

Steel market update: May 2010

Summary

Our previous report issued in March noted that the continued growth in Chinese output was putting further pressure on raw material supplies, leading in turn to rapid steel price rises.

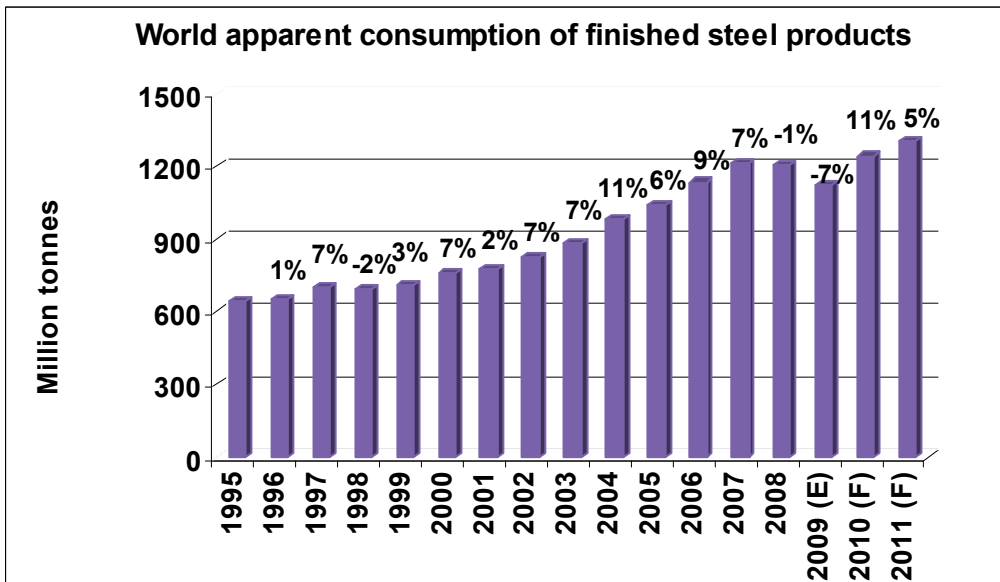
Most major steel producers have now concluded their price negotiations with their iron ore suppliers. Reflecting the immense market power that the three principal miners now exercise, they have forced through prices at the upper end of analysts' predictions. Even more worryingly, they have also imposed the termination of the annual benchmark price system, which has for decades provided stability to the iron ore market, replacing it with a quarterly, index-linked pricing system. This threatens increased volatility for steel markets in the future.

The following document updates the data provided in the March briefing in the light of these latest developments.

World steel demand

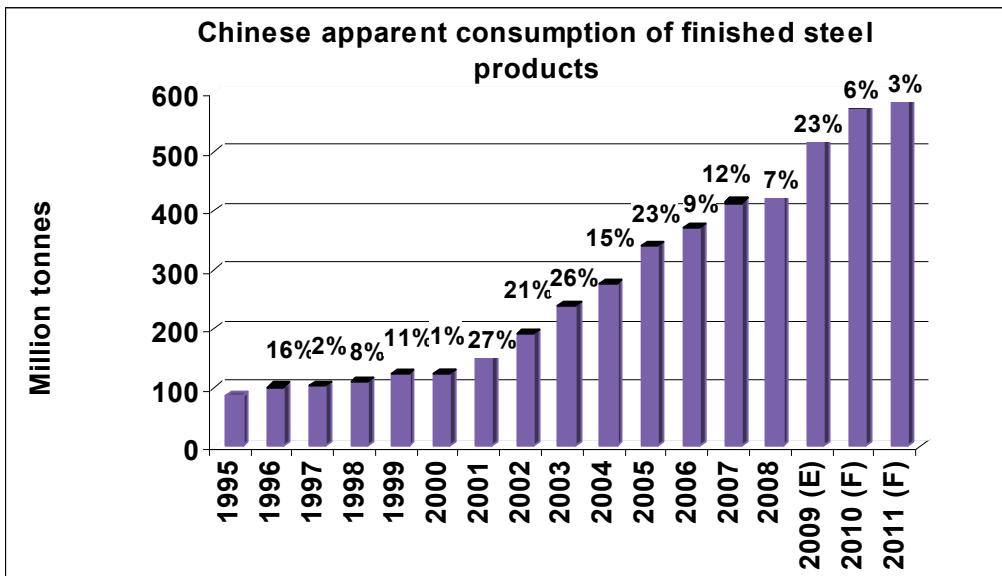
Global steel consumption is estimated to have fallen by 9% in 2009.

The World Steel Association (worldsteel) has recently issued its latest forecasts of **apparent** steel consumption in 2010 and 2011. Stronger growth is now predicted for the current year, as the developed world emerges from recession, and with the ending of the de-stocking that characterised much of 2009.



Source: worldsteel

Unlike 2009, which was characterised by sharp declines in the developed world partially offset by continuing growth in developing countries, it is expected that China's growth rate will slow down in 2010 and 2011.



Source: worldsteel

Indeed, all regions are expected to experience strong growth this year.

Apparent steel consumption by region

	Consumption: million tonnes				Growth rates		
	2008	2009 (E)	2010 (F)	2011 (F)	2009 (E)	2010 (F)	2011 (F)
EU 27	181	118	135	145	-34.7%	13.7%	7.9%
Other Europe	25	24	27	30	-5.6%	13.8%	11.8%
CIS	49	36	40	43	-26.9%	11.2%	8.0%
NAFTA	129	81	100	107	-37.3%	23.5%	7.2%
Central & South America	44	34	40	43	-24.1%	20.2%	6.7%
Africa	26	26	29	31	0.9%	8.7%	9.1%
Middle East	43	41	45	48	-5.5%	9.8%	8.3%
Asia & Oceania	762	762	826	858	-0.1%	8.4%	3.9%
<i>of which China</i>	443	543	577	595	22.6%	6.3%	3.1%
TOTAL WORLD	1,260	1,121	1,241	1,306	-11.0%	10.7%	5.3%

Source: worldsteel

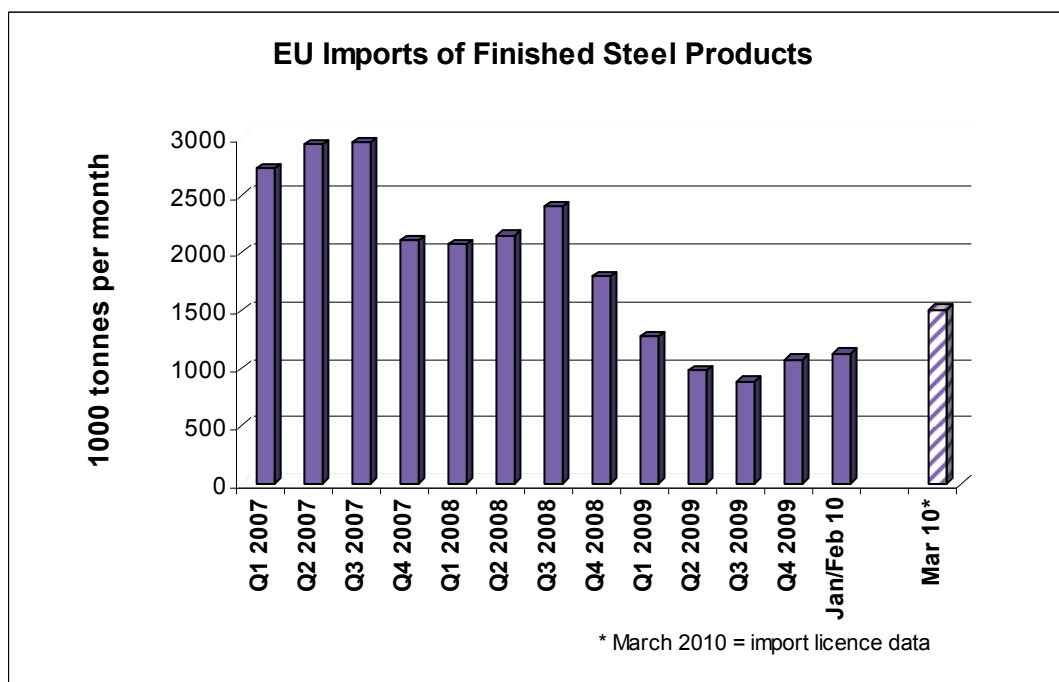
It should be stressed that the above forecasts are for **apparent** consumption, and therefore, in the case of developed countries in particular, feature a strong element of re-stocking. The recovery in **real** demand in developed markets during 2010 is expected to be far more subdued. The latest forecasts by Eurofer (the European Confederation of Iron and Steel Industries) predict EU real consumption in 2010 will grow by a mere 0.1%, rising to 5.0% in 2011. Nevertheless, it is apparent demand that drives companies' order books.

Steel output

World crude steel production in Q1 2010 was 29% up on the same quarter last year. Within that, the EU's output increased by 37%.

Steel imports

Imports of finished steel products into the EU during 2009 fell faster and deeper than domestic supply. The downward trend reversed in Q4 2009, but up to and including February 2010 imports remained at very subdued levels. Import licence data for March from the EU's prior surveillance scheme suggest that the upward trend will continue, although there is still a long way to go before imports return to 2008 levels.



Source: Eurofer

Raw material prices

China's strong growth meant that supplies of sea-borne **iron ore** remained tight. China imported over 600 million tonnes of iron ore in 2009, an increase of more than 35% compared with the 444 million tonnes imported in 2008. This growth has continued this year: imports in the first two months totalled 142 million tonnes¹ (equivalent to an annual rate of 856 million tonnes).

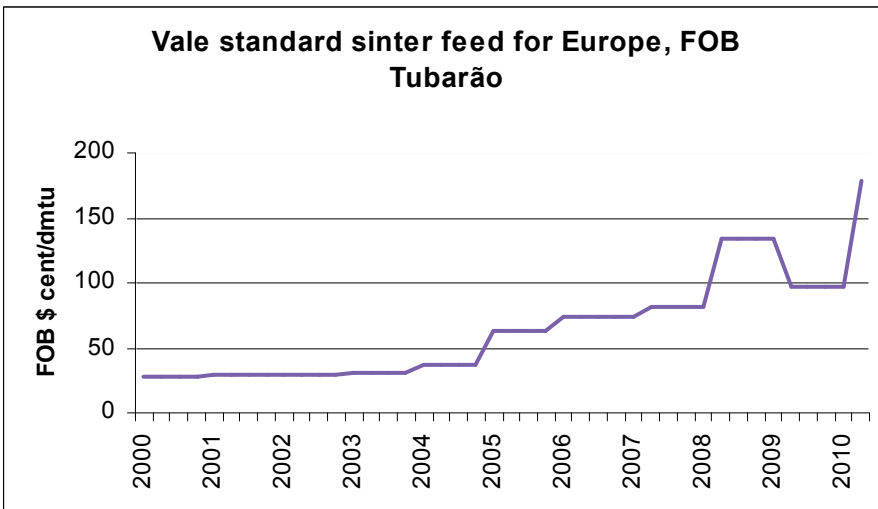
This has given the miners immense pricing power, reinforced by the near-oligopolistic structure of the market, with three suppliers dominating sea-borne trade in ore. Accordingly the major miners have forced through the ending of the annual benchmark pricing system, which had for many decades delivered stability to iron ore markets, to be replaced with quarterly indexed price adjustments. All global steel producers, including the Chinese, have been forced to acquiesce in this new system.

The first of these quarterly adjustments, for Q2 2010, resulted in massive increases of 80% to 90%. This was at the top end of the range of price increases foreseen by analysts, but needs to be compared with the 166% increase in spot prices since April 2009².

(A proposed joint venture to combine the Australian operations of Rio and BHP Billiton is currently being investigated by the European Commission under EU competition law. Eurofer, on behalf of the European steel industry, has now additionally asked the Commission to investigate whether the recent price rises infringe competition law.)

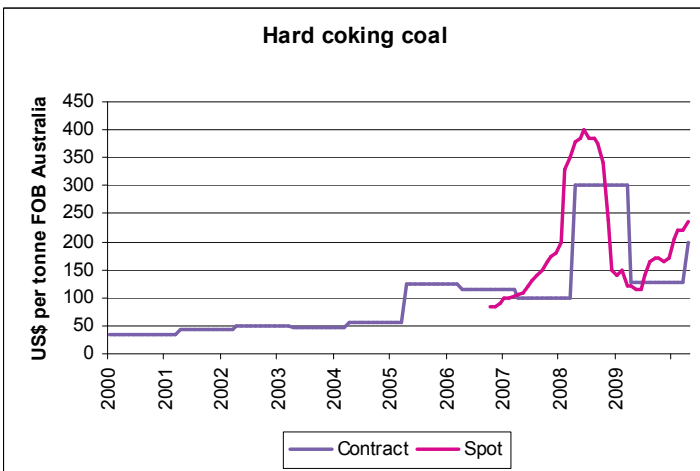
¹ Source: ISSB on-line Trade Enquiry System.

² Based on Indian spot prices CIF China: \$64 per tonne in April 2009; \$170 p.t. April 2010. Source: Corus.

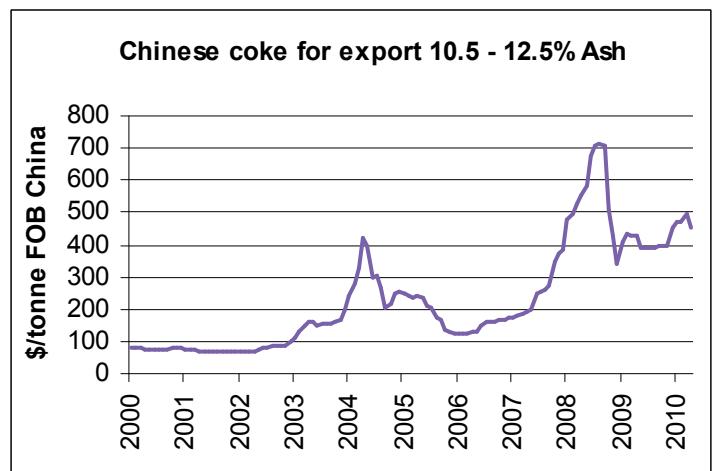


Source: Steel Business Briefing

Similar developments have been observed for **coking coal** and **coke**. Spot prices climbed during 2009 continuing this trend during the early months of 2010. Accordingly the coking coal contract price rose in April by 36%. One analyst (ANZ) has predicted that the coking coal market will be short of 4 million tonnes in 2010, which will add momentum to price increases.

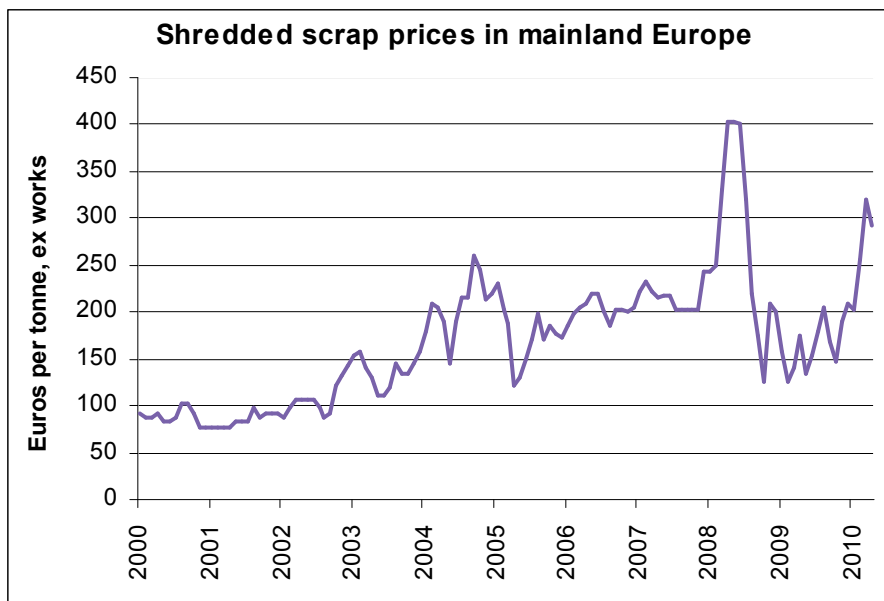


Sources: Steel Business Briefing and Corus



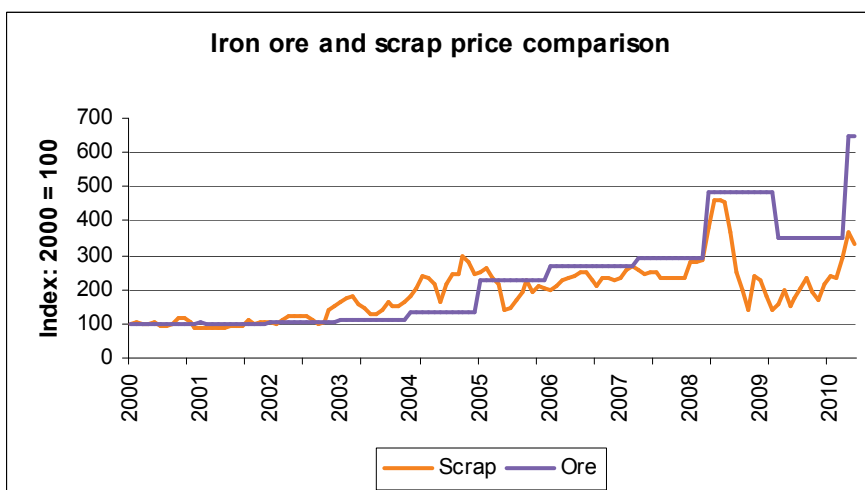
Source: Steel Business Briefing

After a year in which scrap prices fluctuated in a series of two-monthly cycles, although with a discernible underlying upward trend, the price for scrap surged in March and April, rising by 37% in just those two months.



Source: Steel Business Briefing

Although scrap prices appeared to come off the boil in the early days of May, the differential between scrap and iron ore prices suggests that there is considerable scope for further rises. With iron ore prices at an all time high, integrated steel producers (i.e. producers making steel through the blast furnace/basic oxygen route using primary raw materials as their principal feedstock) will seek to maximise the proportion of scrap used in steelmaking in order to mitigate the impact of the ore price hikes on their costs. This in turn will increase demand for scrap. Historically there is a fairly close correlation between movements in scrap and ore prices, but scrap is currently lagging.

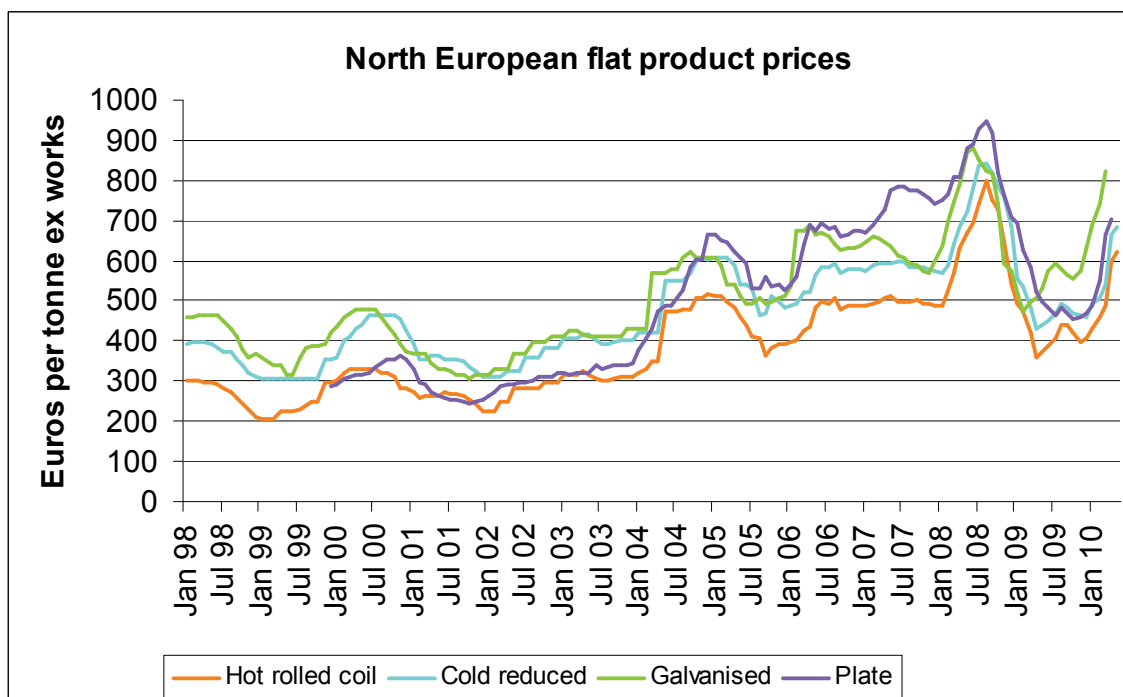


Source: Derived from Steel Business Briefing data

Steel product prices

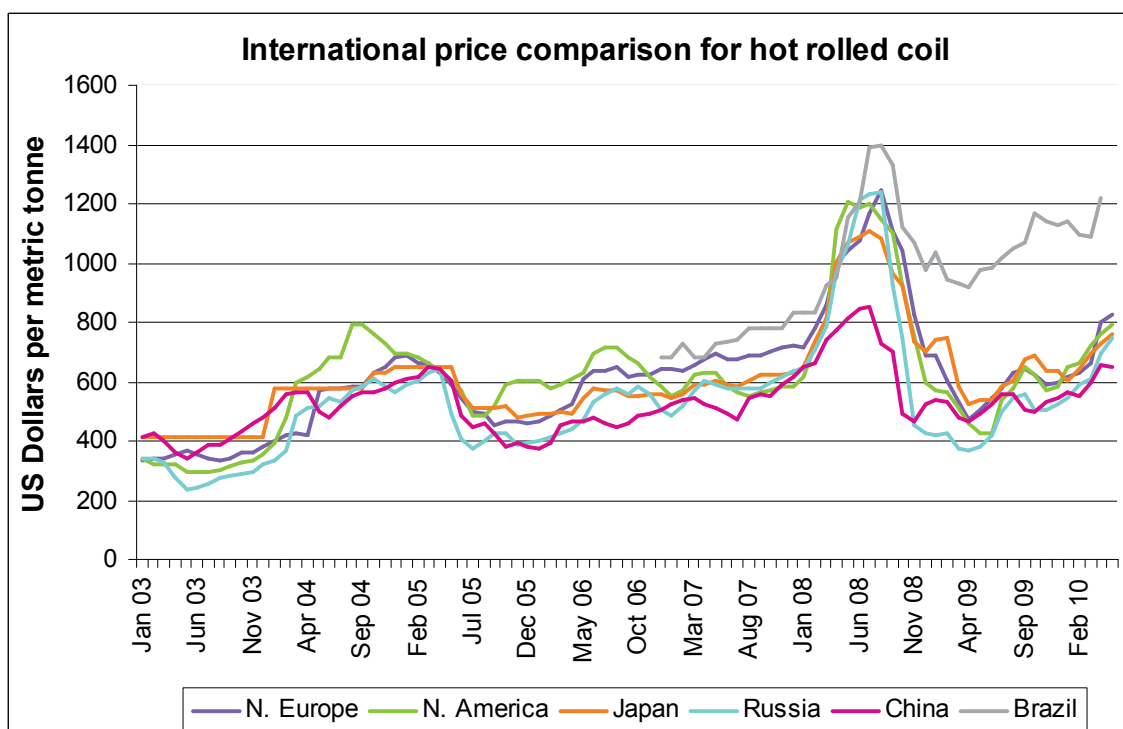
Following the price collapse of 2009, European flat product prices saw a slow recovery in line with the slow pick up in apparent consumption, rising by an average of 15% between May 2009 and February 2010.

Once the size of the raw material price hikes became clear however, steel producers sought to start recovering these cost increases. European flat product prices have risen by a further 35% since February.



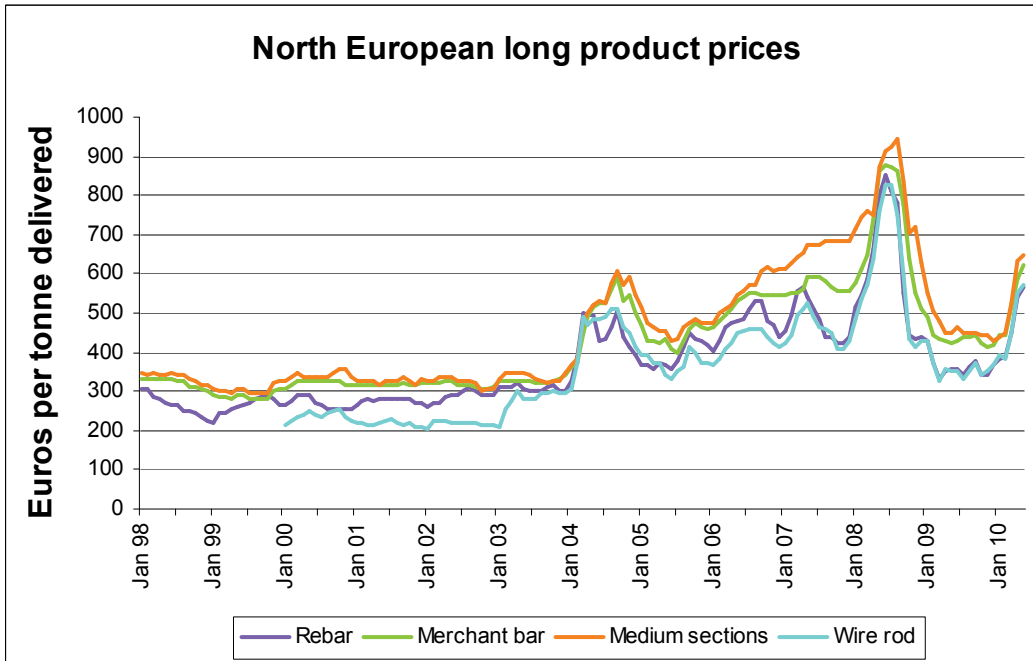
Source: Steel Business Briefing

Unsurprisingly, given that all developed world producers and the Chinese have been hit by the same iron ore hikes, a similar upward trend has been observed across the world.



Source: Steel Business Briefing

As stated in previous reports, there is a strong relationship between scrap prices and long product prices in Europe. Long products initially recovered more slowly than flat products. By February of this year, long products had risen by only 7% on average from the bottom of the market in March 2009. Since February however, reflecting the strong increase in scrap, long product prices have risen by an average of 45%.



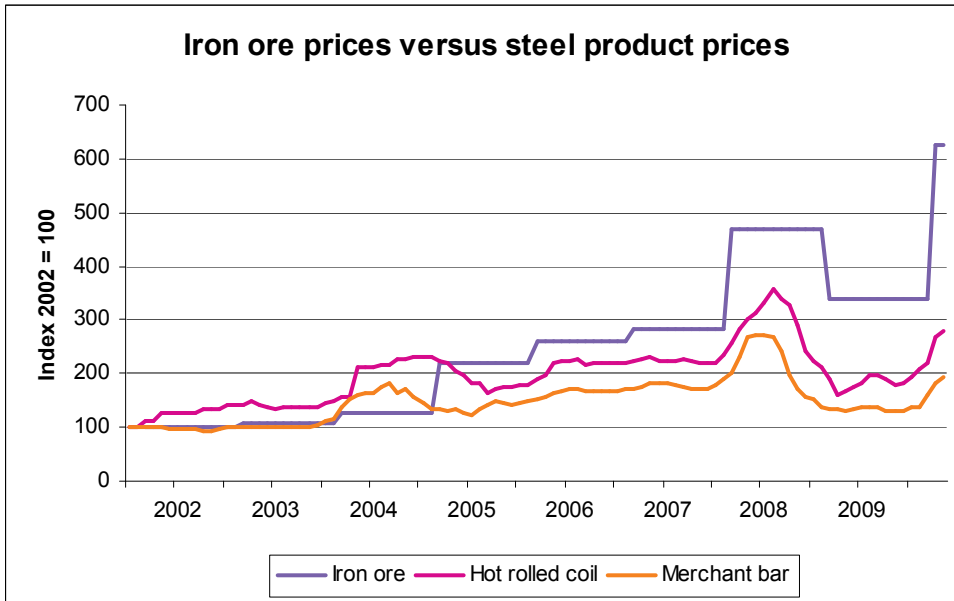
Source: Steel Business Briefing

Long product prices are likely to continue to move in relationship to scrap prices. As stated earlier, the demand from integrated producers to use larger quantities of scrap in their furnaces is likely to become a factor in influencing scrap prices, as will the strength of demand in middle eastern markets.

European integrated steel producers are continuing to raise prices so as to recover the unprecedented raw material price hikes. Corus for example in the last week of April announced £80 per tonne increases for plate and sections. Lakshmi Mittal has spoken publicly of the need for customers to adapt to the new situation, and in an interview with the *Financial Times* on 30th April said that the new iron ore pricing arrangements could push the cost of steel up by one third in the coming months. ArcelorMittal has also been reported as seeking to move away from annually-priced contracts with its major customers.

It is worth re-stating that all producers across the world are faced with the same raw material costs, and all producers will be seeking to recover those increases in their own prices.

The following graph tracks – as an index - prices in the EU for two common steel products against movements in iron ore. Steel producers failed fully to match the sharp raw material price rises in 2008. Steel product prices then fell more rapidly and more sharply than iron ore prices. Despite the recent sharp increases in steel prices, these still lag the iron ore price hikes by a significant margin.



Source: Derived from Steel Business Briefing data

Conclusion

The cost-price squeeze suffered by steel producers over the past two years has been exacerbated by the Q2 iron ore price hikes. Despite the significant rises in steel product prices this spring, further increases will be required to enable steel producers to cover their costs and return to viability.

The forecast pick up in European apparent demand, and the fact that, although there has been some growth in European steel imports, these remain at historically low levels, both suggest that there is a reasonable chance of recently announced price increases sticking.

There are early hints that the shift away from annual benchmark pricing to quarterly index-linked movements in raw material prices could provoke a fundamental reassessment of European steel producers' own pricing mechanisms.

04 May 2010