

# **McCoy Bolt Works**

## **Steel & Input Cost Economics 2010**

*January 2010*

### 2010 Outlook – Input Costs

The U.S. Government flooded the economy with dollars in late 2008 and into 2009 in an effort to combat the risk of financial collapse. U.S. Federal spending resulted in a record deficit and set the stage for a new record in 2010. While the Federal Reserve claims to know how to reverse course in the money supply expansion, the historical record is nearly perfect in demonstrating that the Fed does not know when. The price of Gold during 2009 went from \$800 per ounce at the beginning to just under \$1200 per ounce at the end. Oil prices remain higher than a global recession would indicate, and commodity prices began to escalate in mid-December 2009.

The expectation for 2010 is the return of inflation across the economy, with the magnitude and timing of economic recovery directly correlating to the magnitude and timing of inflation. Commodity prices are already increasing on the expectation of demand recovery.

### 2010 Steel Outlook

Special Bar Quality (SBQ) Steel Prices will continue to fluctuate with the change in #1 Busheling Scrap, due to the surcharges in place from all mills. A 10% base price increase was announced for January 1 by all SBQ mills, but will likely not take full effect until the end of the first quarter. A scrap price rally is under way despite still-low U.S. demand, due to demand from the Middle East and China.

Lower scrap supply in the winter months, starting in December/January, together with the return of steel mills to purchasing for the first quarter, will lead to more volatility and scrap prices spiking higher in the first quarter. With scrap inventories so low and mills undertaking production cuts, a supply squeeze could occur mid-year when seasonal demand is expected to pick up. The Auto Industry is the largest generator of scrap. Since auto production continues to be slow, scrap supply will be heavily constrained when demand accelerates, which will create another round of large price increases.

Aside from the impact of the scrap market on steel prices, bar products mills cut production to match declining demand during 2009. With inventories at or near all-time historical lows, there is the potential for a quick tightening in markets once demand recovers. If demand recovers too quickly, steel prices will increase rapidly while delivery lead times start extending. In addition, protectionist policies are escalating in both application and consideration, which will facilitate higher steel prices than would otherwise be true. Finally, prices for electricity and natural gas (major cost factors for electric arc furnace producers) are both projected to increase throughout next year.

The foregoing factors all point to continued, possibly extreme, fluctuations in total steel prices for 2010, along with some risk of supply disruption due to slow recovery of mill capacity.

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Long Term Outlook

Over the next 20 years, global demand for steel will exceed supply because of the economic growth of the emerging markets (BRIC nations: Brazil, Russia, India, China), where steel consumption per capita is well below that of developed markets. Since steel supply is both capital and time intensive, price fluctuations will continue in times of spiking demand with delayed additions to supply. The consolidation of the steel industry is also changing the dynamic for steel mills during periods of declining demand. The industry today is cutting production to match demand, rather than cutting price to attempt to stimulate demand or gain market share.

The United States continues to be the largest exporter of steel scrap, and the U.S. auto industry the largest generator of scrap. With the recession, scrap supplies remain low. Recovery in other global markets drives increased demand for scrap exports and therefore higher prices. The devaluation of the dollar, among many other negative impacts, also supports stronger off-shore scrap demand and higher prices for struggling U.S. steel consumers. This trend will continue and escalate, particularly as other parts of the global economy recover more quickly than the U.S.

While the steel and scrap markets are global, Protectionism continues to distort geographic areas of the market. Some countries subsidize their domestic steel industry, some countries protect their domestic industry, and some do both, while all countries desire to export. The U.S. began to more actively act in a protectionist manner during 2008, and escalated such activity throughout 2009 (see Bibliography). As is always the case, protectionism will act to increase prices in the home market getting protected. Higher prices in merchant and industrial quality bar products will drive higher prices in SBQ bar products.

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**BACKGROUND**

*Special Bar Quality (SBQ) Products*

Bar Products generally segment into four categories ranging from lowest mechanical performance specifications and commensurate price to highest: Merchant Quality (reinforcing bar), Industrial Quality (general fasteners), SBQ (transmission gears, engine parts, high stress fastener applications, and drive train parts), and Engineered Tool Steels. Merchant, Industrial and SBQ products are carbon steels, although SBQ generally uses micro alloys, and Engineered Tool Steels tend to be specialty alloy metals.

While each of the market segments is unique, they all interact. As requirements move up the quality / price spectrum, the potential steel mill supplier population is reduced. All mills are capable of producing merchant quality bars, and foreign competition is much more active at the lower ends of the price / quality spectrum. Few mills in the U.S. are capable of SBQ and Engineered Tool Steels, and those mills face very little foreign competition. At times of periodic market distortions, when merchant and / or industrial quality steel prices begin to approach or exceed those of SBQ, for example, SBQ producers will either drive a return to the traditional price premium, or change production mix to those products generating the best return. In either case, SBQ prices are affected by supply / demand dynamics in other market segments.

*SBQ Steel Cost Drivers and Pricing*

The market and supply base for steel is fully global. SBQ steel producers use electric arc furnaces which melt high quality industrial scrap (primarily, Number One Busheling). The U.S. steel industry for the past five years priced their products according to a spot or negotiated base price plus surcharges for scrap, energy, and alloys, as applicable to the particular product. In so doing, steel producers effectively created a mechanism for adjusting prices monthly as the major cost driver commodity prices fluctuate.

Scrap and Iron Ore are the biggest drivers of fluctuations, and the generally increasing average, for steel prices. The U.S. continues to be the primary global source for scrap, and the auto industry is the primary scrap generator. As witnessed in 2008 and 2009, scrap prices in the U.S. can increase due to global demand, even when domestic demand is falling. Scrap prices are also affected by iron ore because integrated mills (those producing steel from furnaces using iron ore and other minerals) can also use scrap. When iron ore prices increase, demand for scrap will increase from the integrated mills, even if demand is stable from electric furnace operators. The global scrap market in terms of supply sources will continue to evolve as global auto production evolves.