MetalsOutlook™ June 1998

Welcome to Metals Outlook™ June 1998

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June 1998

I. COVER STORY

Growth in the American economy accelerated in 1997 to the fastest pace in 9 years, helped by a burst of production in the final quarter that has continued so far in 1998. The nation's gross domestic product, the sum of all goods and services produced within U.S. borders, increased by 3.8% in 1997, according to just-updated Commerce Department data. In other significant indicators, unemployment fell to a 24 year low of 4.9% and inflation subsided to an 11 year low of 1.7%. In our Cover Story, we'll discuss how this has set the stage for what is expected to be continued strong manufacturing activity in 1998. The U.S. consumed more than 121 million tons of steel last year, up from 118 million tons in 1996. U.S. and Canada combined logged 4.5% growth to 138 million tons. These are the highest steel use totals in years. According to industrial economists polled by PURCHASING, it reflects underlying demand strength in the North American steel using economy, which should at least maintain a high level of steel use in 1998.

Manufacturing is a Surprise

Last year's manufacturing growth was led by a business investment boom and supported by healthy consumer spending for all kinds of products, especially the key goods made from metal of cars and trucks, and major appliances. Business investment in equipment, from computers to machine tools and from turbines to heavy machinery, soared by 12.2% last year. The largest increase in 13 years. Total consumer spending advanced 3.3%, the best in 3 years. Note that consumer spending on durable goods from autos to household appliances jumped 5.7%. And another growing market for steel, housing construction, grew 2.8% last year.

Atop all that, U.S. worker productivity has been registering a larger than expected increase in recent months. Productivity rose by a still healthy 1.7% in 1997 after a 1.9% rise the year before. The gain, reported by the Labor Department, was double the lackluster 0.8% average annual productivity increase from 1990 through 1995. Productivity measures output per hour of work. Economists, as an explanation for the peaceful coexistence of robust economic growth and low inflation, are holding out the pickup in the past 2 years. Healthy productivity gains mean employers can pay workers more because they're producing more, without raising price tags too much.

Last year's gain in non-farm business productivity came as output rose 4.5% and hours worked increased 2.7%. Compensation per hour rose 3.8%, the same as 1997. But, because inflation was lower, inflation-adjusted compensation improved, from a 0.8% increase in 1996 to a 1.5% gain in 1997. Unit labor costs, a key barometer of inflation pressures, were up 2.1% in 1997, compared with 1.9% in 1996. In manufacturing alone, productivity increased 4.4%, the best gain in 11 years. Unit labor costs fell 0.9%, the 3rd consecutive annual decline. That partly explains why U.S. manufacturers have maintained strong profits while holding the line on prices.

The healthy productivity and low inflation of the past 2 years also is evidence, say the experts, that the economy is in little danger of slipping into recession. This year, economic growth is expected to moderate but continue steadily. With Asian financial turmoil threatening to slash U.S. export sales and send a wave of cheap imports across U.S. borders, economists expect growth to slow to a more restrained 2.5% in 1998. One economist believes that "The economy, especially the manufacturing economy, is behaving as if it remains in a mid-expansion phase, rather than an end-of-expansion phase."

Simply put, manufacturing activity may cool in 1998 to a new-orders growth rate of 5% or slightly less, economists say, but that's because export orders are expected to slump for the first time in 2 years. Still, there is little chance there will be much of a reversal of the strong manufacturing activity that has entered its 8th year of growth. After all, durable goods orders have been on a slow and steady rise for the past 6 months.

Now, it's true that some U.S. manufacturers believe that economic conditions are poised for a modest decline in the coming summer months. "These execs are concerned that the economic instability of the East Asian nations is slowing manufacturing growth there and the need for such raw materials as metals, and is slowing Southeast Asian demand for products manufactured here," says Joseph Duncan, Chief Economic Advisor to the Dun & Bradstreet business research firm. "Foreign imports continue to rise," he says, "while U.S. exports are being threatened by the diminished buying power of the Asian trading partners."

On the other hand, construction execs surveyed by Dun & Bradstreet have raised their expectations because of steady or expanded business. Contractors have high optimism levels, says Economist Duncan, because of "a low interest rate environment, modest growth in home sales prices, depreciated costs of basic building materials, rising personal incomes, and by continued high levels of consumer confidence. "

A different block of manufacturers surveyed by the American Production and Inventory Control Society are less concerned about the U.S. manufacturing outlook. While it's true that mid-winter production has slowed slightly and inventories of semi-finished goods have fallen slightly, shipments of finished goods remain strong. Economist Michael Evans also points out that unfilled orders at manufacturing plants actually surged in the 1st quarter. Evans says this indicates, to him, that the impact of the Asian financial crisis has about passed in the U.S. "Why else," he asks, "do surveys of production planners show them gearing up for continued healthy manufacturing activity well into this summer?" According to Evans: "It turns out that none of the gloom-and-doom scenarios will come to pass. There is no global meltdown. The countries of Southeast Asia are grudgingly meeting their fiscal obligations. They realize there is no other sensible choice. I'm not suggesting that the trade deficit won't balloon this year. However, that negative impact on the U.S. gross domestic product will be offset by strength in domestic consumption and fixed business investment."

It can't hurt manufacturing that U.S. consumer confidence is at a 30 year high. A wide majority of respondents at the 5,000 households polled by the Conference Board in the 1st quarter say they expect to purchase new motor vehicles, houses, and appliances over the next two quarters. "It's not surprising that people are confident because anybody can get a job right now," says John Ryding, Senior Economist at Bear Stearns. "Buying conditions are really good," he says, noting the relatively subdued inflation rate and the decreases in retail prices seen over the past year means that consumer spending will continue strong in 1998.

Ed McKelvey, Senior Economist at Goldman Sachs, agrees that spending will likely remain strong this year. "Although it's difficult to directly link consumer confidence with consumer spending, consumer confidence is always a reflection of what's going on in the economy," he says. McKelvey adds that the growth in real income, job growth, and wage gains, which consumer confidence reflects, will power more spending. So, he says, "There's nothing overriding high employment and economic growth in our economy." And that's no more evident than in the steel marketplace.

Steel strength in 1997 was tied to a 14% rise in production from the non-residential equipment, electrical machinery, and shipbuilding sectors, plus 8% demand growth from business equipment, non-electrical machinery, trucks, fabricated metals, oil and gas-well drilling, and railroad products sectors. Sales to automotive, appliance, and other consumer durable-goods production improved 5%.

The economists say manufacturing will remain strong and generally reject the views of steel-trade executives who suggest that the strong dollar, gyrating financial markets, and economic woes in the Far East are likely to lead to lower U.S. demand for steel. The industrial bulls also point to new forecasts, which insist that shipments by U.S. manufacturers will match the 5.5% growth rate of last year. Economist Priscilla Trumbull of the WEFA Group notes that, "U.S. manufacturing, especially metalworking, still has an awful lot of momentum." Latest regional report from the Organization for Economic Cooperation and Development also predicts another couple years of solid, if somewhat slower, expansion in both the U.S. and Canada.

Key to the bullish steel-use outlooks is the expected level of 1998 business in transportation equipment, industrial machinery, agricultural equipment, and commercial equipment industries. "The latest 3 year surge in manufacturing activity has been the strongest sustained period of production in almost a quarter century," says Mark Ulmer at Standard & Poor's/DRI. For evidence Ulmer cites reports that auto and truck makers remain busy. Motor vehicle shipments, which surprised the experts last year at 16.5 million units in the U.S. and Canada, are expected to gain another 2% or so this year.

Economist Ulmer also notes that aircraft builders can't keep up with orders. In fact, the aerospace industry is expected to increase shipments by 17% to 17.5% again in 1998. By adding space vehicles with military and commercial aircraft, the economists are looking for another 20% shipment growth. That's probably why supplier execs like CEO Don Muzyka at Special Metals Corp. believes that aerospace-grade super stainless steels, superalloys, and special alloy products will have enormous mill leadtimes for some time to come. "The superalloys mills booked close to 100% of available capacity last year," he says, "and production schedules and order backlogs are indicating strong sales again in 1998."

Atop that, many industrial machinery makers, especially metal-cutting machine-tool suppliers, remain heavily backlogged with orders. Agricultural equipment remains at strong levels and as industry continues to retool worldwide, capital equipment buyers continue to source substantial quantities of lathes, metal-forming tools, cranes, industrial boilers, and all other forms of machinery and equipment. Commerce, in fact, now sees something like 8% growth in total heavy machinery production in 1998. Little wonder that sales execs at Armco now expects continued strength for stainless and specialty steels used in automotive, industrial, and consumer applications. Ditto for electrical steels used in power generator manufacturing.

II. METAL CHIPS: STAINLESS STEEL OVERVIEW

The consensus forecast for the U.S. use of all grades of steel is stable, at the very high level of 997. However, 1998 could be a very interesting year in the stainless steel segment. Stainless buying rose by a full 7% last year, and all specialty steel use rose by 5% to a total in excess of 3 million tons. Almost all of that was shipped into the OEM. Service center inventories rose by almost 8% but still were under 400,000 tons, or 3.5 weeks of supply. In the marketplace, that's not alot of inventory.

The analysts, who suggest 3% to 4% growth at best, question the industry's 7% to 8% sales growth forecast for 1998. Still, Brian Leslie, the Director of Stainless Steel Market Development for the Specialty Steel Industry of North America trade group, points out that, "With transportation, construction, and food-service markets all positive and growing, the trend for 1998 indicates continued improvement in demand.'' Leslie forecasts a 7% to 8% increase in flat-rolled demand, a 6% to 7% growth in plate sales, and a 5% to 6% rise in bar consumption.

Today, stainless steels are used in a myriad of applications, from the kitchen sink to car mufflers. For years, industry insiders have said that the OEM could support a 4% annual increase in demand. However, since 1990, the U.S. demand rate has averaged 6%. This unusually high growth rate in consumption can be traced partly to the auto industry's conversion to chrome-bearing stainless for exhaust systems. Now, there's more being used to make fuel lines, airbag canisters, and brake lines. Stainless steels are a mainstay in the production of commercial airliner parts, medical replacement parts, electronic components, and equipment used by the various process industries. All of these markets have been sales-growth arenas lately, with no letup in sight.

The value-added specialty steels also are making their way into household chimney liners, storm windows, bulk solids handling equipment, tank containers, pumps and valves, and a host of other durable goods, notes market guru Leslie. And, because the metal's surface can be highly polished, it's also finding more uses in architectural decorations and such building uses as elevator doors. High-grade stainless steels contain nickel as well, which improves their metalworking properties.

A Global Steel Update

World consumption of steel products will total 700 million metric tons in 1998, only a 0.8% gain over demand in 1997, but enough to set a world's record for consumption. Latest forecast from the International Iron & Steel Institute (IISI) projects stability in North America, continued growth in Europe, and continued growth in China to offset any dropoff from the suddenly troubled "tiger economies'' of the Far East, says Lenhard Holschuh, Secretary General. The world consumed 695 million metric tons of steel last year, the largest amount of steel in history, and 30 million tonnes more than had been expected. Holschuh pins last year's 4.5% growth in demand on stronger than expected sales in the U.S., Canada, Mexico, Brazil, Argentina, Spain, and Germany. "North American steel markets are being pulled along by a healthy level of consumption in the U.S. especially, where sales of cars and light trucks, new and existing housing, major appliances, and industrial machinery of all kinds were at extremely high, and not anticipated levels,'' Holshuch says. "There will be continued strength in the use of steel in the U.S. and Canada this year,'' he says, "Although some drawdown by users and distributors from their in-house inventories may lower year-against-year apparent consumption a bit.'' That's why IISI forecasters see U.S. and Canadian demand slipping slightly to 118 million tonnes from last year's 121 million tonnes.

South American steel demand was paced last year by a 15% increase in Brazil and a 14% jump in Argentina, where strong output by the automotive industry and high growth in construction were the key drivers. Steel use in these two nations propelled the region's overall steel use to 37 million tonnes. Since there are no economic storm clouds in the region, Holshuch forecasts "use" this year, rising further to almost 38 million tonnes.

"In Europe, there is growing optimism that the economic activity improvement of 1997 will accelerate in 1998,'' Hoslchuh says. He notes that economic-dampening monetary and fiscal restraint appear to have ended as most nations are now on track to join the single European currency system in 1999. "The single European currency has rather surprisingly already given a boost to the economic prospects of its would-be members: their currencies have weakened against the US dollar and sterling, thereby promoting an export-led revival,'' Holschuh explains. "The main beneficiaries of this development have been the automotive and engineering industries,'' says the IISI official, ""and this is reviving the steel markets of Western Europe.'' So, use rose last year by 7.7% to 139 million tonnes in Western Europe, and is still climbing to 142 million tonnes this year. Holscuh says eastern and central Europe threw off the lethargy of 1996 and steel use rose by 5% last year. "Steel consumption in central and eastern Europe is picking up in the face of higher export and domestic demand, and another 4% growth is probable in 1998,'' says Holsuch. The Czech Republic and Poland account for most of the increase, with Russia still floundering.

"Asia's steel markets have in recent years been some of the world's fastest growing,'' he notes, adding that "Asia now accounts for 45% of world steel consumption.'' However, 1998 will be a dicey year for the region, and may not even grow the 0.5% to 316 million tonnes as is now projected by IISI economists. Holschuh sees 5% annual growth likely for Mainland China, "Where the steel market has settled down to relatively orderly growth." However, he also sees less strength in the 1998 steel markets of Korea and Taiwan because of the banking and stock market woes there. "Japan's economic activity seems to indicate as much as a 3 million-tonne decline in demand this year,'' he adds. Atop that, the IISI seer projects declines in steel demand in Thailand, Malaysia, Indonesia, and other Far Eastern nations.

An 8% growth in South African steel consumption last year reflected strong exports and investment, and helped push steel growth throughout the African continent and the Middle East. Hoslchuh reckons a further 2% growth should occur this year to almost 25.5 million tonnes.

III. FORGING NEWS: CHINA STEEL LEADS WORLD AGAIN

World crude steel production rose 6.6% in 1997 to a record level of nearly 800 million metric tons, according to preliminary estimates from United Nations Economic Commission for Europe (ECE), which monitors the global industry from Geneva. The survey ranked China as the world's largest producer for the 2nd year in a row with 107.3 million tonnes of output, followed by Japan with 104.7 million tonnes, and then the U.S. at 99.2 million tonnes. The total world increase of 49.6 million tonnes was due largely to a renewal of economic growth in the European Union and to a steady growth in new production capacity in the U.S. and Asia. That's why such Top 10 producers as the U.S., Germany, Italy, and South Korea all marked up healthy increases.

Asian countries, in fact, showed dynamic growth despite the financial storm that hit the region in the second half of the year. Note that Taiwans output leaped 31.2% to 15.9 million tonnes. Japan's output was up by 6%, partly due to the stimulus from foreign demand as the decline in the yen's exchange rate against the dollar and European currencies gave Japanese steel a price advantage. South Korea's output advanced by 8.4% to 42.2 million tonnes -- spurred by new capacity installations that went into operation during 1997.

In the EU, according to the ECE, total output for 1997 increased by 9.1% over 1996 to 159.9 million tonnes. The ECE report says the jump was due to low interest rates and falling inflation which had strengthened business confidence, as well as the depreciation of European currencies against the U.S. dollar which had brought a surge in foreign demand. Germany, the top EU producer, saw an increase of 13.7% to 45.2 million tonnes. Output in Italy was up 7.2% to 25.6 million tonnes, in France by 12.2% to 19.8 million tonnes, in Britain by 3.9% to 18.7 million tonnes and in Spain by 13.7% to 13.8 million.

In the U.S., the third-largest single producer, output reached its highest level since 1981 -- up 4.8% to 99.2 million tonnes -- partly due to the start-up of a number of new mini-mills for flat-rolled products during the year. Canada's output surpassed 15 million tonnes. In Latin America, which with 52 million tonnes accounted for just over 6% of the total world figure, production growth was slower. Brazil increased output by 3.8% to 26.2 million tonnes and Mexico by 6.6% to 14.1 million tonnes.

Russia, the world's fourth-largest single steelmaker, was down 2.1% to 48.2 million tonnes due to a decline in domestic steel consumption. Ukraine, the other major steel region of the old Soviet Union, boosted output by 13% to 25.2 million tonnes despite Russia's poor performance. Poland, eastern Europe's main producer, saw a jump of 11.2% to 11.6 million tonnes.

IV. PURCHASING FOCUS: THE NORTH AMERICAN STEEL ALLIANCE

Between 1997 and 2001, the North American Steel Alliance will spend $100 million on a public awareness program to educate the public about steel. The Steel Alliance is a coalition of more than 90 U.S. and Canadian companies, producers, suppliers of raw materials, various service centers, numerous processors, and some customers. In the following Q & A, Dave Hoag, the Chairman of LTV Steel and Chairman of the Alliance, explains why the program was initiated, and what it's been up to.

Q: Why the PR program?

A: Steelmakers are all too familiar with the very competitive marketplace in which all of us work. How our markets are constantly changing, and how competing materials are always trying to replace steel. To maintain and grow our market share in North America, our industry has engineered one of the greatest comebacks in the history of North American industry. And while steel customers do know about our efforts and our accomplishments, the consumer and other important constituents -- like the media and the government and the financial institutions -- do not know about the wonders of the new steel or the value it can bring to their lives and those of future generations. If we are to expand and create new markets, we need to help our customers and our other constituents by creating widespread consumer demand for products made of steel. In that way, when consumers are faced with purchasing decisions, they will choose steel over plastic or over aluminum.

Q: What's the goal of the program?

A: If we do our job well, consumers will demand that the products they buy are made of steel. And the media and the government and our other audiences will look more favorably at steel as an industry. The Steel Alliance intends to change consumers' ideas. Not only about steel, but about all materials. We know from research that consumers want more steel in the products they buy and use -- once they learn the facts. As individual steelmakers, we do promote steel to our customers. The manufacturers who use our steel to produce autos, refrigerators, and other durable goods. The Steel Alliance helps create demand for our customers' finished products, which is demand created because of steel, the material. How consumers view our industry will affect their desire to have steel in their lives. Despite $50 billion in capital investment by this industry in North America, consumers still thought of the steel industry as dirty, polluting, and low tech. Many audiences were not even aware that steel was recyclable, much less that it is the most recyclable material on earth. However, the consumer did equate steel with strength, durability, and long-term value.

Q: What's been accomplished to date?

A: Much has been done in only a few months. We have told steel's story to over 100 million people. Aggressive public relations activities generated media stories that have reached more than 25 million consumers. Initial advertising purchases included Big Event placement, such as the National Basketball

Association playoffs and network season finales that helped us reach over 180 million people. Our research suggests the campaign is effective in even this very early stage. Prior to May's campaign launch, consumers gave steel a favorability rating of 58; 0 was on the cold or unfavorable side, 100 was on the warm or favorable impression. Two months into the campaign, the number had jumped from 58 to 66, which represented a significant increase of 14%. When consumers were asked if they viewed steel as part of the environmental problem or as part of the environmental solution, we reported a positive shift from 55 in May to 58 in June. A campaign of this magnitude has the potential to secure for us our current steel markets, and to grow the demand for our material in new applications. Members of the alliance believe that a positive image for steel throughout the world can serve to help our global steel market. Guess how we know we are succeeding? Imitation is, indeed, the greatest form of flattery. And, at this time, we know that lumber is planning a campaign similar to ours. Plastics are increasing their efforts, and aluminum is now undertaking a study to determine whether or not they should conduct a similar campaign.

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