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Macro Snapshot

A Quarterly Report on Trends Affecting the Metals Sector

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Times are good for the North American and global economies. The industrial sector is on track for a strong year. But the metals sector should keep an eye on rising interest rates and trade policy shifts in the months ahead.

In this report:

Outlook for the North American Economy

United States

Key Drivers: Tailwinds

Strong Labor Market: At 3.9%, U.S. unemployment hangs near multi-decade lows. Meanwhile, job growth continues at a robust pace, averaging 215,000 monthly gains in the first seven months of 2018, well above 2017's pace of 182,000 jobs. A healthy labor market underlies strong growth for the whole U.S. economy. An economy near full employment signals positive business conditions and rising aggregate demand. It also suggests faster wage gains and consumer spending growth over the near term. However, a tightening labor market will contribute to worsening labor shortages.

Robust Business Investment: Business capex spending is on a tear since mid-2017, buoyed by an ongoing industrial and energy sector resurgence, as well as corporate tax cuts. Investment in nonresidential structures surged at a 13.3% annualized pace in the second quarter, the second straight quarter of 10%+ growth. Intellectual property investment likewise remained healthy in Q2. Equipment investment continues to expand robustly, but shows signs of peaking and may decelerate later in 2018.

Government Spending Revival: Both federal and state/local spending have come back online after years of subtracting from U.S. GDP growth. Improved state & local budget outlooks and a $1.3 trillion federal spending bill (passed in March 2018) contribute to the revival.

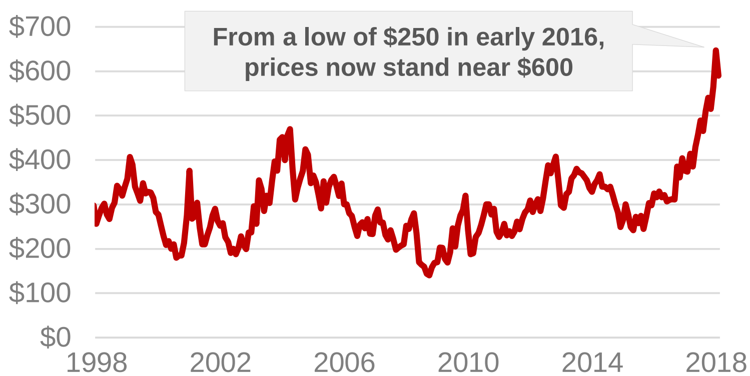
Key Drivers: Headwinds

Trade Conflicts: Rapid shifts in U.S. trade policy and the implementation of widespread retaliatory tariffs together are a major source of uncertainty for the U.S. economy.

Sluggish Housing Sector: A struggling U.S. housing sector faces rising mortgage interest rates and labor shortages, as well as surging input costs. In particular, prices for **framing lumber** (see chart) have skyrocketed in recent months. Forest fires in Canada, railcar shortages across North America, and the recent imposition of U.S. tariffs on Canadian lumber are all to blame.

U.S. Framing Lumber

$ per thousand board feet



Key Drivers: Factors to Watch

Inflation is not yet at breakout stage, but most signs point to the likelihood of accelerating inflation over the coming months. Several major drivers of inflation – including labor costs, oil prices, and fiscal policy – are running hot. Tariffs on foreign goods may add to upward pressure on prices.

Inflation Driver	Current Status	Near-Term Trend	Metric
Labor Costs	→	↗	Avg. Hourly Earnings
Domestic Growth	↗	↗	GDP
Oil Prices	↗	↑	WTI Spot Price
Expectations	→	↗	TIPS Spread
Global Growth	↗	↗	Global GDP
Fiscal Policy	→	↑	Gov't Spending

Interest Rates are all but certain to continue rising through the year, and there is a good possibility that borrowing costs and the cost of capital will rise even faster than markets expect. As inflationary pressures build, the Federal Reserve is likely to compress its rate hike schedule in order to cool a heating economy. Increases in the federal funds rate, the Fed's benchmark policy rate, will drive up borrowing costs throughout the U.S. economy – especially short-term borrowing costs.

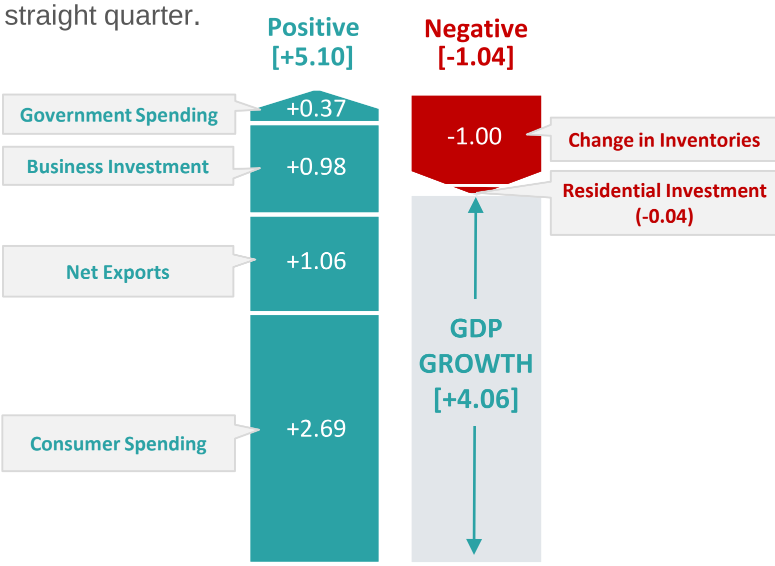
Throughout 2018, it is worth keeping a close eye on the **Yield Curve** – the spread between long-term and short-term bond yields. As the Fed raises rates, two-year Treasury yields tend to rise faster than ten-year yields, causing the yield curve to flatten. Over the course of 2018, the spread between 10-year and 2-year bond yields has narrowed from 52 basis points in January to 29 basis points in early August 2018. A yield curve inversion – when the spread dips below zero – often precedes an economic recession, as it tends to indicate the market's perception that the Fed is raising rates faster than the U.S. economy can handle.

Outlook for the North American Economy

A Look Back: U.S. Q2 2018 Economic Activity

Contributions to GDP Growth by Sector

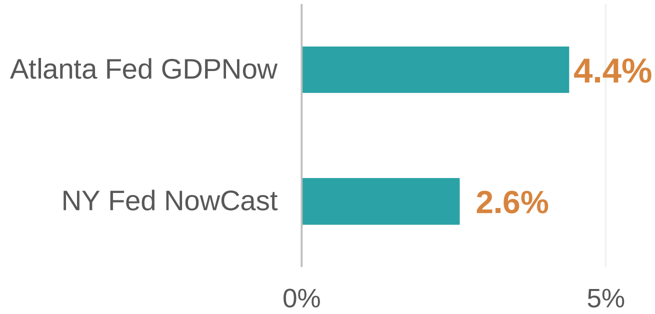
The U.S. economy expanded at a 4.1% annual rate in Q2 of 2018, the strongest quarterly growth in nearly four years. Consumer spending, business investment, government spending, and net exports all expanded robustly. However, private inventories subtracted a full percentage point from growth and residential investment contracted for the second straight quarter.



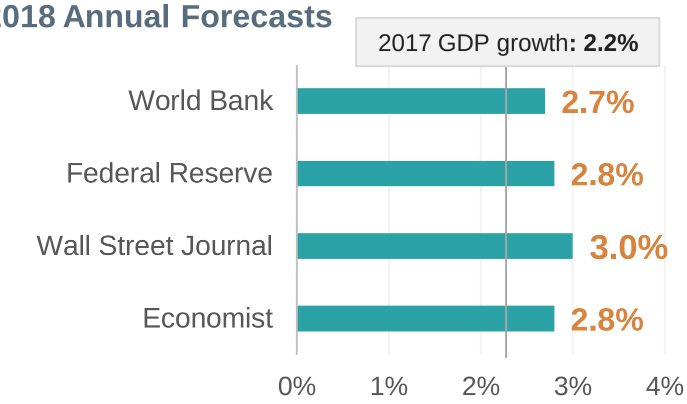
Source: Bureau of Economic Analysis (BEA)

Looking Forward: U.S. GDP Forecasts

Q3 2018 Forecasts (annualized)



2018 Annual Forecasts

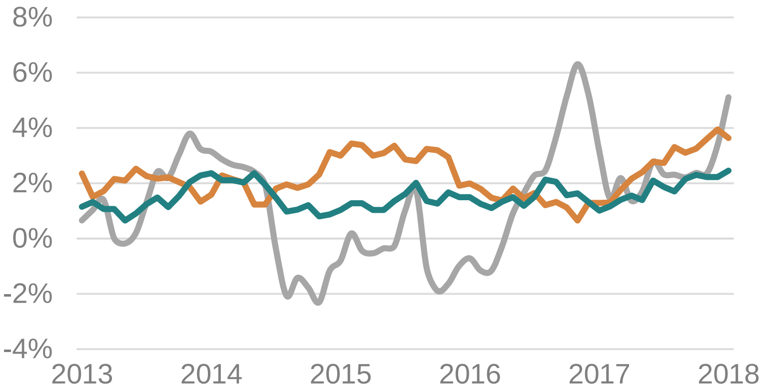


Canada

The outlook for Canada's economy is encouraging. Although first quarter growth came in at a disappointing 1.3% annualized increase, the economy is still on track for a moderate 2.3% GDP expansion in 2018, compared to last year's 3.0% increase. The latest data on Canada's industrial sector indicate potential for acceleration in late 2018. Canada's Markit Manufacturing PMI edged down to 56.9 in July but remains historically elevated.

Canada: Inflation Indicators

Year-on-year growth in PPI, hourly wages, and CPI



Source: Statistics Canada

Robust gains in several **inflation** measures (see chart) drove the Bank of Canada to raise its benchmark interest rate by 25 basis points, to 1.5%, on July 11.

Mexico

The Mexican economy contracted at a 0.3% (annualized) rate in the second quarter of 2018, the weakest quarterly growth in five years. Industrial production and agricultural production both fell amid growing uncertainty surrounding U.S. trade policy.

Mexican automobile production was up 0.7% in the first half of 2018 compared to the same period in 2017. However, auto sales are otherwise down sharply in 2018: for the six months ending in June, auto sales were 8.4% below their level last year. The decline is likely due in part to the uncertainty around NAFTA renegotiations, which have stretched into their second year. Importantly, businesses may be weighing the possibility that a final NAFTA deal could include stricter U.S. domestic content requirements or a higher minimum wage requirement for the Mexican auto sector, which would raise production costs in Mexico.

On July 1, Mexico elected Andrés López Obrador as President, who will take office in December. Although branded as a left-wing populist, López Obrador's actual record as mayor of Mexico City indicates his economic policies may turn out to be more pragmatic than feared. However, he has vowed to adopt a combative stance toward the U.S. on NAFTA-related issues.

Focus on the U.S. Industrial Sector

Recent Activity

Industrial Production

Industrial production rose 0.6% in June and is up 3.8% on the year. Industrial activity has surged in recent months, buoyed by robust expansion in the oil and gas sector. High prices and rising demand should sustain IP this year.

Capacity Utilization

Capacity utilization rose 0.3% in June and has recovered from recent lows reached during the oil price collapse. Manufacturing CU remains muted, while CU in the energy sector hovers above 90%. CU above 80% is a sign that capex spending may accelerate.

New Orders of Durable Goods

New orders of durable goods rose 0.7% in June, the second straight monthly increase following a decline in April. New orders remain 8.0% above year-ago levels, while orders for core capital goods (nondefense, non-transportation) have decelerated from late-2017 highs.

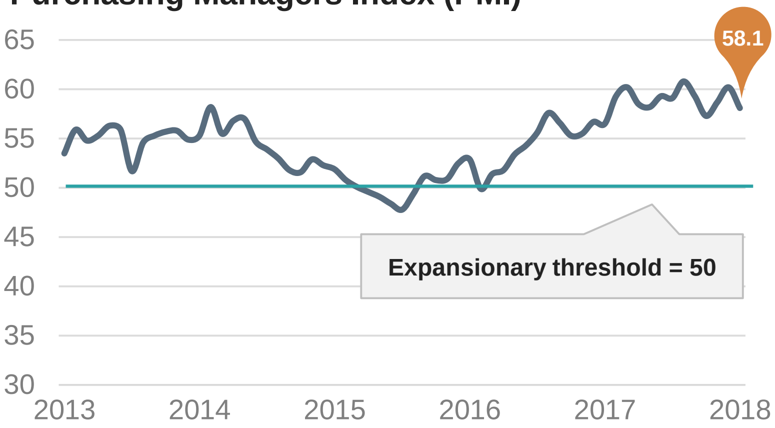
Shipments of Durable Goods

Shipments of durable goods increased 1.0% in June and are 7.2% above year-ago levels. An indicator of same-quarter GDP growth, strong shipments growth indicates that business are investing at a healthy clip in the third quarter.

Outlook

Industrial sector momentum is strong, signaling a continuation of robust manufacturing activity for the remainder of 2018. Although the ISM Manufacturing Index declined to 58.1 in July, it remains well above the expansionary threshold. Other leading indicators of manufacturing activity have seesawed, but their levels remain high.

ISM Manufacturing
Purchasing Managers Index (PMI)



92.3

The **PayNet Small Business Lending Index (SBLI) - Manufacturing** edged up in May and is now at its highest level since 2009. Credit conditions for small business manufacturing are generally healthy.

42.1

Average Weekly Hours for production and non-supervisory manufacturing employees held steady at 42.1 hours. Activity remains strong but a surge is not imminent.

Key Drivers

Factors to Watch

Oil prices have recently touched above $75/barrel for the first time since November 2014. This recovery – following the 2014-16 oil price collapse, when prices fell to $27/barrel – is a major force behind the recent acceleration in oil & gas activity and for industrial sectors linked to the extraction industry, including trucking, rail, and shipping. The gradual rise in oil prices over the last several months has been driven by a combination of acute supply shortages (e.g., output collapse in chaos-ridden Venezuela and Libya, U.S. sanctions on Iran) and surging demand amid strong global economic growth.

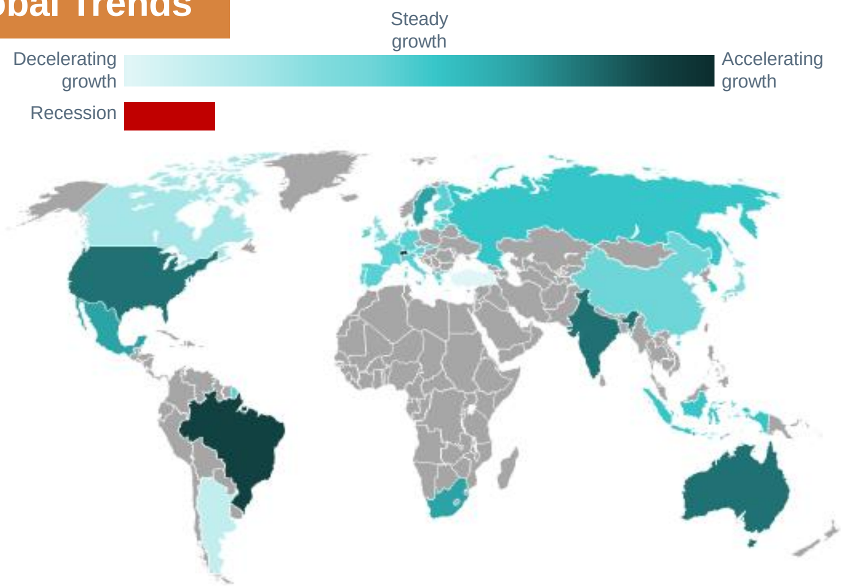
Looking ahead, the trajectory for oil prices is highly uncertain and highly volatile – even more than usual. Further supply disruptions are likely, but ongoing geopolitical disputes put pressure on prices in both directions. For example, U.S. threats to impose further sanctions on countries buying Iranian oil add to supply shortages, but China's recent imposition of tariffs on U.S. crude may encourage U.S. suppliers to turn toward the domestic market, which could push domestic prices downward.

Bottom line: To capitalize on higher prices, the U.S. oil industry will stay exceptionally busy over the coming months. Technological advances in fracking made during the 2014-16 period dramatically improved profitability, meaning that activity should remain robust even in the event of an oil price decline. However, a rise in oil prices above $80/barrel would start to weigh on the overall U.S. economy, as consumers and energy-consuming sectors begin to feel the pain.

Outlook for the Global Economy

Global Trends

Cyclical upswing begins to fade: The synchronized global growth trend that began in 2017 appears to be breaking down in mid-2018. Although many of the world's major economies are experiencing a growth acceleration in 2018 – including the United States, India, and Brazil – the majority saw growth peak last year and are beginning to slow (see map). Still, not a single major economy is in a recession. Underlying conditions for global demand remain strong, which provides a boost to industrial and manufacturing activity in the North American economy. However, this encouraging picture is threatened by a number of headwinds, including trade disruptions and ongoing trade policy uncertainty, rising interest rates, currency crises in emerging markets, and a potential slowdown in China.



Sources: International Monetary Fund (IMF), *Economist* forecasts, Keybridge

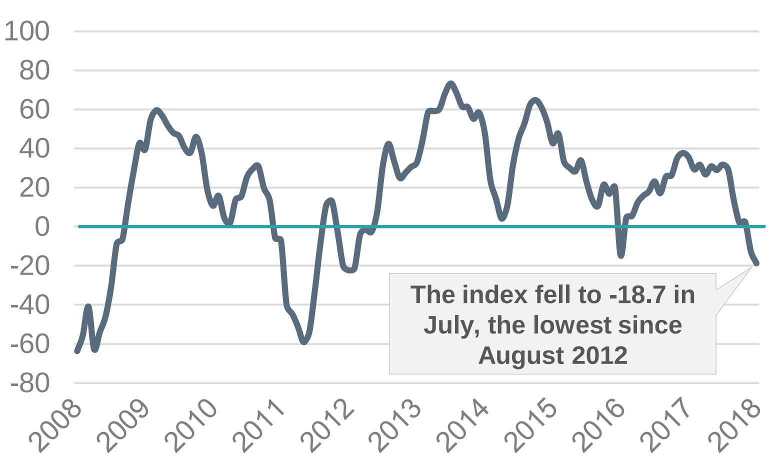
Trade barriers disrupt global supply chains: The United States' imposition of tariffs on steel and aluminum and additional taxes on $50 billion of Chinese products are prompting retaliatory tariffs on U.S. exports, most notably crude oil, cars, and farm products. Together, these policies will disrupt complex global supply chains, leading to shortages and higher prices on most inputs and final goods. In many cases, uncertainty about imminent trade policy changes will add to the disruption, as businesses struggle to manage their inventories and predict the next shift. Like all trade policy changes, tariffs will create winners and losers. Winners are likely to be domestic industries whose inputs and customer base are located in-country, while companies that export or rely on foreign inputs may struggle to adapt. In the near to medium term, all business types will have to monitor closely how trade policy shifts will affect their supply chains and customer demand.

Major Markets

Advanced Economies

Growth is slowing in the **eurozone**. The euro area Purchasing Managers Index (PMI) has fallen for the past several months and now sits at an 18-month low, while the ZEW economic expectations index fell further in July (see chart). Much of the slowdown is driven by **Germany**, the bloc's largest economy, largest metals exporter, and most vulnerable country to tariff effects. As a result, many analysts and economists worry about a broad-based eurozone deceleration after an exceptionally strong 2017.

ZEW Eurozone Growth Expectations Index



Source: ZEW (Center for European Economic Research)

Emerging Markets

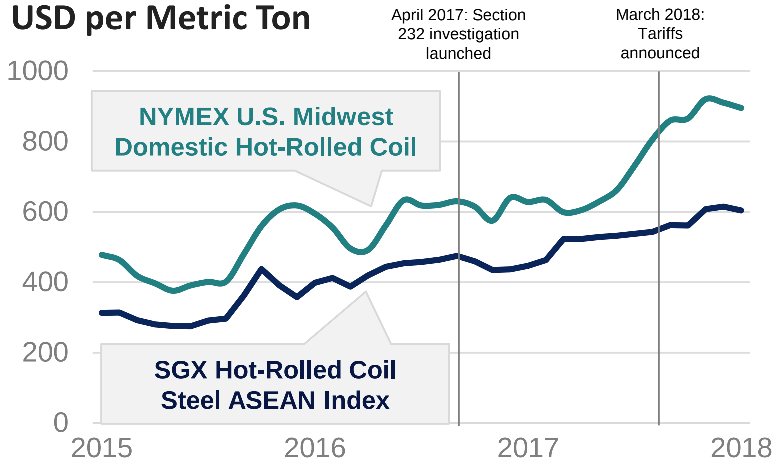
Economic activity in **China** has shown signs of easing as the government struggles to reduce the massive debt burden facing many state-owned firms. Fixed-asset investment decelerated to 6.0% annual growth in June, the slowest since 1999, while industrial output also moderated. Going forward, a protracted trade war with the U.S. would likely cause severe damage to economic activity in China. As the world's largest steel exporter and the primary source of global growth, a Chinese slowdown would have a significant impact on steel and aluminum supply and the total global economy. On net, minor upward pressure on prices from a decline in supply would be outweighed by depressed global demand.

Turkey and **Argentina** are suffering speculative attacks on their currencies which have driven a 29% depreciation of the Turkish lira and a 47% depreciation of the Argentine peso since January. In the short term, Turkey, a major steel exporter, may see demand for its steel grow as its products become relatively cheaper on the world market. However, currency depreciation and domestic inflation will eventually weigh on industrial activity. The depreciations are driven partly by rising U.S. interest rates, which has sucked capital out of emerging markets and into the United States. If these effects spread to other major economies, such as Russia or Brazil, global economic growth will take a hit.

Recent Developments in Metals Pricing

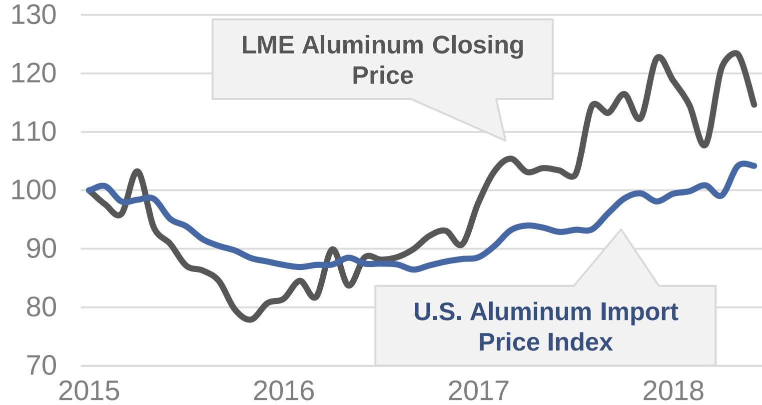
Spot prices for steel and aluminum have experienced increased volatility over the past quarter due to market uncertainty surrounding the Section 232 investigations on steel and aluminum imports to the U.S., and the recent imposition of tariffs on metals imports from major U.S. trading partners. U.S. tariff policy has already resulted in sharp price increases on steel and aluminum in the domestic U.S. market. As a result, domestic U.S. steel prices have lately risen well above international prices (see left chart). Conversely, that divergence has not yet occurred for aluminum (see right chart), where global price increases have lately exceeded those of domestic import prices. The delay is likely due to U.S. sanctions on Russia (a major aluminum exporter) in April which pushed up global prices, while massive aluminum stockpiling ahead of the imposition of aluminum tariffs may be keeping a temporary cap on U.S. aluminum import prices.

Steel Futures, Hot-Rolled Coil
USD per Metric Ton



Source: Macrobond

Aluminum Prices, LME vs. U.S. Import Index, Jan 2015 = 100



Sources: Macrobond, Keybridge

Policy Trends

New Trade War Fronts

New tariffs on steel and aluminum imports to the United States are disrupting supply chains across North America. The proposed next round of tariffs is likely to be significantly more damaging.

The metals sector is already contending with the consequences of new tariffs on steel and aluminum imports to the United States (imposed by the Trump administration starting in March) and Canada (imposed in retaliation in July). Companies that source inputs from abroad now face significantly higher costs, product shortages, and administrative costs associated with requesting exemption. Although the policies may succeed somewhat in reshoring metals manufacturing, the medium term consequences will significantly complicate business planning and will put a damper on aggregate growth.

Proposed future tariffs – including an additional $400 billion on Chinese products, and a 25% tariff on imports of cars and auto parts – would be significantly more disruptive if implemented. Steel and aluminum tariffs affect the metals industry alone, while the proposed tariffs would affect the entire goods producing sector of the U.S. economy and would weigh particularly heavily on the U.S. auto sector – which comprises a substantial 3.5% of the economy.

Auto Fuel Efficiency Standards

The Trump administration's deregulatory stance may soon fall out of line with more stringent state-level standards, creating uncertainty for auto manufacturers.

Over the coming months, companies servicing auto manufacturers should keep an eye on developments related to U.S. Corporate Average Fuel Economy (CAFE) standards. The Trump administration has recently proposed several measures designed to relax fuel efficiency standards, and has already determined that the standards set for the 2022-2025 period are non-binding – a sign that further easing is to come.

However, 13 U.S. states, comprising 40% of the U.S. market, are currently permitted to enforce their own fuel efficiency standards, and have vowed to continue enforcing the current standards. In that case, auto manufacturers will face the difficulty of having to comply with two sets of standards – or lose the opportunity to sell to nearly half the U.S. market.

To prevent this, the Environmental Protection Agency (EPA) is seeking to eliminate state-level autonomy on fuel efficiency standards, a move certain to lead to protracted legal battles – and even greater uncertainty.

About the Macro Snapshot

The **Macro Snapshot** is an economic report that highlights how key trends in the North American and global economies are likely to affect the metals sector over the near term. It is designed to help business executives stay up-to-date on the most important macro-level economic and policy trends driving industrial sector activity, end-user market demand, and recent metals price movements. On behalf of the Metals Service Center Institute (MSCI), Macro Snapshot reports are produced on a quarterly basis by Keybridge, a boutique economic research consultancy comprised of economists and public policy experts based in Washington, DC.

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