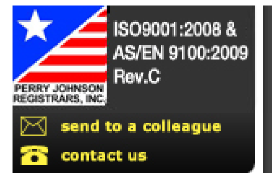

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MetalsOutlook™ February 2003

Publisher's Statement

Well the stock market didn't end well, and it is said that January's numbers are a sign for the rest of the year. Lets hope not!

The National Purchasing Manager Report for January is 53.9. This is a clear sign as to what the short term metals and metal-working environment looks like (under 50, contracting economy, over 50 expanding economy). The economy is expanding, but at a slow rate.

It looks like a slow, long recovery, but one that's better than a downturn. So sit back, take it in, and relax because that's all you can do.

Welcome to Metals Outlook™ February 2003

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Tom Stundza's Comments

This is Tom Stundza, executive editor of Purchasing Magazine. Welcome to the February edition of Metals Watch! of 2003.

All the ingredients are in place for the U.S. economy to improve at a moderate yet steady pace this year. That's the prediction from Jack Guynn, the president of the Federal Reserve Bank of Atlanta, and a large number of economists in their 2003 forecasts. But many of these experts also caution that several things have to break just right to turn the stuttering recovery of 2002 from the recession of 2001 into a sustained economic expansion of 2003 that creates jobs and profits.

"The U.S. economy is like a punch-drunk boxer, staggered by one too many blows but working to recover in the corner," says economist Ethan Harris at the Lehman Brothers brokerage in New York. "Absent new shocks, the recovery should begin by the spring or summer." But the phrase "absent new shocks" is a major caveat these days, and forecasters are more guarded than usual.

For example, Macroeconomic Advisers, a St. Louis forecasting firm, cites six items that would have to go "right" for growth to be at the 3% to 4% annual rate forecast by the soothsayers. The firm's list: The stock market must trend higher, consumer spending must remain moderately strong, business confidence will have to improve, hiring will need to accelerate, business capital spending must turn up, and war with Iraq must either be avoided or resolved relatively quickly with minimal damage to oil production and distribution facilities. All six requirements are linked, but there is an overarching uncertainty--the possibility of a war with Iraq. That prospect is hurting both consumer and business confidence because of the potential for a continued escalation of oil prices that could damage economies around the world. The possibility of other terrorist attacks on the U.S. also is a serious worry.

In the face of such uncertainties, many corporate executives are being cautious in the extreme. Heads of manufacturing firms, in particular, are holding back on making commitments to beef up inventories of raw materials, semifinished goods or finished products. They are holding back on making commitments to hire new workers. They are holding back on making commitments to increase spending on new plants and equipment. The reason? They cannot predict with much confidence where the economy truly is headed. President Bush has unveiled a new set of tax cuts, calling for a reduction of taxes on dividends received by individuals and new incentives to spur business investment. The package has been billed as a "needed stimulus" for the economy, though some economists doubt these proposals can do much to help in the short-run.

Similarly, there is much doubt when steel demand-whether carbon or stainless-will rebound. Even the bulls say late in the second quarter. Here's why. Eleven-month factory orders in 2002 were 1.1% below the tally through November a year earlier. Economists say that means that new-order recovery and factory operations won't start to show improvement until the springtime months. So, increased purchases of steel and other metals needed for industrial manufacture won't happen until June or later. This fits with recent buyer surveys, which show that metalworking activity has decelerated from earlier in 2002, and less steel is needed these days.
"Demand for steel overall remains weak because of general economic fear and uncertainty that has caused steel markets to become very lean," agrees analyst Aldo Mazzaferro at Goldman, Sachs & Co. So, we'll discuss these weighty economic and steel-demand matters in this edition of MetalsWatch!, and then we'll close with a conversation about Buying Steel Better, tips that have come from a series of buyer surveys we've done at Purchasing Magazine.

.Comments to Tom Stundza: stundza@reedbusiness.com

I. Cover Story: From Recession to Bush's $674 Billion Expansion Plan, A Rough Road to Hoe!

Despite all the caveats, most forecasters expect 2003 to be a better year economically than the last one. After all, the U.S. economy does have a lot going for it: extremely low interest rates, continuing fiscal stimulus, strong productivity growth, low inflation, very low business inventories -- and perhaps above all, a striking tendency to grow under normal conditions. Most economists expect the U.S. economy to forge ahead--with or without additional stimulus from the Bush plan--because many of the imbalances that caused the 2001 recession largely have been resolved.

President Bush's $674 billion economic expansion package includes a new tax-cutting plan, an extension of federal unemployment benefits, an immediate increase in the child care tax credit; a more rapid reduction in the so-called marriage penalty and grants to cash-strapped state governments. But, when polled to gauge their view of President Bush's previous efforts to help the stagnant economy, a resounding 70% gave him failing marks. Actually, 30% of the buyers who answered an online poll by Purchasing magazine said he's doing a good job, but the majority said he's been working with flawed economic-advancement policies, Still, 20% of the buyers hope his new economic advisers are a good start.

Still, economists note that fiscal and monetary policies are in place to boost growth. For instance, businesses cut back production so sharply in 2001 that they managed to shed the excessive quantities of unsold goods built up in the economic boom of the late 1990s. They cut back, too, on spending on new plants, equipment and software until some of the excess production capacity created by an earlier surge in such investment was absorbed. The share of production capacity actually in use is still quite low. But some observers, such as Jerry Jasinowski, president of the National Association of Manufacturers, say that's because much of the idle equipment is obsolete. Economist Robert DiClemente of Salomon Smith Barney in New York says the decline in business investment over the past two years has been so great that--even in the high-tech arena--"spending did not even keep up with the rate of obsolescence." Eventually, he says, the need for new equipment "suggests a sustained revival of capital spending growth, once businesses begin to look past current geopolitical risks."

Meanwhile, the Federal Reserve has pegged its target for overnight interest rates at only 1.25%, the lowest level in a generation. Longer-term rates, which the Fed influences but does not set, are also generally low, with those on 30-year fixed-rate home mortgages running well below 6% and some automakers still offering zero or very low-rate financing to buyers of new motor vehicles. Two other positive forces are expected to help the economy, low inflation and rapid growth of productivity, the amount of goods and services produced for each hour worked. In the 12 months ended in November, the Commerce Department price index for personal consumption rose by just 1.5%. That is so low that Fed officials believe they can lower their interest rate target without worrying about causing inflation to accelerate.
The low level of inflation is also important because it means that workers' pay has been rising faster than the prices of what they buy. This has allowed them to continue to increase their spending. The 2001 federal tax cut also boosted take-home pay. In fact, gains in consumer spending were the mainstay of the 2002 economy. Remarkably, businesses used labor so efficiently that moderate economic growth was achieved with essentially no increase in jobs. That savings on the cost of labor meant companies could increase their profit margins without having to raise the prices of what they sell. But economist William Dudley of the Goldman Sachs brokerage in New York says much of the benefit flowed to consumers instead. "Rapid productivity gains have accrued to consumers in the form of lower price inflation," he explains

In the long run, productivity gains are extremely important, because they are the ultimate source of improvements in the nation's standard of living. In the short run, however, the gains reduce the demand for more workers, which was the key reason only a handful of the roughly 1.5 million payroll jobs lost during the 2001 slump have been regained. As a result, even the optimistic forecasters predict that the unemployment rate would still be above 5.5% and perhaps close to 6% late this year.

This relatively high level of unemployment has helped depress consumer confidence and raised questions about whether households will continue to increase their spending, supporting the economy until

business investment returns in a big way. The three-year collapse of stock prices also continues to depress consumer spending. "The economic rebound has been hampered by the $5 trillion decline in household net worth since the slowdown began," says Mickey Levy, chief economist for Bank of America in New York. That effect on household wealth has so far probably held consumer spending about 3.5% below what it otherwise would have been, and the wealth loss will hurt spending this year, he predicts.

Another piece of the complex economic outlook is what is likely to happen to corporate profits, which are a significant factor in business investment decisions. As result of the recession, after-tax corporate profits fell to a low annual rate of $428.5 billion in the fourth quarter of 2001. By the July-September period of last year, they had climbed back up to an annual rate of $453.8 billion, according to the Commerce Department. A number of analysts expect them to continue to increase, but only a modest 10% or so this year. Such a gain would still leave after-tax corporate profits far below the peak rate of $573.8 billion reached in the fall of 1997.

Finally, there are two more negatives weighing on the economy. First, state and local government budgets are a disaster. This is a result of sharp drops in revenue due to the recession and the big drop in stock prices, which wiped out capital gains income for many individuals. To cope, states, which generally have to have balanced budgets, at least on paper, are cutting back spending and, in a few cases, raising taxes, and that is sure to be a drag on growth. Second, this country is likely to grow this year about twice as fast as Europe, while Japan will be lucky if it grows at all, a number of economists predict. That means the U.S. trade deficit could also be a further drag on growth, as imports increase faster than production of goods produced for export. The value of the dollar has dropped recently, but the shift so far is not great enough to boost U.S. exports or curb imports. And, if there's anything that could delay recovery in the domestic metals market, it could be a surge in imports of metalworked goods.

II. Metal Chips: Manufacturing Is Weak, Metals are Weaker

The metalworking economy clearly was improving earlier in 2002. But, as summer progressed into autumn, industrial began to struggle again--as manufacturing firms remained reluctant to expand production or to make big investments in brick-and-mortar and heavy equipment capital spending. For the year, steel consumption now looks to have dropped by an estimated 6%, falling under 100 million tons for the first time since 1995. Even with the fourth quarter slide, the 12-month rolling average for steel prices show an increase of 34% for flat-rolled products-and by 5% overall-because of punitive tariffs and reduced domestic supply in the second and third quarters.

As the year closed, buyers regained pricing leverage for rolled and cast steel products, and there's a chance of further price erosion because of a rocky start for the industrial economy in the New Year. Actually, prices for bar mill products, castings and forgings barely moved last year because commercial construction and machinery manufacture were weak. But, as the year closed, prices fell because of continued weak demand in the face of more-than-adequate supply. A few market mavens expect metal prices to increase in 2003. Their reasoning is that rising energy and raw material prices will increase as the economy rebounds, and the mills will get the marketplace to offset these costs.

Most analysts, though, reject that view and predict that spot metal prices will continue to fall in 2003--as increased domestic production and higher imports will coincide with sluggish growth in demand. Importantly, with the manufacturing sector still feeling the brunt of the general economic downturn, buyers' remain reluctant to accumulate inventory. In fact, Purchasing's latest buyers' surveys suggest weak end-user demand will continue well into the second quarter. Analyst John Anton at Global Insight in suburban Philadelphia says that 2003 will be a flat year for demand. "Some key end-markets are expected to decline from 2002; although the drops will not be large, they will disappoint those who are expecting a growth year," he says. "The outlook for nonresidential construction shows no recovery; meanwhile, machinery spending is likely to be only slightly positive, with hopes of stronger revival awaiting 2004."

Global stainless steel production was strong last year, but demand for the non-corrosive steel in the North American market was tepid and sales prices actually fell by 4%. Analyst Curt Woodworth at J.P. Morgan Securities Inc. in New York suggests that strong stainless steel demand will return to North America-but not until very late in the year. Analyst John Mothersole at Global Insight agrees that strong stainless steel production isn't sustainable just now because of the weak industrial economy worldwide.

Steel mill bookings for early 2003 deliveries aren't very strong because some key end-use sectors are uncertain about their direction. Steel demand is expected to decline in such key end-use markets as motor vehicles, capital goods, oil service and consumer durables. Given the anemic pace of recovery in the national economy, high consumer debt burdens and the lack of pent-up demand, the automotive analysts continue to predict a dropoff in production--because of a weaker pace in sales to 16.5 million vehicles, as compared with 17 million-plus this year. The housing market has been strong, but Fannie Mae's chief economist David Berson now forecasts that 2003 home sales will slip by just 1-2%. That's because mortgage rates may rise in 2003, but the 30-year loan now near 6% probably won't go much higher than 6.75 percent, the economist predicts. Nonresidential construction isn't expected to begin to increase activity until 2004 (and regain its old vigor until 2005).

III. Purchasing Focus: Metals Buyer Concerns And Issues

Not all that many metal buyers actually source product in the forms and shapes available directly from mills. Most often, mill products undergo some pre-production processing before they reach the original equipment manufacturer's receiving dock.

Sheet products, for example, are leveled and edged; laser cut, plasma cut or sheared to specified lengths; slit to certain widths; blanked into shapes to be stamped, roll formed and/or welded, among other pre-production processing operations. What follows are some questions, suggested by savvy steel buyers, which should be asked to improve the buying process.

Are the specifications up to date? Are the blueprints faded and dusty? Does engineering need to be

pressed to review design specifications? Are new grades or shapes now available that are suitable for the function of the end product?

Is the metal working properly? Buyers admit that manufacturing personnel aren't always happy with the way the metal being purchased performs when fabricated. Are there alternative grades more suitable for the way the metal will be fabricated? Can other suppliers provide the same products that fabricate better?

Is the metal prepared and shipped properly? Do suppliers have ideas to improve the life and integrity of the processed steel product being shipped. Are there new ideas in packaging that will increase the acceptance of the product by the internal customers?

Is the metal costing you too much? How often do you compare contract prices against spot-market prices? When did you last review the per-ton charges for so-called "extras," the charges incurred for processing services?

Are you overpaying delivery costs? Are you investigating the use of new inventory handling or replenishment programs where the supplier absorbs some/all of the costs? Who's inspecting and certifying the metal being delivered--you or your supplier?

Well, that's all for this Purchasing Focus, and for Metals Watch. This is Tom Stundza, executive editor of Purchasing Magazine.

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Thanks for your time and hope that you have enjoyed reading MetalsOutlook™. Don't forget to subscribe so that you won't miss an issue.

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