

## Cutting Edge Newsletter™ October 2008

## Business Briefing

**The Credit Crisis - What Happened?**by Art Raymond, [araymond@raymondnet.com](mailto:araymond@raymondnet.com)

The public, fed by the media, believes that greedy Wall Street types caused the current credit crisis. The talking heads point at the giant Ponzi scheme made up of exotic securities concocted in search of higher investment yields. This pyramid required ever rising home prices for support. Once the speculative bubble broke, the scheme collapsed under the weight of negative homeowner equity.



According to Russell Roberts, professor of economics at George Mason University, there's more to the story. Beginning in 1992 Congress pushed Fannie Mae and Freddie Mac to increase their purchases of mortgages aimed at low and moderate income borrowers. By 1996 the Department of Housing and Urban Development (HUD) set the target of Fannie and Freddie-backed loans extended to these classes of borrowers at 42 percent. That target increased to 50 percent for 2000 and 52 percent in 2005.

For 1996 HUD additionally required that 12 percent of all Fannie and Freddie mortgage purchases be to borrowers with incomes less than 60 percent of their area's median income. These target purchase amounts rose to 20 percent in 2000, 22 percent in 2005, and 28 percent in 2008. Billions of dollars of these loans were adjustable rate and required less than 10 percent down payments.

At the same time the Community Reinvestment Act (CRA) was forcing traditional banks to increase loans to sub-prime borrowers. This law, passed in 1977 during the Carter administration, was modified in 1995 to increase by 80 percent the number of loans going to low and moderate income home buyers.

In 1997 a major milestone in this story occurred: Fannie and Freddie guaranteed the first securitization of CRA loans by the late investment banking firm Bear Stearns. Politicians and policy makers magically had a method of increasing home ownership without committing federal budget dollars. And bankers of every ilk who followed suit made nice profits in abetting this sleight of hand.

Add the Taxpayer Relief Act of 1997. That law increased the demand for high-value homes by raising the capital gains exclusion from \$125,000 to \$500,000 on primary homes. Beneficial changes affecting capital gains earned on rental property also increased demand for that investment class.

And don't forget the Federal Reserve who added to the speculative fire in 2003 by pushing the federal funds rate to a 40-year low of 1.25 percent. Rates on adjustable rate mortgages followed thus making monthly payments more affordable. Bankers then made matters worse by creating more and more exotic mortgages that lowered the hurdles required to qualify.

These conditions fueled heavy speculation. Economist Robert J. Shiller calls it irrational exuberance, the social contagion of boom thinking. We simply reached a tipping point after which everyone became overly optimistic. Continuing market feedback encouraged further bidding up of prices.

The result: the average price of a house in the U.S. doubled between 1997 and 2005. And the homeownership rate rose from 64 percent in 1994 to 69 percent in 2004.

But speculative bubbles always end with blood in the streets. As interest rates ticked higher, mortgage payments rose. Demand for houses stalled and then fell. Once home prices started dropping, the values underlying those exotic mortgage-backed securities fell too. The smoke and mirrors that camouflaged the house of cards blew away and with it the house itself.

There is plenty of blame to go around: politicians and policy makers; bankers on Wall Street and Main Street; over-leveraged investors in mortgage-backed securities and real estate; and yes, the seemingly innocent who were using their home equity to finance an excessive lifestyle. When something is too good to be true, it usually is...

*Bottom Line:* Beware of free lunches. The aforementioned smoke and mirrors used by Washington have put the entire global financial system at risk. Hundreds of billions of dollars have been shifted

into housing instead of more productive investments. We absolutely must learn the hard truths from these painful lessons. Attempting to remedy this crisis with more fiction will simply mean repeating this sad history.

### What's Next?

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In hopes of remedying this situation, Congress, after an intense last-minute debate, finally approved a bill that will enable the Treasury to invest \$700 billion in mortgages and mortgage-backed securities combined with \$152 billion in tax breaks and other tools useful in combating the credit crisis. While the mechanics of this intervention are unknown at the moment, we can anticipate that something akin to the Resolution Trust Corporation of 1989 (RTC) will be implemented. The RTC was an asset management company owned by the federal government and charged with liquidating real estate-related assets previously owned by insolvent savings and loan associations. It also assumed the insurance functions of the former Federal Home Loan Bank Board. In 1995 the RTC's duties were transferred to the Savings Association Insurance Fund of the Federal Deposit Insurance Corporation (FDIC).



Between 1989 and mid-1995, the RTC closed or otherwise resolved 747 S&Ls with total assets of \$394 billion. For a full explanation on how the RTC operated, go to Wikipedia.

What happened after the RTC solution was set in place in August 1989? In a recent presentation, Merrill Lynch's David Rosenberg answered that question:

- **Stock Market:** The U.S. stock market dropped for another year with the S&P 500 index falling nearly 30 percent before the bull market of the 1990s took off in October 1990. Remember the stock market is a leading economic indicator.
- **The Economy:** Real GDP fell from about 3.5 percent growth to a 1 percent decline over nearly two years before bottoming in 1Q1991.
- **Home Prices:** Prices of houses declined for another two years finally hitting bottom in mid-1991.
- **Unemployment:** Unemployment rose from just over 5 percent to a peak of nearly 8 percent over three years. Remember that unemployment is a trailing economic indicator.
- **Interest Rates:** The yield on 10-year Treasuries jumped a full point over the next year before declining by three points over the subsequent three years.

*Bottom Line:* Batten down your hatches. A consumer recession still lies before us. If history is prologue, the next few years will be tough economically speaking. The economy always returns to its mean, and those transitions can be painful.

### Europeans Woodworkers Feeling Impact of Log Exports

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Since 2004 the export of hardwood logs has increased by 50 percent. The main species include oak, beech, and poplar, and the primary destination is China and other Asian markets. China is the world's largest timber importer. These sales are reducing the availability of logs and lumber for European woodworkers and causing prices to rise. More importantly Chinese and other producers in low labor cost countries are converting these logs into value-added products for export back to European markets. The result is low-cost competition. Chinese plywood shipments to Europe have increased tenfold in five years. Parquet flooring imports jumped 164 percent in 2007. Wood furniture imports are growing by 30 percent annually. Various woodworking trade associations are calling for anti-dumping tariffs on Chinese imports and restraints on log exports.

### U.S. Enacts Illegal Logging Ban

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An amendment to the Lacey Act has banned the import of products that contain illegal timber. Illegally logged wood is defined as timber sold below market price or cut in violation of treaties, laws and regulations. The intent of this amendment is to protect the world's forests from deforestation.

The impact of this bill is twofold:

- Improved market opportunities for U.S. log exporters - These firms faced competition from traders who sold at prices as much as 50 percent of market price.
- Higher prices for imported products made of wood - Foreign converters of illegally logged timber will be forced to use higher priced, legal timber.

Importers of wood products will be required to document wood species and country of origin. Exact methods of enforcing this law are under development.

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### Economic Tidbits

*Those opposed to offshore drilling are most probably ignoring the full story. Few know that offshore development is one of the federal government's greatest sources of non-tax revenue. Energy companies paid \$7 billion in 2007 in rents on their drilling leases. The government also receives a royalty on the market value of gas and oil produced from these leases. And don't forget that oil companies pay lots of taxes on their profits.*

*One estimate of potential revenues from offshore development totals \$2.6 trillion based on recovering 86 billion barrels of oil and 420 trillion cubic feet of natural gas that is undiscovered but recoverable. While Congress has forbidden analysis of the Outer Continental Shelf for 26 years, most experts believe those volume estimates are conservative.*

*Add the fact that fossil fuels are expected to provide the same share of total energy in 2030 as they do today. Our foreseeable future depends on oil and gas. Isn't it better for us to keep a few of the bucks we are now shipping to unfriendly, oil-rich countries?*

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## Sector Report

### Kitchen Cabinets

The downturn in cabinet production is now in its twenty-second month of negative performance. According to the KCMA's *Trend of Business Survey*, August cabinet sales fell by 26.2 percent versus the same month last year. Year to date cabinet sales have dropped 17.2 percent vs. 2007 with stock cabinet sales down a whopping 19.2 percent, custom sales down 17.4 percent, and semi-custom sales off 15.3 percent.

At the company level...

- **Masco** reported cabinet sales of \$608 million in its 2Q2008, a decline of 18 percent. Operating profit fell to \$37 million, a drop of 61 percent.
- **American Woodmark** announced a 16 percent decline in its 1Q2009 sales. The company is growing market share in a very weak environment. Remodeling sales were down 16 percent. Management has reduced headcount by about 30 percent in the last three years but maintained excess capacity. As a result overhead costs as a percent of sales have increased. Gross margin fell to 15.9 percent from 20.7 percent, and the bottom line was breakeven.
- **Kohler Company** has announced the closure of its kitchen cabinetry division, Canac. Canac's primary market was new home construction in North America. Their Statesville, NC, plant will be shuttered in October idling 522 workers. The company will cease distribution operations across the U.S. by year end resulting in the loss of another 280 jobs. Kohler acquired Canac in 1996 and had already closed their Thornhill, Ontario, plant earlier this year due to the strong Canadian dollar.

### Home Furniture

#### Furniture Factory Orders Drop

According to accounting firm Smith Leonard, orders for furniture from U.S. factories declined by 17 percent in July vs. the same month last year. This performance marks the worst month in over a year. Shipments also were down falling by 10 percent from last year.

Year to date orders are running 10 percent behind 2007 while shipments are behind by 8 percent. For 2007 83 percent of the survey participants reported orders down for the year.

At the company level note the layoffs, closings, and consolidations in the upholstery sector. Historically upholstery is the first furniture category to recover following an economic downturn. The continuing rationalization of capacity by upholsterers confirms that the economy remains in the doldrums. This product category has heretofore been less affected by imports...

- **Furniture Brands International**, the second largest U.S. furniture maker/importer, reported a 13.4 percent decline in 2Q2008 sales. Gross profit dropped by 8.9 percent to 24 percent; operating income, by nearly 74 percent to 0.97 percent. Its Broyhill division announced the consolidation of five of its upholstery plants into a former case goods plant in Lenoir, NC. Four of the shuttered plants are in Lenoir while the fifth is in nearby Taylorsville, NC. About 75 workers or 10 percent of the work forces in the five plants will be laid off. In better news, its Thomasville division is adding about 100 jobs to its Plant C in Thomasville, NC. Plant C was largely idled in mid-2007 and will be used to improve delivery times to retailers. Earlier this year Thomasville added 100 jobs at its Lenoir, NC, wood furniture plant.
- Producer/retailer **Ethan Allen** is expanding its presence in Europe by adding small stores and studios within existing home furnishings stores. The company currently operates 295 stores and nine manufacturing plants in the U.S.
- Producer/retailer **La-Z-Boy** reported a 6.6 percent decline in its 1Q2009 sales to \$321 million. Sales dropped across all product lines with upholstery falling 6.9 percent; case goods, 10.2 percent; and retail, 6.2 percent. Operating profit was \$(13.2) vs. \$(12.9) in the same quarter last year. Management reported that cost savings in their manufacturing operations were yielding positive results. However their retail stores are operating at an out-sized loss.
- Case goods and upholstery importer/producer **Hooker Furniture** reported 2Q2009 sales down by 12 percent. Profits declined 57 percent from the same quarter a year ago. The company has laid off 25 employees in its wood furniture due to the prolonged industry slump. The workers were primarily in operations, administration and warehousing.
- Upholstery producer/retailer **Norwalk Furniture**, closed early in September due to a lack of bank financing, has been purchased by local investors. The company will operate under the name Norwalk Custom Order Furniture and will continue production at its Ohio plants. The Mississippi and Tennessee plants are not included in the deal. The new owners expect to hire 150 to 200 workers. Details of the new financing were not released. However the State of Ohio had earlier offered a low-interest loan of \$1.86 million to keep the company in business. No news was released on the fate of the 59 Norwalk retail stores. In July contract producer Kellex Corporation purchased one of the Valdese, NC, plants operated by Norwalk under the name Hickory Hill. That 354,000 sq. ft. plant will employ 50 workers, and the new owners plan to invest \$1.7 million to update the facility.
- **Chromcraft Revington** reported a 2Q2008 loss of \$6 million as sales fell by nearly 22 percent. The company operates under the Chromcraft, Peters-Revington, Silver, Cochrane, and Sumter brand names. Also management announced its plan to cease manufacture of upholstery and the closure of its Lincolnton, NC, upholstery plant. About 185 workers will be laid off, and the plant assets will be sold.
- **Cramco**, the Philadelphia, PA-based casual dining supplier, is bringing its plant back on line in response to rising costs from its foreign suppliers.
- **Statton Furniture Mfg.**, Hagerstown, MD, is ceasing operations after 82 years producing high-end solid cherry 18th century case goods. In the last 15 years their employment had declined from 200 to 38.
- Upholstery producer **Flexsteel** said its 4Q2008 residential furniture sales were off 6.4 percent while full year revenues dropped by 0.6 percent. The company has implemented price increases and closed two plants to balance capacity with demand. The Lancaster, PA, plant produced home furniture and will continue as a distribution center. The second plant in New Paris, IN, produced seating for recreational vehicles. In total about 250 jobs will be lost.
- **Ashley Furniture** is laying off about 200 workers at its upholstery plants in Ecu and Ripley, MS.
- **CR Home** is closing its Lincolnton, NC, upholstery plant idling 185 workers.

News from the Canadian furniture industry was mixed...

- Canadian furniture producer **Dorel** posted its 2Q2008 revenues at \$594 million, a 29.3 percent gain over the same period last year. For the first half sales were up nearly 26 percent. These performances represent the strongest second quarter and first half in company history. Their RTA division, Dowagiac, MI-based **Ameriwood**, is resuming operations at one of their plants to meet increased demand. The plant will employ as many

as 100 jobs.

- Canadian case goods producer **DeFehr Furniture** has received court-ordered protection from creditors under the Canadian Companies' Creditors Arrangement Act. The company will shutter its Transcona plant near Winnipeg and lay off as many as 200 workers. Operations will be consolidated into its Furniture Park factory.
- Canadian upholstery specialist **Sklar Peppler** is closing its Ajax, Ontario, plant and moving all production to its facilities in Mississippi and Oregon.
- Canada's oldest furniture maker **Gibbard Furniture Shoppes** of Napanee is ceasing operations after 173 years. Management blames the strong Canadian dollar and increased competition from Asia. About 90 workers will be idled.

Chinese furniture producers are also suffering...

- **Samson Holding** reported a 32 percent decline in profits as its first half 2008 sales dropped by 9 percent. The company is the parent of Lacquer Craft, China's second largest furniture maker, as well as U.S. divisions Universal Furniture, Legacy Classic and Craftmaster.

### Office Furniture

BIFMA, the sector trade association, reported a 1 percent decline in August orders and a 4 percent decline in shipments. Year to date, orders are flat while shipments are down 1 percent vs. 2007.

At the company level...

- **Steelcase**, the world's largest manufacturer of office systems and business furniture, reported a 9.3 percent gain in its 2Q2009 revenues with North American sales growing by 2.1 percent and international sales by 34 percent. Operating margin was 9.17 percent, down from 6.7 percent last year.
- **Herman Miller** announced a 2.6 percent decline in its 1Q2009 revenues to \$479 million. Operating margin rose to 11.8 percent. North American sales fell 2.6 percent while international sales dropped by 4.5 percent. One positive note - total backlog rose by nearly 19 percent vs. last year.

### Wood Flooring

- **Lumber Liquidators**, one of the largest U.S. specialist flooring retailers, reported 2Q2008 sales of \$128 million, up 21 percent from last year.

### Lumber, Wood Components & Panelboard

- **Uniboard Canada**, a producer of panelboard, has purchased ATC Panel's particleboard mill in Moncure, NC. The company plans to invest \$120 million at the Moncure facility to install MDF and HDF lines. This expansion will add about 100 employees to the current work force of 160. The recent opening of Swedwood's new furniture plant in Danville, VA, has increased local demand for HDF, which is used in lightweight furniture panels made for parent company Ikea.
- **Catawissa Lumber** is closing its West Jefferson, NC, wood component plant and idling 67 workers. Production will be consolidated into its factory in Paxinos, PA.
- **Georgia-Pacific** is closing its Columbus County, NC, saw mill and plywood operations due to slow sales to the housing industry. About 400 workers will be laid off.
- **Weyerhaeuser** is selling its Delta, BC, hardwood sawmill which produces lumber for use in furniture, cabinet and pallet production

### Non-Residential Construction

The American Institute of Architects' Architecture Billings Index rose to 47.6 in August but remained below 50 for the seventh consecutive month. A score below 50 indicates weakness in the pipeline for new projects that will be constructed nine to 12 months in the future.

Inquiries about new projects were above 50 for the third month in a row.

Those firms specializing in institutional projects remain the only group that is yet to fall below 50 in the current downturn. Billings at residential, industrial, and commercial specialists, however, have remained below 50 the entire year.

The AIA Index score plus anecdotal evidence from millwork firms specializing in non-residential work continue to show a negative outlook for this sector as well as office furniture.