MetalsOutlook™ December 2007

Publisher's Statement

This month, MetalsWatch! focuses on supply and demand. In the face of volatile prices, suppliers and metalworking companies reduced inventories so they wouldn't be caught long if prices fell. That appears to have pushed the volatility issue into 2008, when prices will be equally unpredictable against low inventories and constant or rising demand.

Purchasing managers have recognized that haggling over price, price, price may raise the overall cost of a project. Going forward, they are looking for supply relationships that can assure them of a fair price, reliable quality, timely delivery, rapid response to emergencies and strong technical support. Those are reasonable requirements, although it may be like the old adage: Cheaper, faster, better – pick any two.

Supply chain management and supplier management are always great strategic goals for larger consumers of raw materials, and there are often cost benefits that smaller metal-working companies may not obtain. However, there is a nugget or two of wisdom in these pages for our readers, regardless of their annual metal spend. We hope you enjoy the issue.

Also, check out the November 2007 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) based on the latest ISM number of 50.8%.

Welcome to Metals Outlook™ December 2007

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December 2007

Tom Stundza's Comments

Welcome to the December 2007 edition of MetalsWatch! This is Tom Stundza, executive editor of Purchasing Magazine and Purchasing.com.

Except for non-residential construction and the energy complex, many major markets for carbon steel products have been weak all year—and non-res now may be weakening this quarter. Steel users have contributed to the weakness in shipments as they worked down their inventories and reduced their steel purchases. So, there has been a decline in steel use of 3% in 2007. In all likelihood, the steel economy is going to encounter another six to nine months of tough sledding, with metalworking and metal-producing companies experiencing further profit disappointments, consumers cutting back on end-product purchases, industrial job growth weakening and possible slowdowns in capital spending.

In a nutshell, housing weakness also has been undercutting consumer confidence, directly hitting consumer buys and industrial production of appliances, motor vehicles, machinery and other products made from steel. Still, North American steel market analysts project growth in steel use of 3% in 2008—even with the expected somewhat soft metalworking economy. These market mavens suggest there will be higher steel shipments by domestic mills next year since imports will continue to be depressed and both service centers and end users will be closing this year with low in-house inventories. So, in our **Cover Story**, we'll discuss the reasons why several market mavens believe there will be a rising price environment for carbon steel mill products next year.

In our **Metals Chips** segment, we'll discuss a recent Purchasing magazine survey of steel buyers, who say they need continued support from the supply chain in this very trying time where smooth purchasing performance is being challenged by major mill consolidations, erratic pricing and inconsistent production and delivery schedules. This is important because steel buyers don't always use lowest price as the primary criteria for choosing suppliers. It's all about quality, they say, and they aren't all that happy as a group these days because mill product quality—especially sheet steel surface quality—has been erratic. They also are less than pleased with delivery performance by the domestic mills and the stocking programs by some distributors.

Procurement and supply organizations are stricter these days when monitoring the performance of their suppliers—even those who already have been certified as operating with excellent quality practices. However, on average, buying groups spend 60% of their supplier-facing time on strategic sourcing activities and less than 20% actively managing suppliers. Without effective supplier management, though, 75% of sourcing savings can disappear within 18 months, according to studies by the Procurement Strategy Council. Buyers polled by the Washington-based council rate performance measurement as the most important challenge in supplier management. Yet, less than 5% of the purchasing professionals polled express complete satisfaction with the systems they have in place. We'll discuss this issue in greater detail in this edition's Purchasing Focus.

I. Cover Story � Will Carbon Steel Prices Rise in 2008?

Despite a 20% annualized rate of decline in housing construction in the third quarter, overall gross domestic product advanced at a 3.9% pace. That's the second consecutive quarter of robust expansion, caused mostly by expanded exports of manufactured products. There also was faster-than-anticipated household and business spending and a second consecutive quarterly large advance in federal defense purchases. However, consumer spending is slowing this quarter—and so are capital goods orders and shipments. Atop that, the third quarter's surprise 7.9% annualized rise in nonresidential fixed investment won't be repeated this quarter. Banc of America Securities' chief economist Peter Kretzmer now expects sustained below-trend expansion—at about 1.5% to 2% real GDP growth—through mid-2008. Following estimated annualized declines in housing of about 17% in 2007, Kretzmer expects a 15% slide in 2008. He also projects that tighter credit conditions will spread weakness to the business sector, with firms scaling back capital spending and hiring plans.

Carbon steel prices, overall, have declined slightly this year. They are starting to move up as the year draws to a close, although the movement is erratic. That's mostly because U.S. steel supply is declining by 3% this year to 131 million tons as domestic mill shipments and imports both have fallen to match reduced net use of 104 million tons. In 2008, North American steel supply will increase slightly to 134 million tons to meet improved demand of 108 million tons—as long as the threat of a manufacturing recession dissipates. These steel supply and demand numbers are hardly breathtaking—and provide little support for any major price increases the mills may plan to seek.

Also, Chuck Bradford, the principal analyst at Bradford Research/Soleil Securities in now suggests that two separate $30/ton sheet steel price increases—one for October, which hasn't been fully successful, and another for January—"probably are a reflection of current market weakness" as the mills try to boost orders for late 2007 sensing a slowdown in purchasing in early 2008. Demand from makers of consumer durables is soft, definitely reducing demand for sheet, rod and bar. It is the high energy prices that are pumping up demand for plate, pipe and tube, and some key specialty steels.

Analyst Bradford says he is "positive about higher carbon steel prices next year, especially with the likely large increase in the prices of iron ore and coking coal in world markets." But, he is less bullish that some other analysts who believe hot-rolled steel sheet may rise next year back to $600/ton, a level last seen in 2004. The rationale of these pricing bulls is that the marketplace will no longer be affected by inventory destocking that negatively impacted demand in late 2006 and throughout 2007. "If we take into account that North American hot-rolled sheet prices have been able to remain above $500/ton for the past year despite a negative headwind from significant inventory destocking by distributors and end users, then prices should easily remain above $500/ton over the next two years," writes analyst Mike Willemse at CIBC Capital Markets. He adds that hot-rolled coil prices "have the potential to increase over $600/ton, as has occurred in the past two upswings in the steel pricing cycle." Another dynamic, says analyst Aldo Mazzaferro at Goldman Sachs Group, is that "global markets will remain much stronger and much higher priced than U.S. markets, which will continue to drain supply away from the U.S. and is set the stage for at least a gradual improvement in pricing here."

In the past two pricing cycles, a flood of imports managed to prevent hot-rolled sheet prices from remaining above $600/ton for more than a few months. However, the continued weakness in the U.S. dollar and a lack of foreign metal could cause prices to remain above $600/ton for much longer in the next pricing cycle. Analyst John Anton at Global Insight agrees that world steel demand will remain strong through 2008. "The economic gains of China and India require large amounts of steel for infrastructure building and industrial output," he says. "And, although Chinese growth is slowing, it remains very high." China has eliminated almost all of its steel export-tax rebates, effectively raising export prices by 13%--making it less attractive in the U.S., Europe and South America and bolstering prices in all countries other than China.

Some analysts also believe that end-market demand will turn positive again at some point, which will likely cause service centers to begin restocking and help push sheet prices back up. Some analysts also believe that carbon steel rod and bar prices also could rise sometime ahead. But, there is no consensus when this pricing surge may occur. Nor is there much bullishness about substantial price increases next year for transaction prices of plate, structurals and tubular goods. And remember that steel demand by the automakers probably will take another hit in 2008. Reason: A soft market for Chrysler, but also General Motors and Ford, will require some slimming down of models, says Tom Libby, senior director of industry analysis at J.D. Power & Associates. He and other analysts now predict the auto industry will sell fewer than 16 million cars and light-duty trucks next year for the first time in a decade, possibly as few as 15.5 million. Chrysler will stop producing four models: The Dodge Magnum, the convertible version of the Chrysler PT Cruiser, the Chrysler Pacifica and Chrysler Crossfire.

II. Metal Chips � Beyond Price in Purchasing Decisions

Earlier this year, a survey of buyers found they were most interested in seeing their service center suppliers expand and upgrade processing capabilities and increase such value-added services as inventory management and cost-control programs. Buyers use metal service centers to shape large metal mill products into usable shapes, assemble small metal pieces into components and provide various supply chain management services. In an updated survey of steel buyers, it has been determined they still want their steel suppliers—mills and service centers alike—to refocus efforts on product excellence. In fact, 92% of all the buyers polled want to see improved and consistent quality from their steel suppliers. That's a huge percentage, especially since the next two top "steel buyer wants" are compliance with promised delivery times (52%) and, then, competitive prices (42%) and availability of needed products (40%). It's the old three-legged stool of quality, service and price.

Most of the steel buyers who report being content with their supply base are those who have ongoing partnering programs. They also suggest their purchasing colleagues "always be clear" when communicating with suppliers—whether it's an order, a compliment or a complaint. In fact, buyer-supplier partnerships were cited as opening the door for those buyers seeking more flexibility in credit arrangements or the development of online procurement programs.

Of course, pricing is a concern to all steel buyers—especially the price of stainless steel sheet, which has exploded by almost 150% over the past two-plus year. And, to put it bluntly, supply and price of stainless steel is driving most buyers nuts. In fact, stainless steel demand is down lately since prices have only recently receded from mega-flood levels and buyers have no intention of paying exorbitantly high prices anytime soon. Entering the final quarter, stainless steel buyers remain anxious because of reduced demand in a slow-growth economy. The buyers see continued slippage ahead in purchasing by the automotive, major household appliances, residential construction, ship building, electrical and material handling equipment and industrial, metalworking and construction machinery sectors.

Purchasing surveys have shown that demand for stainless steel in the U.S. has been sliding for some months and is on pace to decline by 8% to 2.92 million tons this calendar year. That's why stainless steel depots are full throughout North America, mills have seen new-order bookings by the OEM evaporate and early autumn prices for workhorse grade Type 304 cold-rolled sheet have collapsed. Now, based on information presented to analysts by stainless steel producing firms earlier this month, analyst Mike Gambardella at J.P. Morgan Securities and other market mavens who had forecast that flat-rolled stainless steel purchasing would perk up this quarter now foresee no buying surge "until further industry inventories are worked down in the first quarter of 2008."

U.S. service center inventories of stainless mill products have continued to decline over the past few months and entered the fourth quarter at 536,400 tons, or 3.4 months of supply, the lowest tonnage in stock since 520,100 tons at the start of 2000. CIBC World Markets analyst Willemse thinks that "any modest increase in end-market demand could cause North American steel prices to surge." However, analyst Mark Parr at KeyBanc Capital Markets points out that "specialty producers are suffering from restrained buyer behavior in the face of raw material volatility, particularly nickel.

When we come back, we'll discuss why 75% of the value created during sourcing efforts may be lost in the first 18 months after contract commitment—and what can be done to stop this cost-savings erosion.

III. Purchasing Focus � The Keys to Supplier Management

Welcome to this edition's Purchasing Focus. Companies are zealously rating the supply base these days to ensure against cracks or breaks in the supply chains being relied upon to support efficient, sophisticated and competitive production operations. The latest Purchasing magazine survey shows that 73% of the buying groups polled give extra business to their best suppliers. However, other studies show that costs of purchasing can reinflate from inefficient purchasing-resource allocation, uncoordinated purchasing activity, incompatible buying data among divisions, unsustainable improvement efforts and, most importantly, ineffective supplier efforts.

Purchasing professionals always have wanted their suppliers to provide high quality, on-time deliveries, competitive prices, quick response to problems and emergencies and strong technical support. However, supplier management can be a time-intensive and costly process.

The results of the latest Purchasing survey also indicate that buyers now also rate their suppliers on sharing data, resources and, if necessary, the personnel to overcome obstacles that stand in the way of mutually agreed-upon goals.

So, research by the Procurement Strategy Council suggests that companies can effectively reduce the supplier management burden by properly shifting performance management responsibility onto the supply base. Companies with supplier performance systems allowing suppliers to self-manage benefit from decreased supply chain costs and increased procurement efficiency.

Buying groups that have tried this approach say there are five standards/key considerations for a total supplier self-management system:

- Have clear and actionable supplier-performance metrics that mesh with corporate business goals and hold improvement opportunities along the supply chain.
- Fully communicate performance expectations that provide tools that enhance supplier insight. Remember that suppliers who fully understand performance expectations will be able to optimize internal processes to buyer requirements.

- Give suppliers in-depth performance information and analytical tools that allow suppliers to better understand their own performance and identify key improvement opportunities.
- Communicate clearly and simply. Procurement group should unbundle complex metrics into easy-to-understand component performance goals that allow suppliers to identify performance gaps and address root causes of product or delivery problems.
- Make sure suppliers understand their relative performance to the buying group's expectations. Buyers must help enhance suppliers' continuous improvement efforts by providing context around performance beyond a list of arbitrary objectives. It doesn't hurt to demonstrate to the supply chain members the best-performance achievements by their competitors or other category leaders.

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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