

ELF CAPITAL MANAGEMENT, LLC
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May 4, 2009

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After A Week on the Road – Is It Time to Buy Industrials?

Have you heard about The Institute for Supply Management's (PMI) Purchasing Managers Index? Do you know what it is?

As expressed by Investopedia.com: "PMI is a very important sentiment reading, not only for manufacturing, but also the economy as a whole. Although U.S. manufacturing is not the huge component of total gross domestic product (GDP) that it once was, this industry is still where recessions tend to begin and end. For this reason, the PMI is very closely watched, setting the tone for the upcoming month and other indicator releases."

I bring up PMI as I recently accompanied a new client of mine through the Heartland visiting manufacturing plants. Of five plants visited, three regularly buy from his company and two were large prospective new clients. His company imports various grades of natural rubber into the USA directly from plantations in the Orient. It is a niche business and there are only a few companies in the US that do this. In 2008, his company sold more than 40,000 tons of natural rubber in the US and, despite the economic downturn they are on target to increase sales by 20% in 2009 and possibly 50% more in 2010.

Our travels took us from Hot Springs, Arkansas to Akron, Ohio and, since the plants were in rural areas, we drove most of the way. When you think of things made out of rubber, what immediately comes to mind? Tires, right? Well, I broadened my thinking some on this trip. We visited a rubber band manufacturer; a producer of a broad array of shock absorption products; a firm that produces conveyor belts and hoses; and two tire companies. Of the tire companies, one specializes in competitive racing tires and the other produces mostly (OEM) original equipment for new cars.

At each plant, our point of contact was with senior purchasing managers and I eagerly accepted any opportunity for a tour of the facility when the offer was extended. Due to security reasons, both tire manufacturers couldn't offer tours. Nevertheless, the experience afforded me both ample time and opportunity to perform my own version of a purchasing manager's survey and here's what I found:

With exception to the racing tire manufacturer, each plant was reportedly operating at roughly 30% or less of their normal capacity. Many admitted this to be true since the fourth quarter of last year. The racing tire plant was operating at or near its normal production level as it has been little impacted by this severe recession. On the other hand, the OEM tire plant was almost idled. Out of the bunch, the OEM tire purchasing manager had very pessimistic prospects for the economy over the near term. His sentiment made much sense upon learning that his plant would normally be producing tires for the 2010 new car models, and that the auto manufacturers had not yet placed their orders for next year. The purchasing manager volunteered little information when

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asked about the plant's finished goods and raw materials inventories. Yet, when driving through the grounds, we saw rows and rows of trailers that were believed to be filled with tires awaiting delivery. A little birdie told us they might be full of tires...

OK, so after singling out the tire manufacturers we visited, it was easy to understand why one was indifferent about the economy and the other concerned. When your business is substantially dependent upon a specific customer type, there is no middle ground – only good or bad. As for the other plant visits, the information gleaned provided more helpful data for evaluation.

The remaining plants we visited each served multiple customer types and there seemed to be little overlap among the market segments their products served. Even the rubber band factory client mix surprised me. Not only do they supply the home/office market, but serve the medical, produce, floral, shipping and military markets as well. They also boasted about having the US Postal Service as a client. As the non-tire producers each served multiple market segments, I was more interested in how they were impacted by the economy these past several months and what their outlook was going forward. The results were strikingly similar.

Each of the plants had reduced production levels well below their current demand and were now maintaining extremely low raw materials and finished goods inventories. All seemed fairly content that they were weathering the downturn and were cautiously optimistic that we would see a rebound in activity over the near term. Most expressed confidence that the economy had bottomed and yet, were uncertain about how they might gauge demand for their products as consumers become more confident about spending. Is there pent-up demand and would activity begin with a burst? Or, will demand resume gradually and grow moderately? Given the availability of credit, or lack thereof, most are hoping for a gradual recovery. This would allow them to rebuild their inventory levels from cash flow rather than having to arrange enough credit to meet a rapid burst in demand. If unable to meet a burst in demand, might they lose market share to those who can?

Here are some other observations and extrapolations I could make from this information. If they are running at a capacity that is well below current demand and have let their inventories diminish to very low levels, wouldn't the slightest increase in demand require them to increase worker hours and/or put more people to work? At the same time, raw materials prices – including that of natural rubber – have come down in price significantly since last year and that could bode well for profits. Once these producers work off the tail-end of an inventory made from raw materials bought at higher prices, the result will bring a boost to profits. I don't know about you, but this sounds like a win-win for this industry sector's role in stimulating an economic recovery and profitability.

Another observation that leads me towards becoming bullish on the industrials sector has to do with another trend that seems to be gaining momentum. It relates to a perceived change in manufacturer's supply chain management strategy. Lately, my natural rubber broker client has received and is following up on several inquiries from large producers for proposals regarding how his company might help manage their inventories. The "buzz-word" is vendor managed inventory. Previously, when cash and credit were abundant, the larger users of natural rubber sought to source directly from the plantations and handle all of the logistics of shipping it to their factory. This required them to commit and tie up

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precious capital for several months prior to receiving the raw materials at the factory. In a vendor-managed relationship, the manufacturers would be invoiced upon delivery and can benefit from economy of scale pricing for shipping costs from the vendor. Even after the vendor's profit margin, the savings can be substantial. Not to mention, that this trend will give a potential material boost in the manufacturer's returns on assets and on equity.

When I returned from this business trip, I wanted to test the ability to extrapolate what I learned into a larger sample. After gathering and charting comparative data relating to Consumer Confidence, PMI and Wholesale Inventories, I became more confident that what I learned on the trip was a representative sample. First, purchasing managers seem to immediately react to consumer sentiment; and, second, durable goods wholesale inventories have plunged significantly since peaking in September 2008. And, given that Consumer Confidence gained significantly in April, it seems to bode well for a recovery.

Market Update

With economic indicators beginning to look upward, the market seems to be telling us that the worst is behind us now. It sure looks to me like it is! While we haven't turned the corner yet when it comes to unemployment, the consumer confidence numbers have improved significantly as mentioned above. Remember, unemployment is traditionally the most lagging of economic indicators.

Given the topic above, this month's market update is both short and sweet. In my November 2008 letter, I made some predictions about the economy and the markets that seem to remain on target. The article can be found via this link: [Predictions letter](#).

As a result of following those predictions, I am happy to report that – taken as a whole – our portfolios under management were UP 18.14% for the month of April. Here are some comparative numbers for you to review:

	Apr 2009	3 Month	Y-T-D	1 Year
ELF's ETF Strategy (net)	18.14%	10.26%	2.96%	-39.43%
S&P 500	9.39%	5.68%	-3.37%	-37.01%
Russell 2000	15.33%	9.93%	-2.38%	-31.92%
MSCI EAFE Index	12.27%	6.34%	-4.17%	-44.57%
MSCI All County World	11.49%	8.28%	-1.07%	-41.24%

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