

Business Briefing

The Horse or The Wagon

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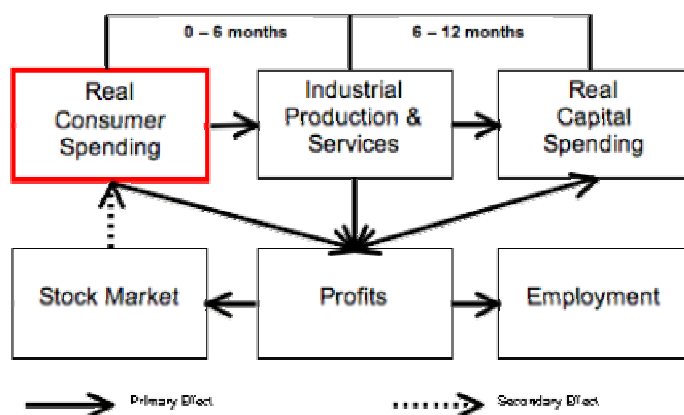
As our economy works through the sub-prime mortgage mess, the economy slides inexorably toward recession. And Washington, in typical election year frenzy, is showing an unnatural consensus for a fiscal stimulus package. On the table thus far are tax rebates for low-to middle-income individuals and some acceleration of expensing of capital investment for businesses.

Which, if any, of these so-called stimuli will provide meaningful results beyond tricking voters into believing our "leaders" really care?

First let's look at tax rebates. As discussed in the December edition, personal consumer expenditures, aka consumer spending, drive the economy. Spending by individuals in the U.S. accounts for 70 percent of our \$12 trillion economy. That spending leads to demand for industrial production and services. As spending increases, demand rises for more production and services. These increases generate corporate profits and need for capital investment. This chronology of the economy is shown in the chart below.

Chart 1: Chronology of Key Economic Indicators

Source: [Ahead of the Curve](#), Joseph Ellis



Note that employment is a lagging indicator ie, it trails other drivers of the economy, because hiring is a direct result of increased consumer spending. On the other hand, the stock market, whose individual components are valued on *expected* corporate profits, is a leading indicator of economic conditions.

Based on the sequence in Chart 1, one can conclude that individual tax rebates – designed to increase spending immediately - achieve greater short-term, cyclical benefit to the economy than incentives from business investment. However rebates come with a cost. For the government to cut checks to individuals in times of budget deficit, Washington must borrow the needed funds in the capital market. The demand for the \$168 billion required by the proposed stimulus package will compete with private enterprises in search of funds. Consumer spending will rise; investment, fall.

What about incentives to stimulate capital investment on plant and equipment? Allowing businesses to recover their capital spending more quickly theoretically causes these investments to be made sooner.

Some economists point to the success of President Kennedy's investment tax credit implemented in 1962 in stimulating the economy. The ITC is the first cousin to full or partial first-year expensing now being considered by Washington. Economic turnarounds in the 70's, 80's, and again in 2002 were attributed to such incentives. Facing the slow recovery from the recession of 2001, Congress

enacted a 30 percent partial expensing rule in the spring of 2002 followed by 50 percent expensing in 2003.

Expensing does not create new deductions but rather accelerates in time deductions that are currently allowable. But little evidence exists in the business cycles since 1960 that capital spending leads consumer demand. After all, private capital investment accounts for only 17 percent of our gross domestic product.

Capital spending is important. Investments in plant and equipment clearly produce jobs and spur productivity. But these benefits are longer term, structural rather than cyclical. And of course, spending on plant and equipment ultimately results in consumer spending via job creation at firms providing those capital items.

You will find economists on both sides of this argument. The job of figuring out the best combination of stimuli – fiscal as well as monetary – in our global economy is more difficult than ever. Two points are worthy of consideration in this debate:

1. The economy remained stagnant through much of 2002 following the 2001 \$600 tax rebate to families. Not until the effects of tax cuts for individuals and investors in 2003 did the economy bounce back. In the 18 months following those cuts the stock market jumped 32 percent and 5.3 million new jobs were created.
2. The Fed is already helping the consumer. The rate on five-year adjustable mortgages is down to 5.11 percent vs. 6.36 percent in 2007. A 30-year fixed rate mortgage now runs only 5.68 percent. Refinancing will free up cash every month for homeowners with high cost loans. The impact of that cash will long outlive that of a one-time rebate.

Economic Fact

Over the last three years Exxon Mobil has paid an average of \$27 billion annually in taxes. To put that number into perspective, let's look at 2004, the most recent year for which data are available:

Total number of tax returns	\$130 million
Number of tax returns for the bottom 50 percent of taxpayers	\$65 million
Adjusted gross income for bottom 50 percent of taxpayers	\$922 billion
Total income tax paid by bottom 50 percent of taxpayers	\$27.4 billion

In other words Exxon Mobil pays as much in taxes as the entire bottom 50 percent of individual taxpayers – 65 million people.

The tax rate for the bottom 50% is 3 percent. Exxon Mobil's rate is 41 percent.

China's Currency Strengthens

Remember the controversy in 2005 about the undervalued Chinese yuan (aka the renminbi)? On July 21 of that year China dropped its pegging of the yuan to the dollar and began managing a small but continuous strengthening of its currency. The fully pegged rate was 8.28 yuan to the dollar. As of this February the dollar had fallen to 7.19 yuan, a 13.1 percent decline. In a mere five weeks this year alone, the dollar lost 1.6 percent of its value in China.

Why is China now letting the yuan strengthen? No doubt officials there are listening to complaints from Washington. But the real reason is inflation. With the recent drop in the dollar's purchasing power, Chinese inflation had risen to nearly 7 percent. A faster pace of yuan appreciation helps reduce imported inflation. Their inflation also stems from the costs of holding down the yuan: China had to print yuan to buy dollars.

While managing the yuan, China was a major purchaser of U.S. government debt, a fact that kept U.S. interest rates low. In 2005 China bought nearly \$85 billion in Treasuries. Last year China became a net seller of our debt instruments. So while the trade imbalance with China continues, the effects of that situation are changing. Stay tuned...

Your Customer's Customers

Many of the products your customers' customers purchase depend on discretionary income, those funds available for spending beyond the necessities of life. Determining who has that extra money is critical to capturing a share of it.

According to the Conference Board, about 73 million Americans have discretionary income, up from 57 million in 2002. The total amount of discretionary income is \$1.7 trillion with the household average being \$24,335. Households earning more than \$100,000 annually hold 78 percent of all discretionary income. The wealthiest concentration of these households is in New England where 63 percent have the ability to spend on discretionary purchases. California has the largest number of households with discretionary income followed by Texas. Importantly, households who earn less than \$50,000 have only 3 percent of total discretionary income.

Sector Report

Kitchen Cabinets

According to the KCMA's *Trend of Business Survey*, December cabinet sales fell by 14.6 percent versus the same month last year. 2007 full year sales were down 12.3 percent vs. 2006. For the year stock cabinet sales dropped 19.8 percent vs. 2006 while semi-custom and custom have declined only 4.7 percent and 5.2 percent respectively. The KCMA forecasts that the industry will be flat at best in 2008.

Spending on remodeling, where the majority of cabinet demand originates, was down about 2 percent in 2007. This year-on-year decline was the first since 2003. The National Association of Home Builders forecasts that remodeling will not recover until 2009. Beyond that homeowner remodeling activity is predicted to rise by 44 percent from 2008 to 2015 or about 3.8 percent annually.

At the company level...

1. Analysts are forecasting a 14 percent decline in cabinet sales at **Masco**, the largest cabinetmaker in the U.S, for their FY2007 and a 5.4 percent drop in FY2008.
2. **American Woodmark**, the second largest cabinetmaker, announced the lay-off of 32 workers at its Allegheny County, MD, plant. This action continues labor cuts that have reduced the company's workforce by about 25 percent. Thus far no plant closings have occurred although analysts have forecasted a 12.7 percent revenue drop in the company's 3Q2008.
3. **MasterBrands** is closing its Crossville, TN lumber processing operation in February and has laid off about 320 workers at its Indiana and Virginia plants. Industry observers attribute the Crossville closure as part of a major increase in international sourcing for wood components.

Furniture

Consumer spending on furniture and bedding rose by only 2.7 percent in 2007 having slowed to 1.6 percent and 1.7 percent in the third and fourth quarters respectively. Deloitte Research's Leading Index of Consumer Durables Spending, having turned negative last September, is pointing to continued weakness in the near term. The conclusion, as confirmed by company reports below: furniture, no matter where it's made is not selling at retail.

Furniture importers are facing fuel surcharges on container shipments to offset the rising cost of fuel. As of January, shipping companies are charging up to \$950 extra for a 40-foot container, up from \$455 a year ago. The cost of fuel for ships has risen from \$295 per ton in early 2007 to \$500 today.

At the company level...

1. **Furniture Brands** announced an 11.9 percent decline in 4Q2007 sales and 11.8 percent for the full year. The company had a net loss of \$40.7 million compared with a \$55.1 million profit last year. Restructuring charges of \$38 million covered the closing of 18 company-owned stores and 5 factories and cutting staff at the Lane, Thomasville, Drexel Heritage, and Henredon divisions. Its quarterly dividend was slashed by 75 percent to 4 cents a share. The sale of its Hickory Business Furniture contract operation is set to close this quarter.
2. **La-Z-Boy**, in the face of declining revenues, is eliminating 30 sales representatives, a reduction of about 20 percent. Along with this consolidation, the company is moving away from traditional wholesale sales force to a more consultative organization aimed to enhance services and support to its dealers.
3. **Ethan Allen** announced a 0.8 percent increase in its 2Q2008 revenues while operating margin fell to 12.9 percent from 14.2 percent in the same period last year. Sales to its retail stores grew by 8.6 percent due to the addition of 11 stores. Wholesale shipments declined by 5.9 percent. The company announced the closure of 12 company-owned retail

stores.

4. **Bassett Furniture Industries** saw its 4Q2007 sales decline by 1 percent and recorded a net loss of \$4 million. The loss would have been larger if not for \$2.1 million in antidumping duties collected from Chinese bedroom furniture producers. The company is focused on improving its 130 store retail operations.
5. **Stanley Furniture** reported a 5.4 percent drop in its 4Q2007 sales. Full year sales dropped 8 percent. Gross margin declined to 10.5 percent. Without the \$8.9 million in antidumping duties the company would have suffered an operating loss.
6. **Hooker Furniture** announced a 7.9 percent decline in its 3Q2008 revenues but a jump of 67 percent in net income. Operating margins improved due to lower inventories, reductions in warehouse space, and other operational improvements. The company, which shuttered its last U.S. wood furniture plant last March, has completed the acquisition of youth furniture maker Opus Designs.
7. **Standard Furniture** is laying off 175 to 190 workers at its Frisco City, AL, plant in March, more than halving its workforce there. The company also announced its re-entry into promotional bedroom at the Frisco City plant. Standard reportedly has invested \$4 million in mechanization and product standardization aimed at reducing its labor cost by 30 percent. The new products will be priced at \$399 to \$599 for four piece sets.
8. Upholstery maker **Klaussner** is idling 130 workers in the consolidation of its Plant 5 production into Plants 1 and 9. The company blamed the bankruptcy of two of its largest customers, Sofa Express and Levitz Furniture.
9. Investors have acquired upholstery and case goods importer **Schnadig Corporation**.
10. Asian furniture makers are feeling the slowdown. **Kasen International**, a large Chinese upholstery producer, saw its revenues decline by 13.4 percent in the first half of 2007. As a result, Kasen closed a plant in Shanghai and is entering retail by opening two stores. **Samson Holdings**, which owns U.S. brands Universal, Craftmaster, and Pennsylvania House, reported an 11.4 percent drop in its revenues and a 47 percent fall in profits during the first half of 2007.
11. Canadian furniture maker **Durham Furniture** is restructuring under the Creditors Arrangement Act, which is similar to a Chapter 11 bankruptcy in the U.S. About 150 jobs are being eliminated as its Chesley, Ontario plant is shuttered and manufacturing is consolidated to its main plant. At its peak, Durham shipped about 75 percent of its output to the U.S. market and has suffered from the strong Canadian dollar.
12. **Shermag**, another Canadian producer, announced the closure of four plants in Quebec and New Brunswick affecting 320 workers. The company's work force will be reduced to 750 in its four remaining plants. Management is evaluating the prospect of going private.

At retail...

1. **Wickes Furniture**, a 43-store furniture retail chain, has filed for Chapter 11 bankruptcy protection and owes its largest creditors more than \$23 million. The company is owned by private equity firm **Sun Capital Partners**. Sun also owns upholsterers Rowe Furniture and Berkline Benchcraft, case goods importer Lexington Home Brands, and Powell.
2. **Domain Home**, operator of 27 upscale retail stores, has also filed for Chapter 11 protection. The company was the 93rd largest furniture retailer in the U.S. with sales of about \$66 million.
3. Chinese furniture maker **Dream Rooms** is establishing a U.S. marketing and distribution arm aimed at selling direct to retailers here. The company operates about 3 million square feet of manufacturing space near Shanghai that makes bedroom, casual and formal dining, occasional, and upholstered products. Their line features American oak, cherry, walnut, and ash hardwoods. Products will be designed by U.S. design firms.

Office Furniture

BIFMA, the sector trade association, reported a 2 percent drop in December orders compared with the 7 percent increase in November. Shipments also decelerated by increasing only 1 percent vs. 5 percent growth the prior month. December's shipments represented the slowest pace of growth in 2007.

In spite of tougher macroeconomic conditions, analysts continue pointing to strength in the primary economic drivers for office furniture demand – corporate profits, non-residential construction, and white collar employment. In addition global demand for these products is growing. The industry is shipping at an \$11.420 billion rate vs. \$13.35 billion at the historic top in late 2000.

At the company level...

1. **Steelcase**, the world's largest manufacturer of office systems and business furniture, announced a 10.5 percent increase in its 3Q2008 sales y-o-y. North American sales improved 9.4 percent; international sales, 15.6 percent. Operating income was up 30 percent to \$52.7 million.

2. **Herman Miller** reported a 1.4 percent increase in its 2Q2008 sales to \$506 million. International revenues jumped 12.1 percent. Operating profit rose 11 percent to \$65.2 million. Operating margin was 12.9 percent.
3. **HNI Corporation** (formerly HON Industries) announced office furniture sales of \$548 million in its 4Q2007, a 1 percent increase. Operating margin in this product sector was 10.4 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.

Non-Residential Construction

A study by the National Association of Real Estate Investment Trusts shows that an investment in U.S. commercial property at the start of 2000 would have quadrupled by the end of 2006. In spite of that strength, the non-residential market has not seen the overbuilding that normally precedes a cyclical downturn. For example, the vacancy rate in U.S. office space is 12.5 percent, the lowest in six years.

One indicator that spending on commercial construction is continuing is the strength of architects' billings. Architects, whose work obviously precedes construction, are not busy when project plans are waning. The American Institute of Architects' Architecture Billings Index is designed to forecast construction activity nine to 12 months in the future. In December the Index was 55.4 with any score above 50 indicating an increase in billings.

Higher education is one sector that is burgeoning. In 2006 colleges and universities completed \$15 billion of buildings and started an equal value of projects in 2007. This spending covers the gamut from new laboratories, student housing, and recreational space.

The reason is demographic. American high schools are pumping out millions of potential college students. University enrollment is projected to rise 13 percent by 2015.

Providing space for research and learning is critical to America's ability to preserve its lead in technological innovation.

Public Policy