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ENERGY APPETITES – – MORE CUSTOMERS IN LINE

Our very first letter described China as the then key factor in the economics of world steel trade. Our reports since then have confirmed this point with a variety of statistical evidence showing what a steel producing behemoth China has become.

We are now seeing another area – energy – where China's appetite is changing the economic ground rules. It has become plain that Chinese demand is an important cause of the run-up in crude oil and associated energy costs. What is more, that demand appears to be on a one-way ratchet; whatever its peaks and valleys, the long-term trend is for ever-increasing claims by the Chinese on world petroleum and gas supplies. And other potentially large consumers of energy, like India, have yet to be heard from. Thus, it is very unlikely that we will ever see our energy costs revert to the levels of just a year or two ago, and they will probably increase, over time, to well above current levels.

This development would represent an important change from past energy "crises," which were caused by short term events, like OPEC actions, freak weather and refinery bottlenecks. In those cases, even severe dislocations were viewed as more or less temporary. And equally important, the effects of shortages were continuously being mitigated by energy conservation measures, particularly by the manufacturing sector, in the industrialized countries. Those countries also began producing consumer products that were more energy efficient, spreading conservation widely. Whatever long term trends that existed could thus be countered by increased efficiencies.

The one area where we in the U.S. have failed to address the long term implications of rising energy costs is, of course, in the automotive sector. The improvements that have been made through more efficient engines and hybrid vehicles have been more than offset by the American yearning for gas guzzlers, so that we are worse off than we were twenty years ago on a per vehicle basis and, of course, we are driving more vehicles. (In 1985, the average mileage per car for the entire fleet was 25.4 mpg; for 2004, it was 24.7.)

In 1940, a college-aged John F. Kennedy wrote "Why England Slept," which described how it came to be that England left itself so unprepared for World War II. One hopes that another young man will not be called upon to explain how our country left itself unready to address the economic challenges of the 21st Century.

Now, a look at the specifics of steel trade:

- Scrap. Prices for #1 dealer bundles and #1 busheling (Chicago) bounced up in early April to \$270 per mt. This was a 12% increase from the prior month's levels, but still a far cry from the roughly \$400 per mt that obtained in the six months from last August through January. Scrap exports for 2004 were 12 million mt, double what they were in 2002. Exports have increased for the past five consecutive years.
- Pig Iron. The spot price for Brazilian pig iron (CIF New Orleans) also rebounded last month, to \$310 per mt. That price has not declined nearly as much in recent months as the prices for scrap. Indeed, it was reported that Brazilian producers are seeking to pass along a recent increase of \$30 per mt in the price of iron ore.
- Ocean Freight. The Baltic Capesize Index held steady at last month's 6605 (compared with 2700 two years ago).
- Natural Gas. For the third straight month, the Nymex contract price went up and is now at \$7.59 per mcf. We are still a dollar away from the record set last November, but the price has increased by \$1.80 since January.
- Exchange Rates. The dollar has strengthened somewhat against the euro and the pound, but the trend now seems to be reversing. As of this writing, the euro was at over \$1.30. The Canadian dollar has been strengthening the last couple of months and now stands at 82¢.

- Pricing. The inventory overhangs continue to subdue pricing for steel products. Nucor reportedly canceled a \$20 per ton increase in sheet products that it had announced earlier in the year. Similarly, European announcements of price increases have been withdrawn. And Canadian producers have asked for government help in meeting demands for price reductions made by the major automakers. Chinese demand is continuing to be high, even though production is projected to hit 322 million mt in 2005, an 18% increase over 2004. One expert suggests that this demand will curb exports, and another has suggested that there will be a firming in the U.S. market as a result.

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