MetalsOutlook™ August 2009

Publisher's Statement

The prognosticators are beginning to mumble recovery under their breath. Antagonists are saying the recovery will be slow or the recession will double-dip. Economists are little better than rumormongers these days. I guess we have all the bases covered.

So, let�s make sure we get some of these "economic indicators" in their correct order. For example, unemployment figures are a trailing indicator, not a leading one. As the economy improves, employment will follow six to 12 months later. Foreclosures aren�t likely to bottom out until employment moves upward. Bankruptcies are also a lagging indicator -- they fall as the economy improves, but not before.

Looking at these factors and trying to predict where the economy is headed is like driving down the highway using only your rearview mirror -- it lacks some accuracy. If you want to predict an uptick, you have to look at industries that ramp up first in preparation for improvements in demand.

Metals is one such industry, where alloy steel, aluminum, carbon steel, stainless, super alloys, titanium and tool steel goes into aerospace, aircraft, building, chemical, defense, gas and oil exploration, manufacturing, nuclear, and many other industries. Here you will see some early indicators of recovery in the coming months. Some industries are staging their buying cycles as you read this, getting updated price and delivery quotes.

It takes some probing, but the early signs are here. Expect movement in late August and September with a pick-up in October and November before the year-end holidays.

Lewis A Weiss

Publisher

For more information on the near-term economic outlook, check out the July 2009 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) and the latest ISM number of 48.9%

Welcome to Metals Outlook™ August 2009

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August 2009

Tom Stundza's Comments

Welcome to the August 2009 edition of MetalsWatch! This is Tom Stundza, executive editor of Purchasing Magazine and Purchasing.com.

"We are in some very hard and severe economic times." So says Labor Secretary Hilda Solis, commenting on the 9.5% unemployment rate that accounts for 15 million Americans being jobless. Atop that, there�s the fact that overall economic growth, industrial production, non-residential fixed investment, housing construction and motor vehicle sales all continue to decline some 18 months into the recession. Federal Reserve Chairman Ben Bernanke and many other economists predict the slump will end later this year. They suggest that the slowdown eased from April to June and that the economy might start growing again as soon as the current July-to-September quarter. Even if it does, though, unemployment, foreclosures and bankruptcies are likely to keep climbing and cause further economic harm, economists predict. "The pain will linger well after the recession is over, making for a subdued economic recovery," says economist Richard Yamarone at Argus Research. So, in this edition�s Cover Story, we�ll look at some key short-term economic indicators to see if there are any "green shoots" of recovery evident.

Then, in the Metals Chips segment, well explore why economists think it will probably take until the final quarter of 2009 before steel demand and purchasing start to recover.

The Institute for Supply Management�s Purchasing Managers Index of 44.8 and the Purchasing Magazine PMI of 42.2, both in June, shows there still is contraction in the manufacturing sector because a reading of 50.0 is needed to show growth. So, the steel market continues to be sluggish, despite protestations by some analysts that recovery has begun. If there has been some pick up in order activity recently throughout the steel chain, it has been driven by seasonal inventory restocking by service centers and distributors rather than real improvement in end-market demand by original equipment manufacturers (OEM). In fact, U.S. end-user purchasing is expected to remain weak for remainder of 2009. Atop that, the steel makers admit very little marketplace impact from the government�s fiscal stimulus package is expected this year. That�s why some forecasters have expanded the U.S. steel use decrease to 37% from the 27% projected earlier.

A series of Procurement Strategy Council roundtables has found that chief procurement officials are convinced there are NO reliable methods to gain insight into supplier financial health. CPOs say that historical financial information, such as in Dun & Bradstreet supplier reports, are too backward looking to reliably identify impending supplier solvency problems. Historical financial information may be passable in an extremely stable environment, but relying on a supplier's prior quarter financial report is insufficient with rapidly changing business conditions, much less one that has quickly fallen into full blown credit crisis and economic melt-down since mid-September 2008. In our Purchasing Focus segment, Dirk Petersen and Brian Powilatis, both directors of the Procurement Strategy Council suggest seven things buyers can do to check out suppliers' health.

I. Cover Story -- Heading for Growth

Latest reviews of the components that make up the gross domestic product show continued destocking of raw materials and commodities, a sharp reduction in fixed-business and construction investment and a significant shortfall in government expenditures. Lately, though, there has been an array of encouraging economic news--ranging from steady if slight growth in the Purchasing Managers� Index reports from the Institute of Supply Management and Purchasing magazine to improved automotive sales and somewhat stronger construction spending. Nevertheless, current levels of consumer confidence and other indicators are still low and consistent with recessionary economic conditions.

The scenario of a downturn gradually bottoming over the coming six months still seems plausible, according to economists, especially if the government�s stimulus package shows stronger positive impact in the second half of the year. With inflation kept in check due to weak demand, the Fed�s monetary policy will remain supportive to growth for the time being. Following several quarters of destocking, the inventory cycle is expected to be reaching a turning point in the near term. All in all, this will result in negative GDP growth improving into slightly positive readings in the final quarter of 2009. On balance, GDP will fall by about 3% in 2009-- with an improvement in economic conditions currently penciled in at 2% in 2010

However, many Americans lucky enough to still have a job are noticing something unpleasant in their paychecks: They're making less money. The Labor Department says wages shrank to their lowest in nearly a year, which underscores one of the big threats to an economic turnaround: Rising joblessness and falling wages for those still working could send Americans back into spending hibernation and short-circuit any recovery. The falling wages come from furloughs, pay freezes and pay cuts imposed by employers across the country. Many also have cut hours: The average work week in June fell to 33 hours, the lowest on records dating to 1964.

Many economists predict unemployment will hit 10% this year and keep rising into next year before falling back. However, this recession has eliminated 6.5 million jobs in about a year and a half. Including laid-off workers who have given up looking for jobs or have settled for part-time work, the so-called underemployment rate was 16.5% in June -- the highest on records dating to 1994. Illustrating how hard it is to land a job, 29% of the unemployed have been out of work six months or longer. That's the most on records dating to just after World War II. Upshot: "The job market will become the Achilles' heel of the coming recovery," suggests Sung Won Sohn, an economist and professor at California State University, Channel Islands.

Average weekly earnings fell about $2 in June to $611.49, the lowest in nearly a year and the first month-to-month drop since March. Most economists still think the recession, the longest since World War II, will end later this year. And that will happen. But the strength of any recovery will depend heavily on Americans' willingness to borrow and spend. And they have been using more of their current income to save or pay down debt.

Some economists suggest that that inventory cycle will be the key to GDP�s growth profile in 2009. Inventories slowed first-half GDP growth, but the economists expect inventories to stop being an economic drag sometime in the second quarter. And they�re talking about stockpiles of raw materials and commodities as well as manufactured goods sitting unsold in various warehouses.

Most key indicators of housing activity--home sales, housing starts and new building permits--are showing signs of stabilization, based upon dramatically improved affordability--for those who can qualify for credit. Best guesstimates are that residential construction spending will starts to rise by year-end.

For this to happen, of course, consumer sentiment will have to improve and consumer spending will have to rebound. The evidence for the second quarter suggests a mild setback for spending, despite help from reduced tax withholding and one-time payments to Social Security recipients. Given continuing steep employment declines, reduced household wealth, debt overhangs, and still-tight credit, it still is hard to make a case for a robust consumer recovery--especially after the negativity of the first half. Economist Nigel Gault at IHS Global Insights expects spending to only gradually improve over the second half of this year. That�s why his full-year forecast remains a 0.8% decline on average for 2009.

II. Metal Chips -- Steel Prices Turn North

Transaction prices for most steel products dropped again in June, according to our buyer surveys. As a group, they�ve gone down each month since last August as a global recession has prevented steelmakers from charging more for their important sheet-mill products. Have you been enjoying the bargain-basement prices for steel? Well, according to several analysts, the situation is about to change into a gradual increase in market pricing for carbon and stainless steel mill products. Reason: The analysts say steel inventories at service centers are so low that the distributors are starting to re-stock--and that could be an indicator of higher sheet and plate prices in the fall. Already, that re-stocking, plus an increase in the price of scrap, has raised transaction prices for merchant bars used in bearings, motor shafts, screw-machine parts, fasteners and hand tools.

While only 21% of the steel buyers polled by Purchasing.com at midyear expect to increase orders this summer, 41% of the end-market steel buyers surveyed by the Institute of Supply Management expect orders to be stronger come autumn. Market analysts forecast that the falloff in steel consumption has likely reached a trough for the current business cycle and, while it will be flat through September, demand should start to recover gradually in the second half--and then more forcefully improve as the market heads past 2009 and into 2010.

Yet, steelmakers have announced substantial price hikes to try and get the list price of hot-rolled steel sheet, the benchmark, up to $520/ton in September--as compared with the sale price average of $380 in July. No matter what the mill executives say, market economists say supply and demand fundamentals do not yet support the price increases.

In his latest review of the U.S. and Canadian marketplace, Peter Fish, managing director of MEPS (International) says that "the recent dire market conditions appear to have bottomed and expectations are for a steady, albeit slow, recovery." This is a common theme in market updates, but it�s a view of the producing--not the buying--community.

Buyers agree the steel market continues to be sluggish and there isn�t any recovery of real demand--despite protestations by some analysts that recovery has begun. So, it appears the price hikes may be premature--as they reflect some mill executives� perceptions of inventory-rebuilding needs among service centers and a minority of end users. In fact, with steel-mill capability utilization still below 50% and major end-use markets remain in full retreat, the mill execs may be misreading the strength of the summertime market.

IHS Global Insight forecasts a third quarter price average of $467/ton, as compared with $397 in the second quarter. The Steel Market Update newsletter today posts $435 as the expected July price but admits the mills will have to "continue their negotiations with those who have been resisting paying the last round of increases." Purchasing�s latest Steel Flash Report has a $417 price average for the third quarter and doesn�t project full acceptance because of slack buying in summer. Steel analyst Mike Gambardella at J.P. Morgan Securities agrees that "the magnitude of steel price hikes will remain muted for the second half of 2009" even though he expects steelmakers to gradually move pricing higher. Even if they do, pricing will remain substantially below 2008 levels.

Gambardella cautions in a note to clients that "substantial industry headwinds remain in place over the medium term, including a structural downshift in normalized demand and the potential for overcapacity." Because of that, "capacity utilization rates should remain depressed, but on an upward trend in the second half" from the 43.7% level of the first half. The industry only made 26.5 million tons through the end of June, a 51.8% decrease from the 54.9 million tons poured during the first six months of last year, when the capability utilization rate was 90.5%. One of his suppositions is that the larger steel mills may prefer to run at relatively low utilization rates to keep supply matched with demand in order to improve the odds for raising steel prices higher.

Meanwhile, stainless steel end-user consumption is not increasing in North America, where buyers are purchasing only for their immediate needs. That doesn�t matter to the mills, which have been selling below cost for some time, and are making a push for higher transaction prices this quarter. Fish at MEPS says that since the onset of the current financial crisis, stainless mills worldwide have been restricting their output and service centers have been running down their inventories. Now, holes are beginning to appear in available stocks and delivery leadtimes are stretching out. So, the mills think the market is ripe for supply-driven higher prices.

The problem is that their costs of raw materials aren�t really exploding. Ferrochrome cost more than it did a while ago but energy costs continue to decline and nickel prices have only inched up from the year's lows of $5 per pound to $7 in the July spot market. Atop that, some nickel producers say it�s unclear if that $7 level be sustained. That�s because recent LME nickel price inflation has been based on speculation that China�s stimulus plan would create a boom in stainless steel demand--which hasn�t happened yet.

Analysts say market fundamentals would suggest an orderly growth in price and consumption of stainless steel. Real demand is still weak in most countries. The nickel price is arguably inflated, given the high level of stocks in the LME warehouses. But, past experience shows that market fundamentals do not always apply in this sector. The analysts at MEPS say that rising stainless steel prices over the next few months may prompt buyers to rethink their current conservative approach to purchasing. They could decide to increase their order volumes in an effort to beat the potential price revival, particularly since most economists believe the bottom of this steel cycle came in June.

III. Purchasing Focus -- Is Your Supplier Healthy?

In Purchasing Focus, we�ll share ways to avoid the disturbing phone call indicating that very same supplier that got a "clean" credit report will shortly to cease operations because of severe financial woes.

To cope with the heightened uncertainty and the mounting issue of supplier financial health, buyers are using a combination of approaches--applying informal tests, identifying alternative suppliers, and hoping for the best--to assess supplier solvency risk. Dirk Petersen and Brian Powilatis, both directors of the Procurement Strategy Council suggest seven things buyers can do to check out suppliers' health. They are:

- Instead of using only Dunn & Bradstreet Supplier Reports, Use Fitch and Moody's Debt Ratings. These agencies are super-sensitive right now and will downgrade at the first sign of trouble; and debt is something most suppliers have, so you can get data even if the company is privately held.
- Partner with accounts payable to monitor changes in supplier behavior.
  Are suppliers asking for payment more quickly or insistently; are they willing to trade early payment for discounts?

- Check with your plants or other users on supplier performance Degrading supplier quality and delivery performance is a leading indicator of financial problems; suppliers can prolong the inevitable by cutting corners for a time.
- Talk to the sub-tier suppliers. Ask about payment terms and changes to order volumes and forecasts.
- Listen to the supplier sales representatives. Are they getting bonuses this year, are they hitting sales targets?
- Monitor automated online news feeds. Have buyers set up RSS feeds from the local media where your key suppliers have operations. A cut back on the second shift won't make the Financial Times or Wall Street Journal, but will be news in the local or area newspapers.
- Explore the application of predictive technology. Members in the automotive and aerospace industries report success anticipating supplier financial risk with tools like Open Ratings which uses a predictive algorithm

And that concludes our Purchasing Focus and this edition of MetalsWatch! This is Tom Stundza, executive editor of Purchasing Magazine and Purchasing.COM.

Good day.

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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