MetalsOutlook™ December 2002

Publisher's Statement

We're well into the fourth quarter and the manufacturing economy is still sideways depending on who you listen to.

Chicago Purchasing Manager December Report stated an index of 54.3, and the National Purchasing Manager's Association December Report stated an index of 49.2� It's anybody's guess: ones up, the other is down!

Meanwhile retail consumers are still buying, Wal-Marts' Friday after Thanksgiving sale reported a record $1.43 billion in sales.� Maybe retail will see a rosy Christmas.

Welcome to Metals Outlook™ December 2002

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December 2002

Tom Stundza's Comments

This is Tom Stundza, executive editor of Purchasing Magazine. Welcome to the December edition of Metals Watch!

After eighteen months of decline, manufacturing grew for seven months, but appears to have turned down again--and the overall economy is barely growing. At a slower pace, the economy is more vulnerable to extraneous events. That�s why economists worry that an unexpected spike in oil prices or a 1,000-point stock market drop might push America back into recession. In fact, the U.S. economy of 2002 has slowed enough in the past few weeks that the Federal Reserve had to provide new stimulus by cutting interest rates by half a percentage point earlier this month. Interestingly, in the middle of this short-term economic malaise comes word that the United States has captured the top spot as the world's most competitive economy--and has the best prospects for further competitive growth over the next five to eight years.

According to a World Economic Forum report published earlier this month, the U.S. is tops of the 80 countries surveyed in both growth current and potential competitiveness. The growth competitiveness index looks at the technology and the macroeconomic environment that drive medium and long-term growth. The microeconomic competitiveness index measures the ability of an economy to make the most of its current resources--in terms of the sophistication of company operations and strategy and of the quality of the national business environment. Meanwhile, back in the present, the Fed's move on interest rates is intended to have a wide ripple effect by making loan money cheaper for a variety of businesses.

So, we�ll provide the latest consensus forecast for the manufacturing economy�with special attention on the metalworking sector. Then, we�ll update you on the steel marketplace�with a close eye on the stainless steel sector�and provide an early forecast for demand trends in 2003.� And, finally, in Purchasing Focus, we�ll discuss the changes in the purchasing function triggered by the economic malaise that has purchasing groups managing their supply chain in new and different ways.

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I. Cover Story: A very balanced economy! Which way will it tip?!

The sluggish labor market and faltering industrial activity evident this autumn all point to a more endangered economic recovery and to momentum moving in the wrong direction. In fact, fresh economic worries have come about despite news that gross domestic product grew by 3.1 percent in the third quarter--about twice as fast as the prior quarter. The economy was spurred largely by Americans visiting car lots to take advantage of cut-rate financing. But the GDP numbers were a bit slower than expected, and economists don't think sales at car dealerships have kept the same pace in October or early November.

Another problem is that most of those GDP gains came at the beginning of the third quarter and petered out by the end. "The momentum has weakened significantly in the last couple of weeks," says Sung Won Sohn, chief economist at the Wells Fargo financial services company. Behind the slowdown is lagging confidence, driven by talk of war in Iraq and by a continuing tide of lay-off announcements. As a result, consumers are finally pulling back from their car and home-buying binge. This caution is expected to continue through the holiday period, resulting in relatively lackluster sales.

Business isn�t showing enough confidence in the economy to build new factories or invest in new equipment, which would pick up the slack for sluggish consumer spending. Much too much was made of the fact that business investment rose 0.6-percent in the third quarter. That was the first rise in eight quarters and, since then, business fixed investment is petering out again. Orders of equipment have gradually lost momentum since posting a sizable gain in July.

That�s because corporate profits remain in tenuous condition despite some recent improvement. New orders for factory goods fell for the third time in the last four months in September--reflecting lingering uncertainty about growth in final demand. And. without an improvement in overall economic conditions, orders for capital goods will remain weak over the coming months.

So, economists such as Bill Sullivan at the Morgan Stanley brokerage are divided whether the Federal Reserve�s latest gambit will ramp up business fixed investment and overall economic growth. Purchases of telecommunications equipment, aircraft, machinery and other products of old-line manufacturing continued to decline in October, says industrial economist Mark Zandi at Economy.com. Daniel Meckstroth, chief economist for theManufacturers Alliance had thought capital spending would rebound in the fourth quarter. �But now,� he says, �I think it will be rather weak into next year." That�s why economist Sullivan, for one, believes the economy may need some fiscal stimulus. Industry is so uncertain about the manufacturing economy that it is waiting to see if Congress provides inducements�such as additional tax relief.

II. Metal Chips: Metal production is 71.6% of capacity. Some say it won't revive until late 2003

What does all this mean to the metals marketplace? Well, Purchasing magazine�s latest survey of buyers at metals-consuming firms creates a business expansion index of 49.4 in November, as compared with 48.9 in October. An index reading below 50 indicates contraction. With continued retrenchment in manufacturing activity, buying plans for metals was just 52.0�slightly lower than the 52.2 of October. Some 32 percent of metals buyers surveyed in November expect an increase in orders over the next three months, the weakest optimism index since the 27 percent of January. This isn�t surprising to economists, who say metalworking activity has slowed considerably over the past few months. In fact, production of metal products is averaging just 71.6 percent of capacity. That�s why there is no indication of a 90-day metals inventory buildup ahead�not with the November index at just 33.9. The director of purchasing for an Atlanta-based service center chain adds: "We're girding for a lean winter. Customer activity is slowing and competition is fierce. The definition of a large order gets smaller every week."

The supplier-relations manager for Pittsburgh-area steel mill adds: "It appears that buyers either have sufficient inventory or are reducing inventory in anticipation of lower prices ahead," Confidence has disappeared about an imminent recovery in metals demand for, based on Purchasing Magazine�s monthly. "It�s as if manufacturing has come to a dead stop," says the purchasing manager of a metal fabricating plant in Indiana. So, even though market prices fell in October, real demand for steel, aluminum and coppermetals didn�t improve. Purchasing's regional data found weakening metals demand in the Northeast, Midwest, and Middle Atlantic region. Demand growth was flat in the West and slightly positive in the South.

This fits with September statistics from the Metal Service Center Institute, which shows distribution-sector inventories rising while year-to-date shipments have stagnated. Shipments seemed to be posting a recovery earlier in the year, but have slipped in recent months. "Year-over-year shipment comparisons should be easy in October and November, due to the impact of September 11th on those months last year, but there is little reason to expect a pick-up in shipments going forward due to the weak macroeconomic outlook," says analyst Aldo Mazzaferro at Goldman Sachs.

Last year was a rough one for producers of industrial machinery and things have not gotten better in 2002. Through midyear, production of special industrial machinery was running a whopping 22 percent below a year. Also through midyear, production of general industrial equipment was off 5 percent.

Analysts suggest any meaningful revival will have to wait until late 2003. Production of engines and turbines is headed for its third year of decline in 2002. The investment climate does not favor a quick rebound in engines and turbines over the balance of this year. Domestic demand will build through 2003 but not hit its stride until 2004. And that�s why stainless and specialty steels and metal forgings all continue to face difficult markets. Producing mills and forging shops had hoped that 2002 would let them shake off months of depressed sales. However, the dropoff in capital spending has kept commodity-grade stainless sales weak. Also, sales are down for the higher margin value-added specialty steel products destined for the commercial aerospace and power generation markets. That�s why the attempted late-summer upturn in stainless steel flat product prices ran out of steam very quickly.

Data from the Metals Service Center Institute shows that shipments through September have weakened from the prior year and that distribution inventories have risen. In fact, current stainless inventory, at 4.5 months of supply on hand, remains above the 4.0 months average of the past five years. Market analysts are suggesting that producers will face an uphill sales and earnings battle until capital spending resumes some steady growth. Similar problems are afoot in the metals forgings market. Metal forgings are used to make automotive parts; aerospace engines, aircraft parts, auxiliary equipment and guided missiles and space vehicles, and industrial gas turbines�as well as numerous offroad vehicle, industrial and commercial equipment, and heavy machinery products. Demand dropped 5 percent in 2001, and could drop by twice that rate in 2002. The demand outlook has been severely weakened for 2003, as well.

In fact, the Global Insight consulting house�s index of activity in steel end-use markets now shows a small decline for 2003, rather than showing an increase. Nonresidential construction is now expected to show virtually no growth in 2003, with recovery not expected until 2004. Vehicle sales and production exceeded forecasts in 2002, but will pay in 2003, with declines expected from current levels. Production will be strong by historical standards, but cannot duplicate this year�s boom. Globally, manufacturing is in a slump. North America, the European Union, and Japan are struggling to show positive growth, while South America teeters near disaster. The prospects for improvement in 2003 are marginal, at best, for global economies are still over-dependent on the United States. Metals consumption, thus, is expected to show only minimal improvement.

III. Purchasing Focus: The continuing mantra of purchasing professionals improved quality, remove waste and stay competitive!

Purchasing has become�again--an important business function.

In fact, some innovative purchasing strategies now are being employed by companies to maintain or improve quality, remove waste from the supply chain, and stay competitive in a global economy.

The best purchasing organizations use innovative ways to reduce costs, improve just-in-time and on-time delivery and boost quality--all of which prove purchasing�s inherent value to the company on a financial basis. Additional traits show how well purchasing works with suppliers. This would include how supplier performance is measured, how purchasing looks beyond purchase price to measure total cost, and sharing of strategic information with suppliers to achieve specific goals. And that includes testing or implementing new approaches and new technology.

The heads of some major corporate supply organizations tell us that every company has unique strengths and weaknesses when it comes to supply, and most companies occupy different positions even when serving the same market. It is up to management to determine the best supply strategy, which will dictate the best target areas for development and use of procurement best practices. Best practice procurement requires a multi-dimensional approach. Why? Because product cost reduction, supplier development expansion, product quality enhancement, supply chain performance growth, product development acceleration and professional development expansion are all strategic purchasing activities.

Talk about multi-tasking. Yet, for a company�s purchasing organization to be considered World Class requires success in these diverse activities.

A key point to remember is that, unlike the NFL, manufacturing isn�t a copycat league. Purchasing professionals review what other supply organizations are doing but they cannot always simply copy the strategies and execution of purchasing professionals at other companies. People, suppliers, processes and other business elements are specific to companies and situations. So, while a great deal of the information that purchasing professionals say they need is statistical and marketplace in nature, a very important subset has to do with management insights.

Buyers want to know what top management is thinking and doing--and why. They also want to know where the company's customers rank the company's quality, responsiveness, service and technical support. Also note that while various observers describe today's global economy as one in transition to a 'knowledge economy', or an 'information society', the fact is that the world remains driven by the "manufacturing economy." Buyers believe manufacturing is moving to an interconnected "information" and "production" world where know-how will become just as important a resource as important as raw materials. Knowledge is largely cognitive and highly personal, management involves organizational processes and manufacturing relies on market knowledge based on competition. They all are crucial organizational resources. So, the rules and practices that determined success in the industrial economy of the 20th century won�t disappear--but will need to be rewritten and reapplied.

Well, that's all for this Purchasing Focus, and for Metals Watch. This is Tom Stundza, executive editor of Purchasing Magazine.

Our next edition is February 2003, see you next year!

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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