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Economic Environment

Economic & Market Outlook for 2003: A Challenging Business Environment by Al Schuler

Over the past year, the American consumer has supported the American—indeed the world economy—virtually single handed" (The Economist, 10/31/02). Consumer spending plus residential investment accounted for over 70 percent of GDP the past two years, and almost all of GDP growth. Government spending was the other sector that contributed some growth while business investment and net exports subtracted from GDP growth. However, the now fragile U.S. economy is expected to expand slowly in 2003 due to uncertainty over terrorism; the weak job market; corporate governance concerns; lingering over-capacity in many industries (which reduces pricing power and profitability); and weak offshore markets. Housing, particularly single-family is expected to remain the bright spot although most analysts expect some pullback (about five percent) from 2002 levels as interest rates creep higher with a slowly improving economy.

To date, the "jobless recovery" (see Figure 1) hasn't slowed consumer spending too much because after tax income gains have been supported by lower taxes and productivity growth. Furthermore, lower mortgage rates facilitated a refinancing boom that put additional money in the pockets of many consumers. However, in the future, consumer spending is expected to weaken as refinancing options dry up, interest rates creep upward, and income gains flatten in the face of a struggling job market. In fact, the Fed was alarmed enough by the fragility of the economy to lower the Fed funds rate 50 Basis Points at their November 2002 meeting. In my opinion, their real concern is disinflation—slower inflation rate, not to be confused with deflation, which is an overall drop in prices across the board.

For the structural components industry, this kind of environment suggests flat pricing with any profit improvement derived mainly from cost reductions, consolidation or finding new ways to help our customers remain profitable. Firms with low cost positions will "survive" in this kind of environment while others scramble to find "niches" or tighten their belts further. Another strategy is to add value to your product or service line. In other words, consider diversifying your product offering to be in a better position to meet any need your customer has. Higher margin products (the products manufactured and distributed by the structural components industry) should do better than pure commodities in this challenging business environment. However, keep in mind that lower commodity prices often drag down higher margin product prices due to substitution.

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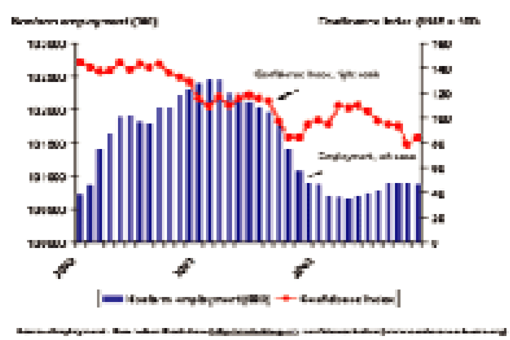

FIGURE 1. JOBLESS RECOVERY MAIN THREAT TO CONSUMER SPENDING (AND THE ECONOMY)

MACROECONOMIC & CONSTRUCTION OUTLOOK

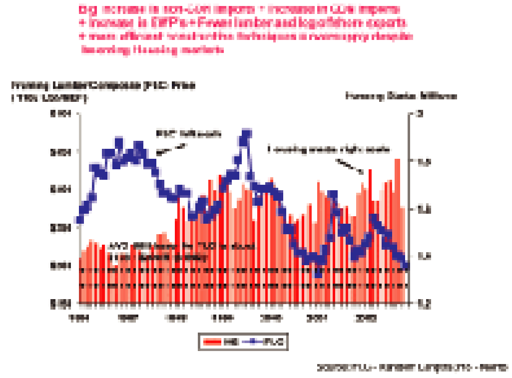

FIGURE 2. GLUT CONTINUES RESULTING IN FLAT PRICING OUTLOOK FOR 2003

	GDP	HS (Million)	CPI	Unemployment Rate
TD Bank	2.9%	1.56	2.6%	5.8%
NAHB	2.7%	1.63	2.2%	5.8%
RISI (consultant)	2.8%	1.62	2.4%	6.0%
APA	3.0%	1.60	-	-
Economy.com	2.5%	1.55	2.0%	6.2%
Consensus	2.8%	1.60	2.3%	6.0%
Table 1. Macroeconomic Outlook for 2003 (December 2002)				

Slow and sporadic economic growth, but no double dip recession is the consensus forecast (see Table 1). Risks to the economy center around uncertainty related to terrorism concerns and job creation for the consumer; over-capacity and the possibility of continuing "disinflation" for businesses. Uncertainty affects confidence and willingness to spend and/or invest by consumers and businesses alike. The main problem for the consumer is the job market—in fact there has been no net job creation in 2002 to date (and some expect unemployment to rise modestly in 2003) and that is starting to impact confidence (Figure 1). Eventually the flat job market will impact income growth and the ability to spend. Business investment won't pick up until over-capacity issues are resolved and confidence returns. Currently, capacity utilization in the manufacturing sector is an anemic 74 percent, which means 26 percent of capacity is idle. The consensus GDP forecast for next year is somewhere between 2.5 and 3 percent.

A major issue in 2003 is the potential for continuing disinflation not only in commodities and manufactured products, but services too. Deflation won't happen, in my opinion, because the government still has many fiscal options left—more tax cuts, accelerated depreciation allowances to encourage business investments, increased government spending, and the option of "printing money" to name a few. And, other central banks (Europe in particular) have considerable room to lower interest rates. But disinflation in a growing number of sectors (it is spreading to the service side of the economy) will cause problems for heavily indebted firms and consumers alike. For firms, pricing power will remain weak due to over-capacity, and that means possible problems in servicing debt from a flat or even falling revenue stream. "Profits are being squeezed, forcing employers to cut costs and people wherever they can," reported Business Week on October 21 of last year. "That would mean less capital investment, lower R&D expenditures, more outsourcing, job cuts, and other penny-pinching measures."

	2001	2002	2003	01- 02 %	02 - 03 %
Total Construction	$496187	$498925	$495125	0.6	(0.8)

Housing is expected to pull back modestly in

Residential	$219237	$237200	$239000	8.2	0.8
SF	$186801	$203950	$203275	9.2	(0.3)
MF	$32436	$33250	$35725	2.5	7.4
Non Res Bldg	$169426	$159075	$159600	(6.1)	0
Non Bldg Const	$107524	$102650	$96525	(4.5)	(6.0)

Table 2: FW Dodge Contract Awards (Million $) (forecast date: November 15, 2002)

such an environment, but remain at relatively healthy levels. F.W. Dodge's latest construction forecast (Table 2) shows total construction contract awards falling for the first time since 1991 as weakening residential markets no longer compensate for continuing weakness in commercial markets. Particularly, the Dodge forecast shows single family (SF) residential construction falling 0.3 percent, a strong reversal from a 9.2 percent increase in 2002.

LUMBER MARKET OUTLOOK

Real lumber prices have fallen 44 percent since the recent peak in July 1999, including an 8 percent drop this year despite record residential construction activity (Figure 2). Lumber markets are oversupplied with North American production expected to reach 65 billion board feet (BBF) in 2002, matching 1999's historical peak. In addition, offshore exports from both Canada and the U.S. continue to fall in the face of tough competition from Europe, Russia, South America and Oceania. Furthermore, through the Third Quarter, 2002, production of wood I-joists, and LVL is on a record setting pace—I-joist production up 4 percent YTD; while LVL production was up 7.6 percent YTD.

Why is the lumber market oversupplied despite the best housing market in history? There are several reasons: First, the imposition of the softwood lumber duties had an unexpected and unintended effect—it actually encouraged more production from Canada as many of the larger, more efficient Canadian mills attempted to lower costs by running flat out over three shifts instead of curtailing production. This was done to impact the anti-dumping percentage that each individual mill has to pay. Another unintended result is the increased flow of tariff exempt, “value added” wooden structural building components (all structural wood components that use softwood lumber) from Canada to the U.S. Second, since 1995, European lumber output has risen 7.2 BBF, up 22 percent (Wood Markets Monthly, November 2002). European lumber has increased its presence in U. S. markets dramatically over the past five years (partly in response to duties on Canadian lumber and favorable exchange rates), doubling every year, and on pace to reach 1.5 BBF in 2002.

All this suggests that wood product pricing will probably be flat in 2003 for both commodity lumber and possibly some wood building components. A sign that over-capacity has even come to engineered wood products is the recent announcement that Weyerhaeuser will close its I-joist plant in Louisiana (a former Willamette plant) to bring industry capacity more in line with demand. Louisiana Pacific has also closed older, less efficient OSB plants for the same reason (as noted in press releases), in addition to continuing a business restructuring to focus on “core businesses.” And quite a few lumber mills, and several plywood plants have been closed temporarily over the past 18 months.

How can the components industry remain profitable in this challenging business environment? Cut costs, reduce debt, and develop innovative products and or services that command higher margins for your entire product line (i.e., reduce reliance on pure commodities.) Here is an example from the banking world (USA Today, 11/15): Intense competition for customers is the driving force for private banks catering to the superrich by developing the capability to advise clients on art, thoroughbreds, leasing/purchasing airplanes, and so on. They also cater to more ordinary folks: some banks source "hard to get" tickets to popular sporting events, hit shows; educate neophytes re: making bids at auctions; and private banks are taking a more active role in educating clients about the nuts and bolts of money management. In other words, they are adding new services or capabilities to keep existing customers and cultivate new ones.

What can the structural building components industry do to take a more active role? Find innovative ways to help the customer buy/better appreciate your product or service. For example, suppose you're a plywood producer trying to convince a pallet manufacturer to switch from lumber to plywood. Part of the "switching costs" may include financing new assembly equipment and sourcing special grade (e.g. impact resistant, moisture resistant) plywood. To get this business, consider helping the pallet manufacturer find appropriate financing and sourcing (perhaps manufacturing it yourself) that special plywood grade that will meet the client's needs. In other words, we need to consider offering new and possibly unique services that make life easier and more profitable for our customers. After, all, that's why we're in business, aren't we?

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