MetalsOutlook™ May 2005

Welcome to Metals Outlook™ May 2005

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May 2005

Tom Stundza's Comments

This is Tom Stundza, executive editor of Purchasing Magazine. Welcome to the May 2005 edition of Metals Watch!

You know, things can�t be all that bad for the world's largest economy since Standard & Poor's just affirmed its highest credit ratings for the United States, based on this country�s high level of wealth and solid�if unspectacular�rate of economic growth. The rating agency affirmed this country�s "AAA" long-term rating and "A-1+" short-term sovereign credit ratings. Standard & Poor's also assigned a stable outlook on the government's creditworthiness, a move that reflects the dollar's "unique role as the world's reserve currency." The agency noted that the dollar's status has regained some of its luster this year against the euro and the yen. U.S. overall economic strength and stability offset the country's shortcomings�which include a low savings rate plus huge budget and trade deficits. The country has been borrowing heavily to fill its huge budget deficits to fund its domestic programs and war expenditures, Standard & Poor�s said. "Still, the strengths continue to outweigh persistent fiscal deficits and low household savings,� according to the rating�s agency. Keep that in mind when you hear that U.S. business activity is moderating� or you read that private-sector economists have cut their forecasts for U.S. economic growth in 2005 compared with their outlook just three months ago.

Business activity tracked by Purchasing Magazine grew in May at the third-slowest pace in nearly two years. The poll of purchasing managers at almost 300 industrial companies found the May index of business activity slipped to 60.1 this month, down from 66.8 in April�and the lowest since the 54.6 average for December 2004 and January 2005. A reading above 50 indicates that business is expanding; a reading below 50 indicates that the sector is contracting. Meanwhile, the 46 economists surveyed by the Federal Reserve Bank of Philadelphia now think real gross domestic product will grow 3.4% on a year over year basis in 2005, down 0.2 percentage points from the previous survey's estimate. However, remember that even the new, lower growth estimate would bring the 2005 economy to $12.134 trillion.

Even economists such as Joel Naroff of Naroff Economic Advisors Inc. in Holland, Pa., say the latest business index "still is pretty good and consistent with pretty decent growth in the economy." In fact, using data and some analysis supplied by economist Tom Runiewicz of Global Insight Inc., this month�s Cover Story will look at the manufacturing sector--and the whys and wherefores of recent capital spending trends in that key metals-consuming sector.

Then, in Metals Chips, we�ll update the stainless steel marketplace. Stainless steel demand has been high worldwide�it actually exploded by 16% in the U.S. last year to 2.5 million net tons�although prices have risen to historic highs. However, world stainless steel mills now are having trouble getting some customers to accept those record-high prices for summer deliveries because of a growing supply glut. Atop that, the International Stainless Steel Forum has cut its production forecast for 2005 to 25.8 million metric tons of stainless steel, just a 5% increase over 2004�s production.

Finally, in Purchasing Focus, we�ll discuss a new study by management consulting firm A.T. Kearney that suggests companies continue to make outsourcing decisions for all the wrong reasons. Outsourcing seeks materials or resources outside of the organization, usually to save money by exploiting the production and supply skills of another entity. That�s why companies talk about outsourcing being driven by cost reduction and the desire to focus on their core operations. However, Kearney says outsourcing should be pursued to seize competitive advantage and, thus, allow the purchasing organization to become a partner in the company�s drive to generate more revenue.

First, let�s open the pages of the Cover Story and look at the industrial economy. Now, it is true that gross domestic product has continued its upward growth path. In fact, the industrial production component in the U.S. is at its highest level in years. Industrial production shows how much factories, mines and utilities are producing�activities that have increased slowly and steadily so far this year. For the first quarter as a whole, industrial production rose at an annual rate of 3.6% after an advance of 4.5% in the fourth quarter. Still, at 118.5% of the 1997 average, overall industrial output was 3.9% above its March 2004 level. Many economists believe there is an underlying optimism about future expansion of business equipment production. The problem is that recent government reports about manufacturing and durable goods orders �really don't tell us much about the strength of underlying real demand for factory goods," says economist David Resler, at Nomura Securities in New York. That�s frustrating to economy watchers because last year�s rebound in manufacturing activity was quite active after three consecutive years of declines. That�s why many industries expanded production and began to fund long-delayed capital spending programs.

On the materials side, output in the primary metals segment grew by 5.5%, the best year since 1994. Basic chemical producers' output rose 4.6%, its fastest growth since 1999. Nonmetallic mineral producers, which manufacture everything from cement to glass, saw output expand 4.6%, the largest gain since 1998. Even paper and paperboard products plants had their best year since 1997. Expanding production often requires investment in new machinery and equipment�and that�s just what happened last year. Production of traditional industrial equipment led all other forms of non-automotive durable goods in activity in 2004. Output of non-electrical machinery grew nearly 12% last year, fueled by a 20% expansion in agricultural equipment and a 25% increase in construction machinery. Electrical machinery output swelled 9%, its best growth since 1984. North American light vehicle production was forecast to increase by about 16% in 2004; instead, it slipped 0.8% last year to 15.75 million units. Still, not all was bad in the transportation equipment sector as manufacturers of medium and heavy trucks experienced a whopping 50% production gain�the largest increase on record.

An issue with 2004 capital spending was that the $14.75 billion total among manufacturing firms was only 36% of the last cyclical peak of $40.5 billion in 1998. Global Insight's industrial outlook for 2005 has been revised downward. A month or so ago, economist Runiewicz was looking at industrial equipment investment to expand 10% to 12% this year, but now this figure will likely be closer to half that amount. His reasoning is that there is a definite downshift under way in the industrial economy. Growth in consumers spending is unlikely to keep up with last year's pace, and is anticipated to slow to 3.8% this year. This is only slightly higher than the 3.7% average over the past 20 years. The problem here is that the Fed keeps pushing interest rates up to help hold back inflation�which is being nudged forward by persistently high energy prices. As a result, manufacturing output growth has also been revised downward, especially in the case of materials use and heavy equipment and machinery production. Last month, it seemed like 4.5% output growth for total manufacturing was possible. The latest forecast is closer to 3.8%. Prices are a barometer for durable goods activity. Carbon steel prices generally have been falling since last September. Nonferrous metals prices may be high, but they�ve stopped growing�and most forecaster see a slide in the second half. Although last year's paper-based container price increases were pushed through easily; however, springtime price hikes for linerboard and corrugating medium have yet to stick. Actually, they remain in jeopardy because of slowing demand from boxmakers. Chemical producers, especially of feedstocks and resins, are also seeing new resistance to announced price increases. Although housing construction remains healthy, the lack of vibrant growth in nonresidential investment is translating into sliding prices for lumber products. Materials are the leading edge of the industrial sector, Runiewicz says, so if intermediate materials demand is softening, then look for this slowdown to occur in finished products as well. And that brings us to the present and future state of stainless steel pricing. Flat-rolled stainless steel supply has been tight in the U.S. for some months. As for prices, sheet and plate transaction averages so far this year are exactly twice the purchase cost in 2002. In fact, U.S. prices are substantially higher than stainless flat-rolled sold in various foreign markets. However, some market analysts have suggested that a 3% to 5% world decline in second quarter pricing is imminent because world producers are expanding output in a global flat-rolled stainless steel market that already is oversupplied. What happened? Well, global output of crude stainless in 2004 was around 7.5%% higher than the year earlier figure�and that increase to 24.6 million metric tons of supply was far out of line with consumption growth.

In the U.S., stainless steel sheet and plate oversupply was less apparent because of stronger underlying consumption growth. But, now in 2005, U.S. demand for flat-rolled sheet steel has been quiet for some weeks. The plate market is quite healthy with excellent demand from the aircraft, nuclear and petrochemical complex. In contrast, the strip market is fragile, primarily due to overstocking. Service center shipments have slowed--and there has been a continuing stock build at the service center level--where stocks are 20% higher than at this time last year. Yet, some American end-use manufacturers have asked the U.S. International Trade Commission to terminate five-year-old duties on stainless steel sheet imports from France, Germany, Italy, Japan, Korea, Mexico, Taiwan, and the United Kingdom. Their worry is that U.S. producers may cut to shortages of stainless steel sheet mill products; in fact, they are suggesting the typical eight-week leadtime could increase to 16 weeks. However, the duties have done little to slow supply of foreign products in a domestic market where Type 304 cold-rolled sheet has risen from $1650/ton in January 2003 to $2450 in April 2005 when including alloy surcharges. Also, additional foreign and domestic material soon may become available.

Finnish stainless steel group Outokumpu and Spanish stainless steel group Acerinox say Asian, European and North American demand have gotten very sluggish as customers are running down their inventories. Global stainless production so far this year is growing more slowly than the unsustainable pace seen in 2004. The MEPS projection for world stainless steelmaking in 2005 is a 3.7% increase over last year�s 24.6 million metric tons. And just this month, the International Stainless Steel Forum says it expects a 5% production increase to 25.8 million metric tons. However, over-supply will continue to affect the market for a little while yet, keeping downward pressure on world pricing, suggest the market analysts at MEPS (International). That�s because additional capacity is entering the scene. Outokumpu is ramping-up its newly expanded melting shop and cold-rolling facilities at the Tornio Works in Finland. Also, Chinese stainless output will rise this year, notably with the start-up of new capacity at Baoshan and Taiyuan.

When we come back, in Purchasing Focus, we look at the outsourcing strategy study conducted by management consulting firm A.T. Kearney in cooperation with the Center for Strategic Supply Research. More than 80% of 165 companies representing 24 industries in the study said that reduced operating costs, reduced capital investment and the need to focus on their core business were the primary reasons for their outsourcing activities. Fewer than half of the companies cited reasons related to revenue growth, such as increased speed to market (46%), improved quality (42%) and faster customer response time (40%). But, first this�..

I. Metals Watch

Welcome back to the May edition of Metals Watch.

The majority of companies with cost-related goals for domestic and foreign outsourcing told A.T. Kearney they met or exceeded the objective of average cost savings for these companies at 10% to 15%. In contrast, the majority of companies with revenue-related goals for outsourcing reported falling short of those percentages. "It's clear there are two different approaches to outsourcing at work," says A.T. Kearney�s Bill Markham. "Companies seeking quick savings focus their efforts on finding less expensive alternatives to operating their business today. Companies focused on tomorrow's business needs are seeking more significant long-term benefits and looking to leverage marketplace skills, technologies and scale to cut costs and increase revenue." The study examined the breadth and depth of outsourcing across 14 different activities in research and development, marketing and sales, supply, manufacturing and distribution, and corporate support. Every company studied reported outsourcing at least one of the activities, with 50% saying they outsourced parts of more than eight.

The most common activities being outsourced were information technology (reported as outsourced by 36% of companies), distribution/fulfillment (32%), legal/regulatory affairs (30%) and manufacturing/operations (24%). However, companies are not outsourcing at a very deep level, according to the study. Eighty-six percent of study participants said they outsource less than 25% of activities overall. The average level of outsourcing penetration across the 14 activities was 16%. Even in information technology, the area with the deepest penetration by outsourcing, only 14% of respondents said they outsource more than 25% of their IT activity. Upshot is that �tactical outsourcing is a follow-the-leader approach, not a road to competitive advantage," says Robert M. Monczka, director of strategic sourcing and supply chain strategy research at CAPS and research professor of supply chain management in the W. P. Carey School of Business at Arizona State University. "Strategic outsourcing can create new ways to compete,� he says, �and possibly rewrite the rules for whole industries."

The report suggests companies define from the outset whether the strategic intent of their outsourcing efforts is cost reduction or revenue generation. It also recommends the following steps to give companies an edge in achieving their outsourcing goals: First, anticipate shifts in the future business environment, such as political and social backlash, changing demographics in emerging economies and dwindling natural resource supplies, and consider the effect these shifts would have on future outsourcing activities. Second, build tomorrow's corporation by seeking skills, technologies and scale from the marketplace rather than assuming that these capabilities must be developed internally.

Third, address the execution issues inherent in any outsourcing activity by clearly defining roles and responsibilities across the corporate functions involved.

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

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