MetalsOutlook™ August 2002

Publisher's Statement

This Summer is Sluggish!!!

We are being told by customers and metal suppliers alike that this has been a very slow summer. So far, and still looking at August to save us all. Don't count on it! The good news is that the same doomsayers are predicting that September through November will save the year. Lets keep our fingers crossed. So, lay back, enjoy August and gear-up for the "busy" fall months.

Welcome to Metals Outlook™ August 2002

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Tom Stundza's Comments

As the United States celebrated its 226th birthday in July, latest production, employment, and income statistics proved that this year's economic improvement continues to be lackadaisical. Call this "the spotty economic recovery." Key indicators like productivity and factory orders are on the rise nationally. Even unemployment has dipped slightly last month. But those numbers haven't yet translated into an economic rebound in many metro areas. Reason: The battered financial services, high-tech, manufacturing and telecommunications sectors still are in a slump. Eventually, that segment of the economy will come around-but probably not until next year.

The Economic Cycle Research Institute's weekly index shows there is evidence of some growth now in the U.S. economic recovery. Jobless claims have trended downward since the end of the first quarter, indicating more stable labor market conditions. Wage and salary growth for the employed remains strong, as payrolls have risen for the last two months now. Low interest rates continue to fuel brisk purchasing of homes and autos. Sales of new and existing homes are buzzing along at record pace, according to just-released May figures. The flood of mortgage applications, furthermore, shows no sign of abating, suggesting home sales will continue to bolster the economy coming months. Also, orders for durable goods have risen for five of the last six months. In fact, just before the Independence Day holiday, the government's report on May factory orders showed that purchasing improved for the third straight month--suggesting that the manufacturing industry continues to recover slowly from its previous period of contraction.

Tentative growth in orders for durable goods has boosted metalworking activity by all of 2% since the end of last year. In fact, the rate of expansion by metals-consuming companies has slipped for two consecutive months, according to business survey data collected by Purchasing Magazine. That explains why there has been such a lackluster increase in steel and nonferrous metals buying in 2002. Surveys show that since the pace of manufacturing recovery is modest, metal-buying plans have slipped for three straight months and anticipated steel-purchasing activity may even decline this summer. Buyers have stopped slashing metals inventories, but don't want to expand in-plant stocks this summer. Overall, fewer metals buyers polled in June plan to boost purchases in coming months because of growing continued slow growth in U.S. manufacturing. We'll see how this relates to steel.

And, finally, in this MetalsWatch edition's Purchasing Focus, we'll discuss why increased competition and a focus on core competencies will continue to drive the need for strategic supplier alliances in 2003 and beyond. Supply managers want to focus on those activities that provide a competitive advantage. However, as outsourced activities increase in magnitude, the potential for risk can also increase, particularly if a limited number of suppliers are used. Therefore, more integrated, high-trust, mutually beneficially relationships with suppliers are required.

I. Cover Story: The economic recession of 2001 was the mildest on record

The economic recession of 2001 was the mildest on record. The recovery, however, will be just as mild. In fact, it won't really be noticeable until next year. U.S. economic growth turned out to be slightly positive in the fourth quarter of 2001, thanks to strong spending by both consumers and governments. Thus, the "recession" contained only one quarter of negative growth in Gross Domestic Product. A stronger than expected upward revision to first quarter GDP figures late in June has shown the economy grew a stunning 6.1% annualized rate in the first quarter. An upward revision to business investment in equipment and software - yielding the first quarter of positive growth since the third quarter of 2000 - was responsible partly for the rise in topline growth. Many economists believe the first quarter's GDP will be the strongest quarterly growth rate of the year. Manufacturers were busy in those three months pumping out goods to replenish depleted inventories in the nation's warehouses and store shelves. Once the first quarter's inventory-liquidation boost is stripped away, economists say the economy will show a more moderate, but still sustainable, recovery--capable of generating a 2.5% growth rate for the rest of the year.

The Conference Board's index of Consumer Confidence dipped in June to a reading of 106 from 110 in May. In fact, the reversal erased the gains of the previous three months. Both the present conditions and expectations components fell as consumers gave business and labor market conditions weaker assessments. So, the unanswered question is: Will consumers and business continue to buy those goods, thus creating sustainable demand that can lead to more output, more hiring and more spending? Our view is that sales will grow by less than 2% this year, and then rise to a real healthy 3.5% in 2003. The recession was led by a sharp decline in business investment. There was double-digit growth for eight straight years from 1993 to 2000, but shipments of core capital goods have declined for the past 15 months-so that investment in 2001 and early in 2002 has been pushed down nearly 9% from its peak. Some economists and Fed Chairman Greenspan suggest there will be single-digit growth this year in spending on equipment and software. The consensus forecast, however, is much more skeptical-falling by almost 3% again this year, followed by solid growth next year-maybe even as high as 9.5%. Profits are key to investment. Only when companies see profits improve, will they start investing again.

Some good news is that business productivity in the first quarter grew at its strongest pace in 19 years. Productivity, a key ingredient of the economy's long-term vitality, grew at an annual rate of 8.4% in the January-March quarter after a strong 5.5% productivity growth rate posted in the fourth quarter of 2001. The big productivity gain in the first quarter came at a price-as businesses cut back on their payrolls. But, in the long run, productivity gains are good for workers, for the economy and for companies whose profits took a hit during the slump. Gains in productivity allow companies to pay workers more without raising prices, which would eat up those wage gains. And, productivity gains permit the economy to grow faster without trigger inflation. For all of 2001, productivity grew by 1.9%, a slowdown from the 3.3% gain posted in 2000 but still a respectable showing given the slump. Federal Reserve Chairman Alan Greenspan has said he remains bullish about the long-term prospects of productivity growth. He and other economists have suggested that the strong productivity gains seen in the late 1990s weren't just a passing fluke related to big investments in productivity-enhancing computers and other high-tech equipment. Rather, those gains may reflect fundamental management and structural changes at companies.

And that may explain why the recession in manufacturing officially ended so quickly. The Fed's manufacturing index bottomed in December of 2001 and has been creeping forward ever since. The industrial sector appears poised for longer-term consistent growth. Until the recovery is firmly established, though, manufacturing won't really revive until the end of 2002 or the beginning of 2003. Economists at DRI�WEFA expect this manufacturing index to rise very slowly in 2002. This admittedly quite modest forecast is based on the fact that it will be tough to recover from the manufacturing contraction of 2001 and the recovery is not a sure thing. The strength of the rebound could quickly dissipate if consumer confidence plunges or energy prices skyrocket; all it would take is another major terrorist attack at home or an escalation of war unfavorable for the U.S.

A crucial issue for the durability of economic growth is whether there will be sustained strong demand for factories to build up inventories and move more product to market. Monthly shipments of manufactured goods have increased by just 2.3% since the close of 2001. And the monthly rate of new orders has risen by just 2.8%. So, there still is uncertainty about the real strength of the manufacturing recovery, and that's why manufacturers remain cautious. While they are extremely eager for a recovery, they do not want to be caught with excess stocks if the economy double dips. The production of machinery-from food preparation equipment to semiconductor fabrication equipment, and everything in between-has fallen victim to the reduced capital spending by business. Assembly and delivery leadtimes often are long, so even a pickup in orders in 2003 won't be reflected until 2004.

Still, the Institute of Supply Management's diffusion index rose slightly in June to 56.2. Readings above 50 indicate expansion of activity in the manufacturing sector, while readings under 50 denote contraction. Production-related indices were mixed in June, with the production indices rising and the new orders and backlog of orders indices slipping. Also slipping a little was the index of buying plans. Still, with all of these forward-trend indices well above 50, manufacturing's prospects for continued growth are positive. The ISM data for June is the fifth consecutive month suggesting that manufacturing industry has expanded. The more volatile Purchasing Magazine diffusion index is 58.8, which also suggests that manufacturing activity is expanding at a modest pace. But, the survey of buyers also suggests activity isn't as strong as in April or May-which is an interesting finding since most buyers think carbon steel sheet prices will keep rising this summer.

Domestic carbon steel mills have shuttered nearly 16 million tons of annual capacity. The Section 201 tariffs imposed by President Bush have depressed supply of foreign steel. And traders say the earliest they expect import supply to rebound is the fourth quarter. So, it's no surprise to find the metals buyer for a stamping company in Michigan saying: "Steel has become a major headache because of the tariff situation, which has caused higher pricing, 14-week leadtimes from the mills, and some shortages." In fact, sheet steel markets are expected to continue experiencing supply tightness into the cooler-weather months.

II. Metal Chips: Purchasing Magazine's market basket of eight carbon steel products is 23% higher than early March

Purchasing Magazine's market basket of eight carbon steel products is 23% higher than early March--before the Section 201 tariffs were imposed. Hot-rolled sheet steel, the benchmark product for the market in terms of pricing, now has risen 62% in cost to about $340/ton--versus $210 at the end of 2001. Some analysts have suggested that the pace of price increases in the U.S. appears to have slowed, but early surveys show that July deliveries of hot-rolled sheet will cost buyers around $380.

Now, Commerce Secretary Donald Evans and U.S. Trade Representative Robert Zoellick have demanded a progress report by Sept. 5 on how the U.S. steel industry is putting its house in order. The letter reflects growing unease within the Bush administration that steelmakers may be profiting from high import tariffs at the expense of customers with no formal plans to make the painful changes needed to keep the industry healthy after the duties phase out by 2005. The White House expects the industry to use the tariff cushion to "consolidate and rationalize operations, reduce costs, enhance efficiency, increase productivity, improve quality and service, and develop new products and markets," the Evans/Zoellick letter says. If the industry is seen as dragging its feet, White House officials say the president "has reserved the right to modify or lift the tariffs." These duties have drawn fire from around the world and have stirred concern at home they will hurt thousands of companies that buy steel. Steel execs say it's still too early for the industry to show concrete changes to make the industry more competitive. Instead, they express alarm over 224 tariff exclusions already made by the administration.

Metalworking firms that use foreign steel have asked the Commerce's International Trade Administration and the U.S. Trade Representative's office for 1,200 exemptions from the tariffs as of July 15, there were 247 such exemptions thus far. ""The exclusions we are granting are the result of a complex decision-making process in which we have balanced the needs of steel consumers and producers while continuing to preserve the integrity of the safeguard measure''-that is, the tariffs," Zoellick says. Typically, exemptions are granted if the domestic industry doesn't make a mill product or enough of the products to satisfy domestic demand. Interestingly, the trade battles haven't affected specialty steel sheet products-which generally were excluded from the tariffs. However, the requests for exclusions from tariffs do include stainless steel bar, rod and wire.

There has been generally weak demand for stainless and specialty steel sheet and plate this, with sales down 18-20% so far this year. These product lines have been affected deeply by reduced demand from two large markets--commercial aerospace and electrical energy. Purchasing of stainless steel sheet and plate, silicon electrical steel, and tool steel--among other specialty steel products-have decreased. Specialty steels and alloys were flat compared to the first half of 2001. Average sales prices for finished commodity products and high-value products also decreased. Industry economists suggest that no significant improvement in demand for specialty steel and forgings can be expected until there is a sustained resumption of capital spending in their key consuming markets. However, some industrial users of specialty steel and forging products are expected to operate better-and need more materials-starting in the fourth quarter.

III. Purchasing Focus: Strategic alliances in purchasing are most beneficial

Strategic alliances in purchasing re most beneficial. In unsettled economic times such as today, strategic alliances are mutually beneficial relationships with key suppliers that allow purchasing to leverage resources. If handled properly, these alliances can strengthen competitive advantage of the supplier--or suppliers--as well.

When discussing alliances, note that they are evolutionary. There are various activities that can characterize the purchasing-supplier alliance. All of these phases or models have the goal of lower total costs for the buying group. So, when buyers discuss alliances, remember they have several key goals:

1. First, there's increased volume. The purchasing organization is able to direct more volume to a given supplier. This is usually driven by the fact that the supply manager has chosen to reduce the number of suppliers with whom to conduct business.

2. Then, there's increased internal economies. Also a result of a reduced number of suppliers, a purchasing organization will find that purchasing goods or services from the same supplier will streamline some processes, such as receiving.

3. There's also increased logistical economies. As a relationship becomes increasingly strategic in nature, transportation and warehousing efficiencies are realized. Firms make accommodations, geographically, that will streamline the movement of goods.

4. Alliances also result in reduced administrative costs. Fewer contracts, fewer invoices, streamlined billing, and automated payments are all examples of administrative efficiencies.

5. Alliances also improve processes. At this stage, the parties are asking each other, "What do I do that costs you money?" Changes might be made by either firm in terms of delivery schedules, forecasting, or

the use of alternate materials.

6. Them there are further cost reductions. Here, the parties aggressively ask, "What can we both do to take more cost out of the process?" Activities include total cost of ownership modeling and business process reengineering.

7. And, finally, alliances allow the partners to seek innovation. At this, the most strategic point, alliance firms ask each other: "In what can we jointly invest that will allow us to compete more effectively?" Solutions can include joint investment in capital structure or designing completely new products or services together.

Also, if any strategic supplier alliance relationship is to be successful, a certain level of trust and commitment must be maintained. And there are risks. Sharing confidential information and creating long-term commitments are essential. The supply manager must trust the supplier to underwrite the sourcing risk and the supplier must trust the customer to provide information to facilitate the material or service support commitment. While senior management and the supply management department may already trust the supplier, others in the organization must also be comfortable with the release of such information. Oftentimes, this is easier said than done. Engrained corporate cultures, which may have established an "us versus them" mentality, can be an obstacle. In the traditional, less strategic experience, written contracts provide a number of controls that are a substitute for trust. These controls may not exist in an alliance arrangement.

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