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THISMONTH
IN CONSTRUCTION SUPPLY

MAY 2011

TRUST BUSTERS

By Greg Brooks. A short break from complaints would've been nice, but clearly that's too much to ask. One out of four Americans are mad that they can't see the photos of the hole in his head; 11% are upset that we took a human life (one that murdered 3,500+ Americans). Others are peeved about Obama getting more credit than Bush (what about the SEALs?), and John Yoo is miffed that we didn't take him alive so we could torture him.

Fortunately, most Americans seem to be ignoring the noise. Their bottom line is simple:

We got him. Turns out we're not quite as helpless as we might look.

That's a critical lesson right now because we're going to need it to take out the other boogeyman haunting us.

The economy is still a mixed bag, but it's no longer a boogeyman. GDP has risen seven straight quarters and is now above pre-recession levels. While the 1Q 2011 growth rate came in at just 1.8%, there's a good chance it'll be revised upward on the second pass.

Some worry that initial unemployment claims are again over the 400,000 benchmark. But private sector job growth has averaged more than 250,000 per month over the past three months. While the March unemployment rate rose from 8.8% to 9.0%, some believe that number is wrong, too.

Pundits complain about a "McJobs recovery" and there are plenty of anecdotes about $20-per hour workers who were laid off and had to take $10-per-hour jobs. There's also anecdotal evidence that workers are retraining for higher-paying jobs that require specialized skills. Plus, the job market is finally opening up for college grads this year.

Overall, wages and salaries in 1Q 2011 were up 1.6% YoY, following a 1.5% gain in 2010. It's true that wage growth is lower than it was during the boom, but it always is. That's why they call it a recession.

Maybe most important, many Americans missed the crash altogether. A study by Northeastern University broke out the unemployment rate in 4Q 2009 (its peak) by income level:

- Bottom 20% income level: 25.0% unemployed
- Next 20%: 13.8% unemployed
- Middle 20%: 8.4% unemployed
- Next 20%: 5.7% unemployed
- Top 20%: 3.6% unemployed

In other words, the people who got whacked hardest were the same people who held McJobs before the recession. Higher-income workers – those most able to afford to buy homes – were mostly unaffected.

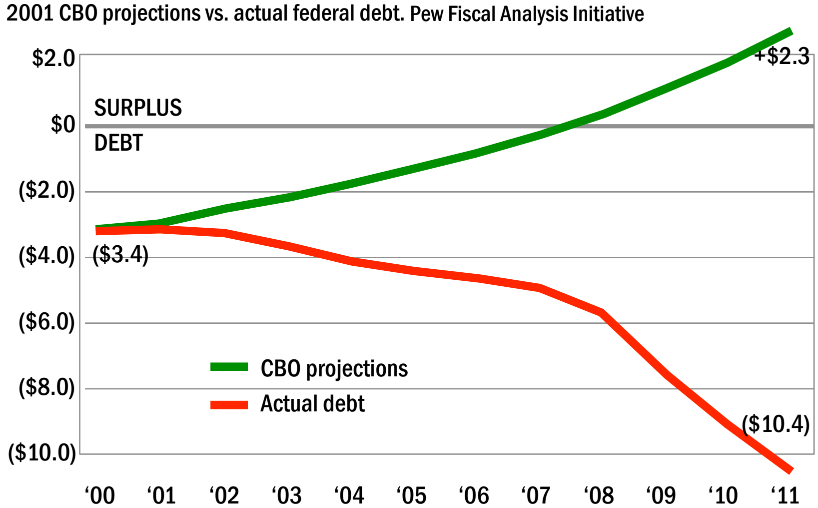
Which brings us to the mystery of the month. So far, housing starts this year aren't just anemic; we're not even keeping pace with 2010. The media is all abuzz about falling home prices, but it's hard to make a case that prices are keeping buyers on the sidelines when 69% say it's a good time to buy a house.

Nor are foreclosures crowding out new home sales, at least not any more than in 2010. According to RealtyTrac, 1Q 2011 REO and auction sales were down 25% YoY.

The notion that willing buyers can't get mortgages is valid to a point. But credit standards are easing. Most banks are lending to creditworthy borrowers and the most affluent 40% of the workforce has been at or near full employment throughout the recession.

Moreover, Americans are not souring on homeownership as some claim; 81% say a home is the best long-term investment you can make.

2001 CBO projections vs. actual federal debt. Pew Fiscal Analysis Initiative



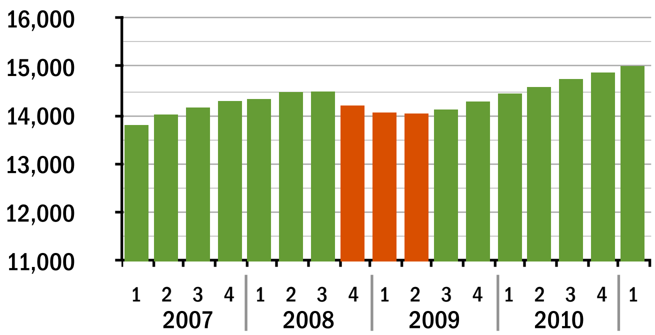
No question the housing market is constricted, but there are still plenty of buyers with the means and the motivation to buy homes. So why aren't they buying?

Because of the other boogeyman. Here's how the Pew Fiscal Analysis Initiative describes him:

"The U.S. will likely owe $10.4 trillion this year *(editor's note: public debt only; the gross debt is $14.4 trillion)*, its largest debt relative to the economy since 1950. However, the Congressional Budget

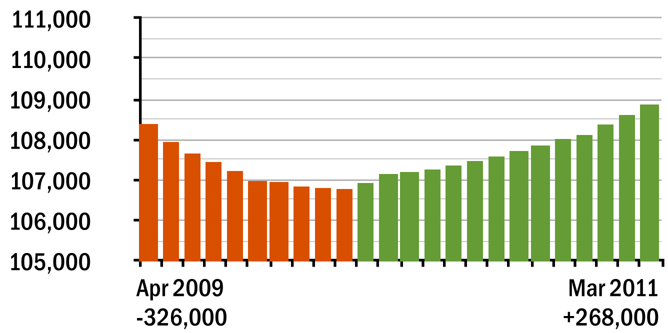
VITAL STATISTICS: U.S. ECONOMY

GROSS DOMESTIC PRODUCT ($ BIL)

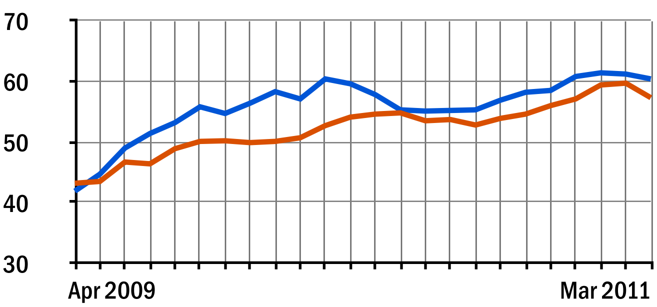


1Q 07: $13,789.5 1Q 2011: $15,006.4

PRIVATE-SECTOR EMPLOYMENT (000)



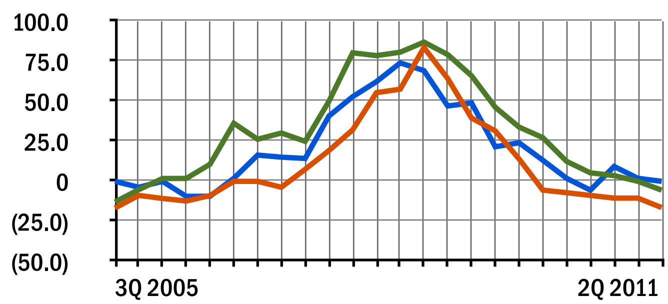
ISM PURCHASING MANAGERS' INDEX



Manufacturing: 60.4 Non-manufacturing: 57.3

Over 50 = expansion, under 50 = contraction

% OF BANKS TIGHTENING LENDING STANDARDS

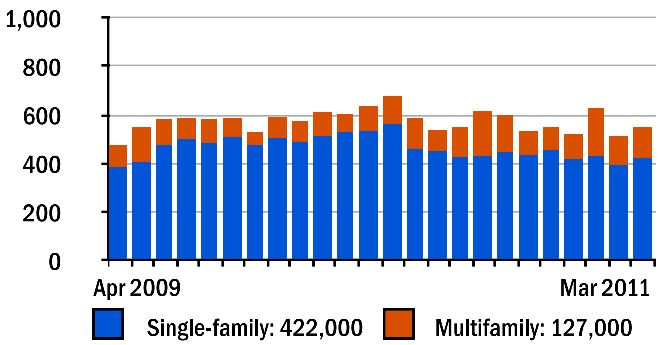


Commercial/industrial loans: -16.4%
Commercial real estate loans: +5.5%
Residential mortgage loans: 0.0%

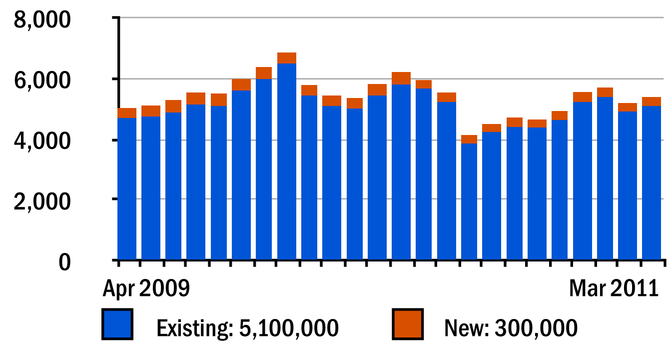
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve, Institute for Supply Management

VITAL STATISTICS: HOUSING

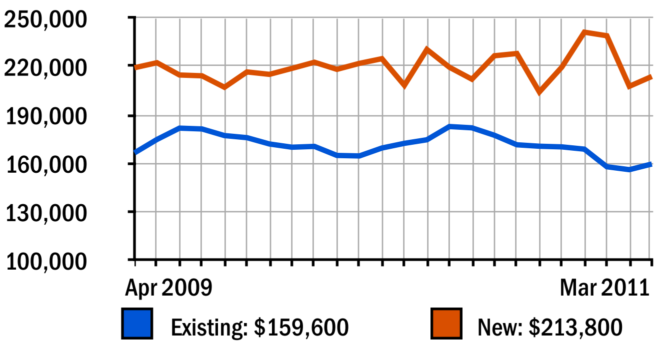
ANNUALIZED HOUSING STARTS (000)



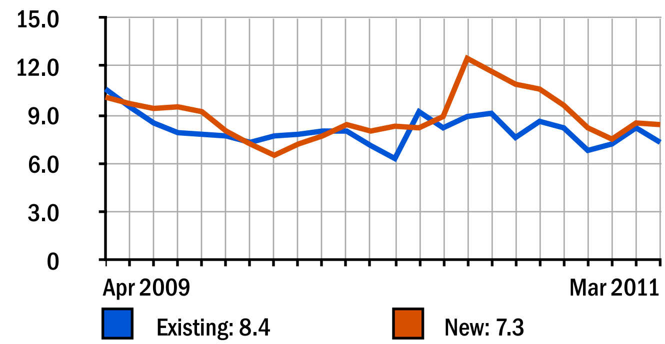
ANNUALIZED HOME SALES (000)



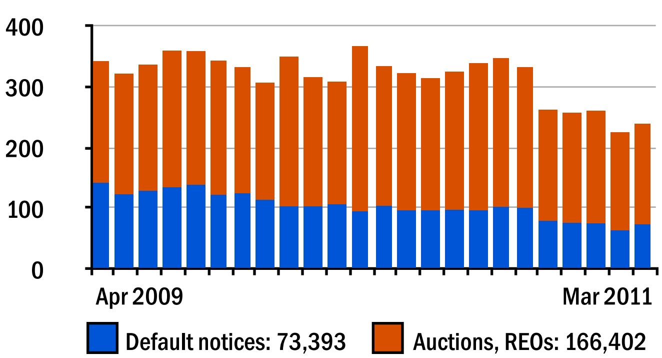
MEDIAN HOME PRICES



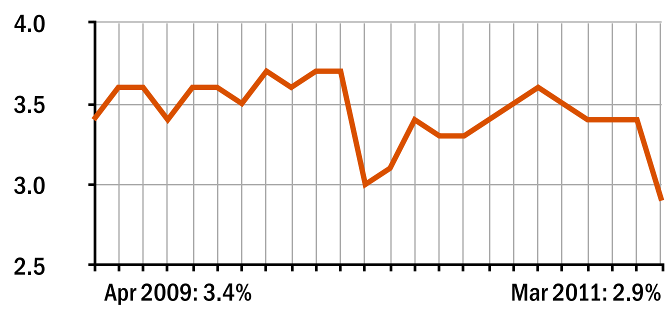
UNSOLD INVENTORY (MONTHS)



FORECLOSURES (000)



30-DAY DELINQUENCY % OF ALL MORTGAGES



[Download current Econo-Matrix spreadsheet at CS24.us](CS24.us)

Sources: U.S. Census Bureau, National Association of Realtors, Freddie Mac, RealtyTrac, Lender Processing Services. EconoMatrix data compiled by:

LBMRESEARCH

Office projected in 2001 that the federal government would erase its debt in 2006 and be $2.3 trillion in the black by 2011 — a $12.7 trillion difference from today's reality."

Mind-blowing? That's one way to put it. The U.S. was on track to be literally in the strongest position in its 235-year history: the leading economic power in the world *and* debt-free. Instead, we're facing the possibility that we'll be paying higher interest rates on the money we need to borrow to pay our bills.

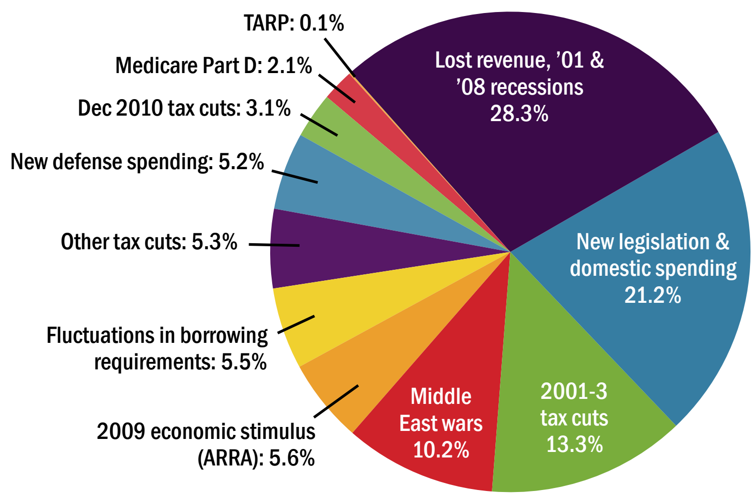
And we accomplished all that in a mere ten years.

To be fair, the single biggest component of that $12.7 trillion was unavoidable. The Pew study (CS24.us registration required; click here if you need a password) found that lost revenue from this recession and, to a lesser degree, the 2001-2 downturn accounted for $3.6 trillion of the total. Costs related to fluctuations in our borrowing requirements ate up another $700 billion. Take away all the other stuff and we'd still be in a hole right now. A little one.

How'd we get here? Like everything else these days, those are fighting words. Politicians on one side blame the Bush tax cuts, the Iraq and Afghanistan wars, and Medicare Part D. Politicians on the other side blame entitlements and the 2009 economic stimulus.

Actually, the second-largest component of the $12.7 trillion swing can be credited directly to politicians: $2.7 trillion in new legislation and domestic spending, not including the 2009 economic stimulus.

How a $2.3 trillion surplus turned into a $10.4 trillion deficit. Pew Fiscal Analysis Initiative



Given who had control of government over the decade, we can't blame one side, either. Turns out bipartisanship is alive and well, after all.

It's probably not be a good sign that we're relying on the same people to get us out of this mess, but that makes it worth an independent look at what it'll take to get the job done.

The Pew study doesn't make recommendations. Its purpose was to calculate the impact of the options available to us. It made three assumptions:

1. Whatever we do won't start until 2016, when CBO projects that the country will be back at full employment.
2. Whatever we do will reach its goal by 2025.
3. The goal is not to eliminate the debt but to reduce it to 60% of GDP, which is widely considered to be a reasonable and manageable level.

That may not be what you had in mind; debt-free sounds better to me, too. But it's a start, so let's see what Pew came up with.

There are three general options: 1) cut spending, 2) raise revenue, or 3) grow faster than the debt.

Most of the discussion so far has been about cutting spending. There are two types: Mandatory spending includes Social Security, Medicare, veterans' benefits, and other programs whose cost is based on the number of people enrolled. Mandatory spending makes up 57% of the budget.

Discretionary spending includes defense and other security programs, plus NASA and government agencies (Education, Transportation, HUD, etc.) that are budgeted each year. Discretionary spending makes up 37% of the budget, with defense accounting for about half of that.

If we cut mandatory spending only, Pew says it'd take a 34% cut to hit the 60% benchmark by 2025. If we cut discretionary spending alone, it'd take 70%. If we cut the two equally, each would have to be cut 23%.

The second option is to increase revenue by raising taxes. Over 70% of Americans favor letting the Bush tax cuts expire for households making over $250,000 per year, but that won't do the trick. Letting *all* the tax cuts expire would stabilize the debt, but the over-$250K crowd only accounts for 25% of the total.

By Pew's calculations, achieving 60% by 2025 would require an across-the-board 55% increase in individual income taxes, or a 26% increase in all taxes (individual and corporate income, payroll, excise, etc.). That would include corresponding cuts in so-called "tax expenditures" – i.e., tax breaks to encourage various activities, such as the mortgage interest deduction.

We could also do some of both, of course. If we cut spending and raise taxes the same percentage, 12% is the magic number that gets us to 60% of GDP by 2025, says Pew.

Finally, we could grow the economy faster than the debt. To reach 60% that way, says Pew, GDP growth would have to average 4.1% annually over the entire ten years. Pew believes that's unlikely; high-growth periods typically last two to four years and CBO projects that we'll average 2.1% over the next decade.

On the other hand, we've done it twice in recent memory. We averaged 4.7% from 1959-69 and had an eight-year run from 1992-2000 – which, incidentally, proved it can be done despite political gridlock.

The common thread was innovation: integrated circuits in the 60s and the Internet in the 90s. We don't know when the next game-changer is coming; that's why we need a thriving business climate. But it's also an argument for a thriving government – both originated in government R&D programs.

We're facing tough choices and deep political differences, but the the fact is that we're not as helpless as we look. Winston Churchill said it best:

"Americans can always be counted on to do the right thing. After exhausting all other possibilities."

Greg Brooks, editor of THIS MONTH, is a 43-year veteran of the construction supply business with 20 years' experience in the field. Brooks is a former editor of ProSales, a steering committee member at the Harvard Joint Center for Housing Studies, and author of Scope of the LBM Industry, published by the National Lumber & Building Material Dealers Association.

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