Leather and Shoes: You Can Run Because of Hide

Like the rest of the world, the sight of Iraqis pounding the toppled statue of Saddam Hussein last week with their shoes transfixed me. Unlike the rest of the world, however, my thoughts quickly turned to the original 12-member Dow Jones Industrial Average and one of its constituents, U.S. Leather (preferred), an issue dissolved in 1952.

Yes, the preferred stock of a leather company ranked as an industrial titan back in May 1896. Now we have issues such as Intel. What, are you going to whack a statue with a Pentium?

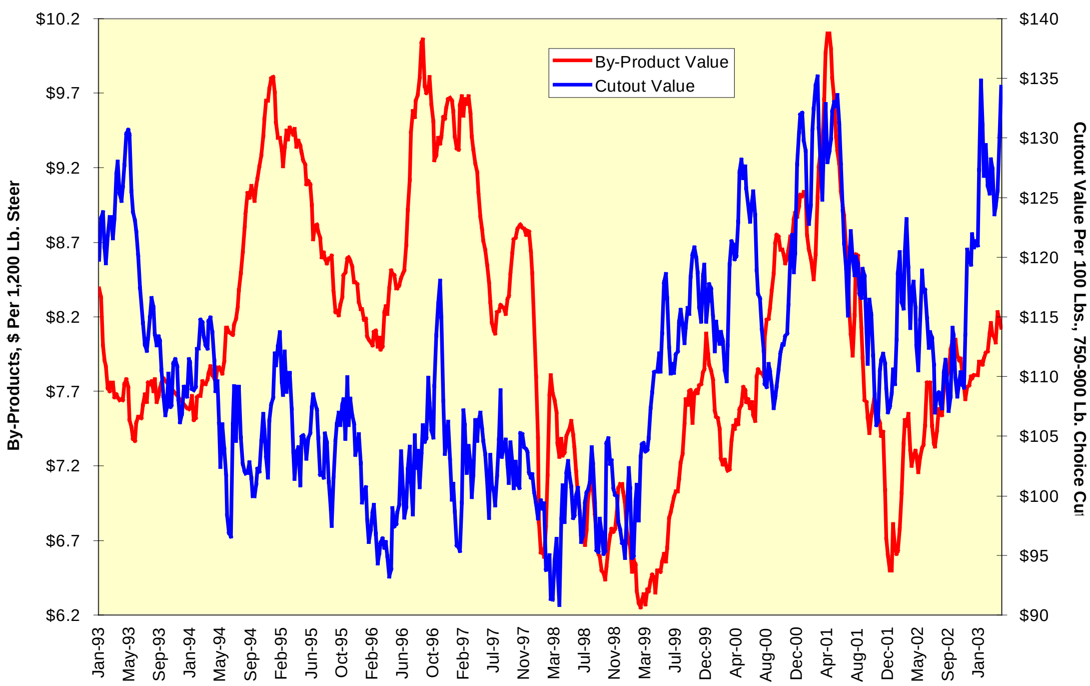
Before we get going, a sincere and serious warning to more sensitive readers is in order. Commodities are not pretty. Nowhere is this more true than in the animal and animal products markets. The memorable advertising line "rich Corinthian leather" masks some things most of us prefer to keep out of mind.

We all have heard how McDonald's breaks even on its hamburgers and depends on selling (freedom?) fries and Coca-Cola for its profit margin. Ford and General Motors have the same setup: They make no money on sedans and depend on financing, which must be a tough business with 0% interest rates. And let's not start on Hewlett Packard's profit margins for inkjet cartridges and laser toner: Not even Gillette has it so good with giving away razors to sell blades.

So it is with the economics of a slaughterhouse: You breakeven on meat for direct sale and make your money on hides and offal. Hides are tanned into leather, and at last observation, I am wearing leather shoes, a leather belt and am carrying a leather wallet and attaché case. Offal encompasses items such as cheek meat, (like bologna?) head meat, bloodmeal and bonemeal, edible tallow for making those freedom fries, bleachable tallow for soap, hearts, livers, tails, tongues, lips, inedible lungs (there are edible lungs?) and for our friends in old Europe, tripe.

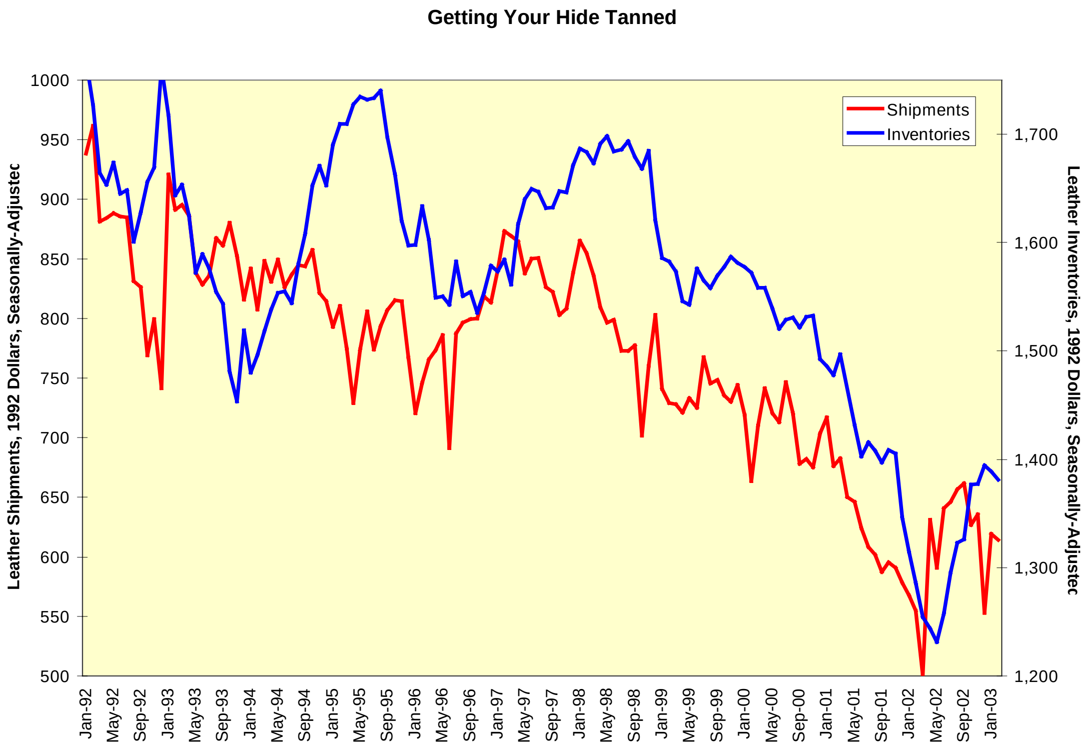
At present, the total by-product value of a 1,200-pound steer is $8.10. The same steer's value per 100 pounds as boxed beef, the cutout value, is just under $135. For a typical 750-900 pound cutout, the by-products represent between .65-.80% of the cutout value before all of the packer's costs are netted.

The Good, The Bad And The Ugly



A Postponable Non-Durable

Shoes, as Imelda Marcos would no doubt attest, can be accumulated in any quantity. Like goods such as wine, olive oil or luxury cars, they'll let you pay as much for a pair of shoes as it takes for you to feel good about the purchase. But if shoes or other leather goods such as sofas and chairs, coats and belts can be accumulated, their purchase can be postponed as well.



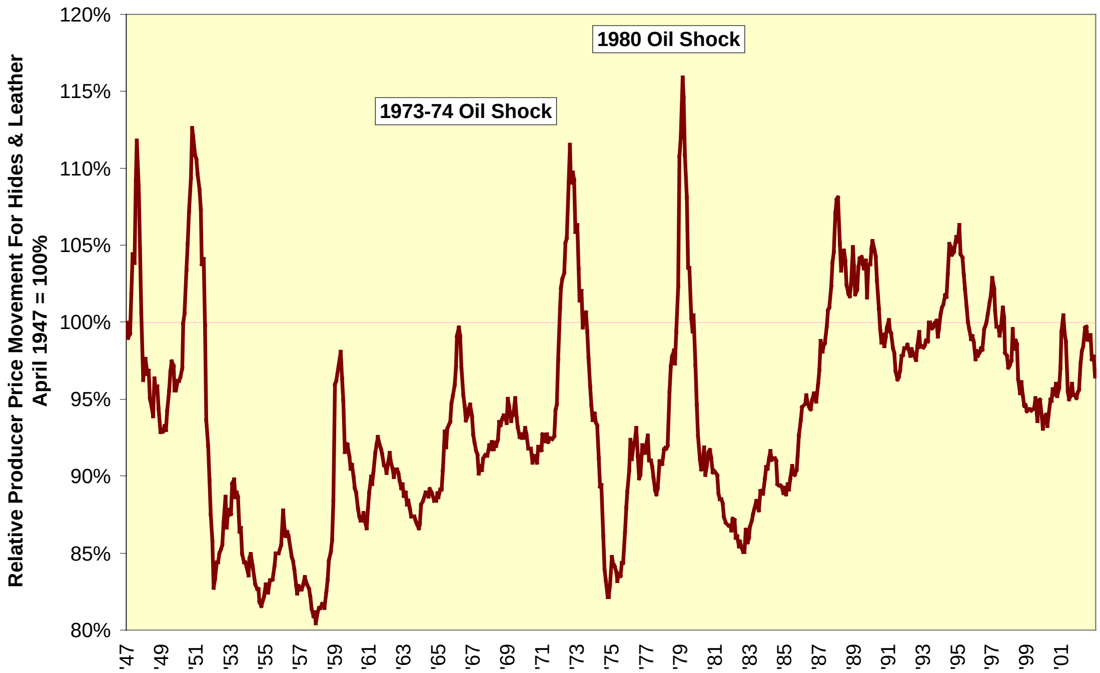
You might think that the shipments and inventories of leather goods might track the growth of the population, plus-or-minus some adjustment for national income levels. But these two series have some definite trends; inventories of leather goods fell by 27% between November 1998 and May 2002, and the latter phases of the inventory reduction resemble the chart of a market crash. In fact, the odd combination of inventories falling along with shipments suggests that less leather was being produced and consumed.

If there ever was a wealth effect from the bull market, it manifested itself in big homes and huge SUV's, not in collections of wingtips, oxfords, loafers, pumps, flats, cowboy boots and stiletto heels. The opposite does not hold, however: The crash in leather coincided with the worst phases of the bear market, and that suggests people were economizing feet first.

Price Cycle Puzzle

The long-term price histories of many basic materials industries have patterns consistent with and explained by investment cycles in that industry. Not so for hides and leather: The two oil shocks not related to either war with Iraq produced faster producer price increases in hides and leather than for general producer prices. Tanning, to the best of my knowledge, is not a particularly energy-intensive industry, and while I could joke that higher gasoline prices force people to walk more and wear their shoes out, I do not think that is at all demonstrable. This simply may be one of the better examples of spurious correlation ever in economic data.

A Little Bit of Sole



In An Oil Rush, Sell Shoes

Leather prices by themselves, as is the case for so many other basic commodities, are a relatively small component of their final goods' price. The two largest U.S. footwear stocks, Nike and Reebok, which together account for 82% of the weight in the 7-member S&P footwear index, are famous for athletic shoes, not for classic leather shoes. The remaining five firms in the index are Timberland, Wolverine World Wide, Brown Shoe, K-Swiss and Stride Rite. Much of the manufacture in the footwear industry occurs in China, Indonesia and other low labor cost locales, and marketing expenses eat up much of the remaining cost structure for these firms.

Still, footwear is going to be around for as long as we have feet, and that is something for those who fancy themselves long-term investors to consider. Over the past five years, the S&P footwear index has outperformed the S&P 500 by 38% on a total return basis, recession or no recession, higher or lower leather prices.

The late Armand Hammer of Occidental Petroleum loved to tell the story of how he persuaded Lenin to give him the pencil franchise in the new Soviet Union; his logic was that the Bolsheviks would want to emphasize education and that students would need pencils.

The same logic might apply in Iraq: Oil and construction firms have high political profiles and long payback periods on their investments. Nike can get in, plaster a few swooshes on all those newly-empty billboards, sell a few shoes and have a limited downside on exposed capital equipment. Besides, they have spokesmen like Tiger Woods, while Halliburton has Vice President Cheney. You choose.