

Good morning, everybody. Dennis Engelbrecht, I guess on our encore series of Digging Deeper.

The question most people have been asking me and wondering about is where is the economy going? Where's the construction economy going? So thought I'd weigh in on that a little bit.

First of all, let me look at my crystal ball. Well, maybe just ... Nobody's crystal ball is going to be perfect when we try to forecast the economy going forward. Certainly, the Fed and everybody else who is paid to do this as a living, nobody knows exactly what's going to happen, but they do their best to try to keep the economy moving along at a moderate pace and controlling inflation as they're supposed to do.

First of all, let's start with the construction economy and where we've been. Where we've been is really an unbelievably fantastic place. Construction industry profits, first of all, are in record territory. They've never been this high. And they've been this high in record territory for five, six consecutive years now. Construction's really in a great place. I guess the downside of that is we're in a cyclical industry and what goes up does come down it. It's illogical to think that it's going to stay up forever. But as well as we're doing right now, I mean, if profits fell to half, they'd be at their normal industry cyclical highs. That's how well we've been doing in construction. We've been doing fantastically. So even if it comes down a little, that's not doom and gloom in any way. 12 years of growth and record profits, that's a pretty good place.

Let's talk about the general economy because construction, certainly commercial and institutional construction, is a laggard of the general economy, generally. In the various down cycles, if you take the last 15 or 20 down cycles, construction has been a laggard by 3 to 24 months, anywhere in there. We usually follow a downturn of the general economy.

Most people think there will be a recession this year in 2023, and some think it may already be beginning. Certainly, if you look at the PMI and other sorts of business activity measures, they're starting to turn to the negative right now. There is a decent chance we're going to be in some sort of slowdown here.

If you looked at all the various prognosticators out there, they probably see '23 as a year of zero GDP growth overall, which probably means some growth, then a recession, then some growth, or maybe we're in a recession now on some later growth, or we grow a little bit in the first part of the year and the second year blah on them.

We're kind of looking at blah. Any way you cut it, that's kind of what everybody sees. There aren't very many people predicting a real serious recession outside of for Great Britain, by the way. Great Britain's not looking really good, but Europe's kind of in the same place. They're muddling along, may already be in a mild recession, but some of their indicators are starting to look a little bit better. And China has opened up, so that helps the global growth picture quite a bit because China is both a big producer and a big consumer, so them opening from their COVID shutdowns is a big factor positive for the world economy and for the US economy. That's probably the good side of that. General economy looking pretty blah, and that's likely to hit construction later, perhaps late '23 or into '24.

Now, there are wild cards out there. Of course, one of the big wild cards is still the Fed tightening by raising interest rates. Interesting thing, I just went back yesterday and looked, but our current interest rate, and even if they go up a quarter of a point is expected here in the next few days, that still leaves us below average. If we look over the last 60 years, interest rates set by the Fed, the federal funds rate, is still below the average of the last 60 years. So, we're not at some crazy place in this effort to stop inflation, but they are continuing to creep up there, but it's still pretty moderate.

We know already that's had an effect on housing, particularly single-family housing and single family housing, of course, is sort of dropping like a rock both in terms of permits as well as construction put in place. That probably is going to continue here for a little while, but that also has already stopped the high inflation on the cost of housing, so that side of it's a positive.

Again, if we look at permits, even though they have been falling through the course of this last year, this last year was really a very high place for permits if you look at it versus other years. Even on a monthly basis, we're only down, again, to about the average of the last 60 years. So, permits, while they've been plummeting, are not down so low that, again, they're huge drag on the economy and the economy going forward. Those are all sort of middling things.

Now let's look back at commercial and institutional construction. Before the pandemic hit, we were already in a slowdown in construction and construction in '20 and '21 both were pretty much flat with just very, very little growth over those two years.

Now, '22 had very substantial growth in commercial and institutional construction, but most of that was probably driven by inflation. There are no certain measures of how much of that growth, which looks to be in the 8% to 10% area, depending exactly what measures you use, but '22 grew substantially, and we don't really know how much of that was really just price growth. But one of the great indicators around that, by the way, is the Portland Cement Association and they measure how much cement has been sold. And basically, last year was pretty much flat in terms of the amount of cement used. And, by the way, they're predicting a downfall in the sales of cement for '23, but we still have sort of an inflation driven construction backlog out there, so it looks like '23 could be a good year for construction. Most people are seeing it as a very good year for construction and a lot of growth, but a lot of that still may be inflation driven. In fact, not doing more construction but doing more dollars of construction. And that's kind of what it looks like '23 has to hold for us.

Now, what about the other leading indicators out there? What are they showing us? Well, probably the most prominent indicators out there come from Dodge in terms of the Dodge Momentum Index and the Dodge Starts Index, and both Dodge Starts and Dodge Momentum have been running in record territory, and even as of the last month, we've seen substantial growth in both of those indexes.

Now those are generally seen as nine to 12 months into the future, so that growth that they're seeing is probably already baked in in a sense for '23. So '23 looks like a good year overall for commercial and institutional construction.

Now, the Architect's Billing Index has shown weakness here over the last quarter, and billings for architects have declined over the last quarter, and that also is another nine to 12 months sort of leading indicator. So if you believe that index, you would see some softness come in by the end of '23.

Now, our own leading index does show strength through '23 and even into the first quarter of '24 with construction then slowing. When I say construction slowing, if we looked at '24 as a whole and what it looks like from our viewpoint, it still looks like very slight growth in '24, but the latter part of '24 is definitely softening and starting to move into decline.

That decline, by the way, is very, very moderate, which is why the year as a whole still looks to be positive for '24 from our viewpoint. But the second half of that year, definitely in a downward trend. But we're not talking about anything near or the great recession where construction and institutional construction fell by 32%. What we're looking at is maybe a peak to trough fall of 4% or 5%, which is almost nothing in the big scheme of things, especially if you go back to where we started, we're at record profitability right now, and we've been in 12 years of growth. If you look from that standpoint, a year where we have a moderate pullback of 3% or 4% or 5% really shouldn't even hit the competitiveness that greatly that we see a great fall in profitability or great fall in revenue for the industry. We just don't see that happening with what's in front of us now.

Of course, we've got, I should say, it really depends on who you are in terms of what work you do in construction, where you are, because it's not the same economic outlook for everybody. The government support for construction, infrastructure, chips, manufacturing, we've got a record amount of government support out there in the market, still most of it yet to come. If you're in the government institutional type sectors, those look very, very strong going forward.

Likewise, if you live in the south, largely driven by people migration, which again has been going heavily to the south, there's more activity in the south. Things are still going better. To some extent out west as well, the coastal areas. But maybe not so much up in the Northeast and the Midwest, although a lot of that infrastructure spending is strong in those areas. The true commercial type of spending is where we might see a larger drop, the things that are really driven by interest rates, driven by housing, those areas, if you're sensitive to those, and I hesitate to say it and hate to say it, but really the smaller companies could feel the downturn a little bit more than the larger companies. Most larger companies I've talked to, they're already set through '24, they've got their backlog, at good profits I might add, that's already sort of baked in for them.

The biggest thing is don't panic, and I should come back to people. Right now, unless construction falls in some dramatic way, the fight for people is probably going to remain the same. People are going to be tight. By the way, that's not a total negative because as long as people are constrained in construction, that's going to keep us from getting to this hyper-competitive world where we're fighting over what little work is in the market. That helps keep margins up and that helps keep profitability up.

Again, as we look to '24 and possibly even into '25, we may have some softness out there that may hit some of you worse than others, but we don't expect it to be anything like you've experienced in the last recession, which was the Great Recession. I should say, the last major recession, we had that minor COVID blip, but that really was so short-lived that it hardly even counts.

I think things are looking good going forward. Certainly, you need to be, depending on where you are in the market, looking at your strategy and looking at what you face, but generally speaking, feel very positive for construction going forward.

Again, Dennis Engelbrecht, Digging Deeper. Thanks for tuning in.