MetalsOutlook™ November 2010

Publisher's Statement

We think everyone is asking themselves the same question: "Where are the orders?"

U.S. economic growth in the third quarter was initially recorded at 2%. Not awful, but not robust, either. The chicken and the egg are at work here. Manufacturing is waiting for consumer demand to pick up before it hires. Consumers are waiting for jobs before they spend. But 2% growth won't create jobs, so we are stuck between gears.

Warren Buffett says the double dip recession is off the table, but the government is capable of screwing up almost anything, especially with their backward vision used as forecasting. Hopefully, the elections will prevent them from doing anything at all. By the time they get around to making a rearview mirror decision, the economy may be on a roll into 2011.

In the meantime, we simply hunker down and do our jobs. In times like these, it is always helpful to remember that there have been times like these. None of them were permanent, but they were all really uncomfortable.

The ISM number of 56.9% reflects what we've been saying for months. As the economy turns, plan ahead. Job growth is beginning; albeit, in fits and starts. Manufacturing is turning; albeit, in fits and starts. We've all seen orders in fits and starts. We encourage you to read the entire ISM report. There are nuggets of gold within it, and more than a few points of light in the following pages of Metals Outlook(TM).

Welcome to Metals Outlook™ November 2010

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I. The Economy -- modest but positive growth

The fourth quarter economy will remain characterized by modest, but positive, economic growth driven by gains in consumer spending, equipment and software spending and federal government spending. Commercial real estate still will be a drag. Inventory rebuilding of raw materials, intermediate goods and finished products has come to an end and will not boost quarterly purchasing growth. Net exports of materials and finished goods will be a modest positive. But, metalworking activity is stuck around 70% of capacity and metalforming companies expect steady-to-down business conditions through year's end. So, market prices for most metals will remain subdued into 2011. Bottom line: The manufacturing economy and its metalworking sector are no longer in intensive care and are growing slowly, but momentum is unpredictable and industrial output faces a long recovery. A year after the official end of the U.S. recession, growth has slowed again without big gains in employment. Joblessness, which was 9.6% in September, has barely budged since reaching a 26-year high of 10.1% last October. A full relapse into a second "back-to-back" general recession remains a 25% probability, many economists wager, but they don't see that as the most likely outcome. Instead, they reckon the overall economy will crawl forward. Gross domestic product has slowed from a 5% annual growth rate in last year's final quarter to 2% this quarter, which will create an average 2.6% growth for this year.

Growth in industrial production--the output of mines, factories, and utilities--has clearly slowed from earlier this year. Slower growth did not derail the manufacturing recovery but did tarnish its luster. Reason: There is weaker fundamental support for goods producers. Still, the manufacturing sector is far totally becalmed as industrial production, the capacity utilization rate, and a return of modest pricing power have continued to improve from 2008-2009. However, the indices from the Institute for Supply Management still show growth but have trended weaker for several months. So, looking at this final quarter of 2010, such key cyclical drivers as residential construction housing and motor vehicles assembly--already at low levels--will stay soft. Nonresidential construction will continue to decline. But, as credit conditions have started to ease, business equipment spending this quarter will increase at close to a double-digit clip. Factory orders have been somewhat encouraging outside the volatile transportation sector. Inventory rebuilding has accounted for a large proportion of the improvement in factory output over the past year, and the impact from restocking is beginning to lose some steam. However, looking at the final quarter, forecasters see strength in only marginal growth in demand for agricultural, construction and mining machinery, for industrial machinery and machine tools and electrical equipment, major appliances and computers. New orders for heavy machinery and production equipment--including metalworking machinery--won't gain considerable ground until domestic manufacturers are beginning to loosen the purse strings. Industry could spend more except that businesses are hanging onto cash because Congress hasn't clarified whether taxes will be going up in 2011. (Economists hope that the post-midterm election lame-duck Congress will settle the question whether the Bush administration's tax cuts will be extended temporarily.) The business uncertainty over existing and future U.S. government policies having to do with health care costs and financial regulations as well as taxes, and that may explain why companies are sitting on more than $2 trillion of cash and not using the money to buy new equipment or hire more workers. The tax uncertainty also may explain why U.S. households are saving about 6% of their after-tax income. Still, there is good news in that consumer spending appears on track for another quarterly 2% growth rate.

In such an economic environment, metals will be easier and cheaper to acquire this quarter. Primary metal consumption growth has been improving since early 2009 but the fourth quarter will show a slowdown as restocking ends. Reason: Metalworking companies have turned a bit more cautious with their inventories as manufacturing's rate of growth has slowed It is not until 2011 that a true balanced, sustainable recovery in nonferrous metals consumption is achieved. Over the past year, overall manufacturing production has risen by more than 6%, but the rate of increase has varied greatly across different segments. Leading the gains have been primary metals, with output up 20%. Robust increases in output of certain kinds of industrial machinery, computers and other business and consumer electronics have supported demand for steel and nonferrous metals, as has transportation equipment, although its growth has been somewhat slower. There are robust sales of U.S.-made industrial products in places like Latin America and Asia, where high commodity prices and aggressive infrastructure investment are fueling demand for capital goods. But the U.S. companies are guarded about their fourth quarter viewpoints because of the apparently weaker projections for October-December manufacturing and raw materials consumption in the U.S., which still is the world's largest economy. To economists, the nagging question is simple: How long can the rest of the world continue to grow, and provide a lucrative market for U.S. manufacturers, if unemployment, stagnant wages and high debt levels back home crimp U.S. consumer spending on the goods those overseas countries export? Thus, looking ahead, the IHS Global Insight growth forecast for 2011 is just 2.2% as manufacturing expansion's staying power has become less convincing.

II. Manufacturing News -- capital spending awaits new orders

Capital spending plans for manufacturers and firms in other industries project little change or modest increases through year's end across the country. That means no fourth quarter surge is seen in production of farm machinery and equipment, construction machinery, metalworking machinery and material handling equipment, turbines and generators and other power transmission equipment, electrical equipment and mining, oil field and natural gas machinery. Also awaiting some strong new-order increases are the producers of pumps and compressors, communications equipment, measuring and control instruments, major appliances and office and institutional furniture. Through August, shipments of manufactured durable goods totaled $1.56 trillion, an increase of 7.6% from the $1.45 trillion a year earlier--but still the second-lowest since the eight-month total in 2004. Meanwhile, January-August new orders for durable goods totaled $1.53 trillion, which is 15% ahead of the eight-month 2009 total of $1.33 trillion. However, orders for transportation equipment--motor vehicles and parts and commercial aircraft and parts--have been down five of the past six months. That fits with the Federal Reserve "Beige Book" report that manufacturing capacity utilization has been mixed this autumn. Manufacturers of high-tech products have been operating near maximum capacity of late, although this reflects a substantial decline in industry capacity over the past three years. The majority of Midwestern manufacturing contacts report that capacity utilization remains below pre-recession levels.

According to an updated forecast by IHS Automotive, North American assembly plants will produce 11.73 million light vehicles in 2010, up 37% from 5.57 million in 2009. However, only 2.8 million vehicles will be assembled in the U.S., Canada and Mexico in the last three months of 2010, an increase of barely 3% from the year-ago fourth quarter. There is no doubt that 2010 will be a better year for heavy-duty trucks than 2009, but buyers have been dipping their toes into the water this year, not diving back in. Sales will be up 10.3% but that's only 298,000 units, as compared with 270,000 in 2009--and 598,000 in the cyclical peak year of 2006. Even with 261,000 units being made this year in the U.S. and Canada (up from 215,000 last year), there still is plenty of excess/underutilized capacity left over by the recession that has to be whittled down.

IHS Global Insight economist Scott Hazelton says residential construction will remain in a trough this quarter. "Growth in residential construction is primarily driven by employment conditions, so until these conditions improve, the prospects for growth in residential construction spending will remain dim," he says. Adding to the problem is the mortgage foreclosure crisis that has led to a large overhang of vacant and for-sale houses on the market. Upshot: Construction of new housing will lag until the inventory of vacant homes returns to "normal" levels. The decline in employment, particularly in the finance and professional services sectors, has maintained high office vacancy rates--somewhere close to 20% of capacity this year. So, construction spending on office space will remain low this quarter--and for the foreseeable future. Highways and streets construction funded by federal stimulus money has boosted some regional non-residential building projects but, overall, commercial construction spending has been in decline throughout the country. That isn't going to change quickly. All this relates to manufacturing in that appliances and electrical equipment manufacturers normally depend on residential and commercial building. Although construction spending remains depressed under 2009 volume, this segment had been on track for 6.3% output growth versus 2009 (due to replacement purchases by the general public). However, with discretionary income being put more and more into savings, the projected fourth quarter quarterly expansion of 2.8% is now in doubt.

III. Metals News -- metals prices level

Earlier this year, metals prices were on a tear as investors were plowing money into both stocks and commodities, reasonably certain that the global recovery was gaining traction. In steel, it appeared that a recovery in demand would be strong and long. However, the post-recession rally in steel came to an abrupt end in the second quarter as marketplace fundamentals--too much supply--overcame mill effort to cover rising cost of raw materials. Prices of nonferrous metals slipped in the summer but have since recorded a slight bounce as primary metal purchasing growth by speculators has rebounded, the Eurozone financial crisis has faded and the dollar has weakened. Like steel, however, analysts expect nonferrous prices to move slightly lower during the fourth quarter on slower consumption growth in China, the world largest base metals market.

onferrous metals demand this quarter can best be described as lackluster, at least in North America and Europe, the second and third largest consuming regions. Asia continues to sparkle, but regional growth is downshifting as Chinese policymakers work to dampen inflationary pressures. The slowdown in Asia is significant because it has been the source of metal consumption growth over the past five years. This is especially true with regard to China, which single-handedly supported global base metal demand between late 2008 and early this year. As for prices, economists such as John Mothersole at IHS Global Insight issue a number of cautions for the fourth quarter: First, this market is beginning to look overbought on a technical basis. London Metal Exchange purchasing volume and open interest have been flat or down since the start of the year, suggesting there will be less buying momentum to carry the market forward. Second, the market will soon come under some selling pressure from hedge funds eager to take profits, lock in results and thereby brush up year-end financial statements. Third, there has been a surge in traded-contract volume on the Shanghai Futures Exchange. Adjusted to reflect the amount of metal underlying the contracts, metal trading volume on the SHFE now exceeds the LME. Curiously, the surge in volume coincides with the rollout of the stimulus package in China during the winter of 2008. Even granting China's position in global metal markets today, there are suspicions that the surge in trading volume over the past 18 months can't be explained entirely by the physical market. So, if part of the support coming from the Chinese market is speculation, trading volume soon won't be sustainable and withdrawal would dampen prices.

"We would argue that together, these factors point to at least a pause or even a slight correction in prices immediately ahead," says Mothersole. Still, he admits there are factors that limit the market's downside at this point. For example, visible inventory has begun to come down, with coverage ratios (inventory expressed in weeks of consumption) inching down. Comparisons of current prices and coverage ratios by the base metals reveal conditions closer to historical ranges compared with early this year. In effect, this market is "more normally priced" today. "Unless we were to see a drop in consumption," says the economist, "it will be hard to justify anything but a very modest pullback in prices."

Meanwhile, purchasing personnel agree there won't be robust demand for manufacturing commodities until sometime in early 2011 but they can't agree whether fourth quarter pricing will strengthen or soften. A quick-pulse poll of a cross-section of supply chain personnel on the street by IHS Global Insight finds many--but not all--projecting slippage in October-December market prices for steel mill products and nonferrous metals. The buyers generally agreed that until domestic housing and commercial real estate markets absorb overcapacity, nonresidential construction gains traction and unemployment begins to improve, there will not be enough end demand for a general economic improvement in late 2010 to support substantially higher metals market prices--even as many suppliers keep trying to implement cost-push price hikes.

Market prices for steel are running about 14% ahead of last year but have turned south this month. Nonferrous metals are about 18% ahead of forecast but trading has been erratic lately. Also late-year announced price increases for some petrochemicals and paperboard packaging haven't stuck. With the economic recovery rapidly slowing, further price increases could be difficult. "I do not think recent run-up in some commodities are sustainable due to the uncertain economic conditions in the near future; it's based more on speculation than real demand," says the general manager at a manufacturer of ion exchange resins for water and wastewater treatment. As the year runs out, "nonferrous metals price will drop in the following months as seasonal demand slows down," suggests the global supply chain manager at a manufacturer of high-performance base materials used in the manufacture of advanced multilayer printed circuit boards. "Prices will drop or moderate in the very near term. These runs are or appear to be more of a "take advantage" of the moment than being sustainable," says director of procurement at a distributor of generic pharmaceuticals. "It looks more like supplier folks are grabbing at mini straws for the very near future and then will take the profits and run."

"My take is the prices will only remain stable or go north if the demand increases," suggests the sourcing specialist at a maker of coaxial cables connectors and cable assemblies. "In my sector of manufacturing, which deals with a lot of defense contracts, demand seems to be increasing. However, some of my sub-tier suppliers who make components for small arms are seeing a drop in business." Some buyers even expect prices to drop after the mid-term elections in November if the Republicans take back the House and Senate. "The primary reason for commodity pricing being highis a weak dollar," asserts the purchasing manager of a manufacturer of waste management and recycling equipment. "If we have a Congress that is perceived to be serious about closing the federal deficit and reducing overall spending, it will lower demand for commodities and add value to the dollar." However, not all purchasing professionals see prices sliding later this quarter. The commodity manager at a manufacturer of direct digital manufacturing systems suggests the pricing trend is upward since suppliers are monitoring capacity operations to match supply with demand.

IV. Metals Outlook -- demand still soft

The fourth quarter won't be the launching pad for stronger demand or pricing of most ferrous and nonferrous metals.

Waning demand for steel across major end-markets and persistent oversupply continues to heap downside pressure on U.S. raw steel production rates--now around 68% of capacity--and quarterly pricing expectations. The latest IHS Global Insight analysis says that spot-market prices for commodity carbon steel products will continue to decline in coming weeks. With plentiful inventories at service centers, announced price increases aren't sticking; in fact, many prices have turned south since deep discounting has been rampant. Lethargic manufacturing and dormant nonresidential construction activity in an uneven economic recovery have continued to depress end-market demand. Analysts say there hasn't been a marked change in seasonal demand drivers. Macroeconomic data like the Institute of Supply Management's leading indicator has softened and end-user inventory restocking momentum has waned. Contacts at service centers indicate that they intend to reduce their inventories for the balance of the year. That's because the IHS Global Insight-adjusted net use is on pace to be 66.2 million tons in 2010, up from 43.4 million a year ago but still among the weakest metalworking years since the early 1990s.

Stainless steel purchases look to be improved back to the 2008 level of 1.29 million tons this year, supported by higher steelmaking and imports. However, demand was artificially boosted for inventory replenishment earlier in the year. Now that inventory is restocked, there has been a flattening of consumption. Prices have been high but erratic because of overstocked inventories at the distribution level in the second half and the unwillingness of end-use buyers to commit to large buys. Price shopping and resistance to mill price-hike announcements will continue this quarter, especially since costs of such raw materials as nickel, molybdenum and cobalt are moderating.

Aluminum demand in the U.S. has begun to improve after two years of decline. Mill product end use is on pace to increase by 21% this year. It's also increasing globally. Near term, the market looks adequately supplied because of a large inventory overhang and ample capacity that continues to smelt lots of metal. Prices, therefore, may decline this quarter as more metal than is needed is pushed on the market. Since this is world-traded metal with pricing set on the London Metal Exchange, speculation and investor sentiment will play a major role. As always, the focus will be on China, particularly on how much metal it is producing and how much indeed is still being made and sold.

Average selling prices for titanium and its alloys have been weak for months because of competitive pressures caused by declines in raw material costs and reduced end-market demand. If aerospace industry purchasing expands, it won't be until later in 2011 and 2012 so no short-term price rebound is expected. Both the Boeing and Airbus supply chains continue to have relatively high inventories created by slower than anticipated production levels over the past two years. The supply/demand imbalance will continue--especially since there has been a production schedule push out on the F-35. In the fourth quarter, no buying surge is expected until much later from power generation and non-aerospace industrial supply chains.

Average selling prices for nickel alloy mill products have moved lower since 2009 while stainless steel pricing has been erratic. This won't change soon despite efforts by producers such as Carpenter Technology Corp. to raise base prices this quarter by an average of 3% to 8% on stainless and specialty alloys products. Nickel prices are projected to drop in the fourth quarter--$9.75/lb versus $10.25/lb in the third quarter--because of anticipated short-term declines in the global production of stainless and specialty steel and nickel-based superalloys.

Molybdenum prices look to be uncertain about direction through the remainder of 2010 as an uptick in September prices is disappearing this month. In a nutshell, increases are being resisted by makers of stainless steel and specialty steel, who have gone into a short-term funk The mills are buying hand to mouth and are declining to stock for the future. It won't be 2011 when revitalized market activity, combined with a lagging supply response, accelerate price increases in Europe and Asia, first, and then North America.

Cobalt's end-markets of rechargeable batteries for hybrid cars and electronics, superalloys for turbines and jet engines and chemical catalysts has improved somewhat in 2010, but growth in these niche markets hasn't propelled prices skyward. New cobalt production coming on stream from 2010 onwards will move the cobalt market into oversupply according to Catherine Virga of CPM Group, addressing delegates at the London Metal Exchange's annual October Metals Seminar. As 2010 cobalt consumption continues to trail production, traded cobalt is running 46% below the prices of 2009. With specialty steel production in North America and Europe relatively dormant and Chinese buying expected to decelerate this quarter, there is downward momentum on prices based on market fundamentals.

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