

World Steel Dynamics (WSD) is a leading steel information service in Englewood Cliffs, N.J. WSD's steel experience, steel database and availability of steel statistics are the principles for performing steel forecasts, studies and analysis for international clients. WSD seeks to understand how the "pricing power" of steel companies the world over will be impacted by changes in the steel industry's structure. To submit your questions for WSD, e-mail WSD@aist.org.



Are the Mills Losing Their Grip?

As the steel buyer for a large OEM global company, I remember all too well the dramatic market price increases of 2004. Several times following 2004, it looked like the dramatic rise of steel prices would slip back, as spot market prices were known to do in previous market periods. We know now that the mills' pricing strength on average over the past two years has proved to be much more resilient than prior periods. While spot market prices remain volatile, in that they change direction more often, the lowest price observed each year has been higher than the previous pricing low.

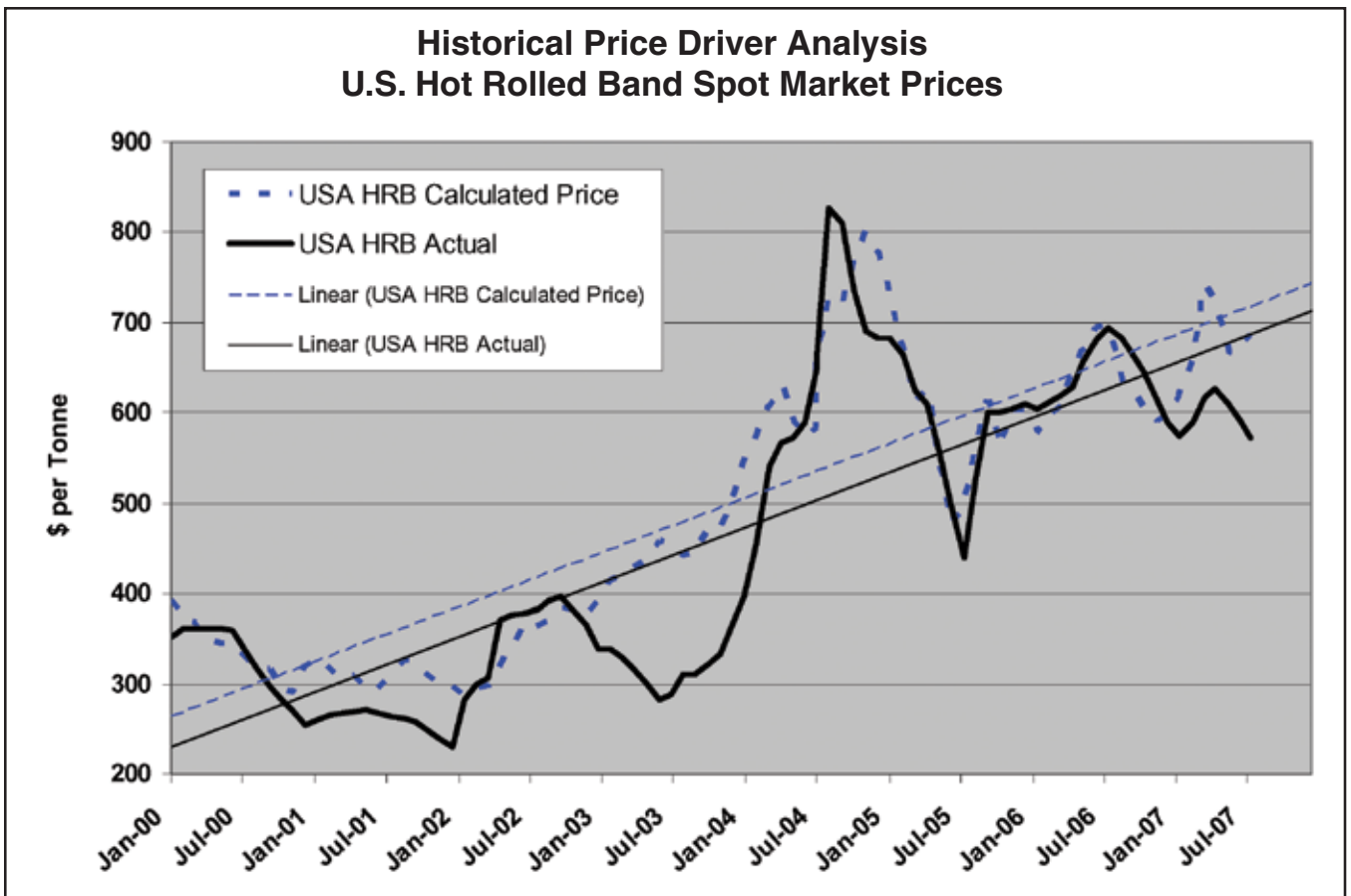
I joined World Steel Dynamics in the fall of 2006 as a managing partner. My efforts are focused on the buyer-seller interface. This involves working closely with steel buying and selling organizations to deepen the understanding of regional market price drivers and global influences. The goal is to achieve more robust steel buying and selling strategies based on this knowledge.

This article will discuss the findings of a recent spot market price driver analysis conducted by WSD. We hope to provide readers insights into the U.S. spot market price drivers. The article also raises a couple key questions about the 2007 pricing pattern that has been experienced over the last seven

months. Are the mills losing their grip on U.S. spot market pricing? What are the pricing implications for steel buyers and sellers going forward?

An analysis was conducted to determine key U.S. spot market price drivers. The goal of the analysis was to use the price drivers in a simple algorithm to predict spot market prices. A couple independent variables (key market price drivers) were identified and were used to adjust a beginning actual spot market price in order to create a pricing comparison between calculated and actual spot prices over the past seven years. The figure below is the comparison of the calculated spot price versus the actual spot price.

Very close agreement can be observed between the calculated price line (dashed) and the actual spot market price line (solid) during 2004–2006. The calculated line uses two key market price drivers to adjust the actual January 2000 spot price to derive spot market prices by month from February 2000 to July 2007. The key price drivers used in the algorithm are currency (US\$/Euro) and the price of scrap (price of #1 busheling – Chicago consumer price). These drivers may be somewhat surprising, in that they are not mill capacity utilization, domestic steel demand or import volume. Linear trend



lines confirm that the calculated price line slope is the same as the actual spot market price slope over the seven-year period contained in the analysis. Pricing correlation departures can be observed in 2001 and 2003, and most recently in 2007, and will be discussed later.

WSD believes that the spot market price driver analysis raises significant implications for steel buyers and sellers:

- The value of the U.S. dollar is a significant steel price driver. If the U.S. dollar weakens, the price of steel rises in the U.S. market. Prior to 2001, the price of steel in the United States was declining, while the dollar was gaining strength. The U.S. dollar is also a key measurement of global steel mill costs. As the value of the U.S. dollar decreases, global steelmakers' costs increase in dollar terms. The value of the dollar has a heavy influence on the United States' market attractiveness to imports versus other regional markets.
- Steel scrap is an obvious price driver, given the successful use of scrap surcharges by minimills in the United States. Scrap price increases reflect the strong global demand growth for metallics to meet the increased rate of steel production worldwide. The volatility of scrap prices reflects changes in steel production, seasonal factors and global trade between regions. It is interesting to note that the correlation of the calculated price and the actual spot price is the strongest during 2004–2006, when steel supply in the United States was generally tight and integrated mills followed the minimill lead on spot prices.
- The observed pricing departures in 2001 and 2003 occurred in the "Old Continuum." This period of time is known for fragmented regional mill capacity, U.S. mill bankruptcies and poor production discipline, in that the mills often chased the "last" spot market ton by lowering prices.
- The most recent pricing departure observed in 2007 has very interesting implications. It has occurred during the "New Continuum," which is a period characterized by higher rates of global steel demand, consolidated regional steel capacity and better-than-previously-experienced mill production discipline in the United States. Buyers might conclude that the 2007 "pricing departure" is evidence that the mills in the United States are losing their grip on steel prices by overproducing. Steel buyers should remain cautious, however, in my opinion, and should not become overly optimistic that the grip will loosen further.

The reasons for my caution to buyers is based on how the 2007 "pricing departure" came about, and on how the U.S. market is valued versus other regional steel markets. While import volumes remain a significant factor, it is noteworthy that U.S. imports are lower in 2007 than 2006, especially in recent months. Steel imports are down 22% overall and are down 50% on hot rolled band year-to-date versus 2006. It is also interesting to note that a "pricing departure" did not occur in 2006, when steel imports were much higher. High import volumes in 2006 may be an influencing factor for the 2007 "pricing departure," in that steel distribution and OEM inventories were too high at the end of 2006.

Two demand shocks have hit the U.S. steel market. The first occurred in the fourth quarter of 2006, when "Big Three" auto-

otive production needed to be slashed to correct for a mix problem. High gasoline prices and slowing house appreciation finally caught up with the consumer, which caused a significant reduction in SUV purchases. More steel is consumed to make SUVs than passenger cars. The second was a worsening of the housing slowdown. New construction rates have been slashed as the inventory of unsold houses increased. This has caused a significant setback to appliance sales this year. The economy continues to muddle along, and the current economic outlook is for it to slowly strengthen in the second half of 2007.

SteelBenchmarker™ regional prices (in the graph on page 20) show how the U.S. spot market prices have significantly dropped below the European market prices. The weak U.S. dollar and stronger European economic growth are significant drivers. Weaker U.S. demand and less attractive regional prices are causing imports into the U.S. market to decline. This can also be observed in the closing gap between the U.S. market price and the world export price.

Steel buyers and sellers are contemplating what is likely to happen next in the U.S. spot market.

- If you are pessimistic about the U.S. economy improving, and possibly concerned about an economic recession, the U.S. spot pricing outlook should remain undervalued versus other regions such as Europe. Prices should remain low until steel supply is tightened by a reduction in domestic mill production.
- If you are optimistic about the economy improving, a buyer should not be waiting on the sidelines for lower prices. Steel inventories have been reduced, imports have decreased and domestic mills have begun summer maintenance.
- Minimills need to consider the 2007 spot market pricing departure from scrap-driven pricing. Available U.S. capacity from integrated mills has caused a near-term change in pricing behavior. The withholding of capacity by integrated mills has provided buyers with more supply options in 2007. Steel customers have recently shown a preference for steel market-driven pricing versus scrap-driven pricing. Scrap prices have proved to be less predictable and currently cannot be hedged by steel buyers. Scrap remains a globally traded metallic that periodically receives pricing from scrap buyers outside the United States. Scrap traders are quick to take advantage of price spreads between regional markets. Scrap prices have the potential to remain stable or even rise in the United States, while steel spot market prices weaken.
- Another mill concern is how much U.S. steel demand has been lost to imports of steel-containing goods. Independent analysis of 2005 U.S. import statistics shows imported steel-containing goods increased 8.5%, and the net import of steel-containing goods increased 6.3% (after adjustment for the increase in steel-containing goods exports). WSD suspects that, when 2006 statistics become available, we will likely see an increase in the growth rate of imported steel-containing goods.

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Do you have a question for World Steel Dynamics? Submit it today to WSD@aist.org.