Stainless 2006: Strong fundamentals but speculative raw materials

According to ISSF, last year’s stainless crude steel production reached only 24.3 million tonnes, declining by 1% compared with 2004. For 2006 we expect an increase to around 26.0 million tonnes (+7%). Particularly China with all its new capacities coming on-stream this year will grow.

The expected growth is supported by robust economic fundamentals, which are better than in 2005. Especially Europe’s biggest economy - Germany - recovered significantly in Q1 which good news for the entire continent.

But it would be dangerous to see the first 2 quarters ’06 as a representative for the entire year since the market has partly been driven re-stocking. Therefore, the second half of this year will bring orders in line with ‘real demand’ and be somewhat lower than in HY1.

An end to the current high price period is not in sight. The latest nickel price rally will keep stainless steel prices on a high level until July. The availability of stainless steel scrap is rather tight making it impossible for the mills to substitute primary nickel through higher scrap ratios.

The U.S. mills have already announced further price increases for May deliveries and the Europeans will follow. Thus, there is no ‘price cliff’ in sight, but the situation remains whether we are already nearing a price level, where substitution of stainless steels (through competing materials) will slow long term growth?

Price situation in Europe, America and Asia

The prices of our basket as average of all grades and product forms have been stabilised in the first three months of 2006. Compared to the average of 2005, basket prices have reached already a level of 79% of the average of 2005. 254 prices already topped last years average in March. Price increases mainly were reported for 316/Duplex in March. Price increases mainly were reported for 316/Duplex stainless steel products, could lead to a further strengthening of the nickel prices.

Ferro molybdenum prices stabilized during the first months of 2006 on a level of 55 US$ per kg. Ferro molybdenum prices fell to around 15 US$ per kg in April. This price is still two times above the historic long term average prices. In the long run, prices could strengthen based on the still rising demand from the aerospace industry. Titanium sponge production has been already lifted by around 17% in 2005. To keep in line with the expected demand development, further capacity expansions for sponge production will be necessary.

Stainless steel scrap

The scrap market is tight at the moment. Particularly in North America and Europe the situation has changed from a surplus in late 2005 to a deficit in 2006. Prices up to 1,500 EUR per t in Europe and over $ 1,730 / long t in the USA have been reached in April.

Titanium

Many stainless steel producers have committed themselves to too high primary nickel supplies in 2005 and did not want to repeat this in 2006. They were reducing long term nickel supply contracts assuming that eventually demand-peaks can be covered by higher scrap intake. The lack of 18-8 scrap leads now to relatively high scrap prices on one hand (NI discounts in scrap as low as 5%) and also on the other hand on changed purchasing specifications allowing scrap processors to supply scrap with less than 8% Ni to the mills.

Historically, scrap availability always increased amid reduced discounts (high scrap prices) after a certain time lag (2-3 months). Thus it can be expected that the scrap situation will normalize at the end of the second quarter.

OUTLOOK

In the short term, some distributors already feel uneasy about the expected alloy surcharge driven price peak in June and July, when most of the April orders will be delivered. In the same period the re-stocking phase will probably come to an end and demand will be rather flat during the holiday period. All alloy surcharges and base prices hold until September when demand is rising again. This will depend to a large extent on the tight nickel market and whether current concerns about Inco’s ability to meet planned short- and long term output will materialize or not.

A key question for the long term health of the stainless steel industry is when the high prices will damage long term demand. There is ‘internal’ substitution, where 300 Series grades are substituted by 400- and to a lesser extent by 200 Series. But, and this is more risky, there is also external substitution where alternative materials, including coated and galvanized steels, aluminium, copper, etc. are being used instead of stainless steels. Nickel prices at 11,000 $/t or more lift the price for 304L for end-users to a level of EUR3,000 ($US 3.600) which is high enough for many to seriously look out for alternatives.

The basic market fundamentals are very good at the moment. The stainless steel industry would deserve a year where it can focus on providing a first class product to its customers and solid returns to all stakeholders. But, in reality the market will be dominated again by a raw material roller coaster driven by speculation rather than fundamentals.
Market Outlook

Strong global growth and synchronized central bank tightening have facilitated a global move towards higher long end yields. Meanwhile, the rally in commodity markets continues at full speed. The next two weeks should be pivotal with the release of important data, while ECB and Fed meetings are just around the corner.

Where we are
FX: Signs that the Fed may stop hiking rates at 5.00% have weakened the USD, but we have not yet seen a clear break out of recent ranges.
Interest rates: A global repricing of rates has pushed US, EUR and Japan rates higher. Trichet damped expectations for a May hike, while the FOMC minutes point at a pause after May. Thus, short ends have outperformed.

Where we’re going
FX: USD is far more vulnerable to changes in US rate expectations, and we see a weaker USD trend ahead. Rates: USD – After a 25 bp hike at the next FOMC meeting in May, we look for a pause but expect the Fed to maintain a tightening bias. We expect the curve steepening to continue.

Commodities: The rally in the commodity markets continues at full speed as oil hit USD 71/bbl, gold reached USD 623/oz and copper is posting a record every day of the week. We expect commodity prices to peak in 2006, though.

FX Update
From ABN AMRO Bank NV

EUR-USD forecast and forward profile*

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Source: ABN AMRO *Note prices were updated at 14.00 GMT on 19 April 2006

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