THE PARLIMENT PAGES

January, 2009

OUR ANNUAL PREDICTIONS –

You are going to read some predictions in this newsletter that will be contrary to virtually every economic authority out there. Is there a chance of realism in these predictions or are these predictions just wishful thinking? Unlike many, we are approaching 2009 with a degree of optimism. We do not believe it to be unfounded and truly believe in the merits of what we forecast.

A LITTLE PERSPECTIVE, PLEASE –

This time last year, I was calling for General Motors to economically collapse and declare bankruptcy. That event would take the headlines and get the housing crunch off of the front pages. While GM's bankruptcy is still a few months away, there is no doubt it has grabbed its share of headlines and has in fact moved the housing crisis to less prominence. The more the focus that is turned away from housing, the better for our industry. Step one in our recovery has taken place.

We also predicted at that time that we would see our business beat 2007 by about 10%. Well, we were wrong on that, but not by much. In fact, our business was up about 10% before the disastrous 4th quarter. However, with all of that said, we are going to end up about even with 2007. We have a large number of customers who are actually up more than 10% this year.

We also said there would be strong geographic pockets and weak areas and that falls exactly as we had foreseen. Parts of our geography were incredibly strong while other areas looked like war zones. We also predicted that there would be major fallout of the big boys and further consolidation in all areas of the distribution and builder chain. That has also played out as we anticipated.

We warned of $4 per gallon gas and we hit that. Sure it has retreated, but don't anyone think for a minute that the lower prices are anything but temporary pullbacks, due to a slow economy. More on that later.

So, all in all, we have hit the target as many times than we have missed. Am I intimidated by the masses of economic experts who will doubt my upcoming projections? Not in the least. After all, virtually none of them predicted any of the events that have transpired over the past couple of years. So, how good is their record?

Is this arrogance? Is it blind optimism? I hope it is neither. I believe the predictions you are about to read are based on sound theory and not headline grabbing hyperbole.

HOW BAD IS THE PRESENT SITUATION? –

In the past month, I have buckled down and have read and analyzed over 1,000 pages of economic writings. I have viewed so many statistics; I fear my eyes may be permanently crossed. I have read dire opinion after dire opinion. There is no question that the western world economy is in the process of a major meltdown. Everyone seems to agree on the causes. Some agree with the steps taken to fix it, while others are screaming bloody murder. I tend to think that the steps taken were ugly but necessary and that there will be the need for substantial additional government intervention in the near future. Without that intervention, I fear we could, in fact, have a total collapse. While the bailout(s) goes against every fiber of my capitalistic make-up, I believe, in the end, it is the only thing that will work. Every day the scenario will continue to play out and only time will tell how bad the situation truly is and what shape the recovery will take.

WHAT IS NOT BEING TALKED ABOUT? –

Most of you will remember the first stimulus package many months ago. In that package, most Americans (legal or not) were given checks for up to $600 in the hopes that would stimulate spending. It worked very well, but it wasn't near enough to offset all of the other negatives that were in play.

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Gas prices today are less than $1.75 per gallon which is over $2.25 less than just a couple of months ago. For the average driver that savings will put an additional $40 per week in his pocket. That times 52 weeks is over $2,000 of extra cash in the pockets of most every driver.

Mortgage interest rates are expected to fall as low as 4.5%. They already today at 37 year lows.Those rates will spur on another round of refinancing. Unlike the refinancing of the past where equity was removed and spent, this refinancing will be done mainly to lower payments. The result for the average refinanced mortgage will be about $200 per month in payments. Over a year's time, those payment savings along with the gas prices will put between $4,000 to $5,000 of additional money into the coffers of an average household. Will that money be saved? In our country, we have not shown a history of saving. Instead it will be spent. After all, that is the American way and this will be one heck of an economic stimulus all by itself.

WHAT REALLY DRIVES OUR ECONOMY? –

While we are all being deluged with the bad news of corporate layoffs and closings, I am surprised at how little is being said about consumer spending and its importance to our economy. Consumer spending represents between 75%-80% of our economy. Clearly a lack of consumer spending can send us into a depression and clearly strong consumer spending can lead us out.

Consumer spending is driven by three primary factors: disposable income; consumer confidence; and credit availability. If we can see positive moves in each of these, I believe those will be the leading indicators of a recovery. Let's look at each.

Disposable income will be increased through the gas price decreases and the upcoming wave of refinancing. It may be further enhanced through some government stimulus checks similar to the plan of a few months ago. It is clear that the average household will have substantially more cash in their checking accounts than they did a few months ago.

Typically, a new President is given a several month press honeymoon. During this time, very little criticism is directed his way. In Obama's case, the press played a significant role in his election. I think it is safe to say that they will protect their stake in him and will deepen and lengthen the honeymoon. The bad news that we have been hammered with for months and months will suddenly disappear. Marginal news will be made to look good and anything good will look spectacular. So, instead of picking up the paper or turning on the tube and seeing catastrophic news, John Q. Public will instead be told everything is looking up. Americans tend towards optimism and it will not take much of this good news to start the upward climb of consumer sentiment and confidence.

Last is the credit question. In our last issue we talked about how important credit is to our economy. It is vital to the expansion of our businesses and it is of particular importance to the mortgage side of our industry. However, its biggest importance may be on the consumer side. We, as a population, have lived above our means for at least 30 years. We have been allowed to do that through the extension of credit. Now those credit windows have been slammed shut. In typical Wall Street fashion, the pendulum has swung and the banks and lending institutions have shut off virtually all new credit and are severely limiting the use of existing credit instruments.

In addition to credit, this country has sadly also thrived on something else: greed. It was the same greed that led to the great crash of 1929 when everyone from taxi drivers on up were speculating on a widely overpriced stock market and the money lenders were free with their margin credit lines. Just yesterday it was the creative mortgage lenders pumping out refinancing and subprime mortgages to anyone interested in speculating in real estate hoping to make a fast buck. Greed and speculation lead to the crash of 1929 and the crash of 2008.

For now, that greed has taken a backseat to fear and that fear has manifested itself in the slamming of the credit windows. The lenders are flush with cash but afraid to lend. However, once consumer confidence begins to tick back up and the heat is reduced on the lending execs, greed will once again overcome fear. When that happens, the lending windows will be again open. Lenders do not make their big bonuses until they make loans. They will not wait long for those bonus opportunities and will once again begin many of the same loose lending practices that got us in this pickle in the first place.

WHEN WILL ALL OF THIS HAPPEN? –

I think the consumer confidence, happy press and greed will all kick in about the same time. I think we have reached the bottom. Caution will prevail on all fronts for at least the next 3 – 4 months. And then, as the press keeps kicking in, we will start to see a sustained recovery that will be noticeable beginning as early as June or July and steadily rising for the balance of the year.

OUR PREDICTIONS –

Our business represents a compilation of the housing and commercial construction industries from as far north as Charleston, to the outskirts of Miami and Ft. Myers in the south, to the burbs of Atlanta in the center and as far west as Pensacola. We sell to an incredible diversity of customers both in size and product categories. As a result of this, our business is a great barometer for economic activity within our geographic coverage. There will always be soft and hot spots but overall, we believe we are a sound indicator.

When we put together our projections for 2009 we took into consideration everything discussed in this newsletter. We talked to our customers, our vendors and industry experts. We examined reams of analytical papers. With that being said, we believe that 2009 revenues will be up from 2008 by about 10% and possibly as much as 15%.

HOW ABOUT BEYOND 2009? –

The forced recovery that we will go through will come at a cost. The massive government spending along with the huge accumulation of non-traditional debt will cost this country dearly into the future. We have had a history of these types of bailouts. Wall Street has swung the pendulum back and forth many times. However, never has the hit been so deep. Only time will tell the extent of our economic degradation. Once the recovery has a foothold, it will most certainly force more conservative financial policies into the future. In the end, it will either make us a much stronger economy or it will be the seeds of our economic failure.

WHAT IS GOING ON AT THE GAS PUMPS? –

Few people realize that gasoline is one of the most commodity driven products around. There is very little finished product storage and there is a huge distribution network that needs to operate at capacity to maximize income. When demand falls, there is no storage to shunt off unused production. The limited storage facilities fill rapidly, and with no place to put the product, the refiners slow down, the tankers sit and wait to unload, and the oil wells cut back production. This ripple effect takes only a couple of days to travel from the gas pumps to the oil wells. Conversely, when demand picks up, there is not enough product in the chain to keep up and prices skyrocket.

The price reductions we are now experiencing are an anomaly caused by a weakening in the economy and short-term fuel consumption habits. Nothing fundamental has changed. Fortunately, these price reductions are likely to last until the economy recovers, however, once we are charging full speed ahead, plan again on $4 or $5 per gallon gas. And, for many of us, we will live long enough to see gas hit $10+ per gallon. The pure truth is that we will soon be consuming more than can be supplied. And the harder truth is that we are consuming more than we are discovering and the shortages will get worse as time passes.

INTEREST RATES –

Mortgage rates are plummeting and we believe they have further to go. We expect them to hit the 4.5% range within the next couple of months. This will open the gates to all sorts of new construction mortgages and refinancing. Additionally, the financial pundits for months have been predicting the potential catastrophe that will result from the interest rate resets on the variable mortgages. With mortgages in that 4.5% range, those resets are not nearly as disconcerting as before. That will help limit the future number of foreclosures. This should be very good for our industry.

A careful look at interest rates will paint a more disturbing long-term picture. Long-term corporate rates are actually rising and the spread over short-term and mortgage rates is becoming bigger each day. This is a clear signal that the money markets foresee a period of very high inflation. Does your company have bank debt? If so, the big questions will be, “How long do I ride the present short-term low interest before fixing rates?” Our suggestion is that even though the temptation is to enjoy these low short-term rates a while, it would be prudent to fix a 5 year interest swap within the next few months.

UNEMPLOYMENT –

The rising unemployment levels are getting an awful lot of press. The talking heads are continuously warning us of the dire consequences of these levels. I truly sympathize with those who have lost their jobs, but the reality is that it does not have a major impact on the economy. Traditionally, this country has at least 5%-5.5% unemployment and the predictions are that it could “skyrocket” to an astounding 9%. Look at it this way. Before, 95% of the population was employed and if their forecast is right there will still be 91% employed. I can’t believe that will have a significant impact on the overall economy.

MATERIAL PRICING –

There is little doubt that 2008 was a year of tumultuous pricing. We saw dramatic increases and equally dramatic decreases. While the instability was difficult, we believe that 2009 is going to be a year of very typical pricing. It has been many years since we have had typical pricing, so let's review what that means. Typically, prices will be flat to slightly down in the first quarter, rising slightly in the 2nd and 3rd quarter and then flat to down rounding out the year.

This typical pricing is impacted by unusual supply/demand issues which has been the dominate factor for the past several years. With worldwide demand shrinking, one would think that would cause further un-typical price devaluation. However, it appears that much of the manufacturing capacity, from steel production to drywall, is being taken off-line to create more stability in pricing. Evidently, the manufacturers would rather have less and profitable volume instead of chasing pricing downward because of overcapacity. Inevitably, someone will blink and production will rise above demand, however, we think that will be on a very limited scale.

There is one possible exception to this prediction. It will be interesting to see how the manufacturing side responds to our forecasted market increase. They may be slow on the trigger and late to respond to the increased demand. It is typically easier to take capacity off-line than to add it. If this does happen, we could run into some shortages and the resulting rising of prices. We will keep you posted on this throughout the year but for now, don't look for anything too wild.

CONSOLIDATION AND FAILURES –

The pace of failures and consolidations is picking up. Some have already happened while others are in the process of being confirmed. Yet others are strongly in the rumor mill and generally expected to happen. These failures and consolidations will affect all areas of our industry supply chain from manufacturing, to distribution, to dealers, to builders. On top of manufacturing cutbacks taking place every day, we believe that at least one and probably two of the big national retail chains will either fold or severely cut back on operations. Several national distributors will make significant market presence reductions and a couple of the national builders will make further pullbacks from our market area.

We typically look at this as a good thing as it weeds out soft competition and leaves the survivors with more quality business.

THE OTHER SIDE OF ENTREPRENEURSHIP –

One of the biggest misconceptions that I have ever seen is the lack of understanding that comes with the risk/reward component of entrepreneurship. Few employees understand the enormity of risk involved in putting it on the line and opening your own business. In good times, entrepreneurs are often times resented by employees because "they are making all of this money." What few truly understand is that the smart entrepreneurs may make a lot of paper profits when the times are good, but instead of taking the money out and spending it, they keep it in the company to build a stronger balance sheet to weather bad times.

When times really get bad, not only does the entrepreneur use his balance sheet to survive but in many cases will have to supplement the company losses by placing further personal capital at risk. We have talked with many of our customer's owners who have foregone paychecks for months, added additional personal asset security to bank loans and written out checks from personal accounts to pay bills. They do this to keep the company afloat and to keep paychecks coming to their key employees.

I have as personal friends at least 3 dozen company owners. Over the past 20 years I have seen firsthand that there is nothing that ages an owner more than losing money. It is just plain not a fun time in his life. I think our employees are beginning to better understand the other side of owning a business.

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