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STEEL MARKET ANALYSIS – MARCH 20, 2008

The steel supply, demand, price and economic dynamics discussed in our February and January website newsletters (http://tonsandtons.com/about/market-news.cfm) persist and, indeed, are becoming even more severe. For the current newsletter issue, we thought a closer examination of the underlying causes would be especially helpful to our clients and friends …

Economic Aspects

Over the past two years, the value of the US dollar has depreciated roughly 22% compared to the Euro ...

US DOLLAR – EURO COMPARATIVE VALUE	
DATE	$ / EURO
3/06	.83
6/06	.79
9/06	.79
12/06	.76
3/07	.75
6/07	.75
9/07	.72
12/07	.69
1/08	.68
2/08	.68
3/08	.65

Resulting from the US dollar's steady and steep descent, along with much higher demand and prices in other world markets, very little foreign steel is or will soon be coming to the US (and especially the Midwest). Steel imports for 2007 fell 26% compared to 2006; 2008 imports are already down 10% from 2007 levels. To the extent foreign steel is arriving, the products are almost exclusively non-sheet (i.e., line pipe, oil country goods, heavy structurals and bars).

Conversely, strong international demand, combined with the dollar's relative weakness against foreign currencies, is leading to an outflow of US raw materials to overseas markets. For 2007, ferrous scrap exports increased 32% over 2006 and more than double the average of the last decade.

Moreover, reports from US docks indicate an increase in US finished steel exports. This strategy allows the domestic mills to capitalize upon much higher prices in other world markets, maximize their production rates (running at 88%-90% thus far this year), and thwart downward price pressure due to weak US demand.

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Raw Material Costs

Steel mills worldwide are experiencing extreme shortages and surging costs related to their essential raw materials. Inclement weather and infrastructure problems have seriously hindered coal and iron ore output from Australia and China in particular.

2008 global steel consumption is projected to grow at about 5%, with China's expected to increase 10%. The BRIC countries (Brazil, Russia, India, China) and Middle East continue to experience enormous demand. With burgeoning economies, they're bidding up world prices for a broad range of industrial raw materials. There is rampant inflation in steelmaking inputs, as the following table illustrates …

COSTS OF MAJOR RAW MATERIALS FOR DOMESTIC STEELMAKING				
DATE	SCRAP	PIG IRON	IRON ORE	COKING COAL
Month	$/gross ton #1 Consumer Bdls. Chicago	$/gross ton	$/gross ton contract	$/net ton contract
9/07	327	425	75	88
10/07	321	422	75	98
11/07	303	435	75	98
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 projected	500	620	124	200

For the preceding table, note that costs are approximate, fluid and vary amongst producers. Nevertheless, these raw materials represent about 80% of the total cost of steel. The integrated mills typically enjoy a current cost advantage compared to the mini-mills, since the integrateds' blast furnaces rely far less on expensive scrap and pig iron than the mini-mills' electric arc furnaces.

Against a backdrop of worldwide and apparently long-term scrap shortages, Nucor and Steel Dynamics (SDI) have recently purchased large US scrap processors to better assure their raw material lifelines and cost parities. Further vertical integration is expected, domestically and internationally.

Transportation costs, and ocean freight in particular, have also had a significant inflationary impact on mills' costs. The mini-mills especially rely on foreign sources of scrap and pig iron. The Baltic Dry Index (BDI) provides an assessment of ocean transport pricing in connection with major raw materials. Since January of 2006, the chief sea freight index has risen about 250%, reflecting significantly higher international shipping charges.

As a consequence of these across-the-board raw material cost spikes, and other hefty increases in the costs of energy (electricity, gas, oil) and labor (direct and indirect), vigorous mill price increases should come as no surprise.

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Steel Price Activity

The below table provides a snapshot of recent, domestic steel contract pricing. In most instances, prices on the spot and secondary markets have risen markedly higher. And the mills have announced further price hikes of about $70/net ton for April-May orders.

MILL BASE PRICES – PRIME MASTER COILS Approx. $/cwt, excluding extras, FOB Midwest Mill			
Date	Hot Rolled	Cold Rolled	Galvanized
9/07	26	31	38
10/07	27	32	38
11/07	28	32	38
12/07	28	33	39
1/08	31	36	42
2/08	36	40	46
3/08	40	44	50

Other Dynamics and Implications

Exacerbating this steep inflation and supply vacuum is the fact that metal distributors' stocks are at their lowest levels since 1997. Service centers and dealers are unwilling or unable to take large positions at today's historically high price levels, especially given the current weakness in US manufacturing. Many are buying only on a hand-to-mouth basis, afraid that the market will implode and they'll be stuck holding expensive steel -- and in a low demand, recessionary context (a.k.a. stagflation).

Credit and cashflow are perhaps the most challenging issues the steel industry is about to face. US commercial banks are now, and quite understandably, looking much more closely at their clients' financial conditions. Today's ton of steel costs about twice as much as it did two years ago. Moreover, this year's US industrial slowdown is engendering a delay in accounts receivables. Consequently, metals distributors, OEMs and fabricators are often drawing down cashflow and credit lines much faster than ever before. A growing number of business bankruptcies and closures is likely.

But all is not bleak. Given the falling value of the US dollar, and relatively low cost of American steel compared to the world market, conditions are becoming ripe for some resurgence in the US metalworking sector. Our finished goods cost structure is becoming much more price competitive, hopefully heralding new business and jobs in the US. In fact, many US manufacturers (i.e., oilfield and agriculture equipment) are enjoying robust overseas demand. Some companies are now rethinking their earlier production offshoring. We may be on the verge of an American industrial revitalization.