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Politics, Policies and Prices – Budget and Sourcing Implications

14 March 2017

John Mothersole, Director, +1 202 481 9227, john.mothersole@ihsmarkit.com
John Anton, Senior Principal Economist, +1 202 481 9231, john.anton@ihsmarkit.com
Overview: Trade and policy issues and the current pricing environment

John Mothersole is a senior leader of the IHS Pricing and Purchasing team. He helps supervise the group’s price and wage forecasts, and is directly responsible as team lead for its nonferrous metal industry forecasts. In addition to his work with IHS clients, John has provided inflation analysis and industry commentary to various news organizations including the New York Times, Wall Street Journal, Washington Post, ABC News, Metal Bulletin, the American Metal Market, and the Engineering-News Record. He received his B.A. and M.A. in Economics from the University of Maryland. John is a member of the National Association of Business Economists. He has also been a member of Purchasing Magazine’s Commodity Council.

Steel: A long history of managed trade

John Anton is the director of the IHS Steel Service and is the ferrous-metals industry analyst for the firm’s Pricing and Purchasing Service. In addition to producing regular forecasts of steel production, demand, and price, he is also responsible for managing IHS’s relationship with major steel clients, including some of the largest mills in the United States, Japan, and Europe. He earned an economics degree from Florida State University and a law degree from the Marshall-Wythe School of Law at the College of William and Mary.
The latest pricing outlook

John Mothersole, Director, +1 202 481 9227, john.mothersole@ihsmarkit.com
Slow acceleration in growth but not necessarily in price inflation

• Global growth will pick up from 2.3% in 2016 to 2.7% in 2017, led by the US and commodity-exporting regions.

• US growth accelerates in 2018 as capital spending resumes and stimulus kicks in.

• The US dollar will appreciate across 2017.

• China’s economic growth will slow further because of imbalances in credit, housing, and industrial markets.

• The recent surge in commodity prices is [nearly] over. Prices look supported over the near-term but not under sustained pressure.

• Downstream, goods price escalation does see a bump in 2017 as recent commodity price increases feed through.
Global growth slowly improves

<table>
<thead>
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<th>2015</th>
<th>2016</th>
<th>2017</th>
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<td>0.3</td>
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<tr>
<td>Russia</td>
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<td>1.0</td>
<td>1.6</td>
<td>2.1</td>
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</table>
The rise in commodity prices and their downstream impact in China

IHS Materials Price Index
percent change year ago

Chinese goods prices
percent change year ago

-60 -40 -20 0 20 40 60
2012 2013 2014 2015 2016 2017

-60 -40 -20 0 20 40 60
2012 2013 2014 2015 2016 2017

-60 -40 -20 0 20 40 60
2012 2013 2014 2015 2016 2017

-6 -3 0 3 6 9 12
2012 2013 2014 2015 2016 2017

-6 -3 0 3 6 9 12
2012 2013 2014 2015 2016 2017

CPI, Consumer Goods, left
PPI, Consumer Goods, left
PPI, Means of Production, right
Chinese manufacturing growth will NOT accelerate -- suggesting support for prices rather than building pressure.

IHS Materials Price Index, 2002w1=1.0, left

Chinese Industrial Production, year over year change, right
$US strength is also a near-term fixture and represents another headwind for commodity prices

IHS Materials Price Index, 2002w1=1.0, left
US$ Trade Weighted Exchange Rate, 2009=1.0, right
The upward momentum in commodity prices breaks

**Crude oil, West Texas Intermediate**

- 2015: $50
- 2016: $60
- 2017: $65
- 2018: $55

**Polypropylene**

- 2015: 60 US cents
- 2016: 65 US cents
- 2017: 70 US cents
- 2018: 65 US cents

**Aluminum ingot**

- 2015: $1400
- 2016: $1500
- 2017: $1600
- 2018: $1500

**Natural rubber**

- 2015: 175 US cents
- 2016: 180 US cents
- 2017: 275 US cents
- 2018: 200 US cents
Potential impact of US trade policies

John Mothersole, Director, +1 202 481 9227, john.mothersole@ihsmarkit.com
Policy assumptions in IHS Markit’s US forecast

• A reduction in the statutory corporate income tax rate from 35% to 20%, partially offset by fewer tax credits, starting in 2018
  • No border adjustments
  • No expensing of capital expenditures

• Personal income tax reforms that lower the average effective federal tax rate from 21.0% to 19.5% starting in 2018

• An increase in public infrastructure investments totaling $250 billion over 10 years

• Federal Reserve policy rate increases of 75 basis points in each of the next three years, bringing the rate to a long-term equilibrium of 3%
The House Republicans’ plan for US corporate tax reform: A border-adjusted cash flow tax

• The principal goal of US corporate tax reform is a reduction in the federal corporate tax rate from 35% to 20% or lower.

• The House Republicans’ plan would transform the corporate income tax into a destination-based cash flow tax that exempts the full value of exports but includes the full value of imports in the tax base.

• This is essentially a tax on domestic consumption. It differs from a value added tax (VAT) by allowing a deduction for domestic wages and salaries—resulting in a smaller tax base.

• Border adjustment would raise tax revenues (about $100 billion per year), helping to finance a reduction in the corporate tax rate.

• A major uncertainty is the extent to which the dollar would appreciate to offset the price effects from border adjustment.
Pros and cons of a border-adjusted cash flow tax

Arguments in favor

• Taxes domestic consumption
• Neutrality regarding location of production
• Removes incentive to shift profits or activities outside US
• Currency appreciation would offset price effects
• Raises tax revenue since US imports exceed US exports

Arguments against

• Tax burden falls on consumers if exchange rates don’t adjust
• Low-income households hit hardest by rise in import prices
• Disruption of supply chains
• Dollar appreciation changes asset and liability values
• May violate WTO rules, which allow border adjustment for indirect taxes, not direct taxes
• Could raise inflation by one percentage point in 1st year
The US president has broad powers to regulate international trade under existing statutes

- **NAFTA Implementation Act of 1993**: Withdrawal with six months notice, return to Most Favored Nation (MFN) tariffs, additional duties after consultations with Congress

- **Trade Expansion Act of 1962**: Impose tariffs or quotas after finding that imports have an adverse impact on national security

- **Trade Act of 1974**: Impose tariffs up to 15% and/or quantitative restrictions for up to 150 days against countries with large balance of payments surpluses; broad discretion if a country carries out practices that are unjustifiable, unreasonable, or discriminatory

- **Tariff Act of 1930**: Arguably supplanted by the Trade Act of 1974. Allows for duties of up to 50% on imports from countries that have “discriminated” against US commerce. Such a finding would be difficult against a WTO member.

- **Trading with the Enemy Act of 1917**: In time of war, powers to regulate international commerce, freeze/seize foreign-owned assets

- **International Emergency Economic Powers Act of 1977**: In a national emergency, powers similar to 1917 act
## Effective import tax rates

<table>
<thead>
<tr>
<th>Emerging Markets</th>
<th>Developed Economies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>31%</td>
</tr>
<tr>
<td>India</td>
<td>31%</td>
</tr>
<tr>
<td>China</td>
<td>27%</td>
</tr>
<tr>
<td>Russia</td>
<td>26%</td>
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<tr>
<td>Mexico</td>
<td>23%</td>
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<td></td>
<td>UK</td>
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<td></td>
<td>France</td>
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<td></td>
<td>Japan</td>
</tr>
<tr>
<td></td>
<td>USA</td>
</tr>
</tbody>
</table>

*Value-added tax (VAT) plus average tariff

Source: NYTimes
Unilateral versus a bilateral or multilateral approach to trade policy?

### US Imports (by value, percent of total)

<table>
<thead>
<tr>
<th>Top 5 Countries of Origin</th>
<th>US Imports from Mexico, Top 5 Industries</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>Vehicles (HS code 87)</td>
</tr>
<tr>
<td></td>
<td>Electrical machinery (HS code 85)</td>
</tr>
<tr>
<td>Mexico</td>
<td>Non-electrical machinery (HS code 84)</td>
</tr>
<tr>
<td>Canada</td>
<td>Instruments (HS code 90)</td>
</tr>
<tr>
<td>Japan</td>
<td>Furniture, bedding, lamps (HS code 94)</td>
</tr>
<tr>
<td>Germany</td>
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</tbody>
</table>

#### US Imports from top 5 countries (percent of total)

<table>
<thead>
<tr>
<th>Vehicles (HS code 87)</th>
<th>Electrical Machinery (HS code 85)</th>
<th>Non-electrical Machinery (HS code 84)</th>
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<tbody>
<tr>
<td>Mexico</td>
<td>China</td>
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<td></td>
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<td>South Korea</td>
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<td>Canada</td>
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<tr>
<td></td>
<td>7.5</td>
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</tr>
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</table>

All data for 2016

Source: IHS Markit Global Trade Atlas
Lumber tariffs in sight

• Recent rally one of the largest short term gains in 20 years.

• Increases are being driven by 90-day retroactive duty period on potential anti-dumping and countervailing duties

• Prices will peak in Q2 with the establishment of a new duty regime

• Delay purchases for now

• Risks to the upside

• Despite the upward revision to our forecast, prices will be volatile.

• Prices may overshoot especially before a duty decision in April
Steel: A long history of managed trade

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Can trade protection actually have an impact? Yes.

• In late 2015, the United States imposed 532% duties on Chinese sheet steel
  • 266% anti-dumping, 266% countervailing duties
• Imports from China plummeted, and are now barely in the system
• Duties are normally 5% to 75%
  • 15% to 20% cuts tonnage
  • anything over 30% is effectively exclusionary
• Anti-dumping and CVD duties last for five years
  • And are almost always extended for another five
• Thus, expire in 2025

US imports of Chinese sheet steel

Source: IHS Global Trade Atlas
What to expect from United States and other key players

• United States
  • Trade cases will be easier for steel mills to win
  • Buy America will be expanded and strengthened
    • All federal construction, possibly state and local
    • Attempt to impose Buy America on pipeline projects
  • Conflict with the World Trade Organization (WTO)

• Other importers
  • Anti-dumping cases will expand to prevent diversion from the United States
  • India, Canada, EU, Brazil, Mexico, others

• Exporters
  • Prices will be weaker, keeping alive a discount to US and Europe
  • Production must be cut to offset loss of exports, or prices will plummet
What products are impacted?

• Most steel protection is not against all steel, and likely never will be
• Instead, the primary tools (anti-dumping and countervailing duties) are specific
  • By product
  • By country
  • And often by company
• An partial example of protection currently in place
  • United States – sheet, plate, OCTG, wire rod, stainless
  • Europe – sheet, plate, stainless
  • India – sheet, stainless, wire rod (many Indian duties are short term, but often renewed)
  • Brazil has local content rules more than anti-dumping, broadly impacting many products
The bottom line on trade for steel buyers

• Watch out for tighter supply, although only the most extreme and frankly unrealistic scenarios would lead to shortages.

• Prices will be higher, but the impact will not be catastrophic. Look for +10%, but risk is to the upside.

• Current trade protection already makes life more difficult but there are partial work-arounds.

• Protection will likely grow even stronger in coming years, and workarounds may be harder.

• Objecting after the fact won’t do much good.
What about the basic outlook for steel in 2017?

**Prices** – will begin to fall in the second quarter, with flat products falling more than longs

**Demand** – rising slowly and will not put pressure on prices

**Supply** – is ample to meet global needs

**Protectionism** – keeps prices 5% to 10% higher in importing countries
The current raw material cycle

Coal prices tripled
- Speculators (foolishly) thinks if it happens to coal, it should happen to iron ore
- Scrap buyers (rationally) turned from semi-finished to scrap

Coal prices dropped
- Weather improved
- China relented on mine slowdowns

Iron ore will drop
- Inventory at all time record
- China is not booming

Scrap trails ore
- Lower ore prices mean lower semi-finished after a month or so
- Mills will switch away from scrap, after a bit of delay
Met coal, FOB Australia

US dollars per metric ton

Scrap and ore

Source: History Argus/MetalPrices.com, forecast IHS

Source: History Argus/Metalprices.com, forecast IHS
Hot rolled coil
US dollars per metric ton

Rebar
US dollars per metric ton
Thank You Questions?

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