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Business Briefing

Forecast Your Own Economy

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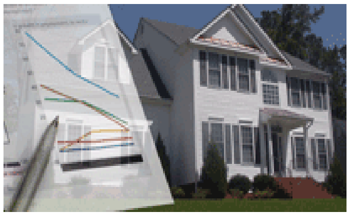
What's so bad about today's economy?



- 3Q gross domestic product up 4.9 percent – the highest in four years
- Exports for the last twelve months up 11.6 percent
- 1.68 million jobs added in the past year
- Inflation at 1.9 percent within the Federal Reserve's comfort range

The storm clouds created by the sub-prime credit mess have darkened an otherwise strong economic picture. Economists are now pessimistic about our economic future. Fourth quarter estimates of GDP are dropping like stones and some economists are predicting recession in 2008.

Economists rightfully have a mixed record when it comes to forecast accuracy. One pundit once said, "An economist is someone who will know tomorrow why the things he predicted yesterday didn't happen today." In spite of the reputation for inaccuracy attached to the dismal science, all astute managers must pay attention to economists' prognostications. The trick is selecting the right economist to heed or, better yet, to develop a set of economic indicators that show the future for your business.

Joseph Ellis, long-time number one retail analyst on Wall Street, offers some enlightening guidance to those seeking an economic crystal ball:

What is the key to navigating the economic future? To build a sound forecast Ellis believes you must understand the sequences of events that recur cycle after cycle in the economy. That understanding enables you to separate the important leading indicators from the less critical lagging metrics.

Which leading indicator provides the best signal of economic direction? With 40 years of tracking data, Ellis found that *real personal consumption expenditures* i.e., consumer spending, always preceded most other indicators by one or two quarters. In every cycle momentum starts in consumer spending and then moves to manufacturing and capital spending. These three elements are the drivers of corporate profits. Once companies feel confident about the economy, they invest and finally add workers. The employment rate then is a lagging indicator. Thus Ellis believes that consumer spending drives employment, that workers get hired after business gets good and are fired after business turns poor.

What then drives consumer spending? The consumer is affected by hundreds of factors such as the stock market and terrorism. However Ellis claims two drivers are primary - *real average hourly wages* and *interest rates***.** Factors like energy prices impact inflation and thus are accounted for in wages and interest rates.

What drives your business? According to Ellis every manager must identify what part of consumer spending causes his business to move up or down. For instance a carton manufacturer might look at the year-to-year spending on the kinds of products shipped in paper boxes. Ellis claims these connections just take good common sense to identify. Anyone with some knowledge of economics and skill with Excel can explore the causes and effects.

What about the timing of key events like recessions? According to Ellis we have a 'recession obsession.' Strictly speaking a recession is defined as a decline in GDP for two consecutive quarters. But by the time we are in a recession, most of the slowdown is well behind us. Like the unemployment rate, the actual recession is a relatively useless lagging indicator. Most economic damage is done in the quarters immediately after growth peaks and slides toward zero. By the time you get to a 2 percent growth rate, the crisis is usually near its end.

Learn more about Ellis' forecasting technique in his book, *Ahead of the Curve*, and at his web site, www.aheadofthecurve-thebook.com.

Economic Fact

Americans work hard but are not the most productive in the world. According to the Bureau of Labor Statistics, U.S. workers rank second only to Norway in annual output per man. The average American worker produced about $90,000 of output in 2006. On an hourly basis our output was just over $50 – behind Norway, Belgium, the Netherlands, and France. Seems our workers are not working as smart as many Western Europeans…

Sector Report

Kitchen Cabinets

October marks the twelfth straight month of weakness in the cabinet industry. According to the KCMA's *Trend of Business Survey*, October sales fell by 9.4 percent versus the same month last year. YTD 2007 sales were down 12.5 percent. For the year stock cabinet sales have fallen just over 20 percent vs. last year while semi-custom and custom have declined only 4.9 percent and 4.6 percent respectively.

At the company level…

- **Masco**, the largest cabinetmaker in the U.S., saw their 3Q2007 cabinet sales drop by 10.9 percent year-over-year to $736 million. Despite the decline operating margin climbed to 14.7 percent from 13 percent in the same quarter last year.
- **American Woodmark**, the second largest cabinetmaker, reported 2Q2008 sales of $160 million, down a whopping 24 percent from the same quarter last year. Operating profit, suffering from capacity under utilization, fell by nearly 91 percent to a meager $1.3 million.

Home Furniture

Furniture Makers 'Discover' Customization Strategy – Domestic furniture makers have finally discovered a strategy that cabinet producers have long employed to defend their market share from imports – customization. For over 10 years U.S. cabinet companies have offered a wide assortment of styling, colors, wood species, and configuration made strictly to a consumer's order. Now **Henredon**, a Furniture Brands company, and **Braxton Culler**, a privately-held upholstery and case goods maker, have introduced customization programs. Henredon's effort, called *Bespoke*, aims to broaden their offering to the upscale design community. The line will include wood and upholstery. *Braxton Colors* is an expansion of Braxton Culler's color palette and is available on all unfinished items stocked in their North Carolina warehouse.

AHFA Opposes Proposed Timber Law – While all right thinking people oppose the use of illegally harvested timber, a recently introduced bill in Congress places the responsibility for policing this trade with U.S. wood users. The American Home Furnishings Alliance is concerned that H.R. 1497 penalizes U.S. companies because foreign governments are not enforcing timber harvesting laws. Most of these businesses have neither the time nor the resources to verify the chain of custody of lumber and other wood products back to their sources in foreign countries. The International Wood Products Association also opposes this bill, which is currently in the House Natural Resources Committee.

China Feels New Pricing Pressure – As reported in earlier editions of *Business Briefing*, Chinese furniture producers are facing a number of pressure points on their profitability. In addition to rising labor and materials costs these include:

- A surcharge on sales volume to motivate the enforcement of anti-pollution regulations.
- The 9 percent increase in the Yuan's value vs. the U.S. dollar.
- The reduction in rebates of value-added taxes that previously stimulated exports.

Industry analysts are predicting that these higher costs will show up as higher prices on U.S. furniture retail floors in 2008. Will this change bring relief to remaining domestic producers or simply encourage the shift of production to lower cost countries like Vietnam? Stay tuned…

At the company level…

- **Furniture Brands** announced a 9.2 percent decline in 3Q2007 sales. A loss of $1.7 million at the operating level was reported. Management said that back office operations will be consolidated and a new product development strategy implemented. Mid-priced brands Lane and Broyhill will target traditional furniture stores and mass-market retailers. Higher-priced Thomasville and Drexel Heritage lines will be sold in dedicated stores while upper-end Henredon, Pearson, and Hickory Chair will be sold through designers. This effort is directed at shifting the company from a manager of a portfolio of furniture companies to a true operating entity.

- **Ethan Allen** announced a 2.4 percent increase in 1Q2008 revenues while net income rose by 108 percent. Sales of company-owned stores which are about half of their total retail exposure, grew by 10.1 percent. Retail operating margin of 0.5 percent reflected the difficult furniture environment in the U.S. The company announced the acquisition of a 40,000 square foot leather cut and sew plant in Mexico. Domestically EA continues to operate two saw mills and seven furniture plants. The case goods factories have resumed 40-hour work weeks.

- **Stanley Furniture** reported a 3.6 percent drop in its 3Q2007 sales. Operating profit fell nearly 37 percent to 4.3 percent of sales. Management announced the closure of its 300,000 square foot Martinsville, VA, plant and the idling of 250 workers. Lines produced at that plant will be consolidated to the company's million square-foot Stanleytown plant.

- **Ashley Furniture** has dedicated a 178,000 square foot expansion to its Ecru, MS, upholstery plant. The total area of the plant is now 1.8 million square feet making it the largest upholstery operation in the U.S.

- **Hooker Furniture** has purchased the assets of New York-based importer Opus Designs. Opus, with annual sales of $6 million, focuses on mid-priced youth furniture, a price point that will complement Hooker's SmartKids brand.

- Manufacturer-importer **Vineyard Furniture International** will begin producing upholstery in a 30,000 square foot plant in Ripley, MS.

- The weak U.S. retail environment plus the strong Canadian dollar are stinging Canadian furniture makers. **Shermag** reported a 40 percent decline in sales in its 2Q2008 and a C$3.7 million operating loss. For the first half of FY2008 sales were off by 35 percent.

- **Chromcraft Revington** reported a 3Q2008 loss of $2.1 million as sales dropped 20 percent. The company is continuing to reduce its reliance on U.S. production as it accelerates the shift to an outsource model.

Office Furniture

BIFMA, the sector trade association, reported October orders for office furniture up 6 percent over the same month last year. Shipments increased by 7 percent. The nice October performance followed a flat September when orders were essentially unchanged from 2006. Most producers are experiencing sluggish North American demand. However, analysts point to strength in the primary economic drivers – corporate profits, non-residential construction, and white collar employment – as supportive of continued industry growth. BIFMA's own forecast indicates that 2007 demand will be 4.9 percent with 2008 coming in at 0.5 percent. The industry is shipping at an $11.335 billion rate vs. $13.35 billion at the historic top in late 2000.

At the company level…

- **HNI Corporation** (formerly HON Industries) announced office furniture sales of $559 million in its 3Q2007, a 4.2 percent increase. This product segment accounts for 75 percent of total revenues.
- **Knoll** reported 3Q2007 sales up 4.25 percent vs. the same period last year. Operating margin rose to 13.5 percent.

Wood Flooring
NOFMA, the primary flooring industry association, has ceased reporting monthly strip flooring production data. When an alternative source for this information is identified, *Business Briefing* will resume reporting this indicator of flooring industry health.

At the company level…

- **Mohawk Industries** reported 3Q2007 sales of its Unilin laminate flooring at $378.4 million, up over 29 percent from the same quarter last year. Operating margin on laminate flooring sales jumped to 18.8 percent, up from 17 percent last year.
- **Armstrong World Industries** announced that its wood flooring sales totaled $191.9 million in 3Q2007, a 12 percent decline from the same quarter last year.
- Producer **Wood Flooring International** of Burlington, NJ, is closing its business and laying off 30 workers as a result of the bankruptcy of **Hoboken Hardwood Floors**, the largest U.S. distributor of hard floor coverings. WFI had expanded aggressively over the past three years
- The North American group of **Tarkett International** has been acquired by private equity firm New Stream Capital. The acquisition includes the company's three plants operating under the name Tarkett Wood.

Non-Residential Construction
Moody's Investor Service reported that the commercial real estate market is feeling the effects of the credit crunch. Developers are seeing stricter credit terms e.g. the requirement to put up 25 percent of a project cost vs. 10 to 15 percent in mid-2007. Issuance of commercial mortgage-backed securities fell to $6.2 billion in October vs. $34.4 billion in August.

Most industry experts believe that any correction will be minimal. Favorable interest rates and tight supply of properties will continue to motivate commercial property development.

In the meantime, Reed Construction Data reported that spending on healthcare facilities will continue to expand faster than the overall economy. Spending on hospitals is up 14 percent; on nursing homes and other residential facilities, up 6 percent; and medical buildings, up 1 percent.

Warehouse construction is steady with rental rates rising at 3.5 percent pace. The national vacancy rate is just above the normal level of 8.5 percent.