The Path Forward for Steel 2019

By Dan Markham, Senior Editor

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Tariff talk dominated the steel market in 2018. How will trade policy and other issues affect the market for the steel supply chain over the next 12 months?

The past year was unquestionably a wild ride for the domestic steel industry. And with the combination of congressional upheaval in Washington, the ever-changing ins and outs of trade policy, the potential for interest rate hikes and more, the next 12 months figure to be just as tumultuous.

Expectations for the year ahead are similarly varied, with projections of demand growth and declines being issued in near-equal measure, depending on the day and the speaker. There are no certainties as the steel industry ushers in 2019.

Metal Center News spoke to five leading steel analysts to get a sense of what to expect in 2019. Consensus was hardly the rule.

Becky Hites, president of Steel-Insights LLC, is optimistic about the year ahead, but acknowledged how fragile her prediction is. "I'm pretty bullish. I may end up falling on my sword, since there are a lot of ways it can go the other way. But I'm a big believer in the tax repatriation program, and the opportunity zones have provided affordable financing for any kind of manufacturing that goes into low-income areas," she said.

The counter to Hites's sunny outlook is veteran steel analyst Chuck Bradford of New York-based Bradford Research, who nonetheless offered his own other hand to a generally pessimistic take. "The outlook is not very good for next year, unless you can get a really good infrastructure program."

Richard Oppelt of consulting firm Accenture splits the difference. Oppelt, Accenture's senior principal director within the metals and mining practice, believes consumption may be down slightly in 2019, but shipments will likely remain flat to up slightly as imports continue to trend downward.

The effort to curb imports through trade actions was the dominant story of 2018, with President Donald Trump's initiation of Section 232 tariff relief, and the dominoes that tumbled in response, driving the domestic industry's performance. How the analysts think the tariff situation is resolved, and the effects on the supply chain, play a large role in their expectations this year.

The tariffs will remain the rule for the foreseeable future, which is good news for domestic producers. "When you consider the tariffs didn't kick in until the second quarter, and really start to impact imports until late in the second quarter, early in the third, a full year of that will push imports down," said Oppelt.

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>
> *Chuck Bradford, Bradford Research*

Hites agrees. With her expectation of consumption growth and significant import declines, she's anticipating U.S. production of 122 million tons next year. "I'm continuing to show imports down," she said. She said foreign steel could drop from 36 million tons in 2018 to as low as 25 million next year, though the domestic producers could be challenged to meet that level of demand given existing capacity.

Not everyone supports the tariffs. Bradford is highly critical of the actions, believing the administration has made a "complete misreading of the steel business," he said. "The trade efforts have made matters much worse."

Bradford believes the inflated domestic price of steel will lead to companies sourcing finished goods from overseas, particularly on products where steel makes up a significant cost. He says history has repeatedly shown this to be true. "It happens every time, and the industry is always worse."

Michael Jenny, managing director of Chicago-based Livingstone Partners, says some companies have gotten, and will continue to get, nicked in the process. "The guys getting squeezed are the ones depending on specific types or sizes or chemistries, but at the same time can't pass their costs increases through. That's meaningful, and a lot of people are hurting from that."

Consequently, he thinks some service centers are better positioned to work through the tariffs. "The service centers

that can manage their working capital and pass through the price increase seem to be doing fine. But I know of one service center handling specialized material that can only be procured overseas, and they're getting pinched."

Timna Tanners, a metals and mining analyst for Bank of America Merrill Lynch, thinks the administration will move toward tightening up the existing end-arounds and exemption issues by extending tariffs to more finished goods. "In the next six months, you'll see more and more evidence of Commerce following through on items made from steel."

The administration took steps in that direction with the Section 301 tariffs that followed later in the year. "They'll plug the holes even more than we've seen. And if that theme continues with semi-finished or fabricated goods, that should support service centers and manufacturers," she said.

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Becky Hites, Steel-Insights LLC.

Hites says the capacity for the tariffs to stay in place is, in part, dictated by the world market. "We're getting more mercantilistic and trying to protect our markets, but the truth of the matter is that's a lot easier to do when all boats are rising," she said.

Fortunately, Hites anticipates most areas will see growth in 2019, though the IMF has revised an earlier prediction of across-the-board global growth to seeing two regions of the world contracting. "Even with two regions down, I still say the world economy will stay on track, and there will be home for all this steel. If five economies are down, it starts to get more challenging," she said.

Here at home, forecasts aren't calling for any wild gains or declines, the analysts acknowledge. Accenture is predicting U.S. GDP growth in 2019 of 2.4 to 2.6 percent. "There is more downside than upside risk to that. A lot of that has to do with the long run of expansionary monetary policy. The late-cycle fiscal stimulus and tariffs should underpin an uptick in inflation," Oppelt says.

That will continue to drive the Fed to increase interest rates. "That makes debt for housing, automotive, government spending more expensive, and that starts underpinning some of the trends we're already seeing," he says.

Those trends include some softening in residential housing and automotive.

The auto industry, of course, is one of the larger markets for steel products, and it is in the midst of an overhaul. GM's recent announcement of plant closures highlights the shift of the traditional domestic producers away from smaller vehicles to supplying almost exclusively SUVS, crossovers and trucks. "They can't sell the things," Bradford says about the smaller vehicles. "It makes no sense to make cars that no one will buy."

For the steel industry, that trend is mitigated somewhat by the greater use of steel in larger vehicles. But two other trends do not work in the industry's favor, Bradford says. Even if steel retains all of its market share in its battle for material usage in newer, lighter vehicles, it will sell less product in the process. "Getting the steel down 20 percent is the target, but that means they'll sell 20 percent less steel." And they can't make that volume loss up in higher prices, he adds.

Furthermore, the simple truth is that automobiles are being built better than ever before, and thus the age at which they need to be replaced is being pushed back significantly.

Beyond auto, there's mixed views on construction. Tanners believes the market will remain strong, supported by the 2018 tax cuts. However, she doesn't expect to see the much-needed infrastructure project get passed.

On the financial side, 2018 was a big year for consolidation, particularly in the service center industry. More of that will likely follow this year, again with most of the activity in the distribution sector.

"We see a lot of turnover happening in the service center space because there's a dearth of succession options for a lot of these guys," says Jenny, whose company is a global M&A and debt advisory firm. "A lot of the younger people aren't growing up saying they want to be in the metals business."

In contrast, there's not a lot of room left on the mill side for consolidation. "In the upstream portion, I can't too much more consolidation occurring," Oppelt said.

Jenny agrees. "There are just fewer targets than they're used to be."

The mills, instead, have turned to internal options to use their cash on hand. Producers spent much of 2018 announcing plans for capacity increases and line upgrades. "They all seem to be focusing on using a temporary cash windfall through these tariffs to really invest internally," Jenny says. "You've seen a bunch of releases, particularly from Nucor and U.S. Steel, about how they're pouring hundreds of millions of dollars into their own operations.

"They've learned from past cycles. They have the money to spend on efficiencies so they can set themselves up to be more resilient in the cycle," he says.

With all of that going on, where will the price of hot-rolled coil settle in 2018? Tanners' latest forecast is for an average of $750 in 2019, a prediction predicated on the conversion of tariffs to quotas from Mexico and Canada.

Oppelt sees something similar. The world price will provide a ceiling on high the domestic price will go, since a spread too large will simply invite the supply chain to take on foreign product and assume the 25 percent tariff. Likewise, the moves the U.S. steel industry have undertaken on the capacity front have been made with the assumption of getting a significant return. "Therefore, I don't see hot-band prices falling back down to $600 per ton or something like that," he says. ■

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