

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.

Three years after policy decisions to address COVID induced a severe recession, we have recovered. The pendulum has swung 180 degrees, and we are now confronted with raging inflation and, again, real possibilities of another recession. Nonresidential construction has nicely weathered the storm as employment, spending, and wages are at all-time highs, but it seems that many of these trends are unsustainable. Our focus continues to be on the primary drivers of selling price to owners.

Second Quarter 2023

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MOCA Systems, Inc. is a full-service Owner's Representative and software development firm serving the design and construction industries.



Surprisingly Strong Construction Fundamentals

Construction spending and employment have risen to records this year, boosted by government outlays for infrastructure, a domestic manufacturing renaissance and a wave of apartment building that got off to a slow start during the pandemic when prices for building materials, such as lumber, were sky high.¹

“Despite a gloomy economic forecast and extraordinarily elevated borrowing costs, contractor backlog and confidence continue to rise,” said Associated Builders and Contractor’s chief economist Anirban Basu. “This mirrors the broader economy, which has thus far proved resilient in the face of rising interest rates.”²

The ratio of unemployed people to job openings ranged from 0.8 to 1.0 during 2018 and 2019. Over the past 5 years, the number of unemployed people per job opening reached a high of 4.9 in April 2020, when there were 23.1 million unemployed people and 4.7 million job openings. Since October 2021, the ratio has been 0.5 or 0.6 every month.³

So employers are hiring, which the Fed (Federal Reserve) doesn’t necessarily want to see as they try to suppress inflation, but the labor force is growing and wage growth is slowing, which the Fed does want to see. As long as rapid job gains coincide with labor force growth, it’s not a huge problem.⁴

Three (somewhat) Key Takeaways⁵

- The prime age (25-54) labor force participation rate (83.1%) is now higher than it was in February 2020 (83.0%), the month before the pandemic began.
- The number of people unemployed for 27 weeks or longer is now below pre-pandemic levels.
- Women (3.5%) have a lower unemployment rate than men (3.6%) for the second straight month.

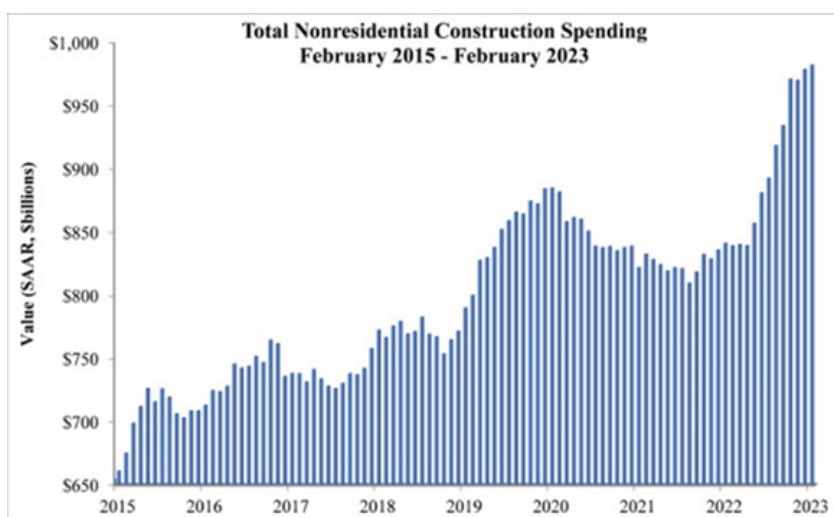
The latest data signal “continued strong demand for jobs in March despite concerns about the banking sector during the month,” said Sam Millette, fixed-income strategist for Commonwealth Financial Network. He said recent reports suggest next week’s jobs report will show continued employment gains in March.⁶

Over the 12 months ended March 2023, the Consumer Price Index for All Urban Consumers increased 5.0 percent; this was the smallest 12-month increase since the year ending May 2021. Energy prices decreased 6.4 percent since March 2022.⁷

Contractors’ input costs rose more than their bid prices in February, according to Bureau of Labor Statistics (BLS) data posted

on Wednesday (Mar 15). The producer price index (PPI) for material and service inputs to new nonresidential construction rose 0.4% for the month and 2.7% year-over-year (y/y)... The PPI for new nonresidential building construction — a measure of the price that contractors say they would bid to build a fixed set of buildings — rose 0.1% for the month and 17.0% y/y.⁸

Even though the cost of commercial building has hit record highs recently, owners and contractors can expect to shell out even more for construction projects in many U.S. cities in the near future, according to a new report from (Sweden-based construction firm) Skanska that looked at 21 major markets.⁹



Source: U.S. Census Bureau

Source: U.S. Census Bureau, Construction Spending ¹⁰



Surprisingly Strong Construction Fundamentals

—Continued

Construction employment, not seasonally adjusted, rose from January 2022 to January 2023 in 306 (85%) of the 358 metro areas (including divisions of larger metros) for which BLS posts construction employment data.¹¹

“Softwood lumber prices appear to be very close to the bottom of their downward trajectory from the highs over the past two years. The general [quarterly] price trend for 2023 will be flat with any temporary price declines rebounding, and any price spikes receding,” says Luke Lillehaugen, senior economist at S&P Global. However, looking y/y, S&P Global expects softwood lumber to decline 28.9% in 2023.¹²

For the seventh-straight month the y/y rise in pay topped the 5.1% rise for all private-sector production employees. The “premium” for hourly construction workers rose to 18.7% over the private sector average of \$28.50 but remained considerably below the average premium in 2000-2019 of 21.5%.¹³

Seasonally adjusted average hourly earnings for production and nonsupervisory employees in construction (craft and office) rose 6.1% y/y to \$33.57 per hour. For the sixth-straight month the y/y increase in pay topped the 5.3% rise for all private-sector production employees.¹⁴

The S&P CoreLogic Case-Shiller National Home Price Index, which measures home prices across the nation, fell 0.2% in January compared with December on a seasonally adjusted basis. Prices have fallen for seven straight months, the longest streak of declines since 2012.¹⁵

THE MARKET’S MESSAGE

Labor and materials costs for nonresidential construction continue to rise. Workers are coming off the streets and filling open positions at increasing rates. Capacity is being partially freed up by the severe downshift in residential construction and spending. Construction-in-Place selling prices continue to rise too, while construction labor costs are increasing at rates substantially higher than the average American worker’s costs are. Inflation in the overheated economy is placing even more pressure on labor rates, although it is easing. There must be a limit....

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How Has the Banking Crisis Impacted Construction?


“With the likely tightening of financial conditions given the growing stress on America’s banks and ongoing efforts by the Federal Reserve to rein in excess inflation, commercial real estate and construction are likely to weaken further during the year ahead,” said Basu. “The current moment is, above all else, defined by uncertainty.”¹ 

Commercial real estate, in particular, is under much pressure. Many stakeholders now wonder, is the recent banking fiasco enough to drag (commercial real estate) down? Several real estate investment trusts have already expressed their concerns directly related to their dealings with Silicon Valley Bank and Signature Bank. Banks lease huge properties across the country.² 

“Overall, the U.S. banking system is healthy, but smaller regional banks could face difficulty, and many have begun to tighten lending standards,” says Dodge Data’s chief economist Richard Branch. “These smaller banks are the lifeblood of the construction sector — providing credit not just to contractors, but also loans to developers for many types of projects.” He adds: “Should credit continue to tighten, it could put many small players in the construction sector in difficult situations and potentially lead to a sharper pullback in construction starts.”³ 

Rising interest rates are taking the air out of bubbly property valuations. Apartment prices are down 21% over the past year, according to the Green Street Commercial Property Price Index. This makes them the second-worst-performing category of real estate after offices, which have lost 25%.⁴ 

“Lending standards for small banks in particular have substantially tightened as banking insecurity intensifies,” said Sarah Martin, Dodge’s associate director of forecasting, in a press release. “As a result, owners and developers are more likely to pull back in the short term, which would further contract the Dodge Momentum Index as we continue into the year.”⁵ 

“I expect that the smaller banks will suffer [due to declining confidence in them] and that will have a negative impact on some construction lending,” (Julian Anderson, president of Rider Levett Bucknall) says.⁶ 

THE MARKET’S MESSAGE

It is too early to tell how, but the credit squeeze brought on by recent bank failures will impact construction. Housing was already slowing down, and now we can expect small banks and their construction clients — many of whom are small businesses — to feel some pain. In the meantime, owners with large cash holdings are not hesitating to move forward.

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Factories, Warehouses, and Data Centers

“Construction industry momentum may falter at some point in the future as project financing becomes increasingly expensive,” said Basu. “That said, some contractors will continue to have significant workflow even in the instance of an economywide recession. That’s due to the arrival of megaprojects, including those emerging from infrastructure programs and investment in more manufacturing capacity in America.”¹

“Nonresidential construction spending increased for the eighth time in the past nine months in February,” said Basu. “Importantly, almost all of the nonresidential sector’s momentum is attributable to manufacturing-related construction, which accounted for nearly 35% of the y/y growth in spending.”²

Construction spending related to manufacturing reached \$108 billion in 2022, Census Bureau data show, the highest annual total on record — more than was spent to build schools, healthcare centers or office buildings.³

The outlook for multifamily construction appears to be cooling. The National Association of Home Builders reported on February 23 that its Multifamily Production Index increased two points to 34 compared to the previous quarter. Readings below 50 indicate that more developers see declining (demand rather) than expanding demand.⁴

The outlook for office construction appears bleak. “Defaults and vacancies are on the rise at high-end office buildings, in the latest sign that remote work and rising interest rates are spreading pain to more corners of the commercial real-estate market,” the *Wall Street Journal* reported on Wednesday (Mar 29).⁵

A building boom in industrial plants, infrastructure and other nonresidential projects is offsetting home construction in the U.S. that has been weakening under the weight of higher interest rates. Contractors said spending on nonresidential projects has stayed strong as borrowing costs rise, which usually drives up the cost of financing construction work.⁶

Commercial planning in February was bolstered by almost 20% growth in office planning activity, as data centers continued to steadily enter the planning queue. Institutional planning was driven higher by growth in education and healthcare projects, notably the continued investment in research laboratories.”⁷

THE MARKET’S MESSAGE

Nonresidential construction has rapidly and thoroughly filled the gaps created by the cooling housing market. Demand for factories has far outpaced all other nonresidential building. Office buildings and multifamily units have suffered, but overall nonresidential construction is as healthy as it’s been in quite some time. Demand and prices continue to rise.

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Slowing Growth and Other Disturbing Trends

“Current strong construction classes like multifamily, warehouse, industrial and storage could see some slowdown due to rising interest rates, investor skepticism and banking tension,” said (Grant Thornton’s industry managing partner Greg) Ross. “Expect to see a fluctuation in consumer confidence that could impact overall demand including high growth areas like single-family, warehouse and multifamily.”¹ ↓

While one month does not a trend make, when combined with an increase in existing home sales, it could mean the bottom of the single family market is near,” says Branch. After a prolonged period of growth, multifamily starts, however, have begun to decline, down 16% through January and February.² ↓

The U.S. office vacancy rate reached a milestone in the first quarter when it rose to 12.9%, exceeding the peak vacancy rate during the 2008 financial crisis.³ ↓

Freight companies are dialing back expectations that demand will recover strongly in the second half of the year amid growing economic uncertainty and signs retailers are growing more guarded about placing big orders in 2023.⁴ ↓

Backlog slipped in March and is now at its lowest level since August 2022. Backlog is down on a monthly basis in every region except for the South, which continues to be associated with elevated levels of current and future construction activity.⁵ ↓

“The deceleration in nonresidential construction activity may have started,” said Basu. “With widespread fears of recession, credit conditions tightening and more decision-makers turning their attention to cost containment, new construction work may be more difficult for contractors to line up.”⁶ ↓

The Dodge Momentum Index, a benchmark that measures nonresidential building planning, tumbled 8.6% in March as banking insecurity brought on by recent bank failures caused small banks to tighten lending standards, according to a Dodge Construction Network report. The index typically leads actual construction spending by 12 months.⁸ ↓

Construction Backlog Indicator

	Mar 2023	Feb 2023	Mar 2022	1-Month Net Change	12-Month Net Change
Total	8.7	9.2	8.3	-0.5	0.4
Industry					
Commercial & Institutional	9.3	9.4	8.6	-0.1	0.7
Heavy Industrial	8.8	10.4	6.3	-1.6	2.5
Infrastructure	7.1	10.0	8.2	-2.9	-1.1
Region					
Middle States	7.3	8.3	7.5	-1.0	-0.2
Northeast	8.0	8.8	8.6	-0.8	-0.6
South	11.4	11.0	9.7	0.4	1.7
West	7.9	8.7	6.3	-0.8	1.6
Company Size					
<\$30 Million	7.5	8.2	7.7	-0.7	-0.2
\$30-\$50 Million	11.2	8.8	8.4	2.4	2.8
\$50-\$100 Million	14.4	14.8	9.6	-0.4	4.8
>\$100 Million	12.9	12.4	13.8	0.5	-0.9

© Associated Builders and Contractors, Construction Backlog Indicator

Source: Associated Builders and Contractors, Construction Backlog Indicator ⁷ ↓

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Slowing Growth and Other Disturbing Trends

—Continued

Several categories of commercial planning fell, led by a 29% and 11% decrease in the office and warehouse sectors, respectively. Overall commercial planning, which includes offices, retail, hotels and warehouses, dropped 6.6% in March.⁹ ↓

The commercial and institutional planning decline in March follows the AIA's Architecture Billings Index's most recent report on softer business conditions in February. The ABI score has declined every month since October 2022, though its pace of decline remains relatively modest.¹⁰ ↓

Privately-owned housing units authorized by building permits in March were at a seasonally adjusted annual rate of 1,413,000. This is 8.8 percent below the revised February rate of 1,550,000 and is 24.8 percent below the March 2022 rate of 1,879,000.¹² ↓

Construction backlog decreased to 8.7 months in March, its lowest level since August 2022, according to Associated Builders and Contractors.¹³ ↓

DODGE MOMENTUM INDEX (2000=100, Seasonally Adjusted)



Source: Construction Dive ¹¹ ↓

THE MARKET'S MESSAGE

Nonresidential construction backlog, shipping activity, and AIA's ABI all declined in March from the previous quarter. This and residential housing's severe fall have led Dodge Data's Momentum Index to fall in March as well. As headwinds persist, this may be the beginning of a sustained pullback in construction put-in-place. This evidence has yet to result in price reductions.

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Final Thoughts

Nonresidential construction continues to defy the data — contractors are confident, owners are paying ever-increasing selling prices, labor is tight and well compensated, and inflation is coming down. This is a good picture, but some of the foundation is crumbling. Although the industry continues to ignore talk of recession, new starts and backlog are declining, indexes are sagging, and we have yet to realize what the banking scare did to construction. Construction has been resilient throughout this recovery and may very well continue to thrive in the face of increasing headwinds, but most of the nation is expecting a recession in the coming year.

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