THE GOOD, THE BAD, AND THE INFLATIONARY

The economy continues to face headwinds, but the next several quarters are shaping up to be decent ones for the U.S. economy and for stakeholders in the U.S. construction industry.

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This year is supposed to be the year that the U.S. economic recovery kicks into high gear. Of course, last year was, too. So was 2013. In fact, the U.S. economy failed to engage any gear other than reverse during the first three months of the year, with gross domestic product (GDP) shrinking 0.7 percent on an annualized basis during that period.[1]

Other indicators, however, have been more positive, particularly recently. After a weak March, job growth was more than solid in April and May. National unemployment has fallen from 6.3 percent to 5.5 percent over the past year and more Americans are hopping back into the labor market by beginning their respective job searches.[2] After several months of weak performance, retail sales growth has begun to accelerate, including at the nation's restaurants and auto dealers.

What do these off-and-on dynamics mean for overall construction spending, specific construction segments, and contractors? This article strives to address those and other issues. The economy continues to face headwinds, but the next several quarters are shaping up to be decent ones for the U.S. economy and for stakeholders in the U.S. construction industry.

The good

Despite economic headwinds in the form of weaker investment in energy segments, the West Coast port slowdown, another brutal winter, and a stronger U.S. dollar and weaker export growth, construction spending in the U.S. expanded meaningfully during the first five months of 2015. The annualized rate of construction spending increased 3.4 percent from January 2015 to April 2015. While that hardly represents spectacular performance, construction spending expanded by just 0.6 percent during the same months in 2014.[3]

In April itself, the most recent month for which construction data is available at the time of this writing, annualized construction spending exceeded the $1 trillion threshold for the first time since November 2008. Despite that, overall construction spending, which encompasses both residential and nonresidential segments, is still roughly 17

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percent below its cyclical peak. That said, the recovery continues.

During the early stages of 2015, nonresidential construction spending expanded more quickly than spending in many residential segments. In April, nonresidential construction spending was 8.8 percent higher than it was at the same time one year prior. Fully 15 of 16 nonresidential construction segments experienced spending growth on a month-over-month basis in April, although that in part reflected effects related to improving weather. The lone exception was the power subsector, which has experienced a slowdown in investment and construction due to oil prices that have been hovering below $60/barrel and natural gas prices that have recently remained lower than $3 per million British thermal units.[4] Power-related construction activity has declined by more.

DRIVEN BY GROWTH IN INDUSTRIAL PRODUCTION IN RECENT YEARS AND A DESIRE TO INSTALL NEW PRODUCTIVITY-ENHANCING TECHNOLOGIES, CONSTRUCTION ACTIVITY AT THE NATION'S MANUFACTURING FACILITIES HAS BEEN SURGING.

Dynamics in the manufacturing subsector are markedly different. Driven by growth in industrial production in recent years and a desire to install new productivity-enhancing technologies, construction activity at the nation's manufacturing facilities has been surging. On a year-over-year basis in April, manufacturing-related construction was up by nearly 53 percent. Low energy prices have helped by increasing the profit margins of many manufacturers, freeing up cash to invest in facilities.

Part of this is attributable to the growing popularity of America as a place in which to manufacture products. Among the companies investing in new large-scale manufacturing capacity in recent years are Airbus, Volkswagen, Boeing, and Caterpillar, among others.

Cheap and reliable natural gas serves as one of the motivating factors. Data from the Energy Information Administration, part of the U.S. Energy Department, indicates that even by simply using current technology, America is home to 87 years of technically recoverable natural gas supply. Certain geologists conclude that America has hundreds of years' supply of natural gas, implying that America's industrial production outlook will continue to brighten.

A number of other hot nonresidential construction segments experiencing growth in spending are tied more broadly to the economy's consumer segment. Between April 2014 and April 2015, construction spending related to amusement and recreation expanded by 23.3 percent. This is a category that includes casinos, along with many other forms of recreation. Commercial construction spending, which includes construction related to retail activities, expanded by 17.5 percent over this period while construction related to lodging was up by closer to 18 percent.

Despite the fact that consumer confidence measures have risen only inconsistently, consumer spending growth continues to be the leading source of expansion in America. Part of this is attributable to an improving job market. According to a preliminary estimate from the Bureau of Labor Statistics, the nation added another 280,000 net new jobs in May and has added more than 3 million new positions over the past year.

There are even signs of recovery in publicly financed segments. For instance, transportation-related construction is up 11.6 percent over the past year. Ready-mix concrete firms, among others, report rising sales and pricing power as more communities embark on infrastructure improvements. Those improvements in turn are helping to induce more private construction, including multifamily residential construction.

While it is true that U.S. housing starts fell by 11.1 percent in May, permits, which foreshadow future starts, rose to their highest level since August 2007.[5] Single-family building permits increased by a modest 2.6 percent in May. Multifamily permits, on the other hand, surged 24.9 percent. Millennials continue to pour into apartments, helping to drive the nation's homeownership rate from more than 69 percent in 2007 to less than 64 percent more recently. At some point, a growing share of these young people, many now in their 20s, will begin to transition from renting to homeownership. Most indicators suggest that this adjustment has yet to begin.

The nation's construction industry has added 273,000 net new positions over the past year. By May, the nation supported 4.5 percent more construction jobs than it did just one year prior. The industry added another 17,000 jobs in May itself.

Not surprisingly, the growth in construction jobs is shrinking unemployment among the industry's workforce and driving wages higher. Construction industry unemployment sank from 7.5 percent to 6.7 percent in May, marking the second lowest industry unemployment rate since November 2007. By April, real average hourly earnings for construction workers were at their highest level in roughly five years. Wages will continue to edge higher given the shrinking supply of available workers and ongoing expansion in construction-put-place.

A disproportionate share of the nation's economic strength from a regional perspective is along the West Coast. Technology-led markets like San Jose, San Francisco, Seattle, and San Diego are at the vanguard of economic growth in America. California ranked eighth in overall percentage job growth nationally between April of 2014 and 2015, adding 2.9 percent to payrolls during this period.[6] The state also ranked first in overall construction job growth, adding 42,600 net new construction jobs over that 12-month period. Washington state chipped in another 18,700 construction jobs, ranking that state fourth in terms of aggregate construction employment expansion. All of this occurred despite a West Coast port slowdown that significantly impacted business operations toward the latter stages of 2014.

Indeed, many of the states that are leading the way in terms of employment expansion today were the weakest performers during the most recent economic downturn. States like Florida (second), Nevada (fourth), Georgia (seventh), Michigan (14th), and Arizona (15th) are now each in the top third of U.S. states in terms of percentage job growth. The foreclosure crisis that afflicted these states is now neatly in the rearview mirror, allowing these states to enjoy some of the nation's most robust recoveries.

Retirement destinations have also been a source of strength. Stock valuations have been near record highs recently, allowing more baby boomers to make the leap into retirement. Many others are no longer underwater on their mortgages, which means that they can more easily sell their homes and relocate. This helps explain the superior economic performance of Florida, Arizona, and other retirement hotspots in recent quarters.

The bad

Obviously, the nation's economic situation is far from perfect. For a second consecutive year, the U.S. economy shrank during the first three months.[7] The lingering effects of the West Coast port slowdown, another brutal winter, and a stronger U.S. dollar all helped conspire to rob the U.S. economy of the momentum it had gathered during midyear 2014.

It is important to remember that the U.S. economy continues to generate below 3 percent growth despite ongoing federal deficit spending and incredibly low interest rates. While it is true that the nation's annual budget deficits have shrunk significantly relative to prior years, the nation's accumulated national debt continues to mount.

Bond markets, sensing that the U.S. Federal Reserve Bank will soon begin increasing short-term rates, have responded by boosting long-term rates. From a cyclical nadir in late January of 1.64 percent, the 10-year Treasury has risen by nearly 0.75 percent or 75 basis points.[8] That move has been supported by an increase in bond yields in other key global bond markets.

There is also the not-so-small matter of stalemated public policy. Washington, D.C., continues to falter in terms of dealing with corporate taxation, immigration, energy policy, and other critical aspects of economic life. In May, Congress extended the nation's Highway Trust Fund by two months, an indication of just how short-term policymaking has become. The result is ongoing uncertainty among many in the business community, which serves to

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diminish the pace of hiring and investment. This helps explain why the national economy continues to fall short of a consistent 3 percent rate of economic growth.

The inflationary

Construction industry stakeholders would be justified in expressing concern regarding interest rates. While they remain extraordinarily low by historic standards, the U.S. economy continues to lean heavily upon the availability of cheap money. The combination of tightening monetary policy and growing evidence of wage inflation could push long-term rates higher faster than anticipated, which could diminish economic momentum in 2016 and/or 2017.

The Consumer Price Index (CPI) expanded by 0.4 percent on a seasonally adjusted basis in May, which was the largest monthly increase in consumer prices since September 2012.[9] The year-over-year increase in prices was just 1.7 percent, however, which was still less than the Federal Reserve's 2 percent target inflation rate. According to the Producer Price Index, which, like the Consumer Price Index, is produced by the Bureau of Labor Statistics, prices for inputs to construction industries expanded by 1.1 percent in May.[10] This represented the largest month-over-month increase in more than two years, but only the third time that input prices have risen over the past 10 months.

Looking ahead

The next several quarters should be good ones for the U.S. economy. We continue to forecast that nonresidential construction spending will expand between 6 and 10 percent in 2015. This will go down as a good year. Because of headwinds like a strong U.S. dollar and weak government spending growth, 3 percent growth may continue to elude America this calendar year. However, the economy should be strong enough to lift the fortunes of a growing number of firms.

Construction firms will continue to struggle to fill job openings. They are hardly alone. According to the Job Openings and Labor Turnover Survey, the number of job openings in America expanded to 5.4 million in April, the highest number of job openings since this data series began in December of 2000. There are now fewer than two job seekers per available job opening in America, the best ratio in many years.

Among other things, these labor market dynamics will lead to faster wage growth and greater investment in labor-saving technologies. They will also ultimately translate into broader inflationary pressures and higher interest rates. In the short term, however, a strong U.S. dollar will help keep a lid on inflationary pressures, and interest rate increases are therefore likely to be gradual. ■

NOTES

1 "National Income and Product Accounts, GDP: First Quarter 2015 (Third Estimate)," U.S. Department of Commerce: Bureau of Economic Analysis (June 24, 2015). Available at: http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm.

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3 "Construction Put in Place," U.S. Census Bureau (June 1, 2015).

4 "Petroleum & Other Liquids," U.S. Energy Information Agency (June 2015). Available at: http://www.eia.gov/petroleum/.

5 "Building Permits Survey," U.S. Census Bureau (May 2015). Available at: http://www.census.gov/construction/bps/.

6 *Op. cit.* note 2.

7 *Op. cit.* note 1.

8 "Resource Center: Daily Treasury Yield Curve Rates," U.S. Department of the Treasury. Available at: http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield.

9 "Consumer Price Index — May 2015," U.S. Bureau of Labor Statistics (June 18, 2015). Available at: http://www.bls.gov/news.release/pdf/cpi.pdf.

10 "Producer Price Index — May 2015," U.S. Bureau of Labor Statistics (June 12, 2015). Available at: http://www.bls.gov/news.release/pdf/ppi.pdf.