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The Cutting Edge™ June2004

Business Briefing

Economic News: Around the World By Art Raymond, A.G. Raymond & Co., Inc.
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China: While China's trade surplus with the U. S. is high and rising, in total, the world's sixth largest economy is running a trade deficit. In February, their trade shortfall was \$7.9 billion following up on a \$30 million deficit in January. Imports in January rose 77% year-on-year while exports gained 40%. The country is importing three times more goods and services per month than in the late 90's.

This balance of trade deficit bodes ill for the U. S. Treasury and our economy. Till now the dollars China has earned by exporting to the U. S. has been converted into massive purchases of U.S. government debt. Now with these dollars being used to pay for increasing imports, China will have fewer greenbacks to support the U.S. bond market. Keep your eyes on this situation as well as the Japanese Ministry of Finance's program to keep the yen cheap vis-à-vis the U. S. dollar. Japanese purchases too have been critical to keeping our interest rates low.

In the meantime the U.S. is exporting more goods and services to China. The Chinese are building cities the size of Houston, TX, each month to house the migration of its population to urban areas. As a result the U.S. is shipping industrial commodities, food/agricultural products, machinery, telecommunications equipment, airplanes, and cars to China in record numbers.

Another Chinese risk is their financial system. The ratio of non-performing loans, i.e., bad debt, at the biggest banks in China is running at a staggering 21%. At U.S. banks, this performance metric is about 0.75-1%, 20 times better than its Chinese counterparts. A recent pronouncement by Chinese banking regulators aims to improve the ratio by expanding lending rather than fixing the bad loans. This ploy is akin to making up the loss on an unprofitable product by selling more product!

The rising trade deficit may, in fact, force the Chinese to revalue their currency, a move long encouraged by U.S. authorities. By increasing the purchasing power of their currency, such a move would make its imports cheaper. But often these maneuverings produce unintended consequences. Who knows? Maybe a floating renminbi falls in value and generates more exports - another way to balance trade.

Economic Factoid - Since 1978, the Chinese economy has averaged 9% annual growth, expanded foreign trade by 15% annually, and generated a trade surplus with the U.S. twice that of Japan's. The economy needs to generate nearly 15 million new jobs every year to keep pace with population growth.

The impact of China on the global economy is huge and growing. The risks to the world of an economic downturn starting in China are high. The U.S. is walking a thin tightrope by relying on China to prop up our economy. But the remedies are complicated and, in many cases, untested. Stay tuned to this critical story.

For more information on the Chinese economy, get a copy of the March 20 survey in The Economist www.economist.com/surveys.

And here at home...

The job-creating machine that's the U.S. economy remained at full throttle in April, as 288,000 new jobs were generated. Added to the 377,000 rise in payrolls in March, this two-month job growth was the strongest in four years. In total, the economy has produced 867,000 new jobs in 2004. And 64% of private companies have hired new workers in the past three quarters. The trend is clearly upward for employment.

Companies hire when additional production is required. And they add capacity when demand outruns supply. The Federal Reserve estimates that manufacturing capacity utilization stands at 76% or so. At this rate, companies have little incentive to expand their factories. Today's rising prices are an indicator of tight supply - the need for more capacity. If so, perhaps capacity utilization is higher than the Fed's data shows. In fact, the Institute of Supply Management's capacity indicator is reporting utilization at 85.6%, up from 80.1% last December. Keep your eyes open for an uptick in capital investment on new plant and equipment. Cash flow, a key source of capital for investment, is strong at many companies as the economy has moved from recovery to expansion. As advisers on facilities design, our company is seeing more projects involving new plants and expansions than in three years. That's a great sign. Planning always precedes major equipment purchases.

Of course higher interest rates mean a slower economy. But will rates really increase enough to endanger the economy? Some economists will tell you that a central bank's interest rate should approximate an economy's growth rate. If rates are lower than growth, money is easy. If higher, money is tight. Easy money leads to inflation, a condition we can see in today's economy.

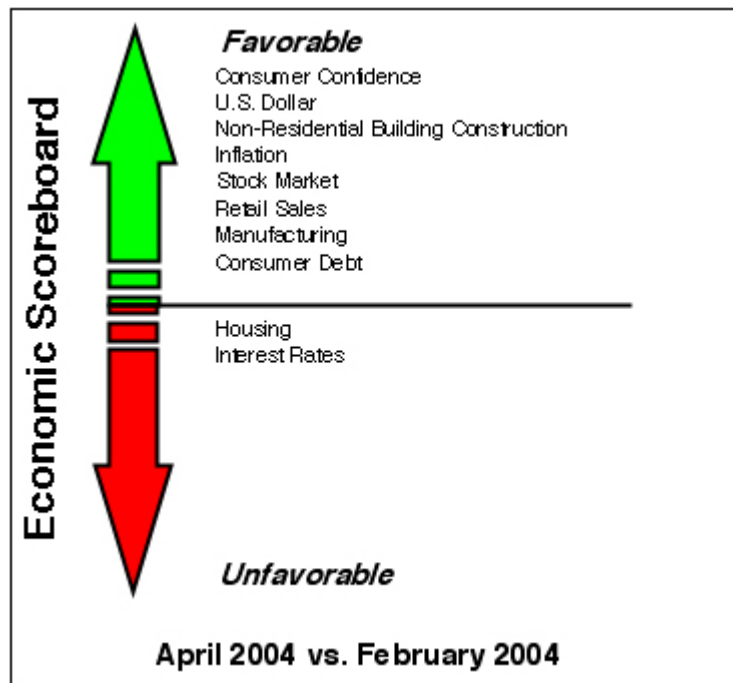
At the moment the natural rate of growth in the U.S. is around 2%, and the Fed's 'federal funds rate' is 1%. On this theory, the Fed has room to increase rates by about one percentage point. But the lower tax on investment income provided by last year's dividend tax reduction may also influence any rate increase. This incentive will drive capital into the market and keep rates down.

If these funds are wisely invested, the result will be more technological advances, higher productivity, higher wages, and rising profits. All these factors are great for the economy. Buckle up.

Solid growth is on the horizon for the U.S. unless outside influences derail the current momentum. Many say that influence could be the price of oil. The talking heads are hammering us with reports that the world is running out of oil and present higher prices will be permanent. Ignore the media and think again. War, especially in the Middle East, can and will push up prices. But the world is

drowning in oil. Back in 1982 the best guesstimate of global oil reserves - crude that's still in the ground - was around 600 billion barrels. Oddly, since that time, the world has used about that much oil, but we now have reserves of 1.05 trillion or so. In fact recent news from Saudi Arabia indicated that their reserves might be as much as 1.2 trillion rather than the 261 billion previously reported. Russia, too, is a growing resource having recently tripled their reserve estimate. In oil as with other commodities, rising prices usually mean rising supply. And don't forget that our economy is twice as energy-efficient as in the late 1970's.

Bottom Line: Keep your fingers crossed. The world is crazy at the moment, and our economy is fragile. One thing is certain however - an increasingly intertwined world means everyone is a stakeholder in the global economy. If common sense prevails, everyone may experience the benefits of a strong economy.



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The Cutting Edge™ - June 2004

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Sector Situation Report

Latest news from the wood products industry by sector...

Office Furniture - The contract office furniture industry is providing a strong sign that business investment is on the rebound. March orders grew by 8% year-over-year, the fourth consecutive month of positive growth. Shipments increased by 5% in March, the second positive month in a row and fifth in the past nine months. BIFMA now forecasts that 2004 shipments will be up 3.5% over last year. Analysts believe demand for office furniture has bottomed and predict improving operating results for major sector players like Steelcase, Herman Miller, and Hon.

Kitchen Cabinets - Cabinet sales continued red-hot by growing a torrid 19.1% in April vs. the same month in 2003 according to the KCMA's Trend of Business Survey. Year-to-date 2004 cabinet sales were up 18.3%.

Masco, the largest U.S. cabinetmaker, reported sales growth of 19% for its 1Q2004. Operating margin fell slightly to 13% vs. 13.1% last year. Cabinet sales grew 18% to \$779 million with operating margin at 14%, up from 13.1%. Estimated capacity utilization in their cabinet plants is 80%. The company's cabinet brands include Merillat, Mills Pride, and KraftMaid.

Home Furniture - The industry is upbeat after the April International Home Furnishings Market in High Point, NC. Exhibiting companies reported attendance up 15%. Many declared this Market the best in three years.

The buzz among exhibitors and attendees was the pending decision on import tariffs on Chinese made bedroom furniture due June 17. Many believe tariffs ranging from 30-40% will be imposed. The Furniture Retailers Association took the opportunity of the April Market to blast the petitioning U.S. manufacturers in trade paper ads and a press conference. This group includes large retailers such as Rooms To Go, Havertys, Rhodes, and JCPenney. Many of these companies have discontinued buying product from the U.S. furniture makers who brought the petition for tariffs to the Department of Commerce. The Furniture Civil War continues...

In the meantime, furniture imports continue to take market share. The table below shows the top 10 source countries for furniture imports in 2003...

Country	2003 Shipments	2002 Shipments	% Change
China	\$6,847.50	\$5,771.20	19%
Canada	2,204.00	2,202.60	0

Italy	1,335.50	1,308.60	2
Mexico	848.60	819.30	4
Taiwan	516.50	595.90	-13
Indonesia	509.40	527.4	-3
Malaysia	507.70	475.00	7
Thailand	375.20	362.2	4
Brazil	320.80	268.70	19
Philippines	185.90	212.20	-12
Top 10 Total	\$15,654.10	\$14,545.10	7%

Brazil, who cracked the top 10 just last year, continued its solid performance as U.S. buyers continue to hedge against the potential tariffs by supplier outside of China. Brazil's exports to the U. S. increased by 38% in 2002.

Vietnam, another potential replacement supplier for those seeking to lessen dependence on China, moved up to no. 11 in the rankings with exports of \$167 million. **Ferguson Copeland**, a Morganton, NC, furniture importer, is set to build a 100,000 square foot plant in Vietnam for production of casegoods and occasional furniture. The plant will house a fully-integrated production line with capacity for 15-20 containers per month.

Stickley Furniture, Manlius, NY, is also building a plant in Vietnam.

In addition to potential tariffs on Chinese products, other foreign producers may be forced to increase prices. Rising lumber cost could mean higher prices on furniture made in Malaysia and Thailand. Higher cost of rubberwood, a primary species used in furniture production in the Far East, is driving price increases of 3-7% on a wide range of export products like occasional tables and casual dining sets.

Potential tariffs, higher production costs, and oil driven cost increases in ocean transport mean change in the world furniture economy. Maybe a slackening in plant closures in the U. S. will result. Strong demand has delayed the closing of two Furniture Brands - Drexel Heritage plants announced earlier this year. Other plants are running full 40-hour weeks.

The news from U.S. furniture makers includes...

Furniture Brands International, the largest domestic furniture producer in the U. S., reported a 7% sales increase in 1Q2004. Sales of their higher-end wood lines - Maitland-Smith, Thomasville, Henredon, and Drexel Heritage - accelerated over the same period last year. Demand, however, has softened at Broyhill, Lane, and Founders, FBI's lower-priced lines.

The company expects to open 61 retail stores this year as it shifts to the Ethan Allen business model of integrated producer-retailer.

Ethan Allen, the most recognized brand name in furniture, reported 3Q sales of \$179 million, up 9% over last year. Gross margin fell to 48.8% while operating margin improved from 14.3% to

15.5%. The company announced the closure of two casegoods plants. The Boonville, NY, and Bridgewater, VA, operations totaled 414,000 square feet and employed 500 workers. The production of these plants will be shifted to the company's six remaining casegoods plants. Ethan Allen also operates five upholstery plants and one accessory plant. After these closures production space will total 4 million square feet. Employment will fall to 4,000 workers. Ethan Allen's retail network includes 312 stores. Management expects to open 15 new stores this year.

RTA furniture maker **O'Sullivan** reported 3Q2004 sales down 16% to \$73 million. For the first three quarters sales were \$210 million, a decline of 12% from 2003. Operating income fell to 4.5% from 10% in the same period last year. As their market matures, all RTA producers are being pressured by low cost, fully assembled products from offshore in wood or wood/veneer.

La-Z-Boy's 2003 sales totaled \$2 billion, down 5.3%. Operating margin fell to 1.5% from 7.7% the previous year. Casegood sales declined 13.3% for the year, and that segment's operating margin continues to be impacted by capacity utilization running below ideal levels and by pricing pressure from imports.

The company took a \$72 million charge to write down the value of its trade names primarily in its casegoods group. La-Z-Boy acquired their casegoods operations from Ladd in January 2000 for \$238 million. These companies include American of Martinsville, American Drew, Hammary, Kincaid/Alexvale, Lea, and Pennsylvania House. CEO Kurt Darrow noted, "The values of our casegoods businesses have been negatively by the onslaught of import competition, primarily from China, and the severe downturn in the hospitality industry since 9/11."

Casegoods maker Stanley Furniture reported a 15% gain in 1Q2004 sales to \$70 million. Gross margin also increased to 24.5%. Operating margin was 11%. Imported product now accounts for 26% of sales vs. last year's 20%.

Sales at Chromcraft Revington fell 6% to \$46.5 million in their first quarter. While gross margin improved to 23%, profits declined 32%. Management noted increased foreign competition across their residential and commercial product lines.

Vaughan Furniture blamed foreign competition in announcing the closing of its Johnson City, TN, plant. The shutdown will idle about 200 workers. Vaughan will continue operations at three bedroom plants and one veneer plant in Virginia employing 1,000 people. Galax, VA, neighbor **Webb Furniture** is laying off 151 employees, almost a quarter of its work force.

Higdon Furniture of Quincy, FL, has broken ground on a new plant in Cairo, GA. The plant will employ about 100 workers and is expected to start production in September. The company produces promotional bedroom at retail price points of \$399 to 999, a category that is proving difficult for foreign competitors due to freight costs.

Wood Flooring - March shipments of strip flooring were up 7% over 2003. For the first three months of 2004 shipments increased by 9%. The strength of the U.S. wood flooring market is attracting foreign competitors. At the National Wood Flooring Association's recent trade show 98 different species of strip flooring ranging from African mahogany to zebrawood were exhibited. Many of these producers were seeking American distribution. And some U.S. flooring producers displayed imported species much like U.S. furniture makers sell products made

overseas. Will the wide array of flooring imports eventually win the pocketbooks of U.S. consumers? If so, will flooring follow the furniture industry "across the pond"?

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