MACRO PULSE™

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Executive Summary*

The latest estimate of annualized 4Q2009 growth in real gross domestic product (GDP) was upwardly revised to 5.9 percent in February. Activity since then, however, suggests that real GDP growth in 1Q2010 will be 3.4 percent – still respectable but weaker than the previous quarter. That expectation derives from observations of tepid domestic demand thanks to continuing job losses. Although many manufacturing and service industries are enjoying a resurgence, the housing sector appears likely to continue exerting a drag on the economy. Recent dollar strength does not appear to have yet dented U.S. exports, but domestic producers' need to expand export markets could be frustrated if the current situation is maintained for much longer. A pause in crude oil's upward price trend is giving the U.S. economy some breathing room, but more stringent environmental regulation and heightened domestic and foreign consumption are likely to push prices higher. ■

U.S. Economic Recovery: Pig in a Poke, or the Real Thing?

U.S. gross domestic product. The U.S. economy grew slightly faster during 4Q2009 than originally reported, and more quickly than 80 percent of all quarters in the last 10 years (Figure 1). Real gross domestic product (GDP) increased at a seasonally adjusted and annualized rate (SAAR) of 5.9 percent (Figure 2),[1] 0.2 percent faster than the 5.7 percent rate estimated in February (Figure 3). Details of the GDP revision indicated that private domestic investment (PDI) – specifically a slowdown in the rate of inventory depletion – contributed essentially all of the change from last month's estimate. Contributions from personal consumption expenditures, net exports and government consumption expenditures were all revised lower.

As we indicated last month, the reasons underlying changes in PDI can be quite opaque. For example, 90 percent or more of the 4Q2009 PDI improvement was due to the change in inventories that occurred over the course of the quarter. Fundamentally, inventories rise when production exceeds sales and fall when sales exceed inventory. That's straightforward enough, although interpreting why inventories rose or fell can be tricky. For example, did they increase because sales were falling and production hadn't ramped back to accommodate? Or did they increase because firms see sales firming and are building inventory in anticipation of greater demand in the near future? While the rationales are diametrically opposed the effect on inventories is the same.

But interpretation is even trickier in this case. Private inventories fell in 3Q2009 because sales outstripped production. In 4Q2009 sales outstripped production once again, again causing private inventories to fall, only not as much as they fell in 3Q2009. Because the 4Q2009 inventory decline wasn't as big as in 3Q2009, that constituted a positive change. The $64 question then is whether or not the smaller decline in inventories is a harbinger of future sustained economic performance or a momentary blip followed by lower economic activity.

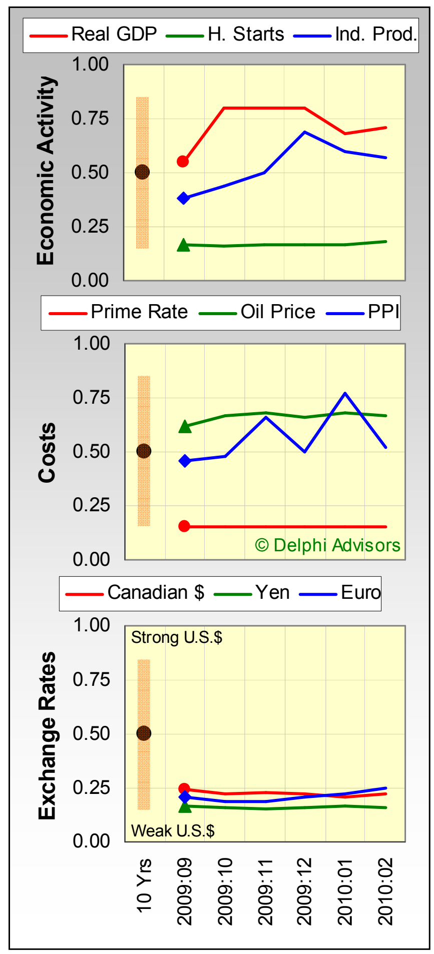

***Figure 1*. Previous six month's behavior of macroeconomic variables indexed relative to their historical 10-year min, max and average (lower and upper ends of the orange bars, and black dots, respectively)**

* Our complete, 24-month forecast is contained in the *Economic Outlook* newsletter, available through Forest2Market (http://www.forest2market.com/f2m/us/products/outlook).

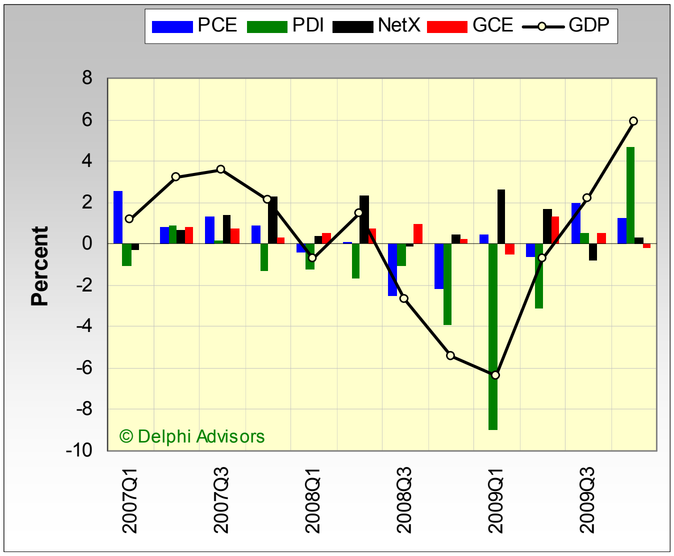

Figure 2**. Contributions – from personal consumption expenditures (PCE), gross private domestic investment (PDI), net exports (NetX), and government consumption expenditures and gross investment (GCE) – to percentage change in historical real GDP; data are seasonally adjusted at annual rates. Source: Bureau of Economic Analysis**

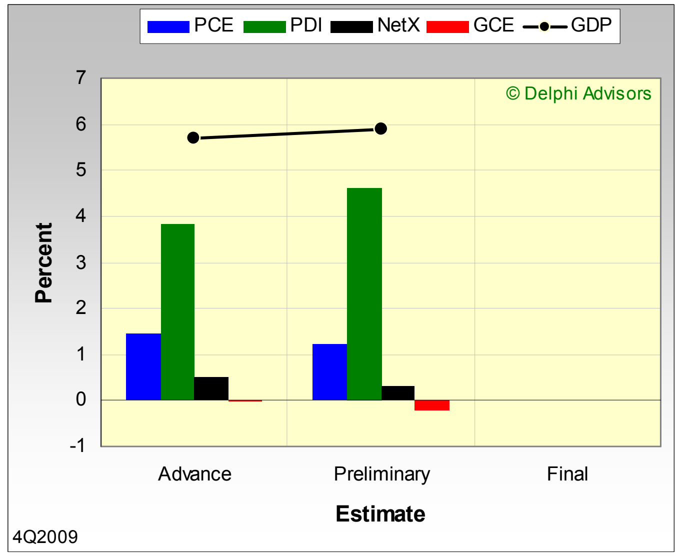

Figure 3**. Percentage change in real GDP, by estimate and component – personal consumption expenditures (PCE), gross private domestic investment (PDI), net exports (NetX), and government consumption expenditures and gross investment (GCE). Source: Bureau of Economic Analysis**

The four subsections that follow provide context for our view about how the components of GDP are likely to behave during 1Q2010 and beyond.

Personal consumption expenditures: Different data sources provide conflicting views of consumer spending. Although the Bureau of Economic Analysis claims consumer spending and non-food retail sales both rose 0.5 in January, state sales tax revenues indicate spending is contracting. Even if spending is truly rising, continuing job losses will suppress near-term aggregate consumption.

• Employment – U.S. non-farm payrolls declined for the twenty-fifth time in the past 26 months, falling by 36,000 in February to 129.5 million.[2] The decline would have been much worse except that the Bureau of Labor Statistics (BLS) added 97,000 "theoretical" jobs via its birth/death models.[3] According to the BLS, job losses were concentrated in construction (-64,000) and information (-18,000), while temporary help services added jobs (+48,000). It is widely believed increases in temporary employment will precede any lasting employment recovery so this may signal firms could start hiring again in the near future. Manufacturing jobs rose by 1,000, the second increase in a row. Employment in the federal government edged up, although the hiring of 15,000 temporary workers for Census 2010 was partially offset by a decline in U.S. Postal Service employment. With the number of unemployed essentially unchanged at 14.9 million, the official unemployment rate remained steady at 9.7 percent. A broader-based measure of labor underutilization – which includes the officially unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force – rose to 16.8 percent.

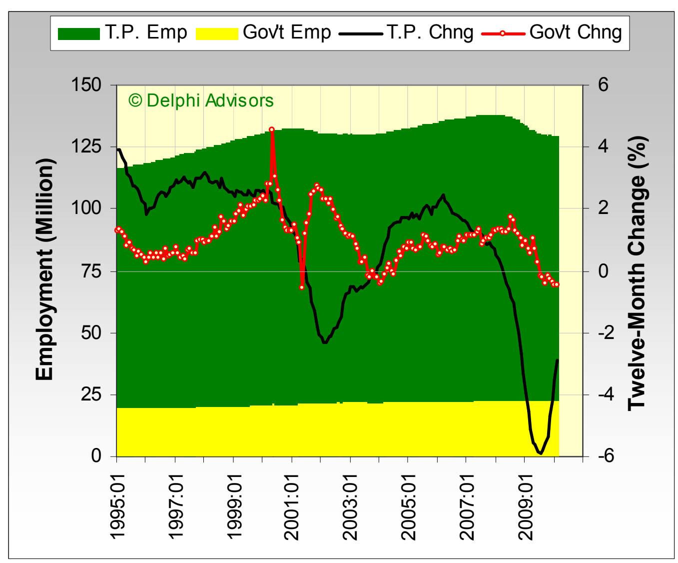

Figure 4**. Components – total private ("T.P.") plus government ("Gov't") – of total non-farm employment versus percentage change from prior 12 months in those components; data are seasonally adjusted. Source: Bureau of Labor Statistics**

On an annual percentage-change basis, private sector job losses continue to moderate at the same time public sector job losses are gradually gaining a head of steam (Figure 4).

The BLS contended that severe snow storms may have depressed the payroll count, but said the impact cannot be quantified. Some analysts dispute the BLS's claim by pointing out that the employment survey asks employers about payroll head count, not the number of employees "on the premises" when the survey is being conducted.[4] In addition, people who miss work for weather-related events are counted as employed in the household survey (the basis for the unemployment rate) whether or not they are paid for the time off.[5] The weather's impact is perhaps somewhat evident in the length of the average workweek, which fell by 0.2 hour (0.6 percent) to 33.1 hours.

In other employment-related news, on 2 March the U.S. Senate approved a provision extending unemployment benefits by 30 days;[6] that provision is part of a $100 billion-plus bill that would also revive a bevy of expired tax breaks, help states with soaring Medicaid costs and prevent doctors from having to absorb big cuts in Medicare payments. At the same time, the House and Senate have been jockeying to advance competing versions of a "jobs" bill (presently with a price tag of $35 billion) blending tax cuts, subsidies for infrastructure bonds issued by local governments, and transportation money.[7]

• Personal income and consumer spending – Consumer spending rose 0.5 percent in nominal terms (i.e., not adjusted for inflation) in January, the fourth consecutive monthly increase (Figure 5). At the same time, tax payments from investments and bonuses in 2009 caused disposable personal income to dip by 0.4 percent. With spending rising faster than incomes, the personal savings rate fell to 3.3 percent of disposable income (from 4.2 percent in December), the lowest rate since October 2008.[8] Non-food retail sales were up 0.5 percent from December 2009 – particularly among stores selling electronics and appliances (1.2 percent), sporting goods (1.0 percent), and general merchandise (1.5 percent), and non-store retailers (1.6 percent).[9]

One needs to take these statistics with a healthy dose of salt, however, because the methodology employed to generate them tends to put the situation in the most positive light possible. Year-over-year changes in retail sales figures, for example, are skewed to the positive by using only same-store sales for comparison; i.e., there is no attempt to account for the loss of sales at firms that have gone bankrupt (or stores that have closed) in the

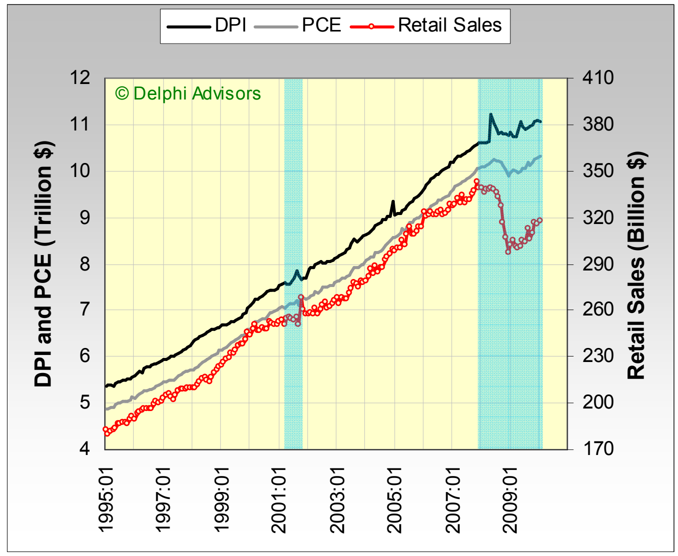

***Figure 5*. Disposable personal income and personal consumption expenditures (nominal dollars, SAAR) versus seasonally adjusted total retail (excl. food service) sales; recessions shown in blue. Sources: Bureau of Economic Analysis, Census Bureau and National Bureau of Economic Research**

intervening time period. A completely different – and more pessimistic – picture emerges if using sales tax receipts as an indicator of retail activity.[10] We are unaware of any state in which sales tax revenues are higher now than a year ago, even though many states have raised their sales tax rates in the meantime.

Private domestic investment: In general, activity in the manufacturing and service sectors is rising, but some forest products-related industries are not consistently sharing in that improvement. Contributions to domestic investment from the housing sector are particularly spotty, and appear likely to continue in that mode.

• Manufacturing and service industry output – Most metrics of manufacturing activity started 2010 on an "up" note (Table 1, Figures 6 - 10). Other than reductions in capacity, the only aspects of manufacturing in retreat (at least among the industries we track) were Paper shipments and inventories.

Another perspective on the strength of shipments comes from the Association of American Railroads' (AAR) *Rail Time Indicators* report. According to the most recent issue of that report, the volume of U.S. rail traffic is still "off" from 2009's levels – and even more substantially relative to 2008 (Table 2).[11] However, lumber and wood products showed an increase in shipped volumes during January 2010, relative to January 2009.

The Institute for Supply Management (ISM) provides

***Table 1*. Most recent reported manufacturing metrics – by industry or sector – and percentage change from prior month, prior year, bottom and peak. Sources: Federal Reserve Board and U.S. Census Bureau**

Metric / Industry	2010:01	2009:12	2009:01	Trough*	Date	Peak**	Date
Industrial Production Index		*---------------- Percentage Change ----------------*					
All Industries	101.1	0.9	0.9	5.5	2009:06	-10.1	2007:12
Wood Products	69.0	3.2	2.0	6.0	2009:05	-26.8	2007:12
Paper	84.9	1.1	6.0	8.5	2009:04	-13.4	2007:12
Capacity Utilization Index							
All Industries	72.6	1.0	2.1	6.3	2009:06	-10.0	2007:12
Wood Products	52.6	3.8	6.2	9.1	2009:05	-22.8	2007:12
Paper	75.4	1.3	8.2	10.2	2009:04	-10.5	2007:12
Capacity (% of 2002 Output)							
All Industries	139.2	-0.1	-1.1	- na -	2010:01	-1.1	2008:11
Wood Products	131.2	-0.5	-4.0	- na -	2010:01	-5.1	2008:03
Paper	112.6	-0.2	-2.0	- na -	2010:01	-3.2	2007:12
Shipments (Billion $)							
Total Manufacturing	383.7	0.3	5.5	8.3	2009:05	-11.9	2008:07
Wood	7.4	0.5	0.2	3.8	2009:03	-10.6	2008:06
Paper	13.0	-0.6	-1.5	2.0	2009:08	-9.0	2008:08
Inventories (Billion $)							
Total Manufacturing	495.2	0.2	-7.5	0.5	2009:09	-6.6	2008:08
Wood	9.3	0.7	-9.8	0.8	2009:11	-16.4	2007:12
Paper	13.3	-1.0	-10.0	- na -	2010:01	-13.1	2008:10
New Orders (Billion $)							
Total Manufacturing	378.4	1.7	9.5	10.9	2009:03	-15.8	2008:07
Durable Goods	174.9	2.6	9.7	10.7	2009:03	-23.0	2007:12
Non-durable Goods	203.5	0.9	9.4	11.0	2009:03	-8.5	2008:07

* Minimum value since December 2007 (the start of the current recession)
** Maximum value since December 2007 (or December 2007 if subsequent months were lower)
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more recent snapshots of activity in the manufacturing and service sectors.[12] Although ISM's survey of U.S. manufacturing firms showed the expansion remained very broad based in February, the pace of expansion slowed (to 56.5 percent, from 58.4 percent in January). Readings over 50 percent indicate more firms said business was improving than said it was worsening. "The manufacturing sector grew for the seventh consecutive month during February," reported Norbert Ore, chair of ISM's Manufacturing Business Survey Committee. "While new orders and production were not as strong as they were in January, they still show significant month-over-month growth. Additionally, the Employment Index is very encouraging, as it is up 2.8 percentage points for the month to 56.1 percent. This is the third consecutive month of growth in the Employment Index. With these levels of activity, manufacturers are seemingly willing to hire where they have orders to support higher employment."

Performance was mixed in February among the two major categories of forest products manufacturing (Table 3). With increases in overall activity, new and backlogged orders, and declining customer inventories, Paper Products looks to be reasonably well positioned for the future. Wood Products, on the other hand, continues to wither; the only ray of sunshine came from a decline in customer inventories, but that was tempered by shrinking order books.

ISM's report on service sector activity was more upbeat; it showed that part of the U.S. economy grew at the fastest pace in more than two years in February. The non-

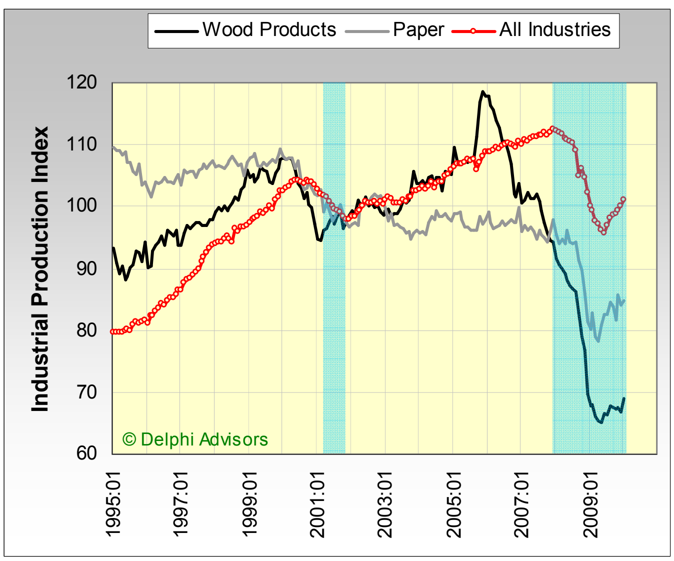

***Figure 6*. Seasonally adjusted industrial production (2002 average index = 100) by wood product and paper manufacturers, and all industries; recessions shown in blue. Sources: Federal Reserve Board and National Bureau of Economic Research**

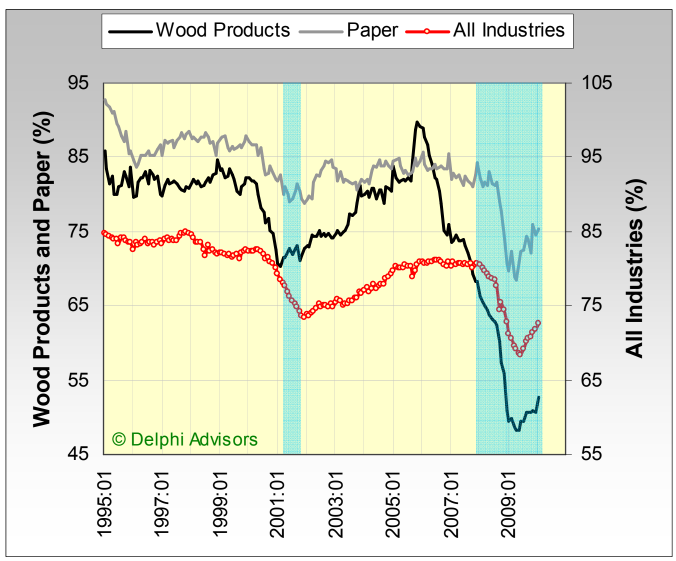

***Figure 7*. Seasonally adjusted capacity utilization among wood product and paper manufacturers, and all industries; recessions shown in blue. Note that the "All Industries" series is shifted to reduce clutter. Sources: Federal Reserve Board and National Bureau of Economic Research**

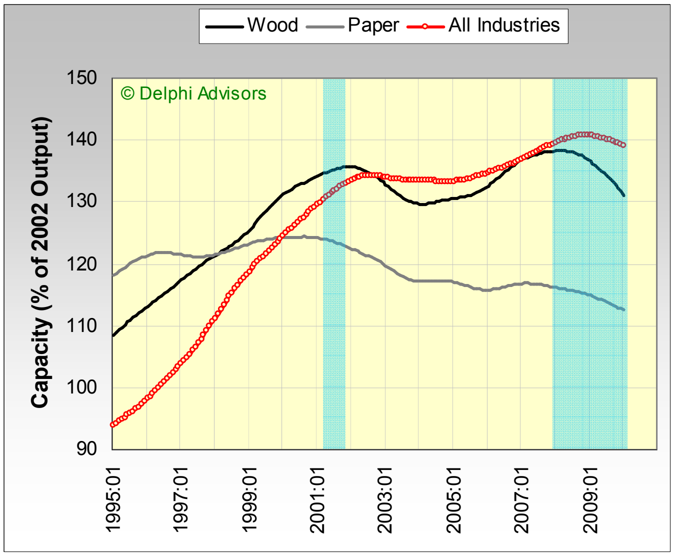

Figure 8. **Capacity of wood product and paper manufacturers, and all industries; recessions shown in blue. Sources: Federal Reserve Board and National Bureau of Economic Research**

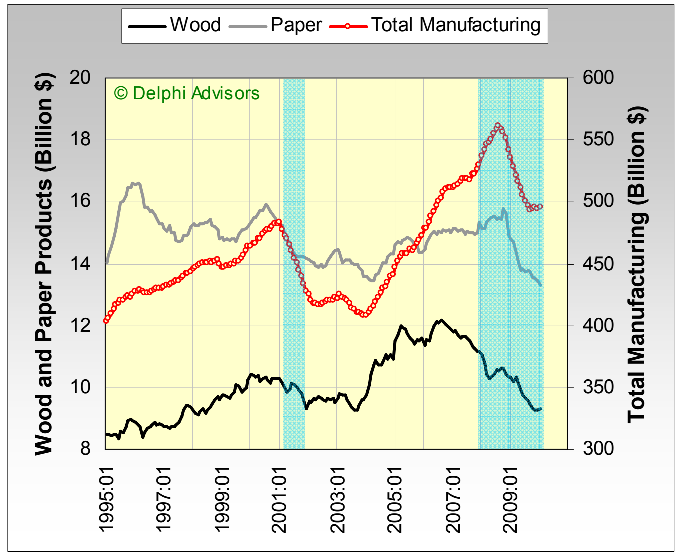

Figure 10. **Seasonally adjusted value of inventories, by sector; recessions shown in blue. Sources: Census Bureau and National Bureau of Economic Research**

Table 2. **U.S. rail traffic, by commodity. Source: Association of American Railroads**

Commodity	2010:01	2009:01	2008:01	Difference '10 - '09	Difference '10 - '08	% Change '10 - '09	% Change '10 - '08
			Thousand Carloads				
Total, all commodities	1,056.7	1,063.9	1,284.2	-7.2	-227.5	-0.7	-17.7
Forest products	38.3	39.1	52.6	-0.8	-14.2	-1.9	-27.0
Primary forest products*	6.5	6.8	9.0	-0.3	-2.5	-3.8	-27.6
Lumber & wood products	9.2	8.8	14.1	0.4	-4.9	4.6	-34.8
Pulp & paper products	22.6	23.5	29.4	-0.9	-6.8	-3.9	-23.1

* Wood raw materials such as pulpwood and wood chips

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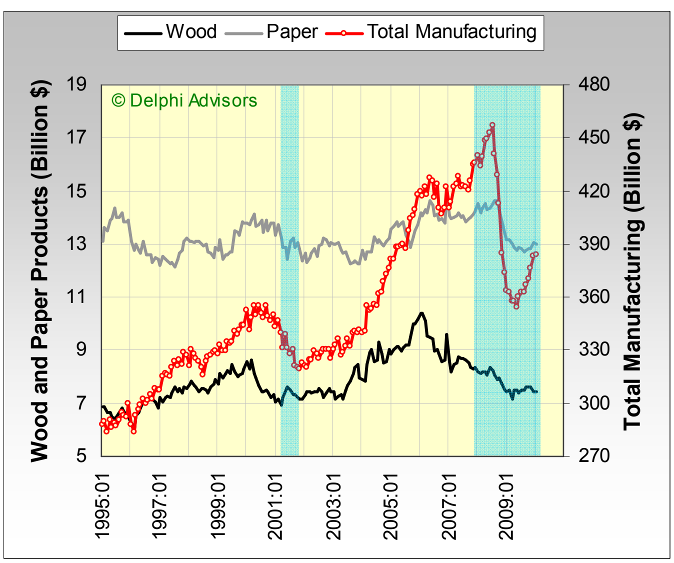

Figure 9. **Seasonally adjusted value of shipments, by sector; recessions shown in blue. Sources: Census Bureau and National Bureau of Economic Research**

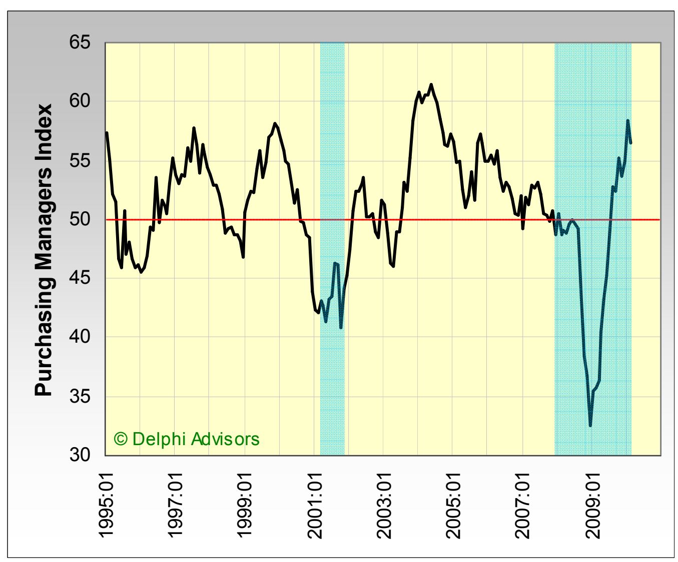

Figure 11. **Purchasing managers' index for manufacturers; an index of 50 is the threshold between expansion and contraction. Recessions shown in blue. Sources: Institute for Supply Management and National Bureau of Economic Research**

***Table 3*. Performance overview of selected industries. Source: Institute for Supply Management**

Category	February 2010 Wood Products	Paper Products	Real Estate	Construc-tion	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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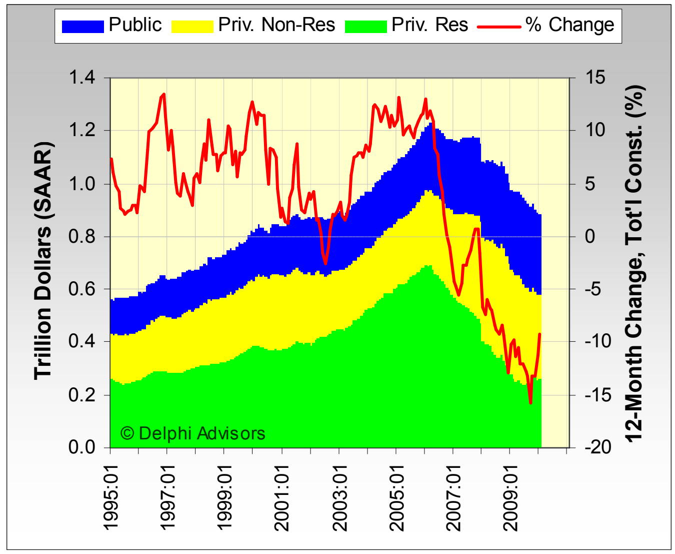

***Figure 12*. Total value of construction (public, private non-residential and private residential) put in place versus percentage change from prior 12 months in value of total construction. Source: Census Bureau**

manufacturing index rose to 53 percent in February from 50.5 percent in January, the best reading since December 2007. "The U.S. economy is recovering...in fits and starts," remarked Jennifer Lee, senior economist for BMO Capital Markets. While that may be true, the three industries most closely related to the forest products industry did not participate in the improvement (Table 3). The only mention of Agriculture, Forestry, Fishing & Hunting in the latest ISM report was a respondent's comment saying, "Business is okay. Customers are doing a lot of price shopping."

• Construction – Construction spending fell for a third straight month in January as flagging commercial activity (e.g., office buildings and hotels) offset an uptick in residential construction (Table 4 and Figure 12).[13] Private housing construction rose 1.3 percent, but that increase was erased by a 2.1 percent decline in nonresidential spending (the tenth consecutive monthly retreat).

Except for the aforementioned pickup in housing starts (Table 5 and Figure 13), the other categories of housing activity received another blow in January. Completions and new-home sales were hit particularly hard – victims perhaps of wet weather in the South and repeated snow storms in the North and Northeast. Others blame the fall-off in new home sales to the pool of foreclosed properties ebbing back into the market. Anecdotal evidence appears to support that contention: When applying for new home loans, banks often alert clients of available foreclosed homes in the same area;[14] banks would understandably prefer to put credit worthy buyers in foreclosed properties instead of lending them money on new homes. "The foreclosure flow is robbing demand from the new-homes market, and that process seems to be strengthening," said Julia Coronado, a senior economist at BNP Paribas. "The new-homes market just can't get off the floor. If new homes suffer, construction suffers and jobs suffer."[15]

The sales rate of 309,000 (SAAR) is the slowest pace on record (data collection began in 1963). Because the inventory of new homes for sale edged up slightly in absolute terms while the sales rate plummeted, the months of inventory jumped to 9.1 months (Figure 14).[16]

Sales of existing homes and condos also dropped in January (-7.2 percent) to 5.05 million SAAR, the lowest in seven months. Sales fell during two consecutive months after rising steadily through the fall in response to a federal subsidy for first-time home buyers. "The latest monthly sales decline is not encouraging," remarked Lawrence Yun, chief economist for the National Association of Realtors (NAR), "and [it] raises concern about the strength of a recovery." Inventories of unsold homes fell 0.5 percent to 3.265 million, but the slow sales pace boosted months of supply to 7.8 months.

***Table 4*. Value of construction put in place, and percentage change from prior month, prior year, and each category's respective bottom and peak. Source: Census Bureau**

Category	2010:01	2009:12	2009:01	Trough*	Date	Peak**	Date
	Billion $ (SAAR)	----------	----------	Change (%)	----------	----------	
Total	884.1	-0.6	-9.3	- na -	2010:01	-28.0	2006:03
Private	577.3	-0.6	-14.3	- na -	2010:01	-40.9	2006:03
Residential	260.8	1.3	-6.4	10.1	2009:06	-62.4	2006:01
Non-residential	316.4	-2.1	-19.9	13.2	2006:01	-25.8	2008:10
Public	306.9	-0.7	2.1	26.5	2006:01	-5.8	2009:07

* Minimum value since 2006:01 (or 2006:01 if subsequent values were greater)
** Maximum value since 2006:01 (or 2006:01 if subsequent values were smaller)

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***Table 5*. Overview of most-recently available housing market conditions, and comparisons to prior month, prior year, and each category's respective trough and peak. Source: Census Bureau and National Association of Realtors**

	2010:01	2009:12	2009:01	Trough*	Date	Peak**	Date
Activity (SAAR, Thous.)							
New Homes		*Percentage Change*					
Permits							
1-unit	504	-0.2	47.4	47.4	2009:01	-72.0	2005:09
All units	622	-4.7	17.1	24.9	2009:04	-72.5	2005:09
Starts							
1-unit	484	1.5	35.6	35.6	2009:01	-73.5	2006:01
All units	591	2.8	21.1	23.4	2009:04	-74.0	2006:01
Completions							
1-unit	427	-12.9	-24.3	0.0	2010:01	-77.7	2006:03
All units	659	-12.4	-15.3	0.0	2010:01	-70.6	2006:03
Sales (1-unit)	309	-11.2	-6.1	0.0	2010:01	-77.8	2005:07
Existing Homes							
Sales (All units)	5,050	-7.2	11.5	11.5	2009:01	-30.3	2005:09
Inventory		*Thousands*					
New (1-unit)	234	233	340	233	2009:12	572	2006:07
Existing (All units)	3,265	3,283	3,611	3,198	2006:03	4,575	2008:07
		Months					
New (1-unit)	9.1	8.0	12.4	4.1	2005:03	12.4	2009:01
Existing (All units)	7.8	7.2	9.6	5.6	2006:03	11.3	2008:04
Median Price (Thous. $)		*Percentage Change*					
New (1-unit)	203.5	-5.6	-2.4	0.0	2010:01	-22.5	2007:03
Existing (All units)	164.7	-3.4	0.0	0.0	2009:01	-28.5	2006:07

* Minimum value since January 2005 (near the peak of the housing market)
** Maximum value since January 2005 © Delphi Advisors

Slack sales affected prices in January. The median price of new homes sold dropped 5.6 percent (to $203,500); existing homes fared somewhat better, falling only 3.4 percent (to $164,700). Affordability of existing homes is again approaching the all-time highs set back at the beginning of 2009 (Figure 15). The S&P/Case-Shiller 10- and 20-city home price indices were essentially unchanged between November and December (each declined roughly 0.2 percent on a seasonally unadjusted basis). "As measured by prices, the housing market is definitely in better shape than it was [at the end of 2008], as the pace of deterioration has stabilized for now," said David Blitzer, chair of the Index Committee at Standard & Poor's. "However, the rate of improvement seen during the summer of 2009 has not been sustained."[17]

The $6,500 "repeat" home buyer tax credit has done little to boost home sales, according to real estate agents around the country. Among the reasons given: The unemployment rate is still near 10 percent and consumer confidence is weak. Harsh winter weather kept Americans shoveling driveways instead of prepping their homes for buyer visits. Many potential "repeat" buyers will need to first sell their current home – a major obstacle for the nearly one-third of homeowners with a mortgage who owe more than their home is worth. Also, $6,500 may not mean much to a buyer with enough equity to sell a property and afford another home. The credit will seldom be enough to cover the real estate agent's commission (typically 6 percent of the sales price), much less moving costs. The agent's commission is $9,882 for a home sold at the national median sales price of $164,700.[18]

One bit of good news on the housing front is that the delinquency rate for mortgage loans on one-to-four-unit

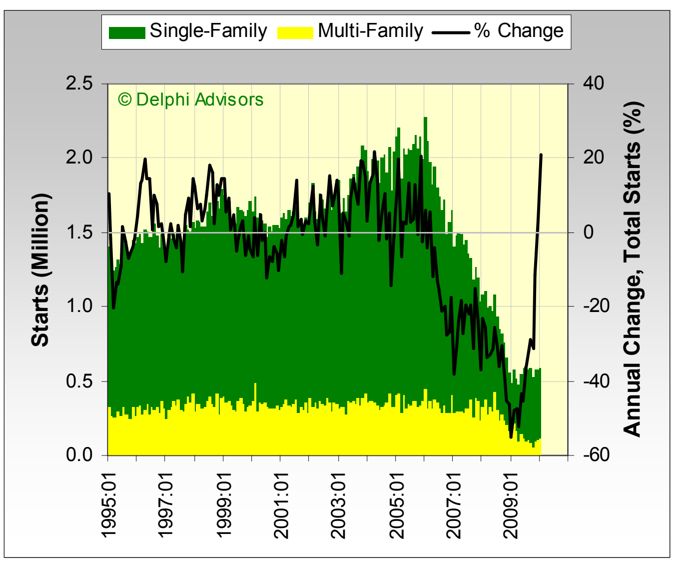

***Figure 13*. Components of total housing starts versus annual percentage change in total starts; data are seasonally adjusted and annualized. Source: Census Bureau**

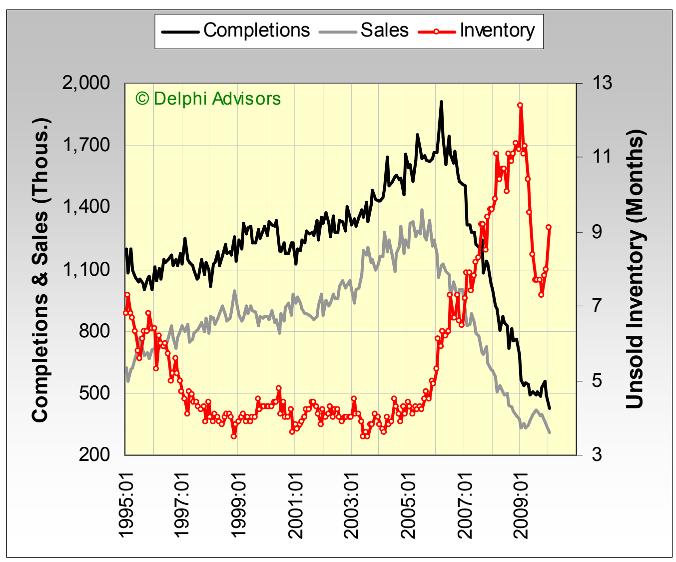

***Figure 14*. New, single-unit housing completions and sales versus unsold inventory expressed as the number of months required to clear the market; data are seasonally adjusted and annualized. Source: Census Bureau**

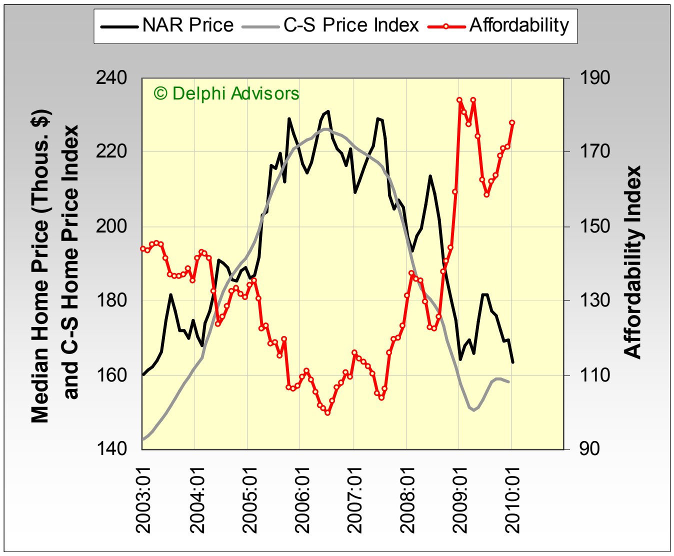

***Figure 15*. NAR median existing home price and Case-Shiller 10-city home price index versus NAR housing affordability index. Sources: National Association of Realtors and Standard & Poor's**

residential properties fell to a seasonally adjusted rate of 9.47 percent of all loans outstanding at the end of 4Q2009, down 0.17 percent from 3Q2009, but up 1.59 percent from a year earlier, according to the Mortgage Bankers Association's (MBA) National Delinquency Survey. "We are likely seeing the beginning of the end of the unprecedented wave of mortgage delinquencies and foreclosures that started with the subprime defaults in early 2007, continued with the meltdown of the California and Florida housing markets due to overbuilding and the weak loan underwriting that supported that overbuilding, and culminated with a recession that saw 8.5 million people lose their jobs," said Jay Brinkmann, MBA's chief economist. "This drop is important because 30-day delinquencies have historically been a leading indicator of serious delinquencies and foreclosures. With fewer new loans going bad, the pool of seriously delinquent loans and foreclosures will eventually begin to shrink once the rate at which these problems are resolved exceeds the rate at which new problems come in. It also gives us growing confidence that the size of the problem now is about as bad as it will get."[19]

While we hope Brinkman's prediction proves to be the case, only time will tell whether the drop in delinquencies is a turning point or simply a momentary hiatus from the ongoing pain. Even if unemployment begins to ebb in the near future the progress back toward something like full employment is expected to be slow. Unemployment and delinquencies are highly correlated.[20] First American CoreLogic reported results of their latest survey that in 4Q2009 nearly 25 percent of mortgage holders in the United States owe more than their mortgages than their homes are currently worth.[21] They estimate 11.3 million mortgage holders are in this predicament, an increase from 10.7 million in 3Q2009. Credit agencies are now reporting a growing trend where mortgage holders are paying credit cards and not paying on their mortgages. TransUnion recently reported a shift in behavior where credit card payments were paid in preference to mortgage payments.[22] A recent FICO report indicated that, for the first time ever, persons with high FICO scores were more likely to default on their mortgage than on their credit card debt.[23] This combination of factors cautions us to not jump to conclusions when interpreting the recent good news with respect to mortgage delinquency.

Net exports: Recent dollar strength does not appear to have yet dented U.S. exports, but that situation could change quickly unless the greenback returns to its weakening trend.

• General – The U.S. monthly international trade deficit increased from $36.4 billion (revised) in November to $40.2 billion in December, as imports increased more than exports (Figure 16). Exports of goods and services increased $4.6 billion in December to $142.7 billion, mostly reflecting an increase in goods exports. Services exports were virtually unchanged. Imports of goods and services increased $8.4 billion in December to $182.9 billion, mostly reflecting an increase in goods imports. Services imports also increased. The most actively traded goods included capital goods; industrial supplies

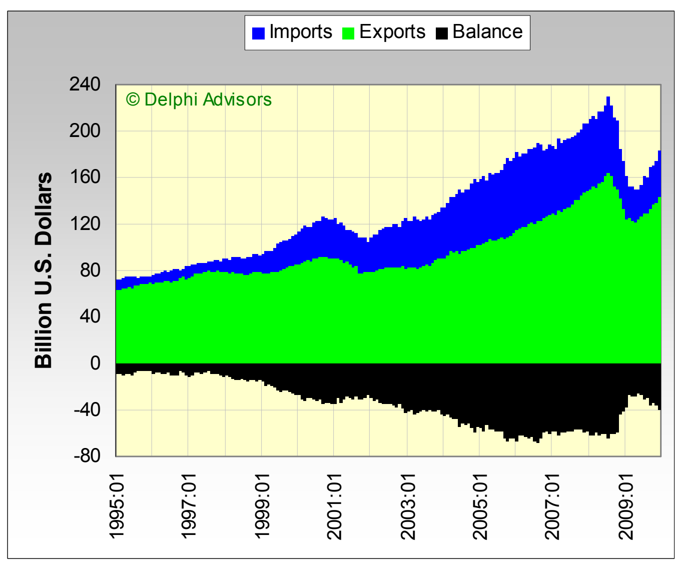

***Figure 16*. Total nominal value of goods and services imported into, and exported from, the United States. Data are seasonally adjusted and reported on a balance-of-payments basis. Source: U.S. Census Bureau, Foreign Trade Division**

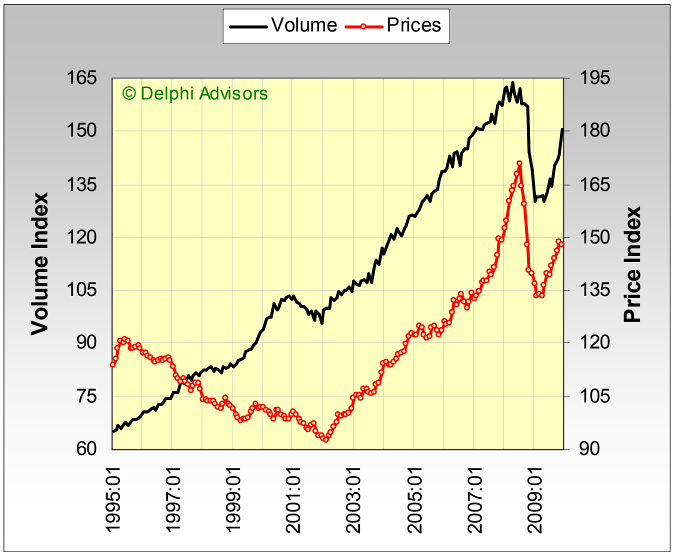

***Figure 17*. Indices (2000 average = 100) of world trade volume and unit prices. Data are seasonally adjusted. Source: Netherlands Bureau for Economic Policy Analysis**

and materials; and automotive vehicles, parts, and engines.[24]

The Netherlands Bureau for Economic Policy Analysis (known by its Dutch acronym CPB) provides a global perspective on international trade (Figure 17).[25] CPB estimates world trade volume expanded by an unprecedented 4.8 percent in December 2009 (up from +1.1 percent in November). Import volumes of emerging economies continued to expand at an accelerated pace (7.8 percent) in December. Import growth was particularly high in emerging economies in Asia and Latin America, but accelerated in advanced economies as well (from 0.7 percent in November to 2.7 percent in December). In December, trade was 8 percent below the peak level reached in April 2008, but 15 percent above the trough reached in May 2009. In 2009 as a whole, trade decreased by an unheard-of 13.2 percent. On a quarterly basis, world trade rose by 6.0 percent between 3Q and 4Q2009, a record increase for CPB's data series (which begins in 1991).

Dollar prices of world trade were up by 4.1 percent in 4Q2009 relative to 3Q. Price momentum (defined as the difference in quarterly averages) turned positive in June, after a series of deep declines that started towards the end of 2008. Dollar prices of traded manufactures decreased by 1.0 percent in December, their momentum still being 2.6 percent, down from 3.1 percent in November, which was the highest figure since July 2008.

• Forest products – U.S. exports of wood pulp, paper and paperboard rose in December to the highest level since January 2008, while imports fell to a new cyclical low (Table 6). Exports were 33.1 percent above, and imports 18.9 percent below, December 2008 levels.

Lumber exports retreated for a second month in December, and are now well below the trend that had been in place since December 2008 (Table 7). Nonetheless, December's exports were 28.8 percent above year-earlier levels. With another drop-off in December, lumber imports appear to have reverted to a declining trend, after

***Table 6*. Most recent six-month trends in U.S. wood pulp, paper and paperboard trade. Source: USDA Foreign Agricultural Service**

	------ *Thousand Metric Tons* ------							Prior Six-Month	
Current Year	**2009:06**	**2009:07**	**2009:08**	**2009:09**	**2009:10**	**2009:11**	**2009:12**	**Totals**	**Change (%)**
Exports	2,859	2,705	2,922	2,750	2,879	2,881	3,029	17,165	
Imports	347	369	356	344	354	346	331	2,100	
Net Exports	2,512	2,335	2,566	2,406	2,525	2,535	2,698	15,065	
Month-to-month change (%)		-7.0	9.9	-6.2	4.9	0.4	6.4		
Prior Year	**2008:06**	**2008:07**	**2008:08**	**2008:09**	**2008:10**	**2008:11**	**2008:12**		
Exports	2,834	2,903	2,896	2,646	2,790	2,177	2,275	15,688	
Imports	504	540	490	519	476	437	408	2,869	
Net Exports	2,329	2,364	2,406	2,127	2,314	1,740	1,867	12,818	
Year-over-Year Change, by Month									
Exports	25	-199	25	104	89	703	755	1,477	9.4
Imports	-157	-171	-134	-175	-122	-91	-76	-770	-26.8
Net Exports	182	-28	160	279	211	794	831	2,247	17.5
Change (%)	7.8	-1.2	6.6	13.1	9.1	45.6	44.5	17.5	
Change between Current Year-to-Date vs. Prior Year-to-Date, by Month									
Exports	-1,860	-2,059	-2,033	-1,929	-1,840	-1,137	-383		
Imports	-1,118	-1,289	-1,423	-1,598	-1,720	-1,811	-1,888		
Net Exports	-742	-770	-610	-331	-120	674	1,505		
Change (%)	-5.3	-4.7	-3.3	-1.6	-0.5	2.7	5.6		© Delphi Advisors

***Table 7*. Most recent six-month trends in U.S. softwood lumber trade. Source: USDA Foreign Agricultural Service**

	Million Board Feet								
Current Year	**2009:06**	**2009:07**	**2009:08**	**2009:09**	**2009:10**	**2009:11**	**2009:12**	**Prior Six-Month Totals**	**Change (%)**
Exports	80	81	90	81	102	97	85	536	
Imports	781	737	802	746	771	712	685	4,453	
Net Exports	-702	-657	-712	-665	-669	-614	-600	-3,916	
Month-to-month change (%)		-6.4	8.4	-6.5	0.6	-8.2	-2.4		
Prior Year	**2008:06**	**2008:07**	**2008:08**	**2008:09**	**2008:10**	**2008:11**	**2008:12**		
Exports	89	102	88	87	86	78	66	507	
Imports	1,113	1,078	1,009	1,056	981	943	743	5,811	
Net Exports	-1,024	-976	-921	-970	-895	-866	-676	-5,304	
Year-over-Year Change, by Month									
Exports	-9	-21	2	-5	16	20	19	29	5.7
Imports	-332	-341	-207	-310	-210	-232	-58	-1,358	-23.4
Net Exports	322	320	209	305	225	251	77	1,387	-26.2
Change (%)	-31.5	-32.7	-22.7	-31.4	-25.2	-29.0	-11.4	-26.2	
Change between Current Year-to-Date vs. Prior Year-to-Date, by Month									
Exports	-72	-93	-91	-96	-81	-61	-43		
Imports	-2,468	-2,809	-3,016	-3,326	-3,536	-3,768	-3,826		
Net Exports	2,396	2,716	2,925	3,230	3,455	3,706	3,783		
Change (%)	-37.7	-37.1	-35.5	-35.0	-34.2	-33.8	-32.5		© Delphi Advisors

trending higher between January and August 2009. December's imports were 7.8 percent below year-end 2008 levels.

In other paper-related trade news, the U.S. Department of Commerce (DOC) will impose tariffs of between 3.92 and 17.48 percent on imports of coated paper from China and Indonesia after determining that companies in those countries received unfair subsidies and harmed U.S. producers by dumping their products in this country. Appleton Coated LLC, NewPage Corporation, and Sappi Fine Paper North America – together with the United Steelworkers – filed unfair trade cases on 23 September 2009 with the DOC and the U.S. International Trade Commission (ITC). The DOC's decision follows the ITC's preliminary determination of injury to the industry last November.[26]

Asia Pulp & Paper (APP), a major exporter of coated paper from China and Indonesia, expressed disappointment with the initial findings. "This is a disappointing preliminary decision," said Terry Hunley, acting president of APP Americas, "but it is a long process and the Commerce Department is still gathering and analyzing all the facts. At the end of the day we expect a significant improvement in these preliminary subsidy findings, and confirmation again that the U.S. industry has not been injured and is therefore not entitled to any special protection."[27]

China and Indonesia are not the only countries with which the United States has ongoing trade disputes – Canada is another. For example, the U.S. Coalition for Fair Lumber Imports claims that support programs provided by the New Brunswick government to reopen the Miramichi Lumber Products mill are in direct contravention of the U.S.-Canada Softwood Lumber Trade Agreement (SLA). The New Brunswick government intends to provide a C$1.5 million loan and another C$1.5 million loan guarantee, as well as an increase in Crown Timber Allocation to ensure the shuttered mill can resume operations.

"This latest New Brunswick government action is yet another example of the efforts of Canada's lumber producing provinces to find ways to subsidize its industry. It runs afoul of the SLA," said Steve Swanson, chair of the Coalition. "The SLA specifically forbids these types of…subsidies because they circumvent the SLA's disciplines designed to promote fair trade in lumber. By using subsidies to open production facilities that otherwise could not obtain financing on the market, New Brunswick's actions will prolong the severe depression in the North American lumber market, at the expense of American lumber producers who operate in an open-market and fair timber pricing system."[28] Diana Blenkhorn, president and CEO of New Brunswick's Maritime Lumber Bureau, discounted the Coalition's claim, saying that the aid is neither a subsidy nor inconsistent with the SLA.[29]

Government consumption expenditures: Low interest rates are preventing U.S. federal debt service payments from increasing dramatically, but the combination of new debt being piled on the old, and our view (we would even say "likelihood") that the Federal Reserve could lose control of interest rates implies that situation could shortly change.

• Deficit/debt – Federal revenues fell short of outlays for a third time since the fiscal year began in October (Figure 18). The Office of Management and Budget estimates the FY2010 deficit will total roughly $1.6 trillion,[30] so the red ink will dip lower during most of the remaining months in the year.

• Interest rates – The Federal Reserve raised its discount, or primary credit rate (the rate it charges banks for emergency loans) to 0.75 percent from 0.5 percent in mid-February.[31] The Fed justified the move as an attempt to push banks to obtain short-term credit from the private market instead of relying on the Federal Reserve. Although the Fed claimed the rate hike is not a tightening of the money supply and does not signal a change in monetary policy, many interpreted the move as suggesting policy makers believe the nation's banks have healed enough to withdraw some of the extraordinary support that Washington put in place during the financial crisis. "This is a victory lap by the Fed," Zach Pandl, economist at Nomura Securities, said. "It is a signal that the Fed is very confident in the health of the banking system. Fundamentally, these actions are a sign of policy success."[32]

• Price stability – Wholesale prices in the United States rose by a seasonally adjusted 1.4 percent in January on double-digit jump in gasoline and home heating oil. Core prices of finished goods – which exclude food and energy goods – rose 0.3 percent in January, led by higher prices for light trucks and other capital goods.[33] At the same time, consumer prices rose 0.2 percent, also mainly due to increases in gasoline and home heating oil. Excluding food and energy, prices for all other items fell 0.1 percent, for an annualized rate of -1.6 percent, the first time the core consumer index declined in 27 years.

The producer price index for all commodities was up 6.3 percent relative to January 2009; the year-over-year change in consumer prices was 2.6 percent (Figure 19). In our opinion these figures dispel the notion that the United States is in the process of falling into a deflation hole. While the decline in the core consumer inflation rate was widely proclaimed as proof of renewed and/or continuing deflationary pressures we would point out that a large share of the decline (about 40 percent according to the Atlanta Federal Reserve[34]) in the core inflation rate was due to shelter. When the shelter component – which is being affected by falling asset prices in the real estate market – is removed from the index, the annualized rate was no longer falling at 1.6 percent but increasing at 1.2 percent.

Currency exchange rates. The U.S. dollar appreciated in February against two of the three currencies we track (Figure 20): by 4.1 percent against the euro, and 1.3 percent against Canada's "loonie." But the greenback slipped by 1.1 percent against the yen. On a trade-weighted index basis, the dollar appreciated 1.6 percent against a basket of 26 currencies and is 19.9 percent be-

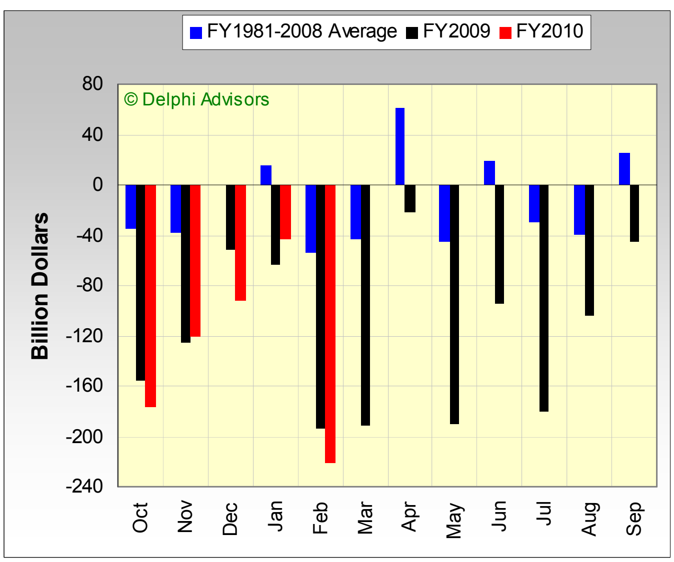

Figure 18. **Comparison of fiscal year 1981-to-2008 average, and 2009 and 2010 federal budget surpluses/deficits, by month. Source: U.S. Treasury Department**

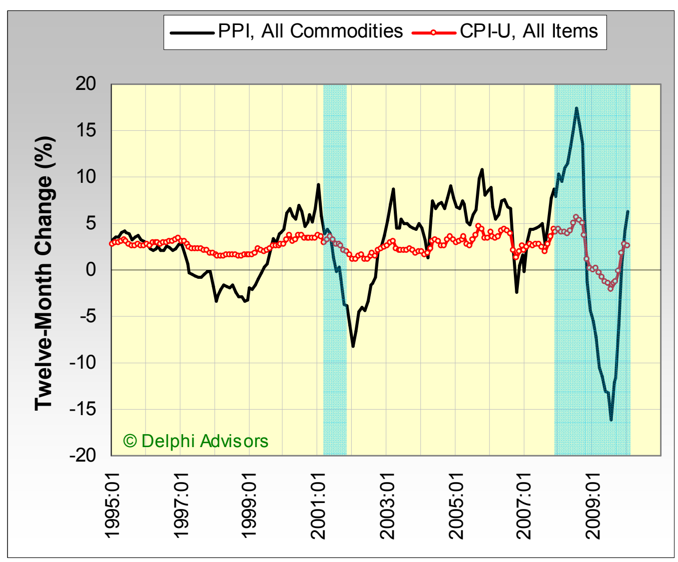

Figure 19. **Year-over-year percentage change in consumer (CPI-U, all items) and producer (PPI, all commodities) prices; recessions shown in blue. Sources: Bureau of Labor Statistics and National Bureau of Economic Research**

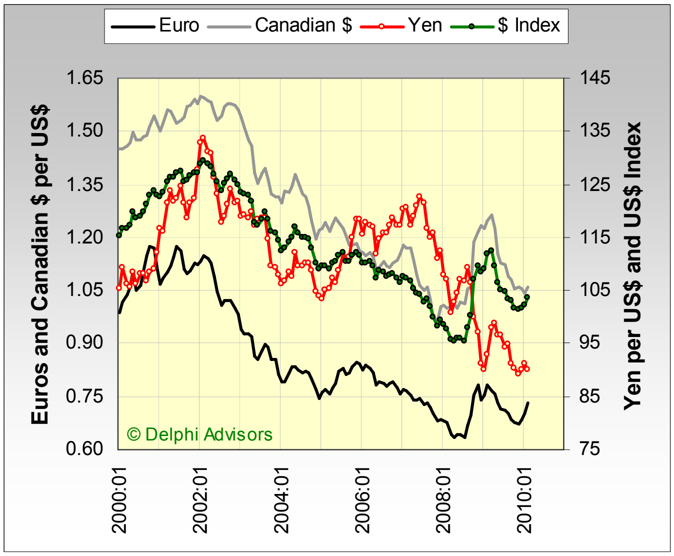

***Figure 20*. Exchange rates between the U.S. dollar and selected foreign currencies, and the trade-weighted, U.S.-dollar exchange rate index; smaller values mean a weaker dollar. Source: Federal Reserve Board**

low its February 2002 peak. The following three subsections discuss some of the reasons why currency exchange rates behaved as they did during the past month.

Canada: News that Canada's economy grew nearly as fast as the United States' in 4Q2009 was not enough to prevent the loonie from weakening against the greenback in February. Safe haven currency movements prompted by concerns over Europe's sovereign debt problems (discussed below) bled over into the loonie-dollar exchange rate, and gave the U.S. dollar "a leg up."

Real GDP grew 5.0 percent (SAAR) in 4Q2009, up from 0.9 percent in 3Q2009, and the largest quarterly increase since 3Q2000. Real GDP increased 0.6 percent (7.4 percent annualized) in December, a fourth consecutive monthly advance. Growth was recorded in most major industrial sectors during December. Goods-producing industries rose 1.0 percent, largely on the strength of mining (+1.6 percent) and manufacturing (+1.0 percent). The services-producing industries rose 0.4 percent, with significant gains in wholesale trade (+1.5 percent) and, to a lesser extent, retail trade.[35]

Monthly lumber production by sawmills decreased 14.3 percent (to 3.44 million cubic meters) in December. Compared with the same month in 2008, lumber production decreased 0.9 percent in December. Sawmills shipped 3.66 million cubic meters of lumber in December, a decline of 9.7 percent from November.[36]

Although not directly related to currency exchange rates, we note that a C$40 million investment by the Canadian government will enable one of that country's largest and most modern kraft pulp mills to generate clean, green energy from forest biomass. Specifically, the Zellstoff Celgar pulp mill in Castlegar, British Columbia is the first mill to receive funding under the Pulp and Paper Green Transformation Program (PPGTP) for its Green Energy Project. This investment will allow the mill to take advantage of waste heat, increase the production of steam from wood waste and increase capacity to generate bioenergy.[37]

Europe: Currency traders appear to be ignoring the positive economic developments in the 16-nation Euro Area (EA16) – e.g., economic expansion since 3Q2009, burgeoning external trade and current account surpluses, and a stable unemployment rate no worse than that of the United States[38] – and fixating on the "soap opera"[39] playing out in the PIIGS countries (Portugal, Italy, Ireland, Greece and Spain).

Such a reaction is understandable, particularly in light of German Chancellor Angela Merkel's recent admissions that Greece's debt crisis has plunged the euro into a "difficult situation" and that the Eurozone faces a "dangerous" period. Other revelations fanned fears even more, including:[40]

- The head of Germany's leading debt management agency warned the euro would collapse if any member defaulted on its debt;
- U.S. regulators said they were investigating the extent to which investment bank Goldman Sachs helped Athens disguise its budget deficit; and
- European Union inspectors warned authorities in Athens they see a deeper than expected recession.

The euro is weakening not only because Greece and several other PIIGS are unable to service their debts,[41] but speculators (including Goldman Sachs, JP Morgan Chase and others) have "added insult to injury" by taking out derivative positions that bet Greece will default. The result "is a vicious circle. As banks and others rush into these swaps, the cost of insuring Greece's debt rises. Alarmed by that bearish signal, bond investors then shun Greek bonds, making it harder for the country to borrow. That, in turn, adds to the anxiety – and the whole [process] starts over again."[42]

At the time this report was being written, Greece's pledge to ramp up planned budget-deficit cuts had failed to yield commitments of financial assistance from other European countries to help solve its financial crisis.[43]

Asia: The yen's appreciation against the dollar during February suggests currency traders may be suffering from selective amnesia; they are turning a blind eye to the fiscal and monetary policy problems plaguing Japan and concentrating instead on positive private-sector data. Granted, quite a bit of that data paints an encouraging picture – e.g., the 4Q2009 rebound in real GDP (Figure 21),[44] continued improvement in total industrial production during January (Figure 22),[45] and higher exports that are growing the country's current-account surplus.[46]

But one would be remiss to ignore the fact that the Bank of Japan (BOJ) held its key interest rate steady at 0.1 percent in mid-February while indicating "there is not yet sufficient momentum to support a self-sustaining recovery in domestic private demand." The BOJ also pledged to "maintain the extremely accommodative financial environment" in order to reverse ongoing deflation.[47]

Because the value of China's yuan/renminbi is not determined by market forces, we do not track that currency. Nonetheless, China significantly influences the world economy, and so we provide some coverage of recent events here. Two developments in China during the past month that have the potential to influence the U.S. market include a raising of bank reserve requirements and an apparent sell-off of U.S. Treasuries by the Chinese.

China raised bank reserve requirements for a second time in as many months in February. The increase is intended to rein in rampant lending that has led to excess manufacturing capacity, and to head off inflation that some fear is coming. "[T]he central bank has huge pressures to mop up excessive funds from commercial banks to reduce their urge to extend corporate loans," said Shi Lei, an analyst at Bank of China in Beijing, in response to the announcement.[48] Although the country is still "awash" in cash, the policy may be working. Two surveys – one by the state-affiliated China Federation of Logistics and Purchasing and another by HSBC – showed slippage in the purchasing managers' indices of manufacturers during February.[49]

Alarm bells sounded in mid-February when China's holdings of U.S. Treasuries shrank by \$34.2 billion (to \$755.4 billion) in December,[50] a sell-off of sufficient size to drop China into second place among the largest foreign holders of Treasuries (Figure 23).[51] The decrease heightened speculation – prompted by Party comments that Beijing is ready to shed "risky" U.S. assets[52,53] – that the country was diversifying out of Treasuries either over fears about their future value[54] or as a means of waging a "cold war" with the United States.[55]

According to sources close to the People's Bank of China, however, the nation's total holdings of U.S. debt did not fall at the end of 2009. Instead, the sources claimed, U.S. Treasury Department data painted an incomplete picture of China's holdings because it failed to account for bonds purchased indirectly through intermediaries in Hong Kong and London.[56] What benefit accrued to China by selling traceable bonds while buying back an equal or greater amount through proxies remained a mystery.

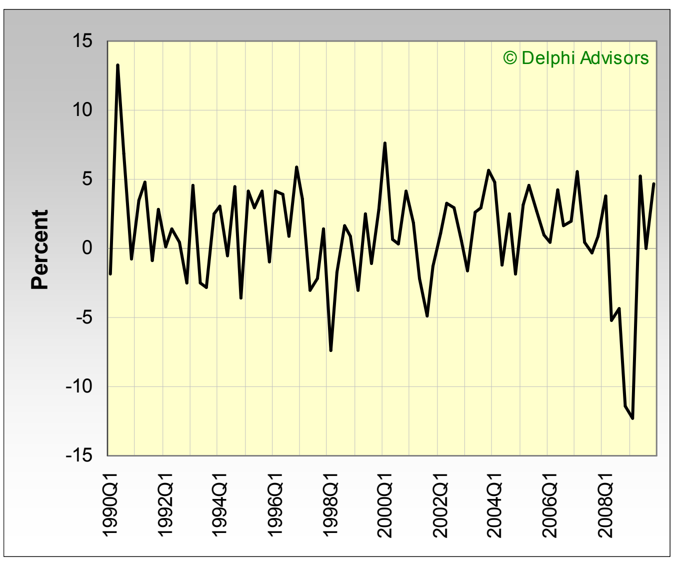

***Figure 21*. Annualized quarterly percentage change in Japan's real GDP; data are seasonally adjusted. Source: Japan's Cabinet Office**

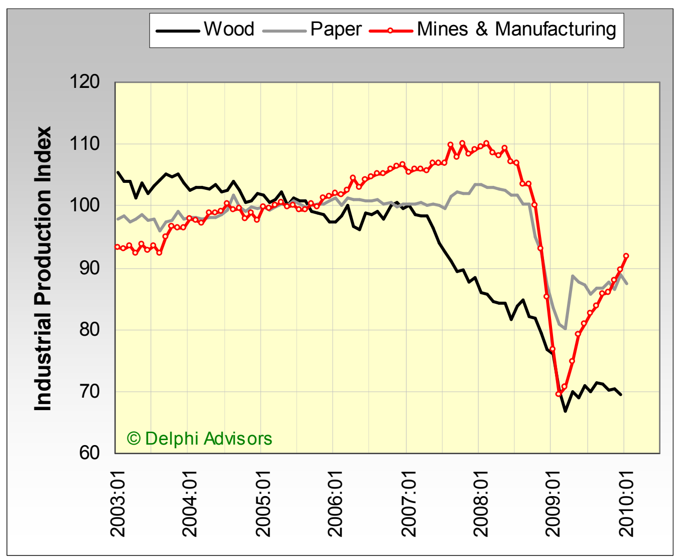

***Figure 22*. Industrial production indices (2005 average = 100) of Japanese wood and paper manufacturers, and mines and manufacturing. Data are seasonally adjusted. Source: Japan's Ministry of Economy, Trade and Industry**

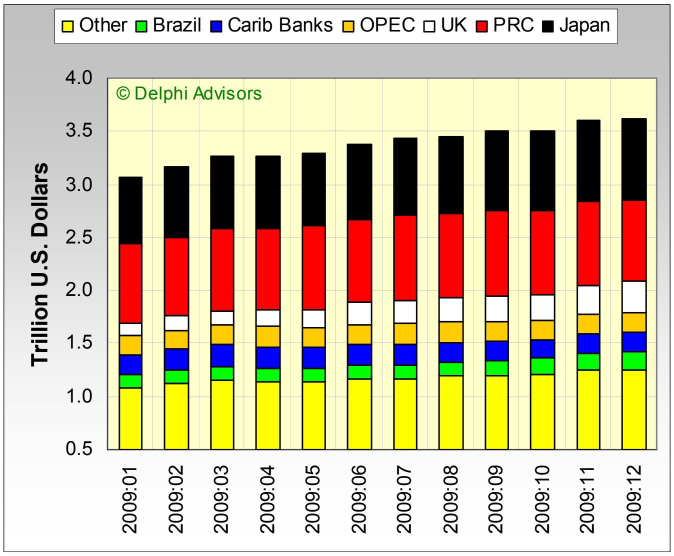

***Figure 23*. Major foreign holders of Treasury securities. Source: U.S. Treasury**

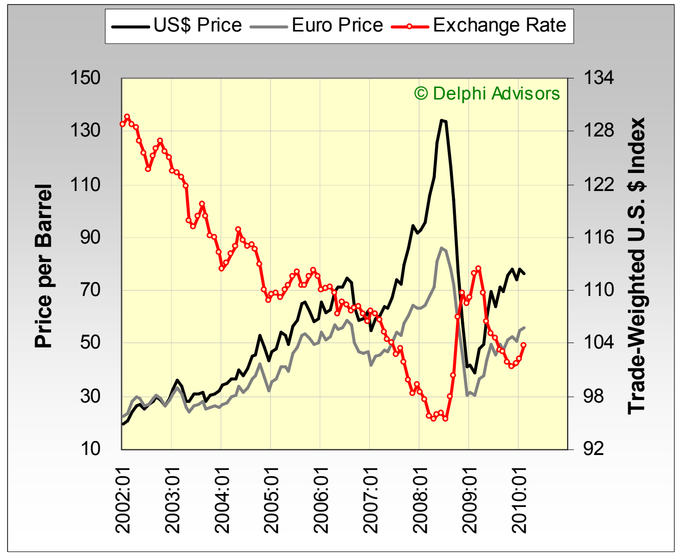

***Figure 24*. Monthly average West Texas Intermediate crude oil price expressed in U.S. dollars and euros, verses monthly traded-weighted U.S.-dollar exchange rate index. Sources: Dow Jones & Co. and Federal Reserve Board**

One possible explanation is that China publicly dumped its short-term debt but replaced it with longer-term debt bought through intermediaries; that's the view of Merrill Lynch economist Lu Ting. Such a trend conforms to changes in the world's economic situation, he said. "During the financial crisis, all countries were looking to make steady, safe investments," Lu said. "Because of long maturity periods, the risk associated with long-term debt was considerable. Now that economies are stabilizing again, increases in long-term debt holdings can be expected."

Although it may be difficult to discern how funds are flowing between the United States and individual countries, trends in the overall amount of Treasuries held by foreigners bear watching, as a loss of demand has the potential to force a sea change in U.S. monetary policy via higher interest rates.

Energy. The upward trend in crude oil prices has nearly stopped during the past few months, but heightened domestic and foreign consumption are likely to push prices higher. Attempts are being made to curb the Environmental Protection Agency's (EPA) authority to regulate greenhouse gas emissions.

Crude oil price: The monthly average price of West Texas Intermediate crude oil fell by $1.80 (2.3 percent) in February, to $76.42 per barrel (Figure 24). That price decrease occurred despite the lagged impacts of a jump in consumption to about 19.2 million barrels per day (BPD) in November (Figure 25) – the latest data available – but coincided with rising crude stocks (Figure 26). Interestingly, daily prices during February regained much of the ground lost in January but were unable to reach the top achieved during the first two weeks of 2010.[57]

Regulation: The Southeastern Legal Foundation (SLF) has filed a Petition for Judicial Review in the U.S. Court of Appeals for the District of Columbia, challenging the endangerment finding on carbon dioxide emissions issued by the U.S. Environmental Protection Agency

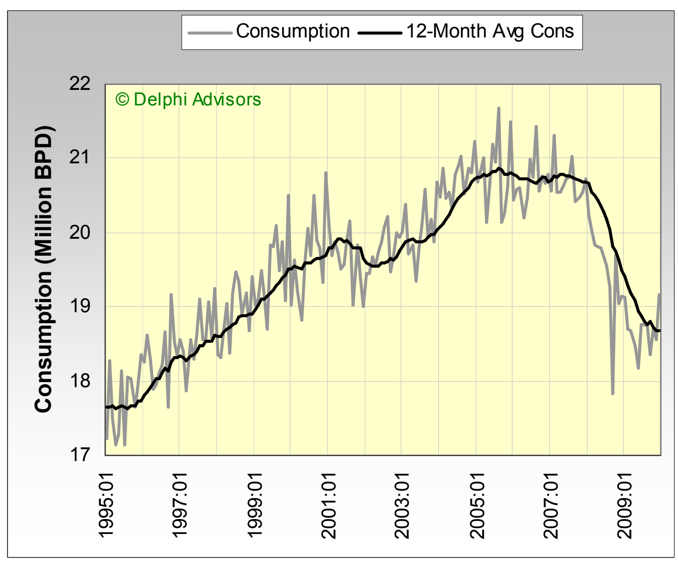

***Figure 25*. U.S. consumption (monthly and 12-month moving average) of total crude oil and petroleum products, in million barrels per day (BPD). Source: U.S. Energy Information Administration**

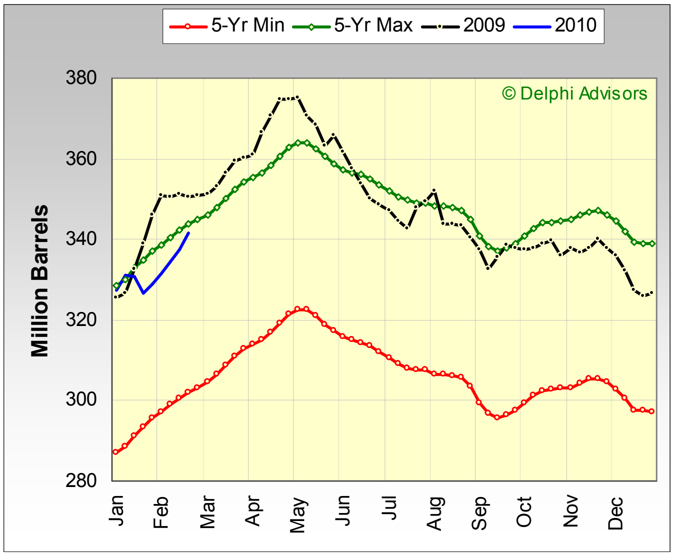

***Figure 26*. Current- and prior-year weekly U.S. crude oil stocks versus average minima and maxima of previous five years (Strategic Petroleum Reserve excluded). Source: U.S. Energy Information Administration**

(EPA) in December 2009. In December, SLF filed a Petition for Reconsideration with the EPA on the Finding and – in mid-February – a supplemental EPA Petition which includes claims of scientific errors and fraud.[58] "Representing a group of well-informed and concerned Americans, including leaders in Congress who have been intimately involved in climate change issues for more than a decade, SLF has filed this important court action to enforce the rule of law and prevent the unprecedented power grab by the EPA and this Administration," said Shannon L. Goessling, SLF Executive Director and Chief Legal Counsel. "The goal is to compel the federal government to follow the laws as enacted by Congress and to pursue legitimate public policy based on legitimate scientific data."

Although the public may believe Cap and Trade is dead, the Obama administration apparently thinks otherwise. In the fiscal year 2011 budget document,[30] summary Table S-2 (titled "Effect of Budget Proposals on Projected Deficits") shows a long blank for "Allowance for Climate Policy" during the period 2010 to 2020. Other items listed in Table S-2 show plus or minus figures indicating how the president's various budget proposals will increase or decrease deficits in future years – but not for climate policy.

Why the blank? Footnote three below the table explains:

> "A comprehensive market-based climate change policy will be deficit neutral because proceeds from emissions allowances will be used to compensate vulnerable families, communities, and businesses during the transition to a clean energy economy. Receipts will also be reserved for investments to reduce greenhouse gas emissions, including support of clean energy technologies, and in adapting to the impacts of climate change, both domestically and in developing countries."

As Don Grove, an analyst with Casey Research put it, "Leaving the presumed savings line blank makes it easier for Congress to negotiate climate legislation. So far it sounds like the president is still expecting to implement cap-and-trade as promised during his campaign."[59] ■

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