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MetalsOutlook™ December 2006

Publisher's Statement

The mixed messages of sector slowdown and economic growth haven't translated into any appreciable downward pricing impact or improvement in delivery times. In fact, some materials continue to increase in price, while the Institute of Supply Management Manufacturing Index for the month of November 2006, released on Friday, December 1, 2006 at 49.5, may be reflecting the seasonal effect discussed by Tom Stundza, below.

Mill lead times have created shortages or out-of-stock conditions in service center inventories that haven't yet subsided, although service centers with global suppliers have worked to ameliorate the vicissitudes of the current cycle that has allowed them to provide a continuous flow of product to their customers, as you will read in Part IV - Purchasing Focus below.

Enjoy the latest issue!

And now for MetalsWatch....

Welcome to Metals Outlook™ December 2006

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December 2006

Tom Stundza's Comments
I. Cover Story: Seasonal Weakness
II. Metal Chips: Manufacturing Outlook
III. Purchasing Focus: Doing Business In Low-Cost Countries

Tom Stundza's Comments

Welcome to the November 2006 edition of MetalsWatch! This is Tom Stundza, executive editor of Purchasing Magazine and Purchasing.COM.

Spot-market price declines for flat-rolled sheet in U.S. were the key changes to the steel market during September and October. To hear buyers tell it, more declines are due in November and December. Our **Cover Story** will home in on the ramifications of high inventories and low demand. Interestingly, fourth quarter prices still look to be higher than a year ago. And the market mavens say it’s unlikely that the current price trough —even if it continues into the first quarter of 2007 — will be very deep. On the other hand, stainless steel flat-rolled prices are so high they are setting records — and look set to advance still further in the next few months. Including raw material surcharges, transaction prices for cold-rolled sheet Type 304 in North America now exceeds $4,000 per net tons, an unprecedented high value. The outlook from analysts is that as long as the costs of nickel, cobalt and other alloys stay high, stainless steel will be pricey.

The steel-pricing scenario masks the fact that the national industrial economy has lost a lot of momentum. That’s our **Metal Chips** segment this month, where economic growth slowed to a 1.6% annual rate in the late summer, the most sluggish pace in more than three years, and dampened demand for all production-grade metals. Weak automobile production continues to dampen the overall U.S. industrial base. The struggling auto industry will continue to reduce assembly rates and slash jobs in the face of inventories for some weeks yet. Companies involved in home building — as well as appliance, home electronics and furniture manufacturing — also are casualties of the sour housing market. Some economists believe growth in the current October-to-December quarter will turn out better — but some others disagree. They point out that weakness in manufacturing is not a new trend — indeed production has been inching down for some time — and the drop has been more pronounced lately because business equipment production is sliding as the year ends.

As new markets emerge and the supply chains are becoming more globalized, sourcing materials from the countries with lower labor and raw material costs increasingly is becoming widespread. India, China, Eastern Europe, Mexico, Brazil — they are just a few of the locales where purchasing executives are sourcing production materials these days. Those nations are only the beginning. Purchasing and supply chain executives really have no choice but to test and investigate these and other areas in this increasingly flat world. Still, we will use our **Purchasing Focus** segment to offer a few cautions for buyers looking into *low-cost country sourcing* as a supply chain strategy.

Comments to Tom Stundza: stundza@reedbusiness.com

I. Cover Story: Seasonal Weakness

The sheet steel marketplace is showing signs of seasonal weakness: Demand is dropping both from service centers and from such key end-users as the automotive and appliance industries, imports are surging, customer inventories are bulging and some prices are sliding.

The weakness in sheet demand from the auto sector has been the most pronounced. Ford, for example, has said that it will slash its fourth quarter output by 21% from year-ago levels, while General Motors and DaimlerChrysler have similarly said that their output will be lower. There's also expanded discounting by some smaller-tonnage mills due to continued cutbacks in automotive production. So there appears to be a market psychology that favors steel buyers. "The market has softened for flat-rolled," says a steel buyer at IBM in New York. "We are seeing abundant inventories and. prices declining from September through November."

In an attempt to combat this, most of the major sheet mills have announced fourth quarter maintenance or other downtime at several of their facilities. Arcelor Mittal has announced that it will indefinitely idle a blast furnace at each of its Ohio and Indiana plants. U.S. Steel is taking three blast furnaces down for maintenance, while Nucor, Steel Dynamics and North Star BlueScope have also planned outages. The idea of these larger mills is to reduce supply of fresh steel in the face of 21-month peak in distribution-sector inventories.

Elevated inventory levels, and reduced demand also are softening prices the in plate, bar and structurals markets. So, the big mills have been trying to maintain high prices by staying out of these arenas. Now, they are easing steel production. J.P. Morgan Securities analyst Mike Gambardella writes that already announced production cuts and timely maintenance outages will reduce U.S. sheet production by nearly 1.5 million tons in the fourth quarter, which represents 8% of total U.S. sheet demand. But, some smaller mills are accepting lower prices to fill their order books. With steel sheet demand looking likely to remain weak during the near term and market sentiment having recently turned decidedly negative, analysts are certain that further price falls are on the cards.

However, the output cuts that have been announced for steel sheet will inevitably have some impact and are likely to limit the extent of the declines. Gambardella suggests that recent "aggressive and proactive production cuts will help work down the inventory overhang at service centers in a few months time given solid underlying demand for sheet steel and declining import volumes." But that may not come until next spring—somewhere in the later first quarter. That's because the typical North American holiday slowdown is likely to be more severe this year—"exacerbated by high inventories throughout the supply chain," says Neil Novich, CEO of the Ryerson service center chain. For long and plate products, inventory levels also are a concern even though analysts think a price collapse for these grades is unlikely.

Also unlikely is a dramatic collapse in stainless steel sheet pricing. Cold-rolled Type 304 sheet prices at $4,000-plus per ton have virtually doubled since the start of this year, and have more than tripled since their most recent historical low point in early 2002. At that time, North American transaction prices were as low as $1,200 per ton. Basis prices have certainly increased this year, and may rise further this quarter. "Stainless steel prices are through the roof and climbing," says a buyer at auto parts supplier Visteon in Michigan. "The stainless steel pricing surcharges are really hurting us," says James Ustaszewski, senior buyer at metal fabrication firm Nu-way Industries in Illinois.

Most of the recent advance is attributable to raw material costs. The alloy surcharge today accounts for the majority of the transaction price. That's because the alloy costs that North American add to their basis figures have jumped by more than 160% since the start of this year. It should be noted that buyers of stainless steel appear to have become much more cautious as prices have risen. The steep increase in basis and surcharges this year has added a greater element of uncertainty to trading conditions. Users who had reduced in-house stocks when alloy surcharges dropped to $1,000 per ton—in the expectation that the climb in the nickel price would go into reverse—now find themselves obliged to pay a lot more for new orders. That's probably why 94% of those polled last month expect prices to remain elevated through year's end.

However, this does not appear to have kept buyers out of the market to any severe degree. Domestic consumption of stainless steel mill products at 1.49 million tons in the first seven months is a 10% increase over 2005. Suppliers report steady demand from end-users, with delivery leadtimes for some stainless mill products stretching into January and even February. However, there is overcapacity in the global specialty steel industry so prevailing high steel prices may not be sustainable next year, some analysts now suggest. Producers may need to adjust production to softer market conditions. Part of the reason is that stainless grades with no or little nickel are growing faster than the high-priced nickel-bearing grades. "Nickel-bearing stainless steel demand is facing consumer resistance in favor of alternative metals," says analyst Jon Bergtheil at the J.P. Morgan Securities.

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II. Metal Chips: Manufacturing Outlook

Economists say the deceleration in manufacturing suggests that slowdowns in both the housing and automobile sectors are spreading to the broader economy, as a drop in home and auto construction translates into fewer orders for factories. Lumber and wood products, appliances, plastics and fabricated metals among those sectors that showed sharp declines in October. "I think I hear the footsteps of housing construction going up the supply chain," says Jim Meil, chief economist at Eaton Corp. in Cleveland. But the major depressed industrial sector is automotive.

Since the mid-1980s, when Japanese automakers began making vehicles in large volumes in the U.S., Detroit's automakers have talked of the need to better align production with demand and move to a model of just-in-time manufacturing. It hasn't really happened, though, so with the U.S. economy slowing, the Big Three have thousands of vehicles without any clear destination. GM's inventory at the end of the third quarter was 76-day supply. Ford's inventory was 75 days and Chrysler's was at 82 days of supply. ``The problem is that the Detroit automakers have excess capacity,'' says AMR Research analyst Kevin Reale. ``And they have to keep plants running to maintain the cost structure of their vehicles.'' IRN analyst Erich Merkle says the longer-term worry is that a prolonged slowdown could show that the latest round of plant closures have not gone far enough. ``The thing that concerns me," he says, "is if sales and assembly volumes continue to drop, which they likely will, given the economic slowdown, they will still be left with excess capacity.''

That's why steel makers shouldn't look at Detroit for rejuvenated demand anytime soon. In fact, the latest data on manufacturing activity offered little support for the idea that the U.S. economy will rebound quickly from a slow third quarter. Economists still anticipate that business spending will remain sturdy in the coming quarters, but the risks to this sanguine forecast have grown. With business confidence slackening and drivers of 2007 growth hard to find, businesses are still choosing investment projects with great care, wary of the drag of over investment. That's because productivity growth has sputtered lately--while labor costs have risen at the fastest pace in two decades. "Nobody ... can be sure how this is all going to end up. Are we going to bounce back ... or is the housing and auto softness going to spread?" asks economist Allen Sinai, head of Decision Economics.

Recent data have shown significant declines in housing and housing-related industries. Some economists argue that any downturn in manufacturing will be short-lived, because consumer demand remains healthy. The government estimates that residential investment fell at an annualized, inflation-adjusted rate of 17% in the third quarter -- the largest quarterly drop since 1991. Now, the Commerce Department reported that overall construction spending fell 0.3% in September from a month earlier, and the National Association of Realtors says its index of pending home sales slipped 1.1% in September from August. Also in September, production in several housing-related sectors -- such as wood products and furniture -- dropped more than 1%, according to the Federal Reserve.

The Labor Department says productivity, the measure of output per worker, stalled from July-September, as labor costs jumped 3.8%. Labor costs have spiked 5.3% in the past 12 months, fastest pace since the early 1980s. While accelerating wages are good for workers--whose compensation has lagged inflation in recent years--rising wages and benefit costs also have the potential to push inflation higher and pull manufacturing lower. Productivity, while complex to measure, is seen as an essential factor in long-term economic health, allowing companies to reap higher profits while giving workers higher pay without raising prices. Over the past year, labor productivity was up 1.3% in the non-farm economy. But, productivity has now slowed to its weakest pace since the fourth quarter of 2005—when it fell 0.1%--supporting other economic readings that have shown a slowdown of the US economy since midyear. Robert Brusca at FAO Economics says the productivity report underscores concerns that the economy may be unable to rebound without stronger productivity gains. The productivity data are "representing a lower speed limit for the economy," he says. But Dick Green at Briefing.com believes the weak productivity gains are simply a reflection of cooler growth. "This poor showing was the result of the weak gross domestic product gain in the third quarter and does not necessarily reflect a trend in underlying productivity," he suggests.

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III. Purchasing Focus: Doing Business In Low-Cost Countries

U.S. companies in greater numbers are heeding the siren's call to source products and parts overseas to reduce overall costs and compete more aggressively at home. A recent study by the Boston-based Aberdeen Group found that chief procurement officers rate low-cost country sourcing as a top priority in coming months, and that companies plan to double their spending with offshore suppliers by 2008. The report also found that purchases from low-cost countries have average cost savings of up to 35% compared to U.S. and Western Europe suppliers.

The savings level was determined, among other factors, by the volume of goods sourced from low-cost countries, with those companies sourcing over 20% in total from low-cost countries benefiting the most. Those numbers alone will gain the interest of U.S. manufacturers, which are always looking to make the most of every penny spent. International buyers report they are motivated by offshore buying opportunities to lower the overall cost of capital for their company, reduce the rates of trade financing, and mitigate financial and operational risks of global trade.

But, while the road to low-cost country sizing looks smooth on the surface and the cost benefits are enticing, there are potholes the size of moon craters for companies that do not properly prepare for all the potential hazards along the way. It's essential in this kind og sourcing to have well-established communication between the buyer and its suppliers to avoid putting the supply chain at risk and limit future cost reduction opportunities. That's why purchasing teams involved in foreign sourcing usually get their market intelligence the old-fashioned way: by researching public reports, the Internet and talking with personal contacts to learn about plant locations and capacities, materials specs and cost structures.

It's similar to the way marketing and sales teams operate, which is no coincidence since several chief purchasing officials are convinced that purchasing is a mirror image of sales and marketing. It's also critical for success in any geographic region is to use information gathering techniques to provide a good sense of the pace of business there and the general culture. That's a good way to determine if the new supplier businesses add value to the supply chain.

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