

SHORT FALL

Commodity producers are expanding capacity to meet growing demand, but lags in supply are putting pressure on Fifth District manufacturers. Will this round of short-term pain spread to consumers?

BY CHARLES GERENA

Globalization has lowered prices for a variety of goods, making a trip to the local big-box retailer a pleasure for value-oriented shoppers. It's also made life downright unpleasant for manufacturers like Martinsville, Va.-based Hooker Furniture.

Aluminum prices weren't high enough for Alcoa to invest new capacity during the 1980s and 1990s. Now, the company is starting to build new smelting facilities like this one in Iceland.



Increased competition from furniture makers in China and other Asian nations has forced the 81-year-old company to lower its own prices, says Lewis Canter, vice president of manufacturing. "Furniture is more of a value for the consumer today than it was 10 years ago," he says. What makes this price war all the more challenging is that many of Hooker's raw materials — which account for a third of total expenses — are more expensive and the company hasn't been able to pass along most of these added costs to customers.

"With the foreign competition in the last few years, the price increases have come fewer and farther between. We have to make sure we don't price ourselves out of the market," Canter says. A small price increase last year and a planned one this fall may cover about half of the added expense for materials like foam, a key component in leather and fabric upholstered furniture.

Hooker Furniture isn't the only company in this predicament. More than half of the 60 large industrial manufacturers surveyed by PricewaterhouseCoopers reported higher material costs in the first quarter of 2006, while 53 percent reported that their own prices either stayed the same or were lower. Overseas competitors also pay more for materials, but domestic manufacturing executives complain that costs associated with health and pension benefits and regulatory compliance are making

it difficult to compete with foreign firms.

Many production inputs have become a lot more expensive in the last five years. For example, the price of copper — used in everything from water pipes to circuit boards — more than doubled to \$8,000 a ton between May 2005 and May 2006. Copper had traded for less than \$3,000 a ton on the London Metal Exchange during the last two decades.

Supply interruptions, such as the shutdown of natural gas production after last year's Gulf Coast hurricanes, have led to price spikes. But several demand-side forces have also pushed up the cost of production inputs over time. The rapid growth of China and India has added to demand from expanding economies around the world. Additionally, many analysts believe that hedge funds and institutional investors have been buying up commodity contracts in lieu of more traditional investments, thus driving up their prices. Of course, hedge funds may be doing this based on their belief that there will be more demand in the future.

Despite higher prices for many commodities, supply continues to lag behind demand. "The global community was really surprised by the huge increase in demand from Asia for oil and industrial metals over the last three years," says Earl Sweet, an assistant chief economist at Toronto-based BMO Financial Group who tracks

commodities. However, “investors have been burned badly over many decades of investing in commodities and were slow to [take] the bait. Now that they are, it’s going to take several years to develop new supplies.”

Economic theory says that rising prices should entice suppliers into the market and encourage existing suppliers to increase their output. Eventually, the increased inflow of goods should stabilize prices and then drive them down. In reality, commodity suppliers don’t leap into action like firefighters responding to an alarm. Each company’s response to a price signal is different and depends on several factors, chiefly the returns that executives expect to make from investments in production capacity.

So, when will commodity supplies come back in alignment with demand? Some economists expect prices to become high enough to decelerate economic growth and accelerate the production of materials in short supply by early 2007. Prices of various industrial metals have already reacted to this anticipated market shift. They fell for five weeks before recovering in mid-June.

In the meantime, higher costs for production inputs will continue to squeeze the margins of manufacturers like Hooker Furniture. Whether household budgets will be squeezed further is another question.

Going From Zero to 60

Producers of various crude and intermediate goods are just beginning to boost their capacity after decades of putting their money elsewhere. Jason Schenker, an economist with Charlotte-based Wachovia, explains how this situation happened.

After the end of the Cold War in the 1980s, Russia dumped its metals into world markets because it needed money to finance its government. Then, the Asian financial crisis in the late 1990s and subsequent recessions in the United States and elsewhere reduced demand for materials. This left many global inventories flush with supply, keeping prices low and

diminishing the potential return on investment for new mines and processing facilities. So, companies directed their capital into real estate, high-tech startups, and other investments that promised better returns.

Now, countries around the world are expanding again. China’s rapid industrialization has made a big splash in the global marketplace, while North American and European economies are strong. This global surge in demand has drawn down inventories of production inputs like copper and zinc to the point where supply increases are finally practical, and prices have spiked to reflect that need.

A good gauge of this trend is the Producer Price Index, which measures the average change over time in the prices received by domestic firms. The PPI for crude goods, such as industrial metals and minerals, increased 111 percent from December 2001 to December 2005. Meanwhile, the PPI for intermediate goods that are partially processed, such as cement and lacquer, rose 27 percent over that period.

The problem is that new supplies don’t show up with the push of a button. “It’s like turning an aircraft carrier,” Schenker says.

While coal mining firms have been reopening abandoned underground mines and nonferrous metal exploration has been rising, discovering and developing enough new mineral reserves to meet demand takes years. Also, it takes time to get financing, obtain permits, buy equipment, and hire workers, whether it’s for a new mine or processing plant. Firms may see high prices and strong demand now, but favorable market conditions have to last long enough to make it worth investing in new capacity.

Paul Campbell, Jr. says this is what happened at Alcoa while he was president of the aluminum producer’s Southeast region. (He retired in 2005 and serves as a consultant based in Charleston, S.C.) The company lagged in creating new capacity during the 1980s and 1990s because the price of aluminum wasn’t high enough.

“You couldn’t justify building the plant,” Campbell recalls. “Now that prices are up, it’s taking awhile to build the facilities to produce the raw materials.” Alcoa is putting a new smelter in Iceland and designing another one for installation in Trinidad and Tobago. It is also expanding its aluminum plants in Australia, Jamaica, and South America. “We’re looking to take advantage of the situation.”

Betting the Farm

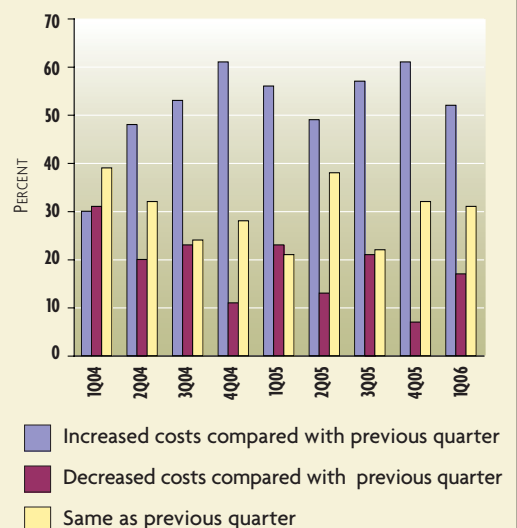
Futures contracts are a good indicator of how long the market expects current conditions to last. They represent an obligation for the buyer to accept delivery of a commodity for a specified price at a future date.

While spot prices can rise dramatically, futures may not rise as much, indicating that current market conditions are expected to be only temporary. However, if futures are persistently higher, then commodity suppliers should have greater confidence in making long-term investments in production capacity.

The Reuters/Jefferies CRB Index averages the futures prices of 17 commodities in six broad categories,

Input Costs Up

Since 2004, more large manufacturers surveyed by PricewaterhouseCoopers are reporting higher input costs, while fewer have seen lower costs.



SOURCE: PricewaterhouseCoopers

including energy and precious metals (which comprise 35 percent of the total). Judging from the index's movements over the last four years, producers appeared to have grounds for optimism. The index was up 23 percent in 2002; 8.9 percent in 2003; 11.2 percent in 2004; and 16.9 percent in 2005. Yet that didn't seem to have much of an effect on supply levels.

Several factors have raised the bar for the return on investment necessary for a company to justify increasing its production. Higher oil prices have added to production costs for makers of asphalt, plastics, and other petroleum-based products, costs which can be hard to pass on to consumers.

Finding reserves of raw materials is also challenging. Some are located in areas of political instability, making investors cautious about committing their money to multiyear exploration and development projects, according to BMO's Earl Sweet.

For instance, New Caledonia has about one-fourth of the world's known nickel reserves, but efforts by the island nation's indigenous population to break from French rule has periodically threatened mine development and expansion. Labor unrest has disrupted copper production in Chile and Mexico.

Finding an optimal location for a processing facility is difficult as well. Kenneth Simonson, chief economist of the Associated General Contractors of America, says producers of construction aggregates prefer to build their plants as close to a sufficient supply of raw materials as possible to save on transportation costs. In addition, they must have access to a plentiful supply of electricity and water. But companies can't build just anywhere. "For many kinds of manufacturing, it's really hard to get zoning and environ-

mental permits. Asphalt and cement plants aren't very appealing neighbors," Simonson notes.

It's Only a Matter of Time

Economists expect this supply lag to correct itself. However, while prices will likely fall from their current heights, Sweet and other economists don't expect them to return to their previous lows of the late 1990s, either. Therefore, Sweet notes, producers should get an adequate return on investment for expanding their capacity. Higher futures prices for copper and other minerals suggest the market shares that assessment.

On the other hand, there are still some significant question marks. Todd Clark, an economist at the Federal Reserve Bank of Kansas City, says everyone is still trying to figure out the impact of China's and India's increased demand for nonrenewable resources. "There is reason to be worried about that and look hard at the issue," he says. Historically, technological advances have led to better ways of extracting natural resources and using them more efficiently, but it's not clear if they would enable commodity producers to meet future demand.

Until things straighten themselves out, what will be the impact on consumers? It may not be as big as one might expect. Even if higher commodity prices start trickling down to consumers beyond the neighborhood gas station, Clark says the effect on cost of living will be limited, since the goods portion of the economy has declined over time. Excluding food and energy, goods represent only 25 percent of consumer spending.

Also, Clark says manufacturers haven't passed much of their increased costs to consumers in the past, and he doubts that trend has changed.

Previous research did uncover a statistically significant relationship between prices of less processed goods and prices for more complete goods. However, recent studies have suggested that this relationship weakened during the 1980s and 1990s.

Indeed, global competition has convinced many companies that their customers won't tolerate higher prices to cover input costs. Instead, they have chosen to sacrifice some of their profit margins in the name of protecting market share. Also, they have tightened their belts by using cheaper inputs, substituting capital for labor, and hedging against price increases with futures contracts.

Back at Hooker Furniture, Lewis Canter looks for ways to improve efficiency. For example, the company trains its workers to reduce overspray of finishes. Canter explains, "Furniture is coming by real fast, so if your technique is sloppy, then you waste more."

Some companies have shifted their attention to niche markets with less competition. Cheaper Asian imports have lowered demand and margins for Hooker's bedroom, home office, and home entertainment offerings. So, the company closed three plants in North Carolina and focuses on producing high-end leather chairs and sofas. It also sells more furniture imported from China, Mexico, Honduras, and other countries.

Canter doesn't see any relief from input price pressures until oil markets cool down. And, even then, Hooker will continue to face pressures on the output side. "Chinese furniture makers pay the same raw material costs as we do, but their labor and overhead costs are so much lower," he remarks. "We are trying to drive down overall costs and determine where the biggest opportunities are." **RF**

READINGS

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