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First Quarter Construction Economics: The Good, The Bad, and The Ugly

By Anirban Basu, Chief Construction Economist, Marcum LLP

The Good

Construction Spending Data Remain Stable ... for Now

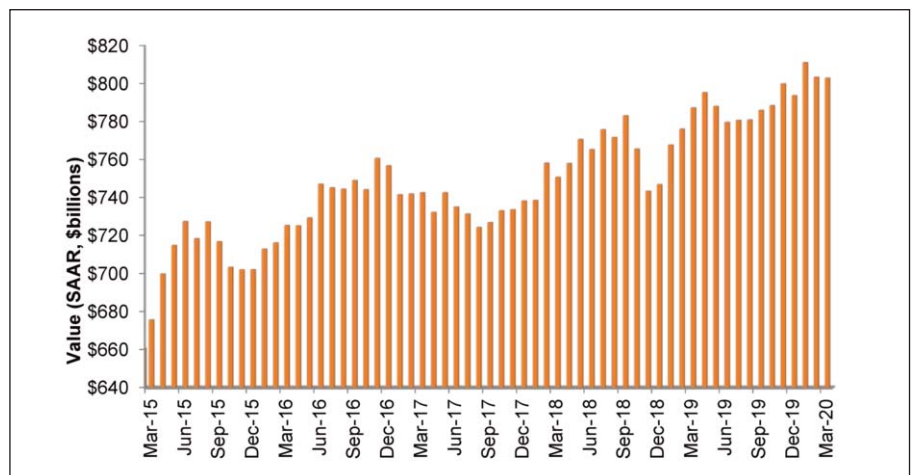
The great debate has been whether the combination of pre-existing backlog and the classification of construction as an essential activity in much of the nation would help shield the sector from the downturn resulting from the coronavirus crisis. Based on March construction spending data, industry activity largely proceeded apace, with recessionary forces impeding broader industry activity to only a limited extent.

These data, however, are inconclusive since they only embody the very early stages of the economic downturn. The pandemic impacted only a portion of March, and that month represented only the tip of the iceberg in terms of the economic impact of COVID-19. Anecdotal evidence indicates that many general contractors are in the midst of discussions with developers and other consumers of construction services regarding potential project postponements and cancellations.

The health of public finances held up in March, and public employees have been less likely to lose jobs than those in the private sector. However, by April, evidence of collapsing state and local government finances became apparent as governors,

mayors, county executives, and others began to observe and report large gaps in budgets. Unlike the federal government, state and local governments must balance their budgets each fiscal year.

▼ Exhibit 1. Nonresidential Construction Spending, March 2015 – March 2020



Source: U.S. Bureau of Economic Analysis

First, my partners and I want to send our best wishes to all of our readers. We hope that you and your families are healthy and your business intact. This is a challenging time for everyone and, certainly, for contractors and other construction business owners. I hope that you've been able to take advantage of some of the thought leadership and analysis that Marcum has been putting out over the past few months, often in webinar form, specifically relating to the construction industry during and, perhaps more importantly, after the pandemic. Please visit the Coronavirus Resource Center at Marcumllp.com or go directly to www.marcumllp.com/coronavirus to access the back catalogue and see what is coming next. We are here to help you and your business set a path to a successful future.

Thank you for your readership and be well,

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

The silver lining is that rapidly deteriorating public finances render it more likely that the federal government will step forward with additional financial support, including possible funding for infrastructure. Interest rates are ultra-low, rendering it advantageous for the federal government to borrow funds and come to the assistance of states and localities.

The Bad

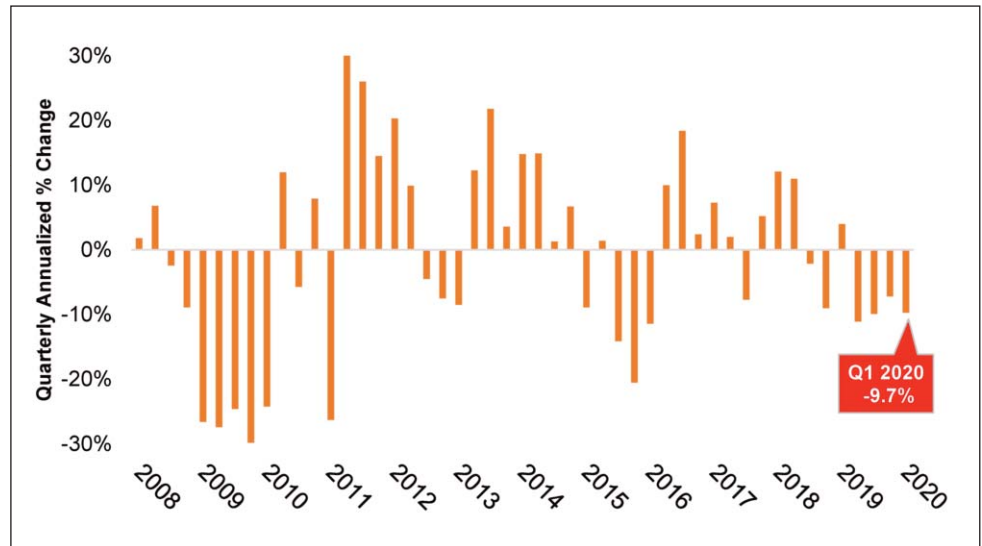
Investment in Structures Down

The second quarter of 2020 stands to be the worst economic quarter of our lives. Economists at JPMorgan predict that GDP will decline during the second quarter by 40 percent on an annualized basis. Other forecasters expect a decline closer to 30 percent, but in any case, the impacts are devastating for businesses, employees, government finances, and the psyche of various economic actors. GDP declined 4.8 percent on an annualized basis during the year's initial quarter despite the fact that January and February were periods of solid economic performance. The GDP decline primarily reflects the economic weakness that characterized March's final three weeks.

Fixed investment in nonresidential structures, the component of GDP most closely tied to the construction industry, contracted at a 9.7 percent annualized rate in the first quarter. Yes, this is bad, but not unusually so, based on the past two years of data. Investment in structures has decreased in each of the previous five quarters, and the first quarter 2020 rate of contraction was slower than the rates observed in the second and third quarters of 2019 (-11.1 percent and -9.9 percent, respectively).

It is possible that construction will weather the abysmal second quarter better than most industries, with backlog serving as a shield of sorts for the industry, and the expectation remains that the third and fourth quarters of 2020 will be far better as economies reopen. But the specter of a possible resurgence of COVID-19 later in the year casts a shadow upon this optimistic portion of the outlook. That said, JPMorgan economists indicated an expectation of double-digit growth in the third and fourth quarters. If those optimistic forecasts come to fruition, investment in structures should rise accordingly.

Exhibit 2. *Change in Investment in Structures, Q1 2008 through Q1 2020*



Source: U.S. Bureau of Economic Analysis

Is the Stimulus Enough?

There is a considerable volume of stimulus in the pipeline. Some of that will help now, but the real impact will occur once people get back to work. Checks to households from the federal government help the payments side of the economy and help reduce stress felt by heads of households to a degree, but output will remain constrained until Regeneron, Gilead Sciences, Bayer AG, Pfizer, Merck, or some other life sciences enterprise identifies a highly effective therapy and eventually a vaccine.

General Motors, Ford, Chrysler, Boeing, GE Aviation, and many other manufacturers have either stopped production or reduced it dramatically. Airline activity has come closer to a screeching halt. Diminished supply translates into diminished demand, which in turn translates into further reductions in supply and so on. But the lack of current production will eventually require the rebuilding of inventories, which represents one of many reasons to expect a sharp bounce-back in economic activity later this year.

And then there's the possibility of an infrastructure-oriented stimulus package. Democrats and Republicans alike have discussed such a package for years. There are several reasons to believe that such a stimulus package is likely. The first is the likely shape of the recovery to come. Though the initial phase of expansion is likely to be brisk, at some point the recovery may run out of steam as previously implemented stimulus packages wind

down, as confidence remains suppressed, and as various economic actors wrestle with high levels of indebtedness. An infrastructure-focused package would provide the expansion to come with greater staying power. Second, there is bipartisan agreement that America's infrastructure is deficient along multiple dimensions. Third, the public sector faces low borrowing costs, which renders financing infrastructure projects more efficient.

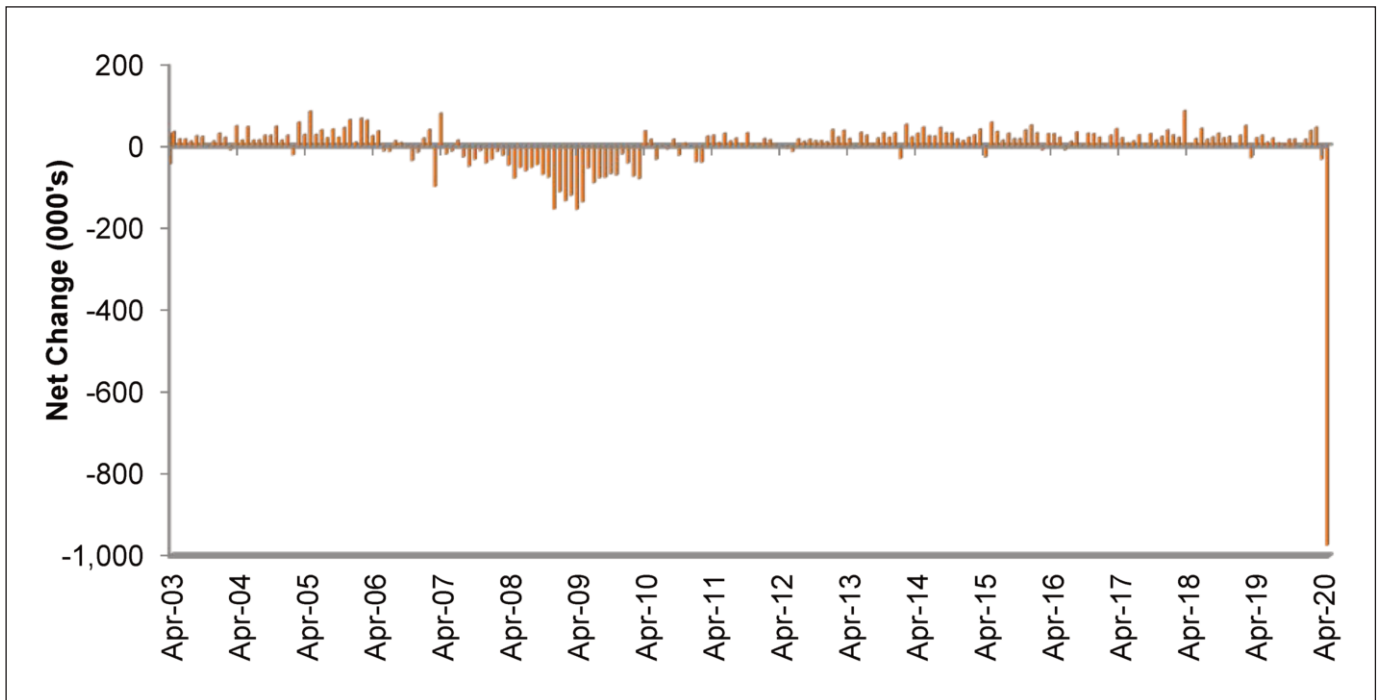
The Ugly

Construction Loses Close to 1 Million Jobs

Typically, construction is protected in the early months of a recession, as months of backlog acquired over prior periods allow contractors to continue working even as the broader economy slows down. That was not the case this time around, however. Though some states allowed construction firms to continue working by deeming them "essential," the economic shutdown has managed to quickly impact the industry. Associated Builders and Contractors Construction Backlog Indicator fell to 7.8 months in April, the lowest reading since the third quarter of 2012.

In April, the construction industry lost just under 1 million jobs on net, the largest single month decrease in recorded history. Construction unemployment rose from 6.9 percent in March to 16.6 percent in April. The last time it was this high was in early 2012 when the industry was still reeling from the aftermath of a burst housing bubble and the Great Recession.

▼ **Exhibit 3.** National Construction Monthly Job Growth (SA), April 2003–April 2020



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

One of the theoretical silver linings to the crisis is that the challenge of securing enough skilled construction workers has been solved. After all, with demand for construction services materially truncated by the public health crisis—construction job openings fell 31.1 percent year-over-year in March 2020—there should be a plentiful supply of workers going forward.

Not so fast. While it is true that demand for construction services will take some time to recover, history indicates that during times of economic stress, many construction workers depart the industry altogether. Following the Great Recession, the U.S. Department of Labor found that roughly 60 percent of displaced construction workers found employment in another industry. Preventing this from happening again is crucial for construction during the potential recovery.

Looking Ahead

While there remains a bevy of issues regarding the timing of the economy's opening and whether or not the economy will have to shut down again come the fall, the baseline expectation remains that the second half of 2020 will represent a period of enormously rapid economic recovery in America. This scenario becomes even more plausible if the federal government moves ahead with assistance to state and local governments and with an

infrastructure stimulus package. Predicting public policy is rather challenging, however, in the context of an imminent presidential election and growing concerns regarding the national debt.

Whether the recovery to come is brisk or not, commercial real estate will be among the slowest segments of the economy to stabilize. The current crisis will leave in its wake many empty storefronts and vacant office suites. The realization among many employers that at least part of their workforce can productively work remotely will further ratchet demand for space lower. Movie theaters, gyms, and other business segments will also be permanently impacted as more people take advantage of investments made during a period of social distancing, whether in the form of Netflix subscriptions or Peloton exercise bikes.

All of this suggests that commercial construction will be among the slower segments of the economy to recover. Accordingly, many contractors are likely to search for projects involving the remodeling of existing structures as opposed to fixating on new construction. The good news is that COVID-19 will likely require many current building owners to take action, including with respect to reshaping air handling systems in order to reduce viral transmission. Moreover, while commercial real estate will be slow to recover, certain segments may experience an acceleration in investment activity, including hospitals, data centers, and testing labs.



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September 29, 2020
2:00 PM Eastern time

Keynote Speaker: **Anirban Basu**

Details to come.

www.marcumevents.com

First Quarter 2020 Performance		Values			% Change from	
Gross Domestic Product (% Growth, SAAR)	2020Q1 ⁽¹⁾	2019Q4	2019Q3			
Overall Real GDP	-4.8%	2.1%	2.1%	NA	NA	
Nonresidential Fixed Investment in Structures	-9.7%	-7.2%	-9.9%	NA	NA	
Construction Spending, SA (\$Millions)	Mar-20	Nov-20	Mar-19	Nov-20	Mar-19	
Total Construction	\$1,360,512	\$1,348,386	\$1,299,118	0.9%	4.7%	
Residential	\$557,895	\$545,237	\$512,055	2.3%	9.0%	
Nonresidential	\$802,618	\$803,148	\$787,063	-0.1%	2.0%	
Lodging	\$29,742	\$30,405	\$34,231	-2.2%	-13.1%	
Office	\$79,264	\$79,558	\$78,982	-0.4%	0.4%	
Commercial	\$88,522	\$89,411	\$86,293	-1.0%	2.6%	
Health care	\$45,651	\$45,022	\$45,095	1.4%	1.2%	
Educational	\$97,682	\$98,152	\$97,485	-0.5%	0.2%	
Religious	\$2,858	\$2,973	\$2,941	-3.9%	-2.8%	
Public safety	\$13,275	\$12,598	\$9,141	5.4%	45.2%	
Amusement and recreation	\$26,541	\$27,001	\$28,209	-1.7%	-5.9%	
Transportation	\$55,463	\$55,882	\$52,492	-0.7%	5.7%	
Communication	\$23,470	\$23,397	\$23,961	0.3%	-2.0%	
Power	\$104,654	\$106,482	\$100,734	-1.7%	3.9%	
Highway and street	\$108,567	\$103,928	\$103,079	4.5%	5.3%	
Sewage and waste disposal	\$25,710	\$25,837	\$24,829	-0.5%	3.5%	
Water supply	\$18,539	\$18,598	\$15,051	-0.3%	23.2%	
Conservation and development	\$8,705	\$9,563	\$8,984	-9.0%	-3.1%	
Manufacturing	\$73,975	\$74,343	\$75,556	-0.5%	-2.1%	
Employment, SA (in thousands)	Apr-20	Mar-20	Apr-19	Mar-20	Apr-19	
National Total Nonfarm	131,072	151,572	150,492	-13.5%	-12.9%	
Construction	6,631.0	7,606.0	7,469.0	-12.8%	-11.2%	
Residential building	722.1	839.7	811.6	-14.0%	-11.0%	
Nonresidential building	753.0	841.5	837.8	-10.5%	-10.1%	
Heavy and civil engineering construction	1,015.9	1,094.8	1,078.8	-7.2%	-5.8%	
Residential specialty trade contractors	1,815.0	2,112.4	2,079.2	-14.1%	-12.7%	
Nonresidential specialty trade contractors	2,324.7	2,717.8	2,661.8	-14.5%	-12.7%	
Producer Price Index, NSA ⁽²⁾	Mar-20	Feb-20	Mar-19	Feb-20	Mar-19	
Finished Goods (SA)	114.3	115.4	115.7	-1.0%	-1.2%	
Inputs to Construction Industries	227.2	229.6	231.5	-1.0%	-1.9%	
General Contractors (New Nonresidential Building Const.)	117.0	117.0	112.9	0.0%	3.6%	
New Nonresidential Building Construction (U.S.)	118.4	118.4	114.0	0.0%	3.9%	
Northeast	118.7	118.5	114.3	0.2%	3.8%	
South	117.9	117.9	113.7	0.0%	3.7%	
Midwest	116.1	115.7	111.4	0.3%	4.2%	
West	120.9	121.1	116.5	-0.2%	3.8%	

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

Construction Services ▼

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- ▶ Identification of fraudulent and preferential transfers and payments
- ▶ Returning undistributed funds
- ▶ Accounting and internal control assessment
- ▶ Performing monthly bank reconciliations
- ▶ Fraud investigation
- ▶ Escrow agent
- ▶ Paying agent

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- ▶ Claims evaluation/administration
- ▶ Indemnity investigations/sources of recovery
- ▶ Monitoring project progress/cost estimates
- ▶ Litigation support/principal tax issues
- ▶ Administration of trust/escrow accounts
- ▶ Cash flow analysis
- ▶ Underwriting support



▼ 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

Anirban Basu is Marcum's chief construction economist. He is also a member of the Firm's National Construction Practice, as well as chairman & CEO of Sage Policy Group, Inc., an economic and policy consulting firm in Baltimore, Maryland. Anirban leads Marcum's research and analysis of the economic health of the commercial construction industry in America. Additionally, he writes the quarterly Marcum Commercial Construction Index and annual Marcum JOLT Survey analysis and is a keynote presenter at the Firm's construction industry summits.

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