1st Quarter 2017

STEEL INDUSTRY REPORT

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Summary

Fiscal stimulus to accelerate economic growth and boost steel demand

- The economic expansion will accelerate to 2.4 percent in 2017 and 2.7 percent in 2018, from 1.6 percent in 2016.
- Tax cuts and increased defense and infrastructure spending will support steel demand.
- Prospects are brightest for construction equipment, autos and aerospace.
- Restrained oil price increases and low agricultural prices will limit improvement in demand from energy-related and agricultural machinery.
- A strong dollar, faster inflation, interest rate hikes and trade disputes pose downside risks to the outlook.

Steel producers have a good year ahead of them as U.S. economic growth accelerates and boosts steel demand. The economic expansion is set to accelerate to 2.4 percent in 2017 and 2.7 percent in 2018 from 1.6 percent in 2016 as weights from the energy downturn and excess inventory accumulation lift (Chart 2). In addition, the government sector is poised to promote growth after fiscal austerity caused it to be a weight on the economy for much of the time since the Great Recession. Congress and the Trump administration will likely pursue expansionary fiscal policy through tax cuts and increased spending on infrastructure and defense. Such policies will boost economic growth by late 2017 and extend through 2018.

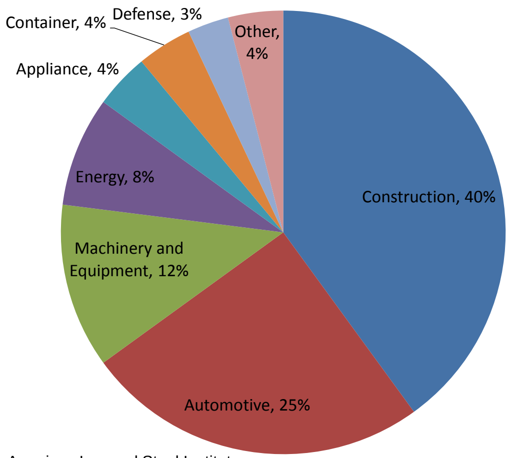
The pickup in economic growth will boost demand for steel, especially from the construction industry. Higher infrastructure spending will help lift non-residential construction by 3.6 percent in 2017 and by 3.3 percent in 2018 (Chart 3). This will be much better than the 2.6 percent and 4.4 percent contractions in 2016 and 2015, respectively. Independent of the change in fiscal policy, real estate development has been gaining momentum as the maturing economic expansion lifts construction of offices, lodging, commercial structures and amusement facilities (Charts 4& 5). On the residential side, declining unemployment, slowly improving income growth, generally high levels of affordability and low mortgage rates will enable homebuilding to march higher by a moderate pace of 3.6 percent and 2.8 percent in 2017 and 2018, respectively (Chart 6).

While fiscal stimulus and recovering real estate markets will support steel demand in construction and related equipment, low commodity prices will limit demand growth for mining and agricultural machinery. The outlook for the oil and gas industry is improving but the industry is unlikely to bounce back in an attention-grabbing way. The number of active rotary rigs fell from a peak of 1,931 rigs in September 2014 to a low of just 404 rigs in May 2016 as energy prices collapsed. The rig count has since risen to 659 as of mid-January as oil prices crept up (Chart 7). Nevertheless, PNC Economics assumes the West Texas Intermediate crude price will end 2017 close to $50 per barrel as higher prices entice drillers to increase output. The increased output will restrain oil prices which, in turn, will limit the pace at which oil and gas investment will recover. Although President Trump has stated his preference for coal and natural gas, low market prices will ultimately keep investment in those sectors rising slowly. In agriculture, farm cash receipts are likely to be flat in 2017 as agricultural prices have yet to recover the way energy prices have (Charts 8 & 9). This will limit the potential for farm equipment demand to recover.

Besides construction, autos and aerospace will be bright spots in the outlook for steel demand in 2017. PNC Economics is forecasting auto sales of 17.5 million units in 2017. This will be equal to 2016's level, which was the best year on record (Chart 10). Pent-up demand from the slow economic recovery has been mostly satisfied, so large gains in sales are unlikely. Still, auto demand will be bolstered as the labor market reaches full employment in late-2017 and the jobless rate hits a cycle low of 4.5 percent. Also, income growth is gaining momentum and credit remains cheap. The aerospace industry will also enjoy strong global demand for fuel-efficient civilian aircraft that will keep its backlog of orders large. On the military side, the prospect of increased defense spending by the new administration is raising hopes that steel demand for use in military hardware will improve.

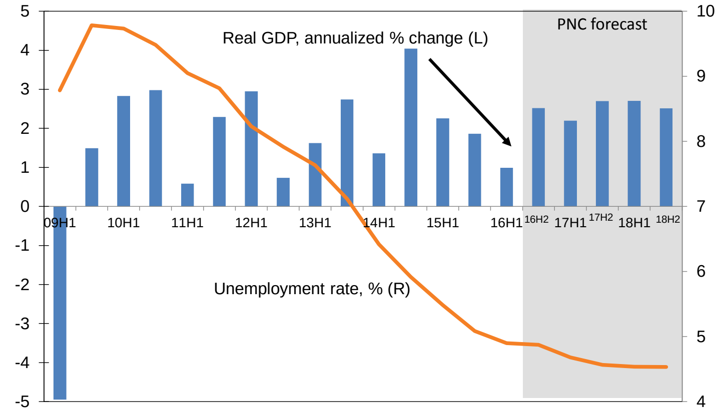
Despite the upbeat projection for economic growth and steel demand, downside risks to the outlook are mounting. Trade disputes in addition to a rapidly appreciating dollar could cut into exports and weigh on economic growth (Chart 11). The probability of recession could increase in 2018 as a large fiscal stimulus is combined with a tight labor market. This could lead to faster than expected inflation. In response, the Federal Reserve could be forced to raise interest rates quickly which could kill the expansion (Chart 12).

Chart 1: U.S. Steel Demand By Source



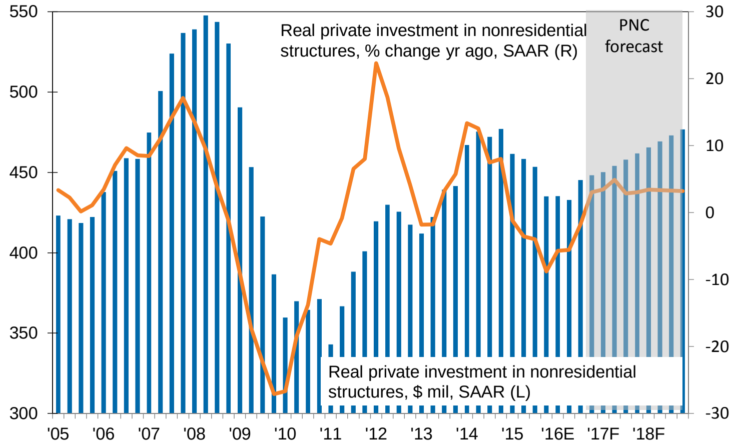
Source: American Iron and Steel Institute

Chart 2: Economy Bouncing Back from Extended Deceleration



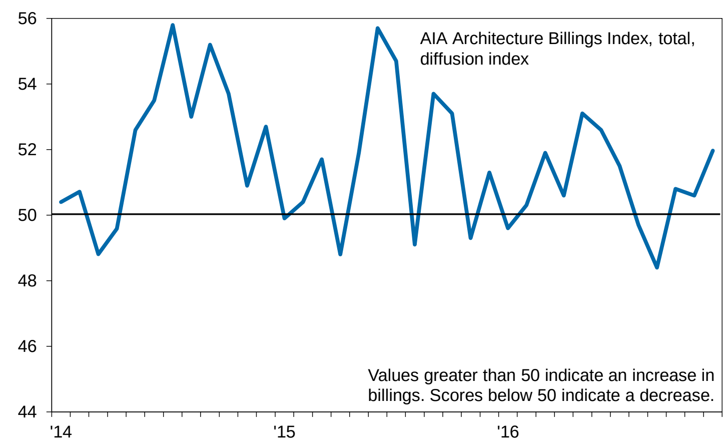
Sources: Bureau of Labor Statistics; Bureau of Economic Analysis; PNC

Chart 3: Fiscal Stimulus Will Boost Nonresidential Construction



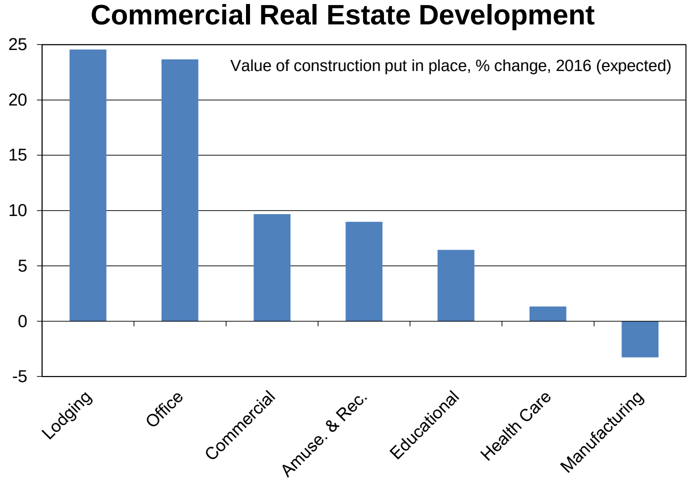
Sources: Bureau of Economic Analysis; PNC

Chart 4: Increased Architecture Billings Point to More Construction



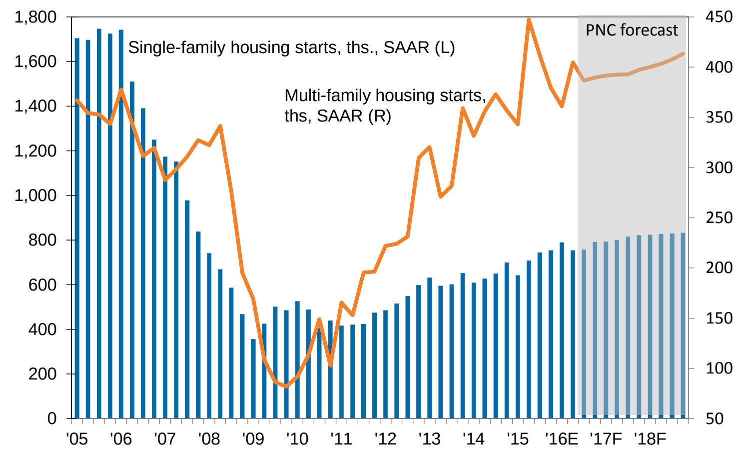
Source: The American Institute of Architects

Chart 5: Maturing Economic Expansion Lifts Commercial Real Estate Development



Source: Census Bureau

Chart 6: Residential Real Estate Continues to Heal



Sources: Bureau of Labor Statistics; Bureau of Economic Analysis; PNC

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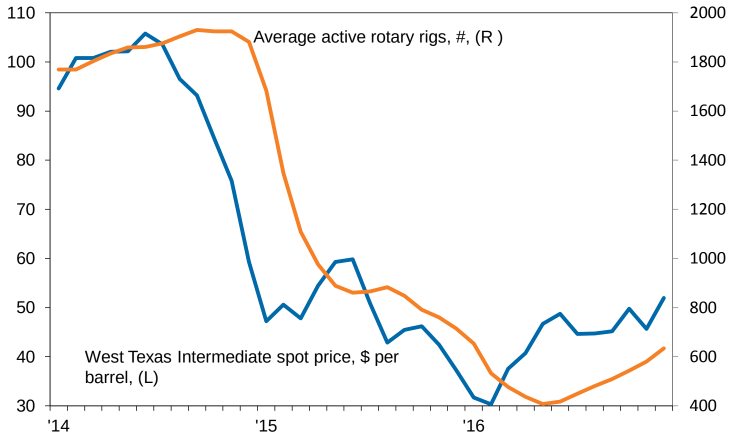
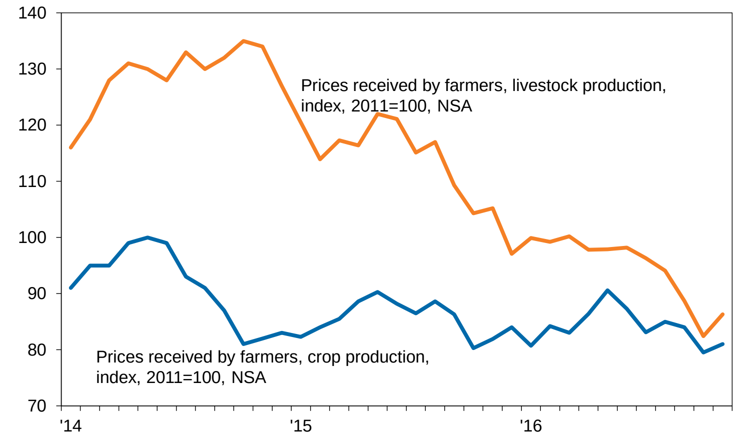
Chart 7: Prices Are Not High Enough to Spur Large-Scale Investment



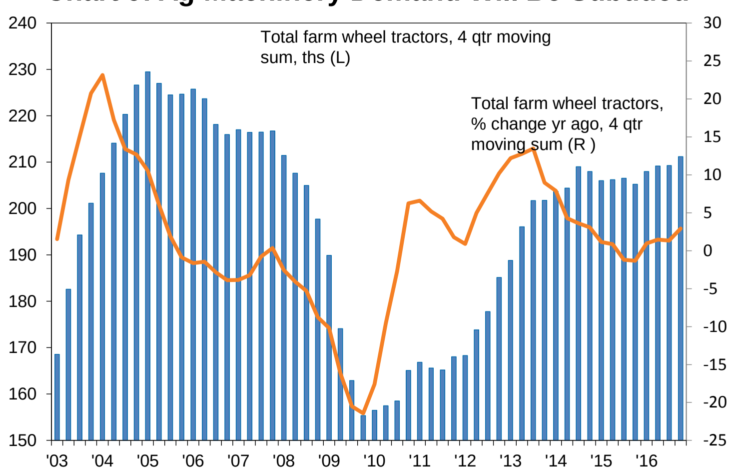
Sources: Energy Information Administration; Baker Hughes Incorporated

Chart 8: Recovery of Farm Incomes Still A Ways Off



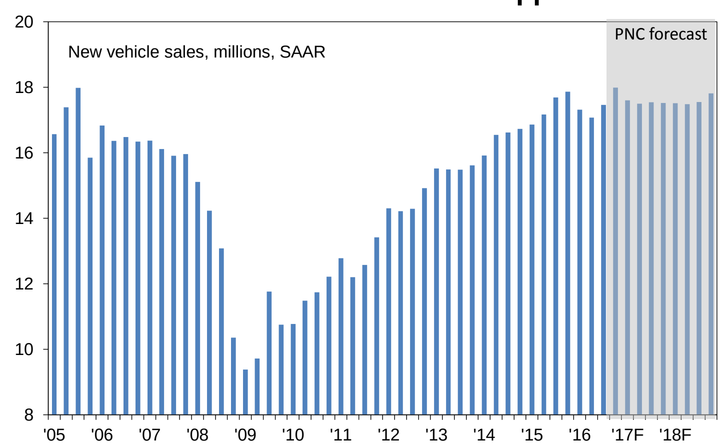
Source: U.S. Department of Agriculture

Chart 9: Ag Machinery Demand Will Be Subdued



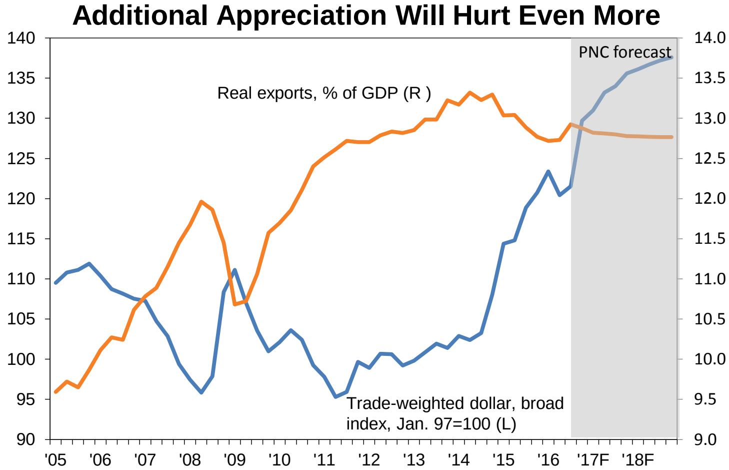
Source: Association of Equipment Manufacturers

Chart 10: Pent-Up Auto Demand Satisfied But Strong Consumer Fundamentals Still Support Sales



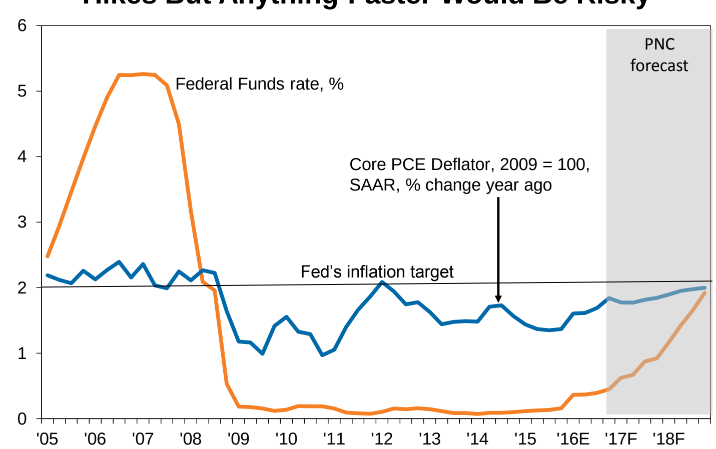
Sources: Bureau of Economic Analysis; PNC

Chart 11: Strong Dollar Will Pressure Exports, Additional Appreciation Will Hurt Even More



Sources: Bureau of Economic Analysis; Federal Reserve; PNC

Chart 12: Baseline Forecast Calls For Slow Rate Hikes But Anything Faster Would Be Risky



Sources: Bureau of Economic Analysis; Federal Reserve; PNC

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