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## *High Cost of Raw Materials*

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### **Surging Prices, Fueled by Emerging-Market Demand, Hit Profits and Consumers**

An unrelenting rise in the cost of raw materials—largely driven by mounting demand from Asia—is cutting corporate profits, hitting stocks and, in some cases, pushing up consumer prices.

One glaring example is the sky-rocketing cost of rubber, a major tire component, which has climbed nearly 74% this year after rising 92% in 2009. Industry analysts and some tire makers, including Goodyear Tire and Rubber Co., in Akron, Ohio, and Bridgestone Corp., in Tokyo, have warned investors about a potential hit to profits.

Rubber prices have risen 74% this year, and lumber is up 59%. Above, tires for recycling in Toyama, Japan, and, below, lumber in Huaibei, Anhui, China

A similar concern faces firms that buy other rapidly rising raw materials. Palladium, which goes into car exhaust systems, is up nearly 39% this year, potentially boosting costs for U.S. car makers as they seek to emerge from their slump.

Lumber, a major cost for home builders, is up nearly 59%. Analysts at Raymond James lowered their ratings on three home builders last week, in part citing “surging lumber costs.”

Iron-ore prices also are rising, while oil and copper prices have tacked on to last year’s huge gains.

Data on producer prices released by the Bureau of Labor Statistics on Thursday shows how rapidly the pressure on corporate America is mounting. The producer-price index showed that crude goods such as iron ore, construction sand and pulp shot up 44.5% year-over-year, the fastest rate since 1974. Including energy and food costs, crude goods prices rose 33.4

The impact of the higher costs is being disproportionately felt by developed countries with struggling economies and lower growth prospects.

Emerging-market countries, which are fueling the rising demand, can better absorb price increases because they are expanding faster.

In many ways, it is a reflection of the changing power toward emerging economies and away from developed nations like the U.S. and Europe.

“The rest of the world is simply not waiting on the U.S. and Europe to fully get their acts together,” Douglas Porter, an economist at BMO Capital Markets, wrote in a recent research note. He likened the U.S. and Europe to a “plodding tugboat” and Asia to a “super-charged cigarette boat,” and called them “two ships passing in the night.”

Rubber’s rally is driven by booming demand in China, where car sales rose 56% in March compared to a year prior, according to IHS Global Insight, as well as elsewhere in Asia. The moribund U.S. car market also shows signs of recovery, though sales are still down sharply from their peaks before the financial crisis.

Supplies of rubber also are tight, largely due to wet winter weather in major rubber-producing nations in Southeast Asia, such as Indonesia and Malaysia. If improving conditions lead to greater supplies, rubber prices could drop later in the year.

Tire makers, meanwhile, are still reeling from the sharp drop in sales that began as the economy weakened in the financial crisis. Tire shipments in the U.S. plummeted 21.1% from 2007 to 2009, according to Modern Tire Dealer, a trade publication.

Goodyear raised prices up to 8% on some tires last week, citing higher raw material costs, and rivals have done the same.

"I make tires for people, so I charge them more money," said Morry Taylor, chief executive of Titan International Inc., which supplies agricultural equipment. "You pass it through."

Yet charging consumers more is a risky strategy with unemployment hovering near 10% in the U.S.

"What could be a worse market for doing that than the one we currently have?" said Sean McAlinden, chief economist at the Center for Automotive Research in Ann Arbor, Mich.

Bridgestone said in February that pricier raw materials would shave 141 billion yen (\$1.5 billion) off 2010 operating profit. Now it thinks that estimate was too low.

"We think the impact will be larger," said Kaoru Tomizawa, a Bridgestone spokesman.

"It's difficult to pass it on to the customers," said Mr. Tomizawa, who said the firm will first try to cut costs internally, "then decide what to do while considering the trend of the market and business environment."

Higher commodity prices also may be acting as a drag on share prices. While the Dow Jones Industrial Average is up 6.8% this year, Bridgestone's shares are down 5% and Goodyear's are up 2.8%.

Meantime, home builders are facing rising costs, even as the industry tries to claw its way back from the housing slump.

The gains in lumber prices have added about \$2,400, or 1.1%, to the price of the median home, according to the National Association of Home Builders.

In a recent presentation, Raymond James analysts concluded that higher lumber costs could shave as much as 3% to 4% off home-builder profit margins unless they pass the costs on to customers or found some other way to reduce expenses.

Raymond James reduced ratings on M.D.C. Holdings Inc., to "outperform" from "strong buy," while cutting Lennar Corp. and Ryland Group. to "market perform" from "outperform."

Lumber costs, as well as the prospect of higher mortgage rates and other headwinds gave the analysts enough pause to "raise the yellow caution flag," they wrote in the report. — Miho Inada of the Tokyo bureau contributed to this article.

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## Notes

<sup>1</sup><http://online.wsj.com/article/SB10001424052748704830404575200530701532768.html>