EXECUTIVE BRIEFINGS

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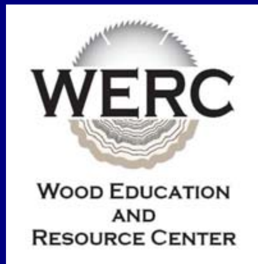

PENN STATE'S CENTER FOR WOOD INNOVATION & SUSTAINABILITY

FOREST RESOURCES BLDG
SCHOOL OF FOREST RESOURCES
UNIVERSITY PARK, PA 16802

Welcome to the third issue of Executive Briefings!

Judd H. Michael, Director

In this issue we finish our three-part series on economic trends and how they are effecting markets for housing and hardwood products. In March we discussed timing for a turnaround in housing, and last month offered an analysis of hardwood demand. It's too soon to tell if the economy is really turning around or not, but many indications are looking more positive. Here in Pennsylvania we are hearing a lot of mixed news from producers; for example, some cabinet manufacturers are calling back workers due to increased demand while others say sales are still very soft.

This month Bob gets on his soapbox and takes aim at those who would have us believe that a recovery in the housing markets can't occur during periods of high (and rising) unemployment. He debunks the popular media myth that housing sales and construction will not improve until unemployment improves. He provides data from previous recessions in order to provide evidence counter to this myth, and concludes that it is likely housing starts will recover even while unemployment is high.

For those of you in Pennsylvania and surrounding areas, we are hosting a training session on Human Resources Best Practices at the Timber 2009 show (State College) on May 29. We will also give a full day training program on Leadership Skills for wood industry managers/executives on June 3rd.
Please drop us a line if you are interested in more info on either of these programs.

If you did not get a copy of either of the first two issues of EB please let us know and we will send one to you.

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Economic Analysis from Bob Berg:

Media Myth: Housing Starts Will Not Recover Until Unemployment Improves

Bob Berg, Asst Director for Economic Analysis

Bob is former COO/CFO with RISI, Inc, and is a globally recognized economist in the wood, paper, and forest industries. Bob's role at the Center is to conduct analyses and provide critical economic information to industry decision makers.

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In recent months it has been common to hear or read that housing sales and construction will not improve until unemployment improves. While anything can happen, history shows us that this has not been the case in recent recessions. In fact, if we do have to wait until unemployment recovers in the current cycle to see an improvement in the housing market it will be the first time in modern history (post-World War II) that this would happen. It is amazing to me that this myth continues to go unchallenged. In this article I would like to debunk this myth and to do this I will rely on graphics and cut back on the dry economic theory.

In a business cycle, housing production is a leading indicator as it typically leads the economy into a recession and it is the first segment to recover. The purchase of homes is highly dependent on interest rates, home prices, personal income and consumer cash flow. Factors that negatively impact these send the housing market into decline very quickly and these same factors eventually send the other sectors of the economy into retreat either by direct multiples from housing or indirect response to the same factors. The Federal Reserve's efforts to slow the economy and dampen inflationary pressures act as a force via increasing interest rates, which impacts housing very quickly. Conversely, reducing interest rates to spur recovery in the economy stimulates housing markets.

A opposed to housing, unemployment is a lagging indicator. Producers respond to falling demand and reduce headcount. During this period, productivity (production per man-hour) slumps because headcount reductions fail to keep pace with reductions in output. On the other side of a recession, employers wait to add headcount until they have to and productivity typically surges during this period. So, the unemployment rate typically does not recover until the economic recovery is well entrenched and producers have the confidence to add headcount.

Furthermore, the economy can recover, or display positive growth, and unemployment can continue to rise (1990-1991 recession and 2000-2001 recession). The unemployment rate can only improve if the economy grows faster than its "potential". The growth potential of the economy is determined by growth in both the labor force and productivity (output per man-hour). Growth in the labor pool is determined by population growth, and the labor market is growing at just shy of 1% per year currently. Meanwhile, productivity (output per man-hour) has increased at a 2.5% average annual rate from 2000-2008. So, current growth potential is between 3.0% and 3.5%. If GDP growth is at or below this pace then the unemployment rate will not improve. This is how you get a jobless recovery. The consensus forecast as reported by the Federal Reserve in Philadelphia calls for 1.0% growth in US GDP in the second half of this year, rising to a 2.9% annual rate in the second quarter of 2010. Unemployment really doesn't improve in this forecast until the second half of 2010. So, you see why it is important to understand that housing starts can recover without an improvement in unemployment (http://www.phil.frb.org/research-and-data/real-time-center/survey-of-professional-forecasters/2009/survq209.cfm).

Now let's get on to the graphics. First, table 1 contains the recessions that I am going to review in this article and the official beginning and end as determined by the NBER (the official keeper of the recession records). I could have gone back to the 1970 recession but I thought that would be overkill.

Table 1: Recent US Recessions: Official Beginning, End, and Duration.

Recession	Start	End	Months
1973-1975	November, 1973	January,1975	16
1980	January, 1980	July, 1980	6
1981-1982	July, 1981	November, 1982	16
1990-1991	July, 1990	March, 1991	8
2001	March, 2001	November, 2001	8
2007-????	December, 2007		17 and Counting

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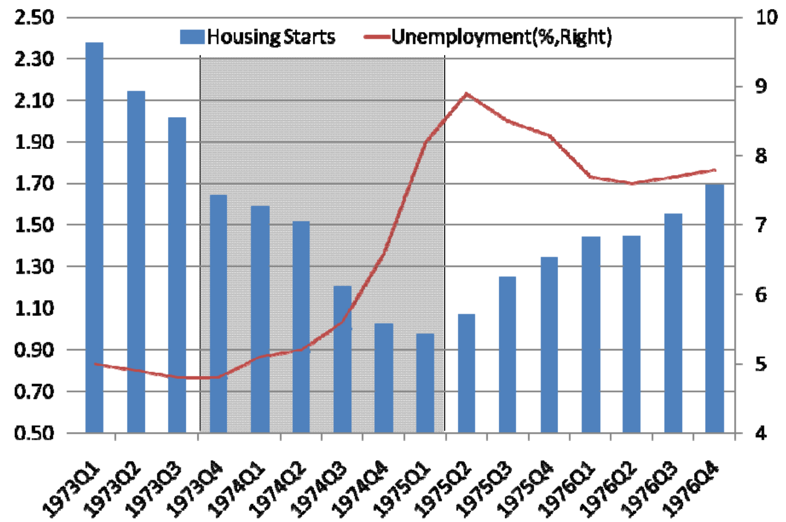
1973-1975 Recession

Housing starts peaked in the fourth quarter of 1992 fully a year before the US economy officially entered into the recession in November 1973 and continued to retreat through first quarter of 1975 (the end of the recession). Over the recession, unemployment surged from 4.8% to 8.2% and after the economy and housing turned up in the second quarter of 1973, the unemployment rate continued to move up to 8.9%. **The unemployment rate remained at elevated levels as housing continued to move higher in the quarters after the recession**.

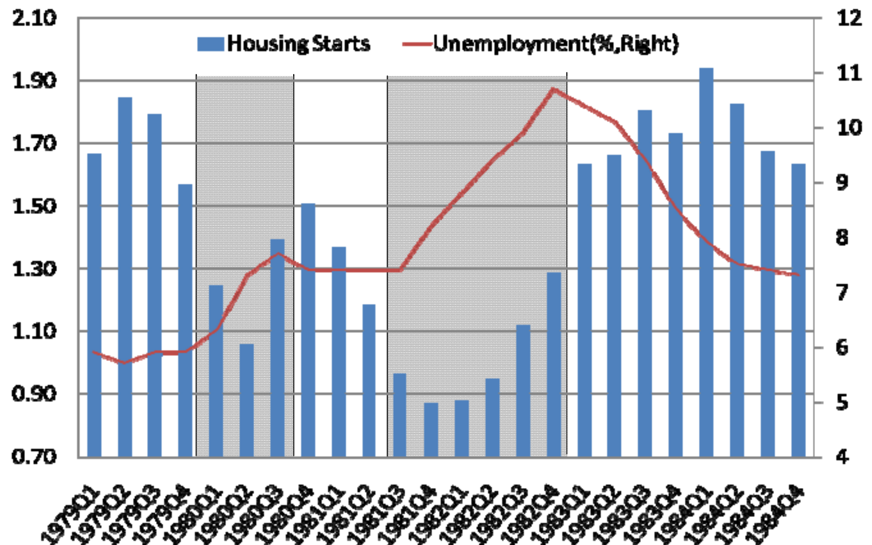
Figure 1: 1973-1975 Recession: Housing Starts and Unemployment.



1980 Recession

The 1980 recession was short because it was caused by credit controls by the Federal Reserve that cut off funding to the mortgage market and the Fed responded quickly to correct for this. Housing peaked in the second quarter of 1979 and the US economy slipped into recession in January of the following year. Housing bottomed in the second quarter of 1980 (the middle of the recession) and rebounded sharply off of the lows. The unemployment rate entered the recession at 6.3% and moved up to 7.7% by the end of the recession. **The unemployment rate remained at the elevated rate while housing production continued to rise.**

Figure 2: 1980 and 1981-1982 Recessions: Housing Starts and Unemployment.



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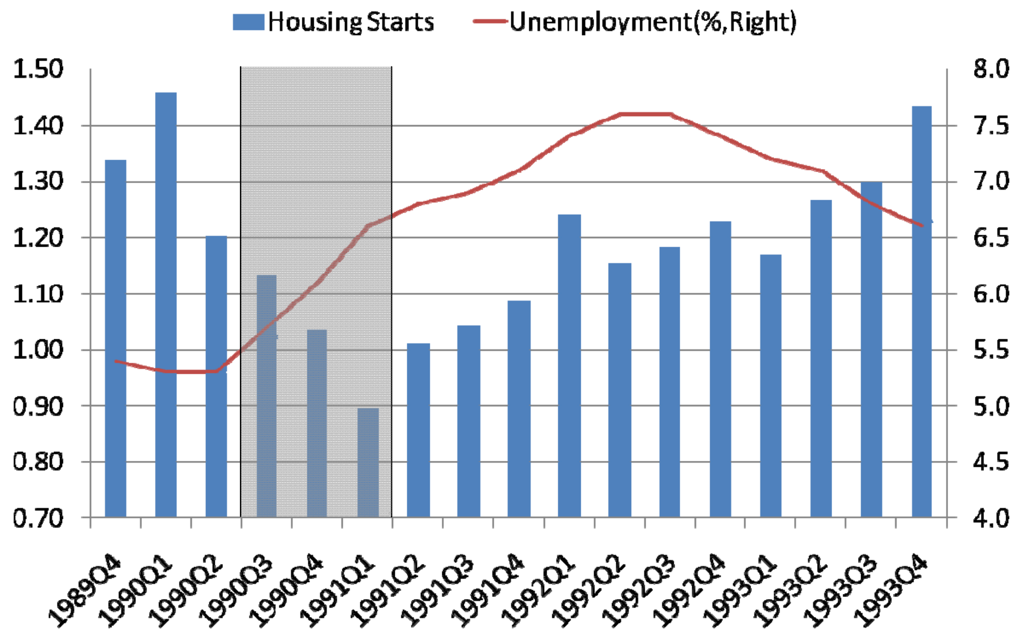
1981-1982 Recession

This was the second leg of a classic "W" recession that resulted from renewed effort on the part of the Federal Reserve to crush inflation (the Volker years). The recession officially began in July, 1981 but housing peaked three quarters before this in the fourth quarter of 1980 and retreated through the fourth quarter of 1981. Housing turned up midway through the recession in the second quarter of 1982. Meanwhile, the unemployment rate entered the recession at 7.4% and increased steadily to 10.4% by the end of the recession. **Clearly housing recovered while the unemployment rate climbed and housing continued to improve after the recession while the unemployment rate remained at historically very high levels (greater than 9.0% through mid-1983).**

1990 Recession

Housing peaked in the first quarter of 1990, two quarters before the US economy slipped into recession (July 1990) and moved lower through the recession. Housing recovered as the economy recovered. Meanwhile, unemployment increased from 5.3% to 6.6% through the recession and continued to deteriorate even after the economy exited the recession and peaked at 7.6% in mid-1992 (five quarters after the economy exited the recession) Meanwhile housing moved higher in parallel to the erosion in the job market. The jobless recovery following the 1990 recession is a good example of what happens when GDP growth falls short of growth potential. Again, **housing recovered at the same time the unemployment rate was getting worse.**

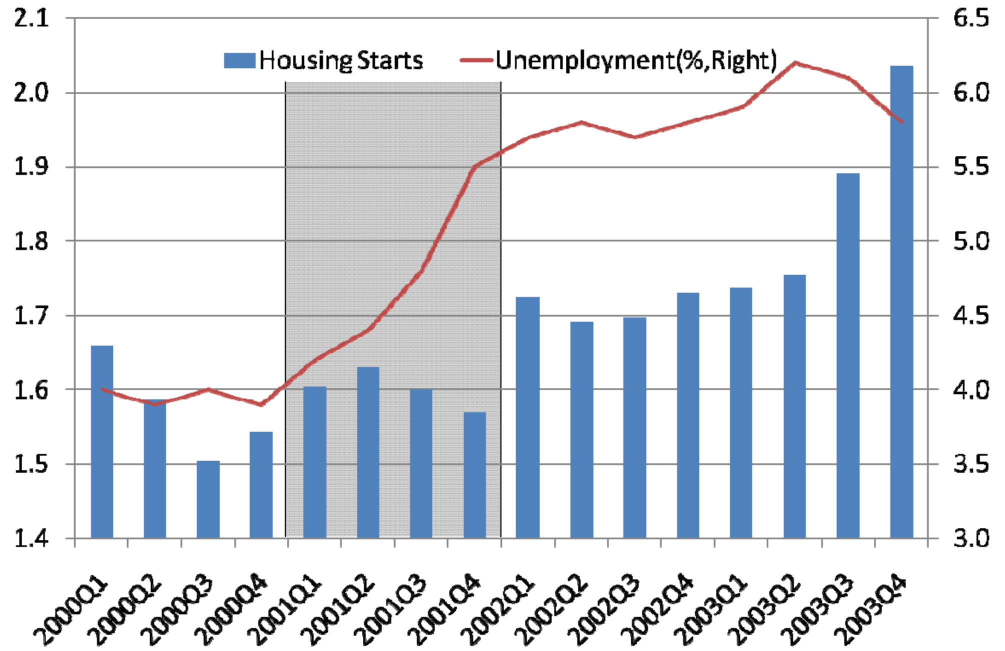
Figure 3: 1990-1991 Recession: Housing Starts and Unemployment.



2000-2001 Recession

The 2000-2001 recession was a strange one in that housing was moving up going into the recession and housing starts during the four quarters of the recession, at 1.60 million units, was up 1.8% from the four quarters leading into the recession. While housing starts held up, unemployment rose from 3.9% going into the recession to 5.5% at the end. **And unemployment continued to deteriorate after the recession while housing moved higher.**

Figure 4: 2000-2001 Recession: Housing Starts and Unemployment.



2007-???? Recession

In the current business cycle, housing starts actually started to decline six quarters before the US economy entered into recession in the last quarter of 2007. And since the beginning of the recession, housing starts continued to decline falling to 0.53 million units on a seasonally adjusted average basis; fully 75% below the cycle peak. Meanwhile, we entered this recession with low unemployment of 4.7%. Unemployment has deteriorated at an increasing rate through the cycle. By the first quarter of 2009, unemployment was at 8.1% and rising.

Figure 5: 2007-???? Recession: Housing Starts and Unemployment.

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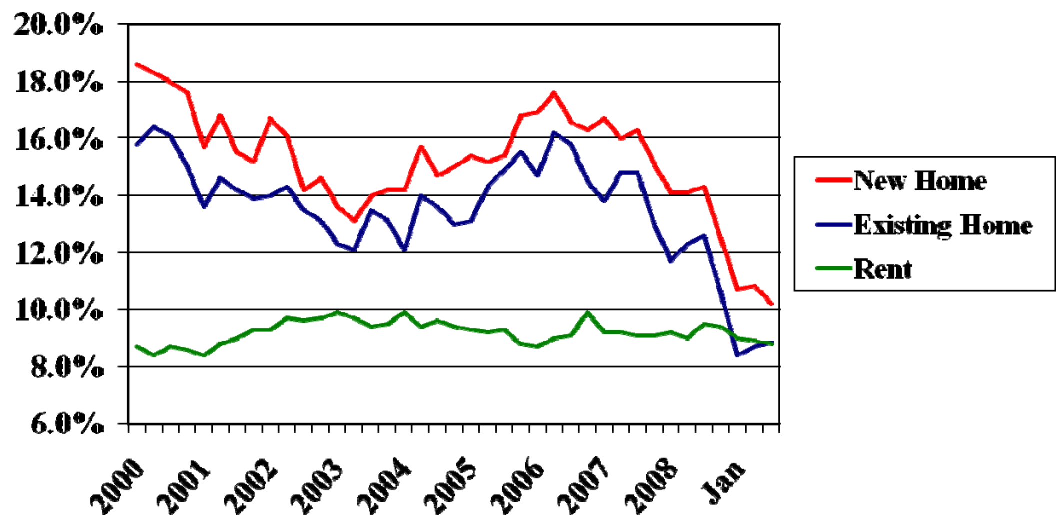
Debunking the Myth – Continued

Now we stand at a critical point in the recession as factors that lead to the retreat have been or are in the process of being reversed. Affordability has improved dramatically as a result of a striking decline in home prices and mortgage rates (see figure 6). Also, the government initiated an $8,000 tax credit to first time home buyers and allowed this credit to be used as a down payment. We have also made significant corrections to the supply/demand imbalance. During the recent fiasco in the housing market, many first time homebuyers have put off buying a home. Recent improvements in affordability and tax credits should start to lure first time home buyers back into the market. In fact, the National Association of Realtors (NAR) reports that half of recent home sales are to first time home buyers. Also, households displaced from homes through foreclosures represent pent up demand as they will move back into housing at a lower level (i.e., apartments). These dynamics should provide the underpinnings for a recovery in housing sales and production just like in previous cycles.

Figure 6: Annual Rent and Mortgage Payment Share of Household Disposable Income.



Can housing starts recover while unemployment is high and rising? The answer is clearly yes based on past experience. And not only can it recover in such an environment but it is likely that it will.

-- Bob Berg

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