If You Build It, Will Bonds Fall?

If, in the spirit of the times we are permitted to say anything nice about someone or something French, let us now praise Frederic Bastiat, the nineteenth century economist who described the fallacy of the broken window. The recent spate of hurricanes, Ivan in particular, illustrated this phenomenon quite well. A burst of economic activity undertaken to restore capital stock destroyed in an event - such as the broken window referenced above - ultimately is a negative for the economy: The effort so expended presumably could have been deployed more productively in creating, not restoring, new productive capital stock.

Previous Storms

Each hurricane or group of hurricanes is different, and arrive upon our shores at different phases in the economic cycle. This makes any sort of comparison of the insured losses in constant dollars as a percentage of GDP a true apples-and-oranges affair.

In late September, I took a look at the last ten years of hurricane damage and its impact on key macroeconomic data in anticipation of a report, such as he monthly employment situation report released last Friday. I tried comparing the actual economic data to the consensus of economic forecasts as compiled by the Federal Reserve Bank of Philadelphia to which indicators were "shocked" by the impact of storms.

Unsurprisingly, the conclusion was the macroeconomic impact of hurricanes taken on the quarterly frequency at which GDP data are reported is all over the map, no pun intended. The largest previous storm group, Hurricanes Andrew and Iniki in 1992, produced the following set of deviations from the forecast consensus:

Assessed Effects Of Hurricanes Andrew & Iniki

Macroeconomic Datum	Qualitative Impact
Coporate Profits	large negative
Unemployment Rate	large positive
Industrial Production	small negative
CPI	large negative
Housing Starts	large negative
Corporate Bond Yields	small positive
Bill Yields	large negative
Bond Yields	large negative
Real GDP	small positive
Real Consumer Spending	large positive
Non-residential Fixed Investment	small positive
Residential Fixed Investment	small positive
Real Federal Outlays	large positive
Real State and Local Outlays	small negative

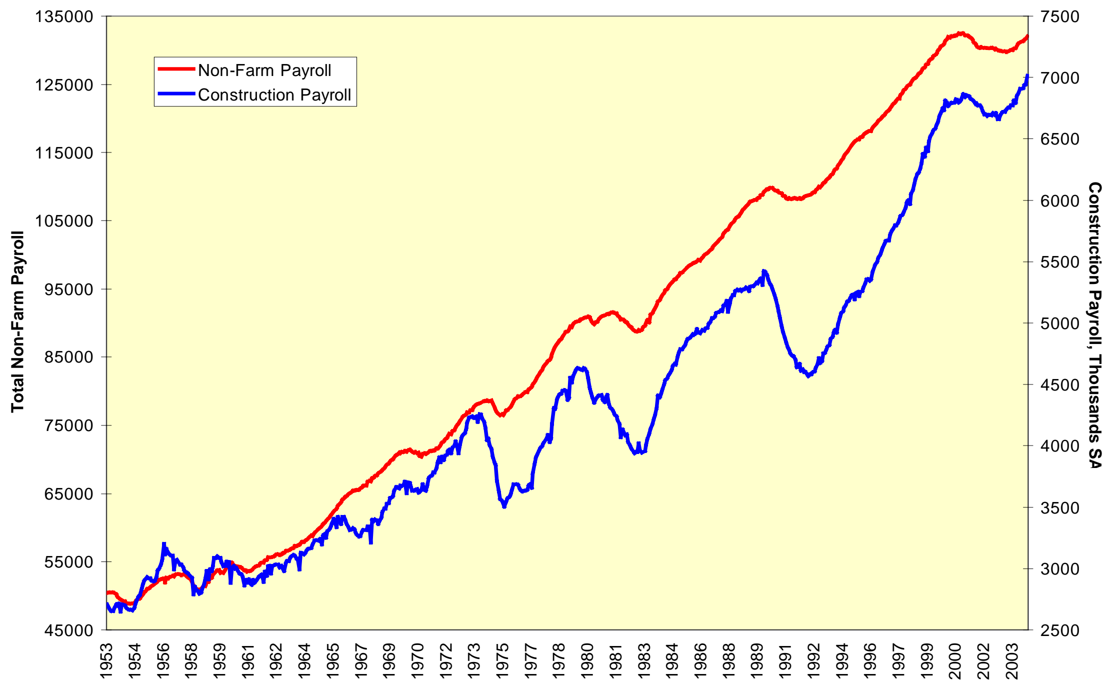
We really cannot compare the third quarters of 1992 and 2004 on the basis of these two natural disasters. The chief difference is the impact on the energy sector, natural gas in particular. Natural gas prices had a temporary spike in the fall of 1992, but at levels far lower than today's levels near $8.00 per million BTU; the high for gas futures spiked from $2.18 in August 1992 to $2.79 in September 1992. Read it and weep.

Relative to expectations, the 1992 storms pushed corporate profits, the CPI and housing starts lower. They pushed the unemployment rate, consumer spending and federal outlays higher. There are some parallels to today, but whether these are causal or coincident cannot be determined.

Something Constructive

The most striking aspect of the employment data for October was the large jump in construction jobs; most felt these were a direct consequence of the hurricanes. How have these jobs affected financial markets, bonds especially, in the past?

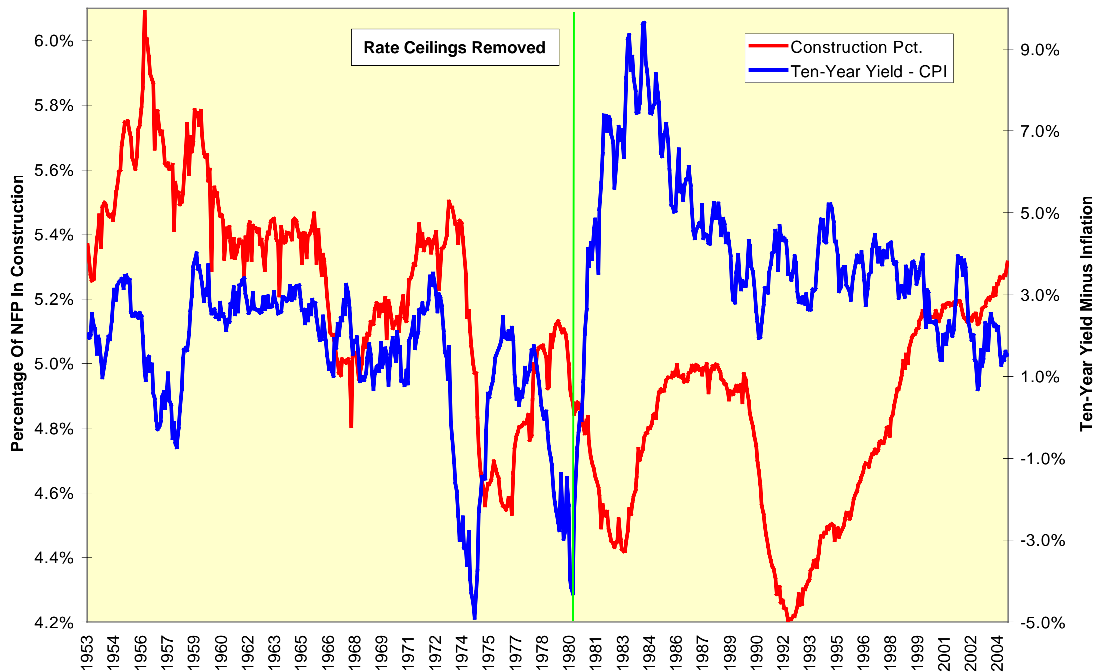
First, let's take a look at the history of construction labor. It is, as we should expect given its reliance on a single industry, far more cyclical in nature than the labor force as a whole.



While its overall rate of growth is lower than the rest of the labor force over a long period of time, something we should expect as a result of productivity increases, this is somewhat deceptive. Prior to the removal of interest rate ceilings on savings accounts in 1980, changes in inflation-adjusted long-term rates led changes in the percentage of the work force involved in construction fairly well.

After this change and the widespread adoption of interest rate derivatives and adjustable-rate mortgages, the Federal Reserve could no long squash housing by raising rates and disintermediating the flow of funds into mortgage originators such as savings and loans. This singular development, and not any of the self-proclaimed sanctity of Fannie Mae or Freddie Mac, has done more to expand home ownership and more importantly, to moderate economic cycles than anything else.

A Structural Change



A second key date is visible in the chart above, and that is the steady increase since September 1992 of the percentage of the non-farm workforce involved in construction. While there are isolated instances of builders importing prefabricated structures from Mexico and elsewhere, construction is more immune to global competition than most industries. Outsourcing construction is difficult.

Finally, one relationship should be clear from both charts presented, and that is the ability of interest rates to both rise and fall regardless of the expansion of the economy, the labor force and the role of construction in both. There may have been many reasons to have sold bonds on the employment report, but an over-examination of the construction sector really should not have entered the equation.

Construction And Real Rates

The bond market, more than any other, is given to knee-jerk reactions and passing fancies on a short-term basis; long-term, it assesses economic reality very well. Part of the noise in this market is the connection between any sign of growth and inflation.

Let's state it firmly: Growth does not cause inflation, increases in the money supply in excess of real growth cause inflation. Each of those construction workers presumably will be paying taxes and otherwise not be drawing various government services that they otherwise would have been. Whether the investment directed toward rebuilding Florida and other damaged regions of the Gulf Coast, including offshore oil & gas installations, would have been used more productively elsewhere cannot be proven, but this is likely the case. After all, no one would spend their own money destroying and then rebuilding the same physical assets.

This means, all else held equal, that the net effect of the hurricanes is a negative for the economy as a whole and therefore should be depressive to interest rates. But the storms were in the past, and as the bond market looks forward, it may not like what it sees. If so, the employment report was an excuse, not a reason, for interest rates to move higher.