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Commercial Construction Index

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Third Quarter Construction Economics: The Good, The Bad, and the Ugly

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

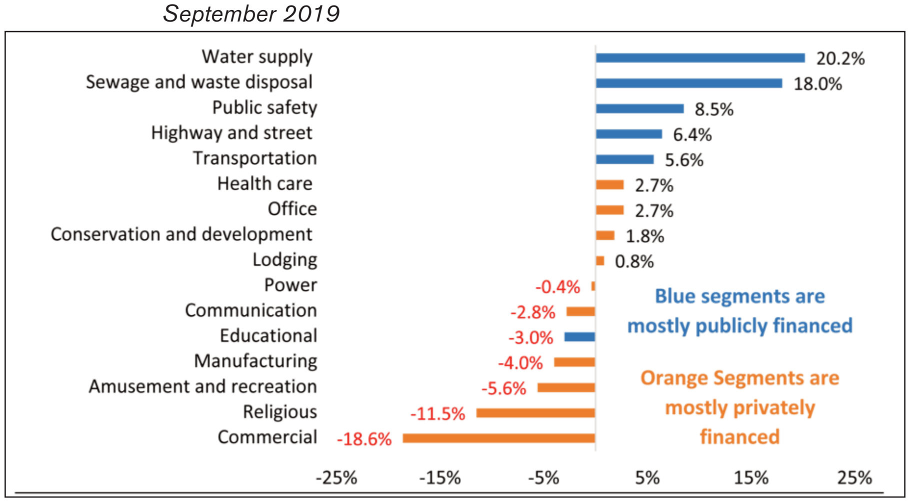
The Good

Public Construction Spending

Despite the lack of a coherent federal infrastructure strategy and the looming insolvency of the Highway Trust Fund, there is no recession in infrastructure spending in America. Public construction spending increased 1.5 percent in September 2019 and was up 6.6 percent year-over-year. With state and local government finances as healthy as they've been in more than a decade, spending has surged over the past year in categories like water supply (+20.2 percent), sewage and waste disposal (+18 percent), public safety (+8.5 percent), and highway/street (+6.4 percent).

Exhibit 1 shows the year-over-year change in every nonresidential construction segment. Those depicted in blue are segments in which the majority of construction is publicly financed, while orange represents primarily privately financed segments. The five fastest expanding segments are all primarily publicly financed, while 10 of the 11 slowest growing segments are primarily privately funded, including the commercial segment, which encompasses retail space. Relative to prior years, spending growth in office and lodging categories has softened markedly.

Exhibit 1. *Construction Spending by Segment, Annual Percentage Change, September 2019*



Source: U.S. Census Bureau

Joe's View

Howdy,

It's well known around here that Marcum's chief construction economist, Anirban Basu, is a bonafide movie-buff. It was no surprise, then, when he came up with a new format for our Commercial Construction Index based on Sergio Leone's classic, 1966 spaghetti western, "The Good, The Bad and the Ugly." Both of us share a commitment to balanced and cautious reporting as we strive to provide our readers with actionable data for their businesses. So, what better way to lay this out than across these three categories? We know there is a lot of information out there for you to consume and we hope that this new structure makes our data accessible and enjoyable to all that read it.

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

The August 2019 reading of Associated Builders and Contractors' Construction Backlog Indicator (CBI) showed average backlog in the infrastructure category increasing to 10.4 months, the lengthiest of any of the three segments considered by the indicator. Because of the large average size of public projects, backlog in the infrastructure segment tends to be lengthier than the commercial and heavy industrial categories. However, the trajectory of infrastructure backlog has generally been more positive than other categories for which ABC measures backlog.

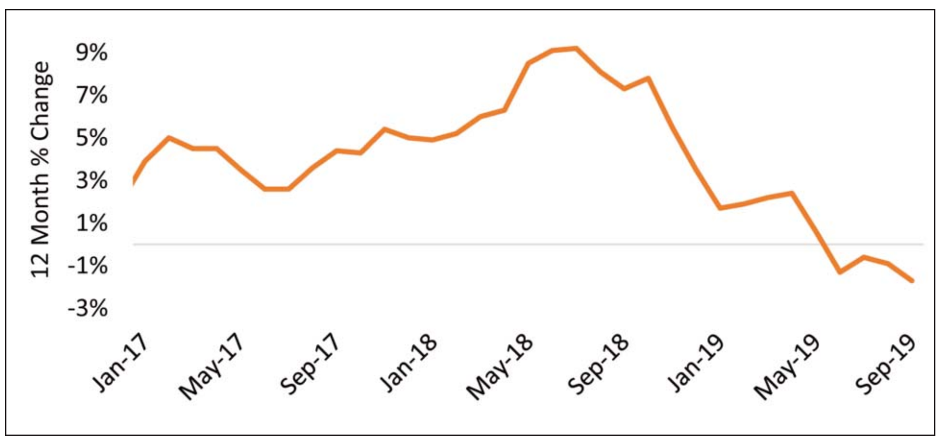
Construction Input Prices

According to the Bureau of Labor Statistics' Producer Price Index (PPI), prices for inputs to construction fell 0.6 percent in September 2019 and are down 1.7 percent year-over-year. All things being equal, this represents excellent news both for those who purchase construction services as well as those who deliver such services. Key to the ongoing construction spending cycle is the ability of contractors to keep construction affordable in order to set the stage for the next set of public and private projects.

Two years ago, in the midst of what had been a synchronized global economic expansion, materials prices were rising rapidly. This continued into 2018. But with the global economy weakening recently, the U.S. dollar remaining strong, and energy output continuing to rise (including oil), materials prices have softened of late. Natural gas prices were down 34.6 percent in September on a year-ago basis. Crude petroleum was down 19.2 percent. Even tariff-impacted categories have experienced price declines, including iron and steel (-12.3 percent), and softwood lumber (-8.7 percent).

Economically, the dip in input prices helps to partially offset rising labor costs. Oil production is set to expand globally in 2020, which could lead to additional decreases in oil and gasoline prices next year.

Exhibit 2. *Prices for Inputs to Construction Industries, 12-Month % Change, 2017-2019*



Source: U.S. Bureau of Labor Statistics

Consumer Spending

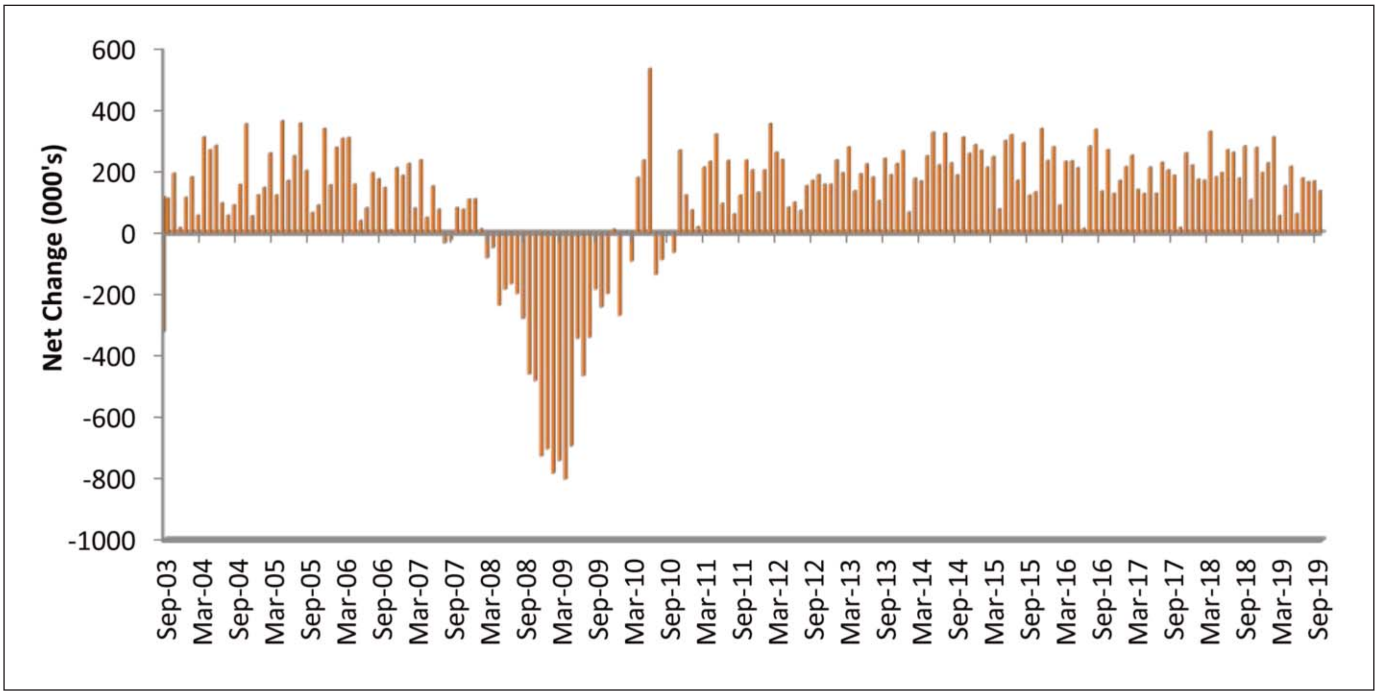
The consumer continues to power the economic expansion, which is now easily the longest in American history. Consumer spending, which accounts for about 70 percent of U.S. gross domestic product, has now increased in 39 consecutive quarters. While both major measures of consumer confidence—the Conference Board's Consumer Confidence Index and the University of Michigan's Consumer Sentiment Index—have wavered in recent months, retail spending excluding food has increased nearly 4 percent over the past year. E-commerce sales, which are up 13.3 percent year-over-year, predictably represent a significant component of that expansion. Consumer spending should be solid during the holidays with consumers basking in the glow of a near-50-year low in unemployment and the strongest wage growth in about a decade.

Labor Market Still Strong

Despite evidence of a weakening U.S. manufacturing sector and ongoing sluggishness in the farm economy, the U.S. economy has added jobs for 109 consecutive months as of October 2019, the longest streak on record. Despite a GM strike that robbed the economy of 50,000 jobs in October and a layoff of 20,000 temporary Census Bureau workers, the economy was still able to produce 128,000 net new jobs in October according to the government's initial estimate.

A labor market that has been associated with more than seven million available, unfilled jobs has helped to attract more people into the labor force, which will at least help keep the economy's momentum going over the near-term. The labor force participation rate increased to 63.3 percent in October, the highest level registered since August 2013.

Exhibit 3. *National Monthly Job Growth (SA), September 2003–September 2019*



Source: U.S. Bureau of Labor Statistics. Note: SA-Seasonally Adjusted.

Construction Employment

Construction industry employment has expanded just 2 percent over the past year, its slowest annual rate of growth since the fourth quarter of 2012 (more on that below). Despite this slowdown, the nation's 20 largest MSAs (metropolitan statistical areas) added construction jobs at a healthy clip between September 2018 and September 2019. Only three of those MSAs added construction jobs at a slower pace than the nation at large (Boston, Chicago, and Riverside), while eight of those areas posted greater than 5 percent annual growth. This represents a nationwide trend in which growth is centered in and around rapidly growing cities in the southern and western parts of the country.

Exhibit 4. *Construction Employment Growth, 20 Largest U.S. Metropolitan Areas, Sep. 2018 v. Sep. 2019*

Rank	MSA	% Change	Rank	MSA	% Change
1	Phoenix-Mesa-Scottsdale, AZ	9.8%	11	Detroit-Warren-Dearborn, MI*	4.5%
2	St. Louis, MO-IL*	8.4%	12	Atlanta-Sandy Springs-Roswell, GA	4.1%
3	San Francisco-Oakland-Hayward, CA	7.7%	13	Baltimore-Columbia-Towson, MD*	3.9%
4	Dallas-Fort Worth-Arlington, TX*	7.1%	14	Miami-Fort Lauderdale-West Palm Beach, FL	3.6%
5	San Diego-Carlsbad, CA	6.3%	15	Houston-The Woodlands-Sugar Land, TX	3.5%
6	Tampa-St. Petersburg-Clearwater, FL	5.9%	16	Washington-Arlington-Alexandria, DC-VA-MD-WV*	3.4%
7	Seattle-Tacoma-Bellevue, WA	5.7%	17	New York-Newark-Jersey City, NY-NJ-PA*	3.0%
8	Los Angeles-Long Beach-Anaheim, CA	5.5%	18	Boston-Cambridge-Nashua, MA-NH*	0.5%
9	Minneapolis-St. Paul-Bloomington, MN-WI*	4.9%	19	Chicago-Naperville-Elgin, IL-IN-WI	-0.4%
10	Philadelphia-Camden-Wilmington, PA-NJ-DE-MD*	4.8%	20	Riverside-San Bernardino-Ontario, CA	-1.3%

Source: U.S. Bureau of Labor Statistics

Rate Cuts, Unexpected, and Most Welcome by Investors

During October's final week, the Federal Reserve cut interest rates for a third time in 2019. At the year's onset, many forecasters expected rate increases as the economy appeared poised to generate faster inflation. Instead, faced with surprisingly low inflation in the context of a weakening global economy and a still sturdy U.S. dollar, the Federal Reserve has seen fit to put downward pressure on borrowing costs, which among other things lowers the average cost of capital for developers and others who utilize the services of contractors.

Among the principal beneficiaries are those tied to residential real estate. In very-late 2019, 30-year fixed mortgage rates averaged a bit less than 4 percent in America. One year earlier, they stood above 5 percent. The run-up to 5 percent mortgage rates in 2018 helped to chill the housing market. By January 2019, existing home sales dipped to a seasonally adjusted annual rate of 4.94 million units, the lowest level observed since November 2015. Between December 2015 and December 2018, the Federal Reserve increased short-term rates no fewer than nine times.

Since that time, the Federal Reserve has changed course as the U.S. economy faced growing headwinds from trade wars, stagnant business confidence, and economic weakness apparent from England and Germany to China and South Korea. Mortgage rates declined as a result, helping to re-stimulate demand for single-family homes and to push home values higher, further supporting consumers' sense of wellbeing.

The Bad

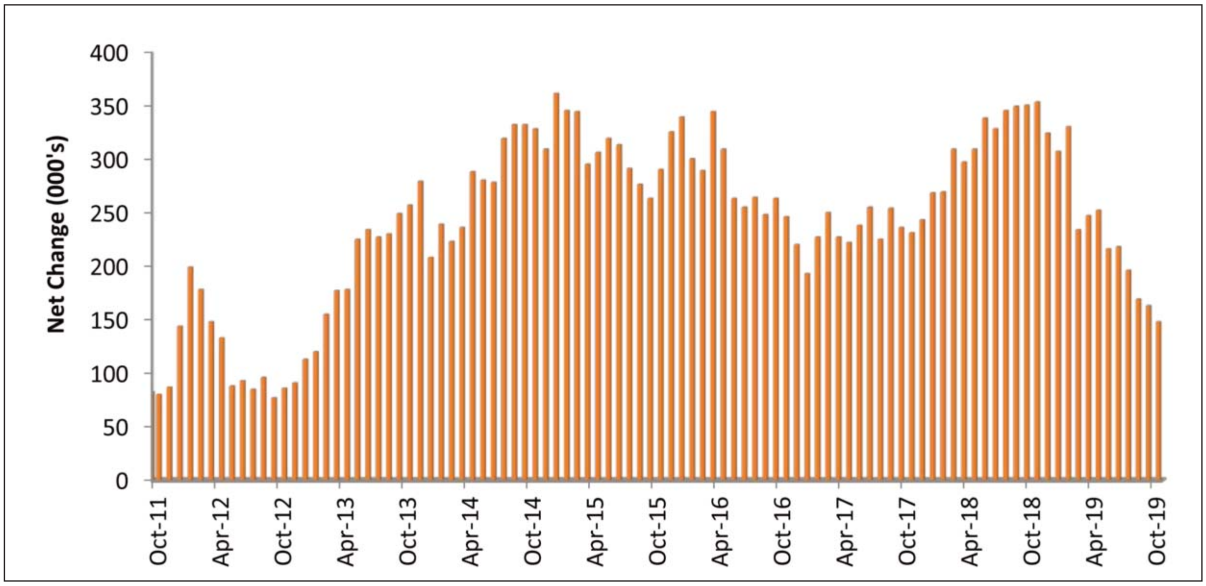
Construction Labor Supply, or Lack Thereof

A confluence of data (along with the cry of contractors) continues to suggest a dearth of available construction workers. According to the U.S. Bureau of Labor Statistics' Job Openings and Labor Turnover (JOLT) survey, the construction industry was associated with 379,000 unfilled positions in August 2019, the highest level recorded in the 19-year history of the data series. Demand for human capital remains high. According to Associated Builders and Contractors' Construction Confidence Indicator, more than 59 percent of surveyed contractors intend to increase staffing levels during the six-month period spanning from the onset of 2019's final quarter to the end of 2020's first.

With 4.8 percent of all construction positions unfilled (also an all-time high), one would expect the paucity of available workers to place additional upward pressure on labor costs. Accordingly, the producer price for construction costs has risen more than 5 percent in the Midwest, West, and Northeast over the past year, in part because many contractors are induced into paying significant overtime.

The lack of available workers has also softened construction job growth. From October 2018 to October 2019, the industry added just 148,000 net new jobs, which translates into 2 percent job growth, the slowest level of year-over-year job gains since the fourth quarter of 2012.

Exhibit 5. *National Monthly Job Growth (Seasonally Adjusted), Construction, October 2011–October 2019*



Source: U.S. Bureau of Labor Statistics. Note: SA-Seasonally Adjusted.

Private Nonresidential Construction Softens

Nonresidential fixed investment in structures, a component of GDP closely aligned with the nonresidential construction industry, contracted at a 15.3 percent annual rate during the third quarter of 2019. The nonresidential building subsector lost 2,000 jobs on net during the third quarter, and employment in the subsector has declined by 8,700 jobs, or 1.1 percent, over the past year. Private construction spending was down 5.7 percent in September on a year-ago basis.

In addition to commercial, lodging, and office components, other segments of private construction have struggled to retain substantial momentum over the past year. For instance, amusement and recreation-related spending is down roughly 16 percent since September 2018.

Manufacturing

The U.S. manufacturing sector is now officially contracting, at least according to the Institute for Supply Management. The ISM manufacturing index was at 48.3 percent in October. While that represented a 0.5 percentage point increase from September, the index has remained below the 50 percent threshold for three consecutive months, with any reading below 50 percent indicating contraction in activity. Respondents to the ISM survey indicate a number of headwinds at work. Among them are global economic weakness, rising labor costs, and uncertainty regarding future currency values and trade policy.

The Ugly

Uncertainty

When the current administration in Washington, D.C. first entered the White House, 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, hearing considerable chatter regarding recession, and looking ahead to next year's national elections.

While the nation has continued to expand economically, vulnerabilities have emerged, including massive levels of indebtedness. For instance, corporate debt has never been higher in America. The same can be said for the federal government. Consumers have also been ratcheting up their indebtedness, seduced by a combination of low interest rates and their own confidence in job prospects. While businesses have begun to slow their spending, consumers haven't. But at some point, slower business spending will translate into slower job growth, leaving many highly indebted consumers exposed.

Looking Ahead

The outlook is decidedly confused. While the global economy sputters and the U.S. manufacturing sector sends out its own recessionary signals, the stock market has surged to record highs as measured by a variety of indices, including the S&P 500 and the Dow Jones Industrial Average. The market has been supported by stronger than expected corporate earnings, hopes for a Sino-U.S. trade deal, and three Federal Reserve rate cuts. There are even signs that the global economy is beginning to recover some momentum, with interest rates in Germany and Japan becoming less negative recently and the yield on the 10-year Treasury note rising in a show of confidence in near-term economic prospects.

At the same time, GDP, business investment, private construction, and other indicators suggest that the broader U.S. economy is, in fact, softening. Given the susceptibility created by enormous levels of indebtedness and elevated asset prices, there is still a chance that the economy will enter recession late next year or in 2021, which would create a new breed of challenges for many contractors at some point in 2021-22.

Third Quarter 2019 Performance		Values		% Change from	
Gross Domestic Product (% Growth, SAAR)	**2019Q3[1]**	**2019Q2**	**2019Q1**		
Overall Real GDP	1.9%	2.0%	3.1%	NA	NA
Nonresidential Fixed Investment in Structures	-15.3%	-11.1%	4.0%	NA	NA
Construction Spending, SA ($Millions)	**Sep-19**	**Aug-19**	**Sep-18**	**Aug-19**	**Sep-18**
Total Construction	*$1,293,614*	*$1,287,054*	*$1,319,675*	*0.5%*	*-2.0%*
Residential	*$517,977*	*$515,054*	*$536,729*	*0.6%*	*-3.5%*
Nonresidential	*$775,637*	*$772,000*	*$782,946*	*0.5%*	*-0.9%*
Lodging	$33,253	$33,666	$32,990	-1.2%	0.8%
Office	$79,778	$79,552	$77,694	0.3%	2.7%
Commercial	$81,957	$82,470	$100,661	-0.6%	-18.6%
Health care	$43,605	$43,291	$42,467	0.7%	2.7%
Educational	$97,183	$94,533	$100,184	2.8%	-3.0%
Religious	$2,659	$2,719	$3,006	-2.2%	-11.5%
Public safety	$10,289	$10,488	$9,486	-1.9%	8.5%
Amusement and recreation	$27,170	$28,184	$28,779	-3.6%	-5.6%
Transportation	$55,564	$55,654	$52,607	-0.2%	5.6%
Communication	$23,522	$23,741	$24,197	-0.9%	-2.8%
Power	$95,581	$96,770	$95,948	-1.2%	-0.4%
Highway and street	$98,263	$95,759	$92,387	2.6%	6.4%
Sewage and waste disposal	$27,303	$27,196	$23,142	0.4%	18.0%
Water supply	$17,839	$16,905	$14,844	5.5%	20.2%
Conservation and development	$9,171	$9,405	$9,006	-2.5%	1.8%
Manufacturing	$72,502	$71,667	$75,550	1.2%	-4.0%
Employment, SA (in thousands)	**Oct-19**	**Sep-19**	**Oct-18**	**Sep-19**	**Oct-18**
National Total Nonfarm	151,945	151,817	149,852	0.1%	1.4%
Construction	7,527.0	7,517.0	7,379.0	0.1%	2.0%
Residential building	846.7	843.8	813.7	0.3%	4.1%
Nonresidential building	819.1	820.8	827.8	-0.2%	-1.1%
Heavy and civil engineering construction	1,088.5	1,082.5	1,071.8	0.6%	1.6%
Residential specialty trade contractors	2,074.7	2,072.5	2,054.0	0.1%	1.0%
Nonresidential specialty trade contractors	2,697.5	2,697.8	2,611.8	0.0%	3.3%
Producer Price Index, NSA [2]	**Sep-19**	**Aug-19**	**Sep-18**	**Aug-19**	**Sep-18**
Finished Goods (SA)	114.8	115.3	115.4	-0.4%	-0.5%
Inputs to Construction Industries	231.0	232.4	235.0	-0.6%	-1.7%
General Contractors (New Nonresidential Building Const.)	115.9	115.7	109.7	0.2%	5.7%
New Nonresidential Building Construction (U.S.)	116.9	116.6	110.6	0.3%	5.7%
Northeast	117.4	117.0	110.8	0.3%	6.0%
South	116.3	116.0	110.1	0.3%	5.6%
Midwest	114.2	114.3	108.5	-0.1%	5.3%
West	119.5	119.1	113.0	0.3%	5.8%

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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Joseph Natarelli

Joseph Natarelli is national leader of Marcum's Construction Industry Practice and 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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