# MetalsOutlook™ January 2006

**Welcome to Metals Outlook™ January 2006**

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## I. COVER STORY

People may feel less inclined to be big spenders this year and the housing market may slip off its lofty perch in 2006. These could become the key developments that would produce slower, though still respectable, overall economic growth. Indeed, the picture emerging from discussions with economists is projected growth of gross domestic product at 3.3% this year. That�s lower than the projected 3.6% growth in 2005. And it could be even lower than this consensus forecast because there�s concern that high energy prices will continue to threaten manufacturing activity. This would be especially true for the output of durable goods, those expensive items meant to last three years or longer. Reading the economic journals, one finds much debate about the projected strength industrial growth will be. Most of the concern is centered on automotive and white goods. Motor vehicle sales for 2005 at about 17 million units sold edged out the 2004 volume of 16.9 million. But, most industry executives are forecasting flat overall U.S. sales in 2006�and that will keep domestic assembly from expanding much more than 2% this year. And, the erosion of purchasing power at U.S. households also could muzzle demand growth this year for major appliances, electrical goods�including home appliances and power tools�and electronics. Still, there�s a consensus among the economists that spending by businesses should firm up as companies boost investment in response to global competition. That�s why few experts believe the economic expansion is in serious jeopardy�a perspective that will be addressed in our Cover Story, the Manufacturing Outlook for 2006.

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## II. METAL CHIPS

Then, in keeping with our Forecast theme, this edition�s Metals Chips section will present the Steel Outlook for 2006. The picture is clearly cloudy early in this New Year. Although they remain elevated, benchmark carbon and alloy steel prices have been gradually falling from their peak level of September 2004. Some analysts believe that supply will remain in line with demand in North America this year. This camp reckons the stage is set for prices to rise above averages witnessed in the fourth quarter of 2005. Other analysts expect an imminent surge in imports, which would pressure sheet prices lower�even though service centers and distributors are keeping their inventories slim because of the pricing uncertainty. The key issue seems to be that overall U.S. steel demand. Use slipped by 4% in 2005�and could slide by another 6% this year. In the North American stainless and specialty steel sector, demand began 2005 very strong but end use wilted in late summer and early autumn so that purchasing declined by around 6%. The elimination of excess stainless steel among distributors helped keep prices up almost 14% for the year. However, a second-half slippage in transaction prices reflected both a decline in end-user and service center demand�plus lowered costs for nickel, chrome and other raw materials. Lowerpriced imports of stainless and specialty steels never abandoned the U.S. market�and the percentage of supply actually grew to 30% last year. And, since nickel and chrome expected to continue to fall noticeably in 2006, benchmark stainless and specialty prices could slide by as much as 10% this year.

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### III. PURCHASING FOCUS

Finally, in this edition�s Purchasing Focus, we�ll present a half-dozen strategies for purchasing managers who are contemplating low-cost country sourcing. These tips were developed by the Aberdeen Group supply chain management consulting firm in Boston. Earlier this month, President Bush traveled to Chicago to talk up what he views as America's rosy economic future. To make sure no one missed the point, the White House dispatched 23 other administration officials to do the same thing around the country. "We're strong, and I'm optimistic about the future of this economy," Bush said in a speech to the Economic Club of Chicago. Other Republican officials fanned out across America to assuage any economic worries. And. there are still a lot of sources of concern�the impact of our military intervention in Iraq on the domestic economy, high energy prices, low-cost offshore producers of numerous materials and products, job losses and plant closures in domestic manufacturing, and eroding consumer confidence. Democratic Party Chairman Howard Dean says Bush doesn't understand the economy�because the White House is �working hard to push a rosy economic outlook that simply does not match the harsh realities confronting the American people." And so begins a congressional election-year debate about the state of the economy that is only expected to intensify. Job growth has slowed lately, a sign the economy may have lost some steam. Purchasing executives nowadays are less optimistic about business than they had been for most of 2005. Consumer confidence took a big hit in early January, dragged down by Americans worries about the future. That�s important because consumer spending accounts for a big chunk of overall economic activity. Consumer spending probably will increase by only 2.9% in 2006, compared with the 3.5% rise in 2005, according to the National Association for Business Economics. David Rosenberg, chief economist for North America at the Merrill Lynch brokerage in New York is even more pessimistic, suggesting that �the consumer sector to slow to 2.25% in 2006, from 3.5% in 2005 and close to 4% in 2004.� Rising interest rates and the toll of high energy bills appear to be playing key roles in the expected belt-tightening by consumers. Atop that, most economists believe that the housing market will slow in 2006. With housing valued at less than in the recent past, and with credit-card repayment minimums doubling or tripling, the appetite of consumers for new purchases should wane. Now, many economic gurus believe that strength in the business sector will at least partly offset the residential-construction slowdown. In fact, the economists see business spending as the most important engine of overall economic growth this year. During the past several years, "companies have rebuilt profits, accumulated cash and streamlined their businesses," says economist Ethan Harris at the Lehman Brothers brokerage. He says that since businesses have underinvested in capital during the past several years, �the economy has been set up for strong growth in capital-equipment spending for an extended period." But, while business activity will cushion the impact of the slowing housing market, it may not completely offset it. Housing has bolstered the economy in many ways. In the third quarter, home prices were an average 12% higher than a year earlier, according to the Office of Federal Housing Enterprise Oversight. According to the Federal Reserve, banks had real-estate assets totaling $2.9 trillion in December. That total, which includes mortgage loans outstanding and property holdings, was up 14% from a year earlier and up roughly 76% from five years ago. The housing boom has allowed millions of Americans to turn their homes into piggy banks, extracting billions of dollars in cash for spending through home-equity loans, cash-out refinancing deals and capitals gains on home sales. But, �what really worries the economists about 2006 is the cost of energy,� suggests Mark Zandi, chief economist at Moody's Economy.com. �The potential for even higher energy prices is a risk to the economic outlook. The economy has digested the higher prices gracefully so far,� he says. �But, it can get a bit of indigestion if energy prices move higher. " Further consolidation in the automobile manufacturing industry poses a downside risk to the industrial economy. Ford is expected to follow General Motors� lead and announce a new round of plant closings in January. Cutbacks at automotive assembly plants and suppliers� parts-making facilities will be drags on both employment and income, and will filter through to service and construction industries. Still, the mavens at Economy.com say manufacturing activity outside of automotive appears to be healthy�with strong demand particularly evident for the industrial, agricultural and telecommunications equipment industries. Heavy machinery and construction and agricultural equipment production activity will maintain demand growth for carbon, alloy and stainless steel in 2006. That�s why market researchers at Global Insight, for example, are projecting total industrial production growth in 2006 of 3.5%--down only slightly from last year's 3.9% growth in manufacturing activity. Strong spending by businesses should power the nation's economy to a fifth straight year of expansion in 2006. Most steel-market scenarios suggests that fairly healthy North American shipments will continue into early 2006 and keep supply tight�at least until the restarts of domestic production in the first quarter of 2006 and imports from China, Russia and other steel-surplus regions start boosting supply and depressing prices. Actually, domestic shipments are kind of wobbly and imports already on the docks have entered the country well under domestic market pricing. So, while it�s probable that sales prices for steel sheet will be higher in 2006 than they were in 2003 (before the price spike occurred), they won�t be as high as they were in 2004 and 2005.

A problem for steel may be that that recent big winners in the industrial growth arena�computers and electronic products and electrical equipment�use more nonferrous metals than ferrous mill products. Even more important, the North American steel market is entering 2006 once again riddled with conflicting forecasts and signals. �Demand appears good, but auto disruptions and general economic concerns sound a cautionary tone,� says analyst Timna Tanners at UBS Securities in New York. �Supply is somewhat tight entering 2006,� she says, �although restarts and imports could more than fill the market�s needs, depending on timing.� Tanners also believes that rising imports and added domestic output will put downward pressure on prices in coming months. Actually, the carbon steel marketplace is going through a boom-bust-boom cycle that has winter 2005-2006 pricing somewhat higher last autumn but equal to March 2004, just when pricing was coming out a lengthy low-priced period. Tanners suggests that prices are perhaps too attractive, with U.S. benchmark hot-rolled sheet at nearly $200/ton higher than Chinese equivalents�thus making the U.S., market an appealing import target. That�s why the UBS Securities forecast calls for regional prices of hot-rolled sheet in coil falling 14% by year�s end.

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## IV. ONE FINAL NOTE...

Buyers acknowledge that supply of carbon and stainless steel sheet and plate is back near balance, as excess inventory has been worked off. Analysts at J.P. Morgan Securities are looking for continued strength in such key stainless and specialty steel markets as military and commercial jet engine components, electrical energy equipment, oil and natural gas machinery, chemical process, food equipment, and medical markets. However, buyers believe recent higher prices should fade by the second quarter of 2006 because expanded imports will boost supply beyond the growth rate of demand.

Merrill Lynch analyst Mike Harrowell says North America is expecting increased imports during 2006. �Mills are presently bracing for an influx of cheap imports during 2006,� says Harrowell. Imports can pressure prices in two ways. The most obvious is disrupting the supply and demand equilibrium. But a more subtle impact is the pressure of lower prices on the market and a threat of increased imports. Analyst John Novak at CIBC World Markets in Toronto already is seeing April bookings for hot-rolled sheet in coil selling at a $50/ton discount to current prices. �We hear that steel buyers are clamoring for lower prices since they are aware that steel globally is trading at a steep discount,� says Tanners of UBS Securities. She adds that �although mills appear to have relatively full order books, the threat of imports can at least cap prices.� Harrowell also sees a connection between this and several anti-dumping cases that have come to a head recently--with the significant result being that the U.S. will not continue to discriminate against imported steel. �U.S. trade administrators appear to be moving to reduce the protection of the steel industry, in favor of downstream manufacturing,� he says, so �steel users who have been complaining about the lack of imports coming into the U.S. now are able to look forward to a greater level of cheaper imported product.� With excess capacity worldwide, North American marketplace always is a prime target for imports. Marriages and manufacturing integration in metals has been under discussion for years. Finally doing it obviously is helping profits, but it isn�t making a lot of friends within the purchasing community. There has been major-league grumbling about a lack of service from mills and poor deliveries. For example, a review of Purchasingdata.com information finds that metals leadtimes have extended by more than 80% since the start of 2003, even though demand for metals collectively has declined by 15%. The grousing is especially loudest when the supplier is one of the companies that have been involved in some kind of consolidation or revamp or spinoff. The North American metals industry is addressing these issues and its lack of consistent profitability by consolidating ownership.

A new Aberdeen Group study found chief procurement officers rating low-cost country sourcing a top priority over the next three years since their companies plan to double their spending with offshore suppliers by 2008. When we come back, Purchasing Focus will discuss some tips to help make purchases from low-cost countries a cost-effective exercise.

Welcome back to Metals Watch and this edition�s Purchasing Focus. You know, U.S. companies in greater numbers are sourcing products and parts overseas to reduce overall costs and compete more aggressively at home. An Aberdeen Group study found that purchases from low-cost countries have average cost savings of 10-35% compared to U.S. and Western Europe suppliers. While cost benefits are enticing, there are potholes the size of moon craters for companies that do not properly prepare for all the potential hazards along the way. With that in mind, here are some tips from industry experts on how to successfully implement low-cost countries� sourcing strategy.

First, calculate all the costs by getting everyone involved. Create a cross-functional team that includes procurement, engineering, supply chain and finance personnel who can coordinate the most efficient and productive low-cost country sourcing plan. By doing so, a company can best anticipate actual savings and set realistic goals and expectations. Second, protect against the theft of intellectual property. When moving to low-cost regions of supply, a procurement organization should have multiple sourcing strategies, whereby different overseas companies supply one of several parts. Collect the components�and don't forget to make sure ahead of time they are compatible�and assemble the final product in the U.S. for improved manufacturing and distribution control. Third, conduct in-depth due diligence on low-cost country sourcing suppliers It is dangerous for a company to simply look at an overseas supplier's website, get a quote for the goods, check a few references and start to do business. Buyers should specifically pre-screen any supplier before entering into a contractual arrangement. Fourth, establish your own international purchasing office. They aren't cheap and require a long-term commitment since recruiting and training local talent take as long as 12 months.

Fifth, consolidate the number of suppliers. When you find the right low-cost country supplier, use them. By consolidating supplier networks and focusing more spending with a handful of key suppliers, companies can significantly reduce the cost of procurement. Sixth, be patient�but have an exit strategy. Low-cost countries will not stay low cost forever. Have an exit plan ready ahead of time should conditions change, whether that is price hikes, political upheaval, or currency fluctuations. The plan should cover what to do about intellectual property and how the contract and production will be phased out.

Well, that's all for this Purchasing Focus, and for this edition of MetalsWatch! More stories on low-cost country sourcing can be found in the archives of purchasing.com. More information on business conditions, product leadtimes and metals and steel pricing�plus my monthly Steel Flash Report and quarterly Energy Flash Report�can be found at purchasingdata.com. This is Tom Stundza, executive editor of Purchasing Magazine.

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