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I. COVER STORY: The North American manufacturing economy

In this edition's Cover Story, we'll update the North American manufacturing economy, and see where it's going to go in 1997.

The latest data shows factory orders are healthy in the U.S. and Canada. Construction spending is hardy, especially for factories, public works, and utilities. Atop that, car and truck sales are robust and then there's the latest index of manufacturing activity from the National Association of Purchasing Management. This continues to indicate a gradually expanding industrial sector. Production for exports has been very strong and capital equipment manufacturing has remained far stronger than had been forecasted. Underlining the manufacturing economy's firm base, comes the Conference Board's latest index of leading economic indicators, which has risen for six consecutive months. This gauge of economic trends forecasts business in the U.S. and Canada up to nine months from now.

Put all this together and you've got what Economist David Jones, at the New York brokerage house, Aubrey G. Lanston and Co., says is "More momentum and more strength out there than most of us thought earlier." One of the biggest surprises has been the growth in orders for heavy equipment. The demand from U.S. factories is beyond what had been forecasted, and the demand from offshore factories has been phenomenal.

Economist Cynthia Latta, at the DRI/McGraw Hill business research house in Lexington, Mass., contends that, "The second half economy probably will be somewhat weaker than during the first half." "But," she adds, "The question is whether manufacturing is slowing enough to avoid overheating." That's what's making fiscal policy makers in Washington nervous. Cahners Economics points to the Purchasing Management Association's business survey, which finds most buyers still reporting little overall price pressure, as evidence that an interest rate hike is not necessary.

Ralph Kauffman, who compiles the surveys, agrees that, "Things are probably going to stay relatively calm in the price sector." While some price hikes are being attempted by the carbon steel and plastic resins industry, stainless steel and chemical prices are stable, and nonferrous metals and packaging prices are weaker now than at midyear.

Also, it's not likely that a Fed-style belt-tightening will be mimicked in Canada. Rick Egelton, the Bank of Montreal's Deputy Chief Economist says, "Canada is poised for several years of solid, non-inflationary growth." That's partly because of the growing demand for Canada's big-bulk natural resources and because Canada is benefiting from a surge of merchandise exports to the U.S., thanks to cuts in tariffs and a low Canadian dollar. In fact, Patricia Mohr, the Vice President for Economics at the Bank of Nova

Scotia says, "Demand for Canadian industrial commodities, including industrial metals, is expected to grow even faster this autumn as manufacturers in the U.S. and overseas rebuild low inventories."

But what's ahead for next year in the U.S., when there's no presidential campaign to stoke the economic fires? Here's the outlook from Daryl Delano of Cahners Economics:

"Capital spending has slowed. It grew at only a 4% rate in the second quarter of this year, and we're expecting that slowdown in capital spending will be partly responsible for the overall slowdown of the economy, and will be the result of higher interest rates. We don't see any risk of recession until 1998 at the earliest. The consensus is that we do run a real risk of recession in 1998 if the Fed, in fact, continues to raise interest rates as we run through 1997. But, at this point, we are 65 months into the economic expansion. This is the third-longest economic expansion of the post-World War II period and the feeling at Cahners Economics is that we still have another year or year-and-a-half to run in this economic expansion."

And that leads us to the largest steel-consuming sector, automotive. North American motor vehicle sales this year have been extremely volatile from one month to the next. But, overall, U.S. and Canadian sales will probably be 2% to 3% higher at 16.3 million cars and light trucks, forecasts Bob Rewey, Sales Vice President for the Ford Automotive Group. Paul Ballew, Senior Economist for J.D. Power & Associates agrees that, "Relative to expectations, 1996 outperforms."

The somewhat slack numbers reported in the summer months are consistent with other statistics showing that the pace of economic growth is slowing in the third quarter after stronger than expected growth in the first half. It doesn't seem to be bothering too many automotive analysts. Jack Kirnan of Salomon Brothers, for example believes, "We are settling down to what I would consider to be a more sustainable sales pace for the next several quarters."

For the past two or three years, hardy growth in jobs and rising wages have given many Americans and Canadians the money to buy new cars and trucks. Car sales are relatively so-so, but purchasing of minivans, sport utility vehicles, and pickup trucks remain very strong. Indeed, sales of popular pickups and sport utility vehicles have been held back by shortages, not by a lack of demand. That's why even the pessimistic economists and analysts think the industry will sell more than the 16 million light vehicles in the U.S. and Canada as last year. "It still will be a decent year, even with a slowdown in the second half," says Economist Diane Swonk, of First Chicago Bank in Chicago.

Those who watch production data note that output right now is within a percentage point or two of last year's assembly and that's with the wildcat strike that messed up production earlier this year at General Motors. So, barring any further labor disruptions this autumn, we're still talking about a 14.5 million vehicle build in the U.S. and Canada again this year, and we're not alone. Michael Luckey, President of the Luckey Consulting Group says, "The industry is having a good assembly year, and I think it will continue."

However, looking at 1997, the forecasters are at odds. The analysts who see a further 2% to 3% expansion in the manufacturing economy next year, also suggest a 2% to 3% growth in motor vehicle sales. Others see as much as 3% to 5% decline. These analysts, and they are in the majority, think there's a fundamental imbalance in motor vehicle supply and demand. Too many cars being built for demand, they say. They point out that car's sales already have slipped at an annual rate of about 2% over the past three years. What saved Detroit so far has been the fact that sales of light trucks and sports utility vehicles have risen by an average 7%. The pessimistic analysts think this growth in sales of trucks and truck-based sport-utilities will wilt next year.

At present, PURCHASING is forecasting 1997 sales of cars and light trucks in the U.S. and Canada at slightly under 16 million units. That's a drop-off in demand of about 2%, and it's back to the sales level recorded in 1995. This outlook is predicated on a belief that the overall 1997 manufacturing economy will enter a "ho-hum" phase, and that consumers will take a pause to absorb existing debt for such big ticket items as cars and trucks. This outlook also suggests a 3% to 4% reduction in North American assembly to slightly under 14 million units.

II. METAL CHIPS: Early forecasts for next year

Now, here's our early forecast for next year's carbon steel sheet, stainless steel sheet, and aluminum mill products.

Let's start with the light metal. Aluminum mill product demand worldwide is slipping, and so are ingot prices. In fact, four key factors of weakened world demand, increased production of ingot, increased global inventories, and the Sumitomo copper trading scandal is pushing ingot prices back to the \$0.71 average of 1994. "The combination of slack demand and rising production has led to a visible rise in inventories, which is more than enough reason to depress pricing", says Tom Van Leeuwen, at CS First Boston in New York.

Aluminum has been hit with such soggy demand in the U.S. that market watchers have abandoned growth forecasts for 1996 and now project a drop in use of about 2.5%. Forever bullish, however, these forecasters hope economic growth will stimulate a 2.5% recovery in demand next year. This is open for some debate.

Demand from automotive, aerospace, and aircraft has been stellar this year, and will be again in 1997. However, demand from construction and a myriad of other industries that use aluminum have been slack, and another year of a slow growth economy might strangle growth in use again. Still, demand could be stimulated by cheaper prices. Taking their cue from ingot, North American mill-product prices first flattened out, and now are expected to be lower, rather than higher, next year.

Now, let's look at hot-rolled and cold-rolled sheet. Since mills and distributors can expect the motor vehicle end-use sector to provide little stimulation next year, Analyst Tom Runiewicz at the WEFA Group, anticipates this year's slowdown in sheet steel use will continue in 1997. In one of the first forecasts for

next year, Runiewicz says, "There may be little discussion about a recession next year, but there's also little discussion about an accelerating economy, especially the consumer-driven economy. That includes cars, trucks, and major appliances."

Freshly audited midyear data for 1996 shows that North American demand for hot-rolled sheet was down by 6%. Cold-rolled sheet use was down by about 2.5%. So, for the year, end use of these two flat-rolled grades will probably slip by 2% to 3% to 34 million tons. But, remember, this comes after four consecutive years of sheet steel consumption growth. Hot-rolled and cold-rolled demand still will be 25% stronger than in the last poor demand year of 1991. That means a consumption year of 37.5 million tons of hot-rolled and cold-rolled sheet being stamped, pressed, and formed into parts and components in the U.S. and Canada.

Also note that galvanized sheet steel use has been boosted by solid construction, steady motor vehicle assembly, and strong capital equipment and heavy machinery manufacture; thus, U.S. use of galvanized looks to be up around 16.5 million tons.

That's almost 5% more than was consumed last year. Galvanized use may slide by 2% or 3% next year, but that would still be a 60% gain over the cyclical low of 1991.

The big question for next year is the state of hot-rolled, cold-rolled, and coated sheet-steel pricing. Right now, the major integrated mills are struggling to get transaction prices back to 1994 levels. The steel makers are anxious not to repeat last year's error on contracts, and are maneuvering to get the auto makers to pay top dollar in 1997. But, it's going to be a battle. As we said earlier, there may be a slippage in calendar-year 1997 assembly. From what we can gather, the car makers are flirting openly with offshore steel suppliers, the aluminum companies, and nonferrous roll-forming firms, to reduce the per-car tonnage of steel required for 1998-model cars and trucks. As Analyst Runiewicz at WEFA Group says, "We see very little support from the demand side for higher sheet-steel pricing next year."

And don't forget...even if some of the big-tonnage mills reduce production to handle overdue maintenance on furnaces and rolling mills, there's additional sheet steel capacity coming on stream from the mini-mills to pick up the slack. Also, keep an eye on Europe. There are still no clear signs of a pending boom in European steel demand. This year's glut of European metal has kept downward pressure on world steel export prices. If things don't pick up on the Continent, some analysts over there are predicting a flood of cheap European steel into the U.S. and Canada in the first half of next year.

And, let's not forget the stainless steel marketplace. Weak world demand has plagued stainless steel all year, dragged down prices, and pushed lots of foreign metal in the North American marketplace.

Still, apparent consumption of stainless steel sheet here is pretty good. In fact, year-to-date use of stainless sheet is 5% better than a year ago. Overall use of stainless grades - including forgings - are now 3% stronger than last year at this time, and could match the record consumption of 2.2 million tons reported for 1995. "The underlying rate of demand growth for stainless steel products remains strong," according to Analyst Bob Hageman at Oppenheimer & Co., who isn't surprised by the latest data. He also believes "Hardy stainless steel and high-performance alloys markets will grow faster than any new capacity expected in the next three years." The near-term key demand driver for stainless steel and the superalloys producers will be the exploding activity in commercial aviation.

One final note about steel that you might find interesting. The big and little players of the North American steel industry are looking to Madison Avenue to drive up demand. Starting in early 1997, Big Steel and the mini-mills (and their raw materials suppliers) will begin promoting the metal with a \$20 million, year-long ad campaign combining television, radio, and print. The ads will push the strong, cheap, and flexible metal as a key to auto safety and sturdy, economical buildings. They will remind consumers that steel - not their arch-rival, aluminum - is the world's most recycled metal.

III. PURCHASING FOCUS: Why companies are reinventing the purchasing function

Let's discuss some of the reasons why so many companies are reexamining their purchasing, raw materials and component sourcing, and overall supply management processes. It's what we call "reinventing the purchasing function."

I'm sure that whether you make, process and distribute, or use key industrial materials, you've all seen a change this decade in buyer-supplier relations. Some changes have come with little pain. Other changes have been traumatic. The key thing to remember is that this change isn't over.

Remember that restructuring the purchasing supply operation of any corporation, large or small, is not a casual or a quick undertaking. As changes have been made, others have been required. Many of the changes have forced purchasing into new levels of cooperation with such other in-house disciplines as engineering, manufacturing, warehousing, marketing, and even finance. Many of these changes have required mill suppliers to deal more directly with their distributor partners. Some have required distributors to rethink their partnerships with some mills.

This reinvention of the purchasing function in North America began early this decade. That's when companies started to improve the quality of the goods they bought so they could improve the quality of the end-products they sold. The early changes have since evolved into an essential ingredient in the development of corporate supply chain management strategies. Change isn't going to disappear. In fact, change probably will intensify as the current economy cools.

Successful manufacturing companies now recognize that cost effective quality purchasing only happens when they use the strengths of their best suppliers. So what's ahead?

First - more supplier involvement in early design for new products;

Second - more supplier involvement in value engineering of existing products;

Third - more intense supply-performance measurement and supplier assessment;

Fourth - more requests for data about present and future materials and processing services, as purchasing personnel intensify their source-planning and supply-base development efforts; and

Fifth - continued pressure to eliminate paperwork and to expand electronic data interchange.

IV. FORGING NEWS

Sales of forged steel, aluminum, titanium and high-temperature alloys improved by an annual average of 13% in 1994 and 1995 so that last year's sales were a record \$4.44 billion. The industry has grown by 15% in the past decade to 149 firms in the U.S. and Canada. So have the volume of shipments; last years total was 1.5 million tons. Sales growth has slowed to a 7.5% rate this year, but that still will mean North American industry shipments in excess of 1.6 million tons. A basically healthy U.S. manufacturing sector is benefiting forging sales. So is the resurgence in commercial aerospace production. Since the domestic forging shops have initiated completed major quality-improvement, production-efficiency, and value-added machining expansions, the heavy forged parts out of North American mills are globally competitive. Also, such technological advances as computer-aided design and manufacturing are becoming widespread.

Lead times from most independent impression-die and open-die forgers are out 10 weeks or so, but a sizable amount of custom-designed parts take between 20 and 30 weeks. Little wonder that buyers are searching service-center warehouses for stocks of forgings. "Production of heavy machinery, machine tools, off-road equipment, railroad hopper cars, and even large freighters continues at a solid level, and boost the demand for forgings", notes Steel Market Analyst, Bernard Lashinsky, at AUS Consultants. In terms of dollar volume, the Forging Industry Association reports 1995 sales of \$4.44 billion, a 10% gain over 1994, and \$1 billion more than the last cyclical peak of 1990, when shipments of 1.3 million tons were valued at \$3.82 billion.

The chief competition for forgings are such substitute materials as powder metal parts, castings, plastics and ceramics. They all sell parts for transportation products (passenger cars, trucks, buses, trailers, motorcycles, bicycles, airplanes and trains); aerospace (aircraft engines, guided missiles, and space vehicles); stationary engines; off-highway vehicles, heavy construction vehicles, and mining equipment; agricultural implements; military ordnance; industrial, petrochemical, and commercial machinery; industrial and commercial refrigeration and air conditioning; pumps, compressors, steam engines and turbines, mechanical power transmission, and specialty hardware.

Most earlier forecasts of a severe sales drop off as the decade closes have been revised. While industry sales could slip a little in 1997-1998 as the capital-equipment economy cools, they see renewed growth in 1999 and beyond. That's because forging execs see long-term growth from commercial aviation and another round of new-business opportunities from the second wave of automotive "transplants" when European-owned domestic auto plants accelerate the purchase of powertrain (engine and transmission) components from domestic forging shops. "There's about \$2.5 billion in annual forged parts for automotive applications alone that are being imported that domestic mills could be supplying by the end of the decade," suggests the Forgings Industry Association. That's why market analysts at Frost & Sullivan think the industry could reach \$6 billion by the end of the decade.

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