MetalsOutlook™ August 2008

Publisher's Statement

Globalization has now visibly arrived in the metals industry at every level. I have spoken about the impending impact of globalization for years. Now, the U.S. metalworking industry is witnessing it first-hand, from mills and distributors, and from OEMs to every small machine shop.

Raw materials prices are rising because of global demand, particularly in China and India. Whether or not our economy cools is irrelevant to metals prices, because other international consumers are fully in the mix, and their consumption is driving up metal prices. Domestic price forecasting models are obsolete, and global production may not catch up to global demand for several years.

As demand increases for metals, supply pressures rise on coke and iron ore, in particular, and alloying elements, in general. The good news is that exploration is increasing to satisfy the demand for the primary elements. That means some sectors heat up while others cool down. It is a complex composite of supply and demand in metals that spans the globe.

For more information on the near-term economic outlook, check out the July 2008 Manufacturing ISM Report On Business� from the Institute of Supply Management (formerly the NAPM, or the National Association of Purchasing Managers – Purchasing Manager's Report) and the latest ISM number of 50.0%

Welcome to Metals Outlook™ August 2008

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August 2008

Tom Stundza's Comments

Welcome to the August 2008 edition of MetalsWatch! This is Tom Stundza, executive editor of Purchasing Magazine and Purchasing.com.

Inflation has been battering manufacturing commodities, transportation expenses and construction materials this year. Industry and construction are having a lackluster year yet energy and raw materials are setting high-cost records—with no sign of ebbing prices in the second half. The fact of the matter is that stagflation is returning to the economic scene—as the downturn is gaining steam while inflation roars ahead.

President Bush this month presented an economic view at a news conference that was much more optimistic than Federal Reserve Chairman Ben Bernanke's testimony to the Senate. The view from the President: "We're going through a tough time, but our economy has continued growing, consumers are spending, businesses are investing, exports continue increasing, and American productivity remains strong." Asked if recent economic data made him worry about a recession, the president replied that "all I can tell you is we grew in the first quarter." Indeed, the economy did grow at an adjusted 1% in the first quarter—and, possibly, a slightly weaker 0.9% in the second quarter. However, Bernanke's narrative to Congress made the first quarter seems ages ago—since economic conditions at the start of the third quarter are fraught with inflation threats that complicate Fed efforts to nurse the ailing economy. So, in our **Cover Story**, we'll look at the differing views of the economy that are making this summer so anxious for many businesses and consumers.

Then, in the **Metals Chips** segment, we'll discuss the inflation at the raw materials level that has boosted commodity prices already this year and will keep them elevated in 2009. You know, after erupting by 26% in 2007, prices this year for a group of metals tracked by Purchasingdata.com are on pace to increase by 16%. And, then, in 2009, buyers can expect flat or a slight 2% slippage. If only the real world was that easy to explain. In truth, market economists and purchasing executives say individual metals pricing remains unsettled—inflated for some commodity metals, deflated for others. The base metals market is a good example: while aluminum, copper and tin prices have risen by 30% to 40% since January, nickel, zinc and lead have fallen between 20% and 40%. Steel is no different: Carbon steel prices are exploding by 46% this year while stainless steel prices have dropped 14% off the record highs of 2007—when prices increased by 42%.

Finally, in **Purchasing Focus**, we'll discuss the pressure from top management to reduce costs and control commodity inflation—which has put tremendous stress on chief procurement officers and has jolted purchasing and supply chain organizations into numerous price risk-management exercises. Purchasing chiefs say that risk management in 2008 is more about reducing today's inflated costs of energy and materials rather than finding ways to minimize future costs. In other words, supply chain management today is more functional than strategic.

I. Cover Story � U.S. Inflation

The U.S. economic downturn has gained steam lately, with a report of the highest inflation since the early 1980s, more bad news for banks and automakers and a suggestion by the Federal Reserve chief that worse days are ahead. President Bush has sought to bolster confidence by declaring that the financial system was "basically sound," but he concedes: "It's been a difficult time for many American families." However, in a somber midyear outlook to Congress, Bernanke tells the Senate that "the effects of the housing contraction and of the financial headwinds on spending and economic activity have been compounded by rapid increases in the prices of energy and other commodities, which have sapped household purchasing power even as they have boosted inflation."

The Labor Department says wholesale inflation, driven by skyrocketing gas and food costs, rose by 9.2% for the 12 months ending in June—the fastest pace since the summer of 1981, during another energy crunch. "Rapid increases in the prices of energy and other commodities ... have sapped household purchasing power even as they have boosted inflation," Bernanke tells the solons. This inflation has helped make real growth in Americans' earnings stagnant and Bernanke cautions that inflation was likely to move "temporarily higher" in the near future. "The government report confirms what every consumer in America has known for months now: inflation is soaring and it's having an adverse impact on the economy," says economist Rich Yamarone at Argus Research.

That's why he believes consumers hit the brakes hard despite a massive infusion of government stimulus checks. Retail sales have turned in their poorest showing in months. And Bernanke now warns that spending by consumers, which provides nearly three-quarters of the nation's economic activity, "seems likely to be restrained over coming quarters. One measure of the economic stress on households is the so-called economic misery index - calculated by adding the 12-month inflation rate and the unemployment rate. With the jump in inflation to 5% in June from 4.2% in May, the misery index is now at 10.5, the first time it has hit double digits since 1993.

So, despite the Fed's considerable lowering of interest rates and efforts to keep capital available to banks and investment banks, Bernanke says "the economy continues to face numerous difficulties, including ongoing strains in financial markets, declining house prices, a softening labor market, and rising prices of oil, food, and some other commodities." These "numerous difficulties" exist despite the Fed's interest rate-cutting campaign, which began last September in hopes of preventing a recession. "Clearly the economy now is on the ropes with weak employment market conditions, declining home and equity prices and surging gasoline prices inducing the consumer to pull back," says Brian Bethune, chief financial economist at Global Insight.

Still, he and other economists say the Fed can't afford to lower rates again to shore things up because it will aggravate inflation—and won't solve continued weakness in housing markets, high energy prices and tight credit conditions. On the other hand, boosting rates to fend off higher prices would deal a setback to the fragile economy and the already crippled housing market. Against this background, most economists predict Bernanke and his colleagues will leave rates alone when they meet next on Aug. 5. It's difficult to chart a course when uncertainty abounds, Bernanke admits.

II. Metal Chips � Global Demand Pushes Prices Upward

And that leads us to this edition's Metals Chips section, where our inflation conversation will center on steel. Steel prices have spiked this year mostly because of increased production expenditures caused by high costs and supply problems for energy products, raw materials and freight charges. So far in 2008, prices for a market basket of 13 carbon, alloy and stainless steel flat-rolled and long products tracked by Purchasingdata.com have risen on an annualized basis by about 50% at midyear. Sheet steel prices in the U.S. and Canada alone are at record levels, almost 90% higher than just 10 months ago and still rising. That's because iron-ore prices on the spot market have been reported as high as $185 a metric ton in Asia lately (an increase of 97% so far this year in spot buys), mainly as a result of strong demand from emerging regional economies and constraints on the global transportation-and-delivery system.

Also, the price of scrap in overseas markets generally is $100-a-metric-ton higher than in the U.S. because of offshore shortages. So, there have been increased exports from the U.S. In fact, the overseas ferrous scrap market has been gobbling up the available scrap like No. 1 heavy melting steel and shredded steel scrap because they are paying for it in cheaper U.S. dollars. So much U.S. scrap steel tonnage is being funneled to markets in Asia, Eastern Europe and Latin America this year that domestic supply has gotten very tight—and costs have gotten very pricey. In fact, shredded scrap, a key electric furnace feedstock, now is at a record $605 a gross ton.

The Upshot: Steel prices are expected to average $933/ton for hot-rolled sheet this year, up from $527 in 2007, and then $948 next year. Cold-rolled sheet is projected at $1,019 this year, up form $614 in 2007, and then rise to $1,051 in 2009. Hot-dipped galvanized is projected to average $1,066 this year, up from $656 in 2007 and then average $1,061 next year. Flat-rolled steel buyers have showed no signs of rushing out any time soon to replenish in-plant stocks. Bu the real risk to the forecast is that they may be too low since steel scrap, like iron ore, have exploded in price in the summer heat.

Some analysts believe the large cost-driven steel price increases of this year eventually will moderate demand to the point that spot-market steel prices will stop growing globally. However, even if that happens in the future, "market prices should remain at historically high levels," according to the Scotiabank Commodities report. Other analysts, such as San Tharani at Goldman Sachs Group in New York, believe that global steel markets will remain in a tight supply/demand balance for some time to come. "Over the last few months, global demand has exceeded existing supply of 1.5 billion metric tons, creating a shortage of steel," he writes to clients, adding that this market situation shows no sign of easing. Also, the metal-stamping shops, hot-rolled fabricators, spinners, slide formers and roll formers who are members of the Precision Metalformers Association don't expect prices of their key raw material, steel, to slide anytime soon, according to a summertime poll.

However, while commodity carbon and alloy steels are being buffeted by raw materials' costs during a period of soft demand, purchasing of high-priced aerospace-grade specialty metals remains strong even as airlines publicly struggle with skyrocketed costs of jet fuel. In fact, the future outlook for new aircraft remains strong because of expected solid demand for new-generation fuel-efficient planes. Already, older and less-fuel efficient planes that are unprofitable to operate are coming out of service. So, the mills, processors and service centers who supply aerospace-grade specialty metals for airframes and jet engines expect purchasing to remain elevated for many months ahead. In fact, use of superalloys and super-stainless grades already are setting records. The dominant jetliner makers already are sold out for the next three year—and sustained growth in purchasing being reported by makers of small-sized commercial and private jets.

Airplane purchasing is being done by a diverse group of air carriers worldwide, insulating the plane and engine producers from regional economic swings. They also say that the current upswing in aerospace demand could extend well into the next decade as foreign carriers expand their under-capacity fleets and domestic airlines upgrade aging fleets. Aerospace tends to be highly cyclical with capital spending by airlines, aircraft manufacturers, governmental agencies and defense contractors influenced by such factors as current and predicted traffic levels, aircraft fuel prices, labor issues, competition, the retirement of older aircraft, regulatory changes, terrorism and related safety concerns, general economic conditions, worldwide airline profits and backlog levels. Still, "aerospace is a far-horizon business, and it has a positive long-term outlook, report buyers.

Looking at the future end-product market, Randy Tinseth, vice president of marketing for Boeing's commercial airplanes unit in Seattle, argues that global jetliner manufacture will continue to be strong, and need much more value-added metals, through 2027. That's why his firm and competitors Airbus of Europe and Bombardier of Canada all are planning to raise production rates next decade to meet projected demand for nickel-based, titanium-based and cobalt-based high-value alloys.

Transaction prices for aerospace-grade metals—titanium and titanium-based alloys, nickel- and cobalt-based superalloys; specialty heat-treated aluminums; such exotic alloys as zirconium, hafnium, niobium and nickel-titanium alloys, and certain super-stainless steel and other specialty metals—can range from $10 to $50 per pound. After processing, value-added metal parts can cost six times as much. Leadtimes for basic metals can run out from four months from intermediary suppliers, according to Purchasingdata.com buyer surveys, to 12 to 18 months from mills.

Meanwhile, in this year of higher commodity costs, chief purchasing officers are intensifying analyses of performance by suppliers, ranking their attentiveness to critical buying-company needs and reevaluating existing strategic partnerships. The goal is to ensure that suppliers don't get into the habit of suddenly charging unexpected extra fees for materials' transportation, packaging or service calls. We'll discuss these and other risk-management efforts in Purchasing Focus when we return, but first this.

III. Purchasing Focus � Action Items to Cut Costs

The steep drop in the dollar this year has pushed up prices for precious and nonferrous metals as well as energy commodities as investors have sought assets that provide a hedge against the falling U.S. currency. This has resulted in numerous risk-management reviews of traded commodities by manufacturing firms.

For steel, many high-tonnage steel-buying teams are working to adjust annual purchase agreements to eliminate or mitigate exposure to cost increases. Sometimes, resale arrangements are used in which the metalworking firms use steel at costs negotiated by its customers and include that cost in the pricing of end products. In other arrangements, firms have material price-escalation provisions in customer contracts which allow unit prices to be adjusted up or down based on commodity cost increases or decreases during agreed-upon quarterly, semi-annual or annual intervals.

Meanwhile, other steel commodity buyers tell Purchasing that they have intensified efforts this year by consolidating purchases, contracting with new global steel sources, identifying alternative materials and redesigning products to be less dependent on higher-cost steel grades. "Everyone is taking price increases on steel," says one steel buyer, "but our goal is to pay no more for similar products than our competitors." To accomplish this, his purchasing and supply management team has begun adding favored nations clauses to purchase agreements, seeking out alternate sources of supply, building supplier partnerships, leveraging the parent company's subsidiary aggregate spend, using electronic sourcing when possible and exploring consortium-buying opportunities.

Here are some key risk-management tips from top metals buyers:

- Improve the accuracy of internal forecasts of raw materials needs
- Improve materials flow from receiving dock to production floor
- Monitor in-house inventories more closely to cut carrying costs
- Improve the quality of purchased raw materials
- Enter into a futures contracts for later delivery at agreed-upon prices
- Eliminate erratic materials handling and production activities
- Share more parts and materials among operating subsidiaries
- Reduce late engineering changes
- Expand purchasing from low-cost-countries
- Expand offshore purchasing and engineering operations
- Mine suppliers for knowledge about new technologies
- Expand value-engineering/value-analysis programs

And that concludes our 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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