The *Cutting Edge*™ - February 2004

Business Briefing

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Political Economics

With the election campaign gathering steam, let's look at the economic issues being bandied about on the stumps…

- **The Economy** – Despite overwhelming data to the contrary, many of President Bush's opponents would have you believe that the economy remains in a recession made by GW himself. The facts are:

  1. The Conference Board, a well-known economic advisory firm, issued data revisions in mid-January showing that the recession began as early as September 2000 under Clinton's watch.
  2. 4Q2003 GDP rose at a 4% annual rate on the back of the 8.2% rate in the third quarter.

  When the economy grows, everything else follows.

- **The Budget** – One remedy for the last recession was a dose of tax cuts and incentives that reduced government revenues. Two further factors, (1) the recession-driven drop in tax receipts and (2) the wars against terrorism and Iraq, combined with those tax cuts to return the federal budget to deficit. Many have forecasted that deficit as large as $500 billion in fiscal 2004. But latest reports by the ISI Group, one of Wall Street's most respected investment houses, show the deficit in 1Q2004 running at only $340 billion. Last year total federal spending was 19.9% of GDP. Compare that to an average of 20.7% during the 90's. In inflation-adjusted dollars last year's deficit was only $267 billion, the fourth largest deficit since 1990. When the economy grows, rising tax revenues shrink the deficit.

- **Manufacturing** – The National Association of Manufacturers sees U.S. production of goods growing 6.1% this year vs. a paltry 1.4% in 2003. This bullish forecast stems from a projected 9% rise in exports plus a 13% increase in business capital investment. Even at 2002's depressed level, goods production was just over 39% of GDP. The highest that measure got was 35.5% in the 40's, 34.9% in the 50's, and 33.6% in the 60's. When the economy grows, the manufacturing sector grows.

- **Jobs** – Yes, the unemployment rate appears stubbornly stuck at around 6%. This situation is true for most economic recoveries. As the economy improves, businesses seek to get the most from existing workers before adding new ones. Thus the unemployment rate is a trailing indicator. Two factors have combined to exacerbate the job situation in this recovery: (1) a glut of capacity worldwide and (2) fantastic productivity. In the late 90's many industries built new capacity. In the U.S. capacity utilization is only 74% vs. a norm of around 80% from 1972 to 2002. Since the construction and start-up of new plants is a huge stimulus to hiring, the U.S. won't get that bonus until existing plants are full. Plus those plants running only 30-35 hours a week must get back to full schedules. As for productivity, U.S. plants are simply making more with fewer workers. And that achievement is great for our economy.

  One productivity example is the telecommunications industry. In 1970 421,000 switchboard operators were employed in the U.S. to handle 9.8 billion long distance calls. Today we make 98 billion calls with only 78,000 operators at a fraction of the cost of those 1970 calls. Using old technology we would need 3% of our labor force to staff long distance calling. Would employing those workers in that way be good for the economy?

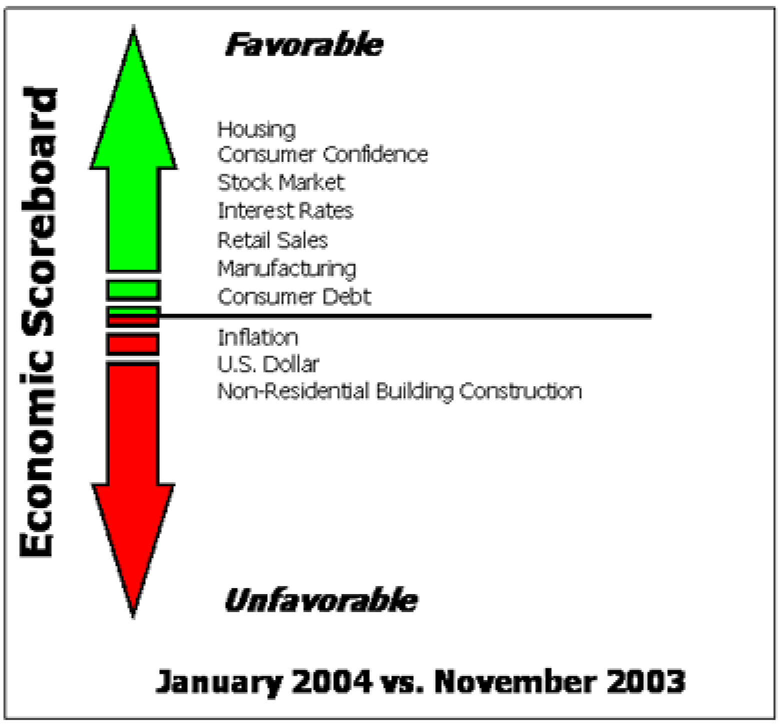
  Remember, too, that U.S. economy is in transition. Import-vulnerable industries like furniture, textiles, and apparel are in decline. In addition, evolving technologies are causing massive restructuring. A case in point is Kodak's recent announcement to eliminate 15,000 jobs and shutter 1/3 of its plant space as it moves from film to digital photography.

What about all those computer programming jobs moving to India? According to the Bureau of Labor Statistics 2.62 million such jobs existed in 1999 at an average wage of $26.41 per hour. In 2002, 2.77 million programmers were employed at an average hourly wage of $29.63. Specific data are unavailable for 2003, but information industry payrolls rose by 4.9% last November. If the U.S. were really losing jobs offshore, employment would not have risen from 136.5 million jobs in November 2002 to 138.6 million last November. Real disposable income is also rising, up 3.9% last year.

Note, too, that the BLS's Household Survey shows a net gain of 700,000 jobs since January 2001. That's a long way from the 2.3 million job losses reported by the Payroll Survey, the source more frequently cited by TV talking heads and opposition politicians. The latter survey, while larger, usually underestimates hiring by new and small firms in the early stages of recovery. When the economy grows, hiring eventually grows.

In our history, real and perceived economic 'woes' disappear when the economy grows. And growth has just begun.

Bottom Line: When judging the economy, do your homework. Think logically. Cut through the chaff and find the kernels of economic truth.



Economic Factoid - Of the 100 largest "economies" on the globe, only 47 are countries. The remainder is multinational corporations. Only 20 of the world's 220 nations have gross domestic products that exceed the annual revenues of Exxon Mobil, the world's largest company. Multinationals now employ 90 million people around the world, pay more than $1.5 trillion in wages, produce 25% of the gross world product, and pay $1.2 trillion in taxes.

Sector Situation Report

Latest news from the wood products industry by sector…

Office Furniture – BIFMA reported that November 2003 orders and shipments declined by 1% year-over-year vs. the same month last year. Further evidence that the sector is not recovering is the 5% decline in orders vs. October. Analysts continue to project a recovery "a quarter or two away," while pointing out strong GDP growth and a small rebound in corporate capital spending.

- Steelcase reported 3Q2004 revenues down 3.3% versus the same quarter last year and announced the closing of its wood furniture plants in Fletcher, NC, and New Paris, IN, idling 480 and 160 workers, respectively.

- Herman Miller noted that 2Q2004 sales were down 7.6% versus the same quarter last year. The quarter, however, was the third consecutive period of sequential sales growth. In spite of a lower gross margin, operating profit grew by 1.4% due to continuing efforts to rationalize the company's cost structure.

- Hon Industries announced the purchase of Paoli Inc. from upholstery producer Klaussner Furniture Industries. Paoli, with annual contract furniture sales of $80 million, will continue to build its strong brand position while benefiting from Hon's lean manufacturing expertise.

Kitchen Cabinets – Cabinet sales rose a torrid 22% in December vs. the same month in 2002 according to the KCMA's Trend of Business Survey. For 2003, cabinet sales were up 13.1% following on 10.9% growth in 2001 and 12.4% in 2002. Sales of custom and semi-custom cabinets rose 24.8% and 19.5%, respectively, in 2003. This performance is evidence of the importance of producing what the consumer really wants. By doing so, the cabinet industry is defending its market from low cost imports.

Importantly, experts predict that spending on kitchen remodeling will rise 11.1% in 2004. Nearly three out of four kitchen jobs is a remodel.

- American Woodmark, the second largest U.S. cabinetmaker, reported sales growth of 17% for their 2Q2004, but gross margin fell to 20.2% from 24.3% in the same quarter 2003. Management blamed the decline on higher lumber, pension, and medical costs as well as increases in overtime. Operating margin also suffered, falling to 8.1% from 10.5%.

- Masco, the largest U.S. cabinetmaker, reported better performance in their cabinet divisions during their 3Q2003. Cabinet sales increased nearly 9% to $802 million with operating margin slipping slightly from 15.4% in 3Q2002 to 15.2%.

Home Furniture – The anti-dumping petition against Chinese bedroom furniture producers has moved one step closer to the imposition of import duties. On 9 January the International Trade Commission made a preliminary determination of injury to U.S. bedroom manufacturers. This ruling ratifies the December 2003 ruling by the Department of Commerce and initiates a full investigation into the dumping allegation. DOC is scheduled to announce its determination on 5 May with any import duties following quickly.

In response, Chinese manufacturers have raised nearly $1.6 million for legal fees to oppose the petition brought by 31 U.S. producers and five labor unions. The Furniture Retail Group, 60 retailers who oppose the petition, announced that any duties would result in higher bedroom prices, lower sales, and the loss of retail jobs.

More background detail on this petition can be found in the December Business Briefing.

On the retail side **Wal-Mart**, the world's no. 1 merchant, is now the leading seller of furniture in the U.S. The company with furniture sales of $1.24 billion is the first non-conventional furniture retailer to head the Furniture Today rankings since Sears held the top spot in 1993. Other non-conventional furniture retailers in the top 25 include Office Depot, Sam's Club, Staples, Costco, Kmart, OfficeMax, Lowe's, and Big Lots. The growth of these non-traditional channels highlights the changing distribution scene for furniture in the U.S.

At the producer level…

- **Furniture Brands International** 4Q results included total revenues of $616.9 million (up 3.6%), gross margin of 27.6% (even), and operating profits of $39.2 million (down 21%). Management noted improved sales trends across all product lines and price points. FBI's Drexel Heritage division announced the closure of two North Carolina furniture plants, idling nearly 400 workers.

- Casegoods maker **Stanley Furniture** reported FY2003 sales of $269.6 million, up 8.8%, and operating profit of $26.2 million, up slightly from the prior year. Imported product accounted for about 20% of sales, and management expects that segment to reach 30% in 2004.

- **Ethan Allen** reported 2Q2004 sales of $241 million, up 5% over the prior year. Gross margin declined by 4.4% while operating margin remained steady at 16.2%.

- **Hooker Furniture** announced record sales of $309 million for their FY2003. The company has turned in eight consecutive quarters of increased sales. The acquisition of Bradington-Young, the leather upholstery specialist, added $44 million to Hooker's 2003 top line. Additionally, shipments of their imported products grew by over 40% vs. the prior year. On the negative side, lower demand for their domestically-produced wood furniture declined. As a result net income fell by 4.4%. Utilization of the four remaining wood plants is expected to rise as total furniture sales increases in 2004.

- High-end producer **Stickley** of Manlius, NY, has announced a $6 million expansion program for their case goods plant. The project includes a 30,000 sq. ft. addition to their finished goods warehouse, a new finishing line, and new rough mill equipment. The expansion was spurred by the acquisition of **John Widdicomb** in mid-2002 and the relocation of its production to Manlius.

- Integrated manufacturer/retailer **Bassett Furniture** reported a 2% decline in FY2003 sales and a loss of $470,000. The company reiterated its primary focus continues to be expanding its retail store program. Bassett has reduced its number of plants from 13 in mid-2001 to seven.

- The growth of imported product continues to affect U.S. furniture companies' domestic operations. **Richardson Brothers,** Sheboygan, WI, wood case goods producer, is closing its 300,000 sq. ft. plant and furloughing 125 employees. The company is replacing its domestic product with imports from China and Bolivia. The plant will be converted to an import warehouse. **Samuel Lawrence Furniture** of Phoenix, AZ, is also forsaking domestic production and closing its 264,000 sq. ft. case goods plant. **Orleans Furniture** announced the implementation of a warehousing program in Vietnam to support its growing imports. This resource will enable its customers to ship mixed containers direct from their Vietnamese supplier plant.

- RTA producer **Doxey Furniture** of Aberdeen, NC, has ceased operations, closed its 200,000 sq. ft. plant, and terminated their work force. When fully producing, the plant employed about 150 workers.

- Canadian producer **Dorel Industries** is closing its Carina Furniture plant in Brampton, Ontario, and terminating 300 jobs. The company's more efficient Cornwall plant will assume production of the Carina line.

Wood Flooring – For 2003, strip flooring shipments were up 1% over 2002. The year ended weakly with November and December shipments each down 1% from the same months in 2002.

Wood Dimension & Components – WCMA, the sector's trade association, reported that shipments in 3Q2003 rose 8.2% year-over-year. July and August sales were up over 10% each. 2003 year-to-date shipments were up 7.8% vs. the prior year. Member companies are predicting growth of 10% in 2004. This solid performance combined with an optimistic forecast may indicate that this sector has recovered from its dependence on the furniture industry.