



This Month

- For Detroit, the top line looks good, but the bottom line is uncertain.
- The Fed is trying a new tactic to take some air out of the housing bubble.
- China revalues its currency – but America should beware what it wishes for.

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Green Light/Red Light

During a recent business trip to Detroit I had the opportunity to visit the historical Ford Rouge Factory. This facility is both famous and infamous.

Henry Ford created this visionary, fully-integrated plant in order to control all the resources and processes required in the production of cars. To this day the effort remains stunning: I was fascinated. On the other hand, the plant was the scene of a brutal confrontation between management and labor in 1937.

The Rouge Factory is still operating (Ford pickup trucks are produced there), but the American car industry appears much less gallant than it used to be, as the burden of legacy costs, cash-flow uncertainty and declining credit ratings extract a heavy toll on the Big Three.

And yet, paradoxical as it sounds, the outlook for the sector is far from negative. A combination of cyclical and structural factors points to a rather robust car sales in the years ahead. Gains in personal income and an improving labor market will support short-term sales, while the long-term picture is brightened by at least three elements:

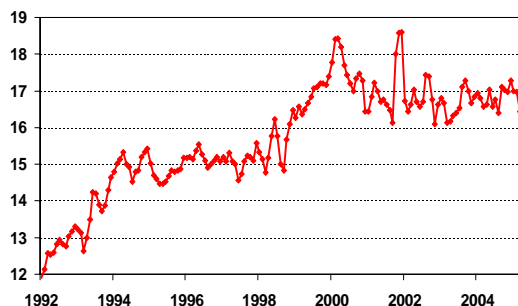
1. The fleet of vehicles on the American roads is ageing. It is estimated that more than 100 million existing cars were manufactured before 1996, and many will soon reach the time of scrappage.
2. Growth in population and the rapid expansion of suburban areas create very favorable market conditions.
3. Adjusted for inflation, vehicle prices have been steadily declining over the years.

Nonetheless, the automotive industry faces major challenges. In one sense, car makers are victims of their own marketing success. From "0% financing" to "employee discounts for everyone," a variety of incentives have kept showrooms crowded, but also created

the buyer's expectation that discounts and special financing are here to stay. Whenever dealers attempt to return to sticker prices, sales drop dramatically.

Total Vehicle Sales

millions of units, 3-month moving average



A second concern is the changing mix of vehicles that are being sold. Demand has drifted in favor of large cars and "crossover utility vehicles" (cars that include many SUV features built on a sedan platform), with traditional SUVs losing ground. This is a problem for the Big Three, because SUVs used to be the most profitable vehicles produced in Detroit. Foreign manufactures also appear to have an edge in making the models currently favored by the market.

Despite these challenges, American producers still offer some vehicles which lead their respective categories. The current problems at the Big Three have more to do with cumbersome pension and health costs inherited from the past. Discussions between management and labor on these topics are at hand; while fisticuffs are not expected, the talks will certainly be very difficult.

During my visit to the Rouge plant, I could almost sense that the themes of seventy five years ago are still being played out today. In Detroit, high achievement in production has often been diminished by difficult labor relations. All assembled hoped that the summer's discussions would lead to a happy new model year.

-- Adolfo Laurenti

ARMed and Dangerous

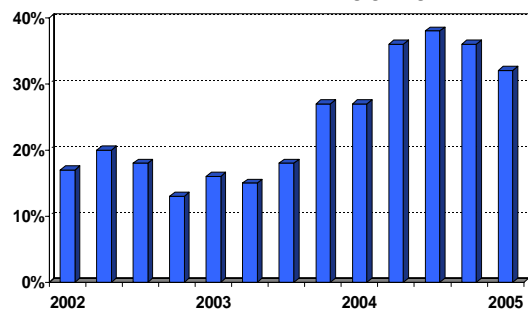
One of the more effective battle strategies is to cut off your adversary's food supply. This has proven especially effective with my son, whose love of ice cream provides an effective lever to promote the cleanliness of his room.

The Federal Reserve is employing similar tactics in its ongoing effort to cool the U.S. housing market. Having failed in its PR campaign to take some steam out of the "froth," our central bank is looking at the elements which contribute to the foam.

Among them are new forms of adjustable rate loans (ARMs) whose costs start low but move upward over time. Some carry an especially low introductory rate, and others allow borrowers to pay only principal. These attractive terms have helped to make ARMs quite popular over the past year, even though short-term rates have been rising.

Floating to the Surface

ARMs as a Percent of Total Mortgage Originations



Source: FNMA

Over time, though, many borrowers will see their payments jump, and learn that paying only interest at first increases the amount of principal which must be paid back in the end.

The Fed, in its role as a supervisory of banks, has warned both mortgagors and mortgagees to handle these products with some care. By controlling the ingredients which can create bubbles, the Fed is hoping to put the housing market on a diet to better long-term health.

Square Peg

On Thursday, with a surprise move, the Chinese government revalued the yuan, which will now float in a tight band against a basket of foreign currencies.

A generation ago, the United States and China took a small step towards improving relations by competing at table tennis, an effort known as "ping pong diplomacy."

Today, economic ping pong with the Chinese has been a less pleasant game. Our trade deficit with China has continued to deepen, and our Congress proposed trade restrictions on China if it did not revalue its currency, which some felt was damaging American businesses. Treasury Secretary Snow turned up the decibel level by criticizing Chinese policy in speeches and editorials.

Chinese typically don't respond well to threats, and they volleyed back that they would follow their own timetable for adjusting their currency. Exports are the main engine of growth for China, and they are keen to maintain a rapid pace of expansion. Any softening in their economy might create unrest among the hordes of Chinese workers who have fled the countryside for jobs in industry. It now appears that Chinese authorities caved in. Although, to many, a 2% revaluation is mostly symbolic, it is an important step, which will likely help US export and dent our current trade deficit.

America should nonetheless be careful what it wishes for. American consumers have benefited greatly from the flow of cheap products from China, and the revaluation of the currency will make these goods more expensive. What also gets lost in all of this is that the forces of trade keep us sharp, and that angering the Chinese may diminish opportunities for American companies to do business there. China, if pushed too hard, will restrict its exports of ping pong balls and paddles, making it much harder for us to compete with them on a level table.