

GOOD

VITAL SIGNS

By
Henry Spelter

The economy as it pertains to the lumber industry remains healthy, but the flu is always lurking.

Party on or last hurrah? A year ago the answer was relatively easy: Let the good times roll! Now, post election in a maturing recovery, it's less clear cut. Nonetheless, recent fears by some that the outstanding economic environment that existed for lumber in 2004 is passé seem premature. Recent trends contrasted with the 1972-74 experience, a period that shares many commonalities with the present, support this view.

Under way since 2002, the economic recovery continues. U.S. Gross Domestic Product completed its second straight year of 4% growth with no letup in sight. This reflects two powerful forces: strong fiscal stimulus in the form of tax cuts and spending increases manifested in large budget deficits (Figure 1); and aggressive monetary measures evident in extremely low and, in real terms, negative interest rates (Figure 2).

A clear difference between 1972-73 rates and the present is that, despite the doubling of the federal funds rate, its real level remains extremely low. The reason is rising inflation, which offset the increases (Figure 3). And, with the central bank's assurances that future rate changes will be "measured," coupled with continued foreign recycling of dollar reserves into longer term U.S. debt, longer term rates have thus far not risen at all and thus have actually fallen in real terms.

This environment is supportive of real estate. Housing starts are apt to continue at their recent pace, thus assuring lumber and panel producers of continued strong demand (Figure 4). These good tidings are reflected in year end lumber prices, which, after skirting with break-even levels in the fourth quarter, rallied as dealers began to restock inventories. Comparison with 1973 suggests considerable upside potential in prices in the first half of 2005 (Figure 5).

A measure of caution suggested in Figure 3 is growing inflation. The headlong pace of the recovery, rising capacity utilization, reductions in unemployment and worldwide demand for commodities are increasing cost pressures and restoring some pricing power to producers. Left unchecked, these trends could extend inflation—already evident in assets and to some extent in services—togoods.

One manifestation of concern over these developments is the course of exchange rates (Figure 6). As in the 1970s, the U.S. dollar has been faltering against major currencies. Should the slide accelerate, more vigorous measures to head off possible financial crises are probable. Most likely to change

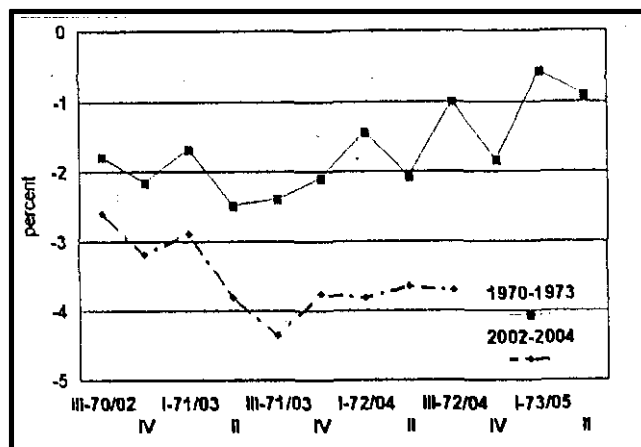


Figure 1: U.S. federal government deficits as a percentage of GDP

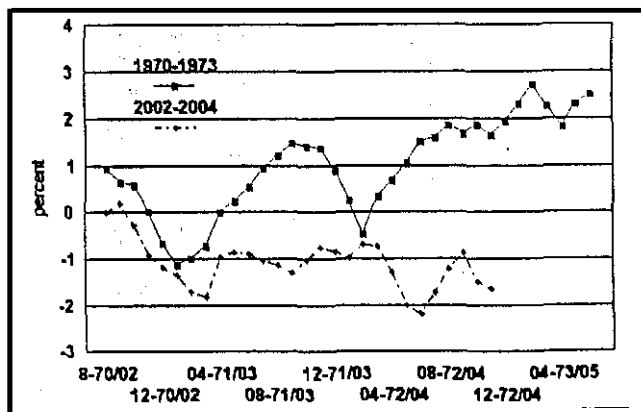


Figure 2: Interest rates on federal funds less yearly change in consumer price index

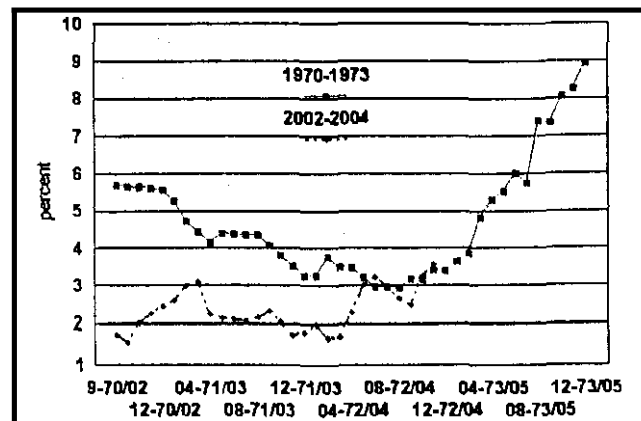


Figure 3: Year over year percentage increase in the consumer price index

would be monetary policy, with the “measured” pace of rate increases replaced by more drastic hikes, as happened in the 1970s (Figure 2). Longer term rates, insulated till now by reassurances of minimal monetary tightening, would then likely rise.

That raises questions about the longer term durability of the housing boom. Home building has been exceptionally strong and home prices have appreciated substantially. This makes homes a major savings vehicle in the U.S. where normal savings are, in the aggregate, small and falling. Even a decline in the rate of appreciation in home values would undermine this savings function and force reductions in consumption in order to make up for losses in wealth. This could usher in problems for an economy that depends highly on consumption for growth.

Despite some regional excesses, home prices in general may not be out of line relative to current low mortgage rates. However, if present rates are unrealistically low, then home prices could also be vulnerable. Again, comparison with 1973 sheds light on this possibility (Figure 7). Firstly, the present rate of price appreciation is not out of line with what occurred previously. Secondly, even though rates rose in 1973, home prices merely flattened a year after the tightening and then only temporarily. Thus, given the amount and duration of monetary tightness normally seen in U.S. business cycles, prolonged deflation in home prices is unlikely. On the other hand, 1973’s experience illustrates the possible effects on home construction, which fell dramatically (Figure 4). However, deregulation of savings institutions (e.g. elimination of interest rate ceilings banks can pay on deposits) and innovations in mortgage financing (e.g. variable rate mortgages) since the early 1980s are likely to better protect the flow of funds to housing in the event of higher interest rates.

Still, how interest rates evolve will be decisive in housing’s future. U.S. interest rates will be influenced by a backdrop of international issues. Among these are major financial imbalances that exist in the world economy characterized by excessive consumption

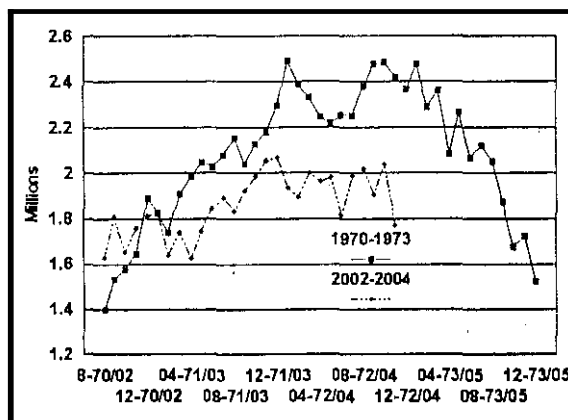


Figure 4: Monthly new housing starts (seasonally adjusted)

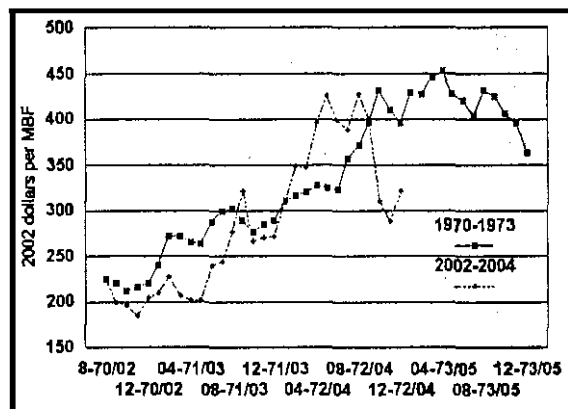


Figure 5: Spruce price (base rate); 1970-1973 compared with 2002-2004.

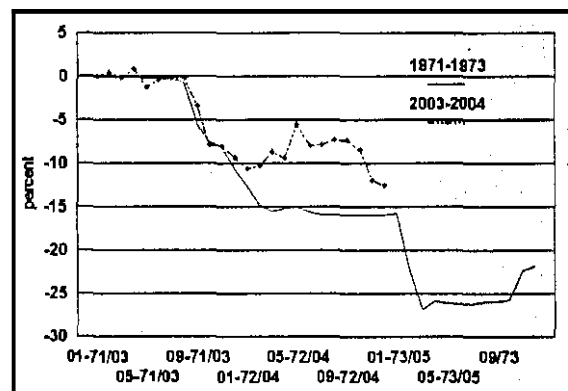


Figure 6: Yen/dollar exchange rate (Jan 1971/2003 = 0)

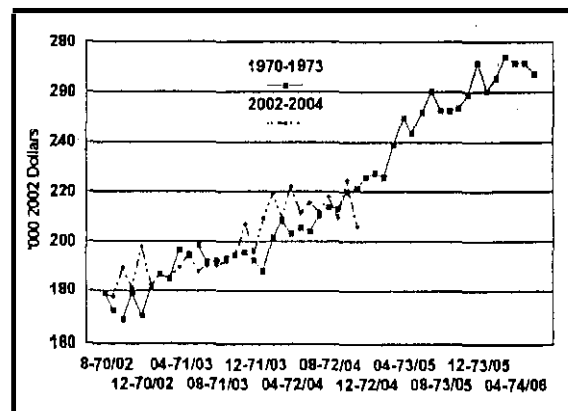


Figure 7: Median prices of new one-family homes, 1971-1973 vs. 2002-2004 ('000 of 2002 dollars)

and inadequate savings in America and its converse in Asia and Europe. Underlying these are embedded conditions within different regions, such as inadequate social insurance/pension programs in many Asian countries or excessive regulation choking off consumption, as in many European mortgage markets. Meaningful change in these conditions is unlikely in the short run, leaving adjustments in exchange rates as the only option to even out trade imbalances.

In the present context of large U.S. trade deficits the likely outcome will be further dollar weakness, a hint of which we can draw from the 1973 experience. From the viewpoint of the wood products industry this is a mixed blessing. Because of the large share of lumber imports, a lower dollar discourages non-U.S. supplies and supports higher prices, as already evident in 2004 due to the Canadian dollar’s appreciation. If the fall of the dollar goes too far, however, then more significant interest rate increases are likely, undercutting construction of new housing and home value appreciation.

How this will play out is impossible to predict. Foreign central banks may continue, for domestic policy reasons, to invest their dollar reserves in the U.S. in order to maintain their currency pegs to the dollar, extending the era of low interest rates. But logic and history suggest otherwise and the possibility of an inflection in recent beneficial trends as the year unfolds should inject a note of caution.

The sawmilling industry enjoyed boom conditions in 2004 that are likely to continue at least into the New Year’s first half. In these circumstances the temptation to roll over some of the gains into new capacity is great. A recent survey by *Paperloop* indicated 2.4 billion BF of new capacity have or will be added in 2004-2005, representing about 3.3% of consumption. Capacity creep in existing plants may add one or so percent to that. Coming at a time when consumption may be peaking, further expansions should be monitored closely. TP

Economist Henry Spelter is an occasional contributor to Timber Processing. Located in Madison, Wis., he can be reached via e-mail at hspelter@wisc.edu.

Spelter, Henry 2005. Good vital signs, Timber Processing (January/February): 16-18.