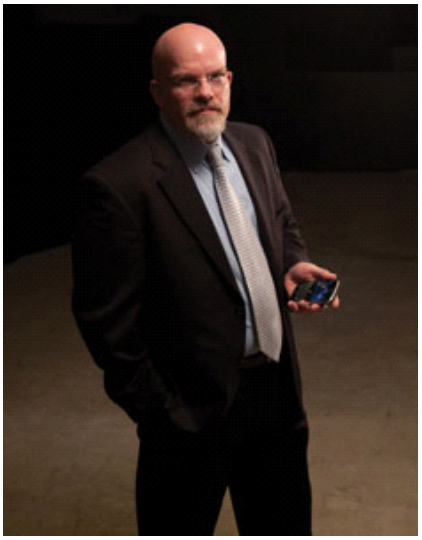
GROWERTALKS

Cover Story

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The View from 30,000 Feet

Dr. Charlie Hall



"Those who forecast the future do so not because they know, but because they were asked." This well-known quote is attributed to the rather famous economic mind of John Kenneth Galbraith, who just happened to be one of the few honorees to receive the Presidential Medal of Freedom twice. Bearing his quote in mind, I offer the following 30,000-ft. view of the major macro issues impacting our industry in 2010 and perhaps beyond.

The economy

Much has been made regarding the fact that we are now in economic recovery, which I find amazing given mainstream media's penchant for not-so-good news. Two widely held beliefs prevail regarding recoveries—deep recessions usually lead to strong recoveries and financial crises usually produce weak recoveries. But the curious thing about the Great Recession (as some have referred to this one) is that it was a deep recession kick-started by a financial crisis and fostered by a sundry of asset bubble bursts. The interplay of these forces simultaneously will likely produce an expansion that begins surprisingly briskly, then gives way to a long period of slow, less-than-stellar growth.

From a green industry standpoint, housing is perhaps the most critical component of whatever economic recovery is now in progress. There is a strong correlation and so far, the housing side of the recovery can be described as three steps forward, two steps back.

The latest housing starts figures are no exception. Builders pulled back on both starts and permits in the last quarter of 2010, perhaps initially out of fear of the expiration of the homebuyer tax credit. The hit was particularly severe in the volatile multifamily housing sector, but even the single-family housing market hit a speed bump. As usual, there is the preverbal silver lining: While this is not good for the soon-to-be-released Q4 Gross Domestic Product (GDP), it is good for the long term re-balancing between housing supply and demand that needs to take place to make things more "normal."

On the demand front, the homebuyer tax credit was extended after all, and even expanded. The Federal Reserve's manipulation of the mortgage market is keeping financing costs down and improving affordability

in many markets and, thanks to the decline in prices, buyers are slowly coming out of the woodwork. I believe we will continue to see a slow, steady recovery in existing and new home sales; a continued gradual decline in the number of homes on the market; a tepid rebound in home construction; and broad-based stabilization in home prices as we head into 2010. Again, slow but steady growth with some bumps along the way.

The good news overall is that the nation's primary indicator of economic productivity, GDP, grew in the third quarter by 2.8%, unofficially ending the recession. We are seeing signs of shrinking inventories, and manufacturers are showing a willingness to replenish these low supplies in anticipation of a broader-based recovery. But we still have tremendous hurdles to face and, in some ways, we have robbed Peter to pay Paul to attain the productivity gains we've realized thus far (e.g. Cash For Clunkers, bailout mania, etc.). Remember the old adage about no free lunch—sooner or later we'll have to pay for all the government stimulus-induced infrastructure spending we have put in place to boost spending and productivity. Some of the stimulus money that remains unspent is for "green" infrastructure-related projects, which may translate into potential market niches for the green industry.

While inflation has not reared its ugly head yet, at some point we'll be talking about fiscal and monetary policy measures to curb inflationary pressures. In the very short run, we can expect to see even more targeted stimuli come out of Congress, but in smaller pieces and with an even greater focus on job creation. To that end, the Fed will likely hold interest rates at a level that will encourage business-level investment as much as possible, and much of this may be related to bolstering green infrastructure, which, again, may indirectly create demand for some of our products and services (e.g. green roofs, carbon offsets, etc.).

The job market

Another curious feature of this recovery is continued above-normal unemployment, prompting some to name this a "jobless recovery." Cautious hiring practices continue to cast a shadow over the outlook for V-shaped economic growth (a short contraction with rapid recovery). Of course, these cautious hiring practices are a two-edged sword.

On the one hand, they are generating exceptionally strong gains in productivity, which strengthens profits and provides the financial wherewithal for business investment in new equipment. But on the other hand, it also undermines consumer confidence and further reduces household incomes that are needed to support spending.

Interestingly, the Department of Labor reports the number of occupational injuries and illnesses that required days away from work mirrored the shifts the recession caused in the labor market in 2008 and 2010. Hard-hit sectors, such as construction and retail, reported fewer injury and illness cases. Older workers experienced more injuries as their labor force participation rose, but incidents among younger, normally more risk-seeking workers fell counterintuitively, mainly because fewer of them remained employed.

The other positive externality of the increased unemployment is that green industry firms have benefitted to a certain extent from the accessibility of more bodies in the available workforce. However, this has pushed back serious discussions of needed immigration reform in Congress. In the interim, I believe we will see more emphasis on enforcement—rather than policy change—resulting in an increase in auditing of businesses across the U.S.

While businesses responded to the recession by cutting their work forces to the bone, eventually they will have to begin hiring to increase output. That time may not be too far off—there is at least some evidence pointing in that direction already. Wage rates will stabilize for a while, but at slightly suppressed levels. In the end, we should expect to see job growth return in the late spring or summer of 2010, albeit a slow growth and the tech industry will likely lead this recovery.

Last spring, bedding plants and perennials fared well in our industry and expectations are the same for this upcoming spring, providing the weather holds. We are much better off economically than we were last year at this time, and consumer confidence indices are nearly twice the levels we saw then. The question is how the Great Recession has impacted long-term spending habits of post-Great Recession consumers.

Long-term consumer behavior

Through mid-2010, households had lost $12 trillion, or 19%, of their wealth because of the collapse in housing and stock prices. That has reduced their purchasing power and pushed them to save more, especially those nearing retirement. Though they'll boost their saving gradually, it still means consumer spending, which comprises about 70% of GDP, will grow more slowly than income, after two decades in which it usually grew more quickly. Leaving aside swings in energy prices, inflation (now about 1.5%) will slip to zero and may turn to deflation in late 2010. Deflation occurs when the inflation rate falls below zero, which drives up real debt burdens, further sapping consumer spending.

But the real question is whether the newfound frugality on the part of post-Great Recession consumers is a permanent behavioral shift or if a new age of affluence will emerge. Pundits differ on this question and I have heard compelling arguments for both sides. Personally, I feel there will be a "return to normalcy," in which people will abandon the exuberance of the boom, but without going overboard into miserliness. However, some folks are looking for a return to Great Depression-born attitudes toward thrift.

Let's dissect this a bit. As logic would dictate, the savings rate during the Great Depression was fairly low because with incomes down or nonexistent, people couldn't afford the luxury of saving. It wasn't until WWII that the savings rate increased dramatically due to rationing and price controls, which continued through mid-1946. During the early post-war years, the savings rate again was low, as consumers used their accumulated savings to buy newly available consumer goods. The savings rate reversed trend and increased again during the 1950s, 60s and 70s.

During the 1980s, 90s and 2000s, we saw the savings rate reverse trend again and decline significantly, perhaps because a more reliable social safety net reduced the need for savings, or social attitudes toward near-term satisfaction versus long-term risk were changing. However, it certainly was not demographic change. The Baby Boomers were advancing into their high-earning years, which are typically high-savings years, so the savings rate should have risen, if nothing else was changing. Some argued that our savings rate got so low because people assumed that their home value appreciation would do their savings for them. However, the savings rate declined steadily through the 1990s, when home price appreciation averaged only 3% per year.

My point—and the big lesson in all this—is consumers can raise their savings rate without going into a bunker mentality. They'll still grow spending, just at a slightly slower pace. That's positive for the economic outlook,

because we need consumer demand in the near term to help the economy get its groove back. As I've noted before, this means retailers should monitor their sales very closely, not only in the aggregate, but also by price point. Stated slightly differently: If we can position ourselves in such a way that our products/services are considered as necessities in people's lives and not mere luxuries, this would be the best recession-proofing and weather-proofing we can do.

Promoting quality of life

The value proposition for our industry in the future must focus on the unique ways in which quality of life is improved for our customer base. Much research has validated the emotional and environmental benefits of flowers, plants and trees. In a nutshell, our green industry products and services improve emotional health; boost seniors' well being; enhance hospital recovery rates; enhance employee innovation and ideas; strengthen feelings of compassion; decrease worry and anxiety; express feelings of compassion; build stronger communities (e.g. America in Bloom); mitigate environmental externalities; and improve the economic value of homes—just to name a few of the benefits.

I cannot overemphasize the importance of this quality of life message, particularly in focusing our differentiation strategies in the future. Whether you are a member of the Boomer, Gen X or Gen Y generation, quality of life is a "higher order" need that is important to you. For example, although the economic downturn has increased anxiety on the part of Baby Boomers about retirement, they are nevertheless proactive in seeking innovative solutions to dealing with age. They view their new stage of life as one of activity and fulfillment rather than idleness. Gen X is the most "time-starved" generation, often juggling career and family obligations, but they maintain a strong commitment to work-life balance in their lives. The Gen Y generation is just beginning their adult lives and facing lots of firsts—their first home, first job, and most importantly, first independent income. They are trying to find the right balance between spending for necessities and spending for entertainment. This generation is concerned not just with function and utility, but also with style.

All of these generational attitudes come down to one thing—enhancing the quality of life through emotional well being, ecosystems benefits and economic paybacks. Our industry research shows there's no better way to do this than through the daily use and/or enjoyment of flowers, plants and trees. All we have to do now is convince consumers our products and services as necessities instead of luxuries. This will, of course, make us even more recession resistant in the future.

Legislative hot potatoes

You'd have to be hiding under a log not to recognize health care and climate control are the main issues that will be addressed by Congress during 2010. As I am writing this, the House has passed its version of healthcare reform and the Senate is getting ready to take on the debate on its version. If the Senate can manage to pass its bill, it still has to be merged with the House bill before President Obama can sign it into law.

The bills have many similarities, including the new requirements on insurers and the creation of new purchasing marketplaces, called exchanges, where self-employed individuals and small businesses could go to shop for and compare coverage plans. One option in the exchanges would be a new government-offered plan, something that's vehemently opposed by private insurers and business groups.

Differences include requirements for employers. The House bill would require medium and large businesses to cover their employees, while the Senate bill would not require them to offer coverage, but would make them pay a fee if the government ends up subsidizing employees' coverage. Another difference is in how they're paid for. The Senate bill includes a tax on high-value insurance policies that's not part of the House bill, while the House would levy a new income tax on upper-income Americans—this is not in the Senate measure. The Senate measure also raises the Medicare payroll tax on incomes above $200,000 annually for individuals and $250,000 for couples. Both bills rely on more than $400 billion in cuts to Medicare.

Regardless of what version is ultimately passed, what is really being debated here is a question of values, which can fundamentally be stated as this: "Should Americans embrace a more robust social safety net at the cost of much higher marginal tax rates, reduced work incentives, and a smaller economic pie?"

From a strictly economic perspective, there is no right answer to this question. Another famous economic mind, Arthur Okun, said long ago that the big tradeoff in economic policy is between equality and efficiency. The pending healthcare reform bill moves us along that tradeoff.

Changing the subject a bit, after a decade or more of talk, a cap-and-trade policy to limit greenhouse gas (GHG) emissions was passed by the House last summer—a sweeping climate change bill known as Waxman-Markey, or officially the American Clean Energy and Security Act of 2010 (ACES). The "cap" part of the policy sets a hard limit on total CO2 pollution, giving certainty to emission reduction over the years 2012 to 2050. The cap gets tighter and tighter over time, reducing emissions gradually. Meanwhile, the "trade" part of the policy allows firms to trade permits that allow the holder to emit CO2. Trade means that the initial allocation of permits does not affect the total cost of reducing pollution. But, the initial allocation of permits does create winners and losers, so this allocation is a key policy choice. One option is for the government to auction the permits, so that the revenue can be used to implement tax cuts or to compensate those who lose. The other option is to give away permits to companies. This free allocation to past polluters is called "grandfathering."

The Senate had delayed any discussions over its version of a GHG bill until this spring, but events of last November dealt a blow that may put off any meaningful debate for a very long time. Hacked e-mails from an influential U.K. climate-science lab suggested that researchers there tried to squelch scientific challenges to what has become scientific consensus—that human beings are largely responsible for climate change. The e-mails suggest that many scientists around the world are concerned about the policy implications of a recent decline in average global temperatures. Although global temperatures remain among the hottest on record, they have declined since 2005 according to various measurements, and no one has sufficiently explained this phenomenon to date. Opponents of significant curbs on greenhouse-gas emissions have, of course, pointed to the disclosed e-mails as reason to pause before implementing any broad policies.

Regardless of when or how soon climate change gets addressed, as greater emphasis is being placed on rehabilitating the environment and combating global climate change, our industry is uniquely positioned to offer low-cost, effective solutions to achieving many of these far-reaching goals. Though it is widely recognized that landscape trees and plants enhance property values and make human environments more livable, we must remind policy makers that the plant materials we produce, distribute, retail and install provide measurable and lasting environmental benefits. Trees, shrubs and flowers sequester carbon, reduce energy use, mitigate water runoff and clean the air.

These ecosystem services, for trees especially, have been quantified by both government and university researchers in hard dollars. By promoting the full array of services and benefits provided by trees and plants in the managed landscape, we can redefine our products and services as aesthetic, economic and environmental assets that increase in value over time. That will go a long way in selling more outdoor living spaces!

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