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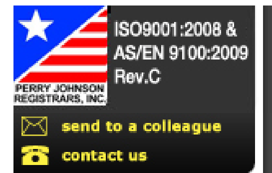

MetalsOutlook™ January 2001

Publisher's Statement

All Metals & Forge, LLC wishes to congratulate Tom Stundza, our Executive Editor of MetalsWatch! and Purchasing Magazine, for his Honorary Award for "Steel Man of the Year", as announced by the Association of Steel Distributors (ASD). This is the first time the association has given the coveted award to an individual outside of the Associations membership. Tom has been the industries news hound for 30 years and has done a most thorough and professional job. Our hats are off for Tom! Keep up the great work! Now for MetalsWatch!...

The current economic expansion now is 118 months old. It began after the last recession in 1990-1991, so it is a lot longer than previous expansions. But, the index of leading indicators has been sluggish in recent months, reflecting expectations of slower economic activity. The headlines each day tell of an increasingly weaker U.S. economy: Automakers are idling plants to work off unsold inventories, laying off workers, and squeezing suppliers. Retailers are closing their doors, some after more than a century in business. Business service companies are eliminating personnel. Computer companies are lowering profit projections. Worried that the U.S. economy is sinking fast, the Federal Reserve earlier this month lowered interest rates a half a percentage point, and further rate cuts are expected in coming months. While most economists are holding back on predicting an outright recession in 2001, they are warning that the U.S. faces a significantly meeker economy until the U.S. Federal Reserve's interest-rate medicine takes full effect.

The economic pain isn't evenly spread, with some industries hit worse than others, and some parts of North America, too. If you're lucky, you work for an energy-related company in the South. If you're unlucky, you're tied to the auto industry in the Midwest. The Fed hopes that its interest rate cuts will boost consumer and capital spending, which have been the main engines of economic growth for the past 10 years. Some sectors will respond quicker than others will. Interestingly, while purchasing data has helped confirm an abrupt slowing of the U.S. economy, a new purchasing activity index suggests Canada's domestic economy has remained robust. In our Cover Story, we'll try to explain what's happening to the economy in both countries.

Then, we'll highlight the latest news about automotive, which remains the driver of the North American manufacturing sector. From the mood inside Cobo Hall at this year's recent North American International Auto Show in Detroit it was obvious that the slowing U.S. economy has hit the Big Three automakers pretty hard. U.S. auto sales for 2000 set a new record of 17.4 million cars and light trucks, an increase of almost 3% from 16.95 million sold in 1999. But, instead of celebrating, the Big Three are forecasting a slowdown in sales and are reducing motor vehicle assembly.

General Motors now says its first quarter North American production will fall to 1.2 million vehicles, down 21% lower than output the same quarter of 2000, and down from the 1.3 million forecast just a month ago. At an auto show press briefing, GM execs told reporters that "the overall reduction reflects moderating near-term demand due to economic and consumer uncertainty and relatively higher-than-desired dealer inventories." The GM cutbacks are similar to the announcements from other U.S automakers. Ford Motor Co. plans to produce 1.05 million vehicles in the first quarter, down 17% from the first quarter of 2000. Chrysler Corp., meanwhile, will make less than 700,000 vehicles in the first quarter, down 26% from the same quarter of 2000.

Not surprisingly, there have been revisions to the forecasts for the steel market in general, and the stainless steel sheet market in particular. Steel is one the most cyclical of industries, and is having some problems right now. Imports are high, and that has triggered some production cutbacks and even some mill shutdowns in the U.S. and Canada.

Finally, in Purchasing Focus, we'll discuss the opportunities for purchasing departments to develop and implement competitive strategies. Professor Robert Monczka, who runs an annual Executive Purchasing and Materials Management Seminar, says that linkage between corporate and purchasing strategy development doesn't exist at a high level within most firms today. Although executive management has recognized the importance of the sourcing process, mechanisms aren't in place universally that directly link the development of purchasing, materials management and supply chain strategies to corporate or business unit strategies.

Still, he suggests the economic slowdown gives executive management an opportunity to examine how purchasing and supply base strategies can be more closely linked with corporate strategies to achieve competitive advantages.

Welcome to Metals Outlook™ January 2001

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I. Cover Story: THE U.S. & CANADIAN ECONOMY

Stephen Roach, chief economist at Morgan Stanley Dean Witter, says the Fed, which tightened its monetary spigots six times between June 1999 and May 2000, may have gone too far in trying to slow what it saw as an unsustainable rate of growth that threatened to ignite inflation. That's why three major Wall Street forecasters now predict the U.S. economy will grind to a halt this quarter and one of them says a full-blown recession in the first half of the year will snap the record 10-year expansion. Pointing the finger at eroding consumer confidence, weak manufacturing, high energy prices and a sharp fall in equity prices, Wall Street investment banks Morgan Stanley and Goldman Sachs, along with research firm ISI Group, believe the economy was about to stall after a decade of growth. In fact, Morgan Stanley predicts the economy will sink into recession, defined as two or more quarters of economic contraction, in the first half of 2001. U.S. gross domestic product growth slowed dramatically in the second half of last year. The government's latest reading on GDP growth showed a sharp slowdown to a 2.2% annual pace in the third quarter of 2000 from 5.6% in the second. Wall Street's gloom is in sharp contrast to the views of most private economists, which were just supported by Federal Reserve Bank of Atlanta President Jack Guynn. He predicts 3% GDP growth for 2001 and says the U.S. economy "still is the envy of the world.''

Still, in a nutshell, U.S. retail sales obviously have weakened, says David Orr, chief economist at First Union Corp. in Charlotte, N.C. And we're not talking about clothing and housewares. "What's hurting the most right now," says Orr, "are the big-ticket, interest-sensitive consumer items like cars and appliances and other things that are postponable.'' On the business side, "amid profit warnings coming out in machine-gun fashion,'' he says, "capital spending appears to be deteriorating." He says that's why the Fed surprised everybody with its early January interest rate cut. "The Fed is trying to reassure business managers that it is safe for them to continue their capital spending investments,'' Orr says. "I think they're looking for a psychological impact, hoping to forestall fear that would paralyze investment.'' Another boost to the economy could come from the tax cuts that have been promised by President-elect Bush. But it remains unclear when such cuts will be enacted, and there traditionally is a long lag time before tax-law changes have an economic impact. A potential drag on any recovery are the continuing high prices for oil and natural gas, which have drained money from consumers' pockets while significantly raising the costs of such fuel-dependent industries as electric utilities and the primary metals industries.

Most economists still suggest the U.S. growth in gross domestic product will ease to about 2.6% in 2001 from better than 5% last year. The slowdown began late last year and so far heavy industry has been hardest hit. U.S. industrial production for all of 1999 was 5%, but it dropped to 3% growth last year. Looking at 2001, Jerry Jasinowski, president of the National Association of Manufacturers, frets that "Much of manufacturing is on the verge of recession.'' In the worst shape, he says, are factories that make such basic products as steel. He points out that nine U.S. steelmakers have filed for bankruptcy protection in the past two years. Jasinowski expects the Fed rate cut to stimulate the stock market, which "should help capital spending for equipment by giving firms greater confidence as well as the wherewithal to make such investments.'' Still, inventories are piling up, especially among durable-goods manufacturers, "which will put a damper on near-term production,'' Jasinowski says.

Meanwhile, in Canada, purchasing activity increased in December from the previous month, according to the new Ivey Purchasing Managers Index, a joint project of the Purchasing Management Association of Canada and the Richard Ivey School of Business at the University of Western Ontario. The December reading of 56, while down slightly from 59 in November, shows that Canada's economy is remaining fairly robust despite the slowdown in the U.S. A reading above 50 indicates that business activity is growing.

Fraser Johnson, assistant professor at the Richard Ivey School of Business, says "One of the big messages of the Canadian data is that we won't see the big dive in manufacturing, like we have seen in the U.S." By comparison, the National Association of Purchasing Management's manufacturing index tumbled to just under 44 in December (its lowest reading since April of 1991). Atop the Ivey Index reading, new government figures from Ottawa show that the Canadian economy is remaining stronger. "And all this data should essentially quash any concerns that the Canadian economy is tanking in tandem with the U.S. economy,'' says economist Marc Levesque at Toronto-Dominion Bank. So, most analysts think the Bank of Canada doesn't need to match the Fed's shock interest rate cuts. Still, because the Canadian economy is heavily dependent on exports to the U.S., there concern is that any slowdown south of the border eventually might hurt the economy to the north.

II. Metal Chips: THE AUTOMOTIVE OUTLOOK

In fact, the depressed automotive manufacturing phenomenon in the U.S. could slow future manufacturing growth, and therefore, steel demand in both the U.S. and Canada. Not too long ago, annual automotive sales of 15 million units were considered respectable. However, starting in 1998, sales began to escalate thanks to flat pricing, generous incentives ranging from low interest rates to good leasing deals to cash rebates. On top of this, the surging stock market, low inflation, a decades-low unemployment rate, record shattering consumer confidence and easy and innovative credit all contributed to an extraordinary period of sales. Under that scenario, the U.S. auto industry's December sales at a 15.5 million-unit annual rate indeed were depressed. And that has caused full-scale recalculations of assembly schedules and materials purchasing plans. General Motors' sales were off 18% last month, while Ford's and Chrysler's were off 15%. "We don't believe December is a one-month aberration,'' says Ford sales analyst George Pipas. "If we thought sales would rebound quickly, we wouldn't have announced a first-quarter production cut on the magnitude we did.'' Auto sales in the U.S. are expected to slump to 15.5 million units in 2001, from last year's record 17.4 million units.

Replacement demand in the U.S., which accounts for 80% of purchases, has been satisfied after seven years of strong gains, setting the stage for a cyclical downturn, says ScotiaBank economist Carlos Gomes. "That's because 60% of American households already own a vehicle under four years of age," according to Gomes, who adds that "the number of U.S. households planning to buy a new car or light truck has fallen to a three year low." U.S. employment growth, another key economic driver for motor vehicle sales, is at its slowest pace in seven years. On the other hand, motor vehicle sales in Canada are expected to edge up to 1.56 million units in 2001, from last year's record 1.55 million as a result of an aging auto fleet and strong employment growth. "Despite strengthening sales in recent years, 45% of the Canadian fleet is still at least nine years old and many vehicles will have to be replaced," says Gomes. "Employment growth also remains stronger in Canada at 2.4% year-over-year," he adds.

A pleasant surprise for steel suppliers over the past three years was the surge in automotive production to an average 15.5 million motor vehicles-including medium- and heavy-duty trucks-in the U.S. and Canada between 1998 and 2000. Other steel-using sectors-including office equipment, appliances, and construction materials-also had a healthy steel appetite. That's because consumer confidence was positive and durable-goods spending held up. All that activity kept steel mills rolling out high-quality product-which peaked at a record in 2000.

The record sales pace in the 1990s has hidden a dangerous development for domestic U.S. car and light-truck makers. The big-three lost U.S. market share in 2000 to 68%, but foreign car-makers have scored big gains in sales and controlled 32% of the market. So, looking at 2001, however, the forecasters are turning negative about North American steel use. The key reason is that motor vehicle manufacturing is projected by some economists, to drop by an average 12.5% this year. Automotive's steel demand, therefore, is likely to cool with motor vehicle production being forecast in some circles to slip under 14 million units in 2000. And that could cut as much as 2.3 million tons of steel from the Big Three's purchasing plans this year.

III. Metal Chips Extra: THE STEEL OUTLOOK

Analyst Tom Runiewicz at the WEFA Group says North American steel demand has grown by an average of almost 6% annually since the last recession in 1991. Over the next nine years, demand will generally be positive, but there will be some major bumps in the road, he says. He believes 2001 will be a major jounce, projecting that steel demand will decline by 6% before recovering in 2002 and beyond.

Looking at seven other major steel consuming industries, Runiewicz suggests the steel-buying outlook will change this year in different patterns, depending on their individual cycles and business patterns. Machinery production, for example, is expected to keep growing, although probably not at the 5% rate that has marked activity for both the electrical equipment and non-electrical equipment sectors. Runiewicz also see a slowdown in production and steel-demand growth in both the fabricated metals and appliances sectors. He doesn't see a continuation of the 2% average annual growth in fabricated metals or a continuation of the 3% average annual growth for appliances.

On the other hand, the combined public and commercial construction industry could explode this year, and spur solid demand growth this year. Over the last ten years, he says, the combined public and commercial construction industry has only grown by less than 2% annually. However, the Transportation Equity Act for the 21st Century has altered WEFA Group's forecast. With $217 billion to be spent on public construction projects, the entire non-residential sector is expected to see almost a 2.5% average annual growth this year and through 2004. Commercial construction also is expected to be healthy this year, he says, although the non-residential outlook is hazy after that. Runiewicz says there will be a dramatic acceleration in demand growth ????? will be the oil and gas drilling industry. "Because of low prices and reduced concerns of an energy shortage, the last ten years have seen almost no growth in drilling until 2000," he says. This year, drilling activity will grow by another 3%, he forecasts, and boost steel sales.

U.S. steel market supply for last year rose 3% to 132 million tons. Mill shipments to domestic customers of 102 million tons were up 2% from the year before. And, mill product imports of 30 million tons were 12% from 1999 tonnage. However, based on Purchasing's calculations, steel use by manufacturing and construction in the U.S. was 114.5 million tons. That was an increase of 5%, leaving end users with in-house inventories and work-in-process steel stocks of about 17 million tons. Another half-million new tons resided at the warehouses of service centers and processors, boosting their year-end total by 3% to a record 9.5 million tons at year's end.

So, in a nutshell, too much steel, despite good demand, is the reason that prices for carbon and stainless steel mill products have fallen significantly since last spring. The projected year-end stock of 26.7 million tons was 6% lower than the 28.5 million tons inventoried at the end of 1999. But, that's going to be more tonnage than the market will need this year, given a consensus outlook for a 5% decline in real steel use in 2001 back to the 1999 level of 109 million tons.

In fact, at the moment, the stainless steel market is choking on metal. Stainless steel deliveries from

domestic mills rose 7% through last August. But, foreign mills boosted imports by 31%. Annualized, and accounting for export sales, this would raise the year 2000 total stainless steel supply by 10% to 2.8 million tons. That supply total clearly is in excess of what the U.S. metalworking economy can justify. Latest forecasts put actual use closer to 2.2 million tons. Thus, the stainless steel inventory overhang is increasing.

Stainless steel consumption has been at a high plateau in the U.S. as construction, chemical processing, automotive and consumer markets have been strong. So, demand for stainless plate and stainless bar sales have been healthy. Most importantly, demand has been steady for sheet, which accounts for 75% of all stainless products. However, the stainless sheet and strip market began to deteriorate this summer. As summer headed into autumn, the production of durable goods began to slip, and manufacturing's need for such raw materials as stainless steel has faltered from red-hot levels of the first half. So, as end-use demand has slowed, service center inventories have grown, and producers have lost the price advantage they gained earlier this year. Delivery leadtimes this autumn are down to 3 weeks. "Inventories are now excessive, both at service centers and mills, and it is doubtful that much business will be placed before February," says analyst Chris Sharp at MEPS Ltd.

Stainless steel is a staple in the production of numerous automotive, aircraft and aerospace parts and food handling, chemical processing, pollution control and medical and health equipment. Chemical processing and related downstream industries have represented an area of strong performance for stainless sales this year. So has the construction market, especially retail and restaurant construction, which is one of the most important sectors for stainless consumption. So, since domestic market observers still say that real end use by these sectors remains at a satisfactory level, the oversupply of stainless can be traced to lots of cheap imports. Traders say low-priced offers are coming from offshore producers. Upshot: Service centers entered autumn with 17% more stainless steel inventoried than at the start of the year. In fact, latest that is, September data from the Steel Service Center Institute shows that stainless sheet stocks are 26% higher than at the same time in 1999.

Stainless steel oversupply is a factor in most regions of the world. The production excesses of the first half must be reigned back to bring supply and demand into reasonable balance. However, a market analysis by MEPS Ltd. detects a considerable amount of complacency from the steelmakers about the potential for overcapacity. During the first half of this year, the world's stainless steel industry was producing at an annualized rate of 20 million tonnes. This is sufficient to meet the anticipated market requirement to 2004, assuming the trend growth rate of the 1990s continues into the next decade. The problem, says analyst Sharp at MEPS, is that substantial extra capacity is planned to come on stream well before mid-decade.

Analyst Vanessa Davidson of CRU International says an early year-2000 spurt of pricing "clearly encouraged some stock-building." Realizing there was a strong market, with leadtimes gradually lengthening and the potential for price hike, service centers and end users progressively built up inventories. However, the market has changed since then. Latest data shows sheet supply through July at 12% more than the first seven months of 1999. Annualized that would bring sheet supply in excess of 2 million tons. Market surveys by Purchasing and market analyst Charles Bradford show that end-user buyers of stainless steel have been reducing orders since August to get their in-plant inventories down. So, the latest forecasts put this year's actual sheet and strip use closer to 1.9 million tons.

Analyst Davidson of CRU says "The strong sales trends for stainless sheet evident in 1999 and early 2000 dissipated in the summer malaise that kept buyers away." And that, she adds, has erased the 4.7% growth rate for 2000 being touted earlier by stainless steel marketers. "It's true that imports have captured any growth we had expected this year," says Carl Moulton, senior commercial vice president at Allegheny Ludlum in Pittsburgh. For example, Moulton says, "That's why domestic mills aren't benefiting all that much from the 11% growth in use of stainless sheet in automotive emission control devices.

Still, there has been increased demand for specialty steel alloys and nickel-based superalloys from the growing markets for electrical power generation turbines and biomedical products. Sales are improving in aerospace and oil and gas markets. And while we're on specialty alloys, market insider's report that shipments have been strong for niobium-titanium alloys for super conducting applications, nickel-titanium shape memory alloys for cellular phones, nickel-titanium super-elastic alloys for the medical industry, and hafnium alloys used in the production of superalloys for aerospace applications.

Switching back to stainless steel, note that industry analysts think that cutbacks in European and Asian stainless steel production are needed to counter high inventories in the face of uncertain consumer demand. U.S. mills have begun to cut production, but European and Asian mills have continued to ride the storm, hoping for a bounce in demand. However, home-market stainless demand has continued to drop this summer and autumn so the mills have continued to ship large amounts elsewhere, especially into North America. Latest data from Commerce, when annualized, would give imports 23% of new-metal supply. Analysts Davidson says that "increasing import penetration poses a threat to domestic production" since the punitive dumping duties have proved ineffective. Since the service centers have stopped stocking excess material, there is less of a buffer to absorb the higher imports, and a large percentage of foreign metal is going into actual use.

Remember that strengthening U.S. sales in the second half of 1999 and the early months of 2000 encouraged mills to raise prices. First by charging higher raw material surcharges and then by reducing discounts off list prices. Order levels were strong and leadtimes had lengthened to 8-10 weeks. The price hikes were concentrated on service center buyers, since the processing / distributing segment handles markets half of all stainless sheet used in North America. The higher-price gambit didn't last long though, as imports rose last year and the service centers haven't been able to raise end-user retail prices because there is too much cheap foreign material in the market.

IV. Purchasing Focus: STRATEGIC PLANNING WITHIN PURCHASING

North American manufacturing firms historically haven't created purchasing and sourcing strategies and plans that link directly to long-term company-wide strategies and short-term business plans. That

changed somewhat last decade and strategic planning within purchasing looks to accelerate as the economy slows, according to Professor Robert Monczka of the Center for Advanced Purchasing Studies. Corporate executives at many firms have come to understand that effective purchasing and supply-base management processes contribute to business-unit and company-wide goals. Firms now promoting the integration of purchasing and corporate strategies are in industries characterized by rapid change, high material-cost content, dependency on external suppliers, and intense competition. In a nutshell-such major metalworking industries as automotive, specialized machinery, major appliance and the like.

A major characteristic of this integrative strategy development involves the linkage of purchasing strategy development with such other functional specialties as sales and marketing, design engineering and manufacturing, says Professor Monzka. This recognizes the need to remove organizational barriers to increased cross-functional integration. That's because a strategic planning process that promotes integrative strategy development encourages the efficient use of limited corporate resources to achieve specific company-wide performance goals. However, various factors or concerns can impact purchasing's ability to develop and implement competitive strategies. The highest rated future concerns to purchasing management include high end-product costs, erratic material costs, inconsistent high quality materials, environmental regulation on purchasing activities, the impact of government legislation on purchase costs, the length of time required to introduce new products and the availability of talented personnel for purchasing positions.

To combat these concerns, Monzka says purchasing management is focusing on strategies that maximize the continuous improvement of suppliers and the sourcing process, particularly in cost, quality and supplier contributions in the new product development process. Effective supply-base management approaches can minimize the impact of concerns that suppliers influence directly, he says, pointing to material product costs, the ability to obtain high quality materials and the length of time to introduce new products. He says purchasing is taking an increasingly active role in working with other key functions and with executive management. Historically, most purchasing organizations have not operated cross-functionally, received adequate computer systems support, or received recognition of purchasing requirements from executive management. That's changing and will accelerate, Monzka says.

That's all for Purchasing Focus, and this edition of MetalsWatch! Watch for our next edition.

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