

Economic Environment

Review of 2002 by Al Schuler

There is no better time than now to review the key economic trends of 2002. These trends are interrelated and each has major impacts on the wood products industry. The trends are consumer spending and housing, business investment, overcapacity, consolidation, inflation and interest rates, and the correction in the stock market. This discussion will provide the basis for the next column in the January/February 2003 issue of SBC Magazine, in which I will offer thoughts on what to expect in 2003.

The U.S. economy experienced a mild recession during the first three quarters of 2001, triggered by a massive pullback in business investment spending and a moderate slowdown in consumer spending that has continued through 2002. The Fed reacted to the economic slowdown by lowering interest rates and keeping them low throughout 2002, thus driving mortgage rates to their lowest level in almost 40 years. The recession was exacerbated by an equity market correction that began in March 2000, and continues today, resulting in a 78 percent value reduction in the NASDAQ and 30 percent fall in value of the Dow Jones Industrials during this period. These declines made residential real estate an attractive alternative to the equity markets. Combined with record low mortgage rates, relatively stable job markets and favorable demographics, housing markets were strong throughout 2002. Indeed, if it were not for the strong housing market in 2002, the economy probably would not have recovered as well as it has. The real story of 2002 has been the housing boom in the U.S. and the support it provided to the rest of the economy.

Unfortunately, the pricing environment for some wood products during this period has not been good due to oversupply in some basic commodities such as lumber and structural panels. Coincidentally, this is a condition the wood products industry shares with most other

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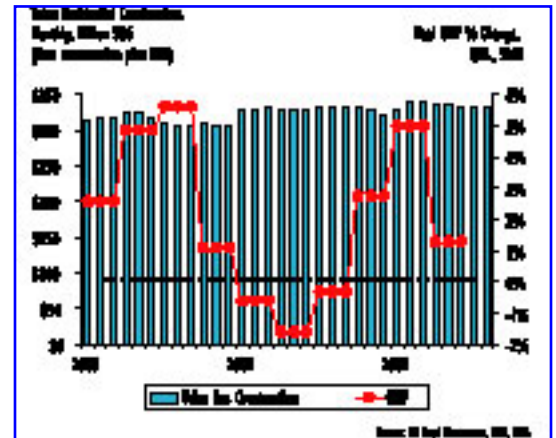


FIGURE 1. RESIDENTIAL CONSTRUCTION REMAINED HEALTHY THROUGH THE RECESSION IN 2001 AND WAS THE MAIN SUPPORT FOR THE RECOVERY DURING 2002.

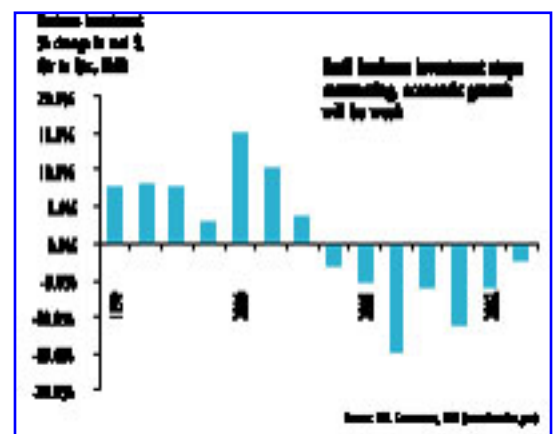


FIGURE 2. BUSINESS INVESTMENT SPENDING HAS FALLEN PRECIPITOUSLY.

commodities such as steel, copper, aluminum, computers and semiconductors, telecommunication equipment, hotel space, automobiles, and many other products and services. This is essentially the result of the “overinvestment boom” of the late 1990s. Correcting the imbalances via consolidation and restructuring will take time.

TREND #1: THE HOUSING BOOM

Housing remained healthy throughout 2002 for several reasons:

- It was the main beneficiary of the Fed rate cuts.
- It benefited from weak equity markets as many Americans switched investment funds from stocks to housing (new housing, resales, remodeling and vacation homes).
- Demographic changes were very supportive.

The U.S. was not the only country experiencing a housing boom. Australia, Canada, the UK, Korea and Spain are displaying strong housing demand and significant gains in real estate prices (David Ingram, Dismal Scientist, 8/22/02). Common themes were quite apparent—relatively stable labor markets, low interest rates and generally weak equity markets, which encouraged surplus liquidity to flow into real estate. Consumer spending slowed some in response to the economic slowdown; however, disposable income was enhanced as many homeowners tapped into home equity (via refinancing), providing extra monthly income as much as several hundred dollars per household.

TREND #2: BUSINESS INVESTMENT

The sharp pullback in business investment was the immediate cause of the recession, and until businesses see fit to reinvest, the current recovery will be slow and tentative (Figure 2). Historically, business investment constitutes about 12-13 percent of gross domestic product (GDP), but during the late 1990s, it accounted for about 18 percent. The end result was overcapacity in many industries including wood products. Overall, capacity utilization remains below 80 percent, and until utilization improves (above 80 percent), businesses will refrain from hiring, keeping the employment situation relatively flat in the coming months. Utilization rates were even lower in other sectors. For computer technology and communication equipment, utilization rates fell below 70 percent, and in the metals and aluminum industry, it remains below 60 percent. Additionally, solid wood products are not immune to these low utilization rates, as 25 percent of capacity is now idle. Business investment plans have also been negatively impacted by the equity market weakness, and by the slew of market related scandals. In essence, we have too much supply and too little demand for many products, which is a proven worldwide problem. The solution is rebalancing the markets via restructuring and consolidation—a slow process that is already taking place in several industries: computer (HP/Compaq merger), airline (U.S. Air bankruptcy), telecommunications (massive layoffs by Nortel and Lucent), and wood products (Weyerhaeuser/Willamette merger, LP's restructuring, GP's reorganization).

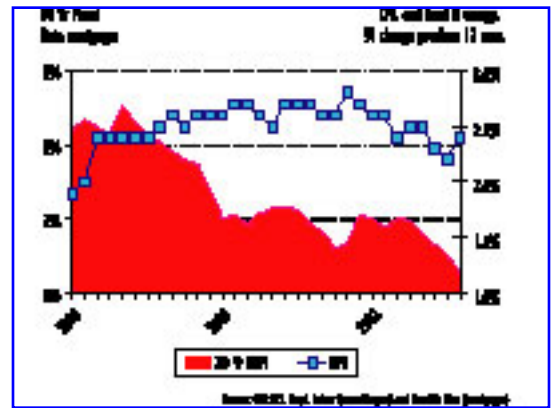


FIGURE 3. INFLATION REMAINS A NON-ISSUE AND THIS MEANS LOW INTEREST RATES

TREND #3: INFLATION & INTEREST RATES

Inflation has been a non-issue due to solid productivity increases, a strong U.S. dollar, and overcapacity, which limits pricing power for most products and services. Of course, the economic slowdown has contributed to lower inflation pressure by reducing overall demand. Inflation is expected to re-main benign for some time, barring more terrorist attacks, war or a precipitous fall in the value of the U.S. dollar. However, as the economy improves, the Fed will be raising interest rates, and the future direction for inflation will be upward although most analysts expect moderate upward movement.

TREND #4: EQUITY MARKETS

Equity markets have fallen mercilessly since their highs in 2000. To date, the correction hasn't significantly impacted consumer spending although it has probably delayed business investment, and will continue to do so until corporate profits improve. Many Americans have simply elected to "sit it out" or "remain pat," and have not changed their 401K or IRA plan allocations during the correction. However, if equity markets continue to fall or remain at current levels for another year or so, consumer confidence and spending may eventually be affected simply because a higher percentage of Americans (over 50 percent) have market holdings in 401K or IRA funds in comparison to less than 30 percent a decade ago.

Realistically, we shouldn't have expected a strong economic recovery in 2002 because the recession in 2001 was short and shallow. Therefore, there was little pent up demand to propel a recovery, as has been the case in past upturns. Historically, the Fed lowers interest rates when the economy slows, and this supports stronger housing activity and consumer spending in general. However, this time, housing never slowed down and consumer spending slowed only moderately. During 2002, we have seen modest and uneven growth, and that means the economy is vulnerable to shocks: additional acts of terrorism, the possibility of a war in Iraq, an oil price spike, or a precipitous fall in the dollar (plausible if foreigners lose confidence in the U. S. recovery). Furthermore, global growth is weak: Japan is in a recession, Germany is close to recession, and South America's largest economies are in trouble (Argentina and Brazil). In fact the only bright spots are among the countries of mainland Asia, Canada, Australia and South Korea. Most analysts don't expect a "double dip" recession, however, the recovery will remain sporadic and uneven until business investment strengthens; that won't happen until factory utilization rates improve.

The key to a healthy economy in 2003 is continued consumer spending through 2002, and a return of business spending. Both depend on confidence—consumers and business leaders—and the key to confidence is the need to instill trust back into the equity markets and strong leadership from political figures. This will foster a healthy housing market in 2003, and provide a strong foundation for resumption in business spending which is needed to get the economy back to trend growth (3 to 3.5 percent).

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