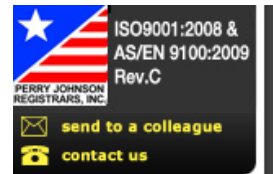




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MetalsOutlook™ October 2003

Publisher's Statement

The Institute of Supply Management (ISM, formally www.NAPM.org) issued their manufacturing index for Sept. (issued Wed. Oct. 1 @ 10:00AM) at 53.7.

This month's index still indicates an expanding manufacturing economy (over 50% is expanding, under 50% indicates a contracting economy)

Over 50% or not, this manufacturing economy is still in trouble and is weak, it won't take much to collapse, at least until 2004 begins. Let's read Tom Stundza analysis of these issues.

Welcome to Metals Outlook™ October 2003

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Publisher

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Tom Stundza's Comments

This is Tom Stundza, executive editor of Purchasing Magazine. Welcome to the October 2003 edition of Metals Watch!

The economy appears to be recovering from its long sabbatical. After nearly three years of lollygagging, interrupted by a couple spurts of energy, the economy appears to be refreshed and ready to charge ahead. While the pessimists might quibble with the speed of improvement, the incoming data confirms strong positive momentum. Consumer demand picked up in the spring and some production began to respond over the summer. However, it's clear that manufacturing still faces some long-term structural problems. The loss of 16% of American manufacturing jobs since George W. Bush became President is a tough issue for both parties, with no easy answer. It's clear the administration's economic policies aren't turning things around quickly. It's also clear the Democratic Presidential aspirants don't have any sound solutions yet, either.

The problem is obvious. American manufacturing jobs are being exported overseas. Everyone understands the reason: Companies want lower labor costs, less red tape and fewer environmental restrictions. So, while the economy has picked up in recent months, many U.S. corporations have found ways to step up production while keeping a lid on their payrolls. Manufacturing is maintaining its competitive edge against foreign--primarily European and Japanese--competitors. In fact, America's workers have continued to lead the world in efficiency. But, that also means many are going without jobs. That problem has the attention of President Bush, who saw his father lose the presidency during the similar environment in 1992. "We want everybody working," Mr. Bush assures union workers in Ohio on Labor Day, kicking off his 2004 campaign. "There are better days ahead."

We'll discuss what's ahead--and then we'll look at the current and expected market for steel, forgings and other production-grade metals. In fact, the shroud enveloping this year's metals marketplace come from

last winter's severe weather, the springtime Iraqi conflict, the lack of capital investment in new machinery and equipment, and weakened late-summer production of motor vehicles and other capital goods built to last for longer than three years. Atop that, nonresidential private construction has weakened because public construction was decimated by a lack of state and local funds at a time when federal dollars were diverted from infrastructure to defense spending.

The steel market has experienced weaker than expected demand this year, whether the buy is commodity grade or value-added. In fact, steel demand in the U.S. this year looks like it will be at its lowest level since 1993. As a result, mill suppliers have been plagued with near-term revenue and margin erosion due to higher prices for natural gas, scrap and semi-finished slabs at a time of low steel sales prices. This scenario may take a while to play out, though, since the market mavens believe the short-term recovery may be weak. Most steel-demand sectors have bottomed out, but have only mild improvements in most forecasts. Looking ahead at the nonferrous metals market, analysts generally agree the worse demand-recession in 30 years is about to end. But, here too, economists say a strong rebound isn't guaranteed.

Interestingly, neither the manufacturing malaise nor the slowdown in metals purchasing has derailed the revolution in procurement of materials for manufacturing. Relationships between suppliers and producers are changing with one goal in mind, the reduction of total costs. Manufacturing systems today are more tightly integrated to financials - from job costing to materials handling. In Purchasing Focus, we'll discuss the key cost centers that purchasing professionals must track.

Comments to Tom Stundza: stundza@reedbusiness.com

I. Cover Story: The Manufacturing Economy

Stops...Starts...Spurts...and a more hopeful 2004 on the horizon.

In his Labor Day stump speech, President Bush promised a new assistant secretary of commerce, one for manufacturing and services. That's symbolism. The meat and potatoes of the Bush manufacturing strategy is tax cuts. The President is banking that his old tax cuts of \$3 trillion will free more capital for corporate investment. He also wants Congress to make permanent the temporary tax breaks for equipment expensing. And he wants to end the corporate alternative minimum tax.

However, no matter what government bureaucracies do, some manufacturing jobs will continue to be lost when companies shift production or supply overseas--or are forced out of business because of cheaper goods. But even this hard truth has to be balanced against the fact that U.S. exports have been growing for the last couple of years, create high-paying jobs here and helping many, many U.S. companies. Economists generally agree that business is just now picking up enough speed to create some jobs next year. However, the National Bureau of Economic Research wonders if something "structural" has changed in the economy that makes recoveries relatively weaker, producing fewer jobs. And a new study published by the Federal Reserve Bank of New York answers, "Yes."

A strong dollar in most recent years has made American-made products more expensive abroad and foreign-built wares less costly in the U.S. And such structural changes are troublesome. You can't put a big wall around the U.S. and keep foreign products out. You can't force cost-cutting American-based multinationals to spend substantially more money to make their products in more expensive U.S. factories. World Trade Organization rules prevent the U.S. and other nations from adopting protective tariffs on foreign-made goods. And rising productivity makes it possible for American manufacturers to produce their goods with fewer humans on the payroll. To many economists, the recent productivity gains are key to the current slackness in job creation. Employers are getting more output from the workers they already have, and thus need to hire fewer new workers.

Workers' output per hour usually falters in a recession. That didn't happen in 2001--and output has continued to grow briskly ever since. So, the authors of the Federal Reserve Bank of New York study--Erica Groshen and Simon Potter--argue that management has become tougher in layoff and hiring policies. Managers lay off both blue- and white-collar workers quickly and are not as prone to hire them back again. Thus, new job growth may increasingly depend on the rise of new firms and industries, and less on rehiring at older firms. Another factor, in this case, was the mildness of the 2001 recession.

The researchers say that stimulative policies such as interest-rate and tax cuts helped keep the recession short---only nine months in length. Low-interest rates meant that the housing, consumer durables, and auto industries were able to maintain strong sales throughout the slump. Thus, they had little room to bounce back in the recovery, as would be normal. In the long run, higher productivity is usually a boon to workers as well as to management, paving the way for higher wages and profits.

Even if industrial production goes from no growth in 2003 to almost 3.5% growth in 2004, as projected, business may be slow to share the gains with their workers. Real wages have been more or less flat over the past year or so. Job growth is also held back, some say, by the massive \$500 billion-plus deficit in international trade. "There's a migration of jobs abroad where wages are so much cheaper," says independent economist Victor Zarnowitz, noting that industrial production accounts for only 10% of all U.S. jobs today jobs. He adds, however, that manufacturing still contributes more than one fifth of the nation's gross domestic product and create spin-off jobs in service, retail and not-for-profit sectors to impact directly 50% total economy.

Analysts believe excess inventories of steel and nonferrous products used by industry appear to have been wrung out of the supply chain. So, with future demand growth now expected, the U.S. metals market should shake itself out of the doldrums--and be quite dynamic--in 2004.

Light vehicle production fell off this summer but will rebound as inventories are worked off, so that steady assembly growth will continue in 2004. Construction continues to drag on steel demand, with further declines more likely than any upturn. Residential building is about to start falling as mortgage rates increase. There should be a rally for nonresidential in 2004, but construction investment will remain below peak levels for some years to come. Still, after two-and-a-half years of cutbacks in capital spending

budgets, economists say there's plenty of pent-up demand out there. And that should mean a rebound for steel purchasing in the various machinery and equipment sectors.

The demand for machinery and equipment stopped declining about 18 months ago, but machinery and equipment producers are still waiting for Corporate America to meaningfully step up their capital spending and for export markets to turn the corner. In fact, domestic spending on machinery and equipment has remained so anemic that machinery and equipment production now has fallen 20% below the last peak in the third quarter of 2000. First-half spending on machinery and equipment was up a scant 0.1% from a year ago, and the market continues to limp along in the second half of 2003, so producers still are waiting for a broad-based recovery to emerge. The consensus outlook of the economists for machinery and equipment is gradual demand improvement, starting late this winter. That's why the economists see machinery and equipment production advancing by 3-3.5% in 2004 and 5-5.5% in 2005.

Lower interest rates, lower energy prices, better financial market conditions, tax cuts and a weaker dollar eventually all should translate into a better capital investment climate. The second half of 2003 should bring with it a little more consumer spending, progress on the export front, industrial sector activity, and ultimately a little more capital spending. Economic growth outside the U.S. should recover in 2004-2005 at the latest-and that will trigger renewed vitality in export-oriented business activities and production. The economists reckon traditional U.S. manufacturing will rack up its best performance in 2004-2005 since 1997-1998. They also think construction investment finally will turn the corner sometime next year. The high-tech sector is poised for a rebound, they agree, which will be reflected in a 2004 rally in semiconductor demand and spending on semiconductor-making equipment. Farm sector income is already improving and should remain supportive to new equipment investment over the next few years, as production and exports rebound and crop commodity prices remain supportive.

II. Metal Chips: About Steel, Aluminum, Copper, Super Alloys and Titanium

To recap, the manufacturing sector has been suffering from reduced activity caused by cheap labor abroad, productivity gains at home, Chinese currency policies that manufacturers say have deflated the costs of their manufactured goods by as much as 40%, a chronically high dollar, skill shortages in the U.S., the increasing sophistication of overseas operations and the near-instantaneous, cross-border flow of information in the Internet era. So, it's no wonder that demand for metals fell in 2001 and again in 2002, and has remained soft through the first half of 2003. Tom Usher, president of U.S. Steel, is just one of the country's metals executives who have described the market as "difficult" for producers. The metalworking economy appears to be adjusting to a future with less industrial activity. The metal-consuming marketplace's business activity index this summer has been just barely above the 50 mark that separates expansion from contraction. However, sheet steel forecasters say demand is on the verge of an upturn, as the manufacturing economy improves.

Some end markets for steel plate and structurals are beginning to recover, but the continued weakness in nonresidential construction will slow the rebound in 2003. The primary end-markets for plate and structurals--ranked by 2002 shipments--are conversion to pipe, construction, industrial machinery, and the oil and gas industry. Demand was soft in 2002 because the strength came from consumer durables, not from the infrastructure markets that the heavy steels service. Some sectors of business investment will improve in 2003, but the upturn will not be particularly strong, according to the analysts. On the other hand, both pipe and the oil and gas industry are aided by persistently inflated energy prices. Oil prices will retreat somewhat, but remain high enough to spur drilling, and natural gas prices will be strong throughout 2003. Drilling rig counts are rising despite the increased difficulty in obtaining capital funding. The non-automotive transportation equipment market is showing growth and appliance manufacture will continue expanding at its recent annual rate of 2-2.5%. So, steel demand should grow by about 9%.

Purchasing of aluminum hasn't been good this year. Recent orders have been erratic for the big-volume mill products, and down for forgings and castings. Copper and brass use in the U.S. is falling for the third year in a row; in fact, it's heading toward the lowest annual consumption level in a decade. However, the metals mavens project at least a 3% growth in aluminum and coppermetals purchasing in the U.S. next year. On the other hand, the decline in aerospace and general aviation manufacture will continue to depress markets for titanium and the superalloys.

Forgings are high-strength parts that have been made by pressing, pounding or squeezing ferrous or nonferrous metal under great pressure. The strength of this fabricated metal products industry is dependent on nonresidential construction, machinery manufacture and the transportation industry--primarily automotive and aerospace. That's why demand for forgings has been less-than-stellar. Since 2000, manufacturing shipments have decreased by an estimated 17%. That's a decline from \$6 billion to \$5 billion in total industry shipments for the custom impression die forgings.

III. Purchasing Focus: Jobs, inventory and other issues that drives costs

Everyone has their own idea of what outsourced procurement means - and they're all right. There are a variety of different approaches to outsourced procurement from a full-blown takeover of the purchasing department to bringing in a niche expert to assist in a specific spend area or technology implementation. When we come back, we'll look at the reasons that companies are outsourcing all or part of the manufacturing process at an unprecedented rate. The reason? An attempt to eliminate some of the problems-and the extra costs--hidden within the manufacturing process. These range from such production inefficiencies as excess materials to such quality control issues as breakage, non-conformity and spoilage.

Many manufacturing systems tend to focus more on the operational issues involved in making a product, than on the financial and cost issues involved in making a profit. Such systems often make it difficult to track, analyze or control inventory-related costs. The end result is that managers don't know the true cost of inventory and how it affects production, cash flow and other related factors. That's why purchasing professionals must track and lower the following five cost centers:

First, purchasing-related costs - These represent costs associated with acquiring goods from suppliers, such as materials costs and transportation or freight expenses. Second, ordering-related costs - These include the costs of preparing, issuing and paying purchase orders, plus receiving and inspection. Purchase approval and special processing costs are also related to the number of purchase orders processed. Third, carrying-related costs - These are the costs associated with holding inventories of goods for sale, including storage, insurance, obsolescence, spoilage, and the opportunity cost of the investment tied up in inventory. Fourth, stock outage-related costs - These costs occur when an organization runs out of an item for which there is a customer demand. When a stock outage for a demand item occurs, a business typically undergoes considerable increased labor and machine costs, expedited re-ordering and shipping costs - which can be easily tracked. But many companies do not - or cannot - track the lost opportunity costs associated with stock outages such as lost revenue on sales and the potential loss of future sales from that customer.

Fifth, quality-related costs - Costs involving quality issues relate to the failure of a product or service to conform to a set standard. This overhead item usually covers four cost areas: establishing quality standards; failure prevention within the quality process; internal failures during assembly, and external failures after shipment to customer. Inventory shrinkage, scrap factors and yield all play important roles in this process as do return merchandise authorizations and engineering or manufacturing change orders.

So, using the Internet allows buyers to specify materials required, quantities, purchase price and other transaction elements that can be routed through assigned review channels to generate electronic approvals for the proposed procurement. Once fully approved, the requisition can automatically be converted to a purchase order.

Well, that's all for this For Purchasing Focus, and for this edition of Metals Watch. This is Tom Stundza, executive editor of Purchasing Magazine.

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