Third Quarter of 2018

STEEL INDUSTRY REPORT

Gus Faucher Chief Economist | **Stuart Hoffman** Senior Economic Advisor | **William Adams** Senior Economist | **Kurt Rankin** Economist

THE PNC FINANCIAL SERVICES GROUP | The Tower at PNC Plaza | 300 Fifth Avenue | Pittsburgh, PA 15222-2401

Summary

US POLICY MIX, GLOBAL MACRO BACKDROP SUPPORTING HIGH STEEL PRICES AND DEMAND

- US steel prices surged on tariffs, higher oil prices, supply chain disruptions, and strong demand in the first half of 2018. Steel shipments grew robustly as well, outpacing real GDP growth.
- US steel prices will remain high in the second half of 2018 and 2019, but their premium to global prices will narrow.
- Little visibility about the outlook for trade policy after the 2018 mid-term elections.

Steel prices surged in the first half of 2018 on a confluence of factors (Chart 1). Most obviously, the 25 percent tariffs on imported steel the Trump administration announced in March have raised prices, but do not in of themselves explain the more than 60 percent premium of US steel prices relative to global benchmarks in mid-2018. Supply chain disruptions caused by the tariffs, exacerbated by trucking capacity bottlenecks, are also adding to price pressures. Oil prices have increased due to deterioration in the Venezuelan energy industry and supply restraint by other OPEC oil producers, also increasing shipping costs (Chart 2). And buoyant global demand conditions play a role as well: the capacity utilization rate in the steel industry rose to its highest since 2014 for both foreign and US steel producers in mid-2018 (Chart 3).

Following 4.2 percent year-over-year growth in domestic steel shipments in the first five months of 2018, PNC forecasts continued solid growth in domestic steel demand in the second half of 2018 and in 2019 (Chart 4). US construction spending is poised for further above-trend growth, supported by fiscal stimulus and strong business profits. Fundamentals for residential investment are still positive, although not as positive as they were in the past few years. The pickup in job growth this year and gradually accelerating wage growth are tailwinds, but are partially offset by headwinds from higher new home prices, rising mortgage rates, rising construction costs, and reduced tax incentives for homeownership as a result of the Tax Cuts and Jobs Act. The auto industry will drag on steel demand; vehicle sales were 17.3 million units at an annual pace in the first half of 2018, the slowest since the second half of 2014. Higher gas prices, higher interest rates, and tighter auto loan underwriting standards are restraining passenger vehicle sales, and driver shortages are constraining trucking industry growth. Conversely, steel demand from the energy industry will be robust: The number of well-drilling rigs active in the United States rose 10.7 percent on the year in mid-July, and energy investment will continue to grow rapidly on high oil prices and strong energy productivity growth (oil output is growing faster than the number of active rigs).

While the domestic steel market is set for solid demand and pricing conditions in the near term, three sources of uncertainty cloud the outlook. The first is the likelihood of more steel imports in coming quarters (Chart 5). The premium of domestic steel prices over foreign prices was large enough in mid-2018 that, tariffs or no, the imported share of the steel market will rise in the second half of 2018 and narrow the US price premium. Both steel price forecasts and futures pricing anticipate a retreat in US prices (Chart 1). A second source of uncertainty is the risk of a pullback in capital spending by businesses involved in global supply chains (Chart 6). The pull-back in the ISM Manufacturing Purchasing Managers Index in the second quarter of 2018 is telling. This survey is aggregated to reflect conditions for both large businesses, who are generally more exposed to international trade, as well as small businesses. Small business sentiment is still exuberant, but managers of large manufacturers are concerned about higher input costs, supply chain disruptions, and foreign retaliation weighing on their exports. Business capital spending could slow if large businesses turn more cautious. A third source of uncertainty is potential tariff policies after the November election. Steel-consuming industries like automaking, and industries targeted by foreign retaliation like agriculture, are advocating a return to policies that are more favorable to their business models.

PNC

Chart 1: Domestic steel price premium set to narrow

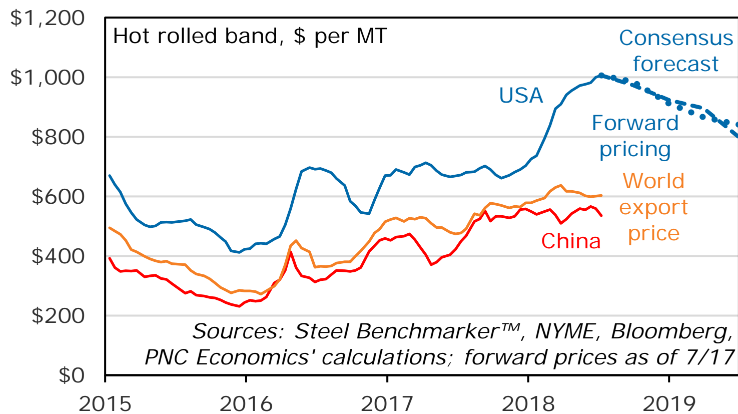


Chart 2: High oil prices adding to shipping costs

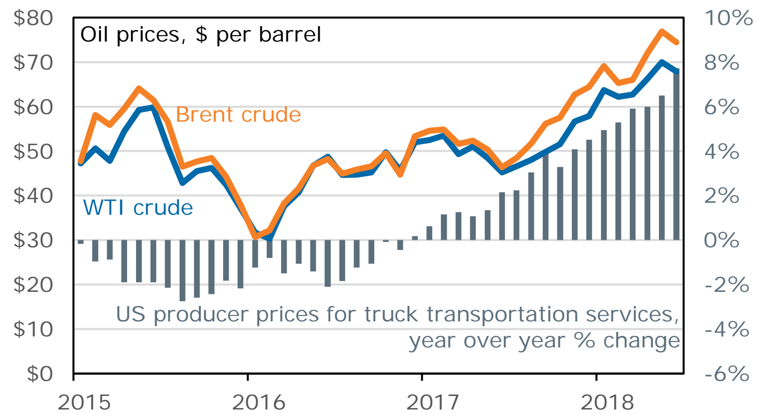


Chart 3: Capacity utilization at a multi-year high

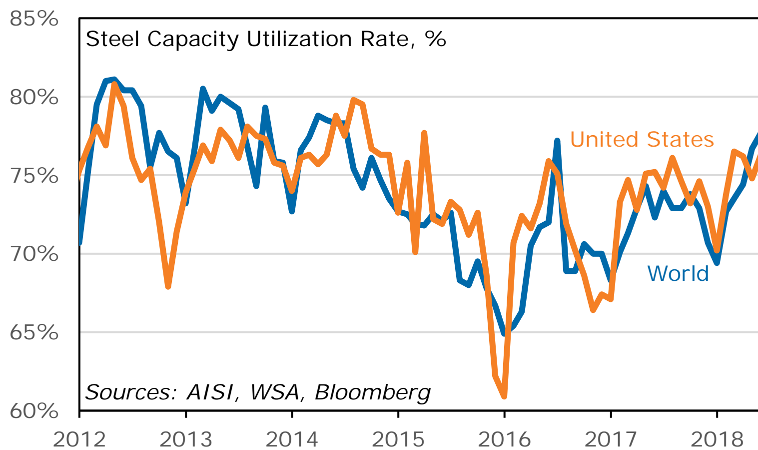


Chart 4: Construction-related steel demand to rise

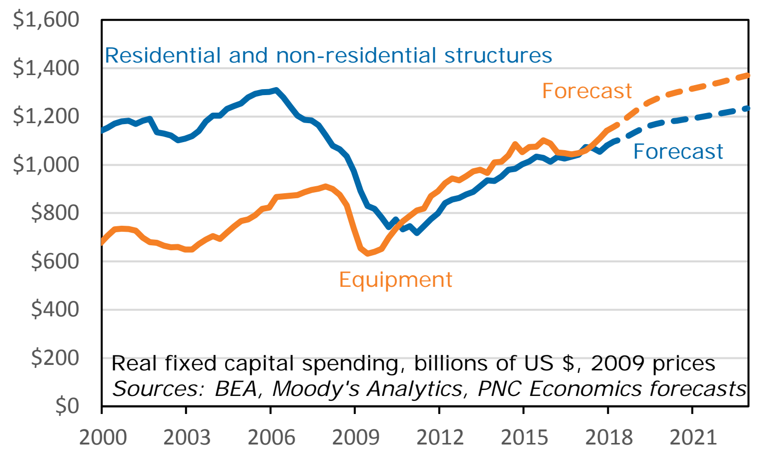


Chart 5: Large US price premium will attract imports

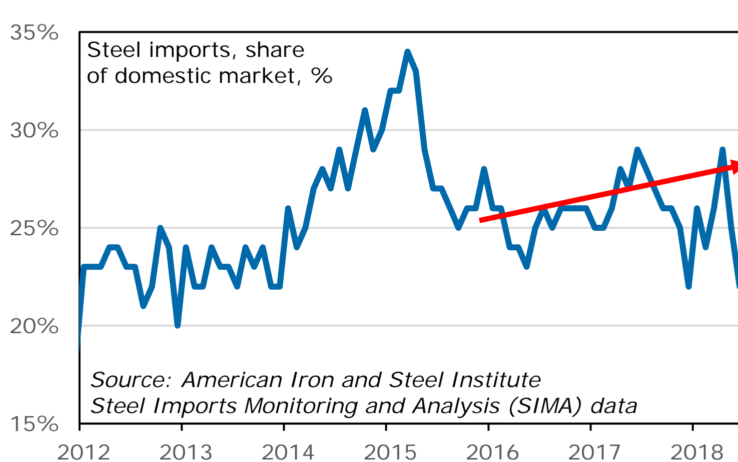
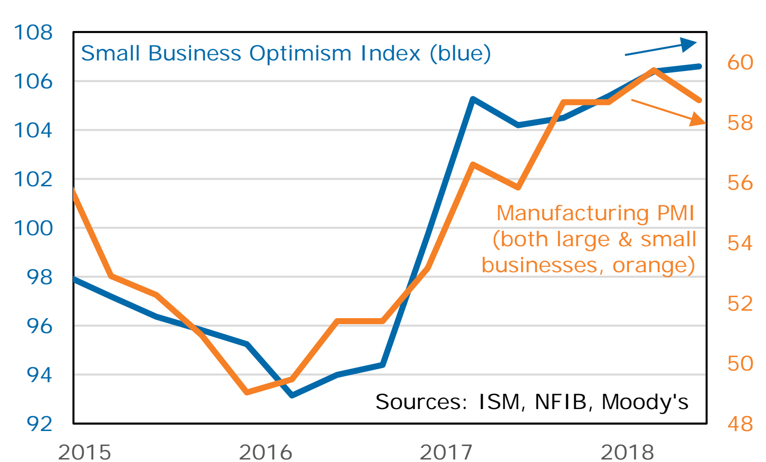


Chart 6: Small & large business sentiment diverges



Visit http://www.pnc.com/economicreports to view the full listing of economic reports published by PNC's economists.

Disclaimer: The material presented is of a general nature and does not constitute the provision of investment or economic advice to any person, or a recommendation to buy or sell any security or adopt any investment strategy. Opinions and forecasts expressed herein are subject to change without notice. Relevant information was obtained from sources deemed reliable. Such information is not guaranteed as to its accuracy. You should seek the advice of an investment professional to tailor a financial plan to your particular needs. © 2018 The PNC Financial Services Group.