DEJA VU ALL OVER AGAIN

Rising input prices are a possible indication of late-cycle dynamics.

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History tends to repeat itself. That is particularly true for construction, which seemingly travels an endless cycle of boom and bust. Trends in construction input prices are no different. A bit more than a decade ago, the County Road Administration Board (yes, CRAB) in Washington State published a report that could have easily described a key element of today's economic reality. The report warned state decision-makers about the growing challenges of rising construction input prices.[1]

At that time, CRAB was able to identify some of the factors that caused construction input prices to spike. Although Hurricane Katrina was more than two years in the rearview window by that point, ongoing efforts to rebuild New Orleans and other impacted areas were drawing resources from the balance of the nation, pulling materials prices higher in the process.[2]

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There were also surging asset prices, with equities, real estate, and other assets rising in value through much of 2007. The peak of nonresidential construction put-in-place would occur the following year, which meant that there was a general demand for materials beyond what was related to storms.[3]

This set of circumstances neatly mirrors those that prevailed for much of 2018. Nonresidential construction spending has been peaking as public construction spending has picked up in light of improved state and local government finances in much of the nation.[4] The country has been wracked with storms and wildfires, and it continues to rebuild from major events impacting Texas, Florida, the Carolinas, California, and other communities. Last year, hurricanes Harvey and Irma combined to cause approximately $200 billion in damage.[5] This year, hurricanes Florence and Michael made their marks on the east coast. Moreover, until stock prices began to wobble in October, many financial assets continued to rise in value, which was correlated with a period of rising commodity and materials prices.

The CRAB report from roughly a decade ago also pointed out that the producer price index for inputs to construction was rising at a significantly faster rate than consumer or general producer price indices. The American Road and Transportation Builders Association (ARTBA) released a report stating that highway and street construction materials prices had increased an incredible 19 percent year over year between June 2007 and June 2008.[6] Certain observed price increases were nothing short of astronomical. ARTBA noted that prices for iron and steel scrap material were up 97 percent year over year, diesel fuel prices were up 85 percent, and asphalt paving and block manufacturing materials were up 14 percent.[7]

While recent construction input price increases have not been as dramatic, materials price inflation has generally outstripped that of the broader economy. According to the most recent data released by the U.S. Bureau of Labor Statistics, construction materials prices were up 7.4 percent in September 2018 compared to the same time a year earlier.[8] A number of the categories that had fueled the runup in materials prices in late 2007 and early 2008 were behaving similarly by 2018. During the year ending in September 2018, iron and steel products were up 12.2 percent, steel mill produce prices were up 18.1 percent, and crude petroleum was up 47.1 percent.[9] Unlike in 2007 and 2008, however, the influence of public policies on materials prices was less apparent. Recent increases in steel and oil prices have much to do with ongoing trade skirmishes and a simmering conflict between the United States and Iran.[10]

The rise in basic materials prices reverberates throughout the construction supply chain. An article published in late June in the *Chicago Tribune* told the story of Mid Continent Nail, one of the country's largest nail manufacturers. The article reported that the company had already seen a 30 percent decrease in orders, which was a result of price increases from tariffs. To offset this, the company laid off a sizable portion of its workforce.[11] Even very large players in construction could not avoid the impacts of tariffs and higher prices. Earlier this year, construction equipment giant Caterpillar announced that it would have to increase prices to help make up for higher input costs. As reported by CNBC, the company indicated that tariffs had added an additional $100 million–$200 million in operating costs.[12]

Sometimes the impact of higher input prices is a combination of higher output prices and shrunken margins. Ken Simonson, the brilliant chief economist of the Associated General Contractors of America, indicated that, "Many of these [input price] increases far outstripped the 4.3 percent rise in the price index for new construction — what contractors are charging to build projects — implying that contractors' profit margins are shrinking as they absorb some of the increased costs."[13]

SHOULD ASSET PRICE WEAKNESS PERSIST, IT IS CONCEIVABLE THAT CONSTRUCTION MATERIALS PRICES COULD CONTINUE TO MODERATE.

That said, the pace of construction materials price increases was actually moderating during the end of the summer. Materials prices fell on a monthly basis in both July and August before rising modestly in September.[14] The recent swoon in U.S. equity prices has been associated with declining oil, natural gas, and copper prices. Should asset price weakness persist, it is conceivable that construction materials prices could continue to moderate. However, it is also important to remember that construction spending is still rising, that trade tensions persist, and that asset prices have buckled on a number of occasions during the current business cycle only to bounce back with tremendous vigor.

Looking ahead

The most likely outcome is for construction input prices to rise moderately in 2019, but that will perhaps happen at a pace that is somewhat more gradual than that experienced for much of 2018. There are many factors to consider.

For instance, some evidence exists that global growth is slowing, including indications pointing to meaningful growth slowdowns in emerging nations such as China, Turkey, and Argentina. While tensions persist between the United States and China, Iran, and other nations, the United States has managed to enter into new trade agreements with the likes of Mexico, South Korea, and Canada. At 2018's onset, it looked like the United States against the balance of the world. Now, it looks like the United States against a subset of nations (although one should not underestimate the economic dislocations that would ensue should the United States and China, representing the world's two largest economies, enter a full-blown trade war).

Financial asset prices have also begun to moderate, which often correlates (but not always) with declining commodity prices. This, in turn, tends to translate into flat to declining construction input prices. The expectation is that monetary policies will continue to tighten in 2019, which translates into higher interest rates. Those higher rates can help pull many asset prices lower, including stocks, bonds, and commercial real estate.

Finally, there is some evidence that the broader U.S. economy has begun to soften. While consumer spending remains strong and should continue to support U.S. economic growth in 2019, business investment has been slowing recently. Should this trend continue, construction starts may not be as pronounced by 2019's second half, which would also tend to exert a moderating influence on construction input prices. ■

NOTES

1 "TAB 18 — Highway construction cost increases and competition issues," County Road Administration Board of Washington (Aug 8, 2008). Available at: http://www.crab.wa.gov/LibraryData/RESEARCH_and_REFERENCE_MATERIAL/Road_Construction/080821HighwayConstructionCostIncreasesAndCompetitionIssues2.doc.

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3 "Construction spending," U.S. Census Bureau. Available at: https://www.census.gov/construction/c30/c30index.html.

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7 *Ibid.*

8 "Producer price indexes," U.S. Department of Labor, Bureau of Labor Statistics (2018). Available at: https://www.bls.gov/ppi/.

9 *Ibid.*

10 "Trade dispute hits construction costs with double-digit aluminum, steel price increases," Bulk Transporter (July 18, 2018). Available at: https://www.bulktransporter.com/fleet-management/trade-dispute-hits-construction-costs-double-digit-aluminum-steel-price-increases; Resnick-Ault, J., "Oil prices higher as U.S. sanctions limit Iran exports," Reuters (Sept 2, 2018). Available

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[13] "Construction cost data shows effect of trade disputes as aluminum and steel costs increase, rate of cost increases hits recent high," Associated General Contractors of America (July 11, 2018) (press release). Available at: https://www.agc.org/news/2018/07/11/construction-cost-data-shows-effect-trade-disputes-aluminum-and-steel-costs-increase.

[14] *Op. cit.* note 8.