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NOTABLE NEWS EVENTS

A couple of recent news reports gave rise to some thoughts about the present state of our economy.

The first was the statement by a rebel group in Nigeria that it will be attacking installations of foreign oil companies with the aim "to prevent Nigeria from exporting oil". Among the targets were the residences of employees – "We know where they live, shop and where the children go to school".

This message, with its barbaric threats, is yet further evidence how terrorism worldwide has changed our society. But the market's reaction to the threats tells another story about our dependence on far-flung outposts of oil reserves for our energy needs.

Most oil companies operating in Nigeria denied the allegations that they had been attacked and maintained that their operations were unaffected. Shell did acknowledge that four of its workers were being held by the rebels, and all the companies are taking security precautions. Last year, the rebel activities shut down about 40% of Nigeria's production for a short time.

The result of this news was a spike in oil prices to their highest level in four months. The unrest in Nigeria caused analysts to consider whether there are other sources that could take up the slack of any cut back in Nigeria. The prospects are not very good: Iran, the second largest OPEC producer, is embroiled in a dispute over nuclear policies that could lead to UN sanctions and decreased production. Venezuela, the largest supplier to the U.S., is not currently on the best of terms politically with our country. Iraq's production cannot supply its domestic needs. Severe cold in Russia has forced cutbacks in its output of crude oil and natural gas.

When these supply data are stacked up against the rising demand that we discussed in our last letter, the prospects are far from sunny. One can only hope that our policy-makers and energy users will wake up to the problem before we go much further down the road.

The second news report that has sparked some questions relates to our old friend China. One recent estimate stated that China's 2006 steel production would exceed demand by about 116 million mt (supply of 453 million mt vs. demand of 337million mt). This report was roundly criticized by the Chinese government, but there appears to be some truth in its suggestion that there will be a large overhang of steel supply from China.

First, China's announced five year plan for 2006-2010 aims at reducing crude steel capacity from the 500 million mt level projected for 2007 to 400 million mt. A current level approaching 500 million mt of crude steel production suggests that the report's estimate of 453 million mt of supply of steel products is at least in the ballpark. Secondly, the Metals Service Center Institute reported that inventories held by its members were at a 7½ year low. The main reason is said to be fear that price weaknesses in Asia will spread to the U.S.

The reported excess of Chinese production may be overstated, but even if it is off by a factor of two, the effects on world prices could still be ominous. An overhang of 58 million mt from a single country would still be huge. And we all know where those overhangs usually end up.

Here are the specifics on cost factors for this month:

- Scrap and Pig Iron. Number 1 dealer bundles and #1 busheling (Chicago) were off significantly from last month, declining $41 to $239 per mt. These prices remain well above the $150 range for the first half of 2003 and June/July of last year. Brazilian pig iron (cif New Orleans) also declined by $10 to $235 per mt. Faced with these declines, Brazilian pig iron producers are curbing production. Iron ore prices are expected to fall in 2006, as Chinese production is projected to exceed demand by some 12 million mt.

- Ocean Freight. No increase here from last month, and it appears that the rates have stabilized a bit. Over the last four months, the Baltic Capesize Index has moved up from about 4000 to 4300; this 7½% increase is modest by comparison with past swings.

- Natural Gas. Speaking of swings, we got the biggest dollar change in the price of natural gas that we have ever seen. There was a decline (thank goodness) of $3.80 per mcf in the Nymex price since the beginning of December. The early January price of $9.78 per mcf was the lowest since last August; however, it may be going up again in sympathy with the crude oil increases that have occurred since the first of the year.

- Foreign Exchange. The euro is up a penny to $1.21 and the pound is unchanged at $1.77 since we last wrote. The Canadian dollar declined 2 cents to 85¢.

We are always interested in receiving your thoughts and suggestions. As usual, we are posting this letter on our website, www.coreysteel.com and on www.steelonthenet.com.