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MetalsOutlook™ February 2004

Publisher's Statement

The Institute of Supply Management (formally National Assoc. of Purchasing Managers), issued their Manufacturing Index for the month of January 2004, issued today Monday Feb. 2, 2004 at 10:00 AM. Again the report shows the economy is very strong with an Index of 63.6.

The economy in general and manufacturing in particular is continuing it�s forward march into better times. The replenishing of equipment, resupplying low level inventories with low interest rates (for now, but don�t panic at higher rates later this year)and the fact that this is a Presidential Election year makes for a very good year all around. What�s even better, is that the pundits are now being to tell the "good news" story for 2005. That might be a bit of a push, but read on and enjoy it while the good times roll.

Welcome to Metals Outlook™ February 2004

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February 2004

Tom Stundza's Comments

The industrial economy is expanding far more rapidly than most people expected six months ago. Although manufacturing output has been volatile and occasionally repressed, at least the trend growth has been improving�rather than declining--over the past few months. Metals producers expect stronger demand�at least through the first six months of 2004. That�s because such metals-consuming industries as energy, agriculture, mining, shipbuilding, automotive and construction are forecasting healthier orders for their products. Metals industry management also projects a healthy increase in prices for steel and the base metals�at least through spring. That�s because that higher demand, shortages of cheap scrap and other raw materials, a lack of foreign-made metals and higher transportation costs.

Economists who track activity in durable goods production agree that a modestly paced rebound in manufacturing is imminent�if not already under way. Joel Naroff, head of a Holland, Pa., forecasting firm, for example, insists that �future manufacturing growth will be broad based and strong." Mark Zandi, chief economist at Economy.com agrees: "All signals point to continued improvement in the all-important business investment category."

Comments to Tom Stundza: stundza@reedbusiness.com

I. Cover Story: The Economy in Total

Manufacturing construction & consumer are all pulling in the same direction
The view from manufacturing buyers participating in Purchasing�s monthly Business Survey is that product demand levels continue to ramp up, in many cases very quickly. Some say end-market orders are rising only slowly. But, very few manufacturing buyers surveyed in early January claim their companies are not participating at all in the recovery. That�s the good news. The bad news is that no one seems to

have anticipated the speed at which the manufacturing economy would accelerate--so there�s a whole lot of gear grinding going on. Purchasingdata.com�s diffusion index that tracks materials inventory strategy among buyers shot up to 42.6 in January�the highest it has ever been�representing a 15-point increase since August. In an economy where inventory has long been verboten, the fact that 26% of buyers now admit to active stockpiling speaks volumes about how lean industrial supply lines have gotten over the past 18 months. It suggests some buyers are feeling a bit panicky about their abilities to keep production lines supplied consistently and also reflects the fact that buyers� commodity inflation expectations are rising sharply.

Looking ahead, there�s certainly no sign that demand for commodities is going to slack off either. Purchasing�s Forward Demand Index, which tracks the overall trend in buyers� 90-day purchase plans, went to 78.9 in January with 69% of buyers saying they will increase order rates for materials and components. The Forward Demand Index for metals buyers went to 82.8 with 75% planning to increase order volumes in the months ahead. So, in this New Year�s edition of MetalsWatch!, we�ll discuss what the buyers, the market mavens and the metals� suppliers see ahead for construction, manufacturing, and metalworking. We�ll pay particular attention to the current chaotic market for steel and other production-grade metals where producers are attempting to raise base prices and initiate surcharges to offset rising costs for scrap, alloying metal and freight.

And, finally, we�ll use our Purchasing Focus segment to discuss why the premier members of the supply base for a Detroit-based axle, drive train and forgings company are rated on product quality, delivery, service, technology and cost-savings performance by a team from procurement, engineering, quality assurance, manufacturing and materials management.

Private U.S. economists have boosted their forecasts for economic growth in 2004, predicting corporate profits and consumer spending will spur the fastest expansion since the boom year of 1984. A closely watched poll of more than 50 forecasters by the Blue Chip Economic Indicators newsletter shows the consensus forecast for 2004 gross domestic product growth rising to 4.6%. Economists say the economy's positive fundamentals as overwhelming and its momentum strong, but they acknowledge risks. A chaotic tumble in the U.S. dollar or another Sept.11-style attack on the U.S. could sap consumer and business confidence and endanger this optimistic outlook.

Tom Hoenig, president of the Kansas City Federal Reserve, says both consumer and business spending now are spurring growth. He agrees with those economists who expect the commercial and industrial slack in the economy to diminish as the year progresses. He says the economy currently is operating below capacity. But, he says, this shortfall should narrow as manufacturing rebounds. Hoenig and most other Fed governors are echoing the universally bullish consensus among economists--who say improvements in manufacturing output should be near 5% in 2004 and 6% in 2005.

But, let�s start this edition by discussion an often-overlooking metals-consuming sector�construction. New government reports show that construction starts and purchases of new single-family homes stayed strong through 2003. Commerce data also shows new housing starts increased by 9.5%--as the condo market provided good support to the multifamily sector. Sales of new homes exceeded a million units in 2003 for the first time in history, and single-family housing starts easily will set a new record at around 1.5 million units. Multi-family starts essentially rose 7.5% in 2003--to around 370,000 units--despite very high vacancies in rental housing.

Economist Dave Seiders of the National Association of Home Builders now estimates that total housing starts will hit 1.84 million units for the year, an 11% increase from 2002 and the highest since 1978. The key drivers of the housing sector in 2003 still are pumping hard in early 2004, with sales and production both sustaining strong momentum. There are some legitimate issues regarding sustainability of the exuberant fourth-quarter performance (an annualized pace of housing starts around 2 million units), but there�s little reason to expect 2004 to be way below the average pace of 2003. Seiders expects some slippage in activity in 2004, but only a 3.5% decrease for total housing starts. "ur surveys of single-family home builders show the outlook is fundamentally solid --the prospects still look good-- for six months out," Seiders says.

More importantly for steel suppliers, there are signs of re-strengthened �albeit erratic-- growth ahead in non-residential construction. The U.S. economics group at J.P. Morgan Securities expects 5% growth in non-residential construction demand for 2004. This expected recovery in commercial building and transportation public works construction would add to steel demand. Already, nonresidential building has started to show month-on-month increases with such commercial structures as offices and stores, hotels and warehouses stronger.

Manufacturing plant activity has reemerged and school construction has perked up again. So has transportation terminal work such non-building categories�especially water supply systems and river/harbor development have showed gains recently. Now, building expansions still are being awaited in healthcare facilities, courthouses, detention facilities and amusement-related projects. Sewer construction and new electric utility starts are somewhat subdued. And highway and bridge construction work are uncertain. It appears that fiscal 2004 appropriations for the federal-aid highway program will receive a moderate increase, but tight state budgets will continue to restrain new construction.

Now, back to the overall economy: Gross domestic product grew an astounding 8.2% in the third quarter of 2003 and is expected to have closed out the year with another three months of solid expansion. Atop that, a string of economic releases in recent weeks have corroborated evidence of overall economic growth. That�s why the 2004 forecasts are bullish. Economy.com expects the U.S. economy�s performance in 2004 to be one of its very best. Gross domestic product growth of 4.6% for this year would mark the largest advance since 1984, when the economy expanded at a 7.2% annual clip. Also note the inflation forecast is "pretty tame" in 2004 since many economists believe the Fed is unlikely to boost interest rates anytime soon in the face of continued weak employment recovery.

For manufacturing to truly recover, though, investment must also ignite. The pace of business investment is critical to the overall economy because most forecasters expect capital spending and inventory rebuilding to drive growth in 2004. And, after being constrained for more than two years, there is proof of renewed vigor in spending on everything from high-tech equipment and transportation equipment to structures and traditional machinery. While all of these investment categories are expected to improve substantially over the next two years, the timing of their takeoffs will differ. Still, metal cutting, shaping and forming activity will perk up--eventually.

However, there is a caution: Overcapacity, lack of pricing power by firms that fabricate metal into parts and products, and corporate efforts to improve liquidity and cash flow could keep metalworking�s recovery activity much softer than in the late 1990s. Still, as we have reported in earlier Metals Watch! broadcasts, industry can�t move metalworking�s infrastructure all that easily. So, most metal-using manufacturing industries in North America can be expected to experience modest growth in domestic production over the coming years. With U.S. manufacturing expected to accelerate�especially for durable goods such as autos, light trucks, heavy trucks, off-road vehicles, heavy machinery and the like--most analyses now suggest the 2004 steel market will emerge from a five-year downturn.

Let�s look at some of those steel-using sectors, starting with automotive. Automakers sold 16.7 million light vehicles in 2003, down only slightly from the total of 16.8 in 2002, but still the weakest year in sales since 1998. Low-interest rate financing continues to support vehicle sales and incentives are expected to remain high going forward. In addition to incentives, manufacturers have introduced many new and redesigned vehicles to spur customer interest in a seemingly spent-up market. The forecasts for motor vehicle sales are all over the map though�from the pessimists who see sales weakening slightly to 16.4 million in 2004 to the optimists who see sales strengthening to 17 million. U.S. light vehicle production of 11.9 million units in 2003 dropped from 12.2 million in 2002. Consensus analysts� projection puts 2004 U.S. production back at 12.3 million units.

Now, let�s review major appliances. The government cut taxes and people depleted their savings buying stuff last year. That allowed major appliance makers to boost shipments by 2%. "This year, however, the fiscal stimulus will likely fade as consumer receive fewer tax breaks on balance than in 2003,� says Goldman Sachs analyst Gary Lapidus. Still, the major appliance makers see underlying demand out there. They now plan to spend millions of dollars in brand marketing activities to keep sales active�and growing�in 2004. That�s why the industry�s economists are forecasting 1.5% growth in shipments slightly above 70 million units.

There are more and more signs of recovery for 2004 throughout such metals-using industries as heavy equipment, metalworking machinery, farm machinery, off-road vehicles and railroad cars. However, remember that we�re not talking about boom times. First, the metal-using economy is coming off a low base. Growth will strengthen gradually�and it could take most metal-consuming industries as much as three years to get back to where they were before the downturn. Second, growth is often uneven early in a recovery.

Still, surveys show buyers are becoming more bullish than they�ve been in the past. Some of this shift in attitude is due to a pickup in orders from buyers of parts and components and steel-using end-use products. Part of it has to do with the improvement in business spending. A consensus of analysts has net supply of steel rising 3.5% in 2004 to 122 million tons after being stuck at 117 million tons for the previous two years. The view is that domestic mill shipments will rise modestly since imports will fall because of the weaker dollar.

Meanwhile, a plethora of steel price increases have been announced for early 2004. Steel scrap and iron ore prices have soared, and supply has tightened, partly because it�s more profitable for suppliers to ship to Asia than to sell in the U.S. With all the mini-mills facing the same cost pressure, higher scrap and energy costs, the need to increase prices is obvious, especially since scrap prices have been increasing rapidly and scrap accounts for possibly 65% of total costs. The integrated steelmakers buy little scrap, but are facing higher coke and iron ore costs as well as costs for natural gas. Since the integrated steelmakers have been largely unprofitable in recent years, we expect that they will take advantage of all the mini-mill spot price increases, although their cost pressures are much less. Unfortunately, most of the sales of the integrated steelmakers are to contract customers and these prices are largely fixed for 2004.

Now, spot demand may be improving, it�s still weakish�so the proposed steel prices are getting ahead of themselves. Steel buyers at the OEM polled by Purchasing Magazine say the mills have set price goals too high and too soon. Market analysts say, "Yes, prices should rise," both because of improving demand and sharply higher input costs. "However, it is hard to accept shortages as a justification for price increases when the steelmaking capability utilization rate is below 80%," says John Anton at Global Insight and Randy Cousins at BMO Nesbitt Burns. Also, buyers still cannot pass along higher steel costs, and will soon balk and refuse to pay.

Thus, some analysts suggest the announced hikes are likely to be only partially imposed in the first quarter, and then abandoned in the second quarter. The problem is that there is no universal scrap surcharges in place for December deliveries. More important: (a) not all buyers are being charged surcharges--most of the surcharges have been attached to service center orders but not OEM, (b) even among those buyers being charged, not all are accepting the surcharges, (c) not all the mills have surcharges in place for January, some are for February, and (d) the different mills have proposed surcharges that are different from each other.

Okay, we�re about to switch focus to purchasing strategies. Many corporate sourcing organizations believe the best suppliers are their strategic partners dedicated to providing products and services to feature outstanding quality, on-time delivery, excellent customer service and competitive pricing. When we come back, we see why Abdallah F. Shanti, vice president of procurement and information technology, insists that American Axle & Manufacturing�s annual Supplier Recognition Awards congratulate �a small but elite tier of suppliers.�

II. Purchasing Focus: Highlighting Americans Axle & Manufacuring

Their story is what's happening to all American manufacturers. This is the new world order! Change with the times or die!

And this edition�s Purchasing Focus. American Axle & Manufacturing produces driveline and chassis systems and forged metal products for trucks, buses, sport utility vehicles and passenger cars. Although American Axle spun off from General Motors in 1994, the former parent handled purchasing of direct materials until 2000. Since then, American Axle has developed its own purchasing system for $1.6 billion in annual buys of direct materials. That has included the repositioning of contracts that General Motors had put in place earlier for American Axle with existing suppliers. Purchasing czar Shanti says his purchasing group �works very closely with our suppliers to improve productivity, and they collaborate with us on product design, manufacturing and tooling development. We try to have a good, solid, collaborative relationship with key, strategic supplier-partners.�

The procurement team applies the same relationship-building methods to its internal supply sources to gain productivity and to achieve a competitive advantage. That�s because about 25% of the $1.6 billion direct materials spend is handled internally since American Axle has its own forging division, which supplies such components as gears, axle and drive shaft components, pinions and the like. Interestingly, the firm buys approximately 250,000 tons of steel annually for its forging operations. In fact, it�s the largest special bar quality steel buyer in the automotive industry.

American Axle has a driveline division, a chassis division and a forging division, and Shanti has adopted the attitude that the purchasing department is another division. That has helped the firm gain cost-saving benefits, he says, as opposed to the old, traditional approach of going out and saying to suppliers, �Give me a 5% or 10% cost reduction.� Shanti wants his purchasing team working with internal partners and suppliers to design the cost out of the product. �Because, if you're a casting supplier to American Axle,� he says, �I look at you as the expert in that domain, and if you can tell me how to design my product better to leverage your manufacturing capability and so on, I've taken cost out without even asking for it.�

That�s obviously important because of competition in a tough manufactured-product marketplace: Listen to what Shanti says: �Our whole procurement department and I work with our suppliers to make sure that they understand that American Axle is not just competing against other axle manufacturers in North America. We're competing globally against axle manufacturers from around the world. We need to be very productive to stay competitive, and we want our suppliers to be able to compete on a global footprint as well. It doesn't matter if you're an American Axle supplier in Korea, China, Mexico or Detroit. We all have to work together to be globally competitive. That philosophy comes from our chief executive officer and our chief operating officer and myself, and it is delivered throughout our whole supply chain. It is a constant theme any time we communicate with our supply chain.�

That�s why purchasing brought in its key strategic suppliers and had an open discussion to determine ways in which they could help each other become globally competitive by leveraging business tools. �We concluded that collaborative engineering and collaborative manufacturing were the two strategic initiatives that would help us achieve our objectives,� and they did,� says Shanti.

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

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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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