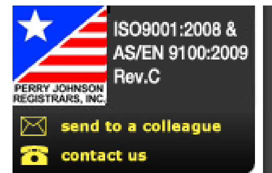

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MetalsOutlook™ September 2010

Publisher's Statement

Perhaps we are being Pollyannaish, but, the prognosticators, conventional wisdom and the concatenation of collective thought from numerous surveys got it -- wait for it -- wrong. Manufacturing activity went up, despite all the divinations of the double dippers. Okay, we're not moving at Mach 3 with our hair on fire trying to keep up with new orders, but you better be lacing up your running shoes.

While there is plenty of skepticism in the following pages, there appears to be good reason for a favorable forward view. The ISM number moved (unexpectedly?!?) from 55.5 in July to 56.3 for August. If the doomsdayers were right, it should have ticked downward.

In our last issue, we believed the recovery was on final approach and ready to land. I would say that it has landed and is taxiing toward the gate where the orders we have all been anxiously awaiting will be out of their seats from a long flight in a holding pattern and finally walking toward us. We will greet them warmly!

Going forward, we think the smart money will be on growth. The category of primary metals, where most of us work, is a leading indicator because these materials form the basis of newly manufactured products anywhere from 3 months (non-durable goods) to a full year (durable goods) in advance. We note that Timken has just broken ground for a $50 million expansion, and mill deliveries at both Timken and Nucor have just moved out from 5 months to 6 months. This is more than just inventory restocking at distributors.

Unemployment has peaked, although full employment is years away. There is a slow shift toward optimism. Consumers, who have been saving at record rates and paying down debt, are developing discretionary spending within their tight budgets. About the only thing that can screw this up is the federal government, depending on whom, what and when they tax. We'll just have to wait and see how that wild hair plays out. In the mean time, please enjoy the following by Tom Stundza, a recognized authority in this field.

Welcome to Metals Outlook™ September 2010

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September 2010

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III. Manufacturing News -- the recovery continues

Tom Stundza's Comments

U.S. metals economy has lost momentum
The U.S. metalworking economy has lost momentum, which doesn't look good for purchasing of metals in the second half. Overall economic growth was probably below 2% in the second quarter as the earlier boost to manufacturing growth from inventory building began to wane, and the broader boost from fiscal stimulus weakened. Metalworking activity has dropped back to where it was late last year. So, underlying demand growth for manufactured durable goods is soft. Overall, "there's no question that the economy

entered the second quarter with plenty of momentum, and left it with very little," says IHS Global Insight economist Michael Montgomery. Indicators are producing somewhat ambiguous readings, but confirm in general the fairly sharp slowdown in growth momentum of the past three or four months that will continue into early winter at least.

The second half of 2010 will witness a tug of war between two opposing forces. On one end, higher incomes and pent-up demand should help slowly revive consumer and business equipment/software spending, which in turn should help employment. On the other end, headwinds from declining nonresidential construction, weak home sales, sluggish purchasing of consumer durables and constrained credit access will continue to weigh down on domestic manufacturing growth. Atop that, slower foreign growth will restrain export growth for manufactured products. So, Montgomery projects third-quarter growth in gross domestic product at 1.7%, only slightly better than the downwardly revised 1.2% in the second quarter. For the year, the latest IHS Global Insight forecast for overall economic growth for 2010 has been reduced to 2.8% (from 3.1%). It's little wonder that the recovery in purchasing of metal mill products, forgings and castings from the depths of 2009 is being pushed into 2011 and 2012.

Revised national account data shows that households have bumped up savings much more than previously thought; economist already knew that business saving was very high. This is important since household caution holds back consumer spending, while business caution holds back employment, reinforcing each other. The "epidemic of thrift" may be good news for the long-term health of the economy, but in the short term it spells painful deleveraging and weak growth in demand for manufactured goods of all stripes. IHS Global Insight economist Gregory Daco says uncertainty about the recovery and job prospects is another factor that is fueling U.S. households' propensity to save more. The recent drops in consumer confidence point to pervasive anxiety about the economy, jobs, the stock market, taxes, etc., and help to explain the weak growth in consumer spending during the second quarter. In fact, the latest wave of economic data indicates that consumer spending growth came in at only 1.6% in the second quarter, indicating that consumers have tightened their belts. A weak employment market, high debt levels, a weak housing market and tight credit are holding consumers back. That's why economists expect just 1.6% growth in consumer spending this year.

The recovery in the automotive sector has been slightly delayed as sales have failed to recover to expected levels. Atop that, monthly motor vehicle sales momentum has slowed, which means that they will only trend to 11.5-million units in 2010 from 10.4 million in 2009. Although all three U.S. automakers escaped the global economic recession, the road forward is rocky and unpaved. Analysts say the industry will have to wait until 2013 for a full recovery in North American auto production. The lack of job creation this year also is chilling the prospects for a rebound in home building, despite mortgage rates heading towards the low 4% range. As a result, Montgomery has further lowered the estimate of 2011 housing starts, from 960,000 to 860,000. The outlook for business structures remains poor so economists foresee weak construction activity through the third quarter of 2011. Drilling activity in the energy sector rose sharply in the first half of the year, but economists expect activity to flatten out over the second half of the year, partly due to the six-month moratorium on deep-water drilling expansion. In this environment, inflation isn't an issue. After averaging $78/barrel in the first half, West Texas Intermediate oil prices are projected to average $76/bbl in the third quarter and $75/bbl in the fourth. Already, tumbling midsummer commodity prices are showing up in lower global producer prices for fabricated metals and other industrial and construction materials.

I. U.S. metals economy has lost momentum

The Institute for Supply Management unexpectedly reported that its factory purchasing managers' index rose to 56.3 in August. The reading was better than July's 55. The ISM tracks the breadth of growth across firms, asking purchasing managers if business is better this month than last. Norbert Ore, head of the ISM's survey committee, notes that August production activity drove the index higher. "There is no sign of double-dip (recession) in manufacturing right now," Ore says, as the production index increased in August to 59.9% from 57% in July. "I don't see cause for alarm going forward," Ore adds, predicting continued "moderate growth" in manufacturing. Wall Street overreacted to the first bit of good news in days but a closer look at the ISM indices and various Federal Reserve Board regional reports shows slower new-order bookings and production cutbacks in many industrial centers. Since factory orders are less strong and inventories are less lean, Brian Bethune, chief U.S. financial economist at IHS Global Insight, cautions that "this could point to some slowdown in September"--and a dip in ISM's factory index.

The two largest end markets for metal products in the U.S. are automotive and construction. Other end markets include appliances, containers, trucks and trailers, machinery, and oil and gas products. Mid-year orders for manufactured durable goods totaled $1.14 trillion, which is 16.5% ahead of the six-month 2009 total of $975 billion. However, orders for transportation equipment, computers and electronic products have been down four of the last five months. In fact, the U.S. Census Bureau reports that new orders for manufactured durable goods in June decreased $2.0 billion or 1% to $190.5 billion. That fits with the latest Beige Book report that manufacturing activity has slowed or leveled off in most Federal Reserve Bank districts.

Automobile manufacturing has been a bright spot for the Cleveland, Chicago and St. Louis districts while automobile parts suppliers have experienced increased demand in the Richmond and Chicago districts. That's why 2010 North American production has been revised slightly upwards by 53,000 units to 11.5 million cars and light trucks. Firms in the semiconductor and aircraft and parts manufacturing industry reported relatively strong demand growth in the Boston, San Francisco and Dallas districts. However, non-automotive activity is flat to down in the New York, Boston, Philadelphia, Cleveland, Kansas City, Chicago, Atlanta, Dallas and Richmond districts. And manufacturing firms generally expect demand growth to taper off with few firms planning post-Labor Day expansions in production. That's why there's some concern that the projected 6% in manufacturing--spurred by an 8.8% expansion in durable goods production--may be overly optimistic.

Steel production declined in both the Chicago and Cleveland Districts. Some manufacturers in the Atlanta and San Francisco Districts reported high excess production capacity. Capacity utilization was below pre-

recession levels in Cleveland and edged lower among steel producers in Chicago. Still, the American Iron and Steel Institute says year-to-date production through mid-August of 55.17 million tons was at a capability utilization rate of 70.7%. That still is a 57% increase from the 35.07 million tons during the same period last year, when the capability utilization rate was 46.2%.

Meanwhile, the economic malaise continues to take its toll on the U.S. construction markets. In the second quarter, total construction spending declined 4.8% year over year. A weakening or our economic outlook now indicates that construction spending changes will be negative through the second quarter of 2011. While growth will return in the latter half of 2011, the spending in the industry will remain far below the pre-crash peaks for quite some time. McGraw-Hill Construction's Dodge Report data shows that non-residential square footage continues to be materially negative year-over-year, with the July 2010 data still showing weakness. Most economists don't expect some pickup in activity to show from the U.S. economic stimulus program until 2011. IHS Global Insight economist Montgomery suggests "the industry will have to wait until well into 2014 to see spending levels once again break the $1 trillion barrier."

II. The Economy -- underlying demand remains generally weak

It looks as if production of important metals will outpace demand in 2010. That's why IHS Global Insight economist John Mothersole expects nonferrous prices to move lower during the next six months as consumption growth slows further. There's a chance for weaker steel pricing ahead, therefore, as supply ramps up in the face of weaker-than-expected recovery in demand.

Global crude production declined 3% in July although output still is up 25% for seven months at 820.965 million metric tons compared with the same period in 2009, figures from the World Steel Association show. Crude steel output from China, the world's top producer and consumer, rose 18.2% to 375.5 million metric tons in the first seven months of the year compared with a year ago. Output for the rest of the world is down 6%. Bank of America/Merrill Lynch analyst Kuni Chen says that "with steel prices expected to decline near term, some high-cost production may be cut in China." Also, the 9% U.S. production decline in July "shows discipline going into a seasonally slower market and is appropriate given a decline in lead times." U.S. mills currently are running at 69% capacity utilization, up from lows of 38%-40% in early 2009 but down from a peak of 75% in May. He optimistically expects the utilization rate to decline into the mid-60% range in coming weeks "as mills respond to shrinking orders."

First-half global aluminum production rose 7% compared to average production levels in the second half of 2009. The International Aluminum Institute (IAI) says primary production in July of 3.4 million metric tons was down 2% for the month although still up 10% for the year. Excluding China, total production of 1.9 million metric tons was down 3% for the month but still up 30% year over year. Primary production in North America was 390,000 metric tons in July was the same level as June and kept annual output flat with 2009. North American producers have removed about 1 million metric tons (20% of capacity) since mid-2008. However, analysts such as Chen say production growth in China remains a potential overhang on the global supply/demand balance. Production has rebounded 19% since the last peak in August 2008. Primary production in China was 1.4 million metric tons in July, the same tonnage as June but enough to boost the seven-month total by 30% year over year. Since mid-2008, Chinese aluminum capacity has increased 20% or roughly 3 million metric tons for a 41% global share. However, some analysts estimate that recent moves to increase home-market power surcharges could threaten about 25% of Chinese capacity, especially in light of weaker near-term commodity metal price trends.

The recent bounce in nonferrous metals prices looks to be temporary as slowing global demand caps further commodity price gains. Seeping pessimism regarding the weakness of the global recovery probably will create pricing volatility in the near term. As for steel, world demand is improving, but many people were overoptimistic over the first half of 2010--and, therefore, overbought. Steel demand is now slowing. China was thriving, but the rate of increase is easing as government stimulus is being withdrawn. Europe and the Americas are much weaker, with small improvement in durable goods offset by continued declines in nonresidential construction. Supply will be in surplus until late in 2010. Once inventory was rebuilt mills needed to cut production but did not do so quickly enough. China is leading the cuts, but also led the increases. Cutbacks will also be seen in Europe and North America. The retreat will be very modest; there will not be a repeat of the collapse of late 2008-early 2009.

The regional steel and aluminum markets remain poised for a long, slogging recovery. Shipments of primary aluminum by North American producers totaled 1.202 million metric tons in the second quarter of 2010, increasing 3% above the previous quarter's total of 1.166 million metric tons. During the first half of 2010, aluminum producer shipments totaled an estimated 9.071 billion pounds, 16.7% above the 2009 total of 7.774 billion. But, Aluminum Association data also shows that inventories are up 12.8% over a year ago. Preliminary estimates indicate that aluminum demand in the U.S. and Canada (shipments by domestic producers plus imports) totaled an estimated 8.302 billion pounds during the first five months of 2010, 19.3% above a year ago. Demand for semi-fabricated (mill) products was up 14% to a total of 5.739 billion pounds. Apparent consumption (demand less exports) in domestic markets totaled an estimated 7.007 billion pounds, 18.8% above 2009. The biggest gainers have been extruded rod and bar, shapes and pipe and tube, drawing stock, bare wire, forgings and impacts, and powder and paste. Sheet, plate and foil shipments at midyear are up but not so much and electrical wire and cable has crashed.

The latest steel-market forecasts reiterate that full recovery for steel shipments above 100 million tons (last seen in 2008) won't occur until 2012. The outlook for this year is 84 million tons, up from 60 million tons in 2009. To add insult to injury, however, weak demand trends continue to strengthen expectation that shipments will relapse over the coming winter. Quick restarts of capacity early this year on a flurry of orders, mostly from service centers rebuilding stocks, pushed the steel market into oversupply. While some mills to promise furnace cutbacks, many promised closings haven't happened yet. And that's why many spot-market steel prices have melted in the heat of summer. However, Severstal North America has idled 3 million tons/of annual steelmaking capacity at its Sparrows Point, Md., facility for two months, and has laid off about 500 workers, due to the temporary mid-August idling of a portion of the plant's finishing operations. A company spokeswoman says the move was made "due to softening market conditions" and "so that we can align our capacity with market demand."

III. Manufacturing News -- the recovery continues

The American Iron and Steel Institute reports that steel mill shipments were flat-to-down in June into the construction, automotive, crude oil, natural gas and petrochemical sectors. Shipments from North American service centers tumbled 11% from June to 2.87 million tons in July as inventories remained basically flat--up in the U.S. and down in Canada. The Metals Service Center Institute (MSCI) says U.S. daily average tons shipped declined to 136,500 tons in July from 146,300 tons in June while Canada's daily average tons shipped declined to 20,100 tons in July from 23,300 tons in June. End of month inventories of 7.45 million tons in the U.S represented 2.6 months of supply, up from 2.3 months-supply at the end of June. In Canada, end-of-month inventories of 1.3 million tons rose to 3.1-months at the end of July compared to 2.6-months at the end of June.

So, in the U.S., steel prices hit a peak in April, started falling in May and may be heading for a nadir this autumn. Third-quarter prices will reflect some of the weakness, but most will show through in the fourth quarter and early 2011. IHS Global Insight senior steel analyst John Anton says "the price increases of the first half of 2010 were almost entirely just a cyclical spike, and cyclical spikes always unwind. Recovery from the excessively low recessionary levels of mid-2009 was justified, but all the rest was simply fluff."

Steel prices continued to melt in July and August, according to an IHS Global Insight survey of buyers. Weak manufacturing and nonresidential construction activity has reduced summer demand and supports forecasts of further spot-market price declines in coming months. In the current uneven economic recovery, demand won't rebound to a more-normal buying environment until 2012. Buyers say sheet buys remain soft, the mills continue to overproduce and service centers have plenty of coil available for speedy delivery Yet, steelmakers, claiming scrap costs are up, are seeking to boost steel prices this autumn by $25-$40/ton, depending on the product line. Economists expect scrap prices to move from slow and erratic gradual increases and declines to a sharp downside correction. There was little fundamental reason for scrap ever to rise, and by the end of 2010 it should be back to the same rough level as at the beginning of the year, suggest analysts.

As consumers remain cautious about big-ticket purchases, such as motor vehicles and major appliances, original equipment manufacturers (OEMs) say business is a little better than last year, but not much. Market feedback suggests that the mills caught up on delivery in the end of second quarter, creating a demand trough and very short leadtimes-which has maintained the July-August degradation in pricing. Steel buyers polled this month see no justification for the announced autumn price hikes. Even Gretchen Haggerty, executive vice president and CFO at producer U.S. Steel, sees an uncertain outlook for total steel sales for the rest of the year as North American and European "economies continue to work their way through a gradual and uneven recovery process." She expects a decrease in shipping and production volumes for the flat-rolled segment this quarter. Looking ahead, Keith Busse, CEO of producer Steel Dynamics doesn't look for the metalworking economy to sharply strengthen; therefore, steel-buying ahead "will be probably just be slow and steady."

Meanwhile, stainless steel prices in the U.S. are still falling as end-user demand remains tepid and buyers are described as lackadaisical by market sources. Transaction prices for Type 304 cold-rolled sheet, a benchmark grade, dropped 7% in August to $2,828/ton from $3,040 in July. Bulk buys reflect this month's slippage in alloying metal surcharges and could drop yet another 1%-3% in September. Such market conditions in North America are pushing ThyssenKrupp to postpone some of its planned stainless hot-rolled capacity in the state of Alabama. ThyssenKrupp North America's $1.4 billion stainless mill is set to begin production in October with an initial cold-rolled sheet capacity of 100,000 metric tons/year, gradually ramping up to a maximum of 140,000/annual metric tons. The mill's planned hot-rolled annealing and pickling line, however, has been delayed until 2011. "The ramp-up of the remaining facilities is still being kept flexible," the company says in a press release. "The same applies to the startup of the melt shop, which was planned for early 2012 and can be delayed by up to 24 months."

World stainless supply is slightly in excess as 24.58 million metric tons of output in 2009 reached about 90% of the regular levels of 2006-2008. This was in excess of actual consumption allowing inventory to build. Additional production this year has added to the global surplus that built through midyear; in turn, the stainless steel sector has reduced smelting this summer World demand began 2010 improving as the global economy slowly recovered from the recession. However, global stainless demand is flattening. Fist, inventory restocking has mostly run its course, removing a significant source of demand that supported the first half of 2010. Second, end-use recovery remains slow and weak. The strongest demand sector for stainless steel--infrastructure investment in China--was greatly boosted by government stimulus is losing steam. In fact, China's well-publicized multi-million-dollar stimulus package is winding down and will largely be withdrawn by 2011. In the U.S., use of stainless steel is rising somewhat erratically--and is still below 2008 peaks. Demand from prime end-use sectors food equipment, construction, automotive and fabricated industrial, commercial and consumer products dropped by 29.5% in 2009 to 1.59 million net tons and look to increase by just15.5% this year to 1.84 million tons. Analyst Mothersole reckons that stainless steel production should be able to meet demand over the remainder of 2010 and across 2011, "but only because global consumption is still depressed."

So, in a nutshell, stainless steel prices have been sliding all summer and will continue to drop briefly in the third quarter, analysts suggest, before they resume upward movement--mostly to reflect expected higher costs for scrap, nickel and ferrochrome. Mothersole says that "it's likely the low prices touched in August will not last all the way through the third quarter of 2010." On a worldwide basis, he and other analysts reckon that stainless steel price increases will outpace carbon steel at least through 2011, and levels will stay high for multiple years. Reason: Chromium costs will rise through 2014, then stay at a level about twice as high as the norm since 2004, although not up to the spike of 2008. Chromium supply from South Africa will be tight through 2011 at least. As demand for stainless recovers, tight availability of chromium will boost prices in 2011-2012 and, thus, alloy surcharges. Mothersole says "the high outlook for ferrochrome means all grades of stainless will be affected. Nickel is normally the element that causes the most price pressure, but not all stainless contains nickel. All stainless contains chromium, so there will be no escape."

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