



Economic Outlook

Forest and Wood Products Industries

May 2010

A P U B L I C A T I O N O F F O R E S T 2 M A R K E T ®

Executive Summary*

At 3.2 percent, the 1Q2010 growth rate in U.S. real gross domestic product was barely half the rate seen during 4Q2009. Despite gains since January, employment is not expected to return to December 2007 levels until December 2011 at the earliest; for that reason, consumers cannot be depended upon to drive GDP expansion. On the other hand, new manufacturing and service-sector orders provide some short-term optimism to our forecast. Also, although only a fraction of historical norms, rising housing permits show potential for modest construction activity; unless Congress extends the home buyer federal tax credit, however, we expect housing starts to retrench for several months in mid-2010 before turning higher again. “Strategic” defaults and foreclosures will remain among the strongest impediments to housing market recovery. Sovereign debt turmoil in Europe, which is strengthening the dollar, risks stifling U.S. exports; crude oil is correspondingly cheaper, but we expect global demand to reverse that trend soon. Heavier taxes will be the “straw” that tips the economy back into recession during 2011. ■

Economic Outlook

U.S. gross domestic product. Our call last month for a 3.1 percent rise in 1Q2010 real gross domestic product (GDP) hit close to the mark; the Bureau of Economic Analysis (BEA) pegged the growth rate at 3.2 percent¹ – considerably lower than 4Q2009’s 5.6 percent. The 1Q2010 figure would have been slower yet had consumer spending not jumped at the fastest rate in three years. As one pundit put it, “we’re back to relying on an extended consumer for economic growth.”²

Of course, the purpose of this report is to forecast what trajectory the economy is likely to take. Our expectation is that the economy will continue to grow – perhaps even at a faster pace than in the first quarter – through at least 3Q2010. As of the time of this writing (early May), just over half of the \$787 billion allocated to the American Recovery and Reinvestment Act of 2009 (ARRA) remained unspent.³ We anticipate most or all of those funds will be flushed into the economy prior to November’s election; doing so will boost activity, probably through year-end 2010. Much of the remaining ARRA funds (especially the “Contracts, Grants and Loans” category) are

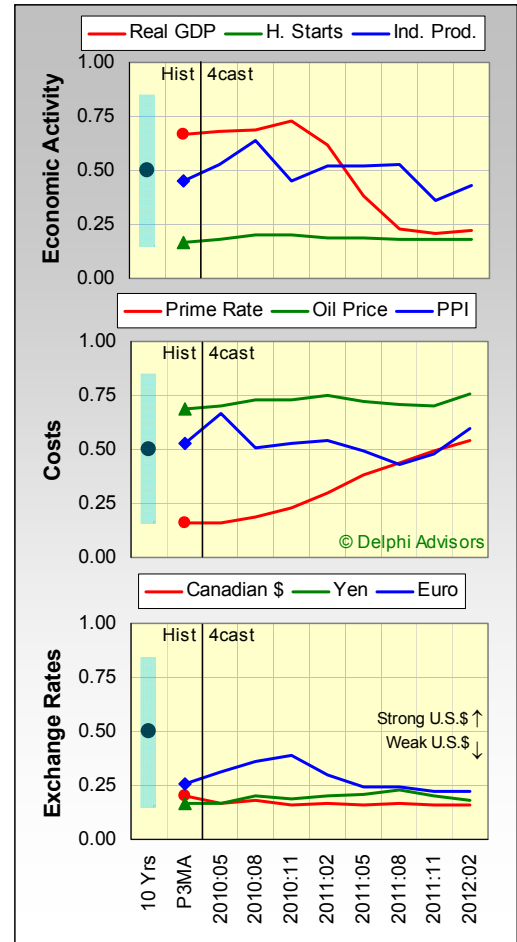


Figure 1. Indexed forecasts of macroeconomic variables relative to their historical 10-year min, max and average (lower and upper ends of the blue bars, and black dots, respectively), and prior three-month averages (“P3MA”); see Table 1, p. 2., for full variable labels. Source: Delphi Advisors

* Page 16 contains a list of articles posted on Delphi Advisors’ website; those articles relate recent economic developments to the U.S. forest products sector and provide context for this forecast.

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Table 1. Key economic 4cast statistics

		Real GDP	Housing Starts	Industrial Production	Prime Rate	Oil Price	CDN\$ / US\$	Euro / US\$	Yen / US\$	PPI, Inter- med Materials
Actual	2010:02	3.24	0.616	0.03	3.25	76.42	1.057	0.731	90.1	-0.06
	2010:03	3.23	0.626	0.49	3.25	81.24	1.023	0.737	90.7	1.00
Estimated	2010:04	3.65	0.542	-1.82	3.20	84.48	1.005	0.745	93.5	0.26
	2010:05	3.50	0.546	0.71	3.20	81.41	0.994	0.752	92.1	1.15
Projected	2010:06	3.45	0.627	3.48	3.20	84.75	0.991	0.756	91.2	0.12
	2010:07	3.61	0.702	-3.62	3.40	82.91	0.991	0.771	89.7	1.44
	2010:08	3.66	0.683	3.02	3.40	86.72	0.998	0.782	92.5	0.08
	2010:09	3.23	0.718	-0.90	3.40	87.53	0.996	0.786	93.9	0.15
	2010:10	3.95	0.786	0.87	3.80	87.53	1.000	0.794	95.9	0.74
	2010:11	4.19	0.743	-0.28	3.80	83.92	0.987	0.804	94.3	-0.13
	2010:12	3.75	0.726	-0.62	3.80	87.47	0.978	0.799	93.2	0.77
	2011:01	3.82	0.685	-0.36	4.35	89.39	0.966	0.805	92.3	0.52
	2011:02	3.52	0.684	1.20	4.35	88.92	0.977	0.788	93.5	0.14
	2011:03	3.56	0.667	1.60	4.35	91.70	0.986	0.750	93.8	0.49
	2011:04	1.70	0.673	-2.47	4.90	88.52	0.991	0.731	94.8	0.68
	2011:05	1.69	0.665	1.10	4.90	87.86	0.976	0.716	94.3	0.42
2011:06	1.54	0.677	2.69	4.90	84.10	0.973	0.716	95.8	-0.16	
2011:07	-2.37	0.675	-3.54	5.35	83.06	0.969	0.715	96.5	0.34	
2011:08	-2.14	0.642	2.73	5.35	84.19	0.981	0.718	97.5	-0.52	
2011:09	-2.40	0.699	-1.77	5.35	82.76	0.985	0.715	97.4	-0.25	
2011:10	-3.76	0.571	-0.45	5.60	83.26	0.992	0.714	97.9	-0.06	
2011:11	-3.70	0.645	-0.79	5.60	80.50	0.983	0.708	95.9	-0.17	
2011:12	-3.86	0.636	-2.46	5.60	81.21	0.974	0.696	94.4	0.56	
2012:01	-3.23	0.644	-0.17	6.00	84.95	0.962	0.692	92.6	-0.05	
2012:02	-3.26	0.612	0.88	6.00	86.30	0.973	0.704	92.9	0.40	
2012:03	-3.22	0.690	-0.25	6.00	91.62	0.980	0.695	92.1	0.33	
2012:04	-2.37	0.660	-2.36	6.50	94.32	0.985	0.698	92.3	1.18	

Notes: All actual data from St Louis Federal Reserve Board's FRED database unless otherwise indicated.
Real GDP is annualized percentage change (chained 2000 US dollars)
Housing Starts are millions of units (seasonally adjusted, annualized rate) as reported by U.S. Census Bureau
Industrial Production is monthly percentage change in index (index not seasonally adjusted) as reported by the Federal Reserve's G-17 report
Prime lending rate is monthly average of daily figures
Oil price is West Texas Intermediate crude, monthly average of daily \$/barrel
Canadian dollar, euro and yen exchange rates are monthly averages of daily figures
Monthly percentage change in Producer Price Index, intermediate materials, as reported by Bureau of Labor Statistics
Projections developed by Delphi Advisors

likely to have a higher impact per stimulus dollar spent than the funds spent to date. But with the likelihood of a second European recession increasing by the day,⁴ and because of persistent high domestic unemployment and continued housing woes, the resulting tepid foreign and domestic final demand will drag the U.S. economy back into recession in 2011 as the fiscal “sugar high” wears off.

As we indicated last month, our outlook for the last half of the forecast period is more pessimistic than it was a couple of months ago. Long-time readers know we have been predicting for quite a while that the economy will teeter into a second recession; but we had hoped the length and depth of the recession that began in December 2007 would be sufficient to correct balance sheet problems such that the second recession would be fairly shallow and short. Those imbalances remain largely un-addressed, however (or are even worse in some cases); consequently, we see the probability of a double-dip rising – and its severity and length increasing.⁵ Our prediction puts us at odds with the bulk of other economists; the International Monetary Fund (IMF), for example, expects U.S. GDP to expand 3.1 percent in 2010 before slowing to 2.6 percent 2011.⁶

The numerical details of our GDP forecast and the variables that underlie it are presented in Table 1 while a comparison of the forecast to the recent past and previous 10 years can be found in Figure 1 (p. 1).

Personal consumption expenditures: Despite employment gains since January, the labor market is expected to remain quite cool for the foreseeable future. Lack of income opportunities will constrain final demand and slow improvements in household balance sheets.

- **Employment** – On its surface, the April employment report from the Bureau of Labor Statistics (BLS)⁷ looked quite encouraging. Non-farm payroll employment rose by an estimated 290,000 jobs, although the unemployment rate edged up to 9.9 percent because of the number of people returning to the labor force. Job gains occurred in manufacturing, professional and business services, health care, and leisure and hospitality. Federal government employment also rose, reflecting continued hiring of temporary census workers. Total non-farm employment stood at 130.2 million in April, down 7.8 million (5.6 percent) from the December peak of 138.0 million.

Digging into the numbers, however, revealed that 188,000 (65 percent) of those 290,000 jobs were the result of models⁸ the BLS uses to account for recent business closings/openings not captured in the employment survey. Because these jobs are statistically derived, many analysts refer to them as “ghost” jobs. Those models do not always perform well, so their results should be taken with a grain of salt.

Besides the 66,000 temporary workers hired to help with the 2010 census (mentioned above), another 26,000 workers were picked up by temporary help services. In total, then, 92,000 (almost a third) of April’s new jobs were temporary in nature. Subtracting the 188,000 “ghost” jobs, the 66,000 Census workers, and the 26,000 temporary private-sector hires from the 290,000 total leaves us able to assert with some confidence that at least 10,000 permanent, full time positions were created in April.

So, where to from here for employment? Figure 2 shows the pace at which the U.S. economy is currently regaining jobs compared with the five previous post-recession recoveries. We calculated job growth relative to the number of jobs that existed in the *first month of each recovery*. During previous recoveries, between four and 37 months passed before the number of jobs available equaled/exceeded the number of jobs that had existed *when the corresponding recession began*.

The St. Louis Federal Reserve Bank considers July 2009 as the end of the recession that began in December

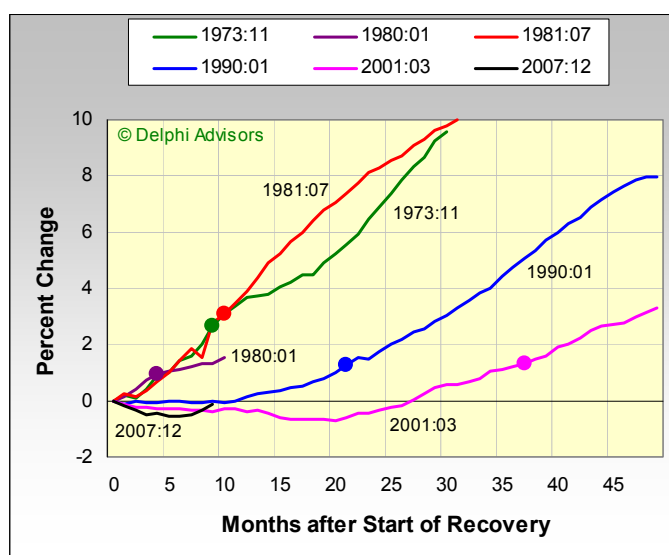


Figure 2. Non-farm employment gains as a percentage of employment at the start of recovery from recession, by month after the start of recovery. Series labels refer to the first month of the corresponding recession; symbols indicate the number of months after the start of recovery at which employment equaled/exceeded the prior peak. Source: Bureau of Labor Statistics

2007.⁹ Using last July as the starting point of the recovery, we mapped out several possible trajectories employment might take. Assuming the economy hereafter adds 408,000; 259,000; or 200,000 jobs *every month* (respectively, the fastest 12-, 60- and 120-month average rates since the mid-1960s), employment will not return to December 2007 levels until sometime between December 2011 and July 2013.

The longer the recovery process is drawn out, the further “behind the eight ball” we will be, as more than 100,000 jobs need to be created each month *just to keep up with population growth*. E.g., if it takes until July 2013 to get back to December 2007’s employment levels, over five million people who want to work will remain unemployed because job creation will have failed to keep up with population growth. This reality explains why officials expect the unemployment rate to “remain elevated for an extended period.”¹⁰

- **Personal income and consumer spending** – In its report on personal income and outlays, the BEA indicated that the rise in spending outstripped the increase in incomes again in March.¹¹ Although incomes still exceed outlays, the two metrics are converging. “There’s clearly pent up demand,” said Howard Davidowitz, CEO of Davidowitz & Associates. “There are needs [and] the consumer is jumping on those needs.”

A question we have struggled with since the Great Recession began in December 2007 is: How can consumers spend at the levels they have, given the dramatic drop-off in employment? As we showed in past reports, some of that support originated from cash-strapped consumers raiding their savings and 401(k) accounts. We also knew that government transfer payments were contributing to incomes, but had never quantified the extent of the support from that source – until now. We have discovered that the proportion of personal income derived from unemployment insurance and other federal government transfers jumped almost exponentially after the recession got underway in December 2007 (Figure 3, p. 4). Although the rate of increase slowed after 2Q2009, the overall proportion remains at its highest level (7.5 percent) since 1947.

Of course it remains to be seen for how long the convergence between incomes and outlays can continue; at some point, consumers will either have to earn more or spend less. It also remains unclear how long transfer payments can remain such a high proportion of personal income. Certainly Congress has shown a propensity to lengthen the time unemployed workers can receive benefits, but that cannot go on indefinitely, either. Indeed, there were signs of growing resistance to further extensions when the latest extension was voted on in

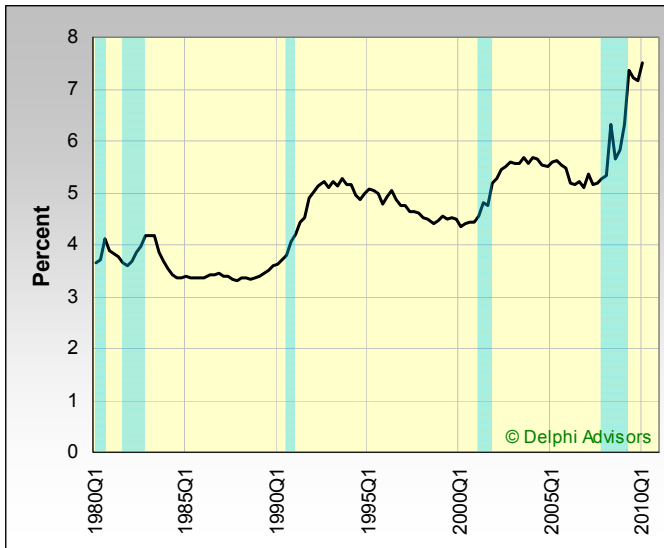


Figure 3. Percent of personal income derived from unemployment insurance and other federal government transfers. Data are seasonally adjusted and annualized; recessions shown in blue. Sources: Bureau of Economic Analysis and National Bureau of Economic Research

mid-April.¹² So unless employment takes up the slack, a fall-off in benefit payments will adversely impact incomes and, hence, demand.

The Consumer Metrics Institute (CMI) collects real-time data on internet purchases of major durable goods in the United States, and publishes a leading index that is well correlated with official GDP figures several months later.¹³ If the historical relationship between the CMI's Daily Growth Index and the BEA's GDP figures continues, the U.S. economy could begin contracting (not just a slowdown in the rate of growth) as soon as late 3Q2010.

Private domestic investment: New manufacturing- and service-sector orders provide some short-term optimism to our forecast. Housing starts will also increase slowly through the beginning of 4Q2010, and then tip over under the weight of additional foreclosures and other challenges.

- Manufacturing and service industry output – Up during eleven of the last twelve months, new orders at the total manufacturing level increased \$5.0 billion (1.3 percent) to \$391.5 billion in March (Figure 4).¹⁴ New orders for nondurable goods provided most of that impetus by increasing \$6.0 billion (2.9 percent) to \$212.8 billion. But durable goods orders dropped by \$1.0 billion (0.6 percent) to \$178.7 billion, after three consecutive monthly increases. Excluding transportation (the biggest “negative”), new durables orders increased 3.1 percent.

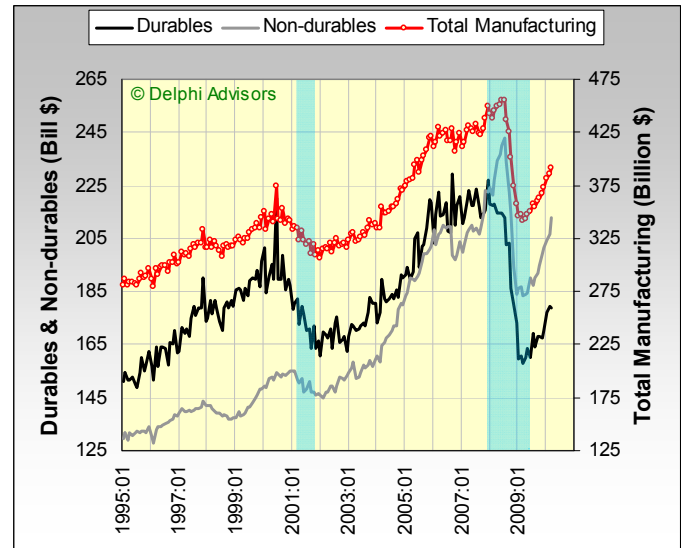


Figure 4. Seasonally adjusted value of new orders, by sector; recessions shown in blue. Sources: Census Bureau and National Bureau of Economic Research

Economic activity in the manufacturing sector also expanded in April for the ninth consecutive month according to the Institute for Supply Management (ISM).¹⁵ “The rate of growth as indicated by the Purchasing Managers’ Index [60.4 percent] is the fastest since June 2004,” said Norbert Ore, chair of ISM’s Manufacturing Business Survey Committee. “Manufacturers continue to see extraordinary strength in new orders, as the New Orders Index has averaged 61.6 percent for the past 10 months. The signs for employment in the sector continue to improve as the Employment Index registered its fifth consecutive month of growth. Overall, the recovery in manufacturing continues quite strong, and the signs are positive for continued growth.” With the Non-Manufacturing Index registering 55.4 percent, the service sector expanded at the same pace in April as it had in March.

The performance of individual industries that are at least somewhat related to the forest products sector improved “across the board” during April (Table 2, p. 5). All industries except Agriculture, Forestry, Fishing & Hunting reported growth in new orders; however, only Paper Products reported growth in new *export* orders. All but Real Estate, Rental & Leasing reported stable or growing employment.

Input costs were higher in April, although the gains were smaller than in March. Commodities whose prices rose in April included fuel, corrugated containers, pulp, envelopes, lumber and wood products, OSB, paper, and paper products.

Table 2. Performance overview of selected industries.
Source: Institute for Supply Management

Category	April 2010				
	Wood Products	Paper Products	Real Estate	Construction	Ag. & Forestry
Overall activity	▲	▲	▲	▲	▲
New orders	▲	▲	▲	▲	—
Production	▲	—	—	—	▲
Employment	—	▲	▼	—	▲
Pace of supplier deliveries	—	▼	—	—	▼
Inventories	—	▼	▲	▲	▼
Customers' inventories	▼	▼	—	—	—
Input prices	▲	▲	▲	▲	▲
Backlog of orders	—	▲	—	▲	—
New export orders	—	▲	—	—	—
Imports	—	—	—	—	—

▲ = increase, higher or faster
 — = no change, or no mention
 ▼ = decrease, lower or slower

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Based on its semiannual survey of purchasing and supply executives, ISM expects economic growth to continue in the U.S. manufacturing and non-manufacturing sectors throughout the remainder of 2010.¹⁶ Wood Products led the list of 15 manufacturing industries expecting growth of at least 3 percent in 2010, while Paper Products was ranked fifth in terms of expected growth rates. Agriculture, Forestry, Fishing & Hunting was the only relevant service industry expecting growth in 2010. Manufacturers forecast a 3.8 percent increase in input prices, while non-manufacturers think their cost increases will remain below 1.7 percent for the entire year.

- Construction – Residential building permits appear to be “soaring” on an annual percentage change basis (Figure 5). However, since prior year and prior month levels are so low the percentage change can be misleading.

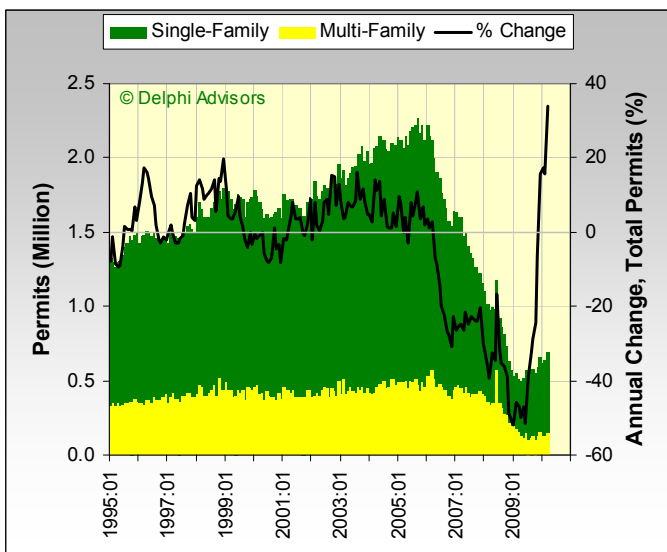


Figure 5. Components of total housing permits versus annual percentage change in total permits; data are seasonally adjusted and annualized. Source: Census Bureau

ing. A review of the underlying numbers shows permits were only 685,000 (SAAR) units during March 2010 – just 174,000 units higher than a year earlier. While a far cry from the “go-go” days of 2 million permits per year, the positive trend in permits at least suggests starts will also increase modestly – barring another economic downturn or other setback. Another source of support for forest products manufacturers is the rebound in remodeling predicted by Harvard University’s Leading Indicator of Remodeling Activity (LIRA). The LIRA suggests annual spending will accelerate, with nearly 5 percent growth in 2010.¹⁷

Sales of both new¹⁸ and existing homes¹⁹ rose in March (Figure 6), thanks in large part to the federal tax credit. Although the National Association of Realtors’ pending home sale index rose 5.3 percent in March,²⁰ we do not expect the impact of the tax credit on existing home sales to be as great this time around as it was leading up to the original November 2009 deadline. “We expect a further sharp rise in April sales then a sharp, though temporary, drop in May,” wrote Ian Shepherdson, chief domestic economist for High Frequency Economics. “After that, much depends on whether Congress extends the tax break; we expect it will.”²¹

Data released by Standard & Poor’s for its S&P/Case-Shiller Home Price Indices showed that year-over-year rates of change in the 10- and 20-city composites were positive in February (the latest data available) for the first time since December 2006 (Figure 7, p. 6).²² Although home prices in nine of the 20 metro areas improved on a year-over-year basis, San Diego was the only market that showed improvement between January and February (graph not shown).

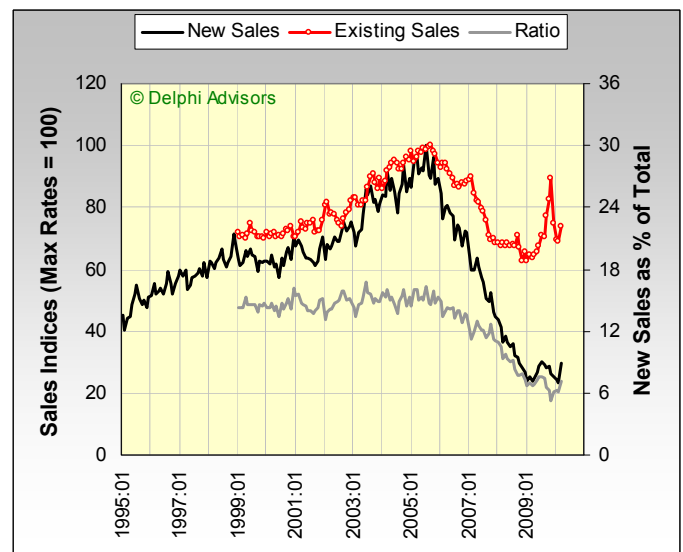


Figure 6. Comparison of new and existing home sales (maximum historical sales rates = 100) versus new home sales as a percent of all sales. Sources: Census Bureau and National Association of Realtors

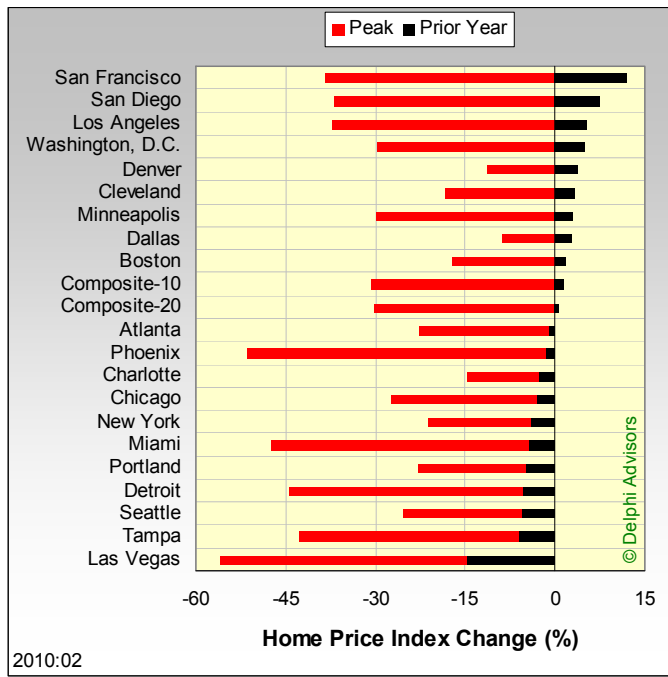


Figure 7. Change in S&P/Case-Shiller home price index from peak and prior year, by metropolitan area. Source: Standard & Poor's

David Blitzer, chair of Standard & Poor's Index Committee, provided the context for why he is somewhat pessimistic about future home price behavior:

"Beginning last November, each [Case-Shiller] report showed gains as fewer cities reported year-over-year declines than in the previous month; those gains ended with this [27 April] report," said Blitzer. "Further, in six cities prices were at their lowest levels [in February] since the prices peaked three-to-four years ago. These data point to a risk that home prices could decline further before experiencing any sustained gains...It is too early to say that the housing market is recovering. Nineteen of the 20 metropolitan statistical areas [MSAs] and both Composites declined in February over January. Fourteen of the MSAs and both Composites have now fallen for at least four consecutive months. In addition, prices reached recent new lows for six cities in February (Charlotte, Las Vegas, New York, Portland, Seattle and Tampa) sending a more cautionary message compared to the annual figures. While 14 MSAs and the two composites show improvement over their trough values reached in the spring 2009, we are not completely out of the woods.

"Existing and new home sales, inventories and housing starts all show tremendous improvement in their March statistics," Blitzer continued. "The homebuyer tax credit, available until the end of April, is

the likely cause for these encouraging numbers and this may also flow through to some of our home price data in the next few months. Amidst all the news, however, we should also pay heed to foreclosure activity, which have reached their highest level in at least the last five years. As these homes are put up for sales, we may see some further dampening in home prices."

The year-over-year increase in the Case-Shiller index would normally cause index co-creator Robert Shiller to extrapolate an upward trend. Instead, "We're in a very unusual circumstance because of the massive bailouts, the homebuyer tax credits, the Fed's purchase of mortgage-backed securities – and these things are coming to an end," Shiller said. "So I don't trust the trend that we have...I'm worried that it might get reversed."²³

Another challenge facing the housing market is the emergence of "strategic" defaults, in which underwater borrowers stop paying their mortgages (and often walk away) even though they are able to make the payments. The magnitude of this problem is unclear – estimates range from 12 percent to over one-third of all defaults – but apparently there is a growing perception that banks will not pursue borrowers who decide to walk away.²⁴ Should this trend continue, the length of time required to clear the inventory of foreclosed homes either currently – or likely to end up – in banks' possession will expand beyond the current estimate of 103 months.²⁵

The Obama administration should make mandatory its now-voluntary Home Affordable Modification Program (HAMP). That is the opinion of Neil Barofsky, the Special Inspector General for the Troubled Asset Relief Program. Barofsky said HAMP's voluntary nature sets up situations in which some borrowers benefit while others, who may be just as deserving, do not. "Giving [mortgage] servicers the discretion to implement principal reduction introduces a questionable inconsistency into the HAMP program and stands in stark contrast to the mandatory nature of the other significant mortgage modification triggers," Barofsky wrote in a 20 April report. The report also urged the administration to consider extending the amount of time unemployed homeowners are forgiven from making mortgage payments, as the maximum six months now allowed may not be long enough. Barofsky noted that nearly 2.8 million foreclosures were initiated in 2009 and that figure is likely to climb during 2010. There were more than 932,000 foreclosure filings in 1Q2010, an annualized pace of more than 3.7 million foreclosures. "Unfortunately, HAMP has made very little progress in stemming this onslaught," Barofsky said.²⁶

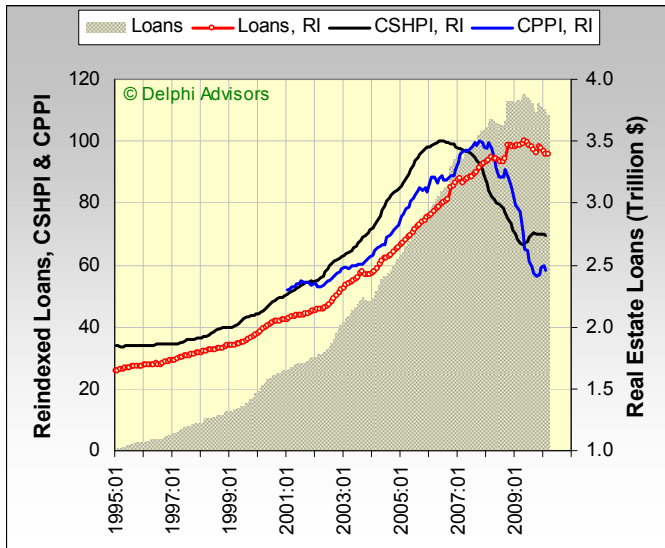


Figure 8. Value of outstanding real estate loans at all commercial banks versus reindexed outstanding loan value (“Loans, RI”), reindexed Case-Shiller 10-city home price index (“CSHPI, RI”), and reindexed Moody’s commercial property price index (“CPPI, RI”); maximum value of each reindexed series = 100. Sources: Federal Reserve Board, Standard & Poor’s, and MIT Center for Real Estate

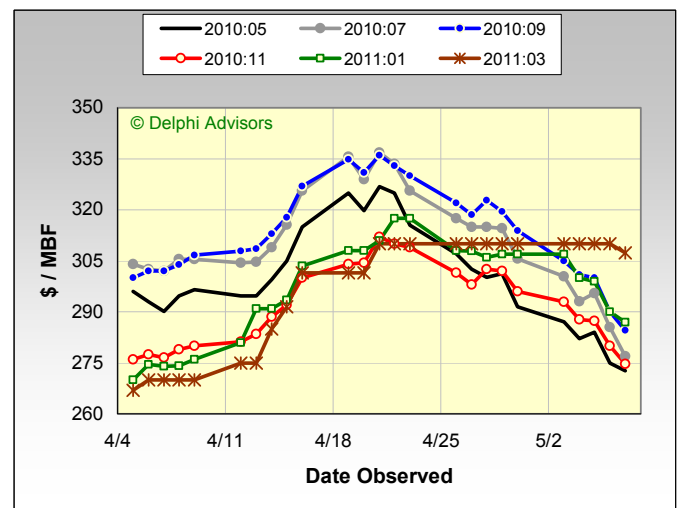
Figure 8 illustrates a serious challenge facing the U.S. economy, and especially the banking industry: the value of outstanding real estate loans carried on banks’ books has not been marked down to truly reflect the decline in the value of the underlying properties. For example, home prices (as measured by the S&P/Case-Shiller 10-city home price index) have dropped approximately 31 percent from their peak; the fall in commercial real estate values (as measured by MIT/Moody’s commercial property price index) has been a more-severe 42 percent. At the same time, however, banks have written down the book value of the loans associated with those properties by less than 5 percent.

Until this divergence between loan value and market value (an estimated \$1.1 trillion) is substantially reduced, it will be difficult for the housing market to engage in a sustainable recovery. Lenders will be reluctant to make new loans while the prospect looms of large capital losses on existing loans. Delphi Advisors’ article “The U.S. Economy’s Gordian Knot: Real Estate” contains a more in-depth discussion of this topic.*

As for specifics of what lies ahead for housing, that market is likely to be buffeted by the competing impacts of rising Treasury yields (and, by extension, mortgage rates), the end of the Federal Reserve’s mortgage-buying program, and HAMP’s expansion (and possible transition to a mandatory program). We expect Census Bureau data to reflect a modest increase in housing

starts through April (in response to the tax cut “commitment” deadline), then dip back for several months before climbing very gradually for most of the rest of 2010. At the same time, we expect prices of both new and existing homes to retrench; there are just too many homes poised to go into foreclosure – up to 4.5 million this year, compared to 2.8 million in 2009²⁷ – for prices not to give up ground. For 2011, we predict housing will trend down to a low of 571,000 starts in October.

Lumber futures traders rode a roller coaster over the past five weeks (Figure 9). Prices initially continued the climb that had started in early 2010, principally due to tight supplies.²⁸ Although the futures market trades in SPF grades, wet weather in the U.S. South earlier in the year nonetheless constricted nationwide lumber supplies and provided upward price pressure. Higher lumber prices also reflected the fact that more Canadian lumber went to feed China’s booming real estate market.²⁹ Overall, however, the futures market seemed to be running ahead of construction industry fundamentals;³⁰ thus, prices retreated during the final two weeks of our data collection period as suppliers expanded production in response to higher prices and improved weather conditions, and China began taking more pronounced steps to deal with what is increasingly being viewed as a real estate bubble.³¹



Contract	Open	Low	Median	High	Close	Trend
----- \$ / MBF -----						
2010:05	296.00	272.60	296.50	326.80	272.60	NEG
2010:07	304.00	277.00	305.60	336.80	277.00	NEG
2010:09	300.00	284.50	313.00	336.00	284.50	FLT
2010:11	276.00	274.60	292.00	312.00	274.60	POS
2011:01	270.00	270.00	300.00	317.50	287.00	POS
2011:03	267.00	267.00	307.40	310.00	307.40	POS

Figure 9. Statistics of prior five-week lumber futures prices, by contract delivery month. Source: Chicago Mercantile Exchange

* <http://tinyurl.com/29wb5vm>

Net exports: It will take additional time to see what impact the recent market turmoil has had on world trade, but the Netherlands Bureau for Economic Policy Analysis estimates the volume of world trade expanded at least through February.³² Closer to home, U.S. exports and imports both rose in February; the trade deficit widened, though, because imports rose more quickly than exports.³³

U.S. exports have increased, but at a decreasing rate, during the past several months. That slowdown in export volumes corresponded to a period of time during which the greenback stopped depreciating against other currencies and, in fact, began appreciating. Interestingly, the U.S. trade deficit flattened during that same period. What this suggests is that although a weak dollar may benefit U.S. exporters by making their products more competitive, that same weak dollar also results in a worsening of the trade balance for countries like the United States that consistently import more than they export.

If recent history is any indication, the stock market gyrations caused by the PIIGS's sovereign debt problems will cause the U.S. dollar to strengthen, particularly against the euro. That, in turn, will make U.S. goods less attractive in European markets and make European goods more attractive in U.S. markets; nonetheless, the stronger dollar could temporarily cap the trade deficit.³⁴ Longer term, however, we expect the dollar to weaken when the same problems now plaguing the PIIGS show up in the United States. While the depreciated dollar may make U.S. exports more attractive, the trade deficit could well widen even more quickly.

In other international trade news, the U.S. Commerce Department "upped the ante" in the dispute over certain Chinese and Indonesian coated-paper imports by imposing preliminary dumping margins ranging from nearly 31 to over 135 percent. The result of the Department's actions will be the immediate requirement for importers of covered paper from the subject countries to post a bond or deposit cash in an amount equal to the announced margins pending final resolution of the cases later this year.³⁵

U.S. fiscal and monetary policy: We are continually refining our views on inflation, interest rates, price stability, and the impacts of debt on the economy. One of the more contentious issues among economic forecasters is the prospect of inflation or deflation in the U.S. economy. For example, Nouriel Roubini, the New York University professor who forecast the U.S. recession more than a year before it began, is convinced that sovereign debt from the United States to Japan and Greece will

lead to higher inflation or government defaults.³⁶ David Rosenberg, the highly respected chief economist of Gluskin Sheff & Associates in Toronto, is at the other end of the spectrum; Rosenberg believes "the Federal Reserve should be worried about deflation and has few weapons left in its arsenal to combat it." Much of the debate stems from disagreements over how terms are defined and used. To avoid this problem, we distinguish between price stability – which the mainstream press commonly calls inflation or deflation when focusing on the consumer or producer price indices (respectively, CPI and PPI) – and monetary purchasing power. Inflation occurs when money *loses* purchasing power, typically because the supply of money increased faster than the supply of goods and services; conversely, deflation occurs when money *gains* purchasing power. Monetary inflation/deflation affects price stability, but that impact can be muted or accentuated by market supply/demand forces and currency exchange rates.

• Inflation and price stability – One of the aforementioned refinements involves considering the levels of *both* money supply *and* total market credit supply when attempting to forecast price stability, the direction of interest rates, and other "downstream" effects. This refinement stems from the fact that both money and credit are used as mediums of exchange for goods and services in the real world. Only by evaluating both can one obtain a complete picture of price stability and inflation.

The sum of money supply (we use MZM) and total market credit expanded in absolute terms until 1Q2009; it has been shrinking since then (Figure 10). Put another way, the rate of annual growth in MZM and credit ("M&C" for short) ranged between roughly 5 and 10

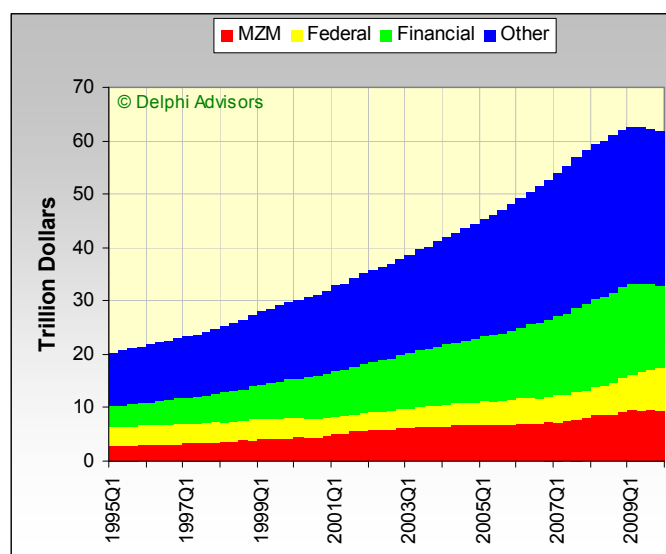


Figure 10. Money supply (MZM), and total market credit by sector (federal, financial and other); data are seasonally adjusted. Source: 11 March 2010 Federal Reserve Board Z.1 Report

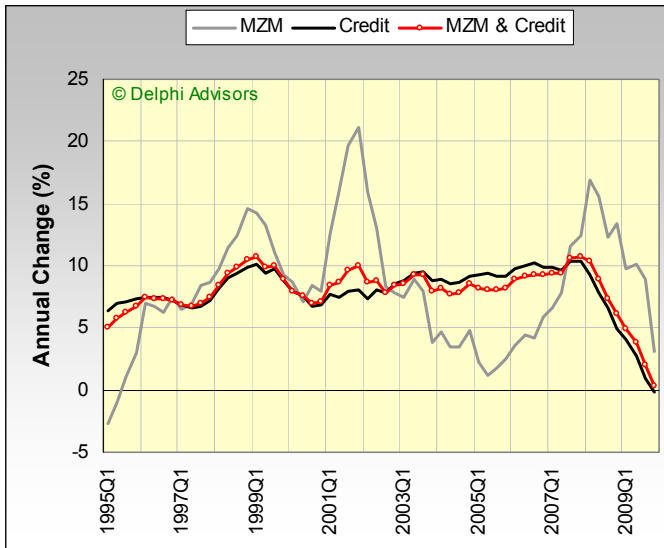


Figure 11. Year-over-year percentage change in money supply (MZM), total market credit, and the sum of money and credit (MZM & Credit); data are seasonally adjusted. Source: 11 March 2010 Federal Reserve Board Z.1 Report

percent until 2008 (Figure 11); the rate of growth fell thereafter, and was practically unchanged by the end of 2009. Obviously, not every component of M&C has declined – for example, federal credit continues to expand – but, in the aggregate, the “pool” has shrunk.

The rapid rate of M&C expansion up until 2008 resulted in greater inflation than has generally been recognized. One might have expected a dramatic rise in consumer prices, but the relatively strong dollar (which made imported goods cheaper and so expanded market supplies) and immigration policies tamped down consumer prices

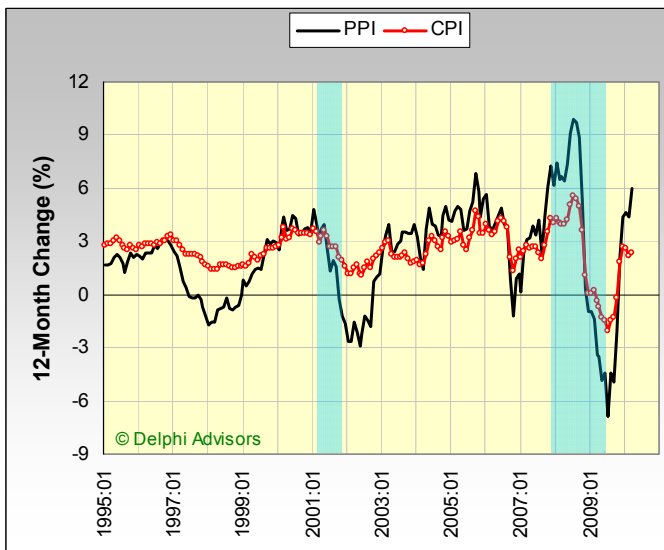


Figure 12. Year-over-year percentage change in consumer (CPI-U, all items) and producer (PPI, finished goods) prices; recessions shown in blue. Sources: Bureau of Labor Statistics and National Bureau of Economic Research

and labor costs. The overall average annual change in the PPI was just 2.2 percent through 2007 (Figure 12) and 2.6 percent for CPI. Instead, much of that inflationary pressure wound up in asset values. For example, the S&P/Case-Shiller 10-city home price index rose nearly 200 percent between January 1995 and June 2006. We further argue that a variation on the classic wage–price inflation spiral was at work. People withdrew equity out of their homes as asset values rose in response to the M&C expansion; that cash increased spending in much the same way higher wages do. The difference is that mortgage equity withdrawals are not classified as wages and climbing home values are not included in the consumer price index calculation (at least not directly). Nonetheless, inflation – particularly the loss of monetary purchasing power relative to housing – was at work in the U.S. economy.

Fast forward to the present. Since MZM has remained relatively constant over the past year, and federal credit (or debt, if you prefer) has expanded, that means the overall M&C “pool” has gotten smaller because of retreats in the Financial and Other components (Figure 10, p. 8). Why did those components contract? Various explanations include a decline in the value of the underlying assets (i.e., the collateral) largely recognized through loan defaults, lowered expectations of future cash flows from those assets, private sector deleveraging, and an unwillingness of financial institutions to take on new debt during the recession. We think the contraction process has just begun, and must continue until the book and market values of the underlying assets are again realigned. The wild card is the rate at which that realignment may occur.

Because of our expectation that the M&C pool will continue contracting, prices could stabilize in the near-to-medium term. That may already be happening; Figure 12 shows that the CPI has broken off its recent year-over-year upward trends. The upward trends (particularly in PPI) since mid-2009 were a delayed reaction to the Fed’s rapid expansion of MZM to maintain liquidity during the credit crises that began in 2007. It is notable that the PPI index rose by 6 percent in the past year despite significant slack in production; PPI and CPI responses generally lag money and credit expansions by two to three years. The slowing rate of M&C expansion since the beginning of 2008, along with other factors, is now contributing to a deceleration in CPI increases. Because of this continuing M&C moderation, we would not be surprised to see both PPI and CPI contract. Increased deficit spending by the federal government, on the other hand, will tend to temper any risk of significant declines in either price index.

As mentioned in the previous paragraph, economic slack (measured by capacity utilization) also played a role in dragging price indices lower through mid-year 2009. Many economists argue that there is little risk of rising prices until consumer demand stimulates higher rates of capacity utilization. However, there is another mechanism besides consumer demand influencing capacity utilization, namely the loss of capacity. Capacity utilization has increased by 7.2 percent since its trough in June 2009, the result of curtailments in addition to increases in consumption (see “Smokey Bear Economy” for an in-depth discussion of this topic*). At some point, manufacturing curtailments will halt in the face of rising capacity utilization rates, largely removing economic slack as a drag on price levels. Only when stronger export demand from a weaker dollar combines with heightened domestic demand and expanding federal credit and money supply do we expect inflationary impacts to be manifested in the CPI and PPI. Creating that combination of circumstances could take some time; John Hussman, economist and fund manager, anticipates “a near doubling in the CPI over the course of about 10 years, focused primarily in the latter half of this decade.”³⁷

- Deficits/debt/stimulus – Another implication of the previous discussion is that, as long as the overall M&C pool continues to contract, MZM and/or Federal credit could conceivably expand without unleashing debilitating inflation and price instability; MZM and Federal credit are both quite small relative to the magnitudes of the Financial and Other components (Figure 10). There is no free lunch, however. Figure 13 depicts a 50-year trend showing an incremental decline in GDP for an incremental increase in total U.S. debt (sum total of federal, state, household, financial, non-financial business, and other sector debt). The graph is particularly alarming because the marginal contribution to GDP from debt recently turned negative. We think the current situation is a function of the recession and thus reversible. Even so, the trend (red) line’s message is unmistakable: Increasing U.S. debt, whether public or private, is siphoning off the economy’s capacity to grow.

- Interest rates – We have maintained that interest rates around the world are going to rise, even in the near-term, whether or not central banks want them to. This is a view shared by the Bank of International Settlements (often referred to as “the central bankers’ central bank”).³⁹ We believe the early signs of this transition became especially noticeable last November when the slope of the Treasury yield curve (the difference or “spread” between 10- and two-year yields) steepened more than at any time since late 2003. Although 10-year

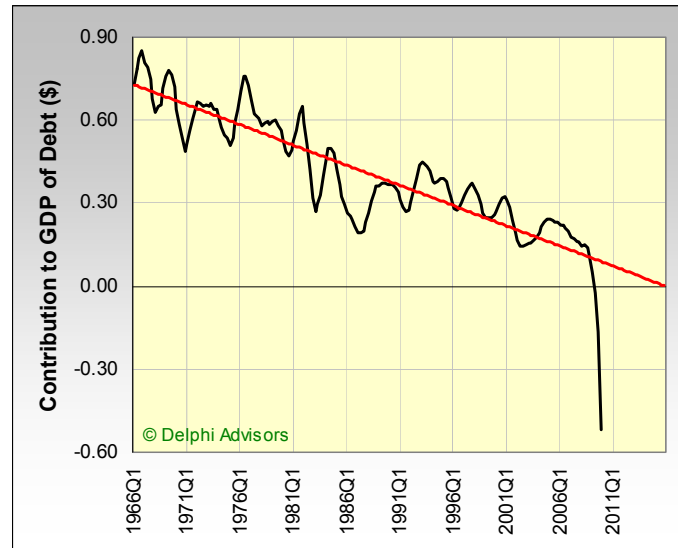


Figure 13. Contribution to GDP of total credit market debt; data are nominal values, not seasonally adjusted. Source: 11 March 2010 Federal Reserve Board Z.1 Report via Market Ticker³⁸

rates have fallen recently and the yield curve has flattened, the curve is still steeper than 98 percent of the daily yield data since January 1990. Because yields generally fall (and spreads narrow) when investors flee to “safe haven” vehicles like Treasuries during periods of economic upheaval, the fact the yield curve continues to be this steep is significant.

Typically a steep yield curve signals that the market anticipates stronger economic expansion in the offing. Investors are reluctant to hold longer-term instruments if central banks are expected to raise interest rates; thus, investors offer lower prices on longer-term bonds, raising their yield to insulate against the risk of higher interest rates in the future. We believe some of that behavior is at currently at work in Treasury markets.

At the same time, another segment of the market is concerned about the United States’ sovereign debt risk. We touched on this in “Ignoring E.F. Hutton.”** While not expecting an out-and-out default, these investors perceive a heightened risk of inflation from both monetary and fiscal policy, and so require a higher yield.

To say that one camp or the other is responsible for current or expected near-term Treasury market direction is an oversimplification. Both perspectives are moving the market. However, that the second one is making its presence known is noteworthy.

We believe a number of factors will drive Treasury yields and interest rates higher. First, the U.S. Treasury is floating an unprecedented volume of securities; al-

* <http://tinyurl.com/29qxs4>

** <http://tinyurl.com/28oywsh>

though investors have so far been willing to soak up those issues, they had – up until early April, anyway – been demanding ever-higher interest rates.⁴⁰ Second, the United States is competing with a flood of public funding demands from elsewhere, especially Europe, China, and Japan. Third, U.S. states and municipalities are turning to debt markets to bridge funding gaps. Fourth, a large share of the merger and acquisition debt from the mid-2000s will need to be rolled over in the next three years, substantially increasing private needs. Fifth, private capital needs will increase if the recovery takes hold. Finally, developing economies are taking on debt to fund growth.

It is the sum total of these demands for capital that first and foremost will drive rates higher. Capital will be rationed to those uses paying the highest yield. Second, there will be a greater recognition of the risk of failure by lenders given the events of the last two years. That increased risk will command a higher interest rate as compensation. Third is portfolio risk. China, among the largest holders of U.S. Treasuries, has indicated a reluctance to continue increasing the proportion of U.S. securities in its portfolio. So, China is looking to limit purchases at the same time the United States is significantly expanding borrowing. This divergence will simply accentuate the capital rationing effect.

The net effect will raise interest rates even while the U.S. economic recovery remains at a very vulnerable stage. Unprecedented government borrowing virtually assures rates will rise, regardless of whether the Federal Reserve wants to hike rates. The rate increase will halt the recovery and cause a second recession. As usual, higher rates will hit mortgage markets particularly hard; coupled with other market dynamics, housing starts will turn lower in late 2010, leading the rest of the U.S. economy into the double-dip recession.

- **Taxes** – Since there is apparently little stomach in Washington D.C. for trimming deficits by cutting spending, another way to bring revenue and outlays into line is by raising taxes. In mid-April, for example, the Senate Budget Committee passed a fiscal 2011 budget that includes a more than three-fold increase in the top dividend tax rate (to 39.6 percent, up from the current 15 percent). If that provision survives the rest of the budget process, fewer businesses are likely to either offer or increase dividend payouts.⁴¹

Paul Volker, former Federal Reserve president and current White House adviser, is now advocating the imposition of a value-added tax (VAT), similar to what is common in many European countries. Volker said the VAT “was not as toxic an idea” as it has been in the

past, and hinted a carbon or other energy-related tax may also become necessary. Though he acknowledged that both were still unpopular ideas, he said getting entitlement costs and the U.S. budget deficit under control may require such moves. “If at the end of the day we need to raise taxes, we should raise taxes,” he said.⁴² President Obama has left a VAT on the table, saying such a tax approach is “something that would be novel for the United States.”⁴³

Available evidence shows a VAT is unlikely to improve the deficit problem because the governments that have implemented them have spent the revenue rather than paying down debt; since VATs were introduced in Europe in the 1960s, government spending has grown 45 percent faster in nations with VATs than in non-VAT countries. We recognize there are differences of opinion in our society over the size and role of government in the economy; our intent here is not to advance a political agenda but only evaluate a likely trajectory for the economy as a backdrop for decision making. According to the academic literature, more government spending typically translates into less economic growth and fewer jobs.⁴⁴ Thus, the expiration of the Bush tax cuts and the prospect of increased taxation, whatever its form, will present additional headwinds for the economy over the next 24 months.

We add into this calculus the recent passage of the federal health care bill. The bill’s complexity complicates our ability to determine how soon various provisions will directly impact the economy. However, we do believe the bill’s prospective impact is one more element in shaping investor expectations of increasing and expanding federal deficits. The Congressional Budget Office has declared the bill will generate net revenue for the Federal government,⁴⁵ but – not surprisingly given the hot rhetoric the issue incited – other analyses challenge the assumptions used to arrive at that conclusion.⁴⁶ Regardless of how it works out for the federal government, the toll on the private sector seems clear: AT&T, Boeing, Caterpillar, Deere & Co., Honeywell, Lockheed Martin, Prudential Financial, and Verizon are among companies who have announced charges (estimated at up to \$4.5 billion) they will have to take against 1Q2010 earnings as a result of the bill’s passage.⁴⁷

Currency exchange rates. We expect the U.S. dollar to appreciate against the euro and yen, but to depreciate against the loonie.

Canada: Canada’s leading indicators are pointing to a continued recovery. Manufacturing (especially for export to the United States) led the composite index higher

in March.⁴⁸ That expectation is consistent with the IMF's forecast of increase 3.1 percent growth in 2010 – on par with the United States.⁶ The loonie is likely to get additional support if, as is widely anticipated, the Bank of Canada (BOC) raises interest rates sooner than the Federal Reserve. The BOC has hinted the time for keeping its policy rate at a record low 0.25 percent “is passing,” and investors are betting Governor Mark Carney will create an interest rate differential relative to the Federal Reserve by raising rates at the 1 June meeting. “There are inherent limits to how far the Bank of Canada can raise rates beyond those in the U.S., but I don't see a problem with Bank of Canada raising rates 1.25 to 1.5 points beyond what the Fed does,” said Craig Alexander, deputy chief economist at TD Bank Financial Group in Toronto, adding, “A strong dollar is going to be a challenge for exports, but the domestic economy can still support moderate growth.”⁴⁹

Europe: The economies of Europe resemble a mountain climbing team whose members are all roped together. If one member begins sliding toward a cliff, there is a chance the entire team could be wiped out. Thus, probably the most critical development during the past month was the €1 trillion aid package negotiated by the European Union, the IMF and the European Central Bank.⁵⁰ (Ironically, one of the IMF's demands requires the Greek government to privatize its health care sector to reduce costs.⁵¹) Given the degree to which the PIIGS economies are interwoven with each other and the rest of Europe⁵² – not to mention the fact that essentially all European countries are exceeding Maastricht Treaty limits regarding either deficit- or debt-to-GDP ratios (or both)^{4,53} – it is critical that the right decisions are made.

Nouriel Roubini believes the euro zone's days may be numbered. “In a few days, there might not be a euro zone for us to discuss,” Roubini said.⁵⁴ We are not yet ready to forecast the European Union's disintegration, although it is certainly possible one or more countries might leave (or be forced out of) the euro. What seems clear – particularly given the flat outlook for Germany's economy⁵⁵ and meager 1.0 percent growth in the euro area during 2010⁶ – is that the euro is in for a protracted slide that could bring it closer to parity with the greenback.⁵⁶

Asia: Despite the IMF's prediction of 1.9 percent growth in Japan's 2010 GDP,⁶ the Bank of Japan (BOJ) adopted a rather glum tone in its own outlook. “The global economy is not in the process of returning to its state prior to the crisis,” the BOJ said in a report. “In advanced economies, including Japan, the outstanding amount of public debt has risen to unprecedented levels as a result of large-scale fiscal spending...Meanwhile,

Japan – where domestic demand is expected to decline against the backdrop of a low birth rate, population aging, and a shrinking population – faces the critical challenge of raising real economic growth and productivity.”⁵⁷ We think the threat of a credit downgrade and attempts to slow the loss of its export market to other lower-cost countries⁵⁸ will result in the yen depreciating against the U.S. dollar.

The Chinese government is attempting (some say too gently) to deflate the property bubble growing in that country. Reports indicate people have been withdrawing their savings and borrowing as much as possible to buy property, regardless of the price – a sign of final frenzy in a financial mania.⁵⁹ Investor Marc Faber, hedge fund manager Jim Chanos and Harvard University's Kenneth Rogoff warn China is “on a treadmill to hell” and could crash within nine to 12 months.⁶⁰ Some Citigroup and other seasoned economists agree with Faber, Chanos and Rogoff that China is already on a path towards a “boom, bubble, and bust” scenario; but they think there are another two years to go while the bubble shapes into its final form, and three additional and painful years during which it will deflate.⁶¹ According to the IMF, on the other hand, China has nothing to worry about – at least for now. The organization forecasts China's growth rate will be 10 percent this year.⁶ Upheaval in China's economy could temper their demand for foreign debt and cause interest rates to rise in the United States.

Energy. Although the dollar's recent strength is making oil cheaper, new offshore drilling restrictions and other regulations will make that a temporary turn of events.

Crude oil price: Europe's financial travails are once again driving investors into the dollar's “safe haven” and causing oil's spot and futures prices to fall (Figure 14). The IMF predicts oil prices will average \$80 a barrel this year and \$83 a barrel next year.⁶ For the following reasons, we think the current situation is unlikely to last for long and prices will exceed the IMF's expectations:

- The BP oil spill, while not immediately affecting oil prices, is likely to raise prices in the medium and long run because of the almost inevitable imposition of new regulations on the industry.⁶² Those regulations will make domestic production more expensive, enabling OPEC and other exporting countries to charge more for their product.
- A recent Joint Operating Environment report issued by the U.S. Joint Forces Command suggests the United States could face oil shortages much sooner than many have anticipated. The report speculates that

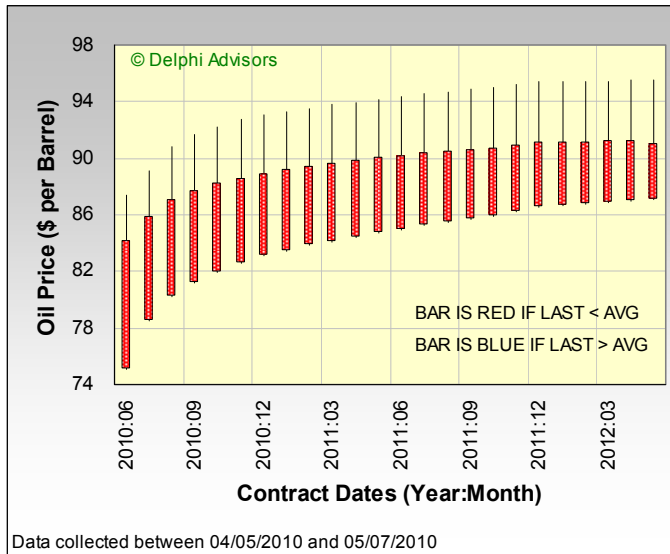


Figure 14. Futures prices for light crude oil by delivery month. The vertical black lines represent the range of closing prices during the data-collection period; the colored bars show the relationship between the last observed and average closing prices. Source: New York Mercantile Exchange

surplus oil production capacity will dry up by 2012; by 2015, the world could face shortages of nearly 10 million barrels per day; and by 2030, the world will require production of 118 million barrels of oil per day but produce only 100 million barrels a day.⁶³

- The House and Senate are moving quickly on a bill to impose a U.S. naval blockade on Iran, a step that could easily be interpreted by that country as an act of war over its nuclear ambitions. Iran's regime has made it clear it is preparing to fight such a blockade by engaging in a five-day sea, land, and air military exercise during late April in the Persian Gulf and Gulf of Oman.⁶⁴ Such a blockade would involve the Strait of Hormuz, the chokepoint through which a fifth of the world's oil flows. While predicting the probability of military conflict is akin to forecasting the timing and severity of a future hurricane, such an event would almost undoubtedly drive oil prices significantly higher.

Biomass energy: Senators Jeanne Shaheen (D-NH), Lisa Murkowski (R-AK), Mike Crapo (R-ID), and Mark Begich (D-AR) introduced a bill at the end of March that would help businesses across the country meet their heating needs with renewable biomass. Senate Bill 3188 (The American Renewable Biomass Heating Act of 2010) would establish a corporate tax credit equal to 30 percent of the installed cost of biomass-fueled heating (or cooling) systems for commercial or industrial applications. The credit would have no maximum and would be available for biomass thermal systems placed in service on or before 31 December 2013. The sponsors say the bill would also bring economic benefits to the timber industry and rural communities.⁶⁵

Cap and trade/Carbon tax: There continues to be talk of some type of energy bill making its way through Congress yet this year.⁶⁶ However, the Deep Horizon disaster in the Gulf complicates trading expanded exploration – which many saw as necessary to gain some degree of Republican support – for a bill that includes cap and trade. In addition, bad press about similar cap and trade schemes elsewhere in the world have erected new obstacles for Congress in an election year. In late April, for example, German prosecutors raided the offices of Deutsche Bank (Germany's largest bank) and RWE (the country's second-largest utility) while investigating \$238 million of tax evasion linked to emissions trading. The United Kingdom, France and the Netherlands are among nations that last year began investigating "carousel fraud" – in which traders bought and sold carbon permits, collected taxes and disappeared before turning the taxes in to authorities. The fraud may have tainted 400 million metric tons (7 percent of the total) of emission trades in 2009.⁶⁷

Despite a continuing barrage of negative stories, however, Congress appears committed to vote on some sort of bill yet this year.⁶⁸ Our expectation is a bill will be debated but its chances of passage are unclear; even if it does pass we expect the trade-offs to gain necessary support will defer the effect of most provisions until beyond the forecast period. ■

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