NORFOLK IRON & METAL

MARKET INSIGHT

November 2019

ECONOMIC NEWS

U.S. PRODUCTIVITY FALLS FOR THE FIRST TIME SINCE 2015. ANOTHER VICTIM OF CHINA TRADE WAR?

The productivity of American workers fell in the third quarter for the first time in almost four years, reflecting a cutback in production as the U.S. economy slowed toward the end of summer.

Productivity declined at a 0.3% annual rate from July to September, the government said Wednesday. It fell a somewhat smaller 0.1% among American manufacturers.

Economists surveyed by MarketWatch had predicted a 0.6% increase in productivity.

The drop in productivity might be just temporary if the economy speeds up again, but it could also be a warning sign. Businesses reduced production in response to softer demand, especially for exports. The trade war between the U.S. and China has disrupted global supply chains and contributed to a world-wide slowdown in economic growth.

Companies increased the amount of goods and services they produced, known as output, by a solid 2.1%.

Yet the hours workers spent on the job rose an even faster 2.4%, the Bureau of Labor Statistics said Wednesday. Productivity is determined by the difference between output and hours worked.

Unit-labor costs, meanwhile, rose at a 3.6% annual rate. Over the past year these costs have climbed 3.1%, the highest year-over-year clip in more than five years.

All figures are seasonally adjusted.

Productivity had accelerated in the past several years as companies boosted investment, punctuated by large 2.8% and 3.6% gains in the first two quarters of 2019. Yet the trade war with China has thrown a wrench in corporate-spending plans. It could be a problem for the U.S. economy if the trade war persists.

Without more business investment, productivity might backslide. That's not good for workers or businesses. Higher productivity is the key to a rising standard of living, resulting in higher pay, more profits and low inflation.

Low productivity is a sign of an inefficient economy. Productivity in the U.S. has risen at an average rate of just 1.3% since 2007, compared with a 2.1% average since the end of World War II.

Source: Market Watch, 11/6/2019

U.S. HIRING RESILIENT WITH 128,000 GAIN, VALIDATING FED PAUSE

U.S. hiring was unexpectedly resilient in October and prior months saw sharp upward revisions, validating the Federal Reserve's signal of a pause from interest-rate cuts and indicating consumers will extend the record-long expansion despite weak business investment and trade tensions.

Stocks rose to fresh records and Treasuries fell after the strong report.

Payrolls increased 128,000 after an upwardly revised 180,000 advance the prior month, according to a Labor Department report Friday that exceeded the median 85,000 estimate in Bloomberg's survey. That includes a General Motors Co. strike-driven 41,600 decline in automaker payrolls and 20,000 temporary census workers leaving their jobs.

The jobless rate edged up to 3.6% from a half-century low, as black unemployment fell to a new record low of 5.4% Average hourly earnings climbed 3% from a year earlier, matching projections after an upward revision the prior month, though the 0.2% monthly gain was slightly below estimates.

The report supports Fed Chairman Jerome Powell's assessment this week that the U.S. economic outlook remains solid and the job market "strong" -- allowing the central bank to take a breather after a third straight interest-rate cut -- despite a persistent trade war with China and an increasingly dim global situation. With businesses pulling back on fixed investment, solid gains in hiring and wages will help drive growth and support President Donald Trump's bid for re-election in 2020.

"Overall the labor market is holding up very, very nicely," Michael Brown, principal U.S. economist at Visa USA Inc., said by phone. "There's no signs here the consumer is losing any momentum."

Fed policy makers are "probably on hold for a while," Brown said. "Today's report certainly supports the Fed view that they have provided accommodation and they'll take a little victory lap."

Revisions added 95,000 jobs for the prior two months, bringing the three-month average to 176,000, though gains remain below 2018 levels.

Minutes after the report, Trump tweeted that it was a "blowout" number and even more impressive when accounting for revisions and the GM strike. The president touted an "adjusted" employment gain of 303,000, which economic adviser Larry Kudlow said adds back in 60,000 jobs related to the strike on top of the revisions and census jobs.

A note of caution came separately Friday in the Institute for Supply Management's factory purchasing managers index. That gauge trailed estimates for October and signaled the sector contracted for a third straight month, with the weakest production level since the last recession.

The jobs data come on the heels of reports this week including third-quarter gross domestic product. The economy grew at a 1.9% annualized pace as consumer spending grew 2.9% -- a step down from gangbusters growth in the prior period but exceeding last year's average. Stocks also hit a record high, even as the figures showed business investment fell for a second straight period and the most since 2015.

"This was certainly a very solid labor market report," Fed Vice Chairman Richard Clarida said in a Bloomberg Television interview. "We have ongoing growth in the economy, we have inflation near our objective so the economy is in a very good place." ***View the rest of the article here: Bloomberg, November 1, 2019***

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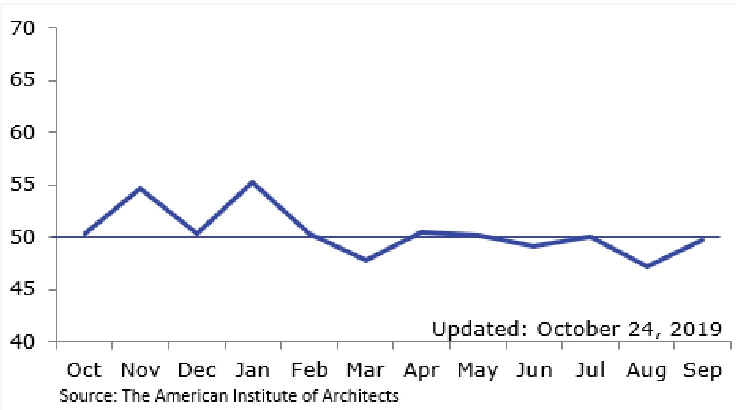
KEY ECONOMIC INDICATORS

Architecture Billings Index (ABI)

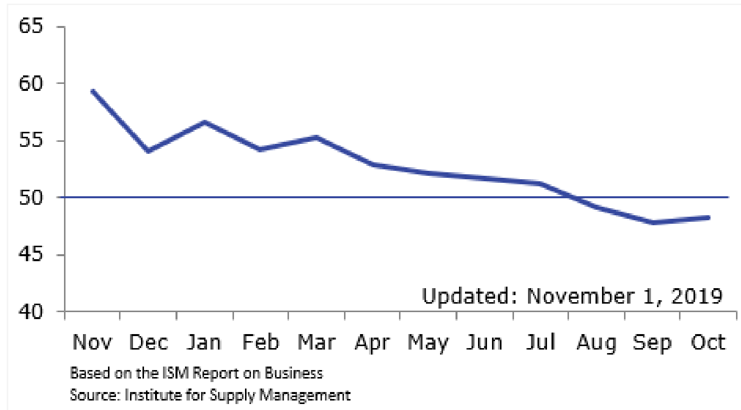


A new report issued by the American Institute of Architects (AIA) shows that the Architecture Billings Index (ABI) moderated in September following relatively bleak August figures.

While the national ABI score—49.7—falls slightly below the 50.0 threshold that would signify growth in billings, the number of new project inquiries (59.0) and design contracts (54.4) executed by firms are both up sharply. The latest figures show a rebound from the August score of 47.2, a recent low-water mark for billings. The report's regional numbers paint a more nuanced picture, as well. The South (52.3) and West (51.3) markets, where a significant amount of residential, commercial, and office building are taking place, lead growth across the nation. By comparison, the Northeast (46.3) and Midwest (45.3) show lower billings figures, overall.

The **Architecture Billings Index (ABI)** is an economic indicator for nonresidential construction activity, with a lead time of approximately 9–12 months. The index is derived from AIA's Work-on-the-Boards survey, which has gathered data on shifts in billings from architectural firm leaders for over 20 years. An index score of 50 represents no change in firm billings from the previous month, a score above 50 indicates an increase in firm billings from the previous month, and a score below 50 indicates a decline in firm billings from the previous month. *Source: **American Institute for AIA, 10/24/2019***

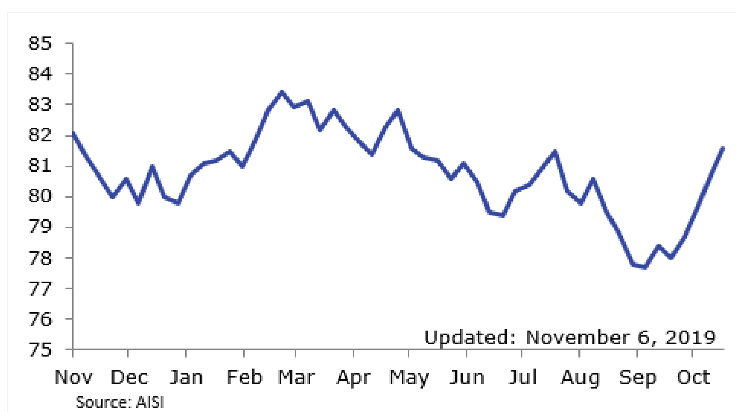
Purchasing Managers Index®



The October PMI® registered 48.3 percent, an increase of 0.5 percentage point from the September reading of 47.8 percent. The New Orders Index registered 49.1 percent, an increase of 1.8 percentage points. The Production Index registered 46.2 percent, down 1.1 percentage points compared to the September reading. The Backlog of Orders Index registered 44.1 percent, down 1 percentage point compared to the September reading of 45.1 percent. The Employment Index registered 47.7 percent, a 1.4-percentage point increase from the September reading of 46.3 percent. The Supplier Deliveries Index registered 49.5 percent, a 1.6-percentage point decrease from the September reading. The Inventories Index registered 48.9 percent, an increase of 2 percentage points. The Prices Index registered 45.5 percent, a 4.2-percentage point decrease from the September reading of 49.7 percent. The New Export Orders Index registered 50.4 percent, a 9.4-percentage point increase from the September reading of 41 percent. The Imports Index registered 45.3 percent, a 2.8-percentage point decrease from the September reading of 48.1 percent.

The Purchasing Managers Index® is based on a monthly survey sent to senior executives at more than 400 companies. A PMI above 50 represents an expansion when compared to the previous month. The further from 50, the greater the change. ***Source: Institute for Supply Management, 11/1/2019***

Raw Steel Production



In the week ending on November 2, 2019, domestic raw steel production was 1,888,000 net tons while the capability utilization rate was 81.6 percent. Production was 1,887,000 net tons in the week ending November 2, 2018 while the capability utilization then was 80.5 percent. The current week production represents a 0.1 percent increase from the same period in the previous year. Production for the week ending November 2, 2019 is up 1.2 percent from the previous week ending October 26, 2019 when production was 1,866,000 net tons and the rate of capability utilization was 80.7 percent.

Adjusted year-to-date production through November 2, 2019 was 81,599,,000 net tons, at a capability utilization rate of 80.3 percent. That is up 2.5 percent from the 79,581,000 net tons during the same period last year, when the capability utilization rate was 77.5 percent.

Raw Steel Production is a domestic report based on estimates from companies representing approximately 90% of the Industry's Raw Steel Capability as compiled by the American Iron and Steel Institute. ***Source: AISI, 11/6/2019***

INDUSTRY NEWS

US STEEL IMPORTS JUMP ON 232 QUOTA OPENING

US steel imports soared month on month in October as countries that are subject to Section 232 quotas rushed to export material - especially semi-finished products - at the beginning of the fourth quarter.

Imports totaled 2.32 million tonnes in October, up by 34.7% from 1.72 million tonnes in September but down by 21.9% from 2.97 million tonnes in October 2018, according to license data from the US Department of Commerce's Enforcement and Compliance Division, last updated on Tuesday November 5.

The majority of the gains - some 557,338 tonnes - came from increased shipments of blooms, billets and slabs, which rose by 171% month on month. Brazil shipped 604,944 tonnes of semi-finished goods last month, after sending no tonnes in August and September, license data shows.

The sharp increase was largely anticipated following a similar jump seen in July. Brazil, a major source of US slab imports, is subject to a Section 232 quota that reopens every quarter.

Shipments of hot-dipped galvanized sheet and strip products also jumped month on month, rising by 20.1% - or 35,846 tonnes - compared with September volumes.

Brazilian exporters sent 31,745 tonnes of hot-dipped galvanized sheet and strip, up by 61% from 19,717 tonnes in September, according to Commerce figures. Shipments from South Korea, which also is subject to 232 quotas, more than doubled month on month to reach 22,444 tonnes in October, up from 9,199 tonnes in September.

Meanwhile, galvanized shipments from Vietnam fell significantly month on month. The Southeast Asian country, which sent an average 14,589 tonnes per month in January-September, exported just 2,050 tonnes of hot-dipped galvanized sheet and strip to the US in October. That volume is down by 79.8% from 10,163 tonnes in September and down by 95.4% from 44,971 tonnes in October 2018.

The biggest drops in US steel imports - on a tonnage and percentage basis - came from line pipe and oil country goods. Shipments of line pipe fell by 27,594 tonnes (28.2%) month on month, while oil country goods volumes declined by 17,487 tonnes (13.2%) in the same comparison.

Imports of flat-rolled products including hot-rolled and cold-rolled sheet declined as well, falling by 15,583 tonnes and 11,325 tonnes respectively month on month in October. ***Source: AMM, November 6, 2019***

ESTIMATED AL ARBITRAGE FALLS FURTHER IN OCT

A falling US Midwest aluminium premium, stronger currencies in Asia and sustained higher freight rates have limited estimated arbitrage opportunities between aluminium warehouses in Asia and the United States.

Weak demand and cheap scrap in the US were the primary reasons for the premium's recent downtrend, while a persistent backwardation on London Metal Exchange aluminium spreads added further pressure to the market.

"At 16.5 [cents per lb], there is no reason to ship metal to the US," one trader said.

The lack of demand for metal is a global trend, with the LME price in October also weak along with premiums.

The LME aluminium cash price traded at an October average of $1,718.48 per tonne, down from $1,748.23 per tonne the month before. The average was at its lowest since Fastmarkets launched the arbitrage indicator in June 2017.

High cost

Rising shipping costs and strengthening Asian currencies also ate into margins for a potential arbitrage trade.

Freight rates have been consistently high in October and September, mostly due to the International Maritime Organization's (IMO) policy that shipping operators use low-sulphur fuels starting from next January.

"Ocean freight rates remain strongly influenced by uncertainty around the impact of IMO 2020 on bunker [fuel]," a market source said. "The latest thinking is that in the absence of comprehensive hedging opportunities, vagaries in the price of fuel will be covered by an extension of the longstanding bunker surcharge regime used to cover other eventualities."

In addition, a slightly stronger Singapore dollar and Korean Won have led to an increase in free-on-truck (fot) rates in dollar terms. The fot rate in Singapore rose by about 1.7% to $50.32 per tonne compared with the month before. In Busan, the rate rose by 1.2% to $42.31 per tonne compared with September.

The increase of shipping and fot costs, combined with a weak US aluminium market, has reflected onto the estimated arbitrage.

For duty-free metal originating from warehouses in Singapore, the estimated arbitrage was at $207.29 per tonne for shipments of 10,000 tonnes via break-bulk vessels, down from $223.58 per tonne the month before.

In Busan, South Korea, the estimated arbitrage for duty-free metal in October narrowed to $218.35 per tonne for shipments of 10,000 tonnes via break-bulk vessels, compared with $234.32 per tonne in September.

In Malaysia, the estimated arbitrage rate for duty-free metal from both Port Klang and Johor in October was $222.68 per tonne for shipments of 10,000 tonnes via break-bulk vessels, down from $238.18 per tonne in October. ***Source: AMM, November 6, 2019***

HERE'S HOW THE TRADE WAR IS AFFECTING THE STEEL INDUSTRY

The steel industry is booming thanks to a red-hot economy, but if the trade war continues and economists are right about an impending economic downturn, then steel — and other industrial sectors — could be in red-hot trouble.

RapidRatings, which evaluates companies' financial health and rates them on a scale of 0-100 (100 being the financially healthiest rating), just released new data showing trouble ahead for the steel industry.

INDUSTRY NEWS

Right now, the U.S. steel industry as a whole is seeing wider profit margins thanks to tariffs. This year alone, net profit margins jumped from 3.5 percent in Q1 2019 to 4.3 percent in Q2 2019 (although this isn't considered a remarkable jump for the steel industry).

But the costs of raw materials in the steel industry are surging: since Q4 2018, iron ore prices skyrocketed a whopping 68 percent. While business is good for iron ore mining firms, those costs are trickling down the supply chain to steel mills, fabricators and welders.

Because of increasing materials costs, the financial health of U.S. companies throughout the steel supply chain is already starting to weaken.

The global average financial health rating (FHR) for steel companies across the supply chain clocked in at a troublesome 51 in Q2 2019, down from 55 at the end of fiscal year 2018. Because U.S. steel companies still rely on non-U.S. companies throughout their supply chains, weak links in the supply chain will eventually catch up to U.S. companies.

"As global supply chains continue to destabilize, the costs of supplier failure are universally felt," RapidRatings said in their steel industry report. "Our data shows that poor financial health increases the likelihood of problematic supplier performance."

At the end of fiscal year 2018, U.S. steel companies and their major importers from Canada and Mexico maintained a decent average FHR of 66. But in Q2 2019, the average dropped to 63.

For U.S.-only companies, the average FHR at the end of fiscal year 2018 was 69, and in Q2 2019 it dropped to 68, which suggests that tariffs and trade tensions between the U.S., Canada and Mexico could end up hurting U.S. companies and workers, especially if Congress doesn't approve the United States Canada Mexico Agreement (USMCA) soon.

With a potential economic downturn on the horizon, U.S. steel companies could be facing big problems when it comes to funding.

"I think many of these companies are going to have more difficult funding over the next couple years than the last three years," RapidRatings CEO James Gellert told InsideSources. "For many of these companies, their credit ratings span the high investment to the medium grade. Their access to capital will be dependent on how bullish and aggressive the cusp B grade line investors are."

According to Bloomberg, big banks like J.P. Morgan are already prepping for an economic downturn by moving workers out of New York City to cut costs.

The Federal Reserve Bank of Philadelphia predicts that seven key 2020 states — six of which voted for Trump in 2016 — will face an economic contraction through March 2020. Two of those states — Michigan and Ohio — are top steel industry states.

That doesn't bode well for the U.S. steel industry, nor for Trump's chances at reelection in 2020.

"Companies that have bonds to refinance in the next couple years may find it harder to refinance that debt than it was to issue that debt initially," Gellert said. "This isn't unique to steel, it's a challenge across industries. But industries that have deteriorating quality overall and are dependent on markets for their core product and their sales that are in turn affected by a downturn in the economy, they're the ones that will be affected faster, and that includes steel."

The U.S.-imposed steel tariffs have been in effect for less than two years, so it's difficult to conclude any net negative or positive effects at this point, but factors like a slowing economy and surging raw materials costs signal trouble for steel.

"I think they're all going to be affected by lower steel prices, tariffs, and questions about demand over the next couple of years [in the event of an economic downturn]," Gellert said. "The ones that are weaker will have a more difficult time in the capital markets." ***Source: Inside Sources, November 7, 2019***