AWAITING THE DOWNTURN: HOW CONSTRUCTION SIGNALS THE NEXT ECONOMIC SHIFT

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Current economic dynamics and their almost-inevitable results are key indicators for contractors considering how to engage the marketplace over the next two years.

Some industries are prone to experiencing lulls in activity before the onset of an economywide recession. Others are associated with delayed effects, with activity continuing apace even as economywide employment and output begin to turn south. Industries that tend to hint at upcoming downturns include manufacturing (inventory cycle), real estate (excesses), and financial markets (irrational exuberance).

Construction is among those industries that tend to lag behind broader economic cycles. The exception is when it is the cause of the cycle. Such was the case approaching the 2007–2009 global financial crisis as a boom in home prices and housing construction was partly driven by faulty lending. This resulted in a collapse in owner-occupied housing, massive losses in the banking system, and eventually the Great Recession. One can observe weakness in the housing market data as early as 2006, which neatly preceded the onset of the Great Recession.

Arguably, something similar occurred before the 1990–1991 recession. Commercial real estate valuations became artificially elevated as a Reagan-era boom coupled with a broad economic shift toward professional and financial services caused the nation's office market to heat up.[1]

Importantly, prior to the 1986 Tax Reform Act, one could make money by losing it.[2] Tax shelters were all the rage. One could take passive investment losses against actively generated income. The result was that some investments in oil and natural gas partnerships, commercial real estate, and other categories were designed to lose money during the early years of the investment, while other investments were intended to generate gains from the outset. Physicians, then operating in the heyday of private practice, seemed especially likely to take advantage of such shelters. Eventually, this produced surplus investment, setting the stage for large-scale losses in such investments, especially after the Tax Reform Act, which robbed tax shelters of much of their value. This ultimately helped produce the savings and loan crisis of the 1980s and the onset of the recession in 1990.[3]

Absent from these types of dynamics, construction activity would at least theoretically be likely to persist at a certain level even as an economywide recession begins. This has everything to do with the length of construction projects. As the economy enters a recession, ongoing construction projects tend to continue. There is a lag

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effect as today's construction projects come to an end and a new generation of construction projects fails to arrive as an economywide downturn reduces risk appetites, tightens up credit, and diminishes the demand for additional space or capacity.

These dynamics matter for contractors considering how to engage the marketplace over the next two years. At stake are hiring decisions, equipment leases and purchases, leasing of space, bid prices, borrowing decisions, and business sales prices.

There has been much talk of recession over the past two years. A V-shaped economic recovery from early pandemic stages triggered an enduring bout of inflation that declared itself during the spring of 2021. After approximately a year of dilly-dallying, the Federal Reserve began raising rates at their fastest pace in more than four decades. Many economists, instructed in the teachings of monetary luminaries like Milton Friedman and Anna Schwartz, concluded that recession was inevitable and would likely begin at some point in 2023.

Alas, it has not happened yet. Some economists, like those at Goldman Sachs, never really thought that recession was likely, while others, like those at JPMorgan and Bank of America, only recently dropped their recession forecasts.[4]

Others still think near-term recession remains likely. Despite ongoing economic momentum, these economists will likely repeat the phrase "monetary policy operates with long and variable lags" the way a zombie might utter the word "brains."

They like to point out that the ability of the economy to generate continued growth and lower inflation has everything to do with improved supply chains. While not all supply chain issues have been resolved (e.g., transformers, generators, switchgear), these challenges are considerably less dire than in 2021 when unmet demand broadly characterized the economy.[5] As supply chains have normalized, unmet demand has been increasingly met, translating into improved transactional volume and economic expansion. Those same supply chain improvements not only have helped lower inflation but also have diminished scarcity.

In other words, while Federal Reserve policymaking has received much of the credit from driving inflation from 9 percent in June 2022 to about 3 percent more recently, the credit really belongs to the world's producers, who have invested in plants, equipment, and people to better meet demand.[6] One could argue that higher interest rates have so far had little impact on the economy. After all, for much of 2023, equity prices have been on the rise, as have home prices. While there was a spate of bank failures this past spring, the economy has largely powered through higher borrowing costs.

That could change. The Federal Reserve only began raising interest rates 18 months ago.[7] Based on available research, it requires roughly that span or a bit more before monetary policy bites into the economy like a vampire starring in a Twilight movie. With credit card debt now topping $1 trillion, bank credit tightening, several commercial real estate segments in disarray, student debt repayment recommencing, and the possibility of large-scale strikes, the risk of recession remains.[8] Accordingly, despite more upbeat economic forecasts, construction executives would be wise to prepare for a downturn beginning at some point over the next 12 months.

Of course, there may be some construction executives who do not fret about such things. After all, the era of the megaproject in the United States is upon us. The level of construction activity occurring at any moment is shaped by numerous factors, including economic growth, interest rates, natural disasters, fiscal policy, and perhaps, above all, the pace of economic transformation.

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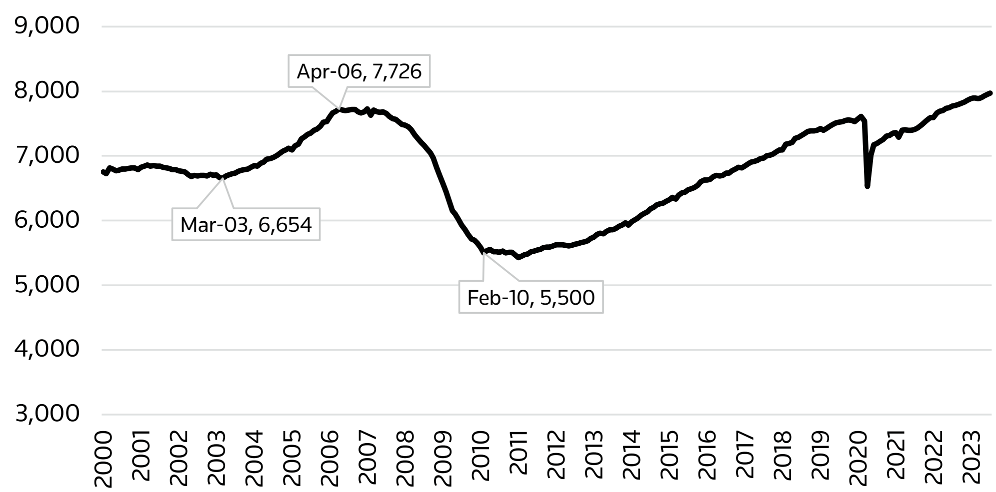
1 Lynn, D.J., "Real estate downturn of the early '90s differs from today's crash in important ways," WealthManagement.com, (Nov 2, 2009). Available at: https://www.wealthmanagement.com/investment-strategies/real-estate-downturn-early-90s-differs-today-s-crash-important-ways.

2 Kagan, J., "Tax Reform Act of 1986: Overview and history," Investopedia (Sept 9, 2023). Available at: https://www.investopedia.com/terms/t/taxreformact1986.asp.

3 Robinson, K.J., "Savings and loan crisis," Federal Reserve History (Nov 22, 2013). Available at: https://www.federalreservehistory.org/essays/savings-and-loan-crisis.

4 "Goldman Sachs cuts chances of US recession in next one year to 15%," Reuters (Sept 5, 2023). Available at: https://www.reuters.com/markets/us/goldman-sachs-cuts-chances-us-recession-next-one-year-15-2023-09-05/; Cox, J., "JPMorgan backs off recession call even with 'very elevated' risks," CNBC (Aug 4, 2023). Available at: https://www.cnbc.com/2023/08/04/jpmorgan-backs-off-recession-call-even-with-very-elevated-risks.html; Pickert, R. and Pandey, S., "BofA joins Fed in reversing recession call amid growing optimism," Bloomberg (Aug 2, 2023). Available at: https://www.bloomberg.com/news/articles/2023-08-02/bofa-joins-fed-in-reversing-recession-call-amid-growing-optimism#xj4y7vzkg.

EXHIBIT 1
Construction Jobs, January 2000 to August 2023



Data from: "All employees, construction," St. Louis Federal Reserve Economic Data, sourced from U.S. Bureau of Labor Statistics. Available at: https://fred.stlouisfed.org/series/USCONS.

This represents a period of enormous transition in the United States. Global trade flows are shifting, supply chains are being restored, energy production and distribution are being revolutionized, IT and biotechnology are rapidly advancing, and public policy is driving dollars into both infrastructure and scale production. The result is the generation of large-scale projects throughout the nation, including in places like Ohio (Intel), Arizona (TSMC), and Texas (Samsung, Texas Instruments, etc.).[9] For contractors connected to these projects, the most likely challenge will take the form of getting the work done with the people available.

However, for contractors unconnected to megaprojects, there remains greater vulnerability to business cycle vicissitudes. It is largely for these industry leaders that this article is being written.

The Business Cycle and its Discontents

The business cycle can be divided into its constituent components. The key takeaway is that these patterns have repeated themselves so frequently that they have acquired an air of inevitability.

The initial phase is expansion.[10] During this often-lengthy period, performance across industries tends to improve. However, improvement in construction tends to lag. The prior downturn has at least temporarily diminished the demand for various types of space, whether office space, retail space, or hotel rooms. It also likely damaged state and local government finances. The economy should recover to a degree before there is net new demand for additional space and more confident financiers, which often results in construction being among the last economic segments to recover.

Such was the case after the 2007–2009 downturn. Many construction segments failed to experience meaningful recovery until the 2011–2013 period, as excess homes and other forms of space needed to be absorbed before financiers felt

5 "DOE actions to unlock transformer and grid component production," Department of Energy (Oct 20, 2022). Available at: https://www.energy.gov/policy/articles/doe-actions-unlock-transformer-and-grid-component-production.

6 "Consumer price index for all urban consumers: All items in U.S. city average," St. Louis Federal Reserve Economic Research. Available at: https://fred.stlouisfed.org/series/CPIAUCSL.

7 Tepper, T., "Federal funds rate history 1990 to 2023," Forbes (July 26, 2023). Available at: https://www.forbes.com/advisor/ investing/fed-funds-rate-history/.

8 Campisi, N., "Americans' credit card debt tops $1 trillion, hitting all income levels," Forbes (Aug 17, 2023). Available at: https://www.forbes.com/advisor/credit-cards/credit-card-debt-hits-new-high/.

9 "Innovating and investing in Ohio," Intel. Available at: https://www.intel.com/content/www/us/en/corporate-responsibility/intel-in-ohio.html; Weatherbed, J., "TSMC delays Arizona factory that will eventually build chips for iPhones and AI," The Verge (July 20, 2023). Available at: https://www.theverge.com/2023/7/20/ 23802107 /tsmc-arizona-chip-factory-delay-q2-earnings-report; Tarasov, K., "How Samsung and Texas Instruments made the Lone Star State

comfortable and demand for new units became apparent.

The 2001 recession, which was punctuated by the September 11, 2001 attacks, was reasonably short and mild. After the tragic events of September 11, 2001, policymakers went into high gear, including reducing interest rates.[11] This helped feed the great housing boom of the early 2000s. During the expansion period before the Great Recession, construction employment increased from roughly 6.6 million in early 2003 to 7.7 million by the middle of 2006, as observable in Exhibit 1.[12]

The subsequent stage is the peak, which is just as it sounds.[13] This is the cycle's high point. This is the moment when people feel most confident in the economy's ability to generate new opportunities and sizable rates of ROI.

The peak is when contractors often struggle to find enough workers. They may also wrestle with rising material prices, as demand for inputs is elevated. During the period preceding the global financial crisis, the peak arrived in roughly 2006. Construction employment remained relatively unchanged at around 7.5 million that year and into the following year.

Then there is contraction. This is the post-peak period.[14] Consumer demand, which today represents approximately 70 percent of aggregate demand, slumps. This can be for a variety of reasons, including a loss of confidence, higher borrowing costs, or the onset of layoffs in key industries ranging from manufacturing and financial services to technology and tourism.

Within the construction segment, demand for engineering and architectural services dries up first. Accordingly, the Architectural Billings Index (ABI) is one of the construction industry's favorite leading indicators. Lately, the ABI has been signaling softening design activity. Eventually, the backlog dries up as fewer new projects find their way to the marketplace, leaving contractors with too little work and diminished pricing power. Layoffs commence. Credit conditions tend to be tight in financially risk-averse environments. As an example of what can transpire during the contraction phase, construction employment declined from 7.7 million in June 2007 to 5.5 million in February 2010, which represented the approximate low point of that cycle.[15]

The final phase is the trough.[16] This is the calm after the storm. However, this period can be unnerving, because many economic actors have sustained financial wounds, are concerned by the possibility of a double-dip recession (see the early 1980s), remain risk averse, and are dealing with what feels like ongoing economic stagnation. The jobless recovery of 1992, which followed the 1990–1991 recession, likely led to the first George Bush losing his reelection campaign (along with that "read my lips" line).

Correspondingly, contractors specializing in public works will likely experience the onset of recovery before those specializing in supporting private developers' needs.

This period can be especially lengthy for contractors, as investment capital is slow to reemerge and must absorb excess space before the next construction expansion cycle begins in earnest. There is also likely to be a substantial disparity between construction segments. Federal policymakers often see it fit to increase spending during periods of economic weakness, investing part of their stimulus packages in infrastructure (see 2009 and 2020–2021). Correspondingly, contractors specializing in public works will likely experience the onset of recovery before those specializing in supporting private developers' needs.

Volatile and Lagging

For decades, economists have recognized the volatility of the construction industry. This is not simply a phenomenon in the United States. A study of European industries found that construction experienced stronger movements in its idiosyncratic business cycle than other eco-

the hub of U.S. chip manufacturing," CNBC (July 20, 2023). Available at: https://www.cnbc.com/2023/07/20/texas-becomes-chip-hub-with-47-billion-investment-from-samsung-and-ti.html.

10 "Economic cycle: Definition and 4 stages of the business cycle," Investopedia (Apr 27, 2023). Available at: https://www.investopedia.com/terms/e/economic-cycle.asp.

11 *Op. cit.* note 7.

12 "All employees, construction," St. Louis Federal Reserve Economic Data. Available at: https://fred.stlouisfed.org/series/USCONS.

13 *Op. cit.* note 10.

14 *Ibid.*

15 *Op. cit.* note 12.

16 *Op. cit.* note 10.

17 Pheng, L.S. and Hou, L.S., The economy and the construction industry, *Construction Quality and the Economy* (Jan 9, 2019): 21–54. Available at: https://doi.org/10.1007%2F978-981-13-5847-0_2.

18 *Ibid.*

nomic segments.[17] The extent of industry-specific fluctuations is partially attributable to the nature of construction demand. The study states, "Demand for construction outputs is considered derived demand from other economic activities."[18] In other words, the construction industry does not generally create demand for its outputs.

Additionally, consider the time it takes to construct. Even as demand for construction declines, construction is ongoing as previously initiated projects approach their conclusion. Therefore, construction tends to oversupply relative to demand for a period, further delaying ultimate recovery. A general rule of thumb is that privately financed construction activities lag behind the performance of the broader economy by 12–18 months, but this parameter is often obtained by simply eyeballing data. Furthermore, this period can vary wildly based on financial conditions, region, and segment.

Given the current levels of contractor backlog, most contractors likely feel secure about their prospects in 2024. That being said, many commercial contractors have already begun to indicate weakness in business volume, given the grinding weakness in office, hotel, and shopping center segments. Many properties are facing the need to refinance debt between now and the end of 2028, which will put further downward pressure on owner cash flow, valuations, and demand for additional space as developers face higher borrowing and development costs.

Viewed holistically, certain contractors may want to plan for less demand for their services, as that demand might manifest at some point later next year or in 2025. Of course, this is if the economy enters a recession and interest rates remain elevated. If, by contrast, the economy smoothly glides into a soft landing, inflation fades, and interest rates dip, there is no cause for concern, but only time will tell. ■