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China Update

These letters began with a discussion of China and its influence on our steel industry. In subsequent letters we have noted the implications of the Chinese economy on many, many facets of our own. This month, China again figured in the news, as it was reported that it holds large amounts of debt issued by Fannie Mae and Freddie Mac, debt that is now explicitly backed by the U.S. government. The subject of our last letter, gloom and doom economist Nouriel Roubini, likes to point out that the Chinese, along with our other major foreign financiers Russia and the Gulf States, are rivals, not allies.

So what's the latest on China? Where are they going? What are they doing?

For predictions on China's future, you will have to look elsewhere. But we have seen some interesting developments that may offer some clues.

First, we saw in the Olympics that China's self image is one of achievement and confidence. They were able to use their huge population, their state controls, their talent and their desire to put on a world-class show. However much we and the rest of the world were impressed, you can bet that the Chinese were even more taken with their accomplishment, and this pride is bound to affect their behavior on many fronts, including economic policies.

It also appears that the Chinese domestic economy continues to realize substantial growth. No one should expect that their economy, unlike every other, will not suffer set backs and down turns. But the trends are very positive and should auger well for continued growth. (Some say that we talked the same way about Japan in the 1980s, suggesting that that country's economy was about to take over the world. Japan quickly sunk into a decades long slackening of growth, largely because of their real estate bubble and inability to deal with their financial institutions. Unlike Japan, China is far from a mature economy and has vast untapped markets it can continue to develop – it is like the Japan of the 1950s, not the 1980s.)

China's foreign exchange reserves have exploded. When we began these letters in February 2004, their reserves were $427 billion; by June 2008, they stood at $1.809 *trillion*, a four-fold increase. Looked at another way, that's about $1,400 for each of China's 1.3 billion inhabitants. China's reserves have traditionally been created by trade surpluses and direct investment from abroad. Now, however, those sources account for only about a quarter of the recent increases. Many believe that the lion's share is from so-called "hot money" from speculators focused on the increased value of the yuan and the widening spread between U.S. and Chinese interest rates.

Whatever the causes, these reserves make China the banker for the world, and especially for the United States.

On the trade front, China continues to enjoy huge surpluses with the U.S. But, recently, the tide (or tidal wave) has started to moderate. U.S. exports to China have grown by almost 75% since 2005 (still only about half of what we sell to Mexico and a quarter of our sales to Canada). Our imports from China were also up in those years, but only by 26%, and imports could actually decline in 2008 for the first time in over 25 years.

Some explanations for the slightly improving trade balance with China include the declining U.S. economy and the increased value of the yuan, but a new factor has unexpectedly come into play – high oil prices. As a result of higher fuel prices, it now costs about $8,000 to ship a 40 foot container from China, compared to $3,000 in 2000. The *Washington Post* recently reported the experience of one company making inexpensive sleeping bags that sell for $9.99 in discount stores across the country. The new world of ocean freight rates meant that it costs $4.44 just to bring the product to this country – freight rates priced the Chinese out of the market, even with their cheaper labor advantage. The company brought its production back to Alabama and can make the bags for 4 to 5 percent below their costs from China. Since fuel costs are not likely ever to return to 2000 levels, the cost calculations leading companies to move production to China are today often obsolete. The *Post* gave some examples of other companies bringing production back to the U.S. or Mexico.

China's response to these developments will probably follow the pattern of Japan and the newly industrialized countries of Asia – upgrade the product mix. It is hard to recall that Japanese goods used to mean cheap and low quality. The country that sold us toys and textiles now supplies the Lexus, Sony tvs and Nikon cameras. In the steel sector, the pattern has been the same, from rebar to the most sophisticated cold rolled sheet. Korea and Taiwan are on this path, and China is pretty sure to follow, particularly as the unit costs of transportation go up.

One thing from all this is pretty clear. China isn't going away. More and more, we shall have to take their economic power into account, and that leaves aside all the political issues they will influence.

Now for some specifics for this month:

- Scrap and Pig Iron. Both #1 dealer bundles and #1 busheling (Chicago) continued their price slide to $510 and $570 per mt, respectively. The price decline (of 40% and 33%, respectively) is perhaps the largest swing we have seen, certainly in dollar terms. Pig iron (spot price for Brazilian product, cif New Orleans) was also down, from $830 per mt to $650, or 22%.

- Natural Gas. The Nymex price for natural gas declined by $1.18 to $7.68 per mcf. Futures buyers have been spooked by the likely decline in economic activity here at home and abroad, just as they have been in the crude market.

- Ocean Freight. Slowing economies have also reduced demand for heavy tonnage carriage. The Baltic Capesize Index stood at 7496, well under half of what it was only three months ago.

- Exchange Rates. Even with all our woes, the dollar strengthened over the last month. As of this writing, the euro is at $1.43, down five cents from last month, the pound is worth $1.82, off two cents, and the Canadian dollar is off a penny at $0.94.

These price declines are not unalloyed good news, since they appear to be a reaction to faltering economies around the world. Moreover, for most companies, which had to buy raw materials at higher prices, the declines will cause a hit to the bottom line as finished products are made with high priced input inventories.

Let us continue to hear from you with thoughts and suggestions for these letters. This one, like all our others, will be posted on our website, www.coreysteel.com, and on the international site, www.steelonthenet.com.