

THE PARLIMENT PAGES

JULY, 2014

The World We Live In -

In almost all of our previous editions, we have made some level of reference to the internationalization of the business world. It is so easy for us to cruise down Main Street every morning and not realize the size of the world around us and its potential impact on our small part of the planet.

In particular, we have written quite extensively about China. The latest of the big questions has been whether China would experience a hard or soft economic landing and exactly what the ramifications would be on our businesses. We will get into the latest on that in just a bit.

In this issue we are going to discuss the impact of internationalization and the wide range of countries that are involved. No longer can we set the telescope on just China. There are literally several dozen countries that have now come into play and the actions by these countries could have a huge impact on some of the products you regularly sell.

We have also learned that there is a distinction to be drawn between political policy and economic policy. As has been demonstrated quite consistently, those policies rarely are in sync and often times will actually contradict each other.

The Expansion of Manufacturing -

As a youngster just starting my business career, I remember quite clearly the emergence of Japan as a center of manufacturing. It did not start fast. In fact, some of you may remember that for a time, anything made in Japan was ridiculed as being cheap and of extreme poor quality. It didn't take them long to get their act together and pretty soon they were known as the quality manufacturing location of the world. In fact, many of the American quality initiatives were copies of the practice that the Japanese had invented.

However, due to political interference, Japan got upside down on their population demographic curve. With fewer people entering the workforce and a host of retirees hitting the government programs, the country quickly began to lose its edge. Over a very short period of time it dropped from being the number two economy of the world to an economy that is now sitting on the precipice of absolute failure.

As Japan faltered, China was waiting in the wings and pulled off a massive shift of manufacturing from their age-old rival. They were able to do this because of Japan's floundering and an insatiable desire of the Chinese political leaders to gain a seat on the national stage. Through unprecedented infrastructure development, the country has moved millions of people from farm-based poverty to a semblance of a middle class. However, the political support was greater than the economic models suggested and pretty soon China started to incur huge cost increases, massive pollution and a labor force that was demanding more money. Accordingly, prices increased and the international markets decided to look for other options.

Saddled between Japan and China is the country of Korea. It was time for Korea to step up and take their place at the podium. Following a similar scenario to Japan, Korea was known as the country of

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cheap products. Think Hyundai or Kia. Now both of those products, along with Samsung have taken center stage as high quality leaders in their field.

So, as the price of their products escalated, other countries have stepped up to take that position as the low cost provider. Depending on the product, in our particular industry, we have seen Vietnam, Malaysia, India, Turkey, Bulgaria, Oman and a host of others fight for the head of the table.

Simply stated, building products today are coming from all corners of the world. And, therein lies a big problem.

Product Dumping -

With so many different players there is no longer clear political or even economic control over the market places. Instead, it has become a free-for-all, where pricing, government subsidies, product liability, and steady source of supply are all weighing in.

As is true for most all developing countries, the infrastructure necessary to manufacturer our types of product are immense. Private investment can rarely do the trick and therefore the governments must step in and make massive investments. As the free market forces take place, competition increases. This is only exacerbated by the large number of players now producing building products.

Faced with a huge infrastructure investment and mounting competition, political decisions are made to dump products on the market even if it is at a loss. Decision makers are wrestling with the political pressure of maintaining jobs along with the economic reasoning of some return on these investments is better than nothing.

One of the biggest consumers of these building products happens to be the United States. Hence, the brokers that import these goods were able to wheel and deal and get some ridiculously low pricing. This obviously had a very negative impact on the manufacturing within our shores and it was not long before the domestic manufactures started to call foul.

With our economy on life support, it didn't take long to get some sympathetic minds working on this problem.

Tariffs -

Under current United States law, any domestic company can sue another company or even a country to protect against product dumping. The remedy for victory would be imposition of tariffs or import duties on the product thereby equalizing the pricing. This is a politically charged event as there are arguments on both sides. However, with the need to bolster our economy, most policy makers today are in favor of these tariffs. Accordingly, a countervailing lawsuit has been filed in regards to bulk and collated nail imports.

While in limbo - supplies will be short -

These countervailing lawsuits are extremely complex. There are huge burdens of proof and in this case there are seven different countries involved as well. This is a lawyers dream come true as suits such as these can run for years. The complexity is such that eventually the defendants will give up and stop their predatory pricing. Often they will have to pay damages to the suing party. In this particular case, with so many different parties, just assessing the responsibility for damages is hugely complex.

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As of today, the importers are in a real quandary. They simply do not know what the ultimate post-tariff price will be on their goods. Without this knowledge, how can they quote a price? The result is that importers have stopped the pipeline of product flow until this is sorted out. This will, in effect, take much of the foreign manufactured nails out of the market place, for a time.

There clearly is not enough domestic production to meet the needs and as a result, we could see some severe nail shortages over the next few months. Nails, whether bulk or collated, are not products that you want to be without.

Back to China -

Few of us here in the States truly understand the magnitude of China. A good friend of mine just returned from spending about a month in the lesser-known interior of the country. He could not believe what he saw. He visited two different cities that very few of us have ever even heard of and told me that each of those cities had populations in excess of 30,000,000. That dwarfs New York City and Los Angeles combined.

Virtually every place he visited he saw dozens of cranes in the sky. He knows about the ghost cities and doesn't doubt they do exist, but he was amazed at the thriving business environment, energy of the people and the signs of obvious growth in the middle class.

After hearing his stories, I did a little more research and came across an astounding piece of trivia. In the last 3 years, China has consumed more cement than the United States did in the past 100 years. So, how do these stories reconcile with the talk about China's economic problems and the possibility of a hard landing?

Things always need to be put into perspective. First, the population of China is more than 5 times larger than the United States. For the past 10 years, China has averaged double-digit (sometimes as high as 18%) growth as opposed to our anemic, less than 2%. China has a stated goal of creating a middle class within a 5-year period. Sometimes, I think our goal is to destroy the middle class. With the creation of a middle class comes massive spending on everything from refrigerators, housing, cars and cell phones.

Understanding these basics gives one the clear grasp of how big China can become. There is no doubt that there is some wobbling in the Chinese economy right now. Some predict a crash that will have worldwide implications. We don't believe that whatever happens in China will cause massive problems around the world. Instead, we think there will be a slow down to a more sustainable pace. Construction will continue and locally made Chinese products will mostly be consumed internally. That, along with the international competition that we discussed before, will greatly negate the impact of Chinese products on our shore.

Interest Rates -

Talk about a confused group of central bankers. Just in the last couple of weeks, I have read articles by 5 Regional Federal Bank Presidents. A couple of them are predicting an increase in rates as early as the first quarter of 2015 while the others are saying just the opposite and that rates will stay at today's low rates for years to come.

There are two implications to this diversity in opinion. First, we have to ask how this body, who have made themselves so important, can have such divergent opinions. Are they not looking at the same information? Some of these esteemed Presidents are claiming that we are on the verge of increasing inflation and rates should rise to counter that move. Others are saying we have entered a deflationary period that begs low interest rates as a stimulus to the economy.

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This lack of cohesion scares the living daylights out of business people. The housing industry is a huge component of the overall economy. Interest rates have a dramatic impact on the public's desire to purchase a new home as well as determining the affordability and size of the purchase.

Secondly, knowing that every day the headlines might read something different creates huge ambiguity in the market. On top of that is the inconsistent and unpredictable level of governmental regulation, the health care mess, and a huge distrust of the fiscal and monetary policies in this country. This creates uncertainty and uncertainty causes people to defer decisions. When decisions are deferred, spending stops which just expands the entire negative situation even more.

For now, we should plan on rates staying relatively steady for at least the next six months. After that, who knows?

Housing starts -

The good news is that our beginning of the year predictions are right on track. The not so good news is that the ratio of single-family homes versus multi-family is not working in the industry's favor. It seems the middle sized single family sector has slowed to a crawl. Larger homes are coming on strong, but that vast majority of starts are in the lesser expensive multi-family apartment complexes.

For several years we have been predicting that housing formations would force new construction. However, as a byproduct of market uncertainty, those households are moving to the less risky alternative of renting. So, while the numbers of starts may look good, the cost per unit is down substantially.

Margin memory -

Good habits are tough to form and bad habits are tough to break. I learned this from years in the training business and find it more appropriate today than ever before.

We all know the devastation caused by the recent economic collapse in housing. We saw massive amounts of layoffs, closures of dealers and manufacturers. Builders simply disappeared. And most importantly, for those of us left, we had to scramble for every single sale. This scramble played havoc on profit margins as our sales people were desperate to make any type of sale regardless of profits. As owners, we were more concerned with margin dollars than margin percentages. "Get the deal at any profit," seemed to be the mantra in those dark days.

Accordingly, sales people formed the bad habit that we call margin memory. They became so accustomed to selling at that discounted margin that they forgot the days when a more respectable number was possible.

While conditions are still not quite up to prime time, we do believe the market does not require that level of deep discounting and it is now time to work on getting those margins up to levels that produce a respectable bottom line profit. However, standing in the way is the memory that the sales people have of the lower margins.

What is the right margin? Obviously, there is no simple answer. However, look at your sales quotes. Are you getting every single one? If you are, perhaps you are not charging enough. It is not a bad thing to lose business occasionally over price. With some careful analysis you can begin to understand that balance point where you get your pricing right. Work on margin memory and you will start to see some increased profits.