By Suzanne Hearn, Forest2Market

Bad news, good news

Key risks to U.S. economy must pass before housing recovers

THE LUMBER AND building materials industry in the eastern U.S. will see some improvement in the short-term. Unfortunately, key risks to the U.S. economy will quickly eclipse these short-term gains.

Looking at the fourth quarter and beyond, the adage "bad news comes in threes" summarizes Forest2Market's economic outlook: high oil prices will push the U.S. into the second leg of the double dip recession, and this will delay the onset of a full recovery for the housing market.

The short-term improvement will come when the protracted winter weather in the Midwest and the Northeast ends. Weather there has delayed the start of the building season, significantly dampening southern yellow pine lumber prices. When spring settles in and the building season begins in earnest, three months of demand will be compacted into the remaining two months of the season. Once mills clear their existing inventory, prices will edge higher.

Higher oil prices are the most significant of all the risks the economy faces at this time. Just as increased consumer spending began stimulating the U.S. economy (the key to a full-force recovery), unrest in the Middle East and North Africa (MENA), increased demand for oil from Japan and China and the weakness of the dollar all combined to drive the price of oil higher. The monthly average spot price for West Texas Intermediate crude oil rose sharply in March, up from $89.58 per barrel in February to $102.94 per barrel *(see chart below)*.

We expect prices to remain high even if demand falls off in response to those high prices. When we look at the spectrum of factors that influence oil prices, they all point in one direction—up:

• Investors are pricing in supply risks. Although some of the MENA conflicts appear to have passed the point of crisis, they could be re-ignited at any moment because the underlying causes of the discontent remain.

• Doubt persists that production from other OPEC countries (especially Saudi Arabia) can be ramped up to replace the lost Libyan output. In 2010, Libya produced roughly 2% of the world's supply of oil, or just under 1.8 million barrels per day.

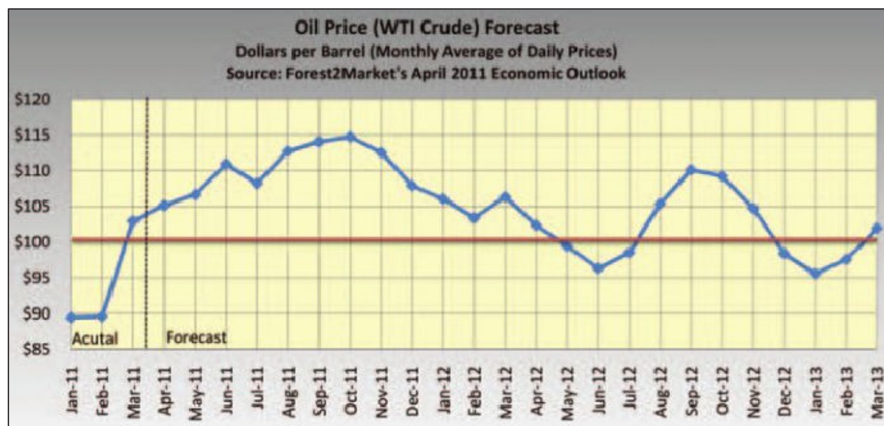
• OPEC countries argue there is little they can do to keep prices under $120 per barrel since prices are being stoked by speculators rather than a supply shortage. UAE Oil Minister, Mohammed bin Dhaen al-Hamli, commented: "International markets are choosing to ignore market fundamentals and bet on the worse case scenarios."

• Post-earthquake idling of some of Japan's nuclear power plants will leave a power vacuum that will be filled with more traditional power sources. Replacing this lost capacity will require the oil-equivalent of 400,000 barrels per day, about 0.5% of the world's 2010 consumption.

• Japan's tragedy has caused other countries, including Germany, Switzerland, Italy, China, Israel and Venezuela, to consider suspending their nuclear power programs. Increased demand for oil will reflect the extent to which these countries' programs are indeed halted.

• A succession of interest rate increases in China has succeeded only in slowing the rate of growth in oil demand rather than actually decreasing it.

Together, the increased demand from Japan and reduced supply from Libya, will leave a deficit of 2.2 million barrels of unmet demand in the world, about 2.5% over 2010's level. Add to these the U.S. Energy Information Agency's estimate of growth in global demand of 1.5 million barrels in 2011 and another 1.6 million barrels in 2012, and that total



grows to 5.3 million barrels, more than 6% higher than 2010 levels. Because of these increases, oil prices are likely to remain above $100 per barrel much longer than they have in the past.

At these levels, oil prices represent a key risk to the U.S. economy. Higher energy prices cut into household budgets and siphon off money consumers would have spent in other sectors of the economy. Building products manufacturers will also feel the effects of higher fuel costs. According to the Institute for Supply Management (ISM), the prices-paid index rose by 3.0 percentage points for manufacturers in March. Wood products, construction and forestry industries all paid higher input prices in March, and inflationary concerns continue to grow. Profits margins will feel the pressure.

The extent to which higher oil prices will affect the economy is a game of probabilities. If oil prices average $100 a barrel for the year, growth could be 0.3% lower than if prices had stayed at last year's average of less than $80 a barrel. Our forecast for GDP factors this possibility in *(see chart at right)*. If prices push even higher, to the $125-per-barrel level, economic growth would be a full percent lower. A few months at $150 per barrel and a second recession is nearly certain.

As the chart at right shows, our forecast does show a brief downturn into the second leg of a wobbly W-shaped recession. Lasting roughly three quarters, we anticipate the bottom will be reached in the first quarter of 2012. By the first quarter of 2013, the growth rate will exceed three percent, and—barring unforeseen events—stay in positive territory.

Because residential construction is a lagging economic indicator, the stalled housing market will exert downward pressure on the economy. The market for new construction continues to be abysmal: the number of building permits issued in February 2011 was 17.5% below December 2010's level, and the number of housing starts also plummeted *(see chart above)*.

Builder reticence to boost activity in the short run is understandable when you take into consideration:

• Inventory of existing homes is hanging just under the nine-month mark.

• Inventory of new homes is nearly the same.

• Another 1.8 million homes are sitting in shadow inventory (in, or on the brink of, foreclosure).

• Another two million homeowners are at least 50% underwater on their mortgages (some portion of these will eventually wind up in short sales or foreclosure).

• Clearing the market of these issues will take two years.

Several factors are exacerbating residential construction woes. Taken together, they signal that the climb out of the abyss will take longer and be more difficult than expected.

• The median price of a new home is $74,500 (48%) higher than the median price of an existing home. In the past, the differential typically ran about 15%.

• Home prices continue to fall. The Case-Shiller Home Price Index has declined for six months straight. According to Standard & Poor's David Blitzer, "none of the statistics are indicating any form of sustained recovery."

• Looking ahead, the Federal Deposit Insurance Corporation (FDIC) is considering a plan to require a minimum 20% down payment for most residential mortgages.

The only remedy for the state of the housing market is time. Once we make our way out of the likely second recession, the two years of overhang in housing inventory will be cleared from the market. And once these two pieces of bad news are behind us, population growth and pent-up demand will drive the recovery in the residential construction market.

In an average year, 1.1 million new households are formed in the U.S. During the recession, that number fell to 0.5 million. For the period since the recession began, the backlog of demand stands at roughly 2 million households. Post-recession, household formations are expected to range from 1.2 to 1.4 annually. There, finally, is the good news.

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