



HOW LONG WILL THE RECOVERY LAST?

2016 has gotten off to a terrible start.

ANIRBAN BASU AND JOSEPH NATARELLI

The prior three recoveries lasted 95 months on average — this one is 80 months old already. Meanwhile, the Japanese economy is so weak that the nation's central bank recently opted to copy the European model and introduce negative interest rates.¹ Emerging economies like Turkey, Russia, and Brazil also continue to stumble, leaving the United States, India, and a handful of others to support global economic expansion.

There are many implications associated with a weak global economy, including weak commodity prices. As of this writing, oil is trading at \$35 a barrel, a far cry from roughly \$110 a barrel during the summer of 2014.² Other commodity prices have similarly collapsed, including steel, iron ore, natural gas, copper, and many others relevant to the U.S. construction industry.

For now, the U.S. economy remains in recovery despite financial and commodity market turmoil. At the end of 2015, the Dow Jones stood at 17,423.03, a drop of 407 points (2.3 percent) over the course of the year. The new year started poorly,

with the Dow dropping another 276 points on the first day the markets opened. This combination of slimming profit margins and turmoil throughout the world had sellers outnumbering buyers in the earliest days of 2016.

According to Harvard economist and Senior Fellow at the Council on Foreign Relations Kenneth Rogoff, things could be much worse around the world.³ Aging populations in both Japan and Europe, as well as financial instability in Greece, could potentially turn a bad situation into another global crisis. Looking at the broader picture, especially among developed nations, the United States is increasingly becoming one of the better growth stories.

That's despite the fact that the U.S. economy grew just 1 percent during the final quarter of 2015, revised upward from an earlier estimate of 0.7 percent supplied by the Bureau of Economic Analysis.⁴ Personal expenditures, nonresiden-

ANIRBAN BASU is the chief construction economist at Marcum LLP and the CEO of the Sage Policy Group.

JOSEPH NATARELLI is the partner-in-charge of Marcum LLP's New Haven office as well as the National Construction Industry Leader.

WHILE THE GLOBAL COMPONENT OF THE U.S. ECONOMY CONTINUES TO SPUTTER, THE DOMESTIC HOUSEHOLDS SECTOR CONTINUES TO DRIVE THE UNITED STATES FORWARD.

tial fixed investment, and more federal spending contributed to the increase, as did a decline in the level of imports.

Naturally, the U.S. energy sector continues to be among the weakest performers. While low energy prices make consumers happier, they also negatively impact economies in places like North Dakota, Oklahoma, Louisiana, Texas, and Alaska.

Energy companies are not the only ones struggling financially. According to the U.S. Department of Commerce, profits among U.S. companies posted the largest annual decline since the 2008 recession last year, falling 2.1 trillion between the third quarter of 2014 and the third quarter of 2015, a 4.7 percent drop.⁵ Fourth-quarter earnings estimates are not fully compiled, but it is likely that corporate profits slipped at year's end as well. This would mean that corporate earnings in the United States have fallen for three consecutive quarters, the first time that has happened since 2009. A recent survey conducted by the American Institute of CPAs indicates that CEO expectations of profitability continue to dim, which implies somewhat slower private hiring and investment during the months ahead.⁶

This wouldn't be as big of an issue in today's economic environment if the factors behind the decline in profitability were temporary. With the nation's official unemployment rate now less than 5 percent, it comes as little surprise that wage inflation is becoming more apparent. In February, average hourly earnings rose 0.4 percent on a monthly basis and are up 1.5 percent year-over-year.⁷ While that's hardly phenomenal, it is indicative of growing skills shortfalls, particularly in industries like construction and trucking. Fourteen states implemented minimum wage increases to begin the new year, also pushing human capital costs higher.⁸

Health-care costs are also on the rise, including rapidly growing prescription drug price increases. According to an AARP report, prices of a market basket of brand-name drugs commonly used by older Americans rose 13 percent in 2013.⁹ There are also indications that

certain insurers will reduce their presence on certain state exchanges, which will also push health-care costs higher.

In the midst of all this, the Federal Reserve has decided to begin applying some economic braking power by recently increasing short-term rates in its control for the first time in almost eight years (December 2015). Coming into the year, the marketplace expected another three or four rate increases, but with the news cycle turning negative, the current expectation is for up to two rate increases in 2016.

While earnings in the United States have been trending downward, the real story lies in the performance between companies invested overseas as opposed to domestically oriented ones. During the third quarter of 2015, the latest for which data are available, domestic profits expanded by 0.4 percent, or \$7.3 billion, due entirely to expanding profits at nonfinancial firms. Over that same time period, foreign profits were down 7.4 percent on a quarterly basis, translating into a \$30 billion loss.

While the global component of the U.S. economy continues to sputter, the domestic households sector continues to drive the United States forward. Retail sales continue to expand at a better than 3 percent clip on a year-over-year basis. Many consumers have also become more comfortable taking on additional debt, including in the form of student loans, first mortgages, auto loans, and credit card debt. Ongoing job growth helps. Based on data regarding voluntary quits, more Americans feel comfortable giving up their current positions, either because they've secured better employment or because they know that they can. After experiencing a slight dip in November, consumer confidence bounced back during December 2015 and remained sufficiently elevated during the first weeks of 2016 before declining in February.¹⁰

Housing also continues to be a significant economic driver. Much of the growth in housing expenditures has taken the form of leases signed for newly constructed apartments. Less well-appreciated is the ongoing rebound in sales of owner-occupied units, both new and existing. The pace of existing home sales

in the United States rose 14.7 percent in December to a seasonally adjusted rate of 5.46 million, a 700,000 unit increase over the previous month.¹¹ New home sales have been almost 10 percent higher than they were 12 months prior. The ongoing decline in the inventory of unsold homes has begun to produce meaningful increases in home prices. According to Case-Shiller data, home values have increased slightly more than 5 percent over the past year.

It is said that commercial construction follows nonresidential construction. That appears to be the case. Nonresidential construction spending increased by more than 12 percent on a year-over-year basis recently, led by spending increases in lodging (e.g., hotels), communications (e.g., the data centers), manufacturing (e.g., the auto sector), amusement and recreation (e.g., casinos), and a handful of other sectors.¹² Construction received a major boost with the recent passage of a \$305 billion federal highway bill, which has already helped road builders, among others, secure additional work.¹³ Improving finances at state and local government levels are also helping to trigger additional education-related construction spending in much of the country.

Positive job and wage growth, along with low fuel prices, will help consumers keep the economy out of recession this year, though the broader outlook for the next two years is decidedly murkier. The nation added nearly 2.7 million net new jobs over a recent 12-month period.¹⁴ States that suffered mightily during the downturn, including California and Florida, are now among the nation's leading job generators. However, many states that specialize in energy production are now struggling with job losses.

Despite challenges in filling available job openings, the construction sector managed to add more than 260,000 net new jobs over a recent 12-month period. There are now 125,000 fewer unemployed construction workers than there were a year ago.¹⁵ Industry surveys indicate that many contractors are now turning away work for the first time in years and that profit margins have become a bit thicker on average.

Looking ahead

Forecasting the economy has become decidedly more treacherous. After several years of subpar but positive growth, the U.S. economic expansion, now approaching the onset of its eighth year, is becoming ragged. The presence of low interest rates during the entirety of the current business cycle has perhaps led to investors taking on a bit more risk than warranted in search of meaningfully positive yields. This is particularly apparent in the U.S. energy sector and in the massive volumes of now distressed debt.

Rising delinquencies in other categories of debt are likely to render private capital a bit more difficult to access and somewhat more expensive. Ultimately that will translate into backlog that expands more slowly. For now, the average contractor appears to have a healthy backlog. Even if we are right that 2017 will be challenging, the year may still be a good one for many contractors. However, the years 2018 and 2019 may turn out to be more problematic.

Naturally, this all presumes that U.S. economic growth will slow over the next year. The recent volatility of financial markets has been largely in response to falling oil and commodity prices. These deflationary forces have caused unease among stock market investors who are worried about significant downward repricing of equities.

If oil prices were to begin to rise, as many analysts predict, equity and stock prices could follow. Rising asset prices could help forestall the next economic slowdown, producing a better 2017 than our current baseline forecast predicts. The key to forecasting the future rests in carefully monitoring private borrowing costs. As those costs rise, the economic forecast dims. ■

POSITIVE JOB AND WAGE GROWTH, ALONG WITH LOW FUEL PRICES, WILL HELP CONSUMERS KEEP THE ECONOMY OUT OF RECESSION THIS YEAR, THOUGH THE BROADER OUTLOOK FOR THE NEXT TWO YEARS IS DECIDEDLY MURKIER.

NOTES

¹Chandran, N., Bank of Japan adopts negative interest rate policy, CNBC (Jan 29, 2016). Available at: <http://www.cnbc.com/2016/01/28/bank-of-japan-adopts-negative-interest-rate-policy-reuters.html>.

²"Energy & Oil," Bloomberg Business. Available at: <http://www.bloomberg.com/energy>.

³McBride, J., 5 expert predictions for the global economy in 2016, *The Atlantic* (Jan 4, 2016). Avail-

able at: <http://www.theatlantic.com/international/archive/2016/01/global-economy-2016/422475/>.

- ⁴ "National income and product accounts," Bureau of Economic Analysis (Feb 26, 2016). Available at: <http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm>.
- ⁵ Davidson, K. and Francis, T., Falling corporate profits blue U.S. growth outlook, *The Wall Street Journal* (Nov 24, 2015). Available at: <http://www.wsj.com/articles/u-s-gdp-expands-at-2-1-pace-in-third-quarter-1448372098>.
- ⁶ "AICPA business & industry U.S. economic outlook survey 1Q 2016," AICPA (2016). Available at: http://www.aicpa.org/InterestAreas/BusinessIndustryAndGovernment/NewsAndPublications/DownloadableDocuments/1Q_2016_EOS_ES.pdf.
- ⁷ "Employment, hours, and earnings from the current employment statistics survey (national)," Bureau of Labor Statistics. Available at: http://data.bls.gov/timeseries/CES0500000016?output_view=pct_1mth.
- ⁸ "State minimum wages/2016 minimum wage by state," National Conference of State Legislatures (2016). Available at: <http://www.ncsl.org/research/labor-and-employment/state-minimum-wage-chart.aspx>.
- ⁹ Jaret, P. "Prices spike for some generic drugs," AARP (July/Aug 2015). Available at: <http://www.aarp.org/health/drugs-supplements/info-2015/prices-spike-for-generic-drugs.html>.
- ¹⁰ "Consumer confidence survey," The Conference Board (Feb 23, 2016). Available at: <https://www.conference-board.org/data/consumerconfidence.cfm>.
- ¹¹ "January 2016 Ten-X Sales and Price Nowcast," Auction.com (Feb 8, 2016). Available at: <https://www.auction.com/blog/january-2016-ten-x-sales-and-price-nowcast-blog/>.
- ¹² "Construction spending," U.S. Census Bureau (2016). Available at: <https://www.census.gov/construction/c30/c30index.html>.
- ¹³ "Fixing America's Surface Transportation Act or 'FAST Act,'" U.S. Department of Transportation (Jan 11, 2015). Available at: <https://www.fhwa.dot.gov/fastact>.
- ¹⁴ "Total nonfarm: Employment, hours and earnings," Bureau of Labor Statistics. Available at: <http://data.bls.gov/timeseries/CES0000000001>.
- ¹⁵ "Construction: Employment, hours and earnings," Bureau of Labor Statistics. Available at: http://data.bls.gov/timeseries/CES2000000001?data_tool=XGtable.