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Is the U.S. Economy Too Strong?

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

Inflationary Pressures Build, Interest Rates Rise

The story of the economy has been akin to a Cadillac meeting a series of jolting potholes. It's an uncomfortable ride, but the vehicle continues to progress, and it's not clear whether or not any of the road imperfections are producing lasting damage. If one were to spend one's time watching CNN, MSNBC, or any number of other media outlets, you would be pounded by news of chemical warfare, late-night bombings, tariffs on steel and aluminum, a burgeoning trade war between the world's two largest economies, frequent terrorist assaults, surging oil prices, an uprising in Gaza, indictments, investigations, sentencing of presidential allies, and an ongoing set of inquiries that threatens the presidency itself. This deluge of unsettling news would appear to be enough to soften economic performance.

But to date, there's little evidence that all this negativity has done much damage to the economy. Here's what we know as of early spring 2018. Even with all the ups and downs recently, the U.S. economy has added jobs for an incredible 90 months. This is an unprecedented winning streak. On top of that, since the economy bottomed out in February 2010, the nation has added approximately 18.7 million new jobs. As of April 2018, total U.S. nonfarm employment was 148,424,000, with 164,000 added during that month.

Compared to previous months, March and April's jobs numbers are relatively low, though weather seems to have played a significant role in the former. There are certain segments of the economy that are especially susceptible to dislocations produced by weather events, including construction and retail trade. The construction sector lost 10,000 jobs in March, but rebounded in April, adding 17,000 positions.

Unemployment declined in April 2018 to 3.9 percent, the first time since December 2000 that unemployment has been below the 4 percent threshold. However, unemployment has declined recently in large measure due to a shrinking labor force participation rate, which as of this writing stands at a lackluster 62.8 percent.

Recent declines in labor force participation are unnerving. With America boasting a record 6.55 million available job openings, labor force participation should be rising. The fact that labor force participation has been declining strongly suggests that human capital shortages will continue to worsen, and that implies faster wage growth (fine), more inflation (not so good), and higher interest rates (problematic for many). Average hourly earnings for all private nonfarm employees rose 4 cents in April, from $26.80 to $26.84. Over the last 12 months, average hourly earnings rose by 2.6 percent (67 cents).

Joe's View

Summer is here and as we look back on the quarter behind us, we find a complex picture of promise and caution. Only the most wildly optimistic of economists (or even regular folks like me) would have dared to wager on the 90 straight months of job growth we have had (!) following the market nadir 8 years ago. However, as we discuss in our analysis of the collected data in this quarter's index, there are complicating factors that have clouded this sunny outcome. Aside from the labor pressures of availability and wage increases which we nearly always note, we're seeing inflation and interest rates rise at the same time. That forecasting cocktail was garnished, this past quarter, with unpredictable and less than favorable weather, which is a real negative factor in many major U.S. construction markets at this time of year.

As always, cautious optimism is the name of my game. I am looking towards future infrastructure construction to carry us forward and upward. Of the 16 nonresidential subsectors, only 4 had double-digit, 12-month growth (Lodging, Public Safety, Transportation, Conservation and Development). Let's hope that the 12-month negative growth in Highways and Streets turns around to prove me right. As we head into some of our industry's most productive months, I wish all of you a profitable and productive summer for your companies and a happy and healthy one for you and your families.

Until next quarter,

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

This dynamic of rising wages, inflation, and interest rates may be the one that will ultimately undo the current economic expansion, now on the verge of commencing its 10th year. Higher interest rates are not good for many asset prices, including the inflated asset prices of stocks, bonds, and commercial real estate. Inflation is emerging from a number of sources, including apartment rents, home prices, gasoline, steel, aluminum, softwood lumber, healthcare, tuition, and of course rising borrowing costs.

For now, the U.S. economic expansion remains firmly in place, with a combination of momentum, tax cuts, global money supply, and confidence propelling the U.S. economy forward. America's economy expanded 2.3 percent in 2017 after growing 1.5 percent the previous year.

The first quarter of 2018 saw the economy expand 2.3 percent on an annualized basis. Current dollar (or nominal) GDP, which incorporates inflation, rose 4.3 percent during the quarter. While that doesn't seem spectacular, first quarters have tended to be weak in recent years, and the most recent first quarter represents reasonably strong performance based on that history.

This economic strength does not appear to be translating neatly into rapid growth in construction spending. Nonresidential construction spending actually declined 0.3 percent in March on a monthly basis according to an Associated Builders and Contractors (ABC) analysis of U.S. Census Bureau data released in early May. Nonresidential spending, which totaled $740.9 billion on a seasonally adjusted, annualized basis, has expanded an unspectacular 2.5 percent on a year-over-year basis.

Private sector nonresidential construction spending fell 0.4 percent on a monthly basis in March and is up just 2.2 percent from a year ago. Meanwhile, public nonresidential spending remained unchanged in March, and it is up 2.9 percent year-over-year. Much of that growth, perhaps all of it and then some, can be explained by rising construction materials prices and expanding compensation costs.

Exhibit 1. *Nonresidential Spending, March 2018, Millions of dollars, Seasonally Adjusted Annual Rate*

Subsector	March 2018	1-month % Change	12-month % Change	36-month % Change
Nonresidential	$740,928	-0.3%	2.5%	10.8%
Lodging	$31,482	-0.2%	11.8%	60.3%
Office	$74,494	0.7%	5.0%	41.9%
Commercial	$91,077	-2.3%	8.1%	41.1%
Health care	$41,329	-2.0%	4.4%	5.4%
Educational	$94,987	0.1%	3.0%	18.0%
Religious	$2,977	3.5%	-7.9%	-6.4%
Public safety	$9,141	-4.2%	11.8%	5.8%
Amusement and recreation	$24,637	1.7%	2.7%	32.4%
Transportation	$51,247	-1.6%	18.5%	11.2%
Communication	$24,062	1.6%	6.4%	19.6%
Power	$95,249	0.3%	-6.2%	-9.9%
Highway and street	$91,218	1.3%	-3.5%	8.2%
Sewage and waste disposal	$20,991	-0.5%	5.9%	-15.1%
Water supply	$11,890	-4.5%	7.0%	-7.5%
Conservation and development	$9,071	8.3%	24.5%	21.6%
Manufacturing	$67,079	-0.9%	-7.0%	-16.5%

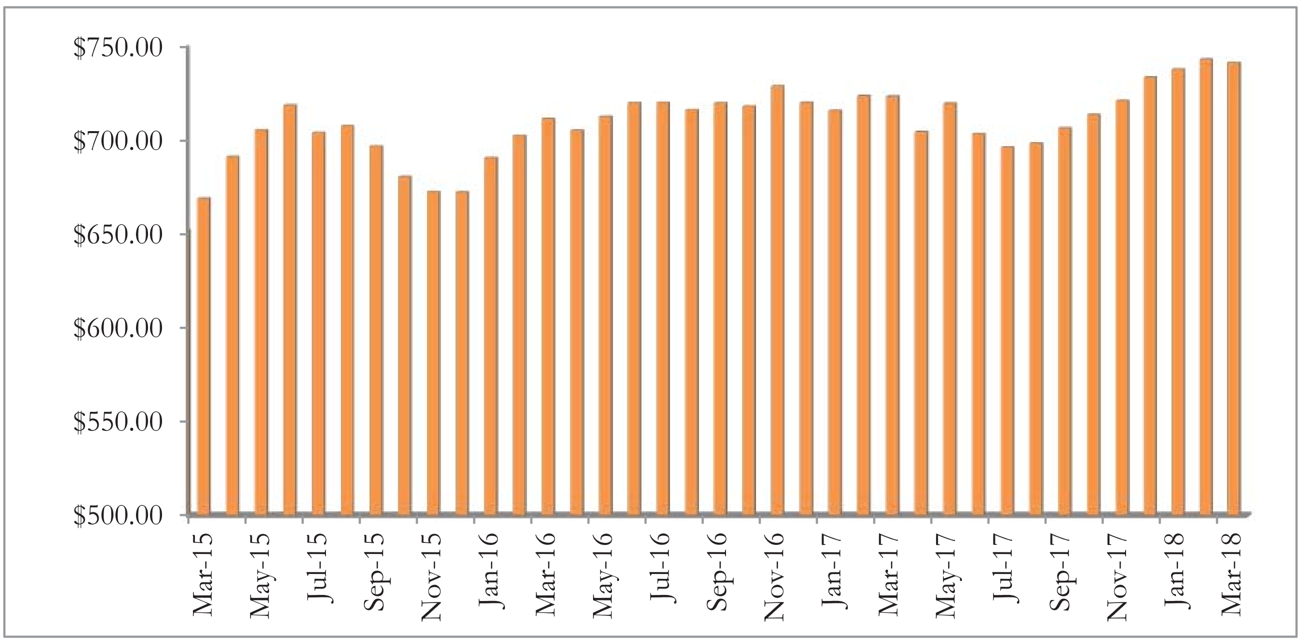
Source: U.S. Census Bureau

It may be that the nonresidential construction spending data are simply failing to capture the fullness of building activity. These data continue to be at odds with other data characterizing growth in the level of activity. For example, first quarter GDP data indicated brisk expansion in nonresidential investment. Data from ABC's Construction Backlog Indicator, the Architecture Billings Index, and other leading industry indicators have also been suggesting ongoing growth. Despite that, private nonresidential construction spending is up by roughly the inflation rate, indicating that the volume of services delivered over the past year has not expanded in real terms – at least if these data are to be believed.

That said, most economists who follow the industry presumed that March data would be somewhat soft. The Northeast and Midwest were impacted by unusually persistent storm activity in March. The same phenomenon impacted March's employment estimates, which indicated that construction lost jobs that month. Other weather-sensitive industries, including retail trade, also experienced slow to negative job growth in March. Leading indicators, including a host of confidence measures, collectively suggest that business investment will be on the rise during the months ahead.

Improved state and local government finances should also support additional nonresidential construction activity. Contractors can expect a meaningful increase in infrastructure spending over the year to come, even in the absence of a federal infrastructure package. Some public construction categories have already begun to experience an uptick in activity, including public safety and transportation.

Exhibit 2. *Nonresidential Construction Spending, March 2015 through March 2018*



Source: U.S. Census Bureau

Perhaps the best evidence of unreliable construction spending data comes from the Bureau of Labor Statistics, the agency that produces the eagerly anticipated jobs reports typically released on the first Friday of each month. According to this source, the construction industry has added 257,000 new jobs, representing a growth rate of 3.7 percent, over the past year. That represents significant growth in construction staffing. These statistics are more consistent with anecdotal and other data than the spending data.

Exhibit 3. *Construction Employment Growth, 20 Largest U.S. Metropolitan Areas, March 2017 v. March 2018, Not Seasonally Adjusted*

Rank	MSA	% Change	Rank	MSA	% Change
1	Phoenix-Mesa-Scottsdale, AZ	8.7%	11	Atlanta-Sandy Springs-Roswell, GA	4.2%
2	Miami-Fort Lauderdale-West Palm Beach, FL	8.0%	12	Chicago-Naperville-Elgin, IL-IN-WI	3.7%
3	Riverside-San Bernardino-Ontario, CA	7.8%	12	Los Angeles-Long Beach-Anaheim, CA	3.7%
4	Detroit-Warren-Dearborn, MI*	7.1%	14	Baltimore-Columbia-Towson, MD*	3.2%
5	Seattle-Tacoma-Bellevue, WA	6.9%	15	Dallas-Fort Worth-Arlington, TX*	3.1%
6	Boston-Cambridge-Nashua, MA-NH*	5.6%	16	New York-Newark-Jersey City, NY-NJ-PA*	2.0%
7	Houston-The Woodlands-Sugar Land, TX	4.9%	16	Washington-Arlington-Alexandria, DC-VA-MD-WV*	2.0%
8	San Diego-Carlsbad, CA	4.5%	18	St. Louis, MO-IL*	-0.8%
9	Tampa-St. Petersburg-Clearwater, FL	4.4%	19	Philadelphia-Camden-Wilmington, PA-NJ-DE-MD*	-1.4%
10	San Francisco-Oakland-Hayward, CA	4.3%	20	Minneapolis-St. Paul-Bloomington, MN-WI*	-2.4%

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

In general, markets in the American South dominate in terms of the pace of overall job growth as well as construction job growth. Among the areas that have added significantly to construction employment over the past year are Phoenix, Miami, and Riverside. The other hot region is the Pacific Northwest, in which communities like Seattle, Portland, and Boise are adding jobs rapidly.

Looking Ahead

The recent decline in national unemployment to 3.9 percent offers both positive and negative news. The positive news is that the U.S. economy continues to flourish, creating new opportunities for job seekers. One would expect that this will help support continued consumer spending growth.

However, the dip in unemployment also foretells more inflationary pressure and higher interest rates. Higher borrowing costs render it more difficult to efficiently finance construction projects. To the extent that interest rates are likely to rise further going forward, construction activity can be expected to flatten at some point in the middle- and long-term.

That said, a combination of recently enacted tax cuts, consumer and business confidence, positive wealth effects attributable to the performance of financial and housing markets, a stronger global economy, and accommodative global monetary policy should position 2018 to be the best year for economic performance in America since 2005. Since nonresidential construction lags the overall economy by roughly one year, even if the broader economy stumbles next year, nonresidential construction activity is likely to be elevated in 2019. Many economists expect more turbulent economic times in 2020 or 2021, which would translate into a more challenging set of circumstances for contractors in 2021 or 2022.

First Quarter 2018 Performance	Values			% Change from	
Gross Domestic Product (Quarterly % Growth)	**2018Q1(1)**	**2017Q4**	**2017Q3**		
Overall Real GDP	2.3%	2.9%	3.2%	NA	NA
Nonresidential Fixed Investment in Structures	12.3%	6.3%	-7.0%	NA	NA
Construction Spending, SA ($Millions)	**Mar-2018**	**Feb-2018**	**Mar-2017**	**Feb-2018**	**Mar-2017**
Total Construction	$1,284,740	$1,306,360	$1,239,564	-1.7%	3.6%
Residential	$543,812	$563,559	$516,631	-3.5%	5.3%
Nonresidential	$740,928	$742,801	$722,933	-0.3%	2.5%
Lodging	$31,482	$31,545	$28,161	-0.2%	11.8%
Office	$74,494	$73,955	$70,972	0.7%	5.0%
Commercial	$91,077	$93,227	$84,282	-2.3%	8.1%
Health care	$41,329	$42,176	$39,591	-2.0%	4.4%
Educational	$94,987	$94,884	$92,209	0.1%	3.0%
Religious	$2,977	$2,877	$3,231	3.5%	-7.9%
Public safety	$9,141	$9,541	$8,179	-4.2%	11.8%
Amusement and recreation	$24,637	$24,214	$23,996	1.7%	2.7%
Transportation	$51,247	$52,068	$43,238	-1.6%	18.5%
Communication	$24,062	$23,682	$22,623	1.6%	6.4%
Power	$95,249	$94,919	$101,548	0.3%	-6.2%
Highway and street	$91,218	$90,082	$94,519	1.3%	-3.5%
Sewage and waste disposal	$20,991	$21,095	$19,829	-0.5%	5.9%
Water supply	$11,890	$12,447	$11,109	-4.5%	7.0%
Conservation and development	$9,071	$8,376	$7,284	8.3%	24.5%
Manufacturing	$67,079	$67,714	$72,163	-0.9%	-7.0%
Employment, SA (in thousands)	**Apr-18**	**Mar-18**	**Apr-17**	**Mar-18**	**Apr-17**
National Total Nonfarm	148,424	148,260	146,144	0.1%	1.6%
Construction	7,174	7,157	6,917	0.2%	3.7%
Residential building	785	781	747	0.5%	5.1%
Nonresidential building	810	805	785	0.6%	3.1%
Heavy and civil engineering construction	999	1,002	987	-0.3%	1.2%
Residential specialty trade contractors	2,016	2,012	1,928	0.2%	4.5%
Nonresidential specialty trade contractors	2,565	2,557	2,469	0.3%	3.9%
Producer Price Index, NSA (2)	**Apr-18**	**Mar-18**	**Apr-17**	**Mar-18**	**Apr-17**
Finished Goods (SA)	114.1	114.1	111.0	0.0%	2.8%
Inputs to Construction Industries	229.2	226.2	215.5	1.3%	6.4%
General Contractors (New Nonresidential Building Const.)	109.3	107.7	104.7	1.5%	4.4%
New Nonresidential Building Construction (U.S.)	109.6	108.4	105.2	1.1%	4.2%
Northeast	109.8	108.9	105.1	0.8%	4.5%
South	109.3	108.0	105.8	1.2%	3.3%
Midwest	107.6	106.4	103.3	1.1%	4.2%
West	111.6	110.4	105.8	1.1%	5.5%

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.*

[3] *SA: Seasonally Adjusted. NSA: Not Seasonally Adjusted.*

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- Marital Dissolution

Joseph Natarelli

Joseph Natarelli is the national leader of Marcum's Construction Industry Practice and an office managing partner in New Haven. 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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