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STEEL MARKET ANALYSIS – JUNE 11, 2008

In the past two months, we generally saw a continuation and exacerbation of the fundamental dynamics affecting the U.S. steel industry since the beginning of the year. Most significant have been and are ...

- plummeting value of the US dollar versus the euro
- meteoric rise in steelmaking costs
- strong global demand
- low distributor inventories
- low import volume
- burgeoning exports
- a steel production oligopoly
- higher steel prices

Economic Factors

Since early 2006, the value of the US dollar has depreciated almost 23% compared to the Euro. This severe fall has significant impact on, among other things, world trade patterns and commodity prices (including steelmaking raw materials and steel as discussed in Essex's March 24 newsletter).

Two key indices of steel industry demand are the U.S. Commerce Department's report on durable goods orders (the fabricated metal products component in particular) and the Institute for Supply Management's (ISM) report on manufacturing. With the US economic weakening, fabricated metal products orders have declined in the past three months. According to the latest available US statistics, April fabricated metals orders dropped 1.2% compared to March, following modest gains in the two prior months. The latest ISM statistics on new orders show a contraction for May and a slowing trend over the past six months. Yet in spite of the economic malaise, steel demand has been surprisingly firm.

Scrap & Other Steelmaking Costs

Steel scrap prices have soared to record heights. Since last December, #1 Consumer Bundles (gross ton, FOB Chicago) rose from about \$329 to \$780 (+137%). This climb is mainly due to ...

- a) The closing of so many stamping plants and overall decline of America's metalworking industry, since the 1980's, has reduced the amount of scrap being generated in the U.S.
- b) Auto, appliance and steel processing plants are generating less scrap volume because of weak production levels.
- c) Iron ore and pellets costs continue to escalate, buoying scrap prices
- d) Mill demand continues strong (especially for prime #1 grades), given their operating rates consistently hovering around 89% of capacity.
- e) Foreigners are bidding up the price of scrap, here and world-over, given robust overseas demand and the weak US dollar. First quarter 2008 scrap exports climbed 8.5% over the same period last year. For full year 2007, ferrous scrap exports increased 32% over 2006 and more than double the average of the last decade.



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MAJOR RAW MATERIAL COSTS FOR DOMESTIC STEELMAKING				
DATE	SCRAP	PIG IRON	IRON ORE	COKING COAL
Month	\$/gross ton #1 Consumer Bdls. Chicago	\$/gross ton divd. Chicago	\$/gross ton contract	\$/net ton contract
12/07	329	455	75	98
1/08	402	490	124	98
2/08	406	580	124	98
3/08	435	585	124	200
4/08	597	620	124	200
5/08	705	790	124	200-300
6/08 projected	780	870	124	200-300

These costs are approximate and vary among producers. They represent 70%-80% of the total cost of steel. Energy, ferroalloys, and transportation expenses have also been rising dramatically. Labor costs have become relatively minor, due to much higher productivity (man-hours per ton) the mills have realized over the past decade.

Given the dramatic impact of scrap costs upon current steel prices, some explanation of the scrap business might be helpful and relevant for you. There are different grades of scrap. #1 dealer bundles and #1 busheling are generally the output of stamping plants and steel coil/sheet processors. These prime grades command a premium price, because both the integrations and minimills require them in relatively large proportion to make sophisticated flat-rolled products. The lower grades of scrap (heavy melting, #2 bundles, shredded, machine shop turnings, etc.) have lesser value, since they generally require more pre-melt processing and their use is limited to the manufacture of lower-end steel products, i.e., plate, structurals, merchant bars, rebar. #1 scrap grades have been and will probably remain in tight supply, and at high price, for the foreseeable future. The lower grades also realized huge price surges over the past several months. Accordingly, junk dealers have been combing the alleys and countryside bringing in substantial amounts to scrap yards. With this month's plentiful supplies of lower grade scrap, there's been a slight price drop in some of these grades. It's also important to bear in mind that scrap prices are very volatile, certainly compared to steel.

The integrated mills can generally use pig iron as a scrap substitute, however a worldwide shortage of pig has significantly driven up its price.



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Demand versus Supply

Domestic steel production remains at 88-90% of capacity, despite a virtual or actual US recession. While automotive, appliance and office furniture markets are very weak, they are being largely offset by very strong demand from the energy, heavy equipment, non-residential construction and farm equipment sectors. Steel product shipments have markedly shifted away from sheet and towards plates, structurals, pipe and tubing and bars.

2008 domestic demand should be about 126 million tons. In terms of supply, domestic production is expected to be about 107 million tons, imports are forecast at 17 million tons, and exports of roughly 12 million tons are expected. Given that scenario, the US is facing a shortfall of 14 million tons, equating to 11% of demand. Even reduced automobile/truck production of only 14 million units this year (a very conservative estimate) will not appreciably offset the net supply deficit.

Globally, steel demand remains robust. In contrast to lackluster activity in the NAFTA countries, there is very healthy steel appetite in Russia/Eastern Europe, China, India, South and Central America, and the Middle East.

Inventories

April service center inventories were 12.4 million tons, slightly higher than March but down 15.1% compared to April of last year. Stock levels continue to be near their lowest in the past 10 years. Many steel distributors have been unwilling, or financially unable, to speculate on large positions at today's historically-high prices.

Secondary flat-rolled availability remains very tight. Most secondary steel comes from surface defects occurring during mill production of quality-critical automotive, appliance and office furniture orders. Because demand from these industries has been quite low, secondary steel volumes have correspondingly dropped.

Imports

Strong global demand, a weak US dollar, scarcity of vessels and high ocean freight costs, have curtailed US steel imports. For the first five months of this year, imports were down an estimated 11.6% compared to the same period last year. To the extent foreign steel has been arriving, it mostly involves billets and slabs, wire rod, rebar, plate, oil country goods, pipe, structurals. Very little sheet was brought in. May imports fell almost 13% compared to April. No substantial pickup in imports is expected anytime soon, and particularly in terms of flat-rolled products into the Midwest.

Exports

First quarter steel exports totaled 2,745,010 metric tons, a 21.4% increase over first quarter 2007. The domestic mills are poised to amplify exports given the low US dollar value, comparatively higher steel demand and prices abroad, and to shore up their production rates.



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Financial Industry Analyses

The investment community has been bullish on the steel sector throughout the year. Many analysts and stock brokerages have recommended buy positions on steel stocks. Three key measurements for steel industry performance are:

- Dow Jones US Steel Index +17.6% (year-to-date)
- AMEX Market Vectors Steel ETF +25.9% (year-to-date)
- Standard & Poor's Steel Index +16.9% compared to S&P 500 -4.6% (through 4/25/08)

Oligopoly

Oligopoly is a market condition in which a small number of sellers have significant influence over market pricing. During the 1980's and 1990's, there were over 30 flat-rolled mills in North America. That relatively large number of producers engendered extreme competition and, by pitting competing mills against one another, customers were able to wield considerable restraint upon steel pricing. Between 2001-2005 the U.S. steel industry underwent a sweeping consolidation, sharply reducing the number of mills. Today, three producers (USS, Nucor and ArcelorMittal) control about 70% of domestic sheet capacity. As such, they can maintain considerable de facto control on steel pricing, especially in the absence of foreign competition.

Steel Prices

Given the recent/current U.S. currency valuation, soaring prices of raw materials, and overall supply-demand context, the steep run-up (illustrated below) in steel prices was practically inevitable.

MILL BASE PRICES – PRIME MASTER COILS Approx. \$/cwt, including surcharges, excluding extras FOB Midwest Mills			
Date	Hot Rolled	Cold Rolled	Galvanized
1/08	31	36	42
2/08	36	40	46
3/08	40	44	50
4/08	50	54	60
5/08	53	57	62



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Market Forecast

Beginning in September of 2007, Essex Trading Company had forewarned its clients and friends of an impending, severe steel shortage and price increases. Today's extremely high prices and weak end-user demand are certainly troublesome. Everyone seems to be waiting for a market collapse. However, market fundamentals are: low US dollar value; continued high steelmaking costs; low distributor stocks; paucity of imports; domestic mill consolidation and strength; and increasing domestic export potential. Moreover, any pickup in mill order books (which traditionally occurs in July-September from automotive), blast furnace outage or other production interruption, can lend renewed market impetus.

There could be some price contraction ahead. The sharp price increases in prime grades of scrap may not be sustainable. Inevitably, these prices will fall. When they do, mills likely will lower scrap surcharges. This could possibly lead to buyers withdrawing from the market and therefore even larger declines. The mills' willingness to lower prices in response to scrap cost declines or, on the other hand, their resistance to do so, may be a strong market signal in the weeks to come.