CONSTRUCTION AS BOTH LEADING AND LAGGING INDICATOR

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Conventional wisdom holds that construction's performance as an industry lags the balance of the economy. This is based largely on the observation that construction spending's decline tends to follow that of broader economic downturn. For example, during the previous downturn, nonresidential construction spending peaked in October 2008, 11 months after the recession began in December 2007 and one month after the global financial crisis began in earnest with the failure of Lehman Brothers on September 15, 2008.[1]

This is an overly simplistic view of the timing of industry cycles. Construction and real estate often precipitate downturns. During the late 1980s, a collapse in commercial real estate values helped to induce the savings and loan crisis, which led to the 1990 recession.[2] A boom in residential values and construction produced financial challenges that became apparent in 2006 as many new homeowners began to fall behind on mortgage payments. Eventually this produced a wave of bankruptcies and subsequent bailouts among financial institutions that gave way to the worst economic downturn since the Great Depression.

While every business cycle is different, there are some commonalities. During expansion cycles, certain asset prices climb rapidly, be it commercial or residential real estate, dot-coms, bitcoin, or other asset prices. This helps create positive wealth effects and expand investor confidence, which in turn helps bolster spending and investment. That dynamic extends and magnifies the business cycle, with growth often accelerating into the latter stages of an expansion.

Investors become vulnerable to sharp declines in valuations when asset prices become overstretched relative to broader economic fundamentals, due to follow-the-leader effects and irrational exuberance. Banks become susceptible to the declining value of collateral, leaving them exposed when and if borrowers begin to default.

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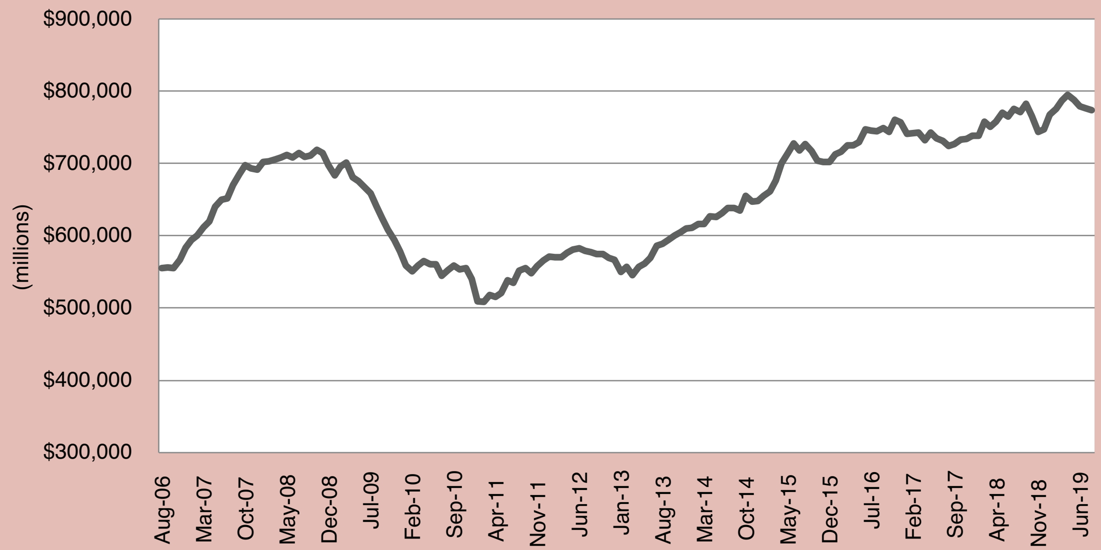
EXHIBIT 1 Total Nonresidential Construction Spending (Millions), August 2006–August 2019



Source: U.S. Census Bureau

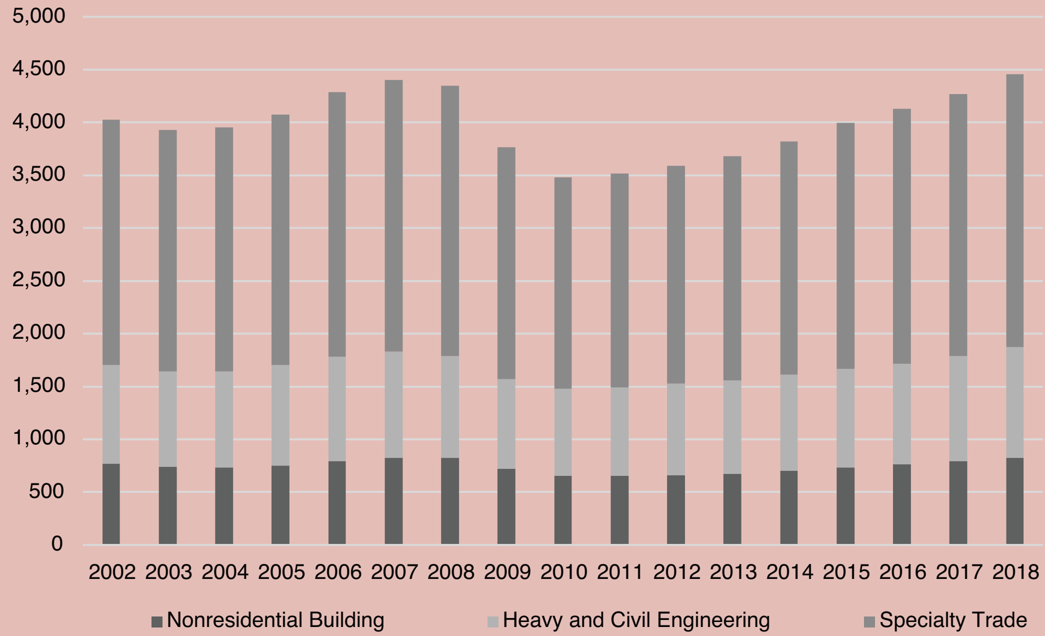
While values are rising, for example in residential or commercial real estate, excess supply can be spawned, rendering the ensuing correction in asset prices all the larger as oversupply becomes apparent and the market responds accordingly.

Because of backlog, real estate values often begin declining well before construction spending slows. For developers and their financiers, this can prove disastrous. Office, apartment, and hotel construction is often elevated as a downturn begins. When those properties become available for lease or bookings, they suffer from vigorous price competition and dwindling occupancy. There are very few economic actors for whom it is more important to discern the latter stages of an expansion cycle than developers.

Public construction spending frequently takes longer to respond to economic downturns. During the early stages of economic downturn, governments continue to collect swollen property tax revenues based on prior assessments. Consumer spending tends to be more stable than other economic segments, which means that retail sales tax collection persists at reasonable levels. Corporate chieftains respond quickly by laying off workers and slashing other costs, which lowers income tax collections, helping corporate profits recover quickly. During the prior business cycle, corporate profits had recovered as early as 2010.[3]

In addition to the various factors that shield state and local government revenues from sharp declines, lengthy project planning cycles mean that it often takes years before outlays on infrastructure adjust to new economic realities. What is more, the federal government often responds to downturns with stimulus packages, which is precisely what occurred in February 2009 as the newly elected Obama administration sought to stabilize an economy in disarray. Among the central features of the American Recovery and Reinvestment Act of 2009, a $787 billion package, was approximately $150 billion dedicated toward public works.[4] While these types of policies limit the extent of economic decline, they also limit the responsiveness of overall construction spending to economic downturns.

EXHIBIT 2 Nonresidential Construction Employment (Thousands), 2002–2018



Source: U.S. Bureau of Labor Statistics

What a difference a percentage point can make

According to the U.S. Census Bureau, the construction industry contributed 4.9 percent of total economic output in 2007, which encompassed the final 11 months of the expansion that began in late 2001.[5] By 2011, the worst year for many contractors during that memorable cycle, construction's share of GDP had declined to 3.4 percent.[6]

Exhibit 2 shows how the decline translated into employment changes, with nonresidential construction losing nearly 1 million jobs between 2007 and 2010. As indicated, many of the losses occurred among specialty trade contractors, including those who worked on commercial projects. By 2010, new project starts had dwindled and, based on employment totals, did not begin to recover in earnest until 2012 or 2013. It took more than a decade for nonresidential construction employment to return to its prerecession peak.

Looking ahead

A recent survey conducted by the National Association for Business Economics indicated that 72 percent of economists predict a recession will occur by 2021's end.[7] Once again, real estate and construction indicators are helping to foreshadow the next downturn, with key metrics such as private construction and the Architecture Billings Index flashing yellow or worse.

If the economy does in fact initiate its next downturn in 2020 or 2021, this would implicate years like 2022 or 2023 for many contractors based on history. Subcontractors, who are especially vulnerable to economic and construction spending downturns, should be on high alert. The implication is that firms that are particularly susceptible to business cycles should take steps now to build up cash reserves and strengthen relationships with bankers and insurers. These firms need to think long and hard about the quality of backlog in terms of generating stable profits and cash flow going forward and ensure that only the best and most motivated workers remain on payroll to maximize future liquidity. ■

NOTES

[1] "Total construction spending," Federal Reserve Economic Data: Federal Reserve Bank of St. Louis. Available at: https://fred.stlouisfed.org/series/TTLCONS; Egan, M., "Lehman Brothers: When the financial crisis spun out of control," CNN (Sept 14, 2018). Available at: https://www.cnn.com/2018/09/30/investing/lehman-brothers-2008-crisis/index.html.

[2] Robinson, K.J., "Savings and loan crisis," Federal Reserve History (2013). Available at: https://www.federalreservehistory.org/essays/savings_and_loan_crisis.

[3] Mishel, L., "Corporate profits have recovered, but job market still depressed," Economic Policy Institute (July 14, 2010). Available at: https://www.epi.org/publication/corporate_profits_have_recovered_but_job_market_still_depressed/.

[4] Wolverson, R., "The stimulus report card," Council on Foreign Relations (March 9, 2010). Available at: https://www.cfr.org/backgrounder/stimulus-report-card.

[5] "Value added by private industries: Construction as a percentage of GDP," Federal Reserve Economic Data: Federal Reserve Bank of St. Louis. Available at: https://fred.stlouisfed.org/series/VAPGDPC#0.

[6] *Ibid*.

[7] Heeb, G., "More than 70% of economists think a US recession will strike by the end of 2021," Market Insider (Aug 19, 2019). Available at: https://markets.businessinsider.com/news/stocks/next-recession-trump-survey-shows-most-economists-predict-downturn-2021-2019-8-1028456445.