THE GOOD, THE BAD, SOME MORE BAD, AND SOME UGLY

What was shaping up to be a year offering less drama than the prior two pandemic-stricken years has instead turned into a roller coaster ride.

ANIRBAN BASU AND JOSEPH NATARELLI

Just like that and the first third of 2022 is in the books. What was shaping up to be a year offering less drama than the prior two pandemic-stricken years has instead turned into a roller coaster ride. There is ample fodder for optimists and pessimists alike, with certain aspects of the economy remaining strong and others faltering in the face of geopolitical conflict, a lingering pandemic, supply chain disruptions, and the highest rates of inflation in the United States in 40 years.

While some contractors have begun to fret about the future as materials prices skyrocket, skilled labor remains scarce, and interest rates rise, others report strong backlog and plentiful demand. Many contractors are supplying as much in the form of construction services as they can and would deliver even more to the market if they could secure additional capacity.

The good, sprinkled with some bad

Let's start with the good news. The U.S. labor market remains red hot, at least from the perspective of jobseekers. As of February, there were 11.3 million available, unfilled jobs in the United States (Exhibit 1).[1] That same month, there were 6.3 million unemployed Americans, which means that there were 1.8 available jobs for every unemployed person.[2] By March, the nation's unemployment rate stood at just 3.6 percent, a whisker above the pre-pandemic rate.[3] Wage growth has been impressive, with average hourly earnings climbing from $30.06 in March 2021 to $31.73 one year later, translating into growth of 5.6 percent.[4]

The nation's labor force participation rate has been rebounding rapidly of late (Exhibit 2). By March, it was up to a pandemic era high of 62.4 percent.[5] In absolute terms, the size of the United States' labor force was just about what it had been two years earlier when the pandemic began undoing the economy.

Workers are returning in larger numbers for a multitude of reasons: vaccinations, diminished infection totals, higher wages, and inflation. More Americans are reporting living paycheck-to-paycheck. Stimulus payments received earlier during the pandemic

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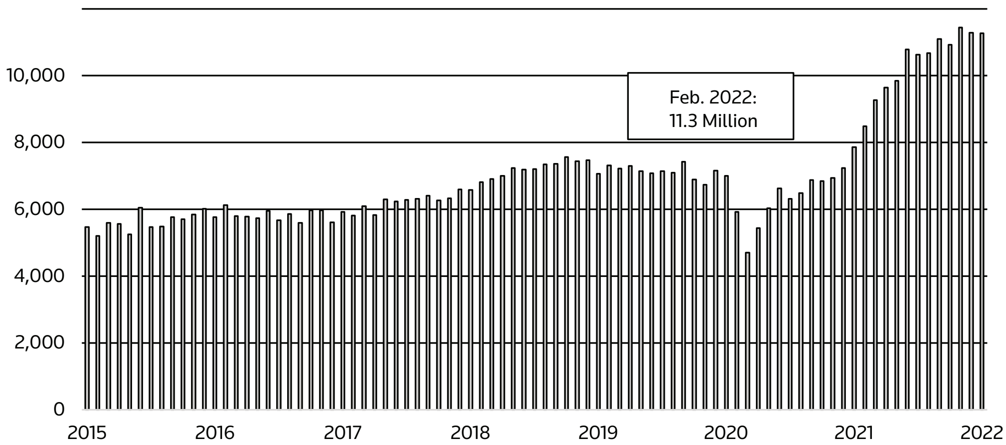
EXHIBIT 1
Job Openings (Thousands), February 2015 Through February 2022



Source: U.S. Bureau of Labor Statistics

are increasingly in the rearview mirror and inflation is hammering household budgets. This is particularly true for the lower-wage workers who lost jobs in such abundance during the spring of 2020, and who now face rising rent, food, and fuel prices, which comprise a larger share of household budgets than is the case for higher income earners.

While wage growth is elevated by historic standards, the cost of living is rising even faster. According to a LendingClub report, by January 2022, 64 percent of the United States' population reported living paycheck-to-paycheck: up from 61 percent in December and just shy of the 65 percent high in 2020.[6] Even among those earning six figures, 48 percent indicate that they are now living paycheck-to-paycheck, such has been the oppressive impact of rapid price growth.[7]

But this is the good news section of this article. If one is, for instance, a construction worker, one must be thrilled with the pace of their compensation growth all things being equal (Exhibit 3). According to the U.S. Bureau of Labor Statistics (BLS), the construction industry added 60,000 workers on net in February.[8] Wages for nonsupervisory workers expanded at their fastest pace in 40 years, rising 6 percent on a year-ago basis in February.[9]

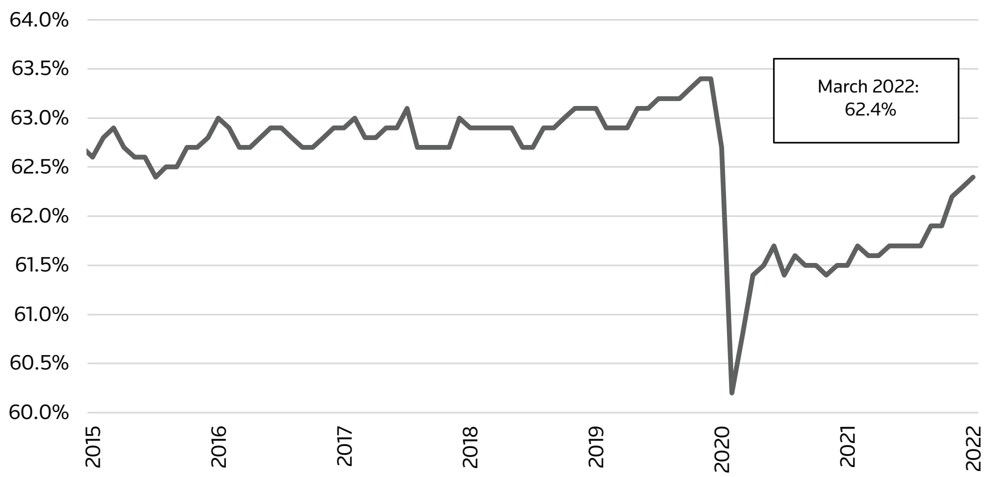
But all things are not equal. Construction workers, like others, have suffered wage losses in real terms. With inflation remaining persistent, workers can be expected to ask for further significant compensation increases going forward. Given the scarcity of skilled workers, many workers will find someone willing to meet their demands.

According to an October survey conducted by the National Association of Homebuilders (NAHB), more than 55 percent of single-family builders suffered a shortage of labor across 16 homebuilding trades, with the most pressing shortage experienced in carpentry.[10] According to the NAHB, subcontractor shortages are even more widespread than shortages of labor employed directly by general contractors. At least 90 percent of single-family builders report a shortage of subcontractors in each of the three carpentry categories; 80 to 85 percent report a shortage of subcontractors in six other trades.[11]

The world is the skilled worker's oyster, but to fully exploit the labor market's abundant strength, workers often find that they need to change employers frequently. Indeed, this has been one of the most interesting aspects of the economic recovery from the pandemic. While the term Great Resignation has become ubiquitous and perhaps over-utilized, the phenomenon is real. According to ZipRecruiter, approximately 64 percent of job switchers indicate that their current job pays more than their

EXHIBIT 2

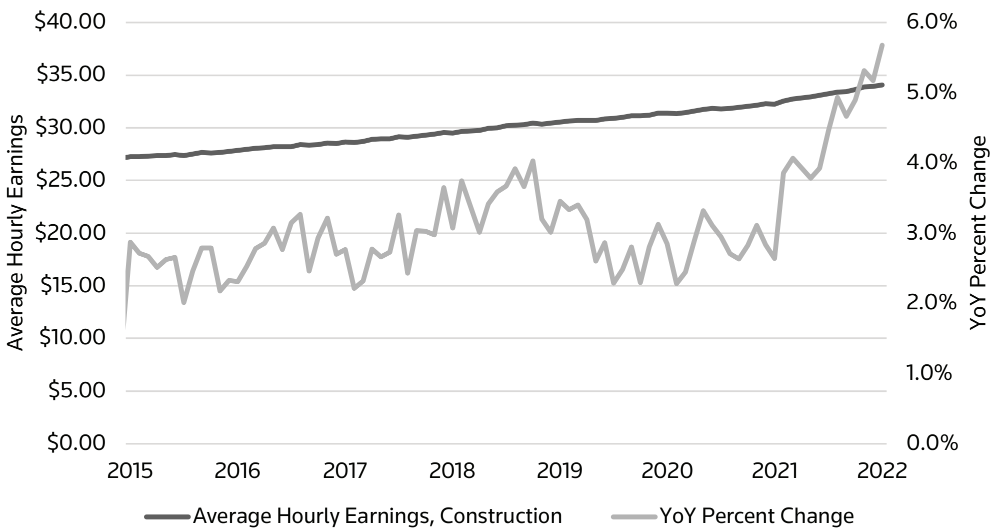
Labor Force Participation Rate, March 2015 Through March 2022



Source: U.S. Bureau of Labor Statistics

EXHIBIT 3

Average Hourly Earnings, Construction, March 2015 Through March 2022



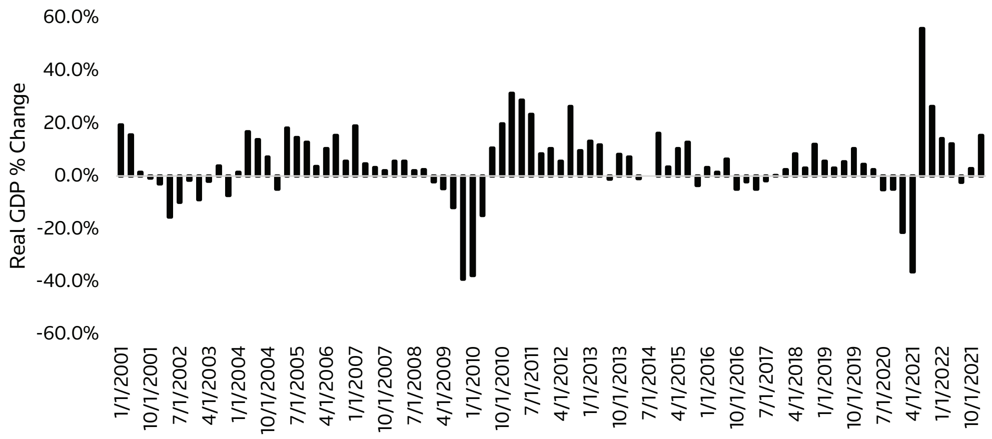
Source: U.S. Bureau of Labor Statistics

prior one. Among these workers, who represent all industries, nearly half received a raise of 11 percent or more. Nearly 9 percent are now making at least 50 percent more.[12]

These dynamics and others have positioned certain economic segments to both power through and also contribute to inflation. In March, the United States added 431,000 jobs, according to the initial estimate from the BLS.[13] With so many jobs waiting for candidates, and with so many Americans finally returning to the labor market, it comes as little surprise that the United States has continued to add jobs rapidly. Those jobs also pay more in general than they would have pre-pandemic. The upshot is that expanding consumer spending power, at least in nominal terms, has helped push retail sales higher. Air travel has also been up despite surging airfares.

EXHIBIT 4

Fixed Investment Equipment Change from Previous Quarter, January 2000 Through January 2022



Source: U.S. Bureau of Economic Analysis

Meanwhile, with businesses unable to secure sufficient levels of human capital, they are turning increasingly to technology and physical capital. Equipment purchases remain elevated and would be even more so were the global supply chain not so rife with dysfunction. Shortages of computer chips, recent economic lockdowns in China, and Russia's assault on Ukrainian democracy continue to hamper smooth delivery of goods across the global spectrum. Nonetheless, the most recent data indicate that business purchases of equipment are on the rise (Exhibit 4).

The bad, sprinkled with some good

Perhaps the most shocking data release in 2022 to date was the initial estimate of first quarter U.S. gross domestic product. At the year's onset, it appeared that the U.S. economy would gain momentum with the reopening of the economy, the steady erosion of mask mandates, accumulated household savings, a recently passed, large infrastructure package, a strong housing sector, healing global supply chains, and the release of pent-up demand from various corners of the economy ranging from travel to weddings.

Instead, the economy was hit with a wave of setbacks. Realizing that it had lost control of inflation expectations and fallen behind the curve, the Federal Reserve pivoted to an aggressive program of monetary tightening, the vast majority of which has yet to be implemented. Key interest rates took off in response, including mortgage rates, which started the year off at around 3 percent, but within a few months had risen beyond 5 percent, slowing the owner-occupied housing market in the process.

On February 24th, Vladimir Putin began a brutal assault on Ukrainian democracy, destroying lives and the built environment in the process. Global supply chain issues proliferated while energy prices surged. Were it not for recent lockdowns in China, home to a quarter of global manufacturing, energy prices would likely have risen even further.

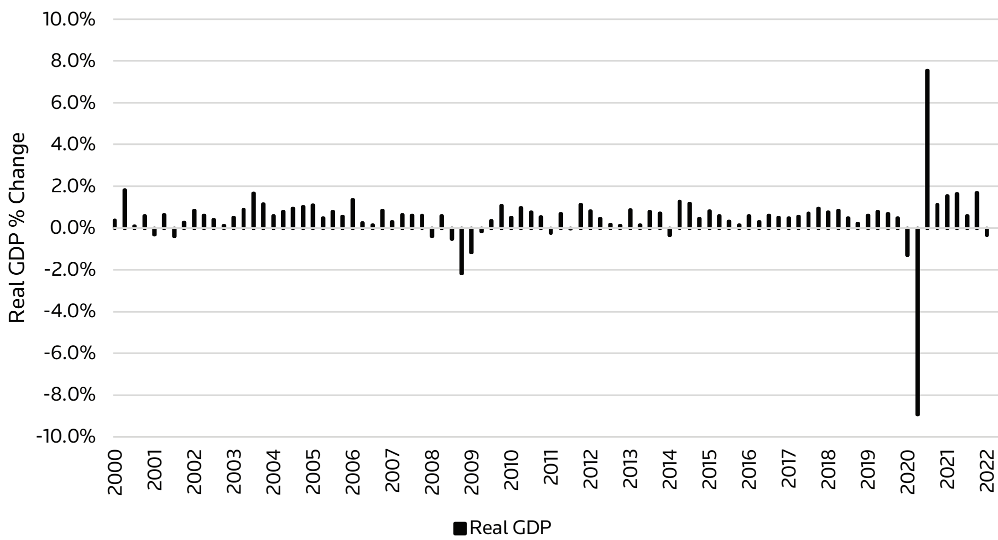
Contractors had already been encountering massive input cost increases before the onset of war in Eastern Europe. By March, the surge was eye-watering, with construction input prices rising more than 24 percent within a year (Exhibit 5). Predictably, energy prices have been at the forefront of cost increases, but key inputs like steel and concrete have also exhibited extraordinarily large jumps in price. Not only do higher input prices threaten profit margins, but they may induce project owners to postpone or even cancel certain projects. To date, contractors have apparently been able to pass along much of their cost increases to project owners (a sprinkle of good), but that may change in a rising interest rate environment.

EXHIBIT 5
Producer Price Index, March 2022

	1-Month % Change	12-Month % Change	% Change Since Feb 2020
Inputs to Construction	2.9%	24.4%	39.1%
Inputs to Nonresidential Construction	2.8%	25.0%	39.2%
Plumbing Fixtures and Fittings	0.5%	6.8%	9.0%
Fabricated Structural Metal Products	0.4%	36.0%	49.6%
Iron and Steel	1.4%	36.0%	90.1%
Steel Mill Products	-4.9%	42.9%	103.1%
Nonferrous Wire and Cable	4.4%	26.3%	48.1%
Softwood Lumber	7.6%	22.9%	136.2%
Concrete Products	0.2%	9.9%	12.8%
Prepared Asphalt, Tar Roofing, and Siding Products	1.6%	22.6%	29.2%
Crude Petroleum	7.2%	62.2%	101.7%
Natural Gas	-30.1%	62.9%	201.2%
Unprocessed Energy Materials	-11.2%	58.7%	116.4%

Source: U.S. Bureau of Labor Statistics

EXHIBIT 6
Real GDP Change from Previous Quarter, January 2000 Through January 2022

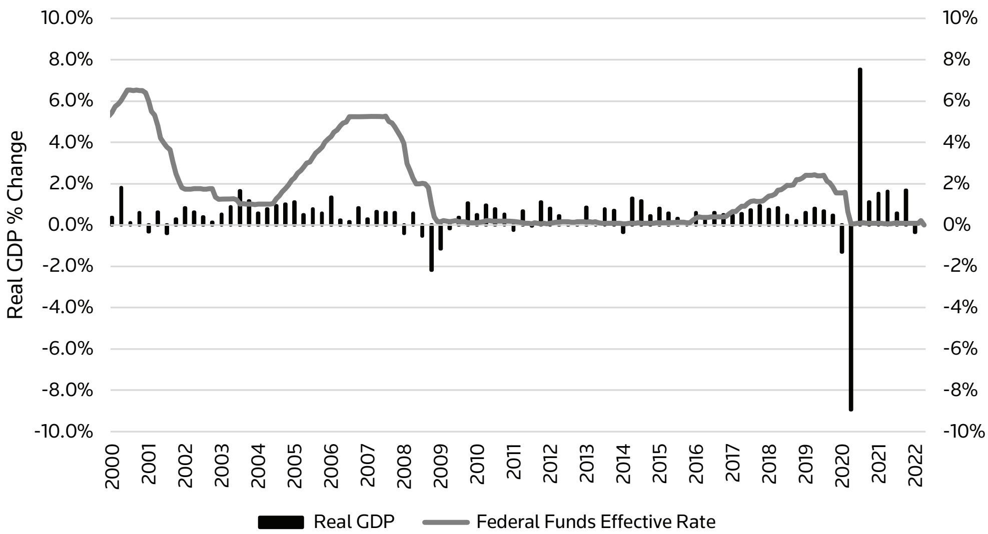


Source: U.S. Bureau of Economic Analysis

There is evidence that even ultra-low interest rates have not been enough to forestall a significant number of project postponements. According to the Architecture Billings Index, design work has been plentiful. Despite that, as measured by Associated Builders & Contractors (ABC), construction backlog (the amount of construction work under contract that has yet to be completed) has been roughly flat in recent months, strongly suggesting that many projects that have been designed have thus far failed to move forward.

All of these headwinds helped produce negative GDP growth in the United States during 2022's initial quarter. According to the Bureau of Economic Analysis, the U.S. economy shrank 1.4 percent on an annualized basis during the year's first three

EXHIBIT 7
Real GDP and the Federal Funds Effective Rate, January 2000 Through January 2022



Source: U.S. Bureau of Economic Analysis, U.S. Federal Reserve

months (Exhibit 6).[14] While consumer spending and business investment were strong, slower federal spending, a lack of inventory accumulation, burgeoning imports in the context of a very strong U.S. dollar and consumer segment, and flagging exports all contributed to exposing the fragility of the U.S. economy.[15]

Nonetheless, most economists expect the next few months to be associated with economic expansion. After all, the job market is very strong, state and local finances are healthy, and there are even indications of supply chain improvement despite myriad headwinds.

And now, the ugly, sprinkled with some promise

Earlier this year, Deutsche Bank, the multinational bank headquartered in Frankfurt, Germany was the first to indicate that the United States is headed for a recession.[16] More recently, bank economists have forecast a deep recession. This has everything to do with the Federal Reserve, which will be ramping interest rates higher in 2022 to curb inflation even with economic growth already sputtering during the year's initial quarter (Exhibit 7).

The impact on most nonresidential contractors is unlikely to be immediate. Contractors continue to work on many projects, with the challenges largely regarding delivery of services rather than demand for them. Contractors who specialize in delivering public projects are also likely to remain busy given President Biden's signing of the Infrastructure Investment and Jobs Act on November 15th of last year.

The construction outlook

As always, hope springs eternal. The American Institute of Architects' (AIA) Consensus Construction Forecast panel predicted that building construction will increase by 5.4 percent this year, and continue to rise in 2023, reaching 6.1 percent.[17] But many of these predictions were generated before the breakout of war in Europe, COVID-19 induced shutdowns in China, and the Federal Reserve's increasingly hawkish stance on inflation. Perhaps the most commonsense approach to the forecast is to suggest that there are many conceivable construction forecasts, with certain segments like multifamily, data centers, industrial, and infrastructure likely to remain strong, and certain other segments vulnerable to the future about to unfold. ■

NOTES

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