MetalsOutlook™ February 2008

Publisher's Statement

This month, MetalsWatch! focuses on the state of the economy. There is a plethora of information about recession being published, but no one can agree if we are in one, just began one, or will soon be out of one.

The Federal Reserve is ratcheting down the key short-term interest rate faster than at any time in recent history – and a stimulus should result. In the interim, there will be pockets of optimism in the economy that can benefit from the January rate reductions.

The infrastructure industries - aerospace, transportation, defense, power, energy, oil, and their subcontractors, are forward-looking, long manufacturing cycle operations where planning and production doesn't drop precipitously simply because of a slowdown in consumer spending. These industries will continue to provide a foundation to the economy while the financial and residential sectors work out their woes.

As you read Tom Stundza's comments in the issue of MetalsWatch, keep the pockets of optimism in mind. There isn't as much gloom and doom in the economy as it might at first appear.

Also, check out the January 2008 Manufacturing ISM Report On Business� from the Institute of Supply Management (formerly the NAPM, or the National Association of Purchasing Managers – Purchasing Manager's Report) based on the latest ISM number of 50.7%.

Welcome to Metals Outlook™ February 2008

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February 2008

Tom Stundza's Comments

Welcome to the February 2008 edition of MetalsWatch! This is Tom Stundza, executive editor of Purchasing Magazine and Purchasing.com.

Is the U.S. economy slipping into recession? Economists, analysts and investors increasingly say it's possible that the economy already has shifted into reverse. The formal recognition of a recession—roughly defined as two consecutive quarters of negative growth—probably wouldn't come for at least six months, if not more than a year, as official judges from the National Bureau of Economic Research in Cambridge, Mass., pour through various readings. But top economists from two of the major Wall Street firms --David Rosenberg at Merrill Lynch & Co. and Jan Hatzius at Goldman Sachs—say it's likely an overall recession already has arrived. Even the general public is worried. Democrats and Republicans alike labeled the economy as their number-one concern in the first-in-the-nation presidential primary earlier this month in New Hampshire. And now, Federal Reserve chief Ben Bernanke has pledged aggressive action—read that, more interest rate cuts—to bolster the weakening economy. That's because the lingering housing slump, high energy costs, expanding unemployment at a two-year high of 5%, reduced industrial activity and weakening consumer spending is fanning recession fears at the national bank.

"You've got a slowdown in employment, weaker income growth, the loss of mortgage refinancing and higher energy prices," says Carl Steidtmann, chief economist at Deloitte Research in New York. "This works against increases in consumer spending," he adds, "which accounts for 70% of economic activity." In our **Cover Story**, we'll also look at the fact that a growing number of top economists also believe the manufacturing recession may already have arrived.

Yet, prices for some manufacturing commodities already are at all-time highs because of reduced midwinter supply and strong global demand. With ferrous scrap prices erupting, sheet steel prices are increasing despite the fact that flat-rolled purchasing clearly is in a recession with U.S. demand off more than 10% in 2007 versus 2006. **Metals Chips** will look at the reasons why hot-rolled steel sheet prices have jumped from an average $544 in December to $565 this month and $579 for February deliveries. March order books aren't yet open but some service center-based buyers expect transaction prices around $590-$600. (CIBC Capital Markets says a price increase announcement has been made by ArcelorMittal for March delivery of hot-rolled sheet at $640/ton.) In the same vein, cold-rolled sheet has jumped from $624 in December to $665 this month and February with buyers saying the mills looking to boost March to $680-$690. Various economists and market analysts say the high price/low demand anomaly is due to cost-driven activity by the mills that are announcing possibly unachievable price highs to offset increased costs for energy and key raw materials. A big problem is that nothing seems to indicate that those or other commodity prices are going to go down dramatically any time soon.

Few supply execs are banking on economic relief in 2008. The vice president of procurement at one large manufacturer tells **Purchasing Focus**: "Prices, driven higher by energy costs, are once again our major concern." And, as with other economic downturns, such market dynamics will prove a blessing and a curse for supply managers. History has shown that when the economic going gets tough, CEOs and CFOs turn to the procurement and supply management organization for help. The current crisis provides an opportunity for supply managers to elevate their strategic position within their companies.

I. Cover Story � Recession in 2008?

The faltering economy has caught the Iraq war as people's top worry, a national poll suggests, with the rapid downturn showing up on the presidential campaign trail. An Associated Press poll this month shows about equal proportions of Republicans, Democrats and independents saying the economy was their major worry, suggesting the issue looms as a potent one in both parties' presidential contests. It also was cited evenly across all levels of income, underscoring the variety of economic problems the country faces.

These indeed are nervous times in Corporate America, and when corporate leaders get nervous, they get cautious and don't hire. They don't expand manufacturing operations, build new offices or factories. The liquidity squeeze has increased the downside risks for the U.S. economy. But also, consumer confidence has tumbled because of the as-yet-unresolved credit crunch. When they get cautious, consumer spending on durable and nondurable goods weakens. So, as 2008 begins, demand for durable goods—products that don't quickly wear out, like household appliances, business equipment and sporting goods—continue to be sluggish. That's why the newest Blue Chip Economic Indicator survey of 52 economists has a consensus forecast for 2008 growth in gross domestic product (GDP) at the same 2.2% as in 2007. Consumer spending has been trending at a 2.8% growth rate in 2007. Wells Fargo Bank expects consumer spending in 2008 to slow to a pace around 1.8%--and could even drop as low as 1% for a time. Residential investment is projected to decline by 8.7% in 2008 after collapsing 17.8% in 2007, says Levy.

Business fixed investment is expected to grow very modestly, while businesses will keep inventories low. The University of Michigan's Consumer Sentiment Index has been falling consistently since last August. And the factors leading the consumer pullback appear fairly obvious, says bank senior economist Scott Anderson, pointing to tighter credit standards, fewer net new jobs, the decline in housing and, perhaps, reduced stock and bond market wealth. The lack of demand for consumer durables already has softened demand for aluminum, copper, chemicals, plastics and steel. Looking at the products that use these materials, Bank of America's chief economist, Mickey D. Levy, sees only "slight growth in domestic demand in the first half of 2008, and recession-type conditions" in such industries as automotive and household durables. Wells Fargo Bank's senior economist, Eugenio J. Aleman, agrees that the Fed's lowering of interest rates won't bring back the U.S. housing market or increase the demand for U.S.-made automobiles.

Is manufacturing activity on the verge of or in a recession? Well, the leading indicators of the overall strength of industrial activity failed to grow in December, according to the latest reports from the Institute for Supply Management, or ISM, and Purchasing Magazine. Economic activity in the manufacturing sector has contracted into a no-growth phase, according to the magazine's latest Business Conditions Survey. The poll of buyers showed business conditions at 45.4 nationally (down from 50.4 in November)—and at a depressed 43.2 in the important Midwest industrial region—on an index where 50 and above shows expansion while below 50 is a sign that manufacturing is contracting. ISM's reading for December was 47.6. These readings were the lowest in almost five years, suggesting that the overall economy may be weakening faster than some economists predicted. What are the buyers telling us? According to Eugenio Aleman, senior economist at Well Fargo Bank, buyers expect the U.S. economy will continue to "fly on low fuel" throughout 2008.

That fits with several other surveys of buyers at original equipment manufacturing firms that show their economic environment is downright dreary. The Purchasing Magazine reading in December was 41% for those buyers planning to boost buying. Also depressed have been the readings from the Philadelphia Fed and the Chicago purchasing council. Buyers polled also expect metals-buying activity to remain in slow-growth mode through the first half of 2008. The key question now is how deep this buying-cutback phase will be and how long it will last. Some economists suggest this purchasing downturn will be comparatively mild and short. However, buyers appear to be somewhat more pessimistic, as evidenced by the decided lack of interest in building inventories of raw materials needed to make things.

Reducing inventories isn't new as assembly plants all over the world are trying to meet CFO demand to cut costs by shifting labor and inventory costs back to their suppliers and doing as little as they can themselves. However, it's an even bigger issue among metalworking companies in the U.S., as steel and nonferrous users are trying to push stocks back down the supply chain to service centers, distributors, processors and, in some cases, the mills. Of course, it's also pushing back investment in cutting-edge technology and more-efficient logistics.

II. Metal Chips � Prices Continue to Rise Globally

Metals prices have completed the sixth year of a bull-pricing phase that started in 2002. Since the end of 2001, a market basket of six basic nonferrous metals traded on the London Metals Exchange has increased in a supercycle spot pricing surge of 338%. While aluminum's price increased by 75% over the six years, copper exploded by 333% and zinc expanded by 172%. What caused this super cycle? Answer: The lack of investment in sufficient new mining, smelting and processing capacity in the 1990s to meet the demand surge this decade from the BRIC nations—Brazil, Russia, India and, especially, China. In fact, China now is the unquestioned driver of the global base metals marketplace, displacing the world's second-largest consumer, the U.S. So what happens to nonferrous pricing in the U.S. market now reflects global—not North American—supply, demand and commodity exchange price benchmarks. A good indicator: The exceptional strength of global demand growth and pricing for copper in 2006-2007 despite weakened purchasing in the U.S.

In the same timeframe, U.S. steel prices have increased by 113%—pushed skyward by the unprecedented spike in stainless steel pricing. Nickel, the basic raw material for stainless, spiked in 2007 to a level 7.5 times higher than the 1990-2002 average, and 59% higher than the 2006 price. However, looking at just the commodity carbon steels, prices have been erratic with volatility caused by the unpredictability of scrap, iron ore and energy; the lack of foreign-made mills products; demand trends within the various metalworking sectors; and the glut or paucity of steel at the distribution/service center link of the supply chain.

Conventional wisdom suggests that key nonferrous metals prices will slide by 15%-to-20% slide during 2008—as expanded global supply catches up with somewhat softer purchasing trends. Copper cathode output is "extremely vulnerable" to supply problems from strikes, floods and earthquakes—and that may keep prices somewhat elevated. Analysts are anticipating that last year's global surplus of primary metal will increase further this year mostly because of sustained purchasing decline worldwide.

Meanwhile, many steel mills are claiming that energy and raw materials costs are rising—and are betting on an unlikely metalworking rebound—in seeking to boost transaction prices back to or beyond the levels of 2005 and 2006. Looking at the steel economy in particular, demand, supply and prices could remain erratic through 2008. Purchasing and carbon steel prices declined in 2007 from 2006 because many metalworking industries slowed production. Some economists say steel inventory is in balance so price increases will occur in the face of soft demand. However, steel transaction prices will be harder to read than in the past, because there is no over-arching trend: Global inventories appear to be in rough balance, so there are no gluts or shortages to cause crashes or spikes. And, in the U.S., January surveys of OEM buyers finds demand erratic for virtually every steel shape. Also, only 36% of the buyers polled are accepting an increase in steel prices, supporting the view that service centers are taking the bulk of the mill-announced hikes. For stainless, is being forecast to decline in 2008, 62% of the buyers say they are paying the same or less than they did earlier.

For 2007, U.S. steel demand was less robust than previously anticipated; in fact, steel demand could be off by as much as 10% when the numbers are crunched. There is a chance of a 7% increase in steel, the bullish analysts suggest. But, there's also a chance for a 7% decline if a manufacturing recession takes hold. In all likelihood, the manufacturing economy in general—and metalworking economy in particular—is going to encounter another year of tough sledding. So, steel demand might not much better this year since end-product consumers—the people who buy the stuff made from steel—have entered 2008 straining under the combined weight of housing gloom, high energy bills, rapidly climbing food costs and a tougher market for consumer credit. That's why mill expectations of a substantial increase in demand may not occur; instead, the end-users view of a slow-manufacturing year will reduce OEM and distributor purchasing by at least 5%. And, even if there is no collapse in demand, many economists believe buyers won't just roll over and accept inflated prices so any increase in the first half could be followed by as fall off in the second half.

There are, of course, "pockets of optimism" for selected specialty metals in 2008. For example, while the production of power equipment declined by 6.5% last year, the analysts see a 3% to 3.5% pickup this year and an 11% surge in 2009—all of which will boost demand for specialty and stainless steels. Worldwide demand growth for crude oil, natural gas and key mined and smelted commodities may slow a bit over the near term, but nothing right now suggests that demand will falter in the years ahead. As a result, energy and commodity prices should remain high enough to stimulate investment in exploration, production and capacity expansion programs, which bodes well for the value-added grades of steel, superalloys and other metals used by manufacturers of mining, oilfield, and gas field machinery and equipment. And, with the global airline industry strengthening, the demand for aircraft has surged. The Asian market is booming, low-cost carriers are exploding across the globe, far-flung flag carriers are aggressively expanding, older airlines are replacing aging aircraft and newly profitable U.S. airlines are looking to replace old and inefficient fleets. Single-aisle aircraft will remain the most popular, but twin-aisle aircraft represent the largest growth opportunity. Boeing and Airbus have seen dramatic increases in orders since 2005, and both are ramping up production to fill these quotas. And, as aircraft manufacturers ramp up production, so also will producers of airplane parts. And, since only airplane, the Boeing 787 Dreamliner, is composite-based, demand for aerospace-grades of aluminum and titanium will be strong for some time to come.

When we come back, we'll discuss why tighter supply markets and a weaker dollar will require purchasing executives to throw out the rule book for negotiating prices and managing suppliers. For many commodities, traditional negotiation tactics — such as reverse auctions — won't deliver the savings buyers have come to expect.

III. Purchasing Focus � Savings? Prove It!

Welcome back to Metals Watch! and this edition's Purchasing Focus. Your CFO will likely give tougher scrutiny to your spend savings claims. And you'll once again be asked to drive additional savings without additional resources.

To succeed in this environment, supply managers will need to adopt alternative negotiation and spend management approaches, says Tim Minahan, senior vice president of marketing at on-demand supply management software provider Procuri. Here are some recommended tactics for purchasing managers to achieve and sustain supply management goals in 2008:

First, adopt alternative negotiations. With the prices of certain commodities continuing their skyward rise, buyers are no longer in the driver's seat for many products. Wringing the best value in negotiations with suppliers will require such alternatives as flexible bidding.

Second, rethink your low-cost country sourcing strategy: With rising labor costs, tighter monetary policies and tougher environmental scrutiny, faraway emerging markets are losing some of their luster. Throw in rising fuel and transportation costs and sourcing from China and other regions are not as fiscally attractive as before. Such factors have prompted many supply management organizations to begin retooling their global sourcing approaches to better reflect total costs — especially landed costs — and to better align with their company's global manufacturing, sales, and customer support strategies.

Third, optimize your spend. Tighter supply markets and a weaker U.S. dollar will require supply managers to devise new ways to improve their spend leverage. This will require improved visibility and analysis of existing spending. Improved visibility will not only provide greater insight into where you are spending your dollars, but it can also help you identify new negotiation advantages. Likewise, improved visibility can help you uncover purchase price variances with given suppliers to ensure that you are maximizing the prices and volume breaks you spent so much time negotiating.

Four, manage demand. One of the best ways to save money is to not spend it. Or, more precisely, not spend it unnecessarily. Several supply management execs plan to improve their ability to identify and aggregate purchasing demand for specific goods and services across business functions or divisions. Similarly, other companies have begun standardizing purchasing requirements to improve negotiation leverage and turnaround with suppliers.

Five, improve cash management: Faced with a tighter economy, supply managers (and other fiscal execs) need to take a more active role in improving working capital. Buyers are quickly learning that automating the invoice reconciliation and payment process can yield some dramatic improvements in costs and cash flow.

Six, embrace sustainable supply strategies: Environmentally and socially responsible supply strategies has already begun. This year, tighter environmental regulations (coupled with the need to offset supply price increases and risks) will drive most of you to employ sustainable supply strategies. The smarter in the bunch will find ways to leverage these approaches to lower supply costs, secure supply and drive greater sales and profits.

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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