1-1-2009

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Brian G. Long

Grand Valley State University, longbri@gvsu.edu

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Recommended Citation

Available at: http://scholarworks.gvsu.edu/sbr/vol15/iss1/4

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West Michigan Supply Management: A Year in Review

Brian G. Long, Ph.D., C.P.M.
Director, Supply Management Research
Seidman College of Business

Although economic history will record that the Michigan recession probably began sometime in 2006, the West Michigan economy was able to avoid the impact of the impending economic downturn until late in the summer of 2008. Lest there be any doubt, the recession is now upon us.

We entered the year fully aware that numerous economic problems were simmering in the background. The tightening of loan requirements and a wave of foreclosures in response to the subprime crisis resulted in a slumping housing market. Auto finance and every other form of consumer credit were being severely restricted. Auto sales were edging lower, and the anxiety level regarding the viability of our local economy began to increase.

However, the valuation of the dollar compared to other world currencies was still very low. Declines in automotive and housing were being offset by strong demands for export goods, including those associated with the aircraft, machinery, and agricultural industries. On a nationwide basis, job losses in Michigan were being offset by job gains in other parts of the country.

For money managers around the world, a dilemma developed. Although it has been well over 60 years since the infamous Breton Woods monetary conference, about 65% of the world’s currency reserves are still in dollars. With the sub-prime mortgage problem still far from being resolved, investing in “packaged” mortgages was now considered less desirable and downright risky. The Federal Reserve continued to cut interest rates, making treasury securities far less profitable. As the price of gold and other commodities started to rise, numerous money managers around the world decided to jump on the bandwagon of commodity speculation. Prices for commodities like cobalt, lead, copper, and zinc vaulted to record levels, severely straining the profitability of many of our local firms that depend on these types of raw material for manufacturing their finished products. The rising price of coal, iron ore, and steel scrap escalated the price of steel to record levels. Predominantly, the producers of these commodities cited demand by Chinese manufacturers as the major cause of these escalations, although some acknowledge that commodity speculation was also playing a role. As oil rose to the range of $150 per barrel, even the OPEC countries argued that at least half of that price was the result of speculation rather than actual market demand.

By late summer, the record price for gasoline was creating major deterrent to auto sales. Although the 2007 gasoline price hike to $3.50 was largely ignored at the time, the 2008 spike to over $4.30 per gallon jolted consumers into a new sense of reality. There was a newfound revival of the discussion about alternative forms of energy. However, by midsummer, gasoline consumption had fallen by 5%, and dealer lots began to overflow with heretofore beloved SUVs and pickup trucks. Firms like General Motors that had banked their future on these high-margin vehicles were starting to bleed.

As we entered the fall of 2008, the speculation binge had run its course, and price for most commodities began to plummet. The British banks and many of the European banks had somehow managed to follow our lead into a sub-prime mess of their own, resulting in a significant international economic decline which still has not run its course.

For most of our local industrial groups, there became no place to hide. The office furniture business had already started to soften in 2007, and many firms began to see significantly lower demand by late summer. Our local auto parts suppliers, who have lived between the proverbial rock and a hard place for years, were now having orders slashed to match the declining production schedules. Even those firms that had won contracts with the Japanese and Korean transplant companies have found that the automotive slump was now encompassing the entire industry.

About the Survey

The monthly survey of business condition, published under the title of “Current Business Trends,” first debuted in Kalamazoo in February of 1979 and was expanded to Grand Rapids in 1988. At present, the survey encompasses 45 purchasing managers from ISM-Greater Grand Rapids, and 25 from N.A.P.M. Southwestern Michigan. For both surveys, the respondents are purchasing managers from the region’s major industrial manufacturers, distributors, and industrial service organizations.

Patterned after the nationwide survey conducted by the Institute for Supply Management, the strength of the survey is its simplicity. Each month, the respondents are asked to rate eight factors as “SAME” or stable, “UP” or improving/rising, OR “Down” as in declining/falling.

New Orders

This index measures new business coming into the firm and signifies business improvement or business decline. When this index is positive for an extended period of time, it implies that the firm or organization will soon need to purchase more raw materials and services, hire more people, or possibly expand facilities. This results in billions of dollars being added to the economy when the index of New Orders is positive, but conversely means that billions of dollars are being pulled from the economy when the index turns negative. Depending on the firm, a significant portion of this money ends up being spent—or not spent—in the local community.
As Figure 1 illustrates, the positive trend of early 2007 was eroding by the end of the year. A small uptick in January 2008 flattened for the next couple of months. By April, incoming orders began to soften, although a flat report in June gave fleeting hope that the storm may have passed. However, one month does not make a trend, and the index eroded for the rest of the year, finishing at -57, the lowest level in the 20-year history of the survey.

![Figure 1: 2007–2008 NEW ORDERS Percent “Up” vs. “Down”](image1)

The production schedules vary widely among different types of manufacturing firms. Some, such as automotive, are highly seasonal. Others build for inventory in anticipation of orders, while others ship immediately upon completion. Holidays, bad weather, and materials shortages may constitute uncontrollable influences.

Production schedules for 2007 ended on a negative note, but briefly rebounded in early 2008. However, from April of 2008 forward, the index was consistently negative, and finished the year at its lowest level. As noted by Figure 2, most of the year was zigzag from one month to the next, indicating that many firms were having at least some difficulty adjusting to market demand.

![Figure 2: 2007–2008 PRODUCTION Percent “Up” vs. “Down”](image2)

**Industrial Inflation**

For most buyers of major commodities such as plastic resins, steel, copper, and motor fuel, 2008 will be remembered as a year of the wildest price swings in history. January and February of 2008 saw industrial inflation ballooning as the prices of key commodities like steel, oil, copper, and aluminum began rising rapidly. By April, many industrial buyers were seeing the worst inflation they had seen in their careers. It seemed like there was no end in sight.

Unfortunately, commodity speculators jumped in to run prices even higher. In May, we reported a 20-year record high for the index of Prices at +76, only to see the same index slide to a record low of -58 in December. Figure 3 shows the extreme nature of these price swings over what is a relatively short period of time. In late November, one survey respondent was quoted as saying that he was now purchasing flat rolled steel for 20% of the price he had paid only four months earlier. Whereas everyone likes a “good deal,” price drops of this nature can be detrimental to the industry as a whole.

From an industrial buyer’s perspective, one of the biggest dangers of any downturn of this nature is what the economists refer to as “structural damage.” Simply put, marginal firms in a particular industry are driven out of the business, as they probably should be, under Darwinian economics. However, altogether too often this washout extends to firms that are otherwise good performers, or even worse, the high quality/higher price firms. They find themselves undercut by cheaper domestic competitors or foreign sources. When the markets finally correct themselves, there is not enough market capacity, and the surviving firms can now charge a higher price, fueling inflation as well as more foreign competition.

As of December, for some commodities such as plastic resins and petrochemicals, prices have not come down nearly as fast as they went up. As we enter 2009, we will see the prices of many of these types of commodities continue to fall.

Compounding the problem of falling prices is the problem of inventory liquidation. When we look back at 2008, we will remember it as the year that we abandon the religion of JIT inventory, probably in response to the panic created by pricing for some commodities going out of control. As prices continue to fall, firms are now utilizing these inventories, resulting in the prices for these commodities falling even further. Unfortunately, the entire world is now cleaning the warehouses that were overfilled in last summer’s buying panic. Historically, we will not be out of our current recession until the inventory liquidation is over. In the past, this kind of liquidation has usually taken about 9 months. However, these are unprecedented times, and the past rules may not apply.
Employment

The Employment index measures the expansion and contraction of the firm's entire workforce, including office and production personnel. Many firms will remain stable for long periods of time, until significant economic events result in new hires or layoffs. Others will add or subtract people one or two at a time.

In the last half of 2007, our index of Employment turned negative. As noted in Figure 4, this workforce reduction was inexplicably halted in February of 2008, although the same negative pattern would soon return by early spring. The pace of layoffs accelerated in late summer and cascaded to a record low in November.

Looking Ahead to 2009

An unfortunate feature of the capitalistic market systems of the world is that they are periodically prone to recessions. This particular recession is more troublesome than most because it affects the production and monetary systems of the entire world. Unlike the shallow recession of 2001, the Federal Reserve was able to mitigate the dot com bust by simply lowering interest rates. With cheap money available, the auto makers propped up sagging sales with numerous rebates and low finance rates.

The causes of this recession are far deeper and more widespread. However, like other recessions, this too shall pass. Here are some clues that recovery may be underway:

First, watch for the prices of the major commodities to stabilize. Most experts agree that the prices for oil, copper, aluminum, and numerous other key commodities are below what it costs to produce them. Hence, we will watch for our index of Prices to return to some kind of equilibrium, and sustain the equilibrium for at least two or three months. We should watch the ISM national index of Prices as well.

Second, keep an eye on China. Since the Chinese are new at the whole science of managing inventories, chances are good that they are overstocked on just about every major industrial commodity. Of course, we need to watch the performance of the overall Chinese economy. When China resumes buying significant quantities of industrial commodities, it should be regarded as a positive sign.

Third, watch for a rebound in the New Orders index. Keep in mind that these orders are often placed weeks or even months before any money is actually paid. Sustained double digit growth in this index is a strong indication that the economy is on the mend.

Fourth, watch for recovery of the international economies. International economic news will provide at least some clues. The J.P. Morgan Global Manufacturing Index may provide additional evidence.

Fifth, there must be a return to price stability in the housing market. When home values are still falling, buyers are reluctant to buy, and banks are reluctant to loan. Statistics like housing starts, sale of existing homes, and reports from local, state, and national real estate organizations may be helpful.

As previously noted, this recession is far more complicated than most. Speculation regarding potential duration is therefore more difficult. However, the best guess at this time is that recovery should start to be evident by mid to late summer.