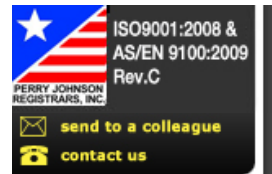




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Tom Stundza's Comments

Welcome to the November 2005 edition of MetalsWatch! This is Tom Stundza, executive editor of Purchasing Magazine. And this is the 53rd such commentary since the series began in 1998.

Steel is anything but predictable. In fact, tracking the ups and downs of steel-market pricing is enough to leave any observer with a case of whiplash. Steel prices reached record highs early in 2004. The bubble burst last September and prices dropped monthly through August of this year until a gradual rebound started. Since hurricanes Katrina, Rita and Wilma created a sharp uptick in steel scrap and energy prices, the mills have been trying to pass these and other higher operating costs through to buyers. Steel prices tend to reflect a number of factors such as the price of steel scrap, where the correlation is quite high. Interestingly, scrap prices have been on a price-up, price-down monthly yo-yo for more than a year and no short-term change in activity is expected. This edition's Cover Story will discuss the near-term outlook for steel demand and pricing. Most analysts believe regional supply and demand fundamentals are better balanced this quarter and should be in equilibrium through mid-2006 boosting spot-market prices for flat-rolled products. Other mavens believe a decline in sheet prices in first-quarter 2006 is inevitable as idled domestic carbon-grade capacity returns just about the same time that a higher level of imports reaches the domestic marketplace. Also note that there are no clear signs yet about the local stainless market.

Steel isn't the only metal in flux as 2005 comes to a close. The base metals bull has been running out of control for three years now, but the inflationary beast may be running out of energy. The prices for base metals—copper, aluminum, nickel, zinc, lead and tin—that are traded on the London Metals Exchange (LME) have rocketed by 75% since the autumn of 2002. Since economists are expecting the world economy to slow down in coming months, they reckon demand for base metals will slow, which will make pricing volatile and on a downward slope. In a nutshell: Lower nonferrous metals prices may be more pronounced in 2006—especially if supplies improve. We'll address this in the Metal Chips segment, with an eye on China. China remains the key wild card in any steel and nonferrous market analysis. There has been a meaningful increase in steel sheet capacity in the second half of 2005, which eventually could distort global sheet trade flows. There also has been expanded production of key base metals within the Middle Kingdom. While apparent consumption in China remains strong, and construction demand is reported to be on the rise, home-market prices for production-grade metals have been slumping—probably because inventories also are on the rise. So, the chances are great that China will shift from a net importer to a net exporter. Ultimately, the impact on U.S. market prices for steel, aluminum and copper—but mostly steel—could depend on the Chinese government's ability to control exports—and/or the responsiveness of U.S. trade officials to potential dumping by Chinese producers.

Finally, in Purchasing Focus, we'll discuss how purchasing organizations can help supply partners create and capture more value through innovative sales approaches that pay attention to end-customer needs.

Inventories at the service centers and at the end-use metalworking companies appear to have declined to more normal levels. The Metal Service Center Institute says the steel inventories of its members declined to a 2.8-month supply, or 12.9 million tons, in September from 3.5 months in July, or 14.3 million tons. Still, in a reflection of the typical boom-bust psychology of this market, service center executives already are increasingly worrying about availability of steel. Supply hardly seems to be an issue, though, since domestic demand is down by 10% so far this year--with reduced steel-buying by the automotive and appliance sectors offset somewhat by expanded buying by the machinery, capital goods and transportation infrastructure sectors.

I. COVER STORY

At the recent Metal Service Center Institute Economic Forecast conference, mill and distribution executives talked about improving demand from the oil and gas, non-residential construction and construction equipment markets. They didn't talk much about automotive, appliance and the other big-tonnage markets that have been in distress this year. U.S. steel shipments in 2005 are likely to be around 104 million tons, compared to 114 million in 2004. And, with economic growth forecasts for 2006 weakening, the mavens expect only a modest rebound to 108 million tons next year. Imports are highly sensitive to domestic pricing. When domestic prices soared in 2004, so did imports. Steel imports have been on a downtrend along with prices--during 2005, and look to be falling 14% year over year. Some analysts expect low imports to continue next year. Of course, there is a chance that excess production in other regions especially China is about to bring greater imports of steel into North America. Steel imports to the U.S. fell to 17.1 million tons in the first eight months of 2005 from 17.7 million tons in the same period last year. Still, China's exports to the U.S. almost doubled to 1.6 million tons in the first eight months of 2005 from 892,000 tons in that period of 2004.

U.S. market prices for steel mill products increased by 42% during 2004. Prices dropped 12% in the first half of 2005 in the face of a global glut, coming off those historically high levels that peaked late last summer. Inventories have since declined, but demand hasn't really grown so average prices up just 4% so far in the second half. The second-half pricing push by North American mills is mostly to offset the increased average per-ton costs due to significantly higher prices for purchased slabs, scrap, iron ore, coal, natural gas, electricity and alloying ferroalloys--as well as fixed operating costs caused by lower production levels. So, steel remains significantly more expensive in the U.S. than in the rest of the world--and that might draw more imports in coming months. Sheet steel product prices in Europe have fallen by almost \$180 a net ton since March and have been basically flat for weeks. Price in North America entered November \$55 cheaper than March but \$115 higher than the low point in August. China, the world's largest steel producer and consumer, is on pace to make a record 350 million metric tons of steel this year. The country's steel industry continues to oversupply its domestic market for lower-grade steel products, and as China's steelmakers seek to get rid of their excess products, they are driving down prices in neighboring steelmaking countries such as Japan, Taiwan and South Korea. Prices there have dropped by an average \$100 a ton in the past six months. In fact, steel prices have been going down throughout Asia all year. These days there is a big gap between the lowest-priced region, which is China, and the highest-priced area, which is North America. The early November price of hot-rolled sheet in coil, the most common steel product, has risen to about \$550 a ton in the U.S., compared with about \$380 a ton in China. That's a range of \$170 a ton. Steel is also costlier inside the Europe Union than in China, yet the gap is narrower at \$66 a ton, so that region's steel market isn't expected to see as much imports from the Asian giant. The analysts say this current divergence in prices globally is quite unusual. International trading in steel is a highly developed business, and the flow of trade around the world tends to smooth out uneven price patterns. Recent increases in ocean freight rates up 75% since the start of August may mean this correction takes a little longer to occur. Some producers say their order books for sheet and plate are filled through December. Shipments of certain construction-grade bar products have been strong. So, it's not a surprise for price increases in October to be recorded for coated sheets, plates, rod, beams and most bar products except the high-end cold-finished grades, which stayed at September's level. However, stainless steel sheet transaction prices slipped slightly for the fourth straight month because consumption is slipping, competition from imports is increasing and alloy surcharges are decreasing.

"Spot prices began to recover in September and we expect further recovery throughout the fourth quarter," says Don Pether, the president and CEO of Dofasco, the Canadian steelmaker. Scrap prices also have picked up in recent weeks, giving steelmakers reason to at least maintain current steel prices in December. Other steel-company executives in the U.S. also are predicting that strong customer demand will bolster steel prices in the fourth quarter and going into 2006. While U.S. steel mills and some Wall Street analysts say they expect buyers to return, others say they believe steel purchasing might slow as winter sets in and cheap imports become available. If that happens, U.S. steelmakers may be setting up for another glut in the first or second quarters of 2006, triggering a price slide similar to the 10-month decline from late 2004 through the first half of this year. Remember that detailed updates on steel market pricing are available to subscribers of my Steel Flash Report and Cold-Rolled Steel Sheet Report, available exclusively on Purchasingdata.com. Now, back to our report. Steel expert Paul Scott at the CRU International metals market research house in London is just one of numerous analysts who see surging supply and falling demand pushing steel prices on a downward path next year. The same is being projected for nonferrous metals in 2006. But, since the prices of nonferrous metals have risen to new heights, the analysts say the descent won't be smooth. Prices for most industrial commodities remain high in 2005 because of low stock levels, healthy demand from China, production and delivery difficulties in the supply chain and artificial inflation on metals exchanges in London, New York and elsewhere caused by speculators and hedge-funds investments. There growing signs that consumption-growth rates for many nonferrous commodities are beginning to weaken. China's industrialization the development of electricity grids and telecommunications networks and the expansion of a transportation infrastructure has been creating a new world demand center for copper. But copper is used extensively in North America and Europe, as well, and world purchases have been much weaker than expected. Analysts believe demand of 14.5 million metric tons this year will match what it was in 2004. The mavens think copper prices will drop almost 15% in 2006 as rising global production pushes the market into surplus. Similarly, intense interest from the speculators has so skewed current aluminum prices that they don't really reflect real demand and supply. But, with world production expanding, the mavens think aluminum prices will drop almost 4% next year. Zinc is the only base metal for which analysts agree on the price trending upwards by about 7% next year. That's because demand growth in Asia caused by booming demand for zinc-coated galvanized sheet has offset the industrial production growth-rate

slowdowns and zinc metal consumption decreases in North America and Western Europe. Global zinc supply is insufficient to satisfy growing demand due largely to the lack of investment in mining and smelting capacity. On the other hand, the mavens think lead prices will drop by more than 11% in 2006. Most of the metal's demand growth is coming from China, which is displacing battery production elsewhere. And the problem for lead is that batteries are becoming its only market. That's because environmental laws have changed electronics production standards so that tin is replacing lead in solders. Yet, the mavens report that high supply and a demand environment described as fairly stagnant and surprisingly weak continue to weigh down tin's pricing. After hitting a cyclical peak last year, tin has slipped by 12% to a 10-month price average this year because of oversupply. Looking ahead at prime-grade metal, the mavens see a 6.6% decline next year.

A lengthy period of growth in world stainless steel demand came to an abrupt halt in the third quarter of this year. Up until then, nickel's supply had been tight and the price had been volatile. The price, which has increased by more than 100% since 2002, has been a major annoyance to raw materials buyers at the world's stainless steel producers. Nickel prices flattened this summer--and now are under downward pressure since demand has been slowed. That's because stainless steel mills worldwide are cutting output to restore some pricing to that metals marketplace. The mavens project nickel prices dropping by at least 15% in 2006. World stainless steel mill executives are struggling to keep transaction prices up but surcharges are starting to crumble. That's been bringing transaction prices down. In the U.S., for example, this month's stainless steel pricing from the mills has slipped 9% since the summertime peak. Note that U.S. apparent consumption actually has declined by 2% so far this year while lower-priced imports now control 32% of supply. The McKinsey & Co. management consulting firm says metal parts suppliers are discovering an approach known as collaborative selling can produce tailored products by forging highly collaborative relationships with buying and engineering groups at selected customers. When we come back, we'll discuss collaborative selling and its flip side--collaborative buying--in this edition's Purchasing Focus.

II. Purchasing Focus

Welcome back to Metals Watch! And this edition's Purchasing Focus. In the mid-1990s, Alcoa's Wheel and Forged Products division began devoting more energy and attention to developing custom products for several auto manufacturers. The result was more distinctive--and often proprietary--forged aluminum wheels for vehicles such as the Special Edition Jeep Grand Cherokee, Ford Super Duty truck, and GMC Hummer. This happened because Alcoa, the world's largest aluminum company, listened to the purchasing-and-engineering teams at the automotive firms who were sourcing wheels. Eventually, Alcoa extended its collaboration with original-equipment manufacturers (OEMs) beyond the development of new products, to include rollout, marketing, and post-sales service. During the past ten years, Alcoa has expanded its share of this market to 35% from 5%. Collaborative initiatives can reduce buying and selling costs by more than 20%, according to supply management experts at McKinsey & Co. However, they add that buyers and their suppliers must have a thorough understanding of the end-use company's procurement, manufacturing and sales economics. And there has to be an extensive sharing of information through joint strategy sessions to uncover mutually beneficial opportunities with personnel as wide-ranging as product engineering, purchasing and materials management, manufacturing and commercial. Interestingly, companies with collaborative procurement programs often wind up working with collaborative selling groups initiated by their suppliers. Periodic reevaluations of relationships between the buyers and the sellers also are commonplace. Intriguingly, buyers say that Alcoa and automotive purchasing/engineering teams hold weekly meetings during critical points in the customer's sales cycle and develop strategies based on a deep understanding of the economics. Remember that developing economic insight into specific elements of the value chain requires detailed industry knowledge but it's an exercise that benefits both the buyers and the suppliers.

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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