MetalsOutlook™ July-August 1996

Welcome to Metals Outlook™ July-August 1996

Lewis A Weiss
Publisher
Comments to Publisher: publisher@steelforge.com

All Metals & Forge Group, LLC
330 Changebridge Road
Pine Brook, NJ 07058
USA

Phone: 1.973.276.5000
Fax: 1.973.276.5050
Toll Free: 1.800.600.9290
http://www.steelforge.com
E-mail: info@steelforge.com

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I. COVER STORY

The economy in general is showing fresh signs of durability.

The metalworking economy, in particular, is showing surprising toughness. While the manufacturing sector may have lost a little steam, it still reminds us of a tortoise's pace - forward movement at a slow and steady gait, and it appears that the long-running inventory correction by end users and distributors has ended. In our report, we will detail the latest economic and metalworking indicators; then we will present a midyear review and outlook for metals.

The manufacturing economy in the middle of 1996 is surprising the odds makers. Peter Jaquette, a Senior Economist at the WEFA Group economic consulting firm, tells MetalsWatch! the current pace of the 5-year-old expansion is moderate. Then, he adds, "Moderate may be too slow a term to describe the current rate of growth in the economy." He emphasizes that, "The economy isn't in a boom," but then adds, "It's growing quite well."

White House Economic Advisor, Joseph Stiglitz, speaking to Purchasing Magazine editors after a recent business conference at Boston College, says that, "All the indicators of the economy are very robust." Stiglitz believes metalworking especially, "Is poised to continue to grow rapidly" in coming months, and there are hard facts to back up this midyear optimism.

The government now says the economy grew at a 2.3% annual rate in the first three months of the year. Many economists expect that growth rate to increase to between 2% and 3% in the second quarter. Factory prices grew slightly in May - which is a sign of cost pressures at the manufacturing level - but Economist Marilyn Schaja at Donaldson, Lufkin & Jenrette Securities, says that, "The kind of economic growth we've been seeing shouldn't reignite inflation. Ideally, what you want to have is 2% to 2 1/2% to 3% rate of growth, because that's not going to trigger real inflation."

A new series of economic reports have just been released which show improvement in future economic activity, strength in construction activity, sustained health in manufacturing, strong consumer buying, and low inflation. In general, the data available to us in mid-June still suggests the U.S. economy is rolling along nicely. Here are some details:

First, the Conference Board, a private research group, shows its latest Index of Leading Economic Indicators rising for the past three months. This leading index is designed to forecast economic activity 6 to 9 months in advance, and 3 consecutive moves in the same direction historically have proven accurate. The latest results, therefore, suggest the economy still will be expanding during the November presidential elections.

Second, housing sales has now risen for two straight months - even with rising mortgage rates, which make purchases more expensive. The Commerce Department says spending on residential, nonresidential and public projects are running at a seasonally adjusted annual rate of more than $552 billion. Spending on single-family homes at a $156-billion-rate was the highest level since the summer of 1994. Spending on apartments and condominiums, at a $22-billion-rate is the highest since the summer of 1989. Nonresidential spending also is up, especially for hotels, motels, and office buildings.

Third, the latest monthly survey of purchasing executives by the National Association of Purchasing Management shows manufacturing is right around 50%. "This is a reasonable level for the purchasing index which doesn't suggest a boom," WEFA's Jaquette points out, "But it also doesn't suggest a major retrenchment either." In fact, the latest NAPM manufacturing report shows lowered backlogs for orders and inventories of materials - and not a drop-off in demand for manufactured goods. On the plus side, it actually shows an increase in production and new orders for factory goods. Note this question: Just how weak can orders for durable goods be, when the backlog this quarter remains in excess of $166 billion?

Tom Hoenig, President of the Federal Reserve Bank of Kansas City, says "The overall North American manufacturing economy's recovery in April and May makes a point. It proves the continued underlying strength of the manufacturing economy - even after the bad weather and the GM strike of the first quarter." As you recall, General Motors' North American operations were virtually shut down during an 18-day strike in March at two brake plants. Hoenig says that "Since the strike ended, metalworking has bounced back and the outlook for the rest of the year remains as solid growth."

He's probably right. Just look at automotive. Four-month sales by the 22 domestic and foreign automakers who sell in the U.S. have risen by 6.3% from last year to 6.4 million cars and trucks. U.S. car sales through May were up 1.6% at 3,700,000 units. Truck sales were 7.1% higher at 2,750,000 units. Note that car and truck sales for just the Big Three automakers were 3.9% higher at 4.8 million. This has prompted Chrysler's Chairman, Bob Eaton, to predict that U.S. auto industry sales will remain strong for the next two years at least. Speaking to Purchasing Magazine at the recent dedication of the new Chrysler World Headquarters in Auburn Hills, Mich., Eaton says he has raised his 1996 U.S. auto industry sales forecast to 15.4 million cars and trucks. "We are very positive through this year and next," Eaton says. Predicting a rosy future, Eaton adds: "We think what we're into is a very steady and sustainable growth period right now." He projects that 1997 sales will equal 1996 results, and note: As if to back up this optimism, the Big Three have just announced they will boost production of light trucks in the second half to meet expanding orders from motor vehicle dealerships.

Then, look at machine tool orders. Sales of machine tools of $1.8 billion are more than 6% higher than in early 1995. Since year-to-date orders have been so robust, industry insiders foresee even greater demand ahead. These tools are long lead time pieces of machinery used to cut, stamp and assemble components for all kinds of products. So, machine tool orders are a barometer of the broader health of the industrial economy. If demand is good - as it is right now - it means metalworking CEOs are confident enough about future demand that they will be replacing or refurbishing factory equipment.

Keep in mind that year-to-date major appliance manufacturing is running ahead of forecast, and probably will close the year at a 2-3% growth level of 54 million units, and there is no indication of a dramatic slowdown in demand for large in-plant machinery or off-road equipment. Atop all that, aviation and aerospace production appears to have come out of a five-year nose-dive.

So, when you put these mostly positive metalworking reports together, the metals-demand outlook is pretty positive for the rest of the year. Buoyed by strong durable-goods sales and a decline in imported steel, North American steel making remains well above 90% of capacity. Bob Grow, President of Geneva Steel and current American Iron and Steel Institute Chairman, now expects U.S. consumption will rise 2.5% to 113 million tons from almost 111.5 million tons last year. He points out that use of auto-grade steels - both carbon and stainless - remains quite good. Stainless demand for non-automotive uses also is beginning to perk up after a rather so-so first half. The key factor in steel is those inventory liquidations by distributors and end users appears over, so second-half sales will be for production purposes.

In the first half, unplanned production problems at several U.S. mills tightened supply of hot-rolled sheet and subsequently some downstream cold-rolled and coated products. North American flat-rolled demand is described as fair-to-steady at midyear. First quarter data showed declines in most categories. That's because of the disparity of buying for production this year versus buying for production and stockpiling last year. The analysts are very confident that second quarter statistics will show some real growth in the use of flat-rolled steel products.

Few steel execs. see demand clouds on the horizon. At least not the CEOs interviewed at the recent American Iron and Steel Institute annual meeting. Dick Wardrop, President of AK Steel, for example, says that "As an industry, we're looking at an awfully good year, and I don't see any reason why it's going to stop." "That's because manufacturing is chewing up a lot of metal, exports are up, imports are down, and inventories at service centers are at the lowest levels in more than two years," comments Jim Wareham, Wheeling-Pittsburgh Steel's CEO. He, for one, sees solid second-half demand in virtually all the end-use steel markets.

Steel service centers so far this year have been shipping at an annualized rate of 26.5 million tons. "If shipments continue at that level," says Dave Roland of the Steel Service Center Institute, "It would be comparable to total shipments for 1994 and just off the record 27 million tons posted by SSCI members last year."

Spot steel prices have moved up a little this spring. After initial resistance from the marketplace, our composite of steel products rose by 4.7% in April from last autumn. They still are 7.5% below the year-ago level, so there is a chance for further hikes ahead. Because of production problems and reduced imports, supply of flat-rolled grades has tightened. So, prices probably will move up again late this summer or early this autumn. The big debate about the July price increases, however, remains "how much" they will rise and "how long" they will stay elevated. Some analysts agree with Bethlehem Steels' CEO, Hank Barnette, who sees higher prices ahead because of continued steady growth in metalworking. Others feel, however, that looming new sheet capacity will remove upward pressure on prices. Only time will tell which camp is right.

Looking at aluminum, another key production metal, analysts point to heavy demand from transportation industries, particularly aviation and aerospace, and other durables. It's true that first quarter consumption of aluminum mill products dropped to 3.5 billion pounds from the 3.9 billion pounds shipped in the same period of 1995. Shipments of sheet, plate, extruded shapes, tube, and forgings all showed a decrease. However, Aluminum Association forecasters still suggest full-year U.S. use of the same 14.8 billion pounds of 1995. The optimism stems from a belief that inventory liquidation of aluminum also has come to an end. (It doesn't hurt that prices are lower than last year.)

Then there's the 1996 use of the superalloys and titanium. Spurred by a reawakening of new jetliner manufacture, the use of these specialty metal products is cruising at high levels. Expected 1996 U.S. use of 140 million pounds will be the highest in seven years. However, previous downsizing of capacity has caught suppliers in a supply bind. Delivery lead times for some key superalloys are out by more than a year. Aggravating the supply problem is the successful development of such new markets as sporting goods. All this is happening even though superalloys, as a group, cost 23% more than they did 18 months ago.

II. METAL CHIPS

Evolutionary changes have transformed the North American metals distribution industry into a globally competitive materials supplier.

These changes are impacting the supply chain from the mills, through distribution, to end users.

Metal service centers supplied more metal to manufacturing last year than ever before: almost 59 billion pounds of steel and nonferrous metal, or more than 35% of all the metal chewed up by metalworking last year. In fact, most 1995 shipments by metal centers set records. 28.4 million tons were shipped by members of the Steel Service Center Institute and the Association of Steel Distributors. Almost 1.1 million tons by members of the National Association of Aluminum Distributors; and close to 600,000 tons by Copper and Brass Service Center Association members. Now, looking at 1996, forecasters still see at least 59 billion pounds worth of metals sourced through distribution.

The steel distribution industry's shipments in all product categories performed at a slightly lower level than expected in the first quarter. However, business appears to have perked up this quarter primarily because of unexpected high demand from the housing, automotive, and construction segments. Steel service centers so far this year have been shipping at an annualized rate of 27.5 million tons. If shipments continue at this level, the full-year total will be comparable to total shipments for 1994 and just off the record 28 million tons posted last year. Similarly, market observers think aluminum service center will rise 3% this year to 21.8 billion pounds.

However, buyers are telling the editors of Purchasing Magazine that distributors must still address certain issues to better serve metal buyers. The Top Five are: (1) Place greater emphasis on customer needs and service demands; (2) Develop stronger strategic relations with mill suppliers; (3) Improve the quality of the processed metal being distributed; (4) Develop low-cost, value-added services; and (5) Reduce the cycle times between orders and deliveries.

In response, several metals distributors tell us they are coming to realize that changing their business practices along these lines can actually help increase internal operating efficiencies - and boost profit margins. That's because service centers are customer-driven enterprises and their customers, the purchasing people in metalworking, want service centers to help them drive down their costs.

This decade, the requirements of manufacturing firms have changed to rely on quick delivery of numerous small lots of specially processed metals. Many firms that once were mill customers now deal with service centers in an attempt to get their metal parts at lower total cost and higher value. That's why good and successful distributors are trying to differentiate themselves through continuous quality improvement programs, capital investments in processing machinery, enlarged inventory, and numerous forms of value-added services.

And that fits right in with the tone of the recent Steel Service Center Institute annual meeting in Cleveland, and the subject of this edition's METAL CHIPS segment. At the sessions, there was a lot of discussion about the evolutionary changes that have transformed the North American steel industry into a globally competitive materials supplier. There was also quite some dialogue about the revolutionary changes impacting the supply chain from the mills through distribution to the end-use buyers.

At one key session, Dave Hoag, the CEO of LTV Steel, and John Mayberry, the CEO of Dofasco, commented on their views of the future supply chain. First, let's hear from Mayberry's discussion on the changing steel marketplace, and how service centers should react.

"We said that for years. Then we went out and tried to get more tons through our equipment. If costs went up, so did prices. Stay with that approach today, and you might as well put a gun to your head. So our approach to our customers has to be seeing the world through our key customers' eyes. Our focus, and this applies equally to Gallatin Steel, our mini-mill in Kentucky, is totally customer driven.

We want to create win-win situations. And one way of achieving that is to work with our customers, including steel service centers, to form mutually interdependent relationships that will be very tough to beat and very tough to penetrate. Win-win relationships have to develop with all of our stakeholders, including our suppliers, because if we don't delight our customers and our shareholders, we have nothing. So we'll do whatever it takes because those are the key elements.

I agree with those who think we're in a period of transition where the relationships between the mills, the service center-processor, the OEMs, and ultimately the consumer link - the car or the appliance are shifting. And don't ask me where's it going to end up because I don't know.

If you're not already in the business of adding value, then you need to be. If you already add value, then maybe you should be looking for ways to add more. I don't think the future's very bright at all for anyone who pursues a buy-low, sell-low policy. The future belongs to those who buy value and add incremental value to delight their customers.

One thing that it does is move you away from a commodity business. Another implication is that the winners will be those who truly understand the value chain and how to add value within it - and who understand the need for and are prepared to change to new relationships between the three main elements of customers, service centers, and mills."

The Steel Service Center Institute conference also heard Dave Hoag's vision of this pending marketplace revolution.

"The real revolution, I don't think, will be centered in technology, although that will certainly be a part of it. But I think the business relationships and the way you and I do business with our customers is where the revolution really is - and that includes steel makers, service centers, processors, and converters, and how we interact to provide total satisfaction to our end users.

Today, we as steel makers must be involved in everything from our customer's product design to the performance of the steel on their production line. Service centers, as you know better than I, are expected to add value by providing pre-production processing and, of course, just-in-time delivery. And, in my opinion, this is just the tip of the iceberg. Manufacturers of all types are concentrating their resources and attention on what they consider to be their new buzzword, core competencies.

Many manufacturers are looking for ways to transfer component manufacturing and blanking (stamping) operations to outside suppliers, as you know, which then free themselves to concentrate on design, assembly, and marketing. Certainly, your industry, as service centers and processors, are responding to these needs by expanding your blanking and processing businesses.

In the near future, we expect our customers to require materials suppliers to become more involved in component supply. Not just steel. This change will create a real revolution. And I think a rare opportunity for us all.

Strategic alliances will increasingly be developed between materials suppliers, converters, processors, service centers, and independent metal-forming or manufacturing firms to provide new levels of value-added services to the manufacturing community. The alliance is the perfect form of response because no single company is likely to be in a position to invest in an entire new line of business. And because of the rapid rate at which change is occurring, alliances can be formed, dissolved, and reconfigured to respond to our ever-changing customer needs."

As you've probably gathered from these comments, there's a lot of change ahead in the metal supply chain. In fact, Hoag went so far as to suggest that "We're standing on the threshold of a new age in steel."

III. PURCHASING FOCUS: The Internet

Everybody knows about it. But, it may be that buyers need a push from suppliers to use it for electronic commerce. That's because purchasing professionals remain skeptical about using the web for electronic commerce.

The Internet is growing by leaps and bounds; as Purchasing Magazine said recently: "The world is going ga-ga over the World Wide Web." Even Purchasing Magazine is going on-line in July. But, suppliers have a real job ahead of them in exploiting the usefulness of the Net and it's more than just putting lists of goods and services on the Web. Many purchasing pros aren't quite ready to trust it for electronic commerce.

Purchasing Magazine's Elena Eptako Murphy talked with numerous buyers at the recent National Association of Purchasing Management meeting in Chicago. She found many buyers expressing deep concerns about the dangers of doing business on the Net. They're not giving up on the technology. In fact, they are gearing up to use the Internet as a tool for gathering information. Purchasing personnel who have access to the World Wide Web indeed are finding new suppliers and products.

But, conducting cash business on the Net? Well ... that's another story.

The magazine recently surveyed a wide sample of its readers about their use of cyberspace. Of those already using the Net, 30% already use it to research potential suppliers. About a quarter of the use is to find out what else a supplier has to offer, to obtain technical data about parts or materials, or to keep abreast of technology trends. Almost as many use it to communicate with suppliers via e-mail, or to check out supplier financials. But only 12% use the Internet to conduct legally binding purchasing transactions.

One potential problem for buyers is verifying the credibility of the source posted on the Net. Another potential problem is financial and transactional security. The advantages of electronic commerce are speed and reduced paperwork. However, at present, there is no fail-safe way to conduct financial transactions over the Internet. Nor is it yet 100% possible to keep hackers from reading or copying information on the Web. Also, according to buyers who have tried using the Internet for business, complex negotiations can't be conducted as well yet as in face-to-face, or at least, phone-to-phone conversations.

Proponents of the Internet contend that the Net is just an imminent evolution of today's business transactions via EDI, or electronic data interchange. After all, with hundreds of thousands of Web pages already available to the point-and-click generation, there's a wealth of information out there. But, for now, it's an unexploited tool that suppliers will have to market with some vigor.

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