MARCUM Commercial Construction Index

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By Many Measures, America Has Fully Recovered

By Anirban Basu, *Chief Construction Economist, Marcum LLP*

Stocks at Record Highs, Unemployment at Multi-Year Lows

For the first time in a decade, economies throughout the world are experiencing a synchronized economic expansion, meaning that all of the world's major economies, whether developed like France or developing like Brazil, are expanding simultaneously. Driven primarily by consumer spending, the U.S. economy entered its ninth year of recovery several months ago. We are in the midst of the third longest expansion in American history and the pace of growth has been accelerating recently.

At 4.1 percent (October 2017), the official rate of unemployment is at a 17-year low. Not coincidentally, consumer confidence is at a 17-year high, with surging stock and housing prices boosting aggregate U.S. household wealth to unprecedented heights. According to the Federal Reserve, the net worth of households and nonprofits rose to $96.2 trillion during the second quarter of 2017. The value of corporate equities rose $1.1 trillion during the quarter, while the value of real estate expanded by $600 billion. With unemployment so low and with liquidity elevated, we might expect that inflation would have become far more apparent by now. This hasn't been the case.

Based on the measure commonly used by the U.S. Federal Reserve to guide policymaking (the core PCE deflator), it appears that the aggregate price level is up by less than 2 percent over the last 12 months (well below that threshold, in fact – 1.3 percent). This is in spite of healthcare providers, construction firms, trucking enterprises, agrarians, and manufacturers reporting difficulty finding qualified people to hire, health insurance premiums surging, rents rising, tuitions reaching new heights, and construction material costs spiking (e.g., softwood lumber, up 15 percent during a recent 12-month period).

One implication arising from the dearth of overall inflation in the data is that the Federal Reserve has managed to refrain from aggressive monetary tightening. For the most part, interest rates have remained extraordinarily low, including mortgage rates. That has fueled additional leveraging of household and corporate balance sheets and supported higher equity prices.

Low interest rates have also induced more consumers to take on additional debt. In September 2017, American consumers collectively increased their borrowing by nearly $21 billion dollars. That represented the largest gain in 10 months and was led by sharp increases in borrowing for student and auto loans. The category that includes credit card debt experienced an increase in consumer borrowing exceeding $6 billion in September. As indicated by the Associated Press, by the end of September, total household borrowing stood at a new record of approximately $3.8 trillion dollars. Importantly, the Federal Reserve data do not encompass home mortgages or other loans such as home equity loans that are secured by real estate.

Here's the issue. While consumer borrowing helps support economic activity today, it may jeopardize economic performance at some point in the future. According to the Federal Reserve, household debt expanded at an annual rate of 3.7 percent during the second quarter of 2017. Consumer credit grew at an annual rate of 4.6 percent.

Joe's View

Ebbs and flows, ebbs and flows. Over the years of creating and reflecting upon the Marcum Commercial Construction Index, you've heard me express feelings of optimism in dark times and skepticism in optimistic times. Well, based on prevailing economic data, this quarter's index offers a particularly sunny report. In fact, we even go as far as to say that America is in full recovery (from the economic disaster of nearly a decade ago). Low inflation, high consumer confidence, low unemployment, low cost averages, the promise of tax reform…the hits keep on coming. I, and we, think that's great news. But, something is still bugging me. Maybe it's just my personality. Maybe it's my decades of living through cycles, but I can't help but see some dangers out there, nevertheless.

So, I'll say: enjoy your prosperity but, as always, plan for the future. Start with your team: Take a look at your most valued team members and think about their proximity to retirement. How many new folks may it take to replace them? At a sub-5 unemployment rate and with escalating healthcare rates, what will that cost you? Next, consider the big picture. Despite our rosy general forecast, the facts in our sector are that non-residential spending is down (at its lowest since 2015). Not only is it down, but it is ever more silo'd by subspecialty. It has not been an evenly spread recovery, and some subsectors have really taken it in the teeth. Let's watch these trends and plan and/or pivot for a profitable future.

Wishing you all a happy and healthy holiday season.

Joseph Natarelli, CPA
National Construction Industry Group Leader, Marcum LLP

Exhibit 1. *Nonresidential Spending, September 2017, Millions of dollars, Seasonally Adjusted Annual Rate*

Subsector	September 2017	1-month % Change	12-month % Change	36-month % Change
Nonresidential	**$698,100**	**0.5%**	**-2.9%**	**13.6%**
Conservation and development	$7,395	12.3%	-7.7%	-9.2%
Educational	$92,197	5.4%	3.7%	16.4%
Transportation	$43,557	3.6%	5.8%	5.8%
Amusement and recreation	$23,870	1.6%	7.9%	39.0%
Highway and street	$84,521	1.0%	-7.3%	1.0%
Lodging	$29,960	0.9%	5.3%	72.8%
Public safety	$8,091	-0.2%	4.7%	-11.7%
Health care	$40,388	-0.3%	0.6%	3.9%
Sewage and waste disposal	$19,294	-0.4%	-10.7%	-15.2%
Communication	$22,848	-0.5%	3.9%	45.5%
Power	$99,185	-0.7%	-8.9%	0.8%
Commercial	$85,998	-1.1%	11.4%	42.2%
Water supply	$11,508	-1.1%	-9.2%	-15.2%
Office	$67,195	-1.2%	-6.1%	43.3%
Manufacturing	$59,017	-3.4%	-20.3%	1.1%
Religious	$3,077	-3.5%	-12.4%	-15.1%

Source: United States Census Bureau

One would expect that faster economic growth, record stock prices, low interest rates, unprecedented levels of household wealth, surging consumer confidence, and elevated business owner confidence (e.g., as measured by the National Federation of Independent Business) would translate into significant nonresidential construction spending growth. However, between September 2016 and September 2017, nonresidential construction spending in America actually declined by nearly 3 percent, with a number of segments recording double-digit declines in spending (manufacturing, religious, and sewage/waste disposal).

Nonresidential construction spending rose slightly (0.5 percent) in September, totaling $698.1 billion on a seasonally adjusted basis according to data made available by the U.S. Census Bureau. Despite that, the absolute level of nonresidential construction spending was at its lowest level since December 2015. Much of the recent weakness has been in publicly financed categories like water supply (-9.2%), conservation and development (-7.7%), and highway/street (-7.3%).

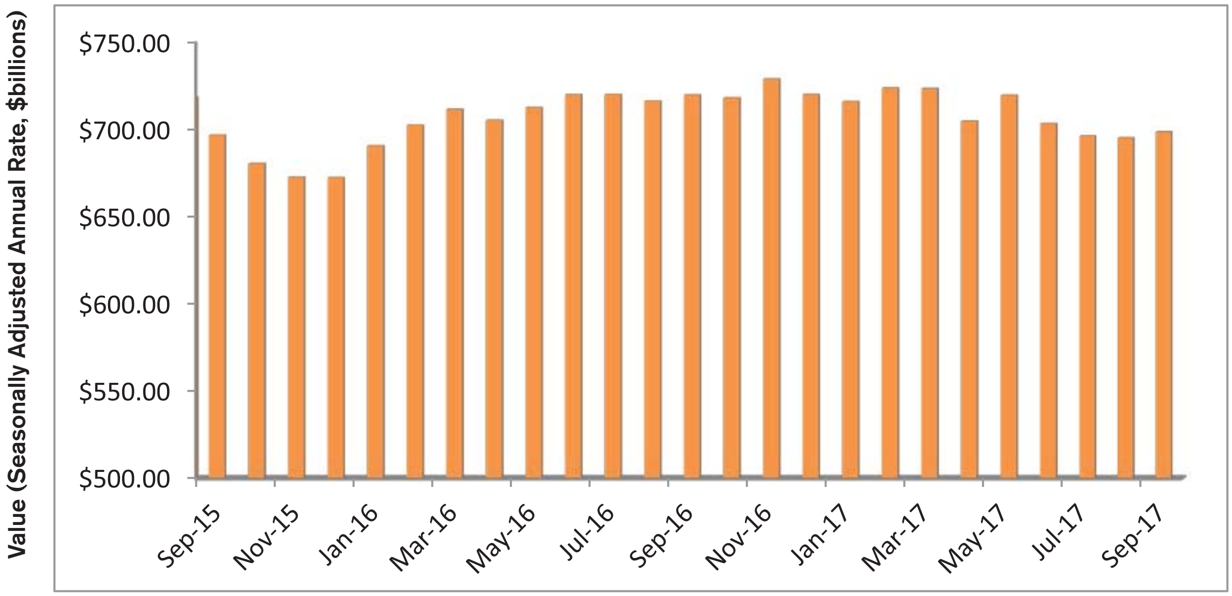
Exhibit 2. *Construction Employment Growth, 20 Largest U.S. Metropolitan Areas October 2016 v. October 2017, Not Seasonally Adjusted*

Rank	MSA	% Change	Rank	MSA	Percent Change
1	Riverside-San Bernardino-Ontario, CA	15.5%	11	Washington-Arlington-Alexandria, DC-VA-MD-WV*	2.5%
2	Detroit-Warren-Livonia, MI*	8.8%	12	Boston-Cambridge-Quincy, MA-NH	2.4%
3	Tampa-St. Petersburg-Clearwater, FL	7.5%	13	San Diego-Carlsbad-San Marcos, CA	2.3%
4	San Francisco-Oakland-Fremont, CA	7.0%	14	Atlanta-Marietta, GA	2.2%
5	Miami-Fort Lauderdale-Pompano Beach, FL	6.0%	15	Philadelphia-Camden-Wilmington, PA-NJ-DE-MD*	2.1%
6	Minneapolis-St. Paul-Bloomington, MN-WI*	5.3%	16	New York-Northern New Jersey-L. Island, NY-NJ-PA*	2.0%
7	Los Angeles-Long Beach-Santa Ana, CA	5.2%	17	Dallas-Fort Worth-Arlington, TX*	1.3%
7	Seattle-Tacoma-Bellevue, WA	5.2%	18	Chicago-Joliet-Naperville, IL-IN-WI	-0.5%
9	Phoenix-Mesa-Glendale, AZ	3.6%	19	St. Louis, MO-IL	-1.9%
10	Baltimore-Towson, MD*	2.7%	20	Houston-Sugar Land, TX	-3.6%

**Construction, Mining, and Logging are included in one industry; Source: Bureau of Labor Statistics*

Despite sluggish spending growth in many nonresidential construction categories, construction firms continue to increase staffing levels. One possible explanation is declining industry productivity. Many of America's most skilled construction workers are hurtling toward retirement. As they leave the workforce, many construction firms are being induced into replacing each skilled construction worker with more than one worker, often in the hopes that these new workers are trainable and will prove reliable. This narrative, though arguably theoretical, is consistent with higher employment, diminished industry productivity (measured in terms of output per hour worked), stagnant industry output, and potentially shrinking profit margins. That said, nonresidential construction spending should begin to expand faster in coming months, with manufacturing and power representing likely sources of improvement.

Exhibit 3. *Nonresidential Construction Spending, September 2015 through September 2017*



Sources: U.S. Census Bureau

One additional source of improvement is pending tax reform. As of this writing, Republicans are racing to deliver a tax relief package by Christmas. There are many proposed reforms that would impact construction firms and their owners directly or indirectly, including a much lower corporate tax rate, the elimination of the alternative minimum tax, a lower tax rate for subchapter-S corporations and similarly situated flow-through tax entities, fewer personal income tax brackets, and the elimination of the estate tax.

Whatever one thinks of this slew of proposed reforms, the implementation of such a tax package would supercharge the U.S. economy, at least for a time. A number of coastal states, including relatively higher tax states like California, New York, New Jersey, and Maryland, would tend not to benefit as much from the package because of the proposed elimination of state and local tax and property tax deductions. Other potential losers are charities, expensive homes, and recipients of healthcare subsidies.

There will be Risks

As always, there are risks to the outlook. With wage pressures building, healthcare costs surging, and fuel prices edging higher, inflation is becoming more apparent. That could translate into some meaningful interest rate increases in 2018, which, all things being equal, is not good for construction spending. The stock market's performance has been simply brilliant. But what goes up can go down.

Asset prices might head in a different direction in 2018, including commercial real estate prices. Segments like hotels, office buildings, and apartments have helped to fuel construction spending in recent years. If the value of properties begins to stagnate or worse, construction spending momentum will eventually wind down. The impact of this may not be felt in 2018, however, but in out years.

For now, there is plentiful momentum. A recent reading of the Conference Board's Index of Leading Economic Indicators suggests that the U.S. economy will enter 2018 with substantial momentum. Corporate earnings remain healthy. Global growth is accelerating. Consumers are upbeat. Tax cuts could fuel faster business spending. All of this suggests that the construction recovery that began in earnest in 2011 may have a few more birthdays ahead.

Third Quarter 2017 Performance	Values			% Change from	
Gross Domestic Product	**2017Q3[1]**	**2017Q2**	**2017Q1**		
Overall Real GDP	3.0%	3.1%	1.2%	NA	NA
Nonresidential Fixed Investment in Structures	3.9%	6.7%	7.2%	NA	NA
Construction Spending, Seasonally Adjusted (in $millions)	**Sep-17**	**Aug-17**	**Sep-16**	**Aug-17**	**Sep-16**
Total Construction	$1,219,544	$1,215,990	$1,195,640	0.3%	2.0%
Residential	$521,445	$521,341	$476,373	0.0%	9.5%
Nonresidential	$698,100	$694,650	$719,267	0.5%	-2.9%
Lodging	$29,960	$29,683	$28,444	0.9%	5.3%
Office	$67,195	$68,006	$71,597	-1.2%	-6.1%
Commercial	$85,998	$86,947	$77,205	-1.1%	11.4%
Health care	$40,388	$40,498	$40,161	-0.3%	0.6%
Educational	$92,197	$87,503	$88,930	5.4%	3.7%
Religious	$3,077	$3,188	$3,514	-3.5%	-12.4%
Public safety	$8,091	$8,110	$7,725	-0.2%	4.7%
Amusement and recreation	$23,870	$23,500	$22,126	1.6%	7.9%
Transportation	$43,557	$42,033	$41,173	3.6%	5.8%
Communication	$22,848	$22,958	$21,996	-0.5%	3.9%
Power	$99,185	$99,858	$108,846	-0.7%	-8.9%
Highway and street	$84,521	$83,661	$91,212	1.0%	-7.3%
Sewage and waste disposal	$19,294	$19,376	$21,601	-0.4%	-10.7%
Water supply	$11,508	$11,634	$12,679	-1.1%	-9.2%
Conservation and development	$7,395	$6,584	$8,009	12.3%	-7.7%
Manufacturing	$59,017	$61,112	$74,049	-3.4%	-20.3%
Employment, Seasonally Adjusted (in thousands)	**Oct-17**	**Sep-17**	**Oct-16**	**Sep-17**	**Oct-16**
National Total Nonfarm	147,010	146,749	146,731	0.2%	1.4%
Construction	6,930	6,919	6,743	0.2%	2.8%
Residential building	766.6	759.4	749.4	0.9%	2.3%
Nonresidential building	764.3	767.6	751.3	-0.4%	1.7%
Heavy and civil engineering construction	970.0	973.0	946.4	-0.3%	2.5%
Residential specialty trade contractors	1,949.9	1,943.8	1,868.6	0.3%	4.4%
Nonresidential specialty trade contractors	2,479.4	2,475.1	2,426.9	0.2%	2.2%
Producer Price Index[2]	**Oct-17**	**Sep-17**	**Oct-16**	**Sep-17**	**Oct-16**
Finished Goods (seasonally adjusted)	112	111.7	108.4	0.3%	3.3%
Inputs to Construction Industries	219	219.1	210	0.0%	4.3%
Nonresidential general contractors	107.1	106.4	103.7	0.7%	3.3%
New nonresidential building construction, National	115.8	115.1	112.2	0.6%	3.2%
New nonresidential building construction, Northeast	108.4	107.4	104.4	0.9%	3.8%
New nonresidential building construction, South	107.6	107.2	105.0	0.4%	2.5%
New nonresidential building construction, Midwest	105.9	105.2	102.7	0.7%	3.1%
New nonresidential building construction, West	108.2	107.9	104.6	0.3%	3.4%

Source: U.S. Bureau of Economic Analysis; U.S. Census Bureau; U.S. Bureau of Labor Statistics

[1] *Advance (1st) Estimate.*

[2] *The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. All figures are indexed from a base year, that base year being different for each individual index.*

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- Marital Dissolution

Joseph Natarelli

Joseph Natarelli is the national leader of Marcum's Construction Industry Practice and partner-in-charge of the Firm's New Haven office. For more than a decade, he has served as a technical reviewer for the AICPA's Audit Risk Alert for Construction Contractors and the AICPA Accounting Guide – Construction Contractors. Joe has also chaired the annual AICPA National Construction Industry Conference.

Anirban Basu

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