Nearing A Tipping Point

Some Fed policymakers and market participants view a tight labor market as a sign that recession risk is still relatively low. After all, the unemployment rate fell a tenth last month to 3.5%, matching its cyclical low. Historically the unemployment rate is a leading indicator ahead of a downturn. Every time in the past when the unemployment rate had increased 60 basis points (bps) from its trough, the economy was either in recession or about ready to enter one. This time is unlikely to be different because the labor market is on the cusp of a substantial pullback in construction employment. A downturn in construction alone may be enough to tip over the economy.

The chart below shows the year-over-year growth rate in real total construction spending versus total construction employment. Both series capture activity in both the commercial and residential sectors. Over the last four quarters, construction spending is down a sizeable 11%, which is the weakest pace since Q1 2010 (-17.5%) when the economy was slowly emerging from the 2008-09 housing crash. At present, construction employment remains robust despite the large decline in construction spending. Can this continue? No.

Through Q3 2022, the latest quarter for which inflation-adjusted construction spending is available, there is a massive 15 percent point gap between spending and employment. This is the largest difference since Q4 1951 (-18.1%). When spending has been negative and a large divergence in the two series ensued, ultimately it was employment that collapsed. This is what we expect in the months immediately ahead, and it should significantly push up the unemployment rate.

According to our calculations, construction employment should be 741k lower in Q3 2022 than what the jobs data show. This alone would push up the unemployment rate by 45 bps. Further declines in construction spending are likely to be seen both last quarter and in the current quarter. In fact, construction specific job losses should approach 1 million. This is easily enough to push the unemployment rate well above 4%. Of course, there would be additional negative knock-on effects from construction-related job declines. Consequently, the fact that the labor market more generally and the construction sector in particular look healthy should not brighten the near-term economic outlook.
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