STRUCTURAL BUILDING COMPONENTS MAGAZINE
March 2004

Economic Environment

Ecnonomic Outlook for 2004: Balanced Growth Supports Best Outlook in Four Years Despite "Jobless Recovery" by Al Schuler

The forecast calls for sunny skies and steady growth, with only a few dark clouds to keep an eye on.

The economic outlook keeps looking better with each passing month. Inflation is expected to remain tame through much of 2004, thanks to productivity increases and lots of unused capacity, both of which help to keep a lid on prices. Following three years of uneven and sub-par growth, most analysts expect stronger and more balanced growth in 2004 (Figure 1). The main drivers over the past several years—consumer spending and residential construction—are expected to remain healthy, while business investment (capital spending) builds on last year's turnaround from contractions in 2001 and 2002 (Figure 2). Capital spending is improving because the important manufacturing sector is finally on the mend again. The ISM Manufacturing Index (formerly Purchasing Manager's Index) rose above 60 for the first time since 1987 (www.ism.ws/ISMReport/index.cfm). In fact, it has been above 50, which indicates an expanding manufacturing sector, for six months now.

Another indicator, the industrial production index, has been improving since March 2003, suggesting that businesses have finally worked through most of the excesses that led to the recession, and are now spending and investing again. Finally, capacity utilization is now back to 76 percent, its highest rate in more than a year. For the economy to get stronger, better balance is critical to avoid overheating in other sectors (e.g., housing), hence the importance

CLICK ON IMAGE FOR LARGER VIEW

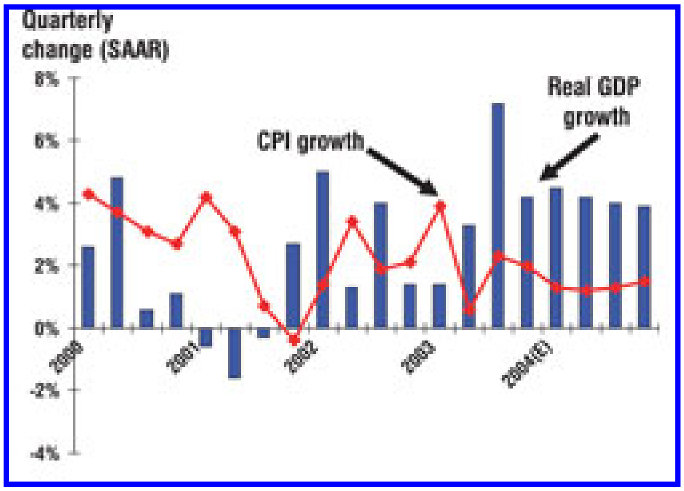

FIGURE 1. STRONG FUNDAMENTALS. (SOURCE: NAHB JANUARY 2004)

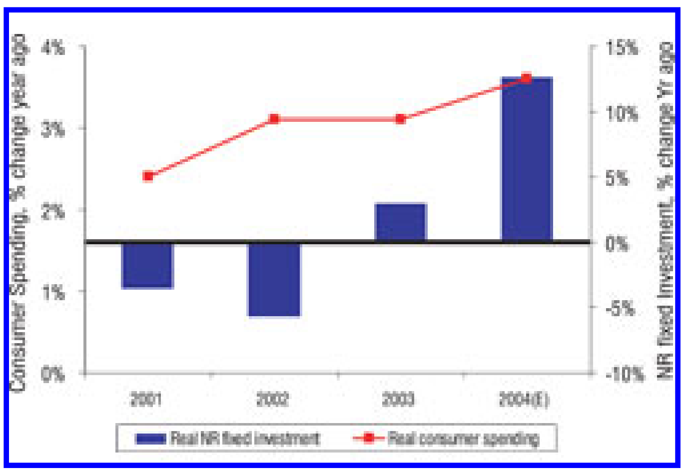

FIGURE 2. BETTER BALANCE AS BUSINESS INVESTMENT SPENDING RESUMES WHILE CONSUMER SPENDING CONTINUES. (SOURCE: FORECAST - www.economy.com - "2004 MACRO OUTLOOK")

for business spending to resume. Rising home values and falling interest rates pushed the housing sector to record levels (dollar value of fixed residential investment), while 40-year lows in mortgage rates encouraged many home owners to refinance and cash out some of their housing wealth. This supported strong consumer spending despite a weak job market which has failed to generate any net increase in employment over the past two years.

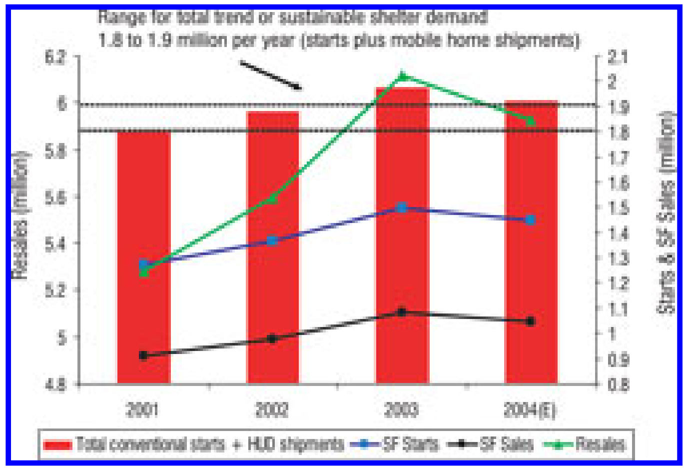

FIGURE 3. HOUSING TRENDS - MODERATE SLOWDOWN IN 2004 (FORECASTS - NAHB FOR STARTS AND NATIONAL ASSOCIATION OF REALTORS [NAR] FOR SALES AND RESALES).

The Fed has indicated it will keep short term rates "accommodative," citing lack of price pressure, although the bond markets will force longer term rates upward in fear of "building inflation in the pipeline." The main issues going forward (besides potential terrorism), are the drag of higher interest rates on the economy and the potential for a continuing "jobless recovery." The concern is that the recovery will not be strong enough to create the number of net new jobs required to bring the unemployment rate down. In addition, with global outsourcing and the potential for better productivity with new equipment and/or software, businesses may be more reluctant to hire new employees, particularly with weaker pricing power resulting from overcapacity (and global competition) in so many industries. One source of potential inflation (and higher interest rates) is the slumping dollar. During the past three to four years, the U.S. was the major source of world economic growth, contributing almost half of the world's growth in GDP. This, plus strong productivity, supported a much stronger and overvalued dollar despite record trade deficits and historically low interest rates. Although it has fallen almost 20 percent against our major trading partners over the past 18 months, many feel the slide is not over. The concern is if it slides too fast, foreign investors may lose their appetite for dollar denominated investments, and that would force interest rates upward to attract foreign investment needed to balance the trade deficit, which many feel has become structural (i.e., long term, and not cyclical).

HOUSING OUTLOOK

Surging home prices have sparked fears of a housing collapse, but widespread price declines are unlikely as home prices in most areas (exceptions include Seattle, Boston, New York City, San Francisco, San Diego and Washington D.C.) have increased in line with income growth (State of the Nation's Housing 2003, Joint Center for Housing Studies of Harvard). Longer term, the housing outlook looks solid for the rest of this decade, supported by sound demographics, strong immigration, and attractive mortgage rates. However, in the short term (12-18 months), we could see some pullback simply because the supply of housing during the second half of 2003 (conventional and HUD code) averaged 2.07 million (SAAR), exceeding sustainable demand (sometimes called trend demand) by about 200,000 units on an annual basis.[1]

The strengthening economy will bring higher interest rates, with the 30-year conventional mortgage approaching seven percent by year end (NAR). However, the improving job market and tax cuts will help to compensate with the end result being a modest pullback in residential housing activity (Figure 3).

CONCLUSIONS

The U.S. economy is in much better shape than it was just six months ago. The job market has stabilized, businesses are investing again, the resilient consumer keeps spending, and interest rates remain tame, thus supporting another good year for housing. Furthermore, inflation remains a non-issue for the time being, as the "jobless recovery" and excess capacity in the U.S. and other parts of the world (plus globalization trends like off-shoring of manufacturing to low cost countries) keep a lid on many price and cost increases. Although the improving economy will nudge interest rates upward, a slowly improving job environment should compensate, thus boosting consumer spending. The main concerns, other than geopolitical/terrorism, are the slumping dollar, the record trade deficit and employment. Overvalued for much of the past five to six years, the dollar is now undergoing a much needed correction. However, the trade deficit must be "balanced" by foreign direct investment, and a weaker dollar makes that more challenging. The consensus is that the dollar will not plunge because that would have dire consequences for the world economy, and that the world's central bankers will do what is necessary to insure an orderly correction, thus insuring a stellar 2004 for the U.S. and, therefore, the world economy. Most analysts don't expect strong job growth until later in 2004. In fact, we need a sustained monthly pace of at least 150,000 net new jobs to bring down the unemployment rate, and that isn't expected until 2005 (www.economy.com).

---

[1]Trend demand consists of three components: net household formations (demographics and immigration), estimated obsolescence of existing housing stock (demolition of older homes), and building for the vacation or second home market (Celia Chen, http://www.economy.com/dismal/pro/article.asp?aid=2557). Consensus estimates (RISI, Economy.com, NAHB) put trend levels at 1.8 to 1.9 million per year calculated as follows: net household formation = 1.2-1.3 million; demolition = 350,000 to 400,000; second homes = 200,000 to 250,000).

Al Schuler works for Forestry Sciences Lab in Princeton, WV. Please note that the economic information/opinions contained in this article are not necessarily those of the USDA Forest Service. Dr. Schuler can be reached at 304/431-2727 or aschuler@fs.fed.us.

SBC HOME PAGE

common interests of those engaged in manufacturing and distributing of structural building components to ensure growth and continuity, and to be the information conduit by staying abreast of leading-edge issues. SBC will take a leadership role on behalf of the component industry in disseminating technical and marketplace information, and will maintain advisory committees consisting of the most knowledgeable professionals in the industry. The opinions expressed in SBC are those of the authors and those quoted solely, and are not necessarily the opinions of any of the affiliated associations (SBCC, WTCA, SCDA & STCA).