

Today's Construction Economy

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Introduction

Today's Construction Economy captures key insight directly from leaders in the construction industry. The newsletter pulls from these observations to determine the market's message.

This quarter's edition highlights the remarkable strength in the nonresidential construction market, even in the face of continually high inflation. Some materials prices are leveling off and even falling, though, and contractors are able to roll high inputs costs into their bids. That is a delicate balance, though — profit margins are forecast to fall as owners balk at increasing bid prices. Scarce skilled labor also continues to be an issue. Our focus continues to be on the primary drivers of selling price to owners.

Third-Quarter 2022

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The U.S. Economy

“Recession is not inevitable today, nor is it the most likely path for the economy,” Moody’s Analytics Chief Economist Mark Zandi said, noting several bright spots including high corporate profits, strong bank balance sheets and abundant consumer savings. [1]

“When inflation has been above 4%, unemployment has been below 4%, we’ve always had a recession within the next two years,” (former U.S.) Treasury Secretary Lawrence Summers said Tuesday (June 5). [2]

...a majority of financial sources – including Morgan Stanley, S&P Global and The Wall Street Journal – place the probability of a recession within the next 12 to 24 months at 50% or less, according to data presented in the webinar. [3]

Unhappy consumers choosing to save rather than spend are the biggest risk to the economy. Unfortunately, the measures we have don’t give a great snapshot of how bad things really are today, or how bad they are likely to become. The only sure thing is that the mood is souring. [4]

Associated Builders and Contractors’ Chief Economist Anirban Basu said the Federal Reserve’s tightening policy to fight inflation will likely drive the economy into recession either later this year or at some point in 2023. [5]

Consumer-price index, change from a year earlier [6]



Employers continued to snap up workers in June – though at a slower pace than earlier in the year – in an economy that is otherwise cooling rapidly under the weight of high inflation and rising interest rates.[7]

THE MARKET'S MESSAGE

There is absolutely no consensus on how much worse the economy will get or when it will start improving. The stock market is certainly signaling a recession. While both inflation and interest rates continue to rise, there are portions of the economy that are healthy and may help deliver a soft landing. Consumer demand is still high, and jobs are plentiful at low unemployment levels.

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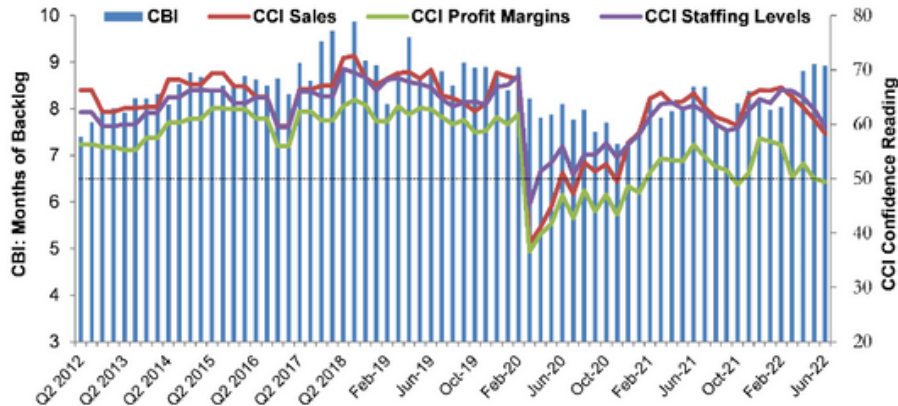


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Confidence and Forecasts



ABC Construction Backlog Indicator & Construction Confidence Index, 2012-June 2022 [1]



©Associated Builders and Contractors, Construction Backlog Indicator, Construction Confidence Index

The (Conference) board's expectations index, which measures consumers' short-term outlook about the labor market, business and income, reached a low of 66.4 in June from 73.7 the prior month. [2]



U.S. construction starts should continue to grow for the rest of the year, despite economic and geopolitical headwinds, according to a Dodge Data & Analytics report....Most of that positivity stems from the amount of projects sitting in backlog, or projects that are planned but not yet begun, said Dodge's Chief Economist Richard Branch during a mid-year construction outlook webinar last week (week of May 16). [3]



"Based on the historical lag between the performance of the economy and nonresidential construction spending, more difficult times could be ahead for contractors in 2024 or 2025," said Basu. [4]



Contacts in both residential and nonresidential construction noted that higher labor and material costs continued to encumber activity, and that rising interest rates had also begun to weigh on demand. Multiple contacts mentioned that it was more cost effective to buy materials in advance of a project start than to purchase materials as needed once building began." [5]



"In the context of rising fears of recession and rising borrowing costs, the stage has been set for softer nonresidential construction activity going forward," said Basu....The market may not prove as robust as anticipated given delayed project start dates as public agencies determine the right moment to purchase construction services. [6]



THE MARKET'S MESSAGE

While 2022 looks like it will be a banner year for nonresidential construction even as stock markets fall and interest rates rise, subsequent years could feel some pain. Construction lags the general economy by 6-9 months, so a U.S. economic recovery late in 2023 could mean that construction suffers well into 2024.

SOURCES

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Jobs and Wages

About 36,000 new employees donned hard hats and reported for work on jobsites in May, according to BLS data, but that didn't come close to filling the 494,000 construction job openings at the end of April, a 40% increase from the number of openings in April 2021. [1]

"For contractors to get more workers on board, I think they'll have to raise pay even more... I expect workforce challenges to outlast materials cost or supply chain issues," (AGC's Chief Economist Ken) Simonson said. [2]

For hourly workers in the trades, pay rose in May by 6.3% year over year, the highest increase since December 1982, according to Simonson. [3]

Average hourly earnings for production and nonsupervisory employees in construction rose to \$32.19 in May, according to the Bureau of Labor Statistics, a 6.3% increase from a year ago and the highest gain in 40 years....But increasingly, those higher wages are coming on the bottom rung of the construction employment ladder, with unskilled laborers seeing the greatest wage gains, economists told Construction Dive. That means construction companies pay more for hard-to-find workers, without necessarily reaping the benefits of increased productivity, or profits. [4]

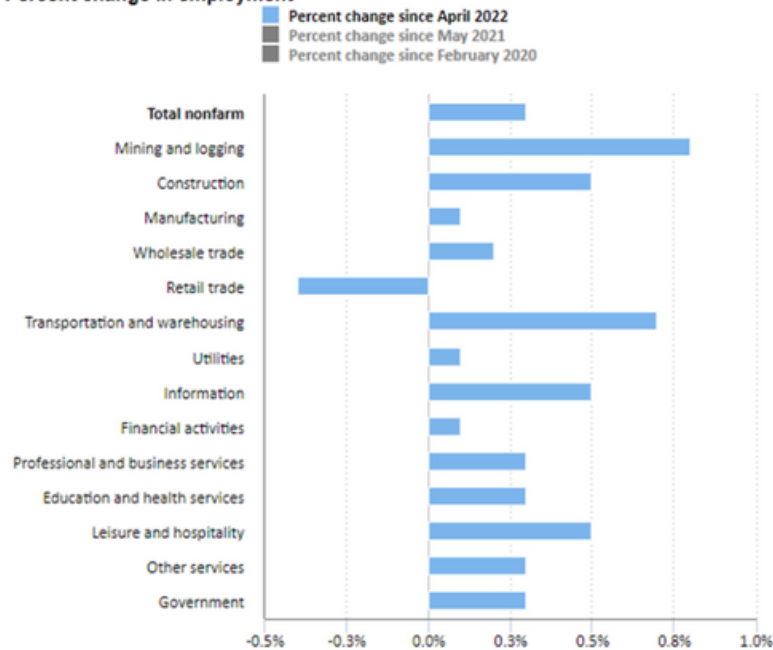
Change in nonfarm payroll employment by industry, May 2022

Select a chart to display:

[5]



Percent change in employment



"Construction still has a considerable premium, as I call it, in what it pays the average worker, compared to other industries," Simonson said. "But that premium has shrunk." [6]

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"We are at an inflection point," (ABC's Chief Economist Anirban) Basu said. "Whatever the level of shortage has been in construction with respect to the workforce, it's about to get worse." [7] 

The (construction) private sector has already reached full recovery, up 140,000 jobs from February 2020, while the public sector is still down by 664,000 jobs. [8] 

Average hourly earnings for production and nonsupervisory employees in construction rose 6.3% year-to-year (y/y), the steepest increase since December 1982 but slightly less than the 6.5% rate for the overall private nonfarm sector. [9] 

The fact that job openings increased so much despite a step-up in hiring suggests contractors expect demand for projects to remain strong in the near term...Together, the record-low layoffs and low unemployment rate and the record high for job openings imply contractors will have trouble finding all the workers they seek. [10] 

"The industry is working hard to recruit new people into the many high-paying career opportunities that are available," said Stephen E. Sandherr, the (AGC's) Chief Executive Officer. "But too few current and future workers are ever even exposed to construction as a career choice, undermining interest in an industry that everyone sees but too few appreciate." [11] 

THE MARKET'S MESSAGE

Despite wage premiums that have prevailed for years, construction labor is difficult to obtain. There are other occupations that are increasingly attracting workers with even higher wages. Construction is hard work – the industry must come up with ways to win out over the other options which apparently look more attractive. Labor costs will continue to set records and remain the driving force behind selling price inflation.

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Material Costs and Supply Chains

Taking inflation out of the equation, the growth in terms of real dollars is closer to 5% to 7%, said (Dodge Data’s Chief Economist Richard) Branch. “Inflation is taking a good chunk out of the growth rates that you’re seeing today.” [1]

Industrial metals are on track for the worst quarter since the 2008 financial crisis as prices are pummeled by recession worries. Copper, the great economic bellwether, has ricocheted into a bear market from a record four months ago, while tin just tumbled 21% in its worst week since a 1980s crisis froze trading for four years. [2]

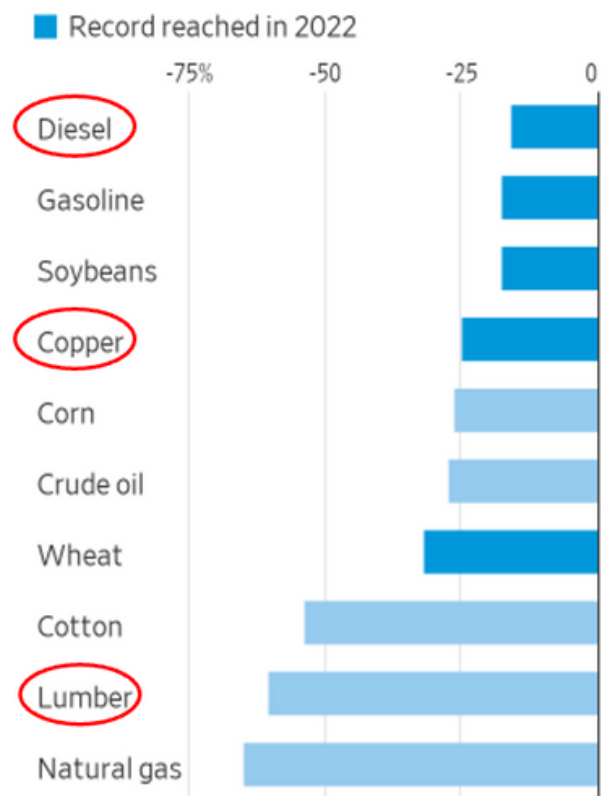
But the Fed’s rate hikes could have a much more immediate impact on discretionary spending, potentially bringing an end to a boom in metals demand in areas like property, car-making and durable goods. And with manufacturers facing rising borrowing costs, there are also growing risks to demand in areas like construction and industrial machinery, which account for a major portion of overall usage. [3]

One category of costs that may improve soon is freight charges, Cass Information Systems reported on Monday (Jun 13), “2022 has featured a big improvement in driver availability, and a flattening of freight demand. This is a deflationary combination, though it will take several months to filter from the spot market into contract rates.” [4]

The Portland Cement Association issued a “Tight Market Conditions Briefing” in May that reported, “Tight cement supply conditions vary by region but some evidence of tightness prevails in portions of 43 states according to PCA’s survey of cement manufacturers. [5]

High-price freight contracts that were written when carrier capacity was tight and a rush to restock inventories was in full force are losing their shine as slowing demand and a wavering U.S. economy send shipping rates sliding. [6]

Percentage off record prices [7]



Note: Continuous most-active futures contracts as of June 30

Source: FactSet

THE MARKET'S MESSAGE

The recent run-ups in materials prices – while still persisting – have been joined by labor supply challenges as equally harmful to construction growth. There are also indications that some key materials prices have peaked and are now falling. It may take a while but falling materials prices can lead to falling inflation.

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Demand — Volume, Starts, and Backlog

To the extent that the economy slows, the Federal Reserve may decide not to raise interest rates as aggressively, at least once the summer is past. That will help moderate increases in the cost of capital, contributing to ongoing demand for construction services, which has slipped in the most recent month, according to ABC's Construction Confidence Index." [1]

"It is simply remarkable that contractors continue to add to backlog amidst global strife, rising materials prices and ubiquitous labor force challenges," said ABC's Chief Economist Anirban Basu. "Backlog is up in every segment over the past year, including in the somewhat shaky commercial category." [2]

"In the headlines, we're hearing more and more talk about recession risk," said Sean Eastman, senior equity research analyst at (the) financial services firm KeyBanc Capital Markets. "Meanwhile, most of the engineering and construction companies I cover just reported record or near record backlog levels in the first quarter." [3]

The ABC's Construction Backlog Indicator, which measures jobs contractors have won, but not started, hit nine months on Wednesday (Jun 15), the highest since September 2019 — before the pandemic and when commercial construction was near its peak...."Backlog is up in every segment over the past year." [4]

"I'm still bullish on construction. Public construction spending, at least, is likely to hold up even if the economy slows dramatically," Ken Simonson, Chief Economist at the Associated General Contractors of America, told Construction Dive. [5]

Industrial real-estate developers have been stepping up building cold-storage warehouses in the U.S. without tenants lined up for the space, betting that pandemic-driven changes in the way consumers buy groceries and meals are here to stay. [6]

Nearly 3.3 million square feet of refrigerated warehouse space was under construction through the second quarter of this year nationwide without companies slated ahead of time to take up the sites, some 1,000% more than was built in 2019, according to a report by real-estate services firm CBRE released Wednesday (Jun 29). [7]

Amazon has delayed or canceled plans for at least 13 facilities in its distribution network this year, according to local news reports....Shifts in plans have affected locations in Texas, Florida, Louisiana, Tennessee and California, per reports. Many of these adjustments surfaced following the company's acknowledgement that it overbuilt its warehouse footprint in April. [8]

"The construction sector is seemingly shrugging off the fear of higher interest rates and a potential recession," said Chief Economist Richard Branch. "Many building sectors have made the turn from weakness to recovery as underlying economic growth and hiring are solid." [9]

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The Architecture Billings Index (ABI), which the American Institute of Architects calls “a leading economic indicator that leads nonresidential construction activity by approximately 9-12 months,” registered a score of 56.5 in April – the 15th consecutive reading above 50, the Institute reported on Wednesday (May 18). [10]

“While business conditions at architecture firms have been very encouraging over the past year, project activity has been steadily shifting toward work on existing buildings,” said (AIA’s) Chief Economist Kermit Baker. “Billings for reconstruction projects exceeded those for new construction for the first time in the last two decades. While the reconstruction share of building activity will continue to ebb and flow, in general, we’ll continue to move toward an increased share of building activity for reconstruction and a decreased share for new construction.” [11]

Nonresidential building starts jumped 32% year-to-date, with institutional starts up 9.0%, commercial starts up 4.0%, and industrial (manufacturing) starts up 266%. [12]

Nonresidential building construction is clearly trending higher with broad-based resilience across the commercial, institutional, and manufacturing spaces. However, growth in the residential market has been choked off by higher mortgage rates and rapidly falling demand for single-family housing. [13]

Construction spending (not adjusted for inflation) totaled \$1.78 trillion in May at a seasonally adjusted annual rate, down 0.1% from the upwardly revised April total but up 9.7% y/y, the Census Bureau reported today (July 1). [14]

Basu said higher borrowing costs, in conjunction with inflated materials prices and rapidly rising worker compensation, give project owners more incentive to postpone or cancel projects, and cuts into contractors’ profitability....“These factors have already begun to whittle away at contractor profit margins.” [15]

THE MARKET'S MESSAGE

The nonrecurring construction market appears oblivious to rising labor and materials prices and interest rates, while the rest of the economy is bracing for a recession. Some sectors are slowing, but backlogs are near record highs, and spending is 10% higher than 2021 levels. Owners are applying lessons learned from the COVID-induced recession to gauge demand and build accordingly.

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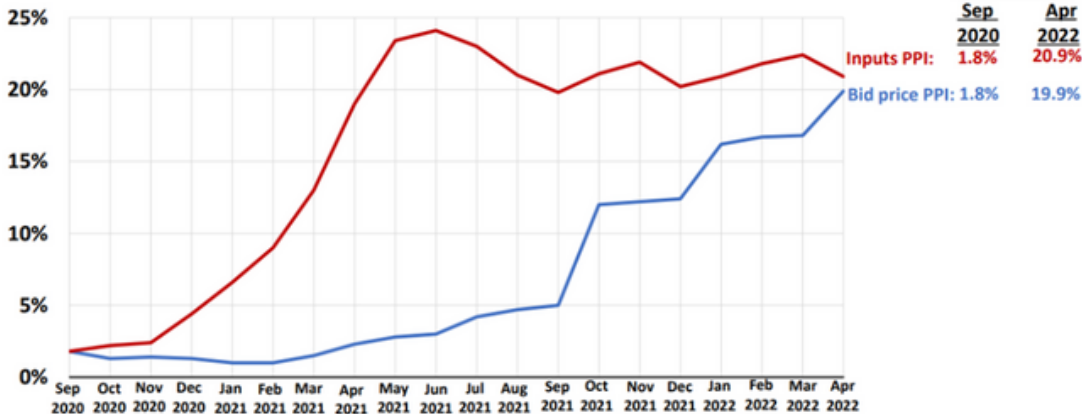
Final Selling Price

Costs vs. bid prices for new nonresidential construction

Year-over-year change in PPIs, Sep 2020–Apr 2022, not seasonally adjusted



[1]



12 months to:

Sep 2020

Apr 2022

Inputs PPI: 1.8% 20.9%

Bid price PPI: 1.8% 19.9%

[1] Source: Bureau of Labor Statistics, producer price indexes, www.bls.gov/ppi

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Producer prices for final demand increased 10.8 percent for the year ended in May 2022, following advances of 10.9 percent for the year ended in April and 11.5 percent for the year ended in March. [2]

Jim Schneiderman, Mid-Atlantic Vice President for Broomfield, Colorado-based Flatiron Construction, told the paper that higher employee costs were starting to eat into the firm's profits....“We learned our lesson and will be building in those higher labor costs accordingly for future work,” he said. “Everyone I talk to in the industry has had this same realization.” [3]

Despite the rising cost of materials, contractors' bids aren't reflecting these increased costs. As a result, 57% of contractors saw a decrease in profitability in 2021. [4]

Contractors' bid prices rose at roughly the same rate as their input costs for the first time since September 2020, according to Bureau of Labor Statistics data posted today. [5]

THE MARKET'S MESSAGE

Contractors have been recovering more and more of their labor and materials cost increases by passing them on in bid prices that some owners are willing to pay. There are still disparities as contractors want to stay competitive while still making a profit. Nonresidential building prices are rising faster than any other product except energy.

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Final Thoughts

Much talk today is about an impending recession, but you wouldn't know it by the way owners are building. Labor supply and increasing wages are the top impediments to growth, as materials prices appear to have peaked. While backlog is currently healthy, an increasing number of forecasts calls for trouble in 2023. Nonresidential construction has surged in the most recent quarter, far outpacing what had been a red-hot housing market.

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