MetalsOutlook™ July 2006

Welcome to Metals Outlook™ July 2006

Lewis A Weiss
Publisher
Comments to Publisher: publisher@steelforge.com

All Metals & Forge Group, LLC
330 Changebridge Road
Pine Brook, NJ 07058
USA

Phone: 1.973.276.5000
Fax: 1.973.276.5050
Toll Free: 1.800.600.9290
http://www.steelforge.com
E-mail: info@steelforge.com

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I. COVER STORY

Welcome to the July 2006 edition of MetalsWatch! This is Tom Stundza, executive editor of Purchasing Magazine and Purchasing.COM.

The economy is at a crossroads with the rate of growth decelerating while the rate of inflation is accelerating. The Federal Reserve is facing the difficult task of figuring out which is more important: putting a lid on prices or keeping the economy humming. At the same time, commodity markets are at a critical juncture as producers are trying to revive prices of such commodities as metals just as demand growth is slowing. Note that it�s been a long time since stagflation was in the economic lexicon. "Stag" refers to a sluggish economy while �Flation� signifies rapidly rising prices. This combination of weaker growth and higher interest rates last was seen in the 1970s and 1980s. But, it could happen again in the marketplace for stainless steel and manufacturing materials if the Federal Reserve Board miscalculates its tightening of monetary policy.

II. METAL CHIPS

Our Cover Story, therefore, will discuss growing concerns about potential adverse impact of inflation on the manufacturing economy.

That�s important because high costs for alloys and other raw material inputs have boosted some stainless steel transaction prices by as much as 60% from five years ago. In fact, on average, stainless price tags at the mill level are the highest since 1989-1990. Transaction prices�the base level plus raw material surcharges�for stainless sheet have increased by 22% already this year. Type 304, cold-rolled sheet, for example is selling for $1.37/pound on July deliveries versus $1.12 last December. This recent spate of sustained elevated prices for stainless steel has caused some buyers to reassess their relationships with mill suppliers�and boost their reliance on service centers. This attitude has been buttressed by delayed mill deliveries of the expensive specialty steel products. We�ll discuss all this in our Metals Chips segment.

III. PURCHASING FOCUS

And, finally, in Purchasing Focus, we�ll discuss how purchasing professionals are reacting to the elevation and volatility of raw materials costs. We�ll detail the buyer polls that show changes in buying patterns, sources and strategic thinking.

IV. COVER STORY 2

Let�s start with our Cover Story, where overall U.S. economic growth raced ahead at a breakneck pace of 5.6% in the first three months of this year. The acceleration in first-quarter growth of gross domestic product primarily reflected an upturn in consumer spending on durable goods, an acceleration in exports, an upturn in federal government spending, and a pick-up in investment in equipment and software. However, the anticipated U.S. economic slowdown has arrived, ushered in by a downturn in housing markets and a deceleration in consumer spending. Surging gasoline prices, rising interest rates, reduced consumer spending and a cooling housing market are all weighing on the economy. That�s why economists now believe overall GDP growth slowed to around 2.5% to 3% in the just-completed April-June quarter and will remain at that pace in the second half of the year as consumers continue to cut back on spending. The cooling housing market will restrain the growth of residential construction activity, but business structures investment and public construction are expected to move up. Overall construction activity is expected, therefore, to ease down only gradually in 2006�and by less than 1% when compared with 2005. Meanwhile, the analysts believe that manufacturing, a sector of the economy hardest hit by the 2001 recession, is likely to slow in coming months along with the rest of the economy. Looking at this goods-producing manufacturing segment, growth averaged 4% in 2005 after increasing 4.8% in 2004. Recent forecasts have put the projected growth in industrial output into a range of 3.8% to 4.5% for 2006. That�s because some economists wonder just how robust the industrial sector will be in the second half of this year. Nondurable goods output is slated to expand by 2% this year, led by the petroleum refining and chemical industries who are struggling to return to normal following the hurricane damage of 2005.

Durable-goods manufacturing, alone, increased 5.7% in 2005 and continued to lead growth for the goods-producing sector. Through the first half, manufacturing of durables�those items expected to last at least three years�has performed well due to business investment and export demand. That�s why most analysts have expected durable goods output to increase by 6.4% in 2006--led by America's love affair with high-technology products and accelerated production of jetliners to meet overseas airline demand for new equipment. One problem: Manufacturing activity growth slowed unexpectedly in June, due primarily to the continued rise in prices for energy and raw materials.

And the issue of inflation�and its impact on the near-term economy--has become a major political and monetary predicament. So, while orders to U.S. factories for manufactured goods have continued to rise, June surveys of buyers by Purchasing Magazine and the Institute of Supply Management both show the rate of growth at a slower pace than in the recent past.

"The modest pull-back in June�s manufacturing growth is in line with the expectation of more moderate growth," says Tom Duesterberg, president of the Manufacturers Alliance/MAPI, an industry group. � We continue to lead the industrialized countries in economic growth and we have very good fundamentals for continued economic expansion,� says Ed. Lazear, chairman of the White House Council of Economic Advisors. �There have been some concerns in the past couple of months that the economy may slow this year. It is better described as likely moderating from very good growth to good growth.�

Although the economic situation is favorable, there are always risks to continued economic growth. For example, Purchasing Magazine�s overall price index of industrial raw materials for durable manufacturing, materials for nondurable manufacturing, and materials and components for construction closed June some 18% higher than the middle of last year. Ben Bernanke, the Federal Reserve chairman, admits he is fretting that inflation expectations have edged up as the overall economy is slowing and raw materials costs are trickling down into producer and consumer prices. Other economists agree that rising energy prices and fuel costs are bleeding through�via higher operating costs at factories, higher gasoline prices, expanding surcharges on freight, and actual manufacturing.

And nowhere is this more evident than in the stainless steel marketplace where inflation is a global phenomenon.

V. PURCHASING FOCUS 2

Metals Chips finds that besides the 22% rise in North American pricing for stainless flat-rolled, transaction prices for Type 304 cold-rolled coils are up by close to 20% in Japan and more than 40% in Germany. While basis prices have gone up, a large part of the increase being paid by stainless buyers is attributable to higher costs for alloys and other raw material inputs. The surge in the nickel price to almost unprecedented levels in the last few months largely is responsible. But other raw material costs also have risen. After dipping in the first quarter of this year, for example, chromium prices have rebounded briskly.

Some mills have further inflated their surcharges by including provision for non-alloyed scrap and energy. Steel market researcher MEPS (International) says the surge in prices also reflects a growing market shortage, as evidenced by mill leadtimes that in some cases stretch out until January 2007. The recent fire at one of the ThyssenKrupp Nirosta stainless steel works is likely to aggravate the European supply tightness. Sheet supply also is extremely tight in the U.S., according to service centers, who are complaining of long leadtimes and incomplete deliveries.

Survey after survey finds industrial, commercial and retail businesses nationwide being worried about rising costs. Many large stainless steel-using companies in the industrial Midwest try to negotiate long-term contracts as protection against market volatility�or they arrange quarterly buying-needs reviews or try to limit the amount bought in the pricing-unpredictable spot market. Now, Purchasing Magazine surveys and conversations with smaller-volume stainless steel buyers show they also are purchasing more than usual as a pricing hedge or shopping around for new supplies and/or new suppliers. But it isn�t as easy as it sounds, according to buyers, since few stainless steelmakers have been raising production to meet higher demand. Also, foreign steelmakers that once served North America have been looking elsewhere for sales opportunities over the past 18 months or so. Also, even so-called �full service� metals distribution centers look at stainless as a specialty item; in fact, service center shipments of stainless steel is just 4% of total steel shipments. And, should buyers chose first-stage processors as sources, they can pay as much as three times what the stainless products would cost from service centers.

In the U.S., the market for stainless mill products is cloudy. Supply through the first quarter expanded at a 9% growth rate, according to data calculations by the Specialty Steel Industry of North America trade association. Interestingly, shipments by service centers through April were only 4.5% higher than a year earlier. The largest stainless steel-consuming sectors are appliances, transportation and medical products. None of these are among the top-performing manufacturing segments this year. According to Moody's Economy.com, those are aerospace and defense products, industrial machinery, semiconductor equipment, electronic equipment and instruments, telecommunications equipment, manufactured housing and recreational vehicles, and computer equipment.

The only available data through March shows consumption of stainless steel sheet and strip was unchanged from a year ago. Bar and rod showed a decrease while plate showed an increase. Worldwide, though, stainless steel purchasing is expected to increase by a solid 8% this year because of expanded production by the aerospace, industrial and power generation industries.

Forecasts issued by the International Stainless Steel Forum and MEPS (International) show production expanding past 26.3 million metric tons this year. Exceptionally strong stainless demand in the European Union and increased activity in China is likely to lead to increased production levels in 2006, according to MEPS. The Sheffield, England-based forecaster sees a rise of 6.4% in Western World stainless steel production to 22.25 million metric tons, up 1.35 million metric tons above 2005. Stainless steelmaking in China and Russia is expected to be close to 4 million metric tons in 2006, about 500,000 metric tons higher than last year.

When we come back, Purchasing Focus will discuss how a growing number of buyers at domestic industrial operations say they have joined with manufacturing personnel more frequently�sometimes as often as weekly�to reevaluate sourcing needs and to find such solutions as new suppliers or alternative commodities to materials inflation and delivery bottlenecks. But, first this:

Buyers appear to have misjudged the cost inflation of raw materials this year�and the unpredictable and unexpected costs are throwing many corporate purchasing budgets into a tizzy. After seeing double-digit price hikes each of the previous three years, purchasing professionals bet on moderate 9% inflation this year on the pricing of a market basket of energy, metals, chemicals, resins, rubber products, lumber, building and packaging materials and electrical and electronic components. Purchasingdata.com suggested that 21% inflation in 2005 for a market basket of 108 commodities would be followed by 5% inflation in 2006. Today, all these forecasts appear to be inadequate; for example, transaction prices for the raw materials tracked by Purchasingdata.com already had increased by more than 11% by midyear�and are expected to climb further.

Already, buyers are working to expand their supply base for raw materials, according to new surveys, as many are moving from spot purchasing to quarterly contracts with guaranteed three-month pricing whenever possible. Many buyers polled by Purchasing Magazine say they have joined with corporate financial staffers to work on cost-reduction efforts through such activities as hedging or low-cost country sourcing.

That may explain why 76% of the buyers polled have approached traders or offshore producers about buying production-grade materials�even though current currency evaluations favor the domestic buyer over the offshore suppliers. Interestingly, a separate study of purchasing organizations this spring by the Aberdeen Group of Boston finds that "market pressures are causing 68% of the companies polled to reduce costs while maintaining quality" at a time when 36% are battling rising commodity prices and 30% are facing tightening raw materials supply. The study also shows that 71% of the buyers polled are sourcing offshore now�as opposed to 45% five years ago.

Well, that�s all for this Purchasing Focus and this edition of Metals Watch! This is Tom Stundza, executive editor of Purchasing Magazine and Purchasing.COM. Good day.

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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 Site Map

All Metals & Forge Group, LLC.
75 Lane Road
Fairfield, NJ 07004 USA

Toll Free: 800-600-9290 Fax: (973) 276 - 5050