TD Bank Financial Group

TD Economics

Topic Paper

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2006 TO TEST STEEL'S METTLE

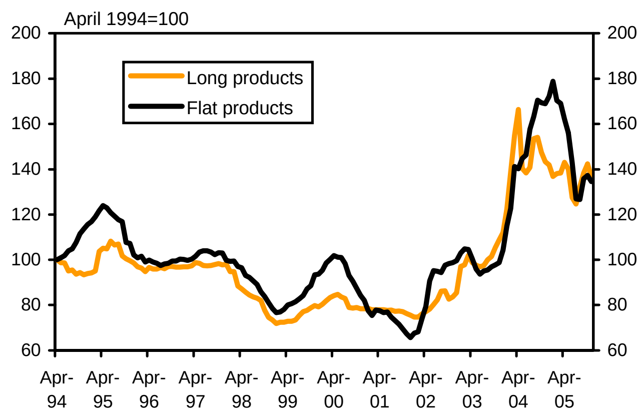
Amid the ongoing rally in commodity prices this year, there is no doubt that the major developments in crude oil and natural gas markets have stolen much of the spotlight. However, a resource sector that is likely to garner a major dose of attention in the weeks ahead lies further up the value-added chain – namely, steel. For it is at this time of the calendar (commonly referred to as "mating season") that negotiations heat up between the world's major steel producers and suppliers of iron ore and metallurgical coal regarding price contracts for the upcoming year. Since the ultimate costs of those materials heavily influence steel prices, and since steel is used ubiquitously, the world will indeed be following the events closely.

Chinese raw material demand drives up prices

In order to put the current events in context, it is useful to review recent developments in the steel market. After plumbing the depths in the late 1990s and again in 2001, steel prices more than doubled between 2002 and 2004. And, while prices have since fallen off their 2004 peak, they remain well above their 5- and 10-year averages. As the accompanying charts reveal, these trends were recorded across both product types and regions.

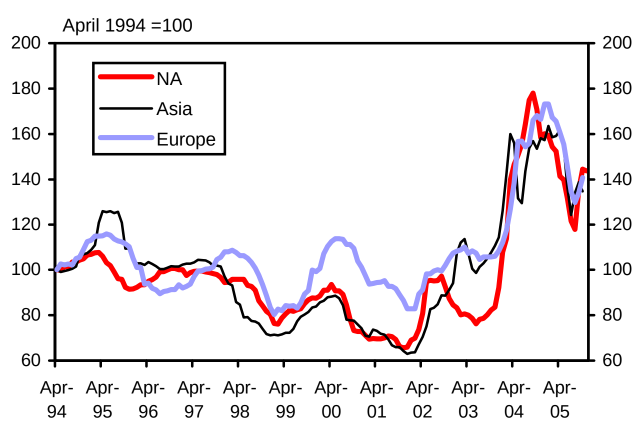
Like most of its counterparts within the resource sector, steel prices have not only ridden the coat-tails of strong U.S. economic growth, but have received a particular boost from the Chinese economy's emergence on the world stage. In fact, powered in part by skyrocketing auto production, growth in steel consumption in China exploded by 20 per cent per year in the 2001-04 period, compared with an annual gain in the rest of the world of less than 3 per cent. In 1994, China accounted for 17 per cent of world steel consumption. That comparable figure is now 27 per cent.

GLOBAL STEEL PRICE INDEX: FLAT AND LONG PRODUCTS



Most recent data: November (month-to-date) to Nov. 11, 2005
Source: CRU International

STEEL PRICE INDEX BY REGION



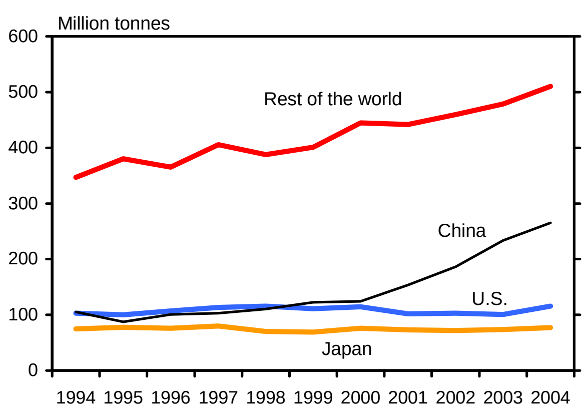
Most recent data: November (month-to-date) to Nov. 11, 2005
Source: CRU International

China's ever-growing demand for steel is no secret. Less commonly known, however, is the fact that China is also the world's largest producer of steel. In fact, over the past two years alone, China has produced more steel than the combined output of Japan and the United States. What's more, spurred by investments in new capacity, growth in steel output has been outstripping that of demand in the country, cutting the gap between domestic consumption and production to only 10 per cent in 2004. This year, China has actually become a net *exporter* of steel products for the first time on record. Keep in mind though that this is an overall picture. The nation still relies on net imports of certain types of steel, such as high-end steel plates used for bridges and buildings.

China's increasing steel self-sufficiency begs the question of how this developing market has continued to wield such an influence on global steel prices. In short, China has become highly dependent on raw materials imports for steel making. As a result, hungry Chinese steel mills have pushed up demand, causing prices for inputs such as iron ore, met coal, coke and steel scrap to skyrocket over the 2002-04 period. Moreover, with the sole exception of coke, prices for these commodities have remained elevated this year, especially for coal and iron ore. As a result, with the steel market remaining firm, producers have had success in passing these price increases on to consumers – that is, until the latter part of last year, when signs of a global supply glut started to emerge.

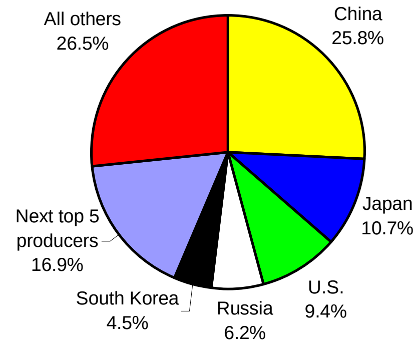
In order to help support prices this year, a number of regions have cut back production, including North America, South America, the European Union and the Commonwealth of Independent States (CIS). Even China – where rapid output growth has been the number-one contributor to the supply glut – appears to be moving in that direction. Recently, China Iron and Steel Association called for a 5 per cent cut in output in the fourth quarter. These cuts will push the global market into a sizeable excess demand position to the tune of around 40 million tonnes by the end of 2005.

APPARENT STEEL CONSUMPTION*: TOP THREE AND REST OF THE WORLD



* Finished steel; Source: IISI

WORLD CRUDE STEEL PRODUCTION, 2004



2004 Production: 1057 million tonnes

Source: IISI

Iron ore and coal negotiations heating up

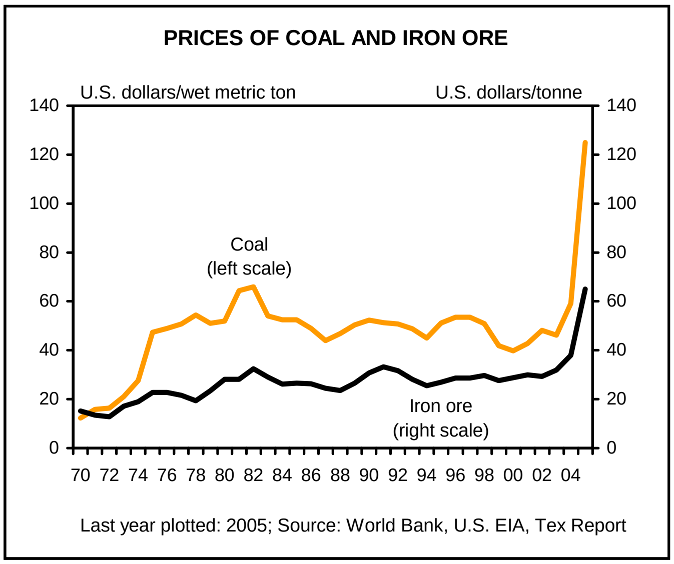
Fast forward to today, where tough discussions over prices are intensifying between the global steel makers and the suppliers of raw materials. Negotiations for the coming year typically start in the fall and can last up to six months. And, prices are normally set once the major steel makers – which have historically been the large Japanese or European producers – sign a major contract with one of the supplying companies. Like auto-sector negotiations, this agreement becomes the benchmark for the rest of the industry.

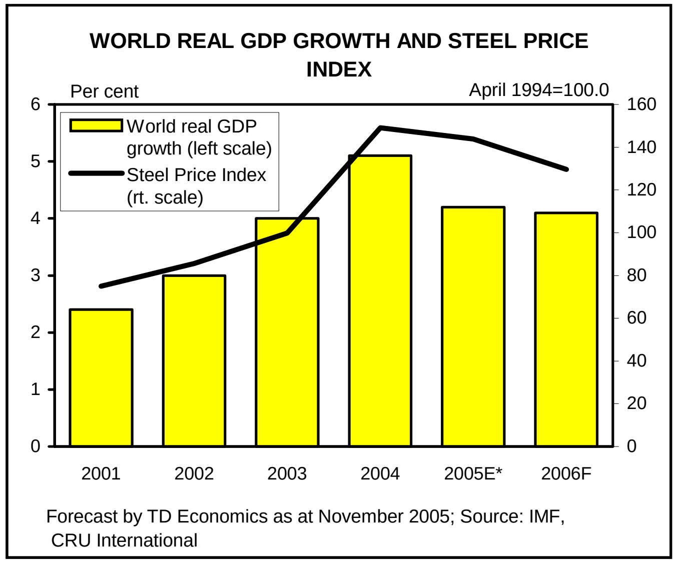
This year, Chinese steel makers are pushing to establish the first deal, given their growing clout in the market. Moreover, they will be pushing for lower raw material prices in light of their weak financial positions. Still, raw materials suppliers will be a formidable opposition. In the case of iron ore, three companies – Companhia Vale do Rio Doce of Brazil, Rio Tinto PLC of Britain, and BHP Billiton Ltd. of Australia – control more than 70 per cent of the export market. Last year, these companies extracted a hefty increase in iron ore prices of 71.5 per cent. And, this year, they are looking for a further increase of up to 20 per cent.

How these negotiations evolve in the weeks to come will be interesting. In our view, the most likely bet is a rollover in iron ore prices next year or perhaps a small cut. The probability for a cut in coal prices is even greater. At the same time, with oil and gas prices likely to pull back by about 25 per cent during 2006 and freight costs well down from their peak, cost-push pressures on steel makers should abate to some extent in 2006.

Steel prices to drop 10% in 2006

Another major factor that is likely to put downward pressure on steel prices is the supply-demand position of the steel market itself, where we expect to witness a moderate deterioration. Although output growth in China is expected to downshift in 2006 from this year's spectacular rate, this is likely to be counter-balanced by a rebound in production elsewhere, leaving the expansion in global supply running at a healthy rate of 7 per cent. At the same





time, look for the increase in global demand to slow to 5 per cent in 2006, dragged down by a slackening in world economic growth in the second half of next year. Thus, growth in supply is poised to outstrip growth in demand next year.

Putting it all together, we expect average steel prices to fall by 10 per cent during 2006. Keep in mind that while this is less than the 15-per-cent drop that we expect for the TDCI overall, steel prices have underperformed most major commodities this year. Looking out over the longer-term horizon, China will continue to remain the dominant force in the world steel market. Since the country is expected to maintain its position as a net exporter of steel products to the rest of the world, any required supply adjustments facing the market over the medium term would need to be largely borne by the world ex-China. That could certainly change if China would be prepared to under-utilize its steel production capacity. We don't see that scenario playing out, however.

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