

NABE Industry Survey®

National Association For Business Economics

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NABE Panel: Growth Slowdown Continues While Price Pressures Ease **October 2006**

The October 2006 report presents the responses of 123 NABE corporate members to a survey on business conditions in their firm conducted between Oct. 2 and Oct. 17, 2006, and reflects third-quarter 2006 results and the near-term outlook. Respondents were grouped into four sectors: goods-producing; transportation, utilities and communications (TUC); services; and finance. The survey originated in 1982. The quarterly survey is one of three taken by NABE; the others are the quarterly NABE Outlook and the semi-annual NABE Economic Policy Survey. Founded in 1959, the National Association for Business Economics is the professional association for people who use economics in their work. **Ken Simonson**, Associated General Contractors of America; **Pat Casey**, TTX Company; and **Gene Huang**, FedEx Corporation, conducted the analysis for this report.

This NABE survey provides insights into these questions:

- Did the second-quarter slowdown in growth continue in the third quarter? What lies ahead? (pp. 2 and 7)
- Are costs for material inputs and labor still rising? Are companies posting price increases? (pp. 3 and 4)
- How prevalent are skilled-labor shortages? How did companies modify hiring or use of outside labor? (pp. 5 and 8)
- What is the outlook for hiring and capital spending over the coming 6-12 months? (pp. 6 and 7)
- Will the dollar strengthen or decline in the next 12 months? What will happen to exports? (pp. 8 and 9)

COMMENTS: "Results of the October NABE Industry Survey showed slower growth in demand for goods and services for the third straight quarter," said **Ken Simonson, Chief Economist, Associated General Contractors of America**. "Price increases for both inputs and selling prices eased in the third quarter, as did the frequency of wage increases. Overall, profit margins improved modestly, with the exception of goods-producing firms, which on balance had lower profit margins than in the second quarter. Relatively fewer respondents reported employment growth or skilled-labor shortages in their firms last quarter. Looking ahead, more than two-thirds of panelists now expect growth of inflation-adjusted gross domestic product to be at an annual rate of 2-3% in the second half of 2006, while a higher share than before expect even slower growth. Fewer respondents than in the previous survey expect their firms to hire or raise prices in the near future. In contrast, capital-spending growth rebounded in the third quarter and is expected to remain strong over the coming year. Panelists expect a substantial housing slowdown but are split on whether their firms will be affected. They report using more non-employee labor, such as contractors, consultants, and temps. A majority of respondents expect the dollar to decline over the next 12 months; respondents whose firms export expect their exports to increase in that span."

Highlights

- **Based on a quarterly survey of 123 corporate NABE members, the demand for goods and services net of inflation at respondents' firms remained positive from July through September but slowed for the third straight quarter.**
- **Price and wage pressures continued to cool down. Expectations for future price and non-labor input costs also eased.**
- **Industry profit margins improved modestly from the previous survey. But, for the third consecutive quarter, more firms in the goods-producing sector reported falling profits than rising profits.**
- **The share of respondents reporting a shortage of skilled labor fell for the third quarter in a row. As before, few respondents reported shortages of unskilled labor, raw material or intermediate inputs, or capital goods.**

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- Employment growth at respondents' firms weakened in the third quarter, while expectations for further employment increases in the next six months hit a one-year low.
- More than two-thirds of NABE panelists said they expect gross domestic product to grow at an annual rate of between 2% and 3% in the second half of 2006. But 17% of respondents expected second-half growth to fall short of 2%. Almost 40% of panelists reported that their forecast was more pessimistic than in the previous survey.
- Capital spending growth among survey respondents' firms rebounded in the third quarter to first-quarter levels, after a dip in the second quarter. Capital spending growth is expected to remain strong over the coming year, led by the transportation, utilities, and communications (TUC) sector. Forecasts of spending on computers and communications equipment were in line with overall capital spending plans.
- A majority of panelists said they expect the housing slowdown to be substantial in the next six months, but they split as to whether there will be a significant impact on their own company.
- Panelists reported increasing use of alternative work arrangements, particularly independent contractors, subcontractors, and consultants. Use of temporary employees also increased.
- A majority of respondents said they expect the real trade-weighted value of the U.S. dollar to decline over the next 12 months; only 12 percent forecasted an increase.
- A majority of the 47 respondents to a question about exports expected an increase in exports from their U.S. operations over the next 12 months; only one foresaw a decrease.

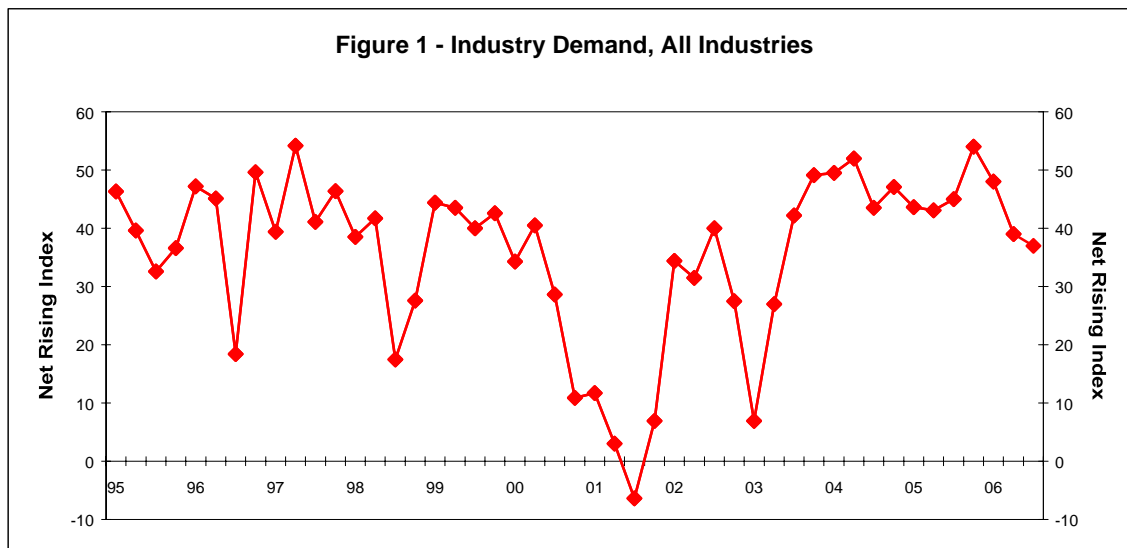
INDUSTRY DEMAND

Industry demand for goods and services slowed further in the third quarter. The net rising index (NRI, percent reporting rising demand minus percent reporting falling demand) stood at 37, the lowest reading since the second quarter of 2003 (see Figure 1). This was the third consecutive quarterly slowdown. The 54 percent of NABE panelists who reported rising demand was in the general range of surveys of the last three years; it was the 17 percent of the sample who reported falling demand that pulled down the NRI reading. That said, the latest NRI reading is higher than the average of the twenty-four year history of the survey of 34. Comparing current results by sector with level of activity from the previous quarter, the goods-producing sectors (manufacturing, construction, mining, forestry, etc.) drove the decline, as the NRI for goods-producers fell to negative territory. Other sectors showed mixed results, with TUC (transportation, utilities, and communications) moderating slightly, services up modestly, and finance up significantly.

Percent of total respondents reporting that demand is:

<u>Survey Month</u>	<u>Rising</u>	<u>Unchanged</u>	<u>Falling</u>	<u>NRI</u>	
October '06	54	28	17	37	
July '06	51	37	12	39	
April '06	55	38	7	48	
January '06	62	30	8	54	
October '05	51	43	6	45	
<u>Sector</u>	<u>Rising</u>	<u>Unchanged</u>	<u>Falling</u>	<u>Q3 '06 NRI</u>	<u>Q2 '06 NRI</u>
Total	54	28	17	37	39
Goods-producing	18	27	55	-36	8
TUC	59	29	12	47	59
Finance	65	25	10	55	26
Services	61	32	7	54	51

TUC = Transportation, Utilities, Communications. Numbers may not sum due to rounding, in all tables.



PRICES

Upward pressures on selling prices eased noticeably from prior quarters. The NRI for price increases, at 13, was the lowest since the third quarter of 2003. Moreover, the percentage of respondents whose firms lowered their prices more than doubled, to 10 percent from 4 percent in the previous two surveys. However, at this lower reading, the NRI was still above the 24-year average of 8. At the sector level, signals are mixed, with significant easing in finance and TUC industries, in contrast to increasing pressures in the goods-producing and services industries.

Percent reporting prices charged by respondents are:

<u>Survey Month</u>	<u>Rising</u>	<u>Unchanged</u>	<u>Falling</u>	<u>NRI</u>
October '06	23	66	10	13
July '06	27	69	4	22
April '06	41	55	4	37
January '06	34	65	1	33
October '05	40	58	2	38

<u>Sector</u>	<u>Rising</u>	<u>Unchanged</u>	<u>Falling</u>	<u>Q3'06 NRI</u>	<u>Q2'06 NRI</u>
Total	23	66	10	13	22
Goods-producing	46	23	32	14	8
TUC	12	88	0	12	35
Finance	15	74	10	5	28
Services	24	74	3	21	16

To compensate for the easing in selling price, the share of panelists reporting that their firms' price increases were "fully realized" increased to 32 from 29 three months ago. Sixty-one percent of respondents reported partial realization—the same as reported in the last survey.

Percent reporting price increases were:

<u>Survey Month</u>	<u>Fully Realized</u>	<u>Partially Realized</u>	<u>Unrealized</u>
October '06	32	61	8
July '06	29	61	10
April '06	36	57	7
January '06	31	59	10
October '05	48	50	2

Expectations for price increases in the coming quarter continued its recent downward trend. With NRI at 15, the upward posture in the pricing expectation is still in place. Indeed, 29 percent of the sample anticipates a price rise while 14 percent anticipate decline. The majority of the sample, about 58 percent, expects no change. In the last several surveys, the share of respondents expecting price decreases has closely matched the actual share in the following survey that reported prices had declined. Expectations of price increases, on the other hand, have consistently been higher than realizations.

Percent reporting expected change in prices charged over the next three months:

	<u>Oct '06</u>	<u>July '06</u>	<u>April '06</u>	<u>Jan '06</u>	<u>Oct '05</u>
Fall more than 5%	3	2	2	1	1
Fall less than 5%	11	6	3	4	3
Will not change	58	56	61	50	50
Rise less than 5%	21	26	30	39	38
Rise more than 5%	8	10	5	6	8
NRI (all rising less falling)	15	29	30	40	42

COSTS

Consistent with the pricing side environment, pressures on costs that respondents paid for materials were also easing noticeably. The NRI for material costs in October was 34 compared to 57 in the July survey. This latest reading is the lowest since January 2004 when NRI was recorded at 26. In the October survey, the NRIs vary from a low of 24 in the services to a high of 41 in finance, with the goods-producing and TUC both at 36. It is important to point out that costs-side NRI has been higher than price-side NRI.

Percent reporting that material costs are:

<u>Survey month</u>	<u>Rising</u>	<u>Unchanged</u>	<u>Falling</u>	<u>NRI</u>
October '06	43	47	10	34
July '06	62	34	4	57
April '06	60	36	4	56
January '06	49	46	6	43
October '05	68	28	4	63

The outlook for future non-labor input price changes has also turned lower. The October reading of NRI at 32 has moved away from a fairly uniform pattern registered since the April 2005 survey. About 16 percent expect a decline. About 36 percent expect no change. And the balance—around 48 percent of the sample—expects an increase, with almost all of them looking for a rise of less than 5%.

Percent reporting expected change in primary non-labor input prices over the next three months:

	<u>Oct '06</u>	<u>July '06</u>	<u>April '06</u>	<u>Jan '06</u>	<u>Oct '05</u>
Fall more than 5%	4	1	1	1	2
Fall less than 5%	12	6	0	5	4
Will not change	36	31	40	35	21
Rise less than 5%	47	55	56	55	52
Rise more than 5%	1	7	4	5	21
Net rising (all rising less falling)	32	55	59	54	57

The percentage of respondents reporting higher wages and salaries paid in the last three months dropped further.

The NRI for wages and salaries edged lower to 23, the lowest reading in seven quarters. At the sector level, the picture is mixed. The goods-producing and finance sectors both experienced continued cooling of wage pressures. In contrast, the services and TUC sectors saw increases in wage pressures.

Percent reporting that wages and salaries are:

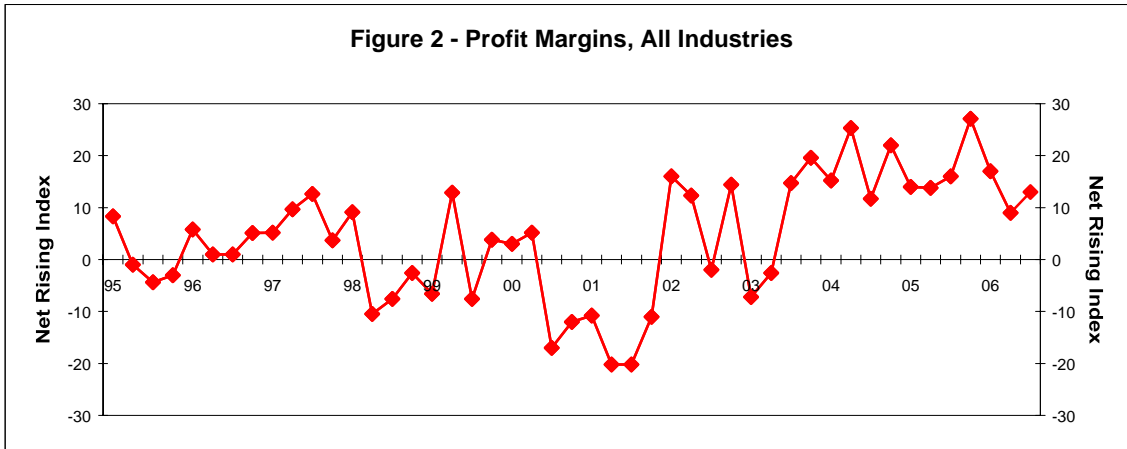
<u>Survey month</u>	<u>Rising</u>	<u>Unchanged</u>	<u>Falling</u>	<u>NRI</u>
October '06	24	75	1	23
July '06	29	68	2	27
April '06	47	50	3	44
January '06	35	62	3	32
October '05	31	69	0	31
July '05	39	60	1	38

PROFITS

Profit margins improved modestly from the July survey. Results, however, were still well below those reported over the past three years. Respondents who said their firms' profits rose in the second quarter outnumbered those who reported falling profit margins by 13 percentage points, an improvement from July's NRI of 9. The NRI for profit margins had averaged 18 percentage points from the third quarter of 2003 to the second quarter of this year, and was 27 percentage points in January 2006, the second-best ever reported. The NRI was negative (more firms reporting decreasing than increasing profits) in the goods-producing sector for a second straight quarter, while the finance sector returned to a positive NRI reading after a negative in July.

Percent of all respondents reporting that profit margins are:

<u>Survey Month</u>	<u>Rising</u>	<u>Unchanged</u>	<u>Falling</u>	<u>NRI</u>
October '06	30	53	17	13
July '06	29	52	19	9
April '06	32	52	16	17
January '06	40	48	13	27
October '05	37	42	21	16



Percentage reporting that profit margins are:

<u>Sector</u>	<u>Rising</u>	<u>Unchanged</u>	<u>Falling</u>	<u>Q3 '06 NRI</u>	<u>Q2 '06 NRI</u>
Total	30	53	17	13	9
Goods-producing	15	60	25	-10	-8
TUC	37	56	6	31	8
Finance	30	48	22	8	-2
Services	35	53	12	23	29

SHORTAGES

The percentage of NABE panelists reporting a shortage in skilled labor (30 percent) fell for the third time in a row and matched the October 2005 reading. As before, only a small fraction of respondents reported shortages in other categories (unskilled labor, raw materials, intermediate inputs, and capital goods). The number of panelists reporting no shortages improved to 62 percent from 56 percent in the July survey and 50 in the April survey.

Percent reporting shortages in survey month:

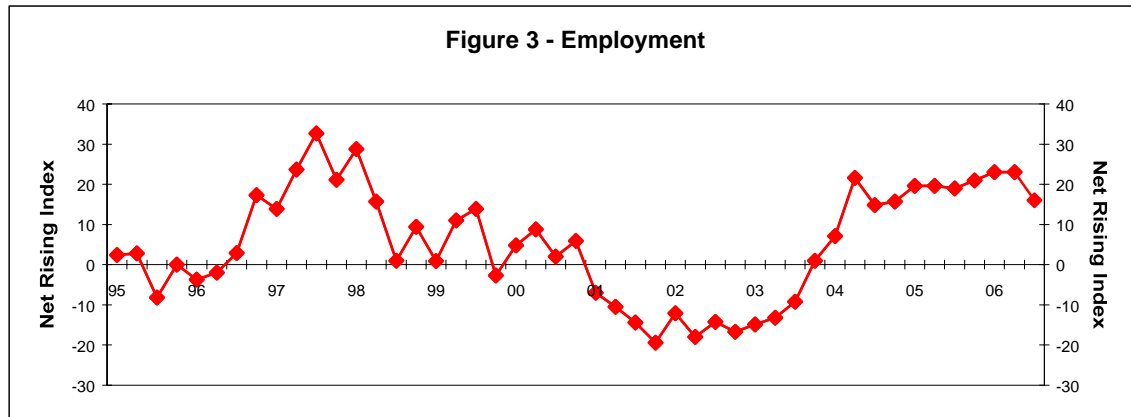
<u>Type of input</u>	<u>October '06</u>	<u>July '06</u>	<u>April '06</u>	<u>Jan '06</u>	<u>Oct '05</u>
Skilled labor	30	38	40	44	30
Unskilled labor	3	4	3	2	5
Intermediate inputs	7	6	5	6	7
Raw material inputs	3	5	8	6	7
Capital goods	2	2	4	2	1
No shortages	62	56	50	53	64

EMPLOYMENT

Employment growth among respondents weakened in the second quarter. The NRI of 16 was the lowest since late 2004 (see Figure 3). The number of firms cutting jobs last quarter remained steady at 11 percent, but the number of firms that increased employment fell to 27 percent from 34 percent in the second quarter. By sector, TUC had the highest NRI (31), followed by services (22), finance (12), and goods-producing industries (0—equal numbers of firms adding and shedding jobs).

Percent of total respondents reporting that employment is:

<u>Survey Month</u>	<u>Rising</u>	<u>Unchanged</u>	<u>Falling</u>	<u>NRI</u>
October '06	27	63	11	16
July '06	34	56	11	23
April '06	34	55	11	23
January '06	30	62	9	21
October '05	31	57	12	19



Respondents were less optimistic about job growth in their companies over the next six months than they were in the last four surveys. The NRI dropped to 13 from 17 in July and 31 in April. The share of firms expecting to increase employment dropped to 29 percent from 31 percent in July and 44 percent in April. The share expecting to decrease through attrition or significant layoffs increased to 16 percent, the highest in more than a year. Two sectors reported more promising prospects for employment gains than in the July survey: services (NRI of 27), followed by TUC (25). The NRI in finance declined to 17, and in the goods-producing industries, more respondents expect their firms to trim employment than add to it for the second straight quarter (NRI of -33).

Hiring Plans in the Next Six Months

(Percent Responding)

	<u>Oct '06</u>	<u>July '06</u>	<u>Apr '06</u>	<u>Jan '06</u>	<u>Oct '05</u>
Increase	29	31	44	42	29
No change	54	55	44	45	58
Decrease through attrition	11	13	10	8	11
Decrease through significant layoffs	5	1	3	5	2
NRI (increase less all decreases)	13	17	31	29	16

CAPITAL SPENDING

Capital spending growth among respondents improved in the October survey. The capital spending NRI rebounded to top 30 for the seventh time in eight quarters. July's NRI reading of 25 was the lowest in almost three years. The NRI for capital spending has averaged 30 over the past three years. This is well ahead of the historic average NRI of 14, and even exceeds the average of 20 for quarters with positive NRI over the survey's history. All major sectors reported a positive NRI in October; the goods-producing sector returned to a modest positive of 3 after July's NRI of 0.

Percent reporting that capital spending is:

<u>Survey Month</u>	<u>Rising</u>	<u>Unchanged</u>	<u>Falling</u>	<u>NRI</u>
October '06	41	52	7	34
July '06	35	54	10	25
April '06	43	50	7	37
January '06	40	50	10	30
October '05	36	58	5	31

The survey indicates capital spending strength should endure over the next year. Fifty-six percent of respondents reported that they expect capital spending at their firms to increase over the next 12 months, while only seven percent expect it to decrease. The October NRI of 49 was an improvement from July's 44. The TUC sector projected particularly

strong spending plans, with 86 percent projecting increased spending and none forecasting decreased spending. The finance sector also foresaw strong capital spending, with an NRI of 56.

Total Capital Spending over Next 12 Months

	(Percent Responding)				
	<u>Total</u>	<u>Goods-Producing</u>	<u>TUC</u>	<u>Finance</u>	<u>Services</u>
Increase more than 10%	9	6	13	6	10
Increase less than 10%	47	44	73	59	28
Stay about the same	38	33	13	25	59
Decrease less than 10%	5	6	0	9	3
Decrease more than 10%	2	11	0	0	0
NRI (all increases less decreases)	49	33	86	56	35

Capital spending for computers and communications equipment is also expected to remain positive over the next 12 months. The October NRI for computers and communications equipment (C&C) was at 48, equaling July results. While C&C spending plans far exceeded overall capital spending forecasts in July, they were about even in October. C&C spending plans were particularly robust in the finance sector, with an NRI of 70; by contrast, the NRI in the goods-producing sector was just 6.

Capital Spending on Computers and Communication Equipment over Next 12 Months

	(Percent Responding)				
	<u>Total</u>	<u>Goods-Producing</u>	<u>TUC</u>	<u>Finance</u>	<u>Services</u>
Increase more than 10%	17	6	6	21	22
Increase less than 10%	39	24	37	54	32
Stay about the same	36	47	44	21	44
Decrease less than 10%	6	18	12	5	0
Decrease more than 10%	2	6	0	0	2
NRI (all increases less decreases)	48	6	31	70	52

SECOND-HALF 2006 FORECAST ASSUMPTIONS

Forecasts for second-half 2006 growth grew more pessimistic between July and October. Only 15 percent of respondents expect second half growth to exceed 3%, down from 29 percent of respondents in July and 63 percent of respondents in April. The percentage of respondents expecting growth to fall below 2% was more than double its April level. A growing majority of respondents expect growth between 2% and 3%.

2006 Forecast GDP Growth

	(Percent Responding)					
	<u><0%</u>	<u>0-2%</u>	<u>2-3%</u>	<u>3-4%</u>	<u>4-5%</u>	<u>>5%</u>
Oct '06 (2 nd -half forecast)	0	17	68	15	0	0
July '06 (2 nd -half forecast)	1	10	60	28	1	0
April '06 (1 st -half forecast)	1	7	29	56	6	1

About half of survey panelists said their forecast for 2006 was unchanged from July to October. But almost 40 percent were more pessimistic than in their previous forecast, while only 13 percent were more optimistic. Increased pessimism was most pronounced in the goods-producing sector, where half of all respondents were more pessimistic than in the previous forecast.

Current Forecast for 2006 in Comparison with Previous Forecast

	(Percent Responding)		
	<u>October '06</u>	<u>July '06</u>	<u>Apr '06</u>
Significantly more optimistic	1	1	2
Somewhat more optimistic	12	9	32
Unchanged	49	54	50
Somewhat more pessimistic	36	34	17
Significantly more pessimistic	3	2	0

Special Questions

A majority of panelists said they expect a substantial housing slowdown in the next six months, but they split as to whether their own business will be affected. While 53 percent of respondents expected a “substantial” slowdown (of 5% or more), versus 42 percent of respondents who expected a “mild” slowdown (0-5%), the percentage who expected an impact on their business (41 percent), was less than the share who foresaw little or no impact (54 percent). In the TUC sector, only one-third of respondents expected a substantial housing slowdown, but that sector had the highest percentage (64 percent) that expected an impact on their business.

Do you expect housing to slow in the next six months, and if so, what effect are you expecting on your business?

(Percent Responding)

	<u>Total</u>	<u>Goods-Producing</u>	<u>TUC</u>	<u>Finance</u>	<u>Services</u>
Yes, I expect a substantial slowdown (>5%), with an impact on my business	28	41	29	32	17
Yes, I expect a substantial slowdown, but little or no impact on my business	25	18	6	24	38
I expect a mild slowdown (0-5%), with an impact on my business	13	14	35	10	7
I expect a mild slowdown, but little or no impact on my business	29	23	29	32	31
I do not expect a (further) housing slowdown	1	0	0	0	2
No observation/not relevant to my business	3	5	0	2	5

The use of alternative or contingent workers is increasing. One-third of respondents said that in the past three months, their company had increased its use of independent contractors, subcontractors, or consultants; 53 percent of TUC panelists reported such an increase. About one-fifth of respondents said their company had increased use of temporary employees. Smaller percentages reported increased usage of offshore services (13 percent), leased employees (2 percent), or other arrangements (3 percent). For each of these arrangements except employee leasing, the number of firms decreasing such usage was smaller than the number with increases.

Over the past three months, has your company increased or decreased its use of these forms of non-payroll labor:

(Percent Responding)

	Increased	Decreased	No change/not applicable	Don't know
Independent contractors, subcontractors, consultants	32	7	49	12
Temporary employees	21	3	58	17
Leased employees	2	2	75	22
Offshore services (e.g., programmers, drafters, call centers)	13	2	71	14
Other	3	1	68	28

The consensus view of the panel is for continued weakening of the U.S. dollar over the next 12 months. A hefty 65 percent of panelists who answered the question expect decline in the real trade-weighted dollar. Only 14 percent expect to see a stronger dollar. This contrast is more evident in the goods-producing industry than in other industries.

Over the next 12 months, what change do you expect in the real trade-weighted value of the U.S. dollar?

(Percent Responding)

	<u>Total</u>	<u>Goods-Producing</u>	<u>TUC</u>	<u>Finance</u>	<u>Services</u>
Increase 5 percent or more	2	0	0	5	2
Increase less than 5 percent	10	4	12	7	14
Stay about the same	19	23	23	23	12
Decrease less than 5 percent	46	45	29	53	48
Decrease 5 percent or more	11	14	23	5	10
Don't know	12	14	12	7	14

More companies expect an increase in exports from their U.S. operations (21 percent) than expect either no change (17 percent) or decline (1 percent). However, there were relatively few respondents to this question; 61 percent said they didn't know or the question didn't apply to their firm.

Over the next 12 months, what change do you expect in exports from your company's U.S. operations?

(Percent Responding)

Increase 10 percent or more	8
Increase less than 10 percent	13
Stay about the same	17
Decrease less than 10 percent	1
Decrease 10 percent or more	0
Don't know or not applicable	61

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