


INDUSTRIAL MARKETS 2007 AND BEYOND:

Managing Through the Mid-Cycle Pause

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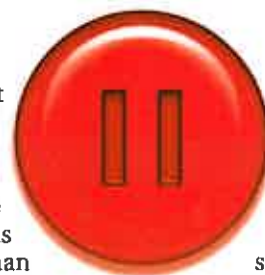


I had the privilege of presenting to AGMA members in 2004 when my focus was “Managing Through the Mid-Decade Boom”. Our thesis was that Industrial America had begun a very strong recovery that would last at least into 2006. That outlook was soon modified into an upturn for U.S. manufacturing companies that would likely last through the end of this decade! However, the only thing that could be guaranteed was that the upturn would NOT be linear.

We are now in that non-linear period. U.S. manufacturing activity lost momentum in the second half of 2006, and is starting 2007 in a less than robust fashion. The ISM (Institute for Supply Management) Report on Business has reported that their PMI (purchasing managers) index has fallen from the mid 50's level (peak of 56.9 in April, 2006) to averaging 50.5 in the four months ending January 2007 including being below the 50 percent level that signifies expansion in both November 2006 (49.9) and January 2007 (49.3).

We believe U.S. manufacturers have experienced a transition into a normal mid-cycle economy defined as top-line growth falls from the robust double-digit levels of 2004 to mid-2006 to low- to mid-single digit levels at best with profit growth of 7% to 10% likely considered outstanding performance. The current slowdown of the domestic economy is typical of a mid-cycle business pause similar to what the U.S. experienced in 1966, 1986 and 1995.

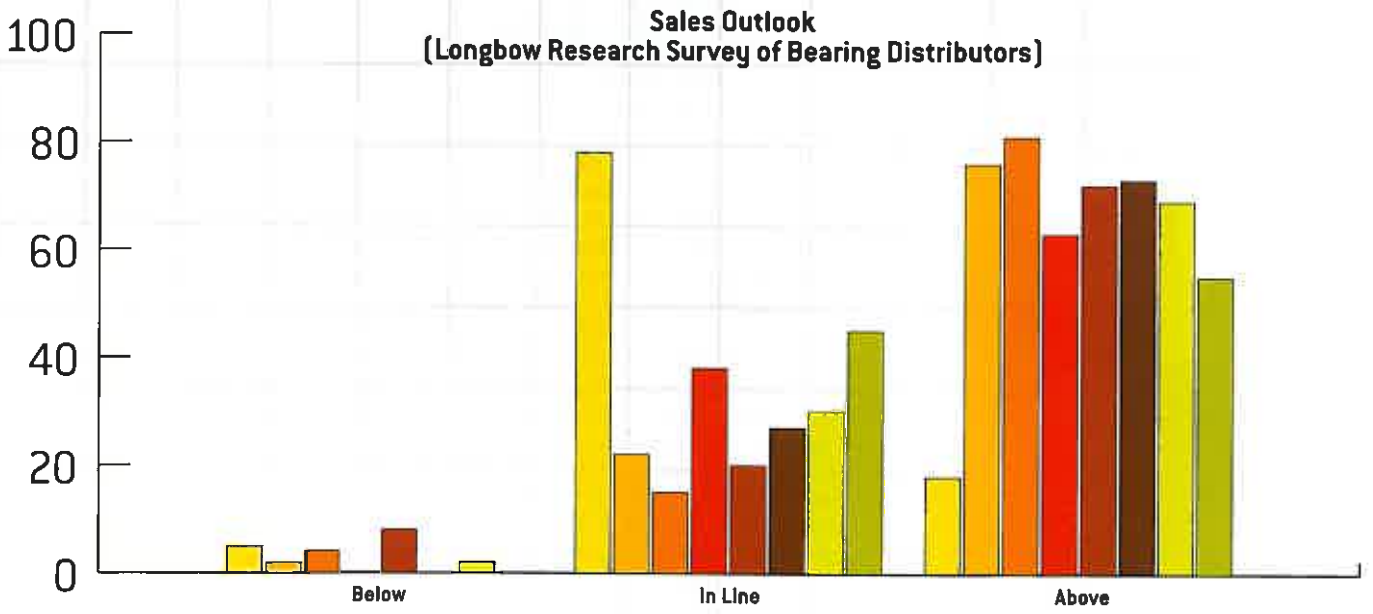
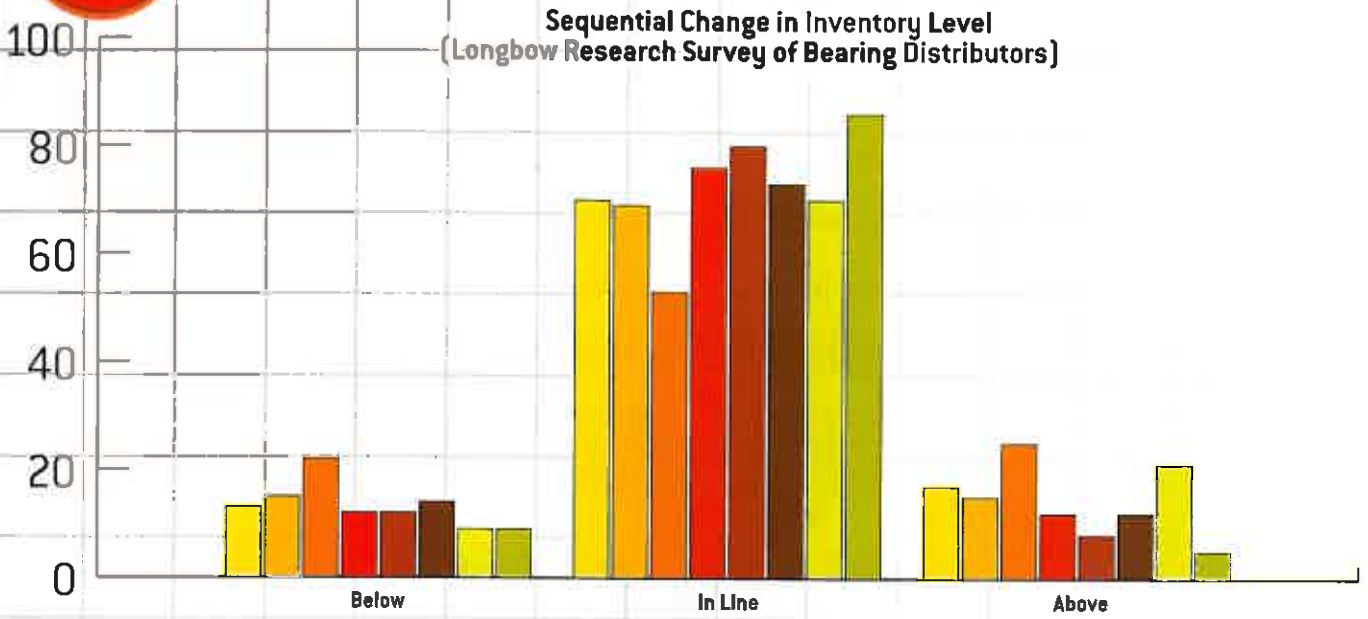
One key characteristic of the mid-cycle transition is that industrial end-markets begin to reflect winners and losers as opposed to the robust growth that most industrial sectors experienced be-



tween mid-2004 and mid-2006. The sales and production declines in the second half of 2006 were most visible in automotive, residential construction, light construction machinery, and farm equipment and were mostly offset by continuing strength in medium to heavy equipment demand and robust international markets.

We believe 2007 should be viewed as a mirror image of 2006. Our near-term forecast is for significant volatility in the industrial economy in the first half of 2007. The production weakness in the automotive, light construction and farm equipment markets of the past six months will carry into the first half of 2007 and be joined by the very sharp emissions-driven fall-off of demand in the medium and heavy truck markets. Further, customer inventories are likely above the desired levels across many industrial markets as evidenced by the ISM customer inventory index registering 52 in January 2007 and being over 50 since October 2006.

Current economic data, supported by our recent surveys of bearing distributors indicate that an inventory correction started in the fourth quarter of 2006 and will likely carry into the first quarter if not first half of 2007.



Source: Longbow Research

The second half of 2007 will hopefully be characterized by a strengthening of demand across many industrial markets including:

- **Automotive NAFTA production in 2007** is likely to be near the 15.25 million produced in 2006, down from 15.75 million units built in 2005. We look for domestic Big Three production to decline at least 4% to 6% (down 8% to 10% in Q1) but New Domestic Production to be up 8% to 10% in 2007 (up 6% in Q1).
- **Housing** will likely stabilize at 1.55 million starts down from about 1.8 million in 2006. The ongoing weakness in residential construction will take its toll on light construction market with production declining about 5% after a 13% decline in 2006 (down over 20% in Q4) as dealers and rental companies adjust their fleets to a lower level of activity.
- **Medium to heavy construction equipment** demand should be flat to up 5% domestically and somewhat stronger outside North America.
- **Domestic farm equipment** demand is expected to be flat to up modestly in 2007 after about a 5% decline in 2006. Larger equipment demand, which declined 13% in 2006 should strengthen and be up 5% to 10% in the second half of 2007 assuming the current surge in commodity prices holds.
- **Heavy truck** demand is expected to plummet between 40% and 50% in 2007 from the record 374,000 NAFTA production last year with Q1 likely the low point for diesel engines and Q2 for truck assemblies.
- **International markets** should remain robust though W. Europe demand is likely to moderate somewhat from 2006 levels.

Our most recent surveys of bearing distributors support our current outlook. Respondents confirmed that demand has moderated with 36% of bearing distributors reporting increased demand in December/January 2007 (down from 51% in October/November 2006); 55% reporting flat demand (vs. 29%) and 9% reporting a decline in activity. Pricing has moderated with 58% of the bearing distributors indicating that pricing is up 0 to 5% and 38% reporting flat pricing.

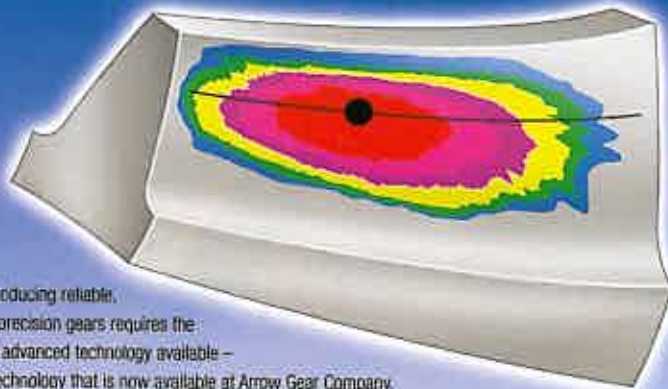
Most important, bearing respondents are reporting that inventories are being brought into line at the distributor level suggesting that significant inventory reduction began in the fourth quarter of 2006. Inventory levels were reported to be at desired levels at 86% of the bearing distributors in the December/January timeframe, with 5% reporting high-

er than desired inventory levels, while 9% reporting lower inventory levels.

While more inventory management will likely occur in the first half of 2007, the risk of an inventory driven recession has been reduced markedly and the industrial sector should be well positioned by as early as the end of the first quarter to rebound in line with any economic upturn. The survey results support the optimism of most industrial manufacturing companies of an improved outlook for 2007 despite the softness of the first part of the year.

The bottom line is that 2006 was a very good year for Industrial America, but 2007 is going to be much more challenging. If the Federal Reserve Board will cooperate and eventually cut rate (don't bet on an early rate cut), then this expansion may have legs to last until the end of the decade. □

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