SMOOTH CONSTRUCTION INDUSTRY RECOVERY REMAINS ELUSIVE

While the tough winter slowed growth, the construction industry looks like it will continue to recover from the recession.

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Any momentum garnered during the final six months of 2013 was stymied by the brutal winter of 2013–14. According to the third estimate from the Bureau of Economic Analysis, the U.S. economy shrank at a 2.9 percent pace during the year's initial quarter.[1] The harsh winter and a decline in private inventories are primarily to blame for the dismal first quarter growth. Thankfully, most economic indicators suggest that both consumer spending and total production have already rebounded from their sluggish first quarter pace. Additionally, indications of forward momentum in nonresidential construction spending have begun to surface, suggesting that the second half of 2014 will be associated with solid growth.

While America is hardly on the verge of an economic boom, there are certain segments that are helping fuel more aggressive recovery and move the nonresidential construction industry forward. One of those industries is the oil and gas sector. The oil and gas industry added roughly 270,000 jobs between 2003 and 2012.[2] This represents an increase of roughly 92 percent compared to an increase of 3 percent in all jobs during the same period. The Bureau of Labor Statistics reports that the U.S. average annual wage in the industry exceeded $107,000 in 2012, the latest full year for which data are available.[3] According to the Wall Street Journal, that is more than double the average for all workers.[4]

Communities aligned to America's energy production renaissance have experienced significant increases in population and employment. Employment in Williams County, home to Williston, North Dakota, increased 276 percent between 2003 and 2012.[5] In nearby Richland County, Montana, employment is up by 65 percent.[6] Data indicate that before the boom associated with the Bakken

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shale formation, average wages for all jobs in Richland County and Williams County were roughly equal to their respective statewide averages.[7] Richland County today has an average wage equal to 133 percent of Montana's statewide average, while the corresponding statistic for Williams County, North Dakota, is 170 percent.[8]

Further progress is anticipated. The World Energy Outlook supplied by the International Energy Agency (IEA) projects that the United States will become the world's largest producer of oil in just a few years.[9] The nation is already basically self-sufficient in natural gas and, in fact, exports natural gas via pipeline to Mexico. According to the Energy Information Agency, by as early as 2011 about 95 percent of the natural gas consumed in the U.S. was produced domestically.[10] By the year 2035, the IEA estimates that the U.S. will be completely self-sufficient in energy, in part because of expected natural gas production emerging from the Marcellus shale region (e.g., Pennsylvania, West Virginia) of the country.[11]

Among the larger U.S. states, Texas will continue to be the strongest and most stable performer. The Lone Star State is America's leading producer of both oil and natural gas, which is helping spawn an associated industrial production boom. For contractors operating in that environment, particularly for industrial contractors, the primary issue will be attracting human capital to fill available project vacancies. Wages/salaries and per diems will expand rapidly in most industrial construction segments. Similar issues are apparent in North Dakota, Louisiana, and elsewhere.

Beyond energy, however, there are few economic segments that are experiencing protracted, rapid growth. Much of the nation's recovery continues to be tied to steady advances in consumer spending. As a result, nonresidential construction's recovery continues to grind forward, with broad-based spending increases remaining elusive.

In May, nonresidential construction spending expanded by 1.1 percent on a monthly basis following a 1.0 percent increase in April.[12] Spending in May totaled $596.2 billion on a seasonally adjusted, annualized basis.[13] Nonresidential construction spending has expanded 6.4 percent over the past year — not bad — but construction spending remains well below prerecession levels. That said, nonresidential construction spending is now at its highest level since October of 2009, though that does not account for the costs of inflation.

BEYOND ENERGY, HOWEVER, THERE ARE FEW ECONOMIC SEGMENTS THAT ARE EXPERIENCING PROTRACTED, RAPID GROWTH.

Spending in nine of the 16 nonresidential construction subsectors that comprise the industry expanded on a year-over-year basis in May, led by the power sector (+25.9 percent), conservation and development spending (+16 percent), lodging (+11.4 percent), and amusement recreation spending (+8.5 percent).[14] The observed gains in lodging and amusement/recreation are likely related to the ongoing increases in consumer outlays, including in the form of rising travel, tourist spending, and gaming.

The five nonresidential construction segments that posted yearly losses in May were the public safety (-10.9 percent), health care (-10.1 percent), religious (-3.9 percent), sewage (-1.3 percent), communication (-1.1 percent), and education (-0.8 percent) sectors. Spending in the water supply category was unchanged from the same time one year ago.[15]

As many are aware, economists do not have a great reputation for forecasting accuracy. That said, the market is performing in lockstep with broad Marcum expectations, with most private nonresidential construction segments in recovery and many public segments continuing to feel the strain of severe fiscal constraints at federal, state, and local levels.

Given expectations for continued economic growth led by the private sector and constrained public budgets, nonresidential construction's recovery will continue to be led by private segments like office, commercial, lodging, health care, and industrial facilities. Some public segments are also likely to recover as public policy focuses on improving water and sewer systems, providing better technology to emergency responders, and upgrading the nation's civil aviation system.

THE HARSH WINTER APPEARS FIRMLY BEHIND US, AND PENT-UP DEMAND FOR CONSTRUCTION SERVICES SHOULD MAKE ITSELF FELT MORE PROFOUNDLY DURING THE MONTHS TO COME.

Despite the lethargic beginning to 2014, all signs point toward brisk expansion in private nonresidential construction segments for the remainder of the year. With banks generally lending more freely and with more developers ready to deploy their accumulated equity more aggressively, construction firm backlogs are expanding, signaling meaningful acceleration in spending. Further, it appears that the factors that inhibited growth in the first quarter are purely transitory and not the result of emerging economic malaise. With the harsh weather firmly behind us, nonresidential construction spending should still expand by almost 7 percent in 2014. In fact, that has been roughly the pace of recovery over the past 12 months.

There are indications of improvement beyond spending totals. Though overall national construction employment expanded by just 6,000 jobs in May according to the U.S. Department of Labor, nonresidential construction employment grew by 8,100 positions.[16] As the weather has warmed, the nonresidential construction labor market has heated up, consistent with the notion that this winter's downturn was due primarily to atmospheric conditions rather than shifting economic ones.

Despite the suppressed levels of job growth during the winter months, total construction employment recently eclipsed the 6 million job mark for the first time since June 2009.[17] Expect construction employment to show marked improvement during the third quarter of 2014 with momentum likely to persist into the fourth.

The national construction unemployment rate fell to 9.4 percent in April on a non-seasonally adjusted basis, falling almost 2 percent during a single month.[18] The construction unemployment rate is likely to fall further going forward, particularly given evidence of emerging skills/labor shortages in a growing fraction of the United States, including in states that suffered massively during the downturn but that are now experiencing rapid recovery. This group of states includes California, Florida, Arizona, and Georgia, among others.

Another aspect of the construction environment is stable construction input prices. This stability was on display for virtually all of 2013. After several years of volatility, the period of March 2013 through December 2013 represented 10 consecutive months of remarkable stability for construction input prices — the monthly change in input prices was less than 0.5 percent for each of those months, according to the U.S. Department of Labor.[19]

True, the first four months of 2014 witnessed the partial return of construction input price volatility — construction materials prices expanded by 0.6 percent, 0.7 percent, 0.5 percent, and 0.4 percent, respectively, over the first four months of 2014.[20] That marks the first time in more than two years that construction materials' prices have risen for five consecutive months. Prices remained unchanged in May, but with instability rising in energy-rich parts of the world, and given the newly established pace of nonresidential construction spending recovery in the U.S., price volatility is likely to become more apparent going forward. This should be of significant concern to chief financial officers, among others, who also face sharper wage increases in much of the country.

Evidence of skills shortages is already apparent anecdotally, in key geographies and increasingly in available data. According to the Job Openings and Labor Turnover Survey (JOLTs) produced by the Bureau of Labor Statistics, skills shortages have already begun to make their mark. The number of available construction job openings stood at 156,000 in January 2014, the highest national figure recorded since May 2008. Despite expanding numbers of construction job openings, hiring is not accelerating. The hiring rate in December (4.3 percent) and January (4.8 percent) represented the lowest tallies since the survey began in 2000 with the exception of February 2007, a turbulent month marked by significant snowfall and a fiscal crisis.[21]

In the long run, the industry will implement a number of responses, including forging new partnerships with high schools and two- and four-year colleges, expanding marketing, and utilizing prefabricated and modular technologies more aggressively. However, it will take years for the construction industry to fully adjust to emerging labor market realities. In the nearer term, the industry is likely to respond simply by raising compensation, which will put downward pressure on margins. There are already stories of contractors showing up to the construction sites to recruit workers away with promises of greater compensation, responsibility, and freedom.

Still more problems linger for the construction sector. Sixty percent of licensed contractors in America operate with 10 or fewer employees. Barriers to entry are quite low. This means that at any given moment some fraction of firms will be relatively inefficient. In a typical market environment (e.g., retail), inefficiency translates into higher prices and therefore diminished market share. Without question, over time inefficient construction firms will be weeded out of the population.

However, in a market that is driven by low bid victories, for a time inefficient firms can operate by supplying low bids. Eventually these bids will translate into financial losses and deteriorating relationships with banks and bonding companies. In the near term, the presence of inefficient firms drives up costs. Startup activity in construction is presently high in part because some of the workers dislocated during the prior downturn are using business formation as a way to reenter the ranks of the employed.

Moreover, even in the absence of inefficient firms, the industry is dominated by smaller firms, which by definition lack the capacity to generate significant economies of scale the way that leading communications, energy, manufacturing, or retail firms do. While this does not explain the ongoing rise in costs, it helps explain why large-scale decreases in cost are unlikely in the near term.

Looking ahead

In July, the nation will begin its sixth year of economic recovery. At long last, it appears that the nation is positioned for a pace of recovery that is more typical of previous cycles. The harsh winter appears firmly behind us, and pent-up demand for construction services should make itself felt more profoundly during the months to come.

Private nonresidential construction is positioned for particular improvement during the balance of 2014. However, there will continue to be downward pressure on margins in much of the nation as competition for work remains fierce. While construction materials' prices have

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remained relatively stable for roughly the past 18 months, labor costs are likely to rise meaningfully in 2014 as expanding firms scramble to find workers who are familiar with the latest technologies and regulations. Homebuilders experienced significant labor cost growth last year and nonresidential construction appears positioned to experience something similar for the balance of 2014 and beyond.

Public segments remain deeply problematic from the perspective of stable construction spending recovery. Authorizing legislation that supports federal highway spending is set to expire on September 30, the end of the federal government's fiscal year. While an extension of the status quo is likely, America's infrastructure investment remains woefully inadequate. With Medicare, Medicaid, and other entitlement spending set to chew up additional federal resources over the course of time, inadequate capital funding levels are virtually assured.

The most likely solution will take the form of public–private partnerships. The global private sector is flush with capital and in search of yield given the prevalence of ultra-low interest rates in much of the world. Public–private partnerships seem to represent an obvious solution to a number of issues facing both prospective users and suppliers of financial capital.

With respect to the broader economy, the news is generally upbeat. The U.S. economy took a step back during the first quarter, with GDP shrinking 2.9 percent on an annualized basis.[22] Financial markets, most economists, and others have largely shrugged off the number, questioning both its validity and relevance. Most seem to agree that weather was the major factor shaping that number and that the economic recovery continues apace.

Job growth in the U.S. has averaged around 200,000 net new jobs per month over the past year.[23] Job growth is likely to accelerate a bit during the months ahead, which will produce additional fuel for America's consumer-led recovery.

Federal Reserve policy remains accommodative and the new Federal Reserve chairman seems unconcerned by inflation. That could change next year, however, as wage pressures are felt more profoundly in construction, distribution, and manufacturing. Despite successfully completing five years of economic recovery, the economy remains fragile and heavily dependent upon low interest rates. If interest rates begin to rise unpredictably and significantly, a relatively sanguine economic outlook could quickly sour. Contractors need to remain on guard for such a possibility. ■

NOTES

1 Gross Domestic Product: First Quarter 2014 (Third Estimate), Bureau of Economic Analysis (June 25, 2014).
2 Current Employment Statistics, Bureau of Labor Statistics (July 3, 2014).
3 Employment Cost Index, Bureau of Labor Statistics (April 30, 2014).
4 Polzin, P. and Whitsitt, B., The U.S. energy boom lifts low-income workers too, *The Wall Street Journal* (April 4, 2014).
5 Quarterly Census of Employment and Wages, Bureau of Labor Statistics (June 19, 2014).
6 *Ibid.*
7 *Op. cit.* note 5.
8 *Ibid.*
9 World Energy Outlook 2014, International Energy Agency (June 3, 2014).
10 *Ibid.*
11 *Op. cit.* note 9.
12 Value of Construction Put in Place Survey, U.S. Census Bureau (July 1, 2014).
13 *Ibid.*
14 *Op. cit.* note 12.
15 *Ibid.*
16 *Op. cit.* note 2.
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19 Producer Price Index, Bureau of Labor Statistics (July 16, 2014).
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21 Job Openings and Labor Turnover Survey, Bureau of Labor Statistics (July 8, 2014).
22 *Op. cit.* note 1.
23 *Op. cit.* note 2.