MARCUM Commercial Construction Index

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MARCUM ACCOUNTANTS ▲ ADVISORS

U.S. Economy is Slowing, and So is Nonresidential Construction Spending

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

20/20 Vision Required to See 2020

The headlines are replete with notions of yield curve inversion, collapsing interest rates, potential recessions in Germany, Italy, South Korea, Brazil, and Russia, faltering consumer sentiment, and volatile financial markets. Many of these indications suggest that additional economic softness is forthcoming. Already, U.S. economic growth has slipped, whether measured by gross domestic product or the rate of monthly job growth.

That is not to suggest that the U.S. economy is in terrible shape. At this moment, much remains upbeat. America's economy can still be characterized as being at full employment, flooded with available job openings, the most rapid wage growth in about a decade, and a still-active consumer. Corporate earnings have managed to hold up despite a sea of issues related to trade wars, shifting immigration policy, Boeing, and skills shortages. There is little reason to believe that a downturn is imminent; it's just that leading indicators are flashing orange and sometimes red signals on an increasingly frequent basis, indicating that economic conditions are set to worsen as we approach the horizon.

There's more. Next year will usher forth a presidential election. Given massive policy differences among contenders on issues ranging from taxes and social spending to regulating energy production or global trade, many economic actors will be predisposed towards embracing a wait-and-see attitude. That stands to further limit transactional volume next year. None of this is especially promising with respect to the 12- to 18-month outlook for the U.S. economy, and where the economy heads, construction will follow.

Already, some of the economy's weakness, particularly in terms of business investment, is being reflected in construction spending data. For instance, monthly nonresidential construction spending declined 1.8 percent in June, the last month for which there are available data. Compared to the same month one year earlier, nonresidential construction spending is up 2.3 percent, or about the rate of inflation.

In other words, nonresidential construction outlays have failed to expand over the past year in real terms despite a surge in spending by state and local governments on a number of infrastructure categories. In June, private nonresidential spending was down 0.3 percent compared to the previous month, and is down 0.4 percent on a year-over-year basis. Growth in several private segments appears constrained by growing concerns regarding market saturation in certain geographies and segments, setting the stage for additional softening during the months ahead.

Joe's View

What can I say, it's been a good year. When we look at the past 12 months in general, it would seem that the market growth and prosperity will continue until…who knows when? So, now would be the perfect time to take a skeptical and informed eye to the future. It's always better to have a plan for tougher times than make a plan amidst them. As you'll read in our economist's assessment, warning signs and historical trends of downturn are out there and have been for a little while. The construction industry, always the first to feel the pinch and last to be relieved of it, even saw some minor downturns this June. Jobs remain aplenty, unemployment is slow, still but nonresidential spending hasn't grown over the past year and that includes the increases we saw in governmental and infrastructure spending. So, what's the message? I won't say we're in for stormy weather (yet) but I will say it never hurts to pack an umbrella.

Stay dry,

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

Exhibit 1. *Private Nonresidential Spending, June 2019, Millions of Dollars, Seasonally Adjusted Annual Rate*

Subsector	June 2019	May 2019	June 2018	1-month % Change	12-month % Change
Nonresidential	$455,712	$457,300	$457,756	-0.3%	-0.4%
Lodging	$33,188	$32,603	$30,702	1.8%	8.1%
Office	$68,184	$67,939	$62,728	0.4%	8.7%
Commercial	$78,702	$77,723	$89,395	1.3%	-12.0%
Health care	$34,300	$34,146	$32,443	0.5%	5.7%
Educational	$17,709	$18,684	$20,904	-5.2%	-15.3%
Religious	$2,751	$2,832	$2,844	-2.9%	-3.3%
Amusement and recreation	$14,597	$14,576	$14,687	0.1%	-0.6%
Transportation	$18,443	$19,505	$17,486	-5.4%	5.5%
Communication	$23,060	$23,342	$24,376	-1.2%	-5.4%
Power	$92,417	$94,383	$97,134	-2.1%	-4.9%
Manufacturing	$70,906	$70,279	$64,168	0.9%	10.5%

Source: U.S. Census Bureau

Though public construction spending was down in June on a monthly basis, it was still up 6.4 percent on a year-ago basis. State and local government finances in much of the nation have been buoyed by a strong labor market, which has expanding income tax collections; by rising home prices, which are contributing to greater property tax collections; by elevated consumer spending, which is bulking up retail sales tax collections.

Among the public construction segments experiencing the most growth in outlays over the past 12 months are sewage/wage disposal (+18.7%), transportation (+7.5%), and highway/street (+6.5%). Spending related to public safety has also been rising and is up nearly 24 percent over the past three years. It is conceivable that recent events will continue to induce state and local governments to invest additional resources into this category to further empower and protect first responders as well as the broader public.

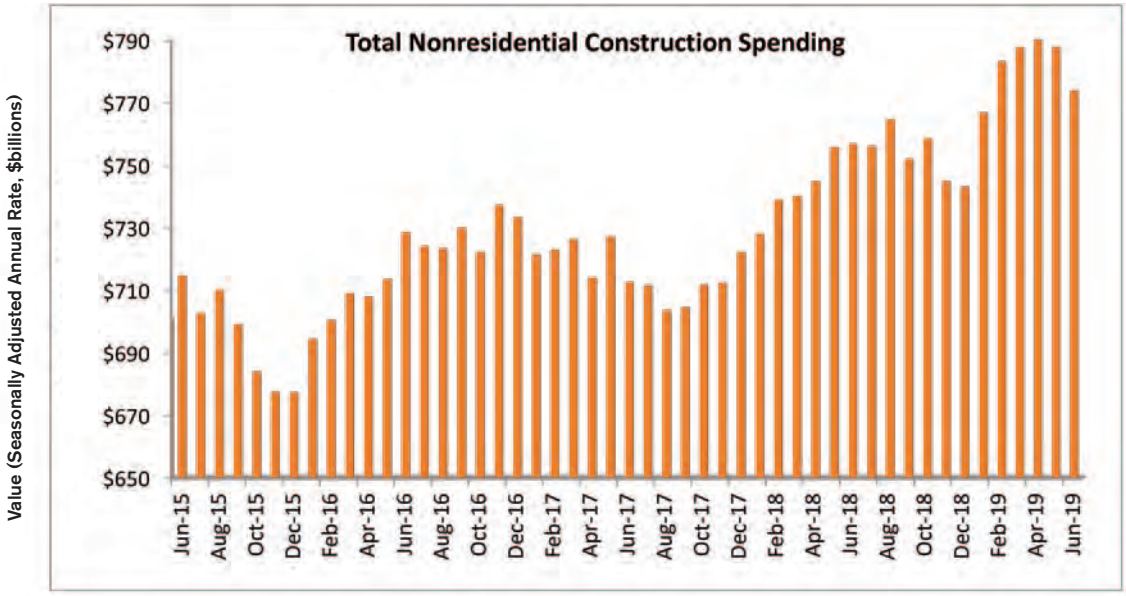
Exhibit 2. *Total Nonresidential Spending, June 2019, Millions of Dollars, Seasonally Adjusted Annual Rate*

Subsector	June 2019	1-month % Change	12-month % Change	36-month % Change
Nonresidential	$773,753	-1.8%	2.3%	6.2%
Lodging	$34,329	1.0%	8.7%	24.1%
Office	$78,950	0.9%	8.9%	16.2%
Commercial	$83,064	1.3%	-10.7%	8.7%
Health care	$42,791	-0.3%	2.1%	7.7%
Educational	$90,672	-6.5%	-0.7%	-3.4%
Religious	$2,751	-2.9%	-3.3%	-26.7%
Public safety	$9,901	-1.5%	4.9%	23.7%
Amusement and recreation	$27,766	0.4%	4.4%	15.3%
Transportation	$56,787	-2.1%	7.5%	22.4%
Communication	$23,166	-1.6%	-5.2%	8.8%
Power	$98,430	-1.6%	-4.6%	-5.9%
Highway and street	$102,209	-6.3%	6.5%	11.1%
Sewage and waste disposal	$26,760	-1.1%	18.7%	18.0%
Water supply	$16,084	0.3%	4.6%	16.5%
Conservation and development	$8,963	3.8%	5.6%	11.2%
Manufacturing	$71,132	0.9%	9.9%	-8.8%

Source: U.S. Census Bureau

While there's no shortage of things about which to be concerned, including corporate debt, household debt, and sovereign debt, nonresidential construction's greatest vulnerability may be attributable to a long-lived arch-nemesis, an insolvent Highway Trust Fund. Based on the current rates of revenue accumulation and spending, America's Highway Trust Fund will be insolvent by 2021. If history is any indication, the looming insolvency of the trust fund will induce a growing number of state and local transportation directors to delay needed infrastructure upgrades, removing one of nonresidential construction's high growth segments in the process.

Exhibit 3. *Nonresidential Construction Spending, June 2015 through June 2019*



Source: U.S. Census Bureau

Is Recession on the Way? Not Yet

It has been a great run for the economy and won't end this year. The consumer is simply too strong for economic growth to come to a complete and sudden halt, absent some type of completely unpredictable, earth-shattering event. Already, America has achieved its lengthiest economic expansion in history, with the nation now well into its 11th year of expansion. According to the National Bureau of Economic Research, the official arbiter of business cycles, the previous record was held by a 10-year period that lasted from early 1991 to early 2001.

Perhaps the durability of the current expansion is not altogether surprising. American business cycles have been generally lengthening over the past four decades. Between 1945 and 1981, American economic expansions lasted an average of just three years and eight months. Since then, they have stretched on for more than eight years on average.

But while America's economic expansions have become lengthier, they have also become weaker. During the 10 business cycles occurring between 1949 and 2007, the economy grew at an average annual rate of 4.7 percent. Since 2009, annual growth has averaged just 2.3 percent. Output per capita has grown even more slowly.

Still, while progress over the course of the past 10+ years can be generally characterized as gradual, persistent economic growth has managed to lift the fortunes of many. Over that span, the economy has also added jobs for 106 consecutive months, creating nearly 21 million net new positions in the process. In July, the last month for which there are data, the economy added another 164,000 jobs.

With the labor force participation rate falling for much of the past decade and given consistent employment growth, the massive labor market slack that characterized years like 2008, 2009, and 2010 has all but disappeared – a reality well appreciated by many a contractor. The unemployment rate currently stands at 3.7 percent, effectively a 50-year low. Over a recent 12-month period, the U.S. construction industry managed to add 202,000 net new jobs, which translates into impressive industry employment growth of 2.8 percent. That's a rate of job growth about twice the balance of the economy, which is rendered all the more impressive by the ongoing difficulty contractors are suffering finding welders, glaziers, pipefitters, ironworkers, electricians, roofers, estimators, superintendents, etc.

Though nonresidential construction employment slipped in July (-2,800 jobs), over the past 12 months, this segment has added 122,300 net new positions. The construction unemployment rate stands at just 3.8 percent, up only marginally over the past year as more Americans wake up to the abundance of middle-income opportunities in goods-producing sectors like construction.

Construction is hardly alone in terms of offering opportunities to Americans earnestly seeking employment. According to the most recent Job Openings and Labor Turnover survey, there were 7.3 million job openings in June. Given that there are 6.1 million unemployed persons, there are 1.2 available job openings per individual searching for opportunity. In other words, demand for human capital remains high, an insight that appears inconsistent with notions of near-term recession.

Exhibit 4. *Construction Employment Growth, 20 Largest U.S. Metropolitan Areas July 2018 v. July 2019, Not Seasonally Adjusted*

Rank	MSA	% Change	Rank	MSA	% Change
1	Phoenix-Mesa-Scottsdale, AZ	9.5%	11	Houston-The Woodlands-Sugar Land, TX	4.3%
2	St. Louis, MO-IL*	7.3%	12	Miami-Fort Lauderdale-West Palm Beach, FL	3.8%
3	San Francisco-Oakland-Hayward, CA	7.2%	13	New York-Newark-Jersey City, NY-NJ-PA*	3.7%
4	Tampa-St. Petersburg-Clearwater, FL	6.4%	14	San Diego-Carlsbad, CA	3.5%
5	Dallas-Fort Worth-Arlington, TX*	6.1%	15	Detroit-Warren-Dearborn, MI*	3.1%
6	Los Angeles-Long Beach-Anaheim, CA	5.9%	16	Baltimore-Columbia Towson, MD*	1.9%
6	Philadelphia-Camden-Wilmington, PA-NJ-DE-MD*	5.9%	17	Chicago-Naperville-Elgin, IL-IN-WI	1.6%
8	Atlanta-Sandy Springs-Roswell, GA	5.6%	18	Boston-Cambridge-Nashua, MA-NH**	1.0%
9	Seattle-Tacoma-Bellevue, WA	4.8%	19	Washington-Arlington-Alexandria, DC-VA-MD-WV*	0.1%
10	Minneapolis-St. Paul-Bloomington, MN-WI*	4.4%	20	Riverside-San Bernardino-Ontario, CA	-0.3%

Source: U.S. Bureau of Labor Statistics

Federal Reserve Reverses Course

With the U.S. economy becoming increasingly vulnerable to a host of factors, including large-scale asset price declines and geopolitical uncertainties emerging from China, Iran, and elsewhere, the Federal Reserve has seen fit to reverse its policymaking stance. Late last year, Federal Reserve leadership strongly hinted that additional interest rate increases were forthcoming to head off potentially problematic inflation. The Federal Reserve increased rates nine times between December 2015 and December 2018, and the expectation had been that more rate hikes would be on the way.

Equity markets were displeased. The Dow Jones Industrial Average and other indices swooned during last year's fourth quarter, helping to produce some pointed presidential tweets. It also seemed to help persuade the nation's monetary policymakers that additional rate hikes may not represent good policy, especially with broad measures of inflation strongly suggesting that America does not have an inflation problem.

Having altered its rhetoric, the Federal Reserve spent much of the first half of 2019 signaling that at least one rate cut could be forthcoming. On July 31, 2019, that rate cut came, and there is a likelihood that additional monetary easing would transpire later this year.

In the world of economics, expect the unexpected. The markets had seemingly been begging the Federal Reserve for a rate cut, and when it came, stock prices tumbled vigorously and then established a volatile sine wave (up and down) pattern. The yield curve inverted, with the yield on the 2-year Treasury note briefly rising above that of the 10-year Treasury, a key recessionary warning signal. While economists debated whether such things really matter, the bond market continues to signal that the U.S. economy is set to slow meaningfully along with much of the balance of the world.

But then again, there are various ways to interpret such things. Interest rates have been falling, and while that may be a signal of softer economic growth, lower borrowing costs are in and of themselves quite good for engaged consumers and expanding businesses.

Indeed, low interest rates represent a primary factor in support of the economic expansion's observed capacity to endure. America's consumer-led expansion has benefited from persistently low borrowing costs, including rock-bottom mortgage rates, which have helped to rejuvenate the housing market even in the context of abundant student debt and a slow pace of new family formation.

What is most remarkable and surprising to many economists is that the combination of incredibly low unemployment, rising minimum wages, expanding tuitions, higher apartment rents, tariffs/trade disputes, elevated prescription drug costs, greater industry concentration in airlines, tech, and other segments, and rising home prices have translated into only modest inflation to date. One might have thought that economy-wide inflation would be deeply problematic by now, but that simply hasn't been the case.

Over a recent 12-month period, the core consumer price index indicated that inflation was running at 1.8 percent on a year-over-year basis, below the Federal Reserve's 2-percent target. A separate measure, one favored by the nation's monetary policymakers, indicates that inflation has been running at 1.6 percent on a year-over-year basis, neatly below the Fed's target.

There are many factors helping to shape a highly desirable equilibrium characterized by consistently low inflation. Among these are softening global economic growth, a reasonably strong U.S. dollar, the Amazon effect (which among other things empowers purchasers to easily compare prices), generally more efficient supply chains, the aggressive move toward generic drugs, and outpatient care. What's more, while certain interest rates have fallen recently in the U.S., this may not necessarily be an indication of a U.S. economy that is poised to fall apart. Interest rates in much of the world are even lower, inducing more capital to flock to America, which, all things being equal, produces better, not worse, economic outcomes.

Looking Ahead

A 2020 recession has seemed likely for at least three years. The current period is especially difficult to forecast, however, given the enormous influence of uncertain policymaking. Tariffs announced one month can be postponed the next. While much of the focus has been on Sino-U.S. trade disputes recently, there are also conflicts involving America and the EU as well as India. Brexit also becomes increasingly perilous, with British governments continuously on the precipice of being undone.

The Federal Reserve may cut short-term rates once more this year, perhaps in September, but it will make little difference. The problem in the U.S. is not excessively elevated borrowing costs. The problem in America is a dramatic increase in the levels of uncertainty facing households and businesses. When the current administration in Washington, D.C. entered the fray, uncertainty facing many businesses declined, regulations were withdrawn, corporate earnings surged, markets rose, employment growth accelerated, and consumer spending took off.

Today, the situation is far different, with Americans struggling to understand the impact of trade disputes, circumstances pertaining to Iran, and the consequences of their own expanding indebtedness. What is known is that there will be elections in the U.S. next year, and that will further expand uncertainty.

From a policymaking perspective, there is a big difference between Donald Trump and Elizabeth Warren. There is a big difference between Donald Trump and Kamala Harris. Indeed, there is a big difference between Donald Trump and any conceivable Democratic president. For business, this means an uncertain future regarding private health insurance, defense contracting, trade relations with China and other partners, taxes, and regulation. For households, this translates into uncertainty regarding federal taxes, state and local tax deductions, incentives to purchase electric vehicles, social assistance, payments to farmers, etc. Even state and local government policymakers face growing uncertainty regarding future federal spending on infrastructure and social programs like Medicaid. Additionally, as noted earlier, the Highway Trust Fund is set for insolvency by 2021, and Washington does not appear positioned to do much more than continue to kick the proverbial can down the road in the context of rampant partisanship.

Ultimately, the sources of uncertainty will induce many economic actors to adopt a wait-and-see attitude, further reducing economic activity in the context of an already rapidly softening global economic environment. It is for these reasons that we may see the onset of recession sometime next year. Given still extensive backlog, this means that many contractors will remain busy throughout 2020, but 2021 and/or 2022 could be markedly different.

Second Quarter 2019 Performance	Values			% Change from	
Gross Domestic Product (% Growth, SAAR)	2019Q2[1]	2019Q1	2018Q4		
Overall Real GDP	2.1%	3.1%	1.1%	NA	NA
Nonresidential Fixed Investment in Structures	-10.6%	4.0%	-9.0%	NA	NA
Construction Spending, SA ($Millions)	Jun-19	May-19	Jun-18	May-19	Jun-18
Total Construction	*$1,286,997*	*$1,303,427*	*$1,314,788*	-1.3%	-2.1%
Residential	*$513,244*	*$515,871*	*$558,134*	-0.5%	-8.0%
Nonresidential	*$773,753*	*$787,557*	*$756,654*	-1.8%	2.3%
Lodging	$34,329	$33,991	$31,573	1.0%	8.7%
Office	$78,950	$78,246	$72,518	0.9%	8.9%
Commercial	$83,064	$81,965	$92,985	1.3%	-10.7%
Health care	$42,791	$42,933	$41,913	-0.3%	2.1%
Educational	$90,672	$97,012	$91,303	-6.5%	-0.7%
Religious	$2,751	$2,832	$2,844	-2.9%	-3.3%
Public safety	$9,901	$10,048	$9,437	-1.5%	4.9%
Amusement and recreation	$27,766	$27,644	$26,587	0.4%	4.4%
Transportation	$56,787	$57,979	$52,848	-2.1%	7.5%
Communication	$23,166	$23,537	$24,447	-1.6%	-5.2%
Power	$98,430	$100,045	$103,148	-1.6%	-4.6%
Highway and street	$102,209	$109,079	$95,934	-6.3%	6.5%
Sewage and waste disposal	$26,760	$27,048	$22,536	-1.1%	18.7%
Water supply	$16,084	$16,038	$15,377	0.3%	4.6%
Conservation and development	$8,963	$8,639	$8,484	3.8%	5.6%
Manufacturing	$71,132	$70,523	$64,722	0.9%	9.9%
Employment, SA (in thousands)	Jul-19	Jun-19	Jul-18	Jun-19	Jul-18
National Total Nonfarm	151,431.0	151,267.0	149,185.0	0.1%	1.5%
Construction	7,505.0	7,501.0	7,303.0	0.1%	2.8%
Residential building	832.5	831.1	805.9	0.2%	3.3%
Nonresidential building	822.6	822.5	825.8	0.0%	-0.4%
Heavy and civil engineering construction	1,075.1	1,079.4	1,058.9	-0.4%	1.5%
Residential specialty trade contractors	2,080.1	2,074.1	2,026.3	0.3%	2.7%
Nonresidential specialty trade contractors	2,695.0	2,693.6	2,585.7	0.1%	4.2%
Producer Price Index, NSA[2]	Jun-19	May-19	Jun-18	May-19	Jun-18
Finished Goods (SA)	115.4	115.9	115.3	-0.4%	0.1%
Inputs to Construction Industries	232.0	235.1	235.1	-1.3%	-1.3%
General Contractors (New Nonresidential Building Const.)	114.9	114.6	109.2	0.3%	5.2%
New Nonresidential Building Construction (U.S.)	115.8	115.7	109.9	0.1%	5.4%
Northeast	115.8	115.6	110.5	0.2%	4.8%
South	115.3	115.2	109.5	0.1%	5.3%
Midwest	113.9	113.3	107.7	0.5%	5.8%
West	118.3	118.4	111.9	-0.1%	5.7%

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. SAAR: Seasonally Adjusted Annual Rate*

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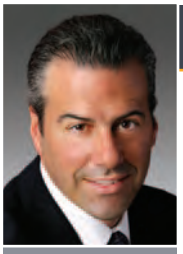

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