MetalsOutlook™ April 2007

Publisher's Statement

While economic activity hovers around the point between expansion and contraction, there is still growth in the economy. It's not time to hunker down, but rather, it's time to manage costs and expenses carefully. That is what our latest issue of MetalsWatch! is all about.

There are substantial revenues to be captured in 2007 while manufacturing manages the return from the investments they have made since 2004. That is what we are seeing across sectors – a cautious "keep it going but keep it lean" approach. Be ready to react to either an upswing or a downturn without losing momentum.

So, with the latest ISM number at 50.9, we trust you will enjoy the guidance in the latest MetalsWatch! And, in just a few days, something big and positive will be happening at www.steelforge.com. It includes a metals outlook through the year 2010, written by Tom Stundza. We'll send you the press release before the ink dries.

Welcome to Metals Outlook™ April 2007

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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April 2007

Tom Stundza's Comments

Welcome to the April 2007 edition of MetalsWatch! This is Tom Stundza, executive editor of Purchasing Magazine and Purchasing.com.

Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke say they are watching developments in the economy very carefully these days—especially since it's now apparent that manufacturing slowed in December and January. Earlier estimates had suggested that economic conditions at the start of 2007 were positive. Now, new data has undermined the optimism, particularly coming in the wake of reduced growth in last year year's gross domestic product and poor new year's orders for durable and factory goods—not to mention the early March slump in the stock market. The American economy will only grow by somewhere between 2.5 and 2.7 percent this year. That would be the slowest pace since gross domestic product (GDP) grew by 2.5 percent in 2003 and 1.7 percent in 2002—back when the country was struggling to recover from the 2001 recession. The downturn in housing sales and construction is turning out to be quite pronounced and is beginning to have a measurable impact on purchases of consumer and commercial goods and capital spending.

The latest economic numbers erase the picture of an economy rebounding and gathering momentum—and have brought into clear focus the fact that businesses are growing more cautious and pulling back on spending as the expansion has entered its sixth year. Business equipment investment actually fell in two of the last three quarters, a sign that manufacturing is in decline, says Timothy Rogers, chief economist of Briefing.com. And, according to former Federal Reserve Board Chairman Alan Greenspan, if businesses hedge their bets and don't invest enough, that could hobble economic growth in gross domestic product for much of 2007 and set the stage for a recession in 2008. In our **Cover Story**, we'll discuss how sharply lower business investment and business inventories than previously forecast have gotten Greenspan all a'bother—and people like Paulson, Bernanke and Roger soon may be recalculating their GDP and industrial outlooks for 2007.

The prevailing conventional wisdom among market economists is that the inventory correction will accelerate over the next few months, and a seasonal pickup in demand should be supportive of higher steel prices. Instead of growing, as most mills have been forecasting, steel demand this year actually could be the weakest in nearly five years, since shortly after the end of the last recession in late 2001. Most analysts have been writing for weeks that various sheet-steel prices are bottoming out as this quarter ends and should start to show a real rebound during the second quarter.

However, the January decline in factory orders and manufacturing production suggest that the downward industrial adjustment was indeed deepening as the first quarter began. So, in our **Metals Chips** segment, we'll discuss why steel buyers haven't begun expanding purchases of cold-rolled sheet and other flat-rolled steel mill products. And we'll investigate the hypothesis of the bearish stainless steel analysts that North American demand could slide as this year progresses.

The primary role of the procurement function in strategic business initiatives has begun to shift in recent times from a singular focus on cost savings and/or cost avoidance to the broader management of supply availability and risk—while still maintaining competitive cost structures. What various Aberdeen Group and Purchasing Magazine studies have shown is that advanced electronic sourcing and negotiation is both an art and a science. In our **Purchasing Focus** segment, we'll discuss how a combination of business and sourcing expertise and leading e-sourcing technologies are used to upgrade and modernize procurement activities .

Comments to Tom Stundza: stundza@reedbusiness.com

I. Cover Story: What About Business Investment?

"The mood on Wall Street changes very quickly and the mood lately has shifted to pessimism," says Alan Skrainka, market strategist at the Edward Jones brokerage in St. Louis. That's because of reduced business investment and spending found in the latest government report on GDP, the broadest measure of the nation's economy. GDP grew at just a 2.2 percent annual rate in the fourth quarter—bringing the annual rate of growth for 2006 down to 3.3 percent.

Then, in a separate report on durable goods, orders for such big-ticket, long-term purchases as equipment, vehicles and computers showed a 6 percent decline in new orders for capital goods excluding aircraft and defense spending. That reading typically is the clearest barometer of business spending—and it was the largest such decline in three years and one of the biggest drops on record. The housing market also doesn't look like it has bottomed out. New home sales dropped almost 17% in January from the previous month following a 14% plunge in starts. Also, the inventory of existing homes for sale is near record levels, and the Fed has just released data showing that delinquency rates on residential real estate loans rose to a four-year high last quarter.

Many economists and economic policy wonks have been worried about the consumer and the weakening housing market, so they were looking for businesses to come to the rescue. But, Dan North, chief economist for Euler Hermes ACI, a firm that manages receivables for a variety of businesses, says that "businesses are not coming and spending as much as people had hoped for." He says the less-closely-watched economic reading of businesses' applications for new credit has been dropping precipitously. And, when businesses aren't looking to get more credit, it's a fairly strong sign of an economic slowdown, says North, who is projecting only about a 2% growth in gross domestic product (GDP) this year—which is way below most forecasts of 3% to 3.5%.

Even some economists more bullish about 2007 agree that the pullback in business investment is a cause for concern. "They're already in the slowdown mode," agrees Brian Bethune, U.S. economist for Global Insight, an economic consulting firm in Lexington, Mass. "Certainly what we're seeing is they're playing it very conservative at this point. Our expectation is there should be some pickup, but there is a certain amount of anxiety among CEOs about the outlook." That's because it's now apparent a downturn in manufacturing is restraining U.S. economic growth. In fact, New York Times economics columnist David Leonhardt has just written that the nation's manufacturing sector has managed to slip into a recession.

Reason 1: Growth in gross domestic product in the fourth quarter of last year was just revised down to a 2.2% annual rate in 4th quarter from 3.5%--setting the stage for slower-than-expected growth this quarter. The revision reflected lower business inventory investment, higher imports and slightly weaker consumer spending than originally estimated. Commerce Department data shows that businesses increased inventories by only $17.3 billion; originally, Commerce had estimated a $35.3 billion increase. Companies had elevated stocks $55.4 billion in the third quarter.

Reason 2: The Commerce Department report that orders for durable goods—big items like major home appliances and factory machines—fell 7.8% in January, reflecting the biggest slide in business equipment demand in three years.

"A big problem for manufacturers is the series of interest rate increases that the Federal Reserve has imposed since 2004," Leonhardt writes. "They may seem like old news, because the last of them came eight months ago, but it typically takes a year to a year and a half for a rate increase to have its full impact. A lot of the big decisions affected by interest rates, like whether to buy a new car or a new piece of factory equipment, aren't everyday decisions. Only now are some families and businesses starting to react to the higher rates." So, if the U.S. manufacturing expansion is more fragile than thought just weeks earlier, there could be real uncertainty about near-future shipments and prices of flat-rolled steel.

II. Metal Chips: What About Expanding Purchases?

Metalworking manufacturing has been sluggish and that has reduced steel use lately.

Reflecting a continued slowdown in general economic activity, steel product shipments through January have fallen for five consecutive months from U.S. metals service centers and six straight months from Canadian service centers. Supply obviously isn't a problem as data from the Metals Service Center Institute shows that January inventories in the U.S. and Canada was 33% higher than a year earlier.

What's obvious is that the sharp pullback in housing construction, engineered buildings assembly and automotive activity in the second half of 2006 has expanded into reduced production of related materials and supplies, major appliances, machinery and heavy trucks. Auto industry economists agree, for example, that 2007 assembly will be flat-to-weaker than 2006. Specifically, says analyst Mark Parr at KeyBanc Capital Markets in Cleveland, "North American auto builds are expected to be flat during 2007." Appliance manufacture and shipments barely crept ahead of 2005 for a 2006 rate of 80 million units. A dip of 3% or more now is being predicted for 2007 because of the slowdown in single-family housing construction. But the slide in steel demand may be more pronounced as the Maytag takeover by Whirlpool soon will reduce North American assembly capacity. U.S. motor vehicle sales edged down to an annualized 16.6 million units in February from 16.7 million the previous month. Both Ford and General Motors have unveiled their production schedules for the second quarter—and both plan to continue with double-digit production cuts through at least mid-2007. That presages less domestic steel tonnage going into auto parts industry, as well. And it's probable now that steel-containing consumer goods also will be produced in less volume this year. So, overall steel-demand outlook projections range from an increase of just 2% to a decline of 3% .

Meanwhile, annualized U.S. consumption of stainless steel sheet last year was 15% over the previous year—even though stainless steel sheet transaction prices continue to rise in lockstep with increasing costs for nickel, cobalt and other key alloying metals. March surcharges will be higher for sheet and plate products—since most analysts suggest that overall demand remains robust. But, buyer surveys suggest that late first quarter demand from electrical products and appliance manufacturers has weakened.

In the March 1 issue of Purchasing, a report on alloying metals notes that strong nickel consumption growth is forecast this year because of continued robust growth in global output of stainless steel—and expanded output of superalloys. When combined with reasonably constricted supply growth, the market is projected to continue the growth in already record-high nickel prices.

However, nonferrous analysts simply don't agree on what's coming. Merrill Lynch analyst Vicky Binns believes that with stainless sheet inventories now 26% higher than when they hit a low point last March, producers are likely to reduce production "as they work through a backlog of material." Binns and most other nonferrous analysts think that will reduce see nickel prices in the near future. And that could start a free-fall in stainless steel pricing as well.

The electronic sourcing revolution that began in earnest in the mid- to late-90's and accelerated through the early years of the new millennium must bridge new challenges if it is to continue its advance. When we come back in Purchasing Focus, we'll see what buyers have to do in coming months to ensure efficient e-sourcing activities that enhance their supply management efforts. But, first this:

III. Purchasing Focus: What About Procurement Technologies?

p class=MsoBodyText style="tab-stops: 2.75in"> You know, a new Aberdeen Group study says that e-sourcing has become a widely accepted business practice that can generate compelling benefits for its users. However, the "one-size-fits-all" approach to e-sourcing, with a laser focus on price, employed by the majority of businesses, actually threatens to dramatically slow effectiveness of the program," according to Andrew Bartolini, Aberdeen analyst research director for global supply management.

He says "procurement organizations must redouble their efforts to extend the system beyond price to total cost and extend the value proposition of their e-sourcing initiatives." That's why procurement analysts say buyers should pursue some or all of the following activities:

- Develop advanced e-sourcing capabilities that move the focus from lowest cost to highest value.
- Leverage capabilities from solution providers and consider recruiting experienced e-sourcing specialists who are well-versed in best practices and maximizing the use of available technology.
- Centralize e-sourcing capabilities that capitalize on the move to center-led organizational structures by aggregating e-sourcing capabilities into centralized operations teams.
- Improve supplier discovery capabilities that expend incremental effort on supplier discovery for second and third generation e-sourcing projects.
- Consider investing in technology and/or services that will extend the reach of your program to include spend analysis, process management, and contract management

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

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

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