



CONSTRUCTION INDUSTRY FINALLY

After a year of recovery in 2014, the construction industry looks like it will continue to grow in 2015.

HITTING STRIDE

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After a challenging start to the year, the nation's economy came racing back as the final snows melted in early 2014. Construction projects that were delayed by the harsh winter got underway, auto sales surged, and people began to dine out, shop, and generally engage in business activity. The impact of ongoing economic progress can be viewed through multiple lenses, including from the perspective of labor market performance. The nation supports more than 2.7 million more jobs than it did a year ago and for the first time in six years national unemployment has fallen below 6 percent.¹ Even the quality of jobs being added has improved of late, with more middle-income jobs being produced in construction, manufacturing, energy, professional services, and IT.

Data regarding national output are consistent with the notion of blossoming momentum. The U.S. economy bounced back with a robust 4.6 percent annualized performance during the second quarter and followed that up with a 5 percent showing during the third.² The third quarter surge represents the fastest pace of growth since the third quarter of 2003. Over the past four quarters, GDP has expanded 2.7 percent.³ Non-

residential fixed investment, which encompasses nonresidential construction activities, surged 7.6 percent over that same time period.⁴

Business investment is likely to continue to be strong in 2015. For many years, businesses have been able to expand profitability by shaving expenses rather than by significantly expanding revenues. This is consistent with subpar macroeconomic growth. That can only continue for so long. At some point, expanding profits requires growing revenues, which in turn requires more capital investment to expand output and generate new products. We appear to be entering such a phase of the recovery.

Third-quarter growth was also partially a reflection of then-ongoing declines in gas prices — declines that continued into the fourth quarter and boosted both consumer confidence and spending power. Consumer confidence is poised to rise to its highest level since January 2007, nearly a full year before the Great Recession began. The most recent uptick in consumer sentiment is consistent with rising sales. The National Retail Federation predicts that sales during the 2014 holiday season will be 4.1 percent above the 2013 level.⁵

The surge in consumer spending was of course reflected in recent GDP fig-

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IT HAS BEEN NEARLY A DECADE SINCE U.S. GROSS DOMESTIC PRODUCT EXPANDED BY MORE THAN 3 PERCENT DURING A SINGLE CALENDAR YEAR.

ures. Household purchases — a component that accounts for nearly 70 percent of the economy — expanded at a 3.2 percent annualized rate during the third quarter.⁶ Among other things, the third quarter witnessed increases in health care, recreation, and financial services spending. For its part, government spending, which has tempered growth during much of the post-2011 period, added more to U.S. growth in the third quarter of 2014 than at any time over the past four years.⁷ Government spending is likely to represent less of an economic drag in 2015, which could allow the economy to generate its best rate of economic growth since the middle years of the previous decade.

A good year would be most welcome. It has been nearly a decade since U.S. gross domestic product expanded by more than 3 percent during a single calendar year. During the 25-year period that began in 1983, America routinely posted 3 percent growth. But the last time the U.S. economy managed to expand by more than 3 percent was in 2005, when the U.S. economy grew 3.4 percent.⁸

Thereafter, the housing downturn began, eventually dragging the broader economy into recession by very late 2007. Construction slowly softened thereafter, with the pace of deterioration accelerating after the failure of Lehman Brothers in September 2008. Spending declines continued through the balance of the recession and even during the early stages of macroeconomic recovery, interrupted briefly during a period of stimulus spending. Even today, six years into the recovery, nonresidential construction activity has yet to fully recover to 2008 levels.

But 2015 is shaping up to be a year of significant recovery for the U.S. construction industry. A number of industries have been adding jobs and boosting output, including manufacturing, which has helped to support more industrial construction activity; professional services, which is driving more office-related spending; retail trade, which is driving more investment in shopping centers; energy, which is fueling investment in the nation's power plants and distribution capacity; and tourism, which is

prompting more spending on hotels, casinos, and recreational facilities generally. Many economists are predicting that the U.S. economy will expand by more than 3 percent in 2015 despite a still shaky global economy and rocky geopolitics in much of the Middle East, in Eastern Europe, along the Pacific Rim, and in parts of Latin America.

Monetary policy remains supportive. Though quantitative easing is for now a policy of the past and despite shifts in Federal Reserve language and guidance during a recent meeting, the nation's central bank remains relatively unconcerned by inflationary prospects and has indicated that interest rates will remain low for many months to come. Recent construction industry surveys indicate that financing conditions are easing. Easier money coupled with low interest rates represent an important source of expanding construction industry confidence.

While 2014 will be remembered as a year of progress for nonresidential construction in America, it was far from a breakaway year. October 2014 nonresidential construction spending was up 4.3 percent on a year-over-year basis, which, while positive, is hardly extraordinary.⁹ In October of 2014, 10 of nonresidential construction's 16 subsegments registered year-over-year growth, including conservation and development (+33.1 percent), manufacturing (+22.2 percent), office (+16.3 percent), and lodging (+15.9 percent).¹⁰

Lower oil prices are likely to impact capital spending in certain energy segments, however. Moreover, should oil prices continue to remain at or below \$60 a barrel for a considerable period, one would expect that the robustness of certain economies, including in Texas and North Dakota, would be negatively impacted. That said, most regional economies benefit from lower oil prices. Despite massive gains in oil production since roughly 2009, America remains a net importer of oil. Moreover, consumers, who represent 70 percent of the economy, are now positioned to spend more on other items, which should help promote even more construction at the nation's

shopping centers and strip malls.

Consistent with growing spending and ongoing recovery, construction continues to add jobs. The sector added another 20,000 jobs in November according to the Bureau of Labor Statistics' preliminary estimate released December 5, 2014.¹¹ This was a marked improvement from October when the construction industry added only 7,000 net new jobs.¹²

Construction unemployment rested at 7.5 percent in November, up from 6.4 percent in the previous month. This was likely due to seasonal effects rather than to permanent ones. Construction firms face growing labor shortages in 2015 and that will translate into wage gains. Still, most construction firms seem comfortable with the notion that profit margins will at least remain steady in 2015.

Despite a lack of complete industry recovery, construction skills shortages are already widely apparent in high-growth states like Texas, North Dakota, Louisiana, Oklahoma, and Colorado. As a result, many construction industry stakeholders can anticipate double-digit increases in wages and per diems in occupational categories associated with particularly elevated levels of demand.

On the other hand, construction materials prices have actually been falling in recent periods, due in large measure to a decline in petroleum and related products. Construction input prices fell 0.8 percent in November and have declined in five of the past six months for which data exist. A confluence of factors have conspired to hammer away at key commodity prices in recent weeks, including ongoing economic weakness in Europe, softening growth in emerging world economies like Brazil and Russia, a strengthening U.S. dollar, and evidence of financial difficulties in Brazil. Many of these factors do not appear to be transitory, meaning that construction input prices are unlikely to surge in the first part of 2015.

Economic weakness and geopolitical angst in other parts of the world have induced many investors to continue to plow monies into U.S. financial markets,

including both equity and bond markets. At the time of this writing, stock prices are surging after a recent period of volatility. Corporate profitability remains at record levels and global investors continue to suffer from a lack of non-US options.

Looking ahead

Sage believes that the U.S. economy is approaching the peak of its business cycle. We are now in a Goldilocks period — one in which the economy is gaining momentum while the Federal Reserve acts as if that's not occurring (true, QE3 is over, but short-term rates are not expected to rise until well into 2015).

Despite a slowdown in oil-production-related capital spending, expect nonresidential construction spending to expand roughly 7.5 percent in 2015. Contractors should expect especially robust spending growth in power (related to natural gas), lodging, manufacturing, and professional and business services (office). Growth within the public sector will continue to be sluggish, though the public sector will represent less of an economic drag in 2015 relative to most recent years. The gap between private and public nonresidential construction spending will be roughly 30 percent by the end of 2014. Private nonresidential spending was 15.6 percent greater than its public counterpart in 2013.¹³ ■

NOTES

¹ "Current employment statistics," Bureau of Labor Statistics (Dec 5, 2014).

² "Gross domestic product: Third quarter 2014 (third estimate)," Bureau of Economic Analysis (Dec 23, 2014).

³ *Ibid.*

⁴ *Op. cit.* note 2.

⁵ "2014 holiday sales forecast for November & December," National Retail Federation (Oct 7, 2014).

⁶ *Op. cit.* note 2.

⁷ *Ibid.*

⁸ *Op. cit.* note 2.

⁹ "Value of construction put in place survey," U.S. Census Bureau (Nov 3, 2014).

¹⁰ *Ibid.*

¹¹ *Op. cit.* note 1.

¹² *Ibid.*

¹³ *Op. cit.* note 9.