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Welcome to Metals Outlook™ March 2006

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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Tom Stundza's Comments

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

Recent business data indicates that the economy has been accelerating during the current quarter after sputtering late last year. Merrill Lynch economist David Rosenberg suggests that growth in GDP will continue this year but at a slower rate in the coming quarters. In fact, they expect a replay, more or less, of the �soft landing� of 1995-1996. A number of factors�things such as the cooler housing market and the spending drag from high energy prices�suggest that consumers are likely to trim overall spending in the coming months so that the economy won�t gallop ahead indefinitely. Wall Street economic gurus say the economy is losing momentum, and that will be evident in the second or third quarters as lagging effects of the housing-market slowdown will begin to bite and as GM and Ford cut auto production substantially. Nonetheless, this edition�s Cover Story finds that growth of the gross domestic product isn�t about to stop on a dime. One bright spot is the capital spending side of the economy, which accounts for about 11% of total GDP. It could provide a stronger-than-expected growth push in the quarters ahead. Signs pointing in that direction include an upturn in unfilled orders for capital goods, an increase in commercial and industrial loans, higher-than average levels of cash on corporate balance sheets, and rising capacity utilization rates in many industries. Also, underlying demand trends have been on the strong side, which ought to encourage companies to increase their capital spending; and it provides a strong hint that the outlook for corporate profits is good. That�s why Steven Narker, wealth management strategist for Merrill Lynch in New York, suggests that the economy will grow at a slower but still respectable clip in the quarters ahead and that surprises are more likely to be pleasant than unpleasant�barring energy or other politico-economic shocks.

Steel is never boring, whether we are discussing the product or supply, demand and pricing trends. While there has been some ebb and flow in demand for steel over the last couple of years, calculations for Metals Chips finds the overall level of steel demand and industrial activity has been consistently strong. For the past two years, actual use has averaged 93 million tons, as compared with an average 88 million tons in the previous four years. Automotive and housing demand has been quite strong, with auto production over the last four years averaging 16.2 million units, from a high of 16.7 million in 2002 to a low of 15.8 million vehicles in 2001. Several steel management teams insist that steel order books are quite full with bookings out to as far as June. That may explain why market pricing has been stable for the past five months.

Then, in Purchasing Focus, we�ll discuss how buyers can avoid problems when gauging performance of service companies under contract to their manufacturing, construction, utility and various commercial companies. Service tasks vary, depending on the person performing the service, differences in customer behavior, and the business environment. So, buyers can't measure and reduce service variance as easily as they can rate and adjust performance of firms who provide production materials.

I. COVER STORY

Strong industrial production remains one of the key drivers for steel demand. And several of the leading economic indicators are suggesting that industrial demand for steel should remain strong at least until the end of 2006. Industrial production data have been quite favorable for the past two years and durable goods orders have grown at a healthy average annual rate of 8%. Order backlogs for durable goods, an important leading indicator, have generally remained at above 10% for most of 2005. The business conditions indicator of two key monthly buyer surveys by Purchasing Magazine and Institute of Steel Management has remained in an expansion zone at above 50% since early 2003. So far this year, the inventory-building cycle has expanded by about 11% above the 2005 average. This important factor behind the strength in the factory sector suggests that at least six months of further acceleration lies ahead in the ratio of shipments to inventories measure. All this suggests that manufacturing activity is likely to remain firm in the near term�and this should be a positive for steel demand.

Demand for business equipment rose for a fourth straight month in January, pointing to increases in manufacturing. Industrial equipment orders also jumped, while demand for aluminum, mining and metal-working equipment also increased. Overall orders for nonmilitary capital goods excluding aircraft, an indicator of future business investment, improved for the second month in January. And, the shipments of these goods, which the government uses to calculate figures on gross domestic product, also increased for the second month. Still, there has been leakage in early 2006 as the key Commerce Department report on all factory orders shows they dropped 4.5% in January, their steepest drop in more than five years. Part of that is because America's top two auto makers continued to lose U.S. market share to foreign competition. So, GM and Ford plan to cut North American motor vehicle production in the second quarter. Offsetting this negative, however, are the growing production schedules of Japanese, European, and Korean car makers that operate plants in North America, and the long-term plans to construct new automotive plant capacity in Toronto, Texas, and Mexico. But, for now, there is some bad news ahead in the second quarter for automotive-grade steel suppliers who had been hoping for a pickup in shipments to Detroit. GM is cutting second-quarter production by 3.7% compared with the year-ago period. The company plans to produce 445,000 cars and 755,000 trucks in the quarter, compared with 458,000 cars and 789,000 trucks last year. Ford plans to reduce second-quarter production by 2% to 325,000 cars and 565,000 trucks, from 294,000 cars and 612,000 trucks produced last year.

Federal Reserve Bank economists are suggesting that the U.S. housing market was already cooling but that the slowing was stabilizing and probably would not undermine the U.S. expansion. The Fed economists say consumers used credit in January at the fastest pace in four months--and echoed earlier reports of brisk, warm-weather-inspired retail sales in the month. Also, the manufacturing sector seems to be on a reasonable footing, aided by strength in exports. Another reason that manufacturing economists are upbeat is that business investment spending is booming. Chris Rupkey, senior financial economist at Bank of Tokyo�s offices in New York, agrees that �business capital spending is coming on strong and the timing of these equipment purchases could not be better." He says that �business spending will take up the slack� even if housing cools somewhat.

II. METAL CHIPS

As analyst Randy Cousins at BMO Nesbitt Burns in Toronto has written: �The steel industry is never boring.� And nowhere is that more evident than in pricing. There are two broad classes of steel products. Flat-rolled steels comprise hot- rolled, cold-rolled and galvanized sheet plus plate. Long products include merchant bar, rebar, wire rod and structurals. After peaking at $756 per ton in September of 2004, hot rolled sheet dropped by $321 per ton or 42% to a 2005 interim low of US$435 per ton in August, then recovered to close the year at $550�and has averaged $545 so far this year. Pricing for long products was much more stable. Using rebar as the benchmark, prices peaked in November of 2004 at $540 per ton. Prices then slipped to $435 by August. In the fourth quarter, rebar averaged $487�and have averaged that price so far this first quarter. As with the other flat-rolled products, plate steels had a dramatic lift in pricing. However, the correction in plate prices was much more modest than sheet steel. Cut-to-length plate sold for $802 per ton at the peak in January of 2005. It pulled back $42 per ton, hitting a low of $760 in July. Since then, plate has recovered $14 per ton in price. On average, cut, or discrete, plate sold for $784 in the fourth quarter of last year and has averaged $774 so far this quarter.

Pricing also has been erratic in the stainless steel market. Using cold-rolled sheet, grade 304, as the bellwether, sales prices peaked at $2460 per ton in March 2004, slipped just under $2300 that November then recovered to a peak of $2595 in June of 2005. Since then, transaction prices�a combination of mill base pricing and surcharges for scrap and alloying metals�have been slipping gradually to $2260 or so in February. The base prices for hot-rolled and cold-rolled stainless steel sheet delivered this month have crept up 3%, however. And, as reported in March 8 edition of the Price and Supply Alert on the Purchasing.com web page, some domestic mills are seeking another 3% on flat-rolled stainless for deliveries in late April and early May. Their reasoning is that sales tags for cold-rolled sheet only increased 1.3% this month because of lower surcharges for scrap and alloying metals. The fact is that world over-production has been pushing down the base prices for global stainless steel prices. From a peak in June 2005, transaction prices for cold-rolled sheet have dropped 12% in North America. Transaction prices still are running 45% ahead of early 2003, however, because of the surcharges.

However, Wall Street analysts note that the financial results reported by the main stainless steel companies were dreadful in the latter part of 2005. It is not surprising that stainless steel producers are moving swiftly to take advantage of better market conditions this year. Market activity appears somewhat stronger this quarter with shipments up about 2% from all of 2005. However, market insiders see more purchasing by service centers than end-use buyers and even the distributors are just buying what they need to refill stocks. Interestingly, buyer surveys have rejected market reports that hot-rolled steel sheet in coil rose by 7% in February. And the average leadtime for mill delivery of all flat-rolled stainless is down to five weeks. Still, with market intelligence very confused and actual statistics running almost three months late, the Allegheny Ludlum unit of Allegheny Technologies Inc., North American

Stainless and AK Steel have proposed 3% price increases for all stainless steel sheet, strip, tubular quality and continuous mill plate products. Allegheny Ludlum also has proposed a 6% increase for tool steel, duplex alloys and auto exhaust alloys. Because different steel products are often used in the same end product or end use, when there is a general pick-up in demand, prices for all steel products tend to move higher. Therefore, historically, it could be argued that demand was the primary driver of steel prices in North America, according to analyst Cousins at BMO Nesbitt Burns. Demand this year is expected to rise by barely 1% because housing and automotive assembly are expected to slip. That�s probably why most management teams still say they expect U.S. and Canadian regional pricing to fall, but the timing of those expectations is being pushed out toward midyear. Analysts say they been impressed with the stability of North American pricing, following its rebound from the summer 2005 lows. �We believe there is higher supply hitting the market, including more material brought by steel traders from foreign markets, but that supply is meeting with good demand and is not resulting in any significant price discounting,� says analyst Aldo Mazzaferro at Goldman Sachs in New York. Of course, nobody knows for sure since marketplace data on mill shipments, exports, imports and service center participation has only been verified for December. The U.S. and Canadian market continues to show good production discipline, Mazzaferro says, as it is up by less than 1% from a year ago, and the distribution chain is reporting 18% lower inventories than in early 2005. Mazzaferro actually believes monthly steel imports could rise to 3.5 million tons in coming months without disturbing the supply-and-demand balance, compared with 2.9 million tons in December and 3.1 million just reported for January.

As services become an ever larger part of the global economy, purchasing managers who source services are rightly looking for ways to improve productivity and efficiency. Services may be more difficult to measure and standardize than the manufacture of products, but executives should not abandon hope. When we come back, Purchasing Focus will discuss a few essential principles of service measurement that buyers need to keep in mind when sourcing services to improve the delivery, pricing, and sales and marketing of services. WELCOME BACK TO METALS WATCH and this edition�s Purchasing Focus on buying services. Faced with stiffening competition, increasingly demanding customers, high labor costs, and, in some markets, slowing growth, service businesses are trying to boost productivity. But, while manufacturing businesses can raise productivity by monitoring and reducing waste and variance in the relatively homogeneous production and distribution processes, service businesses find that improving performance is trickier. And that can create problems for the buying groups that purchase services.

Services are highly customizable, and people�the basic unit of productivity in services�bring unpredictable differences in experience, skills, and motivation to the job. That�s because service customers, activities and performance arrangements vary widely. Yet, despite such seemingly uncontrollable factors, many purchasing executives refuse to accept a high level of variance�and a great deal of waste and inefficiency�in the costs of service from providers.

Eric Harmon, an associate in McKinsey & Co.'s Dallas office, suggests a few essential principles to measurement service performance while reining in total costs. First, service companies need to be compared against prior performance rather than against poorly defined external measures. Second, buyers must look deeply into financial costs of the service companies in order to discover and monitor the root causes of those expenses. Third, buyer and their service providers must set up broad cost-measurement systems to report and compare all expenses across the functional silos common to service delivery organizations.

Harmon says none of these principles is easy to implement. Purchasing executives are likely to face resistance from frontline personnel managers who insist that services are inherently random and that service situations are unique. Also, service-company managers who have grown used to the protection that lax measurement affords may be reluctant to view their operations through a more powerful lens. But only by adopting these principles and implementing rigorous measurement systems throughout the organization can purchasing executives begin to identify reducible variance and take the first steps toward bringing down costs and improving the pricing and delivery of services.

Well, that's all for this Purchasing Focus, and for this edition of MetalsWatch! More stories on sourcing services can be found at purchasing.com. More information on business conditions, product leadtimes and metals and steel pricing�plus my monthly Steel Flash Report and quarterly Energy Flash Report�can be found at purchasingdata.com. This is Tom Stundza, executive editor of Purchasing Magazine.

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All Metals & Forge Group, LLC.
75 Lane Road
Fairfield, NJ 07004 USA

Toll Free: 800-600-9290 Fax: (973) 276 - 5050