Lumber Market - Status & Trends

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Henry Spelter, Forest Products Laboratory

U.S. End Use. The artificial U.S. economic recovery is stuttering. Artificial because rather than organic advances in investment and private sector activities, it is largely propelled by government deficit-based spending. With the national debt closing in on GDP, the public sector though is starting to be constrained by mounting concerns over the rising debt. The greatest ramifications of this are at the state and local government levels where a looming $200 billion deficit likely means coming layoffs and other stringency measures. Austerity is also being applied in Europe but with few benefits in terms of improved credit ratings or financing costs.

A deceleration in the U.S. Money supply is also evident. When you save and invest, your savings circulate and money supply grows. If instead you pay down loans, money is extinguished and its supply shrinks. This seems to be happening as deleveraging, reducing debts relative to assets, is placing economic activity on a slower path. To compensate, some sector ought to show strength. Often this falls to exports but problems in Europe and a stronger dollar are inhibiting this. Private investment is also weak from the residue of previous overbuilding and feeble final demand.

That leaves government as the spender of last resort. That could make sense had the public finances been managed counter cyclically with spending held down and debts paid off in the boom to allow greater spending in the bust. But piling on debts in good times and bad has reduced the margin by which government can spend more than it has and still retain credibility. Thus we arrive at the present impasse where an extended period of subpar growth and slack employment opportunities is the likely outcome, a sort of catch-22 where we can't spend our way out of the morass safely due to over indebtedness but growth is slowed for lack of demand.

Shipments. Inventories between mills' loading docks and end users' work sites typically fall by about 200 million board feet in June. This year I estimate they increased by 65 millions. The decisive element was the higher share of Canadian shipments that was U.S. bound to take advantage of the duty free window. Part of that flow was makeup for shipments deferred from May and part was brought forward from July. The overall rate of shipments, however, was not excessive either in Canada or the U.S. and actually decelerated when two extra working days are factored in.

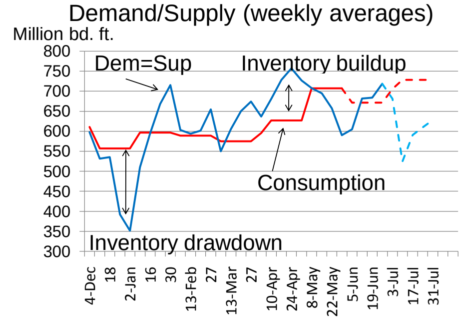
Trade. Duties on Canadian "Option A" exports to the U.S. resume at 10% in July and 15% in August. The surge triggers and quotas will also be reactivated. June exports to the U.S. increased by a third over May and, like clockwork, surged at the end. These are certain to be choked back in July, though unclear as to how much. On the U.S. side, lumber exports showed the largest year/year gain in over a decade, rising by 42% through April, though this wood consists of higher grades than the domestic mix and thus does not redirect much commodity lumber away from domestic markets.

Margins. At the end of **June** SPF margins turned negative, though likely still cash positive. With a 10% tariff both become negative. Margins in the south were close behind but a little better while west coast margins were the worst. Weaker construction slowed gains in end use while falling prices made holding inventory prohibitive. The excess volumes shipped from Canada were likely warehoused in re-loads where they dampen any urgency to restock farther down the supply chain. Stabilization requires that overhang to be worked off in the weeks ahead. Figure 1 indicates the approximate balances between supply and demand through June and outlines what likely needs to happen to assure buyers that the excess volumes are being drained. For the dashed blue line to be realized, U.S. shipments have to remain at June's reduced pace, which is likely given the slew of curtailments, and Canadian imports need to revert to May's rate of 35 mmbf/day, which is also possible with upcoming vacations (figure 2). On the demand side end use would need to recover to 700+ mmbf per week. That is discussed overleaf.

End Use	Mar	Apr	May	Jun	y-t-d	% chg
30-yr Mortgage	5.0%	5.1%	4.9%	**4.8%**		
Home starts (thou)	634	659	**593**	**602**	**618**	16%
New home sales	389	446	300	**n/a**	366	4%
Exist home sales	5,360	5,790	5,660	**n/a**	5,374	15%
All unsold units	3,854	4,243	4,105	**n/a**	3,895	-5%
Lumber use (mil)	2,644	2,759	2,828	2,954	**15,926**	5%
Shipments (million board feet)						
Canada	1,824	**2,017**	**1,757**	**1,872**	**10,825**	13%
U.S.	2,120	2,342	**2,026**	**2,069**	**12,290**	3%
Can shipmnts/cap	70%	**81%**	**78%**	**75%**		
U.S. shipmnts/cap	59%	68%	**65%**	**60%**		
Trade (million board feet)						
Can to U.S.	825	851	750	**995**	**4,747**	16%
Other to U.S.	34	40	**50**	**50**	**243**	-23%
$US/$Can	0.98	0.99	0.96	**0.97**	**0.97**	17%
$US/Euro	1.36	1.34	1.26	1.22	1.32	-1%
Gross mill margins						
BC int dim	24%	34%	26%	**1%**	**21%**	-Nm-
Ontario stud	8%	19%	21%	**2%**	**9%**	-Nm-
Oregon dim	5%	18%	4%	**-15%**	**4%**	-Nm-
Montana dim	26%	40%	32%	**7%**	**24%**	-Nm-
Alabama dim/tim	31%	49%	54%	**18%**	**30%**	-Nm-
Georgia dim	30%	46%	44%	**5%**	**25%**	-Nm-
Texas dim	25%	44%	39%	**2%**	**21%**	-Nm-

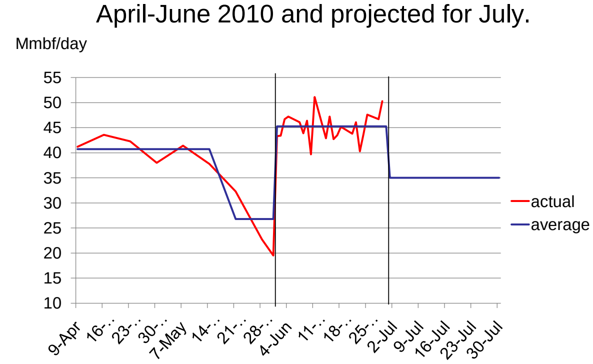
Note: numbers in **boldface** are preliminary estimates.

Figure 1. - U.S. Consumption (monthly averages), Demand/Supply (weekly averages)



WWPA, SFPA, StatCan, Spelter estimates

Figure 2. - Canadian lumber exports to the U.S., April-June 2010 and projected for July.



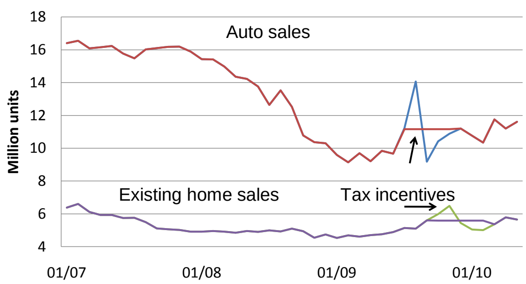
Source: DFAIT, Spelter

Topic of the Month: Housing at midyear

Henry Spelter

The government's $8K/6.5K home buyer credit expired in April and real estate activity collapsed like a badly cooked soufflé. That was expected. What is hoped is that it will spring back in a couple of months as the line for unmet housing needs reforms. The experience with auto sales when the cash for clunkers program ended supports this (figure 1). That program, at high cost, did jolt activity temporarily but in reality mainly rescheduled it. The first homebuyer tax credit last fall had a similar effect. Given these precedents, the fears that home sales will disappear into a sinkhole after the tax credits seem overwrought.

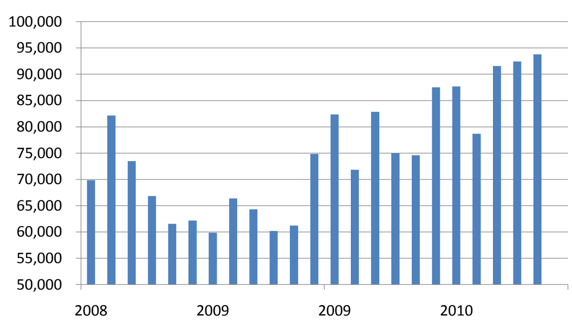
Figure 1. – Automobile and existing home sales – Impact of tax incentives



Source: St Louis Fed

That said, the expectations for housing at the beginning of 2010 were modest at best and remain so. A worrisome trend is a rise in bank repossessions of foreclosed homes (figure 2). This suggests that lenders are starting to dispose faster the backlog of distressed properties that have built up since real estate imploded in 2006/07. According to reports and authoritative bank analyst Meredith Whitney these properties are being put on the market at a faster clip, leading to increasing pressure on real estate values.

Figure 2. – Number of foreclosed home repossessed by lenders ("REO" properties)

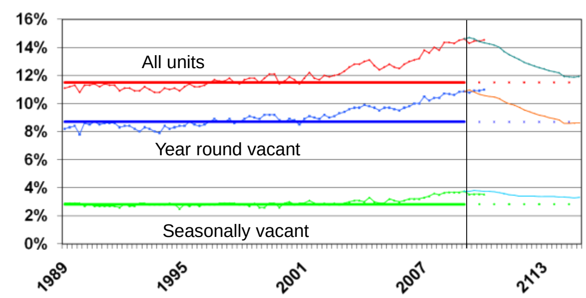


Source: Realty Trac

So called strategic defaults are a growing problem for lenders also and will likely become more so if prices take a renewed hit. Retail sales and personal consumption expenditures have grown nicely since early 2009 despite lackluster wage and job growth. One of the possible reasons for this is that a growing number of distressed homeowners have chosen to stop paying their mortgages, essentially living rent free for a year while the foreclosure process drags on and spending the savings. This boosts consumption but drags down banks' finances. A recent report found a 53 percent increase in such defaults in the first half of 2009. Mortgage securitizer Fannie Mae was compelled to warn last week that it would sue those who have the capacity to pay but walk away as well as bar them for seven years from obtaining new mortgages backed by it. About a quarter of mortgages have higher values than the underlying homes are worth and the temptation to default will increase if prices take a renewed dip, likely making these threats ineffective.

Underscoring the problem is the ongoing overhang of excess homes, whether of the advertised variety or the hidden, shadow inventory kind. This is encapsulated by the Census' quarterly survey of households which continues to show the overhang of vacant units barely dropping from its peak level in the first quarter of 2009 (figure 3). In fact the share of properties that are vacant year round hit a peak of 11% in the latest report, well above its 8.7% historical average.

Figure 3. – Shares of U.S. homes that are vacant, 1989-2010 with projection to 2015



Source: U.S. Census, Dept. of Commerce

Against this negative backdrop we need to remember that the underlying population demographics favor greater new home demand. The average yearly number of households formed over the last 40 years was nearly 1.2 million. In 2009 it was a negative 60 thousand as high unemployment caused people to move into more dense living arrangements. So far through March that number has rebounded by 350 thousand.

In summary, housing is in the throes of withdrawal from the tax credit. Still excessive backlogs of overvalued dwellings threaten to erode prices in a vicious circle. Also ongoing is a less than spectacular recovery which is holding back job creation, the ultimate cure for depressed demand. Population basics, however, favor higher activity of around 1.5 to 1.6 million units (one- and multi-family). Absorbing the overhang of about 3 million year-round vacant units should pave the way for a return to those levels. That, however, could take two or more years during which activity will lag potential. In the meantime, wood producers have to face the fact that capacity, despite 15% shrinkage, is still in excess. The onus is on them to manage supply, to have awareness of inventory swings, take opportunities when they arise but not get seduced by temporary surges. All easier said than done.

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