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Publisher's Statement

Welcome to Metals Outlook™ September 1998

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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I. COVER STORY

One of the more interesting developments in theU.S. economy is the amazing recent concession by Alan Greenspan. In recent testimony before the Joint Economic Committee of the U.S. Congress, the Chairman of the Federal Reserve Board actually suggested that we all consider what a great party this economy continues to be. It's certainly true that most North Americans are enjoying good times. Wages are up while consumer prices are not. Interest rates are relatively low, allowing the public to renegotiate mortgages, pay off bills, and still have money to spend on travel and entertainment. At the corporate level, improved productivity has allowed companies to hold the line on prices, raise their profits. Companies are able to invest in new plants, develop new products and major corporations have used their strong market positions and extra cash to acquire competitors and increase market share. In this edition's Cover Story, we'll look at the near-term outlook for this amazing North American economy.

Then we'll analyze just why the North American steel market is as strong as it is. We'll also look at the latest trade falerup in stainless steel and we'll take a special look at the superalloys market an arena where supplies are tight, leadtimes are extensive, and prices are high. Finally in Purchasing Focus, we'll discuss why buyers do, in fact, discuss price during supply negotiations.

II. The North American Manufacturing Economy

Overall industrial production is growing at almost 3.5% annual rate. Private industry wages and salaries are growing at an almost 4% annual rate. What's behind all this good economic news and midyear optimism about the North American economy for the second half? First off, factory orders for big-ticket goods are very strong, fueled by strong domestic demand led by increased consumer and corporate wealth and low unemployment. Also, construction spending has been increasing since late last year. So, it's little wonder that consumer confidence remains close to a 20-year high. Americans and Canadians remain optimistic that the North American economy's healthy rate of growth will continue.

Monthly orders for durable goods from U.S. manufacturers continue to average in excess of $185 billion. That's very high. Don Hilber, an Economist at Norwest Bank in Minneapolis, now says U.S. manufacturing growth will be almost 4% this year. That may be slower than the 5% annual average manufacturing growth of the past three years, but it's still a very healthy rate of growth. Economists have, in fact, boosted their forecasts for 1998 manufacturing growth. Reason: Renewed strength in orders for civilian and military aircraft, industrial machinery, highway and off-highway motor vehicles, large appliances, corporate and consumer electronics and the primary raw materials - especially metals, chemicals, and plastics. Another factor is that there has been almost no year-to-date impact on North American end-product manufacturing from the weakened Southeast Asian economy. Raw materials have been hit, hard in some cases, but not end products.

The latest survey of a thousand manufacturing executives by Dun & Bradstreet finds the majority primed for solid business well into Autumn. Their production levels are high, yet there's actually been a drop off in their finished goods inventories. In other words, they're selling what they make, and expect this trend to continue. Joe Duncan, Dun & Bradstreet's Chief Economic Advisor, says that "Strong consumer spending rates and expanded export sales to Europe have buffered the North American manufacturing economy against any damage caused by lower demand for manufactured goods normally sold to Asia." So, while the economic theorists fret about such things as interest rates and the Asian question, consumers seem to be happy with the status quo. Bob Dederick, the Economist at Northern Trust Co. in Chicago, points out that the consumer is still on a tear. "And why not?" he asks, "Given low unemployment rates, the strong increases in income, the decline in consumer-product inflation, and the high level of the stock market." That's probably why the Conference Board's measure of consumer confidence has been at a very high level for the past several months.

A historically high number of consumers in both the U.S. and Canada believe that jobs are plentiful, and that the job market will remain at least as strong as it is now during the next six months. Such optimism is consistent with third quarter hiring plans in the latest survey by the Manpower temporary employment agency. Then there's spending plans. The Conference Board says 40% of all North American consumers expect to buy some major appliance before year's end, and more than 10% still plan to buy a new vehicle. From what the economists can fathom from their consumer surveys, higher incomes, the low jobless rate, and most importantly, expectations of a sustained healthy economy are bolstering these robust spending plans. We know that consumer sentiment is important because consumer spending accounts, directly and indirectly, for two-thirds of the nation's overall economic activity. Lynn Franco of the Conference Board says that its readings continue to suggest that consumers plan to continue contributing favorably to further economic growth.

And that optimism is showing up in other economic indicators. The Conference Board's latest index of ten leading economic indicators shows that the economy will continue its advance for the next six to nine months. In fact, income growth and low interest rates are maintaining demand for housing and home prices are rising only moderately. That's why some 5% of all consumer households just surveyed in North America indicated plans to purchase a home during the next six months. And, also note that total construction spending has been increasing since late last year, supported by low interest rates produced as a side effect of Asian financial turmoil. Residential construction continues at a seasonally adjusted rate in excess of $285 billion. Nonresidential commercial projects are healthy at an annual rate of more than $167 billion. This activity is centered just now on offices, hotels and motels, and shopping centers - but construction on industrial buildings isn't exactly depressed. Even government construction is running at a healthy seasonally adjusted annual rate of $136 billion, and that's before spending under the new highway and road bill begins.

Interestingly enough, with all this good news, there still is only "cautious optimism" from the central bankers in Washington and Ottawa. That's because while they have paid recognition to the amazing economy, it remains highly unlikely for the Chairman of the Federal Reserve Board or the Bank of Canada to get up and dance. The Fed's Alan Greenspan and Gordon Thiessen, Governor of the Bank of Canada, continue to say that any inflationary pressures will be dealt with. A signal that the central banks are ready to boost short-term interest rates, if necessary, even at the expense of slower future growth and profitability.

And there has been recent problems with the Canadian dollar. Thiessen has to be worried about the value of the Canadian dollar, which has been battered lately by the strong U.S. dollar and the drop in export sales to Asia of Canadian oil, lumber, coal, gold, nonferrous metals, and steel. Still, Greenspan and Thiessen just now agree that a central bank's policies must be to keep the expanding economy going. They point out these policies must be to facilitate the movement of a strong economy into the 21st century. And that's why Bank of Canada officials have made it clear in recent months that their main preoccupation is with controlling inflation and not propping the Canadian dollar.

In the U.S., the key concern right now probably is labor. The U.S. jobless rate is at its lowest point in 28 years. While the ability for firms to expand in view of diminishing labor availability is the obvious downside to the tight labor market, in certain slow growing industries, the labor shortage takes on an additional dimension. In many old-line manufacturing companies, primary metals like steel, chemicals and plastics, automotive, industrial machinery, and construction machinery - payrolls have not increased appreciably in twenty years. As a result, some companies, particularly in major metropolitan areas that have very weak population growth, are facing the retirement of much of their workforces with little hope of replacing the workers. So, even though ongoing capital investments and efficiency improvements mean that the companies do not need to replace all of the retiring workers, the limited availability of workers, especially skilled workers, makes it problematic to replace even a portion of the workforce. The inability of companies to replace workers will lead companies to continue to invest in labor-saving capital equipment. Many companies will increase the outsourcing of parts manufacturing and companies will continue to set up shop in parts of North America (or even overseas), where labor availability is less of a problem.

III. THE NORTH AMERICAN STEEL MARKET

Why has there been all this steel-oriented metalworking activity? Part of the reason has been the continued strength in North American production of automobiles, light trucks, minivans, sports utility vehicles, heavy trucks, and off-road construction vehicles. These all require thousands of parts and components made from steel. But, there's another reason. Steel has become much more competitive on a cost, quality, and overall value basis. You don't hear much these days about steel losing markets to such competing materials as aluminum, concrete, plastics, and wood. In fact, steel is going after some traditionally non-steel uses utility poles and house framing to name just two.

Purchasing Magazine's monthly survey of buying trends shows better than 85% of the steel buyers surveyed last month looking to maintain or expand their purchases over the next quarter. Then there's the WEFA Group index of steel-consuming sectors, which now is forecasting a 4% growth this year. That would be its highest annual level this decade. This index looks at steel-buying trends in business equipment, non-electrical machinery, trucks, fabricated metals, oil-well and gas-well drilling, railroad and shipbuilding, non-residential construction, electrical equipment, packaging, and the key consumer goods of appliances, residential housing, and automobiles. Also, there's steel industry statistical data, which shows growth so far this year in orders from the manufacturers of construction and contractors' products; appliances, utensils and cutlery; machinery, industrial equipment and tools; automotive and other types of transportation equipment, including aviation and aerospace; oil and gas machinery and equipment, and the service centers and distributors who service myriad metalworking firms.

So, it doesn't look as if steel-buying is about to head south anytime soon. Beyond the so-called major end-use markets, there's a lot of steel-buying from many, many small companies that don't make headlines. In fact, more than one market analyst is pinning the continued strong demand for steel on the reindustrialization of North America. And more than one think tank has written that improved manufacturing competitiveness has fueled a North American industrial renaissance beyond just automotive, appliance, and machine tool manufacturing. Arnold Tenenbaum is the current Chairman of the Steel Service Center Institute, whose members tend to supply these smaller steel-using firms. He notes that SSCI members "Aren't seeing the tremendous expansion in the steel economy now as we have seen in the past several years, but instead we are looking at more steady, long-term growth in steel demand."

In fact, the U.S. steel industry may be on track to post a record year for mill product shipments, say steelmakers and distributors queried at the recent Steel Service Center Institute and American Iron and Steel Institute annual meetings. Paul Wilhelm, President of U.S. Steel, reckons "The U.S. market is going to stay so strong that the mills could ship 110-to-111 million tons." That would mark a record year. Wilhelm and Curtis Barnette, CEO of Bethlehem Steel both think demand is so robust that they expects U.S. steelmakers to remain at full production levels for the remainder of the year. Shipments of U.S. steel mill products increased 7% through April compared with the same year-earlier period. AISI data shows industry shipments of 36,839,984 tons through the first four months of this year compared with 34,421,856 tons in the corresponding 1997 period. Shipments have been driven by increased sales to the makers of construction and contractors' products; appliances, utensils and cutlery; machinery, industrial equipment, and tools; and oil and gas equipment.

Atop all that, the U.S. achieved a surplus of 1.2 million net tons in indirect trade in 1997, the first time this has happened since the AISI began tracking this data in 1984. In 1996, there was a 325,000-ton deficit in world trade of steel-containing goods. "The 1997 data confirms that U.S. manufacturers are among the world's most competitive producers of high quality steel- containing goods,'' suggests Andrew Sharkey, President of the steel trade group. "It's a key reason why recent U.S. shipments and consumption of steel have been at historic high levels."

Note that such construction products as home and garage doors increasingly are being made from steel. Also, look at metal furniture shipments. Production last year set a record and output looks to grow past that level by some 5% this year. Then there's agricultural equipment. Steel-product manufacture is growing at a 3% annual rate. And how about industrial and commercial material handling equipment? Or people-moving equipment such as elevators, escalators, and so-called moving sidewalks. Systems producers say they can't keep up with orders. There are literally thousands of niche metalworking firms who are busy just now. That's got to be why Purchasing Magazine's latest survey of steel buyers found 90% who forecast metalworking activity at sustained or improved levels through the third quarter. Manufacturing could report slowing business this summer, but even if that happens, it won't impact steel use until the first quarter of next year.

Also note that business investment in plant and equipment is providing a source of strength for steel manufacturers, service centers, and construction-product fabricators. One thing that hardly ever gets mentioned is that the steel industry is a significant users of steel. In fact, we now have data that the North American steel and related industries have spent close to $4 billion annually for the past ten years in new plant and equipment. And don't forget that steel demand is bound to be bolstered by the $400 billion federal spending authorization for road and highway construction and repair .

IV. THE NORTH AMERICAN STAINLESS STEEL MARKET

U.S. stainless steel producers and the steelworkers union have formally accused eight countries of illegally selling stainless steel mill products in the U.S. at below-market prices. The domestic mills called for new tariffs on coiled sheet from France, Germany, Italy, Japan, Mexico, South Korea, Taiwan, and the United Kingdom. This could really mess up supply, since the foreign mills control 26% of the U.S. market.

The U.S. producers, United Steelworkers of America, Butler Armco Independent Union, and Zanesville Armco Independent Organization filed the unfair trade complaint with the Commerce Department and the International Trade Commission. The petitioners claim the domestic firms are barely breaking even despite increased worldwide demand for specialty steel products. "We filed this case to bring the industry back to profitability for our shareholders and to save jobs,'' says James F. Will, Chairman of the Specialty Steel Industry of North America industry group. The domestic industry is charging the eight nations with "Blatant disregard of U.S. trade laws and international trade rules,'' says Will, also the CEO of Armco Inc. "There's over-capacity worldwide (yet) new capacity is built often with foreign government support, and the producers in these countries are almost desperate to sell at any price.''

Stainless steel sheet is used in kitchen sinks, dishwashers, chemical tanks, and a wide range of other appliances and products. It is the specialty steel industry's largest product line, accounting for three-quarters of production. Will says that subsidies and other foreign practices allow companies in other countries to sell these sheets in the U.S. at cut-rate prices. Domestic execs claim some stainless sheet products are being sold by as much as 77% below U.S. list prices, which is why the U.S. spot-market price for stainless sheet has dropped by 20% over the past two and half years despite rising 5% average annual growth in consumption.

The trade complaint was filed by Allegheny Ludlum Corp., Armco Inc. and J&L Specialty Steel Inc., all based in Pittsburgh, and the Washington Steel division of Bethlehem Steel Corp. in Coatesville, Pa. Jack W. Shilling, President of Allegheny Ludlum, alleges that "Imports from many foreign producers are being dumped into this country in large quantities at unfair prices.'' He says this has "Contributed significantly to unacceptably low levels of earnings and cash flow,'' pointing out that "Adequate earnings and cash flow are necessary to continue with important capital investment programs which will keep us competitive today and allow us to grow in the future.''

Stainless imports at 26% market share Imports of stainless and other specialty steels continued to hold a 26% share of the U.S. markets in the first quarter of 1998, according to revised data from the Specialty Steel Industry of North America trade group. Imports were 22% in the first quarter of last year, but closed out 1997 at a 26% share of market.

THE NORTH AMERICAN SPECIALTY ALLOYS MARKET :

Mill leadtimes and future availability are the key concerns expressed in Purchasing Magazine surveys of superalloys buyers. Reason: U.S. use of superalloys rose by almost 10% in 1996 and 11% last year. This year's sales may slip to 7%, as users try to absorb earlier sales, but not enough to tighten mill leadtimes substantially.

This kind of demand is being driven by a resurgent aerospace industry, which delivered 2,092 civil aircraft in 1997 for income worth $4.5 billion, a 46% increase over 1996 and early forecasts show no slippage ahead for potentially as long as 20 years. Don Fuqua, President of the Aerospace Industries Association in Washington, now estimates that "The three civil aircraft segments - commercial transport, general aviation aircraft, and civil helicopters - will experience double-digit sales growth again this year.'' This sustained rebound in demand for aircraft engines and airframes has pushed the leadtimes for superalloys out to a year and beyond for specialized grades. Common grades still take almost three months to get delivered. So, it's little surprise that alloys buyers are relying more and more on service centers.

Some background: Commercial aviation orders are surging as the existing fleet has reached an age when carriers must either fix or replace the jets, creating demand for both spare parts and new aircraft. Atop that, civilian aircraft sales are booming in the glow of a rosy consumer economy. Fuqua points out that "Sales of commercial aircraft are rising because passenger and freight traffic carried by world airlines has been climbing since 1993.'' This trend, which is expected to continue, has led to a surge in aircraft orders, and the aircraft manufacturers have responded by initiating efforts to double their production. Military aviation sales appear to have hit bottom after a nine-year decline, since they rose last year to $42.3 billion. Also pushing demand for superalloys has been the fact that aerospace companies are moving into the commercial space arena. "The demand for U.S. commercial space products and services represents a new and rapidly growing market of $1 billion last year," says Fuqua. That was a one-year sales increase of 18%. Atop that, "Constellations of satellite networks offering direct-to-home broadcast television, long-distance and mobile communications, and high-band multimedia connections are in production and starting service," adds Fuqua.

With aviation/aerospace demand ablaze again, and the other markets doing well, the metals mavens suggest that superalloys consumption will average 170 million lbs. annually in 1995-1999. For 1998, superalloys will remain in strong in demand. Reason: AIA projects that U.S. aerospace sales will reach $144.5 billion in 1998. This will represent a new record (in current dollars), eclipsing the previous sales peak of $139.2 billion in 1991. The increase will be based on an estimated $10.5 billion rise in civil aircraft sector sales, a $2.2 billion increase in space business, and $2.5 billion in additional sales in related products and services. These gains will offset modest declines in the missiles and military aircraft sector. Aerospace business with the U.S. government will remain flat for the second year in a row.

However, it's not just aerospace that's driving demand. The unexpectedly strong capital equipment economy also has been a factor, as superalloys now are used in land-based power turbines and various equipment used by the process industries. When sales to traditional military and commercial aviation/aerospace markets dried up earlier this decade, superalloys suppliers were challenged to make sales into other markets. That's when producers started exploring automotive, special tooling and machining, environmental, chemical process, energy exploration, energy distribution, and power-generation markets. All this is why last year's superalloys use was an estimated 171.2 million lbs. in the U.S., the highest level in two decades. And, purchasing could rise as high as 183.5 million lbs. this year, suggest the market analysts. They note, for example, that the use of superalloys for automotive components also looks to expand rapidly. ****

Why do Buyers Discuss Price During Supply Negotiations?:

One of the biggest complaints about buyers is that they pay too much attention to component or raw materials prices, and not the "total package" of goods and services being marketed by suppliers. That's not really the case, but price is a key factor.

Picture this scenario: It's 1906 and you're standing in a small garage-type factory in Highland Park, Mich. Before you, the company's pattern maker and purchasing agent are working on the mockup of a new machine's framework. As the pattern maker puts the model together piece by piece, the buyer calculates the cost of the materials and labor piece by piece. They come up with an assembled prototype cost of $50, as long as the materials are bought in bulk and the machine's chassis is produced in volume in an assembly line. That's the estimate they present to their boss, Henry Ford, for his new Model N automobile. As it turns out, this cost estimate was pretty much in line with the actual negotiated contract with the carriage builder - who was paid $72 per chassis, and that included a $20 profit. Henry Ford went on to make 1000 of these Model Ns. He and his staff continued to estimate material supply costs in such a way that it helped the fledgling Ford Motor make an enormous number of Model Ts at prices that were affordable to everyday working people.

The point of the story is that if purchasing professionals are doing their jobs, they are considering price and value supplied as part of their cost analysis. Buyers determine the best suppliers. They also have to control their costs. And controlling costs from the best suppliers is done by buying the best package. The best way buyers can determine the best package is to determine price, cost of ownership, cost of inventory, cost of acquisition, cost of transportation, product quality, customer service, and problem solutions provided.

Unfortunately, the price to the buyer gets too much attention - so much attention, sometimes, that it appears to be the only consideration. Part of that perception is the buyer's fault. Because he hasn't explained to the supplier how price fits into total cost and value considerations, price discussions get out of proportion to their overall significance. But suppliers also have to remember that part of the misconception about the importance of price is their fault. Rather than selling their total package of materials and services, and detailing their costs and profit expectations, sales people all too often approach supply negotiations with only one component - the price. Remember. If the supplier sells price harder than anything else, the buyer will center his talks on price at the expense of everything else.

OUR NEXT COVER:

MID - YEAR MANUFACT

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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