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Economic Environment

"2001 Lumber Market Outlook" by Al Schuler

REVIEW OF 2000

The past year has been a classic case of too much lumber. Unfortunately, in commodity markets, this is the "nature of the beast." Three years of record housing activity, attractive interest rates and a booming economy drove demand for building materials, including lumber, to modern day records. In fact, we saw outright shortages of some materials like wallboard and bricks. Materials were not the only items in short supply. Many builders had trouble finding experienced framing crews—a problem that is still evident today. Prices have started pulling back after they peaked in the second quarter of 1999. This process will continue until market balance returns.

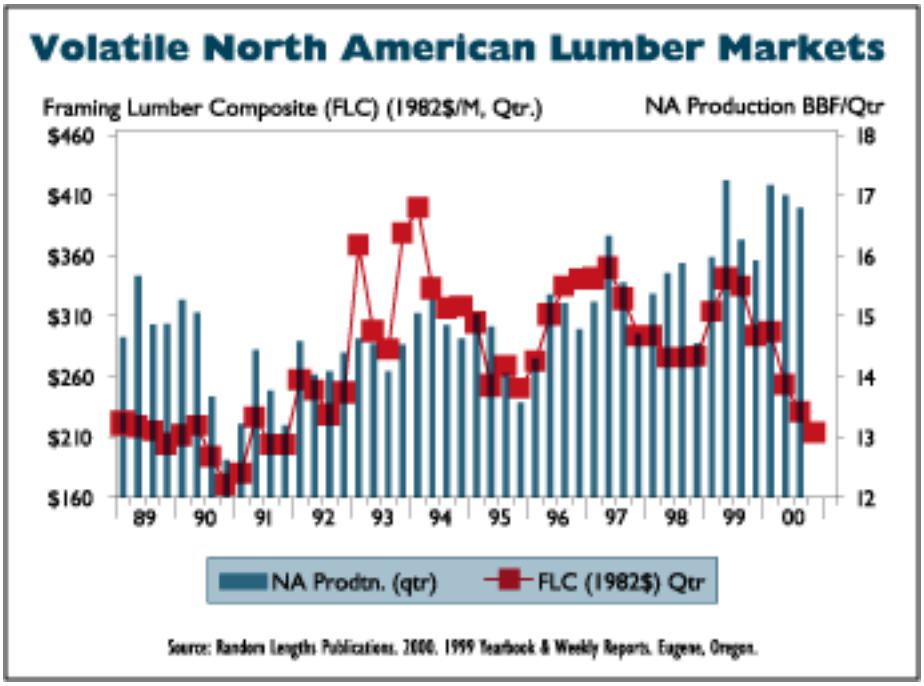

FIGURE 1
CLICK ON IMAGE FOR LARGER VIEW

The late 1990's were the best of times, but as is often the case, the boom/bust commodity lumber cycle has shifted. In 2000, supply caught up with demand as the economy began slowing in response to Federal Reserve (FED) rate hikes. Prices fall when this happens. But, because mills can't curtail production very quickly (logistical problems like avoiding

layoffs, union pressure, etc.), the market imbalance continues (see Figure 1). There are other reasons why mills keep producing: (1) some believe they have a competitive cost advantage; (2) some have differing views of the immediate future; and (3) some simply have deeper pockets. Eventually, prices will stop falling when the market tightens—supply drops to meet the new demand.

This sounds simple, but in the real world, demand and supply are never in sync due to the reasons mentioned above. When lumber prices get too high, builders substitute by using alternative building materials like I-joists, LVL, glulam, trimmable end trusses, roof trusses, steel studs and related components and imports. In addition, they step up their search for more efficient construction techniques. Prices are always nudging producers (supply) and consumers (demand) towards an equilibrium or balance.

Record lumber production in 1999 (65.4 bbf) brought prices down beginning in the second half of 1999. The previous record was in 1987 when North American mills produced 64.1 bbf. Last year, both major producing regions had record outputs: The U.S. South produced 16.8 bbf while Canada produced 28.9 bbf. Adding to the "oversupply," I-joists, LVL and glulam reached a record 5 bbf and equivalent to almost eight percent of softwood lumber production.

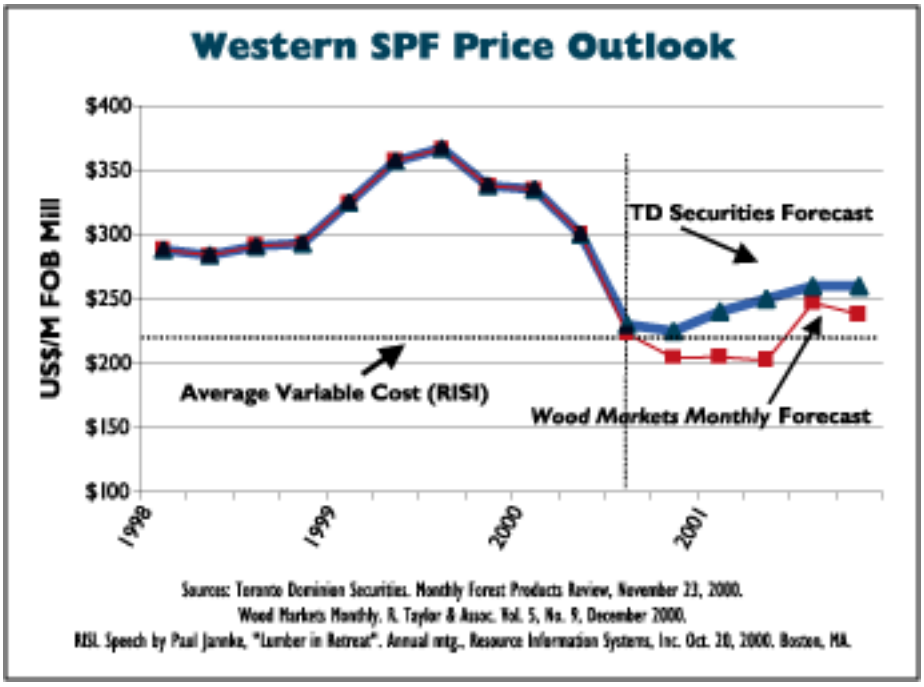

FIGURE 2
CLICK ON IMAGE FOR LARGER VIEW

Housing	1999	2000	2001	2002
Total Starts	1,675	1,598	1,524	1,564
Single Family (000)	1,340	1,262	1,212	1,240
Multi Family (000)	335	336	312	324
New Home Sales (000)	909	884	834	855
Existing Home Sales (000)	5,197	4,981	4,721	4,839
Interest Rates	**1999**	**2000**	**2001**	**2002**
Fixed rate	7.4%	8.1%	7.9%	7.8%
ARM	6.0%	7.1%	7.2%	7.1%
Prime	8.0%	9.2%	9.5%	9.3%

Source: NAHB. 2000. Housing and Interest Rate Forecast, Economics Department, Revised November 13, 2000. Washington, D.C.

Table 1. Housing and Interest Rate Forecast

TABLE 1
CLICK ON IMAGE FOR LARGER VIEW

2001 OUTLOOK

Demand Side: The consensus is that the FED will be successful in orchestrating a "soft landing" for the economy. Interest rate increases of 175 basis points (0.175%) from 1998 through 2000 are expected to slow the economy to a more sustainable rate of growth. The third quarter GDP of 2.4 percent is early evidence that the FED medicine is working and that the next FED move could lower interest rates beginning in 2001. The National Association of Homebuilders (NAHB) outlook reflects the "soft landing" scenario (see Table 1). The major risk with this outlook is the "soft landing" assumption. Some believe that a "hard landing" or recession is possible because the FED has already raised rates too high. Furthermore, higher energy prices are expected to strain consumer spending and divert potential housing expenditures to heating and fuel expenses.

Supply Side: The third quarter bellwether 2x4 KD Western SPF mill price of $223/M approached the industry-wide average variable cost (AVC) of approximately $221/M (RISI, 2000). Sooner or later, mills cut back on production (e.g. take downtime) when they are losing money. History tells us that price will remain near AVC until production falls enough to impact price. For example, when customers begin experiencing problems getting products, their bid prices rise. Toronto Dominion Securities and Wood Markets Monthly's (R. Taylor & Associates) latest lumber forecasts have Western SPF bottoming in late 2000, and then firming in 2001 as the demand/supply balance improves (see Figure 2). A moderately more optimistic forecast by CIBC World Markets (Dec. 2000) has Western SPF averaging $280/M in 2001. With today's low prices and extreme volatility, some analysts are suggesting that lumber markets may need more leadership, presumably from the larger, integrated producers. However, my feeling is that price volatility (in both directions) is the "nature of the beast." Also, I feel that we have viable options to manage exposure to price volatility—buying and selling via contracts and participating in the lumber futures market. Finally, it is clear that the use of I-joists, LVL, glulam and trusses can always be a consideration since price volatility is usually considerably less of an issue than it is with solid sawn lumber (*WOODWORDS*, June 2000). Remember that lumber is a commodity, and the key to lumber company profitability is managing all costs because you have little control over prices.

CONCLUDING THOUGHTS

One caveat to the above outlook is the outcome of the Softwood Lumber Agreement. Will it be renewed? If not, will something (e.g. countervailing duty) replace it? As I have said before (*WOODWORDS*, Jan/Feb 2000), supply restrictions tighten the market and drive prices higher. The converse is also true—expiration of the SLA on April 1, 2001 (and no CVD) could increase the flow of lumber to U.S. markets resulting in a weaker pricing environment.

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