CONSTRUCTION VOLUMES PLATEAU AT HIGH LEVEL

Not only have spending reports indicated a lack of positive momentum, but recent employment data also suggest that nonresidential construction activity has plateaued.

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Partially lost amidst all the discussion of Brexit and volatile financial markets is evidence that the U.S. economy continues to expand. Construction remains one of the economy's busier segments, with many contractors continuing to report lengthy backlog and steady to expanding profit margins.

The good

Many of the factors that positioned the construction sector to become more active remain in place. Global investment capital continues to flow aggressively to the United States, particularly to tier 1 cities like New York, Seattle, and Miami. Events like Brexit only serve to expand interest in investing in the United States. Not coincidentally, interest and commercial real estate capitalization rates remain low. National output continues to climb, albeit slowly.

The e-commerce economy is driving demand for new fulfillment centers and warehouses, while technology companies continue to fuel construction in cities like San Jose, Boston, Seattle, and San Diego. There is also evidence of significant cybersecurity-related activity in the Baltimore–Washington Corridor, positive impacts of the auto sector's rebound in Detroit and elsewhere, and large industrial projects in Nevada, Louisiana, Texas, South Carolina, and other markets. Millennials are flocking to trendy towns, including to Denver, Charleston, Austin, and Portland, spurring residential and commercial activity.

While contractors are no longer becoming busier, the level of construction activity seems to have stabilized at a relatively high rate. The Associated Builders and Contractors' Construction Backlog Indicator (CBI) inched down from 8.7 months of backlog in the final quarter of 2015 to 8.6 months in the first quarter of 2016.[1]

Despite the small reduction in backlog, many contractors continue to express

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satisfaction with the amount of work they have under contract. Subcontractors are much busier than they were several years ago, with general contractors reporting greater difficulty securing experienced contractors. Some construction firms are turning away work for the first time in years. The recent stabilization of backlog may reflect supply constraints as much as demand stagnation.

The nation has now successfully completed seven years of economic recovery. The official unemployment rate is down to 4.7 percent, which means that the country is now very close to full employment.[2] Auto sales and other forms of retail activity remain reasonably strong. Online activity is robust. The nation's hotels are fuller, and office vacancy rates have been trending lower in many metropolitan markets.

The bad

That's what makes recent construction spending releases made available by the Bureau of Economic Analysis so surprising. Construction spending fell 1.3 percent on a seasonally adjusted basis in May 2016.[3] Losses were widespread, with 11 of 16 subsectors experiencing decreased spending for the month.

When adjusted for inflation, nonresidential construction spending today is essentially unaltered from a year ago. The industry's recovery appears to have stalled. Not only have spending reports indicated a lack of positive momentum, but recent employment data also suggest that nonresidential construction activity has plateaued.

Given lengthy backlog among contractors, there is little reason to think that the volume of nonresidential construction put-in-place will weaken significantly during the near term. The data are consistent with the notion that economic actors have become more cautious over the past year, perhaps delaying projects. This hesitation may be due to a number of factors, including concerns regarding overbuilding and the 2016 election cycle.

Weakness in the nation's energy sector has certainly contributed to this state of affairs, but the lack of nonresidential construction spending growth is not fully explained by low oil and natural gas prices. A lack of aggressive public sector spending is also contributing to the industry's recent malaise, and the broader economic outlook for 2017 and 2018 remains decidedly murky.

One of the possible factors behind the recent sluggishness in nonresidential construction is that many developers have come to the conclusion that the commercial real estate cycle is now in its seventh inning or later. One of the conventional wisdoms has been that the current real estate cycle will prove to be much different from the cycle that preceded the Great Recession. Chastened by the global financial crisis, banks have become more conservative in their lending. While that may be a source of frustration to some, it implies that there is a much lower chance of excess building and speculation now relative to the past.

THE WORLD'S FINANCIERS HAVE BEEN SITTING ATOP A GLOBAL SAVINGS GLUT.

However, the world's financiers have been sitting atop a global savings glut. Foreign and domestic investors have been on the search for yield, frustrated by low interest rates on bonds. With U.S. stock prices having risen so much and with price/earnings ratios elevated, many investors have chosen to supply substantial sums of equity into U.S. commercial real estate, unlocking bank and other forms of debt financing in the process. This group of investors includes private equity firms, insurers, and public pension funds.

The result has been an onslaught of construction in key construction segments ranging from lodging and office to retail and casinos. Some developers may have become unnerved by the possibility that their next project will meet with an unfavorable reception given so much competition for tenants and purchasers. This has likely contributed to the recently observed slowdown in nonresidential construction spending growth.

Meanwhile, household formation continues to be reasonably brisk. Presently, household formation is running at an annual rate of 1.28 million, higher than the long-term average of 1.16 million. Young adults appear to be forming households roughly in line with rates observed before the housing boom/bust according to the Federal Reserve Bank of San Francisco.[4]

The pace of housing starts climbed by nearly 7 percent in April to an annual pace of 1.17 million according to the U.S. Department of Commerce. However, even in the area of residential construction, not all news is good. As indicated by MarketWatch, a recent softening in building permits suggests that work on new properties could taper off of last year's double-digit pace.[5]

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For years, construction executives and project managers have complained about shortfalls in human capital, noting a lack of availability among electricians, carpenters, and project managers among others. But during recent months, construction firms have actually been collectively letting people go.

Based on the most recently available data from the Bureau of Labor Statistics, construction employment has fallen for two consecutive months, shedding a net 15,000 positions in May after posting a loss of 5,000 jobs in April. The broader economy fared only slightly better. By adding only 38,000 net new positions in May, the nation added fewer jobs during any month since September 2010, when the economy lost jobs.

The ugly

The economy has been flashing some warning signals recently, perhaps hinting at the next economic downturn. Arguably, the most worrisome of these signals comes in the form of declining corporate profits.

As indicated by a variety of media sources including *The Wall Street Journal*, corporate profits have been weighed down by both the slump in energy prices and slowing global growth. Although the calendar year is barely halfway over, the International Monetary Fund has already downgraded its outlook for worldwide growth in 2016 twice.

While corporate profits rose at a 1.9 percent pace during the first three months of the year according to the U.S. Department of Commerce, they declined 8.1 percent during the fourth quarter of 2015 after falling 3.3 percent during the third.[6] On a year-over-year basis, first quarter 2016 profits were down 3.6 percent, and profits as a share of the overall economy remained depressed from the record levels reached earlier in the expansion, according to writer Ben Leubsdorf.[7]

Given recent increases in the value of the U.S. dollar against the British pound, euro, Chinese renminbi, and Canadian dollar, corporate earnings could remain flat or worse as exports continue to sag and competition from cheaper imports stiffens. Corporate profit recessions are frequently followed by general economic ones.

For construction firms, the implication is a further reduction in private capital spending. To support profitability, firms often aggressively cut costs and also often embrace a more risk-averse investment posture.

Additionally, the Conference Board's Leading Economic Index declined 0.2 percent in May, "primarily due to a sharp increase in initial claims for unemployment insurance." While this index suggests that the economy will continue to expand at a moderate pace over the near term, Conference Board analysts warn that "volatility in financial markets and a moderating outlook in labor markets could pose downside risks to growth."[8]

Looking ahead

Economists have a tendency to engage in trend forecasting. The trend has been one of modest economic growth. That moderate growth has been enough to fuel rapid recovery in certain construction segments that had been associated with an utter lack of construction spending during the recession and its immediate aftermath.

With so many construction firms reporting lengthy backlog, there should be a solid level of construction spending going forward. However, the broader economy has begun to flash warning signs. Nonresidential construction activity tends to lag the broader economic cycle by about one year. That means that should the U.S. economic recovery, now in its eighth year, unravel at some point in 2017 or 2018, construction firms would feel much of that impact in 2018 or 2019. ■

NOTES

1 "Construction backlog reaches new high for largest contractors, ABC reports," Associated Builders and Contractors, Inc. (June 21, 2016) (press release). Available at: http://www.abc.org/NewsMedia/ConstructionEconomics/ConstructionBacklogIndicator/tabid/272/entryid/6383/construction-backlog-reaches-new-high-for-largest-contractors-abc-reports.aspx.

2 "Current employment statistics — CES (national)," U.S. Department of Labor Bureau of Labor Statistics (June 3, 2016). Available at: http://www.bls.gov/ces/.

3 "Value of construction put in place at a glance: May 2016," U.S. Census Bureau (April 1, 2016). Available at: https://www.census.gov/construction/c30/c30index.html.

4 Furlong, F., "Household formation among young adults," Federal Reserve Bank of San Francisco Economic Letters (May 23, 2016). Available at: http://www.frbsf.org/economic-research/publications/economic-letter/2016/may/household-formation-among-young-adults/.

5 Bartash, J., "U.S. home construction rebounds in April," MarketWatch (May 17, 2016). Available at: http://www.marketwatch.com/story/us-housing-starts-climb-66-in-april-2016-05-17.

6 "First quarter 2016 QFR," U.S. Census Bureau (June 6, 2016) (press release). Available at: http://www.census.gov/econ/qfr/.

7 Leubsdorf, B., U.S. first quarter GDP growth revised higher; corporate profits rose, *The Wall Street Journal* (May 27, 2016). Available at: http://www.wsj.com/articles/u-s-first-quarter-gdp-revised-higher-corporate-profits-rose-1464352524.

8 "The Index declined 0.2 percent in May to 123.7," The Conference Board (June 23, 2016) (press release). Available at: https://www.conference-board.org/data/bcicountry.cfm?cid=1.