5 percent, an indication that the construction workforce remains busy. However, there is also evidence suggesting that some people who have been working in construction or looking for construction jobs have been lured to other industries. This is not surprising. The U.S. economy added more than 2.4 million positions during a recent 12-month period, creating more options for workers with varied skillsets.

It should be concerning to construction industry leaders that while sectoral employment declined during a recent three-month stretch, industry unemployment also fell. The implication is that fewer people are making themselves available for construction work. Presuming the construction recovery continues, this implies sharper increases in wages and benefits going forward, which, all things being equal, will squeeze industry profit margins.

There are a number of potential explanations for the recent dips in nonresidential construction spending. For instance, though commodity prices have stabilized recently, many inputs to construction remain cheaper than they were a year ago. To the extent that savings from cheaper materials prices are being passed along to purchasers of construction services, the data will reflect diminished construction spending even in the absence of reductions in square footage or units delivered.

Stagnation in public investment represents another explanation. While private nonresidential spending expanded 2.5 percent on a year-over-year basis between June 2015 and June 2016, public nonresidential spending fell 5.9 percent over that same time period. Much of the decline in public investment is traceable to spending declines in the highway and street, educational, and sewage and waste disposal categories. These are the three largest public construction segments. If these are excluded from consideration, total nonresidential spending would have grown 0.7 percent on a year-over-year basis rather than retrenching 1.1 percent.

Weakness in the global economy represents yet another factor. U.S. merchandise exports fell sharply last year, which helps partially explain the double-digit decline in manufacturing-related construction over the past year. Low oil and natural gas prices have also contributed to diminished construction industry momentum, particularly in certain geographies.

For many years, construction employment surged in markets like Dallas, Oklahoma City, Williston and Houston. That is no longer the case. Today, construction employment growth has been far more apparent in technology-intensive markets like Boston, San Francisco, and Seattle.

Exhibit 2. *Construction Employment Growth in 20 Largest U.S. Metropolitan Areas June 2015 v. June 2016, Not Seasonally Adjusted*

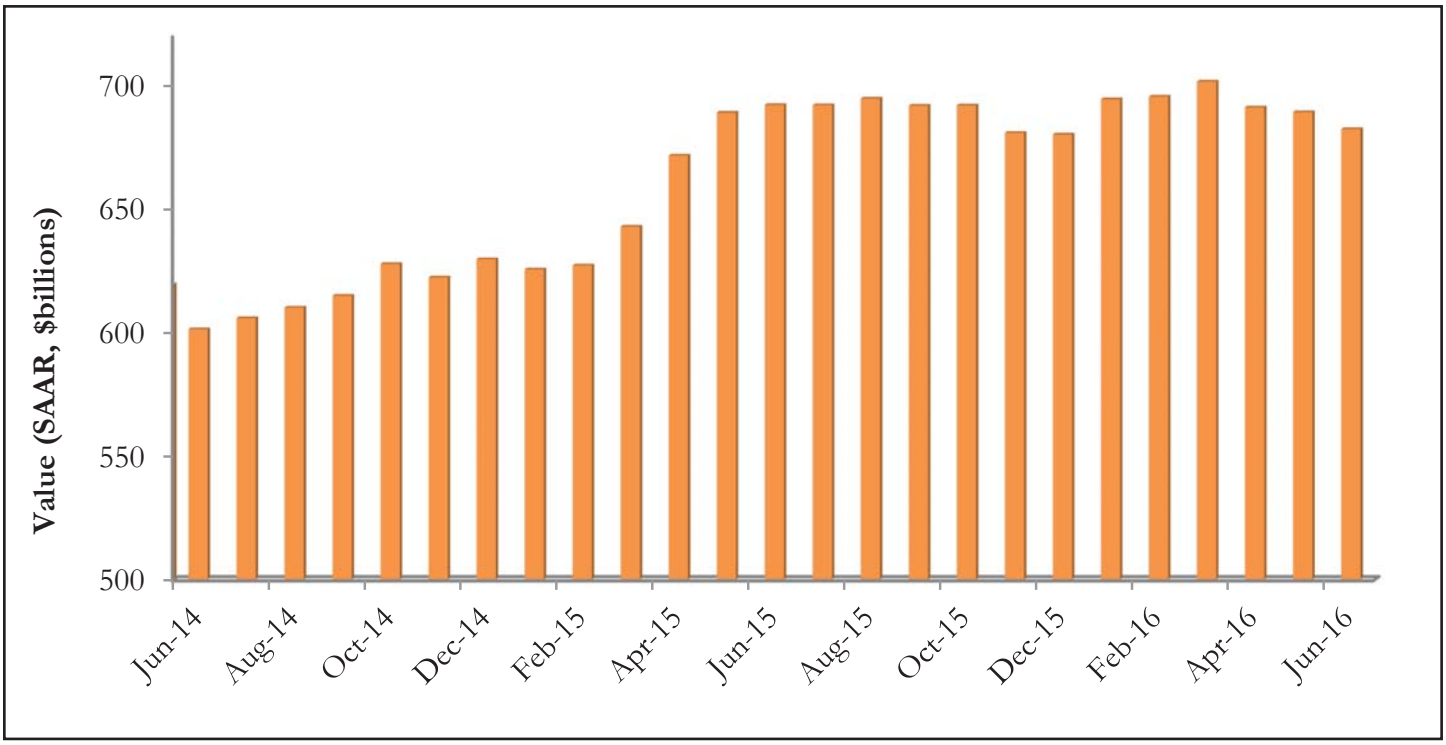
#	MSA	%	#	MSA	%
1	Boston-Cambridge-Quincy, MA-NH	10.30%	11	Riverside-San Bernardino-Ontario, CA	5.20%
2	Phoenix-Mesa-Glendale, AZ	10.00%	12	St. Louis, MO-IL	4.70%
3	San Francisco-Oakland-Fremont, CA	8.20%	12	New York-Northern New Jersey-L. Island, NY-NJ-PA*	4.70%
4	Los Angeles-Long Beach-Santa Ana, CA	7.60%	14	Philadelphia-Camden-Wilmington, PA-NJ-DE-MD*	3.30%
5	Tampa-St. Petersburg-Clearwater, FL	7.30%	15	San Diego-Carlsbad-San Marcos, CA	2.90%
6	Seattle-Tacoma-Bellevue, WA	7.10%	15	Baltimore-Towson, MD*	2.90%
7	Atlanta-Marietta, GA	6.70%	15	Minneapolis-St. Paul-Bloomington, MN-WI*	2.90%
8	Miami-Fort Lauderdale-Pompano Beach, FL	6.50%	18	Dallas-Fort Worth-Arlington, TX*	0.80%
9	Washington-Arlington-Alexandria, DC-VA-MD-WV*	5.60%	19	Detroit-Warren-Livonia, MI*	-.90%
10	Chicago-Joliet-Naperville, IL-IN-WI	5.30%	20	Houston-Sugar Land, TX	-.50%

**Construction, Mining, and Logging are included in one industry; Source: Bureau of Labor Statistics*

Graph ▼

CEOs generally remain hesitant to invest in equipment and software. This may also help explain recent declines in both labor productivity and profitability. The lack of business investment in the U.S. economy has left the current economic expansion even more dependent on consumer spending, at least partially explaining the Federal Reserve's ongoing unwillingness to raise interest rates and borrowing costs.

Exhibit 3. *Nonresidential Construction Spending, June 2014 through June 2016*



Source: U.S. Census Bureau

Looking Ahead

The U.S. economic expansion has now entered its eighth year. Recession remains unlikely in the very near-term, with consumers continuing to expand outlays in the context of still-impressive job growth, accelerating wage gains, and remarkably low interest rates. Positive wealth effects from both equity and housing markets are also inducing household spending.

However, there are indications of overheating in certain segments of the economy. Weak economic performances in Europe, Japan, much of Latin America, Russia, South Africa and elsewhere is inducing global capital to flow in large amounts to the U.S. This has helped to keep bond prices high, interest rates low, stock prices elevated, and commercial real estate humming. Construction of office space and hotel rooms remains brisk in part because of inflows of foreign capital. While this is good for contractors currently, it increases the probability of overbuilding and eventual market adjustment.

Moreover, as the S&P 500 and NASDAQ continue to vault toward new highs, the possibility of significant downward equity market adjustments rises. Price-earnings ratios have increasingly become stretched. If corporate earnings fail to expand, market adjustment and associated losses in wealth and confidence assuredly will follow.

Such dynamics would jeopardize the current moderate construction industry recovery. Correspondingly, the 2018-2019 industry outlook appears distinctly murky. Even in the wake of a general economic downturn next year, many contractors are positioned for at least a decent 2017 given current levels of backlog. This is akin to the dynamics of the prior business cycle, when the broader economy entered recession in December of 2007, but nonresidential construction spending did not peak until October of the following year.

Second Quarter 2016 Performance	Quarterly Values			% Change from	
Gross Domestic Product	**2016Q2**	**2016Q1**	**2015Q4**		
Overall Real GDP	1.20%	0.80%	0.90%	NA	NA
Nonresidential Fixed Investment in Structures	-2.20%	-3.40%	-3.30%	NA	NA
Construction Spending, Seasonally Adjusted (in $millions)	**16-Jun**	**16-May**	**15-Jun**	**16-May**	**15-Jun**
Total Construction	1,133,543	1,140,902	1,130,490	-0.60%	0.30%
Residential	451,560	452,019	440,957	-0.10%	2.40%
Nonresidential	681,983	688,884	689,533	-1.00%	-1.10%
Lodging	27,107	26,915	23,343	0.70%	16.10%
Office	64,443	64,162	55,454	0.40%	16.20%
Commercial	70,506	72,092	65,557	-2.20%	7.50%
Health care	40,253	40,831	42,275	-1.40%	-4.80%
Educational	84,467	85,296	88,258	-1.00%	-4.30%
Religious	3,961	3,876	3,818	2.20%	3.70%
Public safety	8,010	7,959	8,742	0.60%	-8.40%
Amusement and recreation	21,524	21,413	21,679	0.50%	-0.70%
Transportation	43,614	43,549	45,105	0.10%	-3.30%
Communication	18,927	18,977	20,127	-0.30%	-6.00%
Power	97,105	96,950	94,250	0.20%	3.00%
Highway and street	88,329	89,562	93,825	-1.40%	-5.90%
Sewage and waste disposal	21,669	22,252	25,346	-2.60%	-14.50%
Water supply	12,523	12,123	14,565	3.30%	-14.00%
Conservation and development	8,323	8,374	7,684	-0.60%	8.30%
Manufacturing	71,221	74,553	79,504	-4.50%	-10.40%
Employment, Seasonally Adjusted (in thousands)	**16-Jul**	**16-Jun**	**15-Jul**	**16-Jun**	**15-Jul**
National Total Nonfarm	144,448	144,193	142,001	0.20%	1.70%
Construction	6,652	6,638	6,437	0.20%	3.30%
Residential building	720	720	691	0.00%	4.20%
Nonresidential building	742	739	725	0.40%	2.30%
Heavy and civil engineering construction	937	935	936	0.20%	0.10%
Residential specialty trade contractors	1,863	1,863	1,773	0.00%	5.10%
Nonresidential specialty trade contractors	2,390	2,381	2,313	0.40%	3.30%
Producer Prices	**16-Jun**	**16-May**	**15-Jun**	**16-May**	**15-Jun**
Finished Goods (seasonally adjusted)	108.2	107.3	110.5	0.80%	-2.10%
Inputs to Construction Industries	209.9	207.6	215.3	1.10%	-2.50%
Softwood lumber (seasonally adjusted)	202.2	202.1	192.2	0.00%	5.20%
Concrete products (seasonally adjusted)	246.6	246.1	239.1	0.20%	3.10%
Unprocessed energy materials (seasonally adjusted)	130.9	120.7	159.4	8.50%	-17.90%
Iron and steel (not seasonally adjusted)	192.4	194.3	200.3	-1.00%	-3.90%

Sources: Bureau of Economic Analysis; U.S. Census Bureau; Bureau of Labor Statistics; NA = Not Applicable or Not Available

Services

Marcum LLP is one of the largest independent public accounting and advisory services firms in the nation, with offices in major business markets throughout the U.S., Grand Cayman and China. Headquartered in New York City, Marcum provides a full spectrum of traditional tax, accounting and assurance services; advisory, valuation and litigation support; and an extensive range of specialty and niche industry practices. The Firm serves both privately held and publicly traded companies, as well as high net worth individuals, private equity and hedge funds, with a focus on middle-market companies and closely held family businesses. Marcum is a member of the Marcum Group, an organization providing a comprehensive array of professional services.

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- Bankruptcy and Insolvency Tax.
- State and Local Taxation.
- SEC and Large Corporate Matters.
- International Taxation.
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- Damage Determination and Expert Testimony.
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- Due Diligence and Capital Formation.
- Computer Forensics.
- Business Valuation.

Operational & Process Improvement

- Business Process Improvement.
- Internal Controls and Governance.
- Real Estate Advisory Services.
- Family Office Services.
- Risk Management.

Joseph Natarelli

Joseph Natarelli is the national leader of Marcum's Construction Industry Practice and partner-in-charge of the Firm's New Haven office. For more than a decade, he has served as a technical reviewer for the AICPA's Audit Risk Alert for Construction Contractors and the AICPA Accounting Guide – Construction Contractors. Joe also served as 2013-2014 chair of the AICPA National Construction Industry Conference.

Anirban Basu

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