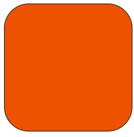

ECONOMIC CONTRACTIONS AND CONTRADICTIONS

More than two years after COVID-19 undid the economy, the economic dislocations produced by the pandemic remain abundantly apparent in the context of a macroeconomic environment that is increasingly characterized by contradictions.

ANIRBAN BASU AND JOSEPH NATARELLI

Before a global pandemic, economic lockdowns, a vicious war in Eastern Europe, and the 2020s in general, the world economy was operating with the smoothness of Wisconsin butter. Policymakers responded to the horrors of two world wars by forging trade agreements, global financial systems, and encouraging corporations headquartered in one nation to invest in others. The result was a level of economic integration that fostered peace, production efficiency, ratcheted transportation costs lower, and supported unprecedented levels of shared worldwide prosperity.

Alas, the clock struck 2020, and everything changed. Even as news of a pandemic spread and then-existing economic momentum was undone and then violently reversed, there was a conventional wisdom suggesting that the *ex ante* economy could be quickly put together, allowing us to put the pandemic behind us both from public health and financial perspectives.

It was not meant to be. More than two years after COVID-19 undid the economy, the virus lurks among us, and the economic dislocations produced by the pandemic remain abundantly apparent in the context of a macroeconomic environment that is increasingly characterized by contradictions.

Inflation, at a four-decade high, is pushing consumer sentiment to an all-time low by some measures, but the labor market continues to add jobs at an unprecedented rate. The unemployment rate is below 4 percent (3.6 percent in June), and domestic demand remains persistently elevated.[1] There are currently a record number of homes under construction, yet the housing market has slowed to a crawl in the face of surging interest rates.

Nonresidential construction spending is rising gradually in nominal terms but falling in real ones. Despite that, contractors continue to report elevated levels of backlog. Publicly financed construction activity is down 2.7 percent year over year in nominal terms according to data from the U.S. Census Bureau, yet the expectation is that the infrastructure package and surplus pandemic relief funds will power that segment in the

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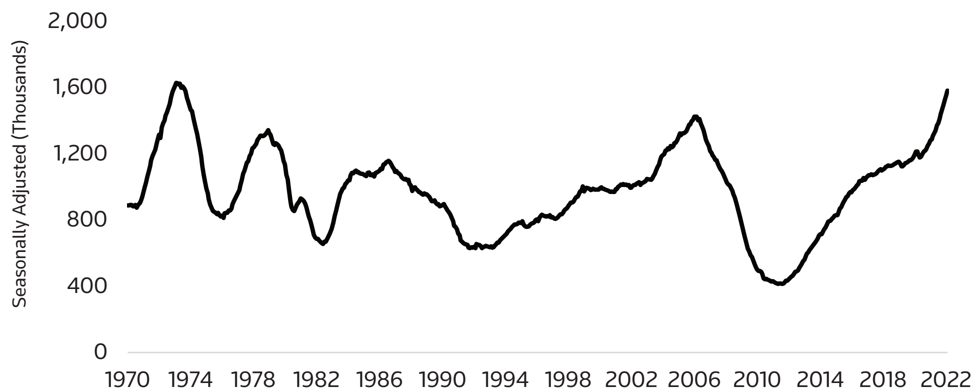
NOTE

EXHIBIT 1
New Privately Owned Housing Units Under Consideration



Source: U.S. Census Bureau

years to come.[2] Shipping costs are falling despite many still reporting supply issues.

Let's make sense of these contradictions in the context of the construction industry by exploring labor shortages, materials prices, supply chains, and both residential and nonresidential segments.

Ongoing labor shortages

While the broader economy continues to add jobs at a rapid pace, labor shortages continue to frustrate the construction industry. As of May 2022, the construction industry recorded 434,000 open, unfilled jobs, or 41 percent more than in May 2021 according to data from the U.S. Bureau of Labor Statistics.[3] Right now, 5.4 percent of all construction jobs are unfilled compared to just 4 percent at the same time last year.[4] In response, contractors are predictably paying higher wages and laying off workers at a historically low rate. Meanwhile, employees are quitting their job at an extremely elevated rate in order to secure the highest wages and/or flexibility available in the marketplace at any given moment.

As a result of labor shortages and higher wages, projects are costing more and taking longer, putting downward pressure on contractor profit margins and upsetting a significant number of project owners. According to the most recent reading of Associated Builders and Contractors Construction Confidence Index, about four in ten contractors expect their profit margins to contract over the second half of the year.[5]

Worsening economic conditions brought about by rising interest rates — the only real policy prescription for inflation — should diminish demand for workers in coming months. All else equal, that will inure to the benefit of the construction industry's labor supply: easing constraints and allowing the industry to return to some semblance of a pre-pandemic normalcy.

Material prices

Then there are those feisty materials prices, which are up 21.4 percent over the past year and 44 percent since the start of the pandemic in February 2020, according to data from the Bureau of Labor Statistics' Producer Price Index.[6]While specific commodities like softwood lumber, a key input to residential construction, garnered much of the attention in 2021 when inflation began to take off, recent increases have been more widespread. For instance, prices for steel mill products, a large component of nonresidential projects, are up 128.2

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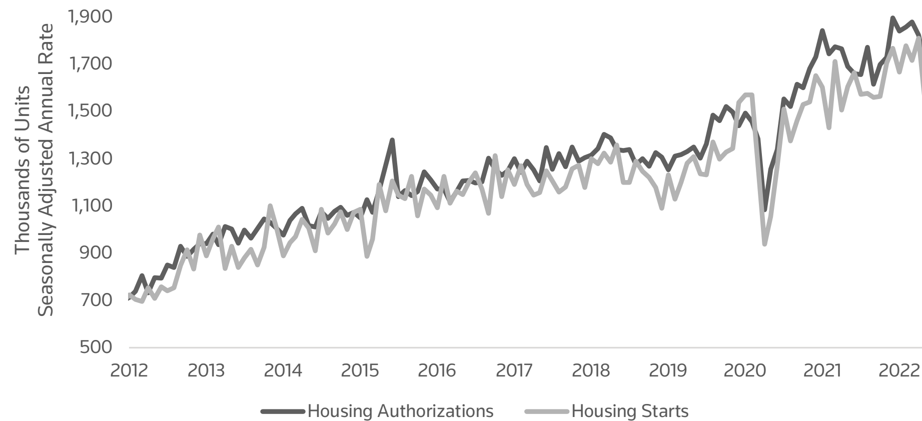
EXHIBIT 2
Housing Authorizations and Starts



Source: U.S. Census Bureau

percent since February 2020. Even categories that have seen relatively modest price increases since the start of the pandemic, like prepared asphalt, tar roofing, and siding products, are up 32.8 percent since the early months of 2020, well above the rate of overall inflation.[7]

Construction input prices have continued to rise at a faster rate than inflation even as the price of certain commodities like softwood lumber have tumbled from their post-pandemic highs. That said, there are emerging signs that commodity prices are falling from their 2022 peaks as global demand slides, the Federal Reserve raises rates, and global supply chain woes begin to subside. The World Bank recently issued a report indicating that much of the world will not be able to avoid recession over the near-term.

As of this writing, steel prices are down 44 percent from their 2022 high achieved on April 1, and copper prices are down 30 percent from the high seen on March 4.[8] While these are future prices, and are therefore not reflected in current construction input prices, the markets are expressing an expectation of falling commodity prices. All else equal, that will alleviate some of the inflationary pressures that have driven construction costs higher over the past year-plus.

Unfortunately, all else is not equal. Energy prices have surged in early 2022 due to a combination of rebounding travel and Russia's invasion of Ukraine on February 24, 2022. However, prices have eased more recently. By early July, crude oil slipped beneath $100 per barrel, up more than 33 percent from the year's onset, but down nearly 20 percent from the highs observed in mid-March.[9] Natural gas prices are up 52 percent since the start of the year despite having steadily declined since the second week of June.[10]

Critically, prices for diesel fuel, a primary input to both construction and material transportation, are up nearly 60 percent since the start of 2022.[11] The price increase has largely been driven by severe supply shortfalls. Domestic stocks of distillate fuels (a category that encompasses diesel) is down 13 percent since the start of 2022 and 20 percent since the start of the pandemic.[12]

Here is the good news for those who yearn for lower energy prices: U.S. oil output reached its highest level since April 2020 during the most recent week for which data are available from the Energy Information Administration.[13] Unfortunately, the Russian invasion of Ukraine remains a complication for energy prices, as Russian advances in the Donbas region are met with occasional Ukrainian victories and a growing

arsenal of sophisticated Western armaments.

Supply chains and transportation costs

Despite ongoing reports of supply chain disruptions, there are indications of smoother operations. As of July 1, 2022, international shipping rates had fallen more than 40 percent from the September peak but remain about 387 percent above pre-pandemic levels according to the Freightos Baltic Index.[14] While that still represents a significant increase, things are moving in the right direction. Some of the kinks have been smoothed out of supply chains, but recent declines are largely attributable to falling international demand, including in China where growth targets for 2022 are unlikely to be met.

Domestic shipping rates fell 9.8 percent in May according to Cass Information System's inferred freight rates, but are still up about 30 percent year over year.[15] Much of this increase is due to the surge in oil prices precipitated by Russia invading Ukraine.

The residential market

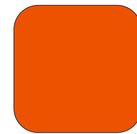
There were more than 1.6 million housing units under construction during May 2022, the highest level in the 50+ years for which the Census Bureau maintains data.[16] Residential construction spending is now at an all-time high, up 18.7 percent year over year and an incredible 56.4 percent since the start of 2020 (Exhibit 1).[17]

There are, however, two factors that suggest these figures are not as encouraging as they initially seem. First, the number of homes under construction partially reflects delays caused by materials and labor shortages. Second, the precipitous increase in construction spending is in nominal terms, so a substantial portion of that increase reflects inflation, not increased homebuilding activity.

The most recent Census Bureau data regarding new housing authorizations and starts indicates a decline in the former of 7 percent and a decline in the latter of 14.4 percent in May (Exhibit 2).[18] That's concerning, but also predictable given the impacts of far higher mortgage rates. While the number of residential building permits in May was still 16.3 percent higher than its pre-pandemic level, housing starts fell 1.4 percent below the February 2020 level (Exhibit 2).[19]

Some of the steep decline in housing starts is attributable to the glut of homes under construction and the previously mentioned labor and materials shortages, but a cooling housing market is also at play. Homebuilders are taking note. The average rate for a 30-year fixed rate mortgage stood at 5.7 percent during the most recent week for which data are available from Freddie Mac, up a staggering 2.48 percentage points since the beginning of 2022.[20] As a result, existing home sales are down 16.6 percent during the first five months of 2022 and new home sales are down 16.2 percent.[21]

The rise in mortgage rates has occurred during a period that was already associated with worsening housing affordability issues. The median sale price of an existing home is up nearly 16 percent over the past year according to the Census Bureau.[22] While the market readjusts to a new equilibrium, homebuying will remain muted as sellers struggle to adjust to a new normal.



THE RISE IN MORTGAGE RATES HAS OCCURRED DURING A PERIOD THAT WAS ALREADY ASSOCIATED WITH WORSENING HOUSING AFFORDABILITY ISSUES.

Much of the focus presently is on rising interest rates as the Federal Reserve continues to tighten monetary policy. However, it is conceivable that at some point over the next year, key interest rates will begin to decline. Some would argue that a recession has already begun in America. They are likely wrong about that, given ongoing strength in the labor market, but a recession over the near-term seems quite likely. Certain interest rates have already begun to decline in advance of expected economic softening, including the yield on the 10-year Treasury. Such dynamics could produce meaningfully lower mortgage rates during the months ahead. In other words, the market is teed up for a bounce in housing starts.

Here is the logic: Despite the decline in housing starts observed in May, inventory levels, which have risen modestly in recent months, remain historically low. There's also a glut of authorized but not yet started units. The falling price of lumber moves things in the same direction. As of this writing, that price is down 53 percent from its mid-March high.[23]

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Nonresidential construction

Nonresidential construction spending is down 5.9 percent in nominal terms since the start of the pandemic according to the U.S. Census Bureau.[24] With nonresidential construction input costs up 44.4 percent over that span, real nonresidential construction spending (i.e., adjusted for inflation) is down double digits.[25]

That decrease would be far more severe if not for a resurgent U.S. manufacturing sector. Construction spending on manufacturing-related structures is up 26.3 percent over the past year as producers race to shore up capacity.[26] Were it not for surging construction activity in this sector, nominal nonresidential construction spending would be down year over year.

Unfortunately, that is about where the good news ends. The office segment is down 2.2 percent year over year, and that figure would be significantly worse if the segment did not include data centers.[27] The commercial segment, which encompasses warehouse and distribution space, is up nearly 10 percent over the past year but has declined in each of the previous three months as distributors pivot from stocking up on inventory to managing their surpluses.[28]

Education-related spending is down 3.1 percent year over year and fell 0.9 percent in May alone, and while surplus pandemic relief funds should eventually buoy this segment, a nationwide decline in public school enrollment limits this segment's upside.[29]

With borrowing costs on the rise and a broadly turbulent macroeconomic outlook, it appears unlikely that the nonresidential sector will experience a meaningful acceleration over the next 12-24 months. What's remarkable about this is that despite these somewhat gloomy construction spending numbers, many nonresidential contractors report that they are operating at capacity. This provides a sense of how constrained nonresidential construction supply capacity has become in the context of slower immigration, the lack of entry into the skilled construction trades by young people, elevated retirement, and slow industry productivity growth.

WITH BORROWING COSTS ON THE RISE AND A BROADLY TURBULENT MACROECONOMIC OUTLOOK, IT APPEARS UNLIKELY THAT THE NONRESIDENTIAL SECTOR WILL EXPERIENCE A MEANINGFUL ACCELERATION OVER THE NEXT 12-24 MONTHS.

The forecast

The Federal Reserve endeavors to engineer a soft landing; largely by placing upward pressure on interest rates, America's monetary policymakers seek to slow the economy and curb inflationary pressures without driving the economy into recession. The rate tightening cycle began in March and will continue for the foreseeable future, with a large rate increase expected in July after the 0.75 percentage point increase in benchmark rates in June.[30] There have been eight rate tightening cycles since the early 1980s. Six have ended in recession. ■

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