WOOD MACHINERY MANUFACTURERS OF AMERICA
MACHINERY, CUTTING TOOLS AND SUPPLIES

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Business Briefing

What to Expect From Bernanke

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Ben Bernanke is set to take over the chairmanship of the Federal Reserve Board from Alan Greenspan in February. As a Princeton professor for 17 of his 26-year career, Bernanke is little known outside academic circles. Most recently, he was a Federal Reserve Board member for three years before his appointment as chairman of President Bush's Council of Economic Advisers in June of this year.

What should we expect as Bernanke takes on the most important economic policy job in the world? Our economy is strong but arguably more complex and global than in 1987. Can he keep the good times rolling?

First, some background...

- **Greenspan's Track Record** The retiring chairman held that position for over 18 years. Worthy of note is Greenspan's track record in his early days at the Fed after Paul Volcker's retirement. Greenspan, in an effort to match Volcker's inflation fighting credentials, broke a string of seven rate cuts and raised rates in the summer of 1987. Four weeks later, Black Monday hit U.S. stock markets, an event that roiled monetary and fiscal policy for the next five years. Remember the 1990-91 recession? Greenspan was not always the economic maestro he is now titled.

- **The Fed's Job** What does the Fed aim to do? The Federal Reserve Act of 1913 gives the Fed three important economic goals: (1) maximum employment, (2) stable prices, and (3) moderate long-term interest rates.

So where does Dr. Bernanke stand on these and other key economic issues...

- **Inflation** At his appointment ceremony, Bernanke emphasized his desire "to maintain continuity with the policies and strategies established during the Greenspan years." But, the two disagree on the way to handle inflation. Bernanke has long advocated setting a medium-term inflation target to institutionalize the Fed's inflation fighting role championed by Paul Volcker and Greenspan. He argues that such a target is critical in fighting both higher inflation and deflation. Greenspan, on the other hand, believes that such a policy hinders the effective pursuit of maximum sustainable economic growth. Note that the U.S. has experienced low inflation since the early 90's without a pre-set target. *Watch for a fast push toward targeting as a break from Greenspan's policies.*

- **Full Employment** As noted above, a primary Fed responsibility is to maintain economic growth that provides full employment. In his Senate hearings, Bernanke testified that inflation targeting would not reduce the importance of full employment as a Fed policy goal. *Listen for Bernanke's early pronouncements on* *employment for an indication of his priorities.*

- **Interest Rates** Overall, Bernanke believes inflation will remain low. However, as an old fashioned inflation hawk, he prefers pre-emption and is likely to raise interest rates as fast or faster than Greenspan if his inflation forecast proves wrong. Note that both Volcker and Greenspan raised rates soon after taking over the chairmanship. *Watch for an early change of direction on rates to indicate Bernanke's power and leadership.*

- **Taxes** Bernanke testified that the initial Bush tax cuts "increased disposable income for all taxpayers, supporting consumer confidence and spending while increasing incentives for work and entrepreneurship." The later cuts "provided incentives for businesses to expand their capital investments and reduced the cost of capital..." *Sounds like a business-friendly position on taxes.*

- **The Housing Bubble** Agreeing with Greenspan, Bernanke believes that the Fed has no business puncturing asset bubbles. *Don't expect him to express much worry about housing prices.*

- **U.S. Debt in Foreign Hands** Bernanke sees the ownership of U.S. debt by foreign central banks as a vote of confidence in our economy and the specter of huge sales of this debt as improbable. He believes that foreign debt holders have chosen to invest in assets that are highly liquid and safe. *Don't expect much concern about the current account deficit.*

- **Political Independence** Bernanke is on the record as saying that he would be independent and play his role in cooperation with other Federal Reserve governors. Missing from that statement was any mention of the White House as part of the policy setting equation. *Expect little influence from the White House or other politicians.*

Being Fed chairman requires expertise in monetary policy, good instincts for economic data, and insight into policy debates outside of the Fed that affect the economy. Since even the most elaborate models of the economy generate only forecasts, the most important qualification for the chairman's job is **judgment**. Close behind is the ability to communicate clearly and persuasively to the world's market makers.

Whatever Bernanke does in the near term, let's hope that his judgment is clear and his words easily interpreted. Our economy is strong. We need a Fed chairman who will stay the present course.

Economic Factoid

In a country of nearly 295 million, 15% of all Federal income taxes are paid by only 129,000 people 0.4% of the population. This "progressive" burden on such few taxpayers has increased since 1980. That year the top 1% of taxpayers paid in 19.1% of total taxes vs. 33.7% in 2003.

On the other end of the scale, the bottom 50% of taxpayers paid in only 3.5% of tax revenues vs. 7% in 1980.

In such a situation an old adage applies "A government that robs from Peter to pay Paul shall earn the everlasting support of Paul."

Sector Report

Kitchen Cabinets

Cabinet sales rose 10.7% in October vs. the same month in 2004 according to the KCMA's Trend of Business Survey. For the first ten months of 2005 sales were up 13.7%.

- **Masco** with its Merillat, Mills Pride, and KraftMaid brand cabinets, reported an 8% increase in its 3Q2005 sales. Operating profit at their cabinet operations fell slightly to 16% from 17.5% year-on-year. Solid gains were also made in their Installation Services business.

Home Furniture

Interesting stories abound in the furniture universe...

Is China Entering The Real Furniture World?

Competition among China's burgeoning furniture industry is heating up as cost pressures grow. The October *Business Briefing* reported concerns among Chinese furniture factories over higher costs for energy and raw materials. Now, Chinese producers are complaining about worker shortages and the recent 2% rise in their currency vs. the US dollar.

In an interview with *InFurniture* magazine, one factory executive noted that the growing number of plants seeking to fill their order books is keeping prices low. "With costs increasing, our margins are growing thinner and thinner." Other factory owners are complaining about small competitors trimming costs by ignoring laws governing worker safety and the environment.

Sound familiar? Those same complaints about their Chinese competitors were heard from U.S. furniture makers in recent years.

Furniture makers who thrive on low-cost labor are now competing with higher tech industries like electronics that pay higher wages and offer better working conditions. This same situation in Taiwan during the early 90's drove many factory owners there to relocate their operations to China. In addition, Chinese farm workers are now earning higher pay in an effort to keep food production growing. This fact has reduced the flow of low-cost workers to the large coastal cities where manufacturing is primarily located.

New Chinese laws have also contributed to higher labor costs. Overtime and vacation pay are now twice the normal wage rate, and overtime is limited to a maximum of 36 hours per month.

Is labor really in short supply? Or are factory owners unwilling to pay a wage sufficient to attract enough workers? "Nobody wants a price war on salary," one company executive recently said. "You can offer better working conditions but not more pay or else workers will be shifting from job to job for an extra $1 per week."

To combat eroding profits, some Chinese producers are shifting up market to goods with higher margin opportunities. If this trend grows, a price floor may develop under which Chinese factories are not competitive with U.S. promotional furniture makers.

The good old days when managers solved production bottlenecks by simply throwing more labor into their plants may be over in the Chinese furniture industry. As always, productivity, not wage cost, is the key to sustaining competitiveness. Opportunities abound in Chinese furniture plants to improve productivity through higher tech machinery, better material handling, streamlined plant layouts, and computerized control software. Will Chinese furniture executives embrace sound engineering as a solution or simply watch as the industry shifts to even lower-cost labor regions?

October High Point Market Attendance Down

Furniture makers exhibiting at the semi-annual High Point Furniture Market saw attendance decline by as much as 25%. Among the reasons cited by industry gurus:

- Poor furniture sales forcing small retailers to skip this Market.
- Competition from the new Las Vegas Market held in late July.
- The cost of attending High Point.

Will the new Vegas Market cause furniture makers to maintain expensive permanent showroom space at both cities? Or will sanity prevail in an industry already battered by price deflation, global overcapacity, and lack of innovation in product and business models?

Successful IPO for Lacquer Craft

The owner of major Chinese furniture manufacturer, Lacquer Craft, raised $243 million in an initial public offering on the Hongkong Stock Exchange in November. According to the prospectus, the funds are earmarked for large expansions at its Jiashan and Donguan, China, factories plus a new warehouse for Legacy Classic, one of its two U.S. marketing companies. Lacquer Craft also sells direct to U.S. retailers through its Universal Furniture operation

Canadian Producers File Complaint Against China

The Canadian Council of Furniture Manufacturers has lodged a complaint with the Canadian International Trade Tribunal seeking an inquiry into furniture imports from China. The complaint notes that statistics show the Canadian market is increasingly monopolized by imports mainly from China. “Since 2000 imports have risen by 200%, and China has replaced the U.S. as the main source of imported furniture.”

If the inquiry shows that Chinese imports have caused material damage to the Canadian industry, safeguard tariffs or quotas may be imposed. Such levies or quotas normally extend for three to five years.

A recent wave of plant closures by Canadian producers continues. Full-line furniture maker **Shermag** announced that its upholstery plant in Quebec will close. About 70 workers will lose their jobs. Shermag closed two other plants earlier this year affecting 178 employees. The company now operates eight plants employing 1,800 workers. The company also reported that its 2Q2006 sales declined by 4.4%.

Foam Shortages Hit Upholstery Sector

A critical shortage of TDI, an ingredient in polyurethane foam, has upholstery makers struggling with short supplies and higher prices. In mid-October, foam suppliers announced price increases up to 40% and began allocating foam to customers. By November supplies had returned to normal, but prices were up 60% to 70% over August.

Coupled with 10%+ increases in frame plywood and 30% in energy are forcing upholsterers to raise wholesale prices in the face of a soft retail environment. These higher prices may increase penetration of imported products in the upholstery sector.

News at the company level remains mixed...

- Casegoods producer **Hooker Furniture** reported a 2.3% decline in its 3Q2005 sales to $82.4 million. For the first nine months, sales were 0.9% below the same period a year ago. Sales of its upholstery line, Bradington-Young, grew by 6.3% in the quarter while its imported wood line increased by 10.5%. Offsetting these increases was the decline in sales of wood furniture produced in its U.S. plants.

- **Ashley Furniture** announced the construction of a new $14.3 million plant in Arcadia, WI, that will add 288 jobs. This plant will enable the reconfiguration of existing space at this site and generate a cost savings of about $6.5 million.

- **Leggett & Platt**, a major furniture component supplier, has completed five acquisitions including two Chinese companies. One of the Chinese companies produces motion mechanisms for upholstered furniture and will support the growing upholstery sector there. Also added were a Toronto, Canada, producer of upper-end down comforters and a Mississippi maker of metal rocker bases. The second Chinese company manufactures retail store fixtures for export to the U.S.

- Mississippi-based upholstery maker **Genesis Furniture** has acquired a 560,000 ft2

Spruce Pine, NC, plant from Henredon Furniture. Genesis will produce promotional and mid-price products at the new location and employ 200 workers.

- RTA producer **O'Sullivan Industries** has filed for Chapter 11 bankruptcy protection. Management reported that the step was taken to address the company's debt burden and was not due to operational problems. The company intends to retain its 1,300 person workforce and maintain product flow to its retail customers.

- **Furniture Brands International** announced that its 3Q2005 sales declined 2.9%. Gross margin was 23.5% vs. 25.3% one year ago while operating profit fell from 5.7% to 3%. Management blamed sales weakness in its Broyhill and Lane lines. In early November **Broyhill** announced the closure of its Lenoir Chair Plant 1 and Veneer Plant idling 421 workers. Since April about 1,200 workers at Broyhill have lost their jobs. Management blamed import competition for this broad restructuring of its domestic capacity and could not predict an end to the layoffs.

- **La-Z-Boy** reported a loss of $6.4 million in its 2Q2006 on a sales decline of 12.7%. Management blamed foam shortages, sluggish retail sales, and hurricanes that offset recent cost-cutting efforts.

- **Stanley Furniture** reported an 8.6% gain in its 3Q2005 sales with operating profits of 11%, a slight decline from the same period last year. 3Q was the 14th consecutive quarter of sales growth in the face of a spotty consumer demand for the industry.

- Producer/retailer **Ethan Allen** reported Q12006 sales growth of 9.1%. Higher advertising spending weighed on SG&A costs leaving operating profit at 12.9% vs. 13.4% one year ago. Its board approved a buy-back plan for up to 2.5 million shares.

- Vietnamese producer **Theodore Alexander** has put its 425,000 ft2 plant in Saigon up for sale. Management cited the inability to fill the plant's capacity with profitable business. The plant produced for OEM customers. Production of its branded line will continue at its million square foot plant.

- **Webb Furniture** announced the closure of its bedroom furniture plant in Galax, VA. About 309 workers in that plant and at the company's administrative office will be laid off. The company will continue operations at its particleboard and mirror plants also in Galax.

Office Furniture

BIFMA reported that October orders increased by 16% and shipments grew 13% vs. the same month in 2004. On a trailing twelve-month basis, orders grew 11.8% to nearly $10 billion. Likewise, shipments jumped by 11.4% during the same period. At $9.84 billion, annual shipments are now about 16% higher than the market bottom of $8.47 billion in November 2003. Analysts opine that the industry is now a picture of good health. Yet the annual shipment rate remains about 26% below the industry's peak performance in January 2001.

- **HNI Corporation** (formerly known as Hon Industries) reported a 10.3% increase in its 3Q2005 sales year over year. Gross margin also improved from 35.9% to 37.4%. Analysts expressed disappointment in this performance given the strong recovery of the office sector.

Wood Flooring

October 2005 shipments of strip flooring rose by 2% compared with the same month in 2004. For the first ten months of 2005, shipments are also up 2%.