



Steel Industry Outlook

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Executive Summary

2017 has been a far superior year for U.S. steel manufacturers than the past few years. A pickup in global demand trends, particularly around Europe and developing nations, coupled with underlying industrial strength in the U.S., has led to stronger U.S. steel prices YoY. We believe the vast majority of the U.S. market's relative stability in 2017 was attributable to robust domestic demand in China driven by strong investment in China's infrastructure and property markets. Currently Chinese domestic hot-rolled coil (HRC) is ~20% higher YoY, a constructive sign for the global steel industry considering China represents 50% of worldwide production despite its domestic market consuming only 43% of the steel produced. Capacity utilization has also improved with the U.S. market registering above 70% since January 2017. With 2017 behind us, we see positive directional trends emerging as we enter calendar 2018.

Investment Rationale

We believe several U.S. steel companies have guided to a weaker Q4-2017 YoY due to input costs that have risen faster than steel selling prices. Hence Q4-2017 results are likely to be marred by input cost inflation and margin compression with the potential to recover in Q1-2018 if recently-announced selling price increases stick. Accordingly we believe the market is likely to be disappointed with Q4-2017 earnings yet bond prices are likely to recover given the more optimistic Q1-2018 outlooks from domestic steel companies.

We believe the demand outlook for the U.S. moving forward is broadly positive and strengthening given positive steel indicators such as improving capacity utilization and higher U.S. domestic pricing amid a stable supply environment aided by China's pollution-driven supply curtailments during the winter months. Given our expectations for a stable organic demand environment in the U.S. in 2018, we believe that performance in 2H-2018 is likely to be more dependent on China's steel demand maintaining equilibrium with supply, otherwise the risk exists that the U.S. market may once again become inundated with imports absent any serious legislation restricting imports. That said, should demand trends wane in China in 2H-2018, we believe the government is still more likely to implement additional stimulus measures to counteract a recession. Against this mixed backdrop, we recommend that investors are overweight the U.S. steel industry in 2018. While we concede that earnings in Q4-2017 are likely to be softer than expectations, we feel they are more likely to present a buying opportunity for investors who are willing to tolerate potential supply-driven risks associated with Chinese fiscal tightening.

Initiating on ArcelorMittal's (MTNA) USD-denominated bonds with Buy ratings

We initiate on all of MTNA's USD-denominated bonds with a Buy rating owing to our belief that the company will benefit from increased cash flow in 2018 on the back of stabilizing to growing global demand trends and apply that cash to further deleverage the organization. Management continues to make achieving IG credit ratings its highest priority. With a FCF yield greater than 20% amid minimal 1.5x net leverage and an almost entirely unsecured capital structure, we view MTNA as likely to achieve IG ratings at some point in the near-term. Therefore we believe the bonds will trade closer to IG indices than HY indices going forward and see MTNA as a "rising star."

Risks:

Risks to the downside include growth-oriented M&A, slowing Chinese demand trends, input cost inflation, a reversal of MTNA's decision to achieve IG ratings, softer global economic trends, regulatory changes and lower steel prices.