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English - Or. English

DIRECTORATE FOR SCIENCE, TECHNOLOGY AND INDUSTRY
STEEL COMMITTEE

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REPORT ON THE ECONOMIC AND STEEL MARKET SITUATION Q.IV/2006, YEAR 2006, AND FORECAST FOR Q.I./2007

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Paper from EUROFER.

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REPORT ON THE ECONOMIC AND STEEL MARKET SITUATION

Q.IV/2006, YEAR 2006, AND FORECAST FOR Q.I./2007

Development of certain elements of the EU economy - Yearly % variations

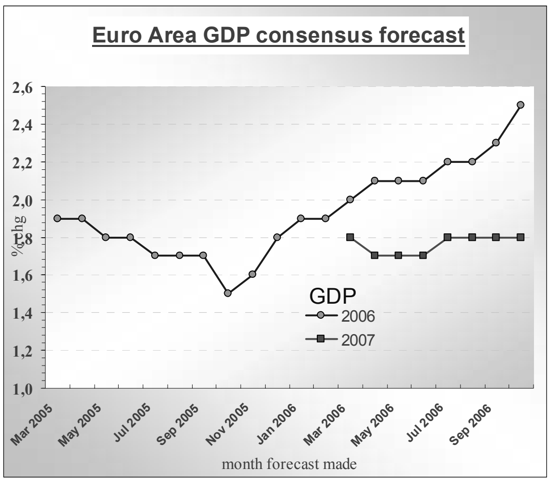
EUROFER FORECAST October 2006

	2005	2006 (E)	2007 (F)
GDP	1.5	2.5	2.0
Private consumption	1.3	2.0	1.5
Government consumption	1.5	1.6	1.3
Investments	2.9	4.4	3.3
Investments in mach. equip.	4.2	4.8	4.4
Investments in construction	1.4	2.8	2.2
Exports	5.6	8.2	4.7
Imports	6.3	8.2	4.7
Unemployment rate	8.9	8.2	7.9
Inflation	1.9	2.0	2.1
Industrial production	1.2	3.0	2.1

(E) = estimate (F) = forecast

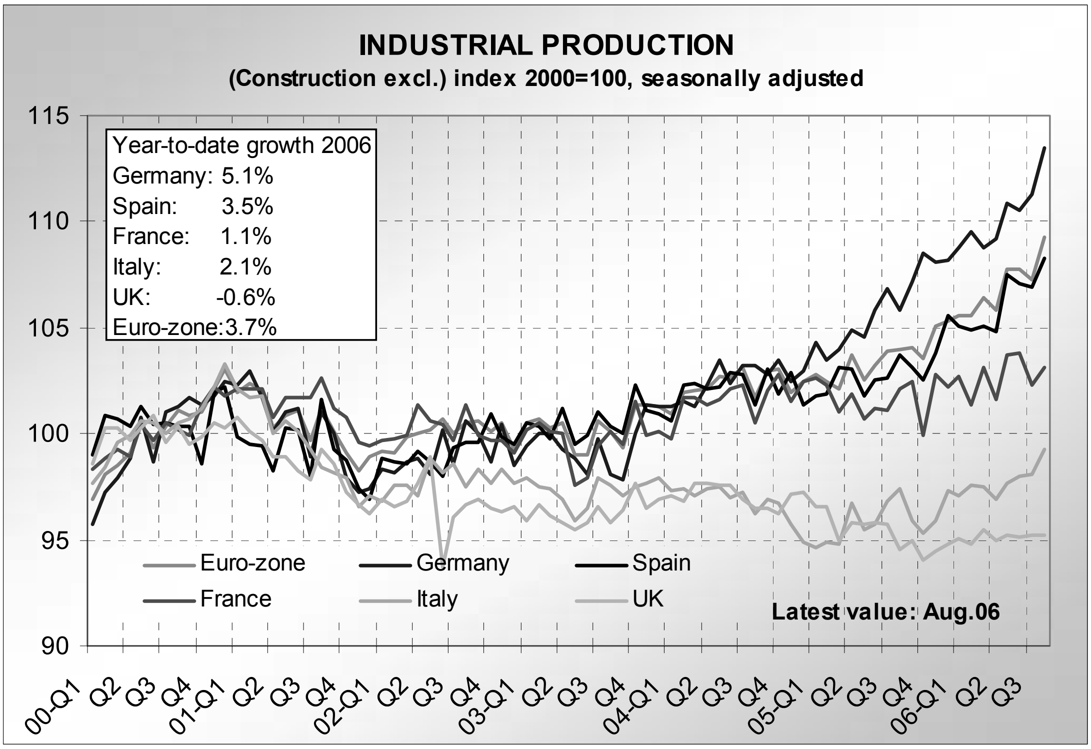
I. General Economic Situation in the European Union

There has been a clear acceleration of economic growth in the first half of 2006. GDP rose by 0.9 % quarter on quarter in Q.2 bringing growth to its strongest level for 6 years. GDP growth for Q.1 has also been revised upwards to 0.8 %. There has been a substantial improvement in the performance of the main continental economies, notably Germany.



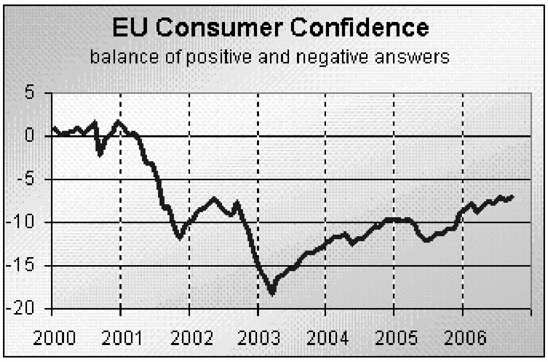
The key drivers are exports and, increasingly, domestic demand. Specifically, investment growth is being underpinned by a robust increase in corporate spending providing a boost for the manufacturing sector. Investment in equipment and in construction have grown strongly, in construction due in particular to the upsurge in activity in Germany.

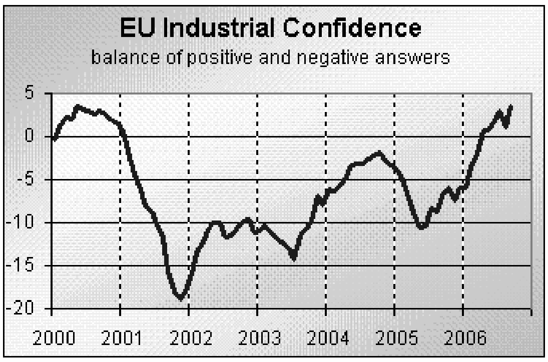
Industrial Production

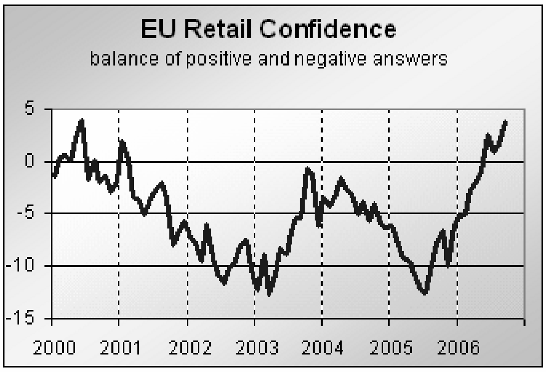


Source: Eurostat

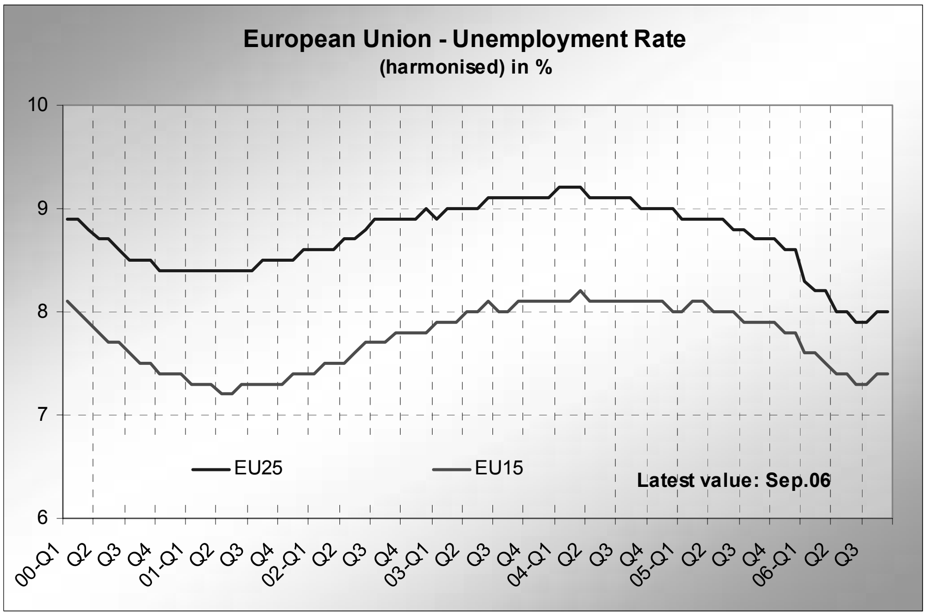
Improvements in consumer expenditure are less marked but there is clear upward potential in Germany in the second half prior to the change in VAT scheduled for 2007. However so far consumer spending in Germany has shown only modest improvement in contrast to France which saw a sharp rise in consumer expenditure in August.







Confidence indicators – both industrial and consumer are at 5-year highs and point to a robust second half 2006.



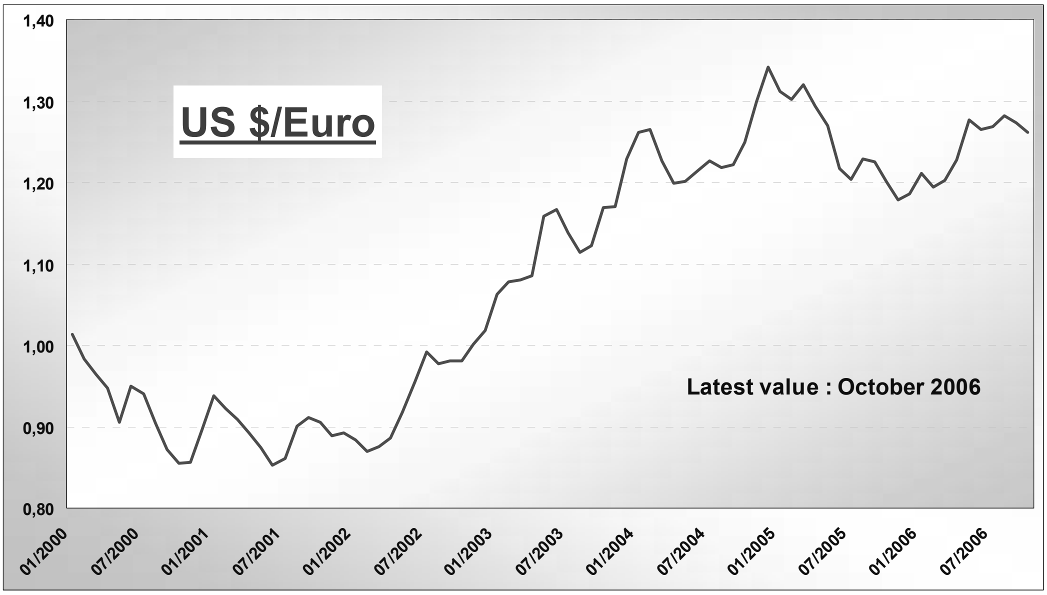
On balance GDP growth in the EU should be about 2.5 – 2.7 %. However, while economic momentum has clearly strengthened this year it may well have already peaked. There are factors which would tend to mitigate the pace of growth next year:

- The world economy is slowing, notably the rate of growth in the USA is expected to see a deceleration as consumer expenditure slackens in response to tighter monetary conditions and a correction in house prices.

- The economic upswing is not generating significant inflationary pressures – with the fall in energy prices eurozone inflation fell to 1.8 % in September compared with 2.3 % in August. Nevertheless, EU monetary policy will become less accommodative with the ECB lifting rates to about 3.5 % by the end of 2006.

- Fiscal tightening in Germany, with the rise in the VAT rate in 2007, and also in Italy will limit consumer spending growth.

- Gains in the euro could begin to affect European competitiveness.



The contribution of external demand to EU economic activity has remained strong this year based on the continued strong expansion of the world economy. However it is likely that there will be a moderation in growth momentum in the latter part of the year – indeed it is already perceptible – due to the effects of monetary tightening across world regions. Depending on its extent, this slowdown is no bad thing, it may return growth in some regions to a more manageable level and unwind some of the imbalances which have developed in certain economies, notably the United States.

Even so, the first signs are that the slowdown worldwide may be rather limited. In the United States the fear is that the falling property market could so significantly slow consumer expenditure that it could tip the economy into recession. This is still a risk but latest figures point to a limited impact on employment and consumer spending so far. US consumer confidence has risen sharply in the last two months and retail sales have stayed surprisingly robust. In addition there is no sign of any impact yet on the wider economy apart from in residential construction activity which has fallen sharply. Investment growth remains at a high level, factory orders are at record levels. The fall in energy prices since the summer is also a positive factor.

Elsewhere, in Japan business investment is seeing strong growth and consumer expenditure is rising. Russian output, on the basis of high energy prices is robust, as is that of Latin America on the basis of high commodity prices.

There are few signs of any slowdown in China or India and the economies of SE Asia.

There are therefore grounds for reasonable optimism that while domestic demand has increasingly taken the place of exports as the main driver of growth in Europe this year, the international context will remain supportive of growth in Europe going into next year.

II. The Steel Market

Steel Using Sectors: Activity Levels

Development of industrial sectors according to Eurofer's estimates
(compared with the corresponding period of the previous year as percentage)

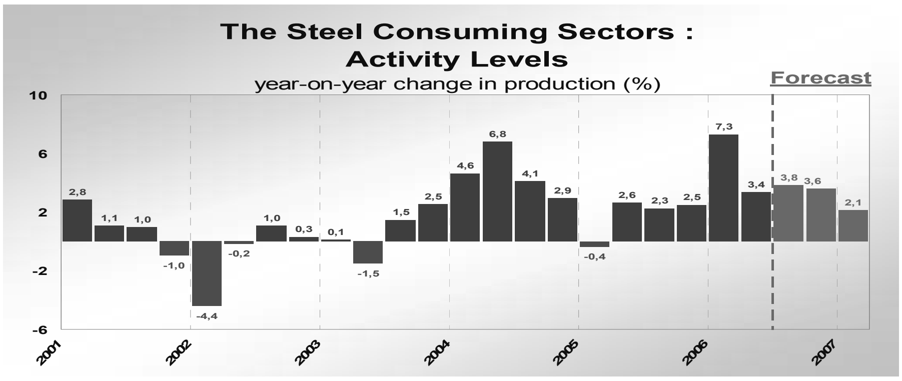
	% weight in total steel consumption of each sector	Q.I/2006 / Q.I/2005	Q.II/2006 / Q.II/2005	Q.III/2006 / Q.III/2005	Q.IV/2006 / Q.IV/2005	Year 2006 / Year 2005	Q.I/2007 / Q.I/2006
Construction	24	5.1	3.6	3.0	2.0	3.4	3.6
Structural steelwork	10	8.8	4.9	4.7	3.6	5.3	3.7
Mechanical engineering	13	9.6	4.9	4.2	3.1	5.4	1.5
Automotive	18	7.1	-1.3	0.6	3.3	2.4	0.3
Domestic appliances	4	11.1	3.6	7.3	6.6	7.1	1.0
Shipyards	1	2.6	-1.4	7.4	3.0	2.7	1.0
Tubes	12	8.3	6.4	6.2	6.1	6.8	3.1
Metalware	13	6.0	3.7	3.6	3.1	4.1	1.8
Miscellaneous	5	6.0	2.9	5.0	1.6	3.9	2.0
TOTAL	100	7.3	3.4	3.8	3.6	4.5	2.1

Estimates of output growth for the first half year have been revised upward. The first quarter saw a very strong level of activity of the main steel using sectors, up by more than 7 %. Quarter two saw output growth at lower but still very positive levels. Strong order intake and high confidence levels in industry point to continued robust growth in the second half of this year.

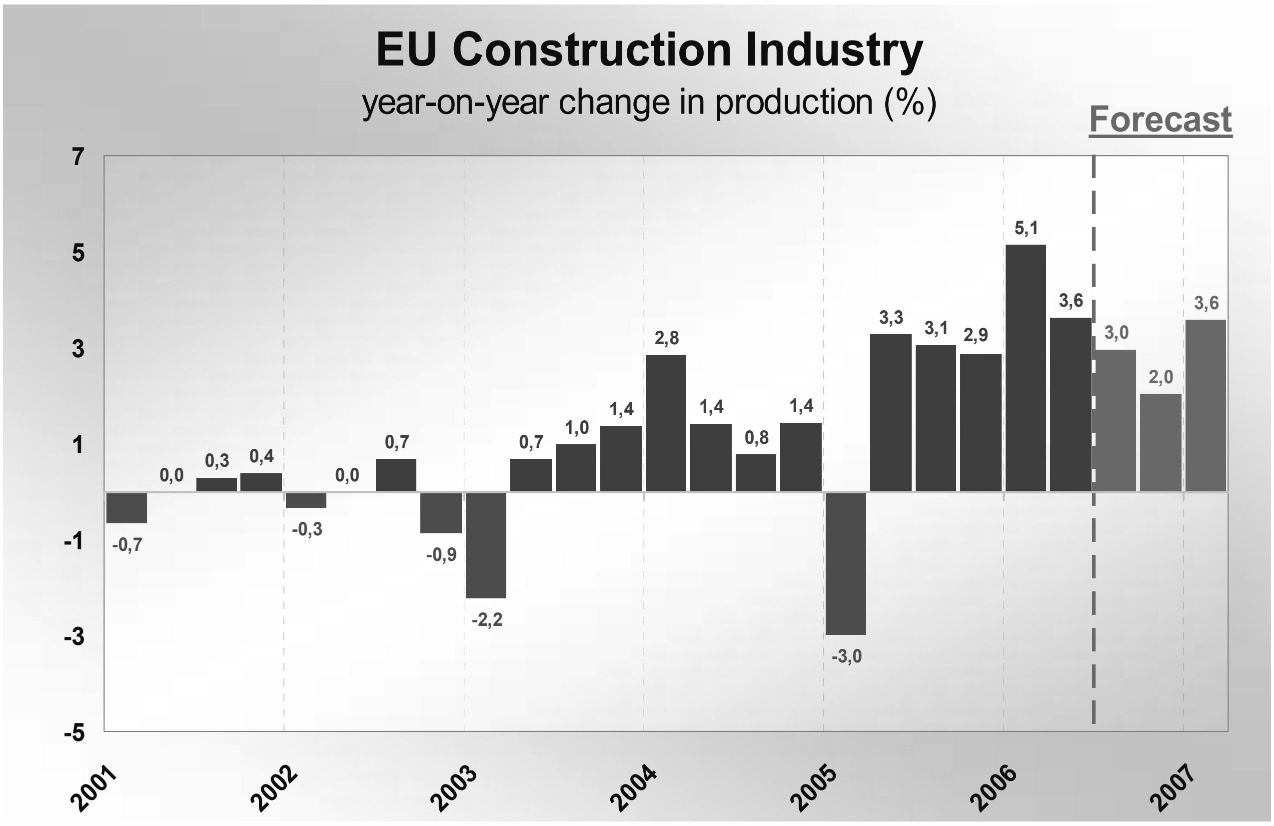
Overall we expect Steel Weighted Industrial Production (SWIP) to grow this year by 4.5 %, a substantial revision upward from previous forecasts.

First estimates for quarter 1/2007 are positive, with a continuation of output growth by most sectors at a healthy level although at a lower level than Q.I/06.

The growth rate of the SWIP in Germany in Q.1/2007 is low due to the anticipated effect of the rise in VAT. This is influencing the outlook overall for Q1/2007.



Construction

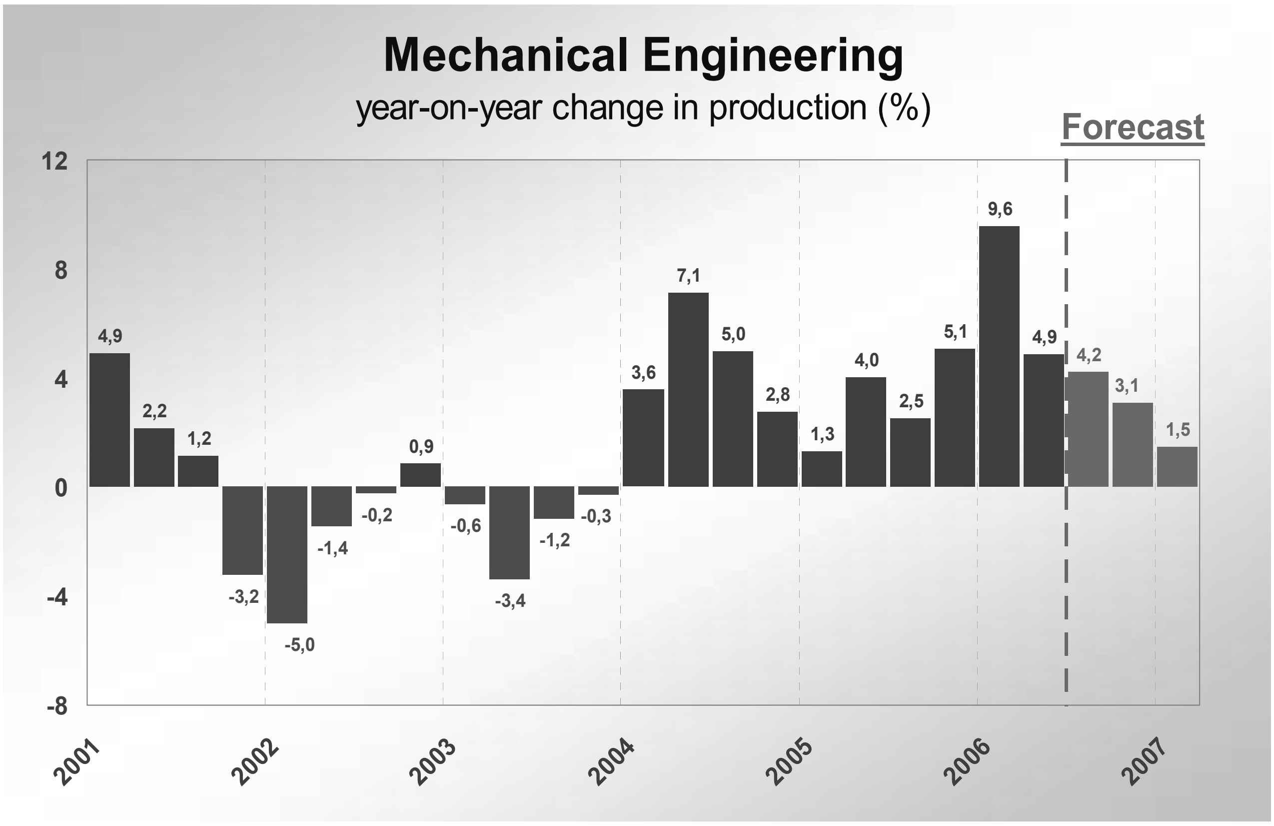


Construction confidence has continued to improve throughout the first half of 2006. Germany is now clearly participating in the upturn in the sector. There are strong gains in output in Germany with confidence increasing as orders pick up. Elsewhere, construction activity is robust.

The first half year 2006 saw output growth of 4 % year-on-year supported by growth in all construction sectors.

Overall output in 2006 is seen as increasing by 3.4 % with particularly strong growth forecasts for central and eastern Europe. The first indicators for Q.I/2007 are for continued strength in the sector.

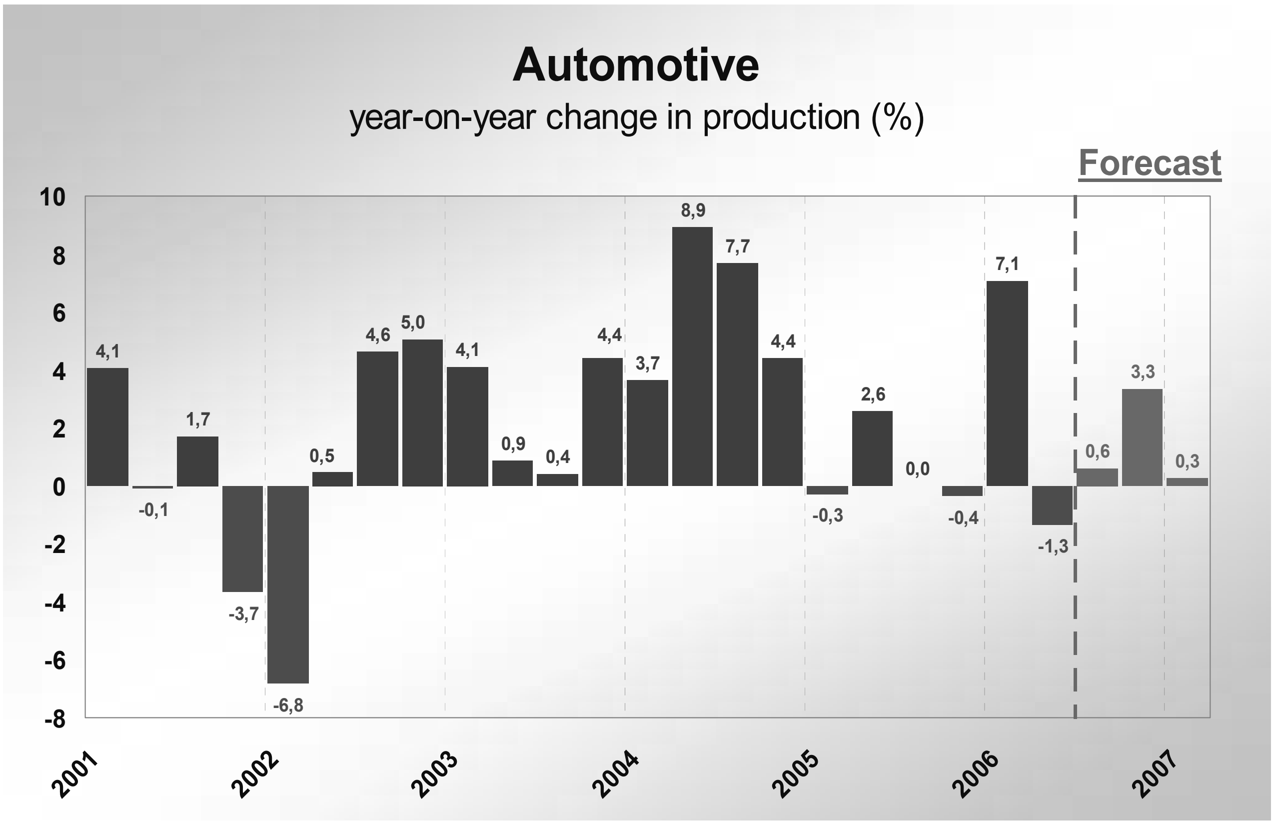
Mechanical Engineering



European business conditions have become much more supportive to investment. The sector is extremely well-placed in terms of activity levels and order books. Most engineering firms are running at near-full capacity. The first half 2006 saw activity levels risen by 7 % year-on-year, those for metal products by 5 %.

Confidence indicators and order intakes point to further – albeit slightly slower - growth in the second half of 2006. The situation is particularly positive in Germany which had had an extremely strong output growth for the past few years based largely on export business. To this is now being added strong domestic demand. German mechanical engineering orders are up 13.2 % in the year up to July, with domestic orders up 11.8 %. For the year as a whole the forecasts of solid growth are confirmed.

Automotive

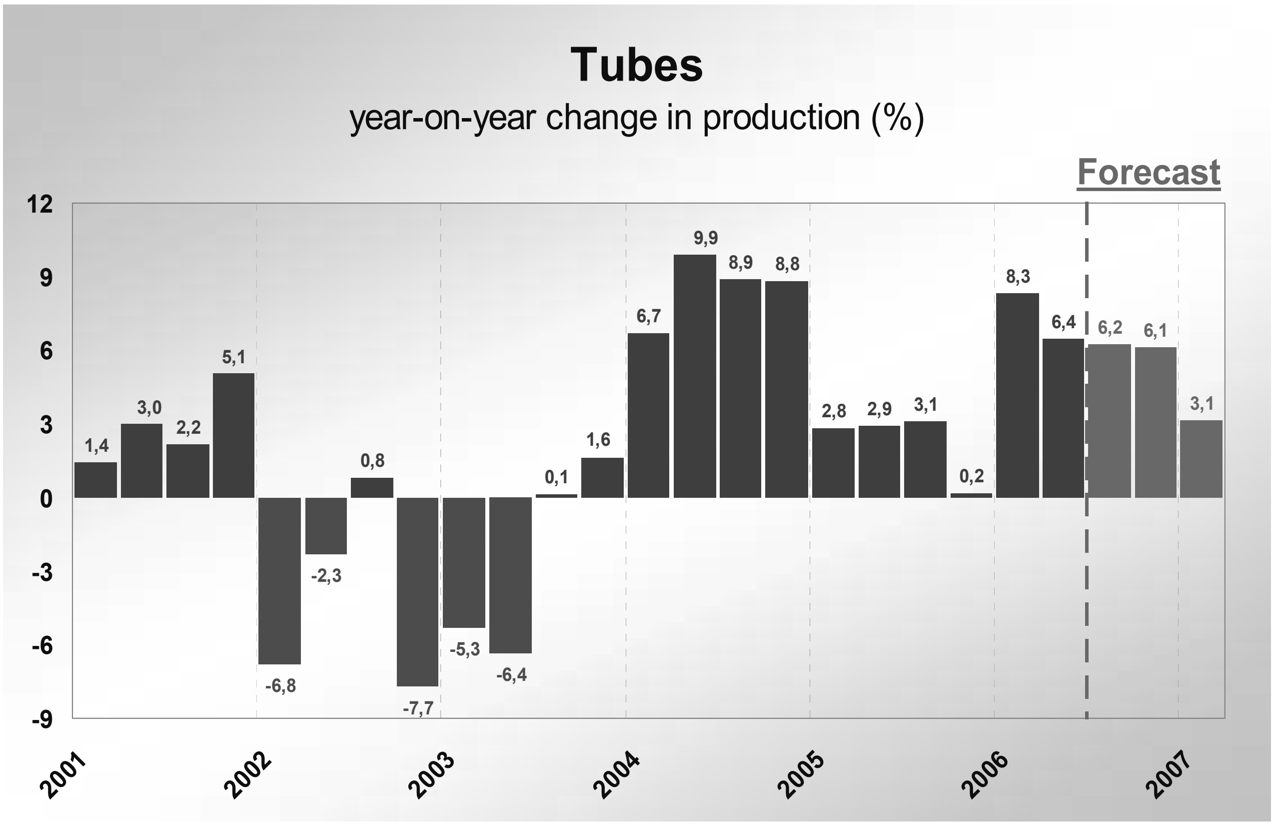

Automotive
year-on-year change in production (%)
Forecast
10
8
6
4
2
0
-2
-4
-6
-8
4,1
-0,1
1,7
-3,7
-6,8
0,5
4,6
5,0
4,1
0,9
0,4
4,4
3,7
8,9
7,7
4,4
-0,3
2,6
0,0
-0,4
7,1
-1,3
0,6
3,3
0,3
2001
2002
2003
2004
2005
2006
2007

Car registrations lost momentum in the first half 2006 and for the second half of the year the expected fall in car output in the EU (despite a recovery in Italy) is not seen as being fully compensated by the expansion of capacities and production in the EU10.

Nevertheless, sales may be boosted at the end of this year by the effects of the VAT rise in Germany in 2007 which may result in purchases being brought forward.

For the third quarter 2006 output will be stable at best with a moderate recovery expected in the final quarter of the year and going into 2007.Overall EU output will rise by 2.4 % in 2006.

Tubes

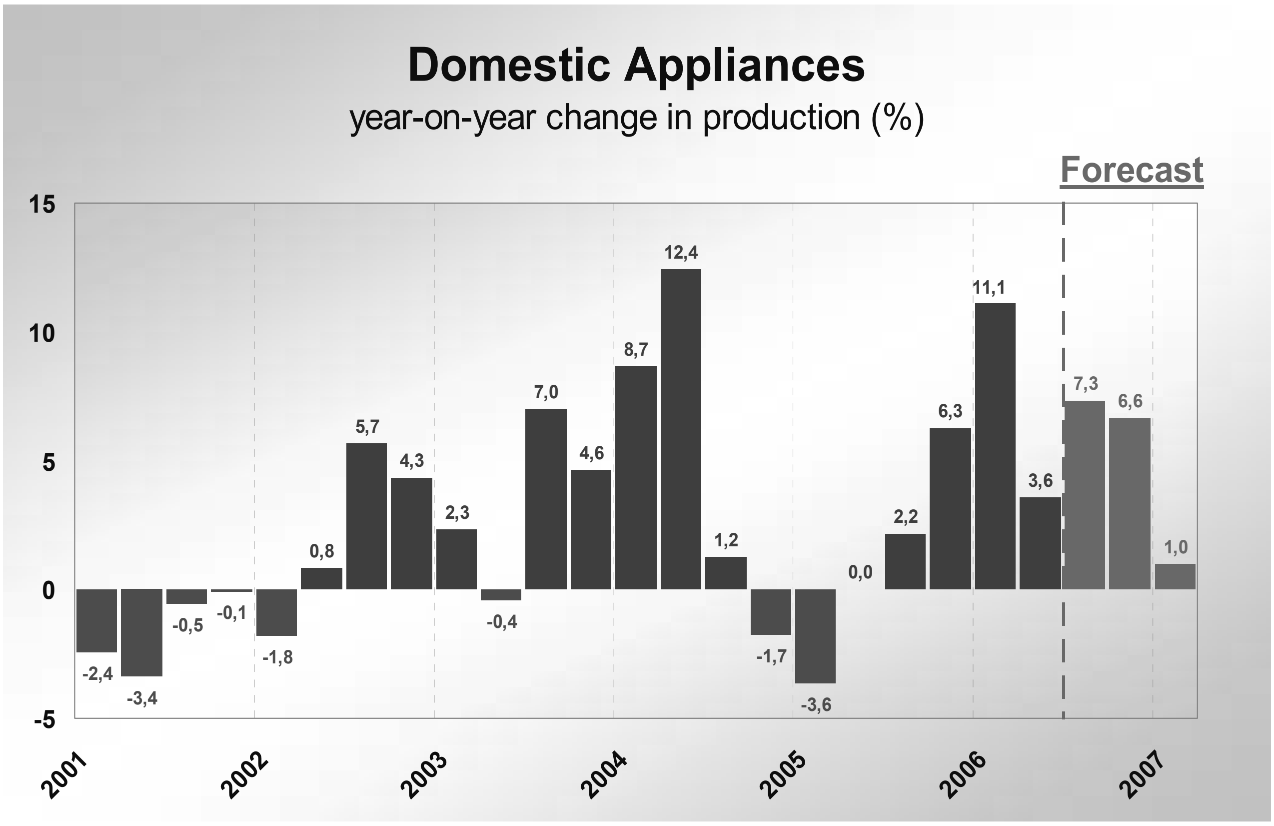


The very strong output levels of the first half of this year are likely to continue into the second half. On the basis of high energy prices, a significant rise in new pipeline projects and strong demand coming from Russia, central America and the Middle East, demand remains very strong for this sector. There have been some falls in energy prices recently which may presage a slowdown in the sector but with the backlog of existing projects, the outlook going into next year is still for high activity levels.

Both large diameter tubes and seamless tube demand is being driven by demand from the energy sector.

Equally, with stronger demand coming from the industrial sector, small welded tubes are improving.

Domestic Appliances



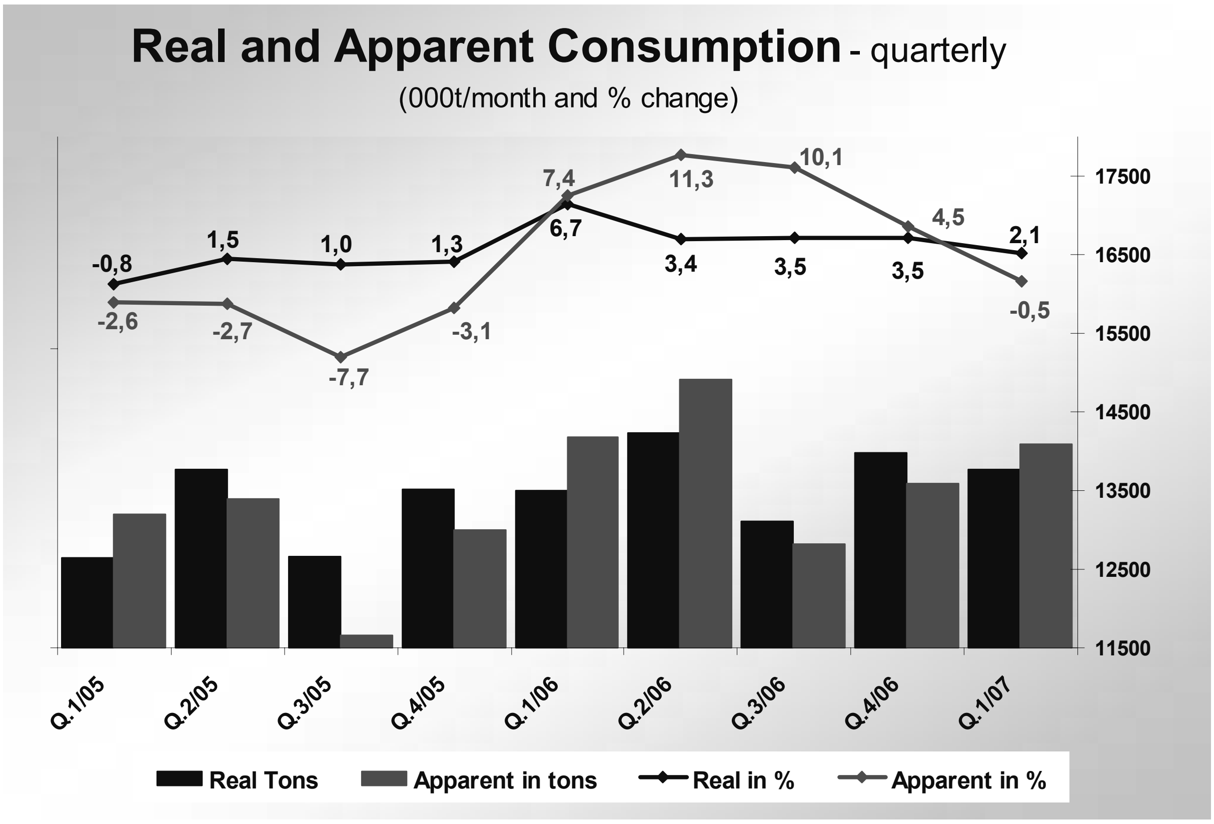
Output levels have risen strongly in the first half of the year and are expected to continue to do so in the second half, particularly if purchases in Germany are brought forward to escape the VAT rise of next year.

Consumer confidence and expenditure are rising, although less so in Germany than elsewhere, notably France. Output levels particularly in the EU10 are high.

Real Consumption

Forecast for real consumption

Period	Q.I/2006 / Q.I/2005	Q.II/2006 / Q.II/2005	Q.III/2006 / Q.III/2005	Q.IV/2006 / Q.IV/2005	Year 2006 / Year 2005	Q.I/2007 / Q.I/2006
	6.7 %	3.4 %	3.5 %	3.5 %	4.2 %	2.1 %



The strength of the EU economic recovery is translating into better than expected demand-side fundamentals.

From the perspective of the end-using industries the outlook is very solid with forecasts being reviewed upwards.

Looking to Q.1/2007 the trend remains positive. The demand component of the steel market outlook – real consumption - therefore remains very good through to the beginning of 2007.

Apparent Consumption

Forecast for apparent consumption

Period	Q.I/2006 / Q.I/2005	Q.II/2006 / Q.II/2005	Q.III/2006 / Q.III/2005	Q.IV/2006 / Q.IV/2005	Year 2006 / Year 2005	Q.I/2007 / Q.I/2006
	7.4 %	11.3 %	10.1 %	4.5 %	8.3 %	-0.5 %

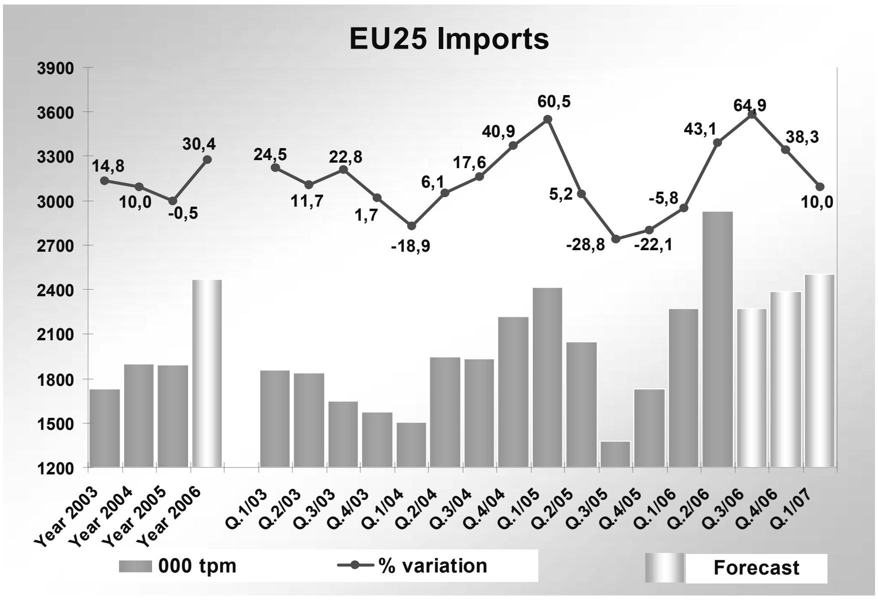
The overdevelopment of apparent consumption in 2004 led to the correction seen in 2005. We may be seeing a similar development going into the end of 2006. Up to the middle of the year restocking was seen as moderate. Stocks levels in relation to real consumption were still low and, at least up to Q.1/06, the apparent consumption rise was not significantly out of line with that of real consumption.

Since then, the dramatic rise in imports and the increase in domestic deliveries has resulted in an accelerating apparent consumption growth, clearly outpacing real consumption in Q.2 and Q.3. This has resulted in an increase in stocks.

The rise in stocks is assessed to be primarily a flat products issue.

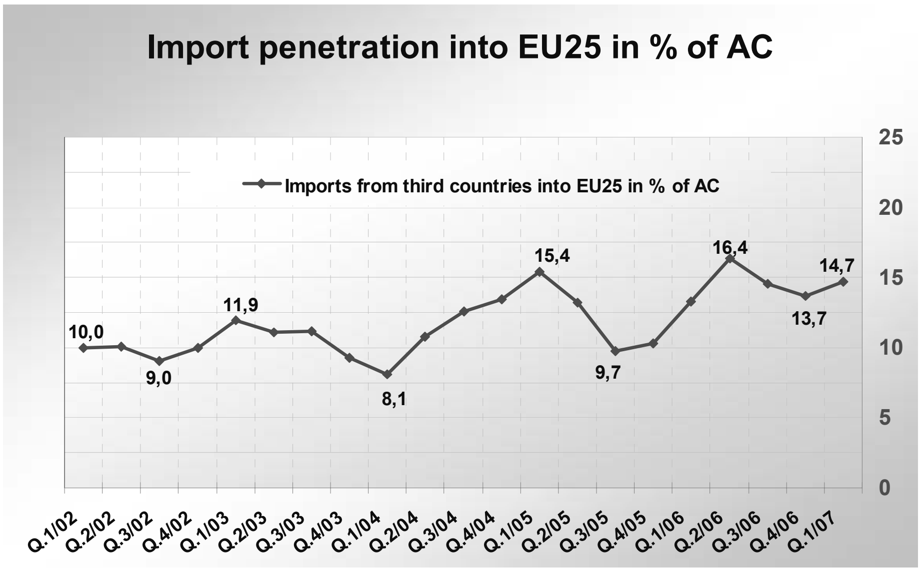
While in Q.4/06-Q.1/07 the continued strength of end-user demand will mitigate supply pressures it is clear that with stocks replenishment estimated as being largely completed in Q.3 if market supply in Q.4 remains high, there is a risk of over-stocking and of the market becoming less well-balanced. This risk has been made clear in our last three reports.

Imports

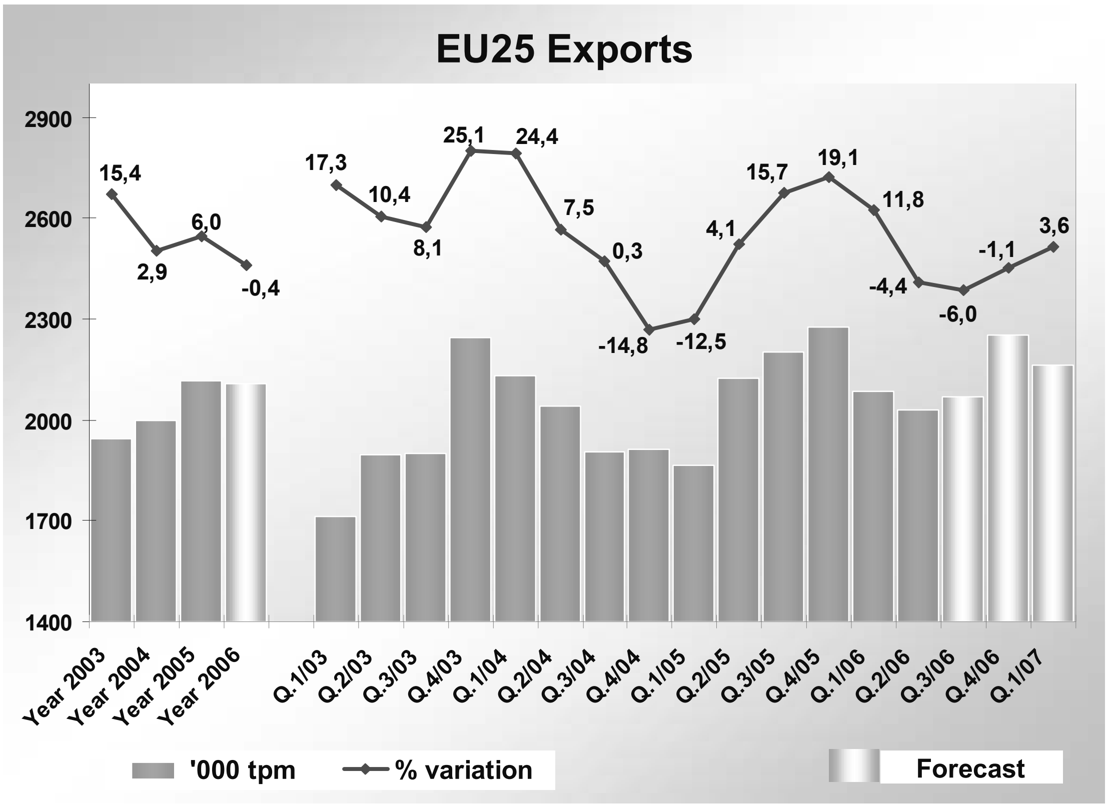


Imports in Q.I/2006 showed a massive rise compared to previous quarters. Imports in Q.2 rose even further to unprecedented levels. Licence information points to further increases in the course of the year, particularly from China. The level of imports and their concentration on certain products and on southern European markets is proving to be extremely disruptive, is creating over-supply, and is leading to an increase in trade tensions.

Note: accession of Romania and Bulgaria January 2007.

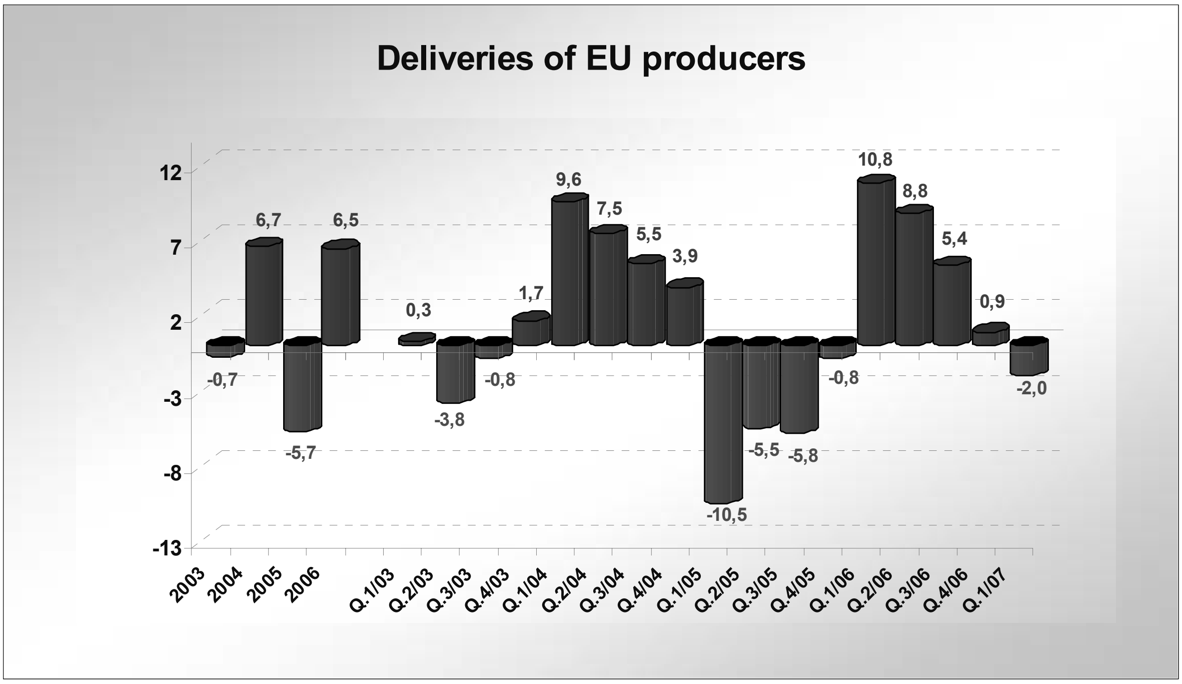


Exports



The dip in exports by European producers may begin to level off at the end of this year as producers face increased pressure on their domestic markets. Exports however are unlikely to rise substantially in the short term given the slight slowdown in growth internationally, particularly in the USA, and, more importantly, the glut of material on international markets coming from China.

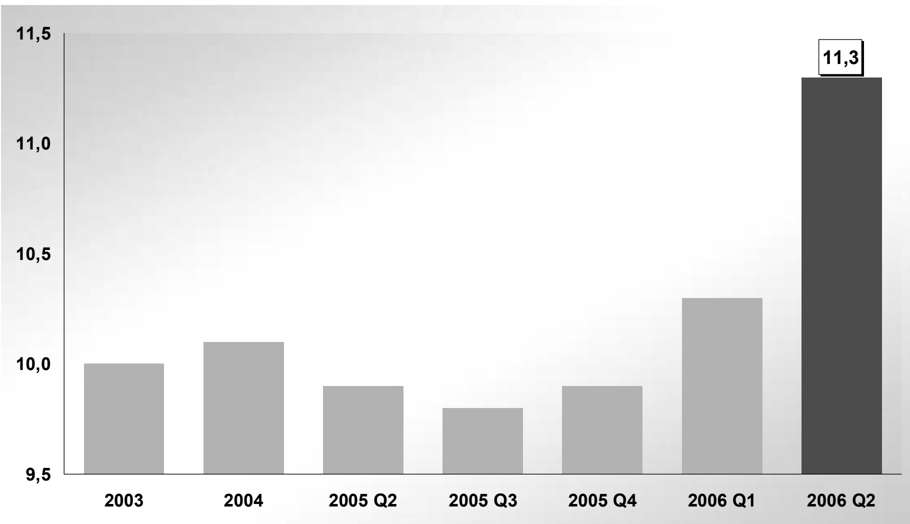
Changes in % (Estimates)	IMPORTS Third Countries	EXPORTS Third Countries	Community deliveries of EU producers
Q.I/2006 / Q.I/2005	-5.8 %	11.8 %	10.8 %
Q.II/2006 / Q.II/2005	43.1 %	-4.4 %	8.8 %
		FORECASTS	
Q.III/2006 / Q.III/2005	64.9 %	-6.0 %	5.4 %
Q.IV/2006 / Q.IV/2005	38.3 %	-1.1 %	0.9 %
Year 2006 / Year 2005	30.4 %	-0.4 %	6.5 %
Q.I/2007 / Q.I/2006	10.0 %	3.6 %	-2.0 %



III. Situation in Third Countries

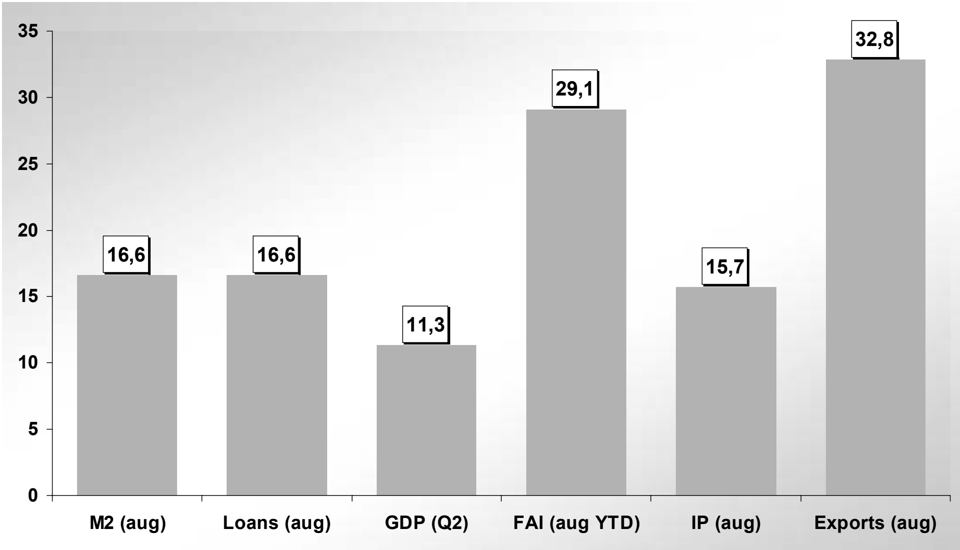
1. China

Real GDP, y-o-y % change

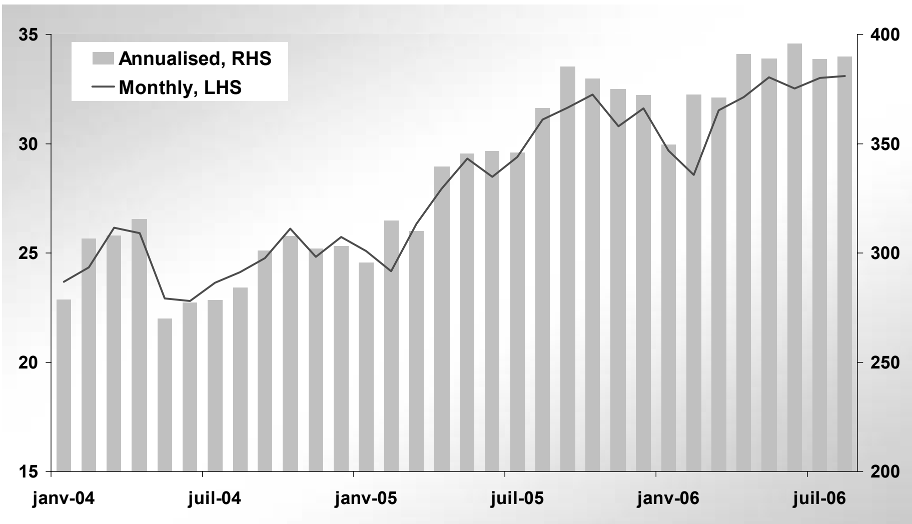


Economic growth was extremely strong in the second quarter. However, there are some tentative signs that it is now responding to government measures to cool the rate of expansion.

y-o-y % change 2005



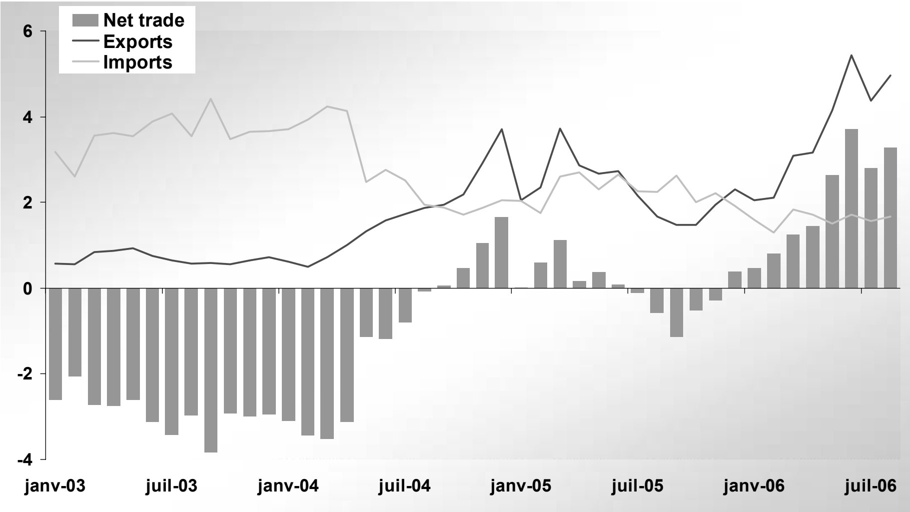
Steel Industry Analysis – Consumption flat since April



Apparent consumption growth is falling month on month. However the continued increase in capacities and production has led to a domestic oversupply and to a significant shift in China's trade balance. China is exporting its excess steel. This is having a major impact on the rest of the world.

Steel Industry Analysis – Net exports remain around 3m tpm

All steel products, m tpm



Steel Industry Analysis - Summary

China Supply Demand						
m tonnes						
					Base Case	Downside Risk
	2002	**2003**	**2004**	**2005**	**2006f**	**2006f**
Crude Steel Production (IISI)	182	222	280	353	422	430
Imports (Actual) (ISSB)	29.3	43.2	33.2	27.3	#N/A	#N/A
Exports (Actual) (ISSB)	6.6	8.2	20.1	27.4	#N/A	#N/A
Net Trade - Total (Actual)	22.6	35.0	13.1	-0.1	#N/A	#N/A
Net Trade - Total (Actual) (CSE)	25.2	38.8	14.6	-0.1	-27.0	-32.5
Net Trade - Total (IISI) (CSE)	24.8	37.1	21.7	#N/A	#N/A	#N/A
App. Demand (Crude Basis) (IISI)	207	260	302	353	395	398
Real Consumption (Crude)	207	255	308	348	404	404
Stock Change	-0.4	4.5	-6.0	4.8	-8.8	-5.6
App. Demand (Finished Product) (IISI)	186	234	270	327	366	369
Real Consumption (Finished Product)	187	230	275	323	374	374
Stock Change	-0.4	4.1	-5.4	4.3	-7.9	-5.0
% Change y-o-y						
Crude steel production		22.0%	26.1%	25.9%	19.5%	21.8%
Imports		47.5%	-23.1%	-17.8%	#N/A	#N/A
Exports		24.1%	143.5%	36.6%	#N/A	#N/A
Apparent Consumption		25.6%	15.3%	21.1%	12.0%	12.9%
Real Consumption		23.2%	19.7%	17.2%	15.9%	15.9%
% World Demand		26.8%	28.0%	31.0%	#N/A	#N/A

Source: ISSB, IISI, Macquarie

2. USA

Macro-economic environment

Second-Quarter Growth. Second-quarter GDP growth has been revised down to 2.6% from 2.9%, on slower inventory accumulation and a bigger decline in residential construction than first announced. Imports were revised up, but so were exports, and the overall contribution of foreign trade to growth was little changed.

Significance: The downward revision to second-quarter growth was not large, but it does reinforce the picture of an economy slowing as housing activity contracts sharply. Residential construction subtracted 0.7 percentage point from second-quarter growth, and the drag is likely to be bigger still in the third quarter, when GDP growth should slip further towards 2%. Fortunately for the growth outlook, sharply falling energy prices are supporting real incomes, and will help consumer spending as we enter the fourth quarter. Consumer spending turned up sharply in July. For the Fed, lower energy prices are reducing the downside risks to growth at the same time that they are reducing the upside risks to inflation. Although the Fed is expected to cut rates in 2007, it should be comfortable staying on hold through early next year. Furthermore, while short-term interest rates have been stable, long-term rates have been falling recently. This is keeping mortgage rates at relatively low levels thereby providing some support to the housing sector. Lower long-term rates will also support business investment, as will the strong profits and cash flow the business sector is enjoying at present.

The University of Michigan's Index of Consumer Sentiment edged up one point to 85.4 from the preliminary estimate to the final for September. The index is up 3.4 points from August's final reading of 82.0. Consumers' expectations for the next one to five years improved, but assessments of current conditions deteriorated compared with August. The index of current economic conditions was down at 96.6; although this was an increase from the mid-month reading, it is still down sharply from 103.8 in August. The consumer expectations index rose to an eight-month high of 78.2, up from 68.0 in August.

Significance: The index is beginning to react to the sharp decline in petrol (gasoline) prices, along with lower mortgage rates, a rising stock market, and more stabilised job growth. The index of current economic conditions remains low at 96.6, although it rebounded slightly from its mid-month reading of 95.7—the lowest level since October 2005. In contrast, respondents were notably more upbeat about future economic conditions, both one year and five years down the road. An easing of inflation and a stock market rally no doubt contributed to the cheerier outlook. Experts anticipate that real consumer spending growth picked up from a 2.6% annual rate in the second quarter to 3.6% in the third quarter. But with housing markets deteriorating and inflation still a threat, another slowdown to 2.0% growth is anticipated in the fourth quarter, followed by cautious spending throughout 2007.

Growth Outlook:

The U.S economy is projected to generate an average annual GDP growth close to 3.4% this year before slowing to 2.7% in 2007. Despite the drag from residential construction, the economy appears to be on solid ground. Housing represents a small share (just over 5%) of the economy.

Sectors	**2006 %**	**2007%**
Fabricated Metal excl. Mach. & Equip.	4.7	1.9
Industrial Machinery excl. Electrical	9.8	4.9
Motor Vehicles & Parts	0.5	-1.2
Electrical Appliances & Housewares	1.4	-1.4
Electricity, Gas & Water	1.4	1.7
Construction	1.0	-1.7

The SWIP is expected to increase by 3.8 % this year and by 0.7 % in 2007.

The US Steel Market

Real steel consumption should grow at the same rate as the SWIP.

Over the first 8 months, crude steel production increased by 9.6%. Over the same period of the first 8 months of this year, imports- including semis- surged by 42.3% year on year. Indeed, it appears that imported steel, which was ordered in spring, arrived in the US during the third quarter in quantities that were higher than the market originally anticipated.

For 2006 as a whole, we project an upturn of apparent steel use (ASU) in the range of 12.0%. Next year ASU should drop by around 8% following the reversal of the stocks cycle. Inventory levels at both steel service centers and manufacturers are currently very high relative to real steel use. More than 70 percent of steel buyers surveyed by the Institute for Supply Management (ISM), Tempe, Ariz., said their September inventories were too high for demand, and even more said they expect to receive less steel and cut stocks in the next few months.

3.. Japan

Industrial production increased by 5.1 % compared to last year. January to July it rose by 3.5 %. Order intake in mechanical engineering – which is considered as an important early indicator for overall economic development – continues to rise strongly with +9 % in Quarter II compared to the previous quarter and + 45 % compared to the same quarter last year. Forecasts for Quarter III are +5 %. Recovery, thus, can be considered to be on solid ground. The second half year 2006 is expected to experience a marked rise in overall production driven mainly by domestic demand. Real GDP in Japan is expected to rise the year 2006 as a whole by 2.8% (against 2.6 % in 2005 and 2.3% in 2004).

In the medium term the economic outlook is favourable. Next year, private consumption is expected to increase markedly due to strong growth in income. Growth in productivity will support a rise in company profits and investments.

For 2007, overall economic growth is forecast to reach 2.6 %.

Order intake of the Japanese steel industry from the domestic market was +1.3 % January to July 2006. Shipyards (plus 8 %), mechanical engineering (plus 5.6 %) and the automotive industry (+4 %) had the best results. The order intake from the construction sector which accounts for almost half of all direct and indirect domestic steel deliveries, stagnated given a restrictive fiscal policy and a fall in public construction.

After having experienced a sharp fall in October 2005, order intake from export markets is showing since then a strong upwards trend: +7.2 % in the first seven months 2006.

In comparison with the corresponding period of the previous year, Japanese exports rose by 3 % in the first 8 months 2006. On the important Chinese market there was a drop of 2.5 %, in Thailand a fall of 17 % and in Chinese Taipei a decrease of -2.9 %. Exports to the USA increased by 53 % and to Korea by 8.4 %.

In the first 8 months 2006 the level of steel imports was by 20 % below that of the same period of last year. Volumes from China, for instance, reduced by one third.

Mainly due to the weak situation in the construction sector, market supply for the whole year 2006 is stagnating (74,4 Mio t). While production is expected to increase by 3 % (104,5 Mio rolled products), imports will fall by 15 % down to 4,7 Mio t and exports will increase by 7 % up to 34 Mio t.