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It was a Good Year

By Anirban Basu, *Chief Construction Economist, Marcum LLP*

Economic Expansion Broadened in '18

It would be easy to argue that U.S. economic performance in 2018 was better than it has been in 13 years. While there has been abundant negativity regarding the propriety of tariffs, trade skirmishes, abandonment of various treaties, shifting immigration policy, recently announced layoffs at GM, and rapidly expanding national debt, there can be little debate regarding whether near-term performance has been solid. It has been.

During 2018's third quarter, the U.S. economy expanded 3.5 percent on an annualized basis. Growth this year has been broad-based, encompassing a combination of consumer spending, business investment, and government outlays, including on water systems, transportation, and other forms of infrastructure.

In October 2018, the nation added another 250,000 net new jobs, surpassing the consensus expectation of 190,000 collectively predicted by market analysts. The official rate of unemployment remained at 3.7 percent for the month, effectively the lowest rate since December 1969 when the U.S. was just entering a recession that would last for 11 months.

Construction Market Continues to Expand…

Data released by the U.S. Bureau of Labor Statistics showed that the U.S. construction industry added 30,000 net new jobs in October. The industry added 330,000 net new construction jobs over the prior 12 months, a 4.7 percent increase. Nonresidential construction employment grew by 13,500 net new jobs for the month, with job growth split nearly evenly between the heavy and civil engineering subsector (+7,100) and nonresidential specialty trade (+7,500).

The fact that the U.S. economy continues to perform well should hardly be a secret. The most recent numbers confirm in large measure that which was already known. Namely, that many private employers continue to view the current period as a good one for enterprise expansion. Overall, household finances are in good shape, which helps support overall economic growth, as well as growth in certain sectors, such as hospitality and retail trade. Workers continue to be in high demand, and for many businesses, the greatest challenge is securing sufficient levels of human capital.

Still, the data does supply some new insight into U.S. economic dynamics. This year may very well be remembered as the year that infrastructure investment roared back in America. The most recent nonresidential construction spending numbers released by the U.S. Census Bureau confirmed massive increases on spending related to water supply, flood control, and transit options over the past year. The fact that spending in the heavy and civil engineering segment continues to grow is consistent with ongoing growth in spending on public works. This is attributable to a number of factors, including rebuilding from certain catastrophes that have occurred over the past two years. This is also a reflection of significantly improved state and local government finances as the recovery works through its 10th year.

Joe's View

Perhaps you've seen me use the phrase "cautious optimism" in some of our past quarterly indices. You may even note that I use it often and that's because it is a core discipline of mine. And the funny thing about cautious optimism is that the better the future looks, the more cautious I feel compelled to be. I'm offering this as preface not to be a party pooper but because the Third Quarter Marcum Commercial Construction Index might be the most positive, most optimistic one we've ever produced.

The results reported for our industry are, I am happy (if cautiously so) to say, almost entirely good news. The economy keeps growing and is doing so in areas that directly affect the success of our industry. Infrastructure and noncommercial building are up. Jobs, in general and in our sectors, are up. Backlogs are up. In short, the third quarter looked really good.

Here comes the cautious part: keep an eye on labor costs. Due to the labor demands that this type of growth creates, wages may become pressurized and rise to the point where they begin to erode profit margins. Also, we are not impervious to the power of a softening global marketplace nor the threat of inflation. OK. Now I feel better.

May all of our forecasts to come look as good as this one does right now, but let's all be ready if they don't.

Stay warm and happy holidays,

Joseph Natarelli, CPA
National Construction Industry Group Leader, Marcum LLP

Exhibit 1. *Construction Employment Growth, 20 Largest U.S. Metropolitan Areas October 2017 v. October 2018, Not Seasonally Adjusted*

Rank	MSA	% Change	Rank	MSA	% Change
1	Phoenix-Mesa-Scottsdale, AZ	14.2%	11	Seattle-Tacoma-Bellevue, WA	4.2%
2	Houston-The Woodlands-Sugar Land, TX	11.6%	12	Washington-Arlington-Alexandria, DC-VA-MD-WV*	3.8%
3	Miami-Fort Lauderdale-West Palm Beach, FL	11.2%	13	Philadelphia-Camden-Wilmington, PA-NJ-DE-MD*	3.7%
4	Atlanta-Sandy Springs-Roswell, GA	8.3%	14	San Francisco-Oakland-Hayward, CA	2.9%
5	Dallas-Fort Worth-Arlington, TX*	6.7%	15	New York-Newark-Jersey City, NY-NJ-PA*	1.8%
6	Tampa-St. Petersburg-Clearwater, FL	6.1%	16	Los Angeles-Long Beach-Anaheim, CA	1.5%
7	Chicago-Naperville-Elgin, IL-IN-WI	5.8%	17	Riverside-San Bernardino-Ontario, CA	0.4%
8	Boston-Cambridge-Nashua, MA-NH**	5.6%	18	San Diego-Carlsbad, CA	-0.2%
9	Detroit-Warren-Dearborn, MI*	5.3%	19	St. Louis, MO-IL*	-0.6%
10	Minneapolis-St. Paul-Bloomington, MN-WI*	5.2%	20	Baltimore-Columbia Towson, MD*	-2.6%

Source: U.S. Bureau of Labor Statistics
**Construction, Mining, and Logging are included in one industry.*

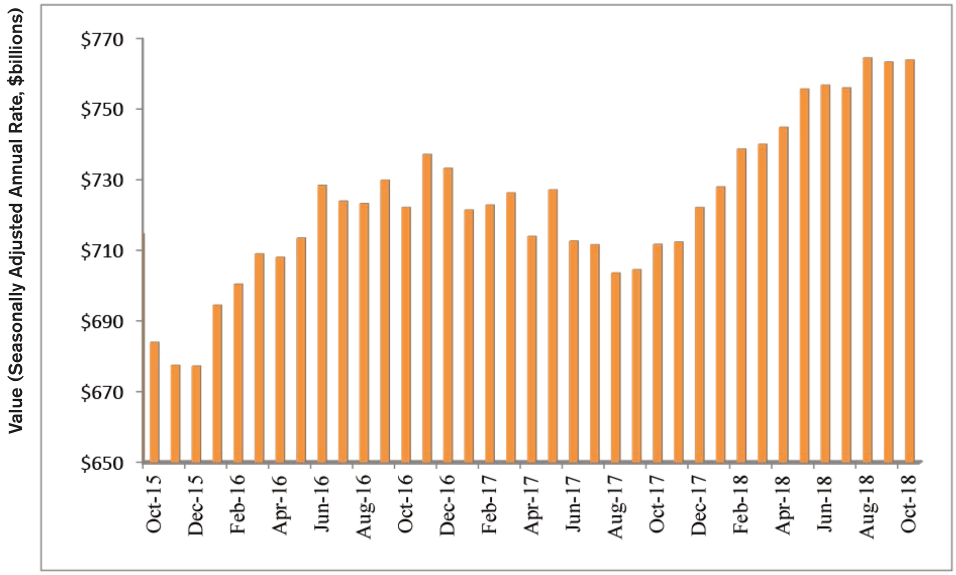
Given the elevated backlog that currently exists in the industry, the expectation is that demand for construction workers will remain elevated. One potential cause for concern is growing evidence that wages have begun to rise much more rapidly as of late. That, along with other sources of inflation, can be expected to push interest rates higher, which in turn would ultimately translate into more expensive financing for construction projects and fewer construction starts. These dynamics could also further suppress industry profit margins. But for now, it is all systems go for the U.S. nonresidential construction industry from the perspective of demand for construction services.

Exhibit 2. *Nonresidential Spending, October 2018, Millions of Dollars, Seasonally Adjusted Annual Rate*

Subsector	October 2018	1-month % Change	12-month % Change	36-month % Change
Nonresidential	$763,782	0.1%	7.3%	10.4%
Lodging	$34,335	1.5%	18.9%	51.5%
Office	$76,024	3.3%	14.8%	28.4%
Commercial	$88,686	-0.2%	1.6%	27.8%
Health care	$42,400	0.0%	-1.0%	5.7%
Educational	$98,891	2.2%	9.0%	15.0%
Religious	$2,960	2.6%	-9.1%	-17.1%
Public safety	$9,547	3.5%	10.3%	-1.0%
Amusement and recreation	$27,877	-0.1%	16.2%	32.3%
Transportation	$53,458	-1.0%	12.5%	18.5%
Communication	$23,863	-0.6%	-4.7%	13.5%
Power	$99,357	-2.2%	8.7%	14.4%
Highway and street	$94,790	-0.1%	5.2%	2.4%
Sewage and waste disposal	$22,222	-1.2%	7.6%	-10.6%
Water supply	$14,165	1.4%	23.0%	0.2%
Conservation and development	$8,105	-8.6%	0.5%	-1.8%
Manufacturing	$67,102	-1.1%	2.6%	-22.9%

Source: U.S. Census Bureau

Exhibit 3. *Nonresidential Construction Spending, October 2015 through October 2018*



Source: U.S. Census Bureau

Along with Broader Economy

Industrial production has been surging, as has capacity utilization. Both white-collar and blue-collar segments have been adding jobs rapidly. Both consumer and business confidence were elevated in 2018, in part due to tax reform passed late last year. As of September, there were 7.0 million available, unfilled jobs in America, nearly an all-time high. According to the most recently available data, there are fewer than 6.1 million unemployed people in America, which means that there are approximately 7 job openings for every 6 job-seekers.

At least theoretically, there is a job for everyone, though job growth has been far more rapid in the American West and South than elsewhere. Among the 25 largest metropolitan areas, the fastest year-over-year construction job growth (October 2017-October 2018) was recorded in Orlando (4.4%). Other communities registering profound rates of employment expansion include Houston (3.9%); Phoenix (3.7%); Seattle (3.6%); Dallas (3.0%); Portland, OR (2.6%); Denver (2.5%); Riverside, CA (2.5%); and Charlotte (2.4%). The slowest growing major metropolitan areas are St. Louis (0.8%), San Antonio (0.9%), and Chicago (0.9%). But the point is that employment growth is apparent in virtually all communities.

Exhibit 4. *Employment Growth, 20 Largest U.S. Metropolitan Areas October 2017 v. October 2018, Not Seasonally Adjusted*

Rank	MSA	% Change	Rank	MSA	% Change
1	Orlando-Kissimmee-Sanford, FL	4.4%	11	Atlanta-Sandy Springs-Roswell, GA	2.2%
2	Houston-The Woodlands-Sugar Land, TX	3.9%	11	Tampa-St. Petersburg-Clearwater, FL	2.2%
3	Phoenix-Mesa-Scottsdale, AZ	3.7%	13	Boston-Cambridge-Nashua, MA-NH	1.9%
4	Seattle-Tacoma-Bellevue, WA	3.6%	14	Baltimore-Columbia-Towson, MD	1.8%
5	Dallas-Fort Worth-Arlington, TX	3.0%	14	Washington-Arlington-Alexandria, DC-VA-MD-WV	1.8%
6	Portland-Vancouver-Hillsboro, OR-WA	2.6%	14	San Diego-Carlsbad, CA	1.8%
7	Denver-Aurora-Lakewood, CO	2.5%	17	Minneapolis-St. Paul-Bloomington, MN-WI	1.7%
7	Riverside-San Bernardino-Ontario, CA	2.5%	17	San Francisco-Oakland-Hayward, CA	1.7%
9	Charlotte-Concord-Gastonia, NC-SC	2.4%	19	Philadelphia-Camden-Wilmington, PA-NJ-DE-MD	1.5%
9	Miami-Fort Lauderdale-West Palm Beach, FL	2.4%	20	Los Angeles-Long Beach-Anaheim, CA	1.2%

Source: U.S. Bureau of Labor Statistics

Despite an uncomfortable level of stock market volatility beginning in October 2018, ongoing signs of a housing market slowdown, recent evidence pointing to a softening of business investment, tightening monetary policy, and a slowing global economy, the U.S. economic outlook for early 2019 looks benign. Growth in gross domestic product has picked up relative to the earlier years of the recovery, partially the result of both confident consumers and business operators.

A variety of domestic leading indicators remains upbeat, including a number related to construction spending such as the Architecture Billings Index and Associated Builders & Contractors' Construction Backlog Indicator. The Conference Board's Index of Leading Economics also signals ongoing momentum as 2018 transitions into 2019.

The Outlook is All about Inflation

Arguably, the most worrisome aspect of the broader U.S. economy takes the form of inflationary pressures. Economists deploy a term called the natural rate of unemployment. When unemployment falls below that natural rate, inflation has a tendency to spike, leading to sharp increases in borrowing costs and softer investment. At 3.7 percent, the official rate of U.S. unemployment is now meaningfully below that natural rate of unemployment. This situation prevailed just prior to the 1980-81 recession, the 1990-91 recession, the 2001 recession, the 2007-09 recession, and now.

It's critical to remember that economic fortunes can change quickly. Many will remember the boom of the late 1990s. That boom was associated with remarkable growth in equity prices, including the now infamous dot-coms. The tech bubble burst during the early months of 2000, and by 2001, the economy was in recession.

Similarly, the economy was humming in 2005, thanks largely to a red-hot housing market. That year, the U.S. economy expanded 3.3 percent, the last time the U.S. economy exceeded the 3 percent threshold. Then the housing bubble burst in earnest during 2006's first half, and by late-2007, the nation found itself in another recession – this time a very deep one.

While that sounds ominous, most economists agree that as of late 2018, recession is not imminent. Much of this has to do with the solid state of affairs characterizing the U.S. labor market, which has not only created job opportunities abundantly, but is now producing more rapid personal income growth. According to the most recently available data, average hourly earnings stand at $27.30, 3.1 percent above its year-ago level.

In response, the Federal Reserve raised short-term rates three times in 2018 through September. Financial markets are pricing in an 80 percent chance of another rate increase in December. At 2017's outset, the prime rate, the interest rate commercial banks charged their customers with the highest credit ratings, was 3.75 percent. At the start of 2018, it had risen to 4.5 percent, and at the time of this writing, it stands at 5.25 percent.

While Federal Reserve Chairman Jerome Powell along with other Fed officials have been indicating a willingness to forestall further rate increases in 2019, burgeoning inflationary pressures may leave policymakers with few options other than to continue to raise rates. The U.S. economy is facing a sea of inflationary pressures at the moment. In addition to wage pressures, there have been rising prices for Chinese imported goods, steel, aluminum, medicines, and tuitions.

True, there are forces pushing in the other direction. The U.S. dollar has been strong in 2018, including against major currencies like the British pound, the euro, the yen, and the Canadian dollar. Lower gasoline prices will also help. Earlier this year, oil was trading at above $70/barrel in North America. As of this writing, oil is selling at barely above $52/barrel.

Looking Ahead

We continue to believe that the next economic downturn will arrive around 2020. The most worrisome aspect of the economy takes the form of inflationary pressures. The recent volatility in equity prices may represent a foreshadowing of the types of asset price dynamics that may characterize much of 2019 and ultimately produce an eventual broader economic downturn. This is of course highly speculative, but recent earnings warnings by large corporations such as Fluor and PPG indicate that some of the shine is coming off of corporate performance and the broader economy. Layoff activity appears to be drifting higher, with a recent announcement by General Motors garnering much of the attention. One of the major vulnerabilities takes the form of significant U.S. corporate debt, which has mounted over recent years due in part to an abundance of stock buybacks.

There is also evidence that the global economy is beginning to soften. This has become especially apparent in Turkey, Argentina, and Italy. The Baltic Dry Index, our favorite global economic leading indicator, has been trending lower recently. The emerging weakness in global activity helps explain why oil prices in North America have recently drifted toward $50/barrel and copper has been trading at less than $2.80/pound. A strong U.S. dollar would tend to reinforce the effects of a weakening global economy by rendering it more difficult for foreign buyers to purchase American goods and services, including both manufactured goods and agricultural commodities. This translates into slower export growth, which also translates into diminished corporate earnings and investment. Indeed, there was some evidence of slowing U.S. corporate spending in the third quarter GDP release.

Still, the consumer spending dynamic remains in full force despite evidence of growing inflationary pressures and a weakening housing market. Given the elevated level of job openings, monthly job growth should remain robust through the first half of 2019. However, thereafter, we expect the economy to soften as it heads toward a more serious slowdown in 2020/2021.

Third Quarter 2018 Performance	Values			% Change from	
Gross Domestic Product (Quarterly % Growth)	**2018Q3[1]**	**2018Q2**	**2018Q1**		
Overall Real GDP	3.5%	4.5%	2.2%	NA	NA
Nonresidential Fixed Investment in Structures	12.0%	-0.5%	9.6%	NA	NA
Construction Spending, SA ($Millions)	**Oct-18**	**Sep-18**	**Oct-17**	**Sep-18**	**Oct-17**
Total Construction	$1,308,848	$1,310,806	$1,247,531	-0.1%	4.9%
Residential	$545,066	$547,638	$535,936	-0.5%	1.7%
Nonresidential	$763,782	$763,168	$711,595	0.1%	7.3%
Lodging	$34,335	$33,824	$28,868	1.5%	18.9%
Office	$76,024	$73,569	$66,235	3.3%	14.8%
Commercial	$88,686	$88,886	$87,330	-0.2%	1.6%
Health care	$42,400	$42,418	$42,811	0.0%	-1.0%
Educational	$98,891	$96,805	$90,743	2.2%	9.0%
Religious	$2,960	$2,886	$3,255	2.6%	-9.1%
Public safety	$9,547	$9,223	$8,655	3.5%	10.3%
Amusement and recreation	$27,877	$27,905	$23,985	-0.1%	16.2%
Transportation	$53,458	$54,024	$47,516	-1.0%	12.5%
Communication	$23,863	$24,011	$25,027	-0.6%	-4.7%
Power	$99,357	$101,564	$91,432	-2.2%	8.7%
Highway and street	$94,790	$94,851	$90,100	-0.1%	5.2%
Sewage and waste disposal	$22,222	$22,483	$20,651	-1.2%	7.6%
Water supply	$14,165	$13,971	$11,513	1.4%	23.0%
Conservation and development	$8,105	$8,866	$8,067	-8.6%	0.5%
Manufacturing	$67,102	$67,882	$65,409	-1.1%	2.6%
Employment, SA (in thousands)	**Oct-18**	**Sep-18**	**Oct-17**	**Sep-18**	**Oct-17**
National Total Nonfarm	149,750	149,500	147,234	0.2%	1.7%
Construction	7,318	7,288	6,988	0.4%	4.7%
Residential building	802.6	799.8	751.2	0.4%	6.8%
Nonresidential building	814.7	815.8	792.3	-0.1%	2.8%
Heavy and civil engineering construction	1,036.1	1,029.0	984.1	0.7%	5.3%
Residential specialty trade contractors	2,053.3	2,039.5	1,961.2	0.7%	4.7%
Nonresidential specialty trade contractors	2,611.6	2,604.1	2,498.8	0.3%	4.5%
Producer Price Index, NSA [2]	**Oct-18**	**Sep-18**	**Oct-17**	**Sep-18**	**Oct-17**
Finished Goods (SA)	116.0	115.3	112.1	0.6%	3.5%
Inputs to Construction Industries	236.3	235.2	219.1	0.5%	7.9%
General Contractors (New Nonresidential Building Const.)	111.3	109.7	107.0	1.5%	4.0%
New Nonresidential Building Construction (U.S.)	112.7	110.5	107.4	2.0%	4.9%
Northeast	113.4	110.6	108.0	2.5%	5.0%
South	112.2	110.1	107.3	1.9%	4.6%
Midwest	110.3	108.3	105.9	1.8%	4.2%
West	114.9	113.0	108.3	1.7%	6.1%

Source: U.S. Bureau of Economic Analysis; U.S. Census Bureau; U.S. Bureau of Labor Statistics.

[1] *Advance (1st) Estimate.*

[2] *The **Producer Price Index (PPI)** program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. All figures are indexed from a base year, that base year being different for each individual index.*

[3] *SA: Seasonally Adjusted. NSA: Not Seasonally Adjusted.*

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We are frequently retained to provide expert witness services relating to the value of a business; loss of a business or segment of a business; determination of reasonable compensation; and other financial matters. Our professionals are often court appointed or jointly retained by the parties involved in a dispute. In addition, our experts are regularly invited to peer and legal conferences to teach, and regularly publish in top industry journals.

- Business Valuations
- Litigation Support
- Financial Forensic Investigations
- Marital Dissolution

Joseph Natarelli

Joseph Natarelli is the national leader of Marcum's Construction Industry Practice and an office managing partner in New Haven. For more than a decade, he has served as a technical reviewer for the AICPA's Audit Risk Alert for Construction Contractors and the AICPA Accounting Guide – Construction Contractors. Joe has also chaired the annual AICPA National Construction Industry Conference.

Anirban Basu

Anirban Basu is Marcum's chief construction economist. He is also a member of the Firm's National Construction Practice, as well as chairman & CEO of Sage Policy Group, Inc., an economic and policy consulting firm in Baltimore, Maryland. Anirban leads Marcum's research and analysis of the economic health of the commercial construction industry in America. Additionally, he writes the quarterly Marcum Commercial Construction Index and annual Marcum JOLT Survey analysis and is a keynote presenter at the Firm's construction industry summits.

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