EVEN A BROKEN CLOCK IS RIGHT TWICE A DAY

Despite entering its seventh year, the country's economic recovery remains fragile.

ANIRBAN BASU AND JOSEPH NATARELLI

This was not a terrible year. About a year ago, we indicated that 2015 was poised to be the best year of the recovery thus far. Remarkably, we appear to be correct. The International Monetary Fund recently issued their estimate for U.S. economic growth for this year. The estimate stands at 2.6 percent, which would be the best year since the recovery began. In 2010, the U.S. economy expanded 2.5 percent.[1] Why then are so many people still so gloomy?

If the economic recovery were likened to a college basketball game, we would be in the early to mid-stages of the second half. With the arrival of mid-June, the nation completed its sixth year of economic recovery and has entered its seventh. As of this writing, the nation is in its 76th month of recovery.

Once upon a time, people would have been right to fret that the end was nigh. The average post–World War II recovery has lasted about 58 months, slightly more than 4.5 years. The previous three economic recoveries lasted an average of 95 months, nearly 8 years. The average duration of economic expansions between 1860 and 1945 was just 26 months. The current recovery may still have a few birthdays in front of it and could end up challenging the lengthiest recovery in U.S. history, which lasted precisely 120 months between March 1991 and March 2001.

It took us a long time to arrive at the middle phase of the recovery. This is typically the lengthiest phase of recovery and ultimately gives way to the late phase when the economy overheats. Already, signs of overheating are emerging, particularly with respect to emerging skills shortages in key industry categories like trucking and construction. Despite this, average hourly earnings across all industries are collectively up only 2 percent over the past year nationally, well below the Federal Reserve's goal of 3.5 percent.[2] Construction wages are up by 2.4 percent year-over-year. There are also indications that certain real estate and technology segments have become overheated, with purchase prices rocketing higher and capitalization rates remaining unusually low.

Nonresidential construction has emerged as one of the economy's leading drivers. Led by a surge of investment in factories, hotels, casinos, and office space, nonresidential construction value put-in-place is up by more than 12 percent over the past year.[3]

Contractors would love for that momentum to continue, but much depends on macroeconomic performance

ANIRBAN BASU *is the chief construction economist at Marcum LLP and the CEO of the Sage Policy Group.*

JOSEPH NATARELLI *is the partner-in-charge of Marcum LLP's New Haven office as well as the National Construction Industry Leader.*

in 2016 and beyond. Already, certain warning signs can be seen. For instance, job growth has begun to soften recently. After adding an average of nearly 250,000 jobs per month during the one-year period stretching from July 2014 to July 2015, the nation added only 136,000 net new jobs in August according to a revised estimate and 142,000 jobs in September according to a preliminary estimate. While two surprisingly tepid months of end-of-summer data should not raise blaring alarm bells, something is not quite right with the economy.

Job growth is typically a lagging indicator, meaning that something else has happened to the economy to cause the recent softness. There are many candidate explanations. At the top of the list is a slowing global economy.

There has been a running thesis suggesting that the so-called BRIC nations — Brazil, Russia, India, and China — would eventually supplant the United States as the primary driver of global economic expansion. This hasn't happened yet. China is set to sustain its lowest rate of annual economic expansion in at least 20 years. Brazil is in a deep recession, and Russia's is even deeper. Among the BRIC nations, only India, the world's largest democracy, is having a solid year economically. Unlike Russia and Brazil, oil production is not a primary source of growth in India. India's primary resource is a large and growing population of talented, educated young people, the ultimate renewable resource.

In addition to weakness in the emerging world, much of the developed world continues to be sluggish. Europe's malaise is well known, and the emerging refugee crisis will put additional pressure on labor markets already associated with high unemployment and strained central government budgets. The Canadian economy, to which the United States exports more output than any other nation, actually recessed during the first half of the year, weighed down in large measure by the collapse in commodity prices. This helped bring the nation's Liberal party back into power, promising new taxes on the rich and higher levels of government spending. The Japanese economy also continues to perform erratically.

Another factor contributing to global economic weakness is the fact that the U.S. dollar is much stronger than it was a year ago. As of this writing, one dollar can purchase 120 Japanese yen. Roughly a year earlier, the dollar could buy around 100 yen. Today, one euro can purchase $1.12. It wasn't that long ago that a single euro could purchase $1.38. Several years ago, one Canadian dollar could purchase more than one U.S. dollar. Today, the Canadian dollar purchases only about three-quarters of a U.S. dollar.

The result has been stifled U.S. exports. U.S. exports are on track to decline in 2015 for the first time since the financial crisis, despite a national push to expand shipments abroad. According to the U.S. Commerce Department, exports of goods and services were down 3.5 percent in July compared to the same period one year ago.

In addition to strains coming from the global economy, the public sector continues to be a relative drag on U.S. economic growth. The inability of Congress to extend the nation's Highway Transit Fund in meaningful ways has delayed project starts. Recent fears regarding another federal government shutdown have also contributed to a not-yet-recovered economy. On top of that, there remains a lack of transparency regarding tax treatment of equipment and related purchases, which further undermines current growth.

To the extent that the economy is performing, it is largely in interest rate–sensitive areas. Low interest rates have represented a boon to nonresidential construction. With interest rates remaining at or near historic lows, investors have been hunting for yield anywhere they can find it. Hotels, office buildings, and other structures have emerged as a favorite among investors, fueling construction in the process. Developers are also supported by an extraordinarily low cost of capital. Of course, an expectedly sharp rise in interest rates would undermine nonresidential construction's presently brisk recovery.

IN ADDITION TO STRAINS COMING FROM THE GLOBAL ECONOMY, THE PUBLIC SECTOR CONTINUES TO BE A RELATIVE DRAG ON U.S. ECONOMIC GROWTH.

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Consumer spending is at the top of the list of economic growth contributors in the United States. Despite still-soft wage growth, consumers continue to lead the way, spending more on restaurants, automobiles, electronics, and lodging. Low interest rates represent a consumer inducement, especially regarding the purchases of new cars, now back to pre-recession levels or better.

Residential construction continues to represent another important economic driver. Both multifamily and single-family segments have been on the mend. According to a recent report from Trulia, a real estate listing and analytics company, multifamily construction activity is elevated relative to historic averages in more than one-quarter of the nation's largest metropolitan housing markets. In red-hot markets like New York City, activity is four times the normal average; in Boston, triple.[4] As reported by CNBC, Dallas, Houston, Seattle, Los Angeles, and San Francisco are all experiencing above-average apartment construction while experiencing below-average supplies of homes available for sale.[5] These and other markets are known for their capacity to attract young college graduates in large numbers, and the in-migration of young knowledge workers is helping propel multifamily development booms.

U.S. housing starts expanded to a near eight-year high in July.[6] Through that month, housing starts have been above a one-million-unit pace for four consecutive months. Interestingly, single-family construction has been at the heart of recent residential recovery. In July, groundbreaking for single-family homes surged by nearly 13 percent to an annualized pace of 782,000 units, the highest level since December 2007, the initial month of the Great Recession.

Where are the workers?

The U.S. construction industry added 8,000 net new jobs in September after adding 5,000 positions in both July and August, according to data made available by the United States Bureau of Labor Statistics. These employment gains are nothing to write home about; the sector added 52,000 more jobs over the same three-month period in 2014. Nonresidential construction, along with its residential counterpart, has wavered in recent months, oscillating between uninspired employment growth and job losses. These employment patterns appear distinctly at odds with spending data that indicate the industry has become much busier in recent months.

The most likely explanation is that the construction industry has nearly run out of construction workers to hire. Many with construction-relevant skills have left the industry or the workforce altogether. When construction employment peaked at 7.7 million jobs in June 2007, the industry's unemployment rate sat at 5.9 percent. Today, with construction employment totaling 6.4 million (16.8 percent lower than the peak), the unemployment rate is eight-tenths of a percentage point lower at 5.1 percent.

The economics of frustration have been at work. Approximately 2.3 million construction workers lost their jobs between 2006 and 2011. Where did they go? Hubert Janicki and Erika McEntarfer, two economists at the Bureau of Labor Statistics, attempted to answer this question.[7] Using data made available by the Census Bureau, Janicki and McEntarfer found that nearly 40 percent of those displaced workers returned to the industry, though not necessarily in the same job. Another 770,000 workers, or one-third, switched industries. Many now work in energy, retail, trucking, or manufacturing. One-quarter of the displaced workers had not found any replacement employment by the end of 2013.

Perhaps the most disconcerting aspect of Janicki and McEntarfer's findings was a shift in hiring, with firms becoming less likely to hire younger workers. The industry experienced a steep decline in the rate of 19- to 26-year-old hires, while the rate of hiring older, more experienced workers declined at a much more gradual pace. This likely has less to do with firms than the workers themselves. Too few young people are entering the construction industry, which means that firms are largely left to compete for older personnel.

Construction input prices plummet

Construction material prices plunged 1.6 percent in September after falling 0.9 percent in August, according to Producer Price Index (PPI) data released by the United States Bureau of Labor Statistics.[8] Year-over-year prices have fallen 5.3 percent, the largest decline in more than six years. Nonresidential input prices exhibited an even steeper drop, falling 1.6 percent on a monthly basis and 6 percent on a yearly basis.

Inexpensive material prices are nothing to complain about in the short run. With tightening labor market conditions and the prospect of higher wages, deflation in input prices may help contractors maintain their profit margins.

Full recovery at last

The all-time high in nonresidential construction value put-in-place occurred in October 2008. By January 2011, nonresidential construction spending had fallen 30 percent. The industry is now nearly fully recovered. According to data released by the U.S. Census Bureau, nonresidential construction spending, which totaled $696.3 billion on a seasonally adjusted annualized basis in August, is only 2.5 percent lower than its prerecession peak.

No segment has exhibited as much dynamism as manufacturing. Despite a lofty U.S. dollar and stagnant exports, construction related to manufacturing expanded 58 percent during a recent 12-month period. Announced investments by Volvo, Boeing, Mercedes, and others imply that manufacturing-related construction will remain active. Low natural gas and oil prices may be helping to fuel manufacturing expansions.

Looking ahead

The U.S. economy is positioned to be decent in 2016 but not spectacular. It is likely that the economy will have to wrestle with higher interest rates and a stronger dollar next year. The net exports category of GDP is already a significant drag on growth, as is the government spending category. We don't expect that to change.

The recovery will continue to be led by consumers. Wage growth is set to accelerate a bit next year, especially in the construction sector and other industries afflicted with skilled labor shortages. Despite entering its seventh year, the recovery remains fragile and heavily dependent upon ultra-low interest rates. This implies that the Federal Reserve will tighten monetary policy only gradually next year.

Although the federal government continues to suffer from gridlock, more states and municipalities are associated with improved finances. That should help better support spending in infrastructure categories next year. ■

NOTES

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